THE EARNED INCOME TAX CREDIT AND WELFARE REFORM

James Williams*

INTRODUCTION

The recent debates about welfare reform show that on national and state levels it is good politics to 'get tough' on welfare.[824] Although the formalized welfare system in the United States dates from the Social Security Act of 1935,[825] the modern version of welfare can be separated into five programs:

- Supplemental Security Income (SSI), which guarantees a national minimum level of income for the aged, blind, and disabled.
- Aid to Families with Dependant Children (AFDC), which consists of cash benefits to families with incomes low enough to qualify. The states determine the level of benefits and eligibility.
- Food stamps, which guarantee a minimum monthly income in this form to persons with incomes below a certain level. The dollar amount of food stamps received depends in part on the size of the family. Federal law forbids treating food stamps benefits as income for tax or welfare purposes.
- Pensions for veterans with low incomes and veterans' disability compensation.
- The Earned Income Tax Credit ("EITC").[826]

The focus of this paper is the EITC and its important role in welfare reform.

The current welfare system has been criticized on the grounds that it does not promote and encourage work. Critics also claim that welfare

---

* Larry Nackerud, Ph.D., and Alicia Issac, D.B.A., are Assistant Professors who teach and do research in the area of social welfare policy for the School of Social Work at the University of Georgia. Nicole Deets, B.S., M.S.W., and Curtis Kleem, B.A., M.S.W., completed their concentration practicum in the Walton County DFCS office. Correspondence and requests for reprints should be directed to Larry Nackerud, Ph.D., at 301 Tucker Hall, School of Social Work, University of Georgia, Athens, Georgia, 30602-7016.

[824] Joel F. Handler, The Poverty of Welfare Reform 2 (1995).

[825] *Id.* at 21.

[826] Colin D. Campbell & William L. Peirce, The Earned Income Tax Credit 9 (1980).

causes a breakdown of the family, as evidenced by the expansion of out-of-wedlock births. The current welfare system is also criticized as not providing enough state flexibility. Finally, critics of the welfare system claim welfare is ineffective in reducing poverty, especially among children.[827]

The EITC addresses several of these complaints. First, the EITC "[i]s strongly pro-work. Only working families qualify for it. In addition, unlike welfare benefits, EITC payments rise rather than fall with earnings across that critical low-income range where we want to encourage work effort."[828] Proponents of the EITC, such as Senator Bill Bradley (D-NJ), feel that it is "an effective, practical tool that provides working Americans the chance to climb the economic ladder to the middle class and build better opportunities for their families."[829]

The effectiveness of the EITC can be evaluated by exploring its practical implications for a hypothetical family of four. Using this as a background, it will be possible to review both the benefits and drawbacks of the EITC as a welfare entitlement program.

THE EARNED INCOME TAX CREDIT

Congress established the EITC as part of the Tax Reduction Act of 1975.[830] The EITC's original goals were to offset the negative impact of social security taxes on the wages of low-income workers and to provide incentives for welfare recipients to work.[831] Supporters of the EITC rationalize that it can stimulate the economy because low-income earners receiving the benefits are, in theory, better able to act as consumers.[832] The EITC gives low-income workers a reduction in the taxes that they owe.[833] Significantly, the EITC offers refunds to low-income workers with

---

[827] *See* The Urban Institute, *Welfare Reform: An Analysis of the Issues,* (Isabel V. Sawhill, ed.)(visited Jan. 20, 1997) <http://www.urban.org/welfare/overview.htm>.

[828] *An Examination of the Development of the Earned Income Credit Tax Forms: Hearing Before the Subcomm. on Gov't Info. and Regulation of the Comm. on Gov't Affairs*, 102nd Cong., 1st Sess. 89 (1992) (statement of Robert Greenstein, Director, Center on Budget and Policy Priorities).

[829] *Bradley Proposes to Restore Funds for Earned Income Tax Credit* (visited Jan. 20,1997)<http://www.competition96.com/bradley/pubs/ eitc.htm>. (statement of Senator Bradley, October 24, 1995).

[830] Campbell & Peirce, *supra* note 3, at 1 (quoting Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (codified as amended in scattered sections of 26 U.S.C.)).

[831] Campbell & Peirce, *supra* note 3, at 1.

[832] *Id.*

[833] *Id.*

no tax liabilities.[834] The EITC distributes these refunds to eligible taxpayers directly through the tax system.[835]

The EITC in Section 32 of the Internal Revenue Code (IRC) provides:

(1) IN GENERAL.- In the case of an eligible individual, there shall be allowed as a credit against the tax imposed by this subtitle for the taxable year an amount equal to the credit percentage of so much of the taxpayer's earned income for the taxable year as does not exceed the earned income amount. (emphasis added).

(2) LIMITATION.- The amount of the credit allowable to a taxpayer under paragraph (1) for any taxable year shall not exceed the excess (if any) of-

(A) the credit percentage of the earned income amount, over

(B) the phaseout percentage of so much of the modified adjusted gross income (or, if greater, the earned income) of the taxpayer for the taxable year as exceeds the phaseout amount.[836]

Earned income means "[w]ages, salaries, tips, and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment for the taxable year. . . ."[837] For 1996, the maximum EITC that a taxpayer with one child could have received was $2,152.[838] A taxpayer with two or more children could have received a maximum of $3,556, and a taxpayer with no children could have received a maximum of $323.[839] Each year the statute adjusts these amounts for inflation based on the Consumer Price Index.[840]

Section 32(b) of the IRC defines the actual amounts that correspond to the EITC. For 1996, these amounts are as follows:

In the case of an eligible taxpayer with:	The credit percentage is:	The phaseout percentage is:
1 qualifying child	34	15.98
2 or more qualifying children	40	21.06

[834] *Id.*

[835] Mary Jo Bane & David T. Ellwood, Welfare Realities - From Rhetoric to Reform 149 (1994).

[836] I.R.C. § 32(a)(1997).

[837] I.R.C. § 32(c)(2)(A)(i) and (ii)(1997).

[838] Rev. Proc. 95-53(.03)(1), 1995-2 C.B. 446-47.

[839] *Id.*

[840] I.R.C. § 32(j)(1)(1997).

no qualifying children	7.65	7.65[841]

Section 32(b)(2) describes the amounts of the EITC as follows:

In the case of an elibible individual with:	The earned income amount is:	The phaseout amount is:
1 qualifying child	$6,330	$11,610
2 or more qualifying children	$8,890	$11,610
No qualifying children	$4,220	$5,280[842]

These amounts show that a given taxpayer who has two or more children will begin to be phased out from the maximum EITC available ($3,556) if his or her income equals or exceeds $11,610. Once income equals or exceeds $28,495, the EITC is completely phased out, meaning that the taxpayer will be totally ineligible for any EITC.[843]

The following example illustrates the effect on a married couple with two dependant children and an income of $10,000.

To calculate this family's EITC, it is necessary to compare their joint income with the initial phaseout amount of $11,610 (see charts above). Since their income of $10,000 is less than the phaseout amount and more than the earned income amount, the couple will receive the full $3,556 EITC available.

If this family's joint income increased to $15,000, their income would be $3,390 more than the phaseout amount ($15,000 income minus $11,610 Threshold Phaseout amount equals a $3,390 excess). This excess income is multiplied by the Phaseout Percentage of 21.06% (see tables above). If we take the $3,390 excess income and multiply it by the Phaseout Percentage, we get $713.93. Then, the excess amount ($713.93) is subtracted from the full amount of EITC available ($3,556). The difference ($2,842.07) is the EITC that this hypothetical family of four with a $15,000 income would receive.

Assume the same family now earns $28,500 in 1996. Since this income exceeds the Completed Phaseout Amount of the EITC (which is

[841] I.R.C. § 32(b)(1)(A)(1997).
[842] I.R.C. §32(b)(2)(1997).
[843] *See* Rev. Proc. 95-53(.03)(2), 1995-2 C.B. 447.

$28,495 for taxpayers with two or more children), the family would be ineligible for the EITC.

The IRC provides that an "eligible individual" can be an individual who has a "qualifying child for the taxable year."[844] A "qualifying child" is one who satisfies an age test, a relationship test, and a residency test, and for whom the taxpayer meets an identification requirement.[845] The EITC is not available to all wage earners whose income is within statutory parameters. Certain restrictions on eligibility exist. As originally enacted, the EITC applied only to taxpayers with a dependant child. Now, a taxpayer who does not have a dependant child is eligible for the EITC if the taxpayer's "principle place of abode is in the United States for more than one-half of such taxable year, [and the taxpayer] has attained age 25 but not attained age 65 before the close of the taxable year. . . ."[846] The childless taxpayer must not be a dependant.[847]

BENEFITS OF THE EARNED INCOME TAX CREDIT AS A COMPONENT OF WELFARE REFORM

The EITC has several benefits that make it an important component of welfare reform. First, because the EITC does not impose any costs on employers, it could not contribute to job losses.[848] Second, supporters of the EITC claim that it does not discourage work[849] - it actually offers an incentive to work because families who have no earnings do not receive a refund check.[850]

The EITC also does not limit its coverage to poor families with children.[851] Low income families without children are eligible, although they receive less of a benefit. However, a family will not receive more money for having more than two children. A family with two or more children can receive a maximum of $3,556,[852] and families receive no more money for additional children. Thus, a family with ten children and a family with two children both receive the same EITC rebate, assuming both families earn the same yearly income.

Capping the EITC benefit arguably addresses the single welfare-mother stereotype that society alleges "has several children in order to get

---

[844] I.R.C. § 32(c)(1)(A)(1997).
[845] I.R.C. § 32(c)(3)(1997).
[846] I.R.C. § 32(c)(1)(A)(1997).
[847] *Id.*
[848] Bane & Ellwood, *supra* note 12, at 149.
[849] *See* The Urban Institute, *supra* note 4.
[850] *See* Campbell & Peirce, *supra* note 3, at 18.
[851] *Contra id.* at 9.
[852] Rev. Proc. 95-53 (.03)(1), 1995-2 C.B. 446-47.

more welfare."[853] Critics of the EITC have countered this by arguing that the Credit's disregard of family size shows that it is not a good welfare program.[854] A larger family has greater needs and a cogent welfare program should address this.[855]

The EITC allows people to choose how they spend the assistance they receive to best meet their family's needs. The EITC provides a lump sum benefit once a year. Critics suggest that the lump sum benefit "is not a particularly effective way of moving people and encouraging people to work when they are not getting that consistent benefit every month in their paycheck."[856] Because the Internal Revenue Service sends the refund directly to the recipient, the EITC allows anonymity. Current welfare recipients may find the welfare system "degrading and demoralizing"[857] because it "has come to emphasize eligibility and compliance to the exclusion of nearly every other goal."[858] Advocates claim that the EITC is a cheaper and simpler form of welfare than other alternatives because the government distributes it directly through the federal tax system.[859]

CHALLENGES OF THE EARNED INCOME TAX CREDIT AS A COMPONENT OF WELFARE REFORM

As stated, a major goal of the EITC is to serve as an incentive to work.[860] However, critics contend that "setting the poor to work is expensive and extremely problematic administratively; this should give us pause before we embrace another 'new solution.'"[861] The expense of putting poor families to work is especially apparent with poor single mothers. Without extensive support, it is unlikely that women with young children will be able to work.[862] Therefore, the government may need to address child care issues before relying on EITC-type incentives which require work as a basis for entitlement.

The EITC does not, by itself, create jobs.[863] It also does not address the question of whether additional resources should be expended to help

---

[853] Handler, *supra* note 1, at 3-4.
[854] Campbell & Peirce, *supra* note 3, at 10.
[855] *Id.*
[856] *Selected Aspects of Welfare Reform: Hearings Before the Subcomm. on Select Revenue Measures and Subcomm. on Human Resources of the Comm. on Ways and Means,* 103rd Cong., 1st Sess. 6 (1993) (statement of Mr. Rick Santorum, Pa.).
[857] The Urban Institute, *supra* note 4.
[858] Bane & Ellwood, *supra* note 12, at 2.
[859] *See* Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 Harv. L. Rev. 533, 534 (1995).
[860] *See* Bosarge v. United States Dep't of Educ., 5 F.3d 1414, 1420 (11th Cir. 1993).
[861] Handler, *supra* note 1, at 32-33.
[862] Bane & Ellwood, *supra* note 12, at 140.
[863] Handler, *supra* note 1, at 143.

potential recipients of the EITC find jobs, or whether potential recipients should be left to find work on their own. Factors such as "[c]hild care problems, health care issues, school problems, bad neighborhoods, and so forth, [make] it . . . questionable how young children and adolescents will fare when their mothers have to work enough hours to achieve self-sufficiency."[864]

Critics have also argued that the EITC's effectiveness in promoting work is often exaggerated.[865] As this paper shows, even a cursory analysis of the EITC can become complex. This complexity may keep potential recipients from understanding how employment creates EITC benefits.[866] Critics of the EITC claim that "[t]his informational gap may blunt both the EITC's potential incentives and its potential disincentives."[867]

Some have criticized the EITC for its structural limitations, which can arguably cause compliance, accuracy, and responsiveness problems.[868] For example, the EITC would not be responsive to low-income taxpayers who do not file tax returns because their income is below the filing threshold. Because the EITC is only dispersed through the tax system, these taxpayers will not receive the credit unless they specifically file for an EITC refund.[869]

Taxpayers who are eligible for EITC may purposely choose not to file a return because the benefit does not necessarily justify their filing a tax return.[870] However, this criticism is not compelling because studies have shown that the "EITC participation rate was 75 to 90 percent in 1990, with the most reliable estimates falling in the 80 to 86 percent range."[871] Finally, the EITC's dependance on the tax system may cause accuracy problems. This is because the tax system narrowly defines "income."[872] The plethora of tax preferences and exclusions that exist can create an imprecise picture of a taxpayer's actual wealth.[873] These potential inaccuracies could cause some taxpayers to receive EITC benefits when they should not be entitled to them.[874]

---

864 *Id.* at 33.

865 Alstott, *supra* note 36, at 534.

866 *Id.* at 548.

867 *Id.*

868 Anne L. Alstott, *The Earned Income Tax Credit and Some Fundamental Institutional Dilemmas of Tax-Transfer Integration,* 47 Nat'l Tax J. 609, 609 (1994).

869 John Karl Scholz, *The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness,* 47 Nat'l Tax J. 63, 64 (1994).

870 *Id.* at 72.

871 *Id.* at 79.

872 Alstott, *supra* note 45, at 611.

873 *Id.*

874 *Id.*

The EITC is not a complete solution to welfare concerns in this country.[875] "Because welfare will continue to be necessary, whatever form of wage or earnings credit may be enacted, one cannot escape the question of whether and how welfare should be reformed."[876]

CONCLUSION

The EITC has an important place in welfare reform, though it has received little attention in the debate.[877] This lack of debate is surprising because the EITC is responsible for granting approximately twenty million Americans a tax refund.[878] "The expansion of the EITC under the Clinton administration is one of the most important antipoverty income transfer measures to have been enacted in a generation. When fully funded, it will pull about fourteen million working poor families out of poverty."[879]

In Poor Support, David Ellwood proposed an expansion of the EITC, plus an increase in the minimum wage and child care benefits.[880] Ellwood's proposal requires a mother to work part- time.[881] He argues that this plan could bring single mothers up to the poverty line.[882] Although the Clinton Administration loosely based its proposals on Ellwood's theories,[883] the current budget limitations suggest that Ellwood's ideas are unlikely to be implemented soon.

According to Wendell E. Primus, Deputy Assistant Secretary for Human Services Policy for the U.S. Department of Health and Human Services, the time has come "[t]o be bold . . . . The real hope is to replace, rather than reform, welfare. That requires making independence and self-support genuinely feasible. The President calls on Government to support, rather than supplant, the efforts of parents. He asks that we reinforce work."[884]

---

[875] *See* Henry Aaron, *Welfare Reform: What Kind and When?, in* Income Support 322, 328 (Peter G. Brown et al. eds., 1981).
[876] *Id.*
[877] *See* Handler, *supra* note 1, at 141.
[878] *Earned Income Tax Credit* (visited January 20, 1997) <http://www.tripod.com/politics/playbook/issues/incometax.html>.
[879] Handler, *supra* note 1, at 141.
[880] David Ellwood, Poor Support 180 (1988).
[881] *Id.*
[882] *Id.*
[883] Handler, *supra* note 1, at 140.
[884] Selected Aspects of Welfare Reform: Hearing Before the Subcomm. on Select Revenue Measures and Subcomm. on Human Resources of the Comm. on Ways and Means, 103rd Cong., 1st Sess. 6 (1993) (statement of Wendell E. Primus, Deputy Assistant Secretary for Human Services Policy, U.S. Department of Health and Human Services).

Commentators suggest welfare reform should move forward "with uniform national mandates, when we can be reasonably certain the consequences of innovation will be beneficial."[885]

Although the EITC appears to successfully embrace the typical complaints about the current welfare system, policy-makers will need empirical data to establish the actual effects and successes of the EITC.[886]

[885] Robert D. Reischauer & R. Kent Weaver, *Financing Welfare: Are Block Grants the Answer?*, *in* Looking Before We Leap: Social Science and Welfare Reform 13, 17 (R. Kent Weaver & William T. Dickens, eds., 1995).
[886] *See* Alstott, *supra* note 36, at 554.