

NTA Forum

Perspectives, Ideas and News from the National Tax Association

Winter, 1994

The Coming of Age of the Earned Income Tax Credit

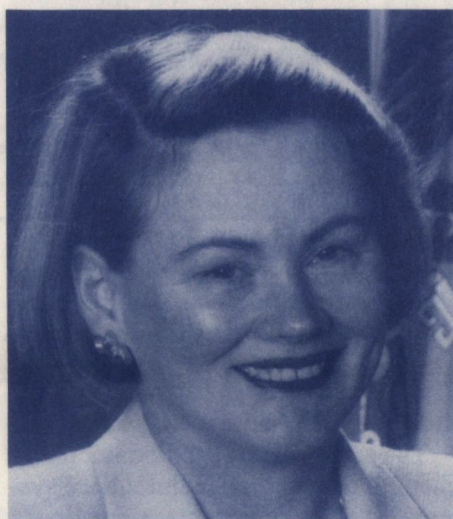
Alicia H. Munnell
Assistant Secretary for Economic Policy
Department of the Treasury

The Administration's \$500 billion deficit reduction plan, which Congress passed in August, contained more than \$250 billion in tax increases. You might think that these increases would provide more than ample material for a talk to the National Tax Association. After all, I could discuss whether higher marginal rates on high-income taxpayers would actually raise revenue — an issue that we at Treasury refer to affectionately as the "Feldstein problem." Alternatively, I could discuss the merits of increasing tax rates retroactively.

After carefully reviewing the list of possible topics, however, I decided that the most interesting aspect of Clinton tax policy was not the revenue raisers, but rather the significant expansion of the earned income tax credit, or EITC. Today, I would like to summarize briefly the history of the EITC, compare the current income maintenance system with Milton Friedman's negative income tax, and describe where we appear to be in the evolution of our income maintenance system.

The Development of the Earned Income Tax Credit

The Earned Income Tax Credit was introduced as part of the Tax Reduction Act of 1975, a stimulus package designed to combat the deepest recession since the Great Depression. It was originally a very modest program that provided a refundable credit of ten percent of earned income, up to a maximum of \$400.



In 1975, three claims were made for the credit (Campbell and Peirce, 1980, p. 1):

1. it would stimulate consumption, since it would be paid to persons with high marginal propensities to consume,
2. it would improve the work incentives of people on welfare, by reducing the effective tax rate on earned income, and
3. it would indirectly refund all or a portion of the Social Security contributions paid by low-income workers.

These are sensible goals, but, given that the credit amounted to less than five percent of the stimulus package, it had limited ability to satisfy the first two. It is interesting to note the tie to Social Security, however, because it demonstrates that even at the outset, the EITC was viewed as a component of a broader system of social insurance and income support.

After its introduction, the EITC grew, but very haltingly. After small expansions in 1979 and 1986, the Omnibus Budget Reconciliation Act of 1990 greatly expanded the EITC. The maximum credit was raised to \$1,998 when the changes were fully implemented in 1994. Despite provisions in OBRA '90 which simplified eligibility determination for the EITC, other changes in the Act may have led to an increase in complexity for taxpayers. The amount of the credit became dependent on the number of children, whether or not the family paid for health insurance, whether a new family member was born during the year, and whether or not the family may have claimed other tax benefits (for example, claiming the young child supplement could reduce the amount a family claimed under the child and dependent care tax credit).

All of these changes set the stage for the expansion of the EITC enacted in this year's Omnibus Budget Reconciliation Act, which represents the most significant increase in scope yet, but also a simplification in process. In 1996, when the changes are fully implemented, the credit for a two-child family will be increased from 25 percent of the first \$7,990 to 40 percent of the first \$8,425 of earned income (with the base indexed thereafter). (All dollar amounts are given in 1994 levels.) Families with income between \$8,425 and \$11,000 will receive the maximum credit of \$3,370. The credit will be reduced by 21.06 percent of income (the greater of earned income or AGI) over \$11,000 (again indexed), so that tax-

(continued on page 2)

NTA Forum

Number 17, Winter, 1994

NTA Forum is a newsletter containing viewpoints, ideas and news from the National Tax Association, a nonpolitical, nonpartisan, not-for-profit organization devoted to advancing understanding of the theory and practice of taxation at all levels of government.

Expressions of opinion contained in NTA Forum are solely those of the authors and do not necessarily reflect those of the Association, its officers, or other members. Material contained in this publication may be reprinted provided the article is reproduced in its entirety and credit is given to the NTA Forum, the National Tax Association, and the author(s).

Please send all correspondence to:
Frederick D. Stocker, Editor
NTA Forum
National Tax Association
5310 East Main Street
Columbus, OH 43213
Phone (614) 864-1221

Elected Officers

President

Helen F. Ladd
Duke University

First Vice President

Sandy J. Navin
General Mills, Inc.

Second Vice President

Emil M. Sunley
International Monetary Fund

Secretary

Janet L. Staton, NTA, Columbus

Treasurer

John D. Hogan
Georgia State University

Executive Director

Frederick D. Stocker

payers with incomes of up to \$27,000 will receive benefits. Assuming the new law were fully implemented in 1994, 15 million families would receive an average credit of \$1,700. When the EITC is combined with food stamps, a family of four, with one full-time earner, will be lifted out of poverty, even if that earner receives barely the minimum wage.

The 1993 legislation not only greatly expanded the earned income tax credit for working families, but also took the revolutionary step of extending the credit to workers without children. The credit for this group, however, is significantly smaller. It is equal to 7.65 percent, the employee's share of the social security tax, up to a maximum of \$4,000. This produces a maximum credit of \$306. (The credit will be phased out at a rate of 7.65 percent of AGI or if greater, earnings over \$5,000. Workers will not be entitled to any credit if they have earnings over \$9,000.) Roughly, 5 million individuals will be eligible for this new benefit.

The Role of the EITC in the Income Maintenance System

The expanded EITC fundamentally changes our income maintenance system. First, it represents a major increase in spending on income support for low-income families. This is extremely important, since total spend-

ing for cash and near-cash income support as a share of output had dropped off during the 1980s, even when output is adjusted for cyclical variations. (For the purposes of this analysis, income support is defined to include food stamps, supplemental security

even at the outset, the EITC was viewed as a component of a broader system of social insurance and income support

income (SSI), aid to families with dependent children (AFDC), the EITC and general assistance payments. This ignores two other, very large transfer programs — Medicaid and housing assistance — that generally provide in-kind assistance.) As Chart 1 demonstrates, the share of GDP that went to cash or near-cash assistance increased steadily from the late 1960s to a recession peak in 1976, and fell markedly until the mid 1980s. It began to pick up again in the late 1980s, but especially in the early 1990s. Although part of this was caused by the recession, it was primarily driven by increases in the food-stamp program and the EITC.

Chart 1. Cash and Near-Cash Income Support as a Percent of GDP

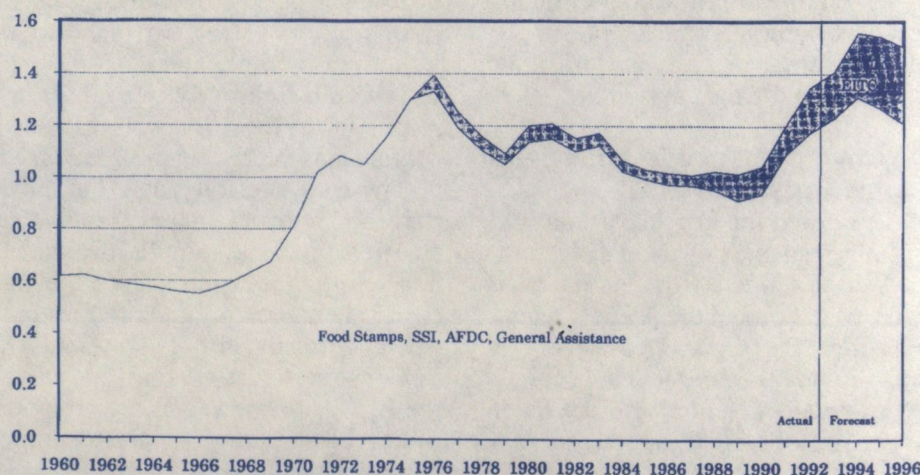


Chart 2. Distribution of Income Support Funding

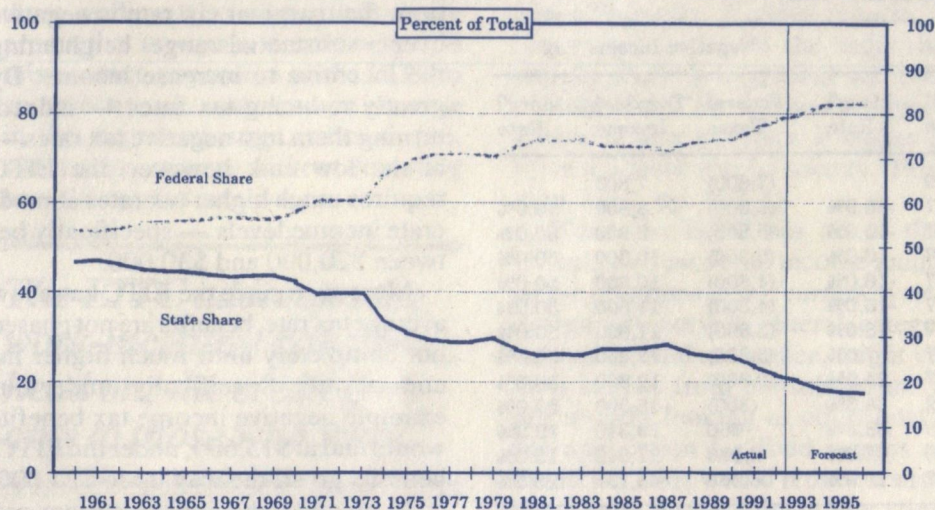
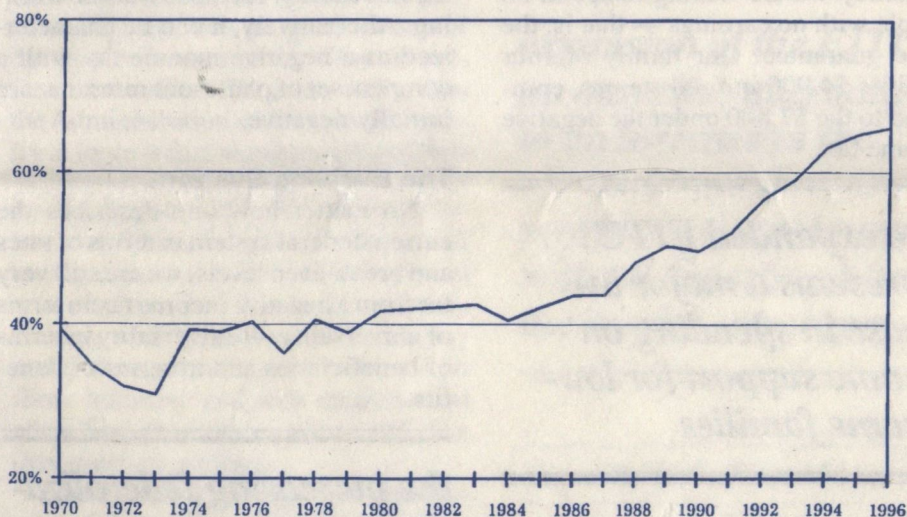


Chart 3. EITC and SSI as a Percent of Income Support



Second, the expansion of the EITC continues a trend toward "federalization" of the income maintenance system. In 1960, the Federal share of these programs was roughly 54 percent. By 1992, the Federal share had risen to 79 percent; by 1996, that share should be 83 percent (Chart 2). The shift is due to three factors: the federalization and consolidation in 1972 of programs for the aged, blind, and disabled into the Supplemental Security Income program, the rapid expansion of the food stamp program, and the introduction and expansion in the EITC.

The shift is profound; we as a na-

tion have decided that we want the federal government — rather than state governments — to provide a basic level of income support. This means federal financing and uniform federally-established benefit levels rather than benefits that vary dramatically from one location to another.

We have also clarified what types of benefits we are most comfortable providing and to whom we want to provide them. We do not want people to starve. Therefore, everyone is eligible for food stamps. Recipients of AFDC and SSI are automatically eligible. Others are eligible as long as they fulfill

work registration and training programs.

This work registration provision brings us to the second major decision we seem to have made as a nation. That is, — above food for subsistence — we are quite willing to provide benefits to those who work or to those we deem should not have to work. This can be seen clearly in Chart 3, which shows the expansion of expenditures for SSI and the EITC relative to other cash payments.

Comparison of the Current System with a Negative Income Tax

When I first started thinking about the implications of the major expansion of the EITC, I focused on the federalization of the welfare system and wondered if perhaps we had ended up — thirty years later — with Milton Friedman's negative income tax. As you probably remember, Friedman suggested an extremely simple system: taxpayers would receive a subsidy equal to half the amount by which the total value of the taxpayers' personal exemptions and deductions exceeded their taxable incomes. This yielded a negative income tax for low-income taxpayers, and a marginal tax rate on income of 50 percent until the negative tax is phased out.

Certainly, in terms of procedure, the increasing federalization of income support is a necessary first step toward a system like a negative income tax. With federalization, programs can be consolidated, integrated, and managed in a coherent fashion. More importantly, this federalization has been accompanied by a restructuring of the form of support that incorporates several aspects of income support — most notably the earned income tax credit — into the existing personal income tax system.

Instead of a comprehensive adoption of the negative income tax, however, we have selectively adapted its features for particular segments of the population.

1. Food stamps are available to all, based solely on a means test, and provide a minimum level of support.
2. People who cannot work are eli-

Table 1. Comparison of the Current Income Support System and a Negative Income Tax

Earnings	Current Income Support System					Negative Income Tax		
	EITC	Food Stamps	Federal Taxes	"Disp'ble" Income	Marg'l Rate	Federal Taxes	"Disp'ble" Income	Marg'l Rate
0	—	4,440	—	4,440		(7,800)	7,800	
2,000	800	4,417	—	7,217	-38.9%	(6,800)	8,800	50.0%
4,000	1,600	3,937	—	9,537	-16.0%	(5,800)	9,800	50.0%
5,000	2,000	3,697	—	10,697	-16.0%	(5,300)	10,300	50.0%
6,000	2,400	3,457	—	11,857	-16.0%	(4,800)	10,800	50.0%
7,000	2,800	3,217	—	13,017	-16.0%	(4,300)	11,300	50.0%
8,000	3,200	2,977	—	14,177	-16.0%	(3,800)	11,800	50.0%
9,000	3,370	2,737	—	15,107	7.0%	(3,300)	12,300	50.0%
10,000	3,370	2,497	—	15,867	24.0%	(2,800)	12,800	50.0%
15,000	2,654	1,297	—	18,952	38.3%	(300)	15,300	50.0%
20,000	1,601	97	660	21,039	58.3%	660	19,340	19.2%
30,000	0	0	2,160	27,840	32.0%	2,160	27,840	15.0%
50,000	0	0	6,863	43,137	23.5%	6,863	43,137	23.5%

gible for SSI and food stamps, which, in essence, form a negative income tax for this group.

- The rest of the federalized income support system is premised on work. We as a society have adopted the premise that individuals who can work should, and that society will ensure that those who work — at least those with children — will be adequately compensated. And we have decided to provide these non-judgmental benefits through the tax system.

When the EITC is combined with food stamps, a family of four, with one full-time earner, will be lifted out of poverty, even if that earner receives barely the minimum wage

Table 1 compares what a two-parent, two-child family have received under Friedman's negative income tax with what they will receive from the combination of food stamps and the EITC. The "disposable income" column depicts a not dissimilar pattern

under the two approaches. The noticeable difference, however, is the amount of money we are willing to spend on people with no earnings — that is, the basic guarantee. Our family of four receives \$4,900 in food stamps, compared to the \$7,800 under the negative income tax.

The expanded EITC . . . represents a major increase in spending on income support for low-income families

The greatest difference, however, is the pattern of tax rates, and the level at which benefits phase out. When the negative income tax was introduced, the two basic criticisms against it were that it would cost too much and that it would discourage work by paying people for doing nothing. Both the income effect and the substitution effect under a negative income tax work in the wrong direction. That is, the negative income tax provides a base of support regardless of work effort, which reduces the incentive to work, and it introduces high marginal tax rates over the phase-out range, which also discourages work.

The EITC addresses the work-in-

centive criticism head on; the credit goes only to those who work. In addition, the marginal tax rate is negative over a substantial range, heightening the incentive to increase income. By greatly reducing tax rates — indeed, turning them into negative tax rates — at the low end, however, the EITC requires much higher tax rates at moderate income levels — specifically between \$20,000 and \$30,000.

Moreover, since the EITC has a low average tax rate, benefits are not phased out completely until much higher income levels. Specifically, under our example negative income tax benefits would end at \$15,600; under the EITC, benefits go all the way up to \$27,000.

In practice, the current system can be viewed as analogous to a combination of a negative income tax — in the form of food stamps — and an earned income subsidy for those who are working. Alternatively, it can be characterized as a negative income tax with a complex set of phase-out rates that are initially negative.

The Evolving System

No matter how one describes the current federal system in terms of rates and break-even levels, we are still very far from a negative income tax in terms of universality — universality in terms of beneficiaries and in terms of benefits.

the increasing federalization of income support is a necessary first step toward a system like a negative income tax

Despite the recent extension of the EITC, the current law provides only minimal support for working individuals and working childless couples. Consistent with the underlying principle that those who can work should, it is easy to argue that basic support — unrelated to work effort — for individuals and couples should be minimal. As a matter of fairness, however, it is

reasonable to provide both income support and additional work incentives to those workers who are not sufficiently productive to earn a decent wage. In this context, expansion of the EITC is an attractive alternative to an increase in the minimum wage, since it provides a decent wage without distorting how the market sets wages.

The EITC addresses the work-incentive criticism head on; the credit goes only to those who work

The other major group left out of the general system are nonworking women with dependent children, who receive benefit under the AFDC program. Indeed, this program is one of the major focuses of the Clinton welfare reform effort. The consensus within the Administration and within the country at large is that women with children — beyond some young age — should work to support themselves like everyone else. Thus, the goal of reform will be to get these mothers off welfare and into employment. To do this requires making work pay. Work does not pay under the current system; those who show initiative and seek employment often find themselves worse off than they were on welfare.

The EITC is an important component of the welfare reform effort. For a worker with two children, the credit will turn a \$4.25 minimum wage job into one paying \$6.00. It will help ensure that people leaving welfare receive more income working than by staying home. The second key to making work pay is health care reform. Currently, beneficiaries leaving AFDC have to worry about losing their Medicaid benefits. A universal health care system will eliminate "medicaid lock" and facilitate the transition from beneficiary to employee.

Turning finally from beneficiaries to benefits, it is important to note that one of Friedman's reasons for suggesting a negative income tax was its sim-

plicity and transparency. In his words, it is directed specifically at the problem of poverty. It gives help in the form most useful to the individual, namely, cash. It is general and could be substituted for the host of special measures now in effect. It makes explicit the cost borne by society. (Friedman, 1962, pp. 192-3)

While the EITC has all of these virtues, the rest of the income maintenance programs in our current system, designed to provide general, categorical and in-kind assistance, might very well benefit from consolidation. We are already looking at consolidating the application for food stamps and the EITC. This would reduce transactions costs and eliminate any stigma that may accompany participation. The last large building block of the trans-

expansion of the EITC is an attractive alternative to an increase in the minimum wage, since it provides a decent wage without distorting how the market sets wages

fer system is housing assistance; housing falls outside the current scope of welfare reform, but is a component that needs to be integrated more fully in a comprehensive system of support.

the current system can be viewed as analogous to a combination of a negative income tax — in the form of food stamps — and an earned income subsidy for those who are working

Conclusion

Let me conclude by saying that the expansion of the earned income tax credit in the Omnibus Budget Reconciliation Act is a very important development. It increases the level of income support in the United States, reversing a marked trend toward decline. It also reinforces a sharp trend toward federalization of the income support system. The significant expansion of the EITC also clarifies where we as a society are willing to spend money and where we are not. The

Table 2. Earned Income Tax Credit Parameters, 1975-93

Calendar year	Credit rate (percent)	Minimum income for maximum credit	Maximum credit	Phaseout rate (percent)	Phaseout range	
					Beginning income	Ending income
1975-78.....	10	\$4,000	\$400	10.00	\$4,000	\$8,000
1979-80.....	10	5,000	500	12.50	6,000	10,000
1981-84.....	10	5,000	500	12.50	6,000	10,000
1985-86.....	11	5,000	550	12.22	6,500	11,000
1987.....	14	6,080	851	10.00	6,920	15,432
1988.....	14	6,240	874	10.00	9,840	18,576
1989.....	14	6,500	910	10.00	10,240	19,340
1990.....	14	6,810	953	10.00	10,730	20,264
1991:						
One QC*.....	16.7	7,140	1,192	11.93	11,250	21,250
Two QC.....	17.3	7,140	1,235	12.36	11,250	21,250
1992:						
One QC.....	17.6	7,520	1,324	12.57	11,840	22,370
Two QC.....	18.4	7,520	1,384	13.14	11,840	22,370
Supp. young child credit.....	5.0	7,520	376	3.57	11,840	22,370
Supp. health credit.....	6.0	7,520	451	4.285	11,840	22,370
1993:						
One QC.....	18.5	7,750	1,434	13.21	12,200	23,050
Two QC.....	19.5	7,750	1,511	13.93	12,200	23,050

* Qualifying Child

**Table 3. Earned Income Tax Credit Parameters under Current Law, Administration's Proposal, & Conference Agreement
1994 Dollars**

	Credit Rate	Plateau Beginning Point	End Point	Maximum Credit	Phase-out Rate	Income Cut-off
<i>Current Law</i>						
<i>1994 and after</i>						
Families with one child	23%	\$7,990	\$12,580	\$1,838	16.43%	\$23,760
Families with two or more children	25%	\$7,990	\$12,580	\$1,998	17.86%	\$23,760
Health Insurance Supplement	6%	\$7,990	\$12,580	\$479	4.285%	\$23,760
Young Child Supplement	5%	\$7,990	\$12,580	\$400	3.57%	\$23,760
<i>Administration's FY 1994 Budget Proposal</i>						
<i>1994</i>						
Families with one child	26.6%	\$7,750	\$11,000	\$2,062	16.16%	\$23,760
Families with two or more children	31.6%	\$8,500	\$11,000	\$2,685	15.80%	\$28,000
Workers without children	7.65%	\$4,000	\$5,000	\$306	7.65%	\$9,000
<i>1995 and after</i>						
Families with one child	34.4%	\$6,000	\$11,000	\$2,062	16.16%	\$23,760
Families with two or more children	39.7%	\$8,500	\$11,000	\$3,371	19.83%	\$28,000
Workers without children	7.65%	\$4,000	\$5,000	\$306	7.65%	\$9,000
<i>Conference Agreement</i>						
<i>1994</i>						
Families with one child	26.3%	\$7,750	\$11,000	\$2,038	15.98%	\$23,760
Families with two or more children	30.0%	\$8,425	\$11,000	\$2,528	17.68%	\$25,300
Workers without children	7.65%	\$4,000	\$5,000	\$306	7.65%	\$9,000
<i>1995</i>						
Families with one child	34.0%	\$6,000	\$11,000	\$2,040	15.98%	\$23,760
Families with two or more children	36.0%	\$8,425	\$11,000	\$3,033	20.22%	\$28,000
Workers without children	7.65%	\$4,000	\$5,000	\$306	7.65%	\$9,000
<i>1996 and after</i>						
Families with one child	34.0%	\$6,000	\$11,000	\$2,040	15.98%	\$23,760
Families with two or more children	40.0%	\$8,425	\$11,000	\$3,370	21.06%	\$27,000
Workers without children	7.65%	\$4,000	\$5,000	\$306	7.65%	\$9,000

Department of the Treasury
Office of Tax Analysis

August 3, 1993

EITC is a wonderful innovation, because, combined with basic support, the EITC can simultaneously provide income support and increase work effort. This means that the EITC is not only a fundamental element to redressing the distribution of income, but also a key to reforming welfare, and to revitalizing labor markets. ♦

Luncheon Address, NTA 86th Annual Conference November 8, 1993.

Bibliography

Campbell, Colin D. and William L. Peirce, *The Earned Income Tax Credit*, Washington, D.C.: American Enterprise Institute, 1980.

Friedman, Milton, (with the assistance of Rose Friedman), *Capitalism and Freedom*, Chicago, Illinois: The University of Chicago Press, 1962.

Committee on Ways and Means, U.S. House of Representatives, *Overview of Entitlement Programs: 1993 Green Book*, Washington, D.C.: U.S. Government Printing Office, 1993.

Shoup Receives NTA's Holland Medal



Carl S. Shoup receives Holland Medal from NTA President Gerald D., Bair

Carl S. Shoup, Professor Emeritus of Economics at Columbia University, was presented the Daniel M. Holland Medal at the NTA Conference last month in St. Paul.

The Holland Medal, established in memory of the beloved former NTA President and long-time editor of the *National Tax Journal*, recognizes "distinguished lifetime contributions to the study and practice of public finance."

In accepting the Holland Medal, Shoup said:

This award carries a very special meaning for me, both because of my friendship with Dan Holland and because this comes from the National Tax Association, the professional group with which I have always felt most closely associated.

Dan's editorship of our *Journal* over so many years greatly enhanced the influence of the NTA in pro-

moting knowledge and understanding of the many aspects of tax problems among taxpayers, legislators, administrators, accountants, lawyers, judges and academic specialists. Cooperation among these groups is crucial to the development of a fair, workable and economically sound tax system.

Let us then take this Daniel M. Holland Medal as a symbol of our Association's achievement in promoting that cooperation among the various tax groups without which a country's tax system will be too weak, too ineffective, to serve as a bulwark against inflation.

One of the world's foremost authorities on the economics of taxation, Shoup served as President of the National Tax Association in 1948-49 and was elected an Honorary Member in 1970. ♦

School Finance Issues to be Examined

NTA will present a panel on "Current Issues and Options in the School Finance Debate" at the annual meeting of the Eastern Economic Association, to be held at Boston's Park Plaza Hotel March 18-30.

Speakers include;

- Andrew Reschovsky (University of Wisconsin), "Fiscal Equalization and School Finance: The Wisconsin Experience"

- William Duncombe and John Ruggerio (Syracuse University), "Cost and Efficiency of Local Public Education: Case Study of New York State"

- Douglas B. Roberts (State Treasurer, Michigan), "School Finance Reform: The Michigan Update"

- Discussants are Katherine L. Bradbury (Federal Reserve Bank of Boston), Robert Strauss (University of Rochester), and Daphne Kenyon (Simmons College).

- The exact time for this session has not yet been announced.

- The NTA session has been arranged and will be chaired by Ranjana Madhusudhan, of the New Jersey Division of Taxation.

- Registration information may be obtained from Carla Scott, at the EEA office, Ph. 401-232-6470, or FAX 401-232-6720.◆

Undergraduate Public Finance Textbooks Reviewed

A review of five widely used undergraduate public finance textbooks was presented at the meeting of the Committee on Education in Public Finance at the St. Paul annual conference. Marion S. Beaumont, Chair of the Committee, prepared the review.

The textbooks reviewed are:

Public Finance and the Price System (3rd ed., 1987), by Edgar K. Browning and Jacqueline M. Browning

Public Finance: A Contemporary Application of Theory to Policy (4th ed., 1993), by David N. Hyman

Public Finance in Theory and Practice (5th ed., 1989), by Richard A. Musgrave and Peggy B. Musgrave

Public Finance (3rd ed., 1992), by Harvey S. Rosen

Economics of the Public Sector (2nd ed., 1988), by Joseph E. Stiglitz

A copy of Prof. Beaumont's 35-page review essay can be obtained from the NTA office. Please include \$5 to cover postage and handling.◆

Conference on Taxation of Financial Services

The program is set for a special NTA seminar on Financial Services Taxation, to be held February 23-24, 1994 at the Bellevue Mido Resort Hotel in Clearwater, Florida.

The conference will be unique in focusing on tax issues that cut across all of the different financial services sectors. Program sessions will include:

- Trends and Developments in the Financial Services Sector

- New Financial Service Products: How Should They Be Taxed?

- Issues in the Taxation of Financial Services Entities

- International Taxation of Financial Services

- Emerging State Tax Issues

- Tax Issues in Asset Securitization

- Consumption Taxation of Financial Services

Full details and registration materials were mailed recently to all NTA members. If you need extra copies please contact the NTA office. Pass the word of this important conference to those of your colleagues who may be interested.◆

We invite you to join us in our work

APPLICATION FOR MEMBERSHIP

NATIONAL TAX ASSOCIATION
5310 East Main Street, Columbus, OH 43213

I wish to become a member of the National Tax Association.

My check for \$_____ is enclosed for the payment of annual dues. I understand that \$50.00 of my dues (\$55.00 for foreign members) covers the subscription cost of *The National Tax Journal*, and that I will receive the *Proceedings of the Annual Conference*, the *NTA Forum*, and all other publications of the Association at no additional cost.

Sustaining Member	\$ 500.00 or more
Corporation or Government Agency	\$ 300.00*
Professional, corporate employee, others	\$ 120.00
Library	\$ 100.00
Government employee or academic	\$ 70.00
Full-time student or inactive retiree	\$ 15.00

* Allows up to three individuals in case of corporations, up to five in case of government agencies.

NAME _____
(PLEASE PRINT)

TITLE _____

AFFILIATION _____

STREET ADDRESS _____

CITY _____ STATE _____ ZIP _____

NTA

Dedicated to advancing
understanding of the
theory and practice of
taxation at all levels of
government

NTA Forum
National Tax Association
5310 East Main Street
Columbus, OH 43213

Address Correction Requested

NON-PROFIT ORG.
U.S. POSTAGE
PAID
COLUMBUS, OH
PERMIT NO. 4422

Winter 1994