THE EARNED INCOME TAX CREDIT ABROAD: IMPLICATIONS OF THE BRITISH WORKING FAMILIES TAX CREDIT FOR PAY-AS-YOU-EARN ADMINISTRATION

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IN THE UNITED STATES, ROUGHLY 110 MILLION TAXpayers will be required to file a tax return for tax year 1999. An additional 10 to 15 million taxpayers, while not required to file a tax return, will likely file one simply to receive a refund of taxes overpaid during the year. These filing requirements can impose monetary, time, and psychic costs. Concern about the burdens imposed by filing requirements prompted the Congress to mandate that the Treasury Department devise plans, if feasible, for a return-free system for "appropriate taxpayers" by 2007 (*IRS Restructuring and Reform Act*).

Thirty-six countries operate an income tax system that exempts at least some taxpayers from a filing requirement (GAO, 1996). Most return-free systems (including the United Kingdom) collect income taxes throughout the year by withholding taxes at the source; these are generally referred to as pay-as-you-earn or PAYE systems. Denmark and Sweden give taxpayers the option of having the tax agency prepare their returns at the end of the year. Two recent studies (GAO, 1996; Gale and Holtzblatt, 1997) examined whether it would be possible to eliminate the filing requirement while retaining many features of the individual income tax. Both studies found that about half of taxpayers could be exempted from a filing requirement with minimal structural changes to the income tax under a tax agency reconciliation system similar to those in Sweden and Denmark. Most of these taxpayers file the relatively simple 1040A or 1040EZ returns, and it is debatable whether the gains of shifting these individuals to a return-free system would offset the costs.

Moving to a PAYE system and increasing the number of U.S. taxpayers exempted from a tax filing requirement to include those who currently file more complicated returns would require substantive changes to both the tax and transfer systems. For example, the U.K. exempts over 85 percent of wage earners from a tax filing requirement using the PAYE system, which is facilitated by using the individual, rather than the married couple, as the unit of taxation, and by the U.K.'s greater reliance on spending programs to deliver subsidies.

One such subsidy is the family credit (FC). Like the earned income tax credit (EITC), the FC is targeted at low-income workers with children, and the amount of the credit is based on work effort. However, the British have administered the FC through the welfare system rather than through the tax system, limiting the information on family structure and household earnings necessary for the tax authorities to administer the PAYE system.

There may be some advantages to operating an "in-work" benefit through a PAYE tax system. Workers would be able to avoid the stigma and the transactions costs associated with the welfare system, and they would see an immediate reward to work in their paycheck. In addition, they would benefit from the administrative simplicity of paying their taxes and receiving their in-work benefits through the employer in a timely fashion during the year. Nonetheless, Gale and Holtzblatt conclude that it would be difficult to administer the EITC through a PAYE system. Paying the credit in advance throughout the tax year could lead to erroneous payments if family circumstances or income unexpectedly changed during the year and there were no reconciliation process at the end of the year.

Recent events, however, suggest the need to reexamine the conclusion that a program like the EITC could not be a component of a PAYE system. Last spring, the British Labour government

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proposed the replacement of the FC with a working families tax credit (WFTC). Like the EITC, the WFTC would be paid through the tax system. Like both the FC and the EITC, the WFTC would be based on family income (not just individual income), and would vary with family size. Nevertheless, most British taxpayers would continue to be exempted from any tax filing requirement, and the unit of taxation would remain the individual.

In this paper, we compare the FC, the EITC, and the proposed WFTC, and examine the conditions under which an EITC-like program and a PAYE system can be combined. First, we describe the different choices the U.S. and U.K. have made in how their in-work benefits vary with family income. Second, we discuss the decision whether to administer earnings subsidies through the tax system or through the welfare system. Third, we examine the tradeoffs involved in deciding the timing of such payments.

BUDGET CONSTRAINTS

The credit schedules of the EITC, FC, and WFTC have a similar structure. All three credits initially rise with earnings and are then phased out as earnings and family income rise further. However, there are substantial differences as well. There is no phase-in region in the U.K. credits, and the EITC phases out more slowly than do the U.K. credits. Moreover, the two U.K. credits explicitly take into account hours worked. These differences raise interesting economic issues.

Comparing the Benefit Formulas

In the FC, eligible families receive a basic credit of £48.80 per week (about $80) in 1998.[1] Claimants receive an additional credit of up to £25.40 ($42) for each child, depending on their ages. To be eligible, at least one custodial parent must work more than 16 hours a week. The credit increases by £10.80 ($18) a week if at least one of the parents works more than 30 hours a week. The FC begins to phase out when the family's net income (gross income net of income and payroll taxes) exceeds £79 ($131) a week. The phase-out rate is 70 percent on net income, which, for a worker making about $12,000 a year, is equivalent to a 49 percent rate on pre-tax income (the exact pre-tax rate depends on a worker's marginal rates from income and payroll taxes). Families are ineligible for the FC if the parents' combined assets exceed £8,000 ($13,280).

The WFTC will increase the amount of the credit received by families with children under age 11 by £2.50 a week ($4.15). For all families, the WFTC will begin to phase out at a higher level of net family income (£90 or $149 a week instead of £79), and the phase-out rate would be reduced from 70 percent to 55 percent (equivalent to a 39 percent rate on pre-tax earnings of $12,000). The British Treasury estimates that the WFTC will cost £5 billion ($8 billion) a year when fully implemented, or £1.5 billion more than the FC, and will increase the number of beneficiaries by 400,000 to 1.5 million families.

Figures 1 and 2 compare annual benefits from the EITC and the WFTC for a single parent with two children (ages 8 and 12) at different levels of annual hours of work.[2] Comparing the two credits, it is important to remember that the WFTC is received either weekly or monthly, while the EITC is generally a single annual payment. In the figures, the worker is assumed to work the same number of hours each week throughout the year. For both credits, payments can vary considerably with family composition and the amount of non-labor income. With these caveats in mind, the simple examples below illustrate the main features of the two credits.

Two key differences between the U.S. and U.K. credits can be seen in Figure 1, in which a $6 hourly wage is assumed. First, WFTC benefits, as with the FC, depend on hours and earnings; EITC benefits depend only on earnings. WFTC requires at least 16 hours of work a week (832 hours per year), and the credit increases at 30 hours a week (1,560 hours per year).[3] In contrast, there is no work-hours requirement for the EITC; instead, the credit initially increases with earned income. Thus, the low-wage worker in this example who works 30 hours a week will receive the same EITC amount as a worker who earns $12 an hour but who works half the hours. In the U.K., this low-wage worker would be entitled to the WFTC (including a bonus for the additional hours of work), while the higher wage part-time worker would receive no credit.

Second, the maximum WFTC can be much greater than the maximum EITC. The maximum WFTC in this example is initially about $7,260 ($7,618 at 30 hours), while the maximum EITC for a worker with two children is $3,756. However, these figures do not take into account the fact that many low-income U.S. workers are also eligible for food stamps, which may bring their total benefits in closer alignment to the WFTC.

Figure 1: **Comparison of WFTC and EITC for a Single Parent with Two Children (Ages 8 and 12) Earning $6 an Hour (1998 Dollars)**

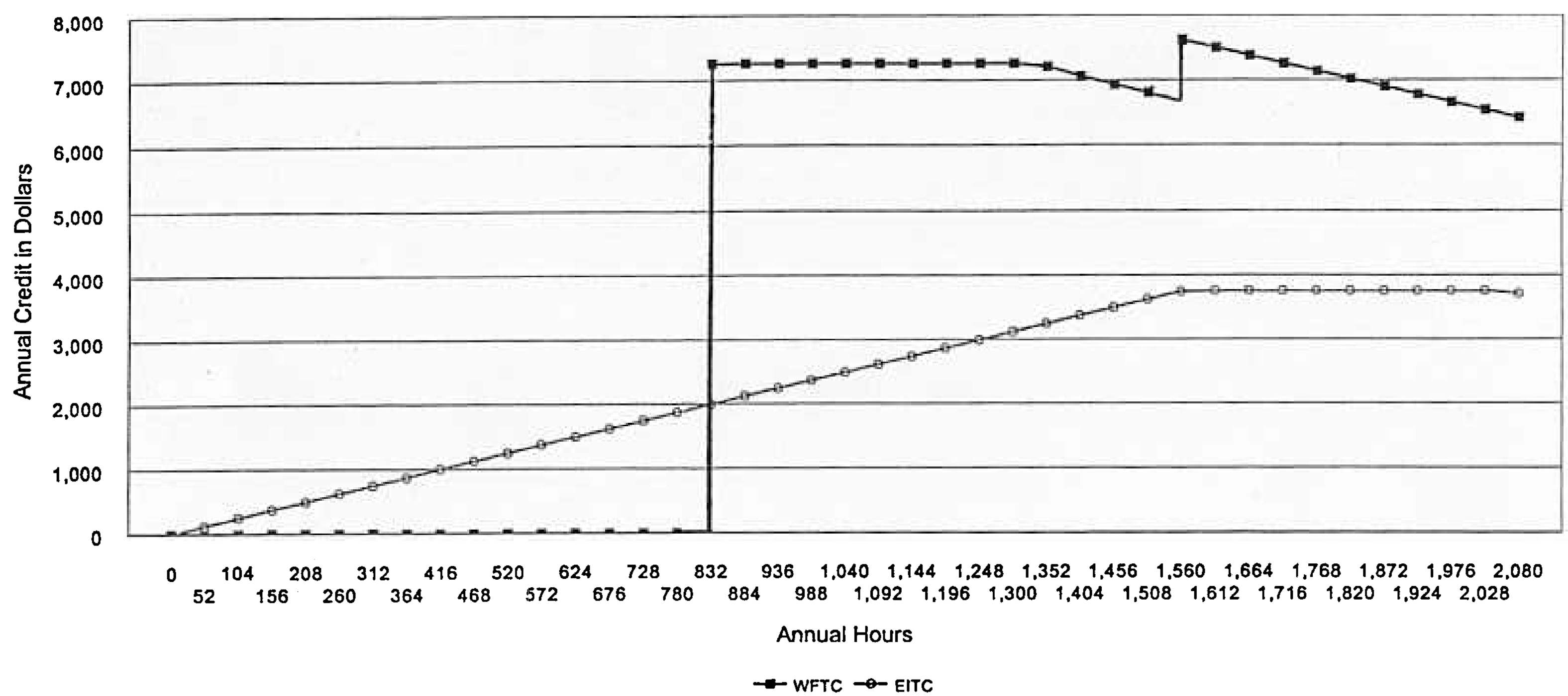
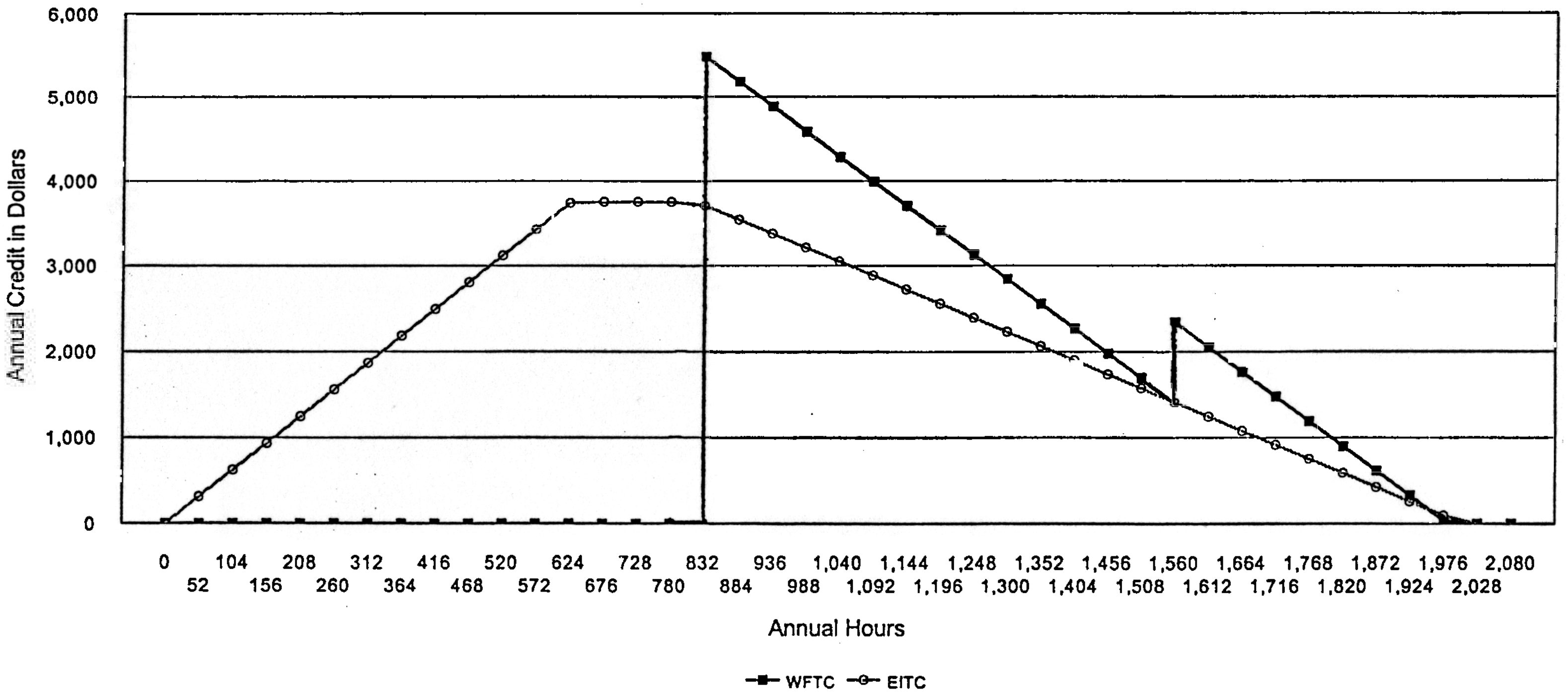


Figure 2: **Comparison of WFTC and EITC for a Single Parent with Two Children (Ages 8 and 12) Earning $15 an Hour (1998 Dollars)**



As Figure 2 demonstrates, for a half-year worker with two children earning $15 an hour, the EITC is reduced by 21 cents per dollar of additional pre-tax income, while the WFTC will be phased-out at rate of 55 percent on after-tax income, which is equivalent to roughly a 37 to 39 percent phase-out rate on pre-tax income. Therefore, while the WFTC is much more generous than the EITC for extremely low-wage workers who work 15 to 20 hours a week, it phases out entirely at income levels roughly the same as the EITC (about $30,000 in both cases).

Conditioning on Hours Worked

The apparent ability of the U.K. to measure hours worked raises the question of why the two countries do not target low-wage workers more directly by providing a wage subsidy. An advantage of a wage subsidy over an earnings-based system is that benefits would not need to be reduced as hours increased. Thus, the labor supply distortions created by the phase out could be eliminated, although decisions concerning moving to higher wage jobs could still be distorted.

The traditional argument against such an approach has been that it is difficult to separate earnings into hours and wage components. In particular, firms and workers would have the incentive to inflate their reporting of hours and deflate their reporting of wages. While the U.K.'s apparent capability to measure hours worked suggests that it might be worth reconsidering this traditional argument, it is likely that it is easier to verify whether a worker has passed a 16- or 30-hour threshold than to measure the exact hours of every worker. In addition, there is no public information on the accuracy of the hours reports in the FC.

Phase-ins and Phase-outs

The figures above illustrated one clear difference in the budget constraints provided by the EITC and WFTC; once a worker in the U.K. starts receiving benefits, additional hours of work reduce the WFTC (ignoring the small increase at 30 hours). In contrast, U.S. workers with earnings in the phase-in region can increase their EITC by working more hours.

The EITC phase-in allows the credit to encourage work for a broad range of workers, while still providing a subsidy for very low-wage workers. It helps bring the credit closer to achieving the goal of eliminating poverty among full-time minimum wage workers, while creating an incentive for part-time low-wage workers to move into full-time work. Absent the ability to measure hours of work, the EITC structure is the logical way to accomplish these objectives. Moreover, at very low-income levels, the phase-in rates help offset the work disincentives associated with temporary assistance for needy families and food stamps, as well as payroll taxes.

THE TAX SYSTEM VERSUS THE WELFARE SYSTEM

As the U.S. and U.K. experiences demonstrate, credits for low-income workers with family responsibilities can be designed to be administered through either the tax or transfer system. The choice depends on administrative, tax policy, economic, and political considerations.

Three Ways of Administering Transfers

Since 1988, the U.K. has administered the FC through the Department of Social Security (DSS), the same agency that handles other income transfer programs, such as child benefits and income support. The image of the typical public assistance program—long wait at a government office, intrusive questions from a caseworker—does not apply to the operation of the FC. Claimants can obtain an application package by phoning the Family Credit Helpline or from any Social Security Office. They complete the application on their own. DSS encourages claimants to provide supporting evidence, such as their national insurance number, their children's child benefit numbers, and pay slips, along with their applications. Completed forms can be mailed to the main Family Credit Unit, which may follow-up with further questions for the claimant or his or her employer over the telephone. While there have been complaints that the length of the form and the stigma of receiving a welfare benefit have discouraged some eligible families from applying for the benefit, DSS reports that 90 percent of new FC claims from employed people are cleared within five days, and that 70 percent of those eligible for the FC claim it.

In the U.S., the EITC is administered through the tax system, and most recipients claim the credit when they file a return at the end of the year. Those with qualifying children attach the Schedule EIC to their tax return; those who do not reside with children can apply for a small credit simply by filling in the appropriate line on their Form 1040. As with all taxpayers, the returns of EITC claimants are matched against W-2s and other information reports filed by payers of income to detect underreported income. In addition, IRS has relied increasingly on verification of social security numbers and other screening devices to identify potentially erroneous claims before refunds are paid out. Tax refunds, including the EITC, are paid on average within 38 days. Scholz (1994) finds that 80 to 86 percent of those eligible claimed the EITC in 1990.

Since 1979, claimants with children have been able to obtain a portion of the EITC in advance during the tax year by filing a Form W-5 with their employer certifying their eligibility. The employer maintains the Form W-5, but does not file it with IRS. The employer is then required to add a weekly increment to the individual's take-home pay based on the predicted EITC at the end of the year. The employer reduces payments of withholding taxes to IRS by an offsetting amount. At the end of the year, the employer notifies the employee and IRS of the amount of the advance payments made on the W-2. Workers are required to file a tax return in order to report the amount of advance payments and any additional credit amounts owed them or payable back to IRS. Although IRS has intensified its outreach efforts to inform taxpayers about the advance payment option, only about 215,000 taxpayers (about 1 percent of those eligible) reported that they received the EITC in advance during tax year 1997.

Beginning in October 1999, the U.K. will replace the FC with the WFTC, administered by Inland Revenue. While many details on administration have not yet been released, it seems likely that many features of the FC will be retained, with the inclusion of at least three new features borrowed from the EITC advance payment option: (1) the credit will be payable through the employer beginning in April 2000 (and directly by Inland Revenue during the transition period); (2) the employer will reduce payments of withholding taxes to offset the costs of the WFTC; and (3) Inland Revenue will be responsible for processing applications and verifying eligibility. WFTC claimants will not be required to file an end-of-year tax return. Instead, claimants will send a form (similar to the application form for the FC) directly to Inland Revenue with information on family composition, family income, and assets. Inland Revenue will then instruct the worker's employer to add the appropriate amount to the worker's regular pay check.

Are There Advantages to Paying Benefits through the Tax System?

Although an expenditure agency administers the FC while a tax agency administers the EITC, the operation of the systems are quite similar; in both cases, an agency that processes many forms and sends out many checks must process an additional form and make additional payments. However, there is a key difference between the two countries because most EITC claimants are required to file a tax return, while most FC recipients are not.

In the U.S., 95 percent of EITC filers would still have reason to file an individual income tax return for tax year 1999 if the credit did not exist, and IRS would still have to process their returns and verify much of the same information regarding their filing status, number of children, and income. About 70 percent of EITC claimants will be required to file a tax return because they have an individual income tax liability (before the EITC), owe special taxes, have self-employment income in excess of $400, or because their gross income will exceed the filing threshold. An additional 25 percent of EITC claimants will file a tax return in order to obtain a refund for over-withheld taxes paid throughout the year. In contrast, less than 15 percent of U.K. wage earners file a tax return.

For a U.S. recipient, it is almost certainly easier to attach an extra form to a tax return than it would be to interact with an additional agency. In contrast, in the U.K., the working parent has contact with both DSS (to apply for the non-means tested child benefit) and Inland Revenue (to supply information necessary to determine the correct PAYE rate), but would not normally provide either agency with all of the information (such as total family income or assets) necessary to determine eligibility for the WFTC if the credit did not exist. Thus, a major advantage of administering earnings-related subsidies through the tax system—an application for benefits that follows directly from an activity that the worker must undertake anyway—is not present in the U.K. PAYE system. Why, then, has the Labour government proposed uprooting the FC from the transfer system and planting it, instead, in the tax system?

During consideration of the WFTC proposal, four reasons were generally cited (Liebman, 1997; Taylor, 1998):

- First, administering benefits through the tax system, rather than the welfare system, would reduce the stigma associated with claiming the FC and increase program participation.

Second, paying the credit through the paycheck would reinforce the distinction between the "rewards of work and remaining on welfare."

Third, shifting administrative responsibilities from the expenditure system to the tax system would make it possible to lower marginal benefit withdrawal rates.

Finally, a tax credit was thought to be politically more acceptable than social security benefits to most claimants and taxpayers as a whole.

Underlying these arguments are certain assumptions regarding the stigmatizing effect of welfare, the reactions of employers to wage subsidies, and political support for tax credits, which may or may not be valid.

Removing the Stigma of Welfare

In the U.S., EITC participation rates appear to be higher than comparable rates for many other programs serving low-income populations, such as food stamp benefits. Participation rates are also higher for the EITC than for the FC. If the EITC's relatively high participation rates are due primarily to an absence of welfare stigma, then the PAYE versions of the EITC may be able to achieve participation rates of 80 percent or more, just as the EITC has. But there may be other reasons for nonparticipation in the FC. Some eligible individuals may not be aware of the program or may find the costs of applying too high. If factors other than welfare stigma affect participation in the FC, then we might not expect to see the high EITC take-up rates duplicated in the WFTC.

Paying through the Paycheck

Paying the credit through the employer, rather than through a government agency, could raise privacy concerns, impose administrative costs on employers, and make it more likely that firms rather than workers capture the subsidy. The U.K. has addressed the first two concerns by adopting procedures that would minimize the involvement of firms in administering the WFTC. Although firms will include the credit in workers' paychecks, workers will apply for the credit by mailing a form directly to Inland Revenue. Inland Revenue will protect worker confidentiality and reduce employer administrative responsibilities by reporting to the firm only the amount of the credit to be included in the paycheck.

Regardless of who makes the payment, it is theoretically possible that firms will respond to a credit that subsidizes wages by cutting wages. Thus, firms may capture some or all of the subsidy. There is no credible evidence as to whether or not this has occurred in response to the EITC or the FC, both of which are generally paid directly to the worker by the government. However, it is worth noting that the Labour government has also called for the institution of a minimum wage, which in some cases would limit the ability of firms to capture the WFTC subsidy.

If a tax credit is payable through paychecks, employers would obviously know if their employees are receiving a credit. Thus, it could be more likely that the subsidy would lead to lower wages (this would probably occur through lower pay increases rather than through actual wage reductions). However, firms are likely to feel constrained to pay all people who do the same job equally. Therefore, if credit recipients are only a small share of a firm's work force, the firm will not be able to capture the subsidies. Even if employers capture the entire subsidy so that the credit does not result in higher take-home pay for individual workers, the tax credit would still lower labor costs for the firm and could thus help boost employment.

Political Support

Taylor (1998) finds that "it is noticeable that the US Administration has secured widespread political support for the EITC at a time when the US welfare budget more generally has been under remorseless attack." For example, in 1996, the Clinton Administration succeeded in blocking congressional efforts to reduce the size of the EITC by showing that the proposed cuts would result in tax increases for working families. It is clear that the Labour government hopes to duplicate the relative political success of the EITC by transforming an expenditure program into a tax cut.

It remains to be seen, however, if accounting changes alone can change perceptions about a program. It may be different in the U.S. where the EITC has been a part of the income tax system since its creation in 1975. Further, its legislative history establishes a clear link between the EITC and tax policy. The EITC was initially established to offset not only the effects of income taxes but also payroll taxes, and subsequent expansions in 1990 and 1993 were designed, in part, to offset a greater share of total tax burdens (including excise taxes) imposed on workers. Indeed, about 80 percent of EITC payments offset the individual income, social security, and other federal taxes borne by families receiving the credit.

It is difficult to imagine political support for programs on the scale of the EITC or the WFTC if they were administered through the welfare system. In the U.S., nearly 20 million tax returns (out of over 125 million) will claim the EITC in TY 1999. It is unlikely that voters would look favorably on a "welfare" program—even one with a pro-work orientation—serving one out of six families. Similarly, during the 1997 debate in the U.K., it was argued that a main advantage of shifting administration of the FC to the tax system would be that it would make it politically palatable to reduce the phase-out rate and extend transfers to workers further up the income distribution (Liebman, 1997). This, in fact, happened. The WFTC is expected to reach 1.5 million families compared with the 1.1 million that receive the FC.

COLLECT AS YOU EARN?

Perhaps surprisingly, one argument for consolidating an in-work subsidy into a PAYE system is missing from the list above. Under a PAYE system, taxpayers pay taxes throughout the year on income as they earn it. Thus, taxpayers should also be able to offset tax payments with a tax credit during the same time period. Receiving the credit as the income is earned may be a critical factor in ensuring that families receive assistance when they are most in need and in connecting reward and work effort, especially for individuals making the transition from welfare to work. Timelier payments, however, may also make the higher marginal tax rates in the phase-out range more transparent.

As a practical matter, it is difficult to design an administrative mechanism that pays the credit in a timely fashion while minimizing noncompliance. To minimize noncompliance, there must be an opportunity to verify eligibility before payments are made. To provide the credit in a timely fashion, eligibility determination must be either ongoing or prospective. The EITC advance payment option and the WFTC each meets one of these goals, but neither achieves both.

Verification before Payment

Little is known about noncompliance in the FC, but a recent DSS report (1998) on welfare fraud identified problem areas in other social security programs that shared common features with the FC. Among their findings, the DSS study found that certain social security eligibility rules, which can also affect eligibility for the FC, were associated with relatively high noncompliance. For example, DSS found it difficult to verify living arrangements, particularly whether couples who live together comply with the requirement that they also file together and report their joint income. The DSS report outlined a number of steps to improve verification of claims before social security benefits are paid, including better matching of data and computer links between offices handling benefits.

The U.S. has experienced similar problems in providing the EITC and has addressed them with similar approaches. In TY 1994, IRS found that EITC overclaims were typically associated with misreporting of taxpayers' living arrangements: taxpayers claimed to live with children when they did not, or they failed to take into account the income of the child's other custodial parent with whom they did reside (Scholz, 1997). Using available data, these were eligibility criteria that IRS could not easily verify before paying out a refund. Recent compliance initiatives should improve IRS ability to verify claims during processing of tax returns. For example, with the assistance of the Social Security Administration and the Department of Health and Human Services, IRS is developing new data regarding children's residency and parents.

The EITC advance payment option, however, presents a more difficult situation. The W-5 that a claimant files with the employer asserting eligibility is not sent to IRS, and there is no verification of eligibility until the taxpayer files a tax return. With so few taxpayers claiming the credit in advance, there is little information (other than a small-scale investigation by GAO in 1992) available about compliance. But given what the available data show about noncompliance, concern has grown that the lag between receipt of the credit and verification could lead to erroneous overpayments of the credit. To limit that risk (and to provide the taxpayer with an incentive to file the return), the advance payment was limited in 1991 to 60 percent of the maximum credit for which the taxpayer would be eligible based on annual projection of income.

In 1994, the advance payment was limited further to the amount that the taxpayer would be able to claim with only one child. Taxpayers claim the remaining portion of the credit when they file their returns.

It is not known yet how the British will verify eligibility for the WFTC, but preliminary information suggests that there will be an opportunity for eligibility verification before claims are approved. WFTC claimants will provide personal information directly to Inland Revenue, which will tell the employer how much credit to pay. Presumably, Inland Revenue could do some verification before approving the claim. For example, they could potentially verify the eligibility of the child against data bases containing information regarding the universal child benefit program before credit applications are approved.

Retrospective versus Prospective Benefit Calculation

To obtain the EITC in advance, workers have to forecast their total earned income, modified adjusted gross income, and family status at the end of the tax year. Workers may be reluctant to make these kinds of predictions for fear that they may make mistakes and end up having to repay some or all of the advance payment. Indeed, the current EITC advance payment look-up tables are not designed to be exact for taxpayers with more than one job during the year or outside sources of income. These tables could be made more precise, but only by increasing both compliance and administrative costs. This suggests that without allowing for some end-of-year reconciliation or adopting a retrospective approach in which payments are based on past, not current earnings, it may be difficult to integrate the EITC into a return-free tax system.

Thus, Gale and Holtzblatt (1997) concluded that it would be very difficult to deliver the EITC through a PAYE system. They found that 13.5 million EITC claimants in 1994 (over 70 percent) could be exempted from tax filing because of the relative simplicity of their returns, but this outcome was possible only if the tax agency took on the responsibility of completing those end-of-year tax returns. Of these EITC claimants, only 5.4 million had the type of return which is presumably associated with the lowest risk of making errors when claiming the credit in advance—returns on which only one spouse had earnings from only one job during the year and no other income was reported on the return. Adding those with income from pensions, interest, dividends, and unemployment compensation would bring this total up to 7.3 million. The remaining 6.2 million EITC claimants had earnings from more than one employer during the year either because both spouses worked or, more often, because one parent worked at more than one job.

At first glance, the U.K. PAYE system would seem to be better able to address concerns of erroneous payments and privacy than the EITC advance payment system. First, the worker divulges personal information about other jobs and income sources only to Inland Revenue, which absorbs most of the cost of calculating the right amount of the credit. Second, the PAYE system uses a cumulative withholding system, in which tax payments are recomputed as income and liabilities change during the year. But, the PAYE system appears to work because it tracks an individual's, not a couple's, income, and most capital income is taxed at the source at the basic rate. In contrast, the amount of the WFTC depends on the family's combined income, which is more difficult to track in a timely fashion.

It is not surprising, then, that the British have chosen to retain the largely retrospective eligibility determination of the FC program. Like the FC, eligibility for the WFTC will be based on earnings, hours worked, and family income over the preceding six to seven weeks before a claim has been made (longer if a worker is paid monthly). The benefit amount is not affected by changes in earnings or income over the six month claim period.[4]

CONCLUSIONS

Both the WFTC and the EITC reward work effort, particularly for new entrants into the workforce and for low-wage workers making the transition from part-time to full-time work. Making the credits available in a timely fashion and paying the credits through the employer have been suggested as ways to further heighten awareness of the link between work effort and income, but the U.S. and U.K. experiences demonstrate that this can be difficult.

While the EITC advance payment option combines both of these elements, most EITC recipients wait until the end of the year and claim a large lump-sum payment. There may, in fact, be offsetting benefits to this approach. Paying the credit when a return is filed shortens the gap between verification and payment, and thus may prevent some noncompliance. Erroneous overpayments of the credit may be prevented because end-of-year filers are able to reconcile their actual income and other circumstances in the privacy of their home, rather than having to tell their employers their best guess. Further, a large lump-sum payment may be a more dramatic demonstration of the return to work than smaller payments throughout the year. And, under the current tax system, most EITC recipients would be required to file a tax return even if the EITC did not exist.

In designing the WFTC, the British have faced similar dilemmas and trade-offs. Given the steps they have taken to exempt wage earners from an end-of-year filing requirement, it is perhaps not surprising that they have not chosen to require WFTC recipients to file an end-of-year tax return. However, in many respects, applying for the WFTC will bear closer resemblance to filing for an EITC at the end of the year rather than the advance payment option. For example, workers will be required to file an application with Inland Revenue indicating their income over a prior period and their current family status, much as U.S. workers do when they file an end-of-year tax return. Thus, the British experience with the WFTC is most likely to prove that it would be possible to spread out EITC payments throughout the year after a worker earned the credit and to make those payments through the worker's paycheck rather than through the tax refund, rather than that it is possible to include an EITC-like program in a PAYE system in a way that responds quickly to changes in a family's circumstances. It is far from clear that such an arrangement would be preferable to the single payment that most EITC recipients receive.

Notes

[1] Exchange rate is £1 = $1.66.

[2] The benefit amounts under the WFTC are measured in 1998 dollars, but under tax laws effective April 1, 1999.

[3] Individuals who care for a child in their own home are entitled to a weekly benefit ranging from £9.3 to £17.1 pounds per child. The child benefit is not means tested. Individuals who work less than 16 hours a week may also be eligible for the U.K. program of income support. As with traditional welfare programs in the U.S., income support benefits are reduced by earned income in excess of some amount (the "disregard").

[4] The relatively short accounting period over which earnings must be demonstrated may encourage some workers to manipulate their earnings during the year in order to obtain the FC. Even in the absence of outright manipulation, these two features of the FC may weaken its target efficiency. Fry and Stark (1993) found that about one-half of FC recipients would not be eligible for the credit based on their current income. The U.K. has instituted rules to curb income manipulation, but these rules add some complexity to the income determination

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