

Cheating the Earned Income Tax Credit

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In early 1995, taxpayers claimed \$4.4 billion more in earned income tax credit (EITC) refunds on tax returns than they were eligible to receive. This revelation has put both the EITC and the IRS under fire, but both defenders and detractors of the credit often miss the broader question: how wage subsidies can best be fit into the nation's transfer and tax systems.

This nation now has a large number of programs to assist low-income individuals: foods stamps, supplemental security income, Medicaid, various housing programs, the new Temporary Assistance to Needy Families (TANF), as well as the EITC. In truth, all of these programs have significant error rates. Most income-conditioned subsidy programs are administered by welfare offices that use monthly accounting systems for the income of individuals. We know that annual accounting systems are difficult enough to run and that these monthly systems are full of errors. Studies that rely on actual contact with welfare families, for instance, reveal that most have at least some source of outside, unreported income, and that the household often contains more adult members than is claimed for welfare purposes. Corruption and certainly unequal treatment of individuals also occur in housing programs that use waiting lists for obtaining eligibility.

Other parts of the tax system are prone to error and cheating. The IRS itself estimates that taxpayers in the aggregate underpay their income taxes by about 20 percent. In addition, there are many legal ways to avoid tax on income—perks on the job, avoidance of any realization of capital gains, and taking excessive amounts of deductions. These legal methods of tax avoidance also result in inequities among taxpayers.

My point is to encourage neither an attack on all government programs nor a defense of the status quo. The difficulties in all government administrative systems simply reveal that EITC problems cannot easily be solved in isolation. Some who attack the program often use the error rate as an excuse to pare the size of the program. But paring may do little or nothing to reduce the error rate of the EITC and, worse, may target the remaining resources in the nation's transfer system. Some who defend the program, on the other hand, want to make light of this error rate and the revealed inability of the IRS to administer this particular program very well. But simple maintenance of the status quo is not a viable defense for the long run, for it pretends that we don't really care how well the program works.

In partial response to the high error rate, the Treasury Department announced a number of new initiatives. (For prior coverage, see Tax Notes, Apr. 28, 1997, p. 484.) Though the initiatives are worthwhile, they were designed quickly to try to mute new criticisms that would arise with the announcement that error rates remained high. No one claimed that these initiatives—a combination mainly of stricter penalties and more enforcement—were going to reduce the error rates dramatically. It was also unclear how an administration committed to a smaller IRS was going to generate those greater resources. What other enforcement efforts would be reduced? One can't simultaneously increase resources for every IRS enforcement problem and reduce total enforcement resources.

One alternative, of course, is simply to eliminate the EITC. Unless one knows what the larger transfer system would look like, however, this is an incomplete response. If the goal is merely to turn EITC responsibilities over to welfare agencies, there is no evidence that enforcement would be much better. Indeed, the original reason for putting the EITC into the tax code was that it was to be based mainly on annual wages as reported for tax purposes. Because W-2 statements on wage payments are made by employers, wages as reported to the IRS on an annual basis are much better monitored than, say, monthly wages as reported to the welfare agencies.

If elimination is pure, and there is no transfer of responsibilities outside of the IRS, then our welfare system effectively moves backward in time. Perhaps the two most dramatic changes in the cash transfer system in the last part of this century have been the adoption and expansion of the EITC and the attempt to put work

responsibilities into the basic welfare system, as reflected in the displacement of Aid to Families with Dependent Children with "Temporary" Assistance to Needy Families. While both efforts have been incomplete and imprecise, they are still viewed by many as superior to a pure welfare approach that emphasizes nothing but handing out money.

Recent reforms, therefore, should be viewed as fledgling steps on the way to replace welfare with workfare. The notion is that if one plays by the rules and tries to work to support one's family, then society will be there to help the family avoid poverty or destitution. Simply get rid of the EITC, and welfare becomes even more attractive relative to work. At the same time, the modern idea of workfare emphasizes private sector, rather than public sector, jobs. Government jobs for the most part have come to be viewed as much more expensive and much less successful at creating productive skills that respond to market demands.

One can certainly debate what size this total system should be. Indeed, this is often the only debate that occurs—with one side favoring any increase in payments, however obtained, and other side opposing all payments, however made. Whatever the total dollars spent for the combined transfer system, however, society cannot dodge the issue of how to design one that minimizes other costs to society.

How might a more administrable system be obtained? Over time there will probably be a number of efforts to redivide and think out better how to share responsibilities among tax, employment, and welfare agencies. This would require a more thorough and honest assessment of just what functions each can and cannot perform. The minimal resources the IRS puts into enforcement efforts is inadequate to run a transfer program, but it is unlikely that we want all who get some wage subsidy to have to go to welfare offices if they get no other assistance.

In the end, government is also likely to turn more to third parties for administrative help. In the case of the EITC, the two principal compliance issues are confirming whether work has occurred and whether eligible children are in the household of the taxpayer. Employers—perhaps through gradual substitution of job subsidies that first go through employer hands—are likely to be called on for the first task. Employers, after all, are the real administrators of most of the tax system, although at a fairly high cost given all of the tax rules they need to follow. Nonetheless, they are the principal monitors of whether work has taken place. As for the presence of eligible children, we may be required to rely more extensively on courts, state and local record systems, and formal documents to establish who are the parents or guardians of children. Finally, support for low-wage work and support for children may need to be separated; their combination in the EITC leads to conflicting goals and a variety of equity and administrative problems.

None of these changes in the EITC will be easy. In the end, however, society's attempt to provide wage subsidies will neither be abandoned nor remain stagnant for very long.

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