

**Simple, Effective, & Necessary:  
Adopting an Earned Income Tax Credit in Pennsylvania**

**A Public Policy Proposal of the Wharton Politics & Business Association  
Released July 1, 2008**

## **Executive Summary**

The poverty rate has increased over the past few decades to 12.1% for all Pennsylvanians and 16.5% for Pennsylvania children. Meanwhile, the state offers one of the 10 most regressive tax systems in the nation. But a solution exists.

Since 1975, the Earned Income Tax Credit has been the nation's most successful anti-poverty program, receiving praise from across the political spectrum. Each year, it lifts millions of working families out of poverty—and it does this not through welfare handouts but by incentivizing work.

In light of this success, a majority of states with income taxes have adopted their own version of this federal tax credit. The Pennsylvania House of Representatives recently passed such a bill, but it was overloaded with tax cuts that would cost the state \$3.8 billion in lost revenue and cut spending for vital services. The Wharton Politics & Business Association recommends a new direction: The Senate should introduce an unadulterated EITC bill at 15% of the federal EITC with the support of Governor Edward G. Rendell and greater media involvement.

## Context and Importance of the Problem

### *Problem Synopsis: Poverty in Pennsylvania*

In 1979, the poverty rate in Pennsylvania stood at 10.5%. Today, that number has jumped to 12.1% (even higher for children at 16.5%).<sup>1</sup> Around the same time, the American Community Survey reported that real median household income had declined 5.1 % since the last census in 2000. Another study ranked the state among the Top 10 hardest-hit states with the most people in severe poverty.<sup>2</sup> The tax system is partly to blame. The Institute on Taxation & Economic Policy ranks Pennsylvania as one of the 10 most regressive state and local tax systems in the nation.<sup>3</sup>

### *Current Policy: Federal Earned Income Tax Credit*

The federal Earned Income Tax Credit (EITC) is a refundable tax credit that supplements the income of working families with qualifying children. Working citizens and couples without children can receive a smaller EITC.

The federal EITC was created in 1975 by a bill sponsored by Sen. Russell Long (D-LA). A credit of up to \$400 for low-income workers with children, it served two purposes: (1) providing a guaranteed minimum income for working Americans and (2) stimulating the economy. Three years later, Congress made it a permanent part of the tax code.

The federal EITC was expanded in 1986 tax reform, 1990 deficit reduction, and finally 1993 when it was doubled (and the credit for very low-income workers without children was included). Today, it is one of America's largest, most successful anti-poverty tools.

The federal EITC is divided into three income ranges, as shown in Figure 1. The first range, called the "phase-in," increases the credit linearly up to the maximum benefit. The second range, called the "plateau," pays the maximum benefit until a certain level. The third range, called the "phase-out," decreases the credit linearly up to the income eligibility ceiling.

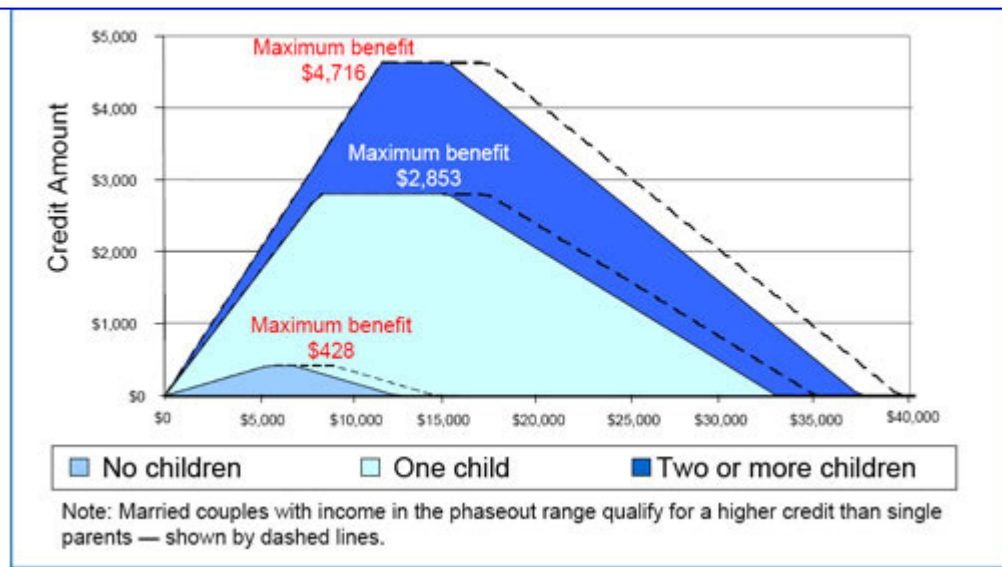
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<sup>1</sup> Wood, Michael, and Sharon Ward. 2008. "A Hand Up: An Earned Income Credit Will Help Working Families." Pennsylvania Budget and Policy Center.

<sup>2</sup> 2007. "Poverty in Western Pa.: Poverty, Hunger Growing Problem." *WTAE-TV*.

<sup>3</sup> Wood, et al.

**FIGURE 1: Federal EITC, 2007**



What makes the federal EITC so successful is its refundability. For each taxpayer, the credit is calculated independent of income tax. Then, the EITC is subtracted from income taxes owed. If the EITC is greater than the income tax liability, the remaining credit is returned as a tax refund. In fact, if the citizen's tax liability is zero, s/he receives the entire EITC as a refund payment.

***Proposed Policy: State Earned Income Tax Credit***

State EITCs are much simpler than the federal EITC because they are merely equal to a fixed percentage (they currently range from 3.5% to 35%) of their federal credit. Although most state EITCs are refundable, a few are nonrefundable; however, the nonrefundable credits are much less successful and less desirable, given that states can use Temporary Assistance for Needy Families funds to pay the refundable portion.

With the addition of North Carolina, Louisiana, and New Mexico in 2007 and Michigan in late 2006, a majority of states with income taxes (including the District of Columbia) now have state EITCs (23 of 42). They are listed in Figure 2.

<sup>4</sup> Levitis, Jason, and Jeremy Koulisch. 2007. "A Majority of States with Income Taxes Have Enacted State Earned Income Tax Credits." Center on Budget and Policy Priorities.

**FIGURE 2:  
STATE EARNED INCOME TAX CREDITS BASED ON THE FEDERAL EITC<sup>5</sup>**

<b>State</b>	<b>Percentage of Federal Credit (Tax Year 2007 Except as Noted)</b>	<b>Refundable?</b>	<b>Workers Without Qualifying Children Eligible?</b>
Delaware	20%	No	Yes
District of Columbia	35%	Yes	Yes
Indiana	6%	Yes	Yes
Illinois	5%	Yes	Yes
Iowa	7%	Yes	Yes
Kansas	17%	Yes	Yes
Louisiana	3.5% (effective in 2008)	Yes	Yes
Maine	5%	No	Yes
Maryland	20%	Yes	No
Massachusetts	15%	Yes	Yes
Michigan	10% (effective in 2008; to 20% in 2009)	Yes	Yes
Minnesota	Average 33%	Yes	Yes
Nebraska	8% (to 10% in 2008)	Yes	Yes
New Jersey	20% (to 22.5% in 2008, 25% in 2009)	Yes	Yes
New Mexico	8%	Yes	Yes
New York	30%	Yes	Yes
North Carolina	3.5% (effective in 2008)	Yes	Yes
Oklahoma	5%	Yes	Yes
Oregon	5% (to 6% in 2008)	Yes	Yes
Rhode Island	25%	Partially <sup>g</sup>	Yes
Vermont	32%	Yes	Yes
Virginia	20%	No	Yes
Wisconsin	4% — one child 14% — two children 43% — three children	Yes	No

<sup>5</sup> Levitis, et al.

## Critique of Proposed Policy

### *Poverty*

The EITC is unequivocally one of the most effective anti-poverty programs.

- In 2003, the EITC lifted 4.4 million people out of poverty.
- The EITC reduced the poverty rate by 1.5 percentage points between 1995 and 1999.
- Today, the EITC lifts more children out of poverty than any other government program.

Without the EITC:

- The poverty rate among children would be 25% higher.
- The poverty gap for families with children would have been 20% higher in 1999.
- Low-income families would suffer 15% more severe cost burdens.

The data indicates, though, that EITCs must be refundable to register such a track record. For instance, the National Center for Children in Poverty found that *refundable* state credits narrowed the overall gap between income and the poverty line for children under age 18 in families with at least one working parent by 1.4 to 9 percent. State *nonrefundable* credits, by contrast, provided virtually no benefit to working poor families.<sup>6</sup>

The Pennsylvania Budget and Policy Center illustrates how a state EITC would bring working families out of poverty: “A single parent working 40 hours per week, 52 weeks per year, earning the new Pennsylvania minimum wage of \$7.15 an hour, would earn \$13,734 after subtracting Social Security taxes. Despite full-time work, the family’s gross earnings would be only 87% of the federal poverty level of \$17,170 for a family of three. At that wage level, and assuming no other income, the federal [EITC] contributes an additional \$4,520 to the household. Adding a 30% state [EITC] adds \$1,356 more, bringing the family to an income of \$19,610 and across the poverty threshold to 114% of poverty.”<sup>7</sup>

### *Work*

The EITC incentivizes greater participation in the workforce among lower-skilled workers. It especially increases employment among single mothers. Specifically, the EITC and other tax reform accounted for more than 60 percent of the increase in single mothers’ employment between 1984 and 1996. Between 1993 and 1999, it contributed another 34 percent to this increase. Because of its three-tiered structure, the EITC positively incentivizes work intensity in the phase-in range, negatively incentivizes work intensity in the phase-out range, and has no net effect in the plateau.<sup>8</sup>

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<sup>6</sup> Holt, Steve. 2006. “The Earned Income Tax Credit at Age 30: What We Know.” Metropolitan Policy Program, The Brookings Institution.

<sup>7</sup> Wood, et al.

<sup>8</sup> Holt.

### ***Macroeconomic Effects***

The EITC does not only affect low-income households but positively impacts entire communities as these households spend their money. One study estimated that each additional dollar received generates an additional \$1.58 in local economic activity and one additional permanent job is created for each \$37,000 claimed. Likewise, the city of Baltimore increased local income and property tax revenues by almost \$600,000 through the spending effects of the EITC alone.<sup>9</sup>

### ***Cost***

Any state EITC can be estimated using (1) the preliminary unpublished Internal Revenue Service data on the total value of federal EITC claims filed by residents of each state and (2) the Office of Management and Budget's projections of the cost of the federal EITC in future years (published in the President's Budget).

According to the Center on Budget and Policy Priorities, the formula has three steps:

1. Estimate the total value of federal EITC claims in a given state for a future fiscal year by calculating the share of the federal EITC attributable to the state in the base year and applying that share to the expected total cost of the federal EITC in a future year.
2. Multiply the state's expected federal EITC claims by the percentage at which the state credit is to be set.
3. Adjust the estimate for the fact that not all federal EITC claimants will claim the state credit.

Accordingly, the CBPP calculated each step for the Commonwealth of Pennsylvania as follows<sup>10</sup>:

1. Amount of Federal EITC Claims, TY 2006 = \$1,414,000,000  
Percent of Total U.S. EITC Claims, TY 2006 = 3.26%  
Estimated Cost of Federal EITC in FY 2009 = \$1,516,000,000
2. Participation rate = 90% of federal participation
3. Estimated Cost of State EITC in FY 2009
  - Set at 5% of Federal Credit = \$68,000,000
  - Set at 10% of Federal Credit = \$136,000,000
  - Set at 20% of Federal Credit = \$273,000,000

### ***What the Experts Say***

The EITC is one of the few government programs that receive broad bipartisan support, especially from the world's top economists. Janet Holtzblatt, the Treasury's leading expert on the EITC, writes:

“Several recent studies have found that the EITC encourages work, as well as alleviates poverty. Comparing the effects of time limits, the EITC, and other policy changes on welfare participation, labor supply, and income, Grogger (2003) concludes that the EITC may be the “single most important” policy parameter for explaining recent declines in

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<sup>9</sup> Holt.

<sup>10</sup> Koulisch, Jeremy, and Jason Levitis. 2008. “How Much Would a State Earned Income Tax Credit Cost in 2009?” Center on Budget and Policy Priorities.

welfare and increases in work and earnings among female-headed families. Meyer and Rosenbaum (2001) found that more than 60 percent of a nine percentage point increase in the employment of single mothers between 1984 and 1986 was due to expansions of the EITC. Dickert, Houser, and Scholz (1995) estimated that expansions of the EITC between 1993 and 1996 would induce more than half a million families to move from welfare to work. Eissa and Liebman (1996) find that the EITC expansion in the Tax Reform Act of 1996 significantly increases labor force participation among single mothers, especially less educated women.”<sup>11</sup>

Conservative Harvard economist Robert J. Barro concurs:

“There exists a serious program in the form of the earned income tax credit that actually helps the working poor in a way that promotes work and discourages welfare. The EITC was originally a Republican idea — started by the Ford administration in 1975 and expanded by the Reagan administration during the glorious 1980s and the Bush administration in 1990... Mr. Clinton's support is not sufficient reason to regard the program as mistaken. In fact, it has a well conceived structure that ought to be retained and perhaps expanded...”<sup>12</sup>

Even Nobel laureates line up in hearty support. Gary S. Becker gave his explicit approval in a 1996 *Business Week* article when he wrote that the EITC “rewards rather than penalizes poor families with working members... Empirical studies confirm the prediction of economic theory that the EITC increases the labor force participation and employment of people with low wages because they need to work in order to receive this credit.”<sup>13</sup> Likewise, Milton Friedman gave his implicit approval years ago when he encouraged the government to adopt a negative income tax. Cornell economist Robert H. Frank observes, “One of the few American welfare programs widely adopted in other countries, the earned-income tax credit has proved far more efficient than conventional programs, just as Mr. Friedman predicted.”<sup>14</sup>

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<sup>11</sup> Greenstein, Robert. 2005. “The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor.” Center on Budget and Policy Priorities.

<sup>12</sup> Greenstein.

<sup>13</sup> Greenstein.

<sup>14</sup> Frank, Robert H. 2006. “The Other Milton Friedman: A Conservative with a Social Welfare Program.” *The New York Times*.

## Policy Recommendations

The Wharton Politics & Business Association recommends the General Assembly of Pennsylvania adopt an Earned Income Tax Credit for its state income taxes.

### *Recent Legislative History*

On February 13, 2007, a state EITC was introduced as H.B. 377 in the Pennsylvania House of Representatives by D. Evans, Bennington, Buxton, Caltagirone, Curry, Freeman, Galloway, Levdansky, Markosek, Myers, Parker, Preston, Walko, and Wheatley. It proposed to amend the act of March 4, 1971 (P.L.6, No.2), known as the Tax Reform Code of 1971, by adding a section to read:

*Section 304.1. Alternative Special Tax Provision for Poverty.*

*(a) Pursuant to section 2(b)(ii) of Article VIII of the Constitution of the Commonwealth of Pennsylvania, which provides for establishing as a class or classes of subjects of taxation the property or privileges of persons who, because of poverty, are determined to be in need of special tax provisions, the General Assembly hereby declares its intent and purpose to exercise its power pursuant to that section by enacting the alternative tax provisions of this section.*

*(b) Having determined that there are certain persons in this Commonwealth whose incomes are such that imposition of an income tax would deprive them and their dependents of bare necessities of life, and having determined that poverty is a relative concept inextricably joined with actual income and the number of people dependent upon such income, the General Assembly deems it to be a matter of public policy to provide special tax provisions for that class of persons to relieve their economic burden.*

*(c) For taxable years beginning after December 31, 2006, an individual having one or more dependents may, in lieu of utilizing the special tax provisions for poverty in section 304, claim a refund in the amount by which thirty per cent of the earned income credit allowable under section 32 of the Internal Revenue Code of 1986 (Public Law 99-514, 26 U.S.C. § 32), as amended, exceeds the tax imposed under this Article for the taxable year.*

After negotiations in the Finance and Appropriations Committees, Part (C) was replaced with the following text:

*(c) For taxable years THE TAXABLE YEAR beginning after December 31, 2007, an individual having one or more dependents may, in lieu of utilizing the special tax provisions for poverty in section 304, claim a refund equal to thirty FIFTEEN per cent of the earned income credit allowable under section 32 of the Internal Revenue Code of 1986 (Public Law 99-514, 26 U.S.C. §20 32), as amended.*

*(D) FOR TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 2008, AN INDIVIDUAL HAVING ONE OR MORE DEPENDENTS MAY, IN LIEU OF UTILIZING*

*THE SPECIAL TAX PROVISIONS FOR POVERTY IN SECTION 304, CLAIM A REFUND EQUAL TO THIRTY PER CENT OF THE EARNED INCOME CREDIT ALLOWABLE UNDER SECTION 32 OF THE INTERNAL REVENUE CODE OF 1986, AS AMENDED.*

When H.B. 377 finally reached the House floor, it included amendments “further providing for imposition, providing an alternative special tax provision for poverty; further providing for requirement of withholding tax; in corporate net income tax, further providing for definitions and for imposition; in capital stock-franchise tax, further providing for definitions and reports; in gross receipts tax, further providing for imposition; in research and development tax credits, further providing for carryover, carryback, refund and assignment of credit, for time limitations, for limitation on credits and for termination; providing for a small business health savings account tax credit and for a new diesel technology tax credit; in inheritance tax, further providing for imposition, for inheritance tax rates and for estate tax; and making a related repeal.”

The amended bill passed the House unanimously and now sits in the Senate Finance Committee.

***Political Analysis***

In its history thus far, House Bill 377 has received little media attention and floor debate, one notable exception being an editorial in *The Philadelphia Inquirer* on January 1, 2008 by Jean Hunt (Executive Director of Philadelphia’s Campaign for Working Families) endorsing the unadulterated EITC version.<sup>15</sup> Three weeks later, *The Philadelphia Daily News* lamented the Christmas-tree final version with the title “EITC Lost in Tax Slash Stunt?” and the words “Harrisburg has a chance to help the poor...guess it was too good to be true.” On June 7, 2008, *The Inquirer* ran an editorial calling for upgrades to the federal EITC, adding “...Gov. Rendell has said Pennsylvania needs an EITC.”<sup>16</sup> Unfortunately, the Republicans weighed down H.B. 377 with so many amendments that it was destined to die in the Senate. A new campaign with the vocal support of Governor Rendell and more media involvement has great promise to succeed before the end of 2008.

***Fiscal Impact***

The fiscal note prepared by the House Appropriations Committee for the original version of H.B. 377 estimated the cost of a 15% EITC at \$25 million in the first year and the cost of a 30% EITC at \$254 million by year three.<sup>17</sup> Fortunately, because the state EITC is just a percentage of the federal tax credit, its administrative costs are negligible.

Some of this cost can be funded by Temporary Assistance for Needy Families (TANF) funds, which are available for state EITCs.

***Next Steps***

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<sup>15</sup> Hunt, Jean. 2008. “Pa. Working Poor Need Earned-Income Tax Aid.” *The Philadelphia Inquirer*.

<sup>16</sup> 2008. “Editorial: Earned Income Tax Credit.” *The Philadelphia Inquirer*.

<sup>17</sup> Wood, et al.

The original EITC bill was a laudable and necessary proposal. Unfortunately, the tax credits and changes added to the final version would cost the state \$3.8 billion in lost revenue and cut spending for vital services.<sup>18</sup>

As a result, the Wharton Politics & Business Association recommends the General Assembly introduce a new unadulterated EITC bill (at 15% of the federal EITC, not 30%, to make it acceptable to all parties) in the Senate as outlined in Appendix I.

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<sup>18</sup> See Appendix II

## Sources Consulted

2007. "Poverty in Western Pa.: Poverty, Hunger Growing Problem." *WTAE-TV*.

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## Appendix I: Recommended Text for Senate Bill

### AN ACT

Amending the act of March 4, 1971 (P.L.6, No.2), entitled "An act relating to tax reform and State taxation by codifying and enumerating certain subjects of taxation and imposing taxes thereon; providing procedures for the payment, collection, administration and enforcement thereof; providing for tax credits in certain cases; conferring powers and imposing duties upon the Department of Revenue, certain employers, fiduciaries, individuals, persons, corporations and other entities; prescribing crimes, offenses and penalties," providing an alternative special tax provision for poverty.

The General Assembly of the Commonwealth of Pennsylvania hereby enacts as follows:

Section 1. The act of March 4, 1971 (P.L.6, No.2), known as the Tax Reform Code of 1971, is amended by adding a section to read:

Section 304.1. Alternative Special Tax Provision for Poverty.

(a) Pursuant to section 2(b)(ii) of Article VIII of the Constitution of the Commonwealth of Pennsylvania, which provides for establishing as a class or classes of subjects of taxation the property or privileges of persons who, because of poverty, are determined to be in need of special tax provisions, the General Assembly hereby declares its intent and purpose to exercise its power pursuant to that section by enacting the alternative tax provisions of this section.

(b) Having determined that there are certain persons in this Commonwealth whose incomes are such that imposition of an income tax would deprive them and their dependents of bare necessities of life, and having determined that poverty is a relative concept inextricably joined with actual income and the number of people dependent upon such income, the General Assembly deems it to be a matter of public policy to provide special tax provisions for that class of persons to relieve their economic burden.

(c) For taxable years beginning after December 31, 2008, an individual having one or more dependents may, in lieu of utilizing the special tax provisions for poverty in Section 304, claim a refund equal to fifteen per cent of the earned income credit allowable under Section 32 of the Internal Revenue Code of 1986 (Public Law 99-514, 26 U.S.C. §20 32), as amended.

Section 2. This act shall take effect immediately.

## Appendix II: PBPC Projections of H.B. 377 Costs

COST ESTIMATES OF AMENDMENTS TO HOUSE BILL 377 (In \$ Millions)							
Amendment	Sponsor	Tax	Brief Description	Eff. Date	2008-09 Costs	Fully Phased-In Costs	Comments
A05040	Reed	CNIT	Adoption of Single Sales Factor.	2008	\$96.5	\$104.8	
A04658	Boyd	Sales	Exclusion of building materials used in constructing animal production facilities.	2008	Unknown	Unknown	
A04951	Beyer	Credit	Creates New Diesel Technology Tax Credit.	July, 2008	Unknown	Unknown	\$5,000 tax credit per new diesel vehicle purchased before 2010. No cap in bill.
A05286	Taylor, R.	PIT	Reduces PIT to 2.99%		N/A	N/A	Quigley amendment (A05354) supercedes this amendment.
A05353	Brooks	CNIT	Rate reduction of CNIT as follows: 7.9% (2009), 7.7% (2010), 7.5% (2011), 7.3% (2012), 7.1% (2013), and 6.9% (2014).	2009-2014	148.8	804.5	
A04399	Perry	INH	Phase out inheritance Tax by 2012	2009-2011	425.7	843.6	Fully Phased-In Costs are based on 2008-09 collections.
A04948	Nailor	Sales	Exempts sales of domestic animals from non-profit shelters from tax.	July 2008	Unknown	Unknown	Fiscal impact expected to be small.
A05287	Seip	CSFT	Increase floor from \$150K to \$300K	2008	61.3	67.2	
A05354	Quigley	PIT	Rate reduction 3.07% to 2.93% to 2.8%.	July 2008, January 2008	753.5	992.4	Fully Phased-In Costs are based on 2008-09 collections.
A05288	Gibbons	CNIT	Increases Net Operating Loss (NOL) carryforward limit to \$5M or 15% of taxable income.	2009	N/A	N/A	Turzai amendment (A05357) supercedes this amendment.
A05356	Cutler	PIT	Exempts combat pay from having PIT withheld.	July 2008	0	0	PIT not currently withheld from combat pay.
A04945	Saylor	Credit	Uncap R&D Tax Credit (currently \$40 million).	July 2008	81.0	81.0	
A05358	Boyd	Credit	Creates a Small Business Health Savings Account Tax Credit.	July 2008	0.0	30.0	Capped in legislation at \$30 million per year. Credit will not be awarded until Dec. 2009 (FY 09-10).
A04949	Ellis	Sales	Exempts downloaded software from tax.	July 2008	55.0	55.0	DOR estimate from 2006.
A04943	Scavello	GRT	Repeal cell phone tax.	2008	215.4	215.4	Collections increased by \$170 million when this was passed in 2004.
A05357	Turzai	CNIT	Uncap Net Operating Losses (NOLs)	2008	619.8	673.1	DOR found uncapping NOLs would cost \$411 million in 2000.
A04947	Phillips	Sales	Clarifies exemption of building materials used by non-profits whose business is construction.	July 2008	Unknown	Unknown	
A05326	Levdansky	Credit	Increases R&D Tax Credit to \$80 million.	2008	N/A	N/A	Saylor amendment (A04945) supercedes this amendment.

**TOTAL      \$2,402.0      \$3,812.0**

Note: Costs do not include the cost of State Earned Income Credits, as originally proposed in HB 377. Estimates are Pennsylvania Budget and Policy Center calculations using Pennsylvania Department of Revenue data. Corporate net income estimates were calculated separately and do not reflect interaction between changes. This table is available from [www.pennbpc.org](http://www.pennbpc.org).