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**The Earned Income Tax Credit and the  
U.S. Low-Wage Labor Market**

by

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# **The Earned Income Tax Credit and the U.S. Low-Wage Labor Market**

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## Abstract

The Earned Income Tax Credit (EITC) is the largest cash or near-cash U.S. antipoverty program. Taxpayers gain access to the EITC by having incomes below certain thresholds and by filing a tax return. For a taxpayer to receive a larger EITC available to families with children, the EITC-qualifying child must live with the taxpayer more than half the year. In this paper I will discuss the EITC and low-wage labor markets in the United States.

Section 1 provides an overview of public assistance programs available to low-income Americans. The U.S. safety net provides an extensive but patchwork set of means-tested transfer and social insurance programs, with the result that individuals and households with similar incomes may receive quite different benefits. Households with children, particularly those with single parents, may receive cash benefits, food assistance, health insurance school meals, and possibly housing assistance. Disabled individuals may receive more generous cash payments and health insurance. Most elderly people receive social security (the public old-age pension), health insurance, and those with low income may instead receive cash payments and benefits from a different health insurance program. Able-bodied, prime-age childless adults may receive food assistance for short time periods. I briefly describe this extensive set of programs and the empirical magnitudes of benefits received by families and individuals in specific circumstances.

Section 2 of the paper discusses the EITC. I describe the evolution of the credit and summarize the research evidence on its targeting and anti-poverty effectiveness, effects on labor supply, EITC administration and compliance, and how the EITC fits into the broader safety net. As mentioned, the EITC plays a central role in U.S. antipoverty policy. But because the credit is available only to those with income, it provides nothing to those who are unable or unwilling to work.

Section 3 of the paper discusses three challenges confronting U.S. antipoverty policy, and the ability of the EITC to effectively address these problems. The problems include, first, the striking increase in the number of individuals (without children – these are referred to as “unrelated individuals” in Census Bureau terminology) who have incomes below the poverty line. These trends are driven, in part, by a disturbing increase in the fraction of males with low levels of education that are not in the paid labor market. Second, the U.S. safety net is now strongly oriented around work. This raises the question of what, from the vantage point of society, we do to support those who, for one reason or another, are unwilling or unable to work. Third, while the structure of the safety net is, to a degree not seen in the U.S., oriented toward work, there is little evidence on effective approaches that can foster a progression of wage increases that will help people achieve self-sufficiency.

Policy implications are addressed in the final section of the paper. There I discuss issues that likely would arise in other countries if those policymakers (and citizens) want to implement an EITC-like policy. Considerations include: the difficulties that may arise when designing a family-based credit in a tax system that is based on individuals as the unit of taxation. The treatment of the self employed. The timing of EITC payments: whether a payment is made annually or more frequently. Whether there should be an hours or earnings requirement associated with EITC eligibility. And whether other features of an economy and its safety net may enhance or detract an EITC-like policy’s effectiveness.

This paper provides an overview of public assistance programs available to low-income Americans; discusses the challenges confronting U.S. antipoverty policy; and discusses the central role played by the earned income tax credit (EITC) in addressing concerns about low-wage labor markets.<sup>1</sup>

The U.S. safety net provides an extensive but patchwork set of means-tested transfer and social insurance programs, with the result that individuals and households with similar incomes receive quite different benefits. Households with children, particularly those with single parents, may receive TANF (a cash welfare program), SNAP (an electronic benefit card that can be used to purchase food), Medicaid (in-kind health care), school meals, and possibly housing assistance. Disabled individuals may receive SSI (cash payments) or SSDI (the disability program that is part of social security) and Medicaid. Most elderly people receive social security (the public old-age pension), Medicare (in-kind health insurance), and those with low income may instead receive Medicaid and SSI. Able-bodied, prime-age childless adults may receive SNAP for short time periods. In section 1 of this paper, I provide an overview of the set of public assistance programs available to low-income Americans.

The U.S. safety net has evolved to emphasize work as a central feature, at least for non-elderly, non-disabled prime-age individuals. The foundation of the work-based safety net is the EITC. In section 2, I discuss the origins of the credit, its evolution over time, and summarize the research evidence on its targeting and anti-poverty effectiveness, effects on labor supply, EITC administration and compliance, and how the EITC fits into the broader safety net.

U.S. antipoverty policy faces major challenges. There has been a striking increase in the number of individuals without children (these are referred to as “unrelated individuals” in

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<sup>1</sup> The Earned Income Tax Credit (EITC) is the largest U.S. antipoverty program for the non-aged population.

Census Bureau terminology) who have incomes below the poverty line. The safety net's emphasis on work raises the question of what, from the vantage point of society, do we do to support those who, for one reason or another, are unwilling or unable to work? Finally, while the structure of the safety net is oriented toward work, there is little evidence on effective approaches that can foster a progression of wage increases that will help people achieve self-sufficiency. Section 3 of this paper discusses these issues.

The final section of the paper discusses issues that likely would arise if policymakers (and citizens) in other countries want to implement an EITC-like policy. Considerations include the difficulties that may arise when designing a family-based credit in a tax system where individuals (as opposed to families) are the primary unit of taxation, the treatment of the self employed, the timing of EITC payments, whether there should be an hours or earnings requirement associated with EITC eligibility, and whether other features of an economy and its safety net may enhance or diminish an EITC-like policy's effectiveness.

## **1. Low-Wage Labor Markets and Antipoverty Programs in the United States**

The official poverty line in the U.S. was first developed in the mid-1960s by Mollie Orshansky, a social science research analyst at the Social Security Administration (SSA). Ms. Orshansky developed a set of poverty thresholds taking the cost of a minimum adequate diet for families of different sizes and multiplying the cost by three to allow for other expenses.<sup>2</sup> Poor families were then identified as those whose yearly income was below the threshold for a family

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<sup>2</sup>The minimum diet she used was the Economy Food Plan, the cheapest of four food plans issued by the U.S. Department of Agriculture. The factor of three was derived from a 1955 Agriculture Department survey.

of a given size. The Orshansky measure remains the official poverty line for the U.S., except they are updated each year by the change in the consumer price index.

In 2008 a single mother with two children would have an income below the poverty line if her income (including cash transfers) was below \$17,346. The poverty line for a married couple with two children was \$21,834. Poverty thresholds for years since 1980 can be found at <http://www.census.gov/hhes/www/poverty/threshld.html>.

Figure 1 (reproduced from U.S. Census Bureau publications) shows the number and percentage of people in poverty in the U.S. between 1959 and 2008. Since 1966 the percentage of people living in families with income below the poverty line ranged between 11.1 percent and 15.2 percent. It was 13.2 percent in 2008 or 39.8 million people.

Figure 2 shows poverty rates by age. In the 1960s and into the 1970s, individuals 65 years or older had by far the highest poverty rates of any age group in the U.S. Due to the maturation of the social security system and the real income growth that occurred up until the early 1970s, elderly poverty rates fell sharply from 1959 through 1975. Today, the elderly as a group have the lowest poverty rates of any age group. 9.7 percent of elderly individuals live in families (perhaps consisting of a single person) with incomes below the poverty line.

The age group with the highest poverty rates is children under 18 years. In 2008 19.0 percent of children under 18 were living in families with incomes below the poverty line, or nearly one in five children in the U.S. Child poverty rates fell from a peak of 22.7 percent in 1993 to 16.2 percent after the long U.S. economic expansion during the 1990s. Many of these children live in single-parent families. Poverty rates for children living in a family where a single mother is the head is 43.5 percent. Poverty rates for children in all other family types are 10.7 percent ([http://www.census.gov/hhes/www/cpstables/032009/pov/new03\\_100\\_01.htm](http://www.census.gov/hhes/www/cpstables/032009/pov/new03_100_01.htm)).

We can learn more about the characteristics of low-income Americans making use of data from the Survey of Income and Program Participation (SIPP). The SIPP data are nationally representative panel surveys that contain information on a variety of topics, including demographic characteristics, monthly household income, the sources of that income, and monthly program participation. Various waves of the SIPP follow households for 3 or 4 years, with respondents being interviewed every four months.

In the 2008 SIPP panel, 30 percent of non-disabled, non-elderly families had incomes below 150 percent of the poverty line. Not surprisingly, these families were much more likely than others to have low levels of education: 19.9 percent of the families with income below 150 percent of poverty had less than a high school degree, while only 9.6 percent of the entire (non-disabled, non-elderly) population had that little education. 28.7 percent of the low-income group had only a high school degree or a GED. This figure was 22.2 percent for the full population. Low human capital is clearly one significant correlate of having an income that would classify a family as being poor or “near poor” (that is, having an income below 150 percent of the poverty line). But 37.7 percent of these near-poor families have at least some college, 10.3 percent are college graduates, and 3.4 percent have education beyond a college degree. The factors associated with having low incomes in the U.S. are varied and complex.

a. The safety net for elderly and disabled workers<sup>3</sup>

In most of this paper, I focus on non-disabled, non-elderly individuals and their families since poverty and economic hardship for prime-age individuals and their families provide a distinct challenge for policymakers in industrialized countries. In general, safety net programs

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<sup>3</sup> For further details on U.S. safety net programs for the elderly, disabled, and prime-age workers, see Moffitt, Scholz, and Cowan (2009).

must make tradeoffs between three objectives: the desire 1) to be generous, so families can have an adequate standard of living; 2) to present households with desirable incentives, whether to work, or marry, or to only have children in situations where they can be supported; and 3) to make efficient use of scarce taxpayer dollars. There is an inherent tension between these three objectives. Generous programs will either be very expensive (if they maintain desirable incentives, such as low claw-back rates) or will have undesirable labor market incentives, through high phaseouts of benefits or “notches” where all benefits are lost if incomes exceed some threshold. Inexpensive programs with desirable incentives will have meager benefits.

The tension between generosity, incentives, and fiscal restraint is less central for programs targeted to the elderly and disabled, since there are fewer expectations that people in these situations should be working (one nevertheless, of course, must be concerned about the effects of public pensions on retirement and hours; and disability programs on labor market behavior). But for prime-age workers, there is no obvious way to resolve the tension between competing program objectives. Different countries around the world and different states within the U.S. resolve these tensions differently. I start by briefly describing the safety net for elderly and disabled workers in the United States. The remainder of the paper focuses on the safety net and labor market challenges of prime-age workers.

Social insurance programs provide near-universal coverage since any individual (or their employer) who makes the required contributions to finance the programs can receive benefits when specific eligibility requirements are met. These programs have dedicated funding mechanisms where, at least in an accounting sense, social insurance taxes are remitted to trust funds from which benefits are paid.

The largest social insurance program is social security, formally known as the Old-Age,

Survivors, and Disability Insurance program (OASDI).<sup>4</sup> Real social security payments tripled between 1970 and 2006 to \$474 billion. Because many retired elderly workers have little labor market and capital income, pre-tax and transfer poor families receive a substantial share of social security benefits, which averaged \$11,566 in 2006. The effect of social security on poverty is clear: as the social security system has grown, elderly poverty has fallen precipitously. The sharpest decline in the elderly poverty rate occurred between 1959 and 1974, a period that coincides with rapid growth in social security spending.<sup>5</sup>

The elderly also receive substantial benefits from Medicare, which provides hospital insurance and supplementary medical and prescription drug coverage for most people over age 65 and for most social security disability recipients under age 65.<sup>6</sup> Real Medicare outlays have increased more than tenfold from \$41 billion in 1970 (the program started in 1967) to \$413 billion in 2006. Real expenditures per Medicare enrollee increased almost five times over the same time period to \$9,378 in 2006. A substantial portion of Medicare benefits go to elderly families whose pre-transfer incomes are below the poverty line. The official poverty measure does not account for Medicare benefits because they are in-kind (via the provision of health care and insurance) rather than in the form of cash.

Disability Insurance (DI), a federal program that is part of the social security program, provides benefits when a covered worker is unable to engage in “substantial gainful activity” by

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<sup>4</sup> In 2008, the OASDI program is financed by a 6.2 percentage point payroll tax levied on employers and employees (for a combined 12.4 percent tax) on earnings up to \$102,000. These tax receipts are credited to the social security trust fund. To receive benefits, a worker must have at least 40 quarters of employment in jobs covered by the social security system (most jobs are now covered). Workers (who are not disabled) can begin drawing reduced benefits as early as age 62; the normal retirement age is 67 for workers born after 1959. Benefits payments increase (nonlinearly) as retirement is delayed until age 72, at which point benefits no longer increase with age of retirement.

<sup>5</sup> From 1959 to 1974, real social security spending increased 210 percent, a much sharper growth rate than other 15-year periods. For example, real social security spending increased 110 percent between 1970 and 1985, and 29 percent between 1991 and 2006.

<sup>6</sup> It is financed by a 1.45 percent payroll tax on uncapped earnings levied on employers and employees (for a total tax of 2.9 percent).

reason of a physical or mental impairment that is expected to last for more than 12 months or result in death.<sup>7</sup> Workers must have a minimum period of covered employment before being eligible; depending on the age at which a disability occurs, this ranges from 6 to 40 covered quarters. DI rules are stringent, with fewer than 40 percent of all applications being granted benefits; roughly 5.4 awards are made per 1,000 covered workers. Around 8.6 million people (including children) receive disability benefits, which cost \$95 billion in 2006. Most DI recipients are pre-tax-and-transfer poor.

Supplemental Security Income (SSI) is a means-tested, federally-administered, cash assistance program for the aged, blind and disabled. The disabled make up nearly 80 percent of recipients: these individuals generally do not have the prior work history needed to qualify for DI. An individual who meets the income, asset and categorical eligibility standards receives a cash transfer of up to \$637 per month; couples can receive up to 1.5 times that amount, and children can receive half that amount, although states are allowed to supplement these amounts. In 2006, 7.2 million people received \$40 billion in benefits.

b. The safety net for prime-age individuals and their families

Unemployment insurance is a state-level program that provides temporary and partial wage replacement to workers who become involuntarily unemployed and who have a recent history of continuous employment at moderately high wages.<sup>8</sup> While UI allows families to maintain their consumption during periods of involuntary layoffs (Gruber, 1997), it has relatively small antipoverty effects because so many unskilled individuals do not have the necessary employment

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<sup>7</sup> Substantial gainful activity is defined as work that involves significant physical or mental effort and that is done for pay or profit. Complex regulations promulgated by the Commissioner of the Social Security Administration define disabilities and substantial gainful activity, though average monthly earnings above some threshold (\$940 in 2008) demonstrate substantial gainful activity for people with an impairment other than blindness.

<sup>8</sup> The federal portion of unemployment insurance is financed by a 0.8 percent tax levied on employers on the first \$7,000 of wages paid to each covered employee. The states levy additional, modest taxes to finance their programs.

history at high enough wages. The Government Accountability Office (2000) reports that in the 1990s, low-wage workers were twice as likely to be unemployed but less than half as likely to receive UI as other unemployed workers.<sup>9</sup> Unemployment insurance is highly cyclical. In 2003, a year of slow economic growth, \$61 billion in real UI benefits were paid out, while real payments were \$25 billion in 2000, a year with low unemployment.

Workers' compensation is a state-level program that provides cash and medical benefits to some persons with job-related disabilities or injuries and provides survivors' benefits to dependents of workers whose death resulted from a work-related accident or illness. Benefit levels vary widely across states. Workers' compensation payments were \$59 billion in real terms in 2005; Meyer, Mok and Sullivan (2007) note that roughly half of total program costs are for medical care. Because there is little Federal involvement in this system, there is little information on its antipoverty effects. Such effects are likely to be small, however, for the same reasons that UI has limited antipoverty effectiveness.

In contrast to unemployment insurance and workers' compensation, which are social insurance programs, means-tested transfers are financed by general tax revenues rather than through dedicated financing mechanisms. All means-tested programs limit benefits to those whose incomes (and generally assets) fall below some threshold. Some are entitlements—all who satisfy the stipulated eligibility requirements get benefits, regardless of the total budgetary cost (e.g., Medicaid, Food Stamps). Other means-tested programs provide benefits only until the funds Congress or a state has allocated are spent, even if some eligible participants are not served (e.g. State Child Health Insurance Program, Section 8 housing vouchers, TANF). Means-tested

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<sup>9</sup> Although UI eligibility varies by state, typically one must have worked for at least two quarters of the previous year in covered employment, be actively seeking work, and have lost one's job through no fault of one's own. A worker can generally receive a maximum of 26 weeks of benefits and these benefits generally replace between 50 and 70 percent of the individual's average weekly pre-tax wage up to some state-determined maximum.

programs have explicit antipoverty goals. Together, they account for a much smaller share of government budgets than social insurance programs.

Medicaid, the largest means-tested transfer program, funds medical assistance to persons who are aged, blind, disabled, or are certain other pregnant women or dependent children. Recipients must meet asset and income tests that are set by states. About 55 million people received Medicaid in 2004.<sup>10</sup> Total real Medicaid spending was around \$320 billion in 2006.

Aid to Families with Dependent Children (AFDC) was the central safety net program for poor families with children from 1936 to 1996 (Moffitt, 2003b). This program was directed primarily at single-parent families, though some two-parent families with an unemployed parent received benefits. AFDC was a means-tested entitlement, meaning that all applicants whose income and assets were below the stipulated levels could receive benefits. States determined benefit generosity that varied widely; funds were provided according to an uncapped federal matching formula.

The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 abolished AFDC and created Temporary Assistance for Needy Families (TANF), which provides block grants to states with few restrictions. States were required to spend at least 75 percent of their “historic” level of AFDC spending, a 5-year lifetime limit was imposed on receipt of federally-supported cash assistance (some hardship exemptions were allowed), and states had to meet targets for moving recipients into work activities. A combination of these AFDC-TANF changes, the longest economic expansion in history, sharp increases in the earned income tax credit, and other factors contributed to a 52 percent decline in welfare caseloads between January 1993 and December 1999. Despite the weak economy in the years after the recession in 2001, TANF

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<sup>10</sup> About 10 percent of Medicaid beneficiaries were 65 or older in 2005; they receive about 26 percent of Medicaid expenditures.

caseloads have not increased substantially from their historic lows.

Several commentators feared that TANF might set off a “race to the bottom,” where states, fearful of attracting low-income families from other states, might lower benefits, which in turn would cause others states to lower theirs. In fact, total AFDC/TANF spending on cash benefits declined from a peak of about \$40 billion in 1995 to about \$20 billion in 2006, but this reduction was roughly proportional to the welfare caseload reduction. Spending on other ancillary services (e.g. child care, transportation) for welfare recipients and other low-income families has, in some jurisdictions, also increased since the mid-1990s.

AFDC/TANF is the archetype of cash-based transfers. As expenditures on these programs have fallen, the main work-based transfer, the EITC, grew sharply from \$5 billion in 1975 to \$45 billion in 2006.<sup>11</sup> Most of this growth occurred after 1987; real EITC expenditures grew at an annual rate of 9.1 percent in the 1980s (due to legislated increases in 1986), 12.5 percent in the 1990s (due to legislated increases in 1990 and again in 1993), and 3.0 percent from 2000 to 2005. No other federal antipoverty program grew so rapidly since the mid-1980s. The EITC is now the nation’s largest cash or near-cash antipoverty program.

The incentives embedded in the EITC differ from those in AFDC/TANF. AFDC recipients with no earnings received the largest welfare payments. In contrast, the EITC encourages low-skilled workers to enter the labor market, since nonearners do not receive the credit and the EITC amount rises with earnings up to about the poverty line.

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<sup>11</sup> The EITC is a refundable credit that taxpayers can receive after filing their tax returns. It seeks to encourage individuals with low earnings to increase their work hours. In 2008, low-income working families with two or more children could get a credit of 40 percent of income up to \$12,060, for a maximum credit of \$4,824, which stays at this level as earnings increase from \$12,060 to \$15,740. Their credit is reduced by 21.06 percent of earnings between \$15,740 and \$38,646. Those with one child can get a credit of 34 percent on income up to \$8,580, for a maximum credit of \$2,917. Childless taxpayers can get a credit of 7.65 percent on income up to \$5,720, for a maximum credit of \$438. See Hotz and Scholz (2003) for further discussion.

A child tax credit was created in the 1997 Taxpayer Relief Act and has been modified several times since then. Until 2001, the credit provided little financial benefit for poor and near-poor families because of limits on its refundability. Beginning in 2002, the child credit was made at least partially refundable for taxpayers with children. In 2009 the credit was a maximum of \$1,000 per child and partially refundable. In particular, fifteen cents of child credit is paid (as a refundable credit) for every dollar earned in excess of \$3,000, up to the total available child credit. The credits are phased-out for married couples with income exceeding \$110,000 (and \$75,000 for single parents).

The safety net for low-income families also includes in-kind benefit programs, the largest of which are food stamps, housing assistance, Head Start, school nutrition programs and the special supplemental nutrition program for women, infants and children (WIC).<sup>12</sup>

Food stamps (now known as SNAP – the supplemental nutritional assistance program) are designed to enable low-income households to purchase a nutritionally adequate low-cost diet. It is the single, almost-universal entitlement for those with low income and assets. The maximum monthly food stamp benefit for a family of four was \$542 in 2008.<sup>13</sup> Food stamp participation and spending increased sharply between 2000 and 2005. The caseload increased from around 18 million to 30 million; spending increased from about \$18 billion to \$31 billion (Rosenbaum, 2006).

The Department of Housing and Urban Development and the Farmers Home Administration

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<sup>12</sup> There are also (generally small) programs designed to enhance human capital. I focus on cash and in-kind programs in this paper.

<sup>13</sup> Families receiving SSI or TANF also receive food stamps. Others must have incomes below the poverty line after subtracting a \$134 per month standard deduction, 20 percent of earnings, dependent care and large shelter expenses, and child support payments. Total income cannot exceed 133 percent of the poverty line. A family must have less than \$2,000 of assets (\$3,000 if a member is elderly). Vehicles (under \$4,650 in value) and houses do not count for the asset tests. PRWORA disqualified most permanent resident aliens and mandated work activities for able-bodied adults without dependents, who are now generally eligible for only 3 months of benefits in a 36-month period if they are not working.

are responsible for safety net housing assistance programs. Because these programs have never been entitlements, waiting lists are common. Aid comes in two principal forms: project-based aid, where subsidies are tied to units constructed for low-income households, and household-based subsidies, where renters choose housing units from the existing private housing stock. Since 1982, project-based aid has been curtailed in favor of rental subsidies. Around \$39 billion was spent on housing assistance in 2007, serving around 5.1 million recipients in 2007. Federal housing subsidies provide roughly \$7,720 in annual benefits per recipient.

The school lunch and breakfast programs are entitlements funded by the Department of Agriculture that provides federal support for meals served by public and private nonprofit elementary and secondary schools and residential child care institutions that enroll and offer free or reduced-price meals to low-income children. Around 10 million children participated in the school breakfast program in 2007. The school lunch program is larger, serving around 31 million children in 2007. Combined expenditures in 2007 were around \$11 billion.

The special supplemental nutrition program for women, infants and children (WIC) provides vouchers for food purchase, supplemental food, and nutrition risk screening and related nutrition-oriented services to low-income pregnant women and low-income women and their children (up to age 5). WIC is not an entitlement. In 2007 roughly 8 million women, infants and children received benefits from WIC at a cost of almost \$6 billion.

Head Start, an early childhood education program launched as part of the War on Poverty, seeks to improve social competence, learning skills, health and the nutrition status of low-income children so that they can begin school on an equal basis with their more advantaged peers (Jacob and Ludwig, this volume). Spending in 2006 was \$7 billion for around 900,000 children.

Figures 3 through 5 summarizes the evolution of means-tested cash transfers to non-disabled,

non-elderly families (in Figure 3), in-kind programs (Figure 4), and all transfers, including social insurance (Figure 5). Figure 3, shows the sharp increase in EITC expenditures beginning in 1986, and the reduction in AFDC/TANF expenditures starting with welfare reform in the mid-1990s. Expenditures on either program never exceed \$46 billion annually.

Changes over time in expenditures on in-kind benefits are shown in Figure 4. Expenditures on these in-kind programs never exceed \$41 billion. As described above, these programs tend to focus on food, nutrition, and housing.

Figure 5 shows spending on all social insurance programs, which now exceeds \$1 trillion annually. It is obvious that social insurance expenditures dwarf expenditures on cash and in-kind transfers to non-disabled, non-elderly households. Social insurance expenditures (in real dollars, excluding workers' compensation due to data limitations) rose at an annual rate of 7.2 percent in the 1970s, 3.3 percent in the 1980s, 2.9 percent in the 1990s, and 4.3 percent between 2000 and 2006. The bottom two lines of Figure 5 show total spending on in-kind transfers (without Medicaid) and cash transfers. Means-tested in-kind transfers (the sum of school nutrition programs, WIC, Head Start, housing assistance, and food stamps) grew at an annual rate of 16.0 percent in the 1970s, 2.1 percent in the 1980s, 2.0 percent in the 1990s, and 5.1 percent between 2000 and 2005.<sup>14</sup> Means-tested cash transfers (the sum of AFDC/TANF, SSI, and the EITC) grew at an annual rate of 3.4 percent in the 1970s, 2.1 percent in the 1980s, 4.2 percent in the 1990s, and fell for the first time in 35 years between 2000 and 2005, despite a weak economy.

The growth rates of both cash and in-kind safety net spending increased significantly in the 1990s relative to the 1980s. In-kind programs continued to increase in the 2000s, while cash

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<sup>14</sup> Medicaid is considerably larger than the combined value of the other in-kind transfers in recent years. In-kind transfers including Medicaid grew at an annual rate of 11.2 percent in the 1970s, 4.5 percent in the 1980s, 6.0 percent in the 1990s, and 6.2 percent between 2000 and 2005.

programs shrunk. Spending on cash and in-kind antipoverty programs excluding Medicaid is around \$200 billion in 2005. Medicaid is an additional \$333 billion in 2005. In the following section, I focus on the largest cash or near-cash programs targeted at non-elderly, non-disabled families and individuals, the EITC.

## **2. The Earned Income Tax Credit**

Since it entered the U.S. tax code in 1975, the EITC has been expanded by both Republican and Democratic administrations. Its most rapid growth came in the last 25 years (notably in 1986, 1990 and 1993). The EITC is expected to cost \$40.9 billion or about 1 percent of federal spending in 2009. It is the largest cash or near-cash antipoverty program in the U.S. Budget.

To receive the earned income credit, taxpayers file their regular tax return and fill out the six-line Schedule EIC that gathers information about qualifying children. The EITC is refundable, meaning that it is paid out by the Treasury regardless of whether the taxpayer has any federal income tax liability. There are several basic tests for EITC eligibility. The taxpayer must have both earned and adjusted gross income below a threshold that varies by year and by family size. Most EITC payments go to taxpayers with at least one “qualifying child.” A qualifying child needs to meet age, relationship, and residence tests. The age test requires the child to be younger than 19, younger than 24 if a full-time student, or any age if totally disabled. The relationship test requires the claimant to be the parent or the grandparent of the child or for the child to be a foster child. Under the residence test the qualifying child must live with the taxpayer at least six months during the year. Another rule limits the sum of taxable and tax-exempt interest, dividends, net capital gains, rents, royalties, and “passive” income to less than \$2,950 (indexed for inflation).

The EITC provides a subsidy to earnings up to a specific income threshold. For example, consider taxpayers with two or more children. The EITC gives a 40 percent earnings subsidy up to \$12,570 in 2009. Taxpayers with earnings between \$12,570 and \$16,420 receive the maximum credit of \$5,028.<sup>15</sup> The credit is reduced by 21.06 percent of earnings between \$16,420 and \$40,295. Hence, there are three distinct ranges of the EITC: the subsidy, flat and phase-out ranges of the credit. The EITC is refundable, meaning that the Treasury pays it whether or not the taxpayer has any other tax liability.

I interpret the weight of the research evidence as suggesting that the EITC is a generally effective, beneficial policy for U.S. low-wage workers. But this view reflects several features of low-wage labor markets in the U.S. that are particularly helpful in enhancing its effectiveness.

The EITC might be a less useful tool in countries with different policy environments.

- Compared to other OECD countries, the U.S. has few employment regulations that constrain the ability of employers to alter the size of their work force. The U.S. also has a low minimum wage of \$7.25 per hour and has few mandated fringe benefits. Consequently, there are few policies that raise the costs of hiring workers above the marginal value of services workers provide. These demand-side factors reduce barriers to hiring low-skill workers and presumably enhance the effectiveness of the EITC in stimulating labor force participation.
- The family is the unit of taxation in the U.S. The target efficiency of the EITC is enhanced by limiting it largely to families with incomes below roughly \$40,000. Countries whose tax systems are based on individual, rather than family income will find it harder to limit the EITC to low-income families.
- The U.S. has a relatively effectively administered and pervasive individual income tax. Consequently, a very large fraction of EITC-eligible families would file tax returns even in the absence of the EITC.<sup>16</sup> This leads to high EITC take-up rates and low administrative costs.

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<sup>15</sup>The maximum credit for families with one child is \$3,043; for childless workers it is \$457; and for families with three or more children it is \$5,657. Current and historical EITC parameters can be found at <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=36>

<sup>16</sup>Holtzblatt (undated) writes that “Less than 2 percent [of EITC recipients] file solely to obtain refundable credits.”

- By OECD standards, the U.S. is a low-tax country (only Japan, Mexico, South Korea, and Turkey have ratios of total tax revenue to GDP that are lower), so employment taxes on low-wage workers do not substantially reduce the after-tax wage. While cumulative marginal tax rates in the phase-out range of the credit are high, they do not appear to be so onerously high as to stifle work.<sup>17</sup>

Even with these favorable circumstances, the EITC's positive employment effects are modest. Meyer and Rosenbaum (2001) estimate, for example, that a \$1,000 increase in tax credits (in 1996 dollars) would increase employment of single mothers by 4.3 percentage points (from a base of around 65 percent). With these institutional facts in mind, the next section briefly summarizes what is known about the EITC.

#### a. Effects of the EITC<sup>18</sup>

My discussion of the EITC's effects covers three broad areas: its targeting and anti-poverty effectiveness, its behavioral effects, and the ability of tax authorities to administer the credit.

##### *Targeting and anti-poverty effectiveness*

By its structure, the EITC is limited in 2009 to taxpayers with earned income and adjusted gross income less than \$40,295 (\$43,279) if they have two (three or more) qualifying children, \$35,463 if they have one qualifying child, and \$13,440 if they have no qualifying children.

Meyer (2009) finds that the EITC lifted the incomes of over 4.5 million people above the poverty line. The majority of EITC payments go to families with children and incomes near and below the poverty line.

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<sup>17</sup>In the phase-out range of the credit, families may face marginal tax rates exceeding 45 percent. If workers bear the full burden of social security payroll taxes, combined marginal rates will be 14.2 percent for payroll taxes (15.3/1.0765) plus 10 percent from the individual income tax plus 21.06 percent for the EITC phase-out. Families also likely pay state sales taxes, income and property taxes. Over some income intervals in the phaseout range families might also lose food stamp, housing or Medicaid benefits.

<sup>18</sup> See Hotz and Scholz (2003) or Meyer (2009) for additional information on the EITC.

The EITC gets high marks for reaching its intended beneficiaries. Scholz (1994) finds that 80 to 86 percent of taxpayers eligible for the EITC appeared to receive it in 1990. Blumenthal, Erard and Ho (2005) find lower take-up rates for eligible households in 1988, while the IRS (2002a) uses non-tax data to estimate somewhat higher take-up rates among eligibles in 1996. There unfortunately are no EITC participation studies for more recent years. Since the time of the earlier studies, the maximum credit increased sharply and the credit extends further up in the income distribution, where filing propensities are very high. The IRS and other organizations have also expanded EITC outreach efforts and 23 states (including the District of Columbia) have adopted EITCs as part of their state income taxes (2 of the state EITCs are not refundable). However, there has been a steady increase in labor force participation of single women with children (Meyer and Rosenbaum, 2000, 2001), and new workers in this group presumably have lower filing propensities than the typical worker in the population because they lack experience with the tax system.

#### *The EITC's effect on labor supply and families*

Analyses of the effects of the EITC on labor market participation come to a nearly unanimous conclusion:<sup>19</sup> it has a statistically significant and large effect on labor force participation of single women with children.<sup>20</sup> Hotz, Mullin, and Scholz (2005), for example, use matched administrative data from public assistance records, unemployment insurance

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<sup>19</sup> Dickert, Houser and Scholz (1995); Eissa and Liebman (1996); Keane and Moffitt (1998); Ellwood (2000); Meyer and Rosenbaum (2000, 2001); Grogger (2003); Eissa and Hoynes (2004); and Hotz, Scholz, and Mullin (2005) find positive employment effects of the EITC. Cancian and Levinson (2006) is the exception. Hotz and Scholz (2003) survey EITC research.

<sup>20</sup> Hotz and Scholz (2003) compute employment elasticities with respect to net income (associated with EITC changes) from selected previous studies that range from 0.69 to 1.16. Grogger's (2003) estimates were not included in our earlier study, but he concludes that the EITC "may be the single most important policy measure for explaining the decrease in welfare and the rise in work and earnings among female-headed families in recent years" (p. 408). Eissa and Hoynes (2004) focus on the employment and hours decisions of secondary workers in married families and find small, negative effects of the credit on work.

records, and federal tax returns for a sample of California residents. Their paper examines four distinct tests of the EITC to isolate its effects on employment. The first test is based on the intuition that if the EITC alters employment, all else being equal, employment rates for two-or-more child families should grow relative to the employment rates of one-child families, as credit amounts available to these groups of families diverged over the 1990s. The second test examines whether or not people eligible for the EITC actually file tax returns and claim it. The third test is based on the intuition that, if the EITC, and not other factors such as the strong economy in the 1990s, is causing employment differences between families with two or more children relative to those with one child, we should expect to see no employment differences (after conditioning on other characteristics) between families with two children and families with three or more children, since the EITC did not change differentially for the latter two groups (the modest increase in the EITC for families with three or more children was not enacted until 2009). The fourth test conditions the sample on those who did not file tax returns and again examines employment changes in the 1990s for families with two or more children relative to families with one child.

Using fixed-effects empirical employment models estimated on a sample of single-parent families, their coefficient estimates are consistent with the EITC having a substantial, positive effect on the employment of families who have used or will use welfare. Specifically, we found the 1993 expansion of the EITC for families with two or more children relative to one-child families increased employment by as much as 3.4 percentage points for families with two or more children, or 11.8 percent of the overall employment gains for this group over the period we studied. This figure is 77 percent of the differential employment gain of families with two or more children, relative to their one-child counterparts.

Studies estimating the effects of the EITC on hours of work for those households that are working find small, negative effects. Liebman (1997) finds no bunching of taxpayers at the beginning and end of the phase-out range, as might be expected if the EITC significantly affects hours and taxpayers are cognizant of the discontinuities in implied marginal tax rates generated by the credit. It is not surprising that negative effects on hours for people already in the labor market are small, since the precise relationship between the EITC and hours worked is likely to be poorly understood by most taxpayers. Most EITC recipients pay a third party to prepare their tax returns, and it is difficult to infer the implicit tax rates embodied in the credit from the look-up table that accompanies the EITC instructions. This confusion is less likely to mitigate positive participation effects, since for these to be operative, taxpayers only need to understand that there is some tax-related bonus to work. Abundant anecdotal evidence indicates that taxpayers have this understanding (see, for example, DeParle, 1999).

Much less is known about the effects of the EITC on other aspects of behavior. There are some signs that the EITC encourages the existence of female-headed families (Dickert-Conlin and Houser, 2002; and Eissa and Hoynes, 2004). Heckman, Lochner, and Cossa (2002) examine the effects of the EITC on skill formation. While they emphasize that much more needs to be done, they reach a tentative conclusion that the EITC has little impact on average skill levels in the economy.

Standard demand and supply models of employment suggest that unless labor demand is perfectly elastic, EITC-induced increases in labor supply will reduce equilibrium wages. The labor supply responses and EITC for those eligible for the credit may result in higher gross incomes, but the EITC may harm the incomes of those not eligible or eligible for only a modest EITC (those are primarily childless couples and individuals in the U.S.). While the identification

problems to examining EITC incidence are formidable, Rothstein (2008) concludes that wage reductions reduce EITC payments by \$0.30 for every \$1 of EITC for low-skilled single mothers, and wages falls by \$0.43 for every \$1 of EITC for low-skilled ineligible workers.<sup>21</sup> Leigh (2009) finds even larger effects.

### *EITC Administration and Compliance*

Compared to alternative delivery mechanisms, the U.S. EITC is inexpensive to administer. As noted above, most EITC recipients would have to file a tax return even in the absence of the credit, so the costs imposed on taxpayers — filling out Schedule EIC — is small. The cost to the IRS is also quite small. The entire IRS budget in FY2008 was \$11.1 billion and the IRS served handled more than 250 million tax returns and collected \$2.7 trillion in taxes. The incremental cost of administering the EITC is surely a tiny fraction of this total. The costs of administering two other major income support programs for low-income families are several billion dollars alone.<sup>22</sup>

While a system based largely on self assessment (like the U.S. income tax) will have lower administrative costs than a more bureaucratic approach, it will also have higher noncompliance. The most recent study of EITC noncompliance examined returns filed in 2000 (for tax year 1999) and found that of the \$31.3 billion claimed in EITC, between \$8.5 and \$9.9 billion (27.0 to 31.7 percent of the total) exceeded the amount to which taxpayers were eligible (Internal Revenue Service, 2002b). Of the errors that the IRS was able to classify, roughly half arise because of qualifying-child errors.<sup>23</sup> About half of those (or 25 percent of the total) arose because

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<sup>21</sup> Key issues concern labor demand elasticities and the degree of monopsonistic behavior in labor markets employing substantial numbers of EITC recipients. We know little about these issues.

<sup>22</sup> These administrative costs of income transfer program also support services that go to program recipients.

<sup>23</sup> Holtzblatt and McCubbin (2004) provide a good discussion of the results of the EITC compliance study and broader tax compliance issues for low-income households. See also Holtzblatt (1991), U.S. General Accounting

the child claimed was not the taxpayer's qualifying child. Of these errors, the most common problem was that EITC-qualifying children failed to live for at least six months with the taxpayer claiming the child. Mistakes of this type can run the gamut from innocent taxpayers running afoul of complex IRS rules to fraud.

These errors were not due to taxpayers "making up" children that they did not have. The IRS will match the social security numbers of EITC-qualifying children claimed on tax returns to registered social security numbers. The problems instead arise from the fact that tax returns do not collect information on the *location* of children during the year. Consequently, absent additional information, the IRS has little ability to scrutinize EITC-qualifying child claims for actual children who perhaps do not live with the taxpayer, particularly prior to when the EITC is paid out. It is also difficult for the IRS to investigate claims about self-employment income before the EITC is paid out.

#### b. The Working Tax Credit and Child Tax Credit in the United Kingdom<sup>24</sup>

Experience with refundable tax credits in the U.K. offers additional insight into design issues and policy considerations that arise with credits targeted to low-wage labor markets. The child tax credit provides income-related support to the main care-person of children. Around 90 percent of U.K. families with dependent children are eligible. The working tax credit (WTC) provides in-work support to around 1 million single people and couples with or without children in low-paid work.<sup>25</sup>

In 2003-04, the WTC provided single people without children an annual credit of UKL 1,525. Single parents and couples with or without children are entitled to an annual credit of

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Office (1998), and McCubbin (2000) for discussions of earlier EITC compliance studies, and Hotz and Scholz (2003 and 2008) for a more detailed discussion of EITC compliance and other EITC-related issues.

<sup>24</sup> Much of this discussion is drawn from Brewer (2003).

<sup>25</sup> The "working family tax credit," introduced late in 1999, was subsumed in these two new credits in April 2003.

UKL 3,025. There is a bonus for those working 30 or more hours a week.<sup>26</sup> Families with children and all adults working can receive an additional credit on approved childcare costs (up to 70 percent of childcare costs for expenses up to UKL 200 a week for families with two or more children).<sup>27</sup>

The following subsections highlight instructive differences between the U.S. EITC and the U.K. working tax credit.

#### *Imposition of a threshold hours requirement for eligibility*

By raising the after-tax return to work, both the EITC and the WTC have unambiguously positive work incentive effects for households fully out of the labor market. But for households in the phase-in range of the EITC, the incentive to work more hours is mixed. The increase in the after-tax wage creates an incentive to work more hours (this is the substitution effect). But the income generated by the EITC creates an incentive to work fewer hours, assuming leisure is a normal good (this is the income effect). For households in the plateau and phase-out ranges of the credit, the EITC provides unambiguous negative incentives on hours. By imposing an hours threshold instead of phasing in, the U.K. working tax credit increases the number of households receiving positive employment and hours incentives relative to a credit on the first dollar of earnings. All households working fewer than 16 hours will see an increase in the after-tax return to work (and, since they do not receive any credit if they have fewer than 16 hours of work, there is no incentive to “buy” more leisure).

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<sup>26</sup> For a recipient working 30 or more hours a week for the entire year, the bonus would be UKL 620.

<sup>27</sup> Families with incomes below UKL 5,060 are entitled to the full amount. Incomes above this level reduce the entitlement at the rate of 37p per pound. Working tax credit benefits are exhausted at around UKL 10,857 for a single person without children, 13,230 for a single parent or a couple working part-time with children, and at 14,911 for a single parent or a couple with or without children working full time.

Hours limits impose a potentially significant additional administrative burden — because hours information is typically not required to implement an income tax — so their desirable labor market incentive effects must be balanced against the additional costs that arise from administering the hours requirement.

*The working tax credit is on a family basis, the tax system is on an individual basis*

As in many countries, the U.K. income tax is levied on an individual basis. The WTC, however, is based on family incomes. Policy-makers in the U.K. believe it essential to target tax benefits on the basis of family income, since it is widely believed that families pool resources when making economic decisions. Eligibility is established by submitting a form to Inland Revenue claiming eligibility based on income in the current tax year (applications will generally be made in the summer and the award based on annual income in the previous tax year). Payments are reflected in worker paychecks as employers adjust their tax and social insurance withholding. At the end of the year, the Inland Revenue will recalculate the credit amount the family is entitled to. Families entitled to a larger WTC will receive the difference. Families entitled to a smaller credit will need to pay back some of the overpayment, though the first UKL 2,500 pounds will be disregarded when making this calculation.

The U.K. experience shows that it is possible to deliver a tax credit based on family circumstances in a tax system that uses individuals as the basic unit of personal income taxation. But the experience does not seem to have been altogether successful. The take-up rate of the working family tax credit — the structurally similar predecessor to the WTC — was only 62 to 65 percent, compared to take-up rates for income support and housing benefits that were over 95 percent in 1999-2000. Low take-up is presumably due, at least in part, to the difficulty that arises in claiming a family-based credit in an individually-based tax system.

*Working family tax credit employment effects appear smaller than those for the EITC*

Blundell and Hoynes (2004) review evidence on the employment effects of the working family tax credit (the WTC predecessor) and the EITC and note that the EITC seems to have a larger effect on employment, even though average EITC benefits are somewhat smaller than average working family tax credits. This may in part be because the incentive effects of in-work benefits in the U.K are dulled by integrations with the rest of the tax and benefit system: U.K. households stand to lose substantial amounts of other benefits when they work. In the U.S., in contrast, expansions of the EITC have generally been accompanied by reductions in other safety net payments (and the imposition of time limited welfare and a strong policy push to increase employment of low-skilled women with children).

It is clear that other aspects of the safety net will affect the behavioral responses to employment-based tax credits. In particular, employment generated by EITC-like employment subsidies can be negligible if the benefit reduction rates of other safety net programs are high when individuals earn additional labor market income.

### **3. Three Major Antipoverty Policy Challenges**

In section 1 I described the wide range of programs that compose the U.S. safety net. In section 2 I described in greater detail the role played by the EITC in addressing poverty and economic insecurity in the U.S. As is clear from the patterns in Figure 1 on overall poverty, and Figure 2, on child poverty, there are many remaining challenges confronting those who are designing policies to improve the well-being of low-income individuals and their families. For example, the U.S. spends a relatively small fraction of its Gross Domestic Product on antipoverty policies. But major changes in poverty will not be achieved by simply reshuffling the 1.8

percent of GDP that is spent on cash and in-kind means-tested transfers (excluding Medicaid).<sup>28</sup>

If antipoverty spending as a fraction of GDP simply increased to its *average* level over the last 31 years of 2.0 percent, there would be an additional \$26.5 billion for new initiatives. Thus, a challenge in every society (with the U.S. being no exception) has to do with constraints imposed by available resources. This problem is well-known and I claim no special insight into how to solve it. Instead, in this section I raise three additional issues that have received less attention in the U.S. poverty policy literature. These issues are raised to reinforce a theme of this paper that, while the EITC is a sensible, generally effective component of U.S. antipoverty policy, it is in no way a complete solution for very difficult underlying problems.

#### *Poor childless individuals*

Since at least 1984, there has been a striking increase in the number of poor childless families in the U.S. “Childless families” in this context includes many single people (in U.S. Census Bureau language, these are “unrelated individuals”). Census figures show the percent of persons in families below the poverty line who were unrelated individuals rose from 20 percent in 1984 to 27 percent in 2004, and the percent of persons in families in deep poverty (that is, with incomes under 50 percent of the poverty line) who were unrelated individuals rose from 18 percent in 1984 to 30 percent in 2004. SIPP data indicate that our non-elderly, non-disabled childless population has characteristics associated with long-term disadvantage – 25 percent are black or Hispanic, and 45 percent have a high school degree or less, for example.<sup>29</sup> Twenty-two percent of these individuals are under 25, and hence this group is not disproportionately students

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<sup>28</sup> Forman (2009) discusses levels of taxation and spending across OECD countries. In Table 1, he shows that the U.S. “Social Spending to GDP Ratio” (of 15.9) is lower than every OECD country except Turkey (13.7), Mexico (7.0), and Korea (6.9). The OECD average is 20.5 (Japan is 18.6). Across countries, there appears to be a clear link between social spending and poverty alleviation.

<sup>29</sup> On the other hand, three-quarters are over age 24, so they are not disproportionately students.

(moreover, there has not been a sharp increase in the fraction of the population going to college in the U.S.). Eighty-two percent of this population is single. Males are 53 percent of the group. There has been considerable policy interest in recent years about the economic problems faced by low-skilled single males (see, for example, Holzer, Edelman, and Offner, 2006; Berlin, 2007; Scholz, 2007). The data here suggest that the problem of low-skilled individuals, nearly fully disconnected from the formal labor market, is of rapidly growing importance.

One vivid example of the challenges associated with designing policy to improve the economic circumstances of poor, childless individuals is raised by incarceration policy in the U.S. In 2001, the lifetime probability of a male spending time in jail or prison was 5.9 percent for whites, 32.2 percent for blacks, and 17.2 percent for Hispanics. One of the particularly troubling weaknesses of the work-based safety net is its inadequate provision for dealing with the increasingly difficult challenge of accommodating the large number of men and women who are or were in prisons and jails in the United States. Extensive social science evidence documents the employment difficulties associated with prolonged exposure to the criminal justice system. It is hard to imagine healthy communities in which, for example, one-third of poorly educated prime-age African American men may be in jail or prison on a given day and a considerably larger fraction are or have previously been under the jurisdiction of the criminal justice system. Most of these men have child support orders and little income that they can use to meet their financial responsibilities to their children. While they face extremely poor employment outcomes, there are few existing federal or state programs that are designed to foster economic self-sufficiency of single, non-custodial parenting men, particularly those with a criminal record.

*Can a work-based safety net succeed in a rich industrialized country?*

A fundamental problem confronts a rich society that designs a work-based safety net. What do you do with individuals (who perhaps have children) who are unwilling or unable to work? Barriers to work may include mild mental retardation, domestic violence, drug or alcohol addiction, mental health issues, spatial mismatches between residential and employment locations, and many other issues. These issues create a long-recognized, but inescapable tension that arises with a work-based antipoverty strategy: we wish to provide a humane level of benefits to low-income families, but in doing so, we create incentives for persons to utilize government assistance rather than move into employment. Recognizing this problem and designing a system that adequately accommodates the needs of these individuals and families, without undermining incentives for work, is a central challenge for a work-based safety net.

There are a range of potential options. As noted above, the U.S. has programs targeted to individuals with disabilities. One possibility would be to expand non-cash, means tested programs and redouble efforts to enroll families and individuals into these programs who, for one reason or another, are unable or unwilling to work. Another possibility would be to create special programs, including perhaps temporary or semi-permanent jobs that help highly disadvantaged single mothers who are having problems finding stable employment. A third option, of course, would be to again alter program rules so access to benefits is no longer dependent on work. But without some modification of existing practice, the U.S. faces the possibility of its most disadvantaged citizens needing to survive without access to adequate resources.

*Can low-skilled workers in the U.S. achieve self-sufficiency?*<sup>30</sup>

The idea that work is the gateway to self-sufficiency and the way out of poverty is a simple, powerful message. Work-based welfare reform aligns the structure of the safety net with the central values of Americans who are not on welfare. It is difficult to see how the safety net for disadvantaged families could fail to embrace work when over 75 percent of women and 91 percent of men between the ages 25 and 54 are in the workforce.<sup>31</sup>

As appealing is the rhetoric of self-sufficiency, it collides with an exceptionally difficult reality for those individuals and families who struggle to escape poverty even as they work, or who cycle in and out of work and welfare. To satisfactorily escape poverty, heads of households have to find and hold jobs that allow them to nurture the physical and psychological well-being of children and other adults in the household. At the same time, it appears that the ability of these adults to support their families at anything close to poverty-line earnings is limited.<sup>32</sup>

The labor market skills of a substantial fraction of adult welfare recipients are notably modest. Just prior to welfare reform, for example, 42 percent of adults in families that received welfare benefits at some point during the year had less than a high school diploma. The overall employment rate of prime-age workers with less than a high school diploma was only 36 percent. Despite educational and other disadvantages that low-income families and individuals face, the U.S. successfully reduced welfare caseloads, from a peak of 5.1 million families in March 1994

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<sup>30</sup> Heinrich and Scholz (2009) is a collection of papers on forward-looking policies to enhance self-sufficiency in the U.S. Sections of the book focus on labor markets, policies toward children, problems arising with criminal justice and those who are unwilling or unable to work, and lessons from other countries and political issues that arise with a work-based safety net.

<sup>31</sup> These figures are the civilian labor force participation rates in 2007, that come from the Bureau of Labor Statistics table generation program, <http://data.bls.gov/PDQ/outside.jsp?survey=ln>, accessed in April, 2008.

<sup>32</sup> In Wisconsin, for example, nearly two-thirds of welfare recipients had earned less than \$2,500 in the two years prior to when they were observed on welfare in July 1995, and only 17 percent had earned more than \$7,500 (Cancian, et al. 1999). These families had, on average, more than two children.

to 2.1 million families in March 2001 and further to 1.7 million families in 2009. These reductions were generated, in part, by far-reaching changes in the way states implement and manage programs, most notably the increased focus on work (Grogger and Karoly, 2005; Mead, 2004). In addition, until 2001, the economy was very strong, generating more than 17 million new jobs and pushing unemployment rates to their lowest levels since 1969. Wages grew throughout the income distribution, as they did not during the economic expansions in the 1980s, while real Earned Income Tax Credit (EITC) benefits more than doubled. Poverty among single-parent (mostly female-headed) households also declined precipitously until the recession of 2001. In effect, this coincidental timing of welfare changes, the strong economy, and EITC expansions paved the way for many more low-skilled people to enter the workforce and improve their economic well-being, although the relative contributions of these factors to their increased employment and reduced poverty is still a matter of debate.

A substantial body of prior research examines average earnings and earnings growth among families leaving welfare after the reforms and concluded that despite the exceptionally strong economy and rapid job growth of the later 1990s, the earnings of welfare leavers were still very low and job turnover was high. In their study of welfare reform experiences in six large cities during the 1996-1999 economic expansion, King and Mueser (2005) observed an increase in the number of individuals who left welfare prior to finding employment. Based on their careful analysis, they suggest that although one might argue that most of these individuals were drawn off of welfare by new employment opportunities, it is more likely that their exit from welfare reflected other factors, including the more stringent conditions for welfare receipt. They concluded that welfare reform did not change the reality that labor market demand for this group

“seldom provides earnings sufficient to pull a family out of poverty,” and that individuals were probably not made better off by reform (King and Mueser, 2005: 165).

Employment is an important first step for families trying to achieve self-sufficiency, but the earnings of most individuals who left welfare during the strong economy of the 1990s were still well below the poverty line, even many years after their exit.<sup>33</sup> And although a majority of studies have focused exclusively on the earnings of *individuals* rather than the total income of *families*, the limited set of more recent studies that have attempted to account for the earnings and benefits available to families suggest that the conclusions we draw from the experiences of individuals hold more broadly (Meyer and Cancian, 1998; Primus, et al. 1999). Hence, the degree to which work will be the primary antidote to poverty will depend greatly on the ability of low-skilled people to maintain employment that, over time, offers a progression of incomes that allows families to be self-sufficient. To date, the evidence in support of a strictly work-focused approach is hardly auspicious.

#### **4. Final Thoughts**

As the preceding discussion makes clear, there are many challenges facing low-wage labor markets in the United States. But work is a foundation to the U.S. approach to antipoverty policy for non-elderly, non-disabled individuals. A cornerstone of work-based antipoverty policies is the EITC. While the EITC is far from a cure-all for all problems of low-wage labor markets, it effectively transfers tens of billions of dollars to low-income working families, without creating substantial adverse effects on labor market behavior, fertility, or marriage.

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<sup>33</sup> Even more troubling, the data used to examine the labor market fortunes of individuals leaving welfare are drawn from a period when the economy was very strong, and at least in Wisconsin there were significant state expenditures for work-supporting child care and health insurance programs.

A number of issues likely would arise in other countries if policymakers (and citizens) elsewhere would like to implement EITC-like policies. These are briefly discussed below.

*Clarity of purpose is critical for designing and evaluating an EITC*

There are many possible goals for an EITC, and each may have specific implications for its design. For example, a central goal of an EITC might be to augment incomes of families with low-skilled workers in ways that minimize undesirable labor market incentives. If this goal is paramount, then policymakers would likely want to make the credit available to all working poor families, wage earners and self-employed alike. If, alternatively, the primary goal of the credit is to increase employment of low-skilled workers, policy-makers might want to tie the introduction of an EITC with a reduction in other safety net programs targeted to able-bodied individuals. Other goals for an EITC might be to draw workers from the informal to the formal sectors of the economy, in which case policymakers might wish to restrict the credit to workers in formal (and not self employment) sectors of the economy.

One early justification for the EITC was that it offset the regressive (on an annual basis) payroll tax for social security. Indeed, for many years the EITC subsidy rate was equal to the employee share of payroll taxes. A leading justification for the EITC expansions in 1990 was that they offset the distributional consequences of capital gains tax reductions for upper-income households. Based on these U.S. experiences, it would be unsurprising to see EITC-like proposals in other counties designed to offset the incidence of taxes that are believed to disproportionately burden low-skilled workers, such as the VAT or other consumption-based taxes. With this policy justification, subsidies might be tied to the VAT (or consumption tax) rate. Choices will still need to be made about the targets of tax relief, whether workers with children, all workers, or workers employed in the formal sector.

*Designing a family-based credit in an individually-based tax system*

The personal tax systems of most countries in the world are organized on an individual basis, as opposed to family basis as done in the U.S. But economic decisions are typically made, and resources shared, on a family basis. Hence, income assistance is best done on the basis of household (or family) resources. One may not wish to use scarce public resources to provide income support, for example, to the spouse of a highly paid executive. A policy choice to administer the EITC on a family basis raises several issues.

First, the family will have to be defined. This needs to be done in a way that tax administrators can easily, electronically verify. Parents and their dependent children living in the same dwelling is a natural unit, in that it should be conceptually straightforward to verify the information. But one might also want to include the resources of grandparents, for example, if they are living in the same residence.

Second, filing procedures need to be developed, by which eligible families augment the individual tax return with a return on a family basis that claims the earnings credit. A concern may arise if low-income households with no tax liabilities are not filing tax returns and, more troubling, do not have employers that are reporting their wages to the tax authorities. Adding potentially many new taxpayers to the system has the potential to create substantial administrative problems. In many countries low-skilled workers have unstable employment, so wage and salary reports will need to be matched from multiple employers. Their family relationships and their residential locations can be fluid. Many will be working in the self-employment and day laborer sectors of the economy or are otherwise on the fringes of formal employment relationships. Providing tax credits to this segment of the population presents formidable administrative difficulties.

Another issue arises with the timing of the economic need that a tax credit is designed to address and actual payment of the tax credit. In the U.S. households receive payments following the submission of end-of-year tax forms. The U.K. has a “pay as you earn” tax system, where the working tax credit is delivered throughout the year. Adding a credit based on family income in a tax system where individuals are the unit of taxation, where not all are in the tax system, and when there is a hope to make timely payments to low-income recipients creates significant administrative challenges.

#### *Children and earnings subsidies*

Another consideration when designing EITC-like subsidies is whether they should target only families with children or all families; and whether the schedule should be more generous for families with more children.

It is potentially expensive to extend employment credits to families without children, which (like students, for example) may be more likely to be poor only temporarily. But both the U.K. and the U.S. make their credits available to childless workers, though the U.S. substantially restricts the amounts they can claim. Apart from directly improving incomes and labor market incentives of the single, extending the credit to single workers might also improve marriage markets.

It is widely agreed across OECD countries that the incomes needed to meet above-poverty living standards increase sharply with family size. If EITC-like subsidies are part of work-based social assistance, it probably makes sense to design the credit so it increases with the number of children in the household.

### *Treatment of the self-employed*

Adopting a refundable, earnings-based subsidy that allows taxpayers with unverifiable income to apply, invites fraudulent claims. Making the self-employed eligible for the credit, therefore, raises difficult administrative issues. On the other hand, a disproportionate share of low-skilled workers in some OECD countries are self-employed (this is clearly the case, for example, in Korea). So if the purpose of the earnings subsidy is to support working poor families, it seems inappropriate to exclude the self-employed.

If the self-employed have lower overall tax liabilities because of tax evasion, an argument could be made that excluding the self-employed could help align the tax treatment of workers and self-employed, since it will convey a differential advantage to wage earners. Over time, if tax wedges between those who are and are not self-employed fall, the self-employed could be made eligible for an EITC-like subsidy.

### *The timing of payments and eligibility*

EITC benefits in the U.S. are, with minor exceptions, delivered annually, in a lump-sum after filing a return. Eligibility is based on the annual income reports from the previous calendar year. EITC benefits are assessed using the larger of total (1) income and (2) wage and salary income (recognizing the households can in principle have negative capital income).

The disadvantage of this approach—delivering EITC payments following submission of a claim in May for money earned the previous year—is that it fails to get money to families with low-skilled workers in a timely manner. This problem is most acute for very poor families. The U.K. delivers the working family tax credit incrementally through the year, as part of the “pay as you earn” tax system.

There are other mechanisms that could be designed to deliver EITC-like benefits in a timelier manner than as an end-of-year lump sum payment. But these mechanisms tend to be administratively complex or, as the case of the advance EITC in the U.S., lightly used.

*Should there be an hours (or earnings) threshold for EITC eligibility?*

As noted above, the U.K. WTC requires recipients to work at least 16 hours. Such an hours threshold ensures that positive employment and hours incentives are given to a larger percentage of low-wage workers than the alternative approach of delivering benefits for the first dollar of earnings. It also presumably results in substantial administrative savings, since payments do not need to be made to workers with small amounts of earnings.

To make an hours requirement work well, employers presumably need to be integrally involved in credit delivery, as they are in the U.K. An earnings threshold could possibly be used instead of an hours requirement. Conceptually an earnings threshold should have the same beneficial incentive effects on employment, hours of work, and administration as imposing an hours threshold, though there may be some reduction in the effectiveness of an EITC-like subsidy in alleviating poverty if those with very low earnings are excluded.

*Labor market considerations*

Three crucial factors will ultimately determine the employment and hours responses of an EITC-like credit. First are the underlying behavioral elasticities of employment and hours with respect to net-of-tax wages. Research in the U.S., for example, finds employment is much more responsive than hours to changes in after-tax wages. If this is true elsewhere, the effectiveness of the EITC-like subsidy will be enhanced. It provides positive employment incentives to those out of the labor market. If participation elasticities are non-negligible, the EITC can induce some

poor individuals to work. However, the negative effects of the credit on hours appear, at least in the U.S., to be small.

Structural simulations of labor market responses to the EITC in the U.S. necessarily focus on the credit's effects on the after-tax wage. These may give misleading results on the credit's employment and hours effects because of the way the credit is administered. Taxpayers need to a great deal of sophistication to understand the link between labor market decisions made between January and December, and their tax consequences the following May. The credit could, for example, significantly increase labor force participation even if people know little about it, so long as workers have some understanding that the tax system rewards work at low levels of earnings. But these informational concerns probably play a larger role when thinking about the hours responses to the credit for workers already in the labor market. Indeed, as mentioned earlier, the large empirical literature on the EITC in the U.S. (surveyed in Hotz and Scholz, 2003) finds negligible effects of the credit on hours for primary workers.

The second key consideration for policy purposes is the interaction between the EITC and other social assistance programs. If households receiving these benefits see no incremental improvement in household income from working, they are very unlikely to work. In this case, the EITC will have negligible beneficial effects. For an EITC-like subsidy to have beneficial labor market effects, it is critical that potential recipients see an increase in economic well-being by working or by taking a higher-earning job.

A final consideration has to do with labor market demand and labor market flexibility. If there are rigidities in the hiring and firing of workers, insurance or fringe benefit mandates, or a minimum wage that prices large numbers of low-skilled workers out of the market, any beneficial effects of an EITC-like subsidy will almost surely be reduced.

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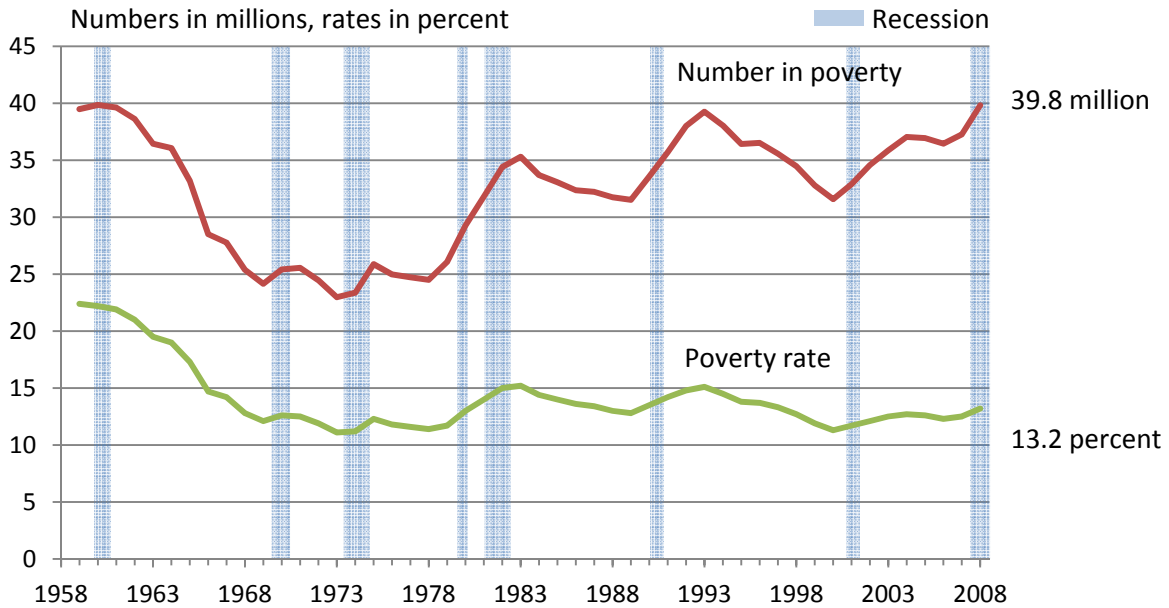
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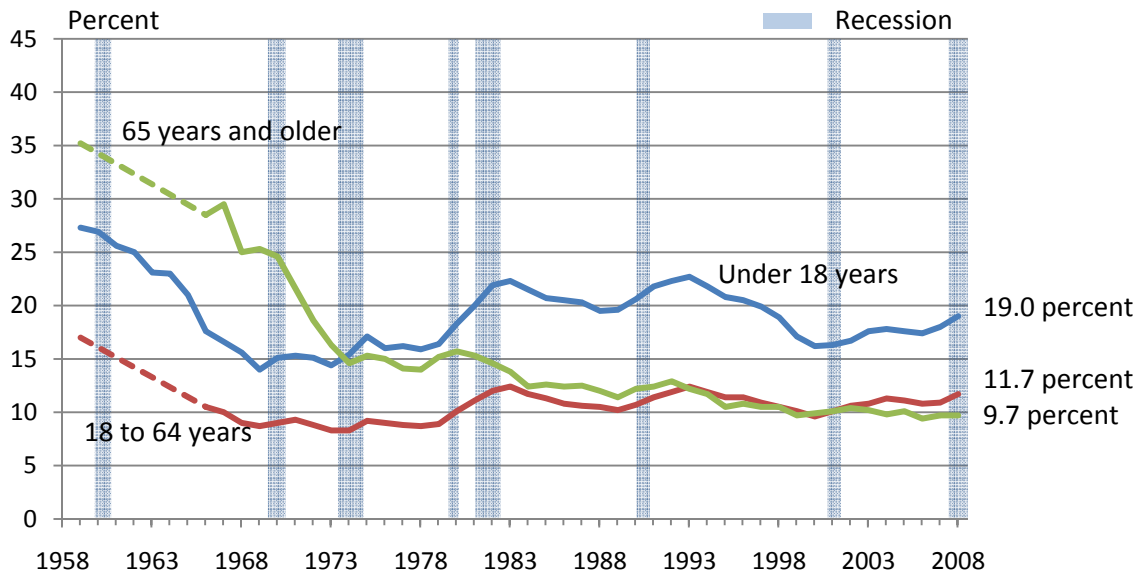
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**Figure 1. Number in poverty and poverty rate: 1959 to 2008**



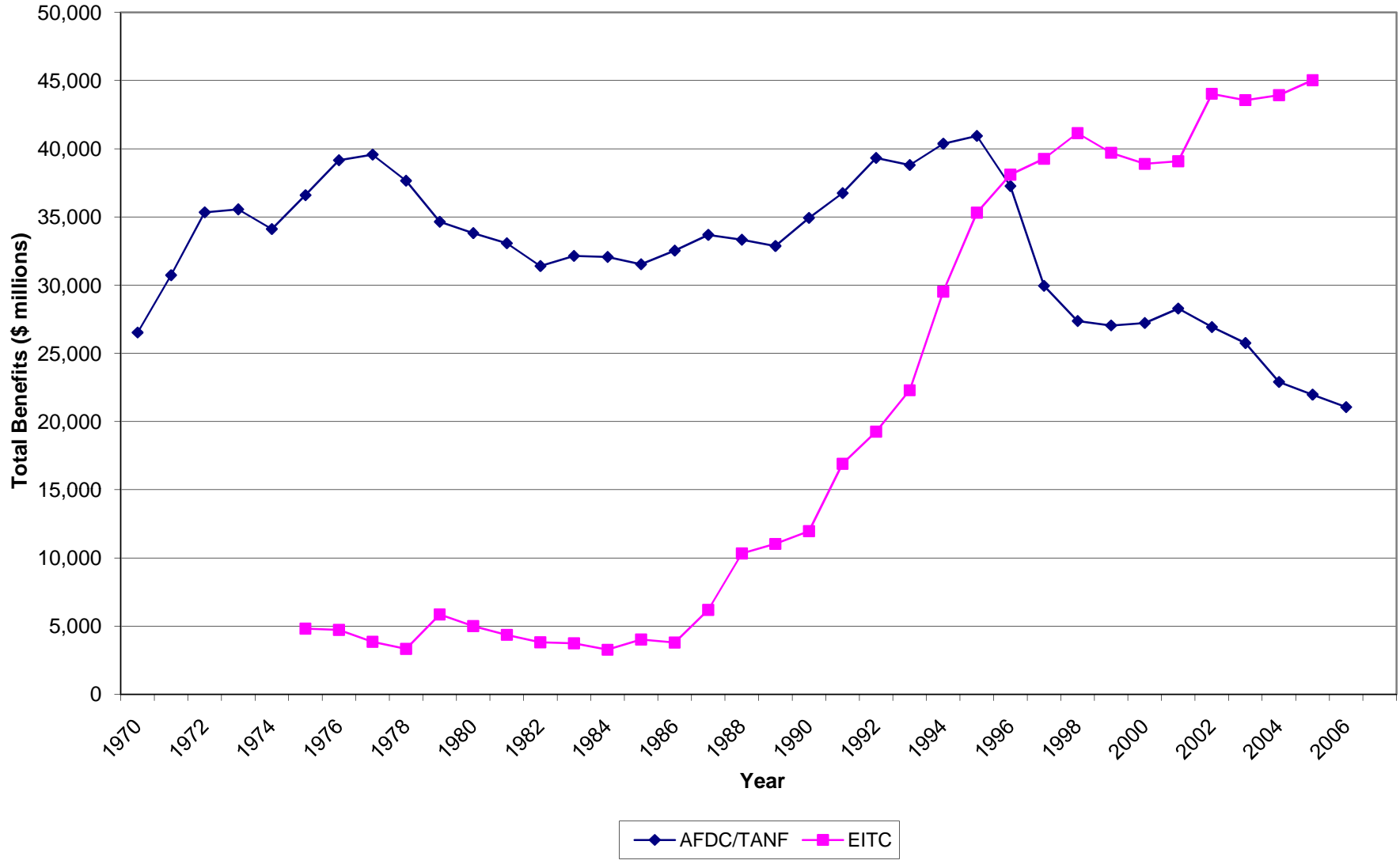
Note: The data points are placed at the midpoints of the respective years.  
 Source: U.S. Census Bureau, Current Population Survey, 1960 to 2009 Annual Social and Economic Supplements.

**Figure 2. Poverty Rates by Age: 1959 to 2008**

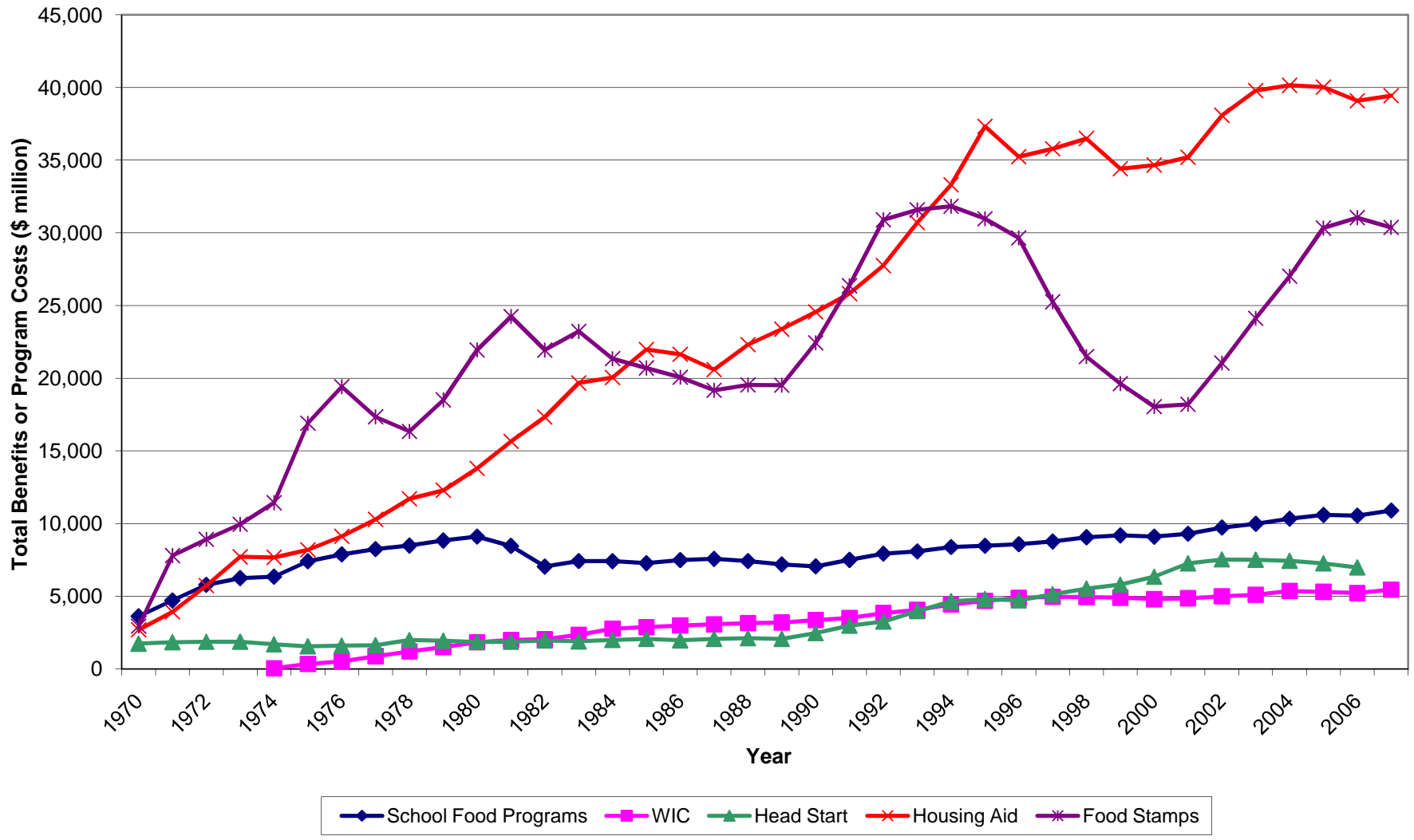


Note: The data points are at the midpoints of the respective years.  
 Data for people aged 18 to 64 and 65 and older are not available from 1960 to 1965.  
 Source: U.S. Census Bureau, Current Population Survey, 1960 to 2009 Annual Social and Economic Supplements.

Figure 3: Total AFDC/TANF and EITC Benefits, 1970-2007 (constant 2007 dollars)



**Figure 4: Total Benefits or Program Costs for Various In-Kind Programs, 1970-2007 (constant 2007 dollars)**



**Figure 5: Total Social Insurance, Cash and In-Kind Means-Tested Transfers (2007 dollars)**

