Complexity, Regressivity, and Income Disparity: Self-defeating Aspects of the Earned Income Tax Credit

Lindsay H. Rubel
Candidate for J.D., 2006,
Washington & Lee University, School of Law

I. Introduction: Complexity problems in the Federal Tax Code co-exist with and contribute to increasingly less progressive real tax rates and increasingly unequal income distribution.

Over the past several decades, the American income tax system has become less and less progressive. While U.S. tax rates have yet to become regressive in absolute terms, the original, progressive rate structure of the income tax system is slowly but steadily eroding. In other words, although the marginal income tax rates at the top of the income distribution remain higher than the marginal income tax rates at the bottom, poorer Americans find themselves paying an increasingly greater percentage of their total incomes to federal, state, and local governments.¹

This erosion of progressivity has occurred in conjunction with growing income disparity.\(^2\) “[T]he average real income of the bottom four deciles has stagnated, [and] the real income of those at the top of the income distribution has grown sharply.”\(^3\) Further, this remains true even after transfer payments, including social security and unemployment benefits, welfare payments, Medicaid and Medicare, housing assistance, and the like, are taken into account.\(^4\)

The Earned Income Tax Credit (“EITC” or “the Credit”)\(^5\) was devised and expanded both to combat the erosion of progressivity and to promote greater post-tax income equality. And while the precise relationship between progressivity and income disparity remains unclear,\(^6\) these two aims were clearly synonymous with the underlying tax justice and antipoverty goals of the EITC.\(^7\)

\(^2\) Why should Americans be concerned about the inequality issue? Writes Paul Krugman: “there's good reason to believe that a society in which most people can reasonably be considered middle class is a better society - and more likely to be a functioning democracy - than one in which there are great extremes of wealth and poverty.” Paul Krugman, Losing Our Country, New York Times, editorial, June 10, 2005; for more information on the social, political, and economic effects of the inequality problem, see Class Matters: A Special Section, New York Times, <http://www.nytimes.com/pages/national/class/index.html>.


\(^4\) See Pechman at p.2.

\(^5\) General guidelines for the EITC are found in § 32 of the Federal Income Tax Code. In brief:

It is a refundable credit available to a taxpayer whose household “earned income” is below a certain amount. As originally enacted, the credit was restricted to households that contained at least one “qualifying child.” The Omnibus Budget Reconciliation Acts of 1990 and 1993 expanded the credit, and in 1994 a reduced-level credit was made available to low-income individuals without qualifying children. An individual eligible for the credit must file an income tax return for the year; married individuals must file a joint return. In addition, the taxpayer must complete and file a Schedule EITC and provide the Social Security number of each qualifying child.


\(^6\) See Hassett & Hubbard at p. 197 (suggesting that a more progressive tax system may actually undermine wages).
Unfortunately, the EITC has failed to live up to its promise. The complexity inherent in the current version of the Credit has, to a certain extent, actually decreased true progressivity in marginal tax rates. Further, the underlying structure of the EITC suggests that it may actually be contributing to the problem of wage stagnation and decline among middle and lower income earners. For all of these reasons, the Earned Income Tax Credit may, in fact, be actively undermining its goals of increasing progressivity and after-tax income parity.

II. EITC: History and Purposes

The Earned Income Tax Credit was enacted in 1975 primarily for the purpose of providing tax relief to the working poor. Policy makers viewed the credit as a means of tearing down the obstacles that the tax system posed to the self-sufficiency of lower-income working families. Keyed to the amount of the filer's reported earned income, the original EITC provided a cash benefit which both refunded the filer's withheld taxes and supplemented this refund with direct cash assistance. Originally, this work-based "Negative Income Tax" payment was available only to families with children.

---

7 The Credit was introduced in 1975 as a way of providing tax equity by allowing lower-income American families to retain more of their earned income, as well as supplementing that income through an earned income based “negative income tax”. Bruce D. Meyer, Introduction, 53 Nat'l Tax J. v, v (2000). As the EITC expanded through the 80s and 90s, its purpose has evolved into that of a full-fledged income support program. Lisa Barrow & Leslie McGranahan, The Effects of the Earned Income Credit on the Seasonality of Household Expenditures, 53 Nat'l Tax J. 1211, 1211 (2000).

8 See Meyer.


10 Tax Reduction Act of 1975, Pub. L. No. 94-12. The first EITC was available to taxpayers with annual incomes below $6000. Id. The maximum available credit was $400, or ten percent of the first $4000 of
The EITC has historically found favor with both conservatives and liberals.\(^\text{12}\) Those on the right view the Credit as pro-work, pro-family, and anti-welfare, while those on the left see EITC as an important poverty-alleviation measure.\(^\text{13}\) Subsequent reforms reflect this widespread approval: These reforms have enormously expanded the EITC's availability, maximum benefit, reduction rate, and break-even point.\(^\text{14}\) And while the Credit still provides a benefit in proportion to the filer's number of qualifying children (up to two children), it has also been expanded to childless lower-income workers.\(^\text{15}\) Additionally, Congress has chosen to tie the amount of the EITC payment to the inflation rate so as to preserve its economic benefit.\(^\text{16}\) Together, these changes and expansions reflect a shift in the EITC's focus from an effort to offset payroll taxes paid by low-income families to a major income support program.\(^\text{17}\)

earned income. \textit{Id.} In its first year, the total cost of the EITC program was $700 million. See Ventry at 995.


\(^{13}\) See Ventry at 997-98.


\(^{17}\) See Lisa Barrow & Leslie McGranahan, \textit{The Effects of the Earned Income Credit on the Seasonality of Household Expenditures}, 53 Nat'l Tax J. 1211, 1211 (2000). As President Clinton stated during the expansions of the 90s, "It's about more groceries and a car, more school clothes for the kids and more encouragement and hope to keep doing the right thing." Jennifer L. Romich & Thomas Weisner, \textit{How Families View and Use the EITC: Advance Payment versus Lump Sum Delivery}, 53 Nat'l Tax J., 1245, 1245 (2000) (quoting President Bill Clinton).
As a result of these late 80s and early 90s expansions, the federal EITC is estimated to raise 4.9 million people, including 2.7 million children, above the poverty line.\textsuperscript{18} Its yearly costs measure an estimated $39.5 billion, making the EITC the largest federal entitlement program.\textsuperscript{19} Further, this figure confirms that the EITC’s costs are higher even than Temporary Aid to Needy Families (TANF) and the Food Stamp program—the nation’s more traditional antipoverty initiatives.

As a result of the changes and expansions of the past two decades, the EITC now stands as the primary American poverty alleviation program; thus, to the extent complexity undermines EITC, it undermines our principal effort to alleviate poverty. As we will see, complexity undercuts both the EITC's original goal of tax relief for lower-income and its current goal of income supplementation for all lower-income working Americans. Specifically, to the extent EITC rules make it too complicated or too difficult to claim the Credit’s benefits, it abrogates its key purpose and reason for existence.

III. The Earned Income Tax Credit’s complexity and structure create negative economic impact upon lower-income filers.

\textit{(A) Complexity causes an erosion of the overall tax base.}

Often, the term "complexity" is a proxy for the Code's inclusion of numerous, complicated deductions and exemptions. Exemptions and deductions primarily favor the wealthy because, come tax day, the wealthy have more at stake than the poor. Thus,

\textsuperscript{18} See Llobrera & Zahradnik.

higher bracket taxpayers possess more of both the will and the economic means to take advantage of complexity, while lower-income filers generally do not have the financial ability or will to utilize the sophisticated tax planning methods available to the top. Further, allowing wealthier filers to shelter larger and larger amounts of their income from actual taxation lowers higher-income filers' effective tax rates. This erodes progressivity in that the higher-income filers' tax bill, as a percentage of their total income, will be lowered as a result of their ability to fully utilize deductions and exemptions.

(B) EITC complexity withholds the benefits of the Credit from eligible recipients, thereby driving up their effective rates of taxation.

(i) Introduction:

Second, and more directly, the complexity of the EITC itself may lead lower-income filers to believe that they are not eligible for the credit, when, in fact, they are, to under-compute their EITC payment, or to feel compelled to pay a professional preparer in order to ensure that the credit is accurately calculated. Moreover, the problem is currently threatening to intensify. Newly implemented “pre-certification” requirements, an Internal Revenue Service move to increase EITC compliance, are nearly certain to

20 See Pechman at p. 3.

21 See id. (“For example, the marginal rates in the United States reached a maximum of 50 percent in 1985, yet the maximum effective rate on total income in the top income class did not exceed about 25 percent”).

22 Again, this is not to suggest that complexity is relevant only for purposes of the EITC. More broadly, the complexity problems inherent in the Internal Revenue Code may manifest as an inability to properly calculate a withholding allowance or to determine whether a return must be filed, whether any income taxes are owed, or whether the refundable child tax credit may be claimed. Janet Holtzblatt and Janet McCubbin, Issues Affecting Low-Income Filers, in The Crisis in Tax Administration, Henry J. Aaron and Joel Slemrod, editors, Brookings Institution Press, 2004, p. 149. In sum, “[c]omplexity may lead to unintentional errors by low-income filers or the failure to claim [several] tax benefits to which they are entitled.” Id.
increase both complexity and the overall level of the administrative burden upon the EITC recipient.  

Finally, it should be noted that the problem of complexity is often exacerbated by the particular familial and financial circumstances of the low-income filer. Provisions that may appear relatively understandable to most taxpayers "may be difficult for low-income filers because of their complicated family lives, erratic work histories, or connection to the underground economy. Deficiencies in education and language skills may make it difficult for low-income filers to understand instructions on tax returns or to compute liabilities."  

(ii) Why complexity exists: 

Federal Income Tax Code complexity exists in part because of political compromise and in part because politicians create tax breaks, credits, incentives, and deductions as means of achieving specific social and economic goals. Take, for example, tax incentives for particular business expenditures (meant to encourage investment of a particular type or in a particular location), mortgage interest and state and local property tax deductions (meant to facilitate home ownership), charitable contribution deductions (meant to encourage contribution to charity, obviously), exclusion of interest on municipal bonds (meant to make certain municipally-beneficial investments more appealing), tax breaks for employers who provide health or life

---


24 Holtzblatt & McCubbin at p. 149.

25 In a sense, complexity is self-perpetuating because it creates roadblocks to future reform. The reform process itself is slowed when, “groups benefiting from the special provisions resists any inroads into their favored tax status. Moreover, politicians are more interested in using the tax system to promote their economic and social objectives than in improving equity and economic efficiency.” Pechman at p. 4.
insurance to employees (meant to encourage employers to provide these benefits), and, of
course, the EITC itself (meant, in part, to encourage welfare recipients to engage in
paying work). It is through these provisions that complexity arises, both because of the
Byzantine sections themselves and because incoherence and internal inconsistency are
the result when new provisions are grafted onto existing Code:

> [L]ike other filers, low-income individuals may find the tax code complicated due to conflict among the goals of tax-policy. Attempts to achieve other tax policy goals—for example, making taxes fairer—often conflict with attempts to make taxes simpler. Using the tax system to promote social policy goals, such as home ownership, health insurance, or education . . . may also increase its complexity.

In particular, the EITC has become the focus of politicians’ conflicting social engineering projects, and, therefore, has become one of the most convoluted sections of the Code. Indeed, “[t]he earned income tax credit (EITC) is a perfect example of how the best intentions can be thwarted by the complexities of real-world situations . . . [T]he credit in practice has become a muddle of confusion that has the IRS -- as well as lawmakers and

---


27 Holtzblatt & McCubbin at p. 149.

28 Illustrative is the 1990 legislation “reforming” credit. “It added three new supplemental tax credits to the EITC, one which applied to households with more than one child, another to households with children who were under one year old, and a third to households who purchased additional health insurance for a child.” Michael J. Graetz, The Decline (and Fall?) of the Income Tax, Norton & Company, 1997, p. 86. Lloyd Bentsen, then Democratic chairman of the Senate Finance Committee, was the driving force behind the health insurance addition, while the first Bush administration was responsible for the credit for households with newly born children, a provision added to please the Republican’s conservative wing. “Congress compromised, as it so often does, by accepting both proposals instead of neither, worrying not at all about people’s inability to comprehend or comply with the provision.” Id.; see also IRS Publication 596 (2004) Earned Income Credit, at <http://www.irs.gov/publications/p596/ar01.html#d0e240> (stating that, for purposes of the 2004 EITC, nontaxable military combat pay may now be included in earned income if the filer makes a special advance election).
tax policy experts -- scratching their heads.” Illustrative of its complexity is the fact that:

The IRS has historically uncovered more errors with the earned-income tax credit than with any other item on the individual income tax return, recently as many as 35-40 percent of tax returns claiming it. Some errors may be due to intentionally excessive claims, but the complexity of the rules that govern eligibility for this credit produces large numbers of mistakes even for people trying to get it right.30

(iii) Scrutinizing the EITC provisions themselves: examples and illustrations of complexity.

Complexity problems in administration of the EITC primarily concern two issues. First, there is the difficulty of defining “earned income”, and second, there are the myriad difficulties presented by the complex family structures found in the lower-income brackets. These two issues are troublesome because statutorily defining earned income, “necessitates at least implicit coordination with the variety of public support available to lower-income individuals,” while, complex family structures call into question the proper definition of “qualifying child.”

Properly defining “earned income” is crucially important because, “the amount of a taxpayer’s earned income dictates the amount of EITC he is entitled to claim.”

Income that is considered unearned, or passive, such as alimony or interest on a bank

29 Kircheimer at 15; see also, A Tax Credit for Crooks, Fortune, Oct. 4, 1993, at 24 (describing the EITC reporting form as "notoriously opaque").

30 Graetz at p. 85.

31 “Relative to other taxpayers, low-income filers are more likely to be single parents or receive means-tested transfers from the government.” Holtzblatt & McCubbin at p. 150. Further, taxpayers living in complicated family situations—for example, situations where the filer is a single parent but the child lives in another family’s home—are disproportionately likely to be poor. Id.

32 Kircheimer at 15.

33 Id.
account, will not count for purposes of calculating the amount of the Credit. Defining
earned income is a difficult task because there are so many different potential categories
of it, and legitimate arguments for inclusion or exclusion of each category of income can
be made on both sides. In the end, classification of income is a hairsplitting task. The
Internal Revenue Service’s current EITC reporting publication indicates that the Service
will treat as unearned income items including, “interest and dividends, pensions and
annuities, social security and railroad retirement benefits (including disability benefits),
alimony and child support, welfare benefits, workers' compensation benefits,
unemployment compensation (insurance), nontaxable foster care payments, and veterans'
benefits, including VA rehabilitation payments.”34 However, earned income will include
amounts deriving from items as diverse as nontaxable combat pay (if elected in advance),
net earnings from self-employment, minister’s housing allowances, and strike benefits.35

Categorizing the receipt of rental assistance is a particularly thorny task, and is
illustrative of the definitional problem in general. “Section 32(j) attempts to coordinate
the EITC with other assistance programs,” stating that, “no refund made to an individual
by reason of section 32 is to be taken into account in calculating income for purposes of
the United States Housing Act of 1937, title V of the Housing Act of 1949, section 101 of
the Housing and Urban Development Act of 1965, sections 221(d)(3), 235, and 236 of

34 IRS Publication 596 (2004), Earned Income Credit (EIC), available at
<http://www.irs.gov/publications/p596/ch01.html#d0e1016>. Also excluded from earned income are
earnings received while an inmate, workfare payments, community property, and nontaxable military pay.
See id.

35 See id. Other items of earned income include “involuntary plan contributions made by an employer
under section 414(h)[,] . . . salary reductions taken under a cafeteria plan, section 401(k) plan contributions,
and federal employee thrift account contributions.” Kircheimer at p. 15. Of course, the necessity of
accounting for these income sources creates a needless administrative hassle for many low income
taxpayers: those filers whose incomes are low enough to qualify them for the EITC are highly unlikely to
be saving money in a 401(k) plan.
the National Housing Act, and the Food Stamp Act of 1977.” 36 When this provision is applied to the, presumptively, lower-income individuals who participate in workfare programs in exchange for rental assistance, the outcome is unclear. The Internal Revenue Service considered this situation in 1992, when it issued advice on the earned income status of the rental assistance such a person would receive in exchange for, and contingent upon, the performance of services to the city. Further, the work had to, “be performed until the value of the work performed meets the value of the rental assistance. If the individual stops work before meeting the assistance amount, his assistance is cut off.” 37

The IRS advice indicated that the Service, in concluding that the value of the workfare participant’s services are earned income for the purpose of Section 32, had struggled with the uncertain categorization of workfare. 38 The advice traced the tax history of the workfare program. It noted that earlier, in Rev. Rul. 71-425, the Service had decided that payments made under a workfare program are neither gross income nor wages 39 because the broader aim of the workfare program is to teach proper work habits as well as substantive job skills to the long-term unemployed. 40 However, in the end, a National Office official decided the issue on the basis of her “gut reaction”: “the value of

36 Kircheimer at 15.
37 Id.
38 See id.
40 See id. at *3-4.
the services is earned income for section 32 purposes, because the individual is not entitled to rental assistance unless he performs the services.”

The rental assistance classification puzzle also illustrates the difficulties that the Code poses to both lower-income taxpayers as well as to tax administrators. In actually applying Section 32 to real-life situations, filers and administrators will often find the specific provision too complex and convoluted, or conversely, too short, too simple, and too imprecise. In the end, the provision can only be implemented with reference to statutory history and in relation to the classification of the item in different contexts. Further, if experienced, well-educated tax administrators find themselves making decisions on the basis of a “gut reaction,” inexperienced, poorly-educated low-income taxpayers (for many of whom English is a second language), can hardly be expected to understand and apply such provisions to their own personal filing situations.

Although the earned income rules are perplexing enough, this issue, “pales next to the question of who is a 'qualifying child.'” Notably, however, the American Jobs Creation Act of 2004 did address one of the primary areas of EITC-related complexity when it created a uniform definition of “qualifying child” within the Federal Tax Code. See Tax Analysts, Tax Notes Today, Tuesday, Oct. 5, 2004.

Moreover, low-income families are more likely to receive government benefits, a fact which complicates the determination of eligibility for family status tax provisions.

41 Kircheimer at 15-16.

42 Id. at 16. Notably, however, the American Jobs Creation Act of 2004 did address one of the primary areas of EITC-related complexity when it created a uniform definition of “qualifying child” within the Federal Tax Code. See Tax Analysts, Tax Notes Today, Tuesday, Oct. 5, 2004.

43 See Holtzblatt & McCubbin at p. 150.

44 See id.
Complexity issues in this area center around the definitions of “household” and “residency” and the proper method of accounting for the receipt of government benefits. Here, the Code’s complexity frequently necessitates multiple computations of similar items for the purpose of determining eligibility for a variety of related but slightly different tax benefits. The necessity for multiple computations may also arise when taxpayers are allowed to compute a credit or deduction in several ways, finally claiming only the largest amount calculated. As in the case of the 1997 additional child tax credit, a future revision of the credit’s formula may inspire Congress to allow calculation under either the older or the newer model.

The “qualifying child” question also raises the issue of defining households—a particularly tricky task for many low-income filers and tax administrators alike. Certain

For example, there are a number of child-related tax benefits available in the Code. These benefits include the child dependent exemption (see IRC Sec. 151(c)(1)(B) (2005) "Additional exemption for dependents" provides an exemption to the taxpayer for each child of the taxpayer who "(i) has not attained the age of 19 at the close of the calendar year . . . or (ii) is a student who has not attained the age of 24"), the child tax credit (see IRC Sec. 24 (2005) "Child Tax Credit". “Section 24 of the Internal Revenue Code allows taxpayers a credit for each of their dependent children who is under age 17 at the close of the taxpayer's tax year. The credit is advantageous to taxpayers as it directly reduces the tax liability for the year and, if the taxpayer has three or more children, may result in a refundable amount of credit.” Federal Register, Vol. 69 No. 139, 69 FR 43659), the EITC, head-of-household filing status (see IRC Sec. 2(b) (2005) "Definition of head of household". A threshold amount of $125,000--$25,000 higher than an unmarried individual who is not a head of household—is applicable to the exemption amount phaseout. IRC Sec. 151(d). Lower marginal rates are also available to those filing as head of household. IRC Sec. 1(b)), and the child and dependent care tax credit (see IRC Sec. 203 (2004). A credit is available for taxpayers who have dependents, as defined in IRC Sec. 152(a)(1), under the age of 13, as well as dependents physically or mentally unable to care for themselves).

Holtzblatt & McCubbin at p. 157. Thus, “over 1 million taxpayers with three or more children compute the additional child tax credit amount twice. First, using a formula that was enacted in 2001, they compute the credit using the original formula, enacted in 1997, which subtracts the EITC from their Social Security taxes. Finally they compare the two amounts and claim only the larger of the two.” Id.

See GAO-02-449 at <http://www.gao.gov/new.items/d02449.pdf>. The Government Accountability Office recently highlighted difficulties in preparer understanding of family composition and benefits eligibility. Id. In a report concerning the new EITC pre-certification procedures, GAO noted first that EITC is a difficult program for the IRS to administer because of fraud and noncompliance concerns. Id. GAO then articulated specific worries about administrative handling of qualifying child documentation, noting that IRS, “[e]xaminers are inconsistent in how they assess supporting documentation provided by taxpayers. We asked 21 IRS examiners how they would evaluate 5 different sets of supporting documents.
benefits are only available to those who taxpayers who are able to qualify as head of household. But, in order to do so, “unmarried filers must demonstrate that they provide over half the costs of maintaining the household in which they and their children or other dependents reside.” However, the exact definition of “household” is not provided in the Code. Thus, many filers and administrators are left frustrated and confused or are forced to apply fact-intensive common law inquiries to the filer’s individual predicament.

The reforms instituted in the Omnibus Budget Reconciliation Act of 1990 attempted to simplify things somewhat by applying a three-part EITC qualifying child eligibility test: “First, [qualifying children] must reside with the taxpayer for over half the year; second, they must be the taxpayer’s son, daughter, grandchild, or foster-child; and third, they must be under the age of nineteen, unless a full-time student (in which case, they must be under age twenty-four), or permanently and totally disabled.” However, even this simplification raises potentially difficult household eligibility and residency issues. In particular, meeting the residency test can prove quite tricky — especially if the taxpayer shares custody of the child with another person. Moreover, in the event of an

---


49 Not surprisingly, the common law defining “household” displays a heavy dependence upon findings of fact. *Estate of Fleming v Commissioner*, 33 T.C.M. 619 (1974), held that multiple households may reside at the same address, even when the members of those various households are blood relatives. The Fleming court relied upon extensive findings of fact in concluding that a widow and her unmarried adult daughter were a separate and distinct household as compared to the household of the widow’s married daughter, with whom they both resided. The court took into account such items as records of magazine subscriptions and duplicative Christmas cards in reaching its decision. Thus, some commentators have noted that Fleming “implies that a tax payer must amass and retain extensive records if they are to prevail on a head of household claim in these types of situations.” Holtzblatt & McCubbin at p. 153.

audit, “the General Accounting Office finds anecdotal evidence indicates that many taxpayers do not understand [required qualifying child-related] documentation.”

Properly accounting for the receipt of government benefits is a final major source of complexity for lower-income filers. Illustrative of this issue is the tax treatment of estranged couples when the individual parents seek to claim EITC-qualifying children:

Married taxpayers may claim head-of-household filing status if they meet three requirements. First, they must live apart from their spouse for the last six months of the year. Second, they must pay over half the costs of maintaining the home in which they and their son, daughter, or stepchild reside during the year. Third, they must be eligible to claim their child as a dependent. If the taxpayer meets these conditions, he or she may file as a head of household and claim the EITC.

However, even those married but separated taxpayers who are able to understand these provisions may find themselves failing the test because they receive government assistance. Further, receipt of outside-support frequently creates a need for the filer to perform multiple, confusing calculations involving lengthy worksheets and hairsplitting divisions of daily household expenses.

---

51 Holtzblatt & McCubbin at p. 154 (citing GAO 02-449). For example, the initial audit contact letter suggests that a notarized statement from a child-care provider can be used to establish proof of a child’s residency. See IRS Form 8836 (2004) at <http://www.irs.gov/pub/irs-pdf/f8836.pdf> (stating that an audited party may provide a Third Party Affidavit from a “[c]hildcare provider who is age 18 or older (such as a babysitter or daycare provider”). However, “79 percent of examiners surveyed by GAO said that they would reject a notarized statement from a relative who claimed to be the child’s babysitter, even though many working mothers, and particularly low-income mothers, rely on their relatives to care for their children.” Holtzblatt & McCubbin at p. 154.

52 See id. at p. 155.

53 Id. Gross income does not include means-tested transfers (TANF, food stamps, and the like), but they do figure into the support test for the dependent exemption and the household maintenance test for head-of-household filing status. Id. at p. 151.

54 Id. at pp. 151-52 (“Publication 510, which explains the rules for exemptions and the standard deduction, contains four pages of instructions on the support test alone, including a twenty-two-line worksheet to help taxpayers determine if they have provided over half the costs of supporting a dependent. The taxpayer must compute the potential dependent’s share of the household’s total expenses (including expenditures on...”)
The new pre-certification regime will compound existing EITC complexity problems.

Upon uncovering EITC-related errors on as many as 35-40 percent of tax returns claiming the Credit, the Internal Revenue Service chose to address the issue. The Service’s primary strategy has been to take a compliance-centered approach, which favors increased audits among lower-income filers. This compliance-centered approach also introduces a new procedure called EITC “pre-certification”—a solution some fear “is tantamount to a 100 percent audit rate (in advance) for some people who claim the EITC.” This procedure was introduced in the 2004 tax year, and many commentators believe that it will increase both complexity and overall level of administrative burden upon the EITC claimant. Particularly troubling is the fact that the new procedures could require some filers to produce documents that may not even exist.

Washington and Lee University

food, housing, education, medical and dental care, entertainment, and transportation) and determine to what extent the taxpayer financed these purchases. Taxpayers must also keep receipts of expenditures—from rent payments to grocery bills—in order to prove support").

See id. at pp. 158-59 (”[W]hile audit rates have generally fallen, the odds of being audited have increased for low-income filers relative to other filers. In 1988 the audit rate among 1040A nonbusiness filers with positive income below $25,000 was 1.03 percent, while the average audit rate among all filers was 1.57 percent. By 2000 the audit rate was 0.49 percent for all taxpayers, but it was 0.6 percent among 1040A nonbusiness filers with income under $25,000 and 1.4 percent among EITC claimants”). The Service's choice to use the audit device as a compliance device of first resort is particularly troubling in that no statistical evidence exists to support the proposition that the poor are more likely to cheat on their tax returns (for example, by claiming non-existent dependents) than the wealthy. See id. at pp. 189-90. Further, the approach confounds logic in that enforcement activity directed at higher-income taxpayers generally produces much greater revenue.


See Greenstein (“A majority of EITC filers use commercial preparers, no doubt in part because of the complexity of the EITC rules. The precertification requirements are likely to drive EITC filers to commercial preparers in still larger numbers and to increase the fees that preparers charge filers subject to pre-certification”).

See id. at pp. 8-9 (noting that the new procedures may require EITC claimants to produce marriage certificates, a requirement which may be impossible to meet if, for example, the claimant is married in a common-law jurisdiction, is unable to afford a state’s processing fee, or was married in a foreign country).
In brief, pre-certification would require EITC claimants to produce documentation in support of their claim and furnish it to the IRS before or at the time of filing. The Service could require some or all filers to supply proof of eligibility before any EITC-related payment is made, while other claimants could be subject to an eligibility examination. In addition, all aspects of the EITC claim may be made subject to the pre-certification requirement. Thus, EITC claimants' may also be required to furnish proof that all qualifying children listed on their return meet EITC residency requirements prior to any EITC payment.

(D) How EITC Complexity Decreases After-Tax Income Parity

Complexity thwarts the underlying purposes of the EITC through two basic mechanisms. First, it creates an inability for lower-income filers to determine their eligibility for the Credit, and, thus, a practical inability to claim it. Complexity also produces the fear of triggering an audit upon performing the EITC calculations incorrectly. In this way, complexity creates reluctance to claim the credit even when the filer knows that he or she is eligible for it. And, of course, if the lower-income filer's withheld income is not refunded and/or supplemented by EITC funds, that filer's effective tax rate remains higher than policy-makers intend. Indeed, "[a]n estimated 10 to 15

59 See Holtzblatt and McCubbin at pp. 179.

60 See id.

61 See id. at p. 180 n. 63. However, the IRS will exercise some selectivity in application of the pre-certification procedure. "Taxpayers are selected for certification if IRS research indicated that they have a relatively high risk of claiming a child who does not meet the residency requirements. A second selection criterion is that the IRS has little or no information from existing data sets to determine their eligibility." Id.
percent of those eligible [for the EITC] don't file for it.\textsuperscript{62} And, although it is impossible to know precisely how many of these 10 to 15 percent choose not to file for complexity-related reasons\textsuperscript{63} (e.g., lack of ability to properly compute EITC eligibility or fear of triggering an audit), if we assume a figure of just one-half, the total value of funds unclaimed for these reasons would still amount to approximately $2.19 billion dollars (using $39.5 billion estimate of EITC costs).\textsuperscript{64}

Complexity also erodes progressivity by diverting EITC funds away from their intended recipients and toward paid commercial tax preparers and "rapid-refund" style lenders. In 2002, The Brookings Institute conducted a detailed study on the diversion of EITC funds. The study examined, "how low-income taxpayers collect tax refunds, including an analysis of the spatial distribution of commercial tax preparers and 'rapid refund' loans in the nation’s 100 largest metropolitan areas."\textsuperscript{65} The Brookings Institute found that, in certain geographical areas, such as Washington D.C., “taxpayers claiming an Earned Income Tax Credit (EITC) of $1,500 spend, on average, more than 10 percent

\begin{itemize}
  \item \textsuperscript{62} David K. Shipler, The Working Poor: Invisible in America, Alfred A. Knopf, 2004, p. 14 (internal citations omitted). Shipler, commenting on the overall level of EITC knowledge among low-wage workers, writes, "I have not yet come across a single worker or boss who knew that with a simple form called a W-5, filed with the employer, a low-wage employee could get some of the payments in advance during the year." Id. at p. 15. Occasionally, employers are not just uninformed, but purposefully misleading. "When I mentioned the W-5 to Debra Hall and she then asked at her bakery, the woman who handles the payroll waved her away impatiently and said she knew nothing about it. Later, the tax preparer told Debra it was better just to wait and get the payment in one lump sum after she filed her return." Id.
  \item \textsuperscript{63} Some commentators suggest that “confused,” rather than intentional, EITC filing mistakes may account for as many as 72 percent of errors. See Burman at p. 190.
  \item \textsuperscript{64} Smeeding, Phillips, & O’Connor.
  \item \textsuperscript{65} Berube, Alan, and others, 2002. The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC. Brookings (May).
\end{itemize}
of this amount on tax preparation, electronic filing and a refund loan if they use a
commercial tax preparer.\textsuperscript{66}

In the lower income Washington D.C. neighborhood home to H&R Block's 14th
Street location, "a simple return with two W-2s filed electronically would run $78."\textsuperscript{67}

Certain transaction fees are specifically targeted at individuals unable to maintain a bank
account, while Block's "rapid refund" service, for those clients enticed by the offer of a
refund check within a "in a day or two," requires an additional $50-$90 fee.\textsuperscript{68} In reality,
these "rapid refund" fees are actually loans with annualized interest rates of between 108
and 2,281 percent.\textsuperscript{69}

These commercial preparers:

do for a hefty fee what their clients could do for themselves for free with
the math skills and the courage to tackle a 1040, or with a computer and a
bank account to speed filing and receipt. But most low-wage workers
don't have the math the courage, or the computer, and many don't have the
bank account. They are so desperate for the check that they give up a
precious $100 or so to get everything done quickly and correctly. "You
get so scared," said Debra Hall, who paid $95 to have her simple return
done after ending twenty-one years of welfare. "I don't know why it's so
scary, but I'd rather have it done right the first time."\textsuperscript{70}

Evidently, Debra Hall's sentiments are common in lower-income neighborhoods.

“Electronic tax filing and preparation services cluster in neighborhoods where large

\textsuperscript{66} Id.

\textsuperscript{67} Shipler at p. 16.

\textsuperscript{68} Id. Of course, EITC complexity does not force lower-income earners to use high-priced refund services.
Nor is complexity directly responsible for the unethical or illegal business practices of certain commercial
preparers. However, it may be said that complexity perpetuates such practices by providing unethical
commercial preparer-lenders with easy access to a vast pool of potential customers—a captive audience
which can be forced to listen, at least once, to the commercial preparer's high-priced services sales pitch.

\textsuperscript{69} Id. at p. 17.

\textsuperscript{70} Id. at p. 15.
numbers of families claim the EITC. High-EITC zip codes are home to 50 percent more electronic tax preparation services per filer than low-EITC zip codes.”71 Often, EITC complexity makes these commercial preparers as incapable of correctly computing refund amounts as their clients72—with devastating results. One tax attorney relates:

A [pro bono client] had gone to a storefront tax-return preparer and had received a refund. Upon audit, the IRS contended that her refund was greater than what she was entitled to. Going through the provisions, I was forced to call for help . . . It turned out that the IRS was correct. The real problem was that her refund was long gone. Now she owed taxes plus interest, and she simply did not have the funds to satisfy the liability.73

The end result of commercial tax-preparer clustering is wide-scale diversion of EITC funds away from their intended recipients (as well as a number of lawsuits directed against the commercial tax preparer-lenders74). In 1999, the total cost of EITC diversion was $1.75 billion, re-routed toward tax preparation services, electronic filing, and high-
cost refund loans.\textsuperscript{75} Thus, the total amount of EITC funds, either unclaimed for complexity reasons or diverted to commercial preparers and lenders may be on the order of $2.19 billion + $1.75 billion, or $3.94 billion total. This number represents approximately ten percent of the total cost of the EITC program. If we translate this figure into hourly wage terms, a minimum wage earner receiving the current federal minimum (in 2003 real dollars) of $5.15 per hour in addition to an EITC payment (equivalent to $2.05 per hour in real 2003 dollars)\textsuperscript{76} would thus take home a sum total of $6.99 per hour after EITC diversion factors are taken into account.

Perhaps the most troubling aspect of these phenomena is that fact that the erosion of progressivity which they produce in real, after tax terms is simply not reflected in the federal tax tables. Policy makers view commercial tax preparation services as discretionary item of personal spending rather than a de facto tax. But the fact remains that, for the Debra Halls of the world, use of these services is anything but discretionary.\textsuperscript{77} In this way, complexity has produced a shadow tax of sorts—a "non-discretionary" levy that impacts lower-income filers more heavily than higher-income

\textsuperscript{75} See Berube, et. al. Even more striking is the fact that, “[i]n 1999, nearly half of the $30 billion in EITC claimed nationwide was refunded through high-priced loans.” \textit{Id.} Moreover, profits earned by commercial tax preparation services from the provision of tax refund loans and “fast cash” products are growing: these services brought in $357 million in 2001—more than doubling the $138 million earned on similar services in 1998. See id. In fact, "refund loans were lucrative enough to provide 8 percent of [H&R] Block's entire profits in 1999, mainly because a Block subsidiary owned a 49.99 percent interest in the loans, made by Household Bank.” Shipler at 17.


ones. Thus, this after tax "tax" contributes both to the erosion of progressive tax rates and to the widening American income gap.

(E) Is the EITC actually contributing to wage stagnation?

One way to view the EITC is as a politically palatable step-in for inflation-indexed minimum wage adjustments. The huge EITC expansions of the 80s and 90s coincided with a slow erosion of the real, inflation-adjusted value of the minimum wage,\(^{78}\) and perhaps this is not coincidental. Indeed, since the late 1970s, there has been an increasingly large gap between annualized minimum wage earnings and the poverty threshold.\(^{79}\)

The EITC appears to be the policy tactic of choice to (partially)\(^{80}\) fill that gap. Throughout the 80s and 90s, an amount equal to the inflation-adjusted hourly value of the minimum wage plus the hourly value of the EITC has held roughly equivalent to the

\[\text{Minimum Wage} + \text{EITC}\]

\(^{78}\) See chart, *Comparison of the Real and Actual Value of the Minimum Wage Plus the Earned Income Tax Credit*.

\(^{79}\) See chart, *The Minimum Wage Is Too Low to Keep a Worker Out of Poverty* at <http://www.aflcio.org/yourjobeconomy/minimumwage/charts.cfm>; see also William P. Quigley, *Ending Poverty as We Know It: Guaranteeing a Right to a Job at a Living Wage*, Temple University Press, 2003, p. 87 (“For a single parent with two children, the official poverty guideline for the year 2002 was a yearly income of $15,020. For a parent with three kids, the yearly income was $18,100. Working full-time, a parent with two kids would need to make at least $7.22 per hour and a parent with three children would need to earn $8.70 per hour in order to at least be lifted over the 2002 official poverty threshold” (internal citations omitted)).

\(^{80}\) See *id.* While one full-time wage of $7.22 per hour is necessary to support a single parent family with two children, the average value of the inflation indexed minimum wage plus EITC is only equal to $6.91 per hour. See *id.*; See chart, *Comparison of the Real and Actual Value of the Minimum Wage Plus the Earned Income Tax Credit*. The real-world impact of this gap should not be underestimated: currently, “one in every four [adult] workers in the United States, more than thirty million people, earn [these] poverty level wages.” Quigley at p. 24. Thus, it is not surprising that “[t]he U.S. Conference of Mayors identified low-paying jobs as the number one cause of hunger in America.” *Id.* In fact, low-wage workers are constantly forced to make untenable choices between basic necessities like food, housing, utilities, safe child care, and medical attention. See *id.* at pp. 72-77; see also Barbara Ehrenreich, *Nickel and Dimed: On (Not) Getting By in America*, Metropolitan Books, 2001.
inflation adjusted value of the minimum wage, alone, throughout the 60s and 70s. If we average out the numbers, we find that the 1961-1974 value of the inflation indexed minimum wage is $7.05, while the 1975-2003 value of the inflation indexed minimum wage plus EITC equals $6.91. The close correspondence of these figures suggests a post-1960 "minimum earning set-point"—an inflation adjusted dollar value that Americans of the last four decades have seen fit to consistently provide to their lowest paid workers, regardless of the method of provision.

Indeed, the breakdown of the EITC budgetary allocation supports this theory. In 2005, the program cost a total of $39.5 billion dollars. Of this sum, only $5.5 billion comprised tax refunds in the traditional sense. The remaining $34 billion is more accurately termed a transfer payment. Thus, in a sense, the yearly EITC budget provides legislators with both a chance to distribute antipoverty funds as well as a helpful political cover for that distribution.

81 See chart, Comparison of the Real and Actual Value of the Minimum Wage Plus the Earned Income Tax Credit. More strikingly, the value of the inflation-indexed minimum wage peaked in 1969 at $8.02 per hour. Id. Since the inception of the Credit, a sum total representing the hourly value of the EITC plus the inflation-indexed value of the minimum wage has never reached that 1969 minimum wage level. Id.

82 If we include, in the first data set, the years 1957-1974, the correlation becomes nearly exact at $6.90. Interestingly, before approximately 1959, when the value of the real minimum wage was consistently lower than it was during the 60s and 70s (and, by extension, lower than the value of the real minimum wage plus EITC during the 80s and 90s), 39.5 million people were living in poverty in the United States, 22.4% of the country's population. U.S. Census Bureau, Current Population Survey, 1960 to 2004 Annual Social and Economic Supplements. Current estimates place the U.S. poverty rate at between 12 and 15%, but many commentators suggest that the official poverty rate measurement methodology is outdated and inaccurate, and the true rate is significantly higher. See id.; see Quigley at 23-24.


84 See id.

85 That is, a payment in excess of taxes collected or withheld.
And although the EITC may or may not be directly responsible for driving down real wages, it is certainly indirectly responsible in the sense that the existence of the Credit weakens political resolve to create a “living wage”\(^\text{86}\). States Rebecca M. Blank, former member of President Clinton’s Council of Economic Advisors, “[w]ithout the EITC, there would be greater pressure to increase the minimum wage.”\(^\text{87}\) The EITC, in effect, provides politicians with a politically safe alternative to raising the wage floor.\(^\text{88}\) Indeed, Congressional debates of the past two decades illustrate exactly how the existence of the Credit has undermined political resolve to provide a livable minimum wage directly to the American worker.\(^\text{89}\)

\(^{86}\) See, generally, Robert Pollin & Stephanie Luce, The Living Wage: Building a Fair Economy, The New Press, 2000. A living wage is the salary necessary for a full-time worker to independently support themselves and their children at or above the poverty line. Id.

\(^{87}\) Rebecca M. Blank and Lucie Schmidt, “Wages and Work,” December 2000, paper prepared for the conference “The New World of Welfare: Shaping a Post-TANF Agenda for Policy,” at p. 17; see also 134 Cong Rec H 2962 (1988), Statement of Rep. Thomas E. Petri: “When H.R. 1834 is debated in the House, all the argument in favor of the bill will turn on the decline in purchasing power of the minimum wage and the difficulty of supporting a family at $3.35 an hour. But almost all of us agree that there is a problem out there that needs to be addressed. The real argument should be and will be over the best solution to the problem. I have proposed a compromise approach that combines a modest increase in the minimum wage to $4 per hour with a reform of the current earned income tax credit, as contained in my Job Enhancement for Families Act (H.R. 4119)”; see J.D. Foster, A Better Alternative to a Higher Minimum Wage, editorial, Wall Street Journal, Mar. 3, 1988, “Rep. Petri’s bill would expand and restructure the EITC as an alternative to raising the minimum wage and as part of welfare reform”; see 146 Cong Rec S 8048 (2000) at *S8058, Fortune magazine article entered into the Congressional Record by Sen. Hollings: “A further expansion [of the Earned Income Tax Credit] would put more dollars in low earners’ pockets and reduce the ranks of the working poor, without the scattershot effect of the minimum wage”; see 149 Cong Rec H 7845 (2003) at *H7847, Statement of Rep. Obey (in the context of the debate over EITC pre-certification): “The Republican majority for years supported the earned income tax credit as an alternative to the minimum wage increase”; see 151 Cong Rec S 2111 (2005) at *S2118, Statement of Sen. Santorum opposing Sen. Kennedy’s proposal to increase the federal minimum wage to $7.25 per hour. Sen. Santorum states that American antipoverty policy should rely primarily upon the EITC rather than an increase in the minimum wage. See id.

\(^{88}\) See id.

\(^{89}\) See id.
In the early 90s, for example, with the American poverty situation at its worst level in decades, the Clinton administration pushed for a package of policy initiatives aimed at helping the working poor—a package it initially believed should include, "an even balance between public and private financing in the form of an expansion of the EITC and an increased minimum wage which would also be indexed for inflation."

However, in the end, Congress failed to approve the prospective minimum wage increase, in part, "because an expansion of the EITC was seen as an acceptable alternative." Further, the history of the EITC vs. minimum wage debate indicates that this particular instance of political compromise, and its eventual pro-EITC, anti-minimum wage increase outcome, was fairly a typical occurrence.

If the $7.00 set-point hypothesis is correct, then it appears that the EITC is now serving neither as a targeted tax refund (as its creators had hoped) nor as an additional antipoverty safeguard (as David Ellwood and President Bill Clinton had hoped). Rather, the Credit it is more accurately termed a de facto business subsidy:

[EITC] permits employers to keep wages low while relying on the federal government to help workers make up the difference between substandard earnings and something approaching a living wage. The British learned this lesson 200 years ago when they imposed their equivalent of the EITC in the form of the infamous Speenhamland provisions. Introduced during the first decades of the industrial revolution, Speenhamland subsidized factory wages to keep workers from starving to death. Quickly, employers

---

90 See Guy Gugliotta, *Number of Poor Americans Rises for 3rd Year*, Washington Post, Oct. 5, 1993, at A6 (quoted in Michael J. Caballero, *The Earned Income Tax Credit: the Poverty Program That is too Popular*, 48 Tax Law 435 (1995)) ("In 1992, for the third consecutive year, the total number of Americans at or below the poverty line increased to 36.9 million, the highest number since 1962"); see also David Hage, *Why Poor Workers Lost Ground in the 1980s*, U.S. News & World Report, June 1, 1992, at 46-47.

91 See Caballero.

92 *Id.*

93 See, above, n. 87.
realized they could drive down wages and let the government pick up the tab for their employees. By the early 1800s, Speenhamland was bankrupting local treasuries and the laws were repealed.94

The first economists to offer the business subsidy critique of the Speenhamland laws were Karl Marx and Freidrich Engels.95 In the 1930’s, historian and economist Karl Polanyi would note that the lowered wages and reduced productivity of which Marx and Engels spoke was possible only because British law still prohibited labor organization and because the complexity of the parish relief scheme created confusion among relief recipients as to their true economic position.96 Indeed, Polyani’s critique is exceptionally apt in an era of diminishing union power and participation rates97 and vastly greater legal complexity surrounding public entitlement schemes.

The U.S. Supreme Court would generate much the same subsidy inference as Marx, Engles, and Polyani in West Coast Hotel Co. v. Parrish (1937),98 the landmark decision approving minimum wage laws:

The exploitation of a class of workers who are in an unequal position with respect to bargaining power and who are thus relatively defenseless against the denial of a living wage is not only detrimental to their health

---


98 West Coast Hotel Co., v. Parrish, 300 U.S. 379 (1937)
and well being but casts a direct burden for their support upon the community. . . . The community is not bound to provide what is in effect a subsidy for unconscionable employers.  

One lesson which emerges from the Speenhamland episode as well as the early battles over minimum wage legislation is that poverty relief in the form of a business subsidy accomplishes its goal only via inefficient means. In brief, greater aggregate economic efficiency could be achieved if business was forced to internalize its labor costs. The Credit has potentially adverse effects on productivity because “[a] wage subsidy tends to reduce the incentive for investment in new technology and capital. If an employer can obtain labor for 80 cents on the dollar, why invest in labor-saving technology?”

On a micro scale, the families and individuals EITC lifts above the poverty line would be economically better off receiving a state or federally mandated living wage or inflation-indexed minimum wage rather than a non-indexed wage plus EITC payment. All other factors being equal, a worker would find his or her financial situation improve as a result of receiving an hourly wage of $7.20 per hour (the 2003 sum total of inflation-indexed minimum wage plus EITC) rather than an hourly wage of $5.15 per hour, supplemented by a government check equivalent to an additional $2.05 per hour (minus, of course, the 10% diversion factor described above). The $7.20 hourly wage recipient

---

99 Id. at 399-400.

100 Bluestone & Ghilarducci.

101 See chart, *Comparison of the Real and Actual Value of the Minimum Wage Plus the Earned Income Tax Credit*. 
will also take the benefit of that higher wage without experiencing the economic
detriment of deferral\textsuperscript{102} on the $2.05 increment.

In sum, to the extent the EITC's existence weakens political resolve to create a
minimum wage equal to the "set-point," it is more accurately termed a business subsidy
than an antipoverty measure. And, in this sense, the EITC both undermines its
antipoverty purposes as well as broadens the pre-tax income inequality divide. Further, if
the theories of Marx, Engels, and Polyani are correct, than the EITC may be actively
contributing to the present incidence of wage stagnation and decline\textsuperscript{103} among lower
income American workers.

IV. Curing the complexity: EITC simplification or EITC elimination?

(A) Repeal of the EITC

If policy makers eliminate the Credit entirely, it will re-introduce those issues
prompting the EITC's creation. Namely, excessive taxation may force certain working
class individuals below the poverty line. Thus, any outright elimination of the EITC
should be concurrent with the creation of a Social Security tax exemption for a certain
amount of annual wage income. Yin and Forman propose a uniform $10,000 exemption
as well as an expanded family tax allowance benefit.\textsuperscript{104} The upside of this plan is that it

\textsuperscript{102} The EITC is available in both lump sum and advance payment form. The advance payment option does
address the deferral issue by making Credit funds available with each paycheck. However, this alternative
is rarely selected. \textit{2000 Green Book}, p. 811. Participation rates in the EITC advance payment program
have remained in the low single digits since the program was created in 1979. See GAO report, \textit{Earned
Income Tax Credit: Advance Payment Option is Not Widely Known or Understood by the Public\textsuperscript{3}}
\cite{GAO/GGD-92-26}.

\textsuperscript{103} See Lester C. Thurow, \textit{The Boom That Wasn't}, \textit{New York Times\textsuperscript{1}}, January 18, 1999, A19.

\textsuperscript{104} See George K. Yin \& Jonathan Barry Forman, \textit{Redesigning the Earned Income Tax Credit Program to
Provide More Effective Assistance for the Working Poor}, 1993, Tax Notes 59 (7): 951-60. Further, Yin and
"would also permit easier and more timely delivery of benefits to recipients." It would also reduce IRS administrative costs, including the costs of EITC enforcement. On the downside, if the Yin-Forman proposal is accepted without a minimum wage hike, policy-makers would need to find a way to ensure that Credit benefits remain targeted at low-income workers. And, the Yin-Forman proposal “is . . . not immune to administrative problems (for example, the IRS would have to track workers who change jobs during the year).”

In sum, this change would clearly be the cause of a great deal of political hand-wringing, especially given Social Security’s status as a mandatory social insurance program rather than as a part of the tax and transfer system. However, it remains a necessary step if policy makers truly intend to accomplish the underlying progressive tax rate enhancement goal of the EITC.

Forman believe that the exemption proposal would not undermine the financial soundness of the Social Security system, and, therefore, could prove politically feasible. “Although the proposal might appear to require policymakers to tamper with the Social Security system, the so-called ‘third-rail’ of American politics, in fact no substantive change to the system would need to be made. Roughly the same combination of Social Security taxes and general revenues, from approximately the same contributors as under current law, would continue to fund the retirement and other obligations of that system if the proposal . . . were adopted. Therefore, the integrity of the Social Security system would be maintained under the proposal without any need to change the amount or distribution of Social Security benefits.” Id. at 952. It should be noted, however, that, in order to meet current Social Security program financial obligations while providing a universal $10,000 exemption, the earnings cap for the old-age and survivors and disability insurance (OASDI) portions of the tax would have to be removed in conjunction with a minor (approximately 0.33%) raise in the OASDI tax rate on both the employer’s and employee’s shares. Id. at 958.

105 Graetz at p. 261.

106 See Holtzblatt & McCubbin at p. 150.

107 See Graetz at p. 261.

108 Holtzblatt & McCubbin at p. 177. As an alternative to tracking workers, the IRS could obligate filers who work at multiple jobs during the year to claim a credit for excess Social Security taxes paid. Currently, the Service requires this procedure for workers who have exceeded the ceiling as a result of working multiple jobs. Alternatively, the Service could create a simple worksheet for taxpayers to enter their W-2 information and calculate their exemption. The downside of the second proposal would, of course, be the creation of yet another worksheet, adding one more level of complexity to the filing process.
(B) Simplification of the existing EITC

Tax reform advocates have suggested several approaches in addition to the more straightforward complexity remedies (e.g. creating definitional uniformity within the Code and doing away with unnecessary requirements for multiple computations). However, it should be noted that reform, in general, and reform of those aspects of the tax Code which are most harmful to low income filers, in particular, is a task which may appear simple on the surface, but which, in reality, is made quite difficult by competing policy concerns. Primarily, while simplification certainly has the potential to reduce the compliance burdens of low-income taxpayers, it may concurrently reduce the ability of tax administrators to target relief at low-income families.109

In attempting to reform those provisions most harmful to lower-income filers, a precarious balance exists between keeping participation rates high and improving compliance. Indeed, many have expressed the belief that it is an extremely difficult task to simultaneously improve compliance rates, properly target tax relief, and achieve the primary reform goals of (1) making the individual income tax system simpler and more user-friendly and (2) lowering administrative costs. At its core, the status of the EITC and like tax benefits as part social welfare scheme and part tax program produces:

an uneasy tension between social welfare advocates and the tax administrator. The former are not knowledgeable about legitimate concerns regarding equity, efficiency, and the administrability of the income tax laws; the latter is inflexible and unwilling to bend tax administration procedures to take into account the known characteristics of the EITC population.110

109 See Graetz at p. 260.

110 Nina Olson, [Head of the IRS Taxpayer Advocate Program], Comment, in The Crisis in Tax Administration, Henry J. Aaron and Joel Slemrod, editors, Brookings Institution Press, 2004, p. 198.
Yin and Forman propose a return to the original, 1975 definition of "earned income"\textsuperscript{111} At its inception, "only those items includable in the taxpayer's gross income were included in 'earned income' for EITC purposes."\textsuperscript{112} Soon, politics intruded, and items generally excludable from taxable income, such as disability income, military subsistence allowances, and the rental value of a parsonage, could be counted for purposes of the EITC earned income calculation.\textsuperscript{113} Thus, "[w]hile most EITC claimants don't have these sorts of income, all have to go through the annoyance of determining whether they do."\textsuperscript{114} By readopting the initial definition of earned income, Yin and Forman contend that it would be possible to, "simplify matters for the IRS and the taxpayer, limit earned income to information already available from the tax return, and possibly reduce the cost of the EITC program."\textsuperscript{115}

A more ambitious suggestion for simplification involves the elimination of the requirement of filing a tax return for the 45 to 50 million individuals and married couples who currently file only Forms 1040EZ or 1040A.\textsuperscript{116} “There is no reason why the IRS cannot make all of the tax calculations for the people who have only wage, dividend, and interest income and who take the standard deduction or who claim itemized deductions only for state and local taxes and home mortgage interest.”\textsuperscript{117} Most of the information necessary to compute non-filed returns is already supplied to the IRS by third parties—

\textsuperscript{111} See Yin & Forman at p. 952.

\textsuperscript{112} Kircheimer at p. 17.

\textsuperscript{113} See \textit{id.} at 17-18.

\textsuperscript{114} \textit{id.} at p. 18.

\textsuperscript{115} \textit{id.}

\textsuperscript{116} See Graetz at pp. 259-60.

\textsuperscript{117} \textit{id.}
employers, banks, states, governments, etc. Of course, many, if not most, Americans would be made extremely uncomfortable by the idea of a federal agency computing their taxes for them. Also, the Service could end up with informational deficits with respect to taxpayers' filing status and number of dependents, among other items. Thus, unless major changes are made to current filing structures (or unless information gathering activities on the part of the federal government are vastly increased), this proposal may prove unworkable.

Another potential route for EITC reform involves providing EITC benefits through the transfer system, rather than through the tax system. This proposal would seem to make structural sense in that only $5.5 billion of the EITC program's costs are traditional tax refunds while $34 billion are essentially transfer payments. The downside of this reform would be that it may “shift (and possibly increase) burdens to other agencies, third parties, and beneficiaries themselves.”

Indeed, the most glaring problem with shifting the EITC away from the IRS and to a more traditional social welfare agency would involve the necessity of forcing current Credit recipients to contact the second agency in order to apply for and receive benefits. It would also mean that these individuals would have to provide the second agency with the same information—income level, marital status, number of children—which they

118 See id. at p. 260.

119 See Budget of the United States Government, GPO (2005), Table 19-5 at <http://frwebgate3.access.gpo.gov>; see also Statements to the House Committee on Ways and Means (1997) by Rep. Rob Portman (stating that, because approximately 85 percent of the credit’s costs are payments in excess of income and self-employment taxes, it is, in reality, a transfer payment and should therefore be provided through the transfer system).

120 Holtzblatt & McCubbin at p. 150.
already provide to the IRS. Further, policy-makers should be mindful of the stigma claiming a means-tested benefit, rather than a simple tax credit, may create in the minds of many low-income filers. Most commentators also express a belief that removing the EITC from the tax system would cause a spike in the administrative cost of providing Credit benefits. One last important point concerning the proposed removal of the EITC from the tax system is the fact that:

[M]ost low-income filers who had adjusted gross income of less than $30,000 file for a reason other than obtaining refundable tax credits. This fact undermines one aspect of the argument for removing the EITC from the tax system. Because these taxpayers must file taxes for one reason or another regardless of the EITC, removing the EITC from the tax system would not completely eliminate the tax compliance burden for these taxpayers.

And, of course, political issues are nearly certain to arise if the full $34 billion "transfer payment" value of the EITC would have to be stated in the budget as an item of direct assistance rather than a tax "refund" item.

(C) Other alternatives: publicity and compliance initiatives

Another possibility involves the creation and the continuing commitment to fully funding free tax preparation and EITC community outreach campaigns. Today, about three-fourths of the nation’s 100 largest cities have some coordinated effort around EITC

---

121 See id. at p. 175-77. This informational requirement would represent a considerable administrative burden to most current EITC recipients: “relatively few individuals who are eligible for the EITC report claiming [other] means-tested benefits. Of individuals who were eligible for the EITC in 2000, only 3 percent appear to have claimed Supplemental Security Income (SSI), 5 percent claimed Temporary Assistance for Needy Families (TANF), and 16 percent claimed food stamps.” Id.

122 See id. at 176.

123 See id.

124 Olson at p. 194.
outreach and free tax prep. The number could easily be expanded, and considering EITC recipients disproportionate dependence upon paid preparers and instant refund services, these types of programs could represent an important advance in keeping more money in the hands of its intended recipients. Moreover, free tax prep can be helpful in getting more low income earners to file at all, a necessary first step in receiving any EITC funds. Free tax preparation services can also generate related positive spillovers for low income families, community volunteers, and local officials.

The IRS's preferred route for the enforcement of EITC provisions involves the increased auditing and the pre-certification initiative, as discussed above. The Service is joined by many tax reformers and advocates in its focus upon compliance. However, a compliance-based approach to EITC problems does “mask[] significant issues that low-income taxpayers face on a daily basis, including worker classification issues and cancellation of indebtedness income.”

Of course, this is not to say that compliance issues simply do not matter. To the extent that it exists, non-compliance funnels away available funds from eligible and deserving recipients. And, as previously noted, the statistics do suggest that EITC non-
compliance is an extensive problem. With greater resources the IRS could improve its administration of the EITC and other provisions that affect low-income filers.

Finding a strategy that improves compliance while minimizing administrative costs and compliance burdens would be key. Difficult policy choices are also involved. For example, “the IRS could examine more of the questionable cases that are identified through existing data sources, such as the Federal Case Registry of Child Support Orders . . . [or] collect information on marriage licenses and divorce decrees to better enable the IRS to verify filing status.”\(^{130}\) Of course, many Americans would be made uncomfortable by increased, and fairly intrusive, data collection on the part of the federal government, particularly on the part of the IRS. Further, this approach would only be effective to the extent that the third-party provided data is accurate and available at a relatively low cost.\(^{131}\)

IV. Conclusion

Some complexity is inherent, and, arguably, necessary, in any Code-based, prospective system of taxation.\(^{132}\) The tax Code must be complex because it is an attempt to implement political and economic policy far into the future while providing for any

\(^{130}\) Holtzblatt & McCubbin at p. 179.

\(^{131}\) See id. at pp. 180-81.

\(^{132}\) See Cabellero (stating that use of the tax Code to deliver an entitlement produces "unavoidable complexity").
foreseeable contingency that may arise. Indeed, in the sense of achieving greater
economic justice, complexity may be a boon for low-income filers in certain instances.\textsuperscript{133}

But is the tax system a proper home for an antipoverty program? From a
distributional and efficiency point of view, the answer seems to be no. Tax
administration agencies exist for the purpose of collecting revenue. And, while the
Service has performed its newly assigned welfare administration function fairly
capably,\textsuperscript{134} provision of social welfare services is certainly not the agency’s purpose or its
strength.

For all of these reasons, I propose an end to the EITC in concert with a federally
mandated living wage\textsuperscript{135} as well as a Social Security tax exemption for up to $10,000 in
annual wage income. This plan should yield the most complete and far-reaching
economic results of any of the available alternatives. Ironically, it may also be the only
measure capable of truly accomplishing the EITC’s underlying purposes. And, while
conventional wisdom asserts that minimum wage increases pose harmful employment
effects and create a risk of inflation,\textsuperscript{136} I believe that, in the end, these potential harms


\textsuperscript{134} But see Olson at p. 198 (stating that “[t]he EITC does bedevil the tax administration system”).

\textsuperscript{135} The living wage is a politically workable idea in that, “[p]olling data show broad general support for a
living wage minimum” Pollin & Luce at p. 9. One “April 2000 survey found that 94 percent of the one
thousand adults questioned agreed with the statement that ‘as a country, we should make sure that people
who work full-time should be able to earn enough to keep their families out of poverty’” Linda Roeder,
\textit{Minimum Wage: Survey Shows Support for Living Wage, Economists Say at Washington Summit, BNA

\textsuperscript{136} But see Pollin & Luce at pp. 131-33 (“[T]here [is] no statistical association between movements in the
minimum wage and the \textit{unemployment rate} . . . other factors in the economy, in particular the level of
overall demand for goods and services [are] far more important than the minimum wage in determining the
level of employment and unemployment in the economy”); Jared Bernstein & Jeff Chapman, \textit{Time to
Repair the Wage Floor}, Economic Policy Institute Issue Brief No. 180, May 22, 2002,
<www.epinet.org/Issuebriefs/ib180.html>: 36
will be outweighed by the efficiency gained in requiring business to internalize its labor costs, the increased self-sufficiency of low-wage workers, a decreased American earnings gap, other indirect benefits of higher wages, and any policy innovations which a more honest debate about antipoverty strategy may generate. In addition, the EITC's high error and diversion rates create extensive credit targeting problems, and, thus, it is not at all clear that the EITC can do a better job with respect to targeting than a living wage law or substantially increased and inflation-indexed minimum wage. Finally,

[T]here is little evidence for any negative effect on employment from past increases in the minimum wage, regardless of the business cycle. By analyzing changes in the employment status of affected workers before and after minimum wage increases, economists have rigorously searched for, but generally failed to find, these negative employment effects. The estimates from the empirical literature show that the impact on employment is either statistically insignificant or slightly negative, a finding widely accepted by economists. And even in cases where there is evidence of job losses, the number or workers negatively affected are tiny compared to the number who get an hourly pay raise.


Inflation fears are equally unfounded. See Quigley at p. 133 (“For businesses that do employ low-wage workers, . . . increased labor costs due to living wages are minimal and can easily be digested by business or passed on to the general public in the form of very, very small price increases”); Pollin & Luce at 134 (“In fact, the wage and benefit increases for most firms due to the living wage requirements will be less than 1 percent of these firms total spending to produce goods and services”). Prof. Pollin has calculated that a one dollar increase in the minimum wage would raise the price of a fast food hamburger by only one or two cents. See Robert Pollin, Economic Analysis of the New Orleans Minimum Wage Proposal, <www.acorn.org/acorn10/livingwage/neworleans.htm>.

137 See Bluestone & Ghilarducci. A minimum wage boost is also “a way to increase workers' earnings without placing any burden on the taxpayer.” Id. And, a raise could provide “increased income to workers who do not qualify for government transfer programs or tax credits.” Id.

138 See id. For example, a minimum wage increase may “decrease the deficit by boosting income tax revenue and reducing welfare payments.” Id. It may also serve as “an incentive to work in the "above ground" economy rather than in the "underground" economy where wages are often higher than the federal minimum.” Id.

139 See Quigley at p. 22. Many Americans believe that hardly anyone but teenagers earns the minimum wage, but this belief is plainly incorrect:
elimination of the Credit would yield $40 billion yearly savings to the American economy as well as relieve government of the obligation to provide a number of social services to lower income workers who are, nonetheless, unable to afford basic necessities.

Although this plan may not raise progressivity much throughout the tax system, it should have a marked effect upon the income inequality gap, and, if the income gap were decreased, the goal of increasing tax rate progressivity would certainly be a less urgent one.\textsuperscript{140} Additionally, this alternative should be the most effective at meeting the tax collection challenges posed by economic globalization, a process which makes tax revenue more expensive to obtain on a dollar for dollar basis\textsuperscript{141}(thus introducing more and more inefficiency into the system the stronger our dependence upon a tax and transfer method of combating poverty).

In the end, a taxation based antipoverty scheme is the wrong approach as illustrated by a number of efficiency markers. For all of these reasons, our reliance upon a politically expedient but economically indefensible alternative must come to an end.

If the minimum wage had been raised in 2001 by $1 an hour, more than 10 million workers, or 8.7 percent of the entire workforce in the United States, would have seen a direct increase in wages and another 9.7 million workers, who earned up to $7.15 an hour, would have also likely seen an increase. Despite the prevailing wisdom that only teenagers and part-time employees work for minimum wages, 68.2 percent of the workers affected would have been over twenty years old and close to half, 45.3 percent of the workers, would be full-timers. The majority of the affected workers would have been women, 60.6 percent, and African American and Hispanic workers would disproportionately benefit.

\textit{Id. at 22-23; see also Edith Rasell, Jared Bernstein, and Heather Boushey, \textit{Step Up, Not Out: The Case for Raising the Federal Minimum Wage for Workers in Every State}, Economic Policy Institute, Issue Brief #149, February 7, 2001, p. 2.}

\textsuperscript{140} See Hasset & Hubbard at p. 199. More unequal wage distribution produces an increased number of calls for income redistribution. “This is also the prediction of the 'rational' (public choice) theory of the size of government proposed by Meltzer and Richard (1981), in which increased inequality increases mean income relative to the income of the decisive voter and thus makes redistribution more attractive to him.” \textit{Id.}

\textsuperscript{141} See \textit{id.} at p. 207.
Comparison of the Real and Actual Value of the Minimum Wage Plus the Earned Income Tax Credit (as of January 1st each year)

© Copyright 2005 Employment Policies Institute
The Minimum Wage Is Too Low to Keep a Worker Out of Poverty

A full-time, year-round minimum wage worker in 2004 earns only $10,712, $4,493 less than the $15,205 needed to lift a family of three out of poverty.