

$$\frac{\partial u}{\partial t} + u \frac{\partial u}{\partial x} = \dots$$

Transfer Facts

$$\frac{\partial}{\partial t} \left(\frac{P}{P^*} \right) + u \frac{\partial}{\partial x} \dots$$

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What is an earned income tax credit (EITC)?

Earned income tax credits (EITCs) are an earnings supplement paid to an individual in the form of a refundable tax rebate. EITCs are usually designed to encourage work among low- and moderate-income families by reducing their effective tax rates. However, they can also be used to incentivise labour force participation of other groups, such as mature age workers in Australia.

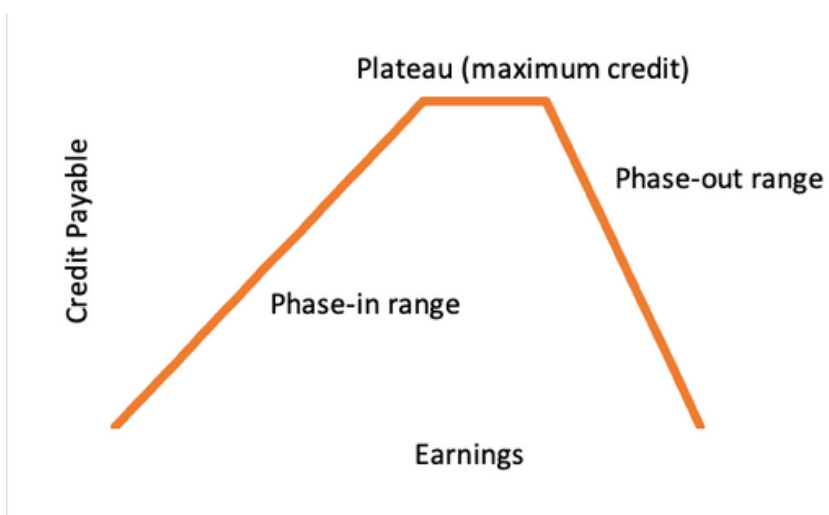
By design, EITCs share characteristics of a transfer payment, but remain a tax offset [\[see our related Tax Fact #6: Good tax policy: Tax offsets or tax deductions and Tax Fact #7: Australia's tax policy: Is the low income tax offset \(LITO\) different to the tax-free threshold?\]](#).

They are similar to transfer payments and other tax offsets because they increase the disposable income of a recipient. By contrast, they differ from other tax offsets because eligibility is linked to income from employment, rather than taxable income.

They also differ from transfer payments because the value of the credit initially increases with earned income (until a maximum earned income level), rather than remaining constant and then decreasing.

This unique design engenders various benefits for EITC recipients. EITCs incentivise employment, lowering the effective marginal tax rate and increasing the earner's disposable income [\[see our related Transfer Fact #2: What are effective marginal tax rates \(EMTRs\)? and Transfer Fact # 3: How can EMTRs influence workforce participation?\]](#). Additionally, since the EITC is only based on income from employment, other sources of income, such as transfer payments, superannuation, or investment income, do not impact recipients' eligibility for the EITC. [\[see our related Transfer Fact #5 – 'What are the limitations and benefits of EITCs?'\]](#). Similarly, individuals only in receipt of non-employment related income are ineligible.

Figure 1. Structure of an EITC



How do EITCs work in practice?

Table 1 outlines the impact of an EITC on the disposable income of an individual earning \$30,000. This example uses a credit rate of 15 per cent. Since EITCs do not preclude claiming other income support payments, the individual in this example claims the JobSeeker Payment, the low income tax offset (LITO), as well as the low and middle income earner tax offset (LMITO).

Table 1. EITC in practice

Income	(a)	\$30,000
Jobseeker payment	(b)	\$1,325.80
Taxable income	(c) = (a) + (b)	\$31,325.80
Income tax	(d)	\$2,493.90
Medicare levy	(e)	\$626.52
LITO	(f)	\$700
LMITO	(g)	\$675
Total income tax	(h) = (d) + (e) - (f) - (g)	\$1,745.42
Income from employment	(i)	\$30,000
EITC	(j) = (i)*0.15	\$4,500
Disposable income with the EITC	(k) = (c) - (h) + (j)	\$34,080.38

The increase in disposable income also reduces workforce disincentive rates (WDRs), which are a barrier that discourages secondary earners from working additional days in paid employment. This tends to impact women more often than men. Building on the example from [Transfer Fact #3: How can EMTRs influence workforce participation?](#), Table 2 highlights the benefits of EITCs for secondary earners, by reducing WDRs.

Table 2. Impact of an EITC on workforce disincentive rates

Days worked per week		1	2	Difference
Taxable income	(a)	\$16,400	\$32,800	\$16,400
Income tax	(b)	0	\$2,774	\$2,774
Medicare levy	(c)	0	\$656	\$656
FTB Part A	(d)	0	0	0
FTB Part B	(e)	\$2,125.65	0	(\$2,125.65)
Net annual childcare cost	(f)	\$3,672.24	\$8,568.56	\$4,896.32
Income from employment	(g)	\$16,400	\$32,800	\$16,400
EITC*	(h)	\$2,460	\$4,500.15	\$2,040.15
Disposable income	(i)	\$17,313.41	\$25,301.59	\$7,988.18

*The EITC in this example has been designed with a 15% rate and a maximum \$4500.15 tax credit value.

Workforce disincentive rate for working a second day per week, per year =

$$\frac{b + c - d - e + f - h}{a} = \frac{\$2,774 + \$656 - \$0 - (-\$2,125.65) + \$4,896.32 - \$2,040.15}{\$16,400} = 51.29\%$$

With the inclusion of the EITC, the WDR decreases by 11.44 per cent from the 63.73 per cent calculated in the example in [Transfer Fact #3](#). The inclusion of the EITC therefore creates a greater incentive for employment, by increasing disposable income and decreasing tax payable.

It is important to note that an EITC in Australia might interact with other aspects of the Australian welfare system and alternative changes could achieve the same objectives as an EITC [\[1\]](#).

It is also possible to design EITCs with respect to household earnings rather than individual earnings, but doing so would fail to address the problem of high workforce disincentive rates for secondary earners. The EITC in the United States is based on household earned income.

TTPI appreciates the research assistance provided by Navjeet Kaur for the preparation of this Transfer Fact.

[1] Ingles, D. (2002) Earned Income Tax Credits: Do they have any role to play in Australia? Australian Economic Review, Volume 34(1), pp. 14-32.

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More information

Contact the director at robert.breunig@anu.edu.au | Contact us at tax.policy@anu.edu.au

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