

Redistribution and Tax Expenditures: The Earned Income Tax Credit

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Overview and Issues

- The EITC is one of the ten costliest tax expenditures in the U.S., with a total tax cost of about \$40 billion.
- The justification for this tax expenditure is redistribution—transferring resources to low income families with children.
 - This redistribution is achieved with less distortion to labor supply and family structure compared to traditional welfare programs
- We discuss the distributional and efficiency consequences of the EITC under current law and under hypothetical reforms.

Outline of the paper and presentation

- I. Operation of the EITC
- II. Distributional analysis under current law
- III. Behavioral impacts of the EITC (review of the empirical literature)
- IV. Hypothetical reforms to the EITC (emphasis on distributional impacts of “major” reforms)
- V. Efficiency analysis of the EITC (applying approach used in Eissa, Kleven and Kreiner)

I. Overview of EITC

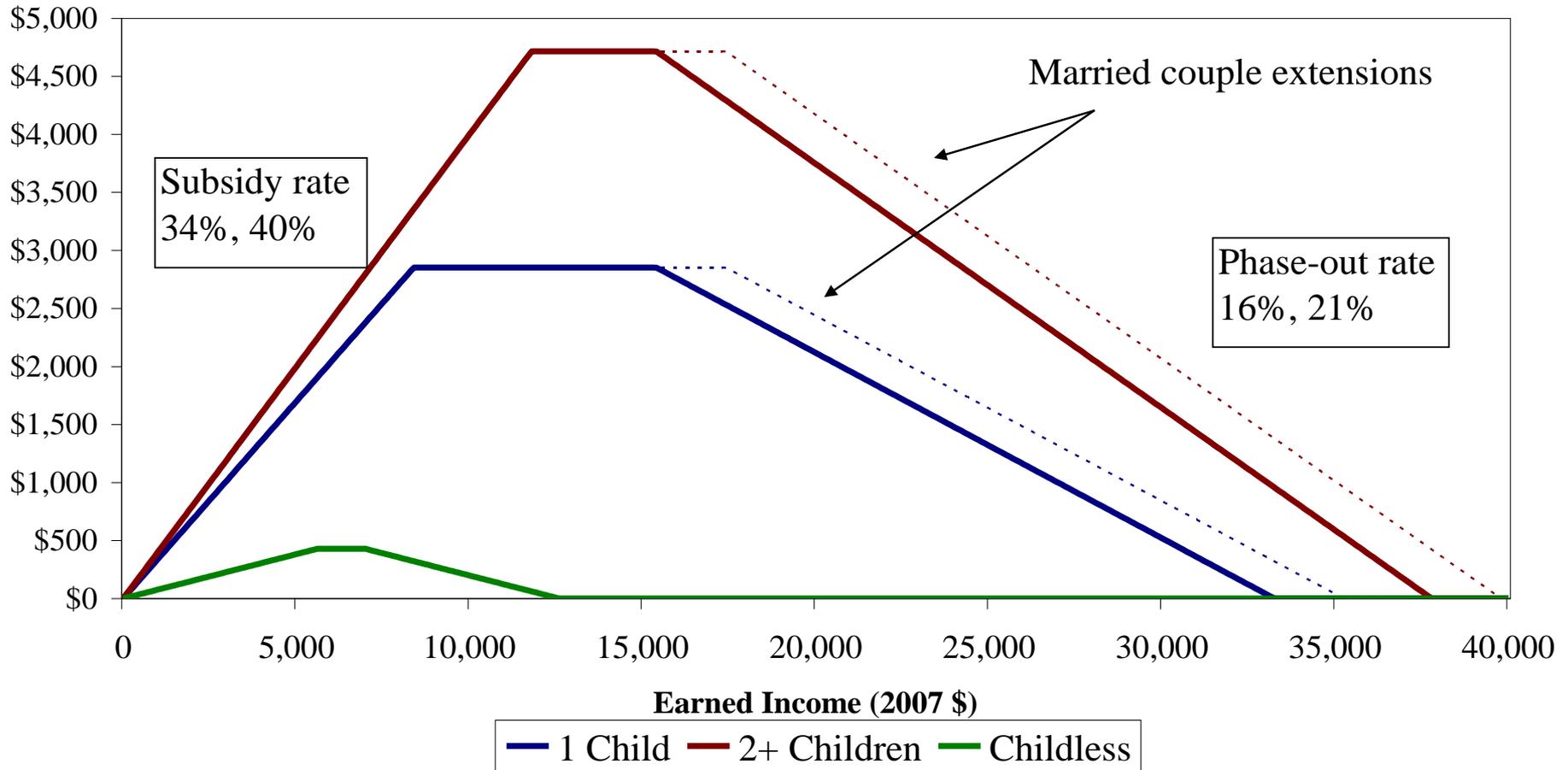
EITC: Structure and total tax cost

- Refundable tax credit for working, low-income tax filers.
- Introduced in 1975; expanded in 1986, 1990, 1993.
- 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).
- Total tax cost: the credit is refundable, so the total tax cost includes a tax expenditure component (reducing taxes owed) and a direct outlay. We focus on the *total tax cost*.
 - In tax year 2007, the credit is estimated to cover 22 million filers at a total tax cost of \$45 billion.

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 region modestly, and (therefore) the phase-out range to \$39,783 (for joint filers) and to \$35,241 (for single filers).

EITC Schedule in 2007

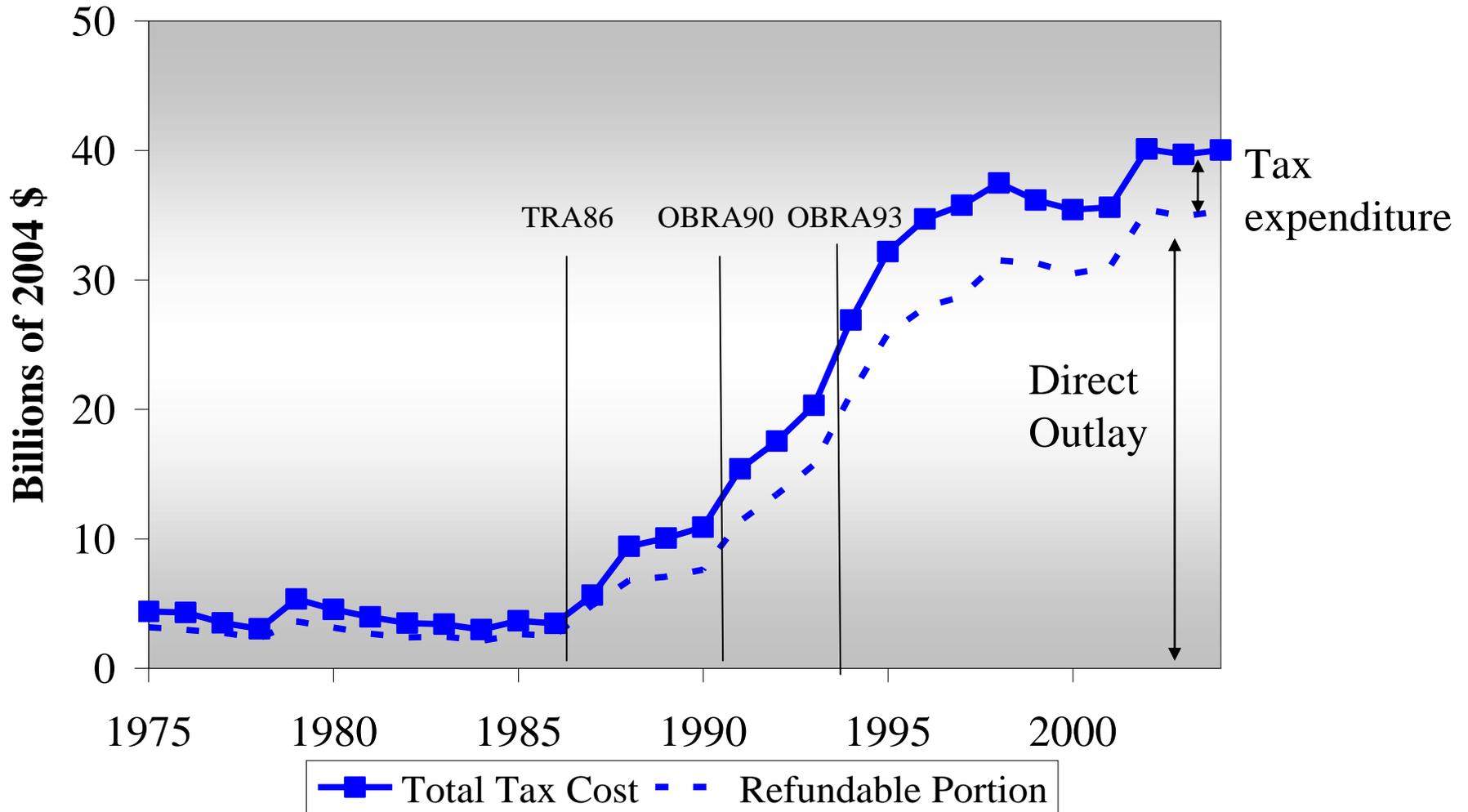


The maximum credit is quite large (about \$4700 for 2+ kids) and eligibility extends well into moderate earning ranges. Median family income for 2006 was \$48,000.

Policy Changes

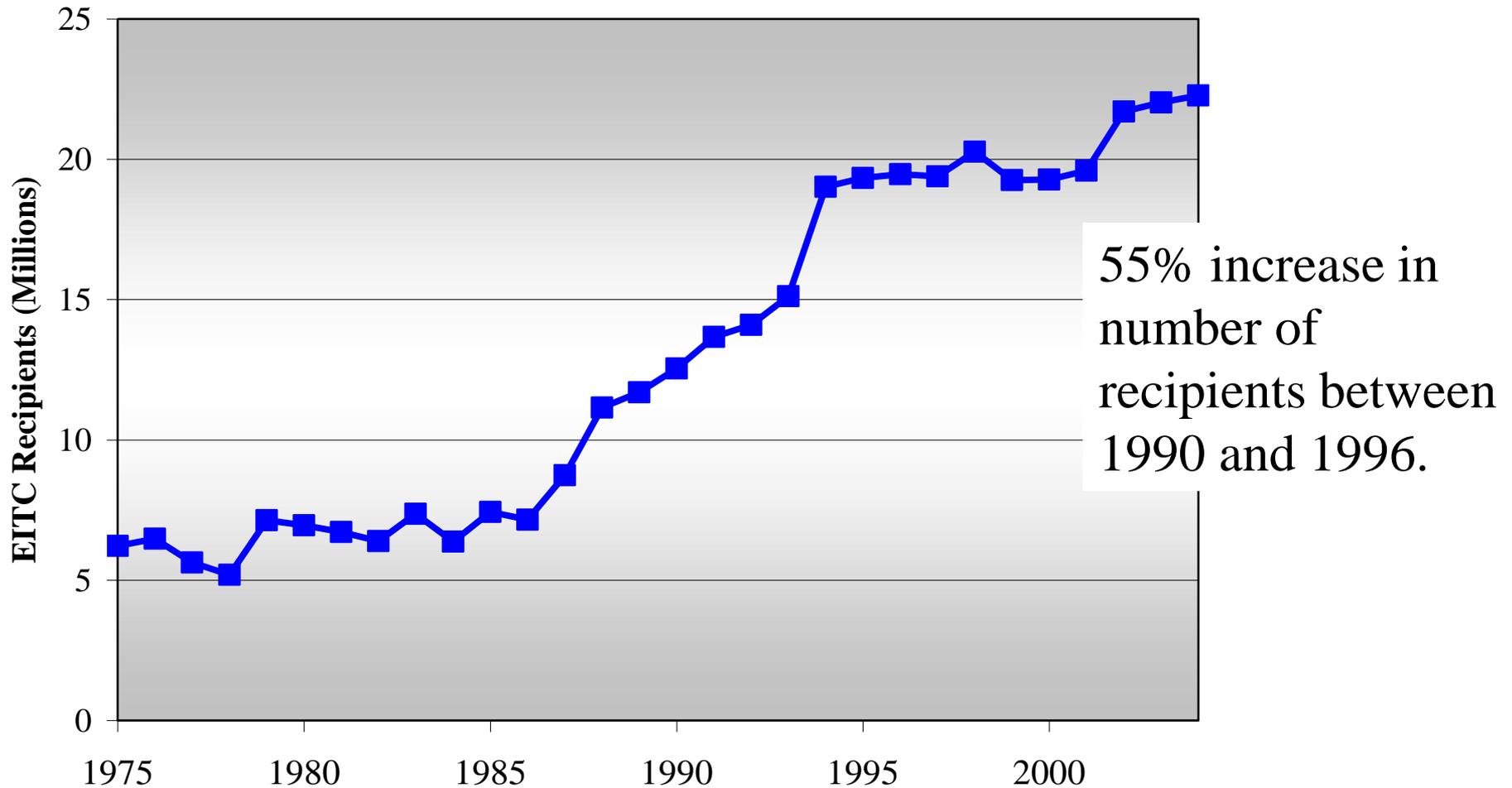
- Started in 1975 as modest work bonus; made permanent in 1978
- EITC expansions:
 - 1986 Tax Reform Act: general expansion and indexed for inflation
 - 1990 OBRA: general expansion and added separate schedule for families with 2 or more children
 - 1993 OBRA: general expansion (larger expansion for families with 2 or more children) and added EITC for childless filers
 - 2001 EGTRRA: extended flat and phase-out range modestly for joint filers
- State policy activity: as of 2006, 20 states and 3 local governments had “add-on” EITCs (not all are refundable)
- Full history of parameters is shown in Table 1.

Tax cost of EITC, 1975-2004



The tax expenditure is modest compared to the direct outlay.

EITC Recipients, 1975-2004



Justification for EITC

- The justification for the EITC is redistribution—providing a transfer through the tax system for low income families with children.
- The vast majority of the total tax cost is the direct outlay (rather than the pure tax expenditure)
- Why provide this transfer through the tax system (rather than as traditional welfare system)?
 - Administrative efficiencies (given dependence on earned income)
 - Lower stigma (and therefore higher take-up)
 - [But compliance is a problem: perhaps administrative inefficiencies around dependent children.]

II. Distributional analysis under current law

- Tabulations are based on the Statistics of Income Public Use Tax File.

Table 2: Distributional analysis under 2004 tax law

	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

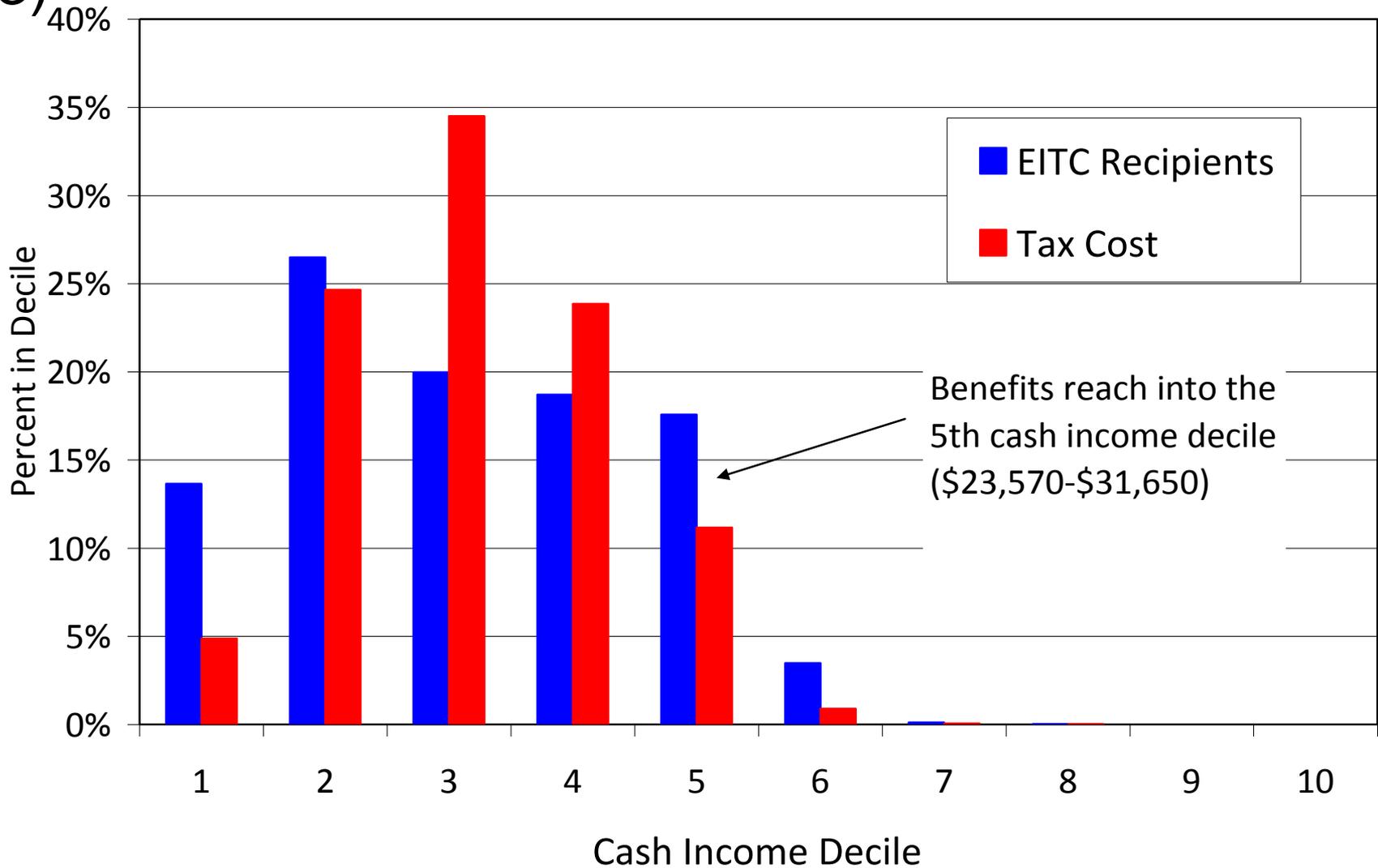
A small amount of the tax cost is for childless filers; but they represent a sizable fraction of total recipients.

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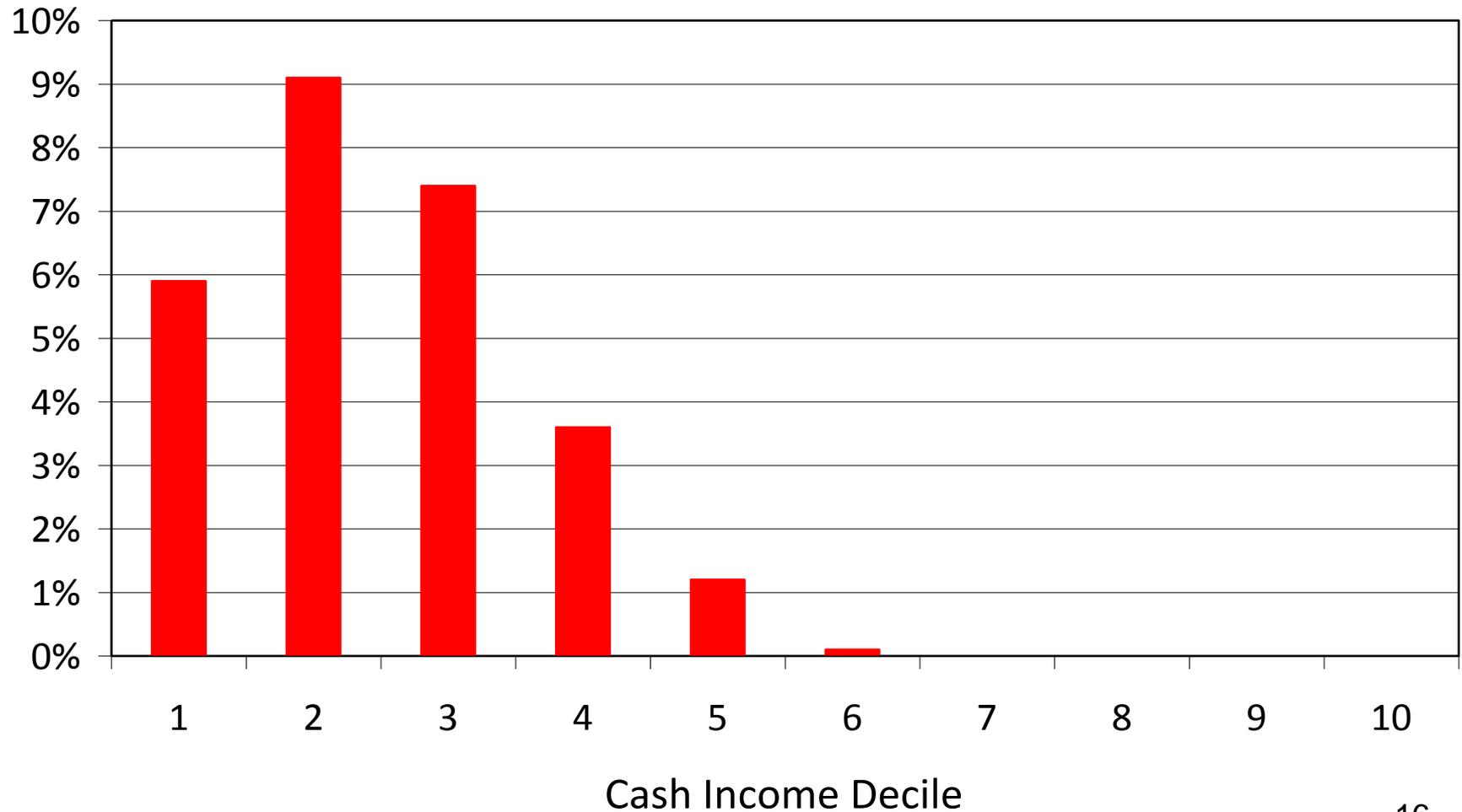
Majority of recipients in flat/phase-out where EITC discourages work

Figure 5: Distribution by Income (More detail in Table 3)



EITC provides a large transfer for these families

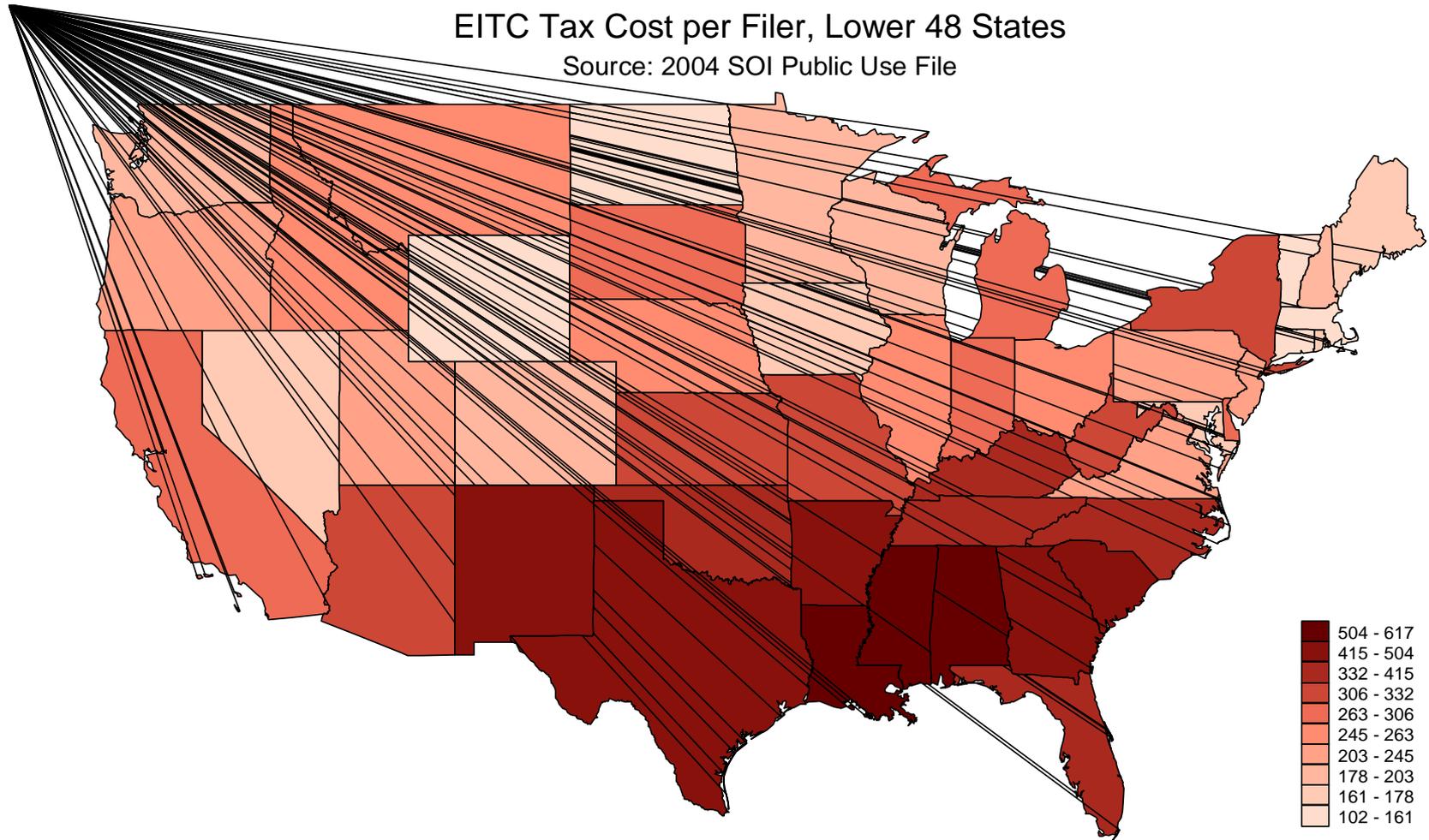
EITC as percent of cash income, by cash income decile



Larger tax costs in poorer states (tax cost per filer, 2004)

EITC Tax Cost per Filer, Lower 48 States

Source: 2004 SOI Public Use File



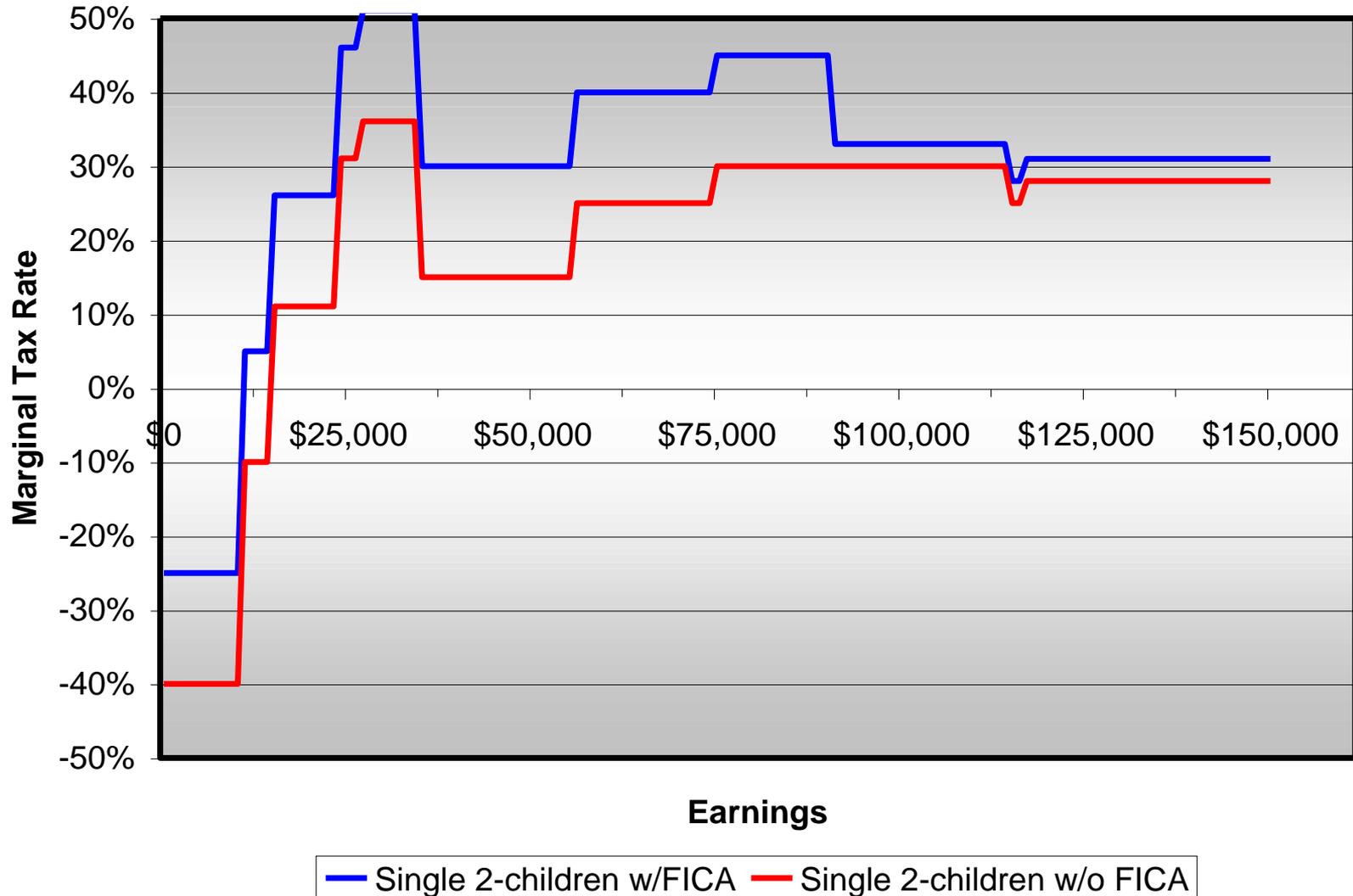
III. Behavioral Impacts of EITC

- Key design feature of EITC (and what distinguishes it from traditional income support programs) is that eligibility requires earned income.
- Creates much smaller distortions to work

Incentive effects of EITC on labor supply

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

EITC generates high marginal tax rates in phase-out



Source: Simulations using TAXSIM (no AMT); 2004 tax law.

Empirical Evidence on Labor Supply & EITC

- Overwhelming evidence that EITC expansions have increased labor force participation by single mothers with children.
 - Stronger impacts found for women with lower wages, lower education levels, and more children.
 - EITC explains up to 60% of increase in employment rates of single mothers between 1984 and 1996.
- 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).
- Small impacts (consistent with theoretical predictions) on secondary earner's labor force participation and hours worked decisions.
- EITC-induced increases in labor supply reduce equilibrium wage, and therefore partially benefits employers (Rothstein 2007)

Annual employment rates for women

