

# THEORETICAL FORMULATION AND IMPLEMENTATION OF THE EARNED INCOME TAX CREDIT

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## **Abstract**

The Earned Income Tax Credit (EITC) is one of the most respected antipoverty programs in the United States. In spite of its success, few studies have examined the political history of the EITC. This paper critiques EITC policy from President Johnson through President Obama, arguing that state-centered political theories best describe EITC's history of formulation and implementation. The paper concludes with a discussion of future challenges for antipoverty advocacy with an emphasis on tax reform strategies.

**S**ocial welfare programs seek to address a variety of problems that negatively affect health, education, and economic outcomes, among others. Collectively, these support programs are often referred to as the “safety net.” Some safety net programs specifically target social insurance (e.g., Social Security, Medicare), while others focus on transfers of resources like Food Stamps and State Children’s Health Insurance (Scholz, Moffitt, and Cowan 2008). Another strategy is to use the tax system as a device for reducing social inequalities. The current paper critiques one such program, tracing the formulation and implementation of the Earned Income Tax Credit (EITC).

The EITC is the largest tax-transfer anti-poverty program for the non-aged in the United States (B. Meyer 2009). Since its inception in the early 1960s, it has been shaped by and adapted to fit changing political contexts. State leaders involved in the distinct periods of policy legitimization, program expansion, administrative backlash, and political scrutiny make the EITC a fitting policy to be assessed using a state-centered political framework. In the most general sense, state-centered approaches

to policy formulation and implementation are based on strategic actions by appointed or elected state officials. These actors are not merely agents of societal interests, but possess varying degrees of autonomy that allow them to pursue institutional, career, ideological, and constituent interests. For example, of central importance in the case of the EITC is the role of state actors' interests. These can be politically pragmatic (i.e., reducing welfare rolls) as well as ideological (i.e., able-bodied adults should work). Additionally, for actors with experience in a specific policy area, their position as "experts" can direct the policymaking process by ensuring that their issue remains on the legislative agenda, for example (Skocpol and Ikenberry 1983).

In contrast to officials' interests, the interests of constituents—groups of citizens that interact with the state—had almost no role in EITC development. The public was largely unaware of the EITC and administrative education and outreach campaigns were ill-used. In spite of past disengagement, there is potential for constituent interests to take priority on the EITC agenda as more demographic groups become engaged in tax reform advocacy.

For the purposes of this discussion, state actors are a comparatively small group of individuals. Although committees worked on each version of EITC legislation, the present summary frames the policies and implementation as products of the president or party leader in a given historical era. In addition to simplifying the discussion, this is useful because it was an individual president who ultimately had to make the final strategic decisions as to how and when to include tax transfer policies in his welfare reform proposals.

## EITC PROGRAM OVERVIEW

The EITC is a refundable tax credit that moves an estimated 4 million people out of poverty each year (Waldfoegel 2009). The EITC is a refundable tax credit, which means a family can receive the credit even if they have no income tax liability. Nearly all families choose to receive the credit as a lump sum as part of their tax refunds (D. Meyer 2009). Although poorly communicated to the public several times during policy formulation, the EITC has a conceptual simplicity: it subsidizes work by poor parents and transfers income to them.

The EITC has grown from about \$4 billion in 1975 (converted to 1999 dollars) to about \$32 billion in 1999; no other federal antipoverty program has grown at a comparable rate (Hotz and Scholz 2001). In 2007, 17 percent of all tax filers claimed the EITC for a total of \$43.7 billion (Kneebone 2009). The program is designed so that working more hours

(phase-in period) will cause earnings to reach a specific threshold (plateau period), at which point the rate of return begins to decrease (phase-out period) (Neumark 2009). For a married couple with three children (filing jointly in 2009): 1) the credit increases during the phase-in period until income reaches a peak of \$5,656.50 (45% of \$12,570); 2) the credit plateaus until earnings increase beyond \$21,420; and 3) based on greater earned income, the EITC begins to phase-out until earnings exceed \$48,279, at which point the credit is zero (IRS 2009).

There has been considerable debate as to the potentially adverse effects of each EITC phase and the number of hours that parents may choose to work. A phase-out rate of 21.06% would mean that a worker loses 21 cents of EITC credit for each \$1 earned above the threshold (Romich, Simmelink and Holt 2007). For this reason, some argue that the EITC incentivizes work only during the phase-in period and that once the threshold is maintained, an individual has no reason to work more hours. Because many contextual factors such as marital status, joint filing, and number of children have been shown to influence how many hours workers may choose to work, there is an entire field of economic modeling dedicated to examining labor supply issues and EITC (Ellwood 2000). Acknowledging that phase-in/out issues are still problematic, the temporary 2009 and 2010 Recovery Act adjustments increased the phase-out range for joint filers by almost \$2,000 (CCH 2009).

#### TIMELINE: HISTORICAL ERAS AND STATE ACTORS

In the 1960s, there were attempts to invent strategies for using the tax system as a device for reducing poverty, including helping low-income families whose tax bills were already at zero. Lyndon Johnson's administration designed what are called Negative Income Tax (NIT) alternatives. These applied negative rates to unused tax exemptions and deductions or made a negative per capita credit (Ventry 1999). President Johnson, who had made his Economic Opportunity Act (1964) one of the cornerstones of the Great Society Program, preferred explicit pro-work, rehabilitative policies in contrast to the NIT proposal (5). In response, his administration began exploring a second category of programs called Guaranteed Annual Income (GAI). These programs provided a minimum income floor under every family and did not incorporate a phase-out system (6). Johnson was even less responsive to GAI proposals, but eventually combined the two policies in one approach. Richard Nixon later tried to bridge the gap between work incentives and minimum benefit levels with his Family Assistance Plan (1969), which contained minimal work requirements. Although the FAP failed,

it set an important tone for the 1970s legislation: successful tax transfer programs must address *both* anti-poverty and anti-welfare goals (13).

Senator Russell Long offered an alternative to both NIT and GAI plans with his “work bonus” credit proposal in 1972. He wanted to direct benefits towards the “deserving poor,” seen as those willing to work. His “work bonus” foreshadowed the EITC structure as it rose to a maximum credit of \$400, declined at a 25% rate from \$4,000, and phased out at \$5,600 (13). “Work bonus” credit proposals passed the Senate but failed the House three years in a row. However, when the country slipped into a recession, Gerald Ford passed the Tax Reduction Act (1975) and Senator Long strategically inserted part of his proposal into the tax code. Jimmy Carter proposed his Program for Better Jobs and Income (1977) but had to drop it because of internal disagreements. However, the EITC had gained enough stand-alone legitimacy to remain in his larger platform. The following year, the Revenue Act of 1978 made the EITC a permanent feature of the tax code, setting the foundation for future EITC expansions (25).

Ronald Reagan’s 1981 Budget Act cut Aid to Families with Dependent Children (AFDC) by 17.4%, removed 408,000 families from welfare rolls, and increased the poverty rate by two percentage points (Ventry 1999, 27); however, the EITC survived these dramatic changes and actually expanded under Reagan’s Tax Reform Act of 1986. In other words, conservative state actors were identifying the tax system as both the problem and solution to the rising inequalities of the 1980s. George Bush (1990) and Bill Clinton (1993) both expanded the EITC, and as Clinton ushered in welfare reform (1996) the EITC found itself in a unique place. While large numbers of families had been removed from welfare rolls and placed on Temporary Assistance for Needy Families (TANF), the EITC remained a consistently supported program. It survived reports of fraud (B. Meyer 1999) and weakened credibility precisely because it was still consistent with the shift towards work-oriented welfare reform policies.

President Barack Obama’s 2009 Recovery Act included some significant changes over previous tax transfer legislation, such as the “Making Work Pay” tax credit and a new one-time cash payment to selected families. Furthermore, his version of the EITC provides a new benefit to the 8.2 million low-income working families with three or more children (one-fourth of which had income levels below the poverty line in 2007) (IRS 2009). But his strategy still emphasizes tax credits over direct programs, favors in-kind benefits rather than cash for low-income families, and focuses on work supports instead of assistance to non-workers (D. Meyer 2009).

Howard (1997, 145) highlights several interesting similarities between how the program was enacted in the 1970s and the various reforms that the EITC underwent in following decades: president proposes comprehensive welfare reform, including EITC expansion; proposal generates widespread

and intense opposition; proposal is defeated; president abandons welfare reform; tax committees later expand EITC as part of larger revenue bill; EITC passes with little debate or societal input. This pattern is fully consistent with the tenets of state-centered theories of policy formation and implementation. Policy is primarily made in absence of interest group influence (e.g., antipoverty advocacy, organized labor) and public opinion (Pierson 1996) and state actors (e.g., committee chairmen, president) strategically focus on furthering their interests (e.g., career, institutional) by using the inherent powers of the state (e.g., congressional majority, procedural technicalities in tax code) to translate their goals into political action (e.g., blocking welfare reform, EITC expansion).

These examples point to an irony in EITC history: although the policy continues to straddle two precarious political arenas (i.e., welfare reform and tax relief), its history of enactment has been largely unremarkable. As a small part of a larger revenue bill it had no hearings or provision-specific votes (Howard 1997). As a result, the EITC involved little input from constituents or debate from interest groups.

## RECOMMENDATIONS

Over the last three decades, the EITC program has been applied to three main policy areas: tax, labor market, and antipoverty. Understandably, at times these various goals have conflicted with each other. How the credit is viewed depends on how much weight one gives to the appropriate role of the EITC in addressing social, economic, or political conditions. During different historical eras state actors often had to shift the focus of the EITC to respond to a purported social problem, be it “welfare dependency,” unemployment, or tax reduction. Because of this, state actors were frequently faced with limited windows of opportunity for how to re-brand the EITC and incorporate (or remove) it from their platform. The longevity of the EITC, bolstered by its place in the tax code, makes it very likely that it will continue to be a tax transfer program with which future administrations contend.

An interesting trend that creates an opportunity is the increasing number of states with EITC programs, of which there are now 22. These supplement the federal EITC (Neumark 2009), which means that the federal government could coordinate with state agencies to identify best practices for other states and counties developing EITC programs. For example, Wisconsin developed an EITC program with explicit reference to the higher incomes that are needed to keep families with three or more children out of poverty. Similarly, the Minnesota EITC includes a second phase-in range, developed to combat the fact that when many minimum-wage earners receive increases in wages or hours they lose cash assistance or

food stamps, and experience tax increases, the sum of which can make the family less financially stable than before (Hotz and Scholz 2001).

Another potential for rethinking the role of the EITC is reevaluating the criteria for receiving work support. For example, the temporary EITC expansions under the Recovery Act of 2009 targeted large families and are conservatively estimated to raise over 400,000 additional individuals above the poverty line (B. Meyer 2009). Similarly, Bernstein (2007) suggests that a basic-needs family budget is roughly 200% of the poverty threshold. The EITC should use this marker as an updated phase-out level. This would also help address the needs of moderately higher income families who may earn too much to qualify for other means-tested programs, yet still require a safety net. In addition to adjusting this threshold level, the actual phase out rate should be lowered in order to prevent benefits from decreasing too rapidly.

In addition to increasing the credit proportionately for family size and improving income cut-offs, EITC programs could also benefit from targeting families with young children. During the highly partisan childcare debates following the 1988 election, President Bush briefly proposed this as strategy to counter congressional Democrats' childcare supplements. Further research is warranted as recent evidence stresses the importance of addressing deep and persistent poverty experienced early in childhood. For example, Heckman (2006) specifically advocates for economic investments during early childhood. Family income in early childhood appears to be more influential for child ability and achievement, in comparison to investments in middle childhood and adolescence (Magnuson and Votruba-Drzal 2009).

Proponents of comprehensive antipoverty programs note that the EITC effectiveness can be increased by pairing it with minimum-wage legislation and closer alignment with family support measures such as childcare tax credits and the dependent care tax credit (Levitan et al. 2003). Innovative strategies in savings and investments are equally necessary to ensure that working poor families can build capital and increase the likelihood of remaining out of poverty.

The First Account program in Chicago offers one such model. The Center for Economic Progress provides free tax preparation for EITC-eligible filers and targets individuals without bank accounts. Filers are assisted in setting up free bank accounts and are eligible to have their EITC funds directly deposited. Data shows that these individuals were equally likely to be using their account compared to (self-selected) individuals that opened accounts after completing a financial education workshop (Mullainathan and Shafir 2009). The federal government can encourage the automatic transfer of EITC funds into bank accounts on a larger scale. This would reduce administrative costs by streamlining EITC dispersal, and also empower communities that traditionally have limited access to building capital.

## CONCLUSION

The political narrative of the EITC offers a glimpse of hope in an increasingly contentious political landscape. For example, during the 1986 and 1990 EITC expansions, Republicans controlled the White House, and Democrats lead the House of Representatives, but in the midst of a gridlocked partisan environment, and centrist intraparty fractions in the Democratic Party, decisive legislative decisions were still reached. The political history of the EITC also holds lessons for advocates. Societal actors and interest groups were largely absent from tax reform discussions; however, organized labor, business, antipoverty, and children's groups have all advocated for EITC expansion at some point. It may prove useful for advocacy groups to remain abreast of tax policy given the reemergence of fiscal responsibility themes recently. If social change through tax reform has been a more palatable strategy than traditional welfare reform it is important for progressive groups to both anticipate challenges in this specific area and also frame antipoverty issues in appropriate terms.

Throughout the last 35 years, none of the various competing senators, presidents, committee chairs, or advocacy groups has ever let another group *claim* the EITC as its own. Using Howard's (1997, 141) term, the EITC's unique "ambiguity" as an open-ended tax expenditure allows a wide range of state actors to tie the program to a variety of issues, and defend it using moral, economic, social, or political arguments. As more groups stake particular interests in the EITC, a disambiguation process could occur and EITC policy could thus evolve in unforeseeable ways.

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