Earned income credit

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A refundable income tax credit for low-income working taxpayers (U.S. Code, Title 26, Section 32).

The earned income credit was originally enacted in 1975, and over the years it has grown to be one of the principal antipoverty programs in the federal budget. The credit was expanded significantly by the Omnibus Budget Reconciliation Act of 1993, and in 1998 some 18 million taxpayers were expected to claim more than $27 billion of earned income tax credits, with an average credit per taxpayer of almost $1,480 per year (U.S. Congress 1996: 809). In 1998, some families will be entitled to claim an earned income tax credit of up to $3,756 per year.

Unlike other tax credits for individuals (e.g., the dependent care credit), the earned income tax credit is refundable. That is, if the earned income tax credit exceeds the taxpayer's tax liability, the Internal Revenue Service will refund the difference. In 1998, for example, of the roughly $27 billion of earned income tax credits expected to be claimed, some $23 billion will be attributable to the portion of the credit that exceeds taxpayers' tax liabilities.

Literally, the statute provides that a taxpayer's earned income tax credit will equal a specified percentage of the taxpayer's earned income up to a maximum dollar amount (U.S. Code, Title 26, Section 32). The maximum credit amount is available to taxpayers over a certain income range and is phased out as a taxpayer's income increases beyond a specified phaseout floor. The Internal Revenue Service publishes tables each year to help taxpayers and their employers determine the proper amount of credit.

Three separate schedules apply, depending upon how many qualifying children the taxpayer has. For 1998, a taxpayer with one child was entitled to an earned income tax credit equal to 34 percent of up to $6,680 of earned income. Those earning between $6,680 and $12,260 could claim the maximum credit of $2,271 (roughly 34% × $6,680). Finally, those earning more than $12,260 would see that $2,271 credit amount reduced by 15.98 percent of the amount of earned income (or adjusted gross income, if higher) above $12,260, resulting in no credit for taxpayers earning $26,473 or more.

Similarly, taxpayers with two or more children could claim a credit of 40 percent of up to $9,390 of earned income for a maximum credit of $3,756 in 1998, but those earning more than $12,260 would see their credit phase down to zero dollars at $30,095 of income. Finally, taxpayers without children could claim a credit of up to 7.65 percent of up to $4,460 of earnings for a maximum credit of $341 in 1998, but those earning more than $5,570 saw their credit phase down to zero dollars at $10,030 of income.

These maximum earned income credit amounts will expand even beyond 1998, as the applicable earned income and phaseout amounts are indexed for inflation.

To be a "qualifying child" within the meaning of the earned income credit, an individual must satisfy a relationship test, a residency test, and an age test. The relationship test is satisfied if the child is the taxpayer's son, stepson, daughter, or stepdaughter; a descendant of the taxpayer's son or daughter; or the taxpayer's foster or adopted child. The residency test is satisfied if the child has lived with the taxpayer at least one-half of the taxable year. The age test is satisfied if the child is (1) under age 19, (2) a full-time student under age 24, or (3) permanently and totally disabled. Also, to be eligible for the credit, childless taxpayers must be over age 25 and under age 65.

The earned income credit is available to both employees and independent contractors, as the term "earned income" is defined to include wages, salaries, tips, and other employee compensation, and the net earnings from self-employment. To claim the credit, a taxpayer must file Internal Revenue Service Form 1040 or Form 1040A. Since 1991, taxpayers with children must also fill out Schedule EIC to claim the credit.

Taxpayers with children may elect to receive advance payment of a portion of their earned income credit in their paychecks throughout the year. To receive the credit in advance, a taxpayer must fill out Internal Revenue Service Form W-5, the Earned Income Credit Advance Payment Certificate, and give it to his employer. The employer then includes a portion of the employee's advance earned income credit amount along with wages, and the remainder of the credit is refunded only after the taxpayer files an income tax return. The Internal Revenue Service publishes tables to help employers determine the proper amount of advance payment. For example, an employee earning between $128 and $235 a week in 1998 gets a $26 per week paycheck increase by electing to receive advance payment of the credit.

History of the credit

The earned income credit grew out of the welfare reform efforts of the early 1970s (Forman 1988: 45–58). The credit was originally added to the

Internal Revenue Code by the Tax Reduction Act of 1975. Over the years, the credit has been expanded, and it is now one of the principal antipoverty programs in the federal budget.

As originally adopted in 1975, the earned income tax credit was intended to offset the Social Security taxes of low-income workers with children and to provide those taxpayers with an increased incentive to work. An eligible taxpayer could claim a refundable credit equal to 10 percent of the taxpayer's earned income for the taxable year, which did not exceed $4,000 (a maximum credit of $400). That $400 maximum credit was reduced one dollar for each 10 dollars of income in excess of $4,000. Thus, the credit was completely phased out at an income level of $8,000. As enacted, the original earned income tax credit was available to taxpayers only for calendar year 1975.

Subsequent revenue acts extended the credit, and it was made a permanent part of the Internal Revenue Code by the Revenue Act of 1978. The Deficit Reduction Act of 1984 increased the maximum amount of the earned income tax credit and renumbered it to its current location in the Internal Revenue Code (U.S. Code, Title 26, Section 32). The credit was expanded significantly by the Tax Reform Act of 1986, and it has been indexed for inflation since 1987. The Omnibus Budget Reconciliation Act of 1990 also expanded the credit and added a supplemental credit amount for families with two or more children.

The Omnibus Budget Reconciliation Act of 1993 expanded the credit even further and made a small credit available to certain childless workers (up to $341 in 1998). By the year 2000, more than 19 million families are expected to claim almost $30 billion of earned income credits, with an average credit per family of almost $1,565 (U.S. Congress 1996: 809).

Analysis

The earned income tax credit is an income transfer program that provides significant financial assistance to low-income workers, especially those with children. Unlike increasing the minimum wage, the expansion of the earned income credit over the past two decades has provided benefits targeted to help the working poor. Also, unlike most other welfare programs or a negative income tax, the earned income tax credit provides significant work incentives to low-income workers (Forman 1988: 67–77). Indeed, as currently structured, the earned income tax credit is one of the federal government's largest and most effective antipoverty programs.

Unfortunately, the earned income tax credit is not without its problems. For example, a recent study estimated that between 80 and 86 percent of eligible taxpayers actually received the credit in 1990 (Scholz 1994). While this is a relatively high participation rate when compared with other transfer programs such as food stamps and Aid to Families with Dependent Children, it still means that approximately 2 million families eligible for the credit in 1990 failed to obtain it. Moreover, remarkably few taxpayers elect to receive their credits by means of the advance payment mechanism. In 1989, for example, only about 40,000 families received advance payments, less than 0.5 percent of those eligible (U.S. General Accounting Office 1992).

Compliance with the earned income tax credit is also a problem. For example, Internal Revenue Service audit data indicate that 42 percent of recipients claimed too large a credit in 1988 and that about 32 percent of recipients were not entitled to any credit at all that year (Stathis 1993). Compliance with the advance payment rules is also problematic: An estimated 49 percent of the individuals who filed income tax returns in 1989 and who had definitely received the advance payment failed to report that receipt on their return, and an estimated 45 percent of those who had received advance payment of the credit failed to even file returns (U.S. General Accounting Office 1992).

Finally, the earned income tax credit has also been implicated in some perverse disincentives for work and marriage. While the credit unequivocally increases the incentive to work in the phase in range of the credit (up to $9,390 of earnings for workers with two children in 1998), the combination of income and Social Security taxes and the phaseout of the credit may discourage work by an even greater number of relatively low-income workers falling in the applicable phaseout ranges (e.g., from $12,260 to $30,095 of earnings for workers with two or more children in 1998). Lowering the phaseout rate could reduce this work disincentive, but it would also stretch out the phaseout range, which in turn would subject more taxpayers to the lowered phaseout rate.

Worse still is the earned income tax credit's impact on marriage. For example, consider a two-earner family with two children. If each earns $10,000 and they file a joint return, the family will get an $1,811 refund. If they divorce and each takes a child and files as head of household, they may each claim a $2,271 earned income tax credit. This is a $2,731 a year incentive for divorce (Feenberg and Rosen 1994).

President Clinton has touted the expansion of the earned income tax credit by the Omnibus Budget Reconciliation Act of 1993 as part of a grander scheme to reform the welfare system and to "make work pay" for low-income Americans. Given the

concerns about participation, compliance, and the perverse disincentives for work and marriage, it seems likely that Congress will reconsider the credit's operation in coming years. One option would be to replace the current earned income tax credit with an exemption from Social Security taxes for the first $10,000 of wages, and to supplement the exemption with a refundable family allowance tax credit based upon the number of children in the family (Yin, Scholz, Forman, and Mazur 1994). This approach would reduce marginal tax rates and their disincentive effects on low-income workers. Moreover, a Social Security tax exemption would reach 100 percent of low-income workers, and it would be less complicated than first collecting Social Security taxes and then using the earned income tax credit to refund them.

Additional readings

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Cross references: budget process, federal; fairness in taxation; labor supply, taxes and; progressivity, measures of; tax equity analysis.