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Income Inequality and the Earned Income Tax Credit

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Abstract: The United States tax code is full of laws with long forgotten historical context. Under this historical context, there are numerous instances of both intended and unintended consequences of such laws. This concept is exemplified by the earned income tax credit, which has proven to both improve and diminish income inequality in the United States. This paper delves into the history of the earned income tax credit, the mechanics of the credit, the controversy surrounding the credit, and how the credit is impacting the future of tax law. The history of the earned income tax credit is linked to the politics of poverty and very much dictates how the earned income tax credit is calculated. There is controversy regarding the effectiveness and the credit's shortcomings. It also very much informs what the tax credit will look like in future tax seasons.

Key words: taxation, EITC
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1. Introduction: Taxation Is a Monetary Fine for Success

Taxes are mandatory payments imposed on the citizens of a government. They are essential for governments to fund services for their constituencies. In the United States, the most significant of these services include national defense, social security and veteran benefits. "In 2021, the US federal government collected over $4 trillion in tax revenue, the bulk of which came from individual income taxes" (Werfel, 2022).

The complex federal tax system in the United States is based on a progressive tax system; taxpayers with higher income pay a higher tax rate. Less wealthy taxpayers still pay taxes but at a lower rate. As recently as 2012, "47% of US citizens do not pay any federal income tax." (Boddupalli, 2021). This does not mean that this 47% pays no taxes; it just means that their income levels fall below the minimum amount of income to pay federal income taxes.

Despite the fact that almost half of US citizens pay no federal income tax, a fair amount of the current US tax code contributes to income inequality. Income inequality as defined by the Encyclopedia Britannica as "the significant disparity in the distribution of income between individuals, groups, populations, social classes or countries." There are many academic studies proving how large income inequality in a society leads to many societal ills (Payne, 2017). This is an area, that if adequately addressed by a tax system could ease such societal issues. Specifically, the federal tax code attempts to close the gap through the application of the earned income tax credit.

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2. Earned Income Tax Credit (EITC)

In 2022, the maximum EITC equaled $6,935 for qualified taxpayers. To qualify for the EITC, a taxpayer must work in the United States or a US Commonwealth, be between 25 and 64 years of age and meet certain earned income requirements. The Internal Revenue Service defines earned income as “income received through personal effort” and includes wages, salaries, tips and net income from self- employment. For 2022, a taxpayer must have worked and earned less than $59,187. It also limits the amount of investment and passive income the taxpayer can receive to still qualify for the EITC. For 2022, this amount is less than $10,300. The taxpayer can file under any filing status and must have valid social security numbers for themselves, their spouse (Werfel, 2022)and their dependents. Having foreign earned income prevents a taxpayer from claiming the EITC. The EITC is structured so that the credit increases the lower the income and more dependents a taxpayer up to a maximum of three. The qualifications are specific and intended to fulfill more of the earned income aspect of this credit.

3. The History of the Earned Income Tax Credit

The EITC is a refundable tax credit for low-income taxpayers. The amount of the tax credit is pegged to income levels and the number of dependent children. The EITC is a rare aspect of tax law since it was enacted in 1975 with bipartisan support. The original EITC, signed into law by President Ford, emerged from the push in the late 1960’s to reform welfare. There was great concern at that time surrounding the idea of providing cash assistance to those in need and was instead described as a “negative income tax” (Crandall-Hollick, 2022). In 1971, Senator Russell Long, chair of the Senate Finance Committee, viewed the concept of a negative income tax as a working bonus and as “a dignified way to help poor Americans” (Crandall-Hollick, 2022) Renamed the earned income tax credit, the law passed in 1975 as a means to help pull the economy out of the 1974 recession. At its passage, qualified taxpayers could claim a maximum credit of $400, equivalent to $950 in 2022 dollars (Crandall-Hollick, 2022). The same report also emphasized that the EITC’s prime objective should be “to assist in encouraging people to obtain employment, reducing the unemployment rate, and reducing the welfare rolls” (Crandall-Hollick, 2022)

Eligibility to qualify for the EITC was expanded in the early 1990’s to include low income wage earners without dependent children. In 1993, President Bill Clinton tripled the earned income tax credit with the intention of assisting over 4 million low income taxpayers. It has become a preferred method of poverty reduction in the United States. Because the credit is embedded in the tax code, there is no need for the federal government to add another level of bureaucracy in attempting to assist the working poor.

Throughout the 2000s, additional changes to the EITC credit formula were enacted by Congress. These legislative changes included restricting taxpayers with investment income but low earned income to qualify and to expand the credit for certain recipients — namely married couples and larger families. At the beginning of 2000, there was bipartisan congressional interest in reducing tax burdens of married couples in general. For low-income taxpayers with little or no tax liability, a marriage penalty is said to occur when the refund the married couple receives is smaller than the combined refund of each partner filing as unmarried. This marriage penalty discouraged low wage earning taxpayers from marrying, and indirectly altered family dynamics for millions of taxpayers.

Also, during the early 2000's, additional changes were made to the administration of the EITC with the intention of reducing improper payments of the credit. Irregularities in refund payouts are an annual fiscal year measure of the amount of the credit that is erroneously claimed and not recovered by the IRS. These refundable credits can be due to honest mistakes or intentional fraudulent claims of the credit. Reducing Improper Payments of Refundable Credits, The Protecting Americans from Tax Hikes Act (PATH Act; Division Q of P.L. 114-113) included a variety of provisions intended to reduce improper payments of refundable credits, including improper payments of the EITC. First, the law included a provision that prevented retroactive claims of the EITC after the issuance of Social Security numbers. As previously discussed, a taxpayer must provide an SSN for themselves, their spouses (if married), and any qualifying children. The PATH Act stated that the credit will be denied to a taxpayer if the SSNs of the taxpayer, their spouse (if married), and any qualifying children were issued after the due date of the tax return for a given taxable year. For example, if a family had SSNs issued in June 2017, the family could (if otherwise eligible) have claimed the EITC on its 2017 income tax return (which was due in April 2018), but could not have amended its 2016 income tax return and claimed the credit on its 2016 return (which was due in April 2017). In addition, the law also included a provision requiring the IRS to hold income tax refunds until February 15 if the tax return included a claim for the EITC (or the refundable portion of the child tax credit). This provision was coupled with a requirement that employers furnish the IRS with W-2s and information returns on nonemployee compensation (e.g., 1099-NECs) earlier in the filing season. These legislative changes were made "to help prevent revenue loss due to identity theft and refund fraud" (Crandall-Hollick, 2022)

According to statistics published by the Internal Revenue Service, "As of December 2022, 31 million workers and families received about $64 billion in EITC. The average amount of EITC received nationwide by a taxpayer averaged $2,043 (IRS website). These working-family tax credits lifted 5.6 million people out of poverty in 2018, including 3 million children, and made 16.5 million other people less poor. This represents about 15% of all tax filers in the United States.

4. Benefits and Controversy

The history behind the current the EITC has been complicated. When the credit was first enacted it was viewed as alternative to welfare. In the late 1960's and early 1970's, welfare programs were viewed largely negatively by the general public. By providing a refundable tax credit similar aid could be provided without the stigma of welfare and rewarded the working poor. Later, in 1993 President Clinton and the house majority speaker, Newt Gingrich, agreed to increase the credit but also agreed to increase the number of recipients to be audited. This compromise is what allowed President Clinton to increase the number of potential beneficiaries but also appeased those in Congress opposed to its expansion. It was also at this time that a penalty was enacted that stated if a taxpayer incorrectly or inappropriately received the EITC they can be prevented for up to 10 years for claiming the credit in the future. With this punitive provision in place, it appears that this most negatively impacts income inequality. If a taxpayer misunderstands the qualifications for the EITC, they are

According to the IRS website, this credit is heavily underutilized (Werfel, 2022). Taxpayers that live in rural areas, self-employed taxpayers, those receiving disability pensions or caregivers of children with disabilities, those without dependent children, taxpayers not proficient in English and grandparents raising grandchildren are all examples of those who might qualify but do not claim the credit. In addition, rightly so, many do not claim the credit out of fear of audit. With greater education and information access, the IRS estimates that another 5 million taxpayers could qualify for the credit. Greater numbers of EITC recipient would ease some of the income inequality in the United States.

Another issue with the EITC is that it reduces as income rises. This can negatively impact the working poor, making them worse off than if they had earned less. This additional income can result in "losing certain welfare benefits, such as housing subsidies, when they earn more than a relatively small amount of money" (Bartlett, 2012).

5. The Future

The federal form 1040 does not require much in the way of demographic data. Taxpayers over the age of 65 and taxpayers who are blind are entitled to additional dollars in standard deduction. There is a place on the 1040 to fill in a taxpayer's occupation. Beyond those two categories, there are no other demographic questions or boxes to complete.

On his first day office, President Joe Biden issued an executive order that could enable the IRS to collect information on race or ethnicity. The taskforce, "Equitable Data Working Group", is expected to work across agencies to improve consistent data collection. Advocates of collecting this data believe that enabling this transparency could relieve some the inequalities built into the tax code. While not asking for the taxpayer race may create the illusion of fairness, it has not yet achieved that. Race data collection could expose provisions where white taxpayers benefit more than non-white taxpayers. By analyzing the statistics of tax deductions and credits properly taken by taxpayer race, could enable the IRS to accurately target populations who are missing out on savings.

"Others worry that requiring taxpayers to self-identify could have unintended consequences" (Politico, 2021). As an example such data could cause undocumented taxpayers to stop filing tax returns. As well, the data could ignite public debate on who is paying their fair share of taxes.

Often inequities occur when the value of the tax break rises with income, and white taxpayers on average have higher income. In addition, evidence suggests that white taxpayers are more likely to have employment that includes health and retirement benefits which are heavily subsidized by the tax code (Brown, 2021).

As the name of the credit suggests, it only benefits taxpayers with earned income and does not assist nonworking taxpayers. This provision, aimed at encouraging people to work, ignores that some cannot work due to health concerns or disabilities. US Treasury statistics estimate that over 10 million taxpayers do not reap the benefits of the EITC.

6. Does the EITC improve Income Inequality?

In a short answer yes. The additional funds provided allow for recipients to obtain more health care, which results in better quality of life and improved employment options. The EITC has also been modeled at the state level, providing recipients with even more benefits.

Continuing to expand the EITC by pegging the credit to the Consumer Price Index as well as encouraging states to mimic the program could result in lifting more and more Americans out of poverty.

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