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EITC AS INCOME (IN)STABILITY?

by

*Kerry A. Ryan**

ABSTRACT

Congress enacted the Earned Income Tax Credit (EITC), inter alia, to entice poor single mothers to work (or work more) as a means of lifting themselves out of poverty. Its design as a wage subsidy that phases out at higher earnings levels is intended to accomplish this goal. A strong labor market is crucial to the success of work-based benefit programs, such as the EITC. The EITC can motivate female household heads to work (or work more), but they cannot act on that motivation if no jobs or additional working hours exist. This Article demonstrates that during economic downturns, the EITC wage subsidy contributes to, rather than prevents, poverty in single-mother families. Lost EITC benefits exacerbate recession-induced earnings losses, a phenomenon this Article refers to as income destabilization. In contrast, the EITC stabilizes the incomes of its wealthier beneficiaries as increased credit amounts offset underlying salary declines. While this pattern of income (de)stabilization is an unintended byproduct of the design of the EITC as a targeted wage subsidy, its negative impact on the economic welfare of female-headed households is problematic, given that these same families are the historically targeted program beneficiaries. This Article

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offers a narrowly tailored proposal that alters the structure of the EITC during recessionary periods in order to prevent EITC-induced income destabilization.

I. INTRODUCTION

The Earned Income Tax Credit (EITC) is the federal government's largest cash assistance program for low income families. In 2011, the federal government distributed $56 billion in cash benefits under the EITC program, almost 3.3 times more than the $17 billion of traditional means-tested welfare dollars distributed under the Temporary Assistance for Needy

Families or (TANF) program.[1] The EITC is a combination earnings subsidy and traditional means-tested welfare program administered through the income tax system.[2]

Congress enacted the EITC, *inter alia*, to entice single mothers to leave welfare and enter the labor market.[3] The design of the EITC as a wage subsidy that phases out at higher earnings levels is intended to accomplish this goal. Eligibility for the credit begins at the first dollar of earned income. The credit amount then rises with earnings (phase-in region), to a maximum credit amount. After remaining at its maximum level for a range of earnings (plateau region), the credit amount gradually declines to zero (phase-out region). The resulting unique EITC budget constraint creates a complicated set of work incentives and disincentives. The credit amount clearly encourages non-working single mothers to become employed, but the phase-out is expected to reduce labor supply among those already working.

Many past studies of the EITC focused on its effectiveness at increasing work or work effort[4] and reducing poverty in female-headed households.[5] Generally, these program analyses focused on the 1990s, a

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1. GENE FALK, CONG. RESEARCH SERV., R41823, LOW-INCOME ASSISTANCE PROGRAMS: TRENDS IN FEDERAL SPENDING (2012).

2. *See* Anne L. Alstott, *The Earned Income Tax Credit and The Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533, 540 (1995) [hereinafter Alstott, *Earned Income Tax Credit*]; Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 UCLA L. REV. 1867, 1868–69 (2005); Leslie Book, *Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor Through the Tax System,* 2006 WIS. L. REV. 1103 (2006).

3. *See infra* note 86 and accompanying text. *See also infra* notes 166–171 and accompanying text (discussing alternative Congressional goals for enacting the EITC).

4. *See, e.g.*, Nada Eissa & Hilary Hoynes, *Behavioral Responses to Taxes: Lessons from the EITC and Labor Supply*, 20 TAX POL'Y AND THE ECON. 73 (2006) [hereinafter Eissa & Hoynes, *Behavioral Responses*]; Emmanuel Saez, *Optimal Income Transfer Programs: Intensive Versus Extensive Labor Supply Responses*, 117(3) Q. J. ECON. 1039 (2002) [hereinafter Saez, *Transfer Programs*]; Bruce D. Meyer & Dan T. Rosenbaum, *Welfare, the Earned Income Tax Credit, and the Labor Supply of Single Mothers*, 116(3) Q. J. ECON. 1063 (2001) [hereinafter Meyer & Rosenbaum, *Labor Supply*].

5. *See, e.g.*, Bruce D. Meyer, *The Effects of the EITC and Recent Reforms*, 24 TAX POL'Y & ECONOMY 153, 159 (2010) [hereinafter Meyer, *Recent Reforms*] (providing that "in 2007, the EITC lifted just over 1.1 million families and over 2.1 million children above the poverty line"). *But see* Phyllis Jeroslow, *The Earned Income Credit as an Anti-Poverty Program: Palliative or Cure?* (July 18, 2012), http://www.social-policy.org.uk/lincoln2012/Jeroslow%20P8.pdf (arguing that these snapshot anti-poverty statistics overstate the antipoverty effectiveness of the EITC program because the official poverty line is an inadequate measure and reflects short-term gains but does not support the upward mobility of EITC beneficiaries).

unique decade for analysis of the EITC for two related reasons. First, it was a period of prolonged economic growth buoyed by a robust labor market.[6] Second, during that era, Congress substantially expanded work-based subsidies, such as the EITC, and contracted entitlement-based subsidies, such as welfare. Safety net reform promised female household heads that "work would pay," and it did. During the 1990s, many single mothers moved off welfare and into paid employment where the combination of earnings and EITC improved their economic well-being.

Lurking behind these EITC successes was an unforeseen danger. By linking the economic welfare of female-headed households to work and work supports like the EITC, this welfare was now inextricably tied to the vagaries of the labor market. This danger was obscured by the strong economy of the 1990s. In contrast, two economic downturns plagued the first decade of the 2000s resulting in unprecedented levels of unemployment, underemployment, and an overall decline in the real value of wages.[7] While all families suffered, these economic downturns hit families headed by single mothers especially hard.[8]

This leads to the question of what role, if any, does a program like the EITC, which is designed to positively affect the labor supply of single mothers in order to improve their economic outcomes, have in a world where demand-side restrictions dominate? The thesis of this Article is that the EITC work incentives are rendered ineffective by a recession and, as a result, the EITC fails to prevent, and lost EITC benefits may actually contribute to, female-headed household poverty. Accordingly, during economic downturns, the pro-work aspects of the EITC should be eased, and the program should instead focus on stabilizing falling incomes to prevent privation.

Historically, the EITC delineated between the working poor and the employable but non-working poor. The former were viewed as "deserving" of assistance (Workers), while the latter were viewed as undeserving because they "chose" not to work (Lazies). One crucial ingredient to the success of the new work-based safety net was a robust labor market. Single mothers can be incentivized to work or work more by the EITC, but they cannot claim the increased financial reward if no jobs exists.

The historically bad labor market during the first decade of the twenty-first century left many single mothers involuntarily unemployed.

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6. *See, e.g.*, Ben S. Bernanke, Governor, Federal Reserve Board, Remarks at the Eastern Economic Association (Feb. 20, 2004), http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2004/20040220/default.htm (referring to the 1990s as the Great Moderation).

7. *See* CARMEN DENAVAS-WALT ET AL., U.S. CENSUS BUREAU, INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN THE UNITED STATES: 2011, http://www.census.gov/prod/2012pubs/p60-243.pdf.

8. *Id.*

These female household heads do not fit into the historical dichotomy between Workers and Lazies. They are not Workers because they are unemployed and not Lazies because they wanted to work, but the market was such that no jobs existed. Given that the EITC is designed to target motivation and not opportunity,[9] the EITC currently discriminates against these single mothers based upon the state of the economy, rather than on some workfare notion of "desert."

The measure of the EITC's anti-poverty effectiveness shifted during the recent economic downturns. If the image from the 1990s was one of the EITC reaching down into the lowest income quintile and lifting female-headed families out of poverty, then the image from the 2000s is one of the EITC spreading its wings preventing families in upper income quintiles from falling into poverty as a result of wage losses. Both types of policies are "anti-poverty," but they are aimed at different beneficiaries and operate through different mechanisms.

The EITC is unique in that it can potentially perform both aforementioned anti-poverty functions within a single program. The wage subsidy in the phase-in range increases the incomes of low income female-headed households, while the phase-out range stabilizes the incomes of relatively wealthier taxpayers experiencing temporary earnings losses. The EITC stabilizes income if the benefit amount increases as wages decline. In that case, the increased EITC amount offsets a portion of the earnings loss thereby stabilizing post-tax income relative to pre-tax income.[10]

However, as this Article argues, the ability of the EITC to positively affect the incomes of all of its beneficiaries depends crucially on a strong economy. During economic downturns, the EITC continues to offer income protection to the increased number of claimants temporarily falling into its eligibility range as a result of earnings losses but actually destabilizes the incomes of poor single mothers suffering recession-induced wage declines.

9. *See infra* Part II Section C. 1.

10. Note that from an *ex ante* perspective, this same mechanism provides a form of income insurance. Under an income-based tax, the government shares in both earnings gains and losses. In the face of uncertain future income, this effectively narrows the range of possible earnings outcomes at both ends. Income risk is thereby reduced because the variance of post-tax income distribution is reduced. Although the income stabilization and income insurance effects of the EITC are related, they are usefully analyzed separately. The income insurance effect is forward-looking—it operates to reduce income risk before labor is supplied. In contrast, the EITC's stabilization effect is backward-looking—it offsets realized earnings losses. Furthermore, stabilization applies to all earnings shocks whereas insurance operates only on unexpected earnings drops. Finally, only actual recipients of the EITC enjoy stabilization effects whereas all taxpayers facing uncertain future income realize risk reduction from the existence of the EITC. I plan to explore the income insurance effect of the EITC in a later article.

Income destabilization results when the EITC amount and earnings move in the same direction. In that event, lost EITC benefits exacerbate the underlying pay cut, resulting in a larger loss to post-tax income than to pre-tax income.

This pattern of EITC income (de)stabilization is a byproduct of the design of the EITC as a targeted wage subsidy. Just as the EITC's uniquely shaped budget function impacts intra-annual labor supply incentives, so too does it affect the amount, availability, and most surprisingly the sign (positive or negative) of the EITC's inter-annual income stabilization capabilities. The EITC phase-out reduces the payoff from working more within a year, but it also eases income losses for those confronted with an annual decline in earnings. While the EITC phase-out is heralded by advocates as a targeting and cost savings device[11] and maligned by critics as an implicit tax creating negative labor supply incentives along the intensive margin,[12] its ability to stabilize post-tax income in the face of salary declines is one of its most underappreciated benefits.[13] In contrast, the wage subsidy provided in the phase-in region increases the payoff from working more within a given year, but it also exacerbates annual wage losses. While the EITC phase-in range is generally celebrated as encouraging single mothers to work,[14] these assessments almost universally fail to account for the range's marginal income destabilization effects.[15]

Evidence of poor single-mother EITC-induced income destabilization contradicts, in part, recent claims that the EITC served in a

11. *See generally*, INCOME TESTED TRANSFER PROGRAMS THE CASE FOR AND AGAINST (Irwin Garfinkel ed., 1982).

12. *See, e.g.*, Paul Trampe, *The EITC Disincentive: The Effects on Hours Worked from the Phase-out of the Earned Income Tax Credit*, 4(3) ECON. J. WATCH 308 (2007); Edgar K. Browning, *Effects of the Earned Income Tax Credit on Income and Welfare*, 48(1) NAT'L TAX J. 23 (1995) [hereinafter Browning, *Effects of EITC*]; Daniel Shaviro, *The Minimum Wage, the Earned Income Tax Credit and Optimal Subsidy Policy*, 64 U. CHI. L. REV. 405 (1997) [hereinafter Shaviro, *Minimum Wage*].

13. *But see*, Yair J. Listokin, *Equity, Efficiency, and Stability: The Importance of Macroeconomics for Evaluating Income Tax Policy*, 29 YALE J. ON REG. 45, 76–78 (2012) [hereinafter Listokin, *Equity, Efficiency and Stability*] (arguing that generally tax expenditures are destabilizing on a macroeconomic scale, but that the phase-out of certain tax expenditures can be stabilizing, and using the EITC as an example of a tax expenditure (destabilizing) with a phase-out (stabilizing)). *Cf.* Thomas J. Kniesner & James P. Ziliak, *Explicit Versus Implicit Income Insurance*, 25(1) J. RISK & UNCERTAINTY 5 (2002) [hereinafter Kniesner & Ziliak, *Implicit Insurance*] (lamenting that the optimal tax literature misses the implicit insurance provided by tax system, including EITC phase-out stabilization).

14. *See infra* notes 69–72 and accompanying text.

15. *But see*, Listokin, *Equity, Efficiency and Stability*, *supra* note 13.

safety net capacity during the recent economic downturns.[16] As indicated *supra*, the success of the EITC as a safety net program depends crucially on whose income needs protection. Phase-in range income destabilization disproportionately impacts female-headed households.[17] The EITC is a fair-weather friend to these single-mother families—boosting incomes when economic times are good and destabilizing incomes when economic times are bad. However, this is the exact opposite response pattern one would want in a safety net program. By definition, a safety net program should increase protection during recessionary periods.[18]

This Article introduces income (de)stabilization as a new variable, in addition to efficiency and equity, to be accounted for in evaluations of the EITC program, and argues for its primacy over competing objectives during recessionary periods.[19] Consider this quote from Alan Greenspan, former Chairman of the Board of Governors of the Federal Reserve System, testifying in favor of temporarily extending unemployment benefits (another income stabilization program) after the 2001 recession:

> [W]hen you get into a period where jobs are falling, then the arguments that people make about creating incentives to work no longer are valid and, hence, I've always argued that in periods like this the economic restraints on the unemployment insurance system almost surely ought to be eased to recognize the fact that people are unemployed

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16. *See, e.g.*, ALAN BERUBE, THE BROOKINGS INST., *The New Safety Net: How the Tax Code Helped Low-Income Working Families During the Early 2000s* (2006), http://www.brookings.edu/research/reports/2006/02/childrenfamilies-berube# [hereinafter BERUBE, THE NEW SAFETY NET]; JIMMY CHARITE , CHYE-CHING HUANG & CHUCK MARR, CBPP, *Studies Show Earned Income Tax Credit Encourages Work and Success in School and Reduces Poverty* 2,7 (Apr. 9, 2013) [hereinafter JIMMY CHARITE ET AL., STUDIES], http://www.cbpp.org/files/6-26-12tax.pdf.

17. *See infra* notes 45–48 and accompanying text.

18. Marianne Bitler, Hilary Hoynes, & Elira Kuka, *Do In-Work Tax Credits Serve as a Safety Net?* (2013) (Goldman School of Public Policy Working Paper) [hereinafter Bitler et al., *Safety Net*]; http://www.socsci.uci.edu/~mbitler/papers/Bitler-Hoynes-Kuka-4-23-13-final.pdf (demonstrating that the earned income distribution for single-mothers is "shifted to the left of the distribution for married parents" and is most concentrated in the EITC phase-in range).

19. *See* Kniesner & Ziliak, *Implicit Insurance*, *supra* note 13, at 18 (lamenting that optimal tax analyses misses stabilization and associated consumption-smoothing as an additional welfare-enhancing aspect of an income tax to be traded off with equity and efficiency).

> because they couldn't get a job, not because they don't feel like working.[20]

In other words, in a weak labor market, a focus on work incentives is misplaced as they are likely rendered ineffective by prevailing market conditions. Instead, during recessionary periods, cash-based safety net programs should offer relief to those experiencing involuntary wage or job losses.

The last part of this Article offers a concrete proposal designed to accomplish this goal. Specifically, when the economy meets some pre-defined conditions indicating a recession, the existing EITC schedule would automatically convert to one resembling a negative income tax (NIT) with an income disregard.[21] Under a traditional NIT program, a maximum transfer amount is provided to non-workers and is immediately reduced as earnings increase at a pre-defined benefit reduction rate. The purpose of the income disregard is to minimize the negative work incentives inherent in a traditional NIT by delaying the maximum benefit reduction until an initial amount of income is earned.

In contrast, under the proposal, the income disregard is designed to prevent EITC phase-in income destabilization. In all but the phase-in range, the current EITC budget function already resembles that of an NIT with an income disregard.[22] Essentially, under the proposal, the phase-in region is eliminated but all other EITC parameters (maximum credit amount and the threshold and completed phase-out amounts) remain unchanged. As a result, post-tax income can only be stabilized or unaffected by the modified EITC. Upon an economic recovery, the EITC structure automatically reverts to its original form.

The EITC critique in the Article is not that EITC income destabilization is, in and of itself, a bad thing. Under normal economic conditions, the EITC properly trades off the benefit of providing a wage subsidy to low-income working families with the potential cost of destabilizing the incomes of those same families if annual earnings losses occur. Instead, this Article's claim is that in severe economic downturns, the subsidy is likely to be ineffective and the likelihood of widespread income

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20. PETE STARK, RANKING MEMBER, JOINT ECON. COMM. DEMOCRATS, THE SOCIAL BENEFITS OF UNEMPLOYMENT INSURANCE FAR OUTWEIGH THE COSTS: AN OVERVIEW OF THE ECONOMIC LITERATURE, ECON. POLICY BRIEF 1 (2003), http://www.jec.senate.gov/archive/Documents/Reports/uicostsbenefits10april2003.pdf (quoting HEARING ON THE ECONOMIC OUTLOOK, BEFORE THE JOINT ECON. COMM., 108TH CONG. 17, (2003) (statement of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System).

21. *See infra* Part IV.

22. Browning, *Effects of EITC*, *supra* note 12, at 24–5.

destabilization substantially increases. Hence, the policy balance shifts in favor of stabilization over incentives. However, once economic conditions return to normal, the primacy of work incentives is restored and the concern about EITC income destabilization is diminished.

This Article contributes to a small, but growing, chorus of scholars critical of the EITC as a safety net program, although it distinguishes itself from these previous efforts by basing its critique on income destabilization.[23] In doing so, it engages with the macroeconomic literature on automatic stabilization[24] and a newly emerging legal literature focused specifically on tax system stabilization.[25] This Article also introduces the legal audience to the insights of inter-temporal poverty analysis[26] in general and as applied to the ETIC in particular.[27]

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23. *See* Anne L. Alstott, *Why the EITC Doesn't Make Work Pay*, 73 L. & CONTEMP. PROBS. 285, 288 (2010) (criticizing the EITC for "focus[ing] on the situation of workers while they hold jobs, ignoring the frequent spells of job disruption due to unemployment, disability, and family needs that are common among low-wage workers. . . . It is, thus, a shortcoming of wage subsidies in general, and not the EITC in particular, that gaps in the social safety net leave low-income workers vulnerable to involuntary work disruption"); Sarah Sternberg Greene, *The Broken Safety Net: A Study of Earned Income Tax Credit Recipients and a Proposal for Repair*, 88 N.Y.U. L. REV. 515 (2013) [hereinafter Greene, *Broken Safety Net*] (relying on interviews with EITC recipients to identify the timing and payment mechanisms of the EITC as problematic and offering a proposed solution).

24. *See, e.g.*, Alan J. Auerbach & Daniel Feenberg, *The Significance of Federal Taxes as Automatic Stabilizers*, 14(3) J. OF ECON. PERSP. 37, 40 (2000) [hereinafter Auerbach & Feenberg, *Automatic Stabilizers*].

25. *See* Lily L. Batchelder, Fred T. Goldberg, Jr. & Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 61–65 (2006) (making the efficiency case for universal refundable credits as the default form tax subsidy but arguing secondarily that such credits stabilize macroeconomic income); Brian Galle & Jonathan Klick, *Recessions and the Social Safety Net: The Alternative Minimum Tax as a Counter-Cyclical Fiscal Stabilizer*, 63 STAN. L. REV. 187 (2010) (arguing that the alternative minimum tax can act as an automatic stabilizer to offset the cyclicality of state budgets); Listokin, *Equity, Efficiency and Stability supra* note 13, at 76–78 (applying Kenyesian macroeconomic principles to demonstrate that most tax expenditures are pro-cyclical).

26. *See, e.g.*, POVERTY DYNAMICS: INTERDISCIPLINARY PERSPECTIVES (Tony Addison et al. eds., 2009) [hereinafter POVERTY DYNAMICS]; Mary Jo Bane & David T. Ellwood, *Slipping Into and Out of Poverty: The Dynamics of Spells*, 21(1) J. HUM. RESOURCES 1 (1986) [hereinafter Bane & Ellwood, *Dynamics of Spells*]; David Hulme, Karen Moore & Andrew Shepard, *Chronic Poverty: Meanings and Analytical Frameworks* (Chronic Poverty Research Center Working Paper 2, 2001), http://www.chronicpoverty.org/uploads/publication_files/WP02_Hulme_et_al.pdf [hereinafter Hulme et al., *Analytical Frameworks*].

After this introduction, the Article will proceed in several parts. Part II provides background material on the EITC, detailing the program's structure, beneficiaries, and labor supply incentives. Part II also frames the history of the program as an evolution from anti-welfare, to anti-poverty, to its current incarnation as an anti-recession or safety net program. Section A of Part III describes the mechanism through which the EITC can (or cannot, as the case may be) offer safety net protection to its beneficiaries, namely through its ability to offset (or exacerbate) pre-tax earnings losses. Section B of Part III draws out some of the normative implications of this pattern of EITC income (de)stabilization in the context of highlighting the winners and losers in the "EITC safety net" paradigm. Part IV is prescriptive, offering a concrete proposal narrowly tailored to address the indicated problem of recession-induced EITC phase-in income destabilization. The Article then concludes.

II. EITC IN GENERAL

A. *Background*

The EITC is a refundable tax credit program that provides a subsidy to low income working households.[28] The EITC operates to reduce a recipient's income tax payable on a dollar-for-dollar basis.[29] If the credit amount exceeds income tax payable, the EITC recipient receives a cash payment from the government in the amount of such excess.[30] In 2010, about 91 percent of all EITC dollars were refunded rather than reducing income tax liability.[31]

The EITC is targeted at working households with positive earned income and total income below a certain threshold that varies by year and

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27. Timothy Dowd & John B. Horowitz, *Income Mobility and the Earned Income Tax Credit: Short-Term Safety Net or Long-Term Income Support*, 39(5) PUB. FIN. REV. 619 (2011) [hereinafter Dowd & Horowitz, *Income Mobility*]; Timothy Dowd, *Distinguishing Between Short-Term and Long-Term Recipients of the Earned Income Tax Credit*, 58 NAT'L TAX J. 787 (2005) [hereinafter Dowd, *Distinguishing Between Short-Term and Long-Term*]; John B. Horowitz, *Income Mobility and the Earned Income Tax Credit*, 40(3) ECON. INQUIRY 334 (2002) [hereinafter Horowitz, *Income Mobility & EITC*].

28. *See generally* I.R.C. § 32 (2006).

29. *Id.*

30. *Id.*

31. IRS, STATISTICS OF INCOME DIVISION, HISTORICAL TABLE 1. INDIVIDUAL INCOME TAX RETURNS: SELECTED INCOME AND TAX ITEMS FOR TAX YEARS 1999-2011 (PRELIMINARY), http://www.irs.gov/uac/SOI-Tax-Stats-Historical-Table-1 (last updated Apr. 19, 2013).

family size.[32] Although a modest EITC is available to childless taxpayers,[33] the bulk of the program benefits flow to taxpayers with at least one "qualifying child."[34] The amount of the EITC is based on the presence and number of qualifying children in the worker's family, as well as the worker's adjusted gross income (AGI) and earned income.[35] The EITC amount generally equals a "credit percentage" of earned income up to the "earned income amount."[36] In 2013, the credit percentage for a household with: (1) no qualifying children was 7.65 percent; (2) one qualifying child was 34 percent; (3) two qualifying children was 40 percent; and (4) three or more qualifying children was 45 percent.[37]

The maximum EITC amount applies to taxpayers with earned incomes between the "earned income amount" and the "threshold phase-out amount."[38] The maximum EITC credit then gradually phases down over a certain income range until it reaches zero when AGI (or, if greater, earned

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32. I.R.C. § 32(a)(1), (b)(1) (allowing the credit and describing the credit amount as a certain percentage of "earned income" but reducing it by a certain percentage of adjusted gross income (or, if greater, the earned income)). *See also* I.R.C. § 32(c)(2) (defining earned income as "wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income for the taxable year" and net earnings from self-employment for the taxable year). This generally means that non-workers cannot benefit from the program. *But see*, Noah Zatz, *Revisiting the Class-Parity Analysis of Welfare Work Requirements*, 83 SOC. SERV. REV. 313, 328 (2009) (arguing that unemployed spouses of EITC recipients economically benefit from the program cutting against the claim that it only benefits workers).

33. In 2001, only two percent of total EITC dollars went to childless income tax filers, while 98 percent of the total EITC expenditures were paid to income tax filers with at least one qualifying child. Eissa & Hoynes, *Behavioral Responses*, *supra* note 4, at 83.

34. *See* I.R.C. § 32(c)(3) (defining "qualified child" by cross-referencing I.R.C. § 152(c) which generally uses an age, residence, relationship, and support test).

35. *See generally* I.R.C. § 32.

36. I.R.C. § 32(a). Earned income includes wages, salaries, tips and other employee compensation, net earnings from self-employment, but excludes amounts received as pensions, annuities, unemployment compensation, or social security. I.R.C. § 32(c)(2)(A), Reg. § 1.32-2(c)(2).

37. I.R.C. § 32 (b)(1)(A), (b)(3)(A). The increased percentage for three or more qualifying children originally applied only in tax years 2009 and 2010. I.R.C. § 32(b)(3). However, it was extended through 2012. *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296, 3299. Recently it was made permanent. *See* American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313.

38. I.R.C. § 32(a), (b).

income) equals the "completed phase-out amount."[39] For taxpayers in the phase-out range (those with AGI or, if greater, earned income, in excess of the "phase-out amount"), the maximum EITC amount is reduced by the "phase-out percentage" multiplied by the amount of AGI (or, if greater, earned income) in excess of the threshold phase-out amount.[40] In 2013, the phase-out percentage for a household with: (1) no qualifying children was 7.65 percent; (2) one qualifying child was 15.98 percent; (3) two qualifying children was 21.06 percent; and (4) three or more qualifying children was 21.06 percent.[41] For taxpayers with AGI (or, if greater, earned income) in excess of the completed phase-out amount, no credit is allowed.

The 2013 inflation-adjusted EITC amounts are set forth in Table 1.[42]

Table 1: 2013 EITC Parameters
Number of Qualifying Children

Item	*None*	*One*	*Two*	*Three or More*
Earned Income Amount	$ 6,370	$ 9,560	$13,430	$13,430
Maximum EITC Credit Amount	$ 487	$ 3,250	$ 5,372	$ 6,044
Threshold Phase-out Amount (*except* married filing jointly)	$ 7,970	$17,530	$17,530	$17,530
Completed Phase-out Amount (*except* married filing jointly)	$14,340	$37,870	$43,038	$46,227
Threshold Phase-out Amount (married filing jointly)	$13,310	$22,870	$22,870	$22,870
Completed Phase-out Amount (married filing jointly)	$19,680	$43,210	$48,378	$51,567

This set of program rules creates an EITC structure with three distinct regions. Initially in the "phase-in" region, the EITC acts as an

39. I.R.C. § 32 (b). The term "completed phase-out amount" is not a statutory term, rather, it is the term used by the IRS in its annual administrative pronouncement on the inflation-adjusted EITC parameters. *See, e.g.*, Rev. Proc. 2013-15, 2013-5 I.R.B. 444, 446.

40. I.R.C. § 32 (a)(2).

41. *See* CHRISTINE SCOTT, CONG. RESEARCH SERV., RS 21352, THE EARNED INCOME TAX CREDIT (EITC): CHANGES FOR 2012 AND 2013 2 (2013).

42. Rev. Proc. 2013-15, *supra* note 39, at 447.

earnings subsidy—as earnings increase, the EITC amount increases by the applicable credit percentage of earned income.[43] The applicable credit percentage is essentially a negative marginal tax or subsidy rate.[44] Approximately 23 percent of EITC claimants are located in the phase-in range.[45] This EITC region tends to be populated by female-headed households.[46] Unmarried and head of household EITC claimants outnumber their married EITC brethren by a three to one margin.[47] The disproportionate share of single EITC participants reflects the higher eligibility rates—due to lower earnings—of single women with children.[48]

Over the next range of earnings ("flat" or "plateau" region), for those who fall between the earned income amount and the threshold phase-out amount, the EITC acts as a lump-sum subsidy—the maximum EITC amount

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43. Alstott, *Earned Income Tax Credit and Limitations*, *supra* note 2, at 541.

44. *See* Shaviro, *Minimum Wage*, *supra* note 12, 459–66.

45. V. Joseph Hotz & John Karl Scholz, *The Earned Income Tax Credit, in* MEANS-TESTED TRANSFER PROGRAMS IN THE UNITED STATES 141, 158 (Robert A. Moffitt, ed. 2003) [hereinafter Hotz & Scholz, *Earned Income Tax Credit*] (or 24 percent of EITC expenditures).

46. *Id.* at 84 (using 2001 SOI data to find that the phase-in range contained 25 percent of EITC head of household and single income tax returns as compared to only 15 percent of married couples). *See also* Bitler et al., *Safety Net*, *supra* note 18, at 8, 30 fig. 4 (demonstrating that the earned income distribution for single-mothers is "shifted to the left of the distribution for married parents" and is most concentrated at the EITC phase-in range); SAUL D. HOFFMAN & LAURENCE S. SEIDMAN, HELPING WORKING FAMILIES: THE EARNED INCOME TAX CREDIT 45 (2003) [hereinafter HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES]; Jeffrey B. Liebman, *The Impact of the Earned Income Tax Credit on Incentives and Income Distribution*, 12 TAX POL'Y & THE ECON. 83 (1998) [hereinafter Liebman, *The Impact of EITC*].

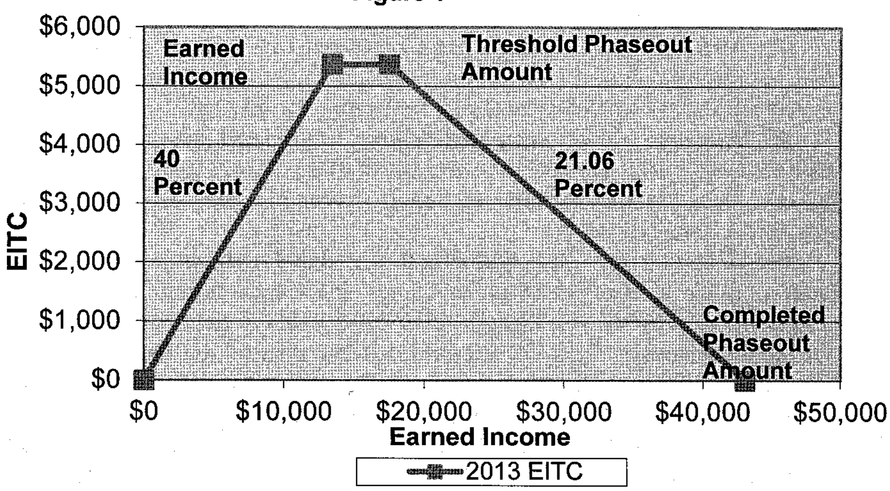
47. COMM. ON WAYS & MEANS, U.S. HOUSE OF REP., 108TH CONG., 2004 GREEN BOOK: BACKGROUND MATERIALS AND DATA ON THE PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS 1340–41 (2004) [hereinafter WAYS & MEANS, 2004 GREEN BOOK] (indicating that in 2003, unmarried and head of household claimants accounted for 75 percent of the income tax returns and expenditures in the EITC program whereas married couples accounted for the remaining 25 percent). *But see* Meyer, *Recent Reforms*, *supra* note 5, at 156 (using Current Population Survey (CPS) which calculated that only 57 percent of EITC dollars go to single parents, but also noting that IRS data "provide better information on numbers of recipients and credit amounts"). *Id.*

48. Eissa & Hoynes, *Behavioral Responses*, *supra* note 4, at 83. In 2008, single parents were the largest EITC demographic group representing 58.7 percent of claimants. Bitler et al., *supra* note 18, at 8–9, 30 fig. 4. By way of comparison, married couples with children represented only 19.4 percent of claimants. *Id.* Earnings of single parent EITC-eligible families tend to be lower than those of families with married parents. *Id.* at 8, 30 fig. 4.

is provided regardless of the level of earnings.[49] The flat region contains 19 percent of EITC claimants.[50] In the "phase-out" range (earnings in excess of the threshold phase-out amount but less than the completed phase-out amount), the EITC acts as a traditional means-tested income transfer program—as earnings increase, the credit amount is reduced by the phase-out percentage.[51] The phase-out percentage operates as an implicit positive marginal tax rate.[52] A majority (58 percent) of EITC claimants are located in the phase-out range.[53] Due to higher earnings, married couples tend to dominate this region. Indeed, more than two-thirds of married EITC recipients are located in the phase-out range.[54]

The 2013 EITC schedule for a head of household income tax filer with two qualifying children is depicted visually in Figure 1.[55]

Figure 1



49. Browning, *Effects of EITC*, *supra* note 12, at 24; Horowitz, *Income Mobility & EITC*, *supra* note 27, at 334.

50. Hotz & Scholz, *Earned Income Tax Credit*, *supra* note 45, at 158 (or 26 percent of EITC expenditures).

51. Alstott, *Earned Income Tax Credit*, *supra* note 2, at 541; Horowitz, *Income Mobility & EITC*, *supra* note 27, at 334. The exemplar of an income transfer program is welfare.

52. *See* Shaviro, *Minimum Wage*, *supra* note 12, 459–66.

53. Hotz & Scholz, *Earned Income Tax Credit*, *supra* note 45, at 158 (or 50 percent of EITC expenditures).

54. Eissa & Hoynes, *Behavioral Responses*, *supra* note 4, at 84 (using 2001 SOI data). *See also* Bitler et al., *Safety Net*, *supra* note 18, at 8, 30 fig. 4 (demonstrating that the earnings distribution for married couples with children is shifted to the right of the distribution for single parents).

55. *See supra* note 42 and accompanying text.

B. Work (Dis)Incentives

Notice that in Figure 1 the slope of the EITC function is steeper in the phase-in range than the phase-out range. This is a result of the higher phase-in or subsidy rate as compared to the lower phase-out or implicit tax rate. The unique shape of the EITC budget constraint results in a complicated set of work incentives and disincentives. The EITC can impact the labor supply decisions of working taxpayers in deciding how many hours to work and the labor-force-participation decisions of currently unemployed individuals.[56]

The EITC labor supply incentives are ambiguous and depend on an individual's: (1) pre-tax and transfer income and (2) the relative weights of the income versus substitution effects.[57] If pre-tax and transfer income is located in the phase-in region, the EITC acts as an increase in net wage rate, causing conflicting negative income and positive substitution effects.[58] The higher wage rate provides an incentive to work more hours because it increases the return to work relative to leisure, but the higher income provides an incentive to work less because the worker can consume as much as before only with less work.[59] The overall net effect on labor supply cannot be predicted.[60] The EITC acts as a lump sum transfer (increase in non-labor income with no change in wage rate) in the plateau region creating only negative income effects.[61] Theoretically, such effects should reduce hours worked. In the phase-out region, the EITC reduces the net wage rate by the phase-out percentage and increases non-labor income by the amount of the

56. *See generally* HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES, *supra* note 46, at 62; Saez, *Transfer Programs*, *supra* note 4; Eissa & Hoynes, *Behavioral Responses, supra* note 4, at 87.

57. *See generally*, HOTZ & SCHOLZ, MEANS-TESTED TRANSFER PROGRAMS, *supra* note 45, at 160–163; Eissa & Hoynes, *Behavioral Responses*, *supra* note 4, at 87–102; HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES *supra* note 46, at 57–66; and SAUL D. HOFFMAN & LAURENCE S. SEIDMAN, THE EARNED INCOME TAX CREDIT 38–42 (1990) [hereinafter HOFFMAN & SEIDMAN, THE EARNED INCOME TAX CREDIT].

58. Eissa & Hoynes, *Behavioral Responses*, *supra* note 4, at 88–89; HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES, *supra* note 46, at 62.

59. *Id.*

60. HOTZ & SCHOLZ, MEANS-TESTED TRANSFER PROGRAMS, *supra* note 45, at 161; Eissa & Hoynes, *Behavioral Responses*, *supra* note 4, at 88–99; HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES, *supra* note 46, at 62.

61. HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES, *supra* note 46, at 62–63; Eissa & Hoynes, *Behavioral Responses*, *supra* note 4, at 88–89.

credit.[62] This creates negative substitution and income effects, both of which are expected to reduce labor supply.[63]

Empirical studies suggest that the EITC failed to significantly impact the labor supply of single mothers. For example, Eissa and Liebman find a small positive (and marginally significant) impact of the EITC on annual hours worked on all single mothers and a zero impact on low-educated single mothers.[64] Meyer and Rosenbaum find mixed (both positive and negative) yet insignificant impacts of the EITC on hours worked for single mothers.[65] In contrast, the ETIC did reduce the labor supply of married women (who tend to populate the phase-out range). Hoffman and Seidman estimated that the EITC decreased the annual hours worked of married women in EITC recipient families by 3.6 percent.[66] Eissa and Hoynes also found that past EITC expansions were associated with decreased average hours of work for married women.[67]

The EITC unambiguously creates an incentive for those single taxpayers not currently working to enter the labor force because it raises the net wage (positive substitution effect) but without making the individual any richer at her current hours of work (no income effect).[68] The empirical literature confirms that the EITC did in fact significantly increase participation of single mothers in the labor force. For example, Eissa and Liebman estimated that the 1986 EITC expansion[69] increased labor force participation among all single women with children by as much as 2.8 percentage points relative to single women without children.[70] Among single women with children most likely to be affected by the EITC (those with less than a high school degree), the relative participation response increased to

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62. HOFFMAN & SEIDMAN, THE EARNED INCOME TAX CREDIT, *supra* note 57, at 41.

63. *Id.*; HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES, *supra* note 46, at 63; Eissa & Hoynes, *Behavioral Responses, supra* note 4, at 89.

64. Nada Eissa & Jeffrey B. Liebman, *Labor Supply Response to the Earned Income Tax Credit,* 111 Q. J. OF ECON. 605 (1996) [hereinafter Eissa & Liebman, *Labor Supply Response*].

65. Meyer & Rosenbaum, *Labor Supply*, *supra* note 4, at 1063.

66. HOFFMAN & SEIDMAN, THE EARNED INCOME TAX CREDIT, *supra* note 57, at 41.

67. Eissa & Hoynes, *Behavioral Responses*, *supra* note 4, at 84. *See infra* notes 87–130 and accompanying text (providing information on past EITC expansions).

68. HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES, *supra* note 46, at 64 (current hours of work are zero).

69. *See infra* notes 88–93 and accompanying text.

70. Eissa & Liebman, *Labor Supply Response*, *supra* note 64, at 605, 607. *See infra* text accompanying notes 87–93 (providing information about the 1986 EITC expansion).

6.1 percentage points.[71] Eissa and Hoynes found that the labor force participation of women with children increased from 73 percent in 1984 to 85 percent in 2003 whereas no such change was evident in single women without children during the same period.[72]

C. *Evolution of the EITC*

1. *Anti-Welfare*

As discussed by Ventry and others, the unique design of the EITC schedule, with its phase-in and phase-out ranges, reflects its historical roots as a pro-work alternative to the negative income tax (NIT) proposals of the 1960s and 1970s which were offered as an alternative to the then-existing traditional means-tested welfare programs.[73] Welfare programs provided the largest benefit to those single-mother families with zero income and phased out the transfer amount as earnings increased at benefit reduction rates

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71. *Id.* at 629. *See also* Meyer & Rosenbaum, *Labor Supply*, *supra* note 4, at 1063 (estimating that 60 percent of the 8.7 percentage point increase in employment of single-mothers between 1984 and 1996 was due to the EITC); Jeffrey Grogger, *The Effects of Time Limits, the EITC and Other Policy Changes on Welfare Use, Work, and Income Among Female-Headed Families*, 85 REV. OF ECON. & STAT. 394, 404 tbl. 4 (2003) [hereinafter Grogger, *Effects of Time Limits*] (estimating that the EITC was responsible for 34 percent of the increase in employment among single-mothers during the 1993-1999 period).

72. Eissa & Hoynes, *Behavioral Responses*, *supra* note 4, at 95–6. There is some new empirical evidence suggesting that the positive labor force participation effects of the EITC leveled off after 2000. Nada Eissa, Henrik Jacobsen Kleven & Claus Thustrup Kreiner, *Evaluation of Four Tax Reforms in the United States: Labor Supply and Welfare Effects for Single Mothers*, 92 J. PUB. ECON. 795 (2008). This study estimated welfare gains along the labor force participation margin (as a percentage of aggregate labor income) for the 1986, 1990, 1993 and 2001 EITC reforms. *Id.* at 810 tbl. 2 (estimated using simulations with "an hours-of-work elasticity equal to 0.1 and a participation elasticity equal to 0.4"). These welfare gains peaked at 4.48 percent for the 1986 EITC reform, declined by one-half after the EITC reforms in the 1990s, and fell to 0.64 percent with the 2001 EITC reforms. *Id.* The authors speculated "that by 2000, previous [EITC] reforms seem to have eliminated much of the inefficiency along the extensive margin." *Id.*

73. Dennis Ventry Jr., *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit*, *in* MAKING WORK PAY: THE EARNED INCOME TAX CREDIT AND ITS IMPACT OF AMERICAN FAMILIES 15, 17 (Bruce D. Meyer & Douglas Holtz-Eakin, eds., 2001) [hereinafter Ventry, *The Collision of Tax*]; HOTZ & SCHOLZ, MEANS-TESTED TRANSFER PROGRAMS, *supra* note 45, at 144–45; HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES, *supra* note 46, at 11–16.

nearing 100 percent.[74] This structure was viewed as problematic mainly because it discouraged work and self-sufficiency.[75] Critics also complained that the welfare programs were state-specific, failed to cover all persons in need, and that recipients were subject to a stigmatizing and demoralizing application process run by a large and inefficient bureaucracy.[76]

Reformers proposed a NIT as an alternative to traditional welfare programs. In general, NIT plans were defined by two features: (1) a basic allowance or guaranteed minimum provided to eligible individuals or households and (2) an offsetting tax which every recipient of the basic allowance paid on his or her other income (typically at a rate less than 100 percent but greater than lowest marginal rate bracket of the positive income tax).[77] The benefit amount paid to the recipient equaled the basic allowance less the offsetting tax.[78] The NIT was viewed as superior to traditional welfare programs by its proponents because: (1) it was a national anti-poverty program—available to anyone meeting the federally mandated (as opposed to state-specific) objective criteria, (2) tax system administration reduced administrative and stigma-related costs, and (3) lower marginal benefit reduction rates minimized work disincentives.[79]

Senator Long (then-chairman of the Senate Finance Committee) objected to the NIT because it provided its largest benefits to those without any earnings thereby undermining the work effort of low income individuals.[80] As an alternative to the NIT, he proposed a "work bonus" program that would, *inter alia*, provide a wage subsidy to low income workers.[81] Long differentiated his program from NIT plans by emphasizing its pro-work nature.[82] Non-workers could not receive the work bonus.[83] As an earnings subsidy, it rewarded, rather than penalized work.[84] Although the work bonus eventually phased out, it did so at a much lower rate than any of the NIT plans.[85] Philosophically, the work bonus program "embodied Long's vision of a program that moved individuals off welfare and into paid employment while keeping others off the welfare rolls. It covered only

74. Ventry, *The Collision of Tax*, *supra* note 73, at 17.

75. *Id.* at 16–17.

76. James Tobin, Joseph A. Pechman & Peter M. Mieszkowiski, *Is a Negative Income Tax Practical?* 77 YALE L.J. 1 (1967).

77. *Id.* at 2.

78. *Id.*

79. Ventry, *The Collision of Tax*, *supra* note 73, at 17; Hotz & Scholz, *Earned Income Tax Credit*, *supra* note 45, at 142, 144.

80. Hotz & Scholz, *Earned Income Tax Credit*, *supra* note 45, at 142.

81. *Id.* at 144.

82. Ventry, *The Collision of Tax*, *supra* note 73, at 22.

83. *Id.*

84. *Id.*

85. *Id.*

working poor families with children and forced the 'underserving' poor either to choose paid employment or resort to stigmatized and inadequate [traditional welfare] services."[86]

2. *Pro-Progressivity*

During the mid-1980s, the EITC was expanded, in part, to counteract progressivity-reducing income tax reform enacted during this period.[87] In particular, the Tax Reform Act of 1986 (TRA86) broadened the tax base, reduced the number of tax brackets, and reduced the top marginal rate.[88] TRA86 was explicitly designed to be revenue neutral, and maintain the then-existing distribution of tax burdens.[89] The expansion of the EITC was one of several tools used to offer tax relief to low income families as a way of offsetting the reduction in tax burden on high income taxpayers thereby maintaining overall burden neutrality.[90] During the 1980s, the EITC phase-in rate increased from 10 percent to 14 percent, the maximum credit amount increased from \$550 (1985) to \$953 (1990) and was indexed for inflation, and the phase-out rate decreased from 12.22 percent to 10 percent.[91] The declining phase-out rate increased the completed phase-out amount from \$11,000 (1985) to \$20,264 (1990).[92] This resulted in a large number of new

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86. *Id.* at 25.

87. Thomas Piketty & Emmanuel Saez, *How Progressive is the U.S. Federal Tax System? A Historical and International Perspective*, 21(1) J. ECON. PERSP. 3, 23 (2007) [hereinafter Piketty & Saez, *U.S. Federal Tax System*]. The Economic Recovery Tax Act of 1981, or ERTA, reduced the top marginal tax rate from 70 percent to 50 percent and cut rates in all other brackets. JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 24 (4th ed. 2008) [hereinafter SLEMROD & BAKIJA, TAXING OURSELVES].

88. SLEMROD & BAKIJA, TAXING OURSELVES, *supra* note 87, at 24; Thomas J. Kniesner & James P. Ziliak, *Tax Reform and Automatic Stabilization*, 92(3) AM. ECON. REV. 590 (2002) [hereinafter Kniesner & Ziliak, *Tax Reform*].

89. SLEMROD & BAKIJA, TAXING OURSELVES, *supra* note 87, at 25.

90. Dennis J. Ventry, Jr., *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit, 1969-1999*, 53 NAT'L TAX J. 983, 1004 (2000) [hereinafter Ventry, *Political History*]. TRA86 also increased the standard deduction and personal exemption amounts which, along with the expanded EITC, effectively removed most of the working poor from the income tax system. *Id.* at 1002.

91. HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES, *supra* note 46, at 14. The 1986 reform also "indexed the EITC for inflation, protecting workers against erosion of the credit's real value." STEVE HOLT, THE BROOKINGS INST., THE EARNED INCOME TAX CREDIT AT AGE 30: WHAT WE KNOW, 2 (2006), http://www.brookings.edu/~/media/research/files/reports/2006/2/childrenfamilies%20holt/20060209_holt.pdf, [hereinafter HOLT, THE EITC AT AGE 30].

92. Kniesner & Ziliak, *Tax Reform*, *supra* note 88, at 594.

EITC claimants, as total credits rose from \$2.1 billion in 1985 to \$7.5 billion in 1990.[93] Tax reforms in the 1990s partially restored some measure of progressivity in the income tax system by increasing marginal rates.[94] The EITC was expanded in part in the 1990s "to ensure that federal deficit reduction initiatives did not further burden lower-income families."[95] The Omnibus Budget Reconciliation Act of 1990, or OBRA1990, increased the EITC phase-in rate, phase-out rate, and maximum credit amount and provided for a more generous credit for families with two or more children.[96] The Omnibus Budget Reconciliation Act of 1993, or OBRA 1993 further increased the phase-in rate, phase-out rate, and maximum credit amount and extended a small credit to childless low income workers.[97] Overall, between 1990 and 2000, the maximum credit amount increased from \$953 to \$2,353 (one child) and \$3,888 (two or more children).[98] During this same period, the phase-in rate increased from 14 percent to 34 percent (one child) and 40 percent (two or more children). Similarly, the phase-out rate increased from 10 percent to 15.98 percent (one child) and 21.06 percent (two or more children).[99] The corresponding credit eligibility cut-off income level increased from \$20,264 to \$27,413 (one child) and \$31,152 (two or more children).[100] The EITC expansions during the 1990s almost tripled the program's cost and resulted in EITC spending that outpaced both traditional welfare and food stamp spending.[101]

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93. HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES, *supra* note 46, at 14.

94. Piketty & Saez, *U.S. Federal Tax System*, *supra* note 87, at 23. OBRA1990 raised the top marginal income tax rate from 28 to 31 percent and OBRA93 raised it even further to 39.6 percent. SLEMROD & BAKIJA, TAXING OURSELVES, *supra* note 87, at 26. TRA97 provided a modest tax cut to middle income families through enactment of various tax credits and tax favored savings plans and cut higher income taxpayers liability by reducing the tax rate on capital gains. *Id.*

95. HOLT, THE EITC AT AGE 30, *supra* note 91, at 2.

96. HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES, *supra* note 46, at 15. The EITC phase-in rate increased from 14 percent to 18.5 percent for one child and 19.5 percent (two or more children), while the phase-out rate increased from 10 percent to 13.21 (one child) and 13.93 (two or more children). *Id.*

97. *Id.*

98. TAX POLICY CTR., EARNED INCOME TAX PARAMETERS, 1976-2012 (2012), http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=36 (dollar amounts not adjusted for inflation).

99. *Id.*

100. *Id.*

101. HOLT, THE EITC AT AGE 30, *supra* note 91, at 2 (citing Ventry, *The Collision of Tax*, *supra* note 73. TRA1997 and the Balanced Budget Act of 1997 included provisions to improve compliance. WAYS & MEANS, 2004 GREEN BOOK, *supra* note 47, at 13–35.

3. Anti-Poverty

During the 1990s the expanded EITC took on a new role as a major antipoverty initiative replacing the traditional entitlement-based social safety net with a set of work-first initiatives.[102] President Clinton publically declared that full-time work at minimum wage plus the EITC would be enough to lift families out of poverty.[103] The expansion of the EITC in the 1990s was meant to make good on Clinton's pledge to "make work pay."[104]

At the same time, traditional means-tested welfare in the US was undergoing a dramatic transformation. The Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA),[105] signed into law in 1996, replaced the existing federal welfare program, Aid to Families with Dependent Children (AFDC), with a program called Temporary Assistance for Needy Families (TANF).[106] Since 1935, the AFDC program had provided an entitlement to cash-aid for low-income, primarily single-parent families with children.[107] Its replacement, TANF, invested more program authority in the states, imposed new stringent work requirements and sanctions for noncompliance, and a lifetime benefit time limit of five years or less.[108] Federal funding also changed from an unlimited matching formula under AFDC to a limited-in-amount block grant under TANF.[109] These changes effectively ended the entitlement nature of welfare.[110]

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102. Ventry (2000), *supra* note 90, at 1008; Hotz & Scholz, *supra* note 45, at 146.

103. *Id.*

104. *Id.*

105 Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, 110 Stat. 2105.

106. *See generally* Rebecca M. Blank, *Evaluating Welfare Reform in the United States*, 40 J. ECON. LIT. 1105 (2002), HANMING FANG & MICHAEL P. KEANE, THE BROOKINGS INST., ASSESSING THE IMPACT OF WELFARE REFORM ON SINGLE MOTHERS, 2004 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 1 (2004).

107. MARIANNE BITLER & HILARY W. HOYNES, THE BROOKINGS INST., *The State of the Social Safety Net in the Post-Welfare Reform Era*, BROOKINGS PAPERS ON ECON. ACTIVITY 71 (2010); SHEILA ZEDLEWSKI ET AL., THE URBAN INST., *What Role Is Welfare Playing in This Period of High Unemployment* (2011), http://www.urban.org/UploadedPDF/412378-Role-of-Welfare-in-this-Period-of-high-Unemployment.pdf?RSSFeed=UI_PovertyandSafetyNet.xml.

108. Yonatan Ben-Shalom et al., *An Assessment of the Effectiveness of Anti-Poverty Programs in the United States*, *in* THE OXFORD HANDBOOK OF THE ECONOMICS OF POVERTY 709 (Philip N. Jefferson ed., 2012) (providing that federal funds cannot be used to pay more than five years of benefits to a single parent over her lifetime and may be unavailable to states that do not set a minimum work requirements); Bitler & Hoynes, *Post-Welfare Reform Era*, *supra* note 107, at 16.

109. *Id.*

110. *Id.*

These changes to welfare, combined with a substantially expanded EITC, compounded by a strong economy, led to a plummeting in welfare participation[111] and caseloads and a large fraction of former welfare recipients entering the workforce.[112] In a sense, the EITC was the carrot pulling single mothers off welfare and into paying jobs.[113] By the end of the 1990s, cash welfare caseloads had fallen by more than 50 percent (from their peak in 1994) down to levels not seen since 1970.[114] Between 1992 and 2000, the employment rate of single women with children increased by 15.3 percentage points from 69.4 to 84.7 percent and the child poverty rate declined 6.1 percentage points from 22.3 to 16.2 percent.[115] By the end of the 1990s, the EITC emerged as the largest cash assistance program for working lower-income families lifting approximately 4 million persons out of poverty.[116]

Safety net reformers assumed that work and work supports, rather than welfare receipt, would improve economic, social and material outcomes for low-income households, particularly single-mother families. Empirical data supports the conclusion that during the 1990s, the economic situation of single mothers improved by leaving welfare and entering the workforce[117] and that a large part of that improvement was related to the expanded EITC.[118] This was especially true for the lowest-skilled single mothers who were on welfare and whose earnings placed them in the phase-in or flat region of the EITC.[119] Indeed, the largest change in employment for single mothers during the period 1986-2007 was for those without a high school diploma.[120]

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111. FANG & KEANE, WELFARE REFORM ON SINGLE MOTHERS *supra* note 106, at 1.

112. Ventry, *Political History*, *supra* note 90, at 1008 (by 80 percent); HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES, *supra* note 46, at 4; THOMAS GABE, CONG. RESEARCH SERV., R41917, WELFARE, WORK, AND POVERTY STATUS OF FEMALE-HEADED FAMILIES WITH CHILDREN: 1987-2009 17 fig.3 (2011).

113. Ventry (2000), *supra* note 90, at 1008. *See also* Grogger, *supra* note 71, at 405 (concluding that "the EITC may be the single most important policy measure for explaining the decrease in welfare and the rise in work and earnings among female-headed families in recent years").

114. Bitler & Hoynes, *Post-Welfare Reform Era*, *supra* note 107, at 71-2.

115. *Id. See also* Grogger, *Effects of Time Limits*, *supra* note 71, at 405 (finding that the EITC explained 34 percent of the increase in employment by female family heads between 1993-1999).

116. HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES, *supra* note 46, at 5.

117. Meyer & Rosenbaum, *Labor Supply*, *supra* note 4, at 1074 fig. II (illustrating the dramatic increase in post-tax return to working for single mothers between 1984 and 1996).

118. Grogger, *Effects of Time Limits*, *supra* note 71, at 405 (calculating that EITC expansions during the 1990s explained 15.8 percent of the decline in welfare use over the period 1993-1999).

119. Meyer, *Recent Reforms*, *supra* note 47, at 163.

120. *Id.*

4. *Anti-Recession: Safety Net Program?*

Lurking behind these EITC successes was an unforeseen danger. By linking the economic welfare of female-headed households to work and work supports, like the EITC, such welfare was now inextricably tied to the cyclicality of the labor market.[121] Such danger was obscured by the strong economy of the 1990s. However, the risks associated with a work-based social safety net came to light during the economic downturns of the early 2000s.

In 2001, the U.S. economy experienced its first recession in over decade. The 2001 recession was notable for its short length and mild effect.[122] A long jobless recovery characterized by slow growth and high unemployment followed this recession.[123] The Great Recession officially began in December 2007 and lasted 18 months.[124] It was the longest and deepest economic downturn since the Great Depression.[125] The Great Recession resulted in an overall decline in the real value of wages[126] and the largest increase in unemployment in the post-World War II era.[127] Unemployment during the Great Recession rose from five percent to a post-recession high in October 2009 of 10.1 percent, a 5.1 percentage point increase.[128] In comparison, unemployment rose only two percentage points during the 2001 recession (from 4.3 percent to a post-recession high of 6.3 percent).[129]

Generally, the parameters of the EITC did not change substantially during the two economic downturns during the first decade of the 2000s. Most of the EITC modifications during this period addressed narrow, specific issues including: complexity, marriage penalties, and lack of

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121. Bitler & Hoynes, *Post-Welfare Reform Era*, *supra* note 107, at 97.

122. MARC LABONT, CONG. RESEARCH SER., R40198, THE 2007–2009 RECESSION: SIMILARITIES TO AND DIFFERENCES FROM THE PAST "Summary" (2010), http://www.fas.org/sgp/crs/misc/R40198.pdf. [hereinafter LABONT, 2007-2009 RECESSION]

123. *Id.*

124. BUS. CYCLE DATING COMM., NAT'L BUREAU OF ECON. RES. (2010), http://www.nber.org/cycles/sept2010.html (last visited Mar. 21, 2013).

125. LABONT, 2007-2009 RECESSION, *supra* note 122.

126. *See* CARMEN DENAVAS-WALT, BERNADETTE D. PROCTOR & JESSICA C. SMITH, U.S. CENSUS BUREAU, INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN THE UNITED STATES: 2011 (2012), http://www.census.gov/prod/2012pubs/p60-243.pdf.

127. LABONT, 2007-2009 RECESSION, *supra* note 122, at 4.

128. *Id.* at 4 tbl. 2.

129. *Id.*

accommodation for larger families.[130] Neither the overall structure nor level of generosity changed in response to the unprecedented levels of unemployment, underemployment, and overall decline in the real value of wages accompanying the 2001 and 2008 recessions.

The question then becomes how, if at all, did the EITC respond during the recent economic downturns? Some commentators claimed that the EITC served as an income-based safety net for families during the 2001 and 2008 recessions.[131] Part III demonstrates that while the EITC offered income protection to its wealthier beneficiaries, it offered no safety net protection to its poorest recipients suffering recession-induced wage and job losses.

III. EITC AS SAFETY NET?

Section A of this Part describes the mechanism through which the federal tax system generally and the EITC in particular can (or cannot) offer income-based safety net protection to families through its ability to stabilize (or destabilize) income in the face of pre-tax earnings losses. Section B draws out the normative implications of this pattern of income (de)stabilization in the context of highlighting the winners and losers in the "EITC as safety net" paradigm.

A. Income Stabilization

1. Federal Tax System, In General

a. Household Level

The federal tax system operates automatically to stabilize income in the event of an earnings loss. When a household experiences a salary decline, reduced tax liabilities will offset a portion of that decline, thereby stabilizing post-tax income relative to pre-tax income.[132] Stabilization results when the

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130. *See, e.g.*, I.R.C. § 32(b)(3) (marriage penalty relief, increased credit percentage for families with three or more children).

131. *See, e.g.*, BERUBE, THE NEW SAFETY NET, *supra* note 16; JIMMY CHARITE ET AL., STUDIES, *supra* note 16, at 2, 7.

132. RICHARD B. GOODE, THE INDIVIDUAL INCOME TAX 288 (1964) [hereinafter GOODE, INDIVIDUAL INCOME TAX]. Government transfers, such as unemployment insurance, food stamps, and welfare can also cushion an income loss resulting in a reduced effect of such loss on after-transfer income. *See, e.g.*, Jonathan Gruber, *The Consumption Smoothing Benefits of Unemployment Insurance*, 87(1) AM. ECON. REV. 192 (1997) (examining empirically whether unemployment insurance compensation smoothes consumption between periods of employment and unemployment and finds considerable evidence of smoothing; Jonathan Gruber, *Cash Welfare as a Consumption Smoothing Mechanism for Single Mothers* (Nat'l

absolute size of the loss in post-tax income is less than the absolute size of the loss in pre-tax earnings.[133]

For purposes of this Article, the amount of income loss offset provided by the tax system will be measured by the ratio of the absolute change in tax liability to the absolute change in gross income.[134] This will be referred to as the stabilization ratio.[135] In effect, it is the percentage of a pre-tax earnings drop that does not carry through to post-tax income because of offsetting decreases in tax payments. On a macroeconomic scale, this measure has been called the tax system's "built-in flexibility"[136] or "normalized tax change."[137]

Bureau of Econ. Res., Working Paper 5738, 1996), http://www.nber.org/papers/w5738.pdf (studying whether the AFDC program smoothes the consumption of women who experienced the event of becoming a single-mother); Susan Dynarski & Jonathon Gruber, *Can Families Smooth Variable Earnings*, 1997:1 BROOKINGS PAPERS ON ECON. ACTIVITY 229 (1997) [hereinafter Dynarski & Gruber, *Variable Earnings*].

133. GOODE, INDIVIDUAL INCOME TAX, *supra* note 132, at 287, n.3 (citing E. Cary Brown for the proposition that "a tax is an automatic stabilizer if the absolute size of the change in income . . . is smaller when the tax is in existence than it would be in the absence of the tax" but noting that other definitions exist). *Id.*; JOSEPH A. PECHMAN, FEDERAL TAX POLICY 75 (5th ed., 1987) [hereinafter PECHMAN, TAX POLICY]; Kniesner & Ziliak, *Implicit Insurance*, *supra* note 13, at 5.

134. PECHMAN, TAX POLICY, *supra* note 133, at 74; GOODE, INDIVIDUAL INCOME TAX, *supra* note 132, at 287.

135. A destabilization ratio will be introduced in Part III Section A.2.

136. *Id.* Built-in flexibility is different than the elasticity of yield which is the ratio of the percentage change in tax to the percentage change in income. GOODE, INDIVIDUAL INCOME TAX, *supra* note 132, at 287. Elasticity is a measure of the tax system's progressivity—a proportional tax will have an elasticity of one, a progressive tax will have an elasticity of more than one, and a regressive tax will have an elasticity of less than one. Auerbach & Feenberg, *Automatic Stabilizers*, *supra* note 24, at 37, 40. Built-in flexibility is more relevant to income stabilization than elasticity. GOODE, INDIVIDUAL INCOME TAX, *supra* note 132, at 288; Auerbach & Feenberg, *Automatic Stabilizers*, *supra* note 24, at 40–41. However, both measures are mathematically related. *See infra* note 137.

137. Auerbach & Feenberg, *Automatic Stabilizers*, *supra* note 24, at 41. *See also* Lily Batchelder, Fred T. Goldberg, Jr. & Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 62 (2006) [hereinafter Batchelder et al., *Refundable Tax Credits*] (adopting the nomenclature of normalized tax change). It is also referred to as the "effective marginal tax rate" as it is equal to the product of the elasticity of individual tax liability (the ratio of a proportionate change in tax to a proportionate change in income) and the average tax rate. GOODE, INDIVIDUAL INCOME TAX, *supra* note 132, at 287, n.2; J. P. Hutton & P. J. Lambert, *Evaluating Income Tax Revenue Elasticities*, 90 ECON. J. 901 (1980). Built-in flexibility equals $\Delta T/\Delta Y$, where T equals tax liability and Y equals gross income, whereas elasticity equals $\%\Delta T/\%\Delta Y$ and the average tax rate equals T/Y.

The federal income tax system is progressive, meaning that a taxpayer's marginal tax rate increases or decreases with income.[138] Under such a system, a taxpayer's average tax rate will be lower than the marginal rate, but it will also decrease or increase with income.[139] In the event of an annual wage loss occurring under a progressive tax system, income tax payments decline by a greater percentage than the change in income itself.[140] As earnings fall, not only is the amount subject to tax lower (lower tax base), but that lower taxable amount is subject to a lower average tax rate.[141] As a result, post-tax income changes by a lower percentage than the change in pre-tax wages.

The federal payroll tax system is proportionate, meaning it has a single rate applied to its tax base.[142] The employee portion of the payroll tax is 7.65 percent and applies to the first dollar of wages up to the applicable taxable amount.[143] A proportional tax can also mitigate earnings losses but only in proportion to the marginal tax rate, and not by more than the marginal tax as in a progressive tax.[144] As wages drop, there is a reduction in the amount subject to tax (tax base), but the tax rate applied to that reduced base remains the same. Hence, the percentage change to post-tax income is directly equal to the marginal tax rate.

Mathematically, elasticity multiplied by the average tax rate will equal built-in flexibility. *Id. See also* Richard E. Slitor, *The Measurement of Progressivity and Built-In Flexibility*, 62 Q. J. ECON., 309, 313 (1948); Robert M. Coen, *Automatic Stabilizers, in* ENCY. OF TAX'N & TAX POL'Y 16, 17 (Joseph J. Cordes, et al. ed., 1999).

138. *See* I.R.C § 1.

139. HARVEY S. ROSEN & TED GAYER, PUBLIC FINANCE 565 (2010) (defining a progressive tax as "one in which a taxpayer's average tax rate increases or decreases with income").

140. PECHMAN, TAX POLICY, *supra* note 133, at 74. Progressive taxes also mitigate income increases by requiring a taxpayer to pay a larger portion of their income in good years. Those with higher incomes find that their tax is increased proportionately more than their income. Listokin, *Equity, Efficiency and Stability*, *supra* note 13, at 54.

141. *Id.*

142. "Payroll taxes" refers to the Social Security and Medicare taxes.

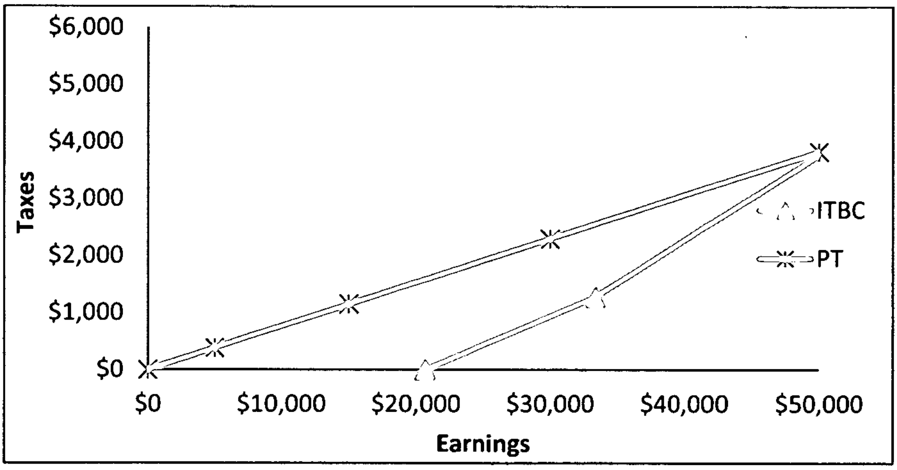
143. The 7.65 percent tax rate is the combined rate for the employee portion of Social Security and Medicare. *See* SOC. SEC. ADMIN., FACT SHEET 2012 SOCIAL SECURITY CHANGES, http://www.ssa.gov/pressoffice/factsheets/colafacts2012.htm. The Social Security portion (OASDI) is 6.20 percent on earnings up to the applicable taxable maximum amount. *Id.* The Medicare portion (HI) is 1.45 percent on all earnings. *Id.* Only the employee portion is considered in this Article because it directly affects disposable income (as compared to the employer portion that indirectly affects disposable income to the extent wages are lowered to account for it). *Accord* Auerbach & Feenberg, *Automatic Stabilizers*, *supra* note 24, at 42–43.

144. PECHMAN, TAX POLICY, *supra* note 133, at 13.

A progressive tax system is a more potent income stabilizer in the event of a salary loss than a proportional tax system. Under a progressive tax, as earnings decline both the tax base and tax rates drop, whereas only the tax base is reduced under a proportionate tax. The result is a larger offset to the lost salary under a progressive tax. Another way to consider the relative ability of each type of tax system to act as a stabilizer is in terms of the stabilization ratio.[145] For any given change in pre-tax salary (denominator), the numerator (change in taxes) will be larger under a progressive system (reflecting the change in base and rates) than under a proportionate system (reflecting a change in tax base only).[146]

Figure 2 illustrates the 2013 income and payroll tax schedule for a female-headed household containing two children.[147]

FIGURE 2



145. *See supra* notes 134–135 and accompanying text.

146. *Accord* Batchelder et al., *Refundable Tax Credits*, *supra* note 137, at 62.

147. This figure was calculated using inflation-adjusted income tax items. Rev. Proc. 2013-15, *supra* note 39. The basic standard deduction for a head of household tax filer in 2013 was $8,950 and the personal exemption amount was $3,900. *Id.* A single-mother with two children would be entitled to three personal exemptions. *See* I.R.C. 151. Accordingly, such a taxpayer would not be liable for positive income tax before credit until earnings reached $20,650 ($8,950+ [3 * $3,900]). *See* Jonathan Barry Forman, *2009 Poverty Levels on Federal Tax Thresholds*, 124(2) TAX NOTES 171, 172 (July 13, 2009) (making a similar calculation for 2009 for various types of taxpayers and calling it the "simple income tax threshold").

In the event of an annual decline in earnings (moving down the earnings distribution from right to left), positive tax payments are reduced as illustrated by lines ITBC (Income Tax Before Credit) and PT (Payroll Tax). Notice that PT is a straight line with a slope equal to the tax rate of 7.65 percent. A decline in earnings changes the tax base only, while the tax rate remains constant. Compare this to ITBC's kinked line. Each kink represents a change in marginal tax rate and the slope between each kink is equal to the applicable marginal tax rate for that range of earnings. Under ITBC, an earnings loss reduces the tax base and the average tax rate.

The following example is designed to illustrate how the income tax (progressive) and payroll (proportionate) tax systems, respectively, operate to cushion household earnings losses. Myrna is a single-mother with two children. During 2012, Myrna earned $60,000. Myrna's salary fell to $30,000 in 2013. The following Table 2 summarizes the stabilization effects of the Federal income and payroll tax systems with regard to Myrna.

Table 2: Myrna

	Earnings	Income Tax	Payroll Tax	Post-tax Income
2012	$60,000	$5,365	$4,590	$50,045
2013	$30,000	$ 935	$2,295	$26,770
Δ	($30,000)	($4,430)	($2,295)	($23,275)
Stabilization Ratio		22.42%	($6,725/$30,000)	
Income Tax		14.77%	($4,430/$30,000)	
Payroll Tax		7.65%	($2,295/$30,000)	

Myrna's earnings declined by $30,000, but her post-tax income declined by only $23,275.[148] Her earnings are stabilized by the tax system because the absolute amount of the fall in post-tax income is less than the absolute amount of the fall in pre-tax earnings.[149] Overall, the stabilization ratio was 22 percent.[150] This is effectively the percentage of the pre-tax earnings loss that did not pass through to post-tax income. In other words, in

148. This amount was calculated using inflation-adjusted income tax items. Rev. Proc. 2013-15, *supra* note 39; Rev. Proc. 2011-52, 2011-45 I.R.B. 701 (assuming her earnings are the only source of gross income and the only deductions are the personal exemption and standard deduction and ignoring the child tax and other available credits).

149. *See supra* note 133.

150. This percentage was calculated as the change in taxes relative to the change in income or $6,725/$30,000.

the face of a $30,000 negative wage drop, Myrna's post-tax income declined by only $23,275 or 78 percent of the loss.[151]

With regard to the income tax, recall that under a progressive tax, income tax payments fall by a greater percentage than the percentage change in earnings itself. This phenomenon is illustrated here: Myrna's gross income declined by 50 percent while her income tax payments fell by 83 percent.[152] Myrna moved from the 15 percent marginal rate bracket to the 10 percent marginal rate bracket as a result of her salary loss. In effect, Myrna's reduced income tax payments cushioned about 15 percent of her earnings loss.[153] Myrna's wage cut also resulted in reduced payroll tax liability offsetting an additional 7.65 percent of the decline.[154] Recall that a proportional tax can cushion earnings losses but only in proportion to its tax rate.

b. *Macroeconomic Level*

Reduced tax payments precipitated by an earnings loss provide a source of non-labor income buffering the effect of that pay cut on disposable income.[155] Since disposable income is a major determinant of consumption, a household's consumption may be more stable than it would be in the absence of the income tax.[156] This last point has macroeconomic implications when the negative income shock is economy-wide, such as in a recession.[157] In that

151. This figure was calculated as $23,275/$30,000.

152. This figure was calculated as $30,000/$60,000 or a 50 percent decline in gross earnings versus $4,430/$5,365 or an 83 percent decline in income tax payments.

153. This figure was calculated as the change in income taxes relative to the change in earnings or $4,430/$30,000.

154. The 7.65 percent tax rate is the combined rate for the employee portion of the Social Security and Medicare taxes. The Social Security portion (OASDI) is 6.20 percent on wages up to the applicable taxable maximum amount. The Medicare portion (HI) is 1.45 percent on all earnings. *See* SOC. SEC. ADMIN., FACT SHEET 2013 SOCIAL SECURITY CHANGES, http://www.socialsecurity.gov/pressoffice/factsheets/colafacts2013.htm/colafacts2013.pdf [hereinafter SSA 2013 FACT SHEET].

155. Dynarksi & Gruber, *Variable Earnings*, *supra* note 132, at 260; Batchelder et al., *Refundable Tax Credits*, *supra* note 137, at 59–60.

156. The degree of actual consumption smoothing depends on the share of liquidity-constrained and credit-constrained households. Auerbach & Feenberg, *Automatic Stabilizers*, *supra* note 24, at 44–46; Kartik B. Athreya & Aaron Steelman, Fed. Reserve Bank of Richmond, *The Earned Income Tax Credit: Recipients, Labor Force Participation, and Credit Constraints, Economic Brief No. 11-03* (2011), http://www.richmondfed.org/publications/research/economic_brief/2011/pdf/eb_11-03.pdf; Batchelder et al., *Refundable Tax Credits*, *supra* note 137, at 61–65.

157. According to Pechman:

event, as personal income declines, tax yields will automatically decline. This can help spur an increase in aggregate demand that can mitigate GNP declines.[158] In other words, "a key aspect of a progressive income tax is providing collective insurance against [household-level] shocks to income, in turn smoothing consumption and dampening the business cycle."[159] For this reason, the tax system is referred to as an automatic stabilizer because it mitigates fluctuations in economic activity without any explicit government action.[160]

Auerbach and Feenberg calculated the ratio of the aggregate change in taxes to the aggregate change in income (normalized tax change) resulting from a simulated one percent change in aggregate income spread neutrally across the population for the years 1962-1995.[161] Over the sample period, the federal tax system (including income, payroll, and EITC) offset between 23 to 32 percent of the change in pre-tax income.[162] Over a similar period, Dynarski and Gruber calculated that changes in tax burdens offset 26 or 35 cents of each dollar of earnings variation, depending on the data set used.[163] Batchelder et al. calculated the normalized tax change for a downward shock to income in 2006 as 29 percent.[164]

> Today it is understood that properly timed changes in tax yields can help increase demand during recessions and restrain growth of demand during periods of expansion. One of the virtues of the progressive individual income tax is that its yield automatically rises and falls more than in proportion to changes in personal income . . . . As a result, disposable income is more stable than it would be in the absence of the tax . . . . Since disposable income is a major determinant of consumption, expenditures of consumers are also more stable than they would be without the tax.

PECHMAN, TAX POLICY, *supra* note 133, at 74–75.

158. PECHMAN, TAX POLICY, *supra* note 133, at 74–75. *See also* Listokin, *Equity, Efficiency, Stability*, *supra* note 13, at 54 (describing Keynesian roots of this phenomenon).

159. Kniesner & Ziliak, *Tax Reform*, *supra* note 88, at 590.

160. Auerbach & Feenberg, *Automatic Stabilizers*, *supra* note 24, at 37; GOODE, INDIVIDUAL INCOME TAX, *supra* note 132, at 286; PECHMAN, TAX POLICY, *supra* note 133, at 74. The transfer system is also a source of household income, consumption smoothing, and automatic stabilization. When income drops, not only do tax liabilities fall, but eligibility for government benefit rises. Benefits provided under social insurance programs such as Unemployment Insurance [hereinafter "UI"] and social assistance programs such as TANF and the Supplemental Nutrition Assistance Program [hereinafter "SNAP"] generally rise as incomes fall.

161. Auerbach & Feenberg, *Automatic Stabilizers*, *supra* note 24, at 41–42.

162. *Id.* at 43.

163. Dynarksi & Gruber, *Variable Earnings*, *supra* note 132, at 262 (using PSID for years 1976-1992 and CEX for years 1980-1993).

164. Batchelder et al., *Refundable Tax Credits*, *supra* note 137, at 63 tbl.1.

2. *EITC as Income (De)Stabilizer*

a. *History*

The income stabilization potential of the EITC played a role in its earliest history. In a sense, the need for stability was the spark that ignited the EITC's enactment. Although a "work bonus" program akin to the EITC was initially proposed in 1972 as a pro-work alternative to welfare,[165] the EITC was not enacted until 1975 as part a fiscal stimulus package intended to mitigate the effects of the 1975 recession.[166] The Tax Reduction Act of 1975 (TRA75) included a package of individual tax reductions, a refund of 1974 tax liability, and an increase in the standard deduction.[167] TRA 1975 also introduced the EITC, which was aimed at the working poor, many of whom paid payroll taxes but no income taxes.[168] A refundable tax credit was seen as a "kind of rebate of . . . [payroll] taxes for low-income workers."[169] The House Ways and Means committee stated that "[a]ppropriate tax reductions will also increase incomes, both directly and through the multiplier effect."[170] In a very real sense, "the EITC became law, not as a part of a debate on social welfare legislation, but as a part of an effort to respond to a recession."[171] As was the case in 1975, the United States recently faced recessionary periods renewing interest in the potential of the EITC as an income stabilizer at both the macroeconomic and household level.

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165. Ventry, *The Collision of Tax*, *supra* note 73, at 17.

166. H.R. REP. NO. 94-19, at 5 (1975) ("[t]he Tax Reduction Act of 1975 takes prompt and effective action to check the drastic downward slide of our economy") [hereinafter H.R. REP. NO. 94-19]. *Id.*

167. *Id.* at 3–4.

168. *Id.*

169. S. REP. NO. 1230, at 425–26 (1972). *See also* S. REP. NO. 553, at 20 (1973) ("a new tax credit provision which has the effect of refunding to low-income workers with children a large portion of the social security taxes they pay"). *Id.*

170. *See* H.R. REP. NO. 94-19, *supra* note 166, at 8. The "multiplier effect" refers to the impact of an exogenous change in aggregate demand on output and is derived from Keynesian macroeconomic theory. DARREL COHEN & GLENN FOLLETTE, FEDERAL RESERVE BOARD, THE AUTOMATIC FISCAL STABILIZERS: QUIETLY DOING THEIR THING 5 (1999), www.federalreserve.gov/pubs/feds/1999/199964/199964pap.pdf. *See generally* Listokin, *Equity, Efficiency, Stability*, *supra* note 13, at 51–55 (linking Keynesian macroeconomic theory to the income tax).

171. *See* HOFFMAN & SEIDMAN, HELPING WORKING FAMILIES, *supra* note 46, at 13.

b. Macroeconomic Level

In fact, only a very small amount of the macroeconomic automatic stabilization provided by the tax system is attributable to the EITC. The Auerbach and Feenberg study cited above estimated that the EITC contributed only about one percentage point to the overall normalized tax change.[172] Batchelder et. al. determined that the normalized tax change for a downward shock to income was reduced by 1.7 percent when the refundability feature of the EITC was removed.[173] Recall that more than three fourths of the benefit of the EITC is in the form of a tax refund.[174] The small role of the EITC with regard to macroeconomic stabilization is probably partially due to the small percentage of the total taxpaying population entitled to claim the EITC in any given year.[175] Furthermore, as described below, the EITC acts simultaneously as an income stabilizer and destabilizer.[176] On a global scale, it may be that these two effects cancel each other out resulting in an overall minimal macroeconomic stabilization effect from the EITC.[177]

c. Household Level

The stabilization capabilities of the EITC at the individual household level are mixed. Recall that the EITC reduces a recipient's tax liability (nonrefundable portion), provides a payment, or both to the recipient in the amount that the credit exceeds his or her tax liability (refundable portion). In general, a liability reduction or an increased transfer payment can stabilize post-tax income relative to pre-tax income in the event of an earnings decline. However, given the unique shape of its benefit function, the

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172. Auerbach & Feenberg, *Automatic Stablizers*, *supra* note 24, at 41–42 (the normalized tax change was reduced from 23 to 32 percent to between 18 and 28 percent without the EITC or payroll taxes included).

173. Batchelder et al., *Refundable Tax Credits*, *supra* note 137, at 63 tbl. 1 (calculated assuming away refundability of the Child Tax Credit as well). *See generally* I.R.C. § 24.

174. *See supra* note 48 and accompanying text.

175. Bitler et al., *Safety Net*, *supra* note 18, at 1 (20 percent of total federal income tax returns claimed an EITC in tax year 2010).

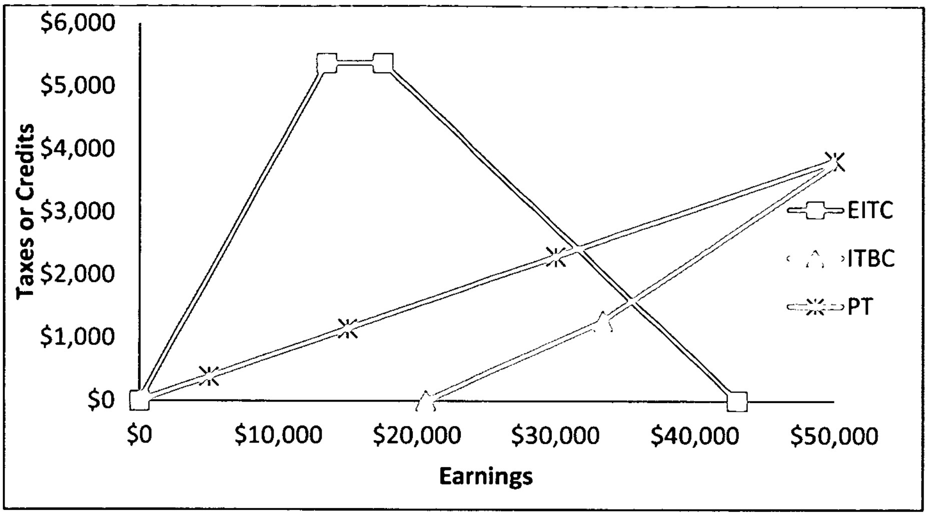
176. *See infra,* notes 180–212 and accompanying text.

177. *Cf.* Ximing Wu, *Labor Supply and Income Effects of the Earned Income Tax Credit and Welfare Programs*, at 3 (Mar. 8, 2005) (unpublished manuscript), http://agecon2.tamu.edu/people/faculty/wu-ximing/public/eitc.pdf (suggesting that the positive and negative labor supply incentives in the phase-in versus phase-out range of the EITC may cancel each other out resulting in a minimal overall labor supply effect from the program).

stabilization properties of the EITC are not uniform across its various regions.

Figure 3 adds the EITC budget constraint onto Figure 2's income (ITBC) and payroll tax (PT) schedule for a head of household taxpayer with two children.[178]

FIGURE 3



Notice that unlike the income or payroll tax systems, the EITC's marginal rate structure is neither uniformly progressive nor proportionate. There is a negative marginal tax rate in the EITC phase-in region, in the flat region the marginal rate is zero, and a positive marginal tax rate exists in the phase-out range.[179] As a result of this unique pattern of changing (in both magnitude and sign) marginal rates, the EITC amount could go up, down, or remain the same in response to an annual wage loss. As a result, it is impossible to say *ex ante* whether the EITC will stabilize, destabilize, or have no effect on post-tax income. It will depend on the taxpayer's beginning earnings (or AGI) level (in the relatively flush year) and ending earnings (or AGI) level (in the year of the wage loss). An annual salary decline could make a taxpayer newly eligible for the EITC, move the taxpayer within or across EITC ranges, or make a taxpayer newly ineligible for the EITC. The following subsections will describe how the EITC operates to stabilize or destabilize post-tax income in these various scenarios.

178. *See supra* notes 42, 147.

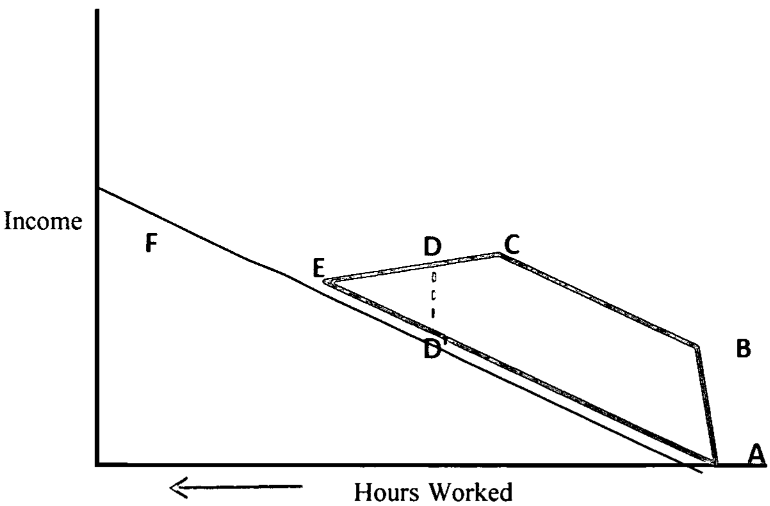
179. *See supra* notes 43–54 and accompanying text.

(1) Newly EITC Eligible

The EITC will offset a portion of any annual earnings decline that newly qualifies a taxpayer for the EITC.[180] In this instance, the actual cushioning effect of the EITC will depend on the relative value of the change in the EITC to the change in the taxpayer's wages.[181] Since the change in the EITC will always be positive (and equal to the EITC amount in the income loss year) for a newly qualified EITC recipient, the EITC will always offset a portion of the salary loss thereby stabilizing post-tax income relative to pre-tax income.

Figure 4 shows a standard labor supply diagram with hours worked on the horizontal axis and income on the vertical axis.

FIGURE 4



The EITC budget function is illustrated by the kinked budget line (ABCE).[182] The linear budget line (AEF) is taxpayer's budget line without the EITC. Assume an individual's hours are decreased so that pre-tax earnings decline from Point F to Point D'. As earnings drop, the individual

180. All EITC recipients receive the credit as part of their annual tax refund check in the year following the year they earned the income entitling them to the credit. This has two implications. First, the EITC is not responsive to short-term (intra-annual) earnings fluctuations. Second, the EITC payment is temporally dislocated from the need that precipitated it. This tempers the claim discussed *supra* that the EITC "offsets" a particular year's income loss. *See* Greene, *Broken Safety Net*, *supra* note 23 (providing a detailed analysis of this timing problem).

181. *See supra* note 135 and accompanying text.

182. Figure 4 is not drawn to scale.

moves onto the EITC budget line. Post-tax income would be at Point D, which is higher than the pre-tax earnings of Point D'. The stabilization provided by the EITC is measured by the difference between Point D' and Point D relative to the difference between Points F and D'.

The Myrna example is updated in Table 3 to take into account the additional stabilization effects of the EITC.

Table 3: Myrna (with EITC)

	Earnings	Income Tax	Payroll Tax	EITC	Post-tax Income
2012	$60,000	$5,365	$4,590	$ 0	$50,045
2013	$30,000	$ 935	$2,295	$2,746	$29,516
Δ	($30,000)	($4,430)	($2,295)	$2,746	($20,529)
Stabilization Ratio		31.57%	($9,471/$30,000)		
	Income Tax	14.77%	($4,430/$30,000)		
	Payroll Tax	7.65%	($2,295/$30,000)		
	EITC	9.15%	($2,746/$30,000)		

Myrna did not qualify for the EITC in 2012 as her income was too high.[183] In 2013, after her $30,000 salary decline, Myrna qualified for a $2,746 EITC.[184] Of the total EITC amount, $935 reduced her income tax to zero and $1,811 was refunded to her upon the filing of her 2013 income tax return. The EITC offset the pre-tax earnings loss by an additional nine percent. After taking into account the additional cushioning provided by the EITC, the federal tax system stabilized Myrna's post-tax income by 32 percent.

(2) Repeat EITC Claimants

The next set of scenarios involves households that experience pay cuts that occur entirely within the EITC eligibility range. This type of annual earnings loss will move a taxpayer along the EITC schedule in Figure 3 from right to left ("reverse EITC function"). Under the reverse EITC function, the

183. In 2012, the completed phase-out amount was $41,952. *See supra* note 42 and accompanying text.

184. This figure was calculated as $5,372 – [.2106 * ($30,000-$17,530)]. *See* Rev. Proc. 2013-15, *supra* note 39.

EITC amount initially increases as earnings drop until the maximum credit amount is reached. The EITC amount will remain at its maximum as wages fall within the plateau region. The credit will then begin to decline as earnings decline within the phase-in region until both earnings and EITC amounts reach zero. The following subsections flesh out the income stabilization effects of the various types of earnings losses occurring within the EITC eligibility range.

(*a*) *Losses within EITC Regions*

(*i*) *Within Phase-out: Marginal Stabilization*

For an annual wage loss occurring entirely within the EITC phase-out range, the increased EITC amount will offset a portion of the loss thereby stabilizing post-tax income relative to pre-tax income. Within this range, the EITC effectively operates as a proportional tax with a rate equal to the phase-out percentage (slope of phase-out line on reverse EITC function in Figure 3). For a single-mother with two children, each dollar of earnings decline between the completed and threshold phase-out amounts results in an approximate 21 percent increase in the EITC amount.[185] Alternatively, post-tax income goes down by only about 79 cents for each lost salary dollar.

For example, assume Jenny's (a single-mother with two children) earnings fell from $40,000 in 2012 to $30,000 in 2013. Table 4 demonstrates how the EITC, as part of the federal tax system, operated to stabilize Jenny's post-tax income.

Table 4: Jenny

	Earnings	Income Tax	Payroll Tax	EITC	Post-tax Income
2012	$40,000	$2,365	$3,060	$ 411	$34,986
2013	$30,000	$ 935	$2,295	$2,746	$29,516
Δ	($10,000)	($1,430)	($ 765)	$2,335	($ 5,470)
Stabilization Ratio		45.30%	($4,530/$10,000)		
	Income Tax	14.30%	($1,430/$10,000)		
	Payroll Tax	7.65%	($765/$10,000)		
	EITC	23.35%	($2,335/$10,000)		

Jenny's earnings dropped by $10,000, but her post-tax income declined by only $5,470 or approximately 55 percent of the salary loss. In effect, the tax system offset approximately 45 percent of Jenny's wage drop. The EITC

185. *See supra* note 41 and accompanying text.

accounted for about one-half of this total tax-system-induced income stabilization.

It is useful to analyze the impact of the various components of the federal tax system for relatively wealthy Myrna in Table 3 as compared to relatively less wealthy Jenny in Table 4. For Myrna, the income tax is the most important income stabilizer. Jenny, on the other hand, realizes more earnings loss offset from the EITC than from the income tax. Indeed, as earnings fall below the simple income tax threshold of $20,650 in 2013 (see line ITBC in Figure 2),[186] the income tax's contribution will cease, and the EITC and payroll tax will be the sole tax system stabilizers.[187]

(ii) Within Plateau: No Stabilization

The EITC will not cushion any earnings decline that moves a taxpayer from a higher to a lower pre-tax income level within the credit's plateau region. Within this range, the credit operates as a lump-sum subsidy unaffected in amount by changes in earnings. In both years, the taxpayer would be entitled to the maximum credit amount. Since the subsidy amount is fixed, a change in pre-tax income translates into an equivalent change in post-tax income.[188] Of course, the EITC amount will change slightly between years because of the required annual inflation adjustment.[189]

For example, Halle's (a single-mother with two children) wages fell from $17,000 in 2012 to $14,000 in 2013. Table 5 sets forth Halle's post-tax position in both years as a result of this wage loss.

Table 5: Halle

	Earnings	Income Tax	Payroll Tax	EITC	Post-Tax Income
2012	$17,000	$0	$1,301	$5,236	$20,936
2013	$14,000	$0	$1,071	$5,372	$18,301
Δ	($3,000)	$0	($230)	$ 136	($2,635)
Stabilization Ratio		12.18%	($366/$3,000)		
	Income Tax	N/A			
	Payroll Tax	7.65%	($230/$3,000)		
	EITC	4.53%	($136/$3,000)		

186. *See supra* note 147.
187. *See infra, e.g.*, Tables 5, 7, and 9.
188. Listokin, *Equity, Efficiency, Stability*, *supra* note 13, at 54.
189. *See* I.R.C. § 32(j).

In this case, it appears that the EITC stabilized Halle by about five percent. However, the entire stabilization provided by the EITC is related to the annual inflation adjustment, rather than a change in earnings.[190]

(*iii*) *Within Phase-in: Marginal Destabilization*

A transfer payment can only offset a pre-tax wage cut if the benefit amount increases as earnings fall. In other words, wages and transfers must move in opposite directions for stabilization to occur. Within the EITC phase-in region, the EITC amount and labor income move in the same direction: the EITC amount declines as wages decline. As a result, the absolute amount of the drop in post-tax income is larger than the drop in pre-tax earnings. [191] In other words, the EITC phase-in range is actually destabilizing to post-tax income.[192]

For a single-parent household with two children, each dollar of earned income lost in the phase-in region reduces the EITC amount by 40 percent (slope of phase-in line EITC in Figure 3)[193] resulting in a $1.40 post-tax income reduction for every dollar reduction in earnings. For example, assume that Pat's (a single-mother with two children) earned income fell from $12,000 in 2012 to $10,000 in 2013.

Table 6: Pat

	Earnings	Income Tax	Payroll Tax	EITC	Post-Tax Income
2012	$12,000	$0	$918	$4,800	$15,882
2013	$10,000	$0	$765	$4,000	$13,235
Δ	($ 2,000)	$0	($153)	($ 800)	($ 2,647)
Destabilization Ratio		-32.35%	(-$647/$2,000)		
Income Tax		N/A	N/A		
Payroll Tax		7.65%	($ 153/$2,000)		
EITC		-40.00%	($-800/$2,000)		

190. Of course, Halle will see her payroll tax reduced and such reduction offsets her wage loss by an additional 7.65 percent.

191. *Accord* Listokin, *Equity, Efficiency, Stability*, *supra* note 13, at 77 (noting that while the phase-out is stabilizing, the credit itself is destabilizing).

192. *See* Howard Tuckman, Jeffrey Williams & John Ortiz, *Tax-Transfer Policy and the Temporal Stability of Household Income,* 6 PUB. FIN. REV. 240, 241 (1978) (defining taxes and transfers as destabilizing if they "increas[e] the variation in household income over what it would have been in their absence").

193. *See supra* note 178 and accompanying text.

Overall, Pat's pre-tax earnings declined by $2,000, but her post-tax income declined by $2,647. Lost EITC benefits exacerbated Pat's underlying wage loss by 40 percent, an amount this article refers to as the destabilization ratio.[194]

Notice that the built-in flexibility of the EITC is marginally negative in the phase-in region.[195] Negative built-in flexibility has been called "destabilizing or perverse flexibility."[196] It is associated with many subsidies since the total amount of the subsidy declines with a reduction in the targeted activity.[197] Perverse flexibility within the EITC phase-in range results from its design as an earnings subsidy. While this may be an optimal design from a labor incentive perspective,[198] it is problematic from an income stabilization point of view.

(*b*) *Losses Across Regions*

(*i*) *Phase-out to Flat: Stabilization*

The EITC will also mitigate the impact of an annual earnings loss that moves a taxpayer from the phase-out region to the flat region on the reverse EITC function in Figure 3. The stabilization ratio for this type of earnings decline will always be less than 21 percent because a portion of the loss occurs in the 21 percent marginal rate range (phase-out) and the rest occurs in the zero percent marginal rate range (flat).

For example, assume Sandrina's (a single-mother with two children) salary declined from $27,000 in 2012 (phase-out) to $15,000 in 2013 (flat), for a total earnings loss of $12,000. Table 7 illustrates how the EITC offsets this wage drop.

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194. This ratio was calculated as EITC benefit reduction of $800/earnings reduction of $2,000. Counteracting this was the 7.65 percent stabilization provided by the payroll tax so that Pat's net destabilization ratio was only -32.5 percent.

195. Built-in flexibility may be either positive or negative. CARL S. SHOUP, PUBLIC FINANCE 552 (Aldine Trans. ed., 3d ed. 2009) [hereinafter SHOUP, PUBLIC FINANCE].

196. David W. Lusher, *The Stabilizing Effectiveness of Budget Flexibility*, *in* NAT'L BUREAU OF ECON. RES., POLICIES TO COMBAT DEPRESSION 77, 85 (Princeton Univ. ed., 1st ed. 1956).

197. *See* SHOUP, PUBLIC FINANCE, *supra* note 194, at 552.

198. *See* Saez, *Transfer Programs*, *supra* note 4.

Table 7: Sandrina

	Earnings	Income Tax	Payroll Tax	EITC	Post-Tax Income
2012	$27,000	$690	$2,066	$3,149	$27,393
2013	$15,000	$ 0	$1,148	$5,372	$19,225
Δ	($12,000)	($690)	($ 918)	$2,223	($ 8,169)
Stabilization Ratio		31.93%	($3,831/$12,000)		
Income Tax		5.75%	($690/$12,000)		
Payroll Tax		7.65%	($918/$12,000)		
EITC		18.53%	($2,223/$12,000)		

In this case, Sandrina's EITC amount increased from $3,149 in 2012 to the maximum 2013 EITC amount of $5,372, cushioning 19 percent of Sandrina's pre-tax earnings drop. By comparison, if Sandrina's $12,000 wage decline occurred entirely within the phase-out range, the EITC would offset about 21 percent of the loss. The only general statement that can be made is that a taxpayer with more wage loss focused in the phase-out range than in the flat range will realize greater income stabilization than a taxpayer with the opposite pattern of loss.

(ii) Flat to Phase-in: Destabilization

If an annual earnings decline moves a taxpayer from the flat region to the phase-in region of the reverse EITC function, the reduced credit If an annual earnings decline moves a taxpayer from the flat region to the phase-in region of the reverse EITC function, the reduced credit amount will destabilize post-tax income. In this case, the destabilization ratio will be more than zero but less than 40 percent, with income destabilization at its highest the more of the earnings loss that is concentrated in the EITC phase-in range as opposed to the flat range.

For example, assume Karla (a single-mother with two children) earned $15,000 in 2012 but only $10,000 in 2013. Table 8 illustrates how the EITC exacerbated Karla's wage loss:

Table 8: Karla

	Earnings	Income Tax	Payroll Tax	EITC	Post-Tax Income
2012	$15,000	$0	$1,148	$5,236	$19,089
2013	$10,000	$0	$ 765	$4,000	$13,235
Δ	($ 5,000)	$0	($ 383)	($1,236)	($ 5,854)
Destabilization Ratio		-17.07%	($-854/$5,000)		
Income Tax		N/A			
Payroll Tax		7.65%	($383/$5,000)		
EITC		-24.72%	($-1,236/$5,000)		

As a result of Karla's $5,000 earnings loss, her EITC amount decreased by $1,236, exacerbating the post-tax income effect of the pre-tax salary decline by 25 percent.[199] As suggested *supra*, the income destabilization ratio for Karla's flat-to-phase-in wage drop (25 percent) was less than the income destabilization for a purely within-phase-in-range earnings reduction (40 percent).[200]

(iii) Phase-out to Phase-in: (De)Stabilization?

For an annual wage decline that moves a taxpayer from the phase-out range to the phase-in range of the EITC, it is not possible *ex ante* to determine whether post-tax income will be stabilized, destabilized, or unaffected by the earnings drop. The EITC amount may be the same, more, or less in the year of the salary loss. The result would depend on where in the phase-out range the taxpayer started in the relatively flusher year (Year 1) and where he or she landed in the phase-in range in the relatively leaner year (Year 2).

A few general observations can be made. First, at any given Year 1 level of earnings in the phase-out range, the lower the Year 2 earnings level in the phase-in range, the less (or more) income stabilization (or destabilization) will occur. For example, assume that in 2012 Mary (a single-mother with two children) earned $27,000 and properly claimed $3,149 in EITC benefits.[201] Table 9 illustrates the level of stabilization or destabilization from the EITC caused by various potential 2013 earnings levels.

Table 9: Mary
(Assuming 2012 Earnings of $27,000 and EITC of $3,149)

2013 Earnings	2013 EITC	Change EITC	Change Earnings	(De)Stabilization Ratio
$13,000	$5,200	$2,051	$14,000	15%
$11,000	$4,400	$1,251	$16,000	8%
$ 9,000	$3,600	$ 451	$18,000	3%
$ 7,000	$2,800	($ 349)	$20,000	-2%
$ 5,000	$2,000	($1,149)	$22,000	-5%
$ 3,000	$1,200	($1,949)	$24,000	-8%
$ 1,000	$ 400	($2,749)	$26,000	-11%

199. Counteracting this was the 7.65 percent stabilization provided by the payroll tax so that Karla's net destabilization was only -12 percent.

200. *See supra* note 194 and accompanying text.

201. This figure was calculated as $5,236 – [.2106 * ($27,000-$17,090)]. *See* Rev. Proc. 2011-52, *supra* note 148.

Second, for any given reduction in earnings, moving from a very high (or very low) Year 1 earned income level in the phase-out range to a very high (or very low) Year 2 earned income level in the phase-in range will maximize the income stabilization (or destabilization) effect of the EITC, as the change in EITC amount will be greatest for this particular type of phase-out-to-phase-in earnings loss. For example, assume that Janet's (a single-mother with two children) wages declined by $27,000 between 2012 and 2013. If she moved from a pre-tax income level of $40,000 (high phase-out level) in 2012 to $13,000 in 2013 (high phase-in level), then her EITC amount would increase from $411[202] to $5,200[203] and offset about 18 percent of her wage loss.[204] If instead Janet moved from an earned income level of $30,000 in 2012 (mid-phase-out level) to $3,000 in 2013 (mid-phase-in level), then her credit amount would increase by $1,317[205] and only stabilize about five percent of her income.[206]

This pattern of income (de)stabilization derives directly from the rapidly changing (in both magnitude and sign) marginal rate structure of the EITC in Figure 3.[207] Although designed to provide a targeted wage subsidy to low income workers, it is likely that the seemingly irrational pattern of income (de)stabilization is an unintended byproduct of that design.

(3) *Newly EITC Ineligible*

Long-term unemployment could make a taxpayer newly ineligible for the EITC.[208] In that event, the taxpayer would lose not only positive earned income, but also positive EITC benefits. As described above, income destabilization occurs when earnings and subsidies move in the same direction.[209] The extent of the destabilization depends on the value of the lost EITC benefits relative to lost wages.

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202. This amount was calculated as $5,236 – [.2106*($40,000-$17,090)]. *See* Rev. Proc. 2011-52, *supra* note 148.

203. This amount was calculated as $13,000 * 0.4. *See supra* Table 1.

204. This amount was calculated as a change in EITC ($4,789)/change in earnings ($27,000).

205. Janet would be entitled to an EITC of $2,517 in 2012 ($5,236 – [.2106*($30,000-$17,090)]) and $1,200 ($3,000*.4) in 2013. *See* Rev. Proc. 2011-52, *supra* note 148; Table 1.

206. This amount was calculated as $1,317 (change in EITC)/$27,000 (change in earnings).

207. *See supra* note 178 and accompanying text.

208. A taxpayer who became unemployed in a year (relatively wealthier year) and remained unemployed throughout the next year (relatively leaner year with no other W-2 or self-employment income) would be the prototype for this type of earnings loss.

209. *See supra* note 191 and accompanying text.

For example, assume Gina (a single-mother with two children) lost her job in the middle of 2012 and remained unemployed for all of 2013. Prior to losing her job, Gina earned $15,000 in 2012. Table 10 illustrates how lost EITC benefits exacerbated Gina's post-tax income loss.

Table 10: Gina

	Earnings	Income Tax	Payroll Tax	EITC	Post-Tax Income
2012	$15,000	$0	$1,148	$5,236	$19,089
2013	$ 0	$0	$ 0	$ 0	$ 0
Δ	($15,000)	$0	($1,148)	($5,236)	($19,089)
Destabilization Ratio		-27.26%	($-4,089/$15,000)		
Income Tax		N/A			
Payroll Tax		7.65%	($1,148/$15,000)		
EITC		-34.91%	($-5,236/$15,000)		

In this case, Gina's earnings and EITC amount fell by $15,000 and $5,236, respectively. Lost EITC benefits destabilized Gina's post-tax income by 35 percent.

d. Summary

In summary, the EITC phase-out range provides marginal stabilization benefits, the plateau region provides no income stabilization, and the phase-in range marginally destabilizes post-tax income relative to pre-tax income. The Auerbach and Feenberg study cited above is in accord with this argument.[210] Focusing only on the contribution of the EITC to the overall automatic stabilization provided by the tax system, Auerbach and Feenberg concluded that the "[EITC] reduce[d] the impact of taxation for [the] lowest [income] quintile, but raise[d] it for the second quintile, and in more recent years, the third quintile, where taxpayers in the phase-out range dominate[d] those receiving [the] additional subsidy."[211] In other words, in the phase-in range (lowest quintile), the EITC destabilizes thereby "reducing the impact of taxation" while in the phase-out range (second and third

210. Auerbach & Feenberg, *Automatic Stabilizers*, *supra* note 24, at 44 tbl. 1.

211. *Id.* at 44. For example, in 1995 the EITC reduced the first quintile's normalized tax response (as compared to the income tax without the EITC) by 0.04, but it increased the second and third quintile's normalized tax response (as compared to the income tax without the EITC) by 0.04 each.

quintile), the EITC mitigates the effect of income losses thereby "raising" the impact of taxation.[212]

This pattern of EITC income (de)stabilization is a byproduct of the design of the EITC as a targeted wage subsidy. The EITC phase-out reduces the payoff from working more within a year, but it also eases income losses for those confronted with annual earnings declines. In contrast, the wage subsidy provided in the phase-in region increases the payoff from working more within a given year, but it also exacerbates annual wage losses. Just as the actual impact of the EITC's intra-annual work incentives depends partly on the location of a beneficiary on the EITC schedule (household-level) or the relative distribution of all beneficiaries across the schedule (macroeconomic-level), so too with the EITC's inter-annual income stabilization effects. This affects the ability of the EITC to serve as a safety net for all of its beneficiaries.

B. *The Good, the Bad, and the Ugly*

This Section draws out the normative implications of the "EITC Safety Net" paradigm through the lens of its likely winners and losers.

1. *The Good: Myrna*

Myrna is the clear winner under the analysis outlined in Section A *supra*. Recall that Myrna (Table 3) suffered an annual earnings loss that made her newly eligible for the EITC phase-out region. The credit amount stabilized Myrna's post-tax income by offsetting a portion of her wage decline.[213] A new study suggests that Myrna represents the prototypical EITC recipient, at least when the program is viewed over time. Dowd and Horowitz studied households' utilization of the EITC over an 18-year period

212. *Accord* Dowd, *Distinguishing Between Short-Term and Long-Term*, *supra* note 27, at 820 (associating economic variables with the probability of claiming the EITC and finding that his results were "roughly consistent with Auerbach and Feenberg . . . that the EITC acts cyclically for the first quintile . . . and counter-cyclically for the second and third quintiles . . .").

213. Given her squarely middle income salary level, Myrna may also be able to seek additional income stabilization from UI. *See generally* U.S. GOV'T ACCOUNTABILITY OFFICE, UNEMPLOYMENT INSURANCE: FACTORS ASSOCIATED WITH BENEFIT RECEIPT GAO-06-341, (2006), http://www.gao.gov/new.items/d06341.pdf; U.S. GOV'T ACCOUNTABILITY OFFICE, UNEMPLOYMENT INSURANCE: LOW-WAGE AND PART-TIME WORKERS CONTINUE TO EXPERIENCE LOW RATES OF RECEIPT GAO-07-1147 (2007), http://www.gao.gov/new.items/d071147.pdf [hereinafter GAO-07-1147].

from 1989 to 2006.[214] Dowd and Horowitz demonstrated that for a majority of EITC claimants, the EITC served as a source of temporary earnings loss offset, rather than as a long-term income maintenance or work incentive program.[215] A total of 42 percent of claimants in the study had an EITC spell that lasted only one year, and 61 percent of EITC recipients claimed the credit for two years or less.[216] A "spell" refers to the duration of continuous time on the EITC measured in years. The 42 percent figure relating to single-year EITC spells tracks closely with a study focused, *inter alia*, on the ability of families with children experiencing large intra-annual income drops to recover from such drops in the following year.[217] Acs et al. reported that two out of five, or 40 percent, of individuals whose monthly family income fell by 50 percent or more made a full recovery within a year.[218]

Although the duration of most EITC spells was short, the frequency of those spells was fairly high. According to Dowd & Horowitz, approximately 45 percent of those EITC recipients who did not receive the EITC for one year claimed the EITC again in the next year and 35 percent of those who did not receive the EITC for two years received it again in the

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214. Dowd & Horowitz, *Income Mobility*, *supra* note 27, at 648. This study used a sample of individual income tax returns filed between 1989 and 2006 that actually claimed the EITC, focusing for the most part on tax returns that claimed a dependent child.

215. *Id.*

216. *Id.* at 11, tbl. 2. The EITC claim length was slightly longer than an earlier study by Horowitz. Horowitz, *Income Mobility & EITC*, *supra* note 27, at 338. This earlier study found that 74 percent of newly eligible EITC families lost their eligibility in two years or less. *Id.* The difference between the two studies can be accounted for by the use of different time periods and data sets. The earlier study by Horowitz used data taken from the Panel Study of Income Dynamics (PSID) for the years 1975-1992. *Id.* at 336. Dowd and Horowitz captured the period 1989-2006 and used tax return data of actual claimants. Dowd & Horowitz, *Income Mobility*, *supra* note 27, at 631. A third study by Dowd for the period from 1989 to 2003 was roughly consistent with Horowitz, finding that 41 percent of EITC recipients received the credit for one or two years, and that 49 percent receive the credit for three years or fewer. Dowd, *Distinguishing Between Short-Term and Long-Term*, *supra* note 27, at 816. Dowd used a data set called the Continuous Work History Sample (CWHS), which is a random panel of individual tax returns created by the Statistics of Income Division of the IRS for the period 1989-2003. *Id.* at 813.

217. GREGORY ACS, PAMELA LOPREST & AUSTIN NICHOLS, The URBAN INST., *Risk and Recovery: Documenting the Changing Risks to Family Incomes, Brief 8* (May 2009), http://www.urban.org/UpleadedPDF/411890_risk_and_recovery.pdf (used data from 1996, 2001, and 2004 panels of SIPP) [hereinafter ACS ET AL., RISK AND RECOVERY].

218. *Id.*

third year.[219] In other words, there was considerable churning, with most taxpayers claiming the credit for short frequent spells.[220]

An important question is what triggered these households to claim the EITC, albeit for a short time. Studying the years 1975-1992, Horowitz demonstrated that a majority (approximately 53 percent) of families who became newly eligible for the EITC did so because of lowered earnings, rather than increased earnings (19 percent) or a change in family structure (16 percent).[221] This data suggests that EITC take-up rates, over time, should be affected more by the income stabilization potential of the EITC than the work incentive aspect. Even more telling was that a majority (approximately 57 percent) of families became newly eligible for the EITC phase-in region because of lowered earnings rather than increased earnings.[222] Indeed, earnings decreases caused more than twice as many taxpayers to become newly phase-in-eligible as compared to earnings increases.[223] Thus, the earnings loss offset aspect of the EITC may be important even in the phase-in range. This is particularly problematic, as the phase-in range is marginally destabilizing in response to wage declines.[224]

Dowd analyzed EITC usage for a sample of taxpayers who were observed for three years in each three-year period from 1989 to 2003. For those who did not claim the credit in Year 1, claiming the EITC only in Years 2 or 3 was associated with, *inter alia*, a decline in wages.[225] Specifically, Dowd observed that those taxpayers who did not claim the credit in the first year, but who claimed it in only the second or only the third year, "experienced substantial shocks in their wage income of, on average, about a quarter of their first year income. For these taxpayers, the EITC made up about one-sixth of the decline in their wage income."[226]

More recent tax return data from 2009 suggests that the EITC played an income stabilization role during the Great Recession. In 2009 (the peak of the Recession), approximately 27 million taxpayers claimed the EITC, an increase of 9.2 percent from 2008.[227] Compare this to the nominal increase in

219. Dowd & Horowitz, *Income Mobility*, *supra* note 27, at 632.

220. *Id.*

221. Horowitz, *Income Mobility & EITC*, *supra* note 27, at 344 tbl. 9 (using data from PSID from 1975-1992).

222. *Id.* at 345. This figure includes families who were previously in the phase-out or flat ranges of the EITC schedule, as well as those earning too much to qualify for the EITC.

223. *Id.* at 344 tbl. 9.

224. *See supra* notes 191–198 and accompanying text.

225. Dowd, *Distinguishing Between Short-Term and Long-Term*, *supra* note 27, at 820.

226. *Id.* at 819–820.

227. JUSTIN BRYAN, I.R.S., INDIVIDUAL INCOME TAX RETURNS 2009, 12 (2009), http://www.irs.gov/pub/irs-soi/11infallbulincome.pdf [hereinafter IRS 2009].

EITC claimants from 2007 to 2008 of only 0.7 percent.[228] Approximately 25 million taxpayers claimed the refundable portion of the EITC in 2009, an increase of 14.6 percent from 2008.[229] From 2007 to 2008, the number of taxpayers claiming the refundable portion of the EITC rose by only 0.6 percent. This is not surprising given the fact that salaries and wages (the largest proportion of EITC recipients' earned income)[230] increased slightly between 2007 and 2008 by 1.9 percent, but fell from 2008 to TY 2009 by 4.1 percent.[231] As more taxpayers moved down the income distribution due to wage declines, more taxpayers qualified for the refundable portion of the EITC.

Taken together, this data paints a very different portrait of the EITC program than the "anti-welfare/anti-poverty" historical narrative discussed in Part II, above. Viewed as a snapshot of a particular year, the program operates as a work subsidy/income transfer program aimed at poor single mothers like Pat and Gina. However, the Dowd and Horowitz study suggests that, over time, it operates primarily as an income stabilization program for middle-class families (like Myrna's) suffering temporary earnings setbacks.

Inter-temporal EITC analyses focus on the movement of households into and out of the program over time. An EITC claimant in any particular year may be there only temporarily due to a negative shock to income (Myrna) or may be a repeat or continual claimant (Pat). In contrast to the majority of EITC claimants who cycle on and off the program frequently, Dowd and Horowitz estimated that 20 percent of recipients are long-term EITC claimants (after starting a spell claimed the credit for five years or more).[232] A GAO study is also in accord, finding that over the five year period between tax years 1999-2005, only about 20 percent of EITC claimants were continual filers, the rest were intermittent (29 percent), one-

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228. JUSTIN BRYAN, I.R.S., INDIVIDUAL INCOME TAX RETURNS 2008, 13 (2008), http://www.irs.gov/pub/irs-soi/08fallbul.pdf [hereinafter IRS 2008]

229. *See* IRS 2009, *supra* note 227, at 13 fig. H.

230. *See, e.g.*, *id.* at 53 tbl. 4 (finding that in 2009 salaries and wages accounted for 90 percent of total earned income, while self-employment income accounted for only 10 percent); THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., R42131, CHANGES IN THE DISTRIBUTION OF INCOME AMONG TAX FILERS BETWEEN 1996 AND 2006: THE ROLE OF LABOR INCOME, CAPITAL INCOME, AND TAX POLICY 5, tbl. 1 (2011), http://www.fas.org/sgp/crs/misc/R42131.pdf (showing that wages and salaries make up 82 percent of total income for the bottom 80 percent of the income distribution in 2006).

231. IRS 2008, *supra* note 228, at 7, fig. B; IRS 2009, *supra* note 227, at 6, fig. B.

232. *See* Dowd & Horowitz, *Income Mobility*, *supra* note 27, at 621.

time (24 percent), discontinued (19 percent), or first-time (eight percent) filers.[233]

The breakdown of EITC claimants into continual versus intermittent users parallels closely with the categories of poverty (chronic or transient) delineated in the dynamic poverty literature (study of spells of poverty over time).[234] Chronic poverty can be defined as a standard of living below the relevant poverty line for an extended period of time.[235] Transient poverty includes the churning poor (standard of living at or near the poverty line who are poor in some periods but not others) and occasionally poor (standard of living above the poverty line but who have experienced at least one period in poverty).[236] Since most of the effects of the EITC are concentrated around the poverty line,[237] one can analogize movements onto and off of the EITC to movements in and out of poverty. The majority of EITC claimants who cycle on and off the program frequently, like Myrna, track closely with the category of transient poor whereas, continual EITC claimants, like Pat, can be analogized to the chronic poor.

The point of categorizing the poor, and by analogy EITC claimants, in the dynamic poverty literature is to recognize that different policies have

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233. TREAS. INSPECTOR GEN. FOR TAX ADMIN, THE EARNED INCOME TAX CREDIT PROGRAM HAS MADE ADVANCES; HOWEVER, ALTERNATIVES TO TRADITIONAL COMPLIANCE METHODS ARE NEEDED TO STOP BILLIONS OF DOLLARS IN ERRONEOUS PAYMENTS, REF. NO. 2009-40-024, 2 (2008), http://www.treasury.gov/tigta/auditreports/2009reports/200940024fr.pdf [hereinafter TREASURY INSPECTOR 2009-40-024]. "Intermittent" filers included those that "claim[ed] the EITC in one year but not the next, then file[d] and claim[ed] the credit again at a later time." *Id.* at 2 n.6. Discontinued filers included those "who had consistently claimed[ed] the EITC but who stopped filing a tax return or no longer qualified for the EITC." *Id.* at 2 n.7.

234. *See, e.g.*, POVERTY DYNAMICS, *supra* note 26; Bane & Ellwood, *Dynamics of Spells*, *supra* note 26; Hulme et al., *Analytical Frameworks*, *supra* note 26.

235. David Hulme & Andrew Shepherd, *Conceptualizing Chronic Poverty*, 31(3) WORLD DEV. 403, 405 (2003) [hereinafter Hulme & Sheperd, *Chronic Poverty*]. The authors suggested five years as the correct period but also admit that five years was an arbitrary and crude approximation for long-term deprivation. *Id. Accord* Martin Ravallion, Dominique van de Walle, and Madhur Gautam, *Testing a Social Safety Net*, 57 J. PUB. ECON. 175, 175–6 (1995) [hereinafter Ravallion et al., *Testing*]. The five year period was defended on three grounds: 1) it is a significant period of time in a person's life in most cultures, 2) data collection often happens in five-year intervals, and 3) some empirical studies indicate that people who stay poor for five years will likely remain poor for the rest of their lives. Hulme & Sheperd, *Chronic Poverty*, at 405.

236. Hulme & Sheperd, *Chronic Poverty*, *supra* note 235, at 405.

237. Liebman, *The Impact of EITC*, *supra* note 46, at 91–94; Meyer, *Recent Reforms*, *supra* note 5, at 159.

different implications for each subcategory.[238] The goal is to formulate programs that can improve the position of the chronic poor by raising incomes at the bottom of the earnings distribution and reduce the probability of the transient poor falling into poverty in times of economic distress.[239] Both types of policies are "anti-poverty" but they are aimed at different potential beneficiaries and operate through different mechanisms.

The EITC is unique in that it can potentially perform both anti-poverty functions within a single program. The work subsidy in the phase-in range increases the incomes of continual EITC claimants, while the phase-out range stabilizes the incomes of intermittent EITC filers. While previous analyses of the anti-poverty effectiveness of the EITC focused on the chronic poor (detailing how many children or single mothers are promoted out of poverty by claiming the credit),[240] the Dowd and Horowitz study illustrated that the EITC can also prevent the transient poor from falling into poverty.

However, the ability of the EITC to simultaneously assist both categories of claimants depends significantly on a strong economy. During economic downturns, when wages are falling or jobs lost, the EITC continues to offer safety net protection to the (increased number) of transient poor (like Myrna), but loses its ability to assist the chronic poor (like Pat and Gina).

2. *The Bad: Pat*

Pat is a clear loser under the "EITC Safety Net" model. Recall that Pat in Table 6 remained in the EITC phase-in range both before and after her annual pay cut and as a result the EITC destabilized her post-tax income.

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238. Jyotsna Jalan & Martin Ravallion, *Is Transient Poverty Different? Evidence From Rural China*, 36 J. OF DEV. STUD. 82, 83 (2000). *See also* Bitler et al., *Safety Net*, *supra* note 18, at 1 (providing that two features of safety net programs are: (1) to raise incomes at the bottom of the income distribution and (2) increase protection in times of need).

239. Ravallion et al., *Testing*, *supra* note 235, at 175–76; Hulme & Shepherd, *Chronic Poverty*, *supra* note 235, at 406; *accord* Bitler et al., *Safety Net*, *supra* note 18, at 1.

240. *See, e.g.*, Bitler et al., *Safety Net*, *supra* note 18, at 1 (providing that in 2011 the EITC lifted 4.7 million children out of poverty); Meyer, *Recent Reforms*, *supra* note 5, at 159 (providing that in 2007 the EITC lifted about 1.1 million families and over 2.1 million children above the poverty line). *But see generally*, Phyllis Jeroslow, *The Earned Income Credit as an Anti-Poverty Program: Palliative or Cure?*, *in* THE UK SOCIAL POLICY ASSOCIATION (July 18, 2012), http://www.social-policy.org.uk/lincoln2012/Jeroslow%20P8.pdf (arguing that these snapshot anti-poverty statistics overstate the anti-poverty effectiveness of the EITC program because the official poverty line is an inadequate measure and reflects short-term gains that do not result in upward mobility for EITC beneficiaries).

This is a direct consequence of the design of the phase-in region of the EITC as a wage subsidy. Wage subsidies are inherently destabilizing—they amplify both wage increases and wage decreases. Recall that in the 1990s, earnings plus the EITC put single mothers in a better post-tax economic situation than remaining unemployed and on welfare. However, with the economic downturns of the early 2000s, rather than improving Pat's post-tax income situation, the EITC worsened it. In other words, the EITC helped Pat when economic times were good but hurt her when economic times were bad. Notice this is the exact opposite response pattern a safety net program should provide. By definition, a safety net program should increase protection in recessionary periods.[241]

Empirical data illustrates how the EITC failed to offset the effects of the 2001 recession for poor female-headed households. Using data reported by the CBO,[242] Bernstein compared the real income of low income (first quintile) single-mother families during the 1990s to the early 2000s, including data on the 2001 recession.[243] Bernstein demonstrated that during the 1990s, low income single-mother families enjoyed large real income gains (4.3 percent), driven by large annual increases in earnings (10.4 percent) and an expansion of the EITC (18.2 percent) that was sufficient to overcome a reduction in welfare benefits (by 11.9 percent). However, the earnings and EITC trends reversed during the period 2000-2005, which included the 2001 recession and the associated jobless recovery. Low income single-mother families' real annual income fell (-2.6 percent) as a result of not only reduced earnings (-3.8 percent) but also reduced EITC benefits (-3.6 percent).[244] Bernstein concluded that during the economic downturn of the early 2000s, the EITC functioned in a pro-cyclical (moving in sync with business cycles) manner for low income single mothers thus failing as a safety net program.[245]

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241. Bitler et al., *Safety Net*, *supra* note 18, at 2.

242. The data used can be found at: CONG. BUDGET OFFICE, 110TH CONG., PUB. NO. 2602, CHANGES IN THE ECONOMIC RESOURCES OF LOW-INCOME HOUSEHOLDS WITH CHILDREN (2007), http://www.cbo.gov/publication/18651.

243. JARED BERNSTEIN, ECON. POLICY INST., A TALE OF TWO TIME PERIODS FOR LOW-INCOME FAMILIES, (June 6, 2007), http://www.epi.org/publication/webfeatures_snapshots_20070606/ [hereinafter BERNSTEIN, TALE OF TWO TIME PERIODS].

244. *Id.*

245. JEFF CHAPMAN & JARED BERNSTEIN, ECON. POLICY INST., FALLING THROUGH THE SAFETY NET LOW-INCOME SINGLE MOTHERS IN THE JOBLESS RECOVERY, ISSUE BRIEF 191, 2 (2003), http://www.epi.org/files/page/-/old/issuebriefs/ib191/ib191.pdf [hereinafter CHAPMAN & BERNSTEIN, FALLING THROUGH THE SAFETY NET]. *See also* Listokin, *Equity, Efficiency and Stability*, *supra* note 13, at 77 (indicating that from a macroeconomic perspective the EITC phase-in is destabilizing or acts in pro-cyclical manner, and the phase-out is

Prior to reform, the phase-out range of traditional welfare programs generally overlapped with the EITC phase-in range and neutralized the effects of EITC income destabilization.[246] However, post-reform welfare failed to play this role during the 2001 and 2008 recessions. TANF benefits declined during the 2001 recession by 6.5 percent albeit at a slower rate than in the 1990s.[247] During the Great Recession, the unemployment rate increased by 88 percent while national TANF caseloads increased by only 14 percent.[248] In some 13 states, welfare caseloads actually dropped between 2007 and 2010.[249] This data suggests that the 1996 reforms (particularly the work requirement and block-grant financing) converted welfare from a countercyclical program (designed to counteract business cycle downturns) into a pro-cyclical program.[250]

The lack of a cash safety net for low income female household heads (like Pat) is particularly problematic as these women are the least able to offset earnings losses through other mechanisms. As a result, it is likely that wage declines associated with the recent recessions negatively impacted this fragile subpopulation's economic well-being. Generally, the important variable in individual or household welfare is not income per se, but the effect that changes on income have on consumption.[251] There are a variety of

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stabilizing or acts in a countercyclical manner); Dowd, *Distinguishing Between Short-Term and Long-Term*, *supra* note 27, at 820 ("the EITC acts cyclically for the first quintile . . . and counter-cyclically for the second and third quintiles"). *Id.*

246. *Cf.* Shaviro, *Minimum Wage*, *supra* note 12, at 462 (providing that "the EITC's negative tax rate in the positive subsidy range offsets what would otherwise be exceptionally high marginal tax rates, due mainly to the phase-out of social welfare benefits").

247. *See* CHAPMAN & BERNSTEIN, FALLING THROUGH THE SAFETY NET, *supra* note 245.

248. *Id.* The authors speculate that UI may have displaced TANF for some low income single parents and that some states actively discouraged applicants from enrolling in welfare.

249. *Id.* at 2; *see also* Sam Syverson, *State TANF Cuts Break Promises, Leave Families Disconnected*, *in* NAT'L WOMEN'S LAW CENTER BLOG (Oct. 12, 2011), www.nwlc.org/our-blog/state-tanf-cuts-break-promises-leave-families-disconnected.

250. *See, e.g.*, CHAPMAN & BERNSTEIN, FALLING THROUGH THE SAFETY NET, *supra* note 245; Bitler & Hoynes, *Post-Welfare Reform Era*, *supra* note 107, at 4 (finding evidence that welfare may be less responsive to business cycles downturns than before reform).

251. There are two different strands of literature on consumption behavior: (1) the complete markets hypothesis and (2) the permanent income hypothesis. Richard Blundell, Luigi Pistaferri & Ian Preston, *Consumption Inequality and Partial Insurance*, 98 AM. ECON. REV. 1887, 1888 (1998); Dynarski & Gruber, *Variable Earnings*, *supra* note 132, at 235–37. The complete markets hypothesis assumes that consumption is fully insured against idiosyncratic shocks to income,

mechanisms a household can access to in order to insulate consumption from wage losses. According to Blundell, at each step in the transformative process of converting wages to consumption, families invoke a number of strategies to deal with income risk.[252] The link between hourly wage rate and earnings is hours, so an individual can increase income by increasing labor supply.[253] Increasing hours may not be an option for a single parent like Pat, whose responsibilities include not only earning wages, but also caring for young children and running a household. Even if Pat could take on additional hours, they may be unavailable during recessionary periods.

The link between individual earnings and family earnings is family labor supply. In response to an earnings loss to one family member, other family members can increase their labor supply to offset the decline.[254] Married couples may be able to reallocate work, care giving, and other household responsibilities to allow one spouse to increase hours worked in response to an earnings shock. There is no partner to pick up the slack when Pat's hours and earnings are reduced as a result of an economic downturn.

The tax (including the EITC) and transfer system operate on earnings to convert them to disposable income.[255] On the tax side, Pat's disposable income was negatively impacted by the EITC because of marginal phase-in income destabilization.[256] On the transfer side, there are two other major cash income stabilization programs: TANF and UI. As described above, in the post-reform era, TANF was increasingly unavailable or underutilized by single-mothers.[257] In its current incarnation, UI fails to

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both transitory and permanent. *Id.* at 235–37. If there is full consumption insurance than idiosyncratic variation in family recourses should not be reflected in family consumption. *Id.* This hypothesis is generally empirically rejected. The permanent income hypothesis, on the other hand, suggests that permanent variations in income should be reflected in consumption, but not transitory variation which should be absorbed through saving or dissaving. The permanent income hypothesis draws a sharp distinction between transitory and permanent variation in income. The latter would be reflected in consumption decisions while the former should not. This hypothesis is also rejected in both aggregate and micro data, as consumption either reacts too little to permanent income shocks or exhibits excess sensitivity with respect to transitory shocks.

252. Richard Blundell, *From Income to Consumption, Understanding the Transmission of Inequality*, 28:1 FOCUS 23 (2011), http://www.irp.wisc.edu/publications/focus/pdfs/foc281f.pdf [hereinafter Blundell, *From Income to Consumption*].

253. *Id.*

254. *Id.*

255. *Id.*

256. *See supra* note 194 and accompanying text.

257. *See supra* Part II Section C.3.

provide significant benefits to low income workers.[258] Accordingly, it is unlikely Pat can rely on transfer programs to cushion her wage loss.

Even if TANF and UI were available to Pat, it is unlikely that the amount of these countercyclical stabilizers would counteract the loss of earnings and EITC benefits.[259] Kniesner and Ziliak compared the "explicit insurance" provided by programs such as Social Security, UI, TANF, and SNAP to the "implicit income insurance" provided by the tax system (including federal and state income taxes, federal payroll taxes, and the EITC).[260] They demonstrated that across all income quintiles, including the lowest where Pat resides, the tax system did as much to stabilize income implicitly as did transfer programs explicitly and taxes did more to reduce consumption variability than did transfer payments.[261]

Finally, there are a number of self-insurance (saving/borrowing) and informal insurance mechanisms (transfers from family members/friends) available to Pat to smooth consumption in the face of her wage decline.[262] Poor female-headed households probably cannot access these self-insurance tools because of credit/liquidity constraints and/or lack of saving.[263] During recessionary periods, family and friends may be unable to gift or loan money

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258. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-01-181, UNEMPLOYMENT INSURANCE: ROLE AS SAFETY NET FOR LOW-WAGE WORKERS IS LIMITED 13 (December 2000), http://www.gao.gov/new.items/d01181.pdf (noting that "[w]hile in the 4 years since welfare reform many former welfare recipients have joined the labor force, often in low-wage jobs, nationwide few states have adjusted their UI programs to eliminate practices that may present difficulties to low-wage workers, particularly these new workers"); GAO-07-1147, *supra* note 213, at 3 (providing that "although low-wage workers were almost two-and-one-half times as likely to be out of work as higher-wage workers, they were about half as likely to receive UI benefits"). *Id.* However, there is evidence that single mothers increasingly accessed UI during the most recent economic downturn to boost their non-labor income. *See* Zedlewski et al., *High Unemployment*, *supra* note 107, at 1.

259. *See* Zedlewski et al., *High Unemployment*, *supra* note 107, at 1.

260. Kniesner & Ziliak, *Implicit Insurance*, *supra* note 13.

261. *Id.* at 12, 14. Transfers reduced consumption volatility by about 8.5 percent on average, and taxes reduced consumption variations by an additional 10 percent. *Id.* at 14. Note that transfers included government programs as well as private transfers. *Id.* at 11.

262. Blundell, *From Income to Consumption*, *supra* note 252; Stefan Dercon, *Income Risk, Coping Strategies and Safety Nets*, 17(2) WORLD BANK RES. OBS. 141, 143 (2002), http://wbro.oxfordjournals.org/content/17/2/141.full.pdf+html. Self-insurance includes precautionary savings (building up assets in high earnings years and applying those savings in low earnings years).

263. EDMISTON, NEW SURVEY, *infra* note 270, at 49 (reporting survey results suggesting that low and moderate income families lack access to traditional forms of credit and that since the financial crisis, these same families have had even greater difficulty accessing credit because of tightened credit standards).

due to their own negative financial circumstances. As a result, the EITC may be the only cash-based safety net available to Pat. This makes recession-induced phase-in range destabilization particularly problematic.

A recent paper by Bitler et al. analyzed the relationship between business cycles and the size of the EITC program. The study found that overall EITC participation increased 1.8 percent in response to a one percentage point increase in the state unemployment rate.[264] However, when this figure was decomposed by demographic group, a familiar result emerged. For married couples with children, a one percentage point increase in the unemployment rate resulted in a 6.3 percent increase in EITC caseloads.[265] Recall that a majority of married couples reside in the phase-out range.[266] In contrast, single parent caseloads actually went down by one percent in response to an increase in the unemployment level.[267] Single parent families dominate the phase-in range.[268] In other words, the EITC is countercyclical for married couples who fall onto the EITC schedule as a result of an earnings loss but is pro-cyclical and provides no automatic stabilization or income protection for single parent families.[269]

The implicit social bargain made by the government during safety net reform of the 1990s was that if you work, we will take care of you. Despite a historically bad labor market, Pat managed to remain employed. She held up her end of the bargain during both good and bad economic times. The government, on the other hand, implicitly reneged on its end of the deal at a time when Pat most needed assistance, as recessionary periods tend to disproportionately negatively impact female-headed households.[270] Clearly, the EITC is not a safety net program with regard to Pat.

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264. Bitler et al., *Safety Net*, *supra* note 18, at 16, 28 tbl. 2 (data from the 1996-2008 SOI).

265. *Id.* (estimate is statistically significant at the one percent level).

266. *See supra* note 54 and accompanying text.

267. Bitler et al., *Safety Net*, *supra* note 18, at 16, 28 tbl. 2 (estimate shows negative but statistically insignificant coefficients).

268. *See supra* notes 45–48 and accompanying text.

269. Bitler et al., *Safety Net*, *supra* note 18, at 24.

270. KELLY D. EDMISTON, FEDERAL RESERVE BANK OF KANSAS CITY, THE LOW- AND MODERATE-INCOME POPULATION IN RECESSION AND RECOVERY: RESULTS FROM A NEW SURVEY 1 (2013), http://www.kansascityfed.org/publicat/econrev/pdf/13q1Edmiston.pdf [hereinafter EDMISTON, NEW SURVEY]. *See also* Bitler & Hoynes, *Post-Welfare Reform Era*, *supra* note 107, at 2 (providing "we also know that downturns cause larger negative impacts on those with lower education and skill levels"); Chi-Fang Wu & Mary Keegan Eamon, *Patterns and Correlates of Involuntary Unemployment and Underemployment in Single-Mother Families*, 33(6) CHILD. & YOUTH SERV. REV. 820, 821 (2011) (providing "families headed by single mothers are at heightened risk of experiencing economic hardships

3. *The Ugly: Gina*

Recall Gina from Table 10, who lost her job in 2012 and remained unemployed for all of 2013. As a result, Gina was not entitled to an EITC in 2013. Sadly, Gina's experience is fairly typical of low income single mothers during the early 2000s. While all families suffered, the economic downturn hit families headed by single mothers especially hard.[271] For the one in four U.S. households that is female-headed, the Great Recession exacerbated a period of losing ground that began in 2000.[272] Single-mother employment rates peaked in 1999, and have been on the decline ever since.[273] Between 1999 and 2007, all single-mothers experienced a five percent decline in employment. The subpopulation of EITC-eligible single-mothers bore the brunt of this decline, as their employment rate declined by 12 percent over this same period.[274] In 2009, over a quarter of single-mothers were jobless the entire year, a third were jobless in an average month, and less than half were employed full-time year-round. [275]

Increased joblessness and decreased access to the EITC (and welfare) combined to increase single-mother poverty. In 2009, 38 percent of single-mothers were poor, whereas only eight percent of married women were poor.[276] Between 2000 and 2009, the percentage of single- mothers with an income less than the poverty level rose by six percentage points from 32 percent to 38 percent.[277] By way of comparison, married women poverty increased by only two percentage points from six percent to eight percent.[278]

This has led to an increase in the number of "disconnected women."[279] This group includes single-mother, former welfare recipients

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and the effects of economic recessions more severely") [hereinafter Wu & Eamon, *Patterns*].

271. Wu & Eamon, *Patterns*, *supra* note 270, at 820.

272. *Id.*

273. Meyer, *Recent Reforms*, *supra* note 5, at 164 tbl. 6.

274. *Id.* (referring to single mothers with low education levels).

275. LEGAL MOMENTUM, THE WOMEN'S LEGAL DEFENSE AND EDUCATION FUND, SINGLE MOTHERS SINCE 2000: FALLING FARTHER DOWN 1–2 (2011), http://www.legalmomentum.org/our-work/women-and-poverty/resources--publications/single-mothers-since-2000.pdf.

276. GABE, WELFARE, WORK, AND POVERTY, *supra* note 112, at CRS-72 tbl. C-4 (2011).

277. *Id.*

278. *Id.*

279. *See* PAMELA LOPREST & AUSTIN NICHOLS, THE URBAN INST., DYNAMICS OF BEING DISCONNECTED FROM WORK AND TANF, http://.www.urban.org/UploadedPDF/412393-Dynamics-of-Being-Disconnected-from-Work-and-TANF.pdf [hereinafter LOPREST & NICHOLS, DYNAMICS]; Lesley Turner, Sheldon Danziger & Kristin Seefeldt, *Failing the Transition from Welfare to Work: Women*

who are no longer working or receiving any form of cash-based public assistance.[280] Losing a job is the most common reason for becoming disconnected, even more common than loss of welfare.[281] With a job loss, these women fall off the EITC benefit schedule and as a result of welfare reform, fail to connect with the TANF schedule. Consequently, disconnected families are worse off economically than other low income single-mother families.[282] The likelihood of becoming disconnected is related to the overall state of the labor market.[283] The percent of low income single-mothers who are disconnected has increased since the mid-1990s. About one in eight low income single-mothers were disconnected in 1996 whereas one in five were disconnected in the period from 2004 to 2008.[284] This data does not include the period encompassing the Great Recession and its aftermath, but early data indicates a continued increase in the number of disconnected women.[285]

IV. PROPOSAL

One may wonder why Gina remained unemployed throughout 2013. Given the extremely poor labor market, it may be the case that Gina searched all year but simply could not find a job. In that case, Gina was involuntarily unemployed. Gina raises a question about whether work-premised programs, such as the EITC and post-reform welfare, are the proper safety net tools to

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Chronically Disconnected from Employment and Cash Welfare, 87 SOC. SCI. Q. 227 (2006) [hereinafter Turner et al., *Failing the Transition*]; Rebecca M. Blank & Brian Kovak, *The Growing Problem of Disconnected Single Mothers*, *in* MAKING THE WORK-BASED SAFETY NET WORK BETTER 227 (Carolyn Heinrich & John Karl Scholz eds., 2009) [hereinafter Blank & Kovak, *Growing Problem*].

280. *See supra* note 279.

281. LOPREST & NICHOLS, DYNAMICS, *supra* note 279, at ix. *Accord* Turner et al., *Failing the Transition*, *supra* note 279, at 245 (indicating that job loss played a more common role in causing a spell of disconnectedness than welfare loss); Blank & Kovak, *Growing Problem*, *supra* note 279, at 243 (stating that "[m]ore than half (57.5) of [disconnected] spells start because of a change in earnings, probably caused by the loss of a job"). *Id.* Finding a job is the most common reason for becoming reconnected.

282. *See supra* note 281.

283. Quinn Moore, Robert Wood & Anu Rangarajan, *The Dynamics of Women Disconnected from Employment and Welfare*, 86 SOC. SERV. REV. 93, 110–11 (2012) (indicating that the "monthly state unemployment rate is estimated to have a large, statistically significant, and positive association with becoming disconnected") [hereinafter "Moore et al., *Dynamics of Women Disconnected*"].

284. *Id.*; *accord* Turner et al., *Failing the Transition*, *supra* 279, at 229 (providing that the number of disconnected women fluctuated between 11 and 15 percent from 1975 to 1995, but that following the 2001 recession that number increased to 20 percent in 2002 and 2003).

285. Moore et al., *Dynamics of Women Disconnected*, *supra* note 283.

rely on in recessionary periods. Recall Greenspan's quote from Part I—during recessionary periods, most work reductions are driven not by incentives, but by the compromised state of the economy.[286] In a weak labor market, a focus on work incentives is misplaced. Instead, during recessionary periods cash-based safety net programs aimed at low income female-headed households should focus on stabilizing incomes to prevent falls into poverty.

This Part offers a narrowly tailored proposal (Proposal) designed to ameliorate the effects of EITC income destabilization during recessionary periods.[287] Under the Proposal, when the economy meets some pre-defined conditions indicating a recession, the EITC phase-in range (for every type of EITC claimant) would shift up and result in an EITC budget function that resembled a NIT with an income disregard. Recall that under a traditional NIT program, the maximum transfer amount is provided to non-workers and is immediately reduced as earnings increase at a pre-defined benefit reduction rate.[288] Under an NIT with an income disregard, the maximum benefit is not reduced until after an initial amount of income is earned.[289] The purpose of introducing an income disregard is to minimize the work disincentives generated by a traditional NIT program. In contrast, the

286. *See supra* note 20 and accompanying text.

287. Welfare or UI could also be used to offset the effects of recession-induced-EITC-based income destabilization, but significant reform would be necessary as neither program is currently configured to adequately serve in this capacity. *See supra* notes 257–258 and accompanying text. Given its history, it is probably a political non-starter to suggest reforming welfare for this purpose. *See supra* Part II Section C. UI, on the other hand, is a more promising alternative given its explicit design as an income stabilization program. COMM. ON WAYS & MEANS, 110TH CONG., 2008 BACKGROUND MATERIAL AND DATA ON THE PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS, SECTION 4 - UNEMPLOYMENT COMPENSATION (Comm. Print 2008). Although beyond the scope of this Article, proposals exist to reform the existing UI program to allow it to more adequately serve low income workers, part-time workers, or both. *See, e.g.*, Karen Syma Czapanskiy, *Unemployment Insurance Reform for Moms*, 44 SANTA CLARA L. REV. 1093 (2004); *but cf.* Gillian Lester, *Unemployment Insurance and Wealth Redistribution*, 49 UCLA L. REV. 335 (2001) (arguing against the use of UI as a means to redistribute wealth to lower-income workers). Others have proposed fundamental restructuring of the program to achieve similar goals. *See, e.g.*, JEFFREY R. KLING, THE BROOKINGS INST., *Fundamental Restructuring of Unemployment Insurance: Wage-Loss Insurance and Temporary Earnings Replacement Accounts*, (2006), http://www.brookings.edu/views/papers/200609kling.pdf. *See also* Walter Nicholson, *The Evolution of Unemployment Insurance in the United States*, 30 COMP. LAB. L. & POL'Y J. 123 (2008) (reviewing and contrasting the various reform proposals).

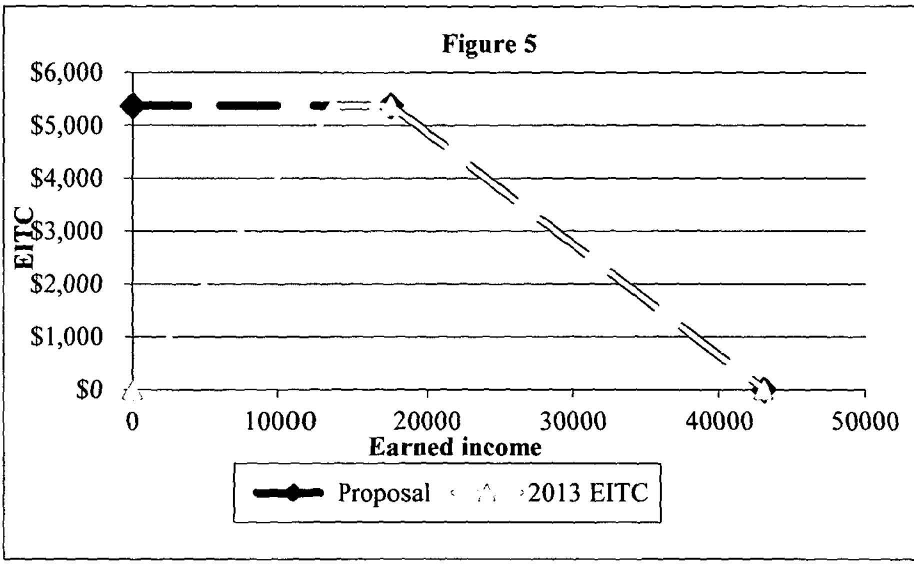
288. *See supra* notes 77–80 and accompanying text.

289. Browning, *Effects of* EITC, *supra* note 12, at 24–25.

purpose of the income disregard under the Proposal is to prevent EITC income destabilization.

The modifications under the Proposal would only apply to those individuals who claimed an EITC in the previous tax year. There are two reasons for this limitation. First, newly eligible EITC recipients only realize income stabilization from the EITC. Stated another way, they do not need protection against EITC income destabilization. Second, as described in more detail below, it limits the category of non-working individuals who can claim a credit under the Proposal.

Figure 5 diagrams the Proposal as applied in 2013 to a single parent with two children along with the unmodified EITC budget function for the same type of taxpayer.



The goal of the Proposal is to maximize EITC income stabilization (or eliminate phase-in range destabilization) during recessionary periods. Essentially, under the Proposal, the phase-in range is eliminated, but all other EITC parameters (maximum credit amount and the threshold/completed phase-out amounts) remain unchanged. As a result, no taxpayer can suffer phase-in range marginal income destabilization.[290] Post-tax income can only be stabilized or unaffected under the Proposal. Low income, single-mother families who normally reside in the phase-in range will realize significant income stabilization benefits in the year of conversion and suffer no EITC-

290. Of course, if a taxpayer moves from a more generous to a less generous EITC schedule because of a change in family status (getting married, divorced, or gaining/losing a qualifying child) destabilization may result. The Proposal does not address that type of EITC income destabilization.

induced income destabilization while the Proposal remains in effect. It will also prevent the irrational income destabilization of certain taxpayers experiencing phase-out-to-phase-in pre-tax earnings losses.[291]

To see this numerically, recall Pat who suffered a purely within-phase-in-range annual wage decline between 2012 and 2013. Assume that in 2013 the economy met the pre-enacted triggering conditions and the 2013 EITC schedule converted to the Proposal. Table 11 illustrates how the Proposal improved Pat's post-tax income situation.

Table 11: Pat

	Earnings	Income Tax	Payroll Tax	Proposal	Post-Tax Income
2012	$12,000	$0	$918	$4,800	$15,882
2013	$10,000	$0	$765	$5,372	$14,607
Δ	($ 2,000)	$0	($153)	$ 572	($ 1,275)
Stabilization Ratio		36.25%	($725/$2,000)		
Income Tax		N/A	N/A		
Payroll Tax		7.65%	($153/$2,000)		
Proposal		28.60%	($572/$2,000)		

Under the Proposal, when Pat's annual wages declined by $2,000, her EITC amount increased by $572. As a result, the Proposal stabilized Pat's post-tax income by about 29 percent. Compare this to Pat's outcome under the normal EITC in Table 6—the EITC destabilized Pat's income by 19 percent because her credit amount decreased by $800 in response to her earnings loss. Overall, including the Proposal, the tax system offset about 36 percent of Pat's $2,000 pre-tax wage decline.

Clearly, the Proposal rebalances the competing EITC objectives by elevating income stabilization over work incentives as a policy priority during recessionary periods. The Proposal's zero percent marginal rate creates additional work disincentives as compared to the normal EITC phase-in structure. However, it does so only temporarily and at a time when the need for income stabilization is most acute and work incentives are unlikely to operate effectively.[292]

Most controversially, an unemployed individual can claim the maximum credit amount under the Proposal, provided of course, that he or

291. *See supra* notes 202–207 and accompanying text.
292. *See* note 20 and accompanying text.

she claimed the EITC in the previous year.[293] This seemingly violates one of the central unwavering tenants of the EITC program: it only applies to Workers. However, the Proposal need not violate so much as redefine what it means to be a Worker in recessionary periods. Under the Proposal, you are considered a Worker and eligible for a credit if you are working or were working before the recession hit. The Proposal recognizes that this type of Worker is probably involuntarily unemployed. Since the EITC was designed to target motivation, and not opportunity, there is no EITC-based policy reason to punish this type of individual. To the contrary, the Proposal offers the cyclically induced unemployed individual the maximum EITC credit amount in order to stabilize income.

For example, recall Gina who worked in 2012, but was unemployed for all of 2013. Table 12 describes how Gina's income situation was improved by the Proposal.

Table 12: Gina

	Earnings	Income Tax	Payroll Tax	Proposal	Post-Tax Income
2012	$15,000	$0	$1,148	$5,236	$19,089
2013	$ 0	$0	$ 0	$5,372	$ 5,372
Δ	($15,000)	$0	($1,148)	$ 136	($13,717)
Stabilization Ratio		8.56%	($1,284/$15,000)		
Income Tax		N/A			
Payroll Tax		7.65%	($1,148/$15,000)		
Proposal		0.91%	($136/$15,000)		

Recall from Table 10 that Gina's unmodified EITC amount declined by $5,236 when she lost her job thereby destabilizing Gina's post-tax income by 35 percent. Under the Proposal, the EITC amount remained almost the same between 2012 and 2013.[294] Consequently, Gina suffered no EITC income destabilization and the tax system overall offset her earnings loss by about nine percent.[295]

293. An individual who became unemployed in the year of conversion would remain eligible for a credit for as long as the Proposal remained in effect.

294. The slight increase in the ETIC amount is entirely attributable to the required annual inflation adjustment. *See supra* note 189.

295. This offset was attributable in large part to the 7.65 percent payroll tax reduction.

The Proposal draws from a concept in the macroeconomic literature known as formula flexibility.[296] Richard Musgrave defined formula flexibility as "an arrangement whereby changes in tax rates and/or expenditure levels are legislated in advance, to go into effect if and when specified changes in income occur."[297] For example, pre-enacted legislation could provide that income tax rates be lowered by x percent when unemployment exceeds y percent.[298] Prior legislation would also define the economic conditions under which all pre-enacted changes would cease and the tax system would revert to its original form.

Formula flexibility was seen by its advocates as an alternative to relying on "discretionary fiscal policy" (a one-time tax rebate, temporary reduction in tax rates, etc.) to combat recessions. Discretionary policy relies on Congress to take affirmative action. This type of fiscal policy is not always effective because it requires (1) Congress to act and (2) to act in a timely manner. Advocates viewed formula flexibility as the solution to these two problems. Business-cycle-induced changes in tax rates or transfer payments are triggered automatically under a formula without required congressional action.[299]

Formula flexibility should be distinguished from built-in flexibility or automatic stabilization introduced in Part III above. Federal tax system automatic stabilization is an accidental byproduct of a system designed to achieve other societal goals (equity, efficiency, revenue raising, etc.) whereas formula flexibility is specifically designed to achieve maximum income

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296. *See generally* LAURENCE SEIDMAN, AUTOMATIC FISCAL POLICIES TO COMBAT RECESSIONS (M.E. Sharpe Inc. ed. 2003) [hereinafter SEIDMAN, FISCAL POLICIES].

297. RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE: A STUDY IN PUBLIC ECONOMY 512 (McGraw-Hill ed., 1st ed. 1959).

298. ALAN S. BLINDER, THE ECONOMICS OF PUBLIC FINANCE 65 (Atlantic Pub. & Dist. ed., 1974). Triggers can also be pre-enacted to cool off the economy. For example, income tax rates will increase by p percent when inflation hits q percent.

299. The idea of using fiscal policy (as opposed to monetary policy) to stabilize the economy during a recession fell out of favor with most economists in the late 1970s. SEIDMAN, FISCAL POLICIES, *supra* note 296, at xi, xii. *See also* Listokin, *Equity, Efficiency, Stability*, *supra* note 13, at 47 (lamenting that during the 1980s until the Great Recession, tax policy scholars conceded to the claimed primacy of monetary policy over fiscal policy and tax-based automatic stabilization fell out of favor). The 2001 recession witnessed a rebirth for countercyclical fiscal policy as Congress moved relatively fast to enact a tax rebate to stimulate the economy). SEIDMAN, FISCAL POLICIES, *supra* note 296; *see also* Listokin, *Equity, Efficiency, Stability*, *supra* note 13, at 47–48 (pinpointing the tax cuts enacted in response to the Great Recession as the moment for the reemergence of fiscal stabilization as a policy tool).

stabilization during economic downturns.[300] Furthermore, "[automatic stabilization] is built into the existing tax and transfer payment structure, while the [formula flexibility], when activated, changes the structure itself."[301]

The current design of the EITC as a targeted wage subsidy is intended to provide an income transfer while encouraging work or additional work effort. The EITC's (de)stabilization properties are an unintended byproduct of that design. In contrast, the Proposal would change the current structure specifically to boost the EITC's income stabilization capabilities (or prevent income destabilization) during recessionary periods. The normal EITC structure and purpose are restored once normal economic conditions prevail.

The most obvious problem with this strategy is devising suitable formula *ex ante* to produce the desired result at the desired time. Of course, this issue is minimized by the fact that the pre-enacted legislation is simply a default position. Congress can always change the formula, (but if Congress tweaks the formula after the fact it converts from formula-driven to discretionary fiscal policy, with all of its own drawbacks). However, if Congress fails to take any action, the pre-legislated tax change is promptly triggered by a decline in the economy.[302] In a sense, formula flexibility is the opposite of temporary tax legislation. Under the former, a tax change comes into existence unless Congress acts whereas under the latter, a tax change ceases to exist unless Congress acts.[303] Although this Article does not define the pre-conditions that would trigger the proposed change, given the argued-for-link between the EITC and the health of the labor market, a formula linked to the unemployment level seems a natural fit.

A second, less obvious problem is budgetary impact. Congress does not know when or if the change will occur, how long it will stay in effect, or how many taxpayers it will effect. As a result, there is no way to forecast its

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300. SEIDMAN, FISCAL POLICIES, *supra* note 296, at xvi.–iii.

301. Howard Pack, *Formula Flexibility: A Quantitative Appraisal, in* STUDIES IN ECONOMIC STABILIZATION 5–7 (Albert Ando et al. eds., 1968).

302. SEIDMAN, FISCAL POLICIES, *supra* note 296, at xvi.–iii.

303. *See generally, e.g.*, Rebecca M. Kysar, *The Sun Also Rises: The Political Economy of Sunset Provisions in the Tax Code*, 40 GA. L. REV. 335 (2006) (critically analyzing sunset provisions and arguing that despite proponent's claims, these provisions may increase the perversion of the tax legislative process); Rebecca M. Kysar, *Lasting Legislation*, 159 PA. L. REV. 1007 (2011) (arguing for the primacy of permanent over temporary tax legislation); Jacob E. Gersen, *Temporary Legislation*, 74 U. CHI. L. REV. 247, 249 (2007) (analyzing the historical, legal, and political implications of temporary tax legislation and concluding that such legislation should be "embraced as the rule rather than eschewed even as an exception" in the proper policy domains). *Id.*

cost.[304] Contingent program expenditures could be minimized by pre-enacting dollar or time limits. For example, the Proposal's modifications would cease if its cost exceeded 15 percent of mean annual expenditures under the regular EITC over last three years. Alternatively, Congress could restrict the operation of the Proposal to a maximum of two or three taxable years.

Of course, under the Proposal, all good things must come to an end. Upon an economic recovery, the EITC structure reverts to its original form. This reversion is the most serious drawback of the Proposal. Phase-in range income destabilization will result for many phase-in claimants when the original lower EITC amounts are restored. Even worse, a within-phase-in-range earnings loss occurring in the year of restoration could generate greater post-tax income destabilization than if the changes never occurred.

To see why this occurs, consider Pat's post-tax income situation in 2014 if the economy improved so that the EITC reverted to its original form. Table 13 specifies Pat's results if she experienced a $5,000 annual earnings loss in 2014.[305]

Table 13: Pat

	Earnings	Income Tax	Payroll Tax	EITC	Post-Tax Income
2012	$10,000	$0	$765	$5,372	$14,607
2013	$ 5,000	$0	$383	$2,000	$ 6,618
Δ	($ 5,000)	$0	($383)	($3,372)	($ 7,990)
Destabilization Ratio		-59.79%	(-$2,990/$5,000)		
Income Tax		N/A		N/A	
Payroll Tax		7.65%	($153/$5,000)		
EITC		-67.44%	($-3,372/$5,000)		

The reverted EITC exacerbated Pat's pre-tax earnings loss by 67 percent. Recall that an unmodified EITC phase-in range can only destabilize post-tax income by a maximum of 40 percent. Accordingly, the effect of the Proposal is to delay, but ultimately increase, the amount of EITC income destabilization for many low income working families.

However, reversion-year destabilization does not sabotage the utility of the Proposal. The EITC critique in the Article is not that EITC income

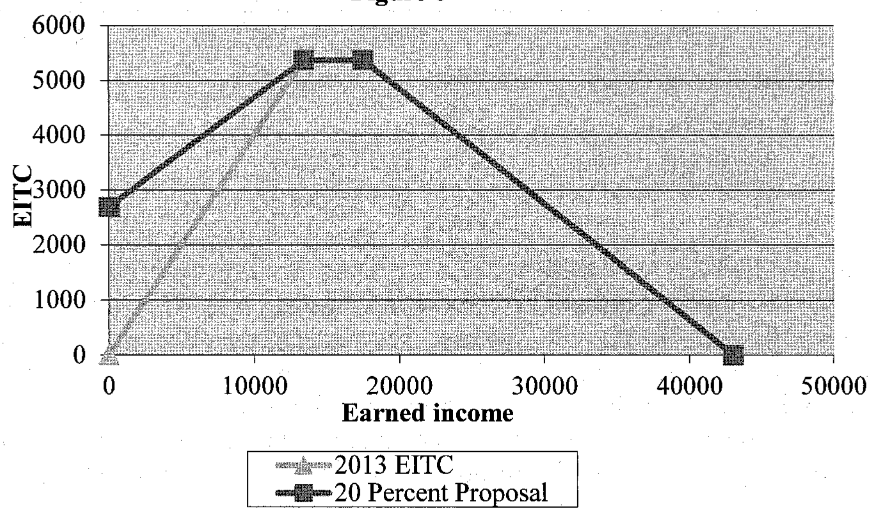
304. Existing budget rules may need to be changed to accommodate such a program. *See generally*, COMM. ON WAYS & MEANS, 110TH CONG., COMPILATION OF LAWS AND RULES RELATING TO THE CONGRESSIONAL BUDGET PROCESS (Comm. Print 2008).

305. This figure was calculated using 2013 EITC parameters, assuming no inflation between 2013 and 2014. *See supra* note 42 and accompanying Table 1.

destabilization is, in and of itself, a bad thing. Under normal economic conditions, the EITC properly trades off the benefit of providing a wage subsidy to low income working families with the potential cost of destabilizing the incomes of those same families if annual earnings losses occur. Instead, this Article's claim is a more nuanced one. In severe economic downturns, the subsidy is likely to be ineffective and the likelihood of widespread income destabilization substantially increases. Hence, the policy balance shifts in favor of stabilization over work incentives. However, once economic conditions return to normal, the primacy of providing positive work incentives is restored and the concern about EITC income destabilization is diminished.

Furthermore, even if the concern about EITC restoration-year income destabilization is valid, it could easily be mitigated. Under the current Proposal, the EITC phase-in rate moves from a negative 40 percent to a zero percent rate. The greater the difference between these two rates, the higher the potential for income destabilization when the normal EITC is restored. The Proposal could easily be tweaked to change the phase-in marginal rate to a negative 20 percent (20 Percent Proposal). Figure 6 illustrates the resulting structure of the EITC with the 20 Percent Proposal (assuming the economic conditions triggered a conversion).

Figure 6



Under the 20 Percent Proposal, income stabilization provided during the recessionary period would be lower, but the potential amount of income destabilization during the restoration year would be halved as compared to the original Proposal. Notice that if economic conditions are such that the Proposal remains in effect for multiple years, the possibility of phase-in destabilization is reintroduced, albeit at a lower rate than under the normal EITC. As a corollary, the 20 Percent Proposal would maintain positive work incentives, but at a lower rate than the normal EITC.

V. CONCLUSION

This Article introduced income (de)stabilization as a new variable to be accounted for in evaluations of the EITC program, in addition to efficiency (labor incentives) and equity (redistributive or anti-poverty effectiveness).[306] The challenge, of course, is that these competing objectives are sometimes at odds with each other. Recall that the EITC phase-out range provides marginal stabilization benefits, the plateau region provides no stabilization benefits, and the phase-in range marginally destabilizes post-tax income relative to pre-tax income. This result is an unavoidable consequence of the design of the EITC as a work subsidy that phases out at higher income levels. The EITC phase-out reduces the payoff from working more within a year, but it also cushions the effect of annual wage declines.[307] In contrast, the wage subsidy provided in the phase-in region increases the payoff from working more within a given year, but it also exacerbates annual earnings losses. Clearly, there is a tension between the EITC's efficiency and income stabilization capabilities.

However, this tension remained hidden during the economic boom of the 1990s. The EITC was originally enacted, *inter alia,* to incentive poor single-mothers to make the transition from welfare to work. Of course, an implicit requirement for this strategy to succeed was a job market with excess capacity to absorb these newly motivated workers. During the 1990s, such a labor market existed and single-mothers moved into jobs. The combination of earnings and EITC lifted many female-headed households out of poverty. In other words, with a strong labor market, the EITC employment incentives and resulting anti-poverty effectiveness properly took center stage and income destabilization remained in the background as an unrealized lurking threat.

However, low income single-mother families fully realized the negative consequences of EITC-phase-in-income destabilization during the 2001 and 2008 recessions. The extremely weak labor market

306. *See* Kniesner & Ziliak, *Implicit Insurance, supra* note 13, at 18 (lamenting that optimal tax analyses misses stabilization and associated consumption-smoothing as an additional welfare-enhancing aspect of an income tax to be traded-off with equity and efficiency).

307. HERWIG IMMERVOLL & MARK PEARSON, INST. FOR THE STUDY OF LABOR, A GOOD TIME FOR MAKING WORK PAY? TAKING STOCK OF IN-WORK BENEFITS AND RELATED MEASURES ACROSS THE OECD 44 (2009), http://ftp.iza.org/pp3.pdf.

disproportionately impacted low income female-headed households as earnings declined and jobs disappeared. The associated loss of EITC benefits worsened the economic well-being of single parent families, reversing many of the gains made during the 1990s. During these recessionary periods, work incentives were nullified and the income stabilization potential of the EITC moved to the forefront.

As a result, a new definition of EITC anti-poverty effectiveness emerged. Rather than measuring how many families were lifted out of poverty through its wage subsidy, during recessionary periods the EITC would be judged by how many families it prevented from falling into poverty through its income stabilization benefit. However, as this Article has demonstrated, households receiving the benefit of the wage subsidy during the 1990s were not the same families realizing the income stabilization benefit of the EITC during the 2000s. Stated another way, EITC phase-in income destabilization prevented the program from assisting the exact demographic group it was designed to help (poor single-mother families) at the exact wrong time (recessionary periods). As a result, the EITC failed as a safety net for this fragile subpopulation of beneficiaries. Reformed welfare offered little to no relief.

This Article offers a narrowly tailored Proposal that alters the structure of the phase-in range during recessionary periods in order to mitigate the problem of EITC-induced income destabilization. By recognizing that labor incentives are rendered ineffective during economic downturns, the Proposal properly rebalances the competing EITC objectives and elevated income stabilization over work subsidies as the means to prevent single-mother poverty.