

# Claimin’ True: Optimizing Eligible Take-Up of the EITC

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*The Earned Income Tax Credit (EITC) suffers from two competing issues: incomplete take-up and overclaims—some eligible people do not claim the credit while some ineligible people do. This Note applies concepts from behavioral economics to these issues to determine why existing reforms have had limited success and what can be done to address them. This Note proposes the creation of an “opt-out” EITC system in which the IRS automatically determines EITC eligibility and the harmonization of the EITC audit rate with the national audit rate, accompanied by a bundle of existing EITC reform proposals.*

I. INTRODUCTION .....	244
II. OVERVIEW OF THE EITC .....	245
A. Description of the EITC .....	245
B. Benefits of the EITC .....	248
C. Take-Up and Overclaim Rates of the EITC .....	250
D. Causes for Uses for Overclaims and Nonclaims .....	251
E. Rational Choice Theory .....	254
F. The Limits of Rational Choice Theory .....	258
III. BEHAVIORAL BIASES AFFECTING THE EITC .....	259
A. Cognitive Burden .....	259
B. Affect-Rich Distortion .....	261
C. Default Heuristic .....	262
IV. EXISTING POLICY PROPOSALS .....	263
A. Reminders as a Nudge .....	263
B. Prepopulated Returns .....	265
C. Expanded Access to Tax Preparation Services .....	267
V. RECOMMENDATIONS .....	269
A. Simplify the EITC .....	269
B. Implement an EITC Default Rule .....	271

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<i>C. Expand Access to Tax Preparation Services</i> .....	273
<i>D. Harmonize EITC Audit Rate</i> .....	274
<i>E. Publicize Reforms</i> .....	276
VI. CONCLUSION.....	276

## I. INTRODUCTION

The Earned Income Tax Credit (EITC) is a federal tax credit for working people of low and moderate income.<sup>1</sup> Although relatively more eligible individuals claim the EITC compared to other benefit programs, there is still room to improve program participation.<sup>2</sup> This issue of incomplete EITC take-up is accompanied by the problem of overclaims—ineligible individuals claiming the credit, or eligible individuals claiming more than they are entitled to.<sup>3</sup>

Previous research applied principles of behavioral economics to EITC noncompliance,<sup>4</sup> but there is limited application of behavioral principles to the issue of incomplete take-up. This Note applies insights from behavioral economics along with traditional economic principles to address the issues of incomplete EITC take-up and overclaims. The goal of this Note is to optimize the amount of valid EITC claims by uncovering a set of policies that can improve the take-up rate of the EITC while simultaneously decreasing the amount of overclaims.

Part II of this Note provides an overview of the EITC system and summarizes the traditional rational choice theory used to evaluate the EITC. Part III describes findings from behavioral economics that help contextualize the issues of incomplete EITC take-up and overclaims. Part IV applies principles of behavioral economics to evaluate the merits of existing proposals for EITC reform. Part V proposes a set of solutions to address the issues of incomplete take-up and overclaims. Part VI concludes that the EITC should be administered through an “opt-out” system analogous to coronavirus (COVID-19) stimulus checks,<sup>5</sup> that EITC claimants should not be audited at a rate above the national average, and that EITC reforms should be accompanied by a bundle of existing reform proposals to further optimize eligible EITC take-up.

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1. *The Earned Income Tax Credit*, CTR. ON BUDGET AND POL’Y PRIORITIES (Dec. 10, 2019), <https://www.cbpp.org/research/federal-tax/policy-basics-the-earned-income-tax-credit> [hereinafter CBPP REPORT].

2. Leslie Book, David Williams & Krista Holub, *Insights from Behavioral Economics Can Improve Administration of the EITC*, 37 VA. TAX REV. 177, 180 (2018).

3. *Id.*

4. *Id.* at 222.

5. *A Guide to COVID-19 Economic Stimulus Relief*, CONSUMER FIN. PROTECTION BUREAU, <https://www.consumerfinance.gov/about-us/blog/guide-covid-19-economic-stimulus-checks/> (last visited Feb. 16, 2021) (explaining that eligibility for COVID-19 stimulus checks was automatically determined based on the IRS).

## II. OVERVIEW OF THE EITC

This Part provides background information on the EITC. Part I(A) describes the EITC; Part I(B) summarizes the EITC's benefits; Part I(C) describes the take-up and overclaim rates for the credit; Part I(D) evaluates the causes for incomplete take-up and overclaims; Part I(E) discusses the traditional, rational choice approach to tax policy and social benefit programs; and Part I(F) considers the limits of rational choice theory.

### *A. Description of the EITC*

Pamela Herd and Donald Moynihan succinctly describe the intellectual and political origins of the EITC as follows:

Friedman first proposed a negative income tax in *Capitalism and Freedom* in 1962, seeing it as a tool to displace other welfare programs while encouraging labor market participation. The negative income tax became the inspiration for the first attempt to pass a wage subsidy, President Richard Nixon's failed Family Assistance Plan (FAP). From the ashes of this failure, the Earned Income Tax Credit (EITC) was born.<sup>6</sup>

Originally, the EITC was, by definition, a tax credit applied toward an employee's payroll taxes.<sup>7</sup> However, the EITC formula has since evolved, and the exact EITC calculation method is significantly complex.<sup>8</sup> Today, the EITC is best described as an IRS-administered social benefit transfer payment consisting of two elements: an earnings supplement and a graduate child allowance.<sup>9</sup>

The EITC is intended to reward work, thus higher levels of earned income result in higher levels of EITC credit.<sup>10</sup> The number of "qualifying children" in an EITC-eligible individual's household influences both the income thresholds for eligibility and the subsequent value of the credit.<sup>11</sup> For example, in the 2020 tax year, the minimum value of the EITC credit is \$538 for a taxpayer without qualifying children earning \$15,820 (or a joint-filing household earning \$21,710), while the maximum EITC value in 2020 is \$6,660 for a taxpayer with three or more qualifying children earning \$50,594 (or a joint-filing household earning \$56,844).<sup>12</sup> An individual must satisfy several tests to be considered a qualifying

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6. PAMELA HERD & DONALD P. MOYNIHAN, ADMINISTRATIVE BURDEN: POLICYMAKING BY OTHER MEANS 191 (2018).

7. STEVE HOLT, THE ROLE OF THE IRS AS A SOCIAL BENEFITS ADMINISTRATOR, AM. ENTER. INST. 1 (2016).

8. For a detailed explanation, *see id.*, at 1-2; Leslie Book, *Bureaucratic Oppression and the Tax System*, 69 TAX LAW. 567, 572 (2016); Jacob Goldin, *Tax Benefit Complexity and Take-Up: Lessons from the Earned Income Tax Credit*, 72 TAX L. REV. 59, 64-65 (2018).

9. HOLT, *supra* note 7, at 1.

10. MARGOT L. CRANDALL-HOLLICK, CONG. RES. SERV., R44825, THE EARNED INCOME TAX CREDIT (EITC): A BRIEF LEGISLATIVE HISTORY 3 (2018).

11. Goldin, *supra* note 8, at 65.

12. Derek Silva, *The Earned Income Tax Credit*, POL'Y GENIUS (Dec. 17, 2019), <https://www.policygenius.com/taxes/earned-income-tax-credit/>.

child.<sup>13</sup> First, the “age test” requires a qualifying child to be less than eighteen years old during the entire tax year, twenty-three years or younger and a full-time student, or any age if “totally and permanently disabled.”<sup>14</sup> Second, the “residency test” requires the qualifying child to reside with the taxpayer for more than half of the tax year.<sup>15</sup> Third, the “relationship test” requires the individual to be the child, grandchild, sibling, niece, or nephew of the taxpayer.<sup>16</sup> Fourth, unlike other child-related tax benefits, a qualifying child can be considered in EITC eligibility even if they provide more than half of their own support.<sup>17</sup> Finally, complicated tiebreaker rules also come into play if more than one taxpayer is eligible to claim the child.<sup>18</sup>

Early on, the IRS took on the responsibility of determining EITC eligibility and calculating benefits for those who did not claim the credit on their tax return but appeared eligible.<sup>19</sup> As the EITC’s popularity expanded, however, the IRS ceased this practice.<sup>20</sup> Claiming the EITC today entails more than just demonstrating eligibility and the IRS calculating the credit.<sup>21</sup> This increased complexity is driven, in part, by tax preparation lobbying.<sup>22</sup> In addition to the standard information necessary for filing a 1040, the IRS now requires additional data from EITC claimants to ensure that the taxpayer is actually entitled to the credit.<sup>23</sup> For example, a taxpayer claiming a qualifying child for the EITC must complete a “Schedule EIC,” or “Earned Income Credit,” that includes “the child’s name, social security number, year of birth, relationship to taxpayer, and number of months the child lived with the taxpayer during the tax year.”<sup>24</sup> Moreover, if a tax preparation service is used, the preparer must submit a due diligence checklist along with the return that attests that the preparer verified key determinants of EITC eligibility.<sup>25</sup>

The complex system of EITC eligibility rules attempts to ensure that only intended beneficiaries receive the credit.<sup>26</sup> To put the complexity of the EITC system into perspective, Section 32 of the Internal Revenue code, which authorizes the EITC, contains over 2,400 words with cross-references to over twenty other sections of the Code and half a dozen other federal statutes.<sup>27</sup> Such a complex

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13. *Id.*

14. *Id.*

15. Goldin, *supra* note 8, at 65; I.R.C. §§ 32(c)(3)(C), 152(c)(1)(B) (2018).

16. Goldin, *supra* note 8, at 65; §§ 32(c)(3), 152(c)(2).

17. Goldin, *supra* note 8, at 65; § 32(c)(3)(A).

18. Goldin, *supra* note 8, at 65.

19. DEAN PLUEGER, EARNED INCOME TAX CREDIT PARTICIPATION FOR TAX YEAR 2005, INTERNAL REVENUE SERV. 152 (2009), <https://www.irs.gov/pub/irs-soi/09resconeitcpart.pdf>.

20. *Id.*

21. See Book et al., *supra* note 2, at 205.

22. HERD & MOYNIHAN, *supra* note 6, at 207. Tax preparation industry lobbying attempts to keep the EITC sufficiently complex so that their services are necessary for claiming the credit. *Id.* For example, “H&R Block has lobbied Congress to increase the length of the form, despite the fact that the additional questions proposed are redundant, seeking information already provided elsewhere in the tax returns.” *Id.*

23. See *id.*

24. Michelle Lyon Drumb, *Beyond Polemics: Poverty, Taxes, and Noncompliance*, 14 E.JOURNAL. TAX RES. 253, 276 (2016).

25. Book et al., *supra* note 2, at 205; see also I.R.C. § 6695(g) (2018) (imposing due diligence requirements for EITC returns).

26. Book et al., *supra* note 2, at 187.

27. Drumb, *supra* note 24, at 276.

system leads to errors in filing both by self-filers and experienced preparers,<sup>28</sup> and may deter eligible individuals from trying to claim the EITC.<sup>29</sup> This deterrent effect is exacerbated by the fact that both the financial cost of claiming the EITC and risk of improper claiming falls on the beneficiary.<sup>30</sup> The lack of price transparency in the tax preparation industry also increases the uncertainty that a taxpayer faces when deciding whether to file a return.<sup>31</sup>

Regardless, taxpayers faced with the responsibility of navigating the labyrinthian of EITC calculations usually turn to paid tax preparation services to claim the credit.<sup>32</sup> From 2006 to 2008, approximately 68% of EITC claimants used a paid tax preparation service.<sup>33</sup> In recent years, the use of paid preparers declined, but official data demonstrating the extent of this decline is not yet publicly available.<sup>34</sup> Although free tax preparation services are available, the services have limited reach<sup>35</sup> and only 3% of EITC claimants utilize free tax preparation services.<sup>36</sup> EITC claimants usually choose return preparers that are not enrolled in the IRS' return preparation program (43%) or preparers from a national tax prep firm (35%) as compared to nonclaimants, who choose non-enrolled preparers 28% of the time and a preparer from a national tax prep firm 14% of the time.<sup>37</sup> EITC Claimants are also less likely to use a Certified Public Accountant ("CPA") for return preparation—10% of EITC claimants use a CPA, compared to 44% of nonclaimants.<sup>38</sup> Self-preparation is less popular. 29% of EITC claimants self-file, as compared to 43% of all taxpayers.<sup>39</sup> These statistics suggest that efforts to

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28. *Id.*

29. See Goldin, *supra* note 8, at 73–86 (2018) (describing a benefit take-up framework that considers the informational and computational complexity of the EITC).

30. HOLT, *supra* note 7, at 5.

31. *Id.* See Chi Chi Wu, *Riddled Returns: How Errors and Fraud by Paid Tax Preparers Put Consumers at Risk and What States Can Do*, NAT'L CONSUMER L. CTR. 15–18 (Mar. 2014), <https://www.nclc.org/images/pdf/pr-reports/report-riddled-returns.pdf> (documenting a lack of transparency surrounding tax preparation fees).

32. HOLT, *supra* note 8, at 5.

33. COMPLIANCE ESTIMATES FOR THE EITC CLAIMED ON 2006–2008 RETURNS, INTERNAL REVENUE SERV. (2014), <https://www.irs.gov/pub/irs-soi/EITCComplianceStudyTY2006-2008.pdf> [hereinafter IRS EITC OVERCLAIM STUDY].

34. *Id.* at 24 n.51. The source of this decline is primarily due to the increasing popularity of tax preparation software. Book et al., *supra* note 2, at 202. Third-party data from Brookings shows that 14,232,945 out of 26,603,395, or 53.5% percent, EITC returns filed for the 2014 taxable year were through a paid tax preparation service. *Earned Income Tax Credit (EITC) Interactive and Resources*, BROOKINGS (Dec. 21, 2016), <https://www.brookings.edu/interactives/earned-income-tax-credit-eitc-interactive-and-resources/> [hereinafter BROOKINGS EITC DATASET].

35. HOLT, *supra* note 7, at 5.

36. IRS EITC OVERCLAIM STUDY, *supra* note 33, at 24. “The IRS sponsors programs that offer free tax return preparation services and counseling to seniors, individuals with low to moderate incomes, those with disabilities, and those for whom English is a second language; the programs are the Volunteer Income Tax Assistance (VITA) program and the Tax Counseling for the Elderly (TCE) program, both of which are staffed by specially trained volunteers.” *Id.* at 24, n.52.

37. *Id.* at 24.

38. *Id.*

39. *Id.* The IRS notes that the rate of self-preparation has increased in recent years. *Id.* at 24 n.51. Third-party data supports this conclusion; based on a dataset covering the 2014 taxable year from Brookings (the most recent available), there were 26,603,395 returns that claimed the EITC, and 11,450,258 (~43%) of those returns were self-filed. BROOKINGS EITC DATASET, *supra* note 34.

improve EITC uptake should be directed at facilitating tax preparation services, rather than trying to increase self-preparation information or CPA access.

### B. Benefits of the EITC

For the 2018 tax year, over twenty-two million families and individuals received the EITC, and the credit lifted more than five and a half million people out of poverty.<sup>40</sup> Estimates suggest the number of children living in poverty would be 25% higher if the EITC were unavailable.<sup>41</sup> In addition to its poverty-eliminating effects, the EITC has also attenuated the poverty level for another sixteen and a half million people.<sup>42</sup> Practically, the EITC is a tool for low and moderate income individuals to achieve their social and economic goals: catching up on unpaid bills, placing a deposit on an apartment in a better neighborhood, or purchasing a vehicle.<sup>43</sup> When EITC recipients spend their refund in the local economy, economic spillover benefits in terms of spending and job creation are substantial.<sup>44</sup> In addition to the *economic* spillover benefits, the *individual* spillover benefits of the EITC credit are immense: increased food security,<sup>45</sup> higher birth weight,<sup>46</sup> improved health outcomes and behaviors,<sup>47</sup> greater mental health

40. CBPP REPORT, *supra* note 1.

41. *Id.*

42. *Id.*

43. Book, *supra* note 2, at 573.

44. Antonio Avalos & Sean Alley, *The Economic Impact of the Earned Income Tax Credit (EITC) in California*, 2 CAL. J. POL. & POL'Y 1, 10 (finding that federal EITC dollars spent in California generate over \$700 million in business sales, 4,600 jobs, and \$355 million in tax revenue). If the EITC were fully utilized in California, the additional payments would spur an additional \$1.55 million billion in output, nearly 9,000 jobs, and \$88 million in tax revenue. *Id.* at 17–18.

45. David H. Rehkopf, Kate W. Strully & William H. Dow, *The Short-term Impacts of Earned Income Tax Credit Disbursement on Health*, 43 INT. J. EPIDEMIOL. 1884, 1890–91 (2014) (“[T]he short-term effects of EITC receipt were on balance more health-promoting than detrimental...[M]any outcomes that are key determinants of health (e.g., food security, smoking/exposure to smoke) were affected in a health-promoting direction.”). Lucie Schmidt, Lara Shore-Sheppard & Tara Watson, *The Effect of Safety-Net Programs on Food Insecurity*, 51 J. HUM. RESOURCES 589, 598, 612 (2016) (analyzing a bundle of social safety net programs, including EITC, and finding that “each \$1,000 in cash or food benefits for which families are eligible reduces food insecurity by 1.1 percentage points”). Food security also has a spillover benefit for both physical and mental health. Kristine Siefert, Colleen M. Heflin, Mary E. Corcoran & David R. Williams, *Food Insufficiency and Physical and Mental Health in a Longitudinal Survey of Welfare Recipients*, 45 J. HEALTH SOC. BEHAV. 171, 182 (2004) (demonstrating that food insecurity leads to declines in both physical and mental health and suggesting that policies that combat food insecurity can help to ameliorate these negative effects).

46. Sara Markowitz, Kelli A. Komro, Melvin D. Livingston, Otto Lenhart & Alexander C. Wagenaar, *Effects of State-level Earned Income Tax Credit Laws in the U.S. on Health Behaviors and Infant Health Outcomes*, 194 SOC. SCI. MED. 67, 74 (2017) (evaluating differences between state-level EITCs and finding that higher levels of EITC are correlated with improved birth weights comparable to an increase in the minimum wage). ALEXANDER C. WAGENAAR, MELVIN D. LIVINGSTON, SARA MARKOWITZ & KELLI A. KOMRO, EFFECTS OF CHANGES IN EARNED INCOME TAX CREDIT: TIME-SERIES ANALYSES OF WASHINGTON DC 2, <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC6351581/pdf/main.pdf> (reinforcing the conclusion that the EITC is associated with improved infant outcomes through the use of time-series analysis of Washington DC’s EITC implementation).

47. Rachael A. Spencer & Kelli A. Komro, *Family Economic Security Policies and Child and Family Health*, 20 CLIN. CHILD FAM. PSYCHOL. REV. 45, 57–58 (2017) (conducting a literature review and finding strong evidence that the EITC has positive effects on “subjective measures of health and health behaviors,” although the long-term impact of the EITC on health are less clear). *See also* Steven H. Woolf et al., *How*

and happiness,<sup>48</sup> and enhanced education performance.<sup>49</sup> Incomplete take-up of the EITC is problematic because eligible individuals that fail to claim the credit lose out on these benefits.<sup>50</sup> Moreover, even EITC-eligible individuals who receive the credit are likely to experience financial and budgeting instability throughout the year.<sup>51</sup>

Administering the EITC through the tax system, rather than through traditional means of benefit distribution has several distinct advantages. First, the presence in the tax code and earned income requirement connects the benefit with participation in the formal economy, which reduces the stigma of participation when compared to traditional welfare programs.<sup>52</sup> Second, the EITC can be administered without the human capital cost of caseworkers usually required for intake and eligibility determinations.<sup>53</sup> The low labor cost of administration contributes to the third advantage of administering the EITC through the tax system: extremely low administrative costs.<sup>54</sup> The administrative costs of the EITC are approximately 1% of the benefits paid out.<sup>55</sup> This is exceptionally low compared to SNAP, a traditionally administered welfare program, with administrative costs that exceed 9% of the program's benefits.<sup>56</sup> The administrative costs of the EITC are also

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*Are Income and Wealth Linked to Health and Longevity*, URBAN INST. 1, 3–6 (Apr. 2015), <https://www.urban.org/sites/default/files/publication/49116/2000178-How-are-Income-and-Wealth-Linked-to-Health-and-Longevity.pdf> (discussing the relationship between income and: chronic disease, life expectancy, inability to procure health insurance, healthy food access, and public transportation access). The EITC can mitigate these issues by increasing the income level of eligible households.

48. Casey Boyd-Swan, Chris M. Herbst, John Ifcher & Homa Zarghamee, *The Earned Income Tax Credit, Mental Health, and Happiness*, 126 J. ECON. BEHAVIOR & ORG. 18, 35–36 (2016) (finding that receipt of EITC increases married mothers' self-reported happiness by 4.4%, feelings of self-efficaciousness by 10.1%, and decreased the measure of their depression by 15.7%).

49. Gordon B. Dahl & Lance Lochner, *The Impact of Family Income on Child Achievement: Evidence from the Earned Income Tax Credit*, 102 AM. ECON. REV. 1927, 1951 (2012) (finding that EITC payments have a “modest, but encouraging, causal effect” on children's test scores).

50. Goldin, *supra* note 8, at 66. While helpful, the EITC credit, on its own, is insufficient to address poverty—even EITC-eligible individuals who receive the credit are likely to experience financial and budgeting instability throughout the year.

51. See Ruby Mendenhall, Karen Z. Kramer & Ilana R. Akresh, *Asset Accumulation and Housing Cost Burden: Pathways to (Not) Saving*, 24 HOUS. POL'Y DEBATE 387, 391–92 (2014) (evaluating a dataset of EITC-eligible individuals and discovering that even households with low housing costs experienced financial instability due to surprise expenses, exceedingly low income, and chronic illness); Timothy M. Smeeding, Katherin Ross Phillips & Michael O'Connor, *The EITC: Expectation, Knowledge, Use, and Economic and Social Mobility*, 53 NAT'L TAX J. 1187, 1202 (2000) (surveying EITC recipients and finding that nearly two-thirds (65%) of recipients plan to use their EITC refund to make ends meet).

52. Book, *supra* note 2, at 573.

53. *Id.*; See Jeffrey B. Liebman, *Who Are The Ineligible EITC Recipients?* 53 NAT'L TAX J. 1165, 1182 (“[T]he welfare system is generally thought to impose a greater burden on beneficiaries than the tax system, both because the time cost of regular meetings with a case worker is larger than the marginal cost of adding an additional form to one's tax return and because of the stigma associated with welfare receipt.”). The unique structure of the EITC has led at least one researcher to describe it as “a welfare program that happens to be administered through the tax system,” rather than a pure tax credit; Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 UCLA L. REV. 1867, 1903 (2005). See also HOLT, *supra* note 7, at 1 (describing the EITC as an IRS-administered social benefit system).

54. Drumbl, *supra* note 23, at 259.

55. *Id.*

56. *Id.*

miniscule compared to the average administrative costs of less than 10% for all means-tested welfare programs.<sup>57</sup>

### C. Take-Up and Overclaim Rates of the EITC

According to joint calculations of the IRS and the Census Bureau, 78% of eligible individuals claim the EITC.<sup>58</sup> Conversely, over 20% of eligible individuals do not claim the EITC.<sup>59</sup> Given that approximately twenty-five million households are EITC-eligible, this take-up rate suggests that approximately five million households fail to claim the EITC.<sup>60</sup>

Where approximately 80% of eligible households claim the EITC, about 86% of eligible EITC dollars are claimed.<sup>61</sup> The discrepancy between the eligible dollar rate and the eligible household rate suggests that those with the most to gain from the EITC are more likely to claim it.<sup>62</sup> The remaining eligible non-claimants would receive an average of \$1,554 if they were to file for the EITC.<sup>63</sup>

On the flip side, there is an overclaim problem with the EITC—either ineligible individuals claiming the credit or eligible individuals claiming a greater EITC credit than the program permits.<sup>64</sup> The Treasury Department estimated that nearly 25% (\$18.4 billion) of total EITC payments (\$73.6 billion) were improper.<sup>65</sup> Moreover, between 28.5% and 39.1% of EITC dollars paid are to ineligible recipients, with the difference explained by nearly 16% of audited claimants failing to participate fully in the audit process.<sup>66</sup> These percentages correspond to annual dollar values of overclaims between \$14 billion and \$19.3 billion.<sup>67</sup> Finally,

57. Robert Rector & Vijay Menon, *Understanding the Hidden \$1.1 Trillion Welfare System and How to Reform It*, HERITAGE FOUND. 11 (APR. 5, 2018), <https://www.heritage.org/sites/default/files/2018-04/BG3294.pdf>.

58. *About EITC*, INTERNAL REVENUE SERV. (Dec. 30, 2019), <https://www.eitc.irs.gov/eitc-central/about-eitc/about-eitc>.

59. *IRS, Partners Nationwide Mark Jan. 31 as “EITC Awareness Day”*, INTERNAL REVENUE SERV. (Jan. 28, 2020), <https://www.irs.gov/newsroom/irs-partners-nationwide-mark-jan-31-as-eitc-awareness-day>.

60. Goldin, *supra* note 8 at 70. Although the EITC take-up rate generally exceeds the take-up rate of other welfare programs, this is likely the result of the EITC being administered through the tax code. *Id.* at 67 & n.46. This suggests the efficiency of the tax system as a distribution method, not an ideal structure for the EITC itself. See also Janet Currie, *The Take-Up of Social Benefits*, in PUBLIC POLICY AND THE INCOME DISTRIBUTION 80, 86–87, 88–108 tbl 3.1 (2006).

61. Goldin, *supra* note 8, at 70.

62. *Id.*

63. *Id.*

64. HOLT, *supra* note 7, at 6. Data suggests that the former category is far more prevalent; between 79% and 85% of all overclaim dollars go to ineligible taxpayers; IRS EITC OVERCLAIM STUDY, *supra* note 32, at 13.

65. FISCAL YEAR 2018 AGENCY FINAL REPORT, U.S. DEPT. OF TREASURY 43 (Nov. 15, 2018), [https://home.treasury.gov/system/files/236/AFR\\_Full%20111518\\_clean\\_508.pdf](https://home.treasury.gov/system/files/236/AFR_Full%20111518_clean_508.pdf) [hereinafter 2018 TREASURY REPORT].

66. Book et al., *supra* note 2, at 193–94 (“The upper estimates assume that all of the nonresponders were ineligible to claim the EITC, while the lower estimate assumes that the nonresponders had a similar rate of noncompliance as the taxpayers who were audited and participated in the Service’s NRP audits.”).

67. *Id.* at 193. This dollar amount is miniscule compared to the estimated \$122 billion tax gap attributable to underreporting of business income on individual returns and the \$40 to \$70 billion annual loss due to evasion through offshore tax havens and abuse of tax shelters. Drumb, *supra* note 24, at 255. Each year, improper EITC claims only account for 3.5% of the total gross tax cap. *Id.*



between 43% and 50% of EITC returns contain errors, with most of those errors benefitting the taxpayer (not the government).<sup>68</sup>

#### *D. Causes for Uses for Overclaims and Nonclaims*

To address the issues of overclaims and incomplete take-up, it is helpful to delineate the causes of overclaims and nonclaims. The United States Treasury identifies the primary cause of overclaims to be errors in claiming a qualifying child,<sup>69</sup> followed by income misreporting and filing status errors, respectively.<sup>70</sup> From an administrative perspective, there are several factors that serve as barriers to reducing the EITC overclaim rate, none of which can be considered the “primary driver of program error”: complex statutory eligibility requirements, lack of IRS authority to make automatic changes to tax returns, high turnover rate of eligible claimants,<sup>71</sup> unscrupulous and incompetent return preparers, and fraud.<sup>72</sup> Given that overclaims occur for a variety of reasons, it is overly simplistic to categorize overclaimers into “intentional” and “unintentional” categories.<sup>73</sup> Steve Holt describes the nuanced motives of overclaimers as follows:

At one end are those who are unknowingly noncompliant in a context of complex rules. At the other end are those who are outright cheating or engaged in criminal enterprise. In between are varying degrees of noncompliance stemming from laziness, obstinacy, habit, protest, social norms, or the actions of return preparers (which may be known or unknown to the tax filer). The various actors and actions along the spectrum require different strategies.<sup>74</sup> These distinctions are important, as each source of overclaiming presents a unique policy challenge that demands a different policy solution.<sup>75</sup>

IRS data illustrate a significant disparity between EITC overclaim rates for different methods of tax preparation.<sup>76</sup> Between 39% and 47% of self-prepared EITC returns in the sample had an overclaim.<sup>77</sup> Surprisingly, paid preparers had a higher rate of overclaims: between 44% and 51%.<sup>78</sup> Returns prepared by the IRS-sponsored tax preparation services, Volunteer Income Tax Assistance (“VITA”) and Tax Counseling for the Elderly (“TCE”) had the lowest rate of overclaims: between 20% and 26%.<sup>79</sup>

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68. Book et al., *supra* note 2, at 180.

69. Kanye West captured the prevalence of this social norm in his song “We Don’t Care” when he rapped, “we claim other people’s kids on our income tax.” KANYE WEST, WE DON’T CARE (Def Jam Records/Roc-A-Fella Records 2004).

70. 2018 TREASURY REPORT, *supra* note 65, at 196. Approximately 6% of improper payments are a result of program design limitations, such as requiring information that isn’t available at the time of filing, or errors in applying tiebreaker rules. *Id.* at 197.

71. *Id.* at 200 (“Approximately one-third of EITC applicants change each year.”).

72. *Id.* at 200–01.

73. Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 5 KAN. L. REV. 1, 23–33 (2003).

74. HOLT, *supra* note 7, at 16.

75. Drumb, *supra* note 24, at 256.

76. IRS EITC OVERCLAIM STUDY, *supra* note 33, at 26 tbl.9.

77. *Id.*

78. *Id.*

79. *Id.*

Similarly, non-claiming can occur for a variety of reasons. Eligible non-claimants fall into two categories: “those who file a tax return (but fail to claim the EITC) and those who do not file a tax return at all.”<sup>80</sup> Nearly two-thirds (64%) of eligible non-claimants are non-filers, whereas only 36% of eligible non-claimants file taxes.<sup>81</sup> Among EITC-eligible individuals that file tax returns, the EITC take-up rate is 91.5%.<sup>82</sup>

There are a variety of explanations for why eligible individuals fail to claim the EITC. One possibility is that eligible non-claimants are “unaware of the credit, their eligibility, or how to claim it.”<sup>83</sup> Similarly, some may be deterred by the additional transaction costs of applying for the benefit, or the costs of learning about eligibility and the application process.<sup>84</sup> Others may be deterred by “the stigma associated with enrollment.”<sup>85</sup> Behavioral research suggests that factors such as procrastination,<sup>86</sup> inattention,<sup>87</sup> and psychological aversion to program complexity<sup>88</sup> may deter participation. Some may claim the EITC but be mechanically disallowed from claiming it due to inadequate response to an audit.<sup>89</sup> Finally, some may be deterred from claiming the EITC due to fear of being audited.<sup>90</sup>

80. Goldin, *supra* note 8, at 11.

81. *Id.*

82. *Id.*

83. Elizabeth Linos, Aparna Ramesh, Jesse Rothstein & Matt Unrath, *Increasing Take-Up of the Earned Income Tax Credit*, CA. POL’Y. LAB 6 (Jan. 2020), <https://www.capolicylab.org/wp-content/uploads/2020/03/Increasing-TakeUp-of-the-Earned-Income-Tax-Credit.pdf>.

84. Saurabh Bhargava & Dayanand Manoli, *Psychological Frictions and the Incomplete Take-Up of Social Benefits: Evidence from an IRS Field Experiment*, 105 AM. ECON. REV. 3489, 3490 (2015).

85. *Id.* See also Goldin, *supra* note 8, at 71 (identifying stigma and ideological opposition as sources of intentional EITC nonparticipation and discussing the possibility of an eligible taxpayer allowing another taxpayer to claim their qualifying child instead). *But see* HERD & MOYNIHAN, *supra* note 6, at 195 tbl.8.1 (listing the psychological costs of the EITC as minimal because there is no requirement to engage with welfare workers). *But cf.* Lawrence Zelenak, *Justice Holmes, Ralph Kramden, and the Civic Virtues of a Tax Return Filing Requirement*, 61 TAX L. REV. 53, 87 (2007) (explaining that administering the EITC through the tax system confers moral value on the claimant by functioning as a ceremony documenting the worker’s social duty of working for a living).

86. See Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 QUARTERLY J. ECON. 1149, 1150 (2001) (finding “that 401(k) participation is significantly higher after automatic enrollment is adopted . . . supports the contention . . . that procrastination is an extremely important factor in the widely perceived inadequacy of individual savings for retirement”). Similarly, individuals may procrastinate in filing tax returns or gathering the data necessary to claim the EITC.

87. See Dean Karlan, Margaret McConnell, Sendhil Mullainathan & Jonathan Zinman, *Getting to the Top of Mind: How Reminders Increase Savings* 23 (Nat’l Bureau of Econ. Research, Working Paper No. 16205, 2010), <https://www.nber.org/papers/w16205.pdf> (predicting that individuals undersave when they are inattentive to future expenditures). Similarly, individuals may be inattentive to the future cost savings associated with claiming the EITC, and thus fail to claim it.

88. *See Id.*

89. See John Guyton et al., *The Effects of EITC Correspondence Audits on Low-Income Earners* 3 (Nat’l Bureau of Econ. Research, Working Paper No. 24465, 2019), <http://www.nber.org/papers/w24465.pdf>.

90. *Id.* at 35 (“[T]here are significant decreases in EITC claiming and tax filing following the audits, but some audited taxpayers may leave benefits on the table by foregoing potentially legitimate EITC claims or not claiming tax refunds based on excess withholding.”). See also Goldin, *supra* note 8, at 71 (“Other filers may prefer not to claim the credit due to the higher audit risk faced by EITC claimants as compared to other taxpayers”). See also Liebman, *supra* note 51, at 1183 (“[I]t is clear that recent efforts at improving

Additional barriers exist for non-filers. Some may be deterred by the direct and indirect costs of filing taxes.<sup>91</sup> If low-income taxpayers do not use a free tax preparation site or software, the average price for tax preparation is between \$200 and \$400 per return.<sup>92</sup> The estimated time burden for completing a Form 1040 is eleven hours.<sup>93</sup> Other non-filers may be dissuaded by the potentially accurate perception that filing taxes would result in a net balance due to the IRS, even with the EITC.<sup>94</sup> Even non-filers who expect to receive a refund may refrain from filing because they believe the refund will be diverted to pay a liability such as “back taxes, child support, or student loans.”<sup>95</sup>

Given that the EITC is targeted to a specific group of taxpayers, it is important to understand how that group of taxpayers differs from the average taxpayer.<sup>96</sup> On average, individuals who can benefit from the EITC are more likely to have a disability and less likely to be educated, literate, and/or have a bank account.<sup>97</sup> The lack of a bank account is especially problematic for taxpayers claiming the EITC, as it can impair the taxpayer’s ability to prove income and expenses for an EITC claim.<sup>98</sup>

Essentially, there are both non-claim and overclaim issues with the EITC. Policy solutions attempting to address only one in isolation may have deleterious effects on the other. The goal, therefore, should be to find compliance mechanisms that do not significantly deter eligible claimants,<sup>99</sup> and conversely, take-up mechanisms that do not significantly decrease compliance.<sup>100</sup>

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compliance have increased administrative costs and have likely discouraged some eligible recipients from applying for the program.”).

91. See Linos et al., *supra* note 80, at 9. For an anecdote that illustrates the complexity of filing for the EITC, see Janet Berry-Johnson, *Claiming The Earned Income Tax Credit? Be Prepared to Substantiate Earned Income*, FORBES (Feb. 1, 2016), <https://www.forbes.com/sites/janetberryjohnson/2016/02/01/claiming-the-earned-income-tax-credit-be-prepared-to-substantiate-earned-income/?sh=2a02b3e173c3>.

92. Goldin, *supra* note 8, at 88. See also Michael Cohn, *Average Tax Prep Fee Inches Up to \$273*, ACCOUNTING TODAY (Jan. 14, 2015) <https://www.accountingtoday.com/news/average-tax-prep-fee-inches-up-to-273> (listing the average tax return cost to be \$273); compare with Paul Weinstein Jr. & Bethany Patten, *The Price of Paying Taxes II: How Paid Tax Preparer Fees are Diminishing the Earned Income Tax Credit (EITC)*, PROGRESSIVE POL’Y INST. 1 (Apr. 2016), [https://www.progressivepolicy.org/wp-content/uploads/2016/04/2016.04-Weinstein\\_Patten\\_The-Price-of-Paying-Takes-II.pdf](https://www.progressivepolicy.org/wp-content/uploads/2016/04/2016.04-Weinstein_Patten_The-Price-of-Paying-Takes-II.pdf) (specifying that EITC-eligible workers spend an average of \$400 at national tax preparation chains). The IRS estimates the average cost for taxpayers filing a Form 1040 to be \$210 per return. *1040 Instructions—2019*, INTERNAL REVENUE SERV. 100 (Jan. 8, 2020), <https://www.irs.gov/pub/irs-pdf/i1040gi.pdf> [hereinafter 1040 INSTRUCTIONS].

93. 1040 INSTRUCTIONS, *supra* note 90, at 100.

94. Goldin, *supra* note 8, at 71-72. This perception may be even more accurate after accounting for tax preparation fees. *Id.* at 72.

95. *Id.* at 72.

96. See NAT’L TAXPAYER ADVOCATE, ANNUAL REPORT TO CONGRESS 235 (2015) <https://www.taxpayeradvocate.irs.gov/reports/2015-annual-report-to-congress/full-report/>.

97. *Id.*

98. *Id.*

99. Book et al., *supra* note 2, at 211, 226.

100. *Cf. id.* at 226 (theorizing “cost-effective mechanisms to encourage compliance without deterring eligible claimants”).

### *E. Rational Choice Theory*

The traditional approach to evaluating take-up is rational choice theory, which predicts that when the advantages of claiming a tax benefit exceed the costs of claiming the benefit, an individual will claim the benefit.<sup>101</sup> Some versions of this model assume that individuals are “tax savvy,” and thus avoid paying additional taxes if they can do so within the confines of the law.<sup>102</sup> Researchers generally consider three interrelated costs of claiming a benefit: stigma, transaction costs, and information.<sup>103</sup>

Robert Moffitt, one of the first economists to evaluate benefit program nonparticipation in a rational choice framework,<sup>104</sup> posits that stigma is the primary cost of participating in a social benefit program.<sup>105</sup> Moffitt’s model includes both a fixed component of stigma from participation in the welfare program as well as a variable component that increases with higher levels of benefit.<sup>106</sup> The model predicts that an individual will only participate in a benefit program if “the extra utility from the welfare benefit outweighs the disutility of participation.”<sup>107</sup>

In addition to stigma, rational choice theory postulates that transaction costs can influence participation in a benefits program.<sup>108</sup> Professor Jacob Goldin evaluates these issues through the lens of program complexity, and identifies two types of complexity that function as a barrier between eligible taxpayers and a benefit program: informational and computational.<sup>109</sup> Informational complexity “refers to the difficulty of obtaining the informational inputs that determine a taxpayer’s eligibility for the benefit, and, if eligible, the benefit amount.”<sup>110</sup> Computational complexity, on the other hand, “refers to the difficulty a taxpayer faces in determining eligibility and benefit amount, on the basis of the required information.”<sup>111</sup>

Several factors increase the level of informational complexity.<sup>112</sup> First, informational complexity depends on the number of variables that affect benefit eligibility.<sup>113</sup> For example, a benefit that considers only age is less informationally complex than one that considers both age and income level.<sup>114</sup> Second,

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101. See Goldin, *supra* note 8, at 67, n.48 (describing nonparticipation decisions based on this cost-benefit analysis as “rational”).

102. See Brad M. Barber & Terrance Odean, *Are Individual Investors Tax Savvy? Evidence From Retail and Discount Brokerage Accounts*, 88 J. PUB. ECON. 419, 419, 440 (2003) (finding that “the average household is tax aware” based on analysis of investment behavior). This model would seem to suggest that individuals will claim the EITC so long as they are aware of it.

103. Currie, *supra* note 60, at 87. See also HERD & MOYNIHAN, *supra* note 6, at 23–29 (developing a framework of administrative burden based on psychological costs, compliance costs, and learning costs).

104. *Id.* at 82.

105. Robert Moffitt, *An Economic Model of Welfare Stigma*, 73 AM. ECON. REV. 1023, 1024 (1983).

106. *Id.*

107. *Id.* Solving Moffitt’s model suggests that the primary disutility from stigma arises from the fixed stigma, rather than the variable stigma associated with benefit amount. *Id.* at 1033–34.

108. Currie, *supra* note 60, at 87.

109. Goldin, *supra* note 8, at 60.

110. *Id.*

111. *Id.*

112. *Id.* at 74.

113. *Id.*

114. *Id.*

informational complexity is influenced by the level of detail required for the necessary information.<sup>115</sup> For example, a benefit requiring a report of the exact number of days spent in the United States is more informationally complex than a benefit requiring a taxpayer to report whether they spent more than half of the year in the country.<sup>116</sup> Third, requiring information that is difficult to obtain or keep track of increases informational complexity.<sup>117</sup> Where it is relatively easy to fill in a birthday, it is harder to track cash receipts.

Professor Goldin points out that the EITC is so complex that it is difficult to even evaluate its level of informational complexity.<sup>118</sup> To illustrate this informational complexity, consider the EITC qualifying child test. It is similar to the test for a dependent exemption, but the EITC test does not include the self-support test like the test for claiming a dependent.<sup>119</sup> However, because part of the EITC refers to the possibility of claiming a married dependent,<sup>120</sup> the self-support test is still potentially relevant in determining EITC eligibility.<sup>121</sup>

Claiming the EITC requires twelve pieces of information about the taxpayer, eleven about each qualifying child, five about each other taxpayer a qualifying child lived with during the year, and three about other taxpayers that the taxpayer lived with during the year.<sup>122</sup> Although the large amount of required information seems facially daunting, most of the necessary information is used elsewhere in the tax return and is easy to obtain, thus Goldin asserts that “the informational requirements of the EITC are unlikely to significantly reduce take-up.”<sup>123</sup>

In addition to informational complexity, computational complexity can influence a benefit’s take-up.<sup>124</sup> The more difficult it is to identify one’s eligibility for a benefit and determine the value of the benefit, the higher the computational complexity.<sup>125</sup> The computational complexity of a benefit depends on the number of inputs, the level of interaction between inputs, and the number of unique calculations required.<sup>126</sup>

Goldin explicates that the EITC has a high level of computational complexity since it has a high number of inputs and requires interaction between several of the inputs.<sup>127</sup> The phase-in and phase-out aspects of the EITC also increase its computational complexity.<sup>128</sup> Although the IRS offers to calculate a taxpayer’s

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115. *Id.*

116. *Id. See, e.g.,* I.R.C. § 32(c)(1)(A)(ii)(I) (2018) (requiring that a taxpayer must have resided in the United States for at least half a year to be eligible for the EITC).

117. Goldin, *supra* note 8, at 74.

118. *Id.* at 76.

119. *Compare* § 32(c)(3)(A) (excluding the self-support test from the EITC) *with* §§ 152(c)(1)(D), (d)(1)(C) (defining the self-support test for claiming a dependent).

120. *Id.* at § 32(c)(3)(B).

121. Goldin, *supra* note 8, at 76.

122. *Id.* at 77–78.

123. *Id.* at 79–80.

124. *Id.* at 81.

125. *Id.* at 82.

126. *Id.*

127. *Id.*

128. *Id.* at 83–84.

EITC credit on their behalf,<sup>129</sup> this offering does not alleviate the burden of determining eligibility or the appropriate number of qualifying children to claim.<sup>130</sup>

Finally, lack of knowledge about a benefit can impede take-up.<sup>131</sup> In order to claim a benefit, individuals need to both know that the benefit exists and remember the benefit when preparing their return.<sup>132</sup> Furthermore, individuals must remember to complete the accompanying paperwork for the benefit—merely checking the EITC box is insufficient because the Schedule EIC must be completed as well.<sup>133</sup> To address this, information about the benefit can be disseminated prior to tax preparation, such as through awareness campaigns, as well as on the tax return itself.<sup>134</sup>

To combat the learning costs of the EITC, the IRS publicizes the EITC using both methods described above.<sup>135</sup> Instructions for the 1040 include seventeen pages of extensive instructions regarding the EITC.<sup>136</sup> The IRS and its partners also raise awareness of the EITC through the EITC Awareness Day, an outreach campaign designed to increase take-up.<sup>137</sup> In addition to the IRS campaigns, both state governments and nonprofits engage in awareness campaigns to spread knowledge about the EITC.<sup>138</sup> Campaigns rely on a variety of information distribution methods: flyers and direct mailings in low-income communities, social media, and canvassing low-income neighborhoods.<sup>139</sup> State and local governments have also required employers to distribute EITC information to employees likely to qualify—approximately forty-six million individuals are required to receive EITC information from their employers each year.<sup>140</sup>

The traditional approach to deterring tax noncompliance is also grounded in rational choice theory, which suggests that the government can improve tax compliance by increasing the expected cost of noncompliance for taxpayers.<sup>141</sup> The expected cost of noncompliance is calculated by the probability of detection times the penalty for noncompliance. The theory suggests that compliance can be increased by increasing either the probability of detection or the penalty for noncompliance.<sup>142</sup>

The IRS compliance regime broadly consists of audits, penalties, and fraud detection.<sup>143</sup> To reduce overclaims, the IRS has a robust compliance system for

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129. 1040 INSTRUCTIONS, *supra* note 92, at 40.

130. Goldin, *supra* note 8, at 86.

131. Currie, *supra* note 60, at 87.

132. Goldin, *supra* note 8, at 86.

133. *Id.*

134. *Id.*

135. *Id.* at 72, 86.

136. 1040 INSTRUCTIONS, *supra* note 92, at 38–54 (providing instructions regarding the EITC).

137. INTERNAL REVENUE SERV., *supra* note 58.

138. Goldin, *supra* note 8, at 72, n.69 (citing extensive outreach efforts by state governments and nonprofit organizations).

139. *Id.* at 72.

140. *Id.* at 73.

141. Kathleen DeLaney Thomas, *The Psychic Cost of Tax Evasion*, 56 B.C. L. REV. 617, 618 (2015).

142. *Id.* (“For example, a rational actor would not evade \$100 of taxes if she had a fifty percent chance of incurring a \$400 penalty (expected penalty of \$200) or a five percent chance of incurring a \$4,000 penalty (same)”).

143. Book et al., *supra* note 2, at 220.

EITC claimants.<sup>144</sup> To allow the IRS annually more time to evaluate EITC returns, Congress enacted mandatory delays on the payment of refunds for returns claiming the EITC.<sup>145</sup> The IRS conducts correspondence audits for 450,000 returns and makes math error adjustments to another 150,000 returns.<sup>146</sup> However, the IRS also identifies five to six million potentially erroneous claims each year that it chooses not to pursue.<sup>147</sup> Additionally, the audit rate for EITC returns is higher than the total audit rate—in 2015, approximately 1.6% of EITC returns were audited, whereas only 0.9% of all taxpayers were audited.<sup>148</sup> More data shows that EITC claimants were audited at twice the rate of the national average.<sup>149</sup> Moreover, 39% of all individual income tax audits were of EITC claimants, even though the EITC audits resulted in less than 7% of additional tax owed due to audits.<sup>150</sup> Finally, the IRS utilizes a variety of supplemental efforts to identify and reduce improper EITC refund claims, such as: (1) two- or ten-year EITC bans for taxpayers that intentionally violate rules, (2) methods to detect and prevent identity theft and fraud, (3) criminal investigations, (4) soft notices for taxpayers that claimed an already-claimed qualifying child, (5) coordination and outreach initiatives with return preparers, (6) penalties for return preparers, (7) software development, and (8) taxpayer outreach.<sup>151</sup>

Traditional law enforcement methods such as audits and penalties are limited in their effectiveness when the law is complex and the target population is poorly equipped to handle the complexity.<sup>152</sup> Although the IRS can impose both civil and criminal penalties, these penalties do not significantly affect the overall compliance rate because the penalties are inconsistently applied, the disallowance regime is difficult to administer, and few criminal prosecutions are pursued.<sup>153</sup> Even though there are millions of returns with potential issues, the IRS is unable to pursue them all,<sup>154</sup> and it has likely reached its upper limit of compliance success based on traditional methods.<sup>155</sup> Thus, policy makers should consider the effectiveness of alternative methods,<sup>156</sup> as discussed in Parts III and IV of this Note.<sup>157</sup>

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144. *See id.* at 209.

145. *Id.* at 182–83; *see also* I.R.C. § 6402(m) (2018) (delaying tax refunds for returns that claim the EITC until February 15th following the close of the taxable year).

146. Book et al., *supra* note 2, at 209.

147. *Id.*

148. *Id.*; *see discussion infra* notes 321–22 (explaining why EITC claimants are audited at a higher rate).

149. 2018 TREASURY REPORT, *supra* note 65, at 200.

150. Book et al., *supra* note 2, at 209.

151. 2018 TREASURY REPORT, *supra* note 65, at 198–200.

152. Nina E. Olson, *Procedural Justice for All: A Taxpayer Rights Analysis of IRS Earned Income Credit Compliance Strategy*, 22 *ADVANCES IN TAXATION* 1, 27 (2015).

153. Book et al., *supra* note 2, at 222.

154. *Id.* at 209.

155. *Id.* at 221. Although the government could theoretically increase compliance by increasing audits and penalties, such a policy is not necessarily cost-effective for the government. DeLaney Thomas, *supra* note 139, at 619. Increased audits and penalties for EITC beneficiaries is even less cost effective since the program targets low- and middle-income taxpayers.

156. Book et al., *supra* note 2, at 222.

157. *See infra* Parts III and IV.

*F. The Limits of Rational Choice Theory*

Policy analysis within the rational choice framework has limited use,<sup>158</sup> as it rests on the flawed assumption that individuals will rationally maximize their utility.<sup>159</sup> Unfortunately, individuals often fail to maximize their utility in line with economic models, and, instead, make flawed assessments of both present and future preferences.<sup>160</sup> Rather than being true utility maximizers, individuals have limits to their rationality, willpower, and self-interest.<sup>161</sup> These concepts are referred to as bounded rationality, bounded willpower, and bounded self-interest, respectively.<sup>162</sup> Bounded rationality demonstrates that individuals have “limited computational skills and seriously flawed memories.”<sup>163</sup> Bounded willpower means that individuals behave in ways that they know are at odds with their long-term interests.<sup>164</sup> Finally, bounded self-interest conveys that individuals care about other individuals, even strangers, in such a way that limits their own self-interest.<sup>165</sup>

Because such behavioral irrationalities exist, increasing benefit take-up within a rational choice framework only results in small net social welfare gains.<sup>166</sup> Professor Goldin elucidates the logic of this as follows:

Intuitively, when nonparticipation decisions are rational, those induced to participate by a change in policy will be near indifferent between participating and not participating. In contrast, when nonparticipation decisions are magnified by behavioral frictions, policies that raise participation make the new participants better off by a more substantial amount (where the size of the welfare gain depends on the magnitude of the behavioral friction that was standing in the way of enrollment).<sup>167</sup>

The traditional economic deterrence model, grounded in cost-benefit analysis based on penalty amount and detection probability, does not adequately explain the high levels of tax compliance in the United States.<sup>168</sup> One explanation for this is that the traditional approach to evaluating noncompliance ignores the psychological cost of tax evasion—individuals may experience psychological discomfort when they cheat on taxes, which may deter the cheating.<sup>169</sup>

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158. See Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1546 (1998).

159. See *Id.* at 1476–78.

160. See Daniel Kahneman & Richard H. Thaler, *Anomalies: Utility Maximization and Experienced Utility*, 20 J. ECON. PERSPECTIVES 221, 222 (2006).

161. Jolls et al., *supra* note 158, at 1476.

162. *Id.*

163. *Id.* at 1477.

164. *Id.* at 1479.

165. *Id.*

166. See Goldin, *supra* note 8, at 67.

167. *Id.* at 67–68 n.48.

168. Olson, *supra* note 152, at 3–4.

169. DeLaney Thomas, *supra* note 141, at 619.



### III. BEHAVIORAL BIASES AFFECTING THE EITC

Some researchers have proposed the application of cognitive and social psychology to the tax system<sup>170</sup>—a behavioral economics approach. The field of behavioral economics applies cognitive and social psychology to economic decision making because the traditional cost-benefit analysis economic framework is often inadequate.<sup>171</sup> The tax system is well-suited for a behavioral economics framework since the cost-benefit model fails to explain compliance rates.<sup>172</sup> Moreover, policy reforms that reduce behavioral frictions are likely to have a greater impact than those that merely impact cost-benefit analysis.<sup>173</sup>

#### *A. Cognitive Burden*

Professor Leslie Book and his coauthors previously utilized the behavioral economics framework of cognitive burden to evaluate EITC compliance.<sup>174</sup> The well-established “law of less work” demonstrates that people are lazy—that is, they prefer less work to more.<sup>175</sup> Although the original formulation of the law of

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170. Book et al., *supra* note 2, at 222; see STEVEN M. SHEFFRIN, TAX FAIRNESS AND FOLK JUSTICE 19 (2013) (“The most fruitful area [for further taxation research] is the realm of social psychology... A second and closely related field is social cognitive psychology . . . .”); see also Olson, *supra* note 152, at 5 (explaining that perceptions of fairness in the tax system influence compliance).

171. Sendhil Mullainathan & Richard H. Thaler, *Behavioral Economics*, LIBR. ECON. & LIBERTY, <https://www.econlib.org/library/Enc/BehavioralEconomics.html> (last visited May 6, 2021).

172. See Olson, *supra* note 152, at 3–4 (arguing that the cost-benefit model fails to explain the high compliance rate in the U.S. tax system).

173. See Goldin, *supra* note 8, at 67 n.48 (“[W]hen nonparticipation decisions are magnified by behavioral frictions, policies that raise participation make the new participants better off by a more substantial amount (where the size of the welfare gain depends on the magnitude of the behavioral friction that was standing in the way of enrollment)”; see also Jacob Goldin & Daniel Reck, *Rationalization and Mistakes: Optimal Policy with Normative Ambiguity*, 108 AEA PAPERS & PROC. 98, 100 (2018) (explaining that individuals who chose not to participate in a social benefit program because of a behavioral bias are “discretely better off” when induced to participate when compared to individuals who chose not to participate based purely on cost-benefit analysis); Sendhil Mullainathan, Joshua Schwartzstein & William J. Congdon, *A Reduced-Form Approach to Behavioral Public Finance*, 4 ANN. REV. ECON. 511, 520–21 (2012) (comparing the utility functions of rational agents and behavioral agents and finding that the envelope theorem does not hold in the behavioral model—marginal agents in the behavioral model are not truly indifferent between action and inaction).

174. Book et al., *supra* note 2, at 230.

175. See CLARK L. HULL, PRINCIPLES OF BEHAVIOR: AN INTRODUCTION TO BEHAVIOR THEORY 294 (1943) (“If two or more behavior sequences, each involving a different amount of energy consumption or work [], have been equally well reinforced an equal number of times, the organism will gradually learn to choose the less laborious behavior sequence leading to the attainment of the reinforcing state of affairs. This corollary applies to a very extensive range of phenomena subsumable under the *law of less work* . . . .”). The principle is still widely accepted. See, e.g., M.E. Walton et al., *Weighing Up the Benefits of Work: Behavioral and Neural Analyses of Effort-Related Decision Making*, 19 NEURAL NETWORKS 1302, 1311 (2006) (validating the behavior of weighing of work constraints against relative rewards using behavioral and neural analyses of animals). Other fields, such as economics, also affirm that individuals choose actions to minimize effort. See Wouter Kool, Joseph T. McGuire & Zev B. Rosen, *Decision Making and the Avoidance of Cognitive Demand*, 139 J. EXPERIMENTAL PSYCH. GEN. 665, 665 (2010) (citing theoretical and empirical studies from both psychology and economics that validate the law of less work).

less work addressed physical effort,<sup>176</sup> psychologists have generally assumed that it extends to cognitive effort as well.<sup>177</sup> Now, there is direct experimental evidence that supports a “law of least mental effort.”<sup>178</sup> To prove the law of least mental effort, researchers have had participants choose between two actions with different cognitive demands. In each experiment, the participants demonstrated a bias toward the less demanding choice.<sup>179</sup> Notably, the bias did not result merely from error-minimizing strategies, long experiments, an ability to describe how the choices differed, or a desire to finish the task as quickly as possible.<sup>180</sup>

Research suggests that antipathy towards cognitive burden can prevent individuals from taking truly “free” money.<sup>181</sup> One study evaluated a distinct class of individuals: employees older than 59 and a half, eligible for employer matching 401(k) contributions, who were at least partially vested,<sup>182</sup> and could withdraw from their 401(k) for any reason without penalty.<sup>183</sup> For these individuals, contributing less than the match threshold to their investment portfolio was not ideal, as they should rationally have contributed an amount equal to the match threshold.<sup>184</sup> Any additional dollar they invested up to the match threshold resulted in additional funds being deposited by their employer with no strings attached; both the deposited and matched funds could be immediately withdrawn and used for any purpose—quite literally an opportunity for free lunch.<sup>185</sup> Surprisingly, over one-third (36%) of the eligible employees in the study contributed below the threshold, losing an average of \$507 per year (1.6% of their annual pay).<sup>186</sup> Survey data revealed that transaction costs could not explain the failure of these individuals to exploit the financial opportunity.<sup>187</sup> Moreover, information campaigns did not produce a statistically significant increase in contributions either.<sup>188</sup>

Further, there is evidence of this burden-minimizing behavior in the tax system. Most taxpayers outsource their tax filing responsibilities to third parties even when the return is relatively simple.<sup>189</sup> Therefore, the informational and

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176. See HULL, *supra* note 175, at 294–95 (discussing the law of less work in terms of “physical dynamics”).

177. See GORDON W. ALLPORT, THE NATURE OF PREJUDICE 20 (1954) (asserting that “[w]e like to solve problems easily,” in the context of categorical thinking); see also Kool et al., *supra* note 173, at 666 (citing a study that evaluates the analogical relationship between mental and physical effort and another that evaluates the relationship between mental and physical effort from a normative perspective).

178. See Kool et al., *supra* note 175, at 678.

179. *Id.*

180. See *id.*; see also *id.* at 677 (adding that another experiment suggested that mental effort could be increased through the use of a monetary reward, although the structure of the study has limited analogical benefit to the EITC).

181. See James J. Choi, David Laibson, Brigitte C. Madrian, *\$100 Bills on the Sidewalk: Suboptimal Investment in 401(k) Plans*, 93 REV. ECON. STAT. 748, 761 (2011).

182. *Id.* at 748 (noting that employees can keep at least a portion of the matched contributions even if they immediately leave the firm).

183. *Id.* at 761.

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.*

189. Book et al., *supra* note 2, at 230–31.

computational complexity<sup>190</sup> of the EITC may serve as an additional potential source of burden-minimizing behavior. Even if an individual would benefit from claiming the EITC, they may refrain from doing so because filing for the EITC requires more physical and cognitive effort than filing a normal tax return. For non-filers, filing taxes imposes more significant physical and cognitive burdens than not doing so.

Finally, the theory of cognitive burden relates to an individual's fears of being audited. Audits are both physically and cognitively demanding due to the time and difficulty associated with gathering documents and conducting correspondence.<sup>191</sup> The concept of cognitive burden may help explain why audit risk deters individuals from claiming the EITC to begin with, as well as why some individuals do not meaningfully complete audits.<sup>192</sup>

### *B. Affect-Rich Distortion*

Affect-rich subject matter may also affect EITC claims. Affect refers to the “faint whisper of emotion” that plays a role in an individual's interpretations of risk and reward.<sup>193</sup> Research suggests that emotion-laden (affect-rich) outcomes can have an outsized effect on economic decision-making.<sup>194</sup> Similarly, if an event is salient (easily recallable), individuals are likely to overstate the likelihood that the result will occur.<sup>195</sup>

Although being audited is a low-probability event, empiricists demonstrate that EITC claimants are more likely to be audited than the average taxpayer.<sup>196</sup> Audits are likely an affect-rich activity given that experiencing an audit “induces strong negative emotions.”<sup>197</sup> Along with being affect-rich, audits have the

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190. See Goldin, *supra* note 8, at 73 (describing informational and computational complexity).

191. See Liz Pulliam Weston, *Low Incomes More Prone to Audits by IRS*, L.A. TIMES (Apr. 16, 2000), <https://www.latimes.com/archives/la-xpm-2000-apr-16-mn-20299-story.html> (explaining that correspondence audits take an average of one hour for the auditor and result in over \$2,000 in additional taxes and penalties, whereas face-to-face audits take nearly twelve hours and result in over \$7,000 in additional taxes). Given that the onus of document collection falls on the taxpayer, the hourly demands of both correspondence and face-to-face audits are likely higher for the taxpayer than the auditor.

192. See Book et al., *supra* note 2, at 193–94 (explaining that some individuals fail to participate meaningfully in audits).

193. See Paul Slovic, Melissa L. Finucane, Ellen Peters & Donald G. MacGregor, *Risk as Analysis and Risk as Feelings: Some Thoughts about Affect, Reason, Risk, and Rationality*, 24 RISK ANAL. 311, 312 (2004).

194. See Yuval Rottenstreich & Christopher K. Hsee, *Money, Kisses, and Electric Shocks*, 12 PSYCH. SCIENCE 185, 186–88 (2001). Affect-rich penalties, such as an electric shock, cause people to overweight small probabilities and underweight large probabilities relative to affect-poor penalties, such as a cash penalty. See also *id.* at 188 (providing a detailed description of the study's methodology).

195. See Cass R. Sunstein, *Terrorism and Probability Neglect*, 26 J. RISK & UNCERTAINTY 121, 121 (2003) (explaining that in the aftermath of a terrorist attack, individuals are more likely to exaggerate the risk of another terrorist attack, as it is salient).

196. See Book et al., *supra* note 2, at 209.

197. BRIAN ERARD ET AL., TAXPAYER ADVOCATE SERV., WHAT INFLUENCE DO IRS AUDITS HAVE ON TAXPAYER ATTITUDES AND PERCEPTIONS? EVIDENCE FROM A NATIONAL SURVEY 96 (2018), [https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/11/ARC18\\_Volume2\\_04\\_InfluenceAudits.pdf](https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/11/ARC18_Volume2_04_InfluenceAudits.pdf).

Further, individuals who view tax payments as money that is taken from them especially respond to an audit with fear, and also feel “angry, threatened, and cautious.” *Id.* at 106.

potential to be a salient outcome, especially for individuals who have recently been audited, heard about the possibility of being audited, or know someone who has been audited. Given that individuals overweight small probabilities of both affect-rich and salient outcomes,<sup>198</sup> individuals may overstate the increased risk of being audited if they claim the EITC (as it is a low-probability and potentially salient outcome), thus enhancing the size of the deterrent impact of EITC-focused audits.

### C. *Default Heuristic*

Another behavioral bias that may contribute to EITC non-claiming is the status quo bias, also referred to as the default heuristic.<sup>199</sup> This bias relies on the principle of sticking with the default choice, regardless of the benefits of switching away from it.<sup>200</sup>

By arranging a more desirable outcome as the default option, default rules deploy the same inertial force that cause inaction, such as a failure to save, to induce positive action, such as saving.<sup>201</sup> Three factors contribute to the success of a default rule: (1) the costly nature of opting out of a default; (2) the varying opt-out costs over time, which create an incentive to opt-out when costs are low; and (3) the procrastination-prone nature of many individuals.<sup>202</sup> These factors cause the default option to be “sticky”<sup>203</sup>—in other words, individuals tend to stick with the default option. The power of default rules is displayed in retirement savings, where default 401(k) enrollment significantly increases savings.<sup>204</sup>

Further study of 401(k) default rules reveals that requiring active decisions (that is, not having a default at all and insisting on an explicit choice)<sup>205</sup> is preferable to either an opt-in regime (where the default is no enrollment) or opt-out regime (where the default is enrollment), so long as decision makers “have relatively heterogeneous savings preferences and a strong tendency to procrastinate.”<sup>206</sup> However, when decision makers have low levels of financial literacy, opt-out models are likely to produce better results.<sup>207</sup>

These studies demonstrate the power of status quo inertia in decision-making. This inertia might help explain the phenomenon of EITC-eligible individuals

198. Rottenstreich & Hsee, *supra* note 194, at 188.

199. KEITH E. STANOVICH, WHAT INTELLIGENCE TESTS MISS: THE PSYCHOLOGY OF RATIONAL THOUGHT 82 (2009).

200. *See id.*; Eric J. Johnson, John Hershey, Jacqueline Meszaros & Howard Kunreuther, *Framing, Probability Distortions, and Insurance Decisions*, 7 J. RISK & UNCERTAINTY 35, 48 (1993) (providing more detailed information on the default bias in the context of an insurance policy study).

201. *See* Richard H. Thaler & Shlomo Benartzi, *Save More Tomorrow™: Using Behavioral Economics to Increase Employee Saving*, 112 J. POL. ECON. S164, S185 (2004).

202. James J. Choi, David Laibson, Brigitte C. Madrian & Andrew Metrick, *Optimal Defaults*, 93 BEHAV. ECON. PUB. POL'Y & PATERNALISM 180, 180 (2003).

203. Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 UNIV. CHI. L. REV. 1159, 1171 (2003).

204. Madrian & Shea, *supra* note 86, at 1150 (finding that default enrollment substantially increases 401(k) participation and that individuals tend to maintain the default level of saving); Thaler & Benartzi, *supra* note 199, at S184–85.

205. Gabriel D. Carroll, James J. Choi, David Laibson, Brigitte C. Madrian & Andrew Metrick, *Optimal Defaults and Active Decisions*, 124 Q. J. ECON. 1639, 1639–40 (2009).

206. *Id.* at 1671.

207. *See id.* at 1667–68.

continuing not to claim the credit and EITC-eligible non-filers continuing not to file taxes. Thankfully, studies of default rules indicate that the power of inertia can be harnessed to maintain a desired outcome, such as EITC take-up. The application of default rules to the EITC is expanded in Part IV(B) below.<sup>208</sup>

#### IV. EXISTING POLICY PROPOSALS

Professor Book and his colleagues have identified three factors that are valuable for policy makers to consider when evaluating reforms to the EITC: “(1) the effect on tax compliance, (2) the effect on eligible taxpayers’ willingness to claim the tax benefit, and (3) the overall cost/burden the measure entails for government and the entire tax ecosystem.”<sup>209</sup> It is important that these factors be considered concomitantly. Generally, policy reforms, including behavioral methods, can have two divergent impacts on a target outcome: facilitation or friction.<sup>210</sup> Professor Calo, who coined these concepts, defines facilitation as “helping citizens develop and consummate their intentions,”<sup>211</sup> and friction as “creating barriers—physical or otherwise—to the conduct citizens would otherwise carry out.”<sup>212</sup> Given that there are both overclaim and nonclaim issues with the EITC,<sup>213</sup> nuanced solutions are necessary. Solutions to overclaiming will likely add friction to the EITC system—creating barriers between intentional or unintentional overclaiming. In contrast, methods to stimulate take-up will likely warrant facilitation—tearing barriers down between eligible individuals and the EITC. Policies that generate too much friction may reduce take-up; policies that facilitate take-up too leniently may increase overclaims. However, a well-tailored set of policies should effectively facilitate take-up while inhibiting overclaims.

##### *A. Reminders as a Nudge*

One popular solution to irrational behavior is the nudge, which Richard Thaler and Cass Sunstein define as “any aspect of the choice architecture that alters people’s behavior in a predictable way without forbidding any options or significantly changing their economic incentives.”<sup>214</sup>

Generally, economic models suggest that nudges are an important tool for overcoming behavioral biases.<sup>215</sup> Reminders are an empirically effective form of

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208. *See infra* Part IV(B).

209. Book et al., *supra* note 2, at 226.

210. Ryan Calo, *Code, Nudge, or Notice?* 99 IOWA L. REV. 773, 801–02 (2014).

211. *Id.* at 777.

212. *Id.*

213. *See* discussion *supra* Parts I(C) and I(D).

214. For information on nudges, *see* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 6, 74–75 (2008); METTE TRIER DAMGAARD & HELENA SKYT NIELSEN, EUROPEAN EXPERT NETWORK ON ECON. OF EDUC., THE USE OF NUDGES AND OTHER BEHAVIORAL APPROACHES IN EDUCATION 14 (2017), <https://op.europa.eu/en/publication-detail/-/publication/30b214a1-f4df-11e6-8a35-01aa75ed71a1/language-en>.

215. *See* Mullainathan et al., *supra* note 173, at 519–20, 522–23 (highlighting the importance of nudges as a policy tool based on a utility function that incorporates behavioral biases). However, even when a nudge successfully changes behavior, the change may not improve social welfare. *See id.* at 530.

informational nudge. Studies show that reminders can help increase savings,<sup>216</sup> enhance credit scores for low-credit individuals,<sup>217</sup> raise return rates for library books,<sup>218</sup> boost vaccination rates,<sup>219</sup> and even aid workplace goal completion.<sup>220</sup> At first glance, reminders appear to be a facially good solution for EITC take-up, as filing for the EITC, which is done once a year, seems analogous to the one-time activities to which Karlan and his colleagues suggest reminders are well-suited.<sup>221</sup>

Surprisingly, a large field study found that text message nudges are unsuccessful in addressing the nonclaim problem.<sup>222</sup> A team of researchers in California implemented a series of randomized controlled trials to evaluate the

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For example, individuals nudged to increase retirement savings may have been better off not saving. *See id.* Similarly, individuals who would suffer a net burden by filing taxes and claiming the EITC would be made worse off by an inducement to file taxes.

216. Karlan et al., *supra* note 87, at 24 (developing a model of savings and consumption behavior that predicts both that reminders to save will increase savings and “reminders mentioning a particular future expenditure will be especially effective,” then verifying these predictions with field experiments). Karlan and his colleagues found that reminders are most effective when they bring to mind a “particular future goal set by the client” and include the means to achieve that goal (i.e., making a bank deposit). *Id.* They also speculate that too many reminders are ineffective, as individuals will begin to ignore them. *Id.* at 25. Thus, reminders are likely most effective for one-time activities, such as 401(k) enrollment or payment of vehicle registration fees. *Id.* *See also* Felipe Kast, Stephan Meier & Dina Pomeranz, *Under-Savers Anonymous: Evidence on Self-Help Groups and Peer Pressure as a Savings Commitment Device*, 23 (Nat’l Bureau of Econ. Research Working Paper No. 18417, 2012) (“[S]avings can be strongly increased by holding people accountable through simple feedback messages.”). The findings of the study also suggest that policies that facilitate behavioral compliance are likely more effective than traditional economic incentives when the impediment to change is structural, such as a complicated process. *Id.* at 24.

217. Anat Bracha & Stephan Meier, *Nudging Credit Scores in the Field: The Effect of Text Reminders on Creditworthiness in the United States*, 28 (Fed. Reserve, Working Paper No. 15-2, 2014) (finding that text reminders significantly increase credit scores of low-credit individuals, do not affect mid-credit individuals, and harm high-credit individuals). Bracha and Meier clarify that reminders help low-credit individuals reduce their rate of credit use and potentially help them improve their payment patterns. *Id.* In contrast, text reminders seem to make high-credit individuals ease up on their financial discipline and increase the size of their collection accounts. *Id.*

218. Jose Apesteguia, Patricia Funk & Nagore Iriberrí, *Promoting Rule Compliance in Daily-Life: Evidence from a Randomized Field Experiment in the Public Libraries of Barcelona*, 64 EUROPEAN ECON. REV. 266, 282–83 (2013) (finding that email message reminders reduced the number of late-returned items and also sped up returns, especially in the population that was previously worst offending). The conclusion of the study generalizes the findings to rule compliance where the rule is simple, well-defined, and low-penalty. *See id.*

219. Katherine Milkman, John Beshears, James Choi, David Laibson & Brigitte C. Madrian, *Using Implementation Intentions Prompts to Enhance Influenza Vaccination Rates*, 108 PROC. NAT’L ACAD. SCI. 10415, 10418 (2011) (demonstrating that reminder letters are effective in encouraging influenza vaccinations and are even more effective when the letter prompts the recipient to confirm their intention of participating).

220. Ximena Cadena, Antoinette Schoar, Alexandra Cristea & Heber Delgado-Medrano, *Fighting Procrastination in the Workplace: An Experiment*, 34 (Nat’l Bureau of Econ. Research Working Paper No. 16944, 2011) (finding that weekly goal reminders improved employee performance and job satisfaction, but only when coupled with prizes and public recognition).

221. *See* Karlan et al., *supra* note 87, at 25.

222. Linos et al., *supra* note 83, at 15. *But see* Bhargava & Manoli, *supra* note 84, at 3524 (finding that “mere receipt of an informational notice [directly from the IRS] and [EITC] claiming worksheet, just months after the receipt of a very similar mailing, led to higher take-up”). Bhargava and Manoli temper their findings by pointing out that the experimental survey samples used in their study are nonrepresentative, thus the “findings may not generalize to other non-claiming populations *even within the EITC.*” *Id.* (emphasis added).

effect of targeted outreach, including text message nudges, on EITC take-up.<sup>223</sup> The trials included the targeted use of both official California Franchise Tax Board letters and text messages, with either a simple message suggesting that the individual is EITC-eligible, a message providing the estimated benefit amount or a message with detailed information on the closest free tax-preparation site.<sup>224</sup> Shockingly, the nudges increased neither tax filing nor EITC claiming.<sup>225</sup> The researchers responsible for the study interpret their results to mean that “outreach alone is likely not enough to improve take-up among non-filing populations.”<sup>226</sup>

Although the failure of both official letters and text message nudges to increase take-up is puzzling, the behavioral theory of cognitive burden, as discussed above, offers an explanation. Even when money is available with minimal effort, individuals may fail to claim it due to cognitive burden.<sup>227</sup> Moreover, academics suggest that poverty exacerbates the impact of cognitive burden.<sup>228</sup> Economist Sendhil Mullainathan and psychologist Eldar Shafir explain that individuals living in poverty experience scarcity: “having less than you feel you need.”<sup>229</sup> Scarcity tends to dominate the mind, reducing individuals’ mental capacities, fluid intelligence, and impulse control.<sup>230</sup> Minds preoccupied with fighting scarcity have fewer resources to devote to life’s other cognitive demands.<sup>231</sup> Since the EITC is targeted toward low- and mid-income individuals,<sup>232</sup> many of whom may deal with the effects of scarcity, the cognitive burden associated with claiming the EITC, and further amplified by scarcity, may be sufficiently large enough to prevent the efficaciousness of reminders.<sup>233</sup>

### B. Prepopulated Returns

Professor Elizabeth Linos and her colleagues, the researchers who performed the text message nudge study, have advocated for reforms to the EITC that reduce the burden associated with filing taxes and claiming the EITC.<sup>234</sup> To reduce the burden inherent in claiming the EITC, Professor Linos proposes simplifying access

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223. This method would seem to counter the effects of ambiguity aversion. *See supra* Part II(C) discussing ambiguity aversion.

224. Linos et al., *supra* note 83, at 8–9.

225. *Id.* at 15.

226. *Id.* at 23.

227. *See supra* Part II(A) discussing cognitive burden.

228. Greg Rosalsky, *The Limits of Nudging: Why Can't California Get People to Take Free Money?* NPR (Feb. 4, 2020), <https://www.npr.org/sections/money/2020/02/04/801341011/the-limits-of-nudging-why-cant-california-get-people-to-take-free-money>.

229. SENDHIL MULLAINATHAN & ELДАР SHAFIR, SCARCITY: WHY HAVING TOO LITTLE MEANS SO MUCH 4 (2013) (emphasis omitted).

230. *Id.* at 13. The magnitude of the impact is significant as well; Mullainathan and Shafir assert that poverty “reduces a person’s cognitive capacity more than going one full night without sleep. It is not that the poor have less bandwidth as individuals. Rather, it is that the experience of poverty reduces anyone’s bandwidth”.

231. *Id.*

232. CBPP REPORT, *supra* note 1, at 1.

233. *See* Rosalsky, *supra* note 228 (discussing the psychology of scarcity and the complexity of the EITC system as possible explanations for why text message reminders failed to increase EITC take-up).

234. Linos et al., *supra* note 83, at 24–25.

by expanding free tax preparation services and connecting low-income individuals with those services (discussed in the next Subpart),<sup>235</sup> and sending eligible, non-filing households tax returns pre-populated with household data compiled from employer records and other social benefit programs.<sup>236</sup>

Unfortunately, pre-populated returns have significant issues and are unlikely to be workable without significant reforms to the current tax system.<sup>237</sup> Due to the complexity of the tax system, pre-populated returns are likely to result in overpayments because it is onerous to capture the data necessary to calculate all adjustments and deductions.<sup>238</sup> Additionally, the federal tax code is so complex that fewer than five percent of current taxpayers would be eligible for return-free filing.<sup>239</sup> Pre-populated returns require an additional step for EITC claimants, as individuals would have to notify either employers or the IRS as to whether their children qualified them for the EITC.<sup>240</sup>

Professor Linos cautions that pre-populated returns also face issues of data timeliness, accuracy, and availability.<sup>241</sup> She also expresses concerns about the complexity of some households' returns and data privacy issues.<sup>242</sup> The high turnover rate of EITC claimants<sup>243</sup> may also impact the feasibility of pre-populated returns.<sup>244</sup> Moreover, because "pre-populated forms for eligible non-filers would likely be limited to simple returns and the state version of the return," this state-level method would fail to help individuals claim the federal EITC.<sup>245</sup>

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235. *Id.*

236. *Id.* at 24.

237. See Goldin, *supra* note 8, at 101 n.152 (discussing structural changes necessary to implement pre-populated returns).

238. See Jared Walczak, *Are Pre-Filled Forms the Solution to Tax Compliance Costs?* TAX FOUND. (Apr. 9, 2018), <https://taxfoundation.org/pre-filled-forms-solution-tax-compliance-costs/>. Additionally, this system is unlikely to improve compliance, as ordinary individuals struggle to comprehend and comply with even simplified tax regulations. ERIC KIRCHLER, *THE ECONOMIC PSYCHOLOGY OF TAX BEHAVIOUR* 12 (2007).

239. Walczak, *supra* note 238. Return-free filing is analogous to pre-populated returns in the sense that the federal government possesses the information necessary to fill out the tax return. However, pre-populated returns require more action by the taxpayer.

240. John W. Snow, *Report to the Congress on Return-Free Tax Systems: Tax Simplification Is a Prerequisite*, TREASURY DEP'T 23 (Dec. 23, 2003), <https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Return-Free-2003.pdf>.

241. Linos et al., *supra* note 83, at 25. Because EITC eligibility and computations are sensitive to annual changes in family status and income, it is difficult to accurately predict a taxpayer's EITC in advance, especially under an exact withholding system. Snow, *supra* note 240, at 23.

242. Linos et al., *supra* note 83, at 25. The pre-populated return is also referred to as "tax agency reconciliation," in which the government prepares a return based on data from employers and payers of interest and sends it to the taxpayer, who has the option of filing the return as drafted or revising it. Zelenak, *supra* note 85, at 54–55. This method is used in Denmark and Sweden and was successfully deployed in a California state tax pilot program. *Id.* at 55. Unfortunately, pre-populated returns require additional personal information to be shared with both the government and one's employer. Walczak, *supra* note 238.

243. See 2018 TREASURY REPORT, *supra* note 65, at 200 ("[A]pproximately one-third of EITC applicants change each year.").

244. *Cf.* Snow, *supra* note 240, at 23 (explaining that the sensitivity of EITC eligibility to family status and annual income makes it difficult to predict a taxpayer's EITC eligibility in an exact withholding system).

245. Linos et al., *supra* note 83, at 24. Pre-populated returns cannot be used to claim the federal EITC as currently structured because individuals would have to determine whether their children fit the definition



### C. Expanded Access to Tax Preparation Services

Several other researchers have proposed expanding access to tax preparation services in order to increase EITC use.<sup>246</sup> To support this advocacy, there is some evidence that use of a tax preparation service increases the EITC take-up rate.<sup>247</sup> Whereas the overall EITC take-up rate is approximately 80% of eligible individuals, approximately 92% of eligible individuals using a tax preparation service claim the credit.<sup>248</sup> This natural experiment suggests that tax preparation services reduce the complexity associated with claiming the EITC.<sup>249</sup> Given that tax preparation services increase the EITC take-up rate, one method of increasing EITC take-up overall is to increase the use of tax preparation services, particularly by EITC-eligible individuals. If access to tax preparation services also increases tax filing in general, expanded access to tax preparation services may induce some of the EITC-eligible non-filers (who account for almost two-thirds of EITC-eligible non-claimants)<sup>250</sup> to participate in the tax system and claim the credit.<sup>251</sup>

The question then becomes: what measures should be used to connect EITC-eligible individuals with tax preparation services? Professor Jacob Goldin suggests the use of tax credits to offset tax preparation fees but warns that such a subsidy would likely negatively impact tax revenue and may incentivize tax preparation companies to raise their prices (as the government, rather than the consumer, bears the cost).<sup>252</sup> Professor Goldin also urges the expansion of free in-person tax assistance (such as VITA/TCE sites) and free online software (such as Free File).<sup>253</sup> However, given that these options are already available and use of them is quite low,<sup>254</sup> Professor Goldin recommends increased awareness for these free tax filing methods to encourage non-filers to file.<sup>255</sup> Considering that free tax preparation

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of a qualifying child under the EITC and inform either their employer or the IRS of the result. Snow, *supra* note 240, at 23.

246. Alissa Anderson, *Expanding Access to Free Tax Preparation Services is Essential to Making the CalEITC a Success*, CAL. BUDGET & POL'Y CTR. (May 3, 2018), <https://calbudgetcenter.org/blog/expanding-access-to-free-tax-preparation-services-is-essential-to-making-the-cal-eitc-a-success/>; Goldin, *supra* note 10, at 99; Linos et al., *supra* note 80, at 24–25.

247. Goldin, *supra* note 8, at 93.

248. *Id.*

249. *Id.* at 93–94.

250. *Id.* at 71.

251. Linos et al., *supra* note 83, at 25.

252. Goldin, *supra* note 8, at 100; see Edward L. Rubin, *Bureaucratic Oppression: Its Causes and Cures*, 90 WASH. UNIV. L. REV. 291, 316 (2012) (“The presence of the private market in the delivery of tax benefits with large software companies and national chain commercial return preparers may in fact create a different agency incentive, one that takes into account private sector interests rather than the interests of the beneficiaries”).

253. Goldin, *supra* note 8, at 100.

254. Fewer than 3% of taxpayers participate in Free File. *Id.* at 89; see also Anderson, *supra* note 246 (explaining that although 70% of U.S. tax filers are eligible to use Free File, less than 2% of taxpayers use the services). Participation in free VITA and TCE programs is miniscule compared to the number of individuals using paid tax preparation services. *Id.* at 88.

255. *Id.* at 100.

services have very low overclaim rates, encouraging individuals to use these services would likely decrease EITC overclaims as well.<sup>256</sup>

Alissa Anderson, from the California Budget & Policy Center, adds some helpful nuance to these problems and proposals.<sup>257</sup> First, VITA sites are not conveniently placed for low-income individuals. For example, nearly half of the zip codes in California with high shares of potentially EITC-eligible individuals lack VITA sites.<sup>258</sup> Second, VITA sites have limited hours—usually just three to five hours per day, two to four days per week.<sup>259</sup> Third, appointments are limited and walk-in clients have to wait for several hours, limiting the convenience of VITA sites.<sup>260</sup> Finally, VITA sites lack sufficient resources to advertise their services against commercial preparers.<sup>261</sup> Additionally, even eligible individuals may be unaware that free tax services are even available to them.<sup>262</sup> Methods to increase the availability and awareness of free tax preparation methods are an important element of the policy bundle needed to increase take-up and reducing overclaims.

However, even if all EITC-eligible individuals used tax preparation services, it is unlikely that the EITC take-up rate would reach 100%.<sup>263</sup> There are several contributing factors. First, tax preparation services are imperfect—some human preparers may mistakenly conclude that an individual is ineligible, and some software may fail to consider all EITC rules.<sup>264</sup> Second, individuals may voluntarily choose not to claim the EITC credit for a variety of reasons.<sup>265</sup> For example, eligible individuals may refuse to claim the EITC due to stigma associated with claiming a benefit,<sup>266</sup> fear of being audited,<sup>267</sup> or “perceived hassle or effort required to sign up.”<sup>268</sup> Finally, a data discrepancy may underestimate take-up: individuals might report lower income to the Census, whose data is used to calculate the take-up rate, than what they must report to the IRS, which determines actual EITC eligibility.<sup>269</sup> Finally, even if tax preparation services are

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256. IRS-sponsored tax preparation services such as VITA have the lowest rate of EITC overclaims of any preparation method: between 20% and 26%, compared to an average of 42% and 49% overall rate of overclaims. IRS EITC OVERCLAIM STUDY, *supra* note 33, at 26 tbl.9.

257. Anderson, *supra* note 246.

258. *Id.* This data is based on eligibility for the California state version of the EITC.

259. *Id.*

260. *Id.*

261. *Id.*

262. In one survey, 75% of likely-EITC-eligible individuals were unaware of free tax preparation services. *Few Tax Filers Who Were Likely Eligible for the CalEITC Knew That Free Tax Preparation Services Were Available*, CAL. BUDGET & POL'Y CTR., [https://calbudgetcenter.org/wp-content/uploads/EITC-Issue-Brief\\_Fig-4.png](https://calbudgetcenter.org/wp-content/uploads/EITC-Issue-Brief_Fig-4.png).

263. *See* Goldin, *supra* note 8, at 93–94 n.136 (outlining potential explanations for the lack of 100% EITC take-up among EITC-eligible individuals using tax preparation services).

264. *Id.*

265. *Id.*

266. *Id.* at 67; *see also* Currie, *supra* note 60, at 87 (describing stigma as an explanation for low benefit take-up, as well as the relationship between stigma and transaction costs associated with claiming a benefit).

267. *See* Guyton et al., *supra* note 89, at 35 (“[T]here are significant decreases in EITC claiming and tax filing following the audits, but some audited taxpayers may leave benefits on the table by foregoing potentially legitimate EITC claims or not claiming tax refunds based on excess withholding.”).

268. Goldin, *supra* note 8, at 67.

269. *Id.* at 94, n.136.

free, individuals may choose not to endure the cognitive burden associated with filing, even when there is likely to be a financial benefit.<sup>270</sup>

## V. RECOMMENDATIONS

As discussed in Parts II and III above, overclaim and nonclaim issues arise from a mixture of economic and behavioral factors.<sup>271</sup> When a problem has a combination of causes, the ideal system of interventions may combine traditional policy responses and behavioral nudges.<sup>272</sup> Although many of the proposals discussed in Part IV have merit, they each entail unique limitations that can be potentially offset by combining several policy proposals, as discussed below. Individual solutions may not work in isolation but bundling several solutions can prove successful.<sup>273</sup>

Thus, Part V proposes a bundle of traditional and behavioral policy solutions to simultaneously increase EITC take-up and decrease overclaims. Part IV(A) advocates for a simplified EITC that can be calculated based on data already required for a standard tax return; Part IV(B) proposes the use of a default rule that automatically grants the EITC to eligible individuals unless they opt-out; Part IV(C) suggests expanding access to tax preparation services as a way to increase take-up in the non-filing population; Part IV(D) puts forward the idea of an EITC audit rate that is harmonized with the average individual audit rate; Part IV(E) recommends that this policy bundle be publicized using methods that capitalize on behavioral biases.

### A. Simplify the EITC

The most important step in both increasing EITC take-up and decreasing overclaims is simplifying the EITC. Thankfully, the barriers to simplifying the EITC are not insurmountable. As Professor Goldin points out, most of the information required to claim the EITC is also necessary elsewhere on the tax return; thus the EITC has a low *incremental* contribution to tax complexity.<sup>274</sup> For example, all information about the taxpayer required for the EITC is also required to determine taxable income or tax liability except whether one is subject to a two- or ten-year EITC ban.<sup>275</sup> All of the information about EITC qualifying children is

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270. See Choi et al., *supra* note 181, at 761 (explaining that cognitive burden may prevent individuals from performing tasks that can result in no-strings-attached money).

271. See *supra* discussions of overclaims and nonclaims throughout Parts I and II.

272. George Loewenstein & Nick Chater, *Putting Nudges in Perspective*, 1 BEHAVIOURAL PUB. POL. 26, 29 (2017).

273. Cf. TOBIAS A. DORSEY, LEGISLATIVE DRAFTER'S DESKBOOK: A PRACTICAL GUIDE 126 (2010) (discussing the importance of creating a coherent policy solution by "selecting the most appropriate concepts and then fitting them together"); REED DICKERSON, THE FUNDAMENTALS OF LEGAL DRAFTING 59 (1986) (explaining that this stitching several policy concepts together is "unquestionably the most elusive part of drafting. The specific pieces should cover the intended areas, and they should leave no gaps: they should not duplicate each other or overlap, and they should not contradict each other.").

274. Goldin, *supra* note 8, at 79.

275. *Id.* at 77, tbl.1.

also required to calculate the dependent exemption except whether the child's social security number is valid for employment.<sup>276</sup> All of the information needed about other taxpayers with whom the child lived during the year is also necessary for the dependent exemption.<sup>277</sup> All requisite information about other taxpayers with whom the taxpayer lived during the year is also essential for taxable income or tax liability determinations.<sup>278</sup>

With a few minor adjustments to eligibility requirements, EITC eligibility could be determined based on data already required on the tax return. To this end, a 2003 Treasury Report to Congress advocated for adopting uniform definitions across tax provisions, especially a unified definition of the qualifying child (which would allow taxpayers to provide the child's name and social security number to determine child-related tax benefits).<sup>279</sup> Such a proposal has support from other experts, such as Nina Olson with the National Taxpayer Advocate.<sup>280</sup> Because the EITC is intended to be available to individuals in non-traditional family structures, the unification of qualifying child and dependent definitions should be done inclusively rather than exclusively.<sup>281</sup> In other words, the most restrictive definitions should be expanded to be more inclusive, rather than narrowing the inclusive definitions to match the restrictive definitions. By unifying the definition of a qualifying child and moving the onus of EITC ban determination and child social security employment eligibility onto the IRS, the EITC eligibility and payout could likely be determined without an additional filing. This method is in line with the original administration structure of the EITC and requires the IRS to determine EITC eligibility and calculate benefit amounts.<sup>282</sup>

Under this simplified system, the IRS could automatically grant any EITC-eligible individual who files taxes the appropriate amount of EITC. By shifting the responsibility of determining EITC eligibility and payout amounts to the IRS, low- and moderate-income individuals are alleviated from the additional burden of completing and filing the Schedule EIC. They also would no longer have the opportunity to intentionally or unintentionally overclaim the credit aside from placing fraudulent information on their traditional tax return. Such a method would heighten take-up for eligible individuals who are already filing taxes<sup>283</sup> and likely minimize unintentional overclaims of the EITC.<sup>284</sup>

The EITC's definitions and requirements should also be simplified so that eligibility determination and benefit computation can be performed based solely on information already required on a standard tax return. Simplifying the EITC would also help limit the effect of ambiguity and betrayal aversion to the extent that individuals are afraid of putting time and resources into claiming the EITC only to have it be denied or for the claim to result in an audit.

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276. *Id.* at 78, tbl.1.

277. *Id.*

278. *Id.*

279. Snow, *supra* note 240, at 23, 43.

280. 2012 *Annual Report to Congress*, NAT'L TAXPAYER ADVOCATE 507–511 (2012).

281. *Cf.* Drumbl, *supra* note 24, at 275 (cautioning against simplifying the EITC because the provisions are structured to grant the credit to households with non-traditional family structures).

282. PLUEGER, *supra* note 19, at 152.

283. This population accounts for approximately one-third of EITC-eligible individuals who fail to claim the credit. Goldin, *supra* note 8, at 71.

284. Drumbl, *supra* note 24, at 275.

Such simplification is also likely to reduce overclaim errors, as EITC errors are at least partially a function of the program's complexity.<sup>285</sup> Simplification also paves the path for an opt-out EITC model, which is likely to significantly increase take-up, as discussed in Part IV(B) below.<sup>286</sup> The desirability of this reform is modulated by one major caveat: simplifying the EITC and determining eligibility based on the standard tax return would not attend to the EITC-eligible population who does not file taxes.<sup>287</sup> Thus, additional measures targeted at the non-filing population are necessary.

Such simplification is likely to be met with opposition from the tax preparation industry, which has opposed previous efforts at EITC simplification<sup>288</sup> because it reduces the need to rely on a tax preparation service to prepare one's tax returns.<sup>289</sup> However, if the simplified EITC were included in a policy bundle alongside a policy that increased demand for tax preparation companies (as discussed in Part IV(C) below),<sup>290</sup> perhaps this elixir would be more palatable.

### *B. Implement an EITC Default Rule*

Although an opt-out model is not currently feasible due to the EITC requiring unique information not necessary elsewhere on the return,<sup>291</sup> an opt-out model may be a desirable method to increase take-up alongside a simplified EITC system in which eligibility and benefits can be determined based on the standard tax return.<sup>292</sup>

Even when the choice to opt out is available, most individuals stick with the default.<sup>293</sup> The power of default rules with the choice to opt out is exemplified by default rules in retirement savings, which cause more individuals to participate and maintain the default level of savings.<sup>294</sup> Notably, a default rule for EITC claims has a lower financial demand than retirement savings because the claimant need not give anything up, but just file his or her taxes. Thus, a default rule of granting EITC for eligible individuals alongside an opt-out option is likely to increase take-up significantly.

To better understand this default rule proposal, there are two helpful points of comparison within the tax system: "check the box" regulations for business taxation and the automatic distribution of COVID-19 Economic Impact Payments. Check the box regulations allow eligible business entities to elect whether to be classified as a partnership or corporation for federal tax purposes.<sup>295</sup> The check the

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285. HERD & MOYNIHAN, *supra* note 6, at 211. *See also* Drumbl, *supra* note 23, at 275 (agreeing that simplifying would likely reduce taxpayer error when claiming the EITC).

286. *See infra* Part IV(B).

287. This population accounts for approximately two-thirds of EITC-eligible individuals who fail to claim the credit and is thus the more important problem to address. Goldin, *supra* note 10, at 11.

288. HERD & MOYNIHAN, *supra* note 6, at 207.

289. *Id.*

290. *See infra* Part IV(C).

291. *See supra* Part IV(A) discussing the EITC's unique informational requirements.

292. *See* discussion of this proposal *supra* Parts III(C) and IV(A).

293. Sunstein & Thaler, *supra* note 203, at 1160.

294. Madrian & Shea, *supra* note 86, at 1150; Thaler & Benartzi, *supra* note 201, at S184–85.

295. *The Final "Check the Box" Regulations*, J. OF ACCOUNTANCY, <https://www.journalofaccountancy.com/issues/1997/dec/smbus.html> (last visited Feb. 1, 2021).

box regulations also include a default rule that treats an entity as a partnership if it does not otherwise make an election.<sup>296</sup> To opt out of a default classification, a business entity must make an additional filing of Form 8832.<sup>297</sup>

Analogously, under an EITC opt-out system, the IRS would evaluate an individual's EITC eligibility and provide eligible taxpayers with credits by default. If an individual desired not to receive a payment, they could opt out. However, because minimizing cognitive burden is especially important for individual taxpayers, the opt-out method should not require an additional form. Rather it should be done by a single box on the tax form, like electing whether to receive one's tax refund electronically or by mail.

A highly salient example of automatic eligibility determination is the recent COVID-19 Economic Impact Payment. The stimulus checks distributed to Americans below a certain income threshold<sup>298</sup> to offset the effect of COVID-19 were automatic for most taxpayers.<sup>299</sup> The government automatically calculated eligibility and distributed checks based on individual's tax filing data from 2018 and 2019 returns.<sup>300</sup> Notably, the stimulus payments varied based on adjusted gross income and the number of qualifying children, both factors considered for the EITC.<sup>301</sup> This system of determining eligibility for economic impact payments demonstrates that the IRS has the infrastructure necessary to calculate benefit eligibility automatically. So long as the EITC is simplified such that eligibility can be fully determined from the standard tax return, an opt-out EITC system seems feasible.

Automatically opting eligible individuals into the EITC is, by definition, paternalistic, as it is "selected with the goal of influencing the choices of affected parties in a way that will make those parties better off."<sup>302</sup> However, any form of organizational choice is inevitably paternalistic, as it involves normative judgments.<sup>303</sup> Thus, the issue is "how to choose among paternalistic options."<sup>304</sup>

Although encouraging the best choice is favorable, blocking choices (a non-libertarian paternalistic approach) is usually undesirable.<sup>305</sup> In contrast, the theory of libertarian paternalism posits that freedom has intrinsic value,<sup>306</sup> and thus choice should be preserved, even though the rational choice is being promoted.<sup>307</sup> To this end, an option to opt out of claiming the (simplified) EITC should be preserved to allow freedom of choice. Individuals may decline to take the EITC for a variety of

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296. *Id.*

297. *Id.*

298. *A Guide to COVID-19 Economic Stimulus Relief*, CONSUMER FIN. PROTECTION BUREAU, <https://www.consumerfinance.gov/about-us/blog/guide-covid-19-economic-stimulus-checks/> (last visited Feb. 16, 2021).

299. *Economic Impact Payments*, INTERNAL REVENUE SERV., <https://www.irs.gov/coronavirus/economic-impact-payments> (last visited Feb. 1, 2021).

300. *See* CONSUMER FIN. PROTECTION BUREAU, *supra* note 298.

301. *Id.*

302. Richard H. Thaler & Cass R. Sunstein, *Libertarian Paternalism*, 93 AM. ECON. REV. 175, 175 (2003).

303. *Id.*

304. *Id.*

305. *Id.* at 177.

306. Edward L. Glaeser, *Paternalism and Psychology*, 73 UNIV. CHICAGO L. REV. 133, 151 (2006).

307. Thaler & Sunstein, *supra* note 302, at 177.

non-financial reasons,<sup>308</sup> thus the ability to opt out should be available to allow individuals to act on those reasons, regardless of rationality.

### *C. Expand Access to Tax Preparation Services*

The proposals discussed in Parts V(A) and V(B) primarily benefit individuals who are already filing taxes but not claiming the EITC. Although the reduced burden of claiming the EITC may induce filing by individuals who would file taxes to claim the EITC but for the extra burden, extra measures are necessary to target the largest population of EITC-eligible non-claimants: nonfilers.<sup>309</sup> Expanding access to tax preparation services is the best way to induce nonfilers to participate in the tax system. There are at least two avenues to do so: adding free services<sup>310</sup> or subsidizing paid services.<sup>311</sup>

If the limitations of free tax preparation services that Anderson identified in California<sup>312</sup> are present nationwide, resources dedicated to ameliorating those issues in areas with high rates of EITC eligibility would likely improve take-up. Since free tax preparation services have the lowest rate of overclaims,<sup>313</sup> addressing those issues and consequently expanding access would also likely improve overclaims.

To further satiate tax preparation demand and to increase the political viability of reform by appeasing the tax preparation industry lobby, expansions of free tax preparation services should be accompanied by an instrument that reduces the effective cost of tax preparation for individuals who are unable to access a free service.<sup>314</sup> Rather than a tax credit, as Goldin proposed,<sup>315</sup> which could potentially increase the sticker cost of tax preparation,<sup>316</sup> a fixed amount paid to a tax preparation service for every EITC-eligible individual serviced is a more desirable alternative.

Under this fixed-fee model, the government would pay a fixed amount, say \$130,<sup>317</sup> to a tax preparation service for each EITC-eligible individual served. To disincentivize overclaims, the fee could be withheld for each individual later deemed ineligible by an audit, or a penalty could be paid for each overclaim. However, with a simplified EITC and opt-out model as proposed in Parts IV(A) and IV(B), the risk of overclaiming can be lowered by the IRS determining

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308. See *supra* notes 83–90.

309. See Goldin, *supra* note 8, at 71 (characterizing nonfilers as the largest population of EITC-eligible nonclaimants).

310. Anderson, *supra* note 246; Goldin, *supra* note 8, at 100.

311. Goldin, *supra* note 8, at 100.

312. Anderson, *supra* note 246.

313. IRS-sponsored tax preparation services such as VITA have the lowest rate of EITC overclaims of any preparation method: between 20% and 26%, compared to an average of 42% and 49% overall rate of overclaims. IRS EITC OVERCLAIM STUDY, *supra* note 33, at 26 tbl.9.

314. See Goldin, *supra* note 8, at 100 (advocating for a tax credit to offset the cost of tax preparation).

315. *Id.*

316. *Id.*

317. This represents the average cost of tax preparation for nonbusiness taxpayers. 1040 INSTRUCTIONS, *supra* note 90, at 100.

eligibility.<sup>318</sup> Paying tax preparation services per EITC claimant will increase administration costs, but the net administrative cost impact will be mitigated by the reduction in overclaims associated with accompanying reforms. Moreover, even if this fee were paid for every eligible EITC-claimant, the EITC would still likely be more efficient to administer than other programs.<sup>319</sup> Finally, incentivizing tax preparation companies to prepare returns for EITC-eligible individuals encourages these companies to invest in outreach efforts, further boosting take-up.

#### D. Harmonize EITC Audit Rate

One method to address the fear of audits associated with the EITC is to harmonize the rate of EITC audits with the average rate of individual audits. The IRS is tasked with enforcing tax laws against more taxpayers than its resources allow.<sup>320</sup> Thus, the IRS must decide which tax laws to enforce and against which taxpayers.<sup>321</sup> In making these decisions, the IRS can decline to enforce tax aspects for a given period of time (“categorical nonenforcement”), focus enforcement on specific laws or taxpayers (“setting priorities”), or nominally enforce all tax laws, leaving the decision of which laws to enforce and against whom to individual agents (“case-by-case decision making”).<sup>322</sup> Currently, IRS enforcement is focused disproportionately on EITC claimants.<sup>323</sup> The emphasis on EITC enforcement is a result of a “general congressional mandate and specific appropriation to increase EITC compliance activities.”<sup>324</sup> Although categorical nonenforcement of EITC overclaims would likely signal acquiescence to noncompliance, simple underenforcement may be possible without sending such a signal.<sup>325</sup>

There are two ways in which the IRS can harmonize the EITC audit rate with the overall audit rate: decrease the amount of EITC audits or increase the amount of non-EITC audits.<sup>326</sup> Because EITC audits are easier and cheaper to complete than traditional audits, the IRS is unable to simply shift resources away from EITC audits to more complex audits—there is a dearth of employee experience and

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318. See discussion of these proposals in Parts IV(A) and IV(B) *supra*.

319. Approximately 25 million households are EITC-eligible with an average benefit amount of \$1,551. Goldin, *supra* note 8, at 70. A \$130 fee per return would result in \$3.25 billion in administrative costs, compared to a total of \$38.75 billion in payouts. This is an 8.38% expense ratio, still lower than the average 16 percent expense ratio of other transfer programs. See Bhargava & Manoli, *supra* note 84, at 3522 (listing the average expense ratio of other transfer programs at 16%).

320. Leigh Osofsky, *The Case for Categorical Nonenforcement*, 69 TAX L. REV. 73, 74 (2015).

321. *Id.*

322. *Id.*

323. See Book et al., *supra* note 2, at 209 (noting an audit rate of 1.6% of EITC returns compared to 0.9% of all taxpayers); 2018 TREASURY REPORT, *supra* note 65, at 200 (showing that EITC claimants were audited at twice the rate of the national average).

324. Leslie Book, *The IRS's EITC Compliance Regime: Caught in the Net*, 81 OR. L. REV. 351, 373 (2002). For a more detailed explanation of the shift, see *id.* at 373–74 n.71. Congressional targeting of EITC claimants arose from disapproval of social spending programs and reports of erroneous EITC claims. *Id.* at 372 n.63. Congress allocated nearly \$750 million over a five-year period specifically for EITC audits. *Id.* at 373.

325. Lawrence Zelenak, *Custom and the Rule of Law in the Administration of the Income Tax*, 62 DUKE L. J. 829, 834 (2012).

326. Some combination of these two approaches is also possible.



skillset.<sup>327</sup> Additionally, the IRS is unable to simply increase the number of audits of non-EITC individuals because it lacks the financial resources to do so.<sup>328</sup> Thus, harmonizing the EITC audit rate with the national rate would require a reduction in the number of EITC audits. Although a massive shift in audit resources to non-EITC claimants is not possible, perhaps some audit refocusing could occur. Additionally, an IRS funding increase could help harmonize the audit rate by increasing the number of non-EITC audits that occur.

There are a few justifications for underenforcement against EITC overclaims, or at least a level of enforcement in line with enforcement rates against the average taxpayer. First, audits of EITC claimants provide a diminutive return relative to the audit rate.<sup>329</sup> From a pure tax-maximizing perspective, audit resources would likely result in more taxes owed if focused elsewhere.<sup>330</sup> Second, the resources lost to EITC overclaims may not be truly wasted from a social welfare perspective, as the additional value is going to EITC-eligible households or households “quite similar to eligible EITC families.”<sup>331</sup> Finally, moving the EITC audit rate in line with the national rate may incentivize EITC take-up by destigmatizing the credit.<sup>332</sup>

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327. Letter from Charles P. Rettig, Commissioner of the Internal Revenue Service, to Ron Wyden, Ranking Member, Committee on Finance, United States Senate 4 (Sept. 6, 2019), <https://www.documentcloud.org/documents/6430680-Document-2019-9-6-Treasury-Letter-to-Wyden-RE.html>.

328. Paul Kiel, *IRS: Sorry, but It's Just Easier and Cheaper to Audit the Poor*, PROPUBLICA (Oct. 2, 2019), <https://www.propublica.org/article/irs-sorry-but-its-just-easier-and-cheaper-to-audit-the-poor>.

329. Book et al., *supra* note 2, at 209 (stating that EITC audits resulted in less than 7% of additional tax owed, even though 39% of all individual income tax audits were of EITC claimants).

330. For example, corporate audits—the IRS spends approximately 20% of its resources auditing large businesses, but these audits result in over two-thirds of additional taxes owed. Osofsky, *supra* note 320, at 86.

331. Liebman, *supra* note 53, at 1184 (“[O]nly 11 to 13 percent of EITC recipients lacked children in their household at the time they received the EITC. While some of these erroneous payments to households with children are going to households with multiple adults and combined incomes that exceed that of the typical EITC family, many of these ineligible families with children are likely to be quite similar to eligible EITC families.”). Liebman’s study was conducted using a dataset from the 1990 taxable year. *Id.* at 1166. Childless households could only claim the EITC beginning in 1994. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13131(b) 107 Stat. 312, 434 (1993). Although Liebman’s conclusion was about ineligible families with children, it is cross-applicable to ineligible households now, regardless of whether they have a qualifying child; distributing the EITC credit to households similar to EITC-eligible recipients may still have some value. *See id.*, at 1183 (“[I]f many EITC errors are inadvertent and involve payments to low-income families with children we may want to place some value on the transfers to ineligible taxpayers, perhaps assigning them the same social welfare weight as a dollar given to the average taxpayer.”). More recent data suggests this is the case. *See* Maggie R. Jones & James P. Ziliak, *The Antipoverty Impact of the EITC: New Estimates from Survey and Administrative Tax Records*, CTR. ECON. STUD. 24 (Apr. 2019), [https://www2.census.gov/ces/wp/2019/CES-WP-19-14.pdf?mod=article\\_inline](https://www2.census.gov/ces/wp/2019/CES-WP-19-14.pdf?mod=article_inline). (“[A]lthough some EITC is incorrectly paid to ineligibles, much of those dollars target individual tax units that are in poverty.”).

332. *Cf.* Guyton et al., *supra* note 89, at 35 (“[T]here are significant decreases in EITC claiming and tax filing following the audits, but some audited taxpayers may leave benefits on the table by foregoing potentially legitimate EITC claims or not claiming tax refunds based on excess withholding.”).

### *E. Publicize Reforms*

In order to maximize the impact of the reforms discussed above, policy changes must be better promoted using behavioral techniques. For example, in publicizing the EITC, the IRS and other promoting entities should play on loss aversion by stating that EITC entitled individuals will lose hard-earned money if they opt out the EITC. To dispel the fear of audits, outreach campaigns should also specify that individuals receiving the EITC are no more likely to be audited than the average taxpayer. Additionally, campaigns should highlight the ease of receiving the EITC—simply file a tax return and receive the credit if eligible, unless, of course, the taxpayer opts out. Although reminders have mixed results,<sup>333</sup> perhaps they will be more successful in inducing individuals to file taxes (and subsequently receive the EITC) when free tax preparation services are more widely accessible.

## VI. CONCLUSION

The EITC offers substantial economic and social benefits to eligible individuals. To maximize the advantages it provides, policymakers should attempt to ensure that as many eligible individuals as possible are claiming the credit. Conversely, to reduce the administrative costs of the EITC (thus improving the net benefit of the credit), it is important to reduce the number of ineligible individuals claiming the credit and minimize the rate of overclaims. Behavioral economics provides unique insight into mechanisms to address these issues. Factors such as cognitive burden, loss aversion, ambiguity aversion, hyperbolic discounting, affect-driven decision making, betrayal aversion, and the default heuristic contribute to the explanation for incomplete take-up the failure of some existing efforts to increase EITC take-up.

To contemporaneously address the problems of incomplete take-up and overclaims, a bundle of policy solutions, both behavioral and traditional, is optimal. A simplified set of eligibility rules for the EITC would help reduce the cognitive burden associated with the EITC and pave the path for an opt-out model that automatically grants the EITC refunds to eligible individuals, capitalizing on the default heuristic. In combination, these two policies have the potential to increase take-up and reduce overclaims for individuals already filing taxes.

To address the EITC-eligible, non-filing population, efforts to increase tax filing are necessary. Expanded access to free tax preparation services, as well as government payments to tax preparation services to neutralize the financial cost of tax filing for EITC-eligible individuals, may increase the rate of filing. Moreover, harmonizing the audit rate of EITC claimants with the audit rate for the average individual taxpayer may serve to increase filing by reducing the influence of affect-rich audits and perceived betrayal aversion. Finally, these reforms should be publicized in a manner that takes advantage of behavioral biases. For example, the

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333. Compare Linos et al., *supra* note 83, at 15 (finding both official letters and text messages to be ineffective at increasing tax filing and EITC take-up), with Bhargava & Manoli, *supra* note 84, at 3524 (finding official letters to increase EITC take-up).

IRS could capitalize on loss aversion by framing failure to file taxes (or opting-out of the EITC) as a loss of an earned refund.

Although beyond the scope of this Note, areas for future research include determining the exact tax code reforms necessary to make the EITC computable based on a standard tax form without reducing the pool of EITC-eligible individuals, cross-applying the proposed reforms to similar tax credits such as the Child Tax Credit and evaluating the feasibility of direct government payments to tax preparation services as a means of subsidizing tax preparation for low-income individuals.