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The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit, 1969–99

Abstract - *This paper uses the political history and pre-history of the EITC to describe how the politics of welfare reform influence tax policies that function as social policy. It suggests that the economic tradeoffs inherent in the formulation of tax-transfer programs are also political tradeoffs. It examines policy choices between costs and labor supply incentives, as well as those between ease of participation and compliance rates. This paper concludes that although economic analysis influenced the creation and development of the EITC, political factors, not economics, animated the history of the program.*

INTRODUCTION

Over the course of the last 30 years, tax expenditures have become increasingly visible components of the U.S. tax-transfer system. Although they do not require annual review by the appropriations process, they are subject nevertheless to the whims of politics and national mood.¹ The Earned Income Tax Credit (EITC) is a case in point. Enacted in 1975 as a refundable tax offset for low-income workers, the EITC appeared to politicians an attractive, work-oriented alternative to existing welfare programs. It was both an anti-poverty and anti-welfare instrument. It complemented national concerns over welfare caseloads, unemployment rates, and the working poor. By the 1990s, the same political forces

¹ Political scientist Christopher Howard (1997) has argued that tax expenditures slip through the policymaking process; they are, he concludes, the result of surreptitious and undemocratic policymaking. Perhaps the complexities of the Internal Revenue Code influence some politicians to cede authority on tax issues to the tax-writing committees. But Howard's view of tax expenditures is more true of the tax policymaking process 30 or 40 years ago, than of recent tax expenditure history. Indeed, since at least the mid-1970s when Congress began requiring the Treasury Department to produce an annual list of tax expenditures, politicians have examined tax expenditures alongside direct expenditures. Many direct expenditure programs are no less technical or confusing than tax expenditures. And politicians understand perfectly well the distributive features of tax programs. With the tax expenditure budget approaching \$700 billion for 1999, politicians cannot afford to ignore its economic and social influences. Therefore, I agree with John Witte that "it seems unlikely" that tax expenditures "are enacted or modified without full congressional knowledge of the intent and effects of the legislators" (Witte, 1985, p. 335).

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that had nurtured the EITC threatened to eliminate it. The EITC was now part of the problem; it had begun to look more like a welfare subsidy (replete with work disincentives, poor targeting, and high costs), and less like a tax offset. It had become simply another federal handout, a welfare program administered through the tax system.²

This paper describes the “collision” of tax and welfare politics. It examines the political history of the EITC to show how the politics of welfare reform influence tax policies that function as social policy. It explains the creation and development of the EITC in relation to a welfare reform consensus that emphasized pro-work, pro-growth, low-cost policies. This paper also uses the EITC to show how economic tradeoffs inherent in the formulation of tax-transfer programs are also political tradeoffs. It examines policy choices between costs and labor supply incentives (or targeting and labor supply disincentives), as well as those between ease of participation and compliance rates. Thus, it highlights a fundamental social policy conundrum of the last 30 years; that is, whether to favor programs with high budgetary costs (i.e., high break-even points), less-targeted benefits, and small marginal labor supply disincentives, or those with low budgetary costs (i.e., low break-even points), more-targeted benefits, and large marginal labor supply disincentives. This study places the dilemma in historical context, illuminating the relationship between technical policy options and the political process.

The first section of the paper describes the intellectual and political heritage of the EITC. It argues that in the early 1970s, Congress viewed the EITC as an alterna-

tive to conventional welfare programs, and in particular, to the negative income tax component of Richard Nixon’s Family Assistance Plan. The second section examines the EITC’s role in President Jimmy Carter’s welfare initiative, the Program for Better Jobs and Income. By early 1977, Carter officials recognized the significant anti-poverty and anti-welfare potential of the EITC. Although Congress did not enact Carter’s welfare proposal, the debates it generated increased both expert and political awareness regarding the functionality of the EITC, and laid the foundation for the bipartisan consensus that expanded the program in 1986. The third section describes the EITC’s phenomenal growth during the 1980s and 1990s. Rising costs, as well as reports that the credit suffered from high error rates, evoked calls for the program’s elimination. The fourth section details both the political and expert debate on the EITC’s labor supply effects and compliance problems. The last section explains how economic analysis interacted with political factors to affect the development of the EITC. It suggests that although economists to some extent became more effective political actors throughout the EITC’s history, their increased effectiveness had more to do with a “meshing” of the political and economic environments (i.e., make work pay) than with their increased appreciation of the “policy game.”

WELFARE DEPENDENCY AND TAX TRANSFERS: THE EARLY YEARS

President Lyndon Johnson’s Great Society identified poverty as the social problem of the 1960s. By contrast, welfare de-

² The Republican *Contract with America* associated the EITC with the old, failed regime of social provision (Gillespie and Schellhas, 1994). Commentators in the popular press voiced similar criticisms, calling it “a program that pays taxpayer dollars to people who don’t even earn enough to be taxpayers” (Roberts, 1993; see also Bovard, 1994). Others went further. They identified the EITC as “the biggest . . . transfer swindle in the history of the nation” (Gross, 1995). Legislators, too, attacked the program. In 1995, Senator Don Nickles (R-OK) called the EITC “the fastest growing, most fraudulent program that we have in Government today” (Nickles, 1995). Such federal largesse, argued Senator William Roth (R-DE) created a tax and transfer system that allowed individuals to make “millions of dollars off [the EITC] by scam” (U.S. Congress, Senate, 1995c, p. 13).

pendency became the social problem of the 1970s.³ While policymakers in the 1960s talked of entitlement-oriented guaranteed annual incomes (GAIs), in the 1970s they debated work-oriented programs. Of course, the dichotomy between the two decades was not this neat; calls for GAIs persisted into the 1970s, for example, and social policies that reinforced work predated the English Poor Laws. Nonetheless, the perceived social crises of the two decades were distinct.

The debates surrounding President Nixon's Family Assistance Plan (FAP) illuminate this distinction. They represent a transitional period between the perceived social ills of poverty on the one hand and welfare dependency on the other. Moreover, the political discussions of Nixon's welfare initiative highlight trade-offs in tax-transfer programs that not only doomed FAP, but also engaged policymakers for the next 30 years. The fight over FAP alerted politicians to how the tax system could alleviate or, conversely, perpetuate social problems. It also spawned alternative tax-transfer proposals, including the EITC.

A Developing Intellectual Vanguard

The United States "rediscovered" poverty in the early 1960s.⁴ Once exposed, the federal government addressed itself to the elimination of what many considered a

poverty epidemic. Social policy experts attempted to fill the "poverty gap." Defined as the income deficiency between a family's income level and a specified poverty level, the poverty gap informed social policy discussions in the early 1960s.⁵ Prompted by President Johnson's declaration of war on poverty in 1964, social policymakers set about formulating various anti-poverty schemes.

These formulations, Johnson declared, would not dole out cash grants. "The majority of the Nation," the President argued in his 1964 Economic Report, "could simply tax themselves enough to provide the necessary income supplements to their less fortunate citizens . . . But this 'solution,'" he continued, "would leave untouched most of the roots of poverty. It will be far better, even if more difficult to equip and permit the poor of the Nation to produce and earn the additional" money required to escape from poverty (Council of Economic Advisors, 1964). Johnson's emphasis on work-oriented programs was rooted in an historical, national aversion to federal handouts. The anti-welfare, pro-work sentiment pervaded the national culture. It emphasized work over dependency, distinguishing between poverty (which was seen as a temporary condition of the working poor and a permanent condition of the disabled and aged) and welfare dependency (which was seen as a pathological and voluntary condition of the indolent).⁶

³ Alice O'Connor has written, "Welfare, not poverty, was the social problem of the 1970s" (O'Connor, 1998, p. 99).

⁴ Historians have identified several studies from the late 1950s and early 1960s that spurred this "rediscovery" of poverty, particularly John Kenneth Galbraith's *The Affluent Society* (1958) and Michael Harrington's *The Other America* (1962). See Brauer (1982, p. 103) and Matusow (1984, p. 119). Although historians correctly identify the importance of these studies, they overlook earlier work on poverty and income distribution, which laid the foundation for later "rediscoveries" of poverty. See Lampman (1954, 1957), Goldsmith (1957), and Lydall and Lansing (1959).

⁵ According to Robert Lampman, the University of Wisconsin economist who animated the modern war on poverty, the aggregate poverty gap in 1963 reached \$12 billion. Robert J. Lampman, "Negative Rates Income Taxation," U.S. Treasury Department, Records of the Office of Tax Analysis (hereafter cited as "OTA"), Record Group 59, Box 53. The OTA estimated in late 1964 that the poverty gap had climbed to \$16 billion. OTA, "Social Security, Financing, Taxation and Welfare, and Income Maintenance," p. 10, August 10, 1964, OTA, Box 41. Filling the poverty gap remained a goal of social policymakers throughout the 1960s. See, for example, Brookings Research Report, "Using Negative Taxes to Narrow the Poverty Gap," 1967, OTA, Box 53.

⁶ For more on the moral perceptions of poverty, see Katz (1986, 1989), Handler and Hasenfeld (1991), Hirschman (1991), and Fraser and Gordon (1994).

Put simply, it conflated social policy with morality. This national consensus, moreover, persisted across time. In 1937, for instance, with the nation immersed in a protracted depression and with millions of Americans without jobs, public opinion favored “work relief” over “cash relief” by a nine-to-one margin (Gallup, vol. 1, 1972, p. 84). A year later, in 1938, as the economy underwent what F.D.R. euphemistically termed a “recession,” 68 percent of respondents opposed paying unemployed citizens “script money” (Gallup, vol. 1, 1972, p. 124). Even in the hardest of times, Americans supported work- over cash-relief programs.

Imbued with this pro-work sentiment, the Johnson administration removed obstacles that prevented individuals from attaining self-sufficiency. Policymakers soon identified the tax system as one of those impediments. In 1965, Joseph Pechman, Senior Fellow at the Brookings Institution and consultant to the Treasury Department throughout the 1960s, observed that “[t]he government has launched a program to alleviate poverty. In such a situation,” he reasoned, “it is clearly undesirable to maintain a tax system that subjects the ‘poor’ as officially defined to taxes.”⁷ Rather than perpetuate the poverty cycle, the tax system could

be a useful “device” in removing individuals from poverty, and in keeping them from turning to welfare.⁸

Fiddling with the tax system in the traditional manner (reducing positive tax rates or raising personal exemptions) would not help low-income individuals whose federal income tax bill was already zero. Reformers needed to alter the tax law to pay out benefits directly. Enter the negative income tax (NIT). By applying negative rates to unused exemptions and deductions—as the early proposals suggested—or by applying a negative rates per capita credit—a structure later plans employed—a negative income tax could close, and even eliminate, the poverty gap.⁹ By running the program from the tax system, moreover, an NIT could improve on existing welfare services. First, it reduced administrative costs by displacing most social workers, which, in turn, complemented the prevailing notion among experts that poverty had more to do with deficiencies in income than character.¹⁰ Second, an NIT improved horizontal equity on the transfer side of the tax-transfer system; that is, it equalized state differences in benefit levels by providing a national, federally subsidized payment.¹¹ Third, and perhaps most important, an NIT also encouraged individuals

⁷ Joseph Pechman to Stanley Surrey, October 13, 1965, p. 3, OTA, Box 53. Stanley Surrey, Assistant Secretary of the Treasury for Tax Policy from 1961–9, perceived the same kind of illogic regarding tax policies in 1965. “At the present moment we are considering easing the income tax on low income groups,” Surrey observed. “However at the same time we are increasing payroll taxes under Social Security. And thus in this sense we are working in contradictory directions.” Surrey to the Secretary, July 25, 1965, The Stanley S. Surrey Papers, Harvard Law School Library, (hereafter, “SSP,”) Box 199, Folder 2.

⁸ Stockfisch to Surrey, January 6, 1964, “Administration’s Anti-poverty Campaign,” OTA, Box 7. The Treasury Department investigated the effect of federal and state taxes on the poor. Brannon to Stockfisch, “Tax Relief for Very Low Incomes,” January 16, 1964, OTA, Box 52; Stockfisch to the Secretary of the Treasury, “Effect of Tax Bill on Poverty Income Classes,” January 27, 1964, OTA, Box 7; Surrey to Stockfisch, “Taxes and Poverty,” March 23, 1964, OTA, Box 7; Stockfisch to Mr. Lusk, “Estimating tax liabilities for poverty levels of income,” March 26, 1964, OTA, Box 52; Surrey to Stone and Brannon, “List of Substantive Tax Matters Requiring Consideration,” July 7, 1965, SSP, Box 180, Folder 5; and OTA, “Two-Year Carryforward and Two-Year Carryback of Unused Exemptions and Minimum Standard Deduction,” August 23, 1965, OTA, Box 53.

⁹ “Negative Tax,” September 1, 1964, Treasury discussion paper for Income Maintenance Task Force Meeting, OTA, Box 53; “Negative Tax Systems: Report of Technical Working Committee, Task Force on Income Maintenance,” September 14, 1965, prepared by the Staffs of the Treasury and the Council of Economic Advisors, OTA, Box 41.

¹⁰ For social science expertise in the 1960s, see O’Connor (forthcoming).

¹¹ I am indebted to one of the referees from the Russell Sage Foundation Press for this observation.

once out of poverty to earn their way toward self-sufficiency. Traditional welfare programs imposed 100 percent marginal tax rates on earnings. An NIT, on the other hand, could avoid these prohibitive work disincentives by using fractional marginal rates, thereby “ensur[ing] that those who work will not remain in poverty.”¹² Due to these myriad benefits, President Johnson’s Office of Economic Opportunity (OEO) made the negative income tax the capstone in its ambitious 1966 anti-poverty program, which promised to “finish the job of ending poverty by the end of 1976.”¹³

As NIT plans proliferated, and as they became more costly, critics associated them with a guaranteed annual income. By most accounts, GAIs provided benefits “as a matter of right” with constitutional guarantees.¹⁴ They resembled “social dividend” plans, contemporaneously under consideration in Britain, that placed an income floor under every family, again, as a matter of right (Rhys-Williams, 1943, 1953). Neither GAIs nor social dividend plans contained phase out rates. And although both plans proposed to close all

or most of the poverty gap, they were prohibitively expensive;¹⁵ worse, they seemed to take the form of a demeaning dole.

Milton Friedman, whose articulation of a negative income tax in 1962 made it a viable policy option, feared the confusion between an NIT and existing GAI plans.¹⁶ He argued that the use of fractional tax rates distinguished negative income taxation not only from guaranteed incomes, but also from conventional welfare programs. Friedman’s NIT utilized a 50 percent phase out rate, substantially lower than the Aid to Families with Dependent Children (AFDC)’s 100 percent rate. Friedman also showed that the marginal rates in an NIT could be graduated to preserve work incentives even further. In fact, the parameters of an NIT could be set so differently from the parameters of a GAI that Friedman publicly denounced the connection between an NIT and “superficially similar but basically very different guaranteed minimum income plan[s].” According to Friedman, the existing “grab bag of relief and welfare measures,” not an NIT, amounted to a “government guaranteed annual income.”¹⁷

¹² OTA, “An Explanation of a Negative Income Tax,” February 9, 1967, OTA, Box 52; Lampman, “Negative Rates Income Taxation,” OTA, Box 53.

¹³ Office of Economic Opportunity, “Program Memorandum on Income Maintenance, FY 1968–72,” June 1966, OTA, p. 1, Box 53. The OEO also produced a separate report discussing the implementation of a negative income tax. OTA, “Office of Economic Opportunity Program for a Negative Income Tax,” July 28, 1966, OTA, Box 53. For reaction to the OEO’s plan, see Tobin (1967).

¹⁴ For NIT benefits “as a matter of right,” see Education, Manpower, and Science Division (Bureau of the Budget) to Charles J. Zwick, “The Income Maintenance System,” October 17, 1966, OTA, Box 52. For a constitutional right to a federally guaranteed livelihood, see Schwartz (1964); “Report of the Task Force on Income Maintenance: Summary and Recommendations,” September 18, 1965, OTA, Box 41; and OTA, “An Explanation of a Negative Income Tax,” February 9, 1967, OTA, Box 52. For a slightly different variant of an NIT as a guaranteed annual income for unemployed workers displaced by technological gains, see Theobald (1963, pp. 155–6).

¹⁵ Social dividend plans after the British models would have cost well over \$50 billion. By contrast, negative income tax schemes designed to close the poverty gap in the United States cost much less, ranging from \$3 to 15 billion.

¹⁶ Friedman (1962). For the development of the negative income tax concept, see Green (1967), Lenkowsky (1986), and Ventry (1997).

¹⁷ Friedman, “The Case for a Negative Income Tax: A View from the Right,” speech given at Chamber of Commerce, National Symposium on Guaranteed Income, Washington, D.C., December 9, 1966, The Milton Friedman Papers, The Hoover Institution Library, Box 49, p. 1. Although other supporters of negative income taxation were also careful to emphasize the differences between an NIT and a guaranteed annual income, the distinction between the two policy options was less real than political. “[P]roperly stated,” Friedman has written, an NIT and a guaranteed annual income “are identical. At least they can be made to be identical if the proper parameters are chosen. For every guaranteed income plus tax structure, there is an identically equivalent negative income tax and vice versa.” Milton Friedman to Dennis Ventry, December 3, 1996, personal correspondence.

Despite Friedman's efforts, many observers continued to associate an NIT with a GAI. President Johnson, for one, did not perceive the distinctions between the two policy instruments as parameterized by NIT advocates within his administration. In Johnson's eyes, both an NIT and a GAI amounted to a cash benefit, and thus, a work disincentive. He opposed the OEO's NIT proposal, for example, on the grounds that it undermined the self help principles of his War on Poverty (Moynihan, 1973, p. 131). He preferred more explicit pro-work, rehabilitative policies. The legislative foundation of Johnson's Great Society, the Economic Opportunity Act of 1964, contained six parts, each of which "reaffirmed the central and traditional objective of extending opportunities for individual initiative;" they provided a hand up, not a handout (Davies, 1996, p. 34). Johnson opposed cash supplements in any form, and preferred "opening to everyone the opportunity for education and training, [and] the opportunity to work" (Economic Opportunity Act of 1964, p. 377).

The American people also favored work over income programs. In a 1966 Gallup Poll, 67 percent of respondents opposed a "guaranteed minimum annual income" (Gallup, vol. 3, 1972, p. 1965). By 1968, public opinion had warmed slightly to a GAI; 36 percent favored and 58 percent opposed a federally guaranteed family income. Tellingly, however, 78 percent of respondents favored guaranteeing a job rather than a cash grant (Gallup, vol. 3, 1972, p. 2133). Poverty may have been the social crisis of the 1960s, but avoiding dependency on the government remained a top priority for Americans and their elected officials. Who better to continue the pro-work legacy than tough, conservative Richard Nixon?

Politics, Economic Research, and the Family Assistance Plan

President Nixon's Family Assistance Plan, introduced in August 1969, provided a bold alternative to existing public assistance programs. Philosophically, it attempted to strike a balance between "the mutually inconsistent goals of adequate benefit levels and work incentives" (Davies, 1996, p. 214). Its federal minimum cash guarantee, in the form of a negative income tax, would replace the much-maligned AFDC program with a uniform national payment that states could supplement at their discretion. Through the use of an income disregard, fractional phase outs, and a requirement that all recipients either maintain employment or seek work, FAP would keep work disincentives to a minimum.¹⁸ Most important, FAP would reverse the rising welfare rolls. In 1960, before President Johnson deployed his forces for a war on poverty, 3.1 million people received AFDC. By 1969, that number had risen to 6.7 million, and would jump again to 9.0 million by 1970 (Berkowitz, 1991, pp. 116 and 93). Johnson's self help programs failed to curb the swelling welfare rolls, and in fact seemed to fuel a developing welfare "crisis."¹⁹ His war on poverty had amounted to "little more than a modestly financed skirmish;" it was oversold, underfunded, and wrong-headed (Esterly and Esterly, 1971, p. 26). It promised economic opportunity through work, but failed to pave the road to self-sufficiency with income supports or jobs. It was now Nixon's turn. FAP, the new President stated, would address the crisis of welfare dependency with a radical new income strategy that lifted individuals out of poverty and at the same time reinforced the work ethic. His

¹⁸ Income disregards provided an exemption level below which the program's marginal tax rates could not reduce earned income.

¹⁹ For the "failed" war on poverty, see Matusow (1984, pp. 217-71), Patterson (1994, pp. 171-84), and Davies (1996, pp. 219-20). For the welfare "crisis," see Moynihan (1968), "Welfare" (1971a and 1971b), and O'Connor (1998, pp. 101-7).

choice of an NIT, however, would make it difficult for him to sell his proposal as a pro-work measure.

The public responded warmly to FAP. One week after its introduction, Gallup found that of those familiar with FAP, 65 percent favored the plan, 20 percent opposed it, and 15 percent recorded no opinion (Moynihan, 1973, p. 268). Eighty-one percent of the telegrams sent to the White House on the subject expressed support, and 95 percent of newspaper editorials praised the proposal (Small, 1999, p. 188). In an informal White House survey of 400 editorials, Counselor to the President, Daniel Patrick Moynihan, proudly reported, "The merging of a work requirement with a general income scheme was far and away the single most praised aspect of the President's proposal."²⁰

Initially, the FAP enjoyed Congressional enthusiasm, as well.²¹ But opposition formed quickly. Liberals thought the plan inadequate, and demanded higher benefit levels. The Nixon proposal provided a national floor of \$1,600 for a family of four, more generous than existing AFDC benefit levels in almost every state. Liberals made it known they would accept nothing less than \$5,500, a figure originally derived by the National Welfare Rights Organization (NWRO) and its campaign against FAP, "Fifty-five hundred or Fight" (Davies, 1996, p. 223).²² Although the \$5,500 plan was estimated to cost \$71 billion and cover 150 million people, the NWRO increased the proposed benefit to

\$6,500 in 1971, a demand that presidential hopeful George McGovern endorsed.²³ Conservatives, meanwhile, professed shock that a Republican president supported what amounted to "a national guaranteed income arrangement" (Reichley, 1981, p. 144). The Nixon proposal, they argued, contained weak work requirements that made its benefits resemble cash giveaways. The FAP would perpetuate, not abolish, existing work disincentives. Al Ullman (D-OR.) complained to administration officials that the proposal "open[ed] up the Treasury of the United States in a way it has never been opened up" (Burke and Burke, 1974, p. 152). Moreover, FAP would add ten million recipients to the welfare rolls, and cost \$2 billion more than existing public assistance programs (Haveman, 1973, p. 35).

The Nixon administration countered. It argued that the bill's price tag was modest compared to the extravagant alternatives. The President carefully differentiated between the work incentive features of his NIT plan and the disincentives of GAI schemes. "This national floor under incomes for working or dependent families," he emphasized, "is not a 'guaranteed income'" (quoted in O'Connor, 1998, p. 113). Nixon expressly reiterated his proposal's work requirements. "The family assistance plan that I propose increases the incentive to work," he wrote George Bush in 1970.²⁴ It allowed recipients to keep their first \$720 of earnings, above which point it taxed additional earnings

²⁰ Daniel P. Moynihan to Art Klebanoff, September 5, 1969, p. 1, Richard M. Nixon Presidential Materials Staff at Archives II (hereafter "NPM") White House Central Files, Subject: Welfare, Box 61.

²¹ As testament to FAP's early appeal, the House Ways and Means reported it out of committee, 21 to 3, and the full body of the House approved it, 243 to 155 (Small, 1999, p. 188).

²² According to Moynihan, the NWRO plan became "a talisman of advanced liberalism" (Moynihan, 1973, p. 250).

²³ The figures are from Moynihan (1973, p. 247). The original data came from an unnamed study by Charles Schultze and Andrew Brimmer.

²⁴ Nixon to George Bush, October 23, 1970, p. 1, NPM, White House Central Files, Subject: Welfare, Box 21. For similar correspondence, see Robert Finch to Lester Maddox, draft letter for the President, November 30, 1970, NPM, White House Central Files, Subject: Welfare, Box 63. Despite these assurances, the President felt compelled by political pressures to direct his administration to use the term "workfare" when referring to the FAP. Tod R. Hullin to Staff Secretary, July 14, 1971, NPM, White House Central Files, Subject: Welfare, Box 62.

at 50 percent up to a phase out of \$4,000. In comparison to AFDC, which used 67 percent marginal tax rates, FAP boasted more positive work incentives.²⁵ Moreover, FAP required that “every adult in the assisted families register at the employment office for work or training or sign up for vocational rehabilitation if handicapped.”²⁶ The plan also included expanded day care and transportation services so that claimants could more easily get to and from work. Despite these assurances, Nixon found it difficult to mobilize support for FAP among Congressional allies. They ignored FAP’s work requirements, and confused the plan’s NIT component with more liberal income maintenance schemes.

Adding to these difficulties, empirical evidence indicated that FAP did not make work pay. The Senate Finance Committee staff produced tables exposing FAP’s work disincentives. Chairman Russell Long (D-LA) used the data to show that under the administration’s bill, a father in a four person family who earned \$2,000 annually would receive benefits that raised his total annual income to \$2,960. But this amount “is less than what he would get if he were totally unemployed,” Long reported. “In other words, he can increase his family’s income by . . . quitting work entirely” (Moynihan, 1973, p. 465). And indeed, under both AFDC and FAP, an unemployed father with no earnings received \$3,000 in benefits from the federal government. Was the administration’s plan no better than the system it proposed replacing, Long asked?

The White House responded lamely. During Congressional testimony, Senator Herman Talmadge (R-GA) asked Secre-

tary of Health, Education, and Welfare (HEW), Robert Finch, about the effects of FAP. A man “could do a little casual labor on somebody’s yard from time to time,” Talmadge hypothesized, “maybe sell a little heroin or do a little burglary and he would be in pretty good shape, wouldn’t he?” Finch responded, “He would be in about the same shape as under the present program” (Moynihan, 1973, p. 473). In a similar exchange, Long asked Robert Patricelli of HEW the logic behind penalizing individuals for choosing work over welfare: “There is none, Senator,” Patricelli admitted (Moynihan, 1973, p. 481).

Nor did the administration have a response to Senator John Williams (R-DE). In a relentless attack on the labor supply effects of FAP, Williams showed that work did not pay under the Nixon plan. Using data produced by HEW, he demonstrated how FAP exacerbated existing benefit reduction rates.²⁷ When combined with Food Stamps, Social Security taxes, Medicaid payments, public housing subsidies, and federal and state taxes, FAP created an even more perverse system of social provision. Even though it replaced AFDC’s 67 percent phase out rate with a 50 percent rate, its benefits extended much farther up the income scale, and affected individuals not affected by AFDC or other welfare programs, particularly the working poor. It worsened what was referred to as “notch” problems, and it raised cumulative tax rates in the tax-transfer system. Williams belabored these notches. In New York City, he told the Finance Committee, a four person family with no earned income could claim \$7,435 in benefits. If the same family earned \$6,000, its

²⁵ In 1967, Congress had reduced marginal tax rates for the AFDC program as part of that year’s Social Security Amendments. The new “30 and 1/3” rule allowed AFDC recipients to keep the first 30 dollars they earned and one-third of additional earnings without having to count them against AFDC benefits.

²⁶ Nixon to George Bush, October 23, 1970, p. 1, NPM, White House Central Files, Subject: Welfare, Box 21.

²⁷ HEW’s tables depicted the “Combined Benefits and Reduction Rates Under Selected Income-Tested Programs for a 4-Person, Female-Headed Family” in four cities: Phoenix, Arizona; Wilmington, Delaware; Chicago, Illinois; and New York, New York. For the complete tables, see Moynihan (1973, pp. 475-79).

total income would increase by only \$1,750; it faced a marginal tax rate of 70 percent. If it managed to earn an additional \$279, its income would *decrease* \$1,656. In an even more extreme case, a 7 person family with no earned income could claim \$10,207 in benefits. If the same family earned \$8,658, its income would fall \$405 to \$9,802.²⁸

FAP was wounded, but not dead. In February 1970, the Nixon administration produced evidence that FAP would increase work effort among recipients. Beginning in 1968, the University of Wisconsin Institute for Research on Poverty and Mathematica, Inc., under the auspices of the OEO, initiated the first of four income maintenance experiments, the New Jersey Graduated Work Incentive Experiment.²⁹ Like the other studies (Denver–Seattle, Iowa–North Carolina, and Gary, Indiana), the New Jersey experiment tested the influence of income supplements on work, consumption, borrowing, saving, and family stability. It was to be completed by 1972. By 1970, however, the Nixon administration needed data to support its case for a negative income tax. At the request of the OEO, the groups conducting the experiments “broke into” the data. In a report entitled, “Preliminary Results,” they summarized the early findings. “There is no evidence,” the report stated, “that work effort declined among those receiving income support payments. On the contrary, there is an indication that work effort of participants receiving payments increased relative to the work effort of those not receiving payments” (Moynihan, 1973, p. 192). The White House immediately released these findings to the press.

The report, although preliminary, began to win over converts to the viability of the NIT-driven Family Assistance Plan. Ways and Means Chairman Wilbur Mills threw his influence behind the proposal, while other legislators stopped talking about the plan’s possible work disincentives.

By the summer of 1970, the report was receiving less favorable treatment, and consequently, so too was FAP. A *New York Times Magazine* article, citing OEO Assistant Director, John O. Wilson, as its source, reported that the Nixon administration “rigged” the preliminary data (Cook, 1970). Senator Williams called it a “political report to justify a conclusion,” and journalists Clark Mollenhoff and Richard Wilson wrote that White House official Daniel Patrick Moynihan “pressured” Wilson to prepare the report. The Government Accounting Office, however, audited the findings and verified their conclusions. The available evidence suggested that the episode merely reflected welfare politics as usual. Nevertheless, the “case [for FAP’s work incentives] was shaken simply in that it was challenged” (Moynihan, 1973, p. 511). With the New Jersey experiment discredited, and no other alternative data sources to validate an NIT, the Nixon administration awaited the inevitable defeat of FAP.

And indeed, the end was near. It seemed that FAP could neither reverse the cycle of welfare dependency nor move welfare claimants into paid employment. Russell Long concluded that FAP would “reward[] idleness and discourage[] personal initiative of those who can provide for themselves” (Moynihan, 1973, p. 515). In a meeting with the President, Long made

²⁸ For both examples, see Moynihan (1973, p. 480). According to Frank C. Porter of the *Washington Post*, Williams’ testimony “torpedoed” the Nixon plan, while Moynihan concluded that the Delaware Senator killed FAP (Moynihan, 1973, pp. 474 and 534). It should be noted that HEW’s tables did not reflect reality. They assumed, for example, that all welfare families lived in public housing, but only a fraction (18 percent in Chicago and 8 percent in New York) lived in public housing units. HEW also assumed that each member of welfare families collected Medicaid. Thus, by overstating the benefits lost to FAP, HEW implied a much larger notch problem (Moynihan, 1973, 480).

²⁹ For the income maintenance experiments, see Pechman and Timpane (1975), Palmer and Pechman (1978), and Munnell (1986).

this point more colorfully. His committee, he told Nixon, objected “to paying people not to work” and to “lay about all day making love and producing illegitimate babies” (Moynihan, 1973, p. 523).

Long’s political acumen perceived another trend: the preference among legislators for assisting low-income, working families. Acting on his instincts, Long proposed an alternative to FAP that directed benefits towards the “deserving” poor, that is, those willing to work.³⁰ His proposal, part of a larger public jobs program, called for wage subsidies to low-income workers, and a “work bonus” equal to 10 percent of wages subject to Social Security taxation. The work bonus rose to a maximum credit of \$400, declined at a 25 percent rate from \$4,000, and phased out at \$5,600. Long argued that it would offset Social Security taxes, act as an earnings subsidy, and “prevent the taxing of people onto the welfare rolls” (Long, 1972). It differed from both NIT and GAI plans in that it conditioned benefits on work. Moreover, whereas an NIT or GAI gave its highest benefits to those with no earned income, Long’s work bonus phased in benefits. And although an NIT phased out benefits, Long’s alternative declined at 25 percent as opposed to 50 percent for most NIT plans. Finance Committee members expressed interest in Long’s work bonus proposal. In 1972, however, Congress rejected it along with FAP.

The debate over FAP accentuated the tradeoffs inherent in tax-transfer programs. It focused on whether a reformed social welfare system would be entitlement-oriented or work-conditioned, permanent or temporary. In defeat, FAP portended the future course of welfare reform. “Welfare” connoted indolence, a

way of life; poverty implied hard luck, a temporary condition of the down and out and a permanent condition of the disabled and aged. After FAP, successful social policy proposals would have to meet both anti-poverty and anti-welfare goals. They would have to fulfill pro-work, pro-growth, low-cost demands.

Helping the Working Poor

Despite its defeat in 1972, the work bonus remained on the policy agenda because of Russell Long’s indefatigable efforts. He attached the plan to various pieces of legislation, and explained to his colleagues how it rewarded work while NITs, GAIs, and existing welfare services promoted dependency. Long perceived his work bonus as a substitute for conventional welfare programs, and in particular, for AFDC. He sympathized with the poor, but differentiated sharply between the working and non-working poor. As a preliminary to his more sophisticated work bonus of 1972, Long unveiled in 1970 a “workfare” alternative to FAP that distinguished between employables and unemployables (defined as the aged, blind, disabled, and single mothers with preschoolers). For the unemployables, Long’s plan offered a modest guaranteed income. For the employables, it provided work and training opportunities. It also allowed income maintenance payments when no work was available, as well as wage subsidies for the workfare participants whose hourly wage fell below the minimum.³¹

The work bonus came later, and reflected an evolving political consensus that payroll taxes fell heavily, even regres-

³⁰ For an animated summary of Long’s distinction between the deserving and undeserving poor, see U.S. Congress, Senate (1972).

³¹ “Outline for Workfare Proposal,” no date, no author, NPM, White House Central Files, Subject Files: Welfare, Box 52, pp. 1–2. See also, “Possible Amendments to Family Assistance,” September 2, 1970, and, “Briefing Paper—Meeting with Senate Finance Committee Members on Family Assistance,” September 3, 1970, both from NPM, White House Central Files, Subject Files: Welfare, Box 52.

sively, on the poor.³² Throughout the 1960s, the Treasury Department and various executive commissioned anti-poverty task forces had noted the regressive effects of Social Security taxation.³³ They also showed that future refinancing of the Social Security system might encumber the poor even more.³⁴ Congress, too, became increasingly aware of payroll tax burdens. It considered amendments to the Social Security Act in 1967, 1970, 1971, and 1972. The emergent national debate over the future of Social Security focused Congress' attention on payroll taxation, and prompted legislators to introduce legislation that relieved the poor from future refinancing of the system.³⁵ Between 1972 and 1973, the employee payroll tax expe-

rienced its sharpest one year jump, rising from 5.2 to 5.8 percent. The longer trend was even more arresting: the worker's share of the tax rose from 1.5 percent in 1950 to 3.0 percent in 1960, and to 4.8 percent in 1970 (Pechman, 1987, p. 332). The surges heightened reform pressures, and made legislative relief of payroll taxes imminent. Russell Long's long-running advocacy on this score made his work bonus the front-runner.

While Long advocated a tax credit for the working poor, others rejuvenated the negative income tax. FAP's demise had not stopped many policy experts from continuing to support an NIT.³⁶ These analysts—housed within universities, Washington thinktanks, and the federal

³² A handful of scholars resisted the conclusion that Social Security taxes were regressive. They argued that the contributory nature of the system assured wage earners "deferred income commensurate with, or in excess of . . . their contributions" (Riesenfeld, 1955). They also maintained that Social Security benefits were progressive with the poor receiving higher payments as a percentage of their income (Harvey, 1965).

³³ Stockfish to Surrey, January 6, 1964, "Administration's Anti-poverty Campaign," OTA, Box 7; Assistant Commissioner to Mr. J. A. Stockfish, "Materials Relating to Impact of Taxes on Poverty," May 4, 1964, OTA, Box 53; Surrey to Files, "Possible Presidential Tax Programs," p. 4, June 8, 1964, SSP, Box 180, Folder 6; OTA, "Social Security, Financing, Taxation and Welfare, and Income Maintenance," August 10, 1964, p. 10, OTA, Box 41; Surrey to Stockfish, October 9, 1964, OTA, Box 53; and Surrey to Secretary of the Treasury, "Income Maintenance Task Force Recommendations," November 14, 1964, OTA, Box 41.

³⁴ The 1964 Presidential Task Force on Sustaining Prosperity argued that "further increases in payroll taxes will force an increasingly large share of the total federal tax burden to fall on lower income families." Task Force on Sustaining Prosperity, Draft of Task Force's Final Report," p. 11, October 28, 1964, SSP, Box 207, Folder 3. See also Surrey to Arthur M. Okun, "Tax Aspects of Post-Vietnam Plans," May 28, 1968, SSP, Box 206, Folder 1. With Social Security taxes rising rapidly, the poor's tax burden could no longer be justified simply by reference to the contributory aspect of the Social Security system. Task Force on Sustaining Prosperity, "Draft of Task Force's Final Report," p. 12; Surrey to Arthur M. Okun, "Tax Aspects of Post-Vietnam Plans"; and Surrey to Stone and Brannon, June 23, 1965, SSP, Box 111, Folder 1. The Treasury Department considered ways to relieve, and even exempt, low-income workers from payroll tax obligations. OTA, "Social Security, Financing, Taxation and Welfare, and Income Maintenance," p. 10, August 10, 1964, OTA, Box 41; OTA, "Exemption of Employee Social Security Tax for the Poor," December 6, 1968, Box 52; and Albert Brisbin to Deputy Assistant Secretary Helmuth, December 5, 1968, SSP, Box 196, Folder 1.

³⁵ Various legislators, predominantly Democrats, proposed their own legislation designed to relieve low-income workers from Social Security taxes. A number of plans provided refundable tax credits similar to Long's work bonus (H.R. 12646, 1974, by Rep. Barbara Jordan, D-TX; and S 918, 1975, Sen. Hubert Humphrey, D-MN), while others provided a tax deduction for Social Security taxes (H.R. 9000, 1973, Rep. William R. Cotter, D-CN; H.R. 15281, 1974, Rep. Bertram Podell, D-NY; and H.R. 1141, 1975, Rep. Joseph Waggoner, D-LA). Still other proposals lowered the Social Security tax rate (H.R. 12489, 1974, Rep. James A. Burke, D-MA, and 125 co-sponsors; H.R. 13803 and H.R. 13804, 1974, Rep. Henry S. Reuss, D-WI; S 1838, 1974, Sen. Vance Hartke, D-IN; and S. 2055, 1975, Sen. Vance Hartke, D-IN, co-sponsored by Sens. George McGovern, D-SD, James Abourek, D-SD, and Hugh Scott, R-PA, Senate Minority Leader). A few plans called for the abolition of Social Security taxes altogether (H.R. 13019, 1974, Rep. Henry S. Reuss, D-WI and Rep. William D. Ford, D-MI). Other proposals extended more general tax relief for the working poor by increasing personal exemptions (H.R. 13048, 1974, Rep. John Matthew Zwach, R-MN; and H.R. 13092, 1974, Wright Patman, D-TX) or allowing an optional tax credit in lieu of personal exemptions (H.R. 13197, 1974, Rep. Martha Griffiths, D-MI; and H.R. 13741, 1974, Rep. Lionel Van Deerlin, D-CA).

³⁶ This paragraph borrows heavily from O'Connor (1998).

bureaucracy—produced economic data that indicated the viability of an NIT-driven income security system. They pioneered modeling techniques that simulated the effects of various NIT designs.³⁷ They helped conduct the income maintenance experiments. And perhaps most important, they enjoyed institutional ties to the federal bureaucracy. HEW's Assistant Secretary for Planning and Evaluation (ASPE), created a sub-division called Income Security Policy (ISP). Michael Barth, former OEO member and FAP designer, staffed ISP with economists from the recently reorganized OEO. Under his direction, ISP funded research on poverty and welfare reform, and maintained close links with the policy research community, which included the University of Wisconsin's Institute for Research on Poverty and the Urban Institute.

The network of social policy experts in and around government provided data for several comprehensive welfare reform proposals in the mid-1970s. It contributed to the work of the Joint Economic Committee's Subcommittee on Fiscal Policy, for example, which conducted a three year, 19 volume study on the U.S. tax-transfer system. Begun in 1972, this study addressed itself to improving the equity, simplicity, incentives, and multi-program interaction of the existing system. It examined a number of anti-poverty alternatives, including comprehensive income supplements, demogrants, in-kind programs, minimum wage increases, wage subsidies, earnings subsidies, and public employment programs (Joint Economic Committee [JEC], 1974, p. 129). Ultimately, the subcommittee, chaired by Martha Griffiths (D-MI), rec-

ommended a dual approach to welfare reform that replaced public assistance programs with a federal system of tax credits and income allowances. In 1974, Griffiths introduced the Tax Credit and Allowances Act (H.R. 17574), a bill that embodied the JEC recommendations. Griffiths' proposal, which she dubbed, "Income Security for Americans" (ISA), replaced deductions and personal exemptions for low-income families with refundable tax credits. It abolished AFDC and Food Stamps, moreover, in favor of a guaranteed income program administered by the IRS. Also in 1974, Secretary of HEW, Caspar Weinberger, proposed on behalf of the Ford administration the Income Supplement Plan (ISP), a comprehensive negative income tax proposal that would replace all existing welfare programs.³⁸ The proposal ensured that a "family would no longer both pay taxes and receive benefits at the same time, but instead would have either a tax liability or eligibility for a transfer" (U.S. Department of Health, Education, and Welfare [HEW], 1976, p. 7).

Despite the extensive research behind both proposals, critics argued that neither advanced the welfare reform debate. In fact, some individuals charged that the two plans amounted to GAI schemes reminiscent of the failed FAP. It "was like going back in time five years," observed Martin Anderson, chair of the ad hoc White House task force charged with evaluating the Ford administration's ISP (Anderson, 1976, p. 10).³⁹ Opponents felt that Ford's and Griffiths' alternatives did not move the discussion beyond unproved and widely criticized income guarantees on the one hand, and disproved public assistance measures on the

³⁷ Washington policy organizations developed many of these models. The Urban Institute, for example, created RIM (Reform in Income Maintenance), TRIM (Transfer Income Model), and DYNAMISM, while Mathematica Policy Research produced MATH (Microanalysis of Transfers to Households). Kraemer, et. al. (1987, pp. 38-62).

³⁸ For the ISP, see U.S. Department of Health, Education, and Welfare (1974) and Weinberger (1976).

³⁹ Anderson had witnessed the debates over FAP, too, when he acted as special assistant to Arthur F. Burns, Nixon's Counselor to the President for domestic affairs.

other. Policymakers seemed neglectful of the lessons provided by FAP, critics believed. They did not acknowledge the extent to which Americans had grown weary of comprehensive welfare proposals that “tax[ed] the many on behalf of the few” (Phillips, 1970, p. 37).

Congress ultimately rejected both Ford’s and Griffiths’ plans, because they did not fit the pro-work, pro-growth, low-cost mold. To be sure, both alternatives emphasized work and economic growth, but not satisfactorily. Moreover, they were too expensive, costing \$15.4 billion and \$4.6 billion, respectively (1974 dollars) (JEC, 1974, p. 162; HEW, 1974, p. F-1). Although each plan explicitly targeted “dependency,” neither convinced Congress that it did enough to alleviate the welfare problem.

The Earned Income Tax Credit

Russell Long’s work bonus presented a more attractive policy alternative and a path towards economic independence. It contained implicit work incentives, and it conformed to budgetary constraints. Moreover, by putting money in the hands of low-income consumers, it complemented President Ford’s pledge to stimulate the flagging economy. The Senate passed versions of Long’s work bonus each year from 1972–4, but the House rejected them on each occasion. With the economy slipping into recession in 1974, President Ford introduced the Tax Reduc-

tion Act of 1975, hoping that tax cuts would bring stimulative effects. Congress responded to Ford’s cue by refunding \$8.1 billion in 1974 individual income taxes and reducing 1975 income taxes by an additional \$10 billion (U.S. Congress, Senate, 1975). As part of the bill’s tax-cutting features, Congress established for one year, section 32 of the Internal Revenue Code, a refundable credit for taxpayers with incomes below \$8,000. The “Earned Income Credit” (EIC) equaled 10 percent of the first \$4,000 of earned income, or \$400. It phased out at 10 percent, and vanished completely at \$8,000. The Finance Committee report suggested that the EIC would “assist in encouraging people to obtain employment, reducing the unemployment rate and reducing the welfare rolls” (U.S. Congress, Senate, 1975, p. 33). It would also offset payroll tax burdens for low-income families.⁴⁰

The EITC embodied Long’s vision of a program that moved individuals off welfare and into paid employment, while keeping others off the welfare rolls. It covered only working poor families with children, and forced the “undeserving” poor either to choose paid employment or resort to stigmatized and inadequate AFDC services.⁴¹ It neglected non-working Americans, including childless, low-income individuals.⁴² In short, the EITC’s modest responsibilities and cost (\$1.25 billion) reflected the prevailing welfare reform consensus that carefully circumscribed its parameters. The credit

⁴⁰ The Ways and Means Report which first included the EIC stated “it is appropriate to use the income tax system to offset the impact of the Social Security taxes on low-income persons in 1975 by adopting for this one year only a refundable income tax credit against earned income” (U.S. Congress, House, 1975, p. 10). See also Long (1975).

⁴¹ As part of this vision, Long introduced an amendment to the Tax Reduction Act of 1975 which would have reduced AFDC payments to EITC recipients by amounts equal to the credit. Although Long’s amendment failed to pass in Conference, the bill’s final language did not require state welfare agencies to disregard the EITC from income when calculating AFDC benefits. The result was that most states considered EITC benefits as income and reduced AFDC payments accordingly.

⁴² The House Ways and Means Committee proposed extending the EITC to all low-income workers, regardless of their family responsibilities. The Senate Finance Committee, however, concentrating on out-of-work welfare mothers and determined to minimize the cost of the proposal, voted to restrict EITC eligibility to low-income individuals with children. The House receded to the Senate in Conference (U.S. Congress, Senate, 1975, p. 33).

would reduce welfare dependency, not poverty.⁴³

Interstice

For three years, the EITC underwent only slight modification, and adhered to its pro-work, anti-welfare charter.⁴⁴ In an effort to tie the credit more directly to work, Congress allowed EITC eligibles an "advance payment" option as opposed to year-end, lump sum payments. The 1978 law also made the EITC a permanent provision of the Internal Revenue Code. The "new" EITC still phased in at 10 percent, but now rose until \$5,000 and provided a maximum benefit of \$500 between \$5–6,000.⁴⁵ Beyond \$6,000, the credit declined at 12.5 percent, zeroing out at \$10,000. These increased thresholds nearly restored the credit's original value, which had eroded due to inflation (Campbell and Peirce, 1980, p. 6) (see Appendix 1 for EITC parameters, 1975–99).

The Joint Committee on Taxation (JCT) attributed the EITC's popularity to how it provided both tax relief and work incentives for low-income families (JCT, 1979, p. 51). In this way, the EITC fulfilled its original tenets as set forth by Congress; that is, as "an added bonus or incentive for low-income people to work," and as a way to reduce welfare dependency by "inducing individuals with families receiving Federal assistance to support themselves" (U.S. Congress, Senate, 1975, p. 11).

A cohort of liberal bureaucrats and academic researchers expressed less excitement for the EITC. They believed the

program's anti-poverty effectiveness quite limited. Despite widespread anti-welfare rhetoric and the popularity of pro-work programs, many economists and social policy officials supported comprehensive cash assistance in the form of a negative income tax. Others, citing the persistent unemployment and eroding wages of the 1970s, advocated ambitious public jobs programs. The EITC did not address these ambitions. It remained small and inexpensive, categorical and limited.

Given the early design of the EITC, neither its proponents nor its critics could have anticipated the program's next stage of development. Indeed, much to everyone's surprise, the EITC would emerge from the welfare reform discussions at the end of the 1970s forever transformed. It would no longer comprise simply a modest work subsidy; rather it would represent an anti-poverty device that could potentially raise the income of all working Americans above the poverty line.

WELFARE REFORM AND THE EITC: THE PROGRAM FOR BETTER JOBS AND INCOME

In May 1977, President Carter announced that his administration was in the process of designing a consolidated income security system. The new tax-transfer system would "scrap" existing public assistance programs, and deliver "jobs, simplicity of administration, financial incentive to work, [and] adequate assistance for those who cannot work."⁴⁶

⁴³ In theory, Long's plan extended "a substantial new application of the principle of taxation according to 'ability-to-pay'" (The Editor, 1974). By refunding more than 85 percent of the total tax on workers, it implied that workers bore both the employee and the employer portion of the payroll tax. And Long argued that the credit would "provide tax relief to people who are too poor to pay income tax, but who still pay Social Security tax and bear the burden of the Social Security tax paid by their employers" (Long, 1975). But in practice, the EITC was hardly radical.

⁴⁴ Congress extended the Earned Income Tax Credit through 1976 (The Revenue Adjustment Act of 1975), 1977 (The Tax Reform Act of 1976), and 1978 (The Tax Reduction and Simplification Act of 1977).

⁴⁵ The Revenue Act of 1978 instituted these modifications to the EITC.

⁴⁶ Statement by the President, May 2, 1977, p. 1, The Jimmy Carter Library (hereafter "JCL"), Domestic Policy Staff (hereafter, "DPS"), Box 318, Welfare Reform (hereafter, "WR"), May, 1977.

Moreover, it would narrow the differences in benefit levels among states by providing a uniform federal payment, increase work incentives for mothers with young children, and provide benefits to low-income, two parent families. During the development of Carter's welfare initiative, the Department of Health, Education, and Welfare and the Department of Labor (DOL) collaborated on a proposal to combine a federal jobs program for the able bodied, with a modest guaranteed income for the non-working poor. In an effort to make work more attractive than welfare, and to keep subsidized jobs to a minimum, HEW and DOL proposed more than tripling the size of the EITC for workers in unsubsidized jobs. The internal discussions over an expanded EITC provide insights into how deeply the pro-work, pro-growth, low cost welfare reform consensus influenced policy alternatives at the end of the 1970s.

Bureaucratic Infighting and Economic Research

Carter's Program for Better Jobs and Income (PBJI) took shape on two separate tracks. HEW and DOL agreed that the plan should differentiate between those expected to work and those not expected to work. However, the two departments differed in how they extended coverage to these groups. HEW advocated comprehensive cash grants, a scheme that most politicians considered a poor alternative to existing welfare programs, but one that many academics and policy analysts still supported. DOL, on the other hand, believed that only those not expected to work should receive cash subsidies. For those expected to work, DOL advocated expanding federal training programs and liberalizing the EITC. Its recommendations followed the assumption that indi-

viduals should "turn first to . . . employment and training or the tax system for support."⁴⁷

The two departments differed not just philosophically, but also analytically. For several years, HEW had employed various microsimulation models, such as MATH (Microanalysis of Transfer to Households) and TRIM (Transfer Income Model), to test the impact of income maintenance reforms on the federal budget and poverty populations (Kraemer, et. al., 1987). Although DOL did not possess MATH or TRIM, several economists in the Office of the Assistant Secretary for Policy and Evaluation Research (ASPER) were familiar with the modeling techniques. Despite their effectiveness in simulating income transfer programs, neither MATH nor TRIM could simulate the pure cash approach of HEW or the pure jobs approach of DOL. Analysts had to design new models. Rather than cooperate in this endeavor, however, the two agencies created their own models. HEW developed a variant of TRIM, named "KGB" for its designers, Rick Kasten, David Greenberg, and Dave Betson. Meanwhile, DOL settled on a variation of MATH called "JOBS" which simulated a service employment program.

The differences in modeling exacerbated differences in agency ideology. Or, as one observer explained, "'Counter-modelling' by DOL and HEW analysts . . . seemed to fuel agency rivalries and competitiveness" (Kraemer, et. al., 1987, p. 130). HEW's model generated numbers that suggested a jobs program would cost substantially more than a cash assistance program. Alternatively, DOL's model forecasted that its jobs and training strategy not only would cost less than HEW's cash approach, but would stand a better chance of reducing the welfare rolls.

⁴⁷ Tom Joe to Stu Eizenstat, "HEW's Proposed Welfare Reform Plan," July 27, 1977, p. 3, JCL, DPS, Eizenstat, Box 318, WR, July, 1977.

Politics and the EITC, Part I

Presented with two distinct welfare reform visions, as well as conflicting micro-simulation data, President Carter and his Domestic Policy Staff (DPS) combined the HEW and DOL proposals. The administration's initiative would include both a jobs and a cash component, Carter told the nation on May 2.⁴⁸ He would unveil a more detailed plan in August. That left three months to produce a bill he could send to Congress. The presence of a deadline, and the political necessity to present a united front, forced HEW and DOL to put aside their differences. The two agencies accepted the need to cooperate, and even agreed to use the same simulation model (KGB).

The détente between HEW and DOL reflected an awareness of politics. So, too, did the decision to recommend an expanded EITC. Recall that opponents of Nixon's FAP objected to the number of recipients the plan added to the welfare rolls, its insufficient work requirements, implicit work disincentives, and cost. The DOL argued that a more liberalized EITC would correct similar deficiencies in the HEW proposal, and increase the likelihood that Congress would pass welfare reform. Unless officials wanted the PBJI to join FAP in the dustbin of failed welfare proposals, they should avoid guaranteed annual incomes and negative income taxation.

Under these assumptions, HEW's cash subsidy promised failure. Tom Joe, a widely respected policy consultant, called the HEW plan "a thinly disguised comprehensive negative income tax system"

(Lynn and Whitman, 1981, p. 153). Likewise, Jodie Allen, DOL's Deputy Assistant Secretary for Policy Evaluation and Research, observed that the proposal amounted to "a high guarantee, high tax rate universal NIT in disguise" (Lynn and Whitman, 1981, p. 154). Such an arrangement, the DPS observed, would mobilize opposition immediately. Both Russell Long and House Ways and Means Chairman Al Ullman could be expected to oppose "the large numbers of persons added to the welfare rolls."⁴⁹ They would also object to the high cumulative marginal tax rates created by HEW's NIT plan. Moreover, Congress would reject the program's cost. An expanded EITC, officials suggested, suffered from none of these liabilities.

Theoretically, the EITC could reduce the welfare rolls. In July 1977, Tom Joe wrote White House official, Stuart Eizenstat, "By expanding the EITC as a major mechanism for supplementing the income of the working poor, the desired distribution of benefits could be obtained without this rapid expansion of the welfare caseload."⁵⁰ Eizenstat, in turn, told President Carter that the EITC could "provide all or most assistance to a significant number of families through a tax credit rather than through the cash assistance system."⁵¹ Administration analysts also argued that by reducing cumulative marginal tax rates, the EITC could "alleviate the disincentives to work for poor families."⁵² The phase in range of the program reduced marginal tax rates, and provided positive work incentives. Unlike HEW's negative income tax, moreover, the EITC's

⁴⁸ Carter did not detail the proposal at his press conference on May 2, but instead provided a set of 12, general goals for welfare reform. Notably, Carter explicitly recommended continued use of the EITC to help the working poor.

⁴⁹ Stu Eizenstat, Bert Carp, Bill Spring, and Frank Raines to President Carter, April 26, 1977, p. 1, JCL, DPS, Eizenstat, Box 317, WR, April, 1977. HEW's own estimate indicated that those covered by direct cash assistance under its program would increase 67 percent, from 23.67 million to 39.58 million individuals.

⁵⁰ Tom Joe to Stu Eizenstat, July 27, 1977, p. 7, JCL, DPS, Eizenstat, Box 318, WR, July, 1977.

⁵¹ Stu Eizenstat to the President, July 31, 1977, p. 11, JCL, DPS, Eizenstat, Box 318, WR, August, 1977.

⁵² Charles Schultze to the President, July 27, 1977, p. 4, JCL, DPS, Eizenstat, WR, July, 1977.

maximum benefit went to low-income, working taxpayers. The phase out range of the credit initially presented officials with problems, however. Just as the phase in reduced cumulative marginal tax rates, the phase out increased them.⁵³ HEW suggested eliminating the EITC, and replacing it with a work expense deduction. For their part, DOL suggested the phase out could begin at the welfare breakeven point (the point at which welfare benefits become zero), reducing additional work disincentives for welfare recipients (Lynn and Whitman, 1981, p. 187). Alternatively, the EITC could phase in up to the tax entry point (the point at which taxpayers enter the positive tax system), and phase down at a low rate (10 percent in most proposals). Structurally, this latter option pulled middle-income families into the program, making it appear “welfare for the middle class” (Lynn and Whitman, 1981, p. 221). DOL did not seem to consider this a political liability, except for its effect on cost (Lynn and Whitman, 1981, pp. 201–26).

In the frenetic three months between May and August 1977, an expanded EITC garnered crucial support. Although the administration only possessed preliminary data from its simulation models (and not actual microdata), it believed the EITC reduced the number of people on welfare while at the same time it increased incentives to work. As testament to the triumphant effort to liberalize the EITC, the Treasury Department, the Council of Economic Advisors (CEA), HEW, DOL,

and DPS all recommended expanding the program on July 31, 1977—only seven days before the President unveiled his welfare initiative to the American people.

Politics and the EITC, Part II

Administration officials were confident in the proposal’s political attractiveness. Tom Joe affirmed that the EITC would “improve[] the legislative feasibility of the plan by using a tax rather than a welfare mechanism.”⁵⁴ It rewarded work, not dependency. It was not “welfare,” observed the DPS, but rather, “closely related to the ‘Workfare’ proposal which Russell Long advanced in 1972.”⁵⁵ It would assist the working poor “without labeling them as welfare recipients.”⁵⁶ An expanded EITC, moreover, could alleviate other deficiencies in the tax-transfer system. It helped the poor without “requiring that they undergo a means test,” for instance, and it provided aid “in a form relatively less stigmatizing” than traditional public assistance programs.⁵⁷ Although an expanded EITC phased out at higher income levels, Carter officials insisted that the credit was hardly “middle-income tax relief.”⁵⁸ They argued that it removed individuals from the welfare rolls, while keeping would-be welfare claimants in the paid workforce. To its supporters, an expanded EITC was a reward for “playing by the rules” and choosing self-reliance over dependency. In addition, a portion of the EITC could be scored in the budget as a

⁵³ As parameterized late in the design of the welfare initiative, the EITC would have increased the combined benefit reduction rate (including Social Security taxes) in states that supplemented cash assistance “to a maximum of 68 percent for those ‘expected to work’ and to a maximum of 86 percent for those ‘not expected to work.’” The DPS demanded that HEW and DOL reduce these “serious work disincentives.” Eizenstat to the President, July 31, 1977, p. 11, JCL, DPS, Eizenstat, Box 318, WR, August, 1977.

⁵⁴ Tom Joe to Stu Eizenstat, July 27, 1977, p. 4, JCL, DPS, Eizenstat, Box 318, WR, July, 1977.

⁵⁵ Eizenstat, Carp, Spring, and Raines to the President, April 26, 1977, p. 2, JCL, DPS, Eizenstat, Box 317, WR, April, 1977.

⁵⁶ Jack Watson and Jim Parham to the President, May 23, 1977, p. 1, JCL, DPS, Eizenstat, Box 318, WR, May, 1977.

⁵⁷ Watson and Parham to the President, May 23, 1977, p. 1, JCL, DPS, Eizenstat, Box 318, WR, May, 1977; Jack Watson and Jim Parham to the President, April 26, 1977, p. 1, JCL, DPS, Eizenstat, Box 317, WR, April, 1977.

⁵⁸ Compare the administration’s conclusions to a 1978 Urban Institute study (Hoffman, 1978, p. xi).

loss in tax receipts (as opposed to revenue outlays), thus making the PBJI appear less costly.⁵⁹

Carter's welfare bill, unveiled on August 7, did not liberalize the EITC as much as some participants had hoped. It contained lower phase in and phase out rates than those agreed upon by officials as late as July 25. Flattening the rates lowered benefit levels, and provided less relief to low-income taxpayers and more to middle-income families. According to an ISP staffer, the last minute changes to the EITC "had all the disadvantages of the large-scale EITC [cost] and really none of its advantages [anti-poverty effectiveness]" (Lynn and Whitman, 1981, p. 221). Joe expressed his "disappoint[ment] that attention was not devoted to more creative use of the EITC."⁶⁰ He suggested that before the White House present PBJI to Congress, it explore "EITC alternatives that could more completely accomplish the goals of welfare as well as tax reform."⁶¹

The administration did not heed Joe's advice, but its welfare proposal was well received, nonetheless. Russell Long praised its "laudable objectives," while Daniel Patrick Moynihan (by this time a U.S. Senator from New York) declared it "the most important piece of social legislation since the New Deal."⁶² Media coverage was equally positive. *The New York Times* wrote, "Mr. Carter's plan . . . turns out to be bold, intelligent, and humane," and *The Washington Post* predicted, "This time around there

is a better chance that a decent version of welfare reform will be enacted" (Lynn and Whitman, 1981, p. 229).

The Post's forecast proved premature. Interest groups lined up to oppose PBJI. Conservatives considered the plan profligate, while liberals thought it penurious. It did not contain a strict work requirement, it contained *too* strict a work requirement. The NWRO was at it again, too, labeling the Carter bill, "JIP," an acronym suggestive of Nixon's FAP.

Hostility to Carter's plan did not simply represent a replay of resistance to Nixon's welfare proposal, however. Unemployment and inflation in the late 1970s posed a dual threat. Economic uncertainty fueled the pervasive sentiment that welfare reform must reward work, stimulate economic growth, and keep costs to a minimum. Equally important, the "datawars" between competing executive agencies and the legislative branch introduced a pall of confusion and deception to the reform process (Kraemer, et. al., 1987). The Carter administration originally estimated that its bill would cost \$2.8 billion. The Congressional Budget Office, however, using the same KGB model as HEW and DOL, pegged the figure at \$14 billion, five times the administration's initial estimate.⁶³ The conflicting estimates gave the impression that the administration "had intentionally placed a deceptively low price tag on PBJI" (Lynn and Whitman, 1987, p. 238).⁶⁴ To make mat-

⁵⁹ Joe to Eizenstat, July 27, 1977, p. 4, JCL, DPS, Eizenstat, Box 318, WR, July 1977. A few individuals on the welfare reform planning team warned, somewhat prophetically, that expanding the EITC would undercut its advantages. The DPS argued, for example, that "folding into the 'welfare system' the earned income tax credit...will appear to be an expansion of the welfare system and will label as 'welfare recipients' people who are not now so perceived." Jim Parham to Jack Watson, April 15, 1977, p. 1, JCL, DPS, Eizenstat, Box 317, WR, April, 1977.

⁶⁰ Tom Joe to Stu Eizenstat, August 2, 1977, p. 3, JCL, DPS, Eizenstat, Box 319, WR, August, 1977.

⁶¹ Joe to Eizenstat, August 2, 1977, p. 3, JCL, DPS, Eizenstat, Box 319, WR, August, 1977.

⁶² Long quoted in Lynn and Whitman (1981, p. 230). Moynihan quoted in, "Carter, Congress, and Welfare" (1977, p. 1701).

⁶³ Nevermind that the different estimates were easily explained: CBO used 1982 dollars while HEW estimated using 1978 dollars, a difference that accounted for \$7 billion of the discrepancy; the CBO refused to include the CETA VI, the wellhead tax, HEW savings from reduced fraud, and reductions in extended unemployment insurance as legitimate offsets; and the CBO did not charge the expanded EITC to tax reform.

⁶⁴ For a fuller description of the discrepancies in costs, see Demkovich (1978, p. 633), Lynn and Whitman (1981, pp. 231-40), and Kraemer, et. al. (1987, pp. 141-3).

ters worse, the administration released new estimates, claiming that its program would cost \$8.8 billion, not \$2.8 billion. The CBO released new forecasts, as well: \$17.4 billion. In the end, the opposition of interest groups, the high costs of welfare reform, persistent stagflation, and the political suspicion surrounding Carter's proposal killed the bill.

In March 1978, Carter dropped PBJI from his agenda. However, the end of comprehensive welfare reform in 1978 signaled a beginning for the EITC. Opponents of the bill rarely attacked the EITC's proposed liberalization. In fact, most observers praised it as positive anti-poverty reform directed at the "deserving" poor. After Carter abandoned the PBJI, a number of Congressional members introduced welfare reform bills, each of which included an expanded EITC.⁶⁵ None of the bills became law, but Congress enlarged the EITC in 1978, making it one of only three welfare-related provisions passed that year.⁶⁶ Recall, too, that the Revenue Act of 1978 raised the maximum credit to \$500, allowed for an advance payment option, and made the credit a permanent section of the Code. And in 1979, Carter included an expanded EITC as part of his Work and Training Opportunities Act (Lynn and Whitman, 1987, p. 252).⁶⁷ Indeed, by the end of the 1970s, the EITC had become "[e]verybody's favorite program" (Lynn and Whitman, 1981, p. 247).

Surviving Welfare Retrenchment

For six years, Congress made only minimal changes to the EITC. The Technical Corrections Act of 1979 addressed the EITC's interaction with federal welfare programs. It required that both the advance and lump sum payments be treated as earned income for individuals who also received AFDC or SSI benefits. The Omnibus Budget Reconciliation Act (OBRA) of 1981 preserved this change, but required welfare agencies to assume that individuals eligible for both AFDC and EITC received their EITC benefits through the advance payment option. This stipulation had the effect of reducing an individual's AFDC monthly payment by the amount of the assumed EITC benefit.⁶⁸ The Deficit Reduction Act of 1984 reversed this provision, allowing states to count the EITC when calculating AFDC benefits only when they could verify that individuals actually received the EITC payment.⁶⁹ The 1984 Act also raised the maximum benefit to \$550, the length of the plateau range by \$500, and the end of the phase out to \$11,000 (see Appendix 1). Despite these changes, inflation continued to erode the real value of the EITC.

Congress's alterations to the EITC might appear minor. In the context of general welfare retrenchment during the late 1970s and early 1980s, however, the changes loom large. Evidence of an expanding attack on the welfare state

⁶⁵ These bills included the House Welfare Reform Subcommittee revisions of PBJI (H.R. 10950), the Ullman Welfare Reform Act (H.R. 10711), the Job Opportunities and Family Security Act of 1978 (S. 2777, also known as Baker-Bellmon-Ribicoff), the State and Local Welfare Reform and Fiscal Relief Act (also known as Moynihan-Cranston-Long), and the Welfare Reform and Fiscal Relief Act (sponsored by Ted Kennedy).

⁶⁶ The other two included 1) eliminating the purchase requirement in the Food Stamps program and creating tighter eligibility requirements for high income recipients, and 2) renewing CETA and tightening eligibility to target only low-income workers.

⁶⁷ Congress never passed the 1979 jobs bill.

⁶⁸ Recent studies suggest that less than 1 percent of EITC eligibles opt for the advance payment. If these studies are any indication of the rate at which individuals chose the advance credit in the late 1970s, state welfare agencies were unfairly reducing AFDC benefits for individuals eligible for both the EITC and AFDC programs. See GAO (1992) and Yin, et. al. (1994).

⁶⁹ OBRA 1990 affirmed this requirement, and also prohibited the counting of EITC as income in determining eligibility for Medicaid, Food Stamps, SSI, and low-income housing benefits.

abounded (Piven and Cloward, 1982; Champagne and Harpham, 1984; Block, 1987). President Carter lost interest in an expensive substitute for the tax-transfer system, and the crusade for comprehensive income maintenance was forgotten. In its place emerged an economical welfare initiative for 1979.⁷⁰ While Carter stemmed social welfare spending, President Reagan cut it. OBRA 81 slashed federal and state welfare expenditures by \$4 billion, and in the process cut AFDC funding by 17.4 percent (Patterson, 1994, pp. 212–3). It eliminated the earnings disregard formula for AFDC, the so-called “30 and 1/3” rule. And it reduced the value of allowable monthly deductions for work-related expenses. These and other features of OBRA 81 had the effect of removing over approximately 400,000 families from the welfare rolls, and of increasing the nation’s poverty rate by 2 percentage points (Patterson, 1994, p. 213).

The EITC, however, survived this retrenchment. As other programs fell victim to the budgetary knife, the EITC escaped relatively unscathed. Legislators and analysts alike viewed the program as a viable alternative to conventional social welfare services. While they worked to maintain the EITC’s integrity, they also devised plans for a substantial expansion of the credit, an expansion that produced a mature anti-poverty program.

MATURITY OR TRANSFORMATION?

The Tax Reform Act of 1986 initiated this maturation process. Between 1975 and 1984, the EITC’s maximum credit had fallen by 35 percent in real terms. TRA 86 offset this erosion, and raised the maximum benefit to \$1,174, slightly more than the 1975 level of \$1,165 (1996 dollars).⁷¹ TRA 86 also increased the point at which

the credit phased out, to \$21,287 (slightly less than the 1975, inflation-adjusted, \$23,301 breakeven point). Moreover, TRA 86 guaranteed the future integrity of the EITC by indexing it for inflation. Reminiscent of the spirit that imbued the original credit, the 1986 changes to the EITC assured that “low-income citizens [were] no longer taxed into poverty” (Senator Spark Matsunaga [D-HI], quoted in Storey, 1996, p. 7). The 1986 law reaffirmed the program’s mandate as a tax offset for low-income families, and upheld Senator Long’s 1972 desire to “prevent the taxing of people onto the welfare rolls” (Long, 1972).

The 1986 alterations to the EITC sprung from efforts on behalf of the Treasury Department and elsewhere to remove working poor families from the income tax rolls (Conlan, et. al., 1988; Steuerle, 1992). In its 1984 *Report on Fundamental Tax Simplification and Reform* (Treasury I), the Treasury noted that inflation had eroded the real value of the “tax-free amount,” the point at which tax is first paid (U.S. Department of the Treasury, vol. 1, 1984, p. 5). Although the overall burden of federal taxes had risen only slightly since 1950 (from 17.3 percent of GNP in 1950 to 18.7 percent in 1983), the poor experienced disproportionately higher tax burdens. As corporate income taxes fell (a trend which accelerated in the early 1980s), Social Security taxes rose sharply. The combined employee and employer payroll tax increased from 3 percent in 1950 to 14 percent by 1984 (Pechman, 1987, p. 318). Rising payroll taxes shifted the tax burden “toward the poor—particularly the working poor” (Blank and Blinder, 1986, p. 198).

In addition to lower tax-free thresholds and rising payroll taxes, the poor faced deteriorating wages. Beginning in the early 1970s, real earnings reversed their

⁷⁰ The 1979 welfare legislation amounted to two bills, the Work and Training Opportunities Act and the Social Welfare Reform Amendments, both of which failed to pass. Despite its modesty (\$5.7 billion), Carter warned his staff, “Do not ask me to approve a higher figure in the future” (Patterson, 1998, p. 130).

⁷¹ Unless otherwise noted, the statistics in this paragraph are from Storey and refer to 1996 dollars (1996, pp. 16–7).

post-World War II upward trend. As the economy worsened, earnings inequality accelerated, creating a “hollowed out” earnings distribution that produced large percentages of workers at the top and bottom of the distribution, and smaller percentages in the middle (Levy and Murnane, 1992, p. 1371). The value of the minimum wage, moreover, deteriorated dramatically between 1981 and 1986, falling in real value from \$4.50 to \$3.35 per hour (1986 dollars). During the 1970s a full-year, full-time minimum wage job kept a family of three above the poverty line. By 1986, the minimum wage fell short of this plateau by 20 percent (Ellwood, 1988, p. 110).

Policymakers endeavored to curb these disturbing trends. Wage subsidies, increases in the minimum wage, and child care tax credits or child allowances all loomed large on the policy agenda. Ultimately, politicians and experts abandoned these alternatives. Wage subsidies faced administrative difficulties, while the minimum wage poorly targeted low-income groups and contained potentially adverse labor demand effects. Child care tax credits faced similar targeting problems, and child allowances resembled too closely the kind of guaranteed income arrangements that Congress had rejected in both 1971 (Nixon’s FAP) and 1978 (Carter’s PBJI). Officials sought alternative ways to address deteriorating wages and income inequality.

Both the Treasury Department and Congress chose the EITC. An expanded EITC could raise the income tax threshold to approximately the poverty level. In conjunction with a larger personal exemption, the EITC could provide greater equity and

“fairness for families” (U.S. Department of the Treasury, 1984, pp. 37, 66–7 [vol. 1], and 15–16 [vol. 2]). An indexed EITC could address the erosion of low-income wages as well as rising income inequality. By the mid-1980s, and with the help of the Treasury, Congress had identified the tax system as both the problem and the solution to rising rates of inequality. From 1984 to 1986, Congressional committees examined the tax treatment of families, and in particular, the increased tax burdens of poor families (U.S. Congress, House, 1984, 1985a–d, 1986; U.S. Congress, Senate, 1985). Politicians introduced bills designed to alleviate taxes on low-income taxpayers.⁷² Most of these plans recognized the anti-poverty effectiveness of the EITC, while many of them called for significant increases in the credit.⁷³ By the time President Reagan unveiled his second major tax bill in May 1985, the Congressional majority believed that poor Americans should be freed from burdensome tax obligations. It also named the EITC as the primary vehicle of this reform. TRA 86 removed over six million impoverished Americans from the income tax rolls by raising the standard deduction and personal exemption, and liberalizing the EITC (Conlan, et. al., 1988, p. 3).

The success of the 1986 tax law, particularly its expansion of the EITC, complemented a political and professional consensus surrounding tax reform as well as welfare reform. By the early 1980s, this political and professional issue network gathered together liberals such as Senator Bill Bradley (D–NJ) and “populist conservatives” such as Congressman Jack Kemp (R–NY).⁷⁴ The idea of reducing in-

⁷² These bills included H.R. 200 (introduced by Siljander), H.R. 373 (Moore), H.R. 416 (Quillen), H.R. 623 (Young of Alaska), H.R. 794 (Frank), H.R. 800 (Gephardt), H.R. 1040 (Rangel), H.R. 1057 (Lloyd), H.R. 1165 (Heftel), H.R. 1551 (Coats), H.R. 2222 (Kemp), H.R. 2472 (Schroeder and others), H.R. 2477 (Kennelly), H.R. 2480 (Rangel), H.R. 2585 (Ford and Rangel), S. 321 (DeConcini and Symms), S. 409 (Bradley and others), S. 411 (Roth), S. 556 (Chafee), S. 888 (Durenberger), S. 909 (Quayle), S. 1006 (Kasten and Wallop), and S. 1194 (Moynihan).

⁷³ Those plans that increased the EITC included H.R. 373, H.R. 1040, H.R. 2472, H.R. 2480, H.R. 2585, S. 411, and S. 1194. Those that maintained the credit or simply modified it to more explicitly offset Social Security taxation included H.R. 200, H.R. 800, H.R. 2222, S. 409, S. 556, and S. 1006.

⁷⁴ Conlan, et. al. (1988, p. 62) describe this consensus in detail.

come tax burdens on the poor resonated with liberals who were drawn to the idea of tax fairness. An enlarged EITC, by supplementing the incomes of the working poor, addressed deteriorating wages and rising income inequality. It also made the tax system more progressive, balancing out the recent increases in Social Security and excise taxes. Conservatives, too, felt the need to remedy unfair tax burdens. Endorsing a larger EITC ameliorated conservative responsibility for the growing disparity between rich and poor, which the Reagan administration accelerated with its early tax and social policy changes.⁷⁵ Along with increases in the standard deduction and personal exemption, a liberalized EITC also benefited middle-class families. Finally, the EITC assuaged anxiety over welfare dependency by theoretically keeping would-be welfare recipients off the welfare rolls and in the workforce.

The EITC enjoyed bipartisan support for another reason: it elided the pitfalls of budget politics. Increased defense spending in the 1980s, along with supply-side tax changes, created huge federal deficits. Shortly after passing the Economic Recovery Tax Act (ERTA) of 1981, Congress began trying to undue its harm.⁷⁶ The Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 and the Deficit Reduction Act of 1984 (DEFRA) raised tax revenues. In 1985, the Gramm–Rudman Act mandated automatic spending cuts if budget targets were not met beginning in

1991. By controlling direct expenditures, Gramm–Rudman and other deficit reduction acts increased pressure on legislators to channel spending programs through the tax system.⁷⁷ The EITC complemented these new budget rules perfectly. Its cost could be scored in both the tax expenditure and direct expenditure budgets. During the political odyssey of TRA 86, the EITC also used budget politics to its advantage by improving the bill's distributional neutrality. It offset tax preferences for high-income taxpayers and corporations, and balanced out the all-important distribution tables.

"It's Just Welfare, It's a Subsidy."⁷⁸

While alterations to the EITC in 1986 reduced taxes for low-income families, changes made in the early 1990s signaled to some observers that the program was headed in the direction of welfare. OBRA 1990 and OBRA 1993 expanded the EITC's maximum benefit and phase out rates, while OBRA 93 also raised the breakeven point. The 1990 bill distinguished for the first time between families with one and two or more qualifying children. And the 1993 law extended the credit to childless, low-income workers. Critics considered the benefit levels overly generous, the phase out an implicit work disincentive, and the higher break-even point a form of welfare for the middle class. Under the changes produced by the 1990 and 1993 bills, the cost of the EITC almost tripled,

⁷⁵ The drastic cuts in social services described above, in combination with the Economic Recovery Tax Cut (ERTA) of 1981, drastically reduced progressivity in the tax system (Kasten, et. al., 1994) and increased inequality (Gramlich, et al, 1993) between 1980 and 1985.

⁷⁶ In fairness to President Reagan, the looming deficit was the product of years of fiscal mismanagement, as well as changing macroeconomic forces (including reduced inflation that resulted in lower federal revenues), not merely the direct consequence of Reaganomics. Indeed, as Gene Steuerle has shown, the "era of easy financing" that characterized postwar fiscal policy ended before Reagan took office (Steuerle, 1992, 1996). Nevertheless, ERTA 1981 and Reagan's increased defense spending accelerated the day of reckoning.

⁷⁷ Deficit reduction efforts began as early as 1974 with the Congressional Budget and Impoundment Control Act. They also included TEFRA and DEFRA, as well as the Omnibus Reconciliation Act of 1987, the Omnibus Budget Reconciliation Act of 1989, and the Budget Enforcement Act of 1990. For how deficit reduction influenced tax policy, see Gutman (2000).

⁷⁸ Comment by Sen. Phil Gramm (R-TX) during Senate Finance debate over the EITC in 1995 (Godfrey, 1995a).

jumping from \$7.5 billion in 1990 to \$21.1 billion in 1994 (current dollars) (U.S. Congress, House, 1999, p. 872). When examined over a longer period, the expansion appeared more dramatic. From 1986 to 1996, EITC expenditures grew by 1,191 percent (computed from U.S. Congress, House, 1999, p. 872). The credit's break-even point, again in current dollars, increased from \$11,000 in 1986 to \$28,495 by 1996; the break-even point had risen from 37 percent of median family income to 67 percent (U.S. Bureau of the Census, 2000, Table F6). Although these changes appeared less dramatic when adjusted for inflation, the EITC's critics focused on its nominal growth. The program, once a Washington darling, now represented "too much of a good thing."⁷⁹

The EITC had grown not only too big and too fast; it also had begun to look less like tax policy and more like welfare policy. Generous benefits extended the program well beyond its mandate. Only a fraction of EITC benefits, opponents argued, offset income and self-employment taxes, while the rest amounted to direct outlays ("Senate Continues Budget Debates," 1995; Kosters, 1993a). Senator Don Nickles (R-OK) insisted that "[i]n almost 99-plus percent of the cases, it is a check paid as a refund to people in lump sum payment" ("Senate Continues Budget Debate," 1995). The federal government, it seemed, was back in the business of "taxing the many on behalf of the few." Or, as Bill Archer (R-TX) complained, "Is it fair to ask middle-income taxpayers to give additional public assistance to those who pay little or no taxes?" (U.S. Congress, House, 1997c).

Noncompliance

The charges against the EITC gained credence when other negative side effects of the program surfaced. Particularly damaging were studies released by the IRS, which reported unusually high error rates for the EITC. Critics of the program interpreted these findings to mean that a large percentage of EITC beneficiaries included defrauders and cheats. The EITC, they concluded, amounted to "a tax credit for crooks" (Aley, 1993, p. 24).

The first episode in the EITC compliance story played out in 1990. In the spring, both the House and Senate passed child care bills that included an expanded EITC. In the weeks before the Conference Committee met, Congress debated whether the IRS could handle an enlarged, more complex EITC. It was particularly concerned about compliance rates. The best available compliance data, the IRS's Taxpayer Compliance Measurement Program (TCMP) study, revealed that in tax year 1985, 46 percent of taxpayers who claimed the EITC may not have been entitled to the benefit amount received. And the overclaim rate (the dollar amount claimed in error divided by the total dollar amount claimed) was 39.1 percent (Scholz, 1994, Table 2). The Treasury responded with a simplification package designed to increase compliance rates by clarifying EITC eligibility rules and enhancing IRS verification of claims (Holtzblatt, 1991). Congress included this proposal in OBRA 1990, a law that significantly expanded the EITC.

The 1988 TCMP study, released in 1992, indicated a drop in the overclaim rate, from 39.1 percent to 35.4 percent (Scholz, 1994, Table 2). Congress still considered

⁷⁹ The full citation is from floor comments Senator William Roth made in October 1995: "The EITC was to create incentives for low-income parents to work. It was that simple. But as they say about too much of a good thing becoming dangerous, such is what happened to this once well-intended program" (Roth, 1995). Similar criticism emanated from the popular press. During the 1995 budget debate, columnist James Glassman argued that the EITC "like many other good ideas in Washington, [has] gotten completely out of hand" (Glassman, 1995).

the error rates too high, however, and wondered if noncompliance would rise in response to increased benefit levels set in 1990 and 1993. Some analysts cautioned that EITC error rates might reach 50 percent (Sparrow, 1993), while others argued that the program facilitated a “superterranean economy” by encouraging taxpayers to overstate their earnings (Steuerle, 1991, 1993, 1995a).⁸⁰

Congress mobilized its forces to investigate the EITC’s compliance problems. Both Houses conducted numerous hearings on the EITC between 1993 and 1997.⁸¹ In 1994, Senator William Roth asked the GAO to investigate the noncompliance charges and determine what the IRS was doing to reduce the error rates (Roth, 1994a). Legislators considered suggestions designed to reform, simplify, and even repeal the credit (Roth, 1994b; Petri 1994, 1996; Yin 1995).⁸² No stone went unturned in the effort to locate perpetrators of EITC fraud. Congress went after EITC claimants, the IRS, the Treasury Department, and even health insurance agents who sold policies to low-income taxpayers eligible to claim the health insurance component of the EITC.⁸³ Critics tied the EITC to a host of national problems, including reduced economic growth, the growing tax gap (the yearly difference between federal income taxes owed and federal income taxes collected), and rising taxes for the middle class (Godfrey, 1995b; U.S. Congress, House,

1997b; U.S. Congress, House, 1997c; GAO, 1994).

Some critics believed the IRS so incapable of administering the EITC that it might be better run through welfare offices.⁸⁴ They cited the substantially lower error rates in the AFDC and Food Stamp programs: 6.1 percent for AFDC in 1994, and 7.3 percent for Food Stamps in 1995 (McCubbin, 1999, p. 56; also see Liebman, 2000). Meanwhile, the EITC overclaim rate hovered well above 20 percent. Welfare offices were not just more efficient than the IRS, EITC critics argued, caseworkers could also more easily evaluate qualifying characteristics for EITC eligibles.

Labor Supply Effects

In addition to compliance and administrative problems, the EITC’s parameters implied work disincentives. When combined with other taxes and transfer phase outs, the EITC benefit reduction rate resulted in marginal tax rates that could exceed 50 percent (Browning, 1995; Steuerle, 1995b–c; National Center for Policy Analysis, 1995). Analysts warned that the EITC could push marginal tax rates for the tax and transfer system to 65 percent for families with two or more children, and 60 percent for families with one child (Browning, 1995). Researchers attempted to determine the extent to which these tax rates reduced work effort.

⁸⁰ Sparrow did not use microdata, and characterized his conclusions as “moderately informed guesses.” Steuerle’s suggestion that the EITC encourages a superterranean economy remains a theoretical prediction; the 1993 and 1994 IRS data provide no indication that overreporting of income constitutes a significant compliance problem.

⁸¹ For these investigations, see U.S. Congress, House (1993a–b, 1994, 1997a) and U.S. Congress, Senate (1995a–b).

⁸² Suggestions included replacing the EITC with an exemption for payroll taxes; providing the EITC benefit to low-income workers through a tax credit awarded to employers; disallowing EITC claims filed electronically; denying the EITC to illegal aliens; eliminating the health care and young child supplemental credits; raising the amount of disqualified income for EITC claimants; and denying the EITC to childless families.

⁸³ OBRA 1990 added a health insurance credit to the basic EITC credit. Available to EITC eligibles who purchased health insurance that included child coverage, the health insurance credit varied with a claimant’s income, and offered a maximum benefit of \$451 in 1992. In 1993, the Clinton administration proposed repealing the supplemental credit, a suggestion Congress acted on in OBRA 1993. For a discussion of abusive insurance sales and marketing techniques involving the EITC, see U.S. Congress, House (1993a) and Greenstein (1993).

⁸⁴ See Congressman Rob Portman’s comments, for example, in U.S. Congress, House, 1997a.

Economic theory predicts that the EITC influences some individuals to enter the labor force, and some secondary workers to leave the labor force. For individuals already in the labor force, the theory predicts an ambiguous (positive substitution, negative income) effect in the phase in range of the credit, a negative (no substitution, negative income) effect in the plateau, and a negative (negative substitution and negative income) effect in the phase out. Researchers attempted to measure the cumulative effects of the EITC based on how many individuals fell into each range of the credit, and how individuals responded to different incomes. By examining tax data, researchers determined the number of EITC recipients in each group: roughly 15 percent in the phase in range, 25 percent in the plateau, and 60 percent in the phase out (Hoffman and Seidman, 1990, p. 88; Scholz, 1994, p. 78). Several analysts— basing their conclusions on the high number of taxpayers in the phase out and on predicted income and substitution effects estimated by other researchers, and without considering changes in labor force participation—concluded that the EITC created aggregate work disincentives (Kosters, 1993a–b; Browning, 1995). Studies that examined microdata predicted a less severe effect on the number of hours worked by persons already in the labor force (Hoffman and Seidman, 1990; GAO, 1993; Holtzblatt, et. al., 1994), while some predicted that the EITC might have “a beneficial effect on labor supply” (Dickert, et. al., 1994, p. 622). Until very recently, however, the evidence remained mixed. Through the early to mid 1990s, legislators seemed more influenced by the apocalyptic warnings of analysts who highlighted the EITC’s potentially significant work disincentives.

Although much of the case against the EITC was constructed without microdata, politicians made it part of their rhetorical attack against the EITC. Out of control growth, error rates, and work disincentives, according to critics, plagued the program. With such features, how could the EITC be considered tax policy and not welfare policy? Indeed, as Senator Phil Gramm (R–TX) bluntly stated in 1995, “It’s just welfare, it’s a subsidy” (Godfrey, 1995a).⁸⁵

Counterattack

The EITC’s supporters recognized the danger in this charge, and defended the credit. They argued that by expanding, the EITC was “doing exactly what Congress intended it to do” (U.S. Congress, Senate, 1997). To the accusation that the EITC was “out of control,” the program’s advocates cried foul play. Senator John Rockefeller (D–WV) called such claims “totally misleading,” while Senator Ted Kennedy (D–MA.) considered the accusations not only untrue, but also unmindful of the EITC’s growth relative to inflation.⁸⁶ In relation to pre–1990 law, the 1990 and 1993 expansions did not increase eligibility up the income scale for families with one child; for families with two or more children, the income cut–off increased only slightly (\$3,700, 1999 dollars) relative to the 1986 tax law.⁸⁷ Supporters emphasized that in 1990 and 1993, Congress altered the credit to cover increased payroll taxes (which had jumped 25 percent from 1980 to 1990), real reductions in the minimum wage, higher excise taxes (particularly the gas tax), and certain “deficit reduction provisions” (Storey, 1996, p. 11).

⁸⁵ Although the EITC is indeed an earnings subsidy, Senator Gramm most likely did not have that distinction in mind when he called the EITC a “subsidy.”

⁸⁶ For Rockefeller’s comment, see U.S. Congress, Senate (1997). The program’s projected 4.5 percent growth rate in 1996, Kennedy argued, barely kept pace with increases in the consumer price index (Kennedy, 1995).

⁸⁷ I am indebted to Janet Holtzblatt for the information relating to the EITC’s expansion in the 1990 and 1993 bills.

The EITC had expanded, moreover, due to bipartisan efforts. George Bush initiated the 1990 expansion, while Bill Clinton, who considered a larger EITC the cornerstone of his first-term pledge to “make work pay,” endorsed the 1993 expansion.⁸⁸ “We wanted the EITC to grow,” recalled Rockefeller, “because of its fundamental role in helping parents who are teetering on the economic edge to be able to choose work over welfare, independence over dependence, dignity over the indignities of the welfare system” (U.S. Congress, Senate, 1997). Far from growing beyond its mandate, the EITC respected the original intent of the credit, which the Finance Committee in 1975 said would provide “an added bonus or incentive for low-income people to work,” and an inducement for “families receiving Federal assistance to support themselves” (U.S. Congress, Senate, 1975, p. 11).

By 1996, the EITC’s responsibilities had changed in one important respect: it was all that kept millions of individuals out of poverty. Beginning in the late 1980s, the nation’s social safety net—as it was traditionally conceived—started to shrink. Public assistance programs gave way to work-oriented programs. States received “waivers” of federal welfare rules, allowing them to experiment with alternative ways of administering welfare services. States responded by imposing strict requirements on welfare recipients in an effort to reduce caseloads. In 1996, the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) re-

placed AFDC with a new program, Temporary Assistance for Needy Families (TANF). TANF eliminated open-ended federal matching grants in favor of block grants, thereby devolving welfare responsibility still further to the state level. In exchange for the block grants, TANF required that claimants work (or that states reduce welfare caseloads), and that states impose a five-year lifetime limit on receipt of benefits. It also allowed states to set shorter time limits and add other requirements. The combination of PRWORA and TANF dramatically decreased welfare caseloads. In addition to the unusually strong economic expansion of the late 1990s, time limits, work requirements, reduced benefits, and administrative actions reduced caseloads by as much as 80 percent in some states. While federal and state welfare programs pushed one-time (and would-be) welfare claimants towards work, the EITC eased the transition. It provided individuals entering the labor force an earnings subsidy, as well as an incentive to remain employed.⁸⁹ The EITC had not grown beyond its mandate; it had merely assumed new responsibilities thrust upon it by the work-oriented welfare reform consensus. The program was working as planned.

Neither was the credit a welfare subsidy. Treasury Assistant Secretary for Tax Policy, Leslie B. Samuels, testified in 1995 that the EITC should still be considered a tax refund. When one accounted for payroll taxes, he revealed, 78 percent of the EITC offset tax obligations, while only 22 percent of benefits exceeded total tax li-

⁸⁸ The Presidential initiative to expand the EITC in 1993 was inspired by David Ellwood’s three-pronged attack on poverty: 1) make work pay (by enlarging the EITC); 2) child support enforcement; and 3) welfare time-limits. See Ellwood’s last chapter in Bane and Ellwood (1994).

In selling the EITC in 1993, Clinton argued that posterity would remember favorably his proposed expansion of the program. “[B]y expanding the refundable earned income tax credit,” he declared, “we will make history; we will reward the work of millions of working poor Americans by realizing the principle that if you work 40 hours a week and you’ve got a child in the house, you will no longer be in poverty” (Shapiro and Greenstein, 1993).

⁸⁹ For a discussion of the EITC’s growth relative to the dramatic changes in welfare policy during the 1980s and 1990s, see Elwood (2000).

abilities (Samuels, 1995). Earlier estimates that ignored payroll tax burdens misrepresented the true nature of the EITC. The credit offset the Social Security tax, and provided an added bonus for low-income families to choose work over welfare. Moreover, it accrued primarily to those working families most in need of assistance, those with incomes between 50 and 150 percent of the poverty line (Liebman, 1998, p. 7).

The "Real" Compliance Rates

It wasn't enough to differentiate the EITC from welfare. If the program were to survive, researchers would have to address its high error rates. It was difficult to deny that the program provided incentives for individuals in the phase in range to over-report income, and for those in the phase out range to under-report income. So, too, did it include incentives to over-claim dependents. These incentives could increase noncompliance, and raise administrative costs.

Between 1994 and 1995 the IRS conducted two studies that measured the rate of EITC noncompliance.⁹⁰ The first study included EITC claims filed electronically in January 1994, for tax year 1993. The second study included EITC claims filed both electronically and on paper, and received by the IRS through April 21, 1995, for tax year 1994. The tax year 1993 study found an overclaim rate of 26.1 percent (IRS, 1995b). It also estimated that IRS enforcement techniques (matching returns to information reports, for example) and legislative and administrative changes effective for the 1995 filing season would have further reduced the overclaim rate to 19.1 percent (IRS, 1995b). The tax year 1994 study reached similar conclusions (IRS, 1997). It estimated a 25.8 percent overclaim rate, and indicated that enforcement activities conducted during the 1995 fil-

ing season would have reduced the overclaim rate to 23.5 percent. Moreover, subsequent legislation and administrative actions that took effect during the 1997 filing season (especially the authority, granted in 1996, to treat missing and invalid Social Security numbers as math errors) would have reduced the error rate to 20.7 percent.

Additionally, the IRS studies showed that some EITC eligibles failed to claim the full amount to which they were entitled. This amount totaled \$293 million, or 1.7 percent of the total EITC claimed for the 1995 filing period. Other studies suggested that non-participants (eligibles who do not claim the credit) constituted an even larger source of underclaimed benefits. Approximately 13.6 to 19.5 percent of eligible EITC recipients did not receive the credit for tax year 1990 (Scholz, 1994). The failure to account for non-participation, researchers have argued, makes it impossible for the IRS to measure the amount of overpayments net of the amount not paid, and could overstate the importance of the EITC compliance problem. Even without these additional adjustments, the evidence suggested that EITC overclaim rates declined relative to the 1980s, and that efforts to reduce noncompliance were succeeding.

IRS, legislative, and executive efforts attacked noncompliance from every angle. In 1990, the Treasury determined a relationship between EITC overclaims and errors in filing status and dependency claims. Consequently, the Treasury presented a proposal to Congress (which it subsequently enacted) that simplified the qualifying child criteria and filing status, and made it easier for the IRS to verify EITC eligibility based on information reporting (Holtzblatt, 1991). The IRS was given the authority to match names and taxpayer identification numbers (TINs) on tax returns to individual Social Security

⁹⁰ For a more detailed examination of these studies, see McCubbin (2000).

numbers (SSNs), including SSNs of qualifying children under the age of one. Moreover, the PRWORA of 1996 allowed the IRS to deny the EITC to undocumented workers. The PRWORA also allowed the IRS to reject electronic returns with missing, invalid, or duplicated SSNs, and to delay refunds for paper returns with similar problems until it could further investigate the cases.

Officials scrutinized electronic filing of the EITC, as well, using field personnel to check electronic return originators (EROs). The IRS discovered that a significant number of EROs had falsified EITC claims (Richardson, 1994). Based on these findings, the IRS stopped issuing the direct deposit indicator (DDI), which showed whether a taxpayer's refund could be used to offset other liabilities (in which case the taxpayer was issued a refund anticipation loan, or RAL). Lenders had relied on the DDI to screen RAL applicants who used the expected tax refund as collateral on short-term debt (Godfrey, 1994).

By 1998, the IRS could also levy penalties against individuals who abused the EITC. The Taxpayer Relief Act (TRA) of 1997 contained provisions that disqualified abusive filers for various lengths of time depending on the infraction. TRA 1997 also granted the IRS authority to recover excess refund payments or unpaid taxes by garnishing a percentage of unemployment and means-tested benefits. In addition, TRA 97 provided the IRS two new data sources (the Federal Case Registry of Child Support Orders and data culled by the Social Security Administration) that will aid in assessing the accuracy of future EITC claims.⁹¹

The IRS also used outreach programs to combat error rates. It established

partnerships with state and local government agencies, national and local community service groups, and social welfare, religious, professional, business, labor, and ethnic organizations. The IRS produced instructional workbooks, nationwide tax forums, and explanatory videos to assist in filing for the credit (IRS, 1994a–c, 1995a, 1996). Moreover, the Service provided training for volunteers to help EITC-eligible taxpayers. It distributed promotional information in both English and Spanish, and worked with local school systems to increase awareness among students' families (Taxpayer Advocate, 1997).

At the behest of the Clinton administration, and through the Balanced Budget Act of 1997, the IRS received special discretionary appropriations for fiscal years 1997 through 2002. In both 1998 and 1999, the funds (\$138 million and \$143 million, respectively) went towards EITC compliance activities. The additional funding yielded a significant return. In 1998, the IRS spent \$101 million adjusting EITC math errors, and auditing and conducting criminal investigations related to EITC claims (IRS, 1999). These activities, the IRS reported in 1999, prevented or recovered \$977 million in EITC overpayments (McCubbin, 1999, p. 61).

In addition to reducing EITC noncompliance, the IRS also kept administrative costs below those of other programs. Recall that some individuals suggested the IRS should transfer administrative oversight of the EITC to welfare offices. Although the EITC experienced higher error rates than other programs, the GAO has estimated that EITC administrative costs equal only 1 percent of payments (GAO, 1995, 1997). Comparatively, administrative costs for AFDC equaled 16 percent of total claims for fiscal year

⁹¹ For a more detailed accounting of the authority granted to the IRS, see McCubbin (2000). Unfortunately, the two new data sources only partially compensate for the lack of a recent TCMP study, last conducted in 1988. Congress has cut funding for the exhaustive study, and in 1998, the Senate explicitly prevented the IRS from conducting another TCMP study. The lack of a current TCMP study prevents not only an accurate picture of EITC compliance rates, but also a whole array of additional tax compliance issues.

1995, and for Food Stamps, 15.4 percent of total claims (McCubbin, 1999, p. 77). It is impossible to determine an optimal administrative cost, but at least by comparison, the EITC appears an administratively efficient tax-transfer program.

The “Real” Labor Supply Effects

While efforts to reduce EITC error rates and instill confidence in the IRS’s administrative capabilities progressed, new studies revealed that the program’s work disincentive effects were not as severe as its critics insisted. Early research had concluded that with a majority of recipients in the phase out range, the EITC reduced cumulative hours worked for low-income individuals (Kosters, 1993a–b; Browning 1995). New research using tax return microdata reached different conclusions. Although the majority of EITC eligibles reside in the phase out range and experience marginal tax rates that can exceed 50 percent, recent studies suggest that the phase out has little or no impact on hours worked (Eissa and Liebman, 1996; Liebman, 1998; Meyer and Rosenbaum, 1998).⁹² The credit provides unambiguous incentives for single workers to participate in the labor force, moreover, and it produces statistically significant increases in aggregate labor force participation (Scholz, 1997; Liebman, 1998; Blank, et. al., 1999; Ellwood, 2000; Meyer and Rosenbaum, 2000). Also, the EITC only slightly reduces total number of hours worked by individuals already in the labor force (Hoffman and Seidman, 1990; GAO, 1993; Holtzblatt, et. al., 1994; Dickert, et. al., 1995), and it raises labor force participation rates among single women who might otherwise choose

welfare over work (Dickert et. al., 1995; Eissa and Liebman, 1996; Liebman, 1998; Meyer, 1998; Meyer and Rosenbaum, 1998; Blank, et. al., 1999). The program raises labor force participation among married men, as well (Eissa and Hoynes, 1998). Of course, not all the evidence is positive. Recent analysts have warned that the EITC might reduce cumulative hours worked among married women (Eissa and Hoynes, 1998). It is important to qualify this last finding, however, by pointing out that it is sensitive to the selection of instrumental variables.⁹³

The overwhelming majority of economic evidence suggests that the EITC constitutes a uniquely effective and viable anti-poverty program (CEA, 1998; Greenstein and Shapiro, 1998; Liebman, 1998; Blank, et. al., 1999; CEA, 1999). It responds directly to the economic changes of the past few decades, “explicitly supplementing the wages received by low-wage workers” (Blank, 1997, p. 111). It offsets the tax burden, which has fallen increasingly on the working poor, accounting especially for rising excise and payroll taxes. It shrinks the income gap between rich and poor (Greenstein and Shapiro, 1998). And as reported by the CEA, the EITC lifted 4.3 million persons out of poverty in 1997, including 2.2 million children under the age of 18, more than any other government program (CEA, 1999, p. 114). The EITC has proven such an effective anti-poverty program at the federal level, that 11 states have enacted their own EITCs.⁹⁴ According to recent studies, state-level EITCs produce the same kind of positive benefits as their federal counterpart (Johnson and Lazere, 1999; Madden, 1999; Rust, 1999).

⁹² Studies using microdata have found that even in the presence of the EITC, “typical tax rates on the poor are not particularly high—they rarely exceed 40 percent.” Dickert, et. al. (1994, p. 636).

⁹³ I am indebted to one of the referees from the *National Tax Journal* for this observation.

⁹⁴ The eleven states include Colorado, Iowa, Kansas, Maryland, Massachusetts, Minnesota, New York, Oregon, Rhode Island, Wisconsin, and Vermont. Eight of the 11 state EITCs are refundable.

THE INFLUENCE OF ECONOMIC RESEARCH ON TAX–TRANSFER PROGRAMS

With the help of economic research, the intense political debate surrounding the EITC has subsided. Studies on the EITC's labor supply effects, for instance, have helped diffuse criticism and mobilize support for the credit. Economic research has also mitigated concerns regarding EITC compliance. Although error rates remain unsatisfactorily high, the evidence indicates they are dropping. Further enforcement efforts promise to lower the overclaim rate still further.⁹⁵ Once OBRA 1993 completely phased in, and as more researchers discussed the EITC as an integral part of a new, work-oriented welfare state, critics stopped calling the credit a welfare program. More generally, economic research has provided an educative function by emphasizing that designing a tax–transfer system involves making tough choices between policy outcomes. If officials wish to keep the EITC narrowly targeted, they must accept attendant high marginal tax rates, which in turn, will theoretically increase the likelihood that recipients trade benefits for work. Likewise, if policymakers want the tax system to perform social policy functions, they must acknowledge that ease of participation might increase error rates. Indeed, economic research has contributed to a more knowledgeable debate over the tax and transfer system.

But the debate itself is far from over. Compliance problems and cost remain highly political issues. The EITC poses questions that do not yield to clarification by scientific research alone. The trade-offs in tax–transfer programs require political solutions. No matter how many studies analysts produce, no matter how much evidence is amassed, policymakers will

continue to debate the EITC's work incentives, its relationship to the private economy, and its cost.

It should come as no surprise that politics influence national social provision. However, exactly when has politics mattered in the development of the tax and transfer system? More importantly, how and why has politics mattered, particularly in relation to economic analysis? During the last 30 years, economic research influenced how politicians used tax provisions as substitutes for direct expenditure programs. But to what extent did politics affect, and even compromise, tax policies that functioned as social policy? The balance of this paper will use the foregoing history of the EITC to analyze the relationship among tax policy, politics, and economic research. It borrows a theoretical framework from political science—the multiple streams model—to clarify how, why, and to what extent economic research versus political rhetoric mattered in the creation and development of the EITC. Three separate “streams” constitute the most common articulation of this model: 1) problem recognition (where enough individuals identify a “condition” as a “problem”); 2) the development of policy solutions (where a policy community generates solutions for the identified problem); and 3) politics (such as swings in national mood, public opinion, or election results) (Kingdon, 1984). Or, as Kingdon describes, “A problem is recognized, a solution is available, the political climate makes the time right for change, and the constraints do not prohibit action” (Kingdon, 1984, p. 93). Issues rise and fall on the policy agenda in relation to whether or not the streams merge (or “couple”) and whether issue advocates (“policy entrepreneurs”) take advantage of certain opportunities (or “policy

⁹⁵ McCubbin (2000) offers evidence to suggest that concentrating on improving enforcement techniques—rather than scaling back the EITC—will most effectively reduce the program's overclaim rate.

windows”) (Kingdon, 1984, pp. 129–30 and 173–204).⁹⁶

Swimming Upstream: The Case of the NIT

Interpreting how and why the EITC rose on the policy agenda requires understanding the policy alternatives that preceded it. The negative income tax was the intellectual and political antecedent to the EITC. Its short-lived, but intense, popularity, followed by its sudden departure from atop the policy agenda and then temporary reemergence, helps explain the success of a work-oriented tax credit like the EITC.

In the early 1960s, “poverty” the condition came to be defined as “poverty” the problem. The Johnson administration developed an arsenal of anti-poverty proposals, including an NIT. By 1966, the OEO believed an NIT could help eliminate poverty within a decade. A number of disparate interest groups supported the NIT concept. “It [was] endorsed by the left-leaning Americans for Democratic Action and by the right-leaning Ripon Society, by the National Association of Social Workers . . . and by a committee of business leaders” (Wilcox, 1969, p. 248). It also had the support of experts. In 1968, 1,200 economists signed a petition encouraging the White House to consider an NIT. Despite these endorsements, the NIT did not rise to the top of the policy agenda, because the President, a critical agenda setting actor, withheld his support.

Only a year later, Richard Nixon gave the NIT new life. “Welfare dependency” had joined “poverty” as a pressing national problem. Rising welfare rolls indicated that the existing system of social assistance perpetuated the time individuals spent on the public “dole.” The FAP

proposal, with its NIT and work requirements, promised to eliminate both poverty and welfare dependency. Powerful interest groups supported the concept of an NIT, and experts evaluated various parameters for an NIT program, all while a new president was looking for a ready-made solution to a national “crisis.” In the language of political scientists, the policy streams converged, and the NIT percolated to the very top of the policy agenda in 1969.

As quickly as the NIT rose, it also fell. After President Nixon proposed FAP, divergence, rather than convergence, characterized the ensuing political debate. Of the many factors that knocked the NIT from atop the policy agenda, two predominate: 1) the highly publicized Congressional debate over notches; and 2) the perceived obfuscation behind the administration’s use of the New Jersey negative income tax experiment. In both instances, credible economic voices challenged the NIT plan. Credible countervoices alone, however, cannot remove an issue from the policy agenda (Cook, 1990, p. 408). It can remain on the agenda if its advocates respond adequately. The Nixon administration neither remedied the notch problems in its NIT program, nor convinced anyone that it had not compromised the integrity of the New Jersey experiment. Indeed, it was difficult to muster counterevidence for a program that contained fundamental flaws: the administration could not parameterize its NIT such that it contained an adequate income guarantee, maintained all the characteristics of the tax system, and provided work incentives, all at an acceptable cost.

The credible countervoices shook the administration’s proposal, but it took additional, “micromediating” factors to knock it from the policy agenda (Cook,

⁹⁶ In addition to Kingdon’s multiple-streams model, political scientists have described the agenda-setting process with the help of other theoretical frameworks, including the convergent/divergent-voice and punctuated equilibrium models. See Cook (1981 and 1990) for convergent/divergent-voice model, and Baumgartner and Jones (1993) for punctuated equilibrium model.

1990, pp. 408–9). Interest groups openly criticized the program. Experts, too, withdrew their allegiance.⁹⁷ Even the President abandoned his initiative. To make matters worse, results from the Seattle–Denver NIT experiments indicated that low-income husbands and wives, presumably in an effort to receive larger cumulative benefits, were more likely to split up in the presence of an NIT. And the media reported all of this. It chronicled FAP’s disintegrating support, as well as the charges that an NIT amounted to a perverse guaranteed annual income that perpetuated the cycle of welfare dependency and undermined family values. In short, the policy community that muscled negative income taxation onto the policy agenda cracked; the streams diverged; the policy window closed on the NIT; negative income taxation fell from the policy agenda.⁹⁸

In the final analysis, the economic research that the administration had hoped would support income supplements helped destroy them. Officials failed to demonstrate to politicians the difficult trade-offs inherent in the design of tax-transfer programs. Moreover, by inadequately addressing the notch problems, and inappropriately breaking into the New Jersey experiment, the Nixon White House discredited social science inquiry and experimentation. It politicized economic research, and for at least the duration of the FAP debates, blurred the distinction between empirical analysis and theoretical prediction.

Convergent Streams: The Case of the EITC

Although the agenda-setting streams diverged in the early 1970s, they did not fundamentally reconstitute themselves.

Welfare dependency remained a national problem. The political environment, too, remained constant; public opinion and elected officials preferred pro-work social programs. The list of policy solutions sounded familiar, as well. None of the ideas captured the attention of Congress, however, and none of the solutions addressed new problems on the policy agenda. Payroll taxes and Social Security refinancing preoccupied legislators in the early 1970s. As the decade progressed, economic growth and unemployment was added to the list, as was tax reduction. A welfare reform initiative that sufficiently appreciated the problem stream as well as the political stream could jump through the policy window.

In 1975, the EITC emerged from the policy stream as the perfect complement to the other two streams. Its benefits accrued to workers, and it provided incentives for individuals outside the labor force to enter. It offset rising payroll taxes, and it reduced income tax liability for low-income individuals. It was run through the tax system, not welfare offices, and it boasted a modest price tag. Moreover, critical policy entrepreneurs supported the EITC, and convinced legislators that it could remedy several prevailing national problems (Michael Stern, Russell Long’s key staff member for the EITC, deserves especial comment). They also demonstrated the relative structural simplicity of the EITC; it phased up to a certain income level, and phased out at an agreeable point. Its modest size kept it from raising cumulative marginal tax rates too high. The streams converged, and policy entrepreneurs pushed the EITC through the policy window.

For the next several years, a group of policy entrepreneurs nurtured the EITC,

⁹⁷ In 1970, Milton Friedman, a one-time FAP supporter, called the proposal, “a striking example of how to spoil a good idea” (Friedman, 1970, p. 89).

⁹⁸ Although Congress rejected negative income taxation in 1972, it enacted the first federally subsidized guaranteed income in the form of the Supplemental Security Income (SSI) program. Restricted to the aged, blind, and disabled, SSI originally provided a monthly income of up to \$210 per couple.

while another group fought to replace it. The first policy community envisioned an expanded EITC that provided more substantive economic support to individuals moving from welfare to unsubsidized work. A second policy community de-emphasized work-oriented policies, and reincarnated a comprehensive, high-rate NIT. In an effort at compromise, the two policy communities merged their proposals, but with disastrous results. The PBJI spoke of work incentives, but it also contained a cash subsidy. It was a workfare bill, and at the same time, it was a guaranteed annual income. Moreover, it was confusing. Charles Schultze, Chairman of Carter's Council of Economic Advisors, acknowledged its complex nature. "The thing got so goddamned complicated," he complained, "that nobody in the world but the three or four people who put it together fully understood it, and I doubt if they did fully" (Lynn and Whitman, 1981, p. 191).

Economic research might have clarified the policymaking process by attaching numbers to predicted behavioral responses, but it only served to confuse the Carter proposal. Modeling data, for instance, divided the administration in the early planning stages, and then later confounded the political process by producing inconsistent cost estimates. Although much of the cost discrepancies were attributable to political disagreements regarding which program savings should be offset against PBJI's costs (footnote 63), economic analysis, it seemed, not politics, complicated the policy process. Not only did economic data attach an aura of confusion and carelessness to the bill, it left the impression that the administration was deceptively fiddling with the economics of its initiative. Reminiscent of FAP, economic research politicized rather than clarified the political discussion. Of course, other factors contributed to the demise of the PBJI (divergence of interest groups, poor presidential leadership, a

heightened anti-welfare sentiment), but the improvident use of economic data killed the Carter welfare bill.

The EITC remained a viable policy solution despite PBJI's defeat. Although it had contributed to the proposal's confusion (complicating break-even points, phase outs, and marginal tax rates), politicians identified the NIT, not the EITC, as the cause of that confusion. Into the 1980s, policy entrepreneurs advocated the EITC as complementary to both the political and problem streams. It provided an incentive for individuals to leave welfare for work, and it satisfied a political conservatism that required pro-work, pro-growth, low-cost social programs. By the mid-1980s, the visible policy participants (the President, members of Congress, and high-level appointees), as well as the hidden policy participants (experts, bureaucrats, and staffers), recognized that the EITC complemented emergent national problems. It could help policymakers address rising tax burdens on working families, for example, and decrease sharpened inequalities between rich and poor. New budget rules, too, worked to the advantage of those desiring an expanded EITC. By 1986, the program enjoyed the support of liberals and conservatives, the President, Congressional leaders, disparate political interests, and powerful policy communities.

If that were not enough, the EITC provided the glue that held together one of President Reagan's most important legislative accomplishments: the 1986 Tax Reform Act. Specifically, the EITC helped policymakers achieve distributional and revenue neutrality in the final bill. As a tax credit for low-income individuals, it offset tax cuts for high-income taxpayers and balanced the incidence of the tax reform package. Also, the EITC's cost could be split between the direct expenditure and tax expenditure budgets. Equally important, policy entrepreneurs kept the EITC simple. They did not confuse the

political debate with the program's structural or administrative technicalities, but rather referred to it as a tax offset for the working poor. They showed how the credit's expansion, although significant, merely reestablished original benefit levels.

To explain the EITC's expansion in 1986, we need look no further than this conflation of interests and careful lobbying effort. A consensus formed around the EITC. The streams merged, and they remained together. No credible countervoice challenged the program. Policy communities defended the credit to their constituents. No viable policy alternatives emerged. The credit remained relatively simple for the media to report: it was a tax credit that removed millions of low-income, working Americans from poverty. Thrust onto the national stage, the EITC was transformed from an obscure tax credit to a more visible social instrument with significant anti-poverty responsibilities.

Economic Research Helps Save the EITC

For the next several years, the "new" EITC enjoyed bipartisan support. However, the bubble burst in the early 1990s. According to critics, the program suffered from high error rates, significant work disincentives, and skyrocketing costs. The EITC was in serious trouble, but it survived for two reasons: 1) it complemented the political stream by providing a coherent, pro-work, pro-growth, low-cost, anti-poverty program; and 2) economic research indicated the extent to which it upheld the principles of the welfare reform consensus.

The Treasury identified causes of taxpayer error, and responded with a series of simplification and compliance proposals. They strained resources to improve and update enforcement techniques. They educated taxpayers on how and when to claim the credit. Their administrative efforts, as we have seen, proved successful.

Other researchers dispelled rumors that the EITC reduced work effort. They showed that the credit provided unambiguous incentives for single workers to participate in the labor force. It also produced statistically significant increases in aggregate labor force participation. The evidence indicated that the credit raised labor force participation among married men, and (more important politically) among single women who might otherwise choose welfare over work.

Collectively, economic research provided a valuable educative function, as well. Economic analysts carefully articulated the policy trade-offs involved in programs like the EITC. They taught legislators about the design and interaction of a comprehensive tax-transfer system. They admitted that although far from perfect, the EITC represented the best available policy solution (Steuerle, 1995a). And most important, it embodied the "make work pay" consensus that had come to dominate social policymaking in the 1990s (Blank, et. al., 1999, pp. 4-5).

CONCLUSION

For much of the EITC's history, political rhetoric, not economic research, dominated the debate over tax-transfers. As this paper has demonstrated, economic analysis helped at least one tax-transfer program survive. In the 1990s, it depoliticized what was otherwise a highly political battle over the EITC. It responded quickly to credible countervoices (TCMP data, theoretical labor supply effects, rapid growth) with even more credible empirical research; it explained the complexities of tax-transfer policymaking to a non-expert audience; it generated consensus about the EITC as a policy solution among various policy communities; and it spoke to national problems and the political environment. In a sense, economic analysts finally learned to appreciate the politics of welfare reform; they

“saved” the EITC by helping merge the three policy streams. In another sense, experts got lucky. The EITC’s survival depended more on a receptive political environment than on economists becoming more effective political actors. The EITC represented the perfect policy solution to a set of social problems, and a welfare reform consensus that favored pro-work, pro-growth, low-cost alternatives. Indeed, economic research was a necessary, but not sufficient, component of the EITC’s survival.

The future of the EITC will depend on the relative flow of the problem, policy, and political streams. Economic analysis will influence whether the streams remain together or diverge. The political process, however, will continue to challenge and distill economic research. More generally, politics, not economics, will dominate future discussions of the U.S. tax-transfer system. The foregoing history of the EITC exposed the powerful influence that national politics and values have on tax-transfer programs like the EITC. It is not the historian’s role to make predictions or to suggest policy prescriptions based on these observations. Rather, it is incumbent on the historian to identify political, social, and cultural trends and continuities that might inform policy discussions. This paper described the intersection of tax policy, politics, and economic analysis. More pointedly, it explored the political uses and abuses of economic theory and research, with specific reference to the EITC. If future social policymaking follows the pattern described in this paper, policy alternatives, regardless of their theoretical or analytical appeal, will have to complement rather than conflict with social and cultural forces to prove successful.

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Appendix

APPENDIX TABLE 1
EARNED INCOME TAX CREDIT PARAMETERS: 1975-99

Year	Phase In Rate (%)	Phase In Range (\$)	Max. Credit (\$)	Phase out Rate (%)	Phase out Range (\$)
1975-78	10.0	0-4,000	400	10.0	4,000-8,000
1979-84	10.0	0-5,000	500	12.5	6,000-10,000
1985-6	14.0	0-5,000	550	12.22	6,500-11,000
1987	14.0	0-6,080	851	10.0	6,920-15,432
1988	14.0	0-6,240	874	10.0	9,840-18,576
1989	14.0	0-6,500	910	10.0	10,240-19,340
1990	14.0	0-6,810	953	10.0	10,730-20,264
1991(a)	16.7 (b) 17.3 (c)	0-7,140	1,192 1,235	11.93 12.36	11,250-21,250
1992(a)	17.6 (b) 18.4 (c)	0-7,520	1,324 1,384	12.57 13.14	11,840-22,370
1993(a)	18.5 (b) 19.5 (c)	0-7,750	1,434 1,511	13.21 13.93	12,200-23,050
1994	26.3 (b) 30.0 (c) 7.65 (d)	0-7,750 0-8,425 0-4,000	2,038 2,528 306	15.98 17.68 7.65	11,000-23,755 11,000-25,296 5,000-9,000
1995	34.0 (b) 36.0 (c) 7.65 (d)	0-6,160 0-8,640 0-4,100	2,094 3,110 314	15.98 20.22 7.65	11,290-24,396 11,290-26,673 5,130-9,230
1996	34.0 (b) 40.0 (c) 7.65 (d)	0-6,330 0-8,890 0-4,220	2,152 3,556 323	15.98 21.06 7.65	11,610-25,078 11,610-28,495 5,280-9,500
1997	34.0 (b) 40.0 (c) 7.65 (d)	0-6,500 0-9,140 0-4,340	2,210 3,656 332	15.98 21.06 7.65	11,930-25,750 11,930-29,290 5,430-9,770
1998	34.0 (a) 40.0 (b) 7.65 (c)	0-6,680 0-9,390 0-4,460	2,271 3,756 341	15.98 21.06 7.65	12,260-26,473 12,260-30,095 5,570-10,030
1999	34.0 (a) 40.0 (b) 7.65 (c)	0-6,800 0-9,540 0-4,530	2,312 3,816 347	15.98 21.06 7.65	12,460-26,928 12,460-30,580 5,670-10,200

- (a) Basic credit only. Does not include supplemental young child credit or health insurance credit.
- (b) Families with one qualifying child.
- (c) Families with two or more qualifying children.
- (d) Taxpayers with no qualifying child.

Source: 1998 Green Book for 1975-97 and Office of Tax Analysis for 1998-9.