

# SPECIAL REPORT

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## Growth of the Earned Income Tax Credit

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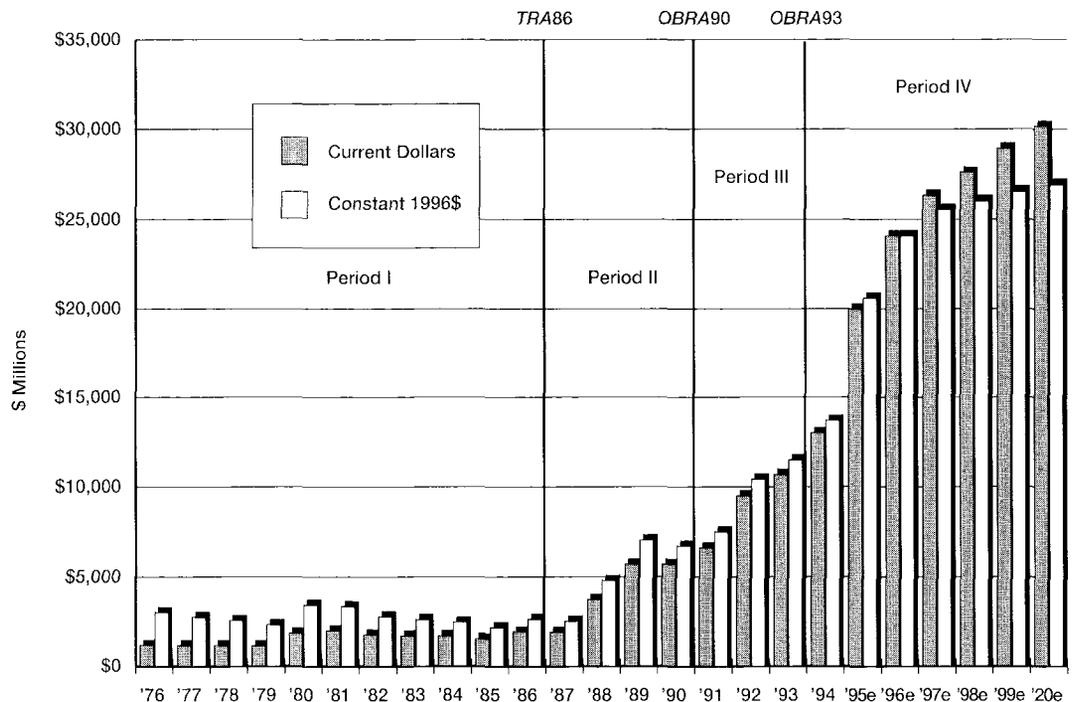
The Earned Income Tax Credit (EITC) became a part of the federal tax code with the Tax Reduction Act of 1975. It had two major objectives: (1) to provide tax relief to low-income workers with children by offsetting the burden of payroll taxes used to finance Social Security, Medicare, and Unemployment Insurance; and (2) to provide an incentive for people to seek gainful employment instead of welfare.

Since its enactment in 1975, the EITC has been greatly expanded, as illustrated by

Figure 1. Table 1 shows that in fiscal year 1976 the total value of the EITC amounted to \$1.1 billion. By fiscal year 2000, the value is expected to exceed \$30 billion. The rapid growth of the EITC program has resulted from successive legislative expansions of both the size of the credit and the size of the population eligible to receive the credit.

The history of the EITC comprises four distinct legislative periods (see Figure 1). The growth in periods two, three, and four are the result of the Tax Reform Act of 1986 (TRA 86),

Figure 1  
Total Value of the EITC



Source: Tax Foundation; Office of Management and Budget; Joint Committee on Taxation.

*Table 1  
Federal Payments, Average Credit, and Eligible Families for the EITC, 1976-2000*

	Tax Liability Reduction Portion of the EITC* (\$Millions)	Refundable Portion of the EITC (\$Millions)	Total EITC (\$Millions)	Number of Families Eligible for EITC† (Thousands)	Avg. Credit Per Family
1976	\$368	\$808	\$1,176	6,473	\$182
1977	253	901	1,154	5,627	205
1978	272	881	1,153	5,192	222
1979	364	773	1,137	7,135	159
1980	573	1,275	1,848	6,954	266
1981	654	1,318	1,972	6,717	294
1982	543	1,201	1,744	6,395	273
1983	476	1,213	1,689	7,368	229
1984	489	1,193	1,682	6,376	264
1985	432	1,100	1,532	7,432	206
1986	507	1,415	1,922	7,156	269
1987	482	1,410	1,892	8,738	216
1988	1,039	2,698	3,737	11,148	335
1989	1,691	4,002	5,693	11,696	487
1990	1,334	4,354	5,688	12,612	451
1991	1,705	4,885	6,590	13,105	503
1992	2,144	7,345	9,489	13,433	706
1993	1,901	8,781	10,682	14,004	763
1994	2,050	10,950	13,000	18,059	720
1995 est.	3,143	16,844	19,987	18,411	1,086
1996 est.	3,877	20,216	24,093	18,692	1,289
1997 est.	4,178	22,166	26,344	19,010	1,386
1998 est.	4,379	23,229	27,608	19,163	1,441
1999 est.	4,591	24,357	28,948	19,538	1,482
2000 est.	4,783	25,375	30,158	19,788	1,524

\*Tax Foundation estimates based on data from the Office of Management and Budget and Joint Committee on Taxation.

†After 1994, eligible families derived from Tax Foundation estimates using data from Joint Committee on Taxation and Internal Revenue Service.

Source: Tax Foundation; Office of Management and Budget; Joint Committee on Taxation.

the Omnibus Budget Reconciliation Act of 1990 (OBRA 90), and OBRA 93. During the time-span from 1976 to 1986 (period one), the total value of the EITC increased at an average 4.8 percent a year (-1.4 percent in constant 1996 dollars). During the time-span between 1986 to 1996 — the period of successive legislative expansion — the total value of the EITC increased at an average rate of 22.1 percent a year (19.6 percent in constant 1996 dollars).

### How the EITC Works

The Internal Revenue Code defines “earned income” as all wages, salaries, tips, and other employee compensation plus the amount of net earning from self-employment. Taxpayer eligibility requirements for the EITC

specify three income ranges: a phase-in range, a plateau range, and a phase-out range (See *Figure 2*). The phase-in and plateau ranges are defined by earned income. The phase-out range is based on earned income or, if it is greater, adjusted gross income (AGI) (a broader measure of income).

*Table 2* shows the various eligible income ranges, credit rates and phase-out rates for all the years the EITC has existed. Examining two hypothetical taxpayers for 1996, the year in which the 1993 law will be fully phased in, will demonstrate how the EITC works.

Ms. Johnson is a single parent of two children and she works a 40-hour week at \$5 an hour. Her earned income for that year will equal \$10,400 (\$5 times 2,080 work hours per year). As *Table 2* shows, this income level falls

within the "plateau" range (\$8,900 to \$11,620); that is, her income falls between (1) the minimum income needed to receive the maximum two-child EITC, and (2) the beginning income of the phase-out range. Ms. Johnson is therefore eligible for the maximum two-child EITC of \$3,560 (the earned income credit rate of 40 percent times \$8,900).

Mr. and Mrs. Smith are a married couple. They have two children. Both Mr. and Mrs. Smith work a 40-hour week at \$6 an hour. In addition, they will receive \$1,000 from some investments they have made. Their "earned" income will equal \$24,960 (\$6 times 4,160 working hours per year). Their total (adjusted gross) income will equal \$25,960 (\$24,960 plus \$1,000), which puts them in the "phase-out" income range of the EITC (\$11,620 to \$28,524). To calculate their EITC, the Smiths must subtract their phase-out amount from the maximum two-child EITC of \$3,560. Since the Smith's AGI exceeds their "earned" income, they must use their AGI to calculate their phase-out amount: (\$25,960 minus \$11,620) times the EITC phase-out rate of 21.06 percent, which equals \$3,020. Subtracting the phase-out amount of \$3,020 from \$3,560 shows that the Smiths can receive an EITC of \$540.

The EITC is a "refundable" tax credit which means that a taxpayer eligible for the EITC is entitled to the entire credit even if the result is a negative tax liability. (Such an outcome would occur in the example of Ms. Johnson, who would have no income tax liability before taking her EITC into account.) The portion of the EITC that results in a negative income tax liability — that is, a monetary payment from the government — is known as the refundable portion of the credit. Monetary payments owed to the taxpayer can be collected in a yearly lump-sum or on a month-to-month basis known as the advanced payment option. *Table 1* reveals that approximately 84 percent of total EITC payments in 1996 will be refunded as monetary payments. So, although the EITC is part of the income tax system, the refundable portion is treated by the Office of Management and Budget as a federal outlay on par with other government welfare programs.

## Legislative Expansion of the EITC

*Figure 2* provides a snapshot illustration of how much the EITC has expanded since its inception in 1975. In 1996 dollars, the maximum 1975-78 credit would have equaled \$745. In comparison, the maximum 1996

credit will be \$3,560. The difference between the maximum EITC for 1975-78 and 1996 amounts to an inflation-adjusted increase of 378 percent. The total income range for EITC eligibility, also adjusted for inflation, has been increased from \$14,895 in 1975-78 to \$28,524 in 1996, a 92 percent increase.

*Table 1* shows the results for taxpayers of the major legislative expansions to the EITC. Eligible families have increased from 6.5 million families in 1976 (7.3 percent of all 1976 tax filers), to an estimated 18.7 million families in 1996 (15.3 percent of all 1996 tax filers). Because of the higher credit rates, the average EITC received per family, in constant 1996 dollars, has increased from \$466 in 1976 to \$1,289 in 1996, a 176 percent increase.

Period one of the EITC lasted from its enactment by the Tax Reduction Act of 1975 until TRA 1986. To qualify for the EITC during period one, a family had to consist of at least one working adult, two or more children, and the family had to receive eligible income. *Table 2* reports that, for most of the period, the maximum credit such a family could receive was \$500. Every few years the income ranges of the EITC would be adjusted to maintain parity with inflation, but that was the extent of the reforms.

Legislative expansion of the EITC began with the passage of TRA 86, marking the beginning of period two (1987 - 1990). This period of the EITC contained an important political debate on a minimum wage increase which many lawmakers wanted to implement. However, opponents of a minimum wage successfully argued that such a policy would have negative economic effects on the unskilled labor force. Furthermore, a minimum wage increase failed to address adequately the EITC objectives of offsetting the burden of payroll taxes, and, most importantly, providing an incentive for low-income workers with children to seek employment rather than welfare. So expansion of the EITC was deemed a superior policy.

The most expansive features of the EITC included in TRA 86 were the lowering of the qualifying child limit from two to one and the increasing of the credit rate from 10 percent to 14 percent. By 1990, the changes made by TRA 86 almost doubled the EITC's nominal income range from \$11,000 to \$20,264, as is shown in *Table 2*. The TRA 86 also initiated the indexing of EITC income ranges for inflation.

**Table 2**  
**Legislative History of the EITC**

Calendar Year	Earned Income Credit Rate	Minimum Income for Maximum EITC	Maximum EITC	Phaseout Rate for EITC	Phaseout Range for EITC	
					Beginning Income	Ending Income
<u>Period I: Tax Reduction Act of 1975</u>						
1975-78:	10.00%	\$4,000	\$400	10.00%	\$4,000	\$8,000
1979-80:	10.00	5,000	500	12.50	6,000	10,000
1981-84:	10.00	5,000	500	12.50	6,000	10,000
1985-86:	11.00	5,000	550	12.22	6,500	11,000
<u>Period II: Tax Reform Act of 1986</u>						
1987:	14.00%	\$6,080	\$851	10.00%	\$6,920	\$15,432
1988:	14.00	6,240	874	10.00	9,840	18,576
1989:	14.00	6,500	910	10.00	10,240	19,340
1990:	14.00	6,810	953	10.00	10,730	20,264
<u>Period III: Omnibus Reconciliation Act of 1990</u>						
1991:						
One child:	16.70%	\$7,140	\$1,192	11.93%	\$11,250	\$21,250
Two + children:	17.30	7,140	1,235	12.36	11,250	21,250
1992:						
One child:	17.60	7,520	1,324	12.57	11,840	22,370
Two + children:	18.40	7,520	1,384	13.14	11,840	22,370
1993:						
One child:	18.50	7,750	1,434	13.21	12,200	23,050
Two + children:	19.50	7,750	1,511	13.93	12,200	23,050
<u>Period IV: Omnibus Reconciliation Act of 1993</u>						
1994:						
One child:	26.30%	\$7,750	\$2,038	15.98%	\$11,000	\$23,750
Two + children:	30.00	8,425	2,528	17.86	11,000	25,300
No children:	7.65	4,000	306	7.65	5,000	9,000
1995:						
One child:	34.00	6,160	2,094	15.98	11,290	24,395
Two + children:	36.00	8,650	3,114	20.22	11,290	26,690
No children:	7.65	4,000	306	7.65	5,000	9,000
1996*:						
One child:	34.00	6,160	2,094	15.98	11,290	24,395
Two + children:	40.00	8,900	3,560	21.06	11,620	28,524
No children:	7.65	4,000	306	7.65	5,000	9,000

Note: A qualifying child must meet 3 eligibility requirements: (1) relationship test - child, stepchild, a descendant of a child, or a foster/adopted child of taxpayer; (2) residence test - child must live with taxpayer for more than half the taxable year; (3) age test - child must be under 19 (24 for full-time student) or permanently and totally disabled.

\*After 1996, all relevant 1996 income levels will be adjusted for inflation.

Source: 1994 Greenbook.

Under OBRA90, the beginning of period three (1990-1993), the EITC underwent further expansion and experienced a structural change. The qualified child requirement was broken into a two-tier system. A family with one child was given a separate, lower credit rate from that of families with two or more children. However, once the 1990 changes were fully phased in, both groups were given an increase in credit rates. As *Table 2* shows, by 1993 a one-child family with earned income of \$7,750 would be eligible for the maximum credit rate of 18.5 percent, resulting in a maximum credit worth \$1,434. A family with two or more children and earned income of \$7,750 would also be eligible for the credit, but at a maximum credit rate of 19.5 percent, resulting in a maximum credit worth \$1,511.

OBRA93, the start of period four (1993-2000), again expanded the EITC by further increasing the credit rates, expanding the income ranges, and transforming the child qualification requirement into a three-tier system.

The new three-tier system expands eligibility requirements to include a "no children" provision, breaking an 18-year long precedent by going outside the original "family only" intentions of the EITC. This new tier will provide a maximum credit rate of 7.65 percent at an income level of \$4,000, resulting in a maximum credit of \$306. The income range will extend to \$9,000. By 1996, maximum credit rates for one-child families will increase to 36 percent (40 percent for two or more children) and the income range will extend to \$24,395 (\$28,524 for two or more children).

## Work Incentives and Disincentives of the EITC

A stated policy goal of the EITC is to encourage people to work rather than seek welfare. However, for most of the people eligible for the EITC, its apparent major economic effect is to discourage work.

The EITC also has a stated policy goal to offset the burden of the combined 15.3 percent payroll tax. The marginal payroll tax rate includes the 7.65 percent employee-rate and the 7.65 percent employer-rate because the tax burden actually falls upon the worker in the form of lower stated pre-tax wages. Ultimately, the

payroll tax reverses much of the EITC's work incentives by contributing to higher marginal tax rates.

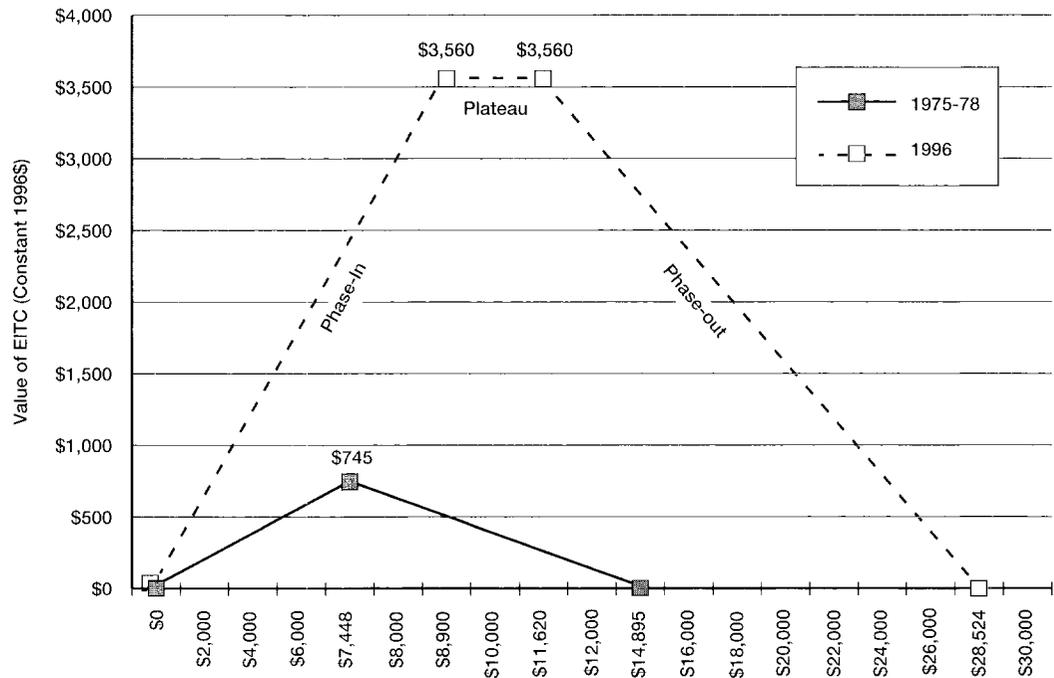
While many government programs affect a taxpayer's marginal tax rate, three of the largest are the EITC, the federal income tax, and the payroll tax. If we look at these in isolation, then we find that only the people in the phase-in income range of the credit are encouraged to increase work effort. A taxpayer with two children in the phase-in range would have no taxable income since the standard deduction and child exemptions are valued above the "minimum income for maximum EITC" of \$8,900. In addition to the incentive of facing no income tax liability, the EITC provides a further work incentive because each additional dollar earned up to \$8,900 makes the taxpayer eligible for an EITC of 40 cents. The EITC offsets the 15.3 percent payroll tax burden, so a taxpayer in the phase-in range faces a *negative* marginal tax rate of 24.7 percent (40 cents of the EITC less 15.3 cents of payroll tax); that is, he receives a 24.7 cent government payment for each additional dollar earned.

On the other hand, a taxpayer in the phase-out range of the EITC faces three disincentives: a statutory marginal (federal) income tax rate of 15 percent, a payroll tax rate of 15.3 percent, and decreasing EITC benefits. According to 1996 law (see *Table 2*), a taxpayer with two children in the phase-out range that earns an additional dollar must forgo 21 cents of his EITC. Thus, a taxpayer in the phase-out range faces an effective marginal tax rate of 51.3 percent (the 15 percent federal income tax rate plus the 15.3 percent payroll tax plus the 21 percent EITC phase-out rate).

Compounding the work disincentive related to the phase-out of the EITC are other federal, state, and local taxes, and other government welfare programs. These other factors increase the effective marginal tax rate faced by people in the EITC's phase-out range. Other taxes add to the tax burden on each additional dollar earned, and the money received from other government welfare programs begins to phase out at approximately the same income range that the EITC begins to phase out.

Professor Edgar Browning of Texas A&M University has examined the effective marginal tax rate of the EITC's phase-out using a more comprehensive list of factors

Figure 2  
Growth of the EITC  
A Comparison of Credit Size and Eligible Income Ranges, 1975-1978 and 1996 (two children), 1996 Dollars



Source: 1994 Greenbook.

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such as federal and state income taxes, payroll taxes, sales and excise taxes, and the loss of other government welfare payments. He found that an additional dollar earned by a taxpayer moving out of the plateau range (\$11,620 plus \$1) is subject to an effective marginal tax rate of 59.6 percent. As the taxpayer's income nears the exit point of the EITC's phase-out (\$28,524 minus \$1), the phase out of other government welfare payments cause the effective marginal tax rate to increase to 65.1 percent. Therefore, the work disincentive manifests itself by encouraging people to stop earning additional income once they reach the plateau income range, where the EITC is maximized and the effective marginal tax rates are much lower, if not zero.

Legislative growth in the EITC has introduced more work disincentives into the EITC because the increased credit rates have contributed to the high marginal tax rates that EITC recipients face in the phase-out income range. These high marginal tax rates have created an unintended incentive to either maintain income levels within the plateau range or to cease further work

effort. Staying within the plateau maximizes a taxpayer's EITC, reduces the loss of other government welfare payments, and shields him from the high marginal tax rates present in the phase-out.

The work disincentives caused by the EITC are more pervasive than the work incentives because a greater number of people are in the phase-out income range than are in the phase-in income range. Professor John Scholz of the University of Wisconsin has estimated, using statistics provided in the 1990 Survey of Income and Program Participation, that after the OBRA93 changes are fully implemented in 1996, 23 percent of EITC-eligible taxpayers will be in the phase-in range, while 61 percent will be in the phase-out range.

One reason for the trend highlighted by Professor Scholz is that, under 1996 law, the phase-out income range is almost twice as large as the phase-in income range. The phase-out range, for a taxpayer with two children, extends from \$11,620 to \$28,524 (a \$16,904 income range) while the phase-in range extends from \$0 to \$8,900. Thus, the overall structure of the EITC spreads more work disincentives than incentives.