Defrauding the American Taxpayer - The Earned Income Tax Credit

A 2011 Earned Income Tax Credit Update

Part 1 of 7
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On tax day 2009 we released a study of the Earned Income Tax Credit. At the time we noted that the credit had quietly become the largest cash transfer program for low-income families in the United States – dwarfing better known programs such as TANF (cash welfare.) Since then Federal spending has expanded far more rapidly than anyone had anticipated while tax revenues have shrunk. In FY2008 the U.S. budget deficit was $0.5 trillion; this year (FY2011) it is projected to be $1.6 trillion.

Every spending program, every revenue source is on the table – or so we are told. Reductions in Medicare, Medicaid, and other "untouchable" social programs have been proposed. Yet the EITC is under the radar in this debate. Neither party has shown any interest in cutting the tax credit. The credit is not subject to the Congressional budget authorization process.

One reason for its relative anonymity: EITC is part of the income tax code. (That's why we chose April 15th to release our study.) The tax code is vast - it contains many different deductions, allowances and credits – of which the EITC is one of the most generous – and important.

Ironically, the best hope for reducing EITC payments may be a government shutdown. At the earliest a shutdown could come a little over a week from this year's April 18 deadline for individual tax returns. Policy observers say that while it is unlikely that a shutdown would prevent the government from collecting tax money, other IRS functions -- including the delivery of billions in tax refunds -- could be affected. The sheer scope of EITC recipients means a vast number of households could be impacted – at least temporarily – by a shutdown.

Obviously, a temporary halt would not reduce the incentives to commit fraud and have out of wedlock children built into the EITC program.

The credit is expected to cost taxpayers a record $62.5 billion in 2011, up 4.5% from 2010. (This amount reflects both the reduction in tax payments plus the EITC refunds many recipients receive over and above their tax payments.) By comparison outlays of the notoriously hard to control Medicaid program are expected to rise by a mere 1.2%:

Federal Spending Projections, 2010-2011 Est.			
Program	2010	2011 Est.	% increase
EITC	**$59.7**	**$62.5**	**4.5%**
Medicaid	$272.8	$276.2	1.2%
Medicare	$519.2	$566.1	8.3%
Social Security	$700.1	$741.0	5.5%
Food Stamps	$70.5	$78.5	10.2%
TANF (cash welfare)	$21.9	$20.7	-5.8%
All Transfer Pyts. ($ trillions)	$2.29	$2.44	6.1%
All Federal outlays ($ trillions)	$3.46	$3.82	9.4%
Data Source: OMB, FY2012 Budget, Historical Tables. Tables 1.1 and 11.3 http://www.whitehouse.gov/omb/budget/Historicals/ EITC: http://www.whitehouse.gov/omb/budget/Supplemental/ (Table 17.2)			

Compare the trend of EITC outlays with that of TANF, another program providing cash to the poor. Formerly Aid to Families With Dependent Children, TANF is widely perceived as a program that does more harm than good, exacerbating poverty by destroying work incentives. Restricting TANF eligibility was the centerpiece of Bill Clinton's pledge to "end welfare as we know it." As a result there are fewer TANF recipients today than during the Clinton boom years. Despite high rates of unemployment and poverty, welfare spending expected to decline by nearly 6% in 2011.

While TANF rolls are down, food stamps, a program that was also once scorned as welfare, has garnered new support. In recent years Congress expanded food stamp eligibility, cut red tape and burnished the program's image with a special effort to enroll the working poor. States eased limits on people with cars and required fewer office visits from people with jobs. These changes, combined with soaring unemployment, have pushed food stamp enrollment to record highs, with one in eight Americans currently enrolled. The program's outlays are projected to jump by 10% in fiscal 2011.

Cash welfare carries a stigma – even among the poor. Why, then, does the EITC remain so popular?

Enthusiasm for the program stems from the perception that, unlike traditional welfare, the tax credit is only available to the working poor, especially families with children. In addition, while welfare benefits decline as a recipient's earnings go up, EITC benefits go up when workers make more – thereby increasing work incentives for low income individuals.

From a distance the EITC looks like a winner. The devil is in the details.

EITC fraud

Technically, only people authorized to work in the U.S. are eligible for the tax credit – you need a valid Social Security number. But identity theft, stolen Social Security numbers, and other scams effectively nullify the restriction. **As a result, illegal aliens actually receive the EITC at even greater rates than legal immigrants.**

Two years ago we reported that households headed by illegal immigrants from Mexico were three times more likely to receive the EITC than households headed by native-born Americans.[1] At the time we noted that the IRS turns a blind eye to this fraud. The agency does little to verify the validity of SSNs on tax returns, or the existence of immigrant children, or to ascertain that they've lived with the taxpayer for more than 6 months as required by law. Illegal alien husbands and wives often file separate returns in which BOTH claim the same children.

In February 2011 the Treasury Department, in effect, acknowledged that the charges we made against the IRS were valid. An audit of IRS procedures by the Department's inspector general stated the following:

"The Government Accountability Office has listed the Earned Income Tax Credit (EITC) Program as having the second highest dollar amount of improper payments of all Federal programs. The Internal Revenue Service (IRS) has made little improvement in reducing EITC improper payments since 2002 when it was first required to report estimates of these payments to Congress. The IRS continues to report that 23 percent to 28 percent of EITC payments are issued improperly each year. In Fiscal Year 2009, this equated to $11 billion to $13 billion in EITC improper payments."[2]

[1] Edwin S. Rubenstein, *Defrauding the American Taxpayer: the Earned Income Tax Credit and Illegal Immigration,* The Social Contract, Spring 2009.
[2] Treasury Inspector General For Tax Administration, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year* February 7, 2011.

The IRS is apparently not interested in cracking down on massive EITC fraud:

"TIGTA [Treasury Inspector General For Tax Administration] has conducted a number of audits that have provided the IRS with specific actions that could be taken to reduce improper payments. While the IRS has implemented some of our recommendations, it has not taken actions to address key recommendations aimed at preventing/reducing EITC improper payments."

While illegal immigration is not specifically mentioned as a source of EITC fraud, the use of bogus Social Security numbers and other actions associated with the receipt of EITC by illegal aliens are prominently highlighted. Once again, the IRS is asleep at the switch:

Recommended EITC Actions That IRS Has Not Taken	
Action	Potential Savings (Over 5 years)
Comply with regulations requiring some taxpayers who previously filed a fraudulent EITC claim to recertify their eligibility before receiving the EITC in a subsequent tax year.	$330 million
Ensure taxpayers comply with the law governing EITC qualifying-child eligibility before allowing EITC claims.	$5.6 billion
Use available third-party data to ensure taxpayers comply with the law requiring individuals to have a Social Security Number that is valid for work when claiming the EITC.	$1.1 billion
Source: Treasury Inspector General For Tax Administration, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year* February 7, 2011. Figure 3.	

The Treasury Department's Inspector General is not optimistic that its tax collection agency will clamp down on the massive fraud:

"The loss of billions of dollars in improper EITC payments annually calls for more aggressive and immediate actions to reduce improper payments by intensifying efforts to eliminate payment error, waste, fraud, and abuse. Executive Order 13520 requires the IRS to intensify its efforts and set targets to reduce EITC improper payments. The IRS has not met this requirement and, as a result, the risk

remains high that no significant improvement will be made in reducing improper EITC payments."[3]

EITC and Population Growth

Two years ago we wrote:

"EITC originated as an income supplement for low income workers. Somewhere along the line its purpose seems to have changed. Today it is a program whose benefits are heavily contingent on parenthood."

Since then the child-bearing incentives built into EITC have become stronger. Two years ago a family with no children received a maximum EITC payment of $438; a family with one child received up to $2,917; two or more children bumped the maxim credit to $4,824. Thus in 2008 children could trigger an 11-fold rise in EITC payments ($438 to $4,824.)

In the 2009 tax year a fourth EITC bracket – for families with three or more children – was added. This change significantly increased the impact of children on EITC payments:

Maximum EITC Payment, 2008-2011			
Tax Year	No Children	3 or more children	Increase due to children
2008	$438	$4,824	$4,386
2009	$457	$5,657	$5,200
2010	$457	$5,666	$5,209
2011	$464	$5,751	$5,287
Source: http://www.taxpolicycenter.org/taxfacts/Content/PDF/historical_eitc_parameters.pdf			

Today the presence of children can increase EITC payments by as much 12.4-fold (from $464 to $5,751.) In dollar terms children increase EITC payments by as much as $5,287 today versus $4,386 in 2008. That's an increase of $901, or 20.5%, in EITC's pro-child incentive.

Not surprisingly the IRS estimates that roughly half of the incorrect filing claims under the EITC involve fraudulent child custodial claims.

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[3] Ibid, page 10.

But most children claimed on EITC tax returns are real – and therein lies the problem. For most poor families the tax credit check is the largest single sum of money they will receive over the course of a year. Their decision to have children may be influenced, at least in part, by the tax credit. Such incentives will be particularly acute for immigrants – for the simple reason that credit represents a larger share of their incomes.

The Census Bureau projects that immigrants and their U.S.-born children will account for 79.5 percent of U.S. population growth between 2010 and 2050. U.S.-born children of immigrants, not the immigrants themselves, are expected to be the major driver. While native-born women are having fewer babies, fertility among their foreign born counterparts has generally continued to increase

Over the nearly 40-years of EITC's existence the share of births to foreign-born mothers has risen faster than the foreign-born share of the U.S. population.

It would be absurd to suggest that immigrants have children solely to get a larger tax credit. At the same time, groups with the highest EITC eligibility rates also have the highest fertility rates. Even a tiny increase in fertility rates, if maintained over the decades, will have enormous consequences.

The role of the EITC in the nation's demographic destiny cannot be denied.

EITC and the Culture of Debt

For poor families, the tax refund check is often the largest single sum of money they receive during the year. They may need the money immediately, however. Refund Anticipation Loans (RALs) give them cash quickly - sometimes in the same day or even within an hour of filing their tax returns. But they are costly.

Nearly three-quarters of all EITC recipients hire commercial tax preparers to do their returns. It not so much the tax preparation – it's the loans – the instant cash - that attracts so many poor taxpayers to these companies. And for the H&R Blocks of the world, it's big money. When you add up the interest payments, preparation costs, and other fees, an EITC recipient can spend more than 10% of the credit just to receive the credit.

Our study detailed the risks RALs pose to borrowers :

"The mechanics of RALs are stacked against the taxpayer. Commercial tax preparers like H&R Block act as loan brokers, but banks actually issue the refund loans. Before transferring the RAL proceeds to the taxpayer the banks deduct interest, the tax preparer's fees, loan application fees, and all other charges. As part of the RAL process, the taxpayer must authorize the IRS to send the refund directly (electronically) to the bank to repay the loan.

The hapless EITC beneficiary is responsible for paying the loan in full no matter how much of the anticipated refund the IRS actually releases. The IRS can deduct any outstanding federal debts – e.g., back taxes, child support, or student loans – from the EITC payment. If the taxpayer cannot repay the RAL, the lender may send the account to a debt collector."

There is good news and bad news on the RAL front.

Good news: The IRS recently announced a policy that increases the financial risk for commercial tax preparers and banks that issue RALs. Starting with the 2011 tax year the tax agency will no longer provide these companies with the "debt indicator" used to facilitate the loans. The debt indicator is simply an IRS e-mail sent to tax preparers after they file an electronic tax return. It contains information on back taxes owed, unpaid child support, or other payments their client owes the federal government - monies that can be deducted from EITC refunds.

In announcing the change IRS Commissioner Doug Shulman stated that **"as we prepare for tax season every year, we look at past practices and consider whether they still make sense. We no longer see a need for the debt indicator in a world where we can process a tax return and deliver a refund in 10 days. We encourage taxpayers to use e-file with direct deposit so they can get their refunds in just a few days."**[4]

The change will likely reduce the availability and volume of RALs issued by private tax preparation services:

"It is still unknown what the short-term and long-term impact of this decision will be on the RAL industry. However, for smaller tax preparers it is likely that they will think twice about offering RALs during the 2011 tax season. On the other hand, some of the bigger tax preparation companies may look for alternative ways to offer RALs while raising the cost. These larger companies may rely on a returning customer's debt indicator from prior years or on a taxpayer's credit score. Either way, it is becoming more difficult and more risky for these companies to offer refund anticipation products. Even before the IRS announced the elimination of the debt indicator, many banks who had previously provided RAL loans decided to get out of the risky RAL business…"[5]

Bad news: By pushing commercial companies out of the EITC business the IRS is increasing the clout of liberal activist groups that offer free tax preparation service. Foremost among them: The Center on Budget and Policy Priorities.

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[4] IRS, *IRS Removes Debt Indicator for 2011 Tax Filing Season*, August 5, 2010. http://www.irs.gov/newsroom/article/0,,id=226310,00.html

[5] Community Tax Coalition, "IRS Announces New policy Affecting Refund Anticipation Loans," August 2010. http://tax-coalition.org/policy-resources/consumer-protections/refund-anticipation-loans/debt-indicator-fact-sheet

CBPP has harnessed a large network of community organizations, schools, state and local governments, labor unions, and advocacy groups to its EITC outreach campaign.

Members receive a "Tax Credit Outreach Campaign Kit"– updated annually – outlining CBPP's strategy for promoting the credit and linking eligible workers to free tax filing assistance. Flyers in Hmong, Tagalog, and eighteen other languages - designed to hook immigrants into the EITC culture - are prominent features. [6]

In recent years CBPP has lobbied for expanding eligibility and increasing EITC payment amounts. The clamp down on RALs is unlikely to offset the expansion of this program envisioned by liberal activists.

[6] Center on Budget and Policy Priorities, *2011 Tax Credit Outreach Kit.* http://eitcoutreach.org/category/outreach-tools