The Future of the Earned Income Tax Credit (Part 3 of 3)

Part Three: Beyond Welfare

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A major reason for the expansion of the earned income tax credit (EITC) in recent years is that it generally has received bipartisan support within the context of major tax and budget reforms. I have been involved in trying to design some of these changes over the years. Among other efforts, in 1978 I participated in a bipartisan simplification of the credit so that it might more easily be made available. In 1984, I introduced indexing into the Treasury proposals leading up to tax reform in 1986.

Now the EITC is on the table again in the current budget package. Despite the increased scrutiny that Congress is paying to issues surrounding the credit—in particular, the extent to which it is subject to fraud and abuse and whether it decreases or increases work effort—I expect that the EITC will be modified only moderately this year. More radical change awaits a broader reform of our tax and transfer structure, especially as it applies to low-income individuals.

What gives the EITC this bipartisan base of support and makes it likely to be a strong survivor in the face of a downsized government? The answer probably lies less with the history of the EITC by itself than with the broader history of all attempts to help lower-income individuals. Today, as a society, we are engaged in a fundamental, but difficult, attempt to try to find alternatives to simple welfare. The EITC, as a device to try to make work more attractive than welfare, represents an important step in that direction. The 20-year history of the EITC makes clear that we have been proceeding in stages toward a different design of our combined tax/transfer system, as it applies to low-income individuals. In this newer world, tax and transfer policy are harder to separate; indeed, budget accounting uniquely counts different portions of the EITC as both tax reduction and expenditure outlay, forcing us to view tax and transfer systems in an integrated fashion.

What makes the EITC program different from most welfare systems is its requirement that at least some income be earned in order to receive the credit. In a sense, the phase-in range for the credit is nothing more than a rough work test. Relative to welfare that pays the highest benefits to those with no earnings or income, the phase- in of the credit as income increases has been designed to provide a maximum benefit at income levels approximating a full-time, minimum- wage job.

In recent years there have been several attempts to convert our welfare system into a more work-oriented support system. EITC expansions are only one example. Mandates that welfare recipients work and attempts to time-limit welfare are others. So also are the targeted jobs credit and attempts to increase "disregards" (minimum amounts of income that can be earned without loss of welfare benefits). None of these mechanisms, unfortunately, has solved many of the complex problems related to work and marriage penalties in transfer programs. Nonetheless, I believe that few voters would want to reverse course and go back toward a purer welfare system. We seem to be in a transition stage, but without a clear-cut map on how we will continue to proceed.

The unwillingness to reverse course, combined with the dissatisfaction with where we are, leads me to the conclusion that the EITC most likely awaits an even broader reform of our combined tax and transfer structure. Unfortunately, reform of these systems, as they apply to low-income individuals, is almost never attempted on a comprehensive basis. Most tax/transfer reforms, including those of the EITC, have traditionally represented patches on the existing system.

As one consequence, the combined tax rate on AFDC (Aid to Families with Dependent Children) recipients who take minimum-wage jobs is still extraordinarily high. This rate derives not only from the EITC and direct taxes, but also phase-outs of welfare benefits as income increases. What this high tax rate means, more generally, is that work in the formal sector still doesn't pay much, making occasional work in the informal sector a better deal. Recent EITC expansions have only made a modest dent in these very high rates of tax.

More comprehensive reform would allow one to try to deal with complex interactions among programs, for instance, by trying to integrate the child credit proposed in the current tax bills, the personal exemption for dependents, and the EITC in ways that would reduce the very strong penalties on work and marriage in the current system. A more universal child credit, for example, might be combined with a phased-in EITC. Some comprehensive proposals along this line have been suggested by George K. Yin (see Tax Notes, June 26, 1995, p. 1828) and Jonathan Barry Forman and Yin in a project commissioned by the American Tax Policy Institute (see Tax Notes, May 17, 1993, p. 951), and more recently, in testimony by Rep. Thomas E. Petri, R-Wis. (see 95 TNT 117-32.)

Unfortunately, while the breadth of current budgetary reform efforts is somewhat sweeping, it has not proved itself capable of dealing with these types of interactive reforms. Note, however, that if tax changes such as a child credit are not going to be included in actual budget enactments this year, but delayed until movement toward budget balance is more certain, then more comprehensive reform could be considered at that later date.

Regardless of how we proceed, we need to be modest in our expectations. I believe that we are in an intermediate stage in the attempt to find true alternatives to welfare, that we will be engaged in this debate for many years to come, and that the design of EITCs and other tax provisions will be an integral part of that ongoing debate.

Other Publications by the Authors

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