HOUSE RESEARCH | **Short Subjects**

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Utilization of Earned Income Tax Credits: Differences Between Urban and Rural Welfare Recipients

Earned income tax credits can increase the incomes of low-income individuals by supplementing their incomes with a tax credit. This short subject explains some recent research on the receipt of Minnesota's earned income credit, the Working Family Credit, among welfare recipients and the differences in utilization between urban and rural areas. Analyses were conducted with data on Minnesota welfare recipients from 1992 through 1999.

What are earned income tax credits?

Earned income tax credits (EITC) are state and federal tax credits for low-income individuals. They are designed to provide incentives to work by supplementing earnings. In the federal program, the credit increases as earnings increase until it reaches a maximum. The credit phases out once earnings or income reach a pre-designated floor.

How is Minnesota's EITC different from other programs?

Minnesota structured its earned income tax credit, the Working Family Credit, differently in order to "make work pay." For some parents with earnings within the phase-out portion of the federal earned income tax credit, an increase in earnings may combine with a reduction in public benefits and in more income taxes, resulting in a decrease in after-tax, after-benefit income. Legislators designed Minnesota's Working Family Credit to prevent that loss in income. The credit is similar to the federal credit until after it reaches a maximum. The amount of Minnesota's credit increases after the first-tier maximum, creating a second-tier, or bump, in credit dollars before phasing out. The second increase in credit dollars compensates for the loss in income arising from a decrease in benefits and an increase in taxes.

Who claims earned income tax credits?

Low-income individuals and families are eligible for earned income tax credits, including welfare recipients. Research by Hirasuna and Stinson shows the following:

- Among individuals eligible for the credits, participation by welfare recipients is relatively low. Eligible welfare recipients claim the EITC between 65 percent and 70 percent of the time, compared to between 75 percent and 85 percent for all eligible households.
- When looking at all welfare recipients regardless of their eligibility, between 38 percent and 65 percent receive the credit.
- Rural welfare recipients are more likely to receive the credits than urban welfare recipients. In Minnesota, only 35 percent of all urban and 46 percent of all rural welfare recipients received Minnesota's Working Family Credit between 1992 and 1999.

Why do some eligible welfare recipients not claim EITC?

Several reasons why welfare recipients do not claim the credit include:

- **Income level.** For welfare recipients with a low level of earnings, the inconvenience of completing the paperwork may not be worth the small benefit of receiving the credit. Welfare recipients may have disproportionately low earnings compared to all eligible households, resulting in fewer receipts of earned income tax credits.
- **Information barriers.** Welfare recipients may not know about the credit or underestimate how much they can receive. Some areas have more organizations that provide information on earned income tax credits and free tax preparation.
- **Skill and language barriers.** Some eligible individuals have a limited ability to complete the necessary forms because of skill or language limitations.

How do rural and urban welfare recipients differ?

Differences in rural and urban settings have an impact on whether welfare recipients claim the credit:

- **Earnings and unemployment.** Labor market opportunities in rural areas differ from urban areas. The rural poor are more likely than the urban poor to hold one or more jobs, but have lower overall earnings because available jobs pay lower wages.
- **Racial mix.** Urban areas have higher concentrations of African American and Asian American welfare recipients, which may relate to differences in earnings between rural and urban recipients. Rural areas have a higher concentration of American Indians who may work and live on a reservation, which results in no state taxable income and ineligibility for the state earned income credit.
- **Availability of information and other resources.** Free tax preparation sites are more prevalent in urban areas while social services and other organizations may inform recipients of the state's earned income credit in rural areas. Rural workers with limited language skills, such as migrant farm workers, may be especially vulnerable when support is not available in their primary languages.

What are the policy implications of this research?

Poverty alleviation programs affect the rural and urban poor differently because of differences in labor markets, demographics, and resources. Understanding these differences can help legislators design a mix of programs that help welfare recipients exit poverty more quickly.

Earned income tax credits may provide an effective incentive for individuals to work more and increase after-tax income. Increasing the amount of the Minnesota Working Family Credit, job growth opportunities, and free tax preparation assistance may increase participation levels in EITC programs.

For more information: Contact legislative analyst Donald Hirasuna at 651-296-8038. This short subject was written by research assistant Anna Hovde based on Donald P. Hirasuna and Thomas F. Stinson's "Urban and Rural Differences in the Utilization of Earned Income Tax Credits: A Study of Minnesota's Working Family Credit," forthcoming in the *International Regional Science Review*.