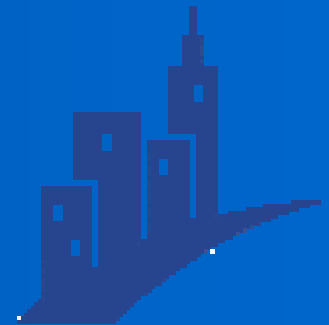


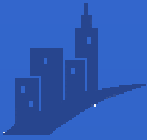
The Brookings Institution

Metropolitan Policy Program
Alan Berube, Fellow



The Earned Income Tax Credit at Age 30: An Overview

European Union Labour Counsellors
Austrian Embassy
February 8, 2006



This presentation distills a new Brookings research brief authored by Stephen Holt



"Despite the EITC's success, important work remains to improve the program's effectiveness through increased participation, reduced complexity, and enhanced awareness of the potential pitfalls of paid preparers and refund anticipation loans."



METROPOLITAN POLICY PROGRAM
THE BROOKINGS INSTITUTION

The Earned Income Tax Credit at Age 30: What We Know

Thirty years since its inception, the Earned Income Tax Credit (EITC) has become a robust and largely successful component of American labor and antipoverty policy. This research brief reviews the structure and history of the EITC, summarizing key research into the people and places it affects as well as its impact on important socioeconomic measures. The brief concludes by examining several issues surrounding the credit, and outlines proposals intended to improve the effectiveness of the EITC as it enters its fourth decade.

The Earned Income Tax Credit (EITC), the nation's largest antipoverty program for working families, plays an important role in the economic life of America's low-income households and communities. It increases the ability of workers in lower paying jobs to support themselves and their families. It represents a large inflow of resources into local economies. It magnifies the importance of the annual tax filing process.

The federal EITC turned 30 years old in 2005. During the past 20 years, many states and localities have enacted versions of the federal credit to benefit their own residents. Meanwhile, a new generation of local leaders has emerged to publicize the availability of the EITC and related tax credits for lower-income families and neighborhoods, and to argue for progressive federal tax policies.

Amid all this, the EITC continues to be the subject of numerous academic reviews and studies. Where the operations and effects of cash welfare programs once dominated antipoverty research, more social science today is devoted to examining the effects of tax code programs such as the EITC on a variety of social and economic outcomes. In fact, it is often difficult to keep abreast of research and sort through competing assertions. Yet such information is relevant to an ever-expanding audience of actors outside Washington involved in policy, outreach, philanthropy, and business.



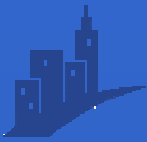
Overview

How the EITC Works

Who Benefits from the EITC

The Effects of the EITC

Other Issues Surrounding the EITC



Some basics about the US income tax system

- **The family is the unit of taxation in the US**
 - Many other countries tax the individual rather than the family
 - Employers withhold taxes from earners, but families must reconcile withholding at end of year

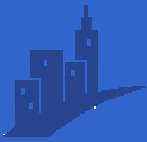
- **The US has a return-based income tax system**
 - Many other countries operate a return-free system for most taxpayers
 - The UK, Germany, and Japan achieve exact withholding through a “pay-as-you-earn” system
 - Denmark and Sweden operate “tax agency reconciliation” systems where the revenue agency prepares tax returns

- **The US uses the income tax as a social policy tool**
 - Income tax “expenditures” totaled \$800 billion in 2005



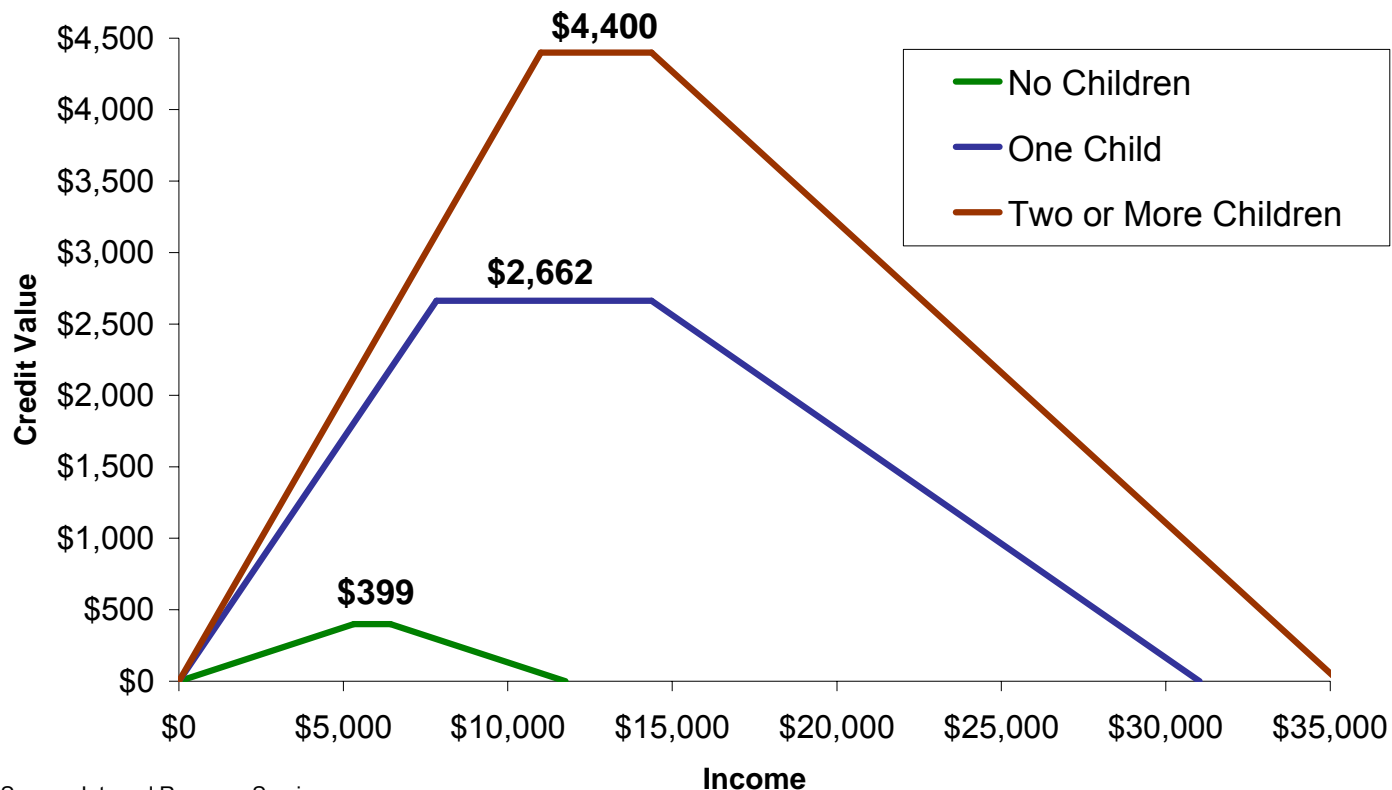
What is the Earned Income Tax Credit?

- **Refundable** income tax **credit** for low-wage workers and families
- **Credit** signifies that it reduces tax dollar-for-dollar (versus a deduction, which reduces amount of income that is taxed)
- **Refundable** means that families who owe no tax may still receive full benefit as a tax **refund**
- Taxpayer must have “earned” income (i.e., they must work)
- Most taxpayers receive the EITC in lump-sum form, along with other tax credits or withheld taxes
- 21 million taxpayers received the credit for 2004
- Total value of the EITC exceeded \$39 billion in 2004



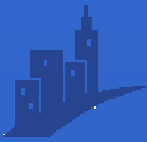
The amount of EITC for which a taxpayer qualifies depends on income and family size

Value of the Earned Income Credit by Income, Unmarried Filers*, 2005



Source: Internal Revenue Service

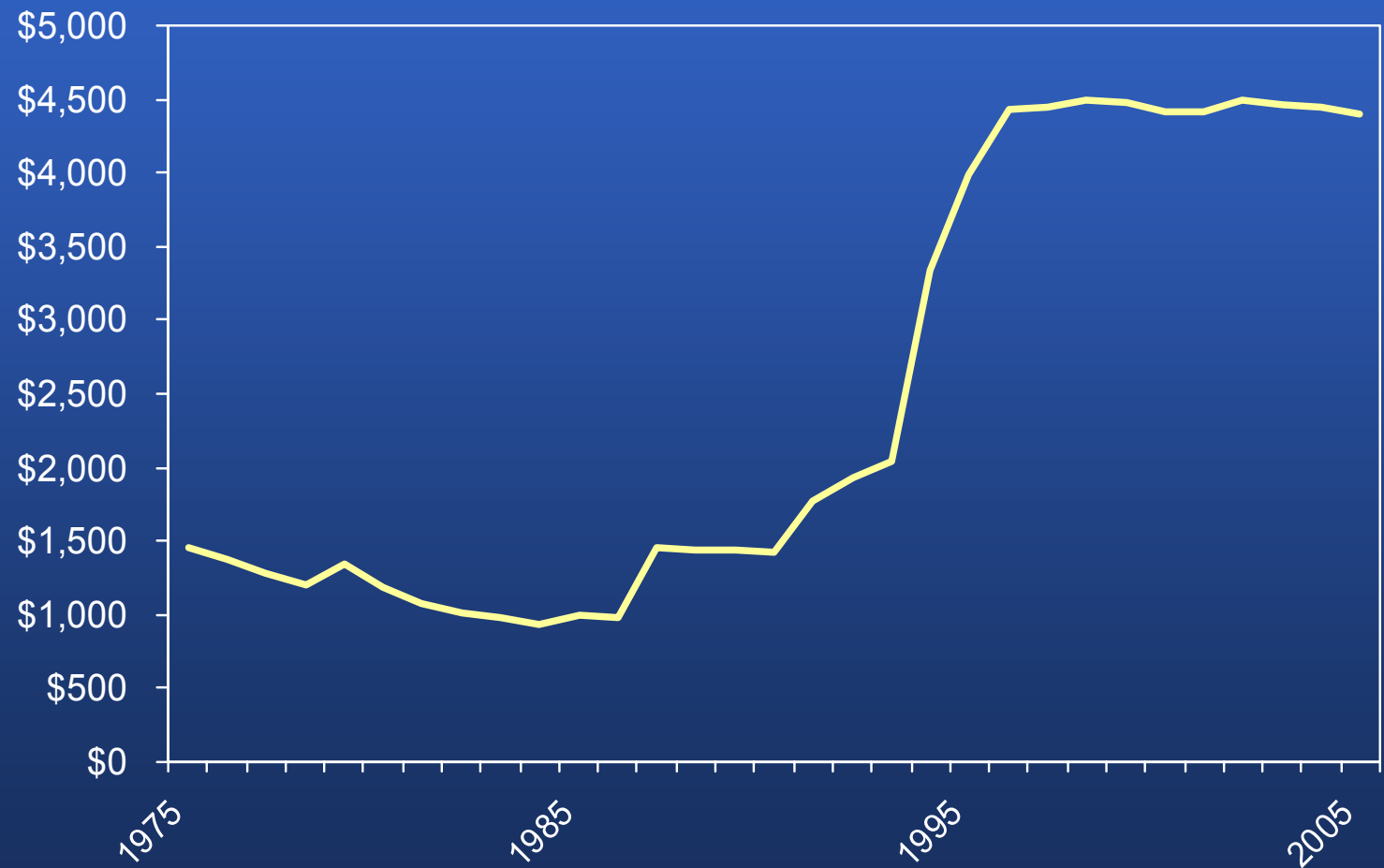
* Married couples filing jointly are eligible for slightly higher credit amounts in the "phase-out" range of the EITC.



The credit has roughly tripled in its maximum value since its inception in 1975

Maximum value of EITC, 1975 to 2005 (in 2005 dollars)

Source: 2004 Green Book



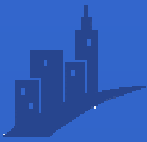


The number of taxpayers receiving the EITC, and the total amount received, have experienced similar growth over time

EITC recipients and total credit value (2004 dollars), 1975-2004

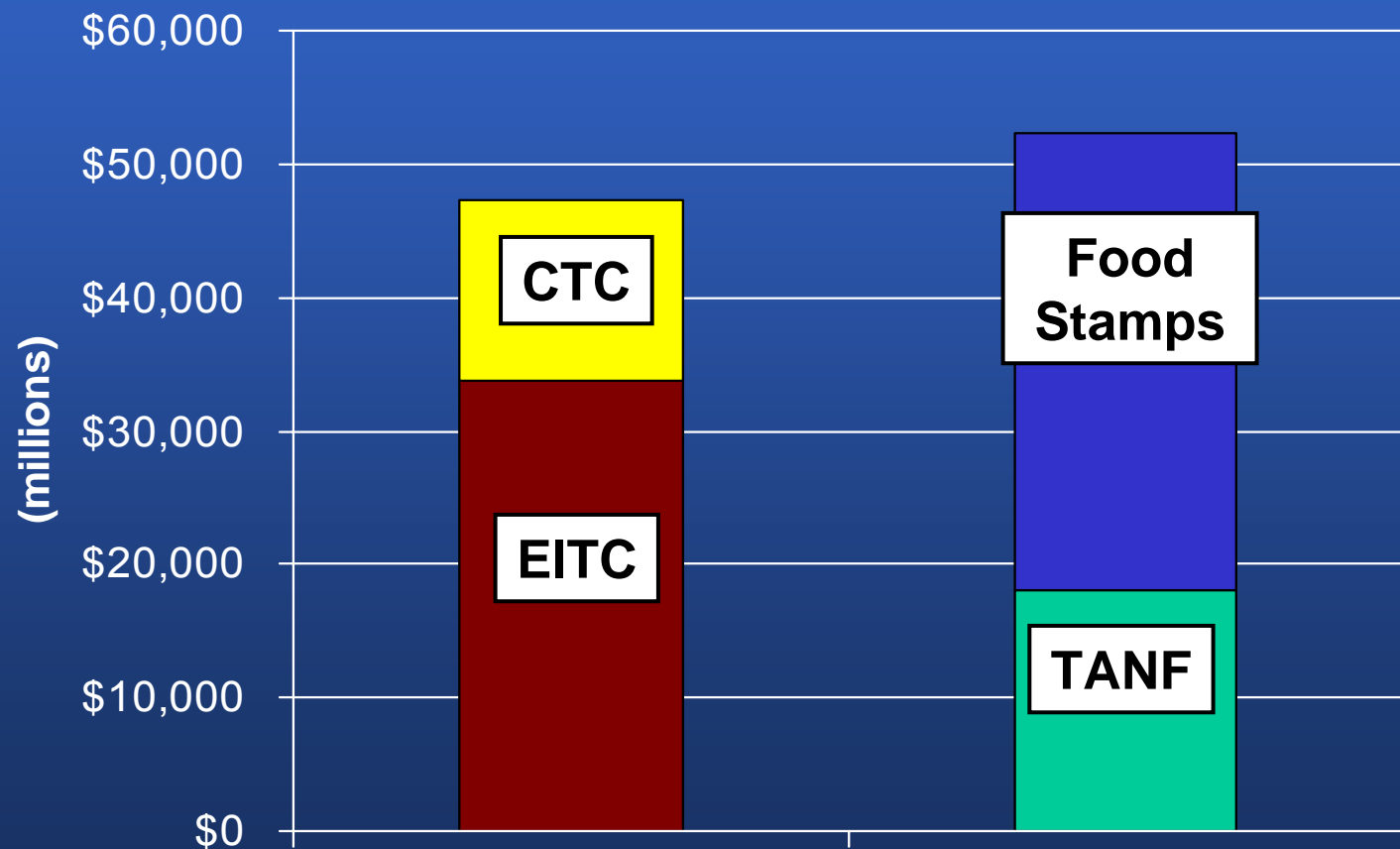
Source: 2004 Green Book





Tax code programs for low-income families now rival in size the value of more “traditional” welfare expenditure programs

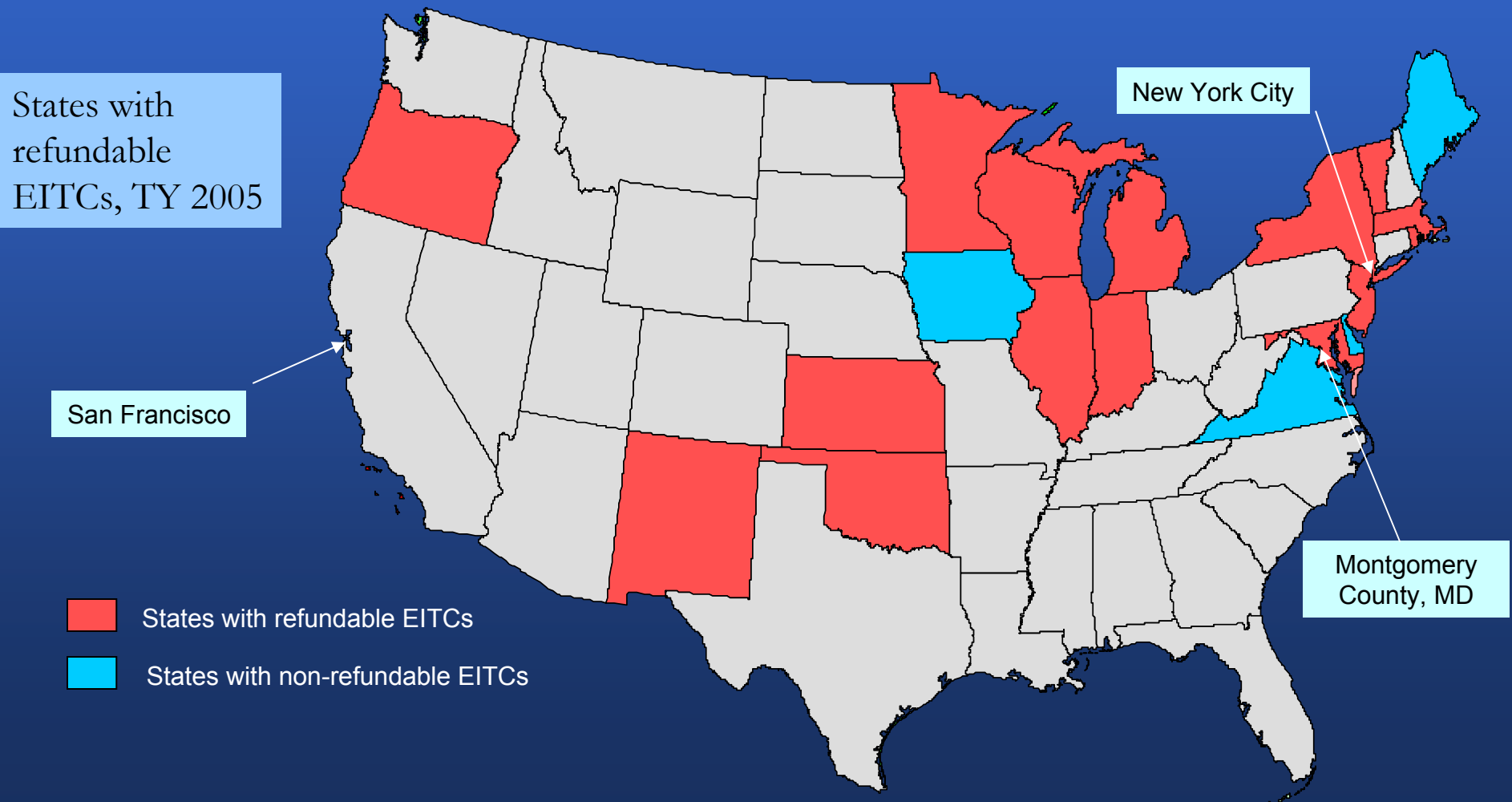
Projected federal outlays, FY2005



Source: FY 2006 Budget



The success of the federal credit has prompted 17 states (and some localities) to enact EITCs in their own income tax codes





Several other countries today provide earned income credits through their income tax systems

Country	Name of credit	Max annual value
United Kingdom	Working and Child Tax Credits	≈ \$12,000 (2005)
France	Prime Pour L'Emploi (PPE)	≈ \$530 (2004) (under expansion)
Belgium	Credit d'impôt sur les bas revenus de l'activité professionnelle	≈ \$611 (2005)
Canada	Child Tax Benefit/National Child Benefit Supplement	≈ \$5,200 (2006)
New Zealand	Working for Families (Child Tax Credit; Family Tax Credit)	≈ \$5,800 (2006)

Some of these credits provide support for low-income workers; some provide support for low-income workers and their children (like the EITC)



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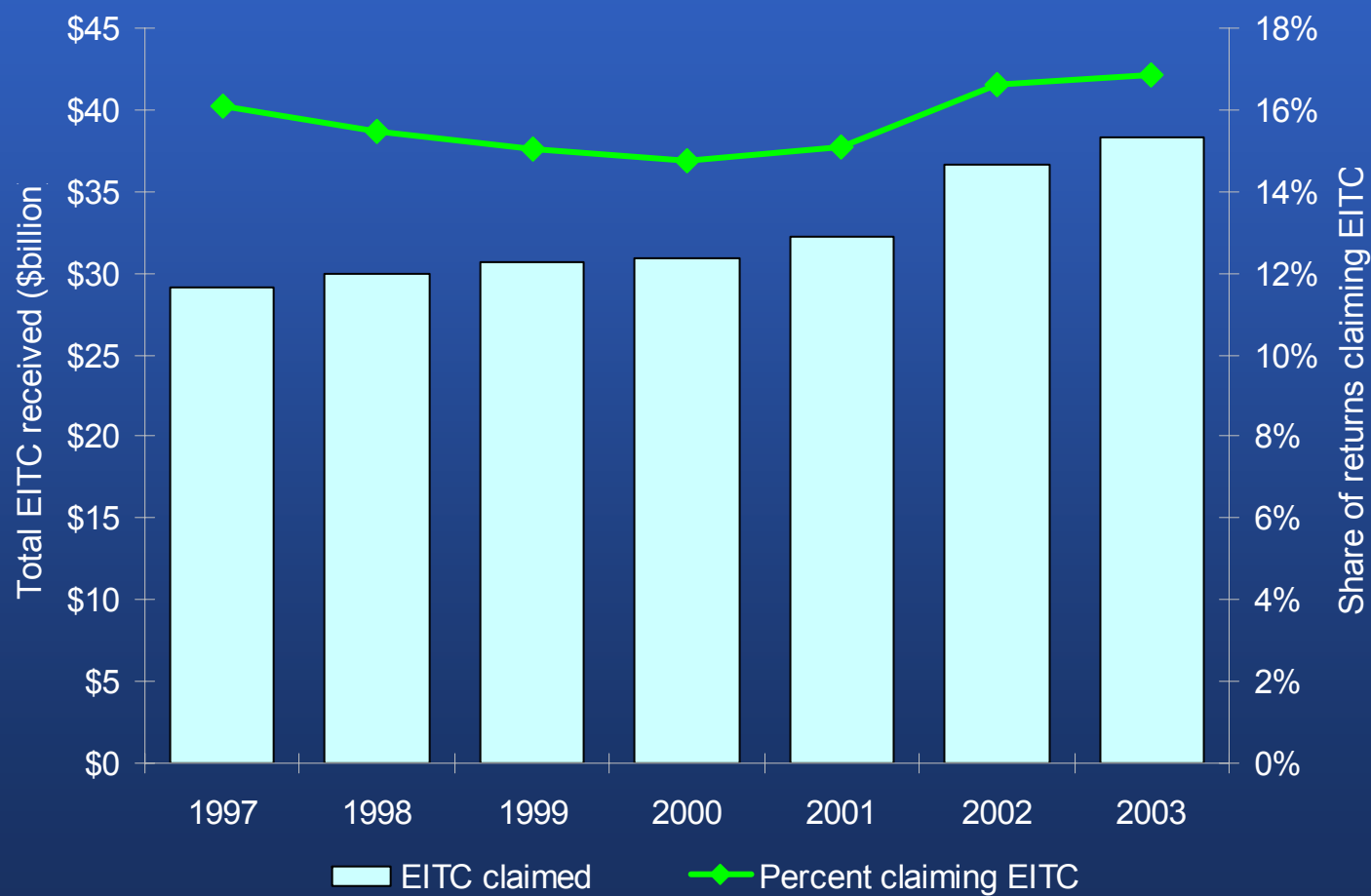
Other Issues Surrounding the EITC



About 17% of U.S. taxpayers received the EITC for 2003

Percentage of taxpayers receiving EITC, and amount received, 1997-2003

Source: Internal Revenue Service

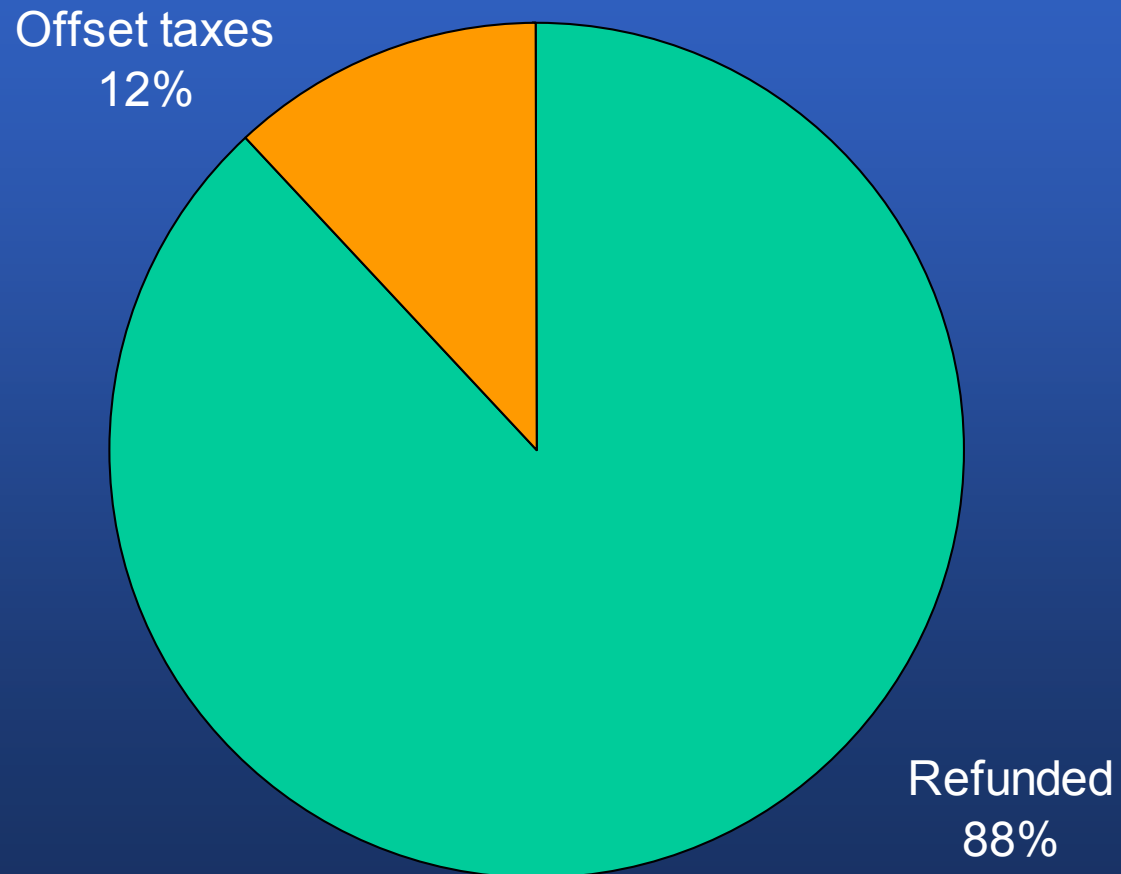




Taxpayers receive the overwhelming majority of EITC as tax refunds; a small portion offsets taxes owed

Disposition of EITC funds, tax year 2003

Source: IRS





The bulk of EITC payments go to families with one or more qualifying children, and to those with incomes from \$10k to \$20k

Characteristics of EITC recipients and payments, tax year 2003

Source: Internal Revenue Service

Children	Recip.	% of Recip.	Value (\$millions)	% of Value
Zero	4.0	19%	0.9	2%
One	8.4	39%	14.0	37%
Two or more	9.2	43%	23.4	61%
Total	21.6	100%	38.3	100%

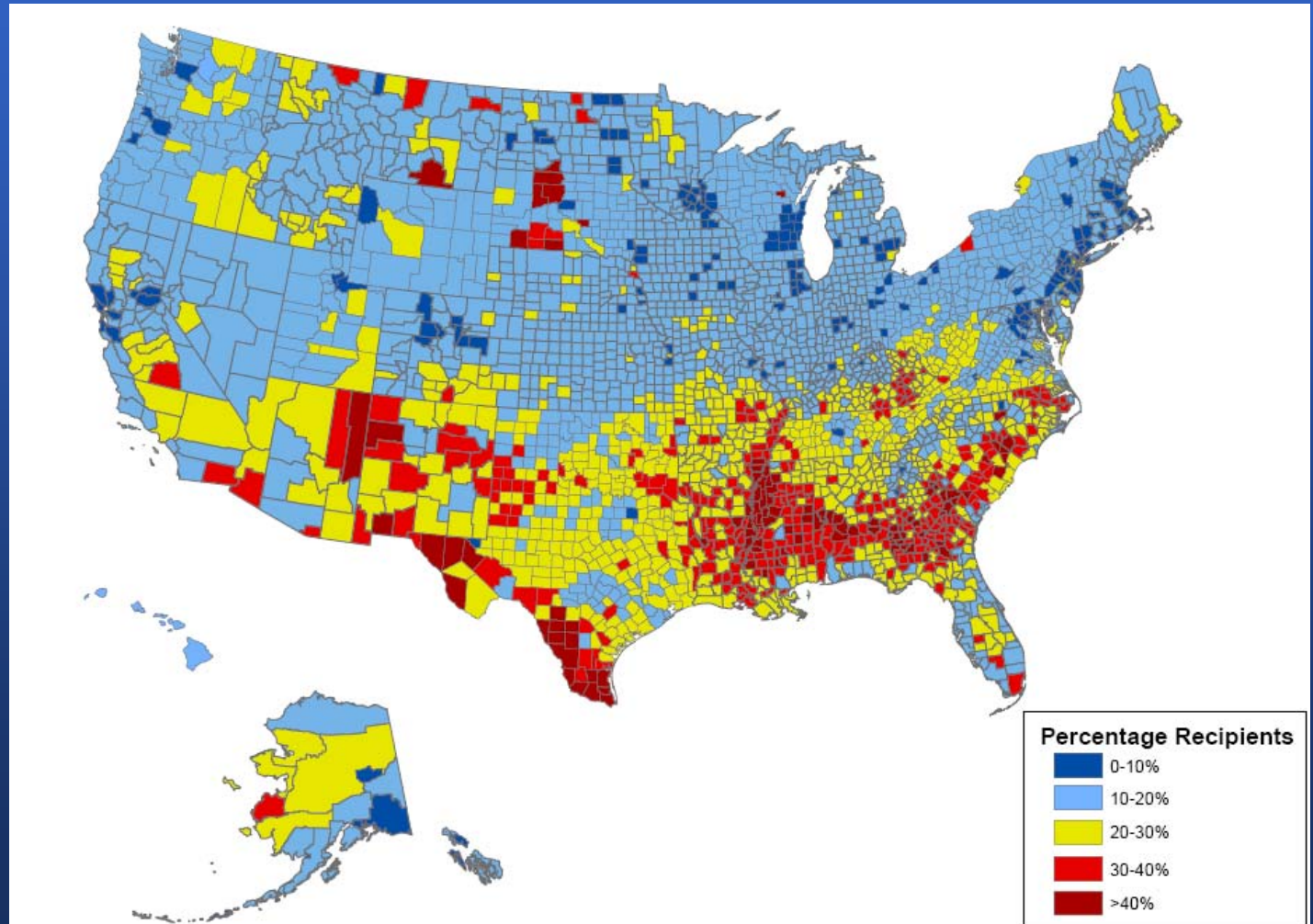
Income	Recip.	% of Recip.	Value (\$millions)	% of Value
Under \$10k	8.1	37%	9.7	25%
\$10k to \$20k	7.4	33%	20.6	53%
\$20k and up	6.6	30%	8.4	22%
Total	22.1	100%	38.7	100%



The southern US sees the highest proportions of its taxpayers receive the EITC

Percentage of returns receiving EITC by county, tax year 2003

Source: Berube. "The New Safety Net" (2006)





Because one must file a tax return to receive the EITC, not everyone who is eligible gets the credit

- **About 80-85% of eligible taxpayers receive the EITC**
 - This is considerably higher than the “participation rate” in traditional welfare programs like TANF and Food Stamps (roughly 50%)

- **Characteristics of eligible non-participants include:**
 - eligible for smaller credit/no qualifying children
 - lower household income
 - larger family
 - male-headed household
 - more self-employment income
 - first language not English

- **Several US states and cities conduct outreach on EITC**
 - Aim to boost claims among eligible taxpayers



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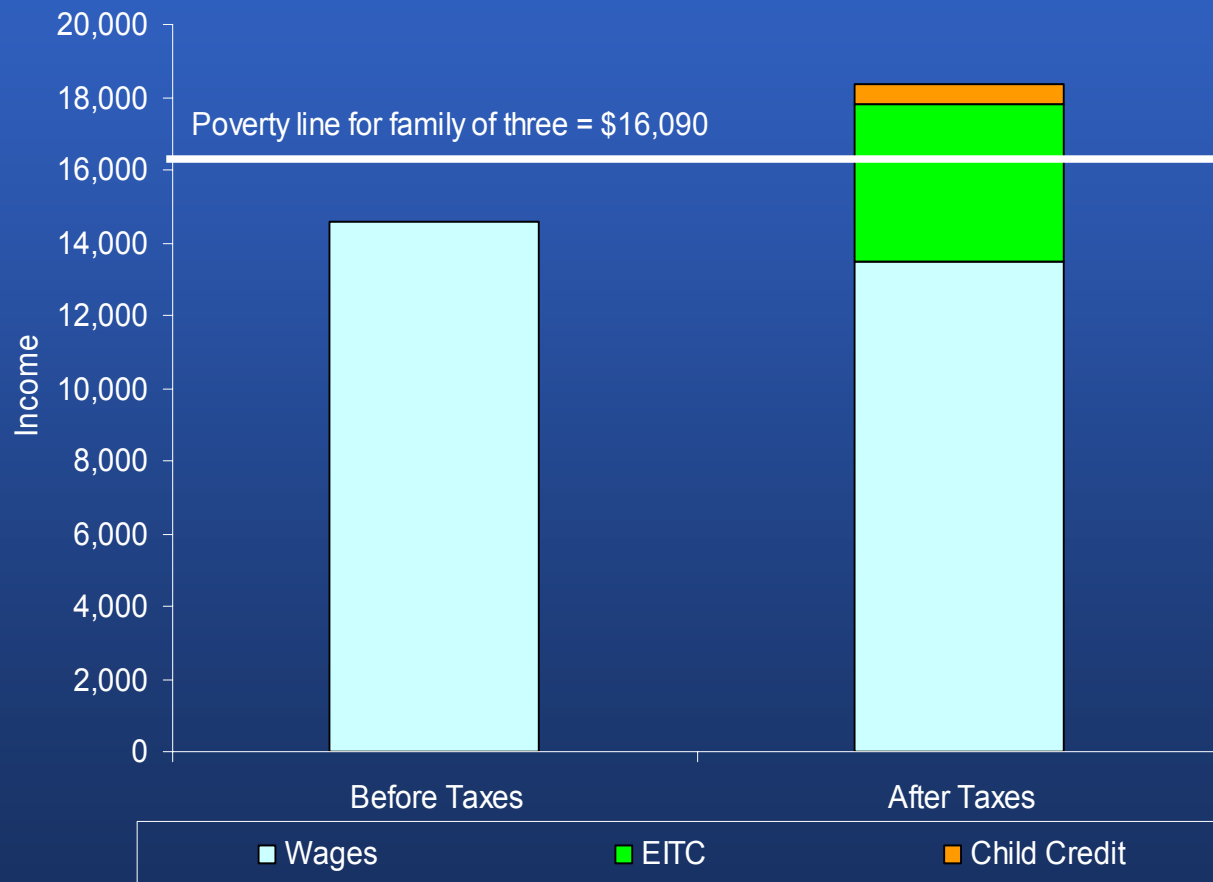
The Effects of the EITC

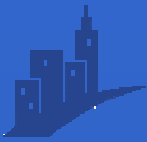
Other Issues Surrounding the EITC



The EITC lifted 4.4 million people—including 2.4 million children—above the poverty line in 2003

Income before and after federal taxes, \$7/hour worker with 2 children, 2005



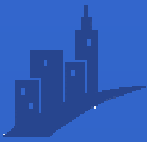


The research literature suggests several other ways that the EITC enhances income and reduces use of public assistance

- More than one-half the decline in child poverty from 1993 to 1997 owed to expansion of the EITC
 - Council of Economic Advisers (1998)

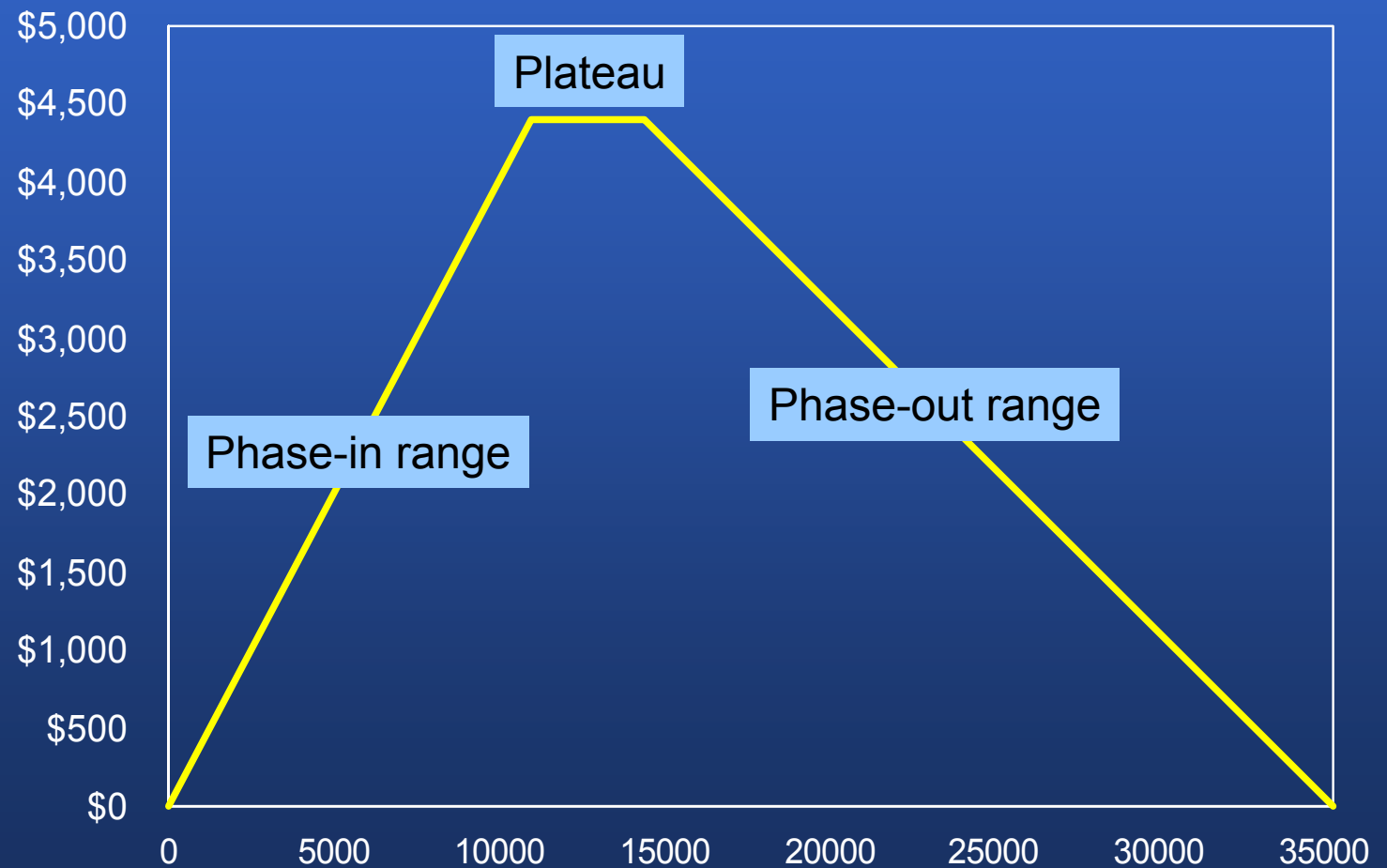
- Refundable state EITCs reduce child poverty in working families by 1.4% (Indiana) to 9% (Minnesota)
 - National Center for Children in Poverty (2001)

- Increases in the credit in the 1990s reduced welfare usage by 10 percent
 - Grogger (2003)



Theoretically, the EITC may have complicated effects on labor supply

Structure of credit for unmarried worker with two or more children, 2005





Yet most research finds that the EITC has had significant, positive effects on overall labor supply

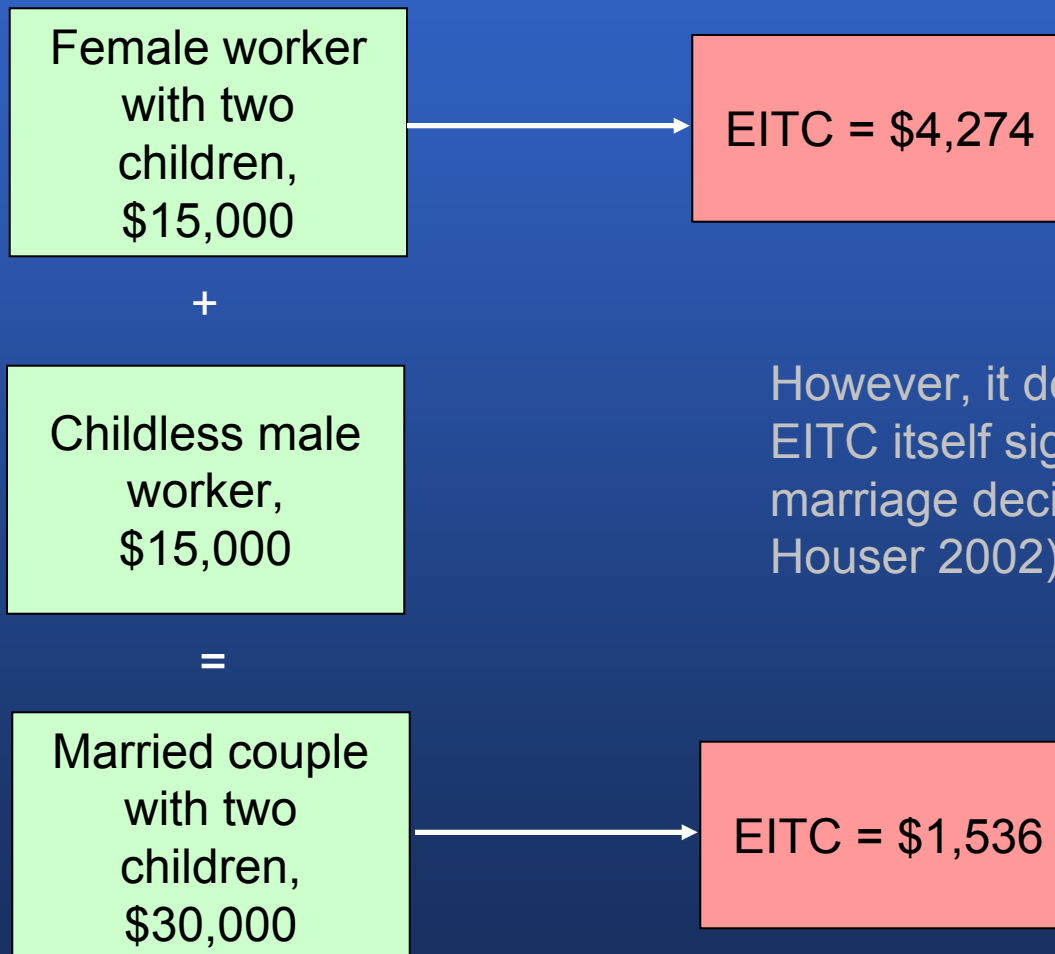
- **Boosts labor force participation among low-income single mothers**
 - Accounted for 60% of increase 1984-1996 (Eissa and Liebman 1996)
 - Accounted for 34% of increase from 1993-1999 (Grogger 2003)
 - Larger credit for 2-child families accounted for 84% of employment advantage over 1-child families in CA (Hotz, Mullin and Scholz 2005)

- **May reduce labor supply among married couples**
 - Credit subsidizes one parent to stay at home by supplementing wages of worker (Eissa and Hoynes 2004)
 - Effects are relatively modest (Ellwood 2001)

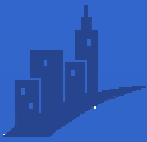
- **Little evidence that EITC “phase-out” reduces labor supply**
 - Ellwood/Liebman 2001; Hotz/Scholz 2003; Keane/Moffitt 1996



Theoretically, the EITC could provide a marginal disincentive for low-income workers to marry



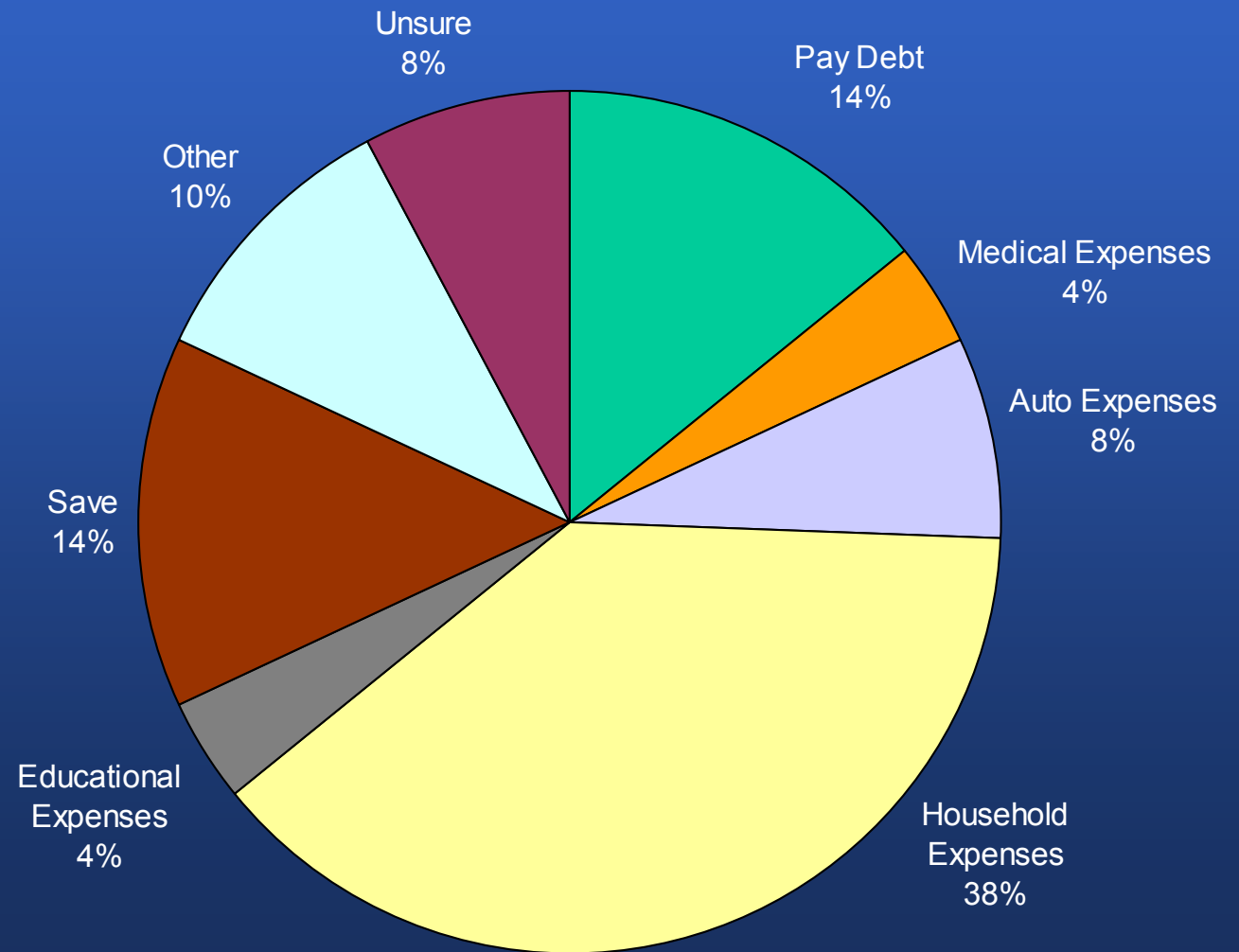
However, it does not seem that the EITC itself significantly influences marriage decisions (Dickert-Conlin and Houser 2002)



The credit boosts household expenditures, normally to meet short- to medium-term needs

“Most important” use of tax refund, sample of low-income taxpayers, Raleigh, NC, 2005

Source: Spader, Ratcliffe, and Stegman 2005





The credit amounts to a significant direct aid program for US cities, where working poor families are disproportionately housed

EITC value
received by city
(\$000s), 10
largest cities,
TY 2003

	Total	Per Sq. Mile
New York, NY	1,471,327	4,856
Los Angeles, CA	613,667	1,308
Chicago, IL	540,636	2,382
Houston, TX	411,916	711
Phoenix, AZ	168,218	354
Philadelphia, PA	288,752	2,139
San Diego, CA	127,747	394
Dallas, TX	222,031	649
San Antonio, TX	268,014	655
Detroit, MI	218,447	1,572



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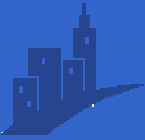
A handful of policy issues surround the EITC

1. Complexity—in the EITC and related credits
2. Access—tax preparers as intermediaries
3. Error—ineligible recipients of the credit
4. Structure—alternative ways to deliver the EITC



Complexity—a host of child-related tax provisions may apply to taxpayers claiming the EITC

Provision	Benefit
Head of household filing status	Larger standard deduction than singles (\$7,150 in 2004)
Dependent exemption	\$3,100 deduction per dependent (2004)
Earned Income Tax Credit	Up to \$4,400 (2004) refundable credit for lower-income workers with children
Child Tax Credit/Additional Child Tax Credit	Up to \$1,000 credit per child; partially refundable for workers with income > \$11k
Child and Dependent Care Credit	Up to \$1,000 nonrefundable credit per child to defray child care expenses



Complexity—a uniform series of tests determine whether a taxpayer may claim these benefits...but there is a lot of “fine print”

Test	Rule
Relationship	Child, stepchild, foster child, sibling, stepsibling, or descendent of these
Residence	Same principal residence as TP for more than half the year
Age	Under age 19 at end of tax year, or under age 24 if full-time students, or disabled
Support	Did not provide more than half his/her own support

Dependent — a qualifying child must also meet these tests:

Nationality — be a U.S. citizen or national, or a resident of the U.S., Canada or Mexico. There is an exception for certain adopted children.

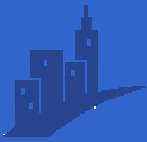
Marital status — if married, did not file a joint return for that year, unless the return is filed only as a claim for refund and no tax liability would exist for either spouse if they had filed separate returns.

Head of Household Filing Status — a qualifying child is determined without regard to the exception for children of divorced or separated parents. Also, a qualifying child who is married at the end of the year must meet the marital status and nationality tests for a dependent (above).

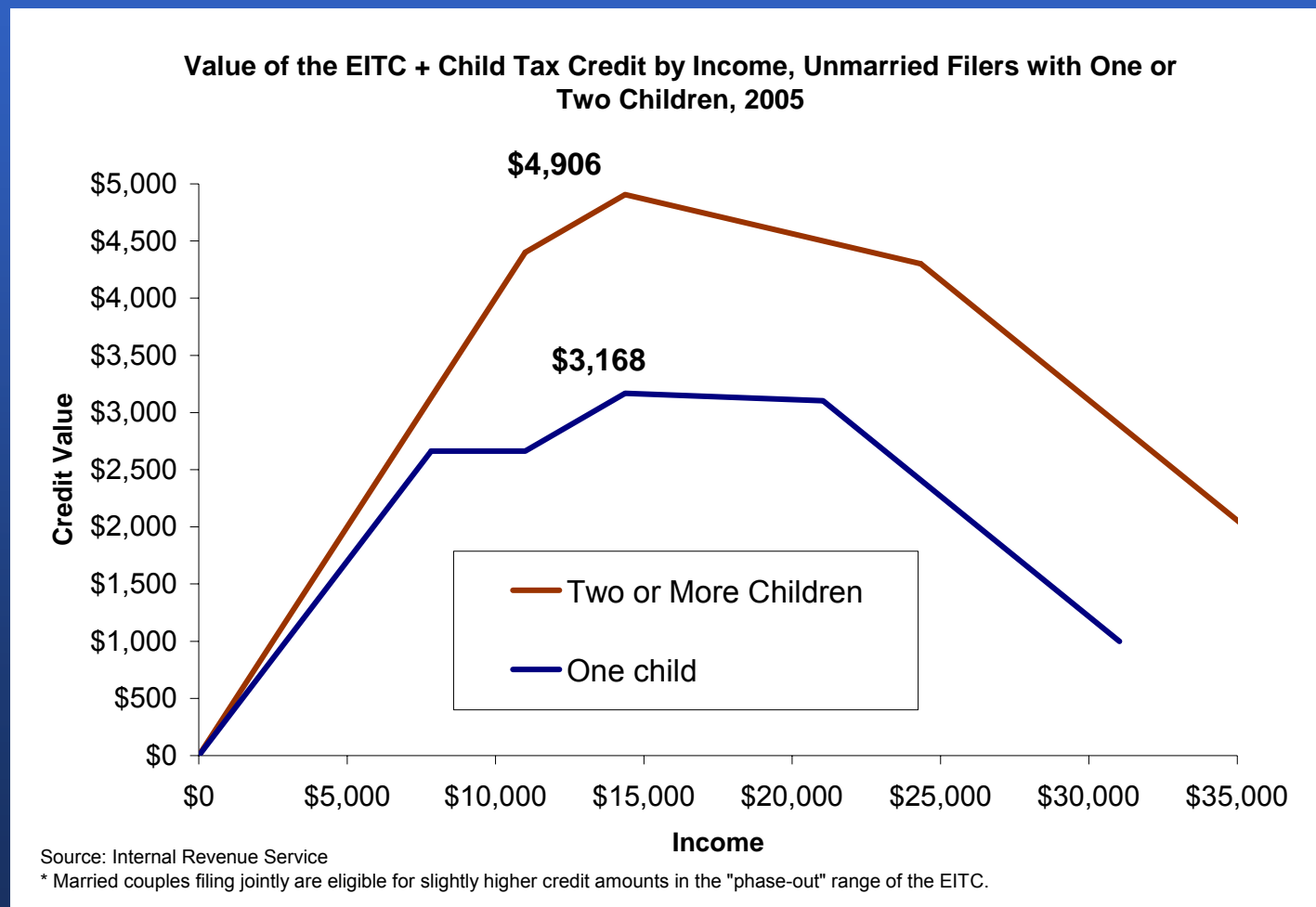
Credit for Child and Dependent Care Expenses — a qualifying child must be under the age of 13 or permanently and totally disabled. A qualifying child is determined without regard to the exception for children of divorced or separated parents and the exception for kidnapped children.

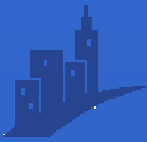
Child Tax Credit — a qualifying child must be under age 17 and a U.S. citizen or national or a U.S. resident.

Earned Income Tax Credit — a qualifying child does not have to meet the support test. Also, a qualifying child must have lived with the taxpayer in the United States for more than half the year and have a social security number that is valid for employment in the United States. A qualifying child is determined without regard to the exception for children of divorced or separated parents. If a qualifying child is married, he or she must also meet the marital status and nationality tests for a dependent (above).



Complexity—the EITC also interacts with the refundable portion of the Child Tax Credit in complex ways





Access—as a result, the majority of EITC recipients pay someone else to complete and file their tax returns

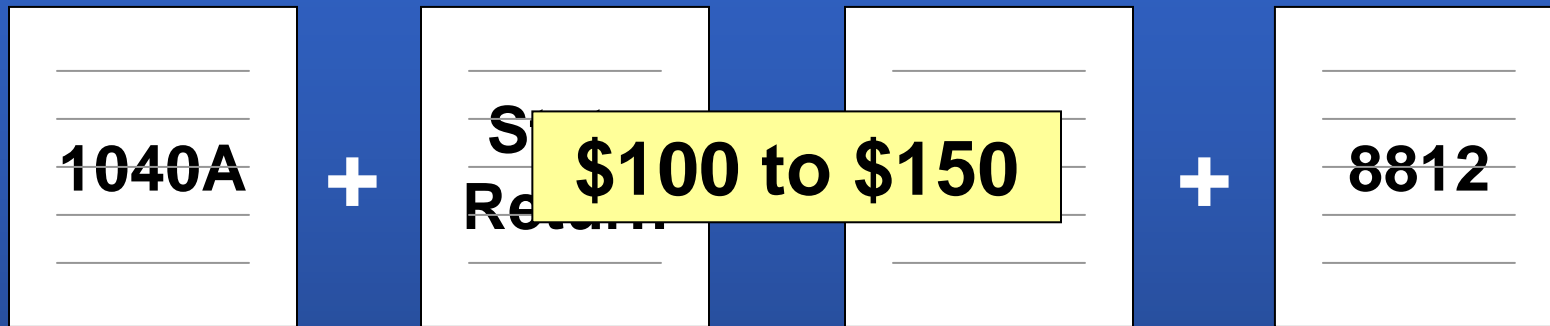
Percentage of taxpayers using paid preparer, TY 2000-2003

Source: Berube 2006





Access—EITC recipients often pay significant sums to access their refund dollars, including via high-cost, short-term loans

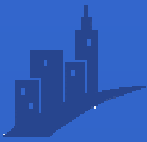


SUPERFAST REFUNDS *When you want your refund in a hurry!*
click here

\$130 (for average EITC refund)

$\$130 \text{ (loan cost)} \div \$2,780 \text{ (loan amount)} \times 365 \text{ (days in a year)} \div 10 \text{ (term of loan)}$

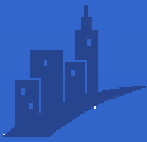
171% APR



Error—EITC received by ineligible recipients has attracted a great deal of attention in recent years

- **Most recent IRS estimate suggested that 27% of EITC received in 2000 was erroneous**
 - Having ineligible qualifying child was most common error
 - Estimate likely overstated; administrative/legislative changes since then have probably reduced erroneous payments by at least one-fourth
 - Not clear how much is intentional/unintentional
 - IRS testing new procedures designed to reduce erroneous claims, but may have potential to frustrate eligible taxpayers
 - Higher error is trade-off for lower administrative costs

- **EITC error rarely analyzed in context of total “error”**
 - Overstated credits (including the EITC) estimated to account for 4.4 percent of the overall “tax gap” (IRS 2005)
 - Political system treats overpayment of EITC very differently than underpayment of other income taxes



Structure—several proposals suggest combining or streamlining existing tax benefits for families, including the EITC

- **Most of these combine various child-related tax provisions**
 - Sawicky and Cherry (2000): Simplified Family Credit
 - Carasso, Rohaly and Steuerle (2005): Unified Child Credit
 - Emanuel (2005): Family Tax Credit
 - Tax Reform Panel (2005): Family + Work Credits

- **Prospects for their adoption in the near term are slim**
 - Most entail significant new costs so as to avoid creating “losers”
 - Yet the EITC has only narrowly escaped cuts the past few years on Capitol Hill
 - Significant changes to the EITC would also cascade to the many states that provide their own versions of the credit

- **Incremental simplification is probably best hope**



The EITC is widely acknowledged to be one of the most successful social policy tools in recent US history

- It reduces poverty and child poverty
- It has led to increased work among single parents, and smoothed the transition to a work-based welfare system
- It reaches a high proportion of eligible families
- It assists recipients in meeting basic family needs, and helps stimulate local urban economies
- Issues remain, but the EITC will likely enjoy continued support during uncertain economic times ahead

www.brookings.edu/metro/eitc

The screenshot shows the Brookings Institution website for the Metropolitan Policy Program. The main content area features an article titled "Working Families at Tax Time" under the "EITC SERIES" section. The article discusses the receipt of the Earned Income Tax Credit (EITC) in immigrant communities and the use of high cost refund anticipation loans (RALs). It notes that RAL usage by EITC filers has declined nationally but remains above average in cities throughout the South. Below the article, there are links to "read ¿Tienes EITC? A Study of the EITC in Immigrant Communities" and "read Step in the Right Direction: Recent Declines in Refund Loan Usage Among Low-Income Taxpayers".

To the right of the article is an "INTERACTIVE SITE" section with links to "Create EITC tables", "How to use EITC data", and "EITC participation note (PDF)". Below this is a "2005-06 CONGRESSIONAL DISTRICTS EITC DATA" section with links to download 2001-2002 tax data in Excel (147KB) and 2002 tax data in PDF (257KB).

On the left side, there is a navigation menu with categories like "Home", "News & Events", "Scholars", "Research Topics", "Programs", "Publications", "Bookstore", "Executive Education", and "About Brookings". The "Programs" category is expanded to show "Economic Studies", "Foreign Policy Studies", "Governance Studies", "Metropolitan Policy", "Policy Centers", and "Projects".

At the bottom right, a box is highlighted with an orange border and an arrow pointing to it. This box is titled "SUBSCRIBE TO Metro Program Listserv" and contains the text: "Sign up here for: Brookings Metro Alerts to stay on top of the latest releases, events, and web features." Below this text is an "E-mail Address" input field and a "SIGN UP" button.