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BTC Brief

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MAKING WORK PAY

Tax Credits for Working Families Enable and Encourage Work by Alleviating Employment-Related and Family Expenses

Timely, accessible, and credible analysis of state and local budget and tax issues

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KEY FINDINGS:

- **Three state tax credits – the Earned Income Tax Credit, the Child Tax Credit, and the Child and Dependent Care Tax Credit – effectively support work and promote healthy childhood development, both of which are important goals that expand opportunity for working families and provide wide-ranging and long-term benefits for the state.**
- **These credits put money into the pockets of more than a million families, helping them make ends meet and provide for their children. They also spur economic activity, as all of the money from the EITC and some of the money from the other two credits go to low- and moderate-income families, who are more likely than wealthy families to spend the money in their local economies.**
- **Administration and application for these tax credits is simplified by leveraging similar programs at the federal level and introducing little complexity to tax forms. As a result, these public investments not only build and strengthen North Carolina's middle class but also are cost-effective.**

NORTH CAROLINA'S STATE INCOME TAX code includes valuable provisions that better enable working families to make ends meet while promoting work among families with children: the Credit for Children (also known as the Child Tax Credit), the Child and Dependent Care Tax Credit, and the Earned Income Tax Credit.

North Carolina's tax credits for working families help parents offset the costs of meeting their children's basic needs, encourage and enable work for low- and moderate-income families with children and adult dependents, and partly offset the upside-down nature of North Carolina's tax system. Even with these credits in place, low-income families pay more of their income in taxes than wealthy households do. Without these credits, working families in North Carolina would be forced to pay much more than their fair share of state and local taxes.

This brief provides basic information about these tax credits, including their purpose and structure, who benefits and how much, and other notable features.

EARNED INCOME TAX CREDIT

Purpose and Structure

The state Earned Income Tax Credit (EITC) is a pro-work tax credit only available to working families, and it is especially important to families working full-time at or near the minimum wage. The state credit is

Three State Tax Credits Provide Critical Support to Working Families in North Carolina

- **Earned Income Tax Credit** is a pro-work tax credit only available to working families, and it is especially important to families working full-time at or near the minimum wage. Not only does the credit help working families make ends meet, research has demonstrated that the EITC has increased participation in the workforce.[1] More than 883,000 families benefited from the state EITC in 2009, representing more than one in four non-elderly households in North Carolina.

- **Child Tax Credit** helps working families earning less than $100,000 per year ($80,000 for single parents) pay for the additional expenses of raising children through a $100-per-child tax credit for dependent children under age 17. Nearly 1.1 million North Carolina families benefited from the state Child Tax Credit in 2008, representing more than one in four households in the state.

- **Child and Dependent Care Tax Credit** provides working families with a tax credit for eligible childcare and dependent care expenses with a cap of $3,000 for one qualifying dependent or $6,000 for two or more qualifying dependents. This provides an essential support for families to stay in the workforce and ensure their children are in safe environments with high-quality care. Nearly a quarter-million North Carolina families benefited from this credit in 2008.

available to North Carolina families who are eligible for the federal version of the credit, with the value of the state credit equal to 5 percent of the federal credit. Not only does the credit help working families make ends meet, research has demonstrated that the EITC has raised participation in the workforce among single parents by increasing the relative economic benefits of work versus public assistance.[2]

The structure of the Earned Income Tax Credit is designed to encourage and reward work: it grows with each dollar of earned income until reaching a maximum amount and then begins to phase out. In 2009, the maximum value of the state EITC was roughly $152 for a family with one child, $251 for a family with two children, and $284 for a family with three or more children.

Who Benefits and How Much?

More than 883,000 families benefited from the state Earned Income Tax Credit in 2009, representing more than one in four non-elderly households in the state. All of the families receiving the state EITC had annual incomes under $50,000, and the average value of the credit was $113. The total value of the state EITC to North Carolina households was just under $100 million in 2009.

Because North Carolina, like many other states, relies heavily upon sales and excise taxes for revenue, low- and middle-income families pay a larger share of their incomes in state and local taxes than wealthy households do. North Carolina's state EITC represents a step toward addressing this imbalance.

Other Notable Features

The federal EITC and state EITCs have a long history of broad, bipartisan support. As of 2010, 24 states (including the District of Columbia) had enacted state EITCs, and Connecticut recently became the 25th state.

Because most state EITCs are calculated as a percentage of the federal credit and administered through state income taxes, they are simple to administer. In most cases, adding an EITC to the state tax form requires only a single line.[3]

Recent research by Greg Duncan and Katherine Magnuson finds that investments to minimize the effects of early childhood poverty are particularly effective at delivering long-term economic returns. Tax credits targeting families with children are one way to deliver such investments, and the returns are significant: young children under the age of 5 living in households earning less than $25,000 see a 20% increase in their earnings as adults when those households receive an additional $3,000.[4] Effectively targeting tax credits to low-income families ensures a cost-effective investment by the state.

CHILD TAX CREDIT

Purpose and Structure

The state Child Tax Credit helps working families earning less than $100,000 per year ($80,000 for single parents) pay for the additional expenses of raising children by allowing them to claim a $100-per-child tax credit for dependent children under age 17.

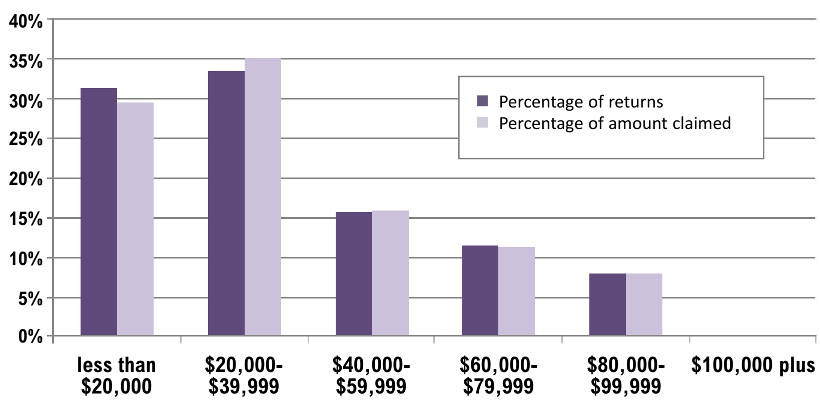
Families who are eligible for the federal child tax credit are also eligible for the state tax credit, easing administration of the credit on state tax forms. Unlike the federal child tax credit, however, the state credit is non-refundable, meaning that North Carolina families with incomes so low they pay little or no state income tax often do not receive the full benefit of the credit.

Who Benefits and How Much?

Nearly 1.1 million North Carolina families benefited from the state Child Tax Credit in 2008, representing more than one in four households in the state.[5] Due to the income cap on the credit, all families benefiting from the credit had incomes under $100,000.

FIG. 2: CHILD TAX CREDIT EVENLY DISTRIBUTED AMONG FAMILIES WITH CHILDREN

Share of total tax filers and total tax credit amount claimed by income group



SOURCE: Special data request of N.C. Department of Revenue, May 13, 2011. Based on data for tax year 2008.

Because the credit is a flat $100 per child, the benefit of the credit is fairly evenly distributed among households earning under $100,000 per year.[6] The total value of the state Child Tax Credit to North Carolina households was $175 million in 2008, with an average value per family of $164.[7]

Other Notable Features

The Child Tax Credit in North Carolina is not directly based on the federal Child Tax Credit and is therefore not partially refundable as is the federal credit. However, North Carolina's Child Tax Credit remains responsive to family size and is able to target low-income North Carolinians because of the income cap on eligibility (See Figure 2).

CHILD AND DEPENDENT CARE TAX CREDIT

Purpose and Structure

Child and dependent care is often the second-largest household expense for working families, with the cost of child care often exceeding 30 percent of monthly income for low- and moderate-income working families.[8] The state Child and Dependent Care Tax Credit helps families with children afford the child care they need to participate in the workforce and ensure that their children benefit from high-quality care and early learning environments.[9]

This non-refundable credit provides working families at virtually all income levels with a tax credit of up to 13 percent for eligible child and dependent care expenses, with a cap of $3,000 for one qualifying dependent or $6,000 for two or more qualifying dependents.

As with the Earned Income Tax Credit and the Child Tax Credit, families who have care expenses allowable under the federal child and dependent care tax credit are eligible for the state tax credit, easing administration of the credit on state tax forms.

The structure of the state credit, however, is different than the federal credit. The federal version varies only by income, with a maximum value of 35 percent of eligible expenses for low-income families and a minimum value of 20 percent for middle- and upper-income families. The state credit varies between 7 and 13 percent of eligible care expenses, depending on income and on the age of the eligible child or, for adult dependents with disabilities, whether the dependent is physically or mentally capable of self-care.

Who Benefits and How Much?

Nearly a quarter-million North Carolina families benefited from the state Child and Dependent Care Tax

Credit in 2008. The total value of this credit to North Carolina households was $55 million in 2008, with an average value per family of $222.

The credit can only be claimed by working families. To be eligible, single parents must be working or actively seeking work and, in a two-parent family, both parents must be working or actively seeking work unless one spouse is a full-time student or is unable to care for himself or herself.[10]

The state version of Child and Dependent Care Credit is especially important to low- and moderate-income families because many of them have greater state income tax liability than federal income tax liability. Only 20 percent of the federal credit went to families with incomes under $40,000 in 2006, but more than 35 percent of the state credit went to families with incomes under the same threshold.[11]

Other Notable Features

The cap on eligible expenses of $3,000 for one child and $6,000 for two or more children is far below the average cost of care in North Carolina. Full-time care for an infant at a child care center in North Carolina was on average $8,508 in 2009 – equal to 38 percent of the median single-mother income in the state. For a four-year old, the average cost of full-time care at a child-care center was $7,206.[12]

The high cost of quality child care is a major obstacle to participation in the workforce for many North Carolina families. The Child and Dependent Care Tax Credit, together with the Earned Income Tax Credit and the Child Tax Credit, can make work pay for parents in low-wage jobs without forcing them to sacrifice the well-being of their children in potentially unsafe, lower-quality care environments.

CONCLUSION

The design of a tax system, just like a state budget, reflects the values and priorities of a state. North Carolina's lawmakers have identified effective tax credits for working families as critical tools for promoting work, supporting child development and growing the state's middle class.

At the same time, these tax credits, especially the Earned Income Tax Credit, go some way toward minimizing the existing upside-down nature of the tax system, which requires lower-income households to pay more in total state and local taxes as a share of their income than higher-income households do. Evidence has found that such supports for families with children reap benefits for decades through improved school achievement and earning potential.[13]

North Carolina's policymakers should continue to support these investments. The benefits will be shared broadly through a stronger middle class now and in the future.

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