EARNED INCOME TAX CREDIT

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

AND THE

SUBCOMMITTEE ON HUMAN RESOURCES

OF THE

COMMITTEE ON WAYS AND MEANS

HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

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EARNED INCOME TAX CREDIT

THURSDAY, JUNE 15, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT, JOINTLY WITH
THE SUBCOMMITTEE ON HUMAN RESOURCES,
Washington, DC.

The Subcommittees met jointly, pursuant to notice, at 10:20 a.m., in room 1100 Longworth House Office Building, Hon. Nancy L. Johnson, (Chairman of the Subcommittee on Oversight) and Hon. E. Clay Shaw, Jr., (Chairman of the Subcommittee on Human Resources) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEES ON OVERSIGHT AND HUMAN RESOURCES

FOR IMMEDIATE RELEASE CONTACT: (202) 225-7601
June 2, 1995
No. OV-8

Johnson and Shaw Announce Hearing on the Earned Income Tax Credit

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight, and Congressman E. Clay Shaw, Jr. (R-FL), Chairman of the Subcommittee on Human Resources of the Committee on Ways and Means, today announced that the Subcommittees will hold a joint hearing on the Earned Income Tax Credit. **The hearing will take place on Thursday, June 15, 1995, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

This hearing will feature invited witnesses only. In view of the limited time available to hear witnesses, the Subcommittees will not be able to accommodate requests to testify other than from those who are invited. Those persons and organizations not scheduled for an oral appearance are welcome to submit written statements for the record of the hearing.

BACKGROUND:

To be eligible to receive the Earned Income Tax Credit (EITC), an individual must have earned income. To target the credit to low-income workers, the amount of the credit to which a taxpayer is entitled decreases when the taxpayer's earned income (or, if greater, adjusted gross income (AGI)) exceeds certain thresholds. The earned income and AGI thresholds are indexed for inflation and are also adjusted to take into account qualifying children. In 1995, a taxpayer with two or more qualifying children will not be eligible for the EITC if his or her income exceeds $26,673. The income cut-offs decline to $24,396 for a taxpayer with one qualifying child and $9,230 for a taxpayer with no qualifying children.

SCOPE OF THE HEARING:

There are three major EITC issues which the Subcommittees intend to examine. First, based on studies by both the Internal Revenue Service (IRS) and the General Accounting Office, there is an alarmingly high rate of errors and fraud in EITC claims. According to IRS data, the noncompliance rate could range as high as 30 to 40 percent annually. Given the fact that the federal government will spend between $25 and $28 billion per year over the next five years on EITC benefits, the loss to the taxpayers from noncompliance could be very high. The IRS took significant steps during the current tax filing season to detect erroneous and fraudulent EITC refund claims. The Subcommittees will examine the effectiveness of the IRS' efforts and whether additional changes are needed to reduce the credit's susceptibility to fraud and errors. We are especially interested in learning whether, as some tax experts have recently argued, fraudulent claims are an inevitable consequence of the value and refundable nature of the EITC benefit.

The second issue to be addressed is whether inappropriate beneficiaries may be receiving the EITC. Under current law a taxpayer may have relatively low earned income, and therefore may be eligible for the EITC, even though he or she may have other significant sources of nontaxable income. Although the credit is intended to help low-income workers, its eligibility criteria does not include all of the resources recipients may have to support their families. Earlier this year, the Administration proposed denying the credit to taxpayers with $2,500 or more of interest and dividend income. This Administration policy was based on the rationale that the EITC should be targeted to families with the greatest need, not those with other resources upon which they can draw to meet family needs. The Subcommittees will examine the implications of changing the credit's eligibility criteria to take into account sources of income that are not currently counted for eligibility purposes.

The Subcommittees are also interested in receiving testimony on the labor market effects of the EITC. As long ago as 1990, the Ways and Means Committee heard testimony expressing concern that the EITC could actually reduce the aggregate level of work in the nation. This effect could occur because earners in the flat range of the credit may have reduced incentive to work additional hours. Even more important, the millions of earners in the phase-out range have an unambiguous incentive to reduce hours of work. The Subcommittees will examine the concern that the credit's large phase-out range may lead to a net reduction in work.

In announcing the hearing, Chairman Johnson said: "Even advocates realize that there are problems with the EITC. Rather than put our heads in the sand while these problems fester, we should take strong action now to make certain the EITC will remain available for the millions of American low-wage parents, especially those trying to leave welfare, who use the EITC exactly as it was intended." Chairman Shaw added that: "This hearing is very important because the design of the EITC has invited fraud. As we maintain the core of this program, we must root out the excesses.

<u>DETAILS FOR SUBMISSION OF WRITTEN COMMENTS</u>:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Thursday, June 29, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

<u>FORMATTING REQUIREMENTS</u>:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at GOPHER.HOUSE.GOV, under 'HOUSE COMMITTEE INFORMATION'.

Chairman JOHNSON. The hearing will come to order.

My colleague, Chairman Shaw of the Human Resources Subcommittee, will be joining us briefly. In the meantime, I would like to welcome you all to this hearing, a joint hearing of the Oversight and Human Resources Subcommittees of the Ways and Means Committee on EITC, the earned income tax credit.

The EITC was first enacted into law in 1975 to offset the impact of FICA taxes and to help encourage those on welfare to enter the work force. The EITC was designed to reduce reliance on AFDC, Aid to Families With Dependent Children, and other transfers by increasing the aftertax return for work.

With a focus of welfare reform on moving people from dependence on welfare benefits to the independence of work and earnings, the EITC plays a very important role, but the cost is high. Under current law, approximately 19 million families will receive the credit in the year 2000 at an annual cost of almost $30 billion, nearly double what the Federal Government will spend on welfare benefits, and well over two times the $13 billion the government will spend on education.

Advocates realize that there are problems with the EITC. If we expect this important benefit for low-income workers to survive, we certainly cannot afford to lose the $5 billion per year that Treasury and the IRS, Internal Revenue Service, estimate we have been losing to fraudulent and erroneous claims.

The credit susceptibility for fraud and errors is apparently due largely to its refundable nature and the fact that the amount of the credit a taxpayer receives is determined by information supplied by the taxpayer and not readily verifiable by the IRS.

In addition, the standards of proof required in the EITC claims are not comparable to the standards of proof required for receipt of other government benefits such as AFDC, Medicare, and unemployment compensation. Establishing eligibility for these benefits normally requires the claimant to meet with government employees face-to-face to produce proof of identification, and other qualifying information. These controls are not part of the EITC Program.

During the 1995 filing season, the IRS took a number of steps to address erroneous and fraudulent EITC claims, and this morning we are going to hear about those efforts and their outcomes. Even if the IRS were able to perfectly verify SSNs, Social Security numbers, and wage and salary income, compliance problems would still arise with regard to self-employment.

As long as the payroll tax and the EITC subsidy are roughly equal, taxpayers have no incentive to overstate income from self-employment to increase their EITC. Doing so would result in a larger credit, but would also obligate the taxpayer to pay higher Social Security taxes on their self-employed income.

As a result of recent expansions of the EITC, there are now strong incentives for taxpayers to manipulate the level of their income from self-employment. The IRS is not equipped well enough to uncover overreporting of income.

Today we will hear more from the IRS about the results of their fraud prevention efforts and some indication of what can be expected next year to further protect the Nation's revenues. Assistant Secretary Samuels will also give the administration's views on reforms to the credit, and we will hear testimony about how to further reduce the credit susceptibility to fraud and errors and how to better target the credit to those who need it most.

I would like to submit my entire statement for the record and acknowledge my cochairman, Mr. Matsui of California of the Oversight Subcommittee.

[The opening statement follows:]

Opening Statement by the Honorable Nancy L. Johnson
Subcommittees on Oversight and Human Resources
Joint Hearing on the Earned Income Tax Credit
Thursday, June 15, 1995

Good morning ladies and gentlemen. I welcome you to this joint hearing of the Oversight and Human Resources Subcommittees on the Earned Income Tax Credit.

The EITC was first enacted in law in 1975 to offset the impact of FICA taxes to help encourage those on welfare to enter the workforce. Thus, the EITC was designed to reduce reliance on AFDC and other transfers by increasing the after-tax return to work. With the focus of welfare reform on moving people from dependence on welfare benefits to the independence of work and earnings, the EITC plays an important role.

But the cost is high. Under current law, approximately 19 million families will receive the credit in the year 2000, at an annual cost of almost $30 billion -- nearly double what the federal government will spend on welfare benefits and well over two times the $13 billion the government will spend on education.

Even advocates realize that there are problems with the EITC.
If we expect this important benefit for low-income workers to survive, we certainly cannot afford to lose the $5 billion per year that Treasury and the IRS estimate we've been losing to fraudulent and erroneous claims.

The credit's susceptibility to fraud and errors is apparently due largely to its refundable nature and the fact that the amount of the credit a taxpayer receives is determined by information supplied by the taxpayer. Much of this information cannot be verified by the IRS at the time the refundable portion of the credit is paid out.

In addition, the standards of proof required on EITC claims aren't comparable with the standards of proof required for receipt of other government benefits such as AFDC, Medicaid or unemployment. Establishing eligibility for these benefits normally requires the claimant to meet with government employees face-to-face, to produce proof of identification, to prove the existence of their dependents, and to satisfy other conditions. These controls aren't available in the distribution of the EITC by the IRS through tax refunds.

During the 1995 filing season, the IRS took a number of steps to address erroneous and fraudulent EITC claims. Among other things, the IRS delayed refunds on *all* returns with an invalid or missing Social Security number to give greater time to verify the refund being claimed. It also checked the validity of all Social Security numbers, and checked for duplicate use of the same numbers.

The preliminary evidence suggests that these checks will help somewhat to reduce the losses from fraudulent claims. For example, through May 21, 1995, the number of dependents claimed for tax year 1994 when compared to the number claimed through the same time period last year, decreased by approximately 800,000. The IRS believes this is probably due to the fact that non-existent or non-qualifying dependents claimed in prior years were not claimed this year -- perhaps because of publicity surrounding the fact that the IRS would verify Social Security numbers.

But even if the IRS were able to perfectly verify Social Security numbers and wage and salary income, compliance problems would still arise with regard to self-employment income. Between 1975 and 1990, the subsidy rate of the EITC was roughly the same as the combined employee and employer share of the payroll tax.

As long as the payroll tax and EITC subsidy are roughly equal, taxpayers have no incentive to overstate income from self-employment to increase their EITC. Doing so would result in a larger credit, but would also obligate the taxpayer to pay higher social security taxes on the self-employment income.

However, as a result of recent expansions of the EITC, there are now strong incentives for taxpayers to manipulate the level of their income from self-employment, and the IRS isn't well equipped to uncover overreporting of income.

Our tax laws and administrative safeguards are generally designed to identify cases where taxpayers *under*state their income, not *over*state it. For example, information reports such as 1099s allow the IRS to verify that taxpayers haven't omitted items of income on their tax returns. However, if taxpayers voluntarily report *more* income than the information reported to the IRS suggests, there's little the IRS can do to detect this in the absence of a full-scale audit, and the payoffs to audits in this area are small relative to other areas.

Today, we'll hear more from the IRS about the results of their fraud prevention efforts and some indication of what can be expected next year to further protect the nation's revenues. Assistant Secretary Samuels will also give us the Administration's views on reforms to the credit. We will hear testimony about how to further reduce the credit's susceptibility to fraud and errors, how to better target the credit to those who need it most, and the credit's impact on incentives to work.

Rather than put our heads in the sand while problems with the EITC fester, we should take action now to make certain the credit will remain available for the millions of American low-wage parents, especially those trying to leave welfare, who use the EITC exactly as it was intended.

I welcome all our witnesses today and thank them for their willingness to testify.

Mr. MATSUI. I would like to thank Chairman Johnson first of all for holding these hearings. Second, I would like to thank the Chair for the fact that she and her staff, in working with our staff, came up with a very good witness list, one in which I think we will get a positive airing of both the problems and solutions on the issue of the EITC. I want to thank you for the way this has been handled.

Chairman JOHNSON. Our staff has worked together very well, as have we.

Mr. MATSUI. Thank you.

I welcome my colleagues, Mr. Petri and Mr. Hutchinson, and certainly the two administration witnesses, the Assistant Secretary for Treasury, Mr. Samuels, and the Commissioner of the Internal Revenue Service, Peggy Richardson.

Let me, if I may, be very brief, but make four observations, Chairman Johnson. One, the purpose of the earned income tax credit is to do two things. It is to move people from welfare to work. Many low-wage earners do not make enough, particularly if they are at the minimum wage level, in order to make a decent living and survive, as a result of that, the earned income tax credit, which was first imposed in 1975 and then extended in 1990 and 1993, and also in 1986 in tax reform, is to provide an incentive to continue to work and to get off welfare. Second, it is to make sure that families that work and who have children find a way to get out of poverty. Those are the two basic elements of the earned income tax credit.

I would disagree with the observation that some make, including in the opening statement of the Chair, that the earned income tax credit has become a disincentive for people to work, because now the threshold is approximately $29,000. A family of three or four making $29,000 would not have any excess income to save and put in a bank account or perhaps buy a house and, as a result of that, they are going to need every penny they make.

We are not talking about people that make $200,000 or $300,000 a year that might have excess income so they do not need to earn any more money to live. We are talking about people really on the threshold. Anybody under $30,000 with three or four in their family in America today cannot make it unless they continue to work and work and work.

I would like to also respond to the issue of the growth of the program. I know that there has been some allegations in the press reports and others that the earned income tax credit is exploding in growth and we need to stop it and we need to reform it.

As I mentioned, in 1986 we had the first major expansion. In 1990, under President Bush—because it has always been bipartisan—we had another expansion, and then we had the third recent expansion in 1993. These are still being phased in.

Of course, as they are being phased in, the program will grow. By the year 1997, the full phase-in will occur, and after that I can assure you that the only growth will be the result of indexing the rates and also population growth. We do not expect a growth anywhere in excess of 3 or 4 percent, whatever inflation should be, and I believe we will have charts to show that.

It is false to say that this program is exploding and will ultimately create a deficit problem. We knew exactly what we were doing under President Bush in 1990. We knew what we were doing under President Reagan in 1986, and we knew what we were doing in 1993 under President Clinton, and that program will fully phase in in 1997 and the growth will be exactly what all taxpayers receive in terms of the indexation of inflation.

The third area and the second point I would like to make is the issue of the error rate, which everyone has seemed to make a big deal about. First of all, it was the Treasury Department and IRS under President Clinton which recently decided to examine the EITC. They found that there could be some problems with approximately 29 percent of the filers making errors on their returns. Of course, that is a rather high alarming number. At the same time, that does not mean 29 percent of benefits were paid out. It means that errors were made in an individual's return.

Second, bear in mind that when that very limited study was done, it was only on electronic filing. It was not on the paper returns that many low-income taxpayers file. It was electronic filing, which most low-income people do not do. That is what actually caused the IRS and Treasury to have their ears perk up and say we had better check these numbers. That was, as I said, in January 1994.

Since that time, the Treasury Department has commissioned a study that came out in September 1994, from that study, they made a number of observations and now they have come up with a number of recommendations, for example, during GATT, the General Agreement on Tariffs and Trade, discussions when we matched the Social Security number of the individual claiming the credit with the return.

We made changes on electronic filing, and now the person on the first electronic filing cannot file unless they provide decent verification. As a result of that, we have now been able to identify in this filing year 4.1 million returns that have errors, and so the service and also Treasury are correcting this problem. Second, they have made additional recommendations, both to the Congress and also in terms of regulations, that we believe will actually satisfy the problem.

Let me conclude by making one last observation, if I may. I think that to some extent we need to talk about this issue in the context of the larger issue of our Tax Code. We are talking about approximately $20 to $25 billion a year for low-income wage earners, people that work, not people that are on welfare.

At a time when we just passed the budget resolution, that gives each person making over $100,000 a year, over $12,000 in tax reductions, an individual taxpayer with a family of three making under $30,000, will get maybe $1,500 or $1,900. Penalizing these families and restrict them from getting this credit at all, was agreed to on a bipartisan agreement. We really need to consider and think about what our values are in America today.

I look forward to these hearings, Chairman Johnson and other Members of this Subcommittee and Committees. At the same time, I hope that we do not do something that will create a disincentive for Americans to work and actually do major harm to the children of America.

Thank you.

Chairman JOHNSON. Thank you.

I yield now to my cochair of this hearing, Mr. Shaw, with the comment that some of the Members who have been waiting to testify have some pretty severe deadlines, and so we will move forward.

Chairman SHAW. Madam Chairman, at this point I would ask that my opening statement be made a part of the record in order to expedite this hearing.

[The opening statement follows:]

Opening Statement by the Honorable E. Clay Shaw
Subcommittee on Human Resources
Joint Hearing on Earned Income Tax Credit
Thursday, June 15, 1995

By almost any account, the Earned Income Tax Credit has been one of Washington's most popular anti-poverty programs. The number of beneficiaries, the generosity of the credit, and the cost to taxpayers have all grown dramatically under Presidents Reagan, Bush and Clinton. And the fundamental premise of the EITC -- that government programs should reward poor Americans who work rather than those who do not and rely on welfare -- has now become almost the fifth gospel here in Washington. I'll call it the gospel according to Charlie, after my good friend Charlie Rangel.

Yet we are now hearing new criticisms of the EITC. The Green Book, for example, tells us that 168,000 people with incomes over $40,000 received the EITC. Even more troubling allegations involve fraud and abuse costing taxpayers billions of dollars. One witness at a recent Senate hearing said the EITC should stand for "Easy Income for Tax Cheats." Make no mistake about it -- this Subcommittee will act to defend the EITC against continued abuse.

The Subcommittee also will consider whether the EITC's eligibility criteria should be changed so that only families without other resources are eligible for the credit. For example, earlier this year the Administration proposed targeting the EITC to families with less than $2,500 in interest and dividend income. A version of this proposal is now law, and we will explore the implications of related changes for families that benefit and taxpayers who support them. We will also examine whether current EITC rules actually may reduce the time some poor families spend working.

Finally, both Republicans and Democrats want the EITC to help parents get off and stay off welfare. Yet the Committee has received disturbing information that most welfare mothers, even those who work, have only the foggiest notion of what the EITC is all about. Welfare departments intent on helping mothers leave welfare must begin programs designed to teach mothers about the EITC. We have invited an entire panel of witnesses to address this issue.

Despite the fact that problems exist, many Americans believe the EITC remains an important part of our country's efforts against poverty. I am one. The EITC helps poor families with children or single parents escape and stay off welfare. It also increases the chances that poor children will learn from their parents the value of work. That lesson is one of the most important any parent can pass on to a child, yet in some parts of our country a personal understanding of the value of work is almost unknown. Until someone suggests a better alternative, the EITC will remain our best bet to reinforce the importance of work, not welfare, for millions of poor families.

Chairman SHAW. I would now recognize the gentleman from Tennessee, Mr. Ford, for any opening statement he might have.

Mr. FORD. Thank you very much, Chairman Shaw and Chairman Johnson. Let me thank the two cochairpersons for calling these hearings today.

I am going to be very brief, and I ask that my full text be made a part of the record, if you do not mind, Madam Chairman.

Some have proposed to cut the EITC either by indexing or by a halt in the phased-in increases we have mandated. Make no mistake about it, cuts in the EITC constitutes a tax increase on millions of hard-working Americans who in most cases have very low wages and low income.

Chairman Archer, the Chairman of the Full Committee on Ways and Means, has made it clear that tax increases will not occur on his watch, and I am counting on him to make certain that his pledge apply equally to working poor people, as well as to the rich and wealthy of this Nation.

I think when we think in terms of the earned income tax credit—and I think Mr. Matsui has said it very well—under both Democrats and Republicans in the White House, we have seen over a 10-year period a program that has expanded. The expansion was the intent all along on a bipartisan basis. It would be expanded to make sure that working Americans can move off many of the public assistance rolls and stay within the work force and bring in wages, and also under the EITC Program, that they would be able to have the necessary benefits that will be needed. It should come as no surprise that spending on this program has now increased because that is what we intended for this program all along.

I once again thank you, Madam Chairman and Chairman Shaw, for calling these public hearings today. Hopefully, we, as Republicans and Democrats, can address this problem on the EITC and make sure that we move forward in the right direction.

Thank you.

[The opening statement follows:]

OPENING STATEMENT OF REPRESENTATIVE HAROLD FORD
June 15, 1995

Today's hearing is an important one because it gives us a chance to examine the facts and dispel several myths that seem to haunt the EITC.

For example, critics charge that spending on the EITC is out-of-control. They are correct that EITC spending has grown. But that is because the Congress, under the leadership of both Republican and Democratic Presidents, decided that it should grow. Over the past ten years, we have repeatedly expanded the EITC -- as a reward for work and as an alternative to increasing the minimum wage. It should come as no surprise that spending on this program has now increased. This is what we intended.

Some have proposed to cut the EITC, either by ending indexing or by halting the phased-in increases we mandated. Make no mistake. Cuts in the EITC constitute a tax increase on millions of hardworking Americans.

Chairman Archer has made clear that tax increases will not occur on his watch. I am counting on him to make certain that pledge is applied equally -- to the working poor as well as the idle rich.

Talk about cutting the EITC is motivated -- first and foremost -- by the need to pay for the tax cuts Republicans have proposed for the wealthy. But clever advocates of tax cuts for the rich are using alleged fraud in the EITC as a smoke screen to hide their true intent.

Let me be clear. Any fraud is unacceptable. Congress has taken legislative steps to address errors and fraud in the EITC. The Clinton Administration has proceeded aggressively to reduce the error and fraud rates they inherited in 1993. If additional legislative or administrative action is needed, let's do it. But we cannot allow unfounded allegations of widespread fraud to be the reason we carve up a program that helps millions of working Americans succeed in their climb out of poverty.

I know that many of my Republican colleagues share this commitment to the EITC. I look forward to today's testimony and to working with you to preserve this valuable anti-poverty tool.

Chairman SHAW. Thank you, Mr. Ford.

If the first panel would sit at the witness table. Mr. Petri, we have you down first. If you would not mind, let Mr. Hutchinson go first, because he has a conflict with another hearing here in the Capitol.

The Chair at this time will recognize Tim Hutchinson from the State of Arkansas.

STATEMENT OF HON. Y. TIM HUTCHINSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARKANSAS

Mr. HUTCHINSON. Thank you, Mr. Chairman. Thank you, Mr. Petri, for allowing me to go first. I appreciate the Committee's indulgence. I know Mr. Petri will be able to handle all the questions that you will have when I excuse myself.

I want to commend you for holding this hearing on the EITC, program which former President Ronald Reagan called the be antipoverty, profamily, job-creation measure to come out of tl Congress.

Unfortunately, in many ways the EITC has strayed far from its original mission. It was designed as a small supplement to help compensate working families who pay payroll taxes. It has evolved into an alternative to traditional forms of welfare assistance. In addition, as it currently stands, the EITC is prone to serious abuse and fraud and is flawed in its design. We need to rethink its construction.

Mr. Chairman, as you know, I have been active in the welfare reform debate. I think that redesign of the EITC is the logical next step in welfare reform. As we continue to work toward the overhaul of our welfare system and the goal of making people more independent, I believe the EITC can be a very valuable tool in this endeavor.

Our Senate colleagues have proposed to roll back the 1993 EITC expansion in their fiscal year 1997 budget resolution. While I do not agree with the Senate action in their proposal, I do think it may be useful for House members to consider many of the reforms in the Senate proposal in a comprehensive overhaul and repackaging of the program.

I have been working on EITC reform legislation. Since the purpose and configuration of the EITC has changed so dramatically over the years, I am calling my legislation the Minimum Wage for Families Act to more accurately represent what I think is the real objective of the EITC. My proposal would make the EITC more profamily and more promarriage.

Under the ever-expanding EITC, single individuals have been made eligible, and families with children in college receive benefits. We need to focus only on families with children, especially those under the age of 18. Disincentives to marriage have developed, as the size of the credit has increased. The bill would change that by incorporating a one-time $2,000 marriage credit. Lump-sum payments, since they were very small at first, made sense. Now they do not and we need to change that.

My bill would make the EITC practically useful by prorating the EITC over the 12 months of the year. In addition, I would draw from the previous work done by my colleague Nathan Deal to make it easier for the EITC to be payable in advance.

Further, my legislation would link the EITC to other welfare programs. We need to do this. Hard-working families should receive direct cash assistance, instead of food stamps. We accomplish this goal by expanding cash benefits under EITC and including those cash benefits when determining eligibility for other traditional welfare programs. This change would empower working families to make more of life's decisions themselves by replacing traditional welfare programs with a cash payment.

In line with President Clinton's proposal, the bill would deny EITC eligibility to individuals who are living in the United States illegally or who do not have proper documentation for employment purposes.

Mr. Chairman, for too long we have been locked in a sterile thirties debate on the concept of minimum wage. We need to break out of that way of thinking by allowing businesses to hire as many workers as they can, pay market wages and utilize government to take family incomes up to a minimum standard of living. An increase in EITC cash payment would mitigate any need for a minimum wage increase.

Under my proposal, a family with two dependents earning the current minimum wage will make $7 an hour in total compensation. A family with one dependent will take home $6 an hour. By supplementing employer provided wages with direct cash assistance from the Federal Government, we do not arbitrarily raise the cost of labor to business and destroy jobs for the very people we are trying to help leave the welfare rolls.

In addition, this proposal conforms to our recently passed budget resolution. Estimates conducted by CBO, the Joint Tax Committee, and my staff on various specifics of the proposal indicate that the overall savings over 5 years from these reforms would be in the $20 to $30 billion range.

Mr. Chairman, the EITC needs to be returned to its original purpose. I think we have a golden opportunity and we should take this opportunity to implement the necessary reforms, and I look forward and welcome the opportunity to work with you and your colleagues on this Subcommittee to bring about constructive and productive changes in the EITC Program.

I thank you for the opportunity to visit with you today.

Chairman SHAW. Thank you, Mr. Hutchinson. You have certainly been one of the leaders in the House on welfare reform, and I think you quite correctly recognize that the EITC is a very important ingredient to welfare reform.

Thank you very much.

Mr. HUTCHINSON. Thank you. Thank you for your indulgence on allowing me to be excused.

Chairman SHAW. Tom Petri from the State of Wisconsin, welcome.

STATEMENT OF HON. THOMAS E. PETRI, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN

Mr. PETRI. Thank you very much. I appreciate the opportunity to testify here today.

The EITC is a vital adjunct of welfare reform and a far better way to help the working poor than is an increase in the minimum wage. In particular, the EITC is also the best way to help families with the expenses of child care, since it does not discriminate against parents who stay home and forgo income in order to care for their own children.

Many of us now believe there should be no such thing as welfare as we have known it for able-bodied people. It produces dependency and is profoundly demoralizing to those who struggle to support themselves without public assistance. Instead, the basic income for all able-bodied people should come from work—publicly supplied, if necessary. Wages alone are not enough for those with families and only minimum wage skills. They need a credit or voucher to help them buy a health plan and a wage supplement geared to their family size.

The EITC is the best way to supplement wages. It is universal and, therefore, without stigma or demoralizing effects. It can be adjusted for need as determined by both family size and earnings. Unlike a minimum wage increase, the EITC does not remove the first rung of the employment ladder for those with the least skills, and it helps millions earning more than the minimum wage.

The current EITC, however, contains serious flaws which must and can be fixed. First, it includes childless people who do not need it as much as others because they would be well above the poverty line without it, if they worked full time. That feature should be eliminated, saving about $1 billion next year.

Second, in its phase out range for families with incomes between $11,000 and $27,000, the current EITC imposes high marginal tax rates of 21 or 16 percent. When combined with Federal and State income taxes, Social Security taxes, food stamp, and housing subsidy phaseouts, and a possible future Medicaid voucher phaseout, this can create total marginal tax rates exceeding 100 percent, completely removing any incentive to improve earnings. We need to take a coordinated look at the combined incentive effects of all these kinds of programs, eliminating the marginal tax rates in some and reducing them in others, including the EITC.

Third, the current EITC contains grotesque marriage penalties. The extreme case is a couple, each earning $11,000, with four kids. As two single-parent two-child households, they get $6,740 of EITC next year. As one $22,000 income household, they get only $1,060. The EITC marriage penalty for that couple is $5,680, and they also face an income tax marriage penalty of $750 and other penalties in other programs.

Finally, the current EITC provides no extra help to families with the greatest need; that is, those with more than two kids.

Fortunately, we can solve all these problems by modifying the $500 child credit in the Contract With America and coordinating that with the EITC. At the same time, we will get a good compromise with the Senate on the child credit issue. I have three versions of this compromise costing one-quarter, one-half and three-quarters of the cost of the $500 child care credit. I will describe the three-quarters version briefly.

First, increase the child credit to $1,100, and at the same time, eliminate the personal exemption for children under 18. This produces a net tax cut per child next year as follows: In the 15-percent tax bracket, a tax cut of $718; in the 28-percent bracket, $386 per child; in the 31-percent bracket, $310 per child; the 36-percent bracket, $192; and in the 39.6-percent income tax bracket, a reduction in taxes of $90 per child.

Now that is progressive, but very competitive with the flat $500 credit. Lowest bracket taxpayers get much more, the 28-percent bracket almost as much, even in the 31-percent bracket, taxpayers get three-fifths as much.

Next, for the real payoff, integrate the $1,100 credit with the EITC by making it refundable for those with earned income. Since it is a universal credit, it does not need to be phased out. You give that credit to high-income, as well as low-income people, and that was in the contract. Then change the EITC to a credit of $1,000 per parent, phasing out single parents between $9,000 income and $19,000 income, and couples between $16,000 and $36,000 income. That cuts the worst case marriage penalty from $5,680 to $200, cuts the marginal tax rate in the phaseout to 10 percent. Both of these results are enormous improvements.

There are charts that accompany my submitted testimony. Under the illustrations in those charts, all lower income two-parent families get much larger credits than under current law. Single-parent families with incomes under about $20,000 generally do slightly worse than under current law, but only slightly, and that is the price we have to pay for eliminating the marriage penalty. Of course, if they have more than two kids, they do much better.

Let me close by reviewing the advantages of this kind of integrated approach. One, it is less expensive. It provides a good compromise with the Senate. The tax cuts are progressive, but very competitive with the flat $500 credit. The credit itself is more than doubled. The EITC marriage penalty is practically eliminated, marginal tax rates are slashed, and larger families get the help they need.

Finally, we support welfare reforms in which the basic income of the able bodied is wages plus general credits plus a general health plan voucher.

Mr. Chairman, we need the EITC to make welfare reform work. The current version has problems, but let us fix them, not do away with the whole program.

Thank you very much for your attention.

[Attachments to the prepared statement follow:]

KILLING MANY BIRDS WITH ONE STONE:
A CHILD TAX CREDIT COMPROMISE THAT COSTS LESS
BUT FURTHERS WELFARE REFORM OBJECTIVES

PROBLEMS TO BE SOLVED:

1. Need House-Senate tax compromise on child credit;

2. Current earned income tax credit (EITC) -- a vital adjunct to welfare reform because it enables low-skilled people with kids to support themselves by working -- has 3 big flaws:

a. contains high marginal tax rates (21% or 16%) during phaseout -- when combined with other taxes and phaseouts (i.e. food stamps, housing subsidies, and a possible medicaid voucher), removes any incentive to get ahead because total marginal tax rate can top 100%;

b. contains high marriage penalties ($5680 + $750 income tax penalty in extreme case);

c. provides no extra help to larger families with greatest need.

SOLUTION:

1. For kids under 18, eliminate personal exemption ($2550 in '96) and substitute $1100 credit -- provides net tax cut per child by bracket in '96 as follows:

15%	bracket	(about 0 to $40K TAXABLE '96 jt. return income)	-- $718
28%	"	(" 40K " 97K " " " " ")	-- $386
31%	"	(" 97K " 148K " " " " ")	-- $310
36%	"	(" 148K " 265K " " " " ")	-- $182
39.6%	"	(over 265K " " " " ")	-- $ 90

2. Universal $1100 credit is refundable for those with earned income and substitutes for a major portion of the EITC -- no phaseout necessary because everyone gets it. Provide extra EITC to PARENTS -- maximum of $1000 per parent -- phasing out for a single parent between $9000 and $19,000 income at a rate of 10%, and for two parents between $16,000 and $36,000 income at 10%.

3. Provide no other EITC; eliminate current EITC for childless people.

4. Optional (to save money): eliminate dependent care credit, which is unfair to parents who forgo income to take care of their own kids.

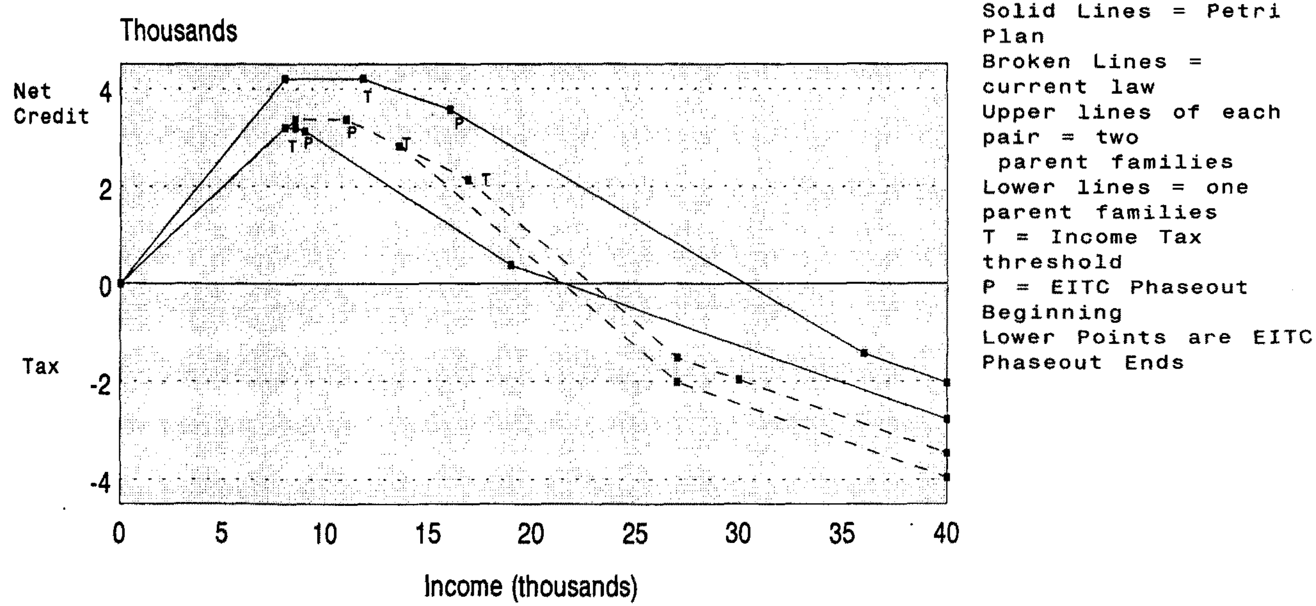
ADVANTAGES:

1. Costs approximately 3/4 as much as flat $500 credit;
2. Tax cut is progressive;
3. Credit itself is doubled;
4. Maximum EITC marriage penalty cut from $5680 to $200;
5. EITC marginal tax (i.e. phaseout) rates cut from 16% & 21% (based on number of kids) to 10%;
6. Provides extra $1100 per child for WORKING poor families with more than two kids;
7. Supports welfare reform in which basic income of able-bodied is wages plus general tax credits plus a general health plan voucher;
7. Eliminates messy overlap between new credit and EITC;
9. Though single parents with 1 or 2 kids get slightly less than current EITC, all two parent families get much more;
10. Hidden effect: cuts unnecessary EITC for students over 18;
11. Probably makes it easier for President Clinton to sign the bill.
12. Shows Republicans can integrate several objectives in one creative solution.

Combined Effects of Income Tax & EITC

Petri Plan vs. Current Law

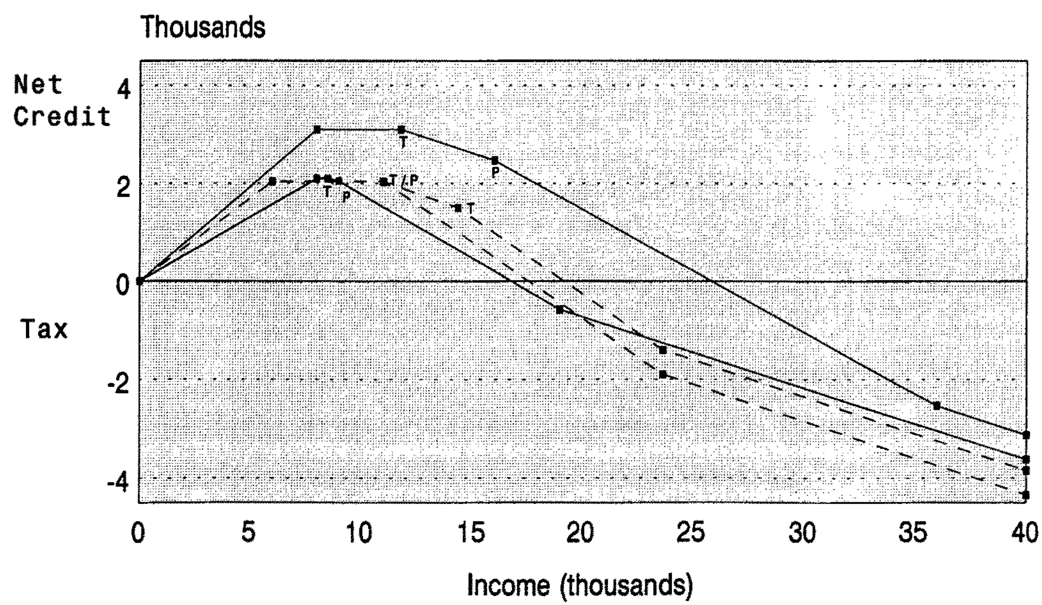
Two Child Families



Combined Effects of Income Tax & EITC

Petri Plan vs. Current Law

One Child Families



Solid Lines = Petri plan
Broken Lines = current law
Upper line of each pair = two parent familes
Lower line = one parent familes
T = income Tax Threshold
P = EITC Phaseout Beginning
Lower Points are EITC Phaseout End

Chairman JOHNSON. Thank you very much, Tom, for your very thoughtful testimony. You have been working on this legislation for about a decade now, and the depth of your knowledge is going to be a great help to us as we look at the problems that have developed.

Are there questions of Mr. Petri by the Members?

Mr. Gibbons.

Mr. GIBBONS. Madam Chairman, I just want to commend our colleague Tom Petri. I thought that was an excellent analytical work-out of the problem we face and I want to tell you I am going to take your testimony and read it very closely. Both you and Mr. Hutchinson I thought were very constructive in your suggestions. I commend you for it.

Mr. PETRI. Thank you. I think the one thing above all that you do as you work in this area is attempt to look at it from the point of view of the individual, rather than from the point of view of the advocates of each of the different programs. Integrate them, because otherwise you would get the law of unintended consequences—we will get it anyway, but it will get a lot worse as we find with things like the marriage penalty, which no one wants, but is the consequence of the current array of programs that we have got.

Mr. GIBBONS. Good thinking.

Mr. RANGEL. Madam Chairlady.

Chairman JOHNSON. Mr. Rangel.

Mr. RANGEL. I do not recall your exact words, but it was something to the effect that a single person could do better if they worked full time. It is an assumption that there is full-time employment and that the worker would prefer to have a lower EITC by having a lower salary. Could you explain that? It is the first objection that you had.

Mr. PETRI. I am having a little trouble hearing the question, but I think you were——

Mr. RANGEL. The current EITC, however, contains serious flaws which must and can be fixed. First, it includes childless people who do not need it because they would be well above the poverty line without it. My question follows, if they worked full time, it would save $1 billion. Why would a person without a child want not to work full time? What makes you assume that they have elected to work part time in order to receive EITC?

Mr. PETRI. I actually amended that testimony as I gave it to say it includes childless people who do not need it as much as others, that is to say, people with children.

Mr. RANGEL. Why would they not need it as much because they have a child?

Mr. PETRI. Because they are above the poverty line, if they are working full time. Obviously, if they are not working full time, they would need it, but presumably sometimes people will elect not——

Mr. RANGEL. Could you run away from that one and say, if they are not working at all, they do not get anything. If they are working part time, should we not assume that people who are poor want to work full time?

Mr. PETRI. If they are not working at all, they should certainly get disability assistance and they should have an opportunity for some sort of employment.

Mr. RANGEL. No, no.

Mr. PETRI. If they choose then not to take that opportunity, I am afraid that there are others who really do not deserve to have——

Mr. RANGEL. There is an assumption in your testimony that people who are working part time without children can and should be working full time. Of course they should be, but I am assuming that there is no full-time employment with someone at these wages. My question is why would you say look for the billion dollars for this——

Mr. PETRI. There is a problem there. we should be working to make sure there are full-time job opportunities or a combination of part-time job opportunities. My part of the country is probably different than yours, but the establishments are no longer advertising sales they are advertising help wanted.

Mr. RANGEL. If they have full-time employment opportunities and they elect part time, I agree with you.

Mr. PETRI. Well, if you are a single person, you can put together a number of part-time jobs to get the same income that you can from one full time.

Mr. RANGEL. It is really not that easy. It is a problem.

Thank you.

Chairman JOHNSON. Thank you.

Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Madam Chairman.

First, I would just like for the record to say what I would have said if Congressman Hutchinson was still here. He said that he thought the EITC logically was the next step in welfare reform. I would just like to put on the record that President Clinton thought of it as the first step in welfare reform, because the EITC does keep people off welfare.

I would like to ask Congressman Petri a question. Your phase-out for couples ranges up to $36,000. Of course, that is higher than current law. What I am worried about, does that take away from a single head of household who would have a lower income? Where do you get that additional money so that it goes up to $36,000?

Mr. PETRI. I will refer to my expert on it.

Mrs. KENNELLY. I have got one of those, too.

Mr. PETRI. Would you want to come up and address that?

Mr. FLADER. That does cost more money to extend the phase out, but it is the price of reducing the phase out rate to 10 percent, and the additional cost is in the order of $1 or $2 billion.

Mrs. KENNELLY. My worry is where do you get it? Would it affect single heads of households with lower incomes?

Mr. FLADER. You can say that it is coming from any place you want to. The overall proposal costs about three-quarters of the $500-per-child tax credit, and the savings come partly from the overlap between the $500 tax credit and the current EITC. It is putting those two things together that gives you the ability to make these changes in the EITC without costing more money than the $500 credit.

Mrs. KENNELLY. Congressman Petri, the reason I bring this up is in a State like mine and maybe a State like yours, we have a disparity. We are a high-income State, but the ones that need and file for the EITC are single heads of households. I would just ask you to look at that as you proceed with your proposal.

Thank you.

Mr. PETRI. Thank you. We would be happy to work with you on that.

Chairman JOHNSON. Are there other questions of Mr. Petri?

Mr. Levin.

Mr. LEVIN. A quick question to my friend Congressman Petri. I think your testimony is really interesting, but the horse is out of the barn, it seems to me. The credit is in the bill that is before the conference Committee, so I do not quite understand how this Committee goes back and does the kind of integration you suggest.

Mr. PETRI. As I understand it, what is before the conference Committee is the budget resolution and there is a wide disparity between the numbers in the House and Senate. However they come out, you can come up with an integrated program in this Committee that will meet easily either one-quarter, two-quarters, or three-quarters of the range you are given in the conference Committee so far as any part of this tax cut is concerned.

I assume once they agree on the budget resolution, they probably will split the difference somewhere between the Senate's $160 billion or whatever it is and ours of $400 or $380 billion or something like that, and then you are going to have to come up with tax change legislation and figure out what you are going to be doing. I guess you did pass a tax bill, but——

Mr. LEVIN. This Committee passed a bill, so you are essentially——

Mr. PETRI. The Senate has not passed it and I am sure there will be plenty of opportunity as you move forward.

Mr. LEVIN [continuing]. You are essentially asking the Committee, once the budget resolution is passed, to reexamine the child credit that already passed here by majority vote.

Mr. PETRI. What I am suggesting is that once the conference is finished on the budget resolution and agreement is reached on what the scope of any tax cut that this Congress would deal with under that resolution this year, that you will then have plenty of opportunity, working with your colleagues in the Senate, to make modifications in the credit.

As you know, I believe there were votes over there to restrict the amount. We have some votes to restrict the coverage. My proposal is to have it phased out in a progressive way and integrated with the EITC. With any change you are going to really make at the end of the day, it seems, to be responsible, you are going to want to take this child credit, the existing personal exemption, the EITC, and other need- and size-based programs that we have got and do the best you can to integrate them, so you do not end up with screwy incentives out there for people. I look at it as an opportunity to work in a bipartisan way to turn this into something that is progressive and that is going to be helpful as we move forward in the welfare reform area.

Mr. LEVIN. Thank you.

Chairman JOHNSON. Thank you very much, Congressman Petri.

Mr. PETRI. Thank you.

Chairman JOHNSON. There are no more questions, and we will invite forward Assistant Secretary Samuels and Hon. Margaret Richardson, Commissioner of the IRS.

I would remind you both that your entire statements will be made a part of the record. If you could keep your comments focused and relatively brief. We have a good attendance at the hearing and questioning will take a long time, and we do have an excellent panel following you. We would appreciate that.

Mr. Samuels.

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

Mr. SAMUELS. Chairman Johnson, Chairman Shaw and Members of the Subcommittees, I am pleased today to discuss the targeting of the EITC, as well as steps that are being taken to improve the EITC. 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 years 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.

In connection with developing the OBRA 1993 changes to the EITC, this administration became aware of serious compliance problems with the EITC and committed itself to do everything in our power to improve compliance. That commitment has been aggressively demonstrated in both legislative proposals and unprecedented administrative actions.

On the legislative side, OBRA 1993 repealed the two supplemental credits that had added a great deal of complexity and were extremely difficult for the IRS to verify. Last year's Uruguay round legislation contained a number of administration proposals, including extending to all children the requirement that they be identified by their Social Security number for EITC purposes. That legislation also denied the EITC to nonresident aliens and required the Defense Department to include on W–2s amounts of nontaxable earned income.

In addition, the IRS has taken bold administrative steps to address compliance issues. Commissioner Richardson will describe the more significant of these actions.

Early indications suggest that the steps we have taken in the last 2 years are working to reduce significant EITC-related errors. Yet, there is more to be done and our commitment to do so remains unwavering.

Several proposals to improve the targeting and administration of the EITC were included in the President's 1996 budget;

First, the proposal to deny the EITC to taxpayers having more than $2,500 of taxable interest and dividends was included in modified form in H.R. 831.

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

A third proposal—and this is a very important proposal —would authorize the IRS 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 to either provide a correct Social Security number or request the IRS to follow the more labor-intensive 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.

Today, we are proposing an additional change that would extend those simplified procedures to reducing EITC claims by self-employed individuals who fail to satisfy their self-employment tax liability. We welcome the opportunity to work with the Subcommittees to address areas of EITC noncompliance, just as we would like to work on addressing error rates in other areas that contribute to the overall tax gap.

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 carefully 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 growth of gross domestic product. As you can see on the chart provided, the growth, after the EITC is fully phased in, will be less than the growth in nominal GDP, gross domestic product.

Some claim that an appropriate response to compliance concerns is substantial across-the-board reductions in the EITC. The Senate budget resolution assumed the EITC would be reduced and tax burdens increased for over 14 million working Americans. Working families with two or more children would be hit the hardest, with an average tax increase of $305 per year. Another proposal introduced in the Senate last week would result in even greater tax increases. We do not believe that raising taxes on millions of low-income working Americans is an appropriate response to the compliance concerns.

The administration's commitment to improving the EITC has been demonstrated through more than a dozen legislative and administrative actions since early 1993. In taking these actions, we have been guided by 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 their eligibility.

The design of the EITC under current law reflects a balance among these four goals. I would like to address briefly 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 the other programs.

The expansion of the EITC in OBRA 1993 was designed to increase the effectiveness of the EITC as a work incentive. The increase in the credit rate will encourage nonworkers to enter the work force and other low-income workers to increase their hours of work. While the overall effect of the OBRA 1993 expansion cannot be measured yet, we believe that the legislation will, on net, increase work effort.

Some workers with larger families will face slightly higher marginal rates as a result of OBRA 1993. However, they are unlikely to change their behavior much in response. These are individuals who are already very attached to 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 phaseout range will likely be far outweighed by the effect of the increase in the credit rate.

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 lift a family of four dependents with a full-time worker earning the minimum wage out of poverty would require a combination of food stamps, enactment of the President's proposal to increase the minimum wage, and the implementation of the expanded EITC.

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 highest at very low earning levels where individuals are often making the critical step from welfare to work.

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 the EITC to families with incomes of up to $28,524 in 1996, the program provides modest relief from the effects of wage stagnation. We believe OBRA 1993 strikes an appropriate balance between encouraging increased work effort and minimizing the distortions resulting from the phase out of the credit.

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. Consequently, we strongly urge that simplification be given weight in evaluating any proposal.

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 in the coming months will not meet these criteria.

Under the Senate budget resolution, the EITC will be eliminated for workers without qualifying children, and the OBRA 1993 increases will be scaled back. We estimate that 14 million working Americans will be adversely affected. EITC recipients with two or more children would lose on average $305 in 1996.

A bill, S. 899, has been introduced in the Senate that would result in even more severe reductions of the EITC for millions of working families. In addition to the Senate budget resolution changes, the bill would repeal indexation of the EITC and further limit eligibility by adding new restrictions on the amount and types of income received by taxpayers.

The combined effect of S. 899, once fully phased in in the year 2000, would be to reduce the EITC for 19 million taxpayers by $602 on average. The board to my right shows the effect on EITC recipients with two or more children of both the Senate budget resolution and S. 899.

Indexation is necessary to ensure that taxpayers do not lose eligibility for the EITC. Eliminating indexing does not address noncompliance problems. Consequently, the administration strongly opposes proposals to eliminate indexation.

S. 899 would also limit eligibility by adding new restrictions on the amounts and types of income received by taxpayers. 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. Also, its complexity will increase error rates.

The bill also restricts eligibility by expanding the definition of income to include nontaxable Social Security benefits, child support payments, nontaxable 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.

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 administration is committed to improving compliance with the EITC. Its significant actions in the last 2 years are clear evidence of this strong commitment. The compliance problems which the administration is addressing should not be used as an excuse to eliminate or reduce the EITC to millions of low-income working Americans who are playing by the rules.

Finally, my written statement contains additional areas of possible improvement we would like to explore with the Subcommittees.

Madam Chair, this concludes my remarks. Thank you.

[The prepared statement and attachments follow:]

STATEMENT OF
LESLIE B. SAMUELS
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEES ON OVERSIGHT AND HUMAN RESOURCES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Chairman Johnson, Chairman Shaw, and Members of the Subcommittees:

I am pleased to have the opportunity to discuss the targeting and labor market effects 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 the EITC was created in 1975, bipartisan support for the tax credit 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 its costs. 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.

While the House budget resolution does not assume reductions in the EITC, we understand that members of the Subcommittees are concerned about the effectiveness of this tax provision. Moreover, the Senate has assumed that the EITC would be reduced in its budget resolutions. We are concerned that many of the proposals that have been discussed in the Senate to change the EITC, though described as compliance measures, would not reduce error rates. Rather, these proposals would simply raise taxes 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. Before considering significant changes to this important tax credit which rewards work, we would urge the Congress to wait, as is assumed in the House budget resolution, 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.

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 was 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 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 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 benefit 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. 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. 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.

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 tax provision provides a cushion to protect moderate-income families from the effects of wage stagnation.

The EITC is designed to target assistance to the very neediest working 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 among families eligible for the EITC. 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 tax credit.

The Ways and Means 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, the tax-writing committees worked with the Bush Administration 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 tax credit 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. 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 making 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.

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. Moreover, other legislative steps, described above, 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). Finally, Congressional action on the Administration's remaining legislative proposals, described below, should further reduce error rates. In combination, implementation of these additional enforcement procedures and legislative actions will make it more difficult for taxpayers to erroneously claim the EITC and further reduce error rates.

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.

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[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).

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 kr ›w 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 the Subcommittees do not meet these criteria.

1. Senate Budget Committee Resolution

The Senate budget resolution assumes that the Senate Finance 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, reducing the EITC rates for families with children, and adopting the Administration's EITC compliance proposals from the FY 1996 budget. 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. The Senate budget resolution would reduce the EITC for 14 million working families, on average, by about $239.

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 have their taxes raised by these proposals. Of these 14 million, 10 million would be workers 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 2 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 ($8,200 in 1996 for a single individual under age 65), a single taxpayer would have a combined income and social security tax liability of $1,394 (including $240 of income tax liability prior to the receipt of the EITC and including both the employee and employer portions of social security taxes). Under the proposal, this taxpayer's tax liability would increase by $101. On average, low-wage workers who do not reside with qualifying children would incur a tax increase of about $173 in 1996.

2. S. 899

Last week, Senators Roth, Nickles, and Pressler introduced a bill (S. 899) to reduce the EITC. S. 899 adopts many 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, S. 899 would reduce the EITC by $37 billion between FY 1996 and 2000 and $66 billion between FY 1996 and 2002.

Under S. 899, indexation of the EITC would be repealed. As a consequence of the repeal of indexation and the lowering of the credit rates, EITC recipients would be entitled to a maximum tax credit of $3,024 in 1996, a reduction of $536 relative to current law. The maximum tax credit 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 non-compliance at all. Instead, it denies eligibility and reduces the EITC for millions of taxpayers who work hard, pay their taxes, and play 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.

S. 899 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 bill's sponsors argue that at prevailing interest rates, it is inappropriate to provide the EITC to taxpayers with assets which can generate a $1,000 of investment income. 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.

S. 899 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 are very concerned about proposals to expand adjusted gross income to include these items.

S. 899 would effectively impose an additional tax on social security benefits of taxpayers who qualify for the EITC. The EITC would be reduced by up to 20 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 reservations 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 raise taxes on 19 million taxpayers, on average, by $602 in 2000 (measured at 1996 income levels). Taxpayers with two or more children 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 in 2000 (measured at 1996 income levels).

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 to all low-income working people. Consequently, the Administration strongly opposes proposals to eliminate indexation or to add complexity to the EITC eligibility criteria.

3. New Initiatives

The Administration is committed to taking additional steps to improve the administration of the EITC beyond the steps which have been taken or proposed in this year's budget. We would be particularly interested in exploring with Congress legislative proposals to improve the ability of the IRS to verify eligibility for the EITC.

First, we are announcing our intention to send to Congress a new legislative proposal which would provide the IRS with additional authority to prevent the payment of problematic refunds. We will propose that the IRS be authorized to use simplified procedures to reduce the amount of a taxpayer's EITC by the amount of unpaid self-employment taxes shown, either directly or indirectly, as being due with the return. Under this approach, taxpayers would have 60 days in which they could either demonstrate that they did not owe social security taxes on reported income 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 information on earnings and social security tax liabilities in order to obtain the EITC.

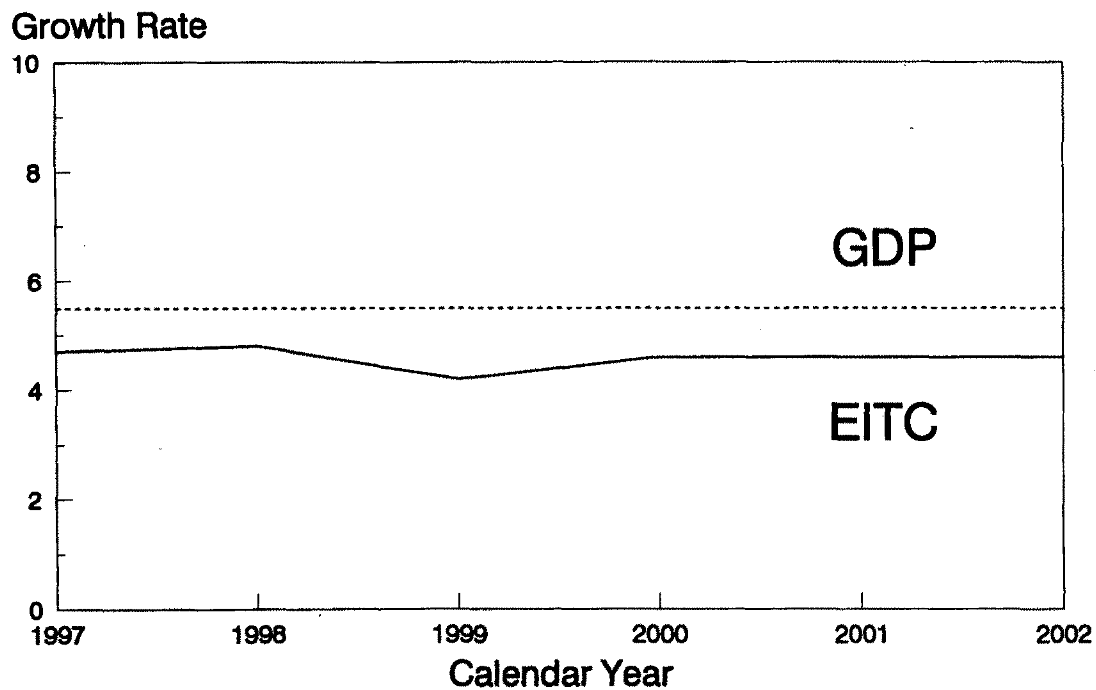
This proposal will ensure that taxpayers pay social security taxes on self-employment income which is also applicable toward their EITC. This proposal would reduce the incentive for taxpayers to over-state income in order to appear eligible for a larger EITC. While there is no conclusive evidence at this time of widespread EITC abuse by self-employed taxpayers, we recognize that the credit structure could lead to such problems in the future. This proposal is designed to deter this potential problem. We will also continue to carefully monitor this issue to determine the scope and nature of any potential or actual abuse.

Second, we are beginning a study to examine the benefits and costs of improving information-sharing between the IRS and States. The study will build on existing IRS efforts to improve information-sharing with State agencies. For example, during the past year, the IRS has been working with the State of California to determine whether wage data from the unemployment compensation system can assist the IRS in validating EITC claims. The new study will examine whether information from State welfare agencies would be useful in determining whether an EITC qualifying child was claimed by the appropriate taxpayer. The study will determine if State data can be made available to the IRS in a timely and consistent manner, and whether changes in disclosure laws are required to facilitate data exchange.

We would also like to explore with the Subcommittees other options for improving the administration of the EITC. For example, reporting requirements for non-taxable earned income, which is used in the calculation of the EITC, could be enhanced.

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 Subcommittees 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

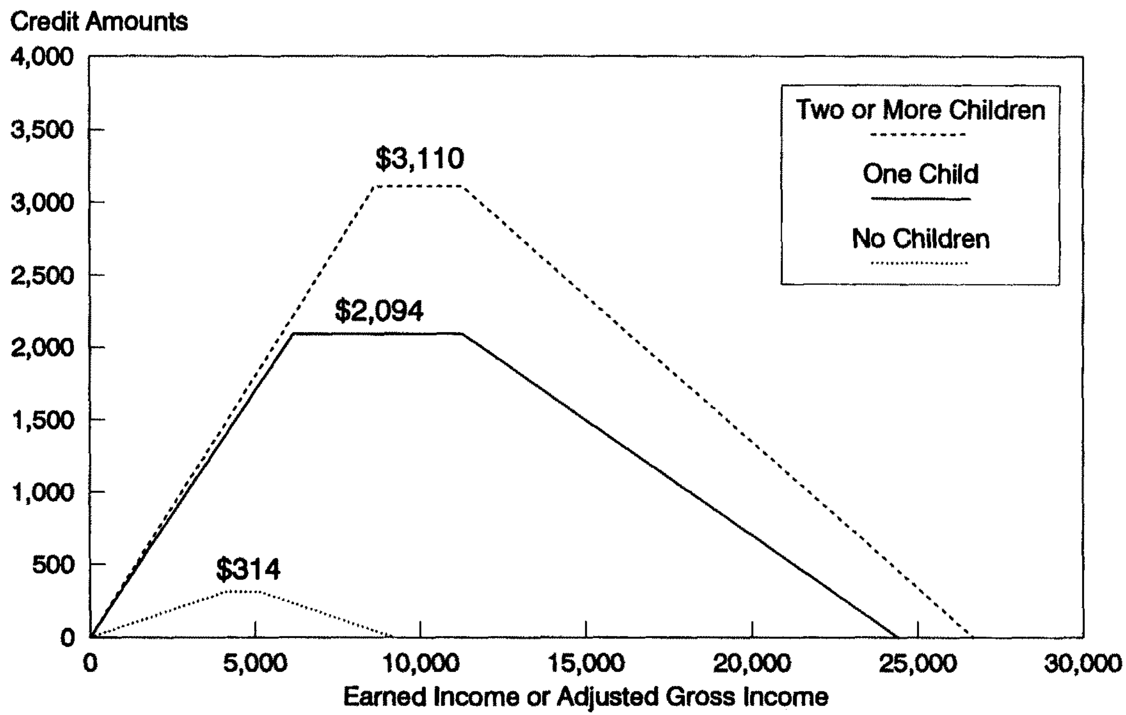


Figure 3: The Earned Income Tax Credit, 1996

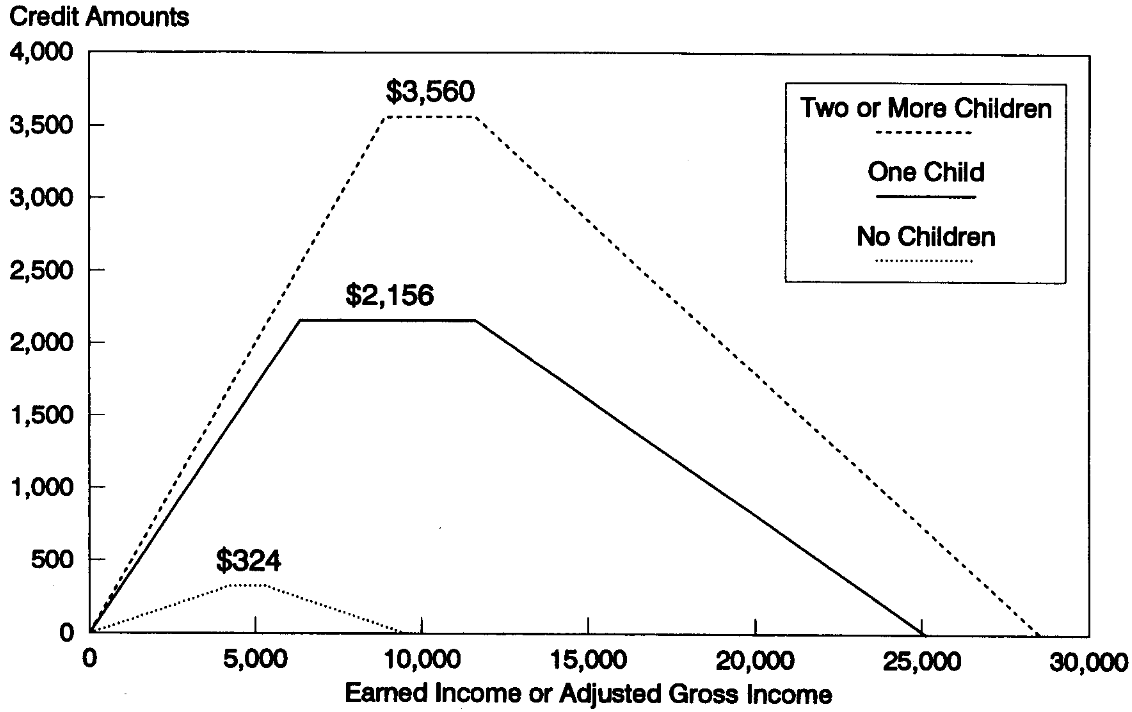


Figure 4: The Earned Income Tax Credit Under OBRA 1990 and OBRA 1993, Fully Phased In

Workers with Two or More Children, 1996 Dollars

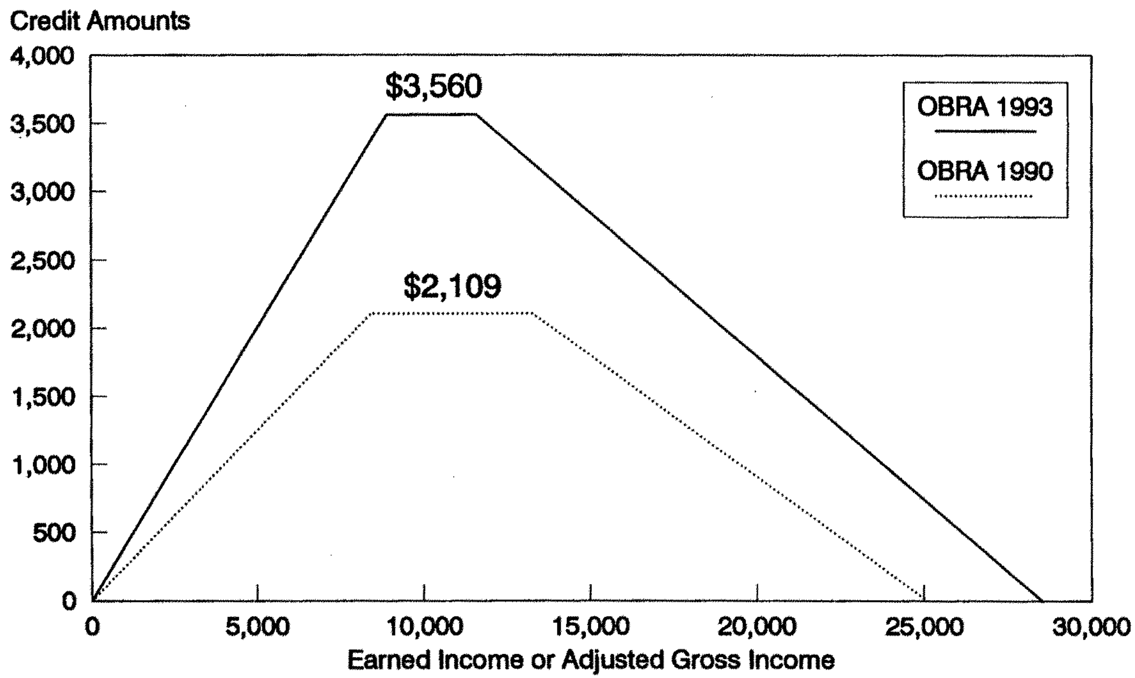
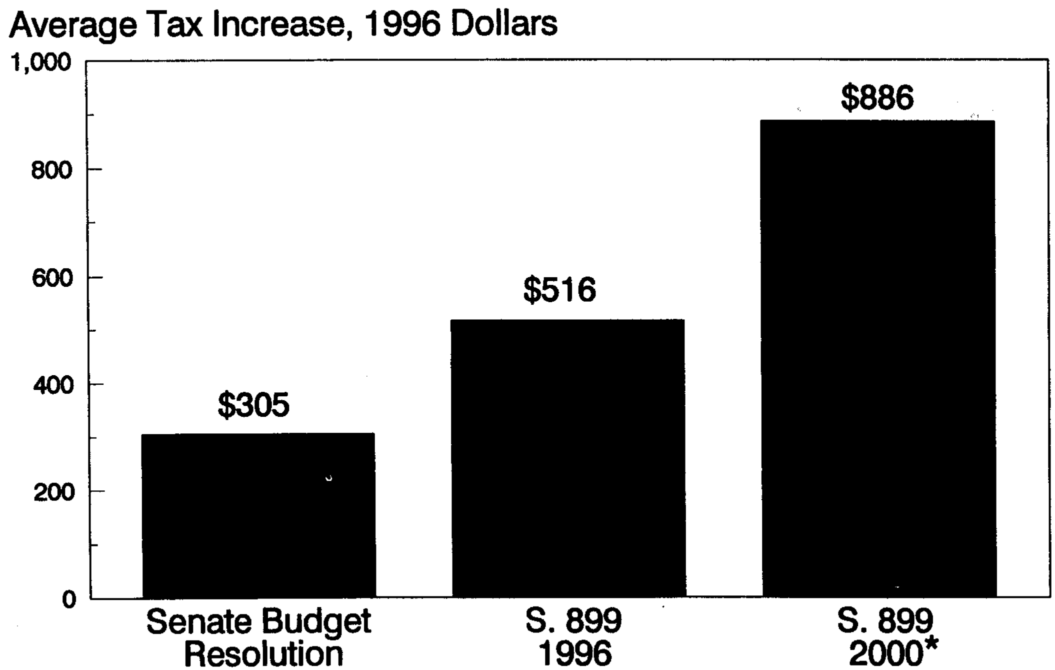


Figure 5: Effect of Senate Proposals on EITC Recipients with Two or More Children



*Estimate reflects effects of deindexation by the year 2000, estimated at 1996 income levels.

Effect of Senate Proposals on EITC Recipients
1996 Income Levels

	Senate Budget Resolution	S. 899	
		1996	2000 *
Total EITC Recipients			
Number of Affected Taxpayers	14 million	19 million	19 million
Average Tax Increase	$239	$311	$602
Taxpayers with Two or More Qualifying Children			
Number of Affected Taxpayers	8 million	8 million	8 million
Average Tax Increase	$305	$516	$886
Taxpayers with One Qualifying Child			
Number of Affected Taxpayers	2 million	7 million	7 million
Average Tax Increase	$137	$166	$563
Taxpayers without Qualifying Child			
Number of Affected Taxpayers	4 Million	4 Million	4 Million
Average Tax Increase	$173	$173	$173

Department of the Treasury
Office of Tax Analysis

June 12, 1995

* Estimate reflects effects of deindexation by the year 2000, estimated at 1996 income levels.

Chairman JOHNSON. Thank you.
Commissioner Richardson.

STATEMENT OF HON. MARGARET MILNER RICHARDSON, COMMISSIONER, INTERNAL REVENUE SERVICE; ACCOMPANIED BY TED BROWN, REFUND FRAUD EXECUTIVE, IRS

Ms. RICHARDSON. Madam Chairman, Mr. Chairman and the distinguished Members of both Subcommittees, I want to thank you for the opportunity to be here today to discuss the IRS' efforts to improve the administration of the EITC.

When I became Commissioner a little over 2 years ago, I recognized the need to improve the administration of the EITC to ensure that it was available only to those working Americans who earned it.

As Assistant Secretary Samuels has stated, legislation that was recently enacted will improve the EITC's effectiveness. The administration has also submitted additional legislative proposals—and another one which was mentioned by Mr. Samuels today—which would aid very much in the administration of the EITC.

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 the 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 to tell you about our future plans.

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 the increased verification of taxpayer SSNs, additional checks of returns claiming refundable credits, including the EITC, and increased compliance resources devoted to preventing and detecting erroneous and fraudulent refund claims before those claims were paid.

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

During the filing season, the IRS devoted substantial resources to ensuring that taxpayers claiming refunds used the proper SSNs. 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 the taxpayer, the taxpayer's spouse and for the dependents that were claimed. As of June 2, 1995, over 10 million missing, invalid or duplicate SSNs have been identified.

To further address noncompliance 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.

A preliminary analysis of the returns that have been filed so far this year does indicate that our efforts are paying off. As of May

26, the number of EITC claims by filers with qualifying children had decreased by 257,000 below 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 had not earned the EITC from claiming it.

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

The reduction in EITC claims and in the number of dependents is particularly significant, considering that the number of individual returns that were filed through May 26 is up over 1 million over this time last year.

In addition to enhancing our systemic filters to detect more questionable refund claims during this filing season, thanks to the additional compliance resource that Congress provided us this year, our 5-year compliance initiative, for the first time in a number of years we were able to substantially increase the enforcement resources dedicated to examining questionable claims, as well as to identifying fraudulent schemes.

Electronically filed returns that had duplicate SSNs 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 to the systemic screens, as of May 26, we had identified over 2,600 fraud schemes and we delayed $65 million that had been claimed on over 46,000 electronic and paper returns.

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

Although the 1995 filing season is almost at an end, we have already begun planning our strategy to prevent all erroneous or fraudulent refund claims, including EITC claims, for next filing season. Information 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 adapt our fraud and error detection systems accordingly. If necessary, we will put in place new technology and additional filters.

The proposed legislation that is now pending would significantly aid our administration of the EITC because it would require EITC claimants to provide valid SSNs for themselves and their qualifying children, and it would permit us to treat an EITC claim the same way we do math errors when a Social Security number is either not provided or the Social Security number provided is not valid.

A similar procedure to the one currently used to correct math errors is appropriate and needed. Although we have the technological capability to identify returns without 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 let their customers withdraw money without providing the necessary information, including an appropriate account number and a PIN, personal identification number. Congress should give us comparable tools.

Madam Chairman, Mr. Chairman, the IRS is committed to stopping EITC noncompliance, while at the same time ensuring that all hard-working Americans who earn the EITC receive it. The assistance of you and the Subcommittees in enacting the legislation that is pending would greatly assist our efforts to achieve these two important goals.

Thank you very much. This concludes my prepared remarks and I will be happy to answer any questions that you or your colleagues have.

[The prepared statement and attachment follow:]

STATEMENT OF MARGARET MILNER RICHARDSON
COMMISSIONER OF INTERNAL REVENUE
BEFORE THE
SUBCOMMITTEES ON OVERSIGHT AND HUMAN RESOURCES
HOUSE COMMITTEE ON WAYS AND MEANS

JUNE 15, 1995

Madame Chairman, Mr. Chairman and Distinguished Members of the Subcommittees:

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 the Subcommittees.

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 June 2, 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 June 2, 1995, over 6.3 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 June 2, 1995, 79.2 million refunds have been issued -- 76 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 420,000 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 June 2, 1995, we had identified 2,685 fraud schemes, delaying $65.9 million claimed on over 46,700 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

Madame Chairman, 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 Subcommittees in enacting the Administration's proposals to aid in the administration of EITC would greatly assist our efforts to achieve these two important goals.

This concludes my prepared remarks. My colleagues and I would be happy to answer any question you or other Subcommittee members may have.

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.

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<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.

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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:

-- 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	$1,480,000,000	$386,000,000
PERCENTAGES	100%	26.1% <2>

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<2> 38.8% of the 1,273,000 returns overclaimed EITC.

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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>

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<3> 6.1% of the 1,273,000 returns underclaimed EITC.

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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 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>

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<4> In 1990, the IRS found that enforcement activities reduced the gross income tax gap between 23 and 26 percent for tax year 1987.

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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.

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.

Chairman SHAW. Thank you, Ms. Richardson.

I would like to commend you and the IRS for many of the savings, and the compliance work that you have done in this area. It is a difficult area, and it is a rapidly growing expenditure of the Federal Government.

I was looking at Mr. Samuels' chart that was up there. Would someone please place that back up on the board? I think it is important to point out that the growth shown on that particular graph under the GDP is somewhat impressive, I would also like to point out that it is from 1997 to 2002, so this is something that has not happened.

I think we need to look at the historical perspective of what has happened. If my figures are correct, I show in 1985 that the program was $2.16 billion, and it has grown, if we use the 1996 project, to $25.86 billion. That is an increase of 1,100 percent. This makes it the fastest growing antipoverty program that we have.

It is interesting, because if you compare it with AFDC, it is far larger than AFDC, which is only about $15 billion, Head Start is $3.5 billion, food stamps is $25 billion, so that we can see that the size of the program itself is just about the size of food stamps now. As a matter of fact, unemployment insurance is only $27 billion, and housing is $21 billion. This really adds up to be one of the huge entitlement programs that we have, and the phenomenal growth of the system I think requires a very close look.

In discussion with the members up here on the panel, it is not our intention at this time to try to gut this program. We consider this a very important part of welfare reform. I do not think that the majority side or the minority side has any intention of gutting the program, but there are some significant adjustments we should make.

In the Republican budget, it was viewed that we could save a little less than $3 billion. In the President's budget, he viewed that we could save about $3 billion. If there is one area that I think we are very close on, I think it is in this particular program that the Republicans and the Democrats agree on.

The Senate came up with a much larger figure, but they made a substantial alteration to the program that we on the House side have not spoken on.

Mrs. Johnson, do you have any questions?

Chairman JOHNSON. Thank you, Mr. Shaw.

Mr. Samuels, there are just a couple of things that I wanted to go through with you. Do you have cost estimates on the three proposals that you have made and on the additional proposal?

Mr. SAMUELS. Madam Chair, the pending proposals that were in the President's budget raise approximately $3 billion over 7 years. We do not yet have a revenue estimate for the proposal that we described this morning.

Chairman JOHNSON. Do you have any demographic information about the EITC rights of single workers? We only discussed this yesterday, but would you for the record get back to the Committee on those receiving the EITC who have no children, what are the age groups, what percentage goes to what age group.

Mr. SAMUELS. Madam Chair, our preliminary information—and we went back after we discussed this yesterday—is that workers without qualifying children residing with them, share approximately the same age demographics as the rest of the EITC population, except workers without qualifying children have to be between 25 and 65. Obviously, there are no taxpayers under 25 who would receive it. As far as we can tell at this point, it is not that different from the rest of the EITC population, and we will be getting you more details on that.

Chairman JOHNSON. Thank you.

I would like to ask you one more question. I still have time to ask Commissioner Richardson a question. Later on, we are going to have some testimony to the effect that a credit reduces work incentives, based on some pretty solid work. Has the Treasury looked at this issue?

Mr. SAMUELS. Yes, we have and our view, as I mentioned in my remarks, is that we believe that, on balance, there will be a net increase in work as a result of the 1993 changes. We have looked at these studies, and a lot of them do not take into account those who were not in the work force moving into work, which is a very important purpose of the program. You have that positive incentive for those who are not in the work force to move into the work force, and for those who are at very low income levels to increase their work, and we think these effects overcome the work disincentive in the phase out period, on balance.

Chairman JOHNSON. Thank you.

Commissioner, I want to commend you on the steps that you have taken this tax filing season to address some of the problems of fraud and abuse in this program. At the beginning of the season when we held a hearing on this issue, the administration testified that they thought there was $5 billion in fraud. It looks from the figures that you have given us today that that may have been an underestimate. I do commend you on your current program.

On the other hand, I want to ask you about an article that appeared in Tax Notes in the June 5 edition, and I quote, "Both the 1985 and 1988, TCMP, Tax Compliance Measurement Program, surveys indicated that nearly 40 percent of taxpayers who took the EITC were not entitled to it."

If you remember the figures that Mr. Shaw just read about how this program's costs have risen, 40 percent has got to be a real concern. "This did not lead to a legislative fix, and no real compliance program was put into place until the 1995 filing season. Analyzing Treasury's figures, the lack of quick action on the EITC problem could have cost $10 billion."

No tax gap reports were ever issued based on the data of the 1985 and 1988 Tax Compliance Measurement Program reports. In fact, the last income tax gap report published by the IRS was from the 1982 tax compliance measurement report. How can Congress effectively meet its responsibilities to take legislative action to address areas of noncompliance, if the IRS does not bring compliance problems to the Congress' attention in a more timely manner?

Ms. RICHARDSON. I am not familiar with the article that you are citing from, but I believe that we have been trying to address this problem and I know we spent a good bit of time last year with this Committee, not just this current filing season, but last season talking about the EITC, what we could do, what we were planning to do.

One of the things that we did was try in a more scientific, if you will, or statistically valid way to analyze where the problems were and what needed to be done. In 1993, some of the problems related to the complexity, as Mr. Samuels testified. Congress did address two of the areas that had led to a lot of the complicating features, and I guess this is the first filing season that we are feeling the impact, positively, I might add, of having simplified the credit for a large number of people. We certainly have been trying to address the problems, both legislatively and with the help of this Committee and the Congress, as well as how through our stepped-up compliance resource efforts.

Mr. SAMUELS. Madam Chair, could I just add one thing?

Chairman JOHNSON. Yes.

Mr. SAMUELS. First, I want to thank you and the members of the Oversight Subcommittee for supporting the Treasury and the IRS and its enforcement efforts. As you know, the IRS began this filing season to match all SSNs and we needed your support to continue with that program, and we are very grateful for it. That is the only way we are going to get this compliance issue under control.

The other thing I would just mention is that when Treasury reported on refund fraud, the estimate was $1 to $5 billion for all refund fraud, not just EITC. We have refund fraud in other areas for which we are very concerned, as well. The estimate was $1 to $5 billion and it was for all refund fraud.

Chairman JOHNSON. I wanted to mention this at this time, because while we certainly have moved forward and the Commissioner has done an excellent job this filing season, they need to be far more aggressive. It is clearly there and the need to better use the information from our TCMPs is very great and we really cannot justify letting information lie for sometimes a decade before we act upon it. As we look at whether to allow another TCMP, which has some disadvantages for the taxpayers, we really have to look at how we get that information more readily, how it gets reported publicly, how we have access to it, as well as you have access to it. Some of those issues have not actually been very well worked out in the past.

Thank you, Mr. Chairman.

Chairman SHAW. Mr. Matsui will inquire.

Mr. MATSUI. Thank you.

I would like to thank both of the cochairs again for their approach on this issue, and certainly for the hearing and the manner in which it is being conducted.

I am going to be very brief. I have just three areas. In terms of the growth of the program, in 1985, of course, the program had started in 1975, and in 1985 that was before the 1986 Tax Reform Act. If I am not mistaken, in the 1986 Tax Reform Act that was sponsored by President Reagan and also Members of the House and Senate, we expanded significantly the EITC. In fact, we added about 6 million more taxpayers that were able to use the EITC. Is that correct, Mr. Samuels or Commissioner Richardson?

Ms. RICHARDSON. It was greatly expanded. I am not sure of the exact number.

Mr. SAMUELS. Mr. Matsui, we think it was probably around 4 million.

Mr. MATSUI. Four million. Since that time, the 1990 bill that increased it and the 1993 bill that increased it, obviously the purpose was to increase it to add more people to the credit, and, second, to increase or decrease the threshold so more of the working poor would qualify.

Let me move to the second area, because there has been a lot of talk about individuals who have no minor children who receive this credit, which was an expansion of the program. We are talking about, believe it or not, for that person a maximum of $314 a year. So, if that is a disincentive to work, I want to meet that individual. But that is what we are talking about, is that not right?

Mr. SAMUELS. One point on that, Mr. Matsui, is that there was a suggestion that a single low-wage worker without qualifying children who was working full time for the entire year at the minimum wage was receiving excess EITC. In fact, that person would receive $40 of EITC, and it would offset $336 of income tax that that person owes. We think that when you look at it in that context, even at that level, that you do not have a problem.

Mr. MATSUI. In other words, at the minimum wage, we are talking about $40?

Mr. SAMUEL. For somebody working the entire year, right.

Mr. MATSUI. Now, if the maximum credit is $314, the study on the Tax Notes that was referred to, the TCMP—and maybe somebody can help me with this—there was a notion that there was up to 40 percent in errors. That was a 1988 study, if I am not mistaken, is that correct?

Mr. SAMUELS. That is correct.

Mr. MATSUI. Since 1988 when actually the expansion occurred in 1986, in 1990 and 1993, and certainly since September 1994 there have been some major changes, as you suggest, plus the 12 additional recommendations that you are making at this particular time, is that correct?

Mr. SAMUELS. That is correct, Mr. Matsui.

Mr. MATSUI. That data is based on old information that does not reflect all of the steps that have been taken?

Mr. SAMUELS. Right.

Mr. MATSUI. One would question the relevance of the TCMP study at this particular time.

Thank you. I have no further questions.

Chairman SHAW. Mr. Zimmer will inquire.

Mr. ZIMMER. Thank you, Mr. Chairman.

Commissioner Richardson, in 1994, the IRS eliminated the DDI, direct deposit indicator, claiming that the refund anticipation loans that have been offered to taxpayers eligible for the EITC are a source of fraud and that the elimination of the DDI, direct deposit indicator, will reduce this fraud.

The Treasury Department's own Tax Refund Tax Force found, and I am quoting, "The issuance of the DDI should neither increase nor decrease the likelihood that the IRS will be the victim of ELF fraud." What specific evidence does the IRS have that indicates that the refund anticipation loans are a source of fraud, and how specifically does the DDI facilitate fraud?

Ms. RICHARDSON. I would like to ask Ted Brown, who is our refund fraud executive, a special agent with the IRS, to address that, because he has spent a significant amount of time on this issue, and particularly on the direct relation between the DDI and fraud.

Mr. SAMUELS. Also, Mr. Zimmer, if I can just mention before Mr. Brown responds, I believe that the quote that you read from the Refund Fraud Task Force assumed that all information and all matching could take place. It was a quote in the context of a situation that does not exist. That was my recollection of it.

Mr. BROWN. Congressman Zimmer, the issue of refund anticipation loans was that they act as an attraction to fraudsters more than a direct link. They are on a track much like banks do not cause bank robberies, but people go there because that is where the money is.

The refund anticipation allows fraud artists or fraudulent claimants to receive the proceeds of their claim within 24 to 48 hours. We can find no equivalent fraud claim situation where the payoff is that fast. It also removes the direct relationship with the IRS with the fraud claimant. It isolates, protects and insulates that claimant from coming through our system. If we identify a fraudulent claim subsequently, the perpetrator has already received the proceeds and in most cases has disappeared.

The primary concern we had with refund anticipation loans is that it increases pressure on the system, makes the system an easy target and the perpetrators get their money quickly and can disappear before our own detection systems could prevent that from happening. That is the direct linkage that we found.

Ms. RICHARDSON. Also, Mr. Zimmer, it reduces any incentive for the lending agency to assess the creditworthiness of the borrower and we do not feel the government should be guaranteeing that a loan was going to be repaid. We think that is the job of the lender.

Mr. ZIMMER. Let me just repeat my question. I said what specific evidence does the IRS have that the refund anticipation loans are a source of fraud? Do you have evidence of this?

Mr. BROWN. We know that there are fraud schemes that we have identified that the use of the refund anticipation loan made attractive. You could create false documentation, create a false return, take it to an electronic return originator and submit that claim. They were not set up to detect fraud, they transmit the return to us and they make a loan for the proceeds, net their own fees and charges. The perpetrator within 24 to 48 hours gets the proceeds and disappears.

In many cases, even when we are successful in detecting the fraudulent return days later, that person is much more difficult to track down at that point and successfully prosecute because of that insulation. Yes, we have examples where that was the attraction, that is what made that fraud more attractive than filing a return directly with the service.

The other concept in fraud control is called exposure period. If you can attempt to file a false claim and get paid in 24 hours or 48 hours, that is much more attractive than if you have to wait 6 or 8 weeks for a refund check to come to an address, and be present to receive your proceeds. That increases the risk. The obvious analogy is for bank robbery. The longer you stay in the lobby, the greater your chances of apprehension, and that is exposure period in its most simple form.

Mr. ZIMMER. Is not the risk to the lender, rather than to the fraudulent taxpayer or the IRS?

Mr. BROWN. Only if we detect the fraud before we made the payment, which usually occurs on an electronic return in 8 to 10 days.

Mr. ZIMMER. This is an electronic return issue more than a refund anticipation loan issue?

Mr. BROWN. The banking industry made refund anticipation loans on electronic returns where we gave the direct deposit indicator acknowledgement saying that, yes, our preliminary screens indicate that there was no offset, no debtor offset and we were willing to pay the refund at that point.

Mr ZIMMER. Now, could you explain to me—and you and Commissioner Richardson have alluded to this—how specifically does the direct deposit indicator facilitate fraud? You said something about guarantee of payment. That is not what it is.

Mr. BROWN. No, it is simply an electronic indication that, after we have received their return, it has passed the initial screens; that is, SSNs appear to be valid, there are no math errors on the return and, more importantly, that there are no debt offsets. Debt offsets mean either that this taxpayer does not owe a prior tax liability which is still open or that there is a debt that we are collecting for some other State or Federal agency, child care support being one of the large groups.

When we give that flag within 24 hours, it says at least at this point it looks like we will honor your request for a direct deposit repayment, and at that point the banks release the payment to the person who has made the claim. Then in our normal processing over the next 8 to 10 days, if we do not identify the fraud, we then make the payment to the bank. In most cases they receive their payment before we are able to identify the problem.

Ms. RICHARDSON. It was virtually certain that a refund would be paid if a direct deposit indicator was given or there was no indication, that there was a debt offset, so the bank would make the loan and then receive the refund on behalf of the taxpayer, if you will, and a guarantee repayment of the loan.

Mr. ZIMMER. I do not understand why that is the fault of the DDI.

My time is up. Thank you.

Chairman SHAW. Mr. McCrery is now recognized for 5 minutes.

Mr. MCCRERY. Thank you, Mr. Chairman. I thank you and Mrs. Johnson for holding this hearing.

I think it is clear that there is bipartisan support for this program. It happens to be my favorite assistance program, because it does reward people who work. I see it more as a means, though, to supplement wages and produce a living wage, so to speak, for low-income people in this country and a much more efficient way to do that than raising the minimum wage. I am very interested in continuing this program and seeing that it accomplishes its purpose.

The one danger to this program, though, is fraud and abuse. I want to compliment the IRS and Treasury for the efforts that you have made so far in trying to prevent fraud and abuse in this program. I think there is more work to be done, and occasionally this Committee may be called upon to provide you with more tools to use to accomplish that. We want certainly to work with you, I do, at least, want to work with you to provide you those tools.

I have had the opportunity to meet with the Commissioner and go into these matters in great detail and I am satisfied that the IRS under Commissioner Richardson is trying to make this program work, and I encourage you to continue those efforts and to work with us on this Committee.

Ms. RICHARDSON. Thank you.

Mr. MCCRERY. I do have some concerns about the way the program is structured now. I do want these two Committees to look at benefits for single persons, as opposed to persons with families with children, and I think perhaps there are some changes that can be made to make the program more effective in those respects.

Mr. Samuels, did you happen to be listening to Representative Petri's presentation?

Mr. SAMUELS. Yes, sir.

Mr. MCCRERY. If so, did you have any thoughts on that? It seemed a rather interesting proposal to me.

Mr. SAMUELS. Mr. McCrery, my very preliminary reaction—and I think it was raised in a question—was that the proposal would shift EITC away from single parents with children to married couples with children, and it seemed to us that that was not a good policy. That was my very preliminary reaction and we will clearly look at this very carefully and give you our views on it. That is what we thought the result would be, just hearing it for the first time and looking at the schedule.

Mr. MCCRERY. That is an interesting comment. I wish you would look at that and give us your comments in more detail, because it does concern me that there is a significant marriage penalty in the EITC the way it is done now, and we may want to address that without unduly taking away from single parents, because certainly they have as hard or a harder time making ends meet than a married couple. It is of some concern and I thought Representative Petri had an imaginative proposal that deserves some attention.

Thank you for your efforts, and we look forward to continuing to work with you to make this program work.

Chairman SHAW. Mr. Gibbons.

Mr. GIBBONS. I think we are caught in the Topsy syndrome here, by that I mean we have got a program that has grown like Topsy, and it has some problem with it and we need to straighten it out.

I am glad, though, to hear that it is still so widely respected by both Democrats and Republicans as far as being a viable, good type of program, and we certainly need to correct it.

The GAO recently did an audit and filed a report on compliance, and I just ask this question in order to put this compliance order in perspective with overall taxpayer compliance. As I recall, and correct me if I am wrong, they said that 64 percent of all of the returns of self-employed were erroneous. Is my recollection correct? Is that the correct figure, 64 percent of all self-employed returns were erroneous in the GAO report? I think that is right, is it not?

Mr. SAMUELS. Mr. Gibbons, the GAO published a report last week entitled "Reducing the Tax Gap," and they indicated that self-employed tax return filers did have a compliance problem and that the IRS estimates that income reporting compliance for self-employed taxpayers to be about 41 percent.

Mr. GIBBONS. I think that waves a red flag at this Committee. We had better pay some attention to that. I spent most of my life being a self-employed person and filing a self-employed return and I realized how difficult it was. I have a lot of self-employed friends, and I am sorry that the noncompliance rate is that high.

These are generally honest, hard-working people with a good education, and if they have that kind of compliance rate, it sure sends a warning to me that there is something wrong in the system out there, it is not the fault of Mrs. Richardson or Mr. Samuels, but I guess all the fault comes back here to the Congress and we had better pay some attention to it.

As I recall—somebody is going to get sick of me recalling all these things—I was a conferee when we created this program back in 1975, and it happened about 4 o'clock in the morning here in this room. We were all exhausted and the Chairman of the Senate conferees, Mr. Long, brought up his earned income credit. He had put it in the Senate bill over there and we all sort of agreed that it was a pretty good idea, and we looked at the staff and said we hope you all can carry it out, and they said we can and that is how this thing got into law.

I did the first Oversight hearing on this, Mrs. Johnson, back when you were a young lady—a real young lady. Boy, I walked into that one, didn't I? [Laughter.]

Anyway, it was not a big problem then. The program was only a few years old and we were just looking at it in the Oversight Subcommittee and it really was not that bad, but it seems like the compliance problems have gotten greater. I have just been looking over these worksheet forms that we have got here. I do not want to blame you for them, Ms. Richardson, or even Mr. Samuels, but I guess I have to blame the Congress.

You have got to be an accounting graduate to understand this worksheet form that we have here. You have to be a very patient and meticulous person to work that thing out. I think we probably need to go back and rethink some of the things we have done in this program. For instance, we really need to simplify what is income. I think we need to do that. Would you like to comment on maybe simplifying what is income in all of this?

Mr. SAMUELS. Mr. Gibbons, I would be pleased to address that. Before I do, could I just mention that you referred at the beginning to the program growing like Topsy, and some people have said it is a program out of control. The program has grown as Congress said it was supposed to grow. The reason I say that is that when some people say it is out of control, they mean that it is growing in a way that nobody anticipated. We have the chart there to dispute these charges.

The EITC has grown in steps pursuant to the 1986, 1990, and the 1993 expansions. That is as Congress decided. It is not a program where costs were suddenly way beyond what anyone thought when Congress passed it. Once the EITC is fully phased in, in 1997, we expect growth to stabilize. We think the program is on track in accordance with what Congress has required.

Mr. GIBBONS. I guess my criticism is more directed to Congress than it is to you because we are the ones that created this Topsy. It is really not as bad as some of the other programs we have created.

Mr. SAMUELS. With respect to simplifying the definition of income, the credit is now based on one's earned income and then is phased out based on the greater of earned income or adjusted gross income. If one was going to look at whether adjusted gross income was the right measurement one issue is that for example, self-employed taxpayers' adjusted gross income reflects deductions for health insurance and some of their SECA taxes. If you move away from adjusted gross income, there will be some distortions between the wage earner who is employed and the self-employed.

We would be pleased to consider whether there are ways of trying to simplify it, but that would be an issue that we think we would have to look at very carefully.

Mr. GIBBONS. Well, the red light is on and I will not transgress on everybody's time but I have got a lot of questions about this program and I would suggest that all of us read the instructions that go along with this form and see if there is not some way we can improve it, not just you but all Members of this Committee.

Thank you.

Chairman SHAW. Thank you, Mr. Gibbons.

The Chair will now recognize Mr. Camp for 5 minutes.

Mr. CAMP. Thank you, Mr. Chairman.

Commissioner Richardson, I have a question I would like to ask you. I commend your efforts in the area of fraud and wish that you would continue to pursue it so that the viability and broad support this program has is not eroded.

Right now, recipients can get advanced EITC, up to 60 percent of the benefit. And the Governor of Michigan has a proposal that would let people receive advanced EITC through State agencies so that people on welfare would file at the State level the same form they now file at the Federal level to get this advanced EITC.

The amount would be obviously calculated based on their earnings as it is now. It would allow them to get this monthly payment in a separate check. The benefits of this proposal, I think, would give an increased incentive to people who are working and on welfare to receive this money as they are working rather than in a lump sum at the end of the year and help with the whole concept of work paying. I think this might increase the number of people who are on welfare to take advantage of the EITC.

I would like to receive your comment on this. Mr. Samuels, if you have any comment, I would be happy to hear that also.

Ms. RICHARDSON. Mr. Camp, I am a very strong supporter of the advanced EITC. I think it makes good sense in a lot of ways. We have labored mightily, if you will, to try to promote it and expand it over the last couple of years. One of the disappointments—and we have been successful—but one of the disappointments I have is that we have expanded from 52,000 or almost 53,000 taxpayers claiming it last year to only 189,000 this year, in the same time period.

It is a significant percentage increase but it is not a lot of the claimants. From the standpoint of our efforts to reduce fraud we think it is an important feature. When I was out in Minnesota a few weeks ago talking with my counterpart in the State of Minnesota, I learned they are very anxious to do something similar to what the State of Michigan would like to do.

I know we are very supportive, as is the Treasury. Mr. Samuels can address it, helping both Michigan and Minnesota work on these plans. We think it can help our compliance and help the people who have really earned the EITC.

We are supportive of the advanced notion and we will do anything we can to help the States make it work in concert with their benefit packages.

Mr. CAMP. I appreciate that.

Mr. SAMUELS. Mr. Camp, last year the administration proposed that there be a pilot program involving four States, and Michigan could be one of those pilots if the proposal was enacted. We support these pilot programs. We think they are very important. It will give us information about how the program is working, and how we can make it work better. In my written testimony, we state that we support the legislative amendments that are needed to permit these pilot projects to take place. In trying to make my remarks as brief as possible, I failed to mention our support for these pilots, but I want to state, for the record, that we strongly support those pilot programs. We think we should try to do that as quickly as possible so that we can see how the States can assist hard-working, low-income taxpayers in receiving the EITC on a monthly or periodic basis throughout the year. We think that is a very good proposal.

Mr. CAMP. Is the advanced EITC available to all those who qualify or only those who have children?

Ms. RICHARDSON. Only those who have children.

Mr. CAMP. All right, thank you very much. Thank you, Mr. Chairman.

Chairman SHAW. Thank you, Mr. Camp.

The Chair will now recognize Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

Earlier this year I was extremely critical of this so-called Contract With America because, in my opinion, it was penalizing people who were poor and dependent on government. I said they had to go to work and, yet, it did not seem to say where those jobs were to come from.

This time, I would like to compliment the Chairs of both the Oversight Subcommittee as well as the Human Resource Subcommittee because they emphasize what most of us have been saying, that most people want to work.

I think that this program removes the temptation of trying to evaluate how much you get from welfare and how much you get from working. This is a unique type of program that encourages people to get into the work force and stay. It gives them an opportunity to look for better jobs once they get on their feet.

I do not see where it is exploding because it levels off in 1997. It does what we want. I do not even know how we could measure the cost, Chairpersons, because in a large number of cases it has completely eliminated the need for AFDC and other supportive programs.

I want to thank both of you and your Subcommittees for working with the administration toward the common goal to eliminate the errors and frauds that have been committed in the past and even more so to continue to work because still a lot of errors exist in this program.

I might even suggest, if the rules permit, that maybe we could have a work force, Republicans and Democrats just to get in a room with the administration and talk this thing out to see how we can perfect it without a lot of hearings and when we come to hearings just do what has to be done.

I do hope that in this newly created atmosphere of bipartisanship, which the President and the Speaker has started and I do not fully understand, that we could, keep people who want to work, working. I think, overall, it is good for our Nation and certainly good for our economy.

I want to thank the administration for admitting that there have been a lot of errors and requesting legislation in order to keep them down and corrected. Whatever contribution I can make I want to be a part of it.

Thank you.

Chairman SHAW. Thank you, Mr. Rangel, for that most historic statement. [Laughter.]

The Chair now recognizes Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Samuels, in your testimony you mentioned the fact that the President is addressing some of the problems with the EITC in his budget. Which one of those budgets? Was that the one early on that failed by 100 percent in the Senate or the one introduced this week?

Mr. SAMUELS. Mr. Collins, it was in the original budget submission and it was in the one that was made public this week.

Mr. COLLINS. It was in the one that was made public?

Mr. SAMUELS. Both of them.

Mr. COLLINS. It was in both, well, that is good. Consistency is unusual, that is great. It has been said that the EITC is a reward for work. But I have a lot of problems with that. I think reward for work should be based on productivity and the pay should come from the employer.

However, I see the EITC as being not so much coming from the employer as it is coming from fellow employees. I base that on the fact that if you have two people working side by side on an assembly line or some job, and they are earning equal amounts of money, say, $8 an hour, and the one worker has a wife and one child and the other worker has a wife and two children. There is quite a difference in the two as far as the net tax liability.

In fact, the couple with the one child or the worker with the one child will actually pay $368 more in tax liability and receive $319 less in EITC for a total difference there of about $687 liability to the government.

Therefore, it appears that you are taking from the one worker with one child and supplanting the worker with two children with part of the income.

I have a problem with that. I think the reward for work, again, should come from productivity and then in pay from the employer.

With the EITC it appears that a lot of it comes from fellow employees.

Two, the purpose of the EITC was to rebate or to offset the Social Security or the FICA taxes. However, when that same worker reaches the age of 62 or 65, depending on the age, they are still eligible for the Social Security. Again, they will be subsidized by other employees.

I think we have some real problems in this system and I hope the administration does come forth with some proposals that will help clarify this problem.

I thank you for being here, and you, too, Ms. Richardson, thank you.

Ms. RICHARDSON. Thank you.

Chairman SHAW. Thank you, Mr. Collins.

Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

I wanted to make one point that I would like Ms. Richardson and Mr. Samuels to be aware. When we wrote the portion on child support in the welfare bill that passed the House of Representatives we believed that one major thing that could become a Federal responsibility was our assistance to States who were seeking deadbeat parents and seeking the funds that they owed to these children, believing those funds, which as I recall totaled $34 billion owed to children, would be a good way to get these kids off the welfare cycle.

In doing that we decided to establish a national registry and that would be an access resource that could be accessed by the units that exist in all the States.

I wanted to bring this to your attention because my question is, as long as we have employers who are submitting W–4s to the national registry and States have access, do you see this, Ms. Richardson for example, as a potential source of information as you are checking on EITC incomes, since that tells exactly and specifically what these folks are making in their jobs?

Ms. RICHARDSON. I am not intimately familiar with the details of your proposal, but, yes, I think that could be very helpful. One of the things that I think we have to be very aware of as we are asking the IRS to do these kinds of things is that we are dealing with very antiquated technology right now. Our ability to verify information and do it in a timely fashion is very much dependent on our being able to continue to receive the funding and support for our tax systems modernization.

We will not have the capacity to do some of the things that people would like us to do in the compliance area and in the area you have mentioned without having a modern information system.

Mr. SAMUELS. Ms. Dunn, I think that it would be an issue that we would like to look at. At the end of my testimony, we mention areas we want to explore, and one of them is sharing data with the States. This registry would be the type of thing that we would want to carefully look at. I appreciate your bringing it to our attention, and we will look at it very carefully.

Ms. DUNN. Thank you and I am glad that you have that attitude because I, too, want to get rid of overlap but, on the other hand, we want to provide any resource that would be helpful and useful in finding information. This, as I understand, has also survived in the Senate welfare bill which has not been voted on but in conference, I suspect that we will be able to have that source as a resource.

Thanks.

Mr. PORTMAN [presiding]. I have one final question as the interim chairman here, as everyone else has gone to vote. I told Chairman Shaw that I could run very fast over to the vote if he would let me ask a question.

First of all, I want to thank both of you for being here and for the very interesting testimony. Mr. Brown, I think we had the opportunity to meet in Cincinnati a few months ago and I learned quite a bit about the efforts that you have undertaken in northern Kentucky and back here in Washington in terms of fraud. I tend to believe, in the context of Mr. Zimmer's questions, that we are making a lot of progress in that area. I think you are doing the right things and we still want to see some results.

Commissioner Richardson, I think you all ought to be commended for handling the fraud problems that have arisen.

Ms. RICHARDSON. Thank you.

Mr. PORTMAN. My question really goes to the income issue. We talked earlier about dividend and interest income and I am very much in agreement with the administration proposal on that. I think others have raised that issue before, the notion that unearned income ought to be part of the calculation.

How about other forms of income? I can give you a quick list here. I think you are probably familiar with this issue, but Social Security income, Railroad Retirement benefits, pension annuity income, veterans benefits, workers' compensation, unemployment compensation, alimony payments? Should not those items also be included in that they represent replacements for earned income?

Mr. SAMUELS. Mr. Portman, I believe that some of those items, like alimony, are included in adjusted gross income. So, in effect, it is counted.

I think there are two separate issues. One issue is that we have a new provision that is a modified form of the administration's proposal. If a taxpayer has more than $2,350 of interest, dividends, and net rents and royalties, then that person is not entitled to the EITC.

There has been some suggestions that maybe one might want to expand the items of income includable under the investment income cap. For example, in a bill that has been introduced in the Senate, distributions from trusts and estates would be added to that amount. When thinking about ways to make the credit better targeted, I would urge the Committee to think about whether you are going to increase complexity which increases error rates and whether the IRS verify these new rules.

For example, on trusts and estates, we have calculated that there are about 10,000 to 20,009 EITC recipients who have income from trusts and estates.

If you wanted to deny the EITC to those taxpayers, you will be, in effect, increasing the burden of all 21 million people who are claiming the EITC in figuring out how to calculate the credit.

Mr. PORTMAN. I can appreciate that and if it is a very small number then that goes to Mr. Gibbons' point. I would just think on Social Security though, we would have a number of recipients and that might be one we could include.

Mr. SAMUELS. Right. I think Social Security is another one where I think when you look at the details, you will have concerns. Under the proposal, EITC recipients who would now be receiving non-taxable Social Security benefits, would be required to add them back into income. This would affect some recipients who are receiving EITC because they have qualifying grandchildren living with them.

The question is whether you want to treat that Social Security recipient somewhat differently by taxing their benefits because one or both of the grandparents is working and caring for their grandchild, but not taxing the benefits of the neighbor next door who is not caring for a grandchild.

The other situation may be a married couple, where one spouse is working and the other is receiving disability from Social Security because an accident or some kind of illness. With Social Security, you have to just decide whether these are the types of situations where you would like to cut back on the EITC. I think it is something we would be pleased to discuss with the Committee, but those are the considerations.

Mr. PORTMAN. Madam Commissioner, if you would be so kind as to put any answer in writing because I have to make the sprint across the avenue?

Ms. RICHARDSON. OK.

Mr. PORTMAN. If you will be willing to stay for additional questions, I think on the other side of the aisle we have some questions.

Ms. RICHARDSON. I just have two simple pleas on that point, something that is easily verifiable and something that is simple. That really makes our job much easier. Thank you, very much.

Mr. PORTMAN. Thank you all and we will recess for 4 or 5 minutes.

Thank you.

[Recess.]

Chairman JOHNSON [presiding]. We will resume the hearing. In view of the other panelists that we have ahead of us, we can begin the hearing. Before I recognize my colleague from Michigan, I would like to ask the panelists each for some information.

Mr. Samuels, would you please get back to us—I want to make this as a formal request on behalf of the Committee—with an analysis of Mr. Petri's proposal? As I listened to his testimony I shared your concern but I believe that later on in his testimony, he did answer that issue of the possible shift away from support for singles.

Knowing him, as I do, and knowing the depth of work he has done on this issue over about the last 12 or 15 years, I think it is important that this Committee take seriously his testimony. He is the only Member who has ever gone into this in great detail and he knows a lot about it and he is extremely smart and I think we all need to look at his proposal. If there is some way we can alleviate the marriage penalty we certainly have an obligation to do so.

I would look forward to hearing from you on that.

Mr. SAMUELS. We will be pleased to do that.

Chairman JOHNSON. And Commissioner Richardson, this goes to Mr. Gibbons' comments earlier and his frustration with the amount we do and do not know about the effectiveness of our Tax Code.

The last time this Committee received any tax cap reports was in 1982. I would like to formally ask you and the IRS to provide us with tax gap reports from the 1988 TCMP and those would include the employment tax gap reports, the individual income tax gap report, and the corporate income tax gap report.

[The aforementioned report is being held in the Committee files.]

Thank you.

I will now recognize Mr. Levin.

Mr. LEVIN. Thank you, very much, Mrs. Johnson.

Like my other colleagues, I very much welcome the spirit within which this hearing is being held. Let me just mention to you—our numbers have dwindled here—but I think the issue remains very important.

My concern is what is going to happen in the budget conference? Because there is a major gap between where the House is and where the Senate is on the EITC.

Chairman JOHNSON. Well, I think the budget conference will come up with its proposal, but each Committee will have its target and how we achieve those targets is going to be up to us.

Line item in the budget resolution does not actually govern appropriations decisions nor do they actually govern tax decisions. Our job is to assure a workable fraud-free EITC and make any other reforms we think are appropriate. I do not consider our work governed, at this point, by the budget conference.

Mr. LEVIN. I am glad to hear you say that though, at some point, the budget resolution can carry instructions that would be so stringent a budget target for this Committee that it might tend to move us in a direction that is different from the spirit here.

Look, I think the fraud and abuse problems have to be grappled with and to the credit of this administration it is doing that.

Let me just ask, so that we all are clear on this, the Senate number would have what implications, Mr. Samuels, beyond fraud and abuse? I take it that there you cannot get $20 billion from doing what we need to do on fraud and abuse, is that right?

Mr. SAMUELS. That is correct, Mr. Levin. The Senate budget resolution assumes enactment of the administration's compliance proposal. That is the proposal to deny the EITC to undocumented workers and to allow the IRS to use the simplified procedures for dealing with taxpayers who do not provide correct Social Security numbers.

That proposal is their only compliance initiative. The balance is a cutback in the program. As the board up there shows, an EITC taxpayer with two or more children, on average, would have a tax increase of $305 in 1996, and that number does not include the compliance amount. That is everything other than the compliance amount. Obviously for low-income workers who are receiving the EITC that is a significant amount.

Mr. LEVIN. Right. I just raised this because I really think that this discussion here, and it has been a useful one, will hopefully have some impact on the conference committee. Otherwise, those who have spoken here in support of EITC could be put into a position where it would be very difficult to carry out, the gist of this hearing.

Chairman JOHNSON. I think as the Congress looks at every appropriated program, we will also look at every tax expenditure program and look at what is in the public's interest as we seek to establish a spending pattern that will lead to balance by the year 2002. I cannot guarantee to anyone here, that as we look at the relative value of every program that we will not look at the relative value of the EITC Program. But, I consider that a different issue than making the law state of the art and the best law that we can make it.

I also think it is very clear from this hearing and from the history of this program that there is very deep bipartisan support for this particular program.

Mr. LEVIN. We are all together on effectively weeding out the fraud and the abuse. If I had time I wanted to ask our two distinguished witnesses to comment on the incentive. Later there will be testimony on whether or not the EITC is an incentive or a disincentive.

Do you want to comment briefly on that?

Mr. SAMUELS. Yes, Mr. Levin, we believe that the EITC is, on balance, a net incentive.

Mr. LEVIN. But the argument in some of the testimony is that especially in the higher income, in the ranges as you move up of those covered by the EITC it becomes a disincentive.

Mr. SAMUELS. Families in the phaseout range tend to be people who are much more attached to the work force. We would not expect them to respond by cutting back on their work, except, in the situation where both spouses are working, and one might decide to reduce their work hours to stay home and take care of the children because of the EITC. We do not think that is a bad outcome.

Obviously, there is a work disincentive any time you have a phaseout but we think the group that is subject to the EITC phaseout is more attached to the work force. For those who might reduce their work hours, the choice may be to stay at home and take care of children.

Mr. LEVIN. Thank you, Madam Chairman.

Chairman JOHNSON. Mr. Herger?

Mr. HERGER. Thank you very much, Madam Chair. I want to commend both of you at the Treasury and the IRS for taking some much needed steps to eliminate the fraud and abuse in the EITC program. Even with the changes, the EITC still adds a layer of complexity to our current system.

Mr. Samuels, I might ask of you, in your opinion, is there any way that we could perhaps juggle the income tax or FICA tax rate brackets like perhaps setting a floor on FICA tax, while providing the same relief to the same families, and at the same time reduce this complexity of the Tax Code with the EITC the way it is currently set up?

Mr. SAMUELS. Mr. Herger, we have looked at those suggestions. Let me just say as you know we are really committed to thinking of all possible ways to make the program as efficient as possible.

My reaction so far to what I have heard of these proposals is that the promise of simplicity and reduction in error rate is a mirage. We would be here talking about exactly the same issues; how to target the FICA floor to the right population?

If you are trying to administer this through a payroll tax system, how are employers going to decide which employee is supposed to be able to get the benefit? You have employees who have multiple jobs. You have couples. Employers will have to figure out who is supposed to get the appropriate benefit, because you are not going to give the FICA floor to everybody. You have to target it.

I think that you would find, at the end of the day, that we really would not have made any progress in either simplification or targeting. And, in addition, it means that you would require employees to go to their employers and explain to them that they are entitled to this benefit, and many employees do not want to have that conversation.

As Commissioner Richardson mentioned, we have been working hard on outreach programs to encourage the advanced payment. While we have seen some success, overall as a percentage of the total, it is still a small fraction of the total number of EITC recipients. We keep asking ourselves why we cannot we do better in getting recipients to claim the advanced payment, because we think that would be a good way of delivering the EITC.

One conclusion is that employees do not like to go to their employers and explain to them that they are entitled to this program. Given the relationship between the employer and employee, I think that there is some question about whether employees would choose to describe what their circumstances are to their employers. In addition, I think sometimes there is a question of whether the employer might say, "Well, now, I know you are getting this benefit, so, I am not going to give you that raise." Finally, we have had very serious problems with the targeted jobs tax credit which is also a credit for employers. These are different programs, I am just giving you a very broad view. Our experience with the targeted jobs tax credit was very unhappy, and we have said we would not support its extension unless it has some serious changes made to it.

When we have looked through these proposals, we think that you wind up with a different set of problems in some sense, but these problems are going to be as serious or more serious than what we currently have. We now have a program that a lot of people understand, and where we feel we are making progress on the error rate issue with the steps that the IRS has taken. That is very important to the proposals we have made and Congress has passed. We have proposals here, before you, which we think will make a significant difference.

We think we are on track and we need your support to continue that and we appreciate your support so far this year on trying to get a handle on this issue.

Mr. HERGER. Thank you, Mr. Samuels.

Chairman SHAW. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman.

Mr. Chairman, I would like unanimous consent to place an opening statement in the record.

Chairman SHAW. Without objection. Any Member who has an opening statement, it will be made a part of the record.

[The opening statement and attachments follow:]

OPENING STATEMENT OF BARBARA B. KENNELLY

EITC Hearing

"The best anti-poverty, the best pro-family, the best job creation measure to come out of the Congress." These are the words of President Ronald Reagan.

As an advocate for the EITC, I agreed with President Reagan, and worked with him on the 1986 indexing expansion changes. I worked with President Bush on the largest-ever expansion in 1990. I worked with President Clinton on the 1993 simplification and expansion. Historically this is a program that has enjoyed strong bipartisan support.

I am pleased that we are having this hearing today to examine problems with the EITC. Let there be no mistake--where errors are made, they must be corrected and where even one dollar of fraud exists, it must be found, stopped and those responsible prosecuted.

I would hope that on a bipartisan basis we can focus on finding solutions to the real problems in the EITC. I would hope that we can distinguish an honest taxpayer mistake from criminal fraud, correct the former and punish the latter without taking benefits away from innocent hard-working EITC families. And perhaps, I would hope that we can acknowledge the multitude of things the Internal Revenue Service has done to stop fraud and find errors as well as recall the many changes the Congress has made in this program in the past 2 years that should address error and fraud. In this area, I would like to include for the record 12 steps the Administration has taken to reduce error rates.

And once we have a real picture of what the problem is and the changes that are in place to address the problem, I would hope on a bipartisan basis, we can take the additional steps necessary to eliminate fraud and minimize errors in the program.

In 1993 some 84,856 families in Connecticut received the EITC. We have tremendous income disparity in Connecticut. For instance, in 1995 45% of all Connecticut families with one child that file as head of household will generally qualify for the EITC while a mere 9.9% of Connecticut families with one child that file married filing jointly will qualify.

Similarly, in 1995 48% of all Connecticut families with two or more children that file as head of household will generally qualify for the EITC while just 10.8% of Connecticut families with two or more children that file married filing jointly will qualify.

The EITC is particularly critical for these families headed by one parent--often a divorced parent with children or a young mother struggling to get off welfare. It is on their behalf that I am very concerned about proposals in the Senate-passed Budget Resolution that would increase their taxes. CT families with one child would have their taxes increased by $1,436 over 7 years by the Senate Budget Resolution. CT families with two or more children would have their taxes increased by $1,778 over 7 years by the Senate Budget Resolution.

What I find particularly troubling is that 90% of the reduction in the EITC in the Senate Budget Resolution has nothing to do with reducing errors, eliminating fraud or ensuring that those not entitled to the credit do not receive it. This Member is willing to do whatever is necessary to reduce errors, eliminate fraud and ensure that those not entitled to the EITC do not receive it. But this Member has NO interest in increasing taxes on struggling families in Connecticut.

I am also greatly troubled by the suggestion that we count child support payments as income for EITC purposes. This simply makes no sense and would represent a major step backward in child support enforcement. Such a change would add unbelievable complication to the EITC--complication that only leads to additional errors. The one thing this program doesn't need is more errors!

Further, the IRS has no data on child support payments, therefore, it would be impossible for the Service to verify this information. I am particularly troubled that non-custodial parents are already taxed on child support payments. To count child support payments as income for EITC purposes would amount to double taxation. I do NOT support taxing child support payments!

Such a change could also actually lessen child support payments whereby divorced payments who find themselves in danger of losing the EITC could negotiate to maximize the EITC and minimize child support payments.

Inclusion of Social Security in income for EITC purposes raises equally troubling questions and should be rejected.

Finally, the House-passed version of welfare reform would eliminate the restriction on how States treat the EITC for AFDC recipients. Under the House-passed bill, States could elect to count all or part of the EITC as income available to an AFDC family and reduce AFDC benefits accordingly. Lump-sum EITC refunds, which 99% of EITC families receive, could be treated by States as an asset immediately available to an AFDC family, thereby disqualifying them from AFDC. Surely EITC is supposed to be an incentive to work, a helping hand in making the transition from welfare to work. I would hope that within the context of EITC reform we can revisit this issue.

Thank you.

12 ADMINISTRATION MEASURES TO IMPROVE THE EITC AND REDUCE ERROR RATES

Source: Treasury, May 12, 1995

Simplicity and Verifiability

- The Clinton Administration recognizes that error rates are a problem and has acted aggressively to reduce them.

- Specifically, the Clinton Administration is committed to structuring the EITC so that deserving and eligible individuals--and only those individuals--are able to claim and receive the EITC.

- Two key means to this end are the <u>simplicity</u> and <u>verifiability</u> of EITC claims.

  -- If eligibility rules are simple, taxpayers can more accurately claim the EITC and avoid costly errors.

  -- If eligibility rules are verifiable, the IRS can better ensure that the EITC is paid only to those who are eligible.

- The Administration has taken <u>12</u> measures to ensure the simplicity and verifiability of the EITC and to reduce erroneous or undeserved claims.

OBRA 1993

1. The EITC was simplified by <u>repealing the complex supplemental credit for health insurance coverage</u>.

   -- Some taxpayers made mistakes in their claims because they did not understand the complicated eligibility criteria.

2. The EITC was further simplified by <u>repealing the supplemental credit for children under the age of one</u>.

   -- This should also improve EITC compliance, as taxpayers could not understand the eligibility criteria for the young child credit, and the rules were difficult to administer.

Uruguay Round Agreement Act of 1994

3. The EITC was denied to nonresident aliens.

    -- Under prior law, nonresident aliens could receive the EITC based on their earnings in the United States, even though they are not required to report their worldwide income to the IRS.

4. Prisoners will not be eligible for the EITC based on their earnings while incarcerated.

    -- The EITC was never paid to prisoners, and this ensures that it will not be paid to them, now or in the future.

5. Taxpayers will be required to provide a taxpayer identification number for each EITC qualifying child, regardless of age.

    -- This will allow the IRS to verify eligibility for each child claimed by the taxpayer.

6. 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.

    -- This will ensure that military personnel receive the benefit for which they are eligible.

Verifying and Delaying Questionable Refunds

8. The IRS has instituted a series of tough new administrative measures to reduce error and fraud in the EITC. The IRS now scrutinizes the social security numbers of all EITC qualifying children.

    -- Children's social security numbers are checked to make sure the numbers are valid, and no child is claimed more than once.

    -- Last year, the IRS only validated the social security numbers of children claimed on EITC returns filed electronically. This year, the IRS is tightening its validation tests and checking all returns--whether they are filed electronically or on paper.

    -- Refunds on returns with missing, invalid, or duplicate social security numbers will be delayed, while the IRS investigates further.

9. EITC refunds may also be delayed if the IRS has questions regarding the validity of the claim.

    -- Certain taxpayers will be required to provide additional documentation to verify that their EITC claim is valid before the credit is awarded.

    As of April 21, 1995, the IRS has delayed refund checks to 6.5 million filers as a consequence of these two actions.

Intensifying Scrutiny of Electronic Return Originators

10. Beginning with the 1995 filing season, the IRS is no longer providing direct deposit indicators (DDIs) to preparers of electronic returns (EROs). The DDIs gave preparers a quick signal from the IRS that a taxpayer was going to receive a refund check. Preparers used this information to advanced taxpayers loans on their refund checks within a couple days of filing a return. With the DDI, the taxpayer would receive a loan, and the IRS would pay the refund directly to the ERO. If the return was later determined to be fraudulent, the IRS -- not the preparer -- was left with the bill if the taxpayer disappeared with the refund anticipation loan.

- -- Eliminating the DDI provides EROs with greater incentives to check the eligibility of EITC claimants. Preparers will not find it in their interest to advance refund anticipation loans to filers who may not be receiving a refund from the IRS.

- -- In its enforcement activities, the IRS has also found that some EROs have been responsible for refund fraud. The IRS has taken several steps to stop this practice:

    - -- Fingerprint and credit checks are conducted on certain new ERO applicants.
    - -- IRS is conducting additional compliance checks to ensure that EROs are meeting new, stricter requirements for participation in the program.
    - -- The IRS is working with the Justice Department to prosecute preparers and EROs who take advantage of the EITC to defraud the Federal government.

Preventive Actions

11. The 1994 Schedule EIC was shortened and simplified to make it easier for low-income taxpayers to understand if they are eligible for the credit.

12. Taxpayers were also warned on the cover of the 1994 tax return that they would be required to provide valid social security numbers for all dependents and EITC qualifying children.

    -- In December 1994, over 180,000 taxpayers who filed in 1994 with incorrect or invalid social security numbers received letters from the IRS alerting them to be more careful on their 1995 tax returns.

    -- IRS participated in extensive media campaigns before and during the filing season to emphasize the need for accurate SSNs.

Additional Proposals To Reduce Errors Still Pending

- The Administration submitted additional proposals as part of the President's FY 1996 budget which are still pending final legislative action.

- The EITC would be <u>denied to undocumented workers</u>.

- The IRS would be authorized to use <u>simpler and more efficient procedures</u> when taxpayers fail to supply a valid social security number. Taxpayers entitled to the credit would have 60 days to provide a correct social security or, if they failed to do so, could refile with the correct information 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.

- The FY 1996 budget for the IRS contains funding for the continuation of its taxpayer systems modernization (TSM) program. 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.

- Last year, the Administration also proposed State demonstration projects to provide alternative ways of delivering advanced payments of the EITC.

We hope that Congress will act on these proposals soon.

Mrs. KENNELLY. Mr. Samuels and Ms. Richardson, thank you for coming this morning, but also thank you for your work in making the EITC work. It is a good program and I know if it had not been for your efforts in the last year or so we would not be where we are today.

Before I ask a question, I would just like to make two points. One, I think we have to be awfully careful not to interchange the word, error and fraud and then come up with a percentage of abuse. Fraud is against the law and it should be prosecuted, but a lot of people make errors, as you know, on the IRS forms. I thank the Chairman for his remarks this morning and for support of the program.

I think we have to remember that in the Senate, that 90 percent of the dollars that they are looking to take from the EITC are not in fraud or error related, it is literally to withdraw money from the program, I thank the Chairman for appreciating that.

Mr. Samuels, back to the Senate, they have suggested that we include child support enforcement and Social Security when figuring out the EITC and I wonder how you feel about that?

Mr. SAMUELS. Well, on the child support, we have a concern about that proposal. We should be encouraging a taxpayer who is responsible for taking care of children to get the child support that he or she, generally she, is entitled to.

If you add child support to income, you are going against that policy. For that reason, there has been a very long tradition of excluding child support from taxable income.

The second problem with child support is that the IRS does not have any way to verify whether somebody is getting child support. By adding child support to income, you then set up a situation where we are inevitably going to have errors because one, people have never been required to include it in income; and two, we have no way of checking.

I think it would be setting up a situation which would increase the complexity of the calculation for millions of working Americans and, at the same time, cause a potential for errors. We have significant reservations about that proposal.

With respect to including Social Security payments, I think when you were out voting we discussed that proposal. I said the considerations to take into effect are that you have kind of two situations. First, a person who is receiving Social Security working and taking care of maybe a grandchild would all of a sudden be treated differently than their neighbor who is getting Social Security and is not taxed on their Social Security because they do not work or care for their grandchild.

Then you would have a situation where one spouse is working and the other spouse is on disability. I do not think anyone anticipated that the disability insurance program might result in a loss of tax credits.

Those are some of the considerations on Social Security that we think you ought to evaluate. Again, we do not receive reports on Social Security from the Social Security Administration (e.g., 1099s) so that we can check, so it would also raise a compliance issue.

Mrs. KENNELLY. Ms. Richardson.

Ms. RICHARDSON. Congressman Kennelly, my two principles would be that whatever changes are made we need to keep them simple and easily verifiable. Those are the two things that are the most important to us as an administrator in making the program work. We hope any changes that are considered can be easily verified and will not do anything to add to the complexity for the taxpayers.

Mrs. KENNELLY. Thank you. Quickly, Mr. Samuels, can you just comment on one of the suggestions in the Joint Tax Committee Report that the EITC be replaced by an employee FICA credit. Have you heard of that one?

Mr. SAMUELS. Yes. Mr. Herger asked me about that and I said that I thought it would be a mirage. When you actually look at these proposals, we will be back here talking about the same problems—targeting, compliance, how do you know whether the person is entitled to it—so we do not think these proposals are an improvement.

Mrs. KENNELLY. You think that is a nonstarter?

Mr. SAMUELS. Yes.

Mrs. KENNELLY. Thank you, sir.

Thank you, Mr. Chairman.

Chairman SHAW. I would like to follow up for just a moment on some of the questioning that you had with regard to income that is excluded. You spoke of child care being excluded in the computation. Is alimony——

Mr. SAMUELS. Alimony is included in income. It is deductible by the——

Chairman SHAW. It is; so, is there any taxable income that is not included in the computation of the EITC?

Mr. SAMUELS. Taxable scholarships and fellowships are not included for earned income purposes but they are included for the adjusted gross income purposes. I think basically all the items——

Chairman SHAW. You work off of the adjusted gross income?

Mr. SAMUELS. Yes, sir.

By the way if I might just follow up on one thing in my response to Mrs. Kennelly on the Social Security, I am told that we do get 1099s for Social Security benefits in order to determine whether someone is subject to tax on benefits. I would like to correct my remarks on that point.

Chairman SHAW. Mr. Gibbons.

Mr. GIBBONS. Thank you, Mr. Chairman.

Let me ask you, Ms. Richardson, just what capacity does the IRS have? Can your machine read taxpayer return information to include the Social Security number? Can your machine read that or do you have to hand-read it?

Ms. RICHARDSON. Congressman Gibbons, today we are doing some scanning of tax returns. I believe we are doing some of the 1040 EZs. But by and large we are still locked into a system where if people file on paper, we keypunch in the data from the face of the return. For returns filed electronically the data is completely captured electronically and we do not have to transcribe the information.

Mr. GIBBONS. Now, once you get that data which most of it must be hand-punched in, I guess, can your computers identify correct or incorrect SSNs for a person?

Ms. RICHARDSON. We have been able to do that this year. We have, as part of our fraud detection efforts, stepped up our ability to match SSNs, to check for duplicate numbers, and to assure that the names and the numbers match with what is on the Social Security records.

Mr. GIBBONS. You have only been able to do that this year?

Ms. RICHARDSON. We have done it this year.

Mr. GIBBONS. All the years prior to that you really could not do it, is that right?

Ms. RICHARDSON. I think that is correct and then we made a concerted effort as part of our antifraud efforts to transcribe all the numbers and assure that not only the taxpayer and the taxpayer's spouse, but dependents were also transcribed and matched.

Mr. GIBBONS. Can your computers tell you whether taxpayer A and taxpayer Z are perhaps claiming the same child dependent?

Ms. RICHARDSON. We can do that this year. One of the reasons we slowed the refund process down was so that we could do a duplicate Social Security number check.

Mr. SAMUELS. Mr. Gibbons, if I could just add, because the IRS has that capability and they have been engaging in this matching this year, that is a reason why we strongly urge the Committee to consider our proposal to simplify dealing with taxpayers who do not provide correct Social Security numbers. The IRS does not have to go through complicated methods of denying EITC if someone does not provide a correct Social Security number.

We think that is a very important proposal and would greatly assist us in our compliance efforts.

Mr. GIBBONS. I can see that the invention of false children and false dependents could be a real problem unless you have some way of identifying them other than off of some given name.

About the Social Security system, I guess it is the only way we have got of doing that, the Social Security number.

Mr. SAMUELS. As you may recall, Mr. Gibbons, in the GATT, General Agreement on Tarriffs and Trade, legislation we have required that a Social Security number be obtained for all children, regardless of age. We are phasing that provision in.

Prior to the GATT change you were not required to have a Social Security number for a child under the age of one, and now we are requiring it for all children, on a phased-in basis, so that we will have a complete file to match.

Mr. GIBBONS. You will not have those any time real soon. When will all that be effective?

Ms. RICHARDSON. 1997, in the next 2 years.

Mr. GIBBONS. 1997?

Mr. SAMUELS. Yes.

Mr. GIBBONS. You mean for——

Mr. SAMUELS. Right now it is all children the age of one or older. Now we are phasing it in for children under the age of one. We wanted to make sure that the Social Security Administration had the ability to provide the numbers because we didn't want to have a requirement that people could not meet. Based on our discussions with the Social Security Administration we developed a phase-in schedule based on how old the child is. For tax year 1995, it is for any child 2 months or older, and then it is 1 month or older next year.

We phased it in to make sure that people could, in fact, get the numbers and that was one of our proposals that was in the Uruguay round legislation, which we think is quite important to our compliance effort.

Mr. GIBBONS. Yes, I recall that.

Now, let me see if I am correct. In calendar year 1997, you will have a complete web, is that right?

Ms. RICHARDSON. In order to claim a child as a dependent or to claim a qualifying child for the EITC, that child will have to have a Social Security number no matter what age.

Mr. GIBBONS. You will be able to tell by that time whether one or more, two or more families are claiming that same child, is that right?

Ms. RICHARDSON. That is correct. We are actually able this year to verify duplicate numbers. I believe that if a child under one did not have a Social Security number we required additional verification that the child was, indeed, who the taxpayer claimed before we allowed the credits to go forward.

Mr. GIBBONS. It will not have eliminated that potential loophole until 1997, is that correct?

Mr. SAMUELS. Excuse me, what I understand, Mr. Gibbons, is that the legislation will be effective in tax year 1997, for all people. It is really in the filing season for 1997 returns we will have it.

With respect to periods before then, the IRS, as I understand the Commissioner's comments just now, is taking special measures for those returns where there are children under the age of one without a Social Security number. They are asking for additional information to fill the gap between now and the time we can do it all with the computers.

Ms. RICHARDSON. That is correct, Mr. Gibbons. I would say that that problem has been addressed this year. Although the requirement to have the numbers is not there until, or fully phased in until 1997, we are verifying before claims are allowed, that, indeed, the child belongs to the person, or it is a qualifying child or properly claimed as a dependent.

Mr. GIBBONS. Well, the reason why I try to get such detailed information on this is that it has long seemed to me and by information that I have picked up on the street as you wander around, that there always has been quite a game where dependency was a test of what you either owed or you got as a benefit.

There is a little faking in that area. I was trying to put it gently. They have been borrowing kids around and borrowing—I do not want to claim it as fraud, but it certainly is fraud, I guess.

Ms. RICHARDSON. Well, one of the, perhaps salutary effects of what we have done this year is that we have 800,000 fewer dependents who were claimed this year over the same period last year.

Mr. SAMUELS. That is a very important point that shows the results of what the Commissioner has been doing. This year we have seen a decrease in the number of dependents and we have actually seen a decrease in the number of returns filed by taxpayers with children which we did not expect. It is less than last year so it is less in absolute terms——

Mr. GIBBONS. Are you telling me that the Clinton administration has reduced our roles of dependency by 800,000?

Ms. RICHARDSON. We have 1 million more returns that have been filed this year, at the same time, over last year. We have 800,000 fewer dependents who have been claimed this year on all returns, and then for EITC purposes the number of returns claimed that had people with qualifying children is down by about 257,000.

Yes, we feel that the steps we took this year, particularly those involving verification of SSNs, have been effective.

Mr. GIBBONS. Well, I realize we have not killed any children or anything like that.

Ms. RICHARDSON. We are not aware that there was any major illness, so we believe it has been attributable to our fraud efforts.

Mr. GIBBONS. Well, that is good.

Chairman SHAW. What I would like to add here is just a brief question along that same line. Why do we not just go ahead and require the Social Security number to be issued with the birth certificate? Everybody is going to need one, whether it be for a poverty program or later becoming a taxpayer. Why not just go ahead and give each child a Social Security number simultaneously with a birth certificate?

Mr. SAMUELS. Mr. Chairman, as I understand it, that will be the effect.

Chairman SHAW. Is that 1997?

Mr. SAMUELS. That is correct, that is 1997.

Chairman SHAW. Is that what is actually required in 1997, is that the Social Security number is——

Mr. SAMUELS. Yes, and so that will show up when we do——

Chairman SHAW. Why do we phase that in, why do we not just go ahead and do it?

Mr. SAMUELS. I think that we wanted to make sure that we were not putting parents of newborns in the position that all of a sudden they would be asked to do something, and the States who administer the registration of births could not deliver. There was just a great concern that no one wanted to put a requirement on people who would then bitterly complain because States had not worked out a way of actually producing the Social Security number.

As we were talking about this last year, among the staff, we would have somebody say, "Well, yes, my wife just had a child and we are still waiting for the number." That was the reason it was phased in.

So, we think——

Chairman SHAW. Are we getting into a problem with an unfunded mandate, though?

Mr. SAMUELS. No, I do not think so. I think that we just really needed people to adjust their systems and make sure the Social Security Administration can provide the information that the States need. The States are registering births anyway. It was just a matter of getting the systems, I think——

Chairman SHAW. Yes, they could probably use that as a filing number themselves.

Mr. English, do you have any questions?

Mr. ENGLISH. Thank you, Mr. Chairman.

Just briefly. I would like to thank the panelists for joining us today to participate. What we are doing today, I think is very important. Because the reevaluation of the design of the EITC is extremely timely right now. I think this program, this tax provision is very important for the working poor. It has enjoyed bipartisan support in the past.

It has a very important role in our discussions on other areas of public policy, such as welfare reform and changing the minimum wage.

I think there are a number of issues here which you have already covered, including the inaccuracy—and I hesitate to use the word, fraud, but that is obviously a significant part of it—the inaccuracy of many forms that are filed—the marriage penalty which I think is a very significant issue and the question which Mr. Samuels has raised, ably here, on simplification.

I have a couple of questions. First of all, Mr. Samuels, has the Treasury looked at the marginal tax rates of people who are leaving poverty, who are leaving the welfare system to become working poor and take a low-paying job?

Can you give us any data on the marginal tax rates that they face?

Mr. SAMUELS. Mr. English, we have looked at that and we can provide you with some specific information. I would say that in evaluating the marginal tax rates there are two issues. As you move into a job, you would be giving up significant benefits if you were receiving assistance. A purpose of the EITC is to offset the marginal rates which are caused by moving off of welfare to work. Also, for example, once you start to work, your first dollar is subject to FICA tax.

When you are thinking about what you are giving up and what you are moving to, you have to worry about the first dollar being subject to the FICA tax. And then, at a certain point, you are subject to income tax.

A worker without qualifying children, for example, becomes subject to income tax below the poverty line. There are significant marginal rate problems for these low-income workers that are a concern. The EITC is supposed to help people by increasing their net wage and offsetting these marginal tax rate problems. It is the only program we have like that.

Mr. ENGLISH. I would welcome your specific information. Mr. Steuerle, who I believe is here to testify today from the Urban Institute, previously indicated that the marginal tax rate can be in the range of 85 percent or perhaps even higher under certain circumstances.

Was that the finding of Treasury?

Mr. SAMUELS. Well, let me just give you some numbers here. The food stamp phaseout rate is 24 percent. The AFDC phaseout rate is 66 percent during the first 4 months of employment and 100 percent thereafter. When you start adding these together you have very high margin tax rates.

Mr. ENGLISH. Your finding has been that the EITC plays a significant role in lowering that marginal tax rate and making it easier to move from welfare to work.

Mr. SAMUELS. Yes, we do.

Mr. ENGLISH. I noted in your testimony that you are opposed to lowering the investment income cap as proposed in the Senate bill on the grounds that it might discourage savings and might contribute to error.

Can you give us any hypotheticals on why you see that as a significant problem?

Mr. SAMUELS. Mr. English, when we proposed an investment income limit we picked $2,500, which was reduced in H.R. 831 to $2,350. We tried to pick a number that we thought would improve targeting, but also not discourage a low-income family from saving for a first house or for medical emergencies, or for education for their children. As you know, we have a very serious problem of savings in this country. The Committee has had significant hearings on this. We are also very concerned about it.

What troubles us is that if you lower this cap down to $1,000, you could hurt people who are trying hard to build a little nest egg. The cap, is also a cliff. If you have $1,001 you lose all of your EITC. When we designed the $2,500 proposal, we pointed out that there is a cliff, and we do not like cliffs as a policy matter.

We were trying, as Commissioner Richardson said earlier, to have something that was simple, easy to understand and was not going to create more complexity that would, in turn, lead to errors.

With a $2,500 cap, we tilted to no phaseout and a cliff. You can see the dramatic result for somebody if they had $1,001 of interest from a savings account, some savings bonds, and they lose all their EITC. It is especially difficult for a population that probably does not keep that close a track on fluctuations in their investment income.

Mr. ENGLISH. Sure. And those points are well taken. Thank you, Mr. Secretary, thank you, Commissioner, and thank you, Mr. Chairman.

Ms. RICHARDSON. Thank you.

Chairman SHAW. Thank you, Mr. English.

That does conclude the questioning.

Yes, Mr. Gibbons.

Mr. GIBBONS. I do not mean to be monopolizing this question thing here.

Chairman SHAW. You go right ahead and then I will ask another one, too.

Mr. GIBBONS. I am wondering if you could explain to me why we have put certain things in certain categories as far as what is income?

For instance, I am looking at—on page 8 of the form that you all have for this, and you have got a chart, on page 304, that shows what is income and what is not income for the EITC.

I have sat through these things for a long time and I have forgotten some of the reasons we use to get to where we are. Maybe you can refresh my recollection.

It seems to me that food stamps are just as much income as cash is. Why did we not classify food stamps as income?

Mr. SAMUELS. Well, Mr. Gibbons, I think that the answer, at least in my mind, is clear. The level of food stamps was set, with the notion that it was not taxable income. If you wanted to tax it, then you ought to take that into account when setting food stamp benefit levels.

That program was established without the notion that that amount is income. In addition, you have a phaseout of food stamps. You have in effect a marginal tax rate for food stamps. As I recall, it is 24 percent. As your earned income goes up, you lose 24 cents on the dollar.

We, in effect, are taxing, through the phaseout, the food stamp amounts already. It seems to me it would be inappropriate, in effect, to hit it twice.

I think that that was the reason why food stamps were not included. Apart from the fact that then we would have to figure out how much they were, who they were given to, and Commissioner Richardson would have a very difficult time in trying to determine, if one theoretically wanted to try to include food stamps, who, in fact——

Mr. GIBBONS. Well, I realize technically it would be a tough problem, particularly since you are just learning how to check SSNs. It seems like to me that I can go down here to Safeway in Southwest Washington, there are a lot of food stamps used there. I go through the line with them and their food stamps are just as much money as my dollar bills are money.

So their food stamps are not taken into consideration at all in family income for the EITC?

Mr. SAMUELS. No, sir. As I was saying, if you wanted to do that, you would have to take account of one, that they are, in effect, subject to a tax because they are phased out. You lose 24 cents on the dollar.

Mr. GIBBONS. I realize that.

Mr. SAMUELS. But, two, if you wanted to do that, you would have to say to yourself, well, should I increase the food stamp benefit—I mean on what level do you want to have people receiving food stamps? As you know, in order to bring a family of four, with a full-time worker earning the minimum wage, out of poverty they need food stamps, they need the minimum wage—not today's minimum wage, but they need a minimum wage that has been increased as the President has proposed by 90 cents—and they need the EITC. They need all three of those so that a family of four with a full-time worker earning the minimum wage can be out of poverty.

If you want to include food stamps in income, and if you believe that is an appropriate objective for full-time workers to have incomes above the poverty level and we certainly do, then you are going to have to increase the EITC or you are going to have to do something to make up the difference.

As I said, that goal right now is not met. We are not with the current system. With today's minimum wage, today's food stamps and today's EITC—we are not bringing that family of four with a full-time worker at the minimum wage out of poverty.

Mr. GIBBONS. I understand that. I am not arguing with you about that. Just looking over this list, on page 304 of the form book, a lot of it does not appear to make a heck of a lot of sense as far as equity is concerned between citizens. You know, I have taken up more time than I should have here. Perhaps I ought to have a private conversation with you and with my staff to argue about why we have classified this thing as we have.

Mr. SAMUELS. Mr. Gibbons, we would be pleased to sit down and go over that with you and your staff.

Chairman SHAW. I believe that we should take another look at it. I would, Mr. Samuels, direct your attention to page 269 of the Tax Guide for 1994, which provides for a number of things that are not included. For instance, taxable items such as alimony.

The chart I am looking at may be wrong, but you will have to take that up with Ms. Richardson. I did not write it.

Mr. SAMUELS. Mr. Chairman, alimony is included for adjusted gross income purposes, not earned income purposes. If you are receiving a substantial amount of alimony and let us say that you had small earned income but a lot of alimony——

Chairman SHAW. Well, if we go back—I do not want to belabor the point, because it either is or it is not—but when we were talking before it was a question of adjusted gross income. I am not trying to get in an argument with you but I am saying, I am following up on what Mr. Gibbons said. To me these items that are listed on page 269, interest and dividends, Social Security and railroad retirement benefits, welfare benefits including all of them, pensions or annuities, veterans benefits, workmen's compensation benefits, alimony, child support, unemployment compensation, taxable scholarship or fellowship grants that were not reported—well that one, I can see where we may not want to include that—variable housing allowances for military. I think all of that goes into somebody's standard of living.

That is what we are trying to do with the EITC, make it so that we do not have working poor. I think that most of these items should be taken into consideration. I realize there are going to be some reporting problems because many of these do not go on the income tax returns. Perhaps this is something we ought to take another look at and I think Mr. Gibbons is quite correct in bringing this up.

Mr. SAMUELS. Mr. Chairman, we would be pleased to work with you on that. If I could just say that the EITC is a credit based on your earned income. There is a phaseout limit which puts all these other items——

Chairman SHAW. That is correct, but the purpose behind it was to eliminate the term, "working poor," because Congress feels—both Democrats and Republicans—if you are working you should not be poor.

Mr. SAMUELS. Right.

Chairman SHAW. So we should take everyone's resources into consideration in deciding whether they are poor. Your problem is compliance, and I understand that and perhaps we can work together to make a few midcourse adjustments on that.

I thank this panel very much. We kept you for an extraordinarily long period of time. You have been very cooperative with us, and we very much appreciate the time you have given us this morning.

Ms. RICHARDSON. Thank you, Mr. Chairman.

Chairman SHAW. The next panel we have includes: Marvin Kosters, a resident scholar of the American Enterprise Institute in Washington, DC; Robert Greenstein, executive director of the Center on Budget and Policy Priorities in Washington, DC; Mr. Eugene Steuerle, senior fellow of the Urban Institute of Washington, DC; Karl Scholz, Ph.D., associate professor, Department of Economics, University of Wisconsin; Jonathan Forman, professor, College of Law, University of Oklahoma. Welcome.

We have each of your written statements. You may proceed as you see fit. If you care to summarize, that would be fine, because we do have your statements up here at the desk.

Dr. Kosters.

STATEMENT OF MARVIN H. KOSTERS, PH.D., RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. KOSTERS. Thank you, Mr. Chairman.

I appreciate this opportunity to be here and say a few words about the EITC. Much has been said about its growth and about the problems that are associated with it. It seems to me that this is a good time to take a look at it to see whether, this is a good way to spend as much money as is scheduled to be spent on it, and to see whether some of the problems really need to be fixed anyway.

There are several issues that I cover in my testimony. Just to summarize, take first the problem of fraud. It has received a good deal of discussion here, but I think that we need to recognize that there is more involved here than simply fraud. The high subsidy rate that can encourage work also encourages token work. Filling out the payroll tax forms and paying those, makes it legal, essentially.

You will have, when it is fully phased in next year, a subsidy rate up to about $10,000 of earnings of 40 percent compared with a payroll tax—a combined payroll tax rate—of a little more than 15 percent. there will be incentives there to exchange work, for example, or perhaps just do the paperwork for it. Such arrangements will be difficult for the IRS to ferret out. No matter how much in the way of increased enforcement is put in place, it would be hard to identify such arrangements or do something about them. There is also the marriage penalty problem and, finally, there is the work incentives issue.

The first thing I would say about the EITC, as it is scheduled to go into place next year is that the cutoff quite high in relation to incomes of the families that are talked about in terms of the working poor.

Some 40 percent of families would be below the income cutoff next year when the EITC is phased in, and families with children; and this can be compared to a poverty rate of less than half that in 1993, about 18.5 percent.

The income cutoff is quite high in relation not only to family incomes, but it is even higher in relation to the typical earnings of an individual worker. If you take workers as a whole, across the country, almost 50 percent of them earned less than $25,000 in 1993.

Now, the main rationale for the growth and popularity of the EITC seems to be that it encourages work. I think it is useful to take a somewhat closer look at that. I believe that the favorable effects on work have been exaggerated and the reason is simply because so many, so far up the income distribution are encouraged to work less rather than more.

We have, for those 40 percent of families with children who are below the income cutoff, 20 percent, or half of that group below the income cutoff, work is fairly significantly discouraged. The real question is whether that 20 or 30 percent who are discouraged or not encouraged to work, would be offset to any significant extent by the 10 percent where no one is working but where someone might be encouraged to consider work. There is some evidence of that, that Professor Scholz has developed, I read that evidence as saying, roughly, "maybe."

It seems to me that we need to recognize that the EITC discourages work for many families. For some families where work is discouraged, their incomes are likely to be actually lower after their EITC payment than it was before. If we take Professor Scholz' numbers, for example, and if we suppose that hours of work will increase as much as he estimates for people who are encouraged to work, we need to recognize that the amount of output, the amount of GDP, is still likely to decline. This is because the wages of those drawn into the work force are likely to be lower, significantly, lower than the wages of those further up the income distribution where there is likely to be a net discouragement of work.

It seems to me that the EITC should be looked at carefully we should see whether its administration ought to be transferred to a welfare bureaucracy that is already in place, and to see whether the subsidy rate should be very sharply cut back to say, the 15- to 20-percent range. Some of the income support payments might then be transferred to a welfare bureaucracy to administer and, perhaps, some of the rest could be used to reduce deficits in the future.

Thank you, Mr. Chairman.

[The prepared statement and attachment follow:]

Testimony of

Marvin H. Kosters
American Enterprise Institute

Committee on Ways and Means
Subcommittees on Oversight and Human Resources
U.S. House of Representatives
June 15, 1995

Improving 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 most of its payments 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. By that time, its cost will have almost quadrupled since 1990.

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 earned income tax credit should be scaled back sharply. Some of the payments now being made under the EITC to the poorest working families could better be administered by agencies responsible for other income maintenance programs.

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 for the EITC of families with children 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.

A large share of families with children have incomes below the EITC income cutoff level according to these data. About 40 percent of families with children have incomes low enough to qualify for EITC payments. This 40 percent who are eligible for the EITC on the basis of their income level can be compared with a poverty rate for families with children of 18.5 percent in 1993. Payments under the EITC evidently extend to families with incomes well above the working poor as defined by the conventional measure of poverty. 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. Families with someone already working and with income in the range where they are eligible for the EITC account for 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 -- up to $8,900 for families with two or more dependents -- the amount of the credit increases as they work more and earn more. For every dollar they earn they receive a 40 cent subsidy in addition, 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. Thus despite the large subsidy to their wages, the increased income they receive reduces pressure to work more. Whether they will work more or less depends on how their work behavior responds, and the evidence suggests that the net effect of these offsetting forces is likely to be quite small. These working families with the lowest incomes account for about 7.4 percent of all families with children (as shown in the table), and they are likely to experience little net work encouragement or discouragement.

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 every additional dollar they earn, 21 cents are in effect taxed away by a reduction in their credit payment. 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.

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 and lower earnings offsets some of the effect on incomes of EITC payments. Indeed, the evidence suggests that many working families eligible for the EITC will actually have lower incomes than they would have in the absence of the program.[3]

In view of this discussion of work incentives for families with someone working, what is the basis for the view that the EITC encourages work? Low-income families with no one working are unambiguously encouraged to work by the EITC. 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. Although the EITC definitely has a positive effect on work incentives among these families, they account for only about 10 percent of all families with children.

Whether work is on balance encouraged by the EITC depends on whether enough people in the 10 percent of families with no one working choose to work, and to work enough, to offset the reduction in work effort expected for the 30 percent with someone already working. More than twice as many families face work incentives that definitely discourage work compared with those who are encouraged to consider working. Is it likely that 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? One study that examines the question concludes that fairly generous assumptions about work choices are necessary for the EITC to actually encourage work instead of on balance discouraging work.[4]

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. Family income cutoffs are quite high in relation to earnings of the typical worker. For example, 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. For all adult workers, 57 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 -- and who would be encouraged to consider 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 families with someone working would be correspondingly reduced, and work would be discouraged for fewer families. In addition, of course, less income would be redistributed, and the transfers that remained would be shifted toward lower income families with children.

Reducing the income cutoff level and phasing out payments more quickly is another approach that could be considered. 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. Under a personal income tax system with progressive marginal tax rates and equal taxation of married couples with the same incomes, complete marriage neutrality cannot be achieved. 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.[5]

The marriage penalty is particularly severe for people who -- if they were not married -- would each be eligible for the maximum credit. 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.[6]

The primary function of the IRS is collecting tax revenue under a system that is largely self administered. Assuring compliance with EITC provisions poses some awkward problems for a tax collection agency. Its activities are 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 these 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 payments 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 a 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 major problems with the EITC 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 also 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 has become too generous and should be cut back to its size in the early 1990s, before it was most recently expanded. I do not argue that income transfers to families with the lowest incomes should necessarily be reduced, but the total cost of income maintenance programs could be reduced significantly without reducing payments to low-income families with children. The goal of providing income support to families with the lowest incomes would be better served by scaling back the EITC and placing more reliance instead 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. "Effects of the Earned Income Tax Credit on Income and Welfare," Edgar K. Browning, National Tax Journal, March 1995.

4. "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.

5. 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.

6. 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

Families with children by Income Range and EITC Eligibility	Percent of Families with Children	Effects on Work Incentives: 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 Phased Out (Credit Payment Declines as Income Increases) 7,594 thousand	19.5%	–	–	–
• Income Range Eligible for the Maximum Credit Payment 1,489 thousand	3.8%	–	0	–
• Income Range Where Credit is Phased In (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.

Chairman SHAW. Thank you, Dr. Kosters.
Mr. Greenstein.

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

Mr. GREENSTEIN. Thank you, Mr. Chairman.

I think as the hearing is making clear this morning, probably the principal issue that needs to be addressed in the EITC is the question of error rates. We should be mindful, both of the progress that is made and of how far we still need to go.

I think Congresswoman Johnson mentioned some of the studies done in the eighties. I think the most recent studies, one of them released just last week, suggests that where we are now is that we have cut the error rate or the Service has cut the error rate about in half from where it was when those studies were done in the eighties. It is still too high and we have a way to go. I am not going to go into detail here, but perhaps during the questioning period, if you are interested I could go through the studies that I think indicate we have roughly cut the error rate in half but we have a further amount to go.

Well, the GAO, General Accounting Office, by the way, has also noted some of that progress in reducing errors. But, I think, part of the discussion here of the EITC and of the growth in the credit, which Congressman Gibbons referred to, is to discuss why the Congress, on a bipartisan basis, has expanded the credit.

The growth of the credit is closely related to erosion in wages for low-paid work. What this board shows you is that since the late seventies the poverty rate for families with children in which a parent works has gone up nearly 50 percent. When wages for low-skilled work erode this not only reduces living standards and increases child poverty, but it lessens incentives to work and it lessens the gains from working relative to receiving welfare.

As a result of that, starting in the mideighties, there was a bipartisan policy emphasis here, in Washington, of increasing the returns from low-paid work with the EITC as the principal policy instrument for doing that. It was started by President Reagan who proposed a large expansion in the EITC that was part of the Tax Reform Act of 1986, President Bush proposed another large expansion in the late eighties that was in the 1990 budget agreement, and then President Clinton in 1993.

These expansions of the credit basically reflected a policy shift away from the minimum wage and away from welfare and to the EITC instead. As you know, the minimum wage is at its second lowest level in purchasing power in 40 years.

What is less well known is the following fact. In the early seventies, before the EITC existed, the number of States in which a mother with two children, who worked and earned wages equal to three-quarters of the poverty line, in which she got welfare as a supplement to her wages was 49. Today it is three.

We basically do not provide AFDC to these families any more, we have moved them out of the welfare system. We have had the minimum wage erode, we have greatly expanded the EITC instead. These were conscious policy choices.

The credit was also expanded in part to offset the payroll tax. It increased in 8 years out of 11, between 1980 and 1990 and the excise tax increases of both 1990 and 1993.

The EITC expansions were also designed to obtain a goal that has broad bipartisan support that if a parent works full time, year-round, the parent should not have to bring up the children in poverty.

One of the first places this was written down was actually in a volume the Heritage Foundation published in January 1989 to guide President Bush when he came in. Heritage called for expanding the EITC enough to bring families of four with a full-time worker to the poverty line without raising the minimum wage. That essentially has been the thrust of these policy expansions.

As a result of that, as Assistant Secretary Samuels said, these expansions really were not out-of-control growth. They were not an anticipated growth. Once the 1993 expansion fully phases in, the credit drops to about a 4-percent-per-year growth rate which is inflation and population growth.

If the Bureau of Labor Statistics modifies the consumer price index, the EITC growth rate would drop a bit further.

The final point on this issue is that these expansions in the credit do not look quite so large when you put them in the context of what happens to the minimum wage and to the EITC and to AFDC. What this board shows you is that if you take a mother with two children who works 20 hours year-round at the minimum wage to 40 hours—anywhere from half time to full time year-round at the minimum wage—her disposable income today, when the EITC expansion passed in 1993 fully phases in, is $1,500 to $3,000 lower than it was in 1972, before the EITC was created.

The reason is that the withdrawal of AFDC and the erosion of the minimum wage and the increases in the payroll tax more than balance out the entire EITC.

This is a reason both why I think in reforming the credit we need to be very careful not to do things that make the gain from working less, and the gains from working relative to welfare less. I think that means not scaling back the 1993 expansion, not deindexing the credit. It is also the reason why Governors, like Governor Engler in Michigan, and Governor Carlson in Minnesota—both of whose welfare commissioners I have talked to in the last week or so about this—both regard the EITC and the EITC as passed in 1993 as a very important part of the welfare reform to move families to work that they are trying to implement in their States.

A couple of quick words on the work incentive point that Dr. Kosters has raised. I also think the work incentive point needs to be looked at carefully in terms of who the people are that the EITC encourages to work more and who it may encourage to work less.

As Dr. Kosters just noted, and I think as Congresswoman Johnson noted earlier, the economic literature suggests that people whose earnings are in that range from zero up to about $8,900 are encouraged to work more because as they work more their credit goes up and that there may be encouragement to work a bit less where the EITC line is coming down.

However, as Bob Reischauer, the CBO Director, noted in 1990 and as virtually every study on this issue has found, the principle group who is encouraged to work less are secondary earners in two-earner families. In nontechnical terms, the additional income the EITC provides enables some mothers in two-parent working families to choose to spend more time with their children.

That is the principal work discouragement of the EITC. As Reischauer noted, that is not necessarily an adverse policy.

Finally, the studies that Marv referred to and I think the Congresswoman referred to, most of them only covered the effect of the credit on people who were already working. New studies, which I guess Professor Scholz will talk about, also look at, for the first time, the effect of the credit on people who otherwise would not work at all, and find that it brings a significant number of them into the work force.

In summary, on the work incentives, we have people who otherwise are not in the work force at all encouraged and brought into work and brought into the labor market; people, primarily single parents, working very little, encouraged to work more; and primarily secondary earners, mothers in married, two-parent families enabled to spend a little more time with their children.

I do not think you can simply lump those altogether, and say the effect is not positive. There is a similar issue—which I am out of time so maybe I will cover during the questions—on the marriage penalty. In two sentences, it is a marriage penalty for two earners thinking about marrying each other.

The EITC also provides a big marriage bonus for welfare mothers who, otherwise when they marry, they lose all their welfare, they may lose all their Medicaid. But if a nonworking welfare mother marries a guy at a $10,000 or $12,000 wage neither can get a major EITC now. They marry and they qualify for the first time. He is earning and she has kids and it actually greatly lessens the disincentives to marry otherwise in the welfare system.

Again, we got to be careful. It is a marriage penalty for some, that is a problem. It is a marriage bonus for the group most want to encourage to marry, people who can get off welfare by getting married and are, without the EITC, discouraged from doing so.

The last point I want to make is that there has been some discussion of the workers without children. Before Congress extended the small credit to workers without children in 1993, the CBO data shows from 1980 to 1993, the Federal tax burdens of the poorest one-fifth of nonelderly households without children jumped 38 percent. The reason was that those eight payroll tax increases and several excise tax increases for families with children were offset by expanding the EITC. The tax burdens of workers without children went through the roof. The 1993 extension of a small credit to workers without children, was designed to help offset that, if we are concerned about having very high Federal tax burdens on any low-income workers, those with children and those without.

Thank you.

[The prepared statement follows:]

TESTIMONY OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR
CENTER ON BUDGET AND POLICY PRIORITIES

House Committee on Ways and Means: Subcommittees on Oversight and Human Resources
June 15, 1995

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.

- Progress in reducing EITC errors was made in the 1990 reconciliation bill, but more needs to be done. This year, the IRS has taken some badly needed steps that appear to be producing significant error rate reduction. Legislation the Treasury Department submitted with the budget also should help reduce errors. Efforts are needed to identify additional steps to lower error rates.

- While seeking to reduce EITC error rates, we should be mindful that the EITC has major strengths. It addresses a key trend that has caused a substantial increase in child poverty in recent years, the erosion of wages for low-paid work. The EITC 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. Consideration should be given to counting some additional types of income in determining whether a filer meets this test if doing so would not add too much complexity. 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 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; it also would conflict with the goals of work-based welfare reform. Rolling back the EITC changes enacted in 1993 would be undesirable as well, reducing the advantages of work over welfare, making it more difficult for workers to escape poverty, and raising tax burdens for some.

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. 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 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. Next year, it will be at its lowest level since 1955.

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. The CBO and Joint Tax Committee forecasts show that once the EITC expansions phase in fully by fiscal year 1997, EITC growth will slow sharply to a little more than four percent per year, with that remaining growth being due to inflation and growth in the U.S. population. Moreover, the EITC growth rate will be smaller than this 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.

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, average AFDC benefits, food stamps, and the EITC, minus federal income and payroll taxes.)

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.

The EITC expansions 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.

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	-$2,471	-$1,595
	-21%	-16%	-13%

Source: Department of Health and Human Services

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

EITC Error Rates

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 GAO subsequently commented favorably on these changes, noting that they "should substantially reduce the number of erroneous EITC claims."[1] But the changes enacted in 1990 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.

The IRS study found that 26 percent of the EITC benefits claimed by filers whose returns were examined were claimed in error. This does not mean that the EITC loss rate was 26 percent. The IRS found that about 26 percent of the EITC benefits *claimed* on the tax returns it examined were claimed in error, not that 26 percent of the benefits actually *paid* were erroneous. The IRS detects some erroneous claims made on tax returns and avoids making overpayments on them. The actual overpayment rate in January 1994 would have been somewhat lower than 26 percent.

The 26 percent figure also may 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. These changes appear to be lowering the error rates.

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, in 1994 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 now also 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 them. These filers could still receive 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.

Effects of These Actions

A new IRS study released last week indicates that if the procedures instituted this year had been in place in 1994, the January 1994 study would have found an error rate of less — and possibly significantly less — than 19 percent.

The IRS was able to determine the effect that some, but not all, of the new procedures (principally the procedures relating to Social Security numbers) would have had if they had been in effect in January 1994. The IRS found these procedures would have reduced the overclaim rate from 26 percent to 19 percent. The IRS was not able to measure the effect of the procedures instituted this year to delay those EITC claims that fall into an error-prone category while the IRS investigates and directs the filer to provide verification of certain aspects of the EITC claim. Had IRS analysts been able to factor in the effects those procedures would have had, the new procedures instituted this year would almost certainly have been found to have reduced the overclaim rate in the January 1994 sample below 19 percent.

Some long-overdue change in the processing of tax returns claiming the EITC is now occurring. Prior to 1991, the IRS did not obtain much of the basic information that establishes whether a family is eligible for the credit. Such information is now captured on Schedule EIC, which was introduced in 1991. And until this year, the IRS made limited use — before making EITC payments — of the information it did receive. This is now changing.

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 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 how 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 director of the Congressional Budget Office, and Henry Aaron, Director of Economic Studies at the Brookings Institution, made this point at an American Enterprise Institute symposium 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 noted 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 observed 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 GAO 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.[2]

In addition, the GAO study and most other previous studies examined the EITC's effects *only on those already in the labor force*. These studies did not examine whether the EITC draws non-workers into the labor force. New research by John Karl Scholz of the University of Wisconsin indicates the EITC has a strong positive effect in inducing single mothers outside the labor force to and begin working. The research of Scholz and his colleagues 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.[3]

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.[4]

In Congressional testimony before this Committee in 1993, the GAO succinctly summarized the EITC's effect on work. The GAO stated: "[The earned income tax credit] works. It offsets payroll taxes, increases progressivity of the tax system, and provides a positive work incentive to the lowest income group with only a slight disincentive to other recipients."

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.

In arguing that the EITC imposes a large marriage penalty, some critics cite a hypothetical case involving two potential marriage partners, each of whom is a custodial parent with at least two children living with them and each of whom earns about $11,000. This hypothetical case does not provide a satisfactory basis for policymaking. It is the hypothetical case in which the marriage penalty is greatest and is exceedingly rare in the real world.

There are few cases in which two people who wish to marry each other are both custodial parents who each live with at least two children and each have incomes in this range. Most male single parents are *not* custodial parents, are not eligible for a significant EITC benefit, and do not lose EITC benefits if they marry.

Census data indicate that of all marriages that occurred in 1990, *fewer than two-tenths of one percent* involved a man with two or more children marrying a woman with two or more children. The likelihood of such a marriage in cases in which both parties are custodial parents *and* also have incomes around $11,000 appears to be close to zero.

This does not mean the marriage penalty issue is not significant. But more typical examples should be considered when assessing the potential effects of the EITC on marital formation. 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 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 male earning $10,000, the EITC benefit in 1996 would drop $82. If she marries a man earning $15,000, the EITC would decline $881. (These figures are for 1996, when the EITC changes enacted in 1993 are phased in fully.)

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 sizeable 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

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.

I am concerned, however, that a number of EITC proposals now emerging in Congress are not compliance provisions designed to reduce error rates. Some emerging 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 live in poverty if a parent works full time throughout the year. 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 earns[5] 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.

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*. This dwarfed the increase in tax burdens borne by any other group of households in any income category. By 1993, the percentage of income that the poorest fifth of non-elderly households without children was 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.

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 (in 1996) and phases out when income reaches $9,500.

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.

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.

Families with children also would be affected significantly. Eight million families with two or more children would lose 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 lessened.

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 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 indexation 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.

Ending indexation of the EITC would be unwise. 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.

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.

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.

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 reducing 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?

Additional forms of income probably should count against this limit *if* this cannot be done without making the EITC too complex. (Increasing the complexity of the credit is a sure way to push error rates back up.) Some have proposed counting estate and trust income, net passive business income, and net capital gains income against this limit. This proposal appears sensible if it does not add too much complexity.

On the other hand, I would not recommend lowering the threshold from $2,350 to $1,000, as has also been suggested. 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, start a business, 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 families saving to make an investment in their future to choose between losing their EITC and consuming enough of their savings to remain below the EITC limit.

A preferable approach would be to reduce the $2,350 limit modestly to $2,000 and index it for inflation. (Whatever the level at which the threshold is set, 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

Senators Roth and Nickles have 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. The argument for counting Social Security is that Social Security benefits represent income these families receive, and this income makes these families less needy. Among the arguments against this proposal are that counting Social Security benefits as part of AGI when determining EITC eligibility and benefit levels would effectively subject Social Security beneficiaries who are raising children to larger taxes on their Social Security benefits than some other Social Security beneficiaries with higher incomes. In addition, counting *all* of Social Security as part of adjusted gross income for EITC purposes could be problematic because a portion of Social Security benefits represents a return of payments that beneficiaries made from income on which they have already paid taxes.

While there are pros and cons to this proposal, it will be difficult to justify it if the provision enacted in 1993 that makes 85 percent of Social Security benefits taxable for more affluent beneficiaries is 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 increasing tax burdens on Social Security beneficiaries at lower income levels.

Counting child support as part of AGI for EITC purposes would be ill-advised. 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. Consequently, such a proposal would be difficult for the IRS to enforce and almost certainly would result in higher error rates. The General Accounting Office recently noted the difficulties of administering a requirement of this nature.

Counting child support in this 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

Steps have been taken in recent years to reduce EITC error rates. More needs to be done. Some other changes in the EITC also may warrant consideration.

But we should not lose sight of the EITC's strong 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.

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 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 phased in fully, 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 deep reductions in the EITC benefits of honest low-income working families would not represent sound policy.

End Notes

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

2. General Accounting Office, September 1993.

3. John Karl Scholz (University of Wisconsin, Madison), testimony before the Senate Governmental Affairs Committee, April 5, 1995; and Stacey Dickert, Scott Houser, and John Karl Scholz, "The Earned Income Tax Credit and Transfer Programs; A Study of Labor Market and Program Participation," November, 1994.

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

5. 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.

Chairman JOHNSON. Thank you very much for your testimony, Mr. Greenstein.

Next will be Mr. Steuerle.

STATEMENT OF C. EUGENE STEUERLE, PH.D., SENIOR FELLOW, URBAN INSTITUTE, WASHINGTON, DC

Mr. STEUERLE. Thank you, Madam Chairperson. It is an honor to work again with these Subcommittees on this issue. I, as Mr. Gibbons, have a bit of age on this issue. I worked on the issue as long ago as 1978 when we tried to simplify the EITC so that we could get it to more eligible people. In the tax reform effort in 1984–86, I introduced indexing into the Treasury proposals at that time as a means of increasing the EITC. I am honored again to work with you on this issue.

My own conclusions to date can be summarized as follows, first the EITC represents an important step in my view in society's attempt to find an alternative to welfare. Second the EITC can best be assessed against alternatives to help low-income households and workers, but not really as a stand alone provision. Third, as currently designed, I have serious questions whether the EITC can be fully enforced by the IRS. And finally, EITC reform can be better accomplished within broader reform of our tax and transfer structures.

I will try to speak very briefly on each of those points. The EITC was expanded substantially in the Tax Reform Act of 1986 and in the budget agreements of 1990 and 1993.

Interestingly, the Clinton administration likes to claim the EITC expansions as one of its major achievements. In fact, the largest expansions of the EITC occurred under Presidents Reagan and Bush, at least when measured in terms of total costs.

Over the years the EITC has been argued to fulfill several purposes. One is to provide assistance to low-income individuals; a second to provide work incentives; and third, more recently it has been contrasted favorably to increases in the minimum wage.

The EITC does not meet any of its goals perfectly. As a compromise, however, it often meets its combined goals better than other alternatives including a pure welfare system and mandates on employers such as minimum wage increases.

The history of the EITC makes it clear that as an incremental step toward a different design of our combined tax and transfer system what makes the EITC distinct and unique and different from the welfare systems is its requirement that at least some income be earned in order to receive the credit. In a sense the phase-in range for the credit is nothing more than a rough work test.

Does this EITC create distortions? Well, as an economist I would have to argue of course it does, as do all taxes and transfers. On net, is it a positive work incentive for the population as a whole? I find that highly unlikely especially when one takes into account the taxes being paid by the taxpayers who have to support the system.

This argument, however, I believe begs the question on the EITC. It is less clear that providing say, $3,000 of earned income credit to someone who earns a modest income is any less of a work disincentive than providing $3,000 of pure welfare benefits to someone who does not work at all.

Moreover, among those who might be given the greatest additional incentives to work are those welfare recipients whose participation in the work force would integrate them more fully into the rest of society—a point just emphasized by Mr. Greenstein.

Unfortunately, as currently designed, I do have serious doubts that the EITC can be fully enforced by the IRS. As best as I can tell there have been three major sources of noncompliance with the EITC.

The first had to do with individuals claiming the EITC even when they had not provided adequate information to meet various support tests and similar eligibility criteria. A second source of noncompliance derived from excessive claims on number of children, a discussion you had quite extensively with the previous panel.

My impression is that the IRS and Treasury, along with recent and proposed Congressional reforms, are going a long way to deal with these two particular problems. A final problem, however, is more fundamental. Now that the EITC rate is substantially in excess of all Federal tax rates, including the Social Security tax, there is a powerful incentive for households not in the welfare system to overdeclare earnings even when there are none. This incentive is gradually creating what I call a new superterranean economy.

The IRS audits only a minor fraction of returns. Even if it audited everyone it would be very difficult to disprove whether self-employment income was real or fictional. Moreover, in some cases legal work creation becomes profitable, as when neighbors simply exchange babysitting and then claim the EITC.

It is unclear how far this problem has developed to date. Nonetheless, I believe that it is crucial that the problem be attacked sooner rather than later.

My final point is that the EITC reform can be better accomplished within broader reform of our tax and transfer structure. Reform of these systems as they apply to low-income individuals is almost never attempted on a comprehensive basis. As one consequence, the combined tax rate on AFDC recipients is still extraordinarily high, in excess of 70 percent at one times minimum wage; at two times minimum wage, and even at three times minimum wage.

More comprehensive reform would allow one to try to deal with these complex interactions—for instance, by trying to integrate together the child credit that is in the tax bills in Congress with the EITC. This issue was discussed with you by Congressman Petri, John Forman has also got some suggestions along these lines.

Barring this more comprehensive approach something still must be done about potential overdeclarations of income. Someone besides the taxpayer, in particular in the case of self-employment income, has to be involved in the monitoring of the declarations of income. For tax systems traditionally that has been the employer who reports income to the IRS and for welfare systems that has traditionally been local welfare agencies.

In sum, the EITC is not a perfect program. It represents a compromise among many competing goals. Its current design may represent merely a step toward replacing welfare with a broader support system more oriented toward work. At a minimum, the EITC today must be reformed to avoid the creation of a larger super terranean economy where overdeclarations of earnings can generate excessive claims for the credit. Ideally reform would be considered along with other welfare and tax reforms including any child credits that might be considered by Congress at this time.

Thank you.

[The prepared statement and attachments follow:]

STATEMENT OF C. EUGENE STEUERLE, PH.D. SENIOR FELLOW, THE URBAN INSTITUTE, WASHINGTON, D.C.

Mr. Chairman and Members of the Committee

Among the many provisions being considered for reform this year is the earned income tax credit (EITC). In size and scope the EITC has become one of the most important elements of the nation's combined tax/transfer scheme applying to low-income individuals. A major reason for its expansion is that the EITC generally has obtained bipartisan support within the context of major tax and budget reforms. I myself introduced EITC indexing into the 1984 Treasury proposals leading up to tax reform in 1986. It is not surprising that after such a period of legislative expansion, we would begin a more in-depth examination of the credit. An important part of that examination relates to how well the credit fulfills its various goals and whether there are alternative or better ways of fulfilling the same objectives. My own conclusions can be summarized as the following:

(1) As a society, we are engaged in a fundamental, but difficult, attempt to try to find alternatives to welfare. The EITC, as a device to try to make work more attractive than welfare, represents an important step in that direction.

(2) All transfers and taxes distort some choices, and the EITC is no exception. The EITC can be best assessed against alternatives that attempt to help low-income households and workers, not as a stand-alone provision.

(3) As currently designed, the EITC cannot be fully enforced by the IRS and, to deter abuse, must be supplemented by further restrictions or restructured.

(4) EITC reform often can better be accomplished within broader reform of our tax and transfer structure.

<u>Background</u>

The growth of the EITC in recent years has been relatively swift; indeed, it has been perhaps the fastest growing of all federal budget items whose growth is due to recent legislative action. Table 1 traces some of that growth. As can be seen, the credit was expanded substantially in the Tax Reform Act of 1986 and the budget agreements of 1990 and 1993. Interestingly, the Clinton Administration likes to point to the EITC expansion as one of its major accomplishments, while some critics like to blame this Administration for any defects of the credit. Yet the largest expansions of the credit took place under Presidents Reagan and Bush -- at least when measured in terms of total cost.

Over the years, the EITC has been argued to fulfill several purposes. One is simply to provide assistance to low-income individuals. In this regard, it has achieved modest success, as can be seen in the antipoverty statistics of Table 2, although it pales in comparison with social insurance programs such as Social Security. Of course, the EITC is targeted to many low-income families whose income is in excess of the fairly low, official poverty levels.

A second purpose of the EITC is to provide an offset to Social Security taxes and, perhaps, other federal taxes. For most families today, the combined employer and employee Social Security tax rate is more important than the income tax rate. It is not hard to understand why: the Social Security tax rate is 15.3 percent on all earnings, while personal exemptions and standard deductions set tax-exempt amounts that insure that low-income individuals pay almost no income tax. For incomes in excess of tax-exempt amounts, the income tax rate for most taxpayers is 15 percent only on the excess amount.

The EITC expansions of 1990 and 1993, however, could not be justified as offsets to federal taxes. The rate of credit was scheduled to rise as high as 25 percent under the 1990 agreement and as high as 40 percent under the 1993 agreement (see Table 3). Since most individuals at low-income levels do not pay income tax, and the Social Security tax rate is 15.3 percent, the EITC pays out far more to many individuals than they pay in any form of federal tax.

While the 1990 and 1993 reforms mainly increased the rate of credit, they made some other changes as well, such as an expanded credit for families with more than one child and a reformed definition of eligibility that was based more upon the home in which a child resided and less upon the amount of monetary support provided. These reforms did not change fundamentally the structure of the EITC system, the income levels at which a maximum credit would be reached, and the levels at which no credit would be made available.

A final rationale for the credit was to provide work incentives. Here, the target was primarily individuals who were on or who might otherwise receive welfare. The connection to other types of transfers -- in particular, Aid to Families With Dependent Children (AFDC) -- is made fairly obvious by the restriction of the credit primarily to families with children. This work incentive goal cannot really be separated from the broader transfer and antipoverty goals. That is, the EITC cannot be justified as work incentive alone, but only as an alternative to other mechanisms to try to make transfers to low-income individuals.

Although comparisons to AFDC have been made throughout the history of the credit, more recently it has also been contrasted favorably to increases in the minimum wage. Many economists believe that increasing the minimum wage reduces the jobs that would be made available to workers whose productivity is between an existing minimum wage and some, new, higher level. Analyses of minimum wage workers, moreover, show that many of them are in middle-income families: older workers with assets and pension income, and married couples where one spouse already works at much higher wages. Accordingly, the EITC has received much support as an alternative not only to welfare, but to minimum wage increases. In this regard, some health reform proposals, such as that of President Bush in 1992, included a health credit modeled largely after the EITC. Again, the argument was that such a credit would be superior to the implicit increase in the minimum wage that would follow a mandate on employers to buy health insurance.

In sum, the EITC does not meet any of its goals perfectly. As a compromise, however, it often meets the combined goals better than other alternatives, including a pure welfare system and mandates on employers.

From Welfare to a Work-Oriented Support System

Whether as a transfer to low-income individuals, an offset to other federal taxes, or a better subsidy than pure welfare or employer mandates, the history of the EITC makes it clear that it is an incremental step toward a different design of our combined tax/transfer system, as it applies to low-income individuals. Indeed, budget accounting uniquely counts separate portions of the EITC as both tax reduction and expenditure outlay -- demonstrating, once again, the need to view our tax and transfer systems in an integrated fashion.

What makes the EITC different from most welfare systems is its requirement that at least some income be earned in order to receive the credit. In a sense, the phase-in range for the credit is nothing more than a rough work test. Relative to welfare that pays the highest benefits to those with no earnings or income, the phase in of the credit has been designed to provide a maximum benefit at income levels approximating a full-time minimum wage job.

Recent years have witnessed several attempts to convert our welfare system more into a work-oriented support system. EITC expansions are only one example. Mandates that welfare recipients work and attempts to time-limit welfare are others. So also are targeted jobs credits and attempts to increase so-called disregard (minimum amounts of income that can be earned without loss of welfare benefits). None of these mechanisms, unfortunately, has solved many of the complex problems related to work and marriage penalties in transfer programs. Nonetheless, I would hate to see us reverse course and go back toward a purer welfare system. We seem to be in a transition stage, but without a clearcut map on how we will continue to proceed.

EITC Distortions and Effects on Work

Does the EITC create distortions? Of course it does, as do all elements of our tax and transfer system. On net, is it a positive work incentive for the population as a whole? Highly unlikely. All transfers are backed up by taxes -- first, by direct taxes to support the system, and, second, by indirect taxes when benefits are phased out as the income of beneficiaries increases. On net across all of society, the financing of transfer systems will tend to increase the potential taxes or losses from working more to a greater extent than the transfer might increase the potential gains to some individuals from working more. Of course, the eventual effect on labor force participation depends greatly on response rates to such incentives.

This argument, however, begs the question. If we as a society are committed to providing some minimal levels of well-being to individuals, especially children, then it is much less clear that providing, say, $3,000 of EITC benefits to someone who earns a modest amount of income is any less of a work disincentive than providing $3,000 of pure welfare benefits to someone who doesn't work at all. The EITC can best be assessed, therefore, against other alternatives that are designed, in part, to provide transfers to low-income individuals. Moreover, among those who might be given the greatest additional incentive to work are those welfare recipients whose participation in the workforce would integrate them more fully into the rest of society.

Compliance and the Superterranean Economy

Unfortunately, as currently designed, I doubt seriously that the EITC can be fully enforced by the IRS. The question of abuse, however, is a complex one that is easily confused because there have been several potential sources of abuse, some of which have been dealt with and some not.

Although the data from the IRS are incomplete, as best as I can tell, there have been three major sources of noncompliance with the EITC. The first had to do with individuals claiming the EITC even when they had not provided adequate support to meet support tests and similar eligibility criteria in the tax system. Some recent reforms went a long way to correcting this problem by changing some of the eligibility criteria and making the primary test the presence of the child within the home of the claimant. I should mention that the complex support tests and head of household tests in the current tax law remain a source of confusion and error even beyond the EITC.

The second source of noncompliance derived from excessive claims of children (and even fictional adults) within the household. Again, while the jury is partly out on the size of this problem that remains, my impression is that the IRS and Treasury have made considerable headway toward solving this problem, and that both Congress and the Administration will probably support some further procedures to insure the validity of social security numbers of taxpayers and their claimed children.

A final problem, however, is more fundamental. In normal tax and transfer systems, there is a tendency to underdeclare income to avoid taxes and the loss or phase out of benefits as incomes rise -- creating what is sometimes called the *subterranean* economy. Now that the EITC credit rate is substantially in excess of the Social Security tax rate -- that is, in excess of the only direct tax paid by many EITC recipients -- there is a powerful incentive for households not in the welfare system to overdeclare earnings even when there are none. This incentive is gradually creating a new *superterranean* economy.

Since the IRS audits only a very minor fraction of returns, usually much less than 1 percent of returns of low-income individuals, it is very difficult for it to monitor superterranean economy work that never takes place. Even if it audited everyone, it is very difficult to disprove that whether self-employment income was real or fictional. Moreover, in some cases, legal work creation becomes profitable, as when neighbors exchange babysitting for each other in order to benefit from the credit.

It is unclear how far this problem has developed to date. Welfare recipients, for instance, may still lose more than they gain from overreporting income. In this regard, let me note that the research on EITC noncompliance to date is inadequate and has been inadequately designed to get at the extent of some of these problems. Nonetheless, I believe that it is crucial that the problem be attacked sooner, rather than later. To deter further abuse, the EITC must be supplemented by further restrictions or partially restructured.

EITC Reform Within the Broader Tax and Transfer Structure

EITC reform often can better be accomplished within broader reform of our tax and transfer structure. The simple fact is that reform of these systems, as they apply to low-income individuals, is almost never attempted on a comprehensive basis. Most tax/transfer reforms, including of the EITC, have traditionally not been comprehensive, but, instead, have represented patches onto the existing system. As one consequence, as shown in Figure 1, the combined tax rate on AFDC recipients who take minimum wage jobs is still extraordinarily high -- even if one assumes full implementation of EITC expansions adopted in 1993. And that rate remains above 70 percent at 1 1/2 times, 2 times, even 3 times minimum wage. What that means, more generally, is that work in the formal sector still doesn't pay much, making occasional work in the informal sector a better deal, despite recent EITC expansions.

More comprehensive reform would allow one to try to deal with complex interactions among programs, for instance, by trying to integrate together the child credit that is in tax bills in Congress with the EITC in ways that would reduce the very strong penalties on work and marriage in the current system. A more universal child credit, for instance, might be combined with an EITC phased in at a rate equivalent to the Social Security tax rate.

Barring this more comprehensive approach, something still must be done about potential overdeclarations of income. Someone beside the taxpayer has to be involved in the monitoring of declarations of income. For tax systems, traditionally that has been the employer who reports income to the IRS; for welfare systems, local welfare agencies have served as monitors.

Underreporting in the traditional tax system has always been a serious problem for independent contractors, sole proprietors, and some self-employed precisely because there is no one else keeping books on the same transactions. This same group is the one for whom potential overdeclaration of income would be hardest to audit.

An EITC with a subsidy rate of 15.3 percent might also be combined with a employer job credit that was required to be passed on to employees, but was refundable only to the extent of other taxes paid over by the employer to the IRS. Thus , total EITC might be limited by amount of tax payments made by a company on its behalf and as withholdings on employees. Or for those with minimal income tax liability, some form of earnings supplement might be made available through welfare agencies.

Again, I do not wish to imply that a more administrable system will not entail costs or a loss of benefits to some individuals. But the current system, in my view, is unsustainable because it has no basic way to audit or enforce compliance on the overreporting of earnings. If we keep building on this system of subsidizing jobs -- a task that could well be taken up by the states with block grant money -- we must develop better administrative mechanisms.

Conclusion

Relative to pure welfare systems and many types of employer mandates, the EITC represents an attempt to increase transfers to low-income individuals without some of the extraordinary work penalties of traditional welfare or some of unemployment and other costs imposed on low-income workers by minimum wage increases and other mandates imposed on employers.

The EITC is not a perfect program. It represents a compromise among many competing goals. Its current design may represent merely a step toward replacing welfare with a support system better oriented toward work. At a minimum, the EITC soon must be reformed to avoid creation of a superterranean economy where overdeclarations of earnings generate excessive claims for the credit. Ideally, its reform would be considered along with other welfare and tax reforms, including any child credits that might be provided.

Table 1

AMOUNT OF EARNED INCOME TAX CREDIT
Total Amount of Credit
($ billions)

Year	Pre-1986	1986 Reforms	1990 Reforms	1993 Reforms
1975	1.3	-	-	-
1980	2.0	-	-	-
1985	2.1	-	-	-
1990		7.5	-	-
1995		11.1	20.0	24.8
1998		12.9	23.0	30.4

SOURCES: Janet Holtzblatt, Janet McCubbin, & Robert Gillette, "Promoting Work Through the EITC," National Tax Journal XLVII, September 1994.

Table 2

ANTIPOVERTY EFFECTIVENESS OF CASH AND NEARCASH TRANSFERS: 1993

	All Persons	Persons in Families with Children
Total Population (thousands)	**259,588**	**144,754**
Number of poor individuals (thousands)		
Cash income before transfers	59,901	32,244
Plus social insurance	42,116	28,753
Plus means-tested cash transfers	38,963	26,726
Plus food and housing benefits	30,794	20,183
Less Federal taxes	33,442	22,183
Plus EITC	28,898	17,750
Number of individuals removed from poverty due to (thousands)		
Social insurance	17,785	3,491
Means-tested cash transfers	3,153	2,027
Food and housing benefits	8,170	6,543
Federal taxes	-2,648	-2,000
EITC	4,544	4,453
TOTAL	31,003	14,494

SOURCE: Sandra Clark and Sheila Zedlewski, The Urban Institute. Based on data from the March 1994 Current Population Survey. Assumes full implementation of EITC changes due by 1996, but population, poverty, and income levels in 1993.

Table 3
EARNED INCOME TAX CREDITS PARAMETERS: PRE-1990 LAW, 1990 LAW, AND 1993 LAW
(All $ amounts are in 1994 dollars)

PRE-1990 LAW

	Credit Rate	Up To	Maximum Credit	Phase-out Rate	Phase Out Range Beginning At	Phase Out Range Ending At
1990	14%	7,990	1,119	10.0%	12,580	23,760
1994 and after	14%	7,990	1,119	10.0%	12,580	23,760

1990 LAW

	Credit Rate	Up To	Maximum Credit	Phase-out Rate	Phase Out Range Beginning At	Phase Out Range Ending At
1991						
1 kid	16.7%	7,990	1,334	11.9%	12,580	23,760
2 kids	17.3%	7,990	1,382	12.4%	12,580	23,760
1992						
1 kid	17.6%	7,990	1,406	12.6%	12,580	23,760
2 kids	18.4%	7,990	1,470	13.1%	12,580	23,760
1993						
1 kid	18.5%	7,990	1478	13.2%	12,580	23,760
2 kids	19.5%	7,990	1558	13.9%	12,580	23,760
1994 and thereafter						
1 kid	23.0%	7,990	1838	16.4%	12,580	23,760
2 kids	25.0%	7,990	1998	17.9%	12,580	23,760

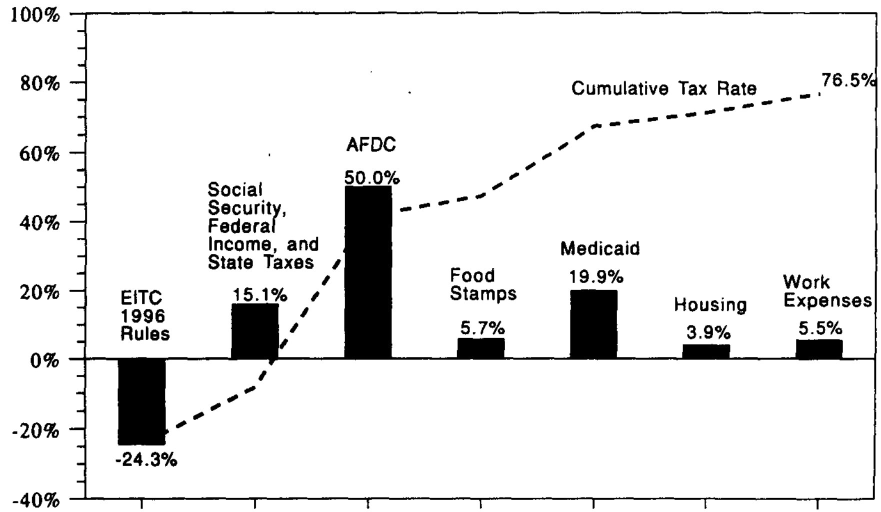
1993 LAW

	Credit Rate	Up To	Maximum Credit	Phase-out Rate	Phase Out Range Beginning At	Phase Out Range Ending At
1994						
1 kid	26.3%	7,750	2,038	16.0%	11,000	23,755
2 kids	30.0%	8,400	2,520	17.6%	11,000	25,300
No children	7.7%	4,000	306	7.7%	5,000	9,000
1996 and thereafter						
1 kid	34.0%	6,000	2,040	16.0%	11,000	23,755
2 kids	40.0%	8,400	3,360	21.0%	11,000	27,000
No children	7.7%	4,000	306	7.7%	5,000	9,000

C. Eugene Steuerle and Gordon Mermin, THE URBAN INSTITUTE

Figure 1: Tax Rate on Minimum Wage Job

By Source of Income Loss - Long-Term
Sample: All AFDC Households



Bars show proportion of income from a transition to full-time, minimum wage work that would be lost due to taxes and changes in benefits from the indicated programs. Tax credits for workers shown as negative. Sample weighted by (household weight)*(change in earnings).
Source: Linda Giannarelli and C. Eugene Steuerle, THE URBAN INSTITUTE.

Chairman JOHNSON. Thank you very much.
Mr. Scholz.

STATEMENT OF JOHN KARL SCHOLZ, PH.D., ASSOCIATE PROFESSOR, DEPARTMENT OF ECONOMICS, LA FOLLETTE INSTITUTE OF PUBLIC AFFAIRS; AND INSTITUTE FOR RESEARCH ON POVERTY, UNIVERSITY OF WISCONSIN-MADISON

Mr. SCHOLZ. Thank you, very much, Madam Chairman and Members of the Committee, for inviting me to testify on the effectiveness and design of the EITC. The EITC plays a central role in policy as it affects the working poor. Over the past 20 years there has been a striking change in the bottom of the Nation's earnings distribution, beginning in the seventies but accelerating over the eighties.

In 1973, the median male, without a high school diploma earned $24,000. By 1989, the median worker with the same level of education earned nearly $10,000 less in constant dollars. The trend is nearly dramatic for males with only a high school degree. The erosion of the Nation's labor market opportunities for people with low levels of education has placed enormous strains on the Nation's antipoverty program. Against this backdrop, the EITC has provided an important supplement to the earnings of low-skilled workers.

Many low-income families are not required to file a tax return even though by filing they may receive the EITC. If the credit is to be successful at meeting the objective of making work pay, families who are eligible for the credit should receive it. The best available evidence suggests that that indeed happens to a large extent; the participation rate of the EITC is around 80 to 86 percent.

The participation rate of the credit is strikingly high when compared to the AFDC and food stamp participation rates. The United Kingdom has an EITC-like program called the family credit administered through the transfer system and directed toward families with children. Official estimates place the participation rate of the family credit at only around 50 percent. Thus, both compared to the other inkind transfers in the United States and comparable work-related benefits in the United Kingdom, the EITC gets high marks for reaching those who are eligible for the benefit. This is the primary advantage of administering the EITC through the income tax system.

Nearly 50 percent of EITC payments by 1996 will go to taxpayers with incomes below the poverty line, and 36 percent of total EITC payments, more than $6 billion, will directly reduce the poverty gap—the difference between total cash income and the poverty line. More than 75 percent of EITC benefits go to taxpayers with wages that would place them in the bottom 25 percent of all workers with children. That is below $7.30 an hour. Thus, the EITC is well targeted.

As people have mentioned, the EITC has different labor supply incentives depending on where the taxpayer's income is relative to the subsidy, flat and phaseout ranges of the credit. The subsidy range of the credit provides mixed incentives to work; the flat and phaseout ranges provide an unambiguous incentive to reduce hours of work. Most EITC recipients are in these ranges which raises the concern that the EITC may lead to a net reduction in the work effort of low-income workers. As Marv mentioned, this concern is borne out in studies on this issue.

The economic magnitude of these effects is small. The estimates that I deem most reliable suggests that the average reduction in hours worked, will be around 11 per year or one-half a percentage point of their total annual hours.

Moreover, to the extent that taxpayers are unaware of the effects of the credit on aftertax wages, both the positive effects of the credit and the subsidy range, and the negative effects of the credit on taxpayers in the phaseout range are overstated.

In sum, the best available empirical evidence suggests that the EITC has a small but detrimental effect on the hours of workers. The credit exerts unambiguously positive labor market incentives on the decisions of whether or not to work.

The empirical work on this topic shows that the increase in net wages, provided by the EITC, positively affects labor market participation and negatively affects public assistance participation, particularly among single parents.

This increase in participation is likely to offset or more than offset the reduction in hours worked. The evidence suggests that the EITC probably will, in aggregate, increase the hours worked by low-income people, but the positive effect is likely to be small. Thus, the EITC is not a magic bullet solution to the problems of low-wage labor markets.

At the same time, the modest positive labor market effects of the EITC should be contrasted to the detrimental effects on both labor market participation and hours of work associated with other income transfer programs.

In the past years, a large number of ineligible taxpayers claimed the EITC according to unpublished data from the IRS Taxpayer Compliance Measurement Program. In 1988, over 30 percent of EITC claimants were ineligible; roughly one-third of the dollar claims were inappropriate.

The GAO testified in 1993 that the credit has been the source of more taxpayer mistakes than any other individual income tax provision.

The future viability of the EITC depends on the ability of the IRS to reduce noncompliance. Doing so requires two distinct tasks. First, programs must be put in place to detect accurately and report the degree of noncompliance and its causes.

I was pleased to read IRS Commissioner Richardson's testimony that the IRS will be doing a detailed EITC compliance study that is to be completed in 1995. Without credible numbers on the EITC noncompliance and evidence about the source of noncompliance, it is difficult to design policy to address the problem.

The IRS has now taken the second step needed to address noncompliance and that is giving greater scrutiny on verifiable items on tax returns. The IRS created an uproar this filing season due to refund delays as it reviewed SSNs more closely.

Nevertheless, this effort together with matching employee and employer W–2 reports seem to be the best way of combatting the noncompliance that jeopardizes the program.

As long as the credit is based on items the IRS is able to verify there is nothing inherent in the credit that would lead to unusually high levels of noncompliance. Moreover, other areas of the Tax Code, for example, schedule C also have large amounts of noncompliance associated with them.

As a matter of sound policy, the costs of reducing noncompliance in every aspect of the Tax Code should be compared to its benefits, so the IRS uses taxpayer resources in as efficient a way as possible.

Just to conclude, the erosion of the bottom of the Nation's labor market imposes a pressing policy problem. The EITC is a sensible, well-targeted policy to address the problem. The credit is threatened by noncompliance.

I now sense that the IRS is taking strong steps to attack this problem. Their efforts should be given time to work. The reason for this is that in other respects the credit is working well.

Most eligible taxpayers receive the credit; its labor market effects are probably in aggregate beneficial, and without a doubt, they are less pernicious than alternative ways of assisting the working poor; the credit is well targeted toward poor and near-poor families; and last, families receiving the EITC are working, an action that, in my opinion, should be encouraged.

Thank you.

[The prepared statement follows:]

Testimony before the
Committee on Ways and Means, Subcommittees on Oversight and Human Resources

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Mr Chairman and Members of the Committee:

Thank you for inviting me to testify on the effectiveness and design of the earned income tax credit (EITC). The EITC plays a central role in policy as it affects the working poor. Over its history, the EITC has received strong bipartisan support, as reflected by the fact that it was increased in 1986 and increased sharply in 1990 and 1993. The real value (in 1993 dollars) of the maximum EITC varied between $739 and $1,068 between 1975 – the year the EITC was adopted – and 1990. By 1996 the real value of the EITC will be roughly three times its 1990 level as a consequence of the 1990 and 1993 legislative changes.

The effectiveness of the EITC depends on (i) whether or not people eligible for the credit actually receive it, (ii) the labor market effects of the policy, and (iii) ensuring that those not eligible for the credit do not receive benefits. The first part of my testimony focusses on these aspects of policy design. The final section discusses a variety of EITC-related policy options.

Labor markets for low-skilled workers in the U.S. have not performed well over the last 20 years

To understand the role of the EITC, and in particular, its charmed existence over the past 20 years, a couple of facts about the labor market for low-skilled workers in the U.S. are useful. As Table 1 shows (next page), there has been a striking change in the bottom of the nation's earnings distribution, beginning in the 1970s, but accelerating over the 1980s. In 1973, the median male without a high school diploma earned $24,079 (in 1989 dollars), by 1989 the median worker with the same level of education earned $14,439. The trend is nearly as dramatic for males with only a high school degree. In 1973, the median male had an income of $30,252, by 1989 the median male with a high school degree had an income of $21,650. Average hourly earnings in private nonagricultural industries peaked in 1973 at $8.55 per hours (in 1982 dollars) and, in 1994 were $7.40 per hour. The erosion of labor market opportunities for people with low levels of education has placed enormous strain on the nation's antipoverty programs. Against this backdrop, the EITC has provided an important supplement to the earnings of low-skill workers.

The participation rate of the credit of the EITC is high

A family receives the EITC by filing a tax return, but many low-income families are not legally required to file returns. A married couple with two children, for example, was required to file a tax return in 1994 only *if* they had income above $16,150, though with an income considerably less than that, the couple would be entitled to an EITC of over $3,000. If the EITC is to be successful at meeting the objective of "making work pay," families who are eligible for the credit should receive it.

Table 1: Median Income of Persons 25 and Over, by Educational Attainment and Gender, Selected years, 1989 Dollars

	Males		
	High School		College
Year	1-3 Years	4 Years	4+ Years
1967	$22,858	$26,894	$39,186
1970	23,442	28,034	40,527
1973	24,079	30,252	41,065
1979	18,697	26,416	36,626
1983	15,138	21,932	35,188
1989	14,439	21,650	37,553

Source: Robert Haveman and John Karl Scholz, "Transfers, Taxes, and Welfare Reform," National Tax Journal, June, 1994, 417-434

It is surprisingly difficult to estimate the percentage of EITC-eligible taxpayers who receive the credit – the EITC participation rate. Household surveys generally collect the information needed to determine eligibility but do not provide information on EITC recipiency. Tax data are best for estimating EITC recipiency, but not all households file tax returns so they are unsuited for estimating EITC eligibility. In an earlier paper I used unique data that allowed me to determine EITC eligibility and EITC recipiency in the same data set: specifically, I use data from the 1990 Survey of Income and Program Participation (SIPP) matched by social security number to selected items from individual income tax returns.[1] The paper describes, in great detail, the steps needed to calculate participation rates. Of the roughly 10 million taxpayers eligible for the credit in 1990, I estimate that between 75 to 90 percent received the credit. For reasons given in the paper, my preferred estimates place the participation rate at 80 to 86 percent.

The high participation (or take-up) rate of the credit is striking when compared to the AFDC participation rate of 62 to 72 percent and the food stamp participation rate of 54 to 66 percent.[2] The

[1]For a more detailed discussion of participation rates, see John Karl Scholz, "The Earned Income Tax Credit: Participation, Compliance, and Anti-poverty Effectiveness," National Tax Journal, 47(1) (March, 1994): 59-81.

[2]These figured are calculated from the 1986 and 1987 panels of the Survey of Income and Program Participation (SIPP) by Rebecca M. Blank and Patricia Ruggles, in their paper "When Do Women Use AFDC and Food Stamps? The Dynamics of Eligibility Versus Participation," mimeo, Northwestern University and the Urban Institute, Washington, D.C., June, 1993.

United Kingdom has an EITC-like program called the Family Credit. It is administered through the transfer system and directed toward families with children. Official estimates place the participation rate of the Family Credit at around 50 percent. Thus, both compared to other in-kind transfers in the U.S. and comparable work-related benefits in the United Kingdom, the EITC gets high marks for reaching those who are eligible for the benefit.

The EITC is well targeted

Nearly 50 percent of EITC payments by 1996 will go to taxpayers with incomes below the poverty line and 36 percent of total EITC payment will directly reduce the "poverty gap" - the difference between total cash income and the poverty line. Because of the design of the credit, however, all benefits (other than those obtained fraudulently) go to taxpayers with incomes that are no more than 73 percent of the median family income in 1993. Put differently, the highest income an EITC-eligible taxpayer can have is $27,000 while the median family income in 1993 was $36,959. In this sense, the EITC is fairly well targeted to working poor or near-poor families.

There is little evidence that a significant number of EITC recipients are high-wage, part-time employees. Based on tabulations from the Survey of Income and Program Participation, I calculate that more than 75 percent of EITC benefits go to taxpayers with wages that would place them in the bottom 25 percent of all workers with children (below $7.30 per hour). More than 95 percent of all EITC benefits are paid to workers with wages below the median of $11.11 per hour. The EITC could be even more tightly targeted to lower income taxpayers by increasing the phase-out rate of the credit. Given the evidence on labor market incentives discussed below, doing so would probably not have particularly large deleterious labor market effects.

The EITC's labor market incentives vary with the income of the taxpayer

The EITC has different labor supply incentives depending on the taxpayer's income relative to the subsidy, flat, or phase-out range of the credit. The subsidy range of the credit increases the worker's marginal return to labor. For taxpayers with incomes in the subsidy range, the wage subsidy is thought to encourage work. At the same time, the income supplement provided by the EITC is thought to decrease recipients' labor supply because more money in hand means that they will choose to work less. The net effect is ambiguous. Households in the flat range of the credit receive the maximum EITC payment and no marginal subsidy for increased work, so these households have no marginal incentive to increase their hours of work, and the EITC supplement provides incentive to work less. In the phase-out range, the EITC is reduced as additional income is earned, which is akin to an additional tax on earnings. Thus the additional tax and the additional income both encourage workers to decrease their hours of work. For households that are not working, it is hoped that the wage subsidy provided by the EITC will encourage participation in the labor market.

The aggregate labor market effects of the credit depend on the distribution of taxpayers within the credit's ranges and the degree to which they respond to incentives. In my National Tax Journal paper I estimate that 77 percent of EITC recipients will have incomes that fall in the flat or phase-out range of the credit in 1996, which raises the concern that the EITC may lead to a net reduction in the labor supplied by low-income workers. The fact that an incentive exists, however, does not necessarily mean that people act on the incentive in an economically significant manner. In the following sections I describe work performed with Stacy Dickert and Scott Houser on the likely effect of the EITC on labor market behavior.[3]

The EITC will have a small, negative effect on the hours worked by people already working

A large body of work in economics examines the effect of taxes and transfers on the hours worked by those in the labor market. Dickert, Houser and I survey this literature and use the empirical results from these studies to simulate the effects of the OBRA93 EITC expansions from 1993 to 1996.

Table 2 (next page), which is drawn from our paper, shows the effect of the 1993 EITC expansion, using 3 sets of labor supply estimates from studies that explicitly model the tax and transfer system. Between the estimates labelled "MaCurdy, Green, and Paarsch" on the low end, and "Hausman" on the high end, the estimates appear to span the range of estimates found in the literature. As expected, we find that the EITC will reduce hours for every group except those in the subsidy range of the credit. Studies of labor supply find that secondary earners are more responsive to changes in taxes and wages than are primary earners. Accordingly, our estimated labor supply responses are larger for secondary-earners in two-parent families than they are for primary earners or single-parent families.

Our reading of the literature suggests Triest's estimates most closely reflect consensus estimates from various branches of the literature. Triest's estimates imply that taxpayers in the subsidy range of the credit will increase hours by roughly 38 hours per year, while taxpayers in the flat and phaseout range will reduce hours by 3 and 21 hours per year, respectively. When aggregated, EITC recipients are estimated to reduce hours by an average of 11 per year. Hausman's estimates are roughly 8 times as large, while the MaCurdy et al. estimates show virtually no response. Our estimates are consistent with, but update earlier estimates from a 1993 study by the General Accounting Office.

While the credit, in aggregate, is likely to reduce the hours worked by workers, the economic significance of these effects is small. Moreover, to the extent that taxpayers are unaware of the effects of the credit on after-tax wages, both the positive effects of the credit in the subsidy range, and the negative effects of the credit on taxpayers in the phase-out range, is overstated. Thus, the best available empirical evidence suggests that the EITC has a small, but detrimental, effect on the hours of workers.

The EITC will have a small, positive effect on labor market participation that probably is sufficient to make the aggregate effect of the EITC on hours of work positive

What's missing from the literature and our calculations from Table 2 are estimates of the EITC's effect on labor market participation. The credit has unambiguously positive labor market incentives on the decision of whether or not to work. Few papers provide guidance for thinking about the size of the effects of the EITC on labor market participation. This is somewhat surprising, as there is widespread agreement among economists that the strongest empirical labor market effects of wages and nonlabor income are on participation, rather than hours of work.

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[3]The following discussion of the tax treatment of low-income households and the effects of the EITC on labor market participation and hours of work is described in more detail in Stacy Dickert, Scott Houser, and John Karl Scholz, "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.

Table 2: Simulated Labor Supply Responses to Changes in EITC Law from 1993 to 1996

	Estimated Percent Change in Annual Hours Worked		
	Kinked budget set simulations[2]		
	MaCurdy et al.	Triest	Hausman
All Recipients (160)	-0.09	-0.54	-4.04
By credit range			
Subsidy (80)	1.88	3.92	13.46
Flat (140)	-0.09	-0.19	-1.79
Phaseout (160)	-0.53	-1.11	-4.73
By marital status			
Husbands (180)	0.00	-0.34	-3.17
Wives (140)	-1.47	-3.03	-11.36
Single female heads (160)	-0.53	-1.11	-4.02
Single male heads (160)	0.00	-0.18	-1.56
By sex			
Male (180)	0.00	-0.34	-3.15
Female (160)	-0.57	-1.17	-4.33

Note: See Dickert, Houser, and Scholz (1995) (the complete citation is in footnote 3) for further detail. Median monthly hours are in parentheses.

We identify the effects of the EITC on labor market participation by making use of the striking variation across states in the after-tax return to work.[4] The typical low-income family in Texas, for example, faces relatively low cumulative tax rates – this calculation reflects both explicit tax rates from the federal income and payroll taxes, and implicit tax rates from benefit-reduction rules of food stamps and AFDC. Low tax rates are primarily a consequence of the low levels of AFDC benefits available to families in Texas. A household in similar circumstances in New York faces considerably higher rates, primarily because of the higher level of AFDC benefits. We find, for example, that average tax rates can exceed 85 percent for New York families receiving AFDC that enter the labor market and work anywhere from 8 to 35 hours per week. This implies that this family, when making labor market participation decisions, will receive no more than 15 cents for every dollar earned in the labor market over a broad range of hours. If tax rates affect labor market participation, we expect labor market

[4]We characterize this variation using a detailed, microsimulation model we have developed that uses monthly data for the 1990 calendar year drawn from the Survey of Income and Program Participation (SIPP). The model is coded in the computer language C, runs on a personal computer, and contains detailed modules for SSI, AFDC, food stamps, the federal income tax, state income taxes, and payroll taxes. See Dickert, Houser, and Scholz (1995) for further details.

participation to be higher in low-benefit states than in high-benefit states, holding other observable characteristics constant.

Our study shows that net wages positively and significantly affect labor market participation and negatively affect transfer program participation, particularly for single parents. Moreover, this result is not an artifact of our particular empirical specification, but clearly emerges in the underlying data even when we do not control statistically for other factors.

The empirical evidence on the effects of the OBRA93 EITC expansion on labor market behavior is summarized in Table 3 (next page). We model the effect the EITC increase on net-of-tax wages, and calculate the implied change in the probability that individuals work. At the mean, the EITC increases the net wage of single-parent families by 15 percent. This leads to a 6.2 percent increase in their probability of working. If each new labor market entrant works an average of 20 hours per week for 20 weeks a year, the hours of single parent families would increase by roughly 72 million hours per year. Similar calculations show that the annual hours of primary earners in two-parent families would increase by roughly 12 million hours.

The EITC will probably discourage labor force participation of secondary workers in two-parent families, as entering the labor market is likely to place the family's income in the flat or phase-out range of the credit. Specifically, on average we calculate that the after-tax return to work for secondary earners will fall by nearly 5 percent as a consequence of OBRA93. We expect that to decrease labor market participation of secondary earners, leading to a reduction of roughly 10 million hours when using the same assumptions as above. Thus, we estimate that the aggregate increase in hours generated by increased labor force participation would be roughly 74 million hours.

The increased hours resulting from higher rates of labor force participation can be compared to the reduction in hours caused by the credit shown in Table 2. We use Triest's (1990) labor supply parameters for the simulation. We estimate that the annual hours of work for single-parent families in our sample will fall by 26.4 million hours, for primary earners they will fall by 13.6 million hours, and for secondary earners they will fall by 14.5 million, leading to an aggregate reduction of 54.5 million hours.

Taken together, the simulations suggest that the aggregate reduction in hours supplied by working households, 54.5 million, would be more than fully offset if new labor force participants work an average of 20 hours per week, 20 weeks per year. If either hours, or weeks worked are lower the offset will be smaller, while if new labor market entrants work more than 400 hours a year, the aggregate effect will be a larger positive number. The important point, however, is that one cannot forget about the participation margin when thinking about the labor market effects of the EITC.

Our evidence, like other papers before us, show that labor market participation appears to be sensitive to changes in wages and taxes. Hence, a policy like the OBRA93 EITC expansions that substantially increases the after-tax return to working for those not in the labor market are likely to elicit greater labor market participation. This increase in participation is likely to offset (or more than offset) the reduction in hours among those who work. The modest positive labor market effects of the EITC should be contrasted to the detrimental effects on both labor market participation and hours of work associated with other income transfer programs.

Table 3: Labor Market and Transfer Program Effects of the OBRA93 EITC Expansion, 1993 to 1996

Labor Market Effects

	New Labor Force Participants		Families in the Labor Market	
	Percent Change in Net Wage	Annual Hours Change Due to Labor Force Participation (million)[1]	Annual Hours Reductions of Workers (million)[2]	Average Annual Reduction in Hours
Single Parents	15.0	72.8	26.4	10.1
Primary Wage Earners	19.6	12.1	13.6	7.7
Secondary Wage Earners	-5.0	-10.4	14.5	30.3
Total		74.4	54.5	11.2

Transfer Program Participation Effects

	Number Leaving Program	Mean Annual Benefit	Mean EITC Payment
Single-Parent Families	398,384	$6,844	$2,040
Two-Parent Families	117,757	$4,702	$2,842

Source: Dickert, Houser, and Scholz (1995).
[1]The estimation of the change in hours from new labor force participation assumes that, on average, these persons work 20 hours per week for 20 weeks per year.
[2]We use the estimated net wage and virtual income elasticities from Triest (1990).

EITC noncompliance has been too high, but sensible steps are now being taken to address the problem

In past years a large number of ineligible taxpayers claimed the EITC, according to unpublished data from the IRS's Taxpayer Compliance Measurement Program (TCMP). In 1988 10.4 million taxpayers claimed the EITC, whereas the TCMP for that year estimates that only 7.1 million were entitled to the credit, indicating that over 30 percent of EITC claimants were ineligible. Of the $5.6 billion in EITC claims, the 1988 TCMP estimates that nearly $2 billion (33.6 percent) were claimed inappropriately. A General Accounting Office official testified in 1993 that "the credit has been the source of more taxpayer mistakes than any other individual income tax provision."

Noncompliance takes many forms, though one of the frustrations with thinking about this topic is in assessing the relative importance of different circumstances. Parents that are separated (or even living together) may file separate returns and both claim the same child as a dependent. Taxpayers may make up children. Taxpayers may misreport earnings or AGI. Some of these cases may not reflect the intent to commit fraud, others clearly do.

EITC rules were changed in 1990 and a 2-page schedule was added to the tax forms because of the widespread perception of compliance problems, but there is little publicly-available evidence that the 1990 changes significantly reduced noncompliance. The IRS did a special study during last year's filing season, examining returns filed electronically during the first two weeks of the filing season, and found that roughly 26 percent of EITC claims were too high. Because of the nature of the sample that was drawn, it is unlikely that this sample was representative of the universe of filers, but the limited available evidence indicates that noncompliance is still a major problem.

The future viability of the EITC depends on the IRS being able to reduce EITC noncompliance. Doing so requires two distinct tasks. First, programs must be put in place to detect accurately and report the degree of noncompliance and its causes. Current policy is being debated in an environment where solid evidence on the magnitude of compliance problems is scanty. I was pleased to see that IRS Commissioner Margaret Richardson testified to the Senate Finance Committee last week that a detailed EITC compliance study is going to be completed in 1995.

The Internal Revenue Service has, perhaps belatedly, taken the second step needed to address noncompliance. This involves giving greater scrutiny to verifiable items on tax returns. The IRS created an uproar this past filing season due to refund delays as they give social security numbers greater scrutiny. Nevertheless, this and matching employee and employer W-2 reports, seem to be the best ways of combatting the noncompliance that jeopardizes the program. As long as the credit is based on items the IRS is, in principle, able to verify, there is nothing inherent in the credit that would lead to unusually high levels of noncompliance. Moreover, other areas of the tax code, for example, Schedule C also have large amounts of noncompliance associated with them. As a matter of sound policy, the costs of reducing noncompliance in every aspect of the tax code should be compared to its benefits, so the IRS uses taxpayer resources in as efficient a way as possible.

Even if the IRS is able to perfectly verify social security numbers and wage and salary income, future compliance problems may arise with self-employment income. Between 1975 and 1990 the subsidy rate of the EITC was roughly the same as the combined employee and employer share of the payroll tax. In this period, as long as the payroll tax and EITC subsidy are about the same, taxpayers will not overstate self-employment income in order to increase their EITC. Doing so would increase the taxpayer's EITC but would obligate the taxpayer to pay social security taxes on the self-employment income, eliminating any advantage to falsely reporting income.

With the sharp increase in the EITC, there are now stronger incentives to manipulate income. It is, of course, not yet clear how people will respond to these incentives, as there is no comparable situation in the tax code. My guess is that over time taxpayers or paid tax preparers will begin to take advantage of the incentive to overstate income in the subsidy range of the credit. The IRS will surely monitor closely the amount of income reported by low-income taxpayers that occurs in forms not subject to information-matching procedures (i.e., income from self-employment). An increase in the proportion of income occurring in these forms will be an early signal that a problem may be developing.

A solution to the potential problems associated with self-employment income would be to restrict the expanded EITC to income reported on W-2s (and only allow an EITC equivalent to the employer and employee share of payroll taxes for other sources of income), though that would create an inequity between low-income wage earners and self-employed households.

Pending EITC proposals may not improve the tax system or the well-being of EITC recipients

In the past months various legislative proposals have arisen that would alter aspects of the EITC. The proposals include adding selected monetary payments to the income base in determining EITC benefits, repeal of indexation for the EITC, and limiting the EITC based on assets.

A current problem with the EITC is that several unverifiable sources of income are currently included in the EITC income base. These include housing allowances or the rental value of a parsonage for the clergy, excludable employer-provided dependent care benefits, voluntary salary reduction amounts (e.g., deductions to 401(k) plans), and anything else of value (money, goods, or services) received from someone for services performed even if it is not taxable (IRS Publication 596). With perfect compliance the inclusion of these items in the EITC income base may enhance the targeting of the credit, but reporting these income items is essentially voluntary. Given the difficulty of enforcing these provisions, I would support a proposal to restrict EITC eligibility and benefits to verifiable items. Adding new income items to the EITC income base that the IRS cannot verify, such as child support payments, non-taxable pension income, and tax-exempt interest would make the EITC even more difficult to administer, and would be a step in the wrong direction.

An important achievement of tax reforms in the 1980s is that most aspects of the tax system are now indexed to inflation. Unlike prior decades, ordinary taxpayers no longer see increasing tax burdens attributed solely to nominal, but not real, increases in income. It would be a very unfortunate change in policy if EITC indexation were eliminated. Working poor taxpayers would see an erosion of the real value of the EITC caused by the vagaries of inflation. If it is the intention of Congress to reduce the real value of the EITC or increase taxes in other ways, it should be done explicitly, rather than by repealing indexing.

Lastly, Administration and Congressional proposals would deny the EITC to taxpayers with assets (based on dividend, interest, and tax-exempt bond income) above some threshold. This proposal would be relatively straightforward to administer, and consequently could, in an effective manner, enhance the targeting of the EITC. I would not oppose such a proposal, though two things should be kept in mind when debating it. First, it will be relatively easy to manipulate portfolios so as to avoid the asset income thresholds without altering the value of the portfolio. Hence, the asset test will in all likelihood exclude fewer families than expected. Second, it may be counterproductive to implement a very restrictive asset test (such as those with a $1,000 threshold). While asset tests of any kind enhance targeting in a static sense, they also can make it nearly impossible for recipients to legally accumulate the assets necessary to take a wide range of choices leading to independence – helping a child attend college, acquiring additional training, or moving away from a dangerous neighborhood.[5]

[5]For example, a family receiving food stamps cannot have financial assets exceeding $2,000 ($3,000 if the family unit has a member older than 59), and cannot own assets and a car whose combined market value exceeds $6,500. A family receiving AFDC cannot have more than $1,000 of financial assets. In a

As with high implicit tax rates on labor earnings, asset tests distort the economic decisions of low-income households and hence reduce the efficiency of antipoverty policy.

Conclusions

Over the past 20 years the EITC has been a favored policy tool for assisting low-income families with children. Between 1975 and 1990 the EITC remained roughly constant in real terms. By 1996 the real value of the EITC will nearly triple from its 1990 level. No other major program directed toward low-income families has grown at a comparable rate in recent years.

The effectiveness of the EITC will depend, in part, on its effect on labor market behavior. Most workers that will receive the credit have incomes that place them in the flat or phaseout range of the credit, where the credit provides an unambiguous incentive for people to work fewer hours. Using recent estimates from the empirical literature on taxes and labor supply, we find that the change in incentives caused by the 1993 expansion of the credit are expected to lead to a reduction in hours of work by those already in the labor market. Our central estimate predicts an overall reduction of roughly 54 million hours a year for families in our sample.

One of the attractions of the EITC is that it provides an unambiguously positive incentive to people not working to get a job. We find, both in descriptive tabulations and empirical models, that the after-tax wage has an economically and statistically positive effect on labor market participation and negative effect on transfer program participation. Thus, when fully phased in, the 1993 EITC expansion will increase labor force participation. Our preferred estimates suggest the magnitude of the participation effect will be large enough to offset the decrease in hours worked by workers.

While economists are predisposed to concentrate on the labor market responses to the EITC, the credit gets mixed reviews on two additional, important, policy dimensions. The participation rate – the fraction of eligible taxpayers that actually receive the credit – is quite high. The credit is reaching its intended beneficiaries. At the same time, many that are not eligible for the credit receive it. With the recent expansion of the EITC, the amount of overpayment could reach billions of dollars annually, an amount that, if it persists, will surely cause the credit to be scaled back, if not repealed altogether. I am hopeful that recent IRS attention to this problem will reduce the error rate and the credit will remain in place. My support for the credit results from the fact that (i) a high fraction of eligible taxpayers receive the credit, (ii) its labor market effects are probably, in aggregate, beneficial, and without a doubt, they are less pernicious than alternative ways of assisting the working poor, (iii) the credit is well-targeted toward poor and near-poor families, and (iv) families receiving the EITC are working, that is, they are "doing the right thing." Given the performance of labor markets for low-skill workers over the last 20 years in the U.S., it sound social policy to try to supplement the earnings of working poor families.

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well publicized case, Cecelia Mercado was ordered by the Connecticut Supreme Court to repay $9,342.75 in AFDC payments because her daughter, without her knowledge, had taken a part-time job and, in a year and a half, had saved almost $5,000 toward attending college. To become recertified to receive AFDC, the daughter and her brother (who had saved nearly $1,000) had to spend their saving until the household's assets fell below the $1,000 asset limit (William Raspberry, Atlanta Journal and Constitution, 8/21/92, p. A10).

Chairman JOHNSON. Thank you, Dr. Scholz.

Professor Forman, we are going to hear your testimony, recognizing that the time is roughly 5 minutes and then we will recess for a few minutes to go and vote and come back.

Professor Forman.

STATEMENT OF JONATHAN BARRY FORMAN, PROFESSOR, COLLEGE OF LAW, UNIVERSITY OF OKLAHOMA, NORMAN, OKLAHOMA

Mr. FORMAN. Thank you, Madam Chairman.

Today the Federal tax system stands at an important crossroads and how this Committee next amends the EITC can change the future of tax policy for years to come. On the one hand, our Federal tax system could require more and more people to file complicated tax returns. On the other hand, we could move in a direction which minimizes the number of people who must even file tax returns.

I believe that the EITC should be restructured in a way that reduces the number of people who need to file tax returns while, at the same time, guaranteeing benefits for low-income workers.

My point is this, because millions of Americans must file tax returns to their earned income credits, there are millions of opportunities for them to make mistakes on their returns or for them to file fraudulent returns.

If it were up to me, I would do three things. First, I would move to a return-free filing system. Second, I would replace a portion of the EITC with an across-the-board $5,000 per worker Social Security tax exemption. Third, I would replace the rest of the EITC with a $1,000 per-child tax credit, along the lines of Congressman Petri's proposal or The National Commission on Children's proposal several years ago.

First, we should move to a return-free filing system in which the IRS prepares returns for most wage earners. Using information reports from employers and other income sources, the IRS could prepare tax returns for most 1040–EZ filers, most 1040–A filers and a few 1040 filers, more than 55 million taxpayers in all.

Those Americans would no longer have to gather information, become familiar with tax laws or prepare and file returns. Nor, would they have to pay private preparers $20 per return just for return preparation and additional fees for electronic filing and refund anticipation loans. In addition, under a return-free filing system, the burdens on the IRS would be reduced.

Second, Congress should replace a portion of the EITC with a $5,000 per worker exemption from Social Security taxes. After all, much of the complexity in this area results from collecting Social Security taxes from every worker and then using the EITC to refund those taxes to low-income workers. Would it not be simpler if the Federal tax system did not collect those Social Security taxes in the first place?

With the Social Security tax exemption, at least 10 million tax returns could be eliminated immediately and IRS resources would be freed for other productive work. This is according to the Joint Committee on Taxation.

Also, unlike, the EITC, which most workers collect around April 15 of the year following their work, a Social Security tax exemption would result in extra money every paycheck. That would be a powerful work incentive. Unlike the EITC, a Social Security tax exemption would reach all 100 percent of low-income workers.

Finally, Congress should replace the rest of the EITC with a $1,000-per-child refundable tax credit, along the lines of the credit proposed by the National Commission of Children in 1991. The credit would be available for all children through the age of 18. It would be refundable and indexed for inflation. Payment of the credit could come in the form of reduced withholding or a tax refund paid annually or perhaps quarterly. Your Committee might start by making the $500-per-child tax credit in the House-passed tax bill refundable.

Unlike the current EITC, a refundable child tax credit would not create marriage penalties. That is because the credit amount would not depend on marital status or family income. Nor would a refundable child tax credit result in the kind of work disincentives that we see in the phaseout range of the EITC. Because the credit would be available to all families with children, regardless of income, it would not have to be phased out at all.

To summarize, by moving to a return-free filing system, and replacing the EITC with a $5,000-per-worker exemption and a $1,000-per-child refundable tax credit, Congress could guarantee benefits to low-income workers and free millions of Americans from having to file returns.

Before concluding, however, let me mention two other possible alternatives to the current EITC. One alternative would be to combine the credit with other welfare programs, like food stamps and Aid to Families with Dependent Children. After all, having multiple Federal welfare programs has resulted in complexity, inequity, and high administrative costs.

Ideally it would make sense to combine the EITC and the other Federal welfare programs into a single comprehensive program that could be administered by a single agency. As this Committee well knows, both the IRS and the Social Security Administration do a great job of writing checks, so either agency could handle this assignment.

Or the revenues now used for the EITC could be bundled together with the appropriations for other welfare programs and revenue shared out to the State welfare agencies.

In any event, the administrative savings that would result from combining the EITC with other welfare programs could be passed on to beneficiaries in the form of higher benefits.

The final alternative to the current EITC would be to replace it with a tax credit for the employers of low-wage workers.

According to standard economic analysis the benefits of an employer tax credit would pass through to low-wage workers in the form of relatively higher wages. Consequently an employer tax credit could end up helping the very same people that we are trying to help with the EITC. Yet, an employer tax credit would be significantly easier to administer than the current EITC if only because there are far fewer employers than low-income workers.

Thank you, again, for this opportunity to testify.

[The prepared statement follows:]

TESTIMONY OF PROFESSOR JONATHAN BARRY FORMAN
UNIVERSITY OF OKLAHOMA COLLEGE OF LAW
BEFORE THE
SUBCOMMITTEES ON OVERSIGHT AND HUMAN RESOURCES
HOUSE COMMITTEE ON WAYS AND MEANS
EARNED INCOME TAX CREDIT
JUNE 15, 1995

HOW TO REDUCE THE COMPLIANCE BURDEN OF THE EARNED INCOME CREDIT ON LOW-INCOME WORKERS AND ON THE INTERNAL REVENUE SERVICE

Madam Chairman, Mr. Chairman, and Members of the Subcommittees on Oversight and Human Resources:

Thank you for inviting me to testify before you today about the Earned Income Tax Credit.

My name is Jon Forman, and I am a Professor of Law at the University of Oklahoma. Although I am a tax lawyer by trade, I also hold Master's degrees in psychology and economics, and prior to entering full-time teaching, it was my privilege to work in all three branches of the federal government, most recently as Tax Counsel to Senator Daniel Patrick Moynihan (D-N.Y.). For the past ten years, I have been teaching courses about both tax law and welfare law, and I have written dozens of articles about the relationship between the tax and welfare systems./1

The purpose of my testimony today is to suggest ways to reduce the compliance burden of the earned income credit on low-income workers and on the Internal Revenue Service (IRS). Basically, I believe that there are ways to restructure the earned income credit that would guarantee benefits for low-income workers and also free millions of Americans from having to file income tax returns. For example, Congress could replace the current earned income credit with a $5,000 per worker Social Security tax exemption and a $1,000 per child refundable tax credit. At the same time, Congress could move the federal tax system toward return-free filing.

I. INTRODUCTION

At the outset, it should be noted that the earned income credit is a whoppingly successful program that has enjoyed broad bipartisan support. Largely because of the earned income credit, millions of low-income American workers pay no federal taxes. And the credit provides important income assistance for millions of low-income working families -- especially single-parent, female-headed households.

Unlike most other welfare programs, however, the earned income credit reaches more than 80 percent of its target population./2 And the earned income credit has lower administrative costs than any other welfare program -- just one percent of program costs, according to the General Accounting Office./3

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[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, <u>Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Credit Program</u>, 11 American Journal of Tax Policy 225 (1994).

[3] Testimony of Lynda D. Willis before the Senate Finance Committee (June 8, 1995).

Unfortunately, to claim the credit, low-income workers must file unnecessarily complicated tax returns. Not surprisingly, low-income workers frequently make mistakes in claiming their credits, and some taxpayers claim credits to which they are not entitled. In short, because millions of Americans must file tax returns to claim their earned income credits, there are millions of opportunities for taxpayers to make mistakes or to file fraudulent returns.

Consequently, the federal tax system now stands at an important crossroads, and how Congress next amends the earned income credit can change the direction of federal tax policy for years to come. The choice is this: Should the federal tax system move toward having even more individuals file complicated income tax returns, or should the federal tax system instead move in the opposite direction and reduce the number of individuals who must file returns?

Because of the repeated expansion of the earned income credit, more and more individuals must now file tax returns, if only to collect their earned income credit refunds. On the other hand, technological changes -- like information reporting and electronic filing -- have made it possible for the federal tax system to move away from having so many individuals file complicated tax returns.

I believe that Congress should restructure the earned income credit in a way that would reduce the number of individuals who must file complicated tax returns yet would still guarantee benefits for low-income workers. In particular, Congress should consider replacing the earned income credit with an alternative tax or welfare program for low-income workers. For example, Congress could replace the current earned income credit with a $5,000 per worker exemption from Social Security taxes and a $1,000 per child refundable tax credit.

II. THE CURRENT EARNED INCOME CREDIT HELPS LOW-INCOME WORKERS

A. BECAUSE OF THE EARNED INCOME CREDIT, RELATIVELY FEW LOW-INCOME WORKERS OWE ANY FEDERAL INCOME TAXES

According to the Census Bureau, more than 39 million Americans live in poverty./4 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 of these 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 regressive Social Security taxes. Fortunately, the earned income credit offsets the Social Security tax liabilities of many low-income workers. Consequently, relatively few low-income workers owe any federal taxes at the end of the year./5

For example, consider the tax treatment of a typical family of four in 1995 -- a married couple with two children. Assuming that the couple's income consists entirely of wages or salaries, the couple will owe no federal taxes unless it earns more than $18,370. Basically, the couple's $6,550 standard deduction and four $2,500 personal exemptions together will shelter $16,550

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[4] 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.

[5] See Appendix for computations.

from the income tax, and the couple's earned income credit will offset the rest of its income and Social Security tax liability. By way of comparison, the poverty level for a family of four in 1995 is just $15,150.

Thus, in large part because of the earned income credit, relatively few low-income families with children will owe any federal taxes for 1995. The earned income credit is especially important to single-parent families. For example, in 1993, 63.7 percent of earned income credit beneficiaries were heads of household./6 The earned income credit also helps protect childless workers and couples from regressive Social Security taxes.

B. FILING INDIVIDUAL INCOME TAX RETURNS IS BURDENSOME AND EXPENSIVE

Unfortunately, even though relatively few low-income workers owe federal taxes, most must file income tax returns and fill out Schedule EIC to recover their over-withheld taxes and their 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./7 That's roughly 27 million returns, and many of those were filed by low-income workers. Also, that year more than nine million low-income workers received earned income credit refunds in excess of their income tax liabilities./8

Moreover, millions of Americans need help preparing their income tax returns. For example, more than 56 million taxpayers used paid preparers for their 1992 tax returns./9 That's about half of all individual taxpayers. Even more astonishing, 777,000 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.

Furthermore, fully half of earned income credit recipients use paid preparers./10 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 workers to private preparers. All in all, filing returns is burdensome and expensive for low-income workers and for the IRS./11

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[6] Testimony of IRS Commissioner Margaret Milner Richardson before the Senate Finance Committee (June 8, 1995).

[7] Internal Revenue Service, Selected Historical and Other Data, 14 SOI Bulletin 175, 205-6 (Winter 1994-1995).

[8] Id. at 178.

[9] Id. at 225.

[10] U.S. General Accounting Office, Earned Income Credit: Targeting to the Working Poor (GAO/GGD-95-122BR) (1995).

[11] Indeed, Americans spend at least $30 billion a year to prepare their individual income tax returns. U.S. General Accounting Office, Internal Revenue Service: Opportunities to Reduce Taxpayer Burdens Through Return-free Filing 1 (GAO/GGD-92-88BR) (1992).

III. SO WHAT CAN BE DONE TO HELP LOW-INCOME WORKERS?

A. SIMPLIFY THE CURRENT TAX SYSTEM FOR LOW-INCOME WORKERS

First, there are a few small changes to the current tax system that could help improve compliance with the earned income credit.

1. Simplify the Current Earned Income Credit

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.

Another reform would be to simplify some of the earned income credit eligibility requirements. For example, it would make sense to eliminate the differences between the definition of a "qualifying child" for earned income credit purposes and the definition of "dependent" for purposes of claiming the dependency exemption.

Still 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.

It might also make sense to limit the earned income credit for self-employed workers to the amount of their self-employment taxes. 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. Such fraud is relatively difficult for wage earners because the IRS can match the employee and employer W-2 forms. Because only a portion of self-employment earnings shows up on 1099 forms, however, it is easy for self-employed workers to overstate their earnings. Consequently, limiting the credit available to self-employed workers may be an appropriate way to curb that abuse (although, admittedly, such a limit would create an inequity between wage earners and self-employed workers).

On the other hand, adding a wealth test to the earned income credit or expanding the credit's definition of adjusted gross income would make the credit even more complicated and so increase the compliance burdens on taxpayers and on the IRS.

2. Let the IRS Prepare Tax Returns for Low-Income Workers

Another reform would be to let the IRS prepare returns for individual taxpayers. Currently, the IRS believes that Office of Management and Budget 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./12

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[12] Office of Management and Budget, OMB Circular No. A-76 (Rev.), Performance of Commercial Activities, 48 Federal Register 37,110 (1983). Promulgated by the Reagan Administration, that ruling generally prevents government agencies from "competing" with private-sector businesses.

In particular, it would make sense to let the IRS prepare returns for those low-income workers 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 workers can get their earned income credit refunds?

3. Move to a Return-free or a Final Withholding Tax System

Another way to help low-income workers who claim the earned income credit would be to move to either a return-free or a final withholding tax system./13 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. Most of these people would no longer have to gather information, become familiar with tax laws, or prepare and file returns. The compliance burdens on the IRS would also be greatly reduced.

Similarly, 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 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? 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. Thus, a final withholding system could significantly reduce burdens on both low-income workers and the IRS.

B. REPLACE THE CURRENT EARNED INCOME CREDIT WITH AN ALTERNATIVE MECHANISM TO HELP LOW-INCOME WORKERS

Given the compliance problems with the earned income credit, it is worth considering some alternate ways to distribute benefits to low-income workers. Specifically, eliminating fraud from the earned income credit program may mean replacing it with a floor on Social Security taxes, an employer tax credit, or a direct expenditure program.

1. Replace the Earned Income Credit with a $5,000 or $10,000 Social Security Tax Exemption and a $500 or $1,000 Per Child Refundable Tax Credit

One alternative would be to replace the earned income credit with alternative tax provisions that could provide similar benefits directly to low-income workers. In that regard, much of

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[13] See generally Internal Revenue Service, Current Feasibility of a Return-Free Tax System (1987); U.S. General Accounting Office, supra note 11.

the complexity of the current system results from imposing Social Security taxes on every dollar of earned income, and then using the earned income credit to offset those taxes for those low-income workers. Wouldn't it be simpler if the federal tax system did not collect Social Security taxes from low-income workers in the first place?

One option would be to add a $5,000 or $10,000 exemption to the Social Security tax system./14 Unlike the earned income tax credit, a Social Security tax exemption would reach 100 percent of low-income workers, and it would be less complicated than first collecting Social Security taxes and then using the credit to refund them. Also, unlike the earned income tax credit -- which most workers collect around April 15th of the year following their work, a Social Security tax exemption would result in extra money every paycheck. This would be a powerful work incentive./15 Most importantly, neither low-income workers nor the IRS would have to mess with tax returns to get the exemption: Millions of low-income workers would simply no longer need to file tax returns. According to the Joint Committee on Taxation, replacing the earned income credit with a Social Security tax exemption would eliminate over 10 million tax returns annually and free IRS resources for other productive work./16

Of course, much of the benefit of the current earned income credit seems to be geared to providing income assistance to families with children. But it would be simpler to provide that type of family benefit through a refundable child tax credit along the lines of the $1,000 per child tax credit proposed by the bipartisan National Commission on Children./17 Congress might start by making the $500 per child tax credit in the House-passed tax bill refundable./18 A portion of the needed revenue could come from the current earned income credit.

Unlike the earned income credit, a $500 or $1,000 refundable child tax credit would not depend upon the marital status of the

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[14] See Yin et al, supra note 2, at 280-83. In 1995, workers and their employers must pay Social Security taxes equal to 7.65 percent of a worker's first $61,200 in wages. Consequently, a $5,000 Social Security tax exemption would simply leave $382.50 a year in the hands of every worker in America and reduce every employer's payroll costs by a similar amount for each employee ($382.50 = $5,000 x 7.65 percent).

[15] Moreover, unlike raising the minimum wage, a Social Security tax exemption would lower the cost of production for employers, thereby increasing their demand for labor. Consequently, a Social Security tax exemption would increase employment opportunities and stimulate the economy -- without driving up the cost of American-made goods.

[16] Joint Committee on Taxation, Present Law Issues Relating to the Earned Income Credit (JCX-24-95) (June 7, 1995).

[17] U.S. National Commission on Children, Beyond Rhetoric: A New American Agenda for Children and Families 80-88 (1991). The National Commission on Children's proposed credit would be refundable, indexed for inflation, and payment of the credit could take the form of reduced withholding or a tax refund paid annually, or perhaps quarterly. See also Yin et al, supra note 2, 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] Contract with America Relief Act of 1995, H.R. 1215, 104th Cong., 1st Sess. § 101 (1995).

parent, nor would it have to be phased out at low levels on income. Consequently, replacing a portion of the earned income credit with a refundable child tax credit could significantly reduce marriage penalties and the work disincentives in the earned income credit's phase-out range.

2. Replace the Earned Income Credit With an Employer Tax Credit

A second alternative would be to replace the current earned income credit with a tax benefit that reaches low-income workers through their employers./19 For example, an employer tax credit could provide tax benefits 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 final alternative would be to combine the earned income credit with other welfare programs like food stamps, Aid to Families with Dependent Children (AFDC), and Supplemental Security Income (SSI)./20 The multiplicity of these federal welfare 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 program that could be administered by a single agency. That agency might even turn out to be the IRS, although the Department of Health and Human Services or the Social Security Administration might be more appropriate. 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. In any event, the administrative savings that would result from combining the earned income credit with other welfare programs could be passed on to beneficiaries in the form of higher benefits.

IV. CONCLUSION

All in all, Congress could restructure the earned income credit in a way that would guarantee benefits for low-income workers and also free millions of Americans from having to file income tax returns. In particular, Congress should consider moving us toward a return-free filing system and replacing the earned income credit with a $5,000 per worker Social Security tax exemption and a $1,000 per child refundable tax credit.

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[19] See, e.g., Yin et al, supra note 2, at 280-86; Jonathan B. Forman, Improving the Earned Income Credit: Transition to a Wage Subsidy Credit for the Working Poor, 16 Florida State University Law Review 41 (1988); Robert H. Haveman & John Karl Scholz, Transfers, Taxes, and Welfare Reform, 47 National Tax Journal 417, 428-30 (1994).

[20] 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).

APPENDIX

This Appendix explores the impact of income and Social Security taxes on individuals with incomes at or below the U.S. Department of Health and Human Service's poverty income guidelines./21 Basically, this Appendix shows that in large part because of the earned income credit, many (if not most) low-income workers will have no net federal tax liability in 1995.

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./22 As more fully explained below, Table 1 shows that married couples with one, two, or three children have net federal tax thresholds that are 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.

TABLE 1. POVERTY LEVELS AND NET FEDERAL TAX THRESHOLDS AFTER THE EARNED INCOME CREDIT 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 (i.e., net federal tax threshold):	4,100	4,100	15,547	18,370	19,245	19,350

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.

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[21] U.S. Department of Health & Human Services, Office of the Secretary, Annual Update of the Poverty Income Guidelines, 60 Federal Register 7,772 (1995). The poverty income guidelines used here are those applicable to all states (except Alaska and Hawaii) and the District of Columbia.

[22] 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 not blind, 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.

Consider a family of four consisting of a married couple and two children. Row 1 shows that the couple's poverty income guideline in 1995 is $15,150. Row 2 shows the simple income tax thresholds for family units of different sizes. These are determined by summing each family unit's standard deduction and its personal exemptions. For 1995, a married couple with two children could file a joint tax return and claim a $6,550 standard deduction and four $2,500 personal exemptions./23 Consequently, the couple would not have to pay any income tax until its income exceeded its $16,550 simple income tax threshold./24

Row 3 of the table shows each family unit's income tax threshold after taking into account the effect of the earned income credit. The earned income credit is a part of the income tax system which can offset a family unit's preliminary income tax liability. Consequently, taking the earned income credit into account raises the income tax threshold for some family units. For example, taking into account the earned income credit, a typical married couple with two children would not actually owe any income tax until its income exceeded $22,360./25

On the other hand, because the Social Security tax system has no standard deductions or personal exemptions, family units must pay Social Security taxes starting with their first dollar of earned income. Hence, Row 4 shows that zero is the Social Security tax threshold for all family units.

Finally, Row 5 shows the combined income and Social Security tax threshold (i.e., net federal tax threshold) for various family units. Because the earned income credit is refundable, it can offset not only individual income taxes, but also Social Security taxes. Consequently, a family unit will have no net federal tax liability until the sum of its income tax and Social Security tax liabilities exceeds its earned income credit. For example, a typical married couple with two children would not actually have a net federal tax liability until its income exceeded $18,370./26

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[23] Rev. Proc. 94-72, 1994-50 I.R.B. 14.

[24] $16,550 = $6,550 + 4 x $2,500.

[25] Algebraically, each computation involved determining the appropriate equation for computing each family unit's income tax liability after its earned income credit and solving for the income level at which that tax liability is equal to zero.

For example, for a married couple with two children with income (I) in excess of its $16,550 simple income tax threshold but less than the $26,673 level at which its earned income credit is fully phased out, the couple's income tax liability (T) can be determined by the following formula:

T = .15 x (I - $16,550) - ($3,110 - .2022 [I - $11,290]).

Setting T equal to zero and solving for I shows that the couple's income tax threshold after the earned income credit is $22,360.

[26] Algebraically, each computation involved determining the appropriate equation for computing each family unit's combined income and Social Security tax liability after its earned income credit and solving for the income level at which that tax liability is equal to zero.

For example, for a married couple with two children with income (I) in excess of its $16,550 simple income tax threshold but less than the $26,673 level at which its earned income credit is fully phased out, the couple's combined income and Social Security tax liability (T) can be determined by the following formula:

T = .15 x (I - $16,550) + .0765 x I - ($3,110 - .2022 [I - $11,290]).

Setting T equal to zero and solving for I shows that the couple's combined income and Social Security tax threshold after the earned income credit is $18,370.

Chairman JOHNSON. Thank you. I thank the panel very much for your really excellent testimony.

We are going to recess for about 7 minutes and rush over and vote and come back.

Thanks.

[Recess.]

Chairman JOHNSON. I am going to reconvene the hearing, although my colleagues have not returned. There is the possibility of a series of votes on the House floor. They may have decided to stay and see how that is going to work out. I returned because I have another engagement that I cannot break at 2:30 and I wanted to have a chance to question the panel.

I am going to go ahead and start with my questions and if others do not arrive, we may have to recess again because I know Members do have a lot of interest in the testimony that this panel has prepared and brought to us.

At least two of you mentioned that there are other ways to provide the subsidy to low income workers that the EITC offers that are preferable. And I am sure that you heard Under Secretary Samuels testify that he felt that the ultimate delivery systems would have the same problems. That eventually you would have to deal with the same issues through using Social Security deductibility and things like that that they are having to deal with currently to assure that the EITC goes only to those who deserve it in the amounts that they deserve it.

I would like you to comment on that. Those of you who recommended—I know Professor Forman did and I cannot remember who else did.

Mr. FORMAN. I think Mr. Steuerle did.

Let me go ahead and comment. I think there will be problems with any type of benefit that is provided in a targeted fashion. I think there is an advantage of the kinds of proposals I made and also Gene Steuerle has made, for example, for a universal refundable child tax credit of $1,000 per child. Because it is universal, that is because everybody gets it, it does not have to be targeted. You do not have problems of targeting, problems of getting the benefit to the right people because you assume that anybody with a child is a right person.

Most proposals along this line——

Chairman JOHNSON. My understanding is that you are saying, Professor Forman, that a better alternative is the $1,000 for everyone with no upper-income limit.

Mr. FORMAN. I would not mind having no upper-income limit. I think the phaseout——

Chairman JOHNSON. I know you would not mind but I can tell you from dealing with the $500 tax credit, it is very expensive and there is absolutely no chance that we could afford to do that.

Mr. FORMAN. You could keep a phaseout at the upper levels. I think what is important in the context of this hearing is that the phaseout not be in this low-income range where it causes marriage penalties and disincentives that discourage low-income people from working. A phaseout at $100,000 or more of income might make sense.

Frankly, I do not look to the Federal government to help me support my children. My wife and I, are just taking care of things and if the government gives me personal exemptions that is great, for my kids, and if they did not that would be OK, too, if the rates were not ridiculously high.

Mr. STEUERLE. Congressman Petri also pointed out that you could eliminate the personal exemption at higher income levels so that you solve your distribution problem in part. Part of the reason that people want to phase out the credit is that they think that they want to take this device, by itself, and make it progressive. I think what Professor Forman and I and some others worry about is, when you try to make every single item in the Tax Code progressive, one-by-one-by-one, you end up with 5,000 phaseouts and this very convoluted structure. Rather than give upper income levels money, there are alternative ways to acheive overall progressivity.

One way to do it might be to just, if you give a credit at that level, eliminate the personal exemption. Then you solve your distribution. You do not have to fight the battle, oh, we gave the child credit and we gave away to the rich because you took something back from the rich.

But you also then start dealing with some of the other problems such as reducing the marriage penalties, reducing some of the work disincentives that are of concern to a variety of members on this panel.

Mr. GREENSTEIN. If I could comment for a moment on this, too.

I think this is a complicated area. There are a lot of things that would go with it. For example, Professor Forman's idea of replacing part of the EITC with exempting the first $5,000 of payroll taxes. If one did that, a number of the issues one would have to address include replacing the lost funding from the Social Security Trust Fund. The exemption of $5,000 of the payroll tax would clearly go well up the income scale so one would want to make sure you want redistributing from tax benefits from working families at $10,000 a year, we are trying to encourage people to leave welfare for work, to people at $60,000 or $80,000 a year, let alone at a higher level.

Similarly there is a political question I guess. In Gene and Professor Forman's suggestion, which I think is an interesting one, if it is politically feasible but the notion of converting the personal exemption into a fully refundable credit, regardless of whether a low-income family has earnings, is not one that seems to enjoy support on Capitol Hill at this time.

If one conditions, as Congressman Petri did, the refundable credit on earnings then you get back into some of the same questions, as Mr. Samuels says, that the EITC has. The final point I would make, I think of all these proposals perhaps the most interesting one to look at is Congressman Petri's. Even his proposal has the following effects.

It transfers some money now going to working families at $5,000 to $15,000 a year, mostly one-parent families, to two-parent families up to $36,000 a year. He raises the break-even on the EITC.

As a result of that, for single-parent families, at $5,000 a year if they have one child, for example, under his proposal the incentive to leave welfare for work is less than small. The total package that you get if you leave welfare for work is lessened somewhat.

Those are, among the kinds of questions that one has to grapple with if you do this restructuring.

Chairman JOHNSON. I would appreciate it if you would take the time to tell us your thoughts on Congressman Petri's proposal. I do not have any reason to believe that the Committee is necessarily interested in going that far but I am very impressed by the degree of the marriage penalty in the tax as it is currently structured.

I think that we have been negligent of those kinds of considerations too long. I think the cost of that to our society is now demonstrably extraordinary. I am interested in looking at Congressman Petri's proposal and would be interested in any followup materials any of you care to share with me on that subject.

[The following was subsequently received:]

The University of Oklahoma

COLLEGE OF LAW

Nancy L. Johnson
Chairman
Oversight Subcommittee
House Committee on Ways and Means
1136 Longworth HOB
Washington, DC 20515

Re: Joint hearing of the Subcommittees on Oversight and Human Resources, Committee on Ways and Means, on the Earned Income Tax Credit, June 15, 1995

Dear Chairman Johnson:

Thank you again for inviting me to testify about the earned income credit before the joint hearing of the Subcommittees on Human Resources and Oversight on June 15th. You asked my panel to consider the impact of Congressman Thomas Petri's proposal, particularly with respect to the marriage penalty. Here goes.

Description of Congressman Petri's proposal

As I understand his proposal, Congressman Petri would replace the personal exemption for children with an $1,100 per child tax credit that would be refundable for those with earned income. Then he would change the earned income credit to a credit of $1,000 per parent, phasing out for single parents between $9,000 income and $19,000 and for couples between $16,000 and $36,000. He would also eliminate the current earned income credit for childless workers. Congressman Petri's proposal is intriguing, and it merits serious consideration.

The refundable child tax credit

Unlike the current earned income credit, a refundable child tax credit would not create a marriage penalty. As long as the child tax credit is not phased out, there is no incentive to divorce or not marry.[1] For example, a low-income woman with two children could claim two child tax credits, and if she marries another low-income worker with two children, together the couple could claim four child tax credits.[2]

On the other hand, like the current earned income credit, because eligibility for the Petri child tax credit is based on having at least some earned income, the Petri child tax credit would sometimes result in a marriage bonus. For example, when a zero-earning woman with two children marries a low-earning man without children, they would get a large marriage bonus: before neither could claim a child tax credit (or a parent credit), but

[1] Of course, a phase-out of the credit at high-income levels (e.g., over $90,000) could result in a marriage penalty for certain high-income taxpayers.

[2] Under the current earned income credit, a marriage penalty of up to about $5,000 can occur if a low-income woman with two children marries a low-income man with two children: before each could claim the maximum $3,110 credit, but together they can claim just one, much smaller credit.

together they could claim two child tax credits (and apparently two parent credits as well).[3]

In passing, I should note that under the universal $1,000 per child refundable tax credit that I recommended in my testimony, there would be neither marriage penalties nor marriage bonuses. For example, a zero-earning woman with two children would get two refundable $1,000 credits whether she marries or not.[4]

The parent credit

At the outset, I must say that there is a certain attraction (perhaps even a certain genius) to the Petri parent credit. I like the idea of rewarding the "parenting" of children rather than simply the "having" of children.

Moreover, the Petri parent credit would reduce marriage penalties for most taxpayers; however, because the parent credit would be phased out, some couples would still face marriage penalties. For example, when a parent with $9,000 of earnings marries another parent with $9,000 of earnings, they would face a small marriage penalty of just $200: before each could each get a $1,000 parent credit, but together they would get just $1,800 in parent credits.[5] On the other hand, if a parent with $9,000 of earnings marries another with $25,000 or more of earnings, they would face a marriage penalty of at least $1,000: before the parent earning $9,000 could get a $1,000 parent credit, but together the couple would get no parent credits, and the $9,000 would be taxed at the couple's highest marginal income tax rate. Still, the marriage penalty under the Petri parent credit would typically be much smaller than under the current earned income credit.

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[3] Under the current earned income credit, there are also large marriage bonuses. For example, a large marriage bonus can occur when a zero-earning woman with two children marries a childless man with $10,000 of earned income: before neither could claim the earned income credit (and he had both an income and a Social Security tax liability), but together they could claim a $3,110 earned income credit and they will not owe any income tax.

My uncertainty about whether the couple in the text example could claim two parent credits or just one parent credit results from my not knowing whether or not Congressman Petri would require each parent to have earned income in order to claim a parent credit. From his testimony and the accompanying tables, I inferred that as long as one parent was working, each could claim a parent credit. Hence, the couple in the text example could claim two parent credits and two child credits for a total credit of $4,200.

[4] At the risk of trying to close the gate after the horses have left, I might pay for extending refundable child tax credits to parents without earned income with the money that the House welfare reform bill would revenue-share out to state welfare agencies. We already provide welfare assistance to nonworking mothers now through Aid to Families with Dependent Children (AFDC) and food stamps, and the universal $1,000 per child refundable tax credit that I favor would simply bypass the state welfare bureaucracies.

[5] Their combined earnings puts them at $18,000; that's $2,000 into the 10 percent phase-out range for married couples ($16,000 to $36,000). Of course, if the phase-out range for a married couple were increased to $18,000 to $36,000, there would be no marriage penalty at all for this couple.

Also of note, the Petri parent credit would provide larger benefits to married parents than to single parents with the same number of children. For example, a married couple with two children could get two child tax credits and two parent tax credits -- up to $4,200 in all. On the other hand, a single parent with two children would get no more than $3,200 -- two child tax credits but just one parent tax credit.

Rightly or wrongly, the current earned income credit does not make such a distinction: both a married couple with two children and a single parent with two children can claim an earned income credit of up to $3,110 for 1995. It seems to me that if a distinction is to be drawn between married parents and single parents, my inclination might be to give single parents the larger benefit, for example, to help defray their likely greater employment-related child care expenses.[6] Then again, the married couples have another parent to feed, and that alone might justify a larger benefit.

Replacing the personal exemption for children

If a refundable child tax credit is adopted, it could make sense to repeal the personal exemption for children, as Congressman Petri has suggested. Having both a credit and a personal exemption to account for children would be unnecessarily complicated. Also, the revenues associated with the personal exemption for children could be used to help pay for a larger child tax credit.

Eliminating the earned income credit for childless workers

Social Security taxes are regressive, and the current earned income credit for low-income childless workers tempers that regressivity. In my testimony, I suggested that a $5,000 per worker exemption from Social Security taxes would be simpler to administer. Nevertheless, the current earned income credit for childless workers is better than nothing, so I would not simply repeal it as Congressman Petri has suggested.

Respectfully submitted,

Jonathan Barry Forman

Jonathan Barry Forman
Professor of Law

cc: Representative Thomas Petri

[6] In that regard, I would be inclined to make the dependent care credit refundable (I.R.C. § 21). Jonathan B. Forman, Using Refundable Tax Credits to Help Low-income Families, 35 Loyola Law Review 117, 130-33 (1989).

Also, poverty is a much greater problem for single parents than for couples, and more than 60 percent of current earned income credit beneficiaries are heads of household -- mostly poor working mothers.

Mr. GREENSTEIN. Could I just make a very quick point that the only way that Congressman Petri's proposal is feasible is if Congress is willing to convert the $500 children's credit into what he does. The only way his proposal is affordable is if he uses the money in that $500 child credit, the House has passed, and restructures it into his proposal, but you cannot do both.

Chairman JOHNSON. I understand that. One of the issues that has developed in the EITC is its cost. When you are putting more than twice the amount of money the Federal Government provides for education for children, college students, and graduate students into an income subsidy you had better be very conscious that you are doing it and very confident that you are doing it for the right reasons.

I think we are doing it for the right reasons. I think this is the right policy and I think the testimony of this panel focusing on the interplay among welfare subsidies, minimum wages, the EITC and FICA and other payroll taxes was very interesting.

I was not aware of the extent to which States had stopped providing welfare to working people. The interaction of the various policies is extremely important. We give it too little attention. That is what interests me about the Petri proposal. I think we have to focus more on interaction. I welcome any thoughts that you have on that.

There are just two other relatively brief questions that I would like to ask you to comment on and then I will yield to my cochair, Mr. Matsui.

First of all, have any of you done any studies about the equity of the EITC State to State?

Mr. GREENSTEIN. Unlike things like AFDC and Medicaid the EITC has the same rules in every State nationally.

Chairman JOHNSON. Well, the reason——

Mr. GREENSTEIN. Because it is true—I think this may be what you are getting at—that the proportion of tax filers who get the credit is higher in some States than in others. That mainly reflects wage structures of the States. In low-wage States a higher proportion of families get it than in high-wage States.

Chairman JOHNSON. Yes. This question comes from my reviewing the material that I was given for this hearing and the tables that show how many filers there are in each State. It was very interesting to me that the New England States with 5 to 6 percent filers were very high cost of living States, were relatively high-wage States but because of our high cost of living what looks like a high wage is not.

It was interesting to me that Alaska, Connecticut, and Hawaii, the three highest cost of living States, have the lowest filing rate. Some of the much lower cost of living but lower wage States have filing rates of 20 percent and more. And we are down to 5 percent.

You look at California, even California is 15 percent. When I looked at who is in that 5 to 6 percent range it is primarily the New England States and others that have remarkably high costs. The older portions of the country tend to have higher costs for a lot of reasons.

I think we do need to think about that. I just wanted to point that out. If any of you have any reflection on that in the future.

Mr. SCHOLZ. Another factor that enters here is that, in States that have State income taxes people tend to be more likely to file Federal income tax returns. I think you will see fewer people in New Hampshire, for instance, file Federal tax returns than you will in States with State tax returns. Another small factor there.

Chairman JOHNSON. That is interesting since Connecticut just adopted an income tax about a year and a half ago, it would be interesting to see if our filing rate goes up.

Mr. FORMAN. Madam Chairman.

Chairman JOHNSON. Yes.

Mr. FORMAN. The problem that Connecticut has say, in comparison to my home State of Oklahoma which has lower average incomes, is if you have a fixed phaseout and it is relatively low, then the poorer portion of your population will tend to be above that phaseout. On the other hand, a low wage earner in Oklahoma, somebody in the bottom 20th percentile of income in Oklahoma would get the tax benefit credit.

I would say this is a problem of all Federal programs, the personal exemption of $2,500 this year is worth a lot more to people in Oklahoma where $2,500 goes further than it does in Connecticut.

Chairman JOHNSON. That certainly is a problem. When you are looking at this particular population we would like to be as equitable as possible.

Mr. GREENSTEIN. I was just going to add, I do not know all the details on the Connecticut income tax, but as I recall the level at which a family begins owing State income tax in Connecticut is much higher than in most other States.

Many people in the EITC range probably are not required to file State income tax in Connecticut.

Chairman JOHNSON. That is a good point, thank you.

Mr. GREENSTEIN. If, as a result of that, they file neither State nor Federal there might be a lower take up rate there than in States where, for example, you start owing State income tax at $7,000 or $8,000.

Chairman JOHNSON. My last question you may not want to comment on but it seems to me that key to eliminating abuse in the EITC system is simply eliminating the system of these loans. I wondered if any of you would want to comment on that?

We have rarely used that instrument of allowing people to, in a sense, borrow against their return and allow middlemen to basically make a profit by reducing the amount of return a taxpayer gets. Since, the whole purpose of the EITC is to expand the incomes of very low earners, it seems unreasonable to allow loan industry participation that diminishes the benefit that the taxpayers are supposed to enjoy.

Any comment?

Mr. GREENSTEIN. I think that is part of it. I think it is part of a larger issue and the larger issue is in any means-tested program the difference between verifying questionable information before payment and having a pure self-certification approach is, in my view, a very large one. If it is pure self-certification the word gets out on the street, that it is pure self-certification.

Prior to this year, if you look at the history of the EITC, prior to 1990, there was not even a schedule, the IRS did not even get on the return some of the basic information that told you whether the person was eligible or not. This Committee financed, and the Bush Treasury Department reformed the credit in 1990 and the results show that they got the errors down some, and started building this scheduled EITC, not until this year did the IRS use the information on the schedule to check, they just made sure that the numbers added up.

Even a year ago, January 1994, on a number of returns they did not check to see if the SSNs of children were accurate. There was no way to check to see if a child was claimed twice. Even for an older child you could write, you had applied for a number and had not yet gotten it from Social Security, and get the credit. There was the easy availability of loans, as you mentioned. There was little system to pull returns that looked questionable and actually verify the way that food stamps or AFDC does before pay out.

The IRS change this year in the EITC, in my view, after following means-tested programs for over 20 years, the single biggest change I have ever seen in 1 year in a program. Now, they check every Social Security number, they check every child's number to make sure no one is claimed twice. You cannot write applied for, you have to actually have a number. Most of these loans have been eliminated.

One of the things that I think is most important is the January 1994 study, that found about a quarter of the benefits being overclaimed, and from that, they erected error-prone categories. You did not hear that much of it from the Treasury because they are a little reluctant to talk about the study in great detail. They do not want people, quite appropriately, to know the details. If your return falls into that category IRS will pull it and send you a questionnaire that requires you to submit verification of various aspects of the claim before they will make the payment.

In my view, that could have a very large effect. In the late seventies, when the Carter administration and I was running the Food Stamp Program, among other food programs, we found that States that did very little verification had much higher error rates. We and the Inspector General went to those States and among the requirements, under threat of fiscal sanction, that we would put on them often were bring on more caseworkers to meet the following amount of verification of questionable cases. Almost uniformly the error rates went down significantly.

Chairman JOHNSON. Interesting.

Mr. GREENSTEIN. When the IRS says, on the back of the Commissioner's testimony here, I notice they did not talk about it, but in the back of her testimony there is a study and what they found in this new analysis is that if they had been doing all the Social Security screens last year that they were doing this year, the error rate that they found or the overclaim rate in that January 1994 would have been down to 19 percent. That does not include, because they cannot measure it yet, the effect of pulling something like a million questionable returns, is what I gather they are doing from this, and verifying data in them before payout. My belief is that when we get all the results in, we will be significantly below 19 percent.

It is still too high and we need to do more. The kinds of things that they have done this year, particularly checking all those numbers, nobody can be claimed twice, and having error-prone categories where you verify before payout, I think that is extremely important.

Chairman JOHNSON. Thank you. I am going to yield to Bob Matsui, my cochairman on the Oversight Committee.

Mr. MATSUI. Thank you, Chairman Johnson.

I want to ask Dr. Kosters a couple of questions. In your testimony—and I am sorry I was not there for your testimony—but you indicate that the EITC is not an incentive to work or it is a disincentive actually to work. Also, we know that 79 percent of every dollar earned over a threshold actually goes into the pockets of the taxpayer.

Now, do you believe basically that tax incentives or incentives in the Tax Code are not of much value or is it just in this particular case here?

Dr. KOSTERS. Well, Congressman Matsui, I believe that the work incentives that are built into the EITC and that are said to encourage work, do not really do as much, on balance, to encourage work as is often said to be the case. For those people who are in the phaseout range—the range where for every additional dollar they earn they need to pay an additional tax in order to reduce the size of the credit payment—all of those people are discouraged for work rather than encouraged.

Moreover, the income cutoff is so high that you are getting up into the income distribution to an area where there are lots of people. This is the thick part of the income distribution so much larger numbers are affected in that range, where work is discouraged, than where work is encouraged. So, on balance, I would say that among working families it seems to me that there is general agreement that work is discouraged for them. If you consider in addition nonworking people who might possibly be encouraged to consider working you might get some additional work on balance. Even then, I would say you are likely to get less total output in the economy.

Mr. MATSUI. What about the fact that these people use every dollar they earn for disposable income, very little of it, maybe none of it goes into savings if you are a family of three or four making under $30,000 a year. That is a first point.

The second point then is when they do work and they get income from that work they are getting more dollars in their pocket. Does that have an incentive to work to it? I mean particularly if it is 79 cents on the dollar?

I mean how could that be a disincentive to work if you need it, because that then prevents you from going into debt for one thing or having to borrow? Why is that not an incentive to work? It seems pretty common sense to me and I do not understand how you reach that conclusion that it is the opposite?

Dr. KOSTERS. I think you have put your finger on a puzzling aspect of this issue. You might say, well, if people are going to get extra money, surely they will work more no matter what their income level or the implicit tax they pay.

Mr. MATSUI. Well, I mean if it were 10 cents on the dollar, I would say, OK, maybe there is no incentive to work. If it is 79 cents on the dollar, it seems to me, particularly if you need the money—if you did not need the money, if you are making $200,000 or $300,000 a year and you do not need the money, then you may not—but if you need the money it would seem that, boy, that is a pretty good incentive to work.

Dr. KOSTERS. Well, for every extra dollar a person earns in that upper range there is, first of all, the 21-cent implicit tax workers could keep 79 cents, presumably, if they were not also in the 15-percent income tax range, plus perhaps State income taxes. Workers probably would not be able to keep quite that much, at least in the upper part of the income range but, below the EITC cutoff.

Moreover, it seems to me that if you do not believe that people are going to respond to work incentives in the upper part of the income range where they receive EITC payments, it is unlikely that people would be encouraged to work in the lower part of the distribution. Consequently, if these incentives produce no encouragement or discouragement to work, that raises a question about why we would not administer these payments completely through other welfare programs if there are no incentive effects. We would then not need to duplicate an auditing bureaucracy which is already in place to administer other programs. We would then not need to expand compliance efforts by the IRS.

Mr. MATSUI. Are you suggesting that we move this to an appropriation?

Dr. KOSTERS. Yes. As a matter of fact EITC payments are outlays instead of offsets to tax liabilities.

Mr. MATSUI. And you would support that?

Dr. KOSTERS. Yes.

Mr. MATSUI. You would support 25 dollars' billion worth of appropriations to these people?

Dr. KOSTERS. Yes, I have suggested that. I think it would be better to administer payments under this program in a different way than through the tax system. Increasingly, as more complexities are added, the EITC looks more and more like the welfare system and it is very difficult for individuals to self-administer such a system. That is why they go to tax preparers, get loans, and so on.

Mr. MATSUI. Frank, it seems just the opposite to me, but I appreciate your comments and all of you. I know my time is running out and we have a vote. But, Mr. Greenstein, much has been discussed about the 1988 TCMP study. Would you just comment on that and explain whether this is an important issue for us to be concerned about, the so-called 40-percent rate of error?

Mr. GREENSTEIN. The issues it raised are important but the data from the 1988 TCMP is really not relevant today. It does not describe the current situation. Congress in 1990—looking at data from the 1985 TCMP which is very similar to data from the 1988 TCMP—for several months the staff of this Committee, the Finance Committee, Treasury, and the IRS on a bipartisan basis did a major restructuring of the credit. That major restructuring, GAO subsequently did an analysis of it, and pointed out that they had removed the single major source of error from the EITC.

There were some extremely complicated rules on support tests, and household filing status and dependency status that were hard for taxpayers to understand and that IRS could not enforce and those were removed in the 1990 change.

I think the indication that there has been real change is that the 1988 TCMP found that about 34 percent of the credit dollars claimed that year were overclaimed.

The January 1994 study of a nonrepresentative sample that probably had an above-average error rate had that figure down to 26 percent and the latest Treasury analysis, IRS analysis which is in the Commissioner's testimony, indicates that the current screens they have in place would have reduced it below 19 percent.

That is what I was referring to when I said we appear to have cut the error rate about in half from what it was at the time of the 1988 TCMP. It is still too high, we have got to do more, but we appear to have cut it about in half.

Mr. MATSUI. I appreciate that answer. I am going to yield to Mr. Cardin.

Mr. CARDIN. Thank you. We only have a minute or two. First let me say that, to my friend Mr. Matsui and to our panelists here, I think on the next panel we have some people who can speak first-hand as to how the EITC was an incentive to work and I think that is the clear record of that effect. One of those individuals is Rhonda Clark, who happens to be from Baltimore, my district. I am not going to be able to be here during your testimony but I want to welcome you to our Committee.

I also would just like to make one point, if I might, for the record. It is interesting that we have been spending all of our time talking about trying to make sure that the error rates are brought down and we all agree on that and we need to change the system to make sure it works efficiently and that only those who are entitled to benefits, receive the benefits.

But we have not been talking much about a large number of people who are perhaps out there who are entitled to the credit who do not avail themselves of the credit. We really have not talked about one of the things that concerns me, which, is that this is a credit that some people are entitled to who do not even know about it. It could be used even more effectively to get people to work and I am not sure that we have taken full advantage of the credit. It is not to diminish the importance of making sure that we reduce the error rates, particularly the fraud rates as low as possible. We should not lose sight of the fact that this is a very valuable program and we should not be timid about making sure it is available to those people who could benefit from it.

I thank the Chairman for yielding to me, and I yield back.

Mr. STEUERLE. Mr. Cardin, if I could just make one addition. To get to your problem, one of the major things you need to do is get to simplification. That has always been a goal. That is a major way you get the EITC to the people who do not yet file for it.

Mr. FORMAN. Mr. Cardin, if I might come back to my proposal which would be for a $5,000 across-the-board exemption from Social Security taxes. Right now, basically 80 percent of the people eligible for the EITC are claiming it. The other 20 percent are not.

If you actually just said, well, we are just not going to collect the taxes on the first $5,000 of wages, then the other 20 percent would not have to pay these taxes and would not have to file the EITC to get the benefit back. We could get some benefit in every worker's hands with an across-the-board exemption.

We have exemptions and standard deductions in the income tax system, but the Social Security tax system is a regressive tax system that hits people on the very first dollar of wages.

Mr. CARDIN. Thank you.

Mr. ENGLISH [presiding]. Thank you.

Gentlemen, we appreciate all of the testimony you are offering today and your massive expertise as a group. Just a few questions on my end. Dr. Kosters, you suggest in your testimony that the welfare system is already better able to administer the EITC Program than is the IRS.

My question is, do you believe that welfare agencies are better able to track the earnings and assets of an individual, and if the EITC were administered by welfare agencies, would that not mean that low-income earners, many of whom have never dealt with the welfare systems, would be required to deal with welfare agencies as well as the tax system?

Dr. KOSTERS. Well, that is an interesting question. There are some people who are getting the EITC who are not dealing with the welfare system, and if we wanted those people to get payments, and right, if kinds of people in different situations might be mentioned, people who are, say, graduate students who might qualify for the EITC, but who are not on welfare. We want those people to get payments. Then they would have to presumably also get them through the same system.

It seems to me that one possible approach to this, though, would be to say, let's have an EITC that roughly compensates people for the payroll taxes they pay up to a certain level, and people who qualify for that can apply for it in the same way it's administered now.

People who get larger payments in the $3,000, $3,500 range, or something like that, those payments should be part of the payment system administered by the current welfare bureaucracy, as reformed. Reform is now under way.

Mr. ENGLISH. Dr. Kosters, I know you are doubtlessly familiar with research by Gary Bertless, which seems to show that welfare mothers who can be expected to stay on the roles for an extended period of time, specifically those with little education, low test scores, and very little job experience, usually can find jobs that pay between $5.50 and $6 an hour, around $12,000 a year, and we have a lot of situations like that in my district.

Bertless finds that most of these mothers fail to raise their wages over a 12-year period. These mothers are going to have to make a go of it on earnings of around $12,000 a year.

Given the reality that our countries will have millions of low-skilled mothers rearing children for as far into the future as we can see, do you think that it would be better for the mother, for the children, and for society if these mothers are helped to a tolerable standard of living through the EITC provision?

I guess expanding on that, is not this strategy far preferable to allowing these mothers to stay on welfare indefinitely?

Dr. KOSTERS. Well, welfare mothers with low-earning capabilities, and in general, as research by Bertless and others shows, welfare mothers do have relatively low-earnings capabilities.

This situation is not a cheery one, whether or not they get EITC payments. It seems to me that in our welfare system, we need to be prepared to provide support to some people. Some will not be in a position to be able to work, and they need to be provided support, perhaps more support than they are now providing.

For others, though, it seems to me, we could differentially treat them, provide them with less support if they are able to work, but choose not to.

My sense is that the EITC is not going to make a big difference on that choice, and it seems to me it needs to be somewhat more of an administered choice.

With regard to whether or not people's earnings rise, people with relatively low earnings, that data of course comes from a period during the past 15 years or so, when people with low-earning capabilities had declining relative wages and they did rather poorly.

It's no surprise that that also applies to welfare mothers, or previous welfare mothers, people who were on welfare and later on went to work. Those with lower earnings capabilities got very slow increases, like others who had not been on welfare previously.

Mr. GREENSTEIN. Mr. English, if I could just add a word. I think your question hit a very important nail on the head, or both of your questions. The fact of the matter is, most of the families that get the EITC, I think, are not on welfare, and most of them are not graduate students either. Many of them are people who probably will not go to the welfare office, if that is where you have to go to get the credit.

We can take food stamps as an example. The working poor are eligible for food stamps. The income level goes up to modestly over the poverty line. The data show that only about a third, or 40 percent of working families that are eligible for food stamps, actually receive it.

I also think, you know, we know that many mothers work their way off welfare and some of them slide back on.

I think the EITC helps prevent some of them from sliding back on. If they have to commute to a rural area in a job, in an old car, and the car breaks down, that EITC, we hear, does things like pay for that $800 car repair, without which they give up the job and they go back onto welfare.

The final point I would like to make is, last week there was a similar hearing to this one at the Finance Committee on the credit, and the GAO made a very interesting point.

Their point was that, while the noncompliance rate is higher in the EITC than in programs like AFDC or food stamps, it's coordinated with the tax system, so less than 1-percent of the dollars and the credit go for administration. The AFDC, food stamps, and other like programs use 12 percent of all the dollars in the program for administration and EITC.

I disagree with Marv on this. I think we are much better off assisting these people through the tax system than making them go back into the welfare system to get a wage supplement.

Mr. ENGLISH. Thank you, Mr. Greenstein.

Dr. KOSTERS. I wonder if I could just add to that. With regard to costs of administration, it seems to me it would be appropriate to add into those costs the costs of paying tax preparers and of floating loans, which seems to me to be a real cost under the EITC as it is currently administered.

Mr. GREENSTEIN. Well, that is a reduction in the benefit the family gets, and in the absence of the refund anticipation loans, I think the commercial preparers often charge $30, $40, or $50 bucks, which is a relatively small proportion of the EITC payment.

The additional payment that, fortunately, is now disappearing, are the additional payments lots of people paid for those loans in the past. If they do not get the loans anymore, the advance loans, then they do not have to make that interest payment for the loan.

Mr. ENGLISH. Thank you, Mr. Greenstein, and I want to thank all of you. I have about 15 more questions, but I am afraid the time does not allow us to pose them, and I appreciate this panel which represents more academic expertise on this subject than I have ever seen assembled, taking the time to come here and offer the benefits of your research.

While I am here, at this moment, alone, I want to say that on behalf of all of the Members of the Ways and Means Committee, we appreciate the contribution that you have made to this debate, and I appreciate your coming out today.

Thank you very much, and I will empanel the next group of witnesses.

We are going to start with the parents who are currently utilizing the EITC.

I welcome Joseph Antolin, deputy director of the Illinois Department of Public Aid, in Springfield, Illinois, who is accompanied by Sherry Alvarez of Chicago, Illinois, a parent currently utilizing the EITC.

Also with them is Dr. Lynn Olson, director of the Division of Child Health Research of the American Academy of Pediatrics, and a visiting scholar for the Center for Urban Affairs and Policy Research of Northwestern University in Evanston, Illinois.

Also Rhonda Clark of Baltimore, Maryland, who is currently utilizing the EITC.

I understand one or two of you have to make the train, so what I would like to do is start with Sherry Alvarez.

STATEMENT OF SHERRY ALVAREZ, CHICAGO, ILLINOIS

Ms. ALVAREZ. Good afternoon. Thank you for having me.

I am nervous. I am a former recipient of public aid. I am working now. I have been working for 1 year. The tax credit has helped a lot because I have had some—while I was working, I had a crisis, and without the credit, I might have lost my job, and would have had to go back to public aid.

Having the credit helps, because I had the money there to prevent losing my job.

The crisis was a propertyowner where I used to live, he sold the building but he did not give me any notice. The new landlady came, and she gave me 30 days notice to leave.

We had no savings or anything, so it would have been hard to find somewhere for me and my kids to stay, without having the credit to back me up.

Mr. ENGLISH. Thank you, we appreciate your testimony, and if you want to amplify on that during the question and answer period, we can do that, too, if you prefer.

Ms. ALVAREZ. Thank you.

Mr. ENGLISH. Thank you so much for taking the time to come here and testify from Illinois.

I would like to recognize now, Rhonda Clark, for your testimony, and we appreciate your being here.

STATEMENT OF RHONDA CLARK, BALTIMORE, MARYLAND

Ms. CLARK. I thank you for the opportunity to speak with the Committee today. My name is Rhonda Clark and I live in Baltimore, Maryland. I am a 26-year-old mother of an 8-year-old girl and a 7-year-old boy. I work full time as a receptionist at the Maryland Committee for Children, and the sole support of my two children.

I am a recipient of the advanced earned income credit, which means I will receive about 60 percent of the re-credit in each paycheck. At the end of the year, I file for the remaining 40 percent, and it is a very simple task to fill out one form with the dependents and sign my signature. It is not a very hard process to go through when filing.

My story is not unique. I am like many others you may know, or you may not know. I dropped out of high school when I became pregnant with my daughter. I received my general equivalent diploma, my GED, but I was an AFDC recipient for 3 years until I went to Project Independence, which provides job training.

Through Project Independence, which is Maryland's welfare-to-work program, I learned skills while I worked for a number of organizations, including the Francis Scott Key Medical Center, in the personnel department, and the Baltimore Public Works Museum, as a tour guide and admissions clerk.

In November 1993, I joined the private sector working full time at the Maryland Committee for Children.

Although you have never met me, you know many others like me. The receptionist who directs your calls, the mother in the grocery store with two children, or the person you pass each morning on the way to work.

The advanced earned income credit is very important to me and my family. I learned about it through my employer and it was easy to apply.

While it is not an answer to all our problems, such as the need for affordable child care and health care, it has been a big help.

Educating the people about the EITC takes place one person at a time. That is why it is important for all of us to spread the word and tell others about the EITC. There are many more people out there who could be getting the help they need, if only they would simply apply for it.

Applying is easy. To get the advanced earned income credit, all I had to do was list my dependents on an application, sign my name, and give it to my employer. The payroll services processed it.

I have my advance earned income credit deposited into a savings account, so that it does not cross my hands, and it does not make me want to spend it right then.

I think it also is a better way of not getting more trouble for myself, giving false information, the information is there in each paycheck.

I enjoy working and I want to continue to work. The EITC gives me some of the help I need to keep working, to stay independent, and to support my family. It is a help I cannot do without.

Thank you.

Mr. ENGLISH. Thank you.

I think what I am going to do, with Dr. Olson and Mr. Antolin's indulgence, is ask the two of you a couple of questions, and then as you need to leave, give you an opportunity to head out, and then I will get their testimony and ask a few more questions.

We very much appreciate all of you taking the time to participate here today, and improve our understanding of the EITC.

For Sherry Alvarez, I have a question. Rhonda, you had indicated that you first heard of the EITC through your employer. Sherry, how did you find out about it?

Ms. ALVAREZ. Also through a similar program. It is called Project Chance, in Chicago, and I volunteered for their program, to go back to school, and I needed one credit to get my high school diploma. I went back and I got my high school diploma, and she was very helpful.

She told me about the DAC Program, and although I found work on my own, she was very helpful. I learned about the credit from Project Chance.

Mr. ANTOLIN. Mr. English, if I may, that is the JOBS Program in Illinois.

Mr. ENGLISH. Very good.

Ms. Clark, in your experience, do mothers in the welfare system understand the EITC?

Ms. CLARK. Not truly. A factor is simply that the government is giving them money. This is what most of the people I spoke with talked about. I have done conferences on the EITC in the past, and what we have found is a lot of people do not know why. They have asked me why, actually, and it is easy enough for me to say it is simple, it gives you the incentive to keep working, to stay.

Instead of making $15,000 that year, you may make $17,000. It opens a lot of eyes and makes them want to stay. Instead of sitting home watching Oprah, they can be working and making $2,000 more that year. It is not clear to a lot, but now, the more we have spread the word the past few years, the clearer it is to people, why they get the EITC.

Mr. ENGLISH. Ms. Alvarez, has that been your experience, too?

Ms. ALVAREZ. I believe so. A lot of people do not understand why they get the credit. I explain that, EITC helps to keep lower income people who have children working.

I guess that is how I explain it. It is for the lower income people with kids. The government wants to keep them working.

Mr. ENGLISH. For both of you, if you were going to take steps to teach mothers about the EITC, what would you look to do? Would there be a good way of getting the word out, do you think?

Ms. CLARK. I cannot really say what would be a good way. I know that most people that are on AFDC do not know about the earned income credit. They do not know until, just by chance, they get that little flier, and then it may mean nothing to them. They just throw it away because they do not know what it means, or it does not pertain to me because I do not work. I am just here getting my AFDC check cashed.

I would just explain to them that it is to help you stay out there, because in my own crisis, worrying about this credit stopping, it may mean like Mr. Goldstein spoke earlier, sliding back into the AFDC system and that is something that I really do not want.

The EITC I believe would be just that little bit, for people that I speak with, knowing that child care cost is the biggest issue. Child care, to me, is more of an issue than the food program.

Who is going to watch your children? That is the most important and most dearest to your heart. We just need to let the mothers know that the money is there for those purposes, for the food purposes, for the child care, the health care.

Money for emergencies. AFDC recipients do not have money for emergencies. That is how I take advantage of my EITC, by having it put into a savings account for that and child care purposes.

Now that I do have the EITC, when my child care facility decides to go to the beach or bowling, there is that $5 or $10 I can pull from my savings to say that they can go, on things that we would never have been able to, otherwise.

It gives the parents the hope that their children can have what they have.

Mr. ENGLISH. I appreciate your testimony because you have given us a perspective that just is not often heard in the halls of Congress. What I would like to do is bring in now Dr. Olson and Mr. Antolin, and if any of you have to leave because we are running so late with this hearing, feel free to head out.

I very much appreciate your time. Mr. Antolin, can I bring you in now for your testimony, and we very much appreciate your taking the time to be here.

STATEMENT OF JOSEPH A. ANTOLIN, DEPUTY DIRECTOR, ILLINOIS DEPARTMENT OF PUBLIC AID, SPRINGFIELD, ILLINOIS

Mr. ANTOLIN. Thank you. This is an important issue to us in Illinois, Mr. Chairman, Members of the Committee. On behalf of Governor Edgar and Director Wright, I thank you for this opportunity.

I am the deputy director for the State Department of Public Aid. That means I am responsible for the AFDC, the food stamps, the employment and training program, child support, and welfare reforms.

One of the things that we have been trying to do for the last few years in Illinois is change what motivates client behavior to move them to work. It is very consistent with what Congress wants the States to do, and which we think the States can do well.

We have the 6th largest AFDC population and the 26th highest grants. We are a low-grant State, relative to most of our neighbors, and have, as a result, thought about welfare to work somewhat differently than many of our neighboring States.

We have established waiver programs that got rid of the two-parent penalty, that have made it much less confusing as to what are the incentives to work. The cornerstone of our programs has established a program called Work Pays, which is a State budgeting method to say to welfare clients, it is worth it to go to work, any time, any place, for any kind of job, for however many hours. They are better off, because they keep $2out of every $3 that they earn.

In addition, we have integrated the EITC as part of the marketing of Work Pays to our clients to motivate them to go to work.

EITC, Work Pays, and the other sets of AFDC waivers that we call Fresh Start, have combined to move people from welfare to work, and what we are trying to do in Illinois. We have trained our staff on how the EITC works, and some of the nuances of the rules, and how they qualify, so that they can explain to our clients.

That is the income maintenance staff, not the traditional staff that talk to clients about work-related activities.

The EITC pamphlets and posters from the IRS are in all our offices, and are available next to the public aid offices.

They are handed out as part of the intake package that individuals get, explaining to them what are some of the programs they can benefit from by working.

Our earned income workers, who deal with clients who have earnings, have IRS tax forms on hand and give them to the clients when they have face to face interaction with them, to urge them to apply for EITC.

All of the Work Pays pamphlets that we have now reference the EITC and the benefits of EITC as well. All of the public presentations, the scripts involved, talk about EITC as well as Work Pays, as if they are part and parcel of the same welfare to work initiative, which is how we are treating them.

There is an annual written notice, in January, that goes to every AFDC client, with their check, telling them about the EITC and the benefits of going to work, and if they have worked in the past year, that they should be filing for it.

EITC information is part of the video that is playing in the waiting rooms in many of our offices now, along with Work Pays and paternity establishment. They are the three important themes.

You might ask what has been the point of that, and various other intermittent things that we have done—media blitzes about Work Pays and the EITC.

Nineteen months ago, when we started the Work Pays waiver, about 6.8 percent of the AFDC population were working adults.

That accounts for about 14,000 cases in our State. Last month, we had 28,400 families working while they were still on AFDC.

In addition, during those 19 months, we had 35,000 families cancel assistance because they were working.

Our AFDC rolls are going down, our earned income rolls have doubled, and what we are basically seeing is more and more people moving into the work force. Admittedly, many are moving into low pay, minimum wage jobs, but that is the market reality.

Why we think EITC is so important is exactly that market reality. The jobs that are being created in Illinois often tend to be entry level, minimum wage, or a little bit more than minimum wage, less than full-time jobs, often without benefits.

Work Pays and EITC make it worthwhile for individuals to leave welfare or have a reduced welfare benefit, and go into the work force.

What Ms. Alvarez did not testify to, if I could add, is that when she started working, there was a modest AFDC supplement. She got a pay raise due to the quality of her work at the insurance company employing her. As a result, she lost AFDC eligibility. She has gotten a subsequent pay raise. EITC has helped smooth through at least two crises that we are aware of.

One, to which she referred, was the eviction where the EITC funding came through in terms of a security deposit and moving expenses, which she otherwise would not have had.

Let me assure you, before EITC and Work Pays, she would have been back on welfare. The second is that she is being asked by her employer to do some traveling, there is money set aside with this year's EITC refund for a car which she plans to purchase. She could not have done that before, and she could not have done it at her salary.

So EITC Is really making it possible for her to keep working and expand her responsibilities, and do better.

[The prepared statement and attachments follow:]

STATE OF ILLINOIS
DEPARTMENT OF PUBLIC AID

Joseph A. Antolin, Deputy Director

**EARNED INCOME TAX CREDIT
ADVISORY HEARING**

June 15, 1995

Good morning, Chairman Johnson, Chairman Shaw, and members of the Subcommittees on Oversight and Human Resources. I am Joseph Antolin, Deputy Director of the Illinois Department of Public Aid. I am responsible for Field Operations, Child Support Enforcement, welfare employment and training programs, and welfare reform demonstrations in Illinois. On behalf of Governor Jim Edgar, Director Robert Wright, and the State of Illinois, I thank you for this opportunity to discuss the Earned Income Tax Credit (EITC) and its integral role in our efforts to move AFDC recipients into the labor force and off welfare.

Illinois is a large, diverse state with the sixth largest AFDC caseload in the nation. Our state has also been a leader in welfare reform by changing the incentives in the system to motivate different behavior. We have integrated EITC into our reforms and our experience. The current EITC program establishes, when used in conjuction with reforms, a powerful financial incentive for clients to work instead of just being dependent on welfare.

1993 FRESH START WELFARE REFORM INITIATIVES

The federal AFDC rules governing work and eligibility are complex and confusing to both clients and staff. They severely limit financial incentives to work, since either after 4 months or twelve months, the AFDC grant is essentially reduced a dollar for every dollar earned. As a result, after a working person's social security and taxes were deducted from income and Medicaid eligibility ended, a working family member was often worse off financially than a person dependent on welfare. To turn these disencentives around, Illinois has implemented a set of federal waivers, policy changes, and a statewide welfare to work marketing program.

In November, 1993, Governor Edgar implemented a multi-faceted federal welfare reform demonstration called Fresh Start. Fresh Start includes statewide waivers to support the family stability and employment potential of two-parent households, and encourage recipients to accept seasonal or temporary jobs; and smaller demonstrations to move homeless families into work, provide job training to at-risk teens before they have a child, and to train unemployed non-custodial fathers so that they could support their children.

However, the main component of Fresh Start, and the centerpiece of Illinois welfare reform is a program we implemented statewide and call Work Pays. The major goal of Work Pays is to give AFDC clients an earned income budgeting system that provides positive, real financial incentives to go to work. Work Pays replaced federal regulations for budgeting earned income (commonly referred to as the "$30 and one-third disregard"). Work Pays sends a simple message to parents on AFDC that they should be working because it will always be in their best financial interest to do so. Under Work Pays, for every $3 earned, the AFDC cash assistance grant is reduced by $1. These grant reductions and the corresponding reductions in the family's food stamps continue until the family has worked their way off welfare.

At the same time Illinois was implementing Work Pays, the federal government was enhancing the value of EITC for working families. Only by going to work could a welfare family obtain the credit. Work Pays and EITC, thus, combined into a powerful incentive for AFDC clients to enter the labor force.

Work Pays and the EITC have been the catalysts for a fundamental change in the welfare culture in Illinois. Public Aid offices no longer simply determine payment levels and authorize the distribution of assistance checks to "eligible" cases. More than ever before, the emphasis of the caseworker and the Illinois welfare system is to help parents find their way off welfare through work. At every client redetermination and interview, caseworkers review the benefits of Work Pays and the EITC. Each local public aid office now establishes an annual target to increase the level of clients who are employed in that county.

As I will explain in detail, Work Pays and the EITC are the cornerstones of an aggressive effort to sell the idea of employment to both long and short-term welfare clients.

HOW ILLINOIS HAS USED EITC TO PROMOTE EMPLOYMENT AND WELFARE REFORM

EITC is an ongoing, essential part of Illinois' intensive efforts to motivate and move large numbers of AFDC clients into the work force. To illustrate:

In FY'95, Illinois contracted with a not-for-profit organization in Chicago, the Center for Law and Human Services, to train our staff in the EITC and how to promote it to clients. Staff now tell job seekers how the EITC can turn a $5 an hour job into one worth $6 an hour.

EITC pamphlets and posters were obtained from the IRS and are readily available to all clients in each of the 142 Department of Public Aid offices in the State. In addition, our earned income budgeting caseworkers have IRS tax forms on hand and encourage clients to file their taxes.

A description of the benefits of the EITC and its role in moving people from welfare to work in conjunction with Work Pays and Fresh Start policies is the focus of our public presentations on Illinois welfare reform to clients, community organizations, and the general public.

The EITC is addressed in detail at all client orientations of the Illinois JOBS Program. In our job readiness sessions with clients, the EITC is discussed as a major incentive for recipients of public assistance to seek, obtain, and retain jobs.

An annual written notice on the benefits of EITC is distributed to all AFDC cases, usually in January. We explicitly emphasize how this program makes work a better option than just welfare.

The EITC has also been a main component in our Work Pays and other welfare reform marketing efforts. Some examples include:

The positive effects of the EITC on an AFDC family who goes to work is a major part of our client Work Pays brochure. Over 150,000 have been distributed since November of 1993.

The EITC is an integral part of our Work Pays video, which is shown on a continual basis in many Department waiting rooms.

EITC calculations are highlighted in our agency Work Pays handout sheets. These give clients tangible examples of how Work Pays and the EITC will really impact their income.

In 1994, the Department placed "Letters to the Editor" from local Department administrators in newspapers throughout the state to explain the thrust of Work Pays and the EITC and the renewed commitment to move people into the work force.

In Spring 1995, the Department hosted two major Work Pays Job Fairs in the City of Chicago. Nearly 4,000 clients volunteered to learn about work opportunities, meet employers, and most importantly, discover how getting a job could benefit their families financially. The Work Pays income disregard, when combined with the additional benefits of EITC, brought home to clients exactly how much their total annual incomes can increase dramatically when they take a job, even a part-time minimum wage job.

What have been the results of this welfare to work effort?

In October, 1993, only 14,144 or 6.8% of the employable AFDC cases in Illinois were reporting earnings from employment. By May, 1995, 28,413 or 13.7% of AFDC cases that include an adult were working. This represents an increase of over 100% in the first 19 months of a 48 month waiver.

In addition, over 35,419 clients have cancelled assistance due to earnings over the same period and Illinois' AFDC caseload has begun to get smaller. I have attached a chart which reflects this tremendous growth in employment. I'd also like to share a map of Illinois which portrays counties which had 20% of the AFDC clients in the workforce prior to Work Pays and to marketing EITC, and contrast with a map of the counties which have at least 20% of the AFDC caseload employed today. These results have exceeded our expectations, but confirm the power of economic incentives in moving people from welfare to work.

We know from client surveys and input from community organizations that the focused marketing of Fresh Start, Work Pays, and EITC have played a major role in this movement to work. Without the availability of the EITC, especially for low wage jobs, these results would not have been achieved as quickly.

NEW EFFORTS AT WELFARE REFORM IN ILLINOIS

To allow us to assist even more individuals to move off welfare, Illinois has embarked on an ambitious plan to further reform welfare in our state. These new initiatives are designed to build on the incentives to work created by the EITC, Work Pays, and Fresh Start, and to strengthen our active efforts to move people into employment and off of public assistance. While we are currently seeking federal waivers to implement some parts of the plan, the basic design put forward by Governor Edgar has four large components:

> First, teen mothers, 18 years old and under, must return or stay in school and complete their high school education or obtain a GED to receive AFDC. They will be better equipped to get a job and avoid the risk of long-term welfare dependency. This is known as Illinois' Teen Parent Initiative and is currently in operation in Illinois. Along with case management and supportive services designed to assist these young mothers, parenting classes are mandatory. The Department contracted with 44 community-based organizations statewide to provide case management to over 7,000 teen parents.
>
> Second, parents whose youngest child is 13 or over will be placed in the "Targeted Work Initiative", which has a two year time limit for receipt of AFDC without earned income. Many persons in this group are long-term welfare recipients. The program is designed to move clients into any employment, but it is likely it will be in part-time, minimum wage jobs. The EITC will be a key factor in these clients staying with the job as they transition off welfare.
>
> Third, job ready AFDC applicants will be required to participate in job readiness sessions and intensive job search. Seeking employment will be a full-time activity for this group in their initial experience with the welfare system for the first six months.
>
> Fourth, the promotion of Work Pays and the EITC will be closely linked to four aggressive and innovative child support collection initiatives. AFDC recipients will be educated as to how the combined benefits of employment, Work Pays, the EITC, and child support payments, is the best approach to escape poverty.

Illinois has chosen to pursue these reforms even before a block grant is reality, in part, in reliance on the availability of the EITC to make any employment provide financial gain for the family.

EITC AND WELFARE REFORM IN ILLINOIS

The reform initiatives I have described involve nearly 100,000 current and future welfare recipients through FY'96. Due to resource reality and to help clients be responsible for their own futures, Illinois will continue to focus on motivating clients to be their own job developers. A big part of this is first convincing them that, indeed, work does pay. They must recognize that even at entry-level or part-time wages where most welfare clients do start working, it makes financial sense immediately to get and keep a job. When job seekers on public aid understand the financial incentives to be gained, they become much more motivated. Employers with entry-level positions are looking for persons with motivation, and the EITC often provides the "carrot" that makes the difference.

From a policy perspective, the beauty of the EITC is that you have to work to get it. It is not just another welfare "entitlement" that simply pays individuals for doing nothing. As we make the receipt of assistance benefits dependent upon the client's willingness to work, we must ensure and constantly reinforce that they will always be financially better off to do so.

Also, a point that should not be lost in the debate over the EITC is its role in supporting employers. An employer is not expected to be a social service agency. An employer wants a dedicated, enthusiastic employee. No employer wants high turnover at his company, even in entry level positions.

The current EITC program reflects the economic realities of the 1990's. Many of the jobs being created during the current economic expansion are entry level opportunities in service or retail areas. Many offer less than full time hours. However, any job is better than no job. The EITC allows individuals to take jobs that are available, but that they may have previously avoided due to low pay or lack of benefits. Since the economy is creating these jobs, the financial incentives must be in place to expect those on welfare to work and to support their families.

The EITC and initiatives like Work Pays in Illinois help to supplement the low wages necessary in many entry-level jobs. This allows a person, new to the workforce, to meet the day-to-day or unexpected financial needs of their family. At the same time, they can continue to be a valued, ambitious employee. As a person gains experience on the job, wages will usually increase, or they may move to a better job. The experience gained and the need for outside financial supports will progressively lessen and will ultimately disappear for that employee in many, if not most, cases.

HOW EITC HELPED A WELFARE MOTHER TO SELF SUFFICIENCY

Congress often uses tax incentives to encourage certain desirable economic or social activity, and is willing to forego the revenue lost to acheive positive results. The home mortgage interest deduction encourages home ownership because when people own their own homes, the strength and stability of the nation is enhanced. People have a real economic and social stake in the society in which they live. Even more than home ownership, the idea that the able-bodied should work and support themselves is one of the fundamental values that we all hold dear. The main purpose of the EITC is to strongly support that value.

With me today is Ms. Sherry Alvarez who illustrates how the EITC has served its purpose. Hers is a successful testament to how positive public policy can help a family leave the public aid roles and become self-sufficient. She will tell you her own story, but I would like to review the principle facts here.

Ms. Alvarez is a mother of two who received AFDC for approximately five years before her income from employment was sufficient to cancel her public assistance case. During that time, she volunteered for the JOBS program and participated in a Community Work Experience placement at IDPA headquarters in Chicago. Subsequent employment at an insurance company has allowed her to successfully leave the AFDC roles.

The EITC was a significant factor when a housing crisis arose for the Alvarez family. They were able to provide a security deposit and the first month's rent with funds from the EITC when they were forced to relocate with little notice. Without the EITC, the family would not have had the resources to relocate while Ms. Alvarez continued working. Moreover, if she would have had to interrupt work, she very likely would have returned to the assistance roles.

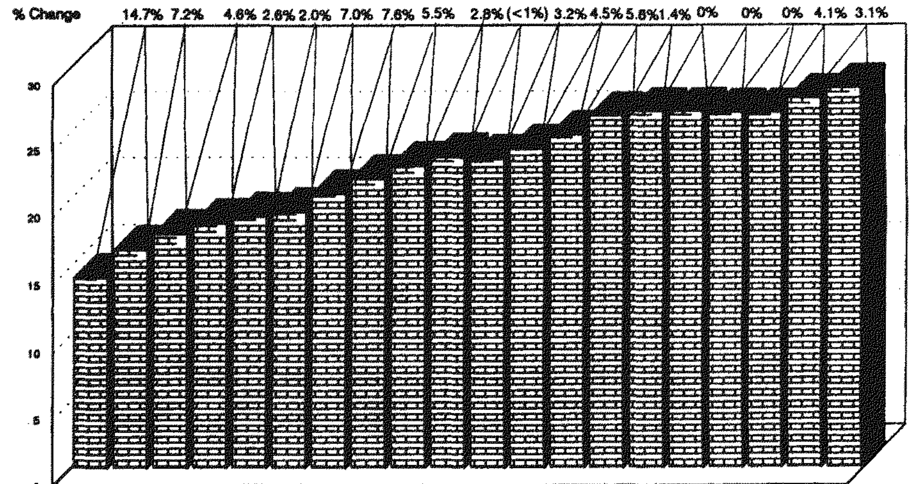
CONCLUSION

I hope my testimony has adequately explained the critical role EITC plays in the efforts of tens of thousands in Illinois alone who are trying to work to create a better life for their families and to become taxpayers. As you consider making refinements in the EITC, please remember its very important role in getting people off of welfare who are hardworking, but happen to earn low wages.

In sum, welfare reform requires state flexibility to design the programs and to use the tools to make work a real alternative to welfare dependency. We have forged ahead in welfare reform in Illinois through the foundation piece, Work Pays, with the EITC as an integral part of that effort. We have made great strides in Illinois and anticipate you will help us continue moving forward on this path even as you refine EITC. Thank you again for the opportunity to address this Subcommittee.

Clients with Earned Income

Adjusted BoMB/Operations Numbers

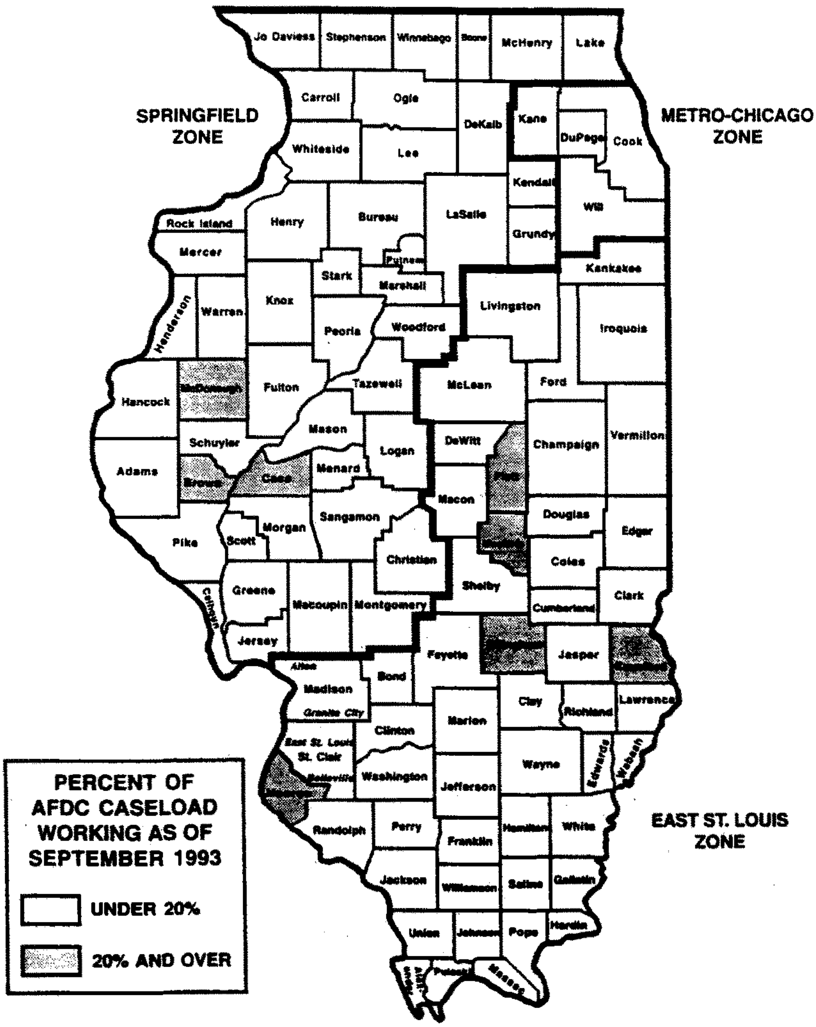


	Oct	Nov 93	Dec	Jan	Feb	Mar	Apr	May	Jun 94	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar 95	Apr	May
Earned income caseload	14.144	16.226	17.368	18.196	18.882	19.026	20.356	21.482	22.466	23.11	22.86	23.714	24.774	26.214	26.56	26.585	26.466	26.506	27.543	28.413
% of caseload	6.8	7.8	8.2	8.6	8.6	8.8	9.4	10	10.4	10.7	10.6	11	11.5	12.2	12.3	12.4	12.5	12.5	13.2	13.7
* Total caseload	208.26	208.395	212.13	212.762	212.873	215.286	216.084	215.378	215.841	215.541	216.664	215.354	215.834	215.196	216.21	214.741	212.497	212.883	209.566	207.35
Closings for earnings	2.892	1.526	1.487	1.486	1.371	1.394	1.826	1.777	1.994	2.106	1.8	2.376	2.271	1.706	2.096	1.874	1.776	1.896	2.391	2.169

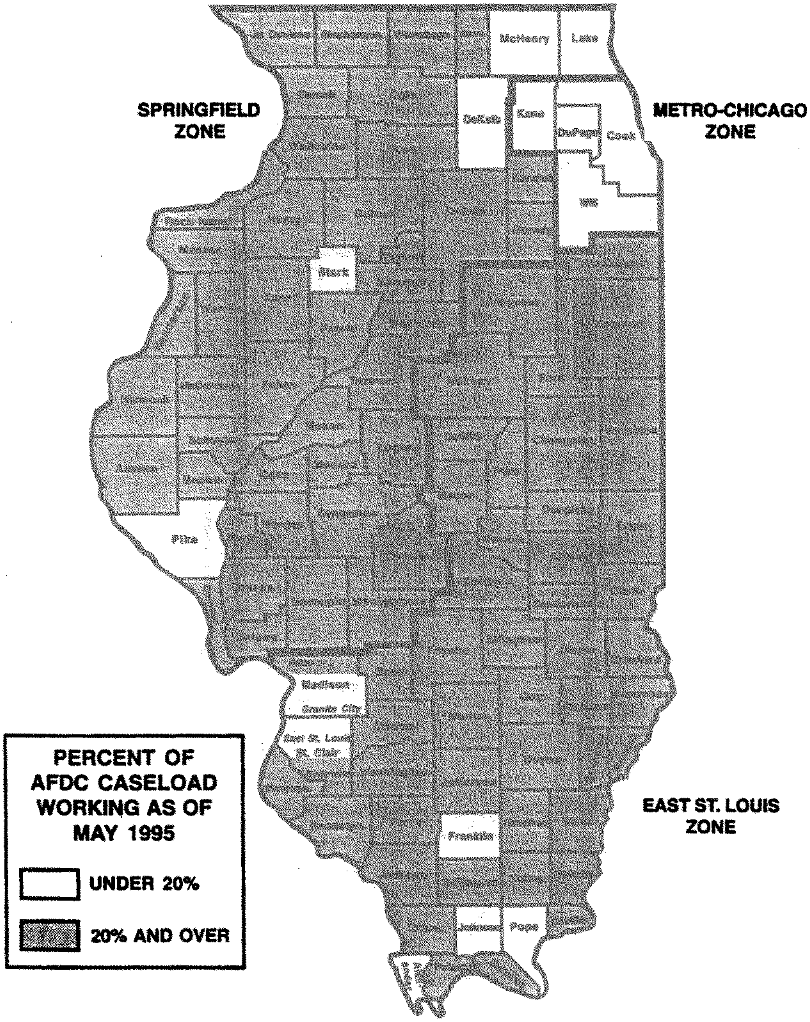
All numbers in thousandths except "% of caseload"

* Excludes child only cases & pregnant women only cases.

Illinois Department of Public Aid



Illinois Department of Public Aid



Mr. ENGLISH. Well, that is outstanding, and what I would like to do at this point is bring Dr. Olson, who has been very patient, in for her testimony, and we look forward to her contribution.

STATEMENT OF LYNN M. OLSON, PH.D., SENIOR RESEARCHER, DEPARTMENT OF RESEARCH, AMERICAN ACADEMY OF PEDIATRICS; AND VISITING SCHOLAR, CENTER FOR URBAN AFFAIRS AND POLICY RESEARCH, NORTHWESTERN UNIVERSITY, EVANSTON, ILLINOIS

Dr. OLSON. Thank you. I am happy to have the opportunity to talk with you about some of the research I have done on the EITC. My intent today is to use that research to talk with you about what the EITC looks like from the street level perspective of women, particularly in the welfare to work group.

I will address three questions. First, what does the monetary benefit of the credit mean for mothers moving between welfare and work? Second, what do these mothers know about the credit? And third, how do they go about obtaining it?

I will suggest the following answers are true for many, if not most, of the families in this category. First, the extra funds they receive from the credit are vital to them. Second, the level of misunderstanding about the EITC is very high, and third, these workers are unlikely to have the knowledge or confidence to do their own taxes.

I draw these conclusions from indepth interviews with 30 women across three welfare-to-work programs in Chicago in 1993. I want to point out that these interviews were done before the kinds of things Illinois has recently been doing, that Mr. Antolin talked about.

Clearly, the women greatly valued their tax refunds, which often went to pay pressing bills. "It saved me," said a mother, facing eviction. Others made special purchases they could otherwise never afford, like the downpayment on a used car, purchasing clothing, or furniture for their children.

"I just look around the house and I see what I worked for. I worked hard, and it felt good."

A few of the more experienced workers were able to make a connection that the credit is one of the benefits they had, now that they were working.

"The earned income automatically affects you in a positive way if you are working. All these incentives, ones with public aid do not have anything."

However, I found that most could not make this kind of explicit link between the credit and their own work efforts.

Some people had never heard of the EITC. More commonly, people had heard about it, but, really, they knew little more than that, and what they knew was frequently mistaken. For example, some were not planning to file because they thought they made too little money to do so. Or, because they did not file in the past, they thought they would be in trouble now.

Others believed that the EITC was the same thing as the tax deduction for dependents, or the child care credit, or the credit for being head of household. Another woman believed that this would affect her food stamp benefits negatively. No one we spoke with had heard of the advanced payment option at that time, and when we explained it to them, they were rather skeptical about it.

I would also point out that there was widespread misunderstanding about the refundable nature of the credit. They did not understand that they were in fact getting additional money from the government, as illustrated by this particular woman, who actually earned so little money that she would not have been paying any Federal taxes.

"Whatever you are supposed to get back, they are still taking out taxes." You get money back, but they have already taken out taxes.

You would hear a lot of, "Well, I am getting my money back." And relatedly, most did not have, really, any idea if working more, or less, would increase or decrease the amount of credit that they were getting.

In summary, it often seemed that people perceived this refund more as an unexplained, very welcome windfall, rather than something that was clearly connected with wages they had earned.

Finally, how do welfare mothers actually go about obtaining their EITC? I think the answer reflects things we have heard today—that many are unlikely to have the confidence or knowledge to actually file their own taxes. Only 4 of the 30 people we spoke with had ever done so, and those tended to be in the past when they could use the EZ form.

A few had vague knowledge of some services like the Vita Tax Clinics, but actually, none of the people had ever used them. In contrast, everybody very clearly knew about commercial tax preparers, where they had gone and paid, at that time, between $65 and $100 to have their taxes done, and these frequently included the refund anticipation loans. I think that the dependence on commercial preparers might also reinforce ignorance about the EITC. Clients will tend to hand over their W–2s and expect the agency to do the job for them. "I just let them fill it out and send it back, and whatever comes, if I have got something coming back, it is OK with me."

And in fact a lot of people did not know whether or not the EITC had been claimed for them. We heard a few examples, where clearly, it suggested that some real errors had been made by the preparer.

I would note that since these data were collected, new IRS policies to reduce fraud should also reduce, of course, the use of electronic filing and the refund anticipation loans.

However, I think we can still expect a group that is going to be dependent on commercial preparers in one way or another. That is not going to change.

In summary, as you consider ways to improve the EITC, I would suggest a few lessons from street level experience.

First of all, the problems of error and fraud in the EITC are apparent and those things do need to be addressed. It is quite unlikely that the women I spoke about today are the people who are the architects of fraud. They clearly would not have the information to be doing that.

Antifraud measures should not create greater barriers for those who are legitimately eligible for the benefits, or make them more dependent on commercial tax preparers.

Second, I would urge that much more attention be given to the practical realities of how the EITC is implemented.

One of the reasons for the popularity of the EITC has been its very low administrative cost. I would argue, though, that it is unrealistic to think that you can efficiently administer a program that large, to that many people, without some real costs.

The EITC is a very valuable program for these families, and I believe there are real opportunities to improve it. The kinds of things I would suggest would very much dovetail with the things that Mr. Antolin said.

With that, I will conclude, and thank you for the opportunity.

[The prepared statement follows:]

**STATEMENT OF LYNN M. OLSON, PH.D.
DIRECTOR, DIVISION OF CHILD HEALTH RESEARCH,
AMERICAN ACADEMY OF PEDIATRICS, AND VISITING SCHOLAR,
CENTER FOR URBAN AFFAIRS AND POLICY RESEARCH,
NORTHWESTERN UNIVERSITY, EVANSTON, ILLINOIS**

Chairmen, subcommittee members, I am pleased to speak to you about the research I have conducted on the Earned Income Tax Credit (EITC). I am Lynn Olson, a sociologist and a visiting scholar at the Center for Urban Affairs and Policy Research, Northwestern University. I am a senior researcher in the Department of Research, American Academy of Pediatrics. The Academy is very interested in welfare reform and its impact on children, but I speak here today on my own behalf.

My intent today is to suggest what the EITC looks like from the street-level perspective of women in the welfare-to-work transition. This is the group, I presume, you most hope will be helped by the EITC, a refundable tax credit for low-income families. I will address three questions:

• What does the monetary benefit of the EITC mean to mothers moving between welfare and work?

• What do these mothers know about the EITC?

• How do they go about obtaining the EITC?

I will suggest the following answers are true for many, if not most, families in the welfare-to-work group: • The extra funds they receive through the EITC are vital. • The level of misunderstanding about the EITC is very high. • These workers are unlikely to have the knowledge or confidence to do their own taxes; they are often dependent on commercial agencies where they pay high fees.

I base these observations, broadly, on several years of experience as a researcher with Project Match, a welfare-to-work demonstration in the inner-city of Chicago. Specifically, these conclusions are drawn from in-depth interviews in 1993 with 30 women in three welfare-to-work programs across the Chicago area. I have also had the opportunity to speak with people around the country involved with the EITC, and their experiences reinforce these conclusions.

Value of the EITC to Very Low-Income Families

The women interviewed in this study had average earnings of only $7800, which put most of them in the phase-in category where the EITC should certainly operate as a work incentive. Clearly the women greatly valued the tax refunds they received. They reported very quickly using their funds, often to pay pressing bills, as in the case of this mother who was facing the threat of eviction:

> "I needed that too. All that went to my rent because I was so backed up paying my rent....It saved me twice. I think this year it's going to do the same thing."

Thus, for many families their tax refund was an essential means of paving over a financial crisis and taking care of bare necessities. Others said they used the funds to make special purchases like a down payment on a used car, new clothing for their children, or furniture:

> "I just look around the house and I see different things that I bought....I was able to look at what I had worked for, because I work hard....Last summer – sometimes I wouldn't get off until 11:30 at night and I had to be right back at six that next morning. So I worked hard and I felt good and got that money back."

A few of the women with more knowledge and work experience identified the EITC as one of the benefits they received now that they were working and not on welfare:

> "The earned income automatically affects you in a positive way if you're working. If you're on public aid you can't even file it....So I'm getting like $700 back...So anything I have – if I needed a car, boom, there it is. If my daughter needed clothes that I couldn't handle before, boom, there it is. All these incentives. Ones with public aid don't have anything."

Misinformation About the EITC

However, most of those we spoke with could not make such an explicit link between the EITC and their work efforts. Ideally, for a program to be an incentive people will understand how it works and will know what they are receiving. It appears these optimal conditions are often not met. A handful of women – those who had been in the work force for several years – were quite knowledgeable about the tax system and the EITC. Yet such cases were clearly the exception.

The workers interviewed valued their tax refunds, but that did not necessarily mean they understood how EITC benefits are determined or even that such a program existed. Before we described it to them, some of the women said they had never heard of the EITC. More commonly, respondents said they had "heard of" the credit, but knew little more than that:

> "I didn't really know about the earned income–not really. I didn't know it's as much as it is. There's a lot of people that don't know that."

These workers were frequently confused or misinformed about EITC regulations anc benefits:

> "I just heard that if you receive AFDC you might be eligible for it."

> "They sent me a thing about how much money I got from unemployment, and they had that (information about the EITC) in there. They had the form, and I read it. It sounded good. But I didn't know how to get it, so it was like, forget it!"

> "You can get back up to $2500, but I got like $1018 back. I don't know if it was how much I made or actually how they go about doing it."

Interviewees were misinformed about eligibility for the EITC. For some a myth was that they were not eligible and were not planning to file because they made too little money. Another problem was confusion among types of tax credits. For example, some thought the EITC is the same as the tax deduction for dependents or the credit for child care payments or being "head of household." There were other fears about filing. One woman thought she would be in trouble because she had not filed last year. Another was mistakenly concerned it would affect her food stamp allotment.

It was not surprising that no one we spoke with was familiar with the advance payment option. When we explained it to them, most of these workers were skeptica about using this choice. Some said they preferred the forced "savings" of getting a lump sum at the end of the year. Others were fearful that the calculations would not work out correctly and that they would owe the government money at the end of the year, money they would not have.

We explicitly asked several of the women where they thought the EITC refund money came from or what determined the amount they would receive. Many were uncertain, as illustrated by the comments of these two women, each of whom earned so little that they owed no federal income tax:

> "Well, some of it has to do with the money they took out and then they gave me so much for my dependent, my son. That's where it came from."

> "Whatever you're supposed to get back, they're still taking out taxes. You get money back but they're still taking out a big chunk. They've already took out taxes."

Thus, many did not know that the EITC is in addition to the money they had withheld in federal taxes. In their view they were just getting back the money that had already been taken from their checks. Relatedly, most did not know if working more or less would increase or decrease the amount of credit they received. In sum, I found most women interviewed perceived their tax refund more as an unexplained, but welcome "windfall," rather than as wages they had earned.

Dependence on Commercial Agencies to Obtain the EITC.

How do welfare mothers actually obtain their EITC benefits? Who files their tax returns? My observations indicate many are unlikely to have the confidence or knowledge to do their own taxes. For example, one-third of the women interviewed did not know that April 15th is the deadline to file taxes. Only 4 of the 30 women interviewed had ever completed their own tax forms.

> "I don't know about this tax and stuff. She was trying to show me one time so I'd do it myself and I never could figure it out."

A few had vague knowledge of community agencies that might assist in preparing taxes or Volunteer Income Tax Assistance (VITA) clinics staffed by IRS volunteers, but none had ever used these services. In contrast, everyone knew of commercial tax preparers. Most had used such agencies to file their taxes, paying fees between $65 and $100 to have their 1040 forms completed, to file electronically, and/or to receive a refund anticipation loan (essentially an extremely high interest, short-term loan so that they could have the use of their tax refund within a few days).

These commercial fees often ate up a substantial portion of the worker's return. In the most egregious case one woman *paid $70* and only *received a check for $30.* Many tax agencies appear to target the market of EITC-eligible filers. During tax season storefront offices spring up in low-income neighborhoods. Numerous ads appear on the sides of buses and park benches, enticing people to "Get your refund now!" Television ads offer both fear tactics and enticements. One ad, which aired at the time of our interviews, asking "Who does your taxes?" showed several people expressing fears that if they did their own taxes they might make mistakes. Included was an older African American man who says, "If I did my own taxes I would go to jail because I don't know what I'm doing!" Other pitches were reminiscent of lottery advertising, with images of people lounging in sunny vacation spots.

Clearly the monetary loss is one problem when low-income workers rely on commercial firms to receive their EITC. But I believe there are other reasons to be concerned about this situation. The system reinforces ignorance about the EITC benefit. Clients rely on the agency to do the job right, and apparently receive little consumer information about how their tax refunds are calculated:

> "You give them your forms...They fill it out and (you) see what money you get back."

> "I was wondering how that works. I never did know that. I just let them fill it out and send it back and whatever comes, if I've got some coming back, it's okay with me."

Many, for instance, did not know whether or not the agency had filed the EITC for them. (During our interviews, copies of interviewees' tax forms were not available, so it was not possible to determine precisely what was or was not done.) From the refund amounts reported it seemed likely that many had been given the credit, even though they had not been told or did not understand what had been done. But a few of the stories we heard suggested the agencies on which low-income workers heavily rely do not always do the job right. Some might not get the full refund to which they are entitled because of the inadequacies of commercial preparers. One of the more knowledgeable respondents explained:

> "If you don't already know it they won't tell you anything. They just fill it out. They won't tell you anything. You have to ask them the questions."

Another woman described a similar experience where the preparer was not going to calculate the EITC into her return:

> "There's a lot of questions she should have asked and she didn't. I asked her what about the earned income. She didn't mention it. I asked her about the head of household. She didn't mention it either....When she got through with them I was only getting $700-something and it totally was wrong after she did it. I explained to her why it was wrong and what she did not do."

Once the EITC and head of household credits were correctly computed the woman received a refund of $1900. Ironically this savvy filer had gone to the agency because she did not trust her own calculations; she wanted to be safe and get a second opinion.

I would note that since these data were collected, actions in 1995 by the Internal Revenue Service (IRS) to hold and check returns where the EITC is claimed should reduce EITC-filers' use of electronic filing and refund anticipation loans. While these new IRS procedures mean EITC filers must wait much longer to receive their refunds I presume they will reduce fraud and errors. The full impact of these changes from the EITC filer's perspective is unknown, but we can assume many will continue to be reliant on commercial agents to prepare their taxes.

Summary and Policy Implications

I believe the EITC is a very valuable program. It supports the hard-fought efforts of low-income working parents to get and stay off welfare and helps them to adequately care for their children. As indicated by your hearing today, there are problems with the system that need to be fixed. I think there is a great opportunity to take action to make certain the EITC reaches those who are eligible and that it is an incentive for families trying to leave welfare.

As you consider these changes let me suggest a few lessons to use from street level experience: First, the problems of errors and fraud in the EITC have received a good deal of attention lately. These issues must be addressed. Given their lack of knowledge about tax rules and procedures, it is quite unlikely the women I spoke about today are among the architects of fraud schemes. While some people who are not eligible receive EITC benefits, there are others who <u>are</u> eligible who do <u>not</u> receive them. Anti-fraud measures should not create greater barriers for those legitimately eligible for EITC benefits. Changes that make filing for the EITC more complicated will increase many workers' dependence on commercial tax preparers.

Second, I would urge that much more attention be given to the practical realities of how the EITC is implemented. It is particularly important to reach the lowest income EITC-eligible families who are likely to be new to the workforce, in the welfare-to-work transition, or on welfare preparing for employment. The promise of very low administrative costs has been one reason for the political popularity of the EITC. But it is unrealistic to think that a program this large – $15 billion to more than 15 million families in tax year 1993 – can be administered without real cost. Currently low-income workers pay much of that cost in fees to tax preparers. Given the complexity of filing requirements, the EITC in actuality cannot be thought of as self-administered for most. It is not possible for the IRS to function as a social service agency to assist all EITC filers; effective implementation of the EITC will require broad-based efforts by many actors, ideally involving local groups most frequently in direct contact with low-income families.

I believe there are a number of steps that can be taken to enhance the value and efficiency of the EITC; let me suggest a few:

• <u>Develop relevant educational messages and material.</u> The EITC rules and benefits should be presented in clear, concrete terms, for example: "Because of the EITC your wages are now equivalent to $x per hour." The basic structure of the EITC needs to be better explained and promoted, for example the message that it is a *refundable* credit where you might be receiving far more than any federal taxes deducted from your check.

• <u>Focus education about the EITC throughout the year</u>. Private groups and the IRS have done a good job of education and outreach campaigns during the tax filing season to urge people to file for the EITC. But if the interest is educating tax payers about the EITC, reducing inaccurate claims, and promoting the benefit as a work incentive, education needs to be a year-round commitment.

• <u>Integrate EITC education and assistance into work programs</u>. One essential way to reach people year round is in programs where low-wage workers are likely to be found, e.g., local welfare-to-work programs, Job Training Partnership Act (JTPA) programs, family support programs, and community colleges. Welfare-to-work programs could integrate into their services practical budget planning and clear information on how working will effect various benefits, including how the EITC will affect their paychecks.

• Enhance awareness of the advance payment option. Receiving the EITC through advance payments may provide a greater work incentive because workers will receive a portion of their benefits on a more "real time" basis. If they do not use this option, by 1996 low-income families could receive as much as one quarter of their annual income in a single payment with their tax refund.

Chairmen, that concludes my prepared statement. Thank you for the opportunity to present these ideas. I will be happy to answer any questions you or other members may have.

Mr. ENGLISH. Well, I am delighted that you have given us the benefit of your insights, and I find that we are probably going to have to conclude this hearing shortly.

I have a number of questions for both of you and I guess I would like to encapsulize them with this.

What should Congress prioritize in making the EITC more accessible to mothers operating on the poverty line, item one?

Item two, what can Congress do to make the program more useful to State welfare departments?

I will start with you, Mr. Antolin.

Mr. ANTOLIN. In terms of reaching more parents, I have to believe more outreach through employers is still a viable place.

We recently had an experience where we had placed someone in Motorola, not a small company, where the client sought the advance payment of EITC, and the Motorola personnel office had never heard of it, did not know how to do it, and did not believe it was possible.

It took some work with them, with our local IRS staff, to get them to process it.

That is a problem when you have major employers who react that way, and imagine what it is when you are talking about smaller employers.

There I think is a big part of the marketing that is still needed. As far as with welfare, there are some States that want to do it as part and parcel of the welfare system.

We think in our State it makes a lot more sense to get individuals moving to work, to get used to filing the tax forms, being part of the mainstream system, the one that you and I——

Mr. ENGLISH. So, you would keep it separate?

Mr. ANTOLIN. Yes. We think there is a huge value in that and would not want to have it added. On the other hand, we like being able to implement it as part of the marketing of welfare to work.

Mr. ENGLISH. Dr. Olson, you have already offered some prescriptions. Do you have anything to add?

Dr. OLSON. There are a lot of specifics that I could talk about, but I think, in general, clearly, there needs to be more education and outreach, and it is not simply done because it really has to be done on a local level.

As Ms. Clark said, it really is about one to one. When it really comes down to it, there is someone there, sitting with their W–2s and a tax form, and that has to be done somehow.

So it is clearly not going to be easy. It needs to go through the type of places where low-income workers are to be found. The welfare programs are a very important place. Other places are certain categories of employers, community colleges, and Job Training Partnership Act Programs.

Those are the places we need to target. To date, a lot of the education and outreach around the EITC has focused on tax filing, and that has been very effective in many ways. That does not really address the problem of getting people to understand what the credit is, how it really is working, and that is an advantage to them.

Mr. ENGLISH. Thank you.

I want to thank both of you for the substantial contribution you have made to educating this panel on the practical effects of EITC, where the program ought to go, what we ought to be doing with the provision.

This will be one of the most important things that we address during this Congress and you have made a very substantial contribution to this debate and we want to thank you very much, and with that, I would like to adjourn this hearing.

[Whereupon, at 3:05 p.m., the hearing was adjourned, subject to the call of the Chair.]

[Submissions for the record follow:]

Governmental Affairs
American
Hotel & Motel
Association

The Honorable E. Clay Shaw, Jr., Chairman
Subcommittee on Human Resources
House Ways and Means Committee
B-317 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Shaw:

The American Hotel & Motel Association (AH&MA), a federation of state and local lodging associations, represents this nation's lodging industry. Over 45,000 lodging properties with more than 3.3 million rooms and over 1.5 million employees operate in the United States. Our industry's annual sales exceed $60 billion and our total payroll exceeds $20 billion. AH&MA's membership ranges from small independent properties to the largest convention hotels. Our membership includes all major resorts and hotel chains.

We offer these comments for inclusion in the record of the June 15, 1995 joint hearing on the Earned Income Tax Credit (EITC) held by your Subcommittee and the Subcommittee on Oversight chaired by Congresswoman Nancy L. Johnson. We believe the EITC has been a valuable tool, targeted to low-wage workers to provide a supplement as they learn, train, and begin their climb up the economic ladder. We believe it is essential to retain the ability of the EITC to meet these goals.

As opposed to an increase in the minimum wage, which is spread broadly across workers whether or not they may need the increase, the EITC specifically helps workers whose earning level and family status warrant support. It contains none of the dampening effects on jobs and job creation which often accompanies an increase in the minimum wage. Additionally, it does not arbitrarily raise the cost of labor to business. The reality today is that in many parts of the county the minimum wage is below the market wages for entry-level employees. In those areas the damage of a minimum wage increase is measured primarily by the ripple effect on wages higher than minimum. Inevitably it distorts the labor market even when minimum wage per se is not an issue. Job creation can be slowed even in those markets. In those parts of the country where the minimum wage accurately reflects the market price for entry level labor, the distortion is more severe. By comparison, the EITC looks not to the market, but instead to the worker and helps only those who truly need help.

Our industry has long supported the EITC and the efforts of Congress to enhance the availability and effectiveness of this program. The EITC addresses several important issues. It strengthens incentives for low-income families to work by supplementing earnings. Work is made more attractive to these families than welfare, and the value of work itself is promoted. As our nation seeks to address the overall problem of welfare, the EITC is one element in that debate. It is important that Congress not weaken the EITC.

As your subcommittees consider the problems that exist with EITC, you are aware of action taken in the Senate to roll back recent changes to the credit. We urge your subcommittees to weigh carefully the best way to eliminate problems and inefficiencies, even fraud to the extent it may exist in the program, and not jump immediately to budget reductions. Eliminating indexing, for example, will increase the tax burden of the working poor and signal a change in the direction of U.S. tax policy. More fundamentally, the message of the value of working and the rewards that come from it will be undermined if harsh restrictions and restructuring happen to the EITC program. We urge you to remember that the EITC is perhaps the most efficient way to provide a targeted, needed supplement to wages.

We commend the efforts of both subcommittees to examine this valuable program. Further, we applaud your commitment to retaining all that is right with this program while considering technical modifications to improve its ability to do what it was designed to: help low-wage earners supporting families learn the value and dignity of work and be encouraged to continue their efforts to enhance their employment potential.

Sincerely,

James E. Gaffigan

James E. Gaffigan
Vice President, Governmental Affairs

WRITTEN 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.

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:

	1 Child	2 or more Children	No Children
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., 30% 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

Lastly, 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. <u>**All Responses on the Checklist Should Consistently Direct the Taxpayer**</u>. 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. <u>**The Worksheet Should be Incorporated in the Schedule EIC**</u>. 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. <u>**The Description of Items Subtracted from "Earned Income" Should be Stated Similarly in All IRS Publications**</u>. 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. <u>**The Taxpayer Should be Directed to the EIC Table Only Once**</u>. 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 Maria Gomez
Commissioner, Department of Human Services
State of Minnesota

Mr. Chairman, Members of the Committee, thank you for the opportunity to submit testimony for the record on behalf of Governor Arne H. Carlson and the Minnesota Department of Human Services in support of the monthly distribution of the Earned Income Tax Credit.

Minnesota is a state that values work, responsibility, strong families and communities. In our industries and businesses we are a people who work hard, are motivated to achieve, and to innovate. Since 1990, over 100,000 private sector jobs have been created in Minnesota, testimony to the working spirit of our state.

One of the key components of the Minnesota Family Investment Program (MFIP) is to make work pay -- a family should always be better off working than being on welfare. And, even when the economy is good, many of the jobs do not pay enough to support a family. The problem is exacerbated when a family has only one wage-earner. These facts make it very difficult for many people to get off welfare and stay off. They also put many low income persons at risk of needing welfare at some time. In Minnesota, we want to support people in their efforts to become self-sufficient through working -- in other words, to make work pay.

One way of doing this is to make available to low income people the tax credits they have earned in a monthly, rather than a yearly basis. By thus increasing their monthly income, people will be able to avoid welfare altogether or to work their way off of welfare.

In Minnesota, we have begun to put a system in place to make these monthly payments. Beginning January 1, 1996, the TaxCredit Express program will package several state tax credits together into a monthly payment for low income people. We believe that this will be a significant step. It would be greatly enhanced, however, if the federal Earned Income Tax Credit (EITC) could be paid monthly as well. For example, a single parent with two children working full time at an hourly wage of $5.60 per hour, child care costs of $350.00 per month, and rent costs of $400.00 would be able to leave Minnesota's welfare rolls because she would be receiving an additional $2.87 per hour in monthly credits.

Although employers can pay the credit periodically through their payroll systems, very few do. We will use Minnesota's Department of Revenue to make the payments.

We have consulted with the key federal agencies, and they have advised us that a federal statutory change is needed before we can include the federal credit in TaxCredit Express. The Department of Human Services has consulted with Jimmy L. Smith, National Director of Submission Processing, Leslie B. Samuels, Assistant Secretary of Tax Policy, of the Department of the Treasury, and from David T. Ellwood, Assistant Secretary for Planning and Evaluation in the Department of Health and Human Services, regarding federal barriers to implementing our program. (Their official responses are available upon request.)

Here is how Minnesota's program will work in the first year. Approximately 30,000 wage-earning Aid to Families with Dependent Children (AFDC) recipients who are working would be eligible to apply for the monthly payment of the tax credits. Fifty percent (50%) of the tax for which they are eligible will be paid monthly. We estimate that, collectively, they will be paid $10.4 million in monthly payments of state tax credits (Minnesota Working Family Income Tax Credit, Minnesota Child and Dependent Care Income Tax Credit, and the Minnesota Property Tax Refund for Renters_. They will receive the remainder to which they are entitled after filing their tax return. The computer system that implements AFDC and other programs statewide will provide employment, income, and other verification, with both monthly audits and annual reconciliation. Incorrectly estimated pre-payments will be subject to collection. We plan to expand the program in future years to other low-income persons, using the information and experience of the first year to refine the program. Additionally, although the basic structure would require some alteration, this feature could be easily incorporated into any welfare system the state would develop in response to the changes currently under consideration.

As you can see, Minnesota is uniquely prepared to incorporate the Earned Income Tax Credit into its TaxCredit Express program. This program, especially with the addition of the EITC, will make the difference between welfare dependency and self-sufficiency for thousands of Minnesotans. I urge you to support federal legislation that would enable this program to make work pay.

STATEMENT OF REPRESENTATIVE JIM RAMSTAD
WAYS AND MEANS OVERSIGHT AND HUMAN RESOURCES SUBCOMMITTEES
JOINT HEARING ON THE EARNED INCOME TAX CREDIT
June 15, 1995

I would like to thank both of our distinguished chairs for holding this joint hearing to discuss issues related to possible reform of the Earned Income Tax Credit (EITC).

The EITC, when properly utilized and targeted, can play a role in helping low-income taxpayers get off and stay off welfare.

In this context, I call the Committee's attention to the efforts of the State of Minnesota, which recently passed bold welfare reform legislation to help get families back to work.

The state plan, called the "Taxcredit Express Program," will provide lower-income people with monthly payments of federal and state income and property tax relief. Monthly payments will help families and workers meet their monthly expenses, allowing workers to support their families and avoid welfare or feasibly work their way out of welfare and into financial independence.

I strongly urge members to give their attention to testimony submitted by the State of Minnesota explaining the need for flexibility to enact their progressive approach to helping Minnesota's working families.

Again, I thank the chairs for calling this hearing and all the witnesses for being here today. I look forward to their testimony on the EITC.

IMPACT OF THE EARNED INCOME TAX CREDIT ON GUAM

Statement of
Congressman Robert A. Underwood
June 15, 1995

Mr. Chairman: Thank you for conducting this important hearing to review the Earned Income Tax Credit (EITC) program. Since the program was established in 1975, it has provided tax credits or direct payments to low income families with children. The EITC provides an incentive for work and is an important bridge between welfare and work. For many working families across the nation, this program has been beneficial in moving people away from dependency and into jobs.

However, I would like to point out how the EITC program affects Guam.

According to the Congressional Research Service of the Library of Congress, about 30 percent of working families with children are eligible for the EITC. When one looks at the demographics in Guam, there are more individuals in the lower rungs of the economic bell curve compared to the nation as a whole. Therefore, the percentage of working families in Guam who are eligible for EITC is double that of the U.S. mainland -- 60 percent. In fact, numerous taxpayers in Guam are taking advantage of the earned income tax credit.

Guam currently uses a mirror image of the Internal Revenue Code as its statutory basis for enforcing tax laws. Unless otherwise exempted, Guam is responsible for implementing tax laws passed by the United States Congress.

The enactment of the EITC is a federal policy which creates a burden on Guam's treasury. This is a federal mandate with no assistance to the local government. For example, during the last four available tax years reported by the Government of Guam's Department of Revenue and Taxation, about $23 million of general revenue funds were paid for EITC obligations. Yet, no EITC funds were directly appropriated by the federal government to offset this tax burden.

This negative impact of federal policy is similar to the compact impact aid as it applies to Guam. The United States Government signed a compact of free association with certain Pacific island nations over a decade ago. One result of this agreement is that the citizens of these freely-associated states can reside in Guam and become eligible for many social services including welfare payments. Although the federal government was responsible for reimbursing the Government of Guam for about $50 million in compact-related expenses, less than $5 million has been appropriated to Guam for compact impact aid. This means that the local government assumes the burden of compliance with compact impact, with little help from the federal government.

The application of the EITC in Guam is currently under review. Congress, in passing the 1986 Tax Reform Act, gave Guam permission to enact its own tax code. We have established the Guam Tax Reform Commission to determine how we will delink from the Internal

Revenue Code. The EITC and its applicability to Guam is one of the issues currently before the Commission. I am hopeful that we will continue to make progress in resolving this and other related tax issues.

Meanwhile, I urge the committee to assess the impact of the EITC on many state and local jurisdictions and to correct the inequities where they exist. We, on Guam, can fulfill our obligation to help working families if the federal government will meet its responsibility to fund this mandate.

Again, I thank you for holding this hearing and request that my statement be made a part of the official hearing record.

United States House of Representatives
Committee on Ways and Means
Subcommittees on Oversight and Human Resources
Hearing on the Earned Income Tax Credit
Washington, D.C.
June 15, 1995

Statement of:

GEORGE K. YIN
PROFESSOR OF LAW
UNIVERSITY OF VIRGINIA SCHOOL OF LAW

Madame and Mr. Chairmen and Members of the Subcommittees:

In this statement, I explain how the EITC program can be reformed to accomplish its objectives more effectively and efficiently. 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 submit this statement in my individual capacity and not as representative of any group.

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 increase	1996 spending (proj.)	1986-96 increase (proj.)
EITC	2.0	13.2	560%	25.1	1155%
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 nominal dollars.

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 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.

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[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.

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 *under*statements of income, not *over*statements;
- 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.

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[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.

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 noncompliance 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

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[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).

expenditure program.[5] But 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 noncompliance if budget responsibility over the EITC program were consolidated with that of other welfare programs.

More generally, Congress is presently considering the conversion of

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[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 direct expenditure programs much higher than those of tax system). But the deadweight loss from noncompliance should also be considered in comparing the administrative costs of the two types of programs. Further, as discussed later in the text, the *duplication* of costs 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).

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* bureacracies, 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 the subcommittees know, 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 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

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[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).

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 subcommittees 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 subcommittees 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. Members of the subcommittees, 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

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[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 (JCX-24-95), June 7, 1995, at 11.

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 the subcommittees know, 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 expected 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

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[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).

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

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[12]See Yin et al., note 4, at 286-94.

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 subcommittees 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. 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

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[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).

the amount of income reported? No. The tax laws and administrative procedures are generally designed to ferret out income *under*statement cases, not the reverse situation of possible *over*statements 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

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[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 1, 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.

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

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[15]See Willis statement, note 5, 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 5, 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.

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 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.

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