OPINION

The Payoff from the Earned Income Tax Credit

BY KARTIK ATHREYA

One of the largest federal antipoverty programs — the Earned Income Tax Credit (EITC) — appears not well-known to many Americans, including many of those it targets. The EITC provides low- and moderate-income workers a subsidy in the form of a credit that's "refundable" in the sense that if the worker's tax bill is less than the credit, he or she receives a refund check from the Internal Revenue Service. The EITC resulted in $66.7 billion in income tax credits to 27.5 million families in 2014, an average of about $2,400 per family. As you would expect, EITC recipients are generally low-income workers: In 2010, Nicole Simpson of Colgate University; Devin Reilly, currently at the consulting firm Analysis Group; and I looked at the characteristics of recipients and found that their mean household income was a little more than $15,000.

The EITC rewards employment, since only those with earnings are eligible to receive it. It is attractive because it is simple to administer and gives recipients complete flexibility in deciding how to use the money they receive. But does the EITC work? Before trying to answer that, it's useful to think through the incentives and disincentives that the EITC sets in motion. As a credit on earned income, the EITC basically raises a worker's effective wage. But this doesn't necessarily mean recipients will choose to work more. When hourly wages go up, individuals may choose to seek more work — either by getting a job, or, if they already have one, by taking on more hours. This is what economists refer to as the "substitution" effect — workers substituting paid work for nonmarket activities, such as caring for their children or parents. On the other hand, being able to earn more per hour allows workers to make any given level of purchases through fewer working hours. This is called an "income" effect, and it works in the opposite direction.

There is another force at work that can partially thwart the EITC from achieving its goals. The program limits eligibility by reducing the recipient's credit once his or her income crosses a certain threshold. In this "phase-out zone," a further increase in income causes a decrease in the amount of the EITC. This, in turn, creates a disincentive for workers in this zone to increase their hours worked.

Whether the incentives or disincentives to work dominate is an empirical question, and recent research offers some answers. The EITC does not appear to strongly affect men's work hours one way or the other. And because of the income effect, the EITC seems to lead some married women to leave work. Nada Eissa of Georgetown University and Hilary Hoynes of the University of California, Berkeley studied the response of married couples to the EITC expansions that took place between 1984 and 1996. They found that, while the expansions slightly increased the labor force participation of married men, they reduced the labor force participation of married women by more than a full percentage point. The success story for the EITC, in terms of increasing entry into the workforce, has been that of single parents, mothers especially. Indeed, researchers have found that the EITC was the main reason that the employment rates of single women with children went up in the 1990s.

The EITC has other benefits for single women, including those who are not EITC eligible. Simulations by Gizem Kosar of the New York Fed in 2014 found that the presence of the EITC in the economy encourages women to gain work experience. As a result, the wages of single women are 5 percent higher in such an economy than in an economy without the EITC.

The EITC also serves as a form of insurance against wage fluctuations, both routine ones and ones that occur during economic downturns. In work that Nicole Simpson, Devin Reilly, and I did in 2014, we found that the EITC may substantially reduce the volatility of a recipient's spending. And strikingly, EITC income appears to have broader effects on family well-being: Recent work has found that for single mothers with a high school education or less, an increase of $1,000 in their EITC is associated with a 6.7 percent to 10.8 percent reduction in low birth weight newborns.

Like every transfer program, the EITC comes with limitations. For instance, some of the money paid to recipients may end up, indirectly, in the pockets of their employers in the sense that EITC payments may enable employers to set wages a little lower. Jesse Rothstein of the University of California, Berkeley has estimated that an average of 30 cents of every dollar of EITC money received by low-skill single mothers ends up in the pockets of their employers in this way. In addition, the EITC cannot help those who've suffered a job loss or are unable to find employment — it is a credit only for earned income, after all. Lastly, by making low-skilled jobs pay more, in effect, the EITC may discourage skill acquisition. If at all substantial, this effect is something for policymakers to keep firmly in mind.

On balance, the EITC appears to play a valuable role in combating poverty and helping low-income individuals — single mothers especially — transition into the workforce, and it may serve as an important buffer against risks. But further research is vital for a full understanding of both its limitations and its benefits. **EF**

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