PERIODIC PAYMENT OF THE EARNED INCOME TAX CREDIT

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I. INTRODUCTION

There has been a shift over the last two decades in public policies designed to provide income support to impoverished households. A focus on encouraging and supporting work has guided this shift, and the tax system has become as important as the welfare office. Emblematic is the nation's largest anti-poverty program: the Earned Income Tax Credit (EITC).

The EITC supplements earnings and is targeted at households with children. In 2008, a person with two or more children at home who works full-time for $6.00 to $7.50 an hour qualifies for the maximum benefit of $4,824 from the federal government. If she resides in one of the several states or localities with its own version of the EITC, she might qualify for even more. Many workers able to claim a large EITC can also receive additional support through other tax code features such as the federal Child Tax Credit (CTC).

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. The worker with two children eligible for the largest EITC has no federal income tax liability and but can nonetheless receive the full credit. At higher earnings, the EITC can offset both income and payroll taxes and provide an additional benefit.

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 monthly payment. There is a reasonably close association in time between financial need and receipt of funds to meet that need. In contrast, almost all EITC households receive no benefit until a few months after the end of the year for which they qualify. Very few utilize the advance payment option to receive a portion of the credit with each paycheck.

This research paper considers the problems with almost exclusive reliance on year-end ("lump sum") payment, and the value of providing a viable periodic payment method. After reviewing the currently available advance payment option, its low utilization, and evidence of its limited potential, the paper suggests a design framework for an alternative system that would provide eligible workers and families with a portion of their EITC throughout the year.

II. THE NEED FOR A VIABLE PERIODIC PAYMENT ALTERNATIVE

The battle between EITC lump-sum and periodic payment methods, it could be argued, has been fully fought and single year-end payments have won convincingly. As described in the next section, the advance payment option has been available since 1979 and has been the subject of several efforts to promote and enhance it. Yet its use remains extremely low. There appears to be an overwhelming desire for large (and larger) refunds. This experience is significant and cannot be ignored.

Nonetheless, a transfer payment system that effectively *obligates* low-income working households to wait months to receive basic assistance they have earned cannot be sensible social policy. In 2008, refundable tax credits can comprise as much as 43 percent of annual income for the households benefiting most from the EITC.[1] Potential program expansions—such as expanding the credit for workers without a qualifying child and the credit for persons with three or more qualifying children or increasing the refundability of the CTC—would exacerbate this.[2]

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

1. Recipients use the proceeds of the EITC to meet consumption needs

Liquidity & Consumption Needs

EITC recipients may not care for the advance payment option and may delay receipt until after the end of the year, but many then pay for a refund anticipation loan (RAL) to receive the lump sum as quickly as possible.[3] RALs may be a bad economic

[1] This reflects the total of the EITC and refundable CTC divided by earnings net of the employee's share of Social Security and Medicare taxes.

[2] For a guide to these options as well as estimated effects on metro areas, states, and the nation, see Alan Berube, David Park, and Elizabeth Kneebone, "Metro Raise: Expanding the EITC to Help Metropolitan Workers and Families" (Washington: Brookings Institution, 2008). The Tax Policy Center has modeled different options for modifying CTC refundability; "Child Tax Credit Refundability Options: Number of Filers Claiming the Credit." Table T06-0004 (Washington: Urban Institution, 2006). H.R. 3970 lowers the earnings threshold to qualify for CTC refundability. If the EITC for families with three or more qualifying children were phased in at a 50 percent rate and the CTC were made refundable at a 20 percent rate for earnings above $8,000, a single parent with three children earning $12,500 would have a total credit of $6,795 (equal to 57 percent of earnings) and one earning $15,000 would have a total credit of $7,295 (49 percent of earnings).

[3] The SPEC Database indicates that 12 percent of low-income taxpayers but 31 percent of EITC recipients utilized a RAL for tax year 2004. A study of Detroit area low- and moderate-income taxpayers found that 30 percent of taxpayers receiving a refund used a RAL. Barr and Dokko (2006). The rate of RAL use among EITC recipients has been declining since tax year 2001. Alan Berube and Tracy Kornblatt. 2005. "Step in the Right Direction: Recent Declines in Refund Loan Usage Among Low-Income Taxpayers." Washington: The Brookings Institution. There appears to have been a dramatic drop in the number of traditional RALs overall in tax year 2005 but a large increase in other products providing quick access to cash (such as paystub or holiday RALs). Chi Chi Wu and Jean Ann Fox. 2007.

choice, but they reflect constrained household liquidity.[4] This is evidence of latent demand for some ability to accelerate payments.

Available data indicate the EITC is mostly used to finance consumption.[5] In many cases, it goes for everyday bills. This should not be surprising. The focal point of the credit's design is bridging the gap between what can be earned in low-wage work and what it takes to support a family. A single-headed household of three receiving the maximum EITC has earnings equal to 69 percent to 90 percent of the federal government's low-end estimate of what it takes to support a family (the official poverty level). The credit fills in and makes it possible to finance basic necessities. The largest refunds are, in a sense, already spoken for.

EITC-eligible households at or above the poverty level qualify for smaller yet often still sizeable refunds. These families may rely somewhat less on the EITC to finance everyday expenses, and may thus use it for durable items such as appliances, furniture, car repair, or a used car.[6] The need for these items is unlikely to be limited to tax season, so the timing of their purchase is more likely to reflect liquidity constraints.

One argument offered in support of large refunds is the opportunity they present for asset accumulation. This envisions lump sum payments being used more for investment purposes—education, home purchase, retirement—than current consumption. Although an admirable goal, evidence suggests it is not a truly realistic reflection of how low-income claimants use the majority of their refund dollars.

"One Step Forward, One Step Back: Progress Seen in Efforts Against High-Priced Refund Anticipation Loans, but Even More Abusive Products Introduced." Boston: National Consumer Law Center.

[4] One calculation is that the annual percentage rate for a RAL during the 2007 filing season ranged from 40 percent to 300 percent. Wu and Fox, "One Step Forward, One Step Back." Urgency is a key factor in utilization of RALs, with a very high percentage of RAL borrowers wanting the cash to pay off bills or other debts faster. Gregory Elliehausen. 2005. "Consumer Use of Tax Refund Anticipation Loans." Credit Research Center Monograph #37. Washington: Georgetown University McDonough School of Business. Another important consideration is the use of a RAL to pay for tax return preparation and filing. Michael S. Barr and Jane K. Dokko, "Tax Filing Experiences and Withholding Preferences of Low- and Moderate-Income Households: Preliminary Evidence from a New Survey" (Internal Revenue Service, 2006).

[5] Several studies examine the disposition of tax refunds, a major component of which is the EITC. Barr and Dokko, "Tax Filing Experiences and Withholding Preferences of Low- and Moderate-Income Households." Jon Spader, Janneke Ratcliffe, and Michael A. Stegman, "Transforming Tax Refunds into Assets" (Chapel Hill, NC: Center for Community Capitalism, 2005). Ryan D. Edwards, "Macroeconomic Implications for the Earned Income Tax Credit." *National Tax Journal* 57 (2004): 45–65. Sondra G. Beverly, Jennifer L. Romich, and Jennifer Tescher, "Linking Tax Refunds and Low-Cost Bank Accounts." *Social Development Issues* 25(2)(2003): 235–246.

[6] Low-income households often associate tax time with a significant purchase. Jennifer L. Romich and Thomas Weisner, "How Families Use and View the EITC: Advance Payment versus Lump Sum Delivery." *National Tax Journal* 53(4, part 2)(2000): 1245–1265. There is economic evidence of EITC-influenced purchasing of durable goods. Andrew Goodman-Bacon and Leslie McGranahan, "How do EITC recipients spend their refunds?" *Federal Reserve Bank of Chicago Economic Perspectives* 2Q (2008): 17–32.

<u>Transaction Costs</u>

As the EITC has grown, so has commercial tax return preparation in low-income communities. A significant portion of the dollars intended to assist households in need has instead flowed to intermediaries. Much of this outflow relates to a product—the RAL—developed to accelerate filers' receipt of their money.[7]

To some extent, the growth in commercial preparation is due to more people having a reason to file a tax return.[8] Filers may also want help negotiating the credit's complex rules. But large lump sum refunds themselves play a large role in this phenomenon. The costs of return preparation, filing, and the RAL can be paid from the refund. Few people know in advance what their refund will be, so the deduction of those fees is not particularly noticeable. Larger refunds generally result in larger fees, but the net payment remains large as well. Credit recipients in a less distorted market might be more inclined toward other return preparation and refund processing choices, thus reducing their transaction costs.

2. Society would derive value from periodic EITC payments

<u>Inhibiting Error and Fraud</u>

Error and fraud associated with the EITC are 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. The larger the available single-payment payoff, the greater the potential allure.[9]

<u>Enhancing the EITC as a Work Incentive</u>

The EITC—in both intention and effect—makes work pay, but the almost exclusive reliance on year-end payments attenuates the connection.[10] In theory, the current advance payment option's augmentation of each paycheck provides the ideal link between work and the credit. The method is unfortunately ineffective otherwise. More viable periodic payment options could also reinforce the work incentive element.

The obscuring of the EITC's "make work pay" rationale could undermine its majoritarian support. The maximum EITC of $4,824 is comparable to average yearly

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[7] Alan Berube and others, "The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC" (Washington: Brookings Institution, 2002).

[8] However, most EITC filers would be filing a tax return anyway. Janet Holtzblatt and Janet McCubbin, "Issues Affecting Low-Income Filers." In Henry Aaron and Joel Slemrod, eds., *The Crisis in Tax Administration* (Washington: Brookings Institution Press, 2004).

[9] Robert Greenstein, "What is the Magnitude of EITC Overpayments?" (Washington: Center on Budget and Policy Priorities, 2003).

[10] Stephen D. Holt, "The Earned Income Tax Credit at Age 30: What We Know" (Washington: Brookings Institution, 2006).

cash assistance paid through the Temporary Assistance for Needy Families program, though the former is fully tied to work.[11] However, 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.

Robustness as Policy Tool

Having the EITC available primarily through year-end refunds limits its effectiveness as a policy instrument. As our largest anti-poverty program, it represents a large infusion of federal (and, increasingly, state) dollars into both the national economy and local markets.[12] The resulting boost in purchasing power helps families pay off bills and perhaps finance some larger household items. This power could be harnessed toward other policy goals as well. For example, the EITC could be seen as a means of increasing housing affordability, but would require an alternative to year-end receipt to be effective. Periodic payments could also help more low-income households make premium payments and obtain health insurance coverage.[13]

Progress on accelerated payment of the EITC could enhance other tax-based policy initiatives. The Child and Dependent Care Credit and credits for higher education have limited utility for lower-income households not only because they are non-refundable, but also because the cash outlays required cannot be offset until the following tax season. Recent arguments for the efficiency of refundable tax credits may lead to additional use of this policy tool, and a viable periodic payment mechanism could be key to their effectiveness.[14]

3. Most other countries use and promote periodic payment

Periodic payment is the predominant method used in several other countries to disburse earnings supplements and child benefits that are analogous to the EITC. The table in Appendix A summarizes key program elements in other English-speaking industrialized democracies. Although each country's programs are distinctive and not directly applicable to the U.S. context in all aspects, what is instructive is the general

[11] The average monthly assistance paid per family in 2004 was $397.41 per month, or $4,769 a year. Based on historical rates of growth, the comparable figure for 2008 could be a few dollars higher per month. *Annual Statistical Supplement, 2005: Other Social Insurance, Veterans' Benefits, and Public Assistance*, U.S. Department of Health and Social Services.

[12] Alan Berube, "Rewarding Work Through the Tax Code: The Power and Potential of the Earned Income Tax Credit in 27 Cities and Rural Areas" (Washington: Brookings Institution, 2003).

[13] The Trade Adjustment Assistance Reform Act of 2002 created the Health Coverage Tax Credit (HCTC) for displaced workers, and features a monthly payment option. Although helpful, the program still requires workers to pay full premiums prior to initiating HCTC payments, and this has limited program participation. Stan Dorn, "Health Coverage Tax Credits: A Small Program Offering Large Policy Lessons" (Washington: Urban Institute, 2008).

[14] Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits." *Stanford Law Review 59* No. 23 (2006).

recognition of the merits of periodic payment and the operation of viable systems for providing it.

III. HISTORY AND STRUCTURE OF THE EITC ADVANCE PAYMENT OPTION

Federal policy has long recognized the merits of accelerated payment of the EITC by making available an advance payment option.

1. Advance payment of the EITC has existed for nearly 30 years

The Revenue Act of 1978 made advance payment of the EITC available beginning in 1979. The basic features created then and detailed in the following section—employee self-certification, mandatory employer payments each pay period financed from payroll taxes and withholdings, and year-end reconciliation through the individual tax return—remain today. Although the full amount of the EITC could be obtained in advance, the maximum credit at that time was $500.[15] The credit subsequently increased in several increments, and the maximum was $953 in 1990. This was equal to a weekly increment of $18.

The Omnibus Budget Reconciliation Act of 1990 increased the EITC further and added a larger credit for households with more than one qualifying child (as well as two smaller, supplemental credits). However, the maximum that could be received in advance was capped at the one-child basic credit amount. In 1993, this equaled as much as $28 for a worker paid weekly.

The Omnibus Budget Reconciliation Act of 1993 gave the advance payment option its current structure. The 1993 Act increased the one-child credit amount and widened the differential between that amount and the credit available to households with two or more qualifying children, but it capped the maximum amount available through advance to 60 percent of the one-child credit.[16] This decreased the maximum weekly pay period advance to $24 in 1994. Annual indexing of the EITC for inflation has increased the maximum weekly advance to $34 in 2008.

2. The Advance EITC relies heavily on employers to effect periodic payments

Enrollment

Most workers who expect to be eligible to claim the EITC for a qualifying child for the current year may elect to receive advance payments.[17] The worker initiates the

[15] All figures in this section are in nominal dollars.

[16] The 1993 Act also created the smaller EITC credit for very low-income workers without a qualifying child, but this credit is not available through advance payment.

[17] Treasury Regulation 31.3507-1(a)(1) disallows an advance payment election by workers not subject to either income tax withholding or employee FICA taxes and by agricultural workers paid on a daily basis.

process by completing IRS Form W-5 and giving it to her employer.[18] The W-5 is short and simple. After filling in her name and Social Security Number, the worker checks a box for each of three lines: 1) certifying her expected eligibility for the EITC, that she does not have another Form W-5 currently in effect, and that she wishes to receive advance payments; 2) her expected filing status; and 3) if married, whether her spouse has a current Form W-5 in effect. The form must be signed under penalty of perjury.

A Form W-5 may be completed at any time during the year. It is effective for the current year only, so the advance payment election must be renewed annually. If a person is working for more than one employer at the same time, she can elect advance payment at only one of the jobs. If an employee wishes to stop advance payment (because of a change in expectations of eligibility or simply to reverse the election), she must file a new W-5 and check the "No" box on the first line. She must also complete a revised W-5 if she is married and her spouse decides to file a W-5 with his employer.

Giving a completed Form W-5 to an employer completes enrollment, effective with the first payroll period ending on or after that date. The employer has no role in verifying eligibility, and there is no communication with the IRS.[19]

Payment Calculation

The amount of each EITC advance payment is determined using tables published annually in Circular E, the Employer's Tax Guide, that are similar to those for calculating income tax withholding. There are separate tables for each length of pay period (weekly, biweekly, semi-monthly, etc.) Each table has three sections corresponding to information provided on the Form W-5: single or head of household, married without the spouse filing a W-5, and married with both spouses filing W-5s.

The employer looks up the current period gross wages in the appropriate table and section and adds the indicated amount to the employee's net pay. The payment amount equals 60 percent of the credit for one qualifying child that could be claimed if the current period's wages were received for the full year. Amounts are rounded to the nearest dollar. The section for a married worker with both spouses filing a W-5 calculates the advance payment at half of the amount otherwise payable.[20]

Payments, Reporting, & Reconciliation

[18] An employer may establish a system to receive Forms W-5 electronically (IRS Circular E).

[19] Circular E does indicate that an employer should consider a Form W-5 invalid if the employee has made an oral or written statement that clearly shows the form to be false. It also advises that an employer should contact the IRS if there is reason to believe that a completed W-5 contains an incorrect statement.

[20] The separate section for married without spouse filing a W-5 is necessitated by the extended phase-out of the EITC for married filers as compared to single and head-of-household filers.

An employer must make an advance EITC payment to any employee who has a Form W-5 in effect for the current year.[21] The employer finances advance EITC payments by deducting them from its payment to the IRS of withheld income tax and employee and employer Social Security and Medicare taxes. If the employer's advance EITC for the pay period exceeds the period's total payroll taxes, the employer may choose to make a proportionate reduction in each participating worker's advance.

Employer filings with the IRS (such as Form 941, the Employer's Quarterly Federal Tax Return) must include the sum of advance EITC payments made for the period. The employer must report each employee's total EITC advance payments for the year on Form W-2.

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.

IV. Problems with the Current Advance EITC

Regrettably, the existing EITC advance payment option is not a viable policy tool. The vast majority of intended beneficiaries do not use it, and there is little evidence that utilization can be increased using the current design. Moreover, there appear to be significant compliance issues associated with the option.

1. Very few EITC recipients utilize the advance payment option

Utilization estimates typically rely on data from individual income tax returns. The General Accounting Office (GAO, now Government Accountability Office) stated in 1992 that fewer than 1 in 200 EITC recipients used the advance payment option in tax year 1989.[22] In tax year 1994, there was an increase in the number of returns indicating an advance from 57,000 to 203,000. This and another increase in return-reported advances in tax year 1997 may have reflected intensive outreach efforts mandated by Congress in 1993.[23] However, neither increase raised the utilization rate above 2 percent.

Return statistics show a general decline in recent years in the number and proportion of returns with advance EITC and in the dollars paid that way. In tax year

[21] Enforcement is limited, because Treasury Regulation 31.3507-1(c)(4) provides that the IRS will not pursue a failure to make an advance payment unless the employer has not withheld and deposited income and payroll taxes.

[22] General Accounting Office, "Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public." GAO/GGD-92-26 (1992).

[23] Internal Revenue Service, "Advance Earned Income Tax Credit: 1994 and 1997 Notice Study, A Report to Congress" (1999).

1997, 1.5 percent of eligible EITC returns reported an advance.[24] 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.[25]

The GAO recently released a report looking at advances reported by employers on the year-end wage and employment tax statement (Form W-2).[26] This methodology found a significantly higher, yet still low, utilization rate of 3 percent for tax years 2002 through 2004.[27] Total dollars claimed were 0.40 percent of total EITC claimed by the advance-eligible population. The individual amounts received were also small. The total EITC advanced in tax year 2004 was less than $100 for 48 percent of reported recipients, and over 86 percent received less than half of the maximum claimable amount.[28]

No matter how it is measured, the advance payment option is clearly not a significant feature of EITC administration.

2. There are several reasons why Advance EITC utilization remains low

The 1992 GAO report identified three principal reasons for low utilization of the EITC advance payment option: 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.[29]

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[24] "Eligible EITC Returns" excludes returns claiming the EITC with no qualifying children, because that credit cannot be paid in advance.

[25] Author's calculations from IRS Statistics of Income Table A—Individual Income Tax Returns, Selected Income and Tax Items for Selected Years, 1996-2000 and 2000-2004, and Table 2.5 –Individual Income Tax Returns, Returns with Earned Income Credit, by Size of Adjusted Gross Income, Tax Years 1996 through 2004. In constant (1990) dollars, total return-reported advance payments declined from $76.5 million in tax year 1996 to $43.2 million in tax year 2004.

[26] Government Accountability Office, "Advance Earned Income Tax Credit: Low Use and Small Dollars Paid Impede IRS's Efforts to Reduce High Noncompliance." GAO-01-1110 (2007).

[27] The GAO looked at EITC advance payments reported by employers on W-2 forms. Because many taxpayers (as the GAO found) do not report these payments on their tax returns, the prior studies based only on tax return data underestimated utilization.

[28] Both sources of advance payment data may even overstate the amount of advances received. The 1992 GAO study noted that 58 percent of a sample of tax year 1989 W-2s had erroneous advance payment entries that were in most cases a misplaced entry of withheld Social Security taxes. A Treasury study of tax years 2001 and 2002 found a number of advance payment errors in tax return records traceable to incorrect entries by taxpayers and incorrect transcriptions by IRS staff. Treasury Inspector General for Tax Administration, "Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received." Ref. No. 2003-40-126 (2003).

[29] Other possible factors include employer unwillingness to participate and employee fears of stigmatization or wage depression if an employer is aware of EITC eligibility. Timothy M. Smeeding, Katherin Ross Phillips, and Michael A. O'Connor, "The Earned Income Tax Credit: Expectation, Knowledge, Use, and Economic and Social Mobility." In Bruce Meyer and Douglas Holtz-Eakin, eds.,

Lack of Awareness

The GAO in 1992 found low familiarity with both the EITC and the advance payment option among workers and employers, and limited outreach by the IRS to increase awareness of the option.[30] Congress in 1993 required the IRS to notify taxpayers with qualifying children who received a refund because of the EITC that the credit could be available through advances in their paychecks.[31] The Treasury Department initiated new outreach in 1994 and conducted a controlled experimental test of outreach effectiveness in 1997.[32] The IRS continues to make available promotional materials directed toward both workers and employers.[33]

The decline in advance payment utilization since 1997 coincides with diminished outreach efforts, and awareness is probably not widespread.[34] Even so, awareness is likely significantly higher than utilization. Simply put, most of those who *are* aware of the option do not choose to use it.

The limited gains achievable from increased awareness may be seen in two tests. The 1997 IRS experiment found an increase in advance payment use from 0.51 percent of the control group (who do not receive a notice publication including Form W-5) to 1.27 percent of the test group.[35] A 2006 experiment using varied methods of information dissemination and enrollment facilitation 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.[36]

Making Work Pay: The Earned Income Credit and Its Impact on America's Families (New York: Russell Sage Foundation, 2001).

[30] General Accounting Office, "Earned Income Tax Credit." Interviews with a small sample of low-income working women in 1993 similarly found little familiarity with the advance payment option. Lynn M. Olson with Audrey Davis, "The Earned Income Tax Credit: Views from the Street Level" (Evanston, IL: Northwestern University Center for Urban Affairs and Policy Research, 1994).

[31] House Conference Report No. 213, 103 Cong. 1 sess. (reprinted in *1993 U.S. Code Cong. & Ad. News* (No. 7A)).

[32] Janet Holtzblatt, Janet McCubbin, and Robert Gillette, "Promoting Work Through the EITC." *National Tax Journal* 47(1994): 591–608. Internal Revenue Service, "Advance Earned Income Tax Credit."

[33] For example, see IRS Publication 1844, "How Advance EITC Can Add to Employees' Take-Home Pay Year-Round."

[34] A 2005 survey at a community tax return preparation program found fewer than one-third of respondents were aware of the advance payment option. Arthur-Damon Jones, "Why is AEITC Take-Up So Low? Evidence from a survey of EITC recipients" (working paper, 2007). Romich and Weisner ("How Families View and Use the EITC") observe, "People do not know about the advance payment option because it is not useful knowledge."

[35] Internal Revenue Service, "Advance Earned Income Tax Credit."

[36] Arthur-Damon Jones, "Information, Preferences and Social Benefit Participation: Experimental Evidence from the Advance Earned Income Tax Credit" (working paper, 2007).

Fear of Overpayment

A pay period's earnings from a single employer—the basis for calculating each advance—are unlikely to be an accurate predictor of a household's annual EITC. At the time of the first GAO study, the payment tables used by employers were based on 100 percent of the annual credit amount, meaning there was no built-in allowance for error.[37] Fluctuating earnings, multiple employers, or a working spouse created particular risks of overpayment that could have resulted in a repayment liability to the IRS.[38]

The Conference Committee for the Omnibus Budget Reconciliation Act of 1993 added the cap on advance payments (at 60 percent of the EITC for one qualifying child) to reduce the risk of year-end tax liabilities.[39] This mitigated the problems inherent in the different calculation bases for advances and the full EITC.[40] Nonetheless, persons working more than one job at the same time receive distorted advances, and married couples with both spouses working need to be very cautious.[41]

With the built-in safeguard of the 60 percent cap (calculated at the lower one-child rate), most EITC recipients probably could safely receive advance payments and not risk a repayment liability. For example, at an annual income of $10,000, the capped advance is equivalent to just 43 percent of the total credit available to a single parent with two or more qualifying children. At an income of $15,000, it is 36 percent, and the percentage declines further at higher incomes. As a device to help recipients avoid overpayments, the cap is quite conservative. Despite that, EITC recipients appear to demonstrate a great aversion to *any* risk of owing money back at the end of the year.[42]

General Preference for a Lump Sum

While almost all EITC recipients (96 percent) claim a tax refund, Americans as a whole like to receive year-end lump sums. Nearly 76 percent of returns not receiving the EITC claimed a refund for tax year 2004.[43] These filers engineer refunds principally

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[37] For tax years 1991 through 1993, those eligible for the higher EITC for two or more qualifying children would have received 100 percent of the one-child credit, but the difference (no more than $77 in 1993) was small.

[38] Stephen D. Holt, "Improvement of the Advance Payment Option of the Earned Income Credit." *Tax Notes* 1583–1588 (1992).

[39] House Conference Report No. 213.

[40] Stephen D. Holt, "Effect of 1993 Budget Act on the Advance Payment Option of the Earned Income Credit." *Tax Notes* 759–763 (1994).

[41] "The 2008 Tax Credit Outreach Campaign: What You Need to Know" (Washington: Center on Budget and Policy Priorities, 2007).

[42] This contrasts with the Australian experience where demand for periodic payments remained high even as one-third of recipients faced repayment obligations (largely due to underestimating of annual income). Valerie Braithwaite and others, "Family Tax Benefit and Cash Economy Activity" (Canberra: Australian National University, 2005).

[43] Author's calculations from the IRS Stakeholder Partnerships, Education and Communication Return Information Database (SPEC Database), which encompasses 128,599,631 returns for Tax Year 2004

through overwithholding (having more taxes withheld from each paycheck than is necessary to meet the annual tax liability).[44] Having less money during the year (permitting the federal government to use it interest-fee) and receiving a lump sum payment later is firmly entrenched in American culture.[45]

Overwithholding occurs among EITC recipients as well. In 2004, a total of $62.0 billion in refunds were claimed on EITC returns.[46] However, the total EITC and Child Tax Credit received was only $52.7 billion.[47] Recipients' refunds included excess withholdings from payroll deductions.

There are many reasons why EITC recipients (as well as others) may reasonably prefer receiving lump sum refunds. As noted above, workers are cautious about overpayment (or underwithholding) and fear having to find cash to pay a net liability at tax time. Even among the less risk averse, there are transaction costs in trying to calibrate the right mix of money now versus money later.[48] Intentional refund generation may be seen as using the IRS to provide a *de facto* savings account that enforces temporary fiscal discipline. An anticipated tax refund can also be a mental accounting device allocating household resources to distinctive uses.[49]

3. Compliance issues plague the Advance EITC

There appear to be significant breakdowns along the prescribed advance payment path: eligible employees file W-5s; employers add advances to each paycheck; employers report total advances on W-2s; employees report the total on tax

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(compared to 132,226,042 total returns reported in IRS Statistics of Income data). Low-income filers not receiving the EITC claimed refunds at a similar rate to non-EITC filers overall (77.6 percent to 75.7 percent).

[44] General Accounting Office, "Earned Income Tax Credit."

[45] Taxpayers have responded to past reductions in withholding rates by increasing withholding to ensure continued receipt of refunds. J. Mark Iwry, "Using Tax Refunds to Increase Savings and Retirement Security" (Washington: The Retirement Security Project, 2005). The tendency to overwithhold does decline at higher income levels. Jannett Highfill, Douglas Thorson, and William V. Weber, "Tax overwithholding as a response to uncertainty." *Public Finance Review* 26 (4)(1998): 376–391.

[46] The average refund claimed by EITC recipients was $2,989. This compared to an average refund of $903 for non-EITC low-income filers and $2,317 among all non-EITC returns.

[47] All figures from SPEC Database.

[48] An estimate looking at tax year 1999 finds that a small fraction of low-income filers had household characteristics permitting simple and accurate computation of tax withholding or EITC advance payment using the methods in Form W-4 and W-5. Janet Holtzblatt and Janet McCubbin, "Issues Affecting Low-Income Filers."

[49] Many scholars have explored these various explanations, building on the work of behavioral economics and other disciplines. Donna D. Bobek, Richard C. Hatfield, and Kristin Wentzel, "An Investigation of Why Taxpayers Prefer Refunds: A Theory of Planned Behavior Approach." *Journal of the American Taxation Association* 29 (2007): 93–111. Barr and Dokko, "Tax Filing Experiences and Withholding Preferences of Low- and Moderate-Income Households." *The IRS Research Bulletin*: *Recent Research on Tax Administration and Compliance*, Publication 1500, Internal Revenue Service. Romich and Weisner, "How Families View and Use the EITC."

returns; and the IRS makes correct matches and pursues discrepancies. The 1992 GAO study found that over half of W-2s had erroneous entries for advance EITC payments, that a large number of apparently valid W-2s did not have a corresponding tax return, and that many filed returns did not report the advances shown on the corresponding W-2s. The Treasury study of tax years 2001 and 2002 found various reporting and processing errors.[50]

The 2007 GAO study addressed compliance issues more directly. Its key findings, based on W-2s showing receipt of advance EITC payments, included:

- About 20 percent were for a Social Security Number that could not be validly matched to Social Security records

- Almost 40 percent did not have a corresponding tax return

- When there was a corresponding tax return, the majority did not report any advance, and only one-third reported the same amount as on the W-2s

The study also found that current IRS procedures are largely ineffective in addressing these issues.[51]

These findings could stem from many sources beyond the data entry problems already cited. Some workers may file W-5s even though they do not have a valid Social Security Number and are thus ineligible to receive the EITC. Some employers may report advances to fictitious Social Security Numbers as a way to reduce payments to the IRS. Name changes not reported to the Social Security Administration can result in a records mismatch reported as an invalid Social Security Number. Taxpayers who fail to file or fail to report advances when filing could be doing so intentionally or inadvertently.

The GAO provided recommendations for administrative changes to address the compliance issues but also raised concerns about their practicality and effectiveness. It concluded by suggesting that the Secretary of the Treasury evaluate the options and advise Congress on whether the advance payment option should be retained.[52]

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[50] Treasury Inspector General for Tax Administration, "Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received."

[51] Advance payment can also interfere with enforcement efforts by enabling partial evasion of refund intercepts used to collect tax debts, child support arrearages, defaulted students loans, etc. An advance received through a paycheck will not be intercepted. When the tax return is filed, the full EITC may be legitimately claimed and the advances reported, leaving only the balance of the EITC claim for capture.

[52] A pending Treasury report mandated by Congress in the U.S. Troop Readiness, Veteran's Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007 (Pub. L. No. 110-28) involves "a study of the benefits, costs, risks, and barriers to workers and to businesses (with a special emphasis on small businesses)" for providing the advance payment option to all EITC recipients.

V. DESIGN FRAMEWORK FOR A NEW EITC PERIODIC PAYMENT OPTION

The current advance payment option is ineffective, yet exclusive reliance on lump-sum payments is also unwise. The following are suggested design principles to guide consideration of a viable alternative system for periodic payment of the EITC (and possibly other current and prospective tax-based income supports). The table in Appendix B summarizes potential program elements using this framework.

1. There is no viable role for 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.[53] 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.[54]

2. The IRS is the appropriate administrative agency.

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. The positioning of the EITC in the tax system is a key feature of the program's appeal, as it lacks the stigma sometimes associated with traditional social welfare programs. The public cost of administration is quite low, with no case managers and primary reliance on self-determination of eligibility.

Governmental entities administering other public benefits are not well-suited to taking a lead role in making periodic payments. Most EITC recipients are not now clients of social welfare agencies.[55] The EITC is tied to work, which is not the focal criterion for other benefits programs.[56] The mistrustful, enforcement-centered approach of traditional benefits programs runs counter to the self-determinative, voluntary

[53] This could be changed with systemic changes in data exchange that do not appear practicable in the foreseeable future. For example, Holt considers the potential with a monthly electronic wage reporting system. "Improvement of the Advance Payment Option of the Earned Income Credit."

[54] The United Kingdom formerly paid the Working Tax Credit through employers, but this ended in favor of direct payments to household bank accounts in April 2006.

[55] At community tax sites participating in the National Tax Assistance for Working Families Campaign in 2007 that asked whether filers had received Food Stamps, Medicaid, SCHIP, TANF, subsidized child care, or subsidized housing during the tax year, 53 percent of EITC claimants indicated they had not (author's calculations for The Annie E. Casey Foundation).

[56] A possible exception is the Social Security Administration. Its social insurance function is tied to work and earnings. Nonetheless, it is commonly associated with providing social welfare benefits rather than encouraging and supplementing work.

compliance character of the tax system and would unreasonably differentiate EITC recipients.[57]

One explanation for the EITC's low administrative costs is that it shifts work to commercial tax preparers (and, to a lesser degree, community tax programs) that serve as intermediaries in delivering the EITC and other tax-based benefits. Based on the experience with tax filing, a direct IRS periodic payment option will likely create new market opportunities. Whether to make explicit (and better regulate) the role of these intermediaries, or to continue a relatively hands-off approach, is a further design choice.

To be sure, whatever role the IRS plays in administering a more effective periodic payment alternative would result in increased EITC administrative costs. A key task, then, is to identify how design features such as those suggested here could complement existing and contemplated IRS processes and systems to minimize additional outlays.[58]

3. "Safe harbor" principles can afford taxpayers protection from repayment risks.

In general, the American tax system is retrospective in its assessment of entitlements and obligations. Actual taxes due cannot be known until after the end of the year. For example, a baby born December 31 qualifies her parents for an income exemption for the full year. At the same time, the system generally requires payments during the year based on prospective calculations. The tax return filed early in the following year represents a settling of accounts between the taxpayer and the government.

The current EITC advance payment option has both elements: a prospective prediction of eligibility for advance payment users tied to current income (similar to payroll withholding), and a year-end retrospective calculation of the actual credit due. Most recipients are clearly unwilling to chance any prediction error and risk a repayment obligation.

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.[59]

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[57] Stephen D. Holt, "Keeping It In Context: Earned Income Tax Credit Compliance and Treatment of the Working Poor." *Connecticut Public Interest Law Journal* 6 (2007): 183–203.

[58] High administrative costs are a problem with the HCTC advance payment program, but these could be significantly reduced by increased program participation and adjustments in the payment mechanism. Dorn, "Health Coverage Tax Credits."

[59] For example, getting married during the course of a year could levy a large "marriage penalty" on low-income filers and result in advance EITC overpayments. See Berube, Park, and Kneebone, "Metro Raise."

Low-income households seldom have the financial cushion to accommodate a repayment debt.

A safe harbor limits liability by providing a method for a taxpayer to demonstrate presumptively that she is acting in good faith. The safe harbor of comparing current year withholdings and credits to prior year taxes determines who must pay estimated taxes. After Hurricane Katrina, the IRS established safe harbor methods for determining property values when making casualty loss claims.[60]

Similarly, 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.

4. Some degree of target inefficiency is inevitable but acceptable.

Inherent in the safe harbor concept is recognition that some workers will receive payments for which they will be found ineligible upon retrospective determination. 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.

A key question regards the percentage of recipients claiming 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.[61] The IRS EITC advance payment study found that nearly 83 percent of tax year 1996 EITC claimants were eligible for an advance in tax year 1997, meaning they claimed the EITC, reported wage income, and listed a qualifying child year of birth on Schedule EIC.[62]

Participation patterns are complicated, however. While most EITC recipients in any year have likely claimed the credit before, a significant number of households are in the claimant population for short periods of time. An IRS study looking at a six consecutive tax years found that about one-quarter of EITC claimants over that period received the credit in only one year. On the other hand, 41 to 46 percent of each year's EITC claimants in tax years 2001 through 2004 claimed the credit all four years. Up to half of each year's claimants were in neither the one-time nor the consistent category.[63]

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[60] Internal Revenue Service, Rev. Proc. 2006-32.

[61] Internal Revenue Service, *Earned Income Tax Credit (EITC) Program Effectiveness and Program Management FY 2002-FY 2003.*

[62] The study did not attempt to estimate the number of 1997 claimants who might have been ineligible for the credit.

[63] W&I Research, "EITC Trends Analysis" (Internal Revenue Service, 2006). The average credit claimed by one-time filers was just over one-third of the average among the consistent population, and the intermittent filers' average claim was about halfway in between.

The degree to which fluctuating eligibility affects target efficiency is an important empirical question meriting additional exploration. One additional factor to consider is how much recipients who are deemed ineligible retrospectively differ from the intended beneficiary population.[64]

The tolerance for target inefficiency is also a policy decision that may vary depending on the reason for ineligibility. For example, the United Kingdom looks to prior-year income and now (after experiencing widespread income-related overpayments) provides a very generous safe harbor for income increases; it is less forbearing for family changes. Two studies of the EITC population (one looking at estimated eligibility and the other at actual receipt) found that variations in income appear to be a greater factor than changes in family composition in fluctuating eligibility and participation.[65]

There is recent precedent for accepting overpayments that result from data sources chosen for administrative simplicity. The Advance Child Tax Credit used as an economic stimulus in 2003 was based on prior-year eligibility but also required applying it 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.[66] The Medicare Part B premium for a higher-income beneficiary is based on her tax return from two years before; the premium can be reduced based on a more recent return if there has been a drop in income due to a "major life changing event," but it cannot be increased due to a rise in income during that period.[67]

5. *Improved communication and reporting can improve targeting and reduce inefficiency risk.*

There is currently no means for a taxpayer to indicate to the IRS that she expects to be eligible for the EITC. Form W-5 includes such a declaration, but the little-utilized forms are not filed with the IRS. There is nothing other than the retrospective claim through the income tax return.

Schedule EIC could include a section permitting the claimant to declare that she expects to be eligible again for the credit. This section would list the filing year's income criteria and a reiteration of the qualifying child criteria. The declaration would need to be signed under penalty of perjury.

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[64] A tax year 1990 study found that most improper EITC claims were from families with children quite similar to eligible families. Jeffrey B. Liebman, "Who Are the Ineligible Earned Income Tax Credit Recipients?" In Meyer and Holtz-Eakin, *Making Work Pay*.

[65] John B. Horowitz, "Income Mobility and the Earned Income Tax Credit." *Economic Inquiry* 40 (2002): 334–347; Timothy Dowd, "Distinguishing Between Short-Term and Long-Term Recipients of the Earned Income Tax Credit." *National Tax Journal* 58 (2005): 807–828.

[66] The 2008 economic stimulus payment does not include any subsequent year reconciliation, but a person who is ineligible for a payment (or qualifies for a reduced payment) based on the 2007 tax return can make a claim on the subsequent year return based on changed circumstances in 2008.

[67] Medicare Modernization Act of 2003, Section 811(a)(4)(B), (C), Public Law 108-173.

New claimants with qualifying children could submit a similar signed declaration of expected eligibility as a stand-alone document.[68] This would include further detail regarding eligibility, space for listing qualifying children (as on Schedule EIC), and could require additional steps (such as affirmatively checking one of several boxes listing common qualifying child relationships).[69]

Creating additional, less traditional opportunities for information transfer could further improve a periodic payment system. One or more mid-year reassertions of expected eligibility via reply postcard, telephone, or transaction terminal could improve compliance and reduce repayment risks. These could be two-way communications by which the IRS informs the claimant of the income and household circumstances associated with their periodic payments, thereby prompting either a confirmation or modification response. This type of system would need a default reaction to a failure to respond, such as suspension of payments or flagging the taxpayer for additional post-filing review.

6. Limiting the portion of the EITC that can be obtained through periodic payment has several advantages.

Although the rationale of 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 transition issues.

The IRS could offer taxpayers a range of options as to the proportion of their expected EITC they would receive in advance. The paradox is that having more choices may actually inhibit participation. Studies in behavioral economics show that a proliferation of alternatives may be confusing and even menacing.[70]

Initially, for reasons of both simplicity and transition, setting a single default (for example, 50% of the anticipated total credit) is probably wise.

[68] If the EITC for workers without qualifying children is increased, periodic payment could be extended to those claimants.

[69] Leslie Book, "Freakonomics and the Tax Gap: An Applied Perspective." *American University Law Review* 56 (2007): 1163–1185. Book advocates using the check box system on Schedule EIC for newly-claimed qualifying children based on findings that increased "visibility" improves voluntary tax compliance.

[70] Marianne Bertrand, Sendhil Mullainathan, and Eldar Shafir, "Behavioral Economics and Marketing in Aid of Decision Making Among the Poor." *Journal of Public Policy and Marketing* 25 (2006): 8–23. Simona Botti and Sheena S. Iyengar, "The Dark Side of Choice: When Choice Impairs Social Welfare." *Journal of Public Policy and Marketing* 25 (2006): 24–38.

7. Payment frequency must balance a) liquidity with accumulation, and b) the connection to work with administrative feasibility.

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.

A middle approach would try to build first on existing calendars. Most of those who interact with the IRS more than once a year do so roughly every quarter.[71] Quarterly 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.

Quarterly payments could be made using the estimated tax schedule, with April 15 being the initial payment for those who file returns early in the year. The remaining payments (for those participating the full year) would be made on June 15, September 15, and January 15. Alternative quarterly dates cognizant of the demands of return processing could also be used. Another option, either for phased-in implementation or long-term use, would be two or three semi-annual payments beginning in June or later.

8. There should be universal use of direct deposit.

Direct deposit to financial institution accounts is most often the only payment vehicle available in other countries. Employers and governments here are trying to move away from paper checks, and a new periodic payment system should reinforce that orientation.

Direct deposit of tax refunds is not yet near universal adoption in this country. In tax year 2004, 42 percent of all filers claming refunds and 38 percent of EITC filers claiming refunds utilized it.[72] Even a sizeable number of those known to have bank accounts do not select direct deposit.[73] This may reflect inertial effects as much as overt recipient choice.

The challenge of delivering payments to unbanked households also must be addressed. An EITC periodic payment system could build on suggested reforms in the financial services sector such as institutional incentives for opening accounts and new

[71] Sole proprietors, persons working as independent contractors, retirees, and others not subject to income and payroll tax withholding must make quarterly estimated tax payments on January 15, April 15, June 15, and September 15 of each year.

[72] Author's calculations from SPEC Database, excluding returns for which refund payment to a bank account is due to a RAL.

[73] Among National Tax Assistance for Working Families Campaign filers who indicated they had a bank account and claimed a refund, 33 percent did not use direct deposit (author's calculations for The Annie E. Casey Foundation).

product lines.[74] 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 who does not provide deposit account information on the tax return or perhaps on the Schedule EIC or separate declaration of eligibility.[75] The Direct Express Card (debit card) offered to Social Security beneficiaries is another delivery model.

9. *Presumptive participation may be a worthy goal, but not for initial implementation.*

There is increasing recognition of the value of automatic enrollment with an opt-out opportunity over opt-in procedures.[76] 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 presumptive participation will increase retirement savings among those who may wish to save but fail to take the necessary steps to effect that intention.

Presumptive participation would reflect a value judgment that periodic payment of the EITC is the *preferential* 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 initially as the periodic payment mechanisms are tested and improved.

10. *Program expansions provide a good opportunity for implementation.*

Any attempt to shift from near-universal reliance on large lump-sum refunds to greater use of periodic payments requires attention to transition. EITC benefits at current levels have been in place for over a decade, and households have undoubtedly incorporated the payment pattern into their budgeting and cash management. Some sectors are likely accustomed to the seasonal flows.[77]

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[74] These options are explored at length in Michael S. Barr, "Banking the Poor." *Yale Journal on Regulation* 21 (2004): 121–237.

[75] The Assets and Transaction account (ATA) proposed by the New America Foundation could be automatically used when a taxpayer chooses not to use direct deposit for a tax refund. Melissa Koide, "The Assets and Transaction Account: A Proposal for a Low Cost, High Value Transaction and Savings Account" (discussion draft, 2007).

[76] William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings" (Washington: The Retirement Security Project, 2005).

[77] Goodman-Bacon and McGranahan, "How do EITC recipients spend their refunds?"

Proposed enhancements to the EITC and CTC present an opportunity to make a transition to more periodic payments concurrent with a program expansion. Phased implementation over two to three years could further facilitate accommodation of new resource flows among recipients and the economy as a whole.

VI. CONCLUSION

The advance payment option of the EITC in its present form is ineffective. The employer-based model is fundamentally flawed, and neither increasing awareness nor modifying program rules can save it. 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 federal government should develop a workable disbursement structure within the IRS that offers both periodic and lump-sum payments. It should balance income support goals with the demonstrated desire to use deferred payment as the "self-control mechanism" of a "precommitment device against overconsumption."[78] It should guard against both repayment risks and improper claims. It should utilize direct deposit and related technologies, and should be adaptable to the periodic payment of other tax-based benefits and coordination with other transfer payments.[79] If successful, it could eventually incorporate presumptive participation. Although no approach is ideal, realizing the full potential of the EITC requires greater attention to the mechanics of how it is paid.

[78] Romich and Weisner, "How Families View and Use the EITC;" Barr and Dokko, "Tax Filing Experiences and Withholding Preferences of Low- and Moderate-Income Households." There is evidence that a more "costless" balanced payment approach would be consistent with household interests and welfare. Lisa Barrow and Leslie McGranahan, "The Effects of the Earned Income Credit on the Seasonality of Household Expenditures." *National Tax Journal* 53 (4, part 2) (2000): 1211–1244.

[79] "Electronic bank accounts lower the cost of redistributing wealth." Barr, "Banking the Poor" (p. 232).

Appendix A

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 (social welfare); Australian Taxation Office (tax)	Canada Revenue Agency (tax)	Department of Social and Family Affairs (social welfare)	Inland Revenue Department (tax); Ministry of Social Development (social welfare)	HM Revenue and Customs (tax)[80]	Internal Revenue Service (tax)
Beneficiaries	Families with children; 1-parent families; 2-parent families with stay-at-home caregiver	Families with children; low-income families with children	Low-income working families with children	Families with children	Families with children; low-income workers	Low-income workers; families with children
Annual benefit amount[81]	$9.432[82]	$5,557[83]	$15,023[84]	$7,262[85]	$17,599[86]	$5,271
Periodic payments	Optional	Mandatory	Mandatory	Optional	Mandatory (choice of frequency)	Optional

[80] 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.

[81] Calculated for single parent, two pre-school children, full-time work, earning $15,000 (any child care components excluded).

[82] To facilitate cross-national comparability, all figures are in U.S. dollars. The rate of exchange used is 1 Australian Dollar equals $0.80 U.S.

[83] The rate of exchange used is 1 Canadian Dollar equals $0.90 U.S.

[84] The rate of exchange used is 1 Euro equals $1.35 U.S.

[85] The rate of exchange used is 1 New Zealand Dollar equals $0.70 U.S.

[86] The rate of exchange used is 1 Pound equals $1.95 U.S.

	AUSTRALIA	CANADA	IRELAND	NEW ZEALAND	UNITED KINGDOM	UNITED STATES
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; spousal utilization; anticipated family composition
Payment frequency options	Periodic (biweekly) or lump sum direct payment; reduced with-holding	Periodic (monthly) direct payment	Periodic (weekly) direct payment	Periodic (weekly or biweekly) or lump sum direct payment; may vary by credit component	Periodic (weekly or every four weeks) direct payment; may vary by credit	Lump-sum direct payment; and/or same as payroll frequency (for workers with children)
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
Safeguards against overpayment	Option of using standard low percentage of maximum; portion payable only at year-end; can report changes in family circumstances	Can report changes in family circumstances	[not applicable]	If uncertain, advise over-estimating income or using annual payment; can report changes in earnings or family circumstances	Very large allowance for increased income; can report changes in family circumstances	Payment limited to 60 percent of maximum EITC for families with 1 child; no periodic payments for CTC
Error reconciliation	Year-end reconciliation; excess payments recovered	No over-payments based on income but those from unreported family changes recovered	No over-payments (eligibility fully established in advance).	Year-end reconciliation; excess payments recovered	Overpayments (based on income for very large increases only or for unreported family changes) recovered	Year-end reconciliation; excess payments recovered

Appendix B
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