

The New California Earned Income Tax Credit

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Overview

This past June, California became the 26th state to pass its own Earned Income Tax Credit (EITC). The new credit, worth as much as \$2,653 per year for families with low earned income, supplements the federal EITC. Families will start receiving the credit in 2016 on income they earned in 2015, and approximately 2 million residents are expected to benefit. The average qualifying household is expected to receive \$460 per year, for a total cost to California of \$380 million for tax year 2015.

The California EITC has a more limited reach than the federal credit – only about a fifth of Californians who receive the federal credit will qualify for the state credit. Nevertheless, the California EITC promises to make a significant dent in extreme poverty in the state. Research on the federal EITC and on other states' experiences suggests that it will both promote work among disadvantaged parents and bring important benefits for children in recipient families.

This issue brief examines how the new California EITC works, how it compares to the federal credit and how it affects both the well-being of working families and the labor market. The brief also looks at how the California credit will interact with the recent minimum wage expansions across the state, and lays out options for future changes.

What is the California Earned Income Tax credit?

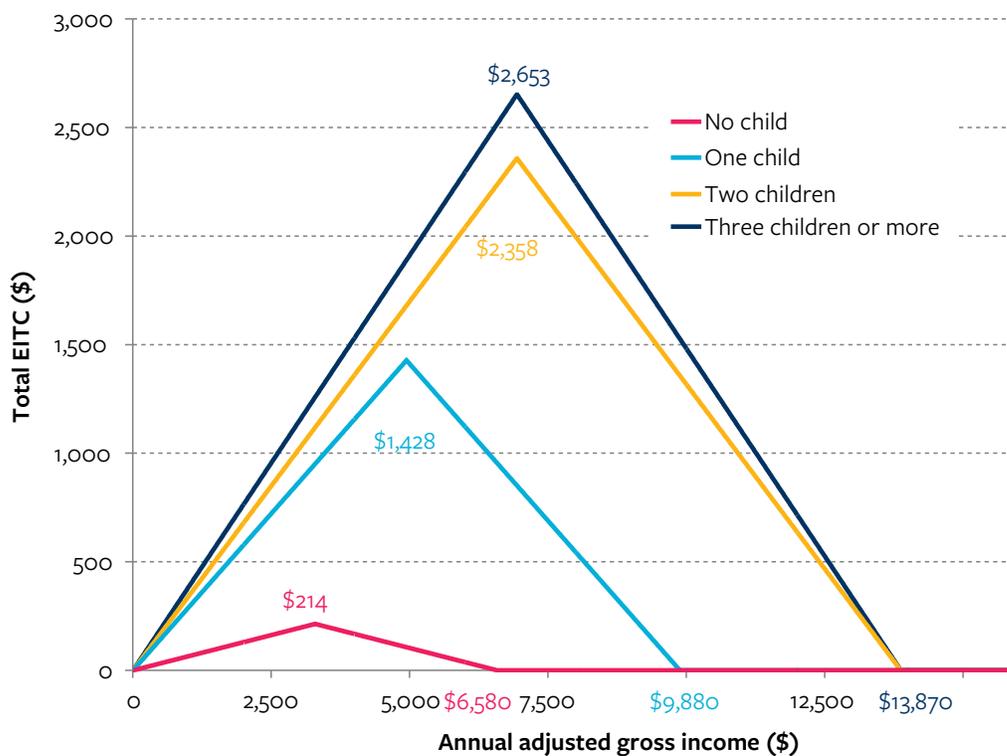
Eligibility and schedule

The Earned Income Tax Credit supports working families with low to moderate wages, supplementing their market incomes. It is designed to encourage work and thereby boost market incomes, while ensuring that families do not live in poverty. It takes the form of a refundable tax credit reducing the amount of tax a family owes or resulting in a refund to the family. Families without earned income are not eligible.

Many states have supplemented the federal EITC with their own credits. California's new EITC will benefit families with very low earnings. As with the federal EITC, families without earned income are ineligible. As illustrated in Figure 1, the generosity of the credit increases with a family's income up to a certain point, before decreasing until the credit is reduced to zero.

The maximum credit is \$214 for a family without children, \$1,428 with one child, \$2,358 with two children, and \$2,653 with three or more children. Relatively few families will qualify for these maximum credits; many families will receive smaller, but still meaningful amounts. No family with earnings above \$13,870 will qualify for the credit, and the threshold is even lower for families without children (\$6,580, see table 1).

FIGURE 1 The California EITC by family size and income, 2015



Source: Authors' calculations using Senate's bill No.38: http://www.leginfo.ca.gov/pub/15-16/bill/sen/sb_0001-0050/sb_38_bill_20150602_amended_sen_v96.htm, and <http://taxpolicycenter.org/taxfacts/>.

TABLE 1 California EITC income thresholds and maximum amounts by family size, 2015

	Maximum value	Earnings at which maximum credit is received	Highest earnings to receive
No child	\$214	\$3,290	\$6,580
One child	\$1,428	\$4,940	\$9,880
Two children	\$2,358	\$6,935	\$13,870
Three children or more	\$2,653	\$6,935	\$13,870

Sources: Authors' calculations using Senate's bill No.38: http://www.leginfo.ca.gov/pub/15-16/bill/sen/sb_0001-0050/sb_38_bill_20150602_amended_sen_v96.htm, and <http://taxpolicycenter.org/taxfacts/>.

Note: The amounts of the California EITC are the same for married couples filing jointly and for single filers.

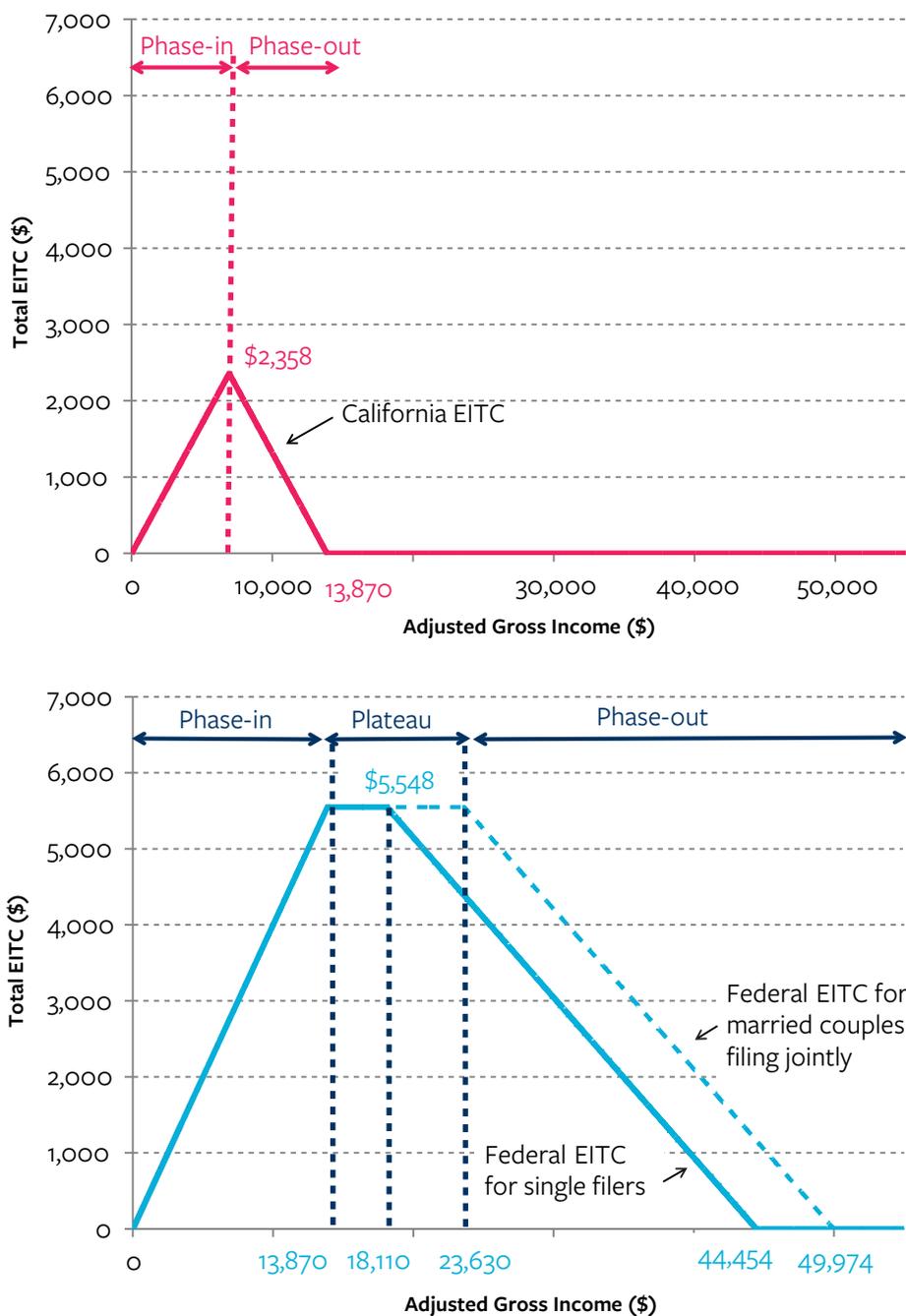
Relationship to the federal EITC

Families can receive both the California EITC (on their state tax returns) and the federal EITC (on their federal returns). The two programs have similar eligibility criteria, which depend on earned income and the number of children, though the income thresholds differ.¹

California is the 26th state to add a state-level credit. Most other states' credits are, like California's, small compared to the federal EITC. But the nature of the schedules differ: Where most other states provide a fixed percentage of the federal credit, the California EITC provides nothing to the higher-income of the federal EITC recipients, concentrating its payments on the families with the very lowest incomes. Figure 2 illustrates how the California schedule compares to the federal schedule for single filers with two children. There are several notable differences:

- The federal credit is more generous, with a maximum credit as high as \$6,242, and reaches much higher into the income distribution than the California credit.
- The federal credit schedule has a range of earned incomes, known as the “plateau,” over which the maximum credit is paid. In this range, additional earnings do not affect the amount of the credit. The California schedule has no such plateau range, and begins decreasing as soon as a person exceeds the earnings level needed to qualify for a maximum credit.
- Under the federal schedule, the plateau range is extended for married couples filing jointly, with a corresponding outward shift of the beginning and end of the phase-out range. The California schedule does not distinguish by marital status.

FIGURE 2 Value of the California and federal credits for a single filer with two children, 2015

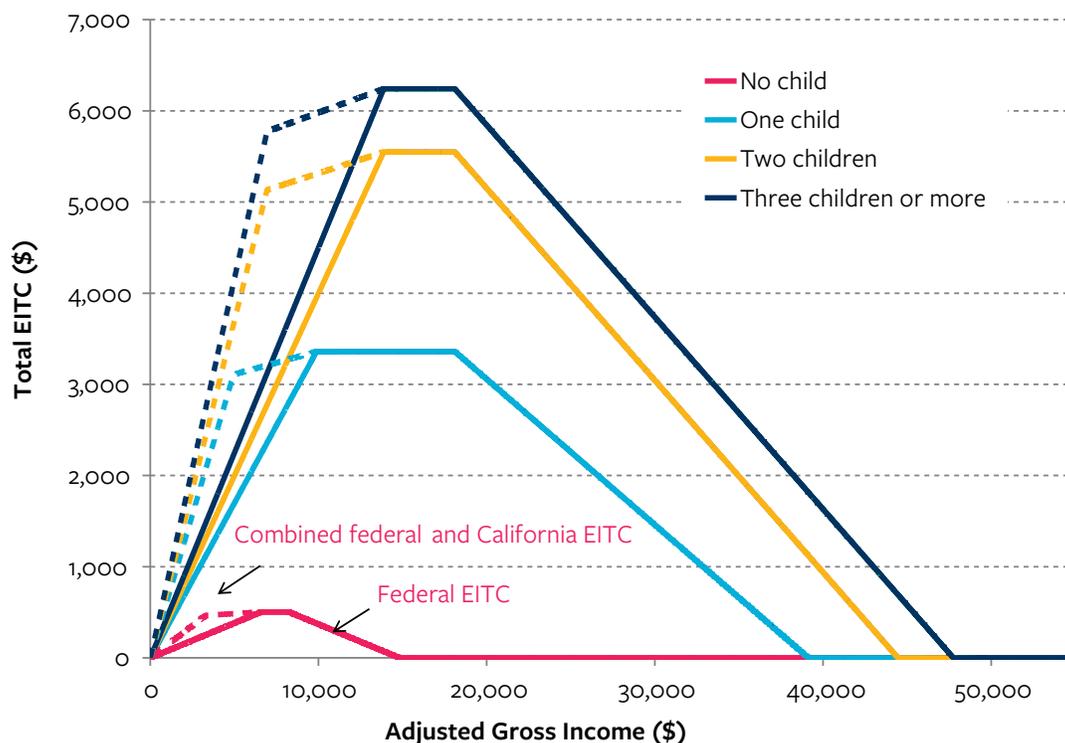


Source: Authors' calculations using Senate's bill No.38: http://www.leginfo.ca.gov/pub/15-16/bill/sen/sb_0001-0050/sb_38_bill_20150602_amended_sen_v96.htm, and <http://taxpolicycenter.org/taxfacts/>.

A final important difference is that self-employment income does not count toward the California credit calculation, although it counts towards the federal credit. This exclusion is discussed in more detail below.

Because families can receive both the federal and state credits simultaneously, the relevant schedule is the combination of the two. Figure 3 illustrates the effective credit schedules for single filers when the California and the federal credits are combined.²

FIGURE 3 Value of the combined California and federal EITC for single filers, 2015



Source: Authors' calculations using Senate's bill No.38: http://www.leginfo.ca.gov/pub/15-16/bill/sen/sb_0001-0050/sb_38_bill_20150602_amended_sen_v96.htm, and <http://taxpolicycenter.org/taxfacts/>.

Notes: Calculations assume that the EITC recipients have no unearned income and that all earnings are subject to wage withholding.

The federal credit differs slightly for married couples, with a somewhat larger "plateau" range (i.e. the range at which the credit is maximized). The value of the maximum credit is the same for single filers and married couples filing jointly.

Impacts of the EITC

Impacts on the well-being of low-income families

Researchers have examined the impact of the federal EITC and other states' EITC supplements on a variety of outcomes. The evidence shows that the credit is very successful at reducing poverty, benefiting recipient parents and children, and promoting work rather than welfare.³

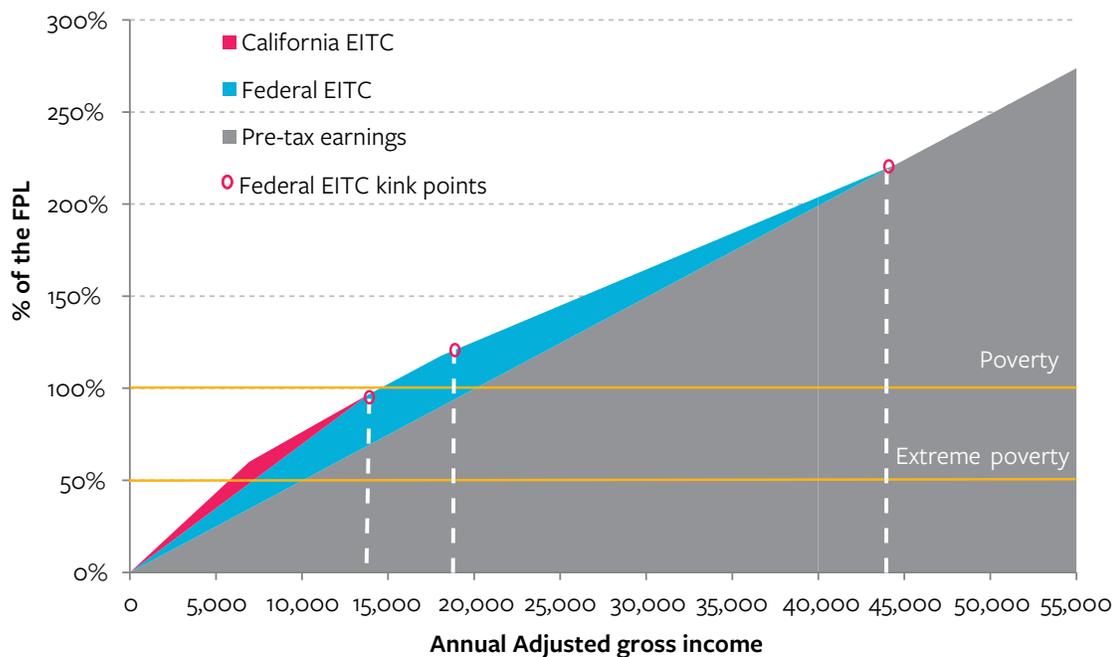
The Census Bureau estimates that the EITC, together with the similarly-structured child tax credit, reduced the U.S. supplemental poverty rate from 18.4% to 15.3% in 2014, lifting 9.8 million people including 5 million children- out of poverty.⁴

These calculations include only the direct effect of the credit, not impacts on family earnings. One recent study found that the effect on poverty is about 50% larger when one includes earnings from additional work.⁵ When the labor supply effects are counted, the federal EITC and the Child Tax Credit (a similar program that is less targeted at low-income families) are estimated to lift 10-15 million people out of poverty. One reason for the strong anti-poverty effects is that the federal EITC provides the largest transfers for families with incomes between 75% and 150% of the federal poverty line.⁶

The Census Bureau estimates that about 16.4% of Californians live in poverty (about 6.4 million people), a higher poverty rate than in the U.S. as a whole.⁷ The California EITC will help combat this. However, because the California EITC is targeted at very low income levels, it will do more to improve the living standards of those living in poverty than to raise families out of poverty altogether. Figure 4 shows that where the federal credit is maximized for families near the poverty line, the California credit is maximized at a lower level, corresponding roughly to the “extreme poverty” threshold of income equal to 50% of the federal poverty line. Families near the poverty line earn too much to be eligible for a substantial state EITC.

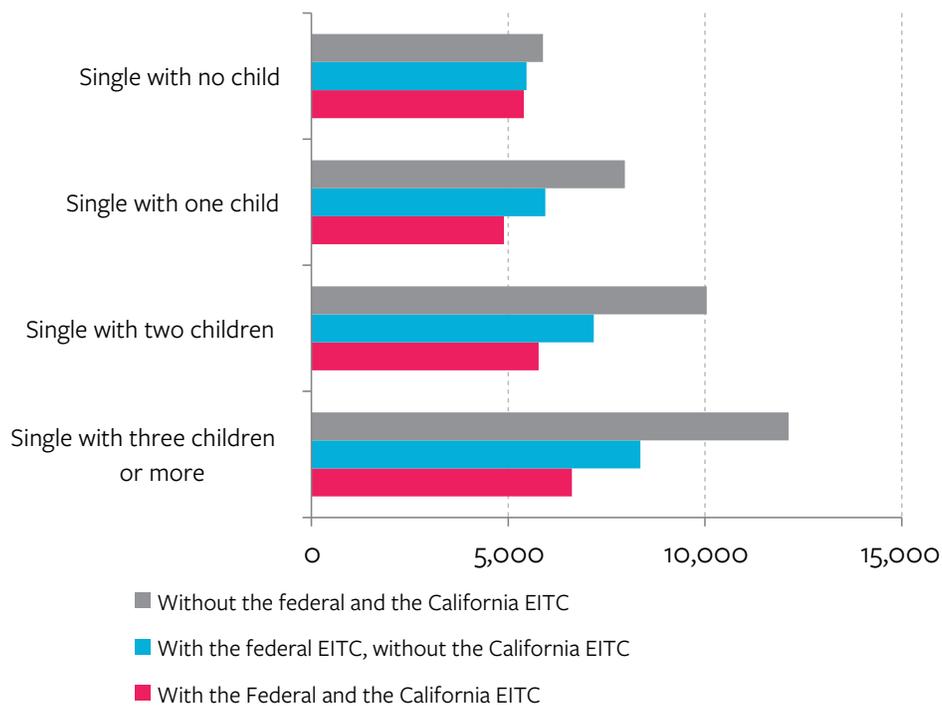
Figure 5 presents another way of looking at this: The extreme poverty threshold for a single person with two children is \$10,045 per year. With the addition of the federal credit, families with earnings above \$7,175 can reach this threshold; the combination of the federal and the California credit allows families with earnings as low as \$5,773 to reach the threshold.

FIGURE 4 Pre-tax earnings and the combined federal and California credits as a percentage of the federal poverty line (FPL), single filer with two children, 2015



Source: Authors' calculations using Senate's bill No.38: http://www.leginfo.ca.gov/pub/15-16/bill/sen/sb_0001-0050/sb_38_bill_20150602_amended_sen_v96.htm, and <http://taxpolicycenter.org/taxfacts/>.

FIGURE 5 Earnings needed to exceed 50% of the federal poverty line



Source: Authors' calculations using Senate's bill No.38: http://www.leginfo.ca.gov/pub/15-16/bill/sen/sb_0001-0050/sb_38_bill_20150602_amended_sen_v96.htm, and <http://taxpolicycenter.org/taxfacts/>.

Research also finds that the EITC improves family outcomes. One striking finding is that the EITC improves both the educational attainment (i.e. the amount of education obtained) and achievement (i.e. the performance of the student as measured by standardized tests) of children in families receiving the credit.⁸ A \$1,000 increase in family income due to the EITC raises children's combined math and reading test scores by about 6 percent of a standard deviation, with important implications for the children's long-run educational and economic success.⁹ There is every reason to expect similar benefits (albeit smaller, given the less generous credit schedule) from the California supplement.

Available evidence also indicates that higher income levels are associated with improved mental health and self-reported health status, though research regarding health impacts is less developed.¹⁰ Other research findings¹¹ indicate that the EITC reduces low birth weights by about 3.5-5.5% per \$500.

Impacts on the labor market

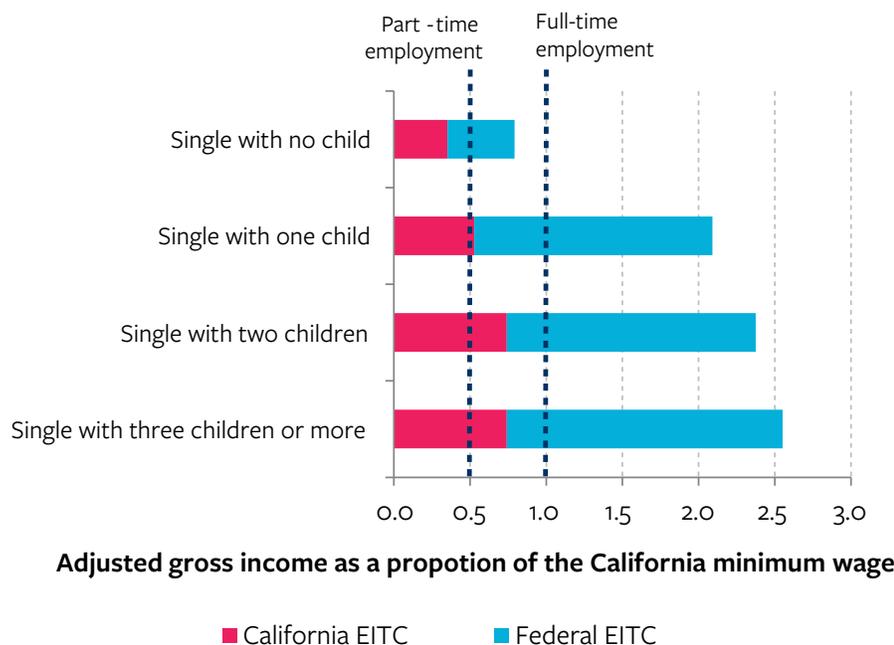
The EITC creates complex labor supply incentives — encouraging non-working single parents to enter the labor force, but also potentially creating incentives to reduce work hours among those who would work anyway, as well as incentives for the second earner in a family to exit the labor force. The evidence indicates, however, that the first effect – increased labor force participation among single parents – is much larger than the others, and that the EITC, on net, increases work substantially.¹² This is expected to be the main effect of the California EITC as well.

One concern regarding the design of the California credit is that it may encourage only part-time employment, as full-time workers, even at the minimum wage, will be well into the phase-out region and may even earn too much to be eligible. Figure 6 shows the cut-off points of the California and federal EITC as a proportion of earnings for a full-time worker earning the minimum wage. It indicates that, for example, a single minimum wage worker with two children would receive the California EITC only if she worked less than 74% of a full-time schedule. By contrast, a family would need 2.4 full-time minimum wage jobs to become ineligible for the federal EITC.

In theory, the EITC also creates incentives for some families to reduce their work – e.g., for full-time workers to cut back to part-time – in order to qualify for (or increase) their credits. But the evidence indicates that there has been little response of this type to the federal credit, and the low threshold of the California credit makes this even less likely.

There is some evidence that secondary earners – the lower-earning workers in two-worker families – have reduced their labor force participation in response to the federal EITC. This can happen because the credit schedule is based on family earnings; a family with one earner might qualify where the second worker’s earnings would take the family out of the eligibility range. This response – in any event smaller than the positive effect on single parents’ participation – will likely be particularly small for the California EITC, as any family with a primary earner making more than \$13,870 per year would already be ineligible for the credit.

FIGURE 6 California and federal EITC cut-off points as a proportion of full-time employment at the California minimum wage level



Source: Authors’ calculations using Senate’s bill No.38: http://www.leginfo.ca.gov/pub/15-16/bill/sen/sb_0001-0050/sb_38_bill_20150602_amended_sen_v96.htm, and <http://taxpolicycenter.org/taxfacts/>.

Note: Calculations are based on a California minimum wage is \$9 and full-time schedules of 40 hours per week, 50 weeks a year.

Policy looking forward

Interactions of the California EITC with the recent expansions in minimum wages at the state and local levels

The introduction of the California EITC comes at the same time as the state and its cities are implementing other policies to improve the well-being of low-income workers, most notably minimum wage increases. In 2016, the state minimum wage is scheduled to increase from \$9 to \$10. To date, ten cities, including San Francisco, Los Angeles, Oakland, and San Diego, have enacted their own, higher minimum wages. The minimum wage will be \$15 in San Francisco in 2018, for example, and \$15 in Los Angeles in 2020. Workers in these cities will qualify for the California EITC only if they work much less than full-time, full-year schedules.

The minimum wage and the earned income tax credit both support the incomes of low-income workers and their families, and are sometimes presented in the public policy debate³ as alternative tools to reduce poverty. But there are good reasons to see them as complements rather than substitutes, and to welcome the introduction of the two policies in tandem.

First, the EITC avoids some of the potential drawbacks of minimum wages: It is targeted at families with children, and it does not reduce the incentive for firms to hire. The latter is an important constraint on the minimum wage, as the hourly wage needed to lift families out of poverty might price workers out of the labor market.

Second, a strong minimum wage can make the EITC more effective. This is because, in the absence of a binding minimum wage, employers are able to capture a fraction of the EITC by reducing pre-tax wages, taking advantage of the extra labor supply created by the credit.¹⁴ This reduces the effectiveness of the EITC as an anti-poverty policy. When the minimum wage is binding, by contrast, the full amount of the EITC stays with the worker.

The California credit may also be seen as a tool to smooth intra-California differences in after-tax incomes and living standards. Many localities in high-wage areas are increasing their minimum wages. This will raise families' earnings, even as it reduces eligibility for the state EITC. It will also expand wage disparities between these localities and other parts of California. The state EITC, which will flow disproportionately to low-wage areas, will help to offset this, reducing the heterogeneity in living standards between high-wage and low-wage areas.

Options for future changes to the California EITC

The California EITC is brand new. As this issue brief indicates above, the federal credit has been enormously successful, and California's initial entry will likely benefit many low-wage working families in the state. But the state credit must be re-authorized each year, and its structure may be revisited in the coming years.

Should the state decide to expand the state EITC, there are two broad ways to do so:

- Increase the generosity of the credit, with the current targeting. The current California EITC phase-in rate (i.e. the rate at which the credit increases with families' income, before the maximum credit is reached) is at 85% of the federal rate. This percentage is

called the “adjustment factor” and must be specified in the state budget bill each year. A smaller adjustment factor would decrease the generosity of the California EITC while a greater adjustment factor would increase this generosity, with the largest changes for families whose earnings currently qualify them for the maximum state credit.

- Lengthen the credit schedule, allowing higher-income families to receive the credit, without increasing the maximum credit.

The first option, i.e. to increase the generosity of the credit with the current targeting, would encourage even more labor force participation among very low-income families and part-time workers. It would also target the state’s scarce dollars at the families in greatest need. The second option, by contrast, could lift a greater number of families out of poverty, and might be more effective at encouraging substantial labor force attachment. But it would not be as closely targeted at the lowest-income families.

Besides those two options, the state legislature may consider extending the credit to self-employed income. The exclusion of this income raises equity concerns, as two people with similar earnings will receive very different credits based on whether the earnings are classified as wages or as self-employment income.

The exclusion of self-employment income from the California credit calculation is apparently motivated by a desire to limit non-compliance. Self-employed individuals with very low earnings can obtain higher post-tax incomes by overstating their earnings, and thereby increasing their federal EITC, and the evidence suggests that many do: Misreporting of self-employment income is one of the biggest sources of noncompliance with the federal EITC.

However, the net effect of the California EITC exclusion is unclear. Including self-employment income in the California calculation would increase the incentive to overstate self-employment income up to the point where the California credit is maximized, but would reduce the existing incentive to overstate it beyond that point, with a net effect that could be positive or negative.

Conclusion

California is now the 26th state to implement a state Earned Income Tax Credit as an add-on to the federal EITC. The design of the California credit is quite different from those used in other states, with much closer targeting to the lowest-income families.

The research is clear that the federal EITC is a highly effective anti-poverty program, with large beneficial effects on recipients’ labor force participation and on their children’s educational outcomes. There is every reason to believe that the California credit will bring substantial benefits to its recipients and to the state.

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- Short, Kathleen. 2015. “The Supplemental Poverty Measure: 2014.” U.S. Census Bureau, Current population reports.

Endnotes

¹ See on California eligibility rules: <https://www.ftb.ca.gov/individuals/faq/net/900.shtml>, and for the federal EITC: <http://www.irs.gov/Credits-&-Deductions/Individuals/Earned-Income-Tax-Credit>. See: <http://www.irs.gov/Credits-&-Deductions/Individuals/Earned-Income-Tax-Credit/Qualifying-Child-Rules> for more information on the qualifying children.

² See also the California Budget & Policy Center online tool: <http://calbudgetcenter.org/blog/new-interactive-tool-shows-how-much-californians-will-benefit-from-the-state-eitc/>.

³ See reviews by Nichols and Rothstein (2015), Hoynes and Patel (2015), and Hotz and Scholz (2003).

⁴ These figures are based on the supplemental poverty measure, released by the Census Bureau since 2010. The official poverty measure does not take account of tax refunds, but the supplemental measure does. See Short (2015) for details on the calculation of the reduction in poverty due to the EITC and for details on the definition of the supplemental poverty measure.

⁵ Hoynes and Patel (2015) estimate that the effect of the federal EITC on poverty is 50% larger when the labor supply effects are counted rather than taking a static estimate. This estimation has been made on single women with children and education below college, a group among which the positive labor effects are concentrated. The poverty reduction may be smaller for other groups of people (e.g. married couples).

⁶ Hoynes and Patel (2015).

⁷ See Census Bureau: <http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?src=bkmk>, percent of persons living below poverty rate (2009-2013)⁸ See section 5.3.4 in Nichols and Rothstein (2015).

⁹ Dahl and Lochner (2012).

¹⁰ See Evans, Garthwaite (2014).

¹¹ See Hoynes et al. (2013).

¹² Eissa and Liebman (1996), Meyer (2002), and Meyer and Rosenbaum (2001).

¹³ See <http://www.nytimes.com/2014/01/05/business/help-the-working-poor-but-share-the-burden.html>

¹⁴ See Rothstein (2010).

¹⁵ See Saez (2010).

Further Reading

The following IRLE working papers provide overviews of the research on the EITC:

- > Nichols, A., and Rothstein, J. (2015), “The Earned Income Tax Credit”, *IRLE Working Paper No. 113-15*. <http://irle.berkeley.edu/workingpapers/113-15.pdf>
- > Hoynes, Hilary, and Jesse Rothstein. Forthcoming. “Tax policy toward low-income families.” *IRLE Working Paper*.

In addition, IRLE affiliates have done a great deal of basic research regarding the EITC. See, for example:

- > Chetty, Raj, Friedman, John N., and Jonah E. Rockoff. 2011. “New Evidence on the Long-Term Impacts of Tax Credits.” Washington D.C.: U.S. Internal Revenue Service.
- > Hoynes, Hilary, Miller, Doug, and David Simon. 2015. “Income the Earned Income Tax Credit and Infant Health.” *American Economic Journal: Economic Policy* 7(1): 172-211.
- > Hoynes, Hilary and Ankur Patel. 2015. “Effective Policy for Reducing Inequality? The Earned Income Tax Credit and the Distribution of Income.” *Goldman School of Public Policy Working Paper*.
- > Lee, David and Emmanuel Saez. 2012. “Optimal Minimum Wage Policy in Competitive Labor Markets.” *Journal of Public Economics* 96: 739-749.
- > Rothstein, Jesse. 2010. “Is the EITC as good as the NIT? Conditional Cash Transfers and Tax Incidence.” *American Economic Journal: Economic Policy* 2:1, 177-208.
- > Saez, Emmanuel. 2010. “Do Taxpayers Bunch at Kink Points?” *American Economic Journal: Economic Policy* 2 (3):180-212.



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