



Nothing for the middle class

Why expanding the Earned Income Tax Credit won't provide the tax relief Illinois families need

The latest version of Senate Bill 397, as recently amended, is quickly working its way through the political channels in Springfield. Included in this bill is a proposal to expand the state's Earned Income Tax Credit to as high as 15 percent in 2013, up from its current rate of 5 percent of the federal earned income tax credit.

This proposal to expand the earned income tax credit is being billed as a benefit to the working poor in Illinois. But expanding the earned income tax credit does not necessarily provide the tax relief that struggling working and middle class families need. Rather, expanding this tax credit often discourages most people eligible for the tax credit from earning more money and advancing their careers.

Instead of expanding the earned income tax credit, Illinois would be better off using funds for the earned income tax credit to help all taxpayers; lawmakers could lower the personal income tax rate or implement a real increase in the personal exemption, beyond simply adjusting for inflation. Households with incomes below \$50,000 claim nearly half of all exemptions, so a higher personal exemption would especially benefit lower and middle-income class families.

The personal exemption offered in the current proposal provides little relief to the majority of taxpayers. Consider the following: Under the current proposal, a family of five earning the median household income of \$75,286 would save a mere \$12.50. By contrast, this same average Illinois family must pay an additional \$1,312 in higher personal income taxes thanks to the January income tax increase; the exemption offsets the January tax hike by barely one-tenth of a percent.

For most, EITC discourages work

To understand why expanding the earned income tax credit will not provide the tax relief Illinoisans need, this analysis examines what economists call the "marginal" impact of the earned income tax credit. Put simply: After reaching a certain level of annual pay, it is less advantageous for an individual to increase his income because every additional dollar earned will come with a higher price tag in the form of taxes. As such, this study calculates the "effective marginal tax rate" that people will face under the earned income tax credit for each additional dollar they earn. Because the Illinois earned income tax credit is an add-on to the federal earned income tax credit, the analysis first begins there.

GRAPHIC 1. PARAMETERS OF THE FEDERAL AND STATE EARNED INCOME TAX CREDIT IN 2011

Parameter	Federal				State (a)				Combined federal and state EITC effective marginal tax rate			
	Single		Married		EITC value (as a percent of federal) (b)							
	Income	EITC Value	Income	EITC Value	@ 5% (Current)	@ 7.5%	@ 10%	@ 15%	@ 5% (Current)	@ 7.5%	@ 10%	@ 15%
Phase-in	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	-42%	-43%	-44%	-46%
Beginning Plateau	\$12,750	\$5,112	\$12,750	\$5,112	\$256	\$383	\$511	\$767	0%	0%	0%	0%
Ending Plateau	\$16,700	\$5,112	\$21,800	\$5,112	\$256	\$383	\$511	\$767	0%	0%	0%	0%
Phase-Out	\$41,000	\$0	\$46,000	\$0	\$0	\$0	\$0	\$0	22%	23%	23%	24%

(a) As proposed by SB 397

(b) Future state EITC amounts are slightly understated because the Federal EITC amount is indexed for inflation

Source: Internal Revenue Service and Illinois Policy Institute

Graphic 1 shows the tax parameters in order for a person to qualify for the federal earned income tax credit in 2011. There are three distinct phases of the earned income tax credit based on the person's income: the phase-in, the plateau and the phase-out. If you make less than \$46,000 as a married couple, you can potentially earn the earned income tax credit.

Up to the phase-in income amount of \$12,750, earned income tax credit benefits accrue to the person at 40 cents for every dollar earned. If the person does not yet earn enough to pay income taxes, the person actually receives a check from the government in the amount of the earned income tax credit (technically called a "refundable" credit). A married person can qualify for a credit of up to \$5,112 when their combined income reaches \$12,750. As a result, earners in the phase-in range benefit from a negative 40 percent effective marginal tax rate. In other words, these workers have an added incentive to work since their tax rate is negative - they actually receive a check from the government for up to 40 percent of their earnings.

Under the proposal, a single person earning between \$12,750 and \$16,700 annually, and a married couple earning between \$12,750 and \$21,800 annually, would continue to qualify for the maximum earned income tax credit of \$5,112. As a result, in this "plateau" income range they would continue to face a 0 percent effective marginal tax rate since the credit amount would not change.

However, once this single person or married couple begin earning more money, they would lose 21 cents of earned income tax credit benefits for every dollar earned. For a married couple, the phase-out begins at \$21,800 in income and ends when they earn more than \$46,000. As a result, in the phase-out income range they are facing a 21 percent effective marginal tax rate.

Because taxpayers lose out on the earned income tax credit as their income increases, there is incentive for workers to keep their income under the "phase-out" level. Specifically, the only time during which the government rewards the worker for earning more money is when the worker's income is moving from zero to \$12,750. The federal earned income tax credit only encourages work effort in the phase-in income range where the effective marginal tax rate is negative 40 percent. The taxpayer is, at best, indifferent during the plateau stage where the effective marginal tax rate is 0 percent. During the phase-out state - \$41,000 for a single person and \$46,000 for a married couple - the taxpayer is actually penalized with an effective marginal tax rate of 21 percent. Since the income range of the phase-out (21,800 to \$46,000) is twice as large as the income range of the phase-in (\$0 to \$12,750), the federal earned income tax credit is spreading more work disincentive than incentives.

The state earned income tax credit, since it is an add-on to the federal earned income tax

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credit, only serves to exacerbate the work disincentives. The current state earned income tax credit is worth 5 percent of the federal earned income tax credit, which creates an effective marginal tax rate during the phase-out of 22 percent (versus 21 percent under the federal earned income tax credit alone). When the proposed state earned income tax credit worth 15 percent of the federal earned income tax credit takes effect in 2013, the effective marginal tax rate during the phase-out will increase to 24 percent. Expanding the state earned income tax credit will only serve to further discourage work.

Compounding the work disincentive related to the phase-out of the earned income tax credit are other federal, state and local taxes and other government welfare programs. These other factors increase the effective marginal tax rate faced by people in the earned income tax credit's phase-out income range. Other taxes add to the tax burden on each additional dollar earned while, at the same time, the money received from other government welfare programs begins to phase out at approximately the same income range that the earned income tax credit begins to phase out.

In fact, a more comprehensive effective marginal tax rate estimate found that the effective marginal tax rate can reach as high as 65 percent!¹ Faced with an effective marginal tax rate that high, many people will find themselves trapped by the earned income tax credit rather than helped by it. Expanding the state earned income tax credit will only dig the hole deeper for those people working desperately to better their economic situation.

Illinois would be better off using this money to lower the personal income tax rate or increase the exemption for all taxpayers, rather than expanding the deeply flawed earned income tax credit.

Endnotes

¹ For details see: Hall, Arthur P. and Moody, J. Scott, "Growth of the Earned Income Tax Credit," Tax Foundation, Special Report, No. 53, September 1995. <http://taxfoundation.org/files/7b76310a7234556cb06bdc66974385bb.pdf>

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Expanding the state earned income tax credit will only dig the hole deeper for those people working desperately to better their economic situation.