

# The Working Families Tax Rebate

By Stacey Schultz and Jeff Chapman

## Executive summary

Washington State is in a deep economic recession. Working families are struggling to make ends meet as more and more people lose their jobs, their homes, and their health insurance. Businesses are struggling to survive as consumer spending plummets.

An unprecedented state budget deficit threatens to make the situation worse. Legislators have responded to the fiscal crisis by proposing deep cuts to the public supports that are most important during tough times. Not only are these proposed cuts harmful to the health and economic security of Washingtonians in the short term, they will have the long term effect of slowing down the overall economic recovery in the state.

A strategy to raise state revenue is needed to avoid dismantling our education, health, and economic infrastructures. But because of Washington State's regressive tax structure, tax increases may unfairly impact lower income earners.

The Working Families Tax Rebate is a strategic response to both the economic and fiscal crises in Washington State. The WFTR will:

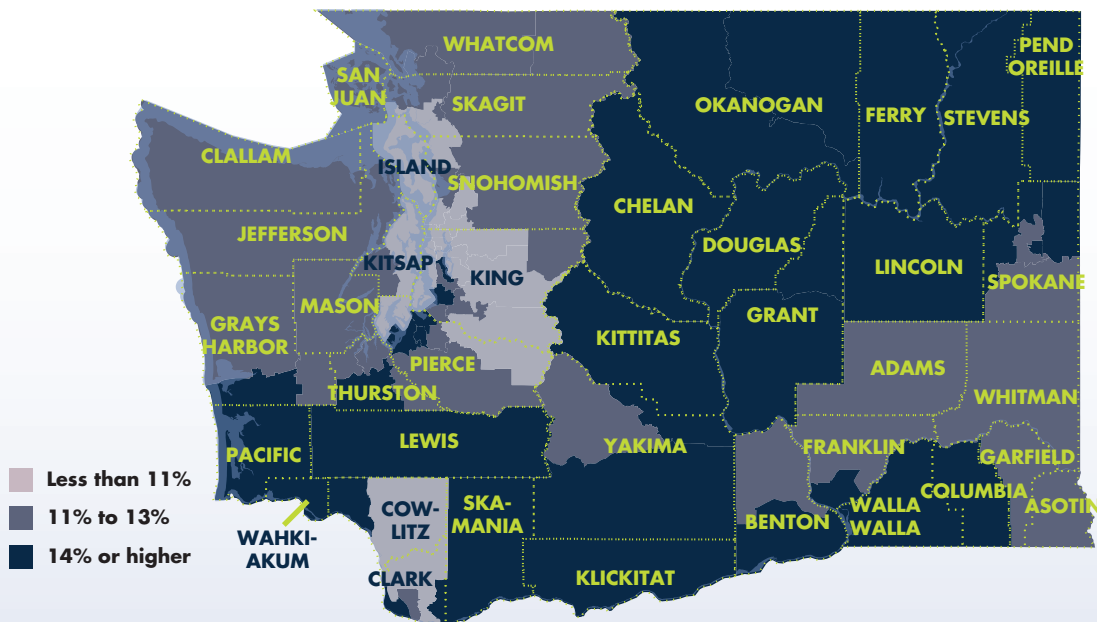
- Refund up to \$500 of the state sales tax to over 350,000 households in Washington.
- Help families and communities recover from the economic recession.
- Offset the costs of a necessary revenue increase for lower income working families.

## A proven approach

The Working Families Tax Rebate will refund a portion of the state retail sales tax to the 350,000 Washington households who qualify for the federal Earned Income Tax Credit.<sup>1</sup> By doing so, the WFTR will provide an income boost to hard-working Washingtonians.

The groundwork for implementation of the WFTR has already been laid. The measure was signed into law last year. Since then, the Department of Revenue has begun to estab-

FIGURE 1: Share of tax return filers eligible for Working Families Tax Rebate in 2006, by legislative district



Source: BPC analysis of Brookings/IRS data

lish an efficient system that builds on the success of the federal EITC.

Administration of the WFTR will be easy to administer and cost effective. The Department of Revenue has an agreement with the federal Internal Revenue Service to receive information about Washington State recipients of the EITC. When Washingtonians fill out a simple online form to apply for the WFTR, the Department of Revenue will be able to match that information with data from the IRS. Since the IRS is responsible for determining an applicant's eligibility, a significant portion of the administration and enforcement of the WFTR will be done by the federal government.

The WFTR will be calculated as a flat percentage of the EITC. A rebate set at ten percent of the federal EITC would provide a tax break of up to \$500 for

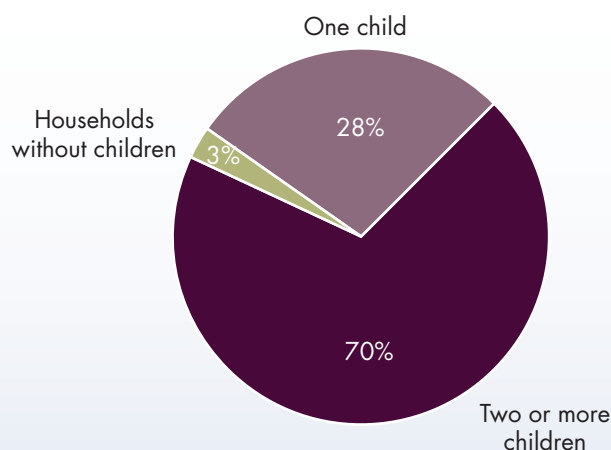
lower income working families. In total it would return over \$60 million annually to working families in Washington.<sup>2</sup>

Twenty three states (including the District of Columbia) have a state EITC that is administered as a percentage of the federal credit. In these states, piggybacking on the federal EITC has proven to be a very effective way to provide additional support to lower income working families. Washington is the first state in the nation without an income tax to enact an EITC and will be a model for other states.

### Recovery for families and communities

The Working Families Tax Rebate will help families and communities recover from the economic recession. Statewide, 12 percent of households were eligible for

FIGURE 2: Percent of Working Families Tax Rebate funds that go to families with children



Source: BPC analysis of American Community Survey

the EITC and would have therefore been eligible for the WFTR. Every community in the state would benefit. Figure 1 shows the share of tax filers who would have been eligible for the WFTR in 2006 by legislative district. The districts with the highest percentages of eligible Washingtonians live in rural and small metropolitan areas. For example, one in four tax filers in the Yakima area would have been eligible for the WFTR.

Experience in other states suggests that implementation of a state tax credit will spur more families to sign up for the federal EITC, bringing additional money into Washington homes and communities.

Nationwide, about 70 percent of EITC checks are spent in the month they are received. A 2003 survey of EITC recipients in Colorado showed their top priorities were to pay immediate bills, make car repairs, and purchase school clothes for children.<sup>3</sup> Other studies indicate that families use the EITC to pay for rent, food, moving costs, educational expenses, and to reduce debt. Two-thirds of parents who receive the

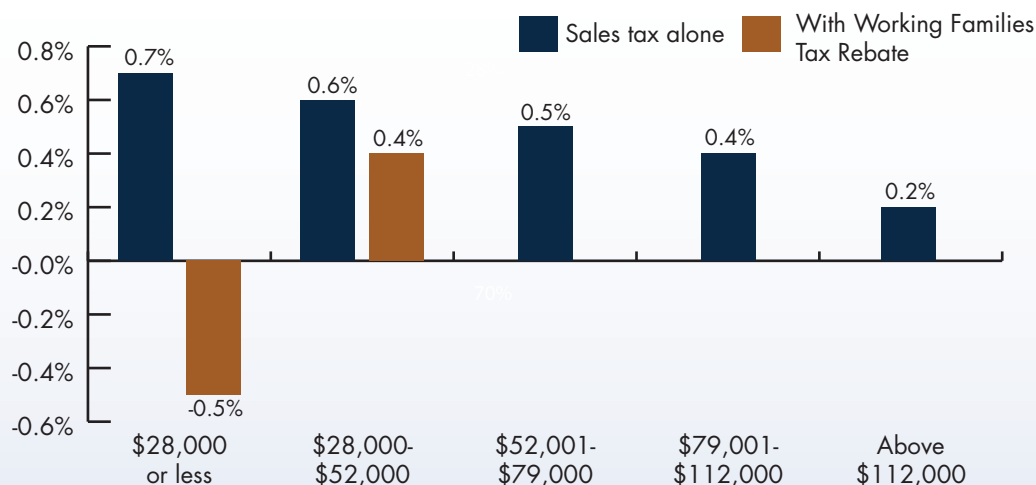
EITC cite spending on children as the priority use of the funds.<sup>4</sup>

Likewise, the Working Families Tax Rebate will overwhelmingly impact families with children. Over 95 percent of the total rebate in Washington State would flow to working families with children (Figure 2). Over 90 percent of these parents earn below 200 percent of the federal poverty level (\$35,200 for a family of three). Families with incomes below this mark often struggle to make ends meet.

### Maintaining our priorities

The state is currently facing a historic budget deficit in large part due to the economic recession. Rather than address the primary cause—inadequate revenue—the Governor and legislators have proposed deep budget cuts. These cuts will do lasting harm to the security, opportunity, and health of working families. Proposed cuts include:

FIGURE 3: Annual cost of sales tax increase and Working Families Tax Rebate as a share of income for families with children



Source: Institute for Taxation and Economic Policy analysis

- Reductions in the number of lower income people who can access affordable health insurance through Basic Health by 40,000.
- Cuts to community colleges and public universities that will limit the availability of education and workforce training.
- Deep reductions in the funds used to equalize school funding across districts.

Cuts such as these would come at a time when public supports are needed most. A revenue increase is necessary to avoid these and other damaging budget reductions.

### Tax fairness

The state has a number of options for raising revenue in order to avoid making deep cuts in important public investments. One example of a revenue option is an increase in the state retail sales tax. A sales tax increase

from 6.5 percent to 7.5 percent would yield about \$2 billion over the biennium. It would be the first state sales tax increase since 1983. A one-penny increase in the retail sales tax would cost lower income families with children an average of \$125 per year. Upper income families would pay about \$544 per year.

While upper income families would pay more in absolute terms, an increase in the sales tax would cost lower income families more as a share of their income. As shown in Figure 3, the sales tax increase would amount to 0.7 percent of income for lower income families, compared to 0.2 percent for upper income families.

The Working Families Tax Rebate is an important tool for revenue policy because it can offset the impacts of a tax increase for families who are struggling to make ends meet during the recession. Figure 3 also shows the net impact of a sales tax increase combined with a Working Families Tax Rebate. The bottom fifth of

Washington families (those earning under \$28,000) would actually see a net decrease in sales tax. The rebate would also significantly lower the cost of the sales tax increase for the next bracket of earners (those earning between \$28,000 and \$52,000).

As noted, because of the structure of the federal EITC, the Working Families Tax Rebate primarily benefits families with children. Adults without children can qualify for the EITC, but they receive a much smaller credit. Importantly, the WFTR does not benefit people who did not work for wages in the previous year. It is therefore an imperfect solution to the problem of the regressivity of a sales tax increase. In the future, progressive reforms to the state's tax system will be needed to fully address the inherent inequities.

## Conclusion

The Working Families Tax Rebate is an effective tool the state can use as part of a strategy for economic and fiscal recovery. It builds on the highly successful federal Earned Income Tax Credit, which lifts millions of people out of poverty nationwide each year. Washington lawmakers should consider raising revenue to avoid deep budget cuts that will harm the state and use the Working Families Tax Rebate to offset the disproportionate impact a regressive tax increase would have on lower income families.

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## Endnotes

1. BPC analysis of Brookings/IRS data
2. Ibid.
3. Spiros Protosaltis, "The Earned Income Tax Credit in Colorado: An Overview," The Bell Policy Center, Denver, Colorado. Based on tax year 2002.
4. Ibid.