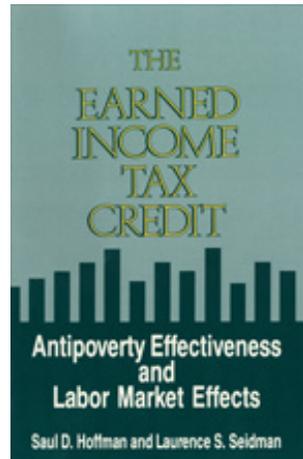

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Introduction

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The Earned Income Tax Credit: Antipoverty Effectiveness and Labor Market Effects

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Introduction

The decade of the 1980s was a difficult time for policymakers concerned with the problems of poverty. The decade began with a recession that pushed the poverty rate in 1982 and 1983 to its highest level in almost 20 years. Despite the improvement in the economy since then, the poverty rate at the end of the decade was still higher than at any time during the 1970s. The 1980s also saw declining poverty rates for the elderly coincide with rising poverty rates for children. In 1987, for example, one child in five lived in poverty, and for children under age six it was almost one in four. Attention was also focused on the “underclass” (Wilson 1987), a group composed of families in concentrated poverty areas and beset with behavioral problems that allegedly left them unable to join in mainstream economic life.

Politically, the decade saw efforts to re-evaluate the success of the “welfare state” and to scale back the “safety net.” There was also a growing consensus that conventional policy approaches to the poverty population via the welfare system were ineffective, or even counter-productive. Charles Murray (1984) first advanced this argument in *Losing Ground*, but it was subsequently endorsed in some respects by the Family Support Act with its emphasis on work requirements and job training.

One income transfer program that has managed not only to escape criticism but, indeed, has gained increased political support and funding is the Earned Income Tax Credit or EIC. What began as a small program in 1975 with the modest intent of offsetting Social Security payroll taxes for low-income workers with children has now become a rallying point in redirecting poverty policy. Indeed, the EIC now often seems to be the policy of choice for a wide range of problems ranging from the minimum wage (“increase the EIC instead”) to child care (“adjust the EIC for family size”). Both liberals and conservatives, Democrats and Republicans, have offered legislation involving EIC adjustments and extensions.

What is the EIC and why is it suddenly so popular? Simply put, the EIC is an income-transfer program that operates through the tax system to provide an income grant (technically, a refundable tax credit) to low-income working households with children. In 1990, it provided a maximum of \$953 and an average of over \$550 to roughly 10 million families.

The popularity of the EIC program derives from its unique design that clearly distinguishes it from conventional welfare programs. Unlike the Aid to Families with Dependent Children (AFDC) program which provides maximum benefits to families who do not work, EIC provides its maximum credit to families with some designated positive level of earned income; in 1990 the maximum benefit, \$953, was obtained by households with earnings between \$6,810 and \$10,734. Families with no earned income receive no benefits at all under EIC. Also unlike AFDC, married couples are eligible for the same benefits as single-parent families with the same income. Thus, EIC can be thought of as endorsing and financially supporting both work and marriage. The same cannot be said of AFDC.

As a way to supplement the income of low-wage workers, EIC also fares well in comparison with an increase in the minimum wage. The minimum wage is a poorly targeted program, raising wages not only for low-wage heads of household but also for many low-wage workers—primarily teenagers—in middle- and high-income families. Moreover, the minimum wage will generate involuntary unemployment whenever the legal minimum exceeds the market wage. The burden of involuntary unemployment falls heavily on low-earning households and poor teenagers.

In contrast, the EIC is well-targeted, since it is based on a household's total annual income, rather than an individual's hourly wage. Moreover, only families with children are eligible. In addition, the EIC does not generate involuntary unemployment. It may raise or lower labor supply, as we will explain in chapter 3, but at the wage that results, labor demand equals labor supply, in sharp contrast to the excess supply of labor generated by a minimum wage.

Finally, a modified EIC can be a vehicle for addressing the issue of child care. A modified EIC would adjust the benefits it provides to the

size of the family and/or the age of children. Although the 1990 EIC does not adjust benefits in this way, both the Senate and the House of Representatives approved legislation in the 101st Congress that would include such a provision.

The EIC currently enjoys broad support across the political spectrum because it is consistent with the basic principles of both a “liberal” and a “conservative” antipoverty strategy. Let’s consider the role of the EIC in each strategy.

The liberal envisions the EIC as a supplement to, not a replacement for, welfare. The working poor are not necessarily more worthy or deserving than the nonworking poor, but they need help and are ill-treated by AFDC, so an EIC is a useful policy. The financing of EIC should not come at the expense of welfare. Most liberals see the EIC as a complement to, not a substitute for, a relatively high minimum wage. Although some liberals recognize that a high minimum wage will reduce the number of jobs employers offer low-skilled persons, many morally object to very low wages and are impressed with the fact that the majority of low-skilled workers remain employed under a high minimum wage.

Where does the EIC fit into the larger liberal strategy? Liberals might prefer a single transfer system that targets all individuals in need regardless of work status. Also, liberals (unless they are economists) generally support a high minimum wage. But the liberal recognizes that conservative citizens who are unwilling to support welfare or a high minimum wage may be willing to support the EIC. Thus, it seems sensible to try to obtain as much conservative support as possible for the EIC, while at the same time resisting cuts in welfare and pressing for a higher minimum wage.

Conservatives, on the other hand, envision the EIC as a replacement for welfare for nonelderly, able-bodied people. They believe that the working poor are generally more worthy and deserving than the nonworking, nonelderly, able-bodied poor, and that government assistance should be targeted on them rather than those who do not work. The financing of EIC, according to conservatives, should come at the expense of welfare.

The EIC should substitute for raising the minimum wage. Permitting employers to offer jobs at low wages will result in more jobs being offered and reduce unemployment for low-skilled persons willing to work. Even if a person begins in a low-wage job, the EIC supplement will compensate for the low wage, and responsible work effort should enable the individual to earn wage increases and promotions.

Some conservatives support varying the EIC with the number of children as an alternative to child-care programs that directly subsidize providers of child care. Other conservatives oppose varying the EIC with the number of children (as well as alternative child-care programs) because they do not want to encourage poor people to have large families. To limit the total cost of EIC, most conservatives would probably support exclusion of the childless working poor.

Thus, although liberal and conservative strategies often conflict, the EIC appears to have an important role to play in each strategy.

In this monograph, we take a close and careful look at the EIC program. We look at its strengths and its weaknesses, its current effects, and also the likely effects of adjustments in the EIC program. We compare it to alternative policies intended to provide financial assistance to low income families.

As is, perhaps, inevitable in writing about important public policy issues, the policies themselves change even as one tries to analyze them. This is especially true for a policy like the Earned Income Tax Credit, whose time in the national agenda has clearly come.

When we began this research, expansion of the EIC had been considered in the 100th Congress, but no action was taken. As we worked (in 1989), the House Ways and Means Committee approved a substantial expansion of the EIC program as part of a new legislative initiative on child care. That bill, which included an increase in EIC benefits and an adjustment of benefits for family size, did not, however, reach the floor of the House during that legislative session.¹ At about the same time, the Senate passed its own child care bill, the Act for Better Child Care Services. The Senate version included a much more modest expansion of the EIC program, limited to families with children under age four. Finally, after we finished this monograph and just as this volume went to press (in the spring of 1990), the full House of Represent-

tatives approved the EIC provisions of the original Ways and Means Committee day-care bill as part of the Early Childhood Education and Development Act.

As we write this, the future of the EIC program is uncertain. There will undoubtedly be changes, but the extent of those changes is still hard to predict. The House and Senate versions differ quite significantly in terms of EIC expansion, and a conference committee must, therefore, reconcile those differences. The House version is more than twice as expensive as the Senate version, and some compromise on the EIC expansion is a genuine possibility. And even then, a presidential veto is a distinct possibility, especially if the version reported out of conference retains many of the features of the House bill. Child-care legislation, supported by President Bush but never passed by either the House or the Senate, was similar to, but yet more modest than, the Senate version with respect to its EIC provisions.

Our approach in this monograph has been dictated, in part, by these developments. Where possible, we have tried to emphasize general principles and effects that are common to any and all EIC programs. No matter what happens to the EIC program in the Congress this session or in the future, these ideas will be valid, and, we hope, useful as well.

Where we have needed to turn to specifics—to explain, for example, *exactly* how the EIC program works—we have used the law as it stood in 1990. Where we have tried to describe who benefits from the EIC, how much in benefits different groups receive, and what effects the EIC might have on the economy, we have used the EIC law as it stood in 1988. Our reasons for doing this are explained in chapter 2. Fortunately, the EIC law in 1988 and the EIC law in 1990 are identical in all important respects. Finally, where we considered expansion and reform of the EIC program, we included among our alternatives a specification that is very similar to the legislation passed by the House of Representatives.

Chapter 1 presents an overview of the EIC: how the EIC works and what it does. Chapter 2 uses the Panel Study of Income Dynamics (PSID) data to estimate the distribution of EIC benefits in 1988 among the population and to describe some of the characteristics of the population of EIC recipients. Chapter 3 analyzes the impact of EIC on labor

supply decisions. Chapter 4 compares the EIC to other antipoverty policies, including a negative income tax (NIT), welfare (AFDC), an increase in the minimum wage, and a wage-subsidy plan. Chapter 5 uses the PSID data to estimate the likely impact of a number of expansions and adjustments of the EIC program. Finally, chapter 6 considers how to increase the EIC participation rate.

NOTE

1. The bill was dropped after a split emerged among the chief sponsors over whether funding should emphasize direct grants to states or a combination of grants and tax credits (EIC) and whether church-related child care centers should be eligible for the provisions of the bill.