

Electronic filing, tax preparers and participation in the Earned Income Tax Credit [☆]

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Abstract

In 2002 more than 18 million low-income individual taxpayers received the Earned Income Tax Credit (EITC). Despite its size, non-participation in this program is a concern and substantial effort is devoted by the IRS, local governments and many non-profits to address it. Using variation across states in the introduction of state electronic filing programs, we show that the introduction of electronic filing had a significant effect on participation in the EITC. Our results are robust to accounting for other welfare, EITC and IRS reforms introduced during the same period. We speculate that the impact of this policy change on the tax preparation industry played an important role in increasing participation.

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1. Introduction

In a recent review of the literature on the take-up of social programs, Currie (2004) concludes that despite years of research effort, there is relatively little knowledge about the main barriers to increased program participation as well as the best policies to decrease these barriers. In this paper we focus on an important social program, the Earned Income Tax Credit (EITC), and study how the introduction of a particular technology (the ability to file taxes electronically) affected the number of EITC claims.

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More specifically, we use the staggered introduction of state electronic filing programs during the 1990s to show that these state programs had a large effect on the number of federal electronic filers as well as the number of EITC claims. Our main identifying assumption is that once we control for state and year effects as well as state-specific time trends, the timing of the introduction of the state electronic filing programs is not correlated with other factors that might have an effect on our outcome variables.

We carry out our analysis using annual public use samples of federal income tax returns issued by the IRS for the period 1988 to 1999 to generate yearly measures of electronic filing and EITC participation by state and income categories. These data are complemented with information from the IRS on the date of the introduction of electronic filing programs for state income taxes.

We find evidence that in an average state, the introduction of state electronic filing increases the number of federal returns that are filed electronically by an additional .6 to 1.1 percentage points. Next we show a similarly large increase in the number of people claiming EITC on their federal tax returns. Our instrumental variable estimate implies that 79% of the increase in electronic filing that resulted from the state electronic filing programs was due to new EITC participants. To test the robustness of our main results, we present a number of specification checks that try to account for possible competing alternative explanations of our results, such as the welfare reform and state-specific welfare waivers implemented during this period, or IRS programs to reduce EITC related cheating.

Our analysis proceeds as follows. We describe the EITC program and the empirical strategy in Section 2. In Section 3, we introduce our data and regression framework. The main empirical analysis is presented in Section 4. We conclude in Section 5 with the discussion of possible mechanisms that might explain our results. In particular, we highlight the role of the tax preparation industry as well as the incentives implicitly provided by the IRS for the industry to target the EITC population.

2. Background and empirical strategy

2.1. EITC

The history and research findings on the EITC have recently been reviewed in a survey article by [Hotz and Scholz \(2003\)](#). Therefore, we will only focus on the features of the program that are relevant for our analysis. The EITC, which is administered through the tax system, was expanded between 1991 and 1994 both by increasing the maximum benefits by almost 50% in real terms and by extending eligibility to childless individuals. The 1999 (the last year we use in our analysis) maximum for workers with two or more children was \$3816, with the phase in range between \$0 and \$9540 and the phase out range beginning at \$12,460. The credit was fully phased out at \$30,580. For single individuals the maximum benefit was just \$347 in 1999 and the program was fully phased out when income reached \$10,200.¹

Although the basic computation of the EITC is straightforward, the eligibility criteria are not. The major difficulty lies in determining whether the taxpayer meets the qualifying child criteria, since age, disability and residency restrictions are in place. Apart from the criteria related to children, there is also room for manipulating the system by adjusting the filing status. For

¹ In 2002, eighteen states had their own EITC programs. This is a relatively new phenomena: in 1999 there were twelve such states, and in 1990 only five. We ignore state EITC programs in most of the paper and provide only some robustness checks that indicate that these programs do not affect our analysis.

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