

Fiscal Fact

Case Study #7: The Earned Income Tax Credit

By

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These results are part of an eleven-part series, *The Economics of the Blank Slate*, created to discuss the economic effects of repealing various individual tax expenditures. In these reports, Tax Foundation economists use our macroeconomic model to answer two questions lawmakers are considering:

1. What effect does eliminating these expenditures have on GDP, jobs, and federal revenue?
2. What would be the effect on GDP, jobs, and federal revenue if the static savings were used to finance tax cuts on a revenue neutral basis?

Key Points:

Eliminating the EITC would:

- Increase tax revenues by \$56 billion on a static basis;
- Increase GDP by \$34 billion; and
- Produce slightly more revenues (\$64 billion) on a dynamic basis;
- Increase employment by the equivalent of approximately 274,000 full-time workers; and
- Produce little change in hourly wages.

Eliminating the EITC and trading the static revenue gains for individual rate cuts would:

- Allow for an across-the-board rate cut of 5.7 percent;
- Boost GDP by \$125 billion per year; and
- Boost federal revenues by \$29 billion on a dynamic basis;
- Increase employment by the equivalent of approximately 783,000 full-time workers; and
- Increase hourly wages by 0.1 percent.

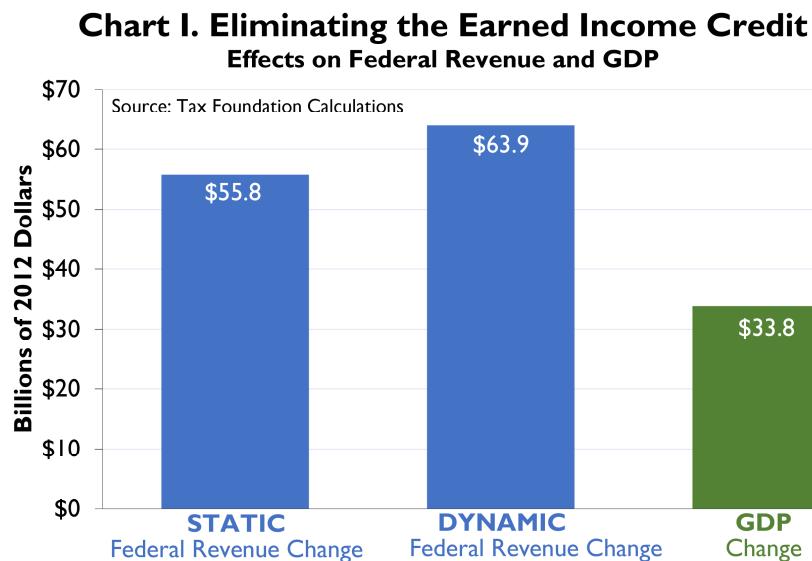
The Earned Income Tax Credit (EITC) was introduced into the tax system in 1975 as a small tax subsidy for the working poor with children. It has been expanded several times and now includes benefits for low-income earners without children, with one child, with two children, and with three or more children. The credit is refundable; after the credit has reduced a filer's tax liability to zero, the filer is eligible to receive the remainder as a check from the government. The refundable part is technically classified as an outlay in

federal budget documents, but people determine the entire credit on their tax forms. The JCT notes that its measure of the tax expenditure includes both the nonrefundable and (much larger) refundable portions.

The EITC has three phases. In the first, each added dollar of earned income receives a federal matching credit, which sharply lowers the marginal tax rates of filers whose incomes are within that range. In the second phase, extra earned income has no effect on the credit's size and no effect on marginal tax rates for filers whose incomes are on the plateau. In the third phase, extra income reduces the credit, which means that the phase-out sharply raises the marginal tax rates of filers whose incomes are within the phase-out range.

For example, in 2012, a single parent with three or more children received a 45 percent match on each dollar of earned income from zero to \$13,090 (a marginal tax rate, or tax subsidy, of minus 45 percent), a constant EITC of \$5,891 if earned income was in the range \$13,090 to \$17,090 (no marginal tax rate effect), and lost the credit at a rate of 21.06 cents for each extra dollar of income over the range \$17,090-\$45,060 (an effective marginal tax rate spike of 21.06 percent). The phase-in powerfully encourages people with very low incomes to work. The phase-out strongly discourages the larger number of people with somewhat higher incomes from working more. It is an empirical question what the net effect on the nation's labor supply is.

When the Tax Foundation's Taxes and Growth model is run under the conventional static revenue estimation assumption that all macroeconomic aggregates are fixed, it appears that eliminating the EITC would lift federal revenue by \$56 billion. (See Chart 1.) This is close to the Joint Committee on Taxation's estimate that the EITC was a \$59.0 billion tax expenditure in 2012.



When our model is rerun under the dynamic assumption that marginal tax rate changes alter aggregate investment, employment, and economic activity, the model estimates that the negative impact of the phase-out depresses the labor supply by more than the phase-in bolsters the labor supply. Once the economy has adjusted, GDP would be \$34 billion higher without the EITC. Because of the growth effect, the model further estimates that the dynamic revenue increase, \$64 billion, would exceed the static estimate.

The growth could be enhanced if the added revenue financed a cut in marginal tax rates. Chart 2, below, shows the outcome if the size of the rate cut were geared to the conventional static revenue estimate. Individual income tax rates could be dropped 5.7 percent (for instance, the current 25 percent rate would become 23.6 percent). The model estimates that as a result of trading the EITC for an across-the-board tax rate reduction, GDP

would be a net \$125 billion larger than otherwise and federal revenue would be a net \$29 billion higher.

We believe that, on net, the EITC probably reduces total hours worked as people who are already in the labor force react adversely to the phase-out. However, several studies have found that the EITC encourages some people to enter the work force who otherwise would not at a rate greater than this model assumes. On the other hand, a second effect outside the model cuts in the other direction. A long series of studies by government watchdog agencies have found a considerable amount of EITC fraud, with over 20 percent of payments being improper.¹ In cases where people have filed tax returns claiming phony work and phantom earned income in order to receive real EITC payments, the credit could be removed with no reduction in work effort in any area except for tax fraud investigation.

Finally, we determined the impact of these scenarios on employment and wages. We found that eliminating the EITC would increase employment by the equivalent of about 274,000 full-time workers with little change in the hourly wage. With the rate cut offset, employment would increase by the equivalent of about 783,000 full-time workers and hourly wages would rise by 0.1 percent.

Chart 2. Using the Static Revenue Gain from Eliminating the Earned Income Credit to Pay for an Across-the-Board Rate Cut Effects on Federal Revenue and GDP



¹ See, e.g., Government Accountability Office, Beryl H. Davis, *Improper Payments: Remaining Challenges and Strategies for Governmentwide Reduction Efforts*, GAO-12-573T, Mar. 28, 2012, <http://www.gao.gov/assets/590/589681.pdf>.

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