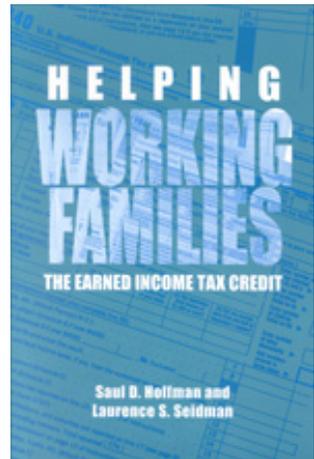

Upjohn Institute Press

Introduction

Saul D. Hoffman
University of Delaware

Laurence S. Seidman
University of Delaware



Chapter 1 (pp. 1-8) in:

Helping Working Families: The Earned Income Tax Credit

Saul D. Hoffman, Laurence S. Seidman

Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 2002

Introduction

When we first wrote about the Earned Income Tax Credit (EITC) in 1990, it was still a little-known and lightly funded government program that played a relatively minor role in the government's broad set of antipoverty policies. The EITC, as it is usually known, had been around since 1975, when it was introduced as a small "work bonus" for very low income working families. It had barely been revised or expanded in the intervening years. Despite the cutbacks of the Reagan years, welfare thoroughly dominated the antipoverty policy approach. Expenditures on Aid to Families with Dependent Children (AFDC) and Food Stamps, the two most well-known transfer programs, were about \$20 billion each and Medicaid, the medical assistance program for the poor, added another \$70 billion. In contrast, total payments under the EITC were about \$7.5 billion and the average recipient family received just \$601. It was still several years before candidate Bill Clinton would promise "to end welfare as we know it" and 6 years before welfare reform, in a form that truly was the end of welfare as we had known it, would actually come to pass.

Yet, even then, the EITC was clearly something different. Unique among income-transfer programs for the poor, the EITC conditioned its benefits on earnings. Families without earnings received nothing, reflecting its linkage to work. 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 the traditional welfare programs like AFDC and Food Stamps, which provided maximum benefits to families without earnings and then reduced benefits at a very high rate as family earnings increased. Married couples as well as single parents were eligible for EITC under identical rules—another difference from AFDC, which provided far more generous treatment of single-parent families than married couples. In fact, the EITC wasn't technically a welfare program. It was a tax credit, administered by the Internal Revenue Service (IRS), not through the welfare system. And nearly unique among 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, and many more, the EITC was even then emerging as a government antipoverty program that both liberals and conservatives could support. It could be broadly seen as endorsing work, since its benefit structure rewarded rather than penalized work, at least among the poorest of its recipients. Conservative politicians, weary of the low workforce activity of AFDC recipients, found that very appealing. Liberals viewed it not as a replacement for traditional welfare, but as a supplement and as a potential source of cash assistance for the working poor, a group often overlooked by most poverty programs. Others noted that it could function as a kind of substitute for a higher minimum wage and that it could do so without the concerns about higher minimum wages reducing employment opportunities and with better targeting of its benefits to low and moderate income households. The EITC operated without a large bureaucracy and without the welfare offices that neither clients nor administrators liked. It was fast becoming, as we wrote then, “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 and change.

We were certainly correct about that! Indeed, it has grown and changed, well beyond even our own expectations. Who could have predicted then that, a decade later, the EITC, and not AFDC, would be the centerpiece of antipoverty programs? How did that happen?

Two major policy actions were decisive in this change in emphasis. The first was change in the EITC program itself, the result of an unusual alliance of conservatives and liberals, a linking of “conservative values” with “liberal funding.” The decade began with an important EITC expansion. This increase, which came under the Bush Administration, was effective in 1991. Then came candidate Clinton who had promised not only to reform welfare but also “to make work pay,” a phrase that signaled his interest in helping the working poor. He made good on this latter promise in 1993, when he proposed and Congress passed a major increase in the EITC.

By 1996, when the changes were fully phased in, the program was almost unrecognizable from its former modest self. As a result of the two sets of changes, the earnings subsidy rate had nearly tripled from 14 percent to 40 percent for a family with two children. The maximum credit had more than doubled and now exceeded \$3,000 for a family with two children, nearly three and a half times higher than the maximum in 1990. Adults without children, who had been ineligible for

EITC benefits, were offered a modest credit. The total number of families receiving benefits jumped by nearly 70 percent to more than 20 million in 1998. Total EITC expenditures nearly quadrupled to \$25 billion in 1995 and over \$30 billion in 2000 (U.S. Committee on Ways and Means 2000).

The second important policy change was the “end of welfare as we knew it.” Welfare reform was a high priority of the Clinton Administration, but it waited in the wings while the ill-fated health care reform initiative was advanced and ultimately defeated. When the administration did finally present a specific welfare reform program in the summer of 1994, it was a casualty of the November 1994 elections when the Republicans took control of the House of Representatives. The president’s welfare reform proposal was never considered. The House Republicans included a very conservative version of welfare reform as a major element in their Contract with America, and they passed an ambitious and wide-sweeping reform. That particular version was vetoed by the president, but the president signed a somewhat modified and slightly milder version of welfare reform in the summer of 1996.

That law, the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, effectively abolished rather than reformed welfare. Effective July 1, 1997, AFDC, the primary cash assistance program for the poor since the mid 1930s, was replaced with the Temporary Assistance for Needy Families (TANF) program. While TANF is essentially similar in its overall benefit structure to AFDC—it provides maximum benefits to families with no income—it is not a legal entitlement as AFDC was, and it imposes strict time limits on lifetime usage as well as other requirements that each state may choose to impose. Most states have revamped their programs, substituting employment activities for check-writing. Almost all states now require recipients to move quickly into available jobs. Nearly half of the states now require TANF applicants to participate in job search or other work-related activities as a condition of eligibility. Strict penalties for noncompliance have been imposed in most states. There is little doubt that the world of welfare has changed dramatically and probably permanently.

Following welfare reform and buoyed by the strong economy and low unemployment rates of the mid and late 1990s, welfare rolls have plummeted. The number of welfare recipients fell sharply from 13

million in 1996 to under 6 million in mid-year 2000; the number of families fell similarly, from 4.6 million to 2.2 million. The TANF caseload is now less than one-ninth of the number of households who receive EITC benefits.

As a result of these two important and related policy changes—the expansion of EITC and the reform of welfare—the EITC has emerged as the largest cash transfer program for the poor and the near-poor. There is little doubt that it will retain that status in the foreseeable future.

In this volume, we offer an overview of the EITC as it stands early in the twenty-first century after the tumultuous decade of the 1990s. We describe, analyze, evaluate, summarize, and critique the EITC in the year 2001, and we also make recommendations for changes on the basis of our analysis. The enormous expansion of the program has brought both a great increase in research about the EITC and its impact on the economy as well as controversy and criticism, both among economists and politicians. A more generous program naturally has more substantial impacts, and not all of them are necessarily positive. High implicit tax rates of the EITC, created by the need to phase out the more generous benefits it now provides, are suspected of providing substantial work disincentives among some recipients. President Bush has spoken of the tax system as the “tollbooth on the road to the middle class”; ironically, some argue that the EITC phase-out rate is now part of the toll. Others contend that substantial marriage penalties are imbedded in the program, while still others allege that the EITC is subject for excessive fraud.

Our own view, reinforced by the many studies we have reviewed, is that the EITC is a government program that, on the whole, works and 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. It is a viable and attractive alternative to an increase in the minimum wage. It does all of this, we will show, while creating relatively few substantial problems of its own. It is, however, not perfect, and we offer a set of very specific suggestions for revising the problems we do identify.

The accomplishments of the EITC are many and they are discussed throughout this volume. Chief among them are the following.

- The EITC provided cash assistance to a total of over 18 million households and provided them an average of about \$1,625 in the year 2000. These households included about 6 million working-poor households who received an average of over \$1,450 and another 3.75 million near-poor households who received an average of \$1,650.
- The EITC reduced the poverty rate in 1999 by 1.5 percentage points. About 4 million persons were lifted out of poverty as a result of the cash assistance they received from the EITC.
- As an income-transfer policy for poor households, the EITC is clearly preferable to the minimum wage. For workers in the poorest households, the EITC operates exactly like an increase in the minimum wage, but without the potentially troubling increase in the wage price of labor that may reduce employment opportunities. For such a worker with two children, the effective minimum wage in 2000 was not its statutory rate of \$5.15, but rather \$7.21, courtesy of the 40 percent wage subsidy provided by the EITC. Additionally, the EITC targets its benefits to low and moderate income households with far more precision than the minimum wage does.
- The EITC has increased the labor force participation of many groups. For example, all estimates indicate that the EITC has increased labor force participation among single mothers, among married women whose husbands have low incomes, and among married men with children. While other factors such as welfare reform and the strong economy are undoubtedly important contributing factors, the EITC has had a major impact on the sharp increase in the labor force participation of single mothers and may well be the leading causal factor.
- Estimates of the impact of the EITC on the hours of work of current workers are relatively small in absolute value, whether positive or negative. There is no empirical evidence that the EITC has had serious adverse effects on hours of work among current workers, as some critics have claimed.

- Concerns about the negative impact of the EITC on marriage appear not to be warranted at this time.

There are, however, some emerging problem areas.

- The EITC penalizes work among workers with incomes at the high end of the EITC schedule, typically a family with earnings in the \$25,000 range. Like any income support program, EITC benefits eventually decrease as a family's income increases. For families with two or more children, this "phase-out" rate is 21 percent. When combined with the federal income tax and the payroll tax, this adds up to a total marginal tax rate of about 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 marriage penalties. 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. In the unlikely event that they each had two children, their EITC financial sacrifice to marry would be \$5,600! EITC marriage bonuses are possible but appear to be less common in practice.
- 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 is still poor even after adding in its \$4,000 EITC income.
- The eligibility criteria are needlessly complex. This is especially true regarding whether or not a household has "a qualifying child" and thus is eligible for the more generous benefits available to households with children. As a result, compliance issues have arisen. Some estimates suggest that as much as 25 percent of EITC payments are "in error," meaning that they do not comply with a strict interpretation of the complex EITC rules.

These problems are not, in fact, independent. This dependence is, in fact, a virtue when attempting to improve the program: a revision that addresses one problem also contributes to solving the others. In Chapter 8, we propose three very specific changes to alleviate these problems: 1) reducing the current EITC phase-out rate for a family

with two or more children; 2) establishing a separate, more generous EITC schedule for married couples; and 3) providing a new rate schedule for families with three or more children. These three simple changes go a long way toward alleviating the above problems.

As is perhaps inevitable in writing about important public policies, the ground is constantly shifting. When we began our research in the summer of 2000, the Clinton Administration had proposed changes in the EITC, but no legislation was passed. As we completed our work in the summer of 2001, the major tax cut legislation of the Bush Administration had just been passed. The legislation included three changes that affected the EITC and/or its interaction with the broader tax code: 1) a new 10 percent tax bracket for the first \$12,000 of income for a married couple, effective in 2001; 2) a refundable child tax credit, worth up to \$1,200 for a family with two children, also effective in 2001; and 3) a change in the EITC benefit schedule for married couples, effective in 2002 and phased in slowly through 2007. The legislation also calls for these changes and all the other changes in the legislation to be eliminated in 2011, although few knowledgeable observers believe that will actually occur.

The tax cut of 2001 did not change the basic structure of the EITC, and our best guess is that the unique structure of the EITC will emerge from the first decade of the 2000s relatively unchanged as compared with the 1990s. Its basic benefit structure, conditioned on earnings and with benefits that first increase with earnings, is now well-established. There may, of course, be changes in benefit rates and other program details, although none appear to be on President Bush's current economic agenda. We hope that the analyses we present will serve not only those who want to know about the EITC as it stands now but also help understand the likely impact of any changes that may be implemented in future years. To that end, we have tried to emphasize general analytical principles. At the same time, we have tried to present a relatively complete account of how the EITC works and what is currently known about the impacts of the EITC. We hope that this volume will be a useful source book for anyone interested in learning about the EITC.

Throughout the book, whenever we use specific numbers to describe the EITC program, we have used the EITC as it stood in the year 2001. That year is the most current for which, at the time of this

research, all EITC program parameters, including the various income thresholds that are an integral part of the benefit schedule, were known. We took full account of the tax code changes in 2001 that affected the EITC in 2001 but not of those that become effective only in future years.

Chapter 1 provides an overview of the history and operation of the EITC. It focuses especially on the unique EITC benefit formula and its implication for marginal tax rates. We include there a full discussion of the newest tax code changes and how they alter the EITC landscape. Chapter 2 looks at the EITC recipient population—who they are, how much they work, what they earn, and what they get from the EITC program. It also examines the impact of the EITC on the poverty rate. In Chapters 3 through 7, we evaluate the impact of the EITC program. In Chapters 3 and 4, we look at the impact of the EITC on individual behavior—labor supply and wage rates in Chapter 3 and marriage in Chapter 4. In Chapter 5, we compare the EITC to other antipoverty and transfer programs, including the minimum wage and TANF. Chapter 6 examines the impact of the EITC on the economy from the standpoint of its efficiency cost. Transfer and tax policies alter the relative prices that individuals face and in the process change the behavior of both recipients (who get the benefits) and taxpayers (who finance the benefits). These changes can end up costing the economy something in addition to the apparent dollar expenditures of the program itself; those additional costs are what economists call efficiency cost. Finally, Chapter 7 looks at the compliance problems of the EITC.

Based on the evaluations presented in Chapter 3 through 7, we offer ideas about how to strengthen the EITC program in Chapter 8. We firmly believe that the program works well in most respects but that modest changes would make a difference. We make a specific proposal to reform the EITC program in a very few selective ways. We then simulate the impact to assess the cost of the reform and see how it would be likely to change the program. Our approach is, of course, not the only way to accomplish reform. Other reforms have been proposed and we describe some of the well-known alternative proposals. We also discuss changes in the EITC program that will become effective after 2001.

Finally, in Chapter 9, we look both backwards at what the EITC has accomplished and forward toward what can be done to strengthen it.