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42. The Earned Income Tax Credit

Congress should

- cut the EITC because it imposes a $60 billion cost on taxpayers, has a high error and fraud 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 income tax system. Benefits are available to households with earnings from employment. In 2015, the program provided $69 billion in benefits to 28 million recipients.

The EITC is partly a tax-cut program but mainly a spending program. It is "refundable," meaning that individuals who pay no income taxes are nonetheless eligible to receive payments. About $60 billion of the benefits in 2015 were refundable.

The EITC has a high error and fraud rate, and for most recipients, it creates a disincentive to increase earnings. Also, the refundable or spending part of the EITC imposes a large cost on other people who pay the taxes to 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. Today, it has credit rates up to 45 percent and a maximum value of $6,269 in 2016. 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 2015 dollars increased from $14 billion in 1990, to $45 billion in 2000, to $69 billion in 2015. The number of recipients soared from 12.5 million in 1990 to 28 million in 2015.

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 the credit reaches the maximum amount and is constant for a certain range (the flat range). Finally, the credit falls as income rises further (the phase-out range).

Consider a single parent with two children in 2016. The maximum credit would be $5,572 if the parent earned between $13,931 and $18,190. Above that, the credit would phase out and then be eliminated when earnings topped $44,648. The phase-out rate is 21.06 percent, so during the phase-out range, the parent loses $210 in EITC benefits for every additional $1,000 earned. The pattern of 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 lower-income individuals. If the EITC is successful, it should increase the labor supply of low earners. On a simple supply-and-demand diagram, the labor supply curve thus shifts to the right, which tends to reduce 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 to note that proponents of the EITC implicitly favor cutting market wages for low earners.

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

People within the EITC's income range have an added incentive to find a job because the credit increases the 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, 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 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 that 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 about three-quarters of people taking the EITC are in those two ranges. So a large majority of people taking the EITC have an incentive to work less, not more.

The EITC is only one of many government programs that alter work incentives. A study by Elaine Maag and colleagues in the *National Tax Journal* examined work incentives on a hypothetical low-income single parent 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 Maag 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. Adding in the effects of reduced Medicaid and Affordable Care Act subsidies further reduces incentives for people to increase their market earnings.

Errors and Fraud

The EITC has a high rate of improper payments—caused by math errors, misunderstanding of the rules, and fraud. The Internal Revenue Service reported that the EITC error and fraud rate in 2014 was 27 percent, which amounted to $18 billion in overpayments.

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 Treasury to send them a check.

Part of the problem is that the EITC is complex. Benefits change as income rises, and it 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 due to issues such as separation and divorce. EITC rules are so complicated that two-thirds of all tax returns claiming the EITC are done by paid preparers. The credit generates so many errors that 39 percent of all IRS audits under the individual income tax are done on EITC filers.

The EITC error and fraud problems have persisted for decades, despite efforts to fix 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. Most payments—$60 billion a year, or 88 percent of the benefits—go to people who owe no income tax. Every dollar of those benefits is a dollar of loss for the people who pay the taxes to support the program.

Extracting those taxes to pay for the EITC damages the economy because it causes people to reduce their productive activities, such as working and investing. This economic 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 6 million or so people out of poverty. But that is a meaningless statistic. If the government gives low-income individuals $60 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 try to pull even more people out of poverty? The answer is that we need to worry about the costs of federal programs, which are the harms done to other citizens and the broader economy. Expanding the EITC would create more fraud, higher deadweight losses, and added disincentives to increase hours worked in the phase-out range.

Reform Options

The EITC should not be expanded, as some policymakers are proposing. Instead, the EITC should be cut, by reining in benefit levels and narrowing eligibility. At the same time, policymakers should pursue other policies to increase market wages and job opportunities. For example, cutting the corporate income tax rate would boost business capital investment. In turn, that would create higher demand for labor, thus generating more jobs and raising wages for all workers.

Suggested Readings

Edwards, Chris, and Veronique de Rugy. "Earned Income Tax Credit: Small Benefits, Large Costs." Cato Institute Tax and Budget Bulletin no. 73, October 2015.

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Maag, Elaine, C. Eugene Steuerle, Ritadhi Chakravarti, and Caleb Quakenbush. "How Marginal Tax Rates Affect Families at Various Levels of Poverty." *National Tax Journal* 65, no. 4 (December 2012): 759–82.

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