Earned Income Tax Credit (EITC): A Discussion

Introduction

What could be the impact of the federal Earned Income Tax Credit (**EITC**), a cash refund, on low income families in Washington State? Both Washington State's minimum wage and the federal **EITC** were increased in 1994. These two increases meant that a woman could have a higher potential income from working at the minimum wage than she would have from welfare, or when compared to the federal poverty guideline or the Washington Need Standard.

What is the EITC?

The **EITC** provides a credit on the federal income tax**--available as a cash refund--**to working-poor families with children. The **EITC** first began in 1975 in order to help adults working at low wages compensate for the burden of the Social Security payroll tax. The **EITC** has political appeal because it rewards work, but is only available to those who work at relatively low wages.

Since 1975 the impact of the **EITC** has been adjusted and increased several times. The latest changes, contained in the federal Omnibus Budget Reconciliation Act (OBRA) of 1993, substantially increased the amount and impact of the **EITC**. The increase in the **EITC** is being phased in from 1994 through 1996. In 1996, it will become "the largest cash or near-cash program directed toward low income households."[1]

The **EITC** rewards increased earnings--to a point. In 1994, the **EITC** payment was greatest when the woman's earned income was $8,400 to $10,999, and the **EITC** disappeared as the earned income increased to $25,000. *(Chart 1)*

How Does a Woman Obtain the EITC?

The **EITC** can be an important component of income, but it is not always claimed by women on welfare who work. A woman who wants to claim the **EITC** for the previous tax year must complete and file Schedule EIC and Form 1040 with the Internal Revenue Service. If she qualifies, due to her earned income and number of children, she will receive an **EITC** cash payment.

A second option is to receive a *portion* of the total **EITC** in **monthly advance payments** from an employer and the remainder in one final payment from the Internal Revenue Service. The monthly advance payments are made if the woman files a W-5 form with her employer. The employer is required to include the advance payment, which is determined from IRS tables, in the employee's paycheck. The amount is paid out of the employer and employee Social Security taxes. Employers do *not* have any out-of-pocket expenses. The federal General Accounting Office has found, however, that very few women apply for advance monthly payments.[2]

What is the Federal Poverty Guideline?

The federal poverty guideline determines the amount of income that is above or below poverty. The U.S. Social Security Administration developed this guideline in 1965 in order to determine the percent of American families who were living below a minimum standard (poverty). This minimal standard was based on a family food budget sufficient to purchase the U.S. Department of Agriculture's "thrifty food plan." In 1965, family budget studies indicated that low income families spent about one-third of their income on food. Thus, the actual cost of all items in the "thrifty food plan," determined by a market basket study, was multiplied by three to arrive at an amount of pre-tax, cash income needed to maintain a minimum standard of living.

The U.S. Department of Health and Human Services publishes the poverty guideline each February in the *Federal Register*, adjusting for the projected increase in the Consumer Price Index for the coming year. The poverty guideline is slightly less for rural than for urban regions and is adjusted for family size. Federal, state and local governments, as well as many private community agencies, use the poverty guideline to determine eligibility for social or health programs.

What is the Washington Need Standard?

The Washington Need Standard is a standard of need for families receiving welfare. Washington State law requires the Department of Social and Health Services to establish "... standards of need each fiscal year..for aid to families with dependent children...shall be based on studies of actual living costs and generally recognized inflation indices and shall include reasonable allowances for shelter, fuel, food, transportation, clothing, household maintenance and operations, personal maintenance, and necessary incidentals..."(RCW 74.04.770)

Washington's Need Standard was first developed in 1976, with a cost-of-living study, reconfigured in 1980, and updated with a new cost-of-living study in 1984. The Need Standard is based upon an assumed minimal, but adequate, standard of living *for a temporary period*. Items such as shelter, food, and clothing were actually priced throughout the state. A methodology for updating the standard on an annual basis was also provided.

Throughout the 1980s, Washington's Need Standard tracked the federal poverty guideline very closely. In 1991, the Department of Social and Health Services conducted a new cost-of-living study.[3] Washington's Need Standard was 15 percent above the federal poverty guideline in 1994.

How Much Does A Family Receive on Welfare?

Washington's Aid to Families with Dependent Children (AFDC) cash grant is below the Washington Need Standard, as allowed in statute. In 1994, a family of three would have received $548 from the AFDC cash grant per month and $258 per month in Food Stamps. This would be an annual income of **$9,648** from just AFDC and Food Stamps.[4]

Assumptions

In this paper, we have assumed that a single woman on welfare, with two children, was able to work 40 hours a week for all of 1994. We have also assumed that she worked at Washington's 1994 minimum wage of $4.90 per hour.[5]

We realize that not all women on welfare actually worked during the year, worked for 40 hours a week, or if they worked, were able to work for the full year. This is a hypothetical case, to show the *potential* impact of the **EITC**.

Findings

Yearly: A woman who worked full time at minimum wage, and received the **EITC** and Food Stamps, could have had an ***annual*** net income above both the federal poverty guideline and the Washington Need Standard in 1994. *(Chart 2)*

Monthly: The same family's ***monthly*** net income picture could have been different. The full **EITC** is not available in 12 equal monthly payments. ***If*** the woman requested *advance monthly payments* from her employer, approximately half of her total $2,528 EITC payment, or *monthly advance payments of $102,* could have been available. *(Chart 3)*

The final payment of $1,304 would have been made by the Internal Revenue Service after she filed her EITC schedule with her federal taxes.

Discussion

Full time employment at minimum wage, with Food Stamps and the **EITC,** can result in an annual income above the federal poverty guideline and above the Washington State Need Standard. The **EITC** can encourage work by boosting net income.

Although the **EITC** has become a potentially important component of income, it is not always claimed by women on welfare in Washington who work and earn a low income. **If** more welfare recipients knew about and took advantage of the monthly advance payments, the **EITC** could help women move out of poverty. There is little recent reliable information on the use of the **EITC** in Washington State. Information from the Family Income Study, before the 1993 OBRA changes were introduced, estimates that up to 21 percent of families on welfare received the **EITC** in 1992.

One way to make the **EITC** easier to obtain would be by having the **EITC** paperwork available in the Community Service Offices of the Department of Social and Health Services. To make the monthly advance payments easier to obtain, Michigan has proposed making **EITC** advance payments through the AFDC and Food Stamp delivery system, instead of through employers.

If you have any questions, please contact Carol Webster or Greg Weeks at the Institute. **March 1995**

1. See "Tax Policy and the Working Poor: The Earned Income Tax Credit," *Focus*, Institute for Research on Poverty, University of Wisconsin, Madison, V. 15, No. 3, Winter 1993-94, pp. 1-13.

2. U.S. General Accounting Office, "Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public," GAO/GGD-92-96, Washington, DC, February 1992.

3. *Cost of Living in 1991 for Low Income Families in Washington State*, Department of Social and Health Services, Olympia, 1991.

4. Sources: Washington State Department of Social and Health Services; Circular E, Employer's Tax Guide and 1994 Earned Income Credit Table, Internal Revenue Service documents; Gordon Fisher, U.S. Department of Health and Human Services and Kathleen Short, U.S. Bureau of the Census.

5. We use a minimum wage of $4.90 per hour, at 40 hours per week, for 4.3 weeks per month. The gross annual income would be $10,113 per year, and the gross monthly income would be $843. The standard payroll taxes are approximately 8 percent or $809 per year ($10,113 - $809 = $9,304).