Why Has the EITC Expanded So Much? Intensive and Extensive Elasticities over Time

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Extended Abstract

How to design income support to the poor? Can we afford to provide large transfers to the income-poor? Since the early 1980s, this question has been at the forefront of policy debates in several OECD countries. Critics argue that the safety net can foster dependency, reduce labor force participation among the poor, and lead to significant economic inefficiencies. As a solution, it has been proposed to replace traditional means-tested transfers with transfers linked to earned income. These transfers initially increase with rising income (phase-in) and gradually decrease as households earn more (phase-out), effectively imposing work requirements.

Motivated by these arguments, the U.S. safety net has undergone major transformations since the 1980s. The system has shifted from providing benefits without work requirements—such as food stamps or family assistance programs—to providing tax credits that are designed to enforce work requirements. This shift is exemplified by the introduction of the Earned Income Tax Credit (EITC) in the 1980s and the Child Tax Credit (CTC) in the 1990s. These tax credits have grown to become some of the largest social welfare programs in the United States, now surpassing food stamps, for instance, even in the years following

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the Great Recession. However, concerns about the distributional impact of such policies have led to calls for a return to unconditional transfers to better support the poorest.

In that context, this paper aims to do three things. First, we document the shift in the distribution of transfers across households in the United States since the 1980s. Second, we quantify the optimal balance between standard means-tested transfers and those conditional on work requirements; third, we investigate the main economic drivers of the change in the nature of the welfare state documented above.

Estimating the distribution of transfers and tax credits across households is challenging due to scarce administrative data and severe underreporting in surveys. Moffitt and Pauley (2018) and Cardona, Moffitt, and Pauley (2022) provide aggregate data since the 1970s, with breakdowns by family type and income bins since 2004 only. Ferriere, Grübener, Navarro, and Vardishvili (2023) provide detailed distributions across the entire income distribution for 2012 only. We document the distribution of transfers and tax credits by income and household type since the 1980s in the United States. To address underreporting, we adapt existing imputation methods to account for the specifics of the safety net before the 2000s. To ensure robustness, we work with two datasets: the Current Population Survey (CPS) and the Survey of Income and Program Participation (SIPP). This analysis will allow us to quantify the extent to which the rise of tax credits has limited redistribution towards the very poor since the 1980s.[1]

We then develop a quantitative model to evaluate the joint optimal system of progressive income taxes and means-tested transfers with and without work requirements, using a structural approach to estimate labor elasticities along the distribution of households. The setup is a life-cycle model with incomplete markets, accounting for heterogeneity in household types and individual labor supply choices along both the extensive and intensive margins. The model also features a new flexible system of taxes and transfers designed to capture the distribution of transfers documented above.

We structurally estimate the model to match observed measures of individual labor supply elasticities, in the spirit of Erosa, Fuster, and Kambourov (2016) and Attanasio, Levell, Low, and Sánchez-Marcos (2018). The goal is to provide structural labor elasticities along the intensive and extensive margins by household type along the income distribution. We then use this model to compute the optimal nature and scope of redistribution, optimizing over the parameters of the tax-and-transfer functions.[2]

[1] At this stage, we have computed estimates of various taxes and transfers for the current time period using both the CPS and the SIPP, accounting for imputations. We have started working with the older waves of the SIPP to extend the analysis back in time.

[2] At this stage, we have coded up the full model and are working on the estimation of intensive and extensive margin labor elasticities by age and demographic characteristics for the current time period.

Finally, we take a historical perspective to understand why the EITC has expanded so much since the 1980s. We recalibrate the model to match labor force participation, inequality, and household characteristics of the U.S. economy in the late 1970s, prior to the documented changes in the U.S. safety net, and derive a new set of labor elasticities. We then compute the optimal tax-and-transfer system for the late 1970s and decompose the effects of each structural shift on optimal taxes and transfers, thereby identifying the key factors determining the optimal design of redistribution.

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