Iowa Fiscal Partnership

POLICY BRIEF

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Support for Working Iowa Families

Iowa's Earned Income Tax Credit: Expansion is in Order in 2012

By Charles Bruner

The 2012 legislative session offers lawmakers a timely opportunity to review and expand Iowa's Earned Income Tax Credit (EITC). The EITC is one of the tax credits subject to specific review by the legislative Tax Expenditure Study Committee, and the Iowa Department of Revenue is conducting a detailed analysis of the current EITC.

Three important reasons stand out for an expansion of the state EITC:

- Increasing the EITC would begin to address one of the biggest inequities in Iowa's tax code, the tax treatment of working families with children. By any measure, working families with children pay disproportionately more in state income taxes than either retired or childless taxpayers.
- Increasing the EITC would better reflect the ability to pay income taxes. Currently, working families with children begin paying state income taxes before they even earn enough to meet basic household needs.
- Increasing the EITC would increase the ability of low-income working families to purchase basic goods and services that contribute to local economic activity and therefore to economic recovery.

Iowa's EITC now reaches over 250,000 adults (14 percent of Iowa's 18-64 population) and over 260,000 children (37 percent of Iowa's 0-17 population). Increasing the EITC would provide needed help to this important part of Iowa's population and Iowa's future.

What is the EITC?

The federal Earned Income Tax Credit (EITC) was established in 1975 and expanded dramatically in 1986 through bipartisan efforts. A refundable tax credit, the EITC provides assistance to lower-income working people, with over 90 percent of the benefit going to working families with children. For tax year 2010, the maximum amount of the federal credit for persons without children was $457, with one qualifying child $3,050, with two qualifying children $5,036, and with three or more qualifying children $5,666.[5]

In 1989, Iowa became the third state in the country to adopt a state EITC, initially equal to 5 percent of the federal credit. In 1990, Iowa increased the credit to 6.5 percent, and in 2007 it increased the credit to 7 percent of the federal credit and made the credit refundable. Today, a majority of states with state income taxes have an EITC. Many states set their credit at a much larger percentage of the federal credit than Iowa.

The EITC has received strong bipartisan support at the national and state levels, both to encourage work and to fight poverty. Because of the federal Earned Income Tax Credit and child tax credit, families who earn $40,000 in income generally have no federal income tax liability; those earning below that amount receive refunds that help them meet basic family needs. The same is not true in Iowa, however. Even with its EITC, Iowa is one of few states that taxes many families with children before they reach a poverty-level income.

Reason One: Improving Equity in Iowa's Tax Treatment of Families with Children

The income tax is the one tax that is based upon a household's actual income and ability to pay. At the federal level, households are defined as married couple households, single households, or single heads of households. The federal income tax recognizes that households of different sizes have different needs and provides both personal exemptions for each household member (currently $3,250) and a child tax credit (up to $1,000 per child) to recognize the costs of maintaining a household. An important tax principle is behind these exemptions and credits: Income necessary to meet basic needs should not be subject to income tax. As a result, families with children pay less in federal income taxes than married couples without children or single individuals with similar levels of income.

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The same does not hold for Iowa's income tax, however. Iowa does not have a personal exemption. Further, Iowa's individual credit for dependents is only $40 per child, or 4 percent of the federal child credit.

The combination of a tiny dependent credit and the absence of a personal exemption results in families with children in Iowa paying a disproportionate share of their income in taxes. At higher income levels, some families with children actually pay more than families with no children at the same income level. Further, because Iowa exempts most Social Security income and some pension fund income from state taxation, retired Iowans owe substantially less than working Iowa families with children, even though their basic household expenses are lower.

With a small personal credit and no personal exemption, Iowa's personal income tax inadequately recognizes the cost of raising a family. In fact, Iowa's small personal credit and lack of personal exemption make its tax code one of the least family-friendly in the nation[1]. Ultimately, addressing these inequities for all families requires a comprehensive revision to Iowa's income tax that includes changes to such exemptions and credits. As a first major step in this direction, raising the state EITC will do a great deal to reducing this inequity for lower- and moderate-income families.

Reason Two: Addressing the Needs of Working Families with Children

All Iowans pay taxes, including sales taxes, property taxes, payroll taxes, gasoline taxes, and other use taxes. Lower-income Iowa families with children generally pay somewhat more in these taxes as a share of their incomes than families or individuals without children do, simply because their living expenses are greater.[2] As their incomes increase, Iowa families have more capacity to pay taxes. When their overall earnings are lower and in particular when they are below what it costs to meet basic needs, their individual income tax responsibility should be reduced.

Iowa families with children begin paying state income taxes at a very low level of income compared with other states, federal taxes, and their ability to meet basic needs.

Because of the small relative size of the EITC and the lack of recognition of the costs of raising a family, however, Iowa families with children begin paying state income taxes at a very low level of income. Iowa is one of the few states nationally where many working families begin paying state income taxes when their income is still below the federal poverty level (for a family of four, $22,350) and well before they earn enough to meet their basic living expenses. While a family of four making $30,000 does not owe federal income taxes (and actually receives a credit), that same family must pay over $700 in Iowa income taxes. At the same time, cost of living data shows that a family of four must earn $51,744 annually if both parents are working and require child care or $34,440 annually if one parent is able to stay home.[3] Raising the state EITC will help to ensure that families are not taxed on income needed to meet essential needs.

Reason Three: Contributing to Iowa Economic Recovery

There is broad consensus among economists that one of the most effective ways to increase economic activity in recovery from a recession is to ensure that people have resources to purchase basic goods in the local economy. Increasing unemployment compensation benefits and raising the Earned Income Tax Credit are two of the most cost-effective ways to increase this consumer demand, with far higher stimulative effects to the economy than other types of tax breaks and credits.[4] Raising Iowa's Earned Income Tax Credit is the most effective way that Iowa, through its tax code, can encourage more local economic activity.

Raising Iowa's Earned Income Tax Credit is the most effective way Iowa, through its tax code, can encourage more local economic activity needed for economic recovery.

Conclusion: 2012 is the Time to Help Working Iowa Families with Children and the Economy

In order to fully address the inequities in the tax treatment of families with children, Iowa lawmakers will need to incorporate personal exemptions into Iowa's individual income tax or raise the dependent tax credit within the state's individual income tax, or both. Doing so, however, requires major shifts in resources and should be part of an overall review and overhaul of Iowa's personal income tax.

Iowa can achieve substantial gains for many working families with children simply by increasing its Earned Income Tax Credit for working families with children. The Governor and the General Assembly can take advantage of the attention being given to the state Earned Income Tax Credit this session to raise it from its low, arbitrary level of 7 percent to one more appropriate to the relationship of federal and state taxes on Iowa's working families. As the Iowa state income tax is approximately 30 percent of the federal income tax, it makes sense to increase the standard for the state EITC to at least 20 percent and move toward 30 percent of the federal credit.

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[1] Phil Oliff and Nicholas Johnson, "*The Impact of State Income Taxes on Low-Income Families in 2010*," Center on Budget and Policy Priorities, November 15, 2011. <http://www.cbpp.org/cms/index.cfm?fa=view&id=3620>.

[2] Carl Davis, Kelly Davis, et al., "*Who Pays? A Distributional Analysis of Tax Systems in All 50 States*," Institute on Taxation and Economic Policy, November 2009. <http://www.itepnet.org/whopays3.pdf>.

[3] Andrew Cannon and Molly Fleming, "*The Cost of Living in Iowa*," Iowa Policy Project, January 2010. <http://www.iowapolicyproject.org/100405-COL-bgd.html>

[4] Hannah Shaw and Chad Stone, "*Zandi Analyses Show 'Democratic' Measures in Tax Cut-UI Deal Boost Economy, 'Republican' Measures Add to Deficit Risks*," Center on Budget and Policy Priorities, December 22, 2010. <http://www.cbpp.org/cms/index.cfm?fa=view&id=3349>

[5] More information about qualifying children may be found at http://www.irs.gov/individuals/article/0,,id=96466,00.html.

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