

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.

Roadmap for the talk

- Operation of the EITC
- Why is there (relatively) broad support for the EITC?
- Expected effects of possible reforms to EITC

(1) Overview of EITC

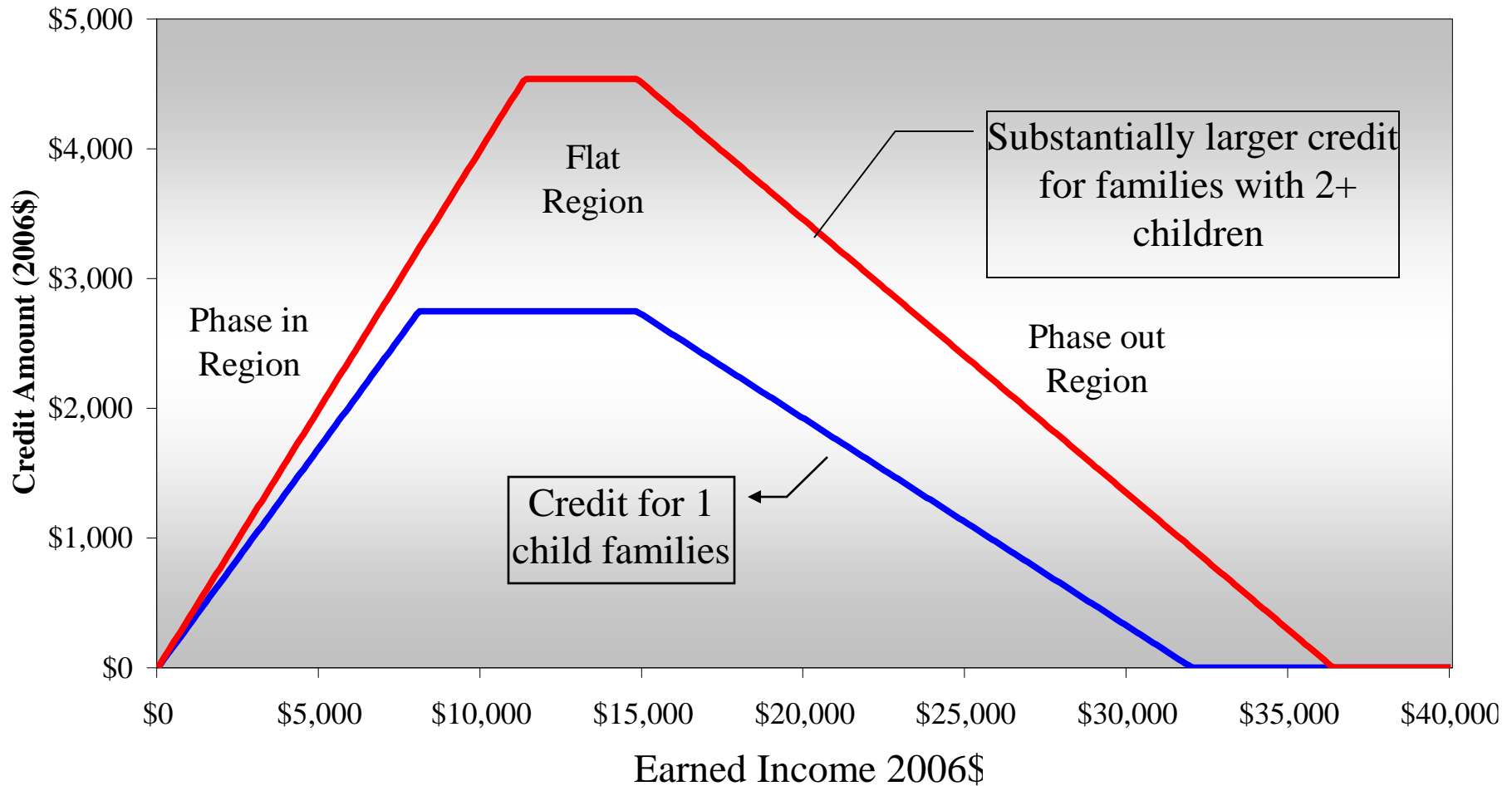
The Earned Income Tax Credit

- Refundable tax credit for working, low-income tax filers with children (much smaller credit for childless)
- Credit available to childless, single parent and two parent families.
- The value of the credit varies with earned income and number of children—with larger credit amounts for families with children
 - The average credit in 2007 was \$1,896 (\$2,236 for claimants with children).
- 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.

EITC Eligibility and Payments

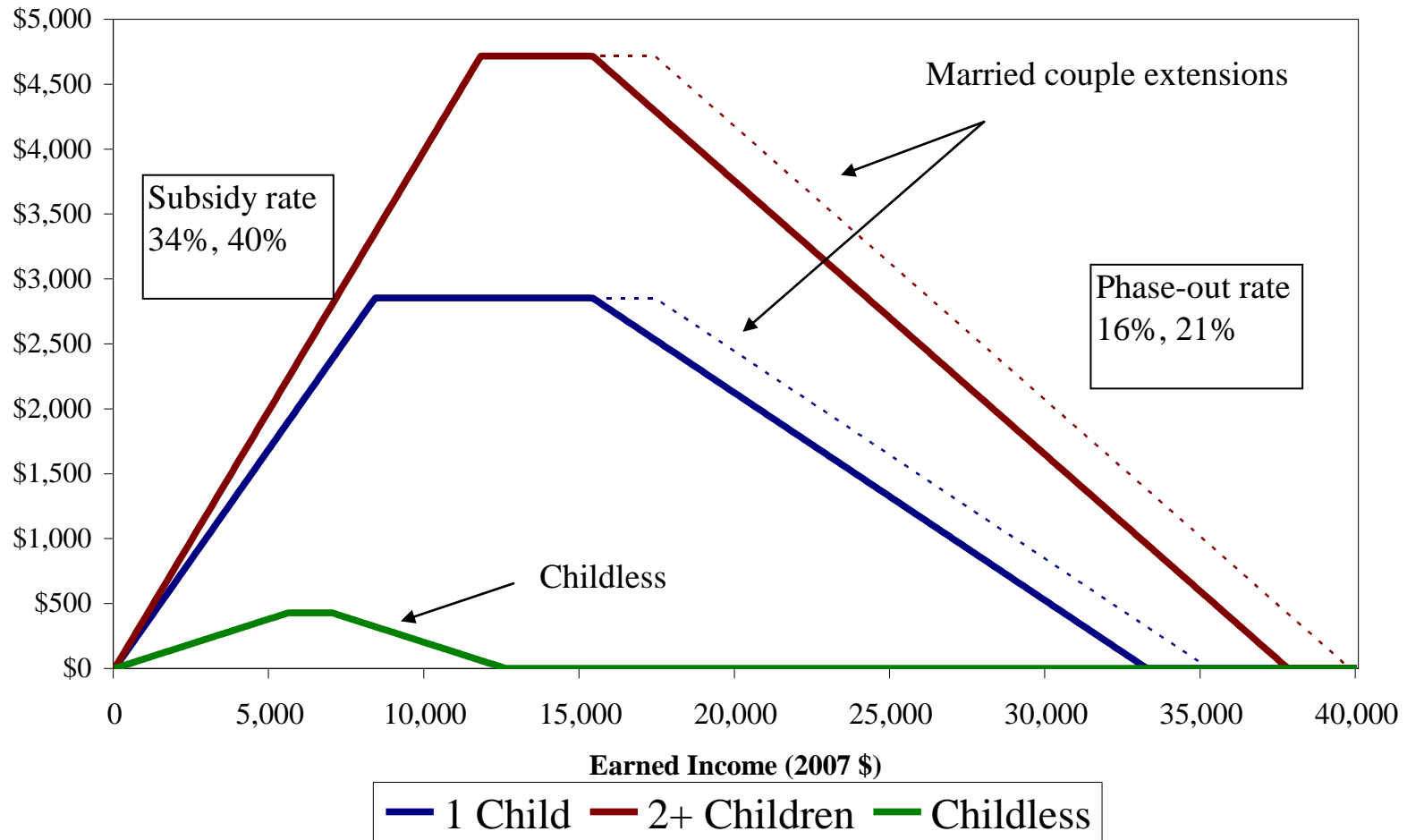
- EITC Eligibility:
 - *Positive* earned income; AGI below limit
 - Until 1991, must have qualifying children (own, grandchildren, adopted).
- Credit amount depends on *family earnings* and *number of children*:
 - Phase-in: credit is flat percentage of earned income
 - Flat range: receive maximum credit
 - 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



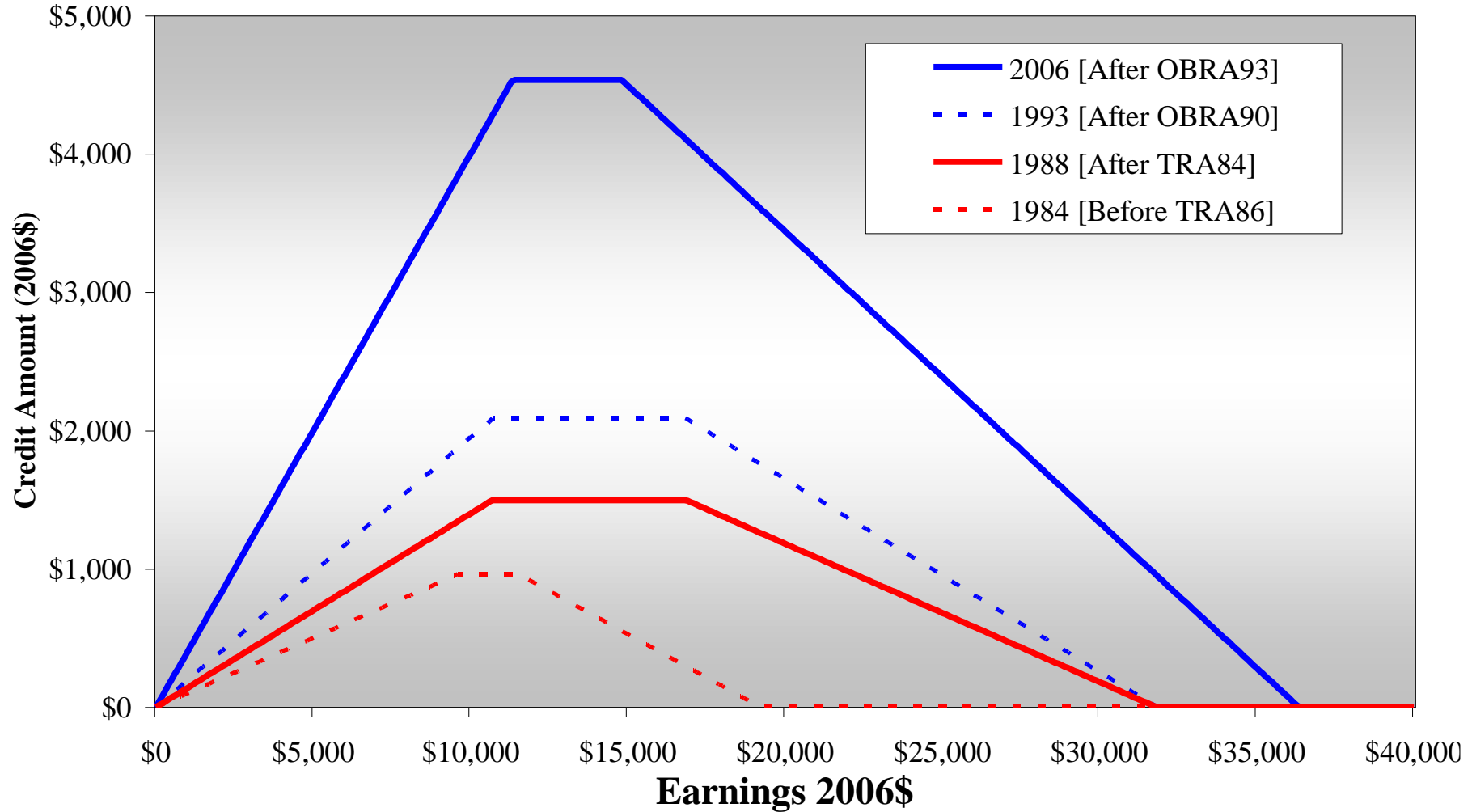
Eligibility extends well into moderate earning ranges. Median family income for 2006 was \$48,000.

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

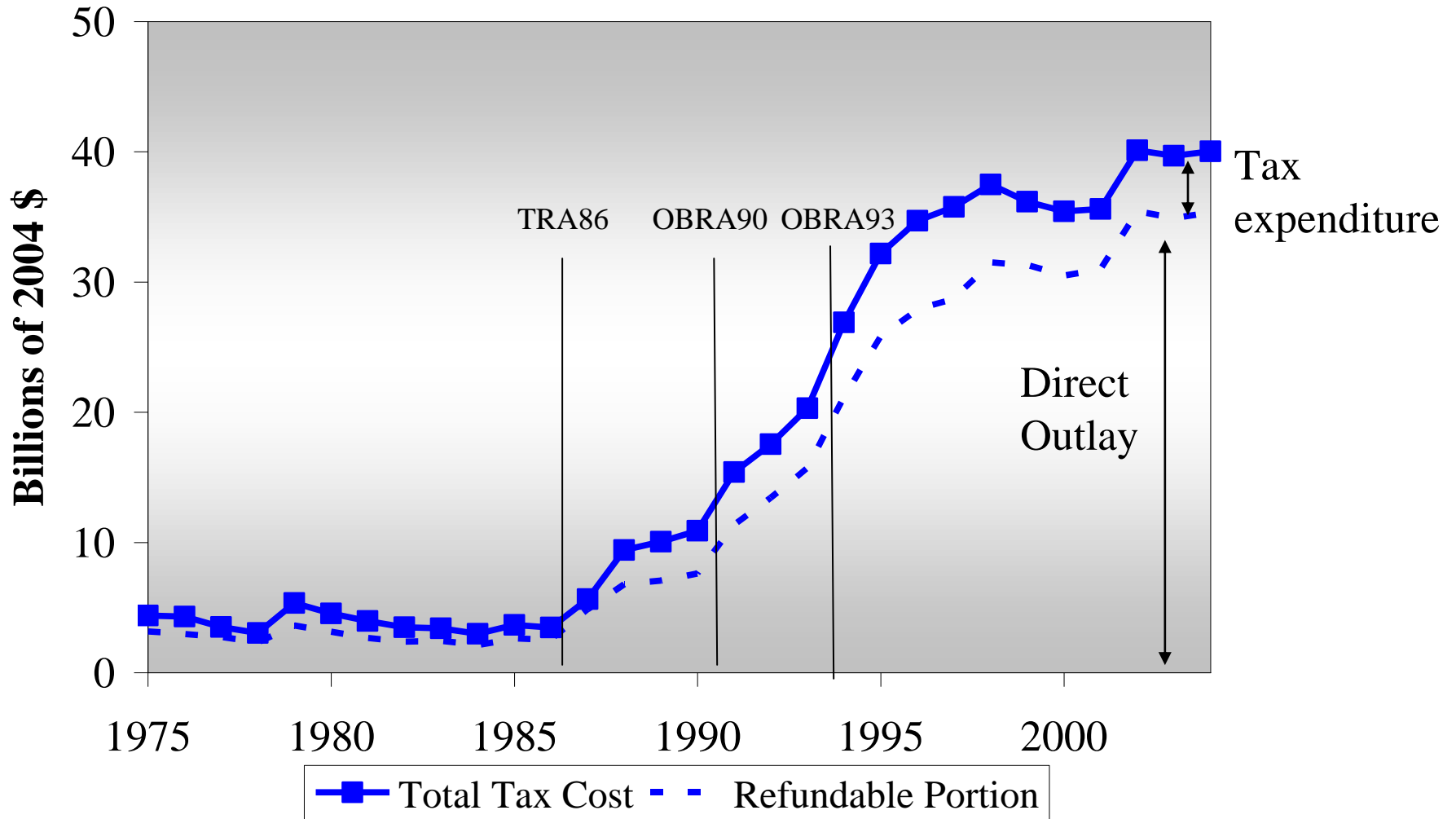


Real EITC Benefits Increasing over Time (2+ children)

Tax laws expanded EITC in 1986, 1990, 1993

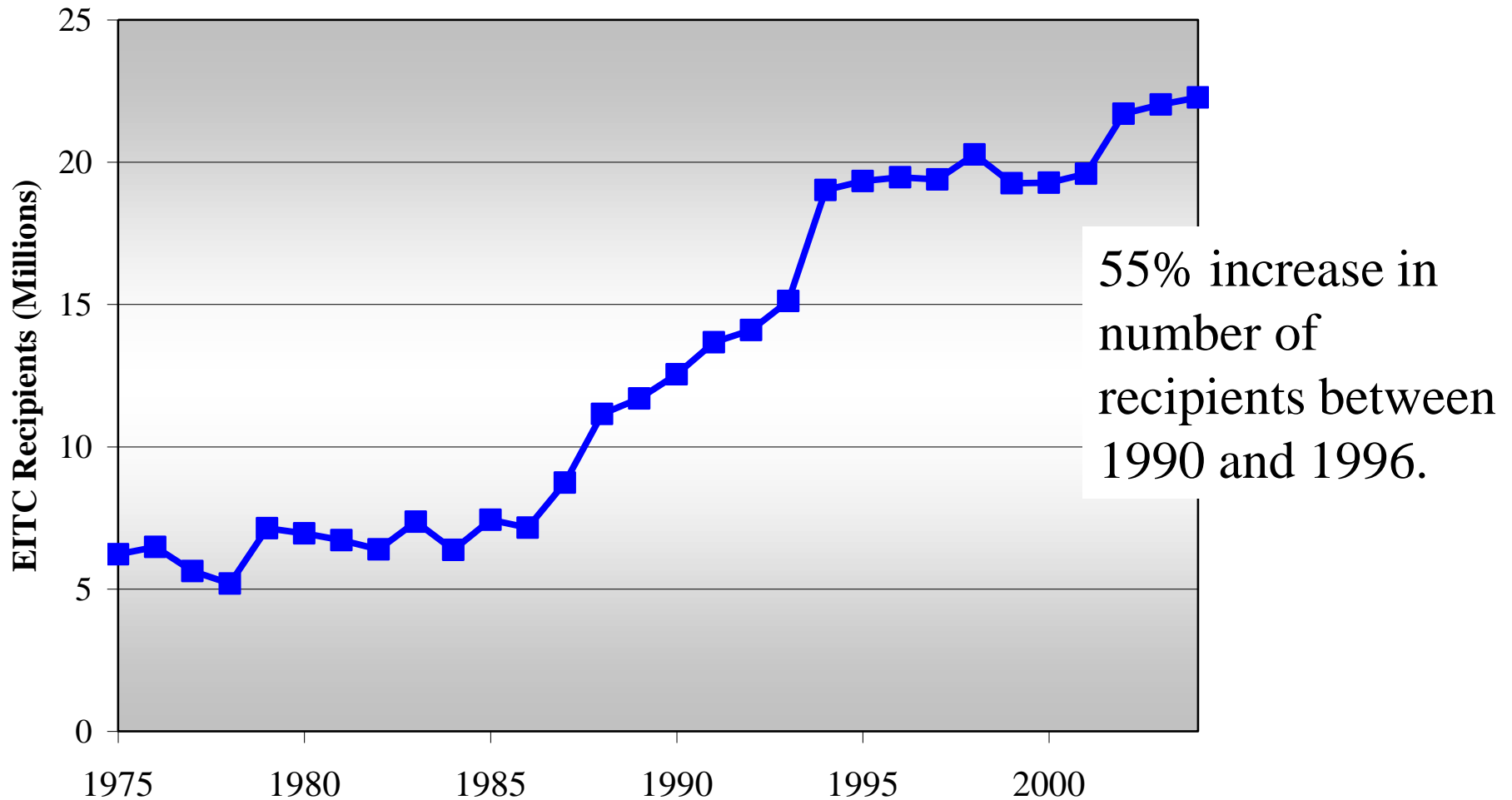


Tax cost of EITC, 1975-2004



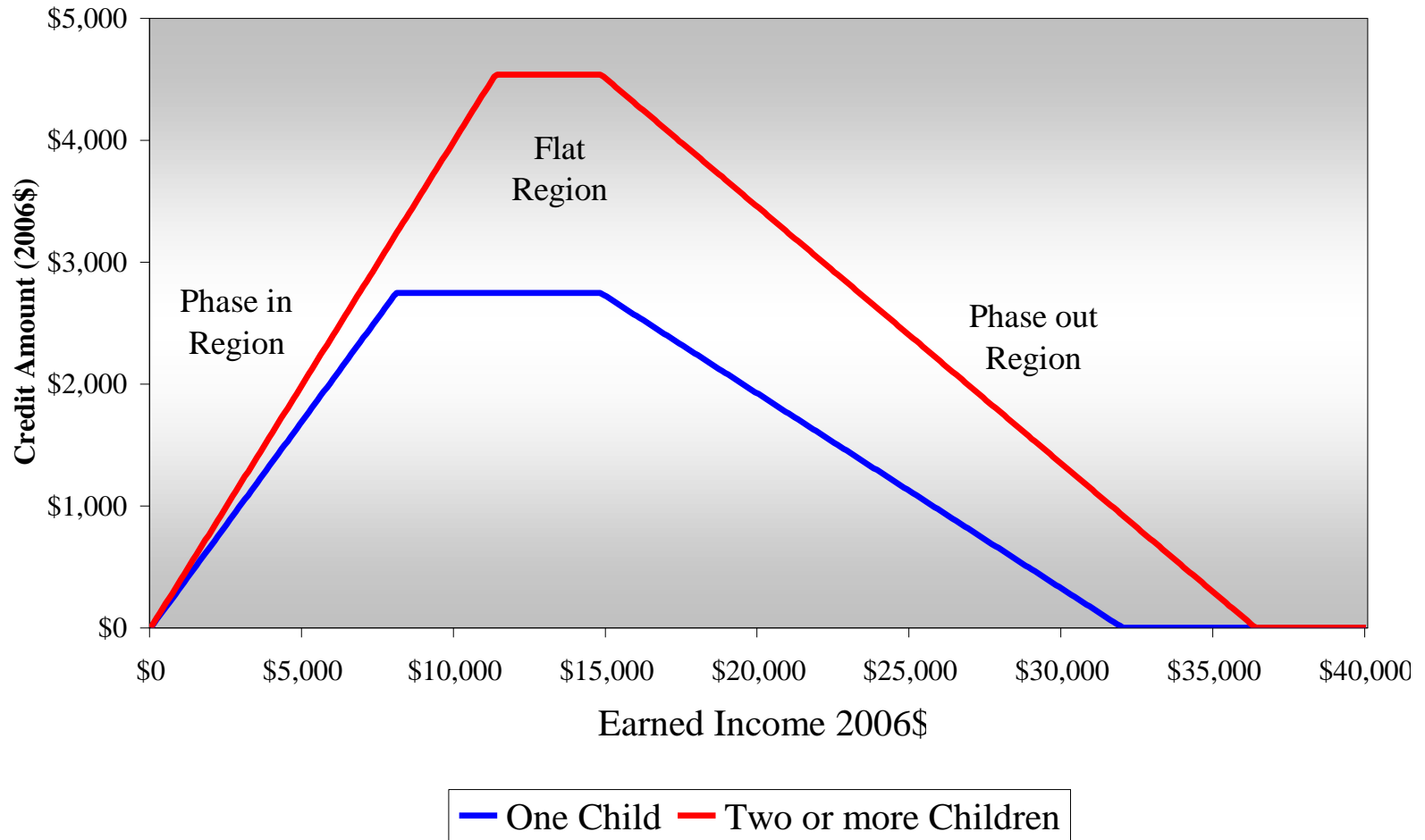
The tax expenditure is modest compared to the direct outlay.

EITC Recipients, 1975-2004

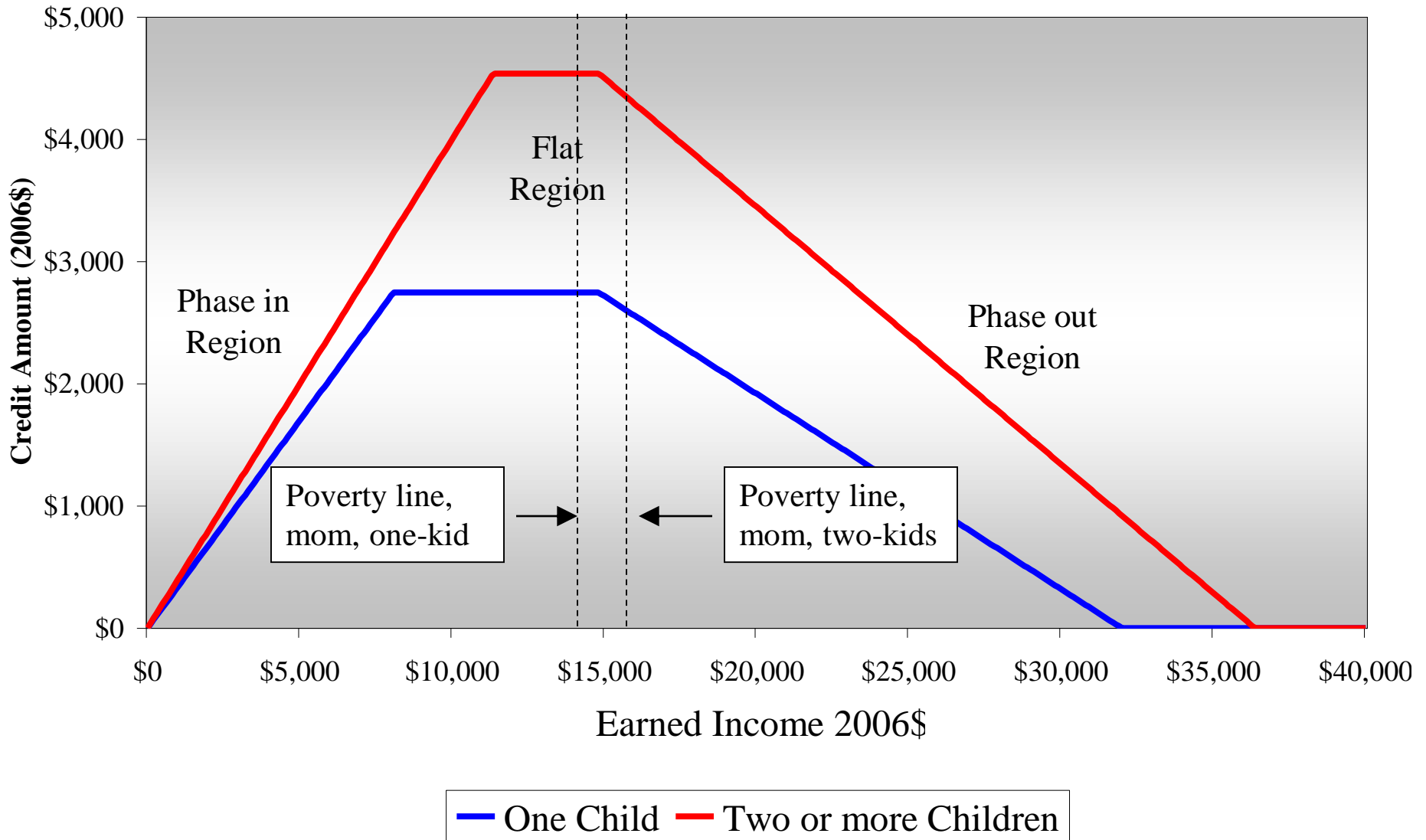


(2) Why is there (relatively) broad support for the EITC?

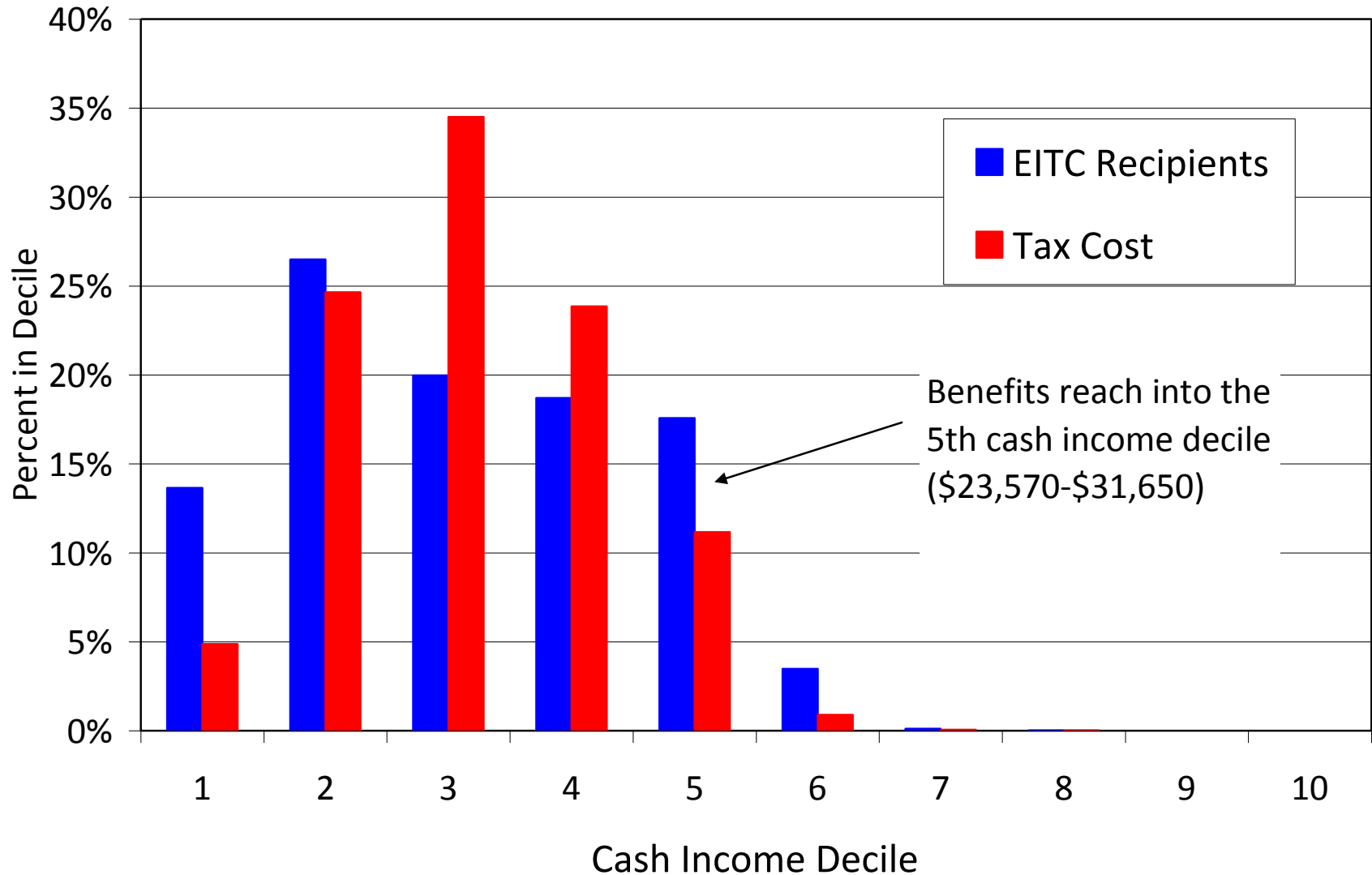
The EITC targets working families (no earnings= no EITC)



The EITC targets low income families



Distribution of EITC tax benefits and recipients by Family Income Decile



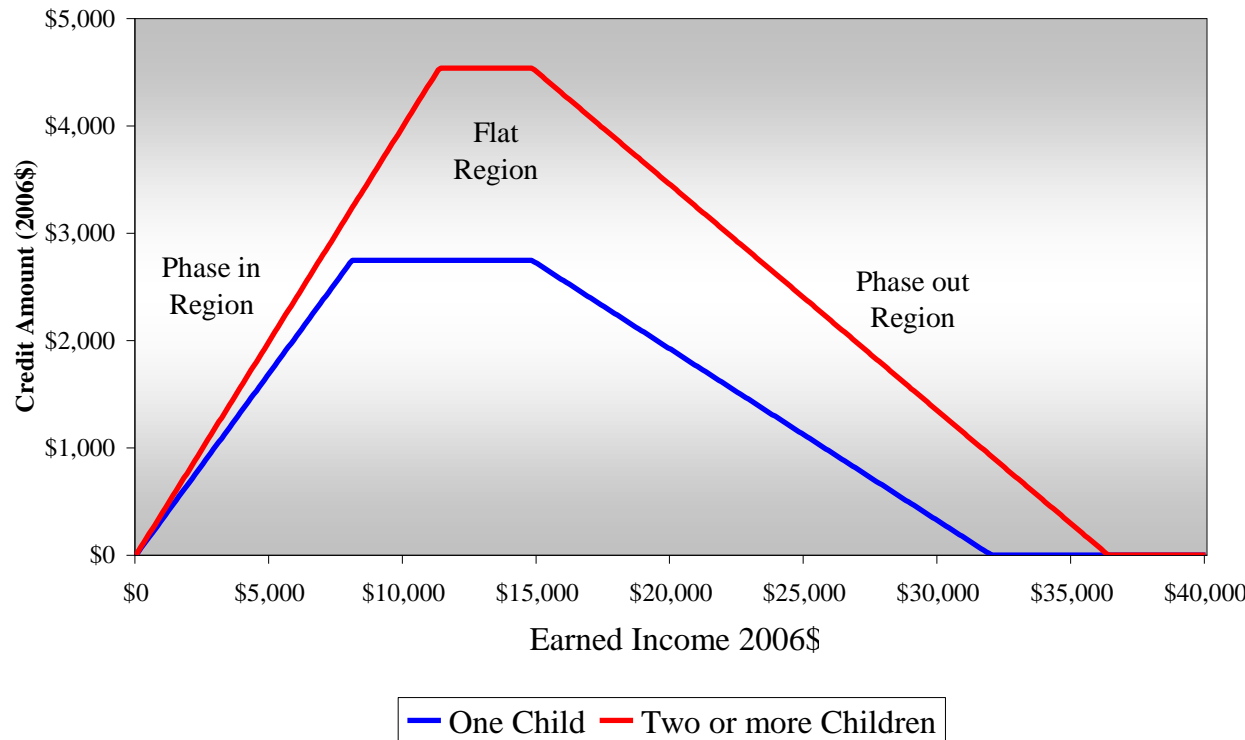
The EITC targets families with children (single parent families)

	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.

The EITC encourages work

- Earnings contingent benefit, high subsidy rate (34%/40%) means higher employment rates
- Research shows overwhelming evidence that EITC expansions have increased labor force participation by single mothers with children.



But that is not quite the whole story

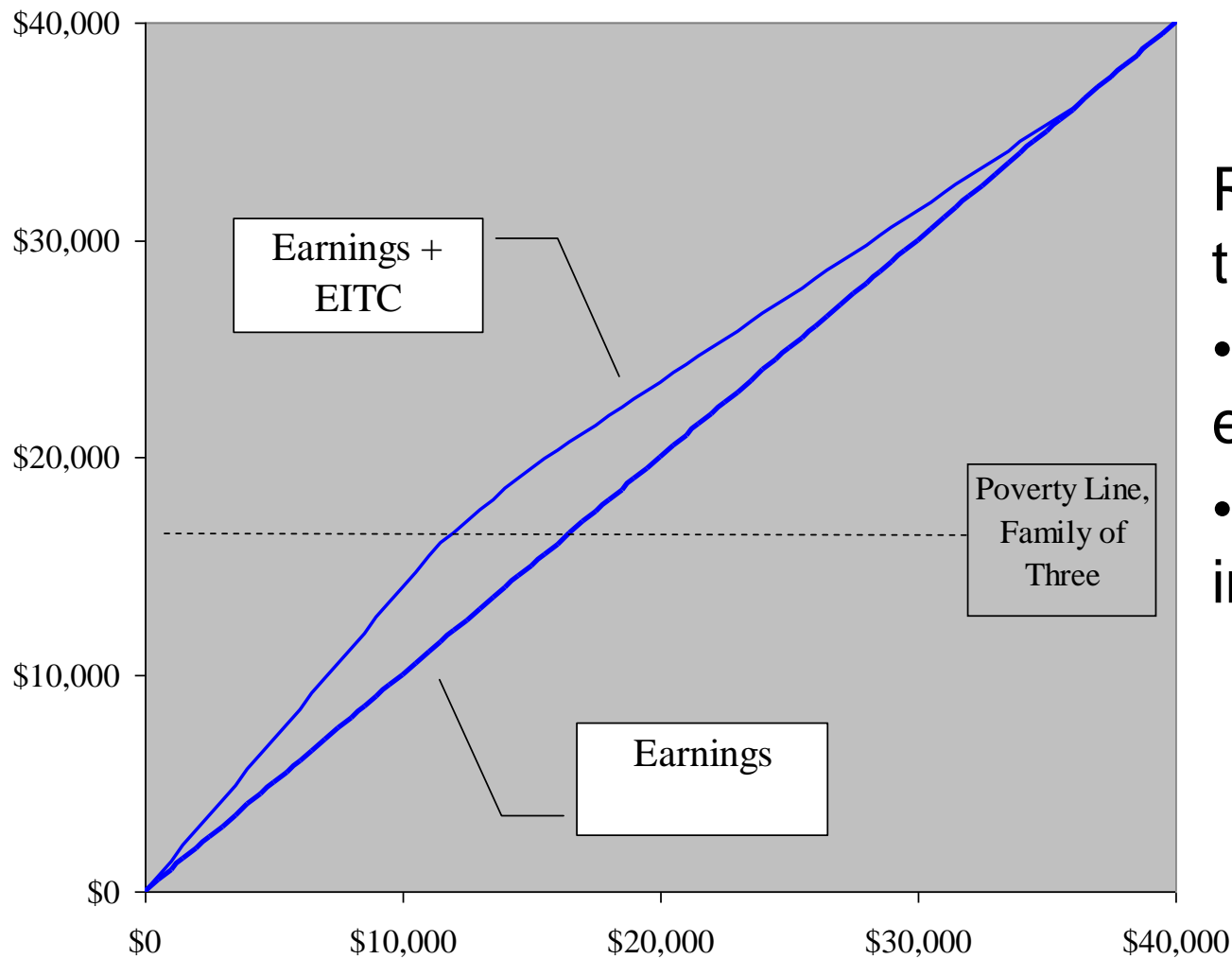
- Phase-out of the EITC creates an increase in the marginal tax rates for those already in the labor force → Hours worked expected to decrease for working single parents
 - Little empirical evidence for this.
 - Explanation may be due to the way EITC is received (lump sum, refund) or lack of knowledge about precise tax schedule (Chetty and Saez 2008).
- In two parent families, secondary earners are expected to reduce employment and hours
 - Empirical evidence supports modest reduction in work among two parent families.

Salience of concerns about possible negative effects for workers

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

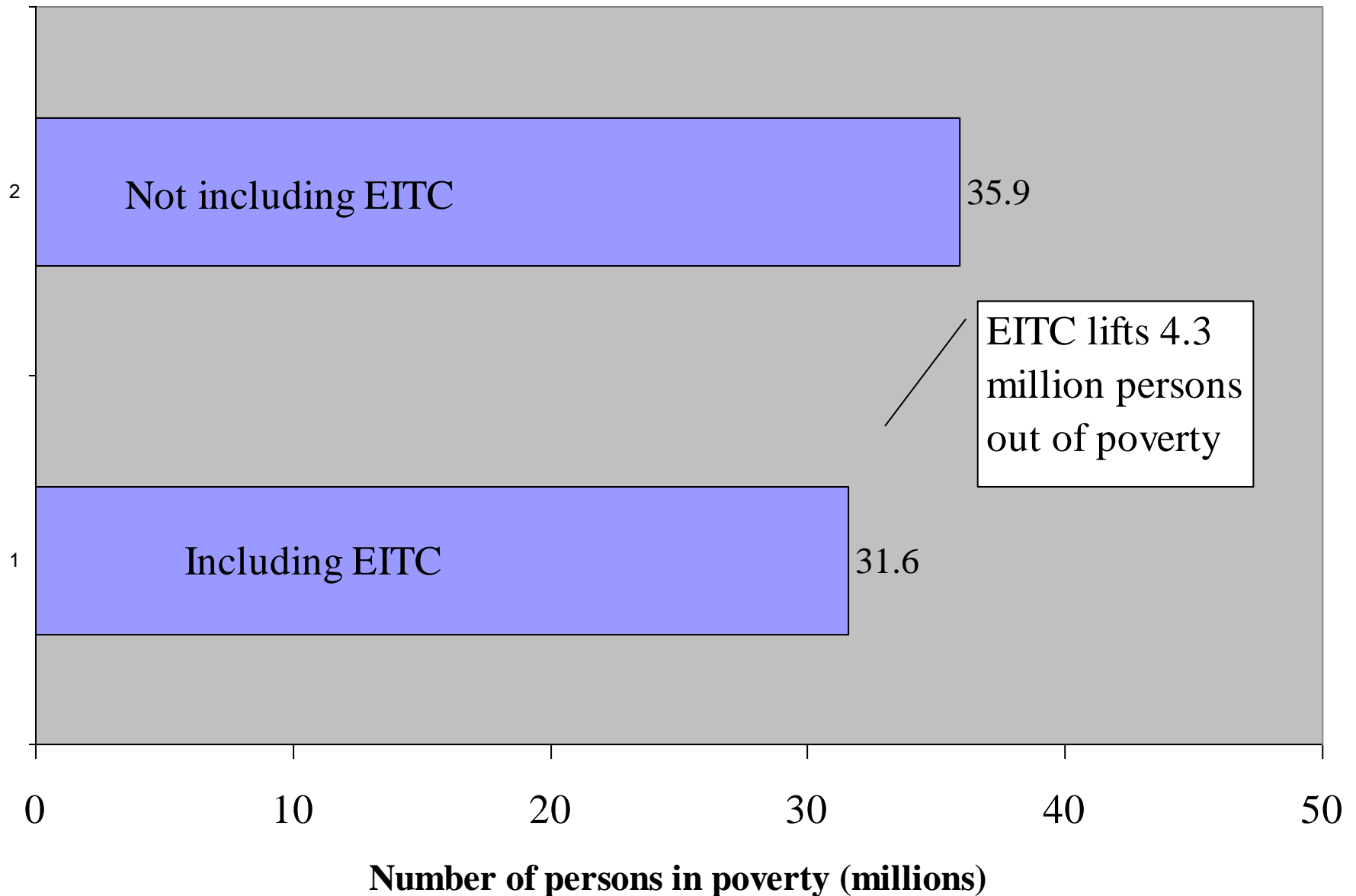
The EITC reduces poverty



Reduction in poverty through:

- Increases in earnings
- EITC pushes income over limit

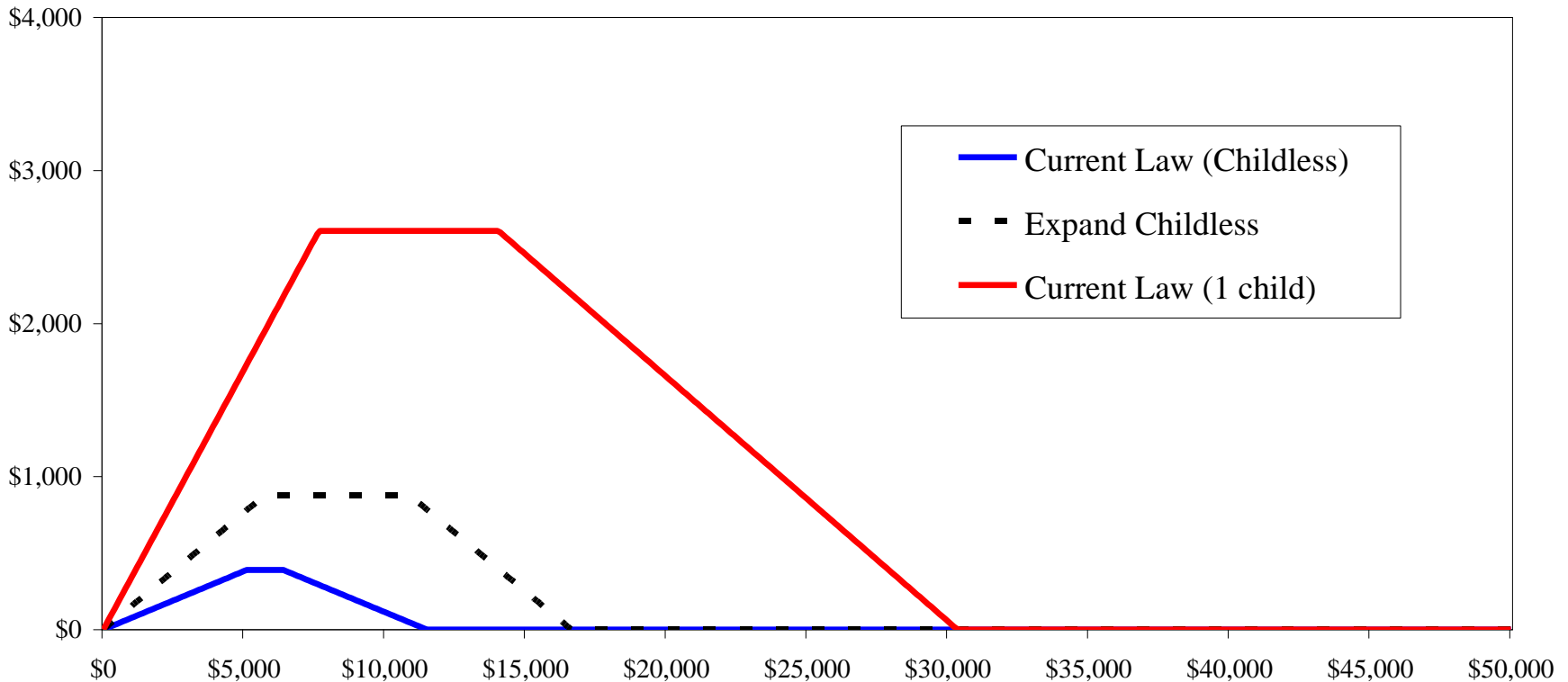
Census estimates of poverty reduction due to EITC, 2003



(3) Possible changes to EITC

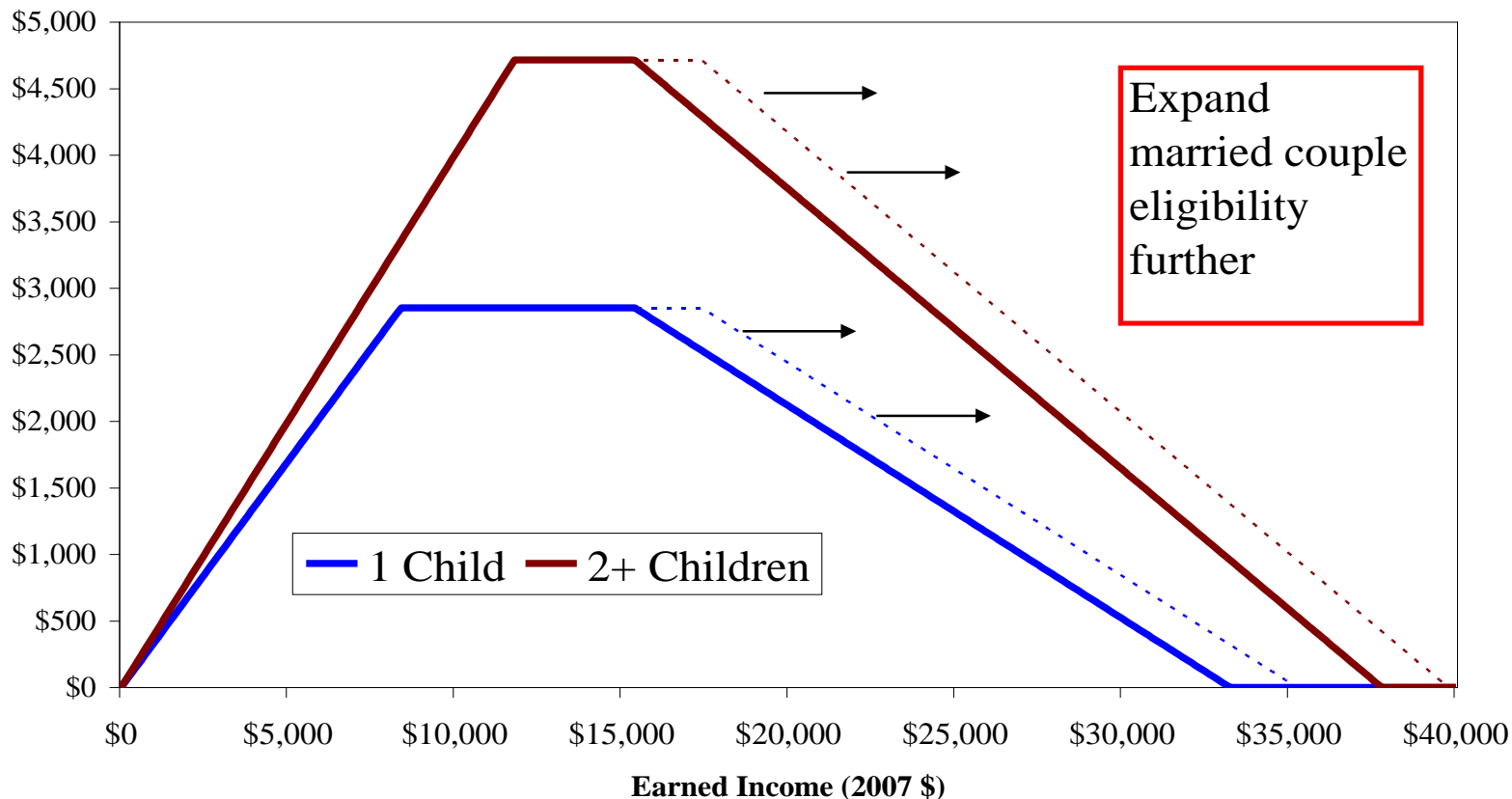
Expand EITC for childless taxpayers

- 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 and stimulus package passed by House
 - 6.2% subsidy for those earnings \$8,100 or less.
 - Each (nondependent) worker is eligible
 - Phased out slowly (2% rate) starting at \$75,000 (\$150,000) for single (married) filers
- Modeled on success of EITC
 - Transfer resources to needy while encouraging work
 - Importance of low phase out rate in minimizing hours worked distortion