GOP Cuts Target Working Poor

Little-Known Tax Credit Used by Many Is Under Fire

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In their drive to reduce federal spending, Republican budget cutters have now targeted one of the government's biggest but least-known anti-poverty programs—one that has won the avid support of every president since Richard Nixon, who first proposed it.

Called the "earned income tax credit," it works much like a tax refund. Workers with incomes near or below the poverty level file a special tax return and receive a check from the Internal Revenue Service that, in most cases, is far greater than any income taxes that have been deducted from their paychecks.

Liberals boast that the EITC has lifted nearly 4 million Americans out of poverty. Conservatives have praised it because it involves almost no government bureaucracy and goes only to people who work.

But despite the program's appeal, its cost—$26 billion in the next fiscal year—and its unfamiliarity to most Americans make it a logical target for a Congress committed to balancing the federal budget in seven years.

Already, the federal government spends more each year on the earned income credit than it does on better-known programs such as housing assistance or food stamps—or even the basic welfare program, Aid to Families With Depen-

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dent Children. On a percentage basis, the EITC is the fastest-growing entitlement program, benefiting one in five American households.

The program also has been plagued by fraud and abuse. The Clinton administration says those problems have largely been solved. But some critics argue that the program's benefits are so generous that new scams are constantly being devised.

The earned income credit also raises the difficult issue of government's role in a free-market economy. A cruel reality of the modern labor market is that it doesn't provide a growing number of full-time workers enough money to support a family. With the earned income credit, the government has essentially committed itself to subsidizing their wages—and guaranteeing that no working family should live below the poverty line.

Back in its infancy in 1980, only 6 million families with annual incomes of less than $10,000 qualified for the credit. The maximum credit that year was a modest $500 per year for a household with two children.

By 1996, however, the program will be expanded to cover about 20 million families. These families, the poorest fifth of the American work force, will receive cash benefits that average $1,341.

The maximum benefit, $3,600, will go to families with incomes below the poverty line—which now stands at about $16,000 for a family of four. But because of the gradual phaseout of eligibility under the program, more than half the money will go to families with earnings *above* the poverty line—incomes as high as $28,500 for working families with two children.

Private studies show that roughly 85 percent of eligible families take advantage of the program—a significantly higher rate than for more established programs such as Aid to Families With Dependent Children (about 66 percent) and food stamps (about 60 percent).

One such beneficiary is Earlene Barnes, 62, of Chicago. A cook in a facility for the mentally ill, she earned $11,000 last year to support herself and a 6-year-old foster son, whom she has since adopted. After applying for the EITC, she qualified for a $2,500 tax refund, equal to more than 20 percent of her earnings.

"It helped pay a lot of bills," she said, including the $900 tuition for her son at a Catholic school.

The Problem of Fraud

The attack on the earned income credit is being led by Republican Sens. Don Nickles (Okla.) and William V. Roth Jr. (Del.), who argue that its generous benefits have made it a magnet for abuse.

"The earned income credit is unbelievably abused at this point," said Nickles. "It has the highest error and fraud rate of any program in government. We better reform it before we let it expand any further."

Most EITC fraud has been of a rather crude sort—taxpayers falsely claiming dependents and spouses to qualify for the maximum credit. Last year, for example, the IRS, using a sample of 1,000 electronically filed tax returns, found that 24 percent of the claims for earned income tax credits were invalid—split about evenly between mistakes and outright fraud. That was down from 34 percent in the IRS's more comprehensive survey in 1988, but even supporters of the program were forced to concede that those numbers were unacceptably high.

The government also has uncovered several organized rings of EITC cheats who simply made up tax returns out of thin air, using fictitious names, Social Security numbers and W-2 forms.

In Houston, eight people were indicted in January for filing 800 bogus returns claiming $1.9 million in earned income credits. A New York City ring, filing 11,000 fraudulent returns, claimed $13.6 million in EITC payments before it was caught.

At a recent Senate hearing, Richard M. Hersch of Ardmore, Pa., testified that his tax preparation firm, Quik Tax Dollars Inc., of Bryn Mawr, Pa., routinely conspired with customers to defraud the EITC program. Hersch estimated that 40 percent of the 29,000 EITC claims he submitted in 1993 were inflated, while another 400 were based on claims from people who were ineligible for the program. Hersch pleaded guilty to tax fraud charges earlier this year in U.S. District Court in Boston.

The IRS has launched a major crackdown on EITC fraud. Beginning in 1994, banks and tax preparation services were prohibited from issuing immediate refund checks to tax filers claiming the earned income credit. And this spring, the IRS delayed checks for millions of taxpayers while its computers cross-checked returns against other information; millions of filers were asked to submit backup data to support their claims for an earned income credit.

As a result of these efforts, 3.5 million taxpayers this year received only partial refund checks while 4.2 million refunds have been withheld entirely, according to IRS Commissioner Margaret Richardson. The agency also identified 2,500 separate fraud schemes, involving $63 million.

Through June, the IRS reported this week, the number of households with children filing for the EITC actually declined for the first time, by 180,000— signs of a healthy economy and the impact of anti-fraud efforts.

Tax experts warn, however, that new types of abuse are almost inevitable. Congress and the administration have already moved to deny EITC payments to undocumented workers, taxpayers with low incomes and big savings accounts and prisoners earning the minimum wage in jail laundries and cafeterias. But other loopholes remain.

Under current law, for example, the full EITC can be claimed not only by the full-time minimum-wage employee, but also the $100-an-hour consultant who works only three months of the year and earns $11,000. This loophole could be closed by adding a minimum-hours requirement for eligibility, but doing so would mean requiring employers to report the number of hours worked by each employee on W-2 forms, a costly administrative burden.

Cutting Back on EITC

In spite of its size and reach, many Americans have never heard of the earned income tax credit—and even fewer understand it. And with no powerful lobby organized to defend it, the credit has become a tempting target for the budget cutters' scalpel.

Proposals to reduce the earned income tax credit fall roughly into two groups.

The first set of reforms aims to curb fraud, reduce errors and better target benefits to working families with children. These proposals include excluding childless workers from the program, counting Social Security payments in the income limits and disqualifying taxpayers who have more than $1,000 a year in savings income.

Taken together, these reforms would cut EITC spending by $3 billion annually when fully implemented in 2000, according to congressional Joint Committee on Taxation estimates. That is roughly in line with the spending reductions required by the recently passed congressional budget, and even supporters of the program concede they are likely to be adopted.

More sweeping and more controversial, however, is a proposal by Roth and Nickles to cancel the increase in credit rates and income limits scheduled to take effect in 1996 and do away with annual cost-of-living adjustments thereafter. The Joint Committee on Taxation estimates these changes would save

$9.4 billion in 2000—a 28 percent cut from projected program costs.

The Clinton administration argues that these rollbacks amount to a tax increase for the poorest 19 million taxpayers—averaging $600 per household. And even some Republicans argue that, at a time when the party is trying to nudge welfare mothers off the dole, it's hardly a propitious moment to roll back subsidies for those who work.

"The earned income credit is an extremely important component of welfare reform, and I think we want to be careful to protect its basic purpose even as we eliminate the abuses in the program," said Rep. E. Clay Shaw Jr. (R-Fla.), chairman of a House Ways and Means subcommittee with jurisdiction over both the EITC and welfare.

One political irony is that cutbacks in the EITC program will hit hardest in several low-wage states that have largely Republican delegations in Congress. According to a Treasury estimate, the five states where more than a quarter of all taxpayers receive the EITC include Louisiana (39 percent), Alabama (29 percent), Arkansas (27 percent), South Carolina and Texas (26 percent each).

Help for Working Poor

George C. Ickes of Chicago is a Republican who believes balancing the federal budget is essential and who generally supports the steps the Republican-controlled Congress is taking to achieve that goal. But he does not believe the earned income credit should be scaled back.

Earlier this year, Ickes served as a volunteer tax preparer for low-income workers and was introduced to a world that was entirely new to him.

"I was amazed," Ickes said. "It really was making a big difference to these folks."

In Chicago, Michael O'Connor agrees. He's the executive director of the Center for Law and Human Services, which recruited volunteers such as Ickes to help low-income workers apply for the earned income credit.

"You take a single mom with a $6-an-hour job—that's $12,000 a year," O'Connor said. She's got two kids. She's really living on the edge. For many of them, this credit can be the difference between hanging in there and falling out of the job market."

Helping the working poor has assumed added importance at a time when their real wages have been stagnating. According to Robert Greenstein, executive director of the Center on Budget and Policy Priorities, a liberal advocacy group, in D.C., full-time minimum-wage workers have suffered a 13 percent decline in disposable income over the past 20 years—even after figuring in welfare, food stamps and the increases in the earned income credit.

"The earned income credit is not perfect, but it's the best way we've come up with to offset the steady income losses suffered by low-skilled workers," said Gary Burtless, a labor economist at the Brookings Institution in Washington. "Scaling back on it now would only aggravate the growing problem of inequality in this country. I think it would be a real mistake."

Steven Pearlstein reported from Washington, Edward Walsh from Chicago.

BY JONATHAN KIRN FOR THE WASHINGTON POST

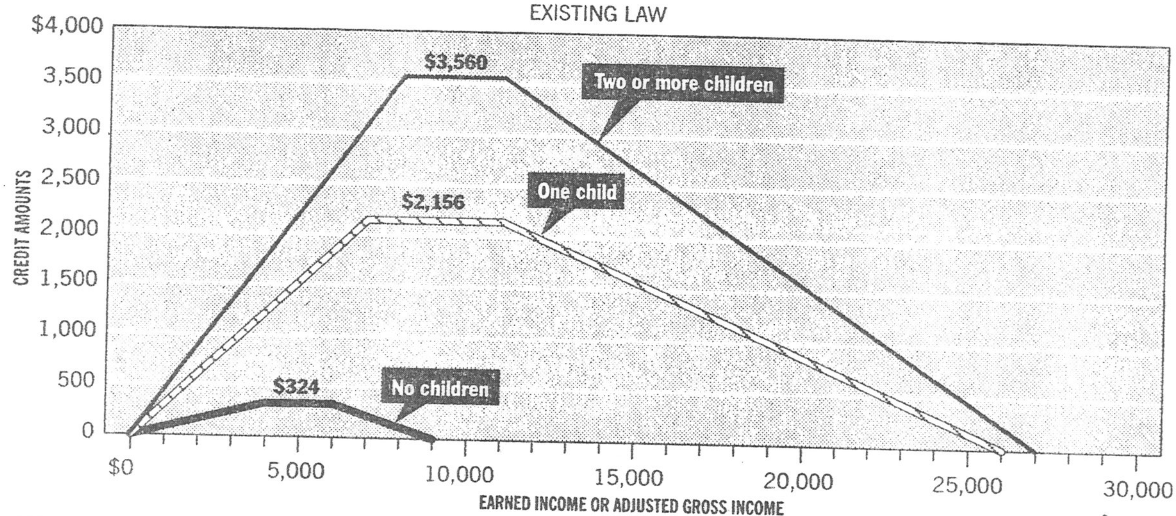
Happy beneficiary: *Earlene Barnes, 62, of Chicago with her foster son, Terrance Chatman, 6. Barnes, who earned $11,000 last year as a cook in a facility for the mentally ill, qualified for a $2,500 tax refund under the earned income tax credit, which she says "helped pay a lot of bills." Despite the support of every president since Richard Nixon, the program is under attack, in part because so many recipients have abused it.*

HOW IT WORKS

The earned income tax credit works as a plateau. Families with very low incomes see their credit increase steeply as their income rises. At the point at which a family with two children earns $8,900 the credit levels off until that income exceeds $11,620 at which point the credit trails off sharply, eventually being eliminated when a family makes $28,524 a year.

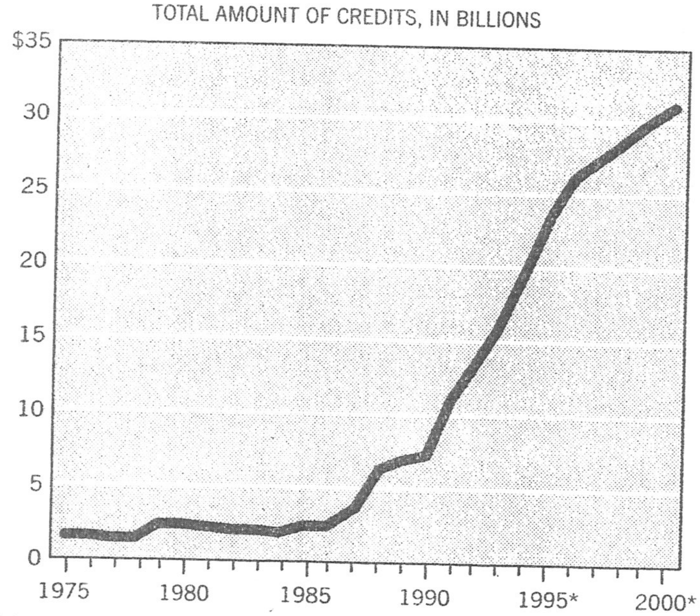
THE EARNED INCOME TAX CREDIT, 1996

EXISTING LAW



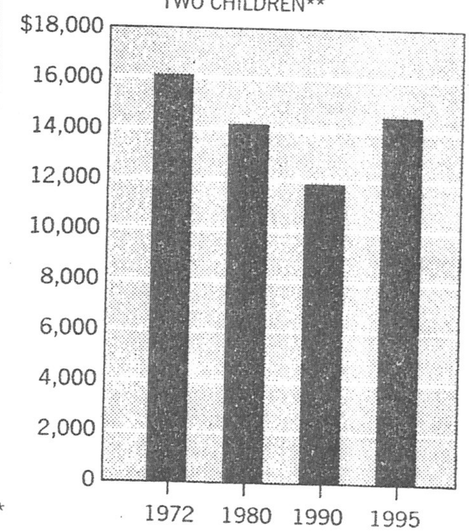
Although the program has grown rapidly . . .

TOTAL AMOUNT OF CREDITS, IN BILLIONS



. . . the working poor are still making less than they did in 1972.

AVERAGE DISPOSABLE INCOME FOR A MOTHER IN A MINIMUM WAGE JOB WITH TWO CHILDREN**



* Projections

** From wages, AFDC, food stamps, EITC and federal taxes, in 1994 dollars

SOURCES: Internal Revenue Service; Joint Committee on Taxation; John Karl Scholz, University of Wisconsin; Department of Health and Human Services