Earned Income Tax Credit

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Introduction

The earned income tax credit (EITC) is offered at both the federal and state levels as a means of providing assistance to lower-income workers. The credit provides a supplement to the wages and self-employment income of such families and is intended to offset the impact of the social security tax and increase the incentive to work.

The federal earned income tax credit has been provided since 1975. In tax years 1991 through 1993, supplemental credits were also provided for health insurance and children under the age of one. The supplemental credits were eliminated beginning in 1994 and the credit was extended to lower-income families without children as part of the federal Revenue Reconciliation Act of 1993. The credit was simplified under the federal Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), and the income phase-out ranges for married couples applying for the EITC were raised in comparison to the levels for other claimants.

A nonrefundable Wisconsin credit was first enacted in 1983 Wisconsin Act 27. The initial state credit was set at 30% of the federal credit and was available only in 1984 and 1985; the credit was repealed, beginning with the 1986 tax year, in 1985 Wisconsin Act 29. A refundable state earned income credit was reinstated in 1989 Wisconsin Act 31, beginning in tax year 1989. In tax years 1989 through 1993, the state credit was calculated as a percentage of the federal credit. Under 1993 Wisconsin Act 16, a separate, stand-alone state credit was established, effective for tax year 1994. In 1995 Wisconsin Act 27, the state credit was modified to again be calculated as a percentage of the federal credit. The credit percentages for 1995 and 1996 and thereafter were established to provide the same level of funding that would have been provided under Act 16.

Both the federal and Wisconsin credits are refundable; individuals with little or no income tax liability may still receive the credit. In 2003, 14 other states and the District of Columbia offered an earned income credit that was calculated as a percentage of the federal credit. Nine states (Illinois, Indiana, Kansas, Massachusetts, Minnesota, New Jersey, New York, Oklahoma, and Vermont) and the District of Columbia offered a refundable EITC and three states (Iowa, Maine, and Oregon) provided a nonrefundable credit. The state of Maryland offered both a refundable EITC and nonrefundable EITC (taxpayers could, in effect, claim one or the other). Finally, Rhode Island offered a credit that was primarily nonrefundable but had a small refundable component.

The remainder of this paper presents detailed descriptions and eligibility requirements of the federal and state earned income credits, program expenditure data regarding the Wisconsin credit, and a discussion of policy considerations relating to the credit.

Federal Earned Income Tax Credit

Calculation of the Credit

The federal EITC is a refundable credit based on income and family size. In addition, starting in 2002, the credit is also affected by filing status.

The EITC is generally based on earned income, although the credit can also be affected by adjusted gross income (AGI). For claimants whose only income is earned income, the EITC is calculated based on a percentage of earned income up to certain thresholds. The credit gradually increases until earned income reaches the first threshold amount, at which a claimant receives the maximum allowable credit. This income level is referred to as the maximum credit income.

Such claimants are eligible for the maximum credit over a range of income levels, starting at the maximum credit income referred to above and ending at a specified phase-out income. For such a claimant whose income exceeds the phase-out income, the credit is gradually reduced as follows: (a) a phase-out rate is applied to the amount by which income exceeds the phase-out income; and (b) the resulting figure is subtracted from the maximum credit to arrive at the allowable credit for a particular claimant. The level of income at which the credit is eliminated is referred to as the maximum income level.

If a claimant has unearned income in addition to earned income, the credit is initially calculated using only earned income, but the phase-out calculation is made using AGI or earned income, whichever is greater. The components of earned income are described below in the section on "Income Used in Determining the Credit."

The maximum credit income, phase-out income, and maximum income amounts are adjusted each year for changes in inflation; the credit percentages and phase-out rates remain the same. The parameters for the federal EITC for tax year 2004 are shown in Table 1.

As shown in the footnote to Table 1, the phase-out income and maximum income amounts are higher for married-joint filers than for other filers. Prior to tax year 2001, filing status was not a factor in the EITC computation. However, EGTRRA provided higher phase-out income levels for joint filers in order to reduce the marriage penalty experienced by married individuals claiming the EITC.

Table 1: 2004 Federal Credit Provisions*

	No Children	One Child	2 or More Children
Credit Percentage	7.65%	34.0%	40.0%
Maximum Credit Income	$5,100	$7,660	$10,750
Maximum Credit	390	2,604	4,300
Phase-Out Income	6,390	14,040	14,040
Phase-Out Rate	7.65%	15.98%	21.06%
Maximum Income	11,490	30,338	34,458

*For married-joint filers, the phase-out incomes and maximum income levels exceed those shown above by $1,000.

The amounts by which the phase-out incomes for joint filers exceed those for other filers are as follows: (a) $1,000 for tax years beginning in 2002, 2003, and 2004; (b) $2,000 for tax years beginning in 2005, 2006, and 2007; and (c) $3,000 for tax years beginning after 2007. For years after 2008, the $3,000 will be adjusted annually for inflation.

Table 2 shows the federal earned income tax

Table 2: 2004 Federal Credit Amounts
Single and Head-of-Household Filers

Earned Income*	No Children	One Child	2 or More Children
$0	$0	$0	$0
2,000	153	680	800
4,000	306	1,360	1,600
6,000	390	2,040	2,400
8,000	267	2,604	3,200
10,000	114	2,604	4,000
12,000	0	2,604	4,300
14,000	0	2,604	4,300
16,000	0	2,291	3,887
18,000	0	1,971	3,466
20,000	0	1,652	3,045
22,000	0	1,332	2,624
24,000	0	1,012	2,202
26,000	0	693	1,781
28,000	0	373	1,360
30,000	0	54	939
32,000	0	0	518
34,000	0	0	96
36,000	0	0	0

*For claimants other than married-joint filers, the credit is based on the greater of earned income or AGI beginning at $6,390 of income for claimants with no children and $14,040 of income for claimants with one or more children. The credit is eliminated at the following income levels: $11,490 for no children, $30,338 for one child, and $34,458 for two or more children.

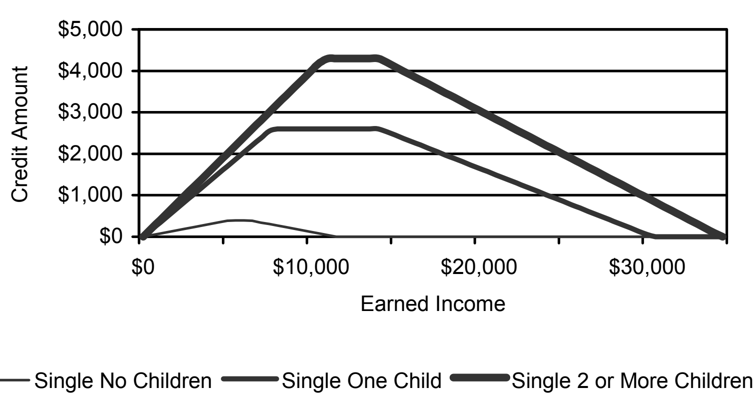
Table 3: 2004 Federal Credit Amounts
Married-Joint Filers

Earned Income*	No Children	One Child	2 or More Children
$0	$0	$0	$0
2,000	153	680	800
4,000	306	1,360	1,600
6,000	390	2,040	2,400
8,000	343	2,604	3,200
10,000	190	2,604	4,000
12,000	37	2,604	4,300
14,000	0	2,604	4,300
16,000	0	2,451	4,098
18,000	0	2,131	3,677
20,000	0	1,811	3,255
22,000	0	1,492	2,834
24,000	0	1,172	2,413
26,000	0	853	1,992
28,000	0	533	1,571
30,000	0	213	1,149
32,000	0	0	728
34,000	0	0	307
36,000	0	0	0

*For married-joint filers, the credit is based on the greater of earned income or AGI beginning at $7,390 of income for claimants with no children and $15,040 of income for claimants with one or more children. The credit is eliminated at the following income levels: $12,490 for no children, $31,338 for one child, and $35,458 for two or more children.

credits for 2004 at various levels of income for filers who are single or heads-of-households (the credit is not available to married individuals filing separate returns). Table 3 shows similar information for married couples filing joint returns.

Figure 1: 2004 Federal Earned Income Tax Credit
Single and Head-of-Household



As shown in these tables, the credit for families with one child is calculated as 34% of earned income until income equals $7,660. If income is between $7,660 and $14,040 ($15,040 for joint filers), the maximum credit of $2,604 is provided. Once income exceeds $14,040 ($15,040 for joint filers), the credit is phased-out at a rate of 15.98% (the credit is reduced by 15.98¢ for every additional $1 in income) until it is eliminated when income exceeds $30,338 ($31,338 for joint filers). The same credit structure exists for the other family sizes. This pattern is illustrated in Figure 1, which shows the federal credit for 2004 for single and head-of-household claimants. [The pattern for married-joint filers would be identical to that shown in Figure 1. However, the income levels at which the credit would begin to be phased out and at which the credit would be completely phased out would exceed those shown on Figure 1 by $1,000.]

Income Used in Determining the Credit

Components of Earned Income. The following types of income are included in earned income for purposes of the EITC: wages; salaries; tips; and other forms of taxable employee compensation (which include net earnings from self-employment, strike benefits, long-term disability benefits received before retirement from an employer-provided plan, and income received as a statutory employee). In addition, for tax years 2004 and 2005, a taxpayer may choose to either include in, or exclude from, earned income combat pay that is excluded from gross income.

The definition of earned income excludes interest, dividends, social security and railroad retirement benefits, pensions and annuities, welfare benefits, alimony, child support, nontaxable foster care payments, unemployment compensation, veterans' benefits, workers' compensation, certain scholarship or fellowship grants, and income of nonresident aliens not connected with U.S. business.

Earned income also excludes amounts received for services from prison inmates while in prison and amounts received for service performed in work activities and from certain community service programs under the federal temporary assistance for needy families (TANF) program. Participants in the Wisconsin Works (W-2) program who are in unsubsidized employment and trial jobs are paid a wage, which is counted as earned income under the EITC. In contrast, the W-2 program also provides cash grants to community service job and transitional placement participants, which are not considered earned income under the credit.

Prior to 2002, earned income had included the following nontaxable items in addition to the components of earned income under current law: voluntary salary deferrals, mandatory contributions to a state or local retirement plan, nontaxable combat zone compensation and military allowances, meals, and lodging provided by an employer, housing allowances or rental value of parsonage for the clergy, employer-provided dependent care and adoption benefits, and educational assistance benefits. EGTRRA provided that these items are excluded from earned income. However, the Working Families Tax Relief Act of 2004 provided that a claimant of the EITC may choose to either include in, or exclude from, earned income combat pay that is excluded from gross income for tax purposes. This provision applies for taxable years ending after October 4, 2004, and before January 1, 2006.

AGI Measure. If a claimant's income exceeds the phase-out income amount, then the greater of AGI or earned income is used to calculate the credit. Prior to 2002, if a claimant's income exceeded the phase-out income level, then the credit amount was based on the greater of earned income and a modified AGI measure.

The modified AGI figure used under prior law required adding back the following amounts to AGI: (a) net capital losses if greater than zero; (b) net losses from trusts and estates; (c) net losses from nonbusiness rents and royalties; (d) 75% (50% before 1998) of net losses from business (unless the loss was from the performance of services as an employee); and (e) tax-exempt interest and nontaxable distributions from pensions, annuities, and IRAs (beginning in 1998).

The current use of AGI rather than modified AGI is the same method that was in place prior to 1996.

Disqualified Income. Beginning with tax year 1996, the credit is denied to individuals having disqualified income in excess of a certain limit. The disqualified income limit is $2,650 for 2004 and is adjusted each year for inflation. Disqualified income is defined as taxable and nontaxable interest income, dividends, net income from nonbusiness rents and royalties, capital gain net income, and net passive income (if greater than zero) that is not self-employment income.

In a ruling issued on November 23, 1998, the Internal Revenue Service (IRS) announced that gains realized on the sale of property used in a trade or business are not counted as investment income. Prior to the ruling, a number of individuals were unable to claim the EITC due to the limitation on disqualified income, particularly farmers who had income from the sale of livestock.

Non-Financial Criteria

In order to claim the federal EITC, an individual must either have a qualifying child or meet the following requirements: (a) not be the dependent or a qualifying child of another taxpayer; (b) be at least 25 years old and not more than 65 before the end of the tax year; and (c) have resided in the U.S. for more than half of the year. A qualifying child must meet all of the following conditions:

1. Relationship. A qualifying "child," for purposes of the EITC, may be a natural or adopted child, stepchild, sibling, or stepsibling of the claimant, or a descendant of any of these. In addition, a qualifying child may be the claimant's eligible foster child.

Prior to 2002, it was required that the child be the natural child, adopted child, grandchild, step-child, or eligible foster child of the claimant. Brothers, sisters, nieces, and nephews could qualify as eligible foster children. Effective with 2002, brothers, sisters, nieces, and nephews are grouped as qualifying children (along with children and step-children), rather than as eligible foster children.

2. Age. At the end of the year, the child must be: (a) under 19 years old; (b) a full-time student under the age of 24; or (c) any age and totally and permanently disabled.

3. Residence. The child must have lived with the taxpayer for more than six months during the year (prior to 2002, for the entire year if a foster child). A child who is born or dies during the year qualifies if the child lived with the claimant during the part of the year the child was alive.

Required Returns

In order to receive the federal credit, claimants must file an income tax return (whether or not they would otherwise be required to file) and a separate earned income credit schedule that provides information on qualifying children. Individuals must provide the name and age of each child and the child's social security number.

Advance Payment

Employees with qualifying children who expect to qualify for the EITC can elect to receive payment of the federal credit in advance with their regular pay by filing a form with their employer (employees without children are not eligible for advance payment). Advance payment is made by the employer, based on tables provided by the IRS, out of the employee's withheld income tax and the social security payroll taxes of the employee and employer that would otherwise be remitted to the federal government. At the end of the year, the advance payments are reported on the employee's W-2 wage statement and entered as a tax due amount on the employee's income tax return. The full credit is then calculated without consideration of the advance payments. If the credit exceeds the advance payments, a refund is provided to the taxpayer. If the advance payments exceed the credit, the claimant must repay the difference.

Advance payment of the credit is limited to 60% of the maximum credit available to a claimant with one qualifying child. Due to the limitation, the maximum advance payment for tax year 2004 was $1,562 (60% of $2,604), or approximately $130 per month, regardless of family size. This provision is intended to prevent recipients of advance payments from incurring a large tax liability at the end of the year if their income had increased and they no longer qualified for the credit. The IRS is directed to notify eligible taxpayers of the advance payment provisions and employers are required to notify their employees about the availability of advance payments of the credit.

Historical data regarding the federal earned income credit is presented in Appendix 1.

State Earned Income Tax Credit

The state earned income tax credit is calculated as a percentage of the federal credit and is claimed on Wisconsin's individual income tax form. The credit is similar to the federal EITC in that it varies by income and family size. Appendix 2 outlines the history of the state earned income tax credit.

Table 4: 2004 State Credit Provisions

	One Child	Two Children	3 or More Children
Percentage of Federal Credit	4%	14%	43%
Maximum State Credit	$104	$602	$1,849

Table 5: 2004 State Credit Amounts Single and Head-of-Household Filers

Earned Income	One Child	Two Children	3 or More Children
$0	$0	$0	$0
2,000	27	112	344
4,000	54	224	688
6,000	82	336	1,032
8,000	104	448	1,376
10,000	104	560	1,720
12,000	104	602	1,849
14,000	104	602	1,849
16,000	92	544	1,672
18,000	79	485	1,490
20,000	66	426	1,309
22,000	53	367	1,128
24,000	40	308	947
26,000	28	249	766
28,000	15	190	585
30,000	2	131	404
32,000	0	72	223
34,000	0	13	41
36,000	0	0	0

Table 6: 2004 State Credit Amounts Married-Joint Filers

Earned Income	One Child	Two Children	3 or More Children
$0	$0	$0	$0
2,000	27	112	344
4,000	54	224	688
6,000	82	336	1,032
8,000	104	448	1,376
10,000	104	560	1,720
12,000	104	602	1,849
14,000	104	602	1,849
16,000	98	574	1,762
18,000	85	515	1,581
20,000	72	456	1,400
22,000	60	397	1,219
24,000	47	338	1,038
26,000	34	279	856
28,000	21	220	675
30,000	9	161	494
32,000	0	102	313
34,000	0	43	132
36,000	0	0	0

Table 4 shows the state credit percentages and maximum credit amounts for 2004. The percentages shown in the table apply for all tax years after 1996. However, the maximum credit amounts change each year as the federal credit structure changes due to indexing for inflation. Families without children and part-year residents are not eligible for the state EITC. Advance payment is not provided at the state level.

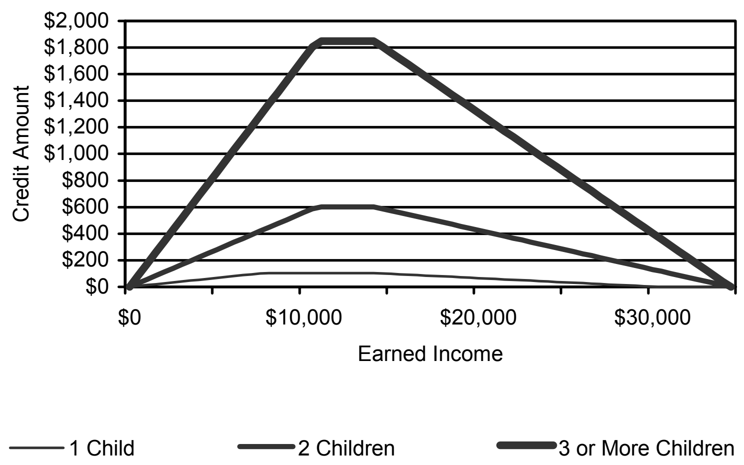
The 2004 state credits for taxpayers at various income levels are outlined in Tables 5 and 6. Table 5 shows the state credits by income level for single and head-of-household claimants, while Table 6 shows the credits by income levels for married-joint filers.

The family size adjustment is significantly greater at the state level than under federal law. The maximum state credit for families with three or more children is more than 17 times the maximum one-child credit and the maximum credit for two children is nearly six times the one-child credit. At the federal level, the maximum credit for two or more children is only 1.65 times the maximum one-child credit.

Because the state credit is calculated as a percentage of the federal credit, the state earned income credit exhibits the same pattern as that seen for the federal credit. For families with one child, the credit increases until income reaches $7,660, the credit levels off at the maximum amount ($104) until income reaches $14,040 ($15,040 for joint filers) and then decreases until it reaches zero at income of $30,338 or more ($31,338 or more for joint filers).

These characteristics are depicted in Figure 2, which shows the state earned income tax credit for 2004 for claimants other than married-joint filers. The pattern for married-joint filers would be identical to that shown in Figure 2, except that the phase-out income and maximum income levels would exceed those shown in Figure 2 by $1,000.

Figure 2: 2004 State Earned Income Tax Credit Single and Head-of-Household



Wisconsin Program Expenditures

The state earned income tax credit is currently paid from the following sources: (a) a sum sufficient, general fund appropriation; (b) federal funding from the temporary assistance for needy families (TANF) program; and (c) revenue from the segregated utility public benefits trust fund.

TANF funding was first used to cover a portion of the cost of the EITC in the 1998-99 fiscal year. According to federal regulations for the TANF program, TANF funding may be used to cover the share of the EITC that is refunded to the claimant (rather than used to reduce the claimant's income tax liability). However, TANF funds may not be used to provide the credit to certain legal immigrants. Based on the federal requirements and on past experience with refundable credits, and allowing for amounts paid to legal immigrants, it had been estimated that slightly more than 80% of the EITC's costs can be paid with TANF funds. As a result, the state used TANF funding for approximately 80% of the EITC's cost from 1998-99, the first year for which it became clear that federal regulations permitted the use of TANF funds for this purpose, through 2002-03.

Under 2003 Wisconsin Act 33, the 2003-05 biennial budget, TANF funds for the EITC were increased to 82% of the total estimated cost of the credit for 2003-04 and 2004-05. Based on recent historical data, it was assumed that increasing the TANF funds to 82% of the total cost would still satisfy the federal regulations with respect to permitted use of TANF funds.

In addition to increasing the share of the cost of the EITC paid for with TANF funds, Act 33 provided that a small portion of the EITC would be funded with revenue from the segregated utility public benefits trust fund in 2004-05. The SEG funding was provided through a new, annual appropriation. Based on Act 33, it was estimated that 82.0% of the cost of the EITC in 2004-05 would be paid for with TANF funds, that 17.7% would be funded through the sum sufficient GPR appropriation, and that 0.3% would be funded through the new SEG appropriation.

Table 7 shows historical state EITC payments by fiscal year. In interpreting the data in Table 7, it should be noted that approximately $2.0 million in credits were processed and accounted for in 1997-98 that should have been processed in 1996-97. If the amounts in Table 7 are adjusted to reflect this processing delay, the 1996-97 amount would be $61.5 million (an increase of 2.7% over the prior year) and the 1997-98 amount would be $62.0 million (an increase of 0.8% over the prior year). Also, the decrease in 1998-99 would be 2.6% instead of 5.6%.

Starting in 1996-97 (and using the adjusted growth rates for 1996-97 and 1997-98 described above), growth in the state EITC over the next years slowed significantly compared to the growth of the three previous years. A number of program changes were made in 1996, such as the requirement that certain losses be added back to AGI when calculating the credit, and the disqualified income limit, which contributed to the slower growth rates. In addition, federal enforcement efforts were increased through a requirement that children's social security numbers be submitted with EITC claims.

Table 7: Historical Wisconsin EITC Expenditures ($ in Millions)

Fiscal Year	GPR	TANF	Total	% Change
1993-94	$40.3	$0.0	$40.3	16.5%
1994-95	49.8	0.0	49.8	23.6
1995-96	59.9	0.0	59.9	20.3
1996-97	59.5	0.0	59.5	-0.7
1997-98	64.0	0.0	64.0	7.6
1998-99	12.4	48.0	60.4	-5.6
1999-00*	11.5	48.3	59.8	-1.0
2000-01	11.9	49.9	61.8	3.3
2001-02	11.5	51.2	62.7	1.5
2002-03	17.7	54.2	71.9	14.7
2003-04	15.1	57.9	73.0	1.5

*During 1999-00, $51.0 million in TANF funding was budgeted and expended for the EITC. However, an adjustment was made in 2000-01 to reduce the total TANF amount for 1999-00 to $48.3 million to comply with federal requirements.

Following several years of relatively slower growth, which lasted through 2001-02, the cost of the EITC increased significantly in 2002-03, growing at a rate of 14.7%. Two factors are likely to have contributed to this growth: (a) a weaker economy, under which some Wisconsin residents would have earned less income than in prior years, making them eligible for the EITC even if they had not been eligible previously; and (b) recent federal law changes that, effective with tax year 2002, modified the definition of earned income and increased the phase-out thresholds for married-joint filers, thereby increasing the range of income over which claimants were eligible for the EITC. As seen in Table 7, the growth rate in 2003-04 returned to a rate more typical in recent years, with the cost of the credit increasing by 1.5%.

Table 8 shows, by tax year, the number of EITC claimants, total credit

Table 8: Historical Wisconsin EITC Claimants

Tax Year	Count	% Change	Amount (Millions)	% Change	Average	% Change
1993	172,425	3.9%	$38.7	15.2%	$224	10.9%
1994	171,260	-0.7	49.2	27.1	287	28.1
1995	191,019	11.5	54.8	11.4	287	0.0
1996	195,980	2.6	58.2	6.2	297	3.5
1997	194,023	-1.0	60.8	4.5	313	5.4
1998	189,102	-2.5	59.9	-1.5	317	1.3
1999	185,442	-1.9	59.1	-1.3	318	0.3
2000	185,499	0.0	59.1	0.0	318	0.0
2001	189,586	2.2	60.3	2.2	318	0.0
2002	210,624	11.1	69.0	14.4	328	3.1
2003	214,164	1.7	69.8	1.2	326	-0.6

Table 9: State Earned Income Tax Credit in 2003 by Adjusted Gross Income

Adjusted Gross Income Amount	Count	Percent of Count	Credit Amount	Percent of Amount	Average Credit
Under $5,000	23,540	11.0%	$4,304,838	6.2%	183
5,000 – 10,000	31,127	14.5	11,408,100	16.3	367
10,000 – 15,000	34,886	16.3	18,441,880	26.4	529
15,000 – 20,000	38,387	17.9	16,161,910	23.2	421
20,000 – 25,000	39,985	18.7	11,923,944	17.1	298
25,000 or more	46,239	21.6	7,525,263	10.8	163
TOTAL	214,164	100.0%	$69,765,935	100.0%	326

Source: 2003 Individual Income Tax Aggregate Data amounts, and the average EITC since 1993. Table 9 presents the distribution of the state earned income credit for tax year 2003 by Wisconsin adjusted gross income. As shown in these tables, 214,164 families claimed $69.8 million under the state earned income tax credit in 2003. Almost half of the total credit for 2003 was received by households with income between $10,000 and $20,000; 49.6% of the total benefit went to the 34.2% of claimants in this range of income. Claimants with AGI under $10,000 received 22.5% of the benefit and made up 25.5% of the credit recipients, while the remaining 27.9% of the benefit was received by the 40.3% of claimants with AGI of $20,000 or more.

Table 10 shows the distribution of the 2003 state credit by the number of children. As Table 10 indicates, the state credit is targeted to families with three or more children. These households made up 18.1% of the claimants, but received 55.8% of the program's benefits in 2003. In contrast, families with one qualifying child accounted for 47.2% of the claimants, but received 9.1% of the benefits. The average credit was $63 for claimants with one child, $330 for two children, and $1,005 for three or more children.

The total credit amounts shown in Tables 8, 9, and 10 differ from the amount in Table 7 because Tables 8, 9, and 10 reflect tax year aggregate data and Table 7 shows fiscal year data.

Policy Considerations

Prior to 1975, assistance to the poor was directed primarily to those who did not have income from work--the elderly, the disabled, and children in families with an absent parent. The earned income credit provides assistance to the working poor through a refundable tax credit that acts as a wage supplement.

At the federal level, the earned income tax credit was originally established as a "work bonus" and was rationalized, in part, as a means of offsetting the impact of the social security tax on low-income families. An additional goal was to increase the incentive to work for such families and lessen the inequities between the working poor and recipients of other categorical aid programs such as aid to families with dependent children (now TANF). Further, by reducing the tax burden of low-income persons, the progressivity of the income tax structure was increased.

In the last half of the 1990s, revisions were made to the federal credit in an attempt to ensure that the credit was directed to lower-income families. Starting with tax year 1996, the disqualified income test was instituted, as was the modification

Table 10: State Earned Income Tax Credit in 2003 by Number of Children

Number of Children	Count	Percent of Count	Credit Amount	Percent of Amount	Average Credit
One	101,156	47.2%	$6,326,885	9.1%	$63
Two	74,237	34.7	24,475,775	35.1	330
Three or more	38,771	18.1	38,963,275	55.8	1,005
TOTAL	214,164	100.0%	$69,765,935	100.0%	$326

Source: 2003 Individual Income Tax Aggregate Data to AGI for purposes of calculating the credit in the phase-out range of income. Effective with the 1998 tax year, the definition of earned income was expanded to include tax-exempt interest and nontaxable distributions from pensions, annuities and IRAs. However, as described in this paper under "Income Used in Determining the Credit," the modifications to AGI for purposes of calculating the credit and the inclusion of nontaxable income as earned income have been eliminated in order to simplify the credit calculation.

At the state level, the earned income credit provides income tax relief to low-income families in a manner that is less costly than increasing the standard deduction or personal exemptions -- provisions that could provide a benefit to taxpayers at higher income levels. Also, because it is refundable, the state credit can be viewed as an offset to state and local sales and property taxes. As noted, the state credit incorporates a proportionately greater family size adjustment than the federal provisions.

Other methods to assist the working poor include education and job training, increases in the minimum wage, subsidized child care for low-income workers, and direct grants. The earned income credit is believed to possess several advantages over these programs. First, funding is targeted directly to those in need of assistance. In addition, administrative efficiency is achieved through the use of the existing income tax system. Finally, the credit's association with the tax system may lessen any stigma associated with traditional welfare-type grant programs.

However, there are a number of criticisms of the earned income credit. First, it is argued that appropriate job training and greater employment opportunities are more important factors in promoting the employment of low-income individuals. In addition, the federal and state credits do not directly account for other wealth of the claimant or non-taxed income. Further, higher benefit amounts require a greater phase-out rate in order to exclude higher-income families from eligibility. This results in a higher effective marginal tax rate on recipients within the phase-out income range and may provide a disincentive to earn additional income from wages or self-employment.

It is also argued that the credit may discourage marriage in certain situations. For example, two unmarried individuals might each qualify for the credit if their incomes were considered separately yet not qualify if their incomes were combined on a joint tax return. As noted, the phase-out ranges for joint filers have been increased over those for single individuals, which reduces, but does not eliminate, this aspect of the marriage penalty.

Another aspect of the marriage penalty is the way in which the size of the EITC varies with the number of dependent children. Because the federal EITC does not increase when a filer has more than two dependent children, a marriage that creates a family with more than two children may result in a lower EITC than if the individuals had remained unmarried. (The same would be true with the state EITC if a combined family resulted in more than three dependent children).

Noncompliance (inappropriately claimed credits) has also been a significant problem with the federal credit. In order to address noncompliance, federal law now requires claimants to provide social security numbers for themselves and their children when filing for the credit. This is intended to reduce fraudulent claims by individuals who do not have qualifying children and individuals who are not authorized to work in the U.S.

APPENDIX 1

Federal Earned Income Tax Credit History

A. Tax Years 1975 Through 1990	1975-1978	1979-1984	1985-1986	1987	1988	1989	1990
Credit Percentage	10.00%	10.00%	11.00%	14.00%	14.00%	14.00%	14.00%
Maximum Credit Income	$4,000	$5,000	$5,000	$6,075	$6,225	$6,500	$6,810
Maximum Credit	400	500	550	851	874	910	953
Phase-Out Income Threshold	4,000	6,000	6,500	6,925	9,850	10,250	10,730
Maximum Income	8,000	10,000	11,000	15,432	18,576	19,340	20,264
Phase-Out Rate	10.00%	12.50%	12.22%	10.00%	10.00%	10.00%	10.00%

	1991			
	Basic Credit		Supplemental Credits	
B. Tax Years 1991 Through 1993	One Child	2 or More Children	Young Child	Health Insurance
Credit Percentage	16.70%	17.30%	5.00%	6.00%
Maximum Credit Income	$7,140	$7,140	$7,140	$7,140
Maximum Credit	1,192	1,235	357	428
Phase-Out Income Threshold	11,250	11,250	11,250	11,250
Maximum Income	21,250	21,250	21,250	21,250
Phase-Out Rate	11.93%	12.36%	3.57%	4.29%

	1992			
	Basic Credit		Supplemental Credits	
B. Tax Years 1991 Through 1993	One Child	2 or More Children	Young Child	Health Insurance
Credit Percentage	17.60%	18.40%	5.00%	6.00%
Maximum Credit Income	$7,520	$7,520	$7,520	$7,520
Maximum Credit	1,324	1,384	376	451
Phase-Out Income Threshold	11,840	11,840	11,840	11,840
Maximum Income	22,370	22,370	22,370	22,370
Phase-Out Rate	12.57%	13.14%	3.57%	4.29%

	1993			
	Basic Credit		Supplemental Credits	
B. Tax Years 1991 Through 1993	One Child	2 or More Children	Young Child	Health Insurance
Credit Percentage	18.50%	19.50%	5.00%	6.00%
Maximum Credit Income	$7,750	$7,750	$7,750	$7,750
Maximum Credit	1,434	1,511	388	465
Phase-Out Income Threshold	12,200	12,200	12,200	12,200
Maximum Income	23,050	23,050	23,050	23,050
Phase-Out Rate	13.22%	13.93%	3.58%	4.29%

APPENDIX 1 (continued)

Federal Earned Income Tax Credit History

C. Tax Years 1994 Through 2004	No Children	One Child	2 or More Children	No Children	One Child	2 or More Children	No Children	One Child	2 or More Children
		1994			1995			1996	
Credit Percentage	7.65%	26.30%	30.00%	7.65%	34.00%	36.00%	7.65%	34.00%	40.00%
Maximum Credit Income	$4,000	$7,750	$8,425	$4,100	$6,160	$8,640	$4,220	$6,330	$8,890
Maximum Credit	306	2,038	2,528	314	2,094	3,110	323	2,152	3,556
Phase-Out Income Threshold	5,000	11,000	11,000	5,135	11,290	11,290	5,280	11,610	11,610
Maximum Income	9,000	23,760	25,300	9,230	24,396	26,673	9,500	25,078	28,495
Phase-Out Rate	7.65%	15.98%	17.68	7.65%	15.98%	20.22%	7.65%	15.98%	21.06%
		1997			1998			1999	
Credit Percentage	7.65%	34.00%	40.00%	7.65%	34.00%	40.00%	7.65%	34.00%	40.00%
Maximum Credit Income	$4,340	$6,510	$9,140	$4,460	$6,680	$9,390	$4,530	$6,800	$9,540
Maximum Credit	332	2,210	3,656	341	2,271	3,756	347	2,312	3,816
Phase-Out Income Threshold	5,430	11,930	11,930	5,570	12,260	12,260	5,670	12,460	12,460
Maximum Income	9,770	25,760	29,290	10,030	26,473	30,095	10,200	26,928	30,580
Phase-Out Rate	7.65%	15.98%	21.06	7.65%	15.98%	21.06%	7.65%	15.98%	21.06%
		2000			2001			2002*	
Credit Percentage	7.65%	34.00%	40.00%	7.65%	34.00%	40.00%	7.65%	34.00%	40.00%
Maximum Credit Income	$4,610	$6,920	$9,720	$4,760	$7,140	$10,020	$4,910	$7,370	$10,350
Maximum Credit	353	2,353	3,888	364	2,428	4,008	376	2,506	4,140
Phase-Out Income Threshold	5,770	12,690	12,690	5,950	13,090	13,090	6,150	13,520	13,520
Maximum Income	10,380	27,413	31,152	10,710	28,281	32,121	11,060	29,201	33,178
Phase-Out Rate	7.65%	15.98%	21.06%	7.65%	15.98%	21.06%	7.65%	15.98%	21.06%
		2003*			2004*				
Credit Percentage	7.65%	34.00%	40.00%	7.65%	34.00%	40.00%			
Maximum Credit Income	$4,990	$7,490	$10,510	$5,100	$7,660	$10,750			
Maximum Credit	382	2,547	4,204	390	2,604	4,300			
Phase-Out Income Threshold	6,240	13,730	13,730	6,390	14,040	14,040			
Maximum Income	11,230	29,666	33,692	11,490	30,338	34,458			
Phase-Out Rate	7.65%	15.98%	21.06%	7.65%	15.98%	21.06%			

*Starting with tax year 2002, the phase-out incomes and maximum income levels for married-joint filers exceed those shown in Appendix 1 by $1,000.

APPENDIX 2

State Earned Income Tax Credit History

	1984	1985	1986-1988	1989	1990	1991	1992	1993	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
A. Tax Years 1984-2001*																		
Percentage of Federal Credit																		
One Child	30%	30%	None	5%	5%	5%	5%	5%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%
Two Children	30%	30%	None	25%	25%	25%	25%	25%	16%	14%	14%	14%	14%	14%	14%	14%	14%	14%
Three or More Children	30%	30%	None	75%	75%	75%	75%	75%	50%	43%	43%	43%	43%	43%	43%	43%	43%	43%
Maximum State Credit																		
One Child	$150	$165	None	$46	$48	$60	$66	$72	$84	$86	$88	$91	$92	$94	$97	$100	$102	$104
Two Children	150	165	None	228	238	309	346	378	498	498	512	526	534	544	561	580	589	602
Three or More Children	150	165	None	683	715	926	1,038	1,133	1,555	1,529	1,572	1,615	1,641	1,672	1,723	1,780	1,808	1,849
Refundable	No	No	None	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

	One Child	Two Children	3 or More Children
B. Tax Year 1994*			
Credit Percentage	1.15%	6.25%	18.75%
Maximum Credit Income	$7,980	$7,980	$7,980
Maximum Credit	92	499	1,496
Phase-Out Income Threshold	12,570	12,570	12,570
Maximum Income	23,740	23,740	23,740
Phase-Out Rate	0.82%	4.47%	13.40%
Refundable	Yes	Yes	Yes

*The credit for tax years 1984 through 1993 and tax years 1995 and after is calculated as a percentage of the federal credit. In 1994, a stand-alone state credit was provided.