HOW INCREASING THE FEDERAL EITC AND CTC COULD AFFECT STATE TAXES

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The American Rescue Plan (ARP) Act of 2021, as passed and signed into law on March 11, 2021, temporarily increases the federal earned income tax credit (EITC) and child tax credit (CTC). These federal increases are designed in part to offset the disproportionately negative economic effects of the COVID-19 pandemic on people with low incomes. The federal tax changes will unambiguously reduce federal taxes by increasing tax benefits for low- and middle-income families.

In some states, these federal changes will affect state taxes because of existing linkages between federal and state tax codes. Of the 28 states with an EITC (as well as the District of Columbia, or DC), 25 will see an automatic increase in their state credits because these states calculate their EITCs as a percentage of the federal EITC. Thus, whenever the federal credit is increased, the state credit (without state legislative action) is also increased. Three states with EITCs (California, Indiana, and Wisconsin) will not see automatic increases, because their state credits are not set at a percentage of the federal credit. Minnesota will see only minor changes in eligibility (but no change to its maximum credit) as a result of expanding access to the credit to younger and older people. We estimate that state EITCs will rise for about 4.6 million households in these 25 states and DC. The average state credit increase for those households will be about $153. Only one state, Oklahoma, has a CTC that will automatically change if the federal CTC changes. About 300,000 households in Oklahoma will see an average increase in their state CTC of about $100.

The legislation will also increase state taxes for about one million taxpayers. Most of these taxpayers will be in states that allow people to reduce their taxable state income by the amount of federal income tax they pay. By reducing federal income taxes, primarily with the increase in the CTC, the proposals will increase state-level income taxes for those taxpayers by an average of about $115. Even with this increase, however, these households will still be much better off because the average reduction in federal taxes from the CTC change (about $2,700) will far outweigh the small state tax increase. Only those with lower federal taxes will face higher state taxes, and overall they will see larger reductions in federal tax than increases in state tax.

The federal EITC and CTC provide substantial assistance to low- and moderate-income families with children. The EITC also provides a small credit to workers without children at home, called "childless" for tax purposes. Together, they lift more people out of poverty than any other government program except Social Security (Fox 2020).

The ARP increases the EITC for childless workers, roughly tripling the maximum benefit to $1,500. It also allows childless workers with moderate incomes to benefit from the credit. The credit will not be fully phased out until a childless worker's income reaches just over $21,000 for single people or $27,000 for married couples, about $5,000 higher than under current law. We estimated in earlier work that this will deliver about $11.8 billion in benefits to 16.5 million workers, representing about 13.5 percent of all childless tax filers in 2021. Benefits will be highly concentrated among the bottom 20 percent of the income distribution (Maag and Airi 2021).

The ARP will also increase the CTC from up to $2,000 per child under age 17 to up to $3,600 per child under age 6 and $3,000 per child under age 18. Importantly, rather than phasing in with earnings as the current CTC does, the full amount of the CTC will go to all low-income children even if their parents do not work. This expansion will deliver about $105 billion in benefits to 40 million families with children.[1] Although the benefits of making the credit fully refundable will be highly concentrated among the bottom 20 percent of the income distribution, the other changes will be more evenly divided over all but the top income quintile.[2]

These federal changes to the EITC and CTC will also trigger automatic changes to 25 state EITCs and DC's EITC along with one state CTC. This happens because these state tax credits "conform" to the federal credits (i.e., they use the same rules and calculations, so when the federal laws change, state laws change as well). In total, state EITCs will deliver an additional $712 million in benefits to 4.6 million households as a result of the federal changes. The CTC in Oklahoma will deliver $30 million in benefits to about 300,000 households.[3]

One federal-state link could lead to *higher* state taxes after the ARP. Six states (Alabama, Iowa, Louisiana, Missouri, Montana, and Oregon) allow taxpayers to deduct federal income taxes from state taxable-income calculations. By reducing taxes owed at the federal level, people in these states will have more income taxed by state-level income taxes (the same thing happened after the 2017 Tax Cuts and Jobs Act lowered federal taxes in 2018). We estimate about 1 million households will owe an average of $115 more in state income taxes as a result of the higher federal child credits.[4] Even with this increase, these households will still be much better off, because to get the state tax increase,

[1] Table T21-0031 "Child Tax Credit (CTC) Enhancement in House Ways and Means Committee Budget Reconciliation Legislative Recommendations", February 10, 2021.

[2] Elaine Maag, "Expanding the Child Tax Credit: Full Refundability and Larger Credit," *TaxVox*, May 26, 2020.

[3] The estimates were done for 2019, the latest available year for the Tax Policy Center's State Income Tax Model. The state EITC matching rates were adjusted to reflect the rates in effect for 2021.

[4] We did not model federal changes to the federal Child and Dependent Care Tax Credit. If we had, a small number of additional tax units would have seen their federal tax drop and their state income taxes increase as a result. Tax Policy Center estimates the expanded Child and Dependent Care Tax Credit will provide benefits to less than 12 percent of all families with children (Table T21-0047).

households had to get a federal tax cut. For example, the average federal tax cut from the CTC change (about $2,700)[5] will far outweigh the average state tax increase ($115).

STATE LINKS TO FEDERAL CHILD TAX CREDITS AND EARNED INCOME TAX CREDITS

As with federal income taxes, many states provide credits that reduce taxes for households with low incomes and families with children. In part, these credits are designed to encourage work, raise the incomes of low-wage workers, and adjust taxes for family size. A family of four tends to have larger expenses (and therefore less ability to pay taxes) than a family of two at any income level. In general, state tax credits are smaller than federal tax credits (Maag 2013).

Although states could design credits independent of federal design, modeling state credits on federal credits can make tax filing easier, because people can simply reference already calculated lines on federal forms and transfer them to state tax forms rather than making new calculations. This also makes tax administration easier for the states. The more similar state credits are to federal credits, the more states are able to piggyback on federal enforcement efforts for their own enforcement.

Ties between state and federal EITCs are particularly tight. In 2021, all 28 states and DC that have an EITC have some connection to the federal credit (table 1). Twenty-five states and DC calculate their EITCs as a percentage of the federal credit, with the match percentage ranging from 3 percent to 100 percent for the childless worker EITC (though some states have more generous rules or extend their EITC to additional taxpayers). Most state credits and the DC credit are refundable, like the federal EITC, meaning taxpayers can receive payments (tax refunds) if their EITC is greater than the amount of income taxes they owe so that they get the full value of the EITC they qualify for. However, six states (Delaware, Hawaii, Ohio, Oklahoma, South Carolina, and Virginia) have EITCs that are nonrefundable. In these states, only the amount of EITC that can offset state income taxes can be received. This is important to remember when thinking about the federal expansion, because if the credit is nonrefundable, an increase to the EITC for workers with very low incomes will be unlikely to alter state EITCs – because the family already likely owes no state income tax (Rueben, Sammartino, and Stark 2017).

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[5] Table T21-0030 "Child Tax Credit Enhancement in House Ways and Means Committee Budget Reconciliation Legislative Recommendations", February 10, 2021. https://www.taxpolicycenter.org/model-estimates/ways-and-means-committee-budget-reconciliation-legislative-recommendations-4.

TABLE 1

Characteristics of State Earned Income Tax Credits for Childless Workers

2021

	Percent of federal credit	Maximum State Credit Before American Rescue Plan	Maximum State Credit After American Rescue Plan	Refundable
California	--	246	246	Yes
Colorado	10	54	150	Yes
Connecticut	23	125	346	Yes
Delaware	20	109	301	No
District of Columbia	100	543	1,503	Yes
Hawaii	20	109	301	No
Illinois	18	98	271	Yes
Indiana	9	49	135	Yes
Iowa	15	81	225	Yes
Kansas	17	92	256	Yes
Louisiana	5	27	75	Yes
Maine	25	136	376	Yes
Maryland	50, 28	272, 152	752, 420	Yes
Massachusetts	30	163	451	Yes
Michigan	6	33	90	Yes
Minnesota	--	289	289	Yes
Montana	3	16	45	Yes
Nebraska	10	54	150	Yes
New Jersey	40	217	601	Yes
New Mexico	17	92	256	Yes
New York	30	163	451	Yes
Ohio	30	163	451	No
Oklahoma	5	27	75	No
Oregon	9	49	135	Yes
Rhode Island	15	81	225	Yes
South Carolina	42	226	626	No
Vermont	36	195	541	Yes
Virginia	20	109	301	No
Wisconsin	NA	NA	NA	NA

Source: Tax Policy Center State Income Tax Model.

Notes: EITC = earned income tax credit; NA = not applicable. Wisconsin does not allow a state EITC for households without children. California's EITC links to certain federal definitions for the EITC but overrides the parameters for calculting the credit with state-specific ones. Indiana links to the federal EITC that was in place prior to the Supplemental Appropriations Act of 2009 (P.L. 111-32). The Maryland percentage is 50 percent for the nonrefundable credit and 28 percent for the refundable credit. Minnesota sets its own credit parameters but bases eligibility on the federal EITC. The District of Columbia's credit for childless workers phases out at higher income levels and can thus be larger than the federal EITC.

The connection between the federal CTC and state CTCs is less tight. Many states have tax credits related to the number of children in a household, and they may even call them a "child tax credit," but only Oklahoma currently conforms to the federal CTC. New York's Empire State CTC is based on the federal CTC as it would have been calculated using the federal rules in place for tax year 2017 (i.e., it avoids benefit increases introduced under the Tax Cuts and Jobs Act of 2017).

CHANGES TO FEDERAL EARNED INCOME AND CHILD TAX CREDITS CAN AUTOMATICALLY FLOW THROUGH TO STATE CREDITS

State tax connections to the federal code are either "rolling" (i.e., state laws automatically change with federal changes) or "static" (i.e., states must formally adopt federal law changes into their code with legislation). If rolling-conformity states want to keep changes from happening automatically, they must pass a law to decouple their state income tax system from the federal income tax system (Auxier and Sammartino 2018). States might be particularly prone to doing this if the federal change would reduce state revenue significantly (Mazerov 2021).

In 2021, all but two of the 28 states and DC with a link to the federal EITC[6] have rolling links to the federal code: a change in the federal EITC will automatically flow through to these 26 jurisdictions unless state legislation prevents it. Indiana has a static link to the federal code and will be unaffected by the federal change (unless the legislature approves it), and California's state law overrides most of the federal EITC parameters and will similarly be unaffected. Wisconsin has a rolling link to the federal EITC but does not allow an EITC for childless workers and therefore will be unaffected by the federal EITC change for that population. As a result, EITCs in 25 states and DC will be affected by the change to the federal EITC for childless workers.

For the CTC, the only state with a connection, Oklahoma, has a rolling link to the federal code, so federal changes will automatically flow through to the state.

IMPACT OF STATE TAX CUTS FROM HIGHER STATE TAX CREDITS

Assuming none of the 25 states and DC that have automatic connections to the federal EITC "decouple" from the ARP's changes, we estimate around 4.6 million households without children will receive an additional $712 million more in state credits (table 2). On average, households with an increase in the EITC will see their state-level EITC rise by $153, or about 23 percent of the federal average increase of $670. The average benefit increase varies by state, from a high of $785 per affected household in DC to almost nothing in Ohio. That average is heavily influenced by DC.

In general, states where credits are a larger share of the federal credit and where the state credit is refundable see the highest average changes. States with nonrefundable credits see smaller changes if they exempt very low–income people from state-level income taxes. (The Tax Policy Center estimates that just over half of the EITC for childless workers goes to people in the bottom one-fifth of the income distribution.[7])

People who qualify for a childless EITC in DC qualify for a DC credit that is at least as large as the federal credit. DC has a 100 percent match for workers with incomes less than the federal EITC phaseout. Because the DC childless EITC begins to phase out at higher incomes than the federal childless EITC, some people qualify for DC EITCs larger than the federal credit for which they qualify. DC's childless EITC was structured this way to bump up the EITC for this group of people, who were largely left out of federal credits. DC may opt to adjust the match rate for childless workers in response to the federal increase. The District could, for example, deliver a credit of 40 percent of the federal credit for childless workers, just as it does for workers with children, now that the value of the federal credit has been increased.

Ohio has a relatively high percentage of the federal credit (30 percent), but its credit is nonrefundable, meaning it can only offset taxes owed. All benefits of the federal credit after the expansion will accrue to single people with incomes under about $16,000 and married couples with incomes under about $21,000. Very few of these workers have any Ohio state tax to offset, so they receive little benefit from their nonrefundable EITC.

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[6] Tax Policy Center Briefing Book. The State of State (and Local) Tax Policy. How do state earned income tax credits work? https://www.taxpolicycenter.org/briefing-book/how-do-state-earned-income-tax-credits-work

[7] Authors' calculations based on T21-0055 – Tax Benefit of the Earned Income Tax Credit, by Expanded Cash Income Percentile 2021.

TABLE 2

Increases in State Earned Income Tax Credits under the American Rescue Plan Act of 2021 (2019 Income Levels)

	Thousands of households benefiting	Average benefit	Share of benefit to households with AGI < 10k	State cost ($ millions)
Colorado	227	72	38	16
Connecticut	146	162	40	24
Delaware	16	97	0	2
District of Columbia	45	785	28	36
Hawaii	28	114	1	3
Illinois	547	128	41	70
Iowa	123	107	41	13
Kansas	117	116	41	14
Louisiana	188	40	43	8
Maine	73	181	39	13
Maryland	253	207	34	52
Massachusetts	292	213	41	62
Michigan	434	47	41	20
Minnesota	82	164	56	13
Montana	42	26	39	1
Nebraska	76	74	38	6
New Jersey	374	278	39	104
New Mexico	104	122	40	13
New York	978	203	43	199
Ohio	NA	NA	NA	NA
Oklahoma	68	33	3	2
Oregon	187	68	40	13
Rhode Island	52	108	39	6
South Carolina	37	63	0	2
Vermont	33	247	40	8
Virginia	104	122	0	13
Overall	4,648	153	39	712

Source: Tax Policy Center State Income Tax Model.
Notes: Estimates are for 2019, which is the latest available year for the Tax Policy Center's State Income Tax Model. NA = not applicable; fewer than 500 households would be affected in Ohio.

As with the additional federal credit, most of the additional state EITC will go to lower-income households. Almost 40 percent of the additional state credits will go to households with adjusted gross income (AGI) less than $10,000, with 97 percent going to households with AGI under $20,000. The share of households in any state with AGI below $10,000 that benefit from the increase in state-level EITC varies from 0 to 43 percent, with almost no benefit going to that group in states where the EITC is not refundable.

About 300,000 households in Oklahoma will receive an average benefit of around $100, for a total of $30 million in benefits. Less than 1 percent of the change in Oklahoma will go to households with AGI under $20,000, because the state CTC is not refundable, so only those households with tax to offset could benefit from the increased credit. Just under half of the benefit will go to Oklahoma households with AGI between $20,000 and $50,000, and just over half of the benefit will go to households with AGI over $50,000. The Oklahoma CTC is more targeted than the federal CTC because it phases out at lower incomes than the federal credit, which extends benefits to over 90 percent of all families with children.

STATE TAX INCREASES STEMMING FROM FEDERAL CHILD TAX CREDIT INCREASES

Although Oklahoma is the only state where taxpayers will benefit from its links to the federal CTC, it is not the only state with taxpayers who will be affected by the federal change. About 1 million households across other states will see their state income taxes increase as their federal income taxes drop from the larger CTC. Three-quarters of those taxpayers are in states with a federal income tax deduction. That is, these states allow taxpayers to reduce their taxable income by the amount of their federal income tax bill. If federal taxes drop, more income will be taxed at the state level.

Other interactions between federal and state laws cause the state tax increase for other households. For example, some states limit certain state credits to federal tax liability. With lower federal tax liability because of the expanded CTC, households can claim less in state credits. This can occur, for example, in Maryland and New York.[8]

The overall average increase in state taxes for those households with a state tax increase is around $115. Despite the small state income tax increase, households are unambiguously better off as a result of the changes to the CTC because the average federal tax reduction (about $2,700) far outweighs any state tax increase.

CONCLUSION

As with many previous federal tax changes, the ARP will affect more than federal taxes—it will change state taxes as well because of conformity rules. Unless states take action to offset its impact, the ARP will increase state EITCs in 25 states and DC, with an average tax reduction of $153 for the 4.6 million childless workers who will see their state EITCs increase. Oklahoma and its CTC will automatically reduce state taxes by about $100 for 300,000 households.

In all cases, states that conform their tax codes automatically to changes in the federal code could pass legislation to decouple their state credits from the federal credit. This would break links between federal and state taxes, which are generally considered both beneficial to taxpayers because they lessen the calculations needed for state income taxes and beneficial to states because they can then rely somewhat on federal enforcement measures.

The federal CTC increases will reduce federal income taxes by about $108 billion in 2021. Some states allow people to reduce how much income they owe tax on by the amount of their federal income taxes. In these states, the drop in federal taxes will lead to more income being taxed at the state level. In other cases, states limit state tax credits to the amount of tax owed at the federal level. When less tax is owed at the federal level, these state tax credits drop. In total, we estimate 1 million households will owe on average about $115 more in state taxes as a result of the cut to the CTC.

[8] For a more complete discussion, see appendix A of Weiner (2020).

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