

**Expanding the EITC for Single Workers and Couples *Without* Children  
(aka Tax Relief for Low-Wage Workers)**

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## Abstract

The Earned Income Tax Credit (EITC), the nation's largest anti-poverty program, now provides tax benefits of roughly \$39 billion dollars a year to over 21 million households.<sup>1</sup> By supplementing the earnings of low wage workers, the EITC "makes work pay." The EITC's popularity can be attributed to its providing both work incentives and tax relief. In 1993, Congress extended a small earned income credit to single and childless couples; however, about 96 percent of EITC dollars still go to families with children. This discussion paper argues that, while the emphasis of the EITC on rewarding work for families with children deserves continued primacy, expansion of the EITC to childless single workers and married couples without children deserves greater attention for the following reasons:

- The disproportionate and growing income tax burden (payroll, sales, excise) faced by this group of workers;
- The growing segment of workers at the bottom of the labor market, particularly single men with low levels of education and training, who remain confined to low wage jobs;
- The strict separation in our thinking between households with and without children requires reexamination, given the growing number of children with non-custodial parents; and,
- With a national savings rate below zero, the need to facilitate asset building for all low-wage workers, including those without children.

We recommend expanding the EITC for single workers and childless married couples with a range of policy recommendations, each targeting specific new subgroups of EITC recipients and addressing a slightly different purpose:

1. Increase the EITC from 7.65 percent to 15.3 percent of earnings up to \$8,080 in order to directly offset payroll taxes; and adjust the phase-in and phase-out ranges;
2. Lower the age requirement for single and childless workers to qualify for the EITC from 25 to 21 to target greater workforce participation incentives to young workers just entering the labor market and making major decisions about work;
3. Encourage single low-income workers to claim the Advance (monthly) EITC and use the increase in employee payroll earnings to contribute toward health care insurance premiums; and,
4. Link the EITC to asset building options such as matched savings accounts for education and training, homeownership, retirement, and entrepreneurship. In addition, remove asset limits for other public benefit programs, particularly to assist those with disabilities to enter the labor market and build assets.

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<sup>1</sup> Data provided directly to authors from the Internal Revenue Service. Data includes EITC claims for TY2004.

## Introduction

The Earned Income Tax Credit (EITC) is a refundable federal income tax credit first enacted with bipartisan political support in 1975. The EITC encourages low-income workers with children to enter and remain in the labor market by supplementing the earnings of those working for low wages, thus “making work pay.” The EITC’s popularity is based in part on its ability to provide both work incentives and tax relief for low-income workers and their families. Considered the nation’s largest anti-poverty program, in 2004 the EITC reached more than 21 million households and provided benefits of more than \$39 billion to low-income workers and their families.<sup>2</sup> Every year, the EITC is credited with lifting more than 4.5 million individuals—more than half of them children—above the federal poverty line (Greenstein, 2005b).

Currently, there is only a small EITC for single workers between the ages of 25 and 64 who are not raising children. The EITC for childless workers currently provides a 7.65 percent tax credit on up to \$5,380 of earnings, with a maximum benefit of \$412.<sup>3</sup> Both the Treasury Department and the Office of Management and Budget (OMB) report that the EITC for childless workers has grown very slowly.<sup>4</sup> In 2002, only about 4 percent of the EITC went to childless workers, totaling less than \$1 billion.<sup>5</sup> However, this group of low-income workers already pays a surprisingly high percentage of its earned income in federal taxes. Childless adults pay positive taxes starting with their first dollar of earnings, as the EITC only offsets half of the 15.3 percent of their earnings that are deducted for payroll taxes (based on the assumption confirmed by a Treasury Department analysis that workers ultimately bear both the employer and employee

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<sup>2</sup> Data provided directly to authors from the Internal Revenue Service.

<sup>3</sup> This is for tax year 2006. See Table 1 for more information on the EITC parameters.

<sup>4</sup> Greenstein, R. & Shapiro, I. (1998). *The consequences of eliminating the EITC for childless workers*. Center on Budget and Policy Priorities. <http://www.cbpp.org/709eitc.htm>, page 5.

<sup>5</sup> Authors calculations using Current Population Survey, Annual Social and Economic Supplement 2003. Numbers are weighted. SAS program provided by and adapted from Meyer and Holtz-Eakin. 2001. “*Making Work Pay: The Earned Income Tax Credit and Its Impact on America’s Families*.” New York: Russell Sage Foundation.

share of payroll taxes in the form of lower wages) (Greenstein, 2000; Marguerite Casey Foundation, 2005). Despite the inclusion of childless workers in the EITC, its current structure offers only minimal support for this sub-population and does not fully offset a range of ongoing regressive tax (payroll, sales and excise) burdens.

In this policy brief, we explore three questions:

1. What do existing policy research and current data tell us about whether the original two goals of the EITC—payroll tax relief and encouraging employment—are being met adequately for the sub-groups of childless single and married workers;
2. Are there additional rationales that would justify an expansion of the EITC for this sub-group; and,
3. What policy changes could accomplish all or some of these policy goals?

## **Summary of Key Findings**

### **The original goals of payroll tax relief and encouraging work:**

This brief argues that, while the salient effects of the EITC on reducing child poverty and rewarding work for low-income workers with children deserve continued primacy, the potential for providing needed economic support and greater federal tax relief to childless single and married workers deserves immediate attention for the following reasons:

- The disproportionate tax burden faced by low-wage single workers, which has worsened since the EITC was enacted in 1975, makes tax relief an even greater priority as an issue of tax fairness. The sharp increase in the tax burdens that these individuals bear resulted primarily from increases in Social Security, sales, gasoline, and other excise taxes. The Center on Budget and Policy Priorities now reports that *three-fourths* of taxpayers pay more in payroll taxes than they do in income taxes (Kamin, 2004). For working poor families with children that have low incomes, these regressive tax increases generally were offset through EITC expansions. By contrast, for low-wage workers without children, little action has been taken to offset these tax increases. Even with the current EITC, these workers pay a strikingly high percentage of their small incomes in federal taxes. If any workers need a tax cut, we argue that these workers do.
- A growing segment of workers at the bottom of the labor market, particularly men with low levels of education and training, remain confined to low-wage jobs and earn marginal incomes or have dropped out of the labor market altogether. These potential EITC recipients have, on average, lower levels of educational attainment and are much more

likely to be high school dropouts. Single workers with disabilities also suffer from high rates of unemployment and low wages. An expansion of the EITC to single low-wage workers could increase the rewards of work and thus the labor market attachment of these sub-groups, as it has done for women with children, and could bring their incomes above the poverty line. Leaving this group at the margins of the labor market undermines the strength of the workforce, communities, and families.

### **Additional rationales for expanding the EITC for “childless” workers:**

In addition to the need for the EITC to better meet the goals of tax relief and encouraging work for childless workers, we also identified three additional reasons why an expansion of the EITC is warranted:

- Given changes in family structure and the growing number of children with non-custodial parents, the strict separation in our thinking between households with and those without children requires reexamination. Many workers who cannot claim dependents because of complex eligibility rules (IRS guidelines determining who is allowed to claim a “qualifying child”) are nevertheless responsible for contributing to the economic support of their children. Very low-wage non-custodial parents can find it difficult to meet their child support obligations and survive economically, which can further marginalize their attachment to legitimate work and to their children’s economic and psychological well-being.
- Single workers who now qualify for the very modest credit can receive few if any other government benefits. They generally are ineligible for means-tested cash and medical assistance funded in whole or in part by the federal government; such assistance is limited to families with children, the elderly, and those with disabilities. This also is true for most housing assistance. The ability of these individuals to receive food stamps is restricted, as well.
- With the national savings rate at zero, innovative approaches that promote savings and asset building for all low-income workers deserve support. The current tax structure favors asset building among middle and upper income families but has too little to offer those with low incomes and low tax liabilities. Interviews with EITC recipients with children show that many use their EITC refunds to make the kinds of investments — paying off debt, investing in education, securing decent housing — that enhance economic security and promote economic opportunity. An expanded EITC linked to opportunities for single low-wage workers to save and build assets could achieve a number of worthwhile social policy goals, including financing primary and secondary educations for the children of non-custodial parents as well as reducing the numbers of people facing poverty in retirement.

## Policy Options for an Expansion of the EITC for Childless Workers

Based on our recommendation for an expansion of the EITC for single and childless workers, we explore four complementary policy options, each targeting specific subgroups of EITC recipients and addressing a slightly different purpose:

1. Increase the EITC from 7.65 percent to 15.3 percent of earnings up to \$8,080 in order to directly offset payroll taxes; and adjust the phase-in and phase-out ranges;<sup>6</sup>
2. Lower the age requirement for childless workers to qualify for the EITC from 25 to 21 to target greater workforce participation incentives to young workers just entering the labor market and making major decisions about work;
3. Enroll workers who are interested in the Advance EITC, which allows those with qualifying children to receive part of the credit in their monthly paychecks, and target the increase in employee payroll earnings (and potential savings in employer FICA contributions) toward health care insurance premiums and/or retirement accounts for these workers; and,
4. Link the EITC to asset building options such as matched savings accounts for education and training, homeownership, retirement, and entrepreneurship. In addition, remove asset limits for other public benefit programs, currently set at levels of approximately \$2000, particularly to assist those with disabilities to enter the labor market and build assets.

Politically, at both the federal and state level, an expanded EITC could embody both progressive and conservative values by: (1) rewarding those who work with an earnings subsidy; (2) providing the greatest benefits to those with the greatest need; (3) offsetting the tax burden on working poor single and childless married couples struggling to make ends meet; (4) providing incentives for people to enter the workforce who otherwise might not do so; (5) achieving these ends without increasing employer costs, without creating hiring disincentives and with minimal government bureaucracy; and 6) helping single workers and families without children, and

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<sup>6</sup> Adapted from Furman, J. 2006. "Tax Reform and Poverty." Center on Budget and Policy Priorities. Washington, DC. A second proposal for expanding the EITC to childless workers has been put forth by Edelman, P., Holzer, H. & Offner, P. 2006. Reconnecting Disadvantaged Young Men. Washington, DC: Urban Institute Press.

potentially many more, to build assets for homeownership, education, and retirement when combined with other institutional supports such as matched savings programs.

### **Policy Significance and Context: The EITC and Tax Policy**

As currently structured, the EITC provides a tax credit for low-income households that is based on income and family status and is fully refundable. Table 1 shows the EITC parameters based on family type and size. The refundable credit, for which a worker applies when filing their annual federal income tax return, helps reduce tax liability and also can provide a refund to the taxpayer. For example, a two parent family with one child with a tax liability of \$1,000 that qualifies for an EITC of \$3,000 would eliminate its \$1,000 tax liability and then receive a refund of the remaining \$2,000 of EITC. The credit applies at three different rates: a low rate (7.65 percent) for taxpayers with no children, a much higher rate (34 percent) for taxpayers with one child, and an even higher rate (40 percent) for taxpayers with two or more children. For tax year 2006, the maximum credit amounts for filers with two or more qualifying children, one qualifying child, and no qualifying children will be \$4,536, \$2,747 and \$412 respectively.<sup>7</sup> While the credit is available to low-income workers without children, the overwhelming proportion of EITC dollars, about 96 percent, go to families with children.<sup>8</sup>

Additionally, the EITC is structured in three phases: a phase-in period, a plateau, and a phase-out period. Figure 1 shows this structure for unmarried recipients based on the number of qualifying children. The criteria for a child to qualify for the EITC are different than those qualifying a child for a dependent personal exemption. For the EITC, a qualifying child must be

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<sup>7</sup> The qualifying child rules are used by the IRS to determine eligibility for specific tax benefits. For most benefits, including the EITC, those with qualifying children receive larger credit amounts. There are additional eligibility requirements for workers without qualifying children. For instance, they must be between the ages of 25 and 64, cannot be someone else's dependent, and must have lived in the United States more than half the year.

<sup>8</sup> Authors calculations using Current Population Survey, Annual Social and Economic Supplement 2003. Numbers are weighted. SAS program provided by and adapted from Meyer and Holtz-Eakin. 2001. *"Making Work Pay: The Earned Income Tax Credit and Its Impact on America's Families."* New York: Russell Sage Foundation.

the filer's son, daughter, adopted child, stepchild, foster child, or a descendent of any of these children, and be under age 19, a full-time student under age 24, or any age if permanently and totally disabled. The child must live with the filer in the United States for more than half of the year. If a child meets the conditions to be a qualifying child of more than one person, the family can decide which taxpayer claims the child for EITC. When two qualified taxpayers claim the same child, IRS will apply tiebreaker rules that, in general, give priority to the child's parent.<sup>9</sup>

The original political debates in the early 1970s over the EITC reflected some differences over its primary purpose: whether to provide payroll tax relief to all low-wage workers or to increase the labor force participation of less-skilled workers who might otherwise rely on public assistance benefits to support their families, or both. Ultimately, Congress structured the tax credit to do both, but only for families with children, thus placing more emphasis on its policy role in welfare reform. In this way, the EITC fulfilled its original tenets as set forth by Congress: "an added bonus or incentive for low-income people to work," and as a way to reduce welfare dependency by "inducing individuals with families receiving federal assistance to support themselves" (U.S. Congress, Senate, 1975).

The earliest proposals for an earned income credit emerged in response to ongoing debates about a minimum income for all Americans and increasing concerns about the impact of rising payroll taxes on low-income workers (Holt, 2006; Ventry, 2001). Traditional forms of individual income tax relief, either by reducing positive tax rates or raising personal exemptions, were of more limited assistance to those low-income workers and their families whose federal

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<sup>9</sup> Under the tie-breaker rule, the child is treated as a qualifying child only by: (1) The parents, if they file a joint return; (2) The parent, if only one of the persons is the child's parent; (3) The parent with whom the child lived the longest during the tax year, if two of the persons are the child's parent and they do not file a joint return together; (4) The parent with the highest AGI if the child lived with each parent for the same amount of time during the tax year, and they do not file a joint return together; or, (5) The person with the highest AGI, if none of the persons is the child's parent.

income tax liability was already zero. Policymakers began to explore whether federal income tax relief should be delivered only as an “exemption,” a “deduction” – which would reduce the amount of *earned* income subject to tax – or as a tax credit that directly offsets tax payments or liability.<sup>10</sup> Some elected officials viewed such tax assistance as part of a broader program to provide a basic social safety net and reduce or eliminate poverty – as well as a convenient administrative way to deliver cash benefits to low-income families.<sup>11</sup> Others viewed this individual tax benefit more broadly as a way to offset the burdens of other taxes that all low and moderate-wage workers pay, regardless of family status, such as payroll taxes, excise taxes, state and local sales, property, and income taxes.

Under existing federal tax law in 1974, workers were not required to pay income taxes unless their incomes exceeded the amount of the minimum standard deduction plus the sum of available personal exemptions. The House Ways and Means Committee concluded in its 1975 report accompanying legislation creating the EITC: “If the problems of low-wage workers are the regressive effects of payroll taxes then the credit should be available to all low-income individuals, regardless of marital status or children” (U.S. Congress, House, 1975). The House version of the EITC covered 28 million taxpayers. In order to keep costs down, the House reduced the proposed tax credit from 10 percent to 5 percent. The one-year revenue loss was projected to be \$2.9 billion, all of which would be received by workers whose incomes were

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<sup>10</sup> In describing these provisions, they do not distinguish between those that the OMB and JCT call tax expenditures and those that are considered part of the normal tax structure.

<sup>11</sup> Phasing out tax credits at a set income level can create high implicit marginal tax rates in the income range over which the benefits phase out. These high marginal rates can discourage work and savings. The combination of regular tax rates and the implicit tax created by lost credits can result in much higher tax rates for people in the phase-out range than for families with the highest incomes (Joint Economic Committee 2001). For example, tax benefits from programs intended exclusively for lower-income families, such as the EITC, phase out rapidly once adjusted gross income exceeds certain threshold amounts. While limiting tax benefits to low-income families results in high effective marginal tax rates over the income phase-out range, the phase-in of refundable tax credits can have the opposite effect.

below \$6,000. Whereas the House version depicted the EITC as payroll tax relief, the Senate Finance Committee's bill depicted the EITC as welfare reform. While the Senate adopted the general concept of the earned income credit, it revised it to improve “its impact on the low-income taxpayers with children” (U.S. Congress, Senate, 1975). Since many low-wage workers were from non-poor families, extending earning subsidies to all workers could be “expensive and inefficient in reaching the poor,” and thus, the Senate plan restricted its subsidy to families with children and applied the subsidy to total family earnings. (U.S. Congress, Senate, 1975). This change involved a revenue loss of \$1.5 billion, or about one-half of the House proposal (U.S. Congress, Senate, 1975). Congress, in the end, accepted the Senate position that the “most significant objective of the EITC should be to assist in encouraging people to obtain employment, reducing the unemployment rate and reducing the welfare rolls; more importantly, most federal welfare programs apply to married couples with dependent children and it is in this area that the EITC can be most effective in reducing any tax disincentive to work” (U.S. Congress, Senate, 1975). By limiting the credit only to low-income workers with families, Congress reduced the number of potential “beneficiaries” from 28 million to 6.4 million. When the tax credit was enacted in 1975, it generated little attention. The initial credit amount was equal to only 10 percent of total income up to \$4,000 (providing a maximum benefit of \$400) and then it phased out at 10 percent until income reached \$8,000 (Hoffman, 2003; Holt, 2006; Ventry, 2001).

The EITC continued to be offered to eligible workers for the next several years and was made a permanent piece of the Internal Revenue Code (IRC) in 1978. Since that time, it has undergone significant expansions with broad bipartisan support. The credit was expanded in 1986 under President Ronald Reagan, in 1990 under President George H.W. Bush, and again in

1993 under President Bill Clinton when the size of the credit was doubled and a small credit was added for workers without children (Holt, 2006). EITC expansions also were used to offset the regressive effects of increases in payroll taxes and in gasoline, alcohol, and tobacco excise taxes for families with children. The 1986 Tax Reform Act explicitly cited this principle of eliminating income tax burdens for families with incomes near the poverty level as the reason for increasing the dollar amounts of standard deductions and personal exemptions. The Omnibus Budget Reconciliation Acts of 1990 and 1993 (OBRA-90 and OBRA-93) increased the credit rate, introduced a larger EITC (with a higher credit rate and more earnings eligible for the matching credit) for families with two or more children, and introduced a small EITC for childless workers. Each of these increases was phased-in over three years. Consequently, the credit rates increased every year from 1990 to 1995.

### **The Rise of an EITC for Single Workers**

In 1993, President Clinton urged making the EITC available to very low-income workers who did not have children; opponents warned that it would be difficult to broaden the EITC to wage earners without children “without breaking the bank.” By 1993, the percentage of income that the poorest fifth of non-elderly households without children paid in federal taxes was double the percentage of income that the poorest fifth of families with children paid and more than five times the percentage that the poorest fifth of elderly households paid (Greenstein, 1998 & 2000). As part of the final legislative agreement in 1993, the EITC was extended for the first time to workers without children. In addition to offsetting a portion of these various tax increases, the establishment of the EITC for poor childless workers partially addressed a piece of unfinished business from the 1986 Tax Reform Act (Greenstein, 2000). One of those goals, often espoused by President Reagan, was to eliminate federal income taxes on workers below the poverty line so

they would not be taxed deeper into poverty. Prior to extension of the EITC to these workers, a single non-elderly worker continued to owe federal income tax when his or her income was well below the poverty line. The EITC raised the income level at which these workers would begin to owe income tax, but that level still remains below the poverty line.

After the 1994 elections, Republicans proposed several new limits on eligibility to the EITC and the House and Senate proposals erased some of the expansion in the credit achieved by President Clinton as part of his 1993 budget plan (CQ Weekly, 1995). Clinton considered expansion of the credit one of his most important achievements, and preserved the EITC as one of his main goals in budget negotiations with Congress. Under the 2001 tax reforms, President Bush allowed more married couples to become eligible for the earned-income tax credit. The bill gradually allowed more filers to take the full or partial credit (CQ Weekly, 2001). By 2004, the Bush budget focused only on EITC compliance and included \$100 million to help the IRS prevent erroneous and fraudulent payments of the EITC. The Treasury Department estimated that 25 percent of the credits distributed were paid in error, including as much as \$9.9 billion in erroneous EITC payments in 1999.<sup>12</sup> The president also proposed a permanent extension of EITC-related provisions enacted in 2001 as part of his 10-year tax cut bill.<sup>13</sup>

Some reformers charge that one of the biggest challenges is the fact that the United States has become divided between a growing class of people who pay no federal income taxes and a shrinking class of people who are bearing the lion's share of the tax burden. Economists at the Tax Foundation estimate that for tax year 2004, a record 42.5 million Americans who filed a tax

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<sup>12</sup> A 2000 study by the Congressional Committee on Taxation concluded that a significant factor in the high EITC error rate is attributable to the increasing complexity of EITC regulations. A 2004 Treasury Department study also cited the complexity of tax rules regarding qualifying children as a contributing factor to EITC error rates .

<sup>13</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16, June 7, 2001.

return (one-third of the 131 million returns filed last year) had no tax liability after they took advantage of their credits and deductions. Broadly speaking, the 42.5 million zero-tax filers are: low-income, young, female-headed households, part-time workers, and beneficiaries of the \$1,000 per-child tax credit or the Earned Income Credit (Hodge, 2005).

Not coincidentally, the latest round of tax cuts follows on the Council of Economic Advisers' (CEA) Economic Report to the President, released in February 2003, which made the case that low-to-moderate income families do not shoulder a fair share of the income tax burden. The document lays the intellectual groundwork for policies that would greatly simplify the tax system, but that would arguably raise the federal tax burden on lower-income workers, while reducing that on the affluent (Weisman, 2002). In keeping with this, Treasury Department economists are drafting new ways to calculate the distribution of tax burdens among different income classes, and those results are expected to highlight what Bush Administration officials view as a rising tax burden on the rich and a declining burden on the poor (Weisman, 2002).

As part of the President George W. Bush's Advisory Panel on Federal Tax Reform, several proposals were advanced to address the needs of low-wage workers. Robert Greenstein, executive director of the Center on Budget and Policy Priorities, focused specifically on the role of the Earned Income Tax Credit in improving tax fairness when single workers begin owing income tax several hundred dollars *below* the poverty line (Greenstein, 2005a). According to his testimony, a single worker at the poverty line (\$10,062) pays \$827 in federal income and payroll taxes when the employee (but not the employer) share of the payroll tax is counted. This is the tax the worker owes *net* of the EITC. Counting the employer share, the worker pays \$1,600 in taxes. Indeed, as Greenstein concludes, the existing EITC could be improved by making it

simpler, reducing its marriage penalty, and expanding the very small EITC for workers without children.

In testimony to the Advisory Panel on Tax Reform, Michael J. Graetz, a law professor at Yale University, proposed a *refundable* payroll tax offset both to replace the EITC and protect low and moderate-income families from increased tax burdens. In addition, Graetz called on policymakers to “recognize financial obligations of non-custodial parents to their children.” According to his logic, “a payroll tax offset would maintain EITC’s work incentives and leave Social Security benefits unaffected while eliminating marriage penalties, increasing take-home pay, and ensuring distributional neutrality.”

#### *What Role for the States?*

In the absence of federal reform, states have experimented with EITC reforms. As of January 2006, 18 states and the District of Columbia have adopted Earned Income Tax Credits. Most recently, Delaware and Virginia enacted new EITCs, Illinois and Oregon changed their state EITC from non-refundable to refundable, and several states and the District of Columbia, expanded existing EITCs. In addition, three local governments—Montgomery County, Md., New York City, and San Francisco—offer local EITCs. Most state EITCs piggyback directly on the federal EITC; those 18 states use federal eligibility rules and express the state credit as a specified percentage of the federal credit. In addition to boosting living standards among working families, state EITCs can play an important role in providing relief from state and local taxes paid by low-income working families, just as the federal EITC serves to relieve the burden of federal taxes on such families. In every state, low-income working families pay a substantial share of their income in state and local taxes. State EITCs have helped ensure that state tax systems do not push working families closer to, or deeper into, poverty.

While the personal income tax burden on poor families is notable in many states, other parts of state and local tax codes often contribute even more to the tax burden on low-wage workers. States are demonstrating little inclination to reduce their reliance on such regressive taxes. In fact, some states in recent years have enacted increases in sales and/or excise taxes. These taxes are regressive, which means they absorb a much larger proportion of the incomes of lower-income households than of higher-income households. Most states rely to a large extent on revenue from sales and excise taxes. Because those taxes fall heavily on low-income residents, the increases in sales and excise taxes in many states are increasing the tax burden on working-poor families. State EITCs for single workers could serve to offset such tax increases for the poor (Nagle & Johnson, 2006).

## **Empirical Evidence**

### *Snapshot of EITC Recipients*

The EITC is characterized by a unique three-stage structure that consists of a phase-in range in which the credit increases as earnings increase, a plateau range in which the maximum credit has been reached and further earnings do not affect it, and a phase-out range in which the credit decreases as earnings increase. All dollar amounts are indexed to inflation. Table 1 shows the basic parameters of the EITC including maximum benefit amounts, income eligibility limits, and phase-in and phase-out rates based on the number of qualifying children. It illustrates the value of the EITC for individuals without children, individuals with one “qualifying child,”<sup>14</sup> and

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<sup>14</sup> In general, to be a taxpayer’s qualifying child, a person must satisfy four tests: 1) Relationship — the taxpayer’s child or stepchild (whether by blood or adoption), foster child, sibling or stepsibling, or a descendant of one of these. 2) Residence — has the same principal residence as the taxpayer for more than half the tax year. Exceptions apply, in certain cases, for (not for EITC) kidnapped children, temporary absences, and for children who were born or died during the year. 3) Age — must be under the age of 19 at the end of the tax year, or under the age of 24 if a full-time student for at least five months of the year, or be permanently and totally disabled at any time during the year. (not for EITC)

those with two or more qualifying children. The criteria for a child to qualify for the EITC are different than those qualifying a child for a dependent personal exemption.

For individuals and couples *without* “qualifying” children, the maximum benefit amount for tax year 2006 is \$412 and covers the employee share of the payroll tax only up to income of \$5,380. Under the Federal Insurance Contributions Act (FICA), 12.4 percent of earned income up to an annual limit must be paid into Social Security, and an additional 2.9 percent must be paid into Medicare. Social Security benefits include old-age, survivors, and disability insurance or OASDI. The FICA tax is considered a regressive tax on income (with no standard deduction or personal exemption deduction) and is imposed (for the year 2006) only on the first \$94,200 of gross wages. As shown in Figure 1, the phase-in rate is much smaller and the maximum benefit plateau much shorter for childless workers. The income eligibility maximum is \$2,000 higher for married couples than for unmarried individuals.

Tables 2a and 2b show EITC data from the Internal Revenue Service (IRS). This data, from 2004, provides the most accurate accounting of EITC claims. However, as Bruce Meyer and Douglas Holtz-Eakin (2001) note, the Current Population Survey’s Annual Social and Economic Supplement (ASEC), which is used to report data in subsequent tables, is the best source of demographic information, such as age, race, and educational attainment, for individuals and families currently receiving the EITC. Table 3 shows the number of EITC recipients and the total benefit amounts by family type in 2002. As the table indicates, single mothers make up the largest group of EITC recipients (6.2 million), followed by married couples with children (5.2 million). Together, these two groups receive nearly 90 percent of all EITC dollars. Single men with children represent about 7 percent of the EITC recipients and receive just over 8 percent of the total benefits. Those without children make up more than 25 percent of the total recipient

population, but receive less than 4 percent of total benefits.<sup>15</sup> This is due to the relatively small benefit amount available to childless individuals and couples. Figure 2 shows that nearly half of the EITC dollars go to single mothers and more than a third go to married couples with children. Single men with children receive less than 10 percent of the total dollar value of EITC benefits.

Table 4 reports additional basic demographic data on EITC recipients with and without children by age, education level, the percentage that are African-American, and the average number of children. As reported in the row, single EITC recipients with children have an average age of 35 while those without children are, on average, five years older. We surmise that the higher average age of single childless workers is likely due in large part to the fact that they are ineligible for the EITC until age 25, while no such age restriction applies to workers with children. There is a considerably wider age gap of 17 years between married couples with and without children (an average age of about 37 for those with children and 54 for those without). While the differing age requirement for EITC recipients with and without children may explain part of this gap, it is doubtful that it could account for all of this difference. More likely, this group of recipients includes older workers who no longer have children at home.

Married EITC recipients, both with and without children, have lower levels of education than those who are single. For example, nearly 70 percent of married EITC recipients have a high school degree or less compared with just more than 60 percent of single EITC recipients. The low educational attainment of married EITC recipients no doubt contributes to their inability to earn enough to raise their incomes above the EITC eligibility threshold in spite of the potential for two earners. Lastly, the vast majority of EITC recipients in each household type reported a race other than African-American. The percentage of non-white recipients in each category

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<sup>15</sup> This percentage is slightly higher than the percentage reported by Meyer & Holtz-Eakin using data from 1999.

ranged from a low of 8.2 percent of married couples with children to a high of 24.1 percent of singles with children.

As Table 5a illustrates, EITC recipients have lower educational attainment than the U.S. population as a whole age 25 and older. Male EITC recipients appear to have the lowest educational attainment. For example, male EITC recipients are twice as likely to have less than a high school education as the general population, and are 50 percent more likely than female EITC recipients to have failed to complete high school. Of EITC recipients, male or female, fewer than ten percent have graduated from college compared with almost 30 percent of the general population. Table 5b shows EITC receipt by race and educational attainment. African-American EITC recipients are twice as likely as non-Hispanic whites to be high school dropouts, and 50 percent more likely to have a high school education or less rather than some college education or a college degree. This same holds true for both male and female African-American EITC recipients. The most dramatic difference emerges from the data comparing the share of African-American men and women with a college degree who are EITC recipients to non-Hispanic whites in the general population. Non-Hispanic whites have four times the percentage of workers with a college degree as African-American men and six times the percentage of women with a college degree.

Table 6 reports EITC recipients and total credit amounts for all 50 states and the District of Columbia (2004) as well as the child poverty rates in each state (2004). As expected because of their large overall populations, California, Texas, Florida and New York have the largest numbers of EITC claimants. All together, about 21.5 million earners received more than \$39 billion in credits, helping to lift many of these individuals and families above the poverty line. The third column in the table shows the percentage of children living in families with incomes at

or below 100 percent of the federal poverty line. The EITC is generally credited with lifting millions of children out of poverty each year.

### *Snapshot on Tax Rates and Burdens*

Figure 3 shows the federal tax rate for married couples who are earning poverty-level wages. As the figure illustrates, those with no children and those with two children faced a similar tax rate until the mid-1980s when the tax rate for married couples with two children dropped significantly due in large part to EITC expansions. In this important respect, the EITC has accomplished one of the original goals of the credit—to offset rising payroll taxes for low-income workers with families. Conversely, the tax rate for those without children has remained remarkably steady at about 15 percent, meaning that childless families and single workers continue to bear a disproportionate amount of the tax burden despite making poverty-level wages.

Figure 4 shows the differences in federal income tax thresholds by family type. The graph shows average tax thresholds for married couples and heads of households with between 1 and 4 children. For instance, in 2006, the federal income tax thresholds for a married couple with one child and a married couple with four children are \$32,537 and \$61,800, respectively. Single individuals and married couples with no children have significantly lower tax thresholds than those with children.

## **Policy Research and Rationales for EITC Expansion**

### *EITC Expansions for Workers without Qualifying Children*

For many, the historic lack of attention paid to workers without children, the lower EITC and labor force participation rates among this population, as well as the realization that a portion of this group is, in fact, helping to care for children, has led to proposals for expanding the credit

for single workers. Additionally, the assumption that the current benefit amount does not truly offset the payroll tax—even though this was cited as a main purpose for extending the EITC to childless workers—is an underlying rationale for expansions to the EITC for those without qualifying children (Furman, 2006; Gitterman, 2003; Greenstein, 1998 & 2000; Waslow, 2000). Some suggest that the EITC should be expanded to twice the current level, from 7.65 percent to 15.3 percent, in order to fully offset payroll taxes (Furman, 2006; Greenstein, 1998 & 2000). Others recommend raising the percent amount of the phase-in and phase-out rates as well as extending the plateau of the maximum benefit amount (Edelman, Holzer & Offner, 2006; Stegman, and Quercia, 2003; Waslow, 2000).

Another justification for the need to increase the EITC for childless workers is their ineligibility for many other types of government aid, such as food stamps and housing assistance (Greenstein, 2000). According to research from Stegman, Davis and Quercia (2003), the EITC, if included as income, reduces the number of households facing severe housing cost burdens by 18 percent (nearly 600,000 families). For childless workers, however, many of whom are not eligible for housing assistance programs, the EITC only removes these cost burdens for about 14,000 recipients, less than 1 percent of the childless workers facing severe housing costs. Expanding the EITC for this group of workers could help reduce this severe cost burden for another 93,000 workers (Stegman, Davis, Quercia, 2003).

#### *Work Incentives and Impact for Single Fathers*

The employment incentives created by the presence of a refundable EITC have proven to be particularly effective for single mothers (Greenstein, 2005b; Meyer and Rosenbaum, 2001a, b). For instance, one study found that employment by single mothers increased by 9 percentage points between the years 1984 and 1996, due in large part to the EITC (Meyer and Rosenbaum,

2001a, b; Porter and Dupree, 2001). A more recent study found similarly substantial impacts of the EITC on employment among various family types, including single mothers (Hotz, Mullin, and Scholz, 2006).

However, evidence suggests that employment among young men between the ages of 16 and 24, particularly among African Americans, declined between the late 1980s and the late 1990s despite a boom in the U.S economy (Edelman, Holzer, Offner, 2006). Edelman et al (2006) document the growing “disconnection” between young men, those aged 16 to 24, and the worlds of school and work, particularly when it comes to young African American men. The authors provide data on the impact that this disconnection is having on the lives of these men and on the communities where they live. According to the authors, employment rates of young black men lag behind those of both whites and Hispanics at every educational level. Between 1970 and 2000, wages for male high school dropouts declined by 18.4 percent, a difference of nearly \$2 an hour. This shows that men with a high school degree or less are participating less in the labor market and making lower wages when they do choose to work (Edelman, Holzer and Offner, 2006). One mechanism for increasing labor force participation among this population is the work bonus generated by the EITC. The incentives for joining the paid-labor force created by the current EITC structure, however, are not as great for childless adults because the maximum benefit amount is relatively small and workers actually begin paying positive income tax starting with the first dollar earned.<sup>16</sup>

#### *Workers who are non-custodial parents*

As many have pointed out, the IRS definition of “qualifying” child overlooks non-custodial parents, many of them fathers (Edelman, Holzer, Offner, 2006; Furman, 2006;

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<sup>16</sup> Although the EITC helps offset the payroll tax for childless workers, it only offsets half of the payroll tax, assuming that workers ultimately bear the burden of both the employee and the employer share of the payroll tax. (Furman, 2006).

Wheaton and Sorenson, 1997). Research indicates that this population faces the greatest disincentives for work and could greatly benefit from the additional income support offered through the EITC (Edelman, Holzer, and Offner, 2006; Furman, 2006). Only 8 percent of poor non-custodial fathers work fulltime and year-round, more than half report a disability or poor health, and 85 percent have a high school education or less (Kilaen, 2003). Approximately 20 percent of non-custodial fathers have incomes below \$6,000 and this figure rises to 40 percent among non-custodial fathers not paying child support (Sorenson et al, 2001).

Reflecting their poor labor market prospects, only 30 percent low income non-custodial fathers paid child support in 1999 compared with 72 percent of non-poor fathers (Kilaen, 2003). The increased emphasis on enforcing child support obligations has improved the economic stability of many custodial families and reduced child poverty to some extent. However, it also has been credited with creating a significant disincentive for poor non-custodial parents, most of them young men, to work in the legitimate labor market where their ability to earn enough to cover their own needs and pay child support can be difficult. Moreover, their wages can be garnished if they are under a formal child support order. Additional work disincentives result from state systems that garnish wages and bank accounts, keep child support payments for families on public support rather than passing those payments onto the children of these workers, and make it difficult for parents who fall behind in payments to eliminate arrearages even when they may wish to make a good faith effort to get current. Those low-income parents that do pay child support, however, pay a higher percentage of their incomes—28 percent of poor fathers paid more than 50 percent of their income in 1999, compared with only 2 percent of non-poor fathers (Kilaen, 2003).

### *Single Workers with disabilities*

According to data from the U.S. Census, roughly one in five Americans have a disability and, for one in 10 of those individuals, the disability is classified as severe (Morris, 2005). Low wages and unemployment are both high among persons with disabilities, contributing to high rates of poverty. One third of adults with disabilities live in a household with total income of \$15,000 or less compared with only one in eight adults without disabilities (Morris, 2005). And while approximately 4 percent of persons without disabilities suffered from unemployment in 2000,<sup>17</sup> this was true for 63 percent of people with disabilities in the same year (Morris, 2005).

In addition to suffering high rates of income poverty, persons with disabilities also suffer from high rates of asset poverty. Only 4 percent of adults with disabilities own a home compared with 70 percent of all Americans. Estimates are that up to 80 percent of people with disabilities have zero or negative assets, compared with 33 percent of all U.S. households (Morris, 2005). In addition to low levels of income, one of the primary reasons that persons with disabilities are asset poor is that the public benefit programs they rely on such as Medicaid and Social Security have low asset limits. Research has documented that participation in such public benefit programs discourages savings (Smeeding et al, 1999; Ziliak, 2001).

### *Marriage Penalties*

As mentioned, EITC benefit levels vary based on factors such as the number of qualifying children and family type. For married couples, the maximum income limit is slightly higher (by \$2,000) than for unmarried individuals, creating a small “marriage bonus.” Still, the EITC generates marriage penalties as well (Carrasso and Steuerle, 2002; Ellwood, 2001; Hoffman, 2003). A “penalty” results when the tax liability of a married couple exceeds the sum of their liabilities as single individuals or single heads of households (Carasso & Steuerle, 2002).

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<sup>17</sup> U.S. Department of Labor Statistics, Unemployment Rate, 2000.

For example, a single woman making \$15,000 with two children and receiving \$2,756 in federal tax credits marries a single man making \$25,000 and paying \$5,930 in taxes. Their new combined income puts them above EITC eligibility and creates combined taxes of \$5,840, with no EITC to offset the tax, thus a \$2,666 penalty as a result of marrying (Furman, 2006; Ellwood, 2001). Although, research often suggests that these kinds of penalties do not have a significant impact on decisions about family formation, they still impose a needless penalty for low-income workers that choose to marry.

### *Participation Rates*

In spite of generally high participation rates in the EITC among all those eligible to receive the benefits, data suggests that individuals without children have the lowest participation rates (Holt, 2006; Stegman, Davis, Quercia, 2003; White, 2001). Analysis from the Government Accountability Office indicate that childless adults make up the largest group of those who are eligible but do not claim the EITC, with nonparticipation rates as high as 60 percent for this population. The lack of participation may be partially related to the small benefit amount available to childless workers.

### *Asset Building*

Assets provide both a safety net for hard times and the means to exit poverty. Asset holding has been shown to promote beneficial outcomes for individuals, families, and neighborhoods.<sup>18</sup> Given the need to increase the national savings rate to boost the economy and to help families save for retirement, economist Peter Orszag argues that the nation's savings policy is exactly upside down because it gives the greatest incentives to wealthier savers (Orszag, 2004). Wealthy savers are more likely to respond to savings incentives by moving

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<sup>18</sup> Page-Adams, D. & Scanlon, E. (2001). *Assets, Health, and Well-being: Neighborhoods, Families, Children and Youth*. St. Louis, MO: Center for Social Development at Washington University.

money around from one investment to another, rather than increasing their total savings. Low and moderate-income individuals, on the other hand, are more likely to add new savings into the mix in response to strong incentives. Early results from demonstration projects in this area show that low and moderate-income families with and without children desire to save and will do so, especially with the added incentive of a matched savings account where the participant's savings are matched at some ratio by public and/or private dollars (Duflo et al, 2005)

Saving and asset-building opportunities, however, must be actively marketed to potential participants. This may be particularly true of single and childless workers who have been marginal targets of such efforts, particularly single men. For example, a study of Individual Development Account Programs in North Carolina found that women comprised 85 percent of program participants, only 10 percent lacked a high school education, and a little more than half had some college education or a college degree (Gorham, Quercia, Rohe, 2002). Such accounts, which are held by a local financial institution, can only be used for purchasing a first home, capitalizing a small business, or for educational or job training expenses and are matched for lower income participants by public and private sources. Researchers documented a similar profile of IDA participants in the national American Dream Demonstration (ADD) program (Schreiner et al, 2001). In our view, this points to a difficulty in more fully integrating men into asset building programs, which will require some creative thinking to address.

### **Analysis and Policy Proposals**

#### *Policy options to expand the EITC for (or provide additional tax relief to) childless single and married workers*

A number of policy proposals for expansion of the EITC for childless single and married workers have been offered over the past decade (Edelman, Holzer, Offner, 2006; Furman, 2006; Greenstein, 2000). The primary motivations behind these proposals has been to: a) improve tax

fairness by mitigating the disproportionate level of taxes paid by single low-wage workers, especially after the tax law changes of the last decade which in many cases have increased the regressivity of the tax code; b) increase this group's attachment to the labor market, as earlier expansions of the EITC have proven to do for low-wage workers with children; and c) reduce the likelihood that workers engaging in significant labor market effort will remain in poverty. In addition, we discuss three other issues that an expanded EITC for childless single and married workers could potentially address: the need to provide stronger incentives for workforce participation for young workers entering the labor market; high health insurance costs; and the importance of helping all low-income workers build savings and other assets.

In this section, we highlight options for expanding the EITC for single and childless workers, each of which addresses a somewhat different purpose and several of which target specific subgroups of EITC recipients. These policy recommendations are summarized in Table 7. For each option, we describe its purpose, the policy change needed, the estimated budget impact if available, and complementary policy changes that are desirable.

### 1. EITC Baseline Expansion for Single and Married Childless Couples

The first proposed recommendation with the broadest impact, also suggested by a number of policy analysts over the past decade (Edelman, Holzer, Offner, 2006; Furman, 2006; Greenstein, 2000), could be described as a baseline expansion. It would increase the EITC to 15.3 percent of earnings to provide relief from payroll and other taxes, doubling the current level of 7.65 percent of earnings. The current EITC level of 7.65 percent of earnings reflects the fact that this exactly offsets the employee share of payroll taxes. However, evidence cited earlier supports the fact that employees pay for both the employee *and employer* share of payroll taxes. Therefore, fully offsetting payroll taxes requires an EITC pegged at 15.3 percent of earnings.

In addition, the phase-in threshold could be raised to match that of a household with one child (up to earnings of \$8,080) and would start phasing out at \$10,000. The phase-out rate could also be increased to 15.3%. According to estimates by the Center for Budget and Policy Priorities (Furman, 2006), these changes would have an additional budget impact of approximately \$3 billion and would increase the maximum EITC benefit for single and married childless workers from \$399 to \$1,236. Increasing the EITC to 15.3 percent of earnings is a common EITC reform proposal because of its relationship to a direct payroll tax offset, thereby meeting the express goal of tax fairness. However, we note that by selecting differing percentage figures for the share of earnings that would qualify and using different phase-in and phase-out thresholds, an almost infinite number of variations of this proposal could be designed resulting in higher or lower EITC benefit levels and a correspondingly higher or lower budget impact.

This proposal for an expanded EITC for single and married childless workers would have multiple benefits. First, it meets the objective of tax relief for a group that has seen little improvement in this regard relative to other income groups. Second, it increases work incentives for all of the beneficiaries mentioned above with the hope that this will result in an increased rate of labor market participation for this group. Third, it will reduce the numbers of low-income singles and childless couples who are living in poverty in spite of working.

In addition, this expanded EITC benefit will raise the income of non-custodial parents which will increase their ability to meet their child support obligations. Several policy analysts have suggested that, as an incentive to work in the legitimate labor market and to meet their court-mandated child support orders, an expanded EITC for non-custodial parents could be made *conditional* on being current on child support. However, in spite of its appeal on equity grounds, this approach is not without its practical difficulties and may be unrealistic in the short run. It

would need to rely on a sophisticated integration of the Internal Revenue Service and fifty different Child Support Enforcement (CSE) systems maintained by the states that vary widely in their effectiveness and already face an uncertain funding future. It also would require a major commitment to upgrading the reliability of CSE data collection and timely transfer to the IRS to make this feasible.

One unforeseen consequence of moving on this proposal too quickly could be a significant increase in the EITC error rate which could then undermine support for a very effective anti-poverty program. In addition, only a subset of children in poverty with non-custodial parents have a formal support order in place, which would limit the impact of this proposal. In spite of these challenges, New York State has recently enacted legislation to link an expanded state-level EITC for non-custodial parents to their being current on child support. If it proves successful, it could be a model adopted by other states and/or the federal government. For now, we feel that the preferable approach to meeting the needs of this group is to expand the EITC for all single and childless married workers which will include non-custodial parents who are most in need of income support.

## **2. Increased Work Incentives for Younger Workers**

In addition to the increased work incentives provided by the baseline EITC expansion proposed above in (1), a second policy recommendation would further increase the incentives for young workers to participate in the legitimate labor market by lowering the age limit at which workers without children can qualify for the EITC from 25 to 21. We view this proposal as an addition to the baseline expansion proposed in (1), which is of higher priority, but it could be instituted independently. Beginning eligibility for the credit at age 21 for workers without children would provide an incentive for a greater number of young workers, confronted with the

difficulty of making ends meet with very low wages, to choose a legitimate job over working in the underground economy, or not at all. No such age requirement applies to workers with children--as long as they are not claimed as a dependent on another taxpayer's return, they may file for the EITC. At the same time, excluding workers younger than 21 would eliminate many of those still living at home and completing school. As is true for EITC recipients with children, this new group of younger EITC recipients would not be able to be claimed as a dependent on another tax filer's return. An analysis of this type of expansion for younger workers offered by Edelman, Holzer, and Offner (2006) includes an estimate of its cost at between \$1 billion and \$2 billion. In addition, they provide an excellent discussion of the need for greater investment in and experimentation with complementary work training and school-to-work transition programs for young workers entering the labor market.

### 3. Expanding available funds for monthly health insurance premiums or retirement plan contributions

A third policy recommendation would assist any worker eligible for the EITC to address the high costs of health care and/or to increase funds available for retirement plan contributions. The health insurance component is particularly relevant to single and childless workers because they are less likely to qualify for Medicaid or the State Children's Health Insurance Program (SCHIP). Workers could enroll in the Advance EITC, which pays low-wage workers an extra amount in their regular paycheck each month. They would then target that Advance EITC to pay a share of their health insurance premium. This amount and any additional insurance premium amount could be paid with pre-tax dollars, which consequently would lower the employer's total payroll amount on which they would be obliged to pay FICA taxes and therefore would generate some savings on the employer side. The employer could contribute an amount equal or greater to

the employer's FICA tax savings to pay some portion of a health insurance premium. This might increase the number of people who could afford to purchase health insurance through their employer plan. A similar approach could be used for an employer-based retirement plan, such as a 401(k). As was true for proposal (2) to make childless workers eligible for the EITC beginning at age 21, we view this proposal as working best if it were in addition to a baseline expansion of the EITC since this would increase the funds available for health insurance premiums or retirement contributions. Without this baseline expansion, the extra funds available each month would unfortunately be negligible compared with the cost of most health insurance premiums. However, even this small amount could be worthwhile when contributed to a retirement account that would build over time, especially if the employer provided a match.

The major obstacle to this proposal is that 99% of current EITC recipients prefer their EITC in a lump sum at tax time. One reason is that many recipients regard the EITC as a system of forced savings over the year and use it for major expenditures such as home or car repair or to pay down debt. A second reason is that tax filers worry that their circumstances could change and they would not be eligible for as much EITC as they estimated. In this situation, they could end the year owing a high tax bill. Even though this scenario is uncommon, it makes some tax filers wary of using the Advance EITC. However, as part of a larger employer strategy to help employees obtain health insurance and build retirement savings, more employees might be willing to participate in such a plan.

#### 4. Helping Childless Workers to Save and Build Assets

As noted above, the vast majority of families that receive the EITC obtain it in a lump sum with their federal income tax refund. Because it can represent a significant amount of money to receive in one payment, it is often used by low and moderate-income families as a way to save

money over the year. As generations of experience with traditional welfare has shown, however, a marginal increase in income rarely ends the poverty cycle for a family without some accumulation of assets. Federal policies have long favored the development of assets through tax breaks for 401(k)s, mortgage interest, and small businesses, and initiatives like the GI bill. Unfortunately, most of these policies do not benefit low-income families, who may not earn enough to pay income tax or have access to tax-deferred retirement accounts.

Recently, anti-poverty organizations have begun to step into this void, addressing wealth inequality by connecting low-income families with savings accounts, new financial products designed to meet the needs of the unbanked and underbanked, and Individual Development Accounts (IDA) which are matched savings accounts that can be used for a home purchase, education, and entrepreneurship. A particular focus of these efforts has been linking low-income individuals and families to asset building opportunities through EITC outreach and free income tax preparation campaigns.

An expanded EITC for childless workers has great potential to be an essential component of a more far-reaching initiative to reduce poverty and build assets if we are willing to experiment with and invest in innovative approaches. We propose that the matched savings account concept be expanded so that, in this case, single and childless workers could use the added income from an expanded EITC benefit to invest in savings vehicles such as Individual Retirement Accounts (IRAs), Coverdell Education Savings Accounts (ESAs), and college savings 529 accounts and that their contributions be matched.

Although ESAs, 529 college savings accounts, and IRAs offer some similar features and options for saving for children's futures, there are some significant differences between them. These differences may create better saving options depending on the specific purpose of the

savings account as well as the family or household income. Each of these savings options offers similar earnings potential and fairly similar tax benefits. The allowable uses and the impact on both financial aid and eligibility for public assistance programs, such as Food Stamps, the Temporary Assistance for Needy Families program and Medicaid, however, create noticeable differences between these savings accounts that may make some more suitable for lower-income families.

For example, research indicates that the most effective way to prevent child savings accounts from affecting a family's public assistance eligibility is to hold the funds in an account that is inaccessible to parents (Rist & Humphrey, 2006). Both ESAs and 529 plans are, or can be established as, custodial accounts in which banks or community organizations serve as the custodian, making those dollars 'un-countable' when determining eligibility for public benefit programs. (Rist & Humphrey, 2006). This is a particularly significant factor for low-income families. Additionally, although both of these accounts must be used toward education, ESAs, unlike 529 plans, can be used toward secondary educational expenses, including tuition and fees, books and supplies, tutoring, special needs services, uniforms, and transportation. For a low-income family, this may be a particularly advantageous type of account to help cover more short-term educational expenses, rather than only the longer-term expense of college. Table 8 compares the advantages of different types of education accounts for asset building by low and moderate-income workers.

Lastly, we consider three complementary policy recommendations that would assist savings and asset building initiatives linked to an expanded EITC. The first is to make the Saver's Credit, which Congress recently made permanent, fully refundable so that it is more advantageous to low-income savers. The second calls for Congress to appropriate funding to the

IRS to fund community free tax preparation programs for low-income tax filers similar to the funds it has provided for free tax preparation programs for the elderly and military families. Such programs can increase EITC uptake among single and childless workers, which is much lower than for workers with children, as well as help to link all EITC recipients to asset building opportunities in their communities.

The third, and final, proposal related to expanding opportunities for asset building, is to increase, or eliminate, the asset limits that are attached to a range of public benefit programs and which have a dampening effect on the propensity of public benefit recipients to save. For example, in many states having assets in a savings account in excess of \$2,000 will result in the loss of Medicaid eligibility. EITC recipients have a limited time period in which to spend down their tax credit refund before it is counted as an asset, potentially disqualifying them for other needed work and family supports. Moreover, asset limit rules vary by benefit program and differ among states, further confusing the issue for recipients. In the long run, these disincentives to save and build assets serve to perpetuate dependence on public benefits and increase the likelihood of living in poverty in retirement. This issue is of particular concern to workers with disabilities since they often must rely on social security and Medicaid.

## **Conclusions and Suggestions for Policy Reform**

### *Putting an EITC for Singles in a Broader Federal Tax Policy Context*

Historically, several U.S. tax provisions have shaped the distributive impact of the federal income tax code on lower-income workers and their families. Currently, the tax rate bracket, the personal exemption, and the standard deduction combine to influence the income levels at which households become subject to federal income tax. The personal exemption reduces the earned income on which workers pay federal income taxes and reduces taxable income to account for

differences in a family's ability to pay taxes based on the size of the family.<sup>19</sup> These exemptions help to offset the higher expenses incurred by larger families, and the tax benefits depends on a family's marginal tax rate. For example, an exemption is more valuable for higher-income families than for lower-income families. For a person in the 10 percent tax bracket, each personal exemption of \$3,000 reduces taxes by \$300. Someone in the 35 percent tax bracket sees a reduction of \$1,050.<sup>20</sup> The standard deduction is the additional amount of money— similar to the personal exemption and based on filing status—that non-itemizing taxpayers may shield from taxable income. As with the personal exemption, these amounts are indexed for inflation. Together, they have added progressivity and simplicity to the tax code by exempting many low-income workers from federal income taxes (Bakija & Seuerkle, 1991).

Over time, the standard deduction has evolved to take on several different forms: a percentage of income; a zero percent tax bracket amount; and a lump-sum amount based on filing status. The personal exemption and the standard deduction can “collaborate” to exempt a flat amount of income from federal tax liability that has varied over time. The final “tax-exempt” threshold, a measure of the potential reduction on post-tax gross income, is the maximum amount of gross income a typical, non-itemizing low or moderate-income individual can receive without having to pay federal income tax (Bakija & Seuerkle, 1991). For example, the earned

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<sup>19</sup> Workers may claim personal exemptions for themselves, their spouse, and their children who live with them and are either under the age of 19 or students under the age of 24. Taxpayers can claim others persons as a dependent if they provide more than half of the person's financial support.

<sup>20</sup> The tax benefit of a standard deduction equals the amount by which it exceeds deductions that would be itemized divided by the average tax rate on such deductions. In addition to personal exemptions, workers can take either a standard deduction or itemized deductions, such as home mortgage interest and charitable contributions. Most low and moderate-wage workers claim a “standard deduction” instead of itemizing their individual income tax deductions

income tax credit (EITC) and the child tax credit (CTC) affect when a family must make out-of-pocket payment of federal income tax.<sup>21</sup>

Distributional and fairness concerns have always emerged during debates on broader tax policy reform proposals. As part of large congressional reconciliation tax-cut packages, EITC expansions have been used to maintain distributional equity for tax policy reform as a whole. Advocates of the EITC in the 1970s made two principal arguments. First, rising payroll taxes meant that many low-income workers now paid more of these taxes than they paid in income taxes. But it was impractical to cut their payroll taxes because there was a strong tradition of having a single tax rate that every worker paid on the first dollar of earnings. Second, EITC supporters argued that because the credit would be available only to those with earned income, it would reinforce work incentives and help get people off welfare. By making the credit refundable, it would offset the disincentive effects of higher payroll tax rates, which had risen from 4.8 percent on workers and employers in 1970 to 5.85 percent in 1975.<sup>22</sup> The brief legislative history makes clear that Congress and the White House both viewed the EITC as a de facto payroll-tax cut relief for low-income workers with families.

The EITC expansions in the 1980s, 1990, and 1993 have been successful in offsetting the regressive effects of increases in payroll taxes and in gasoline, alcohol, and tobacco excise taxes for low-income workers with children. However, as this discussion paper argues, the goal to reduce the regressivity of the tax code has been missed for single and married couples *without*

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<sup>21</sup> “Non-refundable” tax credits could reduce or eliminate federal income tax liabilities for low- and moderate-wage individual and their families. However, the tax benefits from “non-refundable” credits would be limited to the amount of a family’s positive tax liability and thus, provide little help to families with minimal or no income tax liability. Refundable tax credits would allow a refund when the amount of the credit exceeds tax liability and the difference is refunded to the family. While tax credits generally would be more valuable to low-income families than exclusions or deductions, unless the credits became refundable they were of little value to many lower-income families with no federal tax liability.

<sup>22</sup> These percentage amounts reflect the payroll taxes that both the employer and the employee were required to pay. The total payroll taxes, combining both the employer and employee share, were 9.6 percent in 1970 and 11.7 percent in 1975.

children. Census data show that the EITC reduces poverty among children more than any other program or category of program. For non-custodial parents, an expanded EITC could deliver additional benefits to the economic well-being of children. The simple conclusion of our work is that workers without children who live below the poverty line should *not* be subject to high federal income taxes and taxed deeper into poverty. We hope to begin a dialogue rather than recommend one way to policy reform.

Some recent reform efforts attempt to simplify and integrate existing tax credits. One plan dubbed the “Simplified Family Credit” would integrate the Earned Income Tax Credit (EITC), the Child Tax Credit, the Additional Child Credit, and the dependent exemption into a single, expanded, simplified credit (Cherry & Sawicky, 2000). There is very little benefit, however, in the Simplified Family Credit or in a refundable child tax credit for those without children; and conversely, those with children are not helped as much by a payroll-tax rate cut or refundable payroll-tax credit.

The most significant challenge for policymakers, policy researchers and Washington DC think tanks concerned about federal tax relief for low-income single and married couples without children is to continue to generate thoughtful empirical analysis and policy conclusions that show how to make our tax code fair for those workers and non-custodial parents who also work hard and play by the rules. The politics of tax policy research will continue to pose major challenges for research on the distributional implications of tax reform.<sup>23</sup> The key challenge is

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<sup>23</sup> A 1999 Treasury Department analysis, which reviewed various ways to assess the distributional effects of tax reform proposals, concluded that a percentage change in after-tax income is “the best measure of the change in a family’s well-being” (Cronin, 1999). The percentage change in after-tax income is particularly important in assessing reform options because after-tax income represents the income that households and individuals have to spend or save. The best data on changes in after-tax income come from the Congressional Budget Office. CBO uses Census data and IRS *Statistics of Income* data to produce what analysts widely regard as the most authoritative and reliable data series on the matter. The CBO data cover the years 1979-2002.

how the trio of federal individual income tax provisions—personal exemptions,<sup>24</sup> standard deduction, and tax credits—together can shelter a certain amount of earned wages from federal tax liability and thus increase the amount of take-home pay of all low-wage workers.<sup>25</sup> Certainly, the budgetary environment of the moment does not hold a great deal of promise for expanded EITC commitments. Yet, recent political history over the last three decades demonstrates that new or expanded work and family support efforts are indeed possible politically, even at times of budget and economic stress. The recent discussion in Congress to support an increase in the federal minimum wage is evidence that measures in support of the working poor are not off the table. In the context of a broader effort to restore greater tax fairness and some needed progressivity to the tax code, an expanded EITC for single and childless workers could emerge as a proposal with considerable political traction.

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<sup>24</sup> Taxpayers may claim personal exemptions for themselves, their spouse, and their children who live with them and are either under the age of 19 or students under the age of 24. Taxpayers can claim other person as a dependent if they provide more than half of the person's financial support.

<sup>25</sup> Deductions provide a higher subsidy rate to higher-income families in higher tax brackets. This “upside down” subsidy feature is peculiar to the tax system. Credits provide the same dollar benefit to all families (up to the limit of the family's tax liability unless the credit is refundable). While tax credits generally are more valuable to low-income families than exclusions or deductions, unless the credits are refundable they are of little value to many low-income families. Refundability means that when the amount of the credit exceeds tax liability, the difference is refunded to the family. Benefits from credits such as education credits or the dependent care credit are limited to the amount of a family's positive tax liability and thus provide little help to families with minimal or no income tax liability.

## Appendix 1: Tables and Figures

**Table 1: EITC Parameters for Tax Year 2006**

	No qualifying children	One qualifying child	Two or more qualifying children
Maximum Credit Amount	\$412	\$2,747	\$4,536
Phase In Rate	7.65%	34%	40%
Phase In Ends	\$5,380	\$8,080	\$11,340
Phase Out Begins	\$6,740	\$14,810	\$14,810
Phase Out Rate	7.65%	15.98%	21.06%
Income Eligibility Ceiling*	\$12,120	\$32,001	\$36,348

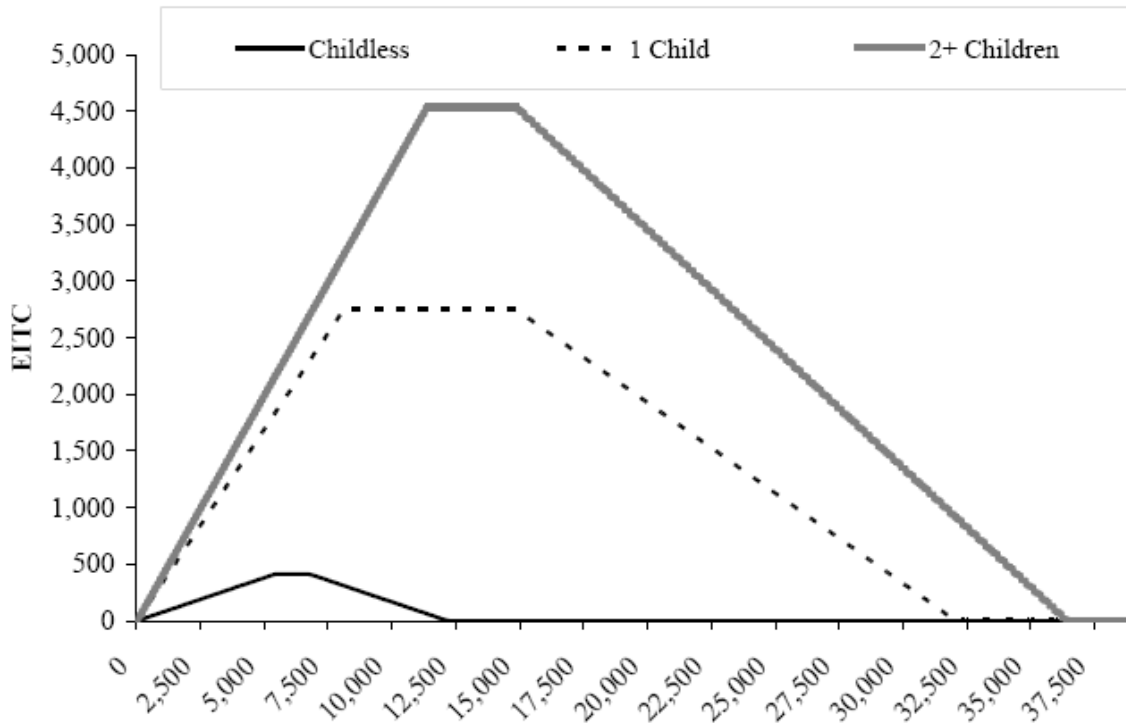
*\*Income eligibility ceiling is \$2,000 higher for married couples in each category (\$14,120 married filing jointly with no qualifying children; \$34,001 married filing jointly with one qualifying child, \$38,348; married filing jointly with 2 or more qualifying children).*

*Source: Table adapted from Holt, Steve. 2006. "The Earned Income Tax Credit at Age 30: What We Know." The Brookings Institution. Washington, DC. Table 1, p.4.*

*2006 data available from the Tax Policy Center*

<http://www.taxpolicycenter.org/TaxFacts/TFDB/TFTemplate.cfm?Docid=368>

**Figure 1: Credit Value of EITC for Unmarried\* Workers, 2006**



*\*Income eligibility ceiling is \$2,000 higher for married couples in each category (\$14,120 married filing jointly with no qualifying children; \$34,001 married filing jointly with one qualifying child, \$38,348; married filing jointly with 2 or more qualifying children).*

*Source: Adapted from Furman, Jason. 2006. "Tax Reform and Poverty." Center on Budget and Policy Priorities. Figure 1, p.3.*

**Table 2a: Total EITC Tax Returns Processed by IRS and Total Benefit Amounts, 2004**

	<b>EITC Recipients (in millions)</b>	<b>Distribution of EITC (Percentage)</b>
<b>Total EITC Tax Returns Processed</b>		
Total EITC Returns (Claimed)	21,389	100
Returns with EITC Entirely Disallowed	284	1
Total Returns Receiving EITC	21,112	99
<b>EITC Benefit Amounts</b>		
EITC benefits of \$1000 or less	7,063	33
EITC benefits of \$1001 to \$2000	4,229	20
EITC benefits of \$2001 to \$3000	5,691	27
EITC benefits of \$3001 to maximum	4,128	19
<b>Advance EITC</b>		
Returns with Advanced EITC	98	0.5

**Table 2b: EITC Recipients by IRS Filing Status and Number of Qualifying Children, 2004**

<b>Recipient Characteristic</b>	<b>EITC Recipients (in millions)</b>	<b>Distribution of EITC (Percentage)</b>
<b>By filing status</b>		
Head of household	11,506	54
Married – filing jointly	4,910	23
Single	4,695	22
<b>By number of qualifying children</b>		
Returns claiming two or more qualifying children	8,999	42
Returns claiming one qualifying child	8,184	38
Returns claiming no qualifying child	3,929	18

<b>By age of qualifying children</b>		
Returns with qualifying child under 19	16,299	76
Returns with qualifying child under 24, 19 & over	1,206	6
Returns with qualifying child 24 & over	287	1

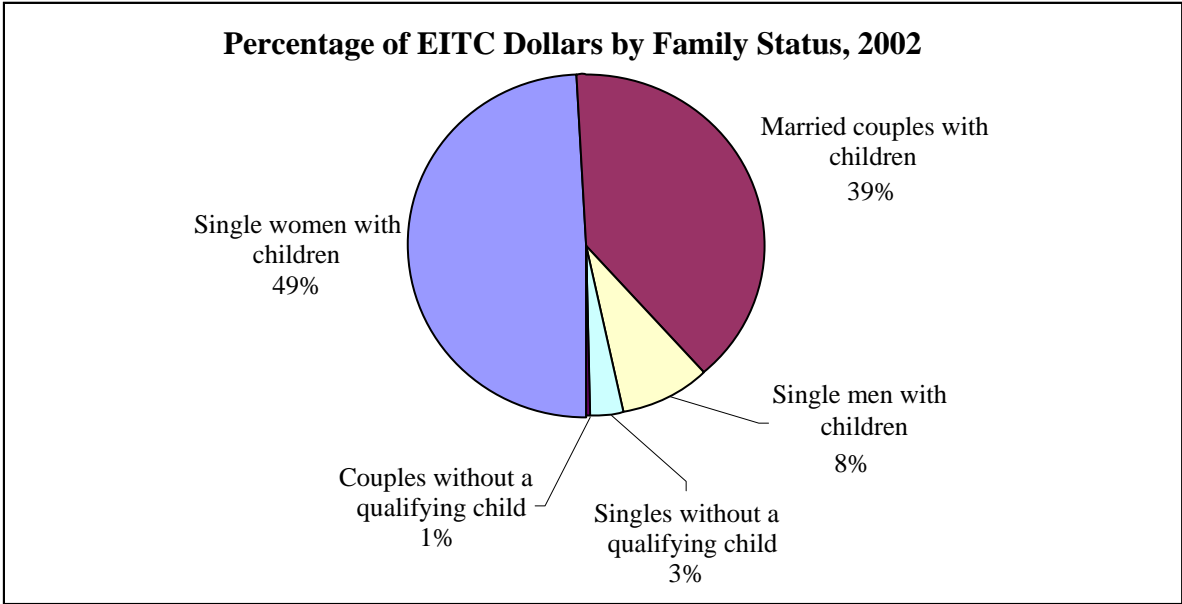
*Source: Data provided directly to authors from the Internal Revenue Service. Data represents 97% of the TY2004 EITC claims processed thru December 31, 2005.*

**Table 3: EITC Total Benefits Received, Number of Recipients and Average Benefit by Family Type, 2002**

<b>Recipient Category</b>	<b>EITC (in millions)</b>	<b>Distribution of EITC (Percentage)</b>	<b>Average Benefit Received (in dollars)</b>
Single women with children			
Total benefits	\$12,656	49	\$2,040
Number of recipients	6,203	37	
Married couples with children			
Total benefits	\$10,078	39	\$1,932
Number of recipients	5,216	31	
Single men with children			
Total benefits	\$2,124	8	\$1,825
Number of recipients	1,163	7	
Individuals without qualifying child			
Total benefits	\$766	3	\$205
Number of recipients	3,745	22	
Couples without qualifying child			
Total benefits	\$135	1	\$233
Number of recipients	577	3	
Total			
Total benefits	\$25,758	100	\$1,247
Number of recipients	16,906	100	

*Source: Authors' calculation using Current Population Survey, Annual Social and Economic Supplement 2003. Numbers are weighted. SAS program provided by and adapted from Meyer and Holtz-Eakin. 2001. "Making Work Pay: The Earned Income Tax Credit and Its Impact on America's Families." New York: Russell Sage Foundation. Table I.1, p.3.*

**Figure 2: Total EITC Benefits by Family Type**



*Source: Authors' calculation using Current Population Survey, Annual Social and Economic Supplement 2003. Numbers are weighted. Original SAS program provided by and adapted from Meyer and Holtz-Eakin. 2001. "Making Work Pay: The Earned Income Tax Credit and Its Impact on America's Families." New York: Russell Sage Foundation.*

**Table 4: Demographic Characteristics of EITC Recipients by Family Status, 2002**

Recipient Characteristic	With Children		Without Children	
	Single	Married	Single	Married
Average age (years)	35.5	37.3	40.6	54.3
Educational attainment (percent)				
High school dropout	18.5	32.0	24.3	32.4
High school graduate	42.0	36.9	36.7	36.5
Some college	32.4	21.7	24.6	19.3
College graduate	7.1	9.4	14.4	11.7
African-American (percent)	24.1	8.2	17.7	16.3
Average number of children, by age of child				
0 to five years old	.5	.8	--	--
Six to seventeen years old	1.1	1.2	--	--
Total	1.6	2.0	--	--

*Source: Authors' calculation using Current Population Survey, Annual Social and Economic Supplement 2003. Numbers are weighted. SAS program provided by and adapted from Meyer and Holtz-Eakin. 2001. "Making Work Pay: The Earned Income Tax Credit and Its Impact on America's Families." New York: Russell Sage Foundation. Table I.3, p.4.*

**Table 5a: EITC Recipients by Education as Compared with Population Age 25+, 2002**

	Age 25+	EITC Recipients		
		All EITC	Men EITC	Women EITC
	%	%	%	%
Less than high school	15.4	24.5	30.54	20.48
High school graduate	32.1	39.2	38.22	39.86
Some college	25.3	27.1	21.19	30.95
College graduate	27.2	9.2	10.05	8.71
	100	100	100	100

**Table 5b: African American EITC Recipients as Compared with Non-Hispanic Whites, 2002**

	All Non-Hispanic Whites	EITC Recipients		
		All African Americans	African American Men	African American Women
	%	%	%	%
Less than high school	10.6	20.49	23.31	19.51
High school graduate	33.0	41.82	42.48	41.59
Some college	26.4	31.73	26.61	33.51
College graduate	30.0	5.96	7.6	5.39
	100	100	100	100

*Source: Authors' calculation using Current Population Survey, Annual Social and Economic Supplement 2003. Numbers are weighted. SAS program provided by and adapted from Meyer and Holtz-Eakin. 2001. "Making Work Pay: The Earned Income Tax Credit and Its Impact on America's Families." New York: Russell Sage Foundation.*

*All figures for the United States (all age 25+ and all Non-Hispanic Whites) are from the U.S. Census Bureau, "Educational Attainment in the U.S. 2003," Current Population Report P20-550, June 2004*

**Table 6: Federal EITC Recipients, Total Benefit Amount and Child Poverty Rates by State, 2004**

	<b>EITC Recipients</b>	<b>Total Benefit Amount</b>	<b>Child Poverty Rate</b>
<b>Alabama</b>	474,760	998,428,847	22%
<b>Alaska</b>	37,763	58,154,607	12%
<b>Arizona</b>	383,818	705,307,735	20%
<b>Arkansas</b>	271,269	531,074,165	27%
<b>California</b>	2,317,220	4,174,314,526	19%
<b>Colorado</b>	253,362	415,534,026	12%
<b>Connecticut</b>	163,678	263,569,045	12%
<b>Delaware</b>	55,537	98,384,315	13%
<b>District of Columbia</b>	47,330	82,980,876	32%
<b>Florida</b>	1,529,960	2,818,748,794	18%
<b>Georgia</b>	824,985	1,674,121,408	18%
<b>Hawaii</b>	83,786	134,752,881	13%
<b>Idaho</b>	97,766	170,103,285	15%
<b>Illinois</b>	839,567	1,535,023,816	18%
<b>Indiana</b>	424,413	740,205,063	15%
<b>Iowa</b>	167,604	271,896,550	12%
<b>Kansas</b>	171,865	295,955,051	15%
<b>Kentucky</b>	335,472	595,416,659	22%
<b>Louisiana</b>	524,116	1,134,602,078	25%
<b>Maine</b>	84,437	132,963,648	17%
<b>Maryland</b>	332,284	575,565,383	11%
<b>Massachusetts</b>	302,053	477,005,627	12%
<b>Michigan</b>	638,232	1,130,240,975	17%
<b>Minnesota</b>	252,053	396,026,471	9%
<b>Mississippi</b>	365,050	783,678,895	25%
<b>Missouri</b>	428,277	761,832,390	17%
<b>Montana</b>	70,533	116,979,869	20%
<b>Nebraska</b>	107,624	183,042,279	12%
<b>Nevada</b>	154,512	263,315,377	15%
<b>New Hampshire</b>	60,897	93,236,545	7%
<b>New Jersey</b>	471,190	823,226,564	10%
<b>New Mexico</b>	191,967	354,681,775	25%
<b>New York</b>	1,432,064	2,568,455,701	21%
<b>North Carolina</b>	736,709	1,394,630,334	22%
<b>North Dakota</b>	39,035	62,955,441	14%
<b>Ohio</b>	781,898	1,371,395,070	16%
<b>Oklahoma</b>	300,415	561,846,598	17%
<b>Oregon</b>	215,535	352,332,250	17%
<b>Pennsylvania</b>	759,583	1,271,929,278	16%
<b>Rhode Island</b>	63,910	109,588,902	17%
<b>South Carolina</b>	417,105	806,173,957	19%
<b>South Dakota</b>	54,339	90,275,241	16%
<b>Tennessee</b>	535,172	997,793,846	20%

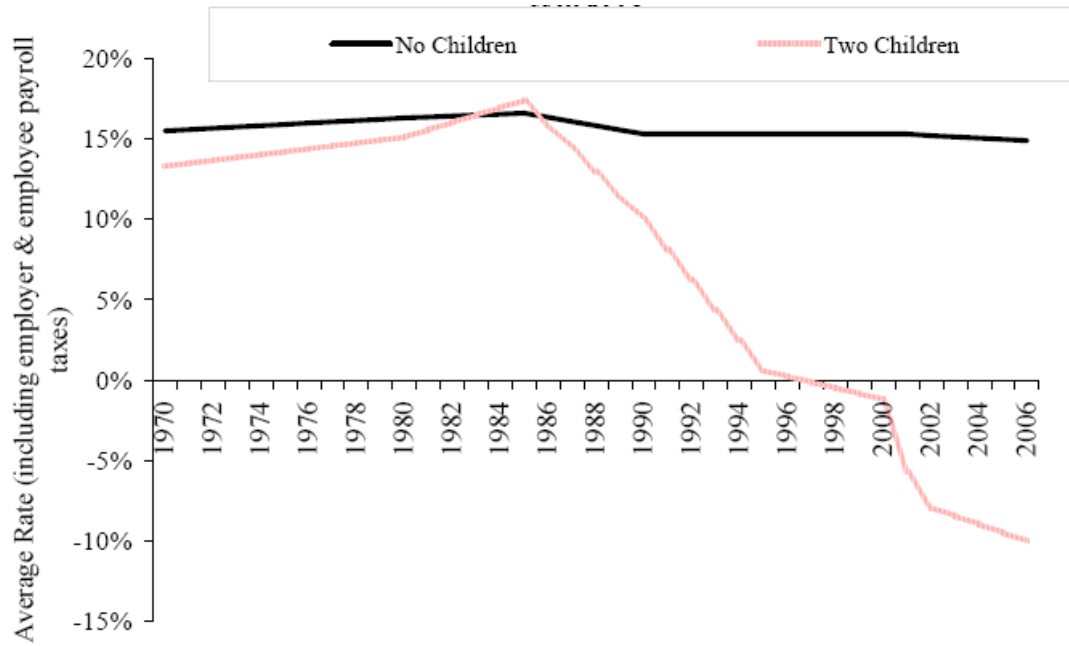
<b>Texas</b>	2,122,126	4,360,320,378	24%
<b>Utah</b>	135,105	235,402,593	13%
<b>Vermont</b>	37,380	55,514,445	12%
<b>Virginia</b>	480,189	848,724,259	14%
<b>Washington</b>	345,414	572,164,861	17%
<b>West Virginia</b>	144,304	244,278,108	24%
<b>Wisconsin</b>	292,669	473,638,158	16%
<b>Wyoming</b>	32,583	52,736,503	13%
<b>TOTAL</b>	<b>21,421,478</b>	<b>\$39,272,987,570</b>	

Source: Adapted from EITC data from “Make Tax Time Pay: 2006 Earned Income Credit and Child Tax Credit Outreach Kit.” Center on Budget and Policy Priorities. Washington, DC.

[http://www.cbpp.org/eic2006/EIC\\_Participation.pdf](http://www.cbpp.org/eic2006/EIC_Participation.pdf)

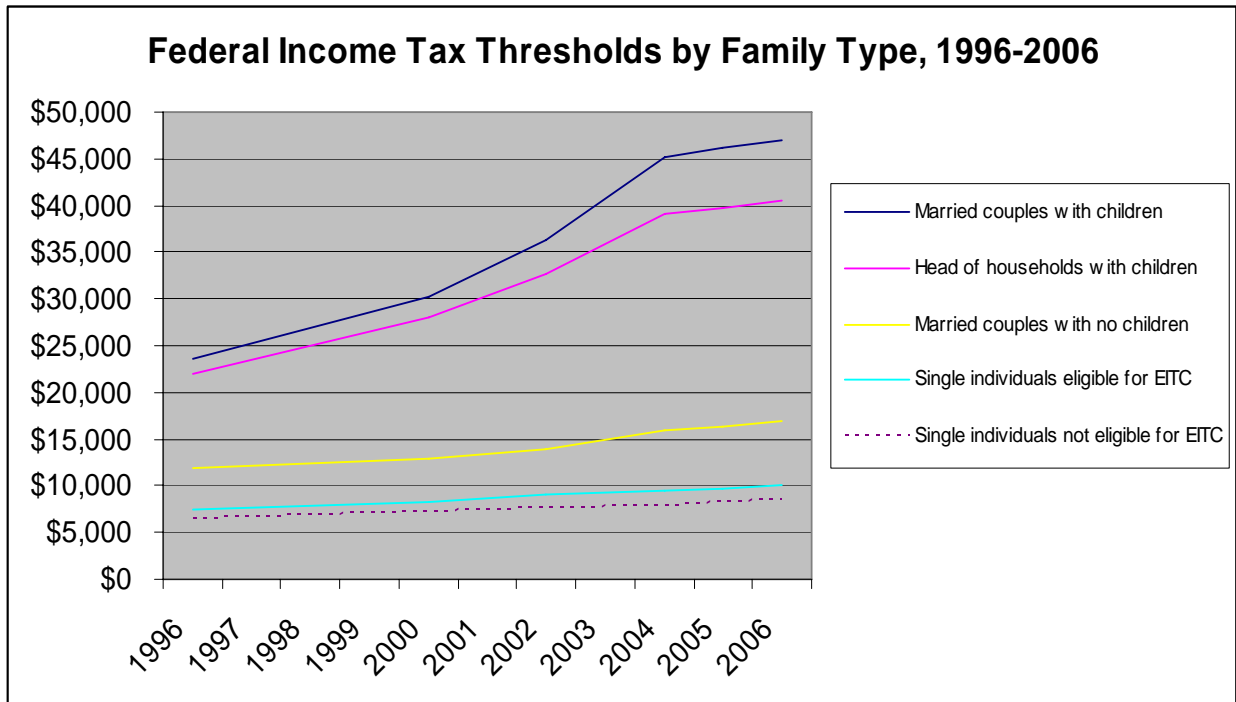
Child Poverty Rates from National Center for Children in Poverty. Data from NCCP’s 50-State Demographic Database. [http://www.nccp.org/media/Child\\_Poverty\\_and\\_Low-Income\\_Rates\\_by\\_State\\_2004.xls](http://www.nccp.org/media/Child_Poverty_and_Low-Income_Rates_by_State_2004.xls)

**Figure 3: Federal Tax Rate for Married Workers with and without Children Earning Poverty Level Wages, 1970-2006**



Source: Adapted from Furman, Jason. 2006. "Tax Reform and Poverty." Center on Budget and Policy Priorities. Washington, DC. Figure 2, p.6.

**Figure 4: Federal Income Tax Thresholds by Family Status**



Source: Adapted from Esenwein, G. (2005). "Federal Income Tax Thresholds for Selected Years: 1996 Through 2006." Congressional Research Service, Report for Congress. Table 1.

**Table 7: Policy Options for Expanding the EITC for Single and Childless Workers**

<b>Purpose</b>	<b>Proposed Change</b>	<b>Budget Impact</b>	<b>Complementary Policies</b>
(1) Baseline EITC expansion to:  a) Provide payroll tax relief; b) Increase work incentives; and c) Reduce working poverty.	a) Increase credit to 15.3 % of earnings to cover payroll taxes; b) Raise phase-in threshold to match that of workers with one child; c) Increase the phase-out threshold to roughly \$10,000 plus marriage adjustment	Approximately, \$3 billion, maximum tax credit of roughly \$1,236 (Furman 2006 p. 8)	a) Raise minimum wage; b) Support for education and workforce training.
(2) Provide incentives for young workers to participate in the legitimate labor market	Lower the age limit from 25 to 21 for single and childless workers who meet income guidelines	\$4.3 billion when combined with an expanded EITC similar to that above (Edelman, Holzer, Offner 2006 p.88)	Same as above, plus school-to-work programs and stipends to participate in education and training programs.
(3) Increase the numbers of people with health insurance and/or contributing to retirement accounts.	Create a mechanism to use Advance EITC payments to be used for employee share of health insurance premiums and retirement plan contributions.	No estimate	
(4) Increase savings and assets for low wage single and childless workers	Provide matched savings deposits for Coverdell, College Savings 529, and retirements accounts such as IRAs in addition to existing matched savings vehicles such as Individual Development Accounts.	No estimate	a) Revise asset limits in other public benefit programs as needed to encourage savings; b) Make the Savers Credit fully refundable; c) Provide federal funding for free income tax preparation and financial education for low-income individuals and families;

**Table 8: Comparisons of Coverdell ESA’s, 529 College Saving Accounts and IRA’s**

	<b>ESA’s</b>	<b>529’s</b>	<b>IRA’s</b>
<b>Allowable Use</b>	Education – secondary and post-secondary	Education – post-secondary only	Post-Secondary education, homeownership, retirement
<b>Tax Benefits</b>	Contributions are made after taxes; earnings and after-tax dollars put into the account are not taxed as they accrue or at withdrawal if used for allowable purposes	Contributions are made after taxes; earnings and after-tax dollars put into savings are not taxed as they accrue or at withdrawal if used for allowable purposes; some states allow participants to deduct contributions to their 529 accounts from state taxable income	Contributions are made after taxes; earnings and after-tax dollars put into the account are not taxed as they accrue or at withdrawal if used for allowable purposes
<b>Fees</b>	Vary based on the vendor	Vary based on the state; some concern about excessively high fees	Vary based on the vendor
<b>Impact on Financial Aid</b>	Less advantageous because assets held in ESA’s are included in calculation of available resources (assessed at a max percent of 5.64)	Less advantageous because assets held in 529’s are included in calculation of available resources (assessed at a max percent of 5.64)	Most advantageous because pension assets are excluded from calculation of available resources
<b>Impact on Public Benefits</b>	Little to no impact because the account is inaccessible to the parents (ESA’s are custodial accounts and the custodian must be a bank or an IRS approved entity); not considered a countable asset when determining eligibility	Little to no impact because the account is inaccessible to the parents (529’s can be set up as custodial accounts with a community organization acting as the custodian); not considered a countable asset when determining eligibility	Greater impact because accounts may be owned by a parent and therefore, funds are considered a “countable” asset for determining eligibility

*Source: Adpated from Rist, C. & Humphrey, L. (2006). Growing knowledge from SEED: Lessons learned from the Saving for Education, Entrepreneurship, and Downpayment Initiative. Corporation for Enterprise Development, August.*

## Appendix 2

### EITC Thresholds and Credit Amounts (2006)

<http://www.irs.gov/individuals/article/0,,id=150513,00.html>

Earned income and adjusted gross income (AGI) must each be less than:

- \$36,348 (\$38,348 married filing jointly) with two or more qualifying children;
- \$32,001 (\$34,001 married filing jointly) with one qualifying child;
- \$12,120 (\$14,120 married filing jointly) with no qualifying children.

Tax Year 2006 maximum credit:

- \$4,536 with two or more qualifying children;
- \$2,747 with one qualifying child;
- \$412 with no qualifying children.

### Uniform Definition of Qualifying Child

<http://www.irs.gov/newsroom/article/0,,id=133298,00.html>

A “qualifying child” may allow a taxpayer to claim important tax credits, including the EITC. In 2004, the Working Families Tax Relief Act created a uniform definition for qualifying child which states that a child must satisfy the following 4 tests:

- **Relationship** — the taxpayer’s child or stepchild (whether by blood or adoption), foster child, sibling or stepsibling, or a descendant of one of these.
- **Residence** — has the same principal residence as the taxpayer for more than half the tax year. Exceptions apply, in certain cases, for children of divorced or separated parents, kidnapped children, temporary absences, and for children who were born or died during the year.
- **Age** — must be under the age of 19 at the end of the tax year, or under the age of 24 if a full-time student for at least five months of the year, or be permanently and totally disabled at any time during the year.
- **Support\*** — did not provide more than one-half of his/her own support for the year.

Some tax benefits also apply additional rules for qualifying children. For the EITC, those additional rules include having lived with the taxpayer in the US for more than half the year and having a social security number for the child. A qualifying child is determined without regard to the exception for children of divorced or separated parents. If a qualifying child is married, he or she must also meet the marital status and nationality tests for a dependent.

\* In order for a taxpayer to claim the EITC, a qualifying child does not have to meet the support test.

## **Qualifying Child Tie-Breaker Rules**

<http://www.irs.gov/pub/irs-pdf/p3524.pdf>

If a child meets the rules to be a “qualifying child” for more than one person the tie-breaker rules apply because only one taxpayer can claim the EITC with that child.

Under the tie-breaker rules, the child is treated as a qualifying child only by:

- The parents, if they file a joint return,
- The parent, if only one of the persons is the child’s parent,
- The parent with whom the child lived the longest during the tax year, if two of the persons are the child’s parent and they do not file a joint return together,
- The parent with the highest AGI if the child lived with each parent for the same amount of time during the tax year, and they do not file a joint return together, or
- The person with the highest AGI, if none of the persons is the child’s parent.

## **Tax information for non-custodial parents**

<http://www.irs.gov/pub/irs-pdf/p4449.pdf#search=%22IRS%20publication%204449%22>

The custodial parent is the parent with whom the child shared the same principal place of residence for the greater portion of the year. Exemptions for dependent children, including the additional tax benefits available through the EITC, are not usually available for non-custodial parents due to the “qualifying child” rules. This is true even if the non-custodial parent provides more than half of the child’s total financial support.

## **Tax information on Coverdells**

<http://www.irs.gov/publications/p970/ch07.html>

- A Coverdell ESA (ESA) is a trust or custodial account created for the purpose of paying qualified educational expenses.
- Contributions to an ESA are not deductible but the amounts deposited grow tax free until distributed.
- When the account is established, the designated beneficiary must be under the age of 18 or a special needs beneficiary. Contributions cannot be made once the beneficiary reaches 18, unless he or she is a special needs beneficiary.
- Almost anyone can contribute to the account, including the beneficiary, as long as the contributors modified adjusted gross income is less than \$110,000 (\$220,000 for joint returns).
- Contributions must be in cash and the annual contribution limit is \$2,000 per beneficiary.
- ESA’s can only be used for educational expenses related to either elementary and secondary schooling or postsecondary schooling.
- Qualified educational expenses include: tuition and fees, books and supplies, tutoring, special needs services, uniforms, transportation and supplementary items and services such as extended day programs. Additionally, some computer-related expenses are also approved.

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