The Earned Income Tax Credit: Small Benefits, Large Costs

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When both liberals and conservatives like a government program, it usually means that it is expensive and expands the scope of government without delivering on its promises. The bipartisan support of the earned income tax credit is no exception.

The EITC is best described as an anti-poverty program that encourages people to work. In a new study published by the Cato Institute, Chris Edwards and I explain that based on a deep dive into the economic literature and the budgetary impact of the program, conservatives and liberals alike underestimate its cost while overselling its benefits. That is why we advise cutting the program.

The EITC is effectively a wage subsidy that gives low-income people a refundable tax credit for working, meaning that some working individuals who pay no income taxes are eligible to receive a payment from the U.S. Treasury. This payment acts as an incentive for poor people to seek work and keep working. These built-in work incentives explain why Republicans and Democrats claim that the EITC is one of our most successful anti-poverty programs and have regularly agreed to extend it. Unfortunately, the EITC is not what it seems to be.

First, it is extremely costly. After extensions in 1986, 1990, 1993 and 2009, the program will provide an estimated $69 billion in benefits to 28 million recipients for a cost of $60 billion in 2015. Though it is being administered through the tax code, the growth in its refundable portion has made it primarily a spending program. In fact, it is the largest federal cash transfer program for low-income households.

Those who would argue it is worth the cost because it is a proven way to encourage poor people to enter the labor force do overlook the fact that the program penalizes people who want to work more hours. Indeed, a large majority of people taking the EITC have an incentive to work less, not more. EITC's advocates also fail to mention its resulting negative impact on the United States' overall output and employment.

Also, there is a tremendous amount of fraud and there are many improper payments with the EITC. As we note, "the Internal Revenue Service reports that the EITC error and fraud rate in 2014 was 27 percent, which amounted to $18 billion in overpayments."

A 2013 report on the issue from a Treasury Department inspector general has striking numbers about the scale of the problem. According to the data, between 2003 and 2012, improper payments for the EITC alone amounted to somewhere between $110.8 billion and $132.6 billion. The reasons listed for the gigantic amount in improper payments range from the absurd complexity of the tax law to the structure of the program to the confusion among eligible claimants.

Unfortunately, fixing the problem won't be easy, because none of these factors alone is the primary driver of the EITC improper payments. The problem is caused by the combination of all of them.

The burden imposed by the program on the economy at large is important, too. Paying for the EITC requires the extraction of resources from the productive sector of the economy. This causes people to reduce their productive activities, such as working and investing, which in turn hurts the economy.

Conservatives' usual response is that in spite of these problems, it beats raising the minimum wage—a policy that actively destroys jobs. But there is no reason for us to choose between two bad options simply because one is slightly less bad than the other.

To be sure, offering to expand the EITC is easier than making the case that, for instance, a fundamental reform of the corporate income tax would have a significant and positive impact on workers' wages because that tax cut would be shared with workers in the form of higher wages. But political expediency won't achieve better policies. For all these reasons, we should cut the EITC, not expand it.