THE EARNED INCOME TAX CREDIT AS AN INCENTIVE TO REPORT: ENGAGING THE INFORMAL ECONOMY THROUGH TAX POLICY

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The Earned Income Tax Credit (EITC) provides financial assistance to low-income workers through a refundable tax credit. The EITC, which has received strong bipartisan support since its introduction in 1975, now represents the nation's largest anti-poverty program for non-elderly individuals. In this Note, I contend that the EITC's historical development failed to account for (and prior scholarly analysis of its impact on labor supply decisions have ignored) the important role of informal employment in the lives of the working poor. This Note presents the first analysis of the financial impact of government transfer and tax programs on the decision to report informal income—income that, were it reported, would be otherwise legal. As the Note's analysis reveals, while drastic changes in both tax and transfer programs may be necessary to provide financial incentives for many households with children to report informal income, more targeted changes to the EITC could provide strong incentives for childless informal workers to report. The Note argues that the benefits to both individuals and society, financial and otherwise, of tax reporting by low-income individuals engaged in informal work merits reconsideration of the EITC's overall structure and administration. Administrative and policy innovations described in the Note are also necessary to maximize reporting compliance.

INTRODUCTION

At a bus shelter in New York City's Greenwich Village, a poster advertises the Earned Income Tax Credit (EITC), declaring: "EITC: It's Your Money. Come and get it!" Each day vendors position long tables of used books and magazines next to this advertisement.[1] These entrepreneurial members of the informal economy[2] compete

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1 For an ethnography of these vendors based on five years spent observing and working with them, see MITCHELL DUNEIER, SIDEWALK (1999).

2 The informal economy is defined and discussed *infra* Part I.

with the Barnes & Noble bookstore across the sidewalk. They also cater to a different market, meeting niche demands for magazine back issues and out-of-print books.

A recent survey of wages reported that a Barnes & Noble clerk in New York City earns $7.75 per hour.[3] Working full time, this amounts to $15,500 per year.[4] A single individual with this income and two or more children would, upon filing her federal income tax return, owe no federal income tax and would be eligible for a payment from the government of $4380, only slightly below the maximum EITC credit.[5]

The individuals working outside Barnes & Noble selling books in the informal economy do not receive a guaranteed hourly wage. Like most Americans who work informally, it is unlikely that these vendors report their income for tax purposes. Unlike most higher-income earners, who avoid reporting informal economic transactions to reduce their tax burden,[6] low-income informal earners could potentially benefit from reporting this income, as doing so might render them eligible for a refundable credit through the EITC.

But is such informal work the type of economic activity the EITC was enacted to or should seek to encourage? This Note argues that certain forms of informal income should be counted for purposes of the EITC. It also offers the first sustained analysis in the legal or policy literature of the tax and transfer program effects of reporting informal income and how these shape the relationship between the EITC and the informal economy.

Although the unreported and often clandestine nature of the informal economy complicates attempts to accurately measure it, all completed studies indicate that the size of this economy is substantial.[7] A 1991 study estimated $461 billion in unreported income in the

[3] *Who Makes How Much*, NEW YORK, Sept. 26, 2005, at 38, 42.

[4] Calculation based on a 2000 hour work year.

[5] The Earned Income Tax Credit (EITC) provides a refundable credit, administered through the tax system, to low-income individuals. As a credit it reduces (offsets) the amount of tax an individual would otherwise owe. As a refundable credit it can result in a direct payment from the government to the taxpayer if the amount of EITC for which an individual qualifies exceeds the tax he or she would otherwise owe. For a detailed analysis of the structure of the EITC, see *infra* Part II.A.

[6] In 2001 the IRS lost approximately $292 billion in tax revenue due to income underreporting. *Testimony Before the Subcomm. on Fed. Financial Management, Government Information, and Internal Security*, 109th Cong. 3 (2005) [hereinafter *Tax Gap Hearing*] (statement of J. Russell George, Treasury Inspector Gen. for Tax Administration), *available at* http://www.treas.gov/tigta/congress/congress_10262005.pdf.

[7] Several sources offer helpful discussions of different methods for measuring the informal economy. *See* OFFICE OF INT'L ECON. AFFAIRS, U.S. DEP'T OF LABOR, THE UNDERGROUND ECONOMY IN THE UNITED STATES 9–26 (1992) (surveying both comprehensive instruments for estimating size of underground economy and studies focused on particular sectors and regions); FRIEDRICH SCHNEIDER, SIZE AND MEASUREMENT OF THE

United States; this represents 8.1% of GDP.[8] A more recent study set the U.S. informal economy at 8.2% of GDP in 1991–92, rising to 8.7% in 2001–02.[9] It is difficult to determine how much of this economic activity is inherently illegal and how much represents unreported earnings from the production of otherwise legal goods and services.[10]

This Note focuses on informal economic activity in the form of unreported income that, were it reported for tax purposes, would be legal. Due to the additional complexities presented by an attempt to encourage tax reporting by employers who pay their employees off-the-books, this Note further concentrates on individuals who are eligible for the EITC[11] and who work informally in situations where they can choose independently to report their income for tax purposes.[12] Throughout the Note this group will be referred to as "self-employed low-income earners" (SELEs). The relevant income includes that

INFORMAL ECONOMY IN 110 COUNTRIES AROUND THE WORLD 33–44 (2002), http://rru.worldbank.org/Documents/PapersLinks/informal_economy.pdf ("Although the different methods provide a rather wide range of estimates, there is a common finding that the size of the informal economies for most transition and all investigated OECD countries has been growing over the recent decade."); Jan L. Losby et al., Informal Economy Literature Review 32–35 (2002), *available at* http://www.ised.us/doc/Informal%20Economy%20Lit%20Review.pdf (discussing four different methods of measuring informal economy); *see also* SUDHIR ALLADI VENKATESH, OFF THE BOOKS: THE UNDERGROUND ECONOMY OF THE URBAN POOR 11–12 (2006) ("[A]lthough one can conclude with some confidence that the underground economy is significant for Americans, one is hard-pressed to have confidence in exact estimations of its size or dollar flow . . . .").

8 Morton Paglin, *The Underground Economy: New Estimates from Household Income and Expenditure Surveys*, 103 YALE L.J. 2239, 2239, 2248 (1994) (estimating size of underground economy in United States by analyzing "household reports of income and expenditures published annually in the Bureau of Labor Statistics Consumer Expenditure Survey").

9 SCHNEIDER, *supra* note 7, at 20 tbl.8. Schneider uses the currency demand approach and data from the World Bank to make his calculations. *Id.* at 6 tbl.2, 20 tbl.8. An analysis of the informal economy in Los Angeles County estimated that approximately 15% of jobs in Los Angeles are filled by an informal workforce of approximately 800,000 workers. Pascale Joassart-Marcelli & Daniel Flaming, *Workers Without Rights: The Informal Economy in Los Angeles* 13–15 (Econ. Roundtable Briefing Paper, 2002), *available at* http://www.economicrt.org/pub/workers_without_rights/workers_without_rights.doc.

10 Some estimates of this division do exist. A 1983 IRS study estimated $249.7 billion in unreported income from legal activities in 1981 and an additional $34 billion from illegal activities that year. Richard D. Porter & Amanda S. Bayer, *Monetary Perspective on Underground Economic Activity in the United States*, *in* THE UNDERGROUND ECONOMIES 129, 129 (Edgar L. Feige ed., 1989).

11 This limitation excludes from consideration income earned by undocumented individuals, who are ineligible for the EITC. Although these individuals likely represent a significant portion of the informal economy, there is sufficient evidence to indicate that even absent this group a sizeable informal economy remains within the United States. *See infra* Part I.B.

12 For a justification of the exclusion of this income, see *infra* note 25 and accompanying text.

earned through an individual's own microenterprise, or through occasional or irregular self-employment.[13]

It is equally difficult to determine how many specifically low-income individuals work within the informal economy. The few studies that have been done, however, as well as anecdotal evidence, indicate that informal economic activity is at least equally prevalent among low-income individuals as it is among the general population.[14]

One study estimated that low-income individuals working in the informal economy in Los Angeles County alone lose approximately $1.39 billion in EITC benefits each year.[15] Even using the most conservative estimates of the size of the informal economy, low-income individuals nationwide who work informally lose out on billions of dollars in potential tax credits. The benefits of reporting, however, are not as straightforward as they might seem: For many filers, particularly those with children, the reduction in transfer program benefits that would result from reporting informal income outweighs these lost EITC benefits.[16]

This Note calls for a reevaluation of the EITC's role as a work incentive. The EITC's design, and prior scholarly analysis of the credit, have ignored the informal economy's important role in the lives of the working poor. Private tax-filing assistants have emphasized traditional/formal wages when preparing EITC returns. Meanwhile, the Internal Revenue Service (IRS) has, by emphasizing wage earnings, given low-income informal workers no reason to believe they might be eligible for the EITC and thereby benefit from reporting their income.[17] Combined, these trends have hindered the EITC's capacity to serve as a financial incentive for formal reporting of earnings from the informal cash economy or bartered services.[18]

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[13] For a more extensive discussion of the categories of informal income discussed in this Note, see *infra* Part I.A.

[14] *See infra* Part I.B.

[15] Joassart-Marcelli & Flaming, *supra* note 9, at 15–16 (estimating lost EITC benefits for 811,000 informal workers).

[16] For an analysis of the tax and transfer program effects of reporting informal income, see *infra* Part III.A.2. For the purposes of this Note, "transfer programs" (commonly known as welfare) include two federal programs: Temporary Aid to Needy Families (TANF) and Food Stamps. TANF, which replaced the Aid to Families with Dependent Children Program (AFDC) in 1997, provides direct cash benefits to eligible families with children, as well as work opportunities. Admin. for Children & Families, U.S. Dep't of Health & Human Servs., Welcome to the Office of Family Assistance, http://www.acf.hhs.gov/programs/ofa/ (last visited Feb. 1, 2008). Throughout this Note, all references to TANF refer only to the cash benefit received by TANF-eligible households.

[17] *See infra* notes 54–57 and accompanying text.

[18] The interaction between barter income and the EITC has received no substantial treatment in the scholarly literature. The potential for low-income individuals to benefit from claiming barter activities as "taxable exchanges of services" is briefly noted in a foot-

This Note proceeds in four parts. Part I discusses the general nature of the informal economy and why its prevalence among low-income individuals merits attention. Part II contends that the EITC's current structure and historical development witness a shift away from the credit's original role as a work incentive. As a result the EITC's purpose has become increasingly unclear. An analysis of the tax and transfer program effects of reporting informal income constitutes Part III. This analysis reveals that while substantial restructuring of the tax and transfer systems would be necessary to create financial incentives for most filers with children, less dramatic changes to the EITC could create positive incentives for childless filers to report informal income. Part IV argues that the benefits of tax reporting by low-income individuals engaged in informal work merit reconsideration of these benefit reductions and of the EITC's overall structure, particularly for childless filers. Although encouraging increased reporting of informal income poses potential compliance problems, administrative and policy innovations can minimize these concerns.

These proposed changes would allow the EITC to better fulfill its original purpose as a work incentive and also expand the credit's role to encourage the reporting of existing informal income.[19] By enabling the EITC to better respond to the economic reality of low-income individuals, the proposal offers these individuals an avenue into the mainstream economy.

I
The Informal Economy

Part I defines the informal economy before focusing on the experience of low-income individuals working informally.

A. Defining the Informal Economy

Both the size and nature of the informal economy remain poorly defined.[20] The term "informal economy" often appears interchange-

note to the treatise *Federal Income Taxation of Individuals*. Boris I. Bittker, Martin J. McMahon, Jr. & Lawrence A. Zelenak, Federal Income Taxation of Individuals § 3.03 n.39 (3d ed. 2002) (noting that, to benefit low-income individuals, EITC must "exceed the combination of the tax imposed under §1 [of the Internal Revenue Code, which outlines the federal income tax] and the Social Security wage tax").

19 This Note's analysis focuses on financial incentives to report informal income. It must be acknowledged that financial considerations alone do not determine whether an individual will choose to report income or not. Complexity, convenience, personal preference, and other factors may also shape this decision.

20 *See* Employment Sector, Int'l Labour Office, Women and Men in the Informal Economy: A Statistical Picture 11 (2002) ("The concept of the informal sector has been debated since its 'discovery' in Africa in the early 1970s."); Edgar L. Feige,

ably with other concepts, including the "irregular economy," "underground economy," and "shadow economy."[21] The informal economy may include both income generated from activities that are inherently illegal (e.g., prostitution, theft, drug sales) and income from legal activities that is not reported as required for tax or regulatory purposes.[22] This paper limits its definition of the informal economy to "unreported income from the production of legal goods and services, either from monetary or barter transactions—hence all economic activities which would generally be taxable were they reported to the [federal] (tax) authorities."[23]

Excepting illegal activities, the informal economy that remains includes a range of unreported income sources: off-the-books income from a third-party employer; self-employment income from a small business or microenterprise that comprises an individual's primary source of income; and income from occasional, irregular, and possibly seasonal work. Any of these income sources could involve payment through the bartering of goods or services in lieu of cash.[24] This Note focuses on SELEs who earn monetary income through microenterprises and/or occasional or irregular self-employment. Thus it will not

Introduction to THE UNDERGROUND ECONOMIES: TAX EVASION AND ECONOMIC DISTORTION 1, 3–4 (Edgar L. Feige ed., 1989) (noting different meanings of underground economy); Susan Pozo, *Introduction* to EXPLORING THE UNDERGROUND ECONOMY: STUDIES OF ILLEGAL AND UNREPORTED ACTIVITY 1, 1 (Susan Pozo ed., 1996) ("Because of its nature . . . direct measurement of the magnitude of underground economic production and participation is usually not possible."); Losby et al., *supra* note 7, at 3 ("The literature is marked by considerable disagreement over the conceptual definition of informal work.").

21 Losby et al., *supra* note 7, at 2. The International Labor Organization introduced the concept in the early 1970s during a study of urban labor markets in Ghana. *Id.* Researchers published the first major study of informal economic activity in the United States in the early 1970s. Louis A. Ferman & Patricia R. Ferman, *The Structural Underpinning of the Irregular Economy*, 8 POVERTY & HUM. RESOURCES ABSTRACTS 3 (1973).

22 *See* OFFICE OF INT'L ECON. AFFAIRS, *supra* note 7, at 2–3 (providing as examples of unreported but legally sourced income: "cash payments made for off-the-books . . . work," "unreported income of family members in small shops," and "unreported income from bartering of goods and services").

23 This definition is borrowed from SCHNEIDER, *supra* note 7, at 3.

24 For a useful "Taxonomy of Types of Underground Economic Activities," see THE UNDERGROUND ECONOMY: GLOBAL EVIDENCE OF ITS SIZE AND IMPACT 5 (Owen Lippert & Michael Walker eds., 1997).

directly discuss off-the-books income from a third-party employer[25] or barter income[26] from any source.

B. *Informal Economic Activity Among Low-income Households*

Attempts to determine the relationship between an individual's income level and his or her proclivity to engage in informal work remain inconclusive.[27] Although some have asserted that access to formal employment renders an individual less likely to engage in informal work,[28] other research has found "those in a favored position in the formal economy are most able to develop and sustain informal economic activities."[29] Burdensome regulations, along with taxes and social security payments, often compel individuals to work informally.[30] To the extent high-income individuals are subject to higher marginal tax rates (MTR),[31] incentives to work informally increase. The incentive structure is not so simple, however, since low-income individuals—with correspondingly lower MTRs—may confront high

[25] The exclusion of off-the-books income is necessary to focus the analysis on the incentives that affect low-income earners' reporting decisions. In order to transition informal off-the-books income into reported income, the employer would need to report the wages she pays, in addition to the earner's reporting. The employer's decision would depend on separate considerations beyond the scope of this paper, including the effects of corporate and partnership taxes.

[26] Barter income is taxable at the fair market value of the property or services exchanged. Rev. Rul. 79-24, 1979-1 C.B. 60; *see also* MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 124 (5th ed. 2005) (explaining rule for taxing barter income). For individuals who operate formal businesses and charge a regular fee for their goods or services, this valuation may be easy. However, for those who operate informally, the valuation of barter activities can lead to additional complexities. Moreover, to the extent a low-income individual who receives the EITC might benefit from reporting a larger income, the valuation of barter activities can lead to additional compliance and gaming concerns. For a discussion of compliance and gaming issues related to the reporting of informal income more generally, see *infra* Part IV.B.2.

[27] Losby et al., *supra* note 7, at 23.

[28] *Id.* (citing studies).

[29] *Id.*; *see also* SCHNEIDER, *supra* note 7, at 25 ("Social networks and personal relationships, the high profit from irregular activities and associated investments in real and human capital are strong ties which prevent people from transferring to the official economy.").

[30] SCHNEIDER, *supra* note 7, at 21, 44; Richard J. Cebula, *An Empirical Analysis of the Impact of Government Tax and Auditing Policies on the Size of the Underground Economy: The Case of the United States, 1973–94*, 56 AM. J. ECON. & SOC. 173, 173 (1997) ("It is generally accepted that the size of the underground economy may be affected by income tax rates.").

[31] A marginal tax rate is the amount of tax an individual pays on each additional dollar he or she earns. For example, an individual subject to a marginal tax rate of 20% who earned an additional $100 would pay $20 in tax on these earnings. Marginal tax rates rise as income increases. *See* GRAETZ & SCHENK, *supra* note 26, at 24–25 (discussing marginal and average tax rates).

effective marginal tax rates (EMTR)[32] due to transfer program reductions.[33]

According to a study of welfare-reliant mothers, 39% of respondents engaged in unreported work, largely to make ends meet while avoiding the loss of welfare benefits.[34] This compares with 5% of respondents involved in reported work and 8% in "underground work" (defined as "inherently illegal").[35] Some contend that the higher incidence of self-reported income among EITC filers might reflect greater participation in casual labor in the form of irregular or occasional self-employment.[36] A survey of the informal economy in rural Pennsylvania found only minor variations by income level in the percentage of families participating in informal transactions.[37]

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[32] An effective marginal tax rate includes reductions in transfer program benefits due to program phase-outs. For example, a low-income individual with a marginal tax rate of 10% might also, at a certain income level, be subject to a phase-out of his food stamps at a rate of 10%. As a result, while his marginal tax rate is 10%, his effective marginal tax rate is 20%. For each additional $100 he earns, he owes $10 in tax and loses $10 in food stamps; so the additional $100 in income only makes him $80 better off.

[33] For an analysis of the effective marginal tax rates facing low-income filers, see *infra* Part III.A.2 .

[34] KATHRYN EDIN & LAURA LEIN, MAKING ENDS MEET: HOW SINGLE MOTHERS SURVIVE WELFARE AND LOW-WAGE WORK 150 tbl.6-1 (1997). The survey's data was obtained between 1988 and 1992, prior to the 1993 expansion of the EITC. *Id.* at 101. Twenty-eight percent of survey participants defined as "wage-reliant," rather than "welfare-reliant," engaged in "supplemental unreported work." *Id.* at 151 tbl.6-2. The decision to pursue unreported work in addition to formal work primarily served to ensure continued eligibility for other government programs or to avoid additional income taxes. *Id.* at 175.

[35] *Id.* at 150, 176.

[36] *See* CAROLYN J. HILL ET AL., EITC ELIGIBILITY, PARTICIPATION AND COMPLIANCE RATES FOR AFDC HOUSEHOLDS: EVIDENCE FROM THE CALIFORNIA CASELOAD 5–6 (1999).

> In 1994, 15.2 percent of all EITC recipients reported self-employment income on Schedule C of their tax returns; this accounted for 7.3 percent of the total income reported by recipients. In contrast, only 10.4 percent of all individual taxpayers reported any self-employment income in 1993 and it accounted for only 4.4 percent of the income they reported.

Id. (citing GAO BRIEFING REPORT, EARNED INCOME CREDIT: PROFILE OF TAX YEAR 1994 CREDIT RECIPIENTS 30 (1996); GAO REPORT, TAX ADMINISTRATION: TAX COMPLIANCE OF NONWAGE EARNERS 7 fig.2 (1996)).

[37] Leif Jensen, Gretchen T. Cornwell & Jill L. Findeis, *Informal Work in Nonmetropolitan Pennsylvania*, 60 RURAL SOC. 91, 99 tbl.2 (1995) (finding that 57.5% of respondents making $7500 or less participated in informal economy compared to 60.7% of individuals making between $7501 and $15,000 and 49.2% of individuals making more than $40,001). It is unclear whether similar results would be found in urban settings. As the authors observe: "lacking economies of agglomeration, essential services may be unavailable or deficient in less densely settled rural areas, forcing people to develop and rely on informal alternatives." *Id.* at 92.

There are strong indications that the informal economy plays an important role in the lives of many low-income individuals.[38] Given this prominence, and its effect on both low-income individuals and their surrounding communities, the informal economy merits attention when determining how to most equitably and efficiently structure the EITC and government transfer programs. Understanding such activity is crucial to confronting poverty and forecasting economic performance.[39]

The next section analyzes the EITC's structure, genesis, and its historical policy justifications. To analyze adequately if and how the EITC should count informal income, one must first understand this history.

II
The EITC's Structure, History, and Purpose

A. The Structure of the EITC

Since 1975, the EITC has provided financial assistance to low-income workers in the form of a refundable tax credit.[40] As a refundable credit, the EITC first serves to offset a taxpayer's income tax liability; if the credit exceeds tax liability, the additional amount is returned to the taxpayer as a refund.[41] Congress has expanded the credit on six occasions, most recently in 2001.[42] These expansions have received the support of both Republican and Democratic presi-

[38] *See* Venkatesh, *supra* note 7 (describing underground economy as "vast, often invisible web that girded" low-income Chicago neighborhood); Alejandro Portes, *The Informal Economy and Its Paradoxes*, *in* The Handbook of Economic Sociology 426, 426–27 (Neil J. Smelser & Richard Swederg eds., 1994).

[39] *See* Employment Sector, *supra* note 20, at 13–14 (noting need to consider informal economic activity and income sources of poor in attempting to accurately "predict and model economic performance" and "understand and address poverty"). Jensen and his colleagues, in their study of informal work in rural Pennsylvania, contend that "a complete understanding of the determinants of economic well-being requires consideration of the full range of strategies that families and individuals use to capture cash and in-kind income." Jensen et al., *supra* note 37, at 104 (arguing that informal work "may be even more important in rural America" than in cities). In-kind income is typically received through the bartering of goods and services.

[40] Dennis J. Ventry, Jr., *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit*, *in* Making Work Pay: The Earned Income Tax Credit and Its Impact on America's Families 15, 15 (Bruce D. Meyer & Douglas Holtz-Eakin eds., 2001). A refundable tax credit "means that people with no tax liability can receive a credit; they file a tax return to receive a cash payment [from the government]." Graetz & Schenk, *supra* note 26, at 420.

[41] Steve Holt, The Brookings Inst., The Earned Income Tax Credit at Age 30: What We Know 5 (2006).

[42] *See* Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 Stan. L. Rev. 23, 34 (2006) (discussing current refundable tax credits).

dential administrations and Congresses.[43] The EITC, which in 2005 provided more than $41 billion in assistance to over 22 million families, represents the nation's largest anti-poverty program for non-elderly individuals.[44]

To qualify for the EITC, an individual must have earned income, which the next section discusses in detail.[45] The size of the credit to which a recipient is entitled, calculated as a percentage of income,[46] initially increases as income rises, then plateaus, and eventually phases out at higher incomes.[47] These percentages, and the relevant income ranges for the credit to phase in, plateau, and phase out, differ depending on the number of qualifying children[48] in a recipient's household.[49] Recipients with two or more qualifying children receive the largest EITC benefit.[50] A much smaller EITC is available for childless workers between the ages of 25 and 64.[51]

The following chart depicts the EITC's structure in 2005:

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43 *Id.* at 35 & n.46; *see also* CHRISTOPHER HOWARD, THE HIDDEN WELFARE STATE: TAX EXPENDITURES AND SOCIAL POLICY IN THE UNITED STATES 64, 139–40 (1997) (noting "universal acclaim among political elites" for EITC); Lawrence Zelenak, *Redesigning the Earned Income Tax Credit as a Family-Size Adjustment to the Minimum Wage*, 57 TAX L. REV. 301, 301 (2004) ("[T]he credit has been popular with both conservatives (for conditioning eligibility on the existence and amount of earned income), and liberals (for its redistributive effects)."). Bipartisan support for the EITC continues despite some recent criticism by conservatives. JASON FURMAN, CTR. ON BUDGET & POLICY PRIORITIES, TAX REFORM AND POVERTY 1–2 (2006), *available at* http://www.cbpp.org/4-10-06tax.pdf.

44 *Hearing on Earned Income Tax Outreach Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 110th Cong. (2007) [hereinafter *EITC Hearings*] (statement of Richard J. Morgante, Comm'r, Wage and Investment Division, Internal Revenue Service), *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=5432.

45 I.R.C. § 32(a)(1) (2000).

46 *Id.*

47 *See* HOLT, *supra* note 41, at 2–5 (reviewing structure, history, and research regarding impact of EITC).

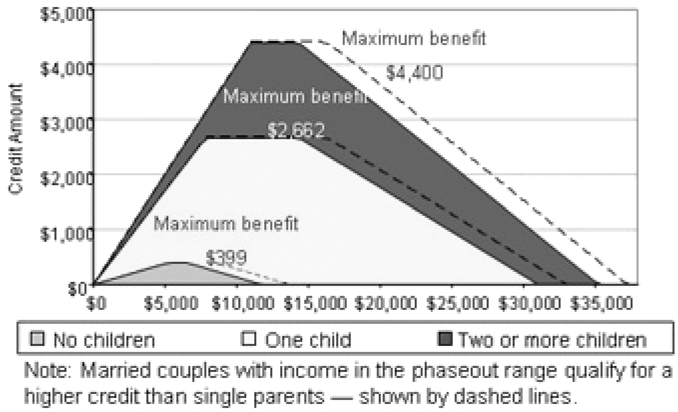
48 "Qualifying children" are defined based on relationship, age, residence, and support. *See* Internal Revenue Serv., U.S. Dep't of the Treasury, A "Qualifying Child," http://www.irs.gov/newsroom/article/0,,id=133298,00.html (last visited Jan. 7, 2008).

49 I.R.C. § 32(b); *see also* HOLT, *supra* note 41, at 3 (discussing current definition of qualifying child).

50 I.R.C. § 32(b)(1)(A); HOLT, *supra* note 41, at 3.

51 I.R.C. § 32(c)(1)(A)(ii) outlines the EITC eligibility requirements for a childless individual.

FIGURE 1: THE FEDERAL EARNED INCOME TAX CREDIT IN TAX YEAR 2005



Source: Center on Budget and Policy Priorities[52]

B. *What Does (and Should) Count as Earned Income?*

The tax code defines *earned income* as: "(i) wages, salaries, tips, and other employee compensation, plus (ii) the amount of the taxpayer's net earnings from self-employment for the taxable year (within the meaning of section 1402(a))."[53]

In describing the EITC, the IRS identifies two sources of earned income: "Earned income generally means wages, salaries, tips, other taxable employee pay, and net earnings from self-employment."[54] The IRS website declares that "[e]arned income includes all the taxable income and wages you get from working."[55] Specifically: "There are two ways to get earned income: 1. You work for someone who

52 Ctr. on Budget and Policy Priorities, The Earned Income Tax Credit, http://www.cbpp.org/pubs/eitc.htm (last visited Feb. 4, 2008).

53 I.R.C. § 32(c)(2)(A). The IRS defines "net earnings from self-employment" as:

> the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member . . . .

Id. § 1402(a).

54 INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, PUBL'N NO. 596, EARNED INCOME CREDIT (EIC) 23 (2006); *see also* Internal Revenue Serv., U.S. Dep't of the Treasury, EITC for Individuals, http://www.irs.gov/individuals/article/0,,id=150557,00.html (last visited Jan. 7, 2008) (noting, among requirements for claiming EITC, that "[an applicant] must have earned income from employment or from self-employment").

55 Internal Revenue Serv., U.S. Dep't of the Treasury, Earned Income Tax Credit (EITC) Questions and Answers: What is Earned Income?, http://www.irs.gov/individuals/article/0,,id=96466,00.html#QA6 (last visited Jan. 7, 2008).

pays you, or . . . 2. [y]ou work in a business you own."[56] This definition, which is also found on IRS forms, arguably gives individuals little reason to believe that informal income might be includible, as the only mention of self-employment income—a reference to "a business you own"—might easily be understood as being applicable only to earnings from a formal licensed business.[57]

Despite these ambiguities in the IRS literature, the tax code's definition of earned income through self-employment as earnings from "any trade or business" is broad enough to include income from occasional informal work or the informal operation of a small business. The next section, which analyzes the EITC's origins and early development, explains why the credit's early proponents emphasized earned income.

C. The Origins and Establishment of the EITC

The EITC originated in the aftermath of President Nixon's failed Family Assistance Plan (FAP), which was introduced in August of 1969 to provide a national minimum cash guarantee.[58] This proposed guaranteed income would have taken the form of a negative income tax,[59] coupled with measures to minimize work disincentives.[60] FAP ultimately foundered amid claims that it would neither end welfare

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56 *Id.* The IRS publication explaining EITC eligibility similarly implies that self-employed individuals must own a registered business: "You may have net earnings from self-employment if: You own your business, or [y]ou are a minister or member of a religious order." INTERNAL REVENUE SERV., *supra* note 54, at 10.

57 Although one might contend that many or most EITC-eligible households are not accessing information via the Internet or reading IRS documentation, the vast majority of EITC recipients utilize paid preparers. These preparers' understanding of what constitutes EITC-eligible income is therefore vitally important. *Cf. EITC Hearings*, *supra* note 44 (statement of Richard J. Morgante, Comm'r, Wage and Investment Division, Internal Revenue Service) (observing that while many EITC recipients may lack access to computer and online EITC Assistant, most EITC returns are completed by paid preparers and online information can aid these professionals).

58 Ventry, *supra* note 40, at 19. A national minimum cash guarantee represents a guaranteed income paid by the government to all citizens. Such a program is alternately referred to as a Universal Basic Income (UBI) or a Basic Income Guarantee. Unlike welfare, such a guarantee does not involve pre-certification or eligibility requirements. *See* Robert M. Solow, *Foreword* to WHAT'S WRONG WITH A FREE LUNCH?, at ix (Joshua Cohen & Joel Rogers eds., 2001) (offering diverse perspectives on desirability and feasibility of UBI).

59 A negative income tax, which represents one possible form of cash guarantee, pays low-income individuals a certain amount of money through the tax system. This amount is reduced as income rises. When the amount reaches zero the individual becomes subject to a positive income tax. Robert A. Moffitt, *The Negative Income Tax and the Evolution of U.S. Welfare Policy*, 17 J. ECON. PERSP. 119, 119 (2003).

60 *See* Ventry, *supra* note 40, at 19 ("[FAP's] use of an income disregard, fractional phase-outs, and a requirement that all recipients either maintain employment or seek work . . . would keep work disincentives to a minimum.").

dependence nor incentivize work.[61] In response to these criticisms, subsequent proposals emphasized incentives for low-income individuals to obtain or increase waged employment.[62]

Senator Russell Long, a key FAP critic, proposed an alternative program to target assistance towards the "deserving" poor by providing subsidies and a "work bonus" to low-income workers.[63] Unlike FAP, which provided higher benefits to those with no earned income, Long's program phased in benefits as income increased, thereby targeting the working poor.[64]

Long's efforts gained support in the Senate and, after failing twice in the House, a temporary, refundable Earned Income Credit (EIC) was adopted in 1975 as part of President Ford's Tax Reduction Act.[65] The Senate Finance Committee's report stressed the EIC's potential for "encouraging people to obtain employment, reducing the unemployment rate and reducing the welfare rolls."[66] The House Ways and Means Committee emphasized the credit's role in offsetting the social security tax burden on low-income individuals.[67] Interestingly, the initial credit, which was phased in at ten percent, offset both the employer and employee portions of the social security tax in effect at that time.[68] The Senate Finance Committee portrayed this as inten-

61 *Id.* at 19–20 (describing insistence of FAP's opponents that program's weak work requirements made its benefits practically "cash giveaways").

62 *Id.* at 22–25 (detailing proposals spearheaded by Senators Russell Long and Martha Griffiths, and President Gerald Ford, all of which emphasized work incentives to varying degrees).

63 *Id.* at 20; HOWARD, *supra* note 43, at 67 (explaining that Long's alternative included ten percent work bonus).

64 *See* Ventry, *supra* note 40, at 22.

65 *Id.* at 25; HOWARD, *supra* note 43, at 69. The initial section 32 of the Internal Revenue Code provided a refundable credit to taxpayers with incomes below $8000. Individuals received 10%, or $400, for the first $4000 of earned income. The credit phased out at a rate of 10% of income over the next $4000 in income. Ventry, *supra* note 40, at 25.

66 Ventry, *supra* note 40, at 25.

67 *Id.* at 53, n.40; HOWARD, *supra* note 43, at 68 (discussing emphasis placed by Long and then-California Governor Ronald Reagan on work bonus's role in reducing effects of payroll taxes on working poor). *See also* 118 CONG. REC. 33,010, 33,011 (1972) (statement of Sen. Long) (asserting that one purpose of EIC is to "prevent the social security tax from taking away from the poor and low-income earners the money they need for support of their families"). Social security taxes, a form of payroll tax (rather than income tax), are automatically withheld from paychecks and are paid on the first dollar an individual earns (unlike income taxes). The employer and employee each pay one-half of the total social security tax (currently 15.3% of earnings). The social security tax is paid at this flat rate on all income up to a certain level, unlike the income tax, whose marginal rate rises as income rises. As a result, social security taxes place a greater burden on low-income individuals than the income tax, to which many low-income individuals are not subject, due to the income tax system's structure. GRAETZ & SCHENK, *supra* note 26, at 13.

68 Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 UCLA L. REV. 1867, 1907 (2005).

tional: "The credit is set at 10 percent in order to correspond roughly to the added burdens placed on workers by both employee and employer social security contributions."[69] The offsetting of tax burdens is closely linked to the EITC's role as a work incentive.[70]

Congress's aim of maximizing income earned "in the market" was focused on maximizing income from *formal* market labor.[71] It is less clear whether the credit's early proponents considered its potential effect on taxpayers' decision to leave the *informal* workforce, either by reporting existing earnings from informal work (and thereby formalizing that work) or by leaving behind informal work to pursue new formal employment opportunities.

D. The EITC's Subsequent Development

The EITC's subsequent development shifted the credit away from its original role as a payroll tax offset and work incentive. As the credit grew in size, it increasingly became a component of broader social policy. The Tax Reform Act of 1986 sought to remove many low-income families from the welfare rolls through the largest increase in the EITC since its establishment.[72] In 1990 the first Bush administration further expanded EITC eligibility and nearly doubled the maximum available credit to $1702.[73] This expansion was partly motivated by the desire to increase support for child-care expenses.[74] These two expansions reveal a conscious effort to broaden the EITC's purposes.[75]

Elected in part on a pledge to ensure that those who worked full-time would not live in poverty, President Clinton supported a further

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[69] *Id.* (quoting S. REP. 94-36, at 11 (1975)). Zelenak describes the Senate Finance Committee as "enlightened" for considering both the employer and employee portions of the social security tax when determining the appropriate size of the credit. Most economists believe that employees bear the burden of both portions of this tax. *See infra* note 135.

[70] *See* Nancy C. Staudt, *Taxing Housework*, 84 GEO. L.J. 1571, 1623 (1996) ("Congress's intent in adopting [the EITC] was in part to encourage taxpayers to work in the waged labor force by offsetting a portion of the tax burden associated with earning income in the market.").

[71] This assumption is based simply on the credit's emphasis on offsetting payroll taxes, which are only a consequence of formal employment.

[72] *See* HOWARD, *supra* note 43, at 145 (describing how Tax Reform Act of 1986 came amidst events that turned EITC into "an object of party competition").

[73] *Id.* at 156 (noting increase from $953 in 1990 to $1702 by 1994).

[74] *See id.* (noting desire, in both 1986 and 1990 EITC expansions, to also render larger piece of tax legislation more progressive); *see also* GRAETZ & SCHENK, *supra* note 26, at 420–21.

[75] *See* Ventry, *supra* note 40, at 46 (claiming that 1986 expansion of EITC transformed program "from an obscure tax credit to a more visible social instrument with significant antipoverty responsibilities").

expansion of the EITC in 1993.[76] This expansion provided, for the first time, EITC support to individuals without children. It also offered households with two or more children greater EITC support than that available to single-child households.[77]

The Bush and Clinton EITC expansions sparked complaints that benefit levels had become too generous, causing work disincentives and creating a welfare program for the middle class.[78] Some commentators noted a decline in bipartisan support for the EITC, perhaps precipitated by this rapid expansion.[79] That most EITC benefits now took the form of a direct payment from the federal government to the taxpayer, rather than an offset of other taxes owed, compounded these criticisms.[80]

As it is currently structured, the EITC provides substantially larger benefits to recipients with children. Thus it is understandable that some critics view the credit as a form of welfare—with benefits based on familial need—rather than as a wage subsidy designed to incentivize market labor. Nevertheless, the EITC—both as originally designed and currently structured—initially increases in value as income rises, thereby providing an incentive to engage in formal work. The next Part will analyze whether this incentive is sufficient to encourage EITC-eligible filers to report informal income or substitute formal employment for informal employment. Determining whether the EITC should provide such an incentive first requires one to consider the credit's purpose.

E. What Should the EITC Be Doing?

Commentators have attributed the historically broad support for the EITC in part to the credit's ambiguous and malleable policy

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76 *See* HOWARD, *supra* note 43, at 156–68 (detailing Clinton's efforts to expand EITC after presidential campaign highlighted economic insecurity of ordinary citizens).

77 *See* C. EUGENE STEUERLE, CONTEMPORARY U.S. TAX POLICY 174 (2004) ("[H]ouseholds with two or more children would receive more help than a one-child household for whom no increase was provided.").

78 *See* Ventry, *supra* note 40, at 34–35 (discussing how focus on nominal growth of EITC led to impression that it was "too much of a good thing"); *see also* HOLT, *supra* note 41, at 3 (speculating that "dramatic growth" of EITC "may have contributed to a decline in the bipartisan support [for the credit]"); James Bovard, *Clinton's Biggest Welfare Fraud*, WALL ST. J., May 10, 1994, at A18 ("[T]he EITC program is the nation's most politically popular, fastest growing, and most fraud-prone welfare program . . . ."). For criticisms of the EITC's effectiveness as a welfare or transfer program, see Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533 (1995).

79 *See, e.g.*, HOLT, *supra* note 41, at 3.

80 *See* Ventry, *supra* note 40, at 35 (describing senators' criticism that EITC was paid in lump sum rather than used to offset income and self-employment taxes).

goals.[81] As indicated, the credit was originally established to offset the regressive burden placed by social security taxes on low-income individuals.[82] By offsetting the payroll tax burden, the EITC sought to "assist in encouraging people to obtain employment, reducing the unemployment rate and reducing the welfare rolls."[83] Recent commentators have continued to champion the credit's role as a work incentive,[84] but have also portrayed the credit as a more economically sound substitute for the minimum wage[85] and as a tool for combating poverty.[86] Although these goals are not incompatible, it is difficult to determine an optimal structure for the EITC in the absence of a clearly articulated purpose. As Lawrence Zelenak has remarked, "Without a clear idea of what the EITC is supposed to do, it is impossible to determine how it should be designed."[87] This Note contends

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81 *See* HOWARD, *supra* note 43, at 141 (claiming that ambiguity is policy attribute most responsible for giving EITC greater historical support than similar direct expenditure programs).

82 *See* Ventry, *supra* note 40, at 25. According to the IRS website, the EITC was established "to offset the burden of social security taxes and to provide an incentive to work." Internal Revenue Serv., U.S. Dep't of the Treasury, It's easier than ever to find out if you qualify for the EITC, http://www.irs.gov/individuals/article/0,,id=96406,00.html (last visited Jan. 7, 2008). *See generally supra* note 67 and accompanying text.

The social security tax, because it is imposed at the same rate on all earners—but only on income up to a certain level—has an initially flat structure, which then becomes regressive. Neil H. Buchanan, *Social Security and Government Deficits: When Should We Worry?*, CORNELL L. REV. 257, 286 (2007). A regressive tax is one that places a greater relative burden on lower income individuals. For example, if a 10% tax is levied on all income up to $50,000, an individual earning $25,000 would pay $2500, or 10% of their total income, in tax. An individual who earns $100,000 would only pay tax on the first $50,000, for a total tax of $5000. As a result, she would be paying a tax equivalent to only 5% of her total income.

83 *See* Ventry, *supra* note 40, at 25 (quoting S. REP. NO. 94-39, at 33 (1975)).

84 MARK D. TURNER & BURT S. BARNOW, EMPLOYMENT POLICIES INST., LIVING WAGE AND EARNED INCOME TAX CREDIT: A COMPARATIVE ANALYSIS 1 (2003) (arguing that EITC "creates significant work incentives for many low-income workers").

85 *Id.* at 8 ("[An] EITC more efficiently targets poor and near-poor families than living wage ordinances."); Daniel Shaviro, *The Minimum Wage, The Earned Income Tax Credit, and Optimal Subsidy Policy*, 64 U. CHI. L. REV., 405, 474 (1997) ("The earned income tax credit (EITC) is considerably better than the minimum wage as a device for both progressive redistribution and encouraging workforce participation among the poor.").

86 *See* HOLT, *supra* note 41, at 26 (describing EITC as "robust and largely successful" component of American antipoverty policy).

87 *See* Zelenak, *supra* note 43, at 301–02 (contending that EITC "remains severely undertheorized" and "that the EITC can and should be revised to function as an adjustment to the minimum wage based on family size"). Zelenak proposes that, in the absence of a clearly articulated legislative intent or readily discernible structural purpose for the EITC, there is reason to encourage the development of new accounts explaining the credit's purpose and ideal structure. *Id.* at 302. Anne Alstott has contended that the peculiar debates surrounding the EITC's goals reflect "unacknowledged normative tensions." Alstott, *supra* note 78, at 557 (including among possible goals for EITC: improving well-being of poor, creating incentives for work, and increasing gross domestic product).

that, among other concerns, the EITC should be structured with the purpose of providing incentives for low-income individuals to report informal income. Unlike other purposes, creating incentives for reporting informal income resonates well with the EITC's original goal of incentivizing work. The next section examines how the current EITC structure might affect the decision to report informal income and what changes would be necessary to provide a strong incentive to report.

III
Incentives to Report Informal Income

A. *Tax and Transfer Program Effects of Reporting Informal Income*

1. *Contrasting the Decision to Report Informal Income with the Decision to Work*

In order to provide an incentive for a person to report informal income—and thereby enter the formal workforce—either the added financial benefit from the EITC and refundable Child Tax Credit (CTC)[88] must outweigh any loss of transfer benefits, or the individual must value sufficiently the long-term benefits of reporting, such as increased future social security benefits.[89] This Section focuses on the financial incentives and disincentives for reporting informal income by quantifying the tax and transfer program effects of reporting.

Although numerous commentators have discussed the high EMTRs affecting low-income filers, they have not analyzed the impact these elevated EMTRs may have on the decision to report informal income.[90] An individual deciding whether to take a second

88 The Child Tax Credit is an additional refundable credit available for tax filers with children; it phases in beginning at higher income levels than the EITC. *See* Internal Revenue Serv., U.S. Dep't of the Treasury, Claiming the Child Tax Credit, http://www.irs.gov/newsroom/article/0,,id=106182,00.html (last visited Feb. 1, 2008) (discussing eligibility for child tax credit).

89 The size of an individual's social security benefit, upon retirement or disability, is based on her average earnings over the course of her working years. *See infra* note 125 and accompanying text. Long-term benefits also include less quantifiable effects on future earning potential like increased access to financial services.

90 *See* Stacy Dickert, Scott Houser & John Karl Scholz, *The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation*, 9 Tax Pol'y & Econ. 1, 1–2 (1995) (analyzing effect of EITC on "hours of work, labor market participation, and transfer program participation"); David T. Ellwood, *The Impact of the Earned Income Tax Credit and Social Policy Reforms on Work, Marriage, and Living Arrangements*, 53 Nat'l Tax J. 1063, 1065 (2000) (discussing impact of high effective marginal tax rates (EMTR) on work and marriage decisions); Daniel N. Shaviro, *Welfare, Cash Grants, and Marginal Rates*, 59 SMU L. Rev. 835, 846 (2006) (analyzing EMTRs of both taxes and benefits phase-outs); Jonathan Barry Forman, Adam Carasso & Mohammed

job, expand his working hours, or otherwise increase income, is concerned primarily with the EMTR, which determines how much of his additional earnings he will actually take home.

In contrast, those who work informally and are deciding whether to report their income are more concerned with their average effective tax rate (AETR),[91] which determines the net financial gain or loss resulting from the decision to report. Whereas the decision to work additional hours or otherwise increase earnings is made on what economists term the intensive margin, the decision to report income is akin to the decision of whether to work or not and is made on the extensive margin.[92] It is—subject to caveats regarding gaming and intentional misreporting of actual income levels, discussed below—an "all-or-nothing" decision.

2. *Quantifying the Results of Reporting Informal Income*

Within the EITC phase-in ranges,[93] where the marginal tax rate is negative, it initially appears that reporting informal income would benefit a low-income individual by increasing his or her refundable credit. In reality the situation is more complex, as individuals in these ranges are potentially eligible—depending on their family size, state of residence, and other factors—for government transfer programs, including Temporary Assistance for Needy Families (TANF), food

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ADEEL SALEEM, THE URBAN–BROOKINGS TAX POLICY CTR., DESIGNING A WORK-FRIENDLY TAX SYSTEM: OPTIONS AND TRADE-OFFS (2005), *available at* http://www.urban.org/UploadedPDF/411181_TPC_DiscussionPaper_20.pdf (discussing ways to reduce high EMTRs on low and moderate-income individuals).

[91] An individual's average tax rate and marginal tax rate (MTR) differ because, while marginal tax rates rise as income rises, the MTR only represents the tax that would be paid on an additional dollar of income; lower portions of income are taxed at lower rates. GRAETZ & SCHENK, *supra* note 26, at 24–25. For example, if income up to $10,000 is taxed at 10% and income from $10,001 to $20,000 is taxed at 20%, an individual earning $20,000 would pay $1000 in taxes on the first $10,000 of earnings and $2000 in taxes on the second $10,000, for a total tax of $3000. As a result, her average tax rate would be 15% (as 15% of $20,000 is $3000), although her marginal tax rate is 20%.

[92] In terms of labor supply, the extensive margin refers to the decision to work or not to work, while the intensive margin refers to the intensity with which one works (most commonly measured by number of working hours). *See* Emmanuel Saez, *Optimal Income Transfer Programs: Intensive Versus Extensive Labor Supply Responses*, 117 Q.J. ECON. 1039, 1039 (2002). It should be acknowledged that when deciding to report informal income, an individual may also make a decision on the intensive margin by deciding how much informal income to report. The difficulty of documenting informal income can lead to gaming on this intensive margin, a topic I discuss further *infra* at Part IV.B.2. Empirical studies indicate that most of the labor supply decisions in response to taxes and transfer programs among low-income individuals occur at the extensive rather than the intensive margin. Emmanuel Saez, Do Taxpayers Bunch at Kink Points? 24–25 (June 13, 2002) [hereinafter Saez, Kink Points] (unpublished paper, *available at* http://elsa.berkeley.edu/~saez/bunch.pdf).

[93] *See supra* Part II.A.

stamps, Medicaid, and housing subsidies.[94] Increases in reported income can lead to dramatic phase-outs of this assistance, reductions that could more than offset a potential increase in the EITC.[95]

For example, a head-of-household filer with two children who does not receive TANF or food stamps and has no formal income would benefit from reporting any amount of informal income under $14,400, the point at which EITC phase-out begins.[96] However, if such an individual received TANF and food stamps and resided in California, a state with generous benefits, she would begin to lose money (by receiving a smaller total payment from the government in transfer program benefits and refundable tax credits) at the point she reported more than $2700.[97] The rapid loss of TANF and food stamps would offset any EITC benefit, subjecting the filer to an EMTR of approximately 42%.[98]

The take-up or receipt of government benefit programs varies dramatically, further complicating attempts to measure the net effect of reporting informal income.[99] Many individuals who are eligible for these benefits do not receive them. Reasons for nonparticipation vary, but may include ignorance of eligibility or burdensome or time consuming application processes. In fiscal year 2004, for example, 55% of eligible households received food stamps.[100] Participation

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94 *See* Daniel N. Shaviro, Employment Policies Inst., Effective Marginal Tax Rates on Low-Income Households 9 (1999), http://www.epionline.org/studies/shaviro_02-1999.pdf (estimating effects of tax and transfer programs on marginal tax rates of incomes up to $25,000).

95 *Id.* at 12 tbl.1 (calculating marginal rates as high as 109.2% for "one-parent, two-child household residing in a high-TANF benefit state and receiving a federal housing subsidy"). A similar family, at the other end of the spectrum (i.e., in a low-TANF-benefit state and not a recipient of a federal housing subsidy) can still face marginal rates as high as 50.6% within this income range. *Id.* at 15 tbl.4.

96 Author's own calculation.

97 Author's own calculation.

98 See Appendix for an explanation of my calculation. In California the EMTR can rise to over 100% at incomes above $14,371 for head-of-household and $16,371 for married, filing-jointly filers.

99 A recent study of marginal effective tax rates affecting low-income households in Wisconsin attempts to measure the incidence of these high EMTRs. *See* Stephen D. Holt, *Making Work* Really *Pay: Income Support & Marginal Effective Tax Rates Among Low-Income Working Households* 73 (Mar. 2005), http://www.americantaxpolicyinstitute.org/doc/Full_Paper.doc (presenting "findings regarding the actual incidence of elevated marginal effective tax rates (i.e., high percentages of additional earnings lost through reductions in income supports) among low-income working households in Wisconsin in 2000").

100 Allison Barrett & Anni Poikolainen, U.S. Dep't of Agric., Food Stamp Program Participation Rates: 2004, at 3 (2006), *available at* http://www.fns.usda.gov/oane/MENU/Published/FSP/FILES/Participation/FSPPart2004.pdf (discussing most recent year for which data is available). The substantially lower transfer program participation rates can be ascribed in part to burdensome pre-certification requirements, which contrast with the EITC's self-declared eligibility. Zelenak, *supra* note 68, at 1915.

rates differed dramatically across subgroups. Over 75% of TANF households also received food stamps; less than one-third of eligible childless individuals obtained these benefits.[101] TANF participation rates are even lower than those for food stamps, with 42% of eligible households receiving benefits in 2004.[102]

Similarly, some filers eligible for the EITC fail to claim the credit. Those without children remain the least likely to make a claim, with approximately 45% of childless eligible recipients participating.[103] This is generally attributed to the small credit these filers receive. Some have argued for an increase in the benefit for single individuals, particularly given the dramatic increases in the EITC for filers with children.[104] Such an increase, in addition to promoting work, would encourage reporting among childless SELEs.

The remainder of this Section analyzes the gain or loss from reporting informal income across three representative states for the 2005 tax year: California, Tennessee, and Michigan. California is a state with relatively generous TANF benefits, where a family of three is eligible for a maximum monthly benefit of $704.[105] Tennessee is a low-TANF-benefit state, with a statutory maximum of $185 each month.[106] Michigan is a state roughly at the midpoint between these two, with a maximum monthly benefit of $459.[107] I analyzed the tax and transfer program implications of reporting informal income within these states for a single individual with two children filing as head-of-household, a married couple filing jointly with two children, and a single individual without children. The analysis considered federal income and payroll taxes,[108] state income taxes, TANF benefits,

[101] Barrett & Poikolainen, *supra* note 100, at 3–4.

[102] U.S. Dep't of Health & Human Servs., Indicators of Welfare Dependence: Annual Report to Congress 2007, at II-19, tbl.IND 4a (2007), *available at* http://aspe.hhs.gov/hsp/indicators07/report.pdf.

[103] Letter from James R. White, Dir. of Tax Issues, U.S. Gen. Accounting Office, to Rep. William J. Coyne, Ranking Minority Member, Subcomm. on Oversight of the H. Comm. on Ways & Means (Dec. 14, 2001), *available at* http://www.gao.gov/new.items/d02290r.pdf. This compares with a participation rate of ninety-three percent among eligible filers with two children. *Id.*

[104] *See infra* note 137 and accompanying text.

[105] Gretchen Rowe, The Urban Instit., The Welfare Rules Databook: State Policies as of July 2005, at 78 (2006), http://www.acf.hhs.gov/programs/opre/welfare_employ/state_tanf/reports/wel_rules05/databook_2005.pdf.

[106] *Id.* at 79.

[107] *Id.* at 78.

[108] The graphs calculate payroll taxes to include only the employee portion of these taxes. An individual who reports self-employment income greater than $400, whether in cash or from bartering, would be required to file Schedule SE and pay self-employment tax at a rate of 15.3%. Internal Revenue Serv., U.S. Dep't of the Treasury, Self-Employment Tax, http://www.irs.gov/businesses/small/article/0,,id=98846,00.html (last visited Jan. 7,

food stamps, and both the EITC and CTC.[109] The Appendix offers a detailed explanation of my methodology.

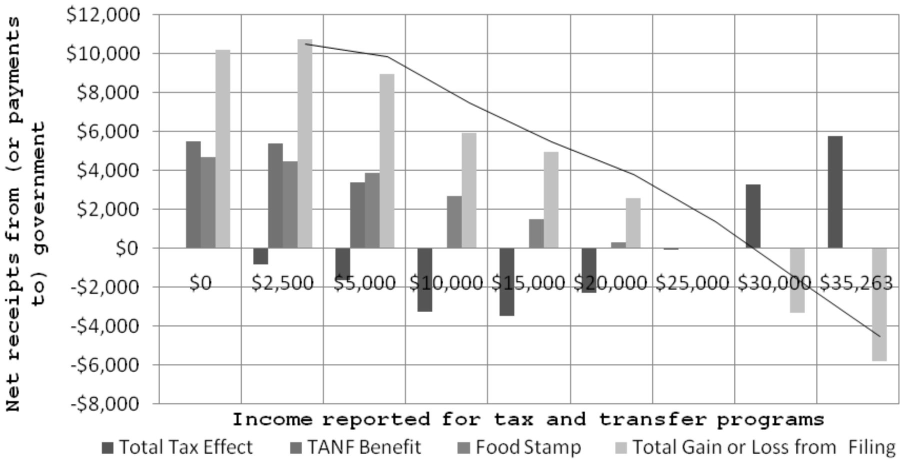
The following graph depicts the effect of reporting informal income on Michigan head-of-household filers with two children who receive TANF and food stamps. The horizontal axis represents the amount of income the individual reports to both tax and transfer program authorities. The bar furthest to the right in each set represents, when positive, the total amount of money received by these individuals through TANF, food stamps, and the tax system. When it becomes negative, these individuals are no longer receiving food stamps and TANF and face a positive tax liability. As the graph reveals, individuals who informally earn over $2500 have no incentive to report this income, as it will result in a net reduction in payments from the government.[110]

2008). This 15.3% rate is equivalent to both the employer and employee portions of Medicaid and Social Security. This tax would, of course, reduce any EITC benefit, resulting in effective marginal tax rates 7.65% higher than those used in my calculations.

[109] None of these three states administers a state earned income tax credit. *See* Ami Nagle & Nicholas Johnson, Ctr. on Budget & Policy Priorities, A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2006, at 1–3 (2006), http://www.cbpp.org/3-8-06sfp.pdf (discussing states with earned income tax credits). I exclude housing subsidy assistance due to the small number of eligible recipients who actually receive such benefits. *See, e.g.*, Norma B. Coe, Gregory Acs, Robert I. Lerman & Keith Watson, The Urban Inst., Does Work Pay? A Summary of the Work Incentives Under TANF 7 n.4 (1998), http://www.urban.org/UploadedPDF/anf28.pdf (citing studies showing less than one-quarter of public assistance recipients also receive public housing assistance); *see also* Shaviro, *supra* note 94, at 13 (noting, with regards to housing subsidies, that "program beneficiaries are only a small subset of eligible families, given queuing for scarce benefits").

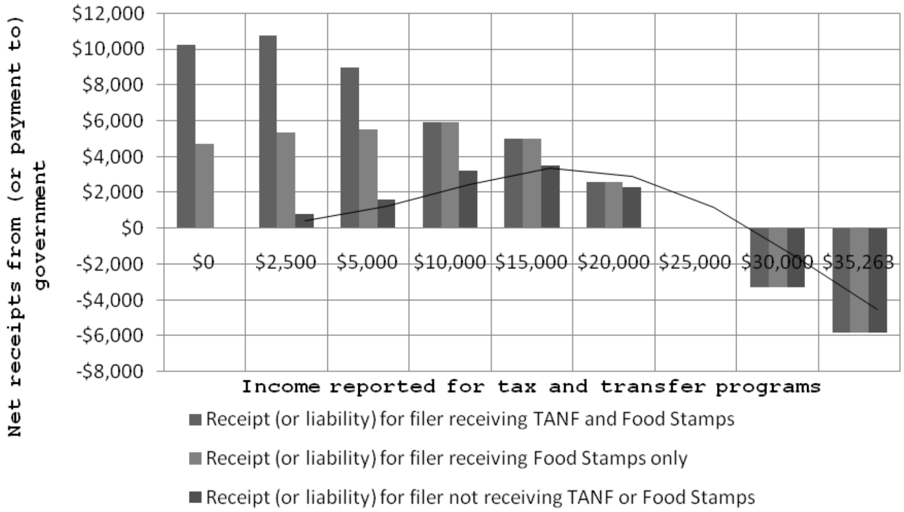
[110] The first bar on this and subsequent charts, which represents the tax effect, is negative when the filer receives money from the tax system (in the form of a refundable credit) and positive when the individual owes taxes to the government. The other three values are positive when the individual is receiving money from the government and negative (in the case of the total gain or loss only) when the individual must pay money to the government.

FIGURE 2: RESULTS OF INCOME REPORTING FOR MICHIGAN HEAD-OF-HOUSEHOLD FILER WITH TWO CHILDREN (RECEIVING TANF AND FOOD STAMPS)



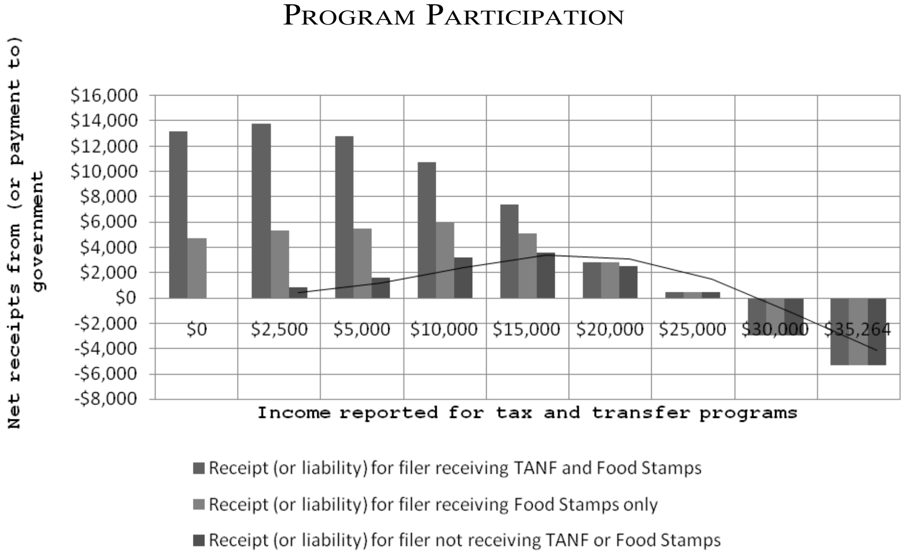
The results differ dramatically for filers who do not receive TANF or food stamps and therefore are not subject to the higher EMTRs that result from a phase-out of these benefits. As the next graph reveals, Michigan filers who receive food stamps (represented by the middle bar in each series) but not TANF would benefit from reporting income up to $10,000. Individuals who receive neither TANF nor food stamps (the third bar in each series and the trend line) would benefit from reporting informal income up to nearly $15,000.

FIGURE 3: RESULTS OF INCOME REPORTING FOR MICHIGAN HEAD-OF-HOUSEHOLD FILER, BASED ON TRANSFER PROGRAM PARTICIPATION



The effects of income reporting in California, as portrayed by the next graph, are quite similar to the effects in Michigan. Differences in the TANF phase-out rate result in a less dramatic loss of TANF benefits for California filers reporting informal income between $2500 and $5000.

FIGURE 4: RESULTS OF INCOME REPORTING FOR CALIFORNIA HEAD-OF-HOUSEHOLD FILER, BASED ON TRANSFER PROGRAM PARTICIPATION

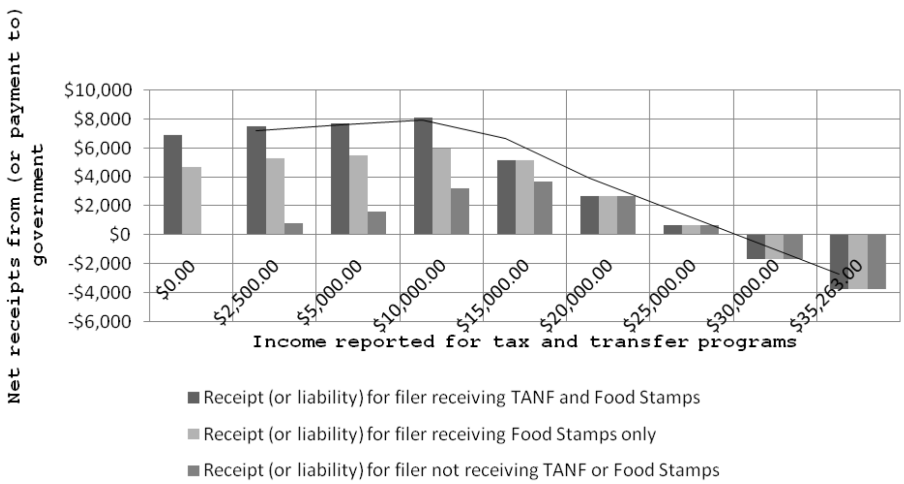


In contrast, in Tennessee, a low-TANF-benefit state, reporting of informal income—up to much higher income levels—results in a net gain for filers receiving both TANF and food stamps. A head-of-household filer with two children reporting $10,885 in informal income would receive total benefits of approximately $8212, nearly $1300 more than a similarly situated filer who reports no income.[111] Tennessee provides the lowest amount of TANF benefits but proves most hospitable to the reporting of informal income by SELEs with children. This is due to the structure of Tennessee's TANF program, which causes a rapid dollar-for-dollar reduction in TANF benefits within a very small income range: from $10,885 to $13,092 for head-of-household filers with two children and $11,881 to $14,592 for married-filing-jointly filers. Prior to these ranges, such filers, even if they also receive food stamps, are still subject to negative EMTRs and AETRs because the phase-in of the EITC more than offsets income lost due to the reduction of TANF benefits. Three recent studies of informal work among African American and Latino urban residents and among rural residents all report median and average earnings from informal work below this range.[112] Tennessee's TANF structure therefore allows the EITC to serve as an incentive for many SELEs to report their income.

[111] See Appendix for my calculation methodology.

[112] ELAINE L. EDGCOMB & MARIA MEDRANO AMINGTON, THE ASPEN INST., THE INFORMAL ECONOMY: LATINO ENTERPRISES AT THE MARGIN 23 (2003), *available at* http://www.ised.us/doc/Informal%20Economy%20Latin.pdf (reporting average monthly income of $792 and median monthly income of $570 among those surveyed); ELAINE L. EDGCOMB & TAMRA THETFORD, THE ASPEN INST., THE INFORMAL ECONOMY: MAKING IT IN RURAL AMERICA 27 (2004), *available at* http://www.ised.us/doc/Informal%20Economy%20African%20Americans.pdf (reporting median annual earnings of $3250 and average annual earnings of $4061 among those surveyed); JAN L. LOSBY ET AL., INST. FOR SOC. & ECON. DEV. SOLUTIONS, THE INFORMAL ECONOMY: EXPERIENCES OF AFRICAN AMERICANS 5 (2003), *available at* http://fieldus.org/Publications/IE_Rural.pdf (reporting average monthly income of $910 among those surveyed).

FIGURE 5: RESULTS OF INCOME REPORTING FOR TENNESSEE HEAD-OF-HOUSEHOLD FILER, BASED ON TRANSFER PROGRAM PARTICIPATION



Given the benefit reductions they face, SELEs with children in Michigan and California who are receiving TANF and food stamps have little incentive to report informal income.[113] Without drastically increasing the size of the EITC or dramatically altering the structure of TANF benefits, there is no clear way to change these disincentives.

Still, for the many SELEs eligible for TANF and food stamps who do not receive those benefits,[114] SELEs who have exceeded the maximum eligibility period for TANF, or those who receive food stamps alone, the negative AETR that remains offers a financial incentive to report informal income up to $15,000. This negative AETR results in gains or losses that are quite similar across the three states.[115]

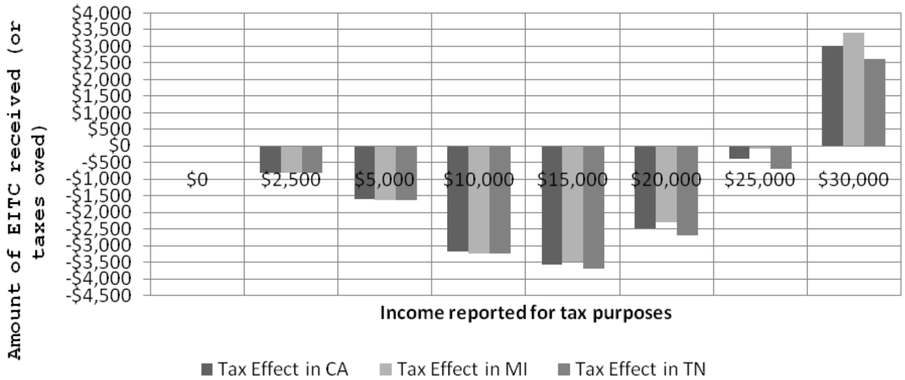
The following graph depicts the effects of reporting income in each of the three states for head-of-household filers with two children who do not receive any transfer program benefits. Negative values represent the refundable EITC received by these filers, while positive values represent taxes owed. As the graph shows, SELEs with children who do not receive TANF or food stamps would, in all three states, benefit from reporting informal income up to $15,000.

113 An analysis of the tax and transfer program effects of reporting for married filers with two children reveals the same basic patterns as for head-of-household filers. These filers are eligible for a larger EITC and larger TANF and food stamps benefits, and these benefits phase out at higher incomes.

114 For a discussion of transfer program participation rates, see *supra* notes 100–02 and accompanying text.

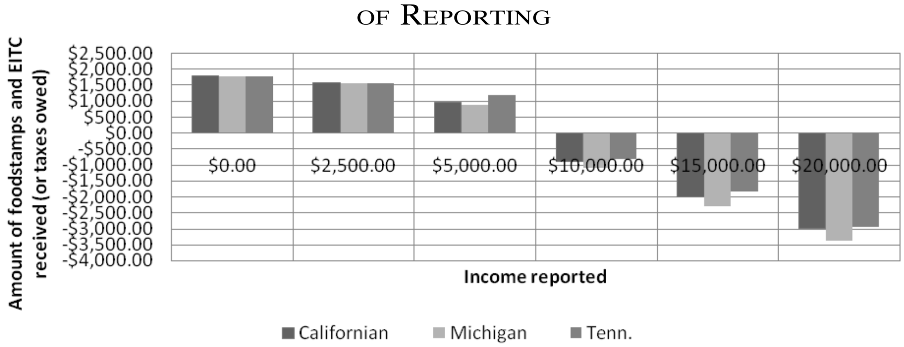
115 The small variation is due to differences in state income taxes.

FIGURE 6: TAX EFFECT ONLY OF INCOME REPORTING FOR HEAD-OF-HOUSEHOLD FILER WITH TWO CHILDREN



In contrast with those filing as head-of-household or as married-filing-jointly, the filing status of single individuals without children shows the least variation in effective tax rates and the gain or loss from reporting across the three states considered. State income taxes cause the only differences in effective tax rates for this filing status, as the graph below indicates.

FIGURE 7: SINGLE FILER WITH NO CHILDREN, EFFECT OF REPORTING



B. *Societal Benefits of Increased Reporting of Informal Income*

The U.S. Department of Labor, in a study of the informal economy, observed that "[i]n some cases, the underground economy may serve as an incubator of small firms and business activities which may eventually move into the formal economy."[116] Informal business

[116] U.S. DEP'T OF LABOR, *supra* note 7, at 32. A recent report by the United Kingdom–based Small Business Council described informal entrepreneurship as "a potential asset to be harnessed." COLIN C. WILLIAMS, SMALL BUS. COUNCIL, SMALL BUSINESSES IN THE INFORMAL ECONOMY: MAKING THE TRANSITION TO THE FORMAL ECONOMY 28 (2005) (on file with the *New York University Law Review*) (examining how informal businesses can be convinced to join formal economy). The Apsen Institute's

activities, particularly those that develop in lower-income and rural communities, can provide needed job opportunities for other members of the community, build equity among low-income individuals, and contribute to broader community revitalization.[117] As the prior analysis indicates, tax policies designed to encourage income reporting by SELEs can aid the transition of these business activities into the formal economy.

Increased reporting of informal income can improve the accuracy of economic analyses, contributing to sounder macroeconomic policy.[118] More accurate economic analysis benefits businesses and financial institutions considering entering into or expanding operations in a particular community.

Finally, an effort to increase reporting of informal income among low-income individuals can contribute to increased reporting of informal income among all earners. Tax year 2001 saw an estimated $312 to $353 billion gap "between what taxpayers are supposed to pay and what is actually paid" in federal income taxes.[119] The most substantial portion of this, as much as $292 billion, came from underreporting of income.[120] To the extent that increased reporting sheds light on the nature and extent of the informal economy and further develops a culture of reporting informal income,[121] it could aid efforts to close this gap.

C. Collateral Benefits of Reporting for Self-employed Individuals[122]

SELEs stand to receive numerous benefits from reporting informal income.[123] The various social welfare programs related to

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report on the rural informal economy identified a number of individuals who used an informal business operation as the starting point for developing a formal entity. EDGCOMB & THETFORD, *supra* note 112, at 42–45.

117 EDGCOMB & THETFORD, *supra* note 112, at 58 (declaring that "locally grown entrepreneurship [is] . . . part of the solution" to economic problems facing rural areas).

118 *See supra* note 39 and accompanying text.

119 *Bridging the Tax Gap: Hearing Before the S. Comm. on Finance*, 108th Cong. 32 (2004) (statement of Mark W. Everson, Comm'r of Internal Revenue Service), *available at* http://www.senate.gov/~finance/hearings/95484.pdf.

120 *Tax Gap Hearing*, *supra* note 6, at 2–3 (statement of J. Russell George, Treasury Inspector Gen. for Tax Administration).

121 For a discussion of how taxpayers' perceptions of whether other individuals are complying with the tax law affects their own behavior, see Michael S. Kirsch, *Taxing Citizens in a Global Economy*, 82 N.Y.U. L. REV. 443, 501–02 (2007) (noting and citing "extensive body of literature suggest[ing] that people's willingness to comply with tax law depends in part on their perception that others are paying their fair share of taxes").

122 For the purposes of this Section, self-employed individuals include both those operating informal businesses and occasional or irregular workers.

123 Although they avoid tax liability, businesses that operate informally also lose out on many potential benefits. *See* WILLIAMS, *supra* note 116, at 6 (noting, primarily in British

the payroll tax—including retirement, disability, and Medicare benefits—represent the most basic of these benefits.[124] Since retirement and disability benefits are based on lifetime earnings, the reporting of informal income can have a considerable impact at retirement or in case of injury.[125] A reevaluation and restructuring of the EITC that carefully considers the credit's effect on informal workers could substantially further these efforts to increase reporting.

The process of filing taxes and reporting income provides individuals with an incentive to keep accurate financial records, which provide a number of potential benefits. Such records, in conjunction with accurate tax returns, can provide documentation to aid SELEs in establishing credit or applying for a loan or mortgage.[126] Formal tax reporting is necessary for an informal business to access larger markets and the potential growth opportunities these present.[127]

The process of seeking assistance with filing a tax return may also provide SELEs with access to valuable business counseling services. Over seventy percent of EITC recipients utilized tax preparation services in 2003.[128] These services can be, and in some cases are, supplied by organizations that provide broader microenterprise development services.[129] SELEs may also be counseled in how to use

context, "the wide range of ways in which individuals and businesses are systematically disadvantaged by operating outside the formal economy, as well as the individual and societal benefits of formalisation").

124 *See* Staudt, *supra* note 70, at 1596–98 (discussing various social welfare benefits tied to and flowing from payroll taxes).

125 *See* SOC. SEC. ADMIN., PUB. NO. 05-10035, RETIREMENT BENEFITS 3 (2007) (noting that benefit payments are based on earnings over course of career such that "higher lifetime earnings result in higher benefits").

126 LISA J. SERVON, NEW AM. FOUND., POLICY OPTIONS TO SUPPORT ENTREPRENEURSHIP AMONG LOW-INCOME AMERICANS 7 (2005) ("[C]ompared to wage-earners, self-employed individuals have added hurdles to establishing credit or applying for a mortgage."). Michigan's pilot EITC microenterprise initiative offers anecdotal evidence of the benefits of tax reporting: "[I]t appears to the entrepreneurs who took part in the pilot that full disclosure of revenues and transparent accounting opens doors to grants, loans, and income support through the tax system." BRIAN REED, MICHIGAN'S STATEWIDE EARNED INCOME TAX CREDIT INITIATIVE: 2006 EVALUATION REPORT 26 (2006); *see also* LOSBY ET AL., *supra* note 112, at 47 (noting obstacles to establishing credit for those in informal economy).

127 *See, e.g.*, LOSBY ET AL., *supra* note 112, at 52 (quoting owner of informal home repair business seeking placement on city government vendor list).

128 ALAN BERUBE, THE BROOKINGS INST., THE NEW SAFETY NET: HOW THE TAX CODE HELPED LOW-INCOME WORKING FAMILIES DURING THE EARLY 2000s, at 8 (2006) (analyzing role of EITC and other tax credits as "new safety net for the low-wage workforce").

129 *See EITC and Microentrepreneurs: One Program's Experiences*, FIELD FORUM, Sept. 2005, at 1, 2 [hereinafter *EITC and Microentrepreneurs*] (describing tax preparation and other microenterprise services as "path to business formalization and development with long-lasting impact").

their EITC refund to develop assets or take advantage of individual development accounts offering matching fund savings.[130]

Some states have recognized the EITC's potential for helping microentrepreneurs formalize and expand their businesses. In 2006, the Michigan Statewide EITC Coalition created a microenterprise initiative that "link[ed] emerging food-related niche entrepreneurs with access to entrepreneurial education, financial support through small loans and Individual Development Accounts offered through a local credit union, and explore[d] the value of tax-refunds in building equity in those businesses."[131] This project offers a potential blueprint for national efforts to use the EITC as a vehicle for transitioning informal enterprises into the formal economy.

IV
Proposals for Increasing the Reporting of Informal Income Among Low-income Households

This Section offers policy recommendations regarding how the structure and administration of the EITC might better respond to the informal economy and encourage SELEs to report. It also addresses the issue of taxpayers strategically manipulating their income reporting to maximize EITC benefits.

A. Structural Changes

As Part III reveals, due to the high EMTRs of filers who have children and receive transfer program benefits, incentivizing informal income reporting by these households would require drastic changes to the EITC. An expansion of the credit significant enough to outweigh the large transfer program losses facing such individuals would be costly and politically infeasible, particularly given the rapid expansion of the EITC for childless filers over the past few years.[132] Since the structure and size of TANF benefits is determined by individual states, the disincentives created by the phase-out of these benefits can only be effectively altered at the state level.[133] In contrast, SELEs

130 *Id.* at 4–5.

131 Reed, *supra* note 126, at 5. The IRS's own efforts to partner with community organizations to provide services to low-income taxpayers utilize a three-pronged approach emphasizing awareness and education, tax preparation assistance, and financial literacy. Internal Revenue Serv., U.S. Dep't of the Treasury, Three-Pronged Approach, http://www.irs.gov/individuals/article/0,,id=108393,00.html (last visited Feb. 1, 2008).

132 *See supra* Part II.D.

133 One possible avenue for reducing these disincentives is for states to consider more rapidly phasing out benefits, as is done in Tennessee. *See supra* notes 111–12 and accompanying text. However, this might prove difficult for states with more generous TANF benefits than Tennessee's rather paltry assistance.

with children who receive minimal transfer program benefits would already benefit from reporting certain levels of informal income under the current EITC structure. Part III indicates that comparatively minor structural changes to the EITC for childless single filers would provide the most effective incentives for SELEs to increase their reporting. This Section focuses its recommendation for structural changes on these filers.

Recent EITC expansions for filers with children have widened the disparity between the credit they receive and the credit available to childless filers;[134] the EITC for childless filers only covers half of their payroll tax burden.[135] Consequently, childless filers do not have adequate incentives to seek formal employment or to report informal income they already receive.[136]

Commentators have proposed expanding the EITC for childless individuals to increase its potential as a work incentive.[137] The General Accounting Office has also determined that an expanded credit for childless filers would increase EITC participation.[138]

Doubling the EITC benefit and phase-in rate for childless filers would dramatically increase the credit's ability to incentivize informal

134 *See supra* Part II.D; FURMAN, *supra* note 43, at 5 (noting that in 2002, childless filers received only two percent of EITC payments, totaling less than $1 billion).

135 This is based on the standard economic assumption that workers bear both the employee and employer portions of the payroll tax. FURMAN, *supra* note 43, at 6; *see also* MARGUERITE CASEY FOUND., THE EARNED INCOME TAX CREDIT: ANALYSIS AND PROPOSALS FOR REFORM 16 (2005), http://www.caseygrants.org/documents/reports/MCF_EITC_Paper.pdf ("[I]t is generally believed that, as an economic matter, both the employee's share and the employer's share [of the payroll tax] are borne by the employee."); Zelenak, *supra* note 68, at 1908 ("[T]here is a consensus among economists that virtually the entire burden of the payroll tax—both the portion nominally imposed on employers and the portion nominally imposed on employees—falls on workers.").

136 FURMAN, *supra* note 43, at 6; *see also* ROBERT GREENSTEIN, CTR. ON BUDGET & POLICY PRIORITIES, THE EARNED INCOME TAX CREDIT: BOOSTING EMPLOYMENT, AIDING THE WORKING POOR 4 (2005), *available at* http://www.cbpp.org/7-19-05eic.pdf ("[E]xpanding the small EITC for [childless] workers might help pull more very poor men into the regular labor force.").

137 *See* MARGUERITE CASEY FOUND., *supra* note 135, at 16 (arguing that if Congress intended 1993 addition of childless credit to offset payroll tax, it should expand credit to cover full payroll tax, which as an economic matter is generally believed to be entirely borne by employee). Jason Furman has proposed doubling the EITC for childless filers to 15.3% and increasing the phase-in threshold to $8080 of earnings, tripling maximum EITC benefits to over $1200. FURMAN, *supra* note 43, at 8. This would give 4 million filers an average tax reduction of $750, at a cost of $3 billion. *Id.* It would also provide a meaningful incentive to report informal income. A 15.3% EITC benefit would fully cover the self-employment tax owed by childless SELEs. *See supra* note 108 (describing self-employment tax).

138 *See* LEN BURMAN & DEBORAH KOBES, THE URBAN INST., GAO STUDY OF EITC ELIGIBILITY AND PARTICIPATION (2002), *available at* http://www.urban.org/UploadedPDF/410435.pdf (noting GAO position that small benefit available to childless filers causes low participation rate).

income reporting among these individuals. In tax year 2007 this change—to a 15.3% phase-in (and phase-out) rate, if the current income ranges were retained—would increase the maximum credit for these individuals from $428 to $856.[139] Single filers without children who are working informally must report their income as self-employment income, subjecting themselves to the full 15.3% payroll tax. The EITC increase described above would completely offset this tax up to the end of the phase-in rate.[140] Since wage earners bear both the employee and employer portions of the payroll tax,[141] equity would call for extending the same EITC increase to wage earners.[142] Moreover, this change would not greatly expand the EITC's cost[143] and would impact a significant percentage of EITC-eligible childless individuals, since a small percentage of such filers receive transfer program benefits.

B. Administrative Changes

1. Education and filing assistance

In 2003, approximately 70% of EITC recipients used a paid preparer when submitting their tax returns.[144] At the same time, a recent study determined that self-employed individuals are 22% less likely than other filers to seek tax preparation assistance.[145] Given the significant role of professionals in preparing EITC returns, the IRS should require paid preparers who participate in its E-file program[146] to educate EITC recipients regarding the possibility and method of reporting informal self-employment income. The IRS could increase training for paid preparers who assist a certain number of EITC filers,

139 Internal Revenue Serv., U.S. Dep't of the Treasury, EITC Thresholds and Tax Law Updates, http://www.irs.gov/individuals/article/0,,id=150513,00.html (last visited Feb. 1, 2008).

140 In tax year 2006 this would completely offset the employer and employee portions of the social security tax for childless single filers reporting informal income up to approximately $5400. *See* Internal Revenue Serv., *supra* note 54, at 44–47 (providing 2006 Earned Income Credit Table).

141 *See supra* note 135.

142 *See supra* notes 67–70 and accompanying text.

143 *See supra* note 137.

144 Berube, *supra* note 128, at 1.

145 Marsha Blumenthal, Brian Erard & Chih-Chin Ho, *Participation and Compliance with the Earned Income Tax Credit*, 58 Nat'l Tax J. 189, 203 (2005). This includes both paid and unpaid assistance. *Id.*

146 The E-file program allows for electronic filing of individual tax returns. Internal Revenue Serv., U.S. Dep't of the Treasury, Individual E-file Electronic Tax Filing Program Overview, http://www.irs.gov/efile/article/0,,id=118451,00.html (last visited Feb. 1, 2008). Individuals who choose to use E-file must access the service through an IRS authorized E-file tax provider: either by utilizing commercial tax preparation software, or through the IRS's free file program. *Id.*

and increase monitoring of the accuracy of the returns filed by these preparers.[147] Such monitoring would be essential given recent problems with fraudulent professionally prepared EITC claims.[148]

A better option, which would enable EITC filers to avoid the cost of paid tax preparation and perhaps ensure better monitoring and compliance, would be to expand the IRS's volunteer tax preparation programs. Only 1.5% of low-income working families access free tax preparation services through the Volunteer Income Tax Assistance (VITA), Military VITA, and Tax Counseling for the Elderly programs.[149] An expansion might prove costly but could be funded in a revenue-neutral manner by reducing the EITC for individuals claiming informal income. This reduction would further encourage the transition to formal employment and could be set at a rate equivalent to the average cost of paid preparation services, thus burdening fewer filers.

Volunteer services often are limited in their capacity to assist with self-employment tax returns, which often require more specific knowledge of relevant tax rules and business practices.[150] Since most VITA sites are staffed by volunteers with limited training, these centers are frequently unable to provide accurate and consistent services for SELEs. To resolve this problem, special VITA sites should be created in targeted areas that cater to filers reporting self-employment income or income from a small informal business. Such services might be offered in conjunction with not-for-profit or government agencies that provide broader technical services to low-income entrepreneurs.

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147 The IRS last increased training for paid preparers in 1999. *See Waste, Fraud, and Abuse in Federal Mandatory Programs: Hearing Before the H. Comm. on the Budget*, 108th Cong. 149 (2003) [hereinafter *Waste, Fraud, and Abuse*] (statement of Leonard E. Burman, Senior Fellow, Urban Institute) (describing 1999 initiative and arguing that "such a strategy could prevent both unintentional and intentional errors on tax returns claiming the EITC").

148 *See, e.g.*, Complaint for Permanent Injunction and Other Relief ¶ 13, United States v. So Far Inc., No. 2:07-cv-11470 (E.D. Mich. Apr. 2, 2007) (citing failure "to teach all preparers critical elements related to tax return preparation, including Earned Income Tax Credit (EITC) due diligence requirements"). The Complaint against Jackson Hewitt also specifically charged the company's branches with fabricating self-employment income—as well as wage earnings and Schedule C expenses—"to reach a specific income level in order to maximize claimed EITC." *Id.* ¶ 42.

149 BERUBE, *supra* note 128, at 11. Given their volunteer staff and limited training, many of these tax preparation sites "are structured to assist only with the EITC claims of wage earners." *EITC and Microentrepreneurs*, *supra* note 129, at 2.

150 In its analysis of the EITC and microentrepreneurs, the Aspen Institute proposes that the more than 500 microenterprise programs in the United States could play a crucial role in meeting the need for free or affordable tax preparation assistance "for income patchers and other informal entrepreneurs." *EITC and Microentrepreneurs*, *supra* note 129, at 2.

2. *Potential Administrative and Compliance Problems with Encouraging the Reporting of Informal Income and Possible Solutions*

Underreporting of self-employment income is a major concern at all income levels.[151] One study reports that self-employed individuals underreport income by 64%; those operating on a cash basis report only 11% of their income.[152] Given this compliance concern, one might naturally question the wisdom of a proposal to increase the reporting of informal income, much of which would constitute self-employment income. The unstructured nature of informal work renders it quite difficult to obtain third-party verification of income. It is easy to imagine "gaming" among SELEs who strategically report income to maximize their EITC benefit.

This is a serious concern. Encouraging the reporting of informal self-employment income may enable deserving individuals to receive the EITC. However, it might do so at the risk of an increase in fraudulent EITC claims. In the past the EITC has come under severe criticism for alleged overpayments due to filers claiming ineligible children.[153] An increase in EITC claims by SELEs might result in similar allegations of fraudulent claims, subjecting the EITC and honest tax-credit recipients to criticism. This consideration might provide cause for concern, but it does not warrant outright rejection of policies that would encourage reporting of informal income. Instead, it offers a reason to strengthen general compliance efforts and close the tax gap among self-employed individuals at all income levels.[154]

The "bunching" of taxpayers at "kink points" in the tax code could suggest the presence of gaming.[155] The EITC's structure creates

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151 *See supra* notes 119–20 and accompanying text.

152 *See* HOLT, *supra* note 41, at 21.

153 *See id.* at 19–21 (discussing political attention and research related to EITC error).

154 As Leonard Burman remarked during congressional testimony:

> Some EITC recipients with income in or beyond the phase-out range of the credit underreported their income and thus increased their tax refund. Half of the unreported income was from self-employment, consistent with ancient evidence . . . that self-employment income is an area of rampant evasion. Again, while the noncompliance among EITC recipients is troubling, there is no reason to think that it is any worse than exists among the taxpaying public generally.

Waste, Fraud, and Abuse, *supra* note 147 (statement of Leonard E. Burman, Senior Fellow, Urban Institute).

155 A kink point occurs where marginal tax rates change rapidly. Saez, Kink Points, *supra* note 92, at 2. A taxpayer has an incentive not to report additional income beyond a kink point since she will pay taxes at a much higher MTR on that additional income. Thus, a large incidence of taxpayers reporting taxable income at or directly below a kink point would likely be the result of taxpayers altering their behavior or simply underreporting their actual earnings to avoid paying the higher tax rate.

kink points at the end of the phase-in period and at the beginning of the phase-out period.[156] One extensive study of individual tax returns found that "the very large kinks created by the expanded EITC since 1994 have generated very little bunching, except for the small group of EITC recipients who are self-employed."[157] Such evidence still leaves unclear whether this bunching results from decisions to alter work intensity or the deliberate misreporting of self-employment income.[158] Regardless of the extent to which it occurs, the potential for gaming remains a valid concern. Given the inherent limitations of IRS monitoring of tax returns that include informal income, more rigorous third-party verification methods may be merited.

A number of European countries have introduced measures to encourage formal rather than informal employment, or to effectively formalize informal employment.[159] These might inform efforts to encourage reporting through the EITC and confront compliance concerns.

One example is Denmark's Home Service Scheme, in which businesses provide government-subsidized household services.[160] The program utilizes town halls as clearinghouses through which households find participating workers.[161] A similar program might be introduced in the United States and modeled on the operation of day labor hiring halls, which now exist in rural and urban areas nationwide.[162] These centers could provide third-party verification of earnings by requiring employers to pay the hiring center, which would then pay workers.

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156 *Id.*

157 *Id.* at 4. Saez finds clear spikes in reporting at the first kink in the EITC schedule for filers with children who earn more than twenty percent of their income from self-employment. *Id.* at 17. He deems this "clear evidence of a response to the program" and manipulation of earnings. *Id.* at 17–18.

158 *See* HOLT, *supra* note 41, at 21 (citing two studies finding no evidence that refundable feature of EITC induces ineligible households to enter tax system simply to claim credit and that overreporting of income to maximize EITC credit is quite rare).

159 *See* WILLIAMS, *supra* note 116, at 29–45 (discussing several European programs).

160 *Id.* at 30. Ninety-one percent of participating companies were one-person businesses. *Id.*

161 *Id.* One difficulty with such programs is that because the jobs are subsidized they might replace regular formal jobs as consumers substitute the use of such workers for formal domestic cleaners. *Id.* However, to a certain extent such a criticism could be applied to the EITC more generally, which serves as a wage substitute that might be criticized for potentially reducing wages and employer labor costs.

162 *See generally* Abel Valenzuela, Jr., *Day Labor Work*, 29 ANN. REV. SOC. 307 (2003) (reviewing day labor practices and related legal and policy issues); ABEL VALENZUELA, JR., ET AL., ON THE CORNER: DAY LABOR IN THE UNITED STATES (2006), http://www.sscnet.ucla.edu/issr/csup/uploaded_files/Natl_DayLabor-On_the_Corner1.pdf (describing day labor nationwide based on surveys of day laborers in twenty states and District of Columbia).

A pilot program of non-profit hiring halls, which could provide tax assistance and financial or business counseling, may offer a model for broader efforts to encourage SELE income reporting while also addressing compliance concerns.[163] Such a program would be particularly useful to low-income individuals who are self-employed but work only occasionally. By providing a larger market for these individuals' goods and services, it could serve to increase their earnings.

Conclusion

Given the substantial potential for gaming, there is no obvious method for ensuring accurate reporting of informal income. At the same time, the benefits to be gained from increased reporting of this widespread form of income demand that policymakers consider the EITC's interaction with the informal economy. While drastic changes in both tax and transfer programs may be necessary to provide financial incentives for many households with children to report informal income, more targeted changes could increase reporting among childless informal workers. This Note offers the foundation for a conversation on the EITC's interaction with the informal economy by providing the first analysis of the impact of tax and transfer programs on the decision to report informal income. It proposes a new vision for the EITC as an incentive for reporting informal income and formalizing informal economic activities. By drawing workers into the formal economy, the EITC would reaffirm its original purpose as a work incentive.

[163] In a future paper I plan to present a more fully developed proposal for how the EITC, in its structure and administration, might treat informal income. I also plan to consider the experience of those working "off-the-books" by examining ways to provide incentives, through the tax code, for both employers and employees to report such income.

APPENDIX: METHODOLOGY

Tax rates and transfer program reduction rates used for calculations:

- **Payroll tax:** calculations include only employee portion of payroll tax, which is 7.65% of all income.[164]
- **Federal income tax:**
  - o **Head of Household Filers (with two children)**
    - ■ **Standard deduction:** $7300;[165]
      Exemptions: 3 x $3200[166] = $9600
    - ■ 10% tax on income from $16,900 to $27,350[167]
    - ■ 15% tax on income from $27,351 to $56,700[168]
  - o **Married Filing Jointly Filers (with two children)**
    - ■ **Standard deduction:** $10,000;[169]
      Exemptions: 4 x $3200 = $12,800
    - ■ 10% tax on income from $22,800 to $37,400[170]
  - o **Single (no children)**
    - ■ **Standard deduction:** $5000;[171]
      EXEMPTION: $3200
    - ■ 10% tax from $8200 to $15,500[172]
    - ■ 15% tax from $15,501 to $37,900[173]
- **Food Stamps:** first 20% of income is disregarded, benefits then phase out at 30% rate, resulting in an effective phase-out rate of 24%.[174]

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164 INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, PUBL'N NO. 15, EMPLOYER'S TAX GUIDE 16 (2005), *available at* http://www.irs.gov/pub/irs-prior/p15--2005.pdf.

165 INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, PUBL'N NO. 501, EXEMPTIONS, STANDARD DEDUCTION, AND FILING INFORMATION 22 (2005), *available at* http://www.irs.gov/pub/irs-prior/p501--2005.pdf.

166 *Id.* at 1.

167 INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, 1040 INSTRUCTIONS 82 (2005), *available at* http://www.irs.gov/pub/irs-prior/i1040--2005.pdf.

168 *Id.*

169 INTERNAL REVENUE SERV., *supra* note 165, at 22.

170 INTERNAL REVENUE SERV., *supra* note 167, at 82.

171 INTERNAL REVENUE SERV., *supra* note 165, at 22.

172 INTERNAL REVENUE SERV., *supra* note 167, at 82.

173 *Id.*

174 Holt, *supra* note 99. This phase-out rate is outlined in the Food Stamp Act of 1977. 7 U.S.C. §§ 2014(e)(2)(B), 2017(a) (2000).

- o STANDARD DEDUCTION: there is a food stamp standard deduction, per household, of $134 in monthly earnings, or $1608 annually.[175]

- **State income taxes:**
  - o Michigan – (Federal Adjusted Gross Income - $3200 per person) x 3.9%
  - o California – 2005 Tax Rate Schedules[176]
    - ■ Deduction and Exemptions available on 2005 Income Tax Return[177]
  - o Tennessee – no state income tax
- **State TANF Rules**[178]
  - o **Michigan: Family of three**
    - ■ TANF Benefit (Payment or Need Standard) = $459/month[179]
    - ■ TANF Maximum = $459[180]
    - ■ Maximum Earnings (at seven months) = $774[181]
    - ■ Earned Income Disregard (operates akin to a deduction) = $200 and 20% of remainder[182]
    - ■ Benefit Calculation = Payment Standard – net income[183]
    - ■ Effective Reduction Rate = 80% (for all income in excess of $200)
  - o **Michigan: Family of four**
    - ■ Unable to obtain 2005 payment standard, I estimated the standard as $559, based on relevant difference in 2007 standards for three- and four-person households.[184]
  - o **California: Family of three**
    - ■ TANF Benefit (Payment or Need Standard) = $704/month[185]
    - ■ TANF Maximum = $704[186]

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175 U.S. Dep't of Agric., Food Stamp Program: FY 2005 Allotments and Deduction Information, http://www.fns.usda.gov/fsp/government/FY05_Allot_Deduct.htm (last visited Feb. 1, 2008).

176 2005 California Tax Rate Schedules, *available at* http://www.ftb.ca.gov/aboutFTB/press/archive/2005/TaxRate.pdf.

177 California Resident Income Tax Return 2005, *available at* http://www.ftb.ca.gov/forms/05_forms/05_540.pdf.

178 ROWE, *supra* note 105.

179 *Id.* at 78.

180 *Id.*

181 *Id.* at 132.

182 *Id.* at 74.

183 *Id.* at 76.

184 STATE OF MICH., DEP'T OF HUMAN SERVS., TEMPORARY ASSISTANCE FOR NEEDY FAMILIES STATE PLAN 7 (2007), *available at* http://www.michigan.gov/documents/dhs/DHS-2007-09-TANF-StatePlan_206533_7.pdf.

185 ROWE, *supra* note 105, at 78.

186 *Id.*

- Maximum Earnings (at seven months) = $1633[187]
- Earned Income Disregard = $225 + 50% of remainder[188]
- Benefit Calculation = Maximum Aid Payment – net income[189]
- Effective Reduction Rate = 50%

o **California: Family of four**
- Need standard/maximum benefit is $862/month[190]

o **Tennessee: Family of three**
- TANF Benefit (Payment or Need Standard) = $942/month[191]
- TANF Maximum = $185 (statutory maximum)[192]
- Maximum Earnings (at seven months) = $1091[193]
- Earned Income Disregard (works akin to a deduction) = $150[194]
- Benefit Calculation = Lesser of (Consolidated Need Standard – net income) or Maximum Benefit[195]
- Effective Reduction Rate = 100%
- Family of four – TANF Payment Standard is $1066; statutory maximum benefit is $226.[196]

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187 *Id.* at 132.
188 *Id.* at 74.
189 *Id.* at 76.
190 DATA SYS. & SURVEY DESIGN BUREAU, HEALTH & HUMAN SERVS. AGENCY, PUBLIC ASSISTANCE FACTS AND FIGURES FOR THE MONTH OF JUNE 2005 (2005), *available at* http://www.dss.cahwnet.gov/research/res/pdf/Paff/2005/PAFFJun05.pdf.
191 ROWE, *supra* note 105, at 79; *see also* TENN. DEP'T OF HUMAN SERVS., TEMPORARY AID FOR NEEDY FAMILIES PROGRAM PLAN OF OPERATION (2005), *available at* http://www.tennessee.gov/humanserv/adfam/TANFStPlan.pdf.
192 ROWE, *supra* note 105, at 79.
193 *Id.* at 132.
194 *Id.* at 75.
195 *Id.* at 76.
196 TENN. DEP'T OF HUMAN SERVS., *supra* note 191.