Where Refundable Tax Credits Fall Flat

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The publication of new data from the Census Bureau on poverty in the United States has bolstered a claim that policy analysts have been making since mid-2021: the expansion of the Earned Income Tax Credit (EITC) and Child Tax Credit (CTC) resulted in a dramatic drop in poverty. The American Rescue Plan boosted EITC benefits anywhere from 2% to 180% depending on family size and expanded CTC benefits from $2,000 per child to either $3,000 or $3,600 depending on the child's age. According to the Census Bureau data, the expanded CTC lifted 5.3 million children and adults out of poverty and decreased child poverty by over 40% in 2021 (Marr et al. 2022). This is the largest year-over-year drop in poverty on record. In 2021, refundable tax credits were the second most effective anti-poverty policy after Social Security (Hughes 2022). The new data is reviving calls by activists and analysts to make the expanded credit permanent after millions fell back under the poverty line once the credit shrunk to its original levels in January 2021 (Center on Poverty & Social Policy 2022).

These programs still have room for improvement despite their successes. Although the tax credits have admirable participation rates (90% for the CTC and 80% for the EITC, according to the Bipartisan Policy Center), that still leaves millions of eligible Americans not claiming benefits (Bipartisan Policy Center 2022). Why are Americans offered thousands of dollars by the federal government turning it down?

The issue lies with the tax filing process. 3.3 million Americans eligible for the EITC did not file a tax return in 2020 (Tax Policy Center 2020a). These Americans are predominantly low-income individuals who are eligible for the credit yet don't earn enough to require a tax filing. An additional 1.7 million who did file in 2020 failed to claim the credit for which they were eligible (Tax Policy Center 2020a). The Chicago Federal Reserve attributes nonparticipation to "a lack of awareness of the credit or the amount they are eligible for, a desire to avoid a complex and burdensome tax-filing process, a distrust of government, or a desire to avoid any stigma associated with receiving tax credits" ((Anderson et al. 2022). Low-income taxpayers may wonder whether the value of the credit is worth the time and money of filing taxes at all.

Can policymakers change this behavior? Solutions have tended towards expanded outreach and "nudging," i.e., tweaking the incentive structure in favor of filing taxes and claiming credits. These trials have had mixed results at best (Anderson et al. 2022; Guyton et al. 2017; Linos et al. 2020a), and are most likely to affect individuals who already regularly interact with the federal government and are aware of the available benefits (Linos at al. 2020b). This still leaves millions behind.

One often-overlooked solution to this issue is to eliminate the tax filing process entirely. Under a system of "return-free filing," the federal government would "withhold taxes owed and do its own accounting" for each taxpayer at the end of the year using earnings information that is already collected from employers, according to the Tax Policy Center ((Tax Policy Center 2020b). All taxpayers would have to do is check their pre-populated document for errors, correct them as necessary and sign; EITC and CTC beneficiaries could then receive their tax credits via direct deposit, check, or debit card as was done under the American Rescue Plan (Internal Revenue Service 2021). No accountants or tax preparation software would be needed. This system has already been adopted by at least 36 countries in one form or another (Tax Policy Center 2020c).

The U.S. has flirted with the idea before. California experimented with this system in 2005: 11,000 taxpayers received their prefilled forms either electronically or by mail; 95% of electronic recipients and 87% of mail recipients claimed it saved them time (Tax Policy Center 2020d). California has since adopted return-free filing as its primary method of collecting state taxes. The system was proposed at the federal level, but lobbying by H&R block and TurboTax killed the legislation in committee (Huseman 2017).

Considering that eligible non-participants would be automatically opted in, it's likely that return-free filing would improve tax credit participation. That the government already collects data on the number of Americans who are eligible for tax credits, with or without a filing, demonstrates that distribution of tax credit benefits would improve. Rather than dealing with a "complex and burdensome tax-filing process" to claim benefits, taxpayers would receive their tax credits automatically.

Though the new Census Bureau data makes clear that the expanded tax credits have been a massive success, the millions of Americans left behind due to procedural burdens cannot be ignored. This experiment in anti-poverty policy during the COVID-19 pandemic has not only shown that a slight reduction in tax burden can lift millions above the poverty line; it also reveals weaknesses in the federal government's method of collecting taxes and distributing benefits. Policymakers concerned with alleviating poverty would be wise to take note.

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