

# **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 reduces work disincentives caused by interactions with income and payroll taxes and the state's welfare program. Like the EITC, the WFC is refundable.

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## **Contents**

<a href="#">How the Federal Earned Income Tax Credit Works</a> .....	3
<a href="#">How Filers Claim the Credit</a> .....	6
<a href="#">The Minnesota Working Family Credit</a> .....	8
<a href="#">The Tax Credits and Poverty</a> .....	15
<a href="#">The Tax Credits and Work Effort</a> .....	18
<a href="#">Appendix: Earned Income Tax Credits in Other States, 2003</a> .....	24

## List of Tables and Figures

### Tables

Table 1: Maximum Federal Earned Income Tax Credit, 2004 .....	3
Table 2: Federal Earned Income Tax Credit Phaseout, 2004 .....	4
Table 3: Minnesota Working Family Credit, 2004.....	9
Table 4: Effect of WFC Restructuring on Net Annual Resources, Single Parent with Two Children, 1998.....	22
Table 5: Effect of WFC Restructuring on Net Annual Resources, Single Parent with Two Children, 2004.....	23

### Graphics and Maps

Figure 1: Minnesota Working Family Credit Recipients, 2001.....	10
Figure 2: Percentage of Returns Claiming Minnesota Working Family Credit, 2001 .....	11
Figure 3: Refundability of Working Family Credit, 2000 .....	13
Figure 4: WFC Recipients by Number of Qualifying Children and Marital Status, 2000 .....	14
Figure 5: Effect of EITC and WFC on Income: Single Parent and Married Couple Families, One Full-Time Minimum Wage Worker, 2003 .....	17
Figure 6: EITC and WFC Ranges, Filers with One Qualifying Child, 2003.....	18

## 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 phase-out 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, and two 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 2004.

Table 1:

### Maximum Federal Earned Income Tax Credit, 2004

	Maximum Earned Income	x	Credit Percentage	=	Maximum Credit
No Qualifying Children	\$5,100	x	7.65%	=	\$390
1 Qualifying Child	7,660	x	34.00	=	2,604
2 or More Qualifying Children	10,750	x	40.00	=	4,300

Note: Dollar amounts are indexed to projected changes in the consumer price index.

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

The credit provides separate phase-out thresholds and phase-out 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 of 2001 provided for higher phase-out thresholds for married couples filing joint returns than for other taxpayers. This change is intended to alleviate the marriage penalty imposed under the earned income tax credit.<sup>1</sup> Table 2

<sup>1</sup> Under the provisions of EGTRRA 2001, the income level at which the credit begins to phase out is 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. The increased amount is indexed for inflation beginning in 2009.

shows the phase-out thresholds, rates, and income at which the credit is fully phased out in 2004, for married couples and for all other filers.

Table 2:  
**Federal Earned Income Tax Credit Phaseout, 2004**

	<b>Phase-out Rate</b>		<b>Phase-out Threshold</b>	<b>Income at which credit is fully phased out</b>
<b>Married couples</b>				
No Qualifying Children	7.65%	of income over	\$7,390	\$12,490
1 Qualifying Child	15.98	of income over	15,040	31,338
2 or More Qualifying Children	21.06	of income over	15,040	35,458
<b>All other filers</b>				
No Qualifying Children	7.65%	of income over	\$6,390	\$11,490
1 Qualifying Child	15.98	of income over	14,040	30,338
2 or More Qualifying Children	21.06	of income over	14,040	34,458
Note: Dollar amounts for the phase-out thresholds are estimates. These amounts are indexed to projected changes in the consumer price index.				

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A marriage penalty may occur under the earned income credit when a single parent eligible for the credit gets married.<sup>2</sup> 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 phase-out range. For example, a single parent with one qualifying child and earned income of \$10,000 qualifies for the maximum credit of \$2,604. 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 \$1,652 (the \$2,604 maximum credit, minus 15.98 percent of income over the phase-out threshold of \$14,040). The couple experiences a marriage penalty of \$953, since the credit is \$953 smaller than what the single parent qualified for before marriage. Increasing the phase-out threshold by \$1,000 for married couples increases this couple's credit to \$1,811 (the \$2,604 maximum credit, minus 15.98 percent of income over the extended phase-out threshold of \$15,040), and reduces the marriage penalty to \$793.

<sup>2</sup> 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," 53 Nat. Tax J. 1107, 1131 (2000) (assumption that couples continue to live together). This study does not reflect the EGTRRA changes.

**Filers with more than \$2,650 in disqualified income are not eligible for the EITC in tax year 2004.**

“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 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 2004, the standard deduction and exemption amounts ensure that a married couple with two dependents will owe no federal income tax until gross income exceeds \$21,900. A head of household filer with one dependent will owe no tax until gross income exceeds \$13,350. Many EITC recipients have gross incomes below these levels; they receive the full credit amount for which they qualify as a refund.

## How Filers Claim the Credit

Most filers claim the credit when they file their income tax returns. They must file either form 1040 or 1040A and complete schedule EIC. The Internal Revenue Service (IRS) will calculate the credit amount for filers who only wish to complete the front of schedule EIC.

### **In 2004, the IRS will operate a pilot “precertification” project.**

The pilot project is an attempt to reduce what studies have shown to be a high rate of erroneous claims for children who do not meet the definition of “qualifying child” for purposes of claiming the credit. In the precertification pilot, 25,000 taxpayers identified by the IRS as at high risk of filing an erroneous claim will be asked to provide verification that children for whom the credit is claimed resided with them for at least half of the tax year. Precertification for the 2004 EITC will occur during the 2003 filing season. This will allow the 70 percent of EITC filers who use a tax preparer to obtain help in complying with the precertification requirements.

### **The credit may be claimed as an advance payment from the employer.**

Individuals may complete a supplement to form W-4 and receive an estimated credit amount as an offset to FICA (Social Security) tax or an addition to wages throughout the year. The advance payment option provides a way for the credit to offset ongoing household costs.

### **Very few people use the advance payment option—less than 1 percent in 2001.<sup>3</sup>**

The advance payment option apparently is not widely known or is not attractive to filers. A series of town meetings conducted by the Minnesota Departments of Revenue and Human Services in 1995 indicate that many potential recipients did not know about the advance payment option. Others were concerned about receiving too much in advance payments and having to pay back the excess. Still others had concerns about employers being unwilling to administer the advance credits or finding out they received the EITC.<sup>4</sup>

Advance payments can result in individuals receiving a larger credit during the year than they are ultimately entitled to. If this occurs, the excess must be repaid when filing the tax return for the year, usually in April. Using the advance payment option requires an individual to estimate total earnings and income for the upcoming year. Because the credit is calculated as an advance payment at only one job, this can pose calculation difficulties for individuals with more than one job and for married couples if both spouses work. Individuals who experience a large increase in

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<sup>3</sup> Approximately 138,000 taxpayers used the advanced earned income payment option in 2001 (down from 169,000 in 1999) out of a total population (in both years) of credit recipients of approximately 19 million. Inspector General for Tax Administration, U.S. Dept. of Treasury, Memorandum for Commissioner, Wage and Investment Division 1 - 2 (June 17, 2003). In 2001, \$67 million was paid out in advance payments out of total earned income tax credits of \$32.5 billion.

<sup>4</sup> Minnesota Department of Human Services and Minnesota Department of Revenue, “Tax Credit Express Pilot Project – 1997 Update,” Report to the legislature (1997).

earnings midway through the year may not qualify for the amount of credit that they have received in advance payments.<sup>5</sup>

Since overpayment could discourage individuals from using advance payments, the Revenue Reconciliation Act of 1993 limited the maximum amount available to 60 percent of the estimated credit.<sup>6</sup> In addition, Congress required the IRS to notify families who receive EITC refunds of the availability of advance payments. Following this change, the percentage of credit recipients using the advance payment option increased significantly, but it has been declining recently.<sup>7</sup> With the maximum EITC over \$4,000, some credit recipients may prefer to receive a single “lump-sum” payment, which may constitute the largest single “check” that a low-income filer receives during the course of the year.<sup>8</sup>

### **The advance payment option imposes an administrative burden on the employer.**

Employers must forward a supplement to the advance payment recipient’s W-4 form to the federal government. They must also adjust their payrolls to take the advance payments into account. This may make some employers reluctant to offer the advance payment option. At least one participant in the Department of Revenue’s 1995 town meetings indicated that his employer did not want to do the necessary paperwork.

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<sup>5</sup> This is apparently a serious possibility. The Treasury Inspector General for Tax Administration reported that 65,000 taxpayers in tax years 2000 and 2001 had advanced payments, but did not qualify for the EITC. This was 22 percent of returns that received advance payments of the credit. These taxpayers had \$15.3 million in unpaid taxes due to the IRS. Inspector General for Tax Administration, U.S. Dept. of Treasury, Memorandum for Commissioner, Wage and Investment Division 8, 17 (June 17, 2003). It is unclear how much of this is due to data entry errors that were not corrected by the IRS. (Some of it obviously is attributable to uncorrected data entry errors, since over one thousand of the accounts also had adjusted gross incomes over \$100,000 and some over \$1 million.)

<sup>6</sup> “Earned Income Tax Credit Effectiveness of Design and Administration,” Testimony before Subcommittee on Select Revenue Measures and Human Resources, Committee on Ways and Means, U.S. House of Representatives, General Accounting Office (March 30, 1993): 9. This change may also have been motivated by a concern that many individuals who receive advance payments never bother to file tax returns—about 40 percent according to a General Accounting Office study. These individuals may be receiving larger or smaller credits than they are actually entitled to. There is also evidence that a fair number of individuals fail to report receipt of advance payments and may be receiving the credit a second time as a lump sum. See also “Earned Income Tax Credit: Advance Payment Option is Not Widely Understood by the Public,” General Accounting Office (February 1992).

<sup>7</sup> In 1993, 0.2 percent of recipients used the advance payment option. This increased to 0.4 percent in 1994 after the notification requirement was enacted. By 1998 the percentage had increased to about 1 percent of recipients, but it had dropped to 0.7 percent in 2001. “Few Taxpayers Taking Advantage of Advance Earned Income Tax Credit,” *Tax Notes* (March 20, 1995); Hotz, V. Joseph and John Karl Scholz, *The Earned Income Credit* 58 (August 29, 2002); Inspector General for Tax Administration, U.S. Dept. of Treasury, Memorandum for Commissioner, Wage and Investment Division, 1- 2 (June 17, 2003).

<sup>8</sup> One study has found that receipt of the EITC affects when eligible families purchase durable goods. Specifically, the credit has led to measurable increases in durable good purchases in February, the most common month in which EITC refunds are received. Lisa Barrow and Leslie McGranahan, “The Effects of the Earned Income Credit on the Seasonality of Household Expenditures,” 53 *Nat. Tax J.* 1211 (2000).

## The Minnesota Working Family Credit

Minnesota, as well as 16 other states, offers a state version of the EITC.<sup>9</sup> Like the federal credit, it is fully refundable. 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 earned income tax credit 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.

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 changes further increased the maximum credit, 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 marriage penalty relief provisions enacted at the federal level, and provided for the phaseout threshold to be higher for married couples than for single and head of household filers.<sup>10</sup> Table 3 shows the credit calculation for tax year 2004 for single and head of household filers, and for married couples filing joint returns.

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<sup>9</sup> Appendix 1 provides a table listing state earned income tax credits.

<sup>10</sup> The income level at which the phaseout begins and ends will be increased for married filers by \$1,000 in 2002-2004, \$2,000 in 2005-2007, and \$3,000 in 2008. It will be adjusted in following years for inflation.

Table 3:  
**Minnesota Working Family Credit, 2004**

	One qualifying child	Two or more qualifying children
<b>Married couple filing jointly</b>		
<b>Credit calculation</b>	8.5% of first \$7,660 of earnings, plus 8.5% of earnings between \$13,370 and \$14,880	10% of first \$10,760 of earnings, plus 20% of earnings between \$16,440 and \$18,590
<b>Maximum credit</b>	\$779	\$1,506
<b>Credit phaseout</b>	5.73% of income over \$17,690	10.3% of income over \$20,800
<b>Maximum income eligible</b>	\$31,293	\$35,421
<b>Single and head of household filers</b>		
<b>Credit calculation</b>	8.5% of first \$7,660 of earnings, plus 8.5% of earnings between \$13,370 and \$14,880	10% of first \$10,760 of earnings, plus 20% of earnings between \$16,440 and \$18,590
<b>Maximum credit</b>	\$779	\$1,506
<b>Credit phaseout</b>	5.73% of income over \$16,690	10.3% of income over \$19,800
<b>Maximum income eligible</b>	\$30,293	\$34,421

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**In 2001, 212,709 filers claimed the credit for a total of \$107.5 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 2001.

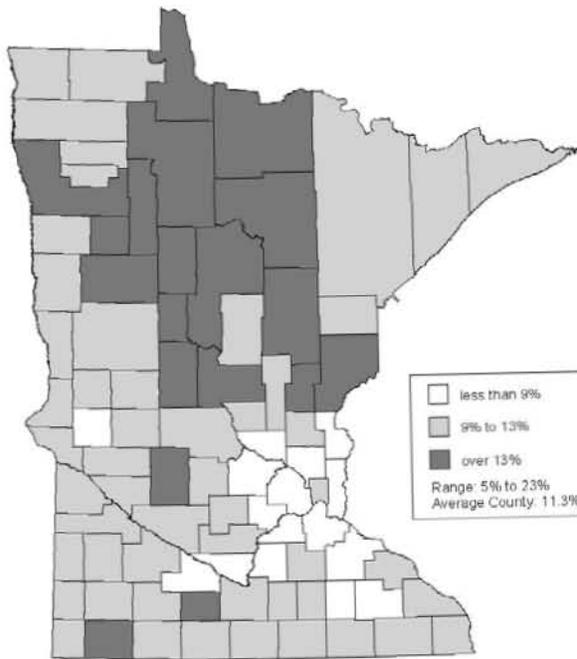
Figure 1:  
**Minnesota Working Family Credit Recipients, 2001**



While over 47 percent of the returns claiming credits came from the Twin Cities metropolitan area, these seven counties generated about 55 percent of all returns filed. Put another way, in 2001 nonmetro filers were more likely to claim the credit than were metro area filers.

Figure 2 shows the percent of returns on which the credit was claimed by county; this ranged from 4.9 percent of all returns in Carver County in the metropolitan area, to 22.9 percent of all returns in Mahnommen County in northwestern Minnesota.

Figure 2:  
**Percentage of Returns Claiming Minnesota Working Family Credit, 2001**



Over 13 percent of all tax returns filed in many north central and northwestern Minnesota counties claimed the WFC, while fewer than 9 percent of returns filed in Hennepin County and the 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 9 percent of all tax returns claimed the EITC and WFC in 2001.**

The number of individuals claiming the credit increased by 46 percent from 1993 to 2001, when over 212,000 Minnesotans qualified for the WFC. Over this time period the credit became available to individuals without dependents, and the maximum credits and incomes increased. Nationwide, 15 percent of all returns filed claimed the credit in 2001. A smaller

percentage of Minnesota returns claimed the federal credit—9.1 percent—probably due to Minnesota’s higher than average personal income. The highest percentage of returns claiming the credit was 29.8 percent in Mississippi, and the lowest was 8.3 percent in New Hampshire.<sup>11</sup>

**The average EITC claimed in Minnesota in 2001 was \$1,472;<sup>12</sup> the average WFC was \$508.**

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, and the increases in the state credit rates in 1998 and 2000.

<sup>11</sup> Internal Revenue Service, Statistics of Income Division, *SOI Bulletin* Spring 2003.

<sup>12</sup> *Ibid.*

In 2001, the average EITC nationwide was worth \$1,691. The state with the highest average was Mississippi at \$1,980, and the lowest was Alaska at \$1,355.<sup>13</sup>

**The Minnesota working family credit cost \$107.5 million in tax year 2001, with the cost estimated to remain at about the same level in tax year 2002.**

The total for 2001 is more than double the \$43.5 million paid in 1997, with the increase due to the 1998 restructuring of the credit and the rate increases in 1998 and 2000.

**About 51.5 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 29 percent of the 2001 recipients owe some tax but receive a credit that exceeds their liability, so a total of 80.5 percent of claimants receive at least part of their WFC as a refund. The remaining recipients—19.5 percent—have tax liability that exceeds their credit. This means that a total of 48.5 percent of claimants use at least part of their WFC to offset tax liability.

Nationwide, 84.7 percent of all EITC recipients receive at least part of their credit as a refund. In Minnesota, 80.6 percent of recipients received a full or partial refund of their EITC compared with a low of 76.4 percent in Vermont, and a high of 89.7 percent in Louisiana.<sup>14</sup>

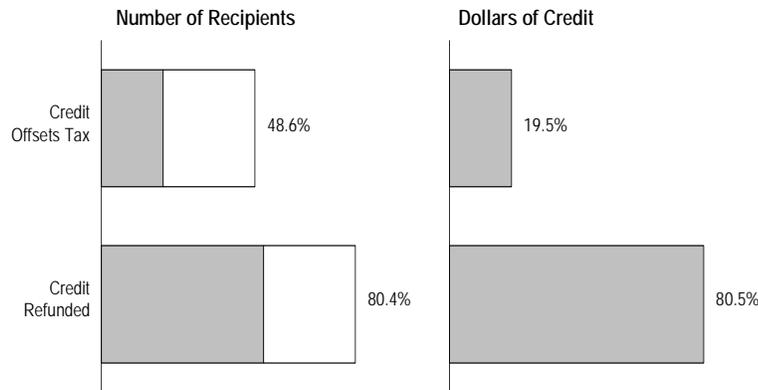
In 1997, the Department of Revenue calculated the WFC for filers who had claimed the federal credit but not the state credit in tax years 1995 and 1996. It issued over \$750,000 in refund checks to 8,380 eligible filers. The restructuring of the credit in 1998 prevents the department from repeating this 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. After the restructuring, the earned income figures needed to calculate the state credit are on a federal worksheet, not the 1040, and are not available electronically. Data from the 2000 income tax sample indicates that about 94 percent of Minnesota EITC recipients also claimed the WFC. This figure has remained fairly constant in recent years.

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<sup>13</sup> *Ibid.*

<sup>14</sup> *Ibid.*

Figure 3:  
**Refundability of Working Family Credit, 2000**



Note: 29% of claimants qualify for a credit that exceeds their tax liability. For this 29%, part of the credit offsets liability, and the rest is paid as a refund. This 29% is shown in white in both bars on the left.

**About one-fifth—19.5 percent—of the total amount paid in WFC offsets tax liability, while four-fifths—80.5 percent—of the total is distributed as refunds.**

In 2001, \$21 million of the WFC offset tax liability and the remaining \$86.5 million was paid as refunds. At the national level, just over 87 percent of EITC dollars were distributed as refunds in 2001, with only 13 percent offsetting the federal income tax. In Minnesota, 84.3 percent of the EITC was refunded compared to a high of 91.1 percent in Mississippi, and a low of 80.4 percent in Vermont.<sup>15</sup>

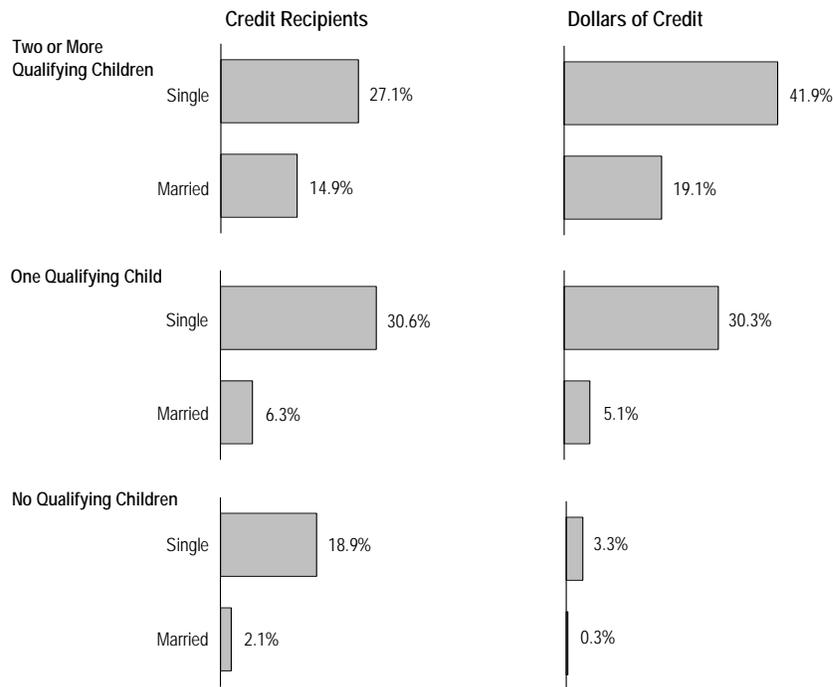
**Most WFC recipients have one or more qualifying children.**

Figure 4 shows that in 2000,<sup>16</sup> 42 percent of recipients had two or more qualifying children and 37 percent had one qualifying child. About 64 percent of the dollars paid in credits went to the 42 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.

<sup>15</sup> *Ibid.*

<sup>16</sup> Data on the total amount and refundability of the credit is from the Department of Revenue's 2001 processing file, while data on the number of qualifying children claimed by recipients is from the 2000 income tax sample, also prepared by the Department of Revenue.

Figure 4:  
**WFC Recipients by Number of Qualifying Children and Marital Status, 2000**



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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. Thirty-one percent of all recipients were single parents with one child, while 28 percent were single parents with two or more qualifying children. Married parents, however, were more likely to have at least two children. Fifteen percent of recipients were married with two or more qualifying children, and only 6 percent were married with one qualifying child.

Over one-fifth of all recipients had no qualifying children. This group, however, received only 3 percent of credit dollars. Claimants without children receive a credit equal to 1.9 percent of their earnings. The credit is fully phased out at a relatively low income—\$10,390 in 2000, compared to a maximum income of \$27,407 for parents of one qualifying child, and \$31,094 for those with two or more qualifying children.

## 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 \$18,400 for a family of four in 2003. 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 above summarizes the credit's history.

<b>History of the EITC and WFC</b>	
1975	Federal Earned Income Tax Credit (EITC) enacted
1979	EITC increased, advance payments made available
1985	EITC increased, 70,000 Minnesotans receive \$24 million
1987	EITC increased and indexed for inflation
1988	EITC phase-out 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; 140,000 Minnesotans receive \$106 million
	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 taxpayers 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"; income for phaseout expanded to include most losses
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/ 2000	WFC percentage increased for first tier of earned income
2001	EITC and WFC phase-out thresholds increased for married joint filers to reduce marriage penalties

**The earned income tax credit has an estimated overall participation rate of 75 percent nationwide,<sup>17</sup> 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,<sup>18</sup> 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 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—they use food coupons, or a special credit 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.

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 2003 earned income tax credit and working family credit will be large enough to lift single parents of one or two children 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 earned income tax credit and working family credit 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 all two-dependent families with only one full-time worker. The federal expansion of the credit that was fully phased in during 1996 resulted in single parents who work full-time and have one or two dependents having total income above the poverty level in 2003. Married couples with only one full-time worker, however, have total income below the poverty level even

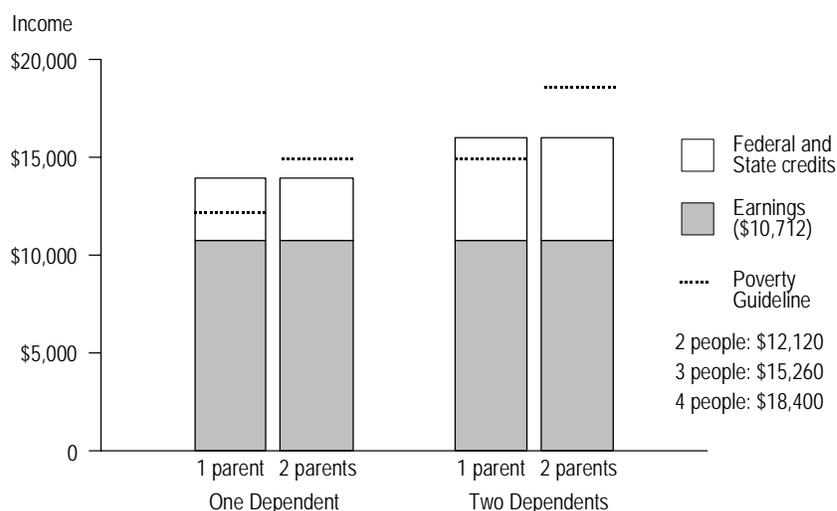
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<sup>17</sup> “Earned Income Tax Credit Eligibility and Participation,” Letter to Representative William J. Coyne, U.S. House of Representatives, General Accounting Office (December 14, 2001). The participation rate estimate was calculated using samples 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.

<sup>18</sup> Scholz, John Karl, “The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness,” 47 Nat. Tax J. 63, 70-71 (1994).

after considering the federal and state credits.<sup>19</sup> The figure uses 2003 poverty levels and minimum wage (\$5.15 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, 2003**



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**The expanded earned income tax credit will not raise the income of full-time working single parents of three 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 2003 poverty guideline is \$12,120 for a two-person family, and \$15,260 for a three-person family. The poverty guideline then increases by \$3,140 for each additional family member. A single parent with three dependents faces a poverty guideline of \$18,400, 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 earned income tax credit and working family credit moves larger families closer to the poverty guideline, but does not lift them above it.

<sup>19</sup> Note that married couples with two full-time minimum wage workers would have income above the poverty guidelines based on wage income alone (\$21,424).

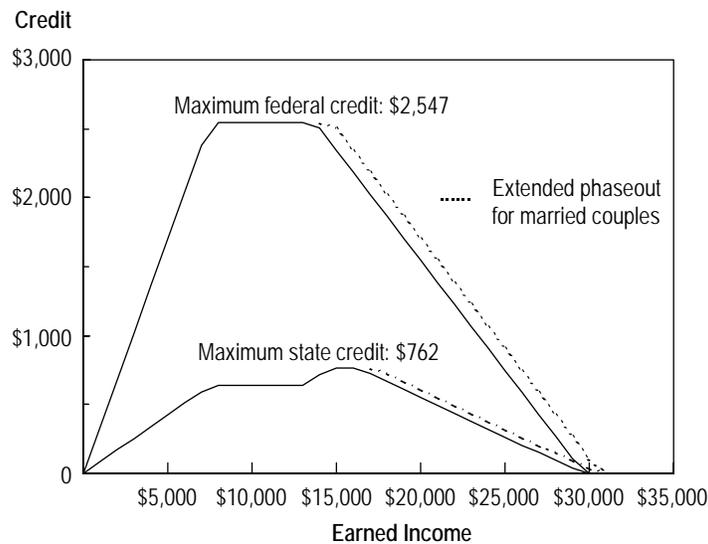
## The Tax Credits and Work Effort

**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' phase-out 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 phase-out range of the credits. Figure 6 graphically shows these ranges of the EITC and WFC for filers with one dependent in tax year 2003. The figure assumes that all income is from earnings.

Figure 6:  
**EITC and WFC Ranges, Filers with One Qualifying Child, 2003**



**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 (by as much as 48 percent in some cases). Because they can earn more, the credits encourage recipients to work more—that is, to substitute work for leisure. An economist would say that the credits have a positive substitution effect on individuals in the phase-in range. In tax

year 2003, an estimated 25.1 percent of Minnesota credit recipients will have income in the EITC phase-in range.<sup>20</sup>

**For filers with incomes above the maximum qualifying amount but below the phase-out threshold, no substitution effect occurs; working more neither increases nor decreases the credits.** In tax year 2003, an estimated 15.6 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 phase-out range; working more reduces their credits.** For example, a 2003 filer with two dependents and income in the phase-out range who received a \$1,000 increase in wages would also experience a \$210 reduction in the EITC and a \$100 reduction in the WFC.<sup>21</sup> 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 59.3 percent of credit recipients will be in the EITC phase-out range in 2003.

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 at least 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 tradeoffs among:

- Targeting or limiting the credit to lower income workers;
- Minimizing the work disincentive that results from “taking away” the credit as income rises; and
- Limiting the cost of the credit.

The credit can have a high phase-out rate, which means that it will go primarily to filers with incomes below the phase-out threshold. The downside of this approach is that there will be a high effective tax rate and large work disincentive for filers in the phase-out range. Or, the credit can have a low phase-out rate, with filers in the phase-out range facing a smaller effective tax rate and a smaller work disincentive. But this approach means that the credit will be available to

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<sup>20</sup> Estimates were made using the House Income Tax Simulation Model, the Minnesota Department of Revenue 2000 sample of income tax returns, and growth assumptions of the February 2003 economic forecast prepared by the Minnesota Department of Finance.

<sup>21</sup> 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.

filers with higher incomes and will cost more. Policymakers must choose between imposing a steep phase-out rate to target the credit to low-income families and to keep the overall cost of the credit low, or using a lower phase-out 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 credit increased total hours worked by 20 million per year.<sup>22</sup> 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.<sup>23</sup>
- More people work as a result of the credit.<sup>24</sup> 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-out range.
- People already working, but who are in the credit phase-in range, tend to increase their hours worked.<sup>25</sup> These individuals receive larger credits by working more. Here the substitution effect of the credit overcomes the income effect.
- Individuals in the flat and phase-out ranges work less as a result of the credit.<sup>26</sup> Here the income effect (for those in the flat and phase-out ranges) and the negative

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<sup>22</sup> 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,” in *Tax Policy and The Economy* 40-41 (James M. Poterba, ed. 1995).

<sup>23</sup> Meyer, Bruce D. and Dan T. Rosenbaum, “Taxes, Welfare Programs, and Employment,” 1998 Proceedings of the 91<sup>st</sup> Annual Conf. of the Nat. Tax Assoc. 191 (1999). 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.

<sup>24</sup> See the summary of six studies in Table 4 in Hotz, V. Joseph and John Karl Sholz, *The Earned Income Credit*, 65-66 (August 29, 2002). All of these studies show positive effects on labor force participation by various segments of the population.

<sup>25</sup> See, e.g., Stacy Dickert, Scott Hauser, and John Karl Scholz, *supra* note 22.

<sup>26</sup> See, e.g., Edgar K. Browning, “Effects of the Earned Income Tax Credit on Income and Welfare,” 48 Nat. Tax J. 23 (1995) (reduction in labor supply for families in the phase-out 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,” 47 Nat. Tax J. 591 (1994). *But see* Nada Eissa and Jeffrey B. Liebman,

substitution effects (for those in the phase-out 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.

- 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.<sup>27</sup> This result occurs because of the income effect and because married couples are more likely to be in the phase-out range of the credit where the work incentive effects are negative, as noted above.

**The working family credit and earned income credit 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<sup>28</sup> 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, the phaseout of the federal earned income credit and the state working family credit, and the payment of state and federal income and payroll taxes. 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 per hour to \$8 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 4 shows the effect of the restructuring on a single parent of two children in tax year 1998, the year the restructuring took effect. 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 earned income credit and working family credit, the phaseout of the MFIP grant, and the imposition of income and payroll taxes. This represents a marginal tax rate of 98 percent.

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"Labor Supply Response to the Earned Income Tax Credit," 61 Q.J. of Econ. 605 (1996) (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 phase-out 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.

<sup>27</sup> Eissa, Nada and Hillary Williamson Hoynes, "The Earned Income Tax Credit and the Labor Supply of Married Couples," Nat. Bureau of Econ. Research Working Paper No. 6852 (Dec. 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.

<sup>28</sup> Marginal rates refer to the share of an increase in income that is paid in tax.

Table 4:  
**Effect of WFC Restructuring on Net Annual Resources,  
 Single Parent with Two Children, 1998**

<b>Hours Worked</b>		0	20	40	40	40	40	40
<b>Hourly Wage</b>			\$5.15	\$5.15	\$6.00	\$7.00	\$8.00	\$9.00
<b>Annual Earnings</b>		\$0	\$5,356	\$10,712	\$12,480	\$14,560	\$16,640	\$18,720
<b>MFIP Grant<sup>29</sup></b>		10,071	6,644	4,391	3,259	1,928	597	0
<b>Payroll Taxes</b>		0	410	819	955	1,114	1,273	1,432
<b>Federal and MN Income Taxes</b>		0	0	0	0	44	481	918
<b>Before restructuring</b>								
<b>FEIC and WFC</b>		\$0	\$2,464	\$4,319	\$4,266	\$3,762	\$3,258	\$2,755
<b>Net Annual Resources</b>		\$10,072	\$14,054	\$17,428	\$17,876	\$17,918	\$18,145	\$19,125
<b>Increase in earnings*</b>		NA	\$5,356	\$5,356	\$1,768	\$2,080	\$2,080	\$2,080
<b>Increase in resources*</b>		NA	\$3,982	\$3,374	\$448	\$42	\$227	\$980
<b>Marginal rate**</b>		NA	25.6%	37.0%	74.7%	98.0%	89.1%	52.9%
<b>After restructuring</b>								
<b>FEIC and WFC</b>		\$0	\$2,571	\$4,507	\$4,461	\$4,065	\$3,961	\$3,396
<b>Net Annual Resources</b>		\$10,072	\$14,161	\$17,616	\$18,071	\$18,220	\$18,847	\$19,766
<b>Increase in earnings*</b>		NA	\$5,356	\$5,356	\$1,768	\$2,080	\$2,080	\$2,080
<b>Increase in resources*</b>		NA	\$4,089	\$3,455	\$455	\$150	\$627	\$919
<b>Marginal rate**</b>			23.6%	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 4 would keep \$150 of a wage increase from \$6 to \$7 per hour. The marginal rate remained high at 93 percent.

Table 5 shows the effect of 1998 restructuring in 2004. The EITC, WFC, and the threshold for income tax liability have increased each year to reflect inflation as measured by the consumer price index. As a result, 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 \$16,430 in 2004. 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

<sup>29</sup> The MFIP grant calculations are based on the transitional standard, family wage level, and earned income disregard percentage in effect in November 2003.

poverty threshold, down from 120 percent when MFIP began.<sup>30</sup> The result is that in 2004, the MFIP grant for a family of three will be fully phased out before the second tier of the WFC begins to apply. The highest marginal rates have shifted up the income scale, with those rewarded with a pay raise from \$7 to \$8 losing 92.1 percent of their increased earnings to taxes and lost benefits. Individuals with earnings increases from \$6 to \$7 faced a marginal rate of 92.8 percent in 1998, but only 77.0 percent in 2004.

Table 5:  
**Effect of WFC Restructuring on Net Annual Resources,  
 Single Parent with Two Children, 2004**

Hours Worked	0	20	40	40	40	40	40
Hourly Wage		\$5.15	\$5.15	\$6.00	\$7.00	\$8.00	\$9.00
<b>Annual Earnings</b>	\$0	\$5,356	\$10,712	\$12,480	\$14,560	\$16,640	\$18,720
<b>MFIP Grant<sup>31</sup></b>	\$10,224	\$7,819	\$4,391	\$3,259	\$1,928	\$597	\$0
<b>FEIC and WFC</b>	<b>\$0</b>	<b>\$2,678</b>	<b>\$5,356</b>	<b>\$5,376</b>	<b>\$5,266</b>	<b>\$4,868</b>	<b>\$4,820</b>
<b>Payroll Taxes</b>	\$0	\$410	\$819	\$955	\$1,114	\$1,273	\$1,432
<b>Federal and MN Income Taxes</b>	\$0	\$0	\$0	\$0	\$0	\$29	\$348
<b>Net Annual Resources</b>	<b>\$10,224</b>	<b>\$15,443</b>	<b>\$19,639</b>	<b>\$20,160</b>	<b>\$20,641</b>	<b>\$20,803</b>	<b>\$21,760</b>
<b>Increase in earnings*</b>	NA	<b>\$5,356</b>	<b>\$5,356</b>	<b>\$1,768</b>	<b>\$2,080</b>	<b>\$2,080</b>	<b>\$2,080</b>
<b>Increase in resources*</b>	NA	<b>\$5,219</b>	<b>\$4,196</b>	<b>\$521</b>	<b>\$480</b>	<b>\$162</b>	<b>\$957</b>
<b>Marginal rate**</b>	NA	<b>2.6%</b>	<b>21.6%</b>	<b>70.5%</b>	<b>76.9%</b>	<b>92.2%</b>	<b>54.0%</b>
* 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 2004 is the reduction in the federal income tax rate from 15 percent to 10 percent, and in the state income tax rate from 6 percent to 5.35 percent. Table 5 also shows that the credits essentially offset the effect of the benefit reductions for an MFIP recipient who enters the workforce, working halftime at minimum wage. This allows the recipient to retain essentially all of her earnings, nullifying the work disincentive that results from the benefit reductions. The high marginal rates occur when the recipient is no longer in the phase-in range of the EIC and WFC, but experiences MFIP grant reductions as a result of increased earnings (e.g., full-time work in \$6 to \$8 per hour range for the examples). Once the recipient has lost all of her MFIP benefits, the marginal rates drop to close to 50 percent.

<sup>30</sup> [Laws 2003, 1st spec. sess., ch. 14, art. 1, sec. 39.](#)

<sup>31</sup> The MFIP grant calculations are based on the transitional standard, family wage level, and earned income disregard percentage in effect in November 2003.

## Appendix: Earned Income Tax Credits in Other States, 2003

**Earned Income Tax Credits in Other States, 2003**

	<b>State (year adopted)</b>	<b>Percentage of federal credit</b>
Refundable credits	Colorado <sup>32</sup> (1999)	10% (not currently in effect)
	District of Columbia (2000)	25%
	Indiana (2002)	6%
	Kansas (1998)	10%
	Maryland (1987) <sup>33</sup>	18% (rising to 20% in 2004)
	Massachusetts (1997)	15%
	New Jersey (2000)	20%; limited to families with incomes below \$20,000
	New York (1994)	30%
	Oklahoma	5%
	Vermont (1988)	32%
	Wisconsin (1989)	4% one child 14% two children 43% three children
Nonrefundable credits	Illinois (2000)	5%
	Iowa (1990)	6.5%
	Maine (2000)	5%
	Oregon (1997)	5%
	Rhode Island (1975)	25%

Source: adapted from V. Joseph Hotz and John Karl Scholz, August 2002, "The Earned Income Tax Credit; adapted from Nicholas Johnson, 2001, "A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2001: An Overview," Center on Budget and Policy Priorities, December, Particularly Table 4. Adoption years are from Dickert-Conlin and Houser (2002), which in turn are from Johnson.

In addition to the information shown in the table, in 1998 Virginia enacted a nonrefundable credit funded through the state's TANF block grant. The credit was enacted prior to publication of the final TANF regulations, and was contingent on approval from the U.S. Department of Health and Human Services (DHHS). DHHS determined that the credit was not allowed under the final TANF regulations. However, DHHS recognized that it was possible to interpret the preliminary TANF regulations as allowing for the credit, and permitted Virginia to fund the credit using TANF in 1999 only. Effective in tax year 2000, Virginia enacted a nonrefundable low-income credit that does not rely on TANF funding. Virginia's low-income credit is allowed for filers with gross income below the federal poverty guidelines, and is not tied to the federal earned income tax credit.

*For more information about tax credits, visit the income tax area of our web site, [www.house.mn/hrd/issinfo/tx\\_inc.htm](http://www.house.mn/hrd/issinfo/tx_inc.htm).*

<sup>32</sup> Colorado's credit is only in effect in years in which the state has a budget surplus, and was suspended in tax years 2002 and 2003

<sup>33</sup> A Maryland taxpayer may claim a refundable credit or a nonrefundable credit (equal to 50 percent of the federal credit), but not both.