EARNED INCOME TAX CREDIT

Congress should

- cut the earned income tax credit because it imposes a $69 billion annual cost on taxpayers, has a high error rate, and creates a disincentive for many workers to increase earnings; and
- enact reforms to boost market wages, such as cutting taxes on business investment.

The earned income tax credit (EITC) is a large federal aid program administered through the tax system. Benefits are available to households with earnings from employment. In 2021, the program provided $71 billion in benefits to 27 million recipients. The EITC is mainly a spending program, not a tax-cutting program. The credit is "refundable," meaning that individuals who pay no income taxes receive payments from the government. About $69 billion of the benefits in 2021 were refundable.

The EITC has a high error and fraud rate, and for many recipients it creates a disincentive to increase earnings. Also, the refundable or spending part of the EITC imposes a cost on the people who pay the taxes that fund the benefits.

Growth of the EITC

In the 1970s, policymakers considered ways to reduce the anti-work effects of the growing welfare state. One way would have been to cut the size of the welfare state, but policymakers instead decided to expand it by enacting the EITC in 1975. Initially, the program was a 10 percent wage credit with a maximum value of $400. Only workers with children were eligible.

Over the decades, Congress expanded the size and scope of the EITC. It now has credit rates of up to 45 percent and had a maximum value of $6,728 in 2021. It provides benefits to workers with and without children.

EITC expansions in 1986, 1990, 1993, and 2009 increased the program's cost. Total benefits in constant 2021 dollars rose from $16 billion in 1990 to

$71 billion in 2021. The number of recipients rose from 12.5 million in 1990 to 27 million in 2021. The American Rescue Plan of 2021 increased EITC benefits for childless workers for one year.

Structure of the EITC

EITC benefits vary depending on the number of children, income level, and filing status (single or married). Initially, the credit rises with income (the phase-in range). Then, it reaches the maximum amount and is constant for a range (the flat range). Finally, the credit falls as income rises further (the phase-out range).

Consider a single mother with two children in 2021. The maximum credit would have been $5,980 if she had earned between $14,950 and $19,520. Above that, the credit would phase out and ultimately be eliminated when earnings topped $47,915. The phase-out rate is 21.06 percent. So during the large phase-out range, the parent faces a disincentive to increase work effort since she loses $210 in EITC benefits for every additional $1,000 earned. The pattern of EITC benefits—rising, flat, then falling—is similar for other types of families.

EITC Reduces Market Wages

The EITC is supposed to strengthen work incentives for low-income individuals. If the program is successful, it increases their labor supply. On a simple supply-and-demand diagram, the labor supply curve shifts to the right, which has the effect of reducing market wages.

A growing labor supply and falling market wages induce employers to hire additional workers. Workers who receive the EITC are better off than before with the combination of a lower market wage and the EITC. But it is interesting that proponents of a larger EITC implicitly favor cutting market wages for low-income earners.

One side effect of the EITC is that, to the extent it works by pushing down market wages, it may hurt low-income earners who receive no EITC or just a small EITC. The labor-supply effect of the EITC also means the program acts as a subsidy to businesses that hire lower-skilled workers because they can pay reduced market wages.

Work Incentives and Disincentives

The EITC affects work incentives in two ways. First, it affects *labor force participation*, or the incentive for nonworkers to gain employment. Second, it affects the *number of hours worked* by people who are working. The EITC affects these factors in different ways for different people, creating both positive and negative effects. More than 30 states have their own EITCs layered on top of the federal program, and these amplify both the positive and negative effects of the federal program.

The EITC encourages individuals who are not working to find a job because the credit increases the financial reward for working. Most economists think that the EITC particularly encourages low-income single mothers to join the labor force, and there is solid empirical support for that positive effect.

However, there is doubt about the strength of this effect. EITC supporters point to gains in labor force participation among single mothers in the 1990s as evidence of the credit's benefits. The number of EITC recipients soared between 1987 and 1994 but was flat in the late 1990s. Yet from 1994 forward, labor force participation by single mothers grew strongly. So other factors aside from the EITC probably caused that late-1990s increase—perhaps the strong economy at the time and federal welfare reforms that increased work requirements.

For workers already in the labor force, the EITC creates a mix of incentives to either increase or decrease hours worked. Workers face an "income effect," which may cause some individuals to reduce work because the EITC allows them to meet their income needs with less work. Workers also face a "substitution effect," meaning the EITC makes working more valuable compared with not working. The substitution effect varies depending on whether individuals are in the phase-in, flat, or phase-out range of the EITC. As a result, people may respond to the credit by working either more or less at different income levels. People have an incentive to reduce hours worked in both the flat and phase-out ranges of the credit, and most people taking the EITC are in those two ranges. Thus, most people taking the EITC have an incentive to work less, not more.

The EITC is only one of the many government programs that alter incentives to work and earn additional income. A study by Elaine Maag and colleagues at the Urban-Brookings Tax Policy Center examined work incentives for a hypothetical low-income single mother with two children in each of the 50 states. As this mother's earnings rise, she pays more payroll taxes and possibly more income taxes, and she receives reduced benefits from the EITC, food stamps, and Temporary Assistance for Needy Families. On average, across the states, the study found that the parent would face a marginal tax rate of about 50 percent in moving from a poverty level of income to twice the poverty level. Here, "marginal tax rate" means the higher taxes paid as income rises combined with the reduction in various government benefits.

Other scholars have found similarly high marginal tax rates from the combined effects of taxation and benefit programs such as the EITC. Economist

Casey Mulligan of the University of Chicago found that the average marginal tax rate on labor income for the median-income household is above 45 percent. Similarly, a study by David Altig of the Federal Reserve Bank of Atlanta and coauthors constructed a detailed model of federal and state tax and spending programs and found that "across all age groups, the median lifetime marginal net tax rate is 46.6 percent for those in the lowest resource quintile" and that "one in four low-wage workers face marginal net tax rates above 70 percent, effectively locking them into poverty."

Errors and Complexity

The EITC has a high rate of improper payments caused by math errors, fraud, and misunderstanding of the rules. The Government Accountability Office reports that the EITC error and fraud rate averaged 24 percent between 2016 and 2020, or about $16 billion a year. People are receiving excess EITC payments based on false information about such items as their income level, filing status, and qualifying children. The EITC is an easy target for dishonest filers because it is refundable, meaning that people can simply file false tax returns and wait for the U.S. Treasury Department to send them a check.

In a 2019 statement, the National Taxpayer Advocate (NTA) noted that a "principal cause of the EITC improper payment rate is the complexity of the rules." EITC benefits change as income rises, and the credit has multiple phase-in and phase-out rates. It is adjusted by filing status and number of children. The rules regarding child eligibility are complex because of such issues as separation and divorce. The rampant errors in EITC filing consume substantial IRS resources. The NTA statement said that for 2017, "35 percent of all individual returns selected for audit were selected on the basis of an EITC claim."

The EITC error and fraud problems have persisted for decades, despite large IRS resources devoted to solving them. This is one good reason to cut or end the EITC. It is unfair to the taxpayers who fund the program for the government to misspend so much of their money year after year.

High Cost on Taxpayers

The EITC is mainly a spending program. Nearly all the EITC benefits—$69 billion in 2021—go to people who owe no income tax. Extracting the taxes to fund these benefits damages the economy by reducing productive activities, such as working and investing. This damage is called "deadweight losses." For the federal income tax, studies have found that the deadweight loss of raising taxes by a dollar is roughly 50 cents.

Suppose that Congress expands EITC spending by $10 billion. Does the expansion make any economic sense? The benefits would have to be higher than the total cost of about $15 billion, which includes the $10 billion direct cost to taxpayers plus another $5 billion or so in deadweight losses.

EITC supporters often say that the program pulls six million or so people out of poverty. But that is a dubious statistic. If the government gives low-income individuals $69 billion, of course they will have more money in their pockets, and fewer of them will be below a measured poverty line.

Why not double or triple EITC benefits and move even more people above the poverty line? The answer is because we need to worry about the costs of federal programs, which are the harms done to other citizens and the overall economy. Expanding the EITC would create higher deadweight losses, more fraud, and added disincentives to increase work in the credit's phase-out range.

Reform Options

Policymakers should cut the EITC by reining in benefit levels and narrowing eligibility. At the same time, they should pursue reforms to boost market wages. Wages across the economy rise over time as worker productivity increases. As such, policymakers should adopt policies favorable to capital investment and innovation. They should minimize tax rates on business income, provide favorable rules for venture capital and angel investment, and reduce regulatory barriers to competition and new investment.

Suggested Readings

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