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Tax policy and the working poor: The Earned Income Tax Credit

by John Karl Scholz

John Karl Scholz, an IRP affiliate, is a member of the Department of Economics and the La Follette Institute of Public Affairs, University of Wisconsin–Madison.

The Clinton administration has articulated four broad themes that will guide welfare reform: make work pay, strengthen child support enforcement, increase access to education and training, and design policies so that welfare does not last forever. Although the agenda has been set, efforts at reforming the welfare system have been largely overshadowed by debates over deficit reduction, the North American Free Trade Agreement, and health care reform. Still, the August 1993 budget bill—the Omnibus Budget Reconciliation Act of 1993 (OBRA93)—largely achieved the first of the four themes of welfare reform as described by President Clinton in his first State of the Union Address: "The new direction I propose will make this solemn, simple commitment: by expanding the refundable earned income tax credit, we will make history; we will reward the work of millions of working poor Americans by realizing the principle that if you work 40 hours a week and you've got a child in the house, you will no longer be in poverty."[1]

By the time the OBRA93 earned income tax credit (EITC) expansion is fully phased in, the credit will be the largest cash or near-cash program directed toward low-income households. In fiscal year 1998 the EITC is expected to cost the federal government $24.5 billion, $7 billion of which is the result of the OBRA93 expansion. In contrast, the federal share of the AFDC program is expected to be $16 billion in 1998. Despite the large size of the program, relatively little has been written about it. This essay examines how the EITC works and discusses several design issues that will become increasingly important as the EITC is expanded.[2] If it is to be the cornerstone of public policy initiatives to support the working poor, it is important that those who are eligible for the credit receive it, that those who are ineligible do not obtain it, and that the design of the program holds to a minimum perverse behavioral incentives.

What is the EITC?

As its name suggests, the EITC is a credit on the federal income tax available to working poor families with children. In 1993 the credit equaled 18.5 percent of earned income (wages, salaries, self-employment income, and farm income) for taxpayers with one child, up to an earned income of $7,750; hence, the maximum benefit is $1,434 (18.5 percent of $7,750) for families with one child. Because benefits increase with earned income (up to a certain point), the EITC seems to encourage work and therefore is a popular antipoverty program. Taxpayers with one child and incomes above $7,750 but below $12,200 receive the maximum benefit. Taxpayers with one child whose incomes exceed $12,200 are in the phase-out range of the credit: their $1,434 credit is reduced by 13.2 cents for every dollar of income earned over and above $12,200. Taxpayers with two or more children are entitled to a slightly higher credit ($1,511, or 19.5 percent of $7,750), taxpayers with a child under one are entitled to a supplemental credit of up to $388, and taxpayers paying for health insurance for a child are eligible for a supplemental health insurance credit of up to $465. Unlike most credits and deductions in the federal individual income tax system, the EITC is refundable—that is, if the amount of the credit exceeds what the taxpayer owes, he or she receives a payment from the U.S. Treasury for the difference.

The EITC was adopted in 1975 and was originally promoted as a way to relieve the burden of the social security payroll tax on low-wage working parents.[3] The original EITC equaled 10 percent of earnings up to a maximum credit of $400 for taxpayers with children, and was phased out at a rate of 10 cents per dollar of earnings (or adjusted gross income, whichever was higher) for incomes between $4,000 and $8,000. The EITC has been increased many times since 1975, though the largest changes occurred in 1990 and 1993. In 1996, when the OBRA93 changes are fully phased in, the credit rate will be 40 percent of earnings for families with two or more children and 34 percent for families with one child, and will for the first time provide a 7.65 percent credit to childless taxpayers with low incomes. The maximum credit (in 1994 dollars) for taxpayers with two or more children will be $3,370; for taxpayers with one child, $2,040; and for taxpayers with no children, $306. EITC parameters are summarized in Table 1.

Does the EITC reach those it is intended to help?

A family receives the EITC by filing a tax return.[4] Many low-income families are not legally required to file returns. A married couple with two children, for example, was required to file a tax return in 1992 only if the couple had income above $10,600, though with an income of this amount, the couple would be entitled to a refundable credit of $1,384. If the EITC is to be successful at meeting the objective of "making work pay," families or taxpayers who are eligible for the credit should receive it.

It is difficult to estimate the percentage of EITC-eligible taxpayers who receive the credit—the EITC participation rate. Household surveys generally collect the information needed to determine eligibility but do not provide information on EITC recipiency. Tax data are best for estimating EITC recipiency, but not all households file tax returns and tax data do not provide demographic characteristics, so they are unsuited for estimating EITC eligibility. In an earlier study I pieced together disparate sources of EITC data and estimated that the EITC participation rate was 70 percent in 1984, which means that roughly 1.65 million eligible taxpayers failed to receive the credit because they did not file tax returns.[5] The EITC, however, has changed significantly since 1984.

To update participation rate figures I used unique data that allowed me to determine EITC eligibility and EITC recipiency in the same data set: specifically, I used data from the 1990 Survey of Income and Program Participation (SIPP) matched by social security number to selected items from individual income tax returns.[6] To calculate participation rates, I first determined the number of taxpayers eligible for the EITC by simulating the 1990 EITC statutes for each respondent in the Survey of Income and Program Participation. The major factors determining EITC eligibility in 1990 were (1) supporting a child,[7] (2) having earned income between $1 and $20,264,[8] and (3) having less than $20,264 of adjusted gross income.

Using data from SIPP, I found that 9.6 to 10.3 million taxpayers were eligible for the EITC in 1990, where the

Table 1
EITC Parameters under Law Prior to OBRA93 and under OBRA93, Selected Years

	Credit Rate	Flat Range		Max. Credit	Phase-out Range	
		Beginning Income	Ending Income		Phase-out Rate	Income Cutoff
Prior Law						
1993 (1993 $)						
1 qualified child	18.5%	$7,750	$12,200	$1,434	13.21%	$23,050
2+ qualified children	19.5	7,750	12,200	1,511	13.93	23,050
Young child[a]	5	7,750	12,200	388	3.57	23,050
Health credit[b]	6	7,750	12,200	465	4.285	23,050
1994 and after						
1 qualified child	23	7,990	12,680	1,838	16.43	23,760
2+ qualified children	25	7,990	12,680	1,998	17.86	23,760
Young child[a]	5	7,990	12,680	400	3.67	23,760
Health credit[b]	6	7,990	12,680	479	4.285	23,760
Omnibus Budget Reconciliation Act of 1993 (OBRA93)						
1994						
1 child	26.3	7,750	11,000	2,038	15.98	23,760
2+ children	30.0	8,425	11,000	2,528	17.68	25,300
No qualifying child[c]	7.65	4,000	5,000	306	7.65	9,000
1995						
1 child	34.0	6,000	11,000	2,040	15.98	23,760
2+ children	36.0	8,425	11,000	3,033	20.22	26,000
No qualifying child[c]	7.65	4,000	5,000	306	7.65	9,000
1996 and beyond						
1 child	34.0	6,000	11,000	2,040	15.98	23,760
2+ children	40.0	8,425	11,000	3,370	21.06	27,000
No qualifying child[c]	7.65	4,000	5,000	306	7.65	9,000

Source: Figures for the August 1993 budget agreement (OBRA93) were kindly provided by Janet Holtzblatt at the Office of Tax Analysis, U.S. Department of Treasury. The other figures are from U.S. House of Representatives, Committee on Ways and Means, *1993 Green Book* (Washington, D.C.: U.S. GPO, 1993).

Note: Figures for 1994 and beyond are in 1994 dollars.

[a]The young child (or "wee tots") credit was for taxpayers who had a child under the age of one in the tax year and incomes in the ranges designated in the table.

[b]The supplemental health insurance credit goes to taxpayers with incomes in the range designated in the table who paid health insurance premiums that include coverage for one or more qualifying children. The taxpayer cannot take advantage of the supplemental health insurance credit on expenses used for the medical expense deduction or health insurance deduction for the self-employed (and vice versa).

[c]The taxpayer must be between the ages of 25 and 65.

variation in the range comes from variations in alternative ways of modeling statutory provisions of the tax code.[9] These results are consistent with those of Thomas Gabe, who used CPS data and found that 10.7 million taxpayers were eligible for the credit in 1991.[10] The *Green Book* shows that the number of taxpayers filing for the credit was projected to increase by 8.7 percent from 1990 to 1991 (presumably due to the weak economy).[11] Applying this rate of increase to my 1990 figures indicates that 10.4 to 11.2 million would have been eligible in 1991, which brackets Gabe's estimate.

The participation rate is the percentage of the eligible taxpayers who receive the credit. As I mentioned earlier, in 1990 the IRS calculated and paid the EITC to all taxpayers who appeared eligible on the basis of their tax form, regardless of whether they claimed the credit.[12] Thus, the most straightforward way of calculating participation is to determine what percentage of eligible households filed tax returns. For the total sample (not conditioning on EITC eligibility) I find that 78.0 percent of the sample filed tax returns: in most cases I determine that the taxpayer filed from observing the tax return.[13] Another 18.3 percent of the sample did not file a return—that is, they provided a validated social security number and were not matched to a tax return, or they did not have a validated social security number but reported in a special SIPP tax topical module that they did not file. The remaining 3.7 percent of households did not provide a valid social security number and did not respond to the tax topical module. It is impossible to determine whether these households filed.

Depending on variations in modeling the statutory tax provisions and the treatment of the "unknown filers," I estimate that 80.5 percent to 86.4 percent of EITC-eligible taxpayers filed tax returns in 1990 and hence received the credit, either because they claimed it on the tax form or because the IRS intervened and computed and paid the credit to the taxpayer. These estimates imply that 1.3 million (13.6 percent) to 2.0 million (19.5 percent) taxpayers eligible for the credit failed to receive it.

The EITC participation rate is considerably higher than rates in other programs directed toward the low-income population. Rebecca Blank and Patricia Ruggles, for example, calculate AFDC participation rates of 62 to 72 percent and food stamp participation rates of 54 to 66 percent, using data from the 1986 and 1987 panels of the SIPP.[14]

A number of factors presumably contribute to the high EITC participation rate. Little or no stigma is associated with the EITC, whereas stigma associated with transfer programs such as AFDC and food stamps may discourage participation in those programs.[15] In addition, transfer program recipients are perhaps less likely to know about or take advantage of programs they may be eligible for: they are, on average, less educated and may be more dysfunctional than EITC-eligible taxpayers, who must work to receive the credit.

As part of the Omnibus Budget Reconciliation Act of 1990 a two-page form (Schedule EIC) was added to the tax return. Until the middle of 1992, the IRS continued to compute and award the EITC to taxpayers who appeared eligible but did not claim the credit, even when schedule EIC was not included with the return. In the middle of the 1992 filing season the IRS discovered that many of the EITC awards made when they intervened were incorrect. Hence they changed their policy so that the first page of Schedule EIC must be completed before the IRS will compute the credit and make an award.[16] The EITC participation rate will be lower in 1993 than it was in 1990 if eligible taxpayers who fail to claim the credit do not respond to the IRS notification that encourages them to file an amended return. At the same time, it seems likely that the 1990 and 1993 increases in the EITC will result in more eligible taxpayers receiving the credit, since the larger the credit, the more likely the taxpayer is to file.

Who are the eligible nonparticipants?

In recent years there has been a considerable amount of EITC outreach.[17] Examining factors systematically correlated with nonparticipation by eligible households may help increase the effectiveness of EITC outreach efforts and provide insight into why some eligible households fail to claim the credit.

There are a number of reasons why eligible taxpayers may not file tax returns to receive the EITC. A taxpayer who has illegally failed to file in previous years or has cheated on previous returns may rationally choose not to enter the IRS system. Taxpayers may also view the inconvenience of filing a return as being greater than the potential EITC benefit. Finally, EITC outreach efforts are predicated on the belief that low-income taxpayers are not aware of the credit, and hence information barriers keep eligible taxpayers from receiving the credit.

In a statistical analysis of EITC participation, I examined a number of factors that are related to different explanations for nonparticipation. For example, fewer information-matching requirements exist for self-employment income, so taxpayers have greater discretion over reporting such income. Thus, if a large percentage of total income comes from self-employment, the taxpayer may be less likely to file a return, even if eligible for the EITC. At the same time, I expect those with more wage income or who work more hours to be more likely to file for the credit. For the latter effect I examined a number of labor market variables.

I expect that the larger the potential EITC payment, the more likely the taxpayer will participate. I also think it is possible that taxpayers who live in a state without a state income tax may be less likely to receive the credit when eligible because low-income households may be less likely to file a federal return when they do not need to file a state return.[18] For similar reasons I suspect taxpayers who live in states with state-level EITCs will be more likely to file a federal return if they can also file a state return to possibly get an additional credit.[19] In the statistical analysis I also included a broad range of economic and demographic characteristics.

My results suggest that higher-income EITC-eligible taxpayers are more likely to receive the credit. As expected, the greater the percentage of earnings consisting of self-employment income, the less likely the taxpayer is to file a return; the larger the potential EITC payment, the more likely the taxpayer is to file; and EITC-eligible taxpayers residing in states without state income taxes are less likely than those who must also pay state taxes to file a federal return.

A large number of taxpayer characteristics are significantly correlated with nonparticipation. These include receiving income from public assistance (AFDC and

General Assistance), having a larger family, being unmarried, being male, and being of Spanish origin. Surprisingly, once a variety of income sources, labor market status, and demographic variables are controlled for, nonparticipation increases with education, so that taxpayers with college degrees are less likely to participate than those without high school diplomas. Among the occupational categories, those working in such private-household occupations as launderers, cooks, and housekeepers, as well as child care workers, equipment cleaners, and laborers, are significantly less likely to receive the credit than those in other occupations. In some of these jobs payments may be made "off the books" or income may be unreported self-employment income. Moreover, employers may be failing to withhold social security taxes and state income and federal income taxes. To the extent that EITC nonparticipants are aware of the EITC, some may prefer not to participate, rather than to formalize an informal working arrangement. This barrier may be a major hurdle to outreach efforts to boost EITC participation among eligibles.

A number of the results of the statistical analysis suggest that the benefit of the EITC may not be worth more than the costs of preparing a tax return when the taxpayer is entitled to a smaller credit, when the reporting of self-employment income may cause scrutiny of previous returns, and when the taxpayer does not also need to prepare a state return. Workers in household services may choose not to file tax returns because they and their employers do not pay the social security payroll tax. It is unlikely that informational barriers are the only explanation of nonparticipation when college-educated taxpayers are significantly less likely to receive the credit than taxpayers with less education. Some nonparticipation appears to be driven by voluntary or rational decisions and hence is unlikely to be affected by outreach.

Table 2
Antipoverty Effectiveness of the EITC under the Law Prior to OBRA93 and under OBRA93 When Fully Phased In by 1996

	Prior Law	OBRA93
EITC-eligible taxpayers with incomes above the poverty line (millions)	6.211	7.582
EITC payments to these households (millions $)	6,224	8,994
EITC-eligible taxpayers with incomes below the poverty line (millions)	4.084	5.451
EITC payments to these households (millions $)	5,820	9,020
Pre-EITC poverty gap (millions $)[a]	20,156	23,982
Post-EITC poverty gap (millions $)	14,544	17,574
Number of households taken out of poverty by the EITC (millions)	0.909	1.380

Source: 1990 Survey of Income and Program Participation.

Notes: All dollar amounts are given in 1994 dollars. SIPP data for 1990 are converted to 1994 dollars assuming a 3 percent rate of inflation.

Prior law calls for a 23 (25) percent EITC subsidy for one (two) children households with earned income under $7,990 in 1994. The maximum credit of $1,838 ($1,998) prevails for earned income between $7,990 and $12,680. The credit is phased out at a rate of 16.43 (17.86) percent for incomes between $12,680 and $23,760.

OBRA93 (see Table 1) adds a 7.65 percent credit for childless taxpayers between the ages 25 and 65 with earned income below $4,000, a 34.0 percent credit for one-child taxpayers with earned income below $6,000, and a 40.0 percent credit for taxpayers with two or more children with earned income below $8,425. The flat range of the schedule stops at $5,000 for childless taxpayers and $11,000 for taxpayers with one or more children. The phase-out rates are 7.65 percent, 15.98 percent, and 21.06 percent, so the credit is fully phased out at $9,000, $23,760, and $27,000.

[a]The poverty gap is defined as the difference between cash income (the sum of earnings, dividends, interest, social security, public assistance, SSI, veterans payments, pensions, unemployment, and alimony) and the poverty line.

How well targeted is the EITC?

Table 2 presents evidence on the "target efficiency" of the EITC prior to, and the changed EITC resulting from, OBRA93, once the new law is fully phased in. Under both policies more taxpayers with incomes above the poverty line than below the poverty line are eligible to receive EITC payments, but because of the progressive benefit structure of the EITC, roughly half the credit payments go to households with incomes below the poverty line. The new law increases substantially the credit payments going to taxpayers with incomes above the poverty line, primarily as a consequence of extending the break-even level of income to $27,000 from $23,760 for taxpayers with two or more children. It increases by over 33 percent the number of taxpayers with incomes below the poverty line who will be eligible for the EITC, primarily as a consequence of extending the credit to low-income, childless taxpayers between the ages of 25 and 65. Under current law roughly $5.6 billion of total EITC payments help close the "poverty gap"—the difference between total cash income and the poverty line.[20] Under the new law $6.4 billion of EITC payments close the poverty gap. However, because the new law sharply increases overall expenditures on the credit, one measure of target efficiency—the fraction of total EITC payments that directly reduce the poverty gap—falls to 36 percent from 47 percent.

Design concerns

Compliance

In past years a large number of ineligible taxpayers claimed the EITC, according to unpublished data from the IRS's Taxpayer Compliance Measurement Program (TCMP).[21] In 1988 10.4 million taxpayers claimed the EITC, whereas the TCMP for that year estimates that only 7.1 million were entitled to the credit, indicating that over 30 percent of EITC claimants were ineligible. Of the $5.6 billion in EITC claims, the 1988 TCMP estimates that nearly $2 billion (33.6 percent) were claimed inappropriately. A General Accounting Office official recently testified that "the credit has been the source of more taxpayer mistakes than any other individual income tax provision."[22] Holtzblatt provides information from the 1985 TCMP concerning reasons for disallowance of the EITC[23] (similar explanations are not available for 1988). Over half the returns were disqualified because the child exemption was disallowed, and over half the disqualified claimants had the filing status changed from one that entitled the taxpayer to the EITC (married filing jointly, head of household, or surviving spouse) to one that did not qualify the taxpayer (married filing separately, or single).[24] Thirty percent of the claimants were disqualified because they misreported earnings or AGI.

The perception of widespread noncompliance was an important issue surrounding the 1990 changes in the credit. Information from the 1985 TCMP showed that many of the ineligible taxpayers who received the credit failed the support test—the restriction that the taxpayer had to provide over half the support for the child who made them eligible for the EITC (see note 7). Items that were counted as support for the child but not provided by the taxpayer included AFDC, child support, and public housing benefits. If the value of these items exceeded the taxpayer's income (defined to include the implicit rental value of owner-occupied housing), the taxpayer would not meet the support test and hence would be ineligible for the EITC. Although taxpayers could learn these details by reading the rules accompanying the 1040 form and supplemental publications (such as the 32-page IRS Publication 596), it may be unreasonable to expect them to be cognizant of these subtleties when preparing their taxes.

Because of the difficulties of linking the support test to EITC eligibility and the resulting noncompliance associated with the test, Congress eliminated the test in 1990 and replaced it with the restriction that a "qualifying" child must live with the taxpayer more than half the year. This statutory change eliminated one of the largest sources of noncompliance.

As mentioned earlier, the 1990 budget legislation also added a new two-page form—Schedule EIC—the first page of which taxpayers are now required to complete in order to receive the credit. Page 1 of the form states the rules governing EITC eligibility, including the requirement that a child must be in residence more than six months (all year if a foster child); gathers information (including social security numbers) on the two youngest children because the credit varies depending on whether the taxpayer has one or two (or more) children; and gathers information on nontaxable earned income (see note 8). The second page of the form walks the taxpayer through the basic EITC benefit calculation, the health insurance credit, and the credit for a child born in the tax year. The latter two credits added considerable complexity to the EITC and hence were eliminated in OBRA93.

Schedule EIC is controversial. The General Accounting Office has recommended that Schedules 1040 and 1040A be modified to collect the supplemental information needed to eliminate Schedule EIC. Doing so would give the IRS the information necessary to calculate and pay the credit to eligible taxpayers who file a return but fail to claim the credit. The IRS opposes this change. The proposed modifications of Form 1040 and 1040A would require all taxpayers to give the birth date of their dependents and indicate whether each dependent is a student or disabled.[25] In addition there is a tension between the residency-based test that defines a qualifying child for the purposes of the EITC and the definition of a dependent, which must satisfy the support test. Mingling the two concepts in the exemption section of the tax forms may prove confusing to taxpayers, and additional space would need to be created so taxpayers could claim up to two nondependent qualifying children. Finally, worksheets would need to be added to the tax forms to include the nontaxable earned income items in calculations for the EITC (see note 8), though the GAO suggests that fewer than 3 percent of all taxpayers report such income.

As the law currently stands there are differences in the definitions of a dependent child and a qualifying child, nontaxable items are included in earned income for the purposes of the EITC, and age restrictions are placed on the qualifying children. As long as these features of the EITC exist, it makes sense to have Schedule EIC. The schedule, in as simple a way as possible, clarifies the statutory provisions governing EITC eligibility. Only the first page needs to be completed. Moreover, eliminating the schedule without any corresponding statutory changes would impose additional burdens on all taxpayers who are not eligible for the EITC. A preferred alternative, discussed below, would eliminate the differences between statutes governing EITC eligibility and other aspects of the tax code. Doing this would simplify burdens on taxpayers, eliminate Schedule EIC, and allow the IRS to again calculate and pay the credit to eligible taxpayers who file returns but fail to claim the credit.

Advance payments

Since 1979, a portion of the basic EITC (the credit for one-child families) could be received by taxpayers in advance during the year from their employers.[26] The employee triggers advance payments by filing IRS Form W-5, "Earned Income Credit Advanced Payment Certificate," with the employer. This form certifies that the taxpayer expects to be eligible for the EITC, has a qualifying child, and has not (and his or her partner has not) filed a W-5 with other employers. Upon receipt of the form the employer is required to include the advance payment in the employee's paycheck. Employers determine the advance payment from tables supplied by the IRS and pay it out of employer and employee social security taxes, so employers are not out-of-pocket any expenses. At the end of the year, advance EITC payments are reported to employees on their W-2, and they must file income tax returns. Advance payments in excess of the credit to which the employee is entitled are treated as a tax liability and must be paid back to the IRS by the employee.

The GAO reported that in 1989 fewer than one-half of one percent of EITC-eligible taxpayers (40,000 families) took advantage of the advance-payment option.[27] In addition, almost half of those who received advance payments failed to file tax returns, despite the requirement that all advance-payment recipients do so. Usage of the advance-payment option does not appear to have increased since 1989.

There is no empirical evidence about why the advance-payment option is infrequently utilized. Taxpayers may prefer receiving EITC payments annually in a lump sum. Eligible taxpayers may not be aware of the advance-payment option or may worry about imposing burdens on their employers.

Congress has taken steps to increase awareness of the advance-payment option. Beginning this year, the IRS is required to notify taxpayers who receive the EITC as a lump sum about the availability of the advance-payment option. Beyond this, it is not clear whether additional steps should be taken. One might think that an incremental benefit received throughout the year would provide a better work incentive for households with incomes in the subsidy range of the credit and provide assistance at the time the participant is more likely to need it. However, the advance-payment option has existed for over ten years, so if there is strong demand for the option, it is surprising that it is not more widely used.

My view is that increasing the awareness of the advance-payment option, as the IRS is now required to do, is useful. Beyond this, the low use of the option suggests that it is not a critical public policy issue except, perhaps, for households making the transition from welfare to work. Michael Wiseman presents a careful comparison of the monthly income a Wisconsin family would receive on welfare compared to after-tax income from a 30-hour-per-week minimum wage job.[28] The month-by-month pattern of income is revealing. Because earnings do not immediately lead to a reduction in AFDC benefits, after-tax incomes of newly working households are higher than the incomes of those on welfare. After several months, however, the combination of AFDC benefit reductions and tax payments makes the incomes of employed households fall below the basic AFDC grant. Hence, there is a concern that once this reduction occurs, households may return to welfare. Wiseman shows that if the EITC is received incrementally through advance payments, employment income is higher in every period, which presumably increases the attractiveness of work over welfare. This logic has prompted Michigan, for example, to apply for a waiver for a welfare demonstration that focuses on administering the EITC advance payment through the AFDC and

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Institute for Research on Poverty
1180 Observatory Drive
3412 Social Science Building
University of Wisconsin
Madison, Wisconsin 53706
(608) 262–6358
Fax (608) 265-3119

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food stamp delivery system. Efforts at increasing usage of the advance-payment option should focus on the population making the transition from welfare to work.

Future incentives for manipulation of reported income

Until 1994, the subsidy rate of the EITC was roughly the same as the combined employee and employer share of the payroll tax.[29] As long as the payroll tax and EITC subsidy are about the same, taxpayers are unlikely to overstate their income in order to increase their EITC. It is difficult to successfully misreport wage and salary income to the IRS, as extensive information-matching procedures are in place whereby employers report to the IRS wages and salaries paid to employees. Taxpayers with incomes below the level that would maximize their EITC could fabricate self-employment income. Doing so would increase the taxpayer's EITC but would obligate the taxpayer to pay social security taxes on the self-employment income, eliminating any advantage to falsely reporting income.

With the sharp increase in the EITC, there are now stronger incentives to manipulate income. A taxpayer who does not work and has two children could receive a payment from the IRS of $3,370 in 1996 (in 1994 dollars) by reporting self-employment income of $8,425 ($8,425 x .40). Doing so would require the taxpayer to pay $1,289 ($8,425 x .153) in social security taxes, leaving a net benefit to the transaction of over $2,000. The IRS is not well-equipped to uncover overreporting of incomes, and the payoffs to monitoring compliance in this area are certainly small relative to other areas of compliance. Of course, the taxpayer's claims need not be illegal. Two families could care for each other's children or watch each other's houses. They could exchange payments of $8,425 for doing so and both receive a net benefit of more than $2,000 if neither had any other sources of taxable income.

It is, of course, not yet clear how people will respond to these incentives to manipulate income, as there is no comparable situation in the tax code. My guess is that over time taxpayers and/or paid tax preparers will begin to take advantage of the incentive to overstate income in the subsidy range of the credit. The IRS will surely monitor closely the amount of income reported by low-income taxpayers that occurs in forms not subject to information-matching procedures (i.e., income from self-employment or income from items mentioned in note 8). An increase in the proportion of income occurring in these forms will be an early signal that a problem may be developing. My fear is that a couple of well-publicized cases of taxpayers reporting fictitious income or paying each other for work like "watching houses" may undermine public and congressional support for the EITC. As discussed below, a solution would be to restrict the expanded EITC to income reported on W-2s (and only allow an EITC equivalent to the employer and employee share of payroll taxes for other sources of income), though that would create an inequity between low-income wage earners and self-employed households.

Labor market incentives

Several studies have addressed concerns about the possible negative consequences the EITC might have on labor supply.[30] The EITC has different labor supply effects depending on whether the taxpayer's income is in the subsidy, flat, or phase-out range of the credit. The subsidy range of the credit increases the worker's marginal return to labor. For households not working, it is hoped that the wage subsidy provided by the EITC will encourage work. For taxpayers with incomes in the subsidy range, the wage subsidy is thought to encourage work. At the same time, the income supplement provided by the EITC is thought to decrease a recipient's labor supply because more money in hand means that he or she may choose to work less. The net effect is ambiguous. Households in the flat range of the credit receive the maximum EITC payment and no marginal subsidy for increased work, so these households have no incentive to increase their hours of work, and the EITC supplement provides incentives to work less. In the phase-out range, the EITC is reduced as additional income is earned, which is akin to an additional tax on earnings. Thus the additional tax and the additional income both encourage workers to decrease their hours of work. These effects prompt the concern that if a disproportionate fraction of the EITC population is in the flat and phase-out ranges of the credit, increases in the EITC could lead to a net reduction in the labor supplied by low-income workers.

Table 3 uses data from the 1990 SIPP to examine the labor market incentives of the EITC. It shows that OBRA93 increases by 42 percent the number of EITC recipients who are in the subsidy range of the credit, primarily by extending the credit to taxpayers between the ages of 25 and 65 without children. At the same time, the new changes almost double payments to households with incomes in the phase-out range of the credit. Twenty-three percent of EITC-eligible taxpayers have incomes that place them in the subsidy range of the credit, where they face positive labor market incentives (if the "earnings effect" outweighs the "income effect"). Sixteen percent of the population receive the maximum credit and 61 percent of the population are in the phase-out range of the credit, where the work disincentives are strongest.

Hoffman and Seidman[31] and the GAO[32] simulate the effects of the EITC on labor supply, using labor supply estimates from studies that examined the Seattle-Denver income maintenance experiments. The GAO estimates that in 1994 under the pre-OBRA93 law (see Table 1) annual hours of work would increase by 6.4 percent (19

Table 3
Labor Market Incentives of the EITC, as Indicated by Payment Levels in Relation to Income

	Prior Law	OBRA93
Number of taxpayers in EITC subsidy range (millions)	2.116	3.005
EITC payments to these households (millions $)	$2,275	$3,161
Number of taxpayers in flat range (millions)	2.223	2.055
EITC payments to these households (millions $)	$4,269	$4,382
Number of taxpayers in phase-out range (millions)	5.955	7.972
EITC payments to these households (millions $)	$5,500	$10,469

Source: 1990 Survey of Income and Program Participation.

Notes: As described in the text, increased income and increased marginal earnings are expected to have opposing effects on labor supply for taxpayers in the subsidy range of the credit. Taxpayers in the flat range or phase-out range of the EITC schedule have an unambiguous incentive to reduce labor market hours. All dollar amounts are given in 1994 dollars. SIPP data for 1990 are converted to 1994 dollars assuming a 3 percent rate of inflation. The figures for number of taxpayers reflect the size of the population in 1990. Budgetary costs and population estimates for later years can be approximated by increasing the figures in the tables by the estimated rate of growth of the EITC-eligible population.

Prior law calls for a 23 (25) percent EITC subsidy for households with one (two) child(ren) with earned income under $7,990 in 1994. The maximum credit of $1,838 ($1,998) prevails for earned income between $7,990 and $12,680. The credit is phased out at a rate of 16.43 (17.86) percent for incomes between $12,680 and $23,760.

For 1996 and beyond (see Table 1), OBRA93 adds a 7.65 percent credit for childless taxpayers between the ages of 25 and 65 with earned income below $4,000, a 34.0 percent credit for one-child taxpayers with earned income below $6,000, and a 40.0 percent credit for taxpayers with two or more children with earned income below $8,425. The flat range of the schedule stops at $5,000 for childless taxpayers and $11,000 for taxpayers with one or more children. The phase-out rates are 7.65 percent, 15.98 percent, and 21.06 percent, so the credit is fully phased out at $9,000, $23,760, and $27,000.

hours a year) for taxpayers in the subsidy range of the credit, fall by 4.6 percent (48 hours a year) for taxpayers with incomes in the stationary range of the credit, and fall by 7.0 percent (70 hours a year) for households in the phase-out range of the credit. The effects are expected to be larger for women in married households, and smaller for single women and men. Both the positive and negative effects are expected to be larger with the OBRA93 EITC increases.

While the GAO report reflects the most careful study of the labor supply effects of the EITC, the results must be interpreted with considerable caution. The Seattle-Denver negative income tax experiments took place in the early 1970s, hence the labor supply estimates are based on behavioral responses that took place more than twenty years ago. In addition, the experiments were different from the EITC. In particular, the experiment emphasized the links between transfer payments, earned income, and the phase-out rate. In contrast, 99.5 percent of EITC recipients receive benefits in a lump sum after filing a tax return. The links between earnings, benefits, and the phase-out are likely to be much less clear to the EITC population.

There are grounds to be concerned about the negative labor market effects of the EITC. Well over half the EITC-eligible population have incomes in the phase-out range of the credit, where incentives to reduce labor supply are strongest. Still, given that the EITC redistributes $27 billion from wealthier households to households with incomes of less than $27,000, its design from the standpoint of labor supply is superior to the alternatives. It provides a positive work incentive for households not working and working only a little. The most severe negative effects are concentrated on taxpayers making more than $11,000 a year, a group that is already working a fairly significant amount and hence may not be greatly affected by the phase out of the credit.

Family structure

One of the least well-understood effects of public policies directed toward low-income households is the effects of programs on family structure.[33] The EITC provides very strong incentives for some taxpayers to marry and others to separate. Consider, for example, a single man with two children and a single woman with two children. Both have incomes of $11,000. By 1996, each will be eligible for an EITC of $3,370. If they marry, their joint income will be $22,000 and they will be eligible for a credit of $1,054. By marrying, their combined EITC falls by almost $5,700, or more than 25 percent of their combined earned income. Similarly, a two-earner couple with four children and with both the husband and wife making $11,000 would increase their combined after-tax incomes by more than $5,700 by separating and maintaining separate households.[34] Thus, it is clear that the EITC creates very large financial incentives for some taxpayers not to marry and for others to separate.

At the same time, the credit increases the incentive for some households to marry. Consider, for example, a single man earning $11,000 and a mother with two children with no earned income. If this pair marries, they will be eligible for an EITC of $3,370. In general, positive incentives to marry are provided to low- or zero-earning taxpayers with children; and positive incentives for separation (or negative incentives for marriage) are provided to couples with children when each has modest earned income.

I know of no empirical evidence that suggests people manipulate their legal living arrangements to respond to these incentives. Still, the incentives are large, particularly in relation to the incomes of the affected taxpayers. From the perspective of social science research, the EITC when fully phased in may provide an opportunity for examining the effects of income transfer policies on the marital status of low-income households. It would be an unfortunate cost of the credit, however, if the incentives discourage people from marriage or encourage families to separate.

Changes to enhance the effectiveness of the EITC

The preceding discussion suggests several changes to the credit that might increase its effectiveness. EITC participation and compliance would be improved if the taxpayer and the IRS could assess EITC eligibility based solely on information provided on Form 1040 or 1040A. To do this without increasing burdens on taxpayers not eligible for the EITC will require several changes. First, nontaxable items such as nontaxable military benefits, housing allowances or rental value of a parsonage for the clergy, and excludable employer-provided dependent-care benefits should be excluded from earned income for the purposes of calculating the EITC. The value of these items cannot be assessed by the IRS except in an audit. Eliminating the nontaxable items would restore the EITC to its original state in 1975, when earned income was limited to items included in the gross income of the taxpayer.

Second, the support-based definition of a dependent should be changed so that it conforms to the residence-based definition of a qualifying child for the purpose of the EITC. The support test is unnecessarily difficult for taxpayers. The GAO estimated that nine million dependency exemptions were erroneously claimed for tax year 1988, primarily because of errors in assessing the support requirement.[35] Changing the support-based definition of dependent to one that relies on residency would significantly simplify the tax system. Senators Moynihan and Packwood introduced legislation to do this in 1993 (S.939).

Third, the age requirements for EITC qualifying children should be eliminated. A taxpayer would list his or her dependents (based, possibly, on either support provided or residency) on the face of the tax return as is currently done. EITC eligibility would then be based on the taxpayer's earned income, adjusted gross income, and number of dependents. This would broaden the scope of the EITC somewhat, by allowing the EITC to be received by the working poor with responsibility for all dependents rather than simply children, but the changes would significantly simplify the tax system for low-income households and allow the IRS to once again compute and pay the credit to eligible taxpayers based on the information provided on the returns.

The IRS, research community, and advocacy groups should ensure, to the extent possible, that EITC-eligible taxpayers are aware of the advance-payment option. Employers are obligated to provide an end-of-year statement about the EITC to employees who did not have income tax withheld during the year. They need not provide this notice to employees who claim exemption from withholding because they had no tax liability in the previous year and expect none in the current year. The latter group is just as likely to benefit from the notice and should receive it. The IRS communicates with millions of nonfilers, who, because of their low incomes, are not likely to owe taxes. Information about the EITC and advance payments should be included in these communications.

Integration of EITC advance payments and the AFDC and food stamp delivery system, such as that proposed by the state of Michigan, holds the greatest promise of making the advance-payment option work best for the population for whom it is most important. The Michigan experiment should be watched closely, and, if successful, implemented on a broader scale.

The EITC provides a number of incentives that many would deem undesirable. These include overstating reported income to the IRS, reducing work effort, and separating or not marrying. If fraudulent reports of income threaten to jeopardize support for the EITC, it would be straightforward to base the expanded credit on wage and salary income, which is accurately reported to and easily verified by the IRS. EITC payments based on other sources of income could be limited to the combined employer and employee payroll tax rate. This change would result in inequity between low-income self-employed households and wage-earning households, but the inequity could be addressed by other provisions in the tax code. Because the EITC is delivered to most taxpayers as a lump-sum payment, I suspect the adverse labor market consequences of the credit are not severe.

Conclusion

The EITC has gone from a program that provided a maximum benefit of $500 as recently as 1984 to one that will provide maximum payments of $3,370 to families with two or more children in 1996. No other program directed toward low-income households has grown nearly as rapidly as the EITC. Its popularity cuts across political ideology. Liberals like the program because it increases the fairness of the tax system by redistributing resources from wealthier to poorer households. Conservatives like the program because benefits are tied to work, so it is consistent with "pro-work" welfare policy. With such a rapid expansion in the credit, however, policymakers, advocacy groups, and analysts will have to pay careful attention to several issues to ensure that the credit serves its intended purposes.

Statutory reforms can improve EITC compliance. Outreach and targeted efforts, such as Michigan's proposed experiment, hold promise for getting advance payments to households making the welfare-to-work transition. More must be learned, however, about the degree to which taxpayers will manipulate reported incomes to receive benefits and the effects of the EITC on labor supply and family structure. ■

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[1]Quoted in Isaac Shapiro and Robert Greenstein, "Making Work Pay: The Unfinished Agenda," Center on Budget and Policy Priorities, Washington, D.C., May 1993, p. 19.

[2]More detailed discussion of many of the issues raised in this essay can be found in my paper "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness," IRP Discussion Paper No. 1020-93, 1993 (forthcoming in the *National Tax Journal),* and in George K. Yin, John Karl Scholz, Jonathan Barry Forman, and Mark J. Mazur, "Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program," forthcoming in the *American Journal of Tax Policy.* I am grateful to my coauthors for teaching me much about the EITC and to John Coder at the Census Bureau for his invaluable collaboration.

[3]The credit has also been defended as an income security program for low-income families, a work incentive for welfare recipients, a subsidy to take account of the child care and health care needs of children in low-income families, and an efficient mechanism for offsetting the effects of regressive federal tax proposals.

[4]Up through the middle of the tax year 1992, the Internal Revenue Service (IRS) would compute and pay the credit to any taxpayer who filed a return and appeared to be eligible for the credit, even if the taxpayer did not claim the credit on the return. Because of the high error rate in payments made when the IRS intervened, the policy was changed so that taxpayers who appear eligible but do not claim the credit are now notified by letter that they may be eligible for a refundable credit if they file an amended return.

[5]"The Participation Rate of the Earned Income Tax Credit," IRP Discussion Paper No. 928-90, University of Wisconsin–Madison, 1990.

[6]Tax return items were matched to the 1990 SIPP through an arrangement between the Census Bureau and the IRS. Since the data resulting from the SIPP-IRS match are not available for public use, all work relating to the matched data was carried out at the Census Bureau by staff having authorized access to the linked data sets. Unfortunately, the tax return information does not include whether or not the taxpayer claimed or received the EITC.

[7]Rules governing whether or not a taxpayer supports a child are complicated. Janet Holtzblatt states (for rules in effect in 1990): "Single parents had to demonstrate that they provided over half the costs of maintaining a household in which a child resided, while married couples had to show that they provided over half the costs of a supported child. Further, the definition of a qualifying child differs among families on the basis of marital status" ("Administering Refundable Tax Credits: Lessons from the EITC Experience," *National Tax Association–Tax Institute of America Proceedings,* 84th Annual Conference, p. 181). AFDC and child support receipts, for example, are considered support that is not provided by the taxpayer, and hence may make the taxpayer ineligible for the credit. In OBRA90 the rules were simplified so that a qualifying child became any disabled offspring or any child under the age of 19 (or under 24 if a full-time student) who lives in the home for more than half the year.

[8]For the purposes of the EITC, earned income includes not only wage, salary, farm, and self-employment income, but otherwise nontaxable sources such as housing allowances or the rental value of a parsonage for the clergy, excludable employer-provided dependent-care benefits, nontaxable military quarters and subsistence benefits, voluntary salary reduction amounts (e.g., deductions to 401(k) plans), and anything else of value (money, goods, or services) received from someone for services performed even if it is not taxable (IRS Publication 596).

[9]Using as much tax return information as possible, I estimate that 10.1 million taxpayers were eligible for the EITC in 1990.

[10]"The Earned Income Tax Credit (EITC), Current Law, and the Clinton Proposal: Characteristics of Eligible Families," photocopy, Congressional Research Service, Washington, D.C., May 25, 1993.

[11]U.S. House of Representatives, Committee on Ways and Means, *1993 Green Book: Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means* (Washington, D.C.: U.S. GPO, 1993), p. 1058.

[12]The U.S. General Accounting Office reports that in 1991, "...if the taxpayer did not claim the EIC but the tax return information on filing status, dependents, and income appeared to meet the EIC qualifications, the computer would automatically calculate the EIC. A tax examiner would then review the return to determine if there was information that indicated the taxpayer was not entitled to the EIC" ("Tax Administration: IRS' 1992 Filing Season Was Successful but Not without Problems," GAO/GGD-92-132, Washington, D.C., September 1992, p. 5, note 6). The same procedures applied in 1990.

[13]Approximately 1.8% of EITC-eligible taxpayers actually file a tax return using form 1040EZ—a form designed for single taxpayers with no dependents and income from wages and salaries (the taxpayer cannot have more than $400 of interest income, for example)—rather than forms that would allow the IRS to flag the return as being eligible for the credit in the event the taxpayer did not claim it. Because a taxpayer cannot claim a dependency exemption on the 1040EZ, filing such a return would mean that an eligible taxpayer would not receive the credit.

[14]Rebecca M. Blank and Patricia Ruggles, "When Do Women Use AFDC and Food Stamps: The Dynamics of Eligibility versus Participation," photocopy, Northwestern University and the Urban Institute, Washington, D.C., June 1993.

[15]Robert Moffitt, "An Economic Model of Welfare Stigma," *American Economic Review,* 73 (December 1983), 1023–1035.

[16]This change is described in U.S. General Accounting Office, "Tax Administration: IRS' 1992 Filing Season Was Successful but Not without Problems." According to unpublished figures from Sharon Patton at the Returns Processing Division of the IRS, as of June 5, 1993, the IRS had mailed 832,000 EITC notices to potentially eligible taxpayers for the 1992 tax year.

[17]See, for example, Center for Budget and Policy Priorities, "The 1994 Earned Income Credit Campaign Information Kit," CPPP, Washington, D.C.; Greater Milwaukee Committee, "The Milwaukee Earned Income Credit Campaign: Reaching Out to the Poor," Project Report, Milwaukee, July 1990; Congress for Working America, "Making Work Pay: The Milwaukee Earned Income Credit Campaign, 1991–1992," Milwaukee, 1992; and the IRS (Margaret J. Lullo, "Statement of Margaret J. Lullo, Deputy Assistant Commissioner [Taxpayer Services], Internal Revenue Service, before the Subcommittee on Select Revenue Measures and Human Resources, Committee on Ways and Means, U.S. House of Representatives," March 30, 1993).

[18]States that did not tax wages in 1990 included Alaska, Connecticut, Florida, Nevada, New Hampshire, Tennessee, Texas, and Washington (Connecticut now has an income tax). Two additional states that should be included, South Dakota and Wyoming, are aggregated with

more than one other state in the data and hence could not be included with the other no-tax states.

[19]Iowa, Maryland, Rhode Island, Vermont, and Wisconsin had state EITCs in 1990 (Minnesota added one in 1991). Iowa is aggregated with South and North Dakota in the data; Vermont is aggregated with Maine. All these states are included with the state-EITC variable.

[20]This reduction in the poverty gap will not be reflected in official government statistics as the EITC is not included in the most widely publicized income concept used to measure poverty—pretax, posttransfer income.

[21]The TCMP collects a stratified random sample of 50,000 tax returns every three years. Each selected taxpayer undergoes an intensive, comprehensive audit by a specially trained examiner. The audits focus on all items of the tax return. For more details about the TCMP program, see Jeffrey Roth, John Scholz, and Ann Witte, *Taxpayer Compliance: Vol. 1, An Agenda for Research* (Philadelphia: University of Pennsylvania Press, 1989), particularly pp. 65–69.

[22]Jennie S. Stathis, "Statement of Jennie S. Stathis, Director, Tax Policy and Administration Issues, General Government Division, General Accounting Office, before the Subcommittee on Select Revenue Measures and Human Resources, Committee on Ways and Means, U.S. House of Representatives," GAO/T-GGD-93-20, Washington, D.C., March 30, 1993.

[23]Holtzblatt, "Administering Refundable Tax Credits: Lessons from the EITC Experience."

[24]Ibid., p. 184. The categories Holtzblatt presented are not mutually exclusive. For example, 41% of the returns disqualified had both the child exemption disallowed and filing status changed. A taxpayer claiming the EITC who did not meet the support test could have the child exemption disallowed and the filing status changed.

[25]A qualifying child must be under the age of 19, or a student under the age of 24, or a disabled offspring of any age.

[26]Because Congress was concerned about employees receiving too large a credit during the year, beginning in 1994 advance payments are limited to 60% of the base credit. Thus, the most a taxpayer could receive is $23 per week (.60 x 2,040/52).

[27]U.S. General Accounting Office, "Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public," GAO/GGD-92-26, Washington, D.C., February 1992.

[28]Michael Wiseman, "Welfare Work Incentives in Real Time," paper prepared for the National Commission on Employment Policy, La Follette Institute of Public Affairs, University of Wisconsin–Madison, December 1993.

[29]The combined employer and employee payroll tax is 15.3%. The EITC for a family with one qualifying child was 18.5% in 1993. Under the 1990 EITC changes, however, the credit was to be increased in 1994 to 23% for taxpayers with one child and 25% for taxpayers with two or more children. Under OBRA93 the corresponding rates are 26.3% and 30% (see Table 1).

[30]See, for example, Saul D. Hoffman and Laurence S. Seidman, *The Earned Income Tax Credit: Antipoverty Effectiveness and Labor Market Effects* (Kalamazoo, Mich.: W. E. Upjohn Institute for Employment Research, 1990), Chap. 3; Marvin H. Kosters, "The Earned Income Tax Credit and the Working Poor," *American Enterprise*, May/June, 1993, pp. 65–72; Edgar K. Browning, "Effects of the Earned Income Tax Credit on Income and Welfare," photocopy, Texas A&M University, College Station, 1993; and U.S. General Accounting Office, "Tax Policy: Earned Income Tax Credit: Design and Administration Could Be Improved," GAO/GGD-93-145, Washington, D.C., September 1993.

[31]Hoffman and Seidman, *The Earned Income Tax Credit*, Chap. 3.

[32]U.S. General Accounting Office, "Tax Policy: Earned Income Tax Credit," Chap. 3.

[33]Robert Moffitt, "Incentive Effects of the U.S. Welfare System: A Review," *Journal of Economic Literature*, 30 (March 1992), 1–61.

[34]Separating would also reduce their (small) federal tax liability. If the family owns their home, it is not even clear that they could not continue to live in the same house. One partner would receive the house in the separation agreement. The homeowner could then "rent" a portion of the home to the separated spouse and children.

[35]U.S. General Accounting Office, "Tax Policy: Earned Income Tax Credit."