The American Earned Income Tax Credit

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Abstract

While the U.S. Earned Income Tax Credit is well over a quarter-century old, its role as a major instrument of social assistance policy is a relatively recent development. This paper provides an overview of the operation of the EITC and recent developments in EITC-related analysis and innovation. Generally speaking, the lessons gained from the American EITC experience seem to be that earnings subsidies can be successfully administered through the tax code and that the EITC did increase labor force participation among lone parents. Anticipated perverse effects on labor supply of the credit phase-out have not been shown to be substantial. Understanding the connection between expansion of the EITC and the precipitous decline in the number of families receiving benefits from Aid to Families with Dependent Children and its successor program Temporary Assistance for Needy Families is complicated by near simultaneity between EITC expansion, state and national welfare reform efforts, and decline in unemployment rates. As experience with the EITC has grown, effects beyond labor supply are attracting attention, including consequences for saving and children's well-being. American experience with the EITC is pertinent to consideration of policies intended to expand low-skill service employment in Europe.

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The American Earned Income Tax Credit

Michael Wiseman*

The topic of this conference is "Innovations in Labour Market Policies." In my judgment the most significant labor market policy development in recent United States history is the expansion of the Earned Income Tax Credit (EITC). The EITC is a national earnings subsidy for low-income workers. The program is credited with substantially increasing labor supply among lone parents and contributing to dramatic declines in take-up of Temporary Assistance for Needy Families, America's program of last resort for destitute families with children. While the credit was originally enacted in 1975, take-up and effects grew substantially after implementation of significant benefit expansions in the early 1990s. Thus even with the usual lags in data accumulation and analysis, we have over a decade of experience with the credit to mine for ideas and lessons.

Generally speaking, the lessons seem to be that earnings subsidies can be successfully administered through the tax code and that the EITC did increase labor force participation among lone parents. Anticipated perverse effects on labor supply of the credit phase-out have not been shown to be substantial. Understanding the connection between expansion of the EITC and decline in the number of families receiving more social assistance is complicated by near simultaneity between EITC expansion, state welfare reform efforts, and decline in unemployment rates. As experience with the EITC has grown, effects beyond labor supply are attracting attention, including consequences for saving and children's well-being. Integration of the major components of the American social assistance "triad"—the EITC, the Food Stamp program, and Temporary Assistance for Needy Families—is yet to be accomplished. American experience with the EITC is pertinent to consideration of policies such as those discussed at this conference by Christopher Pissarides that are intended to expand low-skill service employment in Europe.

My plan is straightforward: I begin with a description of the structure of the EITC and a review of take-up. I then summarize the results of a number of important recent studies of EITC effects. I close with some questions for which researchers and academics are still seeking answers, as they are wont to do.

How the EITC Operates

The EITC is available to low-income working taxpayers.[1] Since Americans are engaged in the process of filing tax returns for 2005 as we are meeting in Vienna, I shall describe the

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[1] For a useful general review of the EITC and other tax credits for low-income families, see Dickert-Conlin, Fitzpatrick, and Hanson (2005). Some of the description that follows is taken from Committee on Ways and Means (2004).

program's parameters as applied to last year's income. There are schedules for (1) taxpayers with one qualifying child, (2) taxpayers with two or more qualifying children, and (3) taxpayers who are over 24, but less than 65, years old and have no qualifying children.

As outlined in Figure 1, in 2005 a single parent with one child and annual earnings less than $7,660 gains $.34 in EITC for every $1 earned to a maximum (at $7,660) of $2,604. This maximum benefit continues until earnings reach $14,040; beyond this amount, in what is termed the "phase-out" range, the benefit declines at a rate of $.153 per dollar of earnings, reaching zero at $31,030. Two children raise the maximum payment to $4,400 and the maximum earnings level for any eligibility to $35,263. Married couples' benefits are the same except that phase-out begins at a slightly higher level. There is a very small EITC (maximum benefit $390 per year) for childless individuals and couples. The fact that the major EITC operates only on adults with child dependents offers an opportunity to gauge EITC effects by comparing changes in labor force participation among those affected by changes in the benefit to contemporaneous change among adults without children.

[Figures and Tables appear at end]

Figure 1: The Federal Earned Income Tax Credit in Tax Year 2005

Of course, worker/taxpayers also have positive tax obligations. One is contributions for social insurance, including social pensions, disability insurance, and hospital (Medicare) insurance in retirement, amounting to 7.65 percent up to a maximum (for all but Medicare component) of $90,000. (An equal amount is paid by employers.) A second is liability for the federal income tax itself and, in many states, state income taxes. Figure 2 shows the change in combined federal tax liability as earnings increase for a family of four, both when counting only federal income tax (including the EITC and social insurance) and when adding, for a sample state (Maryland), state income taxes and the state's own earned income credit.[2] These data are for 2004, the latest year for which state information was readily available. EITC benefits are indexed, so the maximum amount paid for a four-person, two-child family for the 2004 tax year was $4,300, $100 less than in 2005.

[Figures and Tables appear at end]

Figure 2: Social Insurance and Income Tax Liability, Family of 4, 2004

Note that at the Low Earnings Level of $14,500 per year, two adults with two children would on balance gain about $3,600 from the tax system.[3] The official U.S. poverty standard for 2004 for a two-parent family of four was $19,157 before taxes (DeNavas-Walt et al., 2005, 45); thus in principle the EITC would almost lift the family out of poverty. This family would in addition be eligible for $2,700 or more in Food Stamp program benefits, and this

[2] As of January, 2006, nineteen states and at least three urban counties supplement the federal benefit with tax credits of their own. Figure 2 was drawn using TAXSIM (http://www.nber.org/taxsim). See Feenberg and Coutts (1993).

[3] The Low Earnings Level is the average of the real value of the national minimum wage between 1967 and 1987; it is adjusted for changes in prices since 1987. The actual minimum wage ($5.15 per hour) has not been increased since 1997; in real terms it amounted to about 74 percent of the 2004 Low Earnings Level standard. See Bureau of Labor Statistics (2005)

would cover the remainder of the gap.[4] The "in principle" modifier is necessary because virtually all filers receive the EITC in the year after a claim accrues. There is provision in the law for partial EITC prepayment on a monthly basis, but very few taxpayers take advantage of this option.

The poverty standard used in the U.S. is an absolute standard rooted in budget studies done a half century ago. It differs from measures commonly used in Europe in that it is invariant with respect to the distribution of income. If one were to take a more European view and identify poverty with incomes less than half the national median based on a commonly used equivalence scale,[5] the threshold for a family of 4 in 2004 would have been approximately $29,000. Obviously, the families we are describing are poor.

The operation of the EITC poses a number of administrative problems and raises various questions about taxpayer response. One administrative concern is fraud; or at least misappropriation of the benefit in cases in which parents not filing together both claim the same child. Scams are possible and have occurred, for example, when persons create artificial exchange of employment at low earnings in order to lay claim to the credit. To date no problem encountered in EITC administration appears sufficiently significant to warrant major program adjustments. The central behavioral concern involves labor supply. Over the range of earnings up to the phase-out, the credit creates substantial incentives for initiation of employment and expansion of earnings. However, beyond the "plateau" of the maximum benefit, the reduction in EITC as earnings go up creates what is in effect a substantial marginal tax rate on returns to work—over 50 percent at $30,000 in the Maryland example plotted in Figure 2. In a typical tax year there are more households in the phase-out range than in the range of increasing or constant subsidy, hence it is possible that the effect of the program as a whole is to reduce labor supply.

Changes over Time

Major EITC policy changes occurred in 1987 (parameters indexed for inflation; effective 1987 tax year), 1990 (substantial expansion including differential benefit for two or more children, effective 1991), 1993 (substantial expansion, effective 1994), and 2001 (various administrative changes, phased in beginning 2002). The resulting pattern of change in the real value of the one- and two+-child maximum benefit is plotted in Figure 3. The substantial relative increase in the benefit for larger families that began in 1994 offers an opportunity for "difference-in-difference" analysis of EITC effects by comparing subsequent changes in labor force participation and hours worked for adults with two or more children to that of adults with only a single child dependent.

[Figures and Tables appear at end]

Figure 3: Maximum EITC Credit, 1975-2004

[4] The Food Stamp program is a means-tested monthly benefit used for food and delivered through an electronic benefits transfer card; it is virtually cash. In July, 2004 the benefit for a family of 4 at zero income was $471 per month; in each month this benefit is reduced by $.24 for each $1 of earnings in excess of $134. The figure in the text is annualized and reflects a cost-of-living benefit increase that occurs in September.

[5] The calculation presumes, as is common in OECD publications, that family costs vary with the square root of family size. See, for example, Förster and Mira d'Ercole (2005).

Figure 4 illustrates both the increase in take-up of the EITC and the average benefit. These data are plotted by tax year of accrual, but it should be recalled that claimants receive payment at the beginning of the following year. Thus the jump in benefit from1990 to 91 was received in 1992. From 1991 (paid 1992) to 1998 (paid 1999) the average credit increased in real terms by 64 percent. There is a lot of money involved here: $38 billion in credits in 2004. Part of this amount simply offsets other income tax liability, but over 87 percent of the total outlay—$33 billion—was accounted for by positive payments.

[Figures and Tables appear at end]

Figure 4: EITC Take-Up and Benefit, 1975-2004

Effects

I turn now to a short and very selective overview of recent EITC-related research.

Labor Supply

The increase in labor force participation among women with children, and in particular among lone parents, is one of the most significant recent developments in the economic demography of the U.S. The response is particularly striking when one compares trends in labor force participation for married women who live with their spouses and have children under 18 to all other women with children. Figure 5 shows the prevalence of labor force participation over the period 1984-2003 for women age 19-44 in various family circumstances.[6] Over this period labor force participation for those in the married-with-children group rose just four percentage points, from 66 to 70 percent. For women in the single-with-children group the increase was by 11 percentage points, from 73 to 85 percent. Lone parents account for over three-quarters of EITC recipients.

[Figures and Tables appear at end]

Figure 5: Women's Labor Force Participation and Family Status, 1984-2003

The most important early study of EITC effects on labor force participation by single mothers is that of Meyer and Rosenbaum (2001). The authors estimate that the EITC increased employment among single mothers by 4-7 percentage points by 1996. Their estimated increase due to the EITC for single mothers with young children and for single mothers with low education levels is larger. Overall, the authors judged the EITC to be responsible for more than 60 percent of the increase in labor force participation among single mothers between 1984 and 1996.

Subsequent work has generally been consistent with the core Meyer-Rosenbaum results. (For a comprehensive review, see Eissa and Hoynes 2005.) Analysts find EITC effects to be most evident on labor force participation for lone parents; little evidence of effects on hours worked has been detected. EITC expansion is typically estimated to lead to small decreases

[6] Figure 5 is Figure V from Eissa and Hoynes (2005); the underlying data are from the U.S. Census Bureau's Annual Social and Economic Supplements to the Current Population Survey, the source for most official statistics on labor force participation, unemployment, and income. Women in school or disabled are excluded. Labor force participation means the woman reported any work (i.e. hours and earnings) during the year. I am grateful to Hilary Hoynes for providing the data; for more detail, see the source.

in hours of employment for married women in families with incomes in the phase-out range. Overall, the failure to detect effects on hours worked is a puzzle given the size of the implicit tax rate in the phase-out range of the tax. Explanations offered for the absence of a significant hours effect include: (1) Most workers can't vary hours significantly, since generally most hold "full-time" jobs; (2) there are considerable errors in measurement of hours of work in surveys, and this errors-in-variables problem prevents detection of hours-of-work effects; and (3) workers simply don't understand the connection between benefits received and hours of work, especially difference in timing between when decisions about how much to work are made and the EITC benefit is received. To date none of these explanations has been conclusively supported or refuted by research. The problem of timing of perception and response clouds much of the analysis of EITC effects, since while changes in policy may be substantial and discontinuous, growth in understanding and the spread of response probably occur gradually.

Such puzzles aside, from a political standpoint the important thing is that the EITC expansion has produced neither administrative problems nor obvious effects on behavior that threaten its endurance as an institution. The EITC has become the central instrument of income support for low-income working families in the U.S.

Welfare

Perhaps the most politically controversial aspect of analysis of the effect of the EITC has been the implications of such work for judgments regarding the efficacy of another feature of recent American social assistance history: welfare reform. In American terminology, "welfare" has traditionally meant the Aid to Families with Dependent Children (AFDC) program created by the Social Security Act of 1936 and "reform" describes the process leading to AFDC's replacement in 1996 with a new program, Temporary Assistance for Needy Families (AFDC) (Wiseman, 2003). For families with children, the American social assistance system has three major components: The EITC, the Food Stamp program, and TANF. The EITC and Food Stamp programs both have uniform national benefits (although, as indicated, some states supplement the EITC). The EITC serves only families with earnings and generally delivers benefits only once a year. The Food Stamp program provides benefits on a monthly basis, but support is adequate only for nutrition. TANF, like its predecessor program AFDC, is support of last resort.

For the first 40 years of AFDC operation, variation across states in the amount of benefits was always substantial, but most other features were standard. Since at least the early 1980's states have allowed the real value of basic benefits paid families without other income to erode. In the late 1980's and early 1990's states, with administrative permission from first Republican and then Democratic administrations, began to increase work and other obligations imposed on applicants for and recipients of AFDC payments in a variety of ways. The 1996 reforms further enhanced the latitude granted states in determining the structure of their TANF programs, including the nature of work requirements, the financial incentives for work, and choices with respect to time limits on benefit receipt. As a result diversity across states in TANF operation has continued to grow.

The AFDC/TANF policy developments of 1990's, as well as substantial economic expansion, are associated with a dramatic decline in the number of families receiving AFDC/TANF cash assistance. Figure 6 plots the number of families receiving AFDC/TANF from 1975 through 2003, along with the national unemployment rate. Obviously, there is a significant correlation between improvements in the labor market and decline in AFDC/TANF receipt.

In addition, the 1994 turnaround in caseload totals coincides with the last of the series of substantial EITC increases. Both the EITC changes and welfare reform primarily affected families with children, and the most substantial changes occurred for single parents, the principle beneficiaries of AFDC/TANF. Thus we have two candidate explanations for declining welfare caseloads. On the one hand, the EITC made work more attractive. On the other, welfare reform, by raising the cost and uncertainty surrounding benefit receipt, made public assistance less attractive. And movement to work was encouraged by a steadily improving labor market. Sorting out the relative contribution of welfare reform and the EITC on these developments is very difficult. In part the problem is again measurement: Because during the 1990's there was so much variation across states in first AFDC and then TANF programs, it is difficult to control for the nature of the welfare alternative in any sort of time series or cross-state analysis of EITC effects. In my judgment, no available analysis has succeeded in doing so.

[Figures and Tables appear at end]

Figure 6: The AFDC/TANF Caseload and Unemployment, 1975-2003

Aside from difficulty in characterizing the variation in TANF programs in ways suitable for the usual methods of statistical analysis, there is a dynamic issue. TANF is "temporary" assistance, presumably providing interim support for adults and their children who are expected to be make effort to return to or begin work. Most evaluations of the EITC effects approach the issue in a comparative static framework, attempting to identify the effect of the credit on the prevalence and intensity of labor force participation. For policymakers interested in accelerating accession to work, it is reasonable to suspect that success involves the dynamic interaction between more aggressive administrative welfare-to-work efforts and the incentive to work created by the EITC. This complicates the parsing of causality.

Analysis of this interaction between EITC expansion and welfare reform is complicated by the general absence of data on welfare accession and termination with detail sufficient to control for state policy choices both in TANF and with respect to taxes and earnings subsidies. Using data from a special federal program of bonuses for states achieving high rates of movement to employment by unemployed TANF recipients, I have found a statistically significant and substantial positive effect of expected income from work on job-taking (Wiseman, 2005). My measure of gain from work reflects local labor market conditions and includes both wage rates and the anticipated supplement from federal and state earned income credits, but it is not clear that the bonus data are adequate for reliably identifying subsidy effects alone.

Whatever the difficulties encountered in econometric analysis of effects, considerable effort is exerted by states to inform TANF recipients of the role of the federal (and, where present, state) EITC in "making work pay."

Saving

Domestic social policy discussions in the U.S. are currently dominated by debate over the appropriate course for reform of the social retirement system. The outcome of this debate is uncertain, but it has served to focus attention on incentives for encouraging private saving. Politically such initiatives are consonant with President Bush's emphasis on developing an "Ownership Society." Practically, were a larger share of the population to have significant assets, vulnerability to economic dislocation would be reduced.

The ticket to membership in the ownership society is saving. Yet the U.S., like most other countries, defines poverty in terms of income, sets standards with reference to consumption, and focuses much of its policy—from the Food Stamp to the Low Income Home Energy Assistance program—on sustaining consumption, not on increasing security through asset accumulation. Despite the difficulties in precise contribution assessment already cited, it is clear that much of the success of American anti-poverty policy in the 1990s was attributable to the role of the Earned Income Tax Credit in encouraging and sustaining labor force participation. Recently various academics and interest groups have focused attention on finding ways of translating part of the new income generated by work into wealth.

As discussed above, while the EITC includes provision for partial advance payment, virtually all households receive it (and any additional state tax credits) after filing their annual income tax returns. A growing body of evidence suggests that saving is best accomplished when arrangements are made to set aside income when received, before opportunities arise for spending. For many low- to moderate-income families the advent of annual federal and state refunds provides a saving opportunity (Beverly, Schneider, and Tufano, 2005). The amounts involved are not trivial, since in addition to the EITC they include various other refundable credits and over-withholding. State refunds add to this.

A substantial portion of all Earned Income Tax Credit refunds are obtained by filers who use the services of tax preparation consultants. There are various reasons for this, including ease of access, the complicated nature of the federal and state tax system, and the opportunity of gaining refunds quickly through short-term ("refund anticipation") loans. In the U.S., the largest of these is H&R Block, Inc. In 2005, Block participated in a randomized trial in which refund recipients were offered various incentives to direct a portion of refunds into Individual Retirement Accounts (Duflo et all, 2005). The results were mixed (an expanded experiment is underway for 2006), but the conclusion of an early evaluation report is interesting: "Our results," the authors write, "suggest that the combination of a clear and understandable match for saving, easily accessible savings vehicles, the opportunity to use part of an income tax refund to save, and professional assistance could generate a significant increase in retirement saving participation and contributions, even among moderate- and low-income households" (Duflo et al., 2005, 1). Experiments of this nature are being promoted by the growing number of economists unsatisfied with the empirical success of predictions of policy impact that are based on traditional full-information rational choice models of consumer behavior.

Given the security of the EITC as a social policy institution, it is likely that analysts and policymakers will continue to seek avenues for improving its long-term impact.

Child Achievement

Consideration of "long term impact" may be important. The EITC has now become a permanent part of the economic situation of low-income families in the U.S. It has raised both the expected income of low-skilled adults with dependents and possibly reduced the uncertainty surrounding such expectations. Both consequences could affect other outcomes of social importance.

Social scientists have long been aware of a positive relationship between family income and children's academic achievement. However, it is difficult to be confident about causality in such data, for both family income and children's achievement may be the product of other, difficult-to-observe factors. If such confounding factors are present, it is possible that the

observed relationship between income and achievement does not provide a guide for predicting the effects of increasing income through policy intervention. Some analysts have attempted to identify income effects in the context of classical experiments in which randomly selected families are provided exceptional resources or opportunities (cf. Duncan, Morris, and Rodrigues, 2004), since in such experiments at least some difference in income between "treatment" and "control" families is generated quite independently of family characteristics. However, such experiments are typically focused on questions other than the determinants of child development and have a treatment horizon that is too short to expect measurable impact on children.

Given their evident endurance, increases in the EITC offer an alternative opportunity to examine the consequences of income change on child development. In a significant recent paper Gordon Dahl and Lance Lochner (2005) report results of study of the relationship between family income and achievement within a longitudinal panel of over 6,000 children five years of age or older for whom data on ability and family circumstances were collected over the period 1986 to 2000. The data include up to five measures of cognitive test scores administered at two-year intervals within the span of the study. The authors use the repeated observations on each child to control for fixed ability and other environmental effects and develop an instrument for expected household earnings to which the contemporary EITC benefit is added. Normalized test scores in math and reading are regressed on the income instrument and various characteristics thought likely to affect achievement. EITC-related variation in expected income comes about because of variation in the EITC schedule over time and across families given variation in predicted income from other sources.

The authors find "modest but encouraging" effects: Translated into effects per dollar of expenditure, their "baseline" estimates imply that the current (2005) maximum EITC credit ($4,400, for families with two or more children) increases the math scores of affected children by about one-tenth of a standard deviation and reading scores by about a seventh of a standard deviation. These effects are not large, but they are comparable in magnitude to estimates of effects of other direct interventions intended to enhance academic performance. The effects appear to be larger for families most likely to be affected, and the estimates are quite robust.

The Dahl-Lochner results provide significant new evidence that positive change in family economic circumstances does translate into improved child outcomes.

Conclusions

The Earned Income Credit is a seasoned and generous instrument of social assistance policy, increasingly well understood and appreciated among low-income American families. It is not clear whether its idiosyncratic annual delivery is a virtue or a shortcoming. Its success as an antipoverty strategy in the short-run is dependent on the availability of jobs, and thus it works well in the context of an economy in which unemployment is low but many jobs pay low wages. This circumstance is unlikely to change in the near future, in part because of the influence of globalization, and as a result the credit will continue as a major vehicle for income support. Given both the timing of the benefit and the dependence on employment, the EITC cannot serve as the whole of social assistance, and attention would be usefully paid to improving integration with the Food Stamp and TANF programs.

There remain many questions. We need better information on the consequences of the EITC for labor supply. In principle the increase in labor force participation brought about by the

EITC should be expected to reduce wages, but such effects have been difficult to uncover (Rothstein, 2005). What are we to infer? That demand is essentially infinitely elastic? Why is it that workers appear to be unwilling to seek advance payment of the EITC? Why do they prefer the forced saving implicit in waiting for collection until income tax filing? Is there a positive role for private tax intermediaries like H&R Block to play in encouraging and facilitating saving? Is such a role contingent on operation of an EITC-type subsidy in the mode observed in the U.S.? Just how significant in practice are the disincentives created by the EITC phase-out for skill accumulation? What policy instruments might be used to offset these effects?

In his keynote address to this conference, Christopher Pissarides (2006) presents a novel argument that expansion of the service sector and in particular of low-skill employment may be essential to expanding women's labor force participation at the upper end of the skill distribution and indeed for raising productivity in general. Clearly the earned income credit has facilitated an increase in employment at relatively low wages in the U.S. The magnitude of the indirect effect of cheaper services on aggregate U.S. productivity has yet to be explored.

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Figure 1: The Federal Earned Income Tax Credit in Tax Year 2005

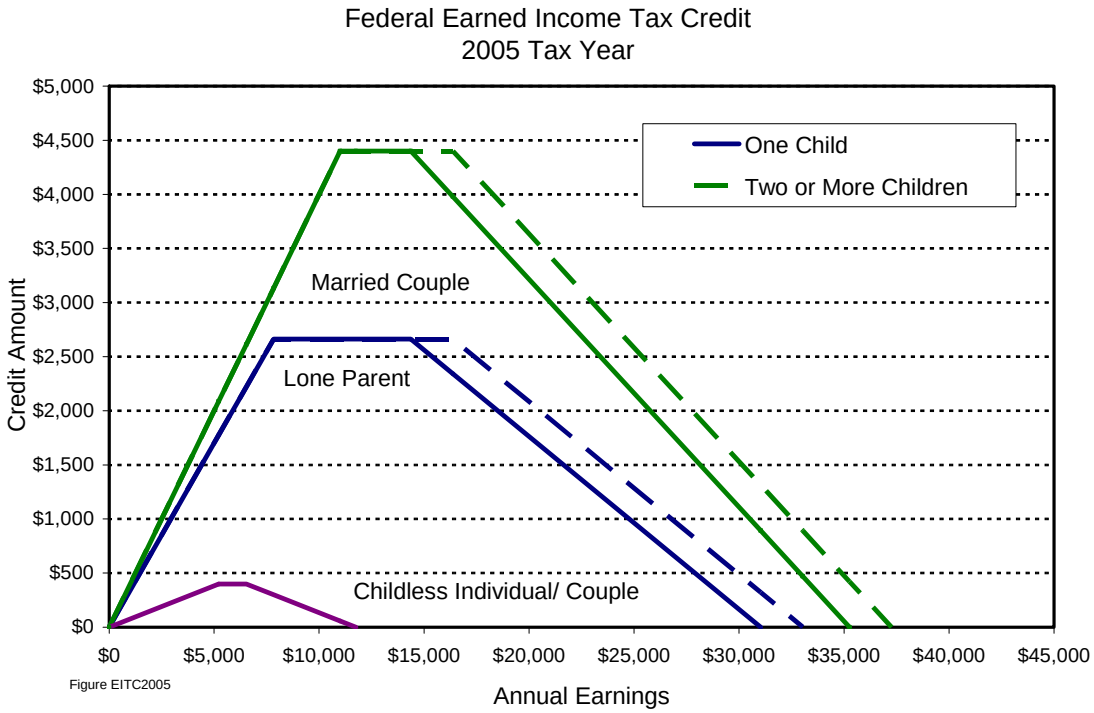

Figure 2: Social Insurance and Income Tax Liability, Family of 4, 2004

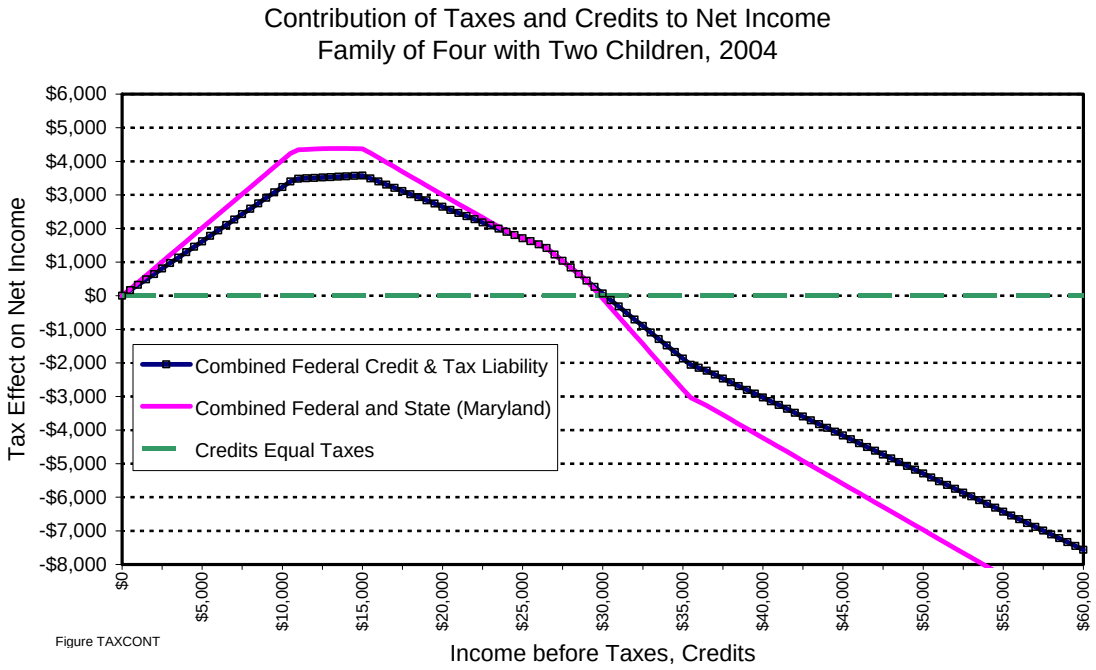

Figure 3: Maximum EITC Credit, 1975-2004

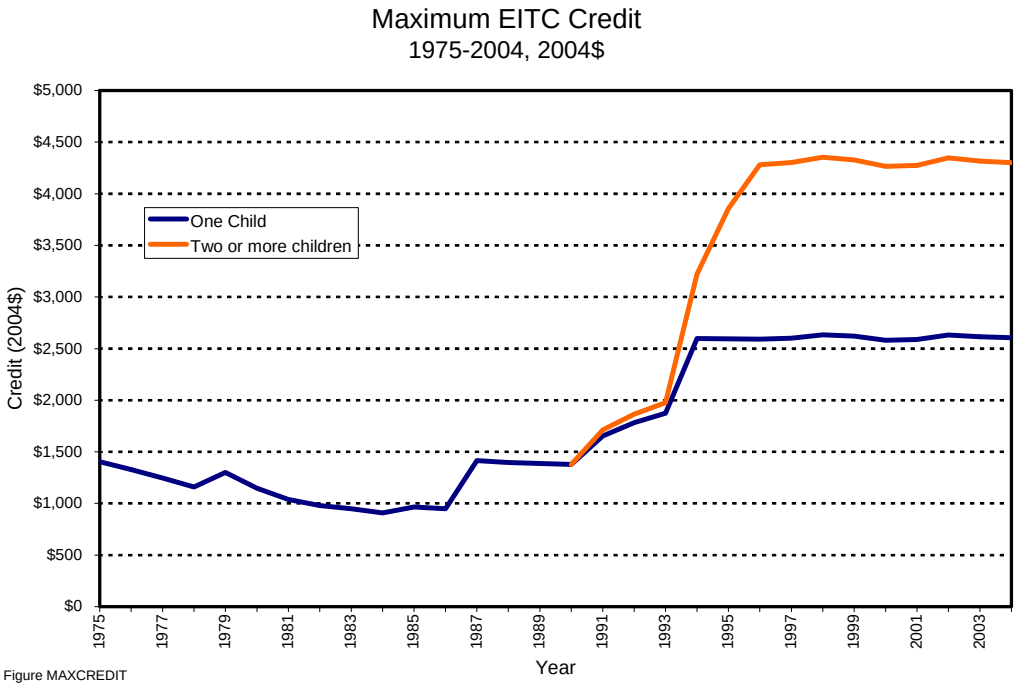

Figure 4: EITC Take-Up and Benefit, 1975-2004

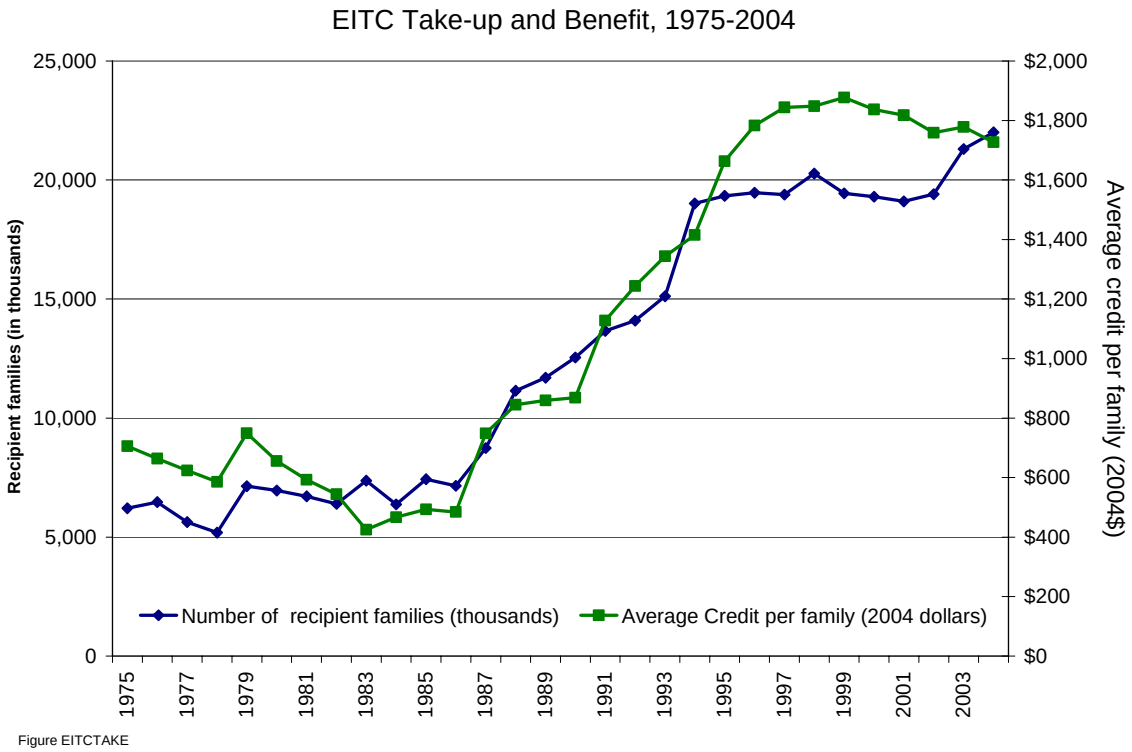

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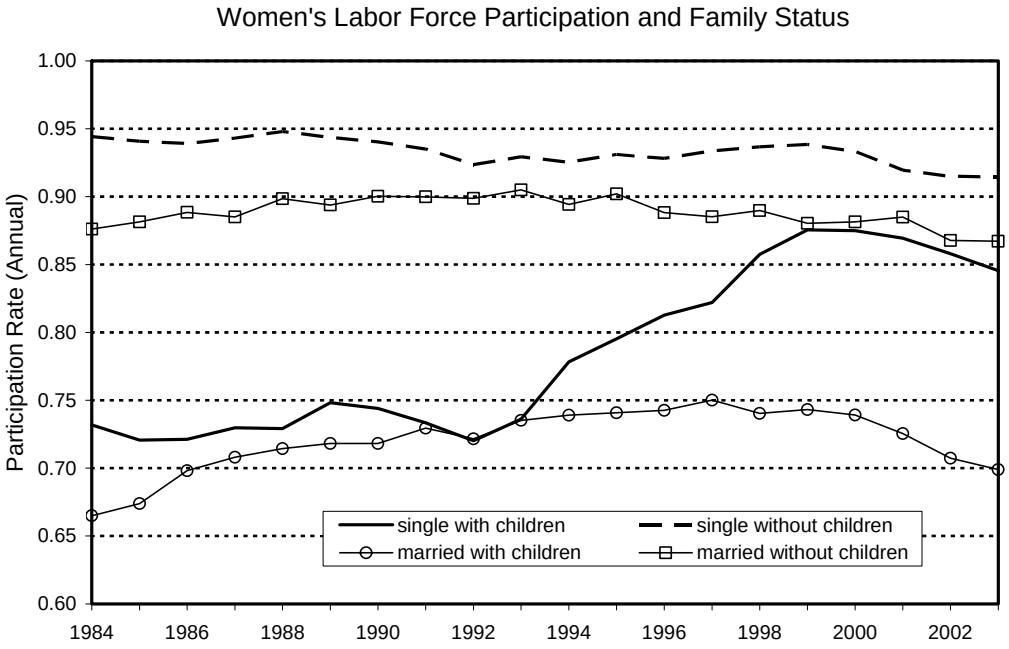
Figure 5: Women's Labor Force Participation and Family Status, 1984-2003



Figure

Figure 6: The AFDC/TANF Caseload and Unemployment, 1975-2003

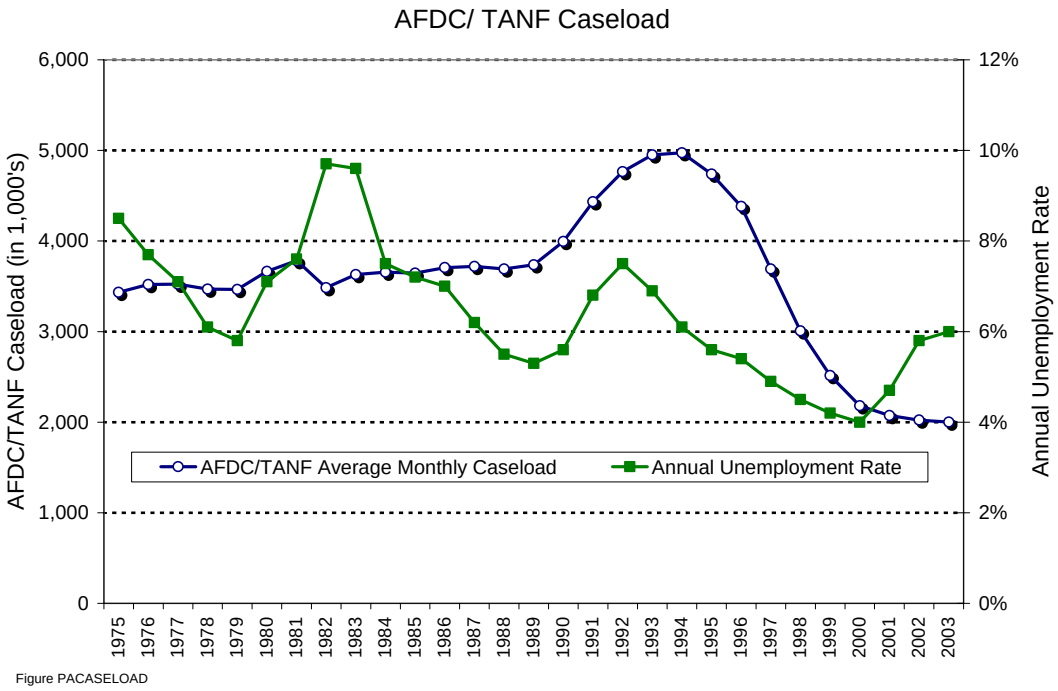


Figure PACASELOAD