The Earned Income Tax Credit: Experiences from and Implications of the Voluntary Income Tax Assistance Program in Georgia

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Abstract

This study used data from Consumer Financial Literacy Program (CFLP) participating families to better understand how families anticipated using Earned Income Tax Credit refunds and their use of direct deposit. Data were collected over three years, through informal verbal interviews the first two years and a written questionnaire in the third. The most common use for a refund by participants was paying bills or debts. Nearly one-third of participants planned to use their refund for savings or asset accumulation. Also, direct deposit participation was positively related with savings and asset accumulation uses of the EITC refund.

Introduction

Since its inception in 1975, the Earned Income Tax Credit (EITC) has increased income and increased the ability to meet expenses among the working poor. With expansions to the EITC and welfare reform during the 1990s, the EITC has become the largest cash transfer program and the single most effective poverty reduction program in the U.S.(Greenstein, 2005; Hoffman & Seidman, 2003; Llobrera & Zahradnik, 2004; Sherman, 2005). The EITC is a refundable tax credit, which means that workers can receive assistance from the EITC even if they do not owe any taxes (but eligible recipients must file a tax return in order to receive the credit).

Multiple benefits of the EITC have been identified. A study of Aid to Families with Dependent Children (AFDC) families in Texas and New York showed that EITC improves work incentives and economic conditions of AFDC families making it easier for AFDC families to escape poverty through work by subsidizing earned income (Ozawa, 1995). "If society wants to reward work, especially in light of widening earnings inequality, the EITC appears to be an effective way to target low-wage workers" (Liebman, 1998, p. 96). The EITC helps to lift families out of poverty, but could also be used by families to build wealth. Expansion and increased knowledge about the EITC can help the program to be even more effective in moving the working poor out of poverty. Using data from the 1990 Survey of Income and Program Participation (SIPP), Scholz (1994) and Phillips (2001) found that in most estimates, 80 to 86 percent of those eligible for the EITC actually received it. This means that around 2.1 million taxpayers entitled to the credit failed to receive it in 1990. According to Internal Revenue Service (IRS) data, $129,933,793 of available EITC funds went unclaimed in the state of Georgia in 2004 (Empowerment for Self-Sufficiency: Georgia Earned Income Tax Credit, 2005). Phillips (2001) attributed unclaimed EITC funds to lack of knowledge of the EITC. Low-income Hispanic parents are less likely to know about the EITC than other low-income parents. Less than 50 percent of low-income parents who did not complete high school know about the EITC and very poor parents are less likely than higher income parents to know about the EITC (Phillips). This lack of knowledge may suggest the need to target these subgroups in awareness programs.

In 2002, the Consumer Financial Literacy Program (CFLP) was introduced to selected counties in Georgia to provide financial literacy education. Tax education was one of the four components of that program. Along with financial literacy for targeted audiences (youth, low- and moderate-income adults and the general public via mass media), tax education was a primary thrust of the CFLP educators. The program provided free tax assistance, e-filing, and information about refundable tax credits, refund anticipation loans, and direct deposit.

This study examined data collected from participating families in the CFLP. Specifically, our focus was (1) to better understand how families anticipate using their tax refund and (2) to better understand their use of traditional banking services, specifically direct deposit, in relationship to their anticipated use of their tax refund. Given the exploratory nature of this study only frequencies and contingency table procedures were used. Implications for the EITC and wealth building will be discussed.

Review of Literature

While there is considerable literature on the benefits and impact of the Earned Income Tax Credit (Beverly, 2002; Liebman, 1998; Smeeding, Ross, O'Connor, & Simon, 1999), less is known about how individuals and families spend their tax returns. The following literature review focuses on those studies that provide some insight into recipients' use of the earned income tax credit and the relationship between the earned income tax credit and savings behaviors of low- to moderate-income households.

Participants can receive EITC funds in two ways. They can receive all of their credit in a lump sum tax refund after a year of work, or recipients can take the advanced EITC, in which up to 60 percent of their total EITC is in their paychecks throughout the year and the remaining amount is received in a lump sum via tax refund (Barrow & Granahan, 2000). Using the Consumer Expenditure Survey from 1982 to 1996 to analyze the impact of the sudden influx of income for EITC recipients, Barrow and Granahan found that expenditures increased in February relative to all other months in households that received the EITC, especially for durable goods. Recipients spent about twenty percent of the refundable portion of the EITC during the month that they received the refund and smoothed some of the income into other months (Barrow & Granahan). Soules (1999) also found from the Consumer Expenditure Survey in years 1980 to 1991 that households consume from 35 percent of their tax refunds up to 60 percent during the first quarter of the year.

Benefits throughout the years may help families cover mid-year budget shortfalls (Beverly, 2002), but a study of 42 randomly selected families in Milwaukee, Wisconsin found that lump sum payments may increase total resources throughout the year because families will find other ways to cover budget shortfalls (Romich & Weisner, 2000). Romich & Weisner also found that people view the combined income tax/EITC check differently than paycheck income; they have a higher inclination to consume durable goods and make large purchases. Among recipients who put EITC into savings, receiving the EITC in a lump sum can help very low-income families manage larger purchases such as furniture, cars, and homes in the short run. A study of low income Chicago area taxpayers done by Smeeding, Phillips, and O'Connor (2000) found that almost 70 percent of all recipients of the EITC with children had economic and social mobility related uses (such as car purchases, paying tuition, or change of residence) for the EITC. This study also found that one-half of all respondents plan to save some or all of the EITC (Smeeding et al.). Beverly also found that many families wanted to save a portion of their refunds to use for large expenditures. However, many low-income families have neither a checking nor savings account (Beverly, 2002).

EITC recipients with greater access to financial institutions are more likely to save a part of their refund (Smeeding et al., 2000). Also, asset accumulation uses for the EITC are positively related with having formal contact with a financial institution (Smeeding et al., 1999). Therefore, checking and savings accounts may facilitate saving by low wage families to make major purchases (accumulate assets) to increase their economic and social mobility (e.g., education, housing, and business ownership). Having a checking or savings account is likely to make it easier for families to set priorities on the use of a large tax refund (Smeeding et al., 1999). They also offer a way for EITC recipients to store the EITC until their priority uses are sorted out. Incentives for savings, along with access to credit markets and federal programs to match low-income savings for specific purposes, such as schooling or home purchases, could lead to increased savings and work efforts of the low income population (Smeeding et al., 1999).

Studying a low-cost bank account pilot program in Chicago, Beverly, Tescher, Romich, & and Marzahl (2001) found that "by helping individuals spend money more slowly and more thoughtfully, introducing some to account ownership or direct deposit, and encouraging some to obtain other mainstream financial products, [checking/savings account programs] may help low-income families 'get on track' for future savings and asset accumulation" (p. 15). Beverly et al. also found other advantages to checking/savings account programs linked to the EITC. Participants did not have to pay to have their tax refund check cashed, direct deposit forced participants to commit to opening accounts before they even received their refunds and were tempted to spend them, and having money in an account instead of in cash decreased the chances that the money would be spent quickly, lost, or stolen. Recipients can spend an unnecessary portion of their tax refund with alternate methods of saving money, such as buying money orders made out to one's self and cashing them later or opening a checking or savings account with fees (Beverly et al.). Through checking/savings account programs linked to the EITC receipt, the cost of saving money can be minimized.

Method

Data were collected through the Consumer Financial Literacy Program (CFLP), a research-based educational program administered by the University of Georgia Cooperative Extension, Family and Consumer

Sciences and the Georgia Governor's Office of Consumer Affairs. The CFLP was designed to move Georgia residents toward financial security through financial education for low- and moderate-income adults and all youth, with an emphasis upon outreach to promote the availability of refundable tax credits, free electronic filing, and direct deposit. CFLP educators were trained and certified by the IRS as Volunteer Income Tax Assistance program (VITA) volunteers. VITA is a program through the IRS that provides free income tax filing assistance to low-to-moderate income families with the use of community volunteers.

The CFLP set up VITA sites in centralized locations in rural southern Georgia counties to file taxes for a set period of time weekly. CFLP also developed portable VITA sites that traveled around to large employers in these areas so employees could file their taxes while at work. Rural areas were targeted by CFLP, as access to free tax preparation services is typically concentrated in urban areas.

The data were collected over three years, tax years 2002, 2003, and 2004. The first two years, data was collected through informal verbal questionnaires conducted by a CFLP tax preparer. The tax preparers asked questions of every participant while the participant's taxes were being filed and marked answers on a tally sheet. The third year, the questions were included as part of the intake form that clients completed before a CFLP preparer saw them. The questionnaire portion was detached from the personal information. The preparer saved this portion of the intake form and indicated use of direct deposit for the current year and noted the amount of the state and federal refunds. With this collection method, there was no way to identify participants and track their surveys from year to year. No participant refused to answer all of the questions or fill out the form, providing an estimated 100 percent response rate. For the 2002, 2003, and 2004 tax filing seasons, 2,306 tax filers participating in CFLP were interviewed or responded to the questionnaire. Questions were asked about previous years' tax filing, use of refund anticipation loans, whether refund was by direct deposit, how they planned to use their refund, and amount of current year's refund (federal and state). Not every question was asked every year, with most of the questions asked in the 2004 tax filing season.

Results

Since this study is exploratory in nature and data are limited to the program data collected by the CFLP volunteers and the self-reported data in the last year for which data was obtained, only descriptive statistics and contingency table analyses were performed. What follows is a basic description of the sample and contingency table results to determine if there were differences between users and non-users of direct deposit and planned use of this year's refund.

Previous Tax Preparation Experiences Among CFLP Participants

Over three years, among the 2,306 participants the CFLP helped (284 in the 2002 tax season, 998 in the 2003 tax season, and 1024 in the 2004 tax season), low-income workers received an average refund of $1,220.37 from the federal government and $148.55 from the state. About 39 percent were repeat filers. Table 1 provides descriptive statistics on the responses to the questions asked of those receiving free tax services through the CFLP for tax years 2002, 2003, and 2004. For each question, frequencies reported are for non-missing responses only and thus the number of participants varies from question to question.

In the 2004 tax season, about 24 percent indicated that they had not filed taxes in the previous year. About 39 percent indicated that they used the CFLP for filing taxes in the previous year while another 9.2 percent indicated that they had used another free tax preparation service. About 12 percent did their own taxes in the previous year, while about 15 percent indicated that a friend or family member did their taxes the previous year. Across the 3 tax seasons, the percentage of CFLP participants using a paid tax service declined from 70.8 percent in the 2002 tax season to 34 percent in the 2004 tax season. When asked about how much they paid for tax services in the previous year, the amount ranged from $12 to $325 in the 2002 tax season with a median of $72.50. In the 2003 tax season participants indicated that they had paid between $19 and $425 with a median of $89 for tax preparation in the previous year. Participants in the 2004 tax season indicated that they paid between $15 and $2,000 to preparers in the previous tax season with a median payment of $92. In the 2004 tax season, approximately 11 percent of the participants indicated that they had gotten a refund anticipation loan in the previous year. This was down from 12.5 percent in the 2003 tax season. Based on CFLP estimates, use of refund anticipation loans had decreased from 17 percent in the previous year in the 2002 tax season.

Use of Refund and Direct Deposit

Of primary interest to this study was the CFLP participant response to the questions, "how do you plan to use <u>most</u> of this year's refund," and "will you receive your refund by direct deposit this year?" Both these questions

Table 1
Frequencies for Tax Years 2002, 2003, and 2004

Variable	2002 Tax Season	2003 Tax Season	2004 Tax Season
Number served	284	998	1024
How did you have taxes done last year?[ab] (n=642)			
Didn't file			24.1%
Here			39.1%
Another free place like this			9.2%
Did my own			12.1%
Friend or family			15.4%
Did you pay a tax preparer last year? (n = 277; n=954; n=950)			
Yes	70.8%	56.9%	34%
No	29.2%	43.1%	66%
Did you get a refund anticipation loan last year?[b] (n=979; n=957)			
Yes		12.5%	10.9%
No		87.5%	89.1%
Did you receive your refund by direct deposit last year?[a] (n=977; n=968)			
Yes		24%	26.2%
No		76%	73.5%
Will you receive you refund by direct deposit this year?[ab] (n=963)			
Yes			48.1%
No			51.9%
How do you plan to use <u>most</u> of this year's refund?[ab] (n=908)			
Pay current bills or debts			45.4%
Catch up on bills or debts			17.6%
Save for an emergency			10.5%
On a vehicle			6.8%
On a house			6.6%
On education			6.6%
Saving for retirement			1.9%
Does not apply/no refund			4.6%

[a] Question not asked in 2002 tax season
[b] Question not asked in 2003 tax season

were asked of the participants in the 2004 tax season. The most common use for a refund by participants was to pay current bills or debt (45.4 percent). Almost 18 percent of the participants planned to use their refund to catch up on bills or debts. Approximately 10.5 percent of the participants planned to save his or her refund for an emergency. Other uses identified by participants included buying a vehicle (6.8 percent), buying a house (6.6 percent), education (6.6 percent) and saving for retirement (1.9 percent). By adding saving for an emergency and saving for retirement, 12.4 percent of participants planned to save their tax refund. Twenty percent of participants planned to use their refund for asset accumulation (purchasing a vehicle, house, or education). An increase in the use of direct deposit was observed among the CFLP participants as direct deposit participants increased to 48.1 percent in the 2004 tax season from 26.2 percent of CFLP participants in 2003 tax season and 24 percent in the 2002 tax season.

Contingency table results (shown in Table 2) indicated there were some differences between those who used direct deposit and those who did not use direct deposit in the 2004 tax season and the planned use of their refund. There was very little difference in the percent of direct depositors and non-direct depositors who planned to pay current bills or debts or catch up on bills or debts. However, differences were found with regard to savings and asset accumulation. About 12 percent of those who used direct deposit planned to save for an emergency compared to only 9.5 percent of those who did not use direct deposit. Fewer direct depositors planned to spend their refund on a vehicle (6.3 percent for direct depositors and 7.5 percent on non-direct depositors). About 9 percent of direct depositors planned to spend their refund on a house compared to only 4.6 percent of non-direct depositors. Slightly more direct depositors than non-direct depositors planned to spend their refund on education (6.9 percent and 6.4 percent respectively). Saving for retirement was low for both groups (2.3 percent among direct depositors and 1.5 percent among non-direct depositors). Overall, 35.7 percent of direct depositors planned to use their tax refund for savings and asset accumulation, compared to 29.5 percent of non-direct depositors.

Table 2
Contingency Table Analysis for Direct Depositors and Non-Direct Depositors and Planned Use of Refund

Use of Refund	Direct Depositors	Non-Direct Depositors
Pay current bills or debts	45.8%	45.1%
Catch up on bills or debts	17.0%	17.6%
Save for an emergency	11.6%	9.5%
On a vehicle	6.3%	7.5%
On a house	8.6%	4.6%
On education	6.9%	6.4%
Saving for retirement	2.3%	1.5%
Does not apply / no refund	.9%	8.2%

What Was Learned from the CFLP and Other Conclusions

In this study, 12.4 percent of EITC recipients planned to save their refund and 20 percent of recipients planned to use their refund for asset accumulation (purchasing a house, vehicle, or education). This is considerably less than the finding by Smeeding et al. (1999) that one-half of EITC recipients plan to save some of their refund and the finding by Smeeding et al. (2000) that almost 70 percent of EITC recipients will use the EITC for asset accumulation. This difference may be attributed to a difference in phrasing of questions between the studies. In this study, participants were forced to choose one major use of their EITC refund, while in the studies by Smeeding et al. (1999 & 2000), participants could indicate multiple uses for the EITC. Perhaps participants in this study planned to use a portion of their EITC refund for savings or asset accumulation after using a portion for a primary need of paying off or catching up on bills and debts.

Compared to Romich & Weisner (2000), participants in this study did not seem to be highly inclined to consume durable goods or make large purchases with their EITC refund. Approximately 63 percent planned to use their income tax/EITC refund to pay off or catch up on bills or debts. Only 6.8% planned to spend their refund on a house and another 6.6% planned to spend their refund on a vehicle. We do not know whether or not paying off or catching up on bills captures previous large or durable goods purchases.

EITC recipients in this study who planned to use direct deposit to receive their refund were more likely to save their refund (13.9 percent versus 11 percent of non-direct depositors) or used their refund for asset accumulation (21.5 percent versus 18.2 percent of non-direct depositors). These findings are consistent with the findings of Smeeding et al. (2000) that EITC recipients are more likely to save part of their refund if they have access to financial institutions and Smeeding et al. (1999) that asset accumulation uses for the EITC are positively related with having formal contact with a financial institution.

Although not recommended by financial practitioners and educators, many taxpayers have more taxes withheld than necessary as a forced mechanism for savings. These taxpayers may find it difficult to save regularly from their paychecks throughout the year because of a lack of self-discipline or other reasons. Therefore, educating EITC recipients on the benefits of using direct deposit as a forced savings mechanism may be one way of increasing the savings rate of this group. In addition, if more EITC recipients are using direct deposit, there will continue to be a reduction in the use of high-cost refund anticipation loans. The use of free tax preparation, e-filing, and direct deposit provide EITC recipients with more money to save and accumulate assets with as opposed to paid preparers, check cashing outlets, and financial institutions.

Anecdotal information from the CFLP indicated that many filers were not aware that direct deposit was free as many asked how much it cost to use direct deposit. Many filers were not aware that they could use a savings account for direct deposit. In an effort to educate and encourage EITC recipients to save, at least a portion of their refund, the CFLP tax preparers deliberately pointed out to the taxpayer the amount of EITC benefits they received.

Drawing from our results, linking tax refunds to bank accounts or savings programs may increase savings and asset accumulation of EITC recipients. Individual Development Accounts (IDAs) address savings and asset accumulation constraints and improve access to savings institutions for the poor. Participants also receive support and financial education from IDA staff (Schreiner, et al., 2001), which may also increase savings. Stoesz and Saunders (1998) suggest that individual contributions to IDAs from EITC refunds be matched by contributions from the TANF surplus. They believe that this would appeal to legislators weary of raising state taxes because it involves no new state revenues. Experiences and results from the CFLP support efforts to link tax refunds to targeted saving programs.

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