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How Would Changes to the Earned Income Tax Credit Affect Rural Recipients?

The earned income tax credit (EITC) has become a major source of income support for low-income rural workers and their families, especially in the South, where the rural poor are concentrated. Program benefits for rural areas are expected to total about $6 billion in 1996, nearly double the 1992 amount, providing benefits to an estimated 4.5 million low-income rural workers and their families. Increasing concerns about escalating costs and the targeting of benefits may result in changes to the EITC program that would reduce both benefit levels and the number of eligible low-income rural workers. Proposed changes to improve the targeting of benefits would exclude many farmers from the program.

The earned income tax credit (EITC) was enacted in 1975 to reduce the burden of social security taxes on low-income workers, thereby encouraging them to seek employment rather than welfare benefits. Program expansions enacted in 1990 and 1993 made the EITC one of the largest programs targeted to low-income individuals. In 1996, the credit is expected to provide an estimated $25 billion to over 18 million low-income workers and their families (or over $1,388 per recipient). Rural residents are major beneficiaries of the expanded credit, with low-income rural workers and their families receiving about a fourth of all benefits.

The EITC's rapid expansion since 1990 has heightened concerns about increased incidents of fraud, imprecise benefit targeting, and high program costs. These concerns have triggered efforts to streamline program administration and to target benefits better. Other program changes have also been proposed that could significantly reduce future benefits.

How the Earned Income Tax Credit Works

The earned income tax credit (EITC) is a refundable tax credit available to low-income workers who satisfy certain income and other eligibility criteria. For low-income workers with children, the criteria require that the children satisfy an age, relationship, and residency test. For workers without children, the criteria require that the taxpayer be between the ages of 25 and 65 and not be claimed as a dependent of another taxpayer.

Unlike most other cash-assistance programs for low-income families, the EITC requires recipients to work. Furthermore, where other benefit-transfer programs reduce benefits for higher earnings, the EITC increases, at least at the lower income levels, for each additional dollar of earnings until a maximum credit is reached. This encourages recipients to work to increase their credit amount. Like most other programs, once an income threshold is reached, the credit is reduced as earnings increase.

Most taxpayers receive the EITC in a lump sum at the end of the year by claiming it on their Federal income tax return. Since the credit is refundable, any amount in excess of Federal income or other tax liabilities is refunded to the taxpayer to help offset social security taxes. Eligible recipients also have an advance payment option that allows them to receive a portion of their benefits throughout the year.

Earned income tax credit, 1996

Type of recipient	Credit rate	Earned income amount	Maximum credit	Phase-out rate	Phase-out begins	Phase-out ends
Families w/1 child	34.00%	$6,330	$2,152	15.98%	$11,610	$25,078
Familes w/2+ children	40.00%	$8,890	$3,556	21.06%	$11,610	$28,495
Workers w/o children	7.65%	$4,220	$323	7.65%	$5,280	$9,500

Example: Families w/1 child with earned income between $6,330 and $11,610 receive the maximum benefit of $2,152. For earned incomes between $11,610 and $25,078, the benefit is reduced at a constant rate of $15.98 per $100 of additional income.

Larger Share of Rural Workers Receive the EITC

Rural households have historically had lower incomes and a higher poverty rate than urban households. In 1992, rural taxpayers reported average adjusted gross income of $24,742 compared with $33,884 for urban taxpayers. That same year, 16.8 percent of rural persons lived in poverty, compared with 13.9 percent of urban people. One reason for the higher rural poverty rate is the preponderance of low-wage jobs found in rural areas. In 1992, rural areas were home to 33 percent of full-time, full-year workers who were poor, but only about 20 percent of all full-time, full-year workers.

Given the income differential and the prevalence of low-wage jobs in rural areas, rural taxpayers benefit the most from programs targeted at low-income workers. In 1992, rural taxpayers received over $3.3 billion in benefits and represented a quarter of all credit recipients. In the same year, nearly 16 percent of rural taxpayers received an EITC (average credit $912) compared with 12 percent of urban taxpayers (average credit $929). Farmers, however, are not major beneficiaries of the EITC. In 1992, only about 8 percent of all farmers (individuals filing a farm income tax return) received the EITC.

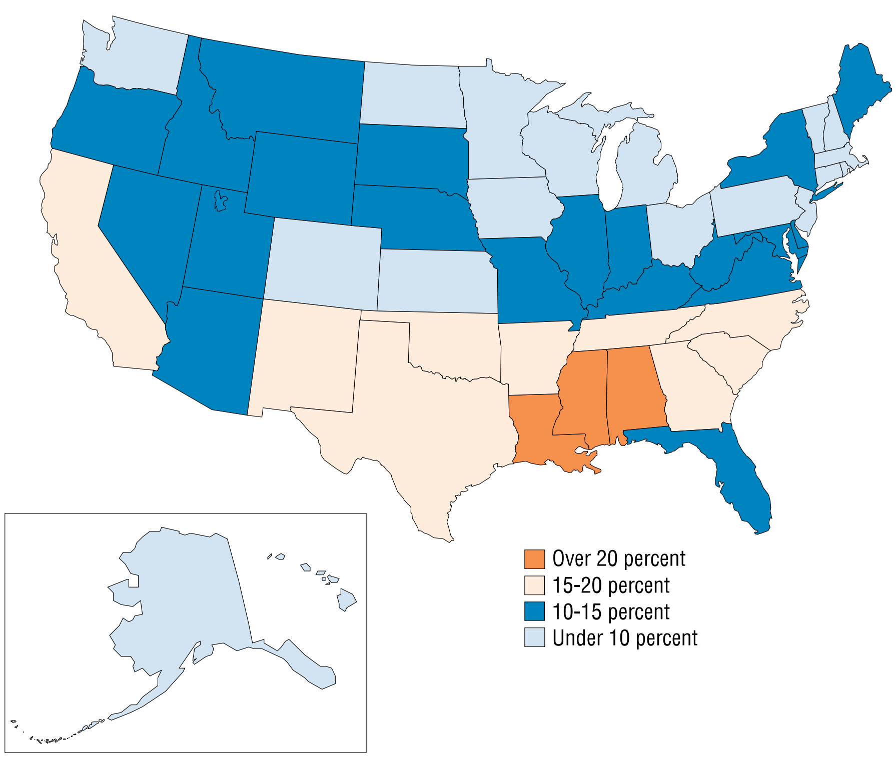
Benefits Are Greatest Where Rural Poor Are Concentrated

In 1992, about one out of every eight taxpayers received the EITC. However, the rate varied widely by State. The share of taxpayers receiving the credit in Southern States, where the rural poor are concentrated, was well above the national average (fig. 1).

Like Food Stamps and Supplemental Security Income, but unlike Aid to Families with Dependent Children (AFDC), the eligibility criteria and rate of the EITC are the same nationwide. This is especially important for the rural poor, since 53 percent of them live in Southern States, where AFDC benefit amounts are well below the national average.

Figure 1

Share of tax returns reporting earned income tax credit by State, 1992



Source: Economic Research Service compiled from Internal Revenue Service, *Statistics of Income Bulletin*, Winter 1994-95.

Recent Changes Increased Rural Benefits

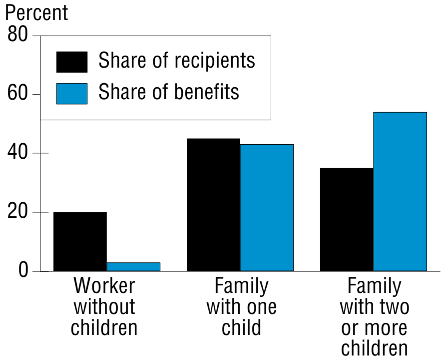
The Omnibus Budget Reconciliation Act of 1990 and the Revenue Reconciliation Act of 1993 broadened EITC coverage and increased its benefit levels. The 1990 act broadened EITC coverage by simplifying eligibility rules and by reducing interactions between the EITC and other low-income assistance programs. The 1993 act extended the coverage to an additional 4 million workers (rural and urban) by offering the credit to low-income workers without children. The combined effects of these acts increased the credit rate from 14 to 36 percent of earned income for workers with one child and from 14 to 40 percent for workers with two or more children. These rate increases, combined with an increase in the maximum income level on which the credit is calculated, have more than doubled the maximum credit for workers with one child and have nearly quadrupled the maximum credit for workers with two or more children.

Both the number of beneficiaries and the level of benefits will increase because of the expanded credit provisions in the 1990 and 1993 acts. Compared with 1992, benefits to rural recipients are expected to nearly double to an estimated $6 billion. Most of these increased benefits will go to low-income workers with two or more children. Their average benefit will increase from $911 in 1992 to an estimated $2,154 in 1996; the average benefit for low-income workers with only one child will increase from $912 to an estimated $1,399.

The extension of the credit to low-income workers with no children will benefit an estimated 900,000 low-income rural workers. However, since the average benefit in 1996 for these workers is much lower ($168), the aggregate benefit is estimated at less than 3 percent of the total EITC for rural workers (fig. 2).

Figure 2

Distribution of Earned Income Tax Credit benefits, by type of rural recipient



Source: Economic Research Service estimated from Internal Revenue Service data.

Targeting and Other Concerns Prompt Program Changes

Even before the 1993 expansion of the EITC became fully effective, concerns about the targeting of benefits, rapidly escalating costs, and increasing evidence of fraud prompted efforts to target benefits better, reduce fraudulent claims, and reduce future benefit levels. Since the EITC is administered through the tax system, participation rates have been high. However, fraud and error rates have also been high, with some Internal Revenue Service (IRS) studies suggesting that as many as a third of EITC recipients were not eligible for all or a portion of the benefits received. The IRS has taken steps to detect fraudulent claims and to make other changes to improve program administration.

Targeting Proposals Can Increase Benefits Provided to the Poor

Until 1991, the combined employee-employer social security tax rate had always exceeded the EITC rate. However, the current credit rate (40 percent) for workers with two or more children is 2.5 times the combined social security tax rate. In fact, only about half of the current credit amount going to rural recipients with adjusted gross income below $10,000 is needed to offset all Federal income and payroll taxes. This indicates that the credit has expanded well beyond a payroll tax offset to become a means of lifting low-income working families above the poverty line.

This expanded role and the escalating costs of the program have heightened concerns regarding the targeting of benefits. The current EITC does not consider a taxpayer's assets or certain sources of income, such as interest, dividend, rent, or royalty income, unless adjusted gross income exceeds earned income (in which case adjusted gross income is used to phase out EITC benefits). Various nontaxable sources of income, including tax-exempt interest, social security benefits, and child support payments, are also not considered in determining eligibility. Under a broader measure of income that includes nontaxable income sources, over 1 million recipients (both rural and urban) have over $30,000 in income. Many of the recipients in this group are clearly outside the intended group targeted for benefits.

Legislation enacted in early 1995 addressed some of these concerns. Beginning in 1996, individuals will no longer be eligible for the EITC if their interest, dividend, rent, or royalty income (disqualified income) exceeds $2,350. The primary purpose of this change was to improve the targeting of benefits by denying eligibility to individuals with a level of asset-based income that suggests some wealth, regardless of their level of earned income. This change could remove from eligibility between 1 and 2 percent of all EITC recipients. While the effect on rural recipients is expected to be slightly less, up to 10 percent of farmers currently receiving the credit will be ineligible in 1996, primarily due to their relatively high level of interest income reported.

Other asset-based income sources, such as net capital gains, could be added to the disqualifying income list. If net capital gains were added, the number of farmers removed from eligibility would double, primarily because sales of certain farming assets qualify as a capital gain.

Another alternative for improved targeting is to expand the definition of adjusted gross income for purposes of phasing out the credit. Under one proposal, adjusted gross income would include certain nontaxable income items, including nontaxable social security benefits, tax-exempt interest, nontaxable pension distributions, and child support payments in excess of $6,000. Certain losses, including farm losses, would also be disallowed, affecting benefits for about 10 percent of current recipients. Again, farmers would be disproportionately affected (primarily due to the disallowance of farm losses) since nearly half of all farmers receiving the EITC reported farm losses, with the average loss about $10,500.

While these benefit-targeting proposals would substantially reduce benefits to farmers, possibly halving the number of farmers eligible for the credit, these changes would primarily reduce benefits to higher income recipients, increasing the share of benefits going to the working poor. However, both the disqualified income test and an expanded adjusted gross income definition would impose additional burdens on taxpayers in determining eligibility and on the IRS in ensuring compliance.

Broader Changes Could Greatly Reduce Future Benefits

Concerns regarding the escalating costs and the expanded role of the EITC have led to proposals that would make much broader changes to the credit. These proposals include eliminating the EITC for low-income workers without children and reducing the credit for higher income workers with children, especially those with two or more children. These changes would have a much greater effect than targeting proposals on future recipients and benefit levels.

Eliminating the EITC for Workers Without Children. Before 1993, the EITC was available only to low-income workers with children. This restriction effectively excluded a large segment of the working poor from receiving benefits under the credit. Providing benefits to low-income workers without children, especially at a rate equal to the employee's share of social security taxes, is consistent with the original objectives of the credit.

Eliminating the EITC for childless low-income workers would remove benefits for an estimated 900,000 rural workers. While the estimate of total benefits lost to these workers is less than 3 percent of the total EITC for all rural workers, the great majority losing benefits would be poor or have total income just above the poverty level. The poverty level for a two-person household is about $10,000. For childless taxpayers, the credit is only available if the greater of earned income or adjusted gross income is less than $9,500. Most affected workers have total income below $20,000, and about 75 percent have income below $10,000.

Reducing the Credit for Higher Income Recipients With Children. As the credit rate has increased, the EITC has been extended to taxpayers with income well above the poverty level, leading legislators to propose reductions in future benefits to such recipients.

One proposal that was incorporated into recent budget reconciliation legislation is to combine a credit rate reduction with an earned income enhancement factor at the lower income levels. This proposed change would reduce from 40 percent to 36 percent the credit rate for workers with two or more children and maintain the credit amount at essentially the same level for lower income recipients. The proposal would also increase the phase-out rate for all recipients with children, reducing the level of income that taxpayers could earn and still receive some benefits. This proposal maintains the credit level for lower income recipients and reduces it for higher income recipients. However, the proposal also would make EITC calculations more complex, and the more rapid reduction of benefits as income increases would reduce the incentive to work for recipients in the phase-out range.

The combined effect of eliminating the EITC for workers without children and reducing benefits to higher-income recipients with children would reduce or eliminate benefits for about half of all rural credit recipients. Rural recipients would lose nearly 10 percent of their estimated benefits in 1996.

Conclusions

The earned income tax credit has become a major source of income support for low-income rural workers and their families, over 4.5 million of whom (about 20 percent of rural taxpayers) will receive an estimated $6 billion in benefits in 1996. This assistance is especially important in the South where the rural poor are concentrated and where benefit levels of other income-support programs are below those in other regions. Recent proposals to improve targeting of benefits, prevent fraud, and reduce future benefits, if enacted, would increase the share of benefits going to the poor but would also significantly reduce future benefits to rural taxpayers, especially farmers.

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Further Readings

U.S. Congress, Joint Committee on Taxation. *Description of Present Law and Discussion of Issues Relating to the Earned Income Tax Credit.* JCX-27-95, June 14, 1995.

U.S. General Accounting Office. *Earned Income Tax Credit: Targeting the Working Poor.* Washington, DC, Mar. 1995.

About the Data

Data for this article are based on special tabulations from the 1992 Internal Revenue Service Individual Tax Model File. For additional detail concerning the data, contact the author.

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