Policy Proposal: Modifying the Federal Earned Income Tax Credit to Better Help Households with One or No Dependents

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This paper discusses four recommendations to improve the federal Earned Income Tax Credit, (EITC), which effectively acts as a wage boost for very-low-income and low-income workers. The credit amount varies tremendously depending on the number of dependents one has. This discrepancy is the paper's main focus. This paper finds that the EITC's failure to significantly help taxpayers without dependents, among other challenges, limits its ability to fulfill the program's goals of incentivizing work and reducing poverty. The four recommendations on average would expand the availability and amount of the credit for most lower-income taxpayers. A conventional economic analysis suggests that these changes would likely incentivize work for many (though not all) affected individuals, increase consumer spending, reduce poverty, and increase equity. In a somewhat limited manner, this paper recommends the set of changes for enactment.

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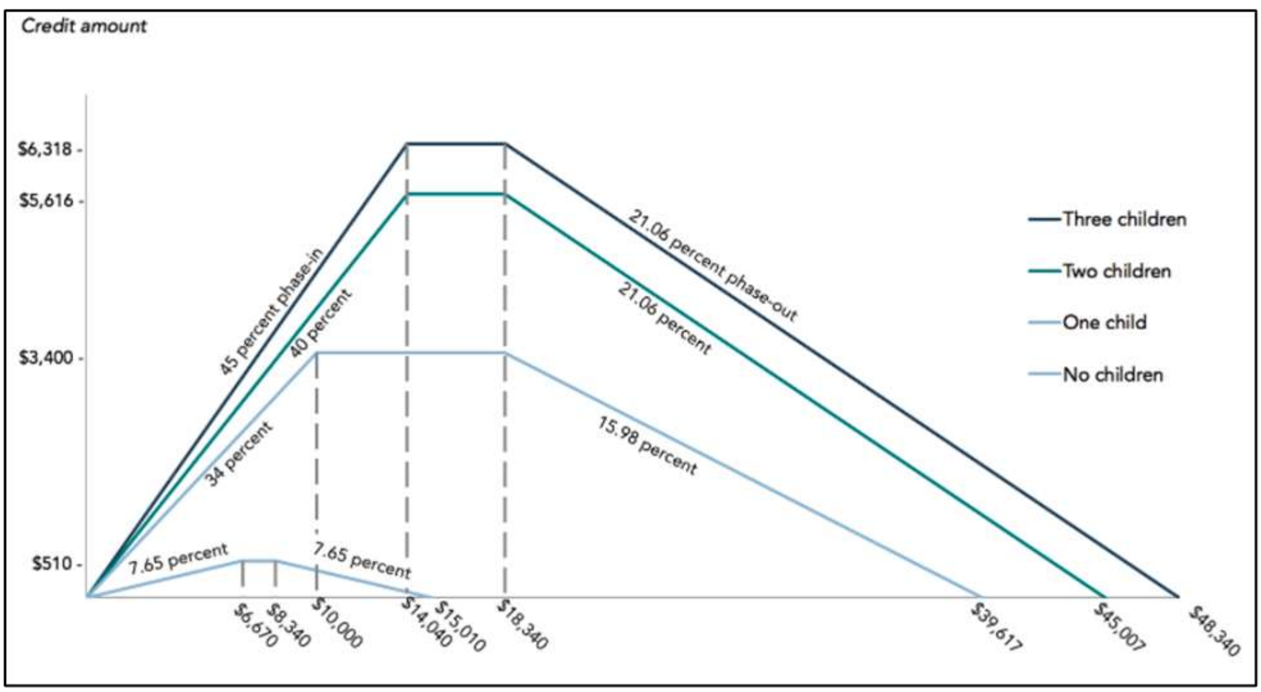
INTRODUCTION

This paper discusses recommendations to improve the federal Earned Income Tax Credit, (EITC), which effectively acts as a wage boost for very-low-income and low-income workers. The credit is fully refundable, which means workers who owe no income tax can still collect the credit. It adjusts annually for inflation and varies tremendously depending on the number of dependents one has. At the maximum credit level, single filers with one dependent receive 6.7 times more than those with no dependents, while those with two dependents receive 11.0 times more and those with three or more dependents receive 12.4 times more (Crandall-Hollick, Falk, and Boyle 2020, 6). This discrepancy is the paper's main focus, as indicated in Figure 1.

Later on, Congress enacted another credit, called the Child Tax Credit (CTC) (Tax Policy Center 2021). Most recently, except for 2021, the CTC provided $2,000 for each child up to age 16 and was only partially refundable. This paper was written prior to the passage of the American Rescue Plan, which temporarily changed aspects of the CTC and EITC (Tax Policy Center 2021). For the purposes of this paper, the 2020 and earlier parameters are assumed for both the EITC and CTC, except where otherwise noted. The CTC does not adjust annually for inflation, and its purpose overlaps significantly with the EITC.

Figure 1: EITC amount at various earned income amounts with specified parameters for a single filer, 2017



Source: Tax Policy Center via Bruenig (2018)

This paper provides a brief background on the creation and numerous iterations of the EITC, the later creation of the CTC and how that reduces the need for the EITC to vary so widely by number of dependents, and how the EITC and CTC overlap. Additional background on the problems this reform seeks to address and a brief discussion of the state EITC programs follow.

The paper then details a set of four proposed changes and discusses their effects on economic incentives, equity, and program cost. It concludes with a positive, though limited, recommendation that these changes be enacted.

BACKGROUND OF THE FEDERAL EITC, STATE EITCs, AND THE CTC

THE EITC

The EITC has changed dramatically from its initial form as a temporary program in 1975 (Crandall-Hollick, Falk, and Boyle 2020, 1; Ventry 2000, 983). In the mid-1970s, the United States entered a recession, and Congress, supported by President Gerald Ford, enacted a temporary tax refund for low-income individuals with dependents (Senate Finance Committee 1975, 42). The initial form was an increasing reduction of tax liabilities based on earned income up to a maximum benefit of $2,000 for individuals earning up to $20,000 (Crandall-Hollick 2018, 3). The benefit then gradually decreased and zeroed out at roughly $40,000 of earned income. Dollar figures throughout the paper have been adjusted for inflation to current dollars (Saving.org, n.d.). It has always been refundable (Crandall-Hollick 2018, 3). In simpler terms, it was a modest wage increase for very-low- and low-income workers. Congressional legislative committee reports at the time suggested it would "encourag[e] people to obtain employment, reduc[e] the unemployment rate and reduc[e] the welfare rolls" and that it would offset payroll taxes for "low-income persons" (Ventry 2000, 995). There were notable differences in opinion between the House of Representatives and Senate on including individuals without dependents; the 1975 act excluded them (Senate Finance Committee 1975). People not earning income also did not receive the benefit.

This temporary credit was extended a few more times and then made permanent by Congress and President Jimmy Carter through the Revenue Act of 1978 (Crandall-Hollick, Falk, and Boyle 2020, 12). From its first enactment, the perception of the credit was part-stimulus, part-welfare, and decidedly pro-work. As mentioned, the initial enactment excluded individuals not earning income and individuals without dependents. The recession provided for a rare political opening in which this type of legislation made it through and quickly became popular (Ventry 2000).

Since its 1975 enactment, the EITC has been modified frequently, with at least seven major revisions. The revisions primarily affected either the credit's eligibility requirements or the credit amount. Notably, it was not until 1990 that the credit varied based on the number of qualifying dependents, and it was not until 1993 that individuals with no dependents qualified for the credit (Crandall-Hollick 2018, 7).

Regarding work incentives, the credit seeks to incentivize work and reduce poverty among very-low- and low-income taxpayers – taxpayers in the phase-in region. An inevitable drawback is that the credit somewhat disincentivizes work in the flat region and significantly disincentivizes work in the phase-out region. In economics jargon, this is caused by (1) an income effect, (2) leisure being a normal good for most consumers, and (3) a non-existent substitution effect. (These terms are explained in a later section.) Additionally, the maximum credit amount, the threshold at which the phase-in ends, and thresholds at which the phase-out begins and ends are annually adjusted for inflation. In other words, the shape of the credit curve remains the same.

While this paper was written prior to the passage of the American Rescue Plan and focuses on the permanent parameters, there were notable temporary pandemic-era changes (Crandall-Hollick 2021a). They primarily impact low-income taxpayers without dependents. For these taxpayers, the plateau region was extended and the maximum benefit level increased from $543 to $1,502. This $1,502 figure is still drastically smaller than the benefit of $3,618 for taxpayers with one dependent.

STATE EITCs

Many states have enacted legislation creating their own versions of the federal EITC. As of January 2022, twenty-eight states operate their own EITCs, as do Puerto Rico, the District of Columbia, and New York City (Internal Revenue Service 2021a; Urban Institute 2021; Balmaceda 2021).[1] Of those thirty-one EITC programs for tax year 2022, twenty-five are refundable, and six are non-refundable.[2] The popularity of EITC programs among the states is especially notable when considering that only 41 states have personal income taxes (Waggoner 2021, 1). In other words, of the 41 states with personal income taxes, approximately 68 percent have EITC programs. This level of popularity appears to indicate the programs–both the federal one and its state-level copies–are successful and politically advantageous.

The state EITC programs typically operate for similar reasons as the federal EITC. That said, there appears to be a greater focus in the literature surrounding state EITCs on the anti-poverty effects instead of the work incentive aspect of the federal EITC (Williams, Waxman, and Legendre 2020, 2).

THE CTC

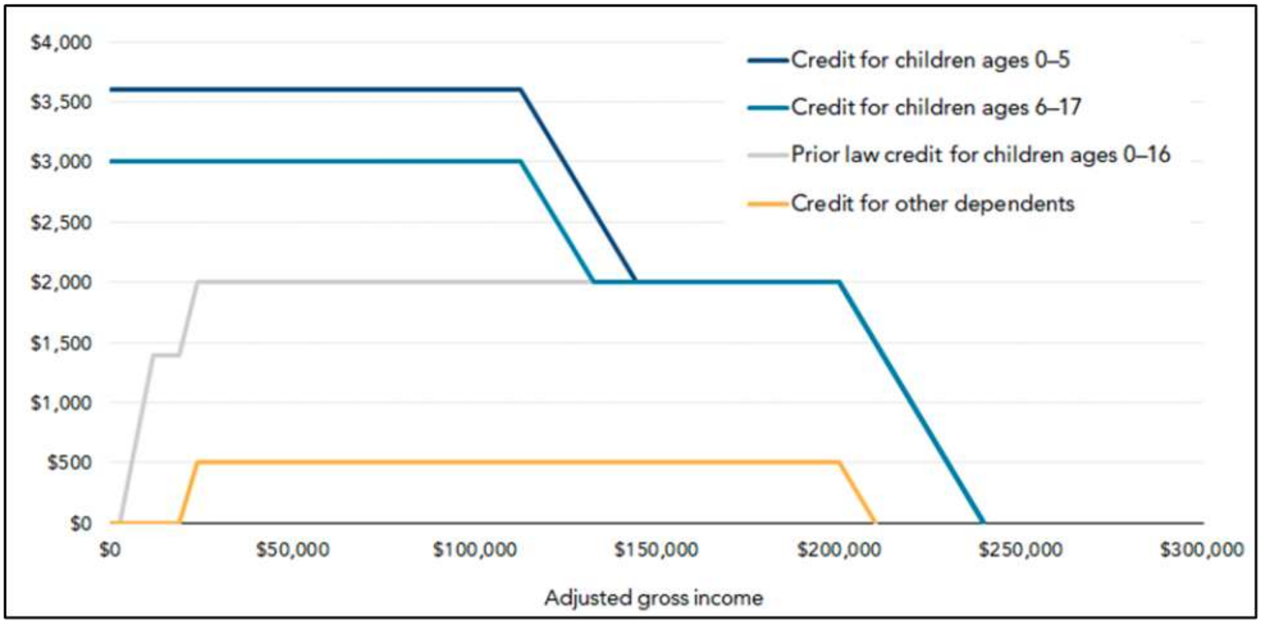
In 1997, Congress created the CTC, which, similar to the EITC, primarily targets individuals with dependents who have some earned income (Congressional Research Service 2018, 1). However, unlike the EITC, the CTC is explicitly designed around children, and from the start it has varied based on number of dependents. Also, unlike the EITC, the CTC began by focusing on tax relief for the middle-class (Congressional Research Service 2018, 1). Due to revisions by the Tax Cuts and Jobs Act of 2017, the CTC expanded to include certain high-income earners with dependents and include more individuals as dependents, such as certain college students (Crandall-Hollick 2021b, 2, 5). Figure 2 shows these changes. The gray line shows what the CTC looked like from 2018 to 2019 and what it will look like from 2022 to 2025, pending any further changes by Congress. Except for 2021, its maximum benefit is $2,000 per qualifying dependent (Tax Policy Center 2021). Also, the CTC is normally only partially refundable, which reduces its impact on very low-income individuals (Crandall-Hollick 2021b, 9). Unlike the full refundability of the EITC, the partial refundability of the CTC means that a taxpayer who does not

[1] Washington and Missouri do not have currently operating EITCs, but they have both passed legislation to enact them in 2023.

[2] The sources consulted have conflicting information on the refundability of Oklahoma's EITC. The state EITC used to be refundable in prior years, but it is unclear if it is currently refundable in this tax year.

have tax liability would only get part of the credit amount, not the full credit amount like they would through the EITC.

Figure 2: CTC Amount for one child/dependent, single filer, 2021



Source: Tax Policy Center (2021)

During the pandemic, Congress drastically expanded the CTC solely for tax year 2021, indicated by the two blue lines above in Figure 2 (Tax Policy Center 2021). As part of this expansion, for tax year 2021 only, Congress made the CTC fully refundable and eliminated the phase-in region (Department of Commerce - Bureau of Economic Analysis 2021). This results in the credit starting at the full credit amount even for someone making zero income (see blue lines).

ECONOMIC WOES OF LOW- AND MIDDLE-INCOME AMERICANS

Since at least 1979, wages of middle- and low-income workers have not increased at the same rate as very high-income workers (Mishel, Gould, and Bivens 2015, 6). Also, economic inequality—proxied by wealth, income, or wages—is at an all-time high (Stone et al. 2020, 1). Significant disparities in income across race and gender still very much persist (Kochhar and Cilluffo 2018, 1; Pew Research Center 2016, 32).

A 2016 analysis of labor trends between 1980 and 2015 found that American workers work much more than they used to. The Pew Research Center found that hours worked weekly, and weeks worked yearly increased on average. Taking these two trends together, the Center found that workers are working the equivalent of an additional "months' worth of work" every year (Pew Research Center 2016, 37). Yet incomes for most Americans are not keeping pace with inflating costs even though workers are working more than they used to (Desilver 2018).

Additionally, in recent decades, the purchasing power of most individuals has declined in real terms due to drastic increases in costs associated with higher education, childcare, health care, and housing, among others (Perry 2018, 2-3).

Further, changes to federal income tax brackets (Tax Foundation 2013), payroll taxes (York 2019), and certain tax expenditures like the Homeowners Mortgage Interest Deduction (Huang and Shaw 2009, 1; Thornton and Estep 2019, 5), have made the US federal tax system much less progressive, harming low- and middle-income Americans.

All these trends taken together paint a bleak economic picture for low- and middle-income Americans. Low-income individuals, regardless of having qualifying dependents or not, are struggling. The current maximum credit amount for a single filer with no qualifying dependents of a paltry $538 is insufficient to counteract the current poor economic conditions seen in the United States. This issue is one of the intended focuses of the proposal to modify the EITC.

MISMATCH OF THE EITC'S NAME AND ITS STATED OBJECTIVES

The EITC's extreme focus on taxpayers with dependents is inequitable. As previously discussed, the EITC was initially created to stimulate consumer spending, incentivize work, reduce welfare rolls, and offset the then-increasing tax liabilities for low-income individuals with dependents. The subsequent enactments that made the EITC permanent and made other changes do not profess to stimulate consumer spending, but do still attempt to incentivize work, keep people out of poverty, keep people off welfare rolls, and offset poor economic conditions.

There is extensive literature arguing that the EITC has led to a significant expansion of labor force participation among beneficiaries, especially single women (Sikivie 2019, 2). There have been arguments that the EITC has decreased poverty among beneficiaries (Greenstein 2015). However, taxpayers without dependents have been largely left out of these benefits. While the name of the EITC might imply that it helps all lower-income taxpayers with earned income, that is misleading: the EITC has a drastically larger impact for taxpayers with dependents than those without dependents. An individual with no qualifying dependents receives approximately $3,000 less annually than someone with one qualifying dependent, and approximately $5,400 less than someone with two qualifying dependents (Crandall-Hollick, Falk, and Boyle 2020, 9). Thus, the name of the EITC hides the fact that it barely benefits low-income people with no dependents. In contrast, the CTC is a more appropriate program to vary based on a taxpayer's number of children, as its name implies.

If the EITC were changed to better include taxpayers without dependents (as this paper proposes), those individuals would presumably see increases in labor force participation and reductions in poverty, as single mothers experienced previously. Additionally, incentivizing work and reducing poverty are noble goals, but, with such a small carrot for people without dependents, the likely behavior change is comparatively quite small, at least relative to the maximum credits available to their counterparts with dependents. The EITC is a prime example of the federal government using policy to influence employment outcomes. However, the most basic principles of behavioral economics point to the magnitude of the impact being somewhat proportional to the size of the incentive. In other words, the various benefit amounts of the EITC presumably have differing success at impacting behavior. The taxpayers with more qualifying dependents are more likely to be swayed towards work than those with fewer or no qualifying dependents.

Additionally, the various benefit levels, which increase based on the number of dependents (see Figure 1 on pg. 2), may appear to create a fairly strong incentive to have one or more dependents. There is possibly an issue of framing here: it may be that the EITC does not provide a strong incentive to have multiple children, but rather, it reduces many of the financial disincentives. To illustrate the claim, the difference in maximum credit for a single filer with no dependents and two dependents is $5,382 (Crandall-Hollick, Falk, and Boyle 2020, 5).[3] Multiplying this by 18 years to roughly estimate the net tax benefit of having two dependents over a lifespan result in $96,876.[4] While this perhaps does not cover the entirety of food, lodging, health, and other costs for the dependents, this would considerably reduce the burden of having dependents, especially for the very-low- and low-income earners that the EITC targets.

PROPOSED CHANGES

This paper proposes a set of changes to the EITC that would address the issues raised above, particularly by better including individuals without dependents.

First, the proposal sets a single EITC formula for all taxpayers that does not vary based on the number of qualifying dependents of the taxpayer. The new benefit amounts and other parameters would switch to the current specifications for someone with two dependents. In other words, individuals with zero, one, or three qualifying dependents would see changes to their benefit amounts, while individuals with two qualifying dependents would not see changes. De-coupling the EITC from the number of dependents would allow it to incentivize work more evenly for all low-income individuals, while leaving the CTC to compensate directly based on dependents.

Second, the proposal increases the credit rate to 75 percent (currently, it ranges between 7.65 percent and 45 percent) without changing the maximum credit amount (Crandall-Hollick, Falk, and Boyle 2020, 5). The credit rate, or phase-in rate, is the slope of the credit in the phase-in portion (see Figure 3 below). This results in the maximum credit being available at a much lower income than before. An individual with two qualifying dependents currently receives the maximum credit amount of $5,920 when their earned income reaches $14,800 (Crandall-Hollick, Falk, and Boyle 2020, 6). Due to this change, individuals would receive that same maximum credit amount of $5,920 when their earned income reaches $7,893.

Third, the proposal increases the phase-out amount threshold from the current amount of $19,330 for an unmarried filer to $30,000 and the current amount of $25,220 for married taxpayers

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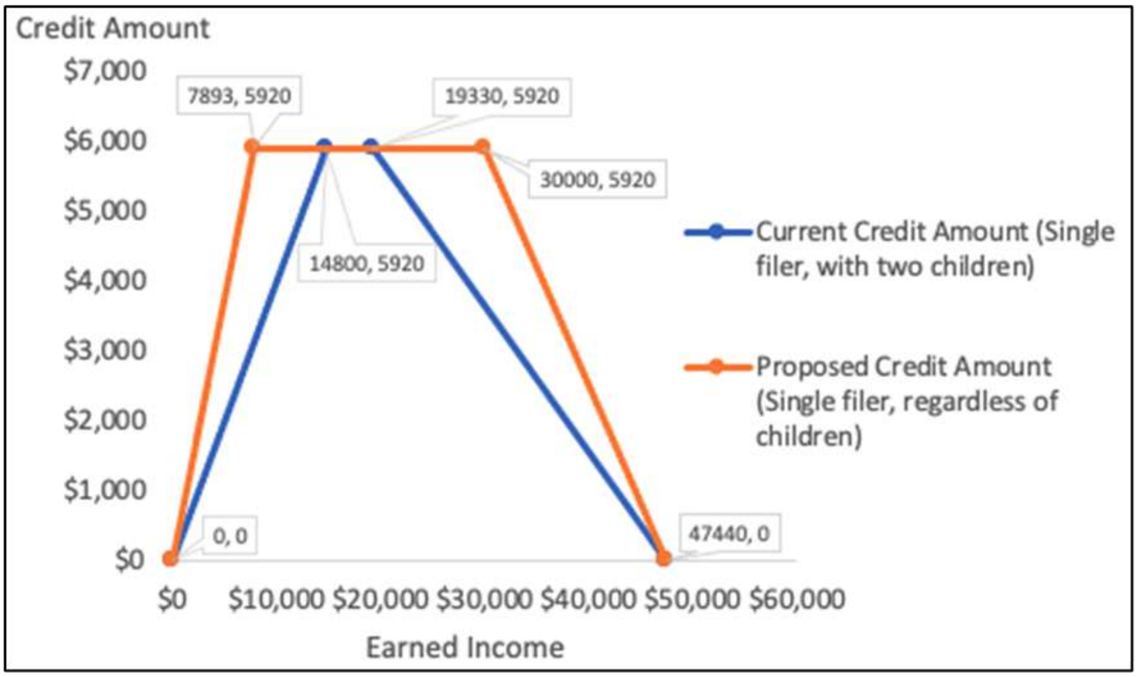
[3] As previously discussed, the maximum credit amounts for tax year 2020 for an unmarried filer with no dependents was $538 and for two dependents it was $5,920 (Crandall-Hollick, Falk, and Boyle 2020, 5). The difference is $5,382 (author calculation).
[4] A net present value calculation here is not necessary because the credit's parameters adjust annually due to inflation. Thus, it remains constant over the 18-year period in present value terms.

filing jointly to $37,500 (Crandall-Hollick, Falk, and Boyle 2020, 5-6).[5] This allows more taxpayers to receive the maximum credit amount.

Fourth, the proposal increases the phase-out rate such that the current earned income amount where the credit reaches zero, which is currently $47,440, does not change (Crandall-Hollick, Falk, and Boyle 2020). The phase-out rate significantly increases because the threshold at which the phase-out range begins increases, while the amount at which the phase-out range ends is unchanged. The phase-out rate for a single filer with two children would change from 21.06 percent to approximately 33.94 percent (Center on Budget and Policy Priorities 2019).[6] These changes are illustrated in Figure 3.

Figure 3: Current vs. proposed EITC amount with specified parameters



Source: Figure prepared by the author

IMPACT ON INCENTIVES

This paper now evaluates the proposal's theoretical impacts on the current economic incentives of the federal EITC. For background, in microeconomic theory, a substitution effect refers to the behavioral change seen due to a change in the relative prices of goods or services,

[5] Prior to these changes, the ratio of phase-out amount thresholds between single filers compared to married taxpayers was 0.60 (for no dependents) and 0.77 (for one or more dependents). The increased phase-out amount thresholds result in a ratio between the two groups of 0.8 (Crandall-Hollick, Falk, and Boyle 2020, 5-6).

[6] The new phase-out rate of approximately 33.94 percent was calculated by the author. The maximum credit amount of $5,920 was divided by the difference of the end ($47,440) and beginning ($30,000) of the phase-out range and multiplied by 100 to form a percent. Calculation: 5,920 / (47,440 - 30,000) * 100 ≈ 33.944954 percent.

including the value of working based on after-tax wages.[7] A related but different concept, the income effect, refers to the behavioral change seen due to one's change in income.[8]

In regard to the amount that individuals work, individuals in the new phase-in region will experience a large positive substitution effect on work as their after-tax wages increase, and a small negative income effect on work. The individuals in the new plateau region will experience no substitution effect and a negative income effect on work. The individuals in the new phase-out region will experience a large negative substitution effect and a small negative income effect on work.

The first proposed change, removing the formula's variance due to the number of qualifying dependents, will almost certainly increase the impact of the credit on individuals with one or zero qualifying dependents. On the other hand, this change lowers the benefit for individuals with three or more qualifying dependents. This will reduce the impact of their credit in terms of incentives.

Another benefit of this change is that it drastically simplifies the tax credit, making it much less complex and therefore more accessible. The IRS currently estimates that roughly one in five individuals eligible to claim the federal EITC do not claim it (Internal Revenue Service 2021b, Treasury Inspector General for Tax Administration 2018). This reduction in complexity of the formula could reduce the currently high rate of unclaimed benefits by making it more accessible to the average taxpayer. This is especially true considering that one of the largest presumed causes of unclaimed benefits is the complexity over who qualifies as a dependent (Tax Policy Center 2020a).

Further, as discussed previously, the proposal will remove a potential incentive to have children by standardizing the credit regardless of dependents. A major caveat to this is that due to the proposal, individuals with no qualifying dependents would have additional after-tax income and thus be better able to plan for child-rearing financially. American Millennials collectively are having fewer children than prior generations (Barroso, Parker, and Bennett 2020, 5, 11); many polls indicate financial worries are a large culprit (Miller 2018). The direct effect of the change, of erasing a potential financial incentive to have children, and a potential indirect result, of higher disposable incomes of individuals with no dependents, conflict. In other words, these effects go in opposite directions. Thus, the resulting effect is unclear.

The second proposed change, increasing the phase-in rate to 75 percent, results in individuals being eligible for the maximum credit amount at a much lower earned income level, about $7,900, instead of $14,800. This would further incentivize work among very low earners, particularly those with no income currently. Not only would this result in significant increases in payouts of the credit for very low-income individuals, which would presumably have strong anti-

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[7] For example, an increase in payroll taxes results in each hour worked being less beneficial than it was before. Thus, payroll taxes have a negative substitution effect on hours worked because people substitute away from working.

[8] For example, many governmental cash transfers have an income effect because they are effectively changing one's overall income. An individual with more income will typically work less and will buy more or less of certain goods based on that change in income.

poverty implications, but also it would significantly improve the work incentive for individuals remaining in the phase-in portion (Tax Policy Center 2020b). This increase in work incentive is due to a larger substitution effect towards work than the current formula offers. Here, theoretically, the EITC recipient would likely choose to work more given that their after-tax wage rate would be significantly higher than under the current formula. The current formula provides for phase-in rates of 7.65 percent, 34 percent, 40 percent, and 45 percent (Crandall-Hollick, Falk, and Boyle 2020, 5-6). All of these are significantly lower than the proposed 75 percent rate.

One of the major historical goals and accomplishments of the EITC has been incentivizing work and reducing poverty (Marr et al. 2015). The proposed changes would likely have similar results. On the other hand, it would reduce the proportion of individuals in the phase-in portion of the credit so that fewer individuals would experience a substitution effect compared to the current EITC formula. The cash flow toward very-low- and low-income individuals should also dramatically increase consumer spending in terms of income effects, because consumption is typically assumed to be a normal good at these income levels. As mentioned previously, there will be a small negative income effect on work in the phase-in region. This will be outweighed drastically by the 30 to 68 percentage point increase in after-tax wages (the substitution effect).

The third proposed change, increasing the threshold at which the credit begins to phase out, would increase the number of people in the plateau region and reduce the number of people in the phase-out region. The fourth change, increasing the phase-out rate substantially (i.e., making the credit phase out more quickly), would have the effect of keeping the credit focused on low-income and lower-middle-income earners. This change would also limit the number of people in the phase-out region. As mentioned, the plateau and phase-out regions both have negative income effects on work. The phase-out region will also have a large negative substitution effect on work.[9] Thus, the third and fourth changes taken together reduce the number of taxpayers who will experience this work disincentive. Another caveat is that the individuals are receiving quite a bit more income in the plateau and phase-out regions. While this has a negative effect on work, it positively affects consumer spending. All the extra spending may create more jobs and help the economy overall.

ADDITIONAL CONSIDERATIONS

EQUITY

Due to significant continued wage and income disparities across race and gender, the proposed changes are likely to positively affect women and Black and Latino individuals. Racial minorities are overrepresented as EITC beneficiaries (Boddupalli and Rueben 2020). One recent study published in the American Economic Journal: Economic Policy found that since 1975 the EITC has led to a 6 percent increase in maternal employment (Bastian 2020). The proposed changes would likely amplify this trend.

[9] As discussed in the Proposed Changes section, the phase-out rate would substantially increase due to third and fourth changes. For a single-filer with two or three dependents, who has an income within the phase-out range before and after the change, the effective marginal tax rate would increase by approximately 12.88 percent. For someone with one dependent, the change would be even larger.

These changes would likely lift many rural individuals, individuals without qualifying dependents, and very low-income individuals out of poverty (Greenstein 2015). In 2018, the current EITC kept 5.6 million people, a majority of whom were children, out of poverty (Williams, Waxman, and Legendre 2020, 2). In 2019, another study found that increasing the phase-out rate, thereby reducing the credit for middle-class taxpayers, would result in a more efficient impact on overall welfare to dollars spent (Sikivie 2019, 2). The proposal's fourth change should do just that, by keeping the program limited to lower- and middle-income taxpayers. Additionally, since the current EITC does not vary geographically to reflect different spending habits and regional prices, the enhanced EITC would reduce poverty in rural areas with lower living costs.

BUDGETARY

One impact not yet discussed is how the changes, especially the first and second, would interact with the refundability characteristic of the credit. When an individual's tax liabilities reach zero and are still eligible for a refundable tax expenditure, they receive a refund. Due to the new phase-in rate of 75 percent and the increase, for most individuals, of the maximum benefit they are eligible for, there will likely be a large increase in the cost of the program, particularly due to tax refunds. The first change alone will result in a substantial increase in outlays.

That said, the expected increases in consumer spending would presumably result in higher tax revenues, mostly at the state and local levels, due to excise taxes and sales taxes. Additionally, the economic stimulus as discussed may result in increased hours worked and more individuals in the labor force, which would increase federal and state income and payroll tax revenues, and potentially reduce the use of means-tested benefits such as Medicaid or the Supplemental Nutrition Assistance Program. These impacts would result in budgetary savings. One study found that an EITC expansion actually only costs 17% of the overall budgetary cost when evaluated over a one-year horizon due to savings incurred by the government in other programs (Bastian and Jones 2021). Overall, the proposed changes would likely have some cost, but the magnitude is unclear. That said, from a societal welfare lens, the reduction in poverty and related economic benefits may outweigh the budgetary consequences.

CONCLUSION AND RECOMMENDATION

This paper found that the EITC's failure to significantly help taxpayers without dependents, among other challenges, limits its ability to fulfill the program's goals of incentivizing work and reducing poverty. A proposed set of changes on average would expand the availability and amount of the credit for most lower-income taxpayers. These changes would address the current economic troubles of low- and middle-income Americans. A conventional economic analysis suggests that these changes would likely incentivize work for many (though not all) affected individuals, increase consumer spending, reduce poverty, and increase equity. Moreover, the costs of these changes would be partially offset by increased tax revenues and savings in other programs. In a somewhat limited manner, this paper recommends the set of changes for enactment.

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