

Earned Income Tax Credit in the United States

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In this article, the author explains the history, role and structure of the earned income tax credit (EITC) which is intended primarily to provide support for low income workers and their families, including its relationship with work incentives. The article offers critical analysis of the current system and proposals for future reform.

Introduction

The earned income tax credit (EITC) is the largest means-tested cash transfer programme in the US, providing substantial assistance to low-income workers. What started as a small credit designed to offset payroll taxes and work disincentives of welfare programmes provided up to \$6,143 in 2014 for workers with at least three children. The credit delivered \$62.9 billion in benefits to 27.9 million families in 2011.¹ Almost all the EITC's benefits go to families with at least one child living at home. Extremely low-income workers without custodial children qualify for a very small credit.

As discussed below, the EITC enjoys broad political support. Unlike its predecessor safety net policies that heavily penalised work, the EITC encourages people to work. Empirical research confirms the credit's effectiveness, particularly for single mothers—the group that previously faced the largest work disincentives. Despite this widespread support for the EITC, however, many well-known criticisms remain. The credit provides almost no assistance to workers without custodial children—a group plagued by low employment and high poverty rates; it may even suppress wages for these workers. Complex credit rules make the EITC difficult for the Internal Revenue Service (IRS) to administer and for some families to comply with, particularly highly mobile households who sometimes share living quarters. This has led to an unusually high error rate and an opportunity for unscrupulous individuals preparing tax returns (“tax preparers”) to commit fraud. In some cases, the EITC may reduce the labour supply of secondary earners. The EITC structure can create significant marriage penalties for some low-income workers.

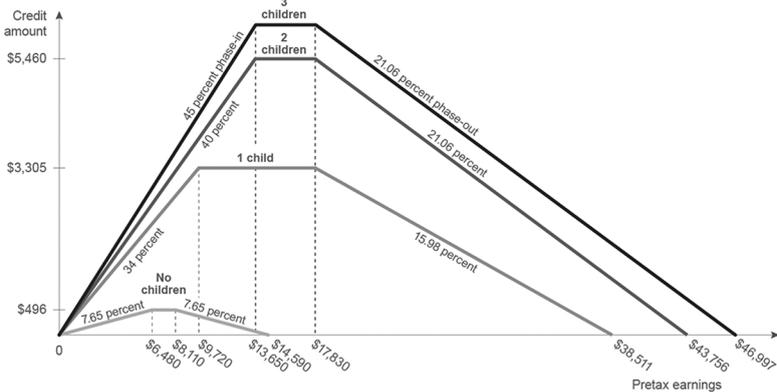
¹ J. Bryan, “Individual Income Tax Returns, 2011” (IRS, 2013), Statistics of Income Bulletin, fall, Washington, DC, fig.H, <http://www.irs.gov/PUP/taxstats/productsandpubs/12infallbulincome.pdf> [Accessed January 29, 2015].

This article details the history of the EITC, identifies who receives it, and summarises previous literature on the work incentives associated with the EITC and other benefits, including reducing poverty and directing much-needed resources toward low-income children at a critical time in their lives. Finally, it briefly discusses possible EITC expansions for workers without custodial children.

How the EITC works

The EITC subsidises low-income working families. It equals a flat percentage of earnings from the first dollar of earnings up to a maximum amount; both the percentage and the maximum credit depend on the number of children in the family. The credit remains at its maximum value until earnings (or income) reach a phase-out point. (The flat portion of the credit schedule is often called the plateau region.) The credit then falls for each dollar of earnings beyond the phase-out point, until it disappears entirely (figure 1). No minimum number of hours per week is required to receive the credit; annual earnings must be within the credit’s eligibility range.

Figure 1. Earned Income Tax Credit, 2014



Note: Assumes all income comes from earnings. Credit starts to phase-out for married couples \$5,430 higher than shown.
 Source: Tax Policy Center, 2014

As is the case with nearly all provisions in the US federal income tax code, for married couples, the credit is based on joint—not individual—earnings. The first year that same-sex married couples were treated as married for federal income tax purposes was 2013.² Prior to that, same-sex couples were required to file separate tax returns.

The EITC is fully refundable: taxpayers subtract the credit they are eligible for from their federal income tax liability—the amount of the credit in excess of federal income tax liability is paid as a tax refund after filing a tax return. This typically happens in the spring following credit eligibility. Although credit rates have varied, the credit’s basic structure has remained the same since shortly after its inception.

² IRS, “Treasury and IRS Announce that all Legal Same-Sex Marriages Will be Recognized for Federal Tax Purposes; Ruling Provides Certainty, Benefits and Protections Under Federal Tax Law for Same-Sex Married Couples” (August 29, 2013), IR-2013-72, <http://www.irs.gov/uac/Newsroom/Treasury-and-IRS-Announce-That-All-Legal-Same-Sex-Marriages-Will-Be-Recognized-For-Federal-Tax-Purposes%3B-Ruling-Provides-Certainty,-Benefits-and-Protections-Under-Federal-Tax-Law-for-Same-Sex-Married-Couples> [Accessed January 29, 2015].

In 2014, a family with one child was eligible for a subsidy of 34 cents for each dollar earned up to \$9,720—a maximum credit of \$3,305. A family qualified for the \$3,305 credit until its income reached \$17,830. At that point, the EITC declined by almost 16 cents for each additional dollar of earnings; the credit phased out completely once earnings reach \$38,511 (figure 1). Larger credits are shown for families with more than one child, as well as the small credit available to a family with no custodial children. The credit began to phase out for married couples at incomes \$5,430 higher than that shown for unmarried workers. All parameters of the EITC are indexed annually for inflation. The estimated maximum benefit for a family with one child in 2015 is \$3,359.³

EITC recipients receive the credit in one of two ways. In a few cases, the amount of tax that would be withheld in a person's paycheck is reduced, effectively delivering a portion of the credit throughout the year. In most cases, EITC recipients do not owe federal income taxes so they receive the credit as a lump sum in the spring when they file their annual tax returns. Earnings between January 1, 2014 and December 31, 2014 are counted on the 2014 tax return, which is due on April 15, 2015. The credit is calculated based on earnings during this period, without regard to when the earning took place. Children typically must meet the qualification standards for at least six months during this period, and marital status is determined on December 31 of the tax year. This is consistent with other aspects of the US federal income tax system.

The federal EITC serves as a model for several states. As of 2014, 23 states including the District of Columbia had state-level EITCs. Typically, after calculating their federal credit, workers use that information when calculating their state-level EITCs. Most state-level EITCs are calculated as a percentage of the federal credit, with the same basic qualifying rules applied. The state credit is in addition to the federal credit, and is administered on the state tax form rather than the federal tax form. Since the information needed to calculate the state credit is supplied on the federal tax form, the administration of the credits at the state level is relatively easy. The credits can be refundable like the federal credit, so anyone who qualifies receives the full credit for which they are entitled, or they can be non-refundable—where the value of the credit is capped at state income tax liability. Two additional states have EITCs (Colorado and Washington), but they have not been funded at the state level, so the credits were not implemented during 2014.

Brief history of the EITC

Congress enacted the EITC in 1975 (Tax Reduction Act of 1975, P.L. 94-12). Credit designers sought to offset the work disincentives faced primarily by individuals on welfare—mostly, single mothers. Designers thought of the credit as both an anti-poverty and anti-welfare programme that countered growing national concerns regarding rising welfare caseloads, high unemployment rates and the working poor. The EITC represented a politically acceptable alternative to the negative income tax component of President Nixon's Family Assistance Plan,

³ K. Pomerleau, "2015 Tax Brackets" (Washington, DC: October 2014), Tax Foundation Fiscal Fact No.440, http://taxfoundation.org/sites/taxfoundation.org/files/docs/TaxFoundation_FF440.pdf [Accessed January 29, 2015].

which was a movement for a guaranteed income. Some people argued that providing a guaranteed income would reduce a person's willingness to work.⁴

At the credit's inception, parents with incomes up to \$4,000 (\$17,700 in 2014 terms) could qualify for a credit worth 10 per cent of their earnings. The value of the credit dropped by 10 cents for every dollar earned above \$4,000; it phased out entirely at \$8,000 of earnings. The credit rate increased twice before 1990; that year, a new, larger credit was added for families with two or more children as part of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) (effective 1991). The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) created a small EITC for workers aged 25 to 64 without custodial children (effective 1994). There is no age requirement for workers with children living at home. The final two significant changes to the EITC came in 2001 and 2008. In 2001, the Economic Growth and Tax Relief Reconciliation Act (P.L. 107-16) increased the point at which the EITC began to phase out for married couples, reducing marriage penalties; in 2009, families with three or more children became temporarily eligible for a larger credit than smaller families (the American Recovery and Reinvestment Act (P.L. 111-5)). This provision expires after 2017. At that time, families with three or more children will begin receiving the same credit as families with two children.⁵

Work incentives and the EITC

The distinguishing feature of the EITC is the attempt by policymakers to create a safety net programme that rewards work rather than penalising it. Early welfare programmes provided the highest benefits to those with no incomes; benefits tended to phase out as earnings increased, strongly discouraging labour force participation. In contrast, the EITC unambiguously encourages work among single recipients for the simple reason that you cannot get the credit without working. While the EITC strongly encourages participation in the workforce, it produces ambiguous incentives for how much people work. In the credit's phase-in range, the EITC raises the net (inclusive of credit) return from working more. For example, a person with one child receives 34 cents in additional credits for every additional dollar of earnings in the EITC phase-in range. While there is an offsetting "income effect" in economics jargon, which might discourage work because people need to work fewer hours to achieve a given income target, most empirical evidence suggests that the higher after-credit return (the "substitution effect") is more important.⁶ In the plateau range of the credit, when workers receive a credit that neither rises nor falls with a change in work effort, the income effect discourages work. People feel richer and so may work a little less. Finally, in the phase-out range of the credit, both the income and substitution effects predict working fewer hours. This effect may extend beyond the EITC eligibility range. In addition, for

⁴ V.J. Hotz and J.K. Scholz, "The Earned Income Tax Credit" in Robert Moffitt (ed.), *Means-Tested Transfer Programs in the United States* (Chicago: University of Chicago Press and NBER, 2003); D.J. Ventry, "The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit, 1969–99" (2000) 53 *National Tax Journal* 983.

⁵ Urban Institute, "EITC-Legislative History" (2014), <http://www.urban.org/safety-net-almanac/EITC/legislative-history.cfm> [Accessed January 29, 2015].

⁶ B.D. Meyer, "The Effects of the Earned Income Tax Credit and Recent Reforms" in J.R. Brown (ed.), *Tax Policy and the Economy* (Chicago: University of Chicago Press, 2010), Vol.24, <http://www.nber.org/chapters/c11973.pdf> [Accessed January 29, 2015].

married couples, there may be an incentive for a lower-earning spouse to stay home to avoid losing tax credits.

The empirical evidence (below) suggests that the EITC has largely fulfilled its goal of encouraging work. There seems to be a slight disincentive for secondary earners in married couples to work—a small portion of the target population. There is some evidence suggesting that workers alter the number of hours they work in response to the EITC, but most of this effect appears to be encouraging people to work more hours, not fewer.

Labour responses for single earners

The decision to work

Empirical research has shown that the EITC encourages people to start working, particularly single mothers (the bulk of people who are eligible for the EITC). Relative to single women without children, single mothers who were eligible for the EITC increased their participation in the labour force, likely as a result of the EITC.⁷ Several studies corroborate these findings.⁸ The studies relied on various estimation techniques, most often comparing employment rates of single mothers to employment rates of single women without children or comparing employment rates of mothers with different numbers of children. Although there are certainly differences between women with and without children and between women with one and multiple children, Meyer found the choices of comparison groups to be reasonable ones, based on other demographic characteristics of the groups.⁹

Empirical estimates of increased labour force participation from the EITC vary from 2 to over 10 percentage points. While the exact size of the employment effect from the EITC might be uncertain, general consensus seems to have settled that the EITC encourages single people to work.

Work intensity

The EITC also affects how hard or how many hours a person works. Early research found little evidence of a response on this margin. Individuals did not appear to reduce their hours if they were just outside the range of EITC eligibility or in the EITC's phase-out or plateau ranges. A study by Eissa and Hoynes found no

⁷ N. Eissa and J.B. Liebman, 1996. "Labor Supply Response to the Earned Income Tax Credit" (1996) May *Quarterly Journal of Economics* 605, <http://www.hks.harvard.edu/jeffreyliebman/eissaliebmanqje.pdf> [Accessed January 29, 2015].

⁸ B.D. Meyer and D.T. Rosenbaum, "Making Single Mothers Work: Recent Tax and Welfare Policy and its Effects" (2000) December *National Tax Journal* 1027; B.D. Meyer, and D.T. Rosenbaum 2001. "Welfare, the Earned Income Tax Credit, and the Labor Supply of Single Mothers" (2001) August *Quarterly Journal of Economics* 1063, http://www.ssc.wisc.edu/~scholz/Teaching_742/Meyer_Rosenbaum.pdf [Accessed January 29, 2015]; V.J. Hotz and J.K. Scholz, 2006. "Examining the Effect of the Earned Income Tax Credit on the Labor Market Participation of Families on Welfare" (Cambridge, MA: National Bureau of Economic Research, 2006), Working Paper 11968, <http://www.nber.org/papers/w11968> [Accessed January 29, 2015]; J. Grogger, "The Effects of Time Limits, the EITC, and Other Policy Changes in Welfare Use, Work, and Income among Female-Head Households" (2003) May *Review of Economics and Statistics* 394; N. Eissa and H. Hoynes, "Behavioral Responses to Taxes: Lessons from the EITC and Labor Supply" in J.M. Poterba (ed.), *Tax Policy and the Economy* (Cambridge, MA: National Bureau of Economic Research and The MIT Press, 2006), Vol.20, <http://www.nber.org/chapters/c0063.pdf> [Accessed January 29, 2015]; C.M. Herbst, "The Impact of the Earned Income Tax Credit on Marriage and Divorce: Evidence from Flow Data" (2011) January *Population Research and Policy Review* 101.

⁹ Meyer, "The Effects of the Earned Income Tax Credit and Recent Reforms" in *Tax Policy and the Economy* (2010), Vol.24.

evidence of decreased hours for single mothers (those most affected by the EITC) compared with single women without children (a similar group affected very little or not at all by the EITC).¹⁰

The strongest incentive to reduce work hours in response to the EITC occurs in the phase-out range of the credit. Even isolating the effects to this phase of the EITC yields no evidence of a reduction in work hours.¹¹ Possibly, little evidence exists because people exercise more control over their decision to enter and exit the labour force than over their decision of how many hours they can work. People in full-time jobs often have little or no control over their hours of work. If the choice is between working 40 hours per week or 0, the incentive for single earners is unambiguous to remain in the workforce. Another possible explanation is confusion. Although people eligible for the EITC appear to be aware of the credit,¹² they may not be aware of how it functions because of the credit's complexity.¹³ The latter would make it difficult for people to respond as economic theory suggests they ought to.

Some more recent evidence finds a small decline in hours worked in the phase-out range. Trampe found a negative effect, but that effect is dwarfed by the positive impact of the EITC in other ranges of the credit.¹⁴

Three additional studies shed light on intensive margin effects. Using tax return data, Saez observed the propensity for EITC claimants—particularly those who are self-employed—to “bunch” at the end of the phase-in range of the EITC, where the credit would be maximised.¹⁵ Wage earners did not appear to respond to the incentive to maximise the credit. The self-employed were likely to have substantial ability to manipulate their earnings (both by reducing hours or reducing reported earnings). This study lent credence to the idea that at least some people are aware of the complex structure of the EITC and how it interacts with earnings. Chetty, Friedman, and Saez followed this work by analysing whether people who live in neighbourhoods that appear to know how the EITC works (as observed by self-employed bunching at the credit maximum) tended to adjust their earnings over time in order to maximise their EITCs.¹⁶ They observed some effort by wage earners to change their hours worked, finding at least a small response to the EITC along the intensive margin. The authors observed the strongest response among people in the phase-in range, who increased their earnings to maximise their EITC. This response is consistent with what credit designers hoped to accomplish—increasing work among low-income households. Jones observed the

¹⁰ Eissa and Hoynes, “Behavioral Responses to Taxes: Lessons from the EITC and Labor Supply” in *Tax Policy and the Economy* (2006), Vol.20.

¹¹ Eissa and Liebman, “Labor Supply Response to the Earned Income Tax Credit” (1996) May *Quarterly Journal of Economics* 605.

¹² E. Maag, “Paying the Price? Low-Income Parents and the Use of Paid Tax Preparers” (Washington, DC: Urban Institute, 2005), Assessing the New Federalism Brief B-64, <http://www.urban.org/publications/411145.html> [Accessed January 29, 2015].

¹³ Eissa and Liebman, “Labor Supply Response to the Earned Income Tax Credit” (1996) May *Quarterly Journal of Economics* 605; B.D. Meyer, “Labor Supply at the Extensive and Intensive Margins: The EITC, Welfare, and Hours Worked” (2002) 92 *American Economic Review Papers and Proceedings* 373.

¹⁴ P. Trampe, “The EITC Disincentive: The Effects on Hours Worked from the Phase-Out of the Earned Income Tax Credit” (2007) 4 *Econ Journal Watch* 308.

¹⁵ E. Saez, “Do Taxpayers Bunch at Kink Points?” (2010) 2 *American Economic Journal: Economic Policy* 180, <http://eml.berkeley.edu/~saez/saezAEJ10bunching.pdf> [Accessed January 29, 2015].

¹⁶ R. Chetty, J.N. Friedman and E. Saez, “Using Differences in Knowledge across Neighborhoods to Uncover the Impacts of the EITC on Earnings” (2013) 103 *American Economic Review* 2683.

same small effects. However, her study relied on Current Population Survey data, which have known measurement errors that may be affecting the results.¹⁷

Reactions of hours worked to the EITC may take longer to observe; and, as workers learn more about the credit, they become better able to respond. The literature remains mixed on the effect of the EITC along the hours worked margin, and reactions that have been identified to date appear small.

Labour response for secondary earners

Like most aspects of the federal income tax system, the EITC operates on family income, not individual income. Among couples with two potential workers, we might expect to see different labour supply responses to the EITC than we observe with unmarried individuals. Couples have greater flexibility in adjusting both whether each person in the couple works and how many hours each person works.

The existence of an EITC that increases the income of primary earners could lead secondary earners to work less than they otherwise would. This is particularly true if the primary earner in the couple has wages in the plateau or phase-out ranges of the credit. As a result of earnings from a secondary earner, the couple could see their EITC decline, which is tantamount to a substantial tax.¹⁸ The EITC along with other costs of working for parents, especially paying for childcare (which some parents receive subsidies for, but most must pay for on their own), can substantially reduce the net return to participating in the labour force for a lower-earning spouse.

Few studies have grappled with the influence of the EITC on joint labour decisions. The work that has been done finds that the EITC decreases labour force participation by secondary earners, effectively subsidising the lower-earning partner in a married couple to stay home.¹⁹ Married couples make up about 30 per cent of EITC claimants and receive about 25 per cent of all EITC benefits.²⁰

Non-employment benefits of the EITC

Recent studies have looked beyond the employment effects of the EITC to identify the non-employment benefits of the credit. In general, the benefits attributed to the EITC stem from increasing resources available to the household. Most obvious, of course, is that the EITC increases household income, which—if counted in estimates of poverty, would reduce poverty, particularly among families with children. The official measure of poverty in the US does not include changes in resources due to taxes. If it did, scholars have determined that the EITC would have been credited with lifting 6.5 million people out of poverty in 2012, including

¹⁷ M.R. Jones, “The EITC and Labor Supply: Evidence from a Regression Kink Design” (Washington, DC: Center for Administrative Records Research and Applications, US Census Bureau, 2013), <http://www.sole-jole.org/13314.pdf> [Accessed January 29, 2015].

¹⁸ G. Acs and E. Maag, “Irreconcilable Differences? The Conflict between Marriage Promotion Initiatives for Cohabiting Couples with Children and Marriage Penalties in Tax and Transfer Programs” (Washington, DC: Urban Institute, 2005), Assessing the New Federalism Brief B-66.

¹⁹ N. Eissa and H. Hoynes, “Taxes and the Labor Market Participation of Married Couples: The Earned Income Tax Credit” (2004) 88 *Journal of Public Economics* 1931, http://gspp.berkeley.edu/assets/uploads/research/pdf/Eissa_and_Hoynes_JPubE%282004%29.pdf [Accessed January 29, 2015].

²⁰ Statistics of Income, *Individual Income Tax Returns 2012* (Washington, DC: Internal Revenue Service, August 2014).

about 3.3 million children.²¹ Changes in income as a result of the EITC are associated with better health,²² more schooling and higher earnings in adulthood.²³

Critique of the EITC

The EITC provides almost no support for families without custodial children. The maximum credit for this group of people is very small compared to the credit available for families with children, as is the qualifying income range. Critics also note the complexity of the EITC, which makes it difficult both for individuals to comply with and for the IRS to administer.²⁴ Complexity also makes the credit a prime target for tax preparers trying to commit fraud. Finally, because the EITC is based on joint income, not individual income, some couples may pay much higher taxes if they are married than if they remain single—the so-called marriage penalty.

Workers left out of the EITC

Nearly all (97 per cent) of EITC benefits accrue to families with at least one custodial child.²⁵ As a result of the credit's design, little opportunity exists to encourage work among workers without qualifying children, and few workers without qualifying children are lifted above poverty. Very low-wage workers who work full time (defined as 40 hours or more per week for the full year) have little ability to capitalise on the EITC. An unmarried individual working full time at the federally mandated minimum wage of \$7.25 per hour qualifies for no EITC in 2014; a married couple with these earnings qualifies for a credit of less than \$400. Just as important, the EITC may be reducing wages for all low-wage workers²⁶—depressing employment rates for people not receiving subsidies from the credit (primarily people without custodial children).

Complexity and the EITC

The National Taxpayer Advocate's annual report to Congress routinely cites complexity as the most serious issue taxpayers encounter.²⁷ For low-income families, the EITC is the source of much of that complexity. In order to determine eligibility for the credit, information on income (both earned and unearned),

²¹ Center on Budget and Policy Priorities, *Policy Basics: The Earned Income Tax Credit* (Washington, DC: Center on Budget and Policy Priorities, 2014), <http://www.cbpp.org/cms/?fa=view&id=2505> [Accessed January 29, 2015].

²² R.A. Baughman, "The Effects of the State EITC Expansion on Children's Health" (University of New Hampshire, Carsey Institute, 2012), Issue Brief 48; H.W. Hoynes, D.L. Miller and D. Simon, "Income, the Earned Income Tax Credit, and Infant Health" (Cambridge, MA: National Bureau of Economic Research, 2012), Working Paper 18206, <http://www.nber.org/papers/w18206> [Accessed January 29, 2015].

²³ R. Chetty, J.N. Friedman and J. Rockoff, "New Evidence on the Long-Term Impacts of Tax Credits" (Washington, DC: IRS, 2011), Statistics of Income paper, <http://www.irs.gov/pub/irs-soi/11rpchettyfriedmanrockoff.pdf> [Accessed January 29, 2015].

²⁴ M. O'Connor, "Tax Preparation Services for Lower-Income Filers: A Glass Half Full, or Half Empty?" (2001) 90 *Tax Notes* 231.

²⁵ J. Bryan, "Individual Income Tax Returns, 2011" *Statistics of Income Bulletin* (2013).

²⁶ J. Rothstein, "Is the EITC as Good as the NIT? Conditional Tax and Transfer Incidence" (2010) 2 *American Economic Journal: Economic Policy* 177, <http://www.aeaweb.org/articles.php?doi=10.1257/pol.2.1.177> [Accessed January 29, 2015].

²⁷ N. Olson, 2010. *National Taxpayer Advocate 2010 Annual Report to Congress Volume 1* (Washington, DC: IRS, 2010); N. Olson 2011. *National Taxpayer Advocate 2011 Annual Report to Congress Volume 1* (Washington, DC: IRS, 2011); N. Olson, *National Taxpayer Advocate 2012 Annual Report to Congress Volume 1* (Washington, DC: IRS, 2012).

demographic characteristics (citizenship status, marital status, age and relationship) and residency is needed. Possibly as a result of the credit's complex rules, two-thirds of families with incomes below the poverty level use paid preparers to help fill out their tax returns; those with very low education levels are the most likely to seek assistance.²⁸ High error rates and the associated improper payment rate—some of which likely stem from this complexity—resulted in erroneous payments of between 22 and 26 per cent of all EITC payments in fiscal year 2013.²⁹ Unscrupulous tax preparers have an incentive to manipulate income reporting to claim fraudulent EITCs, increasing the fees they charge and the refunds their clients receive. Of the estimated \$11.1 billion in erroneous EITC payments made in 1999, Holtzblatt and McCubbin estimate that 57 per cent were attributable to returns filed by paid preparers.³⁰ Both the Government Accountability Office and the Treasury Inspector General for Tax Administration as well as groups at the state and community levels have conducted limited studies into the prevalence of return preparers committing fraud on EITC returns. Substantial evidence of misconduct exists, ranging from advising clients to report incorrect income amounts, not verifying that children claimed for EITC purposes actually lived with the taxpayer for the requisite period, returns being altered after the client has signed them, and failing to follow basic due diligence requirements.³¹

The IRS has sought to better regulate preparers, but these efforts have been blocked by the courts.³² Besides better regulating preparers, credit simplification offers another avenue to reduce errors associated with the EITC. Another benefit to credit simplification might be a decreased reliance on paid tax preparers.

Marriage penalties in the EITC

Beyond affecting a secondary earner's willingness to work, the EITC may financially penalise some couples who are married or discourage unmarried couples from marrying. A marriage penalty (or bonus) exists if a couple owes more (or less) in taxes as a couple than they would if they were single. The EITC is the largest source of marriage penalties and bonuses for low-income workers.³³ It encourages marriage for single parents with very little or no earnings. Marrying someone without children and earnings in the EITC range will typically increase the couple's EITC, relative to the combined EITC of both individuals. The inverse is true for a single parent with earnings in the plateau or phase-out range of the credit. In this case, the addition of earnings from a partner could eliminate a parent's

²⁸ Maag, Elaine. 2005. "Paying the Price? Low-Income Parents and the Use of Paid Tax Preparers" (2005) Assessing the New Federalism Brief B-64.

²⁹ Treasury Inspector General for Tax Administration, 2014. *The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply with the Improper Payments Elimination and Recovery Act*, (Washington, DC: US Department of the Treasury, 2014), Reference Number 2014-40-027, <http://www.treasury.gov/igta/auditreports/2014reports/201440027fr.pdf> [Accessed January 29, 2015].

³⁰ J. Holtzblatt and J. McCubbin, "Issues Affecting Low-Income Filers" in H.J. Aaron and J. Slemrod (eds), *Crisis in Tax Administration* (Brookings Institution Press, 2004).

³¹ N. Olson, *Protecting Taxpayers from Incompetent and Unethical Return Preparers* (Written Statement of Nina E. Olson National Taxpayer Advocate before the Committee on Finance, United State Senate, April 8, 2014).

³² National Consumer Law Center, *Riddled Returns: How Errors and Fraud by Paid Tax Preparers Put Consumers at Risk and What States Can Do* (National Consumer Law Center, March 2014).

³³ Acs and Maag, "Irreconcilable Differences? The Conflict between Marriage Promotion Initiatives for Cohabiting Couples with Children and Marriage Penalties in Tax and Transfer Programs" (2005) Assessing the New Federalism Brief B-66.

EITC entirely. The penalty does not appear to reduce marriage rates,³⁴ but it can create a large inequity in the tax treatment whereby two single individuals pay thousands less in taxes than a married couple with equal income. To mitigate marriage penalties, the EITC phases out at higher incomes for married couples than single individuals. This adjustment does not eliminate marriage penalties associated with the EITC.

The next stage of expansion for the EITC

Proposals from both major political parties in the US aim at providing a bigger work incentive to individuals without children at home. Many analysts and policymakers have noted declining employment rates for this group, particularly young men, and an interest in building on the success of the EITC.³⁵ At issue is how such a credit should be designed.

Any reform effort should be designed so the EITC for workers without custodial children is large enough to induce people to work without exacerbating the credit's inherent problems. Unfortunately, these two goals can be at odds.

Little empirical research exists on how large an EITC would be necessary to address the joint problems of falling employment and marriage rates and increasing incarceration rates. However, analysts note that the EITC for workers with one child increased employment among low-skilled single mothers.³⁶ Analysts believe that a similar incentive could increase employment rates among individuals without children at home, given the two groups' similar education profiles.³⁷

One option for increasing the EITC for workers without children would be to simply mimic the EITC schedule available to families with children. Doing so can create extremely large marriage penalties. At the extreme, a single parent with earnings of \$9,720 can receive a credit of \$3,305 today. If the parent marries anyone with earnings in excess of \$13,540 (so the couple's joint earnings total at least \$23,260, the point at which the EITC begins to phase out for married couples), the credit the family is eligible for declines. The maximum EITC the partner is getting at these wages is less than \$100 (the EITC for single workers without

³⁴ Eissa and Hoynes, "Taxes and the Labor Market Participation of Married Couples: The Earned Income Tax Credit" (2004) 88 *Journal of Public Economics* 1931; D.T. Ellwood, "The Impact of the Earned Income Tax Credit and Social Policy Reforms on Work, Marriage, and Living Arrangements" (2000) 53 *National Tax Journal* 1063.

³⁵ A. Carasso et al., 2008. "The Next Stage for Social Policy: Encouraging Work and Family Formation among Low-Income Men" (Washington, DC: Urban-Brookings Tax Policy Center, 2008), Discussion Paper 28; P. Domenici and A. Rivlin, *Restoring America's Future: Reviving the Economy, Cutting Spending and Debt, and Creating a Simple Pro-Growth Tax System* (Washington, DC: Bipartisan Policy Center, 2010), <http://bipartisanpolicy.org/sites/default/files/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf> [Accessed January 29, 2015]; Executive Office of the President and Department of the Treasury, *The President's Proposal to Expand the Earned Income Tax Credit* (Washington, DC: Department of the Treasury, 2014), http://www.whitehouse.gov/sites/default/files/docs/eitc_report_final.pdf [Accessed January 29, 2015]; S. Holt and E. Maag, "Considerations in Efforts to Restructure Work-Based Credits" (Washington, DC: Urban Institute, 2009); I.B. Sawhill and Q. Karpiow, *Raising the Minimum Wage and Redesigning the EITC* (Washington, DC: Brookings Institution, 2014), Center on Children and Families paper, <http://www.brookings.edu/~media/research/files/papers/2014/01/30%20raising%20minimum%20wage%20redesigning%20eitc%20sawhill/30%20raising%20minimum%20wage%20redesigning%20eitc%20sawhill.pdf> [Accessed January 29, 2015].

³⁶ Grogger, "The Effects of Time Limits, the EITC, and Other Policy Changes in Welfare Use, Work, and Income among Female-Head Households" (2003) *May Review of Economics and Statistics*.

³⁷ P. Edelman et al., "Expanding the EITC to Help More Low-Wage Workers" (Washington, DC: Georgetown Center on Poverty and Inequality, 2009), available at <http://www.urban.org/publications/1001341.html> [Accessed January 29, 2015]; J.K. Scholz, *Employment-Based Tax Credits for Low-Skilled Workers* (Washington, DC: Brookings Institution, 2007), The Hamilton Project report, http://www.hamiltonproject.org/files/downloads_and_links/Employment-Based_Tax_Credits_for_Low-Skilled_Workers.pdf [Accessed January 29, 2015].

children is entirely phased out once income reaches \$14,590). The couple will typically lose the single parent's EITC. If, on the other hand, a substantial EITC was available to the worker without children *before* marriage, the couple would stand to lose the EITC of both workers as their joint earnings pushed them into and beyond the credit's phase-out. Although research has not shown a substantial shift away from marriage as a result of marriage penalties in the EITC,³⁸ these much larger penalties stemming from a larger credit for workers without custodial children may be cause for concern.

Another option would be to replace the existing EITC with an individual worker credit that does not depend on household income. Similar credits have been described in Domenici and Rivlin³⁹ and Carasso and colleagues,⁴⁰ among others. The hallmark feature of these credits is that they are calculated based primarily on the earnings of an individual, regardless of the number of children in the family or marital status. Although these credits can efficiently deliver a tax subsidy for work that does not discriminate based on marital status and does not create marriage penalties, they are also far afield from how the US federal income tax system typically works, which is based on joint earnings for married couples.

Conclusion

The EITC enjoys a long history of popular support from both major political parties in the US because of its ability to encourage work, particularly among single parents. Empirical evidence suggests that the credit increased employment rates of single mothers between 2 and 10 percentage points. The empirical literature is not yet settled on how much the EITC affects a person's choice of hours to work. Early studies found the EITC had no effect on the number of hours a person works, except secondary earners, who may decrease their hours. In these cases, the EITC may be subsidising the lower-earning spouse in a married couple to stay home with children (which is not necessarily a bad thing). Most recently, analysts have found some evidence that people change the number of hours they work in response to the EITC, but the effects have been economically small. The most intense effects have been along the phase-in range of the credit, where analysts observe an increase in the number of hours worked.

The existing EITC offers no substantial work incentive for people without custodial children. Analysts believe that this group would respond to an EITC in the same way single mothers responded, which is to say their employment rates would increase. Policymakers need to consider carefully how that expansion should take place, to avoid exacerbating the EITC's existing problems.

³⁸ Herbst, "The Impact of the Earned Income Tax Credit on Marriage and Divorce: Evidence from Flow Data" (2011) January *Population Research and Policy Review*.

³⁹ Domenici and Rivlin, *Restoring America's Future: Revising the Economy, Cutting Spending and Debt, and Creating a Simple Pro-Growth Tax System* (2010).

⁴⁰ Carasso et al., "The Next Stage for Social Policy: Encouraging Work and Family Formation among Low-Income Men" (2008), Discussion Paper 28.