

Lecture 3: The Earned Income Tax Credit

reference: Hotz, V. J. and J. K. Scholz, “The Earned Income Tax Credit,” in Means Tested Transfer Programs in the United States 2003, ed Robert Moffitt.

The EITC was the fastest growing federal antipoverty program over the period from 1975 to 1999. In '75 EITC spending was \$3.9 billion, and in '99 it was \$31.9 billion, or within \$4 billion of combined federal expenditures on TANF *and* food stamps.

A Brief Sketch of the EITC's Legislative History

In **1975**, Congress drafted a tax reform bill cutting taxes in response to the recession begun in 1974. The initial EITC was attached by Senate Finance Committee Chair Russell Long to the bill.

The *temporary* (18 mos) initial credit to workers with children was 10% of wage income up to \$4000, phased out at a 10% rate over the \$4000 to \$8000 range.

In **1978**, the credit was made permanent and a flat range was inserted between the benefit's phase-in and phase-out ranges. See Hotz & Scholz Fig 1 for a diagram of the credit as a fn of income.

Spending on the social safety net declined late '70s-early '80s, and though the EITC legislation was unchanged, credits were not indexed and inflation eroded much of their value.

TRA86: In 1986, the EITC was supported by both liberals and conservatives. TRA86 indexed credits to inflation and increased

benefits in 1987 to the point where their real value matched the '75 value of the credits.

Post-Reagan, the feeling among Democrats was that the tax reforms under Reagan had not been favorable to low income families (eg the flattening of the marginal tax rates with income in TRA86). In 1990 deficit reduction was a big item on the agenda of Congress, and taxes were raised under Bush. Democrats were very concerned about the distributional consequences of the 1990 tax reform, and the EITC was the most acceptable to Republicans among the available means of changing the distributional consequences of various tax reform packages. The **1990 bill** brought an EITC expansion that was phased in over 3 yrs, and an extended credit for parents of 2+ children.

In 1993 Clinton designed an EITC expansion under which full time work at the minimum wage plus food stamps plus the EITC would raise family net-of-payroll income above the poverty line. This also entailed an expansion of the credit increase with # of children. The **1993 budget bill** passed by one vote in the Senate, and won no Republican support. The EITC became a Democrat's program under Clinton.

EITC Rules

Credits are refundable, i.e. paid out by the Treasury whether not the recipient owes taxes.

Eligibility requires that the taxpayer earned below a ceiling amount that varies by year and # kids, above which the phase-out is

complete. The recipient needed a qualifying child until '94; post-'94 there is a small credit for non-parents.

Qualifying child: Younger than 19, or 24 if in school, or any age if disabled. Relationship to the child must be parent, grandparent or foster parent. The child must reside with the recipient ≥ 6 mos/yr.

Nonlabor income requirement: Total tax-exempt interest, dividends, cap gains, rents, etc. must be $< \$2350$, indexed.

In 1999, the credit for a 2+ children parent was 40% of income up to a ceiling of \$9540. The flat range was \$9540 to \$12,460, and the phase-out rate was 21.06% over the range \$12460 to \$30,585. This schedule is also in Fig. 1.

Fig 2a shows total tax payments and marginal rates for 2 parent 2 child families in IL in '98. The information included on total tax payments is valuable as it demonstrates the u-shape of credits paid out to low-income workers with wages earned.

Figure 2b presents the same information for a 2 parent 2 child family in 1984, demonstrating both the very high marginal rates faced by some low income families in '84 and the size of the EITC expansion from '84 to '99.

State-level EITCs: 14 states and D.C. have EITCs. Most are pegged to the federal EITC payment, and have the same requirements. There is, however, much variation in the rates of such EITC supplements paid by states.

Interaction with Other Social Welfare Programs

EITC eligibility is determined as a part of the tax process, and payments are made through the Treasury, so EITC payments are generally separate from transfer programs and have few interactions with them.

EITC and AFDC: In '79 the requirement that EITCs be treated as earned income for AFDC, Food Stamp & SSI passed.

OBRA81 further required welfare agencies to assume that qualifying families in fact received EITC when calculating benefits.

In '84 this was reversed, and AFDC benefits were reduced only with evidence of actual EITC receipt.

OBRA90 withdrew EITCs as income or resources in the month received or following month in eligibility tests for AFDC, Medicaid, food stamps, SSI and low-income housing benefits.

In 1993, the EITC was excluded from counting in asset tests for the first 12 mos after receipt, after which it could cause recipients to fail eligibility requirements.

EITC and TANF: How these programs will interact is not yet clear. States can count EITC as income in determining state-level welfare eligibility. Many TANF programs involve employer subsidies and job-related activities that may or may not trigger tax obligations and EITC payments. The 1997 budget bill requires that the EITC not be claimed on 'community service' and 'work experience' jobs funded under TANF. In general, the laws on TANF/EITC overlap are not well developed.

Ineligible Claimants

Since the IRS administers the EITC, its cost of administration is particularly low for a program of its size. However, noncompliance is a big problem due to low oversight. In 1995, 25.8% of EITC payouts exceeded the amounts to which taxpayers were entitled.

Program Statistics

Table 3 shows EITC maximum benefit and number of claimants over time since 1975.

Scholz (1994) used matched tax return and CPS data to find that between 80 & 86% of eligibles received the EITC in 1990.

Factors likely to have changed participation among eligibles since 1990:

- the max credit rose from \$1207 in '90 to \$3756 in '99 (in '99 \$)
- this new max extended the credit to higher-income groups, whose propensity to file tax returns is greater
- outreach efforts by the IRS & others
- increased labor force participation by single mothers, who are less likely to file
→ Hotz, Hill, Mullin & Scholz (1999) find that EITC participation rates for single mothers who'd recently received AFDC were in the 42-54% range
- efforts to enforce EITC compliance may have led some eligibles not to claim

No study of the participation rates among eligibles in EITC since 1990 has been done. The difficulty with such a study is that no single data set includes information on both eligibility criteria that would allow determination of the eligible population and income tax returns revealing EITC receipt.

Antipoverty effects

Scholz & Levine (2000): > 60% of EITC payments go to families below poverty line based on pre-EITC income. ~1/2 of total payments directly reduce poverty gap.

Fig 3 shows 1997 data on the distribution of EITC returns filed and payments made by adjusted gross income class.

In 1997 23.3% of claimants were on the phase-in range; they received 22.3% of payments. 18.2% were in the flat range, and they received 26.4% of payments. 58.3% were in the phase-out, with 51.3% of payments.

EITC does seem to go to low-wage high-hours workers (not high wage earners who choose to work limited hours): Scholz (1996) using the SIPP—2/3 of EITC payments go to workers w/ wages \leq \$6.43/hr. Liebman (1997)—in '90, 60% of EITC recipients worked \geq 1500 hours.

Distributional consequences: Between '76 & '96, the share of income to the lowest fifth in the US fell from 4.4% to 3.7%. Liebman finds that for families w/ children, the EITC offsets 29% of that decline.

Finally, the CEA reports that in 1997 and 1998 the EITC removed 4.3 million individuals from poverty.

Labor Supply

The primary argument used in support of the EITC is that it provides stronger work incentives than programs like AFDC, food stamps and Medicaid.

While this comparison is accurate, the shape of the budget constraint induced by the EITC structure creates a complicated, and not always positive, set of work incentives.

Consider the budget set created by the AFDC program, as compared with the budget set resulting from the EITC in Fig 4.

Labor supply incentives of the EITC along the phase-in, flat and phase-out segments:

U_0^I to U_1^I : For non-workers before the program, the EITC increases the wage paid for the initial hour, and several subsequent hours, of work. There is no income effect of the EITC if pre-EITC the individual didn't work, so only the substitution effect is relevant and since the price of market goods consumption has decreased relative to leisure, individual I shifts out of leisure and into positive hours of work.

The EITC can have only (weakly) positive effects on hours and participation for non-workers.

Note that if a worker initially worked positive hours but still located in what would be the phase-in region of the program before its inception, then with the addition of the EITC the worker could either increase or decrease hours—wage has gone up, and we're in the classic income v. substitution dominance ambiguity.

U_0^{II} to U_1^{II} : If a worker initially locates on what would be the flat segment, then with the implementation of the EITC the worker's

wage is the same, but her income is greater. If leisure is a normal good, the EITC will result in a decrease in hours.

The EITC will not change the participation decision of a worker who is initially on the flat segment, but it may reduce that worker's hours.

U_0^{III} to U_1^{III} : Workers who initially work a number of hours that would be in or above the phase-out region will have both an income effect of the EITC credit and an incentive to reduce hours in order to receive (more of) the credit. The EITC implementation *decreases* the marginal wage for those on the phase-out region. This segment of the credit is effectively a negative income tax, and can be expected to have the same effect on labor supply as taxing away benefits in transfer programs (AFDC, Medicaid).

The phase-out region of the EITC credit results in both a negative substitution effect and a negative income effect on hours (though clearly it will not change the participation decision).

Overall, the effect of the EITC on labor force participation is unambiguously positive, but the EITC may decrease or increase total labor hours supplied. An important observation in the consideration of this question is that in 1997 58.3% of claimants were in the phase-out region.

In the next lecture, we'll look at the influences of the EITC on the labor supply of married earners, referencing Eissa and Hoynes (1998).

Empirical Results on Labor Force Participation and Hours

See Figure 5 and Table 4