

Tax Policy for Low-Income Families: The Earned Income Tax Credit

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Tax Policy in the Obama Era
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Overview and Issues

- In the last 15 years, the EITC has expanded into the most important government cash program for low income families with children.
- The EITC has relatively wide ranging support because it is shown to transfer resources to low income families while promoting work.
- Here I review features of the EITC and discuss the implications of hypothetical changes to the program.

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Roadmap for the talk

- Operation of the EITC
- Distributional analysis: Who gets the EITC?
- Behavioral impacts of the EITC
- Expected effects of possible reforms to EITC

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(1) Overview of EITC

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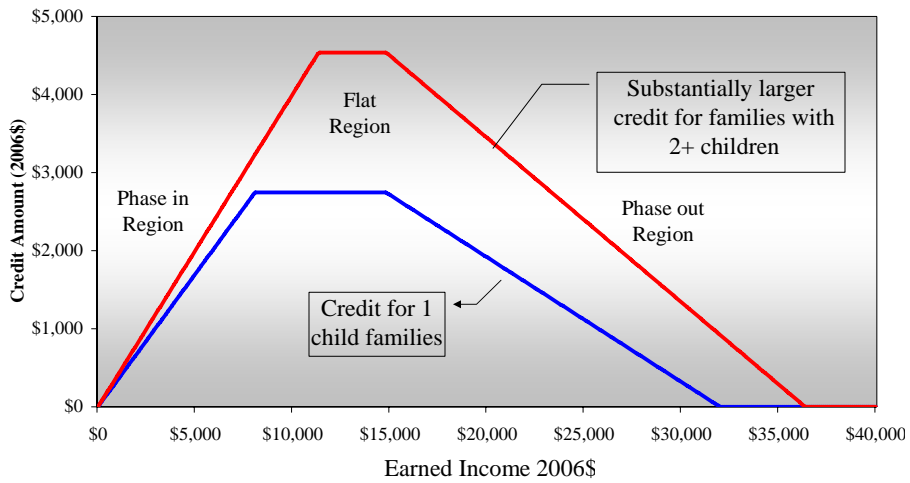
The Earned Income Tax Credit

- Refundable tax credit for *working*, low-income tax filers with children (much smaller credit for childless)
- Introduced in 1975; expanded in 1986, 1990, 1993.
- Total cost of the EITC is \$35 billion (compared to \$24 billion for TANF and \$33 billion for food stamps) making it the largest cash or near cash program for low income families in the US.
- The value of the credit varies with earned income and number of children—with larger credit amounts for families with children (and especially 2+ children).
 - The average credit in 2007 was \$1,896 (\$2,236 for claimants with children).
- Credit available to childless, single parent and two parent families.

EITC Eligibility and Payments

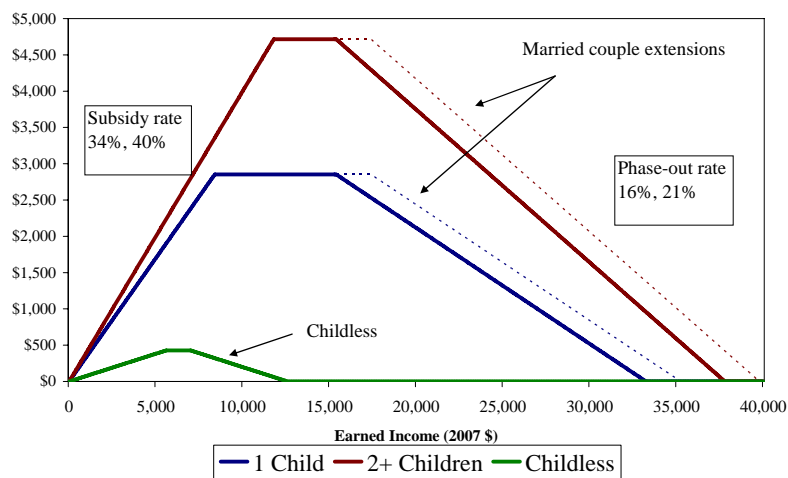
- EITC Eligibility:
 - *Positive* earned income; AGI below limit
 - Until 1991, must have qualifying children (own, grandchildren, adopted).
- Credit amount depends on *family earnings* and *number of children*:
 - Phase-in: credit is flat percentage of earned income
 - Flat range: receive maximum credit
 - Phase-out: credit is phased out at a flat rate
- Until 2001, EITC parameters were identical for single and married filers.
 - EGTRRA extended flat/phase-out regions for married couples; now \$3100 higher than for singles.

EITC Benefit Structure, Single mothers in 2007

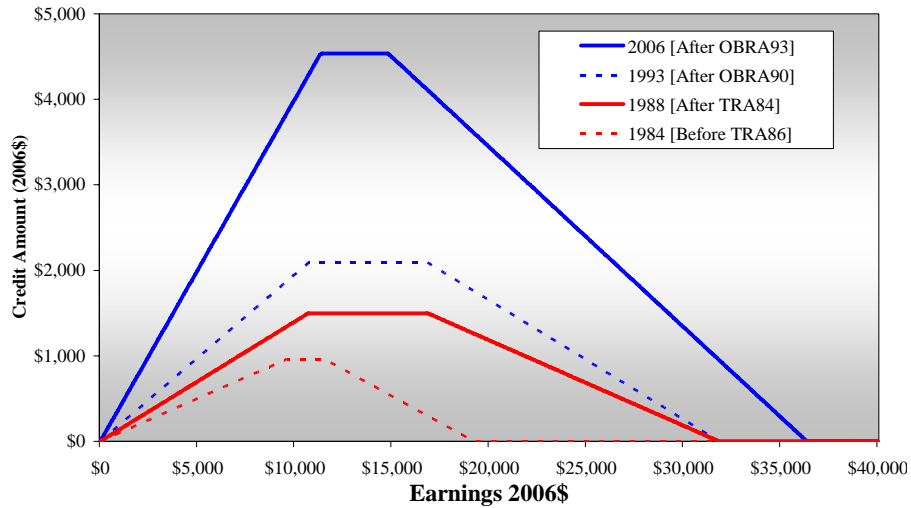


Eligibility extends well into moderate earning ranges. Median family income for 2006 was \$48,000.

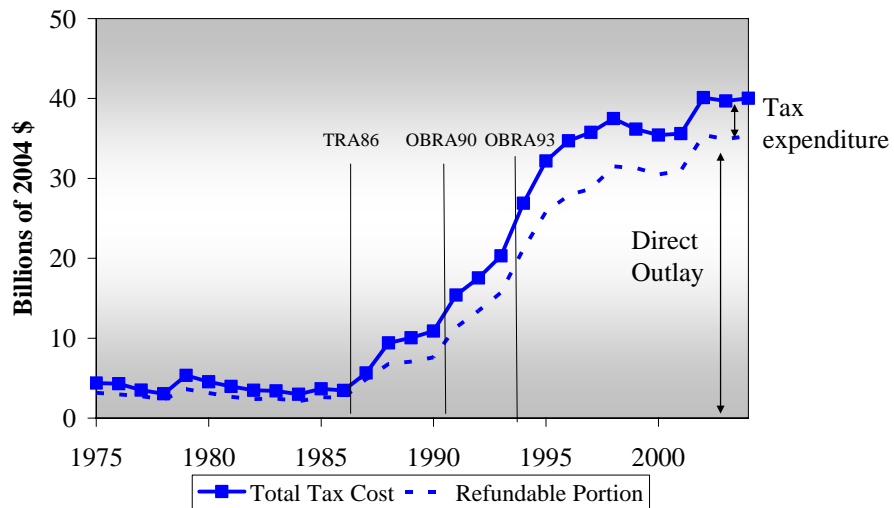
More detail in EITC Schedule – Married couple extensions and credit for childless



Real EITC Benefits Increasing over Time (2+ children) Tax laws expanded EITC in 1986, 1990, 1993

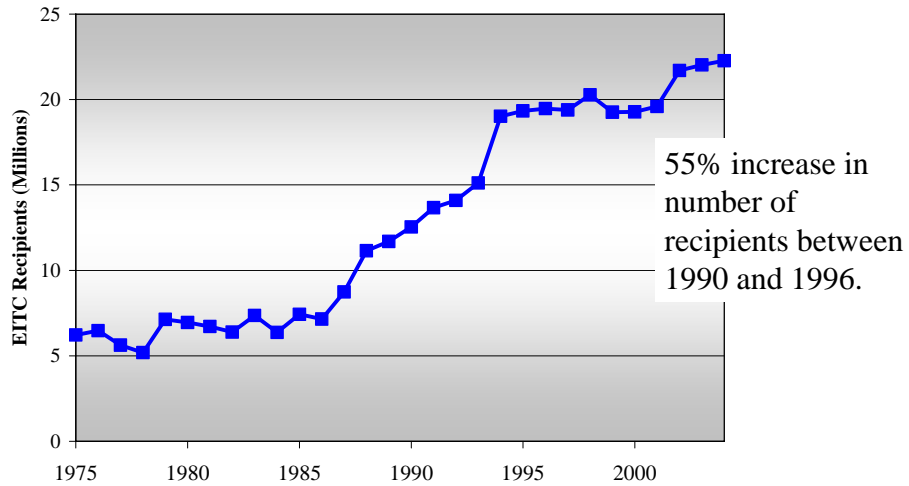


Tax cost of EITC, 1975-2004



The tax expenditure is modest compared to the direct outlay. 10

EITC Recipients, 1975-2004



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(2) Distributional analysis

Tabulations are based on the Statistics of Income Public Use Tax File. Data are for 2004 and reflect 2004 tax law.

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Recipients and Costs of the EITC

	EITC Recipients		Total Tax Cost		Average payment
	Number	% of total	Amount	% of total	
All	22.1		\$40.1		\$1,806
<u>Number of EITC</u>					
1 child	8.4	38%	\$14.4	36%	\$1,715
2+ children	9.2	42%	\$24.7	62%	\$2,693
No Children	4.6	21%	\$1.0	3%	\$218
<u>Filing Status</u>					
Head of Household	11.7	53%	\$26.1	65%	\$2,230
Joint Return	5.1	23%	\$10.0	25%	\$1,953
Single	5.3	24%	\$3.9	10%	\$742
<u>EITC Range</u>					
Phase In	5.9	27%	\$9.1	23%	\$1,544
Flat	4.2	19%	\$11.7	29%	\$2,817
Phase Out	12.1	54%	\$19.2	48%	\$1,595

A small amount of the tax cost is for childless filers; but they represent a sizable fraction of total recipients.

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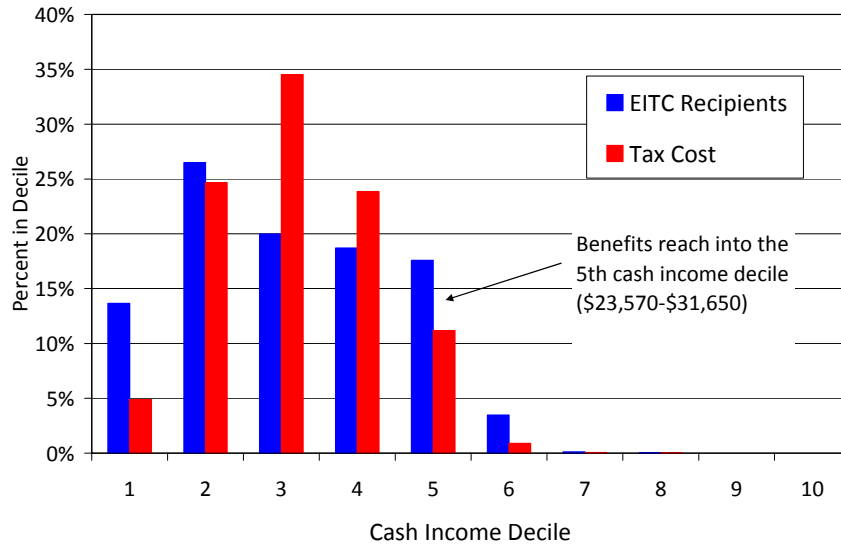
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Majority of recipients in flat/phase-out where EITC discourages work

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Distribution by Income



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(3) Behavioral Effects of the EITC

Key design feature: No tax benefit without working.
Redistributes income while also subsidizing work.

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Incentive effects of EITC on labor supply

- **Single/head of household filers:**
 - Extensive margin: increases in employment
 - Intensive margin: reduces hours worked by most eligible workers (beyond the phase-in)
- **Secondary earners [married couples are 25% of tax cost]:**
 - Extensive margin: reduces employment for all but the very lowest earning families
 - Intensive margin: reduces hours worked by most working women
 - EITC is unlikely to have any positive impact on the labor supply of married couples

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Empirical Evidence on EITC

- **Single Parents:** Overwhelming evidence that EITC expansions have increased labor force participation by single mothers with children.
 - Limited to no impact on hours worked by people in the labor force, even in the phase-out region.
 - Explanation for this pattern of behavior may be in the way EITC is received (lump sum, refund) or lack of knowledge about precise tax schedule (Chetty and Saez 2008).
- **Married Couples:** Small impacts (consistent with theoretical predictions) on secondary earner's labor force participation and hours worked.
- **Poverty:** EITC shown to remove almost five million people from poverty in 2002, more than any other government program

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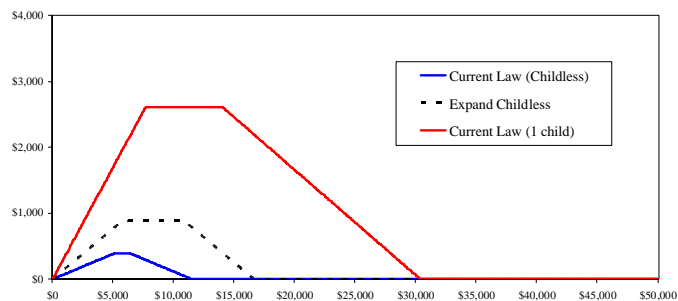
Behavioral Predictions and Support for EITC

- The justification for the EITC is redistribution—providing a transfer through the tax system for low income families with children.
- Widespread support for the EITC is due in large part to the fact that the program distributes income to *low earning* families while promoting work.
 - Benefits go to working families
- Contrast to traditional welfare programs (TANF) which transfer resources while discouraging work
 - Benefits go to nonworking families
- EITC is viewed as successful public policy.

(4) Possible changes to EITC

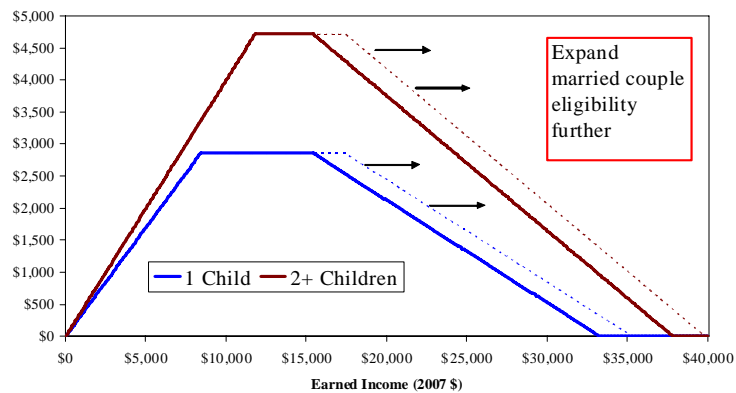
Expand EITC for childless taxpayers

- Credit for childless taxpayers is quite small
- Many proposals consider expanding this
- Effects: increase incomes of low earning childless; encourage work



Expand eligibility for married couples

- Expand income eligibility range further for married couples
- Effects: reduce marriage penalty (likely small impacts), reduce secondary earner work incentives



Make work pay credit

- Part of candidate-Obama's tax plan
 - 6.2% subsidy for those earnings \$8,100 or less.
 - Phased out slowly
- Modeled on success of EITC
 - Transfer resources to needy why encouraging work
 - Importance of low phase out rate in minimizing hours worked distortion