

The Earned Income Tax Credit: What Makes Sense for California?

In recent years, California and other states have either considered or developed their own earned income tax credit (EITC) plans to supplement the federal EITC. The federal EITC is designed to ensure that full-time, low-wage work will bring a family with children above the poverty line. As a refundable credit administered by the Internal Revenue Service, the federal EITC provides assistance to families even if they have no tax liability. Today, the federal EITC is the largest federal cash or near-cash assistance program, far outdistancing expenditures on Temporary Assistance for Needy Families (TANF) and Food Stamps.

A well-targeted state EITC can advance various policy goals by supporting low-income families and increasing their incentives to work. Designing such a plan is a challenge, however, especially if policymakers consider the ways the plan is likely to interact with other federal and state programs. For example, EITC families that collect Food Stamps and receive CalWORKs benefits may find that additional hours of work are virtually uncompensated. Recent California bills do not seem to consider those interactions. As with 15 of the 17 state programs that had been implemented as of April 2003, these bills have proposed a simple percentage “add-on” to federal EITC benefits. In *Evaluating State EITC Options for California*, Thomas MaCurdy lays out four distinct approaches to a state EITC and tests them against three criteria: their effects on work incentives, the distribution of benefits by family type, and cost. He concludes that if California wishes to implement its own EITC, it should not simply “add on” to the federal plan. Rather, it should design a program that considers a family’s hourly wages as well as its earnings.

Comparing the Options

For purposes of analysis, the report presents four basic program options:

- state EITCs that add on to the federal EITC program,

- those that apply tax credits to earnings in ways that differ from the federal schedule,
- those that consider both wage levels and earnings, and
- those that emulate a minimum wage for specific family types.

MaCurdy evaluates each option in two ways. First, he models existing California programs and evaluates how each proposed option, if adopted, would affect work incentives. He then predicts the distribution of benefits and the cost of each program. These predictions are based on simulations using U.S. Census data for a sample of California families in 1999.

Under the first two program options, income alone determines the benefits to families. As a result, the benefits paid to low-wage families working full-time are identical to those paid to families working half as much at twice the wage. MaCurdy notes that this option does little to improve work incentives and that CalWORKs and Food Stamps recipients would face serious disincentives to full-time work. Under the first option, qualified families would receive \$305 per year on average, and the program could cost more than \$730 million annually if all eligible families participated.

Under the second option, the state could target families with different earnings levels. If it targeted families close to the poverty threshold, it would encourage employed CalWORKs families to work the additional hours required to leave aid. At a maximum benefit of 15 percent, this option would cost 40 percent less than the add-on EITC. Fewer families would receive this maximum benefit under this option, and the average benefit would therefore drop to \$256 annually. A program targeting families at the lowest earnings levels would distribute comparable benefits and cost half as much as the add-on option.

Both the third and fourth options link EITC benefits to a family’s hourly wages as well as to its earnings. In doing so,

these options reduce the likelihood that families with relatively high hourly wages but low earnings will benefit from the state EITC. As a result, these two options better target poor working families and improve work incentives. The third option provides a share of the maximum EITC benefit based on the share of full-time work. Consequently, a family working full-time receives the full 15 percent supplement, but a family working half-time receives only half as much. This option costs just over three-quarters of the add-on EITC.

The fourth option pays the difference between a worker's market wage and a threshold wage, such as \$7.50 per hour, for up to 40 hours per week of work. This subsidy can be phased out beyond the equivalent of full-time work, or workers may be allowed to keep the maximum subsidy even if they work more than full-time. In effect, this option operates like a minimum-wage law that applies only to low-income families with children. As an anti-poverty policy, this approach is preferable to regular minimum-wage laws because it targets the relatively small portion of minimum-wage workers who belong to low-income families. Families

combining part-time work and welfare also benefit under this plan because the EITC does not reduce welfare benefits. This option costs somewhat more than the add-on EITC, but it improves incentives for additional work and provides more than four times the benefits to qualifying families.

Policy Implications

The findings indicate that if California wishes to implement its own EITC, it should not simply "add on" to the federal plan. Rather, it should design a program that considers a family's hourly wages as well as its earnings. This approach lacks the administrative simplicity of the add-on EITC, which most states have preferred until now. The biggest challenges to a wage-linked EITC are identifying hourly wages or hours of work, especially for families with multiple workers. These challenges may not be insurmountable, however, especially given the fact that average wages used to be reported under California's unemployment program. Moreover, by targeting low-wage families and encouraging additional hours of work, this approach better serves California's families and the state's income-support goals.

This research brief summarizes a report by Thomas MaCurdy, Evaluating State EITC Options for California (2004, 109 pp., \$12.00, ISBN 1-58213-068-X). The report may be ordered by phone at (800) 232-5343 [U.S. mainland] or (415) 291-4400 [Canada, Hawaii, overseas]. A copy of the full text is also available on the Internet (www.ppic.org). The Public Policy Institute of California is a private, nonprofit organization dedicated to independent, objective, nonpartisan research on economic, social, and political issues affecting California.
