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Trade-offs Between Targeting and Simplicity: Lessons from the U.S. and British Experiences with Refundable Tax Credits

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Introduction

In the United Kingdom and many other European countries, every child receives a cash benefit. Eligibility for the benefit, as well as the benefit amount, is determined without regard to the parents' income or asset holdings or marital status. As automated data systems become more sophisticated and unique identifiers (e.g., the social security number in the United States) become more prevalent, universal benefits could be as easy to distribute as voter registration or library cards.[1]

However, policymakers have other goals in addition to making the job of program administrators easier. These goals may include removing families from poverty,

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[*] Views and opinions in this paper are those of the author and do not necessarily represent the policies or positions of the Treasury Department.

[1] Even with universal benefits, there will be problems for administrators to sort through. Keeping accurate and timely records on births and deaths is one hurdle. Administrators may also have to settle competing claims when more than one "guardian" claims benefits on behalf of a minor child or disabled adult.

encouraging work, and restraining budgetary costs. In the United States, the earned income tax credit (EITC) was expanded in 1993 both to make work pay and to lift more full-time minimum wage workers out of poverty. To achieve this goal, the maximum credit rate for families with two or more children was increased from 25 percent to 40 percent of earnings and the maximum credit was increased by nearly $1,400. Eligibility for the maximum credit rate was limited to families with incomes below $8,425, and families with incomes above $27,000 were ineligible for any credit.[2] Achieving certain other goals of the 1993 legislation – namely deficit reduction – would not have been possible had similar size benefits been provided to all families.

Thus, policymakers – in the United States, but also increasingly in the United Kingdom – rely on targeting to provide benefits to the neediest families without breaking the bank. But targeting can also increase compliance burdens for applicants and administrative costs. Targeting also may require trade-offs with other tax and social policy goals.

Distinguishing among families based on differences in ability to pay can achieve horizontal equity goals, but codifying these distinctions may be difficult and result in confusing laws. Taxpayers (and administrators, as well) may be confused by subtle distinctions, leading to unintentional errors. Phasing out benefits to provide assistance to those with the greatest need may achieve vertical equity goals, but can also result in high marginal tax rates and marriage penalties. High marginal tax rates and marriage penalties may adversely affect labor supply and family formation decisions. They may also encourage applicants to misreport income and family status (such as number of children and filing status) to obtain more benefits.

Short of eliminating targeting, policymakers can strive to make the eligibility rules simple to understand and easy to administer. But simplification may go only so far. If policymakers choose to target benefits, then they must address the question of which government agency can best reach out to the targeted population and administer the program well.

In several earlier papers (Holtzblatt, 2000; Holtzblatt and McCubbin, 2004), I have suggested that in the United States assistance to at least some low-income

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[2] 1996 law in 1994 dollars.

individuals can best be done through the individual income tax system. In particular, there are three features of the U.S. tax-transfer system that favor this approach. First, the income tax already collects information on income and family characteristics, which may also be used to target benefits. Little or no additional information may be required for a targeted benefit. Second, many low-income workers file tax returns, even if they owe no income taxes. Third, many low-income workers do not receive federally-funded assistance from other government agencies, such as state welfare offices. Providing assistance through the tax system may be the most effective method of reaching the working poor.

These arguments, however, do not necessarily extend to other countries and other tax systems. For example, the unit of taxation in the United Kingdom is the individual, so the tax authorities know little about a family's composition or well-being. Second, the United Kingdom has an exact withholding tax system, in which about two-thirds of taxpayers are exempted from filing returns. In addition, the United Kingdom has a universal child benefit that every parent is entitled to receive. The child benefit has – until recently – been administered by the U.K.'s Department of Social Security. These factors would seem to suggest that the United Kingdom should rely on the transfer system to provide further assistance to low-income families.

Yet, the last decade has seen an explosion of tax credits in the United Kingdom. Tax credits have been created for families with children, low-income workers, disabled individuals, and older reentrants into the labor market. The British experience demonstrates that there can be other administrative and political reasons for using the tax system to deliver targeted benefits.

Part I: U.S. Tax-Transfer System

Benefits of Using Income Tax System to Deliver Targeted Benefits

Over the past two decades, the income tax threshold in the United States has gradually risen. Expansions of child-related tax benefits have increased the income tax threshold for families with children to roughly twice the poverty level. For unmarried individuals without children, the income tax thresholds have also increased over the

poverty level but at a much slower pace. In 2004, a single filer with no children is exempted from income tax if his or her income is less than 119 percent of poverty.

Because many low-income families are exempt from income taxation, the income tax system might not seem the obvious way to provide them with additional assistance. However, there are several other factors to consider. First, the U.S. income tax system already collects information that be used to distinguish among families based on ability-to-pay criteria. Second, the tax system requires many individuals to file even if they do not have an income tax liability. Third, many low-income filers have little or no contact with other government agencies. For them, the point of contact with the federal government is the tax system.

Assistance to low-income families can be provided through refundable tax credits, which entitle recipients to the full amount of the credit even if they have little or no income tax liability. (The amount payable in excess of income tax liability is scored as an outlay in the federal budget accounts.) Currently, in the United States, there are three refundable tax credits: the EITC, the refundable portion of the child tax credit (known as the "additional child tax credit"), and the health coverage tax credit. To be eligible for the first two credits, an individual must have earned income. The newer health coverage credit is available only to certain dislocated workers[3] and, as Table 1 demonstrates, is a very small program relative to the other two refundable tax credits.

Distinguishing among families. In the U.S. income tax, the unit of taxation is the individual or, if married, the couple. The definition of income is fairly broad, although means-tested government benefits and certain interest income are exempt from taxation. The income tax adjusts for ability-to-pay based, in part, on family composition, with the taxpayer receiving additional exemptions for children and other dependents and if he or she is elderly or blind. In addition, taxpayers are eligible for a standard deduction, which size varies based on marital status or, if unmarried, the care of children and other dependents.

[3] Eligible individuals include people who receive a Trade Readjustment Allowance (TRA), workers who are 50 or older and who receive a certain percentage of the wage differential between the wages of their previous, adversely-affected employment and their new full-time employment, and pension benefit recipients of the Pension Benefit Guaranty Corporation (PBGC).

As a result, taxpayers already provide information on the first page of the tax return that would also be required to target benefits to families. Taxpayer-reported information is supplemented by independent information reports about individuals' income – from wages to interest and dividends – from third-party payers. Third-party information provides a check on taxpayers' reports and also includes data on people who do not file returns. The IRS receives more than one billion information returns, including several hundred million wage reports, each year (U.S. Treasury Department, 2003).

What has been missing from IRS data files – until recently – has been independent data on family relationships. Although the tax system differentiates between taxpayers based on marital status (joint filing), living arrangements (head of household filing status), and family composition (dependents), the IRS did not systemically verify these requirements for many years outside of an audit environment. This has been gradually changing since 1986 and has been partly driven by efforts to improve the administration of refundable tax credits.

The first step in this effort was a requirement in the 1986 Tax Reform Act that taxpayers report a unique identifier (typically, the social security number) for each child over five claimed as a dependent or EITC qualifying child. While this effort was motivated by IRS reports that the number of claimed dependents exceeded reasonable expectations, subsequent efforts were driven by concerns about administering the EITC. Within a decade, a social security number was required for every dependent from birth. In 1996, the IRS was authorized to use expeditious processes to deny both dependency exemptions and the EITC unless taxpayers provided valid social security numbers. Once the IRS could validate social security numbers upfront during processing, the agency began to mount an effort to check for duplicate claims of EITC qualifying children as well as dependent exemptions.

In 1997, the IRS gained obtained access to two new data files that can be linked to IRS files through social security numbers. The first file is the Federal Case Registry of Child Support Orders (FCR) that contains information on custodial arrangements for children whose parents are divorced or separated. The FCR is maintained by the Office of Child Support Enforcement in the Department of Health and Human Services. The second is Kidlink, a Social Security Administration file linking the names and social

security numbers of children and their parents. Together, these two data files allow the IRS to check for questionable claims of provisions based on a child's source of support, living arrangements, and relationships.

Currently, the IRS is using both files in a limited manner. The Treasury Department is currently evaluating the quality of information provided by states for tax enforcement purposes. Kidlink contains information for children who received social security numbers since 1998, meaning that the file will not contain information on a complete cohort of potential child dependents and EITC qualifying children for at least another decade. Still, the files contain sufficient information to be used to help select returns for audits and other enforcement activities.

Independent information on filing status is still scanty. Many states and localities do not have automated registries of marriages and divorce, making it impossible at this time for the IRS to obtain access to data on marital status. The IRS is currently testing various commercial data sets that contain information on the names of individuals cohabiting in the same residence. This test is being done in conjunction with an EITC compliance initiative to determine if such data can be useful in detecting questionable claims of marital status.

Most of the family-related activities are aimed at questionable EITC claims, but the IRS has the authority to use this information for non-EITC issues as well, including claims of dependency exemptions and filing status. A key lesson from the past decade is that the inclusion of the family-related credits in the IRS creates synergy. Just as the income related information reported to the IRS helps in the administration of the targeted benefits, the administration of refundable tax credits has made the IRS seek out data that may have broader consequences for tax administration.

Filing Requirements. Individuals are required to file a tax return when their gross income equals or exceeds the sum of the taxpayer's personal exemption and the standard deduction (the "filing threshold"). Single individuals without children generally incur income tax liabilities when their gross income exceeds the filing threshold. Thus, it is unlikely that such individuals would be required to file a tax return unless they owe income taxes. But if, for example, they have dependents, then they are required to file returns even when they have no positive income tax liability. In effect, they must file

returns to identify the dependents who, by making them eligible for dependent exemptions and certain tax credits, also wipe out their income tax liability.

As Figure 1 demonstrates, the gap between the filing and income tax thresholds has widened, particularly for families with children, in recent years. By 2004, a married couple with two children did not incur any tax liability until their income exceeded 198 percent of poverty. However, they were required to file a tax return with income about 84 percent of poverty. Beginning in 1994, the gap between filing and tax thresholds also increased for childless workers, as a result of an extension of a small EITC to very low-income childless workers. In 2004, they are required to file a return when their income is about 98 percent of poverty and pay taxes when their income is about 119 percent of poverty.

As Table 2 shows, nearly 90 percent of filers are required to file a tax return. Most of the remainder file to obtain refunds of income taxes that were overwithheld during the year. This is true even of low-income filers. Among taxpayers with adjusted gross income below $30,000, about 79 percent are required to file a tax return and an additional 16 percent file to obtain refunds of overwithheld income taxes. (And among those who file to claim either the EITC or the additional child tax credit, nearly 96 percent are required to file.) Less than 2 percent file solely to obtain refundable tax credits.

<u>Point of Contact</u>. Many low-income individuals who have contact with the income tax system do not appear to have regular interactions with other government agencies. Because they are able-bodied and work, they may not be eligible for some forms of assistance such as supplemental security income (SSI). Income and asset tests may limit assistance to the most needy individuals and families. For example, a household with income above 133 percent of poverty and $2,000 of assets is not eligible for assistance.

Even if they meet the eligibility criteria, many low-income individuals – particularly the working poor – do not the claim the benefits to which they are entitled. Only about 52 percent of eligible households claimed food stamps in 2001. Among eligible households with earnings, the food stamp participation rate was 44 percent (Cunnyngham, 2003). Applying for food stamp benefits imposes significant compliance

burdens on individuals, particularly the working poor who often must take time off from work to apply for benefits in-person. (see Ponza, 1999; GAO, 1999) Some low-income individuals may steer away from applying for certain types of low-income assistance due to stigma concerns.

Thus, it is not surprising to find that relatively few filing units eligible for the EITC report receiving cash transfers. Among low-income workers eligible for the EITC in 2000, only about one in four reported claiming one of the major low-income benefits administered by state welfare agencies or the Social Security Administration in 2000. (See Table 3.)

Drawbacks of using the tax system to deliver targeted benefits

As the preceding discussion suggests, there are compelling arguments as to why the tax system can be used to provide benefits to low-income individuals. But there also are reasons why the tax system may not be the best approach. First, the annual accounting framework of the tax system makes it difficult to time payments to coincide with a family's needs. Second, the U.S. income tax is a self-assessment system, meaning that taxpayers and credit applicants alike are often either on their own when completing tax returns or paying others to help them. Third, the IRS has many responsibilities and must balance many priorities. The danger is two-sided: a slight nudge in either direction can disturb this delicate balancing act, causing the IRS to devote too many or too few resources to the task of administering refundable tax credits.

Timing. In the U.S. tax system, income is measured on an annual basis, and returns are filed at the end of the tax year. An annual accounting system, combined with end-of-year reconciliation, has two consequences for providing targeted benefits. First, an individual may be eligible for assistance based on annual income even though his or her current monthly income is relatively high. Second, it is difficult to time receipt of benefits to coincide with the taxpayer's need. Taxpayers typically do not receive their tax credits until they file returns at the end of the year.

While it is difficult to change the annual accounting system, there have been at least two attempts to accelerate payments of credits. Since 1978, EITC claimants have had the option of requesting advance payments of the EITC from their employers

throughout the year. (Neither the self-employed nor childless individuals can avail themselves of this option.) Employers offset the costs of the advance payments by reducing their payments of withheld income and employment taxes and notify the IRS of individuals' receipts of advance payments at the end of the tax year. At the end of the year, credit claimants must reconcile advance payments received during the year with the amount of credit for which they were actually eligible. If they receive too little, they can receive the remaining amount when they file their tax return at the end of the year; conversely, if they receive too much, they must repay the overpayment with their tax return.

While the advance payment option provides a mechanism to receive payments on a timely basis, only a small number of EITC claimants have ever claimed the credit in advance. During tax year 2002, 130,924 taxpayers – less than one percent of EITC claimants with children – claimed the EITC in advance. The reasons for the low utilization rate are not fully known. One popular explanation is that workers simply do not know that they have the option of claiming the credit in advance. A General Accounting Office study (1992) provided some support for this theory when investigators found widespread ignorance about the advance payment option among low-income workers. To remedy ignorance, the Omnibus Budget Reconciliation Act of 1993 required that the IRS to test the effectiveness of sending notices to EITC claimants, informing them about the advance payment option. The IRS (1999) found that notices increased participation in the advance payment option by a statistically significant, but small, amount.

There may be other barriers to participation in the advance payment option. The GAO study also found that once informed, many workers stated that they would prefer to receive the EITC in a lump-sum payment. While some workers might simply prefer the forced savings provided by receipt of a lump-sum payment at the end of the year, others may not claim the EITC in advance for fear of being forced to repay a sizable overpayment at the end of the year if their income or family status changes during the course of the year. (To limit the risk of overpayments, Congress constrained the advance payment to 60 percent of the maximum credit for which a worker with one child would be entitled in 1993.) Workers might also be reluctant to ask their employers for advanced payments of the EITC.

Another mechanism to accelerate the payment of credits was used in 2001 and again in 2003, but in neither year was this mechanism applied specifically to target relief to low-income families in a more timely fashion. Instead, the motivation behind advancing payments of the rate reduction credit in 2001 and the child tax credit (including the refundable portion) in 2003 was economic stimulation. Thus when the child tax credit was increased by $400 for tax year 2003 in the Jobs and Growth Tax Relief Reconciliation Act, policymakers also wanted taxpayers to begin spending their tax cuts as quickly as possible. The tax act was enacted in May, and taxpayers began to receive checks for the increase in the child tax credit within two months. Eligibility for the advance payments was based on income and family characteristics as reported on the taxpayer's 2002 tax return. If there was a change in filing status or income during 2003 that was in the taxpayer's favor, he or she could claim the remaining amount when they filed their 2003 tax returns. However, unlike the EITC advance payments, taxpayers were not required to repay overpayments of the advance credits if the change in circumstances was not in their favor. Neither the advance payments of the rate reduction credits or the child tax credits were done on a permanent basis.

Given the difficulties in accelerating payments without risking overpayments, one should ask whether concern with timeliness of payments (for reasons other than economic simulation) is misplaced and possibly paternalistic. Three different types of studies find evidence that low-income working families do not rely on the lump-sum EITC payment solely for current consumption. Surveying a sample of individuals claiming the EITC in free tax preparation clinics in Chicago, Smeeding et al (2001) find that they plan to use the credit for savings, car purchases, tuition payments, and moving expenses. Using the Consumer Expenditure Survey, Barrow and McGranahan (2001) find that consumption rises, particularly for durable goods, in the months in which EITC refunds are received. Based on interviews of credit claimants in an ethnographic study of the New Hope Project in Milwaukee, Romich and Weisner (2001) conclude that families view lump-sum payments of the EITC as a form of forced savings. These studies would support a view that low-income working families are able to smooth consumption over the year to account for the receipt of large lump-sum payments.

Self-assessment System. The tax system relies on self-assessment, which means that filers either prepare their own returns (sometimes with the help of special software packages) or they pay others to help them. Taxpayers may also turn to IRS assistance centers or IRS-sponsored volunteer sites for help with tax returns, but the limited availability of free assistance locations can mean long lines and long waits for such services.

Low-income filers face two hurdles in dealing with a self-assessment system. First, they are often poorly educated. Among filers with incomes below 200 percent of poverty, more than a quarter lack a high school diploma (Holtzblatt and McCubbin, 2004). For many, English is not their native tongue. Nearly 20 percent were born in countries where English was neither the official or primary language (Holtzblatt and McCubbin, 2004). While a few forms and publications are available in Spanish, most are available only in English.

A second hurdle is the complexity of the eligibility rules used to target assistance. As I (together with Janet McCubbin) have detailed in earlier papers (2003, 2004), the rules governing programs for low-income filers are complicated, sometimes mirroring the complexity in claimants' lives. For example, the additional child tax credit requires proof that the taxpayer provided most of a child's support. However, proving support requires retention of receipts throughout the year on shelter, food, clothing, child care, education, etc. It may be particularly difficult for taxpayers to demonstrate (or prove) compliance with this test when the taxpayer receives outside support from the government or others in addition to his own earnings. The EITC requires proof that the taxpayer lived with her child for over half the year, but parents who share custody of a child may be hard pressed to prove with whom the child resided for 188 days.

Further adding to the confusion is the fact that taxpayer may be eligible for both the EITC and the additional child tax credit, but the credits' eligibility criteria – while similar – differ in subtle ways. In 2005, an estimated 22 million taxpayers – including 16 million filers with children – will claim the EITC. Eleven million filers are estimated to receive the additional child tax credit. Not surprisingly, there is significant overlap between these two populations – with about 8 million (or 75 percent of additional child tax credit claimants) expected to claim both credits. Yet, as Table 4 demonstrates, each

credit uses somewhat different rules to target income and family size and composition. Tax experts, themselves, are challenged at trying to explain the difference in the two credits' definitions of earned income.[4]

The educational deficiencies of credit recipients, combined with the complexity of the credits' rules, may contribute to the increasing number of EITC claimants who are turning to paid preparers. In 2000, about 53 percent of all taxpayers used paid preparers. Use of paid preparers was higher among EITC claimants, with about 64 percent paying someone else to prepare their return.[5] But it is also possible that EITC claimants turned to preparers for other reasons. They may turn to paid preparers to file electronically, which enables them to receive refunds more quickly. Refundable tax credits have increased substantially in recent years, and recipients may be trading off income for more leisure.

Conflicting Priorities in the IRS. To state the obvious, administering low-income benefits is not the sole task of the IRS. The IRS is responsible for administrating both individual and corporate income taxes, the estate tax (while it continues), and various excise taxes. It also has a role in the administration of pensions and tax-exempt agencies. The IRS processes over 135 million individual and corporate income tax returns a year as well as over a billion information returns from employers and other third-parties. In total, the IRS collects roughly a trillion dollars in taxes each year, while it pays out about $40 billion in refundable credits annually. To achieve these tasks, the IRS receives a budget of nearly $10 billion – of which less than $200 to $300 million is devoted to administering refundable tax credits.

Within its $10 billion budget, the IRS must balance all of these competing priorities. On the one hand, the relative size of refundable tax credits subject to rest of plate means other issues may (and perhaps) should dominate. On the other hand, political sensitivities surrounding refundable tax credits can sometimes give more weight to its concerns. In the past decade, the IRS has conducted four EITC compliance studies but

[4] Both credits define earned income to include only taxable compensation. But the additional child tax credit further restricts earned income to compensation included in taxable income. For example, some ministers add parsonage allowances to self-employment income when computing self-employment income taxes and the EITC. However, such allowances are excluded from taxable income for purposes of the regular income tax and the additional child tax credit.

[5] Unpublished IRS data.

no comparable studies were done on other provisions in the income tax system – a problem that will be remedied soon with the completion of the National Research Program, a comprehensive study of compliance among individual income taxpayers in 2001. The downside of four EITC compliance studies, with none of other tax provisions, is a pervasive view that the credit is the IRS's largest compliance problem. Evidence of this concern is the higher audit rate for EITC claimants than for all taxpayers (Holtzblatt and McCubbin, 2004) and the fact that the Administration's FY 2005 Budget contains three separate performance goals (one still to be determined) for the EITC out of a total of 54 goals for the entire IRS (OMB, 2004). Until more comprehensive compliance data become available, one cannot judge if this emphasis is too much or too little.

How well do refundable tax credits do in meeting their goals?

In deciding between refundable tax credits and other approaches, clearly an important consideration is how well the former do in achieving policy and administrative goals. Much of the evidence to date is about the EITC, which is not surprising since it has been in existence far longer than the other refundable credits.

There is some evidence to support the view that the EITC achieves its policy objectives. In 2002, the EITC lifted 4.6 people out of poverty, including 2.5 million children under the age of 18.[6] Several recent studies have found that the EITC encourages work. Meyer and Rosenbaum (2001) found that more than 60 percent of a nine percentage point increase in the employment of single mothers between 1984 and 1986 was due to expansions of the EITC. Dickert, Houser, and Scholz (1995) estimated that expansions of the EITC between 1993 and 1996 would induce more than half a million families to move from welfare to work. A study by Eissa and Liebman (1996) found that the EITC significantly increases labor force participation among single mothers, especially less educated women.

The story is more mixed on the administrative side. The good news is that most people who are eligible for the EITC claim the credit. Between 75 and 86 percent of those eligible for the EITC claim the credit (Scholz, 1994, GAO, 2001, Treasury, 2002b). As noted earlier, participation rates for the food stamp program, particularly among the

[6] Authors' computations based on Census data (www.census.gov/hhes/poverty/poverty02/r&dtable5.html).

working poor, are notably lower. On the other hand, noncompliance among EITC claimants is high. A study conducted by the IRS of compliance among EITC claimants in tax year 1999 found that between $9.7 billion and $11.1 billion of EITC claims were erroneous.[7] IRS enforcement activities prevented or recovered about $1.2 billion in erroneous claims. Thus, between $8.5 and $9.9 billion in EITC claims – or between 27.0 and 31.7 percent of total EITC claims – was erroneously paid to taxpayers for tax year 1999 (Treasury, 2002a).[8]

As Table 5 shows, errors are primarily associated with the targeting criteria that are difficult for the IRS to verify. The largest source of EITC errors in 1999 was the failure to claim a child who met the qualifications for the credit. Typically, taxpayers failed to demonstrate that they resided with a qualifying child for the required amount of time. Many taxpayers also misstated their relationship to the child claimed for the EITC at the same time that they misreported how long the child resided with them.

Misreporting of filing status was the second largest source of errors. Many taxpayers claimed to be single or head-of-household filers when they were, in fact, still legally married and required to file either jointly with their spouse or "married filing separately." About $2.1 billion in EITC overclaims was attributable to cases where the taxpayers filing status was changed to married filing separately, either alone or in combination with other errors. In addition, over $600 million in overclaims was attributable to couples who should have filed joint returns. In these cases, the EITC was reduced or eliminated when the income of the two spouses was combined.

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[7] See U.S. Department of the Treasury, Internal Revenue Service, February 28, 2002b. The study was based on audits of 3,457 randomly selected tax year 1999 returns filed during 2000 and claiming the EITC. The sample represents a population of 18.8 million tax returns and about $31.3 billion in EITC claims. The EITC errors identified in the study include both intentional noncompliance and unintentional reporting mistakes, and the two types of errors are not readily distinguishable in the data. Returns were selected before mathematical and clerical errors were corrected as part of routine IRS processing. Therefore simple computational errors are also counted as noncompliance in this study.

[8] The difference between the upper- and lower-bound estimates is attributable to alternative treatments of taxpayers who failed to appear for an audit. Unless otherwise noted, the estimates in this paper are based on the upper-bound set of estimates and on the amount of overclaims prior to any IRS enforcement activities.

About $1.7 billion in EITC overclaims occurred on returns with income reporting errors. Farm and non-farm business income – much of which is not reported independently to the IRS – accounted for 57 percent of the unreported income.

The tiebreaker rule accounted for a substantial portion of EITC overclaims. At the time of the study, only the taxpayer with the highest adjusted gross income could claim the child in an extended-family household. The IRS study counted nearly $2 billion of EITC claims by the lower-income taxpayers as errors, without any adjustment for the amount that should have been claimed by other adults in the household. Since the study was conducted, the AGI tiebreaker was simplified, so that it now only applies when more than one taxpayer claims the same child. Had this provision been in effect in 1999, about $1.4 billion of EITC overclaims would have been eliminated. If in addition other simplification and enforcement provisions that were enacted in 2001 had been in effect in 1999, EITC overclaims would have been reduced by roughly $2 billion (Holtzblatt and McCubbin, 2004).

Comparing spending programs and refundable tax credits

Lacking data on overall taxpayer compliance, we cannot answer the critical question of how EITC error rates compare to compliance rates for the rest of the income tax. Nor can we answer the fundamental question of whether the EITC causes noncompliance or if the noncompliance we observe among EITC claimants is symptomatic of more pervasive problems throughout the tax system. The EITC error rate can (and is often) compared to noncompliance rates in means-tested programs administered by non-tax agencies. This is a valid comparison, if the question is whether a benefit should be provided through the tax system or through an expenditure system. Even if the decision is to keep the credit in the tax system (because eligible individuals have little interaction with the agencies that run welfare programs), the comparison may shed light on whether there are better administrative practices that could be adopted by the IRS.

In past papers (2000, 2004), I have compared the EITC error rate to that of the food stamp program. One of the reasons to compare the food stamp program to the EITC is that both – unlike many other programs targeted to low-income families -- are available

to people attached to the work force. (Unlike the EITC, food stamp benefits are also available to non-workers.) Both have similar targeting provisions. As Table 6 shows, both programs have requirements regarding income, assets, household composition, and citizenship. Food stamp benefits phase out at a steeper rate than the EITC, contributing to higher marginal tax rates (but over a shorter income range) than the tax credit. Despites these similarities (and differences), the food stamp overpayment error rate is substantially lower than that of the EITC: 6.16 percent (Rosenbaum, 2003). One possible explanation for differences in the error rates is the dissimilarities in how the two benefits are administered. Another reason may be differences in how compliance is measured in the two programs.

First, the food stamp application typically requires more information than the taxpayer is required to provide on a Schedule EIC. In part, this is due to the fact that the taxpayer provides much of the necessary information elsewhere on the tax return. The Schedule EIC asks only for information not available elsewhere on the tax return or through independent data sources: the child's name, social security number, and months of residency in the taxpayer's home. Food stamp applications vary by state, but typically require extensive information on income, assets, and household composition.

Second, the food stamp program is not a self-assessment program. With few exceptions for the elderly and disabled, food stamp applicants are required to visit a state office to apply for benefits. A personal interview with a state caseworker is required. Most state offices, however, are opened only during working hours, requiring applicants to take time off from their own jobs in order to apply for benefits.

A third difference between the two programs is the timing and source of third-party verification. Administrators in both programs recognize the need for third-party verification. With the exception of the W-2 required from all filers with earnings, no documentation is required of EITC claimants at the time of application. As discussed earlier, the IRS has developed several automated data systems that can be matched against tax returns during processing in order to identify questionable claims. When anomalous EITC claims are detected, the taxpayer may be asked to supply documentation in support of their claim. State food stamp programs typically require applicants to provide much more documentation at the time of application. Massachusetts, for

example, requires documentation of identity, residence, utility bills, bank accounts, pay stubs, dependent care expenses, unearned income, self-employment income, rental income, medical expenses, etc.

Collecting this information is not without cost. Combined federal and state administrative costs for the food stamp program are about $4 billion – roughly 40 percent of the IRS total budget for a program that serves far fewer units (about 9 million food stamp households compared to 130 million plus returns). Food stamp participation rates are low, with less than half of eligible working households claiming the benefits to which they are entitled.

Finally, to some extent the comparison between the EITC and food stamp error rates can both understate and overstate the differences between the two programs. While both error rates include erroneous payments in the numerator, the denominator for the EITC is the amount claimed while the denominator for food stamps is the amount paid. The EITC error rate would be larger if the denominator was the amount paid, while the food stamp error rate would be smaller if its denominator was the amount claimed.

On the other hand, the IRS may measure erroneous payments (the numerator) more stringently than is done in the food stamp program. In the typical EITC compliance study, every aspect of EITC eligibility is scrutinized. While no one would want to be the subject of a food stamp quality control study, USDA investigators may be less intense than their IRS counterparts. Food stamp quality control manuals make no mention of investigating whether the household actually purchases and prepares meals together. (Some of the state food stamp manuals explicitly state that this is too difficult to measure.) Since 2001, food stamp benefits are not affected by earnings fluctuations over six-month period. To verify self-employment income, quality control examiners often rely on tax returns, which would be the beginning – not the end – of an IRS audit. Testimony of neighbors and friends is accepted in a food stamp interview, while IRS investigators may discount such information.

The food stamp program offers two lessons. More up-front requirements may be a contributory factor in keeping error rates down, but they also increase administrative costs and may lower participation. The other lesson is that some reasonable expectations about what can be administered can be built into compliance measures.

Part II. British Tax-Transfer System

Features of the British Income Tax-Transfer System

The British income tax system offers an interesting contrast to the U.S. income tax system. It is an exact withholding system, in which Inland Revenue attempts to insure that the exact amount of tax liability is withheld so that taxpayers are not required to file returns at the end of the year to obtain refunds or to pay a balance due. Exact withholding systems, like the United Kingdom, typically apply a PAYE ("pay-as-you-earn") tax withholding plan for wage income.

The British system illustrates the important relationship between tax structure and tax administration. Key features of the British tax system include:

- The unit of taxation is the individual.
- There are only three statutory rates applicable to taxable income: 10 percent, 22 percent, and 40 percent. Eighty percent of taxpayers are taxed at the basic rate.
- Separate rates apply to interest and dividend income, but taxes on these items are withheld at the source.
- Some capital gains income is exempt from taxation.
- The British system has fewer itemized deductions, and the manner in which taxpayers claim these deductions differs. For example, taxpayers may reduce the amount of their payments to charitable organizations by the tax benefit, leaving it up to the charity to collect their donations from Inland Revenue.

About two-thirds of British taxpayers are able to avoid filing tax returns. Those who are required to file include taxpayers with significant amounts of asset income and/or capital gains. Taxpayers with self-employment income are also required to file returns.

Relative to the U.S. income tax system, the British tax system does little to differentiate among taxpayers based on family needs. Until recently, there were allowances for married individuals and single parents – similar in concept to our standard deductions for married couples and heads of households – but there was no differential rate treatment based on marital status or deductions and credits for children.[9]

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[9] Married couples were entitled to a "married couple" allowance. In 1999, the amount was equal to 1,970 pounds ($3,140) if both spouses are under 65. For all eligible taxpayers, the value of the allowance is equal

Instead, the British provided assistance to families with children, particularly low-income working families, through the social security system. Since 1977, the linchpin of this assistance network was the child benefit, available to all families with children, regardless of their income or assets. The universal child benefit was supplemented by other assistance programs, including benefits for low-income working families. In 1971 (four years before the enactment in the United States of the EITC), the U.K. introduced the Family Income Supplement (FIS), which provided an earnings supplement for families with at least one full-time worker. In 1988, the FIS was expanded and renamed the Family Credit (FC).

Since coming into office in 1997, the Blair Government has implemented major reforms to tax, transfer, and regulatory systems. Many of these reforms were motivated by goals that should sound familiar to U.S. policymakers: making work pay and helping families with children, particularly those most in need. As part of these reforms, a minimum wage was implemented, and benefits for families with children – particularly low-wage workers -- were expanded. Particularly noteworthy was the increasing reliance on the tax system to provide these benefits. The reforms to the tax system have occurred in two phases.

In the first phase, the Labour government shifted administrative responsibility for some assistance programs to Inland Revenue. In 1999, the United Kingdom replaced the FC with the Working Family Tax Credit (WFTC). Like the FC, the WFTC is based on the couple's combined earnings, the number of hours worked, and the number of children in the family. By reducing the credit's phase-out rate, more families became eligible for the WFTC. And responsibility for the administration of the credit was shifted from the Department of Social Security to Inland Revenue. WFTC claimants, however, were not required to file an end-of-year tax return. Instead, claimants were sent a form (similar to the application form that had been used for the FC) directly to Inland Revenue with information on family composition, family income, and assets. Inland Revenue then instructed the worker's employer to add the appropriate amount to the worker's regular

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to 10 percent of 1,970 pounds. The couple could elect to divide the married couple allowance between them equally or to allocate it wholly to either spouse. Except for taxpayers aged 65 or older, the married couple allowance was repealed after April 2000. Unmarried individuals who live with a child under age 18 were entitled to an additional personal allowance equal to the married couple allowance. This additional personal allowance was also repealed after April 2000.

pay check. Self-employed individuals received the credit directly from the Tax Credit Office.

Over the next several years, other tax credits were added to the British tax system. Notably, the allowances for married couples and single parents were repealed and replaced with a new nonrefundable Children's Tax Credit in April 2001. The Children's Tax Credit was a nonrefundable credit equal to 520 pounds for each child under the age of 16.

The British experience in the first phase of reform made their tax system increasingly like the U.S. Targeted tax credits were available to families with children that depended, to some degree, on the combined income of the child's parents. And like the U.S. experience, the British tax credits based eligibility on similar, but subtly different, criteria. As Table 6 demonstrates, the two credits had different definitions of children and income.

Even as the children's tax credit was being implemented, the British government was laying the groundwork for the next phase of reforms. In 2000, the U.K. Treasury Department announced that further reform was necessitated by the earlier reforms. According to the British Treasury:

> Using one system to achieve two objectives – in the case of the Working Families' Tax Credit, better work incentives and increased family support – can give rise to tensions. At the same time, using several different instruments to contribute towards a single goal – increased family support in Income Support, the Working Families Tax Credit and the Children's Tax Credit can mean a duplication of effort (2000, pg. 22).

Thus, the British proposed to separate the child support and work incentives functions of the various tax credits. In April 2003, the WFTC, disabled person's tax credit, and children tax credit were replaced by two credits: the Child Tax Credit and the Working Tax Credit. Both are refundable tax credits and use the same definition and unit of income. Neither credit has an assets test. However, eligibility for the Child Tax Credit does not depend on work status, and eligibility for the WTC is not limited to workers with children. Table 7 describes the eligibility criteria for the CTC and WTC.

While the CTC is available to nonworkers and the WTC is available only to workers (including those without children), a common application is used to apply for either credit. The individual (and his or her partner) must provide address, date of birth, and national insurance number, as well as their children's names and the family's child benefit reference number. The application also asks about child care expenses, hours worked, and income. So, in many respects, the credit application looks like a U.S. income tax return. But after the first year, the applicant does not need to complete another application. He or she can look at their record on-line and notify Inland Revenue of any changes in family and financial circumstances.

The other difference is the payment method. The credits are not paid in one lump sum. Rather, they are paid in weekly or monthly increments throughout the year. The WTC is paid through the employer (who subtracts credit payments from tax payments), while the child tax credit is paid to a bank or building society account. Further, the credits are effectively paid in advance and based on prior year's income. Should there be a change in circumstances (including an increase of income in excess of 2,500 pounds), credit recipients may have to repay the excess to Inland Revenue at the end of the year.

The second phase of reform was marked by two other shifts in administrative responsibilities. First, the consolidation of child-related benefits does not end at the tax system. When fully implemented this year, the child tax credit will also include amounts for children previously paid in Income Support (including the Minimum Income Guarantee) and income-based Jobseeker's Allowance. This change – combined with the fact that the refundable child tax credit is not tied to earnings – means that individuals who typically do not have contact with Inland Revenue are being brought into the tax system solely to obtain refundable tax credits. The initial plan is to have information collected by the agencies that these individuals would typically deal with. The information would then be forwarded to Inland Revenue, who would then dispense checks to the eligible individuals.

The second event was that administration of the universal Child Benefit was shifted from the Social Security administration to Inland Revenue. However, the Child Benefit has not been reclassified as a tax credit. The application process for the Child

Benefit remains separate from that of the targeted Child Tax Credit. To apply for the Child Benefit, applicants must provide the child's birth or adoption certificate.

Arguments for and against using the British tax system to deliver targeted benefits

Reforms since 1997 have made the British tax system – at least with respect to working families and children – look more like the U.S. income tax system. However, there is a key difference between the two countries because most EITC claimants are required to file a tax return, while most U.K. tax credits recipients are not. In the United Kingdom, the working parent had contact with both Department of Social Security (in order to apply for the non-means tested child benefit) and Inland Revenue (to supply information necessary to determine the correct PAYE rate), but he or she would not normally provide either agency with all of the information (such as total family income or assets) necessary to determine eligibility for the CTC if the credit did not exist. Thus, a major advantage of administering subsidies through the tax system -- an application for benefits that follows directly from an activity that the worker must undertake anyway -- is not present in the U.K. system.

In both the first and second phases of reform, the Labour government has offered several reasons for using the tax system to deliver targeted benefits. One argument is that shifting the FC (and later other expenditure programs) into the tax system would allow for better integration of the tax and transfer system by simplifying and streamlining the administration of various programs. Closer coordination of tax and transfer policies would also focus attention on high marginal tax rates; in both phases, reforms have been accompanied with expansions of assistance to families, thus reducing the marginal tax rates on lower income families (while increasing them on families higher up the income scale who previously were ineligible for such benefits). (Taylor, 1998, U.K. HM Treasury, 2000, Brewer et al, 2001, Brewer et al, 2003) Further, with the most recent consolidation of credits, the patchwork of eligibility rules that characterized the first phase has been replaced with simpler uniform rules. These arguments make a compelling case for consolidation of assistance programs, but they could support placement of the new credits in either the tax or transfer system.

There are several other arguments – some made by the Labour government, some not – in support of using the system to provide targeted assistance. First, payment of the WTC builds on the PAYE system, in which taxes are withheld by the employer. The WTC operates as a reverse-PAYE in a manner similar to the EITC advance payment option. As with the advance payment option, the worker must repay any amount that is overpaid during the year, but the British limit the risk of repayments by ignoring income fluctuations less than 2,500 pounds. Paying the credit through the paycheck was viewed as important to reinforce the distinction between the "rewards of work and remaining on welfare" (Taylor, 1998).

A second consideration was stigma. Administering benefits through the tax system, rather than the welfare system, was expected to reduce the stigma associated with claiming the FC and thus lead to an increase in program participation. From an outsider's perspective, the amount of attention paid to stigma concerns in the United Kingdom is interesting. The application process for the FC was not very different from that now being used for the WTC and child tax credit. Unlike U.S. transfer programs run by welfare agencies, low-income families did not have to go to a state office to apply for the FC but instead could deal with the Department of Social Security through the mail.

The evidence is mixed as to whether the shift to the tax system has reduce stigma and increased participation among those eligible for the credits. In 2000-01, 62 to 65 percent of eligible families received the WFTC. In contrast, about 66 to 70 percent of families eligible for the FC received it in 1998-99 – the last year of the FC's existence. However, among WFTC recipients who would have been eligible for FC under its more restrictive income requirements, participation rates were higher – about 75 to 81 percent of those eligible for WFTC received it. (U.K. Inland Revenue, 2002) The higher participation rates among those who were eligible under both credits might be attributable to a reduction in stigma – but it also might result from the increased credit amounts.

A tax credit was thought to be politically more acceptable than social security benefits to most claimants and taxpayers as a whole. The Taylor report concluded that operating the FC through the tax system "would ensure greater acceptability to both the claimants and taxpayers." The report went on to note, "It is noticeable that the US

Administration has secured widespread political support for the EITC at a time when the US welfare budget more generally has been under remorseless attack."

There is one argument that could have been made in defense of the shifting responsibilities, but is not. Inland Revenue is presumably in a better position to verify eligibility for targeted benefits because of the amount of information on income reported to Inland Revenue in an exact withholding system. What was lacking in the British system (as in the U.S. income tax system) was independent information on family relationships. This shortfall was partly rectified by the transfer of administration of child benefit to Inland Revenue. With this new responsibility presumably came access to data file containing names of parents linked to their children and authenticated by receipt, at application, with the child's birth or adoption certificate. Because applicants for the Child Tax Credit must provide both their National Insurance number and a child benefit reference number, Inland Revenue has the capability to link data from the two programs in order to verify claims. In effect, Inland Revenue – through the universal Child Benefit – gained access to the counterpart of Kidlink in the United States, without having to wait a generation for the completion of the file. From an organizational perspective, it may have be easier to shift the existing files on children and parents to Inland Revenue rather than to provide the Department of Social Security with all the income information collected in the tax system. The British experience also raises the question of whether a universal benefit may be a way to obtain data that would not be otherwise easily accessible and which can be used to help target other benefits.

Part III. Conclusions

Providing targeted assistance to low-income individuals through the income tax system may be appropriate under certain circumstances. Under the current tax system in the United States, many low-income working individuals would file income tax returns even if there were no refundable tax credits. Information on their earnings and other income is regularly reported to the IRS. Many of them are either ineligible for needs-based benefits provided by other agencies, or they choose – either because of high transactions costs or concerns with stigma – not to claim those benefits. Thus, for low-

income working individuals, the point of contact with the federal government is often the IRS.

The experience of Great Britain demonstrates that even when these conditions do not hold, policymakers may still find it advantageous to use the tax system as a delivery mechanism. One argument, stated by politicians in the U.K., is political: they (and possibly their U.S. counterparts) find that providing benefits through the tax system is more acceptable than expanding spending programs. But the British experience suggests that there may be other considerations. The British, for example, use their exact withholding system in reverse to pay work-related tax credits to workers in a timely fashion. Concern that the stigma of applying for benefits through a "welfare" agency may cut participation also motivates interest in using the tax system. And possibly the most obvious argument in support of using the tax system to provide targeted benefits is the one seldom mentioned: the income tax system in the United Kingdom, as in the United States, has the best access to information on income.

Yet as the U.S. experience demonstrates, operating targeted benefit programs through the tax system is fraught with difficulties. Key among them is the fact that the tax system lacks complete data on family composition and needs. Limited resources, relative to other priorities, may limit the IRS's ability to prevent payments of questionable claims. As a result, noncompliance may be higher than in spending programs that rely on more labor-intensive (and more expensive) enforcement techniques.

Reducing noncompliance among EITC claimants remains one of the biggest challenges for the IRS. This year, the IRS is piloting a small program in which 25,000 EITC claimants were asked to provide documentation at the time they filed their tax return demonstrating that they resided with their qualifying children for the required length of time. Without ceding control of the tax credit, the IRS is instead testing the adoption of one of the practices used commonly by other agencies in the administration of targeted benefits. This pilot will be carefully evaluated, to determine the effect of the additional documentation requirement on both compliance and participation.

The British experience also suggests that much simplification can be achieved by consolidating assistance programs. In the United States, several analysts have suggested

that child-related tax benefits could be consolidated into one tax credit (Ellwood and Liebman, 2001, Sawicky and Cherry, 2001, Carasso, Rohaly, and Steuerle, 2003). In recent years, the Department of the Treasury has made a number of proposals that would simplify the current targeting rules for the EITC and the additional child tax credit. Some of these proposals conform the eligibility rules for the EITC and the additional child tax credit more closely: by, for example, defining a child and earned income in the same way and by eliminating the EITC investment test. These proposals also lay the groundwork to someday consider the consolidation of the two credits.

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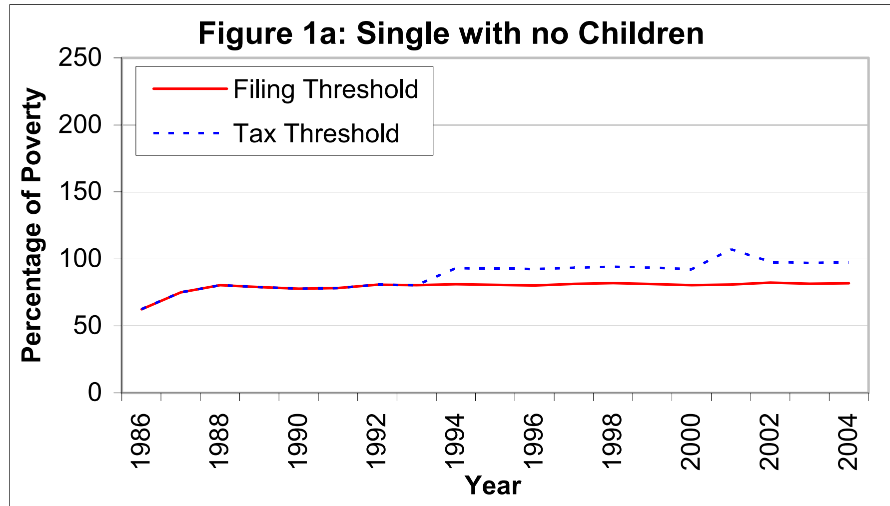
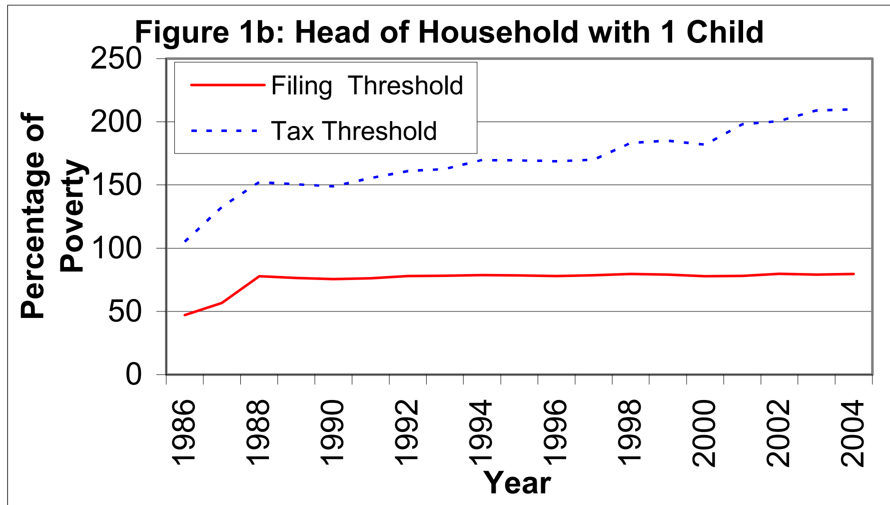
Table 1
Costs of Refundable Tax Credits
Millions

Tax Credit	Fiscal Years						
	2003	2004	2005	2006	2007	2008	2009
Earned Income Tax Credit (EITC)							
Receipts	5,099	4,884	5,006	5,477	5,515	5,603	5,780
Outlays	31,961	33,551	34,148	34,488	34,388	34,539	35,161
Total	37,060	38,435	39,154	39,965	39,903	40,142	40,941
Child Tax Credit							
Receipts	37,970	24,340	29,860	24,810	24,680	24,480	25,430
Outlays (Additional Child Tax Credit)	6,435	7,447	11,486	8,440	8,237	7,956	7,909
Total	44,405	31,787	41,346	33,250	32,917	32,436	33,339
Health Coverage Tax Credit (HCTC)							
Receipts	-	50	60	60	70	70	80
Outlays	-	60	90	100	120	130	140
Total	-	110	150	160	190	200	220

Source: U.S. Office of Management and Budget (2004). Table 18-2.

Figure 1: Filing and Tax Thresholds Relative to Poverty Threshold





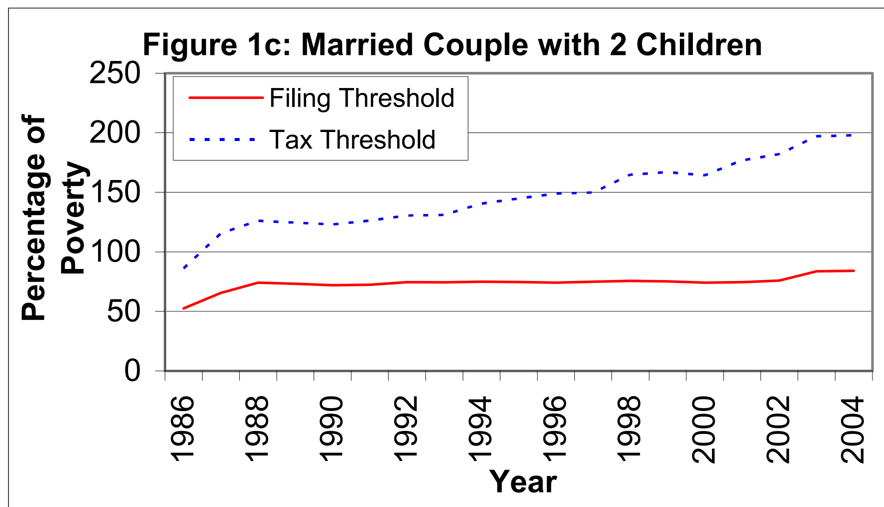


Table 3
Overlap Between EITC and Transfer System in 2000

Transfer	% of EITC-Eligible Filing Units Reporting Receipt of Transfers
Temporary Assistance for Needy Families (TANF)	5
Supplemental Security Income (SSI)	3
Food Stamps	16
Medicaid	17
Any of Above	24

Source: Author's calculations based on March 2001 Current Population Survey.

Table 4:
Comparison of EITC and Additional Child Tax Credit in 2004

Eligibility Criteria	EITC	Additional Child Tax Credit
Income Tests		
1. Earnings	Yes	Yes
Minimum amount	No minimum	Greater than $10,750
Maximum amount	$35,458 (if married with two children)	No maximum
Definition	Sum of wages, salaries, tips, other taxable employee compensation, self-employment income	Same as EITC except earned income must be included in computing taxable income
2. Adjusted gross income	Yes	Yes
Maximum amount	$35,458 (if married with two children)	$150,000 (if married with two children)
Definition	Same as AGI for regular tax	Modified to include amounts earned abroad or in certain possession.
3. Investment income	Yes	No
Maximum amount	$2,650	N.A.
Definition	Sum of interest (including tax-exempt), dividends, capital gains, rents, royalties, and certain passive income	N.A.
Family Status		
1. Children	Affects size of credit	Must have to qualify
Number	Two	No limit
Age	Under 19 Under 24 if full-time student No age-cut if disabled	Under 17
Relationship	Son, daughter, grandchild Sibling, niece or nephew if cared for as if taxpayer's own Foster child if cared for as if taxpayer's own	Same as EITC
Residency	More than six months	Residency test applies only to foster children, who must reside with taxpayer for 12 months
Support	No support requirement.	Must provide over half child's support
2. Marital status		
Unmarried	Yes	Yes
Married	Must file jointly	No restrictions

Table 5
EITC Overclaims by Type of Error
1999

Error	Amount of Overclaim ($ in millions)[1]
Family Issues	
Qualifying Child	3,284
Residency	2,698
Relationship	1,447
SSN Not Valid for Employment	421
Age	206
Filing Status	2,724
AGI Tiebreaker	1,984
Income	1,710
Underreported Income	1,494
Business Income	854
Other Income	640
Earned Income Overreported	171
Income Recategorized (Total Unchanged)	45
Other Errors	437
Errors Corrected in Processing	939
Did Not Appear for Audit	2,226
Total	11,118

Source: Holtzblat and McCubbin, 2004.

[1] Sum of this column exceeds total because returns with more than one error appear in more than one row.

Table 6:
Comparison of EITC and Food Stamps in 2004

Eligibility Criteria Income and Asset Tests	**EITC**	**Food Stamps**
1. Earnings	Yes	No
Minimum amount	No minimum	No minimum
Maximum amount	$35,458 (if married with two children)	Benefits reduced by 30% of earnings
Definition	Sum of wages, salaries, tips, other taxable employee compensation, self-employment income	
2. Gross income	Yes	Yes
Maximum amount	$35,458 (if married with two children)	$23,928 (for a family of four)
Definition	Adjusted gross income	Sum of
3. Investment	Income test	Asset test
Maximum amount	$2,650	$2,000 ($3,000 if elderly)
Definition	Sum of interest (including tax-exempt), dividends, capital gains, rents, royalties, and certain passive income	Sum of cash on hand, bank accounts, stocks, bonds, IRA and Keogh plans. Some less liquid assets (autos) counted.
Household composition	**None**	**Prepare and purchase meals together.**
1. Children	Affects size of credit	Affects size of benefits
Number	Two	No limit
Age	Under 19 Under 24 if full-time student No age-cut if disabled	Under 18 or 21 if applicant's child
Relationship	Son, daughter, grandchild Sibling, niece or nephew if cared for as if taxpayer's own Foster child if cared for as if taxpayer's own	Minors in parental care under 18 Own child if under 21
Residency	More than six months	Part of household unit while benefits are paid
Support	No support requirement.	No support requirement
2. Marital status		
Unmarried	Yes	Yes
Married	Must file jointly	No restrictions

Table 7:
Comparison of Working Family Tax Credit (WFTC) and Children Tax Credit

Eligibility Criteria	WFTC	Children's Tax Credit
Refundable	Yes	No
Income and Asset Tests		
1. Earnings	Yes	No
Minimum amount	No minimum but must work at least 16 hours a week	Not applicable
Definition	Sum of wages, salaries, tips, housing allowances, self-employment income. Net of taxes (including children's tax credit), National Insurance contributions, and one-half pension contributions.	Not applicable
2. Income	Yes	Yes
Definition	Couple's combined cash income after taxes.	Gross income. Phases out on higher earner's income if he or she is in higher tax rate bracket
3. Assets	Yes	No
Maximum amount	8,000 pounds	Not applicable
Family Status		
1. Children	Must have to qualify	Must have to qualify
Number	No limit	No limit
Age	Under 16 (when) Under 19 if full-time student	Under 16 at start of tax year
Relationship	Not applicable.	Own child (including adopted and step) or a child supported by taxpayer
Residency	Child must reside with claimant as member of family.	Child must live with taxpayer for some part of tax year.
Support	No support requirement.	Applicable if child is not taxpayer's own
2. Marital status		
Unmarried	If living alone, file separately; if cohabiting with partner, file jointly.	Same as WFTC
Married	Must file jointly	Same as WFTC

Table 8:
Description of Child and Working Tax Credits

Common eligibility rules

1. Claimant must be at least 16 years old and normally living in the United Kingdom.
2. Eligibility is based on gross income. If the individual is married or cohabiting, then eligibility is based on the couple's gross income.
3. Credits are initially based on prior year's income. If income during tax year exceeds prior year's income by £2,500, the recipient will have to repay a portion or all of the credit.

Child Tax Credit

Who is eligible? To be eligible for the child tax credit, an individual (or the couple, if married or cohabiting) must be responsible for one or more qualifying children. In 2003-04, eligibility extended to families with incomes of to £58,000 a year.
Definition of child. Children must be under the age of 16 or 19 if a full-time student. The applicant must be responsible for the child. Deciding who has the main responsibility for the child is based on facts and circumstances, such as the child's residency with the applicant.
Amount of credit. The child tax credit consists of two basic components: the family element (one per family) and the child element (one per each child). In 2003-04, the maximum amounts of the family and child elements were, respectively, £545 per family and £1,445 per child. The family element is doubled for families with children under the age of one. There are also supplements to the child element for disabled children.
Phase-out. In 2003-04, families with annual gross income below £13,230 were entitled to the full credit. The child elements were phased-out for incomes above £13,230, so that a family with one child and £17,135 would receive only the family element. The family element is phase-out between £50,000 and £58,134 (£66,269 if the family has a child under the age of one).

Working Tax Credit

Who is eligible? Working Tax Credit is for people who are employed or self-employed (either on their own or in partnerships), who usually work 16 hours or more a week, are paid for that work, and expect to work for at least 4 weeks. Applicants must work at least 16 hours a week. Applicants must be at least 16 years old and either is responsible for at least one child or is disabled. Able-bodied workers without children are eligible if they are at least 25 years old and work a minimum of 30 hours a week.
Amount of credit: In 2003-04, the maximum credit was £1,525 for unmarried individuals without children and £3,025 for couples (with or without children) and single parents. Workers with children who work 30 or more hours a week were entitled to an additional £620. There were also supplemental amounts for if workers incurred child care expenses, were disabled, or were over 50 and reentrants into the workforce.
Phase-out. Applicants with annual gross income below £5,060 were entitled to the full amount. As income exceeds £5,060, the credit is phased-out. The credit was reduced to zero at £10,857 for single workers without children and income about £10,857, at £13,237 for part-time workers with children, and £14,911 for full-time workers with children.