

Department of Legislative Services
 Maryland General Assembly
 2006 Session

FISCAL AND POLICY NOTE

House Bill 346 (Delegate Hixson, *et al.*)
 Ways and Means

Income Tax - Earned Income Credit - Refundable Amount

This bill increases, from 20% to 25%, the percentage of the federal earned income credit (EIC) that must exceed the State income tax in order for an individual with one or more dependents to claim the State refundable credit. The bill also increases the calculation of the county refundable EIC, if the county has a refundable EIC. The county refundable EIC authorized by the bill would be the amount by which five times the federal EIC multiplied by the county income tax rate exceeds the county income tax liability.

The bill takes effect July 1, 2006 and applies to tax year 2006 and beyond.

Fiscal Summary

State Effect: General fund revenues could decrease by approximately \$28.1 million in FY 2007 due to an increase in refundable EICs claimed. Future years reflect the estimated number of individuals claiming the credit. No effect on expenditures.

(\$ in millions)	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
GF Revenue	(\$28.1)	(\$29.3)	(\$31.3)	(\$32.6)	(\$33.9)
Expenditure	\$0	\$0	\$0	\$0	\$0
Net Effect	(\$28.1)	(\$29.3)	(\$31.3)	(\$32.6)	(\$33.9)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Expenditures could increase by approximately \$3.4 million in FY 2007 in Montgomery County due to an increase in grants distributed from the county's EIC program.

Small Business Effect: None.

Analysis

Current Law: An individual who qualifies for the federal EIC and has one or more dependents can claim a refundable State EIC equal to 20% of the federal credit, minus any pre-credit State income tax liability. The nonrefundable State EIC is currently 50% of the federal EIC, not to exceed the total pre-credit State income tax liability.

To the extent provided, the county refundable EIC is the amount by which four times the federal EIC multiplied by the county income tax rate exceeds the county income tax liability.

Background:

Federal EIC

The federal EIC began in 1975 as a temporary program to return a portion of the Social Security taxes paid by lower-income taxpayers and was made permanent in 1978. The Tax Reform Act of 1986 increased the maximum benefit of the credit and phase-out levels and indexed the credit to inflation. The next substantive expansion of the credit occurred in the 1990s with the federal Omnibus Budget Reconciliation Acts of 1990 and 1993. Both laws again increased the value of the credit and phase-out levels. The 1990 law provided for different credit amounts for taxpayers with one or two and more children, and the 1993 law expanded the credit to childless taxpayers.

The expansion of the credit in the 1990s is estimated to have tripled the cost of the credit, and the credit is now the largest anti-poverty entitlement program. The federal EIC is generally considered a successful anti-poverty program by researchers. A joint Internal Revenue Service (IRS) – Department of Treasury task force estimated that nationwide the EIC lifted 4.3 million individuals, including 2.3 million children, out of poverty in 2000. In recent years, the IRS has paid about \$30 billion annually to about 29 million EIC recipients.

The federal tax credit, however, has been consistently plagued by overclaim rates. The IRS estimated that 27 to 32% of EIC credits in 1999 (the last year data is available) were erroneously or fraudulently claimed, or approximately \$8.5 to \$9.9 billion out of a total of approximately \$31 billion claimed. In response, the IRS has instituted a certification process and other reforms in an effort to reduce overclaim rates. The IRS' relative degree

of success in reducing overclaims will impact Maryland's EIC, since State eligibility standards rely on whether the taxpayer claimed the federal EIC.

Maryland EIC

Maryland's income tax law has provided a nonrefundable State EIC equal to 50% of the federal EIC since 1987. Chapter 5 of 1998 established a refundable EIC for taxpayers who both meet the eligibility requirements of the federal credit and have at least one dependent. The value of the initial refundable credit was equal to 10% and increased in two steps to 15% in tax year 2001 and beyond.

Chapter 493 of 1999 altered the calculation of the credit allowed against the county income tax in response to the 1997 tax law establishing flat county income tax rates. The amount of credit allowed against the county income tax is equal to the amount of federal EIC claimed multiplied by 10 times the county income tax rate, not to exceed the county income tax liability for the tax year.

Chapter 510 of 2000 accelerated to tax year 2000 the 15% value of the credit and also authorized counties to provide, by law, a county refundable EIC. While no county has provided a refundable credit that can be claimed with the tax return under the formula provided under State law, Montgomery County's Earned Income Credit program acts as a grant program by matching the State EIC claimed by the taxpayer. Under the program, eligible taxpayers receive a check from the Comptroller, but the grants are paid for by Montgomery County. Chapter 581 of 2001 phased in an additional 5% increase in the value of the credit, with a three-step increase of the credit increasing its value to 20% beginning in tax year 2004.

Earned Income Tax Credits in Other States

Seventeen states and the District of Columbia offer earned income tax credits that supplement the federal credit. Most of these states follow the federal practice of making the credit refundable. **Exhibit 1** summarizes the EIC in other states, expressed as a percentage of the federal credit.

Exhibit 1
Earned Income Tax Credits – Other States

<u>State</u>	<u>Percent of Federal EIC</u>
	<u>Refundable</u>
Minnesota	Varies with earnings, average 33%
New Jersey	20% (if income ≤ \$20,000)
Vermont	32%
New York	30%
District of Columbia	25%
Kansas	15%
Massachusetts	15%
Colorado*	10%
Indiana	6%
Illinois	5%
Oklahoma	5%
Wisconsin	4% – one child, 14% – two children, 43% – three + children
	<u>Nonrefundable</u>
Rhode Island**	25%
Delaware (effective TY 2006)	20%
Virginia (effective TY 2006)	20%
Iowa	6.5%
Maine	5%
Oregon	5%

*Colorado's credit is currently suspended.

**Five percent of any excess is refundable.

Source: Department of Legislative Services

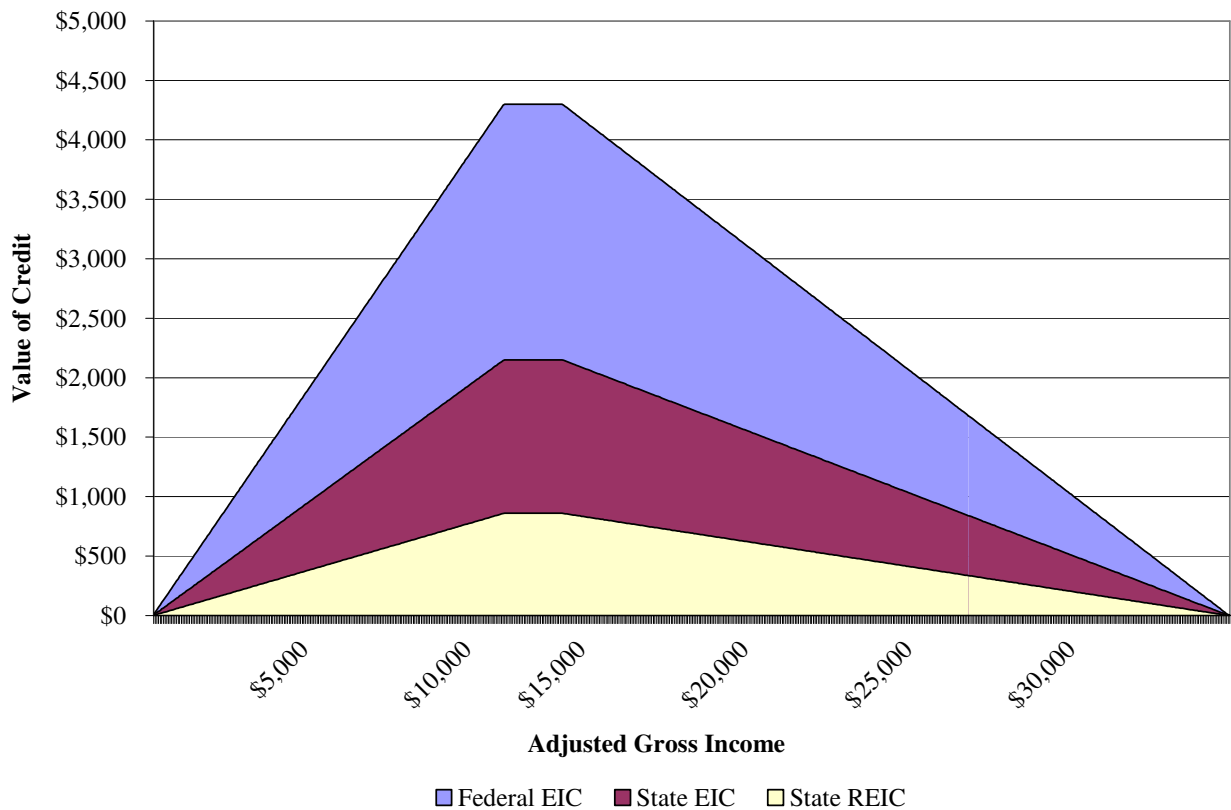
EIC Value, Requirements, and Amounts Claimed

To claim the federal EIC in tax year 2004, a taxpayer must have earned income, less than \$2,650 of investment income, and a modified federal adjusted gross income of less than \$11,490 with no qualifying children, \$30,338 with one qualifying child, or \$34,458 with two or more qualifying children. In tax years 2004 and earlier, the phase-out range is

\$1,000 higher for joint returns. The Economic Growth and Tax Relief Reconciliation Act of 2001 increases the phase-out range for joint returns by \$1,000 for tax years 2005 through 2007 and by \$2,000 for tax years 2008 and beyond. In order to claim the credit, no taxpayers can file under married filing separately, and taxpayers without qualifying children must be between 25 and 65 years old and cannot be the dependent or qualifying child of another taxpayer.

Exhibit 2 illustrates the value of the federal EIC, State EIC, and State refundable earned income tax credits (REIC) in tax year 2004 for an individual taxpayer with two or more dependents.

Exhibit 2
Earned Income Credits for an
Individual with Two Dependents
Tax Year 2004



Source: Internal Revenue Service, Department of Legislative Services

The actual value of the State credits claimed, however, may not always equal the amount shown above and depends on the taxpayer's tax liability.

In tax year 2003, 349,585 State taxpayers claimed approximately \$1.1 billion in federal EIC credits, 239,410 claimed approximately \$64.1 million in State EICs, and 189,335 claimed approximately \$67.8 million in State refundable EICs. **Exhibit 3** lists the breakdown by county the amount of State EIC and refundable EIC in tax year 2003.

**Exhibit 3
State EIC Claimed by County
Tax Year 2003**

	<u>Number of EIC Returns</u>	<u>EIC Amount</u>	<u>EIC Percent Total of Returns</u>	<u>Number of REIC Returns</u>	<u>REIC Amount</u>	<u>REIC Percent Total of Returns</u>
<u>Western Maryland</u>						
Allegany County	3,066	\$815,629	10.4%	2,518	\$886,754	8.6%
Garrett County	1,461	402,014	11.9%	1,083	380,860	8.8%
Washington County	5,524	1,521,269	9.1%	4,189	1,439,491	6.9%
Region Total	10,051	\$2,738,912	9.8%	7,790	\$2,707,105	7.6%
<u>Central Maryland</u>						
Anne Arundel County	14,740	\$3,808,874	6.4%	11,934	\$4,389,427	5.2%
Baltimore City	30,606	15,214,020	21.8%	44,546	16,007,066	18.2%
Baltimore County	53,265	8,378,080	8.4%	22,170	7,905,778	6.1%
Carroll County	3,499	933,736	4.8%	2,727	929,028	3.8%
Frederick County	5,734	1,511,469	5.8%	4,255	1,488,337	4.3%
Harford County	6,273	1,694,481	6.0%	4,855	1,630,257	4.7%
Howard County	5,492	1,396,841	4.7%	4,264	1,511,764	3.7%
Montgomery County	27,903	6,913,957	6.6%	22,129	8,145,088	5.3%
Prince George's County	48,759	12,909,336	12.9%	38,095	14,247,192	10.1%
Region Total	196,271	\$52,760,794	9.7%	154,975	\$56,253,937	7.6%
<u>Lower Eastern Shore</u>						
Dorchester County	2,184	\$646,679	15.6%	1,756	\$601,869	12.6%
Wicomico County	5,087	1,426,015	13.5%	4,143	1,475,899	11.0%
Somerset County	1,508	406,574	17.0%	1,344	459,072	15.1%
Worcester County	2,323	622,611	9.5%	1,865	611,951	7.6%
Region Total	11,102	\$3,101,879	13.0%	9,108	\$3,148,791	10.7%

	<u>Number of EIC Returns</u>	<u>EIC Amount</u>	<u>EIC Percent Total of Returns</u>	<u>Number of REIC Returns</u>	<u>REIC Amount</u>	<u>REIC Percent Total of Returns</u>
<u>Upper Eastern Shore</u>						
Caroline County	1,771	\$480,307	13.2%	1,502	\$542,973	11.2%
Cecil County	3,220	890,233	8.3%	2,553	872,906	6.6%
Kent County	889	237,806	10.3%	670	227,275	7.8%
Region Total	5,880	\$1,608,346	9.7%	4,725	\$1,643,154	7.8%
<u>Southern Maryland</u>						
Calvert County	2,230	\$592,285	6.0%	1,826	\$628,441	4.9%
Charles County	4,403	1,194,941	7.5%	3,558	1,209,668	6.0%
St. Mary's County	3,043	816,133	7.7%	2,421	846,213	6.1%
Queen Anne's	1,244	322,013	6.4%	1,012	352,112	5.2%
Talbot County	1,528	418,353	9.3%	1,065	368,888	6.5%
Region Total	12,448	\$3,343,725	7.3%	9,882	\$3,405,322	5.8%
Nonresident	3,658	\$562,760	3.9%	2,855	\$611,571	3.0%
Total	239,410	\$64,116,416	9.4%	189,335	\$67,769,880	7.5%

Source: Income Tax Summary Report, Tax Year 2003, Office of the Comptroller

Approximately 9.6% of all State resident tax returns claimed the EIC while approximately 7.6% of all resident returns claimed the refundable EIC. Although both EICs are concentrated in Baltimore City and Prince George's County (representing approximately 44% of all credits claimed as compared with approximately 27% of the State's population), the credits are claimed frequently in other parts of the State. One of the credits is claimed more frequently than the average State resident rate in seven other counties (Allegany, Caroline, Dorchester, Garrett, Kent, Somerset, and Wicomico). Generally, the credit has a high claim rate in Baltimore City, Prince George's County, Western Maryland, and the lower Eastern Shore excepting Talbot and Worcester counties. The credit is claimed more infrequently in the Baltimore and Washington DC suburbs (excepting Prince George's County) and Southern Maryland.

State Revenues: The provisions of the bill increasing the value of the credit are effective beginning tax year 2006. As a result, general fund revenues could decrease by approximately \$28.1 million in fiscal 2007 and by \$33.9 million in fiscal 2011. This estimate is based on existing data on the EICs and takes into account the effect of federal

legislation that will increase the amount of the individuals who will be able to claim the credit in future tax years.

The State recently enacted an increase in the minimum wage paid to private sector workers who are covered by federal or State labor regulations. It is not clear what impact this will have on the amount of refundable EIC claimed by individuals. Increasing the amount of minimum wages paid to a lower-income individual would increase the amount of earned income of the individual that qualifies for the federal EIC, potentially increasing the individual's federal EIC. For example, the increase in the minimum wages paid to a full-time worker with labor-income only and two dependents in tax year 2005 would lead to an increase of \$8 increase in the State refundable EIC claimed. However, not all individuals affected would realize an increase. For taxpayers who had a federal adjusted gross income of at least \$11,000, an increase in wages paid would decrease the amount of State refundable EIC claimed.

Local Expenditures: Montgomery County has a local EIC grant program based on the State's refundable EIC. Payments for this county EIC grant are made in the fiscal year following the fiscal year in which the returns are filed. Accordingly, Montgomery County expenditures could increase by approximately \$3.4 million in fiscal 2007, \$3.6 million in fiscal 2008, \$3.8 million in fiscal 2009, \$4.0 million in fiscal 2010, and \$4.1 million in fiscal 2010. No county has currently authorized a refundable county EIC as provided under current law.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Comptroller's Office, Internal Revenue Service, Department of Legislative Services

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