

# MONEY MATTERS...\$...\$...\$

FOR KIDS, FOR COMMUNITIES, FOR KENTUCKY

A Fiscal Policy Research Brief  
By Kentucky Youth Advocates

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## Repealing State Car Tax is Wrong Vehicle for Low-Income Tax Reform:

How to Spell True Tax Relief: E-I-T-C

### Introduction

Providing tax relief through repeal of the state car tax is a bad idea. Very little tax relief would actually go to lower- and middle- income persons. Instead, larger benefits would accrue to persons owning Porsches, Jaguars and such. If alleviating the excessive tax burden on low- and moderate-income persons is the goal, implementing a state earned income tax credit would provide more targeted, more direct assistance to those who need relief the most.

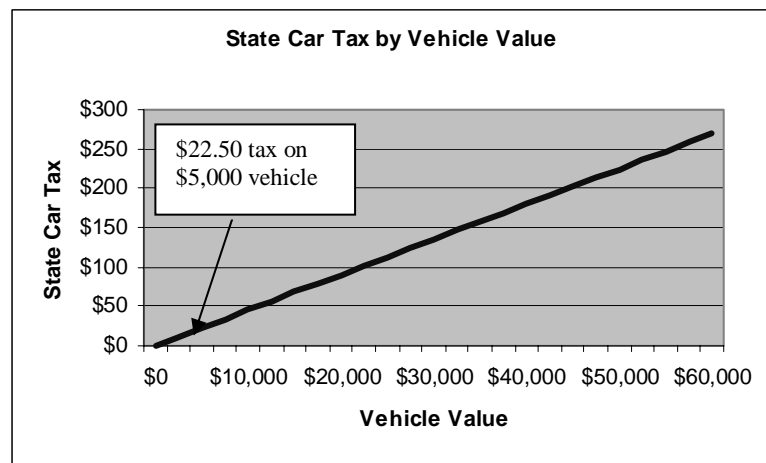
### CAR TAX VS. EITC

To receive the same \$572 tax relief, a family of three earning just \$14,000 would either have to:  
A) own a \$127,000 vehicle or  
B) receive a 15% state EITC.

### Who Pays the State Car Tax?

Everyone who owns a motor vehicle pays an annual tax to the state government based upon the value of his or her vehicle. The state tax rate is \$0.0045 on every dollar. Here's how the tax is calculated. Take, for example, a person owning a \$5,000 vehicle. They would annually pay a \$22.50 state car tax [ $\$5,000 \times 0.0045$ ]. Or consider a person owning a \$40,000 vehicle. They would pay \$180 [ $\$40,000 \times 0.0045$ ]. Figure 1 below shows the relationship between vehicle value and state car tax. As shown, the car tax rises proportionally with vehicle value.

Figure 1



## Tax Relief: State Car Tax Repeal vs. State EITC

Given the choice between repealing the state car tax and implementing a refundable state EITC as a way of providing low- and moderate-income tax relief, the latter wins hands down. A refundable state EITC provides greater tax relief to a more targeted population than repeal, or even partial repeal, of the state car tax. Figure 2 highlights the monetary benefits of a state EITC compared to repeal of the state car tax. It shows that a state EITC provides greater tax relief to lower income persons than does repeal of the state car tax. Let's explain.

As we know, the car tax is based upon the value of one's vehicle. A state earned income tax credit, on the other hand, is based upon a family's annual earnings. So, in order to compare the tax benefits created by repealing the state car tax to the tax benefits created by implementing a 15% state earned income tax credit<sup>1</sup>, we must make at least one assumption. In this case, we decided to hold vehicle value constant at \$5,000. That is, we assume that every low-income person owns a car worth \$5,000. Clearly, this assumption does not apply to all low-income persons. Some will own cars with lower vehicle values; thereby reducing the tax relief that repeal of the state car tax will create. And other low-income persons will not even own a vehicle. This fact will negate any positive impact that repeal of the state car tax would have. Still, choosing \$5,000 as the basis of our analysis has additional merit since H.B. 825 would exempt persons from paying the state car tax if their vehicle was valued at or below \$5,000.

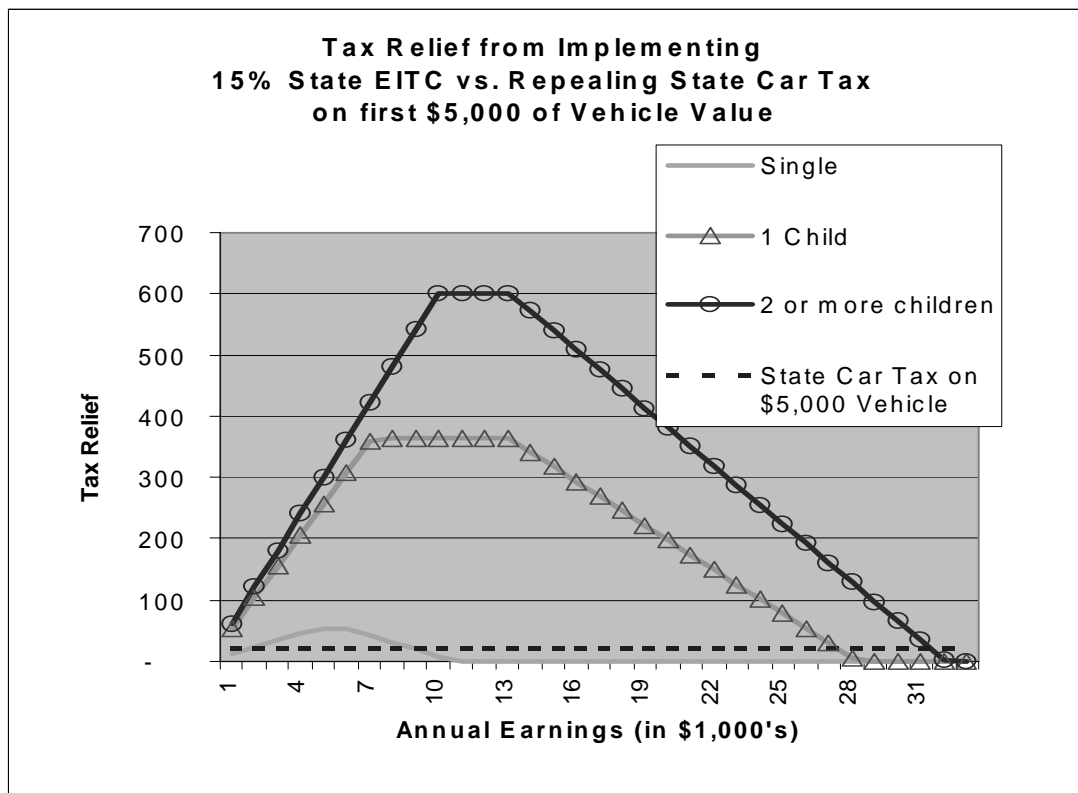


Figure 2

<sup>1</sup> Assumes that this family meets all the eligibility requirements necessary to receive the federal earned income tax credit.

In order to get a better feel for the information found in Figure 2, let's look at a few examples.

**Example 1**

Mary and Joe have two children and combined annual earnings of \$25,000. Let's also assume that they own a \$5,000 vehicle—a reasonable hypothesis given that this vehicle represents one-fifth of this family's annual earnings.

Repeal of the state car tax would save Mary and Joe \$22.50 annually. A refundable 15% state EITC, by comparison, would save the family \$224 annually, a 900% improvement over the state car tax repeal!

Vehicle Value	\$5,000	Annual Earnings	\$25,000
Savings from Car Tax Repeal	\$23	Savings from State EITC	\$224
		<b>EITC Improvement:</b>	<b>\$202</b>

**Example 2**

Carol has two children and annual earnings of \$14,000—which is poverty level income. For example purposes, she also owns a \$5,000 vehicle.

Under this situation, Carol's annual state car tax bill is the same \$22.50 as with Mary and Joe. If the state car tax were repealed, she would save \$22.50; the amount of the state car tax. If a 15% refundable state EITC was implemented, however, this same family could have their tax bill cut by \$572! This is a 2,400% improvement compared with repeal of the car tax.

Vehicle Value	\$5,000	Annual Earnings	\$14,000
Savings from Car Tax Repeal	\$23	Savings from State EITC	\$572
		<b>EITC Improvement:</b>	<b>\$549</b>

Similar results occur for most persons earning less than \$34,000 and owning a vehicle valued at less than \$28,000.

**Conclusions**

A 15% refundable state EITC would provide significantly greater tax relief to low- and moderate- income families than would repeal, or partial repeal, of the state car tax. Further, a state EITC provides targeted relief to working low-income persons. Repealing the state car tax, on the other hand, only minimally reduces a lower-income person's tax bill; and then only if they own a car. By comparison, a state EITC does not make owning a car a prerequisite for tax relief. Repealing the entire state car tax—a position endorsed by a majority of Kentuckians in a 1998 constitutional amendment—would cost \$75 million annually; a 15% refundable state EITC would cost about \$69 million annually.

## **What is an Earned Income Tax Credit (EITC)?**

The earned income tax credit is an offset to a working person's individual income tax liability. In layman's terms, an EITC reduces the amount of income taxes that a working person owes. And for some low-income persons, the EITC means additional tax relief via a cash refund.

The federal government first used the EITC. It was implemented in the 1980's with the endorsement of President Reagan. One of the primary attractions was the requirement that individuals have earnings—hence, they must have worked—in order to be eligible for the EITC.

The EITC is widely recognized as an effective and efficient means of providing targeted tax relief to low- and moderate-income working individuals, particularly those with children. Today, families with two children and earnings less than \$34,000 are eligible for the federal EITC.

Presently, 15 states and the District of Columbia also have a state earned income tax credit. These state EITC's are modeled on the federal government tax credit.



This research brief is produced by Kentucky Youth Advocates, through the State Fiscal Analysis Initiative. Any questions or requests for further information concerning Money Matters should be directed to Rick Graycarek, Senior Analyst, 624 Shelby Street, Frankfort, KY 40601, [rgraycarek@kyyouth.org](mailto:rgraycarek@kyyouth.org), 502-875-4865. Additional tax and budget information can be found at KYA's website, [www.kyyouth.org](http://www.kyyouth.org).