

Poverty and Human Capabilities Studies Capstone:

Why Should America Support the Earned Income Tax Credit?

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1. Introduction

During the recent presidential campaign, Mitt Romney was caught vilifying the 47% of Americans who pay no income tax. What followed was a wave of criticism against our tax system, including arguments that people need to have “skin in the game” and that everybody must “pay their fair share.” First of all, Romney’s statement – or, at least, the even bolder assertion that nearly half of all Americans pay no taxes – is simply not true. While some Americans pay no *federal* income tax, those Americans pay many other taxes: payroll, excise and state income taxes. Secondly, the harsh reaction highlighted a public misconception of how our tax code works. Our tax code is long and complicated, but understanding how it works and why certain parts exist is a vital part of comprehending the efforts our federal government makes to maintain the well-being of the working poor.

One important reason not all Americans pay federal income tax is the Earned Income Tax Credit (EITC). This refundable credit was designed to incentivize work and combat the regressive nature of other taxes, such as the payroll tax. The EITC supplements low-wage work. It offers a refundable tax credit for people who earn below a certain income level. Unlike the minimum wage law, which puts extra burden on employers, the EITC is made to give workers a fair wage without putting extra pressure on specific industries. Since Congress passed the EITC in 1975, it has had widespread bipartisan support (Forman). But in the wake of the recent economic crisis, people have begun to question whether the EITC is worth supporting. When Ronald Reagan signed a major EITC expansion in the 1986 Tax Reform, he said:

“The bill I’m signing today is not only an historic overhaul of our tax code, and a sweeping victory for fairness; it’s also the best anti-poverty bill, the best pro-family measure, and the best job-creation program ever to come out of the Congress of the United States” (Welna)

Unfortunately, this same support does not exist today. The instability of the federal budget and economic stagnation have led people to question whether the EITC is beneficial to the country at large.

The purpose of this paper is first and foremost to bring more attention to the Earned Income Tax Credit and to respond to growing arguments against it. First, I will explain the arguments and attacks. Then, I will explain why any tax expenditure (whether benefiting low-income or high-income families) should be seen as a form of social spending; I will also defend the refundable portion of the EITC. Finally, I will answer the broad question: “Is the EITC an effective program?” In the end, I will show that the EITC is successful at lowering marginal tax rates and increasing labor supply. Just as importantly, I will also show that the Earned Income Tax Credit is one of the most effective anti-poverty programs in the United States today; as a result, it should be both supported and expanded.

2. History and Background

The first version of the Earned Income Tax Credit was created as part of the Tax Reduction Act of 1975 (Forman). It was created with the intention “to offset the Social Security taxes of low-income workers with children and to provide those taxpayers with an increased incentive to work” (Forman). After minor legislative changes it was expanded and refined during the Tax Reform Act of 1986, becoming similar to the program we have today (Forman)¹. Since then, there have been various expansions. Most notable are the Omnibus Budget Reconciliation Act in both 1990 and

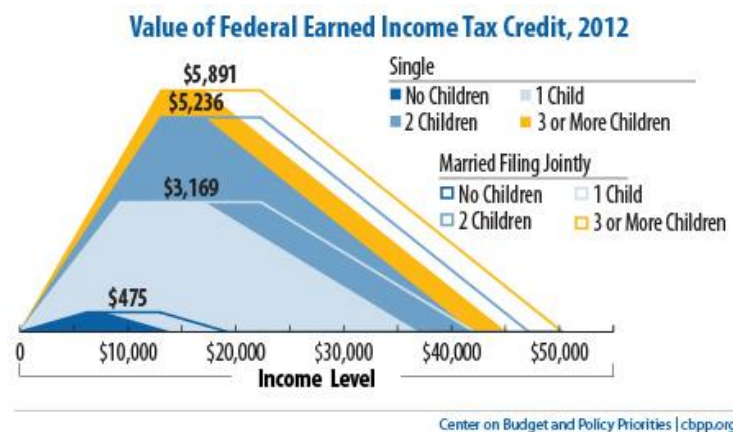
¹ In 1987 the EITC was indexed for inflation (Forman).

1993, and a temporary extension in the American Recovery and Reinvestment Act in 2009 (Forman and CBPP, 3).²

The Structure:

So how does the Earned Income Tax Credit work? The EITC is a refundable tax credit. Tax credits reduce the amount of federal income tax a household owes. If the credit amount is greater than the amount owed, the government will compensate the household that amount. The amount of the tax credit varies depending on the filer's marital status, number of children, and amount of earned income. Since it is designed to encourage work it only is applicable to specific types of incomes that a household receives—earned income. Earned income “includes wages, salaries, tips, and other employee compensation; union long-term disability benefits received prior to minimum retirement age; and net earnings from self-employment” (Athreya, Reilly, and Simpson, 233). It is important to note that many government programs like Social Security or TANF are not considered earned income (Athreya et al., 233). For example, a person receiving only Social Security benefits would not qualify for the EITC. It is shaped like the graph below from the Center for Budget and Policy Priorities.

Figure 1. Value of Federal Earned Income Tax Credit



² This expansion was original to expire in 2012, but it was expanded again through 2017 under the American Taxpayer Relief Act (CBPP, 3).

source: CBPP, <http://www.cbpp.org/files/policybasics-eitc.pdf>

During the upward sloping portion of the graph individuals or families are in the “phase-in period” meaning that the amount of the credit is increasing with the next dollar of earned income. Then, during the flat period you receive a consistent amount per dollar earned. Finally, there is the “phase-out period” where the amount you receive per dollar diminishes until it reaches zero. These three sections have different incentives and different rewards for work. It is designed to help people gain employment and increase their work hours, maintain a constant rate of supplemental income for a certain period of time, and then slowly ease people off of EITC.

The “phase-out” period is probably the most criticized and also most distinctive part of the program. The phase out period is unique because it avoids a strict threshold like most other government programs. Thresholds are generally viewed as unfavorable because they disincentive work past a certain point. For example if there was a strict EITC cut off of \$30,000, we would see a lot of people functioning right below the \$30,000 mark so that they will still receive the EITC benefit. It creates a cliff that clearly encourages people to work less in order to keep their credit. The phase out period of the EITC avoids the problems associated with thresholds. The sloped nature is meant to ease people out of it. Therefore your credit decreases over a wide income range so that when you are eventually dropped from the EITC you do not lose a significant amount of income. Still, many question whether this current structure and credit amounts are appropriate.

3. What are the arguments against the EITC?

There are three main arguments against the Earned Income Tax Credit. The first relates to fairness—some people think that everybody should pay federal income taxes. The second also relates to fairness—some people argue against government handouts or assistance. Finally, there is an efficiency argument. People believe that the EITC is an inefficient use of money.

Since its creation, the EITC has had widespread bipartisan support. However, with recent concerns over budgetary issues, the EITC is losing some of that support. People have expressed concern over the fact that 47% of Americans pay no federal income tax, which indirectly attacks the EITC. For example, Michelle Bachman stated that every American family “can afford to pay” \$10 in federal income taxes (Foley). Similarly, Rep. Eric Cantor and Senator Orrin Hatch, both powerful members of congress, argued that everybody should have “skin in the game” by paying federal income taxes (Mascaro). These claims are also arguments for eliminating or scaling back the Earned Income Tax Credit. The troubling reality is when we hear politicians or individuals talk about the percentage of people who pay no federal income tax, we rarely hear them mention the EITC. People say all Americans need to “pull their weight,” rather than say “the United States should eliminate the EITC”. So our job is to make the connections between their claim that everybody should pay federal income tax and the fact that the EITC makes it possible for those 47% not to do so. Threats to make more Americans pay federal income taxes are essentially threats against the EITC in disguise.

Even when the attack is not directly toward income tax, we still hear attacks on government handouts or “passing out checks.” There is confusion when it comes to rhetoric like “getting a government check”. Many attribute this with welfare, or Temporary Assistance for Needy Families (TANF) formally known as Assistance to Families with Dependent Children (AFDC) (Currie, 18). But, in reality the EITC is the largest cash-transfer program in the United States (Eissa and Hoynes, 1). Cash transfer means the government sends direct cash instead of in kind assistance, such as food or housing assistance. So, people who attack “government handouts” may actually be targeting the EITC instead of TANF. Historically, AFDC or TANF was a large program that provided assistance to many different families; however additional restrictions and policy changes have drastically decreased the number of families eligible for TANF. In 2011, an average of 4.4 million individuals

received TANF, but 27 million, almost seven times as many families received the EITC that same year (IRS, "Earned Income Tax Credit Statistics")(U.S. Department of Health and Human Services). Therefore, when people talk about “government checks” they are often talking about the EITC. But the EITC is not just a free government handout. The EITC is only available to families where at least one adult is employed. It is necessary to correct the “government handout” language, so that critics understand exactly what they are attacking. Since the EITC is so extensive, having misconceptions about its size and purpose can be detrimental.

Finally, there are certain members of congress who directly attack the EITC. For example, the Ryan Budget included drastic cuts to the EITC (Plumer). Politicians often say we “can’t afford” the EITC. The “can’t afford it” argument is essentially an attack on the program’s efficiency. If somebody says we “can’t afford” something, the suggestion, however implicit, seems to be that the expense is an inefficient or undesirable use of that money. Although doing so may be politically unpopular, we can (almost) always raise revenues to support a worthwhile program. To make this point clearer, if the EITC was perfectly efficient and flawlessly solved all the problems it was intended to fix, then we would presumably be willing to spend a large amount of money to maintain it. Saying we cannot afford something implies that we are better off as a country using that money on another program or even putting it back in taxpayer’s pockets. Therefore, if this argument still exists, we need to prove the EITC’s efficiency as a way of addressing those concerns.

4. Tax Expenditures: Social Spending/The Refundable Portion of the EITC

As shown in part 2, many attacks against the EITC are about how it costs too much money or how the government needs to spend less of its revenues. Since the EITC is a form of tax expenditure, it is a little confusing to understand how it fits into the national budget. Often EITC families receive a physical check, but even when a physical check is not sent, any “deduction” in

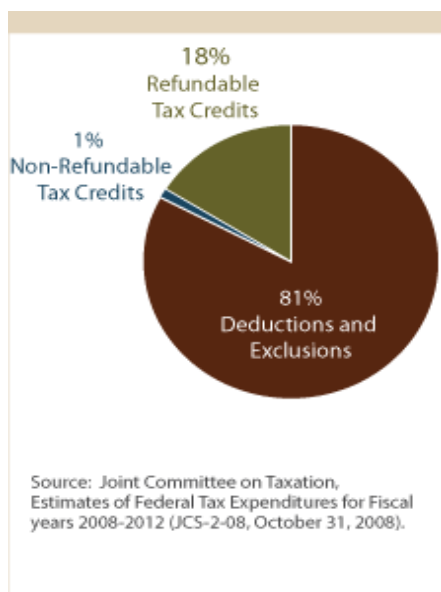
revenues is a “cost” to the government. The purpose of this section is to explain why tax expenditures are social spending. The fact that tax expenditures are a form of social spending has important implications for what programs we compare to the EITC and how we view welfare spending. To clarify, a tax deduction is a deduction in taxable income. Therefore,

$$\text{Loss in government revenue} = \text{dollar amount of deduction in taxable income} * \text{tax rate.}$$

A tax credit is a decrease in the amount of taxes owed dollar for dollar.

The United States has an intricate tax code that is too long for most people to read. In general, Americans believe in the power of using tax breaks, deductions, decreases, or even increases to incentivize certain behavior. In fact, the United States even uses its tax code as a vital component of its welfare state through programs like the EITC and the Child Tax Credit. Using the tax code to address social concerns can be an effective tool. The trouble is that our tax code is so long and complicated that few completely grasp how much money the federal government spends on these different tax maneuverings. I will explain why *all* tax expenditures need to be seen as social spending so that we can accurately analyze the EITC.

Figure 2. Individual Income Tax Expenditures



<http://www.taxpolicycenter.org/briefing-book/background/shelters/expenditures.cfm>

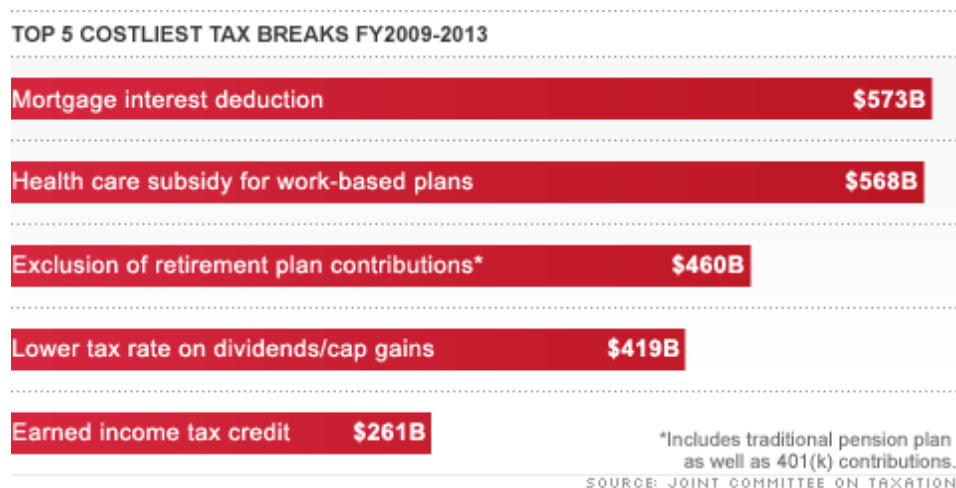
Yes, there is actually a tax expenditure budget that is completed by the Office of Tax Analysis in the Treasury Department and the congressional Joint Committee on Taxation (Steuerle and Reynolds). Although these two estimates do not always align, the “Office of Management and Budget (OMB) publishes the Treasury’s estimates in its Analytical Perspectives volume that accompanies each year’s publication of the Budget of the U.S. Government” (Steuerle and Reynolds). These “tax expenditures

operate essentially like direct expenditures, even though they appear as tax breaks” (Steuerle and Reynolds). This portion is paramount for understanding why all tax expenditure is social spending and why the Earned Income Tax Credit should remain refundable. The OMB’s tax expenditure budget was \$878 billion in 2008 (Steuerle and Reynolds).

When we understand that tax expenditures are in fact a form of social spending, we come to the realization that a large portion of this social spending is going toward middle to upper income families and corporations. Of course not all of it is, but as Christopher Howard points out, “for every dollar spent on traditional anti-poverty programs, the United States spends almost as much through the tax code helping individuals who are lucky enough to have health and pension benefits at work or rich enough to buy a nice home (these are often the same people)” (Howard). In 2010, the federal government lost about 105 billion in revenues from the Home Mortgage Interest Deduction³ (Hanlon). During this same year, Earned Income Tax Credit, the most expansive anti-poverty program in the US cost only \$60.9 billion (IRS, "Earned Income Tax Credit Statistics").

Below is a graph that shows how expensive different tax breaks have been over the past five years.

Figure 3. Top 5 Costliest Tax Breaks FY2009-2013



source: Sabadi, http://money.cnn.com/2010/04/14/pf/taxes/mortgage_interest_deduction/

³ (\$470.4*tax rate= appx. \$108 billion).

If Michele Bachmann had her way, and everyone paid \$10 in income taxes, the refundable portion of the EITC would presumably cease to exist. Often, critics like Bachmann agree with the tax credit, but do not think that the individual should be refunded the money via the government when the tax credit exceeds the taxes owed. In 2010, the refundable portion made up about 92% of the entire EITC program⁴. Eliminating it would essentially abolish the program. To respond to the “skin in the game” argument and the “government handout” argument, I will address why eliminating the refundable portion of the EITC threatens the fairness of our tax code. To do this, I will use a hypothetical situation and a discussion of marginal tax rates.

To preface this explanation, I would like to include a reminder that altering the tax code is often intended to incentivize certain behavior. For example, the Home Interest Mortgage

Deduction was designed to increase home ownership because the government believed there were positive societal benefits to more people owning a house (Korte). The Earned Income Tax Credit was designed to encourage entrance and retention in the workforce, supplement wages that are very low without harming the employer, and decrease the marginal tax rate at certain income levels.

Table 1 below shows a realistic tax situation for three different Americans. Person A owes \$390 in federal income taxes, Person B owes \$1,650 and Person C owes \$3,563. Person A works paycheck to paycheck at a low paying job. As a reward and to acknowledge that this wage is unsustainably low they are granted a \$3,440 tax credit through the Earned Income Tax Credit and do not owe any federal income taxes. Instead, the government sends them the difference between the amount of their credit and the amount they owed. The government owes Person A \$3,050 because their actions meet the demands of the tax provision and the person is behaving in the desired way (i.e. being employed at a low wage job). Person B works hard at a low paying job and is

⁴ Calculated using IRS data from 2010. $\text{Portion refundable} = \frac{\text{amount in dollars refundable portion}}{\text{amounts of dollars refundable portion} + \text{earned income used to offset other taxes}}$

rewarded with a \$1,330 tax credit through the EITC. Person C files for itemized deductions including tax deductions for the Home Mortgage Interest Deduction, Charitable Donations, State and Local Taxes, and Medical Deductions. Because of Person C's actions they are rewarded a \$21,947 deduction in their taxable income, which equals about a \$2,857 loss in government revenues for this particular individual.

Table 1. Hypothetical Tax Situation for one head of Household and 2 Children

	A	B	C
Income	\$24,000	\$34,000	\$60,000
Personal Exemptions	\$11,400	\$11,400	\$11,400
Standard Deduction	\$8,700	\$8,700	-
Itemized Deduction	-	-	\$21,947
Loss in Gov't Rev due to Deductions	\$870	\$870	\$2,857
Taxable Income	\$3,900	\$13,900	\$26,653
Tax Rate	10%	10%, 15%	10%, 15%
Tax Liability	\$390	\$1,650	\$3,563
EITC	\$3,440	\$1,330	-
Tax Refund	\$3,050	-	-
Tax Due	-	\$320	\$3,563
Total loss in Gov't Revenue (Deductions and credits)	\$4,310	\$2,200	\$2,857

Using data from the IRS, I calculated a hypothetical situation where two individuals, A and B receive a standard deduction and the Earned Income Tax Credit. Person C is at a higher income

level so they file for itemized deductions, which come with many different tax deductions that are not available to Person A and Person B. Each person was assumed to have two children and the marital status of single. The tax breaks are the ones listed in the paragraph above (Mortgage Interest Deduction, Medical Deduction, Contributions Deduction and State and Local Taxes Deduction). There is a more complete description on how these numbers are calculated and explanations of terminology in Appendix 1. The purpose here is to show that if the EITC is *not* refundable we will be taking away a huge portion of the benefit that the most vulnerable and low-income working families in our country receive.

Person A and Person B are being rewarded a tax credit of \$3,440 and \$1,330 respectively through the Earned Income Tax Credit. Since both Person A and Person B are meeting the requirements for the EITC at their respective income levels why should Person A's benefit be decreased so drastically? If the EITC changed to a nonrefundable program, their benefit would decrease from \$3,440 to only \$390, which would alter the intended effects of the Earned Income Tax Credit. For individuals to be able to benefit from the credit as intended, individuals need the refundable portion of the EITC. Therefore, to make this a fair situation, we would have to decrease the benefits received by Person B and Person C by \$3,050 as well. To think of it differently, what if everybody sent his or her tax liability to the federal government in the mail. Person A would send \$390, Person B would send \$1,650 and Person C would send \$6,855⁵. Then the government sent them all back a check with the amount of money they receive through tax credits or tax deductions (for now we will ignore personal exemptions for simplicity). So Person A would get a check for \$3,440 for the EITC. Person B would get a check for \$1,330 for the EITC. Person C would receive a check for \$2,857 for itemized deductions. If Person A did not receive the full amount, this would clearly not be fair. Some may argue that the credit amount is simply too high for the EITC, but as I

⁵ This number is calculated by adding the itemized deductions from Person C's back into Person C's taxable income.

will explain further, the credit amounts are intentionally high and actually much lower than the amount the federal government loses from other tax deductions, especially at very high income levels. If you refer to figure 3, you will see that the US government spends less money on the EITC than it does on many other tax provisions. The reason these other tax provisions are not refundable is because they target behavior that only applies to household incomes too high to ever be negative.

As mentioned before, many Americans argue “government checks” are not fair, but those checks are a tool to offset regressive taxes, which are truly not fair. Regressive taxes are taxes that take up a larger proportion of a low-income household income than a high-income household income. For example, excise taxes are “taxes paid when purchases are made on a specific good, such as gasoline” (IRS, “Excise Tax”). This is regressive because a \$1 increase in that tax takes away 1/20,000 of a \$20,000 annual household income, but only 1/80,000 of a \$80,000 annual household income.

Let’s pretend we have three people. One makes \$20,000 annually, the other \$80,000 and the last \$250,000. They all live on the same street and drive the same number of miles to and from work. They even drive the same car and get gas from the same gas station. If they each spend \$1,000 annually on gasoline taxes, how does that affect the percentage of income spent on the gas tax? Table 2 shows the low-income person making \$20,000 is impacted by the tax significantly more than the two with higher incomes. These numbers get more extreme as we move up and down the income ladder.

Table 2. Regressive Taxes

Income	Annual \$ Spent on Gas Tax	Percentage of Income Spent on Gas Tax (Annual \$ spend on Gas Tax/Income)
20,000	1,000	5%
80,000	1,000	1.25%
250,000	1,000	0.04%

Marginal tax rate calculates what proportion of a specific dollar at a specific point is taken away in taxes or loss of benefits. For example, if a household makes \$20,000 annually, the marginal tax rate explains how much of the 20,001st dollar would be taken away through taxes or loss of benefits. If that 20,001st dollar was taxed a certain percentage and coupled with a decrease in the amount of benefits provided, then possibly 50% (50 cents) of that 20,001st dollar may be taken away.

To understand this more, we need to understand low wages. As our country has developed, there has been an influx of low wage jobs that accompanied our growth; jobs like house cleaning that used to be personal chores are now low wage occupations (Kenworthy, 40). This, along with the decline of unions and minimum wages that are not linked to inflation has left a large portion of countries like the United States with unsustainably low wage jobs (Kenworthy, 40-41). The EITC works as a sort of subsidy for companies. It recognizes that these low paying jobs are unsustainably low, so it supplements that low income without putting added stress of the employers of those low wage jobs (an argument we often hear against minimum wage).

Since many aspects of our tax code are regressive and impose high marginal tax rates on low-income people, the EITC is a way to offset these rates while still incentivizing intended behavior. The EITC has a phase out period for incomes between about \$22,000 and \$50,000 for a married couple with three children, as shown in the CBPP picture in part 2. This phase out period is particularly important because this is the same range that the families are losing their eligibility for other support like TANF, SNAP and Medicaid. When families are within this range, their marginal tax rates are extremely high because they lose significant benefits for each additional dollar they earn resulting in that dollar being taxed at up to 100% rate on the margin (Brannon, 2). This means that the entire extra dollar earned is equal to an entire dollar lost in benefits. Marginal tax rates are important because people's behavior is much more closely linked to their marginal rate than their

overall rate (Brannon, 1). What the EITC does is help offset some of these other losses so people do not lose the benefit all together when they go above a certain income.

In fact, to reduce marginal tax rates for the EITC, we could expand it to cover higher income levels and make the phase out period shallower. Another way we could decrease marginal tax rates would be to decrease other benefits. If an individual never receives a benefit, then they have less to lose (Brannon, 4). This argument fails to recognize that Americans need the other in-kind benefits like SNAP and Medicaid. Eliminating those programs or other aspects of our welfare system should be treated as separate issues and analyzed as specific programs, not just cut as a part of a marginal tax discussion. No matter what we do with other programs, the EITC should not be cut because this would increase marginal tax rates at certain levels, which may cause less employment and activity in the workforce. I will talk more about marginal tax rates in part 5b.

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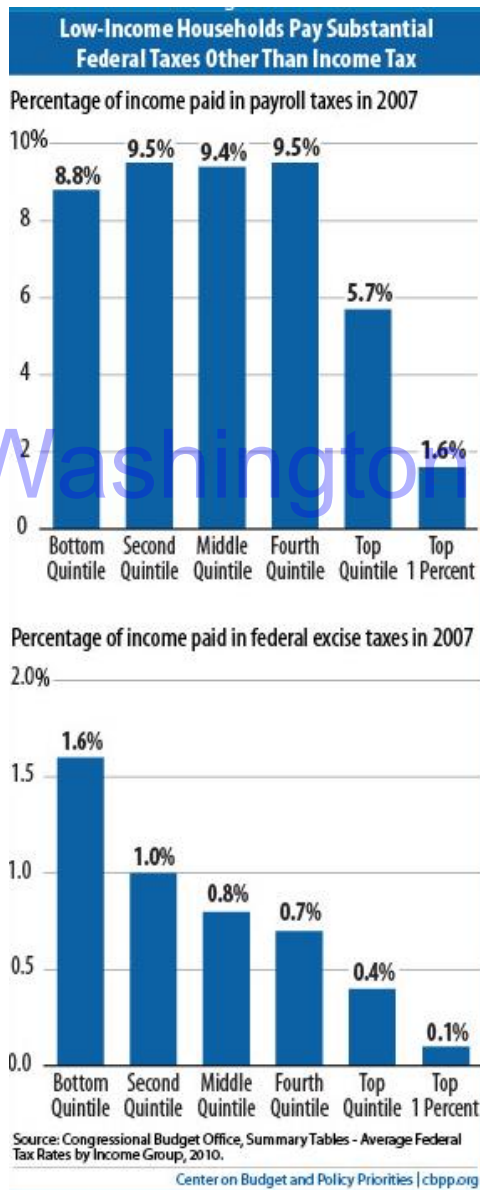
5. Is the EITC effective?

To know whether the Earned Income Tax Credit is an effective and worthwhile program, we need to decide how we are going to assess it. This is primarily a response to the “we can’t afford it” argument because that argument asks us to evaluate whether or not supporting the EITC is an efficient use of our money. There are three main goals of the EITC. The first is to help offset the regressive nature of the payroll and other taxes. The second is to reward work, or in other words incentivize workforce participation. And the third is to supplement unsustainably low annual income. I will argue that the EITC is successful in each of these three categories.

5a. Offsetting Regressive Taxes and Improving Marginal Tax Rates

One of the reasons the EITC was created, was “to offset the Social Security taxes of low-income workers” (Forman). The EITC actually stemmed from Milton Friedman’s crusade for a Negative

Figure 5. Regressive Taxes



Source: Marr and Huang,
<http://www.cbpp.org/cms/?fa=view&id=3505>

Income Tax (Frank). This Negative Income Tax (NIT) would give all people a basic standard of living. That

benefit would be reduced as they worked more and claimed more income (Frank). This was his solution to what he

considered an abundance of ineffective welfare programs (Frank). Because of the NIT’s negative effect on workforce

participation, the EITC was created instead because it has explicit work requirements; you don’t work, you don’t get

anything (Frank). Therefore, the birth of the EITC was largely in response to this need for additional welfare

support and the idea a negative tax was a good way to achieve additional support.

This graph to the left from the Center on Budget and Policy Priorities shows how federal taxes can be

regressive. It depicts how low-income individuals are paying an extremely high percentage of their income

towards taxes beyond the federal income tax. The Earned Income Tax Credit is a tool used to combat these numbers.

By giving money back to the individuals who are paying those high percentages towards the Social Security Payroll

tax, federal Excise taxes and State and Local taxes, we are driving down the overall percentage of income those households put towards federal taxes. The EITC targets the same families harmed by regressive taxes, so it is a way of getting more money back in the pockets of those Americans, thus offsetting certain regressive taxes. Essentially, the EITC makes the current federal income tax program even more progressive.

Marginal tax rates play a key role in a discussion of the effectiveness of the EITC. The Richmond FED completed an intensive study on marginal tax rates and the EITC (Athreya, Reilly, and Simpson). The main limitation of the study is that it is calculated for “gross income only and does not include Federal Insurance Contributions Act (FICA) contribution (i.e., Social Security and Medicaid)” (Athreya et al., 240). Therefore, this report only analyzes the effects on marginal tax rate between income and the EITC, no other loss of benefits at different income levels. It found during the phase in period, the marginal tax rate is very low, “-40 percent for both single and married filers” (Athreya et al., 240). During the flat region, marginal tax is about 0 percent. During the phase-out period, families experience between a 15 and 36 percent marginal income tax rate (Athreya et al., 240).

Those calculations give us a good starting point for understanding EITC effects on marginal tax rates, but it is important to understand how the EITC is interacting with other existing programs. Clifford F. Thies of Shenandoah University testified to the U.S. House Ways and Means Committee on June 27, 2012 about this exact topic. He argues that we have a “dead zone,” meaning an area where “additional earnings were mostly negated by reduced benefits” (Thies, 3). He warns against allowing anybody to pay an implicit marginal tax rate of above 50%⁶, but especially not low-income families (Thies, 10). According to his calculations low income households are subject to between a 50-100% effective marginal tax rate (Thies, 4). His issues lie more with the Payroll tax,

⁶ Thies cites Milton Friedman as saying that “nobody should pay a tax rate of more than 50 percent” (Thies, 10).

but the EITC is a good way to offset the regressive nature of the Payroll tax (Thies, 9-10). With this logic, the EITC should be expanded to create a shallower slope, which would drive down the marginal tax rates even further. But, at the very least it should not be eliminated or diminished because those rates would be much worse without it.

When the opponents of the Earned Income Tax Credit argue they want everybody to pay federal income tax, they are asking for a more regressive tax system. This goes beyond the efficiency claim that it is clearly successful at achieving one of its main goals, offsetting regressive tax rates. It is also attacks the fairness of the tax system when we cause our tax system to become more regressive. Few individuals would argue for a regressive tax on the principle that the poor should not have to pay a higher percentage of their income on a certain tax than their wealthy counterparts, yet that is essentially what individuals suggest when they consider eliminating or diminishing the EITC.

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5b. Effect on Labor Supply

When the Earned Income Tax Credit was created, another of its purposes was “to provide those taxpayers with an increased incentive to work” (Forman). Therefore, the design of the EITC basically makes it a wage subsidy. It increases the average hourly wage making work or employment more attractive. From an economic, theoretical standpoint, the EITC has a very important positive extensive effect on labor supply (Athreya, Reilly, and Simpson, 243). There are two ways to evaluate the EITC’s effect on labor supply: extensively and intensively. Extensive is entry into the labor market and intensive is a calculation of an increase or decrease in the quantity of hours worked by an individual (Eissa and Hoynes, 73). There have been encouraging findings that the EITC particularly helps single parents and mothers gain and maintain employment (Eissa and Hoynes, 75). To assess how the EITC affects labor supply, Eissa and Hoynes look at major expansions of the EITC and

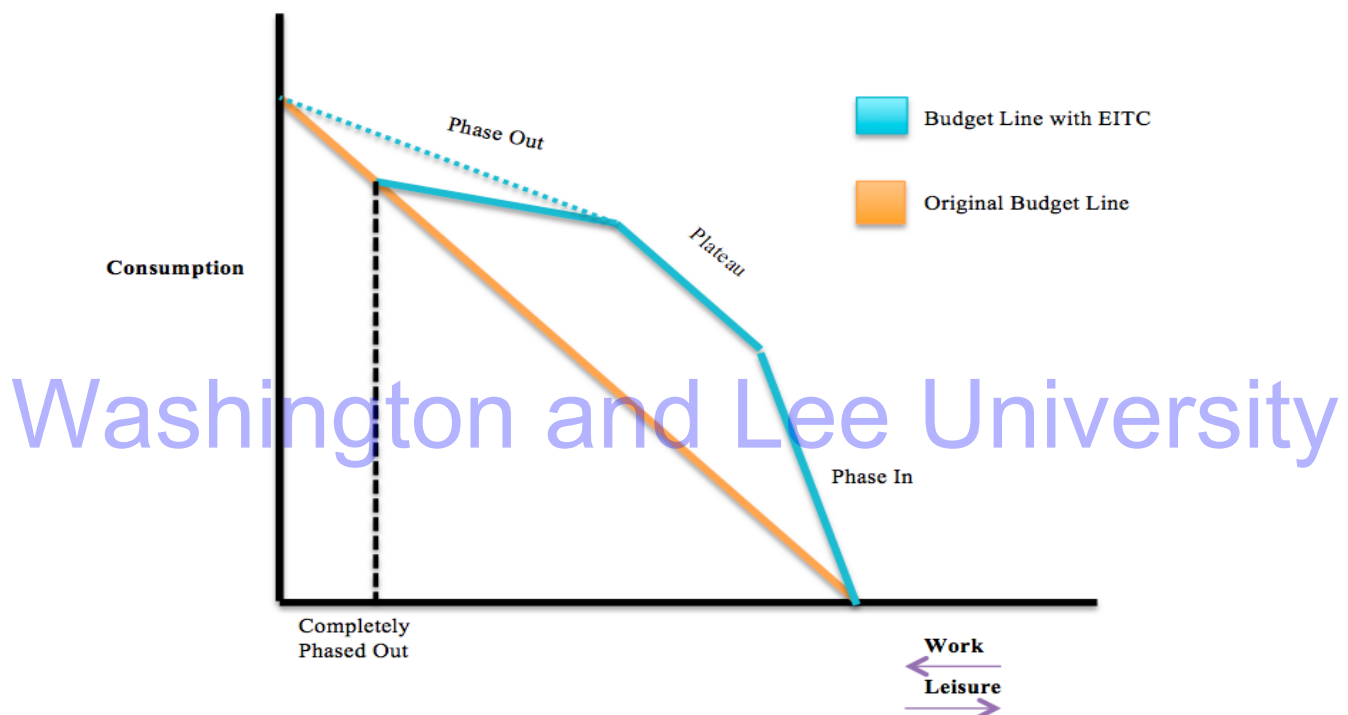
how those compare to labor trends at the same time (Eissa and Hoynes, 80). Additionally, many states have Earned Income Tax Credit programs that can be used to assess the effect since there is variability in the size and scope between states (Eissa and Hoynes, 81).

The reason the EITC has such a strong impact on labor supply is because of its effect on marginal tax rates, mentioned in part 5a. The calculations by Eissa and Hoynes find “the EITC reduces average tax rates of entering (part- and full-time) work across all family sizes and all wage levels, thereby illustrating the prediction that participation should unambiguously increase for single parents” (Eissa and Hoynes, 90). How big are those effects? In one study, Meyer and Rosenbaum found that “60 percent of the 8.7 percentage point increase in annual employment of single mothers between 1984 and 1996 is due to the EITC” (Eissa and Hoynes, 98). Then again they found that “35 percent of the increase in participation between 1992 and 1996, is due to the EITC” (Eissa and Hoynes, 98). Another study, this one by Eissa and Liebman, found that the 1986 expansion alone created a 2.8 percentage point increase in participation (Eissa and Hoynes, 98). These are very large and substantial positive effects on the labor supply, particularly on the work habits of single mothers.

From a purely theoretical standpoint, the Earned Income Tax Credit could create disincentives to work during the phase out period of the credit. To illustrate the possibility, I will use an example of a hypothetical worker, Sarah, who is a single mother of two. Sarah recently transitioned from working at a nursery and earning \$24,000 annually, to a new job as a receptionist where she earns \$40,000 annually. At both levels she would qualify for the EITC. This wage increase from \$24,000 to \$40,000 pushes Sarah into the “phase out period.” For every dollar earned in income, she loses a portion of her EITC. Now let’s assume the receptionist job is paid hourly with an intended hours worked*hourly wage equal to \$40,000. If the EITC did not exist, the improvement from earning \$39,999 to \$40,000 would mean a \$1 increase. With the EITC and its

phase out period, in particular, the \$1 increase becomes a \$1 loss in EITC credit. Therefore, there is less incentive for Sarah to take an additional hour and work a little harder than there would be with no EITC. This is true for the phase in portion of the Figure 4. For a more in depth explanation of the economic theory behind the incentives and disincentives for work force participation and the EITC please see Appendix 2.

Figure 4. Theoretical Budget Lines with and without the EITC



As shown in this graph, the budget line faced by an individual changes with the introduction of the EITC. Originally, the slope of the orange line is simply the wage. With the EITC, it is the solid blue line. With the EITC the slope becomes steeper than the original during the phase-in, the same as the original during the plateau and shallower than the original during the phase-out. The slope during the phase out period is what was affecting Sarah and causes concern for policy makers and critics. This happens because wage is increasing at a slower rate (the slope is shallower) than it would be without the EITC. The dotted blue line shows a way that the EITC could be expanded to

lessen the difference between the slopes of the orange and blue lines. Yes, this would cost more money, but it may also encourage more hours worked than the current structure.

C. Eugene Steuerle puts it clearly, “Work subsidies such as the EITC generally encourage work for those who might otherwise not work or simply reside on welfare, but may tend to discourage work at higher income levels, particularly for second jobs in a family or moving to full time work” (Steuerle, 1). The total amount of the credit decreases during the phase out period. Since the amount of the credit in totality is decreasing, for every additional hour worked there is a higher marginal tax rate. But, there are many assumptions at play here. We assume that low-income heads of households are sitting around plotting their marginal tax rate and working the number of hours that they calculate to be the best rate. This is fairly unrealistic. In fact, a study found “though most families had heard of the EITC, most did not know that they needed to earn a certain amount in order to maximize their credit⁷ (Currie, 25). What we are more interested in understanding, is if there are any major trends in people cutting back on work. For example, would Sarah purposefully work less at her new job for fear of losing her credit or not? A study by Eissa and Hoynes suggest despite economic theory, there is “little evidence” that the EITC “reduced hours worked by the vast majority of eligible workers” (Eissa and Hoynes, 98). In fact, when they graph the average hours worked by single women, they found no significant reduction in hours worked even when the expansions occurred (which would theoretically decrease hours worked) (Eissa and Hoynes, 100). This expresses the limits of economic modeling and suggests there may be behavioral and outside factors at play, which make individuals act in a way that the theory does not predict.

⁷ Romich, Jennifer L., and Thomas Weisner. "How families view and use the EITC: Advance payment versus lump sum delivery." *National Tax Journal* 53.4; PART 2 (2000): 1245-1262.

5c. Lifting people out of poverty

This section will analyze whether the EITC has been successful at accomplishing its goal of lifting Americans out of poverty. This will help address the “can’t afford it” efficiency argument by proving the money spent on the EITC is an appropriate way to spend the money. The EITC had less explicit goals regarding anti-poverty measures when it was originally created. However, the expansions did have more clear goals towards reducing poverty in the United States. For example, when Bill Clinton signed major expansions to the EITC in 1993, he said “we will reward the work of millions of working, poor Americans by realizing the principle that if you work 40 hours a week and you've got a child in the house, you will no longer be in poverty” (Welna). Additionally, when Regan made expansions in 1986, the well-known hero to conservatives called it the “best anti-poverty bill” (Welna).

To be perfectly fair, before we can decide whether the EITC is lifting people out of poverty, we have to define poverty. The current system we use in the United States to define the poverty threshold is based on food budgets set in place during 1963-1964 as a portion of overall income (Census Bureau). The calculation takes into account age and size of family, but does not consider geographic location (Census Bureau). It excludes noncash benefits, capital gains or losses and uses before tax income (Census Bureau). This measure has some clear flaws. Given the varying portions of income spent on food, different geographic living prices and effects of noncash benefits, there is a lot this poverty measurement does not capture. Just recently, the Census Bureau introduced the Supplemental Poverty Measure (SPM) (Short). The main difference is this SPM takes into account many of the “government programs designed to assist low-income families and individuals that are not included in the current official poverty measure” (Short). This new measure makes strides towards achieving a fairer and more realistic calculation of what constitutes poverty in the United

States. For the purposes of this paper I will use the Supplemental Poverty Measure when data is available.

Currently, rates of poverty are much higher for children than for adults; in 2011 the overall poverty rate was 15%, whereas the child poverty rate was 21.9% (ASPE Human Services Policy Staff). Children are typically incapable of lifting themselves out of poverty, at least until they reach a working age. Therefore, the impact the EITC has on children is a great indicator of whether it is successful at lifting one of the most victimized and vulnerable populations out of poverty. The structure of the EITC as shown in part 2, clearly favors families that have children. In fact, over 75% of EITC filers are from households with children (Athreya et al., 237). Thus, we know that the EITC is affecting children. A closer look shows that it may have a substantial and significant positive impact on these children.

From a strictly numerical perspective, are we lifting people out of poverty? Yes. The Center on Budget and Policy Priorities found a combination of the EITC and CTC lifted 9.2 million people, including 4.9 million children above the poverty line in 2010 (Charite, Dutta-Gupta and Marr, 1). This uses the SPM measurement of poverty instead of the official measure (CBPP, 2). The 2009 expansions alone lifted 1.6 million people out of poverty (Charite et al., 1). For the EITC specifically, they found it lifted 5.4 million Americans out of poverty including 3.0 million children in 2010 (Greenstein). These numbers were even higher with 6.6 million people and 3.3 million children lifted out of poverty in 2009 (Greenstein and Wancheck). This shows the EITC is successful in helping more low-income individuals during times of greater economic distress. Overall, this is a significant number of people. This is especially important since a study by Dowd and Horowitz showed “of people who received the EITC over an 18-year period, 61 percent received the credit for only one or two years at a time” (Charite et al., 2). This indicates the EITC is successful as a simple lift for families that have fallen on hard times, not a dependency prone

program. With an economic recession like the one experienced beginning in 2008, the short-term additional income had significant positive effects for those receiving them. Since the vast majority of EITC recipients participate in the program for a meager one to two years, the EITC is effective at lifting people out of poverty. The program helps to make labor force participation a worthwhile endeavor to combat chronic poverty and its effects.

There is a body of research supporting the claim that a minor increase in parental income can have significant positive effects on a child's academic achievement, lifetime earnings, and future weekly hours worked. If all of this is true then we are likely making an upfront investment that will pay for itself in the long term. Research found that "estimates imply that each \$1,000 in tax credit increases student test scores by 6–9% of a standard deviation" (Chetty, 3). In this study, they use data linking the parents tax records to that child's test scores for the year following the increase in income (Chetty, 6). They use the findings of an increase in test scores, higher for math than for reading but statistically significant for both, to predict "college attendance, earnings, and other indicators such as teenage birth rates" (Chetty, 21). What makes this article particularly relevant is that it analyzed the effects of the Earned Income Tax Credit and the Child Tax Credit, not just an increase in the overall household income. This allows us to see how much the actual credit itself affects children. Greg Duncan has done similar work on how increased income is beneficial for children in low-income families. A specific study showed a \$1,000 increase in income "sustained over two to five years led to modest but statistically significant increase in young children's school performance on a number of measures" (Charite et al., 8). In further studies, the conclusion was a \$3,000 increase in income for a working parent has similar effects to two extra years of schooling for the child that grew up in that household (Charite et al., 8).

A closer look at what recipients of the EITC are spending their money on may be the answer. A new working paper from the National Poverty Center begins to answer this question.

They completed 194 interviews of “heads of households” receiving a total refund of at least \$1,000 (Mendenhall et. al, 1). Although the study is limited in size and variability, it begins to answer the question “what do EITC recipients plan to spend their refund on?” Some important findings are that over two-thirds of the surveyed participants planned to spend some of their refund on Savings and Assets (Mendenhall et al., 43). Similarly, about a third used part of it to pay back debt and 44.3% used it on overdue bills (Mendenhall et al., 43). For many parents and guardians, they see the EITC as their children’s money, one woman was quoted saying “I just feel that [the refund] belongs to them” (Mendenhall et al., 19). This likely explains why the increase in income has a positive effect on children. Between less everyday stress, saving money for a rainy day and indulging in some of the important cultural treats, children are sure to be better off when their parent’s income is increased.

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5. Conclusion and Policy Recommendations

Up to this point, I have aimed to show that the Earned Income Tax Credit is a particularly successful anti-poverty program. The EITC is a unique program because it is consistent with the public’s belief in the “American Dream,” the view that hard work will be rewarded. It utilizes free market principles and redistributive measures to increase the desire to work for able Americans, while at the same time providing income support for wages that are too low. Additionally, it helps mobilize people who work hard, functioning under the assumption that nobody who works hard should remain in poverty. Therefore, understanding how the Earned Income Tax Credit works and how successful it is should go a long way towards silencing the comments and criticism about the percentage of Americans who pay no federal income taxes.

Where do we go from here? First, making the provisions set forth in the 2009 American Reinvestment Act and then extended until 2017 American Taxpayer Relief Act is a good first step.

These provisions reduced the marriage penalty and created additional benefits for those who have 3 or more children (before the only categories were 0, 1 or 2 children) (CBPP, 3). Second, more research about the effect of the EITC marginal tax rates would be helpful in determining how and during what portion of the EITC we should expand the credit. For example, should we expand the phase out? Increase the phase in? Increase the overall amount at all income levels? The research mentioned in this paper is a good start, but more needs to be done to make a solid argument for how we can make this program even more effective.

Finally, we need to increase awareness of the Earned Income Tax Credit at all income levels and all occupations. During the summer of 2012, I was in a representative's office speaking with a staffer who had never heard of the EITC. This experience is deeply troubling for two reasons. First, the expansions for the EITC were set to expire in a short period of time. How could this staffer inform the representative how to vote if he had no idea what was at stake? And secondly, the EITC is the *largest* cash transfer program in the United States; it effects a huge portion of our country (Eissa and Hoynes, 1). It is important we hold our representatives accountable for knowing and protecting the programs that are successful. We need to ask Michele Bachman, Paul Ryan, Eric Cantor and Orrin Hatch to be explicit when making their "skin in the game" argument. How would they achieve this? Would they cut the EITC? Asking them to be explicit in their claims changes the dynamics and facts of the conversation. Similarly, we need to encourage our friends, family members, and colleagues to abide by the same set of standards, so when we hear attacks against "government handouts" we can understand exactly what they mean and what they are upset about. If our conversations move away from passionate, but ultimately empty rhetoric and towards analysis and criticism of specific programs, we will be a lot closer to a more constructive conversation.

Appendix 1.

Table 1. Hypothetical Tax Situation for one head of Household and 2 Children

	A	B	C
Income	\$24,000	\$34,000	\$60,000
Personal Exemptions	\$11,400	\$11,400	\$11,400
Standard Deduction	\$8,700	\$8,700	-
Itemized Deduction	-	-	\$21,947
Loss in Gov't Rev due to Deductions	\$870	\$870	\$2,857
Taxable Income	\$3,900	\$13,900	\$26,653
Tax Rate	10%	10%, 15%	10%, 15%
Tax Liability	\$390	\$1,650	\$3,563
EITC	\$3,440	\$1,330	-
Tax Refund	\$3,050	-	-
Tax Due	-	\$320	\$3,563

Table 2. Federal Income Tax Rates

Tax Rates	
10%	up to 8700
15%	8701-35350
25%	35350-85650

Table 3. Calculating Itemized Deductions

Medical		
Number of returns claimed	Total amount of claims	Average
1,174,915	\$8,957,504,000	7624
State and Local		
Number of returns claimed	Total amount of claims	Average
5,351,407	\$14,980,907,000	2799
HMID		
Number of returns claimed	Total amount of claims	Average
4,512,612	\$39,918,410,000	8846
Contributions		
Number of returns claimed	Total amount of claims	Average
4,473,343	\$11,975,878,000	2677
	TOTAL of averages:	21947

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To calculate the data above, I used data from the IRS⁸. I chose an income level for each of the different people. Then, each family received a Personal Exemption, is available to everybody of \$11,400, which is (\$3,800—the standard personal exemption for a head of household * 3—the head of household plus two dependents). This decreased each family's taxable income by \$11,400.

There are then two different deductions that are available to every person. The first is the Standard deduction. The second is itemized deductions. People generally choose whichever

⁸ IRS Individual Income Tax Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax It, <http://www.irs.gov/uac/SOI-Tax-Stats---Individual-Statistical-Tables-by-Size-of-Adjusted-Gross-Income>

IRS Adjusted Gross Income, <http://www.irs.gov/uac/SOI-Tax-Stats---Individual-Statistical-Tables-by-Size-of-Adjusted-Gross-Income>

IRS Six Important Facts about Dependents and Exemptions<<http://www.irs.gov/uac/Six-Important-Facts-about-Dependents-and-Exemptions-1>>.

number of these two would be higher. The standard deduction is \$8,700 for any family. The itemized deductions change based on many different factors. To benefit from the Home Mortgage Interest Deductions or other deductions of that sort, you have to itemize your deductions. This means that you must save receipts from different transactions. For example, to receive a deduction for charitable donations, you must save to receipts to show that that income was going towards charity. The itemized deduction method is more complicated, but many higher income Americans choose it because they receive a higher deduction in their taxable income.

In this situation, Person A and Person B both take the standard deduction. Person C uses itemized deduction. Because Person C is hypothetical and we do not know the exact calculations for this individual, therefore I used averages. These averages were the average deduction for:

- Medical expenses
- Home mortgage interest deduction
- Contribution deductions
- State and local taxes

These are the four major categories or the ones that account for most of the typical itemized deductions. I used data from the IRS to determine the averages for incomes between \$60,000-\$75,000 (IRS, “Individual Income Tax Returns with Itemized Deductions”). I find the average I used the formula= (amount in dollars/number of returns). Then I added the averages for each category together to get the average itemized deduction in the four major categories for incomes between \$60,000-\$75,000. These calculations are shown in table 3 above.

Next, I used the formula below to calculate taxable income:

$$\text{Taxable Income} = \text{Income} - \text{Personal Exemption} - (\text{Standard or Itemized Deduction})$$

Taxable Income was then taxed at the rates show in Table 2. So, the first \$8,700 of taxable income was taxed at a 10% rate, the income between \$8,700 and \$35,350 was taxed at a 15% rate.

That is how I determined tax liability for each person.

1. For Person A their tax liability-their tax credit amount= the amount of tax refund. The loss of revenue to government through deductions was calculated by subtracting the standard deduction amount of $\$8,700 * \text{tax rate of } 10\%$.
2. For Person B their tax liability- their tax credit amount= the amount of federal income tax due. The loss of revenue to government through deductions was calculated by subtracting the standard deduction amount of $\$8,700 * \text{tax rate of } 10\%$.
3. For Person C their tax liability= the amount of federal income tax due because they did not receive any tax credits, only tax deductions. Instead, to calculate the amount of government revenue loss from Person C, I took the amount of the itemized deductions (\$21,947) and taxed at the tax rates shown in table 3. This is likely a low range because that \$21,947 would in reality be taxed at a higher rate because Person C's total taxable income would be pushed up into the 25% bracket, so this is a low estimate of \$2,857.

Appendix 2

When a person's hourly wage is increasing it means the opportunity cost of leisure time (i.e. not working) is also increasing; you give up more wage by not working than you would otherwise. This is the substitution effect. During the phase-in period there is a positive substitution effect because the rate at which the individual's earnings are increasing is also increasing. During the flat plateau period, there are ambiguous effects. This is because the flat portion is parallel to the individual's original budget line. There is a negative substitution effect during the phase-out period of the credit (Meyer and Rossembaum, 1975). This is the place at which the individual's wage is increasing at a decreasing rate. At the same time, there is an income effect at play. The income effect is the concept that as an individual acquires more wealth they are more willing to give up work for leisure. For example, if you are working for \$10 an hour and work 60 hours a week and your wage increases to \$60 an hour, you may choose to decrease your work hours to 40 because simply put, you do not need as much and you *feel* richer.

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