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THE EARNED INCOME TAX CREDIT:
Boosting Employment, Aiding the Working Poor

By Robert Greenstein

An innovative tax credit that was established in 1975 for low-income working families and has long enjoyed bipartisan support, the Earned Income Tax Credit has been found to produce substantial increases in employment and reductions in welfare receipt among single parents, as well as large decreases in poverty. Research indicates that families use the EITC to pay for necessities, repair homes and vehicles that are needed to commute to work, and in some cases, to help boost their employability and earning power by obtaining additional education or training.

"The EITC has become a powerful force in dramatically raising the employment of low-income women in recent years."

- Committee for Economic Development

The success of the federal EITC has led 18 states to enact their own EITCs that supplement the federal credit. In addition, the United Kingdom introduced a Working Families Tax Credit modeled on the EITC in 2000 that is credited with contributing to a substantial decrease in child poverty in that country.

The EITC has enjoyed substantial bipartisan support. President Reagan, President George H. W. Bush, and President Clinton all praised it and proposed expansions in it, and economists across the political spectrum — including conservative economists Gary Becker (a Nobel laureate) and Robert Barro, among others — have lauded it.

The EITC increases employment among single parents. A substantial body of research has been conducted on the EITC over the past decade, including numerous studies of its effect on employment.[1] Only people who work are eligible for the EITC, and for workers with very low earnings such as those who work less than full time, the size of the credit increases with each additional dollar of earnings, providing an incentive for more work.

The research, which includes studies by some of the nation's leading labor economists, finds that the EITC has had a powerful effect in substantially increasing the proportion of single mothers who work. In a review of the research, Rebecca Blank, a noted economist and the Dean of the Gerald R. Ford School of Public Policy at the University of Michigan, has written that there is "unanimous" agreement that the EITC expansions implemented in the 1980s and 1990s increased employment among single parents.

This report is part of a series that reviews the accomplishments of public benefit programs, including Medicaid, food and nutrition programs, and the Supplemental Security Income program. The other reports can be found at www.cbpp.org.

EITC Basics

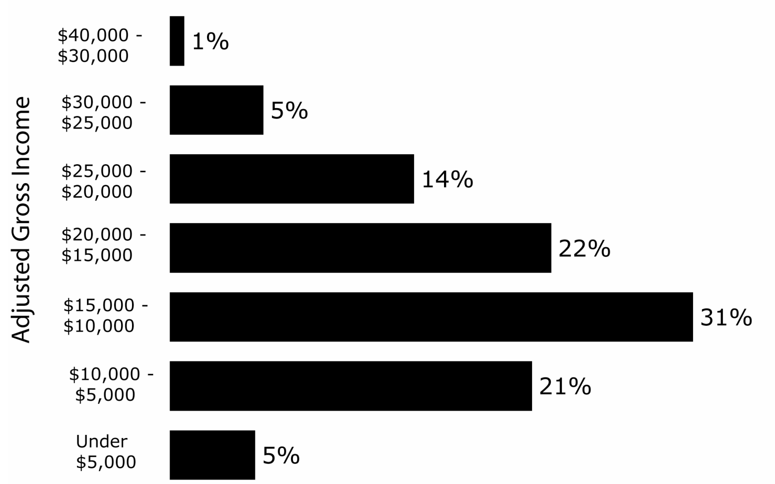
The EITC reduces tax burdens and supplements wages for low-income working families. Working families with children that have annual incomes below about $31,000 to $37,000 (depending on marital status and the number of children in the family) generally are eligible for the credit. Poor workers without children that have incomes below about $12,000 can receive a very small EITC. In the 2003 tax year, some 22.1 million working families and individuals received the EITC. Among families with children, the average EITC was $2,100.

The EITC is a "refundable" tax credit, which means that if a worker's income tax liability is less than the amount of the credit for which he or she qualifies, the worker receives the remaining amount of the credit as a refund. The EITC was fashioned in part to offset the regressive payroll tax burdens that low-income workers face, as well as income taxes that they may owe.

One of the key goals of the EITC is to "make work pay" — to reward low-wage work by reducing the taxes that low-wage workers pay on their earnings and by supplementing their wages, and to bring a family with a full-time minimum-wage worker to the poverty line so the family does not have to raise its children in poverty.

Where do EITC Benefits Go?

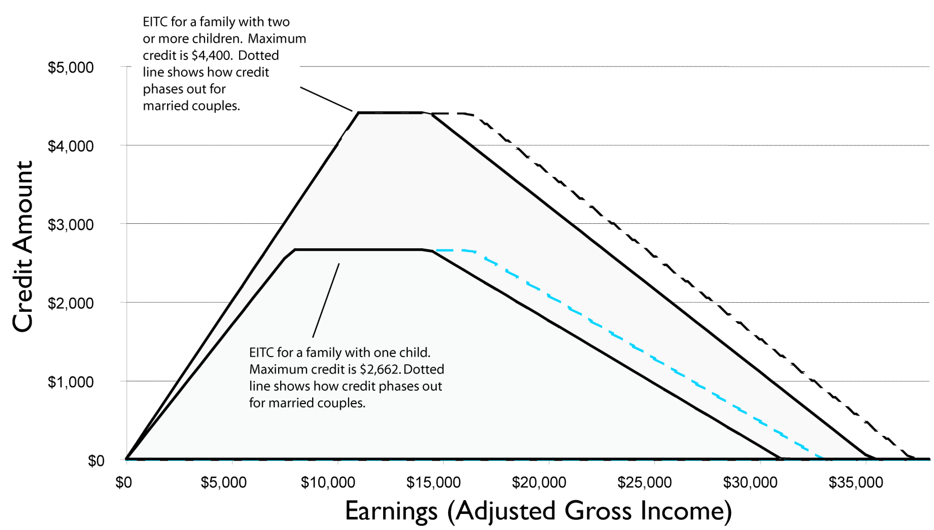
In tax year 2002, about three-quarters of EITC benefits went to families with adjusted gross income between $5,000 and $20,000 a year.



Source: Internal Revenue Service, Statistics of Income 2002, http://www.irs.gov/pub/irs-soi/02in33ar.xls

How the EITC Works (Tax Year 2005)

For families with very low incomes the size of the credit they are eligible for increases with each dollar of earnings. The credit is reduced gradually for families with higher earnings.



Some of the most extensive research has been conducted by economists Bruce D. Meyer at Northwestern University and Dan T. Rosenbaum at the University of North Carolina at Greensboro. In two published studies, Meyer and Rosenbaum found that the EITC expansions instituted between 1984 and 1996 were responsible for more than half of the large increase in employment among single mothers during that period.[2] They also found that the most significant gains in employment traceable to the EITC were for mothers with young children and mothers with low education levels.

Other studies have found that due to the EITC's effects in increasing employment among single mothers, expansions of the EITC produced large declines in receipt of cash welfare assistance. Economists Stacy Dickert, Scott Houser, and John Scholz estimated that expansions of the EITC between 1993 and 1996 induced more than a half a million families to move from welfare (AFDC cash assistance) to work.[3] In addition, in a recent study that examined the effects of welfare time limits, the EITC, and other policy changes on labor supply, welfare receipt, and income, economist Jeffrey Grogger concluded that the EITC may be the single most important policy for explaining recent increases in work and earnings and declines in receipt of cash welfare assistance among female-headed families.[4]

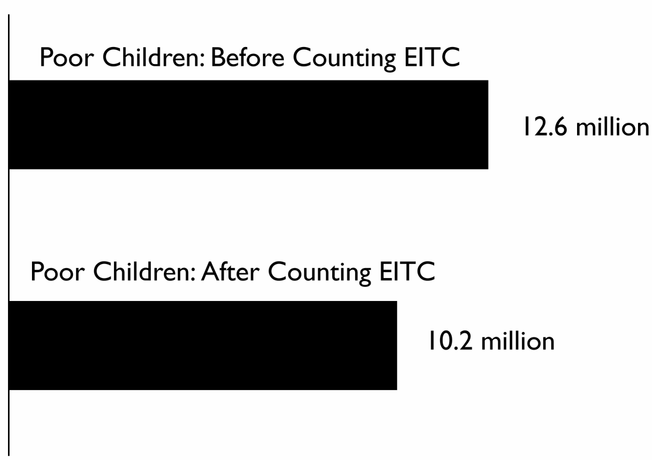
Based on the research, a report issued by the Committee for Economic Development, an organization of 250 corporate executives and university presidents, concluded that "The EITC has become a powerful force in dramatically raising the employment of low-income women in recent years."[5] The CED report urged the federal government to strengthen the EITC. Similarly, Ron Haskins, who played a central role in designing the 1996 welfare law as the lead Republican staff member on that legislation for the House Ways and Means Committee and who subsequently served in the Bush White House, has pointed to the EITC as playing a critical role in the strong increase in employment rates among single mothers that occurred in the latter part of the 1990s. Haskins has written, "Although there are undoubtedly many factors related to this remarkable increase in employment by single mothers, welfare reform, recent increases in the EITC, and a booming economy are the most important factors."[6]

The EITC reduces poverty. Recent research also documents another powerful effect of the EITC: reducing poverty. Census data show that in 2003, the EITC lifted 4.4 million people out of poverty, including 2.4 million children. *Without the EITC, the poverty rate among children would have been nearly one-fourth higher.*[7] Census data show that the EITC lifts more children out of poverty than any other single program or category of programs.

FIGURE 1

Reducing Child Poverty

In 2003, the EITC directly lifted 2.4 million children in working families above the poverty line.



Source: CBPP analysis of Census data.

The EITC strongly complements the minimum wage. For several years after the EITC expansions of 1990 and 1993, the combination of the EITC, the minimum wage, and food stamps met the goal of ensuring that a family of four with a full-time minimum-wage worker would not have to raise its children in poverty. This goal cannot be met by the minimum wage alone; the minimum wage would have to be set at more than twice its current level to achieve the goal by itself. Concerns that setting the minimum wage at that high a level would cause a significant loss of jobs make that alternative infeasible. This is one reason why a broad array of policymakers has supported achieving the goal through the combination of the EITC and food stamps, which do not increase costs to employers and thus do not risk causing job losses, and the minimum wage. (We are short today of meeting the goal that a family of four with a full-time minimum wage worker not have to raise its children in poverty, due to the erosion of the minimum wage to inflation over the past seven-plus years. The minimum wage has not been raised since September 1997; the Consumer Price Index has increased 20 percent during this period.)

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Research shows that many families that receive the EITC use it to pay for basic necessities like housing, utilities, food, and basic household appliances. The research also suggests that some families use their EITC to make purchases or investments that can help them maintain their jobs and their homes or to improve their employability so they have a better chance of moving into the middle class. The research indicates, for example, that a significant share of families use part of their EITC to repair or replace a car needed to get to work, to make essential but costly repairs to a home such as repairing a leaking roof, or to pay for more education or job training.[8]

Strengthening the EITC

Low-income workers between ages of 25 and 64 who are not raising minor children are eligible only for very small EITC benefits. The credit for workers not raising children averages about $220; this credit is available only to workers with incomes of less than about $11,750 (less than $13,750 for a married couple without children).

For these workers, the EITC simply offsets a portion of the federal taxes they pay; it does not supplement wages. In fact, even with the small EITC that poor single workers without children receive, such workers begin to owe federal income tax several hundred dollars *below* the poverty line. A single worker with wages equal to the poverty line ($10,062 in 2005) pays a total of $827 in federal income and payroll taxes *after* the EITC is taken into account, if only the employ*ee* share of the payroll tax is counted. When the employ*er* share of the payroll tax is counted as well (as economists generally believe it should be), these workers pay $1,600 in federal income and payroll taxes. They are taxed into poverty.

Enlarging the small EITC for these workers could reduce poverty and hardship. Furthermore, by increasing the returns from work, expanding the small EITC for these workers might help pull more very poor men into the regular labor force.

Treasury Expert and Leading Conservative Economists Praise the EITC

In a recent paper, the Treasury's leading expert on the EITC, Janet Holtzblatt of the Office of Tax Policy, reviews the research on the EITC's on work and poverty. Holtzblatt writes:

> "Several recent studies have found that the EITC encourages work, as well as alleviates poverty. Comparing the effects of time limits, the EITC, and other policy changes on welfare participation, labor supply, and income, Grogger (2003) concludes that the EITC may be the "single most important" policy parameter for explaining recent declines in welfare and increases in work and earnings among female-headed families. Meyer and Rosenbaum (2001) found that more than 60 percent of a nine percentage point increase in the employment of single mothers between 1984 and 1986 was due to expansions of the EITC. Dickert, Houser, and Scholz (1995) estimated that expansions of the EITC between 1993 and 1996 would induce more than half a million families to move from welfare to work. Eissa and Liebman (1996) find that the EITC expansion in the Tax Reform Act of 1996 significantly increases labor force participation among single mothers, especially less educated women."*

Similarly, in the mid-1990s, at a time when Congress was considering proposals to cut the EITC, two of the nation's leading conservative economists rallied to the EITC's defense.

In a 1996 *Wall Street Journal* column, conservative Harvard economist and then *Journal* contributing editor Robert J. Barro observed: "...There exists a serious program in the form of the earned income tax credit that actually helps the working poor in a way that promotes work and discourages welfare. The EITC was originally a Republican idea — started by the Ford administration in 1975 and expanded by the Reagan administration during the glorious 1980s and the Bush administration in 1990....Mr. Clinton's support is not sufficient reason to regard the program as mistaken. In fact, it has a well conceived structure that ought to be retained and perhaps expanded..."**

Similarly, in a 1996 *Business Week* article, Nobel laureate Gary S. Becker praised the EITC for aiding poor families without reducing employment, discouraging work, or increasing reliance on public assistance. Becker wrote that the EITC "rewards rather than penalizes poor families with working members....Empirical studies confirm the prediction of economic theory that the EITC increases the labor force participation and employment of people with low wages because they need to work in order to receive this credit." Becker also applauded the EITC for being "fully available to families with both parents present, even where only one works and the other cares for their children...."*** [i.e., for being available to low-income working families with stay-at-home mothers].

* Janet Holtzblatt, "Trade-offs Between Targeting and Simplicity: Lessons from the U.S. and British Experiences with Refundable Tax Credit," 2004.

** Robert J. Barro, "Workfare Still Beats Welfare," *Wall Street Journal*, May 21, 1996.

*** Gary S. Becker, "How to End Welfare 'As We Know it' — Fast," *Business Week*, June 3, 1996.

The EITC also could be improved for families with three or more children, who are more likely than smaller families to be poor. Some 36 percent of all children live in families with at least three children, but more than half (54 percent) of *poor* children live in such families. An increase in the EITC for families with three or more children, as has been proposed at various points in the past by Members of Congress of both parties (such as Senator Orrin Hatch), could help address the higher poverty rates that exist among working families with at least three children.

Such a proposal would build on the current structure of the EITC, which provides a larger credit for families with two or more children than for families with one child, but does not provide any increase based on family size beyond that. This proposal would recognize that the costs of living and of caring for children rise when there are more children in the family (as do benefit levels in most public assistance programs), but that wages do not. Modestly enlarging the EITC for families with three or more children thus could increase the EITC's effectiveness in promoting work, reducing cash welfare receipt, and reducing poverty among these families.

Another improvement that could be made in the EITC would be to reduce the marriage penalty it can create. The 2001 tax-cut legislation eliminated marriage penalties in certain other parts of the tax code, but left an EITC marriage penalty in place, although it reduced that penalty. A further reduction in the marriage penalty the EITC can engender would be sound policy.

Finally, the EITC remains much too complex for low-income working families. Due in significant part to its complexity, the EITC can lead to tax-filing errors, and about 70 percent of filers claiming the EITC resort to paying commercial tax preparers to file their return, a larger percentage than for tax filers generally. (See appendix to this paper.) Simplification of the EITC would be highly desirable.

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1 For a summary of research on the EITC, see V. Joseph Hotz and John Karl Scholz, "The Earned Income Tax Credit." In Robert A. Moffitt, ed., *Means-Tested Transfer Programs in the United States* (Chicago: The University of Chicago Press, 2003).

2 See Bruce D. Meyer and Dan T. Rosenbaum, "Making Single Mothers Work: Recent Tax and Welfare Policy and its Effects." In Bruce D. Meyer and Douglas Holtz-Eakin, eds., *Making Work Pay: The Earned Income Tax Credit and Its Impact on America's Families* (New York: Russell Sage Foundation, 2001) and Bruce D. Meyer and Dan T. Rosenbaum, "Welfare, The Earned Income Tax Credit, and the Labor Supply of Single Mothers." *Quarterly Journal of Economics* 116(3): 1063-2014. Less research has been done on the impact of the EITC on work effort by married couples. Findings from two studies suggest that married women in two-earner families that receive the EITC work somewhat less because of the EITC. Whether this is a desirable or undesirable result depends on one's view of whether it is beneficial or harmful for one of the parents in a two-earner family to work less and spend more time caring for the couple's children; a number of economists and analysts from across the political spectrum have argued this should not be viewed as a negative outcome. See David T. Ellwood, "The Impact of the Earned Income Tax Credit and Social Policy Reforms on Work, Marriage, and Living Arrangements," in Meyers and Holtz-Eakin, *Making Work Pay*.

3 Stacy Dickert, Scott Hauser, and John Karl Scholz, "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation," *Tax Policy and the Economy,* Vol. 9, MIT Press, 1995.

4 Jeffrey Grogger, "The Effects of Time Limits, the EITC, and Other Policy Changes on Welfare Use, Work, and Income among Female-Head Families," *Review of Economics and Statistics*, May 2003.

5 Committee for Economic Development, "Welfare and Beyond: Making Work *Work,*" 2000.

6 Ron Haskins and Wendell Primus, *Welfare Reform and Poverty*, Brookings Institution, 2001. http://www.brookings.edu/dybdocroot/wrb/publications/pb.pb04.htm

7 Analysis of Current Population Survey data by the Center on Budget and Policy Priorities. In 2003, the EITC reduced the number of children in families with below-poverty disposable income from 12.6 million to 10.2 million and the number of Americans (all ages) in families with below-poverty disposable income from 35.3 million to 30.9 million, a decline of 4.4 million. This analysis uses a measure of poverty that counts food, housing, and energy assistance benefits as income and subtracts income and payroll taxes.

8 Timothy M. Smeeding, Katherin Ross Phillips, and Michael A. O'Connor, "The Earned Income Tax Credit: Expectation, Knowledge, Use, and Economic and Social Mobility." In Meyer and Holtz-Eakin, *Making Work Pay*.

APPENDIX A

EITC Error Rates

The EITC is criticized for having a high rate of overpayments. The actual level of overpayments, however, is in doubt. The most recent IRS study of EITC overpayments was for tax year 1999.[i] While this study is often cited, it is likely to overstate the *current* overpayment rate significantly for two reasons, as described below. It is clear that the EITC continues to have a significant error problem, due in part to its high degree of complexity, but reliable information on current EITC error rates is not available.

The principal reason that the data from the IRS study of error rates in 1999 overstate the current error rate is that since 1999, Congress has made substantial changes to reduce EITC overpayments. The Treasury's leading EITC experts have estimated that changes in the EITC enacted in 2001 reduced EITC overpayments by approximately $2 billion a year.[ii] The IRS also has instituted a battery of administrative changes in how it handles the EITC and scrutinizes EITC returns. In addition, the IRS has increased the number of EITC returns that are audited by 25 percent since 2001. (The IRS is now pilot-testing three further changes in EITC procedures to determine their effectiveness in reducing overpayments, and the Bush Administration submitted a legislative proposal to Congress last year that would significantly simplify the EITC and reduce errors. Congress has not acted on the Administration's proposal.)

The other reason that the study of error rates in 1999 is problematic is that the study may itself have overstated the error rate for 1999. Nina Olson, the IRS' National Taxpayer Advocate, has documented that in many cases, apparent findings by the IRS that certain EITC claims represent overpayments are not correct. When the IRS rules in an audit that an EITC claim is erroneous, but a taxpayer challenges the ruling and a process ensues that involves a number of contacts between the taxpayer and the IRS, the ruling that the claim is invalid is frequently reversed. Reversals are particularly widespread in cases where the taxpayer receives assistance in understanding what documentation the IRS is seeking to verify the taxpayer's EITC eligibility and in assembling the appropriate documents. Olson has emphasized that IRS' study of EITC overpayments in 1999 did *not* allow for an adequate interactive process of this nature and may have reflected premature judgments in a number of cases that EITC payments were made in error.

Indeed, a recent analysis by Olson's office shows that in 43 percent of the cases studied in which a tax filer whose EITC claim was partially or entirely denied in an audit sought reconsideration of the denial, the denial was overturned. Denials were overturned in nearly half of the cases where an EITC filer requested and received assistance from the IRS' Taxpayer Advocate Service.

This suggests that some portion of the EITC claims classified as erroneous in the study of 1999 tax returns may have been valid claims for which a tax filer, acting without assistance, was unable to provide documentation that satisfied the IRS reviewers within the timeframes the IRS study allowed. In a report to Congress in 2003, Olson stated that for these reasons, she believes the 1999 study "overstates the overclaim rate."[iii]

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[i] Internal Revenue Service, "Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns," February 28, 2002.

[ii] Janet Holtzblatt and Janet McCubbin, "Issues Affecting Low-Income Filers," in *The Crisis in Tax Administration*, ed. by Henry Aaron and Joel Slemrod, Brookings Institution Press, 2004.

[iii] Taxpayer Advocate Service, Internal Revenue Service, "The National Taxpayer Advocate's Report to Congress: Fiscal Year 2004 Objectives," June 30, 2003, pp. 20-21.

APPENDIX B
EITC Claims Filed for Tax Year 2003*

State	
U.S. Total	**22,112,000**
Alabama	485,000
Alaska	39,000
Arizona	400,000
Arkansas	278,000
California	2,510,000
Colorado	267,000
Connecticut	168,000
Delaware	57,000
District of Columbia	52,000
Florida	1,576,000
Georgia	845,000
Hawaii	86,000
Idaho	101,000
Illinois	855,000
Indiana	426,000
Iowa	172,000
Kansas	177,000
Kentucky	343,000
Louisiana	535,000
Maine	87,000
Maryland	350,000
Massachusetts	308,000
Michigan	645,000
Minnesota	259,000
Mississippi	373,000
Missouri	436,000
Montana	74,000
Nebraska	110,000
Nevada	160,000
New Hampshire	62,000
New Jersey	496,000
New Mexico	199,000
New York	1,497,000
North Carolina	751,000
North Dakota	40,000
Ohio	787,000
Oklahoma	314,000
Oregon	225,000
Pennsylvania	773,000
Rhode Island	65,000
South Carolina	424,000
South Dakota	55,000
Tennessee	547,000
Texas	2,162,000
Utah	140,000
Vermont	38,000
Virginia	500,000
Washington	355,000
West Virginia	146,000
Wisconsin	293,000
Wyoming	34,000

Source: IRS data for Tax Year 2003 covering claims filed through December 2004.

*Note: U.S. total and state figures have been rounded.