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Journal of Public Economics 88 (2004) 1931–1958

JOURNAL OF PUBLIC ECONOMICS

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Taxes and the labor market participation of married couples: the earned income tax credit

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Received 23 January 2002; received in revised form 26 August 2003; accepted 6 September 2003

Abstract

A distinguishing feature of recent changes to the US system of public assistance is its increasing focus on *working* families and reliance on the *tax* system to transfer dollars to needy families. After a decade in near total obscurity, the earned income tax credit (EITC) was expanded to become the largest cash-transfer program for lower-income families with children. Advocates of the EITC argue that, unlike traditional welfare, the credit helps "promote both the values of family and work". Indeed, empirical evidence consistent with economic theory suggests that the EITC promotes employment among eligible unmarried women with children. To target benefits to lower-income families, however, the EITC is based on *family* income, leading to traditional welfare-type disincentives for most eligible secondary earners. In fact, the EITC is likely to reduce overall family labor supply among married couples.

This paper examines the labor force participation response of married couples to EITC expansions between 1984 and 1996. The effect of the credit is estimated using both quasi-experimental and traditional reduced-form labor supply models. Results from both models show the same qualitative conclusion, that the EITC expansions reduced total family labor supply of married couples. In all cases, we find a decline in labor force participation by married women that more than offsets any rise in participation by their spouses. While the labor force participation rate of married men increased by about 0.2 percentage points, that of married women decreased by just over a full percentage point. These aggregate effects mask substantial heterogeneity in the population. Women facing the strongest disincentives were more than 2 percentage points less likely to work after the expansions. These findings imply that the EITC is effectively subsidizing married mothers to stay home, and therefore, have implications for the design of the program.

Keywords: Labor supply; EITC; Taxes

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0047-2727/$ - see front matter
doi:10.1016/j.jpubeco.2003.09.005

1. Introduction

The system of public support for poor families in the United States has undergone a major transformation over the past two decades. Major state and federal reforms to the Aid to Families with Dependent Children (AFDC) program, now known as Temporary Assistance for Needy Families (TANF), have reduced dramatically the role and relevance of traditional welfare. At the same time, a series of tax acts have increased public assistance to the *working* poor; expanding the earned income tax credit (EITC) to become the largest cash-transfer program for lower-income families with children. Over 20 million families are projected to have benefited from the tax credit in 2000, at a total cost to the federal government of about 30 billion dollars (US House of Representatives, 2000).[1]

These changes have resulted in part from the long standing criticism that traditional welfare programs generate adverse incentives to work. In fact, advocates of the EITC argue explicitly that redistribution occurs with much less distortion to labor supply, in sharp contrast to other elements of the welfare system. In particular the credit is said to encourage labor force participation. Empirical evidence consistent with economic theory suggests that the EITC promotes employment among eligible unmarried women with children (Eissa and Liebman, 1996; Meyer and Rosenbaum, 2001).

The popular view that the credit "encourages work effort" is unlikely to hold among married couples, however. To target benefits to lower-income families the EITC is based on *family* income (as opposed to individual income), leading to a very different set of incentives for married taxpayers. Primary earners (typically men) may slightly increase labor force participation, but most secondary earners in recipient families are expected to *reduce* their labor supply. Two pieces of empirical evidence suggest that the impact of these disincentives on secondary earners may be substantial: first, labor force participation of secondary earners has been shown to be particularly sensitive to taxes (Triest, 1992); and second, the share of the EITC population facing these disincentives is significant—in 1994 one-third of all recipients with children and about 40% of the phase-out population are married couples (US General Accounting Office (GAO), 1996). Overall, therefore, the EITC is unlikely to generate any positive labor supply for married couples.[2]

In this paper, we study the labor supply response of married couples to the EITC using Current Population Survey data from 1984 to 1996. Over this period, a series of EITC expansions raised the number of recipient families from 6.4 to 19.5 million and the real value of the maximum credit from \$755 to \$3556 (1996 dollars). We examine the impact of these expansions on the labor force participation decisions of married couples with children. We focus on participation instead of hours worked primarily because the economic predictions (while still ambiguous) are the clearest on the participation margin; because the resulting empirical methods are more credible; and because existing work suggests that the employment margin is important for the

[1] By comparison, federal spending on TANF, which block grants to AFDC, is fixed at about 16 billion dollars per year through the year 2001 (US House of Representatives, 1996).

[2] If neither spouse is working, the EITC is predicted to increase family labor supply. This effect is unlikely to be important in practice, however, CPS data show that at most 2.5% of less-educated married couples jointly report no employment during this period.