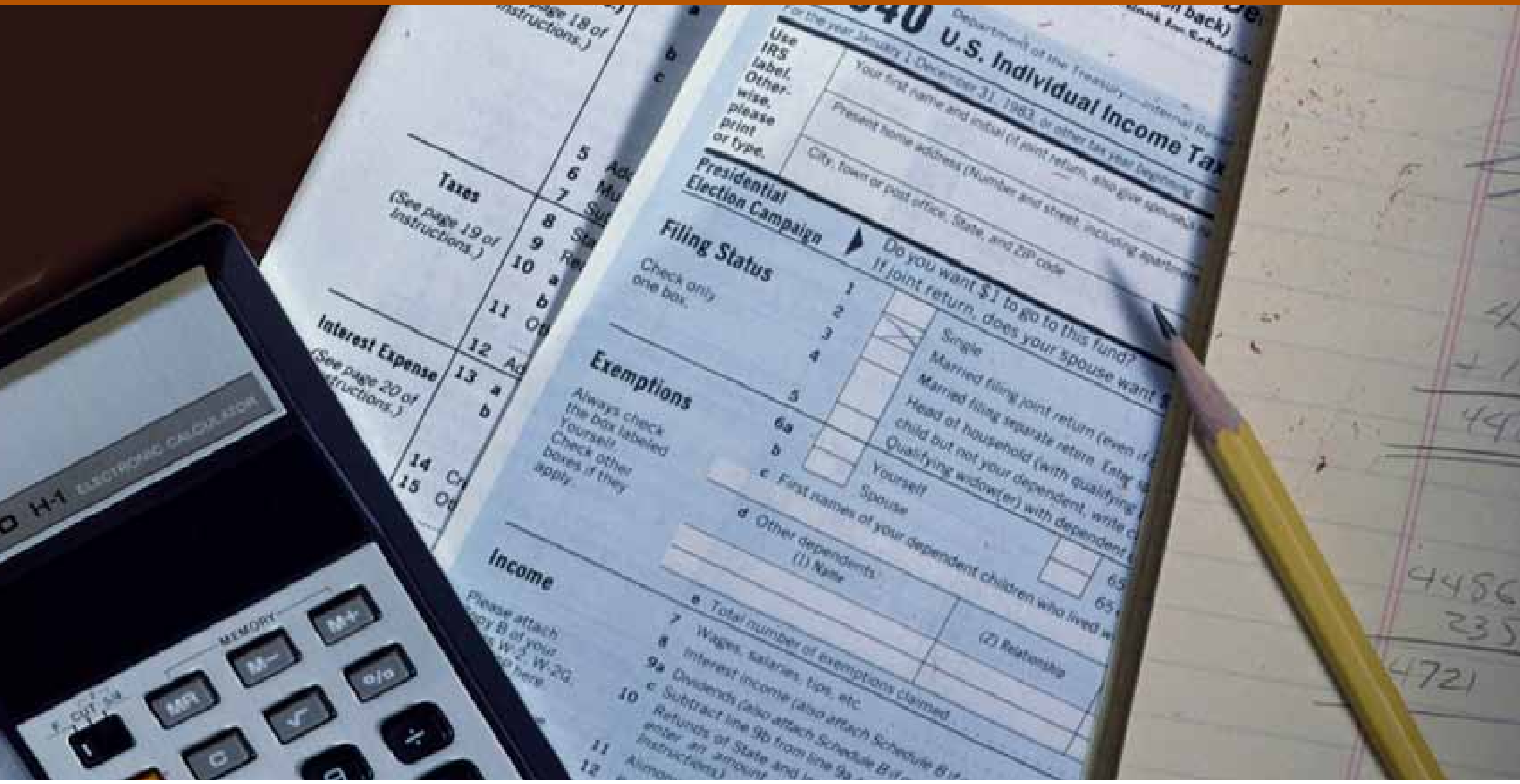

Beyond Lump Sum

Periodic Payment of the Earned Income Tax Credit

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Over the last two decades, public policies designed to provide income support to impoverished households have shifted focus to encourage and support work. As a result, the tax system has become as important as the welfare office in supporting the poor, as evidenced by the nation's largest anti-poverty program for working families: the Earned Income Tax Credit (EITC).

Although the EITC is an income tax credit, it functions for many of its recipients as a transfer payment to offset payroll taxes and provide additional cash. The EITC is fully refundable, meaning that its size is not determined by a person's income tax liability. Workers eligible for the largest credits have no federal income tax liability but still qualify to receive the full value of the credit. A key difference between the EITC and other forms of income support is timing. The norm for programs such as cash assistance, Food Stamps, and Social Security is a monthly payment. In contrast, almost all EITC households receive a large, single payment after the end of the tax year for which they qualify.

This article considers the problems with almost exclusive reliance on year-end ("lump-sum") payment, the value of providing payments periodically throughout the year, and the limitations of the current EITC advance payment option. President Obama's fiscal year 2010 budget has proposed to eliminate the advance option, adding greater urgency to this debate. This paper concludes with a design framework for an alternative periodic payment system.

The Need for a Viable Periodic Payment Alternative

Practical evidence and some research points to the popularity of large refunds among EITC recipients. But a transfer payment system that effectively obligates low-income working households to wait months for basic assistance they have earned is questionable social policy. For tax year 2008, refundable tax credits could comprise as much as 43 percent of annual income for the households benefiting most from the EITC.[2] Expansions of the Child Tax Credit and education credits in the American Reinvestment and Recovery Act of 2009 (ARRA) will further augment refunds for some working families, at least temporarily.

From the perspectives of both recipients and society as a whole, there are additional merits to having a viable periodic payment alternative.

First, available data indicate the EITC is mostly used to finance consumption, such as everyday bills, or for some families, larger items such as appliances or furniture.[3] While efforts to help EITC recipients use large refunds for longer-term wealth building strategies are admirable and in some cases successful, evidence suggests that most low-income claimants use the majority of their refund dollars for more immediate needs.

Second, a significant portion of EITC dollars intended to assist households in need has instead flowed to commercial tax preparers. Much of this outflow relates to a product—the refund anticipation loan (RAL)—developed to accelerate filers' receipt of their money.[4] These high priced loans, with annual percentage interest rates ranging from 40 percent to over 700 percent, divest about $1.57 billion in fees each year from EITC payments to working parents.[5] RALs are popular because they allow families to get their money more quickly, and large lump-sum refunds disguise their costs, which can be deducted from the refund amount.

Third, the EITC—in both intention and effect—makes work pay, but an almost exclusive reliance on year-end payments weakens the connection between the credit and work. The lump-sum payment can look more like a bonanza to both recipients and policy makers. A more effective and widely used periodic payment option would better underscore the "earned" quality of the credit.

Fourth, delivering the EITC primarily through year-end refunds also limits its effectiveness as a policy instrument. The credit provides a boost in purchasing power which helps families pay off bills and perhaps

Table 7.1 **Payment methods for earnings supplements and child benefits in other countries, 2007**

	AUSTRALIA	CANADA	IRELAND	NEW ZEALAND	UNITED KINGDOM	UNITED STATES
Program name	Family Tax Benefit, Parts A & B	Child Tax Benefit; National Child Benefit Supplement	Family Income Supplement	Working for Families Tax Credits	Child Benefit, Child Tax Credit, Working Tax Credit	Earned Income Tax Credit; Child Tax Credit
Administering agency	Family Assistance Office; Australian Taxation Office	Canada Revenue Agency	Department of Social and Family Affairs	Inland Revenue Department; Ministry of Social Development	HM Revenue and Customs [1]	Internal Revenue Service
Annual benefit amount [2]	$9,432	$5,557	$15,023	$7,262	$17,599	$5,271
Periodic payments	Optional	Mandatory	Mandatory	Optional	Mandatory (choice of frequency)	Optional
Basis for calculating payments	Estimated earnings; current family composition	Income for prior calendar year; current family composition	Income for prior month (or other appropriate period); current family composition	Estimated income; current family composition	Prior year income; current family composition	Current period income from disbursing employer; anticipated family composition
Periodic payment amount	$322 (biweekly)	$463 (monthly)	$289 (weekly)	$279 (biweekly)	$1,354 (every four weeks)	$33 (weekly)
Periodic disbursement method	Direct deposit to financial institution	Direct deposit to financial institution, or check	Direct deposit to financial institution	Direct deposit to financial institution	Direct deposit to financial institution	Addition to paycheck by employer

1 The scope of the tax agency role is relatively recent; the absorption of the Child Benefit Agency into Inland Revenue in the United Kingdom occurred in April 2003.

2 Calculated for single parent, two pre-school children, full-time work, earning $15,000 (any child care components excluded). To facilitate cross-national comparability, all figures are in U.S. dollars. Rates of exchange used per 1 unit of foreign currency are: Australian Dollar ($0.80 US); Canadian Dollar ($0.90 US); Euro ($1.35 US); New Zealand Dollar ($0.70 US); British Pound ($1.95 US).

finance some larger household items. Periodic payment could increase the affordability of housing or health insurance.[6] It could also enhance other initiatives (such as refundable assistance for higher education and child care) where the timing of outlays does not currently coincide with tax season.[7]

Finally, error and fraud associated with the EITC remain major concerns. Although frequently-cited estimates of improper claims are likely overstated and include many inadvertent mistakes, the EITC does provide opportunities for those taxpayers (or tax preparers) willing to commit fraud. Reducing single-payment payoffs at tax time could reduce the potential allure of such illicit activity.[8]

Periodic payment is the predominant method used in several other countries to disburse earnings supplements and child benefits that are analogous to the EITC (see Table 7.1). Although each country's programs are distinctive, the general recognition of the merits of periodic payment and the operation of viable systems for providing it are instructive.

The EITC Advance Payment Option—Structure, Utilization, and Issues

Federal policy recognized the merits of periodic payment and introduced an advance payment option of the EITC in 1978. Unfortunately, the Advance EITC suffers from a poor design, as reflected by the low take-up rate among recipients.

Most workers who expect to qualify for the EITC and are able to claim at least one qualifying child for the current year are eligible to receive advance payments and do so by enrolling through their employers. The employer has no role in verifying eligibility, and there is no required communication with the IRS. The advanced amount is determined according to IRS formulas and assumes the current period's wages are received for the full year; this amount is added to the employee's paycheck on a regular basis. The employer finances advance EITC payments by deducting them from its withholding and tax payments to the IRS. A worker receiving EITC advance payments must file a Form 1040 or 1040A tax return and report the payments. If the total advances exceed the credit for which the worker is eligible, the excess constitutes an additional tax owed and could result in a net payment liability.

Very few EITC recipients utilize the advance payment option. Tax return statistics show a general decline in recent years in the number and proportion of filers claiming the Advance EITC. In tax year 1997, 1.5 percent of EITC returns for workers with qualifying children reported an advance. This declined to 0.8 percent by tax year 2001 and remained at that level in tax year 2004. Total reported advance payments for tax year 2004 represented just 0.16 percent of the total EITC claimed by taxpayers with qualifying children.[9]

A 1992 General Accounting Office (GAO) report identified three principal reasons for low utilization of the EITC advance payment option that remain relevant today: 1) many eligible employees and their employers were not aware of the option; 2) some employees feared having to repay advances when they file their tax returns; and 3) some employees preferred a single lump-sum refund payment instead of smaller periodic payments.[10]

Awareness of the advance payment option likely remains low, and outreach efforts may not change this. A 1997 IRS experiment designed to inform eligible recipients led to only a very small increase in advance payment usage.[11] A 2006 experiment at different locations of a major national employer doubled to quadrupled advance payment use, but that similarly amounted to a small number of new participants.[12]

The possibility of repayment liability is another factor behind low take-up, though program design mitigates this risk. The advance payment option has a ceiling, set at 60 percent of the EITC for a family with one qualifying child, which reduces the risk of year-end tax liabilities. Most EITC recipients could safely receive advance payments and not risk a repayment liability (for example, a household earning an annual income of $10,000 would receive a maximum advance payment equivalent to just 43 percent of the total credit for two or more children). Nonetheless, EITC recipients appear to demonstrate great aversion to any risk of owing money back at the end of the year.

The preference for a lump-sum refund also runs strong among taxpayers in general. Nearly all EITC recipients (96 percent) claim a tax refund, as do a majority of non-credit recipients (76 percent).[13] By intentionally generating a refund via overwithholding (having more taxes withheld than is necessary to meet annual tax liability), EITC recipients and others effectively use the IRS as a de facto savings account that enforces temporary fiscal discipline.[14]

In addition to low utilization, the Advance EITC also suffers from compliance problems, documented in reports from the GAO and the Treasury Department.[15] The GAO provides recommendations for administrative changes to address the compliance issues but also raises concerns about their practicality and effectiveness. It concludes by suggesting that the Secretary of the Treasury evaluate the options and advise Congress on whether the advance payment option should be retained. President Obama's FY 2010 budget proposal to eliminate the Advance EITC indicates the judgment of the new administration.

Design Framework for A New EITC Periodic Payment Option

The current Advance EITC is ineffective, yet exclusive reliance on lump-sum payments is also unwise. The following are suggested design principles (also summarized in Table 7.2) to guide consideration of a viable alternative system for periodic payment of the EITC (and possibly other current and prospective tax-based income supports).

Make payments directly, not through employers

In theory, employers are good intermediaries: they already have a periodic payment relationship with their employees, and they have more frequent contact with the IRS through regular deposit of payroll taxes and withholdings and quarterly report filings. Nonetheless, employers will not play a meaningful role in periodic payment. An employer has little of the information needed to assess worker eligibility and make accurate payment calculations.[16] Workers appear to have little appetite for interacting with their employers in this way. There is also nothing in the international experience to indicate greater potential for employer involvement.[17]

Use the IRS to administer periodic payments

Although the IRS has less of an explicit social welfare function than tax agencies in other countries, it remains the best choice for making periodic payments. Governmental entities administering other public benefits are not well-suited to taking a lead role in making periodic payments, especially as most EITC recipients are not now clients of social welfare agencies.[18] The EITC is tied to work, which is not the focal criterion for other benefits programs. The enforcement-centered approach of traditional benefits programs runs counter to the self-determinative, voluntary compliance character of the tax system and would unreasonably differentiate EITC recipients.[19]

Adopt a modest "safe harbor" to protect taxpayers from repayment risk

The current EITC advance payment option has both prospective and retrospective elements: a prediction for advance payment eligibility based on current income (similar to payroll withholding), and a year-end calculation of the actual credit due.

In some situations, such as a temporarily unemployed worker returning to a well-paying job, requiring repayment of excess periodic payments may make sense. More problematic are overpayments that result from the inability to project accurately the EITC for which a taxpayer is ultimately eligible. Income may fluctuate in unanticipated ways over the course of a year, and family composition can change unexpectedly.

A safe harbor limits liability by providing a method for a taxpayer to demonstrate presumptively that she is acting in good faith. A worker requesting and receiving EITC periodic payments in good faith should be protected against incurring a repayment liability. The safe harbor could be a combination of having properly claimed the EITC in the prior year and a reasonable expectation of eligibility in the current year.

Accept some degree of target inefficiency

Inherent in the safe harbor concept is recognition that some workers will receive payments for which they were not eligible. This will decrease the EITC's target efficiency, or the proportion of total payments that are received by the program's target population. The design challenge is to keep the inefficiency within reasonable bounds.

If prior year eligibility for the EITC is used to establish eligibility for current-year periodic payment claims, target efficiency will depend in part on how likely recipients are to claim the credit in successive years. One IRS analysis found that just over 70 percent of tax year 2000 EITC claimants also claimed the credit in tax year 2001.[20] Yet an IRS study looking at six consecutive tax years found that about one-quarter of EITC claimants over that period received the credit in only one year.

The tolerance for target inefficiency is also a policy decision that may vary depending on the reason for ineligibility. Two studies of the EITC population found that fluctuations in eligibility and participation were more closely tied to variations in income, rather than changes in family composition.[21]

The Advance Child Tax Credit was used as an economic stimulus in 2003 and set a precedent for tolerating overpayments in favor of administrative simplicity. Eligibility was based on prior-year eligibility but also required applying the advanced credit against the subsequent year's credit. However, recipients who received an advance in excess of their subsequent year credit did not incur a repayment obligation.

Use communication and reporting to improve targeting and efficiency

There is currently no means for a taxpayer to indicate directly to the IRS that she expects to be eligible for the EITC in the current tax year. She can only make a claim after the fact through the income tax return filed in the next calendar year.

Schedule EIC (part of the Form 1040 which the taxpayer completes in order to claim the credit for qualifying children) could include a section permitting the claimant to declare that she expects to be eligible again for the credit in the coming year. The declaration would be signed under penalty of perjury. New claimants with qualifying children could submit a similar signed declaration of expected eligibility as a stand-alone document.

Creating additional, less traditional opportunities for information transfer from taxpayers to the IRS—via postcard, telephone, or online transaction—could further improve the efficiency of a periodic payment system.

Limit the portion of the EITC that can be obtained through periodic payment

Although the rationale for providing families with benefits as quickly as possible could justify accelerating the full amount of the credit, it is preferable to follow the current advance payment practice of limiting the periodically-paid percentage. This approach provides a cushion that reduces repayment risk for recipients and serves as a curb on inefficiencies resulting from the safe harbor approach. It preserves the ability to use the EITC (along with overwithholding) as a means of accumulation, and it minimizes complications related to the transition from lump sum to periodic payment. Initially, for reasons of both simplicity and transition, setting a single default (for example, 50 percent of the anticipated total credit) is probably wise.

Balance liquidity with accumulation, connection to work with administrative feasibility, in determining payment frequency

A focus on helping households with everyday needs and reinforcing the earned quality of the EITC would argue for weekly or biweekly disbursement (as occurs in other countries). However, this would ignore the demonstrated desire for some degree of forced savings; furthermore, increased frequency of payments inevitably increases administrative costs.

Most of those who interact with the IRS more than once a year do so roughly every quarter.[22] Quarterly periodic EITC payments would enable some accumulation while providing a regular source of funds. Once the program is established and well-tested, a monthly frequency option could be explored as well.

Mandate use of direct deposit

Direct deposit to financial institution accounts is most often the only payment vehicle available for in-work tax benefits in other countries. Private employers and the public sector in the U.S. are trying to move away from paper checks, and a new periodic payment system should reinforce that orientation.

A periodic payment system would have to address the challenge of delivering payments to "unbanked" households, perhaps by offering institutional incentives for opening accounts and new product lines.[23] The expansion in transaction volume that would result from greater use of periodic payments could advance those efforts. Accounts could be established for any recipient not providing deposit account information on the tax return or perhaps on the Schedule EIC or separate declaration of eligibility.[24] The Direct Express Card (debit card) offered to Social Security beneficiaries is another delivery model.

Make periodic payments an "opt-in" for initial implementation

There is increasing recognition of the value of automatic enrollment with an opt-out opportunity, as opposed to programs that require voluntary opt-in for enrollment. The Pension Protection Act of 2006 permits employers to use automatic enrollment with 401(k) and 403(b) plans. Workers have the right to withdraw from the plan, but the expectation is that automatic enrollment will increase retirement savings among those who

Encouraging Direct Deposit

Direct deposit offers a number of advantages, such as safety and convenience, yet many people who receive Social Security and Supplemental Security Income (SSI) still get checks. Go Direct is a national campaign, sponsored by the U.S. Department of the Treasury and the Federal Reserve Banks, aimed at increasing awareness of these benefits and helping people sign up for direct deposit of federal payments. An estimated 140 million federal benefit checks are mailed each year; Treasury estimates that if these payments were converted to direct deposit, taxpayers could save about $130 million annually.

But what if recipients don't have a bank account? The Direct Express® Debit MasterCard® card offers an innovative solution. This prepaid debit card allows recipients to receive their benefits and make purchases electronically, with no risk of lost checks or stolen cash. Recipients do not need a bank account to sign up for the card, and there is no credit check or minimum balance requirement. In addition, there is no sign up fee and no monthly fee. Most services are free; there are fees for a limited number of optional transactions and services. Payments are made every month and are automatically posted to the Direct Express® card account, allowing users to withdraw cash from ATMs, make purchases at stores that accept Debit MasterCard® or even pay bills online. Currently, the Direct Express card may only be used for Social Security and SSI payments. For more information, visit www.GoDirect.org and www.USDirectExpress.com.

may wish to save but would have otherwise failed to take action to opt into the plan.

In this context, automatic enrollment would reflect a value judgment that periodic payment of the EITC is the preferred method from both the recipient's and society's perspectives. This proposition is yet untested. At the outset, policy makers should aim to offer recipients two equally reasonable and viable choices.

Given the history of the advance payment option, the "opt-in" approach requiring taxpayer initiation would likely lead to low initial take-up. However, this would actually be advantageous as periodic payment mechanisms are tested and improved.

Consider implementing periodic payment in conjunction with program expansions

Any attempt to shift from large lump-sum refunds to periodic payments requires attention to transition. The approximate current levels of EITC benefits have been in place for over a decade, and households have undoubtedly incorporated the payment pattern into their budgeting and cash management. Some sectors of the economy are likely accustomed to the seasonal flows as well.[25]

ARRA makes temporary enhancements to the EITC and the Child Tax Credit which the administration and Congress will likely seek to make permanent. Expansion of either program would provide an opportunity to phase in a new periodic payment system for those credits over two to three years.

Conclusion

In its lump-sum form, the EITC meets a desire for large tax refunds seen throughout the population. Nevertheless, there are strong reasons for developing a viable alternative, with none more significant than accelerating payment of earned benefits to cash-strapped families. The flaws evident from experience with the existing Advance EITC recommend a new approach. The principles enumerated in this article provide a framework for developing a detailed design of a periodic payment system. Although no single approach is perfect, realizing the full potential of the EITC requires greater attention to the mechanics of how payments are made. CI

Table 7.2 **Elements of a Periodic Payment System**

This table summarizes potential elements of an alternative periodic payment method for the EITC using the design framework outlined in the paper.

Administrative responsibility	• Internal Revenue Service • No employer role
Eligibility	• Prior year EITC receipt plus declaration on Schedule EIC of expected continued eligibility • Detailed declaration of expected eligibility from new claimants
Recipient choice	• "Opt-in" during initial implementation period • Goal of presumptive ("opt-out") participation
Payment method	• Direct deposit to financial institution accounts • Debit cards or special accounts for unbanked recipients
Frequency of payments	• Probably quarterly (at least initially)
Size of payments	• Initial default of 50 percent of anticipated total credit (equally spread over periodic payments)
Periodic reporting	• Development of mail, phone, or online methods for periodic verification of eligibility
Error reconciliation	• "Safe harbor" (no repayment obligation) for payments based on valid declarations of eligibility • Conventional enforcement and recovery of improper payments

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Beyond Lump Sum

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