INFORMATION BRIEF
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The Federal Earned Income Tax Credit and The Minnesota Working Family Credit

The federal earned income tax credit (EITC) provides a wage supplement equal to a percentage of the earnings of low-income individuals. The credit is fully refundable; if the credit exceeds a filer's tax liability, the rest is paid as a refund.

The Minnesota working family credit (WFC) is also a tax credit that is a percentage of earnings. Before 1998, the WFC was set as a percentage of the federal EITC. Legislation enacted in 1998 restructured the WFC as a percentage of earnings. This restructuring reduced work disincentives caused by interactions with income and payroll taxes and the state's welfare program. Like the EITC, the WFC is refundable. This information brief describes the credits.

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The federal earned income tax credit (EITC) and Minnesota working family credit (WFC) equal a percentage of the earnings of low-income individuals, up to a maximum amount. The credits are phased out for filers with incomes above dollar limits. Different maximum amounts, credit percentages and phaseout rates apply for people with zero, one, two, or three or more dependents. The credits are refundable; if the credit exceeds a filer's tax liability, the rest is paid as a refund. Eligible individuals claim the credits when they file their federal and state income tax returns.

In 2010, about 350,000 Minnesota filers claimed federal EITCs totaling $666 million, and state WFCs totaling $193.6 million. About 13 percent of all filers claimed the credits. The average EITC was $1,906; the average WFC was $586. Most credit recipients had one or more qualifying children.

Twenty-four other states offer earned income tax credits. Most of these equal a percentage of the federal credit and are refundable, but a handful of states provide nonrefundable credits. These programs are listed in the appendix.

The Tax Credits and Poverty

The EITC was designed to provide financial assistance to families who would otherwise be living in poverty. Since the EITC took effect in 1975, the federal government has expanded the program significantly, and the current credit parameters are indexed annually to keep pace with inflation.

Nationwide, the EITC has an estimated participation rate of 75 percent, a rate that is higher than other traditional income assistance programs.

The 2012 EITC and WFC combined will be large enough to lift single parents and married couples with one child above the poverty level. But they are not enough to raise the income of full-time working single parents of two or more children above the federal poverty guidelines.

The Tax Credits and Work Effort

Because the credits phase out when income increases, their effect on work incentive varies depending on where an individual is on the income scale. If an individual is in the phase-in range, the credits reward individuals with a higher return on work; if an individual is on the phaseout range, the credits reduce the return on work. This provides a work incentive for those in the phase-in range, and a work disincentive for those in the phaseout range; such a disincentive is inevitable for a credit that phases out as income increases. Most research suggests that the EITC increases total work effort by a small amount.

The Tax Credits and Compliance

The growth of the EITC program has led to concerns about compliance and payments to ineligible recipients. The IRS has conducted three pilot compliance tests or studies to better understand how to reduce overclaims for the EITC:

- The Qualifying Child Residency Study had the objective of reducing erroneous claims for children who don't meet the definition of a qualifying child by requiring precertification of children

- The Filing Status Study had the goal of reducing the number of taxpayers filing as head of household in order to claim larger credits than they would be eligible for as married joint filers

- The Automated Underreporter Study (AUR) sought to reduce income underreporting that results in larger credit claims

The IRS determined that neither precertifying qualifying children nor requiring documentation of filing status were cost-effective; while both reduced the number of erroneous claims, the administrative costs exceeded the savings realized by reducing erroneous claims. Third-party income matching developed in AUR proved to be cost-effective and has been incorporated into IRS methodology used in annually reviewing a subset of all EITC claims.

How the Federal Earned Income Tax Credit Works

The federal earned income tax credit (EITC) equals a percentage of earned income, up to a maximum amount. The credit increases as earnings increase, up to the maximum amount. The credit then remains constant until earnings reach the phaseout threshold. It phases out as income increases above the threshold.

This section describes how the credit is calculated. Filers do not have to perform these calculations to obtain the credit; instead they enter relevant information in a worksheet and look up their credit in a table keyed to income and number of qualifying children.

Earned income, up to a maximum amount, is multiplied by a credit percentage to calculate the credit.

Earned income generally consists of income from wages, salary, and self-employment. Different maximum amounts and credit percentages apply for individuals with zero, one, two, and three or more dependents. The maximum amount of earned income that qualifies for the credit is indexed each year for inflation. Table 1 shows the credit percentages, maximum amounts, and maximum credits for tax year 2013.

Table 1:
Maximum Federal Earned Income Tax Credit, 2013

	Maximum Earned Income	x	Credit Percentage	=	Maximum Credit
No Qualifying Children	$6,370	x	7.65%	=	$487
1 Qualifying Child	9,560	x	34.00	=	3,250
2 Qualifying Children	13,430	x	40.00	=	5,372
3 or More Qualifying Children	13,430	x	45.00	=	6,043

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The EITC is phased out for filers with incomes above set dollar thresholds.

The credit provides separate phaseout thresholds and phaseout rates for filers with zero, one, and two or more qualifying children. The thresholds are indexed annually for inflation. Although the credit is a percentage of earned income, the phaseout is based on the greater of earned income or adjusted gross income. Use of adjusted gross income as an alternative limit is intended to adjust the amount of credit for other sources of income (such as investment income, unemployment compensation, and so forth).

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 provided for higher phaseout thresholds for married couples filing joint returns than for other taxpayers. This change was intended to alleviate the marriage penalty imposed under the earned income tax credit. The American Recovery and Reinvestment Act (ARRA) of 2009 further increased the threshold for married joint filers. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (TRUIRJCA) of 2010 extended the increased threshold for two years, through tax year 2012. The American Taxpayer Relief Act (ATRA) of 2012 extended the higher thresholds put in place under ARRA through 2017, and made the EGTRRA thresholds permanent in following years.[1] Table 2 shows the phaseout thresholds, rates, and income at which the credit is fully phased out in 2013, for married couples and for all other filers.

Table 2:
Federal Earned Income Tax Credit Phaseout, 2013

	Phaseout Rate		Phaseout Threshold	Income at which credit is fully phased out
Married couples				
No Qualifying Children	7.65%	of income over	$13,310	$19,680
1 Qualifying Child	15.98	of income over	22,870	43,210
2 Qualifying Children	21.06	of income over	22,870	48,378
3 or More Qualifying Children	21.06	of income over	22,870	51,567
All other filers				
No Qualifying Children	7.65%	of income over	$7,970	$14,340
1 Qualifying Child	15.98	of income over	17,530	37,870
2 Qualifying Children	21.06	of income over	17,530	43,038
3 or More Qualifying Children	21.06	of income over	17,530	46,227

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A marriage penalty may occur under the earned income credit when a single parent eligible for the credit marries.[2] The couple's combined income is likely to be higher than the single parent's income was, resulting in a reduction or complete loss of the credit due to more income being in the phaseout range. For example, a single parent with one qualifying child and earned income of $10,000 qualifies for the maximum credit of $3,250. If this individual marries a single filer who also has $10,000 of earned income, the couple has a combined earned income of $20,000. Before the phaseout was extended for married couples, this couple would have qualified for a credit of $2,856 (the $3,250 maximum credit, minus 15.98 percent of income over the phaseout

[1] Under the provisions of EGTRRA 2001, the income level at which the credit begins to phase out was increased for married couples filing joint returns by $1,000 in tax years 2002-2004, $2,000 in tax years 2005-2007, and by $3,000 in tax year 2008 and indexed for inflation in following years. ARRA 2009 further increased the threshold to $5,000 in 2009 and provided for it to be indexed for inflation in 2010. Like most provisions of EGTRRA 2001, the increased phaseout threshold for married filers was scheduled to expire after tax year 2010, but was extended through tax year 2012 under TRUIRJCA 2010. ATRA extended the $5,000 increased threshold, indexed from 2009, through 2017 and made the $3,000 increased threshold, indexed from 2008, permanent beginning in 2018.

[2] Conversely, some couples receive a marriage bonus. This generally occurs for lower income couples, where an individual with modest earnings marries an individual who has one or more dependents and low or no earnings. In such a case, marriage results in more earnings qualifying for the credit and a marriage bonus. Marriage penalties tend to occur among couples with higher incomes, while couples with lower incomes tend to have bonuses. One study has estimated that the EITC causes about 10 percent of federal income tax marriage penalties. Janet Holtzblatt and Robert Rebelein, "Measuring the Effect of the EITC on Marriage Penalties and Bonuses," *National Tax Journal* 52 (2000): 1107, 1131 (assumption that couples continue to live together). This study does not reflect the EGTRRA changes.

threshold of $17,530). The couple would have experienced a marriage penalty of $394, since the credit is $394 smaller than what the single parent qualified for before marriage. Increasing the phaseout threshold by $5,340 for married couples increases this couple's credit to $3,250 (the maximum credit) and eliminates the marriage penalty.

Filers with more than $3,300 in disqualified income are not eligible for the EITC in tax year 2013.

"Disqualified income" consists of the following:

- taxable and nontaxable interest
- dividends
- rent and royalty income if greater than zero
- capital gain income if greater than zero
- net passive income that is not self-employment income, if greater than zero

In 1995, Congress limited claimants to $2,350 in disqualified income, effective in tax year 1996. In 1996, Congress lowered the $2,350 limit to $2,200 before the original limit took effect and indexed the $2,200 annually for inflation. The implementation of a disqualified income limit, along with using adjusted gross income for the phaseout, is intended to stop individuals with significant assets but low income in a particular year from claiming the EITC.

The credit is fully refundable.

If a filer is eligible for a credit that exceeds his or her tax liability, that filer receives the amount of credit that exceeds liability as a refund. Many credit recipients have little or no tax liability. In 2013, the standard deduction and exemption amounts ensure that a married couple with two dependents will owe no federal income tax until gross income exceeds $27,800; the federal child credit of $1,000 per child further increases the income level at which a married couple with two children first owes tax to $47,083. A head of household filer with one dependent will owe no tax until gross income exceeds $16,750; with the child credit this increases to $26,750. Many EITC recipients have gross incomes below these levels; they receive the full credit amount for which they qualify as a refund.

In 2010, 349,510 Minnesotans claimed $666 million in earned income tax credits.

Of this amount, $84 million offset liability, and the remaining $582 million was paid as refunds. The 349,510 claims represented 13.6 percent of all federal returns filed by Minnesotans. The average EITC claimed by Minnesotans was $1,906. Nationwide, 19.1 percent of all returns claimed an average EITC of $2,202. The percent of returns claiming the credit ranged from 12.1 percent in Connecticut to 32.8 percent in Mississippi, and the average credit claimed ranged from $1,740 in Vermont to $2,559 in Mississippi.

Filers claim the credit when they file their income tax returns.

Filers eligible for the EITC must file either form 1040 or 1040A. Taxpayers who want to have the IRS calculate the credit amount for them do so by also completing Schedule EIC; taxpayers who want to calculate the credit themselves complete a worksheet included in the instructions for form 1040.

Prior to tax year 2011, taxpayers had the option of claiming all or part of the credit as an advance payment from their employer.[3] Very few people used the advance payment options. It imposed an administrative burden on employers, who had to adjust their payrolls and forward a supplement to the taxpayer's W-4 to the IRS. It also posed compliance issues and presented opportunities for abuse, since individuals could potentially receive a larger credit during the year than they were ultimately entitled to. A 2007 Government Accountability Office report[4] recommended that the IRS consider options to reduce noncompliance among the small number of claimants who received advance payments. If those options were found to be impractical, the GAO recommended that the U.S. Treasury secretary make a recommendation to Congress on retention or repeal of the advance payment option.

The President's Budget for Fiscal Year 2010 proposed eliminating the advanced payment option. The press briefing materials indicated that the elimination was based on the high error rates associated with the option. Office of Management and Budget Director Peter Orszag said the program "does not work well."[5] The budget for fiscal year 2011 contained a similar provision,[6] and elimination of the option was enacted and signed into law in August 2010.

[3] Public Law Nunber 111-226 repealed the advance payment option, effective in tax year 2011.

[4] U.S. Government Accountability Office, *Advance Earned Income Credit* (August 2007).

[5] White House, Press Briefing by OMB Director Peter Orszag and CEA Chair Christina Romer, February 26, 2009, http://www.whitehouse.gov/the_press_office/Press-Briefing-by-OMB-Director-Peter-Orszag-and-CEA-Chair-Christina-Romer/ (accessed May 26, 2010).

[6] U.S. Department of the Treasury, "General Explanation of the Administration's Fiscal Year 2011 Revenue Provisions," February 2010, 94, http://www.wipfli.com/resources/images/11984.pdf (accessed May 26, 2010).

The Minnesota Working Family Credit

Minnesota, as well as 24 other states, offers a state version of the EITC.[7] Like the federal credit, it is fully refundable. Most state credits simply equal a percentage of the federal credit. Minnesota's credit initially followed that pattern. In 1998 the legislature restructured Minnesota's credit so that it equals a percentage of earned income, rather than a percentage of the federal credit. The 1999 Legislature increased the percentage of the first tier of income that qualifies for the credit. Claimants must continue to meet federal eligibility requirements.

The WFC equaled 10 percent of the federal credit when it was first implemented in 1991. The legislature increased it to 15 percent of the federal EITC for tax years 1993 to 1997. In tax year 1998 the WFC was scheduled to increase to 25 percent of the federal credit. However, the 1998 Legislature restructured the state credit, effective in tax year 1998, in order to reduce high marginal rates faced by low-income taxpayers.

History of the EITC and WFC

1975	Federal Earned Income Tax Credit (EITC) enacted
1979	EITC increased; advance payments made available
1985	EITC increased
1987	EITC increased and indexed for inflation
1988	EITC phaseout floor increased
1991	EITC increased; filers with two or more children receive larger credit than those with one; supplemental credits for health insurance and young children added
	Minnesota implements the refundable Working Family Credit (WFC), equal to 10 percent of the EITC
1993	WFC increased to 15 percent of the EITC
1994	EITC increased; supplemental credits eliminated; EITC extended to claimants without dependents
1995	EITC increased; qualifying income decreased for filers with one child
1996	EITC rate increased for filers with two or more children; claimants limited to $2,200 in "disqualified investment income"
1997	WFC increased to 25 percent of the EITC for filers with dependents, effective tax year 1998
1998	WFC restructured as a percentage of earnings rather than a percentage of EITC; change intended to decrease high marginal rates imposed during phaseout
1999	WFC percentage increased for first tier of earned income
2001	EITC and WFC phaseout thresholds increased for married joint filers to reduce marriage penalties, effective tax year 2002
2009	EITC rate increased for claimants with three or more children, phaseout threshold further increased for married joint filers
2010	EITC increased rate for three or more children and increased phaseout threshold for married claimants extended through tax year 2012
2011	WFC phaseout threshold for married claimants increased for tax year 2011 only
2012	EITC increased rate for three or more children extended through tax year 2017, increased phaseout thresholds for married claimants made permanent

[7] The appendix provides a table listing state earned income tax credits; Colorado is listed in the table but excluded from the count of states offering state EITCs since its credit has been suspended since 2001.

The 1998 restructuring did not change the maximum credit for filers with no qualifying children and those with one qualifying child, but increased the maximum credit for tax year 1998 from $939 to $1,127 for those with two or more qualifying children. The 1999 Legislature increased the maximum credit for all filers, and the 2000 Legislature increased the credit rates to ensure that all claimants received at least 25 percent of the federal credit. In 2001, the legislature conformed to new federal marriage penalty relief provisions that provided for the phaseout threshold to be higher for married couples than for single and head of household filers. When Congress further increased the married couple phaseout thresholds for tax years 2009 and 2010 in ARRA 2009, Minnesota did not conform but instead retained the smaller increases that had been previously enacted. When Congress extended and indexed the ARRA increases to tax year 2011 and 2012, Minnesota conformed for tax year 2011 only. In tax year 2012 there is no increase in the phaseout threshold at the state level for married joint filers.[8] Table 3 shows the credit calculation for tax year 2013 for single and head of household filers, and for married couples filing joint returns.

Table 3:
Minnesota Working Family Credit Calculation, 2013

	One qualifying child	**Two or more qualifying children**
Credit calculation	8.5% of first $9,560 of earnings, plus 8.5% of earnings between $16,690 and $18,580	10% of first $13,430 of earnings, plus 20% of earnings between $20,530 and $23,210
Maximum credit	$973	$1,879
Credit phaseout	5.73% of income over $20,830	10.3% of income over $24,720
Maximum income eligible	$37,815	$42,963

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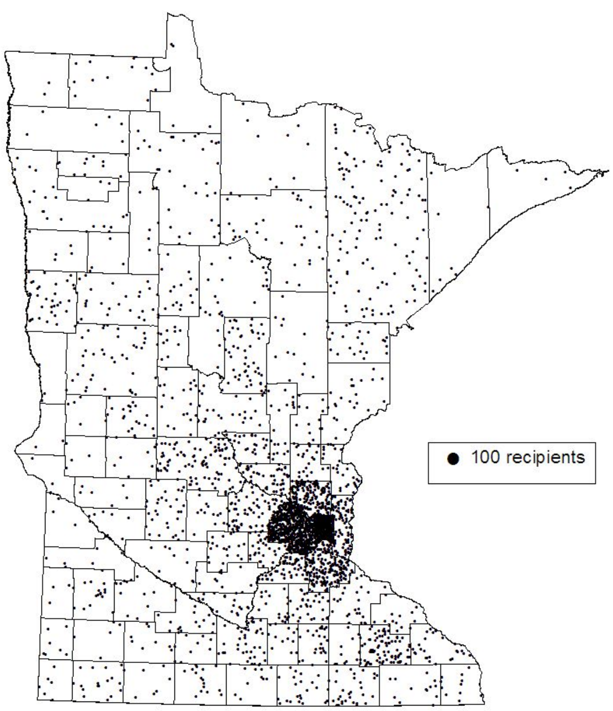
[8] The income level at which the phaseout begins and ends was increased for married filers by $1,000 in 2002-2004, $2,000 in 2005-2007, and $3,000 in 2008. It was adjusted in following years for inflation and equaled $3,130 in tax years 2009 and 2010. When the corresponding federal provision was extended through tax year 2012, Minnesota enacted a matching increase for tax year 2011 only, with an increase of $5,080 at the state level.

In 2010, 330,040 filers claimed the WFC for a total of $193.6 million.

When the credit was restructured in 1997, there was concern that fewer families would claim the credit because the calculation had become more complicated. However, the number of claimants declined by only 4 percent from 1997 (the last year before restructuring) to 1998, the first year the restructured credit was implemented. Figure 1 shows the distribution of returns by county for 2010.

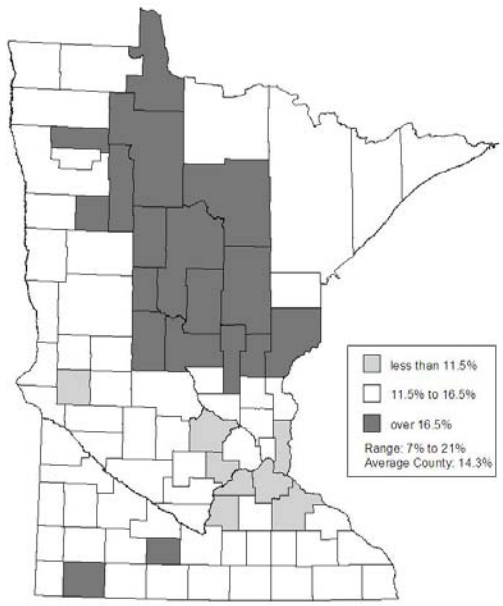
Figure 1:
Minnesota Working Family Credit Recipients, 2010



While over 48 percent of the returns claiming credits came from the Twin Cities metropolitan area, these seven counties generated about 51 percent of all returns filed. Put another way, in 2010 metro filers were slightly less likely to claim the credit than were nonmetro area filers

Figure 2 shows the percent of returns on which the credit was claimed by county; this ranged from 7.1 percent of all returns in Carver County in the metropolitan area, to 20.8 percent of all returns in Wadena County in north central Minnesota.

Figure 2:
Percentage of Returns Claiming Minnesota Working Family Credit, 2010



Over 16.5 percent of all tax returns filed in many north central Minnesota counties claimed the WFC, while fewer than 11.5 percent of returns filed in most suburban Twin Cities metropolitan counties claimed the credit. Generally higher incomes in the metro area make it less likely for filers to qualify for the credit.

Statewide, about 13 percent of all tax returns claimed the EITC and WFC in 2010.

The number of returns claiming the credit increased by about 34 percent over the last ten years, from about 203,500 in 2000 to about 330,000 in 2010. The number of returns filed increased just over 1 percent over the same time period. The credit has changed in two ways in that time period, both of which contributed to the increase in the number of claimants. The credit rate increased in 1998 and again in 2000, and the extended phaseout range for married joint filers took effect in 2002, and was increased in 2009.

Nationwide, 19 percent of all returns filed claimed the federal credit in 2010. A smaller percentage of Minnesota returns claimed the federal credit—13.6 percent—probably due to Minnesota's higher than average personal income. The lowest percentage of returns claiming the credit was 12.1 percent in Connecticut and the highest was 32.8 percent in Mississippi.[9]

Both the average working family credit and the total credit amount per year have increased dramatically since the credit took effect in 1991.

The average WFC was $78 in 1991, when the credit rate was 10 percent, and $142 in 1993, when the rate increased to 15 percent. The increases since 1993 resulted from significant expansion of the federal credit, which took effect in 1994, the increases in the state credit rates in 1998 and 2000, and the extended phaseout range for married joint filers, beginning in 2002.

[9] U.S. Department of the Treasury, Internal Revenue Service, Statistics of Income Division.

Table 4 shows the total amount of credit claimed, number of claimants, average amount claimed from 1991 through 2010, and projected amounts for 2011 to 2015.

Table 4:
Minnesota Working Family Credit, 1991 to 2015

Tax year	$ claimed (millions)	Number of claimants	Average credit
1991	$9.7	123,774	$78
1992	$11.5	134,746	$86
1993	$20.5	145,161	$142
1994	$29.6	187,155	$158
1995	$36.9	206,387	$179
1996	$42.5	214,581	$198
1997	$43.5	212,658	$205
1998	$79.6	204,675	$389
1999	$88.6	203,032	$437
2000	$100.7	203,500	$495
2001	$102.7	202,266	$508
2002	$128.3	245,967	$522
2003	$127.4	247,068	$516
2004	$130.3	249,841	$522
2005	$138.8	258,672	$537
2006	$147.2	267,603	$550
2007	$163.3	289,293	$565
2008	$172.6	297,107	$581
2009	$193.8	325,673	$595
2010	$193.6	330,040	$586
2011 (projected)	$208.6	344,000	$606
2012 (projected)	$196.2	330,600	$593
2013 (projected)	$200.1	333,900	$599
2014 (projected)	$204.1	337,200	$605
2015 (projected)	$208.2	340,600	$611

Source: Minnesota Department of Revenue

The Minnesota working family credit cost $193.6 million in tax year 2010, with the cost projected to increase to over $200 million in tax year 2011.

The total for 2011 is over five times the $43.5 million paid in 1997, with the increase due to the 1998 restructuring of the credit, the rate increases in 1998 and 2000, and changes to the phaseout for married joint filers in 2002 and 2009. The decrease in the overall credit amount from 2011 to 2012 reflects the sunset of the extended phaseout range for married joint filers, which is only in effect through tax year 2011 at the state level.

The average EITC claimed in Minnesota in 2010 was $1,906;[10] the average WFC was $586.

In 2010, the average EITC nationwide was worth $2,202. The state with the highest average was Mississippi at $2,559, and the lowest was Vermont at $1,740.[11]

About 57 percent of WFC recipients have no tax liability, but file a tax return to receive the credit as a refund.

As Figure 3 shows, another 25 percent of the 2010 recipients owe some tax but receive a credit that exceeds their liability, so a total of 82 percent of claimants receive at least part of their WFC as a refund. The remaining recipients—18 percent—have tax liability that equals or exceeds their credit. This means that a total of 43 percent of claimants use at least part of their WFC to offset tax liability.

Nationwide, 87 percent of all EITC recipients receive at least part of their credit as a refund. In Minnesota, 87.4 percent of recipients received a full or partial refund of their EITC compared with a low of 83.1 percent in New York and a high of 90.6 percent in West Virginia.[12]

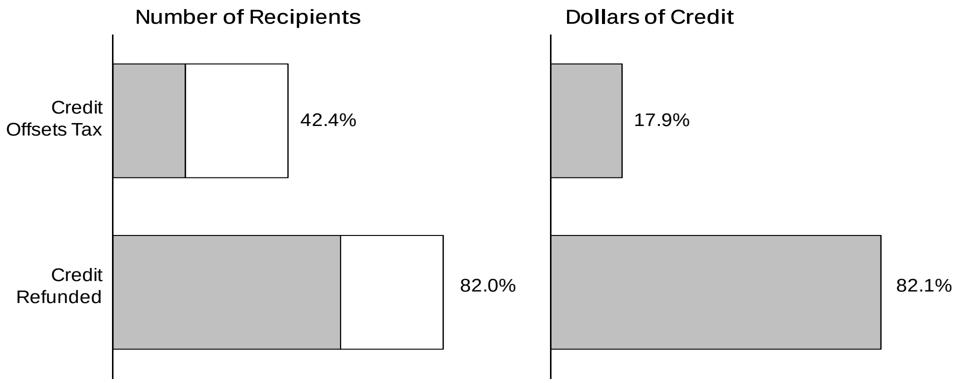
In 1997, the Department of Revenue calculated the WFC for filers who had claimed the federal credit but not the state credit in tax years 1995 and 1996. It issued over $750,000 in refund checks to 8,380 eligible filers. The restructuring of the credit in 1998 prevents the department from repeating this project. Prior to 1998, the state credit was a percentage of the federal credit, and the federal credit was available electronically to the department, as coded from Form 1040. The earned income figures needed to calculate the restructured state credit are on a federal worksheet, not the 1040, and are not available electronically. Data from the 2010 income tax sample indicates that about 96 percent of Minnesota EITC recipients also claimed the WFC. This figure has remained fairly constant in recent years.

[10] Ibid.

[11] Ibid.

[12] Ibid.

Figure 3:
Refundability of Working Family Credit, 2010



Note: 25.4% of claimants qualify for a credit that exceeds their tax liability. For this 25.4%, part of the credit offsets liability, and the rest is paid as a refund. This 25.4% is shown in white in both bars on the left.

About one-fifth—17.9 percent—of the total amount paid in WFC offsets tax liability, while four-fifths—82.1 percent—of the total is distributed as refunds.

In 2010, $158.9 million of the WFC offset tax liability and the remaining $34.7 million was paid as refunds. At the national level, just under 87 percent of EITC dollars were distributed as refunds in 2010, with only 13 percent offsetting the federal income tax. In Minnesota, 87.4 percent of the EITC was refunded compared to a high of 90.6 percent in West Virginia, and a low of 83.1 percent in New York.[13]

While nationwide the percent of claimants receiving at least part of the credit as a refund (87 percent) happens to equal the percent of the total amount paid in credits, in Minnesota 85.4 percent of EITC recipients receive a full or partial refund, and 87.4 percent of the total paid in EITCs is paid as a refund.

Most WFC recipients have one or more qualifying children.

Figure 4 shows that in 2010,[14] 38.7 percent of recipients had two or more qualifying children and 35.1 percent had one qualifying child. About 64 percent of the dollars paid in credits went to the 38.7 percent of claimants who had two or more qualifying children. This group received a disproportionate share of credit dollars because of higher credit rates and a higher income at which the credit phases out for parents with two or more qualifying children than for those with one or no qualifying children.

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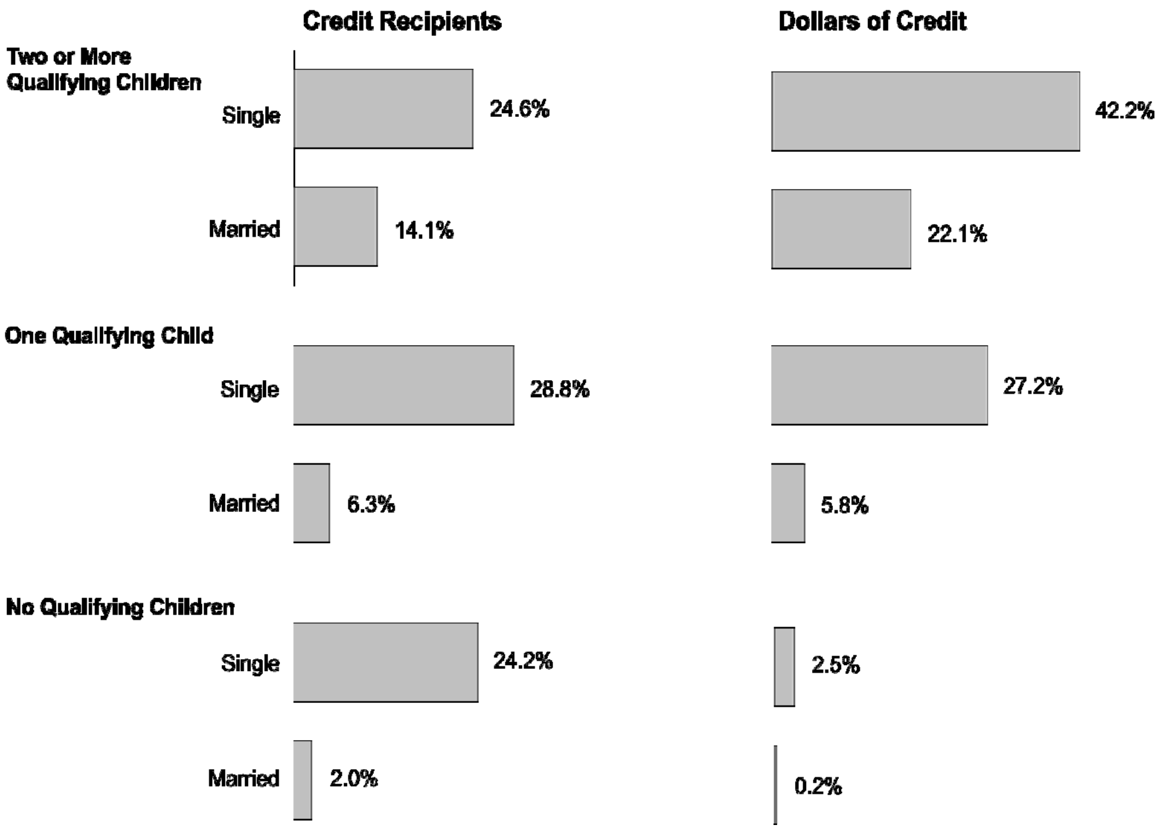
[13] Ibid.

[14] Data on the total amount and refundability of the credit is from the Department of Revenue's 2010 processing report, and data on the number of qualifying children claimed by recipients is from the 2010 income tax sample, also prepared by the Department of Revenue.

Figure 4:
WFC Recipients by Number of Qualifying Children and Marital Status, 2010



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Single parents who received the credit were slightly more likely to have only one child than to have two or more; 28.8 percent of all recipients were single parents with one child, while 24.6 percent were single parents with two or more qualifying children. Married parents, however, were more likely to have at least two children; 14.1 percent of recipients were married with two or more qualifying children, and only 6.3 percent were married with one qualifying child.

Over 26 percent of all recipients had no qualifying children. This group, however, received only about 3 percent of credit dollars. In 2010, claimants without children received credits equal to 1.1925 percent of their first $5,990 of earnings. The credit is fully phased out at a relatively low income for filers without qualifying children—$13,470 in 2010, compared to a maximum income of $35,487 for parents of one qualifying child, and $40,287 for those with two or more qualifying children.[15]

[15] The maximum incomes shown are for single and head of household filers. In 2010, the maximum income eligible for the working family credit was $3,130 higher for married couples filing joint returns.

The Tax Credits and Poverty

The EITC has long been viewed as a way to provide financial assistance to families who would otherwise be living in poverty. In 1975, when the EITC took effect, the federal poverty guideline for a family of four was around $4,000, the income amount at which the EITC phaseout began. Since then, the poverty guidelines have risen with inflation to reach $20,650 for a family of four in 2007. Many view the EITC as a way to raise working families above the poverty level; to this end the federal government has expanded and revised the EITC to keep pace with inflation.

The 1993 changes to the EITC provided a significantly larger credit for families with two dependents than for those with one. This recognizes that two-child families face higher costs for basic needs than one-child families. The 1995 and 1996 changes sought to ensure that the credit was reaching its target population of low-income workers and not those who simply had low income in any one year. The 1998 WFC restructuring sought to alleviate high marginal tax rates imposed on low-income families. (The box on page 9 summarizes the credit's history.)

The EITC has an estimated overall participation rate of 75 percent nationwide,[16] a higher rate than most nontax assistance programs such as food stamps.

The earned income and working family tax credits are relatively effective at reaching the low-income population, due in part to an ongoing outreach campaign authorized by the legislature in 1991 and conducted annually by the Minnesota Department of Revenue. The high participation rate compares favorably with an estimated 54 percent to 66 percent participation rate for the food stamp program,[17] which targets a similar population. There are several reasons for the higher rate of participation in the EITC. First, unlike the food stamp program, the EITC asset test is limited to the "disqualified income" test and does not limit tangible personal property, such as automobiles.

Second, the stigma associated with participating in a public assistance program, such as food stamps, may deter people from using the program. Those who participate in the food stamp program must do so in a public way—using a special debit card to pay for their groceries. Because of this, some potential recipients may choose not to participate in the program. In contrast, use of the tax credits is private—eligible individuals simply complete a tax form without apprehension of public stigma.

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[16] "Earned Income Tax Credit Eligibility and Participation," Letter to Representative William J. Coyne, U.S. House of Representatives, General Accounting Office (December 14, 2001). The participation rate estimate was calculated using samples of Census Bureau and IRS data. The letter reported estimated participation rates of 45 percent for families without qualifying children, 96 percent for families with one qualifying child, 93 percent for families with two qualifying children, and 62.5 percent for families with three or more qualifying children; also "The Earned Income Tax Credit," IRS Tax Tip 2007-23; IRS website.

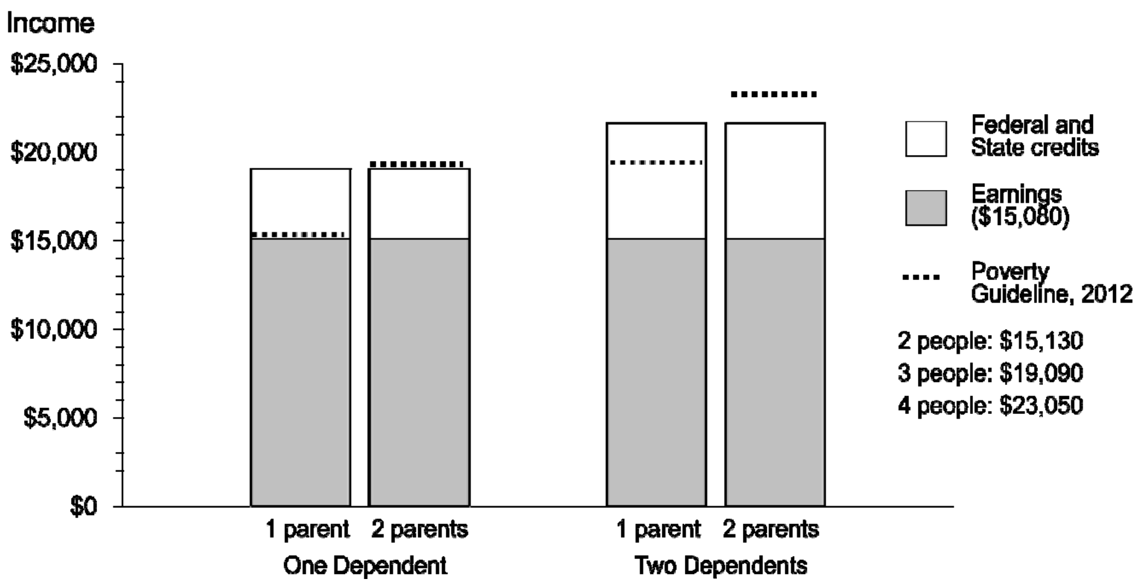
[17] John Karl Scholz, "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness," *National Tax Journal* 47 (1994): 63, 70-71.

Third, in 1998 Minnesota began to administer the food stamp program as part of the Minnesota Family Investment Program (MFIP), the state's version of welfare under the federal Temporary Assistance to Needy Families (TANF). The TANF portion of MFIP benefits is subject to a five-year lifetime limit. While individuals can receive food stamps for more than five years outside of MFIP, the publicity surrounding the five-year time limit may discourage some people from applying. Finally, applying for and collecting food stamps requires more time and effort by a potential recipient than filling out and mailing a tax return once a year.

The 2009 EITC and WFC will be large enough to lift single parents and married couples with one child above the poverty level.

Figure 5 compares the earnings of single parent and married couple families with one full-time minimum wage worker plus the EITC and WFC to the federal poverty level for two-, three-, and four-person families. Prior to 1993, the credit served to raise single-parent families with one dependent above the poverty level, but fell short of this goal for two-dependent families with only one full-time worker. The 1996 federal expansion of the EITC resulted in married and single-parent families with one dependent, and also single parents with two dependents, having income above the poverty guideline, after taking the credit into account. Married couples with two dependents, however, have total income below the poverty guideline even after considering the federal and state credits.[18] The figure uses 2012 poverty guidelines and federal minimum wage for large employers[19] ($7.25 per hour) and assumes that all income is from earnings.

Figure 5:
Effect of EITC and WFC on Income: Single Parent and Married Couple Families, One Full-Time Minimum Wage Worker, 2012



House Research Graphics

[18] Note that married couples with two full-time minimum wage workers would have income above the poverty guidelines based on wage income alone ($30,160).

[19] The federal minimum wage for employees of establishments that have at least $500,000 of gross receipts per year increased to $7.25 per hour effective July 24, 2009.

The federal EITC, combined with Minnesota's WFC and the increased state minimum wage, is not enough to raise the income of full-time working single parents of two or more dependents above the federal poverty guidelines.

The poverty level increases as family size increases, while the EITC and WFC reach their maximum amounts for families with two dependents. The 2012 poverty guideline is $15,130 for a two-person family, and $19,090 for a three-person family. The poverty guideline then increases by $3,960 for each additional family member. A single parent with three dependents faces a poverty guideline of $23,050 but receives the same EITC and WFC as a single parent with two dependents. As family size increases, the gap between earnings from a full-time, minimum wage job plus the EITC and WFC and the poverty guideline also increases. The EITC and WFC moves larger families closer to the poverty guideline, but does not lift them above it.

The Tax Credits and Work Effort

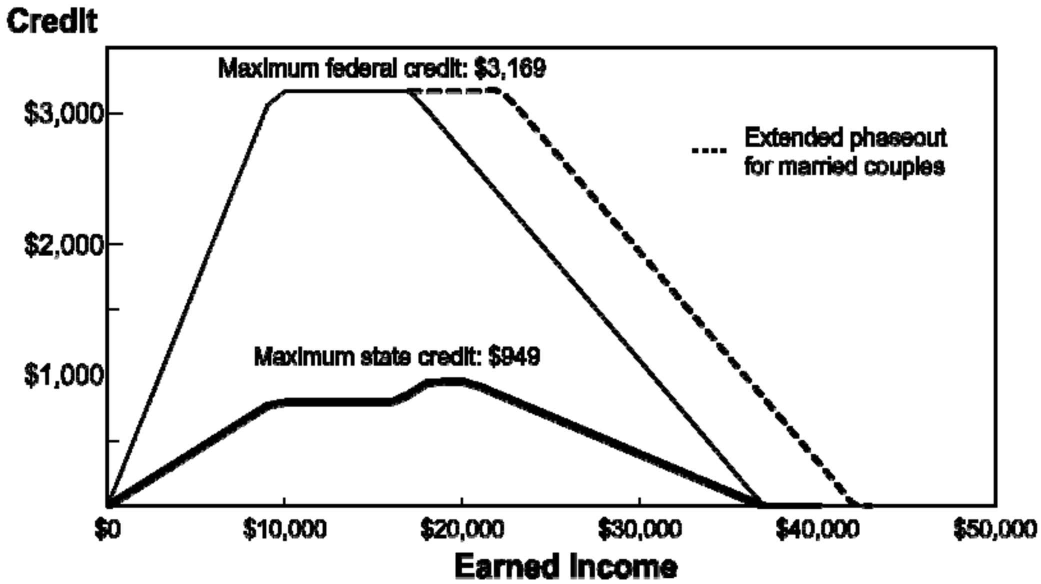
The work incentive effects of the credits depend upon which part of the credits affects the individual: in the phase-in range, the credits reward individuals with a higher return on work, while the credits' phaseout provisions actually reduce the return on work for those affected.

Also important is how the EITC and WFC interact with other features of the income tax and with transfer programs. The 1998 restructuring of the WFC was intended to alleviate high marginal rates caused by program interactions.

Economic theory suggests that the EITC and WFC have two contradictory effects on individual work effort: the substitution effect and the income effect.

The **substitution effect** suggests that by increasing or decreasing the return on work, the credits cause individuals to work more or less (to "substitute" work for leisure or vice versa). To understand the potential substitution effects of the credits, it is necessary to look at what happens to the credit if a filer's wages increase. Filers can be affected in three ways, depending upon whether they are in the phase-in, flat, or phaseout range of the credits. Figure 6 graphically shows these ranges of the EITC and WFC for filers with one dependent in tax year 2012. The figure assumes that all income is from earnings.

Figure 6:
EITC and WFC Ranges, Filers with One Qualifying Child, 2012



For an individual in the phase-in range, a greater work effort results not only in greater earnings but in larger credits as well.

As long as the individual's income is less than the maximum qualifying amount, the credits increase the wage rate. The return for working is higher (in 2012, by as much as 42.5 percent for individuals with one qualifying child, 50 percent for those with two qualifying children, and 55 percent for those with three or more qualifying children). Because individuals can earn more, the credits encourage recipients to work more—that is, to substitute work for leisure. The credits have a positive substitution effect on individuals in the phase-in range. In tax year 2012, an estimated 23 percent of Minnesota credit recipients will have income in the EITC phase-in range.[20]

For filers with incomes above the maximum qualifying amount but below the phaseout threshold, no substitution effect occurs; working more neither increases nor decreases the credits.

In tax year 2012, an estimated 22 percent of credit recipients will have income in the EITC "flat" range.

Finally, the substitution effect is negative, creating a work disincentive, for filers in the phaseout range; working more reduces their credits.

For example, a 2012 filer with two dependents and income in the phaseout range who received a $1,000 increase in wages would also experience a $210 reduction in the EITC and a $100

[20] Estimates were made using the House Income Tax Simulation (HITS) Model, the Minnesota Department of Revenue 2010 sample of income tax returns, and growth assumptions of the November 2012 economic forecast prepared by the Minnesota Department of Management and Budget.

reduction in the WFC.[21] This can be viewed as a 31 percent implicit tax on the additional $1,000 of wages. To put this in a broader context, these same filers are likely to pay a 10 percent or at most 15 percent federal income tax, and a 5.35 percent state income tax. An estimated 55 percent of credit recipients will be in the EITC phaseout range in 2012.

The earned income and working family tax credits also have an **income effect**. The credits effectively increase the income of low-income workers; they receive both their wages and the credits. Economic theory suggests that this income effect will cause some individuals to work less. With the credit, they can maintain the same standard of living while working fewer hours. The common sense of the income effect can be seen from an extreme example—it is the reason one expects lottery winners to quit working or work less. While the magnitude of the earned income tax credit or other wage supplements is much smaller, the effect is similar. The work disincentive of the income effect affects all individuals who qualify for the credit, regardless of which range of the credit they are in.

The work disincentive effect is inevitable in a credit that includes a phaseout.

In designing the credit, Congress and the legislature are faced with these trade-offs:

- Targeting or limiting the credit to lower income workers
- Minimizing the work disincentive that results from "taking away" the credit as income rises
- Limiting the cost of the credit

The credit can have a high phaseout rate, which means that it will go primarily to filers with incomes below the phaseout threshold. The downside of this approach is that there will be a high effective tax rate and large work disincentive for filers in the phaseout range. Or, the credit can have a low phaseout rate, with filers in the phaseout range facing a smaller effective tax rate and a smaller work disincentive. But this approach means that the credit will be available to filers with higher incomes and will cost more. Policymakers must choose between imposing a steep phaseout rate to target the credit to low-income families and to keep the overall cost of the credit low, or using a lower phaseout rate that makes the credit available at higher incomes and costs more to fund.

Most available research suggests that the EITC increases total work effort by a small amount.

Numerous national studies have analyzed the impact of the EITC on work effort. The results of the studies vary, but generally suggest that:

- The work incentive effects of the credit are probably positive. The net effect of the credit likely is to increase the total number of hours worked. One estimate is that the

[21] This calculation of the change in "take-home" pay does not take into account the effect of Social Security or Medicare tax, or the phaseout of other credits that the filer receives, such as the federal and state dependent care credits.

credit increased total hours worked by 20 million per year.[22] Another study concluded that the federal and state earned income credits were responsible for a substantial portion of the increase in the employment of single mothers in the early to middle 1990s.[23]

- More people work as a result of the credit.[24] A major effect of the credit is to increase labor force participation. The credit provides an unambiguous incentive for those not working to take a job. These individuals are not affected by the "income effect" (unless their spouses work), and the "substitution effect" provides a higher return for their earnings in the phase-in range.

- People already working, but who are in the credit phase-in range, tend to increase their hours worked.[25] These individuals receive larger credits by working more. Here the substitution effect of the credit overcomes the income effect. In general, this effect to encourage individuals already working to work more is much smaller than the effect of increasing participation.

- Individuals in the flat and phaseout ranges work less as a result of the credit.[26] Here the income effect (for those in the flat and phaseout ranges) and the negative

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[22] *See, e.g.*, Stacy Dickert, Scott Hauser, and John Karl Scholz, "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Markets and Program Participation," *Tax Policy and The Economy* 9 (1995): 40-41.

[23] Bruce D. Meyer and Dan T. Rosenbaum, "Taxes, Welfare Programs, and Employment" (1998 Proceedings of the 91st Annual Conference of the National Tax Association, 1999), 191. The period between 1991 and 1996 saw a remarkable increase in the number of single mothers who were employed—e.g., a 10-percentage point increase between 1991 and 1996 for single mothers with children under six. The study found that earned income credits explained between 39 percent (using a measure of weekly employment) and 57 percent (using a measure of annual employment) of the increase. This study is the first that we are aware of that analyzes the effect of state credits. The study, however, does not analyze the effects of state credits independently of the federal credit. Maximilian D. Schmeiser, "Expanding New York State's Earned Income Tax Credit Program: The Effect on Work, Income, and Poverty," *Applied Economics* 44, no. 16 (2012): 2035-50, estimated the effects of the New York state credit on hours worked, income, and poverty rates. It estimated that the New York credit, set at 30 percent of the federal credit, increased employment of single mothers by between 7,125 and 21,363 and labor earnings between $63.4 million and $94.3 million.

[24] *See* the summary of six studies in Table 3.4 in V. Joseph Hotz and John Karl Scholz, "The Earned Income Credit," 173-176, in Robert A. Moffitt, ed., in *Means-Tested Transfer Programs in the United States*, Chicago: University of Chicago Press, January 2003. All of these studies show positive effects on labor force participation by various segments of the population. *See also* Nada Eissa and Hilary W. Hoynes, "Behavioral Responses to Taxes: Lessons from the EITC and Labor Supply," *Tax Policy and the Economy* 20 (2006): 73-110.

[25] *See, e.g.,* Dickert, Hauser, and Scholz, "Earned Income Tax Credit."

[26] *See, e.g.,* Edgar K. Browning, "Effects of the Earned Income Tax Credit on Income and Welfare," *National Tax Journal* 48 (1995): 23 (reduction in labor supply for families in the phaseout range may be large enough that half of the families' disposable incomes are reduced as a result); Janet Holtzblatt, Janet McCubbin, and Robert Gillette, "Promoting Work Through the EITC," *National Tax Journal* 47 (1994): 591. *But see* Nada Eissa and Jeffrey B. Liebman, "Labor Supply Response to the Earned Income Tax Credit," *Quarterly Journal of Economics* 111, no. 2 (1996): 605 (analyzing the effects of the increase in the credit enacted as part the Tax Reform Act of 1986). This study found no negative effect on the labor supply of those in the phaseout range. The authors speculate that this may result from the fact that the credit typically does not affect take-home pay, but is received as a lump sum in the next year. This study analyzed a period before the 1990 and 1993 expansions and before much of the publicity about the credit.

substitution effects (for those in the phaseout range) induce people to work fewer hours. The effects probably are smaller than the credit's incentive to increase labor force participation and work effort by those in the phase-in range.

- Studies also have found that the EITC induces low-income single women to report self-employment income and for those in the phase-in range to report more self-employment income (thereby maximizing their credits).[27] It is unclear the extent to which this effect represents increasing work effort (e.g., undertaking new entrepreneurial efforts or increasing those efforts) or simply reflects reporting previously unreported income to claim larger credits.

- One study also found that single women who were induced to enter the workforce by the credit expansion in 1993 did not generally end up taking "dead-end" type jobs, but experienced wage growth after entering the workforce.[28] This is an important finding, since it has implications for the long-term cost-effectiveness of credits. If many recipients remain mired in low-paying jobs, they could experience long periods where they collect the credit.

- The credit tends to discourage work by married women. One study estimates that the credit reduced married women's participation in the workforce by one percentage point.[29] This result occurs because of the income effect and because married couples are more likely to be in the phaseout range of the credit where the work incentive effects are negative, as noted above.

- Finally, one study using an experiment with users of H&R Block tax preparation services, found that tax preparers educating credit recipients about where they lay on the credit's curve (i.e., in the phase-in, flat, or phaseout ranges) was much more effective in increasing work effort than was making the credit parameters more generous.[30] These effects applied to both self-employed individuals (who may simply have been reporting more income) and wage earners.

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[27] Sara LaLumia, "The Earned Income Tax Credit and Reported Self-Employment Income," *National Tax Journal* 52, no. 2 (June 2009): 191-217; Emmanuel Saez, "Do Taxpayers Bunch at Kink Points?" *American Economic Journal* 2, no. 3 (2010): 180-212 (finding clear evidence that credit recipients who report self-employment income bunch at the first "kink" in the EITC schedule where the credit is maximized relative to the amount of wages or self-employment income).

[28] Molly Dahl, Thomas DeLeire, and Jonathon Schwabish, "Stepping Stone or Dead End? The Effect of the EITC on Earnings Growth," *National Tax Journal* 52, no. 2 (June 2009): 329-346.

[29] Nada Eissa and Hillary Williamson Hoynes, "The Earned Income Tax Credit and the Labor Supply of Married Couples," National Bureau of Economic Research Working Paper No. 6852 (December 1998). This study also concludes that the credit has little effect on the labor supply of married men, but because of the effects on married women the credit causes family labor supply and pre-tax earnings to fall. The authors conclude that their results "imply that the EITC is effectively subsidizing married mothers to stay at home * * *." *Id.* at 30.

[30] Raj Chetty and Emmanuel Saez, "Information and Behavioral Responses to the Taxation: Evidence from an Experiment with EITC Clients at H&R Block," National Bureau of Economic Research, working paper (September 7, 2008). This suggests that lack of understanding of the complicated credit structure is a barrier to its effectiveness and that investing more on education efforts would be more cost-effective than making the credit formula more generous. The authors' estimates suggest these efforts could be more than ten times as cost-effective.

The WFC and EITC combine with other features of the income tax, the payroll tax, and the state's welfare program to produce high marginal tax rates for individuals in some income ranges. The 1998 restructuring of the WFC was intended to alleviate high marginal rates.

The 1998 restructuring of the WFC reduced high marginal tax rates[31] that resulted from the interaction of the federal and state income tax systems and MFIP, the state's TANF program. Single parents with two children who worked full-time and earned between $6.00 and $8.00 per hour faced high marginal tax rates, sometimes exceeding 100 percent, due to the loss of MFIP benefits (64 percent marginal rate), the phaseout of the federal earned income credit and the state working family credit (25.3 percent), and the payment of state and federal income and payroll taxes (28.7 percent). The 1998 restructuring introduced a second tier to the WFC, which began to phase in when income reached the level at which the MFIP grant was completing its phaseout, and single parents had incomes high enough to owe federal and state income taxes. In tax year 1998, an individual whose income went from $7.00 per hour to $8.00 per hour would lose eligibility for MFIP, and begin to owe federal and state income taxes. These costs of getting a raise in pay were offset by an increase in the WFC, due to implementation of the second tier.

Table 5 shows the effect of the restructuring on a single parent of two children in tax year 1998, the year the restructuring took effect, at various wage levels starting at $5.15 per hour, the minimum wage in 1998. Before the restructuring, a wage increase from $6.00 to $7.00 per hour would have resulted in increased earnings of $2,080 ($14,560 minus $12,480), but increased resources of only $42 after factoring in the phaseout of the EITC and WFC, the phaseout of the MFIP grant, and the imposition of income and payroll taxes. This represents a marginal tax rate of 98 percent.

[31] Marginal rates refer to the share of an increase in income that is paid in tax.

Table 5:
Effect of WFC Restructuring on Net Annual Resources, Single Parent with Two Children, 1998

Hours Worked	0	20	40	40	40	40	40
Hourly Wage		$5.15	$5.15	$6.00	$7.00	$8.00	$9.00
Annual Earnings	$0	$5,356	$10,712	$12,480	$14,560	$16,640	$18,720
MFIP Grant	$9,156	$6,644	$3,216	$2,084	$753	$0	$0
Payroll Taxes	$0	$410	$819	$955	$1,114	$1,273	$1,432
Federal and MN Income Taxes	$0	$0	$0	$0	$44	$481	$918
Before restructuring							
FEIC and WFC	$0	$2,464	$4,319	$4,266	$3,762	$3,258	$2,755
Net Annual Resources	$9,156	$14,054	$17,428	$17,876	$17,918	$18,145	$19,125
Increase in earnings*	NA	$5,356	$5,356	$1,768	$2,080	$2,080	$2,080
Increase in resources*	NA	$4,898	$3,374	$448	$42	$227	$980
Marginal rate**	NA	8.6%	37.0%	74.7%	98.0%	89.1%	52.9%
After restructuring							
FEIC and WFC	$0	$2,571	$4,507	$4,461	$4,065	$3,961	$3,396
Net Annual Resources	$10,072	$14,161	$17,616	$18,071	$18,220	$18,847	$19,766
Increase in earnings*	NA	$5,356	$5,356	$1,768	$2,080	$2,080	$2,080
Increase in resources*	NA	$5,005	$3,455	$455	$150	$627	$919
Marginal rate**	NA	6.6%	35.5%	74.3%	92.8%	69.9%	55.8%

* Increase from column immediately to the left of the entry
** Percentage of earnings that result in increased taxes or reduced benefits compared to the column immediately to the left

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After the 1998 restructuring, the family in Table 5 would keep $150 of a wage increase from $6.00 to $7.00 per hour (or a $2,080 increase in annual gross pay). The marginal rate remained high at 92.8 percent: 64 percent from the loss of MFIP benefits, 7.65 percent from payroll taxes, 19 percent from the EITC phaseout (offset by the second tier of the WFC), and 2 percent as income taxes begin to apply.

Table 6 shows the effect of 1998 restructuring in 2012. The EITC, WFC, and the threshold for income tax liability have increased each year to reflect inflation as measured by the consumer price index. The income level at which the second tier of the WFC begins to apply for a parent with two children has increased from $14,350 in 1998, to $20,020 in 2012. The MFIP grant, which consists of a food portion and a cash portion, has not increased at the same pace. The food portion is adjusted annually to reflect increases in the federal food stamp awards. The cash portion, which makes up about two-thirds of a family's grant, has remained unchanged since MFIP was implemented in 1998. In addition, the legislature has modified the MFIP grant calculation so that families exit the program when income reaches 115 percent of the federal poverty threshold, down from 120 percent when MFIP began.[32] The result is that in 2012, the

[32] Laws 2003, 1st spec. sess., ch. 14, art. 1, sec. 39.

MFIP grant for a family of three is almost fully phased out before the second tier of the WFC begins to apply. However, a family of three will still be in the MFIP phaseout when they begin to owe federal and state income taxes and when the EITC begins to phase out. The highest marginal rates have shifted up the income scale, with those rewarded with a pay raise from $8.00 to $9.00 losing 89.7 percent of their increased earnings to payroll taxes (7.65 percent) and lost benefits (61 percent for MFIP, 21.06 percent in phased out EITC).

Table 6:
Effect of WFC Restructuring on Net Annual Resources, Single Parent with Two Children, 2012

Hours Worked	0	20	40	40	40	40	40
Hourly Wage		$7.25	$7.25	$7.50	$8.00	$9.00	$10.00
Annual Earnings	$0	$7,540	$15,080	$15,600	$16,640	$18,720	$20,800
MFIP Grant[33]	$1,005	$722	$339	$313	$260	$154	$48
FEIC and WFC	**$0**	**$3,770**	**$6,545**	**$6,545**	**$6,545**	**$6,202**	**$5,920**
Federal child credit	$0	$681	$1,812	$1,890	$2,000	$2,000	$2,000
Payroll Taxes	$0	$577	$1,154	$1,193	$1,273	$1,432	$1,591
Federal and MN Income Taxes	$0	$0	0	$0	$0	$0	$107
Net Annual Resources	**$12,060**	**$20,081**	**$26,351**	**$26,592**	**$27,028**	**$27,336**	**$27,599**
Increase in earnings*	**NA**	**$7,540**	**$7,540**	**$520**	**$1,040**	**$2,080**	**$2,080**
Increase in resources*	**NA**	**$8,021**	**$6,270**	**$241**	**$436**	**$309**	**$263**
Marginal rate**	**NA**	**-6.4%**	**16.8%**	**53.7%**	**58.1%**	**85.2%**	**87.4%**

* Increase from column immediately to the left of the entry
** Percentage of earnings that result in increased taxes or reduced benefits compared to the column immediately to the left

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Also contributing to changes in the marginal rates from 1998 to 2012 is the reduction in the federal income tax rate from 15 percent to 10 percent,[34] and in the state income tax rate from 6 percent to 5.35 percent. Significant increases in the federal child credit and making this credit partially refundable offset high marginal rates in the MFIP phaseout. The 2005 and 2009 increases in the minimum wage affects annual earnings and the MFIP grant available. Table 6 also shows that the credits more than offset the effect of the benefit reductions for an MFIP recipient who enters the workforce, working half-time at minimum wage. This allows the recipient to receive a work bonus, as net resources increase by more than the increase in earnings. High marginal rates occur when the recipient is no longer in the phase-in range of the EITC and WFC, but experiences MFIP grant reductions as a result of increased earnings (e.g., full-time work in $7.50 to $10.00 per hour range for the examples). Once the recipient has lost

[33] The MFIP grant calculations are based on the transitional standard, family wage level, and earned income disregard percentage in effect in August 2012.

[34] Marginal rates for married joint filers are further reduced by the increase in the federal standard deduction to twice the deduction allowed single filers.

all of his or her MFIP benefits (at wage levels beyond what are shown in the table), the marginal rates drop substantially as the EITC and WFC continue to phase out.

The Tax Credits and Compliance

The EITC has grown to be among the largest cash or near-cash income transfer-type federal programs, somewhat lower than outlays under the food stamp program and well above TANF, the more traditionally thought of “welfare” programs.[35] This growth has led to concerns about compliance and payments to recipients who are not eligible for the credit. The Internal Revenue Service reports that about $10 billion to $12 billion in erroneous EITC payments are made each year, or over one-quarter of the payments.[36]

In an attempt to reduce overclaims for the EITC, the IRS has conducted three pilot compliance tests—the EITC Qualifying Child Residency Study, the EITC Filing Status Study, and the EITC Automated Underreporter (AUR) Study.

Earlier studies have shown a high rate of overclaims for the EITC. The Qualifying Child Residency Study had the goal of reducing erroneous claims for children who do not meet the definition of “qualifying child” for purposes of claiming the credit; the Filing Status Study, the goal of reducing taxpayers filing as head of household in order to claim larger credits than they would qualify for as married joint filers; and the AUR Study, the goal of reducing income underreporting in order to qualify for a larger credit. In 2008 the IRS issued a report on the three initiatives,[37] and subsequently issued an addendum addressing the cost-effectiveness of implementing new compliance measures suggested by the studies.[38]

The Qualifying Child Residency Study focused on determining the effect of requiring claimants to certify that qualifying children had lived with the claimant for more than half the tax year, which is a precondition to claiming the EITC. In each of three years the IRS required a

[35] Outlays under TANF in fiscal year 2011 were $21.3 billion and for the food stamp program, $77.6 billion, while the tax expenditure for the EITC was $59.5 billion. Office of Management and Budget, *Budget of the United States Government: Fiscal Year 2013*, Historical Tables 248, http://www.gpoaccess.gov/fdsys/pkg/BUDGET-2013-TAB/pdf/BUDGET-2013-TAB.pdf (accessed December 20, 2012); Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2011–2015* (January 17, 2012): 44.

[36] Inspector General for Tax Administration, U.S. Department of the Treasury, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* (December 2008): 1. For fiscal year 2011, the Internal Revenue Service estimates that 21 percent to 26 percent of the credit was issued improperly. Inspector General for Tax Administration, U.S. Department of the Treasury, *The Internal Revenue Service is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements* (March 2, 2012): 5.

[37] U.S. Department of the Treasury, Internal Revenue Service, IRS Earned Income Tax Credit (EITC) Initiatives, *Report on Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests* (2008).

[38] U.S. Department of the Treasury, Internal Revenue Service, IRS Earned Income Tax Credit (EITC) Initiatives, *Addendum to the Report on Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests* (2008).

sample of taxpayers to certify residency of qualifying children. From one year to the next the IRS improved its methodology in selecting the sample in order to focus on claims that, based on other data, were more likely to be reporting qualifying children who did not meet the residency requirement.

The IRS reports that the certification requirement deterred ineligible taxpayers from claiming the EITC, and reduced the number of erroneous claims. However, the IRS continued to track taxpayers who were required to certify in subsequent tax years and found that the deterrent effect tended to decay over time. This suggests that an ongoing, rather than a one-time, certification requirement would be necessary to reduce erroneous claims and overpayments. However, the addendum to the full report analyzed the return on investment from implementing a certification requirement and found it to be substantially lower than the return on pre-existing correspondence audits of EITC claims; in addition, the certification requirement had the effect of deterring a small percentage of eligible parents from claiming the credit. As a result, the IRS does not plan to require certification of qualifying child residency in the near future.

A related study by university researchers found that child support registry information data could provide an independent method of verifying qualifying child residency of credit claimants.[39] This study matched Wisconsin child support registry information for EITC claimants with court records and found a high correlation between the two (estimated 96 percent accuracy). Subject to some significant caveats, the federal registry information could be used to preverify whether a claimed child meets the residency requirement for individuals who are in the registry under the IRS's math correction authority.[40]

The Filing Status Study was developed in response to a finding in the tax year 1999 compliance study showing that a significant share of improper EITC claims were from individuals who filed as single or head of household, when they should have filed as either married filing jointly or married filing separately. Using the correct filing status would either decrease the amount of credit allowed or make them ineligible to claim the credit.

The Filing Status Study focused primarily on individuals who claimed the EITC as single or head of household, but who had filed as married filing jointly or separately in one of the three previous years. Taxpayers in the sample group were asked to provide documentation of their marital status before the IRS released their EITC. In the tax year 2003 trial, 22 percent of returns in the sample group were unable or unwilling to document their filing status, and EITC amounts paid to the group were reduced by 20 percent. For 2004 the IRS revised the sampling methodology to better target individuals more likely to be filing erroneously, and this resulted in a higher rate of claim adjustments and credit reductions.

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[39] V. Joseph Hotz and John Karl Scholz, "Can Administrative Data on Child Support be Used to Improve the EITC? Evidence from Wisconsin," *National Tax Journal* 51, no. 2 (June 2008): 189-203. In 1999, Congress directed the IRS to study the possibility of using federal child support registry data for EITC compliance purposes.

[40] The authors note that this could result in a fair number of "false positives" and the initial denial of refunds to eligible claimants. Ibid. This could be a serious problem, since a fair number of recipients are unlikely to meet the 60-day requirement to appeal the denial. Thus, the cost of reducing erroneous payments may be to deny a smaller number of legitimate claims that never get paid or (at best) force eligible claimants to go through more difficult administrative processes to receive the credit.

The IRS also verified filing status with a smaller sample of claimants filing as head of household who had not filed as married in a previous year. This study resulted in some head of household filers changing to single status. Since heads of household and single filers use the same parameters for determining the credit amount, the adjustments did not result in a reduction in the amount of credit paid.

While the Filing Status Study did identify some claimants who should have used a different filing status and received a smaller credit (or no credit), the IRS concluded that it did not detect a high enough percentage of ineligible claims to make it worth continuing. In addition, verification of filing status was found to impose a substantial burden on taxpayers, with a relatively small cost savings in terms of reduced credit payments.

The Automated Underreporter (AUR) Study focused on improving the selection of EITC returns for review to focus on returns that may have misreported income. It did this by matching third-party income information (such as W-2s received from employers) to return data, and including returns that appeared to under- or overreport income in the population to be sampled. Including the third-party income data in the sample selection process increased the percentage of returns in the sample that had assessments for tax from about 72 percent to 82 percent. The IRS has since incorporated the third-party income matching developed in AUR in its ongoing methodology for reviewing about 300,000 EITC claims annually.

Appendix: Earned Income Tax Credits in Other States, 2012

State (year adopted)	Percentage of federal credit	Notes
Refundable credits		
Colorado (1999)	10% (not currently in effect)	Colorado's credit is only in effect in years in which the state has a budget surplus
Connecticut	30%	
District of Columbia (2000)	40%	
Illinois (made permanent in 2002)	7.5%	The credit rate increases to 10% for 2013 and following years
Indiana (2002)	9%	Indiana's credit expires after tax year 2011
Iowa (1990)	7%	Iowa's credit became refundable in 2007
Kansas (1998)	18%	Kansas' credit increased from 17% to 18% for tax years 2010-2012 only
Louisiana (2007, effective 2008)	3.5%	
Maryland (1987)	25% (refundable) or 50% (nonrefundable)	A Maryland taxpayer may claim the refundable credit or the nonrefundable credit, but not both
Massachusetts (1997)	15%	
Michigan (2006, effective 2008)	6%	Michigan's credit decreased from 20% to 6% of the federal credit beginning in tax year 2012
Nebraska (2006)	10%	
New Jersey (2000)	20%	New Jersey's credit decreased from 25% to 20% in 2010
New Mexico (2007)	10%	
New York (1994)	30%	New York's credit decreases to 20% if the federal government reduces the state's TANF grant
North Carolina (2007, effective 2008)	5%	North Carolina's credit expires after tax year 2013
Oklahoma	5%	
Oregon (1997)	6%	Oregon's credit was nonrefundable before tax year 2006 and expires after tax year 2013
Vermont (1988)	32%	
Washington (2008)	10%	Washington's credit equals the greater of $50 or 10% of the federal credit and was suspended in tax years 2009 and 2010
Wisconsin (1989)	4% one child 11% two children 34% three children	In tax year 2011, Wisconsin's credit decreased from 14% to 11% for two children, and from 43% to 34% for three or more children

State (year adopted)	Percentage of federal credit	Notes
Nonrefundable credits		
Delaware (2005)	20%	
Maine (2000)	5%	
Rhode Island (1975)	25%	15% of Rhode Island's credit in excess of liability is refundable
Virginia (2004, effective 2006)	20%	
Sources: Shen Stesel and Qiana Flores, Earned Income Tax Credit 2009-2012 Enactments, National Conference of State Legislatures (updated July 2012); Ifie Okwuje and Nicholas Johnson, *A Rising Number of State Earned Income Tax Credits Are Helping Working Families Escape Poverty*, Center on Budget and Policy Priorities (October 20, 2006); Jason Levitas and Jeremy Koulish, *A Majority of States with Income Taxes Have Enacted State Earned Income Tax Credits*, Center on Budget and Policy Priorities (October 5, 2007); "Maryland Enacts Tax Package," *State Tax Notes* 46 (November 26, 2007): 592; same adoption years also from Dickert-Conlin and Houser (2002), which in turn are from Nicholas Johnson, "A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2001: An Overview," particularly Table 4 (December 2001; summary updated in May 2004); and from Ed Hatcher and Amy Beall, "Education Leadership and Persistence Pay Off in Delaware: New State EITC Will Benefit 28,000 Low-Income Workers," *The EITC Policy Update* (September 2005); Jason Levitis and Jeremy Koulish, *State Earned Income Tax Credits: 2008 Legislative Update*, Center on Budget and Policy Priorities (October 8, 2008).		

In addition to the information shown in the table, New York City, San Francisco, and Montgomery County, Maryland, have enacted local earned income tax credits.[41]

For more information about tax credits, visit the income tax area of our website, www.house.mn/hrd/.

41 Nicholas Johnson and Erica Williams, *A Hand Up: How State Earned Income Tax Credits Are Helping Working Families Escape Poverty*, Center on Budget and Policy Priorities (April 2011).