A Kick While Down

How the State Budget Increases Taxes on Working Virginia Families

The Commonwealth Institute

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Overview

Buried deep within the budget is a critical change to the state's Earned Income Credit program that will raise taxes by a total of $6 million on 114,000 working Virginia families starting in 2010.

Under the federal Recovery Act passed last year, the federal Earned Income Tax Credit (EITC) was temporarily improved for tax years 2009 and 2010 to help working families cope with the impacts of the recession. The improvements provided expanded marriage penalty relief and a new tier of benefits for families with 3 or more children (previously the credit topped off at 2 children).

Virginia's state version of the EITC (called Virginia Earned Income Credit or EIC) allows families to claim 20 percent of their federal EITC. This means that any increase in the credit at the federal level automatically flows to Virginians' state credit, too.

However, the state budget disallows the improvements made in the Recovery Act at the state level for 2010. This means that although Virginians will get the extra help in their 2009 credit, they will lose this help next year. Furthermore, if Congress acts to extend the life of these EITC improvements beyond 2010, Virginia's budget would continue to disallow them.

At a time when the Governor has pledged not to raise taxes and to focus on jobs and work, while expressing a commitment to "protecting families," this tax increase flies directly in the face of all the rhetoric. The EITC has a proven track record demonstrating that it provides incentives to work, helps struggling families, reduces child poverty, and helps stimulate local economies. By eliminating marriage penalty relief, raising taxes on low-income working families, and weakening a program with a proven performance record, Governor McDonnell is working against his own stated goals for his administration.

Executive Summary

- Virginia's budget changes the state's earned income tax credit (EIC) and raises the taxes of many working families in Virginia by over $6 million in 2010.
- The change impacts about 114,000 families with 3 or more children who earn less than $49,000 a year.
- The change increases income taxes of impacted families by a substantial amount: for a married couple with three children, the average tax increase in 2010 is $205 and for single parents with three children, the average tax increase is about $125.

A Proven Anti-Poverty Tool that Incentivizes Work

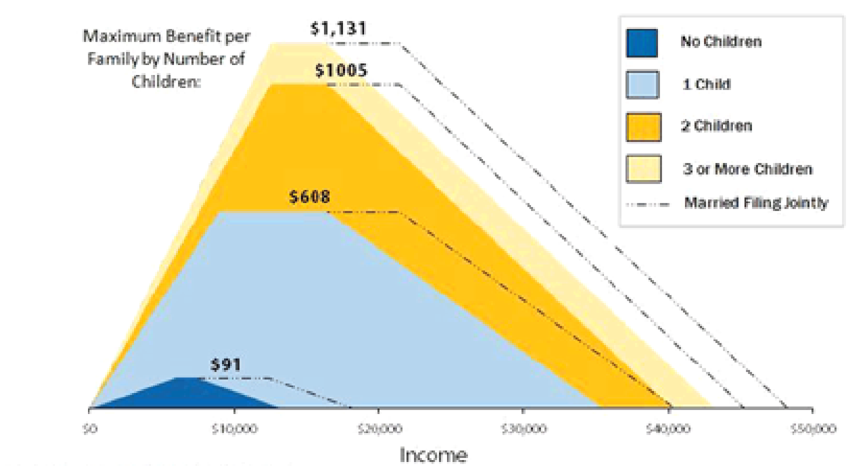
As one of the largest and most effective tools for addressing poverty in the United States, the federal earned income tax credit increases the returns to work for low-income Americans by offering a credit based on their earnings and the size of their family. Under the program's formula for calculating credit size, the more a family earns, the bigger the size of their credit up until they hit the maximum credit amount. Beyond that point, families can earn a certain amount without losing any of their credit. Once the family's earnings exceed that amount, their credit is slowly phased-out for each additional dollar earned.

The work incentives created by the program have allowed the EITC to enjoy bipartisan support throughout most of its history. In 2009, the federal credit lifted an estimated 6.6 million individuals out of poverty, including 3.3 million children. Without the program in place to supplement the earnings of low-wage workers, the child poverty rate would have been nearly one-third higher.

By launching the Virginia Earned Income Credit (EIC) in 2006, Virginia made a commitment to working families in the state by allowing eligible individuals and families to receive a nonrefundable credit equal to 20 percent of their federal earned income tax credit to help offset their state income tax liability.

Recovery Act Enhancements Target Virginia's Most Vulnerable Working Families

Figure 1: Virginia Earned Income Credit, 2009



Source: Center on Budget and Policy Priorities, 2010.

Virginia's credit provides a powerful and proven tool for strengthening the Commonwealth's working families, its communities, and its economy. The economic downturn has forced the state to serve the increased needs of its residents with fewer resources – and in the process, the state has had to make difficult decisions about how to balance the budget. Unfortunately, Virginia has chosen to protect unevaluated tax expenditures and pursue unproven economic development schemes at the expense of one of its most high performing programs at a time when it is needed most.

What "Decoupling" Means for Virginians

Virginia's credit is pegged to the federal credit – meaning that Virginia filers can claim 20 percent of their federal EITC as their state EIC. Figure 1 shows the size of credit a Virginia household can receive for 2009 based upon their earnings, marital status, and family size under the enhancements passed as part of the Recovery Act.

As shown in Figure 1, the Recovery Act adds new benefits for families with three or more children. This increases the maximum benefit for these families by roughly $126, and is intended to address the fact that families with three or more children are more than twice as likely to be poor as families with fewer children.

The Recovery Act also addresses the program's marriage penalty by extending the income eligibility levels for married households $5,000 beyond the eligibility of single households (previous law set this differential at just $3,000). By extending eligibility for married filers by an additional $2,000, more Virginia households will qualify for the maximum credit amount.

Figure 2, however, shows what these benefits will look like in 2010 as a result of Virginia's decision to decouple from the federal enhancements. Both the new tier of benefits for families with 3 or more children, and the marriage penalty relief drop away. The result is over $6 million more in income taxes paid by 114,000 of Virginia's low-income families – and at a time when they are least equipped to take this blow.

In addition, decoupling from these federal enhancements will make tax preparation much more complicated for Virginia's families receiving the state credit. So long as the state's credit is a straight 20 percent of the federal credit, filers simply have to use the federal tax tables to determine their federal credit and then take 20 percent of that amount for their state credit. Now that Virginia has decoupled from the federal credit for 2010, filers will have to go beyond this simple 20 percent calculation, back out any portion of the credit they receive in additional marriage penalty relief or the third tier of benefits, and then calculate their state credit amount. This will require separate tax tables that will create unnecessary confusion around the state's program and the amount families are eligible to claim.

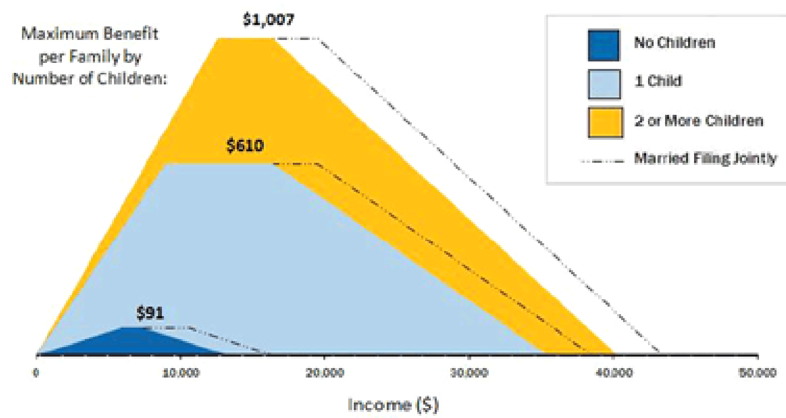
The EIC Has Sweeping Stimulative Effects

Because Virginia's EIC reduces income taxes for low-income families, it frees up more resources to pay for the goods and services families need such as transportation, utility bills, and supplies for their children. This keeps dollars flowing through Virginia's local economies and maintains (or even boosts) consumer demand so that Virginia can transition beyond the downturn more quickly and smoothly.

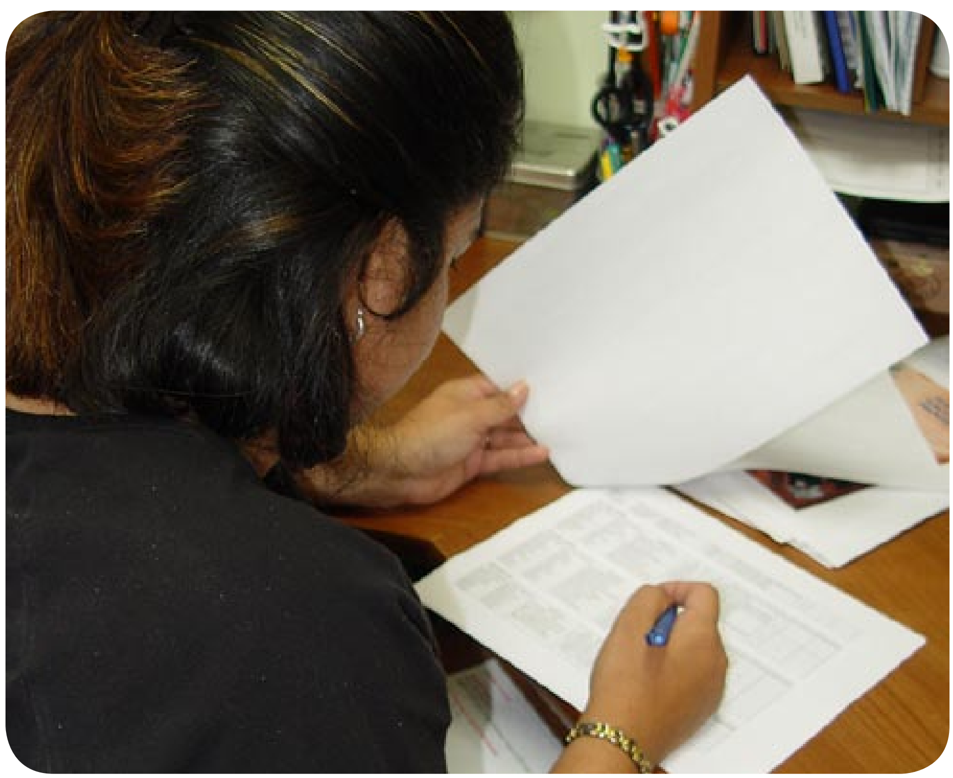
In 2006, one out of seven Virginia taxpayers claimed the federal EITC, which means that at least half a million Virginians are also eligible to claim the

Budget Reduces State EIC by $6 million in 2010

Figure 2: VA's Earned Income Credit decoupled from Recovery Act Enhancements, 2010

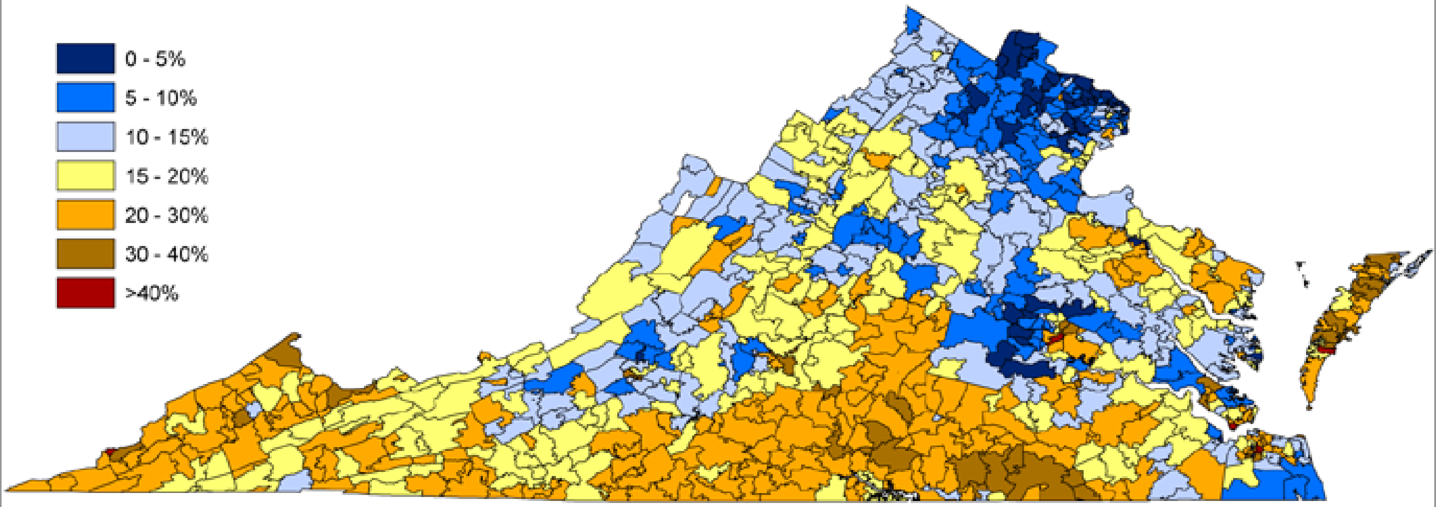


Source: Center on Budget and Policy Priorities, 2010.



The EITC Supports Working Families Across Virginia

Figure 3: Earned Income Tax Credit Recipients as a Share of Total Filers by Zip Code, Tax Year 2006



Source: Brookings Institution analysis of IRS data

Virginia earned income credit (EIC). As shown in Figure 3, recipients of the earned income tax credit are spread throughout the state: families in all 134 counties claim the credit. In rural counties, 20.5 percent of tax filers claimed the EITC. In urban counties, 13.4 percent of tax filers claimed the EITC. Sixty percent of these claimants earn less than $20,000.

Conclusion

The bottom line is this: The changes enacted under the Recovery Act last year target segments of Virginia's workforce that are particularly at risk of being taxed into poverty. In light of the economic challenges facing our state and our families, now is not the time to be cutting a program with a proven track record of promoting self-sufficiency, providing incentives to work, and delivering needed tax relief to working families across the state.

The Commonwealth Institute

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