The increasing role of the Earned Income Tax Credit

The Earned Income Tax Credit (EITC) is one of the major federal programs providing assistance to the working poor. Administered by the Internal Revenue Service, it is a tax credit on the federal income tax that is available to certain workers with low earnings who have a "qualified child."[1]

The EITC has been described both as a tax reform and as a welfare program.[2] It is a tax reform in that it mitigates the regressive social security tax for low-income workers who pay little or no federal income taxes.[3] It is a welfare program because it supplements wages for low-income households. Thus, it is an attractive policy for those who wish to redesign the welfare system to give greater work incentives to low-income households.

The EITC does not serve the entire population of working poor because it excludes those without a "qualified child." It also requires that an income tax return be filed. Because the Tax Reform Act of 1986 effectively eliminated those with incomes below the poverty line from the federal income tax rolls, there is concern that some households that are eligible for the EITC will fail to obtain it.

Description of the EITC

The credit is available to parents having at least one "qualified child," who file a joint return or a "head-of-household" return. Until 1991, the law required that for the purpose of obtaining the EITC, over half of the support for the child had to come from the taxpayer's own income and not from sources such as Aid to Families with Dependent Children (AFDC). The credit is indexed for inflation.

In 1990 the credit consisted of 14 percent of earnings up to $6,810 (for a maximum rebate of $953 if no tax was owed). No adjustment was made for family size. The rebate remained at the maximum until adjusted gross income reached $10,740, at which point it was reduced by 10 cents per dollar of adjusted gross income, until it was entirely phased out at $20,270.

The budget law passed in October 1990 (OBRA-90) adds $18 billion to the EITC over the next five years. It both expands the credit and to some extent adjusts it for family size. In 1991 the phase-in rate (the rate of the credit up to an earned income of $6,810) will be 16.7 percent for families with one child and 17.3 percent for families with two or more children. This means the maximum credit will rise to $1,137 for families with one child and $1,178 for larger families. The EITC will also incorporate a 6 percent credit on the first $6,810 for families who buy health insurance and a 5 percent credit for families with infants under a year old. The EITC phase-in rate will continue to rise through 1994, when the new provisions are fully in place. At that time, the phase-in rate will be 25 percent for a family with more than one child, and the phase-out rate will be 17.9 percent. In 1995, when the new EITC provisions are fully implemented, total yearly EITC expenditures are expected to *increase* by over $7 billion as a consequence of the new budget law. To provide a comparison, total outlays in the Food Stamp program were roughly $15 billion in 1990.[4]

The increased budgetary expenses for the EITC and the change in its design—the fact that the credit differs for families of different size and special credits provide a rebate for health insurance and the care of infants—suggest that it has become a major policy tool of the federal government to increase the incentives to work among those whose incomes are below the poverty line. It is hoped that it will increase these incentives among those who have the option of receiving AFDC. If, however, the EITC is to take its place as a major program, it must reach the population to whom it is targeted, and participation could be a serious problem because, as mentioned above, those entitled to the EITC must file a federal income tax return, even though their income may be low enough to exempt them from any filing requirement.

The important issue of the participation (or take-up) rate of the EITC has been explored by Institute researcher John Karl Scholz (see box, p. 20). The rest of this article is a description of his research.

Calculating the EITC participation rate

The participation rate in any government program is defined as the number of participants divided by the number eligible for the program. These rates are not, however, easy to estimate, since both the numerator and the denominator are often hard to come by. The rates vary for the different

Institute Publications on Tax Policy
and the Poor

This article is drawn from the work of John Karl Scholz, "The Participation Rate of the Earned Income Tax Credit," IRP Discussion Paper no. 928-90.

Related Institute publications are the following:

Gary Burtless and Robert Haveman, "Taxes, Transfers, and Labor Supply: The Evolving Views of U.S. Economists," in *The Relevance of Public Finance for Policy-Making*, Proceedings of the 41st Congress of the International Institute of Public Finance (Detroit: Wayne State University Press, 1987). IRP Reprint no. 583.

Howard Chernick and Andrew Reschovsky, "The Taxation of the Poor," *Journal of Human Resources*, 25, no. 4 (Fall 1990), 712-735. IRP Reprint no. 639.

Sheldon Danziger, "Tax Reform, Poverty, and Inequality," in *The Economics of Tax Reform*, ed. Bassam Harik (Kalamazoo, Mich.: W.E. Upjohn Institute, 1988). IRP Discussion Paper no. 829-87, 1987.

Sheldon Danziger, "Antipoverty Policies and Child Poverty," *Social Work Research Abstracts*, 26 (December 1990), 17-34. IRP Discussion Paper no. 884-89, 1989.

Irwin Garfinkel, Daniel Meyer, and Patrick Wong, "The Potential of Child Care Tax Credits to Reduce Poverty and Welfare Recipiency," *Population Research and Policy Review*, 9, no. 1 (January 1990), 45-63. IRP Reprint no. 626.

Joseph A. Pechman, "Tax Treatment of Families in Modern Industrial Countries: The Role of the NIT," *Focus*, 12:3 (Spring 1990).

Philip K. Robins, "Federal Financing of Child Care: Alternative Approaches and Economic Implications," *Population Research and Policy Review*, 9, no. 1 (January 1990), 65-90. IRP Reprint no. 628.

Eugene Steuerle and Paul Wilson, "The Earned Income Tax Credit," *Focus*, 10:1 (Spring 1987).

Eugene Steuerle, "Uses of the NIT Framework," *Focus*, 12:3 (Spring 1990).

programs and for the same program in different locales. Such factors as stigma, the generosity of the benefits, the attitudes of caseworkers, and changes in the regulations affect participation rates over time, as does the state of the economy. In 1975-76, the participation rate in the AFDC program was estimated to range from 95 percent in the District of Columbia to 56 percent in Arizona; the estimated range for participation in Supplemental Security Income was from 77 percent in Louisiana to 20 percent in Nebraska. Estimates of Food Stamp participation rates ranged between 58 percent in California and 12 percent in North Dakota. In general, estimates of the national participation rates for Food Stamps and SSI ranged between 50 and 60 percent in the 1970s, far below the rates for AFDC.[5] More recent data on Food Stamps, using as the denominator the poor population, provide an estimated participation rate of 58.7 percent in 1988 and a high of 68.1 percent in 1976.[6]

In calculating the participation rates for the EITC, Scholz used the numbers given in the *Green Book*[7] and IRS microdata[8] as two measures of the number of recipients of the EITC, and he used data from the March 1980 and March 1985 Current Population Surveys (covering the years 1979 and 1984) to estimate the number of eligibles.[9] The years 1980 and 1985 were chosen to allow Scholz to benchmark the 1980 CPS against the 1979 IRS tax data and to benchmark the 1985 CPS against data for 1984 from the Survey of Income and Program Participation (SIPP),[10] as well as 1984 IRS data. To calculate EITC-eligible households, he used CPS individual, family, and household data to simulate the income tax returns that family units in the CPS could have filed.[11]

To account for possible biases caused by discrepancies in reported income from self-employment, two measures were used to estimate the number of EITC-eligible taxpayers. The first reflected the provisions of the law. Families (with dependents in the household) who had an earned income of between $.01 and $10,000 and had less than $10,000 adjusted gross income (AGI) were considered eligible for the EITC in the years 1979 and 1984.[12] The second included taxpayers with dependents and either wages and salaries or earned income (which includes income from self-employment) between $.01 and $10,000. (This is an upper-bound definition, since taxpayers may have either earned income or AGI above $10,000 by this measure.)

Table 1 provides the participation rates in the EITC based on these alternate calculations. As can be seen, the EITC participation rate was between 97 and 120 percent in 1979 and between 104 and 144 percent in 1984. Such numbers are puzzling, to say the least, since they suggest that under the statutory definition of eligibility, in any case, more people received the credit than were entitled to it.

The cause of the discrepancy

In an effort to determine why more people appeared to receive the EITC than were eligible for it, Scholz explored

Table 1

Participation Rate of the EITC, 1979 and 1984

Year	Statutory Definition of Eligibility[a] (in 1000's)	Upper-Bound Definition of Eligibility[b] (in 1000's)
Number of taxpayers eligible		
1979 (CPS)	5,800	6,986
1984 (CPS)	4,435	5,528
1984 (SIPP)	5,272	6,968
	Green Book	IRS Microdata
Number of taxpayers taking the EITC		
1979	6,954	6,798
1984	6,376	5,758
Range of implied participation rates		
1979 (CPS)	97.3%-120.0%	
1984 (CPS)	104.2%-143.8%	
1984 (SIPP)	82.6%-120.9%	

Source: John Karl Scholz, "The Participation Rate of the Earned Income Tax Credit," IRP Discussion Paper no. 928-90, p. 6. Data for this table come from the 1980 and 1985 Current Population Survey; the 1984 Survey of Income and Program Participation; U.S. House of Representatives, Committee on Ways and Means, *1989 Green Book*, pp. 790-795; and the Arthur Young Tax Research Database, University of Michigan.

[a]$0 < earned income < $10,000, and AGI < $10,000.
[b]$0 < wages and salaries or earned income < $10,000.

Table 2

Taxpayer Compliance Measurement Program: Data on the Earned Income Tax Credit, 1982 and 1985

	1982	1985
Number of returns (millions) claiming the EITC	6.014	6.424
Had EITC increased	.214	.253
Had EITC decreased	2.248	2.953
Had EITC decreased to zero	1.722	2.496
Total returns entitled to EITC[a]	4.366	4.004
Total EITC claimed (millions of $)	$1,749	$2,091
Amount that should have been claimed	$1,236	$1,325

Source: John Karl Scholz, "The Participation Rate of the Earned Income Tax Credit," IRP Discussion Paper no. 928-90, p. 15. These data are from unpublished worksheets of the Internal Revenue Service, Taxpayer Compliance Measurement Program, 1982 and 1985. The 1982 figures come from TCMP, Phase III, Cycle 8, 2/27/86. The 1985 figures come from TCMP, Phase III, Cycle 9, 4/11/89.

[a]An additional category is excluded from the table, taxpayers who made a mistake elsewhere in their return and thus were entitled to the EITC but failed to claim the credit. This category, which contains a small number of taxpayers, is labeled "not reported but established." This accounts for the slight difference between the figures in the table.

four possibilities: that he had made inappropriate assumptions when constructing tax-filing units from the CPS; that there were inconsistencies in the data used to examine the working poor (the CPS, the SIPP, and the IRS data); that improper imputations were performed in the CPS in adjusting for missing data on the number of households with low wages and salaries; and finally that taxpayers were not complying with the tax code. He examined each of these possible sources of error and found that adjusting participation rates based on evidence of noncompliance substantially lowered these rates.

Table 2 presents evidence from two cycles of the Taxpayer Compliance Measurement Program of the IRS on the degree of EITC noncompliance in 1982 and 1985. The magnitude of noncompliance was strikingly large in both years. In 1985, 46 percent of those who claimed the credit claimed too much (39 percent had their credit decreased to zero), and $766 million was claimed inappropriately.

Among the possible causes of the noncompliance is that taxpayers filed head-of-household returns to which they were not entitled. (For example, a mother living with her parents may not be considered to be providing shelter and therefore may not be entitled to head-of-household filing status.) Another problem may have been the provision of the law that required more than one-half of one's support be from sources other than public assistance when determining EITC eligibility. This requirement was difficult to enforce, since information on public transfers is not collected on tax returns. (The requirement has been dropped in the current law.) It has also been suggested that children have been claimed as dependents by more than one taxpayer and that fictitious children have been claimed. The 1986 tax reform required parents to include social security numbers for dependents over age 5. This requirement substantially reduced the number of dependents being claimed on tax returns. New regulations in OBRA-90 require parents to obtain tax identification numbers for children over the age of one, which will further reduce problems associated with inappropriate claims of EITC eligibility.

Reevaluating the participation rate

Data from the 1984 SIPP, where roughly 5.5 million taxpayers appeared eligible for the EITC, adjusted for a noncompliance rate of 33 percent (between the 29 percent of 1982 and the 39 percent of 1985), yield an EITC participation rate of 70 percent in 1984. Although it might have been expected that the tax reform of 1986 would have lowered this participation rate by eliminating the tax-filing requirement for a large number of low-income families, Scholz's simulations suggest a relatively large number of taxpayers took the EITC following the 1986 tax reform. He estimates that the participation rate of eligibles was 76 percent in 1988—rather high as participation rates go. Yet even this figure implies that roughly 2.1 million low-income families who were entitled to the credit failed to receive it. He suggests, therefore, that efforts be made to publicize the credit, particularly among the employers of low-wage workers. If it is possible to simplify the determination of head-of-household filing status, such a course should be pursued, as this may also ease the problem of noncompliance.

The reform contained in OBRA-90, eliminating the requirement that more than one-half of one's support be from sources other than public assistance when determining EITC eligibility, is important, since the amount of transfer income received has little bearing on the objectives of the EITC—to relieve the regressive burden of the payroll tax for social security and to encourage work among the poor. Given these objectives, extending the EITC to poor childless couples and individuals may be a possibility for the future.

Conclusion

The recent consensus embodied in the Family Support Act of 1988 is that welfare should serve only as a temporary expedient for the needy. The thrust of the new legislation is to provide training and assistance in job search to enable those on welfare to become self-sufficient. The Earned Income Tax Credit is an increasingly important component of this approach. If the EITC is to be effective in enhancing work as opposed to welfare, knowledge about it must be widespread so that it is available to all of those to whom it is targeted. ■

---

[1]For taxpayers filing joint returns, a qualified child is any dependent. Those filing head-of-household returns must provide at least half the support for a child for at least half the year to be eligible for the credit. Thus, a custodial parent can claim the EITC, for example, even if the custody agreement grants the other parent the dependency exemption.

[2]See Eugene Steuerle and Paul Wilson, "The Earned Income Tax Credit," *Focus*, 10:1 (Spring 1987), for a description of the various rationales for the EITC.

[3]The social security tax is a uniform payroll tax of 6.2 percent levied on covered earnings up to the annual maximum taxable wage base of $51,000 for Old Age, Survivors, and Disability Insurance and 1.45 percent up to $125,000 for Medicare hospital insurance. This 7.65 percent employee share is matched by the employer for a combined contribution of 15.3 percent. Self-employed workers pay the full 15.3 percent.

[4]Calculations in this paragraph are by John Karl Scholz.

[5]Much of this discussion of participation rates is drawn from Robert H. Haveman, *Poverty Policy and Poverty Research: The Great Society and the Social Sciences* (Madison: The University of Wisconsin Press, 1987), pp. 87–88.

[6]U.S. House of Representatives, Committee on Ways and Means, *1990 Green Book* (Washington, D.C.: U.S. Government Printing Office, 1990), p. 1269. This yearly publication was formerly called *Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means*. In this article it is consistently referred to as *Green Book*, preceded by the appropriate year.

[7]*1989 Green Book*, pp. 790–795.

[8]The tax data are from the University of Michigan, Arthur Young Tax Research Database, a panel of individual income tax returns from 1979 through 1984. They are described in Joel Slemrod, "The 1979–84 Linked Panel of Tax Return Data: Sampling and Linking Methodology," University of Michigan, Ann Arbor, November 1988 (photocopy).

[9]The CPS is a survey conducted monthly by the U.S. Bureau of the Census. The sample consists of approximately 60,000 households nationwide and collects primarily labor force data about the civilian noninstitutional population. The March supplement collects additional information, including money income received in the previous calendar year.

[10]The SIPP is a series of panel surveys conducted by the U.S. Bureau of the Census in the 1980s to monitor short-term changes in the economic situations of persons, households, and families in the United States. It has a more frequent sampling frame than the CPS and greater targeting of low-income families.

[11]The simulation does not account for the roughly 500,000 married couples who file separate returns. For the most part, these taxpayers would not be eligible for the EITC even if they filed joint returns.

[12]The criterion that over half of the taxpayer's support for a dependent must come from sources other than an income maintenance program (such as AFDC) was ignored in this simulation.