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Michelle Lyon Drumbl
Excerpt
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Introduction

Rethinking the Earned Income Tax Credit

I just wanted to check in and see if you had heard anything . . . I am honestly getting a bit anxious because my transmission just went out in my only vehicle.[1]

Imagine your federal income tax return shows a refund due of several thousand dollars, even though your annual income last year was below the poverty line for a household of your size. This happens to you every filing season; you receive a lump-sum financial windfall that constitutes a significant percentage of your household income each year. This year, however, instead of receiving the lump sum you receive a letter asking you to prove that your child lived in your household last year. Seems easy enough; you gather school records, a letter from a neighbor, a divorce decree and custody order, and you send these to the Internal Revenue Service (IRS), hoping the refund will be released to you soon, because you really need it right now. But it doesn't come. You wait, you inquire, but you cannot reach an IRS representative on the telephone during the limited time you have free in which to call.

I routinely encounter clients in this situation. I direct a low-income taxpayer clinic and provide pro bono legal representation to individuals who have a controversy or dispute with the IRS. Some people are surprised there is even a need for such clinics. In fact, there is a great need, because the Internal Revenue Code is the statutory home of the Earned Income Tax Credit (EITC), a domestic social benefit program for the working poor. Of all the individual income tax returns selected for audit each year, roughly one-third are selected on the basis of an EITC claim.[2] Many of the clients I work with

[1] Email from a former client (writing to inquire when she would receive her EITC refund after we sent substantiating documents to the IRS) (on file with author).

[2] In fiscal year 2017, a total of 933,785 individual income tax returns were selected for examination (representing 0.62 percent of all individual income tax returns filed in calendar year 2016). Of the total individual returns selected for examination, 327,805 (35 percent) were

eventually prevail and receive their refund – but the process can take months, and sometimes more than a year. Others never receive their refund, and face penalties for filing an improper claim. In any of these cases, a delayed or denied refund can be devastating for families with few resources.

The United States introduced the EITC in 1975. It was conceived as an incentive for individuals to work rather than rely on welfare benefits, and a way to mitigate the payroll taxes that apply to the first dollar of wages earned. With time, however, the US EITC policy has shifted thanks to political compromise, stagnant wages, and extensive amendments and expansions. It has expanded from a relatively modest work incentive to one that now also operates as a robust antipoverty program administered by the IRS. Today, more than twenty-five million tax filers claim it each year.

The EITC is the most significant earnings-based refundable credit available in the Internal Revenue Code. It is a refundable tax credit for low-income individuals and couples, particularly those with children. Numerous studies show its positive effect on low-income families. These same individuals may also be eligible for the Child Tax Credit (CTC), another refundable tax credit available to working families. Together, these two credits represent a significant part of the social safety net for low-income individuals and families.

The United States is the oldest example of a country using its domestic tax system to deliver and administer social welfare benefits to lower-income individuals or families. This approach is no longer unique to the United States. Other countries – including the United Kingdom, the Netherlands, New Zealand, France, Canada, Australia, and Sweden – have experimented with or incorporated analogous credits into their tax systems. An EITC-like credit has become "mainstream" in certain other countries that imported the concept from the United States. Forty-plus years after the introduction of the EITC, might the United States now be able to improve upon it by importing experiences and lessons learned in other countries?

The EITC has long enjoyed bipartisan support in the United States because it is thought to incentivize work while lifting millions of families out of

selected for examination on the basis of an EITC claim (representing an audit rate of 1.18 percent on the 27,858,140 returns claiming EITC that year). I.R.S., PUB. 55B, DATA BOOK, 2017 23–26 (2018), https://www.irs.gov/pub/irs-soi/17databk.pdf. These numbers are not anomalous to fiscal year 2017. *See* Kathleen Pender, *IRS Income Tax Audit Chances are Slim, Except for These People*, SAN FRANCISCO CHRONICLE (Apr. 15, 2015), https://www.sfchronicle.com/business/networth/article/IRS-income-tax-audit-chances-are-slim-except-for-6202608.php; David Cay Johnston, *I.R.S. More Likely to Audit the Poor and Not the Rich*, N.Y. TIMES (Apr. 16, 2000), https://www.nytimes.com/2000/04/16/business/irs-more-likely-to-audit-the-poor-and-not-the-rich.html.

poverty. At the same time, the EITC suffers much criticism because of its consistently high error rate, its failure to reach all eligible families, and its limited impact in reducing poverty among childless workers. Other challenges degrade the integrity of the credit, such as return preparer fraud and tax-related identity theft.

Even with the higher audit selection rate for EITC returns (relative to non-EITC returns) and myriad approaches aimed at improving accuracy and educating taxpayers, the IRS nonetheless has been unsuccessful at reducing the rate of EITC overclaims. Since 2003, the estimated rate of improper payments on EITC claims has exceeded 20 percent. Annual improper EITC payments have ranged between an estimated minimum of $8.6 billion (in 2004) to an estimated maximum of $18.4 billion (in 2010). To provide context for these figures, federal spending on the National School Lunch Program was nearly $12.6 billion in 2014. In other words, in some years more federal money flows to improper EITC claims than to subsidizing lunches for schoolchildren.

The EITC is an undeniably important program. Despite its error rate and other shortcomings, it effectively helps many low-income families. But from my perspective as an advocate for low-income taxpayers, its implementation is far from ideal. This book tells the story of the EITC, examines the shortcomings of its administration, and imagines ways in which this social benefit might be delivered more effectively. This book is a call to reimagine how a largely successful social program – by certain metrics – can be improved upon as part of a broader effort to address poverty in the United States.

I first trace the evolution of the US EITC from a work bonus incentive into an antipoverty program. The first chapters identify the modern challenges that the IRS faces with administering the EITC. I then examine how other countries have chosen to administer similar social benefits through their respective tax systems. One striking difference is that some countries, even those that administer the credit through their tax agencies, choose to deliver the benefit in regular increments throughout the year instead of in one annual lump sum as a tax refund. In particular, Canada and New Zealand provide useful case studies for assessing year-round delivery of tax-based family credits to a significant percentage of their population. By examining their systems in depth, it is possible to consider the advantages and feasibility of importing such a model to the United States.

I conclude that Congress should restructure the EITC, importing ideas from how Canada and New Zealand have implemented work and family tax credits. In short, I argue that the EITC should be returned to its original function as a credit to incentivize work and ease the regressive nature of payroll taxes. At the same time, the antipoverty income support element that currently results from claiming one or more qualifying children should be reconfigured as a family-support credit. In repackaging it, I argue that Congress should split off this portion of the credit from the tax refund, such that it can be delivered quarterly rather than annually. Further, I recommend that at least a portion of the family-support element be made exempt from offset or application toward other debt.

The potential benefits of such a restructuring are fourfold. First, it would convey a more coherent tax policy to the public – both those who receive the credit and those who do not. Second, it presents an opportunity to simplify the current structure of the EITC and related family benefits. Third, if structured properly it would reduce the rate of improper payments, as well as reduce opportunities for tax return preparer fraud and tax-related identity theft. Finally, restructuring would allow the EITC to function better as a true antipoverty program because funds would be made available regularly instead of as an annual lump sum subject to offset.

This book does not question the importance of the EITC program to those who rely upon it. Rather, it questions whether the program is living up to its potential from an administrative perspective. It considers why and how the EITC should be restructured. It provides an in-depth look at the problems and challenges of how it is currently delivered. It balances these flaws against the benefits and the stated purpose of the program. It contemplates administrative methods that might work more effectively and be more beneficial to low-income individuals. It examines ways in which other countries have developed their EITC analogs, and considers how the United States might borrow ideas from these foreign systems to improve its own.

The reimagination I propose in this book is largely inspired by my work with low-income taxpayers. As I have found with so many of my clients, poor administration and design can wreak havoc on the lives of EITC recipients. There are also undesirable consequences for the government and all taxpayers. It is time to rethink the EITC.