

EARNED INCOME TAX CREDIT

HEARING
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ONE HUNDRED FOURTH CONGRESS
FIRST SESSION

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JUNE 8, 1995
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CONTENTS

OPENING STATEMENTS

| | Page |
|--|------|
| Packwood, Hon. Bob, a U.S. Senator from Oregon, chairman, Committee on Finance | 1 |
| Moynihan, Hon. Daniel Patrick, a U.S. Senator from New York | 1 |

ADMINISTRATION WITNESSES

| | |
|---|---|
| Samuels, Hon. Leslie B., Assistant Secretary for Tax Policy, Department of the Treasury, Washington, DC | 2 |
| Richardson, Hon. Margaret Milner, Commissioner, Internal Revenue Service, Washington, DC | 6 |

PUBLIC WITNESSES

| | |
|---|----|
| Greenstein, Robert, executive director, Center on Budget and Policy Priorities, Washington, DC | 31 |
| Kosters, Marvin Ph.D., director of economic policy, American Enterprise Institute, Washington, DC | 34 |
| Willis, Lynda D., associate director, tax policy and administration issues, General Accounting Office, Washington, DC | 35 |
| Yin, George K., professor of law, University of Virginia School of Law, Charlottesville, VA | 38 |

—ALPHABETICAL LISTING AND APPENDIX MATERIAL SUBMITTED

| | |
|--|-----|
| Greenstein, Robert: | |
| Testimony | 31 |
| Prepared statement | 49 |
| Hatch, Hon. Orrin G.: | |
| Prepared statement | 63 |
| Kosters, Marvin Ph.D.: | |
| Testimony | 34 |
| Prepared statement | 63 |
| Moynihan, Hon. Daniel Patrick: | |
| Opening statement | 1 |
| Packwood, Hon. Bob: | |
| Opening statement | 1 |
| Richardson, Hon. Margaret Milner: | |
| Testimony | 6 |
| Prepared statement with attachment | 69 |
| Roth, Hon. William V., Jr. | |
| Prepared statement | 80 |
| Samuels, Hon. Leslie B.: | |
| Testimony | 2 |
| Prepared statement | 85 |
| Responses to questions from Senator Moynihan | 102 |
| Willis, Lynda D.: | |
| Testimony | 35 |
| Prepared statement with appendix | 103 |
| Yin, George K.: | |
| Testimony | 38 |
| Prepared statement | 110 |

IV

COMMUNICATIONS

Page

| | |
|--|------------|
| American Institute of Certified Public Accountants | 117 |
| Forman, Jonathan Barry | 128 |
| Joint Committee on Taxation staff report: "Present Law and Issues Relating to the Earned Income Tax Credit," dated June 7, 1995 | 133 |

EARNED INCOME TAX CREDIT

THURSDAY, JUNE 8, 1995

**U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.**

The hearing was convened, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman of the committee) presiding.

Also present: Senators Roth, Chafee, Hatch, Simpson, D'Amato, Murkowski, Nickles, Moynihan, Baucus, Bradley, Pryor, Rockefeller, Breaux, Graham, and Moseley-Braun.

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

We have two entirely disparate hearings this morning; one on the Earned Income Tax Credit, and then we will have five nominees for different positions, none of which have any connection with the Earned Income Tax Credit, when we finish.

I would say about the Earned Income Tax Credit, I understand the studies and I understand the fraud that has been alleged and the lack of tight enforcement.

But, by and large, I think it is a program that has worked as we intended it would work and hoped it would work when we created it 20 years ago, much to the credit of Russell Long in pushing this. We were trying to find some way to relieve lower income working people—it was not intended as a welfare program—from the burden of the Social Security tax, which, of course, has no progressivity to it at all. So, I would hope that we can agree upon what reforms are necessary, but can keep the program and keep it helping who we intended to have it help.

Senator Moynihan?

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Precisely, Mr. Chairman. There is a strange lineage to this measure. It is a form of a negative income tax, so Milton Friedman certainly has some theoretical claims on it.

I think this came in the aftermath of President Nixon's proposal to establish a guaranteed income, a proposal which was vigorously rejected by the progressive-minded folk because it was inadequate.

Those same progressive-minded folk are now in the process of abolishing the Aid to Families with Dependent Children program altogether, such does the vagrant ways of political fashions. But we

have had this program in place for 20 years. I think Ms. Richardson can speak to the question of, is it being properly managed, are there abuses? But for the rest, the main issue is, what are the rates that we want, how much do we want to return in this mode? I think it is a very efficient one, but I would like to hear from our distinguished representatives.

The CHAIRMAN. It was also interesting, on the guaranteed family income, the opposition from some sources—mainly liberals—who did not like the idea that we were going to just give money to the poor.

Senator MOYNIHAN. That is right. Well, that will not happen anymore. [Laughter.]

The CHAIRMAN. Secretary Samuels.

STATEMENT OF HON. LESLIE B. SAMUELS, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary SAMUELS. Chairman Packwood and Senator Moynihan, I would like to have my written statement placed in the record and summarize it.

The CHAIRMAN. Without objection.

[The prepared statement of Secretary Samuels appears in the appendix.]

Secretary SAMUELS. I am pleased today to discuss the scope and purpose of the Earned Income Tax Credit, as well as steps that are being taken to improve the credit. I will briefly touch upon compliance issues; Commissioner Richardson will address administrative matters more completely.

The administration is strongly committed to the goals of the EITC, which are to make work pay and to lift workers out of poverty in the most efficient and administrable manner possible. With its message of "work pays," the EITC helps reduce dependency on welfare and increase reliance on jobs. This is why the EITC has been supported on a bipartisan basis during its 20-year history.

During the 7-year period between 1986 and 1993, Congress voted to significantly expand the EITC in three major pieces of legislation under three Presidents: the Tax Reform Act of 1986, OBRA 1990, and OBRA 1993. Both the 1990 and 1993 expansions were deliberately phased in over a period of years by Congress. The EITC provides tax relief to millions of working Americans, and that relief is not, and has never been intended to be, limited solely to Federal income taxes.

Under current law, over 78 percent of the EITC offsets Federal payroll and income taxes. I would note, this does not include excise and other tax burdens borne by low-income workers.

Under the Senate budget resolution, the EITC would be reduced and tax burdens increased for over 14 million working families. Working families with two or more children would be hit the hardest, with an average tax increase of \$305 per year.

During the past several months, some observers have suggested that the EITC is growing uncontrollably. To the contrary, the increases in the EITC have resulted from careful, considered actions by Congress to gradually phase in the 1990 and 1993 expansions over a period of years.

Once the 1993 expansion is fully phased in in 1996, future growth will be slightly less than projected GDP growth. The table there shows once the EITC is fully phased in, it will then grow at slightly less than projected GDP. We do not view this as a program out of control.

We share the concerns of those members of this committee and others who are troubled by error rates associated with the EITC, just as we are troubled by error rates in other areas that contribute to the overall tax gap.

The administration is strongly committed to reducing both inadvertent taxpayer errors, and the less common but more troubling, fraud. We welcome the opportunity to work further with this committee to address these areas.

However, the only EITC compliance proposals in the Senate budget resolution are those that are contained in the President's budget. Significant reductions of the EITC, such as those contemplated in the Senate budget resolution, do not address compliance issues in any other way.

The administration's commitment to improving the EITC for low-income families has been demonstrated through more than a dozen legislative and administrative actions since early 1993. In taking these actions, we have been guided by the following four key goals: to make work pay for those who might otherwise be on welfare; to ensure that an individual who works full-time throughout the year will not live in poverty; to target benefits to those with the greatest needs while minimizing distortions; and to make it easier for eligible individuals to claim the credit and for the IRS to verify the eligibility.

The design of the EITC under current law reflects a balance among these four goals. I would like to briefly address each of them. First, for low-income families the EITC makes work pay in two ways. Unlike many other assistance programs for low-income families, the EITC is limited to working families. Moreover, the credit amount initially increases rather than decreases for each additional dollar of earnings.

The positive link between the EITC and work can help offset the work disincentives created by other tax and transfer programs, such as Social Security taxes and food stamp benefits. The EITC, with its positive credit rate on low earnings, is the only program designed to help offset the marginal tax rates imposed by these other programs.

A second goal is to ensure that a person who works at a full-time job for the entire year will not live in poverty. In order to ensure that a family of four, dependent on a full-time worker earning the minimum wage, is lifted out of poverty, would require a combination of food stamps, enactment of the President's proposal to increase the minimum wage, and the EITC. So, as you can see, we have not met the goal yet. We are not there.

Third, the benefits of the EITC should be targeted to families with the greatest needs and to those who can be best served by the positive incentives associated with the EITC. The credit rate is the highest at very low earnings levels, where individuals are often making the critical step from welfare to work.

Because larger families have greater needs than smaller families, taxpayers with two or more children are entitled to a larger EITC than taxpayers with one or no children. Also, by providing EITC to families with incomes of up to \$28,524 in 1996, the program provides modest relief from the effects of wage stagnation.

The fourth goal of the EITC is simplicity and verification. If eligibility rules are simple, taxpayers can accurately claim the EITC and avoid costly errors. With simple and verifiable eligibility rules, the IRS can also better ensure that the EITC is paid only to taxpayers who are eligible for the credit. Consequently, simplification should be given great weight in evaluating any proposal.

As I mentioned, the administration and Congress have taken a number of important legislative and administrative actions during the past 2 years to improve the effectiveness and administration of the EITC. OBRA 93 expanded the EITC and makes the program more effective in achieving its policy objectives.

Last year's Uruguay Round legislation contained four provisions to improve compliance, as well as targeting of the EITC to those with the greatest need. As Commissioner Richardson will explain, the administration has taken very significant steps to ensure that those who are not eligible for the EITC do not receive it.

The administration included several proposals to improve the targeting and administration of the EITC in this year's budget submission. The administration proposed to deny the EITC to taxpayers having more than \$2,500 of taxable interest and dividends, and was included in modified form in H.R. 831.

Also, under a second budget proposal, only individuals who are authorized to work in the United States would be eligible for the EITC, beginning in 1996.

Our third proposal would authorize the Internal Revenue Service to use simplified procedures to resolve questions about the validity of a Social Security number. Last year, the administration proposed that States be given additional flexibility with respect to the EITC by allowing four demonstration projects to determine the effect of alternative methods of delivering advance payments of the EITC. We continue to support this important project.

The administration evaluates other proposals to modify the EITC by the same criteria we apply to our own proposals. We are concerned that many of the options that may be considered by this committee will not meet these criteria.

The Senate budget resolution assumes that savings can be achieved by repealing the EITC for workers without qualifying children, scaling back the increases for families with children, and adopting the administration's EITC compliance proposals for the 1996 budget.

These proposals would limit the effectiveness of the EITC in reducing poverty generally and encouraging work. We estimate that 14 million working Americans would be adversely affected by the assumptions in the Senate budget resolution.

EITC recipients with two or more children would lose, on average, \$305 in 1996. Very low-wage workers with only one child would lose, on average, \$137 relative to current law. As you can see from the second bar from the left on the chart, the average for all

EITC recipients is \$305 per year that they would lose as a result of the Senate budget resolution.

The Senate budget resolution also assumes the repeal of the EITC for 4.4 million very low-wage workers who do not reside with qualifying children. The EITC, for these workers, was designed to help offset the work disincentive effects of the Social Security tax. Under the resolution, these 4.4 million low-wage workers would lose eligibility for an EITC of up to \$324 and would incur, on average, a tax increase of about \$173 in 1996.

During the recent deliberations on welfare reform in this committee, a possible amendment was circulated that would reduce the EITC far more deeply than the budget resolution.

Under the amendment, indexation of the EITC would be repealed. Indexation is necessary to ensure that taxpayers do not lose eligibility for the EITC solely because of inflation. Under current law, an estimated 16.7 million taxpayers with children will claim the EITC in 1996.

If benefit thresholds are not adjusted for inflation, participation would shrink to 14.8 million by the year 2002. Eliminating indexing does not address the compliance issue. Rather, it denies eligibility for the EITC to millions of law-abiding, working Americans and reduces the tax benefits to millions of others who are playing by the rules.

It is inappropriate to suspend indexation on the one provision which is solely targeted to low-income taxpayers. Consequently, the administration strongly opposes proposals to eliminate indexing.

The amendment would also limit eligibility for the EITC by adding new restrictions on the amount and types of income received by recipients. For example, the investment income cap would be lowered from \$2,350 to \$1,000. We have serious reservations about this proposal, since it discourages savings and increases complexity.

The amendment would also restrict eligibility for the EITC by expanding the definition of income to include non-taxable Social Security benefits, child support payments, non-taxable pension income, and tax-exempt interest.

We would have serious concerns about imposing an additional tax on Social Security benefits of taxpayers who qualify for the EITC. Low-income elderly workers with children could be subject to higher taxes on Social Security benefits than some of their better off neighbors.

The proposal could also affect non-elderly workers with young children, too. The EITC would be reduced or eliminated for a low-wage worker whose disabled spouse receives disability insurance benefits.

The tax system does not count child support as income to the custodial parent because child support payments are a continuation of the other parent's obligation to support his or her child. Custodial parents should be encouraged to seek child support rather than being penalized for obtaining it.

Moreover, this change would be extremely difficult for the IRS to administer because it does not currently receive information about child support payments.

The combined effect of these proposals, once fully phased in in the year 2000, would be to reduce the EITC for 19 million taxpayers by \$602 per year, on average. For eight million taxpayers with two or more children, the EITC would be reduced, on average, by \$886.

The CHAIRMAN. Mr. Secretary, as you know, I would ask you to restrain yourself this morning.

Secretary SAMUELS. All right. One more paragraph.

The CHAIRMAN. All right.

Secretary SAMUELS. The administration is committed to improving compliance with the EITC. Its action in the last 2 years is clear evidence of this strong commitment. The compliance problems with which the administration is addressing should not be used as an excuse to eliminate or reduce the EITC benefits to millions of low-income working Americans.

Finally, my written statement contains additional areas of possible improvement we would like to explore with the committee. This concludes my remarks, and thank you.

The CHAIRMAN. Thank you.

Now we have Hon. Peggy Richardson, the Commissioner of Social Security. Commissioner?

Commissioner RICHARDSON. Internal Revenue.

The CHAIRMAN. What is the matter with me? You know what I am thinking of? We have got two nominees coming for public trustees.

Commissioner RICHARDSON. That is right. I think I have an easier job.

The CHAIRMAN. Normally I would say no—[Laughter.]

But I think you do have an easier job right now.

STATEMENT OF HON. MARGARET MILNER RICHARDSON, COMMISSIONER, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Commissioner RICHARDSON. Mr. Chairman and distinguished members of the committee, I have a written statement which I would like to summarize, but I would like to have the written statement included in the record, please.

The CHAIRMAN. Without objection.

[The prepared statement of Commissioner Richardson appears in the appendix.]

Commissioner RICHARDSON. I do appreciate the opportunity to be here today to discuss our efforts at the IRS to improve the administration of the Earned Income Tax Credit. When I became Commissioner just a little over two years ago, I recognized the need to improve the administration of the Earned Income Tax Credit to ensure that it is available only to those working Americans who have earned it.

As Assistant Secretary Samuels has stated, legislation has recently been enacted to improve the EITC's effectiveness. The administration has also submitted additional legislative proposals which are still awaiting action by Congress that would aid us in the administration of the Earned Income Tax Credit.

In addition to these important legislative initiatives, beginning with the 1994 filing season and continuing through this filing season, the IRS has taken several steps to improve the administration of the EITC. A preliminary analysis of returns that have been filed so far this year indicates that our efforts have paid off.

This morning I would like to describe for you what we have done this filing season to improve EITC compliance and tell you just a little bit about our future plans.

As part of our continuing efforts to improve compliance overall with the tax laws, but particularly with EITC, this year we implemented numerous systemic verifications and enhancements.

These initiatives include increased verification of taxpayers' Social Security numbers, additional checks of returns claiming refundable credits, including the Earned Income Tax Credit, and increased compliance resources that were devoted to preventing and detecting erroneous and fraudulent refund claims before the refunds were paid.

An important part of our strategy included delaying refunds that, as a result of computer analysis and fraud identification profiles, appeared to be erroneous. This additional time for review helped us check questionable claims and to detect fraud schemes, including those that employed the duplicate uses of Social Security numbers.

During this filing season, the IRS devoted substantial resources to ensuring that taxpayers claiming refunds used correct Social Security numbers. We have been checking paper returns for missing, invalid, or duplicate SSNs and we have not been accepting electronically filed returns without correct, valid SSNs for taxpayers, their spouses, and dependents. As of May 26th of this year, over 10 million missing, invalid, or duplicate Social Security numbers have been identified.

To further address non-compliance problems related to refundable credits, during this filing season we performed additional checks on returns claiming these credits to ensure that only those taxpayers who were entitled to them received them.

Preliminary analysis of the returns that have been filed so far indicates that these efforts have paid off. As of May 26th, the number of EITC claims by filers with qualified children had decreased by 257,000 compared to this time last year.

Prior to the 1994 tax year, EITC claims had increased each year since 1989. We believe that our efforts this filing season have kept those who have not earned the Earned Income Tax Credit from claiming it.

Also, through May 21st, approximately 800,000 fewer dependents were claimed compared to this time last year. Thus, for the first time in several years, the number of dependents being claimed did not increase.

The reduction in the EITC claims and the number of dependents claimed is particularly significant, Mr. Chairman, considering that the number of individual returns that was filed through May 26th is up over one million from this time last year.

In addition to enhancing our systemic filters to detect more questionable refund claims during this filing season, we substantially increased the enforcement resources dedicated to examining questionable claims, as well as identifying fraudulent schemes.

Electronically filed returns that had duplicate uses of Social Security numbers were rejected. By rejecting these returns, erroneous claims and fraud schemes, that in past years had made it into the system, were kept out. In addition, as of May 26th we had identified 2,579 fraud schemes, and we delayed \$62.5 million that was claimed on over 30,000 electronically-filed and paper returns.

Beginning last filing season and continuing through this year, we have also delayed refunds with questionable EITC claims until we could examine the returns. As a part of this initiative, from January of 1994 until April of 1995, we have examined over 370,000 returns and \$330 million in refunds were not paid because taxpayers were not able to verify they were entitled to the EITC they had claimed.

As we continue the examinations of more than 700,000 EITC returns that are currently in our inventory, we expect comparable results. That is, the EITC claimed an error will never be paid.

Although the 1995 filing season has not ended, we have already begun planning our strategy to prevent all erroneous or fraudulent refund claims, including those relating to EITC, for the next filing season.

The information we have learned this filing season will be the basis for modifying and refining our current procedures. We will revise the standards for participation in the electronic filing program and we will be adapting our fraud and error detection systems accordingly. If necessary, we will put in place new technology and additional filters.

The administration, as Mr. Samuels indicated, has proposed legislation that would significantly aid our administration of the EITC. The legislation would require claimants to provide valid Social Security numbers for themselves and qualifying children, and to permit us to treat an EITC claim the same way we do math errors when an SSN is not provided or a Social Security that is provided is not valid.

A procedure similar to the procedure that is currently used to correct math errors is appropriate and needed. Although we do have the technological capability to identify returns with obvious mistakes, because the statutory deficiency procedures require multiple actions, and they are more complex than math error procedures, we can only reach a limited number of taxpayers with our current resources.

The proposed math error procedure would be used only in those instances where a taxpayer's EITC claim was not substantiated by a valid Social Security number. Banks do not allow their customers to withdraw money if they do not provide the necessary information, including an appropriate account number and a PIN, and Congress should require that we have the same resources so that we, too, can prevent fraud and erroneous payments.

We are committed to stopping EITC non-compliance, but we are also committed to assuring that all hard-working Americans who earn the EITC are able to receive it. With the assistance of you and your committee, we would greatly be able to enhance our efforts and to achieve our important goals.

That concludes my remarks. I would be happy to answer any questions.

The CHAIRMAN. Thank you, Madam Commissioner.

Mr. Secretary, this chart that you have up here, can you explain that to me, the budget resolution has confirmed in May, and the budget resolution actual assumptions?

Secretary SAMUELS. Mr. Chairman, in May we were informed in discussions with the budget—

The CHAIRMAN. Is this the Senate budget resolution?

Secretary SAMUELS. That is the Senate budget resolution. The Budget Committee staff informed us that the cuts in EITC were going to be made in a particular way, that is, that they were going to keep the credit rate for families with two or more children at 36 percent, and the next increase is to go from 36 to 40.

The CHAIRMAN. In other words, you are assuming this assumption will be adopted by this committee in that chart and we will do what the Budget Committee tells us.

Secretary SAMUELS. No. This is an example so that the committee would understand, when it is evaluating options, of what the consequences would be.

The CHAIRMAN. All right. Now, what is the second one, just the resolution as adopted?

Secretary SAMUELS. Right. We determined, based on materials that were placed in the Congressional record as part of the Senate budget debate, that, in fact, the assumptions in the Senate budget resolution were to, one, cut the credit rate for families with two or more children, from 36 to 35 percent, and to cut the credit rate for families with one child from 34 percent to 30.15 percent. So the reason we wanted to put that up is because there was a lot of different discussion with numbers.

The second column is what we understand, and we have confirmed this with the Senate Budget Committee, as to what they were assuming. While this allows you to analyze in making your decisions what their assumptions were, obviously this committee is going to make the decisions.

The CHAIRMAN. I want to go to the third and fourth lines, now. The Welfare Reform Amendment, 1996 law, and the Welfare Reform Amendment, 2000 law. Do I understand that is your presumption of Senator Roth's amendments? -

Secretary SAMUELS. That is our estimate of Senator Roth's amendment.

The CHAIRMAN. And you are suggesting that Senator Roth would introduce an amendment that will increase people's taxes? Senator Roth, listen to this. [Laughter.]

Secretary SAMUELS. Mr. Chairman, this amendment would increase taxes in the first year, because it stops the indexing, by \$516. These are for taxpayers with two or more children. And in the year 2000, it is \$886 for taxpayers with two or more children.

The CHAIRMAN. Senator Roth, I am amazed at you. Raise people's taxes.

Senator MOYNIHAN. Mr. Chairman, I have to insist that the Senator considered, but did not offer it.

Senator ROTH. Well, Mr. Chairman, just let me point out that EITC is basically an income redistribution, it is not a tax matter. What we are really talking about is welfare.

I think that it is important to understand that the EITC—I am sorry I was not here at the beginning—is the fastest growing entitlement in the Federal Government. It has grown approximately 1,427 percent from 1985 to 1995. Today, roughly one out of five families is eligible for EITC. It is the only program where you get a tax credit without having to pay any taxes. It is an income redistribution, make no mistake about that. It is not a tax matter.

Middle class, as well as working poor, are eligible for EITC. Just let me point out that, under the current law, beginning in 1996, it will phase out at roughly \$28,500. That is more money than many, many college graduates, particularly in rural areas, are receiving. What we are saying is, if they have a child they would be eligible.

The CHAIRMAN. My time is about up. [Laughter.]

Senator ROTH. That is all right. I will yield you some of my time, Mr. Chairman.

But I think the important thing to understand is that roughly 30–40 percent of the payments have not been in compliance. This is the biggest rate of fraud that we have had in any program. We are concerned about food stamps. The fraud there is roughly 6–8 percent. But if the past is a prologue, Mr. Chairman, we are talking about 30–40 percent fraud. That could be as much as \$37 billion in the next five years.

My time is running out, I gather. But make no mistake, this is a program that needs—and badly needs—revamping. We are all for helping the working poor, but there is no grounds, no justification, for continuing a program as is that is resulting in the high amount of fraud that this program has, and people who are working hard and getting no benefits are helping to pay for this fraud. That makes no sense, Mr. Chairman, in my judgment, and this program is one that is badly in need of fixing.

The CHAIRMAN. I just wanted to say to Senator Nickles who just came in, we are not on opening statements, we are on my questions.

Senator NICKLES. An interesting answer to your question.

The CHAIRMAN. Can you put up that other chart now, the growth in GDP and EITC. I will just ask this question quickly and then go to Senator Moynihan.

If I read that correctly, is the administration predicting a GDP growth, on average, of about 5.6 percent every year for the next 5 years?

Secretary SAMUELS. It is about 5.5, and it is in nominal dollars.

The CHAIRMAN. Oh. It is in nominal.

Secretary SAMUELS. Right.

The CHAIRMAN. Oh.

Secretary SAMUELS. Yes.

The CHAIRMAN. Is the EITC projection in nominal also?

Secretary SAMUELS. Yes.

The CHAIRMAN. All right. Well, then I understand. Because if we are presuming a 2–3 percent inflation, we are assuming—

Secretary SAMUELS. Right. The EITC, when it is fully phased in, which, as you know, was authorized by Congress, it will grow just a little less than the GDP.

The CHAIRMAN. I was just intrigued with the GDP and nominal figures. I thought, gee, if that is real growth, we have had nothing like that since World War II.

Secretary SAMUELS. No. Basically, EITC will grow with the rate of inflation plus population growth.

The CHAIRMAN. Right.

Secretary SAMUELS. That is what we project. That number is slightly less than the GDP.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman. Just two points.

One, may I say with conviction but not force, because I think it is plain to the committee, the Earned Income Tax Credit is not a mode of income redistribution, it is a mode of lessening the tax burden of persons with low incomes who pay Social Security taxes, as we call them, the Federal Insurance Contribution Act, on their first dollar of income, who pay incomes taxes, all of whom at one point or another will be paying excise taxes.

Could I ask Mr. Samuels, would he give us any estimate of the proportion of the recipients of the EITC who might receive more in a refund than they have paid in one or another form of tax?

Secretary SAMUELS. Senator Moynihan, about 46 percent of the recipients have income tax liability, about 78 percent of the EITC covers income tax and the Social Security taxes, and then above that there are the excise taxes and other tax burdens. We do not have a specific number because it is difficult—

Senator MOYNIHAN. There would be few, if any, persons who receive more in the way of refund than they have paid in the way of taxes.

Secretary SAMUELS. Yes.

Senator MOYNIHAN. Yes. I think that is the fact. Try to get that in a table, will you? Because we are going to hear this argument again.

Just in the way of random observations on a spring morning, I see on page nine of Ms. Richardson's testimony, you would have thought that enough human sorrow had come out of the Los Alamos National Laboratory, but we now learn they are also helping the government to collect taxes. You have five new anomaly detection pattern recognition tools, have you?

Commissioner RICHARDSON. That is right.

Senator MOYNIHAN. God help us all. [Laughter.]

Commissioner RICHARDSON. And they are working.

Senator MOYNIHAN. And they are classified.

Commissioner RICHARDSON. That is right.

Senator MOYNIHAN. Well, that is what you expect.

Could I just make one gentle request of Mr. Samuels, and one specific one? You speak of the work disincentives involved with the FICA tax and food stamps. Do you have any quantification on that or is that just something you have to assume to exist, the work disincentives? It is in your testimony several times.

Secretary SAMUELS. I do not think I have any specific data.

Senator MOYNIHAN. Will you go back and ask around?

Secretary SAMUELS. Sure. (See p. 102.)

Senator MOYNIHAN. And could I make one other point? The administration is beginning to talk about the Aid to Families of De-

pendent Children, which we refer to as welfare, as somehow a counter-cyclical economic program that is very much tied to employment and things of that kind, which I do not think is substantiated. It may be important to know.

But you say you have been guided in the following four key goals. One, to make work pay for those who might otherwise be on welfare. I do not think you have any data that would argue this exchange, as it were, the hedonic exchange. Work is not paying enough, so I am going to go on welfare. They do not come out of the work force, do they, or do you have data?

Secretary SAMUELS. Senator Moynihan, I think the point is that the EITC helps individuals get off of welfare and onto work by making work more valuable. We have a 40 percent credit rate. That is really the point we are trying to make.

Senator MOYNIHAN. All right. Could you try to give us some data, if you have some? I do not doubt that you do. It would help a lot, and thank you very much. (See p. 102)

The CHAIRMAN. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

First of all, let me point out that in talking about offsetting, the figures given by the Secretary include the payroll tax paid by the employer as well as the employee.

So let me point out again, Mr. Chairman, that one of my great concerns is the high rate of fraud that has been experienced in this program and the high rate of fraud that is still anticipated, if the past is a prologue, according to the General Accounting Office. We are talking about 30-40 percent. Those are extremely significant numbers.

And just let me point out that in a recent article by Gene Steuerle at the Urban Institute, he says that "The Treasury was responsible for adding to the EITC problems by encouraging fraud in the program through the 1993 changes, and that the real issue, designing policy that is administrable in the first place, is swept under the table in the 1993 bill."

I would like to ask you, Mr. Samuels, what are your proposals to solve the serious problems that Mr. Steurele points out? What are your comments on his thoughtful article?

Secretary SAMUELS. Senator Roth, if I could make several comments. First, the administration—

Senator ROTH. I would ask that you keep it relatively short because our time is limited.

Secretary SAMUELS. Yes. I want to, first, make some comments on the error rate. We think that a correct way to analyze the EITC error rate is to look to amounts paid out in error, not the number of returns that had errors in them, because you could have 100 percent errors in return at a dollar per return. I do not think that we—

Senator ROTH. You are not arguing, Mr. Samuels, are you, that the fraud and abuse in this program is not a serious matter.

Secretary SAMUELS. Absolutely not. Absolutely not.

Senator ROTH. You are arguing that it is less than, say, for example, food stamps?

Senator ROCKEFELLER. But listen to his answer, Senator.

Secretary SAMUELS. Senator Roth, what I was going to draw your attention to is that the IRS has finished its study of the 1,000 electronically-filed EITC returns in January of 1994 and, as you know, that is a very limited study and is not typical.

The results of that study—and Commissioner Richardson can elaborate—is that 26 percent of the amount claimed was in error—not the amount paid out. If we had in place the law changes that were in place for 1994 in 1993 and we had our matching in place—but not our special screening, so it is not everything that we did—we think that the amount would be reduced to 19.1 percent. That is still not acceptable for us and we are continuing to work hard on it. As I said, that number does not include the special screens that were in place for this year, but we are absolutely committed, as you know, to reducing the error rate on EITC and we will continue to do that.

Senator ROTH. Well, just let me point out, I know the Treasury is always optimistic about the future, but, frankly, most commentators do not share that optimism. I want to congratulate Ms. Richardson for the steps that she is seeking to take, but the fact is, we are enriching this whole program. The credit is going up to 40 percent. In the judgment of many people, leading commentators on the matter, this is becoming a greater incentive to fraud.

And you have two kinds of fraud. You have the fraud by the individual who lies about children, or whether they are of age, residence, whether they really are making the earnings they claim, and you also have the professional fraud. We literally have those who have been making millions of dollars off this program by scam.

Senator BRADLEY. Could you cite one example?

Senator ROTH. Yes, I would be happy to. I was in West Virginia about six weeks ago. I do not think I have the article here with me, about a fellow that was imprisoned because of a scam.

Senator BRADLEY. Millions of dollars?

Senator ROTH. Yes, that is right.

Senator MOYNIHAN. Did he have a Cadillac?

Commissioner RICHARDSON. Senator Roth, I believe that was one we addressed at the hearing before you in April that did not involve—

Senator ROTH. Just let me finish. Thank you.

We had, before the Government Affairs Committee, a fellow by the name of Hersch, a convicted felon, who admitted—to answer your question, Mr. Bradley—that his scam alone had amounted in the millions, and he said it was an invitation in the future to fraud. He all but said he could hardly wait till he got out.

Senator BRADLEY. Could the IRS respond?

Commissioner RICHARDSON. I was not present when Mr. Hersch testified, but I did later see it, I believe, on C-SPAN.

Senator BRADLEY. He was here under the Witness Protection Program.

Commissioner RICHARDSON. As I recall, he said that had he been trying what he tried this year with the filters and the fraud detection and controls we had put in, he would not have been able to perpetrate the fraud that he was able to do.

Senator ROTH. But he also said that he felt that it was an open door to future fraud as well.

Commissioner RICHARDSON. Well, I guess I do not recall that particular comment. But I do remember, he was very—

Senator ROTH. You can review the record.

Commissioner RICHARDSON. Right.

The CHAIRMAN. Senator Breaux, then Senator Bradley.

Senator BREAU. Thank you very much, Mr. Chairman, and thanks to our panelists.

To compare, to say, or to imply that the Earned Income Tax Credit program is a welfare program is like saying Shaquille O'Neill is a circus midget. It is just so farfetched. In my opinion, the EITC is about work.

If you look at the history of the EITC and the bipartisanship that allowed it to come about, I just cannot understand why the debate has become so partisan in the efforts to raise taxes on people who are the least fortunate among us who are trying to work. I do not understand why the debate has gone like it has.

When President Reagan called this program the best anti-poverty, best pro-family, best job creation measure to ever come out of the Congress, our own Chairman, Senator Packwood, in 1991, said that the Earned Income Tax Credit is a key means of helping low-income workers with dependent children get off and stay off of welfare.

The Chairman of the Budget Committee, Senator Domenici, in 1990, said that the EITC is a great way to help low-income families with the cost of raising their children, and all of the debates we are engaging in when we are talking about welfare reform is about getting people to work. I agree with all these statements.

Senator Long, who is my predecessor in the Senate, said we need to have something that encourages people to work, and this is it. Does it have problems? Of course. There is not a Federal program designed that is perfect. Nothing we do is perfect. But you do not throw the baby out with the bath water.

Let me ask you questions on the fraud issue. I think most of my colleagues on the other side are saying, let us make massive changes in this program and decimate it because there have been some fraudulent claims made.

Let us try to put that in perspective, Mr. Samuels or Ms. Richardson. The fraud rate for people filing the Earned Income Tax Credit, how does that compare with the fraud rate or the gap in other areas? What about self-employed people, what is the gap there?

Secretary SAMUELS. Senator Breaux, let me make just one point. When we talk about the error rate, there are unintentional errors and intentional errors. They are not all fraud. I mean, people do make mistakes in writing numbers down. I know some people who are dyslexic. They make mistakes. We all make mistakes.

Commissioner RICHARDSON. There are some who are not who make mistakes, too.

Senator BREAU. These are also just claims as well, they are not actual payments.

Secretary SAMUELS. Right, these are claims. And I am not suggesting that we do not have a serious problem, but when we talk about this I think it is unfair to characterize this as a fraud issue. It is an error rate problem and it is, in part, because the credit has

been complex and we are trying to simplify it. If you simplify it you will make it easier for people to understand it and be able to claim it.

So if you look at the tax gap numbers, the GAO came out this week with a study, the results of a symposium they had. At the end they have a table of the tax gap numbers. So for 1992, the total tax gap is \$127 billion.

Senator BREAUX. That is for all taxpayers?

Secretary SAMUELS. All taxpayers, including corporate and individual. The tax credits of individuals, of which the EITC is one—there are other tax credits—are about one percent of the total of the tax gap.

Senator BREAUX. So 99 percent of the tax gap comes from people who are non-Earned Income Tax Credit filers.

Secretary SAMUELS. Right. Right. And, for example, if you look at the tax gap for non-farm sole proprietors for 1992, it is \$30 billion. We are not saying that that justifies not focusing on the EITC problem.

Senator BREAUX. I understand that.

Secretary SAMUELS. But I think we should put it in context.

Senator BREAUX. I am trying to do exactly that. So the tax gap, the shortage of income that should have been paid from sole proprietorships and non-farm is \$30 billion?

Secretary SAMUELS. Was estimated for 1992, yes, sir.

Senator BREAUX. How much is the estimated tax gap for EITC?

Secretary SAMUELS. This is all the credits, was \$1.3 billion.

Senator BREAUX. Versus \$30 billion.

Secretary SAMUELS. Correct. And that also includes other credits.

Senator BREAUX. Mr. Chairman, I think the point is very clear. Is there a problem? Of course there is a problem. But, I let's look at the problem in comparison to other areas. Why aren't we spending as much time looking at sole proprietorships who do not file the right amount of tax returns, at the tune of \$30 billion.

There are those who are trying to basically decimate a program where the tax gap is \$1 billion. I would suggest that the amount of people who are now working and are encouraged to work as a result of this program is something this committee must recognize. I think, clearly the committee needs to improve it, yes, but protect it also and improve it.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bradley, then Senator Pryor.

Senator BRADLEY. Thank you very much, Mr. Chairman.

First, let me compliment Ms. Richardson. I think that the IRS is doing a very good job of countering that fraud that did exist. I think you said that you detected 10 million returns that had duplicate Social Security numbers.

Commissioner RICHARDSON. Or 10 million instances where we had erroneous Social Security numbers. Correct.

Senator BRADLEY. And those, of course, would be caught if you had to file, as you do now, the Social Security numbers for the dependents as well as the parents, right?

Commissioner RICHARDSON. Correct.

Senator BRADLEY. So that one of the largest areas where there was not abuse has already been corrected. I mean, there were cases

where several people were essentially filing a dependent and it was the same child, and they were taking three or four different deductions. Now, that would be ended, is that correct?

Commissioner RICHARDSON. Right. Where we have spotted duplicate numbers we have kept them from being used, and will continue to do that.

Senator BRADLEY. In addition to that, in the GATT round, we made some other significant changes to tighten up on eligibility. We said that no EITC goes to a non-resident alien; is that correct?

Secretary SAMUELS. That is correct, Senator.

Senator BRADLEY. And did we not also say, because there was the anomaly of some people receiving an EITC at the same time they had a surprising amount of interest income, that if you have interest income over about \$2,300 that you cannot get the EITC; is that correct?

Secretary SAMUELS. Senator Bradley, that was correct. That was in H.R. 831.

Senator BRADLEY. Right. Are there other things specifically that the administration has done to tighten up on Earned Income Tax Credit?

Secretary SAMUELS. Senator Bradley, since 1993 we have taken over 12 legislative and administrative steps. One of the other parts of the Uruguay Round legislation is that we are requiring Social Security numbers for all children.

It was, up until then, just for children over the age of one, and we were seeing, unfortunately, a surprising number of children under one show up on tax returns. So we are now requiring Social Security numbers, on a phased-in basis, so that when they do this matching they can catch erroneous or duplicate numbers. So, that is a proposal.

We also have, as an administrative matter, stopped the so-called Direct Deposit Indicator, which was used in the refund anticipation loan business, because we determined that that facilitated abuse of the system by people who were trying to claim their credit, get their loan, and then disappear. Let me say, all of these, like the DDI, have been controversial, but we are committed to the integrity of this program.

Senator BRADLEY. And these changes have produced results?

Secretary SAMUELS. Yes. Actually, as Commissioner Richardson has mentioned, the returns filed this year for taxpayers with qualifying children are down 257,000. Also, the analysis that the IRS did as part of this 1994 study show that the erroneous claims were going from 26 to 19.1, showing that we are on the right path. We are not finished; we have to keep going.

Senator BRADLEY. And could you once again, for the record, as clearly as you can state, draw the distinction between claims and refunds, these claims and what is called fraud?

Secretary SAMUELS. Senator Bradley, the amounts claimed are tax returns filed claiming the EITC. We think that the right analysis is to look at what the government ultimately pays out in error after it has applied all of the processes that the IRS has at its disposal, which are audit processes, and these matching processes, and their screens. So, there is a whole series of things that are taken by the IRS.

Senator BRADLEY. Commissioner Richardson?

Commissioner RICHARDSON. Senator Bradley, our 1994 study was a very limited study for a very limited purpose. We are doing a very comprehensive study for the 1995 filing season, analyzing a broader range of returns. When that is completed at the end of the summer we will have a much better handle on exactly where some of these things are.

Senator BRADLEY. Well, my sense is that the administration is getting control of this program and is making sure that those who are not eligible for it shall not get the program.

Commissioner RICHARDSON. Absolutely.

Senator BRADLEY. And the reason you are doing that, is you want the dollars to go to the eligible recipients who are working Americans. You cannot get this program unless you are working. It is for the purpose of offsetting your Federal tax liabilities, your income tax liabilities, your Social Security tax liabilities, and your excise tax liabilities.

When we increased the Earned Income Tax Credit in 1993 we also increased excise taxes. For those who talk about the growth of this program, in 1975 you could not get it if you earned more than \$8,000 a year. Now it is up to \$28,000 or \$30,000 a year.

So what do you expect is going to happen? You are giving a bigger tax cut to more people in America at low income levels who are working and, therefore, you are going to lose revenue, just as, for example, in other programs through the Tax Code we also lose money.

For example, Section 29 is a very interesting little provision to help oil. I know Senator Rockefeller and Senator Nickles like this, but just in terms of its increase. [Laughter.]

Senator BRADLEY. It is a bipartisan bill.

But, between 1985 and 1995, it grew from \$80 million a year to \$1 billion a year, so we have to keep these growth rates in perspective.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. Thank you, Mr. Chairman.

As we are pulling obscure sections out of the Tax Code it seems this morning, and my friend, Bill Bradley, is talking about Section 29, we could also talk about Section 936. [Laughter.]

Senator PRYOR. But we will not go into that. I will not belabor that point.

Senator BRADLEY. We have cut that 40 percent. I am ready to cut them all 40 percent.

Senator PRYOR. Well, we are going to talk about that later.

Mr. Chairman, I think you know, and some of our colleagues around the table know, I do not go around passing out many bouquets to the Internal Revenue Service. I have not in the past. But I think it might be healthy for us to step back just a moment and look at what we have done in the history of the Earned Income Tax Credit.

The first thing is, the Internal Revenue Service did not pass the EITC, we did. Congress passed it, we expanded it. We started it in the mid-1980's, and we expanded it in 1990 under President Bush. It was bipartisan. I wish it had been bipartisan in 1993, but it was not. But, at any rate, in the Congress we did what we did.

The IRS is trying to now implement some very stringent safeguards to keep this program from being abused. Philosophically, I think the program is sound. We cannot, as all of us know, defend what abuse has taken place. I stand ready to work with both sides of the aisle to try to correct this.

But I think something in Commissioner Richardson's statement needs to be borne out and reemphasized, and that is, from January of 1994 through April of 1995, 370,780 returns were examined. Now, as a result, \$330 million in refunds were not paid because those taxpayers basically were unable to verify they were entitled to the Earned Income Tax Credit. That is on page eight of the Commissioner's statement.

I applaud you for what you are doing. I know this last filing season you made a lot of taxpayers very angry. Or the Internal Revenue Service did, not you, yourself, Madam Commissioner. But you made a lot of taxpayers very angry. I think we probably had to go through some of that to make sure that we are trying to bring out and to do away with the abuse.

Do you have any predictions for next year's filing season, how this is going to go forward, how we are going to prevent some of the chaos that we have created in the 1995 period?

Commissioner RICHARDSON. Senator Pryor, one of the things that we had announced before the filing season that I think caused the most concern to the largest number of taxpayers was the Social Security number verification. Where peoples' names and numbers on the Social Security records did not match what they had put on their tax returns, we did have further contact with the taxpayers. Now that the records in most of those instances have been corrected, we should not have any concern, and those taxpayers should not have reason to be concerned next year.

But what we will be doing next year is learning from what we are studying this year and putting into place other filters that are hopefully more refined and will not be quite as broadly based as they were this year. I would expect a smoother filing season next year. Based on the preliminary results, we feel that we have kept a lot of fraud out of the system this year.

I mentioned in my testimony that we have 800,000 fewer dependents who were claimed this year than at this time last year, yet we have a million more returns that have been filed. So, I think we clearly were successful on that front.

We have 257,000 fewer EITC claims for people with children, yet the total number is up because this year the credit was expanded to include people who do not have children. So I think the message that we sent to people is, we are very serious about making the EITC work for the people who are entitled to it and not for those who are not.

As you know from other conversations we have had, I am very concerned about compliance across the board. We want our tax system to work for everybody. Most people do pay their taxes on time, and what they owe. They have a right to expect that we will assure that everyone else does the same thing.

Senator PRYOR. Madam Commissioner, I want to thank you very much.

I yield back the balance of my time, Mr. Chairman.

The CHAIRMAN. Senator Nickles.

Senator NICKLES. Mr. Chairman, thank you very much.

First, I want to remind my colleague, Senator Bradley, I joined with you to make changes in Section 29 because I thought it was unfair, even though it affected oil companies. I just wanted to remind you of that fact.

Most everybody around here says that we need to balance the budget, and most of us at one time or another say that we need to reduce the rate of growth of entitlements. There is no program in government that is growing faster than the EITC. None. None.

Just a few facts. In 1986, this program cost \$2 billion; in 1990, \$6.9 billion; in 1995, it cost \$25.3 billion; in the year 2002 it is estimated to cost \$36 billion. No program in government has grown this fast. No program over the last 10–12 years has grown as fast as the EITC. No program in government has as high a fraud rate as this program. No program. No other tax provisions.

GAO says—and I am looking at their study—the most recent taxpayer compliance study showed about 42 percent of EIC recipients received too large a credit, and about 32 percent were not able to show they were entitled to receive any credit.

Senator BRADLEY. What is the date of that?

Senator NICKLES. That was the most recent taxpayer compliance, and that was in 1988.

Senator BRADLEY. That is before the changes.

Senator NICKLES. Let me make some further comments.

The 1994 study that the IRS alluded to showed that 29 percent received too much EIC, and 13 percent were judged to have intentional errors, which Senator Roth noted. It is the government's most fraudulent program and it is the most rapidly growing program. It is unbelievable to think that we would have this kind of expansion while you have such unbelievable fraud and abuse and intentional errors.

A couple of other comments. I heard some of my colleagues say, hey, Reagan bragged on the EITC. Well, he bragged on it when it was less than a \$2 billion program. Now we have a program that has grown significantly.

In 1990, the maximum benefit that anybody could receive was \$953. The maximum benefit in 1995 is \$3,110. Next year, it goes to \$3,564 unless we are able to freeze it at the 1995 level. Senator Roth and I have proposed doing that.

Still, more money is going to go out. I tell my colleague, Senator Breaux, and others, who have said we are raising taxes, 99 percent of this program is paid out in lump sum.

Senator BRADLEY. You mean, like a tax refund?

Senator NICKLES. Just a minute. Let me make my comments. You have made yours.

Eighty percent of this is written as a check as opposed to a tax credit. So, we call this a tax credit—correct me if I am wrong, Mr. Samuels or Commissioner Richardson—but 80 some odd percent is written out as a check, as a lump sum. So this is a lump sum cash payment. The cost of EITC now exceeds AFDC, so it is a very large cash payment program. It is a welfare program, it is an income redistribution program, and it is fraudulent.

Senator Roth and I have proposed several changes. Denying EITC to illegal aliens; would you all agree with that proposal?

Secretary SAMUELS. That is in the administration's budget, Senator Nickles.

Senator NICKLES. All right.

Would you agree with repealing the EITC childless benefit? And also, I might mention to Senator Breaux, your predecessor, Senator Long, says that this program should not be given to childless couples.

Secretary SAMUELS. Senator Nickles, the EITC for workers who do not have living with them qualifying children offset the employee portion of FICA taxes and we think that if you look at that group, that very low-income group, it is absolutely appropriate that they get the EITC for working. These people are working. This is not a welfare program, Senator Nickles.

Senator NICKLES. Well, it is a welfare program, Mr. Samuels. What you just said then is significant. My daughter, who is a graduate student, is entitled to receive EIC. I do not know if that is what it is intended to do. Correct me if I am wrong, but a person can have a million dollars in assets and still receive this benefit.

Senator BRADLEY. Not if it bears interest.

Senator NICKLES. I did not say if it bears interest. You can have a million dollars in assets in a growth fund and not have an interest payment. You can have a million in a farm and lose money and maybe make the right amount of money, \$14,000, and still receive benefits. Is that not correct?

Secretary SAMUELS. Senator Nickles, we have addressed, I think, in an appropriate way, the question of targeting the EITC.

Senator NICKLES. I do not want to lose all of my time. Am I correct that you can have a lot of assets and still qualify for the EIC?

Secretary SAMUELS. Under the proposal that was adopted in H.R. 831, you lose EITC if your interest dividends, net rents, and royalties exceed \$2,350.

Senator NICKLES. Well, I am aware of that. But you can have a lot of assets. You can have a farm that is worth a million dollars and not have any interest or dividend income. You can invest in growth stocks that lost some money.

And you also have a situation where a lot of people, such as my daughter, who is a graduate student, can work so many hours and maybe have their income come in at just the right range and now qualify for this benefit.

My point is that Senator Roth has done a very good job of pointing out that this program is fraught with abuse, it is growing totally out of control, it is a cash outlay program and it needs to be reformed.

The reforms that we are talking about would just curb the growth. It would still continue to be a \$25 billion plus program, and increase about \$1 billion per year. To allow it to continue to grow as it has is, I think, grossly irresponsible.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Rockefeller, and then Senator Graham.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

As I understand it, Mr. Secretary, the expansion in EITC reflects, as Senator Pryor indicated, a direct result of public policy in-

stituted by the Congress, and I believe it began in 1986 with President Reagan. It was on a bipartisan basis at that point, and had strong support from President Bush in 1990. It expanded again in 1993, so that we were in the process of phasing in those expansions.

I am going to say something which I think will be taken as partisan, and perhaps it is. But the vehemence of those who are emphasizing that the fraud in this program is just simply out of control when the evidence is that the fraud, thanks to this administration, is being sharply curtailed through 12 specific actions is troubling. Many of the so-called fraud is a \$1 mistake, or something of that sort, which often happens. There is fraud and that is recognized by all of us and we are trying to get rid of it.

But I have to confess, I just absolutely have to confess out of honesty, that I wonder about this attack on EITC—which to me is one of the finest things we do in this country in terms of rewarding work as opposed to welfare. People could much more sensibly make a case that they should go back on welfare because they get health benefits, and many families on this program are probably not working for a company that offers health benefits. So, they are clearly choosing work over welfare. The country has decided to reward that.

I honestly wonder whether my friends on the other side are beginning to become so severely embarrassed about the cuts that they have made in welfare, and in Medicare, and Medicaid that they are attacking this in some form as a way to try to cover that up, or to distract public attention from that. I may be entirely wrong. On the other hand, I may be partly right.

President Clinton was a member of the National Commission on Children which I chaired for 4 years. He obviously was not President at the time. But that had three senior members of the Bush administration on that commission, and, by a unanimous vote, 32 to 0, we approved an enormous program to support children and families over the entire spectrum of their lives and we strongly endorsed, on a bipartisan basis, the Earned Income Tax Credit. So I would just ask, in your view, how does EITC reward work and how do you believe that this, therefore, affects welfare?

Secretary SAMUELS. Senator Rockefeller, the EITC program is the only program that does reward work in a way that, as your earnings go up, you receive more credit. In most of the other programs, as your earnings go up you lose benefits.

In the EITC—and we have a graph here that I can put up so you can see the structure of the program—there is a heavy work incentive. There is a heavy work incentive in the phase-in stage. So, this is an example of how the program is structured.

So if your income is between zero and \$8,900, you will get a 40 percent credit on a fully phased-in basis, and then when you hit the plateau you stay at the maximum amount. Then there is a phase out.

With every program for low-income working Americans you want to have to have phase-outs. So, in the phase-out period there is obviously some work disincentive. We think, on balance, the work incentive in the phase-in part of the EITC will encourage work. It has encouraged work.

Senator ROCKEFELLER. Thank you, Mr. Secretary. I actually am able to both talk, listen to one person, and hear the Secretary, so I did hear your answer.

It is interesting. In the 1993 budget it was called the greatest tax increase in history. I looked at my State of West Virginia, which is one terrific State. There are, in fact, individuals who will pay more income tax because of that 1993 Act, 4,192 individuals who will do that.

On the other hand, there are 105,000 West Virginia families working in this range just above welfare who will have the benefit of an Earned Income Tax Credit. One of the things that we recognized—and Mr. Chairman, this will be my final sentence—is it is really a twofold problem.

One, is that a lot of people do not know about the Earned Income Tax Credit. One of the things that has been going on in government is, people who deserve the credit did not apply because of the complexity of the Earned Income Tax Credit forms. A lot of people who deserved it, in fact, did not receive it.

So, that is another reason for the expansion and simplification. On a bipartisan basis, signed by the Presidents, there has been several key expansions on the EITC. I will not ask a question, I will just stop there.

The CHAIRMAN. Senator Graham, then Senator Hatch.

Senator GRAHAM. Thank you, Mr. Chairman.

I would like to continue the line of questioning that Senator Rockefeller commenced. If the purpose of this program is, in substantial part, to provide an incentive for persons to move from welfare to what is admittedly low-income employment, what empirical data do we have that the program has, in fact, achieved that result?

Secretary SAMUELS. Senator Graham, there have been some studies that have been undertaken, and I think that our analysis of those, when you look at them all, and particularly when you take into account the incentive of the Earned Income Tax Credit for people who are not in the work force to get into the work force, that is a very important point that some of the earlier studies did not address. They just focused on people in the work force.

We think we have to look at people who are not in the work force, the people who are going to take advantage of the phase-in, and it is an important incentive for them. And, overall, it has been a positive program for the purposes of encouraging people to work.

Senator GRAHAM. But do we have some statistics of how many people, what are the characteristics of those people, what has been the staying power, once employed, of those persons?

Secretary SAMUELS. Right. In a 1994 study, Professor Sholtz of the University of Wisconsin simulated the effects of the OBRA 90 changes on labor force participation and he found that the effect of the EITC on participation decision could dominate other effects. He finds that, by 1996, the EITC could result in an increase in labor supply—that is, people entering the work force—of 19.9 million hours relative to 1993 law. So that was a 1994 study by a well-known academic in this area.

Senator GRAHAM. Did that study indicate what the people who represented that 19 million work hours would have done but for

the Earned Income Tax Credit? That is, would they have been unemployed?

Secretary SAMUELS. These are all non-workers.

Senator GRAHAM. And were they eligible for and receiving some forms of public welfare?

Secretary SAMUELS. Yes.

Senator GRAHAM. Has there been a calculation of what that cost was to the public that was offset, terminated, or reduced as a result of their employment?

Secretary SAMUELS. The transfer program participation rates show that for a single-parent family, the mean annual benefit that they were giving up was \$6,844, and for two-parent families it was \$4,702. So this is the amount that they were receiving in income transfer programs.

Senator GRAHAM. And what was the equivalent value of their Earned Income Tax Credit?

Secretary SAMUELS. Their mean Earned Income Tax Credit for single-parent families was \$2,000 to \$2,040, and for two-parent families, \$2,842.

Senator GRAHAM. So would that indicate that there was to the public a savings of approximately \$2,000 plus for each of those families as a result of the differential and what they are receiving in public assistance as opposed to what they are now receiving in the Earned Income Tax Credit?

Secretary SAMUELS. For the single-parent families, it is estimated to be about 400,000 leaving the assistance programs. It was a difference between \$6,800 in mean annual benefit and \$2,000 in mean EITC payments, so it is actually \$4,800 per family for those 400,000 families.

Senator GRAHAM. I was interested that there is quite a disparity among the States in terms of the percentage of participation. At the top of the participation list is Mississippi, where some 29 percent of the filers are Earned Income Tax Credit participants, to Connecticut, where there are 5.5 percent.

What are the factors that contribute to that significant differential among the States?

Secretary SAMUELS. Senator Graham, I think that it is really a question of two things. One, the economic conditions in particular States and the income levels in those States, and, two, the availability of information about the program. I do not know how much that second component is a factor, but it is a factor.

The administration has been engaging in an outreach program to make sure people who are entitled to the EITC know about it, but I think it is principally economics. If you look at the average income levels there is a correlation between the average income levels and the EITC recipients.

Senator GRAHAM. Well, I was wondering if there might not be another factor which goes back to the first series of questions, and that is the trade-off of welfare benefits versus Earned Income Tax Credit. The Earned Income Tax Credit is relatively consistent across the country; a person in Mississippi earning the same amount as a person in Connecticut would get the same amount of Earned Income Tax Credit.

Secretary SAMUELS. Correct. Correct.

Senator GRAHAM. Whereas, there is a tremendous variation in welfare benefits in the range of three, four, five to one, from high benefit States to low benefit States.

To what degree do you think that that factor may affect the extreme differentials of participation in the Earned Income Tax Credit from State to State?

Secretary SAMUELS. We really do not have any data on that.

Senator GRAHAM. I wonder if you might look and see if there is a correlation between the State set of benefits that are available which aggregate into the numbers of 4,800, et cetera, that you just gave, and the Earned Income Tax Credit participation.

Secretary SAMUELS. Yes.

Senator GRAHAM. Thank you.

The CHAIRMAN. Just to put Professor Sholtz's records in perspective, I am going to quote from what the Joint Committee prepared for us. "Estimates suggest that just under one-quarter of recipients are in the phase-in range, over three-fifths are in the phase-out range, and the remainder about one-sixth in the plateau range. So, for the vast majority of individuals, the marginal effect of the credit is unambiguously to reduce work incentives."

Senator HATCH?

Secretary SAMUELS. Senator Packwood, can I just comment on that?

The CHAIRMAN. Yes. Well, you threw out Professor Sholtz's name, so I thought I would—

Secretary SAMUELS. Right. We have considered, and I was careful to say, the net benefit, because we recognize that there is a work disincentive in the phase-out.

The CHAIRMAN. Yes.

Secretary SAMUELS. But we also think that the people in the phase-out range are ones that are more well-established and connected to the work force, and it is very unlikely that they are going to say that, I have reached the maximum credit and I am going to stop working.

We think that probably where you get the work disincentive is where you have a couple and both are working, and maybe one of the working spouses decides to stay home and take care of children.

But I think that those people are more committed to the work force. We recognize the work disincentive, but we think that it is probably limited, and it is more targeted on people where there are two working spouses.

The CHAIRMAN. I think your statement may be correct, because there is an interesting caveat in this study, and I was going to read it. We think everybody absolutely sits down and plots out to the minute exactly how they are going to be affected by anything.

The Joint Tax Committee says that they "presume the individuals correctly perceive the effect of the credit on their after-wage income. Most of the EITC claimants receive their credit in lump sum at the time they file their returns. If they do not make the connection between the amount they receive in credit and their earned income, these estimates of labor supply effects may be incorrect," which I think is a fair caveat.

Senator HATCH?

Senator HATCH. Thank you, Mr. Chairman.

Welcome to both of you. Commissioner Richardson, I personally think you are doing a fine job down there. I know that you are making a lot of changes that I think are good.

Senator CHAFEE. That is always dangerous. The next word is but.

Senator HATCH. No, there are no buts there. There are not buts there, in spite of the skepticism exhibited by Senator Chafee.

You just made a point that our chart here makes as well. Personally, I support the EITC. I think basically across the board it does a pretty good job, but there are flaws and you and I both know it. We have got to work on it and try and resolve it. But here is one of the biggest flaws, and this is a big program with the EITC because the EITC currently has a strong bias against marriage.

This example makes the case. John, who earns \$11,000 a year, is a divorced father of one. In 1994, he wants to marry Marie, a single mother of two, who earns \$13,000 a year. As singles, under current law they would receive a combined tax refund of \$4,128. If John and Marie were to marry, they would have to pay \$581 on their joint tax return. So this amounts to a marriage penalty of \$4,709, or almost 20 percent of their combined income for 1994. Financially, they would be crazy to marry—financially. Morally, it would be the right thing to do. At least, some think so today in our society.

Senator CHAFEE. Can't two live cheaper than one?

Senator HATCH. I can say that Chafee comes from a bygone age, is all I can say.

But, to make a long story short, you can see that it just is not right, and I am concerned about it. Frankly, has the Treasury Department studied the marriage penalty in connection with the EITC? If so, is the administration considering any proposals to alleviate the EITC marriage penalty, or do you have any ideas for reform for us this year?

Secretary SAMUELS. Senator Hatch, we have been considering this problem; it is one of concern.

Senator HATCH. It is your hope that the wife will just quit and go and be a good homemaker?

Secretary SAMUELS. No. I think that the other side of the marriage penalty is also that there are significant marriage bonuses. For example, if Marie was on welfare and not working and she married John there would be a significant—

Senator HATCH. Sure. I acknowledge that, but that does not solve this problem.

Secretary SAMUELS. I understand. But I think, in looking at these problems, one has to look at kind of probabilities that you would have two people in that situation. And I am not trying to minimize the problem, but I think when you look at the people who have been receiving EITC and the chances that you are going to have two workers who are both custodial parents—

Senator HATCH. Now, philosophically, that is a nice thing. But if it practically happens, and it does, do you have any ideas how we can solve it?

Secretary SAMUELS. Well, I think that the problem is to solve marriage penalties. This is an important example to show the ef-

fects of marriage penalty. It is just not restricted to the EITC, it is really a function of the low-income targeting of the EITC and treating a couple as a single economic unit. That is not restricted to the EITC. So, if you are going to try to solve this problem you could change phase-out rates and make them longer, but that, of course, will increase the cost of the credit.

So we have been struggling with ways of trying to figure out how to do this, given our fiscal and budget constraints. I think that where we would come out is that the program design has to take into account, obviously, competing considerations, and this is obviously one of the adverse factors that you have. To fix this without pushing someplace else in the program and making it more expensive is really the trade-off.

Senator HATCH. Well, there might be some way of alleviating some of the pain. Instead of having them pay almost \$600 when they would have had \$4,128, maybe there is some middle ground or something that we could work out. I do not know.

Secretary SAMUELS. We are continuing to think about this issue.

Senator HATCH. You are the experts. We would like to have you make suggestions in this area, because I am tired of this marriage penalty and this incentive for people not to get married and just live together.

Let me just ask one other question. Is there any data available showing how many taxpayers claim the EITC from year to year, and how many of them claim it only once or twice? In other words, can we see any evidence that the program has been successful in lifting people out of poverty; do we have anything on that?

Secretary SAMUELS. There was a report that was released yesterday by a national commission that was studying the matter and they found that, over a 10-year period—and we are still looking at the report and analyzing it, but as I recall, their report was over a 10-year period—you would see 39 percent of the families at one point over that period might qualify.

That is because people have dips, unfortunately, in life and there are times when you get sick, or you lose your job, or there is an illness in the family and you have to take care of a sick relative, so people would dip down. So, that is why there is 39 percent over a 10-year period. I think that they found about 16 percent was an average basis throughout that period.

Senator HATCH. All right. Thank you.

Mr. Chairman, can my statement be made a part of the record?

The CHAIRMAN. Without objection.

[The prepared statement of Senator Hatch appears in the appendix.]

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Let me just say to Ms. Richardson and Mr. Samuels, I am in favor of this program. I will confess, I am no expert in it. I note that in our State we have not really taken a great deal of advantage of it. I do not know why.

Do you make efforts to alert people of this? It seems like such a bonanza for people to use. I take it, with the disparity between the different States, it must, to some degree, be because they do not know about it. Is that right?

Commissioner RICHARDSON. Senator Chafee, I cannot speak to the disparity among the various States; as Mr. Samuels said, it is a function of the income people earn. But we have made a very aggressive effort over the last several years to advertise the Earned Income Tax Credit, particularly the advanced Earned Income Tax Credit, and I believe that last year, right after the filing season, we sent letters to all taxpayers that looked to be eligible for the Earned Income Tax Credit.

There were 14 million letters that were sent out to people last year at the end of the filing season. This year, we have already notified about 300,000 who look to be eligible for the credit, and we will continue to do that as we process their returns.

We have had an aggressive advertising campaign and we have worked very closely with a number of community groups and State tax authorities to make sure that we can use their resources and their contacts to let people know about it.

Senator CHAFEE. I just was looking at the New England States, and the percentage of returns using it are very low. Connecticut, which is a high-wage State, is understandably low at 4.9 percent; Massachusetts is at 6 percent; my State is at 8.1 percent, but we are a relatively low-wage State; New Hampshire is at 7.1; and Vermont is at 9.1. All of them are low, relative to the rest of the Nation, why, I do not know.

I just want to say, I know that some of these GAO reports are old, but they certainly are disturbing. This one here is not so old, where it talks about a quick, 2-week study in 1994. You have seen that, obviously.

Commissioner RICHARDSON. Right.

Senator CHAFEE. So, Mr. Chairman, I think this is a worthwhile hearing. It is astonishing, the increased use of the EITC Nationally and the corresponding increased costs. But if it is available, I certainly want to make sure that folks in my State are aware of it.

Thank you very much.

The CHAIRMAN. Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you, Mr. Chairman.

At the outset I want to apologize for just getting here. I was in the Banking hearing on GATT and financial services, and Senator D'Amato asked me to mention to you, Mr. Chairman, that he is not here because he is chairing that hearing.

I have a written statement for the record, Mr. Chairman, that goes into detail regarding my support of the EITC and my disappointment, if not opposition, to the direction that has been taken by the Budget Committee in reducing the EITC, or reducing the eligibility for it. Of about 10 million EITC recipients, nearly half of those recipients with children would be affected by that proposal and would see their average EITC refund cut by \$270. Families with two or more children would be hardest hit by the proposal that we have coming out of the Budget Committee.

I am sure that has been said already. I do not know how much of what I have to say has been said, but I thought it was important for us to recognize that, in light of the fact that we are in the process of revising the safety net for poor children, in light of the fact that we are undertaking to achieve balance with the budget and deficit reduction, it is important that we are mindful that, as an

American family, we are all in this together and that it is short-sighted, in my opinion, to burden the poor the most with our deficit reduction and budget balancing efforts.

If anything, we need to recognize that, by contributing to the well-being in the welfare and the ability to continue to work that the EITC provides, we really help our economy overall and assist our efforts to achieve fiscal integrity and budget balance. So, I strongly support EITC, I strongly support its implementation, and I strongly support, frankly, the dissemination of information regarding the program.

I have been concerned, as has everyone else in this Congress, regarding the allegations and charges of error and fraud in the program, but I daresay—and this would get to my question, having to do with the actual efforts that are being made in terms of outreach—from my preliminary investigation and look at what is going on here, it does not appear to be so much a matter of fraud as a matter of error.

Particularly given the fact that we are talking about the lowest income working Americans, could it not be—and I would like your response—that most of the problems that we have had with the implementation of EITC has been a function of inadequate information or information that is not calculated to communicate effectively with the people who may be eligible for participation in this initiative?

Secretary SAMUELS. Senator Moseley-Braun, I think it is, at least in my experience, clear that the complexity of the calculation makes it difficult for low-income workers to calculate the EITC. We have made significant efforts to try to simplify the form.

I know that before the form was simplified, it must have been 1992, I had the occasion of looking at the form for someone who was clearly entitled to it, as far as I could tell. It was the first time I ever looked at the form, and I had been practicing tax law at that point for 25 years, and I frankly had to scratch my head and try to figure out how it worked. It was not obvious.

I think that the changes that were made in OBRA 93 to try to simplify the form, where we got rid of the two supplemental credits, should go a long way to reduce the error rate when people just make honest mistakes.

We are concerned about the error rate. As you know, we have been taking numerous steps to try to make sure that the error rate is as low as possible and that only those working Americans who are entitled to the credit will receive it.

Senator MOSELEY-BRAUN. Ms. Richardson?

Commissioner RICHARDSON. Yes, Senator Moseley-Braun. To just supplement what Secretary Samuels said, we are finding this year that there have been fewer errors and I think that we will find, as we conduct our study of the returns filed this year that have taken into account the changes that you made in 1993, that we probably will have fewer errors and fewer problems with the administration of the law.

Senator MOSELEY-BRAUN. Well, if anything—and I see the light is already yellow—one of the kind of over-arching issues that comes before this committee is the interest of everybody in tax simplification and making the whole process simpler, it would seem to me—

and I am going to be very brief here—that this would be a wonderful place to start.

I would ask if you have undertaken plans to revise, simplify, and try to do even better than was done in 1993 with regard to the information that goes out on the EITC.

Secretary SAMUELS. I think we are committed to making sure that the information is disseminated. As Commissioner Richardson mentioned, the IRS this year has already notified—

Commissioner RICHARDSON. Over 300,000 people we have notified this year who look like they are eligible for the credit. We have very extensive volunteer programs. We had over 1,000, what we call Volunteer Income Tax Assistance (VITA) sites, people out there to help taxpayers prepare their returns, and we worked very closely with the non-profit community and various community groups, State tax administrators, to try to make sure the information is out there, and that it is clear. We will continue to do that.

Secretary SAMUELS. If I might just add, as the committee considers any adjustments to the program I would urge that you give simplification great weight. Every time you start with another adjustment, it makes it more complicated for 21 million working Americans to fill out the form.

Senator MOYNIHAN. Which is what we tried to do in OBRA 93.

Senator MOSELEY-BRAUN. Well, in closing, my only comment would be, to the extent that we can revisit the form and try to resimplify it even more, that would, I think, be constructive with regard to the administrative of this important program. We would not want to see it lost because the administration of it is awry.

The CHAIRMAN. Senator Roth.

Senator ROTH. Mr. Chairman, Senator Nickles and I are introducing a bill today to correct what we see as being some of the serious problems of this legislation. I think it is important to understand, what we seek to do is not to do away with a program, but to focus it on the working poor. There are some problems, serious problems, with this program. Let me just illustrate what they are.

One, the program is not based on how many hours you work, but on earned income. So let me point out that a lawyer who works 100 hours at \$100 and makes \$10,000 is eligible for the Earned Income Tax Credit, whereas a poor person who works as a waiter and works 2,000 hours at \$5 is eligible for the same payment. To me, that does not make sense. Why should the retired lawyer who may work 100 hours be qualified for the credit? That is point number one.

Senator BRADLEY. How do you correct that?

Senator ROTH. Well, we are making a study of that right now. But I think what you do, is require a certain number of hours being worked rather than basing it on earned income. Now, the problem with that is, it complicates it. I know that. That is one of the reasons we are studying it.

Second, it is also true that wealth does not rule out receiving the Earned Income Tax Credit. One can be living in Beverly Hills in a million dollar house and still be eligible. I think that is a serious problem. Or one can be a 24-year-old student and earn \$9,000 or less and be eligible. These are serious problems.

Furthermore, let me point out that certain kinds of income do not count. For example, child support payments. There is an actual case where a woman was being paid \$5,000 a month for support of the children and she continued to be eligible. This is an actual case where it was designed to take advantage.

Now, we are not talking about peanuts. It is estimated that our legislation would save something like \$40 billion over the next 5 years. Mr. Chairman, we have some serious budget goals to meet and it seems to me, if we can make savings here that are needed, that that helps us when we address the problems of Medicare.

The CHAIRMAN. Further questions? Senator Bradley.

Senator BRADLEY. Mr. Chairman, I think that the relevant point to make, and I take legitimate concern on the part of Senator Roth and Senator Nickles. I hope they are not really attempting to simply eliminate this program, but to work with the administration in correcting the abuses that have become clear in the program's operation.

To the extent that either Senator has suggestions on the administration of the program that both simplify and tighten up the program, I am sure the administration would welcome their suggestions.

But if we simply take the effect of their proposal that they are introducing today, it is, as that chart illustrates, a tax increase of substantial amounts on working families. It is a tax increase in 1996, on average, of \$500 and a tax increase in the year 2000 of \$800. That is average, which means there are some that are going to have a significantly larger tax increase.

My sense is that people do not understand the program, because when they say, well, it does not offset income tax liability, they ignore the fact that most people who earn under \$28,000 do not have a whole lot of income tax liability, but they have a whole lot of Social Security tax liability, and they pay Social Security taxes, they pay gasoline taxes, and they pay other excise taxes. And, as they earn more money, they get reduced benefits in terms of food stamps and other programs.

If the idea is to get people to work, one of the ways that you do this is you relieve them of the tax burden that they incur at a level that discourages work. Just as it is an incentive for somebody who makes a lot of money to pay less tax if they invest in X, Y, and Z, and therefore you give them a tax credit, or whatever, so if someone is beginning to work you give them a break in order to encourage them to work. This goes to nobody who is not working.

Proposals to tighten up, I think, are legitimate, proposals to essentially emasculate it result in tax increases of nearly \$1,000 per person. I am sure that both Senators do not want to increase taxes on only those people who earn under \$28,000 a year, but that is the effect of the proposal.

Hopefully, we will be able to have a reasoned discussion of this and work to tighten it up and simplify it, which is a little bit like that, but, nonetheless, an effort worth making.

The CHAIRMAN. Any other questions?

[No response.]

The CHAIRMAN. If not, Mr. Secretary, Madam Commissioner, thank you very much.

Secretary SAMUELS. Thank you.

Commissioner RICHARDSON. Thank you.

The CHAIRMAN. Now, if we might, we have a panel of Robert Greenstein, Marvin Kosters, Lynda Willis, and George Yin.

I think most people know of my admiration for Senator Moynihan, but he had a wonderful expression that I cannot resist passing on that he said just a few moments ago. He said, is it not amazing, 60 years ago this government was trying to figure out how to create jobs for people to take, now we are trying to figure out how to get people to take the jobs that have been created. It is a difference in 60 years.

We will start with Mr. Robert Greenstein, who is the Executive Director of the Center on Budget and Policy Priorities, who has been before this committee numerous times.

STATEMENT OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES, WASHINGTON, DC

Mr. GREENSTEIN. Thank you very much, Mr. Chairman. Let me charge right in.

I think there is probably broad agreement that the biggest problem with regard to the Earned Income Tax Credit is the error rates. The IRS actions this year are very important, but, clearly, more needs to be done.

I would like to note, as someone who administered the food stamp program in the late 1970's and tried to get the error rates down there, and we succeeded in cutting them in half during that period, that this year the IRS has made a C change in the credit. Prior to this year, like many other parts of the Tax Code, whatever you put on the form was largely what you got. There was very little checking before anything was sent out.

This year, that has changed sharply. I would note that in their new study where they estimate that, had the procedures they have put in place this year been in effect a year ago, that that study would have found about 19 percent of the benefits over issued.

That does not include—because they cannot measure—something very important they have done for the first time this year. They are now taking those returns that fall into error-prone categories, pulling them out, sending people a questionnaire, and asking for documentation and additional information before sending out the credit.

This is a longstanding practice in things like food stamps and AFDC. It has never been done before in the Earned Income Credit. Every State that started doing this in food stamps had a significant reduction in the error rate, and I am hopeful that when the data comes in that that will show further improvement here as well.

I believe changes in the credit should focus on three areas: improved compliance and reducing errors, what counts against the wealth test, and possibly what counts against adjusted gross income. I would urge against changes that would repeal parts of the 1993 expansion or de-index the credit and reduce benefits for honest working families.

I think we need to put in context the reasons the Earned Income Credit has been expanded. As this chart shows, between 1977 and 1993 the poverty rate for families with children in which the family

had worked grew by nearly half, and eroding wages for low-skilled work reduced living standards, increased child poverty, lessened incentives to work, and decreased the gains from working relative to welfare.

Since the mid-1980's, there has been a bipartisan policy emphasis on increasing remuneration from low-paid work, with the EIC as the principle policy instrument for doing that. President Reagan, President Bush, and President Clinton were all a part of this.

Mr. Chairman, what I think is particularly important is that these EIC expansions reflected a major policy shift. The EIC has supplanted, to a large degree, both the minimum wage and welfare as a way of aiding the working poor. As you know, the minimum wage is now at its second-lowest level in purchasing power in 40 years. What is less well-known, and may be of particular interest to Senator Moynihan, is in 1972, before we had the EIC, 49 States provided AFDC as a wage supplement to a mother with two children earning three-quarters of the poverty line. Today, three States do. We have moved away from AFDC, away from the minimum wage, and toward the Earned Income Credit.

That is a principle reason it has been expanded, as well as an attempt to achieve a bipartisan goal, first, I think, stated in print by the Heritage Foundation in 1989 that the EIC should be expanded to the point where, if a parent works full-time year-round, the children should not have to be raised in poverty.

What the next table shows is that these EIC expansions do not look quite so large when placed alongside the changes in the minimum wage and AFDC. What this table shows you is that, for a mother who works 20 hours a week year-round at the minimum wage, 30 hours, and 40 hours a week, that when the 1993 EIC expansion is fully in place, she will still be \$1,500 to \$3,000 worse off than in 1972 because the erosion in the minimum wage and the withdrawal of AFDC for working families is greater than the entire Earned Income Credit.

In a nutshell, economic forces that push down wages for low-skilled work, along with policy decisions in the minimum wage and AFDC areas, led to a bipartisan consensus among policy makers to increase the EITC substantially instead of doing things in the AFDC and minimum wage areas in order to avoid large reductions in living standards of the working poor and of poor children.

A couple of comments on work and marriage incentives, and then I will wrap up. Mr. Chairman, you noted an issue with work incentives. Let me note that the research is pretty consistent here in supporting something Robert Reischauer stated a couple of years ago, that the families the EIC encourages to work less are different from the ones it encourages to work more. The research unambiguously shows—and this is mentioned in the Joint Tax Committee report—that the work reduction is primarily among wives in two-parent, two-earner families.

Reischauer's point at a 1990 symposium was it is not necessarily a negative for social policy if the EIC allows a wife in a two-earner family to elect to spend more time with her children and less time working. By contrast, the people the EIC encourages to work more are those working little, if at all, primarily in single-parent families.

The Joint Tax Committee report you mentioned, and you mentioned Professor Shultz's study. Well, when it says that the majority of those on the credit are in the area where hours of work might be reduced, the Joint Tax Committee notes that is for those already working.

And there is an additional effect where those who are not working at all, the new research indicates the EIC significantly increases work effort and draws into the labor market those who otherwise would not work at all, and the increase in their work hours is larger than the decrease which is primarily among wives in two-earner families.

Finally, on the marriage front, I think this is a very tricky area, a difficult area. There are marriage penalties, they are significant. The other side of the coin, as Mr. Samuels noted, is there is a very important marriage bonus for a group we care a great deal about, and that is mothers on welfare. We know that marriage is the main route off of welfare.

In the absence of the EIC, a non-working mother who contemplates marrying a man with low earnings risks losing AFDC, some of her food stamps, most of her Medicaid. There is a huge marriage penalty in the welfare system. If she marries that man, they can qualify for up to a \$3,000 Earned Income Credit and it offsets a good part of that marriage penalty.

So what we have here, as in the work area, we have some marriage penalty for people, both of whom are already working, making \$10,000, \$15,000, who think about marrying, we have a marriage incentive that reduces the marriage penalty we would otherwise have for welfare mothers who are thinking about marrying and getting off of welfare and who, without the EIC, face punishing penalties if they do marry.

So these are all among the reasons why I would recommend concentrating on compliance and on looking at areas where people may not need the credit as much because of other kinds of income they have and not on doing the 1993 expansions or removing indexing of the credit.

Thank you.

Senator MOSELEY-BRAUN. Mr. Chairman, before questions, and I do not mean to nitpick, for the witness I would just want to point out, because words are important and the words we use here are important, without taking issue with your testimony, except to say that women who work in the home work. So you will probably make it clear in the future when you refer to women in the home, that you do not just say women who work versus women who do not work, because they do work.

The CHAIRMAN. The most inept question around is, are you a housewife or do you work?

Senator MOSELEY-BRAUN. Well, that is exactly why I raised the point.

The CHAIRMAN. I understand.

Senator MOSELEY-BRAUN. I did not mean to nitpick, but I think it is really important that we recognize that women who work in the home are working women.

Mr. GREENSTEIN. If you viewed it that way it would strengthen the point, the two-parent families.

[The prepared statement of Mr. Greenstein appears in the appendix.]

The CHAIRMAN. Next, we will take Dr. Marvin Kusters, who is the director of Economic Policy for the American Enterprise Institute.

Doctor?

STATEMENT OF MARVIN KOSTERS, PH.D., DIRECTOR OF ECONOMIC POLICY, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. KOSTERS. Thank you, Mr. Chairman and members of the committee. I appreciate this opportunity to discuss the Earned Income Tax Credit.

Basically, I believe that, given the problems with the program, the best way to address them would be to cut back the size of the program. It is not that I think the program is not a good idea; I think there is a role for the Earned Income Tax Credit.

But I think it has grown too big and has caused a number of problems, including the non-compliance and fraud problem and it has increased the size of the marriage penalty. I think, probably most importantly, the question of the influence on work of the program has been over-simplified and somewhat misunderstood.

So, what I would like to do is to focus mainly on the question of work incentives and talk a little bit about how it works.

First of all, given the cut-off level that is in legislation for next year, the first question to ask is, among families with children, what fraction are below that cut-off level? It turns out it is about 40 percent. That is to say, about two out of five are in the income range where they would be eligible for the Earned Income Tax Credit.

This is a large number compared to, for example, an 18.5 percent poverty rate among families with children. This seems to be well above what you might call the working poor, if you think of the poor in terms of the poverty rate that is usually used to define them.

The second distinction is among those 40 percent below the income cut-off, how many of these families have someone working? It turns out that about three-quarters of them do.

That is, about 30 percentage points worth have someone working and they would be eligible directly for their Earned Income Tax Credit payments and would generally benefit from them. Those above that income level, of course, would be paying higher taxes to finance it.

Those who are working are affected in different ways. Those highest up in the income range are most discouraged from working, those in a small, intermediate range probably would not have much discouragement effect, but generally they would be discouraged. It is only those at the bottom end of the range, where there is a 40 percent subsidy rate, where work could be encouraged.

Incidentally, this is a very large subsidy rate below \$9,000 or so in comparison with, for example, the combination of the worker and the employer's payroll tax payment of 15.3 percent.

So what we need to recognize, and I think most academics who have looked at this agree, that for those who are working, some

three-fourths of that 40 percent below the income cutoff, work will tend to be, on balance, discouraged. That is, there will be less work among these people.

Now, it may be that this is a good idea for some secondary workers who would be involved in child care, but it does seem like an oddly-designed program in that regard in that, with two dependents, you would be more encouraged to work outside the home than within the home. In any case, what I think needs to be recognized is that, for these families, a very large share of them would tend to work less rather than more.

Now, there is a group, of course, who would be encouraged to work rather than not work, and that is the other 10 percent, the people not in the work force. Now, people concerned with welfare reform have looked at what fraction of these people could be induced to work. It seems that many people think that 50 percent or so of those would be an ambitious and large number who might consider working. So we need to recognize that some fraction of this 10 percent might not be in a position to work. But others who might be and some might choose work.

So, on balance, I think it is an open question whether there would be more work in total with an EITC than without it. However, given that that is just not clear one way or another, what we need to recognize is that, the higher we go up the income distribution, the more people are discouraged from working because the income distribution, gets thicker toward the median. However, the same 10 percent are the maximum who would be encouraged to work.

It seems to me it would be desirable from that point of view to cut back on the size of the Earned Income Tax Credit in terms of the rate, in terms of the income cutoffs, in terms of the size of the maximum benefits. This would, in addition to reducing the number who are discouraged from working, also alleviate, to some extent, the marriage penalty and it would reduce the incentives that are now there for fraud.

I think there is really more going on here than fraud, too. It is a question of people who would do things that are perfectly legal that they would not do in the absence of the program, given the rather high subsidy rate. That is, they would be engaged in the equivalent of taking in one another's laundry, to some degree, when doing their own would otherwise make more sense.

I want to make clear that I am not suggesting that the program should be abolished. I think that just because it is a good program does not mean that larger is always better.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Doctor.

[The prepared statement of Dr. Kusters appears in the appendix.]

The CHAIRMAN. Now we will take Lynda Willis, who is the Associate Director for Tax Policy and Administration Issues for the GAO.

STATEMENT OF LYNDA D. WILLIS, ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Ms. WILLIS. Good morning, Mr. Chairman.

The CHAIRMAN. Good morning.

Ms. WILLIS. I will submit my entire statement for the record. In addition to the statement that we provided your people yesterday, there are some changes this morning to reflect the data that was released by IRS in terms of their final numbers.

We are pleased to be here today to assist you in your efforts to look at the Earned Income Credit. My testimony is based on a body of work we have done, including our current work for Senator Roth.

In my summary statement today, I will focus on a couple of points. First, a reliable overall measurement of non-compliance with EIC provisions has not been made since 1988, but non-compliance is a problem.

The Internal Revenue Service studied EIC claims filed electronically during two weeks of January in 1994 and estimated that 39 percent of the returns claimed credit that they were not entitled to receive, either in whole or in part; 26 percent of the refund amount claimed was not due claimants.

When considering actions to address the EIC's non-compliance problem, the perspective of non-compliance problems and other programs may be useful. Whether the EIC non-compliance is higher than for other programs depends in part on what the EIC is compared to and what is considered in making the comparison.

Within the tax system, the EIC non-compliance rate tends to be high, but is not the highest. For instance, IRS believes that informal suppliers, self-employed individuals who operate on a cash basis, do not report 89 percent of their income.

The self-employed, as a group, are estimated to under-report their income by 64 percent. Of course, these examples are for non-compliance in reporting income to pay taxes. In contrast, the EIC is a refundable credit with most of the funds distributed classified as Federal outlays.

Among Federal outlay programs that are similar in size to the EIC and serve similar populations, non-compliance rates appear to be lower. According to State-reported data, in 1992 the food stamp program over-issued food stamps to 17.6 percent of applicants. Overall, food stamp over-payments in 1992 represented about 8.2 percent of total benefits paid under the program.

The AFDC program had over-payments representing 5.3 percent of total benefits in that year. However, the lower non-compliance rates for these programs are associated with administrative costs that are many times higher than those of the EIC.

In 1993, AFDC administrative costs represented about 11.6 percent of total AFDC expenditures, and food stamp administrative costs represented about 12.4 percent of expenditures.

While EIC administrative costs are not compiled by IRS, based on average processing costs for tax forms and assuming that all of the costs of identifying and investigating fraudulent refund schemes are EIC-related, and those are conservative assumptions, we believe that the EIC administrative costs may not exceed 1 percent of EIC program costs.

This filing season, IRS expanded its efforts to ensure taxpayer compliance. Not surprising with a new initiative, some problems occurred. The expanded SSN verification procedures for paper returns identified many problem returns, but some that should have

been identified were not. Computer problems also caused some returns not to be selected when they should have been.

IRS also experienced some problems as it began checking for duplicate SSNs. These problems included difficulties in constructing the data base to use in identifying duplicate SSNs, poorly organized computer listings that enforcement personnel found difficult to use, and cumbersome procedures for coordinating the work of different service centers.

It is still too early to assess the success of IRS's expanded enforcement initiatives. IRS is conducting a more comprehensive study that should shed light on whether compliance has improved. However, results may not be available until fall.

Although some improvement in EIC compliance levels may result from IRS's current efforts, in the long-run, sound enforcement of EIC will require even better verification of recipients' eligibility before refunds are made.

Turning to my second point, although EIC is intended to assist the working poor, historically eligibility criteria have not considered all of the resources recipients may have to support themselves and their families.

While the Self-employed Health Insurance Tax Act of 1995 added new wealth-based eligibility criteria, if Congress wishes to revisit this test it could consider adding additional forms of asset-derived income, as well as changing the threshold.

Another approach to taking into account more of taxpayers' resources would be to add certain income to their adjusted gross income when determining EIC awards. According to Joint Committee on Taxation estimates, up to \$2.1 billion could be saved in fiscal year 1997 by recognizing certain non-taxed income, as well as child support payments.

Both an EIC wealth test and an expanded definition of taxpayers' AGI make EIC more complex and add to the burden on taxpayers and IRS. Also, since income information reported on tax returns can only roughly reflect taxpayers' actual wealth, using such data to determine EIC eligibility could raise fairness questions.

Mr. Chairman, that concludes my prepared statement.

The CHAIRMAN. Thank you very much.

[The prepared statement of Ms. Willis appears in the appendix.]

The CHAIRMAN. We will conclude this morning with George Yin. Senator Moynihan, I do not know if you remember, George used to work for this committee.

Senator MOYNIHAN. Indeed. Welcome back, sir.

The CHAIRMAN. When I took over as Chairman he was here and he was the best tax person we had. I wanted to keep him desperately and academia pulled him away. I said, oh, dear, who are we going to get to replace him, until Diefendorfer said, well, we have hired some woman named Lindy Paull.

Senator MOYNIHAN. Lindy Paull. I remember her.

The CHAIRMAN. So there was a silver lining to the cloud, George, when you left. It is good to have you with us.

STATEMENT OF GEORGE K. YIN, PROFESSOR OF LAW, UNIVERSITY OF VIRGINIA SCHOOL OF LAW, CHARLOTTESVILLE, VA

Mr. YIN. Thank you, Mr. Chairman. It is good to be back. I have included in my written statement a range of reform options for the EITC for the committee's consideration.

In the few moments that I have today I would just like to discuss two ideas listed in my summary sheet as points 1 and 2-A. I would be happy, of course, to respond to any questions about any of my suggestions, as well as the basic need for reform.

My first reform suggestion is to encourage the committee to rethink the wisdom of having the EITC benefit administered through the tax system by the IRS, at least to the extent the program overlaps welfare programs.

For many years, as you know, much favorable commentary in academic circles has supported this idea, and I consider myself one who, in the past, has generally favored it.

But, after 20 years of experience with the EITC program, I think we have a nice test case of that academic theory and I find myself now thinking that, on balance, it may not be such a good idea to provide such benefits through the tax system.

The advantages of that idea are plain enough. Administrative costs are expected to be lower, we expect that providing such benefits through the tax system is thought to ease participation with a resulting higher participation rate, and it also eliminates the stigmatizing effect of receiving the benefit as a direct transfer.

But the disadvantages of delivering the welfare element of the EITC through the tax system are also becoming increasingly evident. Let me just quickly mention three of them.

First, of course, is that non-compliance is simply going to be a problem anytime you permit claimants to certify themselves as eligible for the government benefit and basically never require them to encounter any person face-to-face in making their claim.

The second reason is, the administrative costs of maintaining duplicate bureaucracies to basically accomplish the same end would seem to be wasteful from the government's standpoint. For example, as the committee knows, Congress recently enacted a wealth test for the EITC which represents an effort to estimate the recipients' overall resources.

But those who administer direct expenditure programs for the poor already have to do that, and do that in a much more precise way. Why require the IRS to duplicate that task, and not as accurately, at that?

As another example—and I think my example here, I believe, is perhaps better than the one that Senator Roth was giving—consider some of my law students. Not a retired lawyer, but a law student who works during the summer at some Wall Street law firm for 6–8 weeks. That is not uncommon. They find themselves eligible for the EITC.

Now, should they get it despite the fact of their high rate of compensation, despite the fact that they are shortly going to be making something like \$80,000 a year or more right out of law school, something I certainly never made.

The CHAIRMAN. Do they make it now?

Mr. YIN. Well, right now they are law students. Should they get it despite being supported by relatives and friends while in school, and, if not supported, despite potentially being supported by very wealthy families?

Now, let me make plain that I am not urging an anti-law student rule, although that may be the unintended result of my testimony. I am simply using it as an example to illustrate the kind of refinements that might be necessary if Congress is really interested in targeting the EITC to the truly deserving, and yet wants to maintain it through the tax system. Why require ~~this~~ duplication of effort to be undertaken by the IRS?

My final reason relates to the work incentive issue. I recently observed a low-income taxpayer being provided tax return assistance by a VITA volunteer. The woman expressed concern that, because she had had withheld only a small amount of taxes during the year, she might owe the IRS some money.

Well, after examining her situation, the VITA volunteer proceeded to inform her that she was entitled to a \$2,000 check from the IRS. Now, I wish, Mr. Chairman and members of the committee, I could describe for you the look on that woman's face.

Now, that was obviously a very pleasant piece of information for the volunteer to convey and for the taxpayer to receive. But I kept thinking about the work incentive effect of that \$2,000. Did the money have any effect on her decision to work or to continue and increase her work effort, or was it perceived simply as some windfall from the IRS gods which might, in fact, induce less work in the future?

In the few moments I have left let me mention, briefly, my second reform suggestion. If the EITC benefit is going to continue to be delivered through the tax system, I urge you to consider implementing instead a small exemption amount from the payment of Social Security taxes.

As the committee knows, the EITC originated, in part, as an effort to rebate to low-income workers the payroll taxes collected from them. Instead of collecting those taxes and then trying to return those amounts to workers in the form of the EITC, it would seem to me to make much more sense simply to refrain from collecting the payroll taxes in the first instance.

Now, there are several advantages to this. First, it would greatly simplify matters. No returns would have to be filed to get the benefit, and we could expect high participation. The link between work and the reward from working would be more evident because the benefit would come in each paycheck rather than as a year-end lump sum amount.

Finally, compliance could be expected to be high because no net benefit would be transferred from the government to the taxpayers.

One last comment. I know that some would be concerned about this proposal because it would seem to decouple the important link between Social Security contributions on the one hand, and benefits on the other.

The important thing to understand though, is that that link has already been decoupled by the EITC program. Low-income workers, in effect, pay no Social Security taxes after the EITC is taken into account. Yet, they are entitled to receive benefits. So my proposal

is simply to do exactly the same thing, but in a direct way, by simply not collecting those taxes in the first instance.

Thank you very much.

[The prepared statement of Mr. Yin appears in the appendix.]

The CHAIRMAN. What did you say, though, about the worker would notice a more immediate effect? I understand what you are saying, they are going to get it each paycheck, but would they eventually notice it or would they assume that is their pay?

Mr. YIN. If they perceive it as simply being their pay, that is fine. The important thing is, they are going to see that by working, their bottom line paycheck amount that they take home and can spend is higher, and that is exactly the reward that we want them to see to induce them to continue to work, and indeed, to work more.

The CHAIRMAN. They will see it when you initially make the changeover. How will they see it, if they are a new hire at \$14,000 a year, and you can take that into account at the time, so their paycheck was always what they get and they never realized about the credit.

Mr. YIN. Well, I think, Mr. Chairman, of course the critical step is going to be when they are first taking the job. And if the question before them is, you know, they are applying for the job and they say, well, you pay so much, but I know I have to pay so much in taxes, and blah, blah, blah, what is the bottom line? If you can tell them the bottom line is higher than it is now, it seems to me that that, in and of itself, is a very important message to induce them to take that job.

The CHAIRMAN. Yes. But is the employer not more likely to say, Mr. Yin, are you married? Yes. How many children do you have? Well, I have two children. All right. The employer thinks you are eligible for the payroll reduction, we will now call it, instead of EITC. You will be making \$15,800 a year. Now, it used to be \$14,000 and you would get a credit.

Mr. YIN. Right.

The CHAIRMAN. So the employee thinks, well, I am making \$15,800 a year. He has no awareness of any kind of government largess.

Mr. YIN. And I do not see any reason why he needs that awareness. I mean, the point is simply, we are getting him the money and we are getting him the money in a way that he can perceive that he is getting a higher reward for his work.

The CHAIRMAN. All right.

Ms. Willis, let me ask you. I sense that you are saying maybe we are being premature in judging the error rate, fraud rate, call it what you want, because we are just almost into the incubant stage of tracking this. Do I read you right?

Ms. WILLIS. Mr. Chairman, the credit has been around for some time, but until this year there has not been any real concerted effort on the part of IRS to deal with non-compliance. This year is 1 year. We do not even have the results back from the measures that were put in place. We are optimistic, based on their design.

However, until we have the actual results back, and we see how well they are implemented—and obviously implementation is as important as design—we will not know how well they functioned and what the error rate actually was.

The CHAIRMAN. Well, now, here is where I want your judgment on something, because you know we give great credence to these kind of GAO studies or comments. Are you suggesting to us that perhaps we ought to go slow because whatever past information we had probably will not be anything comparable to what we are likely to have in the next 6 months to a year?

Ms. WILLIS. We will not have an up-to-date estimate of non-compliance under current procedures until the end of the year.

The CHAIRMAN. I understand that.

Ms. WILLIS. And the last one we had was 1988, and a lot has changed. So I think to make changes based on 1988 data and a 1994 study raises some questions.

The CHAIRMAN. Thank you.

Senator D'AMATO. Mr. Chairman?

The CHAIRMAN. Yes.

Senator D'AMATO. Can I make an observation? Because I know I rely on staff. They have all of these technicalities. But you said non-compliance?

Ms. WILLIS. Yes, sir.

Senator D'AMATO. Is that a term of art? I mean, it seems to me that if we are talking about errors and fraud, that is not non-compliance. I just choose to differentiate or distinguish the term that is used. I heard non-compliance. To me, non-compliance is somebody did not do something.

The CHAIRMAN. You mean, it would be like saying for 5 years you have not paid your income tax and it is non-compliance.

Senator D'AMATO. Yes. I just have difficulty understanding the use of that term.

The CHAIRMAN. Go ahead.

Ms. WILLIS. Allow me. Senator D'Amato, IRS does not measure fraud in this particular instance. When they did their 1994 study they measured non-compliance, which includes unintentional errors, mistakes. It is a broad category. They divided out of that a category in their preliminary estimates for intentional non-compliance, which is about the closest thing that we have to a measure for fraud, but non-compliance is much bigger than fraudulent behavior.

Senator D'AMATO. All right. Very well.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Let me pursue for just a moment what Senator D'Amato has raised. One of the great distinctive features of the American revenue system is the self-assessment. The American citizen tells the government how much he/she owes and the government takes their word for it.

A British subject does not tell the Queen how much he owes her, she tells him or her and Inland Revenue makes out your income tax and says, here it is. You are free to appeal. You can appeal all you like. You can appeal for 50 years; you never win, as lawyers will tell you over there.

We have a very high compliance rate, do we not? We take samples regularly and there is a measure of fraud, but a small fraction of the population of filers pay less than they owe and about the same fraction pays more and it turns out to be because the forms are complicated. Is that not about right?

Ms. WILLIS. Well, Senator, while we have a high compliance rate based on worldwide standards, if you look at the numbers, the variation in compliance among different groups is great. We testified before the House Ways and Means Committee earlier this week to that effect. Wage earners, where you have withholding and reporting to IRS—

Senator MOYNIHAN. Again, your self-employed.

Ms. WILLIS. Yes. It gets down to where you do not have income that is readily identifiable by IRS, where there is not third-party information reporting, your compliance goes down a great deal for informal suppliers.

Senator MOYNIHAN. Well, I guess my point is, and I just want to associate myself with Senator D'Amato, if we have 28 percent non-compliance in this area where people are filing income tax returns, that is very high, is it not?

Ms. WILLIS. It is high.

Senator MOYNIHAN. Is there any other group of people who file who are so high? By definition, the people working off the books do not.

Mr. YIN?

Mr. YIN. Senator, if I could, I think, as Ms. Willis said, withholding does a lot to get the compliance rate up in the general population. In areas where there is not withholding—sole proprietors are a perfectly good example of that—I think their compliance rates are not nearly as high as for the general population. So we see a common problem, if you will. The EITC rate is clearly high, but, in selected other areas, there are also, unfortunately, high rates of non-compliance.

Senator MOYNIHAN. Mr. Greenstein?

Mr. GREENSTEIN. If I could just add here, I think this year the IRS crossed the rubicon in a sense with the EIC. It has moved away from being purely self-certification like the rest of the Tax Code, and in a sense half-way, or a part of the way in between the way the rest of the Tax Code works and the way means-tested assistance programs work.

If you look at a year ago, you could drive three Mack trucks through. They did not check all Social Security for children claiming the EIC, they did not check to see if any child was claimed twice, you could write "applied for" in some cases for a child's Social Security number. All of that has been closed off.

But what is perhaps more important, and you did not hear too much about it earlier because the IRS is somewhat reluctant to talk about it, is they have a new procedure they put in place this January based on the year-ago study, where they identify categories of EIC filers that were found in the January 1994 study to have high error rates. If you fall in that category, they pull your return and they investigate further.

Senator MOYNIHAN. Right.

Mr. GREENSTEIN. They send a form out—this is unprecedented—where they ask for additional information, accompanied by documentation that comes back in.

Senator MOYNIHAN. I have got you. This is the Los Alamos National Laboratory, with five new anomaly detection pattern recognition tools.

I would say that we did make changes in OBRA 93 that seem to be coming in effect. The Chairman made the point, if we are going to respond to this problem let us respond to the problem as it exists now rather than the one we ran into 6 years ago. But this was a little discouraging to find that much going on. Maybe we are in a new situation, and we will keep in touch with that.

Thank you, Mr. Chairman. Thank you all.

Dr. KOSTERS, did you want to say something?

Dr. KOSTERS. No, sir.

Senator MOYNIHAN. All right. Thank you.

The CHAIRMAN. Senator Rockefeller.

Senator ROCKEFELLER. Mr. Chairman, first of all, I would ask for the Chairman's indulgence. I, unfortunately, have to go give a speech, which is not, in my view, a great blessing for anybody. But I have to do that at 12:00.

Senator MOYNIHAN. Think of your audience.

Senator ROCKEFELLER. I am thinking about the audience, Senator Moynihan.

We have two nominees coming up that I really wanted to be here to talk about, to introduce and to question. One of them is Ira Shapiro, who was my first administrative assistant when I came to Washington as an entirely green Senator.

The CHAIRMAN. And you want to question him?

Senator ROCKEFELLER. Well, to his advantage.

The CHAIRMAN. All right.

Senator ROCKEFELLER. And, second, Marilyn Moon, who is up for another very important position, with whom I worked on the Pepper Commission. I would just like to put those statements in the record of that hearing, if that is all right.

The CHAIRMAN. Without objection.

Senator ROCKEFELLER. That would be it. Thank you, sir.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. I just was reviewing some of the testimony here. I thought the points that Mr. Greenstein made were extremely interesting. We have got quite a perplexing situation developing in our country where we have got an increasing number of people working for very, very low wages, comparatively speaking.

I worry about whether our society is getting divided into two groups; those who are educated and doing very well and those who, I presume through lack of education and lack of skills, are down at the bottom of the heap. Once upon a time you could get by with that if you had a strong back and a willingness to work, but that does not seem to apply anymore.

I was interested in the statistics you showed. I voted against the increase in the minimum wage, but on page two of your testimony, Mr. Greenstein, you talk about the power of the minimum wage. Did you give this in your oral testimony?

Mr. GREENSTEIN. Just for a second or two.

Senator CHAFEE. Yes. It is at its second-lowest level on a constant dollar basis, since 1955, and by next year it will be at its lowest level since 1955. I am not sure what is magic about 1955. I think it would be interesting what happened before that. But, in any event, I think that we should be concerned about this.

This is not directly related to the Earned Income Tax Credit, necessarily, although I think that the Earned Income Tax Credit has had an important mitigating effect, as you point out, in boosting the after tax income of these individuals. I know it is something that you have worried about, Senator Moynihan, and I am glad to have a chance to look at this testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Senator Moseley-Braun.

Senator CHAFEE. Yes, go ahead. I have a little time left.

Mr. GREENSTEIN. I was just going to briefly comment. In fact, if you look at the debates on the House and Senate floor, particularly when the largest EIC expansion took place—and that was not 1993, it was 1990 in the reconciliation bill—there is extensive discussion among a number of people supporting that expansion that this is a preferable way to go than raising the minimum wage. I think one can make an argument that one might not need as large an EIC as we now have if we had a higher minimum wage, or if we had a different configuration in the way AFDC works.

But, essentially, we made policy choices on a bipartisan basis over 20 years to say we are not going to use AFDC as a way to supplement the wages of the working poor; and we are going to let the minimum wage erode, and we think the EIC is a better policy instrument.

Part of my concern is if we now say, hey, the EIC is too large, we are going to cut it back, we are kind of like pulling the rug out unless we are revisiting the other policies at the same time, which I do not see us doing.

Senator CHAFEE. Well, I think it is important that we consider all of these things, the minimum wage, the Earned Income Tax Credit, the AFDC. They all, as you point out, tie together. That has been helpful to me.

The CHAIRMAN. Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman.

I would like to pick up a little bit on the point that Senator D'Amato raised when he talked about the non-compliance word, and Ms. Willis was, I think, very clear in pointing out that there is a distinction between non-compliance and fraud.

It may be, since we do not yet have an adequate measure of which is which, we are kind of groping as to how much of the non-compliance is actually fraud, inadvertent error, or error just from the administration of the program.

So I would like to focus in on the latter part, which is the administration of the program issue. Professor Yin, in his written statement, had a number of suggestions, the second of which was to require that the EIC be calculated based on earnings that are reported on the W-2 form only. I think that, in some regards, that may respond to Senator Roth's concern about people, the lawyers that you mention work 100 hours a year.

If it were limited or required that the only income to qualify would be that income reported on W-2 forms, that might be a procedural step in the direction of addressing the non-compliance issues or what is perceived as fraud in the administration of the program.

Really, I guess I am posing the question to the panel, do you see that the suggestion of using the W-2 form as a means of verification, that that would reduce the allegations and the concern about fraud in the administration of this program?

Ms. WILLIS. Senator, I would like to respond to that. IRS currently matches the W-2 information to the EIC returns.

Senator MOSELEY-BRAUN. After the fact.

Ms. WILLIS. After the fact.

Senator MOSELEY-BRAUN. Right.

Ms. WILLIS. Because they do not have technology to do it in a more timely fashion. So, until they have the technology, the capability to do it more timely, to tie the refund—and I am not saying that we would not support this—or tie the EIC to W-2 matching would delay it by several months in terms of the people receiving it. It also would eliminate from the program those people who are not wage earners, the people who are self-employed individuals who do not have W-2s to file.

Mr. GREENSTEIN. If I could add a note here, one would need to weigh, as Lynda just said, the degree of the delay against the degree of improvement it would give you, the longer the delay the less the perceived tie to work and the less the work incentive effect.

But I really wanted to make a related point, which is, to the degree that IRS can move forward with tax system modernization, that will help enable a number of mechanisms such as this to be done on the compliance front and substantially reduce error rates further.

It has been a disappointment to me that in the appropriations process in recent years the IRS's requests for tax system modernization have been chopped back. The IRS's computer systems are not what they need to be to administer these kinds of systems and we badly need to get that modernization in effect so that we can move to more matching systems. The more that they are computerized, the more matching we can do on a timely basis, the lower we will get that error rate.

The CHAIRMAN. Senator Roth, then Senator D'Amato.

Senator MOSELEY-BRAUN. Mr. Chairman, I did not get a chance to hear from Professor Yin, whose suggestion it was in the first instance. If you would not mind, I would like to hear his response.

The CHAIRMAN. George?

Mr. YIN. Thank you, Mr. Chairman. Thank you, Senator Moseley-Braun.

I would just like to make one comment about the delay aspect. I think I would certainly concede that until the IRS has the mechanisms in place to be able to do the matching prior to sending out the money, you are going to have some amount of delay. I guess Ms. Willis said it would be a few months in time, and perhaps that is correct.

But I think, in a sense, that delay is kind of an odd concern on the part of the committee, and the reason why is that, as I am sure the Senator knows, there is another procedure to get the EIC during the course of the year. It is called the Advance Earned Income Credit program, where taxpayers can apply and actually get little bits of the EIC each month in their paycheck. Very few taxpayers subscribe to that program.

Now, there are a lot of reasons for that. I assume many of them do not know about it. There are all kinds of reasons. But certainly one reason I think many analysts have suggested is that taxpayers are affirmatively electing to get the money in a lump sum, just as many taxpayers who pay taxes affirmatively elect to overpay their taxes during the year so they get a refund back at the end of the year, so this is very common.

Now, if that is the case, then it seems to me, you know, the concern about, well, delaying that lump sum which they have electively chosen to already delay a year, if delaying it another two or 3 months to get a handle on the non-compliance issue, it seems to me that, yes, it is a concern, but I would not consider it an over-riding concern.

The CHAIRMAN. Senator Roth.

Senator ROTH. I would, first, say to my distinguished colleague from Illinois that, as part of my bill, I do have matching of the W-2 forms as part of a change.

I think we all agree that certain steps that have been taken by the Internal Revenue Service hopefully will provide increased compliance. At the same time, I think there is fairly broad consensus also that, as we raise the credit to 40 percent, it increases the incentive for fraud. Would you agree with that, Professor Yin?

Mr. YIN. Yes, most definitely. In that regard, I would tend to disagree with those who have suggested that the recommendation to freeze EIC levels at 1995 levels, or what have you, is unrelated to fraud and non-compliance generally.

I will say that, at least in my view, all of these are second-best solutions. I think there are first-best solutions, as I mentioned in my testimony. But if you are going to continue the program as it is now, you are not going to make the kind of more major reform that I would view as more of a first-best solution, then I think freezing it at 1995 levels, or, indeed, I would even suggest reducing it even a little bit further, will have a positive impact on the non-compliance rate.

Now, does that mean there are some deserving people who are going to get less money than they should? Yes, definitely. Are we concerned about that? Yes, of course. I am very concerned about it, and I assume every member of the committee is concerned about it.

But there is a balance here, and the balance is simply getting the money to deserving people, but trying to stop sending money to those who are not deserving. It seems to me, a proper balance would be to cut back on the size of the program somewhat.

Mr. GREENSTEIN. Could I add a word on that?

Senator ROTH. I have limited time.

Ms. Willis, we have had a number of calls from the IRS regarding concerns that they have about the IRS. One report was about some EITC refund claims that came from likely illegal aliens, another call was from an investigator who was helping to research the fraud and error rates of the EITC. He told us a story about the taxpayer and how, even though the taxpayer clearly had filed a fraudulent return, the IRS and Justice Department decided to pay the refund rather than fight it in court.

Now, I would like to have you advise me about those cases. One of my concerns is, if that is our approach to enforcement, is that not going to increasingly invite fraud? I mean, it is, of course, a difficult and expensive process to pursue one of these cases. On the other hand, we have had widespread non-compliance. Could you comment?

Ms. WILLIS. Senator, while the statute under which we have access prohibits us from discussing individual cases, what I can say is that when you have inconsistent application and when the compliance efforts are not provided across the board, you have more of an incentive for people to be non-compliant.

I think that is one of the reasons why IRS needs to be as efficient as possible and make sure that it is able to follow up on, and has the resources to look at, those cases and track them through.

Senator ROTH. Well, my time is up.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

I am wondering if Professor Yin could help me. First of all, I am intrigued, and it seemed to me that he offered a methodology of dealing with the non-compliance issue. See, I can learn to use those technical phrases. That would be—and if I am wrong, Professor, I want you to tell me that—to have people who fall within the ability to claim an Earned Income Tax Credit not to pay those dollars in to the system. I guess most of them come from the FICA tax, is that right?

Mr. YIN. Yes, that is correct.

Senator D'AMATO. So that if you are going to qualify, let us say for the particular circumstance of the taxpayer that would get an Earned Income Tax Credit refund of \$1,000, let us say, they just would not pay that \$1,000 in, whether it would be through the income tax or the FICA system, right?

Mr. YIN. Well, that is right. I do not know how the numbers would play out, but the notion is that some part of that \$1,000 check that they are getting is a reimbursement to them of the FICA taxes that were withheld out of every paycheck, just like all working Americans.

Senator D'AMATO. Now, would you not then just about eliminate all of the so called non-compliance?

Mr. YIN. Well, I would not go that far.

Senator D'AMATO. Well, again, you certainly would not add, you would reduce this dramatically.

Mr. YIN. Yes, absolutely. Well, I believe that to be the case.

Senator D'AMATO. Now, the advantage to that is, the people are getting their money immediately. They are not waiting. Politicians will not like it because they do not get the opportunity to send a check out and say, ha, ha, look what I am giving you. They are not giving them anything, they are giving them back the money that we said they should be able to keep because they should not be paying taxes if they are earning at a certain level.

Now, there is one complicating factor—there may be more, but least in my own myopic view that I see—and that would be if you are taking money from what would otherwise go into the Social Security fund, it would seem to me that that is simple. That is just a mechanical transaction at the end of the year.

Let us suppose there was \$5 billion that came from FICA. You would just take the money from the general Treasury, which you do now, and instead of sending it out in all these little checks and then those in office get this great kick because, you know, ha, ha, I sent you a check. Right?

Mr. YIN. Yes. The Senator is absolutely right.

Senator D'AMATO. They would just transfer that \$5 billion, let us say, from the general Treasury into the Social Security system.

Mr. YIN. The Senator is absolutely right. The EITC program obviously costs a substantial amount of money, and all we are saying is, shift that money over to the Social Security trust system to make sure that that system remains as solvent as it is now.

Senator D'AMATO. So, Mr. Chairman, there are probably some other wrinkles, but it would seem to me that that might be a manner by which to substantially aid in compliance and we meet the objectives and the philosophy of encouraging working people to work. In other words, do not put that tax on them.

Mr. GREENSTEIN. I was just going to say, there are a few other wrinkles that are tricky. For example, if you simply say we are not going to collect a certain amount of the payroll tax, you would end up probably significantly increasing the effective benefit from what you are replacing the Earned Income Tax Credit with for workers without children—employers do not know people's filing status—and you would be reducing it for families with children.

Another issue, is the way the current Earned Income Credit is structured in order to encourage work. For families with two or more children, it is a 40 percent credit up to about \$9,000, meaning that since you pay about 15 percent in payroll tax and you lose 24 percent in food stamps for each additional dollar you earn, this is designed to offset that to keep those work incentives high and draw people into the labor market. You would have less of that under this effect.

The final issue, is that unless you had some mechanism, and I do not know how the employer would know the total income of the filing unit, the employer would not know other earners in the filing unit, so if you simply said the first \$10,000 in earnings are not subject to the payroll tax for anybody, you would have substantial tax cuts for people at \$100,000 or \$200,000 a year in your effort to deal with issues for people with \$10,000 or \$15,000 a year. So, I think this would be a very complicated shift that would have a lot of wrinkles in it.

The CHAIRMAN. There is nothing that is wrinkled.

Senator D'AMATO. I said it was a little simplistic. But, anyway, thank you Mr. Chairman.

The CHAIRMAN. Folks, thank you very, very much. You were very patient while we went through the first panel. Thank you.

[Whereupon, at 12:15 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF ROBERT GREENSTEIN

I appreciate the opportunity to testify before the Committee today. I am executive director of the Center on Budget and Policy Priorities, a non-profit public policy organization that examines federal and state fiscal policies with an emphasis on policies affecting low- and moderate-income families. Funded by foundations, the Center has been engaged in analyzing issues related to the earned income credit for a number of years. Last year, I also served as a member of the Bipartisan Commission on Entitlement and Tax Reform.

In my testimony today, I would like to make several points.

- The EITC's biggest problem involves error rates. Progress in reducing errors was made in the 1990 reconciliation bill, but more needs to be done. In the last several months, the IRS has taken some badly needed and overdue steps that hold promise for making significant reductions in error rates. Legislation that the Treasury Department submitted with the budget also should help reduce errors.
- While seeking to reduce EITC error rate problems, we also should be mindful that the EITC has considerable strengths. It addresses one of the key trends that has caused a substantial increase in child poverty in recent years, the erosion of wages for low-paid work. It also helps substantially in making work more remunerative than welfare. It is an important building block for welfare reform that places some limitations on cash assistance and seeks to move families to work.
- Certain reforms in the EITC eligibility structure are desirable. The imposition earlier this year of a "wealth test" on the EITC was a sound move. Some additional types of income should probably be counted in determining whether a filer meets this test. Proposals to bar EITC receipt for tax filers in which either the parent or the qualifying child is residing here illegally also should be enacted.
- Some proposals, however, need to be regarded with considerable caution and would be unwise. A proposal to end the indexing of the EITC, for example, would cause large increases over time in the tax burdens of millions of low-income working families whose wages are simply keeping pace with inflation and would conflict with the goals of work-based welfare reform. Rolling back the EITC changes enacted in 1993 also would be undesirable, reducing the advantages of work over welfare, making it more difficult for workers to escape poverty, and raising tax burdens for some.

In short, we need to be mindful of the strengths of the EITC as well as of the areas where it has weaknesses that need strengthening. We need to improve the integrity of the EITC, but we need to do so in ways that do not lessen the credit's positive effects.

THE BASIS FOR THE EITC

The need for, and growth of, the EITC in recent years is closely related to the erosion of wages for low-paid work. Between 1977 and 1993, the poverty rate for families with children in which the family head works grew by nearly half. In 1977, some 7.7 percent of such families were poor; by 1993, some 11.3 percent were. More than 60 percent of all poor families with children contain a worker.

Moreover, a study by Northwestern University economist Rebecca Blank, a former staff member of the President's Council of Economic Advisers in the late 1980s, found that wage erosion exceeded all other factors in importance in explaining why

poverty rates did not decline more during the economic recovery of the 1980s. In addition, Census data show that the proportion of full-time year-round workers paid a wage too low to lift a family of four to the poverty line rose by one-third between 1979 and 1993, from 12 percent of full-time year-round workers in 1979 to 16 percent in 1993.

Eroding wages for low-skilled work reduce living standards and increase child poverty. They also lessen incentives to work and decrease the gains from working relative to receiving welfare. Starting in the mid-1980s, these trends led to a bipartisan policy emphasis on increasing the remuneration from low-wage work, with the EITC as the principal policy instrument for accomplishing the task.

President Reagan proposed a major EITC expansion in 1985, which was included in the 1986 Tax Reform Act. Congress passed a further expansion in 1990, with strong support from the Bush Administration. President Clinton proposed a final expansion that Congress passed in 1993.

These expansions signaled an increased reliance on the EITC and a decreased reliance on the minimum wage as an instrument of wage policy. The purchasing power of the minimum wage is now at its second lowest level since 1955. By next year, it will be at its lowest level since 1955.¹

These expansions also reflected another policy shift the EITC has supplanted AFDC as a means for supplementing the wages of poor single parents with children. In 1972, before the EITC was created, 49 states provided AFDC as a wage supplement to a mother with two children whose earnings equal 75 percent of the poverty line. Today, just three states do. Policymakers have largely opted to move these families out of the welfare system and instead to reward their work effort through the EITC.

The EITC expansions also were designed to help offset the effects of a series of increases in the payroll tax. One of the EITC's purposes has always been to help offset regressive payroll taxes. Payroll tax hikes took effect in 1980, 1981, 1982, 1984, 1985, 1986, 1988, and 1990.

Similarly, the EITC expansions also were intended to help offset increases in regressive excise taxes. Excise taxes were most recently raised in 1990 and 1993.

Finally, the EITC expansions were designed to attain a goal that has enjoyed strong bipartisan support that if a parent works full-time year-round, the parent should not have to raise his or her children in poverty. This goal has been espoused across the political spectrum. For example, the volume that the Heritage Foundation published in January 1989 to guide the incoming Bush Administration called for expanding the EITC sufficiently to bring families of four with a full-time worker to the poverty line.

Specifically, this goal is that wages from full-time year-round work at the minimum wage (net of payroll taxes) should lift a family of four to the poverty threshold when combined with the EITC and food stamps. When the 1993 EITC expansions are phased in fully, the nation will be close to attaining this goal and would reach it with a modest increase in the minimum wage.

EITC growth rates over the past decade thus do not reflect unanticipated cost increases; the rate of recent EITC growth is due to explicit policy decisions by Congress and three Presidents to expand the credit for the reasons just cited. Nor do the recent growth rates signify that the program is spinning out of control. Once the EITC expansions phase in fully, EITC growth will slow sharply to a little more than four percent per year.

¹ Over time, too much pressure will be placed on the EITC if it has to carry all of this load and the value of the minimum wage continues to erode. A modest strengthening of the minimum wage would be desirable.

IS THE EITC OUT OF CONTROL?

Some have said that EITC costs are rising uncontrollably. A budget task force headed by Senator Judd Gregg stated in a March 1995 report that the EITC is "out of control" and that there will be "significant long-term fiscal hemorrhaging unless action is taken to contain [the EITC]" and to "restrain its unsustainable rates of growth."

The EITC was expanded both at the request of President Reagan in 1986 and on a bipartisan basis with strong support from President Bush and Congressional leaders of both parties in 1990. President Clinton proposed a final expansion in 1993. The 1986 and 1990 expansions each phased in over several years, creating high rates of EITC growth in the late 1980s and early 1990s. Similarly, the 1993 expansion is phasing in now.

Once the 1993 expansion is phased in fully, substantial EITC growth will halt. The Congressional Budget Office forecasts that after 1997, the EITC will grow at a rate of less than 4.5 percent per year. This modest growth is due to inflation and population growth, and it will be smaller if the Consumer Price Index is modified in a fashion that reduces the measured inflation rate. Even without changes in the CPI, the CBO forecast indicates that as a percentage of the Gross Domestic Product, EITC costs will *decline* after 1997. Thus, the EITC will not contribute to projected long-term increases in the deficit as a percentage of the Gross Domestic Product. This is very different from the situation in programs such as Medicare and Medicaid where rapid rates of growth persist indefinitely and do not result primarily from specific federal decisions to expand the programs.

Moreover, the EITC expansions do not look quite so large when placed alongside the near-elimination of AFDC as a wage supplement to single mothers working at least half-time and the large drop in the buying power of the minimum wage. An analysis conducted by the Department of Health and Human Services shows that when the EITC expansion enacted in 1993 is phased in fully, the disposable income of a mother with two children who works half-time throughout the year at the minimum wage will be nearly \$3,000 lower than it was in 1972, after adjusting for inflation. (Disposable income includes wages, AFDC, food stamps, and the EITC, minus federal income and payroll taxes.²)

The HHS analysis found similar results for single parents with two children who work 30 hours a week throughout the year at the minimum wage as well as for those working 40 hours a week. (See Table 1.) In both cases, the family's disposable income will be at least \$1,500 below 1972 levels, after adjusting for inflation, when the 1993 EITC expansions take full effect. In short, single parents working at the minimum wage will have less disposable income than they did in the early 1970s before the EITC was created.

²These figures reflect average weighted AFDC benefits across the 50 states. Figures for 1972 are adjusted for inflation using the CPI-U-X1 rather than the regular CPI, which rises more rapidly. Had the regular CPI been used, the decline in disposable income would have been even larger. All figures are expressed in 1994 dollars.

Table 1

**Average Disposable Income For a Mother and Two Children
From Wages, AFDC, Food Stamps, EIC, and Federal Taxes
(in 1994 dollars)**

Number of Hours Worked Per Week At Minimum Wage Throughout the Year

| Year | 20 Hours | 30 Hours | 40 Hours |
|--|------------------|------------------|------------------|
| 1972 | \$13,827 | \$14,976 | \$16,057 |
| 1980 | 11,772 | 13,199 | 14,145 |
| 1990 | 10,082 | 10,735 | 11,804 |
| 1995 (with EIC at fully phased-in 1996 levels) | 10,925 | 12,505 | 14,462 |
| Change in Average Disposable Income for a Mother and Two Children | | | |
| 1972-1995 | -\$2,902 -21% | -\$2,471 -16% | -\$1,595 -13% |

Source: Department of Health and Human Services

The EITC expansions thus should be seen as part of a larger set of economic and policy developments. Economic forces pushing down wages for low-skilled work, combined with policy decisions in the minimum wage and AFDC areas, confronted policymakers with a need to increase the EITC substantially to avoid large reductions in the living standards of working poor and near-poor families with children.

BENEFICIAL ASPECTS OF THE EITC

The 1986, 1990, and 1993 EITC expansions reflected decisions to help cushion the erosion of wages for low-paid work, while placing less emphasis on the minimum wage and AFDC as mechanisms to accomplish this goal. The expansions also reflected the desire of policymakers to make work more remunerative than welfare and bring families with a full-time working parent closer to the poverty line. Finally, these expansions reflected a recognition that with its faults, the EITC remains one of the soundest of the low-income transfer programs.

In designing means-tested programs, policymakers face a dilemma. If a means-tested benefit phases out as a household's income rises, the program inevitably will create some work disincentive effects (since the benefit will decline as earnings rise) and probably also some marriage penalties (since some single workers who have incomes low enough to qualify may become ineligible if they marry and their income rises). These effects can be avoided if the benefit is made available at all income levels, with no reductions in the benefit as income rises, but that would make the benefit prohibitively expensive. Policymakers thus face trade-offs in designing means-tested programs.

The EITC differs from most other means-tested transfer programs in two crucial respects. First, it is limited to those who work; those who do not work may not receive it. It thus helps to make work more remunerative than non-work rather than the other way around.

Second, unlike welfare benefits that decline as soon as income begin to rise and can thereby discourage people from entering the labor force the EITC increases as earnings rise up to \$8,900 (for a family with at least two children). It does not begin to decline until a family's income surpasses \$11,620 (in 1996) and then declines much more gradually as earnings rise than public assistance benefits do.

Moreover, the major EITC benefit the EITC for families with children is limited to parents that live with their children. Absent parents do not receive major EITC benefits.

The result is that the EITC rewards work and encourages those who are not working to enter the labor market. It also distinguishes the working poor from the non-working poor and custodial parents from absent parents. As Gary Burtless of the Brookings Institution has noted, the EITC probably has stronger beneficial effects and more modest adverse side-effects than most or all other programs to boost the incomes of low-income families.

CURRENT EITC ISSUES

I would like to turn to several current issues relating to the EITC. These include questions relating to error and fraud in the credit, work incentives, and marriage penalties.

EITC ERROR RATES

EITC error rates are too high and need to be brought down. In discussing efforts to reduce error, I would offer a caveat. Congress needs to be careful not to institute reforms that make the EITC significantly more complicated for taxpayers and the IRS. Congress also should avoid changes that the IRS cannot administer or enforce. Such steps would be likely to increase the error rate further.

We need to be mindful both of the progress that has been made in reducing error rates as well as of the task that remains. In 1990, staff of the Senate Finance Committee, the House Ways and Means Committee, the Treasury, and IRS worked on a bipartisan basis to craft reforms to reduce the error rate. These reforms were enacted into law in that year's reconciliation bill.

The changes made in 1990 included a major overhaul and simplification of EITC eligibility rules, including the elimination of complex rules that were responsible for a significant share of the errors prior to 1990. (As a result, data on EITC error rates for years before 1990 do not reflect current conditions.) The 1990 reforms also included the introduction of a new form—Schedule EIC—that taxpayers must file to receive the credit and that provides the IRS with key information relevant to EITC eligibility it had not previously obtained. Today, the IRS denies the credit to families that do not file Schedule EIC; in the past, it awarded the credit to families that appeared eligible whether the families indicated they were applying for the EITC or not.

These changes were significant. The IRS audits in 1985 and 1988 that found the EITC error rate to be high discovered that one of the principal reasons for the high error rate lay in a series of arcane IRS rules on household filing status that few low-income families could understand and that the IRS could not enforce.³

The EITC law was rewritten in 1990 to address these problems. The 1990 law dropped the complex test and arcane rules that were largely unenforceable, replacing them with new rules the IRS could administer. In September 1993, the GAO commented favorably on these changes, noting that "OBRA 1990 resolved the major administrative problems associated with complicated filing status and dependency determinations . . ." The GAO added that "The OBRA changes made it easier for IRS to administer the basic credit because there are no longer different eligibility rules for different filing statuses . . . Because this issue was the largest source of taxpayer errors in the pre-OBRA period, the change should substantially reduce the number of erroneous EITC claims."⁴

The changes in the 1990 law also led to a new requirement that families file Schedule EIC to obtain the credit. Prior to 1991, families needed only to file the 1040 or 1040A form to get the EITC. No specific EITC questions had to be answered, and no EITC-specific information provided. The EITC worksheet the IRS had designed was printed in the instructions section of the 1040 and 1040A tax booklets and was not submitted to the IRS. The result was that IRS did not receive some basic information needed to make accurate EITC eligibility determinations.

The changes enacted in 1990, however, addressed only part of the problem. Much more remained to be done. This was shown by a frequently cited, but sometimes misunderstood, IRS study of tax returns filed in January 1994.

³Under these rules, a single parent with children could legally file as a head-of-household only if she provided more than half of her household's support. In determining whether she provided more than half of the household's support, the parent was supposed to calculate the household's total support and include in it any AFDC payments, child support payments, and the like the family received. The parent was then supposed to calculate the portion of overall household support that she herself provided, and in so doing, the parent was not supposed to count any income from AFDC or other public benefit payments. Similarly, the parent was not supposed to count, as support she provided, any child support payments she received. If, after completing these calculations, a single parent found that more than 50 percent of the household's support came from sources other than herself, she was supposed to submit her tax return as a single filer rather than as a head-of-household.

Most parents assume a single filer is someone who lives on his or her own, not a parent who heads a family with children. As a result, large numbers of single parents who were supposed to file as single filers submitted their returns as heads-of-households instead. This contributed to EITC error rates since heads-of-households were eligible for the credit but single filers were not.

⁴General Accounting Office, *Earned Income Tax Credit: Design and Administration Could be Improved*, September 1993, pp. 58-59.

The IRS study found that approximately 25 percent of the EITC benefits claimed by those whose returns were examined were claimed in error. This does not mean, however, that the EITC loss rate was 25 percent. The IRS found that about 25 percent of the EITC benefits claimed on the tax returns it examined were claimed in error, not that 25 percent of the benefits actually paid were erroneous. The IRS detects some erroneous claims made on tax returns and avoids making overpayments on them. Hence, the actual overpayment rate in January 1994 would have been somewhat lower than 25 percent. (In other means-tested programs that collect data on error rates, the error rate is the percentage of benefits paid in error, not the percentage of benefits erroneously claimed on program applications.)

Unfortunately, the IRS study was not designed to determine what proportion of EITC benefits actually were issued in error. The IRS conducted the study to determine the extent and nature of erroneous claims on tax returns so it could deploy its resources most effectively in processing the returns and catching the errors.

The 25 percent figure may also overstate the error rate in January 1994 for another reason. The 1,000 tax returns examined in the study were not representative of EITC returns filed in 1994. The returns examined in the study were limited to returns filed electronically during the first two weeks of the 1994 tax filing season. Electronic filing has been more susceptible to refund fraud than conventional tax filing, and some families that file in January do so before they have received all of their W-2 forms. In addition, some of the characteristics of the 1,000 filers examined in the study do not match those of EITC filers overall. Many experts believe that EITC error and fraud are likely to have been higher among returns filed electronically in the first two weeks of the filing season than among EITC returns overall.

RECENT ACTIONS TO COMBAT ERROR AND FRAUD

Since the time the study was conducted, the IRS has instituted a series of new procedures to address problems the January 1994 study identified. A new study is in progress to measure the effect of these procedures.

In 1994, the IRS checked little of the information on tax returns containing an EITC claim before sending out EITC checks. That has now changed sharply. In addition to verifying the Social Security numbers of all adults claiming the EITC, the IRS now also verifies the numbers of all children in EITC families before sending EITC payments to make sure the claims are valid and no child is claimed twice. (In 1994, the IRS did some checking of Social Security numbers, but the checking was less rigorous and less comprehensive. For example, last year the IRS did not check to ensure that no child was claimed twice, and on many returns, the IRS did not verify children's Social Security numbers at all.) The IRS also now pulls EITC returns falling into any of several error-prone categories, sends these families a questionnaire, and requires families to provide additional documentation verifying their claims before payment is made.

Several million EITC returns have been delayed this year due to apparent discrepancies found in Social Security numbers or while EITC claims are verified. Nothing remotely on this scale has been done before.

In addition, during the first half of the 1994 tax filing season when the study was conducted, some filers could claim that they had applied for Social Security numbers for their children but had not yet received the numbers. These filers could still be awarded the EITC. This procedure created an opportunity for abuse. It has since been fixed. Today, such EITC claims are denied.

Also, the GATT legislation enacted last fall includes a provision requiring Social Security numbers for infants who are claimed on a tax return. Until now, parents have not had to provide Social Security numbers for children under the age of one. This new provision, which takes effect in tax year 1995, will eliminate another potential problem area. To the extent that some problems involving Social Security numbers may remain, they would apparently be resolved by legislation the Treasury Department has submitted to Congress to strengthen the IRS' powers to deny questionable EITC claims.

Finally, the IRS has altered procedures relating to "refund anticipation loans." In the past, EITC applicants that used a commercial tax preparer were usually able to walk out the door with a check in the amount of their EITC benefit within a couple of days after they filed their tax return. Under the new procedures, checks are no longer provided on such a rapid basis, and use of refund anticipation loans apparently has fallen sharply. Those attempting to abuse the system who sought in the past to "take the money and run" can no longer do so. As the IRS Commissioner has noted, until this year refund fraud schemes were assisted by the easy availability of refund anticipation loans.

Several conclusions emerge from this discussion. First, error rates found in studies of the EITC during the 1980s do not reflect current conditions in the EITC. They portray conditions before both the changes enacted in 1990 and the further changes the IRS instituted this year.

Second, the move this year to check and verify various items of EITC eligibility before payment is made represents an important change in handling the EITC. Prior to 1991, the IRS did not even get the basic EITC eligibility information now contained on Schedule EIC. Until this year, the IRS made limited use of the information it did receive before it made EITC payments. This has now changed in important ways.

In my view, these changes are likely to have a significant effect. In most means-tested benefit programs such as AFDC and food stamps, experience has shown that error rates are higher when little verification is done and that verification can lower error rates substantially. In my own experience as Administrator of the Food and Nutrition Service at USDA in the late 1970s, my agency and the Inspector General found that where verification was lax, error rates were elevated. The Inspector General and the agency I headed often directed states with high error rates to expand efforts to verify information on applications. We consistently found this caused error rates to fall. I believe the same results will be found to result from the new IRS procedures.

THE EITC AND WORK INCENTIVES

Important issues are sometimes raised about the EITC and work incentives. Based on economic theory, it is generally assumed that the EITC encourages work among those working little or not at all.

It is also assumed that the credit acts as a modest work disincentive for other families, primarily those whose income exceeds \$11,620 (in 1996) and whose EITC benefits are consequently reduced as their earnings rise.

The issues relating to the credit's effects on work incentives are sometimes misunderstood. The effect of the EITC on the level of work performed by families whose incomes exceed \$11,620 is not clear. For the EITC to discourage these families from working more, the affected families would need to understand how the EITC is reduced as their earnings rise that is, they would need to be cognizant of the EITC's effect on their "marginal tax rate." It is not clear that many families know this.

Furthermore, if the EITC does have some work disincentive effects on families whose EITC benefit falls as their earnings increase, these effects may not be adverse from society's standpoint. Both Robert Reischauer, then the director of the Congressional Budget Office, and Henry Aaron, Director of Economic Studies at the Brookings Institution, emphasized this point at an American Enterprise Institute symposium on the EITC in 1990. Reischauer and Aaron noted that the families the EITC encourages to work more are likely to be quite different from the families the EITC may encourage to work less. The families encouraged to work more are heavily made up of single parents who work little if at all, precisely the group whose work effort we most want to boost. By contrast, the families whose EITC benefits decline as their earnings rise families with incomes over \$11,620 include large numbers of two-parent families. Reischauer and Aaron stressed that a major part of the EITC's probable effect in inducing modestly less work among families in this income range is its effect in enabling a parent usually the mother in two-parent working families to work a little less so she can spend more time with her children.

Reischauer emphasized that this should not necessarily be regarded as an adverse outcome and that it may be desirable from society's standpoint for a parent in two-parent working families to be able to spend more time with her children. He cautioned that lumping increased work effort among single mothers who otherwise would work little or not at all with reduced work effort among married mothers in two-parent working families who wish to spend more time with their children can confuse rather than illuminate debates on the EITC's effects.

Reischauer and Aaron's point is supported by academic research and a General Accounting Office analysis. The GAO estimated that the percentage reduction in hours worked as a result of the EITC is four times greater among wives in two-parent families than among husbands in such families. In addition, the GAO's estimates showed little percentage change in work effort among single parents.⁶

In addition, the GAO and earlier studies examined the EITC's effects on those already in the labor force. New research by one of the nation's leading EITC experts, Professor John Karl Scholz of the University of Wisconsin, indicates that the EITC

⁶ General Accounting Office, *Earned Income Tax Credit: Design and Administration Could Be Improved*, September 1993.

has a strong positive effect in inducing single mothers outside the labor force to enter the labor force and begin working. The research suggests that the increase in the number of hours worked by parents whom the 1993 EITC expansions will draw into the labor force will exceed the decrease in hours worked by those (principally wives in two-parent families) who may work somewhat less because of the expansion.⁶

Another recent piece of recent academic research, examining the EITC's effects on work effort among single mothers, produced similar results. It concluded that the EITC succeeds in increasing work among single mothers who previously have been out of the labor force and accomplishes this without diminishing work effort among single mothers whose EITC benefits decline as their earnings rise.⁷

THE EITC AND MARRIAGE PENALTIES

The issue of the EITC and marriage penalties is another complex area. The EITC penalizes marriage for some and rewards it for others. It does not represent an unambiguous marriage penalty.

The most common example in which the EITC can penalize marriage involves a single working mother with one child who is considering marrying a man who earns modest wages but does not live with a child or receive the EITC. The EITC that such a couple would receive if they marry could be lower than the EITC the mother currently gets. If a single mother with one child who earns \$5,000 working part-time marries a man earning \$10,000, the EITC benefit in 1996 would drop \$82.⁸ If she marries a man earning \$15,000, the EITC would decline \$881.

If the mother earning \$5,000 has two children, marrying a man earning \$15,000 would cause a smaller EITC loss about \$200. And if such a mother marries a man earning \$10,000, the EITC benefit would increase about \$850.

On the other hand, if the mother earns \$10,000 herself and has two children, the EITC benefit loss becomes larger. For example, if she marries a man earning \$10,000, the loss is \$1,760.

The EITC thus can penalize marriage. It also can reward marriage substantially. The EITC offers a sizable marriage incentive to a single mother who has no earnings and receives AFDC. Since marriage is one of the principal routes out of welfare, it is particularly important to encourage marriage among this group.

In the absence of the EITC, a non-working mother on AFDC who contemplates marrying a man with low earnings risks losing a great deal. If she marries, she and her children will become ineligible for AFDC and also lose some of their food stamps. In addition, she likely will become ineligible for Medicaid. Depending on her children's ages and her husband's earnings, some or all of her children may lose Medicaid coverage as well. The marriage penalties embedded in the welfare system are strong.

The EITC helps to offset these losses and ease these penalties. By marrying, the couple will gain an EITC benefit of up to \$2,157 if they have one child and up to \$3,564 if they have two or more children (when the 1993 expansions phase in fully). This will partially and in some states, wholly make up for the mother's loss of AFDC benefits when she marries.

For poor single mothers with little or no earnings, the EITC thus significantly lessens the marriage penalties the welfare system creates. It can provide these women an incentive to marry and leave welfare. This point is sometimes overlooked when the EITC and its effects on marriage are discussed. It is not accurate to speak of the EITC as simply penalizing marriage. It penalizes it for some and rewards it for others, including the group for which there is the greatest concern for encouraging marriage, single mothers on welfare.

Proposals to Alter the EITC

In the last six months, two pieces of legislation have been enacted that tighten the EITC, weeding out families with a limited need for it and enabling stronger actions to be taken to curb errors and fraud. Legislation passed last fall in connection with ratification of the GATT treaty included provisions to bar nonresident aliens from receiving the EITC. Previously, some of these individuals could qualify based

⁶ John Karl Scholz (University of Wisconsin, Madison), testimony before the Senate Committee on Governmental Affairs, April 5, 1996; and Stacey Dickert, Scott Houser, and John Karl Scholz (University of Wisconsin, Madison), "The Earned Income Tax Credit and Transfer Programs; A Study of Labor Market and Program Participation," November, 1994.

⁷ Nada Eissa (University of California, Berkeley) and Jeffrey B. Liebman (Harvard University), "Labor Supply Response to the Earned Income Tax Credit," December, 1994.

⁸ All figures in this analysis are for 1996, when the EITC expansions enacted in 1993 are phased in fully.

on their earnings in the United States, even though they could have additional income outside the United States about which the Internal Revenue Service had no knowledge. The GATT legislation also required Social Security numbers to be provided for children under age one so a tax filer could not claim the EITC (or a larger personal exemption) on behalf of a fictitious infant.

Second, legislation enacted in April 1995 made households ineligible for the EITC if they have more than \$2,350 in income from interest dividends, rents and royalties, and tax-exempt interest. This provision is designed to eliminate EITC benefits for households with substantial assets. Between them, these two pieces of legislation reduced EITC costs by several billion dollars over five years.

Some additional steps would be useful in reducing errors. In particular, legislation the Treasury Department has submitted to strengthen the IRS' ability to deny questionable EITC claims would represent an important addition to IRS' error-fighting arsenal.

In addition, the IRS is currently conducting a study of EITC errors in tax returns filed in 1995. These findings should lead to additional administrative actions to combat errors and may also suggest some additional legislative steps that might be taken.

It also may make sense to consider a proposal made several years ago by Senator Packwood to modify the rules for claiming the personal exemption for a child so they match the rules for determining when a child is a "qualifying child" for EITC purposes. Under current law, some parents can claim a child for the personal exemption but not for the EITC. Other parents may claim a child for EITC purposes but not for the personal exemption. The inconsistencies in federal tax law between the rules for claiming the personal exemption and the rules for claiming the EITC cause errors in both areas of the tax code. I believe the General Accounting Office has recommended conforming the rules governing the personal exemption for a child to match those used in the EITC, as Senator Packwood proposed.

I am concerned, however, that a number of EITC proposals now emerging in Congress are not compliance provisions and are not designed to reduce error rates. These proposals would reduce EITC benefits largely through broad-scale benefit reductions, not through new procedures to improve the accuracy of EITC payments.

Some of these proposals would affect millions of honest families in which a parent works for low wages. These include proposals to repeal part or all of the 1993 EITC changes and a proposal to repeal the indexing of the EITC for inflation.

REPEALING PART OR ALL OF THE 1993 EITC EXPANSION

The budget resolution the Senate approved in May assumes partial repeal of the EITC expansions enacted in 1993. Those expansions substantially increased the EITC for families with two or more children and also established a small credit for very poor workers without children.

The 1993 provisions were designed to attain the bipartisan goal that families (or at least, families of up to four people) should not have to live in poverty if a parent works full-time throughout the year. As noted, this goal was endorsed across the political spectrum in the years before 1993.

Accordingly, the 1993 law set the EITC for a family with two or more children at the level that would bring a family of four with a full-time minimum wage worker to the poverty line if the family also received food stamps (and if the minimum wage kept pace with inflation, as President Clinton had earlier recommended).

The 1993 expansions also were designed to reduce the work penalties built into the welfare system and to make low-wage work more remunerative than public assistance. When families leave welfare for work, they lose cash welfare payments, some of their food stamps, and, ultimately, some or all of their family's Medicaid coverage. The increased EITC payments help to offset this loss and make the overall compensation package from working compare more favorably with continued reliance on public assistance.

The 1993 EITC expansions helped to promote work in another way as well. Payroll taxes consume 15.3 cents of each additional dollar a poor family earns⁹ while food stamp benefits consume 24 cents. For families with two or more children and low-wages, the EITC will fully offset these adverse effects, providing a 40-cent credit for each additional dollar earned when the 1993 expansions are in full effect.

⁹ Most economists believe that employees effectively pay both the employer and the employee share of payroll taxes, with the employer's share of the tax being passed through to employees in the form of lower wages.

In these ways, the 1993 EITC changes helped to pave the way for welfare reform. The EITC expansions laid the groundwork for tough reforms in the welfare system that substantially tighten work requirements placed on public assistance recipients.

The 1993 law also aided very poor workers without children. It created a small EITC that provides a maximum credit of a little more than \$300 and an average credit of about \$170 for poor workers between the ages of 25 and 64 who do not live with children and have incomes below about \$9,500 (in 1996).

A small EITC was extended to these workers partly because their federal tax burdens had escalated sharply since 1980, as a consequence of a series of regressive payroll and excise tax increases. A Congressional Budget Office analysis showed that between 1980 and 1983, the average federal tax burden of the poorest fifth of non-elderly households rose 38 percent. (Stated another way, the proportion of income consumed by federal taxes rose 38 percent among these households.) This dwarfed the increase in tax burdens borne by any other group of households in any income category. (See Table 2.) By 1993, the percentage of income that the poorest fifth of non-elderly households without children were paying in federal taxes was double the percentage of income paid by the poorest fifth of families with children and more than five times the percentage paid by the poorest fifth of elderly households. (See Figure 1.)

Table 2

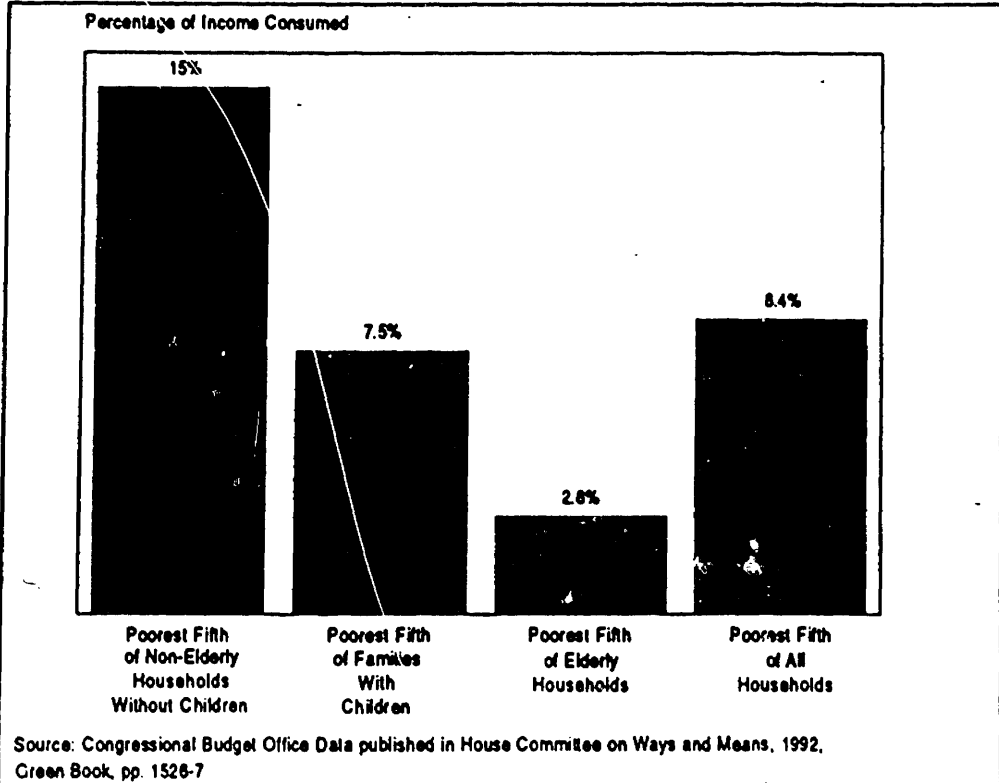
| Changes in Federal Tax Burdens, 1980-1993 | |
|---|--|
| Household Category | Change in the Percentage of Income Consumed by Federal Taxes |
| Non-elderly households without children | |
| poorest fifth | +38% |
| middle fifth | 5 |
| top fifth | -3 |
| Families with children | |
| poorest fifth | -19% |
| middle fifth | 1 |
| top fifth | 1 |
| Aged | |
| poorest fifth | -22% |
| middle fifth | -14 |
| top fifth | -11 |
| All households | |
| poorest fifth | 4% |
| middle fifth | -2 |
| top fifth | -3 |

Source: Congressional Budget Office data published in House Committee on Ways and Means, 1992 Green Book, pp. 1526-7.

The sharp increase in the tax burdens borne by these households occurred primarily because of a series of increases in Social Security, gasoline, and other excise taxes. For low-income families with children, these regressive tax increases were generally offset through EITC expansions. For poor workers without children, no offsetting actions were taken before 1993.

Accordingly, the 1993 law established a modest EITC that offsets the payroll tax these workers pay on their first \$4,230 in income. The credit starts phasing out when income surpasses about \$5,300 and falls to zero when income reaches approximately \$9,500. (These are the 1996 parameters.)

Figure 1
Percentage of Income Consumed by Federal Taxes
For Different Low-Income Groups, 1993



In addition to offsetting a portion of these tax increases, the EITC for poor workers without children also has the effect of nearly completing a piece of unfinished business from the 1986 Tax Reform Act. One of the Act's goals was to eliminate income tax burdens on workers below the poverty line so they were not taxed deeper into poverty. The 1986 Act accomplished this goal for all filing units except non-elderly single individuals. Prior to the extension of the EITC to these workers, a single worker began owing federal income tax when his or her income was about \$1,300 below the poverty line. The EITC has raised the income level at which these workers begin owing income tax close to, although not all the way to, the poverty line. (Single working individuals remain the one group of workers who begin owing federal income tax while they are still in poverty.)

The EITC for very poor workers without children thus has provided needed tax relief for a group of low-income workers who generally receive little aid from other government assistance programs and who otherwise would pay a substantial percentage of their very small incomes in federal taxes.

THE SENATE BUDGET RESOLUTION

The EITC changes assumed in the Senate budget resolution would repeal the small EITC for workers without children. These changes also would cancel entirely the final phase of the EITC expansion for families with two or more children, scheduled to take effect in tax year 1996, and scale back the EITC benefit structure in place in tax year 1995.

Poor workers without children would face a substantial increase in their federal tax burdens; the payroll taxes they pay on their first \$4,230 of earnings would no longer be offset. In addition, their federal tax burdens would rise to higher levels than these burdens had reached before the 1993 law took effect, because these workers would be affected by the gasoline tax increase enacted in 1993. The Treasury Department estimates that 4.4 million workers would face an average tax increase of \$173 if the credit for workers without children is repealed.

Nearly eight million families with two or more children also would be affected, losing a maximum of \$445 (and an average of more than \$300). In addition, about two million families with one child would lose up to \$244 each.

As a result of these changes, the number of families in which a parent working full-time at a low wage would fail to escape poverty would rise somewhat, while the extent to which work paid more than welfare would be somewhat diminished.

Some families with children would face absolute cuts in their EITC benefits under this proposal. The EITC they would receive for 1996 would be smaller than their benefit for 1995.

For example, a family with two children that earns \$8,500 in 1995 about what full-time year-round work at the minimum wage pays will receive an EITC of \$3,060 for 1995. Under the changes assumed in the Senate resolution, its EITC for 1996 would decline to \$2,975. Its EITC would be reduced while its minimum wage earnings remained frozen and prices for necessities rose. Similarly, a mother with one child who works nearly 30 hours a week at the minimum wage and earns \$6,000 would see her EITC fall from \$2,040 in 1995 to \$1,809 in 1996, a reduction of \$231.

Few of the low-income workers who would be adversely affected by these changes would benefit from any of the tax cuts currently under consideration. CBO data show that because the proposed children's tax credit is not refundable, the one-third of the children in the country with the lowest incomes would not benefit from it. If a children's credit is enacted for families with incomes of up to \$250,000 while the EITC is scaled back, the effect will be to grant a children's credit to families at relatively high income levels while withdrawing part of a credit for families with children that are working at low wages.

THE EITC AND INFLATION ADJUSTMENTS

A proposal also has been advanced to end indexation of the EITC. Curiously, this proposal would undo a Reagan initiative. It was President Ronald Reagan who proposed in 1985 that the EITC be indexed.

The Reagan proposal was designed to fix a problem in the EITC benefit structure. If the EITC is not indexed, millions of working poor and near-poor families find that if their earnings simply keep pace with inflation, their EITC benefits decline each year while their payroll taxes climb. The result is the imposition of steadily increasing tax burdens on working families that have experienced no increase in purchasing power, a phenomenon that was widespread in the late 1970s and early 1980s.

A family's EITC benefit begins to phase down when the family's income passes a certain income level. For every dollar that a family with two children earns above \$11,620 (in 1996), the EITC is reduced 21 cents. This \$11,620 income threshold is indexed for inflation. If the indexation feature is repealed, a family with income at or above \$11,620 whose income rises at the rate of inflation will find its EITC falls even though the family's purchasing power has not increased.

Such a family also will owe more in payroll taxes. For each dollar its earnings rise, the family's payroll taxes will increase 7.65 cents while its EITC drops 21 cents.

The effects of failing to index the EITC would grow with each passing year. If a family's income simply kept pace with inflation and EITC indexing had ended, a family with two or more children and income of \$12,000 in 1996 would, five years later, receive an EITC \$460 smaller than the credit it had received in 1996. The family's EITC would be more than \$1,000 lower than it would have been had the EITC continued to be adjusted for inflation. And while its EITC was falling, the family's payroll tax would have climbed \$167.

In real terms, the purchasing power of such a family's EITC would decline by 27 percent in the five-year period. For some working families, the decline would be steeper. Families that earn \$20,000 and whose wages simply keep pace with inflation would find that the purchasing power of their EITC would decline more than 50 percent over five years if indexation ended.

Working poor families at lower earnings levels also would be adversely affected. Consider a family that works 40 hours a week throughout the year at \$4.50 an hour, making \$9,000 a year and living several thousand dollars below the poverty line. If indexing is eliminated, the purchasing power of its EITC would erode while its payroll taxes increased, causing the family to be nudged steadily deeper into poverty.

Ending indexation of the EITC would be an unwise course to follow. It would result in substantial increases over time in federal tax burdens for large numbers of low-income working families that have experienced no increase in their standard-of-living.

It also would make millions of working poor families with children poorer over time and turn a steadily increasing number of near-poor working families into poor families, by pushing them below the poverty line. The Treasury Department estimates that by 2000, nearly 18 million tax filers would be adversely affected by this proposal and would lose an average of more than \$600 apiece in that year.

Ending the indexation of the EITC also would be inconsistent with the goals of "making work pay" and promoting work over welfare. If the EITC is not adjusted for inflation, the gain from working at a low-wage job rather than relying on welfare will erode as the real value of the EITC declines over time.¹⁰

Finally, ending EITC indexation would be inconsistent with other Congressional action being taken this year. There is no discussion of ending the indexation of other features of the tax code such as the personal exemption, the standard deduction, or the tax brackets. If EITC indexation ends, families at higher income levels would continue to be shielded from the effects of inflation on their tax burdens while working poor and near-poor families faced substantial tax increases. Moreover, the House of Representatives has passed legislation to index capital gains tax benefits, the estate and gift tax, and depreciation deductions used primarily by large corporations. It is difficult to discern how ending EITC indexation fits in with these other policies unless the principle is that affluent investors and large companies need protection against the effects of inflation on their taxes but low-income working families do not.

Congress also may pass a number of other tax cuts that disproportionately benefit households at higher income levels and large corporations, such as reductions in capital gains tax rates and an easing of the corporate alternative minimum tax. If EITC indexation is ended while various tax cuts are approved, many low-income working families will face increases in their tax burdens while those at higher income levels and large corporations receive tax reductions.

Proposals such as repealing part of the 1993 EITC changes or ending EITC indexation have a common feature. They would leave low-income working families facing eroding wages for low-skilled work, a sharply lower minimum wage in real terms, and the near-elimination of cash welfare assistance for families working more than half-time with reduced help from the earned income credit. The policy instrument supported for years by many who oppose raising the minimum wage and advocate cutting public assistance programs would itself be scaled back or partially withdrawn.

THE "WEALTH TEST"

Several other EITC proposals warrant comment. In April 1995, Congress passed legislation denying the EITC to families with more than \$2,350 in income from interest, dividends, rents and royalties. The Clinton Administration had proposed a similar provision, with a limit of \$2,500, adjusted for inflation.

Three issues have been raised concerning this provision. Should additional forms of income should count against it? Should the \$2,350 level should be lowered? Should the \$2,350 level be indexed?

Unless there are administrative problems or complexities that make such a course of action unwise, additional forms of income probably should count against this limit. Senator Roth has proposed counting estate and trust income, net passive business income, and net capital gains income. This proposal appears to make sense as it would deny the EITC to families without a significant need for it.

On the other hand, I would not recommend lowering the threshold from \$2,350 to \$1,000, as Senator Roth also has proposed. A threshold that low would disqualify some poor and near-poor working families that are saving for legitimate reasons, such as to send a child to college, purchase a home, or meet a medical emergency (an increasing concern as the number of low-income working families that lack health insurance rises). Prudent policy would not force such families to choose be-

¹⁰ Failure to index the EITC also would weaken the credit's effectiveness as a work incentive in another way. Currently, families earning \$10,000 or \$11,000 a year do not face an increase in their marginal tax rates when their earnings rise with inflation. But if the EITC is not indexed, such families soon will be pushed above the point where their EITC begins to drop 21 cents for each additional dollar earned. The marginal tax rate these families face thus would rise 21 percentage points.

A substantial number of families at this income level already face substantial marginal tax rates because they receive other benefits such as food stamps or housing benefits that decline as earnings rise. To raise the marginal rates of these families an additional 21 percentage points due to failure to index the EITC could increase their combined marginal tax rates to levels approaching 100 percent in some cases.

tween losing their EITC and consuming enough of their savings to remain below the EITC limit.

Reducing the threshold in this manner also would pose equity problems. It would disqualify a growing number of working families with limited incomes who are saving so they can purchase a modest home, while retaining EITC eligibility for those who have already purchased a home and no longer need the same level of savings.

A preferable approach would be to reduce the \$2,350 limit modestly to \$2,000 and index it for inflation. (Whether the level at which the threshold is at, the level ought to be adjusted for inflation. Otherwise, the credit will ultimately be denied to families with a strong need for it as the limit erodes over time.) This would generate approximately the same level of savings over the next 10 years as the provision that Congress passed in April 1995, while insuring that as the years pass, the limit does not squeeze out a steadily increasing number of low-income working families with a legitimate need for the credit.

COUNTING SOCIAL SECURITY AND CHILD SUPPORT PAYMENTS

Senator Roth has also proposed that Social Security, tax-exempt interest, non-taxable pension distributions, and child support be counted as part of adjusted gross income (AGI) for purposes of determining eligibility and benefit levels for the EITC. Counting Social Security in this manner has both advantages and drawbacks. Counting child support would be unwise.

Unlike the proposal to count child support, the proposal to count Social Security could be administered by the IRS. Those affected would primarily be two-parent families in which one parent works while the other is disabled and receives Social Security disability benefits, elderly individuals who are raising a grandchild and who work and have modest earnings, and families containing a child receiving Social Security survivors benefits. There may be concerns about reducing the EITC of such families. I am interested in seeing data on who the affected families are before reaching a judgment on this provision.

I would note that if EITC savings are sought, this approach is preferable to repealing part of the 1993 law or ending indexation; those steps would hurt poorer families and diminish the gains of work over welfare in ways that counting Social Security would not. It would be difficult to justify such a proposal, however, if the provision enacted in 1993 that makes 85 percent of Social Security benefits taxable for more affluent beneficiaries were repealed. If that is done and Social Security also is counted as part of AGI for EITC purposes the effect will be to reduce tax burdens on Social Security beneficiaries at high income levels while raising tax burdens on beneficiaries at lower income levels.

Counting child support as part of AGI for EITC purposes is another matter and would be quite unwise. This change, which would reduce the EITC for many divorced working mothers, would pose both administrative and tax equity problems.

The Internal Revenue Service has no information on the child support payments that a custodial parent receives, and it lacks a reliable means of securing this information. Such a proposal would be difficult for the IRS to enforce and almost certainly would result in higher error rates as a consequence. The difficulties of administering a requirement of this nature were recently noted by the General Accounting Office.

Counting child support in the manner also would cause double-counting of income. Non-custodial parents already pay income tax on the income from which child support payments are made. Counting child support payments as part of AGI and lowering the EITC as a result effectively taxes this income twice.

Finally, such a policy change could lead to a reduction in child support collections. Since some of the non-custodial parent's support payments would effectively be taxed away, some non-custodial parents would have a reduced incentive to make child support payments.

Conclusion

While steps have been taken in recent years to reduce EITC error rates, more needs to be done. Some other EITC changes also warrant consideration.

We should not, however, lose sight of the EITC's virtues. The EITC is boosting the incomes of millions of poor and near-poor families with children that are working and staying off welfare. With the steady erosion of wages for low-paid work over the past 20 years and the likely continuation of this trend in the future, the EITC plays a critical role. It also provides an important underpinning for welfare reforms to move families from welfare to work and helps to offset regressive taxes that low-income workers face. It is part of the welfare reform strategies of policymakers such as Governor Engler of Michigan.

In addition, the EITC has helped change the federal income tax system from a system that pushes working poor families deeper into poverty to a system that helps lift them out. An analysis by the Department of Health and Human Services has found that in 1984, the tax system pushed 1.8 million people living in families with children below the poverty line. When the recent EITC expansion is fully phased in, the tax system will lift more than two million such people out of poverty.

The EITC has been substantially tightened this year to reduce errors and attack fraud. Further improvements are needed. But the EITC's mission remains as important as ever. Deep reductions in the EITC benefits of honest low-income working families would not represent sound policy or be a desirable part of an EITC reform agenda.

PREPARED STATEMENT OF ORRIN G. HATCH

Mr. Chairman, thank you for holding this hearing today on the Earned Income Tax Credit (EITC).

The EITC began as a refund of payroll taxes paid by lower income taxpayers and to encourage work—objectives that I am for. Since its inception, however, the EITC has been greatly expanded. In fact, the cost to the government is projected to skyrocket from \$1.5.6 billion in 1993 to \$28.4 billion in 1996. This is not a small program.

Currently, a large portion of the cost of the EITC benefits are going toward transfer payments to taxpayers. In 1994, of the more than \$20 billion spent on the EITC, about \$4.6 billion was for actual rebates of tax and an additional \$17.2 billion was for grants to EITC recipients. Nearly 80 percent of the benefits of the EITC program do not go toward refunding taxes but toward direct grants to millions of taxpayers. This is a great shift from the original purpose of this program.

While I support the idea of alleviating the payroll tax burden on the working poor, the EITC program may be running out of control. Not only is the cost escalating at a great pace, but also a large number of recipients are receiving payments based on fraudulent claims. While I applaud the Internal Revenue Service for taking some steps to stop this fraud, I think we can do a great deal more to end fraudulent EITC claims.

Mr. Chairman, I would like to mention another serious problem with the EITC: the current EITC has a strong bias against marriage. Let me share an example. John, who earns \$11,000 a year, is a divorced father of one. In 1994 he wants to marry Marie, a single mother of two, who earns \$13,000 a year. As singles, under current law, they would receive a combined tax refund of \$4,128. If John and Marie were to marry, they would have to pay \$581 on their joint tax return. This amounts to a marriage penalty of \$4,709, or almost 20 percent of their combined income for 1994. Financially, they would be foolish to marry.

Mr. Chairman, the marriage penalty paid by low-income families is mostly due to the fact that many singles can qualify for the EITC on their separate incomes. When married, however, the tax code combines the spouses' incomes to determine EITC eligibility. This often places the couple above the income threshold for EITC and creates a tremendous disincentive for marriage. Mr. Chairman, this is an important area in which the EITC falls far short of its goal to strengthen working families.

I hope the witnesses today will address these problems and the Committee can work to find a solution that will ensure the financial viability of the EITC program in a way that benefits working families.

PREPARED STATEMENT OF MARVIN H. KOSTERS

IMPROVING THE DESIGN OF THE EARNED INCOME TAX CREDIT

Mr. Chairman and members of the Committee: Thank you for this opportunity to give my views about the earned income tax credit (the EITC) and how it could be improved.

The EITC has become a major income transfer program. It redistributes income to low-income people who work, with almost all of its benefits going to workers with dependents. Since it began in 1975, the program has been greatly expanded, most recently in 1993. Provisions enacted then will not be fully phased in until next year.

The argument most frequently made for redistributing income through the EITC is that it encourages work. Although some are encouraged to work by the EITC, others face incentives to work less and their numbers have increased as the program

has grown. In addition, the expansion of the EITC has led to higher marriage penalties and increased incentives for uneconomic activities and fraudulent claims. For these reasons, I believe the most direct and effective way to improve the design of the earned income tax credit is to scale it back sharply.

The Scope of the EITC

The projected cost of the EITC in 1996 is \$26 billion in budget outlays and offsets to personal income tax payments. This is roughly comparable to the costs of food stamps (\$27 billion) and housing assistance (\$27 billion). The cost of medicaid is much larger (\$96 billion). The federal share of family support payments (AFDC) is considerably smaller (\$18 billion), but when state and local expenditures are included the total is somewhat larger (about \$33 billion). The EITC has become a major component of total federal expenditures to redistribute income to families with low incomes.

A brief description of how the EITC works is necessary to discuss its effects. I will describe its application to a family with two dependents when current law is fully phased in next year. At incomes of up to about \$8,900, the credit provides a subsidy of an additional 40 cents for each dollar earned, up to a maximum credit of about \$3,560. Families in the relatively narrow income range between \$8,900 and \$11,600 are eligible for the maximum credit. The credit is reduced by 21 cents for each additional dollar earned where the credit is phased out in the income range between about \$11,600 and \$28,500.¹ Families with one dependent receive a smaller maximum credit and are subject to correspondingly lower subsidy and phase-out rates. Low-income workers without dependents are also eligible for a small credit, but I will not discuss how they are affected.

Eligibility of families with children for the EITC depends on their income level and work status. The data that I use to see how many families are affected and how they are affected are from the Current Population Survey. This information on households with children that are likely to comprise tax filing units is shown in the table at the end of this statement.

The point that is illustrated very clearly by the information in the table is that a large fraction of families with children have incomes below the EITC income cut-off level. About 40 percent of families with children have incomes low enough to qualify for EITC payments. To see how the program extends into the middle class, the 40 percent proportion eligible for the EITC can be compared with the poverty rate for families with children, which was 18.5 percent in 1993. All of the families in these two bottom income quintiles in which someone is working are directly affected by the EITC. The families in the other three quintiles are affected indirectly by the need to pay higher taxes to finance the EITC payments.

Effects on Work

To examine the effects of the EITC on work incentives, it is necessary to distinguish further between families by their work status and income level. Low-income families with no one working are unambiguously encouraged by the EITC to consider working. For them, the EITC amounts to a bonus for working as long as their income remains below the eligibility cutoff, but they receive credit payments only if they are induced to work and generate earnings. These families below the income cutoff with no one working account for only about 10 percent of all families with children. Among these families the EITC definitely has a positive effect on work incentives; it encourages those not working to consider work.

Families with someone already working but with income below the level at which they become ineligible for the EITC account for another 30 percent of families with children. These families are eligible to receive credit payments without any change in their work behavior. The program may induce them to modify their work choices, however, and the work incentives they face depend on their income levels.

For families with the lowest incomes, the amount of the credit increases as they work more and earn more, and they are accordingly encouraged to work more through this "substitution effect." However, the credit payment they receive would permit them to maintain or even increase their income without working as much, and this "income effect" discourages work. The total effect of these incentives is uncertain for working families in the lowest income range where the credit is being phased in. Whether they will work more or less depends on how their work behavior responds to the subsidy rate—the amount by which the credit payment increases as earnings increase—and the amount of the credit payment. These working families with the lowest incomes account for about 7.4 percent of all families with children as shown in the table.

Families with somewhat higher incomes receive the maximum credit in an income range that includes an additional 3.8 percent of families. They receive no additional

encouragement to work through the substitution effect, while the additional income they receive from the credit produces an incentive to work less. Families in this income range will tend to work less.

For families with still higher incomes, where the credit is being phased out, the reduction in the amount of the credit payment as they earn more money is equivalent to an additional tax on earnings. For them, work is discouraged both by the reduction in net earnings from additional work, and by the additional income from the credit payment they still receive; the (negative) substitution effect is reinforced by the income effect. Families in this income range face the strongest incentives to work less, and they account for about 19.5 percent of all families with children.

These data indicate that the work incentive effects of the EITC are either negative or neutral for about three times as many families as those with positive work incentives. More than twice as many families face work incentives that definitely discourage work compared with those who are encouraged to consider working.

There is really no controversy among analysts about the appropriateness of this analytical framework or about the direction of incentive effects that are at work. Studies that have examined the implications of the EITC among working families generally conclude that their work effort is likely to be reduced compared with work behavior in the absence of the program.² Less work in response to negative work incentives among working families could be offset by greater incentives to work among families with no one working. I know of only one study that examines the question of whether enough of those who are not working might be encouraged to work to offset a reduction in work among those who are already working.³ This study concludes that fairly generous assumptions about work choices are necessary for the EITC to actually encourage work instead of on balance discouraging work.

Can anything be done to improve the balance? In my view, the EITC discourages work for too many families, too far up the income distribution. Among adult high school graduates (25 years old or more), half earned less than \$18,000 in 1993, and half of college graduates earned less than about \$31,000. These earnings levels can be compared with EITC eligibility up to incomes of \$28,500 in 1996. For all adult workers, 67 percent earned less than \$25,000 in 1993. Credit payments under the EITC extend farther up the earnings scale than can reasonably be viewed as covering only the working poor.

Reducing the maximum amount of the credit, reducing the income limits for eligibility for the credit, and reducing the subsidy and implicit tax rates would reduce the number of working families for whom work is discouraged, while the number of low-income families with no one working would be unchanged. Downsizing the EITC would reduce the strength of positive work incentives for families with no one working, but negative work incentives for the smaller number affected would be correspondingly reduced. In addition, of course, less income would be redistributed, and the transfers that remained would be shifted toward lower income families with children.

Another approach that could be considered is reducing the income cutoff level and phasing out payments more quickly. But unless the size of the maximum credit were also reduced, this would increase the implicit marginal tax rate on earnings and strengthen incentives to cut back on work for the remaining families. If the credit payment is large, there is really no escape from the dilemma of a punitively high implicit tax rate or extension of payments to a large number of families higher up the income distribution.

The Marriage Penalty

It has long been recognized that tax liability under the individual income tax is often higher for two individuals who are married than it would be if they were single instead. Marriage neutrality cannot be achieved under an individual income tax system with progressive marginal tax rates and equal taxation of married couples with the same incomes. Until recently, however, marriage penalties have not been a problem for families with relatively low incomes because they either paid no taxes or their tax liabilities were small and rates were very low. The EITC brought the marriage penalty to low-income families, and the big expansion of the credit in the 1990s made it a significant problem.⁴

The marriage penalty is particularly severe for people who—if they were not married—would each be eligible for the maximum credit. Marriage would eliminate one maximum credit payment and bring the couple well into the income range where the remaining credit is being phased out. Under the most adverse circumstances the marriage penalty could amount to over \$5,000, which for the family affected would be about 25 percent of the combined income of the married couple. Such a tax penalty creates an economic disincentive for marriage, and it reduces economic rewards

from employment for married secondary workers compared with their unmarried counterparts.

The marriage penalty could be reduced by introducing a two-earner credit, based on the same logic as the two-earner deduction in the individual income tax law from 1981 to 1986. This would, of course, increase the cost of the program. The problem could also be ameliorated by reducing the size of the EITC. A significant reduction in subsidy and phase-out rates and in the maximum credit amount would greatly reduce the importance of the marriage penalty.

Incentives for Waste and Fraud

The high subsidy rate for earnings at low family incomes produces incentives to engage in both legal and illegal activities to take advantage of payments under the EITC program. Because the earnings subsidy rate very substantially exceeds payroll tax liabilities, the EITC makes some work attractive that would not otherwise be undertaken. In other words, it encourages activities that could be characterized as taking in one another's laundry when doing one's own would make more sense. Activities of this sort could be perfectly legal, but they would contribute little to economic well-being and mainly produce transfers for EITC recipients.

The rewards produced by credit payments and subsidy rates that are high in proportion to income have also apparently stimulated illegal activities. Audits by the IRS have shown a high incidence of credits claimed that are in excess of amounts for which families were eligible, and many credit payments for which families were ineligible. Efforts have been made to make the program more easily administrable, and this might help to reduce errors. But the subsidy rate and the size of credit payments have also been increased substantially, increasing incentives to make fraudulent claims.⁵

Assuring compliance with EITC provisions poses a particularly awkward problem for the IRS. Its activities have been oriented primarily to identifying hidden or under-reported income, not to looking for ways in which income from earnings might be exaggerated. Earlier tax reforms removed many low-income families from the tax rolls, but the EITC has swept many low-income families back in. Auditing many returns, each with a relatively small dollar amount at stake, is quite expensive in relation to the revenue impact of errors and noncompliance that are identified. The IRS may also be reluctant to press too hard to recoup overpayments, and it may find them very difficult to collect. Yet, unless reasonable compliance can be assured, the IRS is likely to be seriously embarrassed and the EITC program discredited.

In considering the auditing and compliance role of the IRS for the EITC, it should be recognized that a large bureaucracy to administer welfare and other social services is already in the field. This bureaucracy is often criticized for devoting too much attention to documentary paperwork and auditing, and too little to counseling and helping families in other ways to improve their circumstances. It makes little sense in this context to establish a separate, parallel bureaucracy in the IRS to administer another program to supplement incomes of low-income families, many of whom also receive benefits under other programs.

As in the case of work incentives and the marriage penalty, the compliance problem is greatly exacerbated by the size of the EITC. Smaller subsidy rates and credit payments would reduce incentives to claim credits to which the family is not entitled. If the size of the EITC were significantly reduced, whether the beneficiaries received partial payment of their estimated credit contemporaneously with their paycheck, or in a lump sum at the end of a tax year (as most now choose), would also be a matter of less consequence.

Summary

The three problems with the EITC that I have described have become more significant as the program was expanded. Although intended to encourage work by helping to "make work pay," the EITC discourages work for too many, too far up the income distribution. As it is currently structured, the EITC imposes a significant marriage penalty on low-income working people. And serious compliance problems have become evident in administering the EITC. All of these problems would be greatly ameliorated by making the EITC less generous.

Since payroll taxes absorb a significant portion of earnings for workers with low incomes, a strong case can be made for relieving those with the lowest incomes from the burden of these taxes while maintaining comprehensive program coverage. An EITC that is significantly more generous, however, introduces more disincentives to work, builds up a significant marriage penalty, and invites fraud. I believe that we have expanded the program too much and that we are now placing too much reliance on the EITC under the guise of improving incentives to work.

I think the EITC should be cut back to dimensions no larger than before it was most recently expanded. I believe that the EITC has become too generous. I do not argue that income transfers to families with the lowest incomes should necessarily be reduced. The goals of providing income support to families with the lowest incomes would be better served, however, by scaling back the EITC and placing more reliance on other income support programs. These other programs should also be reformed, of course, to place more emphasis on making work a condition for eligibility when this is appropriate.

ENDNOTES

1. Income levels for the EITC are indexed for inflation. The estimates reported are from *Reducing Entitlement Spending*, Congressional Budget Office, September 1994.
2. For example, *Earned Income Credit: Design and Administration Could be Improved*, U.S. General Accounting Office, September 1993; "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness," John Karl Scholz, *National Tax Journal*, Vol. 47, No. 1, 1994; "Promoting Work through the EITC," Janet Holtzblatt, Janet McCubbin, and Robert Gillette, *National Tax Journal*, Vol. 47, No. 3, 1994; and "The EITC and the Working Poor," *The American Enterprise*, Marvin H. Kosters, May/June, 1993.
3. "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation," Stacy Dickert, Scott Henser, and John Karl Scholz, paper prepared for NBER Tax Policy and the Economy conference, November 1994.
4. It should be recognized that under some circumstances the EITC can give rise to a marriage bonus. I do not regard that as a problem. From the point of view of socio-economic indicators, marriage is one of the most common ways in which families move off of welfare and out of poverty. For extensive discussion of the marriage penalty, see "Alleviating Marriage Penalties in the Income Tax and the Earned Income Tax Credit," Anne L. Alstott, *Tax Notes*, February 27, 1995.
5. *Earned Income Credit: Targeting to the Working Poor*, U.S. General Accounting Office, March 1995.

Table

**Effects on Work Incentives and Proportions of Families
Affected by the Fully Phased in Earned Income Tax Credit**

| <u>Families with children by Income Range and EITC Eligibility</u> | Percent of Families with Children | <u>Effects on Work Incentives</u> | | |
|--|---|-----------------------------------|------------------------|-----------------|
| | | Income Effect | Substitution Effect | Total Effect |
| All Families with Children 38,895 thousand | 100% | | | |
| Families with Incomes Too High for Eligibility for the EITC 23,163 thousand | 59.6% | 0 | 0 | 0 |
| Families in Income Range Eligible for the EITC | | | | |
| —Families with Someone Working: | | | | |
| • Income Range Where Credit is <u>Phased Out</u> (Credit Payment Declines as Income Increases) 7,594 thousand | 19.5% | — | — | — |
| • Income Range Eligible for the <u>Maximum Credit</u> Payment 1,489 thousand | 3.8% | — | 0 | — |
| • Income Range Where Credit is <u>Phased In</u> (Credit Payment Increases as Income Increases) 2,871 thousand | 7.4% | — | + | ? |
| —Families with No One Working: | | | | |
| • Eligible for Credit if Someone Decides to Work 3,774 thousand | 9.7% | + | + | + |

Source: Estimates are based on the March, 1992 current population survey data reported in The Earned Income Tax Credit EITC, Current Law and the Clinton Proposal, Thomas Gabe, Congressional Research Service, May 25, 1993. The assumptions used to develop these tabulations differ in several ways from circumstances that will prevail in 1996, but these differences are not likely to affect estimates of proportions of families very much because both family incomes and thresholds for EITC eligibility move up proportionately with inflation.

PREPARED STATEMENT OF MARGARET MILNER RICHARDSON

Mr. Chairman and Distinguished Members of the Committee:

I appreciate the opportunity to be here today to discuss the IRS's efforts to improve the administration of the Earned Income Tax Credit (EITC).

The EITC is a credit that is available only to low and moderate income workers who have earned income and meet certain income thresholds. The amount of the credit increases if the worker has one or two qualifying children. The EITC is designed to make work pay and to lift workers out of poverty in the most efficient and administrable manner possible. Since becoming Commissioner over two years ago, I recognized the need to improve the administration of the EITC and to ensure that the EITC is available only to those hard working Americans who have earned it.

To improve the EITC's effectiveness, in 1993 the Administration supported a proposal to simplify the credit by eliminating the two supplemental credits for health insurance coverage and for taxpayers with children under 1 year of age. The proposal was enacted as part of the Omnibus Budget Reconciliation Act of 1993. In the 1994 GATT legislation, the EITC was denied to nonresident aliens and prisoners. Taxpayers are required to provide a taxpayer identification number for each EITC qualifying child, regardless of age. Also, members of the Armed Forces stationed abroad are now eligible for the credit, and the Department of Defense is required to report to both the IRS and military personnel non-taxable earned income paid during the year that is included in computing the EITC.

The Administration has submitted additional legislative proposals which are still pending legislative action. The proposals include a provision that would deny the EITC to undocumented workers, and a provision that would authorize the IRS to use simpler and more efficient procedures when taxpayers claiming the EITC fail to supply valid social security numbers.

In addition to these important legislative initiatives that will aid in the administration of the EITC, the IRS, beginning with the 1994 filing season and continuing through this year's filing season, has taken several steps to improve the administration of the EITC. A preliminary analysis of returns filed so far this year indicates that our efforts have paid off.

This morning, I would like to share with you what the IRS has learned about EITC compliance, describe for you the IRS's actions during this filing season to improve EITC compliance, and discuss with you our future plans.

FILING SEASON STUDIES

During the 1994 filing season, as part of our efforts to gain a better understanding of the characteristics and extent of EITC compliance, the IRS performed a small study of electronically filed returns over a two week period. The study of 1059 returns selected in the last two weeks of January was designed to provide the information needed to put controls in place quickly for the rest of the 1994 filing season that would prevent and detect EITC compliance problems, including fraud. This study is now final, and a detailed report of this study is attached as an Appendix.

Information from this 1994 filing season study was used to develop additional controls to stop EITC noncompliance, including fraud, for the 1995 filing season. In addition, to expand our understanding of EITC compliance, we are conducting another study this year. This study involves a statistically valid, random sample of approximately 2,000 refund returns filed electronically and on paper throughout the 1995 filing season claiming the EITC. Results from the 1995 study will be used to expand our understanding of issues identified during the first study. The field work and analysis of results will be completed this fall, and we will be pleased to share the results with this Committee.

To improve compliance in all areas, including EITC, the IRS must continually assess emerging trends and constantly revise prevention mechanisms. Strategies, which are perfectly satisfactory today, may be useless tomorrow. The study of refund returns filed during this filing season will provide valuable information to better hone our strategy for next year's filing season and beyond.

FISCAL YEAR 1995 INITIATIVES AND RESULTS

As part of our continuing efforts to improve compliance, the IRS implemented numerous systemic verifications and enhancements for the 1995 filing season. These initiatives include increased verification of taxpayers' social security numbers (SSNs); additional checks of returns claiming credits, including the EITC; suitability checks and increased monitoring of Electronic Return Originators (EROs); and increased compliance resources devoted to preventing and detecting erroneous and fraudulent refund claims before the refunds are paid. In addition, an important part

of our strategy included delaying refunds that, as a result of computer analysis and fraud identification profiles, appeared erroneous or perhaps fraudulent. This additional time for review helped us check questionable claims and detect fraud schemes, including duplicate uses of SSNs.

Closer Scrutiny Of Returns

Internal IRS studies and the report of an outside expert confirmed that erroneous or fraudulent refund claims, including EITC claims, often involved the use of incorrect or invalid SSNs. As a result, during the 1995 filing season the IRS has devoted substantial resources to ensuring that taxpayers claiming refunds used the proper SSNs. A correct, valid SSN must be provided for the taxpayer, spouse, and dependents before an electronically filed return will be accepted. As of May 26, 1995, over 4.3 million occurrences (not returns) of missing, invalid, or duplicate SSNs have been identified on electronically filed returns resulting in the affected returns being rejected and, thus, prevented from entering the filing system electronically.

The checks of SSNs are not limited to electronically filed returns, however. We are also checking paper returns for missing, invalid, or duplicate SSNs. As of May 26, 1995, over 6 million SSN errors were identified on returns filed on paper which resulted in correspondence with the taxpayer and a delay of the refund.

We spent a lot of time both before and during this filing season urging taxpayers to use correct SSNs for themselves and their dependents. The importance of using accurate SSNs this filing season was emphasized in many ways, including a message to that effect on the cover of all tax packages and through many public announcements. Although the verification of SSNs caused delays for some taxpayers legitimately claiming refunds this year, once the SSN is corrected, these taxpayers should not experience delays in future years because of SSN problems.

To further address noncompliance problems related to EITC and other credits, such as motor fuel excise tax credits, during this filing season, we performed additional checks on returns claiming these credits to ensure that only those taxpayers who were entitled to such credits received them. On some returns, refunds were delayed to allow us additional time to verify claims prior to issuing the refunds.

At the beginning of this filing season, the IRS estimated that 82 million individual returns claiming refunds would be filed in 1995 and up to eight percent of these refunds could be delayed as a result of the screens and filters put into place. Through May 26, 1995, 78.9 million refunds have been issued—75.7 million were issued for the full amount of the refund; 3.2 million were partial refunds. Only 4.2 million refunds have been delayed in their entirety—numbers that are consistent with our original estimates.

A preliminary analysis of returns filed so far this year indicates that our efforts to perform additional checks of refund claims and to verify SSNs have paid off. As of May 26, 1995, 17.3 million returns have been filed claiming the EITC. While the total number of EITC claims has increased by 3.2 million over last year, this increase is solely attributable to claims by filers without qualifying children who were first eligible to claim the EITC in 1994. If the EITC filers without qualifying children are disregarded, EITC claims have decreased by 257,000 from last year. We project that by the end of the filing season, EITC claims with qualifying children will decrease by 100,000—200,000 over last year. Because prior to the 1994 tax year, EITC claims had increased each year since 1989, it appears our efforts this filing season may have kept those who had not earned the EITC from claiming it.

Additionally, through May 21, 1995, the number of dependents claimed for tax year 1994 when compared to the number of dependents claimed in tax year 1993 (based on returns filed through the same period last year) has decreased by approximately 800,000. We believe that, if this pattern continues, when the 1995 individual returns have been filed (including extensions) either fewer dependents or no more than the same number of dependents will have been claimed for 1994 as were claimed in 1993. If so, this would be the first time in several years that the number of dependents being claimed did not increase. Our preliminary analysis shows that this result is probably due to the fact that non-existent or non-qualifying dependents claimed in prior years were not claimed this year. The reduction in EITC claims and in the number of dependents claimed is particularly significant when you realize that the number of individual returns filed through May 26, 1995 has increased over last year.

We at the IRS recognize that we must balance our efforts to detect and prevent EITC noncompliance with the need to ensure that those hard working Americans who are eligible for the EITC receive it. This filing season, although we performed additional checks to ensure fraudulent or incorrect claims did not get into the system, we also sent over 300,000 notices to taxpayers who appeared to qualify for the EITC but who had failed to claim it on their 1994 tax returns.

Our screens are designed to detect erroneous or suspicious returns. Unfortunately, some taxpayers who have filed complete and accurate returns also had their refunds delayed. We regret the inconvenience caused them, but I believe that most taxpayers want us to maintain the integrity of the tax system by making certain that only those who are entitled to refunds get them—even if additional time is needed to verify the accuracy of refunds claimed.

Enforcement Activities

In addition to enhancing our systemic filters in order to detect more questionable refund claims during the 1995 filing season, we substantially increased the enforcement resources dedicated to examining questionable claims as well as identifying fraudulent schemes. Criminal Investigation Division resources in our Questionable Refund Detection Teams were increased by 11 percent and Examination resources were increased by 277 percent—over 1,700 enforcement staffyears are being devoted to detecting and preventing refund fraud.

This filing season, electronically filed returns that had duplicate uses of SSNs for dependents and EITC qualifying children were rejected. By rejecting these returns, erroneous claims and fraud schemes that in past years made it into the system were kept out. In addition to these systemic screens, as of May 26, 1995, we had identified 2,579 fraud schemes, delaying \$62.5 million claimed on over 30,000 electronic and paper returns.

Beginning last filing season and continuing this filing season, we have delayed refunds with questionable EITC claims until the returns can be examined. As a part of this initiative, from January 1994 through April 1995, 370,780 returns were examined. As a result of these examinations, \$330 million in refunds were not paid because taxpayers were unable to verify that they were entitled to the EITC claimed. As we continue the examinations of more than 700,000 additional returns with questionable EITC claims that are currently in the Examination Division inventory, we expect comparable results—EITC claimed in error never being paid.

FUTURE PLANS

Although the 1995 filing season is almost at an end, under the direction of Mr. Brown, the Filing Fraud Executive, we have already begun planning our strategy to prevent all erroneous or fraudulent refund claims, including EITC claims, for next filing season.

Valuable information learned this filing season will be the basis for modifying and refining our current procedures. We will revise the standards used to screen EROs and adapt the systemic screens used to detect fraud and errors during this filing season; if necessary, we will put in place new technology and additional filters.

To identify more sophisticated fraud schemes, we are working with the Los Alamos National Laboratory to design software which detects anomalies and matches patterns in large data sets. Five new anomaly detection/pattern recognition tools have been tested at the Cincinnati Service Center this filing season. Preliminary results indicate that these tools will significantly enhance our ability to detect filing fraud schemes.

While we will continue to enhance our detection and prevention efforts, the key to improving our ability to detect increasingly sophisticated fraud schemes is our Tax Systems Modernization Program. Without modern technology—hardware and software—applying expert systems analysis to large databases is virtually impossible. Tax Systems Modernization will not only provide the computing power and capacity needed to apply sophisticated fraud detection systems, but, equally as important, it will also provide more timely access to information.

In addition to enhancing our technological capabilities, the Clinton Administration has proposed legislation to aid significantly our administration of the EITC and especially our efforts to improve EITC compliance. This legislation would require EITC claimants to provide valid SSNs for themselves and their qualifying children and permit the IRS to treat an EITC claim in the same way it does math errors when an SSN is either not provided or the SSN provided is invalid.

Under current law, if the IRS detects an EITC claim with a missing or invalid SSN, before the refund claim is denied, it is subject to multiple actions under the statutory deficiency process, a process that typically takes about 8 months. The proposed procedure would authorize the IRS to recompute a taxpayer's tax liability if a tax return contains an EITC claim with a missing or invalid SSN. Before any adjustment is final, the IRS would send the taxpayer a notice asking for a correct SSN. If the taxpayer did not respond within 60 days (under statutory deficiency procedures taxpayers get two notices, a 30-day notice and a 90-day or statutory notice) the taxpayer's refund would remain adjusted.

A procedure similar to the procedure currently used to correct math errors is appropriate and needed. Although the IRS has the technological capability to identify returns with obvious mistakes, because the statutory deficiency procedures require multiple actions and are more complex than math error procedures, we can only reach a limited number of taxpayers with our current resources. The proposed math error procedure would be used only in those instances where a taxpayer's EITC claim has not been substantiated by a valid SSN. Banks do not allow their customers to withdraw money without providing all the necessary information, including an appropriate account number and a PIN. Congress should give the IRS comparable tools.

CONCLUSION

Mr. Chairman, the IRS is committed to stopping EITC noncompliance, while at the same time ensuring that all hardworking Americans who earn the EITC receive it. The assistance of you and your Committee in enacting the Administration's proposals to aid in the administration of EITC would greatly assist our efforts to achieve these two important goals.

Mr. Chairman, this concludes my prepared remarks. My colleagues and I would be happy to answer any question you or other Committee members may have.

Attachment.

Appendix

Internal Revenue Service

STUDY OF EIC FILERS FOR TAX YEAR 1993

June 1995

1994 Earned Income Tax Credit Compliance Study

I. Introduction

The Internal Revenue Service undertook this study early in the 1994 filing season in order to identify ways of reducing refund fraud associated with the Earned Income Tax Credit (EITC) during the remainder of the 1994 filing season. This information was also viewed as critical for designing new fraud control interventions for the 1995 filing season. Although the initial scope of the study was focused on identifying apparently fraudulent or intentionally overstated claims for EITC, it became evident that the results provided broader information on taxpayer understanding and compliance with EITC qualification requirements.

It is significant that this compliance study was the first of its kind conducted by the Service. As noted in the following sections, the validation of sampled EITC claims was very different from traditional IRS compliance measurement programs. Therefore, its unique character offers valuable information on taxpayer compliance but these "first-time" results provide limited comparability to previous studies because of the difference in methodology.

It is also important to understand that this study was never intended to provide an overall assessment or measurement of EITC compliance for the entire filing season. Because the study only included early filers on the electronic filing system, it cannot be interpreted as representative of all electronic filers or all paper filers claiming the EITC during the 1994 filing season. For this reason, the Service recognized the need to design a more comprehensive compliance study for the 1995 filing season. The 1994 study did not seek to measure or quantify "fraud" in the EITC, but sought to provide useful information about the types of errors or abuse that could be used by persons to file fraudulent or overstated claims with the IRS.

II. Sample Design

The study sample was drawn from tax returns claiming the EITC and filed electronically during two early weeks of the 1994 filing season (January 14 thru January 28, 1994). A computer program was written to select every 1,001st EITC return with the 517th return as the initial starting point for sampling in each of the five IRS processing centers that receive electronically filed returns. This systematic sampling procedure ensured that the number of returns sampled at each center would be approximately proportionate to their EITC filing volumes during the sampling period. In order to maintain geographic balance in the sample, the sampling rates were manually adjusted in some centers. This systematic method of sample selection was designed for simplicity.

The total sample selected was 1,068. During the field validation phase, additional cases were dropped from the sample. These deleted cases included returns where the EITC schedule was attached but no EITC amount was claimed, returns filed from overseas military addresses (FPO/APO), and returns where the taxpayer had died or could not be located.¹ The final sample count used for the analysis was 1,059.

Returns that were filed electronically in the 1994 filing season were subject to a variety of validity and consistency checks before being "accepted" by the IRS. This included checking all Social Security Numbers (SSNs) listed on the return and matching the dependent's birth date to the Social Security Administration record. If any SSN was invalid, the return was rejected and could not be included in the sample. The sample included returns with "SSN applied for" for a child under one year of age.

As noted previously, this sample was not designed to provide representative data for all EITC filers during the 1994 filing season. However, to examine how the early electronic filers claiming the EITC differed from all EITC filers, data from the sample was compared to the Statistics of Income Sample of 1993 filers. (Table 1 summarizes this information.)

Sample period - Between January 14 and January 28, 1994, the electronic filing system accepted 1,273,000 tax returns claiming the EITC. The average EITC claimed was approximately \$1,163. Head of Household (HOH) claimants comprised about 78.8% of the total. Married Filing Joint (MFJ) filers accounted for 20% of the total and the remaining 1.3% were filed by Single filers with dependents.

Filing Season - For the 1994 filing season, 15,117,000 returns claiming EITC were filed according to the 1993 tax year Statistics of Income data. The average EITC claim was estimated to be \$1,025. HOH Filers represented 63.7% of EITC claimants, MFJ and Single filers accounted for 32.9% and 3.4% respectively.

The sampled EITC returns filed electronically during the last two weeks of January 1994 differed from EITC claims filed during the entire filing season in the following categories:

¹ The cases that were dropped from the sample because the IRS could not locate the taxpayer were limited to situations where the taxpayer could not be located, nor could information on the return be confirmed or validated from other sources. In other cases that were retained in the sample, the taxpayer could not be located but information was validated by employers, preparers or other family members.

- » During the filing season, 64% of EITC claimants are head of households, compared to 79% during the last two weeks of January.
- » During the filing season, 13% of EITC filers claim Schedule C income. In the EITC study, only about 1% of filers claimed Schedule C income.
- » During the filing season, about 15% of filers claiming the EITC have adjusted gross incomes below \$5,000. In the EITC study, about 8% of the sample have adjusted gross income below \$5,000.

III. Methodology for Determining Errors

- A. The initial step in building case files from the sampled returns was conducted in the service centers. Transcripts of the taxpayers' prior filings were obtained and associated with the sample return. The case file was then transmitted (usually within 3-5 days of the filing of the return) to a Special Agent (criminal investigator) for contacts to verify the EITC claim.
- B. The Special Agent assigned the sample return was required to contact the taxpayer, the electronic return originator/transmitter, the tax return preparer (if different from the electronic return originator) and, the employer (if W-2 wages were the source of EITC qualifying income). The agent was also instructed to contact other third parties if needed to validate the EITC claim. These contacts were made face-to-face at the residence or business location rather than requiring the taxpayer or witness to appear at IRS offices. The agent was required to complete his/her inquiries within seven days, so that the findings could be used to make necessary changes in the 1994 questionable refund screening procedures. The agent tested the accuracy of qualifying earned and adjusted gross income, the filing status of the taxpayer and the existence and qualifications of qualifying children reflected on the EITC schedule. If the agent believed the claim was incorrect, he/she also made a subjective assessment of the reason for the error (e.g., the error was part of a fraudulent refund scheme, the error was made intentionally or was due to unintentional error/misunderstanding). When the agent considered his/her inquiries complete, they telephoned an experienced agent who acted as the national coordinator on the study. This senior agent reviewed the findings to ensure completeness of the inquiry and consistency with the other inquiries being conducted across the country. If satisfied, the senior agent approved the return of the file to the originating Service Center.

- C. After the file was returned to the originating Service Center, it was reviewed. If the return was deemed "part of a scheme," it was controlled as a fraudulent refund claim, and no refund was issued. If the claim needed adjustment (i.e., the claim was classified as having an intentional or unintentional error), the return was referred to the Examination Division for a correspondence audit with the taxpayer. If the claim were viewed as correct, the refund was released. Copies of these files were then forwarded to the Cincinnati Service Center for transcription into the sample database.
- D. All completed sample files were transcribed into a database for analysis. During this initial stage, tax examiners reviewed all case files to determine if they agreed with the Special Agent's assessment. The tax examiners' assessments of the cases were included in the data base. Subsequently, tax examiners reexamined the case files to determine the reasons for taxpayers' errors. Based on this more comprehensive review of the facts reported in the case file, the tax examiners changed their assessments in some cases. The database also contains this information.

Over the following months, data inconsistencies and errors were identified and corrected. The results from correspondence audits were added to the files as these contacts were completed. Also, additional comparative information was added to the database as it became available. For example, information reports (W-2s and 1099s filed with the Service) were matched to the sample files during the fall of 1994. Returns were also matched to the duplicate use SSN file to identify cases where other persons had also claimed the qualifying child.

Lastly, all cases were reviewed to assign "best and final" codes to the case file. When complete information was still not available from the Examination Division, the tax examiner made a "best and final" determination on the basis of the available evidence. These determinations were used for the purposes of the study only and did not affect the taxpayer's receipt of the refund.

IV. Calculation of Error Rates

A. *Overclaims* The following results represent the estimated number of taxpayers in the sample period population who claimed more than the correct credit. The error rates are reported as values and percentages of dollars. These statistics are weighted figures.

| OVERCLAIMS | TOTAL \$ CLAIMED | AMOUNT OF OVERCLAIMS |
|-------------|------------------|----------------------|
| VALUES | \$1,430,000,000 | \$386,000,000 |
| PERCENTAGES | 100% | 26.1% ² |

B. *Underclaims* The following results represent the estimated number of taxpayers in the sample period population that claimed less than the correct EITC. The error rates are reported as values and percentages of dollars. These statistics are weighted figures.

| UNDERCLAIMS | TOTAL \$ CLAIMED | AMOUNT OF UNDERCLAIMS |
|-------------|------------------|-----------------------|
| VALUES | \$1,480,000,000 | \$13,000,000 |
| PERCENTAGES | 100% | 0.9% ³ |

V. Estimate of "Net" Overclaim Rate

The estimates shown in Section IV, provide information on the amount of EITC *claimed* erroneously by taxpayers whose returns were accepted by the IRS. In some cases, the IRS would have detected erroneous claims by using conventional enforcement techniques (e.g. matching of returns to information reports). These estimates also do not reflect legislative and administrative changes which were implemented in 1995 in order to reduce errors. Since the study was conducted, the IRS has begun to reject electronic returns which either do not include a taxpayer identification number for EITC qualifying children or use a social security number for a child which has already been used by another taxpayer. In addition, the Schedule EIC no longer includes the supplemental credits for health insurance. These provisions were repealed in the Omnibus Budget Reconciliation Act of 1993, partly because of concerns by the IRS that it could not easily verify eligibility for the supplemental credits prior to the payment of a refund.

The overclaim rate can be adjusted to reflect the potential effects of conventional IRS enforcement activities and legislative changes which were in effect during the 1995 filing season. Adjustment for these actions would have reduced the estimated amount of

2 38.8% of the 1,273,000 returns overclaimed EITC.

3 6.1% of the 1,273,000 returns underclaimed EITC.

overclaims by \$104.3 million (from \$386.3 million to \$282.0 million), reducing the dollar overclaim rate from 26.1% to 19.1%. As a consequence of certain IRS enforcement activities and legislative changes, the dollar amount of overclaims would have been reduced by about 27%.⁴

Notably, this "net" estimate does not reflect the full extent of increased 1995 IRS enforcement activities. During the 1995 filing season, the IRS implemented new screening tests to detect questionable EITC claims. The screens were designed to identify returns with problem refunds which would not have been identified through more generalized detection methods, such as matching returns with information reports. In designing these new screening tests, the IRS has used the results of the 1994 EITC compliance study, as well as other information, in order to better identify problem refunds. During the 1995 filing season, such refunds may be subject to delays of up to eight weeks, while IRS further investigates. The net estimates do not reflect the effects of the new screening tests.

⁴ In 1990, the IRS found that enforcement activities reduced the gross income tax gap between 7.3 and 26 percent for tax year 1987.

TABLE 1

Comparison of Weighted Sample Characteristics of 1993 EITC Claimants

| Category | EITC Compliance Study | | 1993 Statistics of Income | |
|------------------------------|-----------------------|------------------|---------------------------|------------------|
| | Number of Returns | Percent of Total | Number of Returns | Percent of Total |
| Total Returns | 1,273,000 | 100.0% | 15,117,000 | 100.0% |
| Filing Status | | | | |
| Married, Filing Joint | 254,000 | 20.0% | 4,979,000 | 32.9% |
| Head of Household | 1,003,000 | 78.8% | 9,622,000 | 63.7% |
| Other | 16,000 | 1.3% | 517,000 | 3.4% |
| Adjusted Gross Income | | | | |
| Less than \$5,000 | 107,000 | 8.4% | 2,281,000 | 15.1% |
| \$5,000-\$10,000 | 319,000 | 25.1% | 3,819,000 | 25.3% |
| \$10,000-\$15,000 | 453,000 | 35.6% | 4,010,000 | 26.5% |
| \$15,000-\$20,000 | 318,000 | 25.0% | 3,500,000 | 23.2% |
| Greater than \$20,000 | 75,000 | 5.9% | 1,507,000 | 10.0% |
| Source of Income | | | | |
| Wages and Salaries | 1,270,000 | 99.8% | 14,301,000 | 94.6% |
| Schedule C Business Income | (*) | 1.2% | 1,980,000 | 13.1% |
| Interest | 36,000 | 2.8% | 2,713,000 | 17.9% |
| Unemployment Compensation | 79,000 | 6.2% | 2,110,000 | 14.0% |
| EITC Supplement | | | | |
| Health Insurance Supplement | 287,000 | 22.5% | 2,953,000 | 19.5% |
| Young Child Supplement | 147,000 | 11.5% | 1,803,000 | 11.9% |

(*) Estimate is not statistically reliable because of small sample size.

U . S . S E N A T O R

Bill Roth

FOR IMMEDIATE RELEASE

June 8, 1995

NEWS RELEASE 202 224 3190

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**ROTH, NICKLES INTRODUCE LEGISLATION TO REFORM FRAUD
AND ERROR-RIDDEN EITC PROGRAM**

WASHINGTON -- "We must plug the multi-billion dollar leaks in this program and get it back on its original course," stated Senator William V. Roth, Jr. (R-DE) as he introduced legislation Thursday aimed at curbing rampant fraud and error in the Earned Income Tax Credit Program, the fastest growing income transfer program in the federal government.

"There is no question that the goal of the EITC program, to encourage the poor to work and to get off welfare, is a worthy goal, and one with which I agree. However, as hearings I held in April confirmed, there are huge loopholes in the program that make it a boon for tax cheats and rip off artists," Roth stated. Roth and Nickles' bill was introduced Thursday as the Senate Finance Committee took up the EITC.

"Under the current EITC program, a part-time lawyer who works 100 hours per year at \$100 per hour can get the same benefits as a fry-cook who works 2,000 hours per year at \$5 per hour. A wealthy Beverly Hills resident who receives hundreds of thousands of dollars in alimony, yet earns less than \$10,000 in income can qualify, while a family of four with an income of only \$30,000 will pay the taxes which ultimately pay those benefits. And those are examples of people who receive the benefits legally," Roth said.

Under the Roth/Nickles bill, the growth rate of the EITC program would be slowed and the top income eligibility level would be reduced to more closely reflect need and reduce fraud. The bill also would deny the tax credit to illegal aliens and include nontaxed sources of income and substantial amounts of wealth to determine eligibility. The measure also would repeal the 1993 extension of the credit to taxpayers without children. According to the Joint Committee on Taxation, the Roth/Nickles bill would save \$39.4 billion dollars over five years.

"Historically, the EITC has been plagued with a fraud and error rate of 30 percent and 40 percent, making it the most fraudulent welfare program on Uncle Sam's books," Roth stated. "In contrast, other federal transfer programs, like food stamps or AFDC, are considered to have fraud and error rates that are too high if they exceed 6 percent to 8 percent. Since the program's inception, the taxpayers have lost about \$25 billion. And the GAO confirmed to me in my hearings that the American taxpayer could lose as much as \$37 billion over the next five years if fraud and waste is not controlled in the EITC.

"The primary sources of fraud in the program are people who falsely claim they have children or understate the age of their children, people who fabricate jobs, and married couples who claim to be divorced, but it doesn't stop there. The taxpayer is also ripped off through scam artists who run organized schemes filing false EITC claims -- sometimes amounting to more than a million dollars," Roth stated.

"Both the working poor who receive the tax credit and the taxpayer who pays for it, deserve an Earned Income Tax Credit program that works -- efficiently and effectively," Roth said.

June 7, 1995 12:00 pm

EITC REFORM PROPOSALS:

1. **Deny the EITC to Illegal Aliens:** Under this proposal, only individuals who are authorized to work in the U.S. would be eligible for the EITC. Taxpayers claiming the EITC would be required to provide a valid social security number for themselves, their spouses, and qualifying children. Social security numbers would have to be valid for employment purposes in the U.S. In addition, the IRS would be authorized to use the math-error procedures, which are simpler than deficiency procedures, to resolve questions about the validity of a social security number. Under this approach, the failure to provide a correct social security number would be treated as a math error. Taxpayers would have 60 days in which they could either provide a correct social security number, or request that the IRS follow the current-law deficiency procedures. If a taxpayer failed to respond within this period, he or she would be required to refile with correct social security numbers in order to obtain the EITC. Effective date of enactment. (*From President Clinton's FY 1996 Budget proposals*)

| <u>ICT Revenue Estimate (in billions of dollars, in fiscal years)</u> | | | | | | | 5 yr | 10 Yr |
|---|-------------|-------------|-------------|-------------|-------------|-------------|--------------|--------------|
| | <u>1995</u> | <u>1996</u> | <u>1997</u> | <u>1998</u> | <u>1999</u> | <u>2000</u> | <u>Total</u> | <u>Total</u> |
| Math-error procedure | --- | .007 | .137 | .142 | .142 | .144 | 0.571 | 1.301 |
| Require SSN's work-related for primary and Secondary Taxpayers | --- | .004 | .082 | .085 | .088 | .091 | 0.350 | 0.858 |

2. **Repeal the Childless Portion of the EITC:** In the 1993 Budget Reconciliation bill, effective beginning in 1994, the EITC was expanded to include taxpayers with no qualifying children for the first time. Since about 85% of the EITC is a "budget outlay," and therefor primarily a welfare program, and since welfare programs have traditionally been aimed at helping children rather than able-bodied adults, this part of the program should be eliminated. In addition, this part of the EITC provides for a maximum credit of only \$314 in 1995, and begins to phase-out at as little as \$5,140, and therefor is of such insignificance as to offer little or no real work incentive. Since the EITC is designed primarily as a "work incentive," this part of the program should be eliminated.

| <u>ICT Revenue Estimate (in billions of dollars, in fiscal years)</u> | | | | | | | 5 yr | 10 yr |
|---|-------------|-------------|-------------|-------------|-------------|-------------|--------------|--------------|
| | <u>1995</u> | <u>1996</u> | <u>1997</u> | <u>1998</u> | <u>1999</u> | <u>2000</u> | <u>Total</u> | <u>Total</u> |
| Repeal of childless EITC | --- | .031 | .616 | .641 | .669 | .702 | 2.659 | 6.636 |

June 7, 1995 12:00 pm

3. **Freeze EITC at 1995 Levels to Reduce Fraud:** Just since 1988, the EITC expenditures have grown five-fold. In addition, fraud and error rates have consistently remained in the range of 30 to 40% of expenditures for about 15 years -- since studies began on the issue. Until 1990, the credit was limited to a maximum rate of 14%, but since that time the maximum rate of the EITC under the law has been increased to a maximum of 40% beginning in 1996 -- or almost three-fold. When the level of the credit was closer to the payroll tax level (7.65%/15.30%) there was considerably less incentive for tax cheats and fraud artists to game the system, however, as a result of the dramatic increase in the level of the credit, the fraud incentives are significantly higher. Under current law, the size of the benefit available from the program no longer bears any relationship to taxes owed by the person making the claim. Accordingly, given our self-assessment tax system, it is just too easy to file a fraudulent claim that is virtually undetectable by the IRS. Suspending the rate of the credit at a maximum of 36% (reducing it slightly to 35% in 1996) will discourage fraud artists, and also slow the growth of this program, which is by far the fastest growing entitlement in the federal budget.

In addition, the phase-out range for the credit has increased from 20,264 in 1990, to a scheduled level of \$28,524 in 1996 --for an increase of over 40% in just 6 years, which is more than twice the rate of inflation over the period. Because this growth is unprecedented during a period of high budget deficits, the outlays for this program's growth should be suspended, to allow true inflation to catch up. If later Congress' should decide to increase the size of the program, when budgets allow, then the inflation growth factor in this welfare program could be voted on at that time. Under this amendment, EITC indexing would be suspended indefinitely.

| JCT Revenue Estimate (in billions of dollars, in fiscal years) | 1995 1996 1997 1998 1999 2000 | | | | | | 5 yr | 10 yr | |
|---|--------------------------------------|----|------|-------|-------|-------|--------------|--------------|--------|
| | | | | | | | Total | Total | |
| Freeze EITC rates and phaseout at 1995 Level | - | -- | .192 | 3.918 | 5.625 | 7.457 | 9.407 | 24.835 | 91.911 |

4. **Increased Scrutiny for Wealth Tests:** As a result of the President's budget proposals and concerns from several Congressional offices, changes were passed as part of H.R. 831 to attempt to restrict the EITC to truly low-income working Americans. Under current law, many wealthier Americans can claim the EITC resulting in the unfair result of poorer Americans paying taxes to pay welfare benefits to those wealthier than they are. Substantial progress was made by denying the EITC to taxpayers with aggregate "disqualified income" exceeding \$2,350. This income includes: 1) interest and dividends, 2)

June 7, 1995 12:00 pm

tax-exempt interest income, and 3) net income from rents and royalties.

This proposal would go further in tightening this loophole by adding net estate and trust income, net passive income from business assets and net capital gains to the wealth test. In addition, the current level of \$2,350 equates to financial assets of about \$40,000 based on a 6% simple annual realized return, which is much higher than asset/wealth tests for other welfare programs. For example, under the AFDC program, if a family has more than \$1,000 in assets they lose their welfare benefits. While under this proposal, a threshold of \$1,000 of income would equate to a presumed value of underlying assets of about \$16,700 (assuming a 6% simple annual realized return), which although generous compared to the AFDC rules, would be more appropriate than the current wealth test. The value of homes, cars and other personal assets would still remain outside of this asset test. If this wealth test is not substantially improved, the result will continue to be that taxpayers with significantly less wealth will be paying taxes into a system which will redistribute the income to those with greater wealth under this welfare program, resulting in more unfairness in the income tax system than otherwise would exist.

| | <u>ICT Revenue Estimate (in billions of dollars, in fiscal years)</u> | | | | | | 5 yr | 10 yr |
|---|---|-------------|-------------|-------------|-------------|-------------|--------------|--------------|
| | <u>1995</u> | <u>1996</u> | <u>1997</u> | <u>1998</u> | <u>1999</u> | <u>2000</u> | <u>Total</u> | <u>Total</u> |
| Add estate & trust income, net passive business income & net capital gains income | -- | .006 | .115 | .123 | .136 | .150 | 0.529 | 1.468 |
| Reduce threshold to \$1,000 | -- | .019 | .385 | .400 | .427 | .464 | 1.696 | 4.200 |

5. **Fairness Requires Equal Income Tests:** Under the EITC, the credit is phased-out as the taxpayer receives more "earned income," or as the taxpayer's adjusted gross income (AGI) increases. The phase-out ranges for both tests are the same. In addition to earned income, AGI includes income from other sources, such as investments, alimony and unemployment. However, AGI does not include other sources of income that nevertheless provide financial support and economic income to families. In general, welfare programs like the EITC should not be paid to beneficiaries who are financially better off than other taxpayers who may be less well off. Particularly if those less well off are still paying income taxes to the Federal Government.

Under this proposal, the AGI test under the EITC would be expanded to include other forms of income offering substantial non-taxed, economic benefits to families. These other sources would be: 1) non-taxable social

June 7, 1995 12:00 pm

security income, 2) child support payments, 3) tax-exempt interest, and 4) non-taxable private pension distributions.

In addition, Treasury would be asked to undertake a study to determine if the current law tax treatment of child support payments is appropriate, or if alternatives should be considered to encourage payment of child support liabilities by parents of the child, and what alternatives would make both parents more responsible for the child's economic well-being.

| <u>ICT Revenue Estimate (in billions of dollars, in fiscal years)</u> | | | | | | | 5 yr | 10 yr |
|--|-------------|-------------|-------------|-------------|-------------|-------------|--------------|--------------|
| | <u>1995</u> | <u>1996</u> | <u>1997</u> | <u>1998</u> | <u>1999</u> | <u>2000</u> | <u>Total</u> | <u>Total</u> |
| Modify AGI to include non-taxed Soc Sec income, child support payments, tax-exempt interest & non-taxed private pensions | --- | .102 | 2.037 | 2.125 | 2.205 | 2.327 | 8.797 | 21.668 |

6. **Deny or Delay the EITC Until the IRS has a Matching W-2:** This rule would preclude a taxpayer from receiving the refundable portion of EITC unless the taxpayer's earnings are listed on a W-2 form, or for which self-employment tax has been paid, in the case of a self-employed taxpayer. If quarterly payroll taxes have been filed, or once W-2s have been filed by an employer, the IRS could refund the EITC. This program would not take effect until 1997 in order to allow the IRS to put into place the proper monitoring facilities. Within one year of passage the Treasury would be required to report to the Congress likely time delays that would result for refundable earned income tax credits.

| <u>ICT Revenue Estimate (in billions of dollars, in fiscal years)</u> | | | | | | | 5 yr | 10 yr |
|---|-------------|-------------|-------------|-------------|-------------|-------------|--------------|--------------|
| | <u>1995</u> | <u>1996</u> | <u>1997</u> | <u>1998</u> | <u>1999</u> | <u>2000</u> | <u>Total</u> | <u>Total</u> |
| W-2 Match Requirement | --- | ? | ? | ? | ? | ? | ???? | ????? |

7. **Electronic Return Originators Must be Checked:** During the 1995 filing season, the IRS instituted fingerprint and credit checks on new ERO applicants to better ensure that only appropriate and responsible individuals participate in electronic filing. Of the 33,000 applications this year that had to undergo suitability checks, 1,500 applicants were rejected because of failure to meet the admission requirements. This provision would require that IRS complete these same tests for all EROs, and not just new applicants. Thousands of EROs from prior years are still in the system and have not been checked. This change would require that all EROs have this minimum check completed before electronic returns are processed by the IRS.

| <u>ICT Revenue Estimate (in billions of dollars, in fiscal years)</u> | | | | | | | 5 yr | 10 yr |
|---|-------------|-------------|-------------|-------------|-------------|-------------|--------------|--------------|
| | <u>1995</u> | <u>1996</u> | <u>1997</u> | <u>1998</u> | <u>1999</u> | <u>2000</u> | <u>Total</u> | <u>Total</u> |
| ERO Background Check | --- | ? | ? | ? | ? | ? | ???? | ????? |

| <u>Total Package 1-7 ICT Estimate (in billions of dollars, in fiscal years)</u> | | | | | | | 5 YR | 10 YR |
|---|-------------|-------------|-------------|-------------|-------------|-------------|--------------|--------------|
| | <u>1995</u> | <u>1996</u> | <u>1997</u> | <u>1998</u> | <u>1999</u> | <u>2000</u> | <u>Total</u> | <u>Total</u> |
| Totals | --- | .361 | 7.290 | 9.141 | 11.124 | 13.285 | 39.437 | 128.042 |

PREPARED STATEMENT OF I. LESLIE B. SAMUELS

Chairman Packwood and Members of the Committee:

I am pleased to have the opportunity to discuss the scope and the purpose of the earned income tax credit (EITC), as well as steps that are being taken to improve the credit. While I will briefly touch upon compliance issues, Commissioner Richardson's testimony will address administrative matters more completely.

The Administration is strongly committed to the goals of the EITC which are to make work pay and to lift workers out of poverty in the most efficient and administrable manner possible. Since Senator Russell Long helped create the EITC in 1975, bipartisan support for the program and its goals has been growing. With its message of "work pays," the EITC helps reduce dependency on welfare and increase reliance on jobs. Prior to 1993, Congress voted to significantly expand the EITC in the Tax Reform Act of 1986 and the Omnibus Budget Reconciliation Act of 1990.

This Administration's commitment to the EITC has been demonstrated through a number of legislative and administrative actions since early 1993. In February 1993, we proposed an expansion of the EITC in order to improve its effectiveness in encouraging work and increasing the disposable income of working families. With certain modifications, Congress enacted the Administration's proposals as part of the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993). The EITC is growing as it was designed to grow pursuant to the three expansions signed into law by Presidents Reagan, Bush, and Clinton respectively. As soon as those expansions are fully phased in, the EITC costs will grow at a slower rate than gross domestic product (Figure 1).

Since the passage of OBRA 1993, we have proposed further legislative changes to improve the administration and targeting of the EITC, while reducing the costs of the program. Four of these proposals were included in the Uruguay Round Agreement Act of 1994 (URAA). As a consequence of that legislation, the EITC is denied to nonresident aliens and prisoners, taxpayers are required to provide a taxpayer identification number for each EITC qualifying child regardless of age, and the Department of Defense is required to report to both the IRS and military personnel the non-taxable earned income used in computing the EITC.

In this year's budget, we proposed that the EITC be denied to taxpayers with \$2,500 or more of interest and dividend income. A similar, but modified, provision was included in H.R. 831, which extended and expanded the 25 percent deduction for health insurance costs incurred by self-employed individuals.

We have also made several proposals which are still pending final legislative action. This year's budget includes proposals to deny the EITC to undocumented workers and to provide the IRS with the authority to use simpler and more efficient procedures when taxpayers fail to supply a valid social security number. In addition, the Administration proposed legislation last year that would permit demonstration projects to test alternative methods of administering advance payments of the EITC. We hope that Congress will act on these outstanding proposals.

As Commissioner Richardson will testify, the Administration has taken other significant actions to strengthen the integrity of the EITC. We have expanded our outreach efforts to ensure that eligible low-income individuals are aware of the EITC and the advance payment option. We have also conducted studies of EITC compliance and the broader issue of problematic refunds. Last spring, then-Secretary Bentsen appointed a Task Force to conduct an independent investigation of the refund fraud, and Under Secretary Noble presented their interim findings and call for aggressive action to the Ways and Means Oversight Subcommittee last October. This year, we have intensified our scrutiny of returns claiming the EITC in order to prevent erroneous refunds from being paid to ineligible individuals.

We understand that members of this Committee are concerned about non-compliance and are also considering ways in which the EITC could be redesigned to reduce the cost of the credit to the Federal government. However, in recent weeks we have become quite concerned about how the goals and purpose of the EITC have been mischaracterized. Moreover, many proposals that have been discussed to change the EITC, though described as compliance measures, would not reduce error rates. Rather, these proposals would simply increase the tax burden on low and moderate-income working families. In fact, some alternative proposals to redesign the EITC would actually cause both non-compliance and work disincentives to increase. Finally, before considering significant changes to this important work incentive, we would urge the Congress to wait until we have had time to observe the effects of both recent legislation and our enhanced compliance efforts.

In the remainder of my testimony, I will discuss in some detail the goals of the EITC and the actions taken by the Administration to strengthen the effectiveness

of the EITC, as well as our views regarding proposals for possible modifications to the EITC.

DESCRIPTION OF EARNED INCOME TAX CREDIT FOR LOW-INCOME WORKERS

The EITC is a refundable tax credit that is available only to low and moderate income workers who have earned income and meet certain adjusted gross income (AGI) thresholds. To be eligible for the EITC, a taxpayer must reside in the United States for over six months. Nonresident aliens are not entitled to the EITC beginning in 1995.

The amount of the credit increases significantly if an individual has one or two qualifying children. A child qualifies a filer for a larger EITC by meeting relationship, residency, and age tests. To meet the relationship test, the individual must be a child, stepchild, descendent of a child, or foster child of the taxpayer. The child must generally reside with the taxpayer in the United States for over half the year. For foster children, the residency test is extended to the full year. A qualifying child must be under the age of 19 (24 if a full-time student) or be permanently and totally disabled. By tax year 1997, a taxpayer must provide a taxpayer identification number (TIN) for each qualifying child.

Computation of the Credit. The credit is determined by multiplying an individual's earned income by a credit percentage. For a family with only one qualifying child, the credit percentage for 1995 is 34 percent. The credit amount increases as income increases, up to a maximum income threshold. For 1995, the income threshold is \$6,160. Therefore, if there is only one qualifying child, the maximum credit for 1995 is \$2,094 (34 percent of \$6,160).

The credit is reduced and eventually phased out once AGI (or, if greater, earned income) exceeds a certain phase-out threshold. For 1995, the phase-out threshold is \$11,290. The phase-out is accomplished by reducing the credit by a phase-out percentage. In 1995, for a family with only one qualifying child, the credit is reduced by an amount equal to 15.98 percent of the excess of AGI (or, if greater, earned income) over \$11,290. The credit is completely phased out and is no longer available to taxpayers with incomes above the end of the phase-out range. In 1995, this income level is \$24,396. The income thresholds for both the phase-in and phase-out ranges are adjusted for changes in the cost of living.

If there are two or more qualifying children, the credit percentage, income thresholds, and phase-out percentage are higher. For 1995, the credit percentage for families with two or more children is 36 percent of the first \$8,640 of earned income. Filers with earnings between \$8,640 and \$11,290 are entitled to the maximum credit of \$3,110 (36 percent of \$8,640).

The phase-out percentage for these families is 20.22 percent. As in the case of the credit for families with one child, the credit is phased out starting at \$11,290. However, the phase-out range for families with two or more children extends to \$26,673.

In 1996, the credit percentage for families with two or more children will increase to 40 percent of the first \$8,900 of earnings. Filers with earnings between \$8,900 and \$11,620 will be entitled to the maximum credit of \$3,560 (40 percent of \$8,900). The phase-out percentage will also increase to 21.06 percent, and the phase-out range will extend to \$28,524. Thereafter, the income thresholds for both the phase-in and phase-out ranges will be adjusted for changes in the cost of living. (The dollar amounts shown for 1996 are estimates.)

Workers who do not reside with qualifying children may claim the EITC if they are between 25 and 64 years of age and are not claimed as a dependent on another taxpayer's return. For these workers, the basic credit is 7.65 percent of the first \$4,100 of earned income for a maximum credit of \$314. In 1995, the phase-out range for these workers is between \$5,130 and \$9,230 of AGI (or, if greater, earned income). The phase-out percentage is also 7.65 percent. The income thresholds for both the phase-in and phase-out ranges are adjusted for changes in the cost of living.

Figures 2 and 3 show the EITC credit structure for 1995 and 1996, respectively.

Advance Payments of the EITC. There are two ways to receive the EITC. Individuals can claim the credit by completing a Schedule EIC when filing their tax return at the end of the year. Alternatively, individuals with qualifying children may elect to receive a portion of their EITC in advance by filing a Form W-5 with their employer. These individuals are entitled to receive on an advance basis up to 60 percent of the credit allowable for a family with one qualifying child. The employer is not required to verify a person's eligibility for the credit.

At the end of the year, the employer notifies both the IRS and workers of the actual amounts of advance credits paid to individual workers on the Form W-2. When

filing tax returns at the end of the year, these workers reduce the amount of EITC claimed by the amount of advance payments received.

Questionable Claims: The IRS must follow normal deficiency procedures when investigating questionable EITC claims. First, contact letters requesting additional information are sent to the taxpayer. If the necessary information is not provided by the taxpayer, a statutory notice of deficiency is sent by certified mail, notifying the taxpayer that the adjustment will be assessed unless the taxpayer files a petition in Tax Court within 90 days. If a petition is not filed within that time and there is no other response to the statutory notice, an assessment is made in which the EITC is denied.

Refundable Nature of Credit: The EITC offsets Federal taxes paid by low and moderate-income families. In recent discussions, there has been some confusion regarding the refundable nature of the EITC. In large part, this confusion appears to stem from the distinction between Congressional intent and budgeting conventions. Under conventional budget accounting practices, the EITC is shown in the budget as a reduction in taxes only to the extent to which it offsets a taxpayer's liability for taxes paid through the income tax system. This is because the EITC is claimed through the income tax system and as a practical matter, the credit can be most easily measured as an offset against the taxes paid through this system. Thus, under these conventions, about 23 percent of EITC costs in FY 1995 are shown in the budget as a reduction in Federal income taxes and other taxes paid through the income system, including self-employment taxes (SECA). About half of EITC recipients have an income or SECA tax liability prior to the receipt of the EITC.

Given that the EITC is created to offset the tax burden of low and moderate-income families, the EITC should not simply be measured as an offset to income and SECA taxes. When the reduction in the employee and employer portions of all social security taxes are included in the calculation, about 78 percent of EITC costs offset individual income and payroll taxes paid by recipients. Nearly all EITC recipients are subject to either individual income or social security taxes before qualifying for the EITC. Even this measure does not take into account other taxes which are offset by the EITC. During the consideration of both OBRA 1990 and 1993, the EITC expansions were also viewed as a way of offsetting the burden of increases in excise taxes, particularly the increases in the gasoline tax.

There has also been some confusion about the fact that most EITC recipients choose to claim the credit at the end of the year as a lump-sum payment rather than by adjusting their withholding or by taking advantage of the advance payment option. In that regard, EITC recipients are not very different from the majority of taxpayers who choose to receive a refund at the end of the year, rather than reduce their income tax withholding during the year. About 70 percent of non-EITC recipients receive an average refund of \$1,150 at the end of the year.

GOALS OF THE EITC

In developing the Administration's agenda for the EITC, we have been guided by the three basic principles of tax policy: efficiency, fairness, and simplicity. Specifically, we have sought expansions and modifications to the EITC in order to achieve the following four goals:

- (1) to make work pay for those who might otherwise be on welfare;
- (2) to ensure that an individual who works full time throughout the year will not live in poverty;
- (3) to target benefits to those with the greatest needs while minimizing distortions; and
- (4) to make it easier for eligible individuals to claim the credit and for the IRS to verify their eligibility.

I would like to address each of these four goals in more detail.

For low-income families, the EITC *makes work* pay in two ways. Unlike many other assistance programs for low-income families, the EITC is limited to working families. Moreover, the credit amount initially increases—rather than decreases—for each additional dollar of earnings. As a consequence, the EITC is different from other low-income assistance programs that are characterized by a reduction in benefits for each additional dollar of earnings. The EITC significantly increases the marginal return from working for both those who do not work at all and those who work less than full-time at minimum-wage jobs throughout the year.

The positive link between the EITC and work also helps offset the work disincentives created by other tax and transfer programs. Between 1983 and 1990, payroll taxes increased five times. Currently, workers are taxed at the combined employer and employee rates of 15.3 percent on the first dollar of earnings for the old-age, survivors, disability and health insurance (OASDHI) programs. Beyond a relatively

low income threshold, food stamp benefits are reduced by 24 cents for each additional dollar of earnings. *The EITC, with its positive credit rate on low earnings, is the only program designed to help offset the marginal tax rates imposed by these other programs.*

A person who works at a full-time job for the entire year should not live in poverty. The Federal government assists low-income families in a number of ways. The Federal government requires employers to pay workers at least the minimum wage, and provides direct assistance to families through food stamp benefits and the EITC. In order to ensure that a family of four dependent on a full-time worker earning the minimum wage is lifted out of poverty, it would require a combination of food stamps, enactment of the President's proposal to increase the minimum wage, and implementation of the expanded EITC.

Earlier this year, Secretary Rubin visited a volunteer income tax assistance (VITA) site here in the District of Columbia. At the site, he met Rhonda Clark, a mother from Maryland. Talking of her experiences with the EITC, Ms. Clark said, "I enjoy working and I want to continue. The EIC gives me some of the help I need—to keep working, to stay independent, and to support my family. It's a help I can not do without." Ms. Clark's experience provide a vivid example of how the EITC makes a difference in people's lives by encouraging them to work and providing them with additional assistance.

As the EITC has increased in recent years, the minimum wage and other benefits received by low-income working families have declined in real value. Without an increase in the minimum wage, its real value in 1996 will decline to its lowest value in forty years. In addition, AFDC benefits are no longer provided for most families in which a mother works at least half-time. In the early 1970s, most states provided AFDC benefits as a wage supplement to a mother with two children whose earnings equaled 75 percent of the poverty level. Currently, only three states provide comparable benefits. The EITC expansions have been necessary to at least partially offset the reductions in the real value of the minimum wage and other Federal benefits.

The benefits of the EITC should be *targeted to families with the greatest needs and to those who can be best served by the positive incentives associated with the EITC.* As a consequence, the credit rate is highest at very low earning levels, thus reaching individuals who are often making the critical step from welfare to work. Because larger families have greater needs than smaller families, taxpayers with two or more children are entitled to a larger EITC than taxpayers with one or no children.

Families with incomes slightly above the poverty level also require assistance. Wages have stagnated for many workers and declined markedly for low-wage workers. Between 1973 and 1993, real hourly wages of full-time male workers at the tenth percentile (that is, those whose wages are just above those of the lowest-paid 10 percent of workers) declined 16 percent, while real hourly wages at the median fell 12 percent. By providing the EITC to families with incomes of up to \$28,524 in 1996, the program provides a cushion to protect moderate-income families from the effects of wage stagnation.

We recognize that the targeting of the EITC to the neediest workers could have unintended effects. First, the EITC increases the income of all recipients, allowing them to maintain their standard of living with less work effort. For very low-wage workers, these negative effects are largely offset by the fact that the credit also increases their after-tax wage rate and thus the pay-off to work. As incomes increase above \$11,290, EITC benefits begin to phase-out. As a consequence, the marginal tax rates for families of modest means increase. Among recipients in the phase-out range, the EITC could cause some individuals, primarily the spouses of other workers, to reduce the number of hours worked in response to higher marginal tax rates.

In this regard, the EITC is similar to any benefit program which targets assistance to the very neediest families. We cannot target assistance to low-income families without causing marginal tax rates to increase for families with slightly higher income. However, we can seek to *minimize such distortions.*

The fourth goal of the EITC is simplicity and verification. If eligibility rules are simple, taxpayers can more accurately claim the EITC and avoid costly errors. With simple and verifiable eligibility rules, the IRS can also better ensure that the EITC is paid only to taxpayers who are eligible for the credit.

Simplicity is particularly important, because eligible individuals can claim the EITC directly when they file their tax return. It is likely that this simple application process has contributed to high participation rates in the program. It has been estimated that between 80 and 86 percent of eligible persons claimed the EITC in 1990.

From the IRS's perspective, it is easier to verify eligibility for the EITC if the rules are simple. Moreover, because the IRS does not ordinarily interview EITC

claimants, it is important that eligibility be based on criteria which can be verified as quickly as possible through independent reporting sources. Simplicity and verification prior to the payment of the EITC are key to the successful operation of the program.

This Committee recognized the importance of the need for simplicity during consideration of OBRA 1990. At that time, data from the 1985 Taxpayer Compliance Measurement Program (TCMP) became available, showing an unacceptable number of erroneous EITC claims. In response, then-Chairman Bentsen requested that the Bush Administration work with the tax-writing committees to address this problem. The simplification provisions contained in OBRA 1990 were a first step toward reducing EITC error rates. As described below, additional steps have been taken since 1990 to further reduce EITC error rates.

LEGISLATIVE AND ADMINISTRATIVE ACTIONS IN 1993 AND 1994

As I outlined in the beginning of my testimony, the Administration and Congress have taken a number of important legislative and administrative actions during the past two years in order to improve the effectiveness and administration of the EITC. I would like to review with you our accomplishments during this period.

OBRA 1993. OBRA 1993 expands the EITC and makes the program more effective in achieving its policy objectives.

First, OBRA 1993 increased the returns from working for those outside the workforce and for other very low-wage workers. (See Figure 4.) For very low-wage workers without qualifying children, the EITC offsets the employee portion of the OASDHI tax. During the past decades, these workers had borne the full burden of increases in OASDHI taxes because they were not entitled to the EITC. For a family with one child, the credit rate for those with low earnings was increased by 11 percentage points from 23 percent to 34 percent. For a family with two or more children, the credit rate for those with earnings below \$8,900 in 1996 was increased by 15 percentage points from 25 percent to 40 percent. For low-wage workers with two or more children, the EITC will fully offset the combined employee and employer portions of the OASDHI taxes and the food stamp benefit reduction formula.

The OBRA 1993 expansion was also a critical step toward achieving the goal that a full-time worker should not live in poverty if he or she works throughout the year. In combination, a minimum wage job, food stamp benefits, and the EITC can lift a single parent with one or two children out of poverty. But, the income (including the EITC and food stamps and subtracting the employee portion of OASDHI taxes) of a family of four with only one full-time, minimum wage worker falls below the official poverty threshold. Prior to the passage of OBRA 1993, the poverty gap for a family of four would have been \$2,435 in 1996. The OBRA 1993 expansion significantly closes that gap. However, since the minimum wage has not kept pace with inflation, the job is not completed yet. This is why the President has proposed that the minimum wage be increased over two years by 90 cents.

OBRA 1993 reduced the poverty gap for minimum wage workers by increasing the maximum benefits by nearly \$1,500 in 1996 for a family with two or more children. For these families, this increase in the maximum credit, without a change in the phase-out range, would have resulted in a phase-out rate of 30 percent. In OBRA 1993, we tried to find a balance between the goals of providing low-income families with sufficient income support, while minimizing the marginal tax rates placed on families with higher, but still modest, levels of income.

Thus, the increases in the maximum credit were accompanied by changes in the income thresholds. For all families with children, the beginning of the phase-out range was lowered by about \$1,600. As a consequence, the phase-out rate actually fell slightly for a family with one child since the end of the phase-out range was left unchanged. To reduce marginal tax rates among families in the phase-out range, eligibility for the EITC was extended to families with two or more children that have incomes in 1996 of up to \$28,524 (or about \$3,000 above the prior level). The combination of these factors increased the phase-out rate from 17.86 percent to 21.06 percent, rather than 30 percent.

While the effect of OBRA 1993 can not be measured yet, we believe that the legislation will, on net, increase work effort. While some workers with larger families will face slightly higher marginal tax rates, they are unlikely to change their behavior much in response. These are individuals who are already very attached to the work force. *They cannot easily adjust their hours of work in response to a small change in tax rates; they need both their jobs and the EITC to meet their day-to-day needs, and most employers will not allow them the discretion to work fewer hours.* The effect of the higher marginal tax rates on some workers in the phase-out range will likely be far outweighed by the effect of the increase in the credit rate. By mak-

ing work pay, the OBRA 1993 increase in the credit rate will encourage non-workers to enter the workforce and other low-income part-time workers to increase their hours of work.

Finally, OBRA 1993 simplified the eligibility criteria for the EITC beginning in 1994 by eliminating the two supplemental credits for health insurance coverage and for taxpayers with children under 1 year of age. These two supplemental provisions added several paragraphs to the instructions, 10 additional lines on the Schedule EIC, and two additional look-up tables. The IRS could not easily verify eligibility for the supplemental credits because it did not receive independent verification of taxpayers' eligibility for them. These changes should improve compliance by reducing errors and improving verification.

URAA. URAA contains several provisions to improve the targeting of the EITC to those with the greatest need. Under this legislation, nonresident aliens are denied the EITC beginning in 1995. Under prior law, nonresident aliens could receive the EITC based on their earnings in the United States, even though they were not required to report their world-wide income to the IRS. Thus, it was possible for a wealthy foreign student to obtain the EITC based on his or her earnings as a teaching assistant at an American university.

In addition, prisoners will not be eligible for the EITC based on their earnings while incarcerated. In the past, prisoners generally would not have been able to claim the EITC because they did not reside with a qualifying child for over half the year. When the EITC was made available to workers without children in 1994, it became possible for prisoners to receive the EITC based on their earnings at prison jobs. Because this provision was made effective for tax year 1994, the EITC will not be paid to these individuals.

URAA also contained two provisions to improve the administration of the EITC. By 1997, taxpayers will be required to provide TINs for all dependents and EITC qualifying children, regardless of their age. By requiring EITC claimants to provide the TINs of all children, regardless of age, URAA improves the ability of the IRS to verify the eligibility of a taxpayer for the EITC.

Under the legislation, the Department of Defense is required to provide military personnel and the IRS with information regarding basic housing and subsistence allowances (or in-kind equivalents) and income excluded by reason of service in a combat zone. These changes will not increase their taxable income but will improve accuracy in reporting and verification of earned income. The savings from this provision are somewhat offset by another provision which extends EITC eligibility to military personnel stationed abroad.

Administrative Actions. The Administration has taken a number of steps to ensure that eligible individuals know about the EITC and the advance payment option. While many eligible persons receive the EITC, fewer than 1 percent of EITC claimants receive the credit through advance payments. The reasons for the low utilization rate are not fully known. One possible explanation is that workers simply do not know that they have the option of claiming the credit in advance. A General Accounting Office study in 1992 provided some support for this theory when investigators found widespread ignorance about the advance payment option among low-income workers.¹

The Administration has intensified its efforts to alert taxpayers of their eligibility for advanced payments. As one of the first steps, President Clinton announced a Federal campaign in 1994 to enroll eligible government workers in the advanced payment system. The Treasury Department and a group of business executives have also joined forces to encourage private-sector employers to notify their workers about the advanced payment option. As required by OBRA 1993, the IRS sends out notices to EITC claimants after the filing season, informing them about the advance payment option and (although not required by the 1993 legislation) also supplying a Form W-5 for their use.

As Commissioner Richardson will explain, the Administration has also taken steps to ensure that those who are not eligible for the EITC do not receive it. During a two-week period in January, 1994, the IRS conducted a pilot study to determine what additional enforcement tools might be necessary to detect and prevent erroneous refunds during the remainder of the 1994 filing season. The results of the pilot compliance study, drawn from a sample of over 1,000 taxpayers who filed electronically during a two-week period in January, 1994, found that about 26 percent of every dollar claimed in the EITC was in excess of the actual amount owed to the taxpayer.

¹ U.S. General Accounting Office. *Earned Income Tax Credit: Advance Payment Option is Not Widely Known or Understood by the Public.* (GAO/GGD-92-26, February 19, 1992).

The results of this pilot study are not representative of the EITC filing population as a whole. Nonetheless, the IRS has taken a number of responsible and needed steps to limit the EITC to those who are entitled to the credit. Beginning this year, the IRS is validating the social security numbers on all tax returns claiming the EITC. Refunds on returns with incorrect or missing numbers are being delayed while the IRS checks the accuracy of the refunds claimed. We estimate that the effects of the social security validation tests, along with conventional enforcement activities and the repeal of the complicated supplemental credits, should reduce the error rate to 19 percent. Using the results of the pilot study and other information, the IRS is also increasing its screening and review of all returns to ensure that only those taxpayers entitled to refunds receive them. As a consequence, refunds may be delayed on other questionable returns. These additional enforcement procedures should further reduce erroneous payments of the EITC. Moreover, we anticipate that the error rates should be further reduced as a consequence of other legislative steps, described above, which are still being implemented over the next several years (e.g., the requirement that taxpayers provide a taxpayer identification number for all children regardless of age). Also, Congressional action on the Administration's remaining legislative proposals, described below, should further reduce error rates. In combination, implementation of these enforcement procedures will make it more difficult for taxpayers to erroneously claim the EITC.

Finally, the IRS stopped providing Direct Deposit Indicators in the 1995 filing season to lenders who were providing refund anticipation loans. This action is also expected to reduce compliance problems that were associated with refund anticipation loans. The IRS's actions this filing season have been applauded as both responsible and necessary by Ways and Means Oversight Subcommittee Chairman Johnson and Ranking Member Matsui in a recent "Dear Colleague" letter to House members.

FY 1996 BUDGET PROPOSALS

The Administration included several proposals to improve the targeting and administration of the EITC in this year's budget submission. We are ready to work with the Congress on those proposals which have not yet been enacted.

Deny EITC to taxpayers having more than \$2,500 of taxable interest and dividends. Under this proposal, the EITC would be denied to taxpayers having more than \$2,500 of taxable interest and dividends beginning in 1996. This threshold would be indexed for inflation thereafter.

This proposal would improve the targeting of the EITC to the families with the greatest need. Under current law, a taxpayer may have relatively low earned income and be eligible for the EITC, even though he or she has significant interest and dividend income. Most EITC recipients do not have significant resources and must rely on their earnings in order to meet their day-to-day expenses, but taxpayers with significant interest and dividend income can draw upon the resources that produce this income to meet family needs.

This proposal, with some modification, was included in H.R. 831, which extended and expanded the 25 percent health insurance deduction for self-employed individuals. H.R. 831 lowered the asset income threshold to \$2,350 and expanded the categories of income subject to the threshold to include tax-exempt interest and net positive rents and royalties. The asset income threshold is not indexed.

In developing the Administration's proposal, we considered a broader list of asset income subject to the cap. We recognized that a broader list might increase equity, by treating the recipients of certain other types of asset income in the same manner as those who receive interest and dividend income. An expanded list would also reduce the incentive to choose a particular type of investment based on its tax or refund consequences. However, we were also concerned because the inclusion of net positive rents and royalties would add complexity to the determination of the EITC. These items are not reported separately on the Form 1040. We did not include the broader list of asset items because we were also concerned that low-income taxpayers could not convert real estate holdings and other types of assets into cash as easily as savings accounts and stocks in a time of need.

While we did not oppose the inclusion of tax-exempt interest and net rents and royalties in H.R. 831, we are very concerned about the asset income threshold not being indexed. We believe that the asset income threshold should be indexed in the same manner as all other income parameters for the EITC. Without indexation, the number of persons affected by this provision will increase over time. By 2000, the threshold would be equal to about \$2,075 in 1996 dollars and would increase the number of affected taxpayers from about 550,000 to 650,000.

EITC Compliance Proposals. Under this budget proposal, only individuals who are authorized to work in the United States would be eligible for the EITC beginning in 1996. Taxpayers claiming the EITC would be required to provide a valid social security number for themselves, their spouses, and their qualifying children. Social security numbers would have to be valid for employment purposes in the United States. Thus, eligible individuals would include U.S. citizens and lawful permanent residents. Taxpayers residing in the United States illegally would not be eligible for the credit.

In addition, the IRS would be authorized to use simplified procedures to resolve questions about the validity of a social security number. Under this approach, taxpayers would have 60 days in which they could either provide a correct social security number or request that the IRS follow the current-law deficiency procedures. If a taxpayer failed to respond within this period, he or she would be required to refile with correct social security numbers in order to obtain the EITC.

In combination, these provisions would strengthen the IRS's ability to detect and prevent erroneous refunds from being paid out. In addition, the proposals would improve the targeting of the EITC by providing the credit only to individuals who were authorized to work in the United States.

Tax Systems Modernization. The budget submission for the IRS contains funding for the continuation of its tax systems modernization (TSM). We urge the Congress to continue to fund TSM. TSM is vital to the long-run efficiency of the IRS's collection functions. TSM will also enhance the IRS's ability to detect erroneous EITC claims.

DEMONSTRATION PROJECTS PROPOSAL

In June 1994, the Administration introduced the Work and Responsibility Act (H.R. 4605). One of the provisions in H.R. 4605 would provide additional flexibility to States with respect to the EITC. We continue to support this proposal.

The proposal would allow four demonstration projects to determine the effects of alternative methods of delivering advance payments of the EITC. States would apply to the Department of the Treasury to provide advance payments of the EITC directly to eligible residents through a State agency. Such agencies could include food stamp offices, Employment Services, and State revenue departments. State plans would be required to specify how payment of the EITC would be administered. To finance these payments, States would reduce payments of withholding taxes (for both income and payroll taxes) from their own employees by the amount of the advance payments made during the prior quarter. The four selected projects could operate for three years beginning in 1996.

This pilot program is designed to determine whether another approach would be more effective for delivering advance payments than the current employer-based system. For example, a State could choose to allow all eligible EITC recipients to apply for advance payments. By receiving the credit as they earn wages, workers would observe the direct link between work effort and the EITC. Through a State program, individuals could have a choice of receiving the credit from a neutral third-party, without fear of the consequences of notifying their employers of their eligibility for the EITC. Moreover, they could receive assistance in determining the appropriate amount of the EITC to claim in advance.

A State could instead choose to target the advance payments of the EITC to welfare recipients—as a way of driving home the message that “work pays.” These individuals may not know about the EITC, and how it can “make work pay,” because they do not have to file a tax return if their adjusted gross incomes are below the tax thresholds (which are generally less than the poverty thresholds).

If the legislation passes, we will evaluate these demonstration projects in order to understand better how individuals respond to receiving advance payments of the EITC. We will pay careful attention to whether the use of State agencies can increase both utilization of the advance payment system and labor force participation by non-workers.

States also have the resources to verify many of the eligibility criteria for the credit better than employers, reducing the risk of erroneous payments being made to ineligible persons. This option would also allow for an evaluation of alternative delivery systems on compliance.

OTHER SUGGESTIONS

The Administration evaluates other proposals to modify the EITC by the same criteria we apply to our own proposals:

- (1) Does the proposal make work more attractive to those outside the workforce and to others with minimal ties to the workforce?

- (2) Does the proposal reduce the poverty gap for full-time workers?
 (3) Does the proposal improve the targeting of the EITC to the neediest individuals and families in the least distortionary manner? and
 (4) Does the proposal make it easier for eligible taxpayers to accurately claim the EITC and for the IRS to verify their eligibility before refunds are paid out?
 We are concerned that many of the options that may be considered by this Committee do not meet these criteria.

1. SENATE BUDGET COMMITTEE RESOLUTION

The Senate budget resolution assumes that this Committee will reduce the EITC by \$13 billion between FY 1996 and 2000 and \$21 billion between FY 1996 and 2002. The resolution further assumes that these savings can be achieved by repealing the EITC for workers without qualifying children, limiting the increases for families with children, and adopting the Administration's EITC compliance proposals from the FY 1996 budget. During the Budget Committee's deliberations on the budget resolution, we believed that the resolution assumed the repeal of the final phase of the OBRA 1993 expansion, which is scheduled to occur on January 1, 1996. As a consequence, the credit rate for families with two or more children would be frozen at 36 percent instead of 40 percent.

During the floor debate on the budget resolution by the Senate, we learned that the reductions in the EITC are deeper than had been earlier thought. The budget resolution does not merely limit the increases for families with children. Instead, it reduces the EITC for many families below the 1995 levels. Under the resolution, the credit rate for a family with two or more children would be reduced from its 1995 level of 36 percent to 35 percent. In addition, the credit rate for families with one child would be reduced from 34 percent to 30.15 percent. According to Treasury's estimates, the EITC proposals in the Senate budget resolution would reduce the EITC by \$16.6 billion over the next five years and \$25.6 billion over the next seven years.

These proposals would generally limit the effectiveness of the EITC in reducing poverty. For example, in 1996, the maximum EITC for families with two or more children is scheduled to increase from \$3,110 to \$3,560. This is the level necessary, in combination with a 90 cent increase in the minimum wage, to close the poverty gap for a full-time minimum wage worker who supports a family of four. Under the Senate budget resolution, the maximum credit would be \$445 less than current law.

By lowering the credit rate for families with children, the proposal also reduces the effectiveness of the credit for encouraging work effort. Under the proposal, many EITC recipients with earnings of less than \$8,900 could receive a smaller EITC than in 1995. The reductions in the credit rate would also adversely affect those who are currently outside the workforce, but who are choosing between work and welfare.

The Treasury Department estimates that 14 million EITC recipients would be adversely affected by the proposals. Of these 14 million, 10 million workers and their families would be adversely affected by the proposed reductions in the credit for families with children. About 8 million EITC recipients with two or more children would lose, on average, \$305 in 1996. About 2 million very low-wage workers with only one child would lose, on average, \$137 relative to current law. (See Figure 5 and attached table.)

The budget resolution also assumes the repeal of the EITC for 4 million very low-wage workers who do not reside with qualifying children. The OBRA 1993 expansion of the EITC for these workers was designed to help offset the work disincentive effects of the social security tax. If repealed, these workers will lose up to \$324 in 1996. At the poverty level (\$7,710 in 1996), a single taxpayer would have a combined income and social security tax liability of \$1,350 (including \$170 of income tax liability prior to the receipt of the EITC). Under the proposal, the taxpayer's tax liability would increase by \$138. On average, low-wage workers who do not reside with qualifying children would incur a tax increase of about \$173 in 1996.

The Senate budget committee resolution claims to address the problems of fraud and abuse and exploding costs in the EITC program. But EITC costs are not exploding. After OBRA 1993 is fully implemented in 1996, EITC costs will increase in tandem with inflation and population growth. Moreover, the resolution contains only one proposal to address fraud and abuse: the Administration's proposal to deny the EITC to undocumented workers and to provide the IRS with the authority to use simpler and more cost-effective procedures when taxpayers fail to provide valid social security numbers. Instead, the Senate budget resolution would reduce the EITC for 14 million working families, on average, by about \$239.

2. WELFARE REFORM AMENDMENT

During the recent deliberations on welfare reform in this Committee, an amendment to reduce the EITC was circulated. (This amendment was ruled as non-germane under Committee rules, along with other tax amendments.) Copies of the amendment were made available at the time of the mark-up, and we would like to take the opportunity to comment on the proposals. This amendment adopts most of the proposals assumed in the Senate budget resolution. However, it would reduce the EITC far more deeply than was considered in the resolution. According to Treasury estimates, the amendment would reduce the EITC by \$37 billion between FY 1996 and 2000 and \$66 billion between FY 1996 and 2002.

Under the amendment, indexation of the EITC would be repealed. As a consequence, EITC recipients would be entitled to a maximum benefit of \$3,024 in 1996, a reduction of \$536 relative to current law. The maximum benefit amount would not change after 1996. By 2000, the maximum credit amount would be reduced by \$1,016—or 25 percent—relative to current law.

Indexation is necessary to ensure that taxpayers do not lose eligibility for the EITC. Under current law, an estimated 16.7 million taxpayers with children will claim the EITC in 1996. If benefit thresholds are not adjusted for inflation, participation would shrink to 14.8 million by 2000.

Eliminating indexation does not address the issue of fraud and abuse at all. Instead, it denies eligibility for the EITC to millions of law-abiding working taxpayers and reduces the benefits of millions of others who are playing by the rules. A number of tax provisions are indexed for inflation each year. These include the personal exemption, standard deduction amount, the width of the income tax brackets, the phase-out ranges for the personal exemption and deduction amounts, and the social security earnings ceiling. It is inappropriate to suspend indexation on the one provision which is solely targeted to low-income taxpayers.

The amendment would also limit eligibility for the EITC by adding new restrictions on the amounts and types of income held by recipients. The investment income cap would be lowered from \$2,350 to \$1,000. Net capital gains and passive partnership and estate income would also be added to the investment income cap. We would have serious reservations about lowering the investment income cap from \$2,350 to \$1,000.

The amendment's sponsors argue that at prevailing interest rates, a \$1,000 investment cap is associated with about \$16,700 of assets, and that it is inappropriate to provide the EITC to taxpayers with savings this high. While we agree that taxpayers with large amounts of assets should not receive the EITC, we view the \$1,000 investment income cap as too restrictive. Low and moderate-income families should be encouraged to save for down-payments on homes, start-up capital for businesses of their own, their children's education or their own retraining. For example, the median price for a home purchased in 1994 by a first-time homeowner was \$125,000, with an average downpayment of 13.7 percent of the price (or \$17,125), while the costs of a four-year education at a typical state university exceeded \$25,000. Under the proposal, the EITC would be denied to many families saving for these investments in their futures unless they liquidated their savings or shifted their investments to exempted assets.

The amendment would also restrict eligibility for the EITC by expanding the definition of income. For purposes of determining eligibility for the EITC, adjusted gross income would be expanded to include non-taxable social security benefits, child support payments, non-taxable pension income, and tax-exempt interest. We have serious reservations about the expansion of adjusted gross income to include these items.

We have serious concerns about the imposition of an additional tax on social security benefits of taxpayers who qualify for the EITC. The EITC would be reduced by up to over 19 cents for each additional dollar of social security benefits. Low-income elderly workers with children could be subject to higher taxes on social security benefits than some of their better-off neighbors. In part, a portion of workers' social security benefits (as well as non-taxable pension income) represent the return of their own contributions from previously taxed income. The proposal could affect non-elderly workers with young children, too. The EITC would be reduced or eliminated for a low-wage worker whose disabled spouse receives disability insurance benefits. Reducing the EITC benefits of social security recipients could also compound the work disincentives already present in the social security programs.

The tax system does not count child support as income to the custodial parent because child support payments are a continuation of the other parent's obligation to support his or her child. Custodial parents should be encouraged to seek child support, rather than being penalized for obtaining it. As a result, we have serious res-

ervations about this provision as well. This provision would also add complexity to the determination of EITC eligibility and would be difficult to verify. In particular, the IRS does not currently receive information about child support payments.

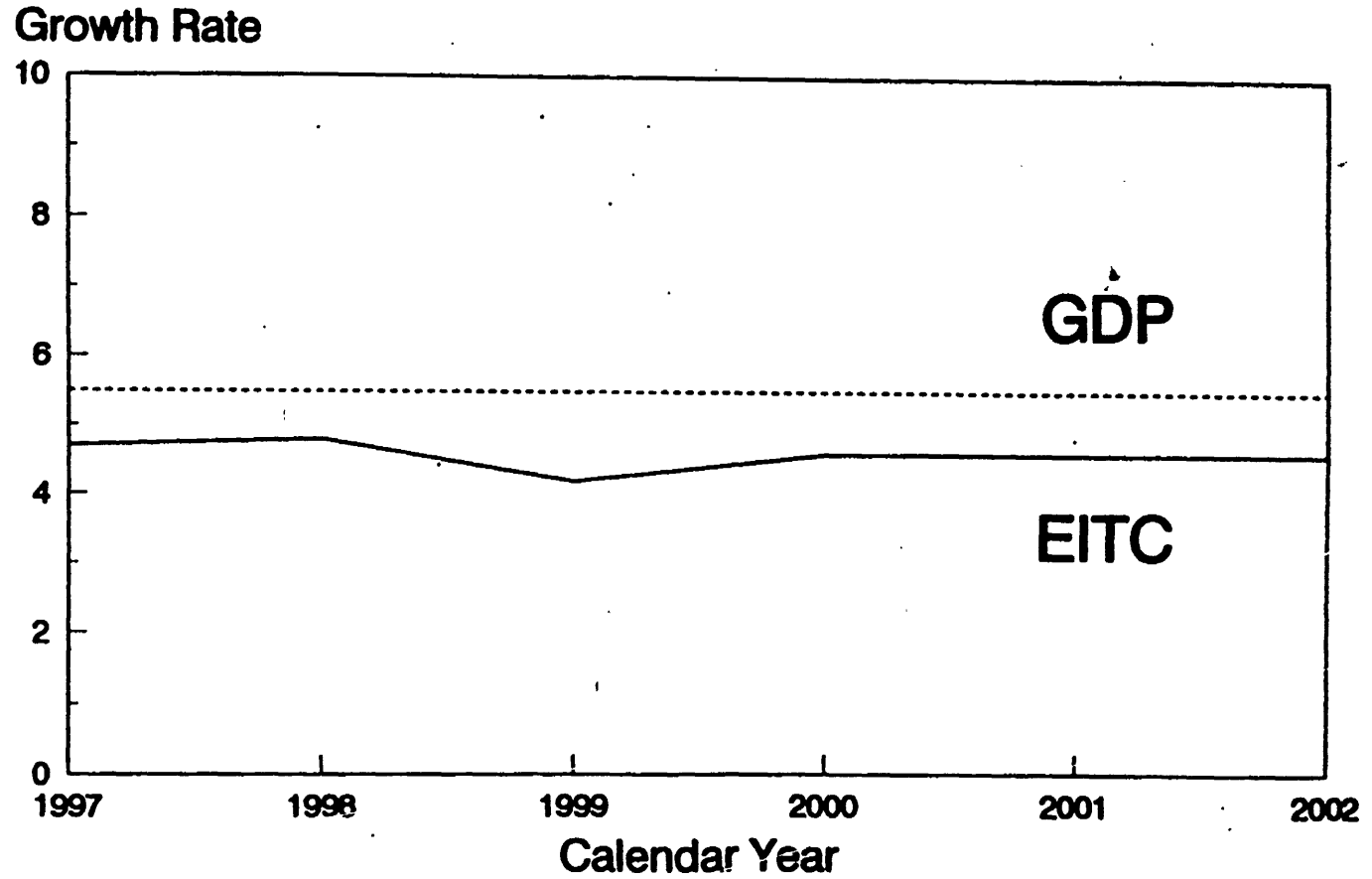
In combination, these proposals would reduce the EITC for 19 million taxpayers, on average, by \$602 (2000 law measured at 1996 income levels). Taxpayers with two or more families would be most adversely affected by these provisions. For eight million taxpayers with two or more children, the EITC would be reduced, on average, by \$886.

The Administration is committed to improving compliance with the EITC rules. Its actions in the last two years are clear evidence of this commitment. The compliance problems which the Administration is addressing should not be used as an excuse to eliminate or reduce the EITC benefits to all low-income working people. Consequently, the Administration strongly opposes proposals to eliminate indexation or to add complexity to the EITC eligibility criteria.

The Administration is committed to taking additional steps to improve the administration of the EITC. We would be interested in exploring with Congress legislative proposals to improve the ability of the IRS to verify eligibility for the EITC. These efforts might include requiring States to provide compatible and timely data on welfare and food stamp beneficiaries to the IRS, so that the IRS could better determine if an EITC qualifying child was claimed by the appropriate taxpayer. Reporting requirements for non-taxable earned income, which is used in the calculation of the EITC, could be enhanced as well.

This concludes my remarks. Thank you once again for providing me with the opportunity to testify. I would be pleased to answer any questions that the Committee may have.

**Figure 1: Growth in the EITC and GDP* •
1997 - 2002**



*Under current law and Administration's January budget assumptions

Figure 2: The Earned Income Tax Credit, 1995

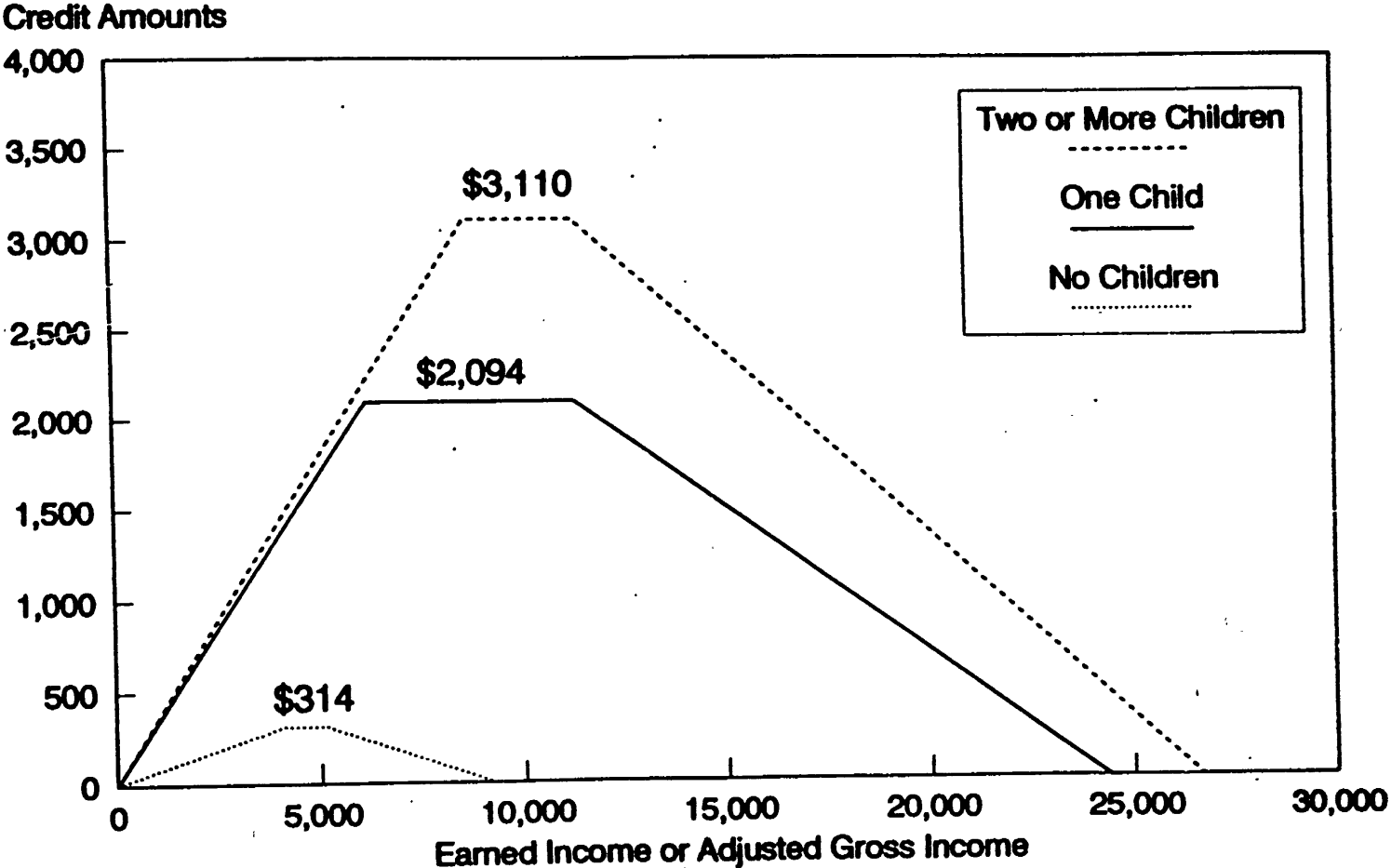
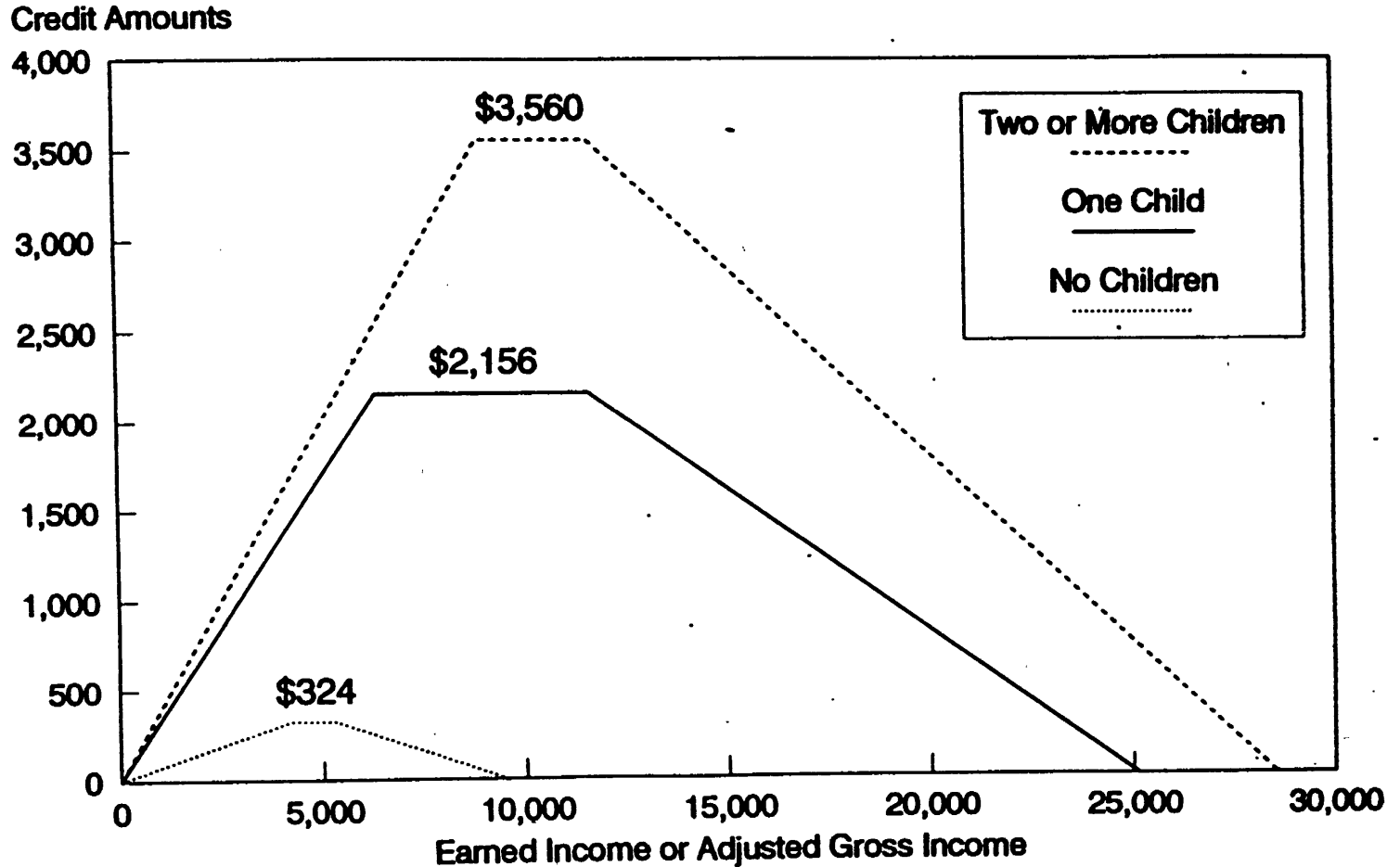


Figure 3: The Earned Income Tax Credit, 1996



**Figure 4: The Earned Income Tax Credit Under
OBRA 1990 and OBRA 1993, Fully Phased In
Workers with Two or More Children, 1996 Dollars**

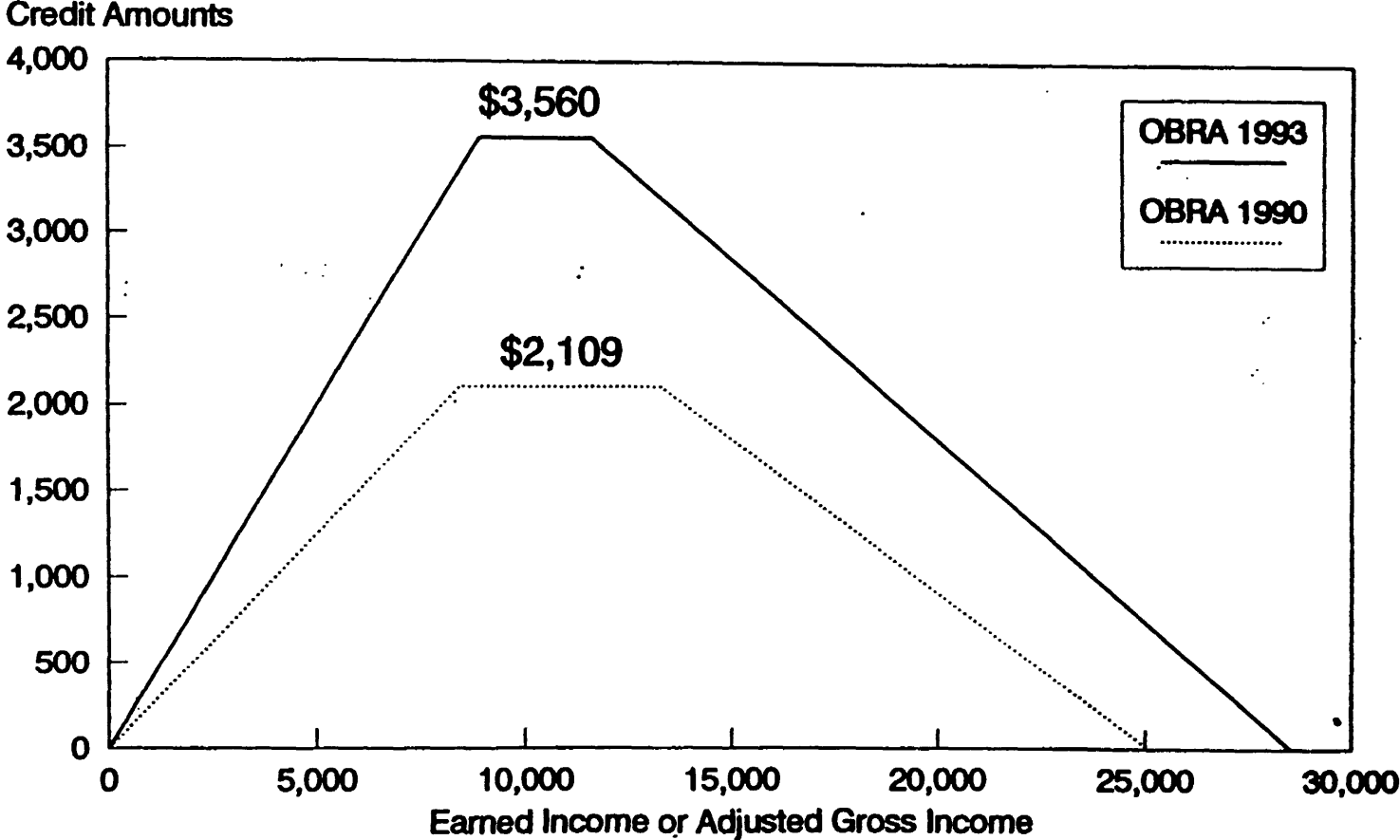
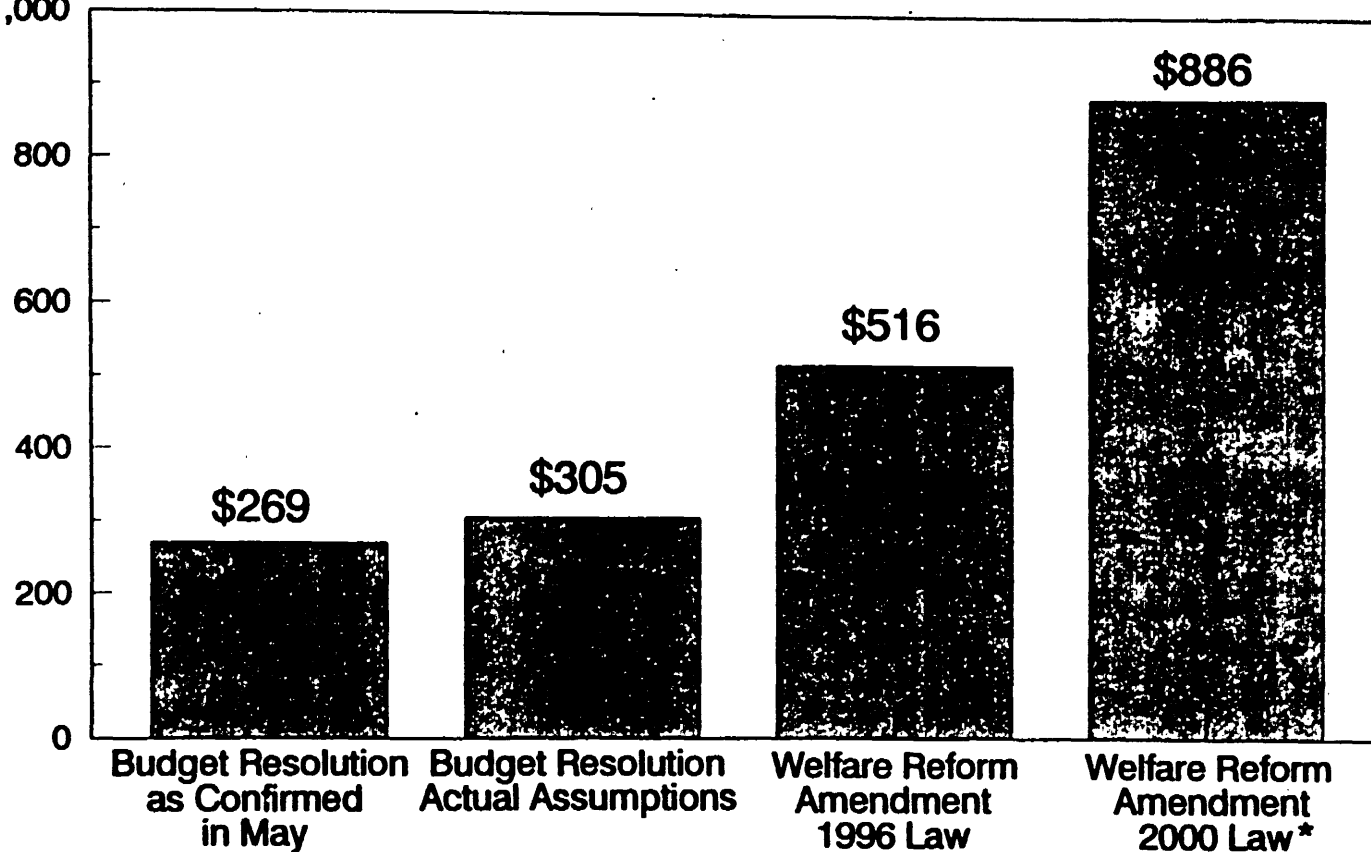


Figure 5: Average Tax Increase for Taxpayers with Two or More Children

1996 Dollars

1,000



* Estimate reflects effects of deindexation by the year 2000, estimated at 1996 income levels.

**Average EITC Tax Increases
1996 Income Levels**

| | <u>Budget Resolution</u> | | <u>Welfare Reform Amendment</u> | |
|---|---|-------------------------------|---------------------------------|----------------------|
| | <u>Confirmed assumptions in May</u> | <u>Actual assumptions</u> | <u>1996 Law</u> | <u>2000 Law*</u> |
| <u>Total EITC Recipients</u> | | | | |
| Number of Affected Taxpayers | 12 million | 14 million | 19 million | 19 million |
| Average Tax Increase | \$235 | \$239 | \$311 | \$602 |
| <u>Taxpayers with Two or More Qualifying Children</u> | | | | |
| Number of Affected Taxpayers | 8 million | 8 million | 8 million | 8 million |
| Average Tax Increase | \$269 | \$305 | \$516 | \$886 |
| <u>Taxpayers with One Qualifying Child</u> | | | | |
| Number of Affected Taxpayers | 0 | 2 million | 7 million | 7 million |
| Average Tax Increase | \$0 | \$137 | \$166 | \$563 |
| <u>Taxpayers without Qualifying Child</u> | | | | |
| Number of Affected Taxpayers | 4 Million | 4 Million | 4 Million | 4 Million |
| Average Tax Increase | \$173 | \$173 | \$173 | \$173 |

Department of the Treasury
Office of Tax Analysis

June 7, 1995

* Estimate reflects effects of deindexation by the year 2000, estimated at 1996 income levels.

RESPONSES TO QUESTIONS SUBMITTED BY SENATOR MOYNIHAN

Question 1: Are there empirical studies which show that food stamps and the social security tax discourage work?

Answer: *Food stamps*—Food stamp benefits are reduced by 24 cents for each additional dollar of earnings. As a consequence, the marginal tax rates for low-income families increase. Among recipients in the phase-out range, food stamp benefits could cause some individuals, primarily the spouses of other workers, to reduce the number of hours worked in response to higher marginal tax rates.

There has been little empirical research on the effects of food stamp benefits on work effort. In large part, this scarcity of research has been due to the fact that it is difficult to isolate the effects of food stamp benefits from other low-income assistance programs. Beneficiaries often obtain other low-income assistance in conjunction with food stamp benefits (e.g., aid for families with dependent children), and there is generally complicated interaction between the eligibility rules amongst these programs. Thus, food stamps are reduced by 30 cents for each additional dollar of AFDC benefits, but AFDC benefits, themselves, are unaffected by the receipt of food stamp benefits.

In a 1988 study, Thomas Flaker and Robert Moffitt examined the effects of food stamps, in combination with AFDC, on the labor supply of female heads. They found that the food stamp program had a modest disincentive effect on female heads, lowering weekly hours of work by about .5 hour per week. Among female heads who were food stamp recipients, the decline in work hours is estimated to be about 1 hour per week or 9 percent. However, the study also found that marginal changes in the program's guarantee or benefit reduction rate had only a small effect on hours of work by female heads. (Fraker, Thomas and Moffitt, Robert. "The Effect of Food Stamps on Labor Supply: A Bivariate Selection Model," *Journal of Public Economics*, February 1988, 35(1), pp. 25-56.)

Social security taxes—Much of the theoretical and empirical literature have taken a comprehensive view of the social security system and its impact on labor supply. In this view, the payroll tax is viewed as only one of many features which affect individuals' decisions regarding work effort over their lifetime. Other features of the social security system, such as the accumulation of social security wealth and the earnings test, also affect an individual's decision to supply labor at various times during their lifetime. Accounting for many of these factors, Richard Burkhauser and John Turner find that social security system, on net, leads to an increase in work at younger ages and a reduction in work at older ages. (Burkhauser, Richard V. and Turner, John A., "A Time-Series Analysis on Social Security and Its Effect on the Market Work of Men at Younger Ages." *Journal of Political Economy*, 86 (4), August 1978, pp. 701-15.) Taking into account the effects of the wage ceiling on payroll taxes, A.M. McElwain and J.L. Swofford find that individuals who expect to have earnings above the wage ceiling during their careers will increase their hours of work during those years. (McElwain, A.M. and Swofford, J.L., "The Social Security Payroll Tax and the Life-Cycle Work Pattern," *Journal of Human Resources*, 21 (2), Spring 1986, pp. 279-87.)

In contrast, many studies which have examined the impact of low-income programs on labor supply have implicitly treated the social security tax as having an independent effect on labor supply. In these studies, individuals modify their labor market activities in response to changes in their wages (net of payroll taxes) and income. (Flaker and Moffitt, Dickert, Stacy, Houser, Scott, and Scholz, John Karl, "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation," *Tax Policy and the Economy*, James M. Poterba (ed.), National Bureau of Economic Research and the MIT Press, 1995, volume 9, pages 1-50.) In effect, these studies assume that low-income individuals are myopic and thus discount the future benefits received from the social security system. Michael Wiseman has suggested that there are significant risks in leaving welfare to work, and that researchers underestimate these risks if they do not view welfare recipients choices in terms of "real time." In this view, a welfare recipient's decision to work will be based on very short-term net gains. (Wiseman, Michael, "Welfare Work Incentives in Real Time," paper prepared for The National Commission on Employment Policy, October 20, 1993.)

Question 2: Have there been any empirical studies showing that the EITC causes individuals to switch from welfare to work?

Answer: In a 1994 study, Stacy Dickert, Scott Houser, and John Karl Scholz simulate the effects of OBRA 1993 on both labor force and program participation. They find that when fully phased-in, the 1993 EITC expansion will, on net, increase labor supply by 19.9 million hours relative to 1993 law. In large part, this net increase in labor supply will be attributable to new entrants to the work force.

Dickert, Houser, and Scholz also find that participation in transfer programs will also fall as a consequence of the expanded EITC. They estimate that nearly 400,000 families headed by a single parent will no longer participate in either AFDC or food stamp. Among married couples, participation in these programs will drop by about 117,000 families. They estimate that the mean annual AFDC and food stamp benefits, in 1994 dollars, are \$6,844 and \$4,702, respectively, for single-parent and two-parent families. In contrast, EITC payments for single-parent and married couple families would be \$2,040 and \$2,842, respectively. (Dickert, Stacy, Houser, Scott, and Scholz, John Karl, "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation," *Tax Policy and the Economy*, James M. Poterba (ed.), National Bureau of Economic Research and the MIT Press, 1995, volume 9, pages 1-50.)

Question 3: How many EITC recipients have a tax liability, even after receipt of the EITC?

Answer: In FY 1995, an estimated 12.7 million EITC recipients (or 63 percent of total EITC recipients) will have a combined pre-credit income and social security tax liability (including both the employee and employer portions) in excess of their EITC.

PREPARED STATEMENT OF LYNDA D. WILLIS

The Earned Income Credit (EIC) is a major federal effort to assist the working poor. As of May 26, 1995, about 17.3 million returns claimed nearly \$20 billion in EIC for tax year 1994. Over the years EIC has been intended to (1) offset the impact of Social Security taxes on low-income workers and (2) encourage low-income individuals to seek employment rather than welfare. In the 1993 expansion of EIC, Congress also recognized a role for it in alleviating poverty. GAO's statement makes the following points:

- A reliable overall measurement of noncompliance with EIC provisions has not been made since 1988. But noncompliance appears to be a problem. The Internal Revenue Service (IRS) studied electronically filed EIC claims during 2 weeks of January 1994. IRS' preliminary estimates indicated that 29 percent of the returns claimed EIC amounts they were not entitled to receive—22 percent claiming a credit when they were not entitled to it and 7 percent claiming too much EIC. About 13 percent of EIC return filers may have intentionally erred requesting or calculating their credit.

Judging by problems spotted by IRS personnel, noncompliance on EIC paper returns is also a concern. As of May 26, 1995, IRS had identified over 3 million paper returns that lacked valid Social Security numbers (SSN) for dependents or EIC qualifying children. IRS asked a significant portion of these taxpayers to provide additional proof of their eligibility.

IRS took several steps this filing season to combat fraudulent or erroneous returns, especially EIC returns. The success of these steps is as yet uncertain. However, IRS is conducting a study of EIC compliance which will help identify whether noncompliance was reduced. Study results may not be available until this fall.

- Although EIC is intended to assist the working poor, EIC eligibility criteria have not considered all of the resources recipients may have to support themselves and their families. However, the Self-Employed Health Insurance Act of 1995 included a provision, effective next year, that denies EIC to claimants who have income from certain types of assets. The act makes claimants ineligible for EIC if they receive more than \$2,350 annually in specified asset-derived income. If Congress wishes to revisit this test, it could consider including additional forms of asset-derived income, such as estate and trust income, as well as changing the threshold amount.

Another approach to taking into account more of taxpayers' resources would be to add certain income to their adjusted gross income when determining EIC awards. According to Joint Committee on Taxation estimates done for Senator Roth, up to \$2.1 billion could be saved in fiscal year 1997 by recognizing certain nontaxed income as well as child support payments.

Both an EIC wealth test and an expanded definition of taxpayers' adjusted gross incomes (AGI) make EIC more complex and add to the burden on taxpayers and IRS. Also, since income information reported on tax returns can only roughly reflect taxpayers' actual wealth, using such data to determine EIC eligibility could raise fairness concerns.

- No one knows how many illegal aliens receive EIC. Illegal aliens may receive EIC if they meet the credit's eligibility rules. Awarding EIC to illegal aliens, however, works at cross-purposes with federal policies that prohibit illegal aliens from legally working in the United States. If the EIC criteria were revised to require that all EIC recipients have valid SSNs for work purposes, which illegal aliens are not eligible to receive, then illegal aliens would no longer qualify for EIC.

Mr. Chairman and Members of the Committee:

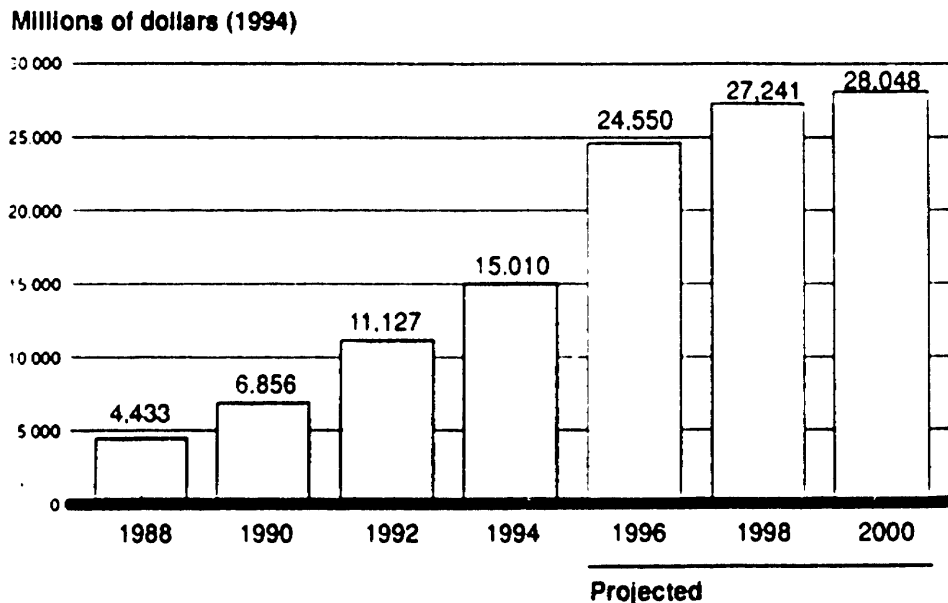
We are pleased to be here today to assist in your review of the Earned Income Credit (EIC). Our testimony is based on a body of work we have done on EIC, including our current work for Chairman William V. Roth, Jr., Senate Committee on Governmental Affairs. It is also based on work we have done related to electronic filing fraud and the Internal Revenue Service's (IRS) annual performance in processing tax returns.

BACKGROUND

Originally authorized in 1975, EIC provides assistance to low-income working taxpayers to offset the impact of Social Security taxes and to encourage them to work. At various times, Congress has broadened EIC coverage and increased the credit amount to (1) ensure that EIC amounts would not fall in purchasing power, (2) increase or maintain the progressivity of the tax system, and (3) better ensure that working individuals would have incomes above the poverty line. As figure 1 illustrates, with these changes the overall cost¹ of EIC is expected to increase more than five-fold in real terms between 1988 and 1996, when EIC costs are estimated to total \$24.5 billion.

FIGURE 1: GROWTH IN EIC PROGRAM COSTS (FISCAL YEARS 1988-2000)

GAO Growth in EIC Program Costs (1988 - 2000)



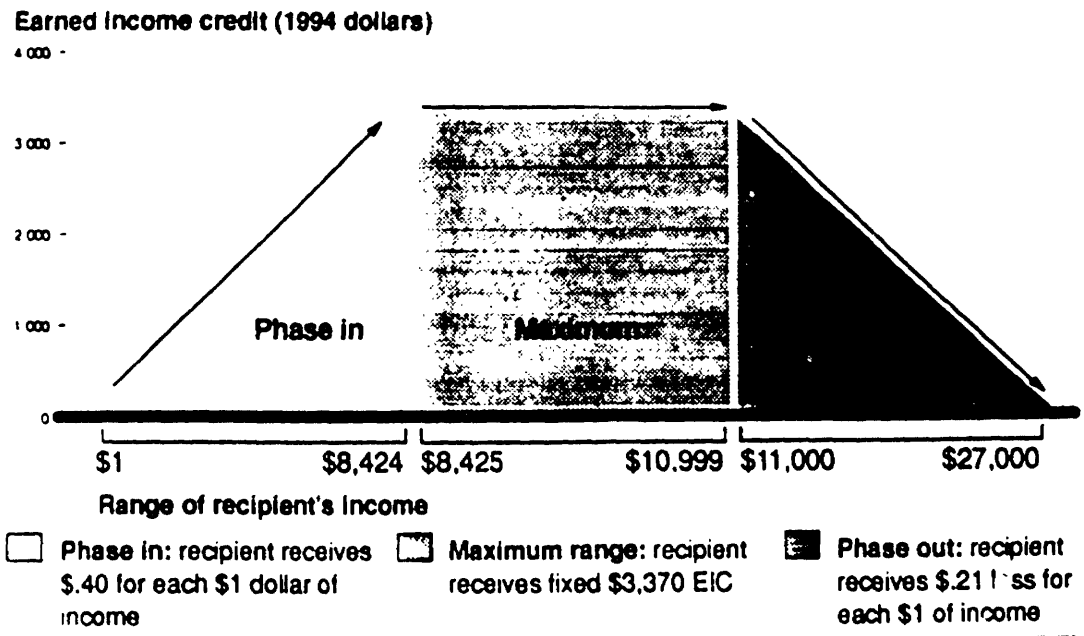
¹The cost figures for EIC include the portion of EIC that offsets taxes recipients may owe as well as any refunds beyond taxes due, which are considered a budget outlay. The cost figures do not include costs IRS incurs to administer EIC.

Note: The projections for fiscal years 1996 through 2000 do not include the effect of the recently created EIC wealth test contained in the Self-Employed Health Insurance Act of 1995. Source: Fiscal year estimates from the Presidents' 1990, 1992, 1994, and 1996 budgets.

The Omnibus Budget Reconciliation Act (OBRA) of 1993 increased the maximum credit available and the income level at which individuals can qualify for the credit. For the first time, it granted eligibility to certain low-income taxpayers without children. As figure 2 illustrates, the credit gradually phases in, plateaus at a maximum amount of \$3,370 for a taxpayer with two qualifying children in 1996, and then phases out until it reaches zero. Taxpayers who qualify for EIC receive a credit against any taxes they may owe and a refund for any amount by which their EIC exceeds taxes owed.

FIGURE 2: RANGE OF EIC FOR RECIPIENTS WITH TWO QUALIFYING CHILDREN (EFFECTIVE IN 1996)

GAC Range of EIC for Recipients With Two Qualifying Children (1996)



Source: Congressional Research Service.

The Self-Employed Health Insurance Act of 1995 further modified the EIC. Although the overall approach of phasing EIC awards in and out on the basis of taxpayers' income was not changed, the act incorporated a test which will deny the EIC to claimants who receive interest, dividends, tax-exempt interest, or positive net rental and royalty income whose sum is more than \$2,350 annually.

NONCOMPLIANCE AND IRS ENFORCEMENT EFFORTS

Noncompliance has been and continues to be a problem with regard to EIC.² IRS has expanded its effort to detect and deter EIC noncompliance.

Extent of Noncompliance

Noncompliance is not a new problem for the EIC. For instance, compliance measurements done by IRS in 1988 estimated that about 42 percent of EIC recipients

² Noncompliance includes erroneous EIC claims caused by negligence, mistakes, confusion, and fraud.

received too large a credit and about 34 percent of the total EIC paid out may have been awarded erroneously.

Although a current, statistically valid measure of overall EIC compliance does not exist, the results of limited studies and of IRS efforts to enforce EIC suggest that a significant compliance problem remains. An IRS study of electronically filed EIC returns during a 2-week period in January 1994 produced a preliminary estimate that 29 percent of the returns claimed EIC amounts they were not entitled to receive—22 percent claiming a credit when they were not entitled to it and 7 percent claiming too much EIC. The total amount of dollars overclaimed represented about 24 percent of the EIC claims during the 2-week period studied. Thirteen percent of the returns were judged to contain intentional errors—a surrogate measure of possible fraud.

Compliance problems in the opposite direction also occurred among EIC claimants. During 2-week period studied, IRS estimates that about 3 percent of EIC returns claimed less EIC than they should have—amounting to about 2 percent of total dollars claimed. Researchers also have estimated that between 14 and 25 percent of eligible families in 1990 did not claim the credit.³

When considering actions to address the EIC's noncompliance problem, the perspective of noncompliance problems in other programs may be useful. Whether EIC noncompliance is higher than for other programs depends in part on what the EIC is compared to and what is considered in making the comparison.

Within the tax system, the EIC noncompliance rate tends to be high, but is not the highest. For instance, IRS believes that "informal suppliers"—self-employed individuals who operate on a cash basis—do not report 89 percent of their income. The self-employed as a group are estimated to underreport their income by 64 percent. Of course, these examples are for compliance in reporting income to pay taxes. In contrast, the EIC is a refundable credit, with most of the funds distributed classified as federal outlays.

Among federal outlay programs that are similar in size to the EIC and serve similar populations, noncompliance rates appear to be lower than the EIC's. According to state-reported data, in 1992 the Food Stamp program over-issued food stamps to 17.6 percent of applicants. State-reported data also show that the program under-issued food stamps to 9.9 percent of applicants. Overall, Food Stamp overpayments in 1992 represented about 8.2 percent of total benefits paid under the program. We were unable to find an estimate of overpayments to applicants for the Aid to Families with Dependent Children (AFDC). The AFDC program had overpayments representing 5.3 percent of total AFDC benefits in that year.

However, the lower noncompliance rates for these programs are associated with administrative costs that likely are many times higher than those of EIC because case workers are required to verify the recipients' qualifications or need. In 1993, AFDC administrative costs represented about 11.6 percent of total AFDC expenditures and Food Stamp administrative costs represented about 12.4 percent of expenditures. EIC administrative costs are not compiled by IRS. However, based on average processing costs for tax forms and assuming that all of the cost of identifying and investigating fraudulent refund schemes is EIC-related, we believe that EIC administrative costs may not exceed 1 percent of EIC program costs.

IRS Efforts to Detect and Deter Noncompliance

This filing season, IRS expanded its efforts to ensure taxpayer compliance. In doing so, IRS used lessons learned from its 1994 study and enforcement experience to improve its systems of identifying possible noncompliant returns. Verifying Social Security Numbers (SSN) validity was key to IRS' efforts. IRS checked the validity of SSNs—expanding its efforts this year primarily to emphasize those used for dependents and EIC-qualifying children. As of May 26, 1995, IRS had identified 4.3 million instances of problems with EIC and non-EIC returns that had been filed electronically. IRS rejected the tax returns associated with these problems. However, the number of rejected returns is unknown.⁴ As of May 26, 1995, IRS had also identified over 3 million paper returns that lacked valid SSNs for dependents or EIC-qualifying children. IRS asked a significant portion of the taxpayers to provide additional proof of eligibility.⁵

³Yin et al., *Improving Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program*, American Tax Policy Institute, Feb. 1994.

⁴Because a return can be rejected for more than one reason, the number of notices may exceed the number of returns. IRS does not know how many of these returns were submitted by (1) persons attempting to defraud the IRS or (2) taxpayers or tax preparers who made mistakes in recording or transcribing SSNs.

⁵The President's proposal, discussed on page 16, would require EIC claimants to have valid SSNs for themselves, their spouses, and their EIC-qualifying children. The proposal also re-

Not surprisingly for such a new initiative, some problems occurred. The expanded SSN verification procedures for paper returns identified many problem returns, but some that should have been selected were not. IRS identified approximately the volume of paper returns with invalid SSNs that it had expected to handle during the filing season. However, the volume of these returns fluctuated widely among IRS Service Centers. For example, one Service Center received about 360 percent of its expected volume, while another received only 61 percent. For the 1995 filing season, IRS was not able to redistribute the workload among the Service Centers. As a result, Service Centers used somewhat different criteria for determining which taxpayers would be asked to provide additional evidence of their EIC eligibility. Computer problems also occurred during the filing season, which caused some returns not to be selected when they should have been.

In addition, IRS delayed refunds primarily in an attempt to identify SSNs used on more than one tax return—its duplicate SSN effort. (IRS had identified duplicate SSNs as a problem during the 1994 filing season.) By May 26, 1995, 6.4 million refunds (primarily EIC returns) had been delayed up to 8 weeks.

IRS also experienced some problems as it began checking for duplicate SSNs. These problems included difficulties in constructing the database to use in identifying duplicate SSNs, poorly organized computer listings that enforcement personnel found difficult to use, and cumbersome procedures for coordinating the work of different IRS Service Centers. IRS is analyzing the results of this year's initiative and plans to make changes for 1996. Further automation of the process is a primary goal.

The steps IRS took this year seem to have been focused appropriately on current indicators of problematic returns. However, it is still too early to assess the success of IRS' new or expanded enforcement initiatives. IRS is conducting a study that should yield statistically-valid measures of compliance with EIC. This study includes both electronic and paper returns filed throughout the filing season. The study should shed light on whether compliance has improved subsequent to the IRS enforcement initiatives. However, results probably may not be available until fall of 1995.

Additional Efforts Needed

Although some improvement in EIC compliance levels may result from IRS' efforts to better verify EIC claimants' eligibility before processing refunds, IRS cannot currently verify all eligibility criteria before sending refunds to taxpayers. In the long run, sound enforcement of EIC may require even better verification of recipients' eligibility before refunds are made.

We have made several recommendations in the past that could help to make EIC less of a problem for IRS and taxpayers. As discussed more fully in appendix I, those recommendations called for (1) eliminating differences between the definition of a qualifying child for EIC purposes and the definition of a dependent for purposes of claiming a dependency exemption; (2) encouraging the advance payment option, whereby persons eligible for EIC can choose to receive it in advance as part of their paychecks; and (3) moving toward more timely computer matching of employer wage information with tax return data.

BETTER MEASURING EIC FILERS' RESOURCES TO DETERMINE ELIGIBILITY

Although EIC is intended to provide assistance to the working poor, claimants' wealth is not taken directly into account in determining EIC eligibility or the amount of the credit provided—as it is for certain welfare programs. However, the Self-Employed Health Insurance Act of 1995 created a test of EIC claimants' wealth that will be effective as of January 1, 1996. This test does not include some types of income taxpayers may receive.

At Chairman Roth's request, we assessed the changes in overall EIC costs that might result from including a wealth test and a more comprehensive adjusted gross income test in determining EIC eligibility and credit amounts. We also evaluated the administrative implications of implementing these tests.

Generally, to facilitate administration of the expanded eligibility tests, we restricted the income items used in the tests to those that are currently reported in some form on the individual's income tax return. For the wealth test, we analyzed asset-derived income such as taxable interest and dividends, tax-exempt interest, estate and trust income, rental income, and capital gains. For the expanded adjusted gross income test, we first analyzed the impacts of including nontaxed Social Secu-

quests authorization to use a simplified procedure to handle returns lacking such SSNs. This proposal may not assist IRS in dealing with invalid dependents' SSNs.

city income, tax-exempt interest, and nontaxed pension distributions in the taxpayer's EIC-adjusted gross income. At Chairman Roth's request, we subsequently added child support payments—which do not currently appear on any IRS form—to the income items.

After we discussed the results of our initial review of the asset-derived income on tax returns that could be included in a wealth test, the potential magnitude of change in EIC payments that would result, and the administrative issues associated with incorporating such a test into EIC, Senator Roth requested revenue estimates covering the next 5 years from the Joint Committee on Taxation. The Joint Committee estimates indicated that potential savings were significant, but that they varied depending on the types of income included in a wealth test and the threshold used to disqualify EIC claimants.

We similarly analyzed the effects of expanding taxpayers' adjusted gross incomes for EIC purposes to include nontaxed Social Security income, tax-exempt interest, and nontaxed pension distributions. For child support payments, we reviewed the administrative issues associated with including such income in an expanded adjusted gross income test. According to Joint Committee on Taxation estimates, expanding adjusted gross income to include nontaxed Social Security income, tax-exempt interest, and nontaxed pension distributions could yield \$1.45 billion in EIC savings in fiscal year 1997. Adding child support payments to the expanded adjusted gross income would increase those savings by another \$686 million according to Joint Committee estimates.

A disadvantage of an indirect wealth test or an expanded adjusted gross income definition is that both would add to EIC's complexity and administrative burden. Complexity, which has been a continuing EIC issue, can lead to increased errors and dissuade deserving taxpayers from claiming the credit. Of those potential changes to EIC criteria that we analyzed, adding child support to adjusted gross income likely would cause IRS the greatest administrative problems, because IRS does not have a ready way to verify such income.

There also are significant limitations in measuring potential EIC recipients' actual wealth by the income they reported on tax returns. For instance, this test would not measure the value of such taxpayer assets as capital stock funds that yield little, if any, annual income. These limitations could raise concerns that taxpayers with similar wealth could be treated differently for EIC.

The President's Budget proposals for fiscal year 1996 also included a change in EIC eligibility criteria—that EIC be denied to anyone whose aggregate interest and dividend income exceeded \$2,500. The \$2,500 threshold was to be indexed for inflation. The President's proposal was incorporated into H.R. 831. During congressional consideration of the bill, the test was modified. As ultimately passed, the test will deny EIC to claimants who receive more than \$2,350 annually in interest, dividends, tax exempt interest, or positive net rental and royalty income. The \$2,350 threshold will not be indexed for inflation. Options for widening asset-derived income included in the test include using net estate and trust income, net capital gains, and lower threshold levels. Adopting an expanded definition of taxpayers' adjusted gross incomes also remains as an option for taking taxpayers' resources more fully into account when determining EIC eligibility and credit amounts.⁶

ILLEGAL ALIEN RECIPIENTS

The Internal Revenue Code does not prohibit illegal aliens from receiving EIC, if they meet the prescribed eligibility requirements. However, illegal aliens cannot be employed lawfully in the United States. Because EIC is intended in part to encourage employment, it works at cross purposes to the prohibition on employment of illegal aliens.

Although no one knows how many illegal aliens may be claiming and receiving EIC, IRS officials estimated that a minimum of 160,000 taxpayers, out of about 8.7 million who filed paper returns claiming EIC in 1994, were likely to be illegal aliens.⁷ IRS expected most of these refunds to be denied because taxpayers likely

⁶These options are discussed in our report, *Earned Income Credit: Targeting to the Working Poor* (GAO/GGD-95-122BR, March 31, 1995).

⁷IRS officials made this estimate based on their enforcement experience and the number of taxpayers entering a code "205(c)" instead of an SSN for their qualifying child. EIC claimants are required to provide an SSN or taxpayer identification number for themselves and their qualifying children. The designation 205(c) is often used by taxpayers to indicate they are not eligible to receive an SSN. Due to a change in how data are compiled, IRS no longer separately identifies the number of 205(c) codes entered by taxpayers in place of SSNs.

would not support their claims by verifying that the qualifying child met the age, relationship, and residency requirements.

Some unknown portion of returns may also be filed by illegal aliens who use SSNs belonging to other individuals. If successfully implemented, IRS' new efforts to detect SSNs that are invalid or have been used on more than one tax return should reduce the number of illegal aliens as well as U.S. citizens incorrectly receiving EIC.

A Senate bill introduced by Senator Roth in 1994 and the administration's proposed Tax Compliance Act of 1995 (H.R. 981 and S. 453) would deny EIC to illegal aliens. The administration's proposal would require that all EIC claimants provide SSNs that are valid for employment in the United States for themselves, their spouses, and their EIC-qualifying children. Because illegal aliens do not qualify for SSNs that are valid for employment in the United States, they would not be able to receive EIC. The administration's proposal would permit IRS to use streamlined procedures to enforce the requirement that EIC claimants have valid work-related SSNs.

The administration estimates that requiring all EIC recipients to provide valid work-related SSNs, and using streamlined procedures to enforce this requirement, would yield about \$400 million in savings in fiscal year 1997.

Mr. Chairman, this concludes my prepared statement. My colleagues and I would welcome any questions that you or Members of the Committee may have.

APPENDIX I

WHAT COULD BE DONE TO MAKE EIC LESS OF A PROBLEM?

Refundable credits, like EIC, pose a challenge for tax administrators. In addition to the concerns about fraud, there also is concern that not all those eligible for EIC are receiving it. We have made several recommendations in the past that could help to make EIC less of a problem for IRS and taxpayers.

The definitions of a qualifying child for purposes of claiming EIC and of a dependent for purposes of claiming a dependency exemption are not the same. A key difference in the two definitions is the requirement, for purposes of claiming a dependency exemption, that the taxpayer provide over 50 percent of a dependent's support (usually referred to as the "support test"). There is no support test in the definition of a qualifying child for EIC purposes. We addressed this problem in a March 1993 report in which we analyzed four alternatives to simplify the laws on dependent exemptions, including two that would change the support test.⁸ On the basis of our analysis, we recommended that Congress consider enacting legislation that would substitute a residency test similar to that used in the EIC program for the dependent support test when the dependent lives with the taxpayer.

A second issue is the timing of payment. Persons eligible to receive EIC can choose to receive it in a lump sum payment after filing a tax return or in advance as part of their paycheck. In February 1992, we reported that fewer than 1 percent of EIC recipients in 1989 took advantage of that second option.⁹ Although use of the advance payment option would help taxpayers benefit from the credit sooner, it could also create problems for IRS if persons receiving the advance payment filed a tax return later but did not report that they had received the credit in advance. Under IRS' returns processing procedures in place at the time we did our review, those persons could receive the credit again as a lump sum payment. We recommended that IRS take various steps to (1) better ensure that eligible taxpayers are aware of the advance payment option and (2) prevent those who take advantage of that option from receiving the credit a second time. IRS has taken steps to better publicize the availability of the advance payment option and is manually checking for duplicate payments of EIC. Advance EIC remains, however, a rarely used option—as of May 26, 1995, about 1 percent of EIC recipients had reported using the advanced EIC for tax year 1994.

With respect to fraud on electronically filed returns, we recommended in December 1992 that IRS work toward electronically matching employer wage information with electronic return data.¹⁰ As of June 1995, IRS had not implemented our recommendation, largely because that kind of match is currently beyond IRS' computer capabilities. Currently, employer wage information other than that provided by taxpayers is not available to IRS until after it has processed taxpayers' returns. This

⁸*Tax Administration: Erroneous Dependent and Filing Status Claims* (GAO/GGD-93-60, March 19, 1993).

⁹*Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public* (GAO/GGD-92-26, Feb. 19, 1992).

¹⁰*Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud* (GAO/GGD-93-27, Dec. 30, 1992).

is because of the time it takes to verify the information and correct any errors.¹¹ IRS has begun to test the possibility of getting partial year's wage information from the states and using it as a means of verifying that the taxpayer is employed and as a source of information on the taxpayer's amount of earned income.

PREPARED STATEMENT OF GEORGE K. YIN

Mr. Chairman and Members of the Committee:

Thank you for inviting me to testify before your committee on the earned income tax credit (EITC) program. I am a consultant to the Treasury Department's Task Force on Tax Refund Fraud, and have performed research on the EITC under the sponsorship of the American Tax Policy Institute, a nonpartisan organization interested in promoting sound tax policy, but I appear before you today in my individual capacity and not as representative of any group.

The purpose of my testimony is to explain how the EITC program can be reformed to accomplish its objectives more effectively and efficiently.

A. OBJECTIVES AND GROWTH OF THE PROGRAM; THE CONTINUING PROBLEM OF
NONCOMPLIANCE.

The EITC program provides cash assistance to low-income working families by means of a refundable income tax credit. The program is intended to rebate the payroll taxes of such families and to provide them with greater income security and a work incentive, all very laudable goals. As a result, since its inception, the program has benefited from broad, bipartisan support and, particularly over the last ten years, it has grown tremendously fast. The following table compares the growth in total federal expenditures for the major means-tested income-support programs between 1986 and 1996:

GROWTH IN FEDERAL EXPENDITURES FOR MEANS-TESTED INCOME-
SUPPORT PROGRAMS, 1986-96

Total Federal Expenditures and Growth Rates

| Program | 1986 spending | 1993 spending | 1986-93 in- crease | 1996 spending (proj.) | 1986-96 increase (proj.) |
|-------------------|------------------|------------------|-----------------------|-----------------------------|--------------------------------|
| EITC | 2.0 | 13.2 | 560% | 25.1 | 11156% |
| SSI | 9.5 | 20.3 | 114% | 27.0 | 184% |
| Food stamps | 12.5 | 24.8 | 98% | n/a | n/a |
| AFDC | 9.2 | 13.8 | 50% | 14.8 | 61% |

Source: U.S. House Comm. on Ways & Means, Overview of Entitlement Programs: 1994 Green Book: Background Material and Data on Programs Within the Jurisdiction of the Committee on Ways and Means (Comm. Print 1994) at 262 (Table 6-25), 389 (Table 10-21), 704 (Table 16-13), 782 (Table 18-11). All spending figures are in billions of dollars unadjusted for inflation.

The table indicates that since 1986, the EITC program has grown far faster than all of the other major means-tested income-support programs, with the nominal growth in the EITC program between 1986 and 1996 projected to be over 1000 percent. According to these figures, by 1996, federal spending for the EITC program will be over one and one-half times as much as the federal Share of the AFDC program.

Unfortunately, the strong support for the program and its rapid growth have not been accompanied by close scrutiny of its basic design and operation, with predictable consequences. There is not yet any reliable data on noncompliance rates following the major changes to the program enacted in 1993 and first effective in 1994 and subsequent years. But in a study of EITC-related returns filed for tax year 1993—when the EITC program was considerably smaller than its projected 1996 levels—the IRS found an excessive EITC claim rate of about 26 percent (by dollars excessively claimed) and 38 percent (by number of excessive claims), and an

¹¹Under the Electronic Management System—one of many planned components of Tax Systems Modernization—IRS expects to electronically receive tax returns, tax information documents (like W-2s), and correspondence. Electronic transmission of W-2s would enable IRS to more quickly verify and correct the information, thus offering the possibility of having that information available to match with data being reported on electronic returns.

underclaim rate of about 1 percent (by dollars) and 6 percent (by claims).¹ If the rate of underclaims represents a very rough indication of the level of inadvertent taxpayer error, these figures suggest an extraordinarily high intentional error rate, in the range of 25 percent of dollars claimed and 32 percent of total claims.² Although the 1993 tax year study only involved a small sample of tax returns claiming the EITC and filed electronically during two weeks in January, 1994, the results are consistent with those of earlier IRS studies conducted in 1982, 1985, and 1988. In short, the program has grown very large very quickly, probably too quickly for any agency to administer effectively.

IRS Commissioner Richardson has expressed some optimism that studies conducted earlier this year of the 1994 tax year will reflect a declining EITC error rate.³ But whatever the latest statistic, design features of the present program virtually guarantee continuing administrative difficulties in the future. Those features include—

- a sizable cash benefit potentially available to any taxpayer willing to file a claim and to certify himself or herself as eligible;
- administration of the program by an agency, the IRS, whose mission has not traditionally included the delivery of welfare-type benefits;
- the existence of tax laws and administrative procedures designed to prevent understatements of income, not overstatements;
- a complex but largely unsupervised claims process involving claimants with relatively low levels of education;
- eligibility rules based in part upon complicated family composition and responsibility issues; and
- constantly changing eligibility standards.

In the following sections, I describe how major reform of the program holds out the possibility of accomplishing its objectives more effectively and with less government waste.

B. PROVIDING SOME PORTION OF THE EITC BENEFIT AS A DIRECT GOVERNMENT EXPENDITURE.

Most analysts believe that although the tax system promotes higher participation in a welfare-type program like the EITC, the potential for noncompliance is also greater. In other words, the tax system transfers benefits pretty effectively, both to those entitled to the benefit and, unfortunately, to those not so entitled. Indeed, in some research I recently completed with several others, we tentatively arrived at exactly that conclusion. Compared to programs like AFDC and food stamps, we found that the EITC program has a higher participation rate but also a higher non-compliance rate.⁴ Thus, if Congress is willing to sacrifice some participation in exchange for improved compliance, it ought to reconsider whether the tax System is the appropriate vehicle to deliver the welfare element of the EITC benefit.

I realize that providing even some part of the EITC benefit as a direct government expenditure rather than through the tax system is contrary to much academic thinking and would have its drawbacks. After all, the tax system is thought to promote participation, eliminate the stigmatizing effect on program beneficiaries, and provide benefits with lower administrative costs than a direct expenditure pro-

¹ See Hearing Before the Senate Committee on Finance on the Earned Income Tax Credit Program, 104th Cong., 1st Sess. (1995) (statement of Margaret Milner Richardson, Commissioner of Internal Revenue) [hereinafter Richardson Finance Committee statement] at Appendix, p.5.

² In its preliminary analysis of the same returns involved in the study, the IRS estimated the intentional error rate to be 12 percent of dollars claimed and 13 percent of total claims, still remarkably high figures. See U.S. Gen'l Acctg. Ofc., Earned Income Credit: Targeting to the Working Poor, GAO/GGD-95-122BR (March 1995), p. 15. These estimates were largely based upon the subjective assessment of the reviewing IRS agent as to the reason for the error, see Richardson Finance Committee statement, note 1, at Appendix, p.3, and were not updated in Commissioner Richardson's latest testimony.

³ See Hearings Before the Senate Committee on Governmental Affairs on the Administration, Design, and Effectiveness of the Earned Income Tax Credit, 104th Cong., 1st Sess. (1995) (statement of Margaret Milner Richardson, Commissioner of Internal Revenue), at 13-14.

⁴ We found the EITC participation rate in 1990 to be between 75 and 86 percent, or more than recent participation estimates of between 62 and 72 percent for AFDC and between 54 and 66 percent for food stamps. But an EITC ineligibility rate of around 32 percent was considerably higher than excessive claim rates of six percent for AFDC and 7.3 percent for food stamps in FY 1990. See George K. Yin, John Karl Scholz, Jonathan B. Forman, and Mark J. Mazur, Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program, 11 Amer. J. Tax Policy 225, 244, 252-53 (1994).

gram.⁵ But after 20 years of experimentation, the disadvantages of delivering the welfare element of the EITC through the tax system are also increasingly evident. Aside from compliance considerations, here are some additional reasons to favor delivery through an expenditure program:

1. **Consolidation of budget responsibility.**—Under current law, budget responsibility over welfare-type programs is dispersed—the EITC, for example, is provided through the federal tax system whereas welfare benefits are provided as direct federal and state expenditures. The dispersal of responsibility may promote a wasteful use of government resources. For example, at a recent Senate hearing, a witness testified that welfare caseworkers may actually encourage welfare recipients to file exaggerated EITC claims in order to maximize the amount of EITC benefit available to them.⁶ Quite clearly, there would be no incentive for that particular form of non-compliance if budget responsibility over the EITC program were consolidated with that of other welfare programs.

More generally, Congress is presently considering the conversion of various entitlement programs benefiting low-income households into block grant programs to be administered by the states. In that consolidation effort, Congress ought not to overlook the EITC program. As currently designed, the EITC program is an open-ended entitlement program administered by the federal government. Claimants meeting the conditions of the tax statute and, indeed, far too many who don't meet those conditions, are "entitled" to the EITC cash benefit. It may well be that Congress wants to confer "preferred" status on the EITC program and maintain its entitlement nature. But that judgment should be made affirmatively, and not by default due to the fact that the program is part of the tax system. If integrated with the welfare system, the EITC program could be a valuable source of funds to finance work initiatives to be administered by the states.

2. **Elimination of duplicate government bureaucracies.**—Perhaps the most important group of EITC recipients are those who are still receiving some amount of welfare benefits. They are likely to be very poor, yet may be trying to work themselves off of welfare. Unfortunately, such families must encounter two bureaucracies, the IRS and the welfare system, to receive the benefits to which they are entitled. Indeed, because of the EITC program, the IRS is gradually duplicating the large and well-developed bureaucracy already in existence in the welfare system to deal with questions of eligibility. Integration of some portion of the EITC program with the welfare system would eliminate this wasteful duplication of tasks.

To illustrate the problem, consider the rough "wealth test" recently enacted by Congress as a condition for EITC eligibility.⁷ As this committee well knows, welfare programs have long contained far more precise (and restrictive) wealth and asset limitations for welfare eligibility.⁸ It would be much more efficient for a single bureaucracy to administer appropriate wealth and asset restrictions for both types of benefits under a single set of rules.

In fact, if it is not soon consolidated with welfare programs, I predict the EITC program will shortly require more refinements requiring the use of further IRS resources. For example, some of my law students this past year, some with responsibility for young children and some without, discovered that working for six to eight

⁵ See Hearing Before the Senate Committee on Finance on the Earned Income Tax Credit Program, 104th Cong., 1st Sess. (1995) (statement of Lynda D. Willis, Assoc. Dir., Tax Policy and Admin. Issues, Gen'l Gov't Div., U.S. Gen'l Acctg. Ofc.) [hereinafter Willis statement] at 7-8 (administrative costs of AFDC and food stamps constituted about 12 percent of program expenditures whereas costs to IRS in administering EITC program may not exceed one percent of total expenditures). The administrative costs of the EITC program, however, include not just the expenses to the IRS of processing and investigating claims but also (1) compliance costs to EITC recipients, both in terms of time spent and money paid for tax return preparation (cf. Joel Slemrod and Nikki Sorum, *The Compliance Cost of the U.S. Individual Income Tax System*, 37 Nat'l Tax J. 461 (Dec. 1984)); (2) compliance costs to non-EITC recipients, who bear the burden of dealing with longer, more complicated tax forms and instructions; (3) the cost of benefits erroneously paid to ineligible EITC recipients as a result of their noncompliance; and (4) the loss resulting from greater public disrespect for the tax system because of the well-publicized high levels of EITC noncompliance. Further, as discussed later in the text, the duplication of costs already incurred by other parts of the bureaucracy would seem, in any event, to be wasteful.

⁶ See Hearings Before the Senate Committee on Governmental Affairs on the Administration, Design, and Effectiveness of the Earned Income Tax Credit, 104th Cong., 1st Sess. (1995) (statement of Donald R. Huston).

⁷ See the Self-Employed Health Insurance Act of 1995, P.L. 104-7, § 4 (1995) (denying the EITC to taxpayers whose combined taxable and tax-exempt interest, dividends, and positive non-business rents and royalties for the taxable year exceed \$2,350).

⁸ For example, AFDC recipients generally may not have more than \$1,000 in resources, not including the value of their home and certain other basic maintenance items. See 42 U.S.C. § 602(a)(7)(B) (1994); 45 C.F.R. § 233.20(a)(3)(i)(B) (1993).

weeks during the summer at Wall Street law firms made them newly eligible for the EITC benefit. This is a surprising result given the high rate of compensation for their work, the \$80,000 per year or more some of them will earn right after graduation, the support provided to some of them by relatives and friends while in school, and the potential of such support available to some of them from their wealthy families. Yet because EITC eligibility relies upon the income of the tax filing unit, which does not include household or parental resources and income (other than income of a spouse), and considers only current levels of annual income, my students are eligible for the benefit. In contrast, most welfare programs at least consider the income and resources of other persons in the same household as the recipient in determining eligibility, make eligibility decisions based upon monthly information, and bar certain full-time students from receiving benefits altogether.

Let me make plain to the committee that I am not urging enactment of a new, "anti-law student" condition to EITC eligibility although that may be the unintended consequence of my testimony. I am simply using the example as an illustration of the type of refinements to the EITC program that may be necessary if Congress really wants to target that benefit for the truly deserving. Why require the IRS to enforce all of those rules when they already exist and are being implemented by comparable spending programs?

3. Improving the effectiveness of work incentives.—A final factor concerns the effectiveness of the EITC as a work incentive, and here, let me relate to the committee a recent experience I had observing a low-income taxpayer being provided tax return assistance by a VITA volunteer. At the outset, the taxpayer expressed concern that because she had had only a small amount of taxes withheld during the year, she might owe some money to the IRS. After examining her situation, the VITA volunteer proceeded to inform her that she was entitled to about a \$2,000 refund from the IRS. Mr. Chairman, I wish I were capable of describing for you the look on that woman's face.

Now that was obviously a very pleasant piece of information for the volunteer to convey and the taxpayer to receive. But I kept thinking about the work incentive effect of the \$2,000. Did the money have any effect on her decision to work, or to continue and increase her work effort? Or was it perceived simply as a return of overwithheld taxes, a product of the VITA volunteer's ingenuity, or as former CBO director Robert Reischauer once commented, a windfall like a winning lottery ticket,⁹ all of which might, in fact, induce less work in the future? In short, because the EITC benefit is delivered through the tax system, which is a mystery to most Americans, because well over half of EITC recipients obtain some type of assistance in filing their tax return, and because virtually all recipients obtain the benefit as a lump sum rather than periodically in their paychecks, it is not at all clear what the recipients comprehend when they receive their EITC check, with resulting uncertainty as to the labor supply effect of the credit.¹⁰ If the benefit were provided as a direct expenditure, the critical link between work and reward could be made more clear.

C. REDESIGNING THE EITC PROGRAM WITHIN THE TAX SYSTEM.

Assuming the EITC benefit will continue to be provided through the tax system, what other design changes might eliminate waste and improve its effectiveness? Here are two ideas. First, Congress could replace much of the program with an exemption from the payment of payroll taxes on the first \$5,000 or \$10,000 of wages.¹¹ The exemption might apply to the employee or the employer's portion of those taxes, or both. As this committee knows, the EITC originated in part as an effort to rebate to low-income workers the payroll taxes collected from them. Instead of collecting such taxes and then trying to return those amounts to workers in the form of the EITC, it would make much more sense simply to refrain from collecting the payroll taxes in the first place.

The beauty of this idea is that an exemption could be easily administered by employers through an adjustment to the payroll tax withholding tables. Taxpayers would not need to file returns to get the benefit—the ultimate simplification for them—so participation levels would be high. Further, the link between work and reward would be more evident because the benefit would arise in each paycheck rather than as a lump sum at the end of the year. Finally, compliance could be ex-

⁹ See Steven Mufson, *Clinton's Social Safety Net: A Bigger Tax Credit*, Washington Post, Mar. 6, 1993, p. A1.

¹⁰ See U.S. Jt. Comm. on Tax'n, *Present Law and Issues Relating to the Earned Income Tax Credit* (JCY-24-95), June 7, 1995, at 11.

¹¹ See George K. Yin & Jonathan B. Forman, *Redesigning the Earned Income Tax Credit Program to Provide More Effective Assistance for the Working Poor*, 59 *Tax Notes* 951 (1993).

pected to be very high because there would be no net cash benefit being transferred by the government back to taxpayers. Hence, the incentive to commit fraud to obtain the benefit would not be nearly as strong as under the current program.

To be sure, many in Congress might be fearful of tampering with the Social Security system. They might object to a proposal that decouples the link between Social Security taxes and benefits. The reality, however, is that for low-income workers, the EITC program has already decoupled the link between taxes and benefits. Such workers ostensibly pay Social Security taxes, and thereby become entitled to Social Security benefits, even though the EITC payment completely reimburses them for their Social Security contributions. They, in effect, pay no Social Security taxes yet are entitled to receive Social Security benefits. My proposal is simply to accomplish the exact same result but in a direct fashion, by not collecting the Social Security taxes in the first instance.

Another reform idea is to provide some of the EITC benefit to low-income workers through their employers.¹² For example, a tax credit could be awarded to the employer of certain qualifying workers. The theory is that the same general transaction—the hiring and compensation of a qualifying worker—can be subsidized by providing a direct benefit to either the employer or the worker in the transaction if the benefit is capitalized in the compensation arrangement.

Once again, the advantage of this idea would be to simplify administration of the program. It would be easier to administer because of the far fewer numbers of employers than workers. Further, employers are more used to dealing with the IRS than are low-income workers so that at least noncompliance due to unintentional errors should be reduced. Finally, the greater dollar amounts involved per-employer rather than per-worker would make IRS enforcement efforts more cost-effective. In a sense, this idea would convert part of the EITC program into a mini-block grant program to be administered by the business community rather than by the federal government.

True, the experience with a similar employer tax credit, the targeted jobs tax credit (TJTC), has not been very positive. But a number of features unique to the TJTC program—its start and stop history, the limited duration of the subsidy to a portion of first year wages, the highly targeted nature of the subsidy directed towards individuals like ex-convicts who are undoubtedly the subject of negative stereotyping, to name a few—may help to explain that program's ineffectiveness. In contrast, a broadly applicable, employer-based subsidy program which is permanent has the potential for avoiding many of the TJTC's pitfalls.

D. DISENTANGLING THE EITC PROGRAM.

Perhaps the optimal reform would be to disentangle the various components of the EITC program and to divide the program into its natural pieces. For example, a small part of the EITC benefit would fit comfortably within the tax system because it reduces income taxes otherwise due. Another part, intended to offset the taxpayer's payroll tax liability, could be provided more efficiently by means of a payroll tax exemption. Still another part, intended to provide additional income support for very poor workers who also receive welfare benefits, might be delivered through the welfare system. Finally, the portion of the benefit designed to subsidize children could be incorporated into a per-child tax credit or an expanded dependency exemption.

E. SMALLER CHANGES TO THE DESIGN OF THE EXISTING PROGRAM.

Finally, let me offer the committee four additional suggestions to improve compliance without a major redesign of the EITC program.

1. Probably the single best step Congress can take to curb noncompliance without a major change is to restrain the growth of the program and the amount of benefit provided. Under current law, the size of the benefit available from the program no longer bears any relationship to taxes owed by the person making the claim. Accordingly, given our self-assessment tax system, it is just too easy to file a fraudulent claim that is virtually undetectable by the IRS.

For example, by 1996, an individual with two or more qualifying children who reports \$8,000 in self-employment income would be entitled to an EITC benefit of 40 percent of that amount, or \$3,200. If that amount were reported, the individual would owe a self-employment tax of about \$1,200, but no income taxes. By reporting that income, therefore, the individual would receive a net cash benefit from the government of about \$2,000 (\$3,200—\$1,200) plus Social Security retirement credit.

¹² See Yin et al., note , at 286-94.

There is therefore a strong incentive in certain cases to falsify the existence of income.¹³

Could the IRS easily establish that the individual in fact earned less than the amount of income reported? No. The tax laws and administrative procedures are generally designed to ferret out income understatement cases, not the reverse situation of possible overstatements of income. Information filing, for example, permits the IRS to verify that taxpayers do not omit items of income on their tax returns. But if taxpayers voluntarily report more income than their paper trail might suggest, there is little the IRS can do to detect an error in the absence of a full-scale audit.¹⁴

2. A second suggestion is to change the program so that the size of the EITC benefit is determined based on income amounts that can be easily verified by the IRS. For example, the benefit could be calculated, as under current law, as a percentage of earned income, but only earnings reported on a W-2 form would qualify. Further, the EITC award to a taxpayer might be delayed until the IRS receives a matching and verified copy of the W-2 from the employer. This rule would preclude a taxpayer from getting any EITC based on self-employment income and various other forms of earned income, all items difficult for the IRS to verify, as well as earnings listed on a fabricated employee or employer W-2 form. This change would also simplify the process of claiming the credit for all taxpayers.

According to the GAO, the IRS does not currently have the computer capability to match employer-provided wage information with taxpayer-provided information prior to the normal processing of the taxpayer's return.¹⁵ Thus, this suggestion would result in some delay in the portion of a taxpayer's refund relating to the EITC. Delaying EITC payments is clearly undesirable, and every effort should be made to accelerate the IRS's matching capability. It should be borne in mind, however, that some part of the EITC population voluntarily chooses to delay their receipt of the benefit by electing not to obtain the credit through the advance payment option.¹⁶ Thus, a brief delay in benefit payments may not be as objectionable as first appears.

3. A third suggestion is to require as a condition of receiving the EITC that a taxpayer reside with a qualifying child for substantially all of the taxable year rather than for just more than half of the year. Under current law, the qualifying child requirement is the source of much confusion and potential fraud. More than one taxpayer, or the wrong taxpayer, may try to claim a particular child, and some taxpayers even claim fictitious children. This change would do nothing to curb the claiming of fictitious children, but it would provide a more easily verifiable test, and would clear up some of the confusion arising in situations where a child lives in several different homes in the course of a year. Unless a child resided with the taxpayer for substantially all of the taxable year, no credit would be available to the taxpayer.

4. Finally, Congress ought to consider barring the claiming of the EITC on electronically filed tax returns. Just as a burglar is going to burglarize the most vulnerable house on the street, those of a criminal mind are constantly casing the soft spots in our federal tax and transfer system. Surely one of the most vulnerable

¹³ See C. Eugene Steuerle, Two Problems with the New Earned Income Tax Credit, 48 Tax Notes 1691 (1990); C. Eugene Steuerle, The "Superterranean Economy," 51 Tax Notes 647 (1991); C. Eugene Steuerle, The IRS Cannot Control the New Superterranean Economy, 59 Tax Notes 1839 (1993).

¹⁴ The concern about the potential overreporting of income may be more than just theoretical. In its final report of the 1993 tax year study, the IRS discovered an interesting "bubble": compared to all EITC claimants for the year, a higher percentage of those sampled (early electronic filers claiming the EITC) reported AGI in the \$10,000 to \$15,000 range. See Richardson Finance Committee statement, note , at Appendix, p.7. For 1993, the maximum credit was available to taxpayers with income between roughly \$8,000 and \$12,000. Thus, if one assumes that early electronic filers are more likely to be noncompliant than the general filing population, the bubble may reflect an effort by taxpayers to report income levels producing the maximum EITC benefit.

The IRS report also indicated that compared to all EITC claimants, a much smaller percentage of those sampled reported having any schedule C business income. Id. This statistic may simply evidence the inability of taxpayers with schedule C income to file returns very early in the filing season. From a noncompliance standpoint, it suggests that if the taxpayers sampled erroneously reported income in the maximum credit range, they may have utilized falsified W-2 forms to accomplish their objective.

¹⁵ See Willis statement, note , at 20.

¹⁶ According to the GAO, despite many steps recently taken by the IRS to publicize and encourage the availability of the advance payment option, as of May 26, 1995, only about one percent of EITC recipients had reported using the option for tax year 1994. See Willis statement, note , at 19. No doubt, some significant percentage of those not using the option still are not aware of it, but its lack of use must also reflect some degree of taxpayer preference.

points is the receipt of EITC money through an electronically filed return. The speed with which a fraudulent claim may be processed and awarded makes that transaction a particularly appealing one to criminals.

To be sure, the IRS has taken important steps during this filing season to curb fraud effected through electronic filing, and Congress should probably await an evaluation of the IRS's latest efforts before barring electronic EITC claims altogether. But there is no strong policy reason to expedite EITC claims, particularly if doing so makes the system more susceptible to fraud.

I recognize that the IRS, tax preparation services, and certain financial institutions may all object to a complete bar of electronically filed EITC claims. The short answer to those in the private sector is that they are not the intended beneficiaries of the EITC program or of electronic filing. If their incidental benefits are limited by this change, so be it. As to the IRS, I think the burden is on them to establish sufficient control over the problem to justify the continued availability of electronic filing in this area.

Mr. Chairman, this concludes my prepared statement. I am happy to entertain any questions of the committee and would be pleased to work with you and your staff to develop appropriate legislative changes in this area.

COMMUNICATIONS

STATEMENT OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

INTRODUCTION

The AICPA is the national professional organization of CPAs, with more than 320,000 members. Many of our members are tax practitioners who, collectively, prepare income tax returns for millions of Americans.

The AICPA urges that simplification of the tax system be made a legislative priority. In particular, the EITC is an area in critical need of simplification.

We strongly urge the Committee and Congress to re-write the EITC rules to be understandable and usable by the taxpayers that this provision is intended to benefit -- low-income wage earners. This group of taxpayers generally lacks the ability to deal with complex tax laws and is unable to pay for tax preparation assistance. The AICPA welcomes proposed changes to make the credit more effective and offers several suggestions.

BACKGROUND ON THE EITC

The refundable EITC was enacted in 1975 with the policy goals of providing relief to low-income families from the regressive effect of social security taxes, and improving work incentives among this group. According to the IRS, EITC rules affect almost 15 million individual taxpayers.

Over the last few years, the number one individual tax return error discovered by the IRS during return processing has been the EITC, including the failure of eligible taxpayers to claim the EITC, and the use of the wrong income figures when computing the EITC. The frequent changes made over the past twenty years contribute greatly to the credit's high error and noncompliance rates.

In fact, the credit has been changed 10 times (1976, 1977, 1978, 1979, 1984, 1986, 1988, 1990, 1993 and 1994). The credit now is a nightmare of eligibility tests, requiring a maze of worksheets. Computation of the credit currently requires the taxpayer to consider:

- 9 eligibility requirements;
- the number of qualifying children -- taking into account relationship, residency, and age tests;
- the taxpayer's earned income -- taxable and non-taxable;
- the taxpayer's AGI;
- threshold amounts;
- phase out rates; and
- varying credit rates.

As part of H.R. 831, the House passed last week and the Senate is currently considering a new factor in determining eligibility -- the amount of interest and dividends, tax-exempt interest, and net rental and royalty income received by a taxpayer, even if total income is low enough to otherwise warrant eligibility for the EITC.

To claim the credit, the taxpayer may need to complete:

- a checklist (containing 8 complicated questions),
- a worksheet (which has 9 steps),
- another worksheet (if there is self-employment income),
- a schedule with 6 lines and 2 columns (if qualifying children are claimed); and
- usually, the normal Form 1040 (rather than Form 1040EZ).

For guidance, the taxpayer may refer to 7 pages of instructions (and 39 pages of IRS Publication 596). The credit is determined by multiplying the relevant credit rate by the taxpayer's earned income up to an earned income threshold. The credit is reduced by a phaseout rate multiplied by the amount of earned income (or AGI, if less) in excess of the phaseout threshold.

While Congress and the IRS may expect that the AICPA and its members can comprehend the many pages of instructions and worksheets, it is unreasonable to expect those individuals entitled to the credit (who will almost certainly NOT be expert in tax matters) to deal with this complexity. Even our members, who tend to calculate the credit for taxpayers as part of their volunteer work, find this area to be extremely challenging. In fact, we have found that the EITC process can be a lot more demanding than completing the Schedule A -- Itemized Deductions, which many of our members complete on a regular basis for their clients.

Our analysis suggests that most of the EITC complexity arises from the definitional distinctions in this area. While each departure from definitions used elsewhere in the Code can be understood in a context of accomplishing a specific legislative purpose, the sum of all the definitional variances causes this Code section to be unmanageable by taxpayers and even the IRS. We recognize that many of the additions and restrictions to the credit over the years were for laudable purposes. However, the rules are so complex that the group of taxpayers to be benefited find them incomprehensible and are not effectively able to claim the credit to which they are entitled.

SUMMARY OF OUR LEGISLATIVE RECOMMENDATIONS

We recommend that Congress adopt the following changes to the EITC:

1. *Simplify definitions and the calculation. (See Appendix for specific administrative proposals that we intend to pursue with the IRS).*
2. *Define "earned income" as taxable wages (Form 1040, line 7) and self employment income (Form 1040, line 12).*
3. *Modify the "qualifying child" rules.*
 - A. *Replace the "qualifying child" definition with the already existing "dependent child" definition.*
 - B. *Increase the incremental amount of credit provided for two children versus one child.*

- C. *Use the dependency exemption rather than the EITC to provide benefits for children.*
- 4. *Combine and expand the denial provisions.*
 - A. *Deny the credit for taxpayers with: foreign earned income, alternative minimum tax liability, and AGI that exceeds earned income by \$2,350 or more.*
- 5. *Modify the EIC Table or provide a percentage rate instead of the table.*

SPECIFIC LEGISLATIVE RECOMMENDATIONS

1. Simplify definitions and the calculation.

The current rules for the EITC, as previously noted, provide different rules depending upon the number of qualifying children the taxpayer claims. The many rates, thresholds, limitations, and classifications regarding this credit are confusing. For the 1994 tax year, the parameters are as follows:

| | <u>1 Child</u> | <u>2 or more Children</u> | <u>No Children</u> |
|-------------------------|----------------|---------------------------|--------------------|
| Credit rate (%) | 26.30 | 30.00 | 7.65 |
| Phaseout rate (%) | 15.98 | 17.68 | 7.65 |
| Earned income threshold | \$7,750 | \$8,425 | \$4,000 |
| Phaseout threshold | \$11,000 | \$11,000 | \$5,000 |
| Phaseout limit | \$23,755 | \$25,296 | \$9,000 |
| Maximum credit | \$2,038 | \$2,528 | \$306 |

RECOMMENDATION: *Congress should simplify the definitions and the calculation of the credit. Specifically, as detailed below, we suggest the definitions of qualifying child and earned income be modified. The many rates, thresholds, limitations, and classifications regarding this credit should be referenced to other similar thresholds and classifications throughout the Code. These changes, and the changes listed below, would reduce the number of pages needed for the worksheets, Schedule EIC, EIC Table, and instructions. (See Appendix for specific administrative proposals that we intend to pursue with the IRS to simplify the definitions and calculation.)*

2. Define "earned income" as taxable wages (Form 1040, line 7) and self-employment income (Form 1040, line 12).

The current EITC definition of "earned income" needs to be simplified. Currently, to calculate the credit, the taxpayer must take into account all earned income, including amounts not otherwise reported on the tax return or not taxed. This is one area where numerous errors are made. As GAO states in its September 1993 report GAO/GGD-93-145, *Tax Policy: Earned Income Tax Credit: Design and Administration Could Be Improved*, "determining the amount of income that should be included in calculating the credit poses a problem for taxpayers and IRS."

Currently, potentially eligible recipients must take into account:

- Taxable earned income (wages, salaries, and tips; union strike benefits; long-term disability benefits received prior to minimum retirement age; and net earnings from self-employment), PLUS
- Nontaxable earned income (defined in the instructions as: contributions to a 401(k) plan and military housing and subsistence, excludable dependent care benefits, pay earned in a combat zone, the value of meals or lodging provided by an employer for the convenience of the employer, housing allowance or rental value of a parsonage for clergy, voluntary salary reductions such as under a cafeteria plan, and "anything of value that is not taxable which you received from your employer for your work").

Furthermore, because taxable scholarships and fellowship grants are reported on Form 1040 line 7, taxpayers are instructed to subtract taxable scholarships or fellowship grants not reported on the Form W-2. This one exception complicates the calculation and is not verifiable, as it is not on the Form W-2.

In addition, as discussed in our administrative recommendations in the Appendix, the earned income calculation does NOT include various other forms of income not on line 7 of the Form 1040 (i.e., welfare benefits, workers' compensation benefits, alimony, child support, unemployment compensation, social security and railroad retirement benefits, pension and annuities, interest and dividends, and variable housing allowances for the military). The exclusion of these items is mentioned in IRS Publication 596, but is not mentioned in the worksheet or instructions. Since these items are taxable, but are not wage income (line 7 of the Form 1040), taxpayers may inadvertently include these items as "earned income".

Currently, the calculation of "earned income" involves a detailed knowledge of tax terminology, such as: "excludable", "taxable", "for the convenience of the employer", and "voluntary salary reductions". The definition of taxable income includes many items not commonly thought of as earnings. In addition, the definition of "nontaxable earnings" is unique to the EITC and is defined in different ways in the instructions and IRS Publication 596 (as addressed in our administrative recommendations in the Appendix). Most people think that "earned income" is wages. Omissions are likely to happen when uncommon terms are used to cover many items that normally are not treated as earnings.

RECOMMENDATION: *Congress should define earned income as wages appearing on line 7 of Form 1040, plus self-employment income from line 12 of the Form 1040.*

Earned income should only include taxable income, as the statute originally provided when it was created in 1975. As GAO points out, much of "this (nontaxable) income is not reported to recipients or to IRS," and IRS has no way right now of verifying the nontaxable amounts. GAO states, "we do not see a need to provide space on the tax return for nontaxable earned income since less than 3 percent of eligible taxpayers claim (report) this type of income." Therefore, nontaxable income should be removed from the EITC definition

of "earned income" to make the process simpler for the majority of taxpayers who need to complete this worksheet.

We also believe that there should be no exceptions to this taxable earned income definition. If Congress wants to treat taxable scholarships and fellowships different from taxable wages, taxable scholarships and wages should not be reported on line 7 of the Form 1040. Alternatively, if taxable scholarships are to be treated as taxable wages (line 7 of Form 1040), the current EITC subtraction for scholarships and fellowship grants should not be allowed.

3. Modify the "qualifying child" rules.

According to a GAO analysis, most EITC errors have been linked to issues involving filing status and qualifying children. The qualifying child test is complex. Taxpayers are confused by the "qualifying child" definition and the different definition for a dependent. The definition of "eligible child" complicates the EITC instructions for determining eligibility. The IRS attempts to communicate that a "qualifying child" usually does not have to be a dependent. However, there are a few exceptions that confuse taxpayers. For example, if one divorced parent has custody of the child, but the other parent claims the child as a dependent, the parent with custody can claim the child as a "qualifying child" for the EITC, but can not claim the child as a dependent. Also, if a child is married, the child must be a dependent (i.e., over half of the child's support is provided by the taxpayer) to claim the child as a "qualifying child" for the EITC. This married child exception confuses taxpayers.

Additionally, the different EITC treatment for different taxpayers -- depending on the number of children -- seems unnecessarily complex, especially for the minor additional benefit derived. The maximum additional credit for more than one child is only \$490. The minor additional benefit is illustrated by an eligible taxpayer with \$4,000 of earned income receiving a credit for one child of \$1,059, while for two or more children, the taxpayer's credit is \$1,208, a difference of only \$149. What is this differential meant to reflect? Clearly, the difference cannot be cost. In addition, there is no EITC difference between taxpayers with two children and taxpayers with three or more children.

Also, taxpayers with and without children are treated differently with regard to their eligibility for the advance EITC. The advance EITC is available only to taxpayers with qualifying children. There does not appear to be any reason for this difference. The EITC should focus on one goal -- earned income.

RECOMMENDATION: *The rules throughout the Code, and especially in this area, could be simplified if just one definition was used consistently. Congress should eliminate the distinction between "qualifying child" and "dependent child". Section 32(c)(1)(A)(I), which currently allows the EITC to certain taxpayers with non-dependent children, should be changed. If the term "eligible children" is restricted to dependent children, section 32(c)(1)(A)(I) could be cross referenced to section 151.*

This definition would provide an easy reference to information already on the Form 1040, line 6, and would eliminate the need for the additional information currently required on the Schedule EIC. We also suggest that the married dependent child test, which is rarely applied, be removed.

Alternatively, if Congress deems that the "qualifying child" is a better definition than "dependent child", then the "qualifying child" test should be used for the dependency exemption as well. Either way, there should be just one definition of child in the Code.

RECOMMENDATION: *The spread in the amount of credit for one child and two children should be made more significant than under the current EIC Table. The difference between one and two children in the current table is so small that it could not possibly reflect a cost differential and it is too incomprehensible for it to be a motivating factor in individual conduct.*

RECOMMENDATION: *Even greater simplification would result if there was no EITC differential based on the number of children. The current three classes of EITC recipients and three considerations at each point in the process are cumbersome. If just one class of EITC recipient existed, the "qualifying child" versus dependent child confusion would be eliminated, making the credit process much easier. In addition, if this recommendation is adopted, all EITC recipients would be able to claim the advance EITC.*

As stated previously, an objective of the credit is to remove the regressivity of the social security tax for lower-income individuals. This objective applies to all lower income taxpayers, regardless of the number of children in the home. Thus, eliminating the incremental amount of the credit based on the number of children would not detract from the stated objectives of this provision. The calculation and the EIC Table would be simplified, and the additional information on age and social security numbers of children (currently required on a separate Schedule EIC) would not be needed for the EITC.

RECOMMENDATION: *Congress should coordinate all of the Code's tax provisions related to children. These child-based tax provisions include: the incremental child EITC, the child tax credit, the dependency exemption deduction, and the proposed family tax credit in H.R. 1215. All of these child tax benefits should be provided through one mechanism — the dependency exemption. The dependency exemption takes into account the total number of children in the household, versus the EITC, which only accounts for up to two children in a household.*

However, since the current dependency exemption is a deduction rather than a credit, the result is regressive (that is, the higher the tax bracket, the greater the tax benefit) at the income levels that the EITC can be claimed. Therefore, if the dependency exemption is to take part of the place of the EITC, one point Congress might consider would be replacing the dependency exemption with a refundable credit, not a deduction. The credit could be refundable and set at a fixed dollar amount per dependent child. This credit could be available in advance from the taxpayer's employer, as is the advance EITC. The per child credit amount could be a round number that is easy to multiply.

The proposed child credit could be phased-out above some threshold AGI that is simple and consistent with other phase-out rules. We suggest that the phase-outs for itemized deductions, personal exemptions, and this proposed child credit all start at the same threshold and that threshold should be a number that is easy to apply -- e.g., \$100,000 of AGI. The phase-out mechanism for all tax provisions in the Code should be the same.

4. Combine and expand the denial provisions.

IRS and GAO have stated that many people receiving the credit are not considered "low-income" individuals. As these individuals are identified, greater restrictions are placed on eligibility for the credit, and the computation is made more complex for all EITC recipients. As mentioned earlier, Congress recently agreed to deny the credit to individuals with interest and dividends, tax-exempt interest, and net rental and royalty income in excess of \$2,350. Additionally, the credit currently is not available if the taxpayer: excludes from gross income any income earned in foreign countries, or claims a tax benefit for foreign housing amounts. An individual who owes alternative minimum tax (Form 1040, line 48) is allowed a credit, but the EITC is reduced by any alternative minimum tax. The taxpayer's AGI is used as a limitation for the credit and greatly complicates the computation for most taxpayers.

RECOMMENDATION: *We support Congress limiting the credit to those taxpayers originally intended to benefit from the EITC. However, we suggest that this limitation only occur through the denial rules, not the computational rules. We recommend that all the denial provisions be included in one place. The eligibility/denial rules should include the current denial for taxpayers with foreign earned income. We suggest adding to the denial rule all taxpayers subject to AMT. This would delete the computational exception for AMT taxpayers.*

Congress also should include in the denial provision taxpayers with AGI that exceeds earned income by \$2,350 or more. H.R. 831's denial for taxpayers with \$2,350 of interest or dividends should be replaced (and essentially combined) with this denial for taxpayers with AGI that exceeds earned income by \$2,350 or more. This exclusion based on AGI would deny the credit to taxpayers with all forms of unearned income (i.e., capital gains, income from partnerships and S corporations, etc.), not just taxpayers with interest and dividends of \$2,350 or more. As the H.R. 831 proposed EITC restriction stands now, these "wealthy" individuals affected by the legislation (i.e., with this type and amount of non-earned income) could change their investments to earn partnership investment income, capital gains, or pay off their home mortgage and still claim an EITC. If H.R. 831 is enacted as currently drafted, when additional abuses occur, Congress will have to add more restrictions to the EITC statute. However, if our proposed broader AGI denial is used, fewer, or no, additional limitations will be needed. This denial of credit for individuals with higher incomes seems to be the intent of the unearned income restrictions.

An important result of moving the AGI calculation restriction to the eligibility rules is that the calculation would be much simpler. The calculation would no longer require a worksheet.

Specifically, in order to implement this change, we suggest that section 32(h), which currently requires a reduction of the EITC for taxpayers subject to the alternative minimum tax, be modified. On the basis of simplicity, this provision should be combined with section 32(c)(1)(D); denying the EITC to anyone claiming a foreign earned income exclusion. Section 32(c)(1)(D) should also include taxpayers with AGI that exceeds earned income by \$2,350. Section 32(a)(2) should also be modified to remove AGI from the computation. All the restrictions based on income should be contained in one paragraph or subsection, rather than throughout this Code provision.

5. **Modify the EIC Table or provide a percentage rate instead of the table.**

Although the IRS EIC Table takes into account all the phaseouts, the table can still be a mystery to many taxpayers. Many taxpayers are confused between the EIC Table and the Tax table.

RECOMMENDATION: Section 32(f) currently requires that the EIC Table have income brackets not greater than \$50 each. Form 1040 instructions currently include two pages of the EIC Table with \$50 brackets, resulting in earned income credit intervals of \$3-\$8. Congress should amend section 32(f) to allow wider brackets which result in greater than \$3 earned income credit intervals. This will reduce the EIC Table to half a page and will minimize the overwhelming nature of the table, and, hopefully, facilitate ease of use.

RECOMMENDATION: We suggest an even bolder alternative — eliminate the EIC Table completely, and instead provide a credit equal to a certain percent (i.e., 10 percent) of earned income. This option could be modified to provide for a few percentage levels (i.e., 10% if earning less than \$8,000, 25% if earning between \$8,000 and \$16,000, and 20% if earning between \$16,000 and \$24,000). This would approximate the average credit currently allowed — \$900 if earning \$3,000 (with 2 qualifying children), \$2,500 if earning \$10,000 (with 2 qualifying children), and \$2,000 if earning \$20,000 (with 2 qualifying children), and would be much easier to calculate. This would be much simpler and would save space in the instruction booklets and ease much of the confusion. The rates could be written directly onto the EITC line of the Form 1040. This, combined with a changes in the "earned income" definition and AGI limitation, should make the worksheets, checklists, and tables a thing of the past.

OTHER REFORMS TO THE SYSTEM

Last, in reviewing comprehensive reform of benefits and tax reform, in general, Congress should consider the problems and complexities for low-earning Americans illustrated above. Some of the reforms listed below have been suggested as a potential solution to the EITC problems.

- Use the EITC to eliminate the regressivity of the social security tax, by setting the refundable credit at the current social security tax rate (7.65 percent). The FICA tax regressivity results because the first dollar earned is taxed for FICA purposes, while (for 1994) income generally up to: \$11,250 - married filing jointly, \$8,050 - head of household, \$6,250 - single, and \$2,450 - married filing separately is exempt from the progressive income tax. This option

would permit all taxpayers with "earned income" to claim this credit regardless of their age, filing status or dependency status.

- Limit the EITC benefit to no more than 15.3 percent (the current self-employment rate) of any self employment income reported. This would address the fraud and overreporting problems involved with self-employment income.
- Exempt the first \$X of taxable earned income from the employee's share of social security tax and from ½ of the self-employment tax. (This tax could be administered by adjusting social security withholding and by amending Schedule SE). Exempting low-income individuals from FICA (social security and Medicare) taxes would directly address (with no paperwork) what the EITC was intended to do -- mitigate the regressivity of the FICA taxes.

CONCLUSION

In conclusion, we have identified quite a few areas that need simplification and proposed various means to achieve it. We support measures to eliminate the current EITC problems so that those who legally qualify for the EITC receive it and can claim the benefits in a simplified and easy process.

APPENDIX – Suggested Administrative (IRS) Changes to the EITC Claiming Process

1. **EITC Line of Form 1040 Should be in the Credits Section of the Form.** Even if the taxpayer is not allowed to claim the credit, the taxpayer must go through many procedures to find out if he/she is ineligible, and then write "NO" on line 56. Line 56 is not even in the section of the Form 1040 dealing with credits; it is in the section of the Form 1040 dealing with payments. The current placement of the EITC line on the tax return could be confusing to taxpayers (although it is in bold). Therefore, we suggest the EITC line be moved to the credit section of the Form 1040.

2. **The IRS Calculation Option Should be Presented at the Beginning of the Checklist and Instructions.** IRS currently offers to calculate the EITC for taxpayers, but it mentions the option rather late in the process and requires the taxpayer to supply additional information on a separate schedule. The IRS calculation option is mentioned on the last line of the checklist, which reads "If you want the IRS to figure it for you, enter 'EIC'" on the appropriate line on the appropriate type of Form 1040. IRS should encourage more taxpayers to use this option and should consider mentioning this option at the top of the checklist and instructions.

3. **All Information Required for the Credit Should be on the Form 1040 – Schedule EIC and the Dependency Exemption Information Should be Combined on the Form 1040.** The Form 1040 should provide sufficient information for the IRS to determine if a taxpayer legitimately qualifies for the EITC. The IRS should inform legitimate eligible taxpayers of the correct credit amount. The taxpayer should not have to take the currently required additional steps of reading the instructions and completing the checklist, worksheet, and Schedule EIC.

We agree with GAO's Sept. 1993 report, *Tax Policy: Earned Income Tax Credit: Design and Administration Could Be Improved*, that stated, "most of the necessary information could be included on the tax return itself. With minor modifications to the dependency and filing status sections of the Form 1040 or 1040A, all the requisite information (the already required child's name, social security number, relationship to taxpayer, and number of months lived with taxpayer, as well as the age and student/disability status of the child) would be available to determine whether a child qualified.... We believe taxpayer simplification can be better achieved by the elimination of the separate EIC Schedule; the separate two-page schedule is an additional obstacle for very low-income tax filers." We, therefore, support elimination of the current separate Schedule EIC that merely covers repetitive information, and suggest the necessary information be combined into the existing Form 1040 exemption section, as shown on page 64 of the GAO report. This issue would disappear if a legislative change is made (as we proposed) so that the distinction in number of children is pursued through the dependency exemption.

We also suggest an even easier modification to the Form 1040. The only additional pieces of information (not currently required on the Form 1040) that are requested on the Schedule EIC are: (1) if the child was older than 18 - whether the child was a student under age 24 or permanently/totally disabled, and (2) the child's year of birth. The year of birth could easily take the place of column 2 on line 6c, where IRS currently asks the taxpayer to check if the child is under age 1. Information in (1) could also be included and coded on line 6c (i.e.,

next to the age, put an S if a student and/or D if disabled). If the legislative change we proposed concerning the definition of "eligible child" and dependent is not made, the taxpayer also could put an "E" on line 6c to indicate that the child is an "eligible child" for the EITC. Form 1040 would then include all the information currently requested on the Schedule EIC.

4. **All Responses on the Checklist Should Consistently Direct the Taxpayer.** The current locations and responses to question number 5 on the checklist are confusing to taxpayers and should be switched. Checklist question number 5 should be worded in such a way that a YES response is positive and a NO response results in the taxpayer not qualifying for the credit (similar to all the other seven questions on the checklist). Accordingly, the YES and NO box locations to question number 5 should be switched too.
5. **The Worksheet Should be Incorporated in the Schedule EIC.** If the credit remains as complex as it is right now, instead of a worksheet calculation, the EITC should be calculated on an IRS designed schedule which is attached to the tax return. The Schedule EIC could be modified for this purpose to include the actual computations rather than mere taxpayer identification information. The IRS also could better monitor the credit amounts and if fraud or abuse is involved. It does not make sense for the taxpayer to first complete a checklist, then be directed to the worksheet, then complete the informational Schedule EIC, and then enter the credit from the worksheet onto the tax return. The IRS never sees the worksheet and, therefore, cannot see where the taxpayer made a mistake in the calculation and if it was intentional or not.
6. **The Description of Items Subtracted from "Earned Income" Should be Stated Similarly in All IRS Publications.** All IRS publications should clearly state the same definition and explanation of earned income. Specifically, IRS Publication 596 currently includes a detailed list of items to subtract from earned income, while the worksheet and instructions do not contain this list. The worksheet and instructions should include this list. Taxpayers may inadvertently include these items as "earned income". Specifically, according to Publication 596, the various forms of income that are not included in the earned income calculation (and are not subtracted on the worksheet) are not included in line 7 of the Form 1040 (i.e., welfare benefits, workers' compensation benefits, alimony, child support, unemployment compensation, social security and railroad retirement benefits, pension and annuities, interest and dividends, and variable housing allowances for the military). Our legislative recommendation to define "earned income" as taxable wages (line 7 of the Form 1040) and self-employment income (line 12 of Form 1040) would greatly simplify this problem.
7. **The Taxpayer Should be Directed to the EIC Table Only Once.** Rather than sending the taxpayer to the EIC Table twice (once for earned income and another time for AGI), the worksheet should direct the taxpayer to enter the smaller of the net earned income or the taxpayer's AGI, and then look up that smaller number in the table. The repetitive reference procedure is not necessary if the AGI is less than the beginning of the phase-out threshold. However, if that is the case, the taxpayer should be told to stop once the first credit amount is found in the table, before entering AGI and completing the rest of the worksheet meaninglessly.

STATEMENT OF JONATHAN BARRY FORMAN

JUNE 6, 1995.

Senator BOB PACKWOOD
 Chairman,
 U.S. Senate,
 Committee on Finance,
 Washington, DC

Re: Simplification and the Earned Income Credit: A Statement for Inclusion in the Record of the June 8, 1995, Hearing on the Earned Income Tax Credit

Mr. Chairman: I am pleased to submit this statement for the record of your Committee's June 8th hearing on the Earned Income Tax Credit. I am submitting this statement in my individual capacity as a Professor of Law at the University of Oklahoma where I teach courses on tax and welfare law and write about the relationship between the tax and social welfare systems.¹ The purpose of this statement is to recommend ways to help simplify the tax system for the current beneficiaries of the earned income credit and for the Internal Revenue Service (IRS).

SIMPLIFICATION AND THE EARNED INCOME CREDIT

Largely because of the earned income credit, millions of low-income Americans pay no federal taxes. Moreover, unlike most other transfer programs, the earned income credit reaches more than 80 percent of its target population.² Unfortunately, to claim the credit, low-income Americans must file unnecessarily complicated tax returns. Not surprisingly, low-income individuals frequently make mistakes in claiming their credits, and some mistakenly claim credits to which they are not entitled. This statement suggests several ways to restructure the federal tax system to help those low-income workers who are currently eligible for the earned income credit.

I. THE IMPACT OF FEDERAL TAXES ON LOW INCOME INDIVIDUALS

A. RELATIVELY FEW LOW INCOME INDIVIDUALS PAY FEDERAL TAXES

According to the Census Bureau, more than 39 million Americans live in poverty.³ The principal federal taxes affecting these low-income individuals are the individual income tax and the Social Security payroll taxes. Because of standard deductions and personal exemptions, relatively few low-income individuals pay any income taxes. On the other hand, because the Social Security tax system has no standard deductions or personal exemptions, many low-income individuals are required to pay Social Security taxes. Fortunately, the earned income credit offsets the Social Security tax liabilities of most low-income individuals. Consequently, relatively few low-income individuals have a net federal tax liability at the end of the year.

For example, Table 1 compares the combined income and Social Security tax thresholds (i.e., net federal tax thresholds) of various family units with their poverty income guidelines.⁴ Basically, Table 1 shows that married couples with one, two, or three children have net federal tax thresholds that are slightly above their poverty income guidelines. On the other hand, the smaller and larger family units shown have net federal tax thresholds that are somewhat below their poverty income guidelines.⁵

¹ I am co-chair of the American Bar Association Section of Taxation Project on Simplification for Low Income Taxpayers, and I have performed research on the earned income tax credit under the sponsorship of the American Tax Policy Institute, but the views expressed here are my individual views and do not represent the position of any group.

² George K. Yin, John Karl Scholz, Jonathan B. Forman & Mark Mazur, *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Credit Program*, 11 *American Journal of Tax Policy* 225 (1994).

³ *Number of Elderly Poor Drops: "Statistical Anomaly" Cited for Part of the Drop*, *The Sunday Oklahoman*, Dec. 11, 1994, at A24. The Census Bureau estimated the total U.S. population at 259.2 million and the overall poverty rate at 15.1 percent.

⁴ U.S. Department of Health & Human Services, Office of the Secretary, *Annual Update of the Poverty Income Guidelines*, 60 *Federal Register* 7,772 (1995).

⁵ An analysis of family units headed by unmarried individuals would show similar results. On the other hand, childless individuals and couples who are under age 25 or over age 64 would have lower income and net tax thresholds than shown in Table 1, as the earned income credit is not available to them.

TABLE 1.—NET FEDERAL TAX THRESHOLDS AND POVERTY LEVELS IN 1995, BY FAMILY SIZE *

| [Dollars] | | | | | | |
|--|-------|--------|--------|--------|--------|--------|
| Family size | | | | | | |
| ROW | 1 | 2 | 3 | 4 | 5 | 6 |
| 1. Poverty levels | 7,470 | 10,030 | 12,590 | 15,150 | 17,710 | 20,270 |
| 2. Simple income tax threshold (before earned income credit) | 6,400 | 11,550 | 14,050 | 16,550 | 19,050 | 21,550 |
| 3. Income tax threshold after earned income credit | 7,357 | 11,550 | 19,386 | 22,360 | 23,425 | 24,490 |
| 4. Social Security tax threshold | 0 | 0 | 0 | 0 | 0 | 0 |
| 5. Combined income and Social Security tax threshold | 4,100 | 4,100 | 15,547 | 18,370 | 19,245 | 19,350 |

* The table reflects assumptions that all family income consists of wages or salaries earned by a single worker, that families of two or more include a married couple (rather than an unmarried head of household with one or more dependents), that all family members are under age 65, and that all family units are eligible for the earned income credit (for example, childless workers are between the ages of 25 and 65). Also, only the employee's portion of Social Security taxes is considered.

Sources: U.S. Department of Health & Human Services, Office of the Secretary, Annual Update of the Poverty Income Guidelines, 60 Federal Register 7,772 (1995) and author's computations.

B. FILING INDIVIDUAL INCOME TAX RETURNS IS BURDENSOME AND EXPENSIVE

Even though relatively few low-income individuals have net federal tax liabilities, most must file income tax returns to recover their over-withheld taxes and refundable earned income credits. For example, for the tax year 1992, almost 24 percent of the 113.6 million individual income tax returns filed showed no income tax liability.⁶ That's roughly 27 million returns, and most of those were filed by low-income individuals. In that regard, a remarkable 46 million taxpayers with adjusted gross incomes of less than \$15,000 filed income tax returns in 1992.⁷ Of these, only about 25 million actually owed any income tax, and the average tax owed by these 25 million was just \$570. Also, more than nine million taxpayers received earned income credit refunds in excess of their income tax liabilities.

Moreover, in a typical year, millions of individuals need help preparing their income tax returns. For example, more than 56 million taxpayers used paid preparers for their 1992 tax returns.⁸ That's about half of all individual taxpayers. Even more astonishing, 7,700 taxpayers paid private preparers to help them fill out 1040EZ forms, and more than 5.5 million taxpayers paid preparers to help them fill out 1040A forms. At \$20 or more per return for preparation and additional fees for electronic filing and refund anticipation loans, that amounts to millions of dollars going from low-income individuals to private preparers.

All in all, filing returns is burdensome and expensive for low-income individuals and for the IRS. The General Accounting Office has estimated that Americans may spend as much as \$30 billion a year to prepare their individual income tax returns.⁹

II. WHAT CAN BE DONE TO HELP EARNED INCOME CREDIT BENEFICIARIES?

This Part outlines some approaches for restructuring the federal tax system to help those low-income workers who are currently eligible for the earned income credit.

A. SIMPLIFY THE TAX SYSTEM FOR LOW-INCOME INDIVIDUALS

1. Simplify the Current Earned Income Credit

Over the years, the earned income credit has become both more generous and more complicated. For example, in 1995, a qualifying taxpayer with two children may claim an earned income credit of up to \$3,110, but the taxpayer needs to file a tax return and fill out Schedule EIC to claim that benefit. Not surprisingly, taxpayer compliance and participation in the program have become major concerns.¹⁰

⁶ Internal Revenue Service, Selected Historical and Other Data, 14 SOI Bulletin 139, 169-70 (Fall 1994)

⁷ Id. at 142.

⁸ Id. at 189.

⁹ U.S. General Accounting Office, Internal Revenue Service: Opportunities to Reduce Taxpayer Burdens Through Return-free Filing 1 (GAO/GGD-92-88BR) (1992).

¹⁰ See generally Yin et al., *supra* note .

One reform idea would be to modify the 1040 Forms so that individuals would no longer have to file a Schedule EIC in order to claim the credit. It would also make sense to simplify some of the earned income credit eligibility requirements. For example, it might make sense to simplify the definition of "qualifying child" or make the definitions of "dependent" and "qualifying child" more compatible.

Another reform would be to simplify the definition of "earned income" that is used to determine the amount of an individual's earned income credit. The current definition of "earned income" includes several items that are excluded from gross income and that are not reported on W-2 or 1099 forms. Most taxpayers eligible for the credit have none of these items, but both taxpayers and the IRS must try to keep track of them. Consequently, one simplification would be to include in "earned income" only those items includable in gross income. Then the credit could be readily computed from information already available on W-2 or 1099 forms and on tax returns.¹¹

Another improvement might be to simplify or repeal the advance payment option. Under current law, eligible individuals can claim a portion of their earned income credit during the year through increases in their paychecks. To receive their so-called advance payment, individuals must provide their employers with IRS Form W-5, Earned Income Credit Advance Payment Certificate, but less than one percent of eligible individuals bother to do this.¹² Incorporating Form W-5 into the standard Form W-4, Employer's Withholding Allowance Certificate, might increase the use of the advance payment option. Alternatively, it might be better to eliminate the advance payment option altogether.

2. Let the IRS Prepare Tax Returns for Low-Income Individuals

The IRS believes that it is barred from preparing income tax returns for individuals by Office of Management and Budget Circular A-76.¹³ Promulgated by the Reagan Administration, that ruling generally prevents government agencies from "competing" with private-sector businesses. The IRS believes that Circular A-76 prevents it from preparing income tax returns, setting up its own electronic filing network, or designing and distributing computer software that would allow individuals to prepare their returns on their own computers.

If the government is truly interested in helping individual income taxpayers, however, then the IRS should be allowed to directly assist taxpayers in the preparation of their returns. In particular, it would make sense to let the IRS prepare returns for those low-income taxpayers who claim the earned income credit. Virtually all welfare programs help individuals apply for benefits, and the earned income credit clearly provides a welfare-like benefit. Why not let the IRS prepare returns so that eligible low-income individuals can claim their earned income credit refunds?

3. Move to a Return-free or a Final Withholding Tax System

Another way to help low-income individuals who claim the earned income credit would be to move to either a return-free or final withholding tax system.¹⁴ Under a return-free system, the IRS would prepare tax returns for individual taxpayers based on information reports received from employers and other taxpayer income sources. Most Form 1040EZ and Form 1040A filers and a few Form 1040 filers could elect to have the IRS compute their tax liabilities and prepare their returns—some 55 million taxpayers in all.

Under a final withholding system, the amount withheld by employers and other income sources is the tax, thus eliminating the need for many taxpayers to file tax returns. Over 30 foreign countries use some form of final withholding, including Great Britain, Japan, Germany, and Argentina. For example, in Great Britain, the income tax is withheld by employers under the British PAYE (Pay As You Earn) final withholding system. When an individual first becomes potentially subject to tax, an initial return must be filed so that the Inland Revenue can determine how much the employer should withhold. Thereafter, individuals with simple incomes and modest earnings are normally required to file a return only about once every

¹¹ For that matter, it might make sense to limit the definition of "earned income" to "wages." Under current law, the high level of earned income credit benefits available can actually provide an incentive for low-income individuals to report fictitious amounts of earnings. Limiting the definition to "wages" would help curb that abuse.

¹² U.S. General Accounting Office, *Earned Income Tax Credit: Advance Payment Option is Not Widely Known or Understood by the Public 3* (GAO/GGD-92-26) (1992).

¹³ Office of Management and Budget, OMB Circular No. A-76 (Rev.), *Performance of Commercial Activities*, 48 Federal Register 37,110 (1983).

¹⁴ See generally Internal Revenue Service, *Current Feasibility of a Return-Free Tax System* (1987); U.S. General Accounting Office, *supra* note .

five years. In 1991, for example, more than 23 million of the 26 million taxpayers eligible for PAYE did not file tax returns.

Would a final withholding system work in the United States? A final withholding system could significantly reduce burdens on both low-income individuals and the IRS. In its analysis of the issue, the General Accounting Office concluded that most taxpayers who now file 1040EZ returns (about 19 million in 1994) and many of those who now file 1040A returns (about 23 million in 1994) could be served by a final withholding system. Most of these people would no longer have to gather information, become familiar with tax laws, or prepare and file returns. The burden on the IRS would also be greatly reduced.

B. REPLACE THE CURRENT EARNED INCOME CREDIT WITH AN ALTERNATIVE MECHANISM TO HELP LOW-INCOME WORKERS

Given the complexity of the earned income credit, it is worth considering some alternative approaches for distributing similar benefits to low-income workers.

1. *Combine the Income and Social Security Taxes*

One approach would involve better integration of the income and Social Security taxes. Much of the complexity of the current tax system results from imposing Social Security taxes on every dollar of earned income and then using the earned income credit to refund most of those taxes to low-income workers. Wouldn't it be simpler if the federal tax system simply did not collect Social Security taxes from low-income workers in the first place?

One option would be to add standard deductions and/or personal exemptions to the Social Security tax system.¹⁵ Another option would be to exempt the first \$5,000 or \$10,000 of earnings by any worker from Social Security taxation.¹⁶ A more fundamental reform would be to combine the individual income and Social Security taxes into a single, comprehensive income tax. Individuals with incomes below some poverty threshold would be exempt from tax, and tax rates could be increased in order to raise the same amount of revenue. In effect, there would be a single, higher-yield income tax instead of the current bifurcated tax system, and millions of low-income individuals would no longer have to file returns.

Of course, much of the benefit of the current earned income credit seems to be geared to providing income assistance to families with children. Still, it might be simpler to provide that type of family benefit through a refundable child tax credit or family allowance tax credit.¹⁷ For example, a portion of the current earned income credit could be replaced with a refundable \$500 per child tax credit.

2. *Replace the Earned Income Credit With a Wage Subsidy Credit for Employers*

A second approach would be to replace the current earned income credit with a tax benefit that reaches low-income workers through their employers.¹⁸ For example, an employer tax credit could provide a tax benefit to the employers of low-wage workers. According to standard economic analysis, these tax benefits would pass through to the low-wage workers in the form of relatively higher wages. Consequently, an employer tax credit would end up helping most of the same low-income workers targeted by the current earned income credit. Yet an employer tax credit would be significantly easier to administer than the current earned income credit, if only because there are far fewer employers than low-income workers.

3. *Combine the Earned Income Credit With Other Welfare Programs*

A third approach would be to combine the earned income credit with other income transfer programs like food stamps, Aid to Families with Dependent Children

¹⁵ See e.g., Jonathan B. Forman, *Using Refundable Tax Credits to Help Low-Income Families*, 35 *Loyola Law Review* 117, 138-39 (1989); Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policy*, 135 *University of Pennsylvania Law Review* 851, 865-68 (1987).

¹⁶ See Yin et al., *supra* note , at 280-83; see also Michael J. Caballero, *The Earned Income Tax Credit: The Poverty Program That is Too Popular*, 48 *Tax Lawyer* 435, 464-68 (1995) (proposing a system of graduated Social Security taxes with a base exemption at the lowest levels of income).

¹⁷ See, e.g., U.S. National Commission on Children, *Beyond Rhetoric: A New American Agenda for Children and Families* 80-88 (1991) (calling for a \$1,000 per child refundable tax credit); see also Yin et al., *supra* note, at 280-86; Jonathan B. Forman, *Beyond President Bush's Child Tax Credit Proposal: Towards a Comprehensive System of Tax Credits to Help Low-income Families with Children*, 38 *Emory Law Journal* 661 (1989).

¹⁸ See, e.g., Yin et al., *supra* note, at 280-86; Jonathan B. Forman, *Improving the Earned Income Credit: Transition to a Wage Subsidy Credit for the Working Poor*, 18 *Florida State University Law Review* 41 (1988).

(AFDC), and Supplemental Security Income (SSI).¹⁹ After all, the earned income credit is just one of dozens of federal programs that provides income assistance to low-income individuals. The multiplicity of these programs has resulted in complexity, inequity, and high administrative costs. Consequently, it might make sense to combine the earned income credit with other federal welfare programs into a single, comprehensive income transfer program that could be administered by a single agency. The agency might even turn out to be the IRS, although the Department of Health and Human Services or the Social Security Administration may be more likely. Alternatively, the revenues now used for the earned income credit could be bundled together with the appropriations for other welfare programs and revenue-shared out to state welfare agencies.

Respectfully submitted,

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¹⁹ See, e.g., Jonathan B. Forman, *Administrative Savings from Synchronizing Social Welfare Programs and Tax Provisions*, 13 *Journal of the National Association of Administrative Law Judges* 5 (1993), reprinted as Jonathan B. Forman, *Synchronizing Social Welfare Programs and Tax Provisions*, 59 *Tax Notes* 417 (1993).

**PRESENT LAW AND ISSUES
RELATING TO THE
EARNED INCOME TAX CREDIT**

Scheduled for a Public Hearing

Before the

SENATE COMMITTEE ON FINANCE

on June 8, 1995

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

June 7, 1995

JCX-24-95

CONTENTS

| | Page |
|--|-------------|
| INTRODUCTION | 1 |
| I. DESCRIPTION OF PRESENT-LAW EARNED INCOME TAX CREDIT PROVISIONS | 2 |
| II. LEGISLATIVE HISTORY | 6 |
| III. DESCRIPTION OF PROPOSALS | 8 |
| IV. DISCUSSION OF ISSUES | 10 |
| APPENDIX | 17 |

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on June 8, 1995, on the earned income tax credit ("EITC") and proposals to modify the EITC.

This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the present-law EITC, its legislative history, proposals, and a discussion of related issues.

Part I of the document is a description of present law, Part II is a legislative history of the EITC, Part III describes certain legislative proposals, and Part IV is a discussion of related issues. The Appendix provides certain data relating to the EITC.

¹ This document may be cited as follows: Present Law and Issues Relating to the Earned Income Tax Credit (JCX-24-95), June 7, 1995.

I. DESCRIPTION OF PRESENT-LAW EARNED INCOME TAX CREDIT PROVISIONS

In general

Under present law, certain eligible low-income workers are entitled to claim a refundable earned income tax credit. The amount of the credit an eligible taxpayer may claim depends upon whether the taxpayer has one, more than one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. The maximum amount of the credit is the product of the credit rate and the earned income threshold. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the phaseout threshold, the credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the phaseout threshold. For taxpayers with earned income (or AGI, if greater) in excess of the phaseout limit, no credit is allowed.

As enacted in Public Law 104-7 (H.R. 831), for taxable years beginning after December 31, 1995, a taxpayer is not eligible for the EITC if the aggregate amount of "disqualified income" of the taxpayer for the taxable year exceeds \$2,350. Disqualified income is the sum of:

- (1) interest (taxable and tax-exempt),
- (2) dividends, and
- (3) net rent and royalty income (if greater than zero).

The parameters for the EITC depend upon the number of qualifying children the taxpayer claims. For 1995 the parameters are as follows:

| | Two or more qualifying children-- | One qualifying child-- | No qualifying children-- |
|----------------------------|---|---------------------------|-----------------------------|
| Credit rate | 36.00% | 34.00% | 7.65% |
| Phaseout rate | 20.22% | 15.98% | 7.65% |
| Earned income threshold | \$8,640 | \$6,160 | \$4,100 |
| Maximum credit | \$3,110 | \$2,094 | \$314 |
| Phaseout threshold | \$11,290 | \$11,290 | \$5,130 |
| Phaseout limit | \$26,673 | \$24,396 | \$9,230 |

The earned income threshold and the phaseout threshold are indexed for inflation; because the phaseout limit depends on those amounts, the phaseout rate, and the credit rate, the phaseout limit

will also increase if there is inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

For 1996 and after, the credit rate will be 40 percent and the phaseout rate will be 21.06 percent for taxpayers with two or more qualifying children. For 1996 and after, the credit rate and the phaseout rate for taxpayers with one qualifying child or no qualifying children will be the same as those listed in the table above.

A worker may elect to receive the EITC on an advance basis by furnishing an advance payment certificate to his or her employer. For such a worker, the employer makes an advance payment of the credit at the time wages are paid. The amount of advance payment allowable in a taxable year is limited to 60 percent of the maximum credit available to a taxpayer with one qualifying child. The advance payment of the EITC is not available to taxpayers with no qualifying children.

In order to claim the EITC, a taxpayer must either have a qualifying child or must meet other requirements. A qualifying child must meet a relationship test, an age test, an identification test, and a residence test.

In order to claim the EITC without a qualifying child, a taxpayer must not be a dependent and must be over age 24 and under age 65. In addition, the taxpayer's principal place of abode must be located in the United States for more than one-half of the taxable year. For purposes of this test, a member of the Armed Forces stationed outside the United States on extended active duty is considered to be maintaining a principal place of abode in the United States.

Qualifying child

Under the relationship and age tests, an individual (or married couple) is eligible for the EITC with respect to another person only if that other person: (1) is a son, daughter, or adopted child (or a descendent of a son, daughter, or adopted child); a stepson or stepdaughter; or a foster child of the taxpayer (a foster child is defined as a person for whom the individual cares for as the individual's child; it is not necessary to have a placement through a foster care agency); (2) is under the age of 19 at the close of the taxable year (or is under the age of 24 at the end of the taxable year and was a full-time student during the taxable year), or is permanently and totally disabled; and (3) shares the same place of abode as the person claiming the credit for more than one-half the year (the entire year for foster children). Also, if the qualifying child is married at the close of the year, the individual may claim the EITC for that child only if the individual may also claim that child as a dependent. Taxpayers who are married (as defined in Code sec. 7703) may claim the EITC only if they file a joint return.

In addition to the above criteria, two "tiebreaker" rules apply:

(1) If more than one individual may claim the EITC (if any) with respect to any qualifying child, then only the individual with the highest AGI may claim the EITC with

respect to the child. For example, assume a hypothetical household comprised of a grandmother, mother (age 25), and child (age 2). Both the grandmother and the mother are eligible to claim the credit with respect to the child. In this case, however, only the individual with the higher AGI is eligible to claim the credit (assuming the other requirements are met).

(2) An individual who is himself or herself a qualifying child may not claim the EITC. If in the above example, the mother is age 17 (instead of age 25), then she is a qualifying child of the grandmother. In this case, only the grandmother could claim the EITC, with respect to her own child (mother, age 17) and her grandchild (child, age 2).

To satisfy the identification test, taxpayers must include on their tax return the name and age of each qualifying child. For returns filed with respect to tax year 1995, taxpayers must provide a taxpayer identification number (TIN) for all qualifying children who were born on or before October 31, 1995. For returns filed with respect to tax year 1996, taxpayers must provide TINs for all qualifying children born on or before November 30, 1996. For returns filed with respect to tax year 1997 and all subsequent years, taxpayers must provide TINs for all qualifying children, regardless of their age. A taxpayer's TIN is generally that taxpayer's social security number. Some taxpayers are exempt from social security taxes because of their religious beliefs. These taxpayers do not have a social security number; instead, the Internal Revenue Service administratively assigns them a taxpayer identification number.

The residence test requires that a qualifying child must have the same principal place of abode as the taxpayer for more than one-half of the taxable year (for the entire taxable year in the case of a foster child), and that this principal place of abode must be located in the United States. For purposes of determining whether a qualifying child meets the residence test, for any period during which a member of the Armed Forces is stationed outside the United States while serving on extended active duty, the member is not subject to the requirement that the principal place of abode for a qualifying child and the member be in the United States.

Nonresidents and the EITC

The EITC may be claimed by a taxpayer meeting the above requirements if the taxpayer is a U.S. citizen or a resident alien.

Section 7701(b) defines a resident alien for income tax purposes. Aliens who do not meet this definition are nonresident aliens. For income tax purposes, an individual is generally considered a resident if the individual:

(1) has entered the United States as a lawful permanent U.S. resident (the "green card test"), or

(2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for 183 or more days during a three-year

period weighted toward the present year (the "substantial presence test"). (An individual who is present in the United States for fewer than 183 days and establishes that he has a closer connection with a foreign country than with the United States is generally not subject to tax as a resident alien on account of the substantial presence test.)

Individuals who are nonresident aliens for any portion of the taxable year are not eligible to claim the EITC for taxable years beginning after December 31, 1994, unless an election under Code section 6013(g) or (h) is in effect for the taxable year.

Under section 6013(g), a nonresident alien who is married to an individual who is either a citizen or resident alien of the United States at year end may elect to be treated as a resident for the entire year. The election applies to the year for which it is made and all subsequent years until terminated. The election will be suspended, however, if neither spouse is a U.S. citizen or resident at any time during a taxable year.

Under section 6013(h), an individual who (1) is a nonresident alien at the beginning of the year and a resident alien at the end of the year and (2) is married to an individual who is either a citizen or resident of the United States at the end of the year may elect to be treated as a resident for the entire year. Thus, this election can be made by a foreign married couple who arrive in the United States during the taxable year and who are resident aliens at year end.

Mathematical errors

The IRS may summarily assess additional tax due as a result of a mathematical error without sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. This procedure is the only one a taxpayer may use for contesting an assessment arising out of a mathematical or clerical error.

II. LEGISLATIVE HISTORY

The earned income tax credit (Code sec. 32) was enacted in 1975 as a means of targeting tax relief to working low-income taxpayers with children, providing relief from the Social Security payroll tax for these taxpayers, and improving incentives to work. As originally enacted,² the credit equaled 10 percent of the first \$4,000 of earned income (*i.e.*, a maximum credit of \$400). The credit began to be phased out for taxpayers with earned income (or AGI, if greater) above \$4,000, and was entirely phased out for taxpayers with income of \$8,000.

The Revenue Act of 1978 increased the maximum credit to \$500 (10 percent of the first \$5,000 of earned income). Also, the income level at which the phaseout began was raised to \$6,000, with a complete phaseout not occurring until an income level of \$10,000. The Deficit Reduction Act of 1984 increased the maximum credit to \$550 (11 percent of the first \$5,000 of earned income) and the credit was phased out beginning at \$6,500 of income and ending at \$11,000.

The Tax Reform Act of 1986 increased the maximum credit to \$800 (14 percent of the first \$5,714 of earned income), beginning in 1987. The maximum credit was reduced by 10 cents for each dollar of earned income (or AGI, if greater) in excess of \$9,000 (\$6,500 in 1987). These \$5,714 and \$9,000 amounts (stated above in 1985 dollars) were indexed for inflation.

The Omnibus Budget Reconciliation Act of 1990 (OBRA 1990) substantially increased the maximum amount of the basic credit and added an adjustment to reflect family size. OBRA 1990 also created two additional credits as part of the EITC: the supplemental young child credit and the supplemental health insurance credit. Both of these supplemental credits used the same base as the basic EITC.

OBRA 1990 also modified the definition of taxpayers eligible for the EITC. Under prior law, taxpayers were required to file a joint return or file as a head of household or surviving spouse in order to be eligible for the EITC. OBRA 1990 generally broadened the set of eligible taxpayers and set out uniform requirements for qualifying children. The definition of "qualifying child" enacted in OBRA 1990 is described in the present-law section.

The Omnibus Budget Reconciliation Act of 1993 (OBRA 1993) expanded the EITC in several ways. For taxpayers with one qualifying child, the EITC was increased to 26.3 percent of the first \$7,750 of earned income in 1994. For 1995 and thereafter, the credit rate was increased to 34 percent. In 1995, the maximum amount of earned income on which the credit could be claimed is \$6,160 (this is a \$6,000 base in 1994, adjusted for inflation). The phaseout rate for 1994 and thereafter is 15.98 percent.

For taxpayers with two or more qualifying children, the EITC was increased to 30 percent of the first \$8,425 of earned income in 1994. The maximum credit for 1994 was \$2,527 and was

² Table 2 in the Appendix shows the parameters of the EITC over its history.

reduced by 17.68 percent of earned income (or AGI, if greater) in excess of \$11,000. The credit rate increases over time and equals 36 percent for 1995 and 40 percent for 1996 and thereafter. The phaseout rate is 20.22 percent for 1995 and 21.06 percent for 1996 and thereafter.

OBRA 1993 also extended the EITC to taxpayers with no qualifying children. This credit for taxpayers with no qualifying children is available to taxpayers over age 24 and below age 65. Finally, OBRA 1993 repealed the supplemental young child credit and the supplemental health insurance credit.

The implementing legislation for the General Agreements on Tariffs and Trade enacted in 1994 made four modifications to the EITC. First, it removed from the definition of earned income in Code sec. 32(c)(2) any amount received for services provided by an inmate of a penal institution. Second, it generally made nonresident aliens ineligible to claim the EITC. Third, it deemed that a member of the Armed Forces stationed outside the United States while serving on extended active duty would satisfy test that the principal place of abode be within the United States. Fourth, it required that members of the Armed Forces receive annual reports from the Department of Defense of earned income (which includes nontaxable earned income such as amounts received as basic allowances for housing and subsistence).

Under Public Law 104-7 (H.R. 831), effective for taxable years beginning after December 31, 1995, a taxpayer is not eligible for the EITC if the aggregate amount of disqualified income (i.e., taxable and tax-exempt interest, dividends, and (if greater than zero) net rent and royalty income) of the taxpayer for the taxable year exceeds \$2,350.

III. DESCRIPTION OF PROPOSALS

A. Administration's Fiscal Year 1996 Budget Proposal

Earned income tax credit denied to individuals not authorized to be employed in the United States³

Taxpayers would not be eligible for the EITC if they do not include their taxpayer identification number (and, if married, their spouse's taxpayer identification number) on their tax return. Solely for these purposes and for purposes of the present-law identification test for a qualifying child, a taxpayer identification number would be defined as a social security number issued to an individual by the Social Security Administration other than a number issued under section 205(c)(2)(B)(i)(II) (or that portion of 205(c)(2)(B)(i)(III) relating to it) of the Social Security Act (regarding the issuance of a number to an individual applying for or receiving Federally funded benefits). Thus, if an individual obtained a social security number solely because that individual is an applicant for, or a recipient of, Federally funded benefits, the individual would be ineligible to claim the EITC.

If a taxpayer fails to provide a correct taxpayer identification number, such omission would be treated as a mathematical or clerical error. Thus, any notification that the taxpayer owes additional tax because of that omission would not be treated as a notice of deficiency.

Earned income tax credit denied to individuals with substantial unearned income⁴

A taxpayer would not be eligible for the EITC if the aggregate amount of interest and dividends includible in his income for the taxable year exceeds \$2,500. For taxable years beginning after 1996, the \$2,500 limit would be indexed for inflation with rounding to the nearest multiple of \$50.

Effective date

These proposals would be effective for taxable years beginning after December 31, 1995.

B. Senate Budget Resolution (S.Con.Res. 13)

The Senate Budget Resolution for fiscal years 1996-2002 (S.Con.Res. 13; S.Rept. 104-82), as passed by the Senate on May 25, 1995, contains a provision that would achieve savings in the EITC. That provision would (1) accept the Administration proposal that would deny the EITC to

³ Included in S. 453, "Tax Compliance Act of 1995," as introduced by Senators Daschle and Moynihan on February 16, 1995.

⁴ Public Law 104-7 (H.R. 831) enacted a similar provision with more stringent limits.

individuals not authorized to be employed in the United States, (2) repeal the credit for individuals with no qualifying children, and (3) set the EITC for 1996 at 30.15 percent of the first \$7,150 of earned income (for taxpayers with one qualifying child⁵) and at 35 percent of the first \$8,910 of earned income (for taxpayers with two or more qualifying children). The phaseout rate for 1996 would be set at 15.98 percent for taxpayers with one qualifying child and 19.37 percent for taxpayers with two or more qualifying children.

⁵ The combination of the reduction in the credit rate and the increase in the earned income threshold would leave the maximum credit for taxpayers with one qualifying child virtually unchanged from present law.

IV. DISCUSSION OF ISSUES

As mentioned earlier (see Part II), two of the stated goals of the EITC when it was enacted were to provide targeted tax relief to working low-income taxpayers with children and to improve those individuals' work incentives. This part discusses the effect of the EITC on work incentives, the EITC's effectiveness at reaching the targeted population, and the IRS's administrative measures to reduce noncompliance. It then concludes with a brief discussion of some proposed alternatives to the EITC.

Effect of the EITC on labor supply

In general, a program like the EITC can have two effects on work effort. First, since it changes the after-tax wage (*i.e.*, the return to each additional hour of work), people might choose to work a different number of hours. With a higher after-tax wage, it is more expensive for individuals not to work, so they may substitute hours of work for hours of leisure. Second, since it increases people's disposable income, they might choose to work less — for instance, by working fewer hours per week, taking more leisure time, or giving up a part-time job. The direction of the first effect (the "substitution effect") depends upon whether the individual's income puts him in the phasein, plateau, or phaseout range of the credit. The direction of the second effect ("the income effect") is to reduce hours worked for all individuals receiving the credit.

For individuals in the phasein range, the EITC increases the after-tax wage, so the substitution effect is in the opposite direction of the income effect. The net change in work effort depends upon the relative magnitude of the two effects. For individuals in the plateau range, there is no effect on the after-tax wage. Since the credit is at the maximum amount, the EITC operates like a lump-sum grant, and work effort would tend to fall because of the income effect. For individuals in the phaseout range, the EITC reduces the after-tax wage, since an additional dollar of earnings will result in a reduction in the EITC received (by the phaseout rate times the additional earnings). In this case, the substitution effect reinforces the income effect, and a reduction in work effort could be expected.

In the aggregate, the effect of the EITC depends upon the relative sizes of the work incentives or disincentives for individuals in the different income ranges and the relative number of EITC-eligible individuals in each of the those ranges. Estimates suggest that just under one-quarter of recipients are in the phasein range, just over three-fifths are in the phaseout range, and the remainder (about one-sixth) are in the plateau range.⁶ So for the vast majority of individuals, the marginal effect of the credit is unambiguously to reduce work incentives. Using estimates from the economics literature of the response of labor supply to changes in after-tax wages, a number of researchers have simulated

⁶ Estimates are from John Karl Scholz, "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness," *National Tax Journal*, 47, March 1994, p. 78, and Janet Holtzblatt, Janet McCubbin, and Robert Gillette, "Promoting Work through the EITC," *National Tax Journal*, 47, September 1994, p. 598.

the effects on aggregate labor supply of recent changes in the EITC.⁷ In general, they find that hours worked increase for individuals in the phase-in range (where the theoretical effect is ambiguous) and decrease for individuals in both the plateau and phase-out ranges (in accord with the theoretical prediction). The effects on labor supply are generally larger for secondary earners in two-parent families than for primary earners or single-parent families.

One caveat with these findings is that they presume that individuals correctly perceive the effect of the credit on their after-tax wage. Most of the EITC claimants receive their credit in a lump-sum at the time they file their tax returns. If they do not make the connection between the amount they receive in credit and their earned income, these estimates of labor supply effects may be incorrect. A second caveat is that the studies did not examine directly the effects of the EITC on labor supply. The studies generally simulated the effects of the EITC using behavioral parameters from the economics literature, in some cases, from the negative income tax experiments from the 1970s, in other cases from other labor supply studies. Thus, the accuracy of the simulation results depends upon whether the parameters from other labor supply studies accurately reflect the behavior of EITC participants.

Most of the estimates of the EITC's effect on labor supply focus on the individuals already receiving the credit and do not attempt to model individuals' decisions of whether or not to work. One study⁸ that does look at the question of labor market participation suggests that the OBRA 1993 changes would, on average, increase the after-tax wage of single-parent families by 15 percent, leading to a 6.2 percent increase in the probability of working. For secondary earners in two-parent families, the OBRA 1993 changes would, on average, decrease the after-tax wage by five percent, leading to a decrease in the probability of working. These changes in labor force participation, which on balance increase the labor force, may offset the reduction in work effort by those already in the labor force. Dickert, Houser, and Scholz calculate that if the new entrants worked an average of 20

⁷ The following sources use labor supply estimates from the Seattle and Denver negative income tax experiments: U.S. General Accounting Office, *Earned Income Tax Credit: Design and Administration Could Be Improved*, GAO/GGD-93-145, September 1993 (looking at the EITC in 1988 and as it would have been in 1994 had the OBRA 1993 changes not been made); Holtzblatt, McCubbin, and Gillette (looking at the OBRA 1990 and OBRA 1993 changes); Saul D. Hoffman and Laurence S. Seidman, *The Earned Income Tax Credit: Antipoverty Effectiveness and Labor Market Effects*, (Kalamazoo, Mich.: W.E. Upjohn Institute for Employment Research), 1990 (looking at the EITC in 1988). Stacy Dickert, Scott Houser, and John Karl Scholz, "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation," in James M. Poterba (ed.), *Tax Policy and the Economy*, vol. 9, (Cambridge, Mass.: National Bureau of Economic Research and MIT Press), 1995, pp. 1-50 (looking at the OBRA 1993 changes) used another set of estimated labor supply responses.

⁸ Dickert, Houser, and Scholz, "The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation," *op. cit.*

hours per week for 20 weeks a year, the increase in labor force participation would more than fully offset the reduction in hours from those already in the labor force.⁹

Some commentators have stressed that one should not look at the EITC as an isolated program but rather as one part of a system of transfers to lower-income individuals.¹⁰ The interaction with other programs can affect labor supply. Other transfer programs, such as Aid to Families with Dependent Children (AFDC), food stamps, and Supplemental Security Income (SSI), contain significant implicit marginal tax rates in the form of the phaseout of benefits as income increases. For individuals whose income puts them in the phasein range of the EITC, the wage subsidy in the phasein range may offset some of the implicit marginal tax from the reduction in other benefits. For individuals whose income puts them in the phaseout range of the EITC, the phaseout of the EITC may exacerbate any implicit marginal tax from the loss of other benefits. On balance, one set of simulations suggest that the combined marginal tax rate (explicit and implicit) on lower-income individuals does not exceed 40 percent, but the variance across individuals may be large.¹¹

Targeting of the EITC to its intended beneficiaries

Because it is delivered through the tax system, the EITC may have better participation rates than other transfers, perhaps because there is less stigma to claiming the credit. The EITC may also involve less intrusion into claimants' lives. Individuals can file a claim by filling out a tax return in the privacy of their own home rather than by standing in line at a disbursement office and being subject to questions. Scholz estimated that in 1990, between 75 and 90 percent of the taxpayers eligible to receive the EITC actually claimed the credit.¹² By comparison, the percentage of eligible individuals claiming food stamps, SSI, and AFDC have generally been lower.¹³

⁹ *Ibid.*

¹⁰ See, for example, Anne L. Alstott, "The Earned Income Tax Credit and Some Fundamental Institutional Dilemmas of Tax-Transfer Integration," *National Tax Journal*, 47, September 1994, pp. 609-619, and Anne L. Alstott, "The Earned Income Tax Credit and the Oversimplified Case for Tax-Based Welfare Reform," *Harvard Law Review*, 108, January 1995.

¹¹ Stacy Dickert, Scott Houser, and John Karl Scholz, "Taxes and the Poor: A Microsimulation Study of Implicit and Explicit Taxes," *National Tax Journal*, 47, September 1994, pp. 621-638.

¹² John Karl Scholz, "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness," *National Tax Journal*, 47, March 1994, p. 65-72. Scholz used a number of methods to estimate the participation rate; the extreme values of the estimate are listed above. His preferred estimate is 80 to 86 percent.

¹³ Robert H. Haveman estimated participation rates for food stamps and SSI of 50-60 percent in the late 1970s and for AFDC from 56 percent in Arizona to 95 percent in the District

At the same time, the EITC may also be more prone to improper claims, because unlike such programs as food stamps and AFDC, there are no caseworkers to process the claims and check up on claimants. Instead, any monitoring of the EITC must come through the IRS tax enforcement process. Estimates using data from the IRS's Taxpayer Compliance Measurement Program (TCMP) suggest that in 1988, 32 percent of the EITC claimants were ineligible for the credit and 34 percent of the credit amount was claimed inappropriately. Data from earlier TCMP audits were roughly similar. Data from the 1985 TCMP suggest that 38 percent of the EITC claimants were ineligible for the credit and 37 percent of the credit amount was claimed inappropriately, while data from the 1982 TCMP suggest that 27 percent of the EITC claimants were ineligible for the credit and 29 percent of the credit amount was claimed inappropriately.¹⁴

No TCMP audits of individual taxpayers have been conducted since the 1988 panel, so there has not been a chance to update these estimates, which come from a sample representative of all EITC claimants. Also, there have been substantial changes to the EITC since 1988, which makes it difficult to extrapolate the findings from TCMP data from the 1980s to the present. For example, one of the contributing factors to erroneous claims of the credit was taxpayer confusion about filing status. On the 1985 TCMP, over half of the EITC returns that were disallowed were a result of taxpayers erroneously claiming a child exemption. Upon audit, over half of those disqualified claims had the filing status changed from one that would have allowed the EITC to be claimed to one that did not (e.g., from head of household to single).¹⁵ The simplification of the qualifying child rules in OBRA 1990 could have helped to reduce this type of erroneous EITC claim. The filing of a separate Schedule EIC (also a result of OBRA 1990) may also have reduced the error rate. On the other hand, the increase in the credit rate and the maximum credit may have encouraged more individuals to claim the credit erroneously.

The IRS studied a sample of EITC returns that were filed electronically during a two-week period in January 1994 in order to look at erroneous EITC claims. Unlike the TCMP data, which provide a sample of the entire EITC population, this sample is only generalizable to the returns filed electronically in that two-week period. The IRS's preliminary analysis of this sample indicated that

of Columbia in 1975-1976. Rebecca M. Blank and Patricia Ruggles estimated participation rates for food stamps of 54 to 66 percent and for AFDC of 62 to 72 percent (both in 1986-1987). Both studies are cited in Scholz, "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness," *op. cit.*, at p. 71.

¹⁴ Scholz, "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness," *op. cit.*, at p. 68-69.

¹⁵ Janet Holtzblatt, "Administering Refundable Tax Credits: Lessons from the EITC Experience," *Proceedings of the 84th Annual NTA-TIA Conference*, 1991, pp. 180-186.

29 percent of the 1.3 million EITC returns filed during the two-week period claimed too large a refund. About 13 percent of the 1.3 million returns were classified as intentional error.¹⁶

Administrative measures to limit fraud

There has been concern that the IRS's institutional goal to process returns and pay refunds quickly have made it susceptible to fraud, in particular where returns are filed electronically and are consequently processed more rapidly. Electronic filing has been fairly widespread among taxpayers claiming the EITC.

The IRS has to date taken some steps to reduce its exposure to EITC fraud. For example, the IRS has instituted a system of matching names and taxpayer identification numbers listed on tax returns with the Social Security Administration's database and lengthened processing time for certain returns by up to eight weeks to allow this matching before issuing refunds. Prior to this filing season, the IRS was unable to match TINs with the Social Security Administration database on a nationwide basis before processing tax returns.¹⁷ This matching may significantly reduce fraud, but it may also substantially delay the issuance of refunds to taxpayers who are entitled to claim the EITC but who do not report their names and TINs on their tax returns identically to the records in the Social Security Administration database.

A possible way to help limit fraud would be increased scrutiny of the approximately 40,000 electronic return originators (EROs). Some EROs do not comply fully with IRS requirements for electronic filing, and several have been convicted of criminal activity in schemes to defraud the government through false EITC claims.¹⁸ Through March 5, 1995, the IRS conducted 3,600 monitoring visits of EROs, resulting in 103 suspensions and 303 warnings.¹⁹ If the ratio of EROs with compliance problems uncovered to date held true for all EROs, it would mean that more than 4,000 EROs are not in complete compliance with IRS requirements. (This would not, however, necessarily be indicative of widespread fraud among EROs.) Another way to reduce dependence upon EROs while still encouraging electronic filing would be expanded use of free electronic filing. As of March 24, 1995, only 122,000 filers used any of the 1,200 free electronic filing sites in the

¹⁶ U.S. General Accounting Office, *Earned Income Credit: Targeting to the Working Poor*, GAO/GGD-95-122BR, March 1995, pp. 14-15.

¹⁷ Testimony of IRS Commissioner Richardson before the Senate Committee on Governmental Affairs (April 4, 1995).

¹⁸ Ways and Means Subcommittee on Oversight hearing of February 10, 1994.

¹⁹ Testimony of IRS Commissioner Richardson before the Senate Committee on Governmental Affairs (April 4, 1995).

United States.²⁰ Some observers believe that the IRS could take additional steps to improve participation in the free electronic filing program.

Another administrative reform that could be effective against EITC fraud would be matching of third-party wage and withholding records (e.g., W-2s) against the tax returns before refunds are issued. Because currently this matching generally is only performed after the refunds are issued, if the IRS determines that a refund that was paid should not in fact have been paid, it must then go to the taxpayer directly to attempt to collect the money. It is inefficient to try to collect relatively small sums of money from a large number of relatively poor individuals. On the other hand, delaying the issuance of refunds until tax returns could be matched against third-party wage data would be a major change to the current system of processing tax returns. It could result in delays of many months between the filing of tax returns and the issuance of refunds, unless significant administrative changes were made to accelerate the processing of third-party wage data. Another course of action would be to make the EITC nonrefundable, but that course might be objectionable to some on policy grounds. The annual refundable portion of the EITC is estimated to exceed \$20 billion per year beginning in 1996.

Replacement of the EITC with another delivery system

To address the issue of EITC fraud, some have argued that the EITC should be replaced with a direct expenditure program. While no one contends that fraud can be eliminated by a direct expenditure program, two other arguments are made in support of the direct expenditure program. First, it is argued that the IRS is ill-prepared institutionally to administer a program that puts a premium on the overstatement of income. In almost all other cases, the IRS seeks to attribute income to a taxpayer and the taxpayer has an incentive to minimize reported income. The second argument is that it could take several filing seasons before the IRS can establish effective matching during the filing season.

Opponents of the direct expenditure alternative respond that no government program is immune from fraud and suggest that the EITC should be fixed, not abandoned. They contend that one way to partially offset the problem of overstatement of income may be to set up some sort of proxy for effective matching before paying the EITC. One alternative would be to use wage information from the third quarter of the previous calendar year for a filing season rather than the annual year-end information.²¹

²⁰ *Supra.*

²¹ Testimony of Finn M. W. Caspersen before the Senate Committee on Governmental Affairs (April 4, 1995).

Another proposal is to replace the EITC with a floor on FICA taxes.²² The theory behind this proposal is that the EITC was initially designed as an offset of FICA taxes for the working poor. The proponents of this proposal claim that this is a more direct solution to the problem of work disincentives caused by high payroll taxes. They contend that it should also be easier than to administer present law and not subject to the same fraud and filing complexity as the EITC. It also frees IRS resources for other productive work because the repeal of the EITC would eliminate over 10 million tax returns annually. This proposal could apply to all taxpayers or could only be available to low-income taxpayers. Some contend that limiting the benefit from a floor on FICA taxes to lower-income taxpayers is more consistent with the original EITC goal of a FICA tax offset for the working poor than is granting more general relief from FICA taxes for all taxpayers regardless of income level. Besides the additional complexity involved, a phaseout of the exclusion for all or only some taxpayers will effect the revenue cost significantly. Opponents of the FICA tax floor argue that the EITC serves as more than a payroll tax offset; it also serves the goal of lifting many working poor above the poverty line. This additional goal would not be served by the replacement of the EITC with a FICA tax floor. Also, this proposal could have the effect of reducing amounts allocated to the Social Security Trust Fund and thereby reducing the solvency of the social security program unless corresponding changes are made to social security benefit payments.

²² Testimony of Professor George K. Yin before the Senate Committee on Governmental Affairs (April 4, 1995).

APPENDIX

The Appendix contains tables and charts providing additional information about the EITC.

Table 1 is based on data from the Internal Revenue Service's Statistics of Income Division and shows over the history of the credit the number of families who received the credit, the total amount of EITC claimed, and the portion of EITC in excess of tax liability. The dollar amounts are not adjusted for inflation. Information for 1994 through 2000 are projections.

Table 2 shows the EITC parameters over the history of the credit in dollar amounts unadjusted for inflation.

Table 3 converts the information for the earnings limit, the maximum credit, and the phaseout ranges from Table 2 into 1995 dollars. It also converts the information on the total amount of EITC and the average credit per family from Table 1 into 1995 dollars.

Table 4 is drawn from Internal Revenue Service, *Statistics of Income Bulletin*, Publication 1136, vol. 14, no. 3, Winter 1994-1995, pp. 178-204. These data pertain to tax year 1992 and come from the aggregate of all returns filed and processed through the Individual Master File during calendar year 1993. They are not edited for Statistics of Information purposes and thus may not be directly comparable to the information in Table 1. The first set of columns show by State the number of returns claiming the EITC (in aggregate and as a percentage of all returns) and the amount of EITC claimed. The second set of columns show the number of returns claiming an EITC that exceeds the taxpayer's tax liability (*i.e.*, at least some portion of the EITC is received as a refundable credit). The number of returns with some refundable credit is shown in aggregate and as a percentage of returns claiming the EITC. The amount of refundable credit is shown, in aggregate and as a percentage of the total amount of EITC claimed.

Charts 1 and 2 show the effects of the EITC changes in OBRA 1990 and OBRA 1993 on the size of the credits that would be available in 1996. For purposes of these charts, all income of the individual is assumed to be wage income.

Table 1.--Data on Earned Income Tax Credits Claimed, 1975-2000

| Calendar year to which credit applies | Number of families who received (thousands) | Total amount of credit (millions) | Refunded portion of credit (millions) | Average credit per per family |
|---|--|---|--|-------------------------------------|
| 1975 | 6,215 | \$1,250 | \$900 | \$201 |
| 1976 | 6,473 | 1,295 | 890 | 200 |
| 1977 | 5,627 | 1,127 | 880 | 200 |
| 1978 | 5,192 | 1,048 | 801 | 202 |
| 1979 | 7,135 | 2,052 | 1,395 | 288 |
| 1980 | 6,954 | 1,986 | 1,370 | 286 |
| 1981 | 6,717 | 1,912 | 1,278 | 285 |
| 1982 | 6,395 | 1,775 | 1,222 | 278 |
| 1983 | 7,368 | 1,795 | 1,289 | 224 |
| 1984 | 6,376 | 1,638 | 1,162 | 257 |
| 1985 | 7,432 | 2,088 | 1,499 | 281 |
| 1986 | 7,156 | 2,009 | 1,479 | 281 |
| 1987 | 8,738 | 3,391 | 2,930 | 450 |
| 1988 | 11,148 | 5,896 | 4,257 | 529 |
| 1989 | 11,696 | 6,595 | 4,636 | 564 |
| 1990 | 12,612 | 6,928 | 5,303 | 549 |
| 1991 | 13,105 | 10,589 | 7,849 | 808 |
| 1992 | 14,097 | 13,028 | 9,959 | 926 |
| 1993 | 15,117 | 15,537 | 12,028 | 945 |
| 1994 ¹ | 18,059 | 19,647 | 16,549 | 1,088 |
| 1995 ¹ | 18,425 | 23,310 | 19,779 | 1,265 |
| 1996 ¹ | 18,716 | 25,825 | 21,880 | 1,380 |
| 1997 ¹ | 18,907 | 26,947 | 22,810 | 1,425 |
| 1998 ¹ | 19,104 | 28,134 | 23,819 | 1,473 |
| 1999 ¹ | 19,369 | 29,417 | 24,839 | 1,519 |
| 2000 ¹ | 19,638 | 30,809 | 25,942 | 1,569 |

¹ ProjectedSource: Internal Revenue Service, *Statistics of Income*, various years

Table 2.—Earned Income Tax Credit Parameters, 1975-1996
(dollar amounts unadjusted for inflation)

| Calendar year | Credit rate | Minimum income for maximum credit | Maximum credit | Phaseout rate | Phaseout range: | |
|---------------|-------------|-----------------------------------|----------------|---------------|------------------|---------------|
| | | | | | Beginning income | Ending income |
| 1975-78 | 10.00% | \$4,000 | \$400 | 10.00% | \$4,000 | \$8,000 |
| 1979-84 | 10.00 | 5,000 | 500 | 12.50 | 6,000 | 10,000 |
| 1985-86 | 11.00 | 5,000 | 550 | 12.22 | 6,500 | 11,000 |
| 1987 | 14.00 | 6,080 | 851 | 10.00 | 6,920 | 15,432 |
| 1988 | 14.00 | 6,240 | 874 | 10.00 | 9,840 | 18,576 |
| 1989 | 14.00 | 6,500 | 910 | 10.00 | 10,240 | 19,340 |
| 1990 | 14.00 | 6,810 | 953 | 10.00 | 10,730 | 20,264 |
| 1991: | | | | | | |
| One child | 16.70 | 7,140 | 1,192 | 11.93 | 11,250 | 21,250 |
| Two children | 17.30 | 7,140 | 1,235 | 12.36 | 11,250 | 21,250 |
| 1992: | | | | | | |
| One child | 17.60 | 7,520 | 1,324 | 12.57 | 11,840 | 22,370 |
| Two children | 18.40 | 7,520 | 1,384 | 13.14 | 11,840 | 22,370 |
| 1993: | | | | | | |
| One child | 18.50 | 7,750 | 1,434 | 13.21 | 12,200 | 23,050 |
| Two children | 19.50 | 7,750 | 1,511 | 13.93 | 12,200 | 23,050 |
| 1994: | | | | | | |
| No children | 7.65 | 4,000 | 306 | 7.65 | 5,000 | 9,000 |
| One child | 26.30 | 7,750 | 2,038 | 15.98 | 11,000 | 23,755 |
| Two children | 30.00 | 8,425 | 2,528 | 17.68 | 11,000 | 25,296 |

Table 2.--Earned Income Tax Credit Parameters, 1975-1996
(dollar amounts unadjusted for inflation)

| Calendar year | Credit rate | Minimum income for maximum credit | Maximum credit | Phaseout rate | Phaseout range: Beginning income Ending income | |
|----------------------|--------------------|--|-----------------------|----------------------|--|---------|
| 1995: | | | | | | |
| No children | 7.65% | \$4,100 | \$314 | 7.65% | \$5,130 | \$9,230 |
| One child | 34.00 | 6,160 | 2,094 | 15.98 | 11,290 | 24,396 |
| Two children | 36.00 | 8,640 | 3,110 | 20.22 | 11,290 | 26,673 |
| 1996: | | | | | | |
| No children | 7.65 | 4,230 | 324 | 7.65 | 5,290 | 9,520 |
| One child | 34.00 | 6,340 | 2,156 | 15.98 | 11,630 | 25,119 |
| Two children | 40.00 | 8,910 | 3,564 | 21.06 | 11,630 | 28,553 |

Source: Compiled by staff of the Joint Committee on Taxation

Table 3.--Earned Income Tax Credit Parameters, 1975-1995 in 1995 Dollars

| Calendar year | Adjusted to 1995 dollars by CPI-U | | | | | |
|---------------|-----------------------------------|----------------|------------------|---------------|---------------------------------|---------------------------|
| | Minimum income for maximum credit | Maximum credit | Phaseout range | | Total amount of EITC (millions) | Average credit per family |
| | | | Beginning income | Ending income | | |
| 1975 | \$11,352 | \$1,135 | \$11,352 | \$22,704 | \$3,548 | \$570 |
| 1976 | 10,734 | 1,073 | 10,734 | 21,467 | 3,475 | 537 |
| 1977 | 10,078 | 1,008 | 10,078 | 20,157 | 2,840 | 504 |
| 1978 | 9,367 | 937 | 9,367 | 18,734 | 2,454 | 473 |
| 1979 | 10,516 | 1,052 | 12,619 | 21,031 | 4,316 | 606 |
| 1980 | 9,265 | 926 | 11,118 | 18,530 | 3,680 | 530 |
| 1981 | 8,399 | 840 | 10,078 | 16,797 | 3,212 | 479 |
| 1982 | 7,911 | 791 | 9,493 | 15,822 | 2,808 | 440 |
| 1983 | 7,665 | 766 | 9,198 | 15,330 | 2,752 | 343 |
| 1984 | 7,348 | 735 | 8,817 | 14,695 | 2,407 | 378 |
| 1985 | 7,095 | 780 | 9,224 | 15,609 | 2,963 | 399 |
| 1986 | 6,966 | 766 | 9,055 | 15,324 | 2,799 | 391 |
| 1987 | 8,172 | 1,144 | 9,301 | 20,742 | 4,558 | 605 |
| 1988 | 8,054 | 1,128 | 12,700 | 23,975 | 7,610 | 683 |
| 1989 | 8,004 | 1,121 | 12,609 | 23,814 | 8,121 | 694 |
| 1990 | 7,956 | 1,113 | 12,535 | 23,673 | 8,093 | 641 |
| 1991 | | | | | 11,871 | 906 |
| One child | 8,004 | 1,336 | 12,612 | 23,822 | | |
| Two children | 8,004 | 1,384 | 12,612 | 23,822 | | |
| 1992 | | | | | 14,178 | 1,008 |
| One child | 8,184 | 1,441 | 12,885 | 24,345 | | |
| Two children | 8,184 | 1,506 | 12,885 | 24,345 | | |
| 1993 | | | | | 16,417 | 999 |
| One child | 8,189 | 1,515 | 12,891 | 24,356 | | |
| Two children | 8,189 | 1,597 | 12,891 | 24,356 | | |
| 1994 | | | | | 20,242 | 1,121 |
| No children | 4,121 | 315 | 5,151 | 9,272 | | |
| One child | 7,985 | 2,100 | 11,333 | 24,474 | | |
| Two children | 8,680 | 2,605 | 11,333 | 26,062 | | |
| 1995 | | | | | 23,310 | 1,265 |
| No children | 4,100 | 314 | 5,130 | 9,230 | | |
| One child | 6,160 | 2,094 | 11,290 | 24,396 | | |
| Two children | 8,640 | 3,110 | 11,290 | 26,673 | | |

Table 4. -- State Data on Earned Income Tax Credits Claimed, 1992

| State | Earned Income Credits | | | Credit in excess of tax liability | | | Refundable Portion as % of EITC Amount |
|----------------------|-----------------------|--------------------|--------------------|-----------------------------------|-------------------|--------------------|--|
| | Number of Returns | % of Total Returns | Amount (Thousands) | Number of Returns | % of EITC Returns | Amount (Thousands) | |
| Alabama | 362,084 | 20.7% | \$367,936 | 298,544 | 82.5% | \$292,761 | 79.6% |
| Alaska | 18,101 | 5.1% | 13,645 | 12,284 | 67.9% | 8,540 | 62.6% |
| Arizona | 249,461 | 14.9% | 236,700 | 203,745 | 81.7% | 188,442 | 79.6% |
| Arkansas | 194,302 | 19.6% | 187,324 | 154,709 | 79.5% | 142,258 | 75.9% |
| California | 2,118,514 | 15.4% | 2,032,135 | 1,808,964 | 85.4% | 1,668,477 | 82.1% |
| Colorado | 164,193 | 9.9% | 148,839 | 123,312 | 75.1% | 108,061 | 72.6% |
| Connecticut | 77,638 | 4.9% | 63,193 | 51,826 | 66.8% | 40,805 | 64.6% |
| Delaware | 34,538 | 10.5% | 32,206 | 26,424 | 76.5% | 24,444 | 75.9% |
| District of Columbia | 48,840 | 16.0% | 45,678 | 38,449 | 78.7% | 35,662 | 78.1% |
| Florida | 847,682 | 13.6% | 812,582 | 671,924 | 79.3% | 611,789 | 75.3% |
| Georgia | 512,534 | 17.2% | 499,658 | 409,619 | 79.9% | 386,393 | 77.3% |
| Hawaii | 37,486 | 6.6% | 31,185 | 25,605 | 68.3% | 20,446 | 65.6% |
| Idaho | 60,978 | 13.2% | 56,129 | 46,023 | 75.5% | 40,949 | 73.0% |
| Illinois | 575,354 | 10.7% | 525,275 | 449,236 | 78.1% | 402,958 | 76.7% |
| Indiana | 270,062 | 10.7% | 246,561 | 201,861 | 74.7% | 181,126 | 73.5% |
| Iowa | 111,443 | 8.8% | 97,888 | 78,674 | 70.6% | 66,051 | 67.5% |
| Kansas | 110,464 | 9.9% | 97,206 | 80,640 | 73.0% | 69,013 | 71.0% |
| Kentucky | 219,252 | 14.3% | 199,832 | 168,907 | 77.0% | 146,097 | 73.1% |
| Louisiana | 376,267 | 22.2% | 367,212 | 313,162 | 83.2% | 294,847 | 80.3% |
| Maine | 55,605 | 10.1% | 47,586 | 39,351 | 70.8% | 30,740 | 64.6% |
| Maryland | 233,430 | 10.0% | 212,476 | 173,127 | 74.2% | 153,402 | 72.2% |
| Massachusetts | 167,745 | 6.0% | 142,124 | 116,308 | 69.3% | 93,736 | 66.0% |
| Michigan | 368,166 | 8.9% | 316,447 | 279,250 | 75.8% | 231,438 | 73.1% |
| Minnesota | 149,133 | 7.2% | 128,558 | 104,861 | 70.3% | 84,507 | 65.7% |
| Mississippi | 297,985 | 28.7% | 304,280 | 253,247 | 85.0% | 248,536 | 81.7% |

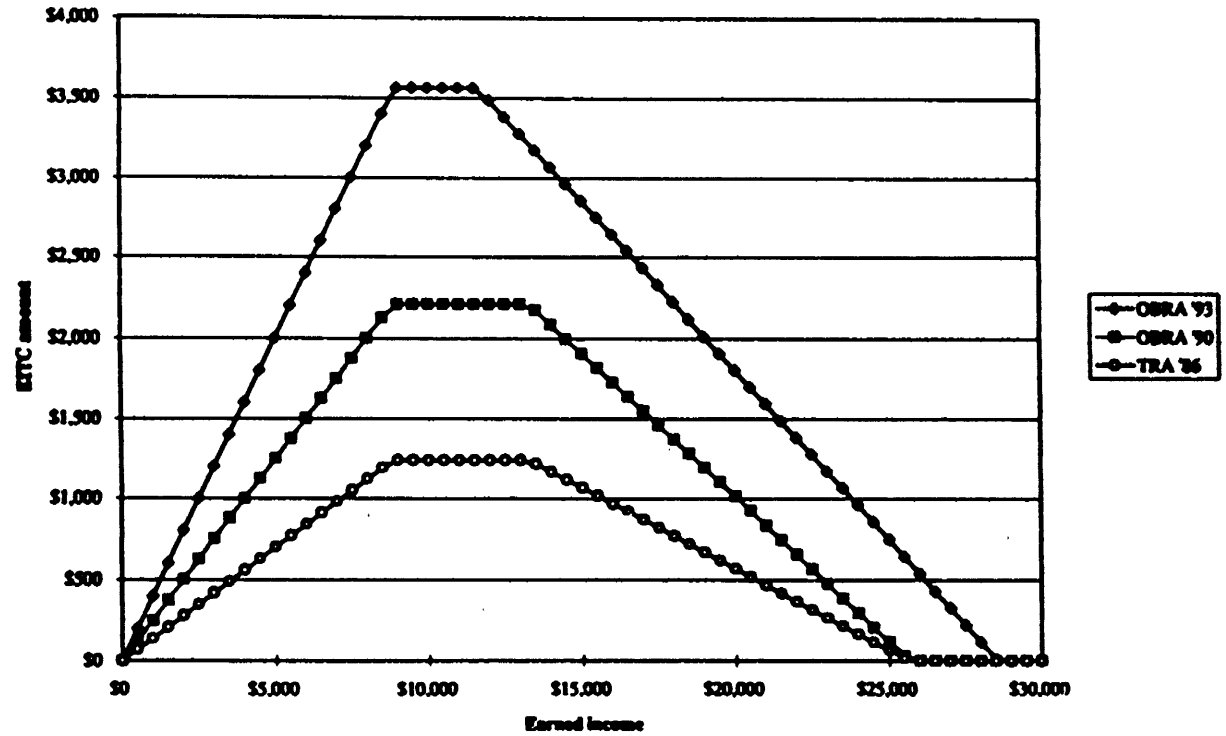
Source: Internal Revenue Service, *Statistics of Income Bulletin*, Winter 1994-95, pp. 178-204

Table 4. -- State Data on Earned Income Tax Credits Claimed, 1992

| State | Earned Income Credit | | | Credit in excess of tax liability | | | Refundable Portion as % of EITC Amount |
|----------------|----------------------|-----------------------|-----------|-----------------------------------|----------------------|-----------|--|
| | Number of Returns | % of Total Returns | Amount | Number of Returns | % of EITC Returns | Amount | |
| Missouri | 279,121 | 12.2% | \$253,795 | 212,029 | 76.0% | \$186,120 | 73.3% |
| Montana | 44,932 | 12.0% | 40,011 | 33,586 | 74.7% | 27,700 | 69.2% |
| Nebraska | 74,031 | 10.0% | 66,586 | 53,996 | 72.9% | 46,257 | 69.5% |
| Nevada | 75,332 | 11.2% | 68,600 | 57,351 | 76.1% | 51,453 | 75.0% |
| New Hampshire | 37,915 | 7.1% | 32,947 | 25,669 | 67.7% | 21,015 | 63.8% |
| New Jersey | 338,193 | 8.9% | 304,798 | 254,625 | 75.3% | 224,217 | 73.6% |
| New Mexico | 127,900 | 18.6% | 119,499 | 105,008 | 82.1% | 93,801 | 78.5% |
| New York | 830,710 | 10.4% | 746,967 | 621,532 | 74.8% | 537,930 | 72.0% |
| North Carolina | 503,333 | 16.3% | 487,277 | 393,652 | 78.2% | 367,745 | 75.5% |
| North Dakota | 26,848 | 9.5% | 23,853 | 19,176 | 71.4% | 15,883 | 66.6% |
| Ohio | 472,901 | 9.3% | 416,539 | 350,625 | 74.1% | 300,959 | 72.3% |
| Oklahoma | 202,588 | 15.2% | 185,897 | 157,299 | 77.6% | 137,837 | 74.1% |
| Oregon | 142,147 | 10.5% | 128,433 | 107,380 | 75.5% | 94,597 | 73.7% |
| Pennsylvania | 465,021 | 8.6% | 405,066 | 334,553 | 71.9% | 283,034 | 69.9% |
| Rhode Island | 36,204 | 8.1% | 31,836 | 26,431 | 73.0% | 22,397 | 70.4% |
| South Carolina | 295,057 | 18.8% | 292,147 | 237,751 | 80.6% | 229,009 | 78.4% |
| South Dakota | 37,156 | 11.7% | 34,060 | 27,348 | 73.6% | 23,281 | 68.4% |
| Tennessee | 361,580 | 16.3% | 341,522 | 283,006 | 78.3% | 256,134 | 75.0% |
| Texas | 1,413,644 | 18.4% | 1,363,423 | 1,156,176 | 81.8% | 1,068,357 | 78.4% |
| Utah | 79,094 | 10.8% | 72,520 | 59,584 | 75.3% | 53,015 | 73.1% |
| Vermont | 24,024 | 9.1% | 20,339 | 16,546 | 68.9% | 12,661 | 62.2% |
| Virginia | 316,935 | 10.8% | 298,600 | 244,386 | 77.1% | 223,904 | 75.0% |
| Washington | 203,952 | 8.5% | 178,446 | 152,388 | 74.7% | 130,412 | 73.1% |
| West Virginia | 96,848 | 14.0% | 87,197 | 74,793 | 77.2% | 65,419 | 75.0% |
| Wisconsin | 182,151 | 8.0% | 160,737 | 132,655 | 72.8% | 111,636 | 69.5% |
| Wyoming | 23,260 | 11.0% | 20,585 | 17,556 | 75.5% | 14,917 | 72.5% |

Source: Internal Revenue Service, *Statistics of Income Bulletin*, Winter 1994-95, pp. 178-204

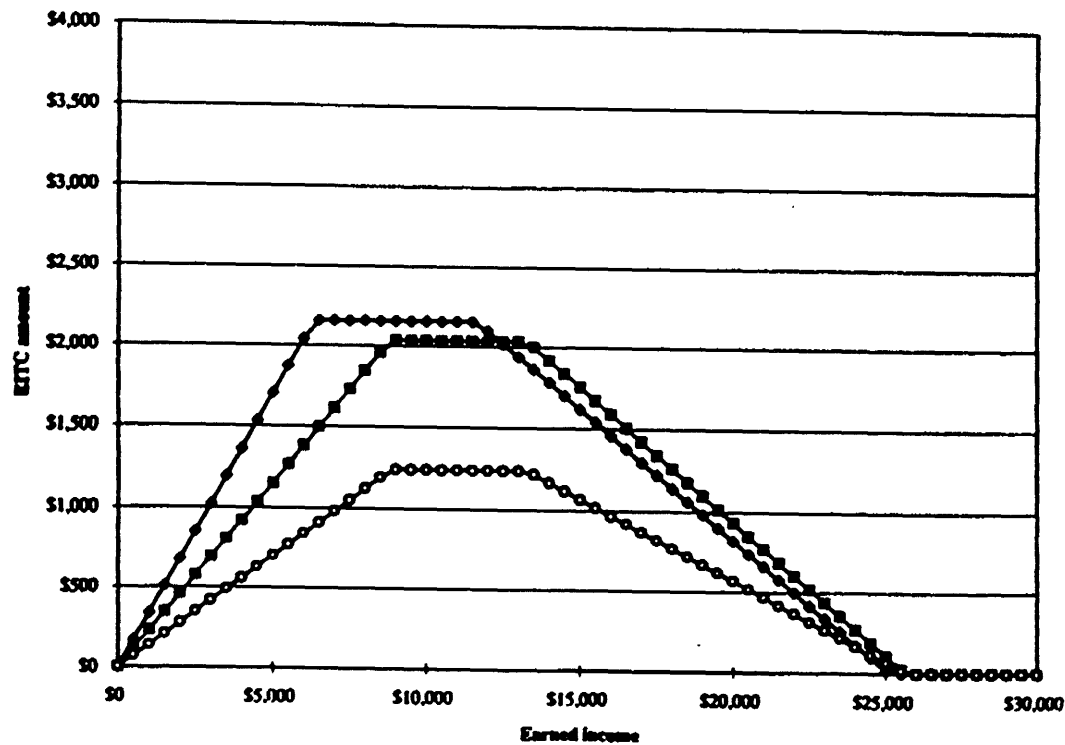
Comparison of EITC for taxpayers with two or more children
(1996 levels)



Source: JCT Calculations

Chart 2

Comparison of EITC for taxpayers with one child
(1996 levels)



◆ OBRA '93
■ OBRA '90
○ TRA '86

Source: JCT Calculations