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Then and Now: The Earned Income Tax Credit

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Then and Now

The Earned Income Tax Credit

In 1990, the Upjohn Institute published our book, *The Earned Income Tax Credit: Anti-Poverty Effectiveness and Labor Market Effects*, a slim 91-page monograph that surveyed quite thoroughly almost everything known at the time about the economic impact of the earned income tax credit (EITC). The EITC, which was introduced in 1975 as a small work bonus for very low-income working families, was then still a little known and lightly funded government program that played a minor role in the government's set of antipoverty policies. Despite the cutbacks of the Reagan era, traditional welfare still thoroughly dominated antipoverty policy.

Yet even then, the EITC was clearly something different. Alone among income transfer programs for the poor, the EITC conditioned its benefits on earnings. Families without earnings received nothing, and benefits actually increased with family earnings through a portion of the income distribution before eventually phasing out at higher incomes. This was just the opposite of traditional welfare programs, which provided maximum benefits to households with no earnings. The unique benefit structure of the EITC for 2001 is shown in Figure 1; households with one child receive slightly lower benefits, and childless households receive a very small maximum credit.

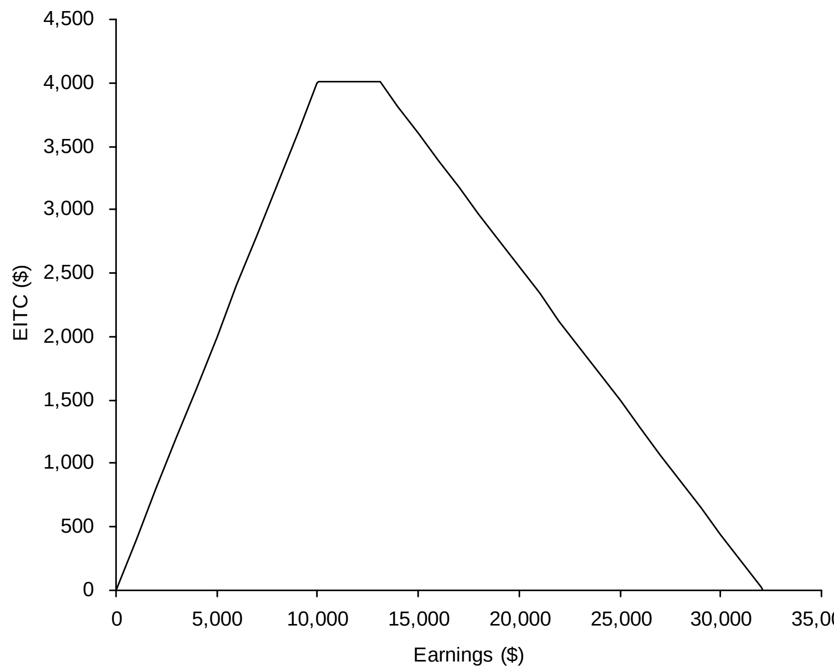
Married couples as well as single parents were eligible for EITC under identical rules, which was another difference from traditional welfare. Technically, the EITC was not even a welfare program—it was a tax credit administered by the IRS. And unlike most other tax credits, it was refundable, which meant that poor working families could fully realize its benefits, even if they owed little or no taxes.

For these reasons, the EITC was emerging as a government antipoverty program that both liberals and conservatives could support. It was fast becoming, as we wrote then in our introduction, "a rallying point in redirecting poverty policy." We noted that its "time in the national agenda has clearly come," and we predicted that it would grow.

passage of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, which led to the end of welfare as we knew it. Effective July 1, 1997, Aid to Families with Dependent Children (AFDC), the primary cash assistance program for the poor since the mid 1930s, was replaced with the Temporary Assistance for Needy Families program, or TANF.

As a result, the EITC today is almost unrecognizable from its former modest self. It is now the largest cash transfer program for the poor and the near-poor, distributing a total of approximately $30 billion to more than 18 million families. In contrast, in 2002, TANF served an average of 2.1 million families, providing them approximately $12.5 billion. As seen in Figure 2, since 1990, the average credit doubled in real terms, and the

Figure 1 EITC Benefits, by Household Income, for Families with Two or More Children, 2001



If only we could be so accurate with all our predictions! Today, it is almost impossible to imagine U.S. income transfer policy without the EITC. Two major policy actions were decisive in this transformation. The first was the expansion of the EITC program itself in 1991, and again and more substantially in 1993. The second change resulted in the

number of households receiving a credit rose more than 50 percent.

The enormous expansion of the EITC has prompted a large increase in research about the EITC and its impact on the economy, as well as some controversy and criticism. In light of that, we set out to update our 1990 book. Our new book, *Helping Working Families: The Earned*

Income Tax Credit, which was just published by the Upjohn Institute (see p. 7 for details), is the result of our efforts. It now weighs in at a respectable 245 pages, befitting the increased importance of the program.

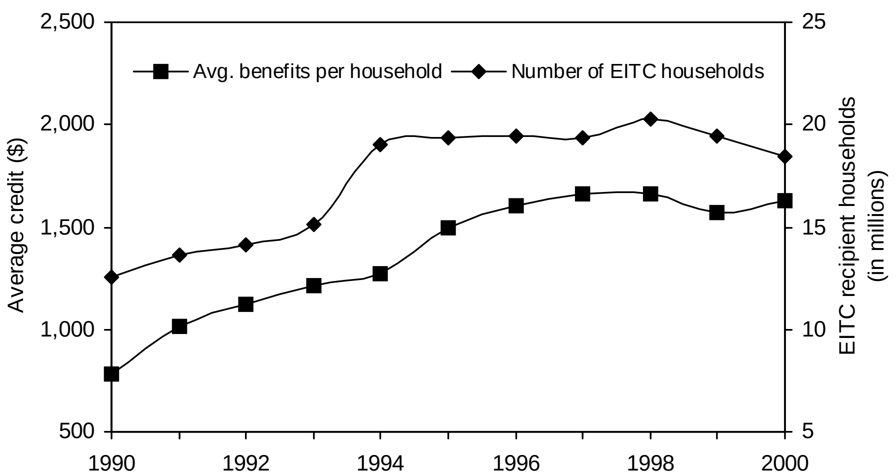
Our own position, reinforced by the many research studies we have reviewed, is that the EITC is a government program which, on the whole, works well. That alone is no small achievement in the policy world of antipoverty programs, many of which have a well-documented history of failure and/or unanticipated negative effects. The EITC continues to offer substantial and meaningful earnings supplements to low- and moderate-income households. It successfully pushes many working families out of poverty, and it is a viable and attractive alternative to an increase in the minimum wage.

However, some problems have emerged:

- Like any income support program, EITC benefits eventually decrease as a family's income increases. As shown in Figure 1, this occurs at a household income between about $13,000 and $32,000. For families with two or more children, the phase-out rate is 21 percent, which, when combined with the federal income tax and the payroll tax, yields a marginal tax rate of nearly 50 percent. There is growing evidence that this high tax rate has discouraged work in married-couple families with moderate incomes.

- The EITC imposes substantial financial penalties on many married couples. If a childless full-time minimum wage worker marries a full-time minimum wage worker with two children, they suffer an EITC marriage penalty of more than $1,600 compared to what they could have if they remained single. If they each have two children, their EITC financial sacrifice to marry would be $5,600!

Figure 2 EITC Receipt and Average EITC Benefits Per Recipient Household, 1990–2000



- The EITC still leaves larger families with low-wage workers in poverty. A married couple with two children and a single wage earner working full time at $6.50 an hour are still poor even after adding in the $4,000 EITC income they would get. Larger families remain even further below the poverty line.

Fortunately, these problems are not independent. Solving one problem contributes to solving the others. The Economic Growth and Tax Relief Act of 2001 has already provided some EITC marriage penalty relief by increasing the beginning point of the EITC phase-out range for married couples by $3,000 over the next five years. We propose a further reduction in the EITC marriage penalty, implemented in a different way. In addition, we would make two more changes:

- Reduce the current EITC phase-out rate for a family with two or more children from 21.06 percent to 15.98 percent, which is the current phase-out rate for a family with one child. This will improve work incentives for families on the phase-out range, reduce the marriage penalty, and help lift larger families above the poverty line by allowing them to retain a greater proportion of their EITC grant while they are still below the poverty income level.

- Provide a new, more generous rate schedule for families with three or more children by increasing the phase-in rate from its current value of 40 percent to 42 percent, and increasing the income on which that credit is earned by about $1,000. This would increase the maximum EITC grant for these families by $600 if they are single parents, and by $1,500 if they are married. This too reduces the marriage penalty of the EITC, and it also helps lift larger families above the poverty line.

In our most recent book, we examine the likely impact of this reform using representative national data on households. Our proposed reform would increase the number of families qualifying for the EITC by about 20 percent and increase program costs by about $13 billion, which really is not an enormous amount. Of all the new spending in our reform, almost half will go to working families with an income that leaves them less than 50 percent above the poverty line, and only about one-sixth will go to families with incomes of at least twice the poverty line. Ninety percent of all new spending goes to families with two or more children. Nothing we can foresee suggests that transfer policy or labor markets will change in ways that will make the EITC less important. In the 2000s, many women with few labor market skills will undoubtedly enter the labor market, most likely in a less robust economy than was seen in the 1990s. Also here to stay, it appears, is the poorer labor market position of less-skilled, less-educated workers. Most economists believe that these labor market changes reflect underlying changes in labor demand driven by changes in technology, especially computerization. That trend is unlikely to change in ways that would benefit less-skilled workers. Globalization of the economy is another contributing factor, and that too is unlikely to be reversed. Policies to promote human capital investment will be important, but there certainly will remain workers whose skills leave them without the ability to earn middle-class incomes. We believe that continued generous assistance to these workers is fully appropriate. It is very much in the American tradition of helping the "deserving poor," here understood to include families above the poverty line but well below middle class. And in that effort, the EITC will remain the policy instrument of choice for the foreseeable future.

Saul D. Hoffman and Laurence S. Seidman both teach economics at the University of Delaware.

New Book Addresses Challenges of Balancing Work and Family

The Upjohn Institute has just published The Economics of Work and Family, *which contains proceedings from the 2000–2001 Werner Sichel Lecture-Seminar Series.* Employment Research *recently sat down with one of the editors, Jean Kimmel, to talk about the book. Kimmel is an associate professor of economics at Western Michigan University, which, along with the Upjohn Institute, is a cosponsor of the annual lecture-seminar series.*

Employment Research (ER): *Thank you very much, Professor Kimmel, for taking the time to provide our readers with some information about your new book, coedited with Professor Emily Hoffman. First, could you tell us why you organized the seminars around this particular set of issues?*

Jean Kimmel (JK): As labor economists, Emily and I are aware of growing concerns regarding workers' efforts to balance work and family, and the related research and policy agendas. While work/family balance has always been a concern for labor economists, with the dramatic recent increases in the employment of women—particularly mothers of young children—the topic is gaining increased interest. It is a timely topic, and we felt the book would be of interest to a broad audience.

ER: *How would you characterize the bottom line of your seminar presenters about the issues such as child care? Is there a role for public policy?*

JK: The only bottom line on which the two child care chapter authors agree relates to the problems of inadequate quality and affordability. They propose to solve the problems in very different ways. Professor David Blau outlines a two-pronged approach in which quality is addressed through incentives for providers to acquire accreditation, and affordability is addressed through income-based child credits that are not given conditional on employment or even the use of paid child care. Professor Barbara Bergmann focuses on the affordability problem, particularly for single mothers, and proposes solutions that include substantial increases in federal spending targeted on child care. Given the severe financial constraints facing single-mother families, it may be that the current approach to welfare-to-work is ill-advised, given its emphasis on work first without sufficient child care support. Although child care spending has increased, single mothers still report being unable to find and pay for quality care.

ER: *What about family leave policies? Are there public policy issues involved with these?*

JK: The federal government entered into the family leave policy arena due to a concern about economic security for families. With the passage of the Family and Medical Leave Act (FMLA) in 1993, most workers are guaranteed 12 weeks of unpaid leave to care for an ill family member or for personal illness. Examining seven years of data concerning access and take-up of this leave, Dr. Katherin Ross Phillips of the Urban Institute found that the majority of such leaves are taken for personal illness, thereby debunking the myth that FMLA is women's policy rather than family policy. Additionally, as Dr. Phillips explains, because FMLA-granted leave is unpaid, workers who might need the leave most are unable to take advantage of it due to financial constraints. She offers a list of specific policy proposals that would help to alleviate the financial burden faced by families with a worker taking leave from work.

ER: *Who is the audience for this book?*

JK: Each chapter in this book is written in a straightforward, nontechnical manner, so the book is intended for a broad audience, including scholars as well as the general public. In addition, Emily and I believe the book would be an excellent supplemental text for numerous college courses, including Women and the Economy, The Economics of the Family, and Labor Economics courses. In fact, I am using the book as a supplemental reader in my Women and the Economy course this semester, and I think the students will find it useful because of its content and will appreciate the relatively low price!

ER: *Thank you. We wish you success with this book.*