Evaluation of the Maryland Earned Income Tax Credit

Poverty in Maryland and the Earned Income Tax Credit



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Department of Legislative Services
Office of Policy Analysis
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September 2015

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Department of Legislative Services
Office of the Executive Director
Maryland General Assembly

Warren G. Deschenaux
Executive Director

September 30, 2015

The Honorable Richard S. Madaleno, Jr., Co-chair, Tax Credit Evaluation Committee
The Honorable Jay Walker, Co-chair, Tax Credit Evaluation Committee
Members of the Tax Credit Evaluation Committee

Ladies and Gentlemen:

As you know, the Tax Credit Evaluation Act of 2012 (Chapters 568 and 569) establishes a legislative process for evaluating certain tax credits. To assist the tax credit evaluation committee in its work, the Department of Legislative Services (DLS) was required to evaluate the credit on a number of factors, including (1) the purpose for which the tax credit was established; (2) whether the original intent of the tax credit is still appropriate; (3) whether the tax credit is meeting its objectives; (4) whether the goals of the tax credit could be more effectively carried out by other means; and (5) the cost of the tax credit to the State and local governments.

During the 2014 interim and 2015 session, the committee reviewed a draft of this report and also held a public hearing on the report. The report makes several recommendations related to the credit. The document is divided into 10 chapters.

Chapters 1 and **2** provide an overview of the Tax Credit Evaluation Act and the earned income tax credit, including credit objectives, history, and eligibility.

Chapters 3 and **4** provide an overview of poverty and the earned income tax credit in Maryland.

Chapters 5 and **6** discuss research conducted on the earned income tax credit and provide data on earned income tax credit claimants.

Chapter 7 discusses earned income tax credit improper payments and the use of refund anticipation products.

Chapter 8 and **9** assess the fiscal impact of State and local earned income tax credits and provide a comparison of earned income tax credits in other states.

Chapter 10 summarizes the findings of the report and discusses recommended changes to the earned income tax credit.

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The Honorable Richard S. Madaleno, Jr., Co-chair, Tax Credit Evaluation Committee
The Honorable Jay Walker, Co-chair, Tax Credit Evaluation Committee
Members of the Tax Credit Evaluation Committee
September 30, 2015
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We wish to acknowledge the cooperation and assistance provided by various State agencies in the development of this report. DLS trusts that this report will be useful to members of the tax credit evaluation committee in future deliberations about the earned income tax credit.

Sincerely,

Warren G. Deschenaux
Executive Director

WGD/mpd

cc: Thomas V. Mike Miller, Jr., President of the Senate
Michael E. Busch, Speaker of the House of Delegates

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Executive Summary

Since the mid-1990s, the number of State business tax credits has grown exponentially, as have related concerns about the actual benefits and costs of many of these credits. Although tax credits comprise a small percentage of total income tax revenues, the number and amount of credits claimed have significantly increased over time.

In response to concerns about the fiscal impact of tax credits on State finances, Chapters 568 and 569 of 2012, the Tax Credit Evaluation Act, established a legislative process for evaluating certain tax credits. The evaluation process is conducted by a legislative evaluation committee that is appointed jointly by the President of the Senate and the Speaker of the House of Delegates. The Act requires that the earned income tax credit be evaluated by the committee by July 1, 2015. To assist the committee in its work, the Department of Legislative Services (DLS) is required to evaluate the credit on a number of factors, including (1) the purpose for which the tax credit was established; (2) whether the original intent of the tax credit is still appropriate; (3) whether the tax credit is meeting its objectives; (4) whether the goals of the tax credit could be more effectively carried out by other means; and (5) the cost of the tax credit to the State and local governments.

First enacted in 1975, the federal earned income tax credit is a refundable tax credit offered to low-income workers. The federal credit has expanded significantly over time and is now one of the largest federal antipoverty programs. Maryland, and about half of all states and the District of Columbia, offers a State earned income credit that supplements the federal credit. Approximately $300 million in State and local earned income credits were claimed in tax year 2012. While there is general consensus that earned income tax credits are effective in raising low-income households out of poverty, it is not without issues. Credit effectiveness is limited by high rates of improper payments, the use of paid tax preparers that charge high-cost products which reduce the value of the credit, and participation rates that could be improved. Additionally, the ability of the credits to reduce concentrated poverty and deep poverty is limited given the work component of the credit.

This report provides an overview of the federal and State earned income tax credits, including how the credits are claimed, the amount of credits claimed, the economic impacts of the credits, and earned income tax credits in other states. DLS also makes several recommendations related to the State earned income tax credit.

No State Agency Is Charged By Statute to Promote Public Awareness of the EITC and Its Eligibility Requirements

The structure of the federal earned income credit (EITC) as a refundable credit allows it to operate with administrative costs that total less than 1% of total program expenditures, significantly lower than the percentage for most or all other social benefit programs. State costs are similarly minimal, as the State earned income credit (EIC) is calculated as a percentage of the federal credit and therefore piggybacks on the federal credit. Due to the nature of how the credit is calculated and claimed, there is no Maryland agency charged by statute to promote public awareness of the credit or its eligibility requirements. As such, low-income individuals that may qualify for the credit may be unaware that the credit exists or that the credit could provide financial assistance to them.

Recommendation: Although the Office of the Comptroller administers the State EIC, the Department of Human Resources (DHR) oversees numerous State antipoverty programs, such as the Food Supplement Program (FSP), Emergency Assistance to Families with Children, Temporary Cash Assistance, and Temporary Disability Assistance Program. Currently, DHR departmental goals, objectives, and performance measures include achieving a certain Work Participation Rate and maintaining the Food Supplement error rate below certain percentages. **DLS recommends that the General Assembly designate DHR, in consultation with the Office of the Comptroller, to promote the credit and gather information regarding participation rates and credit effectiveness. DLS also recommends that State EIC goals, objectives, and performance measures (*e.g.*, obtaining a certain State credit participation rate) be integrated into DHR's objectives and budget measures.**

In order to develop an effective outreach program, DHR should investigate causes contributing to deficiencies in the credit participation rate, including area poverty rates, workforce participation rates, and public awareness of the credit. The agency should employ creative ways to reach out to those populations it identifies as not claiming the credit. For example, DHR and the Office of the Comptroller should explore coordinating information regarding working recipients of FSP assistance and State EIC recipients to ensure that FSP recipients have applied for the EIC where eligible. In addition, the Internal Revenue Service (IRS) has suggested methods for states to pursue in order to promote the EITC. These strategies include integrating messages with public assistance checks, tax forms, and public utility bills, as well as promoting the program through signs on public transportation. **DLS recommends that DHR employ these and additional innovative methods in its outreach. DHR's outreach should focus on promoting the federal credit, because increasing participation in that credit would have the greatest effect on reducing poverty and is cost-effective to the State.**

Additional Low-income Taxpayers May Benefit From an Expanded State Earned Income Credit

Although the EITC has proven an effective tool to alleviate poverty, the program does not benefit all impoverished workers equally. According to the Brookings Institution, due to the "modest provision" for childless workers and its phase out at 55% of full-time, minimum wage earnings, a childless worker making poverty-level wages would effectively be taxed into poverty under current law. While proposals to increase federal EITC benefits for childless workers have been introduced in the past, none has moved forward. The District of Columbia has expanded its EITC program beyond federal eligibility requirements by extending the credit to noncustodial parents between 18 and 30 years of age who are in compliance with a court order for child support payments.

In addition, although the American Tax Relief Act of 2012 expanded EITC benefits for taxpayers with three or more qualifying children, these expanded benefits will currently expire after December 31, 2017, and are not guaranteed to continue. Should these expanded federal credit benefits sunset, DLS estimates that State EIC claims would decline by approximately $15 million annually.

In order to make changes like those discussed above, current law would have to be altered to essentially "decouple" the calculation of and eligibility for the State and local credits from the calculation of the federal credit.

Recommendation: While the federal and State earned income credits have positive effects on reducing poverty and the credits do not currently proportionally benefit childless workers, the potential fiscal and administrative costs associated with decoupling from the federal credit and creating a stand-alone State EIC may outweigh the benefits that would otherwise accrue if the State EIC was expanded. In addition, the existing EITC has a high error rate, estimated at between 22% and 26% of total credits claimed, and expanding State EIC eligibility would add further complexity without providing additional simplifications. **Therefore, DLS recommends that the General Assembly continue to monitor federal actions concerning the EITC and the effects of the recently enacted minimum wage increase on poverty levels in the State. In addition, DLS recommends that the Office of the Comptroller provide an estimate of the potential administrative costs associated with decoupling the State credit and the potential for improper payments resulting from that decoupling by October 1, 2015.**

Maryland Is the Only State to Have Separate Refundable and Nonrefundable Credits

Maryland is the only state to provide a refundable EIC, a nonrefundable EIC, and a low-income (poverty level) credit. Some impoverished working taxpayers receive both the State EIC and the low-income poverty level credit, which may be claimed against both the State and county income tax. Rhode Island previously offered both a nonrefundable and refundable credit, but that state recently eliminated its nonrefundable credit.

Recommendation: DLS recommends that the Office of the Comptroller examine the impact of eliminating the nonrefundable credit and expanding the poverty level tax credit to hold harmless those affected by eliminating the nonrefundable credit. Additionally, the Office of the Comptroller should comment on the administrative complexity of having both a refundable and nonrefundable EIC. Under current law, in order to qualify for the poverty level credit, a taxpayer must have income below the poverty income guideline published by the U.S. Department of Health and Human Services, which is adjusted annually for inflation. While DLS is able to suggest cost-neutral methods to repeal the nonrefundable credit and expand the poverty level credit, DLS does not have access to the necessary data to develop a solution or solutions that would limit harm to current recipients. The Office of the Comptroller possesses data that would aid in crafting a more complete remedy, so they should assess whether it is possible to guarantee recipients will be held harmless if the nonrefundable credit is eliminated. If it is not possible for recipients to be held harmless, the Office of the Comptroller should identify the categories of taxpayers that will receive additional benefits and those that could lose benefits from eliminating the nonrefundable credit and expanding the poverty level tax credit.

The EITC's Complex Eligibility Requirements and Constantly Changing Population of Eligible Claimants Contribute to Taxpayer/Tax Preparer Errors and Improper Payments

Among the factors contributing to the EITC improper payment rate include the complexity of the credit, particularly where taxpayers face changing family or fiscal situations, and the constantly changing population of taxpayers eligible to claim the credit. Misunderstanding of EITC requirements regarding who may claim a child or incorrect information about family composition or income levels result in the majority of EITC overclaims. In addition, the complexity of the credit impacts not only taxpayers who prepare their own returns but also paid tax preparers.

Recommendation: DLS recommends that the Office of the Comptroller institute additional education and outreach efforts to both taxpayers and tax preparers concerning the EITC. The Office of the Comptroller should look to recent measures undertaken by the IRS to educate taxpayers and tax preparers regarding credit requirements. In addition, the Office of the Comptroller should partner with the State Board of Individual Tax Preparers and professional associations, such as the Maryland Association of Certified Public Accountants, the Maryland Society of Accountants, Inc., the Maryland State Bar Association, and a member of the National Association of Enrolled Agents, to ensure tax preparers are competent in filing EITC claims.

Recommendation: Although questions have been raised about the methodology used by the IRS for determining improper payment rates, the agency has estimated that 22% to 26% of EITC payments are issued improperly. The State EIC improper payment rate is currently unknown. However, in light of the calculation of the State and local EIC as a percentage of the federal credit and considering that State and local EIC payments totaled $302.9 million for tax year 2012, DLS estimates in excess of $50.0 million were improperly paid to EIC claimants. **In order to ensure that State and local funds are properly paid to eligible claimants, DLS recommends that the Office of the Comptroller investigate improper State EIC payments and develop strategies to address this issue. DLS also recommends that State EIC goals, objectives, and performance measures regarding improper payments should be integrated into the Office of the Comptroller's objectives and budget measures.**

Costs Associated with Refund Anticipation Products and Tax Preparation Services Erode From the Potential Benefits and Effectiveness of the EITC

Refund anticipation products have been marketed to taxpayers by lenders to permit access to estimated refund monies sooner than otherwise available under traditional IRS refund processing periods. These products are particularly targeted to low-income taxpayers, including EITC recipients. In addition, as many recipients of the EITC pay for professional assistance in preparing tax returns, the EITC is the only antipoverty program for which recipients pay to receive benefits. Costs incurred for refund anticipation products and tax preparation services combine to undermine the effectiveness of the EITC program by eroding the EITC funds received by low-income taxpayers and transferring funds to lenders and tax preparers.

Recommendation: Although the State has taken steps to regulate aspects of refund anticipation products, DLS recommends that the General Assembly consider additional measures to limit the adverse effects of these products on the effectiveness of the EITC. These measures include (1) prohibiting tax preparers who are not registered with the State from brokering refund anticipation products; (2) prohibiting businesses whose primary purpose is not tax preparation from offering refund anticipation products; (3) revoking the registration of tax preparers who violate State refund anticipation loan laws; and (4) providing funding for educational campaigns concerning utilizing reputable tax preparers and direct deposits for refunds. **The General Assembly should also continue to monitor the types of refund anticipation products offered in the State.**

Recommendation: In order to combat the erosion of EITC funds by tax preparation costs, DLS recommends that the General Assembly consider providing additional funding for free tax preparation services. In addition, DLS recommends that the Office of the Comptroller and DHR coordinate efforts to increase public awareness of free tax preparation services offered in the State.

Regulation of Individual Tax Preparers, Particularly Through Competency Requirements, Could Assist in Reducing EITC Improper Payments

Research has indicated that the regulation of individual tax preparers assists in reducing erroneous EITC payments. Maryland has taken steps to regulate individual tax preparers in the State by requiring preparers to register with the State Board of Individual Tax Preparers and meet certain registration requirements. Registered individual tax preparers must also satisfy continuing education requirements prior to renewal. In addition, as of October 2, 2014, a new Maryland Examination is available to registrants. The deadline for passing the Maryland Examination is December 31, 2015, after which passing the examination will be required before an individual may apply to register with the board. Current registrants will have until December 31, 2015, to take and pass the Maryland exam.

Recommendation: DLS recommends that the General Assembly continue to monitor the implementation of testing requirements by the State Board of Individual Tax Preparers.

Chapter 1. Overview and Background

Introduction

The federal earned income tax credit (EITC) is a refundable tax credit offered to low-income workers. The EITC program, first enacted in 1975, expanded significantly over time and is now one of the largest federal antipoverty programs. Maryland, and about half of all states and the District of Columbia, offers an earned income credit (EIC) that supplements the federal credit, with the implicit objective to reduce poverty.

Maryland offers a nonrefundable credit, which is equal to the lesser of 50% of the federal credit or the State income tax liability in the taxable year. If the nonrefundable credit reduces a taxpayer's liability to zero, the taxpayer is eligible to claim a refundable credit equal to 25% (gradually increasing to 28% by tax year 2018) of the federal credit, minus any pre-credit State income tax liability.

A total of 415,404 recipients claimed State and local credits totaling $302.9 million in tax year 2012. The fiscal impact of the State EIC program has expanded significantly over time, increasing by 6.5 times in real terms since 1990, an average annual growth rate of 9%. Significant factors contributing to this increase include the establishment and subsequent expansion of a State refundable credit as well as increased poverty and federal EITC enhancements. While there is general consensus among researchers that the EITC is an effective tax policy that helps raise low-income households out of poverty, it is not without issues. Implementation issues which limit effectiveness include high rates of improper payments (credits claimed by ineligible individuals), the use of paid tax preparers that charge high-cost products which drain the value of the credit, and participation rates that could be improved. Additionally, the ability of the EIC to reduce concentrated poverty and deep poverty is limited given the work component of the credit.

Tax Credit Evaluation Act

Overview

In response to concerns about the impacts of certain tax credits, Chapters 568 and 569 of 2012 established the Tax Credit Evaluation Act, a legislative process for evaluating certain tax credits. The evaluation process is conducted by a legislative evaluation committee and must be done in consultation with the Comptroller's Office, the Department of Budget and Management (DBM), the Department of Legislative Services (DLS), and the agency that administers each tax credit. The committee is appointed jointly by the President of the Senate and the Speaker of the House of Delegates and must include at least one member of the Senate Budget and Taxation Committee and one member of the House Ways and Means Committee.

The following credits are required to be reviewed by the date indicated:

- July 1, 2014: Enterprise Zone and One Maryland credits;
- July 1, 2015: Earned Income and Film Production Activity credits;
- July 1, 2016: Sustainable Communities and Research and Development credits; and
- July 1, 2017: Businesses That Create New Jobs, Biotechnology Investment, and Wineries/Vineyards credits.

In lieu of the evaluation dates listed above, if a tax credit has a termination date provided for by law, an evaluation of that credit must be made on or before July 1 of the year preceding the calendar year of the termination date.

Department of Legislative Services' Evaluation

By June 30 of the year prior to a tax credit's evaluation date, the evaluation committee is required to meet with the Comptroller's Office, DBM, DLS, and the agency that administers the credit to prepare a plan for evaluation. By October 31 of the same year, DLS is required to publish a report evaluating the tax credit.

The report submitted by DLS must discuss:

- the purpose for which the tax credit was established;
- whether the original intent of the tax credit is still appropriate;
- whether the tax credit is meeting its objectives;
- whether the goals of the tax credit could be more effectively carried out by other means; and
- the cost of the tax credit to the State and local governments.

By December 14 of the same year, the evaluation committee must hold a public hearing on the evaluation report. By the twentieth day of the legislative session before the evaluation date of a tax credit, the committee is required to submit a report to the General Assembly that states whether or not the tax credit should be continued, with or without changes, or terminated.

Income Tax Credit Implications to State Budget

Although the reduction in State revenues from tax credits are generally incorporated in the State budget, most tax credits are not subject to an annual appropriation required for other State programs. However, a few credits are subject to a budget appropriation, including the biotechnology investment and sustainable communities tax credits, and State reimbursement for one-half of the local property tax revenue losses under the Enterprise Zone Tax Credit Program. Reporting information for State tax credits varies. Under certain tax credit programs, agencies are required to publish specified information about the credit on an annual basis. DBM is required to prepare every other year a statement of the estimated amount by which exemptions from all types of State taxation reduces revenues.

Although tax credits comprise a small percentage of total income tax revenues (less than 3% in fiscal 2009), the number and amount of credits claimed has increased over time. Prior to 1995, there was one credit primarily for individuals (earned income credit) and two primarily business tax credits (enterprise zone and Maryland-mined coal credits). Since 1995, 29 tax credits primarily for businesses and 15 tax credits primarily for individuals have been established. This includes temporary and expired tax credits.

The tendency has been for credits to be established in clusters by year. Twenty-nine of the credits were established between 1995 and 2002. A resurgence occurred more recently, with 10 credits established since 2012, including 7 primarily for businesses. The total amount of credits has increased from a little less than $50 million in tax year 1994 to about $250 million in tax year 2008. Most of this increase has been due to an increase in tax credits for individuals, and in particular earned income credits, which have increased by almost five-fold since 1994.

Chapter 2. Credit Objectives, History, and Eligibility

Intent of the Federal and State Credits

The original intent of the federal earned income tax credit (EITC) was to help offset payroll taxes for low-income families. It was enacted initially as a temporary measure in the Tax Reduction Act of 1975 and made permanent in the Revenue Act of 1978. The Tax Reduction Act of 1975 aimed to achieve two long-term objectives:

(1) offset the impact of Social Security taxes on low-income workers; and
(2) encourage low-income people to seek out employment.

However, since being made permanent in 1978, the focus of the program shifted as federal legislation enacted in 1986, 1990, 1993, 2001, and 2009 significantly expanded the program including increased phase-out amounts and credit values. The EITC is now one of the largest federal antipoverty programs – the U.S. Census Bureau estimates that in 2012 the EITC lifted 6.5 million people, including 3.3 million children, out of poverty. No other tax or transfer program prevented more children from living a life of poverty, and only Social Security keeps more people out of poverty.

Neither of the legislation enacting both the State nonrefundable and refundable credits explicitly identified an objective or intent. Given that the State earned income credit (EIC) supplements the federal credit, the objective of the State program is assumed to be to reduce poverty.

Policymakers and researchers identify several justifications for a governmental role in reducing poverty including:

- the economic and social consequences of poverty on individuals, including children, and the wider community and economy;
- the significant benefits of reducing poverty; and
- the additional imperative given the recent significant increase in poverty.

History of the Federal Earned Income Tax Credit

The EITC was first enacted in 1975, providing a supplement to wages earned by low-income workers in the form of a refundable tax credit. The EITC began as a temporary program to return a portion of the Social Security taxes paid by working, low-income taxpayers and was made permanent in 1978. The Tax Reform Act of 1986 increased the maximum benefit of the credit and phase-out levels and indexed the credit to inflation.

The next substantive expansion of the credit occurred in 1990 and 1993 with the federal Omnibus Budget Reconciliation Acts. Both laws again increased the value of the credit and phase-out levels. The 1990 law established an enhanced credit for taxpayers with two or more children, and the 1993 law expanded the credit to taxpayers without dependents. The expansion of the credit in the 1990s is estimated to have tripled the cost of the credit, and the credit is now the largest antipoverty federal entitlement program.

In 2001, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) increased the income phase-out amounts for married couples. The American Recovery and Reinvestment Act expanded the credit through 2010 by increasing (1) the value of the credit for households with three or more children and (2) the income phase-out amounts for married couples. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended these provisions through 2012, and the American Taxpayer Relief Act of 2012 further extended them through 2017. Additionally, the 2012 Act made permanent a portion of the EGTRRA income phase-out amounts for married couples.

History of the Maryland Earned Income Credit

Since 1987, Maryland has provided a nonrefundable State EIC equal to 50% of the federal credit for eligible taxpayers. The total amount that could be claimed was limited to the taxpayer's tax liability imposed in the year. Although the legislation establishing the State nonrefundable credit did not explicitly create a credit against local income taxes, the State credit also reduced a taxpayer's local income taxes. Chapter 5 of 1998 established a refundable credit for taxpayers who meet the eligibility requirements of the federal credit and have at least one dependent. The refundable credit provides a refund to the taxpayer if the credit is greater than tax liability. Both credits are based on federal eligibility and the value of the federal credit received, so changes to federal law also impact the State credits. The value of and eligibility for the credit has changed many times since its enactment, with most changes occurring after the enactment of the refundable credit.

The initial value of the refundable credit was 10.0% of the federal credit for tax years 1998 and 1999, rising to 12.5% in tax year 2000 and 15.0% in tax years 2001 and beyond. The amount of credit allowed against the county income tax is equal to the federal credit claimed multiplied by 10 times the county income tax rate, not to exceed the income tax liability.

Chapter 510 of 2000 accelerated the phase-in of the increased credit value enacted by Chapter 5 of 1998, increasing the refundable credit value from 12.5% to 15.0% for tax year 2000 and beyond. Additionally, the Act authorized counties to provide a local refundable credit equal to the amount by which three times the federal credit multiplied by the county income tax rate exceeded the county income tax liability. As of 2014, no county has provided the credit that can be claimed with the income tax return in the method provided under State law. Montgomery County maintains a separate grant program as detailed below.

Chapter 581 of 2001 further increased the refundable credit value from 15% to 16% for tax years 2001 and 2002, increasing to 18% for tax year 2003, and 20% for tax years 2004 and beyond. Chapter 581 also increased the calculation of any authorized county refundable credit.

Chapter 3 of the 2007 special session expanded the credit further by increasing the refundable credit value from 20% to 25% of the federal credit and extending eligibility to individuals without dependents. Additionally, the Act further increased the calculation of a county refundable credit.

Most recently, Chapter 389 of 2014 increased the refundable credit value from 25% to 28% of the federal credit, phased in over four years, beginning with tax year 2015.

Exhibit 2.1 shows by year of enactment major federal and State legislation impacting the programs.

Exhibit 2.1
Federal and State Legislation

Year	State	Federal
1975		Credit enacted
1979		Credit made permanent and amount increased; advance payments made available
1985		Credit amount increased
1987	State and local nonrefundable credits enacted	Credit amount increased (and indexed for inflation)
1988		Phase-out floor increased
1991		Credit amount increased; filers with two or more children receive larger credit than those with one; supplemental credits for health insurance and young children
1994		Credit amount increased; extended to claimants without dependents; supplemental credits eliminated
1995		Credit amount increased; qualifying income decreased for filers with one child
1996		Credit amount increased for filers with two or more children; claimants limited to $2,200 in “disqualified investment income”
1998	Refundable credit enacted at 10%, phasing to 15% by 2001	
1999	Calculation of credit against county income tax altered	
2000	Counties authorized to provide refundable credit	
2001	Refundable credit increased, phasing to 20% by 2004	Phase-out thresholds increased for married joint filers, effective tax year 2002
2007	Refundable credit increased from 20% to 25% of the federal credit; credit expanded to individuals without dependents	
2009		Credit amount increased for claimants with three or more children; phase-out threshold further increased for married joint filers. Provisions apply to tax year 2009 and 2010
2010		Enhancements enacted in 2009 extended through 2012
2012		Credit amount increased for filers with three or more children extended through tax year 2017; a portion of increased phase-out thresholds for married claimants made permanent
2014	Refundable credit amount increased from 25% to 28% of the federal credit, phased in over four years	

Source: Department of Legislative Services

Federal and State Credit Eligibility

Low- and moderate-income workers may be eligible for a federal refundable credit that generally equals a specified percentage of earned income (wages and other employee compensation plus net self-employment earnings) up to a maximum dollar amount. If the amount of the credit exceeds the taxpayer's federal income tax liability, the excess is payable to the taxpayer as a direct payment. The determination of whether a taxpayer is eligible for the federal credit can be complex. The Internal Revenue Service produces Publication 596 to provide guidance on eligibility. In tax year 2013, it was a 39-page document.

To be eligible in tax year 2014, a taxpayer must have earned income, investment income of $3,350 or less, and a modified federal adjusted gross income of less than:

- $46,997 ($52,427 married filing jointly) with three or more qualifying children;
- $43,756 ($49,186 married filing jointly) with two qualifying children;
- $38,511 ($43,941 married filing jointly) with one qualifying child; and
- $14,590 ($20,020 married filing jointly) with no qualifying children.

The phase-out range for joint returns is temporarily $5,430 higher than the amounts for individual returns. The taxpayer must have a valid Social Security number; be a U.S. citizen or resident alien; not apply for the foreign earned income exclusion; and not file under married filing separately.

If all of the qualifying requirements above are met, a taxpayer then must meet further requirements. To determine which additional requirements must be met, a taxpayer must determine whether he or she has a qualifying child. Qualifying children are those that meet certain relationship, age, and residency guidelines. Generally, a child qualifies if he or she is under guardianship of the taxpayer; is under age 19, or age 24 if a student, or any age if disabled; lives with the taxpayer; and is not married and filing his or her own tax return.

If a taxpayer has one or more qualifying children and meets the above requirements, the taxpayer is eligible to claim the credit. If a taxpayer does not have a qualifying child, but does meet the preceding above requirements, then in order to qualify, the taxpayer must be at least age 25 but under age 65, cannot be the dependent or qualifying child of another person, and must have lived in the United States for more than half of the year.

A taxpayer who claims the federal credit is eligible to claim the State credit. Some taxpayers claim only the nonrefundable credit, generally those with higher tax liabilities; others will claim both, while a third group will claim only the refundable credit. A taxpayer first calculates the nonrefundable credit, which is equal to the lesser of 50% of the federal credit or the State income tax liability in the taxable year. If the nonrefundable credit reduces a taxpayer's liability to zero, the taxpayer is eligible to claim the refundable credit. In tax year 2014, the refundable credit is equal to 25% of the federal credit claimed, minus any pre-credit tax liability. For instance, if a taxpayer claimed a federal credit of $400 and has a pre-credit State tax liability of $50, the refundable credit equals $50. About one-half of all taxpayers who claim the refundable credit have some pre-credit liability. In these instances the Comptroller's Office advises the individual will claim both credits – the nonrefundable credit is equal to the amount of pre-credit liability claimed, and the refundable credit claimed represents the amount of refund issued. Taxpayers who do not have any pre-credit liability will claim only the refundable credit.

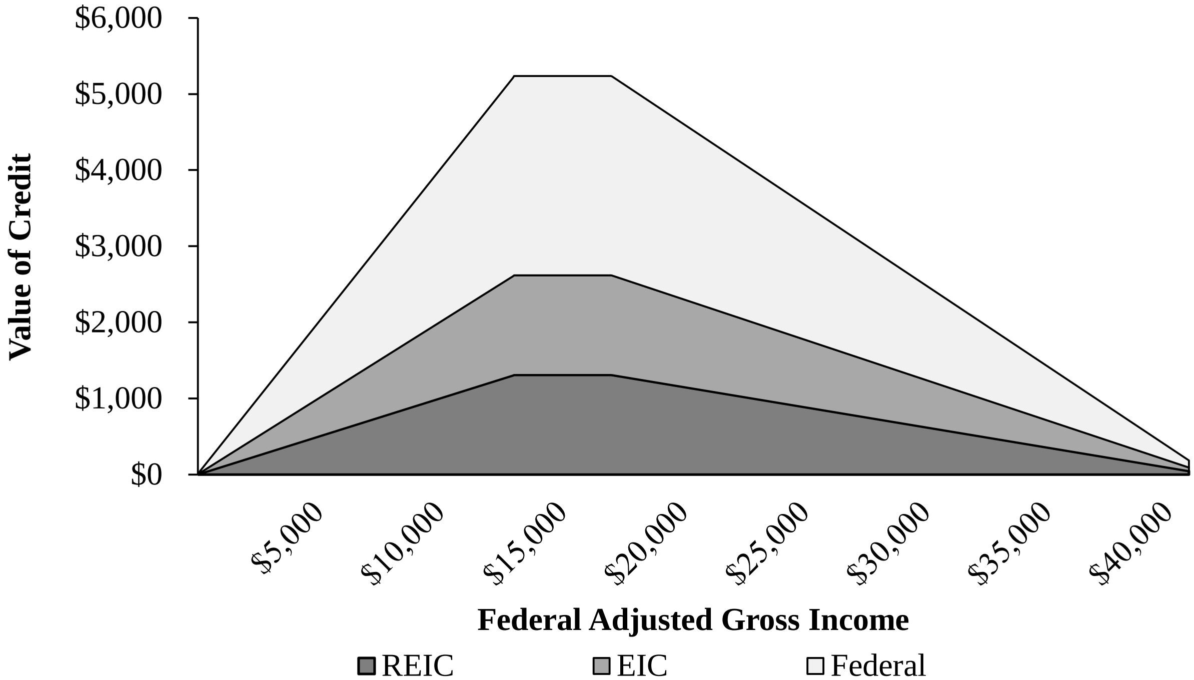
Federal and State Credit Values

The maximum federal credit for tax year 2014 is as follows:

- $6,143 with three or more qualifying children;
- $5,460 with two qualifying children;
- $3,305 with one qualifying child; and
- $496 with no qualifying children.

Exhibit 2.2 illustrates the value of the EITC, State EIC, and State refundable earned income credit (REIC) in tax year 2012 for a taxpayer with two dependents. The actual value of the State credits claimed, however, may not always equal the amount shown in the exhibit. The refundable credit is reduced by any pre-credit tax liability and the nonrefundable credit is limited by the taxpayer's total tax liability, which typically could be much less than 50% of the EITC. For tax year 2014, individuals with incomes between $13,650 and $17,830 qualify for the maximum credits, and for an individual with two dependents the credits equal $5,460 (federal), $2,730 (State EIC), and $1,365 (State REIC).

Exhibit 2.2
Earned Income Credits for an Individual with Two Dependents
Tax Year 2012



EIC: earned income credit
REIC: refundable earned income credit
Source: Internal Revenue Service; Department of Legislative Services

Montgomery County Grant Program

While no county has provided a refundable credit that can be claimed with the income tax return in the method provided under State law, Montgomery County's Working Families Income Supplement program acts as an earned income credit grant program by generally matching the refundable State credit claimed.

Under the Montgomery County program, eligible taxpayers receive a check from the Comptroller, but the grants are paid by the county. A Montgomery County resident who receives a Maryland refundable credit is eligible to receive an additional refund from the county. When the program began in 2000, recipients generally received an amount equal to their State refund. The only exception was that the county refund amount varied because there is no county tax offset for outstanding liabilities (unpaid income tax, tuition fees, and child support) as there is with State refunds.

While the county refund initially matched 100.0% of the State amount, the county reduced the amount amidst the fiscal pressures generated by the Great Recession. Recipients were eligible to receive 72.5% of the State refund in tax year 2011, 68.9% in tax year 2012, and 72.5% in tax year 2013. However, in 2013, the Montgomery County Council passed legislation that phases in the restoration of the grant amount to equal the State refund by tax year 2016.

Poverty Level Credit

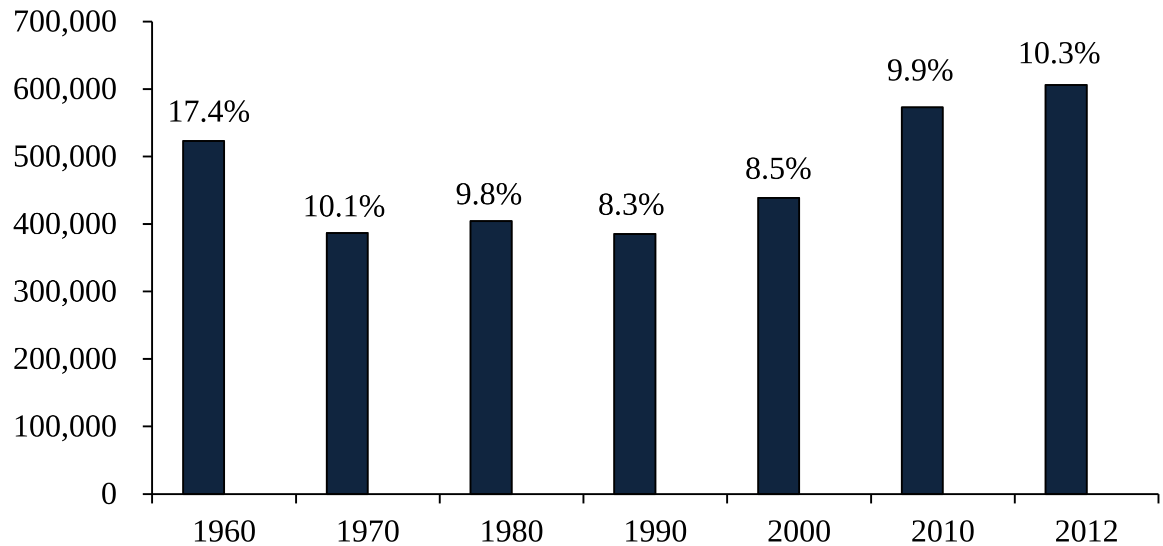
In addition to the State EIC program, the State provides an additional nonrefundable income tax credit known as the poverty level credit, which was established in 1998, the same year in which the refundable credit was established. The credit was established to eliminate any remaining State and local tax liability for households who have incomes below the poverty level and claim the nonrefundable earned income credit. Generally, if a household's Maryland State tax exceeds 50% of the federal earned income credit and the household's earned income and federal adjusted gross income are below the poverty level, the household may claim a credit of 5% of its earned income. The county credit amount equals an amount equal to the county income tax rate multiplied times the taxpayer's earned income. To qualify for the poverty level credit, a taxpayer must have income below the poverty income guideline published by the U.S. Department of Health and Human Services. These amounts are adjusted annually for inflation.

Chapter 3. Poverty in Maryland

Incidence of Maryland Poverty

Exhibit 3.1 shows the number of Marylanders living in poverty and the poverty rate since 1960. Significant reductions in poverty occurred in the first four decades as the percentage of individuals in poverty halved from 17.4% to 8.5%. There were 85,000 fewer individuals in poverty in 2000, a 16.0% reduction from 1960, even as Maryland's population increased by 2 million. However, poverty has recently increased in both absolute and percentage terms, primarily due to the impact of the Great Recession and changes in long-term trends predating the recession. The one-fifth increase in the poverty rate since 2000 translates to an additional 152,700 individuals living in poverty. Although poverty rates have decreased in some counties since the Great Recession, the State rate continues to increase even as the economy continues its recovery.

Exhibit 3.1
Number and Percentage of Maryland Residents Living in Poverty



Source: U.S. Census Bureau; Department of Legislative Services

Official and Supplemental Poverty Measures

The official poverty measure is based on minimum food requirements and family size, and has remained largely unchanged other than for annual updates for inflation. Researchers raised concerns over the adequacy of the measure, and in 2010, a federal interagency working group developed a new Supplemental Poverty Measure (SPM) incorporating many of the recommendations made in a 1995 National Academy of Sciences report. The SPM is a more comprehensive measure by taking into account additional sources of income and the impact of certain expenses.

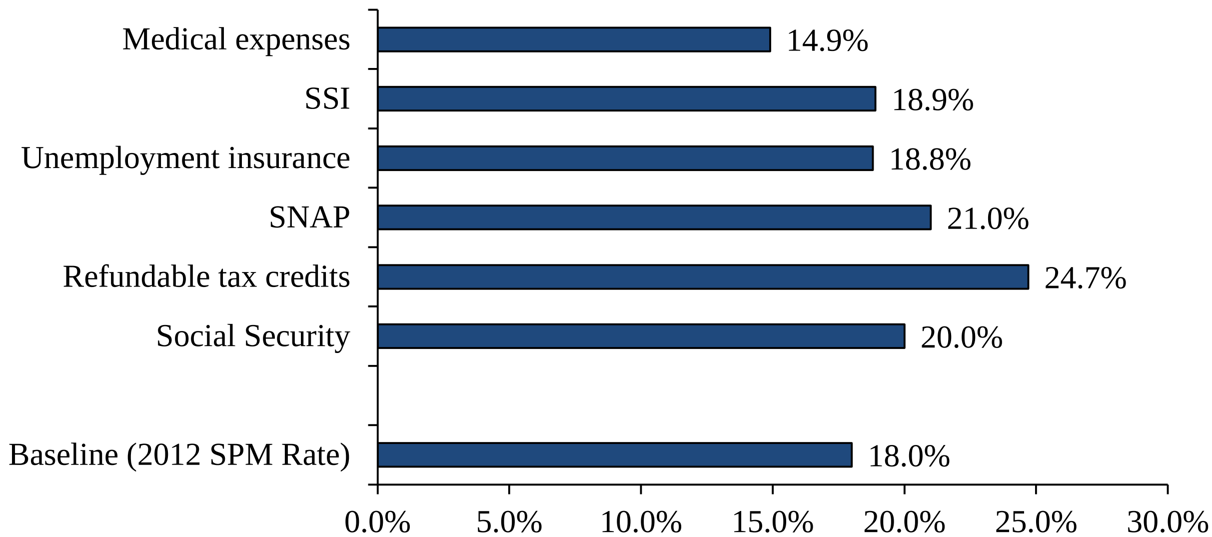
The official poverty measure includes cash benefits from the government, such as Social Security and Unemployment Insurance benefits, Supplemental Security Income, public assistance benefits, such as Temporary Assistance for Needy Families, and workers compensation benefits, but does not account for tax or noncash benefits aimed at improving the economic situation of the poor. In addition to taking into account cash benefits and necessary expenses, the SPM includes tax benefits and noncash transfers. The impact of tax benefits includes certain refundable tax credits such as state and federal earned income tax credits. Unlike the official poverty measure, which produces uniform estimates for all lower 48 states, the SPM is adjusted for geographic differences in housing costs.

The estimated prevalence of poverty nationwide increases, from 15.1% to 16.0%, when comparing the official poverty rate to the SPM. However, in most states the prevalence of poverty decreases or the change is statistically insignificant. The Maryland SPM in calendar 2010 to 2012 is about one-third higher than the official rate – 13.4% compared to 10.1%. This increase is the fifth largest in the United States, and Maryland's poverty ranking rises from forty-ninth lowest to twenty-eighth under the SPM and is higher than neighboring states West Virginia and Pennsylvania. According to the U.S. Census Bureau, higher SPM rates may occur from many sources but generally reflect higher expenses, housing costs, and taxes. For example, the Kids Count Data Center estimates that more low-income children in Maryland (three-quarters) live in a household that faces high housing costs. Although the SPM provides a more comprehensive estimate of poverty, virtually all U.S. Census Bureau data uses the official poverty measure, and this measure is used to determine eligibility for many government programs.

Exhibit 3.2 shows the nationwide impact of programs on the calculation of family resources and the poverty rate for children. Without refundable tax credits, which consists of the federal and state earned income tax credit (EITC) and the child tax credit, the supplemental poverty rate would have been 19.0% instead of 16.0%. The impact is even greater for children since the supplemental poverty rate would have been 24.7% in the absence of refundable tax credits, rather than 18.0%. No other program has a bigger effect on children in poverty than the refundable tax credits, and only Social Security did more to remove people from poverty than refundable tax credits.

While the EITC is the largest antipoverty program for working families, only about 35% of households in poverty in 2013 were eligible for the credit. A taxpayer must work to be eligible, and unfortunately many in deep poverty do not work.

Exhibit 3.2
Impact of Various Programs on U.S. Child SPM Rates
2012



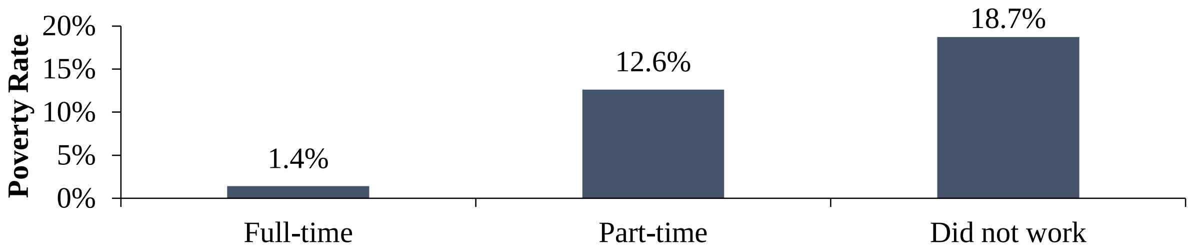
SNAP: Supplemental Nutritional Assistance Program
SPM: Supplemental Poverty Measure
SSI: Supplemental Security Income
Source: U.S. Census Bureau; Department of Legislative Services

Factors Influencing Poverty

Poverty is geographically diverse and not limited to certain populations; however, some groups are more likely to experience poverty, and research has identified numerous factors that increase its likelihood. Children are especially at risk, as the poverty rate for Maryland children, 13.1%, is 60.0% higher than for elderly Marylanders (8.1%). Infant poverty rates are even higher, averaging 15.6% with about one in four African American infants and one in five Hispanic infants living in families with incomes below poverty, compared with 7.9% of infants in white families. Research has also determined that family structure is also an important determinant of poverty rates. Among the 100,500 Maryland families with income below the federal poverty level, 73.0% are headed by a single parent. About one-fifth of all female-headed households have incomes below poverty, compared with 2.7% of married family households. **Appendix 1** shows poverty rates by age and other factors in Maryland regions.

Although multiple factors influence poverty, given the EITC's requirement that recipients work, it is important to concentrate on the interrelated impacts of education, joblessness, and poverty. Not surprisingly, those with full-time employment year round are much less likely to be poor (1.4%), compared to a little less than one in five individuals who did not work during the year who are in poverty, as shown in **Exhibit 3.3**. Many of the poor struggle to find full-time employment, as 12.6% of Maryland's poor who work part-time or part of the year are in poverty.

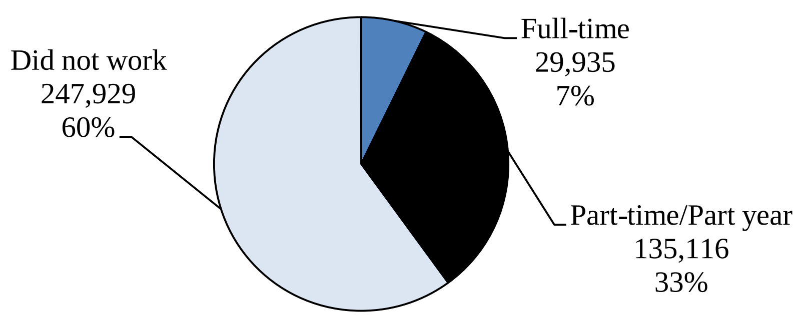
Exhibit 3.3
Poverty Rates by Work Status
Calendar 2012



Note: Work status is for individuals age 16 and older. Part-time workers include individuals who also work a portion of the year.
Source: 2012 American Community Survey; Department of Legislative Services

About 6 in 10 of Maryland's poor did not work during 2012, and about one-third worked part-time or a portion of the year, as shown in **Exhibit 3.4**. Although full-time employment significantly decreases the likelihood of being poor, it is no assurance that individuals escape poverty as 7% of the poor in Maryland earn wages below the poverty level. The incidence of poverty by work status among Maryland residents is similar to the national average.

Exhibit 3.4
Distribution of Maryland Individuals in Poverty by Work Status
Calendar 2012

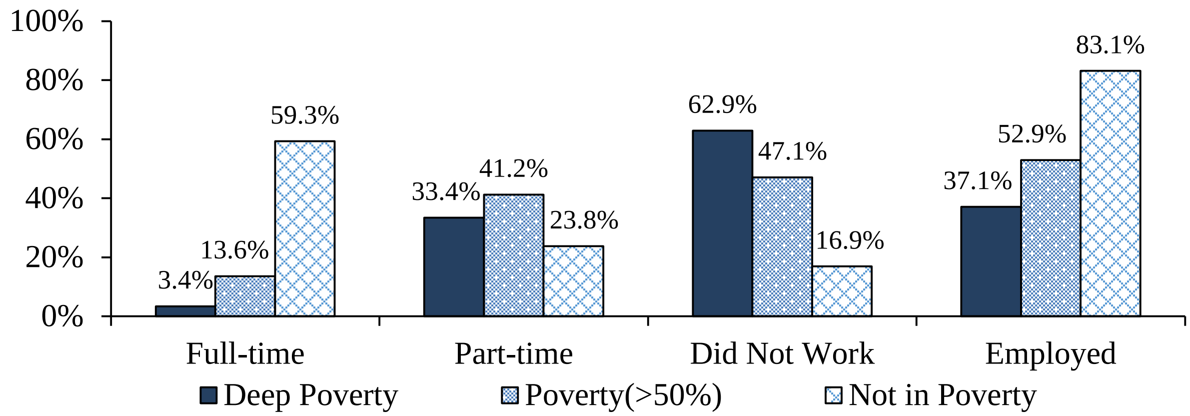


Note: Work status is for individuals age 16 and older. Part-time workers include individuals who also work a portion of the year.
Source: U.S. Census Bureau; Department of Legislative Services

Eligibility for the EITC is not restricted to households with incomes below the poverty line, which is roughly $19,800 for a family of three in calendar 2014. Eligibility varies with family size and the credit phases out at income levels higher than the poverty threshold. These differences preclude a perfect identification of the target population through U.S. Census Bureau or other government sources of data. However, based on the credit's income phase-outs, research suggests that a close proxy is the number of individuals with incomes that are less than 200% of the poverty level. This is higher than the typical income eligibility for other safety net programs; eligibility for the Supplemental Nutritional Assistance Program (SNAP), for example, is limited to households earning less than 130% of the poverty threshold.

Individuals with incomes of less than two times the poverty level are a diverse group with dissimilar family resources. A family of three with an income level twice that of the poverty level has an income of $39,600, while a family of three in deep poverty, earning less than half of the poverty level, has an income of $9,900. The propensity to work varies significantly among the low-income Marylanders targeted by the credit, as an individual earning just above the poverty level (100%-125%) is seven times more likely to be employed full-time than an individual in deep poverty. **Exhibit 3.5** compares the work status of Maryland individuals in deep poverty (incomes of less than 50% of the poverty level), individuals with incomes between 50% and 100% of the poverty level, and all Marylanders who are not in poverty.

Exhibit 3.5
Work Status of Marylanders According to Poverty Level
Calendar 2010-2012



Note: Work status is for individuals age 16 to 65 and is calculated as the ratio of employed per total population age 16 to 65.
Source: U.S. Census Bureau; Department of Legislative Services

Long-term trends combined with the impact of the Great Recession have decreased employment rates among low-income Marylanders, thereby reducing the proportion of the low-income individuals that can claim the credit. **Exhibit 3.6** shows the change in employment rates by poverty status since the Great Recession.

Exhibit 3.6
Percentage of Maryland Individuals by Work Status
Calendar 2007 and 2012

	2007	2012	% Change
Maryland (all)			
Full-time	52.5%	54.4%	3.6%
Part-time	30.5%	25.1%	-17.9%
Total Employed	**83.1%**	**79.5%**	**-4.3%**
Did Not Work	**16.9%**	**20.5%**	**21.2%**
Poverty			
Full-time	7.6%	8.5%	11.8%
Part-time	43.8%	37.3%	-14.7%
Total Employed	**50.5%**	**45.0%**	**-10.9%**
Did Not Work	**49.5%**	**55.0%**	**11.1%**
Deep Poverty			
Full-time	1.4%	3.4%	145.9%
Part-time	41.0%	33.4%	-18.4%
Total Employed	**42.9%**	**37.1%**	**-13.6%**
Did Not Work	**57.1%**	**62.9%**	**10.2%**

Source: U.S. Census Bureau; Department of Legislative Services

From 2005 to 2012, the number of low-income Marylanders increased from 1.1 million to 1.4 million, a 20% increase. The increase was not uniform, as the rates of growth among the lower distribution was significantly higher, as the percentage increase in poverty was twice the rate of the increase in the population with incomes of 100% to 200% of the poverty level.

Poverty Is Often Concentrated and Persistent in Certain Areas

Research indicates that poverty is often concentrated and persistently present in many areas. People living in poverty tend to be clustered in certain neighborhoods rather than being evenly distributed across geographic areas. Concentrated poverty has been described as the coincidence of a number of social ills including poverty, joblessness, crime, depressed economic conditions, and low levels of skills in small geographic areas. Factors that have contributed to the concentration of poverty include the dramatic decline in blue-collar employment caused by de-industrialization, out-migration, and a growing mismatch between the educational levels of residents and the skill levels demanded in growth industries.

Persistent poverty is often associated with inner cities, but it is also a problem in many rural areas. According to recent research conducted by the Population Reference Bureau, metropolitan areas accounted for more than three-fourths of children living in persistently poor neighborhoods. However, children in rural (nonmetropolitan) counties were more likely to live in persistently poor neighborhoods (15%) than were their metropolitan counterparts (11%). In 2000, the study found that there were 8.3 million children living in persistently poor neighborhoods – defined as neighborhoods with poverty rates of at least 20% in 1980, 1990, and 2000. Moreover, a recent study conducted jointly by the U.S. Federal Reserve and the Brookings Institution found that poverty is spreading and may be re-clustering in suburbs, where a majority of America's metropolitan poor now live.

The recent U.S. Federal Reserve and Brookings Institution study examined the challenges, trends, and impacts of concentrated poverty. The study stated that concentrated poverty presents some of the deepest economic and social challenges facing America today, as concentrated poverty and joblessness exact a grave toll on people who continue to live in its midst and threatens to perpetuate disadvantage across generations. Other research indicates that children growing up in poor neighborhoods are at a higher risk of health problems, teen pregnancy, dropping out of school, and other social and economic problems than are children living in more affluent communities. Long-term joblessness is associated with deep, permanent reductions in future earnings as well as decreased mental and physical health. This body of research argues that concentrated poverty places additional burdens on poor families that live within them, beyond what the families' own individual circumstances would dictate. In addition, concentrated poverty can have wider effects on surrounding areas that limit overall economic potential and social cohesion.

Although concentrated poverty persists in Maryland, it is less prevalent in Maryland than in the rest of the nation. About 9% of Maryland's population lives in areas with poverty rates of 20% or more, compared with a little less than one-quarter nationally. In addition, the percentage of population living in poverty areas is lower in Maryland than in each surrounding state.

Persistent and Deep Poverty Population

Many individuals fall into poverty at some point in their lives due to the loss of a job or life events that necessitate time away from work such as the birth of a child or a health crisis. These events can also push individuals temporarily into deep poverty; however, most people are able to recover relatively quickly and regain stable and permanent employment. The earned income credit is one part of the safety net – individuals who experience sudden poverty can receive significant assistance from SNAP, Temporary Cash Assistance (TCA), and unemployment insurance benefits. Even if significant numbers of the poor are unemployed, the EITC can help lift them out of poverty once they regain employment – three-quarters of all individuals who fall into poverty experience it for less than four years. However, the weak job market and other factors have made this type of quick recovery more difficult – research conducted by the University of Baltimore found that recent "leavers" of TCA had lower rates of employment both before and after receipt of assistance compared to recipients who left in two earlier periods.

A significant population of the poor experience deep and persistent poverty. Most of these individuals face multiple and complex barriers to employment including individuals with physical and mental disabilities, lack of education, learning disabilities, the need to care for others with mental or physical disabilities, criminal records, lack of citizenship, domestic violence, and past or present substance abuse. Work requirements and other conditions imposed by many federal programs, such as the EITC, may be beneficial for the working poor or people experiencing short spells of poverty or unemployment but do not address the needs of people in persistent and deep poverty. This diverse group includes the homeless, single mothers, undocumented immigrants, and young people. Not only are these disadvantages often persistent throughout one's lifetime, but can often lead to the intergenerational transmission of poverty. Research has found that socioeconomic gaps in children's cognition and behavior open up early in life and remain largely constant throughout school years. By the start of kindergarten, not only do poor children perform significantly worse on tests of cognitive ability, but teachers also report that these children have much more difficulty paying attention and exhibit behavioral problems. As a result of the social and economic challenges of growing up in poor households and communities, these individuals are more likely to live in poverty as adults.

Since the mid-1990s, the federal government has increased incentives for adults to work and reduced the availability and generosity of benefits for the nonworking, nondisabled population. These policy changes have substantially increased work and earnings among the low-income population, and particularly unmarried women with children. However, researchers note that these changes, intended to move recipients from welfare to employment, were enacted in a time of economic prosperity. Deep poverty has been found to be concentrated in populations most affected by the change in federal government assistance programs. A number of single mothers were unable to successfully transition to the labor market owing to many of the barriers to work described above. Researchers have identified a growing problem of disconnected single mothers – a very poor group that for some period of time do not work or receive public assistance benefits.

The prevalence of deep poverty has increased in the last few decades along with the overall increase in poverty. Although total federal assistance to the low-income population has increased substantially since the mid-1980s, it has been redistributed away from those in deep poverty – in 2004, the poorest of all families received an estimated 32% of all federal transfers to the low-income population (incomes less than 200% of the poverty line), substantially less than the 56% received in 1983. Researchers question whether this shift in federal assistance, along with the complex array of some 80 different means-tested federal government programs, is sufficiently addressing the challenges of deep and persistent poverty.

Barriers to Employment – Education and Work Skills

A common and easily identified barrier to stable employment is a lack of education and work skills. In 2013, the Department of Legislative Services evaluated the effectiveness of the enterprise zone tax credit, which provides tax credits to businesses that locate or expand in economically distressed areas. The Department of Legislative Services found that the tax credit is not effective in providing employment to nearby residents who are chronically unemployed and/or live in poverty. Although a number of factors contribute to this problem, a major contributor was the lack of education among residents and resulting lack of skills relative to those demanded by employers. Enterprise zones are geographically diverse; however, many are located in Western Maryland and the Eastern Shore. In addition, the largest zone is located in Baltimore City.

Research has identified a strong correlation between education, employment, and poverty. **Exhibit 3.7** shows educational attainment and poverty rates by region. The regions of the State with the lowest educational attainment, Western Maryland, lower Eastern Shore, and Baltimore City, also have the highest poverty rates, 13.7%, 16.2%, and 25.2% respectively. However, poverty rates are generally higher for residents of these areas even after controlling for education – Baltimore City residents with at least a high school diploma are more than twice as likely to be poor than similarly educated individuals in the State. Moreover, Baltimore City residents with at least a bachelor's degree are more likely to be poor than a Central Maryland resident who has a high school diploma.

Exhibit 3.7

Education Rates and Poverty Rates by Education

Calendar 2010-2012

	Education Rates				**Poverty Rates by Education**			
	<High School	**High School**	**Some College**	**Bachelor's or Greater**	**<High School**	**High School**	**Some College**	**Bachelor's or Greater**
Baltimore/Harford	9.3%	27.7%	28.1%	34.9%	16.5%	9.4%	6.8%	3.0%
Baltimore City	20.3%	29.2%	24.0%	26.5%	34.2%	23.7%	18.3%	7.2%
Montgomery	8.8%	14.3%	19.9%	57.0%	16.0%	10.1%	7.2%	2.8%
Prince George's	14.3%	27.1%	28.7%	29.9%	15.5%	8.4%	6.6%	3.5%
Central Maryland	7.5%	23.4%	26.8%	42.2%	16.8%	6.8%	4.2%	1.7%
Southern Maryland	8.5%	30.9%	32.0%	28.5%	15.5%	7.4%	4.7%	1.5%
Western Maryland	12.6%	39.7%	28.5%	19.2%	21.2%	10.2%	9.6%	4.3%
Upper Eastern Shore	11.6%	34.5%	27.8%	26.1%	21.0%	9.8%	6.3%	2.5%
Lower Eastern Shore	13.5%	34.2%	26.9%	25.5%	22.7%	13.3%	9.5%	4.8%
Maryland	**11.1%**	**25.7%**	**26.2%**	**37.0%**	**20.3%**	**10.6%**	**7.4%**	**3.0%**

Source: U.S. Census Bureau; Department of Legislative Services

This data shows the linkage between education and poverty but it also reveals how other factors contribute to poverty. Individuals in high poverty areas of the State are more likely to face additional barriers to entry beyond the lack of education and live in areas that experience concentrated and/or persistent poverty. All things being equal, residents of these communities are more likely to live in poverty than their individual or family situations suggest due to lower availability of jobs and other community problems.

Areas that experience poverty for a short period are likely better off than areas of concentrated and persistent poverty. About 350 counties in the United States, representing about 11.0% of the total population, had a poverty rate of at least 20.0% in 1980, 1990, and 2000. Ten years later, the total number of persistently poor counties increased to 384. No Maryland county is on this list; however, Baltimore City has remained persistently poor over this period and longer. The poverty rate of Baltimore City exceeded 20.0% in five out of the last six decades; the lone exception was 1970, when the poverty rate was 18.4%. Areas of concentrated and persistent poverty exist in other parts of the State, albeit on a smaller scale. Several towns in Western Maryland and the Eastern Shore have higher poverty rates and/or deep poverty rates than Baltimore City and have experienced long-term distress. Hurlock, Federalsburg, Salisbury, Crisfield, and Princess Anne have deep poverty rates of between 12.5% and 17.8%, compared to a rate of 12.4% in Baltimore City. Poverty rates in Princess Anne, Crisfield, and Pocomoke City hover around 30.0%, above the 25.2% rate of Baltimore City.

Poverty and Workforce Participation by Region

Given the persistence of poverty and lack of job opportunities in high poverty, persistently poor areas, these individuals are less likely to secure stable, long-term employment. Of the adult, nonelderly Baltimore City population who were poor, about 55,800 did not work, of which 30,600 were in deep poverty. Between 73% and 86% of the poor who resided in Crisfield, Snow Hill, Federalsburg, Cambridge, and Cumberland did not work in the past year. About 71% of Baltimore City residents who are poor and live in a poverty area did not work; in Western Maryland three quarters did not. By comparison, about 45% of the poor who live in Prince George’s and Montgomery counties did not work. These effects are consistent within counties. For example, Baltimore City residents who are in poverty and live in a concentrated poverty area are less likely to be employed than a resident who is in poverty and resides in a poverty area or neighborhood with a poverty rate of less than 20%. Employment gains in these other regions are consistent across gender, but are more pronounced with respect to full-time employment and males. Baltimore City males who are in poverty and live in a nonpoverty area are 3.4 times more likely to be employed full-time, whereas females are two-thirds more likely. The lack of work throughout one’s life perpetuates poverty – about 18% of Baltimore City’s elderly population lives in poverty compared to 5% to 7% in low poverty areas of the State, reflecting low receipt of Social Security and other retirement income earned during working years.

Exhibit 3.8 shows the correlation between deep poverty, poverty, and low-income population by region and the percentage of the population that is employed.

Exhibit 3.8
Poverty, Deep Poverty, and Low-income Population by Region
Calendar 2010-2012

	Percent of Population			
	Deep Poverty	Poverty	Low-income	Employed
Baltimore/Harford	4.6%	8.9%	21.9%	63.2%
Baltimore City	12.4%	25.2%	46.6%	54.3%
Montgomery	3.0%	6.9%	17.5%	67.7%
Prince George's	4.7%	9.6%	24.5%	66.8%
Central Maryland	2.8%	5.6%	14.6%	67.3%
Southern Maryland	3.6%	6.9%	16.5%	65.2%
Western Maryland	6.4%	13.7%	33.4%	58.3%
Upper Eastern Shore	4.7%	10.7%	24.8%	60.4%
Lower Eastern Shore	7.7%	16.1%	35.9%	56.6%
Maryland	**4.9%**	**10.1%**	**23.3%**	**64.0%**

Note: Employed is ratio of employed individuals to total population for individuals age 16 to 64.
Source: U.S. Census Bureau; Department of Legislative Services

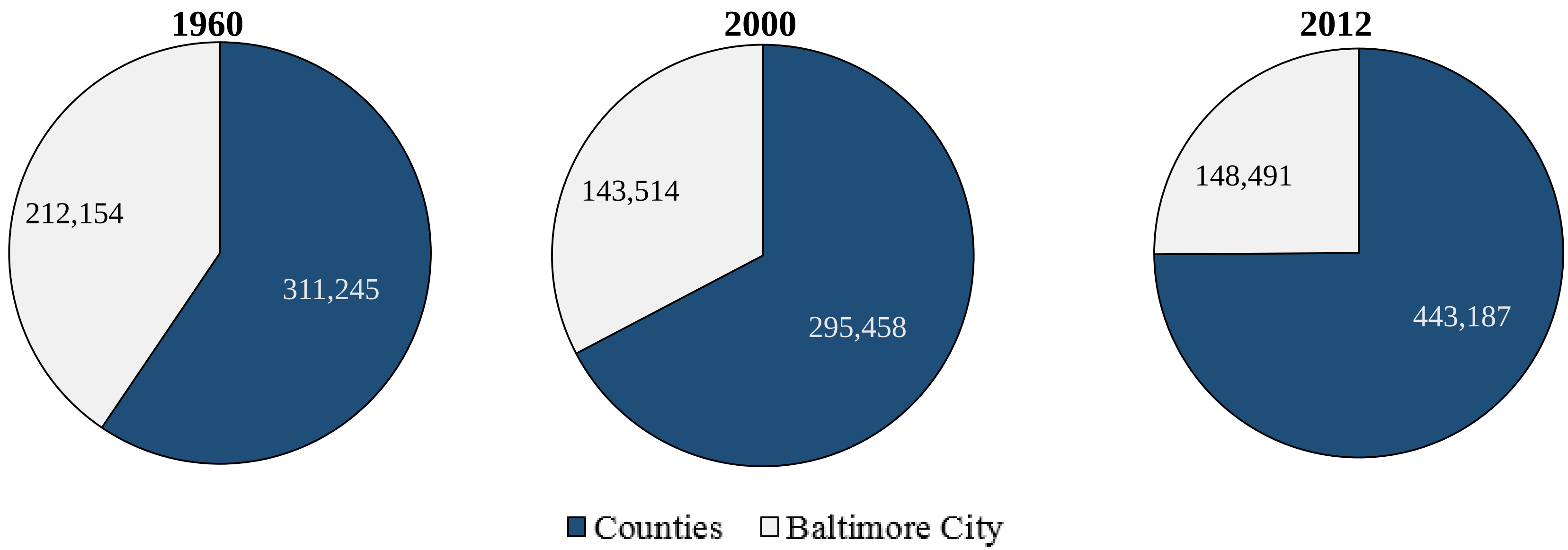
The Changing Geography of Maryland Poverty

As mentioned previously, poverty in Maryland decreased significantly from 1960 to 2000 but has subsequently increased. Changes in population growth and other economic and demographic factors within Maryland have altered the relationship between location and poverty. Baltimore City has remained persistently poor while poverty rates have fluctuated over time in many Maryland counties. The overall decrease in poverty from 1960 to 2000 resulted from a decrease in poverty rates in counties except Baltimore City, and a shift in the State's population away from the city. In 1960, 17 out of 24 counties had a poverty rate in excess of 20.0%. By 2000, the overall poverty rate in all counties except for Baltimore City decreased from 14.9% to 6.5%. In contrast, the poverty rate in Baltimore City was much more stable, decreasing modestly from 23.2% to 22.9%. The population of Baltimore City decreased significantly in contrast to rapid growth in other counties. A little less than one-third of all residents in 1960 lived in Baltimore City, decreasing to 12.0% in 2000 and to 10.0% in 2012.

The increase in poverty since 2000 has been broad in its reach – poverty rates are now higher in all counties but three (Garrett, Kent, and St. Mary's). The overall State increase in poverty was driven by changes in other counties, in which 147,700 or 97.0% of the additional individuals in poverty reside. This resulted also from slower rates of poverty and population growth in the city. The 8.0% increase in city poverty rates, to 24.8% in 2012, was less than the one-third increase (6.5% to 8.6%) in poverty rates in all other counties.

These demographic and economic changes have altered the geographic distribution of poverty in Maryland. In 1960, 40.0% of the poor lived in Baltimore City, but by 2000 a little less than one-third of the poor were city residents. The percentage of the poor who reside in Baltimore City continues to decrease and now comprises about one-quarter of all individuals in poverty, as shown in **Exhibit 3.9**.

Exhibit 3.9
Poverty in Baltimore City and Counties



Total = 523,400 Total = 439,000 Total = 591,700

Poverty Rates

	1960	2000	2012
Baltimore City	23.2%	22.9%	24.8%
Counties	14.9%	6.5%	8.6%
Total	**17.4%**	**8.5%**	**10.3%**

Source: U.S. Census Bureau; Department of Legislative Services

The Geography of Deep Poverty Has Shifted Along with Poverty

Although a higher percentage of the low-income population is comprised of individuals in poverty within Baltimore City, Western Maryland, and the Eastern Shore; the Great Recession significantly increased the deep poverty population in more affluent counties. From 1999 to 2008 the total number of individuals in deep poverty decreased statewide by 5%, totaling 204,100 in 2008. However, the deep poverty population decreased by one-quarter in Baltimore City. In contrast, there was mixed results across individual counties, as both the rate and total number of individuals in deep poverty decreased in 10 counties and increased in 13 others. The Great Recession reversed the deep poverty reduction in Baltimore City and increased deep poverty in 19 counties. The decrease in four counties, however, was modest and not statistically significant. Overall, the Great Recession increased deep poverty by 38%, or 63,100 individuals.

Deep poverty has increased in every county since 1999, increased by at least one-fifth in all but three counties, and more than doubled in Cecil, Charles, Harford, and Wicomico counties. **Exhibit 3.10** shows the change in deep poverty by Maryland region. The overall increase in deep poverty and joblessness since the Great Recession has increased the amount of need among the low-income population beyond that provided by the State EIC. If unemployment and deep poverty persist within more affluent counties, this will reduce the gap in the credit's effectiveness in more affluent counties relative to high-poverty areas.

Exhibit 3.10
Individuals in Deep Poverty by Region
Calendar 1999-2012

Region	1999	2008	2012	Change 1999-2012	Over Time
Baltimore/Harford	27,800	33,900	47,500	19,700	
Baltimore City	75,700	55,400	74,100	-1,600	
Montgomery	22,800	19,600	29,900	7,100	
Prince George's	32,400	32,000	39,900	7,500	
Central Maryland	23,200	24,700	34,500	11,300	
Southern Maryland	7,300	9,300	12,200	4,900	
Western Maryland	11,000	10,300	15,100	4,100	
Upper Eastern Shore	6,800	8,300	11,100	4,300	
Lower Eastern Shore	9,400	10,500	15,300	5,900	
Total	**216,300**	**204,100**	**279,600**	**63,200**	

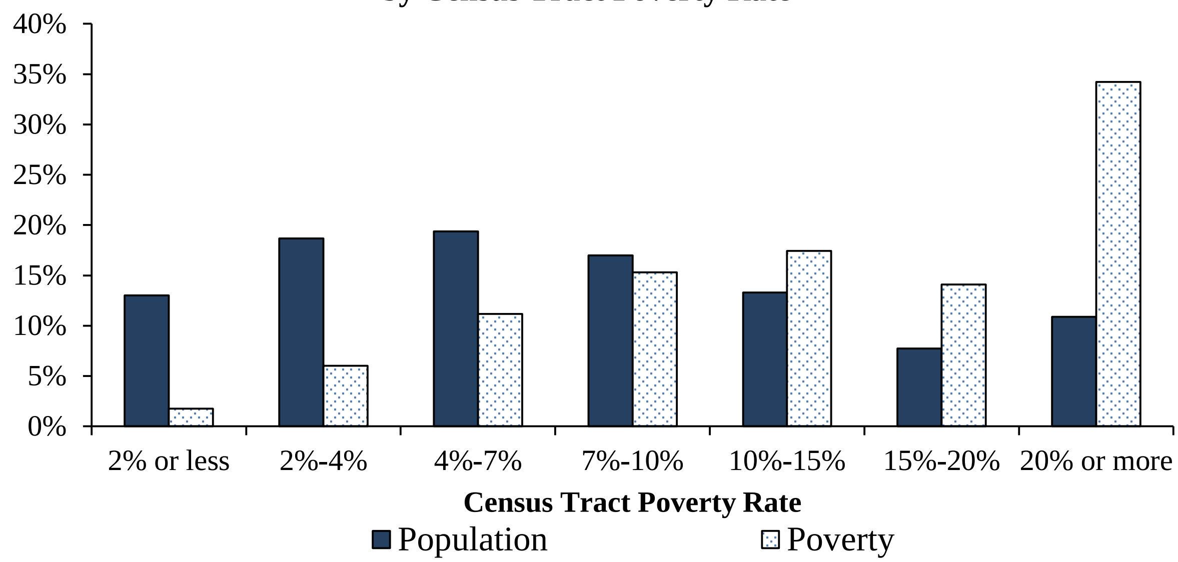
Source: U.S. Census Bureau; Department of Legislative Services

Impact of Concentrated Poverty

In 2012, 10.3% of Maryland's population lived in poverty. However, poverty is not distributed evenly across neighborhoods or throughout the State. Instead, a strong relationship exists between place and poverty as poor individuals and families tend to live near one another, clustering in certain neighborhoods and regions. The U.S. Census Bureau designates any census tract with a poverty rate of 20.0% or more as a poverty area. Researchers also identify census tracts with extreme levels of poverty, 40.0% or more, as areas of concentrated poverty. Between 1990 and 2000 the percentage of people living in poverty areas in the United States fell from 20.0% to 18.1%. This trend was reversed from 2000 to 2010 both in the United States and Maryland as both the number and proportion of individuals living in poverty areas increased. In 2000, a total of 427,200 residents or 8.3% of the total State population lived in a poverty area. In 2010, the total number of poverty area residents increased to 614,000, or 10.9% of the total State population. Compared to the rest of the nation, a lower percentage of individuals live in poverty areas and the increase in Maryland since 2000 was the fifth lowest among the 46 states with an increase over the same period.

Exhibit 3.11 shows the distribution of Maryland's population and individuals in poverty based on the poverty rate of the census tract. A majority of Marylanders live in an area that has a poverty rate of less than 7%; these areas contain a little less than one-fifth of the poor. By contrast, one-third of the poor live in a poverty area, even though the total population of these areas is 80% less than areas with poverty rates of less than 7%.

Exhibit 3.11
Distribution of Maryland Population and Poverty
by Census Tract Poverty Rate



Source: U.S. Census Bureau; Department of Legislative Services

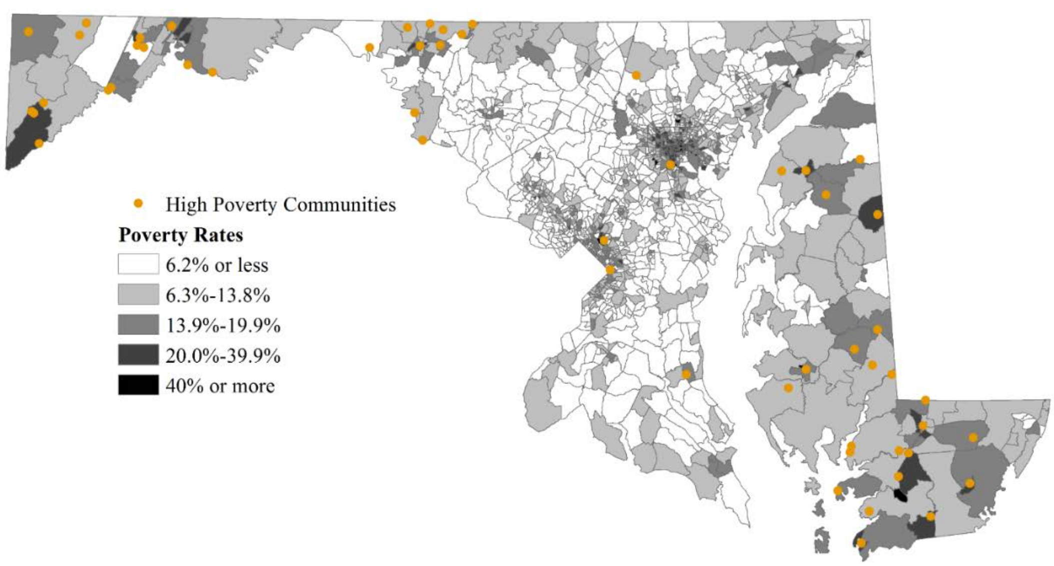
Although poverty has become more widespread across urban, rural, and suburban areas of the State, large areas of the State have significantly higher poverty rates. In addition, poverty areas and concentrated poverty are much less prevalent and are confined to geographically smaller areas – 86% of the Maryland population that resides in an area of concentrated poverty is located in Baltimore City. In addition to Baltimore City, poverty is more concentrated in the lower Eastern Shore and Western Maryland.

Communities with concentrated poverty pose additional challenges to residents beyond that imposed by the individual's or family's circumstances. These neighborhood impacts include a mismatch between job opportunities and residents, crime, and a perpetual shortage of finance capital, stores, employment opportunities, and institutional resources. The lack of job opportunities facing low-income individuals in these areas is greater than for low-income individuals who reside in other areas of the State, thus limiting the ability of the EIC to reduce poverty in areas of concentrated poverty.

Exhibit 3.12 shows poverty rates by Maryland census tracts. The incidence of poverty is lowest in most of Central Maryland, the Capital Region, and Southern Maryland. Poverty rates are higher in Western Maryland, Baltimore City, the Eastern Shore, and parts of Central Maryland and the Capital Region. Exhibit 3.12 also shows the Census Designated Places or communities with poverty rates of at least 20%. In contrast to the distribution of poverty, poverty areas are much more common in Baltimore City, Western Maryland, and the Eastern Shore. In high-poverty counties, a greater population of the poor and total population are concentrated in poverty areas. In more affluent counties, there are fewer areas of concentrated poverty and the poor are more equally distributed across the county.

Exhibit 3.12

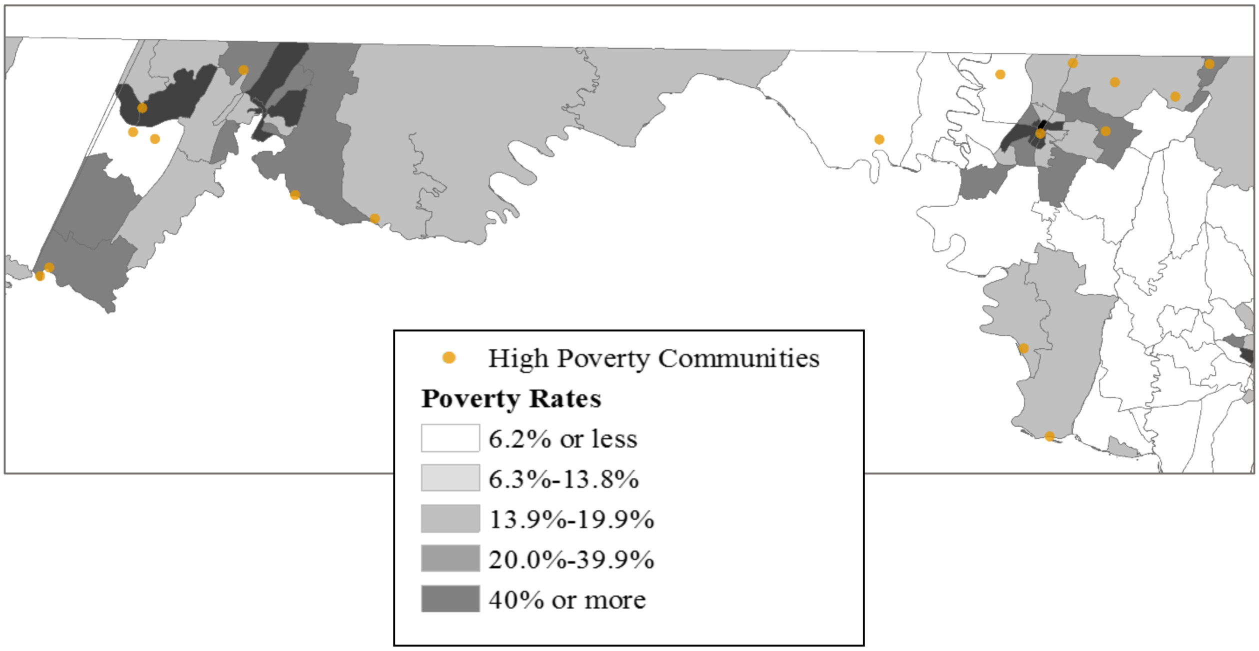
Maryland Poverty Rates by Census Tracts and Poverty Areas



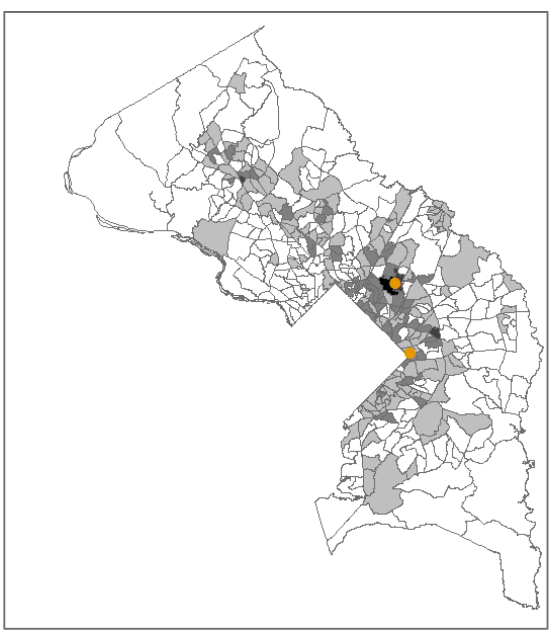
Note: High poverty communities are communities with poverty rates over 20%.

Poverty in Regions of Maryland

Western Maryland



Capital Region



Baltimore City

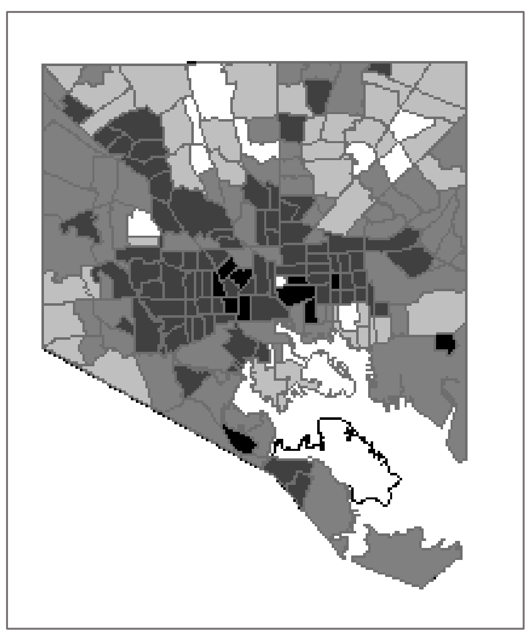
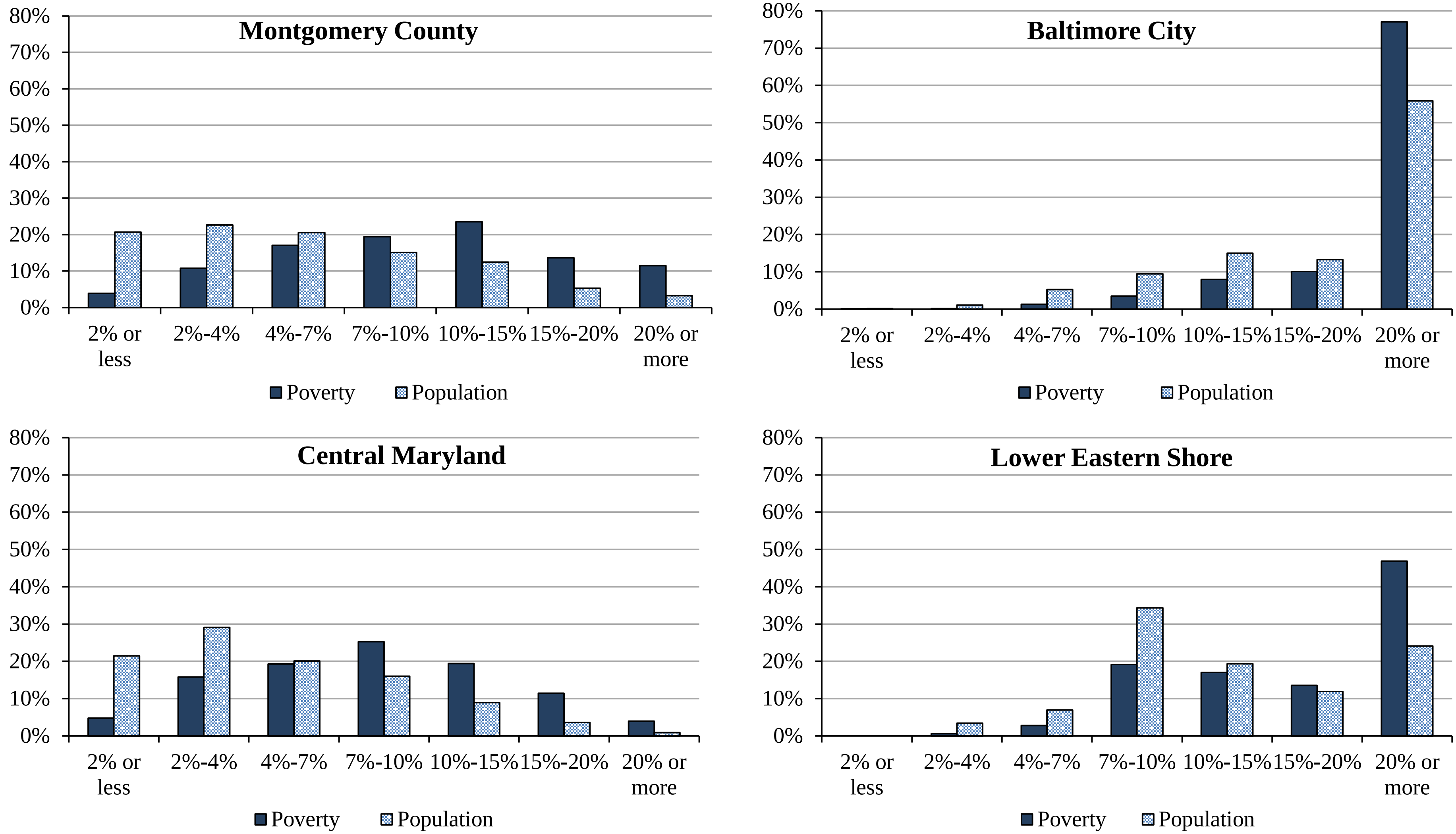


Exhibit 3.13 compares the distribution of population and poverty of two regions with a low concentration of poverty areas , Montgomery County and Central Maryland, with two regions with a high concentration of poverty areas, Baltimore City and Lower Eastern Shore.

Exhibit 3.13

Distribution of Population and Poverty by Census Tract



Source: U.S. Census Bureau; Department of Legislative Services

Poverty areas and areas with concentrated poverty are much less uniformly distributed than poverty. For example, Western Maryland has one-quarter the population of Baltimore and Harford counties and one-third the number of individuals living in poverty. However, Western Maryland has three-quarters of the amount of the poor living in poverty areas and triple the amount living in concentrated poverty areas in Baltimore and Harford counties. More than one-half of Baltimore City's total population resides in a poverty area, and these areas are also home to three-quarters of all of Baltimore City's poor. More than one-half of all of the poor who reside in a poverty area live in Baltimore City, and 85% of those in concentrated poverty areas live in the city. In comparison, there are no poverty areas in Southern Maryland and less than 1% of Central Maryland's population live in a poverty area. **Exhibit 3.14** and **Exhibit 3.15** show by region the distribution of the poor who live in poverty areas and concentrated poverty areas.

Exhibit 3.14

Distribution of Poverty by Poverty Areas and Region

Calendar 2008-2012

		Individuals in Poverty Who Live Within:		Percent of Total Individuals In Poverty Within:	
Region	**Total Individuals in Poverty**	**Poverty Areas**	**Concentrated Poverty**	**Poverty Areas**	**Concentrated Poverty**
Baltimore/Harford	85,500	16,400	400	19.2%	0.47%
Baltimore City	139,900	107,800	30,400	77.1%	21.7%
Montgomery	63,200	7,300	0	11.6%	0.0%
Prince George's	73,200	16,200	2,500	22.1%	3.4%
Central Maryland	65,500	2,600	0	4.0%	0.0%
Southern Maryland	21,500	0	0	0.0%	0.0%
Western Maryland	31,200	12,900	900	41.3%	2.9%
Upper Eastern Shore	17,900	2,900	0	16.2%	0.0%
Lower Eastern Shore	34,200	16,000	1,700	46.8%	5.0%
Total	**532,100**	**182,100**	**35,900**	**34.2%**	**6.8%**

Source: U.S. Census Bureau; Department of Legislative Services

Exhibit 3.15
Share of Total Population and Poverty by Region and Poverty Area
Calendar 2008-2012

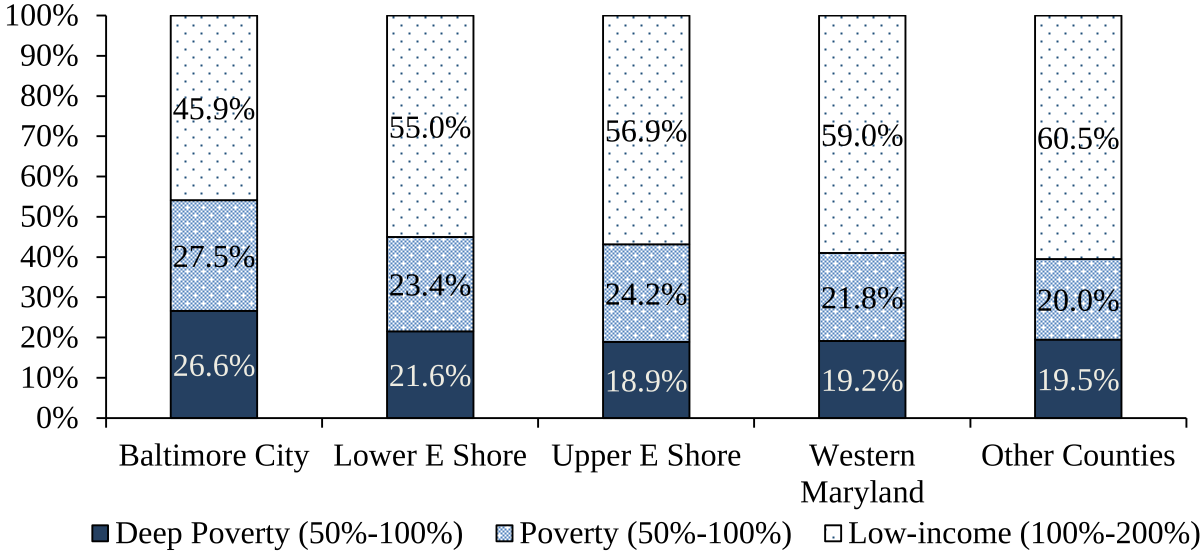
		Share of the Poor Residing in:		
Region	**Share of Population**	**State**	**Poverty Areas**	**Concentrated Poverty**
Baltimore/Harford	18.3%	16.1%	9.0%	1.1%
Baltimore City	10.6%	26.3%	59.2%	84.7%
Montgomery	17.1%	11.9%	4.0%	0.0%
Prince George's	14.9%	13.8%	8.9%	7.0%
Central Maryland	21.3%	12.3%	1.4%	0.0%
Southern Maryland	6.0%	4.0%	0.0%	0.0%
Western Maryland	4.2%	5.9%	7.1%	2.5%
Upper Eastern Shore	3.6%	3.4%	1.6%	0.0%
Lower Eastern Shore	4.1%	6.4%	8.8%	4.7%

Source: U.S. Census Bureau; Department of Legislative Services

More of the Low-income Population Is in Deep Poverty in Certain Regions

The propensity to work increases significantly as incomes rise. In addition to an increased prevalence of areas with persistent and concentrated poverty, a greater share of the Baltimore City low-income population is in poverty and deep poverty, decreasing the likelihood that these individuals are able to work and claim the credit. For example, 27% of the Baltimore City low-income population is in deep poverty, compared with 17% in Montgomery County. There is a corresponding increase in individuals with incomes of between 150% and 200% of the poverty line – about one-half of Montgomery County's low-income population compared to about one-third of Baltimore City's. **Exhibit 3.16** compares across regions of the State the percentage of individuals with incomes less than 50% of the poverty line, 50% to 100%, and 100% to 200%.

Exhibit 3.16
Distribution of Low-income Population by Poverty Status
Calendar 2010-2012



Source: U.S. Census Bureau; Department of Legislative Services

Chapter 4. Poverty and the Earned Income Credit

The Challenge of Poverty and the Earned Income Credit

The federal earned income tax credit (EITC) is an important safety net program for low-income families. A survey on EITC beneficiaries found that 69.0% planned to use part of the credit for "making ends meet." In 2011, the EITC lifted 4.7 million children out of poverty, more than any other program. The EITC helps workers support themselves and their families. Despite its comparative advantages, the EITC is not without flaws. The EITC provides financial assistance to low-income households and reduces poverty via a tax credit based on wages, filing status, and family size. Implementation issues, which limit effectiveness include high rates of improper payments (credits claimed by ineligible individuals), the use of paid tax preparers that charge high-cost products, which reduce the value of the credit, and participation rates. The Internal Revenue Service has struggled of late to provide credible assessments of the problems, and has not implemented effective solutions. Research has also questioned the value of the credit relative to family size – one analysis concluded that the generosity of the credit is not proportionate to the needs of families of different sizes and to households without children. Some advocates stress that the credit could alleviate more poverty by redistributing credits toward families with young children, regardless of family size.

Reducing poverty by supplementing wages and encouraging employment is at the core of the EITC's cost-effectiveness. However, most of the poor do not work or work only part-time – millions of Americans cannot obtain jobs that pay enough to lift them out of poverty. For many, the principal barrier to obtaining a good job is the lack of occupational skills sought by employers. Global economic forces have led to a polarization of job opportunities – expanding opportunities for high-skilled, high-wage workers and stagnant wage growth and limited opportunities for low-skilled workers. It is increasingly difficult for individuals to be economically secure with limited education and skills. Employment rates are particularly low among those in acute distress, those in deep poverty, and residents of neighborhoods suffering from a concentration of poverty. Long-term trends and the Great Recession have led to a significant increase in these populations, leading to a decrease in the propensity of low-income Marylanders to work. In addition, labor force participation has decreased for all populations.

The EITC is tied explicitly to work – an individual or family without earned income is not eligible for the credit. This approach is in contrast to other social safety net programs, such as Temporary Assistance for Needy Families and the Supplemental Nutritional Assistance Program (SNAP), which provide the bulk of their assistance to those in most need. A comparative assessment of the EITC relative to other social safety net programs must account for the differing populations most helped by each program, limiting their ability to replace, rather than complement, the other programs.

The poor are a diverse group whose hardship is due to no one particular cause and, therefore, does not lend itself to one effective remedy. The comprehensive solution to poverty involves actions beyond the safety net's role in providing direct assistance to the poor. Investments in education and job skills are necessary to bolster human capital. In order to harness any increased capacity, the economy must create jobs and opportunities throughout the income spectrum. The

EITC is considered to be an effective program that is the cornerstone of the federal effort to alleviate poverty, sufficient in scale to effect substantial reductions in poverty. Its role should be viewed relative to the diverse needs of the poor and multi-faceted approach necessary to mitigate poverty.

The characteristics of Maryland's low-income population relative to the rest of the United States present a mixed picture. Maryland is a high-income state that not only has a lower poverty rate but a lower incidence of other common measures – deep and concentrated poverty and poverty areas. As discussed in more detail in this report, the population with incomes of 200% or below the poverty level is a good proxy for the low-income population. Employment rates increase significantly with income within this group of potential earned income credit (EIC) claimants, thereby increasing the likelihood of receiving its benefit. Although there are some differences in the employment rates of these groups in Maryland, these populations do not differ significantly in a way that would enhance EIC effectiveness. The total employment rate of Marylanders in deep poverty is about 4.0% lower than the national rate (36.9% compared to 38.3%), identical in the next group (53.8%), and about 1.0% higher than the national rate in those slightly above poverty (62.6% to 61.8%). Maryland residents are more likely to be part-time workers as full-time employment rates are lower for all three groups.

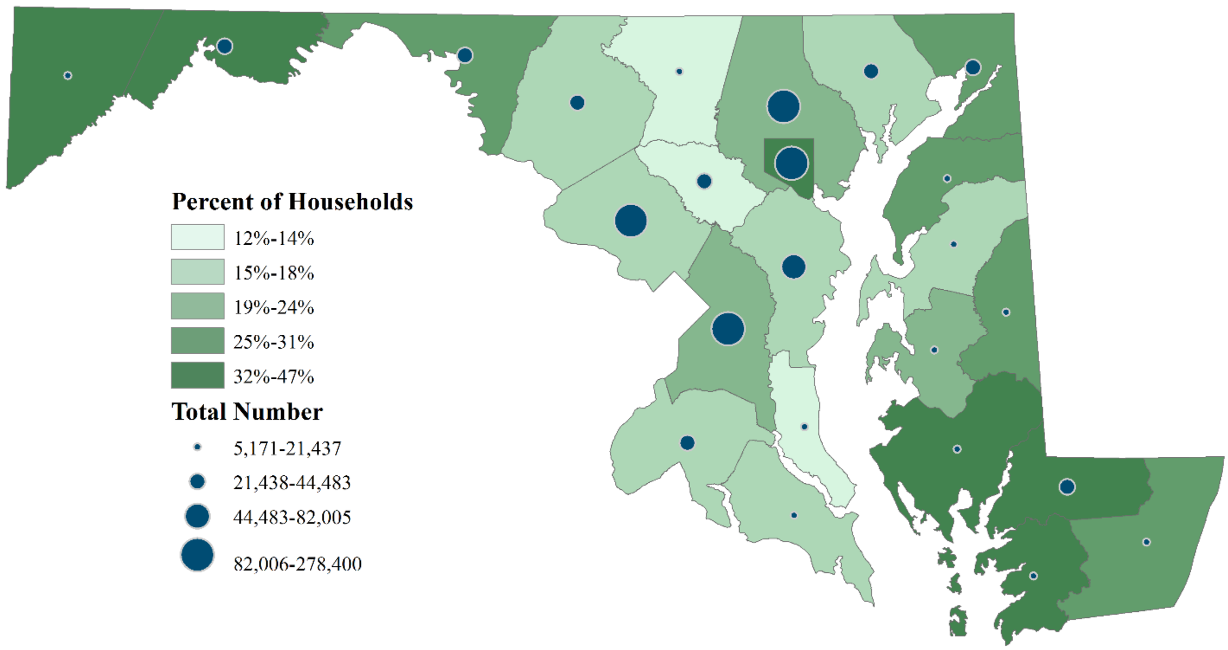
With the strong correlation between rising income levels and employment, the distribution of the low-income population will impact the likelihood that low-income individuals receive the benefit of the credit. The incidence of deep poverty in Maryland is about one-third lower than the United States overall (4.9% vs. 7.0%); however, of the low-income population in Maryland (200.0% or less of the poverty level), those in deep poverty comprise a little more than one-fifth. This is slightly higher than the national rate. The proportion of individuals with incomes between 50.0% and 125.0% is about 10.0% lower in Maryland; accordingly the proportion of individuals with incomes between 150.0% and 200.0% is about 10.0% higher.

EIC Claims Relative to the Low-income Population

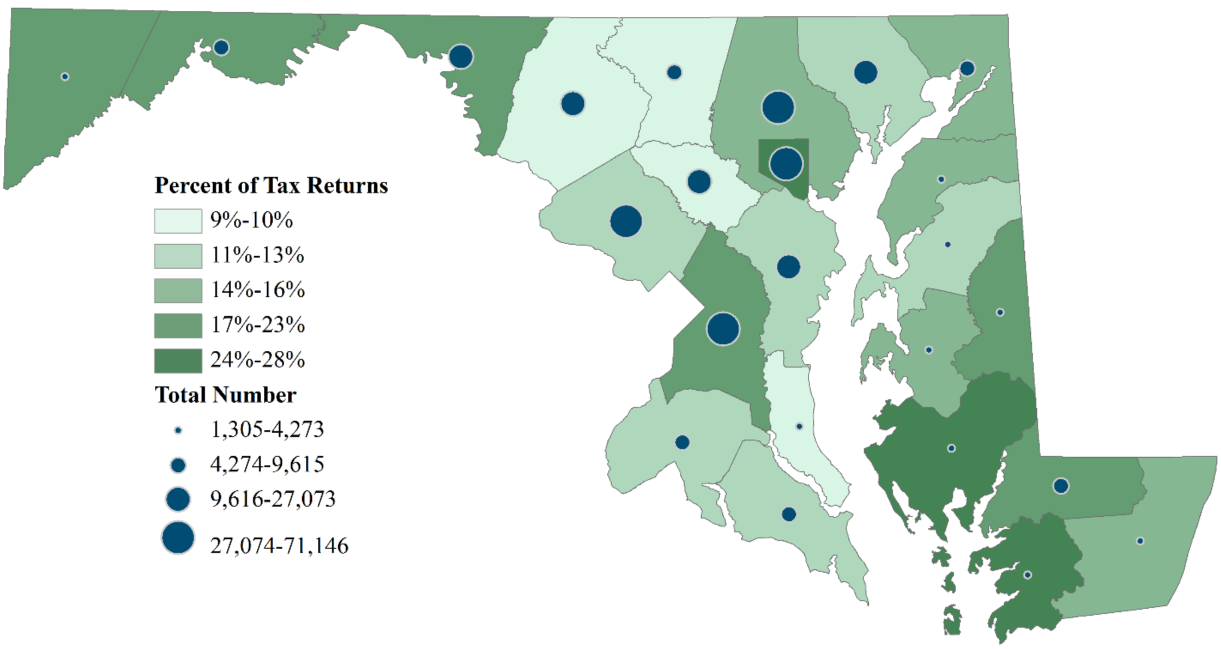
As discussed in this report, poverty has shifted from urban areas of the State to suburban and rural areas. The Department of Legislative Services analyzed county-level State EIC claim data from tax year 1999 to 2012. Generally, the EIC has responded to the suburbanization of poverty as there is a very high correlation between a county's low-income population and the number of taxpayers who claim the State EIC. This reflects some of the advantages of the program – a targeted people-based program accessed through the tax system. In contrast to other programs, there are fewer barriers to the credit related to the type of community in which one lives. Many location-focused federal and State policies, for instance, aim to improve neighborhoods, addressing the localized market failures that contribute to poverty by upgrading the physical and economic environments in poor neighborhoods through regulations, tax credits, and grants for economic and affordable housing development. Traditional social safety net program participation may vary in those areas depending on proximity to administrative offices. The high correlation between the low-income population and EIC claims also reflects another advantage of the credit – eligibility is restricted to lower-income individuals. **Exhibit 4.1** shows the high correlation between the low-income population in Maryland counties and the number of EIC claimants.

Exhibit 4.1
Comparison of Low-income Population and EIC Claims

Low-income Population



EIC Claims



EIC: earned income credit
Source: Comptroller's Office; U.S. Census Bureau; Department of Legislative Services

Receipt of the EIC Relative to the Low-income Population Is Not Uniform

Overall, the credit is well targeted to the low-income population and responds to the presence of low-income households regardless of whether in urban, rural, or suburban areas. The credit has generally responded to the increase in poverty in suburban and rural areas. The number of individuals claiming the State EIC increases with a county's low-income population – a greater number of credits are claimed in Baltimore City and Baltimore, Montgomery, and Prince George's counties reflecting larger low-income populations. Accounting for differences in county populations leads to a similar conclusion – the percentage of households claiming the credit across counties is closely tied to the percentage of the county population with low incomes.

The ideal antipoverty measure would be uniformly effective – it would provide assistance to those in the most distress, those with little or no income, as well as the higher-income working poor. The EIC reduces poverty significantly in Baltimore City and other low-income areas of the State. However, relative to the level of need, as measured by the prevalence of the low-income population and poverty, the EIC is under-claimed in Baltimore City, Western Maryland, and parts of the Eastern Shore. A statistical analysis controlling for the variation in the low-income population and other factors across counties suggests that claims in these regions are about one-fifth less than in other regions. EIC claims in these other areas are proportionate to the low-income population whereas there are about four claims for every five low-income individuals in the underrepresented areas of the State. The greater prevalence of deep poverty, and areas of persistent and concentrated poverty in these areas limits the number of poor individuals who work, thereby reducing the EIC's effectiveness in helping the total low-income population.

EIC, Poverty, and Traditional Safety Net Programs

Research has indicated that the EITC has several advantages over traditional safety net programs including low administrative costs. However, improper payment rates have averaged between 20.0% to 25.0%. In comparison, over the last several fiscal years SNAP error rates in Maryland have averaged 6.2% and the Temporary Cash Assistance (TCA) payment accuracy is 95.8%. Historically, EITC participation rates have been greater, but this advantage has eroded in the midst of recent significant increases in State SNAP participation. The EITC reduces poverty by supplementing the wages of low-income individuals. A significant advantage of this method is the additional poverty reduction resulting from increased work among the low-income population. Traditional safety net programs have been found to discourage work.

Under the Tax Credit Evaluation Act, the Department of Legislative Services is required to assess whether the intended objective of the credit, reducing poverty, could be achieved more cost effectively by other means. As the previous paragraph indicates, the EITC has advantages and disadvantages relative to traditional safety net programs. Traditional safety net programs have a much greater reach in communities with high levels of unemployment and distress than the EITC. As a result, the EITC is a more sufficient method of reducing poverty in lower poverty areas, but the EITC leaves a greater amount of unmet need in areas of high poverty. The EITC is an important component of State and federal efforts to reduce poverty. However, it has a limited ability to replace other programs in areas of high poverty. There remains an additional need for people-based programs targeted to those in deepest poverty and place-based programs that aim to improve the community.

EIC and Social Safety Net Response to Poverty in Maryland

In areas with poverty rates of less than 15%, households are more likely to claim the State EIC than receive traditional safety net program benefits. As poverty rates increase in these neighborhoods, both programs respond similarly to an increase in poverty as measured by the increase in households receiving either benefit. In areas with poverty rates exceeding 15%, receipt of traditional safety net program benefits rises much more quickly relative to the increase in poverty.

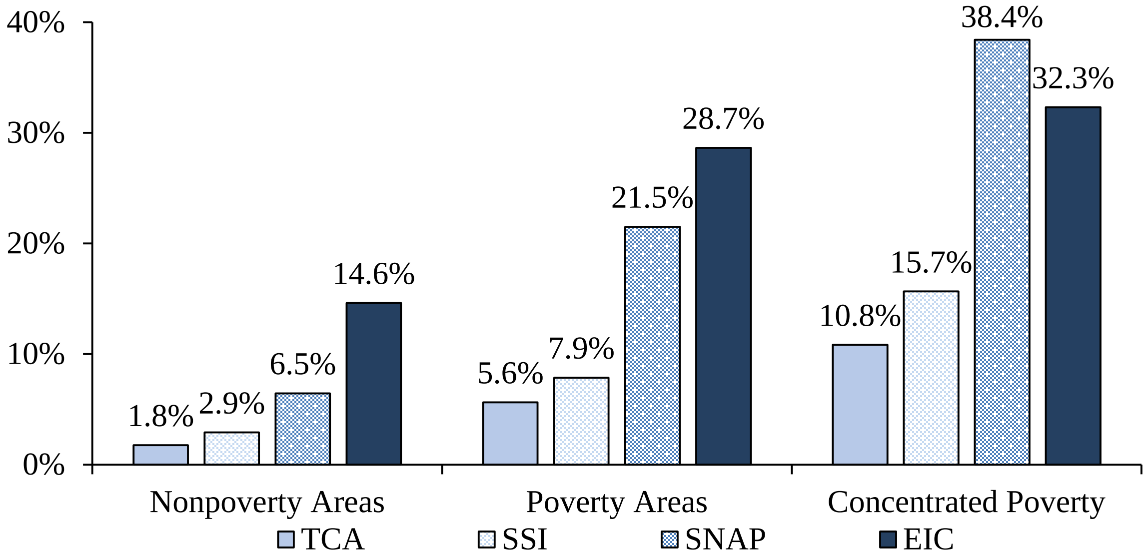
A total of 734,400 people or 13.0% of the State's population live in 173 census tracts with poverty rates of less than 2.0%. On the other end, 69,900 people live in concentrated poverty areas with an average poverty rate of 51.4%. An individual who lives in a neighborhood with concentrated poverty is 40 times more likely to be poor than a resident of the lowest poverty neighborhoods. The likelihood of receiving SNAP benefits is 16 times greater, compared with a 4 times greater probability of claiming the State EIC. The amount of State EIC credits claimed in these lowest poverty neighborhoods, $14.1 million, is double the amount claimed in concentrated poverty areas that have 90.0% fewer people, but almost four times as many poor (35,970 versus 9,400). Traditional safety net programs provide assistance proportionately to the number of individuals in poverty. About 28.0% of the State's poor live in poverty areas with poverty rates of less than 40.0% and about 7.0% live in concentrated poverty neighborhoods. About one-quarter of all SNAP and TCA recipients are residents of these poverty areas, compared with 18.0% of all EIC recipients. This disparity is magnified in concentrated poverty areas – 6.0% of all SNAP and TCA recipients are residents of poverty areas compared to only 2.6% of all EIC claimants.

Even though poverty increases significantly when comparing neighborhoods with poverty rates of up to 15%, labor force participation is consistent across these neighborhoods. The average employment-to-population ratio for individuals age 16 to 64 averages between 70% and 71%. When neighborhood poverty rates exceed 15%, particularly within poverty areas, the ratio of employment-to-population decreases, reaching a low of 42% in concentrated poverty areas.

Exhibit 4.2 shows the percentage of households that receive SNAP, TCA, Supplemental Security Income, and claim the State EIC in areas with poverty rates of less than 20%, poverty areas with poverty rates of up to 40%, and concentrated poverty areas. The number of EIC claimants is based on claim data provided by the Comptroller's Office. Receipt of other programs is based on U.S. Census survey data. Researchers have concluded that this data severely underreports the number of households receiving benefits. For example, the survey data underreports the number of Maryland households that receive SNAP by 40%. The amount of underreporting can also differ with income levels. As shown in Exhibit 4.2, a greater number of households in concentrated poverty areas, 38% versus 32%, receive SNAP benefits than claim the

EIC. If SNAP benefits are underreported in neighborhoods with concentrated poverty by the average amount of 40%, this suggests that the percentage of households that receive SNAP benefits in concentrated poverty areas is double the percentage of households that claim the State EIC.

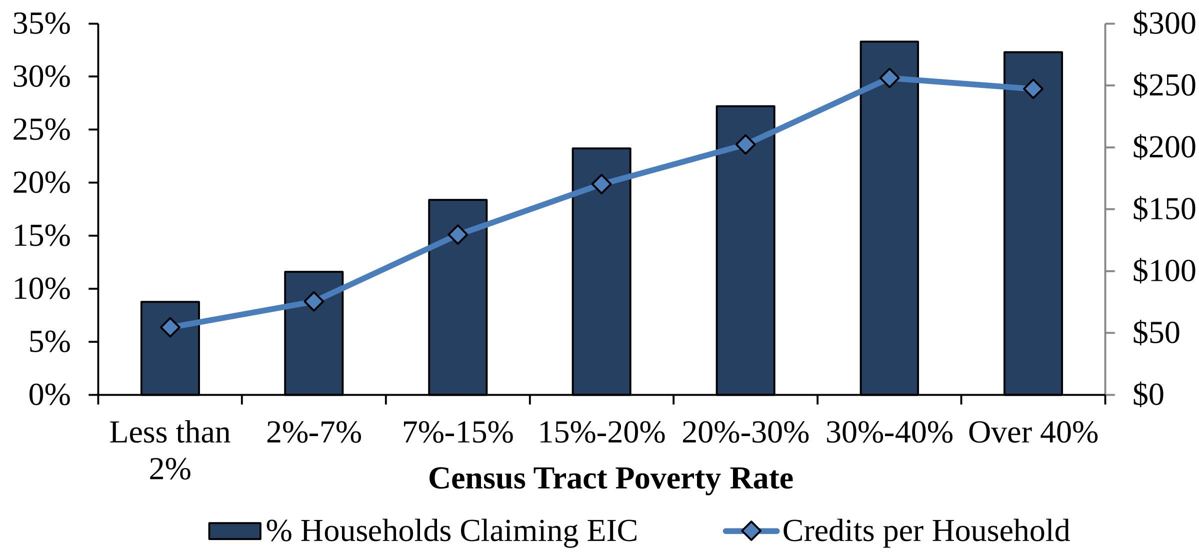
Exhibit 4.2
Receipt of EIC and Other Safety Net Programs by Neighborhood Poverty Level
Calendar 2008-2012



EIC: earned income credit
SNAP: Supplemental Nutritional Assistance Program
SSI: Supplemental Security Income
TCA: Temporary Cash Assistance
Note: Poverty areas shown here include only areas with poverty rates of between 20% and 40%.
Source: Comptroller's Office; U.S. Census Bureau; Department of Legislative Services

Although the State EIC is not as responsive to increases in poverty as traditional safety net programs, the percentage of households claiming the credit and the average amount of credits claimed relative to the entire population generally increases as poverty increases. About 9% of all households in neighborhoods with poverty rates of less than 2% claim the credit, compared with one-third of households in poverty areas with poverty rates of less than 40%. The average amount of credit claimed for every household in the census tract increases from $55 to $250. The percentage of households claiming the credit in concentrated poverty areas decreases slightly to 32%, and the average credit claim decreases to $247, as shown in **Exhibit 4.3**.

Exhibit 4.3
Percent of Households Claiming EIC and Average Claim
By Census Tract Poverty Rate



EIC: earned income credit
Source: Comptroller's Office; U.S. Census Bureau; Department of Legislative Services

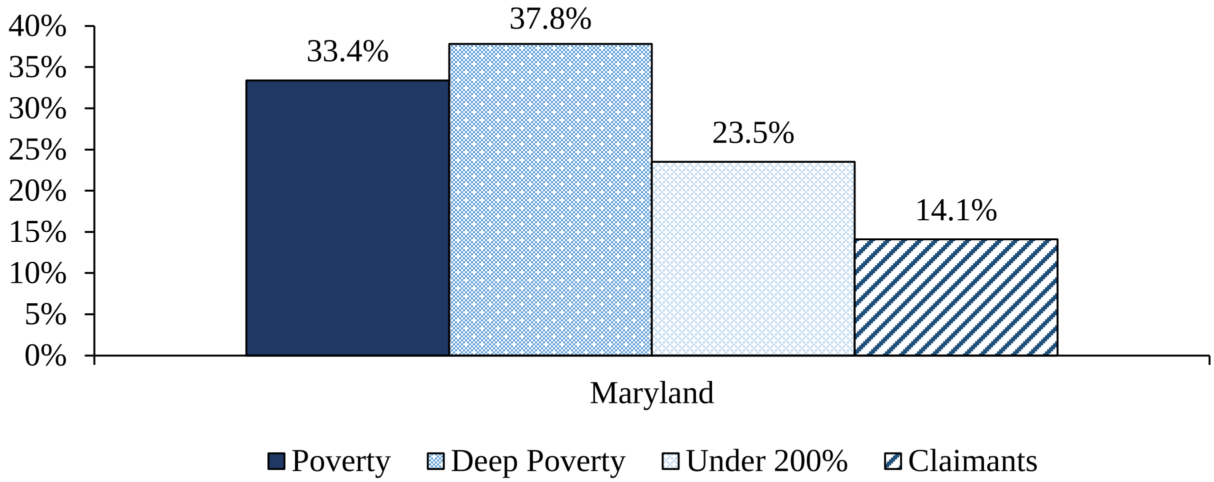
EIC and the Great Recession

As the impact of the Great Recession rippled throughout the economy and weakened the demand for labor, households fell into poverty through the loss of employment and reduction in hourly wages and/or work hours as more individuals worked part-time even though they sought full-time work. The EIC provided assistance to households who experienced economic hardship through reduced work hours, decrease in wages, or the loss of one job in a two-income household. However, the EIC may not provide assistance to households that fell into poverty due to the loss of employment of both spouses or of the sole earner of the household.

Research has found that the federal credit generally responded to the increase in the low-income population since the recession. The State credit also generally responded as well – since 2008 the total low-income population increased by 23.5% and the number of EIC claimants increased by 14.1%, as shown in **Exhibit 4.4**. For every 100 additional Maryland low-income individuals, EIC claims increased by 60. Overall, the EIC was less responsive to the increase in poverty and low-income population than other safety net programs such as SNAP.

Although EIC claimants increased in every county where the low-income population increased, the EIC's response varied across counties. In Montgomery, Anne Arundel, and Howard counties, EIC claims increased by a similar amount as the low-income population. However, EIC claims did not track the low-income population increase in several areas, including Baltimore City, parts of the Eastern Shore, and Prince George's County. In Baltimore City, EIC claims rose by only 1.3%, even though the low-income population increased by 10.5% – for every additional 100 low-income individuals EIC claims increased by 13. Cecil County's low-income population increased by two-thirds, with EIC claims increasing by only 13.0%.

Exhibit 4.4
Increase in Maryland Poverty, Low-income Population, and EIC Claimants
Calendar 2008-2012



EIC: earned income credit
Source: Comptroller's Office; U.S. Census Bureau; Department of Legislative Services

There May Be Lags in Responding to Increased Hardship during Recessions

From 2008 to 2012, the number of Montgomery County EIC recipients has closely tracked the change in the number of low-income residents, both increased by a total of 23.0%. However, there was a quicker and larger magnitude increase in poverty – increasing by 35.0% in 2010, 5.9% to 7.7%, and has decreased since to 6.4%. The labor market was at its worst in 2010 as reflected by total job losses and an unemployment rate that peaked at 5.8%. The county unemployment rate has since decreased to 5.2%, still well above prerecession levels, and since 2010 the county added an additional 10,000 private jobs.

Over a similar period, the number of Montgomery County TCA and SNAP recipients increased more quickly and proportionately to the increase in poverty. TCA recipients increased by about 50%, to 2,000, and there were 32,000 SNAP recipients, a 60% increase, well above the 35% increase in EIC recipients.

As economic conditions improved, low-income households who fell into poverty due to the loss of employment were able to reenter the workforce and claim the EIC. In contrast, these households could immediately claim TCA and SNAP. Recognition lags are also a source of delays – households are more likely over time to become more aware of the EIC and participate. In addition, individuals who suffer sudden and acute levels of hardship through the loss of a job might be both more willing to quickly seek assistance from TCA and SNAP. Finally, the Department of Human Resources actively promoted SNAP and the State's participation rate increased significantly whereas there was no State agency promoting the EIC and participation rates remained unchanged.

Chapter 5. Earned Income Tax Credit Research

Overview

Owing to its significant scope and impact on poverty, the federal earned income tax credit (EITC) has been studied extensively. There is consensus among researchers that the tax credit is effective and helps raise low-income households out of poverty. The credit increases the well-being of the poor through two channels – the direct financial assistance provided and the increased earnings resulting from encouraging individuals, particularly single mothers, to enter the workforce. For those already in the workforce, the EITC does not seem to have a significant work disincentive effect and may actually increase work efforts for those knowledgeable about the credit. The program has relatively high participation rates, low administrative costs, and compares well to other social safety net programs primarily because these other programs have been found to discourage work. Some studies have shown that the EITC has other positive benefits on households, besides reducing poverty and encouraging work. While it is generally agreed that the EITC meets its objectives, it is not without problems. The program has a significant error rate, and the complexity of the EITC has led to improper payments. Paid tax preparers, especially those that offer products such as refund anticipation checks, reduce the effectiveness of the EITC. In addition, the credit's work requirement may limit its ability to help significant populations of the poor.

EITC and Poverty Reduction

Tax Credit Theory

Tax credits reduce individual or business tax liabilities or provide refunds (money) in order to meet a stated policy objective or societal improvement. These credits lower the after-tax cost of the beneficial activities, creating incentives for individuals or the marketplace to increase these targeted activities, thereby increasing societal benefits. However, poorly designed policies may not lead to any improvement or decreases in social welfare. A major impediment to effective tax credit design is their propensity to provide money to individuals who would have acted in the desired way in the absence of the credit. It is not sufficient that the policy lead to any level of improvement; the policy must be cost effective relative to other options.

The federal government established the EITC as a temporary incentive to encourage work among low-income individuals by offsetting payroll taxes, thus lowering the after-tax cost of work. As the credit evolved and the value of the benefit expanded, the program reduced poverty primarily through the redistribution of income to low-income individuals compared to the impact of incentivizing work. This is an important distinction relative to other credits that meet policy objectives solely by encouraging activities and outcomes. The credit reduces poverty primarily by providing cash directly to low-income individuals. The impact of the credit on altering behavior, primarily through additional labor force participation, provides additional positive benefits.

Labor Force Participation

Labor Force Entry

Labor supply theory predicts that the EITC encourages additional labor force participation. The EITC increases after-tax wages for some workers, creating a sufficient incentive for individuals to enter the labor force because the credit is only available to those earning income. Most studies have found evidence that the EITC supports labor force participation among single mothers and is considered the single most important policy for increasing work among unmarried mothers. However, the lower benefit provided by the EITC to childless individuals is typically not a sufficient incentive for these individuals to enter the workforce.

Labor Force Hours

Labor supply theory is less clear on the effects of the EITC for those already in the workforce. Workers have a fixed amount of time, which they divide between work and leisure. The substitution effect predicts that as higher after-tax wages increases the opportunity cost of leisure, the individual will work more since leisure time becomes more expensive. However, the income effect suggests that as the EITC increases income, the person prefers more leisure time and works less. The substitution and income effects have opposite impacts on labor supply; it is ambiguous what the overall effect is, but researchers have generally found the substitution effect is greater than income effects.

Theoretically, the EITC discourages work hours in all but the phase-in region, in which the effect is ambiguous. However, studies have found only small, if any, responses to the hours worked and earnings of EITC recipients. Most studies found no effect of the EITC on hours of work, while only those with self-employment income reported bunching where the phase-in ends and the plateau begins. EITC recipients tend not to be fully aware of the structure of the credit schedule, so recipients tend not to reduce their work hours when they are in the phase-out range. Very few recipients are aware whether working more would increase or decrease their credit and adjust their work hours accordingly. The Internal Revenue Service does not publish the EITC phase-in, plateau, and phase-out structure in a clear way, reducing the ability of taxpayers to discern the impact of working and the credit. One study found that when taxpayers were informed about the EITC structure, those who were initially in the phase-in and plateau ranges changed their work behavior to maximize their refund, while those in the phase-out region had no change in work behavior.

Family Structure

The EITC could impact family formation and configuration owing to the influence of filing status and number of qualified children on the credit's value. The EITC can result in both marriage penalties and bonuses, situations which occur when the value of the credit differs based on marital status. For example, individuals who get married may experience a marriage bonus (an increased credit) if only one spouse works, while the credit of two working married spouses filing jointly could be less than the combined credit previously received by each unmarried individual. Marriage penalties outnumber bonuses by at least two to one; however, research has shown that the credit does not impact fertility nor family formation.

Ancillary Benefits

Studies have shown that the EITC provides additional benefits beyond the primary benefits of reducing poverty and supplementing the wages of low-income households. These studies have shown that the EITC improves the education of recipients' children, stimulates the economy, and improves the health of not only recipients, but also the infants of recipients.

The EITC has been found to improve test scores, particularly in math, and increase the likelihood that a student graduates high school or receives a general equivalency diploma. Other research estimated that the EITC raises combined math and reading test scores by 6%. Additionally, a larger EITC increases the odds that a recipient's child will enter college. A $1,000 increase in EITC refunds received in the spring of the high school senior year increased college enrollment in the next fall by approximately 2 to 3 percentage points.

The EITC has also been linked to improved health – receipt of the EITC reduced the incidence of low birth weight and increased the mean birth weight for infants of recipients. Another study found that the EITC causes households to temporarily spend more on healthy foods. Additionally, the EITC has reduced maternal smoking, which is likely a result of increased labor force participation. Once women become employed, it may become easier for them to quit due to workplace bans on smoking.

Studies have found that the EITC improves the financial security of single mothers. A study found that single mothers who enter the labor market due to the EITC improve their labor market outcomes through increased earnings over time. The EITC encourages work – single mothers become employed and gain the skills needed to increase their future earnings.

The EITC Is a Targeted Incentive

Numerous federal and State programs provide tax relief, financial assistance, or otherwise aim to increase the well-being of the poor. These policies include minimum wages, the federal child tax credit, and State sales and use tax exemptions for groceries. In contrast to the EITC, which can only be claimed by low-income individuals, a significant portion of the benefit of these other programs will accrue to higher-income individuals. In recent years, there has been significant debate over increasing federal and State minimum wages. The EITC is better targeted than minimum wages, as researchers estimate that an increase in the EITC will alleviate more poverty than a similar increase in the minimum wage. About one-third of low-wage workers are from families with incomes that exceed three times the federal poverty level, including teenage workers and second-income earners. The U.S. Congressional Budget Office reported that any "increase in the resources of lower-income families would require a greater shift of resources in the economy if done by increasing the minimum wage than if done by increasing the EITC." In addition to the relative efficiency of each policy, there are distributional issues as the burden of increased cost to businesses through a higher minimum wage differs from the cost of increasing the EITC. Furthermore, increases in the EITC from wage increases among individuals in the phase-in range will be partially offset by a reduction in EITC benefits among those in the phase-out range.

Chapter 6. Characteristics of Earned Income Credit Claimants

Characteristics of Claimants

To characterize the State earned income credit (EIC) population, the Department of Legislative Services (DLS) analyzed State tax returns claiming the State nonrefundable EIC or refundable (REIC) credits in tax year 2012, the most recent year tax data is available. A total of 415,404 recipients claimed $244.3 million in State credits and $58.8 million in local credits. Almost two-thirds (64.4%) of the total amount was distributed as refunds with the remaining one-third (35.6%) offsetting tax liability. Tax returns claiming the State credit comprised 14.0% of all tax returns filed. This section describes the distribution of recipients by the number of qualified children, filing status, and Maryland Adjusted Gross Income (MAGI). The majority of recipients filed as head of household and had MAGI of under $20,000; 40.0% of recipients had multiple qualifying children. Additionally, using 10 years of data from 2003 through 2012, DLS examined the frequency that recipients claimed the State credit, and found that the majority of recipients claim the credits for a short period of time.

Filing Status

Head of household filers are much more likely to claim the EIC, comprising a little more than one-half of all returns claiming the credit. By comparison, only 7% of joint filers and 8% of single filers claimed the credit, as shown in **Exhibit 6.1**.

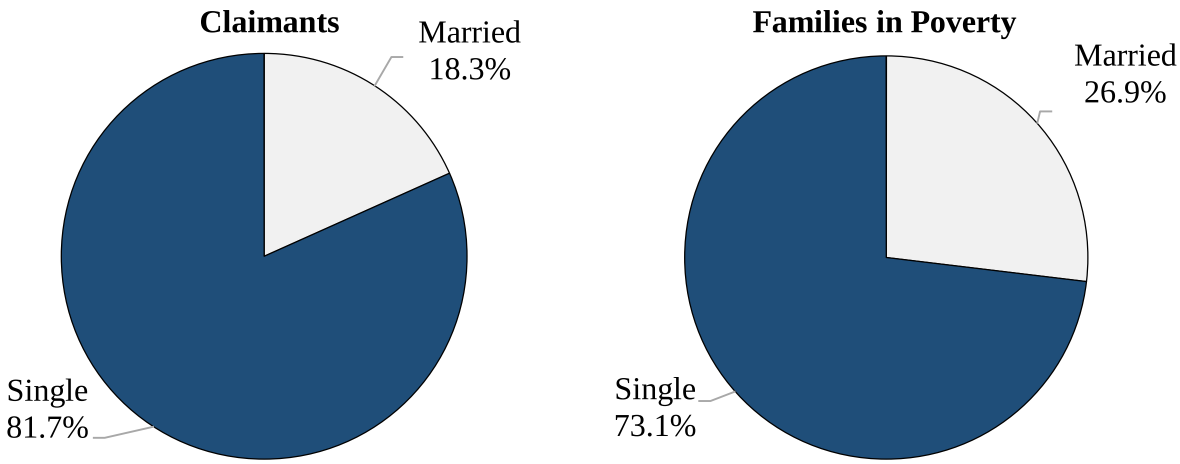
Exhibit 6.1
Total Credits Claimed by Filing Status
Tax Year 2012

Filing Status	Number of Households	Distribution of Households	Amount of Claims	Distribution of Claims	Average Claim
Head of Household	224,080	54%	$163,688,780	67%	$730
Joint	76,084	18%	50,507,271	21%	664
Single	115,240	28%	30,093,730	12%	261
Total	**415,404**	**100%**	**$244,289,781**	**100%**	**$588**

Source: Comptroller's Office; Department of Legislative Services

It is not surprising that joint filers consist of less than one-fifth of claimants given the family structure of those in poverty and the marriage penalties that taxpayers are often faced with when claiming the credit. As **Exhibit 6.2** illustrates, the marital status of State EIC claimants closely corresponds to the marital status of families in poverty. Less than 3% of married families in Maryland are in poverty, while approximately 18% of single families are in poverty. Of families in poverty, about three out of four families are unmarried, with the majority of those families headed by females. Of the 73,400 unmarried families in poverty, 62,500 are headed by an unmarried female.

Exhibit 6.2
Marital Status of Families in Poverty and Claimants
Tax Year 2012



Source: Comptroller's Office; U.S. Census Bureau; Department of Legislative Services

A marriage penalty exists when two unmarried individuals qualify for the credit when filing two individual tax returns and then do not qualify (or receive a smaller credit) when their incomes are combined on a joint tax return. The federal American Reinvestment and Recovery Act of 2009 increased the phase-out income ranges for joint filers, and the marriage penalty was reduced, but not eliminated. Additionally, a marriage that creates a family with more than three children may cause a marriage penalty since the federal earned income tax credit (EITC) does not vary after three qualified dependents. However, studies have found that the federal credit does not influence marriage decisions.

Head of household filers claimed 67% of all State credits, joint filers claimed 21% of the credits, and single taxpayers claimed the remaining 12%. There was no significant difference in the distribution of claims for the REIC versus the EIC. The EIC program provides single taxpayers with no dependents a modest credit; these taxpayers claimed an average of $261 in State credits compared to an average of $730 for heads of household in State credits. Single taxpayers without qualifying children are eligible for the least valuable credit; accordingly, total claims from this group comprise the smallest percentage of credits. Single taxpayers also have low participation rates compared to head of households and married taxpayers, which is discussed in more detail later in this chapter.

Qualifying Children

In order to estimate the number of returns with qualifying children, the number of exemptions claimed on the Maryland return was reduced by the number of taxpayers and spouses represented on the return. For instance, a single return with three exemptions is assumed to have two qualifying children while a joint return with three exemptions is assumed to have one qualifying child. Most claimants had either one or two qualifying children.

Exhibit 6.3 shows that in 2012 a similar number of taxpayers with one qualified child and two or more qualified children claimed the credit, 36% and 40%, respectively. However, filers with two or more qualified children receive 60% of all credits while those with one child receive 36% of the credits, reflecting the more generous credit for larger families. This is very similar to research findings that although EITC recipients with two or more qualified children made up 42% of EIC recipients in 2004, they received 62% of the credits in that year.

While a significant number of claimants (23.7%) had no qualifying children, they claimed only 4.0% of the total credits claimed. This is consistent with the structure of the EITC and studies on the EITC, which found that childless recipients represent 21.9% of all recipients, but account for only 2.7% of the total federal credit cost in 2008. The maximum federal benefit for childless taxpayers was $475 in 2012, which is less than one-tenth the size of the maximum credit for households with two qualifying children.

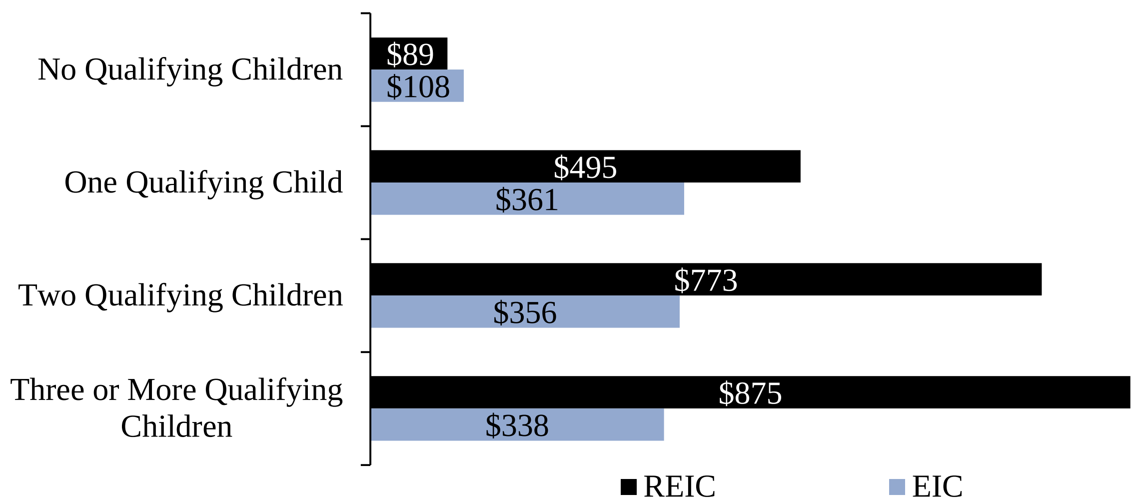
Exhibit 6.3
Claimants by Number of Qualifying Children
Tax Year 2012

Number of Qualifying Children	Number of Households	Distribution of Households	Amount of Claims	Distribution of Claims	Average Claim
None	95,592	23.0%	$9,779,611	4.0%	$102
One	150,010	36.1%	87,928,963	36.0%	586
Two	110,636	26.6%	93,667,374	38.3%	847
Three or More	59,166	14.2%	52,913,833	21.7%	894
Total	**415,404**	**100.0%**	**$244,289,781**	**100.0%**	**$588**

Source: Comptroller's Office; Department of Legislative Services

Exhibit 6.4 shows the average refundable (REIC) and nonrefundable (EIC) credits by number of qualifying children. The REIC provided the largest benefit relative to other credits for taxpayers with children, as this benefit increased with the number of children. Unlike the refundable credit, the average EIC and local earned income credit claimed did not increase with the number of children. These credits are nonrefundable and are limited by tax liabilities. For taxpayers with multiple children, the average REIC was double the amount of the nonrefundable credit claimed. In 2012, the average refund for taxpayers with no qualifying children was $89, substantially less than the $875 refund received by taxpayers with three or more children.

Exhibit 6.4
Average Credits by Number of Qualifying Children
Tax Year 2012



EIC: earned income credit
REIC: refundable earned income credit
Source: Comptroller's Office; Department of Legislative Services

Adjusted Gross Income

Exhibits 6.5, **6.6**, and **6.7** show the distribution of the State refundable and nonrefundable credits by MAGI. Taxpayers with higher MAGI tend to claim a greater amount of nonrefundable credits, reflecting higher tax liabilities. A majority of the nonrefundable credits were claimed by taxpayers with MAGI of between $20,000 and $35,000, while the majority of the refundable credits were claimed by taxpayers with MAGI of between $5,000 and $25,000.

Exhibit 6.5
Refundable Credit Claims by
Maryland Adjusted Gross Income
Tax Year 2012

Income	Households	Percent of Households	REIC ($ in Millions)	Percent of Claims	Average Credit
Less than $5,000	39,421	13.7%	$5.8	3.7%	$147
$5,000-10,000	66,353	23.0%	28.0	17.8%	422
$10,000-15,000	56,951	19.7%	48.6	30.9%	853
$15,000-20,000	52,969	18.4%	40.9	26.0%	772
$20,000-25,000	38,729	13.4%	21.5	13.7%	556
$25,000-30,000	21,965	7.6%	9.0	5.7%	409
$30,000-35,000	8,720	3.0%	2.7	1.7%	305
$35,000-40,000	2,542	0.9%	0.6	0.4%	238
$40,000-45,000	667	0.2%	0.1	0.1%	181
$45,000 or more	145	0.1%	*	0.02%	185
Total	**288,462**	**100.0%**	**$157.2**	**100.0%**	**$545**

*Amount claimed is negligible.

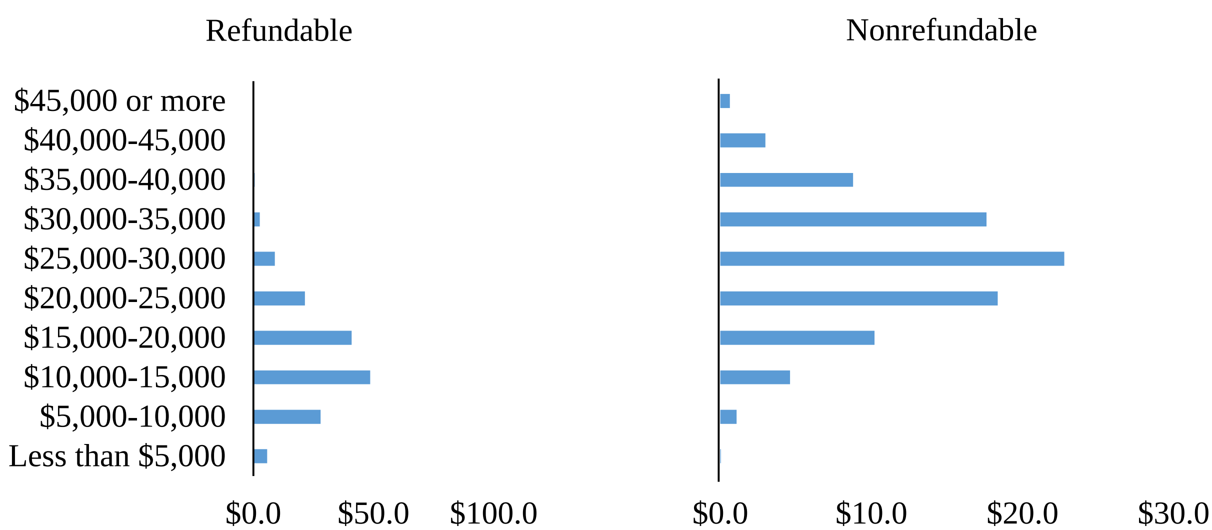
Source: Comptroller's Office; Department of Legislative Services

Exhibit 6.6
Nonrefundable Credit Claims by Maryland Adjusted Gross Income
Tax Year 2012

Income	Households	Percent of Households	EIC ($ in Millions)	Percent of Claims	Average Credit
Less than $5,000	1,580	0.6%	$0.0	0.0%	$21
$5,000-10,000	13,792	5.1%	1.1	1.2%	78
$10,000-15,000	53,735	19.7%	4.6	5.3%	86
$15,000-20,000	44,484	16.3%	10.2	11.7%	229
$20,000-25,000	45,808	16.8%	18.4	21.1%	401
$25,000-30,000	43,556	16.0%	22.8	26.1%	522
$30,000-35,000	36,951	13.6%	17.6	20.2%	477
$35,000-40,000	21,022	7.7%	8.8	10.1%	418
$40,000-45,000	8,644	3.2%	3.0	3.4%	344
$45,000 or more	2,635	1.0%	0.6	0.7%	238
Total	**272,207**	**100.0%**	**$87.1**	**100.0%**	**$320**

EIC: earned income credit
Source: Comptroller's Office; Department of Legislative Services

Exhibit 6.7
State Credits Claimed by Maryland Adjusted Gross Income
Tax Year 2012
($ in Millions)



Source: Comptroller's Office; Department of Legislative Services

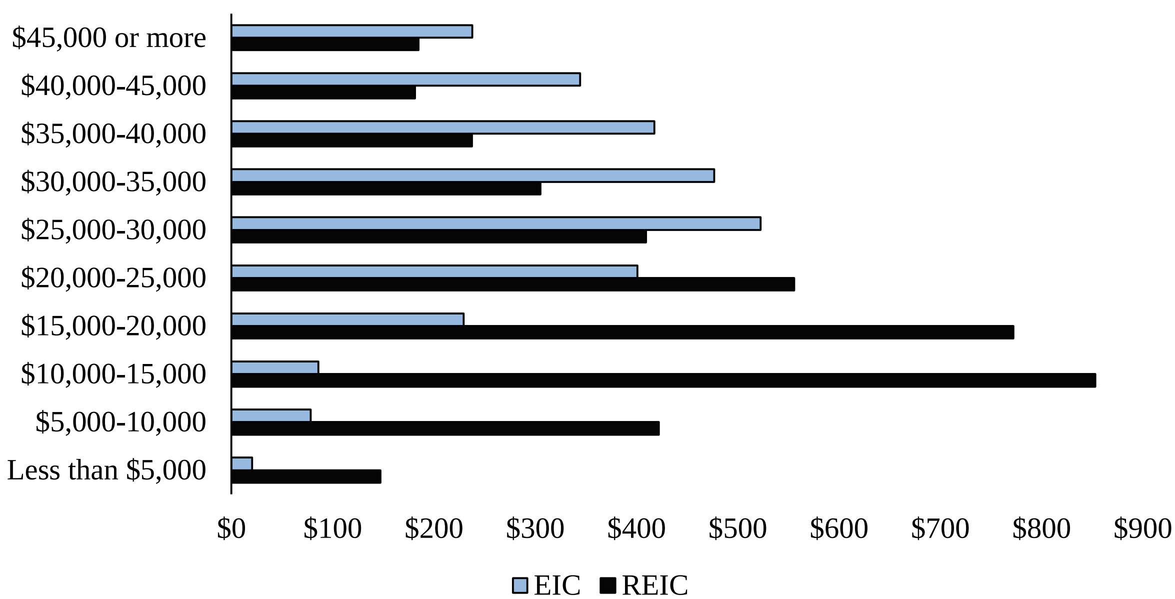
Of the State tax returns with MAGI of less than $20,000 in 2012, 27% claimed either credit, compared to less than 1% of taxpayers with MAGI of over $40,000. Approximately 40% of taxpayers with MAGI between $10,000 and $15,000 claimed either credit. Fewer taxpayers with MAGI of less than $5,000 claimed the credits, only 14%, presumably because they did not have any earned income. While some taxpayers with low income may not be eligible for the credit due to age, nontaxable income, and other factors, 85% of taxpayers with MAGI of less than $5,000 did not claim the credit, suggesting that the credit may have a limited impact in alleviating deep poverty.

As **Exhibit 6.8** shows, taxpayers with MAGI of less than $25,000 received on average more in refundable credits than nonrefundable credits, while those with MAGI of over $25,000 received more in nonrefundable credits. For example, a taxpayer with MAGI of between $10,000 and $15,000 received an average REIC of $853, while the average REIC with MAGI of between $25,000 and $30,000 was less than half of that, at $409. However, a taxpayer with MAGI of between $25,000 and $30,000 received an average EIC of $522 while a taxpayer with MAGI of between $10,000 and $15,000 received on average less than a fifth of that amount, or $86.

Exhibit 6.8

Average Credits by MAGI

Tax Year 2012



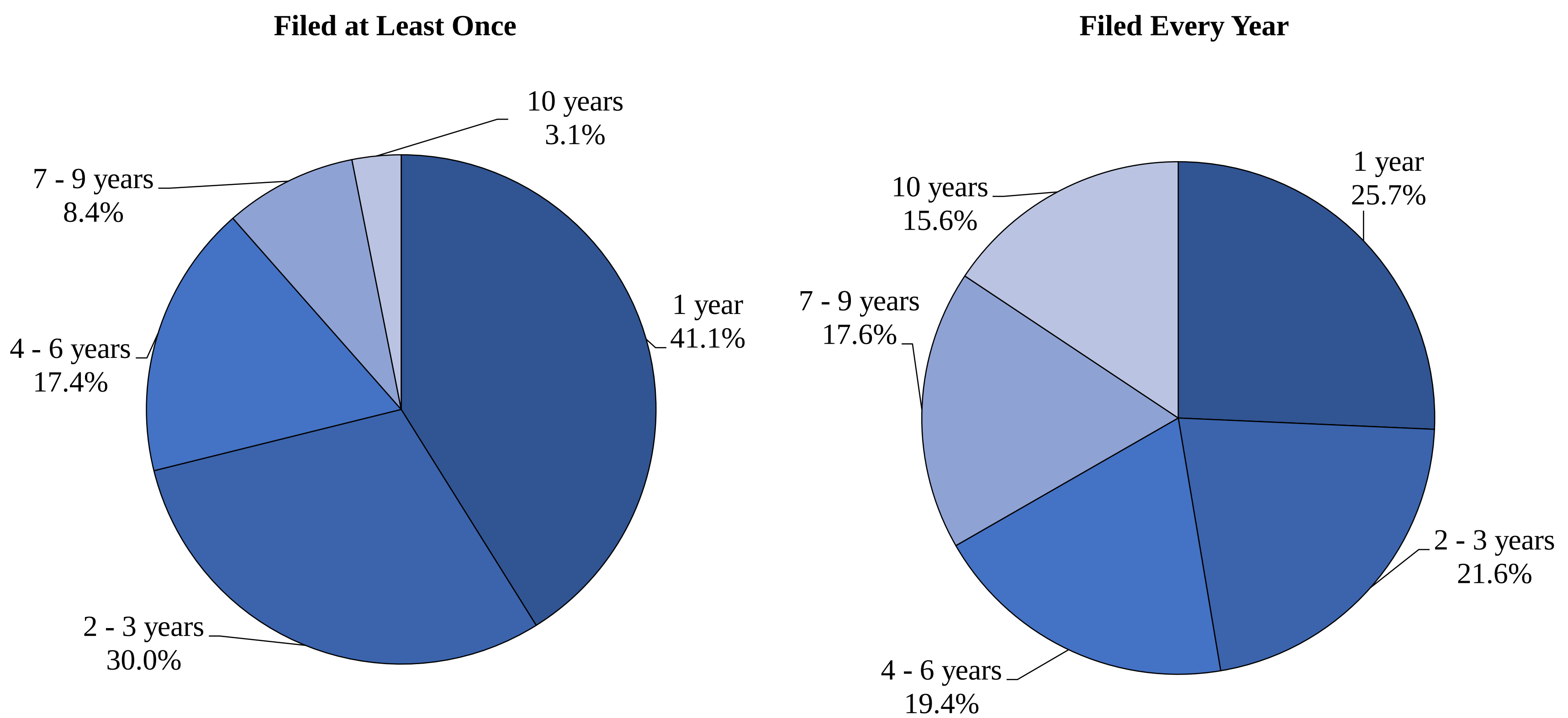
EIC: earned income credit
MAGI: Maryland adjusted gross income
REIC: refundable earned income credit
Source: Comptroller's Office; Department of Legislative Services

Longevity of Claims

The majority of taxpayers claiming either State credit only claimed the credits for a short period of time. As **Exhibit 6.9** illustrates, 70.0% of the 1.26 million taxpayers claiming the credits at some point during the past 10 years claimed the credits for 3 years or less. Only 11.5% of the recipients claimed the credits for 7 years or more. Between 2003 and 2012, 3.0% of all those claiming the credit in at least 1 year claimed it in every year, while 40.0% claimed the credit in only 1 year. During that time period, only a small percentage, 1.7%, claimed the local credit, but not one of the State credits. It is likely that a taxpayer that claims the local credit was eligible for the State credit, but did not file his or her tax return correctly.

Exhibit 6.9 also shows the number of years a taxpayer claimed the credit for those taxpayers that filed a return in every year between 2003 and 2012. Although 1.26 million taxpayers claimed the credit at least once between 2003 and 2012, only 20%, or 256,113 of those taxpayers, filed a tax return in every year between 2003 and 2012. Of the taxpayers that filed every year, 26%, or 63,156 taxpayers only claimed the credit in 1 year, while 16%, or 38,454 taxpayers claimed it every year. During the period, approximately half of recipients that filed every year claimed the credits for 3 years or less. **Appendices 2**, **3**, and **4** provide the data on the number of years that tax returns were filed for taxpayers claiming credits in the past 10 years and the frequency of claims.

Exhibit 6.9
Number of Years Taxpayers Claimed EIC or REIC
Tax Years 2003-2012



EIC: earned income credit
REIC: refundable earned income credit
Source: Comptroller's Office; Department of Legislative Services

Taxpayers who claimed the credit for only a short period of time tended to claim the credits in consecutive years. Of those claiming the credit in 2 out of the 10 years, 72% claimed the credit in 2 consecutive years. Of those claiming the credit in 3 out of the 10 years, 61% claimed the credit in 3 consecutive years. Often, the credit is a temporary safety net for families experiencing financial difficulties.

Taxpayers who claimed the credit for longer periods of time exhibited greater variation. For those claiming the credit in 6 of the 10 years, for example, only 46% claimed the credit in 6 consecutive years. Taxpayers frequently moved in and out of receiving the credit, reflecting changes in income, the eligibility of children, and family structure.

Of the 509,806 taxpayers who claimed the credit in only one year, 30% only filed a tax return in the year in which the credit was claimed. These taxpayers may have only filed a return in one tax year because they moved out of state, fell below the filing threshold, or deceased.

Participation Rates

The participation rate is the percent of the eligible population that claims the earned income tax credit. Nationally, approximately 79.0% of all eligible taxpayers claimed the federal credit in tax year 2010; in Maryland, the federal credit participation rate was slightly lower at 76.4%. Most taxpayers who claim the federal credit also claim the State credit, suggesting a similar participation rate for the State credit. In contrast to other programs such as the Supplemental Nutrition Assistance Program (SNAP) and Temporary Assistance for Needy Families (TANF), the federal EITC participation rate has remained relatively constant nationally. Unlike for the federal credit, however, there is no estimate of the State credit participation rate.

It is important to study the participation rate to determine whether the intended beneficiaries actually claim the credit. Determining the participation rate is difficult because calculating the number of households that receive the credit (the numerator) and the number of eligible households (the denominator) is challenging. Using the number of households receiving the credit as the numerator overestimates participation since it includes improper payments made to individuals who are not eligible for the credit. Other sources of data must be used to determine the number of eligible households as federal tax data only includes information on households who file tax returns. Population survey data from the U.S. Census Bureau can be used, but this data presents difficulties, such as household definitions, the determination of credit receipt, and sampling errors. The Internal Revenue Service (IRS), in cooperation with the U.S. Census Bureau, estimates that 79% of all eligible taxpayers nationwide received the federal credit in tax year 2010, and that one out of every five eligible taxpayers did not claim the credit. Historically, one in four eligible taxpayers have failed to claim the federal credit.

Reasons for Not Claiming the Credit

The IRS found that households who are eligible but do not file a tax return account for approximately two-thirds of nonparticipants. Additionally, research indicates that participation is significantly lower for households that are not required to file a return (35% compared with 90% for those taxpayers who are required). There are numerous reasons why an individual whose income is below the filing threshold opts not to file a return. An individual may unfavorably view the inconvenience of filing a tax return compared to the credit's potential benefit or the individual may not be aware that he or she would receive a refund if a return were filed.

The IRS and the U.S. Government Accountability Office (GAO) found that those eligible for a higher credit are more likely to claim the credit. The GAO found that the participation rate in 1991 was 75%, with 89% of the total amount of credits claimed. The IRS reports that participation rates were about 42% for taxpayers eligible to claim a credit below $100 and 90% for taxpayers eligible for a credit of $4,000 or more. This is consistent with research findings that a larger benefit entices more taxpayers to file and claim the credit.

Additionally, research has found that receiving income from Social Security and public assistance, having a larger family and being unmarried, male, or Hispanic were significantly correlated with nonparticipation. The IRS reports that the people who fail to claim the EITC typically include those (1) living in nontraditional homes, such as a grandparent raising a grandchild; (2) whose earnings declined or whose marital or parental status changed; (3) without children; (4) with limited English skills; (5) living in rural areas; (6) with earnings below the filing threshold; and (7) who have disabilities or are raising children with disabilities.

Amount of Unclaimed Credits

The GAO estimated that in 1999, 17.2 million households were eligible to claim $23.5 billion in federal credits; however, only 12.9 million households claimed $20.9 billion. Participants had an average EITC of $1,620, while those not claiming the credit were eligible for an average credit of $605, or 37.3% of the average claim. Based on this information and the IRS estimate that 23.6% of eligible households are not claiming the credit, the amount of potential federal credit left unclaimed is equal to 8.8% (23.6% times 37.3%) of the amount actually claimed in Maryland. Thus, an additional 131,300 Maryland households could have claimed $81.3 million in federal credits in tax year 2012 but did not. An estimated 95.0% of those claiming the federal credit claim the State credit, and the estimated amount of potential State credit left unclaimed is slightly higher at 10.0% of the total amount actually received. As such, an additional 150,800 households could have also claimed a total of $24.5 million in State credits. Nonparticipants were eligible for an average federal credit of $619 and State credits of $162. A 1.0% increase in the participation rate would provide an additional $3.4 million in federal credits and $0.9 million in State credits to an additional 5,600 Maryland households.

Participation Rates Compared to Other States

Maryland's participation rate ranks thirty-eighth among the 50 states and the District of Columbia. Mississippi has the highest participation rate (85.2%) while Oregon has the lowest (71.0%). With the exception of the District of Columbia and New Jersey, Maryland's surrounding states have higher participation rates, as shown in **Exhibit 6.10**. State-level federal participation rates are based on the U.S. Census Bureau's American Community Survey. These estimates are not as accurate as the Current Population Survey, which is used to calculate the national participation rate. Thus, while it is useful to compare differences in state-level participation rates, caution should be used due to the difficulties of determining participation rates and different methodologies employed.

Exhibit 6.10
Federal EITC Participation Rates in Surrounding States
Tax Year 2010

State	Federal Participation Rate
Delaware	77.9%
New Jersey	75.7%
Pennsylvania	81.9%
West Virginia	83.1%
Virginia	79.0%
District of Columbia	74.0%
Maryland	**76.4%**

Source: Internal Revenue Service

Participation Rate Trends

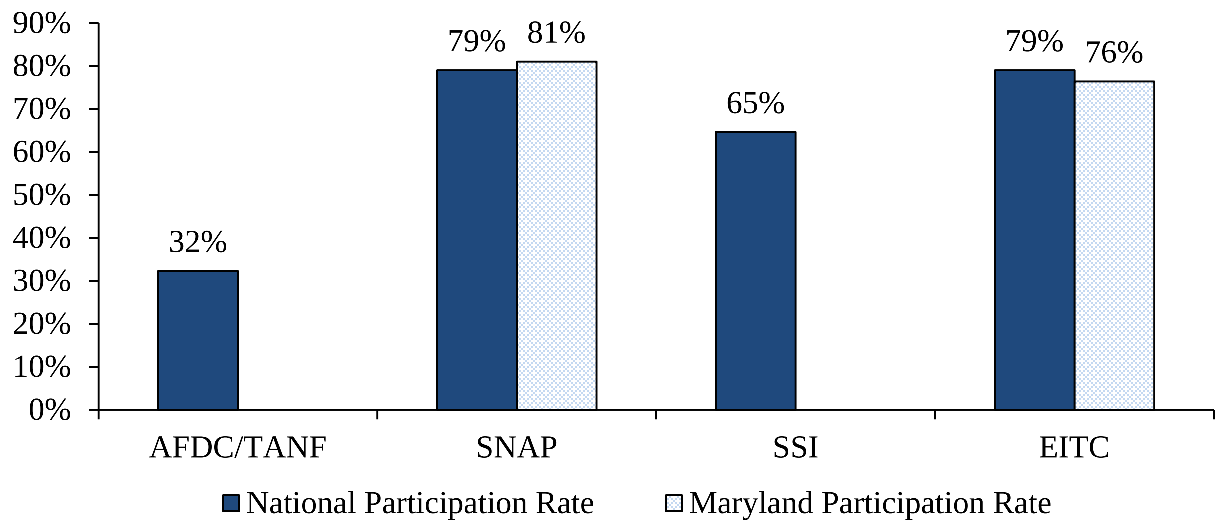
Research conducted by the IRS, GAO, and other organizations has indicated that federal participation rates have remained relatively unchanged. This research estimated that the participation rate was between 80% and 86% in 1990, 75% in 2005, and 79% in 2010. The IRS estimated that the participation rate for taxpayers with qualifying children was 81% in 2005, which is comparable to previous estimates conducted in 1990. Two factors contributed to the decrease in participation after 1990. First, federal legislation extended credit eligibility beginning in tax year 1993 to childless individuals, a population less likely to claim the credit. Second, the IRS previously calculated and issued credits to eligible taxpayers who filed a return and failed to claim the credit but it has subsequently ceased doing so.

Other Program Participation Rates

The participation rate of the federal EITC has generally been higher than most other social safety net programs. The EITC participation rate (79.0%) is comparable to the SNAP participation rate (78.9%). In Maryland, the EITC participation rate in tax year 2010 was 76.4%, slightly below the national average, while the Maryland SNAP participation rate in fiscal 2011 was 81.0%, slightly above the national average. Aid to Families with Dependent Children (AFDC)/TANF, and Social Security Income (SSI) had lower federal participation rates of 32% and 65%, respectively. There are several reasons why the EITC participation rate is higher than other social safety net programs. Since the EITC is accessed through the tax system, there is little or no stigma attached to claiming the credit. Additionally, some people may feel more inclined to claim the credit because the credit is marketed as the taxpayer earning it by working as opposed to a welfare handout. Furthermore, the EITC does not require an application or an interview. On the other hand, a taxpayer must submit a tax return to claim the EITC, which can be a barrier, particularly in light of the complexity of tax returns.

Exhibit 6.11 shows the United States and Maryland participation rates for the EITC, the SNAP program, AFDC/TANF, and SSI. State-level participation rates are not available for AFDC/TANF and SSI.

Exhibit 6.11
U.S. and Maryland Social Safety Program Participation Rates
Calendar 2010



AFDC: Aid to Families with Dependent Children
EIC: earned income credit
SNAP: Supplemental Nutritional Assistance Program
SSI: Supplemental Security Income
TANF: Temporary Assistance for Needy Families

Source: Internal Revenue Service; U.S. Department of Health and Human Services; U.S. Department of Agriculture; Department of Legislative Services

Declines in the AFDC/TANF participation rate coincided with the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (commonly known as welfare reform), which replaced AFDC with the TANF program that placed lifetime limits on the amount of time a family could receive federal assistance and required states to meet work participation rates. The recent increase in SNAP participation rates may be attributed to, among other reforms, the Maryland Department of Human Resources (DHR) actively marketing the SNAP program and conducting outreach efforts. In contrast, there is no State agency actively providing awareness of the State EIC program or making an effort to increase awareness in eligible populations that receive other safety net benefits.

DHR oversees numerous State antipoverty programs, such as the Food Supplement Program (FSP), Emergency Assistance to Families with Children, Temporary Cash Assistance, and Temporary Disability Assistance Program. Currently, DHR departmental goals, objectives, and performance measures include achieving a certain Work Participation Rate and maintaining FSP error rates below certain percentages. For example, in the fiscal 2015 budget, DHR sets an objective to maintain the FSP error rate at or below 3% in federal fiscal year 2014, and continue this reduced error rate through federal fiscal year 2015. By setting clear goals, objectives, and performance measures, the Department of Budget and Management and DLS are able to evaluate DHR's performance and hold the department accountable for meeting the performance measures. Additionally, StateStat, a performance measurement and management tool, works closely with DHR to meet specified goals by monitoring agency performance monthly and identifying data trends.

DHR administers numerous State antipoverty programs, but does not oversee the State EIC. The Office of the Comptroller administers the State EIC, but it does not set goals, objectives, and performance measures for the program. Due to the nature of how the credit is calculated and claimed, there is no Maryland agency charged by statute to promote public awareness of the credit or its eligibility requirements. As such, eligible low-income individuals may be unaware of the credit's potential benefit.

Ways to Increase Participation Rates

Despite having a relatively high participation rate, more can be done to increase the State's participation rate. The IRS lists best practices for government agencies to promote the EITC, such as:

- include EITC messages in public assistance checks;
- include an EITC message on Form 1099 issued for tax refunds, unemployment, etc.;
- include EITC messages in state employee W-2 forms;
- coordinate EITC communication activities among state agencies;
- collaborate with other partners to promote state credits in conjunction with the federal credit;

- place EITC information on public transportation vehicles and at bus stops; and
- encourage public utilities to include EITC messages in utility bills.

In February 2014, the New York City Department of Finance and the IRS partnered to try to reach New York City residents who appeared to be eligible in tax year 2010 for the federal credit but did not claim the credit. After the IRS sent out letters and received no response, New York City sent out notices to approximately 5,500 residents to encourage them to amend their tax return and claim the credit. The Virginia Department of Social Services mailed and called potential EITC-eligible public assistance recipients to encourage them to claim the EITC, and the department found that spending approximately $42,000 on outreach via mailings and phone calls netted an increase in EITC benefits of approximately $2.4 million.

Chapter 352 of 2011 required employers in Maryland to provide a written or electronic notice to an employee who may be eligible for the State EIC stating that the employee may be eligible for the federal and State credits. Since the bill did not take effect until January 1, 2012, it is too soon to determine if this notification requirement has significantly increased participation.

Chapter 7. Improper Payments and Refund Anticipation Products

Improper Payments

Following the enactment of federal legislation increasing the earned income tax credit (EITC) for certain taxpayers and efforts to reduce improper payments and waste in federal programs, new focus has been brought to the EITC improper payments rate. The Internal Revenue Service (IRS) has struggled to reduce improper payments, using both traditional enforcement methods and nontraditional techniques to increase compliance with the agency's only program identified as a high risk for improper payments. According to the IRS, 22% to 26% of EITC payments were issued improperly in federal fiscal year 2013. In light of the magnitude of the EITC, approximately $60.0 billion in federal fiscal year 2013, these improper payments totaled approximately $13.3 billion to $15.6 billion. Improper payment rates under the EITC program also impact Maryland revenues, as an individual who claims the federal credit but who otherwise did not meet eligibility requirements can claim a refundable or nonrefundable State credit. Consequently, an erroneous EITC claim may also prompt an improper Maryland payment.

An improper payment is generally any payment that should not have been made or that was made in an incorrect amount or to an ineligible recipient. Factors contributing to improper payments include (1) the complexity of the credit; (2) the constantly changing population of eligible taxpayers; and (3) statutorily mandated tax return processing time periods. As shown in **Exhibit 7.1**, in its federal fiscal year 2013 report, the U.S. Department of the Treasury provides the following improper payment rate and amount outlook for federal fiscal years 2014 through 2016.

Exhibit 7.1
Improper Credit Payments
($ in Billions)

	Total Amount[1]			Percent of Claims
Estimate	**2014**	**2015**	**2016**	**2014-2016**
High	$15.1	$15.6	$15.9	25.9%
Low	12.9	13.3	13.5	22.1%

[1]Estimated total improper payments are based on projections of EITC tax expenditures plus outlays as estimated by the Office of Tax Analysis within the U.S. Department of the Treasury, adjusted to account for the difference between taxpayer claims and accounts received by taxpayers due to return processing and enforcement.

Source: U.S. Department of the Treasury

Underpayments

Improper or erroneous payments may be classified as underpayments or overclaims. The U.S. Department of Treasury considers underpayments those amounts disallowed by the IRS in processing that should have been allowed. Under these parameters, an individual who is entitled to receive the EITC but does not claim it on a tax return does not constitute an underpayment.

Tax year 2009 was the first year in which the IRS included underpayments in its calculation of improper EITC payments; underpayments were not a significant source of errors, increasing the overall improper payment rate by less than 0.05%. Previously, the Treasury Inspector General for Tax Administration had criticized the IRS for its failure to include underpayments in its estimate of improper payments, as the omission understated the rate or dollar value or both of improper payments. The Inspector General maintains that the IRS should continue to evaluate the significance of underpayments and ensure that underpayments are included in its annual estimates of the EITC improper payment rate if reasonable.

The Center on Budget and Policy Priorities (CBPP) has challenged the IRS's limited definition of underpayments. According to the CBPP, IRS error rates fail to account for offsetting underpayments – instances in which a credit is wrongly claimed and another taxpayer who may have been rightly eligible did not claim the credit. For example, if a noncustodial parent claims the credit mistakenly, the noncustodial parent's EITC counts as an overpayment, but the amount that the custodial parent was eligible to claim, yet failed to do so, is not taken into account. In such instances, the IRS study generally counts the credit that the noncustodial parent received as an overpayment without netting out the credit that the custodial parent should have claimed.

Overclaims

In its annual review of IRS compliance, the Treasury Inspector General for Tax Administration estimated EITC improper payments for federal fiscal 2003 through 2013, as shown in **Exhibit 7.2**.

Exhibit 7.2
Estimated EITC Improper Payments
Federal Fiscal 2003-2013
($ in Billions)

	Error Rate		Total Amount	
Federal Fiscal Year	**Lower Bound[1]**	**Upper Bound**	**Lower Bound**	**Upper Bound**
2003	25%	30%	$9.5	$11.5
2004	22%	27%	8.6	10.7
2005	23%	28%	9.6	11.4
2006	23%	28%	9.8	11.6
2007	23%	28%	10.4	12.3
2008	23%	28%	11.1	13.1
2009	23%	28%	11.2	13.3
2010	24%	29%	15.3	18.4
2011	21%	26%	13.7	16.7
2012[2]	21%	25%	11.6	13.6
2013	22%	26%	13.3	15.6
Total			**$124.1**	**$148.2**

[1]For fiscal 2005 through 2009, the IRS computed the minimum and maximum improper payment rates (*i.e.*, upper and lower bounds) using different sets of assumptions concerning the compliance of certain EITC claimants.
[2]The Treasury Inspector General for Tax Administration concluded that the IRS understated fiscal 2012 improper payment estimates, as the estimates do not reflect the extension of the additional EITC for families with three or more children.

Source: U.S. Department of the Treasury, Treasury Inspector General for Tax Administration

The IRS' Taxpayer Advocate Service (TAS) has asserted that IRS overclaim estimates are too high. The organization noted that the estimates have "an uncertain statistical basis to the extent that they are based on previous IRS studies." The TAS demonstrated earlier studies had incorrectly assumed that all taxpayers who failed to document their claims were not eligible. In addition, as noted previously, earlier IRS studies have failed to account for individuals who may not have claimed the credit but were nonetheless eligible. Therefore, the TAS believes that IRS studies have overstated the overclaim rate when they relied exclusively on the outcome of audits, as audit outcomes are frequently incorrect and a significant number of entitled taxpayers are being denied the credit in error.

The CBPP has also questioned the accuracy of the IRS estimates. In addition, the organization suggests that these error rates nevertheless are much lower than rates of noncompliance in other portions of the tax code. For example, the 2001 IRS "tax gap" study, which assessed noncompliance throughout the tax code, found that 51% of rent and royalty income, 57% of small business income, and 72% of farm income went unreported, costing the federal government an estimated $109 billion, at least 10 to 12 times the size of total EITC improper payments for that year.

Reasons for Improper Payments

A number of factors contribute to improper payments, including:

- credit complexity, especially in changing family or fiscal situations;
- a constantly changing population of eligible taxpayers; and
- constraints placed on the IRS under statutorily mandated tax return processing times.

The CBPP attributes the majority of errors to the credit's complexity, particularly regarding families whose composition changes over the course of the year. The CBPP notes that overclaims typically result from a misunderstanding of the application of rules regarding who may claim a child, especially in changing family situations, or from incorrect information about family composition or income levels. Although the EITC may only be claimed by an eligible parent who has custody of a qualifying child for more than half of a year, a noncustodial parent may mistakenly claim the EITC on behalf of the child. For example, a noncustodial parent who pays child support may incorrectly believe that he or she is eligible to claim the credit. This misunderstanding may be reinforced if the noncustodial parent is entitled, under the terms of a divorce agreement, to claim the child for the personal exemption and the child tax credit.

Alternatively, erroneous claims may stem from the recent separation of parents. Although married couples must generally file joint returns to claim the EITC, separated parents often file their own returns. Under these circumstances, a custodial parent filing a separate return who wishes to claim the EITC must have lived apart from his or her spouse for more than six months of the tax year and have lived with the qualifying child for more than six months of the year. In addition, the custodial parent must also be able to claim head-of-household filing status and meet the complicated "household maintenance" test. Numerous errors result from the complexity of this test and errors may persist for years. Prior proposals to reduce error rates have included simplifying this rule.

The complexity of the credit impacts not only taxpayers who prepare their own returns but also paid preparers. Paid preparers consist of both tax practitioners – certified public accountants (CPAs), attorneys, and enrolled agents – and unenrolled preparers. In many states, anyone may be an unenrolled preparer regardless of education, experience, or other standards. Although CPAs, attorneys, and enrolled agents are subject to Department of Treasury Circular No. 230 standards of practice, unenrolled preparers – who constituted 55% of all preparers as of March 2014 – are generally not subject to its requirements. Although many taxpayers rely on preparers to provide them with accurate, complete, and fully compliant tax returns, the U.S. Government Accountability Office estimates that paid preparer tax returns showed a higher error rate (60%) than returns prepared by taxpayers (50%). In addition, the National Taxpayer Advocate has noted that unenrolled preparers not affiliated with a national tax preparation firm "are most prone to error," with 49% of the EITC returns they prepare containing errors that average 33% of the amount claimed. Although errors are not necessarily the fault of preparer's (*e.g.*, preparers rely on information provided by taxpayers), the potential impact of paid preparers on the federal government's ability to collect revenue and minimize errors is nevertheless significant. Recognizing that untrained preparers can easily make errors in preparing EITC claims, the IRS has sought greater oversight of all paid preparers.

Although the majority of errors appear to result from the credit's complexity rather than intentional fraud, elements of the credit may lead taxpayers or tax preparers to misreport income or children in order to receive a larger credit. For example, a taxpayer may misreport the number of qualifying children, as taxpayers with one or more qualifying children receive a substantially larger credit than taxpayers with no qualifying children. Similarly, married taxpayers may misreport their filing status as unmarried persons, because married taxpayers who file jointly may receive a smaller credit than they would otherwise receive filing as unmarried persons. Misreporting filing status may allow the taxpayers to claim a larger credit, even if the taxpayers do not duplicate their qualifying child claims. In addition, as the amount of the credit depends on a taxpayer's income – initially increasing in earned income, then constant as income rises, and finally decreasing until phased out – taxpayers may also misreport income in order to maximize the credit received. For example, a taxpayer may omit earnings in order to avoid phasing out of eligibility for the credit. Alternatively, a very low-income taxpayer may overreport income in order to receive the credit and take advantage of its increasing rate at lower income levels. However, studies show that income overreporting occurs much less frequently than income underreporting; reasons for this disparity may be the risk of jeopardizing eligibility for other public benefits. Moreover, it should be noted that many errors contributing to EITC overclaims frequently also result in mistakes on other parts of an individual's tax return. Misreporting income, marital status, and information concerning children affect an individual's entire tax liability, not just EITC eligibility.

Efforts Undertaken by the IRS to Reduce Improper Payments

In combating improper payments and improving compliance, the IRS faces two significant hurdles: (1) a constantly changing population of taxpayers eligible to claim the credit and (2) statutory tax return processing time periods. As the credit is based on income and family size, eligibility for the credit can change with financial status and family structure. Furthermore, eligibility criteria have changed multiple times since the credit's inception in 1975. Consequently, a portion of EITC claimants each year are first-time claimants or taxpayers whose eligibility for the credit is intermittent from year to year. As noted by the Treasury Inspector General for Tax Administration, this varying population makes it difficult for the IRS to gain lasting improvements in compliance through outreach, education, and enforcement. Moreover, federal law requires the IRS to generally process tax returns and pay any related tax refunds within 45 days, constraining the IRS's ability to conduct extensive eligibility checks comparable to those that occur with other federal programs that typically verify eligibility prior to the issuance of payments or benefits.

Nevertheless, the IRS has undertaken several steps to address compliance by conducting a number of education and outreach efforts to both taxpayers and tax preparers including:

- conducting EITC marketing campaigns, include utilizing social media methods such as Twitter and YouTube;
- partnering with more than 300 coalitions, including nonprofit organizations, financial institutions, and government agencies, to conduct additional outreach through direct mail and media efforts;
- holding an annual National EITC Awareness Day to promote awareness of the credit and educate eligible taxpayers;
- having EITC-related materials available on its website;
- sending computer-generated notices to taxpayers who file returns, appear to be eligible, but fail to claim the credit;
- undertaking efforts to provide greater access to available IRS services through Saturday service events and special service days; and
- partnering with key tax software associations to reduce EITC errors and assist preparers in meeting EITC due diligence requirements.

The IRS has implemented an automated process known as math error authority, or summary assessment, in order to systematically deny an EITC claim in certain circumstances, including clerical errors or invalid taxpayer identification numbers. Math error checks are performed before refunds are issued to taxpayers. Using math error authority, the agency may correct arithmetic or clerical errors, automatically preparing an adjusted return for a taxpayer. Moreover, in the case of the EITC, the IRS is authorized to correct errors such as omission of a Social Security number.

Furthermore, the IRS has implemented automatic computer screens to identify questionable EITC claims. The database utilized by the IRS combines data from the following sources: (1) the *Federal Case Registry*, containing extensive information on custodial and noncustodial parent-child relationships; (2) *Kidlink*, containing Social Security numbers of children born since 1998 and those children's parents; (3) *DM-1*, containing Social Security numbers and Individual Taxpayer Identification Numbers; and (4) *Numdent*, containing Social Security Administration data providing information from birth certificates, including parents' names. This database permits the IRS to identify and prevent payments on erroneous claims. In addition, the IRS also compares income data on EITC claimants' returns and data reported by employers on informational documents, such as W-2 forms, to identify filers who appear to be underreporting income. If a taxpayer files a reckless or fraudulent claim, the IRS may prohibit the taxpayer from claiming the credit for 2 or 10 years, respectively. Following this denial period, the taxpayer must file Form 8862 (Information to Claim Earned Income Credit After Disallowance) to enable the IRS to verify eligibility.

The IRS has also undertaken efforts to reduce erroneous claims made using commercial tax preparers. For example, the IRS requires all tax return preparers to use preparer tax identification numbers when submitting tax returns. By assembling a registry of preparers, the IRS has been able to track returns submitted by individual preparers. The agency then sends warning letters to preparers who submit returns with significant errors and conducts due diligence visits to preparers who exhibit a pattern of filing errors. The Treasury Inspector General of Tax Administration has indicated that a significant percentage of preparers who have received these "due diligence" visits have subsequently changed their behavior, either by becoming compliant or ceasing to prepare returns.

The IRS has sought greater oversight of paid preparers. In June 2011, the IRS issued regulations amending Circular 230 to subject all paid preparers to its standards, thereby subjecting unenrolled preparers to competency testing and continuing education requirements. The IRS and Tax Advocate Service hoped that these regulations would have substantially enhanced EITC compliance with preparer-prepared returns, as about two-thirds of tax returns claiming EITC benefits are completed by preparers rather than by the taxpayers themselves. However, in January 2013, the U.S. District Court for the District of Columbia held that the IRS lacked the statutory authority to regulate all paid preparers and could not implement its testing and continuing education requirements. Although the IRS appealed the ruling, the decision was affirmed by the U.S. Court of Appeals for the District of Columbia Circuit in February 2014. The President's fiscal 2015 budget, currently before Congress, includes a proposal to explicitly authorize the Secretary of the Treasury and the IRS to regulate all paid preparers.

Although the IRS currently lacks the authority to regulate all paid preparers, four states – California, Maryland, New York, and Oregon – regulate paid preparers. **Exhibit 7.3** compares the requirements in these states.

Exhibit 7.3

State-level Paid Preparer Requirements

Requirements	Oregon	Maryland	California	New York
Registration	Yes	Yes	Yes	Yes
Qualifying Education	Yes	Yes[1]	Yes	No
Continuing Education	Yes	Yes	Yes	No
Testing	Yes	Yes[2]	No[3]	No
Date of Implementation	1973	2008	1974	2009

[1]Qualifying education requirements in Maryland do not require prior tax education.
[2]Paid preparers in Maryland do not have to pass a qualifying test until after December 31, 2015.
[3]Paid preparers in California who take self-study courses for qualifying education must pass a final exam as a means for evaluating successful completion of the course.
Source: U.S. Government Accountability Office; Department of Legislative Services

Studies conducted by the U.S. Government Accountability Office comparing error rates for returns filed throughout the country revealed a "higher level of accuracy of Oregon's tax returns... suggest[ing] that a robust regulatory regime involving paid preparer registration, qualifying education, testing, and continuing education may help facility improved tax compliance."

Further Recommendations for Federal and State Action

The U.S. Department of Treasury has recommended several EITC simplifications, including a recommendation permitting filers who live with a qualifying child but do not claim the child for the EITC to claim the smaller credit for workers not raising a child. Currently, individuals living with qualifying children – even if they are unable to claim that child for their own EITC – are prohibited from claiming the EITC for workers without children. This may occur where an uncle, mother, and child live together. Although the uncle may claim the child for the EITC where the mother does not, if the mother claims the EITC for the child, the uncle may not claim the smaller EITC for childless workers even if he would otherwise qualify.

The Comptroller's Office advises that it conducts various tax compliance efforts to reduce improper payments. The Department of Legislative Services requested more detailed information on these efforts and estimates for total State earned income credit improper payments and the estimated impact, if any, on State improper payment rates relative to federal rates. The Comptroller's Office did not submit the information in time for inclusion in this report.

Refund Anticipation Products

Refund anticipation products, such as refund anticipation loans (RALs) and refund anticipation checks (RACs), have been marketed to taxpayers by lenders to expedite estimated refund monies sooner than otherwise available under traditional IRS refund processing. These products are targeted to low-income and unbanked taxpayers, including EITC recipients. However, these loans and deposit products disguise tax preparation costs, entail high loan fees, and are subject to add-on fees. These combined costs undermine the effectiveness of the EITC by eroding the funds received by low-income taxpayers. Recently, the federal and state governments have undertaken significant measures to combat these burdensome fees and improve consumer disclosure.

Refund Anticipation Loans

RALs are short-term (generally, one- to two-week) loans, secured by individuals' expected income tax refunds. The loans are facilitated and advertised by paid tax preparers and are contracts between the taxpayer and lender. Before issuing the loan, the lender first deducts fees for tax return preparation, electronic filing (e-filing), finance charges, and processing; the lender then issues the taxpayer the balance of the refund by check, direct deposit, debit card, or as a down payment on a good or service. After the IRS processes the taxpayer's tax return, the agency transfers the refund directly to the lender to repay the loan.

RALs provide one method by which a taxpayer can expedite his or her refund. In fact, for an additional fee, a taxpayer could obtain a same-day RAL rather than undergo regular IRS processing periods ranging from five days to eight weeks. However, RALs entail a number of disadvantages for the borrower. First, the loan's short duration and the numerous associated fees often translate to borrowing costs equating to triple-digit annual percentage rates. In addition, RALs pose a number of risks to borrowers. For example, a RAL must be repaid even if the taxpayer's refund is denied, smaller than anticipated, or frozen. If a taxpayer is unable to pay back the RAL, the lender may refer the account to a debt collector or the debt may adversely impact the taxpayer's credit score. Moreover, if a taxpayer with unpaid RAL debts applies for a RAL or RAC from any commercial preparer the following year, a portion of that refund may be seized to repay the prior unpaid debt.

The National Consumer Law Center (NCLC) has noted that RALs are mostly marketed to low-income taxpayers, as IRS data revealed that 94% of taxpayers who applied for a RAL and 84% who obtained a RAC in 2011 were low-income individuals. Moreover, the NCLC observed that EITC recipients are vastly overrepresented among RAL and RAC consumers. Although EITC recipients constituted only 20% of individual taxpayers in 2011, IRS data showed that over 85% of RAL consumers and 50% of RAC consumers for that year were EITC recipients. IRS data further shows that 38% of recipients applied for either a RAL or a RAC in 2011. Meanwhile, only 9% of taxpayers who did not receive the EITC obtained a RAL or RAC. Consequently, significant EITC funds are siphoned off through RAL and RAC fees, as well as associated add-on fees.

As shown in **Exhibit 7.4**, the consumer demand for RALs remained consistent for a significant portion of the prior decade, peaking in 2004 when 12.4 million RALs were made, amounting to $1.24 billion in loan fees. However, a series of events lead to a precipitous decline in RALs during the past five years.

Exhibit 7.4

Refund Anticipation Loans

Tax Year 2000-2013

(in Millions)

Tax Year	Applications	Percent Change	Loans	Loan Fees
2000	12.0	–	10.8	$810.0
2001	13.4	12%	12.1	907.0
2002	14.1	5%	12.7	1,100.0
2003	13.5	-4%	12.2	1,100.0
2004	13.8	2%	12.4	1,240.0
2005	10.7	-22%	9.6	960.0
2006	10.0	-7%	9.0	900.0
2007	10.2	2%	8.7	833.0
2008	9.9	-3%	8.4	738.0
2009	8.4	-14%	7.2	606.0
2010	6.9	-18.5%	5.0	338.0
2011	1.0	-84.5%	0.8	46.0
2012	0.9	-16%	0.6	38.6
2013	0.1	-88%	Unknown	Unknown

Source: National Consumer Law Center

The lending market for RALs began its decline on December 24, 2009, when Pacific Capital Bancorp – the parent company of Santa Barbara Bank & Trust (SBBT) – announced that its regulator, the Office of Comptroller of Currency (OCC), had refused to grant the bank regulatory approval to make RALs in the 2010 tax season. As SBBT had previously provided approximately 75% of the RALs offered by Jackson Hewitt, that tax preparation chain was left without a RAL lender for over half of its franchises. In April 2010, JP Morgan Chase, one of the three largest RAL lenders, voluntarily left the market. In August 2010, the IRS announced it would no longer provide the Debt Indicator, an indication on taxpayer accounts for taxpayers with outstanding liabilities collectible by the federal government (*e.g.*, prior tax debt, unpaid child support, delinquent student loan debt, etc.). The lack of this information and capability to evaluate applicants increased risk to lenders. In October 2010, the Office of Thrift Supervision issued a supervisory directive to MetaBank, a spin off from SBBT, effectively prohibiting it from issuing RALs. On December 24, 2010, H&R Block announced its RAL lending bank partner, HSBC Bank, had terminated its agreement to provide RAL loans following an OCC directive. Following notices from the Federal Deposit Insurance Corporation (FDIC) that the practice of originating RALs without the benefit of the Debt Indicator is unsafe and unsound, the three remaining State-chartered banks left the RAL market after the 2011 tax season.

With the evaporation of this RAL lending market, RALs steeply declined in volume after 2010; nevertheless, nonbank lenders remain in the RAL market on a smaller scale. Furthermore, NCLC has observed the emergence of "phantom RALs," where tax preparers claim to offer RALs in a bait-and-switch tactic to draw potential customers when those preparers in reality do not offer the product.

Refund Anticipation Checks

A RAC is a nonloan alternative to a RAL. With a RAC, a bank establishes a temporary account to receive the taxpayer's refund. Following the refund's deposit into the account, the bank deducts the tax return preparation, electronic filing, and processing fees and disburses the remaining funds to the taxpayer. These funds may be deposited in a bank account created by a financial institution or paid preparer on behalf of the taxpayer, in the taxpayer's own account, or on a prepaid debit card issued by the paid preparer. Generally, a taxpayer will wait between 5 to 14 days to receive his or her RAC. RACs generally cost between $30 and $55. In 2012 and 2013, taxpayers paid at least $630 million in each year for RACs.

RACs have grown in popularity over the past several years as the availability of RALs has declined. Like RALs, RACs are subject to add-on fees. Proponents note that RACs benefit unbanked taxpayers who lack traditional access to financial accounts, loans, and credit. Furthermore, although RACs do not provide significant time advantages over the direct deposit of a refund to the taxpayer's own bank account, RACs permit a taxpayer to pay for tax preparation fees out of the anticipated refund. The NCLC has raised concerns that RACs make taxpayers less price sensitive, as the ability of commercial preparers to deduct the tax preparation fees from RACs enables them to withhold information on the price of preparation and contributes to a lack of transparency in tax preparation fees.

Add-on Fees

Costs associated with both RALs and RACs are further increased by tax preparers who charge add-on fees, including application, document processing, e-filing, service bureau, transmission/software, and technology fees. NCLC notes that add-on fees provide an opportunity to generate additional revenue and constitute a considerable source of profit for some preparers. In addition, some preparers attract customers with discounted preparation fees and then utilize add-on fees to make up for the discounted price. As preparers often charge multiple add-on fees with each fee ranging, for example, from $10 to $40, the total cost of these fees may be significant. NCLC estimates that 7.8 million RAC and RAL consumers paid approximately $195 million in add-on fees in 2013. In addition, the U.S. Government Accounting Office notes that taxpayers who receive their refund on a prepaid debit card may incur further fees for using the card. These fees and alternatives may not always be disclosed by the tax preparer. Furthermore, taxpayers who lack bank accounts may face check cashing fees, further eroding refund benefits.

Tax Preparation Fees and Refund Anticipation Products Erode EITC Funds

Nina Olson, the National Taxpayer Advocate, has noted that as many recipients of the EITC pay for professional assistance in preparing tax returns, the EITC is the only antipoverty program for which recipients pay to receive benefits. Although recipients may consider the expense of tax preparation, averaging well over $150 per taxpayer, as a cost to obtain something that they might otherwise not have received, return preparation costs divert a significant amount of program funds away from taxpayers.

Federal and state regulators have undertaken steps to combat the erosion of EITC funds by tax preparation, refund anticipation product, and add-on fees. As noted above, the IRS ended its Debt Indicator program, making the originating of RALs a significantly more risky practice for lenders. Moreover, the OCC and FDIC prohibited institutions under their jurisdiction from providing RALs. In addition, the IRS and Bureau of Consumer Financial Protection have begun discussing whether a need for further regulation of RACs exists and whether additional steps must be taken to help consumers understand tax preparation fees.

The IRS also offers several free tax preparation services. Taxpayer assistance centers are walk-in sites offering answers to both accounting and tax law questions, as well as tax preparation assistance. The Free-File program provides federal tax return preparation and an e-filing program for eligible taxpayers. Finally, the Volunteer Income Tax Assistance and Tax Counseling for the Elderly programs offer free tax assistance to persons with low- to moderate-income (generally, $52,000 or less), the elderly, persons with disabilities, and persons with limited-English proficiency. Although public awareness of these free services is lacking, the IRS has expanded its marketing of volunteer preparation programs. Furthermore, the IRS has undertaken efforts to allow taxpayers who may not have an account at a financial institution to receive their refund through direct deposit on a debit card issued by an IRS national banking partner. The agency hopes that providing these low-cost or no-cost refund options will reduce the demand for refund anticipation products.

Maryland and 19 other states regulate refund anticipation products. Chapter 730 of 2010 required a person who facilitates a RAL or RAC to provide the consumer with certain written and oral disclosures. In the case of a RAL, the required disclosures include the amount of any loan fee; a statement that the product is a one- to two-week loan; and a notice that the consumer is liable for the full amount of the loan, even if the consumer's tax refund is less than expected. The required disclosures in connection with a RAC include a statement that the consumer may receive a tax refund in the same amount of time without paying any fee if the consumer's tax return is filed electronically and the refund is deposited directly into the consumer's bank account. In addition, Chapter 730 established certain restrictions on refund anticipation loans and checks. Specifically, Chapter 730 prohibited a facilitator from requiring a consumer to take out a RAL as a condition to obtaining tax preparation services, charging any fee other than the fee imposed by the lender, or arranging for any third party to charge a fee in connection with a refund anticipation loan or check. The industry-specific statute was enacted following earlier attempts by the Commissioner of Financial Regulation to apply the Maryland Credit Services Businesses Act (MCSBA) to tax preparers facilitating RALs; the Maryland Court of Appeals later held that the General Assembly did not intend for the MCSBA to apply to those facilitators (see *Gomez v. Jackson Hewitt, Inc.*, 427 Md. 128, 46 A.3d 443 (Md., 2012)).

The Maryland CASH Campaign, a statewide network of organizations that promotes programs, products, and policies that increase the financial security of low- to moderate-income individuals and families, has recommended a number of actions the State should take to further regulate these products, including:

- prohibiting tax preparers who are not registered with the State from brokering RALs, RACs or any other refund loans;
- prohibiting tax preparers from charging any fee except for the RAL, RAC, or other refund loan fee charged by the lender, *i.e.*, prohibit add-on fees;
- prohibiting businesses whose primary purpose is not tax preparation from offering RALs, RACs, and any other refund loans;
- conducting investigations; including secret shopping, to ensure that tax preparers are effectively disclosing the proper information to taxpayers;
- ensuring the investigation of complaints against paid tax preparers and enforcement of the applicable laws;
- revoking the registration for tax preparers who violate State RAL laws;
- providing funding for free tax preparation services; and
- providing funding for educational campaigns concerning utilizing reputable tax preparers and direct deposits for refunds.

Maryland Utilization of RACs

Exhibit 7.5 summarizes, by region, the average costs of RAC and preparation fees utilized by Maryland return filers for tax year 2012. During that tax year, there were 2.6 million Marylanders individual tax returns processed by June, of which 399,232 claimed the EITC. Approximately 40% of filers claiming the EITC utilized RACs compared to only about 10% of nonclaimants, illustrating that primarily low-income filers utilize RACs. As the exhibit reflects, the highest percentage of EITC claimants purchasing RACs resided in Baltimore City.

On average, 53.3% of Maryland taxpayers claiming the EITC utilized paid tax preparation services, with the highest utilization of paid preparation services in Montgomery and Prince George's counties. These services cost an average consumer approximately $67, totaling approximately $14.3 million statewide for EITC claimants. On average, these fees were equal to 4.0% of the total federal credit claimed by the taxpayer. Only 2.4% of Maryland EITC claimants utilized volunteer tax preparation services, with the highest utilization of volunteer services in Baltimore City and the Lower Eastern Shore counties. In addition, RAC fees cost the average Maryland consumer approximately $20, totaling approximately $3.1 million for EITC claimants. Combined, RAC and paid preparation fees cost low-income Maryland taxpayers $17.4 million, undermining the effectiveness of the credit.

Exhibit 7.5
RAC and Preparation Fee Costs
Tax Year 2012

	Filing Method for Filers Claiming EITC			Average Amount				Percent of Filers Utilizing RACs		
Region[1]	**Self**	**Paid**	**Volunteer**	**EITC**	**RAC**	**Prep Fee**	**Total Fees**	**EITC**	**No EITC**	**All Returns**
Baltimore/Harford	45.5%	52.0%	2.0%	$2,208	$20	$68	$88	40.0%	9.7%	14.1 %
Baltimore City	42.3%	53.4%	3.9%	2,489	26	63	90	52.1%	15.5%	26.2%
Montgomery	35.3%	61.7%	2.2%	2,143	11	53	64	22.4%	6.2%	8.2%
Prince George's	40.8%	57.9%	0.9%	2,260	21	61	82	41.4%	15.7%	20.3%
Central Maryland	48.6%	48.2%	2.7%	2,078	17	73	90	34.1%	8.0%	10.8%
Southern Maryland	48.5%	48.9%	1.2%	2,196	21	73	93	41.4%	10.7%	14.5%
Western Maryland	44.5%	51.2%	2.9%	2,122	20	67	87	39.1%	9.7%	15.1%
Upper Eastern Shore	48.4%	46.7%	2.9%	2,163	19	73	92	38.7%	8.9%	13.3%
Lower Eastern Shore	49.6%	44.6%	3.9%	2,294	22	74	97	44.2%	10.4%	18.1%

EITC: earned income tax credit
RAC: refund anticipation check
[1] Central Maryland Region includes Anne Arundel, Carroll, Frederick, and Howard counties. Southern MD Region includes Calvert, Charles, and St. Mary's counties. Western Maryland Region includes Allegany, Garrett, and Washington counties. Upper Eastern Shore Region includes Cecil, Kent, Queen Anne's, and Talbot counties. Lower Eastern Shore Region includes Caroline, Dorchester, Somerset, Wicomico, and Worcester counties.

Source: Brookings Institute; Department of Legislative Services

As **Exhibit 7.6** shows, RAC usage rates tracked the poverty rates of Maryland jurisdictions. Jurisdictions with higher poverty rates, such as Baltimore City and the Lower Eastern Shore counties, saw higher consumption of RACs by both EITC claimants and nonclaimants. Meanwhile, jurisdictions with lower poverty rates, such as Montgomery County and the Central Maryland counties, had lower RAC rates.

Exhibit 7.6

Filer Utilization of RACs and Poverty Rates by Jurisdiction

2012

	Percent of Returns with RAC			
County	**No EITC**	**EITC**	**All Returns**	**Poverty Rate**
		Lowest Utilization		
Montgomery	6.2%	22.4%	8.2%	6.9%
Howard	6.5%	27.3%	8.4%	5.0%
Carroll	6.6%	30.9%	8.7%	5.2%
Queen Anne's	6.5%	31.4%	9.3%	8.1%
Frederick	8.4%	33.2%	11.1%	5.8%
Talbot	7.3%	32.6%	11.1%	9.5%
Garrett	7.2%	28.8%	11.2%	12.0%
Average	**6.6%**	**26.0%**	**8.8%**	**6.5%**
		Highest Utilization		
Baltimore City	15.5%	52.1%	26.2%	25.2%
Somerset	12.4%	45.3%	21.8%	21.2%
Dorchester	11.9%	45.6%	20.7%	18.2%
Prince George's	15.7%	41.4%	20.3%	9.6%
Wicomico	11.5%	45.9%	19.8%	17.7%
Caroline	10.6%	41.1%	17.0%	14.1%
Washington	10.8%	43.1%	16.6%	12.5%
Average	**14.8%**	**45.3%**	**21.8%**	**15.9%**

EITC: earned income tax credit
RAC: refund anticipation check
Source: Brookings Institute; Department of Legislative Services

Chapter 8. Fiscal Impact of State and Local Credits

State and Local Credits

The fiscal impact of the State earned income credit (EIC) program has expanded significantly over time, increasing by 6.5 times in real terms since 1990 with an average annual growth rate of 9%. Significant factors contributing to this increase include the establishment and subsequent expansion of a State refundable credit, increased poverty rates, and federal earned income tax credit enhancements. In tax year 2012, a total of $302.9 million in State and local credits were claimed. **Exhibit 8.1** shows the total amount of State and local credits claimed since tax year 1987, the first year credits could be claimed.

Exhibit 8.1
State Nonrefundable (EIC), Refundable (REIC), and Local Earned Income Credits Claimed (LEIC)
Tax Year 1987-2012

Tax Year	EIC	REIC	Total State	Local	State & Local
1987	$9,724,400	$0	$9,724,400	$4,744,600	$14,469,000
1990	21,367,800	0	21,367,800	10,525,500	31,893,300
1995	51,322,000	0	51,322,000	27,517,600	78,839,600
1999	60,594,200	23,983,100	84,577,300	37,985,100	122,562,400
2000	62,537,300	40,757,800	103,295,100	38,954,300	142,249,400
2001	60,356,100	48,454,800	108,810,900	38,855,100	147,666,000
2002	62,942,900	56,919,200	119,862,100	43,230,400	163,092,500
2003	65,394,200	68,779,700	134,173,900	43,982,700	178,156,600
2004	67,749,500	80,474,400	148,223,900	46,401,300	194,625,200
2005	69,632,100	90,213,400	159,845,500	47,644,800	207,490,300
2006	70,760,800	84,373,600	155,134,400	47,833,000	202,967,400
2007	74,575,500	78,757,200	153,332,700	49,631,300	202,964,000
2008	64,994,000	119,835,100	184,829,100	43,677,200	228,506,300
2009	76,442,000	138,203,400	214,645,400	51,286,500	265,931,900
2010	78,169,600	141,029,200	219,198,800	52,621,500	271,820,300
2011	80,749,700	146,401,400	227,151,100	54,743,300	281,894,400
2012	86,988,700	157,158,000	244,146,700	58,772,000	302,918,700

Note: Data on local credits is not available before tax year 2000, the amounts shown are imputed.
Source: Comptroller's Office; Department of Legislative Services

Significant Credit Expansion in the 1990s Fueled Growth

The EIC program increased at its greatest rate during the 1990s as the number of claimants increased from 132,600 in 1990 to over 300,000 a decade later. Credits increased in real terms by over $100 million over this period, more than tripling the amount claimed in 1990. This translated to an annual rate of increase of 14%, significantly higher than the following decade's 5% annual growth.

Information is not readily available during this period on the amount of federal credits claimed by Marylanders or the participation rates, obviating a precise attribution of the sources of the increase. However, it is likely that the increase in claimants was due to several federal and State credit expansions that increased the value of the credit and enticed additional taxpayers to claim the credit, rather than an increase in the number of low-income workers and individuals in poverty, which decreased throughout the decade. Increased State participation during this period appears to have mainly been a byproduct of enhancements to the credit, as discussed below.

Congress enacted several enhancements to the federal credit during the 1990s. In addition, credit growth in the decade also reflected expansions enacted in the 1980s, specifically the Tax Reform Act of 1986 which also indexed the credit's value to inflation. The Omnibus Budget Reconciliation Act of 1990 expanded the federal credit and created a supplemental credit amount for families with at least two children, followed by the Omnibus Budget Reconciliation Act of 1993 which expanded the credit further and created a modest credit for certain childless workers.

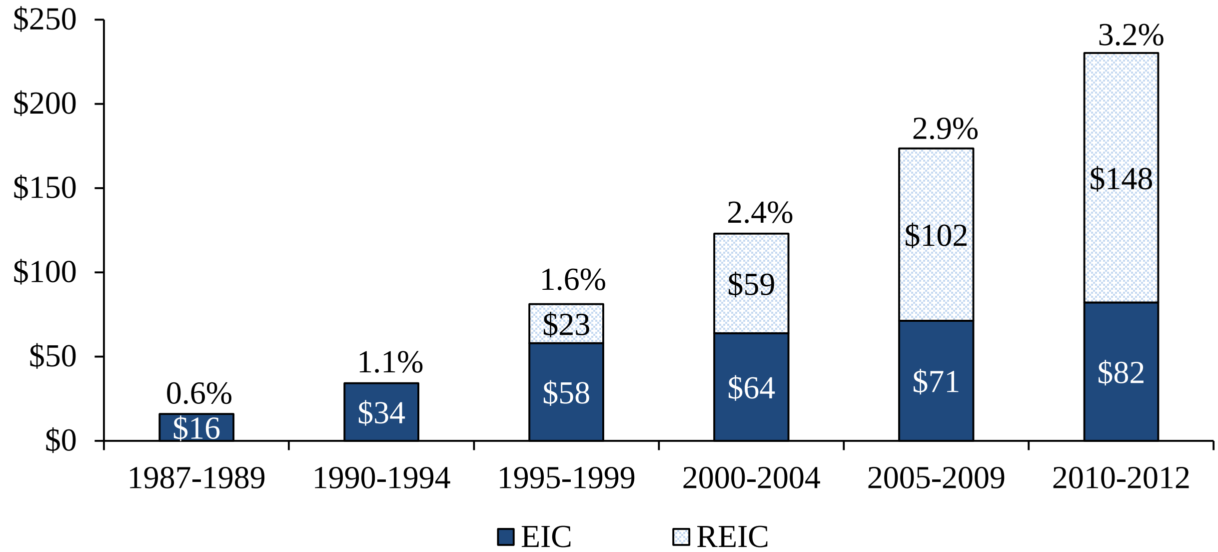
This legislation increased the maximum federal credit from $953 in 1990 to $3,888 in 2000. These enhancements generally flowed through to the State credit; accordingly, the average State credit increased in real terms from $283 to $453 over the same period. In contrast to the program's recent growth, which has been fueled by expansion of the refundable credit, the total increase in credits claimed in the 1990s was roughly split between the nonrefundable and newly established refundable credit. Claimants increased sharply after establishment of the refundable credit, thereby increasing the program's rate of participation.

Program Growth Since 2000

Exhibit 8.2 shows the growth in State earned income credits since the program's inception. Refundable credits contributed to more than 80% of the total increase since tax year 2000 and largely reflects several State enhancements increasing the percentage value from 10% in its first year to 25% through tax year 2014. In addition to these increases, Chapter 389 of 2014 phases in over four years an increase in the value of the credit to 28%, beginning in tax year 2015.

As a percentage of total personal income tax revenues, State credits increased from an average of 0.6% in tax years 1987 through 1989 to an average of 3.2% in tax years 2010 through 2012, as shown in Exhibit 8.2.

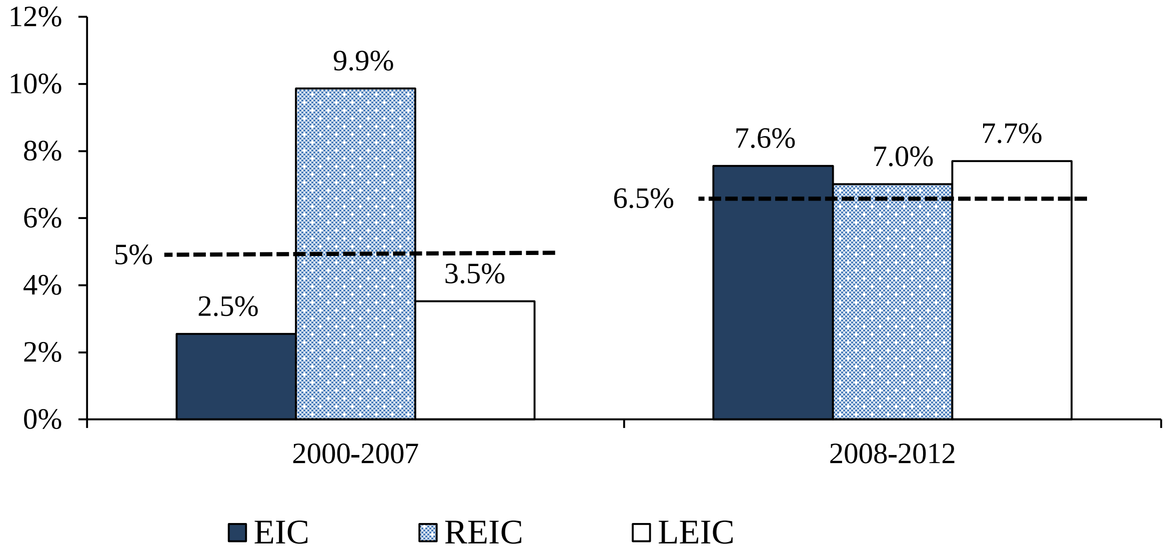
Exhibit 8.2
Average Total State Credits Claimed
Tax Years 1987-2012
($ in Millions)



EIC: earned income credit
REIC: refundable earned income credit
Note: Amounts are expressed in nominal dollars and are not adjusted for inflation. Refundable claims in 1995-1999 represent tax years 1998-1999 only, the first years in which the credit were available.
Source: Comptroller's Office; Department of Legislative Services

Exhibit 8.3 shows the growth rates of the refundable, nonrefundable, and local earned income credits compared to the increase in federal credits claimed by Maryland residents in two periods – from 2000 to 2007 and since 2008. The latter period reflects an increase in the value of the refundable credit, federal enhancements, and the impact of the Great Recession. State and local growth rates are slightly above the federal credit in the second period while growth in the refundable credit significantly outpaces all other growth rates in the first period. After adjusting for inflation, the amount of nonrefundable credits claimed through 2010 was roughly constant before increasing more rapidly thereafter.

Exhibit 8.3
Federal, State, and Local Credit Annual Growth Rates
Tax Year 2000-2012



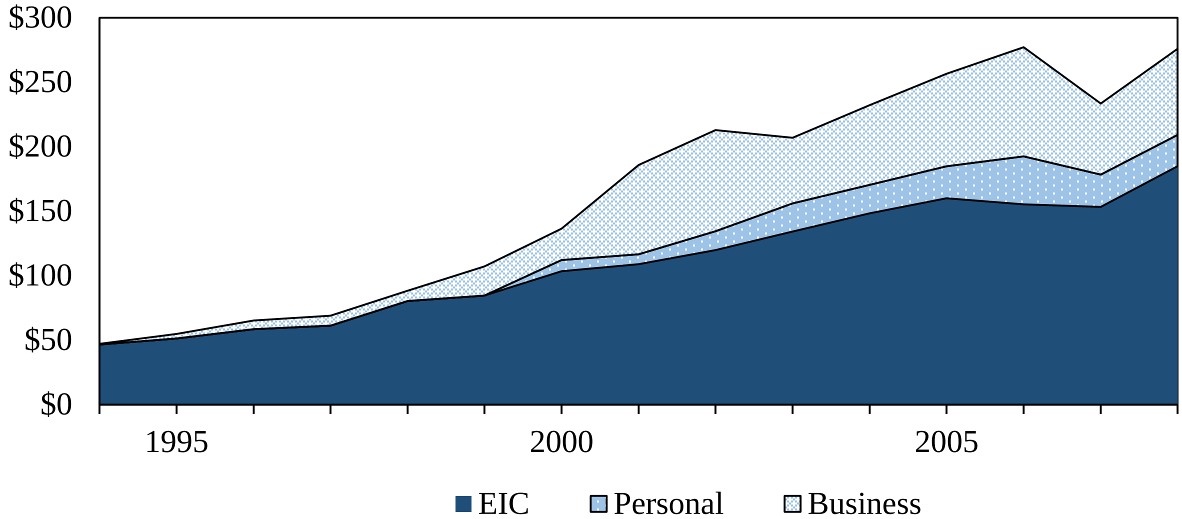
EIC: earned income credit
LEIC: local earned income credit
REIC: refundable earned income credit
Notes: Amounts are expressed in nominal dollars and are not adjusted for inflation.
Dashed line represents growth in total federal credits claimed by Maryland residents.

Source: Comptroller's Office; Internal Revenue Service; Department of Legislative Services

Credit Expenditures Relative to Other Tax Expenditures

The earned income credit is significantly larger in scope than all other State income tax credits except for the tax credit for taxes paid to other states, which is a structural tax credit necessary to prevent double taxation of income. In tax year 2012, a total of 405,600 residents claimed either the State refundable or nonrefundable earned income credit. The State poverty level (38,800 taxpayers), child and dependent care expenses (26,200), quality teacher incentive (6,200), and long-term care insurance (4,300) credits have the next highest utilization, with these credits totaling about $17.5 million in tax year 2012. A total of 1,300 residents claimed all other personal tax credits in the amount of $2.9 million in tax year 2012. **Exhibit 8.4** compares the total State earned income credits claimed to all other personal tax credits and business tax credits in tax years 1994 through 2008. Although the number and amount of other credits has grown considerably since 1994, earned income credits constituted the significant majority of credits claimed during this period and continued to comprise a little more than two-thirds of all credits in tax year 2008.

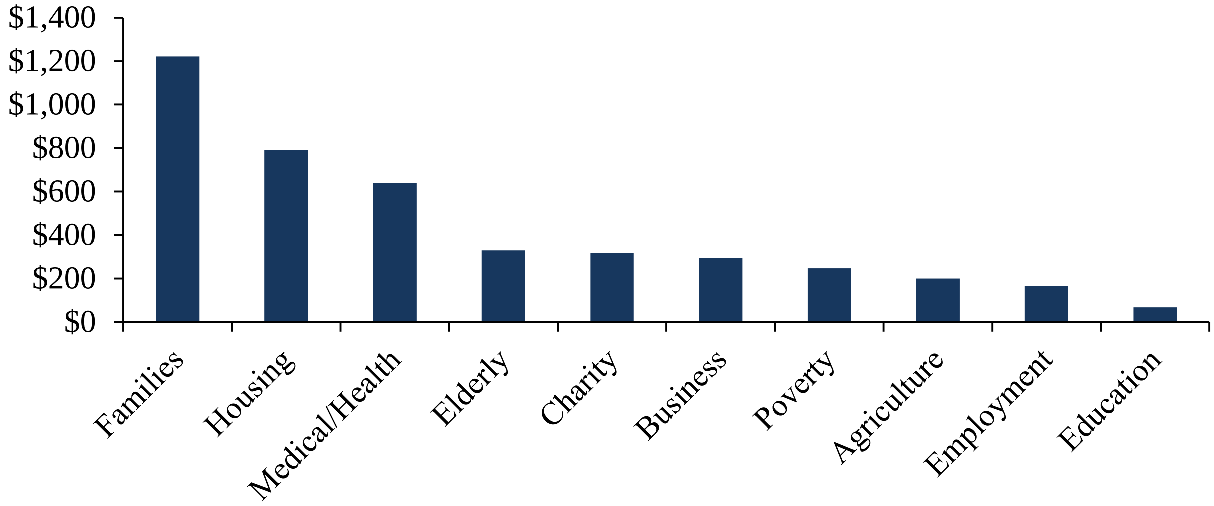
Exhibit 8.4
Earned Income Credit, Personal, and Business Tax Credit Claims
Tax Years 1994-2008
($ in Millions)



EIC: earned income credit
Notes: Amounts are expressed in nominal dollars and are not adjusted for inflation. Figures do not include the tax credit claimed for taxes paid to other states. Certain business tax credits reflect amounts certified and not actual amounts claimed.
Source: Comptroller's Office; Department of Legislative Services

Although the State EIC is an outsized credit compared to other tax credits, its magnitude lessens significantly compared to other tax expenditures. Tax expenditures are a broader measure including all tax preferences (such as credits and exemptions) which lead to foregone State revenue. Tax preferences can be structural components of a tax (available to most or all taxpayers such as personal income tax deductions and personal exemptions) or targeted toward a specific population or objective. The Department of Budget and Management publishes biennially an estimate of the amount of revenue foregone resulting from tax expenditures by category and tax impacted. **Exhibit 8.5** shows the top 10 categorical tax expenditures in fiscal 2014 – tax expenditures specifically targeted to alleviate poverty (including the poverty level credit) are the seventh highest tax expenditure. It should be noted that not all of the tax expenditures are mutually exclusive, as other categorical tax expenditures assist low-income individuals. For example, some of the benefit of the sales tax exemption for food consumed off premises (included as a family expenditure) also helps low-income individuals.

Exhibit 8.5
Top 10 Tax Expenditure Categories
Fiscal 2014
($ in Millions)



Source: Department of Budget and Management, *Maryland Tax Expenditure Report, Fiscal 2014*

Exhibit 8.6 shows by county the number of taxpayers who claimed either the State or local earned income credit, the total amount of credits claimed, and the percentage of all taxpayers who claimed the credit. Exhibit 8.6 also shows total credits claimed as a percentage of net State income tax revenues collected in the county.

Fifteen percent of tax returns, or a little more than 1 in 7 returns overall, claimed the credit in tax year 2012, with the incidence of the credit widespread across urban, suburban, and rural areas. The two jurisdictions with the highest utilization of the credit, with a little more than 1 in 4 returns claiming the credit, are Baltimore City (population 622,100) and Somerset County (26,500). In addition, residents are 20% more likely to claim the credit in Prince George's County, Western Maryland, and five out of the nine Eastern Shore counties. Residents are less likely to claim the credit in Montgomery, Kent, Talbot, and Queen Anne's counties and Southern and Central Maryland. Even within high-income counties with the lowest percentage of claims, Carroll and Howard counties, the credit is claimed by 1 in 13 tax returns.

The ratio of refundable to nonrefundable claims is fairly consistent across counties – on average, refundable credits comprise 65% of all claims, with a low of about 62% in higher-income Queen Anne's, Carroll, and Frederick counties and a high of 68% in Baltimore City. Claims in three counties – Prince George's, Montgomery, and Baltimore counties – and Baltimore City, which has the highest total claims, account for a little less than two-thirds of the total credits claimed. The amount of claims mostly reflects the higher population of these jurisdictions relative to other counties.

Exhibit 8.6
State Earned Income Credits Claimed by County
Tax Year 2012

County	Claimants	EIC	REIC	Total	% of Total Taxpayers	% of Total Taxes
Allegany	5,781	$1,128,600	$2,103,700	$3,232,300	19.7%	8.3%
Anne Arundel	27,763	5,921,600	9,729,100	15,650,700	11.0%	2.1%
Baltimore City	71,848	15,059,800	31,817,900	46,877,700	28.9%	12.6%
Baltimore	58,441	12,676,600	21,722,900	34,399,500	14.8%	3.5%
Calvert	4,341	902,600	1,581,900	2,484,500	10.5%	2.3%
Caroline	3,002	654,800	1,202,900	1,857,700	21.2%	10.1%
Carroll	7,001	1,398,900	2,268,400	3,667,300	8.9%	1.9%
Cecil	6,561	1,422,400	2,459,200	3,881,600	15.0%	6.1%
Charles	8,703	1,895,200	3,236,800	5,132,000	12.8%	3.5%
Dorchester	3,771	769,500	1,513,500	2,283,000	25.5%	12.2%
Frederick	11,845	2,478,800	3,967,700	6,446,500	10.6%	2.3%
Garrett	2,411	490,400	849,600	1,340,000	18.1%	7.4%
Harford	12,930	2,720,200	4,627,300	7,347,500	11.0%	2.7%
Howard	11,986	2,395,400	4,351,900	6,747,300	8.8%	1.3%
Kent	1,285	258,500	467,400	725,900	14.5%	4.0%
Montgomery	55,640	11,084,100	20,763,500	31,847,600	11.6%	1.7%
Prince George’s	73,242	16,094,800	27,864,200	43,959,000	17.7%	6.6%
Queen Anne’s	2,427	509,900	816,400	1,326,300	10.9%	2.4%
St. Mary’s	5,618	1,145,000	2,199,400	3,344,400	12.0%	2.9%
Somerset	2,338	481,000	939,000	1,420,000	27.9%	16.5%
Talbot	2,566	539,700	925,100	1,464,800	14.1%	2.8%
Washington	11,798	2,496,500	4,285,600	6,782,100	17.8%	6.2%
Wicomico	9,917	2,120,800	3,993,800	6,114,600	23.4%	10.6%
Worcester	4,370	831,400	1,589,300	2,420,700	16.3%	5.6%
Resident Total	**405,585**	**$85,476,500**	**$155,276,500**	**$240,753,000**	**15.0%**	**3.6%**
Out of State	**9,896**	**$1,512,300**	**$1,881,500**	**$3,393,800**	**5.6%**	**0.9%**
Total	**415,481**	**$86,988,700**	**$157,158,000**	**$244,146,800**	**14.4%**	**3.4%**

EIC: earned income credit
REIC: refundable earned income credit
Source: Comptroller’s Office; Department of Legislative Services

Local Costs

Although legislation establishing the nonrefundable credit did not explicitly create a credit against local income taxes, the State credit reduced local income taxes as well. While no county has provided a refundable credit that can be claimed with the income tax return in the method provided under State law, Montgomery County's Working Families Income Supplement Program acts as a grant program by supplementing the State REIC received by the taxpayer. Montgomery County estimates that the program will provide $18.3 million in refunds to 34,800 recipients in fiscal 2015.

Exhibit 8.7 shows by county the number of local earned income credit claimants in tax year 2012, total amount claimed, and percentage of all taxpayers who claim the local credit. Exhibit 8.7 also shows the estimated percentage of total local income tax revenues foregone under the program. On average counties forgo 1.3% of income tax revenues, with a minimum of less than 1.0% in several counties to a maximum of slightly over 5.0% in Somerset County.

Exhibit 8.7
Local Earned Income Credits Claimed by County
Tax Year 2012

County	Claimants	Total Claims	Percent of Total Taxpayers	Percent of Total Income Tax Revenues
Allegany	3,374	$779,709	11.5%	3.0%
Anne Arundel	18,067	3,350,055	7.1%	0.8%
Baltimore City	47,182	11,129,201	19.0%	4.1%
Baltimore	38,665	8,167,516	9.8%	1.3%
Calvert	2,744	575,232	6.6%	0.8%
Caroline	1,911	393,866	13.5%	3.3%
Carroll	4,317	963,687	5.5%	0.8%
Cecil	4,148	906,259	9.5%	1.7%
Charles	5,691	1,250,909	8.4%	1.2%
Dorchester	2,381	465,760	16.1%	4.0%
Frederick	7,564	1,663,888	6.7%	0.9%
Garrett	1,430	294,524	10.7%	2.6%
Harford	8,343	1,893,567	7.1%	1.0%
Howard	7,581	1,748,787	5.5%	0.4%
Kent	795	168,111	9.0%	1.7%
Montgomery	36,042	8,115,469	7.5%	0.6%
Prince George’s	50,231	11,780,488	12.1%	2.3%
Queen Anne’s	1,522	370,630	6.9%	0.8%
St. Mary’s	3,518	785,747	7.5%	0.9%
Somerset	1,438	347,772	17.1%	5.2%
Talbot	1,649	276,346	9.1%	1.3%
Washington	7,387	1,588,793	11.2%	2.3%
Wicomico	6,402	1,516,894	9.7%	3.3%
Worcester	2,660	238,767	6.3%	1.7%
Total	**265,042**	**$58,771,977**	**9.6%**	**1.3%**

Note: Refundable grants made under the Montgomery County Working Families Income Supplement Program are not included.

Source: Comptroller’s Office; Department of Legislative Services

Future Fiscal Impact

The credit's future fiscal impact will likely be shaped by the program's recent influences, including:

- State and federal legislation altering the credit;
- participation and improper payment rates;
- demographic and economic changes impacting population, poverty, and lower-income wages;
- indexation of federal credit components to inflation; and
- federal, State, and local income tax changes.

Chapter 389 of 2014 increases the percentage value of the refundable credit from 25% to 28%; this increase is phased in over four years beginning with tax year 2015. It is estimated that this enhancement will reduce State revenues by $4.2 million in fiscal 2016 and by $26.6 million when the full increase occurs in fiscal 2019.

Federal legislation enacted in 2010 and 2012 extended the American Recovery and Reinvestment Act's of 2009 (ARRA's) provisions – a portion of the increased phase out for married couples ($3,000 or $5,000, indexed for inflation) was made permanent, but other provisions expire in 2017. After 2017, workers with three or more qualifying children will receive the same credit as similarly situated workers with two qualifying children, and the phase-out range for married couples will begin at $3,000 above the level for unmarried workers. Under current law, the U.S. Joint Committee on Taxation estimates that federal credits will increase by 1.4% annually through federal fiscal year 2017 before decreasing by a little more than 3.0% in the next fiscal year, reflecting the termination of ARRA's remaining benefits.

Numerous changes to the federal EITC program have been proposed by the U.S. Congress and President, think tanks, and advocates. The President's federal fiscal year 2015 budget proposed to permanently extend the remaining ARRA enhancements and expand the credit for individuals without children by increasing the value, increasing the age limit, and simplifying eligibility rules. The U.S. Treasury estimates that the proposals will increase federal claims by about 10% in federal fiscal years 2016 through 2018 and by about 15% beginning in fiscal 2019. U.S. Representative Paul Ryan recently introduced a similar plan.

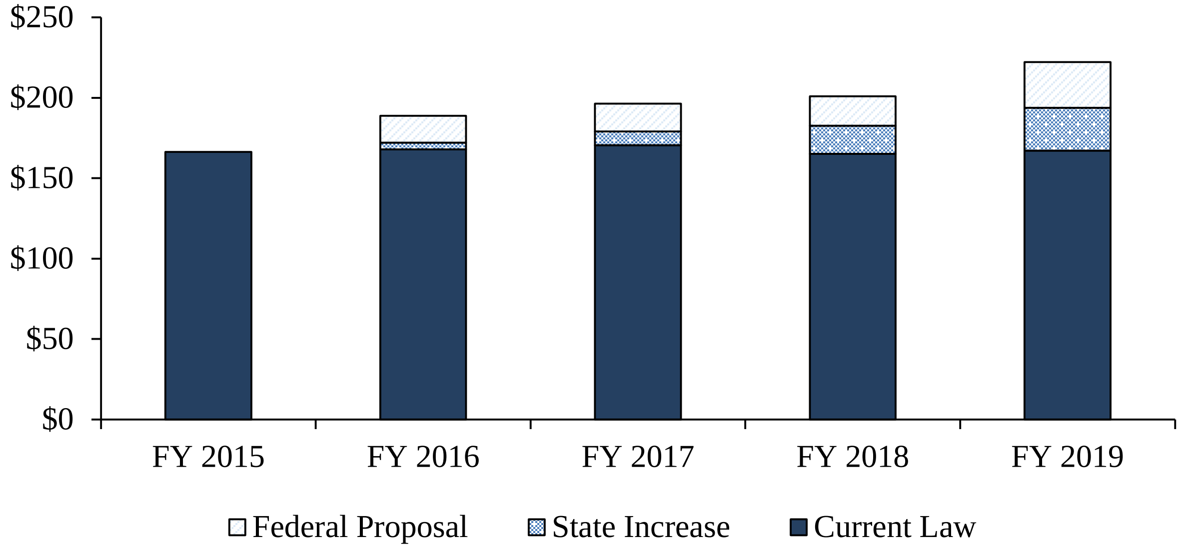
Exhibit 8.8 shows the estimated refundable credits that will be claimed in fiscal 2015 through 2019 including the amount of additional credits resulting from Chapter 389. It also shows the impact on total claims if federal legislation extends ARRA's provisions and enhances the credit for individuals without children. Under current law, claims will increase from about $170 million in fiscal 2015 to slightly under $200 million in fiscal 2019. Federal legislation expanding the credit for childless individuals will increase claims by a little more than $15 million annually and extending ARRA's provisions will increase claims by another $15 million beginning in fiscal 2019. These proposed changes will also increase nonrefundable State and local credits, but the limitation of these credits' values to tax liability will impact the credits less.

Exhibit 8.8

Estimated Refundable Credits Claimed

Fiscal 2015-2019

($ in Millions)



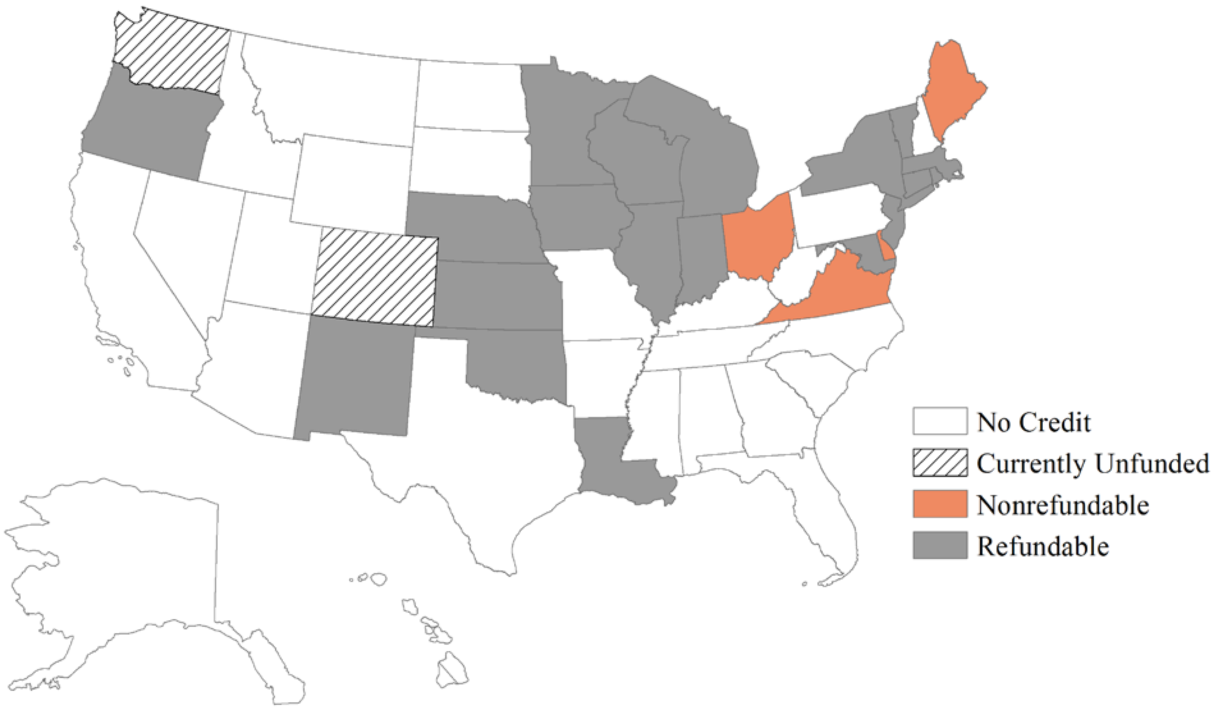
Source: Comptroller's Office; U.S. Joint Committee on Taxation; U.S. Treasury; Department of Legislative Services

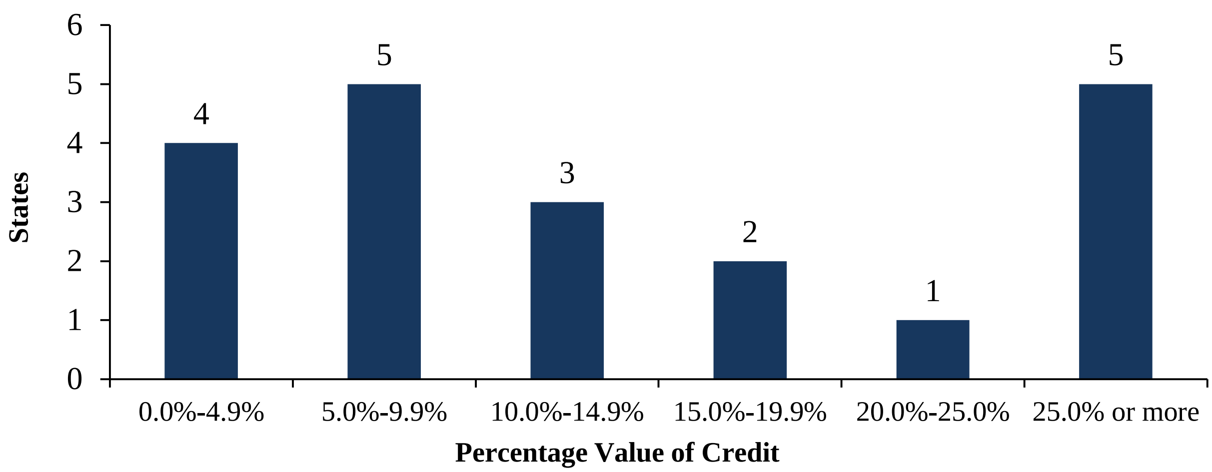
Chapter 9. Overview and Comparison of Credits in Other States

Credits in Other States

Twenty-five states and the District of Columbia currently have a state earned income credit (EIC) that supplements the federal credit, with state credits totaling about $3 billion. All but four of these states – Delaware, Maine, Ohio, and Virginia – have a refundable credit or refundable component. In two states, Washington and Colorado, the program is currently suspended due to a lack of funding. **Exhibit 9.1** illustrates the states with an EIC program by type of credit and shows the distribution of states by the value of the refundable credit. **Appendix 5** contains information on state EIC programs in calendar 2014.

Exhibit 9.1
State Earned Income Credits and Distribution of Refundable Credit Values
Calendar 2014





Source: Center on Budget and Policy Priorities; Internal Revenue Service, Institution on Taxation and Economic Policy; Department of Legislative Services

Basis of State Credit

Three components generally determine the potential value of a state credit relative to the federal credit claimed by the individual:

- **Conformity:** Does the state conform to federal eligibility standards, reduce the number of claimants by imposing additional restrictions, or increase claimants by extending eligibility to individuals who do not qualify for the federal credit?

- **Percentage Value:** The greater the percentage value of a state credit, the greater potential benefit to an individual.

- **Refundability:** Refundable credits allow an individual to receive a refund (cash payment) in addition to any reduction in tax liability if the credit exceeds the tax liability imposed in the year, thereby increasing the value of the credit.

Factors other than the percentage value of the credit, eligibility standards, and refundability impact the effectiveness of a state program including demographic and economic trends, implementation, and changes/differences in income tax burdens for low-income individuals. These factors may not always be easily identified and quantified, but should be considered when comparing programs in different states or the Maryland credit throughout the years due to variation over time and across states.

Credit implementation factors include differences in participation and improper payment rates and the incidence of refund anticipation products. As discussed in this report, there are questions about the accuracy of the limited state-level data available for some of these factors. A high improper payment rate will erode some of the benefits provided in a state with an enhanced credit relative to other states. Differences in family structures will also impact the credit as the credit provides a higher value credit to larger families relative to households with fewer or no qualified children.

Given significant differences in the cost of living among states, the impact of $1 in assistance will vary from state to state. The cost of living also impacts the amount of credit claims indirectly through its impact on wages. A lower amount of credit claims in one state can reflect lower wages and the cost of living rather than these individuals being worse off than similarly situated individuals in other states.

Changes and differences in low-income tax burdens will alter the impact of EIC programs. Comparing the amount of credits claimed across states reflects only the impact of the credit and is not a comprehensive analysis of low-income taxpayer burdens. Tax increases can reduce refunds and increase claims in nonrefundable states. Measuring the amount of refunds provided over time can provide a clear picture; however, this data is not available for most states. For all of these reasons described here, more claimants and/or credits do not necessarily demonstrate a superior credit.

The majority of states have established a refundable credit based on federal eligibility criteria as discussed below.

Calculation and Refundability

Every state except Minnesota determines its credit as a percentage of the total federal credit claimed by the individual – a taxpayer's state credit is equal to a portion of the federal credit. The Minnesota Working Family Credit is calculated without regard to the federal credit, though it is equal to a percentage of the taxpayer's earned income received during the year.

Most states conform to federal eligibility standards – individuals who claim the federal credit are eligible to claim the state credit. Childless individuals may not claim Wisconsin's credit, and Ohio limits the credit's value for those taxpayers whose net taxable income is greater than $20,000. The District of Columbia extends eligibility of its credit to certain noncustodial parents aged 18 to 30 years old who are not eligible for the federal credit, if the parent is current with court-ordered child support payments. Some states that also have similar low-income or poverty tax credits specify that an individual cannot claim both credits, so in most instances individuals claim the higher value EIC.

Given that low-income individuals typically have little or no tax liability, researchers have concluded that refundability is a key component of EIC programs. Other than the four states with a nonrefundable credit only Rhode Island and Maryland currently have separate refundable and nonrefundable credits, but beginning in tax year 2015 Maryland is the only state. The fiscal 2014 Rhode Island budget converted its credit to a fully refundable credit only equal to 10.0% of the federal credit. The typical refundable credit is equal to 13.7% and ranges from a minimum of 4.0% in Louisiana to a maximum of 40.0% in the District of Columbia. Maryland has an above average value credit as the percentage value of the refundable credit is the sixth highest. This does not take into account the nonrefundable State and local credits. Comparing across states the percentage of total State credits claimed relative to the federal amount claimed by residents suggests that Maryland's State credit is the fourth highest value credit.

Trends Over Time

Since Rhode Island established the first state program in 1986, the number of states with a credit expanded rapidly in the 1990s in the midst of federal welfare reform policies. By 2000, 16 states had established a program (11 with refundable credits). There was a net increase of 7 states through 2008, for a total of 23 states. The number of states has increased slightly since the Great Recession, but recent actions have been more ambiguous. **Exhibit 9.2** shows the states in which the credit has recently been expanded, established, decreased, or terminated. Based on information from the National Conference of State Legislatures, 7 states have increased the value of the credit with 3 states reducing the credit value since 2009. Ohio established a limited 5% nonrefundable credit, while North Carolina decreased then terminated its credit effective in tax year 2014. Recent actions reflect policy choices, constrained budgets, and legislative actions that were part of larger tax overhauls.

Exhibit 9.2
State Earned Income Credit Legislative Actions
2009-2013

Increase	New	Decrease	Terminate
Connecticut	Ohio	Michigan	North Carolina
Illinois		New Jersey	
Indiana		Wisconsin	
Iowa			
Minnesota			
Oregon			
Kansas			

Notes: Does not include legislation which increased the state credit in states that required action to conform to recently enacted federal legislation or include a decrease if the action was temporarily delaying a recently enacted increase.

Source: National Conference of State Legislatures; Department of Legislative Services

Credits in Surrounding States

The Maryland EIC is more generous than the nonrefundable credits in Delaware and Virginia and the credit in New Jersey but provides less than the 40% refundable credit in the District of Columbia, the highest value credit in the United States. **Exhibit 9.3** compares the impact of the federal credit in Maryland and its surrounding states and also has information on state EIC programs.

Exhibit 9.3
Federal and State Earned Income Credits in Maryland and Surrounding States
Tax Year 2012
($ in Millions)

	Federal Credit		State Credit			
	Claimants	**Total Claimed**	**(% of Federal)**	**Enacted**	**Claimants**	**Total Claimed**
Pennsylvania	942,080	$1,976.0		*No Credit*		
New Jersey	599,320	1,302.4	20%	2000	547,300	$239.7
Virginia	624,030	1,373.9	20%*	2004	325,254	117.3
West Virginia	159,830	341.1		*No Credit*		
Delaware	74,540	165.5	20%*	2005	52,876	8.0
District of Columbia	55,410	122.9	40%	2000	58,166	57.5
Maryland	**425,080**	**930.6**	**25%/50%**	**1998**	**405,629**	**$244.1**

*Nonrefundable credit
Note: New Jersey state data is for tax year 2011.
Source: Internal Revenue Service; various state departments of revenue; Department of Legislative Services

State EIC Over Time and Compared to Other States

Federal and State legislation enacted since the inception of the program has significantly expanded the State EIC program. In addition, demographic and economic trends have impacted the program including changes in family structure and the impact of the recent recession which has increased the number of individuals in poverty while decreasing employment rates and labor force participation of low-income individuals.

Based on an analysis of the average amount of real (adjusted for inflation) taxes reduced and refunded (cash provided), the benefit provided by Maryland's EIC:

- has increased over time;
- has increased relative to the benefit provided by the federal credit;
- is greater than that in all but a handful of other states; and
- now provides a greater amount of refunds.

There is some evidence, however, that the headwinds generated by long-term trends and the Great Recession, which decreased the employment of low-income individuals, has reversed some of these gains.

Although EIC claimants and credits have increased over time and particularly since the Great Recession, so has the number of low-income individuals and residents in poverty. In addition, claimants and credits vary across jurisdictions, reflecting differing poverty rates and low-income population characteristics. The U.S. Census Bureau does not identify the working poor or population that is eligible to claim the earned income credit, and the Internal Revenue Service (IRS) has struggled to calculate the population that is eligible to claim the credit. Research suggests, however, that a readily available proxy is the estimated number of individuals with incomes that are 200% or less of the poverty threshold. This population will be referred to as low-income individuals, as it includes all individuals (children, adults, and the elderly). The population is greater compared to the number of EIC claimants, which is generally claimed by households. The population is also wider in scope because it includes *all* low-income individuals, not just those that have a job or who are otherwise eligible to claim the credit.

In order to assess the Maryland credit relative to credits in other states, the Department of Legislative Services (DLS) collected data on federal and state credits claimed in states with EICs. Although the IRS reports information on the federal credit for each state, no central data is available for state credits. DLS compiled information on state claims in 15 states, but could not readily obtain information on the amount of refunds. This data is used to estimate if Maryland's high-value credit has a higher participation rate and provides additional assistance to the low-income population. There is no information on the participation rates of state credits. The number of state credit claimants in each state relative to how many taxpayers claim federal credits will be a proxy – it does not equal the state participation rate given individuals are less likely to file state returns but measures the reach of the benefit provided by the state credit relative to that delivered by the federal credit. The second approach compares the amount of state credits awarded relative to the federal credits, assessing the additional benefit provided by the state program. This reflects both the generosity of the state credit provided to each individual claiming the credit as well as the participation rate for the State credit relative to the federal credit.

In addition, unique aspects of Maryland's EIC program include (1) the establishment of both a refundable and nonrefundable credit; (2) a credit that can be claimed against local income taxes; and (3) a local grant that can be claimed by residents of its most populous county. These increased benefits should entice additional participants relative to a stand-alone state credit. Other factors could decrease the credit's effectiveness in Maryland relative to other states, including its high cost of living. The Massachusetts Institute for Technology calculates that the living wage in Maryland is $11.79. In order to make ends meet, residents of West Virginia require one-third less ($8.01) than Marylanders and 40% less than the amount required in Montgomery County.

The approach employed here differs from academically minded pursuits that attempt to control for all variables in order to isolate the impact of one policy change on outcomes. Rather, it assesses the Maryland credit based on changes in conditions over time and across regions. During the time period federal and State legislation enhanced the credit, but joblessness and underemployment increased among low-income population, potentially negating the benefits of enhancing the credit. Similarly, the Maryland credit is compared to other states, given that other factors such as participation and eligibility may differ in each state.

Recent State and Federal Credit Enhancements

Recent federal and State legislation enacted just prior to 2008 and in the midst of the Great Recession (2009) boosted the amount of money provided to low-income Marylanders during the severe economic downturn that significantly increased the incidence of poverty, joblessness, and underemployment. The Tax Reform Act of the 2007 special session (Chapter 3) enacted significant changes to the State personal income tax, including an expansion of the refundable earned income credit. Chapter 3 increased from 20% to 25% the percentage value of the credit and extended eligibility to individuals without dependents who could previously only claim the State and local nonrefundable credits. As in other states, the recession's negative impact on State finances required the State to reduce spending and raise revenue in order to balance the budget. Unlike several other states in the midst of these fiscal pressures, Maryland did not delay an increase in the credit or reduce the credit outright.

From 2007 to 2012, the number of State claimants and total credits claimed increased by twice as much as the increase in federal claimants and credits claimed over the same period, likely driven by the State enhancement. Over this period, federal claimants increased by 14% and total credits increased by 21% compared with 29% and 43%, respectively, for the State credit. **Exhibit 9.4** shows the change in the amount of State nonrefundable, refundable, and local credits claimed by residents relative to the amount of federal credits claimed by residents since 1999. For every federal dollar claimed by a resident in the first period shown below, the State credit eliminated 11.7 cents in State taxes and provided 9.9 cents in refunds for a State total of 21.6 cents. In the latter period, the amount of State refunds increased to 16.5 cents for every federal dollar for a State total of 25.6 cents, as shown in Exhibit 9.4.

Exhibit 9.4
State Tax and Local Tax Reductions and State Refunds
As a Percentage of Federal Credits
Calendar 1999-2012

Year	EIC	REIC	Total State	Local	Total
1999-2004	11.7%	9.9%	21.6%	7.7%	29.3%
2005-2007	11.0%	12.9%	23.9%	7.4%	31.4%
2008-2012	9.1%	16.5%	25.6%	6.1%	31.7%

EIC: earned income credit
REIC: refundable earned income credit
Source: Comptroller's Office; Internal Revenue Service; Department of Legislative Services

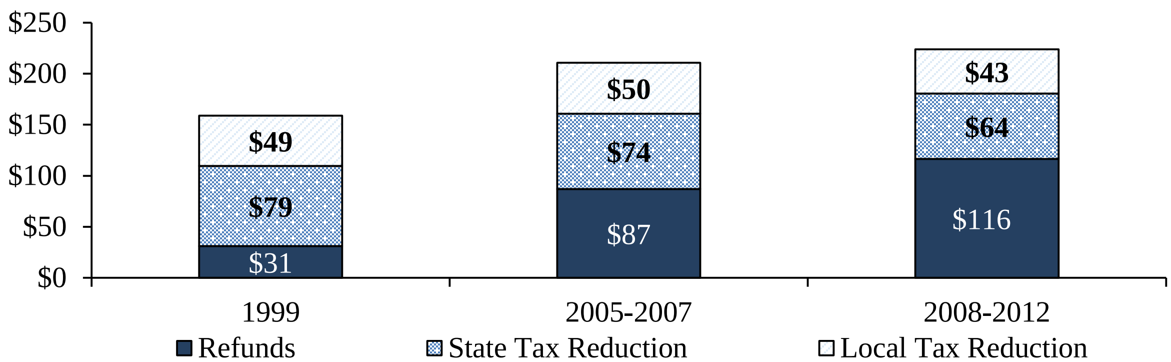
The American Recovery and Reinvestment Act of 2009 (ARRA) temporarily expanded the federal credit by increasing the credit for taxpayers with three or more children and increasing phase outs applicable to all married couples. The Budget Reconciliation and Financing Act of 2009 (Chapter 487) overrode the State's automatic decoupling provision for three Internal Revenue Code amendments enacted by ARRA, including clarification that the State did not decouple from the enhanced earned income credit enacted by ARRA. Enhancements to the State credit, including federal enhancements to which the State conformed, provided roughly an additional $40 million in refunds to low-income individuals in tax year 2012.

Exhibit 9.5 shows the amount of State and local tax reduction as well as refunds (cash) provided by the State program since 1999, adjusted for the number of individuals with incomes below 200% of the poverty level and for inflation. In 1999, the credit eliminated an average of $128 in State and local taxes for each low-income individual and provided an average refund of $31. The expansion of the refundable credit to childless taxpayers and the increase in the value of the credit from 10% to 25% over this period, along with federal enhancements and other factors, nearly quadrupled the average amount of cash refund provided to each low-income person in Maryland, equaling an average of $116 in 2008 through 2012. Thus, although the number of low-income individuals has increased, the value of the benefit provided for each low-income person in the State has also increased over time. This also accounts for individuals who do not claim the credit but does not account for improper payment rates, which reduce the actual effectiveness of the credit but have been relatively unchanged over time. It is worth noting that the State credit is a supplement to the federal credit, which provides a substantially higher benefit amount. The average federal refund over this period also increased by about 10% to $610. The combined amount of refunds (federal and State) increased from $587 to $726, an increase of nearly one-quarter.

Exhibit 9.5

State and Local Tax Reductions and State Refunds Per Capita (Low-income Population)

Calendar 1999-2012



Note: Low-income population is the number of individuals with incomes below 200% of the poverty threshold in the year.

Source: U.S. Census Bureau; Comptroller's Office; Internal Revenue Service; Department of Legislative Services

The recession significantly increased poverty rates and created historically weak labor market conditions, including a large increase in the long-term unemployed. The labor force participation rates have not returned to pre-recession levels. The recovery has also failed to recoup these job losses, as many individuals exit the labor force after fruitless job searches. The U.S. Federal Reserve described the rate of adults not in the labor force as unprecedented in the postwar era.

Although the real benefit provided by the credit has increased over time relative to the entire low-income population, there is evidence that these gains are being eroded, as joblessness has increased among low-income individuals. The peak average federal and State refund (per low-income person) occurred in 2009 and has decreased in every year since. In 2012, the average benefit was 10% less than the 2009 amount and lower than the amount provided in 2008. The value of the credit increases beginning in tax year 2015. It is not clear whether this enhancement will be sufficient to offset the negative impacts of increased poverty and joblessness. Since 1999 however, evidence suggests that credit enhancements and increased State participation have been greater than the drag of increased joblessness. The average benefit has increased over time, and the number of claimants relative to the total low-income population has not decreased.

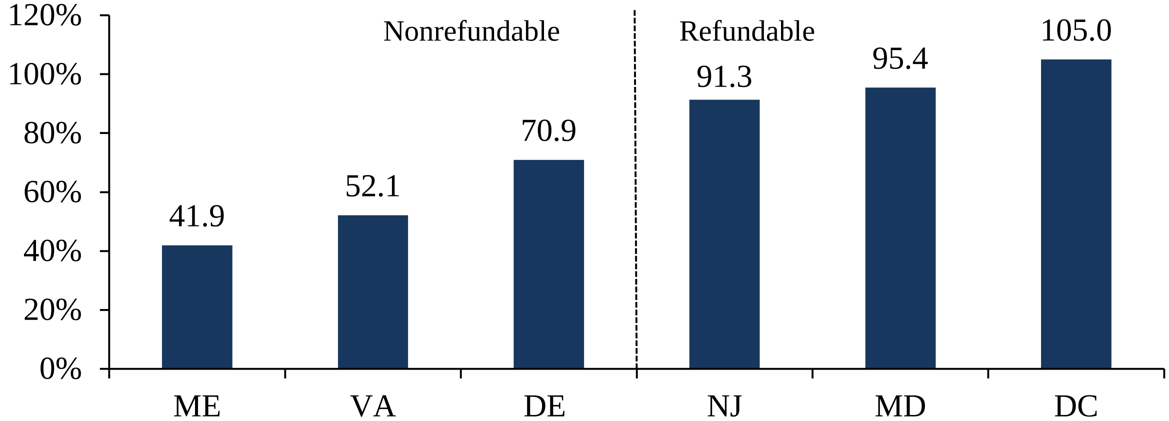
Maryland Credit Benefit Compared to Other States

DLS compiled information on claimants and total credits claimed in 15 other states with earned income credits and combined the available information with IRS data reporting the number of claimants and federal credits claimed in each state. This data was used to assess the number of people who receive assistance under the program and the additional supplement provided to each claimant.

Refundability is a Key Component of An Effective Credit

Many low-income individuals have little or no tax liability. About 140,400, or a little less than one-half of the taxpayers who claimed the State refundable credit, did not have any tax liability. Two of the four states – Delaware, Maine, Ohio, and Virginia – with a nonrefundable credit are surrounding states. **Exhibit 9.6** compares the number of individuals who claim a state credit relative to those that claim the federal credit in three nonrefundable states with available data to the refundable credits in Maryland, New Jersey, and the District of Columbia. The total number of state claimants relative to federal claimants is significantly lower in nonrefundable states compared to relative participation rates that exceed 90% in New Jersey, Maryland, and the District of Columbia. In addition, Delaware's relative participation rate is overstated because that state's Department of Finance advises that the total claimants reported includes individuals who do not receive any benefit due to a lack of tax liability. The District of Columbia's rate in excess of 100% reflects its credit's expanded eligibility to noncustodial parents – this could also reflect other factors such as relative differences in participation and improper payment rates.

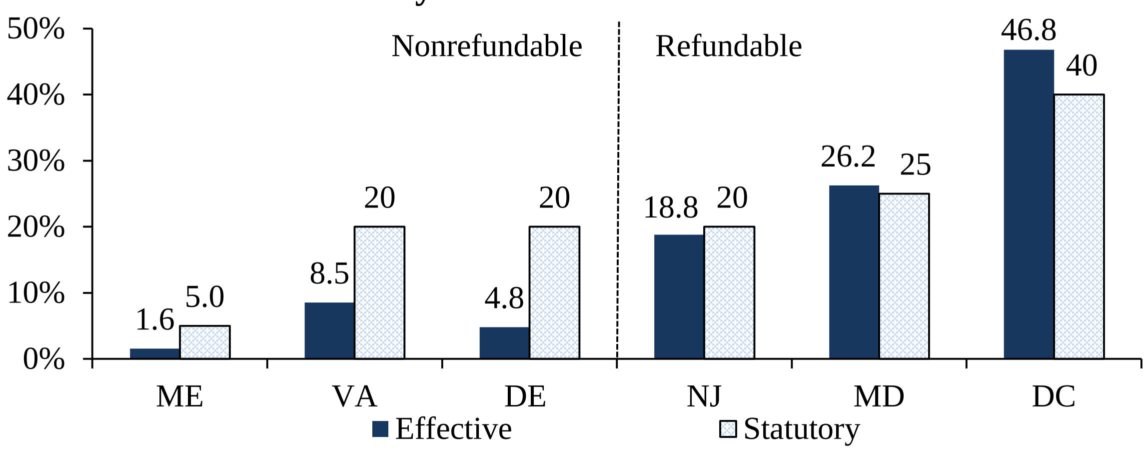
Exhibit 9.6
Relative State Participation Rates
Percentage of State to Federal Claimants



Note: New Jersey is tax year 2011 data.
Source: Internal Revenue Service; various state departments of revenue; Department of Legislative Services

Exhibit 9.7 illustrates the additional supplement provided by each state credit relative to the percentage value of the credit established under state law. Although the value of the credit is equal in New Jersey, Delaware, and Virginia (20%), nonrefundability in the latter two states significantly reduces the total amount of credits relative to the statutory rate. The ratio of state to federal credits claimed in New Jersey is close to its statutory rate and exceeds it in Maryland and the District of Columbia, reflecting the additional impact of the nonrefundable credit and expanded eligibility, respectively.

Exhibit 9.7
Statutory and Effective State EIC Rates



EIC: earned income credit
Source: Internal Revenue Service; various state departments of revenue; Department of Legislative Services

The benefit provided by Maryland's credit is significantly higher relative to the nonrefundable credit states. For every dollar of federal credit claimed in tax year 2012:

- Delaware, Maine, and Virginia reduce state tax liabilities by between 1.6 cents and 8.5 cents; and
- Maryland reduces State tax liabilities by 9.3 cents (an additional 6.3 cents in local taxes) and provides 16.9 cents in refunds.

Exhibit 9.8 compares the amount of state and federal credits claimed and recipients in states that have a nonrefundable credit and by value of refundable credit – low (less than 10.0%), moderate (10.0% to 19.0%), and high (20.0% and over). Nonrefundable states, with an average credit of 15.0%, have significantly less participation than low-value refundable credits (average value of 5.8%) and the additional credit is slightly less. Participation rates among refundable state credits appear similar, but the additional total state credit is five times higher in high-value states compared with low-value states.

Exhibit 9.8
Federal and State Participation and Credits
By Credit Value

			Credits/Low-income			% Returns Claiming		State / Federal	
	States	**Rate**	**Federal**	**State**	**Total**	**Federal**	**State**	**Participation**	**Dollars**
Credit									
Nonrefundable	3	15%	$557	$31	$588	16.6%	7.8%	47.0%	5.0%
Refundable									
Less than 10%	4	5.8%	541	31	572	17.1%	16.2%	89.2%	5.6%
10%-19%	3	13.5%	514	69	583	15.8%	16.0%	87.1%	13.5%
20% and over	7	29.7%	592	170	762	15.1%	14.7%	93.0%	28.7%
Maryland		**25%**	**$701**	**$184**	**$885**	**15.9%**	**14.3%**	**95.4%**	**26.2%**
Total	**17**	**19.4%**	**$560**	**$99**	**$659**	**14.9%**	**14.1%**	**85.2%**	**17.1%**

Nonrefundable: Delaware, Maine, and Virginia
Refundable (<10%): Illinois, Michigan, Oregon, and Rhode Island
Refundable (10%-19%): Kansas, Nebraska, and Wisconsin
Refundable (>19%): Connecticut, Maryland, Minnesota, New Jersey, New York, Vermont, and the District of Columbia

Source: State Department of Revenues; U.S. Census Bureau; Internal Revenue Service; Department of Legislative Services

Chapter 10. Findings and Recommendations

Based on the information and analysis provided in this report, the Department of Legislative Services (DLS) makes a number of findings and recommendations about the State earned income credit, as discussed below.

No State Agency Is Charged By Statute to Promote Public Awareness of the EITC and Its Eligibility Requirements

The structure of the federal earned income credit (EITC) as a refundable credit allows it to operate with administrative costs that total less than 1% of total program expenditures, significantly lower than the percentage for most or all other social benefit programs. State costs are similarly minimal, as the State earned income credit (EIC) is calculated as a percentage of the federal credit and therefore piggybacks on the federal credit. Due to the nature of how the credit is calculated and claimed, there is no Maryland agency charged by statute to promote public awareness of the credit or its eligibility requirements. As such, low-income individuals that may qualify for the credit may be unaware that the credit exists or that the credit could provide financial assistance to them.

Recommendation: Although the Office of the Comptroller administers the State EIC, the Department of Human Resources (DHR) oversees numerous State antipoverty programs, such as the Food Supplement Program (FSP), Emergency Assistance to Families with Children, Temporary Cash Assistance, and Temporary Disability Assistance Program. Currently, DHR departmental goals, objectives, and performance measures include achieving a certain Work Participation Rate and maintaining the Food Supplement error rate below certain percentages. **DLS recommends that the General Assembly designate DHR, in consultation with the Office of the Comptroller, to promote the credit and gather information regarding participation rates and credit effectiveness. DLS also recommends that State earned income credit goals, objectives, and performance measures (*e.g.*, obtaining a certain State credit participation rate) be integrated into DHR's objectives and budget measures.**

In order to develop an effective outreach program, DHR should investigate causes contributing to deficiencies in the credit participation rate, including area poverty rates, workforce participation rates, and public awareness of the credit. The agency should employ creative ways to reach out to those populations it identifies as not claiming the credit. For example, DHR and the Office of the Comptroller should explore coordinating information regarding working recipients of FSP assistance and State EIC recipients to ensure that FSP recipients have applied for the EIC where eligible. In addition, the Internal Revenue Service (IRS) has suggested methods for states to pursue in order to promote the EITC. These strategies include integrating messages with public assistance checks, tax forms, and public utility bills, as well as promoting the program through signs on public transportation. **DLS recommends that DHR employ these and additional innovative methods in its outreach. DHR's outreach should focus on promoting the federal credit, because increasing participation in that credit would have the greatest effect on reducing poverty and is cost-effective to the State.**

Additional Low-income Taxpayers May Benefit From an Expanded State Earned Income Credit

Although the EITC has proven an effective tool to alleviate poverty, the program does not benefit all impoverished workers equally. According to the Brookings Institution, due to the "modest provision" for childless workers and its phase out at 55% of full-time, minimum wage earnings, a childless worker making poverty-level wages would effectively be taxed into poverty under current law. While proposals to increase federal EITC benefits for childless workers have been introduced in the past, none has moved forward. The District of Columbia has expanded its EITC program beyond federal eligibility requirements by extending the credit to noncustodial parents between 18 and 30 years of age who are in compliance with a court order for child support payments.

In addition, although the American Tax Relief Act of 2012 expanded EITC benefits for taxpayers with three or more qualifying children, these expanded benefits will currently expire after December 31, 2017, and are not guaranteed to continue. Should these expanded federal credit benefits sunset, DLS estimates that State EIC claims would decline by approximately $15 million annually.

In order to make changes like those discussed above, current law would have to be altered to essentially "decouple" the calculation of and eligibility for the State and local credits from the calculation of the federal credit.

Recommendation: While the federal and State earned income credits have positive effects on reducing poverty and the credits do not currently proportionally benefit childless workers, the potential fiscal and administrative costs associated with decoupling from the federal credit and creating a stand-alone State EIC may outweigh the benefits that would otherwise accrue if the State EIC was expanded. In addition, the existing EITC has a high error rate, estimated at between 22% and 26% of total credits claimed, and expanding State EIC eligibility would add further complexity without providing additional simplifications. **Therefore, DLS recommends that the General Assembly continue to monitor federal actions concerning the EITC and the effects of the recently enacted minimum wage increase on poverty levels in the State. In addition, DLS recommends that the Office of the Comptroller provide an estimate of the potential administrative costs associated with decoupling the State credit and the potential for improper payments resulting from that decoupling by October 1, 2015.**

Maryland Is the Only State to Have Separate Refundable and Nonrefundable Credits

Maryland is the only state to provide a refundable EIC, a nonrefundable EIC, and a low-income (poverty level) credit. Some impoverished working taxpayers receive both the State EIC and the low-income poverty level credit, which may be claimed against both the State and county income tax. Rhode Island previously offered both a nonrefundable and refundable credit, but that state recently eliminated its nonrefundable credit.

Recommendation: DLS recommends that the Office of the Comptroller examine the impact of eliminating the nonrefundable credit and expanding the poverty level tax credit to hold harmless those affected by eliminating the nonrefundable credit. Additionally, the Office of the Comptroller should comment on the administrative complexity of having both a refundable and nonrefundable EIC. Under current law, in order to qualify for the poverty level credit, a taxpayer must have income below the poverty income guideline published by the U.S. Department of Health and Human Services, which is adjusted annually for inflation. While DLS is able to suggest cost-neutral methods to repeal the nonrefundable credit and expand the poverty level credit, DLS does not have access to the necessary data to develop a solution or solutions that would limit harm to current recipients. The Office of the Comptroller possesses data that would aid in crafting a more complete remedy, so they should assess whether it is possible to guarantee recipients will be held harmless if the nonrefundable credit is eliminated. If it is not possible for recipients to be held harmless, the Office of the Comptroller should identify the categories of taxpayers that will receive additional benefits and those that could lose benefits from eliminating the nonrefundable credit and expanding the poverty level tax credit.

The EITC's Complex Eligibility Requirements and Constantly Changing Population of Eligible Claimants Contribute to Taxpayer/Tax Preparer Errors and Improper Payments

Among the factors contributing to the EITC improper payment rate include the complexity of the credit, particularly where taxpayers face changing family or fiscal situations, and the constantly changing population of taxpayers eligible to claim the credit. Misunderstanding of EITC requirements regarding who may claim a child or incorrect information about family composition or income levels result in the majority of EITC overclaims. In addition, the complexity of the credit impacts not only taxpayers who prepare their own returns but also paid tax preparers.

Recommendation: DLS recommends that the Office of the Comptroller institute additional education and outreach efforts to both taxpayers and tax preparers concerning the EITC. The Office of the Comptroller should look to recent measures undertaken by the IRS to educate taxpayers and tax preparers regarding credit requirements. In addition, the Office of the Comptroller should partner with the State Board of Individual Tax Preparers and professional associations, such as the Maryland Association of Certified Public Accountants; the Maryland Society of Accountants, Inc.; the Maryland State Bar Association; and a member of the National Association of Enrolled Agents, to ensure tax preparers are competent in filing EITC claims.

Recommendation: Although questions have been raised about the methodology used by the IRS for determining improper payment rates, the agency has estimated that 22% to 26% of EITC payments are issued improperly. The State EIC improper payment rate is currently unknown. However, in light of the calculation of the State and local EIC as a percentage of the federal credit and considering that State and local EIC payments totaled $302.9 million for tax year 2012, DLS estimates in excess of $50 million were improperly paid to EIC claimants. **In order to ensure that State and local funds are properly paid to eligible claimants, DLS**

recommends that the Office of the Comptroller investigate improper State EIC payments and develop strategies to address this issue. DLS also recommends that State EIC goals, objectives, and performance measures regarding improper payments should be integrated into the Office of the Comptroller's objectives and budget measures.

Costs Associated with Refund Anticipation Products and Tax Preparation Services Erode From the Potential Benefits and Effectiveness of the EITC

Refund anticipation products have been marketed to taxpayers by lenders to permit access to estimated refund monies sooner than otherwise available under traditional IRS refund processing periods. These products are particularly targeted to low-income taxpayers, including EITC recipients. In addition, as many recipients of the EITC pay for professional assistance in preparing tax returns, the EITC is the only antipoverty program for which recipients pay to receive benefits. Costs incurred for refund anticipation products and tax preparation services combine to undermine the effectiveness of the EITC program by eroding the EITC funds received by low-income taxpayers and transferring funds to lenders and tax preparers.

Recommendation: Although the State has taken steps to regulate aspects of refund anticipation products, DLS recommends that the General Assembly consider additional measures to limit the adverse effects of these products on the effectiveness of the EITC. These measures include (1) prohibiting tax preparers who are not registered with the State from brokering refund anticipation products; (2) prohibiting businesses whose primary purpose is not tax preparation from offering refund anticipation products; (3) revoking the registration of tax preparers who violate State refund anticipation loan laws; and (4) providing funding for educational campaigns concerning utilizing reputable tax preparers and direct deposits for refunds. **The General Assembly should also continue to monitor the types of refund anticipation products offered in the State.**

Recommendation: In order to combat the erosion of EITC funds by tax preparation costs, DLS recommends that the General Assembly consider providing additional funding for free tax preparation services. In addition, DLS recommends that the Office of the Comptroller and DHR coordinate efforts to increase public awareness of free tax preparation services offered in the State.

Regulation of Individual Tax Preparers, Particularly Through Competency Requirements, Could Assist in Reducing EITC Improper Payments

Research has indicated that the regulation of individual tax preparers assists in reducing erroneous EITC payments. Maryland has taken steps to regulate individual tax preparers in the State by requiring preparers to register with the State Board of Individual Tax Preparers and meet certain registration requirements. Registered individual tax preparers must also satisfy continuing education requirements prior to renewal. In addition, as of October 2, 2014, a new Maryland Examination is available to registrants. The deadline for passing the Maryland Examination is December 31, 2015, after which passing the examination will be required before an individual may apply to register with the board. Current registrants will have until December 31, 2015, to take and pass the Maryland exam.

Recommendation: DLS recommends that the General Assembly continue to monitor the implementation of testing requirements by the State Board of Individual Tax Preparers.

Appendix 1

Poverty Rates by Age and Ethnicity

	Poverty Rates by Age			Percent of Individuals in Poverty:		
	Children	Age 18-64	65+	White	African American	Hispanic
Baltimore/Harford	12.0%	8.3%	6.5%	50.6%	33.9%	7.0%
Baltimore City	36.5%	22.8%	18.0%	16.3%	75.1%	4.2%
Montgomery	8.2%	6.4%	6.7%	25.6%	30.6%	30.6%
Prince George's	12.4%	9.1%	6.8%	12.5%	58.4%	23.4%
Central Maryland	6.9%	5.0%	5.5%	50.1%	26.8%	11.6%
Southern Maryland	9.6%	6.0%	5.5%	43.6%	39.2%	5.8%
Western Maryland	20.4%	12.7%	8.3%	78.9%	13.6%	3.2%
Upper Eastern Shore	15.6%	10.1%	6.0%	68.7%	17.3%	8.4%
Lower Eastern Shore	23.2%	16.1%	7.5%	49.4%	39.2%	5.1%
Maryland	**13.3%**	**9.3%**	**7.6%**	**45.7%**	**11.6%**	**35.2%**

Appendix 2

Number of Years Taxpayers Claimed Either Credit

All Taxpayers

Tax Years 2003-2012

Years	Taxpayers	Percent
1	509,806	41.1%
2	231,429	18.7%
3	140,798	11.4%
4	94,851	7.6%
5	69,453	5.6%
6	51,236	4.1%
7	40,539	3.3%
8	33,383	2.7%
9	30,086	2.4%
10	38,454	3.1%

Appendix 3

Number of Years Taxpayers Claimed Either Credit Who Filed All 10 Years

Tax Years 2003-2012

Frequency	Taxpayers	Percent
1	63,156	25.7%
2	31,028	12.6%
3	22,166	9.0%
4	18,166	7.4%
5	15,713	6.4%
6	13,671	5.6%
7	12,964	5.3%
8	13,436	5.5%
9	16,962	6.9%
10	38,454	15.6%
Total	**245,716**	**100.0%**

Appendix 4

Number of Years EIC Claimed Versus Number of Years Tax Returns Filed

Tax Years 2003-2012

	Number of Years Credits Claimed												
Years Filed	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**Total**	**Percent**
1	830	154,331	-	-	-	-	-	-	-	-	-	155,161	12.3%
2	1,030	74,758	67,444	-	-	-	-	-	-	-	-	143,232	11.4%
3	1,164	47,584	34,801	39,070	-	-	-	-	-	-	-	122,619	9.7%
4	1,288	36,845	22,997	22,066	25,789	-	-	-	-	-	-	108,985	8.6%
5	1,168	31,204	18,201	14,910	14,473	19,159	-	-	-	-	-	99,115	7.9%
6	1,077	28,204	15,754	12,245	10,937	11,476	15,242	-	-	-	-	94,935	7.5%
7	1,231	25,493	14,201	10,663	9,154	8,502	8,873	13,227	-	-	-	91,344	7.2%
8	1,522	23,677	13,466	9,761	8,125	7,395	6,715	7,854	12,085	-	-	90,600	7.2%
9	1,849	24,554	13,537	9,917	8,207	7,208	6,735	6,494	7,862	13,124	-	99,487	7.9%
10	10,397	63,156	31,028	22,166	18,166	15,713	13,671	12,964	13,436	16,962	38,454	256,113	20.3%
Total	**21,556**	**509,806**	**231,429**	**140,798**	**94,851**	**69,453**	**51,236**	**40,539**	**33,383**	**30,086**	**38,454**	**1,261,591**	
Percent	1.7%	40.4%	18.3%	11.2%	7.5%	5.5%	4.1%	3.2%	2.6%	2.4%	3.0%		

Appendix 5

State EIC Programs

Calendar 2014

State	Value	Notes
Colorado	10%	Currently unfunded.
Connecticut	27.5%	
District of Columbia	40%	
Delaware	20%	Nonrefundable.
Iowa	15%	
Illinois	10%	
Indiana	9%	
Kansas	18%	
Louisiana	4%	
Massachusetts	15%	
Maryland	25%/50%	
Maine	5%	Nonrefundable.
Michigan	6%	
Minnesota	33%	Actual percentage value varies, average amount is shown.
Nebraska	10%	
New Jersey	20%	
New Mexico	10%	
New York	30%	
Ohio	5%	Nonrefundable – limited for taxpayers with net taxable income over $20,000.
Oklahoma	5%	
Oregon	5%	
Rhode Island	3.75%/25%	Converted to fully refundable credit of 10% in 2015.
Virginia	20%	Nonrefundable.
Vermont	32%	
Washington	10%	Currently unfunded.
Wisconsin	4%-34%	Credit cannot be claimed by childless individuals 4% – 1 child 11% – 2 children 34% – 3 or more children.

Source: National Conference of State Legislatures; Center for Budget and Policy Priorities; Tax Credits for Working Families