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United States General Accounting Office  
Washington, DC 20548

December 14, 2001

The Honorable William J. Coyne  
Ranking Minority Member  
Subcommittee on Oversight  
Committee on Ways and Means  
House of Representatives

Subject: Earned Income Tax Credit Eligibility and Participation

Dear Mr. Coyne:

The Earned Income Tax Credit (EIC), which is expected to provide over \$30 billion in refundable credits in fiscal year 2002, is a major federal effort to assist the working poor. The EIC is intended to offset the burden of the Social Security payroll tax on low-income workers and to encourage low-income individuals to work. The amounts of credit that taxpayers receive depend on the taxpayers' incomes and the number of qualifying children they have.<sup>1</sup> Taxpayers must file a tax return in order to claim the credit. Prior evidence suggests that many eligible households have not received the credit.<sup>2</sup> You asked us to provide estimates of (1) the number of eligible households and the number of those who did and did not participate in the EIC program and (2) the amounts of credit foregone by nonparticipating households. You also asked that we provide these estimates disaggregated by the number of qualifying children in the households claiming the credit.

We used data from the Census Bureau's Current Population Survey (CPS) for 1999 to estimate the number of households eligible for the EIC. We obtained estimates from the Internal Revenue Service (IRS) for the number of eligible taxpayers who claimed the EIC for tax year 1999. Because the CPS and IRS data are based on samples, our estimates are subject to sampling error.<sup>3</sup> In addition, the CPS database, while useful for estimating EIC eligibility, do not contain all of the data needed to definitively determine EIC eligibility. Our methodology and its limitations are described in further detail in the enclosure. We sent a draft of this correspondence to IRS for

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<sup>1</sup> A qualifying child must meet a relationship test (with respect to the taxpayer claiming the credit), an age test, and a residence test. In tax year 2001 the maximum amount of credit that a taxpayer with no qualifying children can earn is \$364. The maximum for a taxpayer with 1 qualifying child is \$2,428, and the maximum for a taxpayer with 2 or more qualifying children is \$4,008.

<sup>2</sup> See, for example, John Karl Scholz, "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness," *National Tax Journal*, Vol. 47, no. 1, (March 1994), pp. 63-87.

<sup>3</sup> The sampling errors measure the extent to which samples of different sizes are likely to differ from the populations that they represent. Each of the sample estimates in tables 1 and 2 is surrounded by a 95-percent confidence interval indicating that we are 95-percent confident that the interval contains the actual population value. In the tables, the upper and lower limits of the intervals are indicated by the value added to and subtracted from the estimate.

review and comment. Their comments and our response are summarized at the end of this letter. We did our work between February and December 2001 in accordance with generally accepted government auditing standards.

## Results

Table 1 shows the number of eligible households<sup>4</sup>, the number of those households that did and did not participate in the EIC program, and the participation rate. Of the total of 17.2 million households that were eligible for the credit, about 12.9 million claimed the credit, representing a participation rate of about 75 percent. The participation rate varied considerably by number of qualifying children in the household. The participation rates for households with one and two qualifying children were about 96 percent and 93 percent, respectively. In contrast, the participation rate for households with three or more qualifying children was about 62.5 percent, and the rate for households with no qualifying children was only about 44.7 percent.

The data available did not enable us to determine the reasons for these differences. The differences in participation rates may reflect actual behavioral differences across the household types, but they may also reflect limitations in the data. Both explanations are discussed in the enclosure. Given the possibility that limitations in our data may explain some of the variation in participation rates by number of qualifying children and the larger confidence intervals for these subgroups due to their smaller sample size, we believe the estimates for the subgroups in tables 1 and 2 are less certain than the estimates for all households.

**Table 1: Number of Eligible Households, by Participation Status and Number of Qualifying Children, 1999<sup>a</sup>**

Dollars in millions

	Households			Participation rate
	Total eligible	Eligible participants	Eligible nonparticipants	
Total	17.2 ± .4	12.9 ± .4	4.3 ± .5	75.0 ± 2.7%
0 qualifying children	4.7 ± .2	2.1 ± .2	2.6 ± .3	44.7 ± 3.9
1 qualifying child	5.0 ± .2	4.8 ± .3	0.2 ± .4	96.0 ± 7.7
2 qualifying children	4.3 ± .2	4.0 ± .3	0.3 ± .4	93.0 ± 8.3
3 or more qualifying children	3.2 ± .2	2.0 ± .2	1.2 ± .3	62.5 ± 8.3

<sup>a</sup>The actual number of households in any of the subgroups presented in the table cannot be less than zero and the actual participation rates cannot exceed 100 percent.

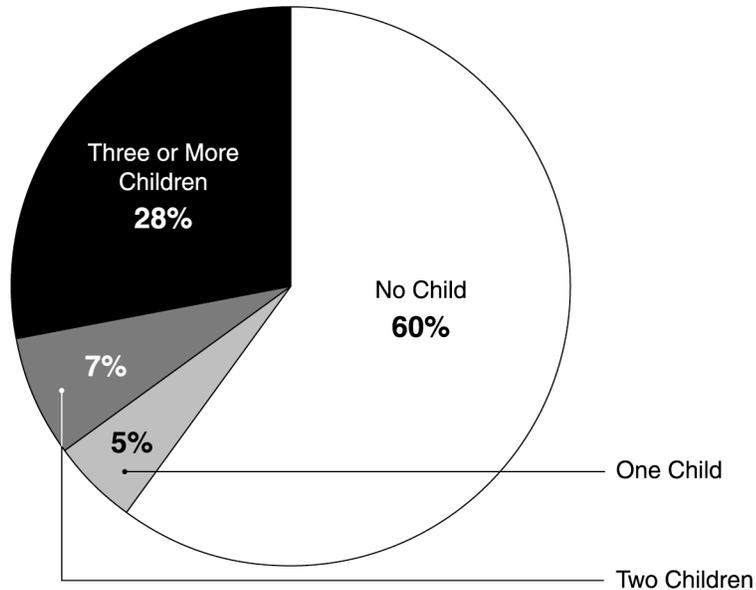
Sources: GAO's analysis of data from the CPS and IRS.

In total, about 4.3 million eligible households did not claim the credit. Figure 1 shows how these households were distributed by number of qualifying children. More than half (about 60 percent) of the eligible nonparticipating households had no qualifying children. Most of the remaining eligible nonparticipating households (about 28

<sup>4</sup> In this letter, households are individuals or married couples. Eligibility is determined with respect to these persons according to the income, residency, family relationship and other rules of the EIC.

percent of the total) had three or more qualifying children. Households with one or two qualifying children accounted for only about 12 percent of the nonparticipants, even though they represented about 54 percent of all eligible households.

Figure 1: Eligible Nonparticipating Households, by Number of Qualifying Children, 1999



Sources: GAO's analysis of data from the CPS and IRS.

We estimate that in 1999 all qualifying households were eligible to claim a total of \$23.5 billion of EIC. IRS estimates that households that actually participated in the program were eligible to claim \$20.9 billion of EIC. This implies that nonparticipating households did not receive about \$2.7 billion of credits for which they were eligible. The amount foregone by nonparticipating households represented about 11.1 percent of the total credit that households were eligible to claim. Table 2 shows the amounts of EIC that nonparticipating households within each of the qualifying child categories were eligible to claim. The table compares these amounts to the total amounts of EIC that all households within those categories were eligible to claim.

Table 2: Amounts of EIC That Participating and Nonparticipating Households Were Eligible to Claim, by Number of Qualifying Children, 1999<sup>a</sup>

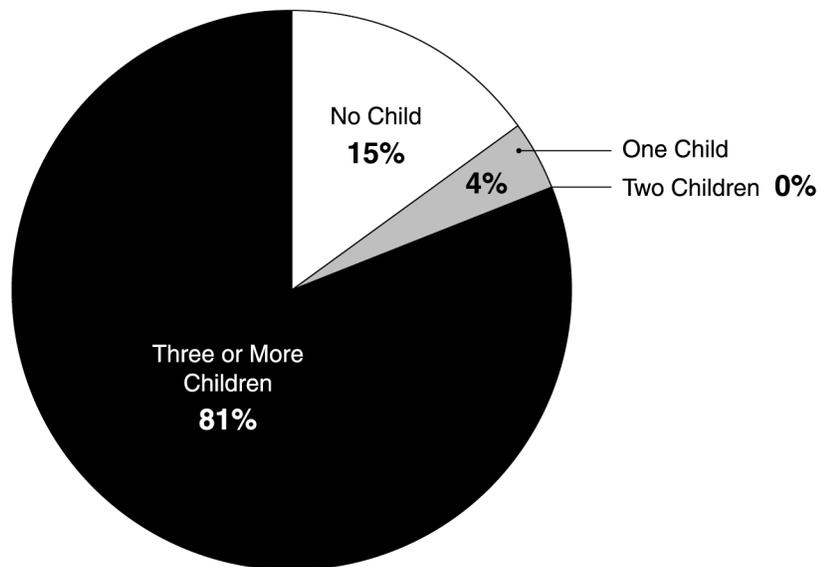
Dollars in billions

	Total amount that households were eligible to claim	Amount that households who participated were eligible to claim	Amount that households who did not participate were eligible to claim	Amount that nonparticipants were eligible to claim as a percent of the total amount that households were eligible to claim
Total	\$23.5 ± .5	\$20.9 ± .7	\$2.7 ± .7	11.1 ± 3.5 %
0 qualifying children	0.8 ± .0	.4 ± .0	0.4 ± .0	50.0 ± 4.1
1 qualifying child	7.2 ± .2	7.1 ± .3	0.1 ± .3	1.4 ± 4.8
2 qualifying children	9.0 ± .2	9.0 ± .4	0.0 ± .5	0.0 ± 5.4
3 or more qualifying children	6.5 ± .2	4.3 ± .3	2.2 ± .4	33.8 ± 5.0

<sup>a</sup>The actual number of households in any of the subgroups presented in the table cannot be less than zero. The same is true for the percentages in the last column. Numbers may not sum to totals due to rounding. Sources: GAO's analysis of data from the CPS and IRS.

Figure 2 shows that households with three or more qualifying children accounted for the preponderance (about 81 percent) of the EIC that nonparticipating households were eligible to claim. Nonparticipating households with no eligible children accounted for most of the remainder (about 15 percent).

Figure 2: Distribution of EIC That Nonparticipating Households Were Eligible to Claim, by Number of Qualifying Children in Household, 1999



Sources: GAO's analysis of data from the CPS and IRS.

## Agency Comments and Our Evaluation

On December 12, 2001, we spoke with a representative of the Director of IRS' Office of Research who provided oral comments on our draft letter. The Director suggested that we add a few more specific caveats to the ones that we already listed in our methodology discussion regarding the use of CPS data to determine the number of households eligible for the EITC. He also suggested that we describe in more detail how we applied the eligibility rules to CPS data and that we clarify certain statements made in the draft. We modified the correspondence as appropriate.

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As arranged with your staff, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies to the Secretary of the Treasury, the Commissioner of Internal Revenue, and the Chairmen and Ranking Minority Members of the Senate Finance Committee and the House Ways and Means Committee, as well as the Chairman of the latter Committee's Oversight Subcommittee. The letter will also be available on GAO's home page at [www.gao.gov](http://www.gao.gov).

If you have any questions, you may contact Jim Wozny or me at (202) 512-9110. Kevin Daly, Wendy Ahmed, and MacDonald Phillips made key contributions to this letter.

Sincerely yours,



James R. White  
Director, Tax Issues

Enclosure

### **Methodology for Estimating Participation Rates for the Earned Income Tax Credit**

We estimated the number of eligible households (individuals and married couples) using the eligibility rules under section 32 of the Internal Revenue Code and data from the Census Bureau's Current Population Survey (CPS). The CPS is a sample of households with information about their income, age, marital status, number of children, and other characteristics. We analyzed the data reported in the 2000 March Supplement of CPS which contains this information for the preceding year. We identified households in the CPS that met the eligibility rules under the Internal Revenue Code, and, using the CPS sample weights, estimated the number of eligible households in the U.S. population. We also estimated the amount of credit that these households were eligible to claim.

We obtained estimates of the number of eligible claimants and the amount of credit that they were eligible to claim from the Internal Revenue Service (IRS). These estimates were based on a random sample of 1999 tax returns with the EIC claimed on the return. IRS audited these returns to determine the accuracy of the EIC claim and other tax return items, as part of their forthcoming tax-year 1999 EIC compliance study. The estimates of eligible claimants are based on the number of returns where the examiners did not reduce the EIC claim to zero. The estimates of the amounts of credit are based on the amounts corrected by the examiners for overclaims or underclaims on the returns. IRS conducted consistency and other tests on the data, and the audits were subject to quality review.

#### **Limitations of Our Analysis**

The CPS does not contain all of the information needed to determine eligibility. Data such as capital gains and contributions to individual retirement accounts are not requested in the CPS survey. However, it is likely that the missing data have little effect on our participation estimates. These types of income and deductions are not common for the lower-income people who may be eligible for the credit. To verify this, we examined the tax returns of households in the 1996 Statistics of Income Public Use File, the most recent data available. We found that no more than 3 percent of households that met the other income limits for credit eligibility had these types of income and deductions.

The CPS also does not have complete information for determining whether a child is resident long enough in a household to be a "qualifying child" for the purpose of determining the amount of credit that the households are eligible to claim. Children must reside in the household for more than half the year (a full year for foster children) in order to be qualifying children. The CPS survey asks only whether the child is resident in the household during the week in which the survey is conducted. This limitation in the CPS data means that some children reported in the survey may not meet the residency requirement while others who meet the requirement may not

be reported. To test the likely impact of this limitation, we checked the low-income households that were surveyed in both the 1999 and 2000 March Supplements of the CPS. We found that 97 percent of the children who were living in these households in 2000 were also living in the same household in 1999.

The CPS contains self-reported data from the survey respondents. Some analysts have raised concerns that this information may not be reported accurately. A National Research Council study that reviewed studies of the accuracy of the survey data concluded that wage and salary information appears to be fairly accurately reported in the CPS. The study also concluded that other types of income, such as interest and dividends, may be underreported but that this underreporting is probably not critical for studies of low-income people for whom these are not important sources of income. The study did not review the accuracy of other household characteristics relevant to credit eligibility that are reported in the CPS. Another limitation of the CPS data is the possible underreporting of certain populations such as the homeless.

As we noted in the letter, differences in the participation rates across household types may reflect actual taxpayer behavior. The lower participation rate for households with three or more children may indicate that taxpayers in those households may be more likely to be married and filing jointly which is a filing status with a higher income threshold for the requirement to file a tax return. Therefore, fewer of these households may be required to file tax returns than households that have similar incomes but fewer children. A household that is required to file a tax return may be more likely to claim the EIC than a household that otherwise would not be required to file a return. The relatively low participation rate of households with no children may be due to the fact that these households receive significantly smaller benefits from the credit than do households with qualifying children. Or it may result from the fact that there is a relatively narrow income range in which taxpayers with no children are both above the filing threshold and below the income cut-off for EIC eligibility.<sup>5</sup> Because we did not have CPS and IRS data for the same households, we could not examine characteristics of the eligible households that would enable us to test these and other factors that may affect participation.

However, it is also possible that the variation in participation rates could result from limitations of the data we used. If, for example, low-income households with no qualifying children inaccurately claimed one or two qualifying children and IRS did not detect all such cases of this misreporting, then the number of no-children households in IRS' study would be undercounted, while the number of one- and two-children households would be overcounted. An undercount of no-children households would mean that our participation rate for that group is understated. Conversely, an overcount of the other two groups would mean that our participation rates for them are overstated.

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<sup>5</sup> In fact, none of the taxpayers who file joint returns and are eligible for the no-child EIC have incomes above the filing threshold.

The variation in participation rates across groups also could be inaccurate if IRS auditors involved in the EIC compliance study spent less effort (or had more difficulty) determining whether households had more than two qualifying children than determining whether taxpayers had one or two qualifying children. The number of children up to two has a significant effect on the amount of credit that all eligible households are allowed to claim. The presence of a third eligible child is important only if one of the first two children that a household identifies is determined to be ineligible. Moreover, taxpayers are not asked to identify more than two qualified children on schedule EIC when claiming the credit. If IRS counted some households that have three or more qualifying children as two-child households, then our estimate of the participation rate for households with three or more children would be understated, and our estimated participation rate for two-child households would be overstated. The data collection instrument for IRS' study did call for auditors to collect information on more than two qualified children.

At the time that we were issuing this letter the Treasury Inspector General for Tax Administration (TIGTA) was about to issue a review of IRS' 1997 and 1999 EIC compliance studies. We read a draft of the TIGTA review and discussed it with officials from TIGTA and IRS' Office of Research, which had a leading role in the compliance studies. The TIGTA review does not directly address IRS' counts of the number of eligible EIC participants. The review raises questions about potential inaccuracies in IRS' estimates of allowable credits for 1999, which we report in table 2. However, the review does not provide a basis for us to determine the extent, if any, of actual inaccuracies. IRS strongly disagrees with TIGTA's assessment and believes that their compliance estimates are reasonably accurate. We did not verify the accuracy of IRS' study.

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