

**NOT PERFECT, BUT STILL PRETTY GOOD:  
THE EITC AND OTHER POLICIES TO SUPPORT  
THE US LOW-WAGE LABOUR MARKET**

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## INTRODUCTION

The earned income tax credit (EITC) has been in the US tax code since 1975. Since its introduction, the EITC has been expanded in Republican and Democratic administrations. The credit's most rapid growth has occurred in the last 15 years, with expansions legislated in 1986, 1990 and 1993. In fiscal year 1999, the credit is expected to cost \$31.9 billion.<sup>1</sup> In comparison, the credit cost roughly \$3.8 billion in 1975 (in 1999 dollars).

Senator Russell Long introduced the credit idea in the early 1970s as an alternative to President Nixon's version of the negative income tax (called the Family Assistance Plan).<sup>2</sup> The negative income tax makes its largest payment to families that do not work and benefits are then reduced as earnings increase. Senator Long was concerned that a negative income tax would increase reliance on welfare and erode work effort. His alternative, the EITC, gives nothing to those without earnings. As shown in Table 1, the EITC provides a subsidy to earnings up to a specific income threshold. For example, consider taxpayers with two or more children in 1998. The EITC gives a 40 per cent earnings subsidy up to \$9 930. Taxpayers with earnings between \$9 390 and \$12 260 receive the maximum credit of \$3 756.<sup>3</sup> The credit is reduced by 21.06 per cent of earnings between \$12 260 and \$30 095. Hence, there are three distinct ranges of the EITC: the subsidy, flat and phase-out ranges of the credit. The EITC is refundable, meaning that the Treasury regardless of whether the taxpayer has any other tax liability pays it out.

As is clear from our comments below, we believe the EITC is a generally effective, beneficial policy for US low-wage workers. But our views on the EITC are influenced, in part, by several features of low-wage labour markets in the US that are particularly helpful in enhancing its effectiveness. The EITC might be a less useful tool in countries with different policy environments.

- Relative to other OECD countries, the US has few employment regulations that constrain the ability of employers to alter the size of their work force and has few mandated benefits. The relative absence of labour market rigidities reduces barriers to hiring low-skill workers and presumably enhances the effectiveness of the EITC in stimulating labour force participation.
- The family is the unit of taxation in the US. The target efficiency of the EITC is enhanced by limiting it largely to families with incomes below \$30 000. Countries whose tax systems are based on individual, rather than family income will have a somewhat more difficult time limiting the EITC to low-income families.

Table 1. **Earned income tax credit parameters, 1979-1998**  
In nominal dollars

	Phase-in rate (%)	Phase-in range	Maximum credit	Phase-out rate (%)	Phase-out income range
1975-78	10.0	0-4 000	400	10.0	4 000-8 000
1979-84	10.0	0-5 000	500	12.5	6 000-10 000
1985-86	11.0	0-5 000	550	12.22	6 500-11 000
1987	14.0	0-6 080	851	10.0	6 920-15 432
1988	14.0	0-6 240	874	10.0	9 840-18 576
1989	14.0	0-6 500	910	10.0	10 240-19 340
1990	14.0	0-6 810	953	10.0	10 730-20 264
1991 <sup>1</sup>	16.7 <sup>2</sup>	0-7 140	1 192	11.93	11 250-21 250
	17.3 <sup>3</sup>		1 235	12.36	11 250-21 250
1992 <sup>1</sup>	17.6 <sup>2</sup>	0-7 520	1 324	12.57	11 840-22 370
	18.4 <sup>3</sup>		1 384	13.14	11 840-22 370
1993 <sup>1</sup>	18.5 <sup>2</sup>	0-7 750	1 434	13.21	12 200-23 050
	19.5 <sup>3</sup>		1 511	13.93	12 200-23 050
1994	23.6 <sup>2</sup>	0-7 750	2 038	15.98	11 000-23 755
	30.0 <sup>3</sup>	0-8 245	2 528	17.68	11 000-25 296
	7.65 <sup>4</sup>	0-4 000	306	7.65	5 000-9 000
1995	34.0 <sup>2</sup>	0-6 160	2 094	15.98	11 290-24 396
	36.0 <sup>3</sup>	0-8 640	3 110	20.22	11 290-26 673
	7.65 <sup>4</sup>	0-4 100	314	7.65	5 130-9 230
1996	34.0 <sup>2</sup>	0-6 330	2 152	15.98	11 610-25 078
	40.0 <sup>3</sup>	0-8 890	3 556	21.06	11 610-28 495
	7.65 <sup>4</sup>	0-4 220	323	7.65	5 280-9 500
1997	34.0 <sup>2</sup>	0-6 500	2 210	15.98	11 930-25 750
	40.0 <sup>3</sup>	0-9 140	3 656	21.06	11 930-29 290
	7.65 <sup>4</sup>	0-4 340	332	7.65	5 430-9 770
1998	34.0 <sup>2</sup>	0-6 680	2 271	15.98	12 260-26 473
	40.0 <sup>3</sup>	0-9 390	3 756	21.06	12 260-30 095
	7.65 <sup>4</sup>	0-4 460	341	7.65	5 570-10 030

1. Basic credit only. Does not include supplemental young child or health insurance credits.

2. Taxpayers with one qualifying child.

3. Taxpayers with more than one qualifying child.

4. Childless taxpayers.

Source: 1998 *Green Book*, Committee on Ways and Means, US House of Representatives, US Government Printing Office, p. 867. 1998 parameters come from Publication 596, Internal Revenue Service.

- The US has a relatively effectively administered individual income tax. Consequently, a very large fraction of EITC-eligible families would file tax returns even in the absence of the EITC.<sup>4</sup> This leads to high EITC participation rates and low administrative costs.
- By OECD standards, the US is a low-tax country (only South Korea, Mexico and Turkey have lower ratios of taxes to GDP among the OECD countries). While cumulative marginal tax rates in the phase-out range of the credit are high, they do not appear to be so onerously high as to stifle work (or create an employment trap).<sup>5</sup>

- The US has a fairly low minimum wage of \$5.15 per hour. While in perfectly competitive markets employer-based and supply-side subsidies (like the EITC) will have equivalent effects, with a binding minimum wage, employer-based subsidies may be more effective policy. A binding minimum wage limits the ability of employment and wages to adjust to an increase in labour supply prompted by the supply-side subsidy.

With these institutional facts in mind, the next section briefly summarises what is known about the EITC. The second half of the paper discusses the advantages and disadvantages of the EITC (in the US context) compared with the minimum wage, new or targeted employment subsidies, payroll tax reductions and universal employment subsidies.

## THE EITC'S EFFECTS

Our discussion of the EITC's effects covers three broad areas: its targeting and anti-poverty effectiveness, its behavioural effects, and the ability of tax authorities to administer the credit.

### Targeting and anti-poverty effectiveness

By its structure, the EITC is limited to taxpayers with earned income and adjusted gross income less than \$30 095 if they have more than one qualifying child, \$26 473 if they have one qualifying child, and \$10 030 if they have no qualifying children. Given the distribution of families filing tax returns, about half of EITC payments go to families with incomes above the poverty line.<sup>6</sup> Scholz (1994), for example, calculates that nearly 50 per cent of EITC payments will go to taxpayers with pre-tax incomes below the poverty line under 1996 rules. 36 per cent of total payments directly reduce the poverty gap. Liebman (1997) plots density functions for EITC payments that show a right-skewed distribution, centred at roughly \$13 000, with most payments going to families with incomes between \$7 000 and \$26 000.<sup>7</sup>

Because the EITC is based on annual family income and not wages, it is possible that the credit could be received by people with high wages who for some reason or another, choose to work relatively few annual hours.<sup>8</sup> In fact, the evidence suggests that in low-wage labour markets, incomes and wages are tightly linked. Scholz (1996) reports, based on tabulations from the Survey of Income and Program Participation (SIPP), that roughly two-thirds of EITC payments go to taxpayers with wages in the bottom quartile of all workers with children (below \$6.43 per hour) and more than 95 per cent of all EITC benefits are paid to workers with wages below the median of \$9.42 per hour. The link between incomes and wages is even tighter for EITC recipients following a 1995 legislative change that limits EITC recipients to less than \$2 300 of investment income.

Though the evidence is now somewhat dated, it appears that the EITC gets high marks for reaching its intended beneficiaries. Scholz (1994) used matched data from tax returns and the SIPP to calculate that 80 to 86 per cent of taxpayers eligible for the EITC appeared to receive it in 1990. Developments since 1990 have an ambiguous effect on EITC participation rates. The maximum credit has increased sharply since then, from \$1 207 to \$3 756 in 1999 dollars, and the credit extends further up in the income distribution, where filing propensities are very high. The IRS and other organisations have also expanded EITC outreach efforts and 11 states have adopted EITC's as part of their state income taxes. However, there has been a steady increase in labour force participation of single women with children (Meyer and Rosenbaum, 1999), and new workers in this group presumably have lower filing propensities than the typical worker in the population. In addition, the IRS no longer will intervene and award the credit when taxpayers file and appear eligible, but do not take the credit. Instead they send a letter to taxpayers encouraging them to consider filing an amended return.

Liebman (1997) presents calculations that provide an interesting perspective on the importance of the EITC in low-wage labour markets. Between 1976 and 1996, the share of income received by the lowest fifth of the population fell to 3.7 per cent from 4.4 per cent. The share received by the top 5 per cent increased to 21.4 per cent from 16.0 per cent over that period. Liebman's calculations show that for households with children, the EITC offsets 29 per cent of the decline in incomes in the first quintile of the population and 9 per cent of the decline in the second quintile. A more direct measure of the EITC's importance is that in 1997 it removed 4.3 million persons from poverty (Council of Economic Advisors, 1998).

### **The EITC's effect on behaviour**

Several papers have examined the effects of the EITC on labour market participation. Dickert, Houser and Scholz (1995) make use of cross-state variation in budget sets facing low income families generated by differences in tax and transfer programmes to estimate how the 1993 EITC expansions would affect labour force participation and hours of work. They estimate the EITC changes would increase labour force participation of single-parent families by 3.3 percentage points (from 56.4 per cent). Eissa and Liebman (1996) find a similar effect (adjusting for the size of the policy change) when examining 1986 EITC and tax changes.<sup>9</sup> Meyer and Rosenbaum (1999) find that EITC changes account for 54 per cent of the increase in the employment rate of single mothers from 1984 to 1996 and 33 per cent of the increase from 1992 to 1996. Given the changes in employment rates over this period, the results are consistent with the earlier papers. The three studies use different empirical strategies and reach similar conclusions, which suggests that the EITC significantly influences the labour market participation of low-income, single parent families.

Eissa and Liebman (1996) also examine the hours worked of taxpayers who were already in the labour market when 1987 EITC phase-outs were extended to additional workers. They find no decline in hours worked as a result of the higher phase-outs. Liebman (1997) also shows that there is no bunching of taxpayers at the beginning and end of the phase-out range, as might be expected with the discontinuity in the implied marginal tax rates. As Liebman notes, negative effects on hours for people already in the labour market are likely to be small, because the precise relationship between the EITC and hours worked is likely to be poorly understood by most taxpayers. The majority of EITC recipients pay a third party to prepare their tax returns and it is difficult to infer the implicit tax rates embodied in the credit from the look-up table that accompanies the EITC instructions. This confusion is less likely to mitigate positive participation effects, since for these to be operative, taxpayers only need to understand there is some tax-related bonus to work. There is abundant anecdotal evidence that taxpayers have this understanding (see, for example, DeParle, 1999).

There is much less written on the effects of the EITC on other aspects of behaviour. Two recent papers examine whether the EITC encourages the existence of female-headed families (Dickert-Conlin and Houser, 1999; and Eissa and Hoynes, 1999). Both papers find quantitatively small, positive effects of the EITC on female headship. Cossa, Heckman and Lochner (1999) wrote a fascinating study of the effects of the EITC on skill formation. While they emphasise that much more needs to be done, they reach a tentative conclusion that the, "EITC has little impact on average skill levels in the economy, but it may have large effects on particular groups of workers". They note the positive entry effects of the EITC and the negative effects that may be present for low-skilled people who would work in the absence of the credit.

### ***EITC Administration and Compliance***

Compared with alternative delivery mechanisms, the EITC is inexpensive to administer. As noted above, most EITC recipients would be required to file a tax return even in the absence of the credit, so the costs imposed on taxpayers of filling out Schedule EIC (a six-line schedule that gathers information about qualifying children) is small. The cost to the IRS is also quite small. The entire IRS budget in FY 1995 was \$7.6 billion and the IRS served 116 million individual taxpayers and 15 million corporations. The incremental cost of administering the EITC is surely a very small fraction of this total. The costs of administering two other major income support programmes for low-income families are much higher. Administrative costs for food stamps were \$3.7 billion in FY 1995, and AFDC administrative costs were \$3.5 billion.<sup>10</sup>

While a system based largely on self assessment (like the US income tax) will have lower administrative costs than a more bureaucratic approach, it will also have

higher non-compliance. The most recent study of EITC non-compliance examined returns filed in 1995 and found that of the \$17.2 billion claimed in EITC, \$4.4 billion, or 25.8 per cent of the total exceeded the amount to which taxpayers were eligible.<sup>11</sup> Additional compliance measures have been enacted in 1994, 1995, 1996 and 1997, which, all else being equal, will reduce the net overclaim rate (Scholz, 1997 provides additional details).

The rate of EITC non-compliance appears higher than the overall US tax gap. Unfortunately, the most recent evidence on overall taxpayer compliance is based on 1988 data, but these results suggest that 17 per cent of total taxes are not paid.<sup>12</sup> While compliance appears to be very high for wage and salary income, presumably because of third-party information reporting, compliance rates on self-employment income, certain types of capital income and income earned in the informal sector are far worse than for the EITC. Nevertheless, EITC non-compliance appears to be the single most important threat to the credit's political viability.

## **STRENGTHS AND WEAKNESSES COMPARED WITH ALTERNATIVE WAYS TO ASSIST LOW-WAGE WORKERS**

A number of policies have been proposed to assist low-wage workers. We compare and contrast the EITC with four of these: the minimum wage, incremental and targeted hiring subsidies, payroll tax reductions and wage rate subsidies.<sup>13</sup> One common theme in all comparisons is that the EITC focuses on families (including one-person families) while the other policies focus on individuals. The focus on families seems quite natural in the US, because the shape of the political debate and social concern about the adverse consequences of poverty for children. As long as families share resources, policies directed at families are also better targeted than those directed at individuals.

### **Minimum wage**

The minimum wage places a floor, below which wage rates cannot fall. We speculate that the appeal of the minimum wage is rooted in an ethical norm about the value of work. Economists, however, have long been concerned about the harmful consequences of the minimum wage on the employment of disadvantaged workers, though there is evidence that changes in the US minimum wages in the last decade have not significantly reduced employment. The employment effects of the minimum wage remain a contentious issue.<sup>14</sup>

The EITC has two distinct advantages relative to the minimum wage. First, if the objective of either policy is to help low wage *and* low-income workers, the EITC is significantly better targeted than the minimum wage. Burkhauser, Couch and

Glenn (1996), for example, show the minimum wage is an extremely blunt tool for assisting low-income families. Using data from the 1990 Current Population Survey they find that 83 per cent of working poor households had wages that were already above the proposed increased minimum (from \$3.35 an hour to \$4.25). In their distributional analysis of the minimum wage increase, they show that only about 21 per cent of the benefits of a minimum wage increase (assuming no changes in employment) would go to workers who are part of families with incomes below 125 per cent of their poverty line. 38 per cent would go to households with income-to-poverty ratios exceeding three. Because of the income restrictions of the EITC, it is clearly a more precisely targeted policy intervention in low-wage labour markets.

The fact that a significant number of the beneficiaries of minimum wage increases are not members of low-income families is a problem in our view, because as a consequence of minimum wage increases, some low human capital workers presumably are not employed. The EITC, in contrast, has unambiguously positive employment effects, both theoretically and in the empirical studies of the credit. Because it is much better targeted than the minimum wage, and has unambiguously positive effects on labour market participation for all groups but secondary earners in two-parent families, the EITC would appear to dominate the minimum wage as a policy tool to assist low-wage workers.

There are two qualifications to this conclusion. First, as currently configured, the EITC provides only a small subsidy to childless taxpayers. Since this subsidy is so small, minimum wage increases could do more to increase the earnings of childless workers than the current EITC. Obviously, there is nothing inherent in the EITC that requires the childless worker provision to be so small. It would be straightforward to expand this provision, though social policy in the US focuses almost exclusively on children, so the likelihood of this expansion occurring in the near future is small. Second, the EITC and minimum wage can certainly coexist. Because of our concerns about unemployment effects of the minimum wage, however, we tend to prefer that any expansion in assistance to low-wage workers come through the EITC rather than the minimum wage.

### **Targeted and new hiring subsidies**

The US has experimented over the last 20 years with a number of marginal or incremental employment subsidies. In 1977 and 1978 the US adopted the New Jobs Tax Credit (NJTC), which paid 50 per cent of the first \$4 200 in wages paid to workers hired in a firm beyond 102 per cent of the previous year's employment (the total subsidy to a firm was capped at \$100 000). The NJTC attempted to increase the demand for low-skilled workers by offering a larger subsidy (as a percentage for compensation) for low-skilled workers. Its costs were capped by the \$100 000 per firm subsidy limitation, and by the fact that the NJTC tried to limit inframarginal



subsidies – money paid to support behaviour that would have occurred anyway – by setting a threshold of 102 per cent of the previous year's employment before jobs were subsidised.<sup>15</sup>

Subsequent tax-based hiring incentives have attempted to further limit infra-marginal subsidies by targeting hard-to-employ workers. The Targeted Jobs Tax Credit (TJTC) replaced the NJTC and was in effect until the mid 1990s. The TJTC provided tax credits for the hiring of economically disadvantaged groups. While groups changed over time, they generally included youths from low-income families, welfare and SSI recipients, Vietnam veterans, certain ex-convicts, and disabled individuals undergoing vocational rehabilitation. By the mid 1990s, the TJTC provided employers a 40 per cent wage subsidy on the first \$6 000 of qualified wages.<sup>16</sup>

The TJTC was replaced in 1996 by a similar credit, the Work Opportunity Tax Credit (WOTC). The WOTC has two tiers. It provides a 25 per cent credit for employment of 120 hours to 400 hours, and a 40 per cent credit for employment of 400 or more hours on up to \$6 000 of earnings (a maximum subsidy of \$2 400 per worker). The two tiers were rationalised as an incentive for employers not to “churn” their workforce. A companion, more generous credit – the Welfare-to-Work tax credit – was adopted in 1997. It targets certain long-term welfare recipients. The credit is 35 per cent of the first \$10 000 of qualified wages in the first year of employment and 50 per cent of the first \$10 000 of qualified wages in the second year of employment. The maximum credit is \$8 500 per eligible employee. The employee must work for the employer for at least 180 days or 400 hours.

The appeal of targeted or marginal wage subsidies is clear. They offer the promise of stimulating employment of disadvantaged workers at a fraction of the cost of universal employment subsidies, or supply-side policies like the EITC.

There is not much evidence that the targeted employment subsidies are effective. Katz (1996) finds that the TJTC may have modestly improved the employment rates for disadvantaged youths. His study is the most optimistic assessment of the TJTC that we have seen. There are three major concerns that have been raised with these incentives. First, while employment rates are lower for targeted groups than they are for the general population, many in each group would be employed even in the absence of the hiring incentive. Hence, significant portions of the subsidy will be inframarginal. Second, the incentives may simply cause members of targeted groups to be hired instead of other disadvantaged workers. Displacement of one disadvantaged group for another will result in no net increase in employment of disadvantaged workers and, for obvious reasons, will detract from the value of the credit. Finally, there is dated evidence that targeted subsidy programmes may actually stigmatise members of particular groups, and hence harm their employment prospects (Burtless, 1985).

We have mixed reactions to the standard concerns raised with targeted wage subsidies. It seems unlikely to us that with tight labour markets, the stigma generated by WOTC or welfare-to-work tax credits could be sufficient to eliminate the beneficial employment effects of a \$2 400 employment bonus for disadvantaged youth or as much as an \$8 500 employment bonus for long-term welfare recipients. We recognise that displacement effects are a serious concern with targeted wage subsidies, though we are not aware of recent studies that assess the quantitative magnitude of these effects. Finally, we are less convinced than some that the infra-marginal criticism is well grounded. Even when the subsidy rewards employers for hiring that they would otherwise do, the additional resources granted to the firm should augment labour demand and hence increase hiring.

At its core, targeted hiring subsidies have a different objective than the EITC. The EITC is designed to augment the incomes of low-income families. The WOTC and Welfare-to-Work tax credits are designed to stimulate employment of targeted groups. While the evaluation literature on targeted credits is at best mixed, they have a fraction of the EITC's budgetary cost.<sup>17</sup> In principle, the supply side (EITC) and demand side (WOTC and Welfare-to-Work tax credits) incentives should make the other policies more effective and hence we think that both should be used. At the same time, we would like to see the Department of Labour and the Treasury Department finance rigorous evaluations of the effectiveness of current targeted employment subsidies.

### **Payroll tax reductions**

75 per cent of all US taxpayers pay more in payroll taxes than they do in individual income taxes.<sup>18</sup> Consequently, when thinking of tax proposals that might be beneficial for low-wage labour markets, it is natural to consider payroll tax reductions. The EITC has always been closely linked to the payroll tax. A commonly given rationale for the credit prior to recent expansions was that the EITC offsets the regressive (on an annual basis) burden of payroll taxes. For many years, the subsidy rate of the EITC was tied to the combined, employer and employee share of payroll taxes. Even today, the EITC subsidy rate for childless workers is 7.65 per cent, the same rate as the employee's share of payroll taxes.

The policy merits of payroll tax reduction proposals depend, of course, on the details of the specific idea. Several concerns are generic to any specific proposal, however. Proposals that exempt the first \$x of earned income from payroll taxes would be administratively difficult for workers who have more than one job or who change jobs during the year. Underpaid taxes could be reconciled at the end of the year on individual income tax forms (as is done with overpaid payroll taxes for affluent taxpayers), but some taxpayers would fail to file, creating a new compliance headache. Revenue neutral proposals that would exempt a portion of earnings, and then tax additional earnings at higher rates would exacerbate the redistribution

involved with social security. In particular, money's worth calculations show that social security is a bad deal compared with alternative, safe investments for affluent singles and couples.<sup>19</sup> As social security is perceived by affluent families to be financially unattractive, pressure could mount for drastically altering social security. Given the importance of the programme in alleviating poverty among the elderly, we think that would be an unfortunate turn of events.

In some contexts, one might envision payroll tax reductions being paired with reductions in mandated benefits, which could help the flexibility of low-wage labour markets. In the US, however, it seems unlikely that payroll tax reductions would be matched with reductions in social security, the programme the taxes finance. Consequently, there appears to be no compelling reason why payroll tax reductions would be a preferred policy option to further expanding the EITC.<sup>20</sup>

### **Wage rate subsidy<sup>21</sup>**

Phelps (1997), in the author's words, "set[s] forth the argument for low-wage employment subsidies as systematically and plainly as [he] can so that it can be evaluated by the general public and, if all goes well, considered for enactment into law". The programme put forth would be an unprecedentedly large intervention in low-wage labour markets – Phelps roughly estimates that the programme would cost \$125 billion annually. We laud the general diagnosis that is made: that the poor performance of low-wage labour markets over the past 30 years has contributed to various social problems in the US, and that it is morally troubling for a country as wealthy as the US to have families, children and individuals face material deprivation.<sup>22</sup>

The intervention advocated by Phelps would be a wage subsidy directed at workers with earnings between \$4 and \$12 per hour. The subsidy would phase out, so firms employing workers at \$4 per hour would receive a \$3 hourly subsidy, at \$8 per hour they would get a \$0.71 per hour subsidy, and at \$12 per hour they would receive a \$0.06 per hour subsidy. The subsidies would be restricted to workers in full-time jobs (defined as 35 hours per week or more). Firms would only need to declare jobs were full time. They would only report the qualifying weekly or monthly wage.

There are several attractive features of wage rate subsidies and therefore, of Phelps' idea. First, the scale of the Phelps proposal is quite breathtaking in that it is roughly twice the combined value of federal TANF spending, food stamps, and the EITC. To help pay for the initiative, Phelps would abolish the EITC, but even with this change, nobody will accuse Phelps of underfunding the initiative. Thinking about the proposal now, at a time when the US Congress passed a nearly \$800 billion tax cut (over 10 years) that would have (the Bill was vetoed by the President) disproportionately benefited those who have already reaped the lion's share of the benefits of the economic prosperity of the 1990s, Phelps' vision and attention to low-wage labour markets is refreshing.

There are also two technically attractive features of Phelps' proposal relative to the EITC. First, in the presence of a binding minimum wage, employer subsidies may be more effective, both in stimulating employment and increasing employees' after-subsidy wage rates. This is because the wage floor imposed by the minimum wage may keep the employer's pre-EITC wage payments from falling to their market clearing level. With the employer subsidy, the post-subsidy wage is the relevant wage applicable to minimum wage laws. Hence, employer subsidies might be useful to mute harmful labour market effects of the minimum wage.<sup>23</sup>

The second attractive feature of the Phelps proposal is that with employer subsidies, there is a tighter link between work and the after-tax, after-transfer return to work than there is with the EITC. With the EITC, almost all workers who receive the EITC get it as a lump sum after filing their tax return. As mentioned earlier, there is anecdotal evidence that workers have a vague understanding that their "refund" is somehow work related, but it is extremely unlikely that a significant number of EITC recipients have a clear understanding of the credit's structure. There would be a much tighter link between policy and paycheck with employer subsidies. Paradoxically, to the extent one is concerned about potential negative labour supply effects on the intensive margin (*i.e.* for people already in the labour market) for the EITC, its ambiguity may be a good thing, mitigating potentially negative effects.

The Phelps proposal also has disadvantages relative to the EITC.<sup>24</sup> The targeting of Phelps' proposal is clearly worse than the EITC. While restricting the employer subsidy to full-time workers will enhance its targeting (at the cost, of course, of helping some low-human-capital workers who for whatever reason, cannot hold a full-time job), there will clearly be some subsidised workers who are members of affluent families, such as children working summer jobs. Late in his book Phelps addresses this concern, by arguing that since low-wage workers contribute to society, it would be wrong if "low-wage men or women who married someone earning a seven-figure income had to forfeit the stimulus provided by the state to their employment and thus their inclusion in the economy, their personal growth and their sense of autonomy" (pp. 165-166). But this assertion ignores the cogent motivations for Phelps's proposal – the emergence of "second-class workers" and their harmful consequences for families and communities. Subsidising the wages of workers in middle class and affluent families does nothing to address the core problem and consequently is a poor use of scarce public resources.

Second, in Phelps's proposal, the return to wage-increasing human capital investments may be very low for some workers.<sup>25</sup> For example, for workers that make investments that would allow them to raise wages to \$5 from \$4 per hour, their incremental wage would increase only \$0.29 (from \$7 to \$7.29 per hour). Added to the 71 per cent implicit tax rate would be payroll taxes and possibly some state taxes. Tax rates of this magnitude would seem to present a severe disincentive to

invest in additional human capital. Moving up the subsidy scale, implicit tax rates continue to be quite high: they are 64 per cent from \$5 to \$6, 53 per cent from \$6 to \$7, and 41 per cent from \$7 to \$8. Average implicit tax rates are 37.5 per cent between \$4 and \$12 an hour in the Phelps proposal. While the potential problem is clear, there are relatively few studies in the empirical economics literature that would help us anticipate how workers might respond to these incentives to alter human capital.

As mentioned above, EITC non-compliance is a serious policy problem. We fear that non-compliance would be an equally (and possibly more) severe problem with employer subsidies without imposing additional, onerous reporting requirements on employers. It is untenable for businesses to simply report wages and not hours, since the IRS would have no way of assessing the validity of claims. Companies will also have incentives to create fictional employment and creatively use bonuses and other compensation mechanisms to trigger subsidy payments. Additional reporting requirements would surely generate enormous resistance by business lobbies, particularly those representing small businesses, and would impose new burdens on the Internal Revenue Service.

The most serious advantage of the EITC over Phelps' proposal, however, is a practical one. We already have an EITC. It has been in the tax code for nearly 25 years. It is better targeted than the wage subsidies and we know that it works. Moreover, the EITC and employer subsidies, particularly in the absence of a binding minimum wage, are very similar policies.<sup>26</sup> Given the similarities, we think the right way to address Phelps' concerns about low-wage labour markets would be to further expand the EITC for childless workers, and possibly increase the credit for families with children.

## CONCLUSION

The problems facing workers with low levels of human capital in the US are severe. Our reading of the economic and policy literatures is that the EITC is the most sensible, primary policy to support low-wage labour markets in the US. Our conclusion is tempered by the institutional facts about US labour markets noted in the introduction. Economies with different institutional features may find EITC-like policies to be less effective or administratively infeasible. Though reliance on the EITC is sensible, we view targeted employment subsidies as a complementary policy. We see less wisdom in minimum wage increases, payroll tax reductions for low-income families, and wage rate subsidies as proposed by Phelps, at least in the US.

## NOTES

1. Budget of the United States, FY 2000, Table 5-1.
2. This paragraph draws on Liebman (1997), who provides a nice discussion of the political evolution of the EITC.
3. The maximum credit for families with one child is \$2 271 and the maximum credit for childless workers is \$341.
4. Low-income families would generally file returns because their incomes exceed filing thresholds or to get back withheld taxes. With the new \$500 child credit along with personal exemptions and the standard deduction, a married couple with two children will not have a positive tax liability until their earnings exceed \$24 600, even without the EITC, but they will be required to file a tax return as long as their income exceeds \$12 500.
5. In the phase-out range of the credit, families may face marginal tax rates exceeding 50 per cent. If workers bear the full burden of social security payroll taxes, combined marginal rates will be 14.2 per cent for payroll taxes (15.3/1.0765) plus 15 per cent from the individual income tax plus 21.06 per cent for the EITC phase-out. Families also likely pay state sales taxes, income and property taxes. Over some income intervals in the phase-out range of the credit marginal tax rates may exceed 100 per cent if families also lose food stamp, housing or Medicaid benefits.
6. The HHS poverty guidelines for 1999 are \$8 240 for a one-person family, \$11 060 for two-person families, \$13 880 for three person families, and \$16 700 for four-person families.
7. Liebman (1997) also reports that 65 per cent of EITC recipients have incomes above \$11 930 in 1997 and thus have incomes in the phase-out range of the credit.
8. Phelps (1997) seems to have this idea in mind when he writes "The real defects in the EITC lie elsewhere in its poor design. The programme is not really a tool to reward work and stimulate the employment of low-wage workers so much as a programme of credits for those who, for whatever reason, have low wage incomes – and not over a lifetime but in the current year. Thus, much of the credits are paid to people whose low wage income is simply the result of late entry or early withdrawal from the labour force" (p. 133, italics in original). Alternatively, Phelps is suggesting that the EITC is received by the very young or very old, but this is incorrect since the small childless worker credit is restricted to taxpayers between the ages of 25 and 64, and otherwise the EITC is restricted to families with children at home (or full-time students under 24).
9. Eissa and Hoynes (1998) find modest negative effects of the EITC on married women's labour force participation, estimating the EITC expansions between 1984 and 1996 reduced the likelihood of labour market participation by around 1.2 percentage point (or 2 per cent).

10. The administrative costs of income transfer programme also support services that go to programme recipients.
11. Scholz (1997) reports that 39 per cent of EITC overclaims involve taxpayers claiming EITC qualifying children who do not live with them for over half the year. 31 per cent of overclaims involve married taxpayers reporting the wrong filing status.
12. Internal Revenue Service, Federal Tax Compliance Research: Individual Income Tax Gap Estimates for 1985, 1988, and 1992, Publication 1415 (Rev. 4-96) Washington, DC, 1996.
13. See Haveman (1996) for a broader discussion of policies directed at low-wage labour markets and OECD (1997) for a useful analysis of low-wage labour markets and policies in OECD countries.
14. See, for example, Card and Krueger (1995) and Neumark and Wascher (1995, 1998).
15. Haveman and Bishop (1979) and Perloff and Wachter (1979) examine the New Jobs Tax Credit.
16. Initially the Targeted Jobs Tax Credit provided a 50 per cent subsidy in the first year and a 25 per cent subsidy in the second year for the first \$6 000 of wages. See Katz (1996) for a discussion of wage subsidies for low-income workers.
17. The Work Opportunity Tax Credit costs in the neighborhood of \$400 million annually. The Welfare-to-Work credit costs in the neighborhood of \$80 million.
18. Congressional Budget Office, 1998, Estimates of Federal Tax Liabilities for Individuals and Families by Income Category and Family Type for 1995 and 1999, May.
19. See Steuerle and Bakija (1994), for example. Calculations of this sort tend to ignore the value one should place on the insurance aspect of social security against disability, unusually long life, and the randomness of endowments.
20. One could imagine targeted payroll tax relief that exempts payroll taxes for specific groups, such as teenagers and jobs paying less than \$6 per hour. Like increasing the minimum wage, however, we expect a relatively small fraction of the beneficiaries of this proposal would be low-income families.
21. In this section we focus on a recent proposal by Phelps. Wage rate subsidies have received considerable attention in the policy literature over the years. Haveman (1994), for example, proposes a far-reaching wage subsidy directed at workers (rather than employers). See Bishop and Haveman (1978) for an earlier treatment of related issues.
22. In lauding the general diagnosis, we disagree with some specific points of argumentation. For example, we think it goes well beyond existing evidence to say that "Men, far from seeing their motives to work and earn and realize their potential left intact by the welfare system, are instead threatened with emasculation by it" (p. 96). More generally, we think the large academic literatures on the behavioral effects of unemployment insurance, Medicaid, food stamps and welfare on a broad range of behaviors, including labour supply, family formation and child well-being does not support Phelps' assertion that "In the United States there is ample reason to believe that such a massive attack on the primacy of employment constitutes a threat to the viability of disadvantaged workers". While the panoply of income security programmes undoubtedly have some negative, unintended consequences, they surely, on net, benefit those they are intended to help. This disagreement should not obscure the more important point – both Phelps and we believe policy can be improved.
23. We note again that the minimum wage in the US is quite low, and hence is not binding for many low-skill workers.

24. Phelps asserts his proposal would be self financing. He suggests it would save \$15 billion annually from Medicaid through improved nutrition and reduced drug use; save \$25 billion annually from the criminal justice system; save \$35 billion annually from welfare, food stamps, child care and housing benefits, and SSI; save \$15 billion from reduced UI payments and increased business taxes; and the remainder would come from abolishing the EITC. Phelps does not wrestle with the empirical evidence that might support or refute these rough estimates. We think they are highly speculative at best.
25. We emphasize that the incentives discussed in this paragraph are distinct from labour supply issues. Wage rate subsidies have attractive labour market incentives (offering positive substitution effects), since the per-hour subsidy will typically not diminish as more hours are worked. Substitution effects are negative for workers in the phase-out range of the EITC.
26. The similarities of the EITC and employer subsidies are obscured in Phelps' book (see, for example, the quotation in footnote 9). One could read Phelps as a forceful advocate for expanding the EITC, particularly the credit for childless workers.



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