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STRATEGIES FOR HELPING LOW-INCOME TAXPAYERS: Comparing a No-Tax Floor to a State EITC

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Executive Summary

- Governor Michael Easley's recommended state budget set aside $63 million to reduce the income taxes paid by low-income taxpayers to be delivered through a "no-tax floor" plan. In fact, hundreds of thousands of the proposed 1.2 million taxpayers his plan claims to help already pay no income tax and would see no new benefit.

- The governor's proposal exposes the inherent difficulties in attempting to reach low-income taxpayers through non-refundable credits. A widely-supported alternative for helping low-income taxpayers is through refundable credits such as a state Earned Income Tax Credit (EITC). A state EITC would not only offset state income taxes owed, but also help offset sales and property taxes which hit North Carolina's lowest-paid workers disproportionately hard. An estimated 825,000 taxpayers and their families would benefit from a state EITC at a cost of $67 million for a 5% state EITC or $134 million for a 10% state EITC.

- In addition to not benefiting very low-income taxpayers, the governor's "no-tax floor" also has numerous design flaws that make it inferior to a state EITC. The "no-tax floor" does not adjust for number of dependents, does not adjust with inflation, and does not offset sales taxes (which is the largest tax expense for low-income families). It also has a steep drop-off effect, so earning one dollar over the floor would trigger a significant amount of tax. Finally, the "no-tax floor" is less targeted and does not reach the taxpayers who need help the most.

- Eight out of the fourteen states that currently have "no-tax floors" also have state EITCs, so the two options are not mutually exclusive. When well-designed, the two approaches can be used simultaneously to achieve the broad-based impact desired by the governor and to target low-income working families who need the greatest support.

Overview

High costs of basic necessities, stagnant wages, and a regressive state and local tax system underscore the need for helping low-and moderate-income North Carolina families make ends meet. Fortunately, two such proposals are currently being seriously considered: the governor's "no-tax floor" plan and a state Earned Income Tax Credit. Both would help a significant number of taxpayers , however, the governor's plan has major structural flaws and does not benefit the number of new taxpayers claimed, nor as many as would a state EITC. Taxpayers with adjusted gross incomes below the proposed "no-tax floors" (with the exception of working dependents) already have no income-tax liability after taking personal exemptions and the standard deduction. Therefore, more taxpayers and their families would benefit from a refundable state EITC that would offset state income taxes and provide a refund to the lowest-income taxpayers with no income-tax liability but who pay a significant portion of their income in other state and local taxes. This issue of BTC Reports *examines both proposals in detail with a special focus on how each proposal would impact low-income workers and their families.*

The Governor's No-Tax Floor Plan

The type of plan proposed by the governor is commonly referred to as a no-tax floor. Currently, fourteen states have no-tax floor plans, most coupled with other means of tax relief. Under the governor's no-tax floor proposal, taxpayers with adjusted gross income (AGI) below a set level, would face no income-tax liability and would be "taken off the tax rolls". For low- and moderate-income workers, AGI is usually the same as income earned through salary or wages. Taxpayers with adjusted gross income above the "no-tax" floor but below the "half-tax" floor would have their income-tax liability cut in half **(Figure 1)** For example, a filer with head of household status and one dependent who earns $19,950, would owe $283 in state income taxes this year. Under the governor's plan, this taxpayer would owe half of that amount or, $142.

FIGURE 1

GOVERNOR'S NO TAX FLOOR PROPOSAL

"NO TAX FLOOR PLAN" Taxpayers with adjusted gross income (AGI) below the floor would face no income tax liability.		**"HALF-TAX FLOOR PLAN"** Taxpayers with adjusted gross income (AGI) above the "no-tax" floor but below the "half-tax" floor would have their income tax liability cut in half.	
Filing Status	**No Tax Floor**	**Filing Status**	**"Half-Tax" Range**
Single:	AGI under $5,000	**Single:**	AGI between $5,000 and $12,500
Head of Household	AGI under $7,500	**Head of Household**	AGI between $7,500 and $20,000
Married, Filing Sep:	AGI under $5,000	**Married, Filing Sep:**	AGI between $5,000 and $12,500
Married, Filing Jointly:	AGI under $10,000	**Married, Filing Jointly:**	AGI between $10,000 and $25.000

Number of Beneficiaries Overstated The governor's proposal claims to remove 545,000 taxpayers from the tax rolls and cut in half the taxes of 629,200 taxpayers, helping an estimated 1.2 million total taxpayers. However, taxpayers with AGI under the proposed no-tax floor already pay no state income taxes after applying the standard deduction and personal exemptions that reduce their taxable income to $0. Taxpayers with dependents begin owing income tax at even higher AGI amounts if they are also eligible for the child tax credit and child and dependent care credit,

FIGURE 2

NORTH CAROLINA'S INCOME TAX THRESHOLD

ADJUSTED GROSS INCOME LEVEL AT WHICH TAXPAYERS BEGIN PAYING STATE INCOME TAX

	"NO TAX FLOOR"	0 DEPENDENTS	1 DEPENDENT*	2 DEPENDENTS*
Single	$5,000	$5,500	$9,675	$13,842
Head of Household	$7,500	N/A	$11,075	$15,242
Married- Filing Jointly	$10,000	$11,000	$15,175	$19,342

*with $100 per dependent Child Tax Credit (CTC), but does not include Child and Dependent Care Credit
Filers with dependents who claim the Child and Dependent Care Credit can have higher AGIs without income tax liability

NC Personal Exemptions	$2,500
NC Standard Deduction	
Single	$3,000
Married Joint	$6,000
Head of House	$4,400
NC Child Tax Credit:	$100 per dependent

both of which help to reduce income taxes owed. **Figure 2** shows the amount of AGI needed before a taxpayer would have a positive income-tax liability by filing status and number of dependents.

The only taxpayers with incomes below the no-tax floors who would benefit are dependents, primarily teenagers, with some earned or unearned income who can not claim the personal exemption. An estimated 71,000 taxpayers, all dependents, would be taken off the rolls under the governor's proposal, not 545,000.

Even some taxpayers proposed to benefit under the "half-tax" plan would see no benefit. For example, a married couple with two dependents does not owe income taxes until their AGI reaches a minimum of $19,342, which is within the category of taxpayers who would supposedly have their income tax bill cut in half.

An analysis conducted by the Institute for Taxation and Economic Policy (ITEP) found that an estimated 577,000 taxpayers (including more than 147,000 dependents) would see their income taxes reduced by the governor's plan, not 629,000. According to ITEP, the governor's plan would impact an estimated maximum of 649,000 taxpayers as opposed to his claim of 1.17 million. Confirmation of ITEP's conclusions can be found by looking at NC Department of Revenue tax data from tax year 2004 which shows that 632,408 taxpayers had no taxable income that year. Since those same taxpayers fall into the AGI categories the governor defined, this confirms that far fewer taxpayers than claimed would benefit from the "no-tax floor" plan.

No-Tax Floor Plan is Not Well Designed. In general, no-tax floors are not bad policy and are one state option for helping low-and moderate-income taxpayers. However, in addition to overstating the number of beneficiaries, the governor's proposal has **five major design flaws:**

- The proposal does **not adjust for family size.** Taxpayers with no dependents would get the same benefit and are held to the same income thresholds as taxpayers with dependents under the governor's plan.

- The proposal **does not adjust for inflation** so the real benefit would decrease each year unless adjusted by state law.
- The proposal has a **steep drop-off effect**. A single dollar of income above the top parameter amounts could trigger a significant amount of tax. Most states with no-tax floors phase in their income tax over a range of income above the floors, but the governor's plan does not have this provision. For example, a head of household filer with one dependent and an AGI of $20,000 currently owes $536 in income taxes. Under the governor's proposal, the taxpayer's income taxes would be cut in half to $268. If the same taxpayer earned $1 more, for a total AGI of $20,001, the taxpayer's income-tax liability would remain at $536. So, the additional $1 of income would double the amount of income taxes owed.
- The proposal **only offsets income taxes and is not refundable**. State income taxes are not the only taxes paid by North Carolina workers. In fact, the impact of the sales tax on low-and moderate-income taxpayers is much greater than the income tax and hits them disproportionately hard compared to wealthier taxpayers. While the no-tax floor helps to offset income-tax liability for some taxpayers, those with AGI under the floor would benefit more from a refundable credit since they already have no income-tax liability. A refundable credit would help offset other state and local taxes, increasing tax fairness and helping those taxpayers close the gap between what they earn and what they need to make ends meet.
- The NC No-tax floor is **not well-targeted**. While a no-tax floor is a broad-based approach to income tax relief encompassing the elderly, working parents with older children, and married couples just starting out in life, other means of income tax relief are more targeted to working families with children. The greatest beneficiaries under the governor's plan are married couples with no dependents earning right at $25,000.

Even if the number of beneficiaries under the governor's proposal were not overstated, the structural flaws described above are enough to give pause. The fact that the lowest-income taxpayers and their families would not be helped by the new plan, however, is the most compelling reason to consider alternative approaches. One such proposal, and one that was proposed by Governor Easley in 2001, is the creation of a state Earned Income Tax Credit.

An Alternative Approach to Helping Low-Income Taxpayers: A State Earned Income Tax Credit (EITC)

An alternative proposal to help low-and moderate-income families is a refundable state Earned Income Tax Credit (EITC). A state EITC would piggyback off the federal program which is the nation's largest and most effective anti-poverty program targeted at low- and moderate-income working families with children. An estimated 825,000 taxpayers (twenty percent of all filers) and their families qualify for the federal EITC, so would also benefit from a state EITC. A five percent state EITC would cost $67 million and a ten percent state EITC would cost $134 million in FY 2007-2008.

A state EITC addresses all five flaws in the governor's plan and benefits more taxpayers. A state EITC would help those who need it the most- working families. For some, it would offset state income taxes owed. For those who already have no

FIGURE 3

TAXPAYERS WHO BENEFIT MORE FROM A STATE EITC	ADJUSTED GROSS INCOME	5% STATE EITC	10% STATE EITC	NC INCOME TAX LIABILITY	BENEFIT FROM NO-TAX FLOOR
Single-parent with one dependent					
Half-time NC minimum wage earner	$6,396	$109	$218	$0	$0 - has no income tax liability
Full-time NC minimum wage earner	$12,792	$143	$285	$188	$0- above the floor
Wages equal to 2007 federal poverty guideline	$13,690	$143	$285	$241	$0- above the floor
Wages equal to 200% of poverty guideline	$27,380	$47	$94	$1,129	$0- above the floor
Head of Household with one dependent					
Half-time NC minimum wage earner	$6,396	$42	$83	$0	$0 - has no income tax liability
Full-time NC minimum wage earner	$12,792	$137	$275	$104	$52
Wages equal to 2007 federal poverty guideline	$13,690	$137	$275	$157	$79
Wages equal to 200% of poverty guideline	$27,380	$42	$83	$989	$0- above the floor
Married Filing Jointly with 2 dependents					
One full-time minimum wage earner	$12,792	$236	$472	$0	$0 - has no income tax liability
Total Wages equal to 2007 federal poverty guideline	$20,650	$201	$403	$79	$40
Two full-time minimum wage earners	$25,584	$150	$299	$375	$0- above the floor
Total Wages equal to 200% of poverty guideline	$41,300	$0- above the threshold	$0- above the threshold	$1,359	$0- above the floor

**PT min wage workers assume 20hrs per week for 52weeks
*FT min wage workers assume 40hrs per week for 52 weeks

income-tax liability, a refundable state EITC would go further by helping to offset other state and local taxes such as the sales tax. Compared to the governor's "no-tax floor" proposal, a state EITC does the following:

- **Adjusts for family size and inflation.** The federal EITC amount is based on a filer's AGI, filing status and number of dependents. The maximum credit

FIGURE 4

TAXPAYERS WHO BENEFIT MORE FROM THE GOVERNOR'S NO TAX FLOOR PROPOSAL

	ADJUSTED GROSS INCOME	5% STATE EITC	10% STATE EITC	NC INCOME TAX LIABILITY	BENEFIT FROM NO-TAX FLOOR
Single with no dependents					
AGI just under $12,500 floor for 'half-tax'	$12,450	$0.50	$1.00	$417	$208.50
* Single Filers with one or more dependents with AGI of $12,450 would benefit more from a state EITC					
Head of Household with one dependent					
AGI just under $20,000 floor for 'half-tax'	$19,950	$101	$202	$533	$266.50
* Head of Household Filers with two or more dependents with AGI of $19, 950 would benefit more from a state EITC					
Married Filing Jointly with 0 dependents					
AGI between 10,000 and 25,000	$17,500	not eligible	not eligible	$390	$195
* Married Joint Filers with one or more dependents with AGI of $17,500 would benefit more from a state EITC					
AGI just under $25,000 floor for 'half-tax'	$24,950	not eligible	not eligible	$837	$419
* Married Joint filers with one dependent and AGI of $24,950 would also benefit more from the governor's proposal.					
Married Joint filers with two or more dependents with AGI of $24,950 would benefit the most from a 10% EITC					

amounts and income eligibility parameters are adjusted annually for inflation. Because a state EITC would be tied to the federal EITC, it automatically adjusts for dependents and inflation.

- **Phases out gradually.** The size of the EITC increases for each dollar earned up to a certain amount, maintains the maximum credit up to an additional amount of earnings, and phases out gradually at higher income levels. A state EITC would reach families earning around $37,000 for single and head of household filers with two dependents and $39,000 for married couples with two dependents.
- **Is refundable, thereby offsetting more than state income taxes.** A state EITC is a refundable credit, so it not only offsets income taxes owed, but for many taxpayers, it would also help to offset the disproportionately negative impact of sales and property taxes on the lowest paid workers. According to data provided by the Institute on Taxation and Economic Policy, North Carolina's lowest-paid workers (bottom 20 percent) pay 10.9 percent of their income to state and local taxes while the wealthiest taxpayers (top 1 percent)

pay only 6.3 percent. Moreover, the impact of the sales tax on low-income families is five times greater than the impact on the wealthiest 1 percent. A refundable state EITC would increase fairness of the state and local tax system and ensure that paying taxes does not push low- and moderate-income working families closer to or deeper into poverty.

- **Is better targeted and benefits more taxpayers.** Unlike the governor's proposal, taxpayers with AGIs low enough to have no income-tax liability and taxpayers with dependents and AGIs above the proposed floors would benefit from a state EITC. **Figure 3** provides examples of taxpayers who would benefit more from a state EITC compared to the governor's no-tax floor proposal. The primary beneficiaries of a state EITC are low-income working families with children. **Figure 4** provides examples of taxpayers who would benefit more from the governor's proposal. The primary beneficiaries of his proposal are taxpayers with no dependents or those with AGI close to the top floor.

One, the other or both?

Helping low-income taxpayers and their families is an important, laudable goal; however, the best means to do so should be carefully considered. Currently, fourteen states have no-tax floors in place. Eight of those states also have state EITCs. It is important to note that the two options are not mutually exclusive. With the exception of New Jersey, 13 of the 14 no-tax floor plans are better structured to address many of the flaws in the governor's plan including adjustments for family size and inflation and/or phase-out provisions. For example, many states tie their no-tax floors to the federal poverty line.

Having both strategies in place simultaneously would provide for the broad-based relief set as a goal by the governor's plan, reaching more single filers with no dependents and taxpayers whose income is not wage-based. It would also benefit for low-income working families with children who need help the most. As with all tax cut proposals it would be more expensive to enact both strategies than to choose one over the other.

Conclusion

A no-tax floor could be a viable option for providing income tax cuts to taxpayers not reached by a state EITC, but should be considered in addition to a state EITC rather than in place of one. A state EITC is a better structured proposal that would benefit more than 825,000 taxpayers and their families, especially those with the lowest incomes who need the help the most. At a cost of $67 million, a five percent state EITC is comparable to the $63 million set aside for low-income tax relief by the governor in his 2007-2009 budget. A ten percent EITC at a cost of $134 million would go even further to increase fairness in the state and local tax system and ensure that paying taxes does not push low-and moderate-income working families closer to or deeper into poverty.

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