Oregon Family Impact Seminar

Helping families help themselves

The Earned Income Tax Credit: Making Work Pay

An executive summary

Presentation by John Karl Scholz, Ph.D.
to the Oregon House Revenue Committee January 18, 2001

What is the federal Earned Income Tax Credit (EITC)?

- It is a refundable tax credit aimed at low-income working families with children. Families who don't make enough money to have positive income tax liability still receive the credit.
- The EITC is the largest cash or near-cash federal program directed at the working poor. Through the EITC program, more than $30 billion is paid to families, most of them with children.
- The program has strong bipartisan support. Since its inception in 1975, it has been expanded by both Republican and Democratic administrations, starting with the Reagan administration in 1986.

How does the federal EITC work?

- Families receive benefits only if they are working.
- Families with two or more children in 2000 can receive a maximum of $3,888 in benefits. The EITC pays families 40 cents for every dollar earned up to $9,720. Benefits start to phase out at $12,690.
- One-child families receive 34 cents for every dollar earned up to a maximum benefit of $2,353.
- A small credit has been available to childless workers since 1993.

OREGON STATE UNIVERSITY
EXTENSION SERVICE

Oregon State University
Extension Family & Community Development Program
Barbara E. Knudson Family Policy Program

What you need to know about the federal EITC

- Eighty to 86 percent of eligible families get benefits.
- Half of benefits paid go to people whose income falls under the poverty line.
- Two-thirds of benefit recipients are in the bottom quarter of the wage distribution.
- In 1998, EITC benefits raised 4.3 million people above the poverty line.

What are the effects of the federal EITC?

- No other program transfers as much money to low-income households with fewer undesirable incentives on family structure and labor market performance.
- It is precisely targeted: it gets money to low-income working families.
- Several studies show it has a modest positive effect on labor market participation. Recent research, for example, has found that since the 1980s, two-thirds of the increase in employment rates of single moms was due to expansion of the EITC.
- Expansions of the EITC since 1986 have dramatically increased the payoff to low-income working families.

Can the EITC be effectively administered?

- Administration is easy and low cost because it piggybacks on the federal tax code through the individual income tax.
- The noncompliance rate is high. Twenty-five percent of payments go to people not technically eligible for payments. Noncompliance is not always outright fraud; it may be a technical violation of complex rules.
- There is a trade-off between the low cost of administration and the high noncompliance rate.

How does the EITC compare with other ways to help families?

- An increase in the minimum wage is not a well-targeted policy; it also benefits those who aren't heads of households and may make it harder to get low-skill workers hired.
- Hiring subsidies tend to target one disadvantaged group at the expense of another and may stigmatize subsidized workers. Subsidies have been shown to be not very effective.
- Payroll tax relief has been proposed as a way to help families. Seventy-five percent of U.S. taxpayers pay more in payroll taxes than in individual income

taxes. Administration would be difficult to coordinate, particularly for people with multiple jobs. It might also alter the universal nature of Social Security, which is a basis for its support.

- Compared to the above policy alternatives, the EITC is a better strategy to help low-skilled workers.

How is the EITC being used in other states and countries?

- Fifteen states have their own EITCs. In ten states, it is refundable. In five states, including Oregon, it is non-refundable. Last year, Colorado, New Jersey, and the District of Columbia implemented their own EITCs.
- The United Kingdom, under the Blair government, implemented an EITC-like program, the working family tax credit.
- Wisconsin has structured the state EITC so that families with three or more children can receive an even larger benefit—as much as $2,000 more. The poverty rates for these large families are very high.
- Minnesota lawmakers were concerned with poverty traps in the tax code—income levels at which return for extra work is very small due to simultaneous phase-out of different subsidies. They adjusted the EITC to phase out after other subsidies are gone in order to avoid an additional disincentive to work.

What is the importance of the refundability of the EITC?

- It is critically important that the EITC be refundable if you want to make work pay. Some working families pay payroll taxes but don't pay income taxes because their income doesn't exceed the sum of the standard deduction and exemptions available to the family. A nonrefundable EITC provides no inducement for these families to enter the labor market.
- Without refundability, the EITC would likely not benefit the lowest skilled families who are trying to make the difficult transition from welfare to work.

Dr. Scholz is Professor of Economics and Director of the Institute for Research on Poverty at the University of Wisconsin–Madison. He has served as Deputy Assistant Secretary of the Office of Tax Analysis at the U.S. Department of the Treasury and as Senior Staff Economist for the Council of Economic Advisers, Executive Office of the President. He has testified before Congress on tax matters and presented a Congressional briefing on the EITC and low-wage labor markets. Areas of current research include understanding the effects of the EITC and other policy interventions to help low-wage workers.

John Karl Scholz
Professor of Economics
Director of the Institute for Research on Poverty
University of Wisconsin–Madison
6434 Social Science
1180 Observatory Drive
Madison, WI 53706-1393
608-265-5367
jkscholz@facstaff.wisc.edu
http://www.ssc.wisc.edu/~scholz/

About the Oregon Family Impact Seminar

Family Impact Seminars provide legislators and other policymakers with state-of-the-art research on current family issues. The seminars have been conducted nationwide to inform policymakers in Washington, DC and six states.

Oregon Family Impact Seminars present objective, nonpartisan information on critical issues affecting Oregon families. The goal is to help policymakers analyze the consequences of policy alternatives for families.

"Helping Families Help Themselves," the first Oregon Family Impact Seminar, was held in conjunction with the House Revenue Committee early in the 2001 Legislative Assembly. It focused on two issues particularly affecting poor and working-poor families: the earned income tax credit, and home visits for families with children.

At the seminar, policymakers had the opportunity to question and to speak individually with the two nationally recognized researchers who presented their findings: Dr. Terry Carrilio, Director of the In-Home Visiting Project and the Social Policy Institute at San Diego State University, and Dr. John Karl Scholz, Director of the Institute for Research on Poverty at the University of Wisconsin–Madison.

This is a summary of Dr. Scholz's presentation. The complete text, and details about the Oregon Family Impact Seminars, are available from Sally Bowman, Oregon State University Extension Family Development Specialist, 161 Milam Hall, OSU, Corvallis, OR 97331-5106; 541-737-1020; e-mail bowmans@orst.edu

Acknowledgements

We would like to thank State Sen. Cliff Trow, State Rep. Lane Shetterly, and their Legislative Aides, Frankie Bell and Sara Watson, respectively, for their support and active assistance in planning and implementing this first Oregon Family Impact Seminar. In addition, we would like to thank our Advisory Committee for their astute guidance, and Bruce Weber and Aphra Katzev for connecting policymakers and researchers.

Sally Bowman
Clara Pratt
Joni Weatherspoon

Oregon Family Impact Seminar
Briefing Reports and Executive Summaries
edited by

Sally Bowman, Extension Family Development Specialist, Oregon State University

Clara Pratt, Barbara E. Knudson Endowed Chair for Family Policy, Oregon State University

Joni Weatherspoon, Family Impact Seminar Coordinator, Oregon State University

SR 1031-x/s • April 2001