The Daily Dish

The Earned Income Tax Credit

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The earned income tax credit (EITC) is a cornerstone of U.S. work and anti-poverty policy, but it has been around for so long that it gets taken for granted and is no longer well understood. It could also stand to be spruced up for the 21st century. Fortunately, Gordon Gray has a comprehensive new study that walks through the history, structure, and impacts of the EITC. He also outlines potential reforms.

The EITC dates to the Tax Reduction Act of 1975. Initially it was a 10 percent tax credit on up to $4,000 in earned income for workers with one or more children and was scheduled to expire in 1976. As it turned out, the EITC was extended regularly, made permanent in 1978, and modified several times. Ultimately, the Tax Reform Act of 1986 raised the credit to 14 percent on up to $5,000 before phasing out for recipients with income above $6,500. These thresholds were permanently indexed for inflation.

Gray notes that 1990 was a significant year for the EITC: “Beginning with the Omnibus Budget Reconciliation Act of 1990 (OBRA90)…the EITC was reorientated more substantially toward reducing family poverty. OBRA90 established two new formulas for claiming the credit, one for workers with one child and a second formula for workers with two or more children. The law also increased the credit rate from 14 percent to an eventual 17.5 percent and 18.5 percent for the two formulas, respectively.”

The EITC has continued to evolve, but the basic pieces remain the same: a credit for earned income as an incentive to participate in work and an index for the number of children (including zero) to fight poverty. Unfortunately, providing more money based on family size can reduce work incentives, but relying more heavily on earned income runs the risk of higher family poverty. Gray has an extensive discussion of these trade-offs, but one fact stands out. Childless workers have the cleanest labor supply incentives, but while they file nearly a third of tax returns claiming the EITC, they only received about 4 percent of the EITC.

For this reason, a more generous EITC for the childless is a recurring reform proposal. Gray documents a number of others, including essentially re-assigning roles and having the EITC focus on work and the Child Tax Credit (CTC) concentrate on anti-poverty efforts. But the most important are probably simplification reforms. Due to its complexity, in 2022, “the EITC suffered an improper payment rate of nearly 32 percent. While this is somewhat elevated, historically the improper payment rate has averaged about 25 percent.”