Improving the Earned Income Credit: Transition to a Wage Subsidy Credit for the Working Poor

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Millions of American families have incomes that fall below the poverty line. Of these, many families are poor despite the fact that at least one member of these families works during the year. In this article, Professor Forman examines one tool in the fight against poverty, the earned income credit. Professor Forman examines the history of the credit and its shortcomings and then suggests ways in which the credit could be improved to better serve the working poor.

TABLE OF CONTENTS

I. HISTORY OF THE EARNED INCOME CREDIT ....................... 45
   A. Background .................................................... 46
   B. Early Tax Credit Proposals.................................. 47
      1. A Work Bonus for Low-Income Workers ............. 47
      2. The Proposed Tax Credit for Low-Income Workers . 49
   C. The Earned Income Tax Credit ............................ 50
      1. The Earned Income Credit and the Tax Reduction Act of 1975 ........................................ 50
      2. Subsequent Changes in the Earned Income Credit .......................... 52
      3. The Tax Reform Act of 1986 ......................... 55
II. OPERATION OF THE EARNED INCOME CREDIT ................. 58
   A. The Credit Itself ............................................. 58
      1. Amount of the Earned Income Credit .......... 58
      2. Eligible Individuals ................................. 59
      3. Earned Income ........................................ 61
   B. Advance Payment of the Earned Income Credit ..... 61

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1. Advance Payment Amount .................................. 61
2. Electing to Receive Advance Payments ................. 62
3. Employer Duties ........................................... 64
4. Recipients Must File Income Tax Returns ............... 65
C. Participation and Cost ..................................... 66

III. THE MECHANICS OF INCOME TRANSFER PROGRAMS ....... 67
A. A Negative Income Tax ...................................... 68
B. A Wage Subsidy .............................................. 69
   1. A Simple Wage Subsidy System ....................... 70
   2. More Complicated Wage Subsidy Systems ............. 72
C. An Income Subsidy .......................................... 73
   1. A Simple Income Subsidy ............................... 73
   2. A Simple Earnings Subsidy ............................ 74
D. Income Transfer Programs Compared ...................... 74

IV. TRANSFORMING THE EARNED INCOME CREDIT INTO AN EF-
FECTIVE ANTIPOVERTY PROGRAM FOR THE WORKING
POOR .......................................................... 77
A. Convert the Earned Income Credit into a Wage
   Subsidy Credit ............................................. 78
   1. The Earned Income Credit Viewed as a Wage
      Subsidy Credit ......................................... 79
   2. Converting the Earned Income Credit to a
      Wage Subsidy Credit .................................. 81
B. Base the Phase-Out on Economic Income and Need ....... 83
   1. The Definitions of Earned Income and Ad-
      justed Gross Income .................................. 84
   2. Changes to Bring the Phase-Out Base Closer to
      Economic Income ..................................... 87
   3. Further Changes to Make the Earned Income
      Credit Needs-Based ................................... 88
   4. Summary ................................................ 89
C. Extend the Credit ........................................... 89
   1. Include a Family Allowance Provision ............... 89
   2. Extend Eligibility to Childless Couples and Sin-
      gle Individuals ........................................ 93
   3. Reduce the Penalties on Two-Earner Couples ....... 93
   4. Summary ................................................ 95
D. Raise the Benefit-Reduction (Phase-Out) Rate ........... 96
E. Improve the Advance Payment Feature .................... 97
F. Raise the Subsidy Rate ..................................... 98
G. Cost Considerations ....................................... 100

V. CONCLUSION .................................................. 101
ONE OF the real travesties of our economic system is that so many Americans work in jobs that do not pay enough to enable them to bring their families over the poverty line. Indeed, of the 32.4 million people who were below the poverty line in 1986, more than eight million worked during the year. Of these working poor, more than two million worked full-time for fifty to fifty-two weeks during that year.

A partial explanation for the hardships faced by the working poor stems from the fact that some 6.7 million workers now earn the minimum wage. In 1988 the minimum wage is $3.35 per hour. Thus, a wage-earner working 2,000 hours a year at the minimum wage would earn just $6,700 per year, far short of the $11,650 poverty guideline for a family of four.

Through the years, dozens of programs have been adopted to help solve the problem of poverty in America. Unfortunately, relatively few programs have been geared towards helping the working poor, despite the fact that there seems to be almost universal agreement

2. Id. at 31 (Table 18).
3. Id.
6. An individual working 52 weeks a year, 40 hours a week, would actually work 2,080 hours a year. Throughout this article, a 2,000-hour work year is assumed in order to make the computations and analyses simpler to understand.
8. One recent study determined that there were 59 major federal welfare programs. U.S. Domestic Policy Council Low Income Opportunity Group, Up From Dependency: A New National Public Assistance Strategy 10, 11-13 (Table 1) (1986) (report to the President assessing the American welfare system and proposing a basic change in public assistance policy) [hereinafter Up From Dependency]. Another study catalogued 74 public programs offering cash and non-cash benefits to people of limited income. V. Burke, Cash and Noncash Benefits for Persons with Limited Income: Eligibility Rules, Recipient and Expenditure Data, FY 1983-1985 (Cong. Res. Serv. Rep. No. 86-161 EPW 1986).
that it is appropriate for the government to do so. One modest federal program that is geared to help the working poor is the earned income credit.

For 1988, the earned income credit provides certain low-income families with a tax credit of up to $874 per year. The earned income credit is refundable: if the amount of the credit exceeds a family's income tax liability, the Treasury will refund the balance. Also, rather than having to wait until the following year to claim the current year's credit on its income tax return, an eligible family may elect to receive advance payment of its expected earned income credit in its pay checks throughout the year.

Since its adoption in 1975, the earned income credit has become an increasingly important program for the working poor. The earned income credit is claimed by more than six million families. For federal government fiscal year 1989, the earned income credit is expected to result in tax subsidies and outlays of almost $5.5 billion.


11. The credit is available only to low-income married individuals filing joint returns who are entitled to a dependency exemption for a child, surviving spouses, and heads of households with a child or descendant. I.R.C. § 32(c) (1988). Thus, single individuals and married couples without dependents are not entitled to receive the earned income credit.

12. See infra note 113 and accompanying text.


15. See infra notes 59-76 and accompanying text.


17. Selected Statistical Series, 1970-1988, in U.S. INTERNAL REVENUE SERVICE, 7(3) STATISTICS OF INCOME BULLETIN 77, 82 (Table 2) (1988); See also Weber & Paris, Individual Income Tax Returns for 1986: Selected Characteristics from the Taxpayer Usage Study, in U.S. INTERNAL REVENUE SERVICE, 7(1) STATISTICS OF INCOME BULLETIN 1, 10 (Table 5) (1987); BURKE, supra note 8, at 68-69; FEDERAL TAX TREATMENT, supra note 16, at 6 (Table 2).

18. See 1989 BUDGET, supra note 16 (SPECIAL ANALYSES, pt. G, at 44-45 (Table G-2)). To the extent that the amount of the earned income credit exceeds a recipient's tax liability and is refundable, the refundable portion is treated as an outlay under budget procedures. See, e.g.,
This Article will evaluate the structure of the earned income credit and will suggest methods for its improvement. My thesis is that the earned income credit can form the basis for an effective antipoverty program for the working poor. This analysis is particularly appropriate now as welfare reform is once again in the limelight of public policy consideration.19

Section I examines the history of the earned income credit. Section II examines the present operation of the earned income credit and of the mechanism for advance payment of the earned income credit to eligible recipients. I then examine in section III the mechanics of various hypothetical income transfer programs for the working poor. In particular, I compare wage subsidy proposals with negative income tax and income subsidy proposals. Finally, in section IV I explore the changes that are needed to convert the earned income credit into an effective antipoverty program for the working poor.

I. HISTORY OF THE EARNED INCOME CREDIT

Although not adopted until 1975,20 the earned income credit grew out of the welfare reform efforts of the late 1960's and early 1970's. In this section I outline the debate over welfare reform and the origins of the earned income credit and trace the expansion of the earned income credit from its initial adoption through the major changes recently made by the Tax Reform Act of 1986.21
A. Background

With the publication of The Other America in the early 1960's, Americans slowly came to realize that there was another America—an America that included poor whites in Appalachia, poor blacks in the South, and poor Indians on reservations. Poverty increasingly came to be viewed as a social problem and as calling for overall reform of the welfare system. For example, in 1962, economist Milton Friedman proposed replacing existing welfare programs with a negative income tax. Basically, a negative income tax is a system of cash grants to families in which the amount of a family's grant varies inversely with the amount of that family's income. Advocates of a negative income tax generally have argued that such cash grants to the poor would be more efficient and less costly than non-cash programs such as food stamps and public housing.

As concern grew about poverty in America, President Lyndon B. Johnson went so far as to declare a "War on Poverty." Also, in January of 1968, President Johnson appointed a blue-ribbon Commission on Income Maintenance Programs to study the income needs of all Americans, to examine all existing government programs designed to meet those needs, and to make recommendations for constructive improvements. The Commission concluded that the welfare system was badly in need of reform, and recommended the development of a direct federal cash transfer program to make payments to all members of the population with income needs. For example, under the Commission's proposal, the federal cash transfer program would have ensured an income of $2,400 a year to a family of four. Essentially, the Commission recommended adoption of a federal negative income tax.

27. Id.
28. Id. at 57-63.
29. Id.
President Richard M. Nixon also favored welfare reform. On August 8, 1969, in a television address, President Nixon outlined a plan to ensure an adequate income for all American families. That plan, known as the Family Assistance Plan, also was essentially a negative income tax for families. It would have provided a cash grant of up to $1,600 per year for a family of four with no outside income. Benefits would have varied with family size and would have been phased out as family income increased. In 1970, a modified version of the Family Assistance Plan passed the House of Representatives but was rejected in conference with the Senate.

B. Early Tax Credit Proposals

Despite the initial rejection of the Family Assistance Plan, the Nixon Administration and Congress continued to work for welfare reform. Out of those efforts, the earned income credit emerged.

1. A Work Bonus for Low-Income Workers

A revised version of the Family Assistance Plan was proposed by the Nixon Administration, and introduced in the House as part of the proposed Social Security Amendments of 1971. In modified form, the Family Assistance Plan passed the House on June 22, 1971. As part of its counterproposal, the Senate Finance Committee’s substitute for the House Bill included the first semblance of an earned income credit.

30. Address to the Nation on Domestic Programs, PUB. PAPERS 637 (Aug. 8, 1969); see also Special Message to Congress on Welfare Reform, PUB. PAPERS 647 (Aug. 11, 1969).
33. Id. §§ 442, 446.
34. 116 CONG. REC. 12105-06 (1970).
37. 117 CONG. REC. 21,463 (1971).
The Senate Finance Committee's proposal called for a "work bonus" to supplement the wages of low-income taxpayers. The work bonus was to have been equal to 10% of the wages of eligible low-income workers who headed families. Generally, families were to have been eligible for the bonus if the annual wage income of the husband and wife combined was $4,000 or less. Only those low-income workers in regular employment who headed families would have been eligible for the work bonus. Because of technical difficulties that the Committee was not then able to work out, the proposal did not cover low-income, self-employed individuals.

The 10% work bonus was to have been administered by the Internal Revenue Service and was to have operated essentially as a refundable tax credit of up to $400 (10% times $4,000 maximum wages) per family. For families whose combined wage income of the husband and wife exceeded $4,000, the maximum $400 work bonus was to have been reduced by one-quarter (25 percent) of the amount by which their wages exceeded $4,000. With this phase-out, the tax credit would have been eliminated once a family's total income reached $5,600.

The proposal also provided that eligible individuals would have been entitled to apply for advance payments of the credit on a quarterly basis. Under this procedure, at any time after completion of the first calendar quarter, individuals could have applied for one-quarter of the tax credit that they would have been entitled to receive based on their earnings for the first quarter and projected earnings for the subsequent quarters. A similar procedure could have been followed for subsequent quarters. To eliminate de minimis claims, no

40. Id.
41. Id. The work bonus was to have applied only to wages covered by social security or railroad retirement. Id. See also S. Rep. No. 1230, 92d Cong., 2d Sess. 425-26 (1972). A special provision would have enabled domestics, yardmen, and other similar business employees earning less than $50 a quarter (and thus not covered by social security) also to qualify for the work bonus. See Principal Provisions of H.R. 1, supra note 38, at 74.
43. Id. at 426.
46. S. Rep. No. 1230, supra note 41, at 425. In this regard, the refund for the fourth quarter tax credit was to have been applied for in connection with the filing of a return after the end of the year, or claimed as a credit in the same manner as an overpayment of income tax. At the end of the year, any individual who had received advance refund payments would have been
quarterly advance refund payment of less than $30 was to have been made.\textsuperscript{47}

Because the work bonus proposal did not vary benefits by family size, but only by income, the Senate Finance Committee expressed the belief that the proposal would have avoided any economic incentive for recipients to have additional children. Also, because the proposal had a graduated phase-out of the amount of the payment as income rose above $4,000, the Committee believed that it would not have created a work disincentive.\textsuperscript{48} The proposal was expected to cost about $1 billion per year and was expected to have provided work bonus benefits to 5.5 million families. The Senate Finance Committee’s work bonus proposal was approved by the full Senate,\textsuperscript{49} but no agreement was reached in conference with the House.\textsuperscript{50}

2. The Proposed Tax Credit for Low-Income Workers

In 1973, the Senate Finance Committee refined its work bonus proposal into a proposed “Tax Credit for Low-Income Workers with Families,” which was included in its version of the Social Security Amendments of 1973.\textsuperscript{51} Like its predecessor (the work bonus proposal), the tax credit for low-income workers would have entitled a wage earner to receive a tax credit of up to $400 per year.\textsuperscript{52} The Sen-

\textsuperscript{47} S. REP. No. 1230, \textit{ supra} note 41, at 425. Of course, no advance refund payment was to have been made for any quarter to an individual who expected to receive too much income for the entire year to have been eligible for a tax credit for the year. \textit{Cf.} S. REP. No. 553, \textit{ supra} note 45, at 22.

\textsuperscript{48} S. REP. No. 1230, \textit{ supra} note 41, at 425-26.

\textsuperscript{49} 118 CONG. REC. 33,014 (1972).

\textsuperscript{50} H.R. REP. No. 1605, 92d Cong., 2d Sess. 29, \textit{reprinted in} 1972 U.S. CODE CONG. & ADMIN. NEWS 5370.


\textsuperscript{52} S. REP. No. 553, \textit{ supra} note 45, at 20-22. Generally, only wages subject to social security were considered for purposes of determining the credit. Thus, self-employed people would not have been eligible for the credit for the social security taxes that they paid on self-employment income. On the other hand, low-income workers who paid railroad retirement taxes would have been treated as if they paid social security taxes for purposes of determining the credit. \textit{Id.} at 20 n.1.
ate Finance Committee report accompanying the bill emphasized that the tax credit provision would have had the effect of refunding to low-income workers with children a large portion of the social security taxes then paid by them.  

Similar to the work bonus proposal, the amount of the proposed tax credit was to have been reduced by one-quarter of the amount by which a family’s total annual income exceeded $4,000.  

In determining when an individual’s income exceeded $4,000 for purposes of the credit, “income” was defined as including all of an individual’s adjusted gross income, increased by certain income specifically excluded from the income tax base and by certain transfer payments and payments for the general support of the individual (such as social security, welfare, veterans payments, and food stamps; but not transfer payments for medicare, medicaid, and the furnishing of prosthetic devices).  

Also, like the work bonus proposal, individuals eligible to receive the proposed credit would have been allowed to apply for advance refund payments of the credit on a quarterly basis.  

The Senate Finance Committee’s tax credit for low-income workers with families was approved by the full Senate, but it was not included in the 1973 legislation.

C. The Earned Income Tax Credit

1. The Earned Income Credit and The Tax Deduction Act of 1975

In 1975, the economy was stagnating, and both the Ford Administration and Congress wanted to enact a tax cut to stimulate the economy. The House Ways and Means Committee for the first time adopted a proposal for a refundable tax credit for low-income workers. The proposal called for a refundable “earned income tax credit” equal to 5% of earned income up to $4,000, for a maximum credit of $200. The credit was to have been phased out as earned income (or adjusted gross income, if greater) increased from $4,000 to $6,000. Since the tax cut was intended primarily as a short-term stim-
EARNED INCOME CREDIT

ulus to the economy, the credit was to apply only for tax years beginning in 1975.60

The House Ways and Means Committee's proposed earned income tax credit was to have applied to all employees, not just those with dependent children, and also to taxpayers with earnings from self-employment.61 Special anti-abuse rules were to have applied to individuals employed by members of their family and to those under age eighteen.62 According to the House Ways and Means Committee's report accompanying the bill, the proposed credit was intended to provide relief for low-income families that had been hurt the most by rising food and energy costs. Believing that low-income people would spend a large fraction of their increased disposable incomes, the Committee expected the credit to stimulate the economy.63 The Committee also believed that it was appropriate to use the income tax system to offset the impact of social security taxes on low-income people.64 The Committee estimated that the proposed earned income tax credit would have cost about $2.9 billion per year.65 The House approved the proposal on February 27, 1975.66

The Senate Finance Committee significantly revised the House's earned income tax credit proposal to make it conform with the work-bonus concept previously reported by the Senate Finance Committee.67 Accordingly, the Senate Finance Committee proposal called for a tax credit of 10% of earned income up to a maximum of $400. The amount of the credit was to have been phased out as earned income (or adjusted gross income, if greater) increased from $4,000 to $8,000. Furthermore, the Senate Finance Committee proposal would have limited the credit only to those taxpayers with dependent children.68 As in the House Bill, this proposal was to have applied only to

61. H.R. Rep. No. 19, supra note 59, at 29-30. This broad definition of earned income included some types of wages and other income that were not even subject to the social security tax, such as government employee wages which were then not subject to social security taxation. Id.
62. Id. at 30. In general, these special rules were intended to avoid any incentive to establish artificial employment arrangements to obtain eligibility for the credit. Id.
63. Id. at 10.
64. Id. at 29.
65. Id. at 31.
68. S. Rep. No. 36, supra note 67, at 11. According to its report, the Senate Finance Committee agreed with the House that it was appropriate to use the income tax system to offset the impact of the social security taxes on low-income people in 1975 by adopting a refundable income tax credit against earned income. The Committee saw that the refundable credit would
tax years beginning in 1975.\textsuperscript{69} The Senate Finance Committee proposal was approved by the full Senate on March 21, 1975,\textsuperscript{70} and would have cost about $1.5 billion per year.\textsuperscript{71}

The Conference Committee basically adopted the Senate version of the earned income tax credit.\textsuperscript{72} The earned income tax credit finally became law for calendar year 1975 on March 29, 1975.\textsuperscript{73} As enacted, the Tax Reduction Act of 1975 allowed a refundable credit equal to 10\% of a taxpayer's earned income for the taxable year which did not exceed $4,000 (a maximum credit of $400). The $400 maximum credit was reduced $1 for each $10 of income in excess of $4,000. Thus, the credit was completely phased out at an income level of $8,000. Only individuals who maintained a household in the United States for themselves and for a dependent child or student were eligible to claim the credit, and, in the case of married people, the earned income credit was available only if a joint return was filed.\textsuperscript{74} As enacted, the earned income credit did not contain the advance refund payment feature that earlier had been suggested by the Senate Finance Committee.\textsuperscript{75} Six-and-one-half million families with dependent children, or approximately 20 million individuals, were expected to be eligible for the credit in calendar year 1975.\textsuperscript{76}

2. Subsequent Changes in the Earned Income Credit

The Revenue Adjustment Act of 1975 extended the earned income credit through June 30, 1976.\textsuperscript{77} The Act also added a provision which

stimulate the economy because low-income people could be expected to spend a large fraction of their increased disposable incomes.

The Committee emphasized, however, that it believed that the most significant objective of the provision was to assist in encouraging people to obtain employment, thereby reducing the unemployment rate and reducing the welfare rolls. \textit{Id.} at 33. As a result, the Committee did not agree with the House that the earned income credit should be available to all individuals who had earned income regardless of marital or family status. Instead, the Committee believed that since federal welfare programs applied primarily to married couples with dependent children, it was in this area that its proposal could be most effective. Thus, while the House Bill would have granted the credit to students and retired individuals with low earned income, the Senate Finance Committee Bill would have limited the credit primarily to taxpayers with dependent children. \textit{Id.}

69. H.R. REP. No. 120, \textit{supra} note 59, at 58-59.
70. H.R. 2166, 94th Cong. 1st Sess. \$ 203 (1975); 121 CONG. REC. 8133 (1975).
71. S. REP. No. 36, \textit{supra} note 67, at 11.
72. H.R. REP. No. 120, \textit{supra} note 59, at 59.
74. S. REP. No. 36, \textit{supra} note 67, at 11.
75. \textit{See supra} note 56 and accompanying text.
76. S. REP. No. 42, \textit{supra} note 73, at 28.
77. Revenue Adjustment Act of 1975, Pub. L. No. 94-164 \$ 2(c), (d), (f), 89 Stat. 970, 971-72 (1975) (codified at I.R.C. \$ 43 (1975)).
required that the amount of any earned income credit received would be disregarded as income for purposes of determining the continuing eligibility (and benefit amount) for individuals and children who received benefits or assistance under other federal or federally financed programs.\textsuperscript{78}

In 1976, the Senate Finance Committee proposed to make the earned income credit permanent.\textsuperscript{79} In the report accompanying its tax bill for that year, the Committee emphasized its view that the earned income credit provided a strong work incentive for those limited to jobs that paid low wages and that the credit provided desperately needed tax relief to a hard-pressed group faced with high food and energy prices and subject to social security taxes.\textsuperscript{80}

As enacted, the Tax Reform Act of 1976 extended the earned income credit only through calendar years 1976 and 1977.\textsuperscript{81} An amendment provided that the refunds resulting from this credit would be disregarded in determining eligibility for or benefits under federal or federally assisted aid programs for those people who are recipients of benefits under the program in the month before they receive their refund. Another amendment eliminated the requirement that a parent must be entitled to actually claim a personal exemption for at least one child in order to claim the earned income credit. Instead, a requirement was added that the parent simply maintain a household for a child who is either under nineteen or a student.\textsuperscript{82} The earned income credit was extended through 1978 by the Tax Reduction and Simplification Act of 1977.\textsuperscript{83}

The earned income credit was finally made a permanent part of the Internal Revenue Code by the Revenue Act of 1978.\textsuperscript{84} That Act sim-


\textsuperscript{80} Id. at 119, reprinted in 1976 U.S. Code Cong. & Admin. News at 3554.


simplified the determination of the amount of, and eligibility for, the credit.\textsuperscript{85} It also extended the credit to 10\% of the first $5,000 of earned income (a maximum tax credit of $500), and raised the income range over which the credit phased out from $6,000 to $10,000 of adjusted gross income (or, if higher, earned income).\textsuperscript{86}

The Revenue Act of 1978 also provided that, after July 1, 1979, employees could elect to have advance payments of the earned income credit added to their paychecks each pay period through the normal withholding mechanism.\textsuperscript{87} The amount of the advance payment was to be determined from tables which would take into account the amount of wages paid and whether an employee's spouse was also claiming advance payments. Employers would reduce their liability for income tax withholding and FICA taxes for the aggregate amount of advance payments made to employees in any pay period.\textsuperscript{88} Finally, effective January 1, 1980, the Revenue Act of 1978 required that the amount of the credit be treated as earned income in determining benefits under other federal and federally aided assistance programs.\textsuperscript{89} The Senate Finance Committee report indicates that treating the credit as earned income for purposes of other federal and federally aided assistance programs was intended to make the earned


\textsuperscript{86} H.R. Rep. No. 1800, supra note 84, at 199-200.


\textsuperscript{88} H.R. Rep. No. 1800, supra note 84, at 200. \textit{See also} Hayes, \textit{Coping with the Advance Payment of the Earned Income Credit}, 57 Taxes 745 (1979). According to the Senate Finance Committee report, the committee believed that the credit would work more effectively if individuals were able to receive it during the year that they were working. The committee also believed that advance payment of the credit would increase the work incentive that was intended to be provided by the credit. Therefore, the committee proposed a mechanism for advance payments of the credit to be made by employers to eligible employees. S. Rep. No. 1263, 95th Cong., 2d Sess. 52, \textit{reprinted in} 1978 U.S. Code Cong. & Admin. News 6761, 6815.

income credit a more effective incentive to work and more of a disincentive for being on welfare.  

The Deficit Reduction Act of 1984 renumbered the earned income credit as Section 32 of the Internal Revenue Code. The Act also increased the rate of the credit to 11% of the first $5,000 of earned income, thus raising the maximum credit to $550 per year. The Act also raised the income range over which the credit would be phased out from $6,500 to $11,000, for taxable years beginning after December 31, 1984. The Act also provided for a reduction in the amount of credit allowed equal to the amount of a taxpayer's liability (if any) for the alternative minimum tax.  

3. The Tax Reform Act of 1986  

In his 1984 State of the Union address, President Reagan asked the Secretary of the Treasury to develop and present a plan to simplify the tax code by December 1984. The Treasury Department submitted its report on tax reform to President Reagan after his reelection. That report called for, inter alia, simplification of the tax system and reduction of the tax burden on the poor. The Treasury report recognized that the earned income credit served to offset social security and income taxes and provided work incentives for many low-income families with dependents. The Treasury report also noted that increases in inflation had reduced both the number of families eligible for the credit and the real amount of the credit for those who remained eligible. The Treasury report pointed out that while the Deficit Reduction Act of 1984 had increased the credit percentage, maximum credit, and income limit for the credit, the new amounts

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90. S. REP. No. 498, supra note 89, at 12.
93. See STAFF OF JOINT COMM. ON TAXATION, supra note 91, at 1160-61. This change was made to ensure that individuals with low earned income but substantial investment income who pay the alternative minimum tax rather than the regular income tax are ineligible for the credit. Id. This change is codified at I.R.C. § 32(h) (1988).
96. Id. vol. 2, at 15.
97. Id.
were not indexed for inflation and so would remain fixed until changed by legislation.98 Accordingly, to eliminate the need for periodic legislative adjustments in the credit, the Treasury report recommended that the maximum earned income credit amount and the adjusted gross income and earned income phase-out limits, beginning in 1985, be indexed to the current rate of inflation.99

The President used the Treasury report as the basis for his Tax Proposals to the Congress for Fairness, Growth, and Simplicity.100 To provide some compensation for the effect of past inflation on the value of the earned income credit and on the number of families eligible for the credit, the President’s proposal also called for increasing the credit percentage and phasing it out at a higher income level.101 Also, to eliminate the need for periodic legislative adjustments to the credit, the President’s proposal called for indexing the maximum earned income credit amount and the adjusted gross income and earned income phase-out limits to inflation.102

The President’s proposal would have increased the earned income credit to 14% of the first $5,000 of earned income, for a maximum credit of $700. The maximum credit of $700 was to have been reduced by 10% of the excess of adjusted gross income or earned income (whichever is greater) exceeding $6,500. Thus, the credit was to have been eliminated when adjusted gross income or earned income reached $13,500. Beginning in 1986, the maximum earned income credit and the adjusted gross income or earned income limit were to have been adjusted for inflation.103

The House Ways and Means Committee’s version of the Tax Reform Act of 1986 proposed to increase and index the earned income tax credit.104 The House Bill would have increased the earned income credit to 14% of the first $5,000 of earned income (maximum credit of $700), effective for taxable years beginning on or after January 1,
1986, and raised the income ceiling at which the credit was to have been completely phased out to $13,500, effective for taxable years beginning on or after January 1, 1986. The income phase-out range was to have been raised from $9,000 to $16,000 for taxable years beginning on or after January 1, 1987. The maximum amount of the credit and the income phase-out range were to have been adjusted for inflation occurring after August 31, 1984. The bill passed the full House on December 17, 1985.

The Senate followed the House Bill, except that the proposed increase in the credit rate to 14%, and the proposed higher phase-out range of $6,500 to $13,500 were to have been effective for taxable years beginning on or after January 1, 1987. Also, the income phase-out range was to have been raised from $10,000 to $17,000, effective for taxable years beginning on or after January 1, 1988. In addition, to promote use of the advance payment feature of the earned income tax credit, the Senate Bill would have directed the Treasury to issue regulations requiring employers to notify employees whose wages were not subject to income tax withholding that they might be eligible for a refundable earned income credit.

As enacted, the Tax Reform Act of 1986 followed the Senate bill, except that the base against which the increased 14% credit applies was raised to $5,714 (increasing the maximum credit to $800). Also, since 1987, the maximum amount of the credit and the phase-out in-

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105. H.R. REP. No. 426, supra note 104, at 94-95. The committee recognized that the earned income credit was intended to provide tax relief to low-income working individuals with children and to improve incentives to work. Since its enactment in 1975, Congress periodically had increased the maximum amount and the phase-out levels of the credit to offset the effects of inflation and social security tax increases. The committee understood that further increases in the maximum amount and phase-out level of the credit were necessary to offset past inflation and increases in the social security tax. In addition, the committee believed that an automatic adjustment to the credit to reflect future inflation should be provided, just as it is provided for the personal exemption, the standard deduction, and rate brackets, to eliminate the reduction in the real value of the credit caused by inflation. Id.


The conference agreement clarifies the form of notice that must be given by an employer to employees whose wages are exempt from withholding pursuant to the code. For example, this exemption applies in the case of high school or college students who have summer jobs. H.R. REP. No. 841, supra note 104, vol. 2, at 13.

Also, for taxable years beginning after 1989, self-employed individuals will be entitled to a deduction equal to half the amount of self-employment taxes, but that deduction will not reduce self-employment earnings for purposes of the earned income credit. See Social Security Amendments of 1983, Pub. L. No. 98-21, §§ 124 (c)(4)(B), (d)(2), 97 Stat. 65, 90-91 (codified at 42 U.S.C. § 401 (Supp. I 1983)).
come range have been adjusted for inflation occurring after calendar
year 1984. For 1988, the income phase-out level has been further
increased from $9,000 to $17,000, plus an adjustment for inflation
occurring after calendar year 1984. Changes in the earned income
credit made by the Tax Reform Act of 1986 were expected to cost
$15.3 billion over federal government Fiscal Years 1987 through

II. Operation of the Earned Income Credit

Section 32 of the Internal Revenue Code of 1986 provides that
qualifying low-income taxpayers may claim a tax credit equal to a
percentage of their earned income for the taxable year. To claim the
credit, a taxpayer must file an income tax return for the year.
For 1988, the maximum earned income credit that a taxpayer may claim
is $874. Unlike other credits for individuals, the earned income
credit is a refundable tax credit; if the earned income tax credit ex-
ceeds the taxpayer's tax liability, the IRS will refund the difference.

A. The Credit Itself

This section discusses the rudimentary facets of the credit—how
much the credit is worth, who is eligible to receive it, and what con-
stitutes earned income. Later, I will discuss the mechanics of receiv-
ing advance payment of the credit.

1. Amount of the Earned Income Credit

The Internal Revenue Code provides that the amount of the credit
is equal to 14% of up to $5,714 of a taxpayer’s earned income for the

111. H.R. REP. No. 841, supra note 104, vol. 2, at 866. This includes both revenue losses
and increased outlays that result because the credit is refundable. Id. at 884; EXPLANATION
OF THE 1986 ACT, supra note 18, at 27-28, 1359 (Table A-2).
112. United States Internal Revenue Service Form 1040 or Form 1040A must be used. U.S.
EARNED INCOME CREDIT]. The credit cannot be claimed on United States Internal Revenue Serv-
ice Form 1040EZ.
113. U.S. INTERNAL REVENUE SERVICE, PUB. NO. 15, CIRCULAR E, EMPLOYER'S TAX GUIDE
47 (Table 7) (1988) [hereinafter EMPLOYER'S TAX GUIDE].
114. For example, the credit for child and dependent care, I.R.C. § 21 (1988), the credit for
the elderly and the permanently and totally disabled, id. § 22, and the credit for interest on
certain home mortgages, id. § 25, are not refundable.
115. Id. § 6401(b). The amount of any refund of income tax is first used to offset any other
tax liabilities of the taxpayer, and then the balance is refunded to the taxpayer. Id. § 6402(a).
year. It also reduces the taxpayer’s maximum potential credit by 10% of the amount by which the taxpayer’s earned income (or, if greater, adjusted gross income) exceeds $9,000. Furthermore, the base amount of earned income, $5,714, as well as the phase-out floor, $9,000, and, consequently, the phase-out ceiling, $17,000, are all indexed for inflation occurring after calendar year 1984. Each year, the IRS publishes tables to help taxpayers and their employers determine the proper amount of a taxpayer’s earned income credit.

For 1988, eligible taxpayers with earned income (and adjusted gross income) of no more than $6,235 may claim an earned income credit equal to 14% of their earned income. An eligible taxpayer with earned income greater than $6,235 and earned income (or adjusted gross income, if higher) not exceeding $9,836 is entitled to an earned income credit of $874. An eligible taxpayer with earned income greater than $6,235 and earned income (or adjusted gross income, if higher) greater than $9,836 is entitled to an earned income credit of roughly $874, less 10% of any earned income (or adjusted gross income, if higher) in excess of $9,836. Consequently, an otherwise eligible taxpayer with earned income or adjusted gross income of $18,566 or more is not entitled to any earned income credit. Additionally, the amount of any credit otherwise allowable is reduced by an amount equal to the amount of a taxpayer’s liability (if any) for the alternative minimum tax.

2. Eligible Individuals

Only married taxpayers with a child, surviving spouses, and heads of households with a child or descendant, are eligible for the credit.
To claim the credit, a married taxpayer\(^\text{127}\) must be entitled to claim a personal exemption\(^\text{128}\) for a child or be so entitled but for a divorce or separation decree.\(^\text{129}\) Also, married taxpayers must file a joint return to claim the credit.\(^\text{130}\) For married taxpayers filing a joint return, the qualifying dependent must be the taxpayer’s child.\(^\text{131}\) Also, the child must have the same principal place of abode as the individual for more than one-half of the taxable year, and such abode must be in the United States.\(^\text{132}\)

Similar rules apply to surviving spouses\(^\text{133}\) and heads of household.\(^\text{134}\) For heads of household, however, the child can be a son, daughter, stepchild, legally adopted child, or a descendent; and the taxpayer must generally be able to claim an exemption for the child.\(^\text{135}\) In addition, an individual is treated as a surviving spouse or

\(^{127}\) In general, a person is considered as married if married at the close of the taxable year. \(\text{Id.} \, \text{s} \, 7703(a)(1)\) (1988). Even if the taxpayer’s spouse dies during the taxable year, the taxpayer is considered as married. \(\text{Id.} \, \text{l} \, \text{e} \, \text{g} \, \text{e} \, \text{h} \, \text{a} \, \text{d} \, \text{y} \, \text{f} \, \text{a} \, \text{r} \, \text{e} \, \text{d} \, \text{s} \, \text{u} \, \text{p} \) under a decree of divorce or of separate maintenance are not considered as married. \(\text{Id.} \, \text{s} \, 7703(a)(2)\). Similarly, certain married individuals living apart from each other during the last six months of the taxable year and filing separate returns are not considered as married. \(\text{Id.} \, \text{s} \, 7703(b)\).

\(^{128}\) See id. \, \text{s} \, 151.

\(^{129}\) \(\text{Id.} \, \text{s} \, 32(c)(1)(A)(i)\). Ordinarily, the taxpayer must have provided over half of the support for the child in order to claim the personal exemption for the child. \(\text{Id.} \, \text{s} \, 152(a)(1)\). However, special rules apply in the case of students, \(\text{Id.} \, \text{s} \, 152(d)\), and in the case of a child of divorced or separated parents, \(\text{Id.} \, \text{s} \, 152(c)\).

\(^{130}\) \(\text{Id.} \, \text{s} \, 32(d); \text{Treas. Reg.} \, \text{s} \, 1.43-2(b)(2)\) (1980). The joint filing requirement does not apply to an eligible individual who is not considered married under I.R.C. \(\text{s} \, 7703(b)\) (1988) (relating to certain married individuals living apart). \(\text{Treas. Reg.} \, \text{s} \, 1.43-2(b)(2)\) (1980). \(\text{Cf. Brooks v. Commissioner, 42 A.F.T.R.2d (P-H) aa 78-5275 (D.S.C. 1978).}\)

\(^{131}\) I.R.C. \(\text{s} \, 32(c)(1)(A)(i)\) (1988). The term “child” includes an individual who is a son, daughter, stepchild, or legally adopted child, a child placed with the taxpayer by an authorized placement agency for adoption by the taxpayer, or a foster child (that is, any other child, such as a grandchild for whom one cares as one’s own). \(\text{Id.} \, \text{s} \, 151(c)(3), 152(a); \text{Treas. Reg.} \, \text{s} \, 1.151-3(a)\) (1963).

\(^{132}\) I.R.C. \(\text{s} \, 32(c)(1)(B)\) (1988); \(\text{Treas. Reg.} \, \text{s} \, 1.43-2(c)(1)(i)(A)\) (1980). Also, the child must reside with the taxpayer, in the United States, and the taxpayer must not be entitled to exclude any amount from gross income under I.R.C. \(\text{s} \, 911\) or 913 (1988). I.R.C. \(\text{s} \, 32(c)(1)(A)\) (1988).

\(^{133}\) I.R.C. \(\text{s} \, 32(c)(1)(A)(ii)\) (1988); \(\text{Treas. Reg.} \, \text{s} \, 1.43-2(c)(1)(i)(B)\) (1980). A surviving spouse is an individual whose spouse died within the two taxable years immediately preceding the individual’s taxable year and the individual furnishes more than half the cost of maintaining a household for the entire taxable year which is the principal place of abode of any dependent children. I.R.C. \(\text{s} \, 2(a)\) (1988).

\(^{134}\) I.R.C. \(\text{s} \, 32(c)(1)(A)(iii)\) (1988); \(\text{Treas. Reg.} \, \text{s} \, 1.43-2(c)(1)(i)(C)\) (1980). A head of household is an individual who is not married as of the close of the taxable year, who is not a surviving spouse, and who has furnished more than half the cost of maintaining the individual’s home a household for the entire taxable year which is the principal place of abode of a child or descendent of the individual who is unmarried or who is married and qualifies as a dependent for whom the individual is entitled to a personal exemption or would be so entitled but for a divorce or separation decree. I.R.C. \(\text{s} \, 2(b), 152(e)(2), (4)\) (1988).

\(^{135}\) I.R.C. \(\text{s} \, 32(c)(1)(A)(iii)\) (1988); \(\text{Treas. Reg.} \, \text{s} \, 1.43-2(c)(1)(i)(C)\) (1980).
head of household only if the household in question is in the United States.\textsuperscript{136}

3. **Earned Income**

The term "earned income" has the same meaning both for determining entitlement to the credit and for the phase-out of the credit.\textsuperscript{137} Earned income includes wages, salaries, tips, and other employee compensation, and net earnings from self-employment.\textsuperscript{138} Earned income is computed without regard to any community property laws which may otherwise be applicable,\textsuperscript{139} and it is reduced by any net loss in earnings from self-employment.\textsuperscript{140}

Earned income includes certain compensation excluded from gross income, such as the rental value of a parsonage,\textsuperscript{141} and the value of meals and lodging furnished for the convenience of the employer.\textsuperscript{142} It does not include amounts received as a pension or annuity.\textsuperscript{143} Earned income also does not include interest, dividends, welfare benefits, veterans benefits, or social security payments.\textsuperscript{144}

**B. Advance Payment of the Earned Income Credit**

Individuals who are eligible to benefit from the earned income credit may elect to receive the benefit of the credit in their paychecks throughout the year. To receive the credit in advance, qualifying individuals must fill out Internal Revenue Service Form W-5, the Earned Income Credit Advance Payment Certificate, and give it to their employer. The employer is then required to pay the employee the appropriate advance earned income credit amount along with the employee's regular wages.\textsuperscript{145}

1. **Advance Payment Amount**

An employee's advance earned income credit is based on the employee's wages from the employer for the pay period. The IRS publishes

\begin{itemize}
  \item 137. Id. § 32(b), (c)(2); Treas. Reg. § 1.43-2(b), (c)(2) (1980).
  \item 139. Treas. Reg. § 1.43-2(c)(2) (1980).
  \item 140. Id.
  \item 144. EARNED INCOME CREDIT, supra note 112, at 1.
  \item 145. Id. at 3.
\end{itemize}
tables to help employers determine the proper amount of advance payment. 146 Separate tables are provided for employees who are not married (or whose spouses do not have an earned income credit advance payment certificate in effect) and for those employees whose spouses do have an advance payment certificate in effect. 147

Separate tables also are provided for daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual, and annual payroll periods. 148 For example, the 1988 table for weekly payroll periods shows that a single employee (and a married employee whose spouse has no earned income eligibility certificate in effect) is entitled to an advance payment amount of 14% of weekly wages up to $114, which is a maximum advance payment amount of $16 per week. That maximum advance payment amount is phased out for wages in excess of $197 per week. 149 Similarly, for a married employee whose spouse has filed an earned income eligibility certificate, the 1988 table for weekly payroll periods entitles each spouse to an advance payment amount of 14% of wages up to $57 per week, for a maximum advance payment amount per spouse of $8 per week. Each spouse's advance payment amount is phased out for wages in excess of $98 per week. 150

2. Electing to Receive Advance Payments

To receive an earned income credit advance, individuals must furnish 151 an earned income credit advance payment certificate to their employer. 152 This certificate is a statement in which the employee certifies that the employee reasonably expects to be eligible to receive the earned income credit for the taxable year 153 and that the employee does not have an earned income eligibility certificate in effect for the calendar year with respect to the payment of wages by another employer. 154 The employee is also required to state whether the employee's spouse has an earned income certificate in effect. 155

149. Id. at 46 (Table 1(a)). See I.R.C. § 3507(c)(2)(B) (1988).
150. EMPLOYER'S TAX GUIDE, supra note 113, at 46 (Table 1(b)). See I.R.C. § 3507(c)(2)(C) (1988).
IRS Form W-5 (the Earned Income Credit Advance Payment Certificate) is prescribed by the IRS as the earned income eligibility certificate. Form W-5 must be prepared in accordance with its applicable instructions, and the date called for therein must be set forth fully and clearly. A Form W-5 is invalid if it is not completed or signed, or if it contains an alteration or unauthorized addition.

Generally, a new Form W-5 must be given to the taxpayer's employer each year. The certificate may be given to one employer only, even if the taxpayer has multiple employers. Married taxpayers' W-5 forms go to their respective employers.

A Form W-5 remains in effect during the calendar year until revoked by the employee or until another Form W-5 takes effect. If the employee no longer wishes to receive advance earned income credit payments, furnishing the employer with a new form W-5 revokes the old one. Also, if after giving the employer a Form W-5 the employee's spouse's certificate is in effect if it will be or is reasonably expected to be in effect on the first status determination date following the date on which the employer receives the employee's certificate. Treas. Reg. § 31.3507-2(c)(3). The status determination dates are January 1, May 1, July 1, and October 1 of each year. I.R.C. § 3507(e)(1)(B) (1988); Treas. Reg. § 31.3507-2(c)(4) (1981).


158. Treas. Reg. § 31.3507-2(b)(2) (1981). Any Form W-5 which the employee clearly indicates to be false by oral statement or written statement to the employer must be treated by the employer as a certificate which is invalid as of the date of the employee's statement. In this context, the term "employer" includes any individual authorized by the employer to receive earned income credit advance payment certificates or to make payroll distributions. If an employer receives from an employee an invalid Form W-5, the employer must consider it a nullity with respect to all payments of wages thereafter to the employee, and must inform the employee of the Form W-5's invalidity. The employer is not required to ascertain whether any completed and signed Form W-5 is correct. However, the employer should inform the district director of the IRS if the employer has reason to believe that the Form W-5 contains any incorrect statement. Id.

159. See I.R.C. § 3507(e)(2) (1988); Treas. Reg. § 31.3507-2(c)(1) (1981). If the employee has not previously filed a Form W-5 with the employer for that calendar year, the Form W-5 will take effect not later than in the payroll period following the date on which the Form W-5 is furnished to the employer. A special rule enables a timely furnished Form W-5 to take effect at the beginning of the calendar year for which it is filed. Treas. Reg. § 31.3507-2(c)(1) (1981).

If the employee already has a Form W-5 in effect for that calendar year and wishes to change it, a new Form W-5 will take effect on the date of the first payment of wages made on or after the next quarterly status determination date occurring at least 30 days after the date on which the employer receives the new Form W-5. However, the employer may choose to treat the new Form W-5 as effective on the date of any payment of wages which is after the date on which the new Form W-5 was received. I.R.C. § 3507(e)(1)(B) (1988); Treas. Reg. § 31.3507-2(c)(2) (1981).


situation changes, such that the employee no longer qualifies for the earned income credit, the employee must give the employer a new Form W-5 within ten days after first learning of the change in circumstances.\textsuperscript{163} If, after an employee has furnished a Form W-5 stating that another Form W-5 is in effect for the spouse of the employee, the spouse’s Form W-5 is no longer in effect, and the employee may furnish the employer with a new Form W-5 reflecting this change of circumstances.\textsuperscript{164}

3. Employer Duties

In general, if an employee has filed a Form W-5, the employer must pay the advance earned income credit amount to that employer along with the regular wages.\textsuperscript{165} An employer is not required to pay advance earned income credit amounts unless the employee’s wages are otherwise subject to either income tax withholding or employee FICA taxes.\textsuperscript{166} Also, employers are not required to pay advance earned income credit amounts to agricultural workers paid on a daily basis.\textsuperscript{167} Finally, an employer should stop making advance payments to an employee after that employee’s earned income reaches the phase-out ceiling for the year.\textsuperscript{168}

Payments of advance earned income credit amounts by an employer are not treated as compensation.\textsuperscript{169} Rather, the employer treats these payments as the employer’s liability for quarterly employment taxes.\textsuperscript{170}

\begin{itemize}
\item \textsuperscript{163} I.R.C. § 3507(e)(3)(A) (1988). The employer is not required to ascertain whether any employee has experienced a change of circumstances which necessitates the employee filing a new Form W-5. However, the employer should inform the district director of the IRS if the employer has reason to believe that an employee has experienced a change of circumstances and the employee does not deliver a new Form W-5 to the employee within 10 days thereafter. Treas. Reg. § 31.3507-2(d)(2)(i)(B) (1981).
\item \textsuperscript{165} I.R.C. § 3507(a) (1988); Treas. Reg. § 31.3507-1(a)(1) (1981). In the case of an individual who receives wages subject to income tax withholding, the term “employee” has the same meaning as set forth in I.R.C. § 3401(c), and the term “wages” has the same meaning as set forth in I.R.C. §§ 3401(a) and 3402(e). If an individual does not receive wages which are subject to income tax withholding, but does receive wages which are subject to employee FICA taxes, the term “employee” has the same meaning as set forth in I.R.C. § 3121(d), and the term “wages” has the same meaning as set forth in I.R.C. § 3121(a). Treas. Reg. 31.3507-1(a)(i), (ii) (1988).
\item \textsuperscript{167} Treas. Reg. § 31.3507-1(a)(1)(ii) (1981). An “agricultural worker” is an employee who performs “agricultural labor,” as that term is defined in I.R.C. § 3121(g).
\item \textsuperscript{170} I.R.C. § 3507(d)(1)(B) (1988); Treas. Reg. § 31.3507-1(c)(1)(i) (1981). These payments are treated as coming first, from the aggregate amount, with respect to all employees, required
\end{itemize}
The amounts of earned income credit paid to employees are treated as if paid directly to the Treasury Department on pay day. If the amount due of earned income advance payments exceeds the amount of employment taxes due, then the employer may reduce each advance payment pro rata. Alternatively, the employer may elect to pay all earned income advance amounts in full and claim a refund for the additional amounts paid, or have the additional amounts paid applied against the employer's liability for employment taxes for the following reporting period. In general, the failure of an employer to timely pay an employee all or any part of an advance earned income credit amount, for all purposes including penalties, is treated as a failure by the employer to deduct and withhold taxes as of that time.

Finally, since 1987, employers have been required to notify employees whose wages are not subject to income tax withholding that they may be eligible for a refund of the earned income credit. The notice must be in writing and should be provided to the employee within one week of the date that the employee is furnished with IRS Form W-2, wage and tax statement. The IRS provides a notice form.

4. Recipients Must File Income Tax Returns

Every individual who receives advance payment of the earned income credit is required to file an income tax return for the year. The tax-
payer's Form W-2 must show the amount received in advance payments for the year.\textsuperscript{181} Any payment advanced in a calendar year is treated as an additional amount of income, and is reflected on the employee's tax return for the taxable year in which the payments were made.\textsuperscript{182}

C. Participation and Cost

For 1986, more than 6.4 million families claimed the earned income credit.\textsuperscript{183} Also for 1986, the total of all credits claimed came to over $2 billion: $.5 billion toward offsetting tax liability, and $1.5 billion was attributable to refunds in excess of current tax liabilities.\textsuperscript{184} Somewhat surprisingly, however, for 1984, the most current year for which complete data is available, only about 10,000 families claimed advance payment of the earned income credit, and the total amount of advance payments came to a little more than $2.5 million.\textsuperscript{185}

Table 1 outlines the estimated cost of the earned income credit for federal government Fiscal Years 1987 to 1989.\textsuperscript{186} For federal government Fiscal Year 1989, the U.S. Office of Management and Budget estimated that earned income credits totalling $5.5 billion would be claimed: $1.6 billion offsetting tax liability, and $3.9 billion attributable to refunds in excess of current tax liabilities.\textsuperscript{187} The expected increase in the cost of the earned income credit is largely attributable to the changes made by the Tax Reform Act of 1986. For example, the Tax Reform Act raised the maximum credit that a taxpayer may claim from $550 per year to $874 per year.\textsuperscript{188}
Table 1: *Estimated Cost of the Earned Income Credit for Fiscal Years 1987-1989* (in millions of dollars)

<table>
<thead>
<tr>
<th>FISCAL YEARS</th>
<th>1987</th>
<th>1988</th>
<th>1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax subsidy</td>
<td>525</td>
<td>970</td>
<td>1,575</td>
</tr>
<tr>
<td>Outlays</td>
<td>1,410</td>
<td>2,895</td>
<td>3,895</td>
</tr>
<tr>
<td>Total</td>
<td>1,935</td>
<td>3,865</td>
<td>5,470</td>
</tr>
</tbody>
</table>

Source: U.S. Office of Management and Budget, Budget of the United States Government Fiscal Year 1989 (Special Analyses, pt. G 44, 45 n.2 (Table G-2) (1988)).

III. THE MECHANICS OF INCOME TRANSFER PROGRAMS

Over the years a wide variety of programs have been developed to help the poor. Among them are public assistance programs, public employment programs, non-cash benefits programs, and the minimum wage. Indeed, the federal government alone operates dozens of programs intended to help the poor. The resulting complexity and overlapping bureaucracies, as well as the failure to solve the poverty problem, have been a general concern. As a result, welfare reform is perennially on the public policy agenda.

Many analysts have called for replacement (or at least supplementation) of the variety of federal and state programs with some type of comprehensive income transfer program.\(^{189}\) An income transfer program is a system that provides cash benefits to the poor. For example, a negative income tax is a type of income transfer program. An income transfer program can be said to be "comprehensive" if it replaces or incorporates other programs.\(^{190}\)

In order to understand how the earned income credit can become an effective antipoverty program for the working poor, it is necessary to examine various types of comprehensive income transfer programs. Accordingly, this section briefly outlines and compares the principal types of comprehensive income transfer systems: negative income tax programs, wage subsidy programs, and income subsidy programs.

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189. See, e.g., sources cited supra note 23.

190. Comprehensive income transfer programs generally have: (1) a formula for computing benefits; (2) a maximum benefit; and (3) a formula for withdrawal of benefits as income rises, known as a benefit-reduction rate (or marginal "tax" rate). Together, these variables determine the income level at which government payments equal zero and a family becomes ineligible for benefits (the break-even point). Cf. Subcomm. on Fiscal Policy of the Joint Econ. Comm., 93rd Cong., 2d Sess., Income Security for Americans: Recommendations of the Public Welfare Study 132 (Comm. Print 1974) [hereinafter Income Security for Americans].
A. A Negative Income Tax

One way to provide benefits to the working poor would be by adopting a negative income tax. A negative income tax is a system of cash transfers to families in which the amount of a family’s cash transfer varies inversely with the family’s income: the lower a family’s pretransfer income, the greater the amount of the government’s net transfer to it. The food stamp program operates somewhat like a negative income tax, since the amount of food stamps increases as income declines. President Nixon’s proposed Family Assistance Plan also was a form of negative income tax.

Theoretically, a negative income tax program could be designed to give every individual a taxable subsidy and allow the positive tax system to recover any excess benefits. During the 1972 presidential campaign, Democratic candidate George S. McGovern proposed just such a demo- grant system. Although such a program might be theoretically possible, it would be extraordinarily expensive; it would fail to adequately target benefits to those who most need them, and it would require dramatic increases in the marginal tax rates of the positive income tax system to recover the government outlay. Accordingly, most serious negative income tax proposals have built-in benefit-reduction components which are independent of the marginal tax rates of the positive income tax system.

Generally, two policy variables can define a simple negative income tax. The target or break-even income level is the income level at which a


193. See 143 Cong. Rec. 11,799-801 (1972). Under McGovern’s proposal, every American would have been given $1,000 a year from the federal government; however, the grants would have been taxable income, and higher proposed tax rates would have recovered much of the benefits provided to those with moderate and high incomes.

family becomes ineligible for benefits and the government subsidy equals zero. The benefit-reduction rate (sometimes called the marginal tax rate) determines the rate of reduction of a family’s subsidy as the family’s pretransfer income increases. In a simple negative income tax, the family’s subsidy is the product of the benefit-reduction rate and the excess of the break-even income level over the family’s pretransfer income.\(^\text{195}\) The maximum subsidy (sometimes called the guarantee) is received by a family with no other income. A household’s net (i.e., post-transfer) income for the year is the sum of its actual income plus the amount of the subsidy it receives.\(^\text{196}\)

Table 2 sets forth a simple negative income tax with a break-even level of $10,000 and a 50% benefit-reduction rate. Under such a negative income tax, every family would have net income of at least $5,000 per year. The maximum subsidy, $5,000, would be received by a family with no other income; those families with the lowest pretransfer income would receive the largest subsidies; those families with higher pretransfer income would receive smaller subsidies.

Table 2: \textit{A Simple Negative Income Tax (NIT)}

<table>
<thead>
<tr>
<th>PRETRANSFER INCOME</th>
<th>NIT SUBSIDY</th>
<th>NET ANNUAL INCOME</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>2,000</td>
<td>4,000</td>
<td>6,000</td>
</tr>
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<td>4,000</td>
<td>3,000</td>
<td>7,000</td>
</tr>
<tr>
<td>6,000</td>
<td>2,000</td>
<td>8,000</td>
</tr>
<tr>
<td>8,000</td>
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<td>9,000</td>
</tr>
<tr>
<td>10,000</td>
<td>0</td>
<td>10,000</td>
</tr>
</tbody>
</table>

\section*{B. A Wage Subsidy}

Another way to increase the net incomes of the working poor is to provide wage subsidies.\(^\text{197}\) A wage subsidy program (sometimes called

\begin{itemize}
\item \text{\textit{195.}} Algebraically, the subsidy received by a household can be expressed as follows:
\begin{equation}
S = m(B - I), \text{ for } I < B, \text{ and}
S = 0, \text{ for } I \geq B
\end{equation}
where S is the amount of the subsidy to the household, m is the benefit-reduction rate, B is the break-even income level, and I is the pretransfer income of the household.

\item For example, a simple negative income tax with a break-even level of $10,000 and a benefit-reduction rate of 50% could be expressed algebraically as follows:
\begin{equation}
S = .50(10,000 - I), \text{ for } I < 10,000, \text{ and}
S = 0, \text{ for } I \geq 10,000.
\end{equation}
This simple negative income tax is displayed in Table 2.

\item \text{\textit{196.}} Algebraically, the household’s net income, \(I'\), can be expressed as follows:
\begin{equation}
I' = I + S
\end{equation}
where I is the amount of the pretransfer income and S is the amount of the negative income tax subsidy.

\item \text{\textit{197.}} \textit{See generally J. Bishop, The Administration of a Wage Rate Subsidy} (1977); A.
a "negative wage tax") is a transfer program that provides cash benefits to supplement the low market wages paid to certain employees. Typically, the amount of the subsidy that an individual receives is based upon the number of hours worked and the hourly wage level.\textsuperscript{198}

1. A Simple Wage Subsidy System

In a simple wage subsidy system, employee wages are increased by an hourly subsidy from the government. Theoretically, a government wage subsidy program could be designed to give every employee an extra dollar per hour worked. Although such a program might be theoretically possible, like the negative income tax proposal, undoubtedly it would be extraordinarily expensive and would fail to adequately target benefits to those who most need and deserve them. Accordingly, typical wage subsidy proposals call for wage subsidies for low-income workers and for a phase-out of those wage subsidies for workers with higher wage levels. Thus, at least after a certain point, the amount of the wage subsidy will vary inversely with the wage level of the worker.

Three policy variables define a simple wage subsidy system. First, the subsidy rate is the rate at which wages are subsidized. Second, the target wage level is the wage level at which a worker will no longer receive a subsidy. Finally, the benefit-reduction rate determines the amount of reduction in the subsidy as the pretransfer wage level increases beyond a certain wage.\textsuperscript{199}

\textsuperscript{198} Most workers are, in fact, paid by the hour or in a manner easily translatable into hours of work (e.g., weekly salary). Problems relating to workers not actually paid by the hour (for example, certain agricultural workers) are beyond the scope of this Article, except to suggest that a similar production-type subsidy could be based upon some other measure of productivity (e.g., bushels of apples picked).

\textsuperscript{199} Algebraically, the per-hour wage subsidy received by a worker can be expressed as follows:

\[ s = rw, \text{ for } w \leq W \]
\[ s = rW - m(w - W), \text{ for } W < w < (r + m)W/m, \text{ and } \]
\[ s = 0, \text{ for } w \geq (r + m)W/m \]

where \( s \) is the amount of the subsidy per hour to the wage earner, \( r \) is the subsidy rate expressed as a fraction, \( w \) is the pretransfer wage level received by the worker, \( m \) is the benefit-reduction
Table 3 sets forth a simple wage subsidy with a target hourly wage of $4.00, a 50% subsidy rate, and a 50% benefit-reduction rate. It can be seen that the largest subsidy is provided to people earning the target wage and lower subsidies are provided to those earning either higher or lower wages.

Table 3: A Simple Wage Subsidy

<table>
<thead>
<tr>
<th>PRETRANSFER HOURLY WAGE</th>
<th>WAGE SUBSIDY</th>
<th>NET HOURLY WAGE</th>
</tr>
</thead>
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<tr>
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</tr>
</tbody>
</table>

In the absence of a wage subsidy, an earner whose only income is from work will have income precisely equal to the product of the hourly wage level and the number of hours worked during the year. The total annual subsidy resulting from a wage subsidy is equal to the product of the number of hours worked during the year and the amount of the subsidy per hour. Under a wage subsidy system, a wage earner will have a net annual (post-transfer) income equal to the sum of the pretransfer earned income and the total wage subsidy received for the year. For example, an individual working 2,000 hours

rate, and W is the target wage rate. For example, a simple wage subsidy with a target wage of $4.00, a 50% subsidy rate, and a 50% benefit-reduction rate could be expressed algebraically as follows:

\[ s = 0.50w, \text{ for } w \leq 4.00 \]

\[ s = 2.00 - 0.50(w - 4.00), \text{ for } 4.00 < w < 8.00, \text{ and} \]

\[ s = 0, \text{ for } w \geq 8.00. \]

Algebraically, this can be expressed as follows:

\[ I = h \times w \]

where I is the pretransfer earned income for the year, h is the number of hours worked for the year, and w is the hourly wage level. For example, an individual working 2,000 hours a year at $4.00 per hour will have an annual earned income of $8,000.

Algebraically, the total annual subsidy, S, can be expressed as follows:

\[ S = w \times s \]

where w is the pretransfer wage level and s is the amount of the wage subsidy per hour.

Algebraically, the wage earner's net annual income, I', can be expressed as follows:

\[ I' = I + S \]

where I is the pretransfer income of the household and S is the total annual amount of the wage subsidy.
a year at $4.00 per hour under the wage subsidy system set forth in
Table 3 is entitled to a net subsidy of $2.00 per hour for a total annual
subsidy of $4,000 per year and total post-transfer income of $12,000
per year.

Table 4 translates the data in Table 3 into an annualized subsidy
based upon the assumption that the worker works 2,000 hours per
year. It can be seen that a simple wage subsidy system provides the
largest transfers to those with moderate hourly wages and the least
transfers to those with either no income or with high income.

Table 4: Annualized Incomes Based Upon a Simple Wage Subsidy
(2000 hours)

<table>
<thead>
<tr>
<th>PRETRANSFER HOURLY WAGE</th>
<th>ANNUAL EARNED INCOME</th>
<th>ANNUAL SUBSIDY</th>
<th>NET ANNUAL INCOME</th>
</tr>
</thead>
<tbody>
<tr>
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<td>16,000</td>
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</tr>
</tbody>
</table>

2. More Complicated Wage Subsidy Systems

Varying the target wage, the subsidy rate, or the benefit-reduction
rate will make a significant difference in the cost, coverage, and la-
bor supply effects of a wage subsidy plan. Also, while the subsidy
rate and the benefit-reduction rate can be the same (as above), this
is not necessarily the case. Furthermore, it is possible to have differ-
ent subsidy rates at different wage rates. For example, it might be
desirable to provide disproportionately larger subsidies to indivi-
duals with hourly wage levels below the minimum wage, so as to
provide greater assistance to those individuals who have especially

203. See, e.g., INCOME SECURITY FOR AMERICANS, supra note 190, at 142-46; A. BLINDER,
supra note 197, at 153-55. Economists use the term "labor supply" to refer to aggregate work
effort decisions of individuals, such as whether and how much to work. Generally, labor supply
increases when wages go up, as the increase in the wages induces more people to work and
induces individuals who are already working to work more hours.
low pretransfer earnings (i.e., workers not covered by the minimum wage).

It is also possible to have more complicated formulae to describe the wage subsidy. For example, an "overtime wage subsidy" would provide a wage subsidy only for hours worked in excess of some minimum number of hours per base period (e.g., more than forty hours a week).\textsuperscript{204} Presumably, such an overtime wage subsidy would encourage employees to work extra hours, or at least some minimum number of hours. Alternatively, a wage subsidy system might provide that only a limited number of hours might be subsidized (e.g., no more than forty hours a week).

C. An Income Subsidy

An income subsidy system is a transfer program that provides cash benefits to supplement the low incomes of some individuals.\textsuperscript{205}

1. A Simple Income Subsidy

As with a wage subsidy, a simple income subsidy system can be defined by three policy variables. The subsidy rate is the rate at which income is subsidized. The target income level is the level beyond which additional income will lead to a reduced subsidy. The benefit-reduction rate determines the amount of reduction in the subsidy as income increases.\textsuperscript{206} Under an income subsidy system, a recipient will have a net (post-transfer) income equal to the sum of pretransfer income and the total income subsidy received for the year.\textsuperscript{207} Table 5 sets forth a simple income subsidy with a target in-

\textsuperscript{204} See, e.g., Kesselman, \textit{Conditional Subsidies in Income Maintenance}, supra note 197.
\textsuperscript{205} See, e.g., \textit{INCOME SECURITY FOR AMERICANS}, supra note 190, at 146-49.
\textsuperscript{206} Algebraically, the total amount of the transfer under an income subsidy system can be expressed as follows:

\[ S = \begin{cases} sI, & \text{for } I \leq R \\ sR - m(I - R), & \text{for } R < I < (m + s)R/m \\ 0, & \text{for } I \geq (m + s)R/m \end{cases} \]

where \( S \) is the total amount of the income subsidy, \( s \) is the subsidy rate expressed as a fraction, \( I \) is the pretransfer income, \( m \) is the benefit-reduction rate, and \( R \) is the target income level.

For example, an income subsidy with a target income of $8,000, a 50% subsidy rate, and a 50% benefit-reduction rate could be expressed algebraically as follows:

\[ S = \begin{cases} .50I, & \text{for } I \leq $8,000 \\ 4,000 - .50(I - $8,000), & \text{for } $8,000 < I < $16,000 \\ 0, & \text{for } I \geq $16,000. \end{cases} \]

This simple income subsidy is displayed in Table 5.

\textsuperscript{207} Algebraically, the recipient's net income, \( I' \), can be expressed as follows:

\[ I' = I + S \]

where \( I \) is the pretransfer income of the household and \( S \) is the total amount of the income subsidy.
income of $8,000, a 50% subsidy rate, and a 50% benefit-reduction rate.

Table 5: *A Simple Income Subsidy*

<table>
<thead>
<tr>
<th>PRETRANSFER INCOME</th>
<th>INCOME SUBSIDY</th>
<th>NET INCOME</th>
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</thead>
<tbody>
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<td>2,000</td>
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<td>16,000</td>
<td>0</td>
<td>16,000</td>
</tr>
</tbody>
</table>

2. *A Simple Earnings Subsidy*

If the amount of the subsidy is based only upon earned income rather than upon all income, then the income subsidy may be referred to as an earnings subsidy. The reduction in the subsidy could similarly be based on earned income or more likely on all income. The earned income credit is essentially a simple earnings subsidy.\(^{208}\)

D. Income Transfer Programs Compared

A comparison of Tables 2 and 4 shows that a negative income tax provides the largest benefits to those who have low pretransfer incomes, while a wage subsidy provides the largest benefits to those individuals who work at moderate pretransfer incomes. Consequently, a wage subsidy can be criticized for failing to target benefits to the destitute who most need a subsidy. Nevertheless, many economists favor a wage subsidy (at least for those who can work) because they believe that a wage subsidy system is likely to promote greater work effort on the part of recipients, whereas a negative income tax system may lead to reductions in work effort by recipients.\(^{209}\) Indeed, there is at least some empirical evidence to suggest that negative income tax subsidies will result in reduced work effort.

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by recipient families,210 and in particular by second-earner spouses.211

According to the economic analysis, cash transfers to individuals have two types of effects on individual decisions as to labor supply.212 First, an income effect will arise any time an individual receives a subsidy. Generally, any cash transfer to an individual will increase the demand for leisure relative to the desire to work, and induce the individual to work less. Thus, the income effect is expected to cause recipients of negative income tax and wage subsidy recipients to reduce their hours of work (although a wage subsidy recipient actually must work to receive any cash transfer).

Second, there is a substitution effect because the relative prices of an hour of leisure versus an hour of work change as a result of a subsidy. The benefit-reduction rate of a negative income tax will reduce the value of earnings, and so make leisure more attractive. On the other hand, a wage subsidy increases the attractiveness of working, because each hour of work results in more compensation than the marketplace would otherwise have provided in the absence of a wage subsidy.

Thus, under a negative income tax, both the income and substitution effects are expected to operate together as work disincentives. For a wage subsidy, however, the income effect and the substitution effect work in opposite directions, and it is believed to be more than likely that the substitution effect will dominate; consequently, reci-


pients of a wage subsidy are likely to increase their labor supply. 213

Also, to the extent that effective higher wages act as a work incentive to those receiving a wage subsidy and so result in their working more hours, wage subsidization actually equalizes the distribution of pretransfer ("market") earnings. By contrast, because a negative income tax reduces the work incentives of recipients and so results in their working fewer hours, a negative income tax makes pretransfer earnings more disperse. 214 There is also reason to believe that a wage subsidy is a much more powerful redistributor of income than a negative income tax. 215

Moreover, wage subsidies actually may increase employment opportunities for low-wage workers. 216 While increasing the minimum wage might reduce the demand for labor by raising the employer's cost per hour of employee service, 217 wage subsidies raise wages without actually requiring employers to pay more for labor services or reducing the demand for labor. Thus, by increasing the wages paid to low-wage workers at no cost to the employers, a wage subsidy should increase the demand for low-wage labor. 218

Another advantage of a wage subsidy relative to a negative income tax is that the poorest workers would gain by reporting rather than hid-

213. See sources cited supra note 197.
214. A. BLINDER, supra note 197, at 153.
215. Id. at 149-56. Blinder developed a complicated economic model to simulate the United States income distribution. He then analyzed a variety of taxes and programs, and he concluded that wage subsidies are more effective than negative income taxes in achieving income redistribution. Blinder further concluded that wage subsidies may be one of the most effective ways to achieve a sizable redistribution of income.

Congress is presently considering whether to raise the minimum wage. For example, bills introduced by Sen. Kennedy (S. 837, 100th Cong., 1st Sess. (1987)) and Rep. Hawkins (H.R. 1834, 100th Cong., 1st Sess. (1987)) would have subsequently increased the minimum wage to $3.85 per hour on January 1, 1988; and to $4.25 per hour on January 1, 1989, and to $4.65 per hour on January 1, 1990. After January 1, 1991, the minimum wage would be indexed for wage inflation. See also Clark, supra note 4.
On the other hand, workers in the phase-out range of a wage subsidy would still have an incentive to under-report wage earnings. Another difficulty is that a wage subsidy provides a perverse incentive for employers and employees to collude in reporting lower wages and greater hours than actually worked by the employee in order to obtain greater government subsidies. Finally, because a wage subsidy would only subsidize those who work, it is likely that separate programs would nevertheless be needed for poor single parent households with young children, the disabled, and those unable to find work.

As with a wage subsidy, an income subsidy can be criticized for failing to target benefits to the poorest recipients. Yet, similar to a wage subsidy program, income subsidies, and, in particular, earnings subsidies would raise the financial return from work and so are likely to provide work incentives for low-income individuals. However, the work incentive effects of income subsidies probably will not be as strong as the effects of wage subsidies since income subsidies and earnings subsidies are not as closely tied to work effort. Even an earnings subsidy is based simply on total income from work, whereas a wage subsidy provides a subsidy based almost directly on the number of hours worked. Income subsidies and earnings subsidies, however, do have the advantage of not requiring employees (and employers) to report the number of hours worked.

Furthermore, as with a wage subsidy, under an income subsidy the poorest workers would gain from reporting earnings. Again, however, higher income workers would have increased incentives to under-report their incomes. Finally, as with a wage subsidy program, an income subsidy would not cover those who do not or cannot work and have no other income, and so separate programs would be needed for them.

IV. TRANSFORMING THE EARNED INCOME CREDIT INTO AN EFFECTIVE ANTIPOVERTY PROGRAM FOR THE WORKING POOR

Under present law, almost any qualifying individual with low earned income is allowed to claim the earned income credit. The credit is available to individuals with great wealth and to individuals who have low earned income as a result of working relatively few hours at a high hourly salary. The earned income credit would be a far fairer and more efficient antipoverty program if it were structured to benefit only those people who have low incomes, work hard, and are needy. In these defi-

219. This discussion follows INCOME SECURITY FOR AMERICANS, supra note 190, at 145.
220. Id. at 146-49. On the other hand, in the phase-out range, the benefit-reduction rate has the effect of reducing the financial return from working.
cit-spending times, the country can little afford a program that fails to so target its benefits.\textsuperscript{221}

With relatively few changes, the earned income credit can be converted into an effective antipoverty program targeted for the benefit of the working poor.\textsuperscript{222} First, the earned income credit should be changed from an earnings subsidy credit to a wage subsidy credit. Second, the phase-out of the credit should be more closely based upon economic income and need. Third, a family allowance provision should be included, and eligibility should be extended to childless couples and single individuals. Fourth, the benefit-reduction (phase-out) rate should be raised. Fifth, changes should be made to encourage more eligible recipients to elect advance payment of the credit. Finally, the maximum amount of the credit should be raised.

\textbf{A. Convert the Earned Income Credit into a Wage Subsidy Credit}

The earned income credit is essentially an earnings subsidy program for qualified families. For 1988 the earned income credit provides a subsidy of 14\% of earned income up to $6,235, for a maximum subsidy of $874 per year.\textsuperscript{223} That subsidy is reduced by 10\% of the excess of earned income (or, if higher, adjusted gross income) that exceeds $9,836, resulting in zero subsidy for families with earned income of $18,566 or more.\textsuperscript{224} The taxpayers' net (post-transfer) income for the year is the sum of their pretransfer income and the amount of their earned income credit.\textsuperscript{225}

\begin{itemize}
  \item \textsuperscript{221} For federal government Fiscal Year 1987, the deficit was more than $150 billion; for Fiscal Year 1988, the deficit is expected to exceed $140 billion; and large deficits are expected for years to come. See 1989 BUDGET, supra note 16, pt. 1, at 5.
  \item \textsuperscript{223} See supra notes 121-24 and accompanying text.
  \item \textsuperscript{224} Id. Algebraically, the amount of a taxpayer's earned income credit can be expressed roughly as follows:
    \begin{align*}
      S &= 14\% \times E, \text{ for } E < $6,235 \\
      S &= $874, \text{ for } $6,235 \leq E \leq $9,836 \\
      S &= $873 - 10\% (I - $6,922), \text{ for } $9,836 < E < $18,566 \\
      S &= 0, \text{ for } E \geq $18,566
    \end{align*}
    where $S$ is the amount of the earned income credit, $E$ is the amount of earned income for the taxable year, and $I$ is the higher of earned income or adjusted gross income.
  \item \textsuperscript{225} Algebraically, the household's net income, $I'$, can be expressed as follows:
For taxpayers having only earned income, Table 6 sets forth various amounts of earned income, the amounts of the earned income credit to which families with such amounts of earned income are entitled, and their resulting net incomes. It is clear that for qualifying families, the earned income credit is an earnings subsidy program, albeit a small one.

Table 6: The Earned Income Credit as an Earnings Subsidy Program

<table>
<thead>
<tr>
<th>ANNUAL EARNED INCOME</th>
<th>EARNED INCOME CREDIT</th>
<th>NET INCOME</th>
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1. The Earned Income Credit Viewed as a Wage Subsidy Credit

With a few simplifying assumptions, the earned income credit may be viewed as a wage subsidy credit for its recipients. First, assume that all recipient families have a single wage-earner who works 2,000 hours a year. Second, assume that the only income that each recipient family receives is the earned income earned by that wage-earner.

Given these assumptions, the earned income credit is essentially equivalent to a wage subsidy credit with a subsidy rate of 14% for wages up to $3.12 per hour, and a 10% benefit-reduction (phase-out) rate for wages over $4.92 per hour. The maximum per hour wage subsidy credit would be roughly $ .44 per hour, and that maximum wage sub-

I' = I + S
where I is the higher of the household's earned income or adjusted gross income and S is the amount of the household's earned income credit.

226. The credit would be phased out even faster if the taxpayer had income other than from earnings, since the phase out is based upon the higher of earned income or adjusted gross income. See supra note 117 and accompanying text.

227. These numbers were derived as follows: the earned income credit equals 14% (.14) of wages up to $6,235, and $6,235 divided by 2,000 hours equals a wage rate of roughly $3.12 per hour. The credit is reduced by 10% (.10) of the amount of earned income (or adjusted gross income, if higher) exceeding $9,836. Thus, the credit phases out when wages exceed $4.92 per hour ($9,836 / 2,000 = $4.918).

228. Mathematically, the maximum earned income credit of $874 divided by 2,000 hours equals $ .437 per hour, rounded to $ .44.
sidy credit would be fully phased out for recipients with wage levels of $9.28 per hour or more.\textsuperscript{229} The total annual subsidy is the product of the hourly subsidy and the number of hours worked per year.\textsuperscript{230} That wage earner will have net (post-transfer) income equal to the sum of the pre-transfer wages and the total annual subsidy.\textsuperscript{231}

For various wage levels, Table 7 shows the annual earnings assuming 2,000 hours of work at that wage, and the amount of earned income credit that a qualifying taxpayer earning that annual wage (and having no other income) could claim. Column 4 of Table 7 translates that amount into a per-hour subsidy. Clearly, for recipients working 2,000 hours a year, the earned income credit operates like a wage subsidy credit of as much as $ .44 per hour. This result is particularly helpful to those taxpayers who have elected to receive advance payments of the earned income credit since they will receive their credit amounts in each paycheck.

Table 7: The Earned Income Credit Viewed as a Wage Subsidy Credit (2000 hours)

<table>
<thead>
<tr>
<th>HOURLY WAGE</th>
<th>ANNUAL EARNINGS</th>
<th>EARNED INCOME CREDIT (EIC)</th>
<th>EFFECTIVE HOURLY SUBSIDY (EIC/2000)</th>
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<tr>
<td>9.28</td>
<td>18,560</td>
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\textsuperscript{229} Mathematically, the credit is fully phased out when income reaches $18,566, and $18,566 divided by 2,000 hours equals a wage rate of roughly $9.28 per hour.

Algebraically, the per-hour wage subsidy received by qualifying families with a single wage earner working 2,000 hours a year could be expressed roughly as follows:

\begin{align*}
\text{s} &= .14 \times w, \text{ for } w \leq $3.12 \\
\text{s} &= .44, \text{ for } $3.12 < w \leq $4.92 \\
\text{s} &= .44 - .10(w - $4.92), \text{ for } $4.92 < w < $9.28 \\
\text{s} &= 0, \text{ for } w \geq $9.28
\end{align*}

where \text{s} is the amount of the subsidy per hour to the wage earner, and \text{w} is the pretransfer wage rate.

\textsuperscript{230} Algebraically, the total annual subsidy, \text{S}, can be expressed as follows:

\[ S = 2,000 \times s \]

where \text{s} is the amount of the subsidy per hour to the wage earner.

\textsuperscript{231} Algebraically, the wage earner’s net income, \text{I'}, can be expressed as follows:

\[ I' = I + S \]

where \text{I} is the pretransfer income of the household and \text{S} is the amount of the household’s earned income credit.
2. Converting the Earned Income Credit to a Wage Subsidy Credit

While the earned income credit provides most of its benefits to the working poor because it operates essentially as an earnings subsidy rather than as a wage subsidy, it frequently provides benefits to taxpayers who may not really need or deserve them. This failure to target the earned income credit to the working poor results from the credit's failure to take into account the recipient's hourly wage rate or labor-leisure choices. Converting the earned income credit into a wage subsidy would better target the benefits to the working poor and increase the work incentives associated with the earned income credit.

As structured, all that is considered in determining eligibility for the earned income credit is the recipient's annual earned income (and, for the phase-out, adjusted gross income, if higher). Consider a qualifying individual whose only income for the taxable year is $5,000 in earned income. Such an individual, with a subsidy rate of 14.76%, would qualify for an earned income credit of $700. One problem is that such a $700 subsidy would be equally available to an individual who earns $5,000 by working 1,000 hours at $5.00 per hour, to an individual who works 500 hours at $10.00 per hour, or even to an individual who works 100 hours at $50.00 per hour. Even worse, the earned income credit can provide a greater subsidy per hour for high-wage workers than for low-wage workers.

Converting the earned income credit into a wage subsidy system would ensure that the subsidy was in part based upon both a taxpayer's market wage rate and labor-leisure choices. Such a wage subsidy credit would pay taxpayers whose earnings resulted from having worked 2,000 hours a year a subsidy equal to the amount of the current earned income credit. Table 7 demonstrated how the present earned income credit would look if it were converted to a wage subsidy credit that provided a wage subsidy of up to $.44 per hour. Under such a wage subsidy credit, an individual earning $5.00 per hour would be entitled to a credit of $.43 per hour, while individuals earning $10 per hour or $50 per hour would not be entitled to any credit at all. As a consequence, the benefits of the earned income credit would be better targeted to the hardest working poor.

The only change that would be required to convert the earned income credit to a wage subsidy would be to base the credit amount on the hourly wage of recipients, rather than on their annual earned in-
come. Relatively few reporting changes would be needed to accommodate such a wage subsidy credit in lieu of the present earned income credit. Almost all employers are already required to report the total amount of wages that they pay their employees for purposes of social security taxation.\(^{234}\) The only additional information that would be required for a wage subsidy credit would be specific information about each recipient's hourly wage and number of hours worked during each pay period. Most employers undoubtedly already keep that payroll information on hand for their own purposes.

Of course, under a wage subsidy credit, both the employer and employee would have an incentive to understate the hourly wage and overstate hours worked in order to maximize the government subsidy. As a partial check, both the employee and employer could be required to report wages and hours worked. Moreover, the existing penalties for false reporting should deter most collusion.\(^{235}\) Furthermore, the opportunities for collusion would be limited by the fact that the credit would continue to be phased out for higher incomes. In any event, even the worst collusion between employers and employees really would not result in anything worse than what already occurs under the existing earned income credit in which hourly wage and hours worked are ignored.\(^{236}\)

The more troublesome problem is how to handle self-employed individuals. Frequently, only self-employed individuals will even know how many hours they actually spend earning income, and they would have an incentive to understate their hourly earnings and overstate their hours worked in order to maximize the subsidy. For example, a lawyer working 100 hours a year for $50 per hour would have an incentive to report his or her income as if he or she had worked 2,000 hours at $2.50 per hour if that was needed to claim a wage subsidy credit.


\(^{235}\) See, e.g., id. § 6653 (additions to tax for negligence and fraud), § 7201 (attempt to evade or defeat any tax), § 7206 (fraud and false statements), § 7207 (fraudulent returns, statements, or other documents).

\(^{236}\) If conversion to a pure wage subsidy credit presents too many administrative difficulties, an alternative approach would be to base the credit on both the number of days or weeks in which the recipient worked, and the recipient's earned income for such a period. For example, under a subsidy based upon weeks worked, each employer would report the number of weeks in which each employee worked and their earned income for that week. An employee might then be entitled to a maximum earned income credit of no more than about $16 for each week worked. Such an approach would at least limit the amount of the credit that could be claimed by an individual who by virtue of a high wage rate was able to earn all of the qualifying earned income in just a few days or weeks. Moreover, such an approach might be needed for those employees who do not work for an hourly wage (e.g., certain agricultural workers). See supra note 198.
Surely it would be overkill to deny the wage subsidy credit to all self-employed people because of a concern over false reporting of hours and earnings.\textsuperscript{237} Self-employed individuals would, of course, be subject to the various reporting penalties, and they could be required to report their earnings quarterly, or perhaps even monthly or weekly. Also, if the phase-out of the credit were modified so as to take into account economic income and net wealth of recipients, as I shall recommend, it would be unlikely that taxpayers who actually have high hourly earnings would be eligible for the credit since they would likely have too much wealth to qualify for the credit. In any event, as with employees, even the worst mischaracterization of self-employment hourly income and hours worked would be no worse than what already occurs under the current earned income credit scheme in which hourly wage and hours worked are ignored.

\textbf{B. Base the Phase-Out on Economic Income and Need}

Most welfare programs are means-tested; individuals are eligible for welfare benefits only if they can demonstrate that they are needy.\textsuperscript{238} For example, to receive Aid to Families with Dependent Children (AFDC), a family must be "needy" as determined by state standards and must meet a resource test established by the state within certain federal limits.\textsuperscript{239} The earned income credit can be said to be means-tested as well, since the amount of the earned income credit is phased out for taxpayers with high earned or adjusted gross income; however, the means-testing feature could be greatly improved.

For 1988, the earned income credit is reduced by 10\% of the amount by which the taxpayer's earned income (or, if greater, adjusted gross income) exceeds $9,836; and if a taxpayer has earned income or adjusted gross income of $18,566 or more, the individual is not entitled to the credit.\textsuperscript{240} Generally, these rules operate to limit the entitlement to those taxpayers with low earned income and low adjusted gross income, and hence a need for government assistance. The means-testing feature is imperfect, however, since the phase-out base does not properly measure income, and does not even consider wealth.

\textsuperscript{237} Another alternative might be to deny the credit to taxpayers in certain traditionally high-wage professions (e.g., lawyers, doctors) while allowing it for traditionally low-wage businesses (e.g., night watchmen, housecleaners, daycare providers).

\textsuperscript{238} One analyst looked at 74 different programs for the poor and found that 90\% of those programs had an explicit income test. See V. Burke, supra note 8, at 15.


\textsuperscript{240} See supra notes 121-24 and accompanying text.
For instance, neither earned income nor adjusted gross income includes the value of welfare benefits, pensions, and many other receipts. One can easily imagine a taxpayer with relatively high economic income but low earned income and low adjusted gross income who still can claim the credit. Consider, for example, a lawyer who has retired and who receives $25,000 of interest on tax-exempt bonds and earns $100 per hour by consulting 50 hours a year. Such individuals would not be prevented from claiming the earned income credit under the present phase-out mechanism since neither their earned income nor adjusted gross income would exceed the applicable limit. 241

If the purpose of the earned income credit is simply to offset social security taxes for those taxpayers who happen to have low earned incomes or to provide work incentives to all taxpayers with low earned incomes, then there is no real problem with allowing any individual with low earned income and low adjusted gross income to receive the credit regardless of need. On the other hand, if the earned income credit is intended primarily to help the working poor, and we are concerned about giving government largess to the middle and upper classes, then the credit would be far better targeted by expanding the phase-out base to reflect need. Redefining the phase-out base would be particularly important if Congress were to decide to extend the earned income credit to cover more people or to increase the subsidy amount.

If the earned income credit is to be needs-based, it would make far more sense to phase-out the earned income credit based upon the taxpayer’s economic income. To understand why this is so, it makes sense to examine the current earned income and adjusted gross income phase-outs. Moreover, some consideration should be given to considering the taxpayer’s wealth in the phase-out mechanism.

1. The Definitions of Earned Income and Adjusted Gross Income

The term “earned income” has the same meaning for the phase-out of the credit as it does for determining entitlement to the credit.

241. Although tax-exempt interest is now a preference for purposes of the alternative minimum tax, I.R.C. § 57(a)(5) (1988), and a taxpayer’s earned income credit is reduced by the amount of a taxpayer’s alternative minimum tax liability, id. § 32(h), because of the high exemption amounts in the alternative minimum tax, a taxpayer still can earn a good deal of tax-exempt interest without incurring any minimum tax liability or having to reduce an otherwise allowable earned income credit. For example, single individuals are not subject to the alternative minimum tax unless their alternative minimum taxable income exceeds $30,000. Id. § 55(d)(1)(B). Consequently, single individuals might not be subject to the alternative minimum tax unless they have more than $30,000 of tax-exempt interest.
Earned income generally includes wages, salaries, tips, other employee compensation, and net earnings from self-employment.242

Adjusted gross income is gross income less certain deductions.243 Gross income generally includes all income from whatever source derived,244 including earned income; however, there are a number of important exceptions that differentiate it from what an economist would normally consider as income.245 In particular, gains are not ordinarily included in gross income until they are realized.246 Moreover, special nonrecognition provisions provide that even certain realized gains are not currently taxed.247 Also, imputed income is almost never included in gross income.248 More importantly, there are numerous statutory exclusions from gross income. For example, the Internal Revenue Code provides an exclusion from gross income for amounts received by gift or inheritance.249 Current law also provides an exclusion of in-

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242. See supra notes 137-44 and accompanying text.
245. The classic economic definition of income (also known as the Haig-Simons definition of income) is as follows:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting wealth at the beginning. The sine qua non of income is gain, as our courts have recognized in their more lucid moments—and gain to someone during a specified time interval. Moreover, this gain may be measured and defined most easily by positing a dual objective or purpose, consumption and accumulation, each of which may be estimated in a common unit by appeal to market prices.

terest on state and local bonds.\textsuperscript{250} Furthermore, a vast number of employer-provided fringe benefits are excluded from gross income,\textsuperscript{251} and current law provides many other statutory exclusions from gross income.\textsuperscript{252} Welfare payments and noncash benefits such as food stamps also are excluded from gross income by long-standing administrative practice.\textsuperscript{253}

In addition, a number of deductions may be claimed in computing adjusted gross income.\textsuperscript{254} While most deductions are intended to take into account actual expenditures that reduce a taxpayer's economic worth, a number of the deductions do not fall within this category. For example, in computing adjusted gross income, taxpayers may de-

\textsuperscript{250} I.R.C. § 103 (1988). While most tax-exempt interest is earned by taxpayers with adjusted gross incomes in excess of the phase-out ceiling, some rather well-off taxpayers may end up qualifying for the earned income credit notwithstanding substantial tax-exempt interest.

\textsuperscript{251} For example, gross income does not include up to $5,000 paid by an employer to the beneficiaries or the estate of an employee, if those amounts are paid because of the employee's death. I.R.C. § 101(b) (1988). Similarly excluded are employee health insurance premiums paid by employers for their employees and their families, \textit{id.} § 106; certain employer-provided life insurance benefits, \textit{id.} § 79 (the cost of up to $50,000 of group term life insurance may be excluded from the gross income of employees); employee awards for length of service or safety achievement, \textit{id.} § 74(c); certain meals and lodging, \textit{id.} § 119; certain legal services benefits, \textit{id.} § 120; qualified transportation benefits, \textit{id.} § 124; certain cafeteria plan benefits, \textit{id.} § 125; employer educational assistance, \textit{id.} § 127; dependent care assistance, \textit{id.} § 129; employee discounts including free passes for airline employees, \textit{id.} § 132(c); working condition fringe benefits, \textit{id.} § 132(d); free parking, \textit{id.} § 132(h)(4); on-premises gyms and other athletic facilities, \textit{id.} § 132(h)(5); and certain \textit{de minimis} fringe benefits. \textit{id.} § 132(e).

Pensions and other forms of deferred income present additional problems in defining a comprehensive income base. In general, cash-basis taxpayers do not include an item in income until they actually or constructively receive it. I.R.C. § 451(a) (1988); Treas. Reg. §§ 1.446-1(c)(i) (1986). Thus, compensation is not included in income until received, even if deferral of payment was agreed to by the taxpayer who performed the services. See, e.g., Rev. Rul. 60-31, 1961-1 C.B. 174. Moreover, the Code excludes from gross income employer contributions on behalf of employees to qualified pension and profit-sharing plans. I.R.C. § 401(a)(1) (1988). Furthermore, income earned by qualified pension and profit-sharing trusts is excluded from gross income until actually distributed to covered employees. \textit{id.} §§ 402, 501(a). Similarly, gross income does not include certain retirement pay for members of the armed services, \textit{id.} § 122, or veterans' disability, survivor, and pension benefits, \textit{id.} § 104(a)(4). Most social security benefits also are excluded from gross income. \textit{id.} § 86. Finally, the income earned on annuities purchased by the taxpayer is not taxed to him until actually received, and when received, only the portion that represents income, as opposed to return-of-capital, is subject to tax. \textit{id.} § 72.

\textsuperscript{252} Excluded are life insurance benefits paid by reason of the death of the insured, I.R.C. § 101(a) (1988); workmen's compensation payments and compensation for personal injuries or sickness, \textit{id.} § 104(a); combat pay, \textit{id.} § 112; mustering-out pay, \textit{id.} § 113; certain other benefits for members of the armed services, \textit{id.} § 134; rental allowances for ministers, \textit{id.} § 107; the gain from certain house sales, \textit{id.} § 121; qualified scholarships, \textit{id.} § 117; foster care, \textit{id.} § 131; and child support payments received, \textit{id.} § 71(c). The payor of child support may not claim any deduction for child support paid. \textit{id.} § 215.


duct contributions to Individual Retirement Accounts.\textsuperscript{255} Self-employed taxpayers may deduct contributions to pensions, profit-sharing and annuity plans.\textsuperscript{256} Accelerated depreciation\textsuperscript{257} and similar types of business tax preferences\textsuperscript{258} are also deductible in computing adjusted gross income.\textsuperscript{259} Also, business and investment losses are deductible in computing adjusted gross income.\textsuperscript{260} Moreover, business operating losses from prior years may be deducted in computing adjusted gross income in the current year.\textsuperscript{261}

2. \textit{Changes to Bring the Phase-Out Base Closer to Economic Income}

It is apparent that neither adjusted gross income nor earned income is as comprehensive as economic income. Consequently, to better target the earned income credit to the working poor, the phase-out of the earned income credit should be based on something like economic income.\textsuperscript{262} The phase-out base could be defined as adjusted gross income determined without regard to most of the exclusions and deductions outlined above. Moreover, imputed income and unrealized gains also could be included in the phase-out base. Furthermore, since social security benefits, noncash welfare benefits, pensions, and child support all increase a recipient’s well-being, whether or not they are economic income, these factors also are candidates for inclusion in the phase-out base.\textsuperscript{263}

A less comprehensive approach would be to use something like alternative minimum taxable income as the phase-out base.\textsuperscript{264} At least a statutory definition already exists.\textsuperscript{265} Alternative minimum taxable income is adjusted gross income decreased by the alternative tax itemized deductions and increased by the amount of certain tax preferences claimed.\textsuperscript{266} While not equivalent to economic income, al-

\textsuperscript{255} Id. § 62(a)(7).
\textsuperscript{256} Id. § 62(a)(6).
\textsuperscript{257} Id. § 168.
\textsuperscript{258} See, e.g., id. § 179 (election to expense certain depreciable business assets).
\textsuperscript{259} To the extent that these are deductible trade and business deductions they may be deducted from gross income to compute adjusted gross income under I.R.C. § 62(a)(2) (1988).
\textsuperscript{260} Id. § 165.
\textsuperscript{261} Id. § 172.
\textsuperscript{262} Cf. Klein, \textit{The Definition of “Income” under a Negative Income Tax}, supra note 191.
\textsuperscript{263} Alternatively, vis-a-vis welfare benefits, it might make sense to make the earned income credit a categorical program; that is, recipients who elect to receive the earned income credit might become ineligible to receive other welfare benefits. Alternatively, the earned income credit could be reduced by 100\% of the welfare benefits received.
\textsuperscript{264} I.R.C § 55(b) (1988).
\textsuperscript{265} Id.
\textsuperscript{266} Id.
ternative minimum taxable income may be closer to that ideal, since many tax preferences are added back into the tax base. For example, tax-exempt interest is included in alternative minimum taxable income. Also, depletion and depreciation deductions are limited so that they more closely approximate economic depletion and depreciation.

The obvious problem with using alternative minimum taxable income as the base for phase-out of the earned income credit is that individuals subject to the alternative minimum tax are allowed to claim a variety of itemized deductions in computing alternative minimum taxable income. For example, home mortgage interest, charitable contributions, and medical expenses are deductible in computing alternative minimum taxable income. These deductions are not allowed in the computation of adjusted gross income, and there is no reason to allow these deductions in determining the base for phase-out of the earned income credit. Accordingly, if alternative minimum taxable income is adopted as the phase-out base, it should be alternative minimum taxable income computed without regard to these alternative tax itemized deductions.

3. Further Changes to Make the Earned Income Credit Needs-Based

Even economic income may not be the proper phase-out base. It may make sense to turn the earned income credit into a needs-based program like typical welfare programs. In that event, a net wealth or resources test might be imposed to force individuals to utilize their own resources before taking benefits from the government. For example, Congress has set a resource limit for eligibility for Aid for Dependent Children (AFDC): A family is ineligible for AFDC benefits if its net worth exceeds $1,000. In determining a family's net worth, the family may exclude the value of its residence, a car (limited to $1,500 in equity value), and certain items of personal property that are deemed essential to daily living.

268. Id. §§ 56(a)(1), 57(a)(1) & (7), (b).
269. Id. § 56(b).
270. These deductions are not allowable in computing adjusted gross income because they are not specifically listed in I.R.C. § 62 (1988).
271. See Steuerle & Wilson, supra note 222, at 702-03.
While the AFDC resource test may seem harsh, it is appropriate to have some type of resource test for the earned income credit. Otherwise, some millionaires may be eligible to receive the credit. In practice, most resource tests will have little impact on the vast majority of the poor since they hold so few assets.\(^2\)

4. Summary

It appears appropriate to expand the phase-out base for the earned income credit to reflect both economic income and other resources that are available for support of the recipient taxpayers. In this way the earned income credit can be targeted to the needy and working poor. Admittedly, expanding the phase-out base would make the provision and its application more complex, but it would do so primarily for those with greater economic incomes and wealth. Individuals with only wage incomes and no significant wealth would still find qualification for the earned income credit fairly simple, and these are the very people who should be targeted to receive the benefits of the earned income credit.

C. Extend the Credit

If the earned income credit is to be targeted to help the working poor, then it is logical that large families should get larger credits. Also, Congress should extend the earned income credit to childless couples and perhaps even to single individuals. Finally, Congress should reconsider ways to limit the current implicit penalties on two-earner couples.

1. Include a Family Allowance Provision

At present the size and rate of the earned income credit are independent of the number of dependents that a taxpayer has. While the credit generally is available only to taxpayers with at least one dependent,\(^2\) no provision is made for a larger credit if the taxpayer has more than one dependent.\(^2\) Thus, unlike the positive tax system, the earned income credit fails to accommodate considerations of family size, and the greater needs of larger families are ignored.\(^2\) Many have

\(^{275}\) Cf. Tobin, Pechman, & Mieszkowski, supra note 23, at 86-87.
\(^{276}\) See supra notes 126-36 for additional information.
\(^{277}\) Cf. FEDERAL TAX TREATMENT, supra note 16, at 14.
\(^{278}\) See Steuerle & Wilson, supra note 222, at 704.
recommended that the earned income credit vary with family size.\textsuperscript{279}
Several countries provide cash benefits to families in the form of children's allowances.\textsuperscript{280}

The positive income tax system controls for family size through the mechanism of the personal exemption.\textsuperscript{281} For 1988, the personal exemption amount is $1,950.\textsuperscript{282} Generally, taxpayers are entitled to deduct a personal exemption for themselves and their spouse, and for each dependent.\textsuperscript{283} Starting in 1988, the deduction for personal exemptions is phased out for taxpayers with high incomes.\textsuperscript{284}

It is obvious that large families need more income for basic needs than small families and single individuals. The poverty income guidelines explicitly recognize this fact.\textsuperscript{285} If the earned income credit is to effectively help the working poor, it seems appropriate to provide a larger subsidy to larger families that can reasonably expect to need the funds. One approach simply would be to base the benefit on the total number of personal exemptions or dependents claimed. The benefit

\textsuperscript{279} See, e.g., \textit{One Child in Four}, \textit{supra} note 9; \textit{Cuomo}, \textit{supra} note 19; \textit{Ladders Out of Poverty}, \textit{supra} note 9; \textit{Bourdette & Weill}, \textit{supra} note 222; \textit{Samuelson}, \textit{supra} note 218; \textit{Federal Tax Treatment}, \textit{supra} note 16, at 14; statements of Robert D. Reischauer, \textit{supra} note 222. \textit{Bourdette & Weill} suggest that the current structure of the earned income credit "contributes to the disproportionately harsh tax treatment of large poor families." \textit{Bourdette & Weill}, \textit{supra} note 222, at 1250.

\textsuperscript{280} See, e.g., \textit{Kamerman, Child Care and Family Benefits: Policies of Six Industrialized Countries}, 103(11) \textit{MONTHLY LAB. REV.} 23 (1980).


\textsuperscript{282} I.R.C. § 151 (1988).

\textsuperscript{283} \textit{Id}.

\textsuperscript{284} \textit{Id.} § 1(g), (h)(1). Apparently, Congress felt that wealthy families did not really need this benefit, especially since their maximum statutory marginal tax rates have been reduced so dramatically.

\textsuperscript{285} The most recent poverty guidelines are $11,650 for a family of four, $13,610 for a family of five, $15,570 for a family of six, $17,530 for a family of seven, and $19,490 for a family of eight. \textit{Poverty Income Guidelines, supra} note 7, at 4214. For family units with more than eight members, an additional $1,960 is added for each additional member. \textit{Id}.
could be keyed into the personal exemption amount. For example, since the 1988 personal exemption amount of $1,950$^{286}$ is essentially equivalent to a tax credit of $292.50 for taxpayers in the 15% bracket, taxpayers eligible for the earned income credit could be allowed to claim additional refundable tax credits of roughly $300 for each additional personal exemption.$^{287}$

A less costly variation on this approach would be to allow additional credit amounts only for children under age six.$^{288}$ Another variation would be to allow additional benefits only for each dependent who is under age fifteen or who is physically or mentally incapable of independent self care.$^{289}$

An alternative approach would be to increase the wage subsidy percentage for families with additional dependents. At present, a qualifying family with one dependent is entitled to a maximum earned income credit equal to 14% of earned income up to $6,235. Under this alternative, a family with two dependents might be entitled to a credit equal to 14.5% of earned income up to $6,235. This would amount to a maximum additional credit per additional dependent of roughly $300.

A problem with approaches that increase the credit amount is that a higher maximum amount of the earned income credit would, of course, take longer to phase-out and would result in a higher phase-out ceiling. With the current 10% phase-out rate, each additional $300 credit would be phased out over a span of $3,000. Accordingly, if the credit amount were to be raised, it might make sense to raise the phase-out rate simultaneously.

Yet another way for the earned income credit to take family size into account would be to raise the floor (and, consequently, the ceiling) of the phase-out for each additional dependent without raising the maximum credit amount. After all, it does seem a bit unreasonable that in 1988 even a family of eight's earned income credit starts to phase out when its income reaches $9,836 and is completely phased out at $18,566 of income, which is even less than the $18,800 poverty

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287. Congress might want to replace personal exemptions with a system of refundable tax credits for all taxpayers. For taxable years 1975 through 1978, there was a nonrefundable personal exemption credit for low-income taxpayers. I.R.C. § 42 (Supp. III 1975); I.R.C. § 141 (Supp. 1975); I.R.C § 141 (1976); I.R.C § 141 (Supp. 1977).
288. Bourdette & Weill made this suggestion, supra note 222, at 1250.
289. Cf. I.R.C. § 21(b) (1988) (expenses for household and dependent care services necessary for gainful employment). Query why the current earned income credit is available to most low-income taxpayers with a dependent, rather than just to those families who have young or handicapped children.
guideline for a family of eight. To avoid this problem, the phase-out floor of the earned income credit could be raised by $1,950 for each additional dependent. For example, in 1988 the earned income credit phases out between incomes of $9,836 and $18,566 for a qualifying family with one dependent. Under the revised approach, the earned income credit would be phased out between $11,786 and $20,516 for a family with two dependents, and the phase-out levels would continue to increase for each additional dependent.

The problem with simply raising the phase-out range is that such a change would not actually increase the amount of the credit for any families with incomes below the phase-out floor. For example, a family with a single wage earner working forty hours a week and earning $3.35 per hour would earn $6,700 per year and would receive no additional subsidy despite an increase in the phase-out range. Nevertheless, if the maximum credit amount were increased to take into account more dependents, it might make sense to simultaneously raise the phase-out ranges.

Regardless of which mechanism or combination of mechanisms is chosen to account for family size, there would be few additional administrative burdens. Tax returns already require taxpayers to report any dependents that they claim. The current advanced payment certificate does not require that dependents be listed, but it could be easily modified. Employer accounting and advance payment of the earned income credit might be a little more complicated as advance payment tables would have to account for family size, but this is really not too difficult for computerized payrolls. Moreover, employers already have to account for family size in withholding for most employees, based upon the number of personal exemptions that they claim for withholding purposes.

If fraud is a concern, taxpayers could be required to report the social security numbers of any dependents that they claim. Starting in 1988, a taxpayer claiming a dependent who is at least five years old will be required to report that dependent's social security number on the tax return. A similar rule could require such reporting on certificates used to elect advance payment of the credit as well. The IRS could then cross-check those social security numbers against other returns to make sure that no dependent is claimed twice or files a separate return.

290. Even if the policy choice is made to limit additional benefits to taxpayers with minor children or children under age 15, the forms could rather easily accommodate those changes.
2. Extend Eligibility to Childless Couples and Single Individuals

Under present law, only families with at least one dependent are eligible for the earned income credit, yet many single individuals and childless couples are poor. In 1986, 6.8 million unrelated individuals were poor. These unrelated individuals constituted 21.6% of the poor. The earned income credit should be extended to them to help alleviate the poverty and to encourage them to work. Undoubtedly, Congress would not want to make the credit available to taxpayers who are claimed on any other taxpayer's tax return. Also, Congress might not want to let full-time students qualify for the credit due to the somewhat voluntary nature of their poverty.

The credit would not necessarily have to be as large for single individuals as it is for couples or families with at least one dependent. After all, the current poverty guidelines are $5,770 for a single individual and $7,730 for a couple. Under current law, if both a husband and wife work and request advance payment of the earned income credit from their employers, then each receives no more than half of the total possible $874 credit. A similar approach could be taken for single individuals and childless couples. For example, a single individual might be allowed a credit of no more than $437 ($874/2). The allowance could be set up to base the credit on 7% of wages up to $6,235, 14% of wages up to $3,117.50, or some alternative in between. Similarly, a childless couple might be allowed a total credit somewhere between $437 and $874.

3. Reduce the Penalties on Two-Earner Couples

The current earned income credit can impose a substantial penalty on two-earner couples. For 1988, the maximum amount of the earned income credit that a married couple could receive is $874. If

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293. U.S. BUREAU OF THE CENSUS, supra note 1, at 6 (Table C).
294. Id. at 5 (Table B).
296. Poverty Income Guidelines, supra note 7, at 4214.
297. EMPLOYER'S TAX GUIDE, supra note 113, at 46-50. If only one spouse works and claims advance payment of the earned income credit, that spouse can receive a maximum of $16 per week as advance payment of the earned income credit. If the other spouse also works and files a certificate, the maximum advance payment that either spouse can receive is $8 per week. See supra note 150 and accompanying text.
298. See Steuerle & Wilson, supra note 222, at 704.
only one spouse works 2,000 hours at the $3.35 per hour minimum wage, a couple could receive the maximum $874 earned income credit. If the other spouse also works 2,000 hours at the $3.35 per hour minimum wage, the couple's earned income credit would fall to just $518.\textsuperscript{299} In effect, there is a $356 surtax on the second earner's wages.\textsuperscript{300} Moreover, the family's earned income would subject it to the income tax.\textsuperscript{301} There is no particular reason why the family's subsidy should fall so dramatically just because one's spouse also works. This is a substantial penalty on two-earner couples.\textsuperscript{302}

Another type of penalty affects two-earner couples electing advance payment of the earned income credit. At present, a married individual may claim advance payments of the earned income credit of as much as $873 per year, but if that individual's spouse also takes a job and requests advance payment of the credit, then each is entitled to receive no more than $436 per year.\textsuperscript{303} In effect, one spouse's advance payment goes down when the other spouse takes a job and claims advance payment of the credit.

There is also a kind of marriage penalty relating to the earned income credit.\textsuperscript{304} Currently, each head of household can qualify for an earned income credit of as much as $874; but if two heads of household marry and combine their households, the married couple would be entitled to a maximum single credit of just $874, not twice that amount.

\textsuperscript{299} The couple's combined earned income would be $13,400 ($6,700 + $6,700). The maximum earned income credit, $874, would be reduced by 10% of their earned income over $9,836, or by $356.40 ($13,400 - $9,836 = $3,564; 10% \times $3,564 = $356.40), leaving a net earned income credit of roughly $518 ($874 - $356.40 = $517.60).

\textsuperscript{300} Id.

\textsuperscript{301} For 1988, a couple with one child could claim three $1,950 personal exemptions and a standard deduction of $5,000. If their only income is earned income of $6,700, they pay no federal income tax; however, if they have $13,400 of earned income, they would have taxable income of $2,550, and they would owe $382.50 in federal income tax ($2,550 \times 15\% = $382.50).

\textsuperscript{302} The marginal tax rate facing our hypothetical couple is the sum of the 10% reduction in the earned income credit plus the 15% marginal tax rate of the income tax for a total marginal tax rate of 25%. Steuerle & Wilson, supra note 222, at 704.

\textsuperscript{303} Employer's Tax Guide, supra note 113, at 47 (Table 7). See also supra notes 146-50 and accompanying text.

While theoretically it is not possible to eliminate these penalties without generating a kind of single penalty, some improvement is possible. Furthermore, if the earned income credit is converted to a wage subsidy, there is some theoretical justification for preserving the first spouse's full benefit even if the second spouse's income raises the family's total income: it could be a powerful work incentive.

Alternatively, the phase-out range could be raised if both spouses work. As under current law, if only one spouse works, the benefits could be phased out at incomes greater than $9,836. If both spouses work the benefits could be phased out at incomes exceeding $19,672. Then, the earned income credit would be phased out only at higher joint incomes. While this approach would greatly raise the floor of the earned income credit phase-out, the phase-out rate realistically could be raised much higher than the current 10%, so that the phase-out ceiling still could remain relatively low.305

4. Summary

In summary, the credit should be expanded to take into account larger families, should be extended to childless couples and singles, and the penalties on two-earner couples should be reduced. It is worth considering how such an expanded earned income credit might look. Such an expanded credit could be made available to all individuals age eighteen or over and not claimed as a dependent by any other adult. The members of the filing unit would be the filer, spouse, dependent children, and any other people dependent on the filer or spouse. Minors (under eighteen) could be allowed to claim the credit if they are married or have a dependent child and are not claimed by someone else as dependents.

For example, each filer might be allowed to claim an earned income credit of 7% of wages up to $6,235, for a maximum credit of roughly $437. If the filer and spouse both work, then each might be allowed to claim a credit of up to 14% of wages up to $6,235, for a maximum credit of $874 each. A nonworking spouse and each dependent might qualify the filer for an additional $300 credit. Table 8 shows the maximum earned income credits that would be available to various types of filing unit families under such a system.

305. At a 10% phase-out, a married couple's earned income credit of $874 would be phased out over the next $8,740 of income. At a 20% phase-out, a married couple's earned income credit of $874 would be phased out over just $4,370 of income.
Table 8:  *A Hypothetical Expanded Earned Income Credit*

<table>
<thead>
<tr>
<th>TYPE OF FILER</th>
<th>MAXIMUM CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single person (working)</td>
<td>$ 437</td>
</tr>
<tr>
<td>Head of household (working) with one dependent</td>
<td>$ 737 = $ 437 + $ 300</td>
</tr>
<tr>
<td>Married couple (only one working)</td>
<td>$ 737 = $ 437 + $ 300</td>
</tr>
<tr>
<td>Married couple (both working)</td>
<td>$ 874 = $ 437 + $ 437</td>
</tr>
<tr>
<td>Married couple with dependent (only one working)</td>
<td>$ 1,037 = $ 437 + $ 300 + $ 300</td>
</tr>
<tr>
<td>Married couple with dependent (both working)</td>
<td>$ 1,174 = $ 437 + $ 437 + $ 300</td>
</tr>
<tr>
<td>Each additional dependent</td>
<td>$ 300</td>
</tr>
</tbody>
</table>

**D. Raise the Benefit-Reduction (Phase-Out) Rate**

At present, the benefit-reduction (phase-out) rate for the earned income credit is just 10%. This seems truly remarkable considering that benefits from AFDC are phased out using a benefit-reduction rate as high as 66.7%.\(^{306}\) Raising this rate would reduce the phase-out ceiling of the credit. For example, if the benefit-reduction rate of the current earned income credit as raised to 20% of the excess of earned income over $9,836, the phase-out ceiling would fall from $18,566 to $14,206. Thus, raising the rate would better target the benefit to the working poor. Moreover, any savings achieved by raising the benefit-reduction rate could be plowed back into the plan in order to raise the amount of the credit available for those still eligible.

Unfortunately, benefit-reduction rates and positive tax rates are additive. Thus, for taxpayers who face both the phase-out of their earned income credit and a positive marginal tax rate of 15%, the effective benefit-reduction rate is 25%;\(^{307}\) for each additional dollar of earned income, their earned income credit will be reduced by $ .10 and they will have to pay $ .15 of federal income tax.\(^{308}\) Nevertheless, a benefit-reduction rate for the earned income credit as high as 25% might well be reasonable.\(^{309}\) Even when coupled with a marginal income tax rate of 15%, the effective benefit-reduction rate would be

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308. Of course, this is still far less than the 38.5% maximum marginal income tax rate for 1987 or the 50% maximum marginal tax rate of 1986 and prior years. *See* I.R.C. § 1(h) (1988); I.R.C. § 1 (1986).
309. Indeed, the original work bonus proposal which is the precursor to the current earned income credit called for a 25% benefit-reduction rate. *See supra* note 44 and accompanying text.
just 40%. While high, even such a benefit-reduction rate seems quite reasonable especially relative to other antipoverty programs.  

E. Improve the Advance Payment Feature

The advance payment mechanism already is ideally structured to form the basis for a wage subsidy credit. Employees can elect to receive advance payment of the credit simply by filing a certificate with their employer. Then, assuming that the employee's earnings are low enough to qualify for the credit, the employer includes the appropriate amount of the credit in the employee's paycheck.

The real problem is that so few employees elect to receive advance payments of the credit. Indeed, only about 10,000 taxpayers claimed advance payment of the earned income credit in 1984. Failure to elect advance payment of the credit reduces the credit's effectiveness as a work incentive since payments are not included in the recipient's regular paychecks. Also, failure to receive the benefit throughout the year reduces the disposable income of eligible recipients during the year, instead, providing eligible taxpayers with a larger annual lump-sum refund. For both of these reasons, it seems appropriate to encourage more eligible recipients to elect advance payment of the credit.

The failure to claim the credit is probably due to the lack of understanding about the credit and the advance payment feature. Also, some eligible individuals may actually prefer to receive larger refunds each April. Still other eligible taxpayers may be concerned that while they appear to be eligible for the credit at the beginning of the year, they will not be eligible for the credit by the end of the year because of unexpected income.

Obviously, steps need to be taken to ensure that every potential recipient is aware of the credit and, particularly, of the advance payment feature. Employers could be compelled to inform all their low-income employees about the advance payment feature, and low-in-

310. Of course, this analysis ignores any benefit-reductions that might simultaneously arise in connection with a recipient being a beneficiary of food stamps or other antipoverty programs as well as the earned income credit. In that event, the cumulative benefit-reduction rate could be even higher.

Problems of program integration such as these are beyond the scope of this Article. It is worth noting, however, that the problem of high cumulative benefit-reduction rates could be solved by making the credit a categorical program; that is, by requiring individuals to choose either welfare or an expanded wage subsidy credit. Those who worked (or could work) would be eligible only for the credit; those who could not (or did not) work would be eligible for other antipoverty programs. Cf. Income Security for Americans, supra note 190, at 146-49.

311. See supra note 185 and accompanying text.
come employees could be required to elect whether to receive advance payments. The Tax Reform Act of 1986 directed the IRS to include in regulations a requirement that employers notify at least those employees whose wages are not subject to income tax withholding that they may be eligible for the earned income credit.312

Another possibility would be to make the advance payment mechanism the exclusive way to claim the credit; taxpayers who failed to claim advance payment of the credit would not receive the credit at all. A better approach might be to provide a small bonus to those taxpayers who elect the advance payment mechanism. For example, eligible recipients who elect to receive advance payment of the credit might be entitled to receive an additional one dollar a week of credit over and above the current statutory amounts. Such an inducement, albeit small, would encourage more eligible recipients to elect advance payment of the credit. Similarly, if self-employed individuals continue to be covered by the credit, special provisions could be made to enable self-employed recipients to receive monthly or even weekly advance payments of the credit.313

F. Raise the Subsidy Rate

Many families are poor despite the fact that one or more family members work. An individual working 2,000 hours a year at the 1988 minimum wage of $3.35 per hour would earn just $6,700 a year. That is more than the poverty guideline for a single individual, $5,770, but it is far less than the poverty guideline for a family of four, $11,650. The current earned income credit provides a maximum subsidy per family of $874 per year. Such a small subsidy can do little to alleviate the financial difficulties of those families. If we are serious about helping the working poor, we need a subsidy that helps them escape the poverty line.314

312. See supra notes 108, 177-79 and accompanying text.
313. Before moving on, it is worth noting that if Congress chose to adopt a comprehensive negative income tax system in lieu of a wage subsidy credit, the advance payment mechanism would be ideal as the basis for distribution of the negative income tax benefits. All employees could receive their negative income tax benefits in their weekly paychecks. Unemployed recipients could select a local bank to distribute benefits to them in a similar manner. Consider the sources cited supra note 191.

For that matter, if Congress ever adopts a value-added tax or dramatically raises excise taxes, it could temper any regressiveness by making a portion of the new taxes refundable to the poor, and by adopting a mechanism to provide for advance payment of any refunds due. See U.S. DEP’T OF THE TREASURY, supra note 95, vol. 3, at 100-08; C. McLURE, THE VALUE-ADDED TAX: KEY TO DEFICIT REDUCTION? 38 (1987).
314. Even though a single individual working 2,000 hours a year at minimum wage would earn more than the poverty guideline for a single individual, it makes sense to provide single individuals with some credit to encourage them to work.
Consider a modest program to provide wage subsidy credit for families whose wage earnings place them below the poverty line. Assume that the program is designed to give such workers a wage subsidy that would bring them halfway to the poverty line. Assume further that each wage-earner works 40 hours a week, 50 weeks a year, for a total of 2,000 hours per year. Further assume that each family has just one wage-earner.

For a family of four with one wage earner working 2,000 hours, the poverty level is equivalent to an effective wage rate of approximately $5.83 per hour ($11,650/2,000 hours). Even this is a far cry from the roughly $9.22 per hour average hourly earnings in the private sector for April 1988.\textsuperscript{315} Thus, subsidizing the wages of a sole-support, minimum-wage worker who is least halfway to the poverty line for family of four would require a wage subsidy of approximately $1.24 per hour.\textsuperscript{316} This is almost triple the current earned income credit which provides a subsidy to such a family of just $ .44 per hour.

Consider a simple hypothetical wage subsidy credit for a family of four with a maximum per hour subsidy of $1.20,\textsuperscript{317} but with a 25% benefit-reduction rate for wages above the minimum wage.\textsuperscript{318} Table 9 displays this hypothetical wage subsidy credit system for various pre-transfer wage rates. While less generous to taxpayers with income over the poverty line,\textsuperscript{319} the wage subsidy credit program displayed in Table 9 would have the advantage of bringing all families of four with a single worker working 2,000 hours a year and earning at least the minimum wage almost halfway to the poverty level. Similar subsidy arrangements could be designed for smaller and larger families. Overall, the wage subsidy credit program outlined in Table 9 undoubtedly would cost more than the current earned income credit. Nevertheless, it is apparent that the current earned income credit does little to improve the situation of the working poor. If Congress truly intends to help the working poor, it should increase the subsidy rate in the earned income credit, perhaps along the lines set forth in Table 9.\textsuperscript{320}

\textsuperscript{316} ($5.83 - $3.35)/2 = $1.24.
\textsuperscript{317} The $1.24 subsidy has been rounded down to $1.20 per hour to make the computations and table more understandable.
\textsuperscript{318} Algebraically, such a wage subsidy credit can be expressed as follows:
\[ s = 1.20 - 0.25 (w - 3.35), \text{ for } 3.35 \leq w < 8.15, \text{ and } \\
\]\[ s = 0, \text{ for } w \geq 8.15 \]
where s is the hourly subsidy and w is the wage earner’s pretransfer wage rate.
\textsuperscript{319} A more generous credit could have a lower phase-out rate or the phase-out could commence at a higher pretransfer wage rate.
\textsuperscript{320} To subsidize the wages of a sole-support, minimum-wage worker up to the poverty line
Table 9: *A Hypothetical Wage Subsidy Credit for a Family of Four* (one wage earner working 2,000 hours a year)

<table>
<thead>
<tr>
<th>HOURLY WAGE</th>
<th>SUBSIDY NET ANNUAL</th>
<th>SUBSIDY NET ANNUAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>HOURLY WAGE PER HOUR</td>
<td>PER YEAR (2,000 HOURS)</td>
</tr>
<tr>
<td>$ 3.35</td>
<td>$ 1.20</td>
<td>$ 4.55</td>
</tr>
<tr>
<td>4.55</td>
<td>.90</td>
<td>5.45</td>
</tr>
<tr>
<td>5.75</td>
<td>.60</td>
<td>6.35</td>
</tr>
<tr>
<td>6.95</td>
<td>.30</td>
<td>7.25</td>
</tr>
<tr>
<td>8.15</td>
<td>0</td>
<td>8.15</td>
</tr>
</tbody>
</table>

G. Cost Considerations

It could be expensive to expand the earned income credit into an increased wage subsidy credit that covers childless couples and singles. Nevertheless, savings could be achieved by raising the phase-out rate, for example, to 25%. In addition, some savings that could be used to expand the credit could be generated by broadening the phase-out base to take into account economic income and wealth and by structuring the credit as a wage subsidy credit rather than as an earnings credit.

Moreover, if Congress decided that the credit should be a major antipoverty program for the working poor, dramatic savings could come from excluding the working poor from other programs, such as food stamps and AFDC, and from shifting the saved funds to an expanded credit. For federal government Fiscal Year 1989, federal outlays for income security are expected to exceed $136 billion, more than $10 billion of which is expected to be for family support payments alone.321 Shifting funds from other income security programs would be a logical way to find the revenue to expand the credit. Similarly, for federal government Fiscal Year 1989, the federal government expects to spend more than $6 billion on job training and employment programs.322 Some of that money might be spent more effectively on a wage subsidy credit than on job training and employment programs.

Analogously, for federal government Fiscal Year 1989, it has been estimated that tax expenditures for education, training, employment,
and social services will be the equivalent of an outlay exceeding $20 billion, and that tax expenditures for income security (other than the earned income credit) will be the equivalent of an outlay exceeding $78 billion.\footnote{Id. at SPECIAL ANALYSES, pt. G, at 38-39. For example, the exclusion for employer-provided educational assistance is estimated to cost more than $3 billion per year, and the net exclusion of pension contributions and pension earnings is estimated to cost more than $72 billion per year.} It would make sense to repeal some of these tax expenditure provisions and channel the resulting savings into an expanded wage subsidy credit.

V. Conclusion

The earned income credit has grown significantly since its adoption in 1975. As structured, it can form the basis for an effective antipoverty program for the working poor. Relatively few changes would be needed to accomplish this result.

First, the earned income credit would be better targeted to benefit the working poor if it were converted to a wage subsidy credit. Second, the earned income credit also would be better targeted to benefit the working poor if the phase-out base of the credit was more closely based upon economic income and need. Third, serious thought should be given to expanding the credit to cover childless couples and single individuals and to increasing the amount of the credit for larger families. Fourth, serious consideration should be given to raising the benefit-reduction (phase-out) rate. Fifth, changes should be made to encourage more taxpayers to elect advance payment of the earned income credit. Lastly, if Congress truly wants to help the working poor, then it should endeavor to find revenues to enable it to raise the amount of the credit.