Testimony by
Jeffrey B. Liebman*
Assistant Professor of Public Policy
John F. Kennedy School of Government, Harvard University

Provided to the
Committee on Finance
United States Senate
Washington, D.C.

March 7, 2001

Mr Chairman, Ranking Member Baucus, Distinguished Members of the Committee:

I want to thank the Committee for the opportunity to testify about the Earned Income Tax Credit (EITC), one of the great success stories of recent American economic policy.

The Earned Income Tax Credit was enacted twenty-five years ago under economic circumstances remarkably similar to those that we face today. When President Ford assumed office, the country was heading into the worst recession since World War II. In January 1975, in his first State of the Union Address, President Ford proposed a large tax cut, in the form of a rebate of taxes paid in 1974, with the goal of getting the economy moving again. This committee, under the leadership of Chairman Russell Long, modified the President's proposal, adding a new program called the Earned Income Tax Credit to ensure that all working families received a boost to their incomes as part of the economic stimulus package. Thus began the process of redesigning the U.S. system of income support into one that makes work pay.

The expansions in the EITC enacted with the support of President Reagan in 1986, President Bush in 1990, and President Clinton in 1993 have continued the process of making work pay for low-wage workers. As recently as 1993, a single-parent family with two children and a full-time minimum wage worker made $12,131 (in today's dollars) with the EITC, well below the poverty line. Because of the expansions in the EITC during the 1990s, that family now makes $14,188 – a 17 percent boost that puts the family above the poverty line. The Census Bureau estimates that the EITC lifts 4.3 million people out of poverty, including 2.3 million children.

---

* Contact information: Telephone: (617) 495-8518. Email: jeffrey_liebman@harvard.edu.

Moreover, the expansions of the EITC have dramatically changed the work incentives facing single mothers. In 1986, a single mother who left welfare and took a job paying $10,000 a year would have received an increase in her income of only $1861; lost welfare benefits and increased taxes would have offset 81 percent of her earnings. Thus there was hardly any incentive for her to leave welfare. In 1998, in contrast, she would have received an increase of $6875. The EITC is responsible for most of the improvement in the work incentives for single mothers over this time period.[1]

These changes in work incentives have been a major factor in the reductions in welfare case loads and the increases in work that we have seen in recent years. As the table below shows, in 1986 only 73 percent of single mothers worked at some point during the year (most of the rest received welfare). By 1993 that number had risen slightly to 75 percent. But over the past decade, this number has reached 89 percent. While welfare reform and the economic expansion clearly played a role in this remarkable increase in work, the leading study on the issue concluded that the EITC was the most important factor – responsible for 63 percent of this increase in the annual labor force participation rate for single women.[2]

Annual Labor Force Participation Rate of Single Women with Children

1986	73%
1993	75%
1999	89%

Source: Author's calculations from March Current Population Surveys. Samples include women with children who are widowed, divorced, or never married, ages 16-45 who are not disabled or in school.

While the successes of the EITC in boosting the incomes of low-wage workers and making work pay are truly remarkable, there are two potential problems with the credit that deserve additional attention from policy makers. First, the phaseout of the credit creates high marginal tax rates for some EITC recipients. Second, a significant fraction of EITC payments are made in error.

For families with incomes above $12,700, the EITC is phased-out at a rate of 15.98 percent for families with one child and 21.06 percent for families with two or more children. Because some families affected by the EITC phaseout also have positive pre-EITC federal income tax liability and therefore face a marginal tax rate of 15 percent, the total marginal tax rate from the federal personal income tax for these families can be as high as 36 percent. Only very high income taxpayers face higher marginal tax rates. Indeed I have calculated that 55 percent of families with children facing marginal tax rates above 30 percent are EITC recipients with incomes below $32,000.[3] Most of the rest have incomes above $100,000. Since these EITC families also face marginal tax rates from the OASDHI payroll tax, from state income taxes, and from the phaseouts of means-tested benefits such as food stamps and housing assistance, their total marginal tax rates can easily exceed 50 percent and, as President Bush has emphasized, potentially represent a significant toll gate on the road to the middle class.

Second, a recent IRS study of taxpayers claiming the EITC in 1997 found that 25.6 percent ($7.8 billion) of EITC claims were made in error. While there are a number of reasons why this number overstates the true cost to the Treasury of erroneous EITC payments, it is clear that there continues to be a significant EITC compliance problem. Most EITC errors are associated with the complicated tax code provisions governing family issues, particularly which taxpayer is allowed to claim a child for the purposes of the EITC. Examples of these kinds of errors include: a divorced father who shares custody of the child and provides child support but incorrectly claims the EITC because the child spends slightly more than half the nights of the year at the mother's home; a mother who is ineligible to claim her child because she lives in her own mother's home, and her mother has slightly higher income than she does; and a mother who is ineligible because she is separated from her husband, but cannot afford to obtain legal separation papers. Because the tax laws governing the EITC, the child credit, and dependent exemptions differ, a taxpayer can sometimes quite legally claim one type of child benefit but be breaking the law if they claim another.

President Bush's tax proposal would make significant progress in reducing the high marginal tax rates faced by EITC recipients because fewer EITC recipients would have positive pre-EITC federal income tax liability; therefore their marginal tax rates would fall by 15 percentage points. However, a substantial number of families with one child would still face high marginal tax rates. Moreover, the President's plan would do nothing to reduce the complexity created by the differing eligibility rules for the EITC, the child credit, and the dependent exemption. It also does less than it could to reduce marriage penalties related to the EITC.

I would urge the Members of this Committee to use this year's tax bill not only to cut taxes but also to simplify the tax code. By combining the EITC, the child credit, and the exemption for dependent children into a single tax credit it would be possible both to eliminate the high marginal tax rates and marriage penalties faced by some EITC recipients and to greatly reduce the complexities that produce the EITC compliance problem. My colleague David Ellwood is speaking to you tomorrow about a specific proposal along these lines that he and I have developed.

In conclusion, the EITC has been remarkably successful in moving people from welfare to work. Now it is time to remove the barriers that could prevent these new workers from moving into the middle class.

1. David T. Ellwood, “The Impact of the Earned Income Tax Credit and Social Policy Reforms on Work, Marriage, and Living Arrangements,” National Tax Journal, December 2000.

2. Bruce D. Meyer and Dan T. Rosenbaum, “Welfare, the Earned Income Tax Credit, and the Labor Supply of Single Mothers,” NBER Working Paper No. 7363, 1999.

3. David T. Ellwood and Jeffrey B. Liebman, “The Middle Class Parent Penalty: Child Benefits in the U.S. Tax Code,”NBER Working Paper No. 8031, 2000.