

The Future of the Earned Income Tax Credit (Part 1 of 3)

Part One: Background

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Among the many provisions being considered for reform in the budget process this year is the earned income tax credit. In size and scope the EITC has become one of the most important elements of the combined tax/transfer scheme applying to low-income individuals. Its growth in recent years has been relatively swift; indeed, it has been perhaps the fastest growing of all federal budget items that can trace its growth to legislation over the past decade.

Table 1 traces some of that growth. As can be seen, the credit was expanded substantially in the Tax Reform Act of 1986 and the budget agreements of 1990 and 1993. Interestingly, the Clinton administration likes to point to the EITC expansion as one of its major accomplishments, while some critics like to blame this administration for any defects of the credit. Yet the largest expansions of the credit took place under Presidents Reagan and Bush—at least when measured in terms of total cost.

Over the years, the EITC has been said to fulfill several purposes. One is simply to provide assistance to low-income individuals. In this regard, it has achieved modest success as an antipoverty measure, as can be seen in Table 2, although it pales in comparison with social insurance programs such as Social Security Old Age, Survivors, and Disability Insurance.

A second purpose was to provide an offset to Social Security taxes and, perhaps, other federal taxes. For most families today, the combined employer and employee Social Security tax rate is more important than the income tax rate. It is not hard to understand why: the Social Security tax rate is 15.3 percent on all earnings, while the income tax rate on first dollars of earnings is zero and, for most individuals, does not rise above 15 percent on the last dollars of earnings.

The expansions of 1990 and 1993, however, could not be justified as offsets to the Social Security tax. The rate of credit was scheduled to rise as high as 25 percent under the 1990 agreement and as high as 40 percent under the 1993 agreement. Since most individuals at low income levels do not pay income tax, the EITC pays out far more to many individuals than they pay in any form of federal tax.

While the 1990 and 1993 reforms mainly increased the rate of credit, they made some other changes as well, such as an expanded credit for families with more than one child and a reformed definition of eligibility that was based more on the home in which a child resided and less on the amount of monetary support provided. These reforms did not change fundamentally the structure of the EITC system, the income levels at which a maximum credit would be reached, and the levels at which no credit would be made available.

A final rationale for the credit was to provide work incentives. Here, however, the target was primarily individuals who were on or who might otherwise receive welfare—those who might earn modest amounts of income in the phase-in range of the credit. The connection to other types of transfers—in particular, Aid to Families With Dependent Children (AFDC)—is made fairly obvious by the restriction of the credit primarily to families with children. This work incentive goal cannot really be separated from the antipoverty goal. That is, the EITC cannot be justified as work incentive alone, but only as an alternative to other mechanisms to try to make transfers to low-income individuals.

Although comparisons to AFDC have been made throughout the history of the credit, more recently it has also been compared to increases in the minimum wage. Many economists believe that increasing the minimum wage reduces the jobs that would be made available to workers whose productivity is between the existing minimum wage and some new higher level that might be made available.

Table 1

Amount of Earned Income Tax Credit

Total Amount of Credit Year (\$billions)	Pre-1986	1986 reforms	1990 reforms	1993 reforms
1975	\$1.3	--	--	--
1980	\$2.0	--	--	--
1985	\$2.1	--	--	--
1990	\$7.5	--	--	--
1995	\$11.1	\$20.0	\$24.8	
1998	\$12.9	\$23.0	\$30.4	

Source: Holtzblatt, McCubbin, & Gillette, *National Tax Journal*, Sept. 1994.

Analyses of minimum wage workers, moreover, show that many of them are in middle-income families: teenagers, older workers with assets and pension income, and families where one earner already works at much higher wages. Accordingly, the EITC has also received much support as an alternative not only to welfare, but to minimum wage increases. In this regard, some health reform proposals, such as that of President Bush in 1992, included a health credit modeled largely after the EITC. Again, the argument was made that such a credit would be superior in its work incentive effects to the implicit increase in the minimum wage that would follow a mandate on employers to buy health insurance.

In sum, the EITC does not meet any of its goals perfectly. As a compromise, however, it often meets the combined goals better than other alternatives, including a pure welfare system.

**Table 2
Antipoverty Effectiveness of Cash and Near-Cash Transfers: 1993**

Total Population (thousands)	All Persons 259,588
Number of poor individuals (thousands):	
Cash income before transfers	59,901
Plus social insurance	42,116
Plus means-tested cash transfers	38,963
Plus food and housing deficits	30,794
Less federal taxes	33,442
Plus EITC	28,898
Number of individuals removed from poverty due to (thousands):	
Social insurance	17,785
Means-tested cash transfers	3,153
Food and housing benefits	8,170
Federal taxes	-2,648
EITC	4,544
TOTAL	31,003

Source: Sandra Clark & Sheila Zedlewski. The Urban Institute. Assumes full implementation of EITC changes due by 1996.

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