Ron Durst

# Many Low-Income Rural Families Benefit from the Earned Income Tax Credit

*The earned income tax credit has become a major source of income support for low-income workers and their families. The credit provided 3.7 million rural working poor with a $3.3 billion boost in income in 1992. Program benefits were largest in the South where the rural poor are concentrated. By 1996, expansions of the program are expected to nearly double the level of benefits provided to the rural working poor. However, major program changes have been proposed that would reduce both the number of credit recipients and the level of benefits.*

THE earned income tax credit was enacted in 1975 as a very modest program to reduce the burden of Social Security taxes on low-income workers, encouraging them to work rather than to rely on welfare benefits. The credit expanded several times since then and has become one of the largest cash or near-cash programs targeted to low-income individuals. The credit provided over $13 billion to low-income workers and their families in 1992, the most recent year for which a sample of income tax returns is available.

Rural residents are major beneficiaries of the earned income tax credit. As a result of the lower income levels, the higher poverty rate, and the prevalence of low-wage jobs in rural areas, a larger share of rural workers is eligible for benefits under the credit. In 1992, 15.6 percent of rural taxpayers received the earned income tax credit compared with only 11.6 percent of urban taxpayers. Low-income rural workers received $3.3 billion in benefits from the earned income tax credit.

### How the Earned Income Tax Credit Works

The earned income tax credit is a refundable tax credit available to low-income workers who satisfy income and eligibility criteria. For low-income workers with children, these eligibility criteria require that the taxpayer's children satisfy an age, relationship, and residency test. For those workers without children (who became eligible for the credit in 1994), eligibility criteria require that the taxpayer be between the ages of 25 and 65 and not be claimed as a dependent of another taxpayer. See "Role of Credit Expanded Greatly in Last Decade," p. 3, for detail on eligibility criteria and credit amounts in various years.

Unlike most other cash assistance programs for low-income families, the earned income tax credit requires recipients to work. Furthermore, unlike other transfer programs that reduce benefits for higher earnings, the credit amount actually increases for each additional dollar of earnings up to a maximum. Once the credit reaches its maximum amount, it remains unchanged over a relatively narrow income range and then it is phased out over a relatively wide income range until it reaches zero.

In 1992, taxpayers with two or more children with earned income up to $7,520 received 18.4 cents for each dollar earned as the credit phased in. For taxpayers with income between $7,520 and $11,840, the amount of the credit remained at the maximum $1,384. Taxpayers with earned income between $11,840 and $22,370 saw their credit phase out at a rate of 13.14 cents for each additional dollar of earned income. Those with income above $22,370 were not eligible for the earned income tax credit. Workers with one child had slightly lower phase-in and phase-out rates and maximum credit.

Since the credit is refundable, any amount in excess of Federal income or other tax liabilities is refunded to the

Ron Durst is an economist in the Finance and Development Branch, Rural Economy Division, ERS.

## Role of Credit Expanded Greatly in Last Decade

The earned income tax credit was adopted in 1975 as a way to reduce or eliminate the burden of Social Security taxes on low-income workers with families and to encourage low-income individuals with families to seek employment rather than welfare. This initial credit was equal to 10 percent of the first $4,000 of earned income resulting in a maximum credit of $400 (see table). The credit was completely phased out for taxpayers with income of $8,000. Over the next decade, minor increases in the credit raised the maximum credit to $550 in 1986.

Since 1986, the Tax Reform Act of 1986, the Omnibus Budget Reconciliation Act of 1990, and the Omnibus Budget Reconciliation Act of 1993 have made major changes in the credit and its eligibility criteria. Among the changes were indexing of the credit to inflation, simplifying rules relating to providing support for children, setting higher credits for workers with two or more children, and reducing the interaction of the credit with other programs by specifying that it was not to be considered as income for purposes of determining eligibility for or the amount of benefits under Aid to Families with Dependent Children (AFDC), Medicaid, Supplemental Security Income (SSI), food stamps, or low-income housing programs. These changes increased benefits and made more low-income workers eligible for the credit.

As these changes were adopted, the earned income tax credit grew. Between 1986 and 1987, the credit jumped $300 to a maximum of $851. In 1991, the maximum credit jumped again and the higher credit for workers with two or more children was instituted. The maximum credit for workers with two or more children increased by $1,017 between 1993 and 1994 while the credit for workers with one child increased by $604. In 1995, the credit for workers with two or more children increased again by about $582, while the credit for workers with one child increased by only $56, opening a much wider gap between the maximum credits for the two types of families. The maximum credit for workers with two or more children is scheduled to jump another $446 to $3,556 in 1996, while the credit for workers with one child is only scheduled to be adjusted for inflation, increasing the maximum credit to $2,152.

In 1991, two supplemental credits were added that are not reflected in the maximums shown in the table. A 5-percent young child credit was available for families with a qualifying child less than 1 year old. A 6-percent credit was also provided for families who purchased health insurance coverage for a qualifying child. Both the supplemental young child and supplemental health insurance credits used the same earned income limits for phase-in and phase-out as the basic earned income credit and were available during 1991-93.

In 1994, a credit was instituted for workers without children. The credit was equal to 7.65 percent (the employee's Social Security payroll tax rate) of earned income up to $4,000. Thus, the maximum credit was $306. The credit phased out at the 7.65 percent rate for earned income over $5,000, reaching $0 at $9,000 of earned income. An estimated 3.7 million low-income workers were eligible for this new credit in 1994. Given the low level of income for which this credit is available, the credit for low-income earners without children almost exclusively benefits the working poor.

### Earned income tax credit rates and income ranges, 1975-1996

| Year | Credit rate | Minimum income for maximum credit | Maximum credit[1] | Phase-out rate |
|---|---|---|---|---|
| | Percent | Dollars | | Percent |
| 1975-78 | 10.00 | 4,000 | 400 | 10.00 |
| 1979-84 | 10.00 | 5,000 | 500 | 12.50 |
| 1985-86 | 11.00 | 5,000 | 550 | 12.22 |
| 1987 | 14.00 | 6,075 | 851 | 10.00 |
| 1988 | 14.00 | 6,225 | 874 | 10.00 |
| 1989 | 14.00 | 6,500 | 910 | 10.00 |
| 1990 | 14.00 | 6,800 | 953 | 10.00 |
| 1991: | | | | |
| Two or more children | 17.30 | 7,140 | 1,235 | 12.36 |
| One child | 16.70 | 7,140 | 1,192 | 11.93 |
| 1992: | | | | |
| Two or more children | 18.40 | 7,520 | 1,384 | 13.14 |
| One child | 17.60 | 7,520 | 1,324 | 12.57 |
| 1993: | | | | |
| Two or more children | 19.50 | 7,750 | 1,511 | 13.93 |
| One child | 18.50 | 7,750 | 1,434 | 13.21 |
| 1994: | | | | |
| Two or more children | 30.00 | 8,425 | 2,528 | 17.68 |
| One child | 26.30 | 7,750 | 2,038 | 15.98 |
| No children | 7.65 | 4,000 | 306 | 7.65 |
| 1995: | | | | |
| Two or more children | 36.00 | 8,640 | 3,110 | 20.22 |
| One child | 34.00 | 6,160 | 2,094 | 15.98 |
| No children | 7.65 | 4,100 | 314 | 7.65 |
| 1996: | | | | |
| Two or more children | 40.00 | 8,890 | 3,556 | 21.06 |
| One child | 34.00 | 6,330 | 2,152 | 15.98 |
| No children | 7.65 | 4,220 | 323 | 7.65 |

[1]For 1991-93, the maximum credit shown does not include the young child credit or the health insurance credit.
Source: U.S. Congress, Joint Committee on Taxation.

taxpayer to help offset Social Security taxes. Most taxpayers receive the credit in a lump sum at the end of the year by claiming it on their Federal income tax return. Eligible recipients also have an advance payment option that provides for periodic payments of portions of the benefits throughout the year. However, few taxpayers take advantage of this option.

### More Rural Workers Receive the Earned Income Tax Credit

Rural households have historically had lower incomes than urban households. Among rural taxpayers, the average adjusted gross income was $24,742 in 1992 compared with $33,884 for urban taxpayers. This represents about a 27 percent gap between rural and urban household income.

Rural residents also have a higher rate of poverty. In 1992, the Current Population Survey estimated that 9.5 million rural persons lived in poverty. This represents a 16.8 percent rural poverty rate compared with a 13.9 percent urban rate. One of the main reasons for the higher rural poverty rate is the large share of low-wage jobs found in rural areas. In 1992, 32 percent of the 2.1 million poor full-time, full year workers lived in rural areas while only about 20 percent of all full-time, full year workers lived there.

Because of the income differential and the prevalence of low wage jobs, it is not surprising that rural taxpayers are major beneficiaries of a program targeted at low-income workers. In 1992, nearly 3.7 million received the earned income tax credit. These taxpayers received over $3.3 billion in benefits from the credit (table 1). Fifty-five percent of them had only one qualifying child. Although the credit rate was slightly higher for those with more than one child (18.4 compared to 17.6 percent of earnings), the credit was phased out at a slightly more rapid rate for families with more than one child. As a result, the average credit for both groups was about the same.

Although there are many more credit recipients in urban areas, they are a smaller share of urban taxpayers. Earned income credit recipients are 15.6 percent of rural taxpayers, but only 11.6 percent of urban taxpayers. There were only minor rural-urban differences in the average size of the credit. For 1992, the average credit for rural workers was $912 compared with $929 for urban workers.

In 1992, in addition to the basic credit, two supplemental credits were also provided for those credit recipients that met certain additional requirements. A 5-percent young child credit was available for families with a qualifying child less than 1 year old. A 6-percent credit was also provided for families who purchased health insurance coverage for a qualifying child. Both the supplemental young child and health insurance credits used the same earned income limits for phase-in and phase-out as the basic earned income credit.

Rural residents benefited more from the supplemental health insurance credit. Approximately 24 percent of rural residents who claimed the earned income tax credit received benefits for providing health insurance to a qualifying child. Only 18.6 percent of urban credit recipients benefited from this supplemental credit. The average health insurance credit for rural recipients was slightly higher at $244 compared with $232 for urban taxpayers. This is consistent with data showing that a higher proportion of rural residents obtain health insurance coverage from private sources other than their employer (Frenzen).

Urban taxpayers, on the other hand, received greater benefits from the supplemental young child credit. About 15.2 percent of urban credit recipients received this supplemental credit compared with only about 12.4 percent for rural recipients. The average urban supplement was

Table 1

**Earned income tax credit recipients and amounts, 1992**

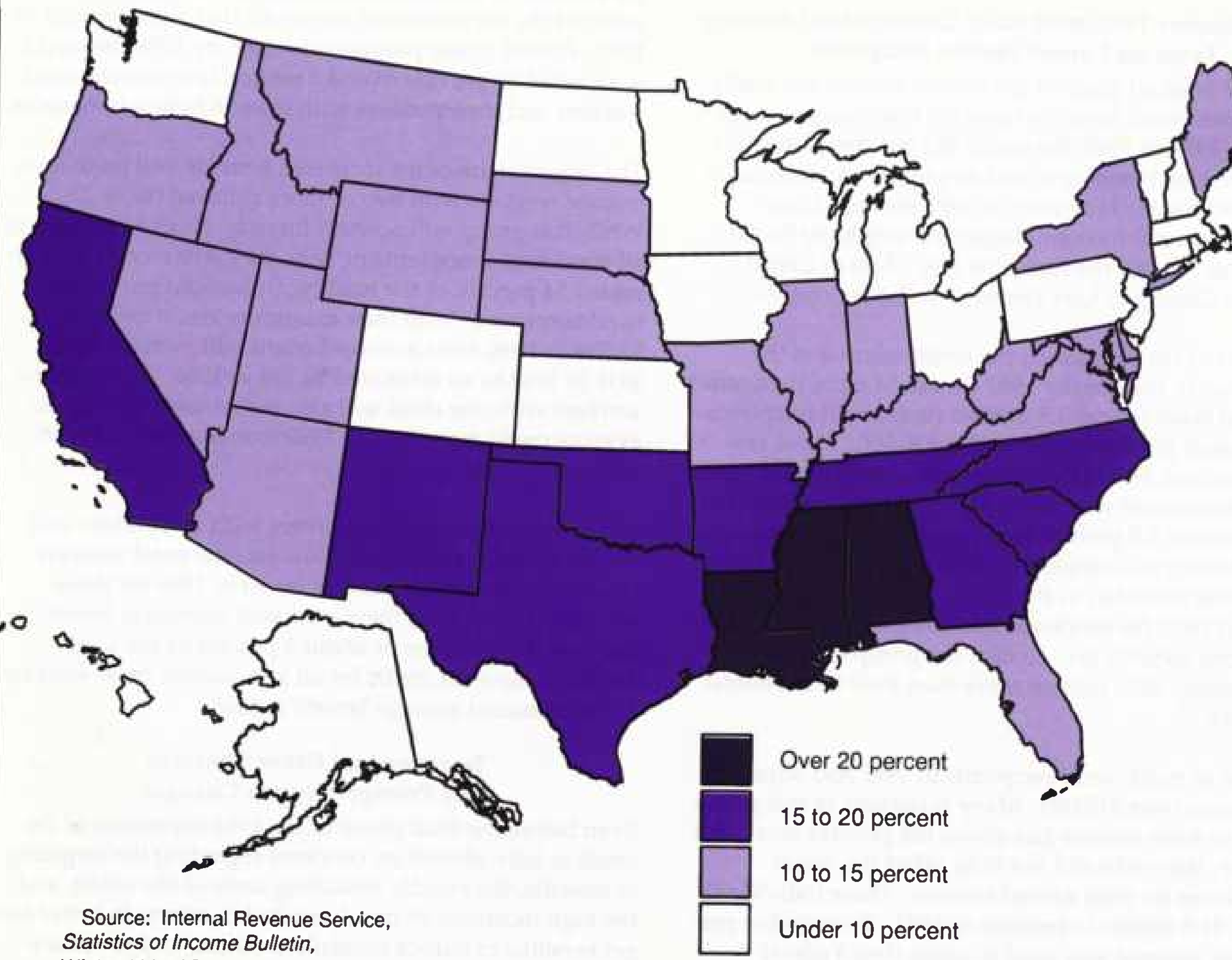
*A larger share of nonmetro taxpayers receives the credit*

| Type of recipient | Nonmetro | | | Metro | | |
|---|---|---|---|---|---|---|
| | Recipients | Total credit | Average credit per recipient | Recipients | Total credit | Average credit per recipient |
| | Thousands | Thousand dollars | Dollars | Thousand | Thousand dollars | Dollars |
| All | 3,669 | 3,344 | 912 | 10,387 | 9,651 | 929 |
| With one child | 2,064 | 1,882 | 912 | 5,771 | 5,310 | 920 |
| With two or more children | 1,605 | 1,462 | 911 | 4,616 | 4,341 | 940 |
| | | | Percent | | | |
| Share of all taxpayers who were credit recipients | 15.6 | NA | NA | 11.6 | NA | NA |

Source: Calculated by ERS using data from the 1992 Internal Revenue Service Individual Tax Model File.

**Share of 1992 Federal income tax returns claiming the Earned Income Tax Credit**

*Southern States, especially Alabama, Louisiana, and Mississippi, have large proportions of their tax filers receiving the credit*




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

also slightly larger at $256 compared with $234 for rural taxpayers.

### Southern States Receive a Large Share of Benefits

Unlike other public assistance programs such as Aid to Families with Dependent Children (AFDC), the criteria for receiving the earned income tax credit and its level of benefits do not vary by region. Within the South, in 1992, 34 percent of the poor lived in rural areas compared with 28 percent of the total population. In fact, 53 percent of all the Nation's rural poor lived in the South compared with only 43 percent of the total rural population. However, only about 19 percent of the aggregate value of public welfare payments went to rural residents. A primary reason for this relatively low share is the fact that maximum AFDC benefit amounts set by Southern States are well below the median for all States.

In 1992, about 13 percent of taxpayers nationally received the earned income tax credit, but the rate varied widely by State. Much higher shares of taxpayers in the Southern States, where the rural poor are concentrated, received credits (fig. 1). Mississippi had the largest share of taxpayers receiving the credit—28.7 percent. Connecticut had the lowest share of returns receiving the credit—4.9 percent.

In addition to having high percentages of taxpayers receiving the credit, several Southern States also have high average credits. In 1992, credits to recipients in Alabama and Mississippi averaged more than $1,000. In contrast, many Northern States have small shares of returns receiving the credit and below-average credit per recipient. The primary reason for the difference in the average credit is that in those States with the lower average credit a larger share of credit recipients have income over the amount at which the credit begins to phase out.

### Earned Income Tax Credit Fully Offsets Social Security Taxes for Lowest Income Recipients

One of the original goals of the earned income tax credit was to offset Social Security taxes for low-income workers. From 1975 to 1990, the credit did not completely offset the combined employer and employee Social Security taxes of recipients. However, in 1991 the credit rate exceeded the combined employee and employer Social Security tax rate for the first time (see "Role of Credit Expanded Greatly in Last Decade," p. 3, for details).

As a result of the increase in the credit relative to the Social Security tax rate, by 1992 the credit more than offset all Federal taxes for the 1.5 million rural credit recipients with adjusted gross incomes below $10,000. These taxpayers received $1.4 billion in credits. Less than 0.2 percent of this amount was needed to offset Federal income taxes. Another 8.5 percent was needed to offset other taxes including self-employment taxes. The remaining amount was refunded to the taxpayer. This refund more than offset both the employer and the employee portions of the social security tax. In fact, the group received approximately $200 million more than their total Federal tax liability.

Over half of rural credit recipients in 1992 had adjusted gross income over $10,000. Many taxpayers in this group are poor or have income just above the poverty level. For this group, the credit did not fully offset the Social Security taxes on their earned income. These individuals received $1.9 billion in benefits in 1992. Twenty-five percent of this amount was used to offset their Federal income tax liability. An additional 10 percent was used to offset other taxes including self-employment taxes. The remaining 65 percent was refunded to offset social security taxes. However, this covered only about half of their share of the taxes and only about one-fourth of the combined employer-employee tax.

### Benefits Are Expected to Increase Substantially

Rural areas will experience a significant increase in both the number of beneficiaries and the level of benefits as a result of the expansions of the credit that were enacted in 1993. Absent major program changes, by 1996 the credit is expected to provide over 4.5 million low-income rural workers and their families with over $6 billion in benefits.

The largest share of the increased benefits will go to low-income workers with two or more children (table 2). While this group will account for only about 35 percent of all rural credit recipients in 1996, they will receive an estimated 54 percent of the total credit amount provided to rural taxpayers. With their maximum credit rising to $3,556 in 1996, their average benefit will increase from $911 in 1992 to an estimated $2,154 in 1996. Low-income workers with one child will also see an increase in their average credit from $912 in 1992 to an estimated $1,399 in 1996.

The credit to low-income workers with no children will benefit an estimated 900,000 low-income rural workers. However, since the maximum credit in 1996 for these workers is only $323, their estimated aggregate benefit is just over $200 million or about 3 percent of the total earned income tax credit for all low-income rural workers. Their estimated average benefit is $168.

### Targeting and Other Concerns May Prompt Program Changes

Even before the final phase of the 1993 expansion of the credit is fully phased in, concerns regarding the targeting of benefits, the rapidly escalating costs of the credit, and the high incidence of fraud resulted in efforts to better target benefits, to reduce fraudulent claims, and to reduce future benefit levels.

Since the earned income tax credit is administered through the tax system, the participation rate has been fairly high. However, the noncompliance rate has also been rather high, with some Internal Revenue Service

Table 2

**Estimated recipients and benefits of the earned income tax credit in nonmetro areas, 1996**

*The credit will provide an estimated 4.5 million nonmetro families with over $6 billion in benefits in 1996, with over half the credit going to families with 2 or more children*

| Type of family | Recipients | Share of recipients | Credit | Share of credit | Average credit |
|---|---|---|---|---|---|
| | Thousands | Percent | Billion dollars | Percent | Dollars |
| With 2 or more children | 1,600 | 35 | 3.3 | 54 | 2,154 |
| With 1 child | 2,000 | 45 | 2.6 | 43 | 1,399 |
| With no children | 900 | 20 | .2 | 3 | 168 |

Source: Calculated by ERS using 1996 earned income tax credit participation and benefits criteria and data from the 1992 Internal Revenue Service Individual Tax Model File.

studies suggesting that as many as one-third of credit recipients were not eligible for all or a portion of the benefits they received. This has prompted the Internal Revenue Service to take steps to detect fraudulent claims.

The current earned income tax credit does not consider a taxpayer's wealth or certain sources of income such as tax-exempt interest, Social Security, or child support payments. Many of the taxpayers with these income sources or wealth may be eligible for the credit but outside the intended group targeted for benefits. Recently enacted legislation addresses some of these concerns. Beginning in 1996, an otherwise qualifying individual will no longer be eligible for the earned income tax credit if the taxpayer has interest, dividend, or net rent or royalty income in excess of $2,350. The primary purpose of this change is to improve the targeting of benefits by denying eligibility to those individuals that may have a relatively low level of earned income but a significant amount of unearned income. In addition, the administration has proposed to prevent illegal aliens from claiming the credit by requiring that an individual must provide a Social Security number that is valid for employment in the United States to be eligible for the credit.

## Summary and Conclusions

After a relatively modest beginning, the earned income tax credit has become a major source of income support for low-income workers and their families. This is especially true for low-income rural workers. With 3.7 million recipients and $3.3 billion in benefits in 1992, the credit provided a significant boost in the income of the rural working poor. The benefit was largest in the South where the rural poor are concentrated and where benefits under other income support programs are below those provided in other regions. Absent major changes to the program, by 1996, the year that the 1993 expansion of the credit is fully phased in, the program is projected to provide over 4.5 million low-income rural taxpayers with over $6 billion in benefits.

### About the Data

Data for this article are from the 1992 Internal Revenue Service (IRS) Individual Tax Model File. This data file contains a sample of actual tax returns with taxpayer identifiers removed to maintain the confidentiality of returns. The file also contains weighting factors to inflate the sample to a representation of the total tax filing population of the United States.

The earned income tax credit for 1992 is the amount reported on the tax returns. Estimates for 1996 were generated by applying the applicable credit rates to the 1992 income levels adjusted for inflation.

The tax returns were classified as metro or nonmetro based on the ZIP code reported on each return.

Metro: Counties in Metropolitan Statistical Areas (MSA's) as defined by the Office of Management and Budget as of 1990. Metro areas include core counties containing a city of 50,000 or more people or have an urbanized area of 50,000 or more and a total area population of at least 100,000. Additional contiguous counties are included in the MSA if they are economically integrated with the core counties. Throughout this article, "urban" refers to metro taxpayers.

Nonmetro: Counties outside metro area boundaries. Throughout this article, "rural" refers to nonmetro taxpayers.

**For Further Reading. . .**

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