

# A Revolution in Poverty Policy

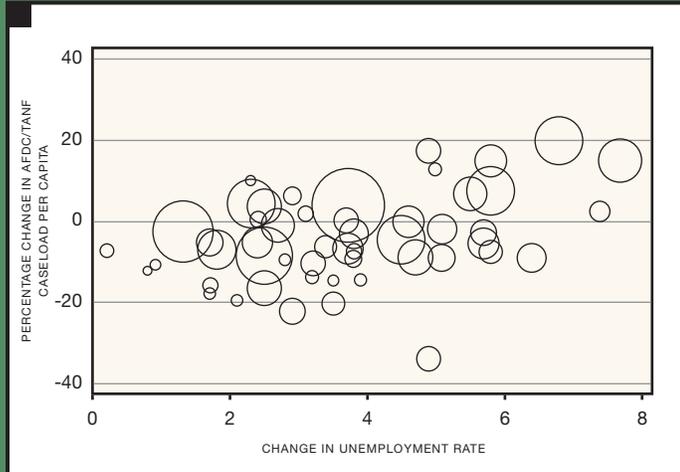
The Earned Income Tax Credit  
and the Well-Being  
of American Families

BY HILARY W. HOYNES

**Over the past 20 years,** the safety net for families with children in the United States has been fundamentally transformed. The 1996 welfare reform led to a dramatic reduction in the amount of state cash assistance and to the elimination of the Aid to Families with Dependent Children (AFDC) program. At the same time, the amount of cash assistance given through the U.S. tax system increased substantially with the Earned Income Tax Credit (EITC).

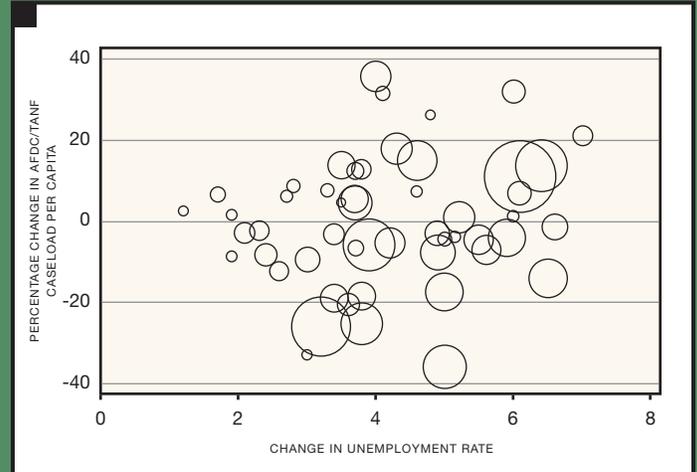
FIGURE 1. Change in Unemployment Rate and Percent Change in per Capita AFDC/TANF Caseloads Across Labor Market Contractions, by State, for the (a) 1979–1982 and (b) 2007–2009 Recessions

Cash Welfare (AFDC) and Unemployment Rate Change Between 1979 and 1982



NOTE: The sizes of the circles correspond to the state population.

Cash Welfare (TANF) and Unemployment Rate Change Between 2007 and 2009



The net result is an almost complete shift in the U.S. safety net for low-income families with children from *out-of-work* assistance to *in-work* assistance. In the midst of the slow recovery from the Great Recession, the EITC is now the largest cash transfer program for low-income families with children. The EITC cost roughly \$59 billion in 2009, as compared with the \$9 billion in Temporary Assistance to Needy Families (TANF) cash payments from the program that replaced AFDC.

Because the EITC now plays a central role in the functioning of the modern safety net, it is important to assess how it affects the work, income, poverty, and well-being of children and families in the United States. The remainder of this article addresses each of these issues in turn.

### The Decline of Welfare

From the 1930s to the 1990s, the AFDC program provided cash assistance to low-income single mothers with children. The program was designed to provide an income transfer for needy families in an era when women with children had minimal labor market attachment. Consequently, AFDC benefits provided a basic income floor, with the benefit then reduced by a dollar for every dollar increase in earnings. Because the “dollar-for-dollar” phase-out of benefits acted like a 100 percent tax on earnings, it should not be surprising that it led to a reduction in work. Although this feature created a targeting of benefits to those with the lowest income levels (by design), it also created a disincentive to enter the labor force because increases in earnings were offset by reductions in the cash transfer.

After 60 years with minimal changes, President Clinton made good on his pledge to “end welfare as we know it,” sign-

ing the 1996 federal welfare reform legislation and thereby eliminating AFDC and replacing it with TANF. TANF, or welfare as we know it now, imposes stringent work requirements, sanctions for noncompliance, and lifetime limits on how long welfare can be received. Importantly, the imposition of time limits essentially ended the entitlement nature of cash welfare for poor families with children in the United States.

As a result, the number of families receiving cash welfare has fallen to historic lows—from a peak of 5 million in 1994 to 1.7 million in 2007 on the eve of the Great Recession. A central tenet of safety net programs is that usage rises in times of need. Yet TANF caseloads have risen only minimally, despite the massive increases in unemployment resulting from the Great Recession. Figure 1 illustrates the changing role of cash welfare by contrasting the response of welfare caseloads in the 1979–1982 and 2007–2009 recessions. The graph plots, for each state and each recessionary period, the percentage-point change in the unemployment rate on the x-axis and the percent change in the AFDC or TANF caseloads on the y-axis. Each circle on the graph represents a state, with the size of the circle corresponding to the state population. Figure 1a shows that in the 1979–1982 recession (pre-welfare reform), states experiencing more severe increases in unemployment had larger increases in their AFDC caseloads than states experiencing less severe recessions. Figure 1b, however, shows that changes in TANF caseloads during the Great Recession (after welfare reform) are almost everywhere lower (and for many states even show *declines* during this significant period of need), with no discernible relationship with the severity of the recession.

### The Rise in the EITC

The EITC provides a cash transfer to low-income working families through the federal tax system, rather than through the state welfare system. The EITC is a refundable credit so that a taxpayer with no federal tax liability, for example, would receive a tax refund from the government for the full amount of the credit. The EITC acts as an earnings subsidy for low earners; a family with one child receives 34 cents for every dollar of earned income, while a family with two or more children receives 40 cents for every such dollar. To become eligible for the EITC, a person must demonstrate positive earned income, as well as adjusted gross and earned incomes below a specified amount. In tax year 2012, the credit topped out at \$3,169 for families with one child, \$5,236 for two or more children, and \$5,891 for families with three or more children. Eventually, the credit is phased out, though at rates much lower than those under the AFDC program. The EITC is now widely utilized—in 2009, 27 million filers received the EITC, a number far greater than the 12.5 million who filed in 1990.

The net fiscal result of the decline in welfare and the expansion of the EITC is illustrated in Figure 2, where trends in real 2009-dollar per capita spending are documented for the three main cash or near-cash assistance programs for families with children in the United States: AFDC/TANF, the EITC, and the Supplemental Nutritional Assistance Program, or SNAP (formerly the Food Stamp Program). For reference, the gray shaded areas indicate official recessionary periods (annualized), and the black vertical line denotes the passage of federal welfare reform. Overall, the cash-based safety net (AFDC/TANF) has shrunk considerably, while the tax- and noncash-based safety net has grown. The cost of the EITC more than tripled in less than 10 years, while TANF payments have almost disappeared. Also notable is the remarkable role of SNAP in the current recession—the number of persons receiving food stamps has more than doubled between 2003 and 2011. The most recent estimates show that about one in seven persons is currently receiving SNAP.

### Welfare-to-Work and the EITC

With welfare reform and the expansion of the EITC, the end result is an almost complete shift in the U.S. safety net from *out-of-work* assistance to *in-work* assistance for low-income families with children. This has resulted in a tremendous change in the work incentives faced by low-income women with children. Implementation of welfare reform (“the stick”) and the expansion of the EITC (“the carrot”) were expected to increase the labor force participation of single mothers. This is exactly what happened. Figure 3 presents, for 1980 to 2010, the percent of women ages 20–58 who worked at all during the year, broken down by single women heading families with children, married women with children in their families, and single women without children in their families. Between 1992 and 2000, the employment of single women with children rose by a stun-

ning 15 percentage points. In comparison, changes were only minimal for the other groups of women (or any group of men). Although this increase in employment among single women with children was partly driven by the strong labor market of the late 1990s, the best available research shows that it is also the result of the welfare and EITC policy changes during that period.<sup>1</sup>

### Where Do These Reforms Leave Needy Families?

With the decline of welfare and the rise in the EITC, the Great Recession provides our first test of how the safety net is faring after welfare reform. How are we doing? Figure 3 showed that, despite the high overall unemployment rates in the Great Recession, the employment rates for single women with children remain above their pre-welfare reform levels. This, however, gives us an incomplete picture of how families and their children are faring. Given the intent of the safety net to increase incomes at the bottom of the distribution, poverty rates are natural measures to examine in assessing whether the safety net is working. If poverty has risen in the Great Recession, how have these changes to the safety net affected poverty among vulnerable families? Put more pointedly, how many people does the safety net remove from poverty?

According to the official poverty statistics, the answer is “none.” The official poverty measure was developed in 1963 and defines a family’s “resources” as equal to their cash, pre-tax income. A family is defined as poor if their resources are below a certain threshold that depends upon the size of their family. Because the official measure relies on a family’s *pre-tax cash* income, the expansion of the EITC and SNAP are not counted as part of family resources and thus are not reflected at all in the official poverty statistics. Thus, as the United States has shifted the safety net away from cash assistance and toward tax and non-cash assistance, our official poverty statistics have become less relevant.

With much fanfare, the Census Bureau recently launched the new Supplemental Poverty Measure (SPM), a measure that is more useful in assessing how the safety net has performed. The SPM is not a replacement for the official poverty measure, but instead an additional measure to be released each year. The new supplemental poverty measure makes several key changes in how we classify individuals as poor. First, in-kind government benefits, such as SNAP, housing assistance, and other nutritional assistance, are included as “income” under the new measures. Second, a family’s income is adjusted for federal tax payments, including deducting payroll taxes and adding tax credits (importantly, the EITC). Third, out-of-pocket medical and work expenses are deducted from income. Fourth, the new measure makes adjustments for differences in the cost of living across geographic areas.

The net result is that the overall rate of poverty is slightly higher using the new measure: in 2010, the official poverty measure reports 15.1 percent of persons are poor, and the sup-

FIGURE 2. Per Capita Real Expenditures for AFDC/TANF, Food Stamps, and the EITC (2009 dollars)

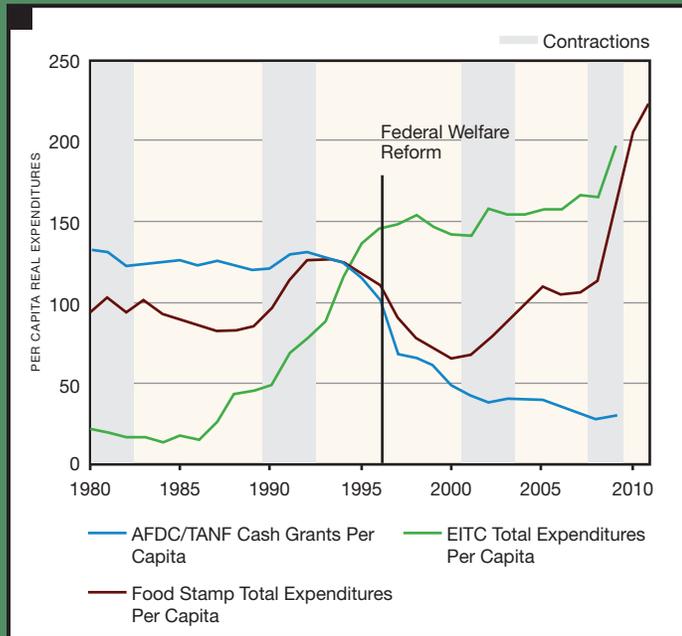
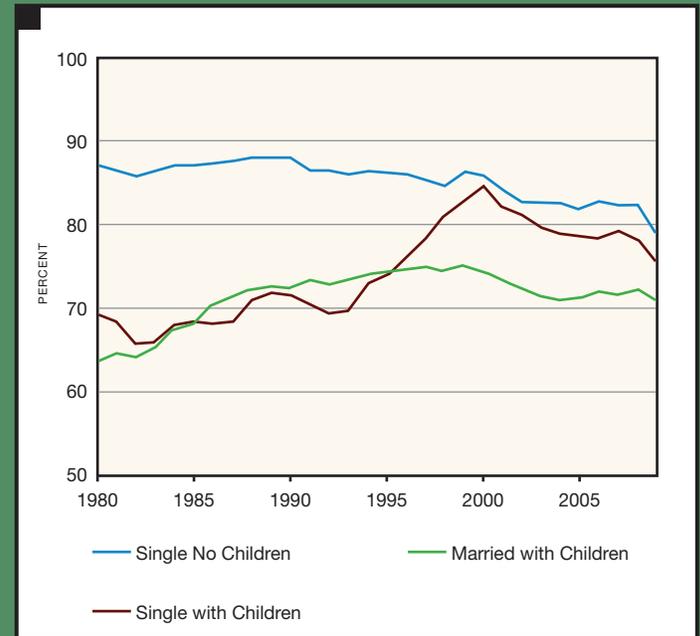


FIGURE 3. Percent of Women Working, by Marital Status and Presence of Children, 1980–2009



plemental poverty measure reports that 16.0 percent are poor. Poverty rates for some groups change substantially. The poverty rate for children falls from 22.5 percent to 18.2 percent, reflecting their greater use of the noncash safety net. Poverty among the elderly, on the other hand, rises from 9 to nearly 16 percent, primarily because of their high out-of-pocket medical costs.

By updating poverty measurement to accurately and comprehensively capture the noncash and tax forms of government assistance, there is now an official measure that can be used to evaluate the success of the safety net. To illustrate the importance of the new measure, Figure 4 plots the fraction of persons who are poor, contrasting the official poverty measure to an alternative poverty measure that closely matches the supplemental poverty measure.<sup>3</sup> The period shown in the graph, 2007 through 2010, is particularly important given the steep increase in unemployment rates that characterized the Great Recession. Between 2007 and 2010, the official poverty rate increased by 2.6 percentage points, from 12.5 to 15.1, while the unemployment rate increased from 4.6 to 9.6. However, the supplemental poverty measure stayed amazingly flat, increasing from 15.3 percent in 2007 to 15.5 percent in 2010. These data show that the safety net is working.

To explore more fully which programs are providing the protection revealed here, Figure 5 presents data based on the Census report accompanying the release of the supplemental poverty measure. We report on how the changes contained in the supplemental poverty measure affect the total count of poor

children. From this, we can obtain estimates of the total number of children who a given program removes from poverty. The figure shows that the EITC removes more children from poverty than any other program: in 2010 the EITC raised 3.1 million children out of poverty. The second most important child anti-poverty program is SNAP, which raises 2.2 million children out of poverty. Among Americans of all ages (not shown in the figure), the report shows that the EITC lifts more than 6 million persons out of poverty, while SNAP lifts more than 5 million persons out of poverty.

### Concluding Reflections on the EITC Revolution

The EITC has become the cornerstone of U.S. anti-poverty policy and has transformed the experience of poverty in the United States. It is the vehicle through which the U.S. safety net has been refocused on *working* families; it is the largest cash transfer program for low-income families with children; it has dramatically increased employment among single women with children; and it now removes more children from poverty than any other program.

The effects of EITC extend well beyond simple income support and poverty reduction. By increasing the income of poor families, it generates additional spending and hence “downstream” economic effects.<sup>3</sup> It leads to various improvements in the mental and physical health of mothers.<sup>4</sup> It brings about a reduction in low birth weight among infants.<sup>5</sup> And it improves the performance of children on cognitive tests.<sup>6</sup> This burgeon-

FIGURE 4. Official Poverty and Alternative Poverty, 2007–2010.

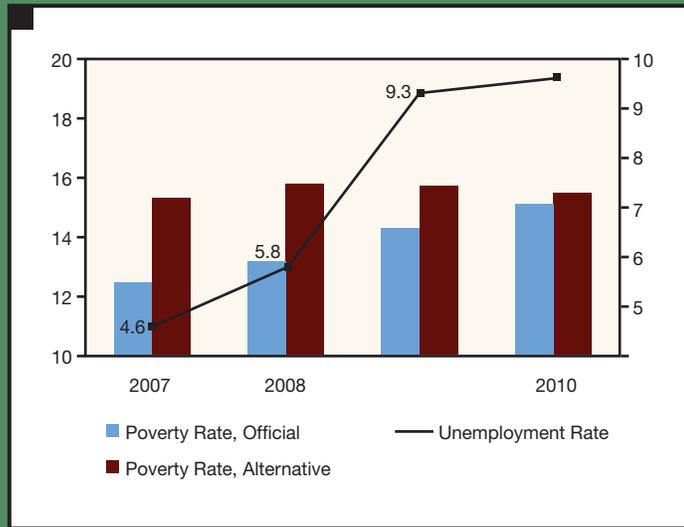
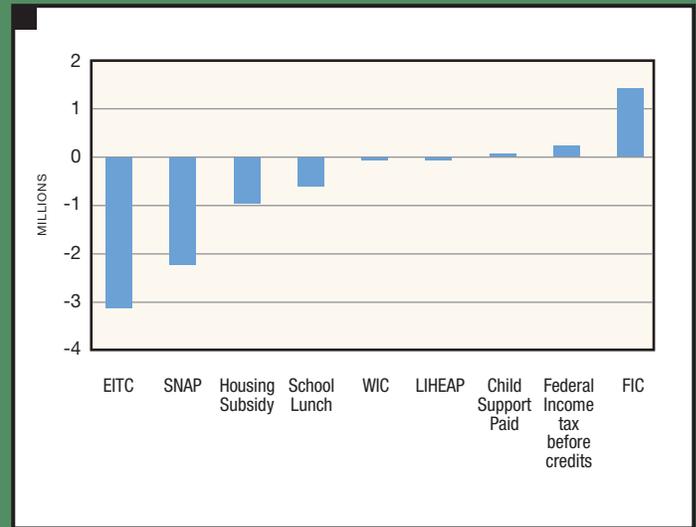


FIGURE 5: Effect of Tax and Noncash Benefits on the Number of Poor Children, 2010 (in millions).



ing body of work suggests, then, that income support programs have benefits that extend well beyond an increase in cash flow for families in poverty. And these benefits of EITC in turn accrue not only to the recipients themselves, but also indirectly to taxpayers who are relieved of the burden of subsidizing the health costs of those in poverty and who benefit from the burgeoning economy and growing tax rolls that the EITC brings about.

The EITC, clearly the cornerstone to the country's "second war" on poverty, may ultimately be judged one of the most successful labor market innovations in U.S. history. Grounded in

a simple (rational action) behavioral model, it has had powerful effects on labor market behavior and on poverty, effects that were for the most part intended and built directly into the program's incentive structure. ■

*Hilary W. Hoynes is a professor of public policy and economics at the University of California at Berkeley, and holds the Haas Distinguished Chair in Economic Disparities. She is the co-editor of the leading journal in economics, American Economic Review.*

## Endnotes

1. Meyer, B. D., & Rosenbaum, D. T. (2001). "Welfare, the earned income tax credit, and the labor supply of single mothers," *Quarterly Journal of Economics* 116(3), 1063–1114.

2. The supplemental poverty measure is available only beginning in 2010. In prior work, we constructed an alternative poverty measure that closely resembles the supplemental poverty measure, and is available back to 1980. For the purposes of this figure, it is necessary to use the alternative poverty measure in order to trace poverty through the recession. For details on this measure see: Bitler, M., and Hoynes,

H. (2010). "The state of the safety net in the post-welfare reform era," *Brookings Papers on Economic Activity*, fall 2010, 71–127.

3. Patel, A. (2012). "The Earned Income Tax Credit and expenditures." (Doctoral dissertation). University of California, Davis.

4. Evans, W., & Garthwaite, C. (2010). "Giving Mom a break: the impact of higher EITC payments on maternal health" (NBER working paper 16296). <http://www.nber.org/papers/w16296.pdf>.

5. For example, see: Hoynes, H., Miller, D., & Simon, D. (2012). "Income, the Earned Income Tax Credit, and infant health" (NBER working paper 18206). <http://www.nber.org/papers/w18206>; and Strully, K. W., Rehkopf, D. H., & Xuan, Z. (2010). "Effects of prenatal poverty on infant health: state Earned Income Tax Credits and birth weight," *American Sociological Review* 75(4), 534–562.

6. Dahl, G., & Lochner, L. (2012). "The impact of family income on child achievement: evidence from the Earned Income Tax Credit," *American Economic Review* 102(5), 1927–1956.