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How to Reduce the Compliance Burden of the Earned Income Credit on Low-Income Workers and on the Internal Revenue Service

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HOW TO REDUCE THE COMPLIANCE BURDEN OF THE EARNED INCOME CREDIT ON LOW-INCOME WORKERS AND ON THE INTERNAL REVENUE SERVICE

JONATHAN BARRY FORMAN*

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In the spring of 1995, Congress became concerned about the high rates of error and fraud associated with the earned income tax credit, a refundable income tax credit for low-income workers.[1] Because of my expertise on the tax problems of

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1. *See, e.g.*, STAFF OF THE JOINT COMMITTEE ON TAXATION, 104TH CONG., 1ST SESS., REP. NO.

low-income individuals in general and on the earned income credit in particular,[2] I was invited to testify about the earned income credit before a June 15, 1995 joint hearing of the House Ways and Means Subcommittees on Oversight and Human Resources.[3] With minor editorial changes, this article reprints my oral testimony and the more detailed and footnoted written testimony that I submitted for the record of that hearing. Finally, this article concludes with a brief update about Congress's recent legislative efforts pertaining to the earned income credit.

Oral Testimony of Professor Jonathan Barry Forman

Madam Chairman, Mr. Chairman, and Members of the Subcommittees on Oversight and Human Resources:

Thank you for this opportunity to present my views about the earned income credit.

Today, the federal tax system 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. 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 file returns.

I believe that the earned income credit can be restructured in a way that reduces the number of people who need to file returns while, at the same time, guaranteeing benefits to low-income workers. My point is this: 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.

If it were up to me, I would do three things. First, I would move the federal tax system toward return-free filing. Second, I would replace a portion of the earned income credit with an across-the-board $5000 per worker Social Security tax exemption. And, third, I would replace the rest of the earned income credit

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JCX-27-95, DESCRIPTION OF PRESENT LAW AND DISCUSSION OF ISSUES RELATING TO THE EARNED INCOME TAX CREDIT (Comm. Print 1995) [hereinafter EIC DISCUSSION].

2. At the time I was vice-chair of the Committee on Low Income Taxpayers of the American Bar Association Section of Taxation. I am also the author of numerous articles on the earned income credit and on the relationship between the tax and social welfare systems. *See, e.g.*, Jonathan B. Forman, *The Income Tax Treatment of Social Welfare Benefits*, 26 U. MICH. J. L. REF. 785 (1994); Jonathan B. Forman, *Administrative Savings from Synchronizing Social Welfare Programs and Tax Provisions*, 13 J. NAT'L ASSOC. ADMIN. L. JUDGES 5 (1993) [hereinafter Forman, *Administrative Savings*]; Jonathan B. Forman, *Using Refundable Tax Credits to Help Low-Income Families*, 35 LOY. L. REV. 117 (1989); Jonathan B. Forman, *Improving the Earned Income Credit: Transition to a Wage Subsidy Credit for the Working Poor*, 16 FLA. ST. U. L. REV. 41 (1988); George K. Yin et al., *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Credit Program*, 11 AM. J. TAX POL'Y 225 (1994).

3. *See, e.g.*, *Advisory from the Committee on Ways and Means Subcommittees on Oversight and Human Resources, Johnson and Shaw Announce Hearing of the Earned Income Credit*, Press Release, June 1, 1995, *available in* LEXIS, Fedtax library, Tnt file.

with a $1000 per child refundable tax credit, along the lines of The National Commission on Children's proposal several years ago.

First, we should move toward 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 1040EZ and 1040A filers and for a few 1040 filers — more than fifty-five 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 or more for return preparation — and additional fees for electronic filing and refund anticipation loans. In addition, under a return-free filing system, the compliance burdens on the IRS would be greatly reduced.

Second, Congress should replace a portion of the earned income credit with a $5000 per worker exemption from Social Security taxes. After all, much of the complexity of the current system results from collecting Social Security taxes from every worker, and then using the earned income credit to refund those taxes to low-income workers. Wouldn't it be simpler if the federal tax system did not collect those Social Security taxes in the first place?

With a Social Security exemption, at least ten million tax returns could be eliminated, and IRS resources would be freed for other productive work, according to the Joint Committee on Taxation.

Also, unlike the earned income credit — 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. And, unlike the earned income credit, a Social Security tax exemption would reach 100 percent of low-income workers.

Finally, Congress should replace the rest of the earned income credit with a $1000 per child refundable tax credit, along the lines of the $1000 per child tax credit proposed in 1991 by the bipartisan National Commission on Children. The credit would be available for all children through the age of eighteen; it would be refundable and indexed for inflation; and 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 earned income credit, a refundable child tax credit would not create marriage penalties. That's 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 phase-out range of the earned income credit. Because the credit would be available to all families with children, it simply would not have to be phased out at all.

To summarize, by moving to a return-free filing system and replacing the earned income credit with a $5000 per worker Social Security tax exemption and a $1000 per child refundable tax credit, Congress could guarantee benefits to low-income workers and free millions of Americans from having to file tax returns.

Before concluding, however, let me mention two other possible alternatives to the current earned income credit. One alternative would be to combine the credit with other welfare programs like food stamps and Aid to Families with Dependent Children (AFDC). After all, having multiple federal welfare programs has resulted in complexity, inequity, and high administrative costs.

Ideally, it would make sense to combine the earned income credit and 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. 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.

A final alternative to the current earned income credit 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 most of the very same people that we are trying to help with 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.

Thank you again for this opportunity to testify before you.

Written Statement of Professor Jonathan Barry Forman

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 Sen. 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.[4]

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

4. 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.

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 $5000 per worker Social Security tax exemption and a $1000 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 eighty percent of its target population.[5] 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.[6]

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

5. Yin et al., *supra* note 2, at 244.

6. Testimony of Lynda D. Willis before the Senate Finance Committee (June 8, 1995), *available in* LEXIS, Fedtax Library, Tnt File.

replace the current earned income credit with a $5000 per worker exemption from Social Security taxes and a $1000 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 thirty-nine million Americans live in poverty.[7] 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.[8]

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 $6550 standard deduction and four $2500 personal exemptions together will shelter $16,550 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% of earned income credit beneficiaries were heads of household.[9] 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% of the 113.6 million individual income tax returns

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7. *Number of Elderly Poor Drops: 'Statistical Anomaly' Cited for Part of the Drop*, 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. *Id.*

8. *See infra* appendix to the Written Statement for computations.

9. Testimony of IRS Commissioner Margaret Milner Richardson before the Senate Finance Committee (June 8, 1995), *available in* LEXIS, Fedtax Library, Tnt File.

filed showed no income tax liability.[10] That's roughly twenty-seven 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.[11]

Moreover, millions of Americans need help preparing their income tax returns. For example, more than fifty-six million taxpayers used paid preparers for their 1992 tax returns.[12] That is 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.[13] 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.[14]

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

10. IRS, *Selected Historical and Other Data*, 14 SOI BULL. 175, 205-6 (1994-1995).

11. *Id.* at 178.

12. *Id.* at 225.

13. U.S. GEN. ACCOUNTING OFFICE, EARNED INCOME CREDIT: TARGETING TO THE WORKING POOR (1995) (GAO/GGD-95-122BR).

14. Indeed, Americans spend at least $30 billion a year to prepare their individual income tax returns. U.S. GEN. ACCOUNTING OFFICE, INTERNAL REVENUE SERVICE: OPPORTUNITIES TO REDUCE TAXPAYER BURDENS THROUGH RETURN-FREE FILING 1 (1992) (GAO/GGD-92-88BR) [hereinafter OPPORTUNITIES].

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.[15]

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.[16] 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 fifty-five million taxpayers in all. Most of these

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15. U.S. Office of Management & Budget, OMB Circular No. A-76 (Rev.), Performance of Commercial Activities, 48 Fed. Reg. 37,110 (1983). Promulgated by the Reagan Administration, that ruling generally prevents government agencies from "competing" with private-sector businesses.

16. *See generally* IRS, CURRENT FEASIBILITY OF A RETURN-FREE TAX SYSTEM (1987); OPPORTUNITIES, *supra* note 14.

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 thirty 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 twenty-three million of the twenty-six million taxpayers eligible for PAYE did not file tax returns.[17]

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 nineteen million in 1994) and many of those who now file 1040A returns (about twenty-three 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 $5000 or $10,000 Social Security Tax Exemption and a $500 or $1000 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 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 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 $5000 or $10,000 exemption to the Social Security tax system.[18] Unlike the earned income credit, a Social Security tax

17. OPPORTUNITIES, *supra* note 14, at 36.

18. *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% of a worker's first $61,200 in wages. Consequently, a $5000 Social

exemption would reach 100% 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 credit — 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. This would be a powerful work incentive.[19] 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 ten million tax returns annually and free IRS resources for other productive work.[20]

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 $1000 per child tax credit proposed by the bipartisan National Commission on Children.[21] Congress might start by making the $500 per child tax credit in the House-passed tax bill refundable.[22] A portion of the needed revenue could come from the current earned income credit.

Unlike the earned income credit, a $500 or $1000 refundable child tax credit would not depend upon the marital status of the 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.[23] For

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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 = $5000 x 7.65%).

19. 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.

20. EIC DISCUSSION, *supra* note 1, at 19.

21. U.S. NAT'L COMM'N 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 L.J. 661 (1989).

22. Contract with America Relief Act of 1995, H.R. 1215, 104th Cong., 1st Sess. § 101 (1995).

23. *See, e.g.*, Jonathan B. Forman, *Improving the Earned Income Credit: Transition to a Wage Subsidy Credit for the Working Poor*, 16 FLA. ST. L. REV. 41 (1988); Robert H. Haveman & John Karl Scholz, *Transfers, Taxes, and Welfare Reform*, 47 NAT'L TAX J. 417, 428-30 (1994); Yin et al., *supra* note 2, at 280-86.

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).[24] 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 to the Written Statement

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 $5000 per worker Social Security tax exemption and a $1000 per child refundable tax credit.

Appendix to the Written Statement

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.[25] 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.

24. *See, e.g.*, Forman, *Administrative Savings*, *supra* note 2.

25. U.S. Dep't of Health & Human Servs., Office of the Secretary, Annual Update of the Poverty Income Guidelines, 60 Fed. Reg. 7,772 (1995). The poverty income guidelines used here are those applicable to all states (except Alaska and Hawaii) and the District of Columbia.

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.[26] 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.

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 $6550 standard deduction and four $2500 personal exemptions.[27] Consequently, the couple would not have to pay any income tax until its income exceeded its $16,550 simple income tax threshold.[28]

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.[29]

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.

26. 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.

27. Rev. Proc. 94-72, 1994-50 I.R.B. 14.

28. $\$16,550 = \$6,550 + 4 \times \$2,500$.

29. 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:

$$T = .15 \times (I - \$16,550) - (\$3,110 - .2022\ [I - \$11,290]).$$

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.

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.

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.[30]

To summarize, table 1 shows that in large part because of the earned income credit, many (if not most) low-income individuals will not have a net federal tax liability for 1995. In particular, low-income married couples with one, two, or three children will generally receive net subsidies from the federal tax system — through earned income credit refunds. Similarly, many low-income childless individuals, childless couples, and large families will also be entitled to refunds for 1995.

On the other hand, some low-income childless individuals, childless couples, and large families will have net federal tax liabilities for 1995. For example, a married couple with four children (family of six) that earns more than $19,350 will have a net federal tax liability. Similarly, a childless individual who is eligible to claim the earned income credit will have a net federal tax liability if she earns more than $4100.

An analysis of family units headed by unmarried individuals (i.e., heads of household) would show results similar to those in table 1. On the other hand, an analysis of low-income childless individuals and couples who are ineligible for the earned income credit (e.g., because they are under age twenty-five or over age sixty-four) would show slightly greater tax liabilities. For example, a twenty-one-year-old childless individual will owe Social Security taxes and so have a net federal tax liability from her very first dollar of earned income.

Update on Congressional Action

Since June, Congress has been working on tax and welfare bills that could have a major impact on the low-income workers who currently benefit from the earned income credit. By the time this article is published, Congress is likely to have passed a tax bill that will substantially cut the earned income credit. On September 19, 1995, the House Ways and Mean Committee approved significant cuts in the earned income credit.[31] Among other changes, the committee's bill would deny the credit to childless workers and to undocumented alien workers, hasten the phase-out of the credit for families with incomes over $11,000, and include Social Security

30. 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:

$$T = .15 \times (I - \$16{,}550) + .0765 \times I - (\$3{,}110 - .2022\ [I - \$11{,}290])$$

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.

31. *See, e.g.*, John Godfrey, *House-Senate Republicans Craft EITC Cuts*, 68 TAX NOTES 1524 (1995).

and other nontaxable annuities in credit eligibility calculations. The Senate Finance Committee is considering similar legislation.[32]

Also, Congress seems poised to enact welfare reform legislation that could have a significant impact on low-income workers.[33] Under both the House and Senate-passed welfare reform bills, the federally mandated Aid to Families with Dependent Children program would be ended. Instead, the States would get greater freedom to design their own welfare programs and would receive federal block grants to help cover the costs of those programs. Just how these new State welfare programs will interact with a revised earned income credit remains to be seen.

32. *Id.*

33. *See, e.g.*, Jeffrey L. Katz, *Uneasy Compromise Reached on Welfare Reform*, 53 CONG. Q. WEEKLY REP. 2,804 (1995).