Fiscal Note & Local Impact Statement

123 rd General Assembly of Ohio

BILL: **H.B. 10** DATE: **March 10, 1999**

STATUS: **As Introduced** SPONSOR: **Rep. Miller**

LOCAL IMPACT STATEMENT REQUIRED: **Yes**

CONTENTS: **Creates a refundable Ohio earned income tax credit (EITC) equal to 15% of the current federal credit**

State Fiscal Highlights

STATE FUND	FY 1999	FY 2000	FUTURE YEARS
General Revenue Fund			
Revenues	- 0 -	$139.7 million loss	$143.9 million loss in FY 2001; losses increase at about 3% annually
Expenditures	- 0 -	- 0 -	- 0 -

Note: The state fiscal year is July 1 through June 30. For example, FY 2000 is July 1, 1999 – June 30, 2000.

- The state will lose $156.1 million in revenue in tax year 1999 (FY 2000) and $160.8 million in tax year 2000 (FY 2001). The state GRF will bear 89.5% of the loss, or $139.7 million in FY 2000, and $143.9 million in FY 2001.
- It appears that Ohio could count the refundable portion of the credit, estimated to be 60%, or $93.5 million, toward the TANF MOE requirement. This would then allow federal dollars that are currently not being spent to be used for services to TANF recipients. In this sense, the $93.5 million would not be lost to the GRF.
- If the work subsidy is effective in helping welfare recipients get and/or keep jobs, future cash welfare costs and medical benefit costs may be avoided.

Local Fiscal Highlights

LOCAL GOVERNMENT	FY 1999	FY 2000	FUTURE YEARS
LLGSF – Libraries and Other Local Governments			
Revenues	- 0 -	$8.9 million loss	$9.2 million loss in FY 2001; losses increase at about 3% annually
Expenditures	- 0 -	- 0 -	- 0 -
LGF and LGRAF – Counties, Municipalities, Townships, Special Districts			
Revenues	- 0 -	$7.5 million loss	$7.7 million loss in FY 2001; losses increase at about 3% annually
Expenditures	- 0 -	- 0 -	- 0 -

Note: For most local governments, the fiscal year is the calendar year. The school district fiscal year is July 1 through June 30.

- The three local government funds would lose a combined $16.4 million in FY 2000 and $16.9 million in FY 2001 from the reduction in state income tax revenue.

- Counties could avoid some welfare costs in the longer run if the work subsidy is successful at helping adults keep jobs and avoid either going on welfare or falling back onto welfare.

Detailed Fiscal Analysis

Background

The proposed Ohio credit would be based on the existing federal credit. Solid data from the IRS, Statistics of Income Division (SOI) is available on the number of Ohioans who claim the federal credit, and the amount of credit claimed. The latest available figures are from tax year 1996, although tax year 1997 figures should be made public soon.

In 1996, approximately 19 million low-income and moderate-income U.S. households received the credit. Among these were 690,866 Ohio households, who claimed $952 million in federal EITC benefits. The federal EITC was extended in 1993 to include very poor individuals without children. Among recipients in Ohio in 1996, 132,557 were workers without a qualifying child. These childless workers were about 19% of the recipients, but they claimed only $26.5 million worth of credits, or less than 3 percent of the total.

The federal credit is determined by the worker's earnings and the number of children in the family. At low income levels, the value of the credit increases as earnings rise (as material that follows makes clear, benefits then plateau and eventually fall). Most means-tested benefit programs work in the opposite fashion—as earnings rise benefits *fall*. Moreover, the EITC does not restrict the eligibility of two-parent families. Two-parent and single-parent families at the same income level receive the same EITC benefit.[1]

The maximum benefits for tax year 1998 (returns filed in 1999) are $2,271 for families with one child and $3,756 for families with two or more children. The maximum amounts go to families with one child that have earnings of at least $6,680 and adjusted gross income (AGI) of no more that $12,250. For families with two or more children the maximum amount goes to families with earnings of at least $9,390 and AGI of no more that $12,250. At income levels above $12,250 the benefits begin to phase out (see Figure 1).

Workers without a child are eligible for a small EITC if their AGI is below $10,040. In 1998, the maximum credit is $341. Nationally, about 3,395,000 very low-income workers received this small EITC, amounting to less than 3 percent of total EITC benefits.

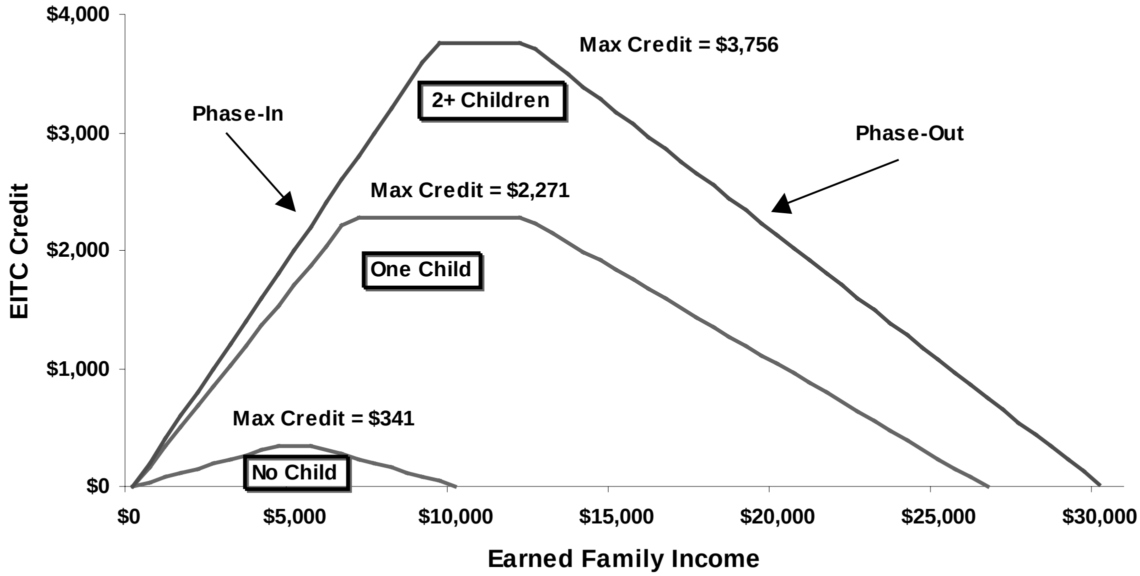
For an Ohio EITC at 15% of the federal credit, the maximum benefit in tax year 1998 would have been:

(i) $563 for families with 2 or more children;
(ii) $341 for families with 1 child;
(iii) $51 for families with zero children.

[1] The Taxpayer Relief Act of 1997 modifies the adjusted gross income (AGI) used to phase out the EITC, beginning in 1998. Filers must add to their AGI tax-exempt interest, nontaxable distributions from pensions and IRAs, and 75 percent of net losses from businesses (up from 50 percent). In addition, no one with more than $2,300 in investment income, such as interest or dividends, may claim the EITC.

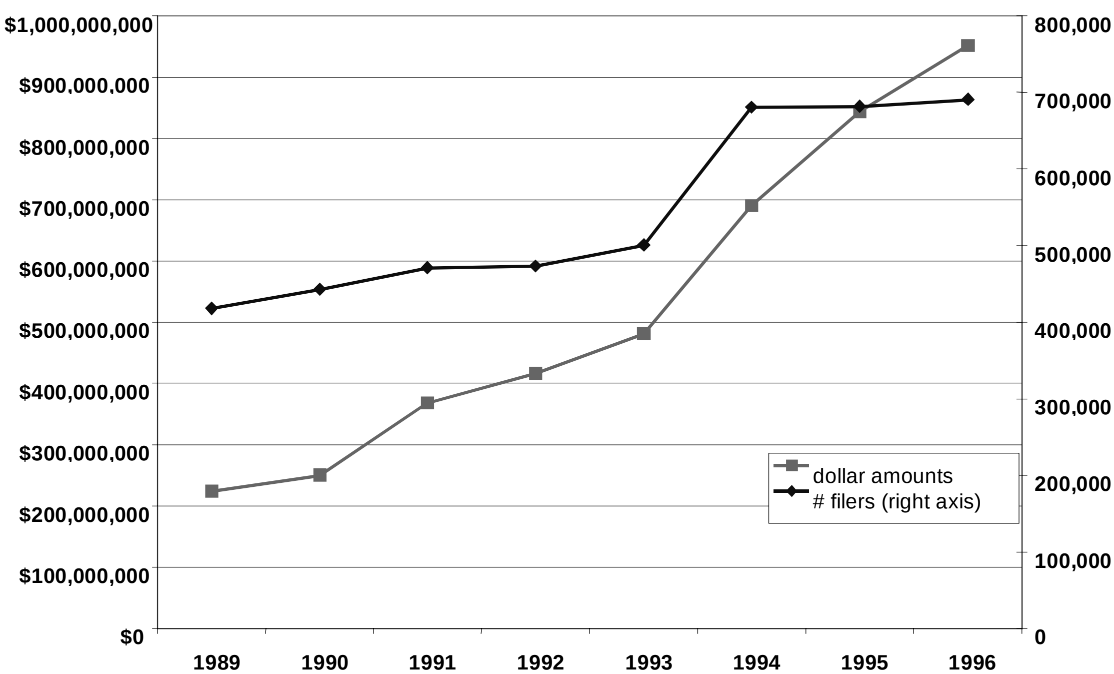
The graph of an Ohio EITC would look just like Figure 1, with lower dollar amounts for the credit.

***Figure 1*:**
Federal EITC Credit Varies with Earned Income and Family Size, 1998 Tax Year



The number of Ohio families receiving the federal EITC, and the total dollar amount of credits claimed, have both risen sharply since 1989. LBO presumes that these increases are the result of the expansions in 1990 and 1993, as well as the enlargement of the workforce. Changes from 1989 to 1996 (the latest year available) are depicted graphically in Figure 2, below. Recipient numbers have slightly increased since 1994, but due to phased-in benefit increases, the credit amounts have continued to rise sharply.

***Figure 2:* Growth in Ohio EITC Recipients and Credit Amounts,**



To estimate the cost of implementing a state EITC in Ohio we have used IRS state level data, which provides information on the number of tax returns and the amount of credit claimed, by income class. Table 1, below, summarizes the basic information on Ohioans who claimed the federal EITC in taxable year 1996 (the last year for which data is available). We have reported the data by two income classes, $0 to $20,000 and $20,000 to $30,000.[2] This is not the optimal breakdown, but it's the way the IRS reports state level data, so we have no choice in the matter.[3]

A look at Table 1 reveals a few salient facts:

TABLE 1

Data on Federal Taxes of Ohioans, Taxable Year 1996

FAGI Class	0-$20,000	$20K - $30K	Total
Ohioans claiming the EITC			
Filers	566,622	124,244	690,866
% of all returns	23.9%	13.8%	12.9%
Dollars	$863,033,000	$89,210,000	$952,243,000
Average/filer	$1,523	$718	$1,378
% of federal tax liability before credit (*)	187.7%	30.7%	100.8%
Non-refundable portion of the EITC			
Filers	68,967	91,012	159,979
Dollars	$130,548,000	$67,410,000	$197,958,000
Average/filer	$1,893	$741	$1,237
% of federal tax liability before credit (*)	28.4%	23.2%	21.0%
Refundable portion of the EITC			
Filers	497,655	33,232	530,887
Dollars	$732,485,000	$21,800,000	$754,285,000
Average/filer	$1,472	$656	$1,421
% of federal tax liability before credit (*)	159.3%	7.5%	79.9%

* federal liability before credit is here computed as estimated liability for EITC claimants only (consistent with Table 3, below), not for all filers in the income class

[2] In prior years, the SOI broke down EITC recipients, along with other Ohio data, into a $0 to $15,000 income class and a $15,000 to $30,000 income class.

[3] There is some disagreement about the EITC numbers for Ohio. In this paper, LBO uses the numbers from the Statistics of Income (SOI) bulletin, published by the IRS's Washington office. The IRS's District Office Research and Analysis Division (DORA) in Cincinnati estimates both a lower number of claims (656,412) and a smaller expenditure ($917.2 million) for tax year 1996. The DORA information has the advantage of providing estimates by county. Those estimates are attached to this paper.

LBO is unable at this point to determine the exact source of the discrepancy, much less to make a judgement call about which data source is superior. Certain unpublished data indicate that the credit amount may be between the DORA and SOI estimates. LBO is using the SOI numbers in the interest of conservatism: if anything, they overstate the potential cost of an Ohio credit.

- The refundable part of the credit is by far the biggest piece. For Ohioans in 1996, the refundable part of the credit accounted for 76.8 percent of the filers (530,887 / 690,866) and 79.2 percent of the dollars ($754.5 million / $952.2).
- The federal EITC benefits about ¼ of Ohio taxpayers whose federal gross income (FAGI) is below $20,000, and about 1/7 of all Ohio taxpayers whose FAGI is between $20,000 and $30,000.
- The average federal tax benefit is about $1,378 per family.

Estimation

In Table 2, below, LBO estimates the revenue loss from a refundable, piggyback state-level EITC at 15% of the federal credit. Table 2 shows that:

- If Ohio had an EITC in effect in taxable year 1996, the revenue loss would have been $142.8 million.
- The average annual benefit per family is $206.75. The benefit is higher for those with incomes below $20,000.
- Because the average Ohio tax liability is so low for filers in the $0 to $20,000 FAGI class, a refundable EITC is several times bigger than the tax liability (295 percent of tax owed). The incentive provided by the EITC is smaller in the $20,000 to $30,000 income class. However, in terms of targeting assistance to welfare recipients first gaining employment, this is appropriate, since most of them will probably take jobs with relatively low wages, so they will fall into the lower income bracket.

TABLE 2

Estimated Revenue Loss from Ohio EITC, Taxable Year 1996

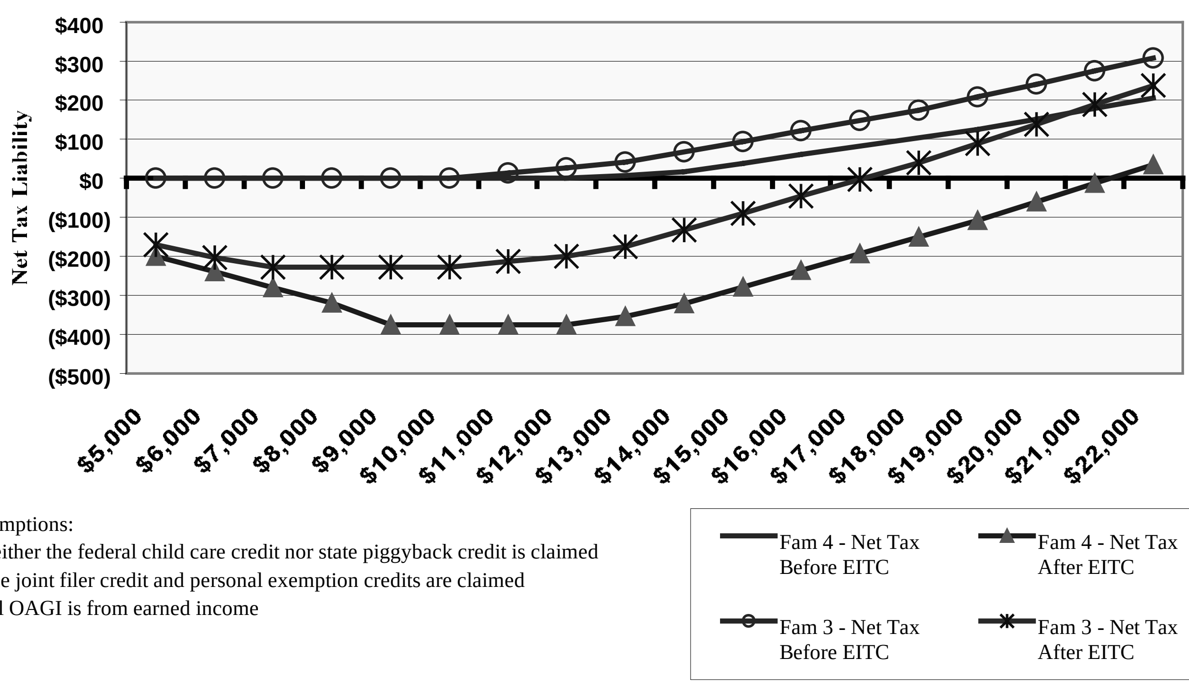
FAGI Class	0-$20,000	$20K - $30K	Total
Ohioans claiming a state EITC			
Claimants	566,622	124,244	690,866
All Ohio Returns	2,128,848	887,300	3,016,148
% of Ohioans who would benefit	26.6%	14.0%	22.9%
Federal Tax Savings	$863,033,000	$89,210,000	$952,243,000
Ohio Credit @15%	$129,454,950	$13,381,500	$142,836,450
Ohio Tax Liability	$164,796,719	$405,966,176	$570,762,895
Estimated Ohio Tax Liability for Filers Claiming the EITC	$43,862,900	$56,845,330	$100,708,230
Average Tax Per EITC Claimant	$77.41	$457.53	$145.77
Average Benefit per Family			
Ohio Credit @15%	$228.47	$107.70	$206.75
Percentage of Income Tax Liability of Claimaints, Covered by the State Credit			
Ohio Credit @15%	295%	24%	142%

Of course, the estimated revenue loss for taxable year 1996 is not the whole story. The federal EITC has shown very strong annual growth since 1990. This was due both to families finding out about the availability of the credit, and to federal law changes that have expanded eligibility and the amount of the credit. However, now that the last expansion, enacted in 1993, was by tax year 1996 fully phased in, significant EITC growth has ended. Projections by the Congressional Budget Office and OMB show that from fiscal year 1998 to fiscal 2003, the EITC is expected to grow at a much slower rate of about 3.0 percent—that is, at a slower rate than expected growth in the U.S. economy, and slower than all other entitlement programs with the exception of farm price supports. Assuming annual growth in the EITC of 3.0%, the estimated revenue loss for tax year 1999 (FY 2000) is $156.1 million. The estimated loss for tax year 2000 (FY 2001) is $160.8 million.[4]

Figure 3, below, shows graphically LBO's estimates of how much a "typical" three or four person family would benefit at varying income levels. We have included families of three because many TANF recipient families, as well as many working poor families, are composed of a parent and two children.

FIGURE 3

Estimated Impact of a 10% State EITC on Ohio Families of Three and Four, Tax Year 1998



Assumptions:
1. Neither the federal child care credit nor state piggyback credit is claimed
2. The joint filer credit and personal exemption credits are claimed
3. All OAGI is from earned income

[4] Published data from CBO in their budget outlook documents show a somewhat higher growth rate, but those figures include the refundable portion of the new per-child tax credit, and exclude the tax offset portion of the EITC. When the figures are adjusted to get a total EITC estimate, the annual growth rate is about 2.7%. OMB projects annual growth through 2003 of about 3.2%. LBO chose to average the estimates and assume a growth rate of 3.0%.

Finally, there is the question of how much of the credit would be refundable in Ohio. In this case, one must not assume that the credit will be 80% refundable, 20% liability offset as in the federal case. In fact, the data suggests that the refundable portion of an Ohio piggyback credit will be less than 80 percent. Furthermore, the portions devoted to refunds and tax offsets will vary with the state credit percentage. In general, a higher state credit percentage will lead to a higher refundable share. This is because state tax liability before the EITC is already determined by other factors: the bigger the EITC gets, the larger the amount devoted to refunds becomes. Table 3, below, shows LBO's calculations of the tax offset and refund portions of the piggyback EITC at 15% of the federal credit.

Table 3

Estimated Refundable and Non-Refundable Shares of EITC, by Credit Level (% of Federal Credit), Tax Year 1999

		Income Level			
Credit Level	Component of Credit	$0 - $20,000	%	Total $0 - $30,000	%
	Total Credit	$141,455,424		$156,077,389	
15%	Refund	$93,526,433	66.1%	$93,526,433	59.9%
	Offset to Tax Liability	$47,928,991	33.9%	$62,550,956	40.1%

So, with a 15% credit, 60 percent of the proposed state EITC is refundable and could count toward the state's Maintenance of Effort requirement (MOE) in the federal Temporary Assistance for Needy Families (TANF) program (see the discussion on using MOE, below). The other 40 percent of the state EITC would have to come from other sources, most likely the state GRF.[5]

Funding Options

As drafted, the bill is silent about paying for the credit. Basically, the money must come from the state GRF, the LLGSF, the LGF, and the LGRAF. However, the state does have options in paying for the credit.

The state could count at least the refundable portion of the EITC toward Ohio's TANF maintenance of effort (MOE) requirement. In guidance to states regarding the administration of TANF programs, as well as in the proposed rule for the TANF program, the federal Department of Health and Human Services (HHS) describes the level of flexibility in developing innovative and creative strategies to support the central goals of welfare reform. As an example of an innovative strategy, both the HHS guidance and the proposed rule documents suggest that states "may choose to expend funds on earned income tax credits . . . that would help low-wage workers keep their jobs."

Of the states that have implemented an EITC (see Appendix B), only Wisconsin currently counts the credit toward meeting its MOE requirement under the TANF program. Indeed,

[5] These are rough calculations based on the aggregate data. Finer calculations would require that LBO have a sample of federal returns of Ohioans. At this point, it appears that the Cincinnati DORA office cannot release such a sample to an agency that is not a state department of revenue.

Wisconsin counts both the refundable and non-refundable portion of the credit toward the MOE. To calculate the portion of the credit which counts toward its MOE, Wisconsin identifies former welfare recipients who are currently filing for the credit and on that basis calculates the amount to count toward the MOE.

In its proposed regulations for the TANF program published November 1997, HHS states that:

Cash assistance also includes State expenditures on behalf of eligible families as part of a State's Earned Income Tax Credit (EITC) program. Under a State EITC program, we have determined that only the EITC cash payments actually sent to eligible families are countable as MOE.

Both Wisconsin and Virginia have requested that HHS allow the non-refundable portion to be counted toward the state's MOE. HHS has so far taken the position that the non-refundable portion is "forgone revenue" and not a payment or expenditure. While it may be possible to structure the EITC in such a way as to constitute a payment rather than a credit—as Virginia is trying to do—it is not clear at this time what response HHS will make. As noted above, in Ohio the non-refundable portion of the federal EITC for tax year 1996 was 21 percent of the total, but for the state piggyback credit the non-refundable portion is estimated to be 40 percent.

The term "eligible families" that is used in the passage quoted above is interpreted by the Administration for Children and Families to mean that: "State expenditures count as MOE only if made to or on behalf of families which: (1) have a child living with a parent or other adult relative (or to individuals which are expecting a child); and (2) are needy under the TANF income standards established by the State under its TANF plan." The income eligibility limit established in Ohio's Prevention, Retention, and Contingency program is 200 percent of the Federal Poverty Guideline (FPG). For a family of three the 1998 FPG is $13,650, and for a family of four it is $16,450. Two hundred percent of these two figures exceeds the maximum income limit for the 1998 federal EITC for families with one child and families with two or more children, respectively (see figure 4). However, the maximum income limit exceeds 200 percent of the FPG for families of two and for families of three composed of one adult and two children. For families with this composition, Ohio can count toward the MOE only the portion of the refundable credit that is for income that falls within the limit of 200 percent of the FPG. In addition, Ohio can not count toward the MOE any credit to workers without qualifying children.

The facts regarding the use of an EITC to meet MOE requirements are summarized in Table 4, below.

Table 4
EITC Payments by Poverty Level and Funding Source

% of Federal Poverty Level	GRF	MOE
Under 200%	non-refundable portion of EITC	refundable portion of EITC
Over 200%	must be used for both refundable and tax offset portions	payments cannot be counted toward MOE

Another question that remains to be determined by HHS is whether state EITC programs will be exempt from the reporting requirements that are mandated for separate state programs. Since HHS has encouraged the development of state EITCs, it seems likely that HHS will accept reasonable "proxy" information that can be derived from tax returns.

States seeking to establish a separate state program that counts toward the TANF MOE requirement should also be aware that expenditures in such programs do not qualify for TANF Contingency Fund MOE purposes. The PRWORA provides matching funds that can be drawn upon by states experiencing an economic downturn. An eligible state must maintain 100 percent of its MOE in the year in which it uses the contingency fund, whereas for other purposes states are required to maintain only a MOE of 80 percent.

TANF Federal Funds

Can a state use federal TANF dollars to fund all or part of state EITC?

As noted above, a large amount of Ohio's TANF federal allotment went unspent in FY 1998. If the state uses TANF federal money directly to fund a state EITC, it can leverage its unobligated reserve of federal TANF funds. Since it avoids dedicating state GRF funds, this option would seem to present the advantage of having a refundable tax credit for low-income Ohio workers paid for with federal funds. While there would seem to be no absolute prohibition on using federal TANF funds for the refundable portion of a state EITC, it seems quite unlikely that states will be able to use federal funds to offset state tax liabilities, if, indeed, it is not illegal.

As well, it should be pointed out that a state EITC can be funded out of its MOE, and then federal TANF funds can be leveraged for programs currently falling under MOE.

There are, however, a number of disadvantages to taking the approach of using federal TANF funds. As noted above, state expenditures as part of a State's EITC program fall within HHS's definition of "cash assistance." All forms of "cash assistance" using federal dollars would seem most likely to fall under the definition of "assistance" and thus be subject to a number of requirements and prohibitions. For example, recipients would be subject to a time limit of five years, minimum hours of work requirements, assignment of child support, and certain data collection requirements. There are also a number of prohibitions to contend with. These include such things as prohibitions against the use of TANF funds to pay for medical services, to provide assistance to unmarried parents under age 18 who do not live in adult supervised settings, to provide assistance for a ten-year period following a conviction of fraud in order to receive benefits in more than one state, to provide any assistance to any individual convicted of a drug-related felony after August 22, 1996, or to provide assistance for “qualified” aliens for a period of five years from their date of entry. Clearly, all of the restrictions and requirements would be so complex and burdensome as to make implementation of a State EITC using federal dollars exceedingly difficult and impractical.

❑ *LBO staff* *Frederick Church, Senior Economist*
Steve Mansfield, Budget Analyst
H:\Fn123\HB0010IN.DOC

APPENDIX A - Impact on Work, Poverty, and Inequality

Census data indicates that the EITC has been effective in reducing poverty and in helping to reduce income inequality.[6] Empirical research also supports the hypothesis that the EITC results in an increase in the number of people working. Recent studies find that expansions in the EITC explain a large portion of the substantial increase in employment rates among single mothers, even prior to welfare reform.[7]

However, empirical research on the issue of whether the EITC serves as a disincentive to additional hours of work once workers reach the "phase-out" range is somewhat contradictory. It has been argued that particularly for two-earner families the phase-out rate acts like an additional tax rate to earnings and thus discourages work over a broad range of incomes. However, some recent research suggests that the most recent expansions of the EITC outweighed any disincentive in the phase-out range.[8]

A concern has also been raised by some policy makers that the EITC "creates a disincentive for marriage" because the parameters of the credit do not change to reflect the marital status of taxpayers.[9] Because of their higher combined incomes, married couples who both work and file a joint return will receive a much lower credit than they would if filing individually. This can happen, but on the other side, there can also be a "marriage bonus," particularly if children are involved. For example, consider the case of an unemployed single mother with two children. On her own, she receives no EITC. If she marries a man who earns $11,000 per year, and they file a joint return, they can claim the 1998 maximum EITC of $3,756.

Generally, the function relating the EITC to marital status is quite complex. There are a number of cases where there can be marriage bonuses, and a number where there are marriage penalties. As a rough rule, families who have children and whose earnings are less than $10,000 receive a marriage bonus because of the EITC phase-in. As incomes rise above $10,000, two-earner couples with children incur a marriage penalty as their total incomes lead to a phase out of their EITC. The penalty is greatest for two-earner families with children whose combined earnings fall roughly in the $20,000 to $30,000 range. In this income range, the EITC is phased out for joint filers. However, if each parent had $10,000 to $15,000 in income and custody of one or more children, and was not married, they would each still get a substantial EITC.

[6] The U.S. Census Bureau makes data available each year on poverty rates before and after government benefits, including the EITC, are counted as income. For a discussion of recent census data and what they show about the effects of various government benefit programs on poverty, see the March 9, 1998 report by the Center on Budget and Policy Priorities, "Strength of the Safety Net: How the EITC, Social Security, and other Government Programs Affect Poverty."

[7] Stacy Dickert, Scott Hauser, and John Karl Scholz, "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation," in James M. Poterba, ed., *Tax Policy and the Economy, Vol. 9*, MIT Press, 1995.

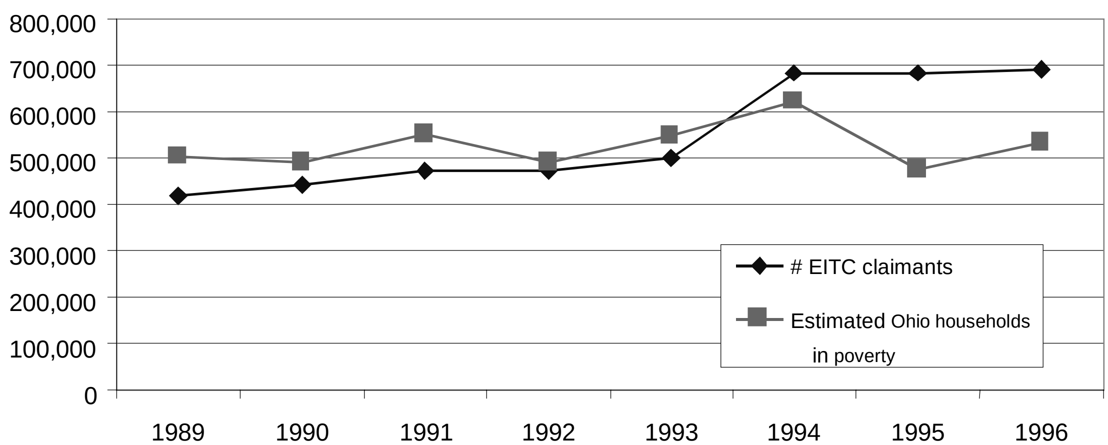
[8] Nada Eissa and Jeffrey B. Liebman, "Labor Supply Response to the Earned Income Tax Credit," *Quarterly Journal of Economics*, May 1996, 112(2), pp. 605-637.

[9] Joint Economic Committee, "Earned Income Tax Credit Page," August, 1995 (http://www.senate.gov/comm/jec/general/eitcpap.html).

Table 5: Federal Poverty Guidelines and EITC Maximum Income Limits (1998)					
Size of Family unit	**EITC Limit, No Children**	**EITC Limit, One Child**	**Eitc Limit, Two or More Children**	**Federal Poverty Guideline (FPG)**	**200% FPG**
One person	$10,040	n/a	n/a	$8,050	$16,100
Two persons	$10,040	$26,460*	n/a	$10,850	$21,700
Three persons	n/a	$26,460	$30,080*	$13,650	$27,300
Four persons	n/a	n/a	$30,080	$16,450	$32,900
Five persons	n/a	n/a	$30,080	$19,250	$38,500
Six persons	n/a	n/a	$30,080	$22,050	$44,100
* exceeds 200% of poverty					

As the table above shows, the EITC even provides tax benefits to families over 100% of poverty. It should not be particularly surprising, then, that the EITC expansions of 1993 have pushed the number of Ohio claimants above the estimated number of Ohio households in poverty. Of course, the design of the credit to include families above 100% of poverty is not arbitrary: it serves the purpose of continuing to provide a tax incentive for work even when the poverty level has been exceeded. Among other things, this should discourage the working poor from sliding back onto welfare.

***Figure 4*: Ohio Poor Families vs. EITC Recipients, 1989-1996**



APPENDIX B – States With Earned Income Tax Credits

Table 6 State Earned Income Tax Credits		
State	**Percentage of Federal Credit**	**Workers Without Qualifying Children Eligible?**
Refundable credits:		
Kansas	10%	Yes
Maryland[a]	10% in 1998 12.5% in 1999 & 2000 15% in 2001	No
Massachusetts	10%	Yes
Minnesota	15% — no qualifying children About 25% — families with children[b]	Yes
New York	20%	Yes
Vermont	25%	Yes
Wisconsin	4% — one child 14% — two children 43% — three children	No
Non-refundable credits:		
Iowa	6.5%	Yes
Maryland[a]	50%	Yes
Oregon	5%	Yes
Rhode Island	27%[c]	Yes

Notes.
[a] A Maryland taxpayer may claim either the refundable credit or the larger non-refundable credit, but not both credits.
[b] Minnesota's credit for families with children, unlike the other credits shown in this table, is not expressly structured as a percentage of the federal credit. Depending on income level, the credit may range from 20 percent to 42 percent of the federal credit; the average state credit is about 25 percent of the federal credit.
[c] Rhode Island's credit is phasing down to 25 percent of the federal credit over five years as part of an overall reduction in the state income tax.