RECOMMENDATIONS TO IMPROVE CALIFORNIA'S EARNED INCOME TAX CREDIT

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California has the 7th largest economy in the world, yet also has among the largest wealth disparities in the country.[i] No one in a state as prosperous as California should experience the daily deprivation caused by poverty, especially working families. However, millions of working Californians are not earning enough to escape poverty. Responding to this growing problem and record inequality, the Legislature passed and the Governor signed a refundable state Earned Income Tax Credit (EITC) in 2015. The new credit offers as much as 85% of the value of the federal credit for families with household annual earnings below about $7,000 to $14,000, depending on their family size, in 2015.

As a result, this tax season, when a household with three or more dependents with earnings of $6,000 files taxes, the household will get a state EITC of $2,295 on top of the federal EITC of $2,700. This would boost post-tax income from $8,700 under current law to $10,975. The new EITC phases out at $13,870 for families with three dependents, which means it will primarily benefit Californians who are working less than full time at or near the minimum wage. While the tax credit will not be enough to lift most households above the federal poverty level, the credit will lift some households out of deep poverty. According to the Department of Finance, the state EITC will benefit approximately 600,000 California households who earn wages. The maximum value of the credit allocated in the state's budget is $380 million, though less may be used depending on how many eligible families are aware of the credit, file their taxes and claim the credit. The new state EITC is funded as a tax expenditure, not from the General Fund.

While anti-poverty advocates throughout the state herald the new law as an important step forward to reduce working poverty, our organizations have identified several ways to strengthen the new tax credit to maximize its effectiveness as a poverty-fighting tool, work incentive, and driver of economic activity.

EITC Counteracts Negative Impacts of Poverty Wages and Under-Employment

A refundable EITC puts hard-earned income back into the pockets of low-wage workers. Research shows that the EITC offsets regressive local and state taxes[ii] and has the potential to lift working families above the poverty line. Furthermore, it improves workers' ability to financially support their children and families, increases economic activity in their communities, improves savings and reduces debt.[iii] This is why twenty-six states plus the District of Columbia have created their own tax credit to accompany the federal credit. According to the Public Policy Institute of California, three million tax filers in California claimed $7.1 billion in federal EITC on their 2012 tax returns.[iv] This amount is equivalent to the amount provided through CalFresh food assistance and roughly twice as much as was spent on CalWORKs cash assistance. As a result of the federal EITC and the Child Tax Credit, 1,239,000 Californians, including 621,000 children, were lifted out of poverty each year, on average, during 2011 to 2013.[v]

Our state's new EITC will further support working families and help spur economic growth. Studies of EITCs adopted in other states have estimated that each additional dollar received by a tax filer can generate a further $1.50-2.00 in local economic activity. In its analysis of policy options for economic and employment growth during 2010, the Congressional Budget Office highlights that the best options to stimulate growth are those that assist households by increasing demand for goods and services, thereby infusing money directly into local communities. The California EITC will help accomplish this.

Improvements Needed to the California EITC Eligibility Rules

Without additional refinement of California's EITC, its poverty-fighting impact will be stunted because several factors block access for groups of low-income working families.

Full-time workers: In California, a person working 35 hours per week at the minimum wage earns $18,200 – an income that's below the federal poverty line for a family of three.. Even a parent supporting a five-member household with this income would be ineligible for the California EITC. If the California EITC were available to full-time, minimum wage workers, it could provide a more valuable work incentive to both part-time employees and new workers entering the labor force. Extending the state EITC to workers with higher incomes would also enable the credit to lift some working families above the poverty line.

Self-employed workers: The state EITC excludes households with work income only from self-employment. This decision was made, according to statements made by the Governor's office, to prevent fraud. However, the difficulty with verifying self-employment income extends across the income spectrum, and there is no justification for exclusively penalizing Californians in deep poverty for this administrative difficulty. Moreover, improper EITC payments mostly result from error, not intentional fraud.[vi] The IRS finds that most EITC errors come from returns completed by commercial preparers, who have perverse incentives to inflate their customers' refunds. A more effective way to prevent fraud and error without disadvantaging the self-employed is to tighten commercial preparer regulations, such as requiring paid preparers pass a test, and fund IRS-certified free-tax preparation services.

Non-citizen workers: Like the Federal EITC, the state EITC excludes workers with an Individual Tax Payer Identification (ITIN) Number. An ITIN is assigned to individuals who work to support their compliance with federal and state tax filing requirements and file a valid federal income tax return. ITINs are for federal tax reporting only, and are not intended to serve any other purpose. IRS issues ITINs to help individuals comply with the U.S. tax laws, and to provide a means to efficiently process and account for tax returns and payments for those not eligible for Social Security Numbers (SSNs). These workers pay taxes regardless of their immigration status and should not be excluded from the benefits of a tax refund that they otherwise are eligible to receive.

Young adults: Childless and non-custodial parent workers between the ages of 21 and 24 are barred from receiving the federal and state EITC.[vii] In California, the rate of unemployment among 20-24 year olds is 11.6 percent, 4.5 points higher than the state average, and over one-third of individuals in that age cohort do not participate in the labor force at all.[viii] Studies evaluating the effectiveness of the federal EITC show that the credit induces substantial numbers of individuals to enter the workforce. The clear positive effect of the EITC on workforce participation suggests that reducing the minimum eligibility age for California's credit to 21 could boost employment for individuals between the ages of 21 and 24, giving them an opportunity to participate more fully in the state's economy. To leverage the power of a state EITC, California should consider lowering the eligibility age for childless workers to 21.

Connecting Eligible Families to the California EITC

There are also important ways to improve the state EITC whether or not eligibility rules are adjusted. The poverty-fighting impact of the EITC would reach more workers eligible for the benefit if the state supported outreach and tax-preparation assistance for working families eligible for the benefit, many of whom are not required to file taxes unless they want to claim their credit. Despite the benefit of the federal EITC, only 75% of eligible Californians claim the credit. Promoting the state EITC provides a great opportunity to increase participation in the federal EITC, which would draw millions of dollars into the state and not only help low-income working families better support themselves, but also boost local businesses and economies as families spend their tax refunds. To ensure a high uptake rate of both federal and state tax credits for low-income families, California should fund robust outreach and free tax-preparation services throughout the state. Tax-preparation sites need paid coordinators to be the most effective in the delivery of volunteer training and tax assistance.

Participate in National Advanced Payment Pilot Discussions

Finally, because EITC refunds are typically distributed as lump sum payments after tax returns are filed, workers and their families are unable to use the credit to help them through tough economic times as they arise during the year. Research demonstrates that advance payment of EITC allows workers and their families to use the credit to meet immediate household needs, such as paying bills and buying groceries.[ix] While advance EITC payments are no longer an option for federal EITC, there are several national proposals for advance payments that are being considered for pilot. California should consider participating in conversations about an advance payment pilot that would give workers the option to collect the credit when they need it most rather than accumulating debt as they await the end of the year and the lump sum payment of the credit.

California's EITC Should Be Strengthened & Its Reach Lengthened

Increasing access to the new EITC will not only restore paths toward self-sufficiency for a significant number of households living below the poverty line, but will also buttress consumer spending, which is necessary to create jobs and a more stable California economy.

Our organizations recommend the following improvements to the new state EITC:

A. Increase the income eligibility limit to enable all working poor families – including full-time workers – to benefit from the state EITC.

B. Adjust eligibility rules to stop excluding key populations from the state EITC:
   - self-employed workers,
   - non-citizen workers, and
   - young adults (age 21-24) who are childless or non-custodial parents.

C. Ensure that all families served through the County Human Services Agencies or applying for Unemployment Insurance, Paid Family Leave and Health Insurance are informed and supported in applying for the state EITC.

D. Ensure that employer notices to low-wage workers regarding the federal EITC be modified to include notice of state EITC.

E. Proving funding for community organizations to do outreach and increase the number and capacity of Volunteer Income Tax Assistance (VITA) sites.

F. Address the predatory nature of "Tax-Time" fly-by-night tax assistance and sub-standard banking practices that target families seeking relief through advance payments of tax credits.

G. Consider working with federal and state stakeholders to participate in a periodic advance EITC payment pilot.

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www.unitedwaysca.org | www.caimmigrant.org | www.policylink.org | www.calassets.org

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[i] Pacific Standard Magazine, "The California Chasm: Inequality in One of the Most Unequal States," (Feb. 2015) psmag.com/business-economics/the-california-chasm-inequality-in-one-of-the-most-unequal-states-in-the-country

[ii] Carl Davis, et al, "Improving Tax Fairness with a State Earned Income Tax Credit," 2 (Washington, DC: Institute on Taxation and Economic Policy, 2014), http://www.itep.org/pdf/eitc2014.pdf.

[iii] EITC and Child Tax Credit Promote Work, Reduce Poverty, and Support Children's Development, Research Finds

[iv] EITC in California, Public Policy Institute of California http://www.ppic.org/main/publication_show.asp?i=925

[v] Center on Budget and Policy Priorities. California Fact Sheet: Tax Credits Promote Work and Fight Poverty. http://apps.cbpp.org/3-5-14tax/?state=CA

[vi] Robert Greenstein, John Wancheck, and Chuck Marr, "Reducing Overpayment in the Earned Income Tax Credit" (Washington, DC: Center on Budget and Policy Priorities, 2014), http://www.cbpp.org/cms/?fa=view&id=3960

[vii] Childless workers under the age of 25 are not eligible to receive the federal EITC. President Barack Obama and Congressman Paul Ryan have proposed reducing the EITC's minimum eligibility age to 21. Office of Management and Budget, Fiscal Year 2016 Budget of the U.S. Government (U.S. Government Printing Office 2015), 54 http://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/ assets/investing.pdf ; Chye-Ching Huang, "What Difference Would Ryan's EITC Expansion Make for Childless Workers?," *Off the Charts* (July 20, 2014), http://www.offthechartsblog.org/what-difference-would-ryans-eitc-expansion-make-for-childless-workers/.

[viii] State of California Economic Development Department, "California Economic Indicators" (accessed February 26, 2015).

[ix] Holt, Steve. Beyond Lump Sum: Periodic Payment of the Earned Income Tax Credit. Available at: http://www.frbsf.org/community-development/files/Holt_Steve.pdf