



# METROPOLITAN POLICY PROGRAM THE BROOKINGS INSTITUTION

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

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*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.*

**T**he 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.

*“A continuing subject of numerous academic reviews and studies, the Earned Income Tax Credit requires a summary of the state of knowledge to provide state and local stakeholders with a better understanding of the nature of the credit, its impact, and its future.”*



This research brief summarizes the state of knowledge on the EITC to provide state and local stakeholders with a better understanding of the nature of the credit, its impact, and its future. It begins with a short history of the EITC and an overview of its structure, administration, and size. It looks at the people and places that benefit from the credit, as well as the gaps that exist in participation. The paper then reviews research on how the EITC affects several important socioeconomic measures, including income and poverty; work effort; wages; family formation; household spending and asset development; and activity in the broader metropolitan economy. It concludes by examining issues of EITC awareness, complexity and costs, and error rates, and summarizes several proposals that would modify or replace the federal EITC to address these concerns.

Although not exhaustive in its review of the rich literature on the EITC, what follows offers a “one-stop shop” for some of the most pertinent research on the credit. It also serves as a reference guide to more than 150 studies that delve deeply into key issues that surround a widely praised policy tool now approaching middle age.

## Part I—How Does the EITC Work?

**T**his section offers an overview of how the EITC operates within the tax code, the details of its evolution, configuration, and administration as well as the operation of its state and local counterparts. In addition, the section offers informative statistics on the current size and structure of these credits.

### *History*

#### **Federal EITC**

The federal EITC has its roots in Nixon-era debates over large-scale initiatives to provide a guaranteed minimum income for all Americans. The credit’s chief proponent, Sen. Russell Long (D-LA), originally proposed a bonus program for the poor who were willing to work, which evolved into a more modest focus on reducing the regressive effects of rising payroll taxes. The first EITC was a small credit of up to \$400 for low-income workers with children, enacted as part of an economic stimulus package (Ventry 2001). In 1975, 6.2 million families claimed \$1.25 billion in credits (Committee on Ways and Means 2004).

The federal EITC generated little initial excitement in 1975, but it gradually grew in size and importance. It was made permanent in 1978 and was expanded significantly as part of a major federal tax law overhaul in 1986. The credit became a more prominent policy tool in 1990 when it was expanded to ensure that federal deficit reduction initiatives did not further burden lower-income families. In 1993, President Clinton and Congress doubled the size of the EITC as the centerpiece of Clinton’s strategy to ensure that a minimum-wage worker could support him- or herself and family with full-time work (Hotz and Scholz 2003). The 1993 expansion also created a small credit for very low-income workers without children at home (Caballero 1995).

The EITC has attracted increasing attention over the years due, in no small part, to its increasing size. The 1986 tax law indexed the EITC for inflation, protecting workers against erosion in the credit’s real value. Indexing, combined with expansions in eligibility, led to phenomenal growth in the program’s size. The 1990 and 1993 expansions together almost tripled the program’s cost (Ventry 2001). By 1996, the EITC exceeded total federal and state Aid to Families with Dependent Children (AFDC) payments (Ellwood 2001), and it surpassed the Food Stamp Program in 1998 (Committee on Ways and Means 2004). Today, the EITC is a large tax benefit for families with children generally, outstripping the Child Tax Credit (CTC) and trailing only the dependent exemption in total budgetary cost (Ellwood and Liebman 2001). In 2003, 19.3 million families received \$34.4 billion from the credit (Committee on Ways and Means 2004).

The dramatic growth in the EITC, together with the significant expansions enacted during the Clinton administration, may have contributed to a decline in the bipartisan support that had long characterized the credit. Some have charged that the EITC is simply a second tier of welfare that has lost any connection to refunding taxes paid. Others raise concerns about the credit's implicit work disincentives and marriage penalties, perceived shortcomings in its targeting of poor families, and its substantial costs. In particular, the IRS' estimates of high error rates have led to charges (largely unsubstantiated) of widespread fraud (Gillespie and Schellhas 1994; Schiffren 1995; Ventry 2001). Recent changes in EITC rules have been designed to limit error and fraud (Internal Revenue Service 2002), while recent expansions in the credit have been limited to married filers (Gitterman, Cotton, and Howard 2003) and military personnel (Bell Policy Center 2005).

### State and Local EITCs

As the federal EITC became a more significant policy tool, states themselves began adopting the idea. By 1994, seven states had instituted their own version of the EITC that operated through their state income tax codes. Because these state credits usually piggybacked the federal credit—meaning that taxpayers receive a portion of their federal EITC on their state return—they grew in size along with the federal credit (Meyer and Rosenbaum 2001).

Adoption of the Temporary Assistance for Needy Families (TANF) program in 1996 stimulated additional growth in state EITCs by allowing states to use TANF funds to pay for part of the costs of a state credit, or to count the expenditures toward the state's TANF maintenance of effort (MOE) requirement (Schott et al. 1999). States have also used EITCs as vehicles for easing regressive tax increases and budget cuts that disproportionately affect lower-income families. In tax year 2005, 15 states and the District of Columbia had a state EITC in place, and an additional state, Colorado, had a temporarily suspended credit (Llobrera and Zahradnik 2004). Two additional state EITCs, Delaware and Virginia, were available beginning in 2006 (State EITC Online Resource Center 2005).

A few locally administered EITCs have sprung up as well. Montgomery County, MD, adopted a local credit in 1999 as an alternative to a living wage ordinance (Toikka and Neveu 2002). Denver started a local EITC in 2002 using TANF funds that the state passed through to local control (Nevel 2002). A New York City EITC took effect in August 2004 (New York State Department of Taxation and Finance 2005), and San Francisco initiated its Working Families Credit in 2005 using local general revenue matched by philanthropic dollars, two-thirds of which were provided by H&R Block (San Francisco Office of the Mayor 2005).

## Structure

### Federal EITC

The federal EITC comprises a series of tax credits that operate differently for different types of filers. All share a calculation formula that (a) increases the credit for each additional dollar earned up to a certain level; (b) maintains the maximum credit payment through an amount of additional earnings; and (c) steadily phases out the credit at higher income levels, up to an income eligibility ceiling. The parameters of the phase-in, plateau, and phase-out ranges vary with number of children in the household and marital status.

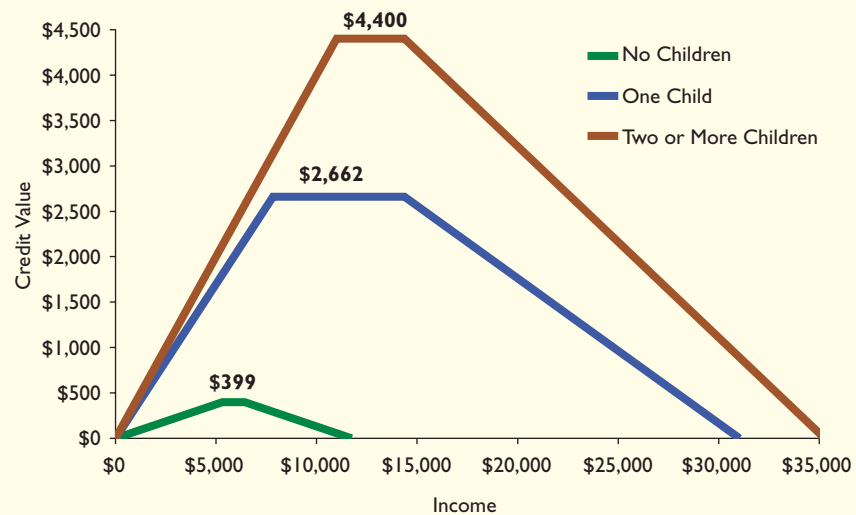
The largest EITC payments are for persons who have qualifying children. The definition of qualifying child has changed over time; currently, a qualifying child is one who (a) is the child or a sibling of the taxpayer, or a descendant of either a child or a sibling (including foster children); (b) lives with the worker more than half of the year; and (c) is under age 19, or under age 24 if a full-time student or permanently and totally disabled. "Tiebreaker" rules govern situations in which more than one taxpayer with earnings could claim the same child, with a custodial parent having priority over any other relative living with the child.

**Table 1. EITC Parameters, Tax Year 2005**

	Single, No Qualifying Children	Single, One Qualifying Child	Single, Two or More Qualifying Children	Married, No Qualifying Children	Married, One Qualifying Child	Married, Two or More Qualifying Children
Phase-In Rate	7.65%	34%	40%	7.65%	34%	40%
Phase-In Ends	\$5,200	\$7,800	\$11,000	\$5,200	\$7,800	\$11,000
Maximum Credit Amount	\$399	\$2,662	\$4,400	\$399	\$2,662	\$4,400
Phase-Out Begins	\$6,550	\$14,400	\$14,400	\$8,550	\$16,400	\$16,400
Phase-Out Rate	7.65%	15.98%	21.06%	7.65%	15.98%	21.06%
Eligibility Ceiling	\$11,750	\$31,030	\$35,263	\$13,750	\$33,030	\$37,263

Source: Internal Revenue Service

**Figure 1. Value of the EITC, 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.

New rules in effect for tax returns filed in 2006 bring the definitions for other child-based tax benefits closer in line with EITC qualification rules (Internal Revenue Service 2005a).

Workers who have no qualifying child may receive the EITC if they are between age 25 and 64, are not someone else's qualifying child, and have lived in the United States more than half the year. Both the income limits and the maximum credit amounts for the childless worker credit are much lower. Table 1 shows the different configurations of the federal EITC for tax year 2005, and Figure 1 shows the structure for unmarried filers.

A few additional provisions govern eligibility for the federal EITC. Affecting many immigrants are requirements that the taxpayer must have been a U.S. citizen or a resident alien for the full year, and that the taxpayer, spouse (if filing a joint return), and all qualifying children must have valid Social Security numbers. To ensure that taxpayers with low earnings but substantial wealth do not receive the EITC, those with investment income greater than \$2,700 in 2005 are

ineligible for the credit (Internal Revenue Service 2005d).<sup>1</sup>

What truly sets the EITC apart from many other provisions of the tax code is its refundability. The amount of the credit for which a taxpayer is eligible is determined independently from the amount of income tax owed. If a taxpayer's family has an income tax liability, the amount of the EITC for which he or she qualifies acts to reduce that tax. Any amount left over once tax liability is reduced to zero is returned to the taxpayer as part of a tax refund. If the taxpayer has no tax liability at all, because of low income or the application of other credits and deductions, he or she may receive the entire EITC as a refund (along with tax withheld). This refundability allows low-income workers who miss out on the benefits of most tax credits and deductions to take full advantage of the incentives offered through the EITC.<sup>2</sup>

### State and Local EITCs

Although nearly all state and local EITCs mimic the federal credit in their basic structure, they vary considerably in terms of refundability, size, coverage, and family size adjustments. In all but one jurisdiction, the state or local credit is calculated directly or indirectly as a percentage of the federal EITC, and the credits have the same eligibility criteria as the federal EITC. In most jurisdictions, the credit is refundable (as is the federal EITC). In some, however, the EITC can only be used to reduce taxes owed, and any excess credit is not refunded to the taxpayer. The federal regulation that TANF funds may be used to support the refundable portion of a state EITC, and not the nonrefundable portion, has encouraged more widespread use of refundable credits (Llobrera and Zahradnik 2004). Table 2 shows enacted state and local credit parameters for 2005.

**Table 2. State and Local EITC Parameters, Tax Year 2005**

Jurisdiction	Refundable?	Percentage of Federal EITC
Colorado [suspended]	yes	10%
Delaware [2006]	no	20%
Illinois	yes	5%
Indiana	yes	6%
Iowa	no	6.5%
Kansas	yes	15%
Maine	no	4.92%
Maryland	yes	20%
Massachusetts	yes	15%
Minnesota	yes	25% (0 children); variable (33% avg.)
New Jersey	yes (mostly)	20%
New York	yes	30%
Oklahoma	yes	5%
Oregon	yes [2006]	5%
Rhode Island	no (mostly)	25%
Vermont	yes	32%
Virginia [2006]	no	20%
Wisconsin	yes	4%, 14%, 43% (by # of children)
District of Columbia	yes	35%
Denver [repealed]	yes	20%
Montgomery County (MD)	yes	20%
New York City	yes	5%
San Francisco	yes	16%

Source: Llobrera and Zahradnik (2004); State EITC Online Resource Center; author's research

Calculating state and local EITCs as a percentage of the federal EITC automatically adjusts credits by family size. In Wisconsin, the adjustment is both more explicit and more dramatic, with sharply different percentages for each of three family sizes. Minnesota is the one jurisdiction that calculates its EITC separately from the federal EITC. The design attempts to mitigate high “effective tax rates” faced by claimants as public benefits such as food stamps and Medicaid phase out simultaneously with the federal credit (Wilson 2000). Even there, however, state credit eligibility is tied to the federal rules.

### *Administration and Payment*

#### **Federal EITC**

The federal EITC for any given tax year is claimed on tax returns filed in the following year. For example, the EITC for 2005 will be claimed on the returns most people file between January and April 2006. Those claiming the EITC with one or more qualifying children must file Schedule EIC and cannot use the simplified Form 1040EZ. Claimants can either use tables in the tax return instructions to calculate the EITC amount themselves, or they can write “EIC” on their return to have the IRS calculate the credit (Internal Revenue Service 2004a).<sup>3</sup> Refunds that include the EITC are typically issued earlier in the filing season than other refunds, with more than 75 percent occurring in February and March (Barrow and McGranahan 2001).

Workers with a qualifying child expecting to claim the EITC can choose to receive a portion of their anticipated credit from their employers during the tax year as part of their paychecks. To exercise the advance payment option, an employee files IRS Form W-5 with his or her employer, and the employer uses tables similar to withholding tables to determine the amount to be added to each paycheck (and deducted from the employer’s own withholding deposits). The tables limit the advance to 60 percent of the maximum credit payable for a worker with one qualifying child. Even with this limit on the size of advance payments, it is possible for a worker to have received excess advances that must be repaid or offset against a tax refund (Holt 1994).

Despite the availability of advance payment, the overwhelming majority of EITC recipients receive the credit as a lump-sum refund.<sup>4</sup> In 1989, fewer than one in 200 EITC recipients used advance payment (GAO 1992), and the proportion remained roughly the same in 2003. A mere 0.2 percent of the total refunded in EITC for 2003 had been paid in advance (Internal Revenue Service 2005b).

Another important aspect of EITC administration concerns recertification. Since 1997, taxpayers whose EITC claims have been disallowed through an IRS audit must be recertified as qualified for the EITC before receiving a credit payment in a subsequent tax year. The taxpayer initiates the process by filing IRS Form 8862 with a return that includes an EITC claim. The IRS then generally requires taxpayers to document eligibility, such as establishing that their child lived with them for more than half the year. Since 2000, a taxpayer cannot be recertified for two years if he or she is found to have negligently claimed the credit through reckless or intentional disregard of the regulations, and for 10 years if found to have committed fraud (GAO 2002). During Fiscal Year 2002, the IRS applied the two-year ban to approximately 8,600 taxpayers, and about 18,000 taxpayers—less than 0.1 percent of the EITC claimant population—had a ban in effect as of July 2003 (Treasury Inspector General for Tax Administration 2004b).

Overall, the amount spent to administer the federal EITC appears to be quite low. Even assuming that all the costs of identifying and investigating fraudulent refund schemes were EITC-related, the Government Accountability Office (GAO) (1995) found that administrative costs probably did not exceed 1 percent of program costs. Under the even more unlikely assumption that 10 percent of the IRS budget applies to administering the EITC, costs would have been only 3 percent of benefits paid in 1995 (Liebman 1997). These percentages are lower than for other transfer programs (Scholz 1997) owing, in large part, to the relatively lower administrative burdens the EITC places on its recipients (Caballero 1995).



### State and Local Earned Income Tax Credits

State and local EITCs offer no advance payment options; therefore, all are claimed in the year following when they are earned. Taxpayers typically claim state and local EITCs by filing a state income tax return with a copy of the federal return attached. Because the state or local EITC is usually a percentage of the federal amount, the amount of the claim is easily established. Piggy-backing on the federal credit allows states to rely on IRS oversight of eligibility (Wilson 2000).

Despite the link to the federal credit, a sizable percentage—estimates place it at 15 percent—of federal EITC recipients fail to claim available state credits, especially in the first years after a state credit is introduced (Center on Budget and Policy Priorities 2003). At least two states, Minnesota and Maryland, have cross-checked state and federal return records to identify non-claimants (Center on Budget and Policy Priorities 2000b).

Local EITCs present additional challenges because many jurisdictions do not have a local income tax. In Montgomery County, MD, the state comptroller provides the county with a list of eligible recipients based on state tax return data, and the county issues checks in late July (Montgomery County Department of Finance 2005). Denver used a two-page application that included an authorization for the city to obtain the applicant's federal tax return transcript directly from the IRS (Nevel 2002). For its Working Families Credit in 2005, San Francisco also used an application form that included the authorization for the IRS transcript. The application was due by the tax filing deadline of April 15, ineligible applicants were notified by June 30, and credits were paid in September (City and County of San Francisco 2005).

## Part II—Who Benefits from the EITC?

**T**he structure of the EITC tells us something about how large its benefits are, and where those benefits are directed. This section examines the research on the geographic areas and demographic groups that benefit from the EITC, as well the number and characteristics of eligible workers and families that fail to claim the EITC.

### Payments

As noted above, spending for the federal EITC has increased dramatically. The EITC grew from \$8.7 billion in 1990 to \$34.4 billion in 2003 (in 2003 dollars) (Gitterman, Cotton, and Howard 2003). State EITC expenditures recently ranged from \$14 million in Vermont to \$501 million in New York (Llobrera and Zahradnik 2004).

The federal government classifies EITC payments as either offsets to tax liabilities or as disbursements representing the refundable portion of the credit. In tax year 2003, roughly 88 percent of EITC dollars were refunded (Internal Revenue Service 2005f). This share has steadily increased from the initial 72 percent in 1975 (Committee on Ways and Means 2004).

An important distinction separates EITC *claims* from EITC *payments*. IRS enforcement procedures—many of which occur without an audit through what is known as “math error authority”—deny or reduce some claims prior to payment. For instance, the IRS eventually denied roughly \$540 million in EITC claims in Fiscal Year 2002 (Internal Revenue Service 2003).

Because the amount of the federal EITC increases with the number of qualifying children, credit expenditures are weighted more to larger families. The majority of EITC dollars are paid to families with at least two qualifying children (Table 3). Taxpayers filing as head-of-household or single (versus married) claimed more than 75 percent of total federal EITC payments in 2003 (Committee on Ways and Means 2004).

The EITC benefits more moderate-income families than traditional government benefit programs such as cash welfare or food stamps (Liebman 2001a). In 2002, 26 percent of EITC payments went to households with adjusted gross incomes under \$10,000, 53 percent went to households with incomes between \$10,000 and \$20,000, and 21 percent was paid to relatively higher-income families (Greenstein 2005).

As the size of the overall federal EITC program increased, the average credit paid to each claimant also rose dramatically, from \$201 in 1975 to \$1,784 in 2003 (Committee on Ways and

**Table 3. EITC Claims by Number of Qualifying Children, Tax Year 2002**

Qualifying Children	Claims (millions)	Percentage of Claims (%)	Amount Claimed (\$billions)	Percent (%) of Amount Claimed
0	4.0	18	0.9	2
1	8.4	39	14.0	37
2+	9.2	42	23.4	61
All	21.7	100	38.2	100

Source: Internal Revenue Service (2004b)

Means 2004). One review found that the credit constituted a 13 percent boost in household income in selected urban and rural communities (Berube 2003). Significant differences in the average EITC payment among geographic areas are associated with underlying differences in employment levels and wages available to low-skilled workers. For example, because low-income working families in the rural South have lower incomes, they tend to receive larger average EITC refunds (Berube 2003; Berube and Tiffany 2004).

### People

#### Eligible Population

An accurate picture of the population eligible for the EITC can help state and local actors better understand which families are most likely to benefit from the credit. Yet a lack of good data often frustrates attempts to identify the characteristics of these families. One of the most recent studies (Hoffman and Seidman 2003) used tax year 1996 data from the Panel Study of Income Dynamics and found that 13 percent of U.S. households that year were eligible for the federal EITC.<sup>5</sup> Table 4 presents these estimates of EITC-eligible households by race or ethnicity, family type, and number of children. Another study of tax year 1999 finds that slightly fewer than one-half of all EITC-eligible households were headed by racial or ethnic minorities, similar to Hoffman and Seidman's estimate (Stegman, Davis, and Quercia 2003).

The EITC-eligible population overlaps with, but is distinct from the population defined as poor. The average household income of those eligible for the EITC is about 125 percent of the federal poverty level. About one-third of households with incomes below the federal poverty line do not have children and fail the age test for the credit for workers without a qualifying child (most are elderly). Nearly as many meet the qualifying child or age tests but do not have earnings. Altogether, only about 35 percent of households in poverty are eligible for the EITC (Hoffman and Seidman 2003).

Several other studies have examined EITC eligibility among other subpopulations, finding that:

- Single mothers with two or more children and less than a high school diploma are more likely to be eligible (95 percent) than those with more than a high school education (65 percent) (Meyer 2002).
- Cohabiting couples with children are more likely to be eligible than married couples, largely because they have lower incomes (Acs and Maag 2005).
- In 1997, 73 percent of households with children eligible for food stamps were also eligible for the EITC, but this fell to between 45 and 47 percent in 1998 and 1999 (Mikelson and Lerman 2004).
- A conservatively estimated 12 percent of military families were eligible to receive the EITC in 2004 (Bell Policy Center 2005).

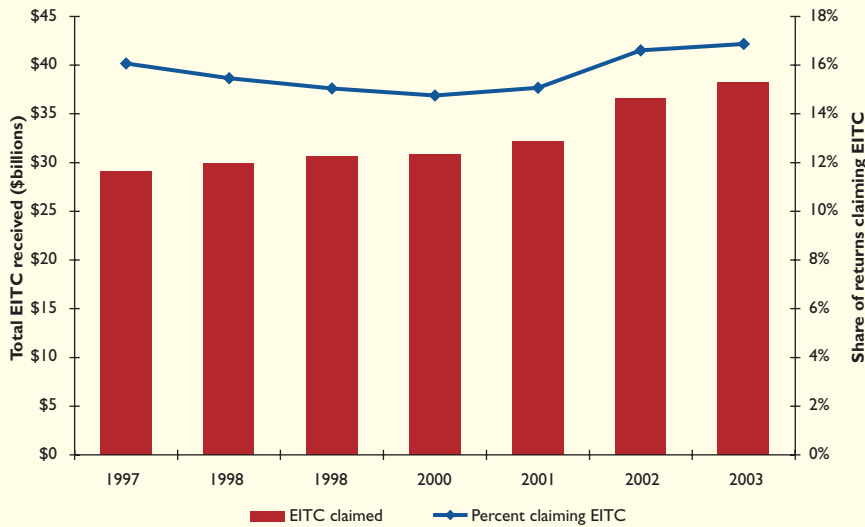


**Table 4. Characteristics of the EITC-Eligible Population, Tax Year 1996**

Characteristic	Percent
<b>Race-Ethnicity</b>	
White	50.8
Black	22.2
Latino	20.7
Other	6.3
<b>Family Type</b>	
Single female with children	35.9
Single male with children	10.0
Married with children	35.3
Single no children	13.5
<b>Family Size</b>	
No children	18.8
1 child	30.0
2 children	28.9
3 or more children	22.3

*Source: Hoffman and Seidman (2003)*

**Figure 2. Percentage of Returns Receiving EITC, and EITC Amount Received, 1997–2003**



*Source: Internal Revenue Service*

**Claimants**

Compared with the EITC-eligible population, more definitive information is available about those who actually claim the EITC. Nationwide, approximately 17 percent of federal individual income tax returns for tax year 2003 included an EITC claim (Figure 2). This was the highest rate in recent years, most likely because of subpar economic conditions in the early part of the decade (Berube and Tiffany 2004). The individuals who compose the EITC population change

**Table 5. Incomes of EITC-Claiming Taxpayers, Tax Year 2003**

Adjusted Gross Income	Percentage of EITC Claimants
Less than \$5,000	13.5
\$5,000 to \$9,999	22.2
\$10,000 to \$14,999	18.7
\$15,000 to \$19,999	15.5
\$20,000 to \$24,999	14.2
\$25,000 to \$29,999	11.5
\$30,000+	4.4

*Source: Internal Revenue Service (2005g)*

significantly from year to year, however, and some cycle in and out of eligibility. Among tax year 2003 claimants, 31 percent did not claim the credit in 2002 (Internal Revenue Service 2005g), and 20 percent of those who claimed for 2001 but not 2000 received the credit for 1999 (Internal Revenue Service 2003).<sup>6</sup>

The rate at which taxpayers claim the EITC varies considerably by location. A higher percentage of central-city families (20 percent) than suburban families (11 percent) claim the EITC. The percentage of rural families claiming the credit is also relatively high (18 percent). In the Northeast and Midwest, EITC recipients are more concentrated in central cities, while recipient households are more scattered in the South and West. Overall, households in the South are more likely to receive the credit than those in other regions (Berube and Forman 2001; Berube and Tiffany 2004).

These differing claim rates carry over to the types of communities in which EITC filers typically live. In suburbs and small metropolitan and rural areas, the plurality of EITC filers live in areas where between 10 and 20 percent of taxpayers receive the credit—approximately the national average. In large cities, however, more than 20 percent of EITC claimants live in areas where at least 40 percent of filers receive the credit (Berube and Tiffany 2004). Thus, recipients tend to be far more spatially clustered in cities than in other types of places.

As shown above in Table 3, more than eight in ten EITC recipients claim the credit with a qualifying child. They split roughly evenly between households with one qualifying child and those with two or more children.

The median income of EITC recipients increased from \$10,808 in 1990 to \$15,400 in 1999 (Lieberman 2001a; Yin et al. 1994). This was only about 9 percent higher in constant dollars; thus, much of the increase reflects the indexing of the EITC for inflation. Table 5 shows the distribution of EITC claimants in tax year 2003 by adjusted gross income. A significant proportion—roughly 30 percent—had incomes above \$20,000. Overall, a majority of EITC recipients have incomes that put them in the phase-out range of the credit, meaning that they would receive a smaller EITC as they earned more (Hoffman and Seidman 2003; Scholz 1994).

Many EITC filers are self-employed. Roughly 21 percent of tax year 2003 returns claiming the EITC reported income from a business, farm, or real estate, a proportion that has grown in recent years (Internal Revenue Service 2005g).<sup>7</sup> More than one-half of self-employed EITC claimants in tax year 2002 had no employer-paid earnings, and 23 percent of self-employment businesses that year filed returns claiming the EITC (Severens 2005).

### **Participation**

The corollary question to “who claims the EITC?” is who is eligible but fails to claim the credit? Among the growing number of local organizations dedicated to improving awareness of the EITC, discussions abound as to how many people miss out on the EITC and who they are. Because these families may qualify for large refunds composed of credits and withheld taxes,

**Table 6. Estimated participation rates among filers eligible for the EITC**

Participation Rate		Study	
Estimate	Population	Year	Source
69 to 74%	All households (with children only)	1988	Blumenthal, Erard, and Ho (2005)
89%	Households (with children) required to file returns	1988	Blumenthal, Erard, and Ho (2005)
80 to 86%	All households (with children only)	1990	Scholz (1994)
50%	California welfare households	1992	Hotz, Mullin, and Scholz (2003)
82 to 87%	All households	1996	SB/SE Research (2002)
75%	All households	1999	GAO (2001)
73%	California welfare households	1999	Hotz, Mullin, and Scholz (2003)
83%	All households	1999	Blumenthal, Erard, and Ho (2005)
94%	Households required to file returns	1999	Blumenthal, Erard, and Ho (2005)
82%	New York state households	2000	Children's Defense Fund of New York (2004)

local campaigns often aim to tap millions of federal dollars “left on the table.”<sup>8</sup>

The percentage of an eligible population that actually accesses a program is commonly known as the *participation rate*. The EITC participation rate cannot be precisely known, and the degree of precision declines with the size of the area being examined. The primary challenge in calculating an accurate EITC participation rate is obtaining a good source of information on eligible taxpayers. The vast majority of taxpayers who fail to claim the EITC when eligible do not file a tax return (SB/SE Research (2002)). Thus, IRS and state tax return records do not contain information needed to identify the size or characteristics of the eligible population.

To identify potentially eligible households, researchers typically look at large-scale surveys such as the Current Population Survey and the Survey of Income and Program Participation. These sources lack some detailed information needed to definitively establish eligibility (e.g., whether a child in the household satisfied the residency requirement). Moreover, a true participation rate must exclude those who claimed the credit but were ineligible (Berube 2005a). It is difficult to identify whether households in these surveys who are judged to be eligible actually claimed the credit. Reporting of EITC receipt by survey respondents is spotty and often unreliable, and matching tax records by Social Security numbers is expensive and less reliable than might be expected (SB/SE Research 2002). Furthermore, because the surveys are national-level samples, they become statistically unreliable when looking at smaller jurisdictions (Berube 2005a).

Nonetheless, several studies have estimated EITC participation rates for varying populations. The studies, using a variety of methods, find that a relatively high percentage of eligible workers claim the federal EITC, with some indications that the rate has increased over time (summarized in Table 6).

The expansion of the federal EITC to workers without qualifying children in 1993 affected overall program participation. Households eligible for this credit have much lower average incomes than those eligible for the credit with qualifying children, and they qualify for a much smaller credit amount. Childless workers made up an estimated 40 percent of eligible non-claimants in 1996 (SB/SE Research 2002) and 60 percent of those not participating in 1999 (GAO 2001), with the latter study finding a participation rate for this group of under 45 percent. Even critics who believed that the GAO methodology likely underestimated the overall EITC participation rate found the estimate for childless households relatively reliable (Burman and Kobes 2002).

Little information exists on participation rates specific to state and local EITCs. As noted earlier, there appears to be a gap between the number of taxpayers receiving state credits and the

number receiving the federal credit, above and beyond the less-than-100-percent participation in the federal credit (Center on Budget and Policy Priorities 2003). At the same time, studies of Wisconsin income tax returns found Milwaukee County participation rates for the state EITC to range from 62 to 87 percent, and central-city Milwaukee rates ranged from 69 to 93 percent among those most likely to be eligible (Pawasarat and Quinn 2004; Quinn 2000). A study of the Minnesota Working Family Tax Credit found that participation rose in periods of high job growth and low inflation (Hirasuna and Stinson 2003).

Participation rates for the EITC are significantly higher than for other federal assistance programs (Burman and Kobes 2003; Scholz 1997). Nonetheless, the EITC participation rate among eligible taxpayers is almost certainly not 100 percent in any geographic area. Researchers generally acknowledge that communities can and should invest in outreach to boost participation in the EITC and other low-income credits without knowing precisely their local participation rate (Berube 2003), though some have expressed skepticism that additional outreach will necessarily lead to higher program participation (Hotz and Scholz 2003).

Several studies have identified characteristics associated with eligible nonfilers—those who could receive the EITC but fail to file a tax return to claim it (Blumenthal, Erard, and Ho 2005; GAO 2001; Hirasuna and Stinson 2003; Hotz and Scholz 2003; SB/SE Research 2002; Scholz 1994). These characteristics, some of which overlap and some of which may at first seem contradictory, include:

- eligibility for a smaller credit
- lower household income
- larger family
- receiving child support
- no qualifying children
- younger parent
- male
- higher percentage of income from self-employment
- employed in a private household occupation
- no high school diploma or college education
- no prior tax filing experience
- living in state with no income tax.

Language and ethnicity may be important as well. Spanish speakers appear to claim the credit at lower rates than others (Scholz 1994), and only 15 percent of Latino low-income parents reported receiving the federal EITC in 2002 (Maag 2005). This may be exacerbated in rural areas, where there is less EITC information and available assistance (Varcoe, Lees, and López 2004). Yet it also appears that residents of areas with high concentrations of immigrants—mainly central-city neighborhoods—have higher EITC participation (Berube 2005b).

The evidence is mixed on the relation between EITC participation and marital status. An extensive study of tax year 1990 finds that eligible unmarried taxpayers claimed the credit at lower rates (Scholz 1994). A study of 2002 Wisconsin state income tax returns, however, finds that among the populations most likely to be eligible for the state EITC, single filers filed for the credit at a significantly higher rate (Pawasarat and Quinn 2004). Another survey finds that married low-income parents were less likely to report having received the credit than unmarried parents (Ross Phillips 2001).

From a purely economic standpoint, some of those not claiming the EITC may be making a rational decision. The benefit of claiming a small credit, for instance, may not be considered worth the cost of obtaining it, in time or in tax preparation fees. A household's personal circumstances may also complicate receipt or even make filing a claim risky (Scholz 1994). For many eligible nonfilers, though, the significant value of the credit would likely outweigh these considerations.

## Part III—What Are the Impacts of the EITC?

Understanding the participation dynamics in the EITC and the benefits it confers to families and communities is critical for designing policies such as state and local earned income credits and for devising effective strategies to reach potentially eligible filers. Evidence on how the EITC affects social and economic well-being is similarly valuable. Fortunately, researchers have devoted a great deal of attention to analyzing the effects of the EITC on measures of income, work, family formation, and household or community expenditure patterns. This section provides an overview of that rich literature.

### *Household Income and Poverty*

The EITC has proved remarkably successful in reducing poverty. In 2003, the EITC lifted 4.4 million people in low-income, working families out of poverty, more than one-half of them children. Today, the EITC lifts more children out of poverty than any other social program or category of programs. Without it, the poverty rate among children would be 25 percent higher (Greenstein 2005). The Council of Economic Advisers (1998) found that more than one-half of the decline in child poverty between 1993 and 1997 could be explained by changes in taxes, and most important was the EITC. Another study found that from 1995 through 1999, the EITC reduced the overall poverty rate by 1.5 percentage points, even though only about one-third of poor households qualify for the credit (Hoffman and Seidman 2003). The total poverty gap—the aggregate difference between poor families' resources and the poverty threshold—for families with children would have been 20 percent higher in 1999 without the EITC (Ziliak 2004).

Expansions of the EITC have proved critical for enabling low-wage workers to support themselves and their families without falling below the poverty line. In the credit's first year (1975), the combination of the credit and full-time, year-round work at the minimum wage provided an income \$107 above the federal poverty level for a family of three. In 1986, a similar combination of wages and the credit would have left the same family \$1,511 below the poverty line. The increases in the credit in the early 1990s reversed this, so that minimum wage work plus the EITC provided \$1,154 more than the poverty level for a family of three in 1995 (Hotz and Scholz 2003). Because the minimum wage has not increased since 1997, however, the same family today (2005) would fall \$1,000 short of the poverty threshold. Nevertheless, for those who are temporarily poor owing to job instability or an economic downturn, the EITC operates as a form of wage insurance (Bluestone and Ghilarducci 1996). This use is largely borne out by the turnover in the credit-claiming population noted earlier.

The EITC can also act as an affordable housing tool. One measure of income adequacy is the percentage of income that a household spends on its housing. In 1999, about one in four EITC-eligible families lived in households with severe housing cost burdens, meaning that housing required more than one-half of their gross income. After adding in income from the EITC, however, the incidence of severe cost burdens among these households dropped by 15 percent overall, and by 25 to 33 percent for families with children (Stegman, Davis, and Quercia 2003).

The National Center for Children in Poverty (2001) studied the effect of state EITCs on poverty among children under age 18 in families with at least one working parent. It found that refundable state credits narrowed the overall gap between income and the poverty line for these children by 1.4 (Indiana) to 9 percent (Minnesota). State nonrefundable credits, by contrast, provided virtually no benefit to working poor families.

Some economists have found that receiving the EITC may offset income losses from reduced use of other public assistance programs. One study finds that increases in the credit between 1993 and 1999 resulted in a 10 percent decline in use of AFDC and TANF during that period. Each \$1,000 increase in the maximum credit amount reduced welfare use by 1.5 percentage points among families with children as young as age 3, and by 3.1 percentage points among families whose youngest child was age 10 (Grogger 2003). In many cases, the drop in program

participation reflects the result of families moving from welfare to work and earning above the income eligibility limits for those other programs. Yet some evidence suggests that, at least in the recent past, the EITC has not always worked in concert with these other programs; one study concludes that the EITC likely led to a decline in the percentage of *eligible* families obtaining food stamps between 1997 and 1999 (Mikelson and Lerman 2004).<sup>9</sup>

### Work

The EITC provides lower-income workers and families with additional income on the basis of their earnings from employment. The amounts can be very significant; thus a natural question is, How does the EITC affect decisions about work? Research strongly confirms that the EITC has played a critical role in bringing more single mothers into the workforce. For those already in the workforce, the effects on labor supply appear much smaller and mixed.

The EITC can theoretically affect two aspects of labor supply: participation (whether or not someone is working) and intensity (number of hours worked). For lower-skilled workers, the EITC offers a positive participation incentive given that it increases the income available to these workers beyond what wages alone would provide. How the EITC affects work intensity, however, varies depending on whether the worker is in the phase-in, plateau, or phase-out portion of the credit's structure (see Figure 1).

In the phase-in range, the incentives are positive. Because the EITC increases with additional earnings, workers are induced to earn more, and thus work more. In the EITC plateau, the effect of the credit on work intensity is neutral. Increased wages compensate for free time lost by working more, but the EITC itself provides no additional compensation. In the phase-out range, the EITC can actually provide a reason *not* to work and earn more because each additional dollar earned reduces the amount of the credit. For an economist, this means that the overall effect of the EITC on labor supply cannot be determined theoretically but must be observed (Hotz and Scholz 2003).<sup>10</sup>

A consistent finding from the numerous studies on the labor supply effects of the EITC is that the credit increases employment among single mothers (Meyer 2001; Meyer and Rosenbaum 2001). Overall, the labor force participation rate for single women with children increased by 2.8 percentage points between 1984 and 1990, and by 6.1 percentage points for the least skilled of these workers (those most likely to qualify for the EITC) (Eissa and Liebman 1996). One study estimates that the EITC and other tax changes were responsible for more than 60 percent of the increase in single mothers' work between 1984 and 1996 (Meyer 2001), and another attributes 34 percent of the increase in employment among single mothers between 1993 and 1999 to EITC expansions (Grogger 2003).

Additional evidence on this question comes from studies examining the effect of the larger credit for workers with two or more children, which was introduced in 1994. The introduction of this larger credit corresponded with a larger employment increase among single mothers with two or more children beginning that year, relative to other family types (Meyer and Rosenbaum 2001). Among single-mother welfare recipients in California, the larger EITC was estimated to account for 84 percent of the difference in the employment rate increases between one-child and multi-child families (Hotz, Mullin, and Scholz 2005), a finding that indicates strong labor force participation.

Although researchers have found large and positive effects on single mothers' labor force participation, they have found no evidence that the EITC induces those already in the labor force to work more hours (Eissa and Liebman 1996; Meyer 2002). Moreover, researchers have found an association between the availability and size of the EITC and the number of married women with children in the labor force. Effectively, the credit has helped married mothers (or fathers, if the mother works) to stay at home by supplementing the earnings of the working spouse (Eissa and Hoynes 2004; Ellwood 2001). These estimated effects are relatively modest, however, and the increases in single mothers' labor supply associated with the EITC appear to outweigh any decreases among married couples (Ellwood 2001; Hotz and Scholz 2003).

As outlined above, the EITC theoretically provides disincentives to working or earning more



when one is in the phase-out range, given that the credit decreases in size with each additional dollar earned.<sup>11</sup> However, there is little evidence to support this contention (Ellwood and Liebman 2001; Hoffman and Seidman 2003; Hotz and Scholz 2003; Keane and Moffitt 1996; Meyer 2002). One reason may be that affected workers are not aware of the disincentive. The EITC is largely hidden from the everyday work world, in sharp contrast to overtime premiums, tax withholdings, and even the incentives in traditional income assistance programs (Liebman 1997; Lipman and Williamson 1994; Romich and Weisner 2001). Even if workers were more aware of the EITC's structure, it is unclear that they have the ability to determine how many hours they should work, or any other factors (such as job security and seniority) involved (Lipman and Williamson 1994). Nevertheless, even if the work disincentives associated with the phase-out of the EITC have small effects on behavior, one could argue for addressing the disincentives on the grounds that taxpayers with low incomes should not incur higher marginal tax rates than taxpayers with higher incomes (Cherry and Sawicky 2000).

Finally, economic analyses of labor force participation and hours worked can overlook the potentially beneficial aspects of reductions in labor supply. In some cases, working (and earning) less may increase the well-being of a low-income household. For example, providing a hard-working parent with the ability to reduce her hours can afford her more time with her children (Alstott 1995).

### **Wages**

Distinct from the labor supply effects of the EITC are its effects on worker wages. Because the credit is an earnings supplement, the EITC could theoretically lead employers to lower wages as they find they can pay less and still fill jobs.

However, there is no strong evidence that the EITC has depressed wage rates significantly. One reason is that EITC-eligible workers are a minority in each rung of the labor market. For example, in 1996, they were 48 percent of those earning less than \$6 an hour, 34 percent of those earning \$6.00 to \$7.50 an hour, and 29 percent of those earning \$7.50 to \$10.00 an hour (Hoffman and Seidman 2003). This limits the ability of the EITC to affect wages marketwide. Moreover, employers would find it difficult to pay different wages to workers in similar jobs on the basis of their EITC eligibility. One study does find that a 10 percent increase in a state EITC was associated with a 4 percent drop in wages of high school dropouts and a 2 percent decline in wages for those with only a high school diploma (Leigh 2003).<sup>12</sup> Another recent study concludes, however, that expansions to the EITC during the 1990s had little apparent effect on hourly wages near the bottom of the wage distribution (Eissa and Nichols 2005). There is some evidence that the EITC helps workers in families earning below the poverty level increase their wage earnings. (Neumark & Wascher 2000).

### **Family Structure**

As with the rest of the tax system, the EITC could potentially influence family formation and configuration given that the credit is calculated at the family level, and because its benefits vary depending on the number of children in the household. Taken as a whole, however, the EITC appears to have small to negligible effects on these family decisions.

The EITC generates both marriage “bonuses” and “penalties.” It generally serves as a marriage bonus—meaning that the total size of the credit is larger for a married couple than it would be if each spouse filed separately—among single mothers who are not working, for whom marrying a worker could result in their family receiving the EITC. Conversely, the EITC acts as a marriage penalty for single mothers who do work, for whom there is a greater likelihood that adding a husband's income to their tax return would place them in the phase-out range of the credit, or above the income eligibility ceiling altogether (Ellwood 2001). These bonuses and penalties apply equally if a couple has been cohabiting and is thus considered two households under tax law (Acs and Maag 2005).

Calculating marriage bonuses and penalties requires artificially splitting up couples to ask,

“what if?” Nonetheless, it appears that penalties associated with the EITC outnumber bonuses by at least two to one (Hoffman and Seidman 2003). A study looking at tax year 2000 estimated that the EITC increased the dollar amount of marriage bonuses throughout the tax code by 6 to 10 percent, and increased marriage penalties by 30 to 32 percent (Holtzblatt and Rebelein 2001). In 2003, the average EITC marriage bonus was \$865 and the average penalty was \$2,089 (Acs and Maag 2005).

The more important question is whether these EITC marriage bonuses and penalties affect marriage decisions. One study finds that for taxes generally (not the EITC specifically), a couple’s initial decision to marry or cohabit is only marginally affected by income tax consequences, but for those cohabiting, the decision to marry is significantly affected by taxes (Alm and Whittington 2003). Yet there is no evidence of dramatic changes in marriage patterns as a result of the EITC (Ellwood 2001), and it does not seem that the EITC itself significantly influences marriage decisions (Dickert-Conlin and Houser 2002). To the extent that any negative effects exist, they are probably small (Hoffman and Seidman 2003).

A different question that has received comparatively little attention is the EITC’s effect on a family’s decision to have children, given the larger payments for low-wage workers who have a first or second child. One study found that EITC expansions during the 1990s increased the probability that non-white women would have a first or an additional child (Baughman and Dickert-Conlin 2003). In general, however, studies of antipoverty programs like the EITC on childbearing have found relatively small effects (Hotz and Scholz 2003).

### *Household Spending and Asset Development*

Because the EITC is most often received as a large, lump-sum payment at tax time, it could have important impacts on household expenditures and savings decisions. Surveys of low-income taxpayers and analysis of large-scale expenditure data suggest that, for the most part, families that receive the credit use the proceeds to meet short- and medium-term consumption needs; a minority of families may be able to apply credit dollars toward longer-term asset development goals.

A few researchers have surveyed individuals who use free tax return preparation programs to gain insights into how EITC recipients plan to use their refunds. In one community, the majority anticipated using their refund to repay debts or meet immediate needs, with only 11 percent saying they intended to save a majority of it (Rhine et al. 2005). In another city, one-half of all respondents indicated that bill payment was the first priority, and 83 percent rated bill paying as their first, second, or third priority. Nevertheless, one-half of those with qualifying children said savings was one of their top three priorities (Smeeding, Ross Phillips, and O’Connor 2001).<sup>13</sup>

Another smaller, ethnographic study analyzed how families actually used refunds that included the EITC. Although some respondents were able to save a portion of their refund, two-thirds had no cash savings remaining two months after receiving their refunds (although a few paid their rent several months in advance and others made savings-like expenditures). Those who did have savings remaining included those reserving money for future emergencies and those setting aside funds for a larger goal, such as a down payment on a house. Overall, two-thirds reported that expenditures on their children were their priority use. Several used refund dollars to purchase larger goods, most commonly furniture (Romich and Weisner 2001).

The EITC stimulates increased spending during tax season. One study found that recipients spend approximately 20 percent of the cash refund in the month they receive it, and that EITC eligibility increases total spending by between 2 and 5 percent in February (the month in which the most EITC is received). In particular, expenditures by eligible families for durable goods increase by 10 percent (Barrow and McGranahan 2001). Another study estimates much higher rates of short-term consumption among EITC recipients, averaging 70 percent of credit dollars in the month they are received, with equal expenditure for durable and nondurable goods (Edwards 2004). The immediate use of credit dollars suggests that families may have spent some of the anticipated proceeds in advance using credit (such as for year-end holiday gifts) and are paying the bills when they receive their tax refunds.

Because tax refunds that include the EITC amount to a financial windfall for many families, some analysts view the program as a tool for longer-term savings and asset development. The challenge to this view is that the families most able to afford long-term savings are not those receiving the largest EITC payments; those credits are typically directed to families with below-poverty earnings. Short-term needs and a desire to be prepared for costly emergencies such as job loss or car problems seem to militate against the use of the EITC to fund structured savings tools such as Individual Development Accounts (Smeeding 2002). Evidence from a program linking tax refunds to no-fee, no minimum balance savings accounts is consistent with this view; 41 percent of those opening accounts with their tax refunds rapidly spent those dollars, while only 14 percent used the accounts as savings vehicles (Beverly, Romich, and Tescher 2003).

Yet even if only a minority of EITC recipients can use the credit to build assets, it still offers a real opportunity to those who can. A survey of free tax preparation site users in Milwaukee finds that 7 percent planned to use their refund toward an investment in themselves or their children, and another 7 percent were saving for a major expenditure such as a house (Goldberg and Percy 2005). Investments in family economic stability can include prepaying a few months' rent or setting aside funds for unforeseen emergencies (Romich and Weisner 2001). How families use the EITC thus suggests that "asset building" might be construed more broadly to include strategies intended to avoid future indebtedness, and that careful study of credit recipients may help identify those who are best positioned to pursue longer-term savings goals.

### **Local Economic Activity**

A final effect of the EITC is the aggregate impact of the credit on households' spending patterns in the local economy. A few researchers have attempted to quantify how much EITC dollars boost economic activity throughout a metropolitan area, mainly in support of efforts aimed at increasing EITC participation.

Particularly in cities, the number of households receiving the EITC (Berube and Tiffany 2004) can have a potentially large effect on local economies as dollars are spent and cycled through the local economy. In 1999, for example, 14 ZIP codes—all located in central cities—each received more than \$20 million in EITC, undoubtedly boosting the purchasing power of those communities (Berube and Forman 2001). An analysis of Cuyahoga County, OH, notes that EITC dollars received by residents in the first months of 2003 equaled all wages and salaries paid in the hotel industry that quarter (Berube 2005c).

A San Antonio study hints at the potentially large economic impact of expanding the EITC rolls, concluding that two-thirds of additional credit dollars would be spent locally. Each additional dollar received is estimated to generate a further \$1.58 in local economic activity, and one additional permanent job would be created for each \$37,000 claimed (Texas Perspectives 2003).<sup>14</sup>

The San Antonio study also finds that each \$1,000 of federal EITC would generate an additional \$2 in local tax revenue. The researchers conclude that modest municipal expenditures on promoting the EITC and free tax return preparation might easily pay for themselves (Texas Perspectives 2003). A similar study in Baltimore found that current EITC receipt generated nearly \$600,000 in local income and property tax revenues (Jacob France Institute 2004). Findings from a similar study in Nashville, conducted through a partnership between an EITC outreach campaign and a local university, helped to generate local governmental support for the campaign there (Hamernik 2005).

Economists also measure the impact of a public program through its efficiency cost: that is, a comparison of the reduction in well-being among those from whom the revenue for the program is obtained (other taxpayers) to the increase in well-being for program recipients (EITC claimants). One study finds relatively high efficiency costs for the EITC (Browning 1995), while another finds relatively low costs (Triest 1993). One key factor that compensates for the increased tax burden on non-EITC recipients is the positive, economywide impact the EITC has on labor force participation (Hoffman and Seidman 2003).

## Part IV—What Other Issues Apply to the EITC?

**N**o one has ever accused the U.S. tax code of being too simple, or free from controversy. The EITC is no exception. This final section provides an overview of the research and latest evidence on a few key issues likely to shape the experiences and strategies of state and local leaders whose work intersects with the EITC.

### *Awareness*

Many communities have promoted the EITC and related tax benefits. Research on issues affecting awareness of the credit is helpful in discerning which families are least likely to know about the EITC, and how families who do know about the credit perceive it.

A key factor in gauging awareness of the EITC, and especially determining whether someone has received it, is how the question is asked. Because the credit is paid as part of the tax refund, recipients are sometimes unable to distinguish it from their other refund dollars. An ethnographic study that permitted greater interaction with respondents found that more than 90 percent were at least somewhat familiar with the EITC with slight prompting (Romich and Weisner 2001). Survey methodology might explain why only about one-third of respondents at free tax preparation sites said they were familiar with the credit (Smeeding, Ross Phillips, and O'Connor 2001). With that caveat in mind, the results of three studies are instructive (Maag 2005; Richardson 2002; Ross Phillips 2001):

- A majority, and possibly nearly two-thirds, of likely eligible respondents said they knew about the EITC.<sup>15</sup>
- Awareness was correlated with income; respondents with incomes at 150 percent of the federal poverty level and above were the most likely to report familiarity with the credit.
- Among racial-ethnic groups, low-income Latino parents were the least likely to have heard about the EITC.
- Those who had received AFDC, TANF, or food stamps in the past were more likely to be aware than current recipients or those who had never received public assistance.
- Low-income parents who had not completed high school were significantly less likely to know about the EITC than low-income parents with some college education.
- Married, low-income parents were less likely to know about the credit than unmarried parents.
- Low-income parents who use a paid tax preparer were less likely to have heard of the EITC.

The problem of inadequate information among Latino communities is seen again in a study of TANF recipients, leavers, and applicants, and in a survey of low-income rural Latino mothers (Richardson 2002; Varcoe, Lees, and López 2004). One issue identified, at least in border communities, is that directly translated outreach materials often fail to take into account the lower education levels of the target audience, rendering many Spanish-language outreach strategies ineffective (Robles 2003).

The ethnographic study that found widespread familiarity with the EITC also noted a general understanding of the relation between earnings and the EITC. However, a few families were misinformed, believing, for example, that eligibility depended on a period of unemployment or a minimum number of hours of work per week. On the other hand, some recipients were highly knowledgeable and could describe the implications of changes in filing status and dependents (Romich and Weisner 2001).

### *Complexity*

That potential recipient households may be confused about the EITC is not surprising, given the complexity of the credit. The National Taxpayer Advocate (2004) finds that numerous and often confusing EITC eligibility requirements leave many low-income taxpayers struggling to determine whether they qualify. One goal for policy could be to ensure that EITC filers are able

themselves to complete the forms necessary to claim the credit; current forms tend to be too complex to understand without outside assistance (Marguerite Casey Foundation 2005), as evidenced by the high proportions of credit recipients who use paid tax preparers (Berube et al. 2002; Berube 2006).

Contributing to the problem are the different and sometimes conflicting rules for other tax code provisions that affect families with children, such as the dependent exemption and the Child Tax Credit (CTC) (Carasso, Rohaly, and Steuerle 2005). Until tax year 2005, different definitions of “child” applied to the dependent exemption, head-of-household filing status, the EITC, the CTC, and the Child and Dependent Care Tax Credit (CDCTC). These definitions have been synchronized somewhat, but important differences remain. Holtzblatt and McCubbin (2004) identified several thorny rules, listed below, that make taxpayers eligible for one or more of these provisions but not others, and failure to negotiate any of these complexities successfully could constitute noncompliance:

- To qualify for the CTC, a taxpayer must have provided at least one-half of the child’s support; no such test applies to the EITC.
- A qualifying child for purposes of the EITC must reside in the United States; no such restriction applies to the CTC.
- Parsonage allowances must be counted as self-employment income for purposes of the EITC but are excluded when determining refundability of the CTC.
- Qualifying for head-of-household status involves a household maintenance test that factors in the costs of food consumed at home, while the support test that applies to the dependent exemption considers all food costs.

The complexity in claiming the EITC is also evident in the below scenario, from a report that assessed whether volunteer tax return preparers correctly prepared returns for low-income clients (Treasury Inspector General for Tax Administration 2004a):

[A]uditors presented a scenario of a single parent who had recently moved to another state. The auditor explained that his or her son had lived with the auditor for only 5 \_ months in 2003. The auditor paid for the son’s expenses while the son lived with the grandparents the remainder of the year. Volunteers did not always ask whether the son’s living with the grandparents was a permanent or temporary situation. Some volunteers made the assumption that it was a temporary situation and prepared the return with the auditor filing as head of household instead of single, thus qualifying the auditor for the EITC (p. 6).

Finally, a GAO study (2002) provides additional evidence of the difficulties encountered in the recertification process for taxpayers who had previously had their EITC claims denied. The GAO presented 21 IRS recertification examiners with five scenarios involving different sets of supporting documentation. In no case did all of the examiners agree, and in some cases their decisions varied significantly. Potential EITC claimants face many such problems in interpreting what are often complicated lives through the lens of the tax code (Greenstein 2002).

### **Error**

Error in the EITC—ineligible taxpayers claiming the credit—has attracted a great deal of research and political attention in recent years. Erroneous claims may stem from negligence or fraud on the part of a taxpayer (or a tax preparer), but they can also result from honest mistakes or confusion arising from the credit’s complexity. Most IRS research has identified a relatively high error rate in the credit, but these studies are not without shortcomings in methodology and timing. Their results are often interpreted in the political sphere, where dispassionate presentation of context, problems, and solutions is frequently lacking. That said, stakeholders will nevertheless do well to understand both the research and political dimensions of the debate on EITC error rates.

The EITC error rate has long been a hot-button issue. An IRS audit program found that in 1982, 34 percent of EITC claimants filed for too large a credit, and about 29 percent of claimants were completely ineligible. These figures increased to 42 and 32 percent, respectively,



in 1988 (Yin et al. 1994). Total overpayment of all tax credits increased from \$2.3 billion in 1985 to \$6.2 billion in 1992, and the rapid growth of the EITC was the principal factor for this rise (Internal Revenue Service 1996). These findings generated widespread concern and even alarm, especially among conservative commentators, although even sympathetic observers have expressed concern (McIntyre 2002).<sup>16</sup>

Two studies of tax returns from 1990 arrive at somewhat different conclusions about those who improperly claimed the EITC. In the first study, error rates were particularly high among male-headed households. Ineligible recipients were less likely to be married and more likely to have never been married. On the whole, they were more likely to be black, have less than a high school education, live in the South, and be age 30 or older. Interestingly, given that profile, they were much less likely to live in a household receiving public assistance (Liebman 2001b).

The other study found a significant, positive correlation between receiving public assistance income and being an ineligible EITC claimant. Other significant characteristics included having less wage income and more self-employment income, living in a metropolitan area, and having a large family (Yin et al. 1994).

The concern over EITC error rates has resulted in several statutory and administrative changes during the last 15 years. These have included simplifying some of the rules that resulted in ineligible claims, applying filters to electronically filed returns, and creating a “dependent database” from the Federal Case Registry of Child Support Orders to identify possibly erroneous qualifying child claims (GAO 1997a; Internal Revenue Service 2002; Liebman 2001b; Treasury Inspector General for Tax Administration 2003a). Congress has also required more audits of returns with EITC claims. In 2002, approximately 83 percent of IRS compliance examination resources were focused on the EITC (Treasury Inspector General for Tax Administration 2003c).

There is some evidence that these efforts to reduce EITC error rates are meeting success. In 1994, taxpayers claimed 26 percent more in EITC dollars than they were entitled to. Enforcement measures reduced the eventual size of improper payments to 24 percent, and procedures put in place in 1997 would have reduced the 1994 rate to 21 percent (McCubbin 2001). Although the IRS-identified error rate increased in 1999 to between 27 and 32 percent, the IRS noted that improvements in detecting error may have led to the higher error rate (Internal Revenue Service 2002). Overall, the statutory and administrative changes since 1999 make it likely that error rates are lower today (Greenstein 2003b). The IRS error rate goal for Fiscal Year 2004 was 22 to 27 percent (Treasury Inspector General for Tax Administration 2005b). Importantly, some research has criticized the methodology the IRS uses to estimate error rates (Treasury Inspector General for Tax Administration 2001; 2003b).

The perceived high level of error in the credit has prompted an EITC “certification test” at the IRS to reduce erroneous payments. Certification involves a separate determination on the basis of additional evidence provided by the taxpayer that he or she is eligible to claim the federal EITC. This might take the form of “precertification,” in which such evidence would be submitted before the taxpayer files a claim. On the basis of research identifying the characteristics of taxpayers who are likely to claim the credit in error, the IRS has considered requiring filers to precertify children’s relationships to the taxpayer, as well as residency in the taxpayer’s household for nontraditional households such as single fathers, grandparents, and foster parents (Greenstein 2003a). At present, the IRS has not yet pursued widespread implementation of these procedures, choosing instead to conduct small-scale tests of their effects.

During the 2004 tax filing season, the IRS asked a nationwide sample of 25,000 of these nontraditional EITC claimants to prove that their qualifying children had met the residency test.<sup>17</sup> In 2005, the IRS contacted a new sample of 25,000 (8,200 of whom lived in Hartford, CT) to test the effect of using third-party intermediaries to assist in proving EITC eligibility (National Taxpayer Advocate 2005). Preliminary results from these studies indicate that the certification requirement reduced overall claims for the EITC with qualifying children. It is yet unclear which portion of the reduction resulted from dissuading ineligible taxpayers and which portion is attributable to eligible taxpayers forgoing a claim because of the increased time and expense involved in preparing and filing the tax return and certification materials (Internal Revenue Service 2005c).



Overall, it remains unknown how many EITC errors stem from misunderstanding or misinterpretation of rules versus negligence or fraud (GAO 2002). The most common sources of EITC error are claims for qualifying children who did not live with the taxpayer for more than half the year, claiming the wrong filing status, and complicated living arrangements involving more than one custodial caregiver (GAO 1997a; Hotz and Scholz 2005; Internal Revenue Service 2002). Filers who satisfy some but not all EITC requirements are more likely to infer (mistakenly) that they are eligible and to make a claim (Blumenthal, Erard, and Ho 2005). However, error rates on the basis of IRS audits do not consider that the process for contesting audit findings is frequently biased against low-income taxpayers in various ways (Olson 2004; Spragens and Abramowitz 2005). Nonetheless, various procedures have successfully reduced the number of improper claims attributable to income reporting problems (Treasury Inspector General for Tax Administration 2000; 2005a).<sup>18</sup>

There is also some suspicion that potentially large EITC amounts have induced more individuals to claim the credit fraudulently, and that this population accounts for at least part of the recent rise in EITC claims. Yet there is little evidence of this type of negligence and fraud. For instance, Scholz (1997) finds no evidence that the refundable feature of the EITC induces ineligible households to enter the tax system simply to claim the credit. A study that examines increases in EITC participation resulting from electronic filing options and quick refunds finds no significant rise in cheating (Kopczuk and Pop-Eleches 2005). Similarly, overreporting of income to maximize the credit is quite rare (McCubbin 2001), as is misreporting self-employment income to qualify for a larger credit (Holtzblatt and McCubbin 2004; Hotz and Scholz 2003).

In the end, EITC error rates should be analyzed in the context of overall federal income tax administration. They appear lower than error rates in other areas of the income tax system. For example, a GAO study estimates that self-employed persons operating on a cash basis report only 11 percent of their income, and that the self-employed overall underreport income by 64 percent. In 1994, overstated credits (including the EITC) accounted for just 4.8 percent of the total difference between federal taxes owed and those paid (the “tax gap”) (GAO 1997b). Preliminary analysis of tax year 2001 data by the IRS’s National Research Project updated this figure to 4.4 percent (Internal Revenue Service 2005e). Studies ascribing greater importance to reducing EITC overpayments versus recovering unpaid taxes (U.S. Office of Management and Budget 2005) appear to disregard the significant shortfalls in other areas of tax collection.

Although EITC error rates perhaps compare favorably to those elsewhere in the income tax system, on the surface they appear to be significantly higher than those for traditional income assistance programs. In 1992, only 8.2 percent of food stamps and 5.3 percent of AFDC benefits were overpayments (GAO 1995). The difference in error rates is by design, however. The EITC can keep its administrative costs low because, unlike social welfare programs, it relies more on voluntary compliance and less on bureaucratic oversight (Caballero 1995; Hotz and Scholz 2003). Moreover, properly controlling for differences in recipient populations and estimation methods would narrow the gap between EITC and other program error rates (Blumenthal, Erard, and Ho 2005). As Zelenak (2004b) argues, if total program costs account for the combination of direct administrative costs, overpayments, and extent of program participation, the tax-based administration of the EITC is clearly superior to the more bureaucratic administration of food stamps (Zelenak 2004b).

### ***Filing Costs and Refund Anticipation Loans***

In addition to risking error, the complexity of the EITC has also complicated the process of preparing and filing a claim, amounting to a significant cost for many credit recipients. Some have argued that these costs should not be attributed specifically to the EITC because most recipients must file a tax return anyway (Hotz and Scholz 2003; Liebman 1997). However, the rapid growth of commercial preparers and of associated products indicates that transaction costs for EITC recipients are significant.

Paid preparers completed about 54 percent of all 1999 individual income tax returns, but

they prepared 66 percent of the returns filed by EITC claimants. By 2003, the proportion of EITC returns completed by preparers rose to 71 percent (Berube 2006). Higher percentages of low-income black and Latino parents, and those with a high school education or less, use a paid preparer (Maag 2005).

There are several potential costs associated with using a paid preparer. Although fees vary widely (GAO 2003), typical charges in 2002–2003 ranged from \$90 to \$100 to prepare a return and from \$12 to \$40 to file it electronically (Berube et al. 2002; Wu and Fox 2003). Many of those using preparers buy additional services, most commonly a refund anticipation loan (RAL), a short-term advance of an anticipated tax refund. Typical RAL charges for refunds are \$75 for the loan and \$33 in document preparation or application/handling fees. Claimants without bank accounts may also incur charges averaging 3 percent (\$45 for a \$1,500 refund) to cash either the tax refund or the RAL check (Wu and Fox 2003).

A study of 1999 returns finds that EITC recipients paid an estimated \$1.75 billion for tax preparation, electronic filing, and RALs (Berube et al. 2002). Another study of 27 urban and rural areas found that in 2000, these transaction costs consumed about 6 percent of total EITC refunds (Berube 2003). The large sums of EITC dollars flowing into lower-income communities, particularly inner cities, have led to a proliferation of paid preparers in those areas (DeParle 1999). By 2002, there were 50 percent more paid preparers per filer in ZIP code areas with high percentages of EITC filers than in areas with low numbers of those filers (Berube et al. 2002).

RALs were not a wholly private-sector innovation. The IRS first facilitated the emergence of RALs in the early 1990s by providing a “direct deposit indicator”; the indicator let a preparer know whether a refund from an electronically filed return would be offset by claims such as prior tax debt, child support arrearages, or defaulted student loans. This enabled the preparer to assess the quality of the collateral for the loan (i.e., the refund). The indicator was terminated in 1994 because of concerns about fraud involving RALs. However, as part of the effort to meet a congressional mandate for increasing the percentage of returns filed electronically, the tool was reinstated for tax year 1999 as the Debt Indicator Program (Wu 2005).

The re-introduction of the Debt Indicator Program led to rapid growth in RALs. Between the 1999 and 2001 tax filing seasons, H&R Block increased its use of RALs by 50 percent (Berube and Kornblatt 2005). Among tax filers using commercial preparers, approximately one-half obtain a loan. This wide use of RALs has generated significant profits for both the preparers and the financial institutions that originate the loans (Berube et al. 2002).

EITC claimants are especially important to the RAL industry. In tax year 2001, 55 percent of all RAL users received the EITC, although EITC recipients represent only 15 percent of all taxpayers. Overall, 43 percent of EITC recipients in tax year 2001 received their refund via a RAL; this decreased to 38 percent for 2002 returns. The highest rates of RAL use among EITC recipients were in the South and large Midwestern cities. Among large cities in tax year 2002, RAL rates ranged from 10 percent in San Francisco to 64 percent in Memphis (Berube and Kornblatt 2005; Berube and Tiffany 2004).

That EITC filers seek professional help is not surprising given the complexity of the EITC, and it has been argued that paid preparation and RALs have been a socially beneficial market solution to the problem of complexity (Kopczuk and Pop-Eleches 2005). A key factor in taxpayers’ willingness to incur fees is that the charges for return preparation, electronic filing, and RALs are often paid as a deduction from the filer’s tax refund. Because these costs are effectively an unseen reduction in a payment whose size is unknown in advance, taxpayers may not perceive them as expensive (Berube and Kornblatt 2005).

One alternative to paid preparers is the IRS Volunteer Income Tax Assistance (VITA) program. Created in 1969, VITA has grown from assisting 104,000 taxpayers in 1970 to 843,803 in 2003. This included nearly 180,000 returns claiming \$236 million in federal EITC benefits (Treasury Inspector General for Tax Administration 2004a), still a small proportion of overall claims. A study in Minnesota finds that increasing the number of free return preparation sites per capita is associated with a slight increase in EITC filing rates (Hirasuna and Stinson 2003). Another study finds that cities with higher proportions of returns prepared by volunteers experi-

enced a larger drop in RAL use between tax years 2001 and 2002 (Berube and Kornblatt 2005).

Although paid or volunteer tax preparation may offer low-income taxpayers needed assistance, it does not always guarantee more accurate negotiation of tax rules. Households receiving tax preparation assistance in 1988 were more likely to claim the EITC improperly than those who prepared their own returns (Blumenthal, Erard, and Ho 2005). Millions of taxpayers may overpay their taxes even though they use a paid preparer (GAO 2003). Governmental audits have also found accuracy problems with IRS-provided assistance (GAO 2004; Treasury Inspector General for Tax Administration 2004a), although measures recently introduced by the IRS have shown some success in raising program quality (Treasury Inspector General for Tax Administration 2005c).

Different groups will come to different conclusions regarding the merits of paid and volunteer tax preparation and how they impact access to the EITC. Regardless, the process by which low-income families receive the EITC will remain a focal point for research, policy, and practice in coming years.

### **Alternative Approaches**

Although the EITC is a hugely successful program on many levels, researchers, advocates, and policymakers have advanced a variety of proposals to reform it in recent years, ranging from modest changes to a complete restructuring. The authors of a recent comprehensive study of the EITC identify several potential targets for reform, including marginal tax rates in the credit's phase-out range; marriage penalties, and antipoverty effectiveness for large families and those headed by a minimum-wage worker (Hoffman and Seidman 2003). The approaches outlined below attempt to address these and other concerns.

#### **Marginal Tax Rates**

The marginal effective tax rate is the percentage of each additional dollar of earnings that is lost to taxes and reduced benefits. High marginal tax rates may be considered unfair and inefficient given that they could discourage work and impede economic opportunity. One simple approach to addressing high marginal tax rates associated with the EITC's phase-out range would be to reduce the phase-out rate for larger families from 21.06 percent to the 15.98 percent, applicable to families with one qualifying child. This would also increase the income eligibility ceiling for those families (Hoffman and Seidman 2003).<sup>19</sup> A more radical approach would be to eliminate the EITC phase-out altogether, making all families with children eligible for the EITC. Although costly (\$53 billion over current law as of 2001), this would greatly reduce the incidence of high marginal tax rates among moderate-income families (Ellwood and Liebman 2001).

#### **Marriage Penalties**

Researchers have suggested two straightforward ways to address marriage penalties resulting from the EITC: base the credit on the earnings of the higher-income parent only; or allow married couples to claim the credit amount they would receive if they were not married (McIntyre 2004). An approach similar to the first alternative would allow two-earner couples to deduct the lower earner's income when calculating the EITC. This would have increased EITC expenditures by \$3.1 billion a year in 2001, or about 10 percent (Holtzblatt and Rebelein 2001). Using this approach with the Minnesota Family Credit would have increased the cost of the credit by only 7 percent, but it would have increased benefits for about 25 percent of married couples already receiving the credit (Wilson 2000).

Remedies for high marginal tax rates and marriage penalties are closely related because the EITC phase-out range causes each (Cherry and Sawicky 2000). Recent marriage penalty relief initiatives have increased the income at which the phase-out range begins for married couples by \$2,000 in tax year 2005. Sawhill and Thomas (2001) suggest a larger (\$5,000) interval for the bump-up of the married phase-out range. Eliminating the EITC phase-out altogether would, of course, lead to a sharp reduction in marriage penalties (Ellwood and Liebman 2001).

Reducing marriage penalties would also improve the ability of two-earner families to escape poverty when working at minimum-wage jobs (Hoffman and Seidman 2003).

### **Credit Adequacy**

Currently, only the Wisconsin EITC provides additional benefits for families with more than two qualifying children. Advocates for creating a larger federal EITC for families with three or more children argue that it would reduce poverty among a group of children for whom poverty remains quite high, while encouraging employment among parents in larger families. The cost in 2000 would have been between \$700 million and \$800 million a year (Center on Budget and Policy Priorities 2000a). One approach would increase the phase-in rate for these households, as well as the end point of their phase-in range (Hoffman and Seidman 2003).

Concerns also surround the adequacy of the federal EITC for persons without qualifying children. A larger credit could increase the number of EITC recipients among very poor men in the legitimate labor force, thereby increasing the ability of noncustodial fathers to pay child support. One proposal would double the phase-in rate to 15.3 percent—the combined employee and employer share of payroll taxes—for these workers (Greenstein 2000; Greenstein 2005).<sup>20</sup> New York Governor Pataki has proposed providing a higher state EITC for noncustodial parents who work, have a child support order in place, and are current in their support obligations (New York Office of the Governor 2005).

### ***Restructuring the EITC***

Several reform proposals call for thoroughly transforming the federal EITC into a differently structured tax credit or other policy tool. The features of these proposals are discussed only briefly here, and readers may wish to obtain more detailed information from the publications referenced below.

#### **1. Unified Child Credit**

A unified child credit would seek to simplify child-based tax benefits by combining several of these benefits, including the EITC, into a single tax allowance. Because a unified child credit could have lower phase-out rates, it could alleviate high marginal tax rates and marriage penalties for lower-income filers.

A proposal by Cherry and Sawicky (2000) calls for a Simplified Family Credit that would be available to all taxpayers with children and earnings. It would resemble the structure of the current EITC, but the phase-out would end at a minimum benefit equal to the value of the dependent exemption and CTC for taxpayers in the middle-income tax bracket. The annual cost (compared with tax law in effect for 2000) would be \$32 billion.

Ellwood and Liebman (2001) propose providing a higher phase-in rate for families with more than two children and ending the phase-out at a level adjusted for the number of children in the family. The annual cost of this proposal in 2001 was estimated at \$27.5 billion (in 2001 dollars).

Representative Rahm Emanuel (D-IL) has proposed a Family Tax Credit that would also incorporate the CDCTC; it would have a 50 percent phase-in rate up to \$3,500 for families with one child, \$5,200 for those with two children, and \$7,000 for families with three or more children. The cost would be \$250 billion over ten years, over and above currently anticipated spending for the EITC, CTC, and CDCTC (Weinstein 2005). A very similar proposal would employ slightly lower phase-out rates and would end the phase-out at \$1,400 per child, at a cost of \$25.2 billion in 2003 dollars (Carasso, Rohaly, and Steurele 2005).

The President's Advisory Panel on Federal Tax Reform (2005) recommends a different unified credit approach. Its proposals would combine the EITC and the refundable portion of the CTC into a Work Credit with a structure similar to the current EITC. A new Family Credit would replace all personal exemptions, the standard deduction, head-of-household filing status, and the nonrefundable portion of the CTC. The proposals' goals are greater simplicity and transparency rather than any fundamental changes in the amount or availability of current benefits.

## 2. Progressive Payroll Tax and Child Allowance

Another restructuring idea seeks to make more explicit the distinction between the original purpose of the EITC—alleviating payroll tax burdens on very low-income workers—and the separate goal of ensuring income adequacy for low-income workers with children. One approach would create a payroll tax structure with progressive rates and exemption allowances (Caballero 1995). A different method would exempt a certain amount of wages from payroll taxes and create a universal family allowance. The family allowance could be available without regard to employment status or income, or it could be tied in part to a minimum level of earnings; it could also provide for both taxpayers and their dependents (similar to exemptions under current law) (Forman, Carasso, and Saleem 2005; Yin et al. 1994).<sup>21</sup> As with the unified child credit, these proposals could reduce phase-out rates and thus address marginal tax rate and marriage penalty concerns. They, too, would lead to greater revenue losses to achieve that relief.

## 3. Wage Subsidy

The current EITC is designed for lower-wage workers but is calculated on the basis of earnings, not hourly wages. An explicit wage supplement (with a minimum hours-worked requirement) could act as a more targeted work incentive, although it would require taking into account work hours and earnings in two-earner households (Eissa and Hoynes 2004). One study argues for a wage-subsidy-based state EITC in California, noting that it would provide greater benefits to low-wage workers and encourage reduced reliance on TANF assistance, while acknowledging the significant administrative challenges such an approach would entail (MaCurdy 2004). Another proposes extending a wage subsidy to employees who reside in distressed communities, covering 50 percent of the difference between the wages they earn and \$10 per hour (Scholz, 2005).

## 4. Housing Subsidy

A completely different approach would convert the EITC into a tool for improving the affordability of housing, the largest expense for most working families. One proposal would provide a credit equal to one-half of a person's housing costs in excess of 30 percent of his or her household income, capped at area fair market rents or another payment standard (Dolbeare 2001). In 1999, this approach was estimated to cost \$15.9 billion annually. It would raise considerable administrative problems, however, such as adjusting the EITC for different housing markets and verifying recipients' housing costs.

An alternative design would retain the EITC's basic structure but set the beginning and end of the "plateau" at amounts intended to ensure that working families pay no more than one-half their total income (earnings plus EITC) for rent in most housing markets.<sup>22</sup> The estimated cost of this proposal in 1999 was \$25 billion (Stegman, Davis, and Quercia 2003). Compared with the first approach, this approach would sacrifice affordability targeting for greater administrative simplicity. One critic notes that both ideas might also exacerbate the problem if the cause of the housing problem is a lack of affordable units rather than insufficient income among working families (Harkness 2004).



## Conclusion

**T**he EITC at age 30 is a robust and largely successful part of American labor and antipoverty policy. The rich, varied, and growing body of research on the subject reflects the credit's significance. The research, and this overview, may prove useful for dispelling myths and for sharpening policy, advocacy, and further focus on areas of true concern.

Despite the program's success, important work remains to improve the EITC's effectiveness. Participation by eligible households, although high, can be increased among particular low-income populations. Greater effort can be made to help taxpayers negotiate the EITC's complexity, better understand the rules that govern it, and avoid exploitation. This would help further reduce erroneous payments and lower transaction costs for low-income filers.

State and local stakeholders can make use of this research in their growing efforts to reach more eligible families with information and free tax assistance. These actors can also play a valuable role by insisting that policy proposals to change or build on the EITC at the federal, state, and local levels reflect the existing research, and by evaluating alternatives on the basis of the research.

The EITC represents a tremendous resource both for the households that claim it and for the communities in which they live. It has surely earned the nation's continued attention and support.



## Endnotes

1. A study of those claiming the EITC in 1988 finds that 5 percent of claimants reported interest and dividend income that would indicate they owned income-producing assets worth more than \$15,000 (O'Neil and Nelsestuen 1994).
2. Two other credits in the federal income tax code have a refundable aspect: the Child Tax Credit, which is partially refundable for families with incomes over \$11,000 in 2005; and a small tax credit to offset the cost of health insurance for displaced workers.
3. However, most taxpayers who claim the EITC use a paid preparer to file their tax return. See "Filing Costs" section.
4. Research by Romich and Weisner (2001) finds that a worker with two children earning \$15,000 in 1998 would have received a 9 percent increase in monthly income from advance payment, but that few prefer that to a year-end, lump-sum payment.
5. Those who were ineligible had no children and were too young to claim the credit for someone without a qualifying child (6 percent), had no children and were too old to claim the credit (22 percent), had children but no earnings (7 percent), or had incomes above the maximum eligibility amount (65 percent).
6. Notably, most EITC filers would be required to file a return even if there were no EITC. In tax year 2000, only 1.5 percent of filers with adjusted gross incomes under \$30,000 had no filing requirement but filed anyway to claim the EITC or Child Tax Credit (Holtzblatt and McCubbin 2004).
7. This was somewhat below the nationwide average for all taxpayers of 25 percent.
8. See, e.g., National League of Cities (2004).
9. By statute, the EITC does not count as income for federal means-tested programs; therefore, its receipt does not directly supplant other assistance. An EITC refund that is saved does not initially count as an asset for programs with asset ownership limits, but the exclusion ends in the second month following receipt of the refund. This could conceivably affect program eligibility, although there is little empirical evidence of such impacts.
10. The refundable portion of the Child Tax Credit helps to offset these disincentives for lower-income workers with children given that the credit phases in at 15 percent of a worker's earnings above \$11,000, up to \$1,000 per child.
11. In tax year 2005, the phase-out range for workers with qualifying children began at \$14,370. The credit declined by roughly \$0.16 for each additional dollar earned by a worker with one child, and by roughly \$0.21 for each additional dollar earned by a worker with two or more children.
12. The researcher attributes this observed effect not to employers lowering wages in direct response to the increased EITC, but instead to lower-skilled workers increasing their labor supply because of the effective pay increase the EITC provides, which in turn leads to a marketwide decline in wages.
13. These surveys were conducted of EITC-eligible taxpayers who used free tax assistance sites in New York City and Chicago; it is unclear how generalizable these results are to all EITC recipients given that the expenditure and savings needs of low-income families who use free tax assistance sites in these large cities could differ from those of similar taxpayers living elsewhere, or those using paid preparers or completing their own tax returns.
14. Note that these estimates are sensitive to the nature of the local economy and depend on industrial mix and the propensity of consumers and firms to consume goods and services within the region. Thus, the \$1.58 estimate is specific to the San Antonio economy and would likely differ from estimates conducted in other metropolitan areas.
15. This rule has changed in tax year 2005, so that for purposes of the CTC, the child must not have provided over half of his/her own support; no such rule applies to the EITC, however.
16. "In a political culture where the cynical expectation is that all programs are permeated by some degree of waste, the EITC and its current 30 to 45 percent error rate is in a league by itself" (Schiffren 1995, p. 27).



17. The residency test requires that the qualifying child live in the taxpayer's household for more than half the year. See Part I, "Structure."
18. A random sample of EITC audit reconsideration cases closed in 2002 and 2003 found that nearly 80 percent had resulted from difficulties in IRS documentation requirements or communication challenges. In 43 percent of the cases, the reconsideration review found that the taxpayer was entitled to virtually all the EITC originally claimed (National Taxpayer Advocate 2004).
19. As noted earlier, the phase-in of the refundable Child Tax Credit for most families over this same income range helps to offset the portion of the marginal tax rate associated with the EITC phase-out.
20. Most economists argue that employees bear the burden of the employer share of payroll taxes in the form of lower wages.
21. Zelenak (2004a) has proposed a variation on the family allowance approach, in which the EITC would make up the difference between full-time minimum wage income and the poverty threshold based on a family's size.
22. The combination of earnings and the EITC at the end of the phase-in range would equal 200 percent of fair market rent in the housing market at the 25th cost percentile; the same combination at the beginning of the phase-out range would equal 200 percent of fair market rent in the housing market at the 75th cost percentile.

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### **Acknowledgments**

The author thanks John Wancheck for his review and comments, and Alan Berube for his helpful guidance and adept editing. The Brookings Institution Metropolitan Policy Program thanks the Annie E. Casey Foundation for its generous support of our research on policies to support lower-income working families, and the Fannie Mae Foundation, the John D and Catherine T. MacArthur Foundation, the George Gund Foundation, and The Heinz Endowments for their general support of the program.

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