THE EITC - NEGATIVE WORK EFFECTS AND FRAUD

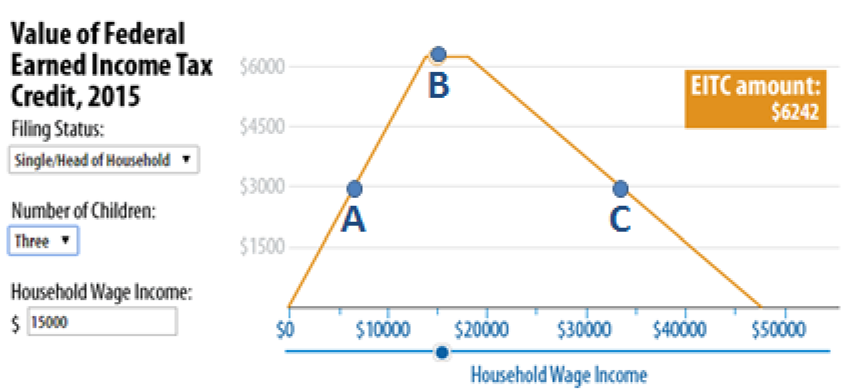
1. The program has two competing influences on labor - - the *tax effect* (technical term: substitution effect) and the *cash benefit effect* (income effect). Taking the tax effect first, in the chart below of a single head with three children, a maximum of $6242 is available at the point of wage earnings of about $14,000.

   A worker with wage income at point A and along the upward slope experiences a boost in net income for each additional dollar earned (wage plus EITC cash benefit). This in theory provides an incentive to add work hours and earned income.

   A worker with wage income who reaches point B no longer experiences any additional boost in net income for each additional dollar earned. Therefore the tax effect is neutral along this flat range.

   A worker at point C and anywhere along the downward slope experiences money taken away in the form of reduced benefits for each additional dollar earned and therefore experiences a negative tax effect to additional work effort.

Taken together the EITC tax effect on work effort is sometimes positive, sometimes neutral and sometimes negative over the entire wage eligibility range.



2. To this consideration it should be noted that the chart above shows that workers who increase their income from zero to $47,000 experience a longer wage period with negative tax effects than with positive ones.

3. The other major influence on work effort is the *cash benefit effect*. The cash benefit effect on work effort is unambiguously negative. If an individual is earning $30,000 and he or she is given $6000 in cash from the government, the average person will reduce the amount of time spent at work and increase time off of work (leisure).

4. The work incentive effects of a guaranteed cash benefit was extensively tested under controlled conditions in the late 1960s and early 1970s (SIME/DIME – Seattle-Denver Income Maintenance Experiment). For this experiment 4800 families were enrolled and given cash benefits with the intent to determine if the cash benefits offered would be offset by reductions in work, and if so how much.[1]

5. In the experiment, families were guaranteed a maximum in today's dollars of between $22,000 and $33,000 ($3800 to $5600 - 1971). As beneficiaries increased their income, the cash benefits were reduced at a rate of between 50% and 80% for each additional dollar earned. The experimenters carefully measured the difference in work effort between those families who received the free guaranteed income and similar others who did not.

6. The results showed that the distribution of guaranteed money has a significant negative effect on the hours worked over a year. Husbands worked 9% fewer hours (they received an annual average net cash benefit of $7600 on top of their wages and reduced work by equivalent of five workweeks). Single mothers worked 21% fewer hours (receiving an average of $12,800 over a year) and youths (16 to 20) cut back on their mostly part time work levels by 24%.

7. It is usually presumed that the current Earned Income Tax Credit encourages work, but closer analysis indicates it does not. The *tax incentive effect* is generally neutral, and the *cash benefit effect* is strongly negative on work effort.

8. Notwithstanding the EITCs negative effects on work, does it nevertheless reward low income labor force participants with government transferred income (welfare connected to jobs)? No - - Not among the low wage non-workers receiving welfare and food stamps. For this group there need not be a connection between legitimate hours of work activity and EITC cash benefits.

    a. First, the IRS has no way of determining hours of work performed for a given legitimate income claimed. Forty hours at $10/hr. is the same as twenty at $20/hr. EITC should act to increase work levels as well as merely adding to net family income.

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[1] Overview of the Final Report of the Seattle-Denver Income Maintenance Experiment; HHS 1983.

b. The IRS does not currently make a determination that *any* reported income claimed by EITC tax filers was actually earned before issuing refundable payments.

9. The Treasury Inspector General for Tax Administration reports that between 22% and 26% of EITC payments were issued improperly in FY 2013. The dollar amounts are between $13.3 billion and 15.6 billion.[2] The EITC has the highest improper payment rate by far, exceeding any other federal program - - e.g. 26% EITC vs. 13% for Medicaid Fee for Service and 12% for UI.[3]

10. The current annual estimate of the improper payments for the EITC alone is greater than the entire budget of the IRS.[4]

11. From the GAO:

> Unlike income transfer programs such as Temporary Assistance for Needy Families and Food Stamps, the EITC was designed to be administered through the tax system. Accordingly, while other income transfer programs have staff who review documents and other evidence before judging applicants to be qualified to receive assistance, the EITC relies more directly on the self-reported qualifications of individuals….. This is especially true when eligibility depends on information that cannot be readily and rapidly verified by IRS as it processes tax returns. EITC eligibility, particularly related to qualifying children, is difficult for the IRS to verify through its traditional enforcement procedures, such as matching return data to third-party information reports. Correctly applying the residence test, for example, often involves understanding complex living arrangements and child custody issues. Thoroughly verifying qualifying child eligibility basically requires IRS to audit individual tax returns, as was done in the tax year 1994 compliance study - - a costly, time-consuming, and intrusive proposition.[5]

12. From the Treasury Inspector General:

> Income reported through information returns such as Forms w-2, Forms 1099 etc. which can be used for verification of some income, become available only after tax returns are processed. Under law, the IRS must process income tax returns within 45 days of receipt or pay interest to taxpayers. [6]
>
> It is estimated that 70 percent or $10.15 billion in improper payments are from authentication errors. These include the inability to authenticate qualifying child

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[2] Treasury Inspector General for Tax Administration; Reference # 2014-40-027; 2014
[3] GAO -15-482T
[4] Expansion of Controls Over Refundable Credits Could Help Reduce the Billions of Dollars of Improperly Paid Claims; Audit #201140045; US Treasury; 2012
[5] GAO-01-487T; 2001
[6] Treasury Inspector General for Tax Administration; Reference # 2013-40-084; 2013

eligibility requirements, mainly relationship and residency requirements; filing status, when married couples file as single or head of household; and eligibility in nontraditional and complex living situations. It is estimated that 30 percent or $4.35 billion in improper payments are from verification errors. These errors relate to improper income reporting which allows claimants to fall within the EITC income limitations and qualify for the EITC. The errors include both underreporting and over-reporting of income by both wage earners and taxpayers who report that they are self-employed.[7]

VARIOUS PROGRAM CHANGES FOR CONSIDERATION:

1. Reduce the maximum dollar level of the EITC, which is too high and discourages work.

2. Make the value of the EITC dependent upon both earned income and hours of employment. Currently the EITC is calculated against earnings, not level of work effort as measured by hours of employment.

3. Reformulate the EITC as a subsidy to employers rather than payments to individuals.

4. *Do not* expand EITC to single men. Single men can easily earn enough to support themselves even in low wage full time employment ($7.00/hr. full time is $14,000/yr, exceeding the poverty line for one person). The availability of the EITC discourages work and promotes fraud (Young men should not be playing video games in the basement while receiving a government check).

5. Provide the EITC as a generous employer subsidy for special very hard to employ groups such as returning offenders - - e.g. pay high subsidy to employers for first 9 – 12 mos. post release.

6. End cash payments to individuals and place benefits into a personal IRS retirement fund accessible after age 62. Currently among the low income population most payments are taken lump sum and are spent all at once.

PROGRAM INTEGRITY RECOMMENDATIONS:

1. Allow IRS to systemically disallow EITC claims then information contained in reliable government data sources does not support the claim. These include sources such as SSA, HHS, Federal Bureau of Prisons and the State' Departments of Corrections. The IRS does not have this math error authority although it has requested it.[8]

[7] TIGTA reference #2014-40-093
[8] TIGTA reference # 2014-40-093.

2. Allow the IRS to systemically disallow EITC claims not supported by National Directory of New Hire data. Currently IRS can use NDNH to identify fraudulent cases, but then must conduct a full audit to take a disallowance. [9]

3. Paid return preparers assist in the preparation of 57% of EITC claims. Unscrupulous preparers contribute to improper EITC claims. When the IRS announced its plan to register return preparers and create enforcement tools, the US District Court for the District of Columbia enjoined the IRS from enforcing some of the requirements, finding that the IRS lacked the requisite statutory authority.

4. Eliminate the requirement that IRS make EITC payment within 45 days for those filers who are using 1099 or self-reported income. Permit the IRS to withhold payment for any filer who the IRS system flags as a potential violator, until taxpayer comes to office with supporting documentation.

5. For the self-employed, require that their required quarterly estimated tax withholding has been paid in relative proportion to the imputed income serving to generate the requested refund. This information is available to the IRS before issuing a refundable credit. If the taxpayer has not made quarterly payments he or she is out of compliance and should not be entitled to a refundable credit.

6. Cross match EITC filing with TANF, SNAP and subsidized housing to determine if household composition and income reported is consistent with that of EITC filing.

7. Use wage withholding information collected by the IRS to determine gross income for those with W-2 filings.

8. After an IRS disallowance, 26% of these filers nevertheless claimed it again the next year. Freeze any subsequent payments until positive verification and issue sizeable offset penalty against future claims.

[9] TIGTA reference #2014-40-093.