
The Earned Income Tax Credit

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What is the EITC?

- Refundable tax credit for low income families with children
- Must have earned income to be eligible
- In tax year 2003, the credit was received by 19.2 million filers at a cost of \$34 billion.
- The average credit per family in 2003 was \$1,784.
- The EITC has become an integral part of federal assistance for low income families.
- [There is a much smaller credit for childless filers. My comments will focus on the EITC for families with children.]

Background and History of EITC

- Started in 1975 as modest “work bonus”; made permanent in 1978
- Substantial expansions have taken place:
 - 1986 Tax Reform Act: general expansion and indexed for inflation
 - 1990 OBRA: general expansion and added separate schedule for families with 2 or more children
 - 1993 OBRA: general expansion (larger expansion for families with 2 or more children) and added EITC for childless filers
- Many states now offer “add on” EITCs
 - In 2003, 16 states had EITCs

Why do we have the EITC?

- Reduce the tax burden and increase incomes of low income families with children
 - Originally aim was to offset payroll tax costs for low income individuals.
- Transfers income to working poor
- Encourages work

EITC Eligibility (for families with children)

- Must have qualifying child
 - Must satisfy age, relationship and residency tests.
- Must have earned income
- AGI must be below limit
 - In 2004, AGI limit for single filers with one child was \$30,338 and single filers with two or more children was \$34,458.
- Investment income must be below limit
 - In 2004, the sum of interest, dividend, rent & royalty, capital gain, and passive income could not be larger than \$2,650.

EITC Payments

- Credit depends on *earnings* and *number of children*:
 - Phase-in: credit is flat percentage of earned income
 - Flat range: receive maximum credit
 - Phase-out: credit is phased out at a flat rate
- Credit is *refundable* (can receive payment even if there is no tax liability)
- Credit based on *family* earnings
- Until recently EITC parameters were identical for single and married filers.
 - 2001 EGTRRA: Expansion in flat and phase-out range \$1000 for joint filers. When fully phased in, in 2007, the flat and phase-out range will be \$3000 higher for joint filers.

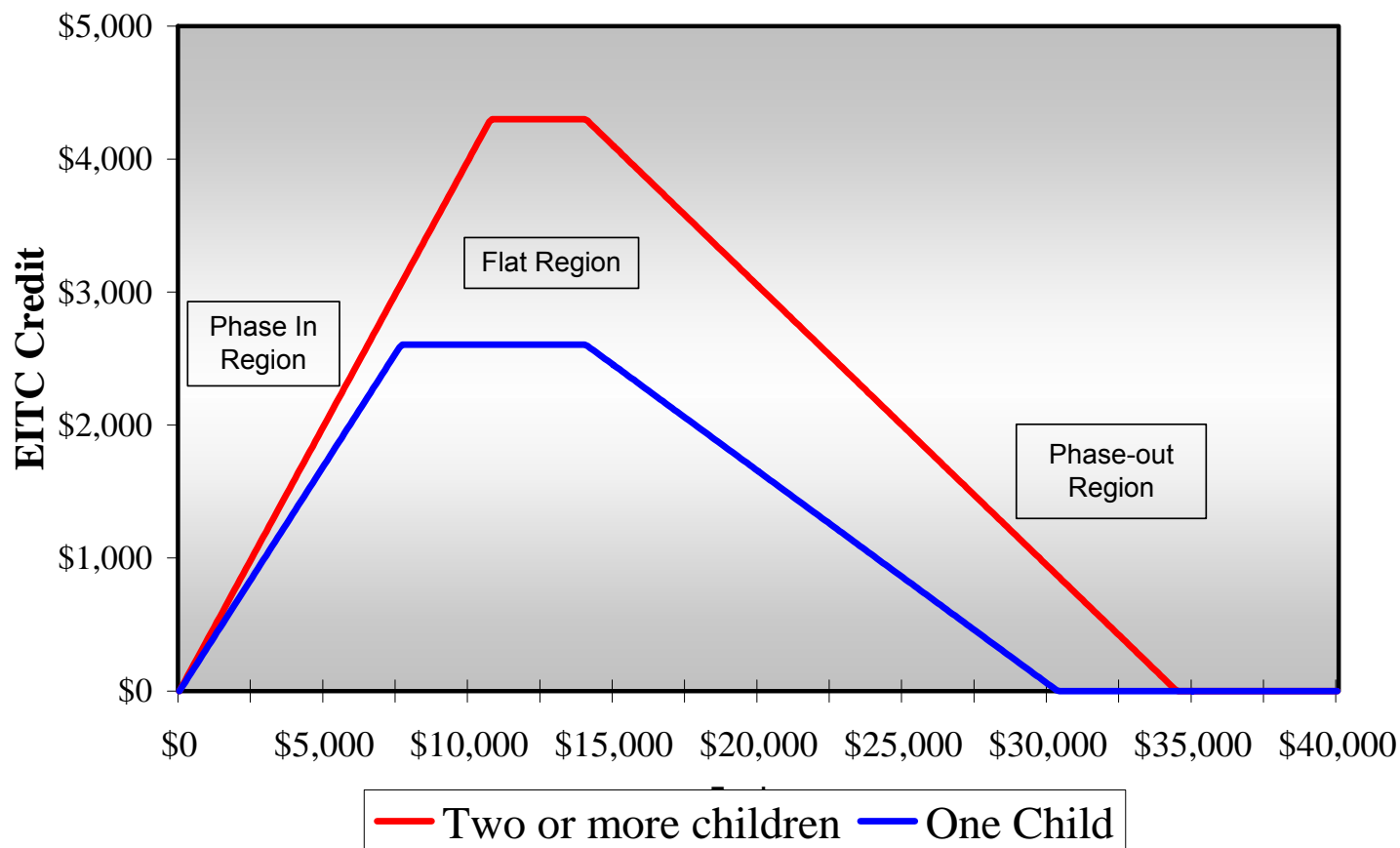
2004 EITC Parameters for Single Filers

	<u>Number of Children:</u>		
	Zero	One	Two or More
Phase-in earnings	\$0-\$5,100	\$0-\$7,660	\$0-\$10,750
Flat range earnings	\$5,100-\$6,390	\$7,660-\$14,040	\$10,750-\$14,040
Phase-out earnings	\$6,390-\$11,490	\$14,040-\$30,338	\$14,040-\$34,458
Credit rate, phase-in	7.65%	34%	40%
Phase-out rate	7.65%	15.98%	21.06%
Maximum credit	\$390	\$2,604	\$4,300

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EITC Schedule – Single Parent Families, 2004



- Larger credit, covering higher earners for families with two or more children.

Who Receives the EITC?

EITC Returns by AGI, Children and Filing Status, 2002-2003

	% of EITC returns	% of EITC expenditures
\$1-\$9,999	29%	20%
\$10,000-\$19,999	29%	40%
\$20,000-\$29,999	24%	28%
\$30,000+	19%	11%
No children	18%	2%
One child	39%	37%
Two or more children	43%	61%
Single & head of household	76%	75%
Married filing joint	24%	25%

Source: Tabulations by income and filing status are from U.S. House of Representatives (2005) for 2003. Tabulations by number of children are from IRS (2005) for 2002.

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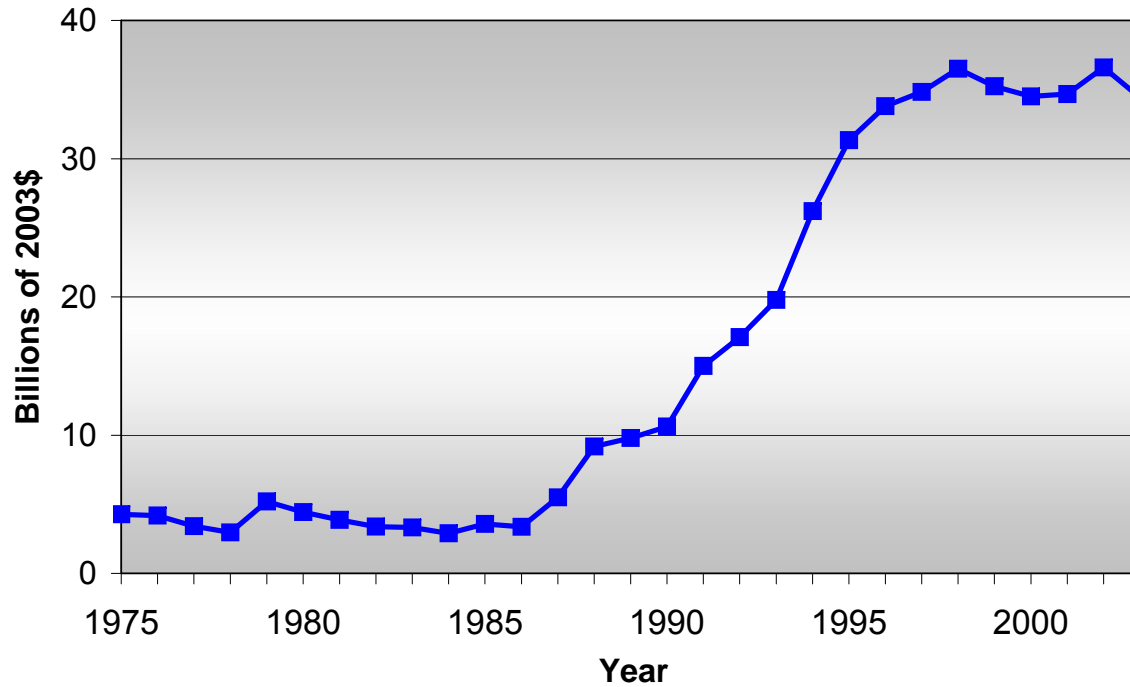
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- The majority of benefits go to single parent recipients, those with two children, and taxpayers with AGI under \$20,000. For reference, the poverty line for a 3-person family in 2003 was \$14,810.

Interaction with other features of tax code

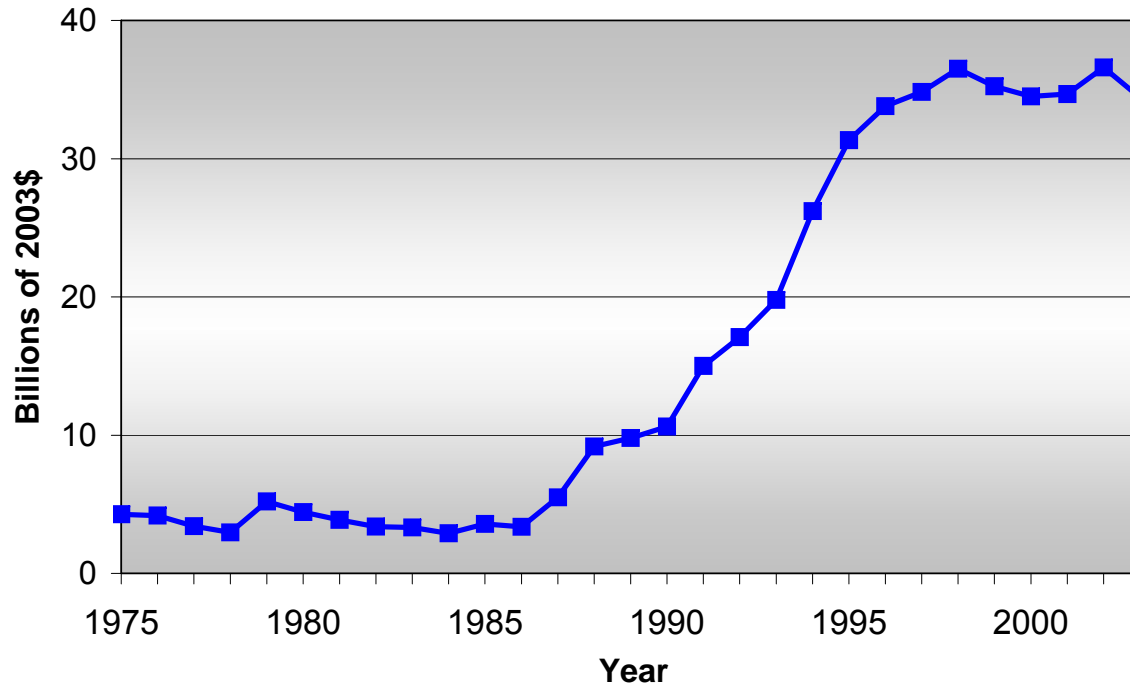
- EITC recipients may also receive the child tax credit and child care tax credit.
 - No direct interaction between EITC and these other credits.
- Personal exemptions
- Standard deduction
- These features are part of an overall patchwork of tax benefits for families with children

Cost of EITC in Billions of 2003 Dollars



Source: *Green Book*, 2004, Joint Committee on Taxation, Ways and Means Committee

Cost of EITC in Billions of 2003 Dollars

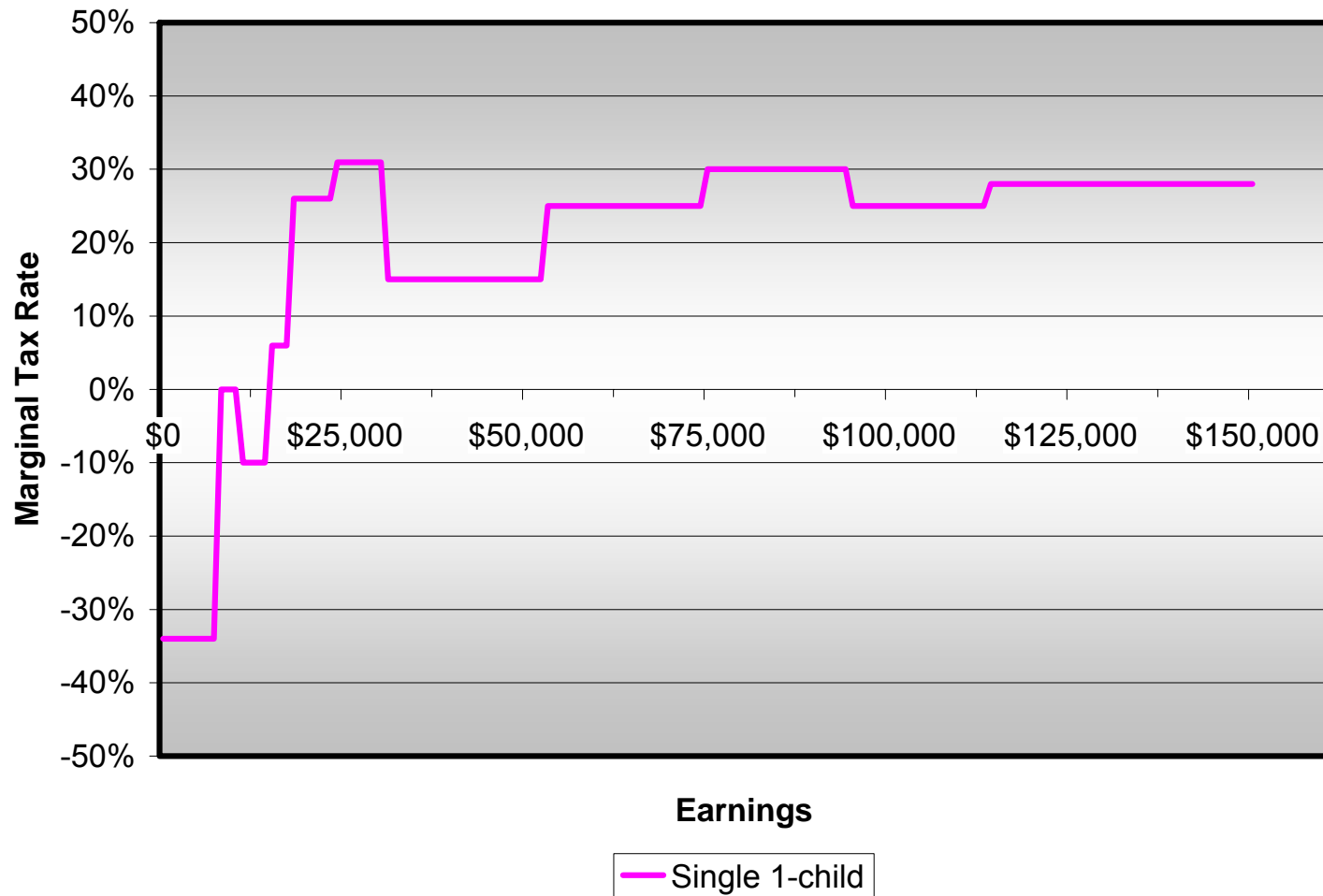


Comparison: EITC reaches more families and costs more than Temporary Assistance for Needy Families (TANF) or Food Stamps:

	EITC	TANF	FS
Cost (billions)	\$33.4	\$24.5	\$21.0
Families (millions)	19.6	2.1	7.4
Average Benefit	\$142/mo	\$351/mo	\$174/mo

The EITC and marginal tax rates more broadly

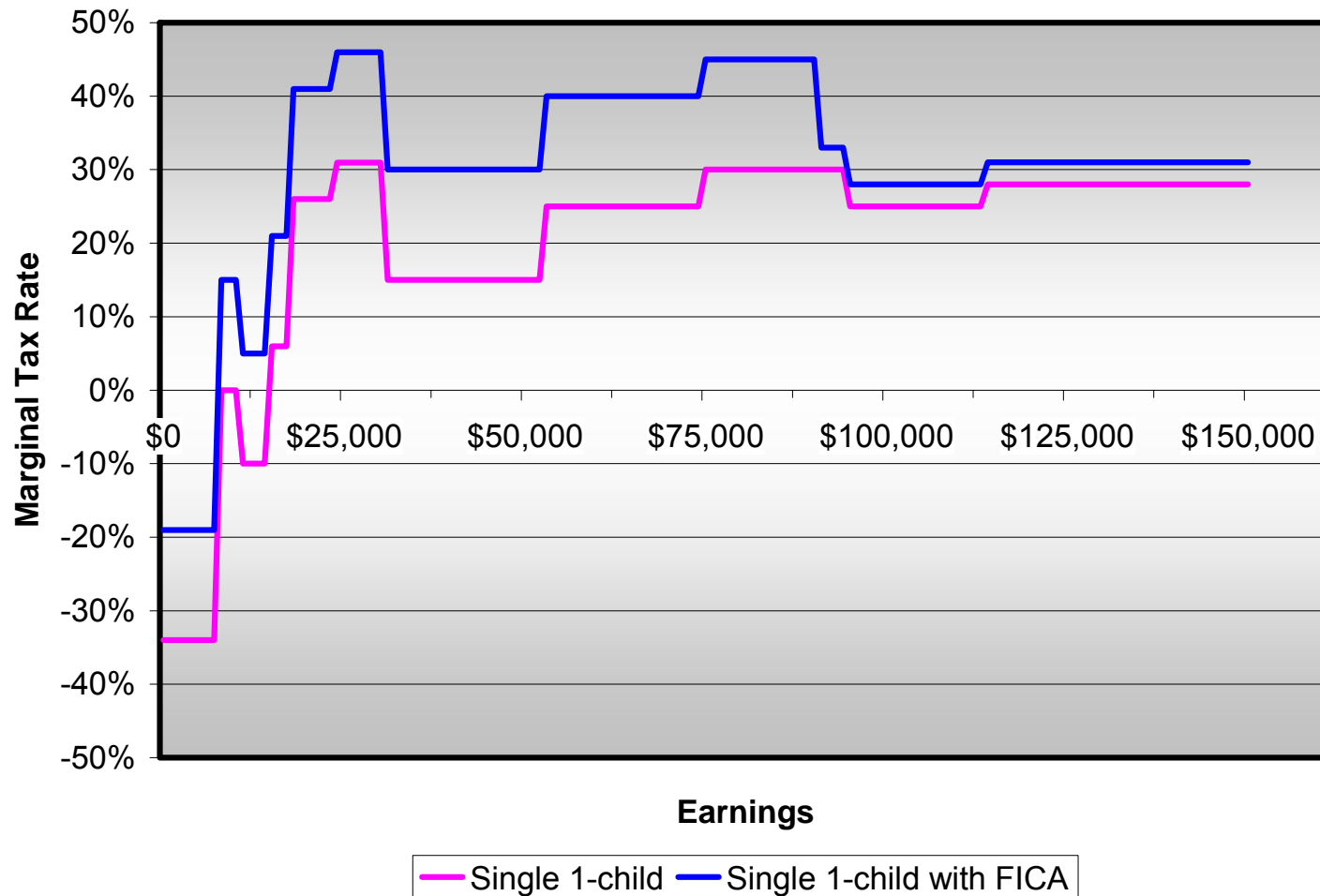
Marginal Tax Rates for Families with One Child, No AMT, 2004



Source: Author's tabulation of NBER's TAXSIM model.

The EITC and marginal tax rates: Adding FICA

Marginal Tax Rates for Families with One Child, No AMT, 2004



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Good tax policy is

- Efficient
- Fair
- Simple
- How does the EITC perform utilizing these criteria?

Efficiency – EITC gets very good marks

- The popularity of the EITC arises from the fact that it transfers resources to low income families while promoting work → *efficient tax*.
- KEY: EITC provides incentive to enter the labor market.
- Research consistently shows that expansions in EITC have led to increases in labor force participation for single mothers with children.
 - For example, one study found that the EITC was responsible for 60% of increase in employment rates of single mothers between 1984 and 1996 (Meyer and Rosenbaum 2001)
- Research also shows that the EITC leads to significant reductions in poverty.

Example: How does the EITC change the incentive to work?

- Consider a single parent with 1 child who earns \$7.50 per hour
- Her work choices are: no work, part time (20 hrs/wk) or full time (40 hrs/wk)
- How does the EITC affect the income gains to entering work?

	Increase in net annual income from entering workforce at:	
	PT work	FT work
Without the EITC	\$5,356	\$10,712
With the EITC	\$7,177	\$13,316

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Without the EITC	\$5,356	\$10,712
With the EITC	\$7,177	\$13,316
Impact of EITC on net income	\$1,821/yr	\$2,604/yr
Impact of EITC per hour worked	\$1.75/hour	\$1.25/hr

Efficiency – Some caveats

- High marginal tax rates in the phase-out region provide disincentive to increase work (or wage rates) for those already in the labor market.
 - Research shows that this negative effect is small for existing workers (Hotz and Scholz 2003).
 - May be due to lack of knowledge about phase-out of credit or lack of flexibility in adjusting hours.
- EITC decreases the incentives to enter the labor market for some secondary earners (lower earning parent in married couple).
 - Research finds evidence of these effects, but the magnitude is small (Eissa and Hoynes 2004).

Fairness in the EITC

- Married filers face largely the same schedule (eligibility, benefits) as single filers.
 - Passed in 2002, and fully phased in in 2007, the phase-out range of married filers will be extended by \$3,000.
- Marriage tax penalty due to EITC—important for low income filers.
- Generosity of EITC by family size
 - Small benefit for childless workers
 - 2 child EITC 65% larger than 1 child (They were almost identical until 1994. See appendix for more on this.)

<i>2004 Max. EITC</i>	
No Children	\$390
1 Child	\$2,604
2 Children	\$4,300

Simplicity

- IRS Publication on EITC (Publication 596) is 53 pages long
- Definition of “qualifying child” is main source of complexity in EITC
- New rules concerning pre-certification may add complexity
- The complexity is a direct result of compliance problems. Main sources of noncompliance
 - No qualifying child
 - Income over-reporting

In-Work Credits in Other Countries

- Following the US, eight other OECD countries have recently introduced in-work credits with the goal of reducing poverty and increasing employment (Owens 2005).
- The UK program is the most established
 - *Working Tax Credit* (replaced WFTC in 2003)
 - Differences from EITC: Hours requirement (≥ 16 hrs/wk) and (relatively) more generous benefit for childless families.
 - Similarities to EITC: Phase-out region (no phase-in due to hours requirement)
 - Add-on to *Child Tax Credit*, which has no phase-in and a much higher and slower phase-out.

Concluding comments

- The EITC provides cash assistance to low income working families with children
- The EITC increases employment and reduces poverty
- Problems to address:
 - Complexity
 - Compliance
 - Fairness: Single vs married couples

Appendix:
Supplementary tables and charts

Definition of Qualifying Child

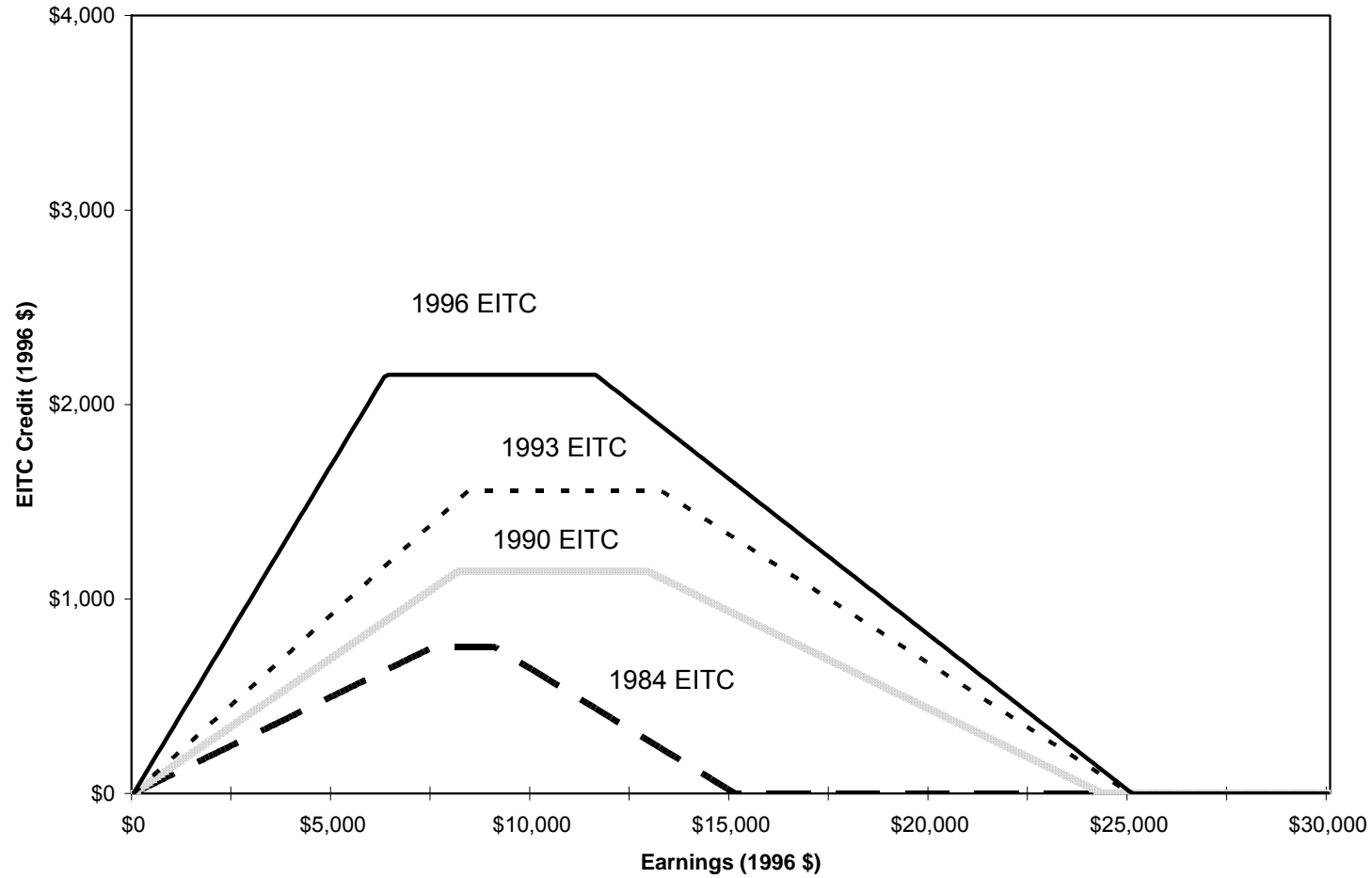
- Age test: Child must be younger than 19 (or 24 if full-time student or any age if totally disabled)
- Relationship test: Filer must be parent, grandparent or foster parent of child
- Residence test: Child must live with filer for at least 6 months during tax year

2004 EITC Parameters for Joint Returns

	Number of Children:		
	Zero	One	Two or More
Phase-in earnings	\$0-\$5,100	\$0-\$7,660	\$0-\$10,750
Flat range earnings	\$5,100-\$7,390	\$7,660-\$15,040	\$10,750-\$15,040
Phase-out earnings	\$7,390-\$12,490	\$15,040-\$31,338	\$15,040-\$35,458
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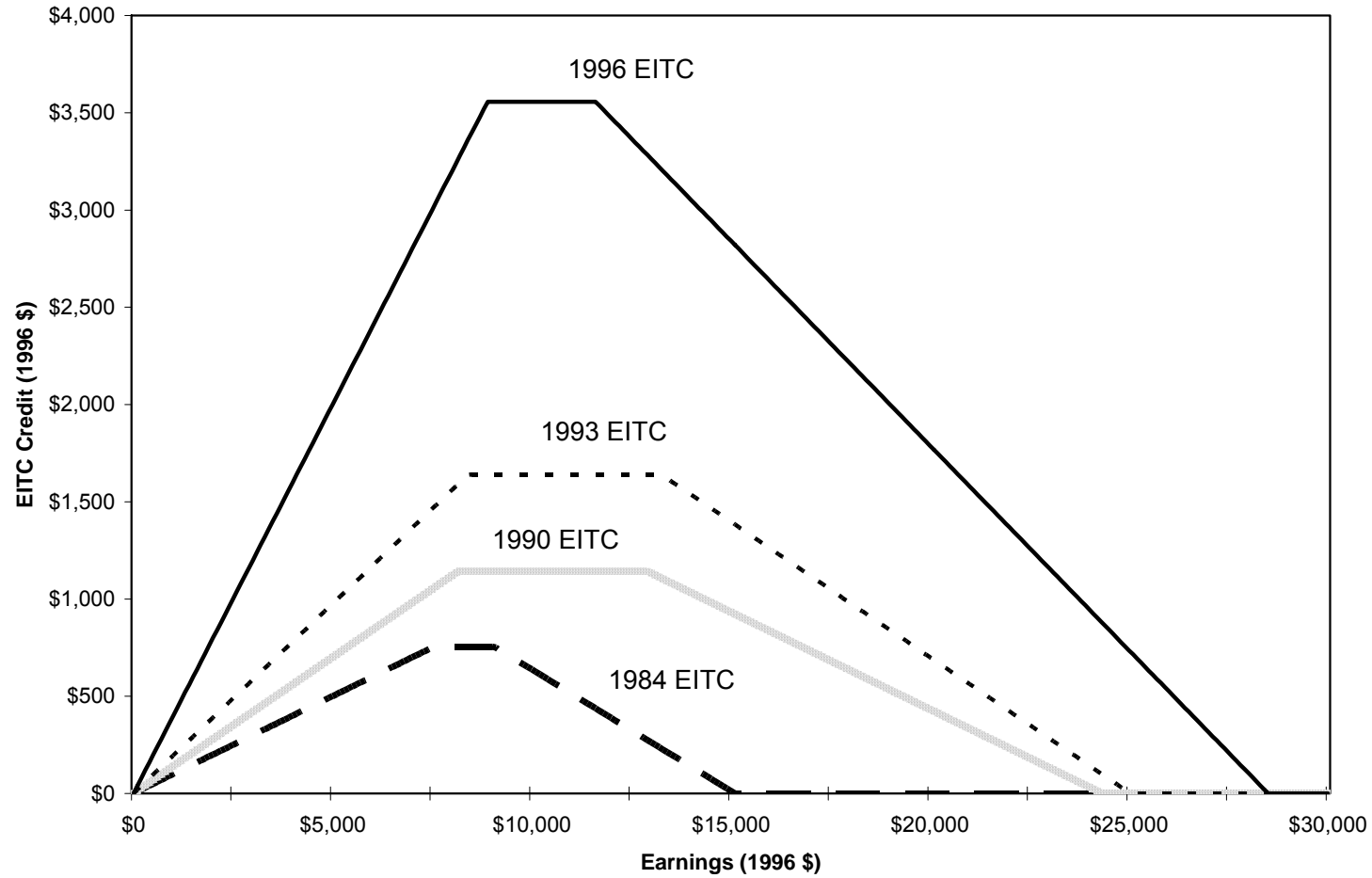
EITC Benefit for Selected Tax Years, By Real Earnings (1996 dollars)

(A) Schedule for Family with 1 Child

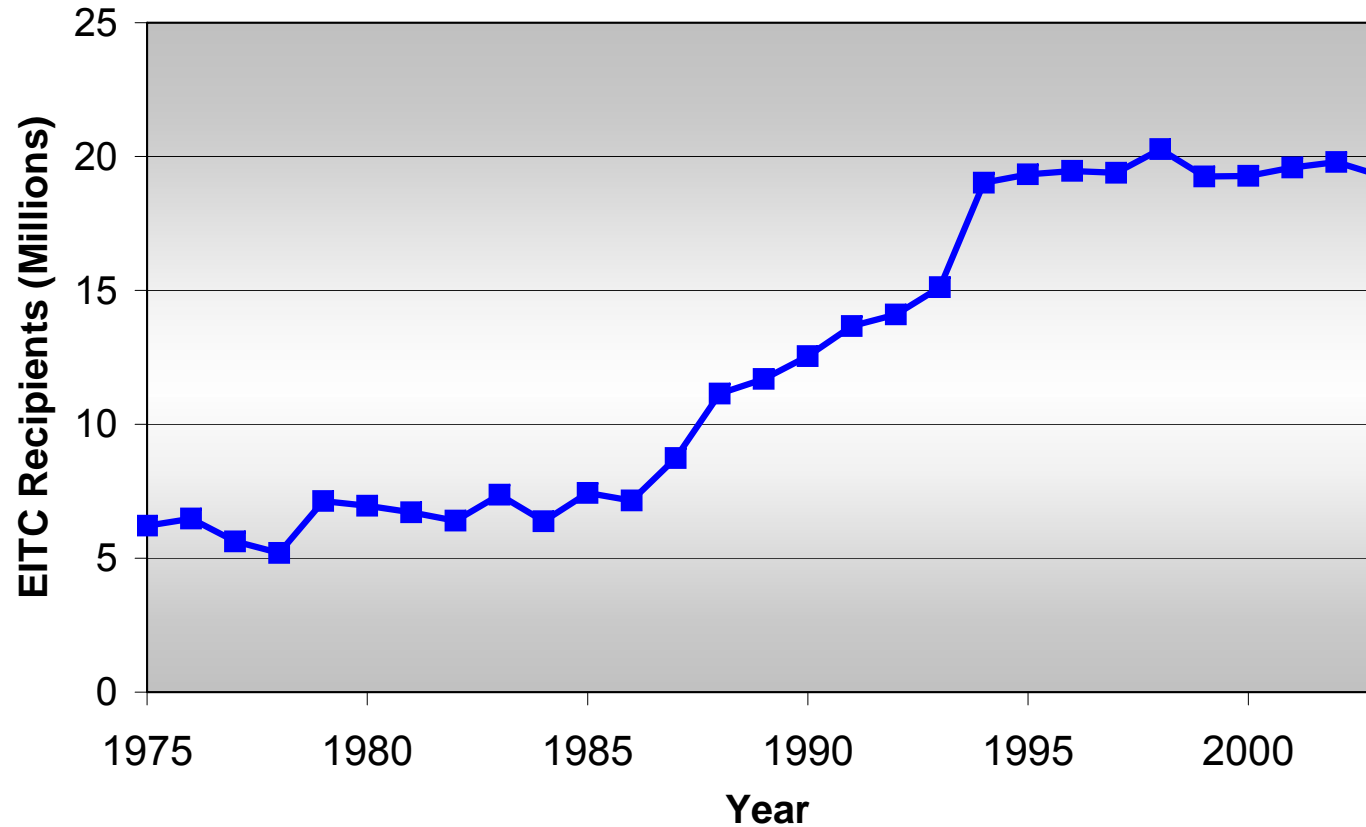


EITC Benefit for Selected Tax Years, By Real Earnings (1996 dollars)

(B) Schedule for Family with 2+ Children



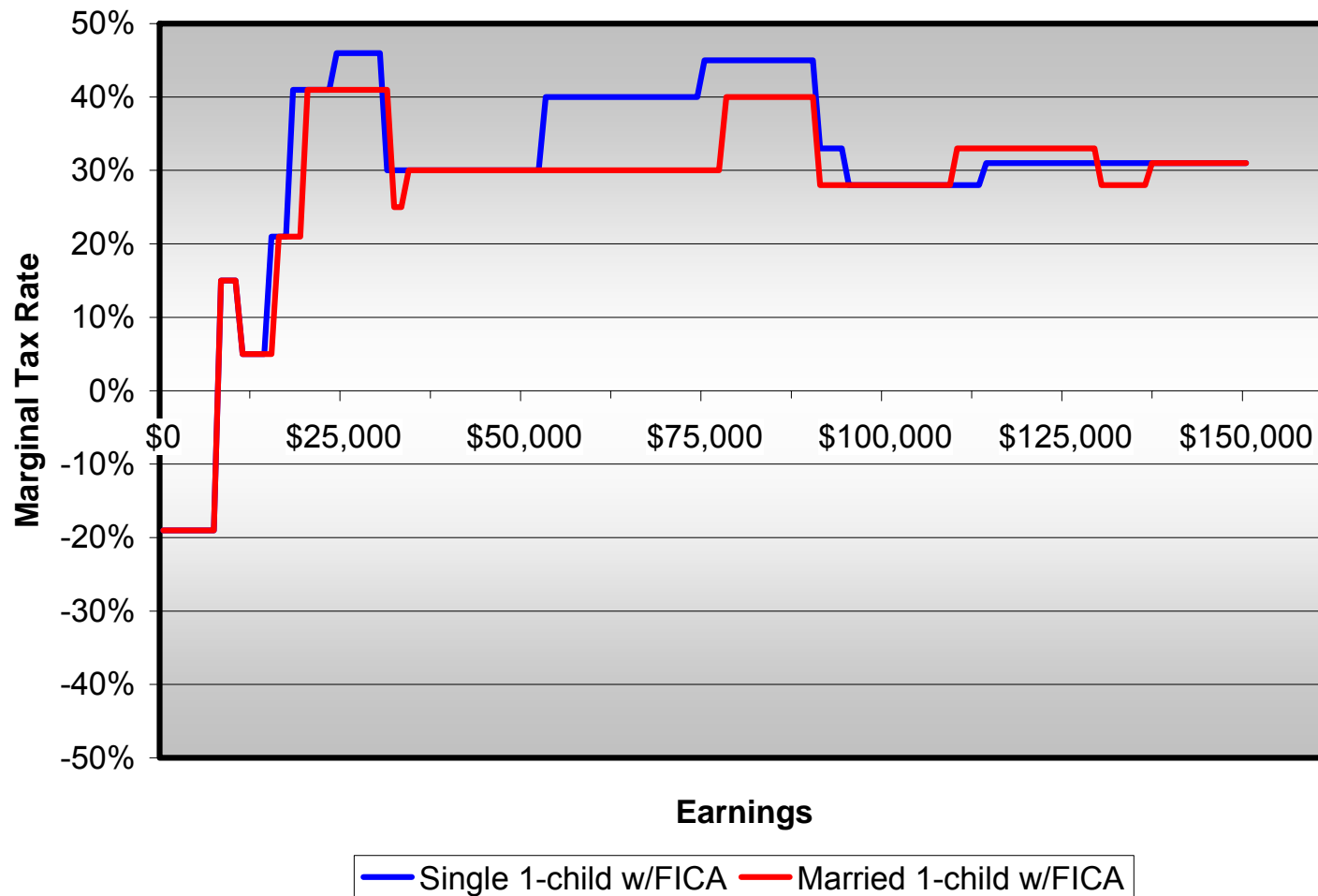
Number of EITC Recipient Families (Millions)



Source: *Green Book*, 2004, Joint Committee on Taxation, Ways and Means Committee

The EITC and MTR: Single and married filers with one child

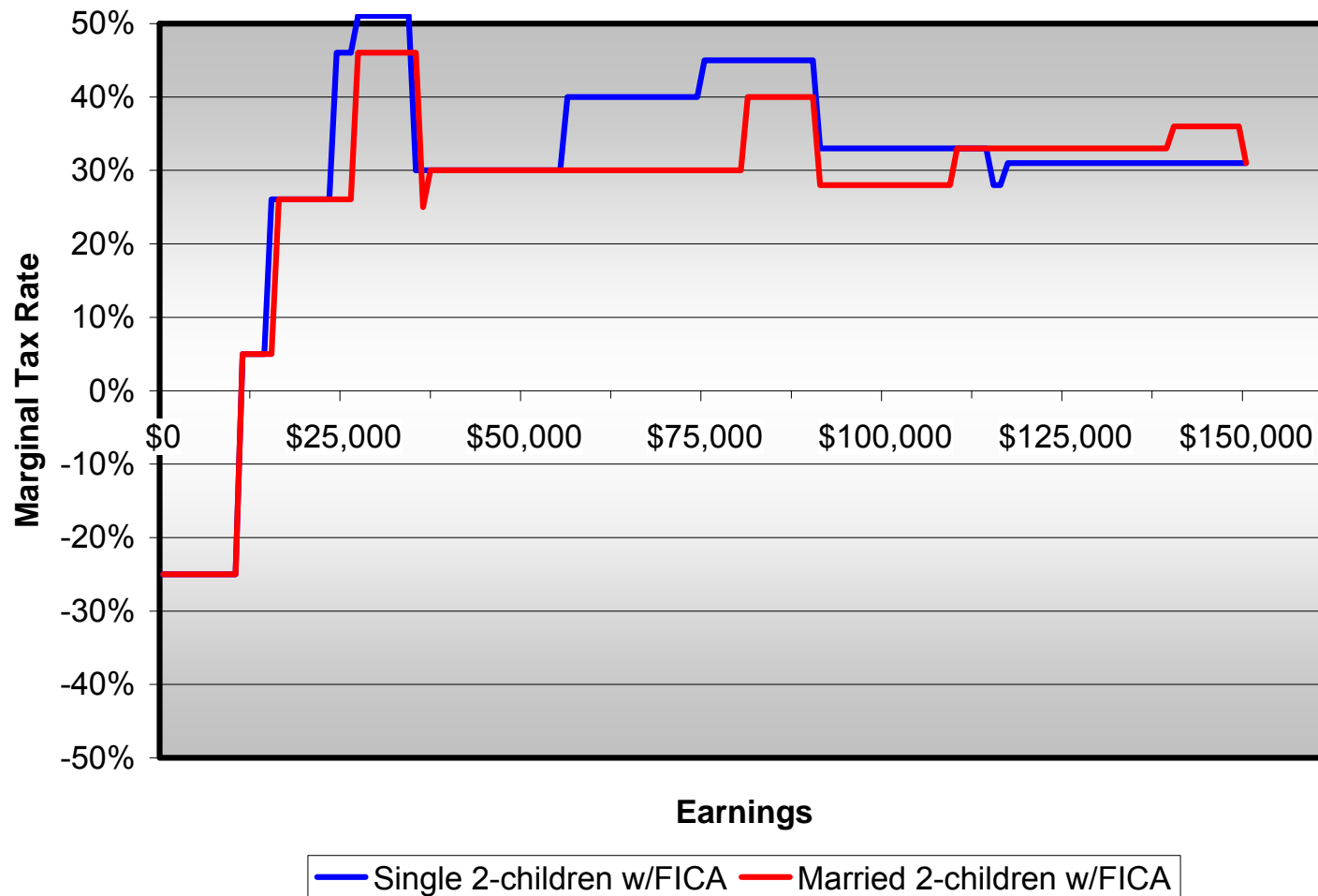
Marginal Tax Rates for Families with One Child, No AMT, 2004



Source: Author's tabulation of NBER's TAXSIM model.

The EITC and MTR: Single and married filers with 2 children

Marginal Tax Rates for Families with Two Children, No AMT, 2004



Source: Author's tabulation of NBER's TAXSIM model.

EITC and gains to increasing work, Single Families, 2004

	Impact of EITC on gains to income from increasing labor supply:		
	No work to PT work	No work to FT work	PT work to FT work
<u>Single, One Child</u>			
\$5.15/hr (min wage)	\$1,821	\$2,604	\$783
\$7.50/hr	\$2,604	\$2,354	-\$250
\$10.00/hr	\$2,604	\$1,523	-\$1,081
\$15.00/hr	\$2,354	\$0	-\$2,354
<u>Single, Two Children</u>			
\$5.15/hr (min wage)	\$4,284	\$2,142	\$2,142
\$7.50/hr	\$3,120	\$3,971	\$851
\$10.00/hr	\$4,160	\$2,876	-\$1,284
\$15.00/hr	\$3,971	\$686	-\$3,285
Source: Author's tabulation of NBER's TAXSIM model. Tax calculations include federal taxes, but no state taxes or FICA.			

EITC and gains to increasing work, Married Couples, 2004

	Impact of EITC on gains to income from increasing labor supply:		
	No work to PT work	No work to FT work	PT work to FT work
<u>Single, One Child</u>			
\$5.15/hr (min wage)	\$1,821	\$2,604	\$783
\$7.50/hr	\$2,604	\$2,514	-\$90
\$10.00/hr	\$2,604	\$1,683	-\$921
\$15.00/hr	\$2,514	\$21	-\$2,493
<u>Single, Two Children</u>			
\$5.15/hr (min wage)	\$2,142	\$4,284	\$2,142
\$7.50/hr	\$3,120	\$4,182	\$1,062
\$10.00/hr	\$4,160	\$3,086	-\$1,074
\$15.00/hr	\$4,182	\$896	-\$3,286
Source: Author's tabulation of NBER's TAXSIM model. Tax calculations include federal taxes but no state taxes or FICA.			

In-work Credits in OECD Countries in 2001

	Target group	Refundable	Approximate Maximum Income Increase (Euros/dollars)	Phase-in	Phase-out	Hours criterion
Belgium ¹	Individual	Yes	440	Yes	Yes	No
Canada (Quebec) ²	Families	Yes	3,150	Yes	Yes	No
Finland	Individual	No	290	Yes	Yes	No
France ³	Individual	Yes	230	Yes	Yes	No
Ireland ⁴	Families	Yes	2,260 or more	No	Yes	Yes
Netherlands	Individual	No	920	Yes	No	No
New Zealand ^{5a}	Families	Yes	7,800	No	Yes	Yes
New Zealand ^{5b}	Families	Yes	780 per child	No	Yes	Yes
United Kingdom ⁶	Families	Yes	6,150 or more	No	Yes	Yes
United States	Families	Yes	4,000	Yes	Yes	No

Source: Owens (2005), Table 3.

Table Notes:

- 1) Introduced in 2002.
- 2) Most Canadian provinces have a scheme similar to this. There are no Federal MWP programmes.
- 3) PPE is an individual tax credit which increases when gross income rises from 30 per cent to 100 per cent of the SMIC (minimum wage).
- 4) FIS equals 60 per cent of the difference between net family income and an earnings limit. For a family with one child the weekly earnings limit is around €170. Figures given here reflect an assumption of hourly earnings of €5.33 and a 40-hour week; with lower earnings and hours, the maximum receipt could be higher.
- 5a) Family Tax Credit. The child minder must work at least 20 hours per week (lone parent) or 30 hours per week (combined hours for a couple with children). The maximum payment equates to the net income subsidy for a lone parent working 20 hours per week at the minimum wage, needed to reach the guaranteed minimum net income of NZD 15,080 p.a. in 2001.
- 5b) Child Tax Credit. The entitlement abates with family income after full abatement of the non work-tested Family Support, and is therefore available to a number of middle- to higher- income working families as well as to all low-income working families.
- 6) WFTC (replaced in 2003) was calculated by adding credits for adults and children and then deleting 55 per cent of the difference between net income and GBP 92.90 per week. The family is here assumed to have gross earnings of €5.33 per hour and a 40 hour week; with lower earnings and hours, the maximum receipt could be higher. Child-care supplements are ignored.

References

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