Insights From Behavioral Economics Can Improve Administration of the EITC

Leslie Book, David Williams, & Krista Holub
The Internal Revenue Service (Service) is a nontraditional but key player in delivering social benefits to the nation’s working poor. In fact, it administers one of the nation’s largest anti-poverty programs: the earned income tax credit (EITC). The EITC is generally praised for its role in reducing poverty and incentivizing low-wage work. While the credit has bipartisan support, the Service continues to face strong criticism over EITC compliance issues.

The Service has generally focused on tax return characteristics in identifying and preventing erroneous EITC claims. We believe that adding an additional focus on taxpayer characteristics may offer new opportunities to improve EITC compliance (and perhaps other areas where there is systemic noncompliance). To supplement existing approaches and build on insights that derive from a taxpayer-centric (rather than tax return-centric) model of compliance, we argue that the Service should draw insights from the field of cognitive psychology. Research in cognitive psychology, a study fundamental to the field of behavioral economics, suggests that people may be more truthful when confronted with increasing psychological costs and a higher perceived likelihood of detection. We offer specific proposals for further exploration. We note that this approach has potential application in other areas of the tax law, but we focus on the EITC because of its broad importance as a matter of national policy, the longstanding and persistent criticism of stubbornly high EITC error rates, and the limitations of the Service’s current approach addressing EITC compliance.

TABLE OF CONTENTS

I. INTRODUCTION ............................................................................................................. 179
II. THE EITC: HOW IT WORKS AND COMPLIANCE CHALLENGES ........ 186
   A. EITC Overview ........................................................................................................... 186
   B. Compliance and the EITC ......................................................................................... 191
1. Measures of the EITC Compliance Problem: A Discussion of Improper Payments and Overclaims.. 191
2. EITC Compliance in Context............................................. 194
3. A Deeper Dive into EITC Noncompliance and the 2014 EITC Overclaim Study............................................. 197
   a. Distribution and Nature of Errors............................... 198
   b. Errors by Preparer Type......................................... 202

III. THE COMPLIANCE PROBLEM: WHAT THE SERVICE DOES AND DOES NOT DO TO REDUCE OVERCLAIMS............................................. 204
   A. Service Efforts to Reduce Overclaims.......................... 204
      1. Measures Directed at Claimants............................... 204
   B. What the Service Does Not Do.................................... 209

IV. TIME TO BROADEN THE COMPLIANCE INQUIRY ...................... 211
   A. Introduction .................................................................. 211
   B. A Brief Review of the Traditional Model of Tax Compliance and Its Relationship to Service Efforts to Drive EITC Compliance .................................................... 213
   C. An Approach to Compliance that Goes Beyond Detection and Penalties.......................................................... 217

V. THE CONTEXT FOR CHANGING THE IRS’S APPROACH TO EITC INTEGRITY TO MEASURES BEYOND AUDITS AND PENALTIES .... 221
   A. Insights from Behavioral Economics.............................. 225
      1. A Brief Theoretical Background on Why Applying Insights from Behavioral Economics May Encourage Voluntary Compliance................................. 225
      2. Specific Proposals.......................................................... 231
         a. Utilizing Data for Targeting and Verification............. 231
         b. Utilizing Behavioral Economics Techniques............ 234
            (1) Tailor or Personalize the Filing Process to Reflect Knowledge of the Taxpayer............................................ 234
            (2) Prompt for Specific Information............................. 235
            (3) Employ Self-Relevant Language........................... 235
            (4) Just-in-Time Communication................................. 236
            (5) Self-Concept Language ....................................... 236
            (6) Including a Jurat or Signature Attesting to the Veracity of the Return.................................................. 236
            (7) Social Proofs.......................................................... 237
            (8) Herd Behavior......................................................... 239
            (9) Inequity Aversion..................................................... 239
            (10) Choice Architecture.............................................. 240
   VI. CONCLUSION .................................................................... 242
I. INTRODUCTION

In addition to its primary role as collector of revenue, the Internal Revenue Service (Service) plays an increasingly important role administering social benefits provisions that are found within the Internal Revenue Code (Code). While tax law has always had substantive provisions that incentivize certain behaviors and provide functions similar to other social programs, over the past few decades Congress has positioned the Service as gatekeeper of benefits — most of which take the form of refundable credits that often generate substantial annual refunds that exceed tax liabilities.

In the summer of 2016, the Service, at Congress’s direction, organized a two-day conference focused on one of the refundable credits it administers: the earned income tax credit (EITC). In The Earned Income Tax Credit Summit (its background briefing for the conference), the Service explicitly recognized that it needed help in administering the credit that has become one of the federal government’s most important tools in offsetting poverty and supplementing low-wage work:

The objective of the Summit is to solicit suggestions for new strategic and tactical approaches that will improve EITC administration and increase participation by eligible taxpayers. The Service is reaching out to EITC stakeholders in all sectors — tax industry professionals, state and federal agencies, consumer advocates, and non-government organizations — to discuss ways to reduce EITC errors, mitigate compliance risks, increase participation for eligible

---

* Leslie Book is a Professor of Law at Villanova University Charles Widger School of Law. David Williams is the Chief Tax Officer at Intuit and has held many executive positions at the IRS, including Director of the Earned Income Tax Credit office. Krista Holub is a Program Manager at Intuit and former Project Director at the Center for Social Development at Washington University in St. Louis. The authors wish to thank Katie Pratt, Ellen Aprill, Jennifer Kowall, Dennis Ventry, Leandra Lederman, Kathleen DeLaney Thomas, Michelle Drumbl, and the participants at the Loyola (Los Angeles) University Law School and Indiana Maurer School of Law Tax Policy Colloquia for insights and feedback an earlier draft of this article. The authors are grateful for the research assistance of Sean Caulfield (Villanova School of Law, JD 2017) and John Mickles (Villanova School of Law, JD expected 2018).


EITC populations and ease taxpayer and government burden.3

While the Service’s own background brief for the EITC Summit identifies improving participation as an agency goal, the EITC in fact has a very high take-up rate relative to other benefit programs.4 Moreover, relative to traditional transfer programs, the Service’s direct cost of administering the program is quite low.5 Program integrity, usually measured in terms of overclaim percentages or the overall program percentage of improper payments, was the elephant in the tax administration room and dominated the conversation.6 The Service estimates that anywhere from 28.5% to 39.1% of the EITC is overclaimed, and that approximately 24% of all EITC payments are improper. The Service also estimates that between 43% and 50% of all EITC returns are incorrect, with the lion’s share of those errors benefitting claimants (rather than the government).7

---

3 See Internal Revenue Serv., Earned Income Tax Credit Summit Background Briefing 3 (2016) (on file with authors); see also H.R. Rep. No. 114–194, at 20 (2015) (“The Committee appreciates the meeting the Commissioner convened with tax-preparation firms, payroll and tax refund processors, and state tax administrators to fight tax-refund fraud. The Committee . . . encourages the IRS to convene a similar summit in 2016 to develop strategies for establishing [EITC] eligibility and credible claims without discouraging the participation of legitimate beneficiaries.”).


5 See Michelle Lyon Drumbl, Beyond Polemics: Poverty, Taxes, and Noncompliance, 5 J. Journal Tax Res. 253, 259 (2016) (estimating total program costs on EITC administration is less than 1%); Hoynes & Rothstein, supra note 4, at 4; see also infra note 29 and accompanying text.


Despite there being little understanding (and often heated partisan debate) about whether EITC errors are the result of willful misconduct or innocent mistake, the Service has been a target for its inability to meaningfully reduce the overclaim or improper payment rate over the better part of the last fifteen years. While the EITC has generally received bipartisan support, proposals to expand the EITC often return to the issue of compliance, with critics keying in on errors as likely due to fraud, while proponents generally look to program complexity as a main driver of error. The compliance problem exists despite numerous efforts made by the Service and Congress to combat errors, including approximately 450,000 annual correspondence examinations requiring claimants to send documents to the Service that prove their eligibility after the filing of a tax return, expanded civil penalties giving the Service the power to punish both claimants and preparers, and Service authority to make changes to

---

8 See Holt, supra note 4, at 5 (stating true extent and nature of problem are subjects of stalemated debate between program skeptics and advocates).


10 For example, in the Protecting Americans from Tax Hikes Act of 2015 (PATH) legislation that made permanent some aspects of the child tax credit and EITC that were set to expire in 2016 (such as an increased credit for families with three or more children and increased phase-out range for married couples filing jointly), Congress added additional compliance measures directed at refundable credit integrity. See Leslie Book, Extenders Bill Gives IRS Additional Powers to Impose Penalties on Preparers and Disallow Refundable Credits, PROCEDURALLY TAXING (Dec. 18, 2015), http://procedurallytaxing.com/extenders-bill-gives-irs-additional-powers-to-impose -penalties-on-preparers-and-disallow-refundable-credits/ (stating that number of provisions on PATH are “part of the quid pro quo associated with extensions and sweeteners to refundable credits that largely benefit lower-income and more moderate-income taxpayers”).

11 See Rubin, supra note 9. This article can be placed among other scholarship attempting to unpack the rhetoric surrounding the EITC compliance problem. See Drumbl, supra note 9, at 254–260; see also Holt, supra note 4, at 5.
certain EITC-claiming returns without giving claimants the full-blown pre-assessment court review that other taxpayers enjoy.\textsuperscript{12} Despite these efforts, the Treasury Inspector General\textsuperscript{13} and the Trump Administration\textsuperscript{14} have asked for additional powers to make unilateral changes in EITC-claiming returns that the Service believes may be incorrect and to impose additional civil penalties on claimants.\textsuperscript{15}

Congress also focuses on EITC integrity by requiring the Service to report annually on measures to reduce program errors, routinely holding hearings on the compliance problem associated with the EITC and refundable credits, and directly suggesting that it is time for the Service to consider different approaches to improve its administration of the EITC.\textsuperscript{16} Most recently, the Protecting Americans from Tax Hikes (PATH) Act, enacted in December 2015, imposes mandatory delays in the payment of refunds for returns claiming EITC and certain other


\textsuperscript{13} See generally TREASURY INSPECTOR GEN. FOR TAX ADMIN., 2016-40-036, \textit{WITHOUT EXPANDED ERROR CORRECTION AUTHORITY, BILLIONS OF DOLLARS IN IDENTIFIED POTENTIALLY ERRONEOUS EARNED INCOME CREDIT CLAIMS WILL CONTINUE TO GO UNADDRESSED EACH YEAR} (2016) [hereinafter TIGTA].


\textsuperscript{16} That prodding recently includes directing that the Service collaborate with third party return preparers to consider ways that data-driven analysis can improve compliance and the calling of the EITC Summit itself. See H.R. REP. NO. 114–194, at 22 (2015) (directing Treasury to undergo data-driven analysis to improve EITC compliance working in collaboration with tax preparer community).
refundable credits. The purpose of the delay is to give the Service more time to identify invalid or fraudulent claims prior to making payments.

These measures reflect a consensus that the Service continuing business as usual, through its continued use of traditional audit and penalty-based approach, is unlikely to produce step-change improvements over the current outcomes. This challenge presents an opportunity to entertain different approaches in considering the compliance problem. The timing of the Service’s openness to new solutions and insights for its administration of the EITC coincides with a growing consensus among tax administrators and scholars that the traditional approach of relying on taxpayer audits and penalties has, in the words of Steve Vesperman, Deputy Tax Commissioner of the Australian Taxation Office and a leading innovator in tax administration, “lost its currency and effectiveness.” While that may be an overstatement with regard to the EITC, the reality is that a Service constrained by resource limitations and myriad competing priorities is unlikely to move the needle on EITC compliance with more of the same tactics. New approaches are needed.

In this article, we discuss an approach that may present an opportunity for the Service to increase voluntary compliance by claimants. It is based on research that suggests that by increasing psychological costs and the perceived likelihood of detection through changes in tax forms, disclosure statements, and possible

---


18 Longtime EITC researcher Steve Holt succinctly frames the question facing the Service and Congress:

The choice facing lawmakers and government officials is either to continue muddling through, aware of but not meaningfully addressing the challenges the IRS faces in administering assistance programs such as the EITC to low-income families, or to affirm the advantages afforded by tax-based administration while being honest about the shortcomings and vulnerabilities and making serious efforts to address them. Sensible changes can make the IRS a viable, trusted, and effective administrator of programs delivering important benefits to low-income Americans.

HOLT, supra note 4, at iv.

communication from the Service, people may be more inclined to be truthful in the process of preparing and filing their claims for EITC eligibility and in responding to Service requests to prove eligibility.

In making the recommendations that follow, we acknowledge that much work needs to be done to prove out the ideas we discuss. Our approach, however, draws on a straightforward proposition: the ideal compliance program is one in which the minimum and most cost-effective amount of intervention is applied to compel a given taxpayer to remit the amount of tax owed. In other words, the cheapest and least intrusive type of Service contact (as long as it is effective) makes the most sense — both for a Service seeking to maximize the effectiveness of its limited resources and for a taxpayer seeking to avoid undue burden.

In theory, this sounds great. Using data analytics, the Service would assess not only the amount of tax due but also the characteristics of the taxpayer — specifically with an eye to determining the most effective compliance treatment. The Service would pursue a particular intervention based on that assessment.

The most intrusive mechanisms (e.g., in-person audits and collection activities) would be deployed in cases where data analytics show these mechanisms would be required in order to compel compliance. This would also ensure that taxpayers inclined to comply anyway do not feel like “suckers” for voluntarily complying in a system where bad actors get away with misconduct. Less intrusive approaches (e.g., letters, notices, etc.) would be used in cases where the data indicated the taxpayer would respond appropriately. Even more hands-off approaches could be used in cases where data suggests taxpayers will respond.

As we discuss below, the Service attempts an approach like this today — following a set pattern of escalating compliance and collection activities in a variety of situations. However, as we also discuss, the main tools the Service uses for EITC rely primarily on characteristics of returns rather than characteristics of taxpayers. Moreover, the Service has attracted criticism from various quarters asserting that (1) it has neglected to invest enough resources to ensure that its actions against the most egregious, noncomplying claimants are effective, (2) it has not meaningfully administered a potentially harsh civil penalty regime, and (3) it has made few efforts to criminally prosecute individual claimants who truly are intent on gaming the system. We believe that by focusing on the characteristics and preferences of the taxpayers themselves, the Service may be able to better plan and implement practices that taxpayers will understand and accept, and, if necessary, more effectively deploy traditional
audits and penalty-based approaches for certain taxpayers unwilling to comply with our proposed additional approaches.

We believe that a focus on taxpayer characteristics may offer additional opportunities to improve EITC compliance. That is not to say that the work the Service already does to ensure EITC compliance should somehow be drastically rethought. Rather, we think that a deeper understanding of taxpayers themselves may yield opportunities to improve EITC compliance without the expanded use of more intrusive and costly tools like examinations and civil or criminal penalties. By explicitly tying in administrative and legislative solutions to insights from cognitive psychology, this paper takes the small — but, we believe, important — step of recognizing that the Service and Congress can no longer rely solely on traditional proposals that focus principally on detecting and deterring noncompliance through audits, penalties, and even the expanded summary adjustment powers that the Trump and Obama administrations asked Congress to give the Service.20

Before proceeding, it is fair to address one caution. This paper does not delve into the analysis of taxpayer characteristics in a way that will prove out which taxpayers will respond best to which compliance tools. We leave that exercise to future work, which will be informed by greater access to data and reliance on expertise from behavioral economists and social psychologists. Instead, we propose a variety of areas — such as those that have shown promise in other countries or disciplines — we believe warrant further investigation. That investigation should include not only a consideration of the proposals’ impact on program integrity, but also consider taxpayer and third-party compliance costs and the possible impact that the measures may have in dissuading eligible people to claim the EITC in the first instance.

Part I of the article provides an overview of the EITC, including a summary of how it works and a review of the EITC’s compliance challenges. Part II discusses the ways that the Service seeks to ensure EITC program integrity. Part III discusses how the current approach to controlling for program errors, while protecting billions in revenue, takes no meaningful action over many millions of potentially erroneous claims. Part IV broadens the inquiry and discusses how general insights from cognitive psychology may improve the way the Service administers the EITC. The section concludes by identifying administrative and legislative proposals that may improve program

20 For proposals to increase the Service’s summary assessment powers, see TIGTA, supra note 13, at 12.
integrity, while also recognizing other program goals such as taxpayer participation and sensitivity to additional governmental and taxpayer costs.

II. THE EITC: HOW IT WORKS AND COMPLIANCE CHALLENGES

A. EITC Overview

The EITC is a benefit administered through the tax system that is designed to provide cash assistance to low- or moderate-income Americans who have earned income. As the figure below illustrates, income and family size are the key determinants of eligibility.

---

21 There are many excellent discussions of the history of the EITC and its current place as one of the main federal policies to address poverty and incentivize work. For a historical discussion, see Dennis J. Ventry, Jr., The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit, Making Work Pay: The Earned Income Tax Credit & Its Impact on American Families 15 (Bruce D. Meyer & Douglas Holtz-Eakin eds., 2001). For a discussion of and compilation of current research of the EITC’s impact on addressing poverty and incentivizing work, see Austin Nichols & Jesse Rothstein, The Earned Income Tax Credit (EITC) (Nat’l Bureau of Econ. Research, Working Paper No. 21211, 2015).

22 See INTERNAL REVENUE SERV., supra note 3, at 4.

23 Section 32 of the Internal Revenue Code (Code) authorizes eligible workers with earnings below certain thresholds to receive the Earned Income Tax Credit. The EITC is refundable, meaning the credit can be paid to someone who does not owe any taxes. This summary borrows heavily from U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-16-475, REFUNDABLE TAX CREDITS: COMPREHENSIVE COMPLIANCE STRATEGY AND EXPANDED USE OF DATA COULD STRENGTHEN IRS’S EFFORTS TO ADDRESS NONCOMPLIANCE 4–6 (2016).
The EITC’s complexity derives from its objective of targeting the benefit to the intended beneficiaries — generally the working poor who live with younger or disabled children who are related to the claimant or claimant’s spouse. The EITC divides the eligible population into eight groups that vary by filing status (excluding from eligibility someone who is married but files as married filing separately) and the number of children claimed as qualifying children. A qualifying child must have a valid Social Security number and meet certain age, residency, and relationship requirements. For example, unless the child is disabled, the qualifying child must be younger than nineteen (or twenty-four if a full-time student).

In terms of relationship, if not the claimant’s biological child or grandchild, the child must be the claimant’s adopted child or foster child. Qualification further extends to nieces, nephews, and siblings (and their children). In addition, unless an absence is temporary, the child must live with the claimant in the US for more than half of the year.

In terms of the amount of the benefit, the EITC is subject to a phase-in range, a plateau and a phase-out range, with the ranges differing depending on family status and number of qualifying

---

25 See id. §§ 32(c)(1)(A)(i); 32(c)(3)(A).
26 See id. § 152(c)(2).
27 See id. § 152(c)(1)(B).
children (up to three). To qualify and receive the credit, individuals must meet other specific requirements (such as having a Social Security number and a limited amount of unearned income) and file a tax return.

The EITC “[p]articipation rate is high, approaching close to 80% overall and even higher among individuals with two or more qualifying children,” though a majority of claimants, like all taxpayers, rely on paid assistance in claiming the credit, either through the use of commercial tax return preparers or the purchase of tax preparation software. The tax system’s outsourcing of application costs to third parties stands in contrast to many other benefits programs, which tend to have high direct administrative costs associated with eligibility screening costs (e.g., caseworkers).

Like other provisions in the tax code, the EITC is dependent upon the individual self-identifying overall eligibility and the amount of the benefit (credit) in the tax return itself. Key attributes of eligibility — residency and relationship — are known only to the taxpayer. Therefore, self-attestation is the only way in which eligibility for the credit can be collected without audit or other means of gathering verification outside the tax filing process.

The credit is generally targeted to working taxpayers with children, though there is a small credit available to childless workers

---


30 Book, supra note 28. For a good summary of participation data, including changes over time and variables, including by taxpayer demographics, see Nichols & Rothstein, supra note 21, at 29; see also Chuck Marr et al., EITC and Child Tax Credit Promote Work, Reduce Poverty, and Support Children’s Development, Research Finds, CTR. ON BUDGET & POL’Y PRIORITIES (Oct. 1, 2015), http://www.cbpp.org/research/federal-tax/eitc-and-child-tax-credit-promote-work-reduce-poverty-and-support-childrens.

31 See Holt, supra note 4, at 6 (discussing lack of pricing transparency in return preparation market and costly fees that some preparers, including some bad actors, have passed to claimants).

32 See Crandall-Hollick, supra note 6, at 3 (noting other programs’ administrative costs are significantly higher due to most screening applicants for eligibility prior to issuing benefits); see also Hearing on Internal Revenue Service Oversight Before the Subcomm. on Fin. Servs. & Gen. Gov’t of the H. Comm. on Appropriations, 113th Cong. 31 (2014) (statement of Nina E. Olson, National Taxpayer Advocate) (stating that the Service has pointed out that EITC “[c]urrent administration costs are less than 1% of benefits delivered. This is quite different from other nontax benefits programs in which administrative costs related to determining eligibility can range as high as 20% of program expenditures”).
between the ages of twenty-five and sixty-five. The maximum credit that a taxpayer can receive for tax year 2016 is summarized below.33

<table>
<thead>
<tr>
<th>NUMBER OF QUALIFYING CHILDREN</th>
<th>None</th>
<th>One</th>
<th>Two</th>
<th>Three</th>
</tr>
</thead>
<tbody>
<tr>
<td>MAXIMUM AMOUNT OF CREDIT</td>
<td>$506</td>
<td>$3,373</td>
<td>$5,572</td>
<td>$6,269</td>
</tr>
</tbody>
</table>

Unlike some other tax credits, the EITC is refundable, meaning that in addition to offsetting liability the Service will refund directly to the taxpayer any excess of the credit over the taxpayer’s tax liability.34 While the EITC is not the only refundable credit, it is the largest in terms of both forgone revenue and refunds paid.35 In 2013, taxpayers claimed $68.1 billion in EITC with about $59 billion, or 87%, refunded, with the average EITC claimed amounting to approximately $2400.36

In 2013, nearly 20% of all taxpayers filing individual tax returns claimed the EITC, and approximately 44% of all filers with children receive the EITC.37 Since the EITC’s inception as a temporary provision in 1975, the number of claimants and the amount that those taxpayers claim has grown significantly.38 Most of the EITC that is claimed benefits lower-income taxpayers. For example, 62% goes to taxpayers earning less than $20,000, with almost 48% of that amount going to taxpayers making between $10,000 and $20,000.39

---

34 See CONG. BUDGET OFFICE, supra note 2 (discussing history of refundable tax credits and noting that in 2015 there were four other refundable credits in addition to EITC).
35 See U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 23, at 11 (illustrating lesser amounts paid for other refundable tax credits, such as Child Tax Credit, Additional Child Tax Credit, and American Opportunity Tax Credit).
36 See id. at 11–13 (source of two figures showing refundable credits). Among families with children, in 2013, the average credit claimed was $3,063. See Hoynes & Rothstein, supra note 4, at 1–2 (noting how EITC now “dwarfs” traditional cash welfare, or Temporary Assistance to Needy Families, which in 2013 only reached 1.3 million families, a substantial decline following welfare reform of mid-1990s).
37 See Hoynes & Rothstein, supra note 4.
There are some interesting characteristics of EITC claimants that present challenges for the Service in administering the EITC. For example, approximately 25% of EITC claimants are sole proprietors (people who run unincorporated businesses by themselves), compared to only about 16% of the total taxpaying population. In addition, people filing as head of household (generally an unmarried taxpayer who maintains a home and lives with a qualifying child) make up only 15% of the taxpaying population, but comprise approximately 47% of EITC claimants. There is a significant amount of turnover in the EITC-claiming population as well, with the Service estimating that approximately 1/3 of the population claiming the EITC changes every year.

According to the National Taxpayer Advocate’s 2015 Annual Report to Congress, low-income taxpayers, on average, have certain unique characteristics. Low-income taxpayers generally have less access to education and lower literacy rates. They also struggle to earn income because of limited transportation options and a lack of accessible child-care services. There is also a link between low-income taxpayers and lower English proficiency. The majority of low-income taxpayers have one or more disabilities. Many EITC claimants do not have bank accounts, a circumstance that has been found to have an adverse impact on a taxpayer’s ability to validate their finances for an EITC claim. They also tend to change their residences more frequently than other taxpayers, which negatively impacts their ability to timely respond to Service correspondence.

There is a rich literature discussing the EITC and its role in incentivizing low-wage work and alleviating poverty. For example, research has shown that the EITC plays a major (perhaps the most important) role in transitioning single mothers off of traditional welfare and into the workforce. The sheer number of claimants and amounts that are claimed are a good indicator of the overall

---

40 See id. at 15.
41 See id.
44 For more recent articles, see generally HOLT, supra note 4; Nichols & Rothstein, supra note 21.
45 See Nichols & Rothstein, supra note 21.
importance of refundable credits in terms of federal policy directed at improving the lot of low-wage workers. It is well-known that the EITC and related family status credits (e.g., the child tax credit) have a major impact on reducing poverty. Together, both credits are estimated to have lifted 9.4 million people out of poverty, and the EITC itself has been cited as the single most important provision in terms of lifting children out of poverty. Recent research suggests the income from these tax credits has a multiplier effect that goes far beyond the important but incomplete tabulation of the credits’ impact on poverty rates in a particular year, with the EITC improving children’s educational outcomes in low-income households and improving the health of infants and mothers.

B. Compliance and the EITC

1. Measures of the EITC Compliance Problem: A Discussion of Improper Payments and Overclaims

Despite the success of the EITC in terms of impact, the Service has significant compliance challenges with the program. The Service releases two main measures of EITC noncompliance: improper payments and overclaims, both of which are based on the Service’s National Research Project (NRP) data. The improper payment

---

46 See id. at 33–40.

47 See Marr et al., supra note 30

48 To be sure, the EITC has limitations in terms of its reach, especially among the nation’s poorest that struggle and have little earned income or who suffer from interruptions in earnings. See Sara Sternberg Greene, The Broken Safety Net, 88 N.Y.U. L. REV. 515 (2013); see also Anne L. Alstott, Why the EITC Doesn’t Make Work Pay, 73 L. & CONTEMP. PROBS. 285, 285 (2010); Dennis Ventry, Welfare by Any Other Name: Tax Transfers and the EITC, 56 Am. U. L. REV. 261 (2007).

49 The Service periodically studies noncompliance in the tax system generally. Much of its estimates relating to noncompliance stem from the Services’ National Research Program (NRP). Under the NRP, the Service selects a representative sample of the population and conducts specialized audits of that sample relying on highly trained auditors. The IRS uses the NRP to study tax noncompliance generally and occasionally with respect to specific types of taxpayers or issues, as well as to compile tax gap estimates. See INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL § 4.22.1.1 (2017). For a discussion of the Service’s methodology in using NRP research to compute the improper payment rate, see generally U.S. DEP’T OF TREASURY, supra note 42. For a discussion of the Service’s methodology in using NRP research to compute the overclaim rate, see generally 2014 EITC OVERCLAIM STUDY, supra note 7.
measure considers the credit improperly claimed net of Service enforcement that the Service is required to report annually.\textsuperscript{50} The overclaim percentage is defined as total dollars overclaimed as a percentage of total dollars initially claimed for EITC prior to Service enforcement. Because the improper payment rate accounts for the effects of Service enforcement and the overclaim rate does not, the improper payment rate is always lower than the overclaim rate. Neither the overclaim rate nor the improper payment rate considers that some eligible taxpayers neglected to claim an EITC to which they were entitled; nor does either take into account offsetting errors that may occur if, for example, one parent improperly claims an EITC that another parent or adult could have claimed but did not.\textsuperscript{51} As such, in addition to not taking into account the effect of Service enforcement, the overclaim rate is not reflective of net EITC errors.

The Service releases the overclaim percentage relatively infrequently, with the most recent released in 2014 and looking at 2006 to 2008 tax returns (referred to herein as “2014 EITC Overclaim Study”).\textsuperscript{52} The Service measures improper payments annually pursuant to federal legislation requiring agencies to review programs that are susceptible to significant improper payments.\textsuperscript{53} While the improper payment rate does provide a useful annual snapshot, overclaim figures provide more specific information relating to the taxpayer and tax preparer behaviors contributing to the erroneous claims in the first instance. Accordingly, many researchers looking to

\textsuperscript{50} See Improper Payments Information Act of 2002, Pub. L. No. 107-300, 116 Stat. 2350 (requiring agencies to review programs and activities that are susceptible to improper payments and take actions to reduce improper payments). For federal programs that classify as high risk, one of which is EITC, OMB provides additional oversight and review.

\textsuperscript{51} See 2014 EITC OVERCLAIM STUDY, supra note 7, at 4–5.

\textsuperscript{52} The Service combined the three years to provide a more statistically accurate sample. See generally id. The prior study examined the 1999 tax year and was released in 2002. See generally INTERNAL REVENUE SERV., COMPLIANCE ESTIMATES FOR EARNED INCOME TAX CREDIT CLAIMED ON 1999 RETURNS (2002), https://www.irs.gov/pub/irs-soi/compeitc. pdf.

\textsuperscript{53} See TIGTA, supra note 13, at 5 (noting that the Service’s 2015 improper payment estimates are “based on information from Tax Year 2011 tax returns that were processed in Calendar Year 2012”). As TIGTA notes, the Service uses NRP data to estimate annual EITC improper payment rate, though given the amount of time it takes the Service to complete its annual NRP the Service’s estimate of improper payment rate is based on data that is approximately three years old. See id.
delve deeply into the EITC noncompliance problem and possible solutions focus primarily on the overclaim figures.\textsuperscript{54}

For 2015, the Service estimates the most recent improper payment rate at 23.8\%, with a dollar value of approximately $15.6 billion.\textsuperscript{55} This rate has generally held steady over the years.

The Service estimates that the overclaim percentage is between 28.5\% and 39.1\%, with corresponding dollar values between $14 billion and $19.3 billion annually.\textsuperscript{56} The difference between the lower and upper estimates is attributable to differing estimates concerning the almost 16\% of EITC claimants who failed to respond to or participate fully in the Service’s NRP audits. The upper estimates assume that all of the nonresponders were ineligible to claim the EITC, while the lower estimate assumes that the nonresponders had

\begin{figure}
\centering
\includegraphics[width=\textwidth]{chart.png}
\caption{Estimated Improper Payment Percentage and Dollars (Billions)}
\end{figure}

\textit{Source: Department of the Treasury Performance and Accountability Reports for Fiscal Years 2009 through 2011 and the Fiscal Years 2012 through 2015 Agency Financial Reports.}

\textsuperscript{54} See CRANDALL-HOLLICK, supra note 6, at 2 (noting that when the Service studies the reasons why there are mistaken claims, the Service looks at overclaim figures because ignoring returns where compliance efforts led the Service to recover or prevent erroneous claims would result in “inaccurate estimates of the major factors that lead to incorrect EITC claims”); Olson, supra note 12, at 12 (noting that while improper payment rate provides consistent net measure, overclaim rate allows researchers to “draw observations of taxpayer behavior and better understand the sources of EITC noncompliance”).

\textsuperscript{55} See TIGTA, supra note 13 (“The IRS estimates that 23.8\% ($15.6 billion) of EITC payments were issued improperly in Fiscal Year 2015.”).

\textsuperscript{56} See CRANDALL-HOLLICK, supra note 6, at 5. See generally id. at 9, Figure 3.
a similar rate of noncompliance as the taxpayers who were audited and participated in the Service’s NRP audits.\footnote{57} Whether the lower or upper estimate is more accurate is subject to heated and often partisan debate,\footnote{58} but the noncompliance figures are significant enough to attract scrutiny in either case. In addition, when the Service releases the annual improper payment rate figures for the EITC, it attracts significant media attention,\footnote{59} and it draws attention to program critics who often suggest that the EITC is riddled with fraud.\footnote{60} As EITC researcher Steve Holt has noted, “concerns about error and fraud continue to undermine the credit’s credibility and prevent the program from fully achieving its goals.”\footnote{61}

2. EITC Compliance in Context

How does the EITC compliance problem compare with the overall compliance issues in the tax system?\footnote{62} To answer that question we must consider the overall tax gap figures. The Service’s latest general tax compliance study looks at the 2008-10 tax years, with the Service estimating an overall tax gap of $458 billion.\footnote{63}

\footnote{57 See CRANDALL-HOLICK, supra note 6, at 5; HOLT, supra note 4, at 6.}
\footnote{58 See, e.g., Hearing on Internal Revenue Service Oversight Before the Subcomm. on Fin. Servs. & Gen. Gov’t of the H. Comm. on Appropriations, supra note 32, at 35 n.107.}
\footnote{60 See Rubin, supra note 9.}
\footnote{61 HOLT, supra note 4, at iii.}
\footnote{62 Another useful comparison point is with other spending or transfer programs. The Office of Management and Budget has designated the EITC has one of sixteen “high-error programs” defined as “programs that report $750 million or more in improper payments in a given year, did not report an error amount in the current reporting year but previously reported an error amount over the threshold, or have not yet established a program error rate and have measured components that were above the threshold.” See High-Priority Programs, PAYMENTACCURACY.GOV, https://paymentaccuracy.gov/high-priority-programs (last visited July 25, 2017). Of those high error programs, the EITC ranks third behind Medicaid Fee for Service ($43.3 billion) and Medicaid ($29.1 billion) in total improper payments and first in terms of improper payment rate, just ahead of school breakfasts, which has a 23% improper payment rate). See id.}
underpayment. The estimated gross tax gaps for those components are $32 billion, $387 billion, and $39 billion, respectively. Service enforcement efforts and taxpayers who pay late account for $52 billion. This results in a net tax gap of $406 billion per year, or a voluntary compliance rate of 81.7% and a net compliance rate of 83.7%. The gap attributable to underreporting (the so-called “underreporting tax gap”) far exceeds that associated with underpayment and nonfiling, accounting for 85% of the total tax gap. Of the underpayment gap, 58% of that 85% figure is attributable to the income tax.

There are significant variations in compliance rates for different types of income. The single biggest driver for voluntary compliance is whether the income is subject to information reporting, as illustrated by the figure below:

64 See generally id. Prior to the release of the 2008-10 figures, the Service released estimates for the 2006 year. While there are slight changes in the overall compliance rate (the 2006 estimate pegged voluntary compliance at 83%), the Service estimates that the voluntary compliance rate remains relatively unchanged, with the change due to differences in methodology and inclusion of new tax gap components. See id. at 2.

65 The nonfiling gap accounts for 7% and the underpayment gap accounts for 9%. Id. at 4.

66 See INTERNAL REVENUE SERV., supra note 63.

67 For more on the role of information reporting and tax compliance, see generally Leandra Lederman, Reducing Information Gaps to Reduce the Tax Gap: When is Information Reporting Warranted, 78 FORDHAM L. REV. 1733 (2010). Professor Lederman observes that a core problem for tax compliance is asymmetric information, i.e., the taxpayer knows more about her facts than the government does. She also observes that the government knows more about its enforcement activities than taxpayers. Both aspects of asymmetry help explain why taxpayers are generally compliant when items of income or expenses are reported to the Service, with taxpayers likely thinking that the reporting increases the taxpayer’s perception that the Service would detect noncompliance. See id.; see also Leandra Lederman, Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance, 60 STAN. L. REV. 695 (2007).

68 See INTERNAL REVENUE SERV., supra note 63, at 5.
The largest share of the individual tax gap is attributable to business income, which accounts for approximately $125 billion and 27% of the overall tax gap. Adding in the unreported related self-employment tax suggests that individuals who receive business income that is not reported by third-party payers are the main source of the individual tax gap. Sole proprietors, for example, underreported their income by 63%. When considering the related unpaid self-employment taxes, the underreporting of business income accounts for approximately 41% of the tax gap.

While one can dig deeper into the individual tax gap studies and small business noncompliance in particular, it is useful to bring the discussion back to the EITC. The voluntary compliance rate for the EITC (looking at lower and upper bound overclaim percentage prior

---

69 Id.
70 Id.
71 See id.
to enforcement) is estimated at between 60.9% and 71.5%. This compares to an overall voluntary compliance rate of 81.7%. However, as illustrated above, that voluntary compliance rate is somewhat misleading, as it falls significantly with items that are not subject to information reporting. As noted previously, key factors that drive EITC eligibility — residency and relationship of children — are not subject to and do not lend themselves to third-party reporting. Approximately 20% of all tax returns include the EITC, but total EITC overclaims comprise 3% to 4.2% of the total tax gap, 4.3% to 6.6% of the gross tax gap for individual income, and 5.3% to 7.3% of the underreporting tax gap for individual income. Despite contributing to a relatively small share of the overall or individual tax gap, in some years EITC audits have accounted for approximately 39% of all Service income tax examinations.

3. A Deeper Dive into EITC Noncompliance and the 2014 EITC

---

73 See 2014 EITC OVERCLAIM STUDY, supra note 7, at 11.

74 We computed this using the lower and upper range EITC overclaim amounts as a numerator and the 2008-10 gross tax gap and gross income tax gap figures as denominators. See INTERNAL REVENUE SERV., supra note 63, at 2; supra note 54 and accompanying text. The share of the tax gap attributable to all credits is 9%. See Drumbl, supra note 9, at 4 (estimating EITC share of gross tax gap at 3.5% but using upper range estimated net improper payments as numerator rather than overclaim amount prior to enforcement).

75 U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 23, at 33 (stating that “EITC examinations account for nearly 39 percent of all individual income tax return audits each year”). In FY 2013, the Service estimated that of approximately $37.1 billion of additional tax owed as a result of examinations about $2.5 billion, or 6.9% of all additional estimated tax owed, was due to examinations of returns that had an EITC claim. See CRANDALL-HOLICK, supra note 6, at 6. Precisely why there is a concentration of Service resources on EITC compliance is outside the scope of this paper. GAO notes that the Service attention to EITC is “[d]ue in part to long-standing concerns about the EITC improper payment rate.” See U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 23, at 33. Some have suggested that a disproportionate attention to EITC noncompliance as compared to other systemic issues of income tax noncompliance may stem from a direct bias against redistributive policies. See Karie Davis-Nozemack, Unequal Burdens in EITC Compliance, 31 L. & INEQ. J. THEORY & PRAC. 37 (2012); Lawrence Zelenak, Tax or Welfare? The Administration of the Earned Income Tax Credit, 52 UCLA L. REV. 1867, 1896 (2005). We find that explanation persuasive. See Leslie Book, EITC: Do Attitudes on Redistribution Fuel a Particular Focus on Errors?, PROCEDURALLY TAXING (Oct. 31, 2013), http://www.procedurallytaxing.com/eitc-do-attitudes-on-redistribution-fuel-a-particular-focus-on-errors/. Lawrence Zelenak also notes, however, that compared to other nontax based transfer programs, EITC recipients receive relatively less attention in terms of agency compliance efforts. See Zelenak, supra, at 1892.
Overclaim Study

a. Distribution and Nature of Errors

While placing the EITC compliance issues in the context of overall tax compliance is helpful, it is also useful to consider more information about the eligibility criteria that claimants fail to satisfy when they improperly claim the EITC. As part of its 2014 EITC Overclaim Study, the Service selected a sample of 7635 returns that were subject to more intensive NRP audits.\(^76\) Those audits differ from more typical Service audits in several ways, including auditor training that emphasizes getting to the correct answer and the fact that almost 95% of the audits are done in person rather than via correspondence. Unlike traditional audits, NRP audits emphasize the collection of information that will interest researchers, including data that could lead to a better understanding of the specific eligibility criteria that claimants fail to satisfy.\(^77\) In its study of EITC overclaims for tax years 2006-08, the Service has released a significant amount of quantitative information relating to EITC compliance beyond the lower and upper bound estimates of the overclaim percentage.\(^78\) To understand the EITC compliance problem in more detail, it is helpful to examine the Service’s data at a more granular level.

As we mention above, the annual dollar value of the EITC overclaim rate is between $14 billion and $19.3 billion, depending on whether one uses the lower or upper estimate assumption for the nonresponders.\(^79\) Beyond those overall figures, the 2014 EITC Overclaim Study sheds more light on the distribution of the dollar overclaim percentages and the nature of the errors. With respect to the distribution of the errors, the Service estimates that most of the overclaim dollars are attributed to taxpayers who are ineligible for any EITC, as opposed to taxpayers eligible for a smaller amount. The 2014 EITC Overclaim Study estimates that ineligible taxpayers account for between 79% and 85% of all overclaim dollars.\(^80\)

\(^76\) See 2014 EITC OVERCLAIM STUDY, supra note 7, at 4.
\(^77\) See id. at 5.
\(^78\) See id.
\(^79\) See supra note 54 and accompanying text. The nonparticipation led the Service to distinguish between known and unknown errors, with the Service unable to determine the source of the errors in the errors classified as unknown due to nonparticipation. See 2014 OVERCLAIM STUDY, supra note 7, at 15 (estimating 8.4 million returns with known error accounting for $11.4 billion in overclaims compared to 3.6 million returns with unknown error accounting for $7.9 billion in overclaims).
\(^80\) See 2014 EITC OVERCLAIM STUDY, supra note 7, at 13.
The following table illustrates the types and dollar significance of EITC-related errors in tax years 2006-08.\textsuperscript{81}

<table>
<thead>
<tr>
<th>Error Type</th>
<th>Number of Returns with Error (millions)</th>
<th>Low Estimate</th>
<th>High Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Reporting Error</td>
<td>6.5</td>
<td>$4.5</td>
<td>$5.6</td>
</tr>
<tr>
<td>Qualifying Child Error</td>
<td>3.0</td>
<td>$7.2</td>
<td>$10.4</td>
</tr>
<tr>
<td>Filing Status Error</td>
<td>1.0</td>
<td>$2.3</td>
<td>$3.3</td>
</tr>
</tbody>
</table>

The table illustrates that the biggest contributors to overclaims are qualifying children errors and income misreporting. Qualifying children eligibility errors accounted for between $7.2 billion and $10.4 billion in overclaims — between 42% and 54% of all overclaims. Income misreporting was the second most significant source of overclaims, accounting for between $4.5 billion and $5.6 billion in overclaims — between 15% and 23% of all overclaims.\textsuperscript{82}

Here are some of the key takeaway points from the study:

1. The costliest error types and their share of the total dollars erroneously claimed were qualifying child errors (42%-54%), income misreporting (24%-32%), and filing status errors (9%-17%).

\textsuperscript{81} See CRANDALL-HOLICK, supra note 6, at 4 table I.

\textsuperscript{82} However, we do not address errors associated with filing status though many of those errors are associated with married individuals claiming head of household filing status to offset a possible marriage penalty among EITC claimants. See id. at 28 (providing examples of how married taxpayers may increase EITC by filing separate returns). For an interesting suggestion that Congress repeal the head of household filing status on the basis that it no longer is as important as when first enacted, see Jacob Goldin & Zachary D. Liscow, Beyond Head of Household: Rethinking the Taxation of Single Parents (Nov. 4, 2016), https://papers.ssrn.com/so3/papers.cfm?abstract_id=2735874 (noting that marriage penalty has lessened over time and observing that distributional benefits of filing status disproportionately benefit higher-income families).
2. The most common error related to misreporting of income, which appeared in approximately two thirds of returns with known errors.\(^8\)

3. While 87% of all children claimed were eligible as qualifying children, the Service estimates that approximately three quarters of the 13% ineligible qualifying children were ineligible due to their failing to satisfy the residency requirement with the tax filer.

4. Of other qualifying children errors, relationship is the next most common error, with approximately one fifth of the 13% ineligible children failing to meet that test (amounting to approximately 3% of all children claimed).

5. While income misreporting accounts for 24%-32% of all overclaims (in dollars), the misreporting of self-employment income is most significant (15%-23%) and misreporting of wage income is least significant (3%-6%).\(^8\)

As previously discussed, there is little in the way of research regarding whether the errors as reflected in the 2014 EITC Overclaim Study are more likely the result of intentional conduct or mistakes. Some observers have attempted to distinguish the inquiry by type of error, suggesting that it is more likely that the qualifying child errors are unintentional and the income misreporting errors are intentional.\(^8\) While the research is not conclusive, there are indicators

---

\(^8\) In its EITC study, the Service was unable to identify the source of an error if the participant failed to participate in the audit; it classified those as “unknown errors.” See 2014 EITC OVERCLAIM STUDY, supra note 7, at iv.

\(^8\) In considering income misreporting, income can be either overreported or underreported to increase the value of or ensure eligibility for some EITC, but the EITC Overclaim Study does not provide information about the breakdown between overreporting and underreporting. See id. at 20. One observer suggests that “income underreporting may be more common than overreporting since the majority of EITC claimants—51.8% in 2008—have income that places them in the phase-out range of the credit.” See CRANDALL-HOLLICK, supra note 6, at 11–12 (noting also that in 2008 26.6% of claimants had income placing them in phase-in range and 21.7% had income in plateau range).

\(^8\) See Hoynes & Rothstein, supra note 4, at 26–28 (observing that differing definitions across related family benefits provisions contribute to Service publications concerning eligibility providing “examples in which many economists would have trouble identifying who was eligible to claim the credit . . .”). In contrast, the reporting
that suggest this observation has some descriptive accuracy. In particular, income misreporting for EITC purposes, as with income misreporting generally, principally relates to self-employment income, which is subject to little or no information reporting. Somewhat paradoxically with respect to other taxpayers, it is possible that claimants in the phase-in range of the EITC are incentivized to overreport income or fail to deduct expenses that would reduce earned income, since the value of the EITC often exceeds the tax liability associated with the additional net income. The fact that income associated with EITC claimants tends to “bunch” near the upper bound of the phase-in range supports the conclusion that taxpayers are manipulating reporting of income to maximize the receipt of the credit (and contributed to California’s prior stance to not allow self-employment income to qualify as earned income for its state earned income credit), but other explanations are possible.86

On the other hand, while the residence of children (the most common of the qualifying child errors) is also not subject to information reporting, some observers have suggested that those errors are more likely due to mistake.87 Those observers point to the sheer complexity of the EITC’s definition of qualifying child, in combination with growing trends among American families to share child care among family members and a general decline in traditional family arrangements where children live with both biological

---


parents.\textsuperscript{88} The absence of conclusive evidence regarding the reasons for the errors in the 2014 EITC Overclaim Study creates an additional challenge for those interested in offering options to address the compliance challenges. Despite that absence, we believe that it is likely that more intentional noncompliance is associated with income misreporting and more good faith mistakes are associated with qualifying child errors (though it is likely that a significant amount of intentional error is associated with returns reflecting mis-claimed qualifying children). That intuition guides some of the proposals we make below.

\textit{b. Errors by Preparer Type}

While our main focus in this article is on measures directed at taxpayers rather than third-party preparers, the 2014 EITC Overclaim Study provides additional information on the distribution of errors across preparer type. EITC claimants are less likely to self-prepare tax returns than the general taxpayer population.\textsuperscript{89} While the Service estimates that the rate of self-preparation for EITC claimants has been increasing since the 2006-08 years in the 2014 EITC Overclaim Study (mainly due to growth in the purchase and use of tax software), paid preparers still play a major role in the delivery of the EITC.\textsuperscript{90}

The 2014 EITC Overclaim Study is the most detailed comparison to date of EITC overclaim percentages across preparer types. While there is no statistical difference in error frequency or magnitude between self-preparers and third-party preparers, there were significant differences and variation by third-party preparer type.\textsuperscript{91}

For example, unlicensed preparers, who were responsible for preparing approximately 43% of all paid preparer returns, were


\textsuperscript{89} See 2014 EITC OVERCLAIM STUDY, \textit{supra} note 7, at 25 (29% for EITC claimants compared to 43% for returns not claiming EITC).

\textsuperscript{90} For a discussion of the Service’s unsuccessful attempt to more directly regulate unlicensed tax return preparers, see generally Alex H. Levy, \textit{Believing in Life After Loving: IRS Regulation of Tax Preparers}, 17 FLA. TAX REV. 437 (2015).

\textsuperscript{91} See generally 2014 EITC OVERCLAIM STUDY, \textit{supra} note 7, at 26 tbl.9.
subject to the highest error rates. Voluntary preparers’ returns, which comprised a very small amount of overall EITC returns, were subject to the lowest error rates.\footnote{See 2014 EITC OVERCLAIM STUDY, supra note 7, at 25.} In addition, while there is significant variation in error rate among type of paid preparer, the error rate is noticeably lower for employees of national preparation chains as compared to preparers who are not volunteer preparers and who are unaffiliated with the national chain preparers. In response to this data, the Service itself cautions against drawing conclusions about the skills or scruples of return preparers based on the overclaim percentages of particular preparer types, noting that the error percentage may “instead reflect the effect of section bias arising from the taxpayers’ choice of preparer.”\footnote{See id. at 24 n.51 (“[T]he rate of self-preparation among EITC claimants has increased over the last several years and the rate of paid preparation has declined.”).}

In prior research, one of this article’s authors has called for increased regulation of tax return preparers, including proposals that share some of the insights from the behavioral economics literature we discuss below.\footnote{See Leslie Book, The Need to Increase Preparer Responsibility, Visibility And Competence, in 2 NAT’L TAXPAYER ADVOCATE 2008 REPORT TO CONGRESS 74 (Jan. 2009); see also TAXPAYER ADVOCATE SERV., 2008 ANNUAL REPORT TO CONGRESS — EXECUTIVE SUMMARY 1, at 19 (2008) (describing Book’s research in Volume 2 of 2008 Annual Report to Congress).} Another led the Service’s implementation of the return preparer oversight program.\footnote{Roger Russell, IRS’s David William Departs, ACCOUNTINGTODAY (Aug. 20, 2012, 11:12 AM), https://www.accountingtoday.com/news/irs-david-williams-departs.} That program sought to regulate unlicensed preparers by imposing mandatory testing and continuing education requirements, in part to address some of the compliance issues we address in this article. It was later enjoined by a federal court on the grounds that the Service lacked the authority to implement such a regime.\footnote{See Loving v. Internal Revenue Serv., 917 F. Supp. 2d 67 (D.D.C. 2013), aff’d, 742 F.3d 1013 (D.C. Cir. 2014). There is a significant body of scholarship analyzing the judicial rejection of the IRS plan to regulate unlicensed tax return preparers. See, e.g., Steve R. Johnson, Loving and Legitimacy: IRS Regulation of Tax Return Preparation, 59 VILL. L. REV. 515 (2014).} While we recognize the importance of third-party commercial return preparers, in this article we focus on the direct relationship between the Service and taxpayers themselves.\footnote{For a discussion of proposals targeting third party preparers as a way to increase EITC compliance, see generally W. Edward Afield, A Market for Tax Compliance, 62 CLEV. ST. L. REV. 315 (2014) (arguing for targeted enforcement of certain}
III. THE COMPLIANCE PROBLEM: WHAT THE SERVICE DOES AND DOES NOT DO TO REDUCE OVERCLAIMS

A. Service Efforts to Reduce Overclaims

In the prior section, we discussed how the Service has conducted numerous studies on EITC overclaims that have identified the major sources of EITC noncompliance, both in terms of the method of preparation as well as the key eligibility criteria that are incorrectly applied. This section explores how the Service addresses EITC noncompliance.

1. Measures Directed at Claimants

The Service is naturally reluctant to provide too much information about its compliance activities, so providing a complete picture of its efforts can be difficult. Further, measuring the effectiveness of these activities is also challenging because the current measurement methodology involves the use of random audits — an expensive and time-consuming endeavor that produces results several years after the work is launched.

What we do know is derived from publicly available reports from the Service, the Government Accountability Office, and the Treasury Inspector General for Tax Administration (TIGTA). In general, these reports and analyses point to the tradeoffs between traditional benefits program administration and delivery of benefits through the tax system. In brief, administrative costs for tax-based programs like the EITC are a fraction of the costs of traditional benefits programs.98 Not surprisingly, the inverse is true for erroneous payment rates — EITC overclaims are roughly a quarter of the overall program costs, while figures for benefits programs tend to be in the low single digits.99 Notably, participation rates tend to be higher for tax-based programs — suggesting clear trade-offs for policy makers as they consider how best to achieve their objectives.100

When looking at the Service’s approach to EITC compliance, it is important to understand these trade-offs. Traditional eligibility verification tools are not available in the tax world, where taxpayers

---

98 See CRANDALL-HOLICK, supra note 6, at 3.
99 See id. at 1–2.
100 See, e.g., U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 23, at 24.
attest to the veracity of their returns and the Service is left to question suspicious claims, usually after the refunds have already been paid. Efforts to move compliance activities “upstream,” i.e. pre-refund, have met with some success (most EITC audits are done before the refund is released), but a three-year test of a pre-certification for EITC eligibility did not pan out.

An overview of the Service’s EITC compliance program demonstrates its current approach to reducing overclaims. To address EITC noncompliance, the Service engages in a number of pre-filing efforts to educate taxpayers. Using a network of community-based organizations, as well as leveraging a limited public outreach budget to deliver public service announcements, the Service seeks to both encourage eligible taxpayers to claim the credit and prompt them to get help in determining the correct amount to claim.

The Service has also built in several requirements that are designed to collect data that corroborates taxpayer eligibility for the credit. Thus, all EITC claimants must submit a Schedule EIC with their returns. If a return has been filed with the use of a preparer (a declining majority of returns), then the preparer must complete and submit a due diligence “checklist” that calls out key determinants of eligibility that the preparer has attempted to verify.

As filing begins, the Service has built in several initial filters that attempt to cull returns with errors. First, it may reject as “unprocessable” returns that contain Social Security numbers that have already been used on other returns. It may also reject returns with missing or obviously false Social Security numbers or those missing required forms or schedules. For example, in tax year 2013, the Service rejected over two million electronically-filed EITC returns. The Service says that about 75% of those returns were resubmitted with the requested information.

101 See CRANDALL-HOLLICK, supra note 6, at 10.
102 See Drumbl, supra note 9, at 286–88.
103 See U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 23, at 40.
104 See Drumbl, supra note 9, at 276.
106 See U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 23, at 22. Returns that are not filed are not subject to this screening. See Holt, supra note 4, at 8.
107 U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 23, at 22.
The Service also uses an algorithmically-based screening system known as EFDS (Electronic Fraud Detection System) to identify potentially fraudulent returns for which it may require additional proof — specific data elements or identity verification — before releasing refunds.\textsuperscript{108}

Another consequence of the EITC’s placement in the tax system is that all taxpayers (including EITC claimants) are generally entitled to receive a statutory notice of deficiency that explains any proposed Service change to a tax return and provides an opportunity to review those changes in the US Tax court before formally assessing the changes.\textsuperscript{109}

The Code provides a limited exception to the so-called deficiency procedures in the form of math error authority (MEA), which generally allows the Service to make immediate changes stemming from mathematical or clerical errors, without the need to issue a notice of deficiency.\textsuperscript{110} Using MEA, the Service can immediately address mathematical or clerical errors on EITC returns, including calculation errors and claims that exceed income limits or include an invalid Social Security number. The Treasury Inspector General reported that in tax year 2014, the Service used its MEA to “identify and systematically correct 166,611 (less than 1%) of approximately 27.6 million EITC claims.” TIGTA estimates that the returns reflected $227 million in EITC claimed.\textsuperscript{111}

The main tool the Service uses to detect eligibility errors is the Dependent Database, a system that incorporates data from the Service

\textsuperscript{108} See U.S. Government Accountability Office, \textit{supra} note 23, at 17. We have been unable to calculate how much revenue is protected through this processing check.

\textsuperscript{109} Section 6201 of the Code gives the Service the authority to conduct examinations, including a review of the taxpayer’s records to allow the Service to determine if the taxpayer is accurately reporting income, expenses and credits. Prior to 1988, the Service had the power to make summary assessments with respect to the EITC, the Technical and Miscellaneous Revenue Act of 1988 amended Code section 6211(b)(4) and essentially provided that an overclaim of an EITC would be taken into account for purposes of determining the existence of a deficiency.

\textsuperscript{110} See I.R.C. § 6213(b) (2015). Section 6213(b)(2)(A) allows the taxpayer 60 days from the date of the math error notice to request abatement of the additional tax specified in the notice. If the taxpayer timely requests an abatement, the Service must abate the assessment and issue a notice of deficiency allowing the taxpayer the right to challenge the Service’s proposed change in Tax Court.

and other sources — including information from the Department of Health and Human Services relating to child custody and the National Prisoner File — as well as other, confidential scoring models that the Service uses to assign a numerical score that indicates the likelihood that the EITC claim is incorrect. These scores are used to determine which returns the Service will audit. Nearly 95% of these audits are conducted by letter and about 80% of those “correspondence” audits are conducted before the Service releases the refund.112

In 2014, the Service selected about 350,000 returns for pre-refund audits and about 87,000 after refunds had been released.113 That same fiscal year, the Service estimated it protected about $1.75 billion in revenue because of closures of EITC examinations. These correspondence examinations can focus on all aspects of EITC eligibility, and the Service does not release details of the issues it covers in correspondence examinations, nor does it break out the revenue protected by audit issue.

In addition to audits, the Service looks for mismatches between taxpayers’ (not just EITC claimants’) reported incomes and their income that third parties report to the Social Security Administration (SSA) through W2s (for employees) or 1099s (for independent contractors). The SSA transfers that payment data to the Service, and then the Service’s Automated Underreporter Program selects a portion of returns with mismatches for further scrutiny. The Service also selects a significant number of EITC-claiming returns for further scrutiny in post-refund document matching review.114 The Service does not consider those contacts as audits.115 Service fiscal year 2014 estimates peg the EITC return-associated revenue protected from document matching at approximately $1.39 billion.116

---

112 See U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 23, at 17.
113 See id. at 18.
114 See U.S. DEP’T OF TREASURY, supra note 42, at 200.
115 See id. at 31.
116 See U.S. DEP’T OF TREASURY, supra note 42, at 200 (second table). Recent legislation accelerates the due date to January 31 for the filing of third party information returns, including the form that covers nonemployee compensation (Form 1099-MISC). It also delays payment of a refund attributable to an EITC and certain other credits until February 15. See Protecting Americans from Tax Hikes (PATH) Act of 2015, Pub. L. No. 114-113, 129 Stat. 3038 (2015). The expectation is that the Service will use the information to screen claims against reported income payments prior to issuing refunds. The Service implemented the PATH requirements in the 2017 filing season and had considerable success in using its access to the information in preventing payment of overclaims that were attributable to income
Using all of this data, the Treasury Department reports the sum of all Service EITC-related compliance activities from 2010-2016:\footnote{117}

<table>
<thead>
<tr>
<th>(In Billions)</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12</th>
<th>FY13</th>
<th>FY14*</th>
<th>FY15**</th>
<th>FY16***</th>
<th>FY10-FY16 Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Examination Closures</td>
<td>1.97</td>
<td>2.04</td>
<td>2.05</td>
<td>2.11</td>
<td>1.75</td>
<td>1.90</td>
<td>1.99</td>
<td>13.90</td>
</tr>
<tr>
<td>Math Error Notices</td>
<td>0.41</td>
<td>0.35</td>
<td>0.33</td>
<td>0.30</td>
<td>0.24</td>
<td>0.29</td>
<td>0.30</td>
<td>2.02</td>
</tr>
<tr>
<td>Document Matching</td>
<td>1.43</td>
<td>1.38</td>
<td>1.55</td>
<td>1.42</td>
<td>1.39</td>
<td>2.31</td>
<td>2.31</td>
<td>13.75</td>
</tr>
<tr>
<td>Amended Returns</td>
<td>0.06</td>
<td>0.04</td>
<td>0.04</td>
<td>0.05</td>
<td>0.06</td>
<td>0.08</td>
<td>0.08</td>
<td>0.38</td>
</tr>
<tr>
<td>TOTAL</td>
<td>3.87</td>
<td>3.75</td>
<td>3.93</td>
<td>3.86</td>
<td>3.43</td>
<td>4.60</td>
<td>4.98</td>
<td>28.04</td>
</tr>
</tbody>
</table>

\* Estimated actual.

\** Preliminary data.

\*** Estimate based on fiscal year 2016 preliminary data.

One additional measure associated with the Service’s correspondence examinations is worth highlighting. The Service views the success of its examinations based, in part, upon the percentage of taxpayers who accept the Service’s proposed adjustments versus the percentage of taxpayers who verified their claims were correct. These percentages are incorporated in the Service’s default and no-change rates and are key agency indicators for evaluating the success of its compliance activities.\footnote{118}

In computing revenue protected by its compliance activities, the Service assumes that changes to EITC claims that it proposes and that taxpayers either accept or to which they do not respond are part of its success in protecting revenue.\footnote{119} For pre-refund audits, the default rate is approximately 57% and the no-change rate is 9.1%. For post-refund audits, the default rate is 58.7% and the no-change rate is misreporting. See \textit{TAXPAYER ADVOCATE SERV., 1 FISCAL YEAR 2018 OBJECTIVES REPORT TO CONGRESS} 65 (2017) (indicating that increases in refund freeze in the 2017 filing season would likely lead to an approximate 2.1% decrease in improper payments from the prior filing season). Prior to the PATH legislation, taxpayers have been using the delay in Service receipt of information returns to facilitate some intentional abuse of the EITC, including taxpayers who after receiving an EITC would later disclaim any receipt of income to ensure qualifying for Supplemental Security Income (SSI). See Leslie Book, \textit{Some More Updates on IRS Annual Filing Season Program and Refundable Credit Errors, PROCEDURAL TAXING} (Feb. 9, 2015), http://procedurallytaxing.com/some-more-updates-on-irs-annual-filing-season-program-and-refundable-credit-errors/.

\footnote{117} See U.S. DEP’T OF TREASURY, \textit{supra} note 42, at 200 (second table). The amended return information is effectively a byproduct of IRS compliance actions that trigger in the claimant the filing of an amended and presumably correct return after receiving correspondence from the IRS.


\footnote{119} See U.S. GOV’T ACCOUNTABILITY OFFICE, \textit{supra} note 23, at 31.
The National Taxpayer Advocate and other taxpayer advocacy groups have raised questions about the implications of the high EITC default rate. Their questions also concern whether nonresponse reflects error or, instead, reflects the possibility that taxpayers do not respond because they are fearful of engaging with the Service or they do not understand or receive the correspondence. It seems likely that some portion of nonrespondents may actually be eligible, raising questions about what conclusions to draw from them. Despite the concerns about nonresponders, correspondence audits protect billions of dollars in revenue annually and remain the biggest tool in the Service’s EITC compliance arsenal.

B. What the Service Does Not Do

Perhaps as important as what the Service does with EITC claims it believes are suspicious is what it does not do. Despite a robust compliance effort aimed at those claims — 450,000 correspondence examinations and 150,000 math error authority adjustments annually — the Service identifies an additional five to six million claims it believes may be erroneous that it does not pursue. TIGTA estimates that these un-pursued EITC claims accounted for more than $20 billion in tax year 2014. In short, the Service knows it gives many questionable refund claims a pass each year. But why?

To understand, it is important to put the EITC enforcement efforts in the context of the Service’s overall enforcement program. First, good tax administration principles require a balanced compliance program that addresses noncompliance across the board, not just in specific areas. EITC compliance efforts already reflect an imbalance. In 2015, roughly 1.6% of EITC returns were audited as compared to 0.9% for all individual taxpayers. Further, EITC audits accounted for 39% of all individual income tax audits, though EITC claimants result in under 7% of additional tax owed because of all examinations. In

120 See id.

121 See id. at 31–32 (suggesting that possibility that some defaulting taxpayers may in fact be compliant brings into question utility of measures when “little is known about the compliance characteristics of the defaulting taxpayers”).

122 See TIGTA, supra note 13, at 10.

123 See id. (“[T]he IRS identified approximately 5.7 million potentially erroneous EITC claims totaling approximately $20.7 billion in Tax Year 2014 . . . .”).

124 See generally id. at 11.

125 See U.S. DEP’T OF TREASURY, INTERNAL REVENUE SERVICE DATA BOOK, 22, table 9a (2013); see also CRANDALL-HOLICK, supra note 6, at 6 n.18 (noting that additional
addition, while correspondence examinations are generally less costly than face-to-face (field) exams, they do involve a significant resource commitment.\footnote{For this reason, the Service has requested authority to use automatic math error authority for a number of additional conditions. In theory, this approach would enable the Service to enhance its compliance efforts without further skewing Service enforcement toward lower- or moderate-income taxpayers while minimizing undue cost or burden on taxpayers. But there has been significant opposition to giving the Service additional automatic powers to reject returns, in part because the Service has been unable to demonstrate that these additional conditions (e.g., mismatches with the dependent database) are accurate enough to warrant dispensing with the pre-adjustment notice and other statutory rights that are generally accorded taxpayers wishing to challenge proposed adjustments. Another potential avenue for addressing incorrect claims might be the expansion of third-party reporting. Research and National Research Program data consistently show that compliance is directly correlated with the presence of corroborating data from a third party (e.g., an employer or a financial institution). The challenge with the tax may result from combination of smaller EITC and increase or presence of income tax liability).}

For this reason, the Service has requested authority to use automatic math error authority for a number of additional conditions.\footnote{Service estimates that each correspondence examination costs Service $410.74 and also imposes significant burdens on taxpayers in terms of time needed to respond to correspondence. \textit{See U.S. Gov't Accountability Office, supra note 23, at 19, 23} (also noting that burden of correspondence examinations on taxpayers is not evenly distributed and that it takes taxpayers approximately thirty hours to fully participate in correspondence examinations).} In theory, this approach would enable the Service to enhance its compliance efforts without further skewing Service enforcement toward lower- or moderate-income taxpayers while minimizing undue cost or burden on taxpayers.\footnote{\textit{See Review of the President’s Fiscal Year 2016 Funding Request for the Department of the Treasury and the Internal Revenue Service: Hearing Before the Subcomm. on Fin. Servs. \& Gen. Gov’t of the H. Comm. of Appropriations, 114th Cong. 17 (2015) (testimony of the Hon. J. Russell George, Treasury Inspector General For Tax Administration) (“The Department of the Treasury has included a legislative proposal to obtain correctable error authority as part of the IRS’s budget requests each year since FY 2013 . . . ”).} But there has been significant opposition to giving the Service additional automatic powers to reject returns, in part because the Service has been unable to demonstrate that these additional conditions (e.g., mismatches with the dependent database) are accurate enough to warrant dispensing with the pre-adjustment notice and other statutory rights that are generally accorded taxpayers wishing to challenge proposed adjustments.\footnote{\textit{GAO estimates that to automatically reject an e-filed return during processing would cost under twenty-five cents per return. \textit{See U.S. Gov’t Accountability Office, supra note 23, at 19 (“[I]n 2014 it cost IRS on average $.21 to process an electronic return . . . ”).} \textit{Hearing on Internal Revenue Service Oversight Before the Subcomm. on Fin. Servs. \& Gen. Gov’t of the H. Comm. on Appropriations, 113th Cong. 34 (2014) (statement of Nina E. Olson, National Taxpayer Advocate).}}

Another potential avenue for addressing incorrect claims might be the expansion of third-party reporting. Research and National Research Program data consistently show that compliance is directly correlated with the presence of corroborating data from a third party (e.g., an employer or a financial institution).\footnote{\textit{See Leandra Lederman, Reducing Information Gaps to Reduce the Tax Gap: When is Information Reporting Warranted, 78 Fordham L. Rev. 1733, 1739 (2010) (observing that the prevalence of mismatches arising from incorrect claims and their corresponding costs might be reduced by requiring that employers and financial institutions report payroll and financial data to the IRS re}}
EITC is that, as previously noted, the key determinants of eligibility for the credit (residency and relationship) are not consistently knowable by the Service — or, for that matter, other government agencies. Put simply, the Service does not possess a database that captures with whom people lived, for how long, and what their relationships were to each other. Without this data, the Service must rely on the traditional self-attestation inherent in our tax filing system, bolstered by examinations and the other compliance tools discussed earlier.

Lastly, it is important to note that Service resources have been increasingly constrained over the past decade. Continued budget cuts have affected both levels of service as well as the Service’s ability to conduct as robust a compliance program.\(^\text{131}\) Thus, expansion of the existing examination program would be very difficult. Part of the reason we are writing this paper is to suggest ways in which the Service could either enhance its compliance program with lower cost options or use its existing tools more efficiently to achieve a stronger reduction in overclaims — while still encouraging eligible taxpayers to claim the credit.

IV. TIME TO BROADEN THE COMPLIANCE INQUIRY

A. Introduction

In the preceding section, we summarized the research on the extent of the EITC compliance problem and the government’s efforts to improve program integrity. It is fair to say that the government’s efforts, while quite robust, have appeared to produce very little measurable improvement in the overall rate of EITC compliance. While the courts have frustrated the Service’s ability to regulate unlicensed tax return preparers,\(^\text{132}\) which was one of the key

---


\(^{132}\) For a discussion of the Service’s unsuccessful efforts to impose mandatory testing and continuing education requirements on unlicensed tax return preparers, see Alex Levy, Believing in Life After Loving: IRS Regulation of Tax Preparers, 17 FLA. TAX REV. 5 (2015).
ingredients of the Service’s plans to reduce errors associated with refundable credits, the basic contours of the Service compliance regime have been in place for well over a decade.\textsuperscript{133} Overclaim rates remain somewhat stubbornly stuck at approximately 25\% of all claims. Despite these challenges, there is clearly an upside to administering the EITC through the tax code. As many have discussed, there are significant nonmonetary benefits associated with housing the EITC within the tax system (such as a lack of recipient stigma often associated with traditional benefits programs), and the direct administrative costs of the EITC are small relative to direct spending programs.\textsuperscript{134} While improper payments are, in an absolute sense, high, compliance with the EITC exceeds other areas of the income tax where there is little third-party reporting — especially the reporting of individual business income, which dwarfs EITC noncompliance in absolute and relative tax gap numbers.\textsuperscript{135}

We believe that it is important to acknowledge the benefits of administering the EITC within the tax system and are strong proponents of presenting a more balanced perspective on the costs and benefits of using the tax system to deliver benefits. We also acknowledge that to look at the current situation and declare victory is not realistic given the continued rate of EITC noncompliance and the legal requirements imposed on the Service to both report on programs with improper payment rates and to produce and implement plans to meaningfully reduce those errors.\textsuperscript{136}

We believe that the Service and Congress can learn even more with a slightly different focus on understanding the multiple sources of noncompliance that contribute to the overclaim rate. In sum, we are proposing that the Service test new approaches to better understand the specific reasons underlying this compliance problem. Noncompliance in this area is a major factor in the overclaim rates, which are generally viewed as too high and as evidence that the EITC

\textsuperscript{133} See CRANDALL-HOLLICK, \textit{supra} note 6, at 18–20 (listing Service efforts to improve compliance such as requirements for EITC due diligence, retaining records, and preparer qualifications).


\textsuperscript{135} See CRANDALL-HOLLICK, \textit{supra} note 6, at 3–4.

\textsuperscript{136} Those legal requirements are summarized in TIGTA, \textit{supra} note 13, at 1–2 (discussing Improper Payments Information Act of 2002 as well as subsequent legislation and Executive Order 13520, which require robust reporting of improper payments and agency efforts to reduce improper payments when there are “significant improper payments”).
is a mismanaged, fraud-riddled program. That commitment to understanding is not an academic exercise. We believe that a better understanding will reveal possible compliance solutions that go beyond the traditional audit and penalty approach that underlies the main weapons in the current Service arsenal.

B. A Brief Review of the Traditional Model of Tax Compliance and Its Relationship to Service Efforts to Drive EITC Compliance

The traditional model of tax compliance is based on classical economic theory, with the degree of tax evasion determined by risk of detection and costs associated with penalties and other sanctions.137 Under this model, a taxpayer deciding whether to comply will weigh the expected cost of tax evasion against the cost of complying.138 As scholars have recognized in applying this in the tax context, the cost of complying is the correct amount of tax that would be owed as a result of filing correctly.139 The cost of evasion considers the amount of tax (if any) that the taxpayer will owe if detected, and any possible penalty that the government could impose on the taxpayer for failing to comply. As the government may not detect the taxpayer’s noncompliance, the taxpayer is expected to weigh the odds that the government may not detect the taxpayer’s noncompliance.140

Given that the EITC is a refundable credit, the cost of complying is the reduced or disallowed EITC, which may result in the taxpayer having a small positive income or employment tax liability and a reduced refund (or no refund at all). The cost of not complying for many claimants is similar to the cost of complying — that is, if the government detects the ineligibility and audits or otherwise denies the EITC claim, the individual will not be entitled to receive the EITC. To be sure, there are other costs associated with filing a claim that an individual knows or has reason to think is incorrect, including possible preparation costs associated with filing the return and the stress associated with potentially interacting with the Service should the Service select the return for examination.


139 Id. at 323.

140 See Lederman, supra note 130, at 1735.
As discussed in the above section, the Service has the capability to identify possibly ineligible claimants.\textsuperscript{141} According to TIGTA, the Service does a reasonably good job of identifying possible ineligible claimants but only communicates with a relatively low percentage (around 10\%) of the claimants that it suspects are filing returns with an EITC overclaim.\textsuperscript{142} The Service communicates with the select claimants principally through correspondence examinations. That correspondence gives a claimant who disagrees with the Service’s proposed disallowance of the EITC and who is unable to convince the Service at this stage the right to a statutory notice of deficiency to pre-assessment Tax Court review. A smaller percentage of the selected potentially ineligible claimants receive math error correction notifications. Unlike correspondence examinations, the math error correspondence allows the Service to assess and essentially unwind the claiming of the EITC without the right to receipt of a statutory notice of deficiency. That said, claimants who contact the Service within a sixty-day period after receipt of the math error notice can demand that the Service abate the assessment and issue a notice of deficiency.\textsuperscript{143}

It is of course possible that the Service may impose monetary civil penalties when disallowing the credit. The classic economic model addressing compliance focuses on penalties as part of the costs for noncomplying.\textsuperscript{144} Even if the Service fails to audit a significant percentage of ineligible claimants, it would be theoretically possible to reduce noncompliance if the penalties are severe enough.\textsuperscript{145} Penalties have been a relatively small part of the arsenal in the effort to control erroneous EITC claims for a few reasons. First, unlike other benefits’ programs, where there is often a vigorous state-based threat of criminal prosecution for fraudulent claims, there are few (if any) prosecutions of improper EITC claiming individuals.\textsuperscript{146} Second, the civil penalties for improper EITC claims have been subject to uncertainty and applied sparingly and inconsistently.

\textsuperscript{141} See TIGTA, \textit{supra} note 13, at 10 (indicating that Service identified five million or so suspicious EITC returns).

\textsuperscript{142} TIGTA, \textit{supra} note 13, at 10.

\textsuperscript{143} See I.R.C. §§ 6213(b)(1)–(2).


\textsuperscript{145} Though some observers have rightly noted the practical limits of excessive penalties. See \textit{id.} at 130.

\textsuperscript{146} See Drumbl, \textit{supra} note 9, at 279.
Consider the accuracy-related civil penalty found within Code sections 6662 and 6663. The accuracy-related penalty imposes either a 20% or 75% penalty on underpayments. Courts and the Service have struggled with how an improperly claimed EITC, which often results in an improper refund rather than a positive tax liability, can trigger a penalty that is premised on underpayments of tax. In 2015, Congress legislatively overruled Rand v. Commissioner, a Tax Court decision that had limited the application of the accuracy-related penalty to refundable credits when the amount claimed exceeded a claimant’s tax liability. The inconsistent approach to the issue has likely diluted its ability to deter claimants from improper payments.

The other main civil penalty in its arsenal against improper EITC claims is the two- or ten-year disallowance period on claimants who either recklessly or fraudulently claim the EITC. This penalty has its pedigree in nontax benefits programs like Supplemental Nutritional Assistance Program, where state agencies can impose disallowance periods on claimants who intentionally or recklessly violate program rules in applying for benefits. The two- and ten-year penalty has not been a major factor in limiting EITC overclaims for a few reasons.

147 141 T.C. 376 (2013).

148 See S. Comm. on Fin. & J. Comm. on Tax’n, 116th Cong., Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029, at 138–40 (Comm. Print 2015) (noting disallowed refundable credits must be taken into account when determining tax shown on return and can reduce tax shown on return below zero for purposes of calculating underpayment subject to penalty under sections 6662 and 6663). The change was given retroactive effect, applying not only to returns filed after December 18, 2015, but also to returns filed previously where the statute of limitations had not expired.

149 The issue of civil penalties and refundable credits is worthy of more attention though outside the scope of this article. We do note, however, that the Tax Section of the American Bar Association has published guidance on what it believes are essential guiding principles for civil tax penalties, including that they be understandable and consistent and not subject to retroactive application. See A.B.A. Sec. Tax’n, Statement of Policy Favoring Reform of Federal Civil Tax Penalties 2, https://www.americanbar.org/content/dam/aba/administrative/taxation/migrated/pubpolicy/papers/whitepaper_sopfavoringreformoffederalciviltaxpenalties.authcheckdam.pdf (last visited Oct. 9, 2017).

150 See generally Book, supra note 38.

One reason is that it is difficult for the Service to gauge the intent of claimants, due to the almost exclusive use of correspondence-based examinations that do not provide the information necessary for the Service to understand the reasons why the claimant incorrectly claimed the EITC. In addition, the penalty’s impact, and thus its possible utility, varies by factors unrelated to the claimant’s conduct. For example, consider two ineligible claimants, both of whom fraudulently claimed the EITC in year one but only one of whom would have been eligible to claim the EITC in later years. Because the ban only has a monetary impact in later years if the person subject to the ban would have been eligible in later years, the penalty may have an impact of over $60,000 over a ten-year period to the person who could have claimed the credit in that ten-year period and no monetary impact on the other claimant. That inconsistent impact dilutes the effect of the penalty, as does a lack of defined standards as to what constitutes reckless conduct, uncertainty regarding procedures surrounding administrative and judicial review of Service imposition of the ban, and challenges the Service faces in documenting and proving the circumstances that would justify its imposition.

Despite the limited reach of traditional audits and existing penalties, scholars have made suggestions rooted in the traditional compliance viewpoint to improve the Service’s ability to both detect and unwind ineligible claimants or improve the penalty regime that the Service applies to claimants. Recently-enacted legislation that increases the circumstances under which the Service can use math-error authority to reverse a potentially ineligible EITC (and other refundable credits) claim fits within that framework. Likewise,

---

152 See Book, supra note 38, at 21–26.

153 The Taxpayer Advocate Service has documented numerous challenges the Service has faced in administering the ban. See David van den Berg, Olson Seeking Regs on Recently Enacted Refundable Credit Ban, 2016 TNT 10-3 (Jan. 18, 2016).

154 See Plecnik, supra note 151; see also Michelle Lyon Druml, Those Who Know, Those Who Don’t, And Those Who Know Better: Balancing Complexity, Sophistication, and Accuracy on Tax Returns, 11 Pitt. Tax Rev. 113 (2013) (suggesting that application of civil penalties in context of refundable credits fails to distinguish conduct that warrants penalty imposition from less intentional inadvertent mistakes that should not attract penalties).

some observers suggest potentially targeting civil penalties more directly at egregious misconduct and stress the need for occasional criminal prosecution of the most aggressive claimants who flout the laws and receive EITC benefits to which they are not entitled.156

In using the traditional compliance model, we also believe that the Service can continue to innovate and improve compliance, using the model as a starting point. It is our view, however, that the Service cannot audit itself out of the EITC compliance problem. Further, there is no silver bullet in the form of third-party information or external databases that would give the Service the certainty necessary to generate either low-cost upfront Service rejections of likely ineligible EITC claims or influence claimants in the first instance to report claims more accurately.157 In addition, while we believe that improving the civil penalty regime and selectively prosecuting the most intentionally noncompliant EITC claimants is important,158 those measures alone will not be sufficient to get the job done. Simply put, the Service needs new tools to address the problems it faces.

C. An Approach to Compliance that Goes Beyond Detection and Penalties

Before we set out to offer our view of the problem, it is useful to summarize how many observers have framed the EITC compliance challenges. The vast majority of EITC overclaims are attributable to

---

156 See Holt, supra note 4; Drumbl, supra note 9.

157 See Crandall-Hollick, supra note 6, at 8–9 (discussing how accuracy concerns hamper the Service from using its authority to rely on Federal Case Registry of Child Support Orders to determine if claimant is likely not living with and claiming child as qualifying child and summarily deny EITC even though Congress has given IRS power to rely on that data).

158 This is especially apt for those claimants who commit affirmative acts of commission in generating improper refunds, such as fabricating businesses and income and misstating income to the Service and differing federal and state agencies to effectively double dip on programs that are means tested but which use differing eligibility.
qualifying children and income misreporting; both are not subject to meaningful third-party information reporting and are not readily verifiable by access to third-party databases. Some observers, in looking at noncompliance in other parts of the tax system, have suggested that when noncompliance is associated with a lack of visibility, it suggests a more intentional type of taxpayer behavior. This behavior can be explained by the Allingham-Sandmo model of evasion, where taxpayers coldly balance the cost and benefits of their actions, considering the risk and penalties associated with detection.

Those who are critical of the EITC (and transfer programs generally) consider the Service compliance problem as reflective of intentional misconduct like fraud. Those who support the EITC tend to view the error rate as largely attributable to the unhappy intersection of EITC complexity and the characteristics of the claimant population. Recent congressional efforts addressing the EITC compliance problem appear to reflect the former view, with Congress enacting measures to improve program integrity through a more robust civil penalty regime and increased opportunities to reverse potentially erroneous EITC claims, but limiting the traditional rights to pre-assessment judicial review of Service actions.


161 See Ernest Istook, Needed: Watchdogs over Waste, Misguided Payments, Wash. Times (Apr. 8, 2015), http://www.washingtontimes.com/news/2015/apr/8/ernest-istook-earned-income-tax-credits-massive-tr/ (former member of Congress calling EITC “champion of all fraud-ridden programs” that is “also is the most difficult to correct because many conservatives have been snookered into giving EITC a free pass. The program pays low-income households with children up to $6,143 a year in cash simply for filing an annual return with the IRS. No social worker interviews, no eligibility checkups. Simply file the form and get a check”); see also Drumbl, supra note 9, at 7 (discussing how program critics often conflate overclaims with fraud).

162 See Gleckman, supra note 81. For a discussion of the characteristics of the EITC-claiming population, see Olson, supra note 12, at 7–14.

163 On the side of the ledger suggesting a more innocent explanation: EITC eligibility is complex; the circumstances of family life are increasingly complex as well; there is significant turnover among the EITC-claiming population on a year-
We believe that the perspectives that program critics and proponents offer are incomplete and in need of a reset. What little (dated) research there is on this topic suggests that EITC overclaims reflect a mix of both intentional and unintentional error, and the quantitative measures the Service and Treasury have released on EITC over the past decade add little insight to this question. In a 2003 article, one of us suggested that labels such as “intentional” and “unintentional” are insufficient to understand the dynamics of noncompliance, especially among lower-income taxpayers claiming refundable credits like the EITC. Instead, the EITC compliance problem is best understood as a variety of different problems along a continuum running from good faith unintentional mistakes stemming from complex family arrangements and confusing legal rules to intentional cheating in the form of misreporting income or a qualifying child’s residence or relationship.

Since that article’s publication, some have drawn on that framework as a helpful way to discuss the issue of EITC noncompliance. For example, Steve Holt notes that EITC noncompliance “takes many forms” and is best thought of along a spectrum: At one end are those who are unknowingly compliant in a context of complex rules. At the other end are those who are

---

164 See Jeffrey B. Liebman, Who are the Ineligible Recipients, 53 NAT’L TAX J. 1165 (2000).

165 As EITC researcher Steve Holt has noted, “[i]n some circles, this discussion has become a proxy war about the merits of the EITC and the character of its recipients.” HOLT, supra note 4, at 5–6.

166 One of us has suggested that the problem of EITC overclaims is best thought of as reflective of many different compliance problems, some of which suggest intentional taxpayer misconduct and other problems suggestive of conduct that is more directly connected to the characteristics of the claimants (such as transiency or literacy challenges) or attributable to third parties such as return preparers who play an important role in the delivery of the EITC and who may facilitate noncompliance. See Leslie Book, The Poor and Tax Compliance: One Size Does Not Fit All, 5 KANS. L. REV. 1, 23–33 (2003). Other observers have agreed with that general description. See, e.g., Olson, supra note 12; HOLT, supra note 4; Drumbl, supra note 9.

167 See HOLT, supra note 4, at 16; Drumbl, supra note 9; Olson, supra note 12, at 28.
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).\footnote{HOLT, supra note 4, at 16.}

Building on this insight, the National Taxpayer Advocate has taken issue with the Service’s law-enforcement-centric approach to EITC compliance. In light of studies that have shown that many taxpayers whose EITC is denied on audit actually get their EITC reinstated after requesting reconsideration and that few EITC claimants have a basic understanding of what the Service is doing when they are selected for audit,\footnote{See Olson, supra note 12.} she critiques the Service’s audit-based law enforcement view of EITC compliance: “one cannot simply assume taxpayers are cheaters and apply traditional law enforcement mechanisms like audit and penalties to that population and hope they will drive compliance behavior.”\footnote{See id. at 27.} If anything, the studies demonstrate that emphasis on EITC enforcement has not significantly budged the improper or overclaim rate for at least the past five years.\footnote{See id.}

The key takeaway here is that different types of noncompliance require different responses.\footnote{See id. at 28.} With limited resources, it may be tempting to default to a one-size-fits-all approach to compliance largely based on audits, penalties, and detection. After all, there are years of data to support these approaches and, as noted earlier, millions of potentially problematic claims that the Service is unable to get to. Thus, there is not a lot of incentive to conduct a deep dive into EITC compliance and update our understanding of why claimants are misreporting eligibility and, more importantly, what can truly help drive down the error rate. Gaining a deeper understanding of the evolving nature of the compliance challenges requires an agency-based commitment to understanding taxpayers lives. The Service would need to train its auditors to understand not only what is technically wrong with a tax return that features erroneous or overstated credits, but also to understand the reasons behind the error — including, for example, whether the error was attributable to taxpayer misunderstanding of eligibility rules unique to the EITC,
whether a return preparer facilitated or encouraged an intentional misstatement of eligibility criteria or income, or whether the error was due primarily to a taxpayer’s desire to misstate facts to enhance the amount or become eligible for the credit. This would require a change to what NTA has framed as the Service’s “incurious” approach to tax administration.

This is a steep challenge. The Service’s existing approach is generally effective — protecting billions of revenue at a very low administrative cost. In addition, default rates and no-change statistics, as we discuss above, show that a high percentage of claimants who are audited in fact do not meaningfully challenge Service-proposed changes to suspicious EITC claims. Yet the Service has likely reached the limit on what its compliance efforts can achieve based on its traditional approaches. As a general matter, sophisticated tax agencies around the world have acknowledged the limitations that these approaches present. The time is right for adding new approaches. In the next section we discuss what should animate the Service and Congress if they want to improve compliance without sacrificing other important goals such as participation and low administrative and taxpayer costs.

V. **THE CONTEXT FOR CHANGING THE IRS’S APPROACH TO EITC INTEGRITY TO MEASURES BEYOND AUDITS AND PENALTIES**

In the prior section, we make the claim that the Service’s traditional approach to addressing EITC noncompliance has hit a wall in terms of its ability to meaningfully move the needle on EITC

---

173 This is a challenge in any time but one that is especially pronounced when an agency faces resource issues. See Chuck Marr & Cecile Murray, IRS Funding Cuts Compromise Taxpayer Service and Weaken [sic] Enforcement, CTR. ON BUDGET & POLICY PRIORITIES (Apr. 4, 2016), http://www.cbpp.org/research/federal-tax/irs-funding-cuts-compromise-taxpayer-service-and-weaken-enforcement (“The Internal Revenue Service (IRS) budget has been cut by 17% since 2010, after adjusting for inflation, forcing the IRS to reduce its workforce, severely scale back employee training, and delay much needed upgrades to information technology systems. These steps, in turn, have weakened the IRS’s ability to enforce the nation’s tax laws and serve taxpayers efficiently, as the National Taxpayer Advocate, the Treasury Inspector General for Tax Administration, the IRS Oversight Board, and the Government Accountability Office have all documented.”); see also Leandra Lederman, The IRS, Politics, and Income Inequality, 150 TAX NOTES 31 (Nov. 11, 2016).

174 See Lederman, supra note 173, at 31.

175 See U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 23, at 31; TIGTA, supra note 13.

176 See generally VESPERMAN, supra note 19.
compliance. To combat EITC error, the Service essentially relies on its traditional approaches to tax compliance, which score of tax returns for likely errors. After identifying likely erroneous EITC returns, the Service examines about 10% of the returns it identifies as potentially reflecting an overclaim. Service efforts are sensibly directed toward screening, communicating, and auditing prior to the payment of EITC-generated refunds, as collection of any erroneously paid refunds is difficult and adds additional program costs.

While the Service has the authority to impose civil and criminal penalties, those sanctions do not appear to play a significant role in the overall compliance rate. This, we believe, is due to the inconsistent application of the accuracy-related civil penalty regime as applied to EITC-claiming taxpayers, a difficult-to-administer disallowance regime borrowed from traditional nontax-based benefits programs, and the low number of criminal prosecutions of individual taxpayers in spite of the egregiousness of some of their actions.

In this section, we offer specific measures that the Service and Congress can incorporate in their approach to ensure EITC program integrity. In offering our suggestions, we believe that the Service should consider systematically integrating insights from cognitive psychology as part of its approach to addressing EITC noncompliance. Research from other disciplines highlights the limitations that humans have in making decisions. The notion that people are rational actors capable of coolly weighing costs and benefits prior to making decisions—including whether to accurately report the items on a tax return—has given way to a more robust reality that considers the ways that people actually act in real-life situations.

Behavioral economics uses insights from other social sciences (mainly psychology) to suggest ways to drive compliance and, more generally, to understand what drives individual decision-making. Those insights suggest that all decisions, including whether to comply with the tax law, are subject to a diverse range of factors that go beyond the two main factors in the traditional model of tax compliance: detection and sanctions.

We believe the Service should explicitly explore the field of cognitive psychology to complement its traditional approach to combatting EITC errors. Cognitive psychology draws from the pioneering works of Amos Tversky and Daniel Kahneman. The work of Tversky and Kahnemann is often credited with challenging the ideas of human nature that mainstream economists had relied on in predicting behavior. For a discussion of the background of modern behavioral economics
examines the ways in which decision-making is influenced by characteristic biases that undermine the ability of people to make rational decisions. Those biases reflect a systematic failure to perceive the effect of an individual’s actions. For example, many people are subject to systemic biases that bring into question the descriptive force of a compliance model that is based mostly on people coldly weighing the odds of a Service audit and the severity of sanctions if caught.

Other areas of psychology also offer promise for tax administrators. For example, the influence of social psychology on tax compliance is somewhat less defined and accepted than that of cognitive psychology. Professor Steve Sheffrin has discussed the notion of folk justice and the importance that it can play in his book *Tax Fairness and Folk Justice*. Sheffrin summarizes research suggesting that the decision to comply with the tax law is influenced by factors such as a perceived substantive fairness of the tax laws themselves and the tax system’s adherence to procedural norms. While we do not discuss this extensively in this article, we note that some proponents, such as the National Taxpayer Advocate, have made a persuasive case for the Service to more directly consider research from this field as part of its overall compliance strategy.

Insights from the field of psychology are best thought of as ways to supplement and perhaps improve the traditional approaches to tax compliance described in the prior section. However, the research has attracted critics, both generally and as applied to tax compliance. One criticism is that many of the results come from laboratory settings rather than field experiments using actual taxpayers and randomized theories, see Alain Samson, *An Introduction to Behavioral Economics*, in *The Behavioral Economics Guide* 2014 1–12 (2014).


179 See Olson, *supra* note 12. Rooted in theories of procedural justice, many scholars have been looking more directly at the relationship between agency power and taxpayer trust, suggesting that tax compliance depends both on the perceived power of tax authorities as well as taxpayer trust in tax authorities. See Katharina Gangl et al., *Tax Authorities’ Interaction With Taxpayers: A Conception of Compliance in Social Dilemmas by Power And Trust*, 37 NEW IDEAS IN PSYCHOL. 13, 21 (2015) (stating there is a delicate relationship between coercive and legitimate power: “To change an antagonistic climate into a service climate, the measures of coercive power, such as controls and punishments, have to be combined with accepted, legitimate power. Once legitimate power is established, reason-based trust is likely to increase and, as a result, a service climate is established with voluntary tax cooperation.”). For an earlier and influential article, see Lars P. Feld & Bruno S. Frey, *Trust Breeds Trust: How Taxpayers Are Treated* (CESifo, Working Paper No. 322; Zurich IEER, Working Paper No. 98, 2002).
controlled trials to tease out the impact of specific variables. In addition, the takeaways are often countered by differing and, at times, countervailing explanations. They lack the descriptive tightness that comes from a single theory, such as the traditional model of tax compliance. Moreover, even when researchers have been able to test hypotheses on thousands of taxpayers in the field, critics question whether the insights can be generalized beyond the specific circumstances of the experiment at hand. This is especially so when the research relates to tax systems in countries where the relationship between citizens and the tax system differs greatly from that relationship in the United States.

We note these limitations in part to caution that the suggested proposals are not guaranteed to lead to surefire successes and encourage adoption only with careful consideration and study. Those studies should depend in part on randomized controlled trials to test the impact of proposals relative to the status quo. In addition, before enacting policies that may be harder and more costly to test, the Service should seek input from interested parties who are familiar with the experiences of lower- and moderate-income Americans and the general difficulties that such people experience when interacting with government. Many of our proposals may not be significantly resource-intensive for the Service to design or implement, but it should consider how to quantify potential costs or benefits of specific proposals on all the players in the tax eco-system.

We also wish to emphasize that we are not suggesting that our approaches should supplant traditional compliance measures. There is no doubt that compliance in the form of audits and penalties are and should remain an important part of the Service’s toolkit. We will suggest, however, that concepts from cognitive psychology may in fact provide ways to improve upon the traditional actions that the Service has used and will continue to use to ensure program integrity.

---

180 For a general critique on the external validity and generalizability of laboratory experiments, see Steven D. Levitt & John A. List, What Do Laboratory Experiments Measuring Social Preferences Reveal About the Real World?, 21 J. ECON. PERSP. 153, 153–74 (2007). For a critique related to tax compliance, see Katharina Gangl et al., supra note 179, at 14 (“Experiments on tax behavior in the laboratory have consistently supported the positive impact of audits and fines on compliance. Nonetheless, the effects are rather weak. Field studies and surveys have yielded effects that are lower than, and sometimes the opposite of the predicted effects.”) (citations omitted).

A. Insights from Behavioral Economics

1. A Brief Theoretical Background on Why Applying Insights from Behavioral Economics May Encourage Voluntary Compliance

A recent article by Kathleen DeLaney Thomas considers tax compliance and argues that it is time to update the standard deterrence model of tax evasion to take into account the psychic cost of tax evasion.\(^\text{182}\) In her view, it is time for the Service and Congress to explicitly incorporate psychological research, which suggests that the government can prompt some individuals to behave more truthfully. According to Professor DeLaney Thomas, the government must recognize that the psychic cost of tax evasion is malleable and subject to influence with measures that differ from the traditional tools in the government’s arsenal.\(^\text{183}\) Co-authors Joseph Bankman, the late Clifford Nass, and Joel Slemrod offer a similar perspective in an article, suggesting that agencies must incorporate psychology research to increase the psychic costs that self-employed individuals experience when intentionally underreporting income or overstating deductions.\(^\text{184}\) Both articles focus largely on self-employed taxpayers, whose income is often not subject to third-party reporting and whose noncompliance often stems from relatively unambiguous binary choices (e.g., “do I report income that I earned last year which the Service may not know of? Do I not report income unless the Service audits me and finds out that I have left it off of my return?”).

According to Delaney Thomas, tax agencies must be sensitive to behavioral “nudges” that may influence taxpayers who would otherwise engage in intentionally noncompliant behavior.\(^\text{185}\) In addition, DeLaney Thomas notes that individuals tend to not consider tax evasion as “cheating” or “stealing.” Instead, people are able to categorize noncompliance with tax law in a way that makes misstating facts on a tax return less problematic than, say, stealing cash directly from someone else.\(^\text{186}\) This ability to categorize tax

\(^{182}\) See generally DeLaney Thomas, supra note 138.

\(^{183}\) Id. at 642.

\(^{184}\) See Bankman et al., supra note 160.

\(^{185}\) See DeLaney Thomas, supra note 138, at 647.

\(^{186}\) Id. at 644 (citing Harold G. Grasmick & Wilbur J. Scott, Tax Evasion and Mechanisms of Social Control: A Comparison with Grand and Petty Theft, 2 J. Econ. PSYCHOL. 213, 217–18 (1982)) (“One survey study compared attitudes about tax evasion with attitudes about petty theft, defined as stealing something worth less than $20, and grand theft, defined as stealing something worth more than $20.”); see also Leslie Book, H&R Block CEO Asks IRS to Make it Harder to Self-Prepare Tax Returns
cheating from other forms of dishonesty effectively lowers the psychic cost of tax noncompliance.

Nonmonetary factors and environment may drive behavior and make it more difficult for taxpayers to be willfully dishonest. Individuals’ perception of psychic cost is malleable. The articles by DeLaney Thomas and Bankman, et al., suggest that the Service must ground any specific proposals in experiments that attempt to gauge the impact and possible costs. That emphasis on testing is important, because the burgeoning field of behavioral economics is replete with many new concepts that hold the potential to help shape tax administration and offer new and potentially cost-effective mechanisms to encourage compliance without deterring eligible claimants. Presently, however, this potential is largely unproven. Experiments in the United Kingdom and other countries offer indications that some approaches could be effective, but there is little hard evidence on which the Service, state departments of revenue, Congress, and the tax preparation industry can rely.

In putting forth the following proposals, we believe it is important to rigorously evaluate the effectiveness of any measure on at least three dimensions: (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.

Compliance and taxpayer burden are difficult to measure, which can make it tempting to adopt what appear to be logical approaches without truly understanding their impact. A case in point is the EITC preparer’s Due Diligence Checklist (Form 8867), which began as a prompt to preparers to ensure that they were asking certain questions and has now become a required part of all third-party prepared tax returns submitted to the Service. The form is designed to gather information to validate eligibility for the EITC and focuses particularly on the residency and relationship requirements. It must

---

and Why That is Good for the Tax System, PROCEDURALLY TAXING (Dec. 3, 2014), http://procedurallytaxing.com/hr-block-ceo-asks-irs-to-make-it-harder-to-self-prepare-tax-returns-and-why-that-is-good-for-the-tax-system/ (citing DAN ARIELY, THE (HONEST) TRUTH ABOUT DISHONESTY: HOW WE LIE TO EVERYONE—ESPECIALLY OURSELVES (2012)) (discussing how Dan Ariely distinguishes circumstances that lend themselves to rationalization for stealing (e.g., downloading music) from other situations where it is more difficult to steal without viewing yourself as bad person (leaving a restaurant without paying)).

be completed by the tax return preparer and submitted as part of the tax return.\textsuperscript{188}

The due diligence checklist is a seemingly logical step toward improving EITC compliance. But there is little evidence demonstrating whether it works. It may well prompt better interactions between preparers and their clients, but it may instead simply reinforce the due diligence that scrupulous preparers would conduct on their own and have little to no effect on preparers committed to erroneously claiming the EITC on behalf of their clients. What we know is that it creates an additional burden for taxpayers and their preparers, but that it can also aid in preparer audits. These costs and benefits have not been weighed to determine the overall benefit of the checklist.

Before adopting any of the ideas we discuss here, we believe a full analysis must be conducted. That said, a word of caution is in order. The tax preparation industry is a large and heterogeneous amalgam of small, mid-sized, and large players — storefront companies, sole practitioners, tax firms, and software companies. Taken together, these players operate under a variety of different statutory requirements, practitioner standards, and government mandates.\footnote{See Sagit Leviner, The Role of Tax Preparers Play in Taxpayer Compliance: An Empirical Investigation with Policy Implications, 60 Buff. L. Rev. 1079, 1088–89 (2012) (categorizing preparer community). There has been a significant amount of scholarship supporting additional oversight over that diverse preparer community. See Patrick E. Tolan, Jr., It’s About Time: Registration and Regulation Will Boost Competence and Accountability of Paid Tax Preparers, 31 Va. Tax Rev. 471 (2012); Danshera Cords, Paid Tax Preparers, Used Car Dealers, Refund Anticipation Loans, and the Earned Income Tax Credit: The Need to Regulate Tax Return Preparers and Provide More Free Alternatives, 59 Case W. Res. L. Rev. 351 (2009).}

They serve different slices of the taxpaying public with varying degrees of success.

Whatever their place in the tax administration ecosystem, tax preparation firms are critical in enabling the Service and state departments of revenue to administer an increasingly complicated set of tax laws and rules. The industry serves as the primary interface between the citizen and government to enable taxpayers to meet their tax filing obligations, with roughly 90% of all taxpayers choosing an intermediary to help them in this process. It fields millions of phone calls and taxpayer inquiries that would otherwise fall to the Service’s

customer service operations. It also maintains the infrastructure that delivers most returns electronically.

For this reason, the relationship between government and industry must be carefully considered. Examples of successful engagements that serve government and taxpayer interests include various public advisory groups that help shape government strategy, the Service’s Free File program (free electronic preparation and filing), the annual Security Summit (coordinating efforts to preserve the integrity of the tax ecosystem), and the Council for Electronic Revenue Communication Advancement (working to advance electronic tax filing and electronic tax administration). But these efforts succeed only to the extent that there is clarity about the desired outcomes and the government shapes the approach.

Effective testing of the ideas discussed here will require close coordination between government and industry. Similar work has already been piloted. A Treasury-Service-industry test of a compliance technique rooted in behavioral economics was conducted during the 2016 tax filing season. The test, conducted in partnership with four tax preparation software companies, included roughly two million taxpayers and sought to determine whether behavioral prompts (treatments) embedded in software products could encourage accurate reporting on the residency of qualifying children for EITC claims. The software companies provided the platforms and experiences in which the test was conducted, while Treasury and the Service provided the sampling frames and determined the compliance impacts. Though the results did not demonstrate the efficacy of the prompts, the engagement model could provide a foundation upon which future work could be built.

Indeed, any rigorous evaluation of a proposal will require contributions from both government and industry including:

1. upfront agreement about what is to be tested;
2. clarity around how the test will be conducted including control v. treatment groups;
3. a pre-established measurement system; and
4. agreement on what success looks like.

Industry will need to agree to set up and administer tests within the confines of different business models, and government will need to determine the effect on compliance and on the rate of claims by eligible taxpayers.

Agreement as to what success looks like is also critical. For programs like the EITC, we believe balance between improvements in erroneous payments/claims and the possible chilling effect on eligible claims are both important measures that must be weighed together. There is also precedent for this.

In 2004, the Service launched a three-year test of a pre-certification requirement for some EITC taxpayers. The test required certain claimants about whom the Service had little information to provide documents corroborating the claims they were making with regard to qualifying children before the Service would release their EITC refunds. The Service conducted three different versions of the test over three tax filing seasons and modified its processes each time based on the previous years’ learning. It created a separately trained team of reviewers to handle the increased paperwork and piloted new ways of verification — including the use of third-party affidavits — to reduce taxpayer burden. It also established a careful measurement system to enable accurate assessment of the requirement’s effects. In essence, the test piloted a hybrid approach to EITC administration that combined standard tax administration with techniques used in traditional benefits programs — a novel approach to addressing EITC erroneous claims.

A key component of the test was a declared measurement structure that looked at both the volume of erroneous claims and the requirements’ deterrence effects on eligible taxpayers. This was among the first times the Service had attempted to quantify the effect of a compliance approach on eligible claimants. The test found that certification had a significant positive effect on compliance but also caused an estimated 1% to 3% of eligible taxpayers to eschew an EITC

---


claim. Ultimately, the Service concluded that while pre-certification efforts could be effective and that there was potential to manage the deterrence effect, the approach came with a higher price tag than traditional tax administration, and, when compared to other investment alternatives, was not as desirable.193

Thus, the Service chose not to pursue pre-certification. But the test broke ground for its approach and inclusion of participation measures as part of the test evaluation. We believe that this balanced approach to measuring the efficacy of compliance activities should be incorporated into any evaluation frame going forward.

With these recent developments as context, there are a number of potential avenues for exploration of behavioral economics-derived approaches to improving EITC compliance. In the following pages, we delineate some ideas and explore how they might be applied. The approaches involve a concept that is a key driver of taxpayer behavior and, for that matter, human behavior in general: cognitive burden (also known as “cognitive friction”).

In behavioral economics, the term “cognitive miser” refers to a person who will seek the path with the least cognitive burden or friction.194 Evidence of this behavior abounds in the tax system, where, as noted earlier, most taxpayers choose third parties to meet their tax

---

193 U.S. DEP’T OF TREASURY, IRS EARNED INCOME TAX CREDIT (EITC) INITIATIVE, ADDENDUM TO THE REPORT ON QUALIFYING CHILD RESIDENCY CERTIFICATION, FILING STATUS, AND AUTOMATED UNDERREPORTER TESTS 11 (2008), https://www.irs.gov/pub/irs-utl/poc_summary_addendum_121708_final.pdf. Even more recently, the Taxpayer Advocate Service has piloted a study that examines the impact of over 7,000 educational letters to taxpayers who were not audited yet who appeared to erroneously claim children as qualifying children on EITC-claiming returns in a study that systematically examines the impact on taxpayers. See INTERNAL REVENUE SERV., NATIONAL TAXPAYER ADVOCATE OBJECTIVES REPORT TO CONGRESS, VOLUME I, FY 2018 67–68 (2017), https://taxpayeradvocate.irs.gov/ Media/Default/Documents/2018-JRC/JRC18_Volume1_AOF_06.pdf. The study looked at the impact of the letter as compared to comparable taxpayers who were not audited and who did not receive the letter and taxpayers who were audited and did not receive the letter. In preliminary findings, TAS reported that the letter had a measurable impact on compliance with respect to the relationship requirements, as those who did not receive the TAS letter repeated their error 77.3% of the time, compared to 74.7% for the TAS group. Importantly, TAS in seeking to continue the testing directly acknowledges that in evaluating the impact of approaches such as sending educational letters to taxpayers the goal of reducing the improper payment rate “must be balanced with minimal disruption to low income taxpayers, who rely on this credit for their day-to-day survival.” Id. at 69. We agree fully with this conclusion.

194 See SUSAN T. FISKE & SHELLEY E. TAYLOR, SOCIAL COGNITION: FROM BRAINS TO CULTURE (2d ed. 2013) (coining “cognitive misers”).
filing obligations, even among taxpayers with relatively simple tax returns. To be sure, there may be other reasons to explain this phenomenon (e.g., fear of audit or asymmetry of information) but there’s no doubt that, at the core of the work done by tax software and tax professionals is a reduction in the cognitive burden associated with completing a tax return.

It is important to understand that the following ideas deliberately introduce cognitive friction to the tax preparation process. In doing so, they attempt to make the burden of noncompliance more salient and to prompt taxpayers to make the right choices. Some may directly affect individual taxpayers using software, while others will have a greater impact on tax practitioners.

These differences also suggest another consideration: the impact of the various treatments on which method of preparation that taxpayers choose. For example, requiring preparers to ask additional questions or obtain additional documentation could encourage taxpayers to seek out tax software that they can complete on their own. Or, the imposition of additional friction — these additional questions — in do-it-yourself tax software could prompt some taxpayers to seek help from preparers. In either case, it is important for the government to consider its role in fostering compliance while avoiding marketplace interventions that hamper taxpayer choice.

2. Specific Proposals

So, what kinds of proposals might be worth considering? We examine two types of proposals, each based on utilizing data for targeting and verification and ideas based on employing various behavioral economics techniques. Notably, it may be effective to layer these approaches such that the data pinpoints where behavioral economics techniques could prove to be most effective. Thus, while we introduce the concepts independently, they may be paired for maximum effectiveness.

a. Utilizing Data for Targeting and Verification

First, let us examine proposals for requesting additional data to verify eligibility. These take the form of (1) additional documents to be submitted along with a return or (2) more specific data requirements to be included on returns themselves that are based on data known about the taxpayer. The Service and state departments of revenue collect data from previously filed tax returns and have access to other data sets from other parts of government. The combination of
these data sets provides grist for compliance modeling that is used for audit selection, as we discussed earlier.

But what if the tax agency could use this data, pre-filing, to identify taxpayers from whom they might request additional documentation? Or, put another way, perhaps the Service could pre-select individuals or classes of individuals for whom additional data would reduce the risk score associated with a return.\footnote{But see Michael Hatfield, Taxation and Surveillance: An Agenda, 17 YALE J. L. & TECH 319, 340 (2015) (describing likelihood that IRS access to and use of big data will shift the dynamics of tax administration, likely reducing compliance burdens and the tax gap).} We propose to pair the request for additional information with the areas not subject to third-party reporting and where voluntary compliance is weakest.

Others have begun to move in this direction. Professor Drumbl suggests that first-time claimants of qualifying children be required to provide a short explanation of the change that triggered the new EITC claim.\footnote{See Drumbl, supra note 9, at 284. Triggering additional or different obligations upon first-time claimants or to claimants reporting something that differs materially from prior years is also consistent with insights from behavioral economics literature that looks at the importance of salience and anchoring. See PAUL DOLAN ET AL., INST. FOR GOV'T, MINDSPACE: INFLUENCING BEHAVIOR THROUGH PUBLIC POLICY 24 (2010), https://www.instituteforgovernment.org.uk/sites/default/files/publications/MINDSPACE.pdf (“[G]overnment advice may have extra power if it acts as an initial anchor, which may be easier to do at moments when people enter a new situation or life-stage . . . ”).} For example, claiming a nonbiological child for the first time could prompt additional questions or documentation of the change in family composition. Likewise, claiming income over a certain threshold that was not claimed in prior years and that is not subject to reporting or withholding could prompt additional questions regarding the income’s source. Enabling tax preparers to capture this data with appropriate privacy protections could enable taxpayers to address potential questions from the tax agency as they file their returns.

Certainly, such a system would require the construction of careful interfaces between the tax authority and the preparer, and it would need to be voluntary. Further, it could not somehow truncate statutory rights to disagree with and challenge Service-proposed adjustments that taxpayers currently enjoy. But it could enable those who are trying to comply to demonstrate their eligibility up front and avoid future questions.
To ensure that the system does not create a new subclass of taxpayers with differing rights, taxpayers who chose not to provide the requested data would not automatically be selected for examination. However, their returns would be scored along with all others using evolving Service compliance models. Depending on the score, their returns could be more likely to be subjected to audit — resulting in potential refund delays and post-filing work to meet Service information requests.

In a similar vein, the current EITC preparer due diligence checklist could be either reformulated or expanded to more accurately address questions the Service might have about a given taxpayer. Again, tax agency knowledge would be required to determine the nature of the questions to be asked. But for taxpayers whom the tax agency believes are compliant, the questions might be fewer and simpler. Of course, this would necessitate a more contemporaneous interaction with the Service to determine which questions would be added or removed from the checklist.

While these proposals are new for the tax system, states are beginning to experiment with this “real-time” approach in administering benefits programs. For example, the New Mexico Unemployment Insurance system experiment is a helpful example for imagining how such a system might work for tax compliance. The New Mexico Department of Workforce Solutions analyzed behavior of online unemployment insurance applicants to identify key decision points. Using this analysis and testing, they developed predictive algorithms to identify — in real-time — high-risk situations for overpayment based on historical data. After identifying the key moments, the team developed a tailored messaging plan to nudge applicants to provide accurate reports.

Specifically, when individuals applied for unemployment insurance in New Mexico and the Department recognized the applicant as having a high risk for underreporting earnings, the applicant received an on-screen pop-up message reminding the filer to report earnings. The New Mexico Department of Insurance tested variations of the message, including prompts such as: “9 out of 10 people in [your county] report their earnings accurately,” and “Reminder, if you worked last week, you are required to report these earnings even if you have not yet been paid.” Filers who were shown

---

the pop-up messages reported earnings more often than the control group. The most successful message tested was: “99 out of 100 people in <your county> report their earnings accurately. If you worked last week, please ensure you report these earnings.” This message resulted in filers reporting earnings at nearly twice the rate of the control group.\footnote{Id.}

There are two interesting characteristics of these proposals. First, they rely on existing data sets and algorithms held by the government to tailor experiences provided by tax preparers. Implicit in this approach when applied to the tax system is the potential for a close partnership between industry and government to enable appropriate data sharing and to comport the burden or friction imposed with the level of information available about the taxpayer.

Second, they would require a sophisticated data infrastructure that does not exist today and would need to be constructed — most likely by the technology industry — to deliver information in a timely manner. This would be no small feat. However, these ideas build on the pre-certification approach tested earlier by the Service but leverage technology in ways that could reduce cognitive burden and increase compliance.

\textbf{b. Utilizing Behavioral Economics Techniques}

The following ideas are rooted in behavioral economics theory and techniques and are based on the notion of increasing the psychological cost of noncompliance through personalization, prompts, self-relevant language, just-in-time communication, self-concept language, social proofing, herd behavior, inequity aversion, and choice architecture. We strive to provide some basic test ideas, though each technique could be employed in various parts of the compliance process (i.e., pre-filing versus during tax preparation) and can be adapted to the type of filing (i.e., software versus tax preparer assisted).

\textbf{(1) Tailor or Personalize the Filing Process to Reflect Knowledge of the Taxpayer}

This idea relies on data from government and industry, applies mainly to taxpayers who use software, and leverages technology already used by the tax software industry to create “right for me” experiences. The theory is that tailored experiences that convey that
the taxpayer is known and understood would encourage the taxpayer to answer eligibility questions accurately. In other words, “if they know me, it’s harder for me to cheat.”

(2) Prompt for Specific Information

This proposal could take a number of forms and is at the core of the “mainstream” behavioral economics approaches that we are proposing the Service and others explore. Two examples, suggested by Bankman, Nass, and Slemrod in their paper Using the “Smart” Return to Reduce Tax Evasion, warrant scrutiny. The first would increase the cognitive costs of providing misleading information by being more explicit in the kinds of information being requested. Asking questions that force taxpayers to lie to get a tax benefit increases the psychological cost of noncompliance. As Bankman and his co-authors note, such a structure forces individuals to commit a lie rather than omit the truth — thereby increasing the friction or burden of the deception. In the EITC context, this could take the form of questions like: “where did you live with the child you are claiming?” or “who else can claim this child?”

A related language-based approach could also be explored. Using more precise language to ensure clarity about what is being asked could increase the cognitive burden of noncompliance. For example, rather than ask a general question about the relationship of the qualifying child to the taxpayer, the question could be: “what is your legal relationship to the child you are claiming?” The use of the word “legal” makes clear that the relationship must meet a specific standard before the child can be claimed for EITC purposes. Thus, the psychological burden of claiming a child who does not meet the standard is harder to avoid.

(3) Employ Self-Relevant Language

The second idea proposed by Bankman et al would employ self-relevant language to more precisely target noncompliance. For example, urging taxpayers to not be “cheaters” (which implicates self-identity) rather than the more distant “don’t cheat” could be a more

---

199 See Bankman et al., supra note 160; see also DeLaney Thomas, supra note 138; DeLaney Thomas, supra note 160.

200 See Bankman et al., supra note 160, at 465–66.

201 Id. at 465.

202 See id. at 474.
powerful deterrent. A similar, more positive approach could be urging people to be good citizens rather than to demonstrate good citizenship. These and other formulations personalize the appeal and thus make it harder for taxpayers to distance themselves from their compliance activities.

(4) Just-in-Time Communication

A related idea is to time delivery of pointed communications to coincide with requests for the taxpayer to provide a piece of information. For example, noting that residency is an area where many people err and encouraging taxpayers to take care to get it right immediately prior to asking the EITC residency test questions underscores the focus on the data being requested and makes it harder to ignore. A more pointed version would note that incorrectly claiming a child can lead to a two-year or even a ten-year ban on the ability to claim the EITC.

(5) Self-Concept Language

Another area ripe for exploration is self-concept maintenance, or the idea that behavior can be modified by appealing to people’s own views or perceptions of themselves. Evidence suggests that focusing people’s awareness of their own standards for honesty can deter dishonesty when it is harder for a person to reconcile her actions with her self-perception. In short, the Service should strive to make it difficult to simultaneously cheat and still hold a positive self-view. In the context of EITC compliance, the potential to appeal to or incite honesty may be possible through careful placement of messages. For example, a simple statement at the beginning of the preparation process calling attention to a standard of taxpayer honesty in the United States could make later misrepresentations more difficult.

(6) Including a Jurat or Signature Attesting to the Veracity

---


of the Return

Requiring taxpayers to sign the jurat at the start of the return means that they have “pre-committed” to honesty. Requiring taxpayers to pre-commit to accurate returns, through the jurat or some other statement, may make it more difficult for them to subsequently lie about whether they qualify for the tax break. A note here: the mechanism for obtaining this pre-commitment matters. If the act is not clear and understood, it is less likely to be effective. Thus, it may not work if it is buried in a stack of forms presented to a taxpayer for signature at the end of the process. By the same token, tax software might need to determine the best way to present the pre-commitment statement to reinforce the need to comply. As Professors Thomas and Soled have noted, to ensure efficacy, taxpayers may need to be prompted with a jurat each time they return to the software, given that completing a single return may require multiple uses of the software.

(7) Social Proofs

Social proofing, or appealing to social norms, has long been a topic of interest among tax administrators and in the research literature on tax compliance. In its usual form, social proofing involves providing the taxpayer with information about how similar taxpayers or those from his or her social set behave in the same situation — thereby establishing a normative standard that may anchor the taxpayer’s behavior. Taxpayers who internalize the observed social norms will face self-imposed costs, like feeling guilty, if they deviate from the norm.

Studies on social proofing have not consistently demonstrated an effect on tax compliance. Additionally, some studies caution that careful consideration of “which type of norm affects compliance

205 See DeLaney Thomas, supra note 138, at 653 (suggesting requiring signing of jurat could lessen tax evasion).

206 See Samson, supra note 177, at 15 (defining “commitments or pre-commitments”).


209 See Samson, supra note 177, at 25 (defining “social proof”).

210 See generally Blumenthal et al., supra note 208.
levels, and under which conditions,” is needed. Variations in results may occur, depending on message framing, the nuances of applying social proofing to attitudes about tax compliance, the extent to which a taxpayer identifies with the situation or group referenced, and misperceptions about compliance behavior.

However, the recent field experiments from Hallsworth et al. found that using social norm messages can accelerate revenue collection among noncompliant taxpayers. Using large-scale natural field experiments in the United Kingdom, the study tested the impact of incorporating variations of social proof messages into reminder letters mailed to taxpayers with a balance due. The first test used five messages on 100,000 individual taxpayers: three norm-based messages (i.e., “Nine out of ten people pay their tax on time”) and two public service messages (i.e., “Paying taxes means we all gain from vital public services...”). All of the test messages showed a significant positive impact on increasing payments compared to the control group, which received the standard letter with no persuasive message targeting the moral benefits of paying taxes. Interestingly, the minority frame (i.e., “You are currently in the very small minority of people who have not paid us yet”) was the most effective.

The second field experiment further investigated the effectiveness of message type by comparing the impact of descriptive norms (i.e., “The great majority of people in the UK pay their taxes on time”) and injunctive norms (i.e., “The great majority of people agree that everyone in the UK should pay their tax on time”). Results demonstrate a significant impact of both injunctive and descriptive norm messages; however, descriptive norms had a significantly larger influence than injunctive norms on increasing payment results.

Building on this empirical evidence, social proofs could be applied to targeted EITC compliance messages. We posit that the social norm is the belief that those who claim social benefits should be honest about their income and family dynamics. Using this norm, we could employ social proof messaging around income reporting and claiming a qualifying child. For example, a basic norm message could


213 See generally Hallsworth et al., supra note 187.

214 Id. at 15, 24–25.
be: “Nine out of ten taxpayers who claim EITC correctly follow the qualifying child rules.” Social norm messages could be employed through many channels either surrounding or during the return prep process — for example, through pre-filing social media campaigns or as pop-up messages in tax return software, modeled after the New Mexico unemployment insurance example discussed earlier.

(8) Herd Behavior

Herd behavior is the idea is that people may choose to do what others are doing rather than use their own information or make independent judgments.\(^{215}\) Herd behavior may be a particularly effective tool for EITC compliance given that awareness of the credit is in part driven by community engagement and word of mouth information transmission.\(^{216}\) One option, perhaps more grounded in traditional compliance, could involve focusing messages on communities with high concentrations of EITC-eligible taxpayers in an effort to drive consistency in accurate refund claiming behavior. The Service already uses a version of this approach by conducting preparer action cases in which multiple clients of a given preparer are audited. A related application for the EITC would be to test compliance tactics in communities known to have a higher incidence of noncompliance. While this approach is more enforcement-focused, more positive opportunities to use strategies aimed at communities with large numbers of EITC taxpayers may also be possible.

(9) Inequity Aversion

Messaging that appeals to a sense of fairness could provide another avenue to incentivize compliant behavior. Inequity aversion, the notion that people prefer fairness and dislike things they perceive to be unfair, is the basis for such interventions. For instance, framing noncompliance as unfair — by putting at risk the existence of the program or giving unqualified people a tax break — could provide another way to drive taxpayers to make appropriate choices.\(^{217}\) To that

---

\(^{215}\) See Samson, *supra* note 177, at 18 (defining “herd behavior”).


end, the Service can perhaps experiment with messages touting the importance of the EITC as a tool to address childhood poverty and the program’s overall positive impact, while noting that a minority of individuals are improperly claiming the EITC. Research suggests that the identity of the messenger itself may be important; for those who may dislike or distrust government, messages that are perceived to be from the government may have less impact than messages than messages delivered by peers respected community members.218

(10) Choice Architecture

Choice architecture, the concept of designing key decision points in a way that intentionally influences behavior, has been shown to affect behavior in many areas outside of tax.219 One application of choice architecture in the tax ecosystem is the Refund to Savings experiment, which nudges low-income tax filers to directly deposit their refunds into a savings account instead of the typically used transaction account. The shift in choice architecture is as simple as making the savings option first on the list, yet it showed increased rates of saving by five percentage points compared to the control group (13% versus 8%), as well as an increase in amounts saved, in a large-scale randomized control trial.220 Behavior modification through micro-changes in choice architecture could be a low-cost and high-impact opportunity for EITC compliance as well. A very simple example can be found in the Service’s online EITC Assistant Tool, through which taxpayers can answer a series of questions to determine eligibility. The tool’s residency question asks: “Did you and your child have the same main home in the United States for more than half the 2016 tax year?” This is followed by radio button options of “Yes” and “No.” Reordering the choice structure to list “No” first is a subtle nudge that may temper incorrectly choosing “Yes” because it is presented as the first and best option. Careful examination of where the current design may encourage a noncompliant choice is an important step to constructing a pilot test of choice architecture.

218 See Dolan et al., supra note 196, at 19.


Stepping back, we would be remiss to not revisit the Treasury-Service-industry partnership. The Treasury recommended the following approaches, though implementation differed across the four participating software providers: (1) requiring the tax filer to confirm that he/she lived with each child being claimed for EITC purposes for more than half the year and to identify the address at which they lived with the child/children the longest, (2) providing clear language explaining that the Service might ask for documentation to substantiate residency, and (3) requiring tax filers to actively certify that the EITC information they provided was correct and could be substantiated with documentation. Results of the randomized controlled trial did not find the combined approach to be effective at affecting EITC claim behavior. However, given the variation in implementation of the treatment and the fact that multiple approaches were being tested simultaneously, these results alone should not deter additional testing. Indeed, the literature suggests that slight variations in the messaging (i.e., injunctive versus descriptive norm language) often determines the effectiveness of the technique. Likewise, targeting approaches based on tax filer data may also improve the efficacy of these techniques.

In proffering this list of ideas, we recognize there are plenty of others that could be explored. These ideas are neither exhaustive nor fully fleshed out, but they do demonstrate areas where, we believe, further exploration, with the appropriate measurement framework discussed earlier, is warranted.

We also recognize that these techniques are most likely to be effective in areas where taxpayers have not already determined that they will lie to obtain the credit. In other words, they may be open to subtle, behavioral prompts that push them back to the right side of the ledger. For these methods to work, then, not only must taxpayers be susceptible to the messages or treatments, but they must actually receive them.

This brings our discussion full circle. The Service’s reliance on traditional compliance approaches does not distinguish among compliance tools to determine which are most effective and least burdensome for specific taxpayers to gain compliance. Thus, audit targets are determined based on characteristics of returns and incorporate little data about the propensity of a given taxpayer to respond to less coercive methods. There may be a more efficient and effective way.

221 Letter from Office of Tax Analysis to the IRS Software Developers Working Group (Sept. 21, 2016) (private correspondence on file with authors).
The ideas we propose for exploration here offer the opportunity for the Service and other state departments of revenue to identify taxpayers for whom noncompliance may be addressed through less expensive methods, freeing up resources for cases where more direct application of government compliance tools is necessary.

VI. CONCLUSION

Improving voluntary compliance with the EITC would improve tax administration. The Service is a key player in delivering benefits to lower- and moderate-income Americans. Being knowledgeable about what will influence taxpayer behavior and implementing that knowledge in EITC procedures can be a key part of the way the Service can reduce EITC program error. The insights we discuss are not novel, but they are somewhat new for tax administrators in this context. By identifying approaches that it can test in real-world scenarios, we believe that the Service can supplement its existing approaches to reducing an overclaim rate that has been stubbornly hovering at or around the 25% mark for the better part of two decades.