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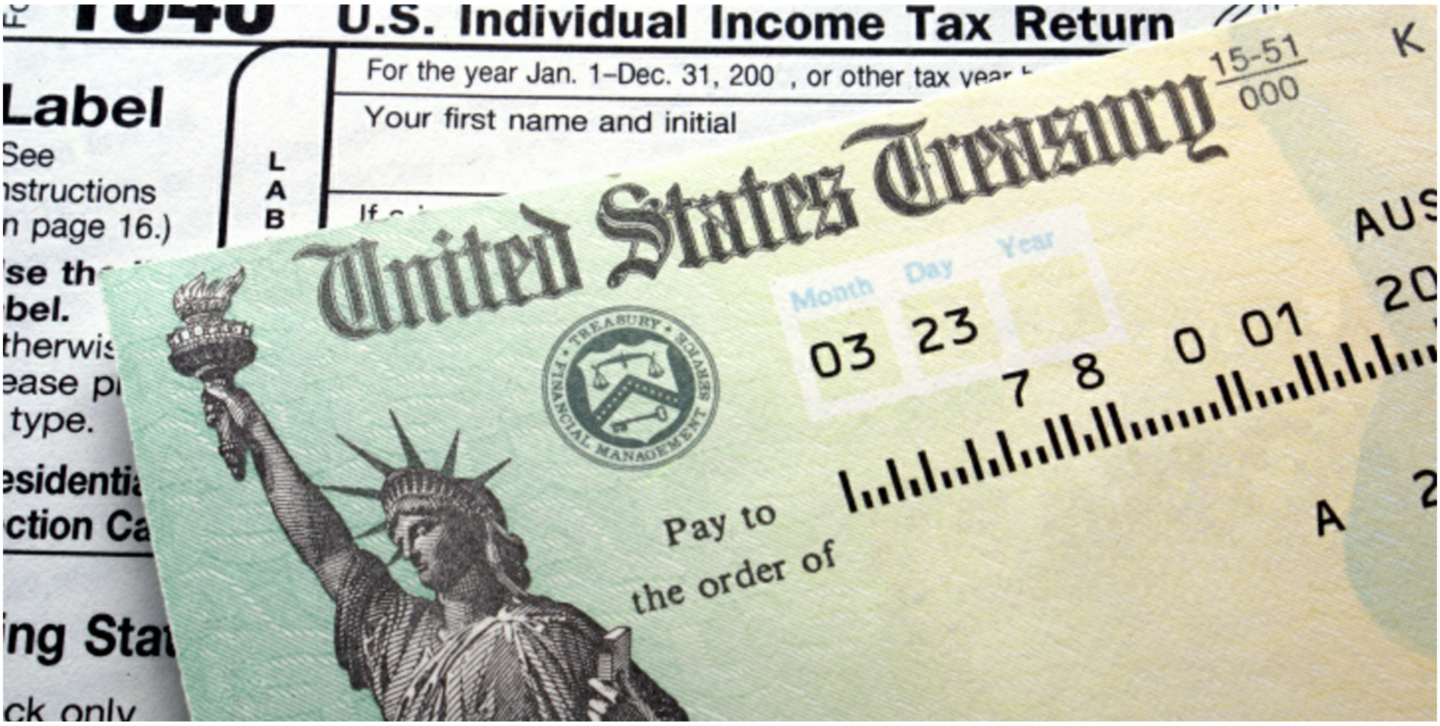


COMMENTARY ECONOMICS

How Can the EITC Be Improved?

APRIL 13, 2015

In the first two posts in our series on the Earned Income Tax Credit (EITC), I explained the program's history and structure, and then explored who it helps and why it works. Today, we're going to look at three ways we can make this incredibly important program even better.

To be clear, there is no doubt that the EITC is a success. It is our largest means-tested cash transfer program, responsible to lifting 6 million people above the poverty line and reducing poverty for another 22 million—all while incentivizing work. It also enjoys bipartisan support in Congress, which is approximately the social policy equivalent of getting accepted into an Ivy League college.

But for all its virtues, the EITC suffers from several notable flaws—each of which has a fix that would put the EITC on even stronger footing.

Stop Penalizing the Childless

Perhaps the most glaring defect in the EITC's design is the negligible assistance it offers childless workers. The maximum credit for workers without children and noncustodial parents is worth just 15 percent of what a one-child family can receive—$496 versus $3,305 in 2014. Indeed, the average credit for a childless worker ($267 in 2012) is less than a tenth that of those with children ($2,970 in 2012).

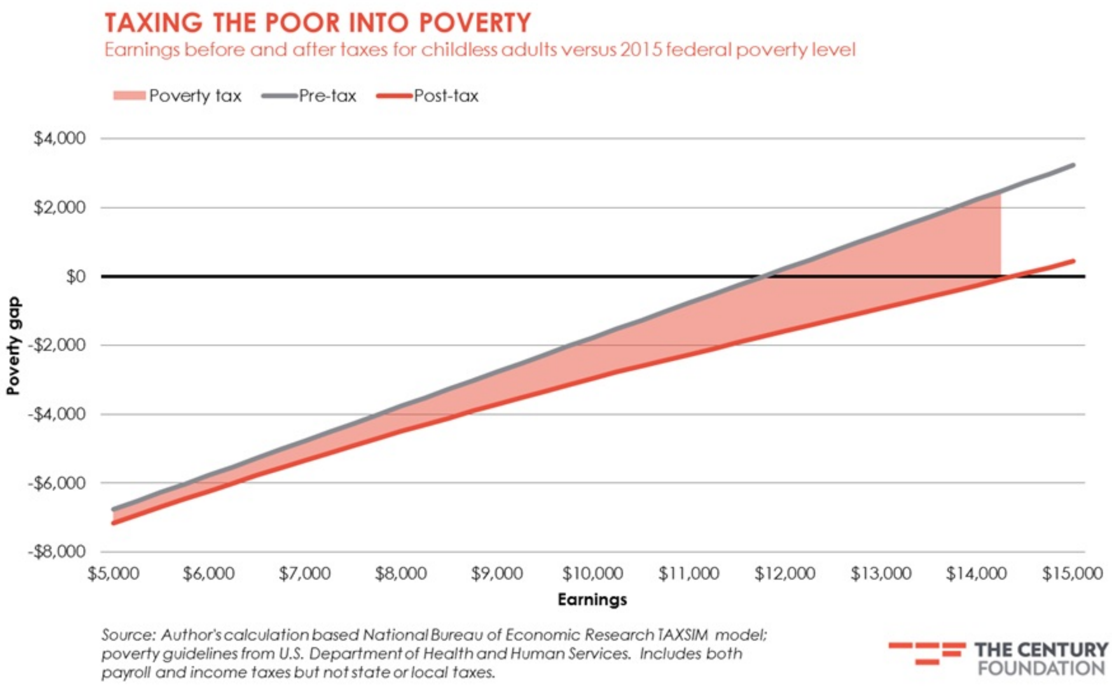
What's more, the eligibility standard for childless workers is at least twice as stringent, with the credit completely phasing out at $14,590 in earnings for singles and $20,020 for married couples. And childless adults under 25 years of age or older than 64 years are not eligible for the credit at all.

The perverse effect of this situation is that the United States actually taxes childless workers into poverty.

To see how this works, consider a single adult with no children who works 35 hours a week, 50 weeks a year, at the federal minimum wage of $7.25 an hour. His annual earnings will be $12,688—just above the federal poverty line of $11,670 for a single person (in 2014). However, he will also owe $971 in payroll taxes (which finance Social Security and Medicare) and $254 in federal income taxes—only a fraction of this will be offset by the $146 he will receive via the

EITC. When all is said and done, his take-home pay will be $11,609; in other words, the federal tax system actually made him poor. (It's easy to do a calculation like this using the National Bureau of Economic Research's TAXSIM program.)

The figure below shows how this "poverty tax" works in general. The shaded region represents the difference between pre-tax and post-tax earnings for low-income childless adults (with the vertical axis indicating the difference between the worker's earnings and the poverty line). As you can see, up to about $14,000 in annual earnings, the federal tax system forces such workers deeper into poverty.



Our hypothetical worker is not alone. According to the CBPP, federal taxes push 1.2 million Americans into poverty—and they make 5.8 million Americans who are already poor even poorer. (Things get worse when you consider that state and local tax systems, which rely heavily on sales and property taxes, are highly regressive, their burdens falling most heavily on low-income households.)

As understandable as it may be that the United States' safety net is more sympathetic toward families with children, it is difficult to justify a fiscal system that proactively pushes people below the living standard we've deemed minimally acceptable (as arbitrary as that standard may be). What's more, the same compelling program design that makes the EITC effective among households with children also applies to those without them: rewarding work is a prudent strategy for reducing poverty.

While most of the research to date has, of necessity, focused on the experience of households with children (because the childless EITC is too small to have an appreciable impact on employment), the studies we have suggest a more generous, more broadly available EITC would significantly boost employment, especially among several particularly disadvantaged groups who have endured labor market hardships in recent years: men without a college education, minorities, women in low-wage occupations, young adults not enrolled in school, older workers, and the disabled.

The utility of an EITC expansion for childless workers has not been lost on policymakers, with similar proposals introduced by both parties. Building off a blueprint the administration introduced in March 2014, President Obama's 2016 Budget would double the phase-in rate and maximum credit for childless adults to 15.3 percent and $1,005, respectively, while extending eligibility up to $18,070 in earnings (about 150 percent of the poverty line), as well as to workers as young as 21 and as old as 66 years.

In a rare show of bipartisan consensus, the poverty action plan released in July 2014 by House Ways and Means Committee chairman Paul Ryan contains a childless EITC expansion exactly in agreement with the president's on all key parameters (with the exception that the Ryan plan doesn't extend the credit to workers age 65 and 66). In addition, since 2013, at least five different proposals have been introduced as legislation by members of Congress. Generally, they are more generous than the Obama and Ryan proposals, offering faster phase-in rates, higher maximum credits (in the $1,300 to $1,500 range), and slower phase-out.

An expansion of the EITC for childless workers along the line of Obama's plan would newly qualify 5.8 million of them for a new credit, while increasing the value of credits already received by an additional 7.7 million Americans. That means 10 million workers would be made less poor, and half a million would be lifted out of poverty. The associated employment incentives would draw more workers into the labor force and encourage them to work more hours, further increasing well-being.

And while the primary beneficiaries would be single adults—especially youth and minorities—children would benefit as well, as some 1.5 million of those helped by the expansion are noncustodial parents. Further, to the extent the EITC steers young workers on a stronger career path, it will improve the circumstances of their future children as well.

Despite the rare cross-party consensus on the EITC, federal action on the issue has stalled, in part, over disagreement about how to pay for it. According to the Treasury Department, the president's proposal would cost about $6.5 billion annually. The administration would fund the expansion primarily by closing tax loopholes exploited by private equity firms, while the Ryan proposal takes a vastly different approach, cutting other social programs, such as the Social Service Block Grant.

In the meantime, while Congress dithers, an important demonstration is under way in New York City. Paycheck Plus, a joint initiative of the City's Center for Economic Opportunity and MDRC, a respected social policy research organization, is in the process of studying the effectiveness of expanded tax credits for childless workers. The experimental program has randomly divided 6,000 childless adults into treatment and control groups, with the former eligible for an earned income credit up to $2,000 annually from 2015 to 2017. Structured similarly to the federal EITC, the Paycheck Plus credit phases in to a maximum between $6,667 and $18,000 in earnings, and phases out at $29,863. The program will use government records to track and compare outcomes, including poverty status, employment, welfare receipt, criminal justice involvement, family formation, and overall well-being.

Reduce Complexity to Save Money and Strengthen Impact

The second major problem with the EITC is its complexity. Like many elements of the tax code, EITC rules are often misunderstood or misinterpreted. Consequently, it has—by a wide margin—the highest improper payment rate of any federal program, at 24 percent. In other words, as much as $14–$17 billion annual program expenditures are made erroneously—about equal to the amount the federal government spends each year on cash welfare through the Temporary Assistance for Needy Families program.

Some of the overpayments are attributable to deliberate fraud, but many are honest mistakes owing to the credit's intricacies. Incorrectly claiming qualifying children—usually because they fail to satisfy either the credit's relationship or residency tests—accounts for about half of overclaim dollars, while misreporting income is the most common (though less costly) error, occurring on two-thirds of all returns.

The likelihood of error is compounded by two amplifying factors. First, about a third of EITC claimants turn over each year, decreasing familiarity with the program. Second, a significant share of EITC recipients rely on paid, but non-professional, tax preparers to file their returns—and these "unenrolled" preparers are among the most error-prone of all filers (more on this below).

How can the EITC be simplified? As with the issue of childless workers, effective bipartisan solutions abound, though they often get caught up in larger debates about fundamental tax reform. Particularly important are proposals that would make qualifying child rules easier to understand for families where parents are separated or divorced, as well as for those living in multigenerational households. Reforms along these lines date back to the George W. Bush administration, and have been reintroduced recently in legislation before both the House and the Senate.

While the details of various plans can differ, most proposals emphasize two key strategies: (a) consolidating the EITC and Child Tax Credit—along with the tax code's litany of other exceptions—into a smaller number of simple credits, and (b) distinguishing credits based on children from credits related to work. By differentiating between aspects of life that are conceptually distinct, parenting and working, the latter strategy is particularly appealing in that it reinforces the logic of a more robust earned income credit for childless workers. Indeed, a stronger childless worker credit can itself go a long way to reducing the incentive for tax filers to overreach in claiming qualifying children.

But before leaving the topic of complexity, we should also give credit to the credit where credit is due: the EITC is unnecessarily complicated, but by the standard of other safety net programs, it is actually a step in the right direction. As it turns out, the tax code is a quite efficient way to administer social programs. Instead of interminable trips to welfare offices and endless conversations with case workers, eligibility and benefit determinations are seamlessly integrated into the IRS' regular course of business. As a result, administrative costs are about 1 percent of benefits—a small fraction of what most programs cost to operate. When these savings are taken into account, they offset a considerable amount of improper payments.

At the same time, confusion about program rules—along with lack of knowledge about the program in general—not only results in overpayments, but leads to underpayments as well. Nationwide, just four out of five eligible households claim the EITC; the claiming rate drops to as low as 71 percent in Oregon and California. On balance, EITC participation rates are similar to that of other major social programs, such as food stamps, which serves 79 percent of eligible individuals. The challenge, then, cuts both ways: expanding participation among eligible households while reducing erroneous payments.

Eliminate Predatory Practices

Simplifying the EITC would go a long way to reducing waste and missed opportunities alike. But with the prospects of federal tax reform generally dim, a more fruitful short-run strategy may be to target reform efforts on something beyond the bounds of the tax code: unregulated tax preparers.

Paid tax preparers file two-thirds of all EITC claims—no doubt in part because of the credit's complexity. However, many of these preparers are not professionals, such as certified public accountants or attorneys, but rather what the IRS refers to as "unenrolled." The threshold for becoming an unenrolled commercial preparer is low—basically anyone with a piece of tax software and an appetite for filing tax returns on the behalf of other people can do it—and EITC recipients often rely upon them because, although they are not subject to meeting professional standards, they are cheap. But often, they are also not scrupulous. As a result, unenrolled preparers comprise the third major issue facing the EITC: exploitation of EITC recipients.

Tax preparation has become a big business, with as many as 1.2 million paid preparers currently in operation. Much of the market is focused on low-income recipients, who tend to be both less educated and more likely to receive refunds—thus making them lucrative targets. In 2013, some 15 million EITC households paid nearly $1 billion in tax preparation fees, according to New America. Not only is this costly, but with half of preparers unregulated and uncredentialed, the services provided can be shoddy and predatory.

Beyond the high fees, opportunistic preparers devise various schemes to siphon off a portion of their clients' refunds. The most common method of doing this currently is refund anticipation checks (RACs). An RAC is a temporary bank account that tax preparers open on a client's behalf for the sole purpose of receiving a refund deposit from the IRS. Once the refund is issued, the account is closed and the client receives a refund by check or prepaid debit card.

While marketed for their convenience and speed, RACs, which typically cost $30 to $50, are actually no faster that the regular IRS refund process, which is generally quite expeditious—90 percent of refunds are issued within three weeks, and e-filers who select direct deposit can get theirs in as few as ten days. Instead, their primary function is to serve, effectively, as short-terms loan for clients who lack the cash to pay the tax prep fee, which is taken off the top when the refund is deposited.

This arrangement is quite expensive: a $30 charge on a $189 tax prep fee is equivalent to an APR of 414 percent. According to the National Consumer Law Center, about half of the 21.4 million RAC customers in 2014 were EITC recipients; collectively, they spent about $425 million on these products, which prey on families that rely upon speedy refunds to pay for urgent needs, such as rent and food. When all is said and done, preparation related fees can erode a fifth of the EITC's value or more for the typical low-income family.

Nevertheless, even this sorry state of affairs is a step up from the situation that existed prior to 2012, when the product of choice for tax preparers and their bank partners were refund anticipation loans (RALs), which charged high fees and interest rates to give EITC recipients immediate refunds. Topping $1 billion annually in the mid-2000s, the RAL business offered EITC recipients what amounted to a two-week loan at a steep price. Fortunately, federal regulations cracked down on the practice beginning in 2011, and today only a handful of non-bank lenders still offer the product.

Unfortunately, while tax professionals, such as CPAs, receive advanced training, pass rigorous qualifying examinations, and are subject to standards of professional conduct, unenrolled tax preparers—the type of preparer upon who most EITC recipients rely—must meet none of these requirements. Given that unrolled preparers are also, unsurprisingly, the most common source of errors and abuses, the IRS has, since 2011, implemented a series of regulations to govern their behavior, by creating and enforcing more robust registration, competence, compliance, and continuing education standards. To date, however, little has been accomplished, as most of the efforts have been blocked by federal courts as exceeding the Treasury Department's statutory authority. What's more, only four states regulate paid tax preparers. Once again, progress, it seems, must await congressional action.

But even in the absence of legislation establishing stronger consumer protections, there is still much that the IRS, advocacy groups, and concerned citizens can do to combat abusive practices.

Most notably, the IRS Volunteer Income Tax Assistance (VITA) program provides free tax help to filers who make less than $53,000 annually, as well as to those with limited English skills and the disabled. In Fiscal Year 2011, VITA made $12 million in grants to 179 organizations who filed 1.1 million returns at 3,700 sites across the country. In total, the IRS Volunteer Program, of which VITA is the largest component, along with the Tax Counseling for the Elderly (TCE) program, enlisted some 89,000 volunteers at 12,500 sites and was responsible for 3.2 million returns. In addition, the IRS provides free filing software for people with incomes below $60,000.

More broadly speaking, promoting financial literacy among low-income households is an important policy objective, whether or not related to tax season—as is widening access to consumer financial products, such as bank accounts. And, as always, refining and strengthening audit efforts can be both a powerful deterrent and a means of recapturing resources. Ultimately, the EITC is valuable only to the extent its intended beneficiaries receive the rewards they've worked to earn.

An EITC Living Up to Its Full Potential

The EITC's three major flaws—limited benefits for childless workers, wasteful complexity, and vulnerability to abuse—are costly, and avoidable. Making the credit more generous for workers without children would reduce poverty for millions while encouraging self-sufficiency. Simplifying program rules in a way that acknowledges the complicated living arrangements many low-income families endure would reduce waste and better channel benefits to those who need them. And regulating unenrolled tax preparers would help ensure these benefits aren't unjustly siphoned off.

Here's the good news. Unlike other safety net programs, the EITC enjoys broad, bipartisan support. And unlike other policy areas in need of reform, there is consensus on the solutions that would improve it. This singular popularity is with good reason: the EITC works. As we strive to make it better, that's a central fact we ought not forget.