

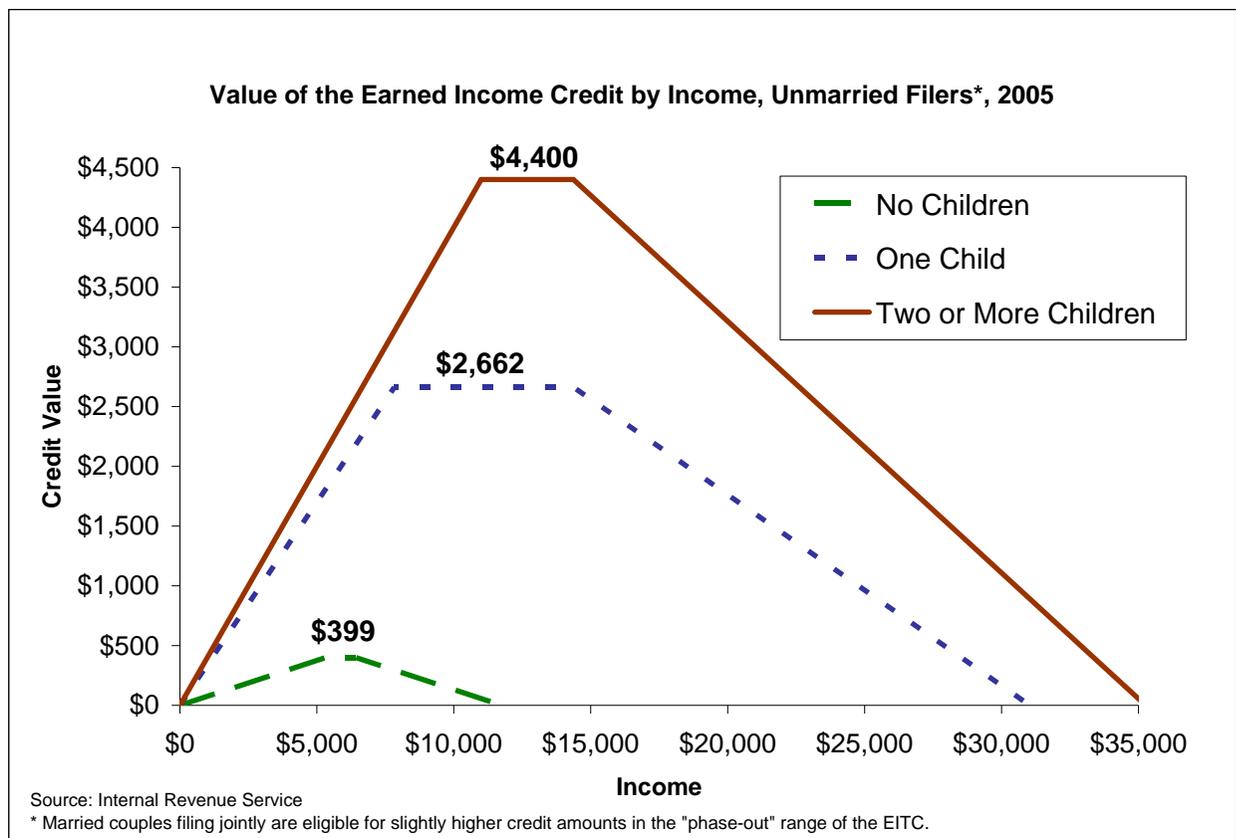
# POLICY MATTERS OHIO

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## Credit Where It's Due: The Earned Income Tax Credit in Ohio

By David Rothstein

The federal Earned Income Tax Credit (EITC) or Earned Income Credit (EIC) is a refundable tax credit available to some working individuals and families who earn less than \$37,263. This credit currently does more to bring working families out of poverty than any other government program. An estimated four million families were lifted above the poverty level because of the EITC program in 2003. The EITC, which varies in value according to family size, marital status and income, can reach a maximum of \$4,400 in the 2005 tax year.



In the 2003 tax season (the latest data available), more than 769,000 Ohio families received the EITC at an average credit of \$1,720, which brought more than \$1.3 billion in federal refunds to Ohio.<sup>1</sup> More EITC dollars come to Ohio than to all but seven other states, and Ohio accounts for approximately 3.4% of all the nation’s credits.

| <b>The Federal Earned Income Tax Credit in Ohio (2003)</b> |                  |                                     |  |                    |
|--|------------------|-------------------------------------|--|--------------------|
| <b>Some Key Facts</b>                                      |                  |                                     |  |                    |
| Total Ohio filers  | Ohio EITC claims | EITC claims as percentage of filers | Total federal dollars refunded to EITC claimants in Ohio | Average EITC value |
| 5,349,587  | 769,212          | 14%                                 | \$1,322,025,827  | \$1,719            |

Source: IRS SPEC database

Ohio could enact a state EITC at a fairly modest cost to the state budget. Providing a state EITC, as 19 states currently do, would be a very well-targeted way of providing modest additional resources to low-income working families, primarily those with children.<sup>2</sup> States that have enacted state EITCs have credits ranging from five percent to 40 percent depending on earnings and other factors. Most states with an EITC have chosen to make those credits refundable, which allows families to receive the full amount of the credit even if the credit is larger than their income tax liability. A refundable EITC at the state-level in Ohio would benefit more than 769,000 families. A ten percent Ohio EITC would provide the average family \$172 annually, at a cost to the state of about \$132.2 million, less than one percent of state expenditures (\$20 billion) in 2005. A 20 percent Ohio EITC would provide about \$344 to the average family and cost about \$264.4 million.

| <b>Costs and Benefits of a State Earned Income Tax Credit in Ohio</b> |                             |               |                             |               |
|---|-----------------------------|---------------|-----------------------------|---------------|
|   | Ohio EITC at 10% of federal |               | Ohio EITC at 20% of federal |               |
| Families benefiting   | Cost to state               | Average claim | Cost to state               | Average claim |
| 769,212   | \$132,202,583               | \$172         | \$264,405,165               | \$344         |

Source: Author’s calculation, based on IRS SPEC data

At least ten states now use a portion of their TANF funds to help pay for a state EITC. This is appropriate because the EITC is targeted to working families earning less than \$37,000 and the vast majority of the credit goes to those with children and those earning substantially less than this ceiling. Federal regulations prohibit TANF dollars from being used to void tax liability at the state level, but funds can be used to refund above the tax liability.<sup>3</sup>

<sup>1</sup> All data comes from the IRS SPEC Return Information Data Base, Tax Year 2003 (October 2005) and the Brookings Institution, unless otherwise noted.

<sup>2</sup> For more information of state EITC efforts, see The Hatcher Group at [www.stateeitc.com](http://www.stateeitc.com) and the Center on Budget and Policy Priorities at <http://www.cbpp.org/pubs/eitc.htm>.

<sup>3</sup> See Ami Nagle and Nicholas Johnson “A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2006,” <http://www.cbpp.org/3-8-06sfp.htm>.

There are ways, beyond enacting a state EITC, in which the program can be made to work better for families. For example, the EITC is often not claimed by eligible participants because they do not file taxes, file incorrectly, or are unaware that the credit exists. The IRS estimates that close to 20 percent of those eligible for the credit do not receive it. However, new studies have also shown that some of those who do claim the credit might not be eligible, and levels of claiming vary from community to community. We previously estimated that the number of EITC recipients could be expanded by about 15 percent, and there is reason to think that such an estimate remains accurate. It's clear that while perhaps more than 100,000 eligible people are not taking part, participation could be expanded by at least five percent (38,460) with more aggressive outreach.<sup>4</sup>

| <b>Expanding the EITC in Ohio</b> |  |   |  |
|-----------------------------------|--|---|--|
| EITC Claims                       | Potential short-term increase in EITC recipients in Ohio, with aggressive outreach | Estimated average unclaimed credit <sup>5</sup> | Estimated potential short-term increase in refunds coming to Ohio families |
| 769,212                           | 38,460   | \$1,289   | \$49,575,713   |

Local coalitions in Cuyahoga County and elsewhere in the state have established volunteer income tax assistance centers (VITA sites) to try to increase claims. The IRS VITA program is a community-run entity, where trained and certified volunteers prepare taxes for free to low-income individuals and families. A coalition in Cuyahoga County, the Cuyahoga EITC Coalition, has seen tremendous gains in the effort to file taxes for free.<sup>6</sup> In 2006, coalition members expect to bring more than \$2 million in EITC and other refunds back into the community.

Low-income families who don't go to volunteer tax preparers sometimes don't file, despite being eligible. In other cases, they go to paid preparers who often charge high fees to prepare the return, and also often convince filers to purchase high-interest loans that enable them to get their returns a little bit more quickly. In Ohio, more than 65 percent of those receiving the EITC went to paid preparers and on average, spent \$120 in preparation and administrative fees.

<sup>4</sup> See Alan Berube "Earned Income Credit Participation: What We (Don't) Know," <http://www.brookings.edu/metro/eitcparticipation.pdf>.

<sup>5</sup> This estimate is based on a calculation of 75 percent of the average Ohio EITC credit.

<sup>6</sup> The Cuyahoga EITC Coalition was established in 2004, see [www.refundohio.org](http://www.refundohio.org) for more information.

| <b>Paid preparation for EITC claimants in Ohio, 2003</b> |  |  |
|--|--|--|
| Number of EITC claimants getting paid preparation        | Percent of EITC claimants getting paid preparation | Estimated overall cost of paid preparation for EITC claimants (at \$120) |
| 503,290  | 65%  | \$60,394,800   |

Of EITC recipients who did go to paid preparers, more than 60 percent purchased high interest loans to get their return that day. These loans, called refund anticipation loans (RALs) often have interest rates of 250 percent. In combination with other fees, paid preparation can cost a filer anywhere from \$150 to more than \$300. The National Consumer Law Center estimates that each year, hundreds of millions of dollars that could have gone to families are diverted to refund loans.<sup>7</sup> In Ohio, more than 300,000 families purchased RALs, and as mentioned, more than 500,000 used paid preparers. If these families spent \$120 on tax preparation and \$130 on a loan (a conservative estimate), then Ohio’s low-income families lost more than \$99 million to paid preparers in 2003.

| <b>Refund anticipation loan purchases by EITC claimants in Ohio, 2003</b> |  |   |  |  |
|---|--|---|--|--|
| Number of RALs  | RALs as a percentage of all EITC returns | RALs as a percentage of EITC claimants getting paid preparation | Estimated cost of RALs for EITC claimants (at \$130) | Estimated cost of RALs and paid preparation for EITC claimants |
| 300,110   | 40%                                      | 60%   | \$39,014,300   | \$99,409,100   |

Enacting a state EITC and doing more to ensure that eligible families know about the credit, know where to access free preparation services, and know to avoid expensive refund loans are three things that Ohio could do to enrich low-income working families and communities in Ohio. Pairing a state EITC with the federal program would also help local communities. The EITC program brings money into communities because much of the credit is spent on basic needs, education, and other local goods and services.<sup>8</sup> Policy Matters Ohio found that many families receiving the EITC use it for paying bills and basic needs, many purchased in the community.<sup>9</sup> Other studies find a direct link from receiving the EITC to wealth and asset building in the community.<sup>10</sup>

<sup>7</sup> See Chi Chi Wu (2006) “High-Priced Refund Anticipation Loans Continue to Take a Chunk Out of Americans’ Tax Refunds,” <http://www.nclc.org/news/content/2006RALReport.pdf>.

<sup>8</sup> For more information, see Timothy M. Smeeding, Katherin E. Ross, and Michael O’Connor, “The EITC: Expectation, Knowledge, Use, Economic and Social Mobility,” *National Tax Journal*, December 2000.

<sup>9</sup> David Rothstein, *Who Takes Credit? Earned Income Tax Credit Recipients in Cleveland.*, Policy Matters Ohio, November, 2005: [http://www.policymattersohio.org/who\\_takes\\_credit.htm](http://www.policymattersohio.org/who_takes_credit.htm).

<sup>10</sup> For two such studies, see The Jacob France Institute, University of Baltimore “The Importance of the Earned Income Tax Credit and Its Economic Effects in Baltimore City,” June 2004 at <http://www.ubalt.edu/jfi/jfi/reports/EITC-rept.pdf>. and Texas Perspectives Inc. “Increased Participation in the Earned Income Tax Credit in San Antonio: 2004 Update,” November 2004 .

## **Conclusions and Recommendations**

**1. Enact a state EITC.** Enacting a state EITC would further help working families with children handle monthly expenses and build assets. Even a small state EITC credit of ten percent would do much to help low-income families with basic expenses. Representatives Miller and Skindell introduced legislation that would enact an Ohio EITC at 20 percent of the federal credit (HB 20).<sup>11</sup> HB 20 was introduced in January of 2005 and remains in the Ways and Means Committee.<sup>12</sup>

**2. Enact RAL legislation.** Ohio does little to regulate paid tax preparation. Other states have passed RAL disclosure legislation and Connecticut has a cap on RALs of sixty percent annualized interest rate.<sup>13</sup> Consumers deserve this kind of protection. Regulating interest rates that banks and paid sites can charge for RALs and requiring that paid preparers disclose the fact that customers can e-file to receive their full refund in approximately ten days are two potential reforms. Former State Senator Mark Mallory of Cincinnati introduced a Tax Refund Protection ACT (SB 59) offering several RAL protections to customers in February 2005, but the bill did not leave the Finance Committee in the Senate.<sup>14</sup>

**3. Increase funding to the VITA program.** Federal policymakers have the opportunity to increase support for the IRS VITA program. A small percentage of eligible low-income families utilize this service and more assistance in the form of advertising, staff, and training would greatly benefit the free filing effort. Increased use of e-filing would also increase the speed of refunds to families.

**4. Create and strengthen community efforts.** Cities, municipalities, and counties across Ohio should invest resources in outreach and VITA sites for the EITC program, as Cuyahoga County did in funding a local coalition. Communities see large returns on their investment through wealth and asset building, volunteerism, partnerships between banks and low-income families, and financial literacy training. Community partnerships should include more than government entities and should involve some of the following: social service agencies, banks, area universities, non-profit groups, accounting firms, religious institutions, United Way, and school districts.

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<sup>11</sup> For more information on HB 20, see [http://www.legislature.state.oh.us/bills.cfm?ID=126\\_HB\\_0020](http://www.legislature.state.oh.us/bills.cfm?ID=126_HB_0020).

<sup>12</sup> As of 3/15/2006, HB 20 remains in the Ways and Means Committee of the Ohio House of Representatives.

<sup>13</sup> As of 3/15/2006, 9 states have RAL regulation: Connecticut, California, Illinois, Minnesota, Nevada, North Carolina, Oregon, Washington State, and Wisconsin.

<sup>14</sup> See [http://www.legislature.state.oh.us/bills.cfm?ID=126\\_SB\\_59\\_I](http://www.legislature.state.oh.us/bills.cfm?ID=126_SB_59_I) for more information on SB 59.

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