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EARNED INCOME TAX
CREDIT

Effectiveness of Design and
Administration

Statement of Jennie S. Stathis, Director
Tax Policy and Administration Issues
General Government Division



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Messrs. Chairmen and Members of the Subcommittees:

We are pleased to be here to discuss the earned income tax credit as a wage supplement and its effect on work incentives. The credit was established in 1975 and expanded in 1990 to increase the progressivity of the federal tax system and to enhance work incentives for low-wage workers.

Today, I want to make five major points:

- The target population for the earned income credit is working families with children. Accordingly, most low-income households do not qualify for the credit.
- For those 18 percent reached, the 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 credit has been the source of more taxpayer mistakes than any other individual income tax provision. IRS introduced a complex schedule in an attempt to prevent ineligible taxpayers from receiving the credit but gives the credit even when the schedule lacks most information.
- Despite simplification efforts, the earned income credit remains fairly complex, primarily because of the supplemental credits but also because families must meet one test to claim a dependent and another to claim a child who qualifies for the credit.
- Most employers and credit recipients are unaware that the earned income credit is available in advance payments. Advance payments did not appeal to many of those who were aware of the option.

Our testimony today is based on three GAO efforts. One is an ongoing review of the earned income tax credit requested by Senator Bill Bradley. The second is a recently issued report to the Chairman of the Senate Finance Committee, TAX ADMINISTRATION: Erroneous Dependent and Filing Status Claims(GAO/GGD-93-60, Mar. 19, 1993). The third is a report EARNED INCOME TAX CREDIT: Advance Payment Option is Not Widely Known or Understood by the Public(GAO/GGD-92-26, Feb. 19, 1992), which was mandated in the Omnibus Budget Reconciliation Act of 1990.

DESIGN OF THE CREDIT

The earned income tax credit is a refundable tax credit available to low-income workers with a qualifying child. The benefits are based primarily on earnings, although total income can affect the amount of the credit.

Congress created the credit in 1975 with two stated long-term objectives: (1) to offset the impact of Social Security taxes on low-income individuals; and (2) to encourage these same individuals to seek employment, rather than depend on welfare benefits.

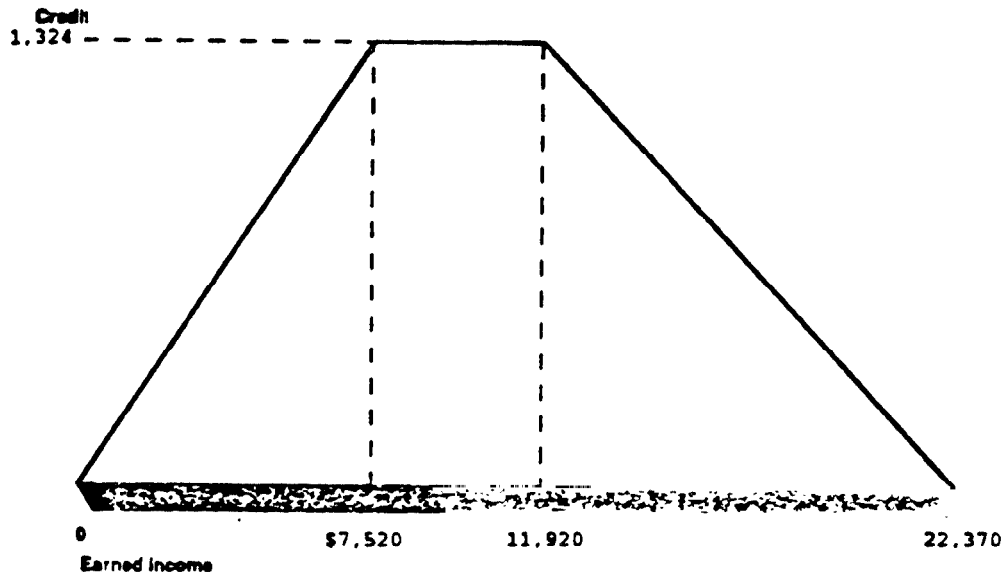
In 1990, as part of the Omnibus Budget Reconciliation Act (OBRA), Congress substantially expanded the credit, making the basic credit more generous and adding provisions that give larger credit amounts to households (1) with more than one child, (2) with a child less than 1 year old, or (3) that pay for health insurance covering a dependent child. OBRA also relaxed and simplified the credit's qualifying criteria.

The credit's structure divides recipients into three groups: lowest income earners whose credit is "phased in," a middle group of low-income earners whose credit is a flat amount, and the highest income recipients whose credit is "phased out." In 1992, the ranges were as follows:

- Qualifying workers with incomes less than \$7,520 received the full credit rate or wage supplement (17.6 percent of earnings for families with one child and 18.4 percent with more than one child).
- Workers whose income ranged between \$7,520 and \$11,920 received the maximum credit amount of \$1,324 with one child and \$1,384 with more than one child.
- Workers whose earnings were greater than \$11,920 saw the credit reduced by 12.57 cents (or 13.21 cents if more than one child) for each additional dollar earned until earnings reached \$22,370, at which point the credit was completely phased-out.

Figure 1: Structure of Basic Earned Income Tax Credit, 1992

(Amounts in dollars)



The supplemental credits add 5 percentage points to the credit rate for a child under 1 year old and 6 percentage points for payment of the health insurance premiums of a dependent child.

As part of OBRA, the credit rate is scheduled to rise to 23 percent for one child and 25 percent for more than one child in 1994. The phase-out rates will also rise to 16.43 percent and 17.86 percent in 1994.

**SIZE OF CREDIT HAS INCREASED SUBSTANTIALLY,
BUT MANY LOW-INCOME FILERS DO NOT QUALIFY**

Between 1988 and 1990, the average credit amount was about \$600 in 1991 dollars. As a result of the OBRA changes, the average amount increased to over \$800 in 1991 and is projected to rise to over \$1,000 by 1994. The average credit amount as a proportion of adjusted gross incomes rose similarly. This effective credit rate was 5.3 percent in 1988 and 6.7 percent in 1991. On the basis of our analysis, we project that it will rise to over 9 percent by 1994.

Our analysis of 1988 recipients showed that slightly over half were above the poverty line with the remainder below that line. Those below the poverty line generally received above average amounts of credit, about \$700, compared to those above the poverty line, whose average credit was about \$500 in 1988.

More than half of the credit recipients had incomes in the phase-out range. The remainder of the recipients were split between those with incomes in the middle range where the credit was constant, and those in the lowest income range.

Only families with children are eligible to receive the credit. As a result, about 18 percent of taxpayers whose adjusted gross income (AGI) was below the eligibility cutoff received the credit in 1988. Single filers became eligible for the credit in 1991, so the proportion of credit recipients may be higher today.

CREDIT INCREASES PROGRESSIVITY OF TAX SYSTEM
ALTHOUGH IT MAY SLIGHTLY REDUCE HOURS WORKED

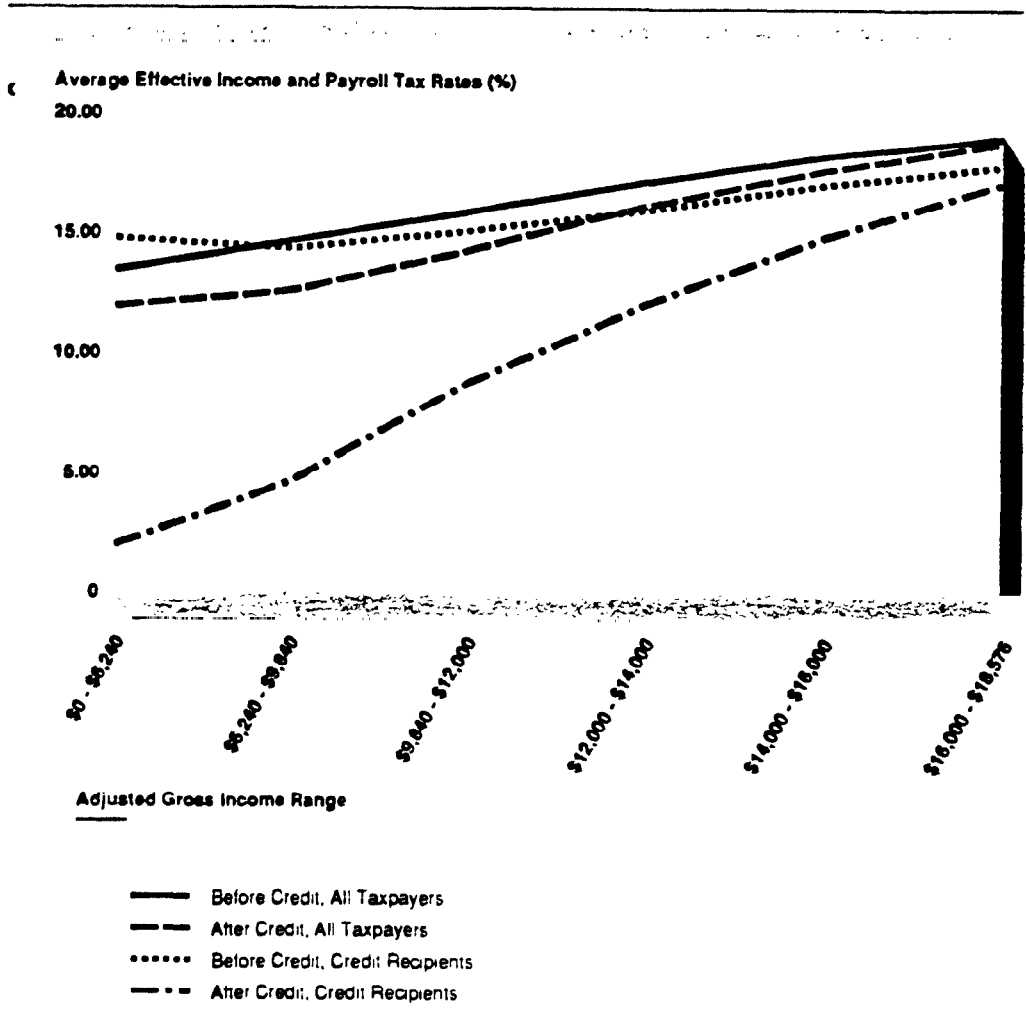
One stated goal of the earned income credit is to offset payroll taxes. We compared the credit received by households in 1988 with their payroll taxes. The credit offset almost all of the employee's share of payroll taxes and is projected to offset 178 percent by 1994.

- For those in the lowest income group, the credit more than offset the employee's share of the payroll tax in 1988. In addition, the credit offset 86 percent of the combined employee and employer payroll taxes. Our calculations show that in 1991 the credit more than offset all payroll taxes for these lowest income workers.

- For qualifying workers with higher incomes (those in the flat and phase-out ranges), the credit offsets a decreasing portion of payroll taxes as earnings increase. On average, the credit offset 89 percent of the combined employee and employer payroll taxes for those in the flat range in 1991 and 28 percent for those in the phase-out range.

We also examined how the credit affected combined payroll and federal income tax burdens. In 1988, credit recipients who were in the lowest income range had their federal tax burden reduced from over 14 percent to about 1 percent due to the credit. Recipients in the beginning of the phase-out range (AGI from \$9,840 to \$12,000) saw their effective tax rate reduced from about 14 percent to about 8 percent. A similar analysis of all taxpayers in these income ranges showed a much smaller effect-- primarily because such a large proportion of them were not eligible for the earned income credit for reasons other than income level. For example, for all taxpayers in the lowest income range, the credit reduced the effective tax rate from about 13 percent to about 12 percent. All taxpayers in the AGI range of \$9,840 to \$12,000 had an effective tax rate of over 15 percent before the credit and about 14 percent after the credit was included.

Figure 2: Average Effective Income and Payroll Tax Rates, Before and After Earned Income Tax Credit, 1988



Incentive Effects

One way of considering the incentive effects of the credit is to examine how the credit affects marginal tax rates.¹ Marginal tax rates (counting employees' payroll taxes and federal income taxes) were a negative 6.49 percent for households in the lowest income range (less than \$6,240 in 1988). This negative tax or effective wage subsidy may act as an incentive to work or to work more hours, if possible.

As workers' incomes increased and they moved into the range of incomes in which the credit was constant, marginal tax rates jumped to 7.51 percent, reflecting payroll taxes. Marginal tax rates jumped again (to 17.51 percent) as workers moved into the phase-out range of the credit (adjusted gross income above \$9,840 in 1988), because the phase-out acted as an effective tax rate of 10 percent on earnings. As an effective tax on wages, the phase-out may reduce the incentive to work. The last jump comes when the worker moved to an income level at which the 15 percent personal income tax rate became effective (\$12,800 in 1988).

While the incentives generated by marginal tax rates and changes in those rates are clearly important, whether and how much people are likely to react to those incentives are also important. We used estimates of labor supply response from the negative income tax experiments of the early 1970s to measure the effect of these incentives on hours worked by credit recipients. Such estimates, from a different time and context, must be used cautiously and could overstate the contemporary response to the credit. But we believe they are the best available evidence of the labor supply response of low-income workers.

Our measures indicate that credit recipients in the lowest income range probably increased their hours worked about 4 percent in response to the credit. Workers in the middle range or the phase-out range of the credit probably reduced their hours worked slightly--by 3 to 4 percent. Because there are many more workers in the latter two categories than in the first category, the net effect on all recipients was probably a 2-percent reduction in hours worked.

SOME PROBLEMS ADMINISTERING THE CREDIT HAVE BEEN RESOLVED BUT OTHERS REMAIN

For many years, the earned income credit has been a major administrative concern for IRS: it is the source of more taxpayer mistakes than any other individual income tax provision. For tax year 1988, an estimated one-third of those who received

¹A marginal tax rate is the increase in taxes that results from a 1-dollar increase in income.

the credit were not entitled to it. The most frequent source of error was filers claiming the wrong filing status; this was usually head of household, because single filers with children were not eligible for the credit before 1991. IRS was always faced with the dilemma of denying the credit to potentially eligible taxpayers or granting it to ineligible filers, primarily because it did not have enough information to make accurate qualification determinations.

Paradoxically, OBRA both simplified and complicated the credit for taxpayers and the IRS. On the one hand, OBRA eliminated some of the major obstacles for taxpayers in determining their eligibility and for IRS in administering the eligibility requirements for the basic credit by replacing the complicated head of household support test with simpler tests based on relationship, residence, and age of the child.

On the other hand, OBRA created some additional complexity for IRS and taxpayers by adding two supplemental credits (health insurance and young child) to the basic credit. Congress had always been concerned that all those eligible for the credit were not receiving it. With the introduction of the new credits this concern increased. In response, IRS substantially increased its outreach efforts, publicizing the credit through seminars and distributing brochures and handouts at meetings of those concerned with potentially eligible clientele. IRS also tried to get information directly to those who might be eligible through news releases, fact sheets, posters, and radio and TV advertisements. IRS has also subsequently modified the notice it sends to nonfilers to let them know that filing a return may be to their advantage because they may be eligible for the credit.

While IRS' outreach efforts improved, in our view IRS compounded some of the new complexities for taxpayers by introducing a complicated schedule that taxpayers had to submit to get the credit. The schedule has four parts and a number of cautionary notes to warn taxpayers about the interactions. We are concerned that some potential recipients may be intimidated by the form. In IRS' view, the primary reason for the schedule was to give them assurance that the credit would be given only to eligible taxpayers. However, the procedures IRS established to process the schedule can still allow ineligible taxpayers to receive the credit.

If a taxpayer submits the Schedule EIC but omits important information, IRS often gives the credit anyway. Submitting the schedule with any information at all often seems to be enough, from IRS' perspective, to allow a taxpayer to qualify. For example, taxpayers can submit a schedule without providing such information as the child's year of birth, Social Security number, relationship, and number of months lived with taxpayer and still

get the credit, even though this information is essential if IRS is to make proper credit determinations.

We believe that IRS should modify the income tax return to capture the data needed to determine basic credit eligibility. For example, IRS could modify the dependent information segment of the tax return to accommodate the differences between a qualifying child and dependent, thus reducing the need for a separate schedule. (See attachment) If the health insurance credit is maintained, space would be needed on the return to write in the health insurance premium. Such modifications to the return, along with clearer tax return instructions, would likely reduce the number of erroneous credit payments.

IRS could establish a program to detect taxpayers who erroneously claim children for earned income credit purposes. This could be done by matching the Social Security number for the child against other IRS records to determine if the child meets the age requirements, was claimed by another taxpayer, or received income. If IRS matched Social Security numbers to detect nonqualified children or W-2 information to check income eligibility, the benefits of such programs would be limited because, under current technology, these matches would have to be done well after the credit has already been paid. IRS' Tax Systems Modernization program may allow IRS to match W-2 information contemporaneously with the incoming tax return. With such a technique, IRS will be better able to ensure that the credit goes to eligible and only to eligible recipients.

SOME ADMINISTRATIVE AND COMPLIANCE PROBLEMS CAN BE ELIMINATED BY LEGISLATIVE CHANGES

While there are changes IRS can make to ensure better compliance with existing law, both compliance and administration could be eased with some legislative changes. One significant change would eliminate the interactions introduced by the 1990 law. Another would do away with the current distinctions between a qualifying child and a dependent.

Some of the most complicated features of the OBRA changes are the interactions between the new supplemental credits and preexisting provisions of the tax code. For example, taxpayers who take the young child supplemental credit are not allowed to exclude employer-provided dependent care expenses. Alternatively, taxpayers who claim the health insurance credit must reduce any health insurance premium deduction. These interactions affect a very small number of taxpayers, but providing for them on a schedule or a tax return is complicated and can be confusing to taxpayers.

Either eliminating the supplemental credits or eliminating the interactions would make it easier to administer the credit

without any additional information other than what is normally on a tax return.

A second complexity is the different tests now in law for claiming exemptions for children and for qualifying children for the credit. Congress could make the job of IRS and the taxpayer easier by making these rules conform. One way of doing this would be to simplify the personal exemption determination by substituting a residency test for the more complex support test. If this change were enacted and the exemption section on the tax return modified to include the child's age, IRS could readily determine if taxpayers are eligible for the basic credit without the need for a separate schedule.

Most of IRS' problems with administering the credit have come about because IRS does not have enough information on the tax return to make an accurate eligibility determination. If either more information is put on the return or the qualifying information is limited to items that can be included on a return, many problems would go away.

ADVANCE PAYMENT MECHANISM LITTLE USED AND NONCOMPLIANCE A POTENTIAL PROBLEM

The advance payment option allows workers who are qualified for the credit to receive it as part of their paychecks rather than wait until they file tax returns. Employees who wish the advance payment must fill out a Form W-5 and submit it to their employers. The employer pays the worker the proper wage supplement and credits that amount against employment taxes owed.

We found that very few workers were taking advantage of the advance payment option; less than 0.5 percent of eligible workers received the advance payment in 1989. From our analysis, it appeared that the main reasons for this low rate were that (1) many eligible workers were not aware of the option and (2) many others preferred to receive the credit as a lump-sum amount.

With some justification, IRS appears concerned about the advance payment option. Because the money is paid out before IRS receives a tax return, advance payments pose a potential noncompliance problem. Using IRS data, we estimated that about 40 percent of those people who may have received an advance payment did not file a tax return. We examined a sample of returns with usable W-2s attached. Of these, only about half reported the receipt of advance payments. Since some of those who did not report receiving the advance payment appeared eligible for the credit, they may have received it a second time. We also found that more than a third of those who filed returns were not eligible for the credit.

Because of the time lag between filing and matching W-2s with tax returns, along with the low incomes of the individuals involved, it is unlikely that IRS would recapture much money even if it pursued people who underreported income or did not file a return. Contemporaneous document matching would also help IRS administer the advance payment by preventing overpayments of the credit to eligible individuals.

CONCLUSIONS

In general, the earned income tax credit appears to have achieved its policy goals, although for a limited clientele. Low-income workers with children have a lower, and in some cases a negative, tax burden as a result of the credit. The credit appears to provide positive work incentives for the lowest income workers and negative work incentives for near-poor workers. The net effect may be a small reduction in work effort.

In recent years, IRS' administration has been made easier in some ways and more difficult in others. While we do not believe the earned income schedule is necessary, certain legislative changes could make it completely redundant. We believe that Congress should at least eliminate the interactions in the supplemental credits if not the supplemental credits themselves. We also believe that Congress should conform the rules for claiming a dependent with the rules for claiming a qualifying child for earned income credit purposes.

Potential recipients and IRS would then be able to determine earned income credit eligibility from the tax return itself. This would help assure that all those qualified, but only those qualified, receive the credit.

This concludes my statement. We welcome any questions that you may have.

Existing and Proposed Dependent Information

Existing

Exemptions
(See page 12.)

If more than six dependents, see page 13.

6a Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a. But be sure to check the box on line 33b on page 2

b Spouse

c Dependents:		(2) Check if under age 1	(3) If age 1 or older, dependent's social security number	(4) Dependent's relationship to you	(5) No. of months lived in your home in 1991
(1) Name (first, initial, and last name)					

d If your child didn't live with you but is claimed as your dependent under a pre-1985 agreement, check here

e Total number of exemptions claimed

No. of boxes checked on 6a and 6b

No. of your children on 6c who:

- lived with you
- didn't live with you due to divorce or separation (see page 14)

No. of other dependents on 6c

Add numbers entered on lines above

Proposed

Exemptions
(See page 12.)

If more than six dependents, see page 13.

6a Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a. But be sure to check the box on line 33b on page 2

b Spouse

c Dependents: (1) Name (first, initial, and last name)	(2) Dependent's year of birth	For a dependent born BEFORE 1973, check if dependent was		(5) If age 1 or older, dependent's social security number	(6) Dependent's relationship to you (for example, son, child, lived grandchild, etc.)	(7) Number of months with you in the U.S. in 1991
		(3) a student under age 24 at end of 1991	(4) disabled (see booklet)			

d If your child didn't live with you but is claimed as your dependent under a pre-1985 agreement, check here

e Total number of exemptions claimed

No. of boxes checked on 6a and 6b

No. of your dependents on 6c who:

- lived with you
- didn't live with you due to divorce or separation (see page 14)

No. of other dependents on 6c

Add numbers entered on lines above

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