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Steep "Cliff" Means Many Working Poor Lose Tax Credit

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ONE STEP FORWARD, TWO STEPS BACK

The way things work in New Jersey, when a low-income household makes a little more money it can turn into a very costly proposition.

Case in point: If a married couple with two or more children and getting the state Earned Income Tax Credit sees its taxable income go to \$21,000 from \$19,000, it actually nets only \$586 more—not \$2,000. Here's why. At \$21,000 the household crossed two thresholds. It is no longer eligible for the state EITC, for a \$769 loss; and it reaches the level where it owes state income tax—for this family, \$224.

Contrast that with what happens when a high-income household sees its prospects improve by the same \$2,000. A household where income rose to \$502,000 from \$500,000 had an added state income tax bill of just \$179.

This dramatic disparity occurs because, of all the states that have EITCs, only New Jersey cuts off eligibility at \$20,000 in yearly income. The other 18 states and the District of Columbia use the same eligibility rules as the federal Earned Income Tax Credit program: depending on family size and income, the amount of benefits decreases gradually; even at \$38,222 a two-adult, two-child family was eligible for at least some EITC benefits in 2006.

WHAT'S AN EITC?

Essentially, an EITC is a credit against income tax. The aim is to help low-income, working Americans climb the economic ladder to self-sufficiency. Only households where someone has a job qualify for the EITC. The federal Earned Income Tax Credit was created in 1975 and has been broadened several times, with strong bipartisan support. President Reagan said of the EITC, "Giving a leg up to those struggling to move up is what America is all about."¹ A major impact of the credit is to lessen the burden of payroll taxes for Social Security and Medicare that fall disproportionately hard on lower income workers. Most EITC dollars go to working people who are raising children, reflecting the substantial extent to which

child-rearing adds to the cost of living. Preliminary figures from the Internal Revenue Service show that 22.2 million households received federal EITC benefits in 2005, including nearly 500,000 in New Jersey.

What makes the federal EITC especially effective in fighting poverty is that the credit is refundable. Most families qualifying for the federal EITC make too little to owe federal income tax. If the amount of EITC they are eligible for exceeds their income tax obligation, they receive a check—a refund—for the difference. According to one study, “this lump sum check can constitute 20-40 percent of the filer’s total income for those who receive the maximum benefit.”²

Because it reduces the burden of income taxes, provides refunds for some people and is available only to jobholders, the EITC has been described as public policy that makes work pay. At the lowest income levels, the federal credit increases with every extra dollar a worker earns. When income reaches the federal poverty line, the credit flattens. Then it gradually decreases as income begins to rise above the federal poverty standard—as opposed to cutting off abruptly. The gradual decrease reduces the likelihood of a situation where someone with a somewhat higher gross income than another person sees the difference reduced because of the impact of paying taxes after an abrupt eligibility cutoff.

The way the federal EITC is structured, in 2006, a married worker with one qualifying child could make up to \$33,888 and still receive a credit. But it would be far lower than the maximum credit of \$2,747 for a married worker with one child making between \$8,500 and \$16,500. Similarly, a married worker with no qualifying children could make up to \$14,080 and still receive a credit, but to get the maximum \$412 the worker could not make more than \$8,500. Qualifying children are those under 19 (under 24 if full time students) or disabled and who live for more than half the year with a parent, grandparent, aunt, uncle or older sibling who is claiming the EITC benefit.

FEDERAL EARNED INCOME TAX CREDIT BENEFITS

Tax Year	Credit Percentage	Maximum Benefit	Phase-out Rate	Phase-out Range	
				(Single/head of household)	(Married filing jointly)
Families with two or more children:					
2005	40% of first \$11,000	\$4,400	21.06%	\$14,370 to \$35,263	\$16,370 to \$37,263
2006	40% of first \$11,300	\$4,520	21.06%	\$14,760 to \$36,222	\$16,760 to \$38,222
Families with one child:					
2005	34% of first \$7,830	\$2,663	15.98%	\$14,370 to \$31,030	\$16,370 to \$33,030
2006	34% of first \$8,050	\$2,737	15.98%	\$14,760 to \$31,888	\$16,760 to \$33,888
Families with no qualifying children:					
2005	7.65% of first \$5,220	\$399	7.65%	\$6,530 to \$11,750	\$8,530 to \$13,750
2006	7.65% of first \$5,370	\$411	7.65%	\$6,710 to \$12,080	\$8,710 to \$14,080

Source: Internal Revenue Service, Center on Budget and Policy Priorities

As opposed to government programs criticized by some as having the effect of discouraging work because earning more would bring an immediate loss of benefits, the federal EITC concept is widely

praised for rewarding the effort to get out of poverty and providing assistance in the transition to a stable work arrangement. Several studies show that the federal EITC more than any other factor contributed to an increase in workforce participation among single mothers since the late 1990s.³

STATE EITCs

Rhode Island established the first state Earned Income Tax Credit in 1986. New Jersey's began in 2000.

Like the federal EITC after which they are modeled, the state programs are only for residents who have jobs. And because state sales taxes and local property taxes take a larger percentage of a low-income household's income than that of the wealthy, state EITCs help offset those regressive levies. Generally, states set their EITC benefits as a percentage of what the federal program offers. Most, like the federal EITC, are refundable.

Most states include workers without qualifying children though, as with the federal EITC, benefit levels are far below what families can receive.

EITCs, STATE BY STATE

State	Percentage of Federal Credit (Tax Year 2006 Except as Noted)	Refundable	Workers Without Qualifying Children Eligible?
Delaware	20%	No	Yes
District of Columbia	35%	Yes	Yes
Indiana ^a	6%	Yes	Yes
Illinois	5%	Yes	Yes
Iowa	6.5%	No	Yes
Kansas	15%	Yes	Yes
Maine	5%	No	Yes
Maryland ^b	20%	Yes	No
Massachusetts	15%	Yes	Yes
Michigan	10% (effective in 2008; to 20% in 2009)	Yes	Yes
Minnesota ^c	Average 33%	Yes	Yes
Nebraska	8%	Yes	Yes
New Jersey ^d	20%	Yes	No
New York ^{e, f}	30%	Yes	Yes
Oklahoma	5%	Yes	Yes
Oregon	5% (to 6% in 2008)	Yes	Yes
Rhode Island	25%	Partially ^g	Yes
Vermont	32%	Yes	Yes
Virginia	20%	No	Yes
Wisconsin	4% - one child 14% - two children 43% - three children	4% - one child 14% - two children 43% - three children	No

Notes: From 1999 to 2001, Colorado offered a 10% refundable EITC. Program was suspended in 2002 due to lack of funds and again in 2005. Under current law, EITC projected to resume in 2010.

a Scheduled to expire in 2011.

b Maryland also offers a non-refundable EITC set at 50% of federal credit. Taxpayers in effect may claim either the refundable credit or the non-refundable credit.

c Minnesota's credit for families with children, unlike the other credits shown in this table, is not expressly structured as a percentage of the federal credit. Depending on income level, the credit for families with children may range from 25% to 45% of federal credit; taxpayers without children may receive 25% credit.

d New Jersey credit available only to families with incomes below \$20,000.

e New York credit would be reduced automatically to 1999 level of 20% should federal government reduce New York's share of the TANF block grant.

f Beginning in 2006, New York also allows certain non-custodial parents who make child support payments to claim an EITC that is the greater of 20% of federal EITC that they would be eligible for with one qualifying child as custodial parent or 250% of federal EITC for taxpayers without qualifying children.

g Rhode Island made a small portion of its EITC refundable effective in 2003. In 2006, the refundable portion was increased from 10% to 15% of the nonrefundable credit (i.e. 3.75% of the federal EITC).

Source: Center on Budget and Policy Priorities

NEW JERSEY'S "CLIFF" AND OTHER PROBLEMS

The law creating New Jersey's EITC called for it to provide a benefit at 10 percent of the federal EITC in 2000, rising in stages to 20 percent in 2003, where it remains today. This puts New Jersey around the middle, relative to what other states offer. And, New Jersey's EITC is refundable.

But in other crucial aspects of the Earned Income Tax Credit, New Jersey has since day one lagged behind the rest of the nation. Efforts on the part of advocates for low-income New Jerseyans and among some legislators have failed to fix these problems.

Most significant is New Jersey's "falling off the cliff" situation, so named because of the state EITC's abrupt removal of any benefits when a family crosses the \$20,000 threshold.

Columbia University's National Center for Children in Poverty cited the economic dangers of sharp cliffs. "As low-wage workers increase their earnings above the federal poverty level, their families begin to lose eligibility for government work supports. Given that some of these benefits drop off quickly, earning more does not always improve a family's financial bottom line. Parents can work and earn more without their families moving closer to financial security."⁴

The federal EITC and those of other states don't just have higher eligibility levels than New Jersey's. They also raise those levels each year to reflect the higher cost of living. New Jersey's EITC doesn't do this. So, the fact that New Jersey's \$20,000 limit has been unchanged since the program started in 2000 is doubly detrimental to low-income households' attempts to become self-sufficient.

And, New Jersey also is one of only three states not to offer any benefits to working poor adults who have no qualifying children. The others are Maryland and Wisconsin.

In sum, New Jersey's Earned Income Tax Credit falls far short of offering the leg up available to those in other states through EITCs. And the magnitude of the difference is intensified by the reality of trying to live in New Jersey on low income. This state has a cost of living one-third above the national average. And housing costs rank fourth in the U.S., according to a 2006 report released by the National Low Income Housing Coalition.

As shown below, the number of people in New Jersey and across the nation receiving federal EITC benefits over the past three years has risen. But fewer New Jerseyans are getting their state's EITC. And

New Jersey's state's EITC eligibility rules make it easy to surmise why: many households have seen income rise to a point still low enough to qualify for federal EITC benefits, but surpassing New Jersey's \$20,000 state EITC cutoff threshold. Indeed, fewer than half of those in New Jersey who got federal EITC benefits also got the state EITC.

In fact, only a little over two percent of New Jersey's population gets the state EITC—the lowest percentage of any state that has an EITC.

EITC RECIPIENTS IN NEW JERSEY

Year	Federal EITC	NJ State EITC	Federal but not NJ EITC	US Total
2003	463,748	223,279	240,469	20.8 million
2004	471,190	212,469	258,721	22.4 million
2005	485,819*	203,440	282,379	22.2 million*

Source: IRS, New Jersey Treasury

* Preliminary unpublished IRS data from the Center on Budget and Policy Priorities

Most of the 282,379 who got the federal EITC in 2005 but not New Jersey's were disqualified from the latter because their income exceeded \$20,000.

The number of federal EITC recipients in New Jersey earning above \$20,000 has been increasing in recent years, according to the Center on Budget and Policy Priorities. This is due to two factors: the yearly increase in EITC income eligibility for inflation and a 2001 federal law that allowed more married filers near poverty to receive the maximum credit and expanded the top income eligibility level for married filers. In 2003 and 2004, 32 percent of New Jersey households getting the federal EITC made more than \$20,000, slightly above the national average of 30 percent.

Provided by the Center on Budget and Policy Priorities, the two examples below illustrate how the cliff effect plays out, based on 2005 eligibility levels and tax rates.

Married Couple with Two Children

A family making \$19,000 would be eligible for both the federal and state EITCs. This family would owe no state or federal income tax. Because the EITCs at both levels are refundable, the family would receive \$3,846 from the federal government and another \$769 from the state—for a combined EITC benefit of \$4,615 and a total income of \$23,615.

Compare that family to a married two-child family that grossed \$21,000. This family would get a \$3,425 benefit from the federal EITC, but nothing from the state. The family would have to pay \$224 in state income taxes. So, this family's net income would be \$24,401—just \$586 more than the first family.

If New Jersey's EITC matched the federal income eligibility standards, this second family would get a \$685 state EITC; their income tax liability would be wiped out and they would get a \$461 EITC refund in their pockets.

Single Parent with One Child

One family makes \$19,000 and the other \$21,000. The first family owes \$530 in federal income taxes but gets back \$1,922 from the federal EITC. It pays no state income tax and gets back \$384 from the state EITC. So the net combined state and federal EITC is \$2,306.

The second family owes \$730 in federal income tax but gets back \$1,603 from the federal EITC. This family gets no state EITC and pays state income taxes of \$259.

If New Jersey's EITC matched the federal standards, then this family would get a \$321 state EITC, the family's income tax liability would be wiped out and it would get a \$62 EITC refund.

In both cases, the absence of a state Earned Income Tax Credit made a significant difference. Of course, with any program like an Earned Income Tax Credit there must be some level at which a family no longer is eligible for benefits. But the federal EITC takes steps to minimize this problem by gradually phasing out benefits, up to a reasonable level of income. Instead of gradually phasing out as a family approaches self-sufficiency, New Jersey's EITC abruptly cuts off the family that still is highly vulnerable just as it tries to gain financial footing.

Not everyone who gets the federal EITC but not the state EITC is a victim of New Jersey's highly restrictive eligibility limits. Some might indeed be eligible for the state program but because it has different requirements might not have realized they were entitled to its benefits. So a corollary of the cliff problem is that having two EITC programs—federal and state—with separate standards for determining who can participate is that some measure of confusion can result in eligible New Jerseyans not getting state EITC benefits.

In 2005, New Jersey's EITC cost the state \$113.5 million and it provided an average benefit of \$558, according to the state Treasurer's Office.

Legislation has been introduced to address some aspects of New Jersey's EITC deficiencies. A-1261/S-750, sponsored by Assemblyman Louis Manzo and Sen. Shirley Turner, would make everyone in New Jersey who is eligible for the federal credit (those making over \$20,000 and workers without qualifying children) also eligible for the state EITC. A-1697, with Manzo and Assembly Members Douglas Fisher and Nilsa Cruz-Perez as primary sponsors and 25 other legislators as cosponsors, would immediately include workers without qualifying children in New Jersey's EITC and would phase in the federal EITC income eligibility standards through Jan. 1, 2009. Neither bill would increase the state EITC as a percentage of the federal benefit. No committee hearings have been held on these measures.

MAKING THINGS RIGHT

When New Jersey's EITC took effect in 2000, the economy was stronger than it is today and the state budget was in much better shape. Since then, an ongoing state budget crisis has made life especially hard for the working poor. Aid to schools and municipalities has not kept up with needs, contributing to increased local property taxes. Meanwhile, costs of such necessities as housing, utilities and gasoline have gone up.

Those who qualify for the state Earned Income Tax Credit need it more than ever. And those who do not qualify, even as they struggle to support their families, face the prospect of falling ever farther behind.

- New Jersey should end "the cliff" by raising state EITC income eligibility standards to match the federal program.

For New Jersey households, there is no magic in crossing the \$20,000 income threshold. That's only \$40 above the federal poverty line for a family of four, and the federal poverty line itself is widely recognized as being much lower than what it really takes to make it on one's own. At \$20,000, poverty still presses in on the ability to raise a family and become self-sufficient. Self-sufficiency does not mean

luxury; the term is used to describe households that do not need government assistance programs. In fact, the actual amount a family of four needs to bring in yearly to be self-sufficient in New Jersey ranges from \$41,350 in Atlantic County to \$61,446 in Hunterdon, according to research done for Legal Services of New Jersey for 2005.⁵

The additional cost of eliminating the cliff would be \$44 million in Fiscal Year 2007, \$45 million in 2008 and \$46 million in 2009.

But more than this needs to be done.

- Low-income workers without qualifying children should receive the state EITC.

Rewarding work is important for everyone, but current policy fails to take into account that some people without children might be trying to save money to start a family. Making this change also would mean New Jersey's EITC eligibility rules completely match the federal EITC—further reducing chances of confusion.

- New Jersey's EITC benefit should be increased to at least 25 percent of the federal EITC.

Appropriate to its high cost of living, New Jersey's EITC would become one of the nation's most generous. Given the difference between the federal poverty line and the income needed in New Jersey to be self-sufficient, implementing a realistic standard is critical.

Adopting these recommendations would provide state EITC benefits to about 250,000 more New Jersey households. The figures below show how much a state EITC that made these changes would cost.

COST OF EXPANDED NEW JERSEY EITC

Level	Fiscal Year 2007	FY 2008	FY 2009
25% of Federal EITC	\$198.5 million	\$200.5 million	\$201.5 million
30% of Federal EITC	\$238.5 million	\$242.5 million	\$244.5 million

Source: Center on Budget and Policy Priorities and New Jersey Treasury

* Uses as current spending level 2005 figure of \$113.5 million; 2006 data not yet available.

Nothing is likely to be done that could retroactively help the working poor in New Jersey who missed out on EITC benefits over the past six years. But it is not too late to correct past mistakes by changing the state EITC going forward. This would be a productive use of state resources, and an investment in the future of thousands of men, women and children.

¹ Reagan, Ronald. "Remarks on Tax Reform to Concerned Citizens." Washington, DC. May 29, 1985.

² *An EITC for New Jersey's Working Families*. Association for Children of New Jersey. December 1999.

³ Nagle, Ami and Nicholas Johnson. *A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2006*. Center on Budget and Policy Priorities. March 2006.

⁴ Cauthen, Nancy. *When Work Doesn't Pay: What Every Policymaker Should Know*. National Center for Children in Poverty. Mailman School of Public Health. Columbia University. 2002.

⁵ Pearce, Diana. *The Real Cost of Living in 2005: The Self-Sufficiency Standard for New Jersey*. Prepared for Legal Services of New Jersey Poverty Research Institute. June 2005.

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