Earned Income Tax Credits: An Overview

Lecture II

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Overview

Lecture 1:
♦ What is it, and where did it come from?
♦ What effect does it have on labor supply and welfare?

Lecture 2:
♦ Alternative models of the EITC
♦ Critiques of the EITC
♦ An Australian EITC?
The EITC – A Review

- The EITC is a subsidy to low-wage workers. Under an EITC, not only do these workers not pay taxes, but they receive money back from the tax office. This can amount to more than US$4000 per year.

- There are three reasons for introducing an EITC:
  - to increase labour supply;
  - to transfer income to the poorest; and
  - to transfer resources to children.

- Theory predicts that the EITC will increase participation, and reduce hours worked for those in the flat and phase-out ranges.

- Empirical studies find evidence that it does increase participation, but not that it reduces hours worked.
Alternative models

♦ Phase in: immediate or sloped?
♦ Phase out: slow or rapid?
♦ Pay singles and families, or only families?
♦ Pay the credit in each pay packet, or at the end of the tax year?
US EITC schedule

Figure 1: Federal EITC Schedule - 2002
UK EITC schedule

£ per week

Hours worked

- WFTC with childcare
- WFTC
- Family Credit
Phase-in

♦ Immediate phase-in rewards all workers over the threshold.
♦ For those already in work, the theoretical prediction on labour supply is unambiguously negative. (But UK research suggests that this isn’t a big issue in practice.)
♦ Sloped phase-in range creates a positive substitution effect: ‘increase earnings, get more EITC’.
♦ UK has a hybrid model – minimum threshold of 16 hours, then boost the EITC again at 30 hours. The effect of this can be seen in the data.
Effect of the UK EITC on hours

Phase-out

♦ Rapid phase-out creates high effective marginal tax rates, which may have a negative effect on labour supply.

♦ Slow phase-out means that the benefit is more expensive, since it is less targeted towards the poor.
Do we give the EITC to singles too?

♦ The US EITC goes to singles too, though the amount is small. The most a single person can get is about $400 – which is $400 \times 1/11$ of the maximum available to a worker with two children.

♦ Not providing the EITC to singles may be justified on the basis that a primary goal of the program is to improve the well-being of children.

♦ But the EITC has the effect of reducing pre-tax hourly wages (Leigh 2004), and the effect is about the same for workers with and without children.

♦ Therefore, if we do not provide the EITC to singles (or provide only a nominal amount), but provide a large EITC to workers with children, then the effect will probably be to make singles worse off on net.
Paid fortnightly or annually?

♦ If the credit comes in the pay packet (UK model), workers get their money immediately. This seems likely to have a bigger positive effect on employment.

♦ If the credit comes at the end of the year (US model), workers can use it as an enforced savings tool.

♦ We know from behavioural economics that many people under-save, and can raise their overall utility by using a pre-commitment device. The EITC is just such a device.
Which do you think is better?

♦ Phase in: immediate or sloped?
♦ Phase out: slow or rapid?
♦ Pay singles and families, or only families?
♦ Pay the credit in each pay packet, or at the end of the tax year?
Critiques of the EITC

♦ May reduce participation from secondary earners
♦ May cause equilibrium wages to fall
♦ Can create a marriage penalty
♦ Potentially susceptible to fraud
Critique 1: Secondary earners

♦ Eissa and Hoynes (1998) find that the EITC reduces the hours of women in couples where both are high school dropouts – which they attribute to the marginal tax rate in the phase-out range.

♦ They find this effect in a small section of the labour market – married couples with children, where both are high-school dropouts.

♦ This could be due to two factors – substitution effect (effective marginal tax rate makes it too costly for the secondary earner to work), or income effect (couple has sufficient money that the secondary earner does not need to work).

♦ Eissa and Hoynes do not disentangle the two (NB. This is hard to do!). However, they do argue that most of the effect is likely to be due to the income effect.
Critique 1: Secondary earners

♦ In the Australian context, Apps (2002) argues that the main factor is likely to be the substitution effect. We know that female labour supply is quite elastic, but the quasi-experimental evidence doesn’t provide much support for this argument. Families seem to systematically misperceive the EITC schedule.

♦ For example, in the UK context, I find no evidence that an EITC expansion reduced labour supply by married women (Leigh 2004). This could be because many of those in the phase-out range are unaware of the fact.

♦ Possible solution: reduce phase-out rate
Critique 2: Wages Will Fall

- We know that wages fall when workers receive a tax credit.
- Is this an argument against the EITC?
- Probably not – since we should expect wages to fall whenever labour supply increases (all else being constant).
- The only important thing is to recognise that wages will fall for all low-wage workers – not just EITC recipients.
- Some have argued that it is possible to reduce the wage fall by raising the minimum wage at the same time. Others have argued that the wage fall is precisely what we want.
Critique 3: Marriage Penalty

- Depending on how the EITC is structured, it is possible that it will create a financial disincentive for couples to marry.
- This matters if we believe that – holding the quality of the relationship constant – marriage is good for kids. I know of no evidence on the causal effect of marriage, but the argument seems credible.
- If marriage is inherently good for children, then an EITC with a marriage penalty might hurt children.
- NB. Australian welfare laws already contain significant marriage penalties for certain family types.
- Solution: Craft an EITC with a minimal marriage penalty.
Critique 4: Fraud

♦ In the late-1990s, much was made of the fact that many Americans overclaimed the EITC.

♦ However, in many cases, this was not deliberate fraud, but accidental misstatement of income.

♦ Solution: Policymakers need to accept that the EITC (like regular taxes) will never be fraud-free. The tax office needs to be vigilant on fraud.
Conclusion: Australia and the EITC

♦ In Australia, the ALP took an EITC policy to the October 1998 election. It was poorly sold, and provided benefits to those earnings as much as $75,000.

♦ Immediately after the election, five economists – Peter Dawkins, John Freebairn, Ross Garnaut, Michael Keating, and Chris Richardson – wrote a letter to the Prime Minister, suggesting an EITC, coupled with a 4-year freeze in award wages.

♦ In September 2003, Australia introduced a “temporary EITC”, called a Working Credit. This allows workers to avoid having their benefits cut when they entered work. It is more generous for those who have been out of employment longer, since the WC is proportional to unemployment duration.

♦ How might we evaluate the Working Credit?

♦ Should Australia have an EITC? If so, what should it look like?