Not Perfect, But Still Pretty Good: How the Earned Income Tax Credit Supports Low-Income Working Families

By John Karl Scholz

The Earned Income Tax Credit (EITC) is the country's largest cash income support program for low-wage families. Since it began in 1975, the EITC has been expanded under both Democratic and Republican administrations. The maximum credit has increased from $550 in 1986 to just over $1,500 in 1993 to more than $3,800 in 1999. In 1997, EITC lifted 4.3 million Americans out of poverty. The intent of the program is to reward working families, while attempting to reduce welfare reliance. The EITC provides a cash subsidy to earnings up to a specific income level, but no money to those who do not have earnings. Its targeting, beneficial labor market effects, and its relatively low administrative costs make it an appealing policy. Eleven states including Wisconsin have turned to the EITC. The chapter compares the EITC to three other programs for low-income workers: the minimum wage, incremental and targeted hiring subsidies, and payroll tax reductions.

The earned income tax credit (EITC) has been available to low-income working families in the U.S. since 1975, with expansion under both Republican and Democratic administrations. It has grown rapidly since its introduction, particularly in the last 15 years. In 1999, the credit is expected to cost $31.9 billion. This compares with a cost of about $3.8 billion in 1999 dollars when it was introduced in 1975. The EITC is the country's largest cash income support program for low-wage families.

What is the Earned Income Tax Credit?

The EITC provides a cash subsidy to earnings up to a specific income level, but no money to those who do not have earnings. The program's intent is to reward working families, while attempting to reduce welfare reliance. It is a tax refund paid to families generally in a lump sum after filing a tax return that reports income earned in the previous year. The maximum credit has increased from $550 in 1986 to just over $1,500 in 1993 to more than $3,800 in 1999. The maximum rate of earnings subsidy has risen from 11 percent in 1986 to 19 percent in 1993 to 40 percent of earned income in 1999. In preliminary data from 1997, the average EITC payment was $1,572.

There are three ranges in the EITC schedule. Taxpayers with the lowest incomes receive an earnings subsidy. For example, taxpayers with two or more children in 1998 who earned less than $9,390 received a benefit equaling 40 percent of their total earned income. Over the second range of income, the EITC neither increases or decreases. In 1998 taxpayers with two or more children who earned between $9,390 and $12,260 received the maximum credit of $3,816. For taxpayers with incomes larger than the top of the second range, the credit is phased out with every dollar that is earned. In 1998, the credit was reduced by 21 percent of each dollar earned for taxpayers with two children making between $12,260 and $30,095 in earned income.

How Effective is the EITC in Reaching Families Who Are Truly Low-Income?

The EITC is available only to taxpayers with earned and adjusted-gross income of less than $30,095 if they have more than one qualifying child, $26,473 if they have one child, and $10,030 if they have no qualifying children. In 1997, EITC lifted 4.3 million Americans out of poverty (Council of Economic Advisors, 1998). About half of all EITC payments go to families with incomes below the poverty line. About two-thirds of EITC payments go to taxpayers with wages in the bottom quarter of all workers with children, or those making less than $6.43 per hour (Scholz, 1996). More than 95 percent of EITC benefits go to workers with wages below the median of $9.42 per hour. To further increase the odds that benefits go only to limited-income families, a 1995 federal change limits EITC recipients to less than $2,300 of investment income.

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How Do Families Use the EITC?

A recent study of 6,000 Chicago-area families examined how low income families use the EITC (Smeeding, Phillips and O'Connor, 1999). About 65% of all families use the refund to pay a bill or purchase a commodity. Utilities and rent were the highest priority items, followed by food and clothing. Clearly, the EITC helps families makes ends meet.

Evidence also exists that the EITC may assist families in moving from welfare to work. Of those expecting a refund in this study, about one-fifth reported a car-related use. Lack of transportation is a serious roadblock to job search, employment and job mobility. The EITC may provide a critical bridge to a higher level of economic well-being by making a dependable source of transportation available to working families (Raphael and Rice 1999; Rimer 1995; Ong 1996). Danziger et al. (1998) find that 47 percent of low-income welfare recipients in their study do not own or have access to a car. But for those who do have a car, the effects of car ownership on earnings are equivalent to the effects of completing high school in terms of higher future earnings. Therefore, the ability to buy a car or truck, insure a vehicle, make repairs, or payoff a car loan increases the opportunity to work more at better paying jobs (Allard and Danziger, 1999).

Eleven percent of households had an expected expense for tuition or schooling, while 7 percent mentioned paying for education as a first priority for EITC money. Families also expressed a desire to use EITC benefits to improve their children's early learning by improving the quality of their child care or for other child-related learning expenses. EITC money also can pay for the recipients' own tuition at a technical college or trade school.

Half the families surveyed mentioned saving as a priority, and more than a third of those expecting a refund decided to save some or all of it. Making regular car payments and paying off bank loans, medical bills, or credit card debt are all uses of EITC that help establish or improve credit history.

Does EITC Affect Work Participation and Female Headship of Low-Income Families?

The EITC has provided a powerful work incentive for low-income earners with children because benefits from Temporary Assistance for Needy Families (TANF) are not counted as income, nor does it affect eligibility for Food Stamps or Medicare. Dickert, Houser and Scholz (1995) estimate the 1993 EITC expansions would increase labor force participation of single-parent families by 3.3 percentage points. Eissa and Liebman (1996) found a similar effect when looking at 1986 EITC and tax changes. Meyer and Rosenbaum (1999) reported that EITC is the primary influence on the increased employment rate of single mothers from 1984 to 1996, and 33 percent of the increase from 1992 to 1996.

Two recent papers found that EITC may increase the number of single, female-headed families, although the effects are small.

How Expensive is the EITC to Administer?

Compared with other income transfer programs, the EITC has low administrative costs. Because most EITC recipients are required to file a tax return even if they do not receive a credit, a formal review and certification of eligibility is not necessary. The cost of administering the EITC was a very small fraction of the total IRS budget in 1995 of $7.6 billion. That budget served a total of 116 million individual taxpayers and 15 million corporations. In contrast, the costs of administering two other major income support programs for low-income families are higher. Administrative costs for Food Stamps alone were $3.7 billion in 1995, and AFDC costs were $3.5 billion, though these programs also provided services that EITC recipients do not receive.

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While a system based largely on self assessment (like the U.S. income tax) will have lower administrative costs than a more bureaucratic approach, it will also have higher noncompliance. The most recent study of EITC noncompliance examined returns filed in 1995 and found that of the $17.2 billion claimed in EITC, $4.4 billion, or 25.8 percent of the total exceeded the amount to which taxpayers were eligible. Additional compliance measures have been enacted in 1994, 1995, 1996 and 1997, which, all else being equal, will reduce the net overclaim rate, but EITC noncompliance remains a serious problem for tax administration.

How Does the EITC Compare with Other Policies to Support Low-Income Working Families?

A number of other policies have been proposed to help low-wage workers. Below are brief comparisons of the EITC and three other programs for low-income workers: the minimum wage, incremental and targeted hiring subsidies, and payroll tax reductions.

Minimum wage

The minimum wage ensures that wages cannot fall below a certain level. Many in our society feel there should be a certain level at which work is valued. Some researchers, however, have concerns about the harmful consequences of a minimum wage on employment levels for low-skill workers. There is evidence that changes in the U.S. minimum wage in the past 10 years have not reduced employment, though this evidence is controversial.

The EITC has a distinct advantage over the minimum wage because it is better targeted to help low-income workers. One study (Burkhauser, Couch and Glenn, 1996) found that only about 21 percent of benefits of a minimum wage increase go to workers who are part of families with incomes below 125 percent of the poverty line. Almost 40 percent of the benefits go to households with income-to-poverty ratios of more than 3. Thus, minimum wage increases are a blunt tool for assisting low income families, whereas the EITC is more precisely targeted to those in economic need.

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One disadvantage of the EITC, under the existing law, is it provides only a small subsidy to childless taxpayers, which might make minimum wage increases more effective in increasing the earnings of low-wage childless workers. Expanding the EITC's childless worker credit would likely be a better targeted alternative, however, and would also have better employment effects than increasing the minimum wage.

Targeted and new hiring subsidies

The U.S. has tried several different marginal or incremental employment subsidies in the past 20 years targeted at hard-to-employ workers. By the mid 1990s, the Targeted Jobs Tax Credit (TJTC) provided employers a 40-percent wage subsidy on the first $6,000 of qualified wages, which include young people from low-incomes families, welfare, and SSI recipients, Vietnam vets, some people with prison convictions, and people with disabilities who were part of vocational rehabilitation programs.

The TJTC was replaced in 1996 by the similar Work Opportunity Tax Credit (WOTC), which provides a 25-percent credit for employment of 120 to 400 hours, and a 40-percent credit for employment of 400 or more hours up to $6,000 of earnings, or a maximum of $2,400 per worker. The Welfare-to-Work credit adopted in 1997 targets long-term welfare recipients and offers 35 percent of the first $10,000 of qualified wages in the first year of work and 50 percent of the first $10,000 in the second year, for a maximum employment subsidy of $8,500 per employee. The employee must work at least 180 days or 400 hours.

The appeal of these targeted wage subsidies is the promise of creating employment for disadvantaged workers at a fraction of the cost of universal employment subsidies or supply-side policies like EITC. However, little evidence exists that the subsidies are effective. Katz (1996) finds that the TJTC may have modestly improved employment rates for disadvantaged youth. However, there are major concerns with these incentives. First, while employment rates are lower for the targeted groups, many in each group would be employed even without the hiring incentive. Second, the incentives may cause members of targeted groups to be hired instead of other disadvantaged workers. Last, there is evidence that targeted subsidy programs actually stigmatize members of some groups, harming their employment prospects (Burtless, 1985).

Targeted hiring subsidies really have a different goal than the EITC, which is designed to increase the incomes of low-income families. The WOTC and

Welfare-to-Work credits try to stimulate employment of individuals in certain groups. While different, they are complementary policies in that each should help the other be more effective.

Payroll tax reductions

Three out of four Americans pay more in payroll taxes than they do in income taxes. So, it seems that payroll tax relief might be beneficial for low-wage earners. The EITC is closely linked to payroll taxes, since those supporting EITC have argued that it offsets the regressive burden of payroll taxes. For many years, the subsidy rate of the EITC was tied to the combined employer-employee shares of payroll taxes.

However, it is difficult to reduce payroll taxes on low-wage workers. Proposals that exempt the first specific amount of income from taxes would be hard to administer for workers who have more than one job or who change jobs during the year. Underpaid taxes could be paid at the end of the year on individual tax forms, as is done with overpaid payroll taxes for affluent taxpayers, but some people would fail to file. Payroll tax changes could also alter the balance of social security financing, which could have wide-ranging political and economic ramifications.

Which Options Has Wisconsin Invested In?

Eleven states have turned to the EITC to support low-wage earners. Wisconsin, in particular, has one of the most generous EITC programs in the country. In1996, more than a quarter million Wisconsin families received federal credits of more than $348 million, or more than $1,000 each. More than 196,000 families received state claims averaging nearly $300 each.

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From 1989, when the state credit was started, through 1993, its rates were 5 percent of the federal EITC for families with one child, 25 percent of the federal credit for families with two children, and 75 percent of the federal credit for families with three or more children. In 1999, the state credit was 4 percent of the federal credit for families with one child, 14 percent of the federal credit for families with two children, and 43 percent of the federal credit for families with three or more children.

By augmenting the federal credit, the Wisconsin state EITC means that families with two or more children in Wisconsin who make between $8,000 and $12,000 are eligible for a combined state and federal credit of more than $5,400, which can exceed 50 percent of the previous year's income. Providing higher benefits for larger families seems to make sense. The 1993 expansions of the EITC were designed so that a family with one or two children with one full-time, minimum wage worker would not have an income below the poverty line. A family with three or more children with a full-time, minimum wage worker would still have an income below the poverty line. The extra tier in the Wisconsin state EITC disproportionately helps those needy larger families.

Conclusion

The Earned Income Tax Credit is primarily targeted to working taxpayers with children. Because political debate in this country often focuses on the adverse effects of poverty in children, the focus on families seems appropriate. Its targeting, beneficial labor market effects, and its relatively low administrative costs also make it an appealing policy to assist low-income working families.

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