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Myths and Facts about an Earned Income Tax Credit in Kentucky

By Ashley Spalding

The federal Earned Income Tax Credit (EITC) is widely known as a highly effective antipoverty program that helps low-income families make ends meet and provides long-term benefits for children. In 2010 it lifted 6.3 million individuals out of poverty.[1] To further capitalize on the success of the program, 25 states have adopted state EITCs linked to the federal credit.

There are many reasons for Kentucky to strongly consider adopting a state EITC. As noted in a recent Kentucky Youth Advocates policy brief, the EITC is associated with healthier babies, lower rates of maternal smoking and better health outcomes across the course of children's lives. The EITC has been shown to improve children's performance in school and their rates of employment and earnings as adults.[2] A state EITC results in more money spent in local stores and businesses, which stimulates the local economy. [3] And it helps make a fairer tax system; in Kentucky, low- and moderate-income families currently pay a greater share of their income in taxes than high-income families.[4]

The Kentucky Chamber of Commerce, however, raises concerns about an EITC for Kentucky in their recent publication, "Should Kentucky Adopt a Credit that is Based on the Federal Earned Income Tax Credit?"[5] This paper's claims about EITCs deserve closer scrutiny.

CLAIM: "The original purpose of the EITC was to lessen the disincentive to work caused by the Social Security and Medicare taxes on earned income. This goal is fully achieved by the federal EITC."

ANALYSIS: The federal EITC was created in 1975 in part to offset these costs but substantially to address poverty alleviation and encourage workforce participation. Its success in the latter two goals is the reason it was subsequently expanded in 1986, 1990 and 1993. Despite its success at lifting millions of families out of poverty, broader economic forces are causing US and Kentucky poverty rates to rise and real (inflation-adjusted) wages for low-wage Kentucky workers to fall over the last ten years.[6] Low-income working families often have difficulty meeting their basic needs, and a state EITC could help alleviate some of this financial pressure. Research shows that families tend to use their EITC refunds on housing, groceries, childcare, transportation and health care costs, as well as to pay off debt and invest in education.[7]

CLAIM: "Correctly determining qualification for the EITC and calculating the EITC is complicated, leading to errors and fraud. The IRS estimates that between 23 percent and 28 percent of EITC claims are paid in error."

ANALYSIS: It is true the IRS has cited an error rate of between 23 and 28 percent of EITC payments based most recently on analysis of a sample of 2006 returns.[8] However, this statistic should be understood in the following context:

- *Very few EITC overpayments are the result of intentional fraud.* In fact, the IRS estimates that 70 percent of EITC claims are filed by commercial tax preparers. Rarely is it the case that the EITC is claimed for nonexistent children; in fact, the IRS automatically screens and rejects any tax return with an invalid Social Security number. Most errors are instead the result of misunderstandings about the EITC's intricate rules about who can claim a child (i.e., in cases involving separated, divorced or three-generation families).[9]

- *The estimated error rate of 23 to 28 percent likely overstates the actual error rate because of significant methodological problems in the IRS study and actions to address error rates the IRS has since taken.*[10] When claims are called into question and the filers are unable to complete the extensive process of providing documentation to prove the validity of their claims, they are automatically counted as errors. The IRS National Taxpayer Advocate reported that when these filers receive help from the Taxpayer Advocate Service in providing requested documents, the ruling is reversed for approximately half of the cases. In addition, several actions have been taken to reduce EITC errors since 2006, the year on which the current estimate is based.[11] For instance, the IRS now frequently relies on automatic computer cross-checks to identify questionable EITC claims before paying them.[12]

- *Even if the estimate is accurate it is substantially lower than the noncompliance rate in a number of other areas of the tax code, including certain types of business income.* For instance, according to a 2001 study, an estimated 51 percent of income from rent and royalties goes unreported, 57 percent of small business income, and 72 percent of farm income. The total cost to the federal government from these areas was $109 billion, which is ten to fifteen times the size of estimated EITC overpayments each year.[13]

Regarding the complexity of the EITC, the implementation of a state EITC in Kentucky could be as simple as adding just one new line to the state tax forms.[14] In terms of the federal EITC rules, it should be acknowledged that much of the tax code is complex—not just the EITC. It would also seem that there are better solutions to the complexity problem, which does cause too many filing errors, than rejecting the EITC outright. Simplifying EITC rules at the federal level would certainly help to reduce errors. The share of EITC tax returns with errors was reduced by approximately 13 percent after a package of EITC simplification measures was enacted in 2001. And a number of very promising proposals to simplify EITC rules have been proposed by the Treasury.[15] In addition, an IRS initiative is currently under way to increase the accountability of commercial tax preparers, who are believed by the IRS to prepare most of the EITC returns with errors.[16]

CLAIM: "A Kentucky EITC would be a direct subsidy to individuals that would be outside of the Commonwealth's annual budget process."

ANALYSIS: As noted by the Kentucky Chamber of Commerce, the EITC is a tax expenditure— a special tax preference, rate or exemption that benefits particular groups, industries or activities. Kentucky currently has more than 200 tax expenditures, and collectively they have become a major drain on state revenue.[17] While the Chamber criticizes a state EITC on the grounds that it is a tax expenditure, it is important to note that a large number of tax expenditures benefit businesses and very few benefit low-income families—and the Chamber has not voiced opposition to any of these business tax expenditures.

In fact, in another recently-released paper the Chamber argues for a new corporate tax expenditure (called the single sales factor apportionment formula) that would give big tax cuts to large corporations without any evidence of economic benefits, and by one estimate would cost Kentucky $55 million a year.[18] It is absolutely the case that tax expenditures should be put on an even footing with budgeted expenditures, and the state should create a process requiring regular review and assessment of all tax expenditures.[19] A state EITC would likely perform well under regular evaluation since its benefits are well documented.

CLAIM: “Claiming a Kentucky EITC would require the filing of a Kentucky tax return by Kentuckians who are not currently required to file a Kentucky income tax return because their income level is low.”

ANALYSIS: The social and economic benefits of a state EITC would seem to far outweigh any small administrative costs. It is unlikely that many of these additional tax returns will be itemized, due to the low incomes of these filers, meaning that any additional tax returns should be relatively simple and add little administrative burden. In fact, the federal EITC is widely known as a program with very modest administrative costs, and states with EITCs report that administrative costs are very low—often less than one percent of program costs.[20] In addition, the state is already working to increase the number of Kentuckians who file for the federal EITC.[21]

CLAIM: “The federal EITC changes frequently, so adopting a Kentucky credit that is a percentage of the federal credit would not be workable unless Kentucky adopted the federal changes each and every year. Otherwise, Kentucky’s EITC calculation could be quite different from the federal EITC.”

ANALYSIS: Most states that have EITCs do set them as a percentage of the federal credit—ranging from 2.5 to 40 percent—so it would be reasonable for Kentucky to strongly consider doing so as well.[22] Among other benefits, it enables very minimal changes to the state tax form. And Kentucky’s tax code is already tied to the federal tax code in many ways for reasons of simplicity. When changes to the federal tax code arise that Kentucky doesn’t agree with, the state simply decouples from those changes. Similarly, Kentucky can decide whether or not to apply future federal EITC changes to its state EITC.

CLAIM: “Tax policy affects behavior; a Kentucky EITC would provide an economic incentive for low-income individuals to move to Kentucky from bordering states, thereby increasing the cost of Kentucky EITC refunds and increasing demands for other public services.”

ANALYSIS: Research on the issue of cross-state migration does not support the claim that household relocation is often motivated by taxes. Rather, taxes have very little impact on cross-state migration.[23] In addition, according to one estimate, Kentucky’s average EITC filer would receive between $100 and $300 depending on the percent of the Federal EITC (5 percent and 15 percent, respectively).[24] Such a small amount of money would not seem to be even enough to cover the costs of moving—and it would not be an easy task for a low-income worker to both attain a new job (which one must have to qualify for an EITC) and housing in another state. Another important point is that three of the seven states surrounding Kentucky, which are listed in the Chamber policy brief, actually already have EITCs.

The Kentucky Center for Economic Policy is a non-profit, non-partisan initiative that conducts research, analysis and education on important policy issues facing the Commonwealth. Launched in 2011, the Center is a project of the Mountain Association for Community Economic Development (MACED). For more information, please visit KCEP’s website at www.kypolicy.org.

[1] Center on Budget and Policy Priorities, "The Earned Income Tax," February 22, 2012, http://www.cbpp.org/files/policybasics-eitc.pdf.

[2] Jimmy Charite, Indivar Dutta-Gupta, and Chuck Marr, "Studies Show Earned Income Tax Credit Encourages Work and Success in School and Reduces Poverty," Center on Budget and Policy Priorities, June 26, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=3793.

[3] Kentucky Youth Advocates, "A State Earned Income Tax Credit Would Help Kentucky Families and Local Economies," April 2012, http://www.kyyouth.org/documents/12pub_Blueprint_State_EITC.pdf.

[4] Carl Davis, et al., "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," Institute on Taxation and Economic Policy, November 2009, http://www.itepnet.org/whopays3.pdf.

[5] Kentucky Chamber of Commerce, "Should Kentucky Adopt a Credit that is Based on the Federal Earned Income Tax Credit?," August 2012, http://policy.kychamber.com/uploads/sites/329/Earned%20Income%20Tax%20Credit820.pdf.

[6] Kentucky Center for Economic Policy, "The Problem of Low Wages in Kentucky," June 8, 2012, http://www.kypolicy.org/problem-low-wages-kentucky.

[7] T. Meeding, K. Ross Phillips, and M. O'Connor, "The Earned Income Tax Credit: Expectation, Knowledge, Use, and Economic and Social Mobility," In Meyer and Holtz-Eakin, *Making Work Pay,* Cited in Kentucky Youth Advocates, "A State Earned Income Tax Credit Would Help Kentucky Families and Local Economies." Center on Budget and Policy Priorities, "Policy Basics: State Earned Income Tax Credits," January 13, 2011, http://www.cbpp.org/cms/index.cfm?fa=view&id=2506.

[8] John Wancheck and Robert Greenstein, "Earned Income Tax Credit Overpayment and Error Issues," Center on Budget and Policy Priorities, April 19, 2011, http://www.cbpp.org/files/4-5-11tax.pdf.

[9] Wancheck and Greenstein, "Earned Income Tax Credit Overpayment and Error Issues."

[10] A new IRS estimate is expected this year.

[11] Wancheck and Greenstein, "Earned Income Tax Credit Overpayment and Error Issues."

[12] More than 80 percent of EITC claims are filed electronically. Wancheck and Greenstein, "Earned Income Tax Credit Overpayment and Error Issues."

[13] Wancheck and Greenstain, "Earned Income Tax Credit Overpayment and Error Issues."

[14] Kentucky Youth Advocates, "A State Earned Income Tax Credit Would Help Kentucky Families and Local Economies."

[15] These simplifications were included in President Bush's budgets in 2004, 2006, 2007 and 2008 but Congress never acted on these proposals. Wancheck and Greenstain, "Earned Income Tax Credit Overpayment and Error Issues."

[16] It should be noted that much greater scrutiny is being given to the tax returns of low-income households than to high-income households (37 percent of IRS examinations of tax returns involved returns claiming the EITC while only 8 percent involved those filed by high-income households and businesses). However, the average amount of revenue loss the IRS prevents from EITC filers is a small fraction of that saved when the IRS examines tax returns filed by high-income households. Wancheck and Greenstain, "Earned Income Tax Credit Overpayment and Error Issues."

[17] Office of the State Budget Director, "Tax Expenditure Analysis," Fiscal Year 2012-2014, November 15, 2011, http://www.osbd.ky.gov/NR/rdonlyres/043EF3FC-B7DC-4B30-9204-53D590ECDE1E/0/2012_2014_TaxExpenditure_Doc.pdf.

[18] Kentucky Chamber of Commerce, "Determining Taxable Net Income for Kentucky's Multistate Businesses – Apportionment," August 2012, http://policy.kychamber.com/uploads/sites/329/Corporate%20Income%20Tax%20820.pdf. Michael Mazerov, "The 'Single Sales Factor' Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?," Center on Budget and Policy Priorities, http://www.cbpp.org/files/3-27-01sfp.pdf. Legislative Research Commission, "Issues Confronting the 2011 Kentucky General Assembly," November 2010, http://www.lrc.ky.gov/lrcpubs/IB233.pdf.

[19] Jason Bailey, "Reforms Needed to Bring Greater Scrutiny to 'Tax Expenditures,'" Kentucky Center for Economic Policy, January 20, 2011, http://policy.kychamber.com/uploads/sites/329/Corporate%20Income%20Tax%20820.pdf.

[20] Wancheck and Greenstein, "Earned Income Tax Credit Overpayment and Error Issues." Center on Budget and Policy Priorities, "Policy Basics: State Earned Income Tax Credits."

[21] "Governor Steve Beshear Helping Kentuckians in Tough Economic Times," http://assistance.ky.gov/freetaxhelp/index.htm.

[22] This range refers to states with refundable tax credits. Tax Credits for Working Families, "States with EITCs," http://www.taxcreditsforworkingfamilies.org/earned-income-tax-credit/states-with-eitcs/.

[23] George I. Treyz, Dan S. Rickman, Gary L. Hunt, and Michael J. Greenwood, "The Dynamics of U.S. Internal Migration," *The Review of Economics and Statistics,* May 1993. William F. Frey, "Internal Migration," in Paul Demeny and Geoffrey McNicoll, eds., *International Encyclopedia of Population,* New York: Macmillan, 2003. Jeffrey Thompson, "The Impact of Taxes on Migration in New England," Political Economy Research Institute University of Massachusetts, Amherst, April 2011, http://www.peri.umass.edu/fileadmin/pdf/published_study/Migration_PERI_April13.pdf.

[24] Kentucky Youth Advocates, "A State Earned Income Tax Credit Would Help Kentucky Families and Local Economies."