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# Potential Impact of EITC Adjustments on Financial Self-Sufficiency among Low-Income Families: A Simulation Model

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*Policies that help low-income mothers find and keep employment as a means of obtaining self-sufficiency have been a focal point of the welfare reform debate in the past decade. In the midst of this dialogue, the Earned Income Tax Credit (EITC) has gained popularity as one of the core work support programs for America's low- and moderately low-income families with children. This study compares the estimated effects of EITC when its value deteriorated in the late 1990s with that of a simulated EITC for which the real value kept pace with the actual cost of living on welfare caseload reductions. Results indicate that the simulated EITC model showed a significantly greater impact on promoting financial self-sufficiency among low-income families. Policy and practice implications for strengthening the purchasing power of the EITC conclude this article.*

*Key words: Earned Income Tax Credit, cost-of-living, low-income working families, families with children, financial self-sufficiency*

Over the past decade the focus of welfare policies has shifted from providing a social safety net to providing conditional and transitional support to families with children

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headed by single mothers. This shift in focus started gradually in the 1980s when the federal government began waiving some program requirements governing Aid to Families with Dependent Children (AFDC), thus allowing states to run their own welfare programs to reduce burgeoning welfare caseloads. This change process swiftly overhauled the welfare system in the U.S. in the 1990s when former president Clinton signed the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) into law in 1996. PRWORA replaced AFDC with Temporary Aid to Needy families (TANF), a policy that discontinued entitlement programs to poor families, and capped funding at the 1994 level of state spending on financial assistance for eligible residents of those states.

In response to both the growing number of single mothers receiving AFDC benefits and to the heightening negative sentiment of the public toward public assistance, states implemented a new set of welfare rules whose primary goal was to increase the participation of those on welfare in the workforce through work incentives. Between 1994 and 2000 new and stricter welfare eligibility and program rules were implemented. At the core of the overall work support package is the federal Earned Income Tax Credit (EITC), a cash benefit paid to low-income working families through the tax system. Low-income families with positive labor earnings are eligible for the EITC, a refundable tax credit. Previous research shows that the federal EITC, along with other work-enforcing policies, significantly reduced welfare caseloads during the years following its widespread expansion in the 1990s (Lim, 2008, 2006). However, the real value of the federal EITC for low-income working families has actually deteriorated since 1998 and through 2000, the period of observation for this current study. This current research extends the primary author's (2008) previous work, which estimated the effect of the fully phased-in federal EITC and state supplemental EITCs on welfare caseload reductions between 1994 and 2000. That investigation controlled for the influence of AFDC waivers and TANF implementation; macro-economic, demographic and political factors; and other state-specific and time-specific unobservables. Using the same data set, this current study estimates the effects of EITC on welfare caseload reductions for the time period during which its value

actually deteriorated (after 1997) between 1998 and 2000. These latter estimated effects are then compared to the effects of a simulated EITC for the same three years, using a hypothetical model that retains the real value of the EITC by keeping pace with the actual cost of living. The purpose of this present study is to provide empirical evidence for policymakers who are in a position to annually modify and adjust the federal EITC to ensure that it viably subsidizes the income of the working poor while simultaneously retaining their participation in the labor force.

## Review of Literature

### *The Federal EITC: Definition and History*

The federal EITC provides a cash benefit to low-income working families through the tax system. To receive the EITC benefit, a family must have positive labor earnings and total income less than a specified threshold, and they must file for the credit. The size of the credit depends on the number of children in the family. The family receives a refund if the tax credit exceeds the tax the family would otherwise owe.

The EITC schedule consisted of three ranges in 2000. If a family had no earnings from labor, then it received no credit. In the phase-in range, the EITC acted as a wage subsidy; that is, as the family's earnings increased, the credit amount also increased. In the stationary or plateau range, the family received a maximum credit amount, regardless of earnings. In the phase-out range, the EITC performed similarly to a negative income tax as the family earnings continued to increase. Then, finally, if the family earnings exceeded the specified ceiling, the family received no credit.

The EITC was first enacted in 1975 as a means of offsetting the tax burden to low-wage taxpayers with children, by providing these taxpayers with relief from the Social Security payroll tax (Hoffman & Seidman, 1990; Scholz, 1993) and enhancing incentives to work (Childman, 1995). When enacted in 1975, the EITC parameter was 10% of the first \$4,000 of earned income and was phased out at a rate of 10 cents per dollar of earnings or Adjusted Gross Income (U.S. House of Representatives, 1996). Over time, changes in legislation have

adjusted the income range affecting EITC eligibility and maximum credit amounts. With the Tax Reform Act (TRA) of 1986, the EITC became an integral component of national anti-poverty efforts. With the passage of the TRA, the dollar amount of the EITC was indexed for inflation (U.S. House of Representatives, 1996), and, as a result, nearly offset all of the erosion that occurred between 1975 and 1984. It is important to note that the actual value of the EITC's maximum credit, in real terms, had eroded by 35% (Steuerle & Wilson, 1987). By adjusting the EITC, the 1986 TRA eliminated the tax burden for more than six million impoverished Americans who were facing deteriorating wages and continued poverty (Conlan, Wrightson, & Beam, 1988).

#### *EITC Expansions in the 1990s*

The TRA of 1986 restored the original value of the EITC, subsequently reducing the tax burden on low-income families. However, a more substantial expansion of the credit was implemented with the passage of the Omnibus Budget Reconciliation Act (OBRA) of 1990 and 1993. OBRA 1990 substantially increased the maximum credit and also began differentiating between families with only one child and families with two or more. The Clinton administration placed the EITC at the center of its plan to make work a more attractive alternative than welfare, and additional changes were enacted in 1993. The 1993 bill extended the credit to childless, low-income working adults (Ventry, 2000), although the credit amount was minimal. The rate remained constant for seven consecutive years (U.S. House of Representatives, 2000). In 1996, when OBRA was fully phased in, taxpayers with two or more qualifying children could claim a credit of 40% of their earnings up to \$8,890, resulting in a maximum credit of \$3,356. This maximum credit amount was available to those with earnings between \$8,890 and \$11,610. The credit benefit began to phase out at a rate of 21.06% of earnings above \$11,610. The credit was incrementally and ultimately phased out when earnings reached \$28,495 (U.S. House of Representatives). Thus, between 1984 and 1996 the total annual EITC amount in nominal dollars received by low-income families with children increased tenfold (U.S. House of Representatives). By 1996, the

EITC had become the largest means-tested transfer program for low-income working families with children (Phillips, 2001). Total EITC spending per family alone (\$31,900) in 1999 exceeded the combined amounts spent on TANF (\$13,449) and food stamps (\$15,766). [See Scholz and Levine (2002) for complete data.]

Expansion of the EITC program not only substantially offset the costs of Social Security taxes, but also offered an alternative approach to families living in poverty which demonstrated a commitment to participation in the labor market. As Scholz (1993) aptly observed, the fact that the EITC program has successfully provided income supplements to poor families without undermining work incentives undeniably justifies retaining EITCs in the anti-poverty legislation tool kit. What distinguishes the EITC from traditional welfare programs is that a person is expected to work in order to be eligible for the credit. It should be noted, however, that the EITC program is similar to other welfare programs in several ways. First and foremost, it is a means-tested program that seeks to change the work behaviors of potential or current recipients of the benefit (from underemployment or unemployment to gainful employment). Families may become ineligible for the credit as they steadily work and increase their earnings, well before they are financially self-sufficient. Further, families may resent being taxed (while the government is making a payment) on their additional earnings in the phase-out range due to its relatively higher marginal tax rate, which results in increasing net gain at a decreasing rate when compared with the rates by which net gains increase for families during the EITC phase-in period. Nevertheless, unlike previous welfare programs, the EITC unequivocally promotes employment for three reasons: (a) the credit increases with the workers' earnings during the phase-in period; (b) the credit rate decreases much less rapidly than typical welfare benefits during the phase-out period; and (c) the income level at phase out is much higher than that of TANF.

#### *Previous EITC Research*

A large body of literature describes the EITC (Dickert-Colin, Fitzpatrick, & Hanson, 2005; Phillips, 2001), and

describes its impact on various employment and income outcomes among single mothers (Blank, Card, & Robbins, 1999; Ellwood, 2000; Eissa & Liebman, 1996; Meyer & Rosenbaum, 2001), changes in welfare caseloads (Acs, Phillips, & Nelson, 2003; Council of Economic Advisors [CEA], 1999; Fender, McKernan, & Bernstein, 2002; Grogger, 2003), and poverty in households with children (e.g., Blank, 2002; Caputo, 2006; Johnson, Llobrera, & Zahradnik, 2003).

Researchers who have conducted welfare caseload studies using theoretical modeling (Acs et al., 2003; Fender et al., 2002) and quantitative empirical methods (Blank, 2002; CEA, 1999; Grogger, 2003; Ziliak, Figlio, Davis, & Connelly, 2000) have identified several factors that historically have contributed to welfare caseload reductions, such as lengthy and robust economic expansion, welfare policy changes, and other work-support programs, among which the EITC consistently emerges as a significant explanatory predictor. Results are consistent across the above-mentioned studies, regardless of the type of data used (i.e., micro data, administrative data, pre- and post-1996 data, and yearly and monthly data). However, because concepts were inconsistently operationalized in this body of research, estimates of the relative importance of factors used in the different models vary considerably across studies. Nevertheless, as a whole, studies show that the EITC has increased employment among families headed by single mothers (Meyer & Rosenbaum, 2001) and that it reduces poverty by providing work incentives to low-income families headed by single mothers with children, the population historically most prone to welfare dependency (Blank, 2002; Eissa & Liebman, 1996). In fact, single women with children are the largest group of workers eligible for the EITC, and families headed by single mothers comprise nearly 50% of the EITC-eligible population. It is estimated that three fourths of those eligible have participated in the EITC program during the 1990s (Dickert-Conlin et al., 2005).

According to Blank (2002), the sharpest increase in employment during the mid-1990s was found among lower-skilled single mothers with young children. Further, Meyer and Rosenbaum (2001) estimated that federal EITC expansions alone explained an approximate 60% increase in

employment during the 12-year time period between 1984 and 1996. Grogger (2003) similarly found that EITC expansions during the 1990s were the single most important policy change that contributed to reductions in welfare use via increased employment and earnings among single mothers. However, Grogger (2003) may have overestimated the true effects of the EITC on welfare use because he neither considered the circumstances of those who remained ineligible for welfare benefits nor controlled for other influential work-related welfare and non-welfare policies.

Despite substantial theoretical and empirical evidence that the EITC is significantly linked to increased employment and income, there is no current research that examines the largest and most recent expansions of the EITC program on welfare caseload reduction. Further, no study has examined how the continued erosion of this credit between 1998 and 2000 has impacted poor, working families. For example, the maximum EITC credit was \$3,756 in 1998, but decreased to \$3,734 (in 1998 dollars) in 1999 and then further decreased to \$3,680 (in 1998 dollars) in 2000. This current study estimates the impact of recent expansions of the EITC program on welfare caseload reductions and then compares these latter estimates with those of a simulated model in which the EITC is hypothetically and fully indexed to the cost of living for the years 1998, 1999, and 2000.

## Method

### *Conceptual Framework*

This study, which extends the primary author's (2006) previous research, employs a pooled time-series, fixed-effects model with welfare caseloads serving as the dependent variable. Federal and state EITCs, welfare policy, and demographic, economic, and political variables comprise the independent variables. Consistent with the author's previous work, the model for this current study uses the following natural logarithm form by:

$$\ln y_{it} = \alpha_i + \beta_1 * EITC_{it} + \beta_2 * \chi_{it} + \delta_t + \eta_{it} + \varepsilon_{it}.$$

The dependent variable is  $y_{it}$ , which is welfare caseloads measured for state  $i$  in year  $t$ . The intercept  $\alpha$  is the individual state effect, which is taken to be constant over time. EITC is the Earned Income Tax Credit variable;  $\chi$  is a vector of other explanatory variables (e.g., demographic, economic, welfare, and political variables);  $\delta_t$  is time effect (constant across states);  $\eta_{it}$  is the state-specific time trends (the interaction of state dummies and the linear time trend variables);  $\beta$  is a vector of coefficients; and  $\varepsilon_{it}$  is the cross-section, time-series error component, which represents the effects of omitted variables specific to the state in a given time period.

Welfare caseload data were compiled from 50 states and the District of Columbia. Thus, 51 panels of annual, aggregate-level data, for the seven-year time period from 1994 through 2000 were available for analysis. (See Lim [2008] for a fuller description of data sources and variables.) Mathematical computations rather than statistical procedures were performed to calculate the subsidy rate for the years during which real value of the EITC deteriorated (1998, 1999, and 2000).

#### *EITC Simulation Measures*

A basic model (Model A) is adapted from the primary author's (2008) research to this current EITC simulation study. The dependent variable, AFDC and TANF aggregate caseload data by state in each year, was defined as the natural log of the ratio of the number of recipients to the number of females between the ages of 15 and 44. The independent variables include the federal EITC and state EITCs, welfare policy changes, unemployment, political environment, and educational attainment. The EITC phase-in subsidy rate is a key parameter of the federal EITC used and state EITC is coded as a dummy variable for each year in the state in which it is implemented. Welfare policy changes during two distinct time periods were dummy coded in each state for the year observed: one to capture the period during which any major waiver was in effect and one to capture the period during which TANF was in effect. AFDC and TANF maximum monthly benefits for a family of three for each state and year are defined in the natural log form. The unemployment rate is used to measure the effect of macroeconomic performance on welfare caseloads. Three political

variables that capture the effect of political influences on welfare caseloads are measured as dummy variables (Blank, 2001) and are entered and tested simultaneously. If the governor of a state was a Democrat, if the majority of both state Houses and Senates was Republican, and if the majority of both state Houses and Senates was Democrat, a 1 was assigned to each condition, respectively. Educational attainment is measured as the proportion of people over 25 years of age who completed high school.

In sum, this study builds upon the primary author's (2008) previous research that used administrative data for the years 1994 through 2000. This current study incorporates a simulated model to compare the eroded phase-in rate (in real dollar terms) of the EITC on welfare caseload reduction with a phase-in rate that is hypothetically indexed to the cost of living for the years 1998, 1999, and 2000. The present study hypothetically indexes the EITC phase-in rate to the cost of living while controlling for (a) maximum monthly benefits; (b) the minimum wage; (c) economic, political, and educational factors; (d) AFDC waivers; and (e) TANF implementation.

## Results

### *Mathematical Computations of the EITC Subsidy Rate*

The EITC subsidy rate for families with multiple children has increased to 40% of the family's earned income since 1996, and, in nominal dollars, a family with multiple children could receive the EITC maximum credit of \$3,556 in 1996. However, the EITC maximum credit amount a family with two or more children could receive in 1996 was \$3,694 (in 1998 dollars). This maximum credit actually increased to \$3,756 in 1998, but decreased to \$3,734 (in 1998 dollars) in 1999. This credit amount further decreased to \$3,680 (in 1998 dollars) in 2000. If the credit level had been kept to at least the 1998 level, the maximum credit in 1999 would have been \$3,839 instead of \$3,816, in nominal dollars. This means that the phase-in subsidy rate of the federal EITC concomitantly should have increased from 40.00% to 40.42% between 1998 and 1999 for families with multiple children. Further, the phase-in rate of the EITC should have increased to 41.56% in 2000 in order to prevent erosion of

Table 1. Comparison of Effects of the EITC and Simulated EITC on the Welfare Caseloads

Variable	Current EITC	Simulated EITC
Federal EITC phase-in rate	-0.012*** (0.001)	-0.016*** (0.001)
Adoption of state EITC	-0.242*** (0.008)	-0.238*** (0.010)
Log (Maximum welfare benefits)	0.185** (0.091)	0.372** (0.165)
Log (Monthly minimum wage)	-2.252*** (0.180)	-2.393*** (0.071)
Unemployment rate	0.136*** (0.006)	0.080*** (0.030)
Republican governor	-0.101*** (0.009)	-0.086*** (0.025)
Both State Senate & House Republican	-0.051*** (0.013)	-0.075*** (0.013)
Both State Senate & House Democrat	0.007 (0.011)	0.024 (0.065)
Percent with high school diploma	-0.017*** (0.002)	-0.008*** (0.002)
Any major AFDC waiver implementation	-0.064 (0.069)	-0.036 (0.068)
TANF implementation	-0.169*** (0.016)	-0.097*** (0.034)
State-Fixed Effects	Yes	Yes
Time-Fixed Effects	Yes	Yes
R-Square	0.997	0.997
F-Statistics	8113.95	10510.16

Note. N = 357 (51 states from 1994-2000).

\*p < 0.10. \*\* p < 0.05. \*\*\* p < 0.01.

the real dollars of the EITC maximum credit.

### *Simulated EITC Model*

Table 1, column 2 presents the estimated coefficients of the variables from the simulated model, which was performed to estimate the effect of the EITC phase-in subsidy rate on welfare caseload reductions, assuming that this rate remained constant, rather than deteriorated in real value, at the 1998 benefit level.

As seen in Table 1, the results from the model that includes the simulated EITC phase-in subsidy rate show the larger coefficient of -0.016 in Column 2, as compared to the coefficient -0.012 in Column 1 of the current EITC. This means that a 1% increase in the EITC subsidy rate resulted in a 1.2% decrease in welfare caseloads with the EITC value eroded. This same increase in the EITC subsidy rate (1%) would have resulted in a 1.6% decrease in welfare caseload if the EITC subsidy rate had not eroded and had kept pace with the actual, current cost of living. (Readers interested in a full description of the relative impact of other variables on welfare caseload reduction listed in Table 1 are referred to the primary author's 2008 study.)

## Discussion

This study estimated the impact of the EITC on reduction of welfare caseloads by comparing the estimated effects with those obtained using a simulated model in which the real dollar value of EITC benefits was maintained at the 1998 level, thereby preventing erosion of the benefit due to inflation. Results show that the EITC would have had a larger impact on the decline in welfare caseloads had it kept pace with the cost of living during the years 1998, 1999, and 2000. In the hypothetical model, a 1.0% increase in the EITC subsidy rate was associated with a 1.6% percent decrease in welfare caseload. In more practical terms, the federal EITC would have been instrumental in rendering approximately 722,525 people ineligible for welfare benefits in any given year from 1994 through 2000, holding all other factors constant. This suggests that had the EITC amount been sustained to prevent erosion of its purchasing power, the EITC could have been even more effective in moving a greater number of families toward financial self-sufficiency. It is useful

to note that, in this study, "financial self-sufficiency" is defined as moving off of welfare or leaving public assistance as defined in Caputo's (1997) earlier study.

It is important to note that a limitation of this study is the use of administrative data, which precludes consideration of the circumstances of those who are removed from welfare caseloads and those who remain ineligible for benefits. This piece of information is an important factor when assessing the strength of work support programs, in light of the fact that many families ineligible for welfare benefits continue to receive other means-tested benefits, such as food stamps, Supplemental Security Income, and housing and child care subsidies, whether they are working or not (Besharov, 2006; Danziger & Seefeldt, 2000).

This current study makes an important contribution to knowledge about the EITC and outcomes of welfare reform efforts. This study presents compelling evidence that the EITC supports poor people who are committed to work and to receiving employment earnings. As many states further restrict eligibility for welfare benefits by imposing work requirements and by providing time-limited aid to their most destitute population, the findings of this study underscore the importance of federal- and state-level governmental accountability for strengthening a holistic work support approach that benefits those whose goal is to achieve financial self-sufficiency. This study also emphasizes the importance of continually adjusting EITC amounts to keep pace with the cost of living. Without adjusting for the effects of inflation, the EITC cannot viably provide wage subsidies of sufficient real-dollar value. Indeed, a more generous subsidy rate would increase the proportion of low-income families whose poverty is alleviated as they move toward greater financial self-sufficiency. If the real value of the EITC continues to erode, as it did during the time period between 1975 and 1985, then the EITC will lose its effectiveness as a viable component of the anti-poverty armamentarium. If this trajectory remains unaltered, then the EITC likely will suffer the fate of its welfare policy predecessors, AFDC and TANF. And, of course, the real victims of policy implementation failure are the children living in families whose income needs are never sufficiently met.

Future research should study the effects of changes in subsidy rates in relation to labor behavior using micro data, while controlling for economic and non-economic variables. Changes in family members' work behaviors intuitively would vary according to how EITCs are perceived. In other words, whether prospective EITC users see EITCs as a reward or a penalty depends upon how knowledgeable they are about how EITCs work. From a more practical standpoint, however, their perceptions of any benefit are inextricably linked to their experiences of financial need and their daily challenges with material hardship. For many families who struggle to make ends meet, it may not be realistic for them to forego traditional benefits during the months they need income, even though they intellectually understand the potential benefits of receiving a higher lump-sum payment from the EITC at the beginning of the subsequent calendar year.

More recently, the Economic Growth and Tax Relief Reconciliation Act of 2001 removed the marriage penalty for many couples and their families by increasing beginning and ending amounts of the phase-out ranges for married taxpayers who file a joint return (Seidman & Hoffman, n.d.). However, this policy has little effect on low-income, working families who are absolutely poor and who cycle in and out of the welfare infrastructure, facing temporary but frequent ups and downs. This brings us back to the most critical issue that the EITC is but one complementary program that comprises a holistic network of anti-poverty and family-strengthening social welfare policies and programs. The EITC cannot and should not replace a financial safety net for those who either cannot work or should not be expected to participate in the labor market, including single mothers with few work support resources who are rearing young children. Although married mothers with younger children are not forced into the labor market by societal norms, the same cannot be said of single mothers, whose work and marital choices have been the target of behavioral modification via punitive welfare reforms. A relatively sluggish reduction in child poverty while welfare case-loads plummet and income gaps widen (despite widespread, full-time, employment among single mothers) reflects the need for a far more comprehensive approach to addressing issues

of welfare dependency, child poverty, and work and marital choices among low-income single mothers.

With the devolution of responsibility for social welfare programs from the federal government to the states, it is timely for social workers to begin assisting state and local policymakers with clarifying and carrying out their new responsibilities more effectively. In terms of direct practice, workers employed in social service agencies that provide financial counseling should pay closer attention to the tax-filing histories and self-employment behaviors of their EITC-eligible clients. Such persons should be educated about their eligibility for the EITC. Self-employed clients should be provided with information about the economic advantages of filing for the credit. In order for practitioners to competently assist low-income families, social workers must be educated about EITCs and, when applicable, about how such programs are administered and implemented in their respective states. This is consistent with recommendations for schools of social work to include contemporary policy practice issues in their policy curricula (Rocha & Johnson, 1997), as well as to highlight policy practice approaches that concretely link social work with social policy (Weiss, Gal, & Katan, 2006).

At the present time, few low-income families receive traditional welfare benefits when they are not working. Thus, an appropriate focus for social workers and policymakers is working families in poverty (a) who no longer receive welfare benefits, (b) who have gained financial self-sufficiency, (c) who have not sought benefits (despite their eligibility), and (d) who have never been eligible for welfare benefits (Pear & Eckholm, 2006). However, bolstering EITCs at the federal and state level is not enough. Efforts to enhance the actual benefits of EITCs should go hand in hand with raising the minimum wage, creating more and better paying jobs, and enacting equitable tax and other policies that support families at work and with child-rearing (Clinton, 2006). This study shows that strengthening the EITC is an effective approach for not only supporting single mothers but also for enabling low-wage workers to earn more. This present study of the potential benefits of an adjusted EITC contributes to a growing body of scholarship that argues for the development and testing of progressive and

socially responsible approaches to facilitate real-life, sustainable changes for children in poverty and the working poor.

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