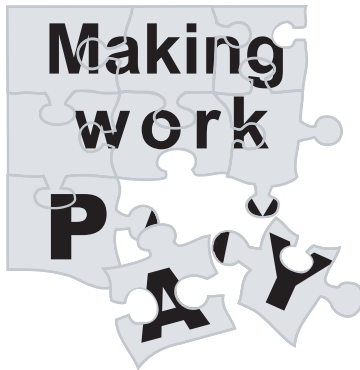


NEXT PIECE OF THE PUZZLE

After Minimum Wage, Iowa Looks at Earned Income Tax Credit



Looking over the scattered pieces of the puzzle of how to help low-income working families in Iowa, the General Assembly and Governor this year agreed to increase the minimum wage. The wage will rise from \$5.15 to \$6.20 on April 1, and to \$7.25 on Jan. 1, 2008.



With the new minimum wage set to take effect, lawmakers are considering the next piece of the puzzle in making work pay for low-income Iowans: an expanded state Earned Income Tax Credit (EITC).

Like a higher wage, the EITC is an effective tool to encourage work because the credit increases with earnings until it reaches the maximum credit (\$4,536

for a family with two children in 2006). Unlike the minimum wage, the amount of the maximum credit is adjusted for inflation each year.



IOWANS AFFECTED BY THE EITC

In 2004, about 13 percent of the state's nearly 1.3 million households filing an income tax return claimed either the federal EITC or both the federal and state credits. Thirteen percent is a sizable share of the population, but it far understates the impact of the EITC in Iowa. Many of those households include working parents with children – thus, far more than 13 percent of the Iowa population benefited from the EITC.¹

HOW THE EARNED INCOME TAX CREDIT WORKS

The federal EITC is a federal tax credit for many working people with earned income of less than \$38,348. The amount of the credit depends on a tax filer's earned income, whether the tax filer is single or married, and whether the tax filer has children. Iowa's current EITC is 6.5 percent of the federal EITC.

WHAT IS A 'REFUNDABLE' CREDIT?

The federal EITC is refundable. This means if the amount of the federal EITC is greater than the amount of federal income tax owed, the tax filer receives a payment from the federal government for the difference. Iowa also has an EITC. Unlike the federal EITC Iowa's EITC is not refundable. Some of the proposals in the Iowa Statehouse would make the Iowa EITC a refundable credit.

However, those numbers could change markedly if Iowa were to expand its credit and make it refundable, reaching many households with workers who don't make enough to pay income tax, or enough tax to receive the full credit.

Currently, a working Iowa family of four making \$30,000 a year receives a refundable EITC of \$1,524 from the federal government – but owes \$1,303 in state income tax.

The Iowa Policy Project

318 2nd Ave. N
Mount Vernon, IA 52314
(319) 338-0773 • www.iowapolicyproject.org

Child & Family Policy Center

1021 Fleming Building • 218 Sixth Ave.
Des Moines, IA 50309
(515) 280-9027 • www.cfpciowa.org

COMPARING IOWA WITH OTHER STATES

Iowa is one of 20 states and the District of Columbia that offer the EITC. Nebraska became the 20th state in the last year. Most places make the EITC a percentage of the federal credit.² While one of the first states to adopt the EITC, Iowa is now one of the least generous:

- Iowa is one of only four of those states that does not offer a refundable credit.
- Iowa's credit of 6.5 percent is among the lowest; only five are lower.
- Nine states offer a credit of 20 percent to 35 percent, with a 10th state scheduled to go 20 percent.
- Among Iowa's neighbors, Illinois has a refundable 5 percent credit, Minnesota has a refundable credit averaging 33 percent of the federal credit, Nebraska has an 8 percent refundable credit, and Wisconsin a credit ranging from 4 percent to 43 percent depending on the number of children.

TOO POOR TO PAY FEDERAL TAX – BUT NOT IOWA TAX

In Iowa, a working family of four begins paying state income taxes when family income reaches \$18,338, which is less than the poverty level. At the federal level, a family of four needs to reach \$41,870 – about two times the poverty level – before the family is liable for federal tax.

WHAT IS BEING DISCUSSED FOR IOWA?

Many ideas are on the table. Among them:

- Governor Culver has proposed increasing the state EITC from 6.5 percent to 10 percent. It would not be refundable. Projected cost: \$4.4 million.
- Another idea being considered in the Senate would increase the state EITC to 9 percent and make it refundable for taxpayers with dependents. Projected cost: \$14.8 million.
- HF531 would raise the EITC to 15 percent and keep it nonrefundable. Projected cost: \$9.6 million.
- HF293 would keep the EITC at 6.5 percent but make it refundable. Projected cost: \$8.7 million.
- The Iowa Department of Revenue has estimated that 89,652 Iowa households making less than \$40,000 a year would benefit from a nonrefundable state EITC set at 30 percent of the federal. Far more – 163,962 – would benefit from a refundable EITC at about 10.6 percent, and the benefits would accrue more heavily among low-income households. Both ideas would cost about \$20 million.

As with any expansion or creation of a tax credit, policy makers should consider how to make up the costs, either in new revenue from another source, or service cuts.

OTHER POTENTIAL PIECES OF THE PUZZLE

Making work pay has many public policy angles. Among other approaches to protect household finances of low-income working families:

- Iowa could provide more consumer protections for working families against having a large portion of their EITC refund swallowed up by predatory lending practices. So-called “refund anticipation loans,” or RALs, promise immediate payment of refunds but can come with exorbitant fees and interest rates. In one recent year, about 23 percent of households that received an EITC lost some of it by using a refund anticipation loan.
- Iowa could strive to increase Volunteer Income Tax Assistance (VITA) sites, and promote use of the EITC while reducing costs of compliance for filers.

¹ Iowa Department of Revenue and Finance.

² Center on Budget and Policy Priorities, New Jersey Policy Perspective.