The Future of the Earned Income Tax Credit (Part 2 of 3)

Part Two: Distortions and Compliance Problems

C. Eugene Steuerle

Document date: June 26, 1995
Released online: June 26, 1995

While the earned income tax credit has received strong bipartisan support in recent years, it has also grown into one of the largest budget items applying to low-income individuals. After almost a decade of legislative expansion through agreements in 1986, 1990, and 1993, it is not surprising that the credit would begin to receive more in-depth examination and criticism. For example, some cutback, particularly in expansions already scheduled for 1996, is being considered as part of the budget agreement this year. The principal sources of concern relate to the credit's impact on work effort and the extent of noncompliance. My own conclusions on these two issues are as follows: (1) All transfers and taxes distort some choices, and the EITC is no exception. The EITC can be best assessed against alternatives that attempt to help low-income households and workers, not as a stand-alone provision. (2) As currently designed, the EITC cannot be fully enforced by the IRS and, to deter abuse, must either be supplemented by further restrictions or be restructured.

Almost all elements of the nation's tax and transfer system can be argued to create some distortions. After all, they affect the rates of return from work, saving, and other activity, and they increase the incomes of some families and reduce the incomes of others. These distortions almost inevitably raise the cost of government policy: if that policy is effective in achieving desirable goals, however, then the benefits may outweigh the costs.

For the EITC, a closely related issue is whether it is a net work incentive for the population as a whole. When looking mainly at the EITC population, including those individuals who might move into the workforce because of the EITC, the evidence is mixed. J. Karl Scholz of the University of Wisconsin, and Alberto Martini, my colleague at the Urban Institute, have some evidence that for this population the net effect on work may be positive. A major reason is that the cutbacks in work by those in the phase-out ranges of the credit may be smaller in size than the increases in work by those in the phase-in ranges, in particular, those who move from unemployed to employed status.

There are a number of reasons why these results are controversial. The method of accounting, for instance, can affect how the conclusions are stated. It may be possible to increase hours of work, but to decrease national product. Thus, if those who move into the labor force work 100 more hours at $5 an hour, but those who are already working cut back 80 hours at $10 an hour, then hours worked goes up (and so might levels of employment), but the total value of production is reduced.

There are further complications. Reductions in hours of work often take place among those families who have more than one worker. If we were able to reduce dependence on welfare at a cost of some spouses spending more time with their children, we might not be bothered so much by any net reduction in product. Another complication is that some of the increase in work involves a movement from the informal sectors of the economy to the formal sectors, which means that the gain in total product is even less than the gain in measured product. At the same time, work in the formal sector probably increases respect for the law and helps some individuals develop a greater ability to deal with work requirements of the modern society.

Even if we could take all these factors into account, the calculations can be misleading. All transfers are backed up by taxes—first, by direct taxes to support the system, and, second, by indirect taxes when benefits are phased out as the income of beneficiaries increases. The types of calculations reported above tend to count only the effects of the transfers and the indirect taxes, but to ignore the direct taxes. On net across all of society, the financing of transfer systems will tend to increase the potential taxes or losses from additional work to a greater extent than the transfer will increase the potential gains to some individuals from additional work.

We could go on, but whether the EITC is a net work incentive is probably the wrong question. If we as a society are committed to providing some minimum levels of well-being to individuals, then it is much less clear that providing, say, $3,000 of EITC benefits to someone who earns a modest amount of income is any less of a work disincentive than providing $3,000 of pure welfare benefits to someone who doesn't work at all. The effect of the EITC on work, therefore, should be assessed against other alternatives that are designed to provide transfers to low-income individuals. Moreover, among those who might be given the greatest additional incentive to work are those welfare recipients whose participation in the workforce would integrate them more fully into the rest of society.

The compliance issue—limits on the ability of the IRS to enforce the EITC—may be more serious. Although the data from the IRS are incomplete, as best as I can tell, there have been three major sources of noncompliance with the EITC. The first had to do with individuals claiming the EITC even when they had not provided adequate support to meet support tests and similar eligibility criteria in the tax system. Some recent reforms went a long way to correcting this problem by changing some of the eligibility criteria and making the primary test the presence of the child within the home of the claimant. Of course, the complex support test and head-of- household tests in the current tax law remain a source of confusion and error even beyond the EITC.

A second source of noncompliance derived from excess claims of children (and even fictional adults) within the household. Again, while the jury is partly out on the size of the problem that remains, my impression is that the IRS and Treasury have made considerable headway toward solving this problem, and that both Congress and the administration will probably support some further procedures to ensure the validity of social security numbers of taxpayers and their claimed children. For those following EITC issues lately, this is the principal noncompliance issue to which IRS Commissioner Margaret Milner Richardson and Assistant Secretary for Tax Policy Leslie B. Samuels have been addressing their recent efforts. (For additional coverage, see Tax Notes, June 19, 1995, p. 1575.)

A final problem, however, is more fundamental. In normal tax and transfer systems, there is a tendency to underdeclare income to avoid taxes and the loss or phaseout of benefits as income rises—creating what is sometimes called a subterranean economy. Now that the EITC credit rate is substantially in excess of the social security tax rate—that is, in excess of the only direct tax paid by many EITC recipients—there is powerful incentive for households not in the welfare system to overdeclare earnings even when there are none. This incentive is gradually creating what I have labeled a new superterranean economy. Since the IRS audits only a very small fraction of returns, usually fewer than 1 percent of returns of low- income individuals, it is very difficult for it to monitor superterranean economy work that never takes place. Even if it audited everyone, it is very difficult to disprove whether self- employment income was real or fictional. Moreover, in some cases, legal work creation becomes profitable, as when neighbors exchange baby-sitting for each other in order to benefit from the credit.

It is unclear how far this problem has developed to date. Welfare recipients who face benefit reductions along with direct taxes, for instance, may still lose more than they gain from overreporting income. Unfortunately, research on EITC noncompliance to date is incomplete and has been inadequately designed to get at the extent of these problems. Nonetheless, I believe that it is crucial that the problem be attacked sooner, rather than later. To deter further abuse, the EITC must be supplemented by further restrictions or fundamentally restructured, perhaps in a broader reform of the nation's tax and transfer systems.

Other Publications by the Authors

- C. Eugene Steuerle