

## Updating and Improving Iowa's Earned Income Tax Credit

September 2006  
Poverty Policy Brief #5



*Carlos and Angelica Garcia are raising two children but struggling to stay ahead. Carlos works full-time, making \$18,000 per year as a counselor for delinquent youth, while Angelica works three-quarter time as a nurse's aid making \$12,000. Because they make \$30,000, Carlos and Angelica are not eligible for most government assistance programs (food stamps, housing and home energy assistance, child care subsidy support). At the same time, their two-bedroom, \$650 apartment takes more than one-third their monthly income and they often pinch pennies to make sure they can pay all their bills. When they completed their income taxes, they knew they were going to receive a refund from the federal government, because of the earned income tax credit (EITC). What they didn't expect was that much of what they got from the federal government they were going to give right back to the state. When they completed their taxes, they received an EITC of \$1,524 from the federal government, but had to turn around and pay \$1,303 to the state of Iowa for state income taxes.*

In 1975, Congress enacted the federal EITC to help working low-income families. With expansions in the program since that time, the EITC has become the country's largest anti-poverty program – helping millions of working families with children out of poverty and toward self-sufficiency. Depending upon earnings and the number of children, the federal EITC provides up to \$4,400 to low-income working families in the form of a refundable tax credit, over and above any federal tax liability they might have. For Carlos and Angelica, the federal EITC in effect increases their family income by \$1,524 to help meet basic family needs.

In 1985, Iowa was one of the first states in the country to adopt a state EITC, but – unlike the federal EITC – Iowa's EITC program has not expanded significantly since that time (nor is it refundable). As a

consequence, tens of thousands of Iowa families like the Garcia's, who owe no federal taxes and even receive a federal tax credit, owe and pay taxes to the state. This defeats part of the purpose behind the federal EITC, in lifting families out of poverty and toward self-sufficiency.

Tax experts generally agree that the income tax should consider the costs of raising children within its overall structure, exempting from taxable income a reasonable amount for each family member to recognize such costs. The federal income tax does this through a personal exemption, a child tax credit, and a refundable additional child tax credit, but Iowa's income tax only provides for a small credit (\$40 per dependent) that falls far short of recognizing these costs.

As a result, Iowa's individual income tax places a particularly heavy burden on low- and moderate-income working families with children, precisely the families that the EITC is designed to help. Rather than helping to make work pay for low-wage workers, Iowa's income tax system works in the opposite direction.

Specific policy proposals needed to address these issues are to:

- **Increase Iowa's EITC from 6.5% to 30% of the federal EITC and make it refundable.**
- **Establish a personal exemption and standard deduction equivalent to the federal exemptions and deductions for Iowa taxpayers.**

The impact on Carlos and Angelica of only increasing Iowa's EITC to 30% of the federal EITC would be to reduce their \$1,303 Iowa income tax liability to \$945. The result of these two proposals taken together eliminates their taxes owed and instead provides a refund of \$457.

In addition to improving Iowa's EITC, the state also can work to ensure that working families eligible for the federal and state EITCs can file for these credits and receive

prompt refunds without excessive charges. One of the predatory financial practices that working families can face is in receiving "refund anticipation loans" RALs from tax preparers who prepare their taxes. By promising immediate refunds, tax preparers can take \$500 or more in fees, at exorbitant interest rates. This hurts not only the family eligible for the tax credit, but takes money out of the community.

Last year, the Iowa General Assembly provided funding for some demonstration Volunteer Income Tax Assistance (VITA) sites to increase claiming of the EITC credit and reduce costs to those receiving the credit. Increasing the use of VITA sites can produce economic benefits to working families, their communities, and the state. In tax year 2003, 3.5% of Iowa taxfilers made use of VITA sites, but some states with strong programs have increased that to nearly 9.3% of all taxfilers.

A specific policy proposal needed to address this issue is to:

- **Expand Iowa's demonstration program supporting volunteer income tax assistance (VITA) sites to additional parts of the state.**

### 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 \$37,263. The amount of the credit depends on a taxfiler's earned income, whether the taxfiler is single or married, and whether or not the taxfiler has children. 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 taxfiler receives a payment from the federal Government for the difference.

Iowa also has an EITC. Currently Iowa's EITC is 6.5% of the federal EITC. Unlike the federal EITC Iowa's EITC is not refundable.