DIVERSE PERSPECTIVES ON CRITICAL ISSUES

Using the Earned Income Tax Credit to Stimulate Local Economies

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Traditionally viewed as an antipoverty program, the federal Earned Income Tax Credit (EITC) is increasingly regarded as a significant federal *investment* in local and regional economies.

> ***The EITC already provides substantial economic benefits to local and regional economies, but it could make an even larger impact.***

Over the 30 years of its existence the federal Earned Income Tax Credit (EITC) has been described variously as a wage supplement, a program to reduce tax burdens, an antipoverty tool, a welfare-to-work program, and a form of labor market insurance. The program has enjoyed expansions under both Republican and Democratic administrations, and in 2006, the EITC will provide more than $40 billion to low-income working families. The credit lifts nearly 5 million Americans above the poverty line each year. Moreover, because the EITC aids only those families with earnings from work, researchers have credited it with raising labor force participation levels and helping families transition from welfare to work.[1]

Yet a significant proportion of eligible workers continue to miss out on the credit. In response, a growing number of state and local officials have begun concerted efforts to

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ensure that all eligible workers gain access to the credit's full benefits. They do so not only to support their constituents' well-being but also because they have come to identify the credit as a tool that promotes local and regional economic health. These local leaders are demonstrating the EITC's importance as a critical federal *investment* in local and regional economies around the country. This paper explores the benefits that families and communities could receive if the full potential of the EITC were realized.

The federal government invests more in cities through the EITC than through traditional "urban" programs.

The EITC was created in 1975, during the Ford Administration, as a way to shield low-wage workers from the regressive effects of rising payroll taxes. In 1975, 6.2 million families claimed $1.25 billion in credits.[2] Today, after several expansions in the program, more than 20 million families benefit from over $40 billion in credits. Most EITC-eligible taxpayers have children under 18 living at home, and earn under $35,000 annually.[3] The average claimant in 2004 received a credit of roughly $1,800, amounting to more than 10 percent of his or her annual income.

What distinguishes the EITC from many other credits in the tax code is its *refundability*. This means that taxpayers receive the full amount of the credit for which they are eligible in the form of a tax refund, even if the amount exceeds their tax liability. Because the bulk of lower-income families have no federal income tax liability (though they do pay significant federal payroll and excise taxes), the EITC's refundability contributes greatly to its antipoverty and work-support effectiveness.

Nationwide, about 17 percent of all individual income taxpayers receive the credit, meaning that a larger proportion of the U.S. population participates in the EITC than in any other federal income supplement program, except for Social Security.

Because many low-income working families with children live in and around big cities, the EITC represents a particular boon to urban areas. An above-average share of central-city taxpayers (20 percent) benefit from the credit.[4] What's more, on average, their credits tend to be larger than credits received by taxpayers in most other locations. In 2002, when the EITC was worth $32 billion nationwide, families in large cities (those with populations over 100,000) received $8.1 billion; families in older suburbs, $5.1 billion.[5]

Despite the large fiscal flows from the EITC to urban areas, policymakers and researchers have traditionally viewed the credit as a boon for *people* and not necessarily *places*. This was due both to a lack of information about where credit dollars were claimed, and to the fact that the dollars are not directed to state, county, or city governments, but instead go straight into the pockets (and bank accounts) of working families.

But thanks to new IRS data and a broadening network of tax-issue advocates, many cities now recognize that more funds are invested in their cities annually through EITC than through many traditional "urban" federal programs. For example, in 2004 the

Community Development Block Grant and HOME programs (which provide cities and states with flexible funds for affordable housing and community economic development) awarded roughly $3.1 billion to nearly 1,000 municipal governments nationwide. That same year, residents of those same cities and towns received over *$20 billion* from the EITC.[6] Both programs contribute to urban and suburban health, of course, but until recently the tax code's tremendous boost to local economies was overlooked.

In addition, many of the same low-wage workers who benefit from the EITC also receive other federal and state tax credits. The federal Child Tax Credit benefits workers with children who earn at least $11,000, adding as much as 40 percent on average to the refunds of EITC-eligible taxpayer. Nineteen states plus the District of Columbia offer their own earned income tax credits, matching the federal EITC at rates ranging from 5 to 35 percent.[7]

Local economies benefit greatly from this annual infusion of cash.

The large sums of EITC dollars claimed in urban areas provide a concentrated cash infusion to local economies—in some cities, more than $1 million per square mile.[8] One study notes that EITC dollars received in Cuyahoga County, OH in the first months of 2003 equaled all wages and salaries paid in the local hotel industry that quarter.[9]

The final economic impact of the credit reaches beyond the initial dollars, however. For many low-wage workers, the tax refund—including the EITC—constitutes the largest payment they receive all year long. Surveys of low-income taxpayers and analyses of federal expenditure indicate that most EITC recipients use the funds to meet short- to medium-term needs: buying clothes for their children, replacing old furniture and appliances, repairing a vehicle, going on a trip, or catching up on past-due rent and utility bills.[10]

Local spending of this kind creates important ripple effects as dollars move among consumers, firms, and their employees. The city of San Antonio, for instance, estimates that each additional $1 in EITC would generate a further $1.58 in local economic activity, and each additional $37,000 would result in one additional permanent job.[11] A similar study in Baltimore finds that EITC dollars generate nearly $600,000 in local income and property tax revenues.[12]

But the credit's economic impact could be even greater.

Despite the substantial economic benefits the EITC already provides to local and regional economies, there is evidence that it could make an even larger impact. There are several reasons why.

First, not all taxpayers who are eligible claim the credit. The best available data suggest that nationwide, between 15 and 25 percent of eligible taxpayers fail to claim the credit.[13] Compared to federal income-support programs such as Temporary Assistance for Needy Families (TANF), Food Stamps, and Supplemental Security Income (SSI), this actually represents relatively high participation. But the amounts foregone are substantial. In tax year 2004, EITC-eligible taxpayers left an estimated $4.9 billion in EITC "on the table," not including additional federal and state tax credits.[14] And, as the San Antonio and Baltimore examples demonstrate, federal dollars foregone by eligible families could generate even larger benefits to local economies and governments.[15]

Some eligible nonparticipating taxpayers are not aware that the credit exists, some face language or cultural barriers, and some may be afraid that by claiming the credit they will sacrifice their eligibility for other important income-support programs.[16] Research suggests that eligible families with very low incomes, a greater number of children, income from self-employment, limited education, or language barriers are more likely to miss out.[17] Cities with large proportions of such taxpayers among their EITC-eligible populations therefore could do a lot to enhance family and community well-being by fostering greater participation in the credit.

A second reason low-income families and their communities are not getting as much as they could from the EITC is that the vast majority—over 70 percent—of EITC recipients file their tax returns through a paid tax preparer.[18] Some turn to these preparers due to the complex rules that govern eligibility for low-income credits and deductions. Others seek the peace of mind of knowing that a professional has completed their return. Still others hope to obtain their refund dollars faster, via electronic filing and financial products such as refund anticipation loans (RALs).

Whatever the reason, low-income taxpayers often pay large sums for these services. The typical fee to prepare federal and state returns exceeds $100, and the several forms and schedules that low-income taxpayers file can push the cost even higher.[19] Many pay an extra $100 to $200 to purchase an RAL, effectively borrowing their own tax refund dollars at an exorbitant interest rate about 10 days before they could receive them directly from the IRS.[20] Across EITC recipients, these fees add up to more than $2 billion annually.

In addition, while many low-income taxpayers receive quality service from paid preparers, concerns persist regarding industry professionalism and accuracy, especially among "fly-by-night" operators.[21] Past IRS research has discovered a significant degree of error in EITC claims; many taxpayers who were ineligible for the credit were found to have received it.[22] These erroneous claims may stem from negligence on the part of the taxpayer or tax preparer, but they may also result from honest mistakes or confusion due to the credit's complexity. Statutory and administrative changes to the credit in recent years have likely reduced the error rate.[23] The IRS continues to test administrative measures designed to reduce EITC error while ensuring that eligible taxpayers retain access to the credit.[24]

Local political, corporate, and civic leaders across the country have joined forces to promote the EITC and connect low-income taxpayers to free tax assistance.

In recent years a growing number of leaders at the local level—from the public, private, and not-for-profit spheres—have discovered these “missed opportunities” for families and communities. Many cities have mounted multipronged efforts to raise the number of eligible taxpayers who claim the EITC, and to provide these families with access to free and low-cost assistance to complete and file their tax returns, a crucial alternative to high-priced commercial tax services. For example:

- **Chicago** mounted the first local EITC drive. Spurred by the promise of economic benefits from greater EITC participation, in 1999–2000 Mayor Richard Daley began annual public-private campaigns to increase awareness of the credit. Local media, utility companies, large employers, and community groups publicize the availability of the EITC and other tax benefits to low-income workers and neighborhoods. Trained staff members provide tax-filing assistance at no cost to tens of thousands of low-income families. Since the campaign's inception, the leading local nonprofit provider of free tax assistance has more than doubled the number of federal returns it completes, saving low-income residents millions of dollars each year. The campaign helped Chicago to achieve greater increases in EITC claims between 1998 and 2002 than other Midwestern cities.[25]

- The city of **San Antonio** runs another large municipal EITC outreach campaign. The San Antonio Department of Community Initiatives leads the effort, using young people in the city's Youth Opportunity Program to provide free tax assistance, and conducting targeted outreach in key industries. In 2005 the campaign filed nearly 25,000 returns for free, making it the second-largest effort in the country after New York City's.[26] San Antonio also uses tax time to promote savings opportunities such as Individual Development Accounts (IDAs), which offer public matching funds for family savings towards homeownership, education, or entrepreneurship.[27]

These and other cities run their campaigns on small amounts of local government money, supplemented by private-sector and philanthropic dollars and in-kind donations. A few cities and older suburbs have gone even farther, assisting local workers by creating their own policy tools that buttress federal and state EITCs. **Montgomery County, Maryland** (outside Washington, D.C.) enacted the first “local EITC” in 1999. More recently, **New York City** began to match the federal EITC at 5 percent using city funds. And in 2005, **San Francisco** created its Working Families Credit, which uses both public and private funds to match the federal credit at between 10 and 15 percent.[28] Campaigns in both New York and San Francisco are also going the extra mile at tax time to help families gain access to financial counseling, low-cost bank accounts, and other tools that can improve their economic health year-round.[29]

Altogether, hundreds of local EITC outreach and free tax assistance campaigns operate in communities around the country each year, including roughly three-quarters of the nation's 100 largest cities. The exact impact of these campaigns on participation in the credit remains unclear, mostly for want of localized data regarding credit eligibility and use.[30] The constant turnover in the EITC population, however—more than 30 percent of

EITC recipients each year did not receive the credit the prior year—suggests that outreach will always be needed to ensure maximum participation and maximum economic benefits for local communities.

Federal leaders can help local actors ensure that eligible families gain the EITC's full benefits.

Congressional leaders can provide a real boost to local EITC campaigns by getting involved in efforts in their states and districts to promote the credit and related tax benefits, and by helping to provide low-wage workers with access to free tax assistance. Local outreach campaigns also give leaders a great opportunity to connect with their constituents and to educate other policymakers and the public about the importance of programs like the EITC.[31] Federal lawmakers can:

- **Publicize** the EITC (and other tax benefits) and information on where to obtain free tax assistance using their websites, their constituent newsletters, and op-eds in local newspapers. Tennessee Congressman Jim Cooper actively participates in the local tax outreach campaign in his Nashville district, sends out a newsletter at tax time alerting constituents of the availability of the EITC, and posts an "EITC Estimator" on his website that allows families to see the size of the credit for which they might be eligible.

- **Participate** in outreach campaigns by visiting free tax assistance sites in their states and districts. These volunteer-staffed sites are generally open from late January through early April. Members of Congress can also encourage their local offices to help recruit volunteers and get the word out to members of the community. In 2004, Missouri Senator Kit Bond visited a free tax site in St. Louis operated by the Gateway EITC Coalition to draw attention to the missed opportunities resulting from under-participation in the EITC. Modest federal support for free tax assistance campaigns could expand their reach even farther and save low-income filers additional money.[32]

- **Protect** the EITC as a support for low-income working families and their communities. In an era of increased labor-market uncertainty for all types of workers, the EITC serves as a critical backstop to ensure that low-wage work will not leave families below the poverty line. Moreover, EITC funds provide a significant stimulus to local businesses and governments. Congressional support for the program in recent years has protected the EITC from potentially damaging cuts, and helped to promote work as the best pathway out of poverty.

Acknowledgment of the EITC's importance as a local economic development tool adds to its long-recognized success in boosting employment and reducing working poverty. Coalitions of local leaders, with assistance from a growing number of federal legislators, are raising awareness of the program's benefits and helping to deliver the program's benefits to all eligible working families and their local communities.

Endnotes:

[1] A comprehensive examination of the Earned Income Tax Credit and research into its effects can be found in Steven Holt, "The Earned Income Tax Credit at Age 30: What We Know" (Washington: Brookings Institution, 2006); and Robert Greenstein, "The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor" (Washington: Center on Budget and Policy Priorities, 2005).

[2] Cited in Holt, "The Earned Income Tax Credit at Age 30." All figures are in current-year (i.e., not inflation-adjusted) dollars.

[3] A small credit—$400 maximum—is available for childless workers with incomes below about $11,000.

[4] Alan Berube and Thacher Tiffany, "The 'State' of Low-Wage Workers: How the EITC Benefits Urban and Rural Communities in the 50 States" (Washington: Brookings Institution, 2004).

[5] Based on the older suburbs identified in Robert Puentes and David Warren, "One-Fifth of the Nation: A Comprehensive Guide to America's First Suburbs" (Washington: Brookings Institution, 2006). Rural areas contain disproportionate shares of low-income workers as well, and their residents receive the EITC at rates nearly as high as those in cities. Berube and Tiffany, "The 'State' of Low-Wage Workers." The higher population densities in cities and older suburbs, however, mean that they receive greater total dollar amounts from the EITC.

[6] Author's tabulations from HUD and IRS data. CDBG and HOME figures do not include grants to counties and states. In only a few suburban towns outside Boston, New York, and Philadelphia (and in Palo Alto, CA) did CDBG and HOME funds combined exceed EITC receipts.

[7] States with their own earned income tax credits include: Colorado, Illinois, Indiana, Kansas, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, Oklahoma, Oregon, Rhode Island, Vermont, and Wisconsin. Delaware, Iowa, Maine, and Virginia have state EITCs that are nonrefundable, meaning that the credits can only be used to reduce income tax liability. Source: **www.stateeitc.com.**

[8] See, e.g., Alan Berube and Benjamin Forman, "Rewarding Work: The Impact of the Earned Income Tax Credit in Chicago" (Washington, Brookings Institution, 2001).

[9] Alan Berube, "Connecting Cleveland's Low-Income Workers to Tax Credits" (Washington: Brookings Institution, 2005).

[10] Sherrie L.W. Rhine and others, "Householder Response to the Earned Income Tax Credit: Path of Sustenance or Road to Asset Building?" (New York: Federal Reserve Bank of New York, 2005); Jennie Romich and Thomas S. Weisner, "How Families View and Use the Earned Income Tax Credit: Advance Payment Versus Lump-Sum Delivery," in B. Meyer and D. Holtz-Eakin, eds., *Making Work Pay: The Earned Income Tax Credit and Its Impact on America's Families* (New York: Russell Sage Foundation, 2001).

[11] Texas Perspectives, Inc., "Increased Participation in the EITC in San Antonio" (Austin, 2003).

[12] Jacob France Institute, "The Importance of the Earned Income Tax Credit and Its Economic Effects in Baltimore City" (University of Baltimore, 2005).

[13] Holt, "The Earned Income Tax Credit at Age 30."

[14] Author's estimate based on IRS data from tax year 2004 and SB/SE Research, "Participation in the Earned Income Tax Credit for Tax Year 1996" (Greensboro, NC, 2002).

[15] Moreover, workers who were eligible for the credit in prior years but failed to claim the credit, or failed to file a tax return altogether, may file either new or amended returns for the last three years to claim those refunds.

[16] In general, receipt of the EITC does not affect one's eligibility for federal and state programs like Medicaid, TANF, Food Stamps, and SSI.

[17] Holt, "The Earned Income Tax Credit at Age 30."

[18] Alan Berube, "The New Safety Net: How the Tax Code Helped Low-Income Working Families During the Early 2000s" (Washington: Brookings Institution, 2006).

[19] Alan Berube and others, "The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC" (Washington: Brookings Institution and Progressive Policy Institute, 2002).

[20] Chi Chi Wu, "Another Year of Losses: High-Priced Refund Anticipation Loans Continue to Take a Chunk Out of Americans' Tax Refunds" (Boston and Washington: National Consumer Law Center and Consumer Federation of America, 2006).

[21] National Taxpayer Advocate, *2005 Annual Report to Congress* (Internal Revenue Service, 2005).

[22] The most recent research from 1999 estimated that 27 to 32 percent of EITC claims were paid in error. Internal Revenue Service, "Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns" (2002). Some research has criticized the methodology the IRS uses to estimate EITC error rates. Treasury Inspector General for Tax Administration, "Opportunities Exist to Improve the Administration of the Earned Income Tax Credit" (Reference no. 2003-40-091, 2003).

[23] Robert Greenstein, "What is the Magnitude of EITC Overpayments?" (Washington: Center on Budget and Policy Priorities, 2003).

[24] For a fuller discussion of error in the EITC and ongoing policy responses, see Holt, "The Earned Income Tax Credit at Age 30."

[25] Alan Berube, "Background on EITC Campaigns" (Washington: Brookings Institution, 2004).

[26] Statistics from the National Community Tax Coalition, **www.tax-coalition.org**.

[27] National League of Cities Institute for Youth, Education, and Families, *Maximizing the Earned Income Tax Credit in Your Community: A Toolkit for Municipal Leaders* (Washington, 2004).

[28] Timothy Flacke and Tiana Wertheim, "Delivering a Local EITC: Lessons from the San Francisco Working Families Credit" (Washington: Brookings Institution, 2006).

[29] *Ibid*; Enterprise Financial Pathways operates a pilot program in New York City to provide low-cost financial planning and public benefits screening alongside tax preparation; see **www.themoneysite.org**.

[30] Alan Berube, "Earned Income Credit Participation: What We (Don't) Know" (Washington: Brookings Institution, 2005).

[31] Examples in this section are adapted from: The Hatcher Group, *Connecting Elected Officials & Free Tax Assistance Campaigns: A Resource Guide* (Bethesda, MD, 2005).

[32] S. 1321, the Telephone Excise Tax Repeal Act of 2005, includes language authorizing $10 million per year in grants to qualified tax preparation clinics for low-income filers.

Additional Reading and Expert Contacts

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