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Responding To the Bipartisan Child Tax Credit Expansion Critics: The Tenuous Evidence Behind Work Disincentives

By Jack Landry[1]

[1] Research Associate, Jain Family Institute Contact the author at jack.landry@jainfamilyinstitute.org. Molly Dektar and Tenaya Nasser-Frederick provided invaluable comments. All errors are mine alone.

Summary

The 2021 expanded Child Tax Credit (CTC) caused a record drop in child poverty but was not renewed beyond 2021. Conservative critics' main objection to the expansion was that it made parents outside the paid labor force eligible to receive the full credit, which critics claimed would cause parents to quit working. In light of this criticism, Republican and Democratic tax writers recently proposed a far more modest expansion of the Child Tax Credit. Unlike the Child Tax Credit in the American Rescue Plan, the proposed reforms maintain a close connection with work, only giving the full credit to parents with incomes upwards of $25,000. To make the credit modestly more generous, it phases in with income faster, providing a larger credit at lower income levels compared to the status quo. The legislation would also enable parents to use either their current year's income or their income one year ago to calculate their CTC.

Despite its restrained scope and bipartisan backing, the proposed reforms have still drawn opposition. Critics argue the expansion will lead parents to temporarily stop working or choose part-time over full-time jobs. Notably, many other analysts from across the political spectrum have concluded that the proposed reforms do not disincentivize work. Nonetheless, several researchers from the American Enterprise Institute (AEI) claim their arguments about work disincentives have yet to be convincingly refuted and that critics are not faithfully engaging with their arguments. This report attempts to explain comprehensively why objections to the CTC reforms on the grounds of disincentivizing work are mistaken.

Does a Faster CTC Phase-In Incentivize Part-Time Work?

While the argument that an enhanced CTC will cause parents to exit the labor force reprises many of the debates over the 2021 expansion, claims that the bipartisan reforms will cause parents to switch to part-time work are novel to this proposal. This line of criticism also could forestall any meaningful CTC reform. If you object to speeding the CTC phase-in because it may incentivize parents working full time to work part time, no change that meaningfully increases the value of the CTC for low-income working parents is possible.

The basic argument is that the proposed reform enables part-time work by giving part-time working parents a larger credit. After families qualify for the full CTC, they have less incentive to earn more because additional income does not increase the credit. In particular, they claim that the status quo phase-in of the CTC helps offset the phasing out of other benefits, and the proposed reform increases implicit marginal tax rates between $20,000 and $40,000 per year. Normatively, the criticism implies parents should have to work full time to get the full Child Tax Credit.[2] If you give a larger credit at somewhat lower income levels, some parents will be able to get the full credit from working part time—which will cause them to opt out of full-time work.

This line of reasoning has no empirical support. The AEI researchers who present the most comprehensive evidence for how the bipartisan reform proposal would incentivize part-time work analyze it only from a theoretical perspective—they do not present any empirical evidence that new incentives in the bipartisan reform proposal would cause parents to shift to working part time.

For their analysis of the lookback provision (using prior year or current year earnings to claim the CTC), the same AEI researchers cite fourteen different studies of the Earned Income Tax Credit (EITC) to support their predictions that the lookback would cause hundreds of thousands of parents to stop working temporarily. The EITC has a similar structure to the reformed CTC that could also—in theory—incentivize part-time work. However, the researchers do not cite the studies testing whether the EITC caused parents to switch to part-time work—they only cite studies showing the EITC causes parents to join the workforce.

To understand how the EITC could incentivize part-time work requires a bit of background. For a single parent with three children (the same demographic AEI researchers use in their CTC example), a family gets the full value of the EITC with $16,510 in earnings—earning more will not increase the value of the credit. This is a much lower level of earnings than what is required to receive the full CTC even with the proposed reform. The EITC is more generous than the CTC, offering up to $7,430 compared to the CTC's $6,000. Finally, the EITC begins to phase out at $21,560, giving a smaller and smaller credit for every dollar of income earned above this point. The CTC does not phase out until $200,000 of income for single parents. The combination of these factors means that the theoretical incentives for part-time work are far stronger for the EITC than the reformed CTC. To optimize their EITC, a parent would work just enough to get the full credit at $16,510 of earnings and avoid earning more than $21,560 since this would cause their EITC to decline. Even with the CTC reforms, a parent would not receive the full credit until they earn over $25,000, and their credit would not decrease until they earn over $200,000.

Despite the theoretical incentives for part-time work in the EITC, studies have found virtually no evidence that families respond to this initiative by

[2] Notably, a trio of Republican Senators proposed a plan that would give parents a $3,000 CTC at $10,000 of income, on the explicit grounds that this was an achievable level of earnings for part- time workers.

reducing how much they work.[3] In a review of research on the EITC for the American Enterprise Institute's Book "A Safety Net That Works," Bruce Meyer (a co-author on the oft-cited paper predicting a permanent, expanded CTC would cause over a million parents to quit working) writes that the "lack of an 'hours effect' is one of the more puzzling yet robust findings in the literature." Since the EITC does not cause parents to reduce their hours or switch to part-time work, it is implausible that the modest changes in the bipartisan reform bill would cause parents to switch to part-time work, as the theoretical part-time incentivizing effect is far stronger for the EITC.

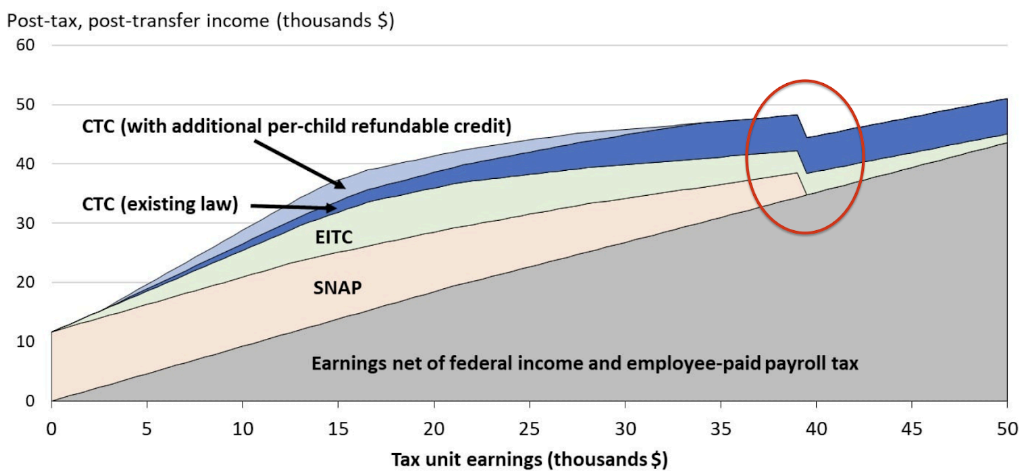
Besides the lack of empirical support for the CTC reforms incentivizing part-time work, the AEI argument has several additional important flaws. For instance, the CTC reforms do not actually ensure that parents can work part time and still receive the full Child Tax Credit. The hypothetical example used by the AEI researchers imagines a parent who makes $20 an hour working 20 hours a week, when 65% of part-time workers make less than $20 per hour. Second, making lower-income parents eligible for a larger credit would—by the same logic—increase the incentive for parents currently not working to enter the workforce.[4] Finally, financially enabling parents to work part time and spend more time with their children could be a good thing. Recent research finds that most parents induced to work by tax credits have very young children, raising questions about the normative underpinnings of tax incentives for parents' work.

A Note on Implicit Marginal Tax Rates and Benefits Cliffs

In the example the AEI researchers use to demonstrate how a family's income net of tax credits and other benefits rises with earned income, they show a large "cliff effect," where a family's total income suddenly drops with a small increase in earnings. (I show their figure below with the red circle added

[3] To my knowledge, there is one published study that shows an exception to this pattern of findings, which finds that new parents slightly decrease earnings in response to the EITC phase-out, and increase earnings in response to the EITC phase-in. However, closely related research from the same authors calls into question how generalizable these findings are outside of the population of new parents they study. The authors conducted a large (n=19,000) randomized controlled trial where professional tax preparers taught tax filers the EITC incentives. Specifically, the professionals encouraged families, who were already working, to work more based on the idea that a better understanding of the EITC could increase earnings—a margin of adjustment that other research rules out. However, the study found no change in average earnings from the intervention—confidently ruling out changes of more than $200. Notably, the original experiment intended to teach filers both the theoretical incentivizing and disincentivizing effects of the EITC. However, tax preppers rejected any disincentive message, as they correctly identified it was in the best interests of their clients to earn more, even if it would reduce their EITC.
[4] In their paper on the lookback provision, the AEI authors acknowledge this, writing, "These changes would increase federal outlays on the CTC and modestly increase extensive margin work incentives (the decision of whether to work at all) since the CTC conditional on any level of earnings would be higher."

highlighting the cliff below). This cliff provides a significant work disincentive—if a family's earnings go up just a little, their total income goes down almost $4,000, making families paradoxically worse off for working more.[5] However, the cliff has nothing to do with the Child Tax Credit reforms—it results from a family getting cut off from SNAP benefits at 130% of the poverty line. It is also unrepresentative of the typical SNAP experience—most states have exercised an option that enables them to expand SNAP benefits to 200% of the poverty line, which ensures a family's SNAP allotment gradually declines with increased income rather than suddenly being cut off.[6]



Suppose a state exercised its option to remove the SNAP cliff. In that case, it would more than wholly offset the increase in the marginal tax rate between $20,000 and $40,000 of earnings from the CTC changes that the AEI authors malign as a barrier to upward mobility. Given the strong theoretical work disincentive in the SNAP benefits cliff, one might think those who worry about work incentives around the CTC reform would be lining up to advocate for its elimination. The reality is the opposite. In 2019, the Trump administration attempted to end the rule that enabled states to end benefits cliffs, a move supported by the same AEI researchers rallying against the

[5] It is worth noting that there is not much evidence that even these benefit cliffs–which are strong theoretical disincentives to working more–actually cause people to work significantly less.
[6] The fact that the cliff is a result of eliminating SNAP benefits is transparently described in the text. However, the figure is still misleading since it is unrepresentative of most households who receive SNAP and inflates the implicit marginal tax rates they report.

modest expansion of the Child Tax Credit to ensure “SNAP is going to the nation’s most needy households.”[7]

Will the Lookback Provision Cause Parents to Temporarily Quit Working?

The other main objection to the bipartisan CTC reforms revolves around the lookback provision—which allows parents to claim the credit based on their current or prior year’s earnings. Critics claim that the lookback will cause some parents to stop working for a year because they can rely on their prior year’s earnings to receive the CTC. Again, researchers from the American Enterprise Institute make this argument in the most detail—their modeling of the lookback provision concludes it would cause over 700,000 parents to quit working every other year.[8]

While there are many research-based reasons why criticisms of work disincentives are flawed, the most convincing may be simple “sniff tests”. For instance, they predict that among single mothers who would otherwise consistently work and earn, on average, upwards of $37,000 a year, 7% will stop working every other year because they can rely on their past earnings to qualify for an average of a $2,335 Child Tax Credit. While the authors defend this result—noting that those dropping out of the labor force could live with parents or romantic partners, and different parents could drop out in different years—in my view, none of their points make this result border the realm of the plausible.

Another helpful sniff test is to examine their analysis of how many parents would *join* the workforce due to the lookback provision. Since the lookback enables parents who work for one year to claim a CTC for two years, the AEI researchers claim this will cause some parents who are consistently out of the workforce to temporarily work for a year. While it may be possible for the lookback to induce a handful of parents to join the labor force, they predict that 35% of single mothers who consistently did not work for two years would join the workforce for one year because of the lookback provision. This betrays how their entire methodology assumes parents’ work behaviors are extremely responsive to small changes in tax policy. To think the lookback provision will move a third of single mothers who are consistently out of the

[7] The AEI authors who support removing the state option to eliminate the SNAP benefits cliff have complained about the proposed CTC lookback provision but are distinct from the AEI researchers arguing the proposed CTC reforms incentivize part-time work.
[8] My criticism of the alleged work disincentives of the lookback provision in this section largely draws on my report disputing the work disincentives in the original expanded CTC.

workforce into temporary work puts too much faith in the power of tax credits.

While these sniff tests provide strong reasons to doubt the AEI team's findings, evaluating policy should not solely rest on potentially naive assumptions about human behavior. The AEI researchers claim their analysis is well grounded in a large body of research. The sections that follow challenge their claims on these merits.

Assumed Responsiveness to Tax Incentives is Not Well-Evidenced

Much of the debate about how the expanded CTC may or may not disincentivize work has focused on a specific parameter called a "labor supply elasticity." The higher the elasticity, the more parents will exit the labor force. AEI researchers who predict large numbers of parents will quit their jobs in response to the lookback provision use the same high labor supply elasticity that predicted over a million parents would quit their jobs in response to a permanent 2021 CTC expansion.[9] In response to criticism that their elasticities were too high, the researchers cite 18 different studies on the responsiveness of single mothers (the demographic group that drives the bulk of the voluntary unemployment in their model) to tax incentives, 11 of which they claim support their preferred elasticities.[10]

The problem with the studies supporting a higher choice of elasticity is that they rely on analyses of the EITC—an area of research that has been called into serious doubt by Henrik Kleven, as I detail below. Out of the 18 studies cited, 14 calculate labor supply elasticities emanating from changes to the EITC. Of the four non-EITC related studies, one was a structural model published over three decades ago, one was an unpublished study of the CTC I criticized in my original report on CTC work incentives (see footnote 18), and two are unpublished dissertations analyzing the CTC, whose elasticities, the AEI researchers admit, are significantly smaller than those they use. In sum—the AEI researchers' case for a high rate of responsiveness to tax incentives almost entirely rests on 14 studies of the EITC.

The case for why research on the EITC has serious flaws admittedly rests on a single study authored by Princeton University economist Henrik Kleven. However, the study is compelling and applies modern best practices to the

[9] Many other researchers (including those at the American Enterprise Institute and the nonpartisan Joint Committee on Taxation) who use the same general methodology when modeling the 2021 CTC expansion use significantly lower elasticities.

[10] I do not focus on the literature studies they also cite, as most of these simply review the specific studies they cite later on.

entire body of research on the EITC that the AEI researchers cite.[11] While the methodology economists use to evaluate EITC reforms is relatively simple, in practice researchers make many different decisions, including what expansion of the EITC to study, what specific outcome variable to use, and what other variables to control for. In recent years, there has been a growing recognition that many studies can be sensitive to these arbitrary choices—modern best practice is to show the results are robust to slightly different ways of analyzing the data. Kleven's research applies this principle to the literature on the EITC. He examines both the five federal and all of the significant state-level EITC expansions over the credit's 49 year existence. He shows that only the 1993 federal expansion is associated with increased parental employment. Outside of this event, a specific idiosyncratic choice of outcome variable, control variables, and analysis sample will occasionally show a significant increase in parental employment, but these are clearly outliers in the distribution of plausible ways to analyze the data. Moreover, a close analysis of the sole expansion that appears to cause an increase in parental employment (the 1993 expansion) shows it is very sensitive to what specific controls are chosen, and the pattern of results is likely driven by the simultaneous end of welfare reform and macroeconomic conditions.

In sum, Kleven's reanalysis of all the historical EITC expansions shows robust evidence that they do not cause parents to join the workforce. This does not simply mean the elasticity used by the AEI researchers is too high, exaggerating the employment impact of the lookback provision. Rather, Kleven's analysis shows that parents are not responsive to tax incentives at all, and the appropriate elasticity to use for modest tax changes is close to zero.[12] The EITC is the largest incentive to work in the entire tax code and offers the best natural experiment to test if parents join the workforce in response to tax-code-based work incentives. The fact that parents are not responsive discredits the entire enterprise of predicting large numbers of parents will drop out of the workforce in response to modest changes in tax policy.

Even for those who hesitate to fully embrace Kleven's results, a conservative interpretation still provides strong evidence that the EITC literature may exaggerate parents' responsiveness to tax incentives, and that an elasticity of .75 based on this research is too high. Notably, in their review of research supporting their choice of the .75 elasticity, the AEI researchers actually count Kleven's study as supporting the .75 number—an egregiously misleading

[11] Readers familiar with Kleven's paper should note that an updated draft from November 2021 (now March 2023) responds to the early rebuttals and provides all the code and data required to replicate the results. While I summarize Kleven's main points, I do not provide a comprehensive summary (my prior report provides a bit more detail).
[12] Even the small changes in labor supply for demographics other than single mothers predicted by the AEI team are not well-evidenced—see footnote number 25 in my prior report.

characterization.[13] While I did not review the dozen other studies they claim support their choice of .75, the mischaracterization of Kleven's study casts doubt on the merits of the rest of their review.[14]

The Experience of the EITC Cannot Be Extrapolated to Analyze the Lookback Provision

Even if we believe the AEI team's results are plausible and trust the research underlying their choice of labor supply elasticities, along with assuming that their more technical methodological shortcomings have not appreciably changed these results (discussed in the appendix), there still remain strong reasons to doubt their findings. The evidence for predicting that thousands of parents will temporarily quit and then reenter the workforce extrapolates from the historical experience with the EITC, where parents (allegedly) entered the workforce in response to a permanent increase in the tax incentive to work. It is tenuous to see parents' response to the EITC as relevant to understanding the effects of the lookback provision at all, let alone something reducible to a single parameter that provides a precise prediction that hundreds of thousands of parents will temporarily leave the labor force. While one has to do one's best to judge a proposed policy with the evidence that exists, there are a number of reasons to think this extrapolation will greatly overestimate the labor supply response to the lookback provision.

Firstly, it is difficult for someone who has been working steadily to leave and then seamlessly reenter the workforce. Even if we imagine the best case scenario, where a parent is working in an industry in a very tight labor market (where there remains a large number of job opportunities for those with gaps in their work experience), parents still might be reluctant to give up their specific job for any number of reasons, be it their coworkers, commute, opportunities for advancement, or other benefits that may not easily be replaceable when reentering the workforce after a year away.

Second, the AEI approach constantly assumes symmetry— i.e. research finding that people can be drawn into the workforce via tax incentives implies they can also be induced to stop working if those incentives are relaxed. However, there is no such iron rule of symmetry in social science, and there are good reasons to think symmetry would not hold in this case. It seems likely that parents would be extremely adverse to voluntarily accepting the large decline in income and standard of living that comes with quitting work for a year—being able to keep your Child Tax Credit would have a very marginal impact on making this more palatable. The reverse logic—being

[13] They cite the range of elasticity Kleven calculates to claim they are "consistent" with .75. The main point of Kleven's paper is to show that while it is possible to compute some outlier high elasticities, the totality of the evidence overwhelmingly clusters for elasticities around zero.
[14] Many other researchers who ignore or discount Kleven's results still believe the correct elasticity is much smaller than .75.

induced into the workforce because you get an extra tax bonus for working—while still unlikely, is more plausible.

Third, even if you discount the criticisms of research on the EITC, there is a strong case that the whole experience of the EITC was historically contingent. EITC expansions coincided with huge changes in the welfare system, shifting cultural attitudes about mothers' work, and skyrocketing incarceration rates. Even if the EITC brought some parents into the workforce, these other factors may have laid the groundwork for the EITC to be effective. Today, when single parent labor force participation is far more commonplace, tax incentives may make no difference in participation on the margin.

Fourth, the AEI researchers assume parents will know about the lookback provision and be able to use it, when evidence suggests the opposite. The EITC, a key tax benefit for low-income families, has existed for nearly 50 years, yet only 75% of eligible filers claim it. Survey research has found many low-income families are not aware of the EITC's existence, let alone the precise levels of income that maximize benefits.[15] Researchers (including Bruce Meyer) often argue that this lack of knowledge helps explain why parents do not work part time to maximize their EITC benefits, as that would require detailed knowledge of the tax code. However, it is possible to understand that you can get a large tax refund from working without any detailed knowledge of the EITC (which would explain how it incentivizes parents to get into the workforce). To understand that you can receive the CTC via your prior year's earnings, you do need good knowledge of the lookback provision, not just general knowledge that working is associated with a large tax refund.[16]

All these factors show that the 'plug and play' approach of estimating the bipartisan CTC's work disincentives without attention to context has serious flaws. One last way to illustrate how the AEI researchers' approach makes minimal adjustments for the unique context of different reforms is that their methodology is almost exactly the same as how they analyzed the 2021 CTC expansion. The only difference is that they divide the number of people leaving the workforce by two, as parents who are disincentivized must work

[15] For instance, recent qualitative research with TANF recipients summarized that, "Almost none of the parents we spoke with had a basic understanding of how tax programs worked, which tax credits they qualified for, or how much they would receive as a tax refund. Many people did not take tax refunds into account when they thought about their income for the year, or consider their tax returns when making decisions about employment. If they received a refund, most respondents regarded it as a surprise bonus."

[16] My report on the bipartisan reform proposal shows how even for someone going through the filing process, it can be confusing to understand how the lookback provision can benefit you, or how to claim it. Many parents who have no earnings but could benefit from the lookback provision based on their prior year's earnings will likely not bother to file a tax return at all.

every other year to get the credit, whereas the 2021 expansion enables parents out of the workforce to receive the credit indefinitely.[17]

Conclusion

When subject to scrutiny, the evidence that the modest reforms in the bipartisan CTC expansion will affect parents' work decisions is virtually nil. CTC critics' first claim is that giving low-income working parents a somewhat larger credit at a lower income level will cause some parents to work part time. However, this is based purely on a theoretical analysis. Empirical evidence from a similar tax credit that provides a far stronger theoretical incentive for part-time work finds it has no such impact.

Second, critics assert that allowing parents to claim the credit based on their prior or current year earnings will cause parents to drop out of the labor force temporarily, relying on their prior year earnings to claim their CTC. While this is superficially better grounded in evidence than the claim that parents will work part time, the research base behind this prediction has been shown to not hold up to the scrutiny of modern best practices. Moreover, critics' analysis makes no provision for the myriad reasons why the unique, novel context of the lookback provision will not cause parents to drop out of the labor force—they model it the same way they would a fully unconditional CTC and then divide the resulting job loss by two.

As Congress considers expanding the CTC, they should focus on the proposals' concrete benefits. The proposed reforms help ensure that low-income families with more than one child get a larger total Child Tax Credit just like middle and high-income families. And by enabling parents to use their prior year's income to claim the credit, the reform promotes family stability. Worries about the second-order effects of these modest improvements on parents' labor force participation are purely theoretical. When subject to scrutiny, critics' claims have very little empirical support, nor do they make much sense on their own theoretical terms.

[17] The only other meaningful difference is that the AEI researchers do not model the dropout decisions of married couples who are both working. This change is not because they believe the lookback provision will necessarily affect married couples differently than the 2021 expansion, but because doing so is "complicated" and they may have been attentive to criticism of this choice after the 2021 paper. They also model the probability that some parents who are consistently out of the workforce will temporarily work.

Appendix: Further Methodological Issues

To predict the number of parents choosing temporary unemployment in response to the lookback provision, the AEI researchers make a combination of questionable decisions and analysis errors that inflate their estimates of labor force dropout, even if you take their general methodology for granted.[18] First, they use survey data to examine households' earnings over two years, then predict their probability of not working based on their lower-earnings year.[19] The justification for this choice is that households have control over how much they earn in different years—in response to the CTC reforms, they assume that parents would specifically choose not to work in their lower-earnings year and receive their Child Tax Credit based on their higher-earnings year (see footnote eight in their paper). While this may be true of a handful of households, the typical family likely has little control or ability to predict how much they will earn in a given year. As their methodology generally predicts a higher fraction of parents will drop out the lower their earnings are, focusing their modeling on the lower earnings year will cause them to overestimate the percentage of parents temporarily dropping out of the labor force.

An analysis mistake compounds the consequences of the decision to model job quitting based on parents' lower-earnings year. The authors use the panel component of the Current Population Survey (CPS) without correcting the bias this introduces relative to the standard single-year analysis. Research comparing year-to-year earnings instability in the CPS to administrative earnings data has found that, without adjustment, the CPS panel measure of year-to-year earnings volatility is double that of the administrative data. With higher-earnings instability, there will be a greater distance between the higher- and lower-earnings year, making the lower-earnings year biased downward. Since, via their methodology, lower average earnings generally result in higher labor force dropout, this again will likely exaggerate their predictions of earnings instability.[20]

[18] To their credit, I can only criticize the AEI researchers' paper along these lines because they are fairly transparent about each step in their analysis.
[19] It is fairly straightforward to correct for this bias to ensure CPS data matches administrative data on earnings instability, something I do in my own analysis of the proposed reform.
[20] This correction will likely make slightly more parents eligible to choose temporary unemployment in their model. They predict parents who have positive earnings in one year but no earnings in another year will not change their behavior in response to the reform. Given that they overstate income instability, some of these parents who will likely have consistently positive earnings, according to their model, would then be eligible to choose temporary unemployment instead. However, this effect is probably swamped by the reduction in the probability of quitting work for those with consistently positive earnings but overestimated earnings instability.