

# Earned Income Tax Credit: Round Two

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## EARNED INCOME TAX CREDIT: ROUND TWO

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## Introduction

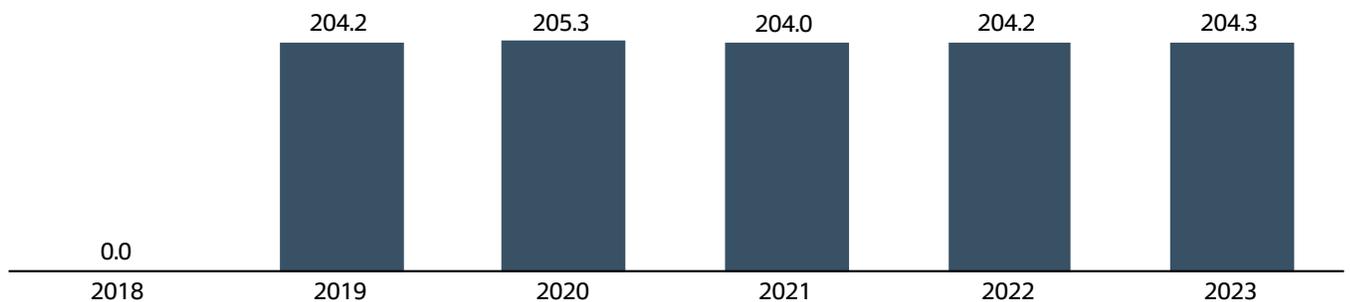
The New Fiscal Plan for Puerto Rico, certified by the Financial Oversight and Management Board (FOMB) on May 30, and the New Fiscal Plan, presented by the government of Puerto Rico on April 5, both propose a locally funded Earned Income Tax Credit (EITC).<sup>1</sup> Section 1052.01 of tax reform bill HB 1544 contains the proposal of the local EITC and provides details on eligibility and the credit's application. According to the exposition of motives in the government's New Fiscal Plan, the new EITC seeks to:

1. Stimulate the percentage of participation in the workforce;
2. Reduce poverty;
3. Increase participation in the tax system;
4. Shrink the informal economy; and
5. Reduce dependency on public assistance.

This is a difficult mission for a tax credit which, according to estimates in the government's New Fiscal Plan, would grant some \$204 million each year to eligible taxpayers.

### Impact in Puerto Rico of the New Earned Income Tax Credit as Estimated by the Government's Fiscal Plan

\$; millions



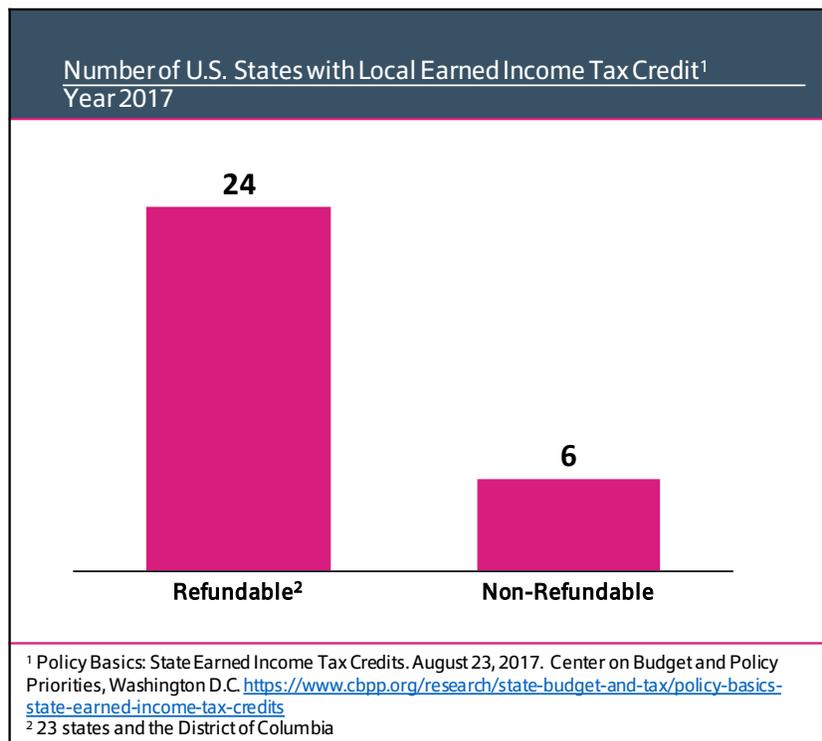
### Estimates by the Government's Fiscal Plan of the number of eligible taxpayers (in thousands)



Source: New Fiscal Plan for Puerto Rico. April 5, 2018. <http://www.aafaf.pr.gov/assets/newfiscalplanforpuerto-rico-2018-04-05.pdf>

<sup>1</sup> New Fiscal Plan for Puerto Rico, Restoring Growth and Prosperity – As Certified by The Financial Oversight and Management Board for Puerto Rico. May 30, 2018. <https://juntasupervision.pr.gov/index.php/en/documentos/>; New Fiscal Plan for Puerto Rico. April 5, 2018. [www.aafaf.pr.gov/assets/newfiscalplanforpuerto-rico-2018-04-05.pdf](http://www.aafaf.pr.gov/assets/newfiscalplanforpuerto-rico-2018-04-05.pdf)

It must be recognized, however, that work tax credits for low-income workers have proved to be an effective tool for encouraging work and reducing poverty in the United States.<sup>2</sup> And the EITC is so popular that in addition to the federal tax credit,<sup>3</sup> 23 states and the District of Columbia have adopted state refundable EITCs oriented toward low-income families and another 6 states have EITCs that are non-refundable but can be used toward the payment of state taxes.<sup>4</sup>



Puerto Rico has experience with earned income tax credits for low and middle-income workers. The Tax Justice Act of 4 July 2006<sup>5</sup> created a work tax credit that was in effect between 2007 and 2013; subsequent laws made certain revisions to the credit. In 2014, the EITC was repealed when the government was seeking ways to alleviate the financial crisis.

This report examines the EITC proposed by HB 1544 and the experience with the eliminated EITC, and it makes recommendations to make the benefits of this tax code more effective.

<sup>2</sup> See Sergio M. Marxuach and Deepak Lamba-Nieves. December 2014, "CNE Policy Primer: The Federal Earned Income Tax Credit: What it Is, How it Works and Its Effects on Working Families." Center for a New Economy, San Juan, Puerto Rico.

<http://espaciosabiertos.org/wp-content/uploads/2017/04/EA-EconSec-PublicPolicyProposal.pdf>

<sup>3</sup> In addition to the 30 state and local EITCs, there is a federal EITC in the 50 states and District of Columbia that is received by every resident who files a federal tax return and is eligible.

<sup>4</sup> Policy Basics: State Earned Income Tax Credits. August 23, 2017. Center on Budget and Policy Priorities, Washington D.C.

[www.cbpp.org/research/state-budget-and-tax/policy-basics-state-earned-income-tax-credits](http://www.cbpp.org/research/state-budget-and-tax/policy-basics-state-earned-income-tax-credits)

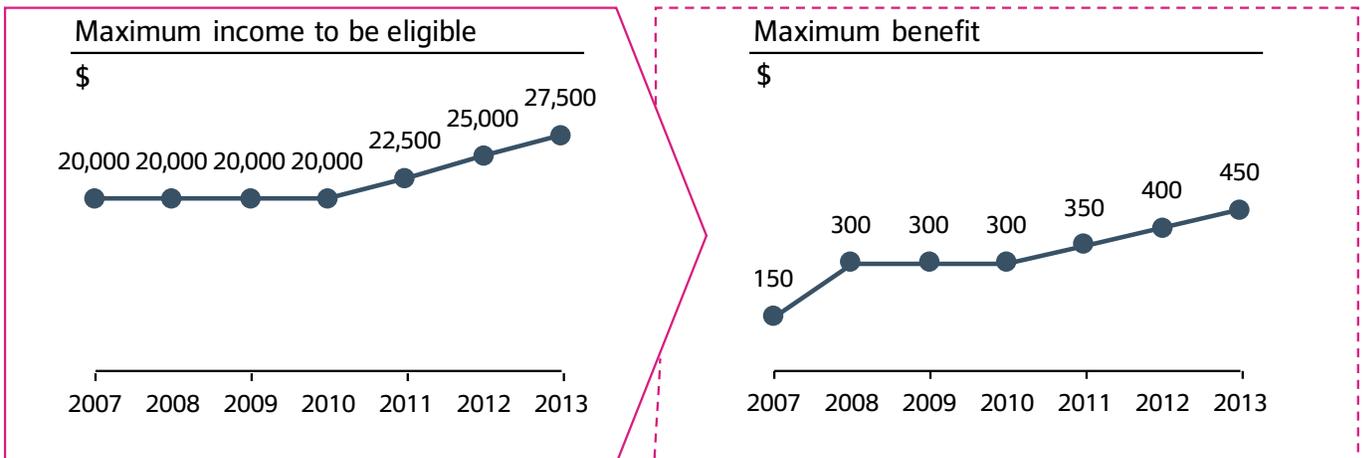
<sup>5</sup> [http://www.ocif.gobierno.pr/documents/Ley\\_117Justicia\\_Contributiva\\_2006.pdf](http://www.ocif.gobierno.pr/documents/Ley_117Justicia_Contributiva_2006.pdf)

## The EITC in effect from 2007 to 2013<sup>6</sup>

Puerto Rico's EITC was in effect between 2007 and 2013. It originated with Law 117 of 4 July 2006, Article 4B 1040G,<sup>7</sup> and was redefined in Law 1 of 2011, Section 1052.01.<sup>8</sup> It was repealed by Law 77 of 2014, Article 22.<sup>9</sup>

The 2007-2013 EITC had the following main characteristics:

- It contained no age limits;
- Individuals with and without dependents were eligible;
- It did not differentiate with respect to the number of dependents;
- Dependents within the tax unit were eligible;
- It did not differentiate with respect to marital status (single, married filing jointly, or married filing separately);
- It was based on the income of the individual persons in the tax unit, not on the income of the tax unit in its entirety;
- It did not set a minimum income for eligibility;
- The maximum income for eligibility ranged from \$20,000 to \$27,500, depending on the year;
- Self-employed income was not eligible unless the business was incorporated and the employee was the owner with a W2 filed;
- It did not have a range of incomes for receiving the credit, but rather a single income point (\$10,000) above which benefits began to decrease;
- The maximum benefit varied by year, from \$150 in 2007 to \$450 in 2013.



Source: María E. Enchautegui. 2014. "A Work Credit that Supports Puerto Rican Working Families". Urban Institute <https://www.urban.org/research/publication/work-tax-credit-supports-puerto-ricos-working-families>

<sup>6</sup> The analysis of the experience from 2007 to 2013 is based in large part on a work by the author published in December 2014: *A Work Credit that Supports Puerto Rican Working Families*, Urban Institute, Washington, D.C.

[www.urban.org/sites/default/files/publication/33471/2000043-A-Work-Tax-Credit-That-Supports-Puerto-Ricos-Working-Families.pdf](http://www.urban.org/sites/default/files/publication/33471/2000043-A-Work-Tax-Credit-That-Supports-Puerto-Ricos-Working-Families.pdf)

<sup>7</sup> LexJuris. Laws of Puerto Rico. <http://www.lexjuris.com/lexlex/leyes2006/lexl2006117.pdf>

<sup>8</sup> LexJuris. Laws of Puerto Rico. <http://www.lexjuris.com/lexlex/Leyes2011/lexl2011001.htm>

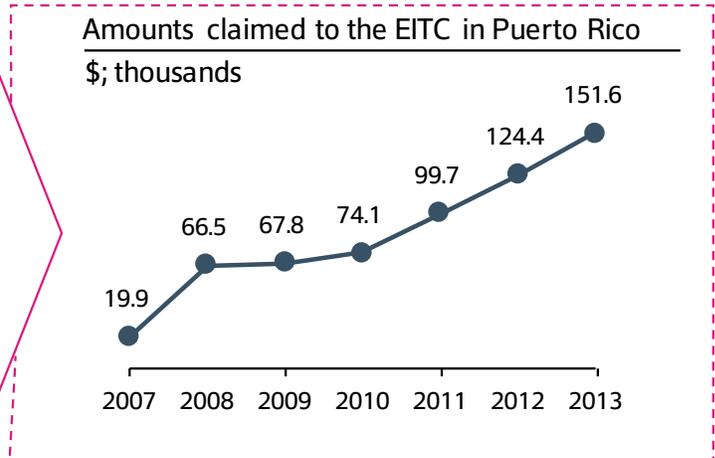
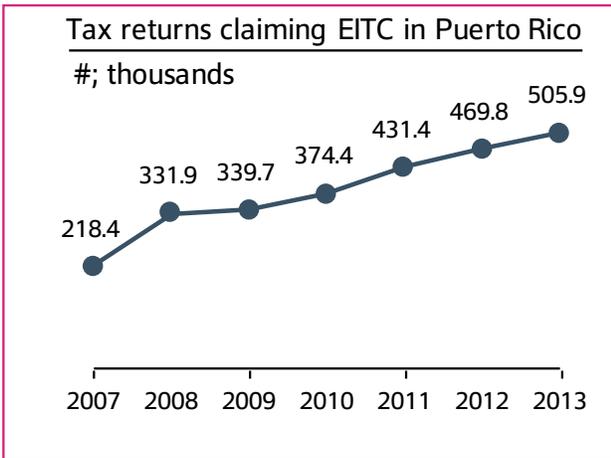
<sup>9</sup> LexJuris. Laws of Puerto Rico. <http://www.lexjuris.com/lexlex/Leyes2014/lexl2014077.htm>

The EITC was a broad work tax credit, granting benefits to a large number of taxpayers. It was not limited to families with dependents, but was applied, rather, to all workers who met the income requirements. As a consequence, a large number of workers became eligible for the EITC, which in turn made it difficult for the government to provide higher benefits.

In 2013, the EITC granted \$151.6 million to 505,962 tax units, for an average EITC of \$299.70.<sup>10</sup> That year, some 48% of tax returns claimed the credit (505,962 out of a total of 1,047,602).<sup>11</sup> As in the United States, almost all the benefits were distributed as refunds, and very little went to pay taxes.

It appears that there was a learning period among potential beneficiaries during the life of the EITC. The percentage of tax returns claiming the benefit rose gradually, beginning with 21% (218,394) in 2007 and climbing to 48% (505,962) in 2013. However, it must be noted that during that period the maximum income for receiving the credit rose from \$20,000 to \$27,500 (see graph on page 3), which also caused the number of eligible taxpayers to rise.

In the design of the Earned Income Tax Credit, instead of having a range of income, there was a single income point for receiving the maximum benefit, which may have incentivized taxpayers to report lower incomes or disincentivized them from generating income above that point. If the income was \$10,000, the individual received the maximum benefit; above \$10,000, they received less.



Fuente: María E. Enchautegui. 2014. "A Work Credit that Supports Puerto Rican Working Families". Urban Institute <https://www.urban.org/research/publication/work-tax-credit-supports-puerto-ricos-working-families>

The structure of the EITC was not stable. In its seven years of existence, it underwent five changes to its structure, including changes in benefits, the maximum income for eligibility, and the rates at which the benefits increased or decreased. The only thing that remained constant was the income point at which the EITC established its maximum, which held at \$10,000.

<sup>10</sup> Department of the Treasury (Hacienda). 2018. Statistics on Tax Returns for Individual Incomes [http://www.hacienda.gobierno.pr/sites/default/files/credito\\_por\\_trabajo\\_2007\\_-\\_2013\\_3.pdf](http://www.hacienda.gobierno.pr/sites/default/files/credito_por_trabajo_2007_-_2013_3.pdf)

<sup>11</sup> Department of the Treasury (Hacienda). 2018. Statistics on Tax Returns for Individual Incomes [http://www.hacienda.gobierno.pr/sites/default/files/distribucion\\_planillas\\_nivel\\_ingreso\\_2000-2014.pdf](http://www.hacienda.gobierno.pr/sites/default/files/distribucion_planillas_nivel_ingreso_2000-2014.pdf)

## Design of the Earned Income Tax Credit in Puerto Rico in 2013

\$. amount of credit per generated income



Source: María E. Enchautegui. 2014. "A Work Credit that Supports Puerto Rican Working Families". Urban Institute <https://www.urban.org/research/publication/work-tax-credit-supports-puerto-ricos-working-families>

### The new EITC proposed in the Tax Reform bill HB 1544

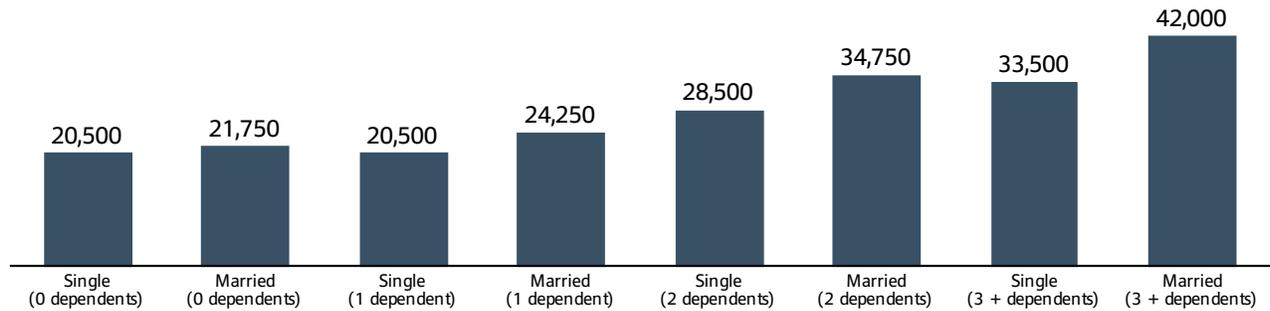
The Tax Reform bill, HB 1544, describes the parameters of the new proposed EITC. Taking this description as a point of departure, the following characteristics are worth noting:

- The bill distinguishes between individuals on the basis of marital status (single or married);
- Individuals with and without dependents<sup>12</sup> are eligible;
- It distinguishes with respect to the number of dependents;
- Married persons filing separately are not eligible;
- It has exclusions on the basis of age: the taxpayer and his/her spouse, in the case of married taxpayers, must be between the ages of 27 and 64;
- It allows self-employed income only when authorized by the Secretary of the Treasury of Puerto Rico;
- Maximum income for eligibility ranges from \$20,500 to \$42,000;
- The maximum benefit varies depending on the individual's marital status and number of dependents, ranging from \$300 to \$2,000; and
- There is a range of incomes, from \$6,000 to \$17,999, at which the individual receives the maximum benefit for persons filing as married or single without dependents, \$300; for other groups, the benefit is more limited.

<sup>12</sup> In the House of Representatives' Tax Reform bill (HB 1544), the word "dependents" is defined as "children."

## Maximum income for eligibility

\$



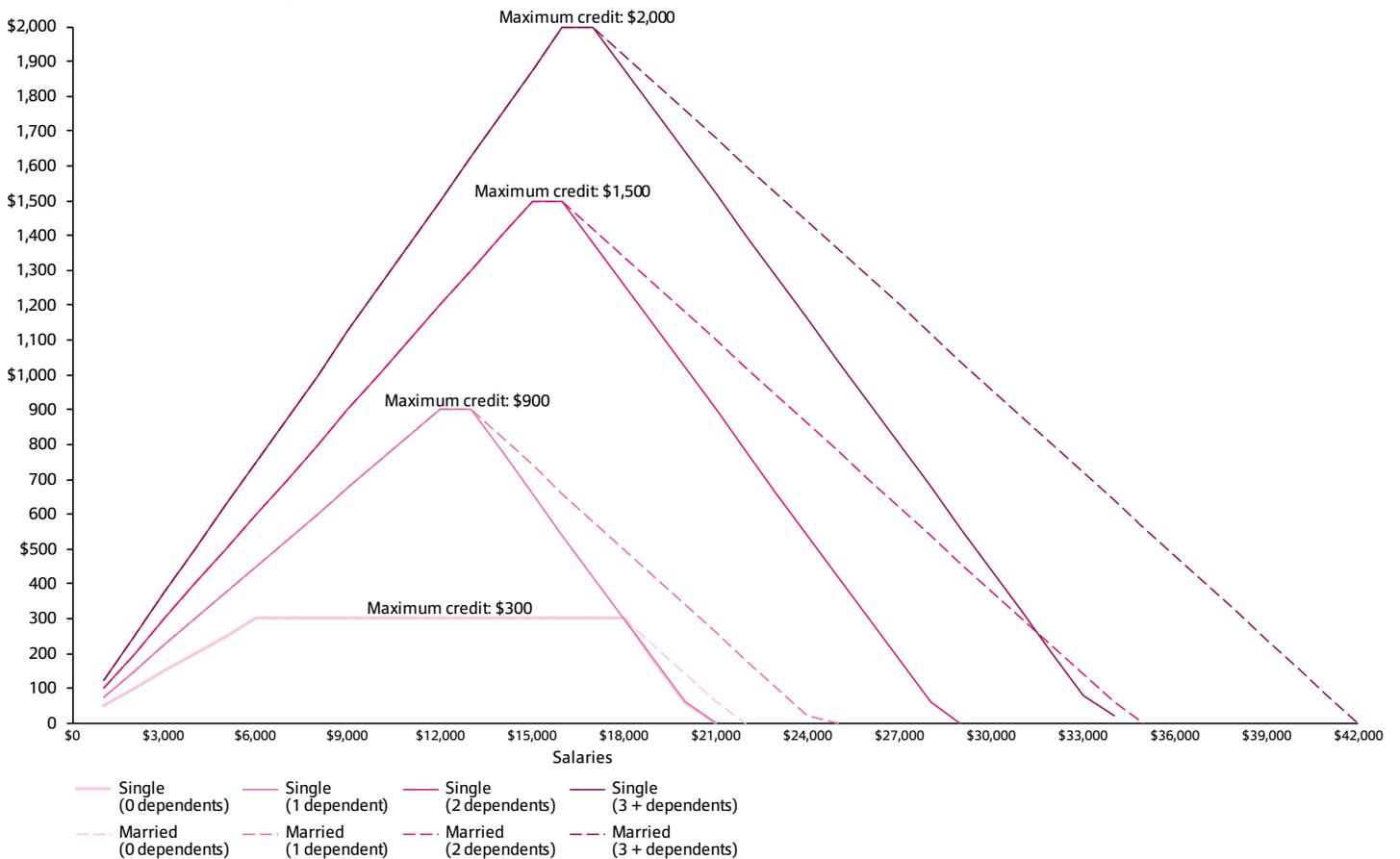
## Maximum credit (\$)



Sources: New Fiscal Plan for Puerto Rico. April 5, 2018. <http://www.aafaf.pr.gov/assets/newfiscalplanforpuerto-rico-2018-04-05.pdf>; New Fiscal Plan for Puerto Rico. May 30, 2018. Financial Oversight and Management Board for Puerto Rico. <https://juntasupervision.pr.gov/documents/>; Tax Reform Project. April 16, 2018. HB 1544, Section1052.01

## Proposed design for the new local Earned Income Tax Credit in Puerto Rico

\$; amount of credit per generated income



Sources: New Fiscal Plan for Puerto Rico. April 5, 2018. <http://www.aafaf.pr.gov/assets/newfiscalplanforpuerto-rico-2018-04-05.pdf>; New Fiscal Plan for Puerto Rico. May 30, 2018. Financial Oversight and Management Board for Puerto Rico. <https://juntasupervision.pr.gov/documents/>; Tax Reform Project. April 16, 2018. HB 1544, Section1052.01

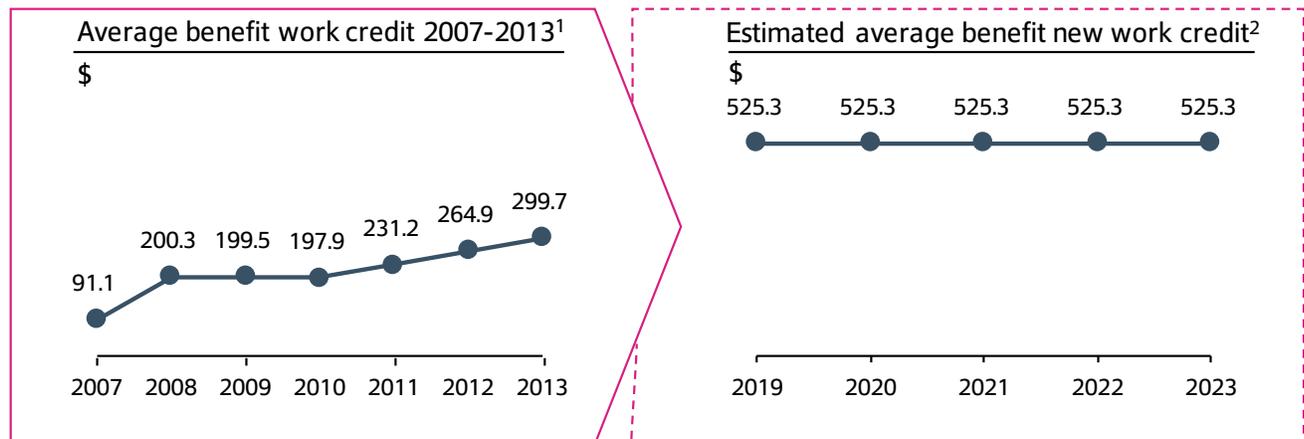
## Comparison of 2007-2013 EITC and new EITC

The following table shows the principal characteristics of the 2007-2013 EITC and those of the new EITC proposed by the Tax Reform bill HB 1544.

Characteristics of 2007-2013 and the New Earned Income Tax Credit proposed in HB 1544		
Variable	Work Credit (2007-2013)	New Work Credit
Eligibility by age	No	Yes
Considers tax status	No	Yes
Focused on families with dependents	No	No
Benefits based on members of tax unit separately	Yes	No <sup>1</sup>
Range of income for maximum credit	No	Yes
Dependents are eligible	Yes	No
Maximum income for receiving benefit	\$20,000 - \$27,000	\$20,500 - \$42,000
Maximum benefit	\$150 - \$450	\$300 - \$2,000
Average benefit	\$299.7 <sup>2</sup>	\$525.3 <sup>3</sup>
Income for receiving maximum benefit	\$10,000	\$6,000 - \$17,000 <sup>4</sup>
Self-employed individuals are eligible	No	Si <sup>5</sup>
Minimum income for eligibility	\$1	\$1
Refundable	Yes	Yes

<sup>1</sup>For married couples, eligibility is based on the couple's joint income. <sup>2</sup>2013. <sup>3</sup>The Fiscal Plan, pp. 162 and 164, reports that the average benefit is \$525.30, but this figure is not sustained when the average benefit is calculated based on the number of tax returns and the program's cost in the table on p. 164. Using these figures, the average benefit is \$709 (i.e., 204,200,000/288,000), although it is possible that the average of \$525.30 was arrived at by assuming that more than one individual in a tax unit would be eligible. <sup>4</sup>\$6,000 - \$18,000 (0 dependents); \$12,000 - \$13,000 (1 dependent); \$15,000 - \$16,000 (2 dependents); and \$16,000 - \$17,000 (3 or more dependents). <sup>5</sup>Only when authorized by the Secretary of the Treasury of Puerto Rico.

Sources: New Fiscal Plan for Puerto Rico. April 5, 2018. <http://www.aafaf.pr.gov/assets/newfiscalplanforpuerto-rico-2018-04-05.pdf>; New Fiscal Plan for Puerto Rico. May 30, 2018. Financial Oversight and Management Board for Puerto Rico. <https://juntasupervision.pr.gov/documents/>; Tax Reform Project. April 16, 2018. HB 1544, Section1052.01



Sources: <sup>1</sup> María E. Enchaetegui. 2014. "A Work Credit that Supports Puerto Rican Working Families". Urban Institute <https://www.urban.org/research/publication/work-tax-credit-supports-puerto-ricos-working-families>; <sup>2</sup> New Fiscal Plan for Puerto Rico. April 5, 2018. <http://www.aafaf.pr.gov/assets/newfiscalplanforpuerto-rico-2018-04-05.pdf>

The new EITC is superior to the 2007-2013 EITC in at least four respects:

- The new EITC considers the recipient's marital status and number of dependents, while the 2007-2013 EITC was overly generic, not differentiating on the basis of these two elements.
- The EITC proposed in Tax Reform bill HB 1544 provides for a range of incomes within which recipients receive the maximum benefit. In the 2007-2013 EITC there were no ranges, but rather a single income point of \$10,000. Therefore, in the EITC proposed in the government's New Fiscal Plan there are fewer incentives to report lower incomes and/or work less in order to remain at the maximum income point. For example, for single individuals and married couples with no dependents, the widest range in the new EITC is for single individuals with 0 dependents, who would receive \$300 if their income is between \$6,000 and \$18,000.
- The benefits of the new EITC are greater than those in the eliminated EITC when the tax unit has dependents. For example, with wage income of \$15,000 in 2013, the EITC provided \$350 in benefits, or 2.3% of income, while in the new EITC, if the individual has 2 dependents, the credit would be \$1,500, or 10% of income.
- Contrary to the 2007-2013 EITC, the new EITC allows self-employed income so long as it is authorized by the Secretary of the Treasury of Puerto Rico. This allows individuals making the transition to self-employment to be able to receive benefits, reducing the risks entailed in the first stages of self-employment.
- In the 2007-2013 EITC, the incomes of members of the tax unit, including dependents, were considered separately. In the new credit, the incomes of the couple are added together, and the dependents are not eligible.

### Lessons from the 2007-2013 EITC that may be useful in the design of the new EITC

The experience with the EITC that was in force from 2007 to 2013 presents a series of lessons for the design of a new program. Incorporating these lessons into a new EITC is important for the program's sustainability in an atmosphere of financial crisis and for greater impact vis-à-vis the objectives set forth in the government's Fiscal Plan, which are: (1) to encourage workforce participation; (2) alleviate the burden of working families; (3) shrink the informal economy; (4) encourage participation in the tax system; and (5) reduce dependency on government assistance. The most important lessons are the following:

1. The delicate balance between a broad EITC and a focused EITC: The government must consider whether it wants to have an impact with a broad margin or a more focused margin; that is, whether it wants to give a smaller credit to more people or a larger credit to fewer people. In the eliminated EITC, the government opted for a small credit to a large number of people. But with a small credit one runs the risk of its having little impact. The tendency to prefer a broad credit is also observed in the proposed credit. In the news media, the governor

reported that “in essence it’s for up to 86% of the population.”<sup>13</sup> On the other hand, an EITC aimed at a population of interest and granting a larger benefit may have a greater impact. For example, if the government wants to incentivize labor force participation, reduce poverty in children, and provide relief to working families, the credit can be concentrated on families with dependents 18 years old and younger, while the eligibility of single individuals and married couples with no dependents is eliminated, thereby allowing a larger credit for families.

2. Interactions with other aspects of the tax code: The EITC should not be looked at in isolation, since the benefits that reach taxpayers’ pockets interact with other provisions of the tax code, particularly fixed deductions. For example, in 2011 a special deduction was introduced for certain individuals which reduced the adjusted gross income and consequently the amount of tax to pay for a broad group of taxpayers and a group of taxpayers with incomes similar to those who were eligible for the EITC. One must be clear about these other tax rules, especially those that are being planned to implement in a tax reform, in order to have a clear idea of what the program’s costs and benefits are.
3. Stability of the design: The EITC should have a stable design so that individuals can know what benefits are applicable to them and thus make decisions on their labor offer. In the seven years of the 2007-2013 EITC’s existence, its parameters were changed five times, making it difficult for the individuals it was designed to help to plan their work lives. With a five-year Fiscal Plan, a stable design is even more important. It is not that the benefit, the income parameters, or the rates at which the benefit is discounted cannot change, but that those changes should be taken into account in the law that creates the new EITC, rather than included in amendments in future years.
4. Avoid incentives to which individuals adjust their tax status in order to qualify: This may be the case with married couples. In order for married couples to be eligible, they should be required to file jointly, because if they are not they can decide to file separately in order to qualify for the EITC. HB 1544 does not provide sufficient information on the treatment of married individuals with dependents who file separately.
5. Accurate projections are crucial for the sustainability of the program: With the financial crisis faced by the government and the measures imposed by the Financial Oversight and Management Board, it is important to be able to predict with a high degree of certainty the number of participants and the cost per year of the credits. Good projections reduce surprises to the Treasury and make the EITC more sustainable. The projection of 288,000 tax returns with eligibility for the EITC that is being made in the government’s New Fiscal Plan may be underestimated. As reported in the press, 836,000 returns were filed in FY 2017,<sup>14</sup> and there will probably be slightly more next year. The projection of 288,000 would represent just 34% of all taxpayers, a very low percentage considering that units earning as much as \$42,000 are

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<sup>13</sup> Gloria Ruiz Kuilán, “Rosselló presenta un nuevo modelo contributivo” (Rosselló presents a new tax model). *El Nuevo Día* (newspaper), April 15, 2018. [www.elnuevodia.com/negocios/economia/nota/rossellopresentaunnuevo-modelocontributivo-2414829/](http://www.elnuevodia.com/negocios/economia/nota/rossellopresentaunnuevo-modelocontributivo-2414829/)

<sup>14</sup> “Hacienda recibe 30 mil planillas más a las esperadas” (Treasury receives 30,000 more returns than expected), *El Nuevo Día* (newspaper), May 3, 2018. [www.elnuevodia.com/negocios/economia/nota/haciendarecibe30000-planillas-mas-alas-esperadas-2419502/](http://www.elnuevodia.com/negocios/economia/nota/haciendarecibe30000-planillas-mas-alas-esperadas-2419502/)

eligible. And it certainly does not jibe with the governor's statement that 86% of taxpayers are eligible. Accurate projections are necessary in order to ensure the life of the program, and the dynamic of the EITC's impacts should also be considered. In the government's new five-year Fiscal Plan, the number of tax units that would claim the EITC remain steady at around 288,000 for the period, with very few oscillations, and the dollar amount of credits granted holds steady at about \$204 million, also with few oscillations (see table on page 1). These projections of stability may be due to the assumption of a population decline in the next five years, but if the EITC is effective in achieving its objectives, then the number of participants may be increasing rather than remaining stable, as the Fiscal Plan projects. Participation in the program also increases to the degree that people become better acquainted with the program, as we have seen with the 2007-2013 EITC. Another aspect that shows the importance of dynamic projections is that, as our experience with the 2007-2013 EITC demonstrates, the EITC attracts taxpayers to the system and, therefore, the number of taxpayers may increase.

6. The design of the program should take into account similar objectives sought by the government: The 2007-2013 EITC had good intentions, and one of its main justifications was that it would reduce the regressivity of the sales and services tax (the IVU) the government had recently imposed. However, its design was not adjusted to meet those objectives. The new EITC can be a tool for encouraging participants in the PAN (nutritional assistance program) and TANF programs to transition to work, an objective that is explicitly stated in the New Fiscal Plan. If this is to happen, the EITC should be greater for single mothers with dependents, since this group constitutes a high percentage of PAN participants. Similarly, the benefits and income limits should be defined to impact the families most affected by the IVU's regressivity. Whatever the objective is, the design should be framed within that objective in order to achieve greatest impact.

### Design recommendations

Considering the financial crisis Puerto Rico is going through, the design of the new EITC should ensure the sustainability of the program and make a larger impact on the workforce and the relief of poverty. The possible impacts on the workforce take time to materialize, underscoring even more the importance of the program's sustainability. Some recommendations to make the credit sustainable and increase its impact are the following:

1. The EITC should be concentrated on families with children between 0 and 17 years of age, with taxpayers under 64 years old, in order to give greater benefits to populations of public policy interest and make a dent in unemployment and poverty.
2. If the credit is maintained for taxpayers with no children, it is recommended that the range of incomes within which these individuals are able to receive the maximum credit be reduced. The Plan says that individuals with no dependents and incomes between \$6,000 and \$18,000 can receive the maximum credit of \$300 for their category. This range is too wide, and

granting the credit to such a large group may come at the expense of not being able to grant a larger credit to families with dependents.

3. If the EITC is maintained for single individuals with 0 dependents, it should be available only for individuals filing as single and between the ages of 25 and 64.
4. The parameters of the continental U.S. should be avoided. The U.S. has a wage/salary income structure different from that of Puerto Rico. The income limits in Puerto Rico should be based on income distribution in Puerto Rico.
5. A minimum income should be established, thereby evidencing the individual's attachment to the labor market. For example, a wage/salary minimum income of \$2,900 might be set for eligibility. This would be the income of an individual working 10 hours a week at a minimum wage of \$7.25 for 10 months of the year.
6. A broader range of income for receiving the maximum benefit should be established for taxpayers with children.

## Conclusions

The Earned Income Tax Credit is good public policy, as it is linked to remunerating behaviors that the government wishes to incentivize. In a setting of severe financial crisis, five-year budget planning, and budget approval by the Financial Oversight and Management Board, it is important that the EITC that is finally designed be sustainable in the years to come and that its potential be maximized for achieving the objectives that inspired it. We cannot reinvent the wheel every time a tax incentive is created. We must take into account the lessons learned from past incentives. The experience with the EITC in force from 2007 to 2013 presents us with lessons and opportunities to design a program of tax incentives for workers that has teeth and achieves its main objectives of encouraging employment and reducing poverty.



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