Community Development Research Brief

The Earned Income Tax Credit in the 12th District

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INTRODUCTION

Within the Federal Reserve's 12th District, over 4 million families and individuals received the Earned Income Tax Credit (EITC) for tax year 2007, totaling over $8 billion in credits. In this Research Brief, we examine trends in EITC usage across the 12th District, and look at how the EITC and tax time provide a unique opportunity to link lower-income households to financial services and other asset building initiatives.

THE EARNED INCOME TAX CREDIT

Nationwide, about one in six tax filers receives the EITC, a federal tax credit that has grown into one of the largest anti-poverty programs in the US since its creation in 1975. The impact of the EITC grew considerably in 1993 when President Clinton and Congress doubled the size of the program as part of a broader set of reforms to encourage work and to ensure that minimum-wage workers could support themselves and their families with full-time work. By 1996, the EITC exceeded total federal and state welfare payments, and it surpassed the Food Stamp Program in 1998.[1] In 2009, the EITC raised the incomes of an estimated six million people over the poverty line.[2]

The EITC provides a tax credit for low- and moderate-income working individuals and families. The EITC formula increases the credit amount for each additional dollar earned, and then phases out at higher income levels. The largest payments are for households with children. In 2007, the average amount of the EITC credit was $1,999. Importantly, the EITC is refundable; if the amount of the credit exceeds the taxes owed, the IRS will refund the balance. For many low-income families, a tax refund is their largest infusion of cash for the entire year. Unlike other federal anti-poverty programs such as food stamps, energy assistance or child support, the EITC carries no restrictions on how the recipient can spend the benefits. Several studies have

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[1] For an excellent review of the history and literature on the Earned Income Tax Credit, see Steve Holt (2006). "The Earned Income Tax Credit at Age 30: What We Know," The Brookings Institution Research Brief, February 2006.
[2] "Policy Basics: The Earned Income Tax Credit." Center on Budget and Policy Priorities, December 4, 2009.

shown that EITC recipients use their refunds to pay bills and debts, cover transportation costs including car maintenance, open savings accounts and build assets, and invest in education or job training.[3] In addition to supporting working families and encouraging work, the EITC may also have an impact on the local economy. A San Antonio study found that two-thirds of EITC credits were spent locally, generating an extra $1.58 in local economic activity for every dollar in EITC refunds.[4]

While the EITC can generate significant benefits, it is underutilized; according to some estimates, between 15 and 20 percent of families who are eligible for the EITC don't claim the credit, leaving valuable money on the table.[5] Because the EITC represents such a large sum of money for low-income households and communities, nonprofits and community organizations have increasingly dedicated significant resources to raising awareness about the EITC and encouraging families to take advantage of the credit. In addition, community groups and local governments have worked to reduce the use of paid tax preparers and high-cost financial products associated with tax season. Approximately 70 percent of all EITC filers use paid tax preparers to file their taxes, and are often sold alternative financial products that take a bite out of their refund check. The most common of these products is the Refund Anticipation Loan (RAL), which is a high-cost loan originated by a tax preparer and backed by a taxpayer's anticipated refund. A typical RAL for $1,500 costs over $60, which, given the short timeframe of the loan, amounts to a loan with an interest rate of 149 percent.[6] Paid tax preparers also offer refund anticipation checks, or RACs, which are temporary bank accounts into which the IRS deposits the refund. RACs are less expensive than RALS, averaging $30. To counteract these asset stripping products, efforts are underway to use the EITC as an opportunity to promote saving and the use of conventional financial products and services.

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[3] Mammen, Sheila and Frances Lawrence. "How Rural Working Families Use the Earned Income Tax Credit: A Mixed Methods Analysis." *Financial Counseling and Planning* 17.1 (2006) : 51-63.
[4] Texas Perspectives, Inc. 2004. *2004 Update: Increased participation in the earned income tax credit in San Antonio*.
[5] Plueger, Dean. (2009) Earned Income Tax Credit Participation Rate for Tax Year 2005. *IRS Research Bulletin* 151-195.
[6] Wu, Chi Chi. (2011). "End of the Rapid Rip-Off: An Epilogue for Quickie Tax Loans." National Consumer Law Center and Consumer Federation of America.

FIGURE 1: EITC TRENDS IN THE 12TH DISTRICT, TAX YEAR 2007

State	EITC Returns	% of All Returns EITC	Total EITC	Average EITC	% of EITC Claims Receiving RAL
Alaska	41,021	11.6%	$ 68,178,394	$ 1,662	18.8%
Arizona	449,603	16.2%	$ 897,677,622	$ 1,997	25.1%
California	2,580,322	15.4%	$ 5,055,150,696	$ 1,959	16.6%
Hawaii	91,330	13.7%	$ 158,661,328	$ 1,737	19.0%
Idaho	111,241	15.9%	$ 208,614,596	$ 1,875	16.6%
Nevada	182,455	14.4%	$ 336,565,985	$ 1,845	29.3%
Oregon	242,754	13.2%	$ 426,849,443	$ 1,758	16.4%
Utah	149,317	13.0%	$ 281,953,262	$ 1,888	16.7%
Washington	378,898	11.6%	$ 674,319,668	$ 1,780	20.1%
12th District	4,226,941	14.7%	$ 8,107,970,994	$ 1,918	18.4%

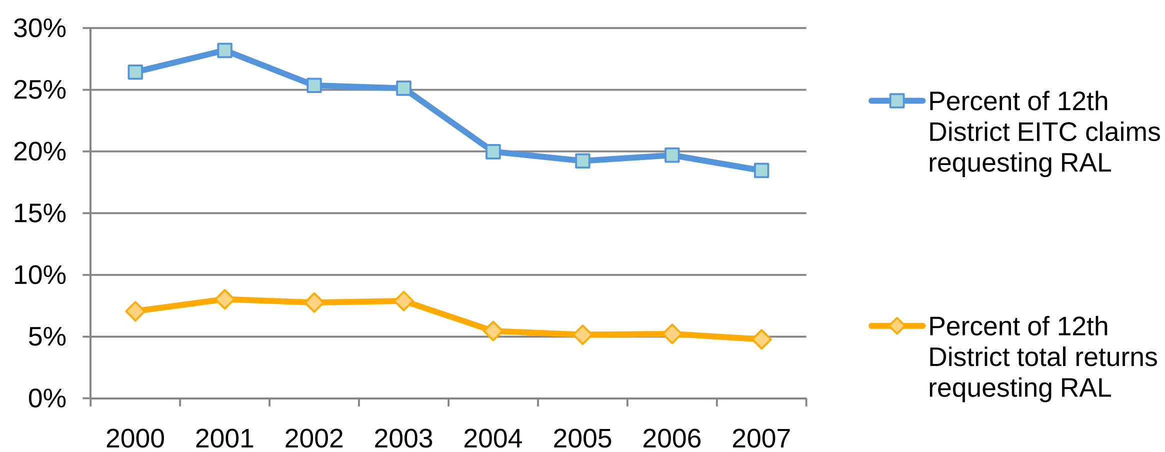
Source: Brookings Institution and IRS

EITC TRENDS IN THE 12TH DISTRICT

Within the Federal Reserve's 12th District, approximately 4.2 million households benefited from the EITC in 2007. In 12th District states with relatively high poverty rates, such as Arizona and California, nearly 1 in 6 filers claimed the credit, and the average EITC refund in 2007 was approximately $2,000. The dollar amounts in Figure 1 demonstrate the importance of EITC relative to other federal anti-poverty programs. Low-income households in California received over $5 billion in credits, more than 120 times the amount that California received from HUD in its 2007 CDBG allocation (about $42 million).[7] Alaska and Washington had the fewest EITC claimants of 12th District states.

The table also shows the disproportionately high use of RALs among EITC filers relative to general filers. The typical RAL/RAC consumer is a low-income, single head-of-household who is between the ages of 26 and 35, has children, used a paid tax preparer and is receiving the EITC.[8] In 2007, nearly 30 percent of all EITC recipients in Nevada used a RAL; RAL usage was also high in Arizona and Washington. On the whole, EITC filers within the 12th District were four times more likely to request a RAL than non-ETIC filers (Figure 2). Assuming each RAL costs around $100, the use of RALs in the 12th District represents a transfer of over $75 million of public subsidies from lower-income households to tax preparers.

FIGURE 2: PERCENT OF TAX FILERS RECEIVING A RAL

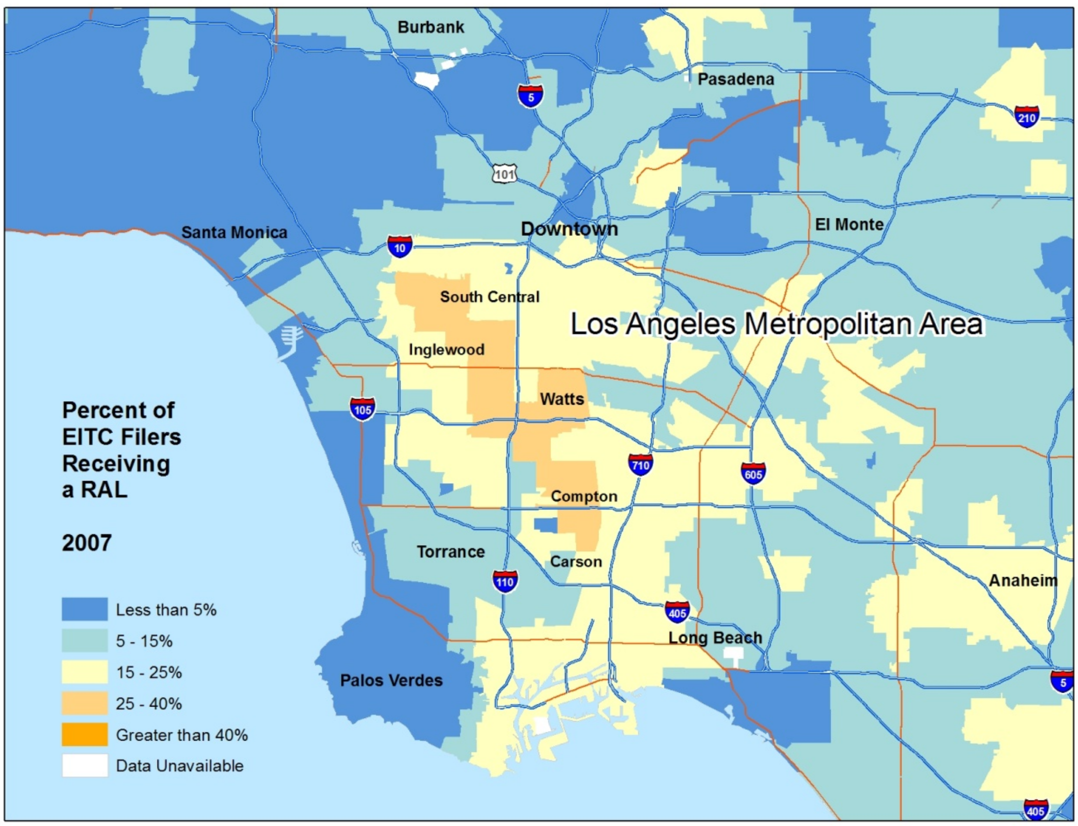


Source: Brookings Institution and IRS

[7] "State of California Community Development Block Grant Program 2007/2008 HUD Allocation." California Department of Housing and Community Development. Available online at http://www.hcd.ca.gov/fa/cdbg/CDBG_Allocation_Chart.pdf
[8] Theodos, Brett et al. (2010). "Characteristics of Users of Refund Anticipation Loans and Refund Anticipation Checks." Washington DC: Department of the Treasury.

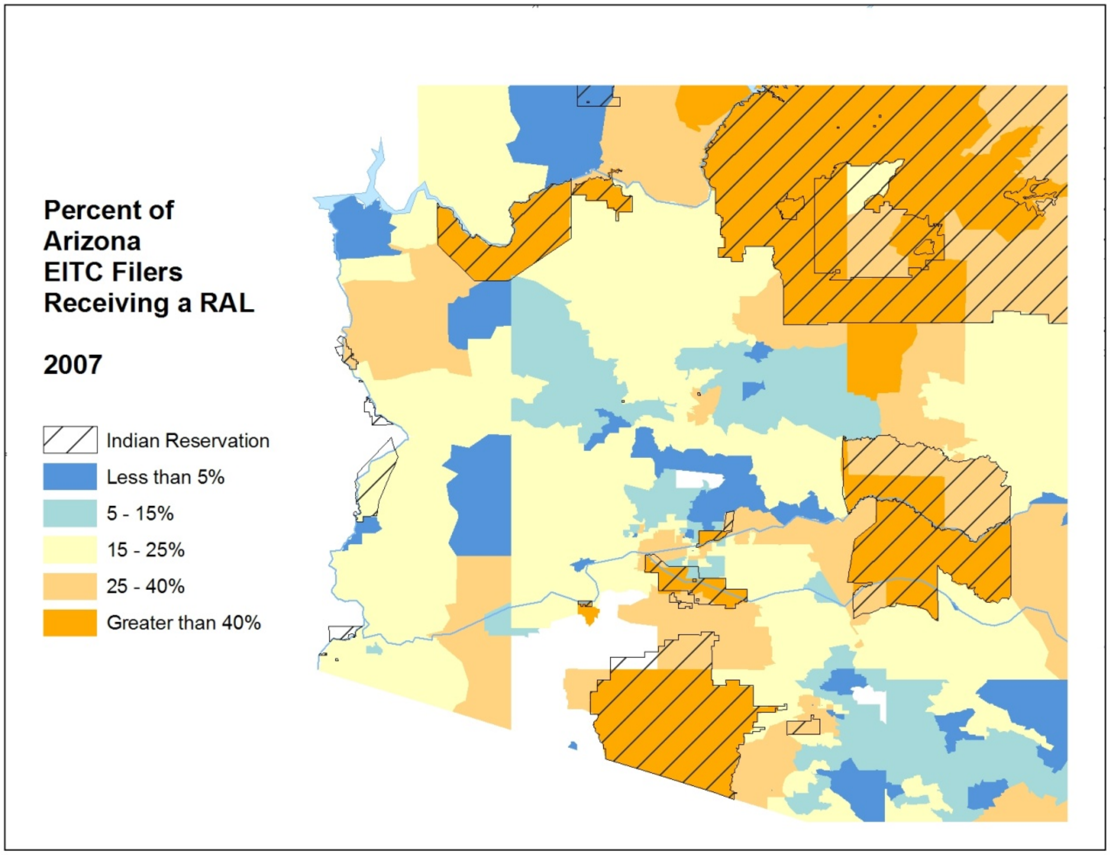
The usage of RALs is also concentrated in low-income and minority neighborhoods. Figures 3 and 4 present maps of RAL usage in Los Angeles and in Arizona. In Los Angeles, the highest rates of RAL usage are in the lower income and minority neighborhoods of South Central Los Angeles. In Arizona, the highest rates of RAL usage are found within Native American Indian reservations. On the Navajo Reservation in northwest Arizona, for example, more than 40 percent of EITC filers received a RAL in 2007.

FIGURE 3: PERCENT OF L.A. EITC FILERS RECEIVING A RAL



Source: Brookings Institution and IRS

FIGURE 4: PERCENT OF ARIZONA EITC FILERS RECEIVING A RAL



Source: Brookings Institution and IRS

On a positive note, the 2007 data reflect a downward trend in the use of RALs. Indeed, RAL usage decreased steadily between 2000 and 2007. Policymakers expect the use of RALs to drop even further, given recent changes in federal policy and regulations. In 2010, the IRS announced that it would no longer make a consumer's "debt indicator" available to tax preparers. The debt indicator denotes whether any portion of a taxpayer's refund will be used to offset outstanding debts to the federal government, such as unpaid back taxes, child support, or delinquent federal student loans. The debt indicator served as an important tool in the RAL underwriting process; without it, the risk of the loan increases, since the refund amount may not be sufficient to cover the loan. Responding to this increased risk, federal regulators including the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation have limited the ability of their member banks to provide the financing for RALs. Only two major tax preparers offered RALs during the 2011 tax season: Jackson Hewitt and Liberty Tax Service, and it is likely that they too will face financing constraints going forward.

LINKING TAX TIME TO ASSET BUILDING

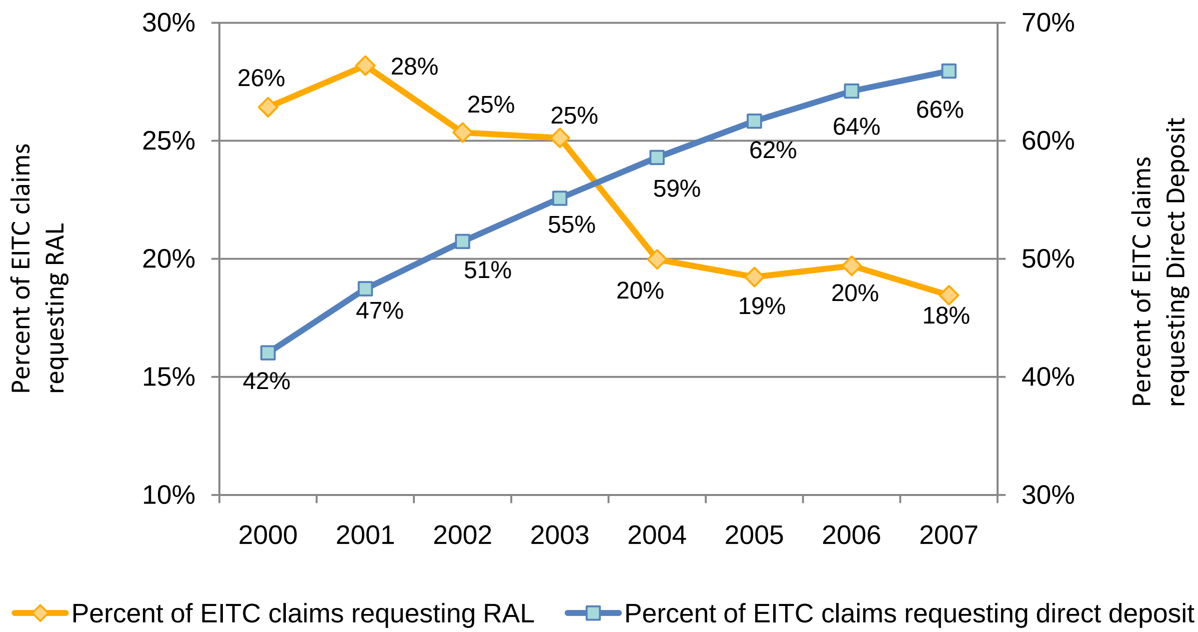
While these regulatory shifts provide welcome restrictions on the accessibility of RALs, efforts to decrease the use of other costly financial products at tax time need to target the underlying reasons why low-income taxpayers are drawn to these products in the first place. Consumers seek out RALs and RACs because these products offer fast access to credit to people with limited savings, they allow low-income workers to pay upfront for tax preparation, and they can be the simplest method of receiving a tax refund for the unbanked.

One of the key policy developments at tax time has been the establishment of Volunteer Income Tax Assistance (VITA) sites, which provide low-income filers with free tax preparation services. In 2007, around 2.5 million taxpayers used VITA sites to prepare their taxes.[9] While this represents only a fraction of all filers (around 1 percent), research has shown that cities with higher numbers of VITA sites see a slight increase in EITC uptake, and a concomitant decrease in the use of RALs.[10] In addition, organizations that run VITA sites have begun to tie their EITC campaigns to asset-building initiatives. By targeting consumers before they receive a large lump sum payment, community groups can use tax time as a teachable moment and an opportunity to encourage savings behavior. A key component of this strategy is connecting the unbanked – consumers without a checking or savings account – to mainstream financial services. Some VITA sites offer filers the opportunity to open a bank account and sign up for direct deposit at the

[9] Phillips, Michael (2007). "Accuracy of Volunteer Tax Returns is Improving…," Treasury Inspector General for Tax Administration Memorandum, August 2007.
[10] Steve Holt (2006). "The Earned Income Tax Credit at Age 30: What We Know," The Brookings Institution Research Brief, February 2006.

same time that they file their taxes. By receiving their tax refund directly into a bank account, low-income families can receive their refund more quickly and safely, which weakens the appeal of refund anticipation loans.

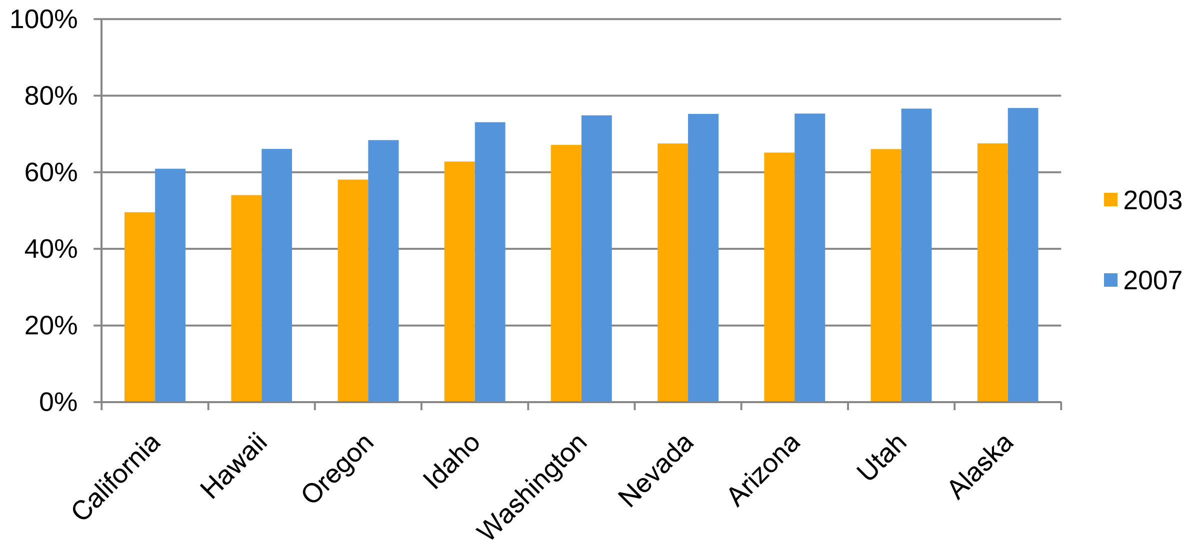
FIGURE 5: CHANGES IN RAL AND DIRECT DEPOSIT REQUESTS



Source: Brookings Institution and IRS

While it is difficult to show a direct causal link between VITA site programs and taxpayer behavior, the trends in direct deposit and RAL usage in the last decade are quite clear. As shown in Figure 5, two-thirds of all EITC recipients in the 12th District used direct deposit in 2007, up from 42 percent in 2000. Only 18 percent of taxpayers who claimed the EITC requested a RAL, down from a high of 28 percent in 2001. The lowest use of direct deposit is in California, where only 60 percent of EITC recipients received their tax refund through direct deposit.

FIGURE 6: PERCENT OF EITC RETURNS RECEIVING DIRECT DEPOSIT



Source: Brookings Institution and IRS

Several ongoing initiatives around the country highlight various ways to boost direct deposit usage, link low-income taxpayers to bank accounts, and decrease the need for refund anticipation products. Many cities have collaborated with community organizations and financial institutions to create Bank On programs, which aim to connect low-income individuals to bank accounts that meet their needs. While Bank On primarily targets customers who frequent check cashers and payday lenders, the program readily suits RAC and RAL users as well. By increasing the supply of safe starter accounts and bringing the unbanked into the financial mainstream, Bank On initiatives eliminate the need for low-income taxpayers to use RACs, since they can opt to receive their refund as a direct deposit. The Treasury Department is launching a Bank on USA initiative, which will help to expand and support local campaigns to bring lower-income households into the financial mainstream.

The federal government has also implemented a series of policy changes to help tax filers save at tax time, including amending tax filing forms to allow tax filers to split their refund into up to three accounts as opposed to requiring receipt in a lump sum, and offering the opportunity to purchase

U.S. Savings Bonds with tax refunds.[11] In a split refund pilot conducted in Tulsa, OK, researchers found that giving taxpayers the option of splitting their refund increased savings among very low-income families. Approximately 15 percent of filers – with an average income of $12,300 – saved $583, or 47 percent of their total refund. Unfortunately, many more filers were interested in participating but were unable to open a savings account due to a ChexSystems[12] disqualification.[13]

To address the needs of the unbanked, the Treasury Department launched a pilot program in 2011 aimed at reaching low-income taxpayers without bank accounts. In January, Treasury mailed letters to 600,000 low-income people and offered them affordable debit cards, which they could then use to receive electronic payments of their federal tax refund. Consumers can continue to use the debit card for purposes other than receiving tax refunds, unlike a RAC. For instance, consumers can opt to receive direct deposit of wages and use the card to pay bills online – both for free. As part of the pilot, half of the cards come without monthly fees, while the other half cost $4.95 a month. Treasury will track usage patterns to determine how the program should expand if it is shown to be successful.[14] At the same time, Treasury is launching a similar program to encourage payroll-card[15] users to direct deposit their refunds onto their existing payroll cards.

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[11] Rachel Black and Reid Cramer (2011). "Incentivizing Savings at Tax Time $aveNYC and The Saver's Bonus," New America Foundation, March 2011. Available online at http://www.newamerica.net/sites/newamerica.net/files/policydocs/Black_Cramer_Incentivizing_Savings_at_Tax_Time_3_11.pdf.

[12] "Chex Systems, Inc. provides account verification services to its financial institution members to aid them in identifying account applicants who may have a history of account mishandling (for example, people whose accounts were overdrawn and then closed by them or their bank)." Definition from ChexSystems website.

[13] An Evaluation of Tax-Refund Splitting as an Asset-building Tool for Low-to-middle Income Individuals. Policy Analysis Exercise prepared by Anne E. Chiou, Samuel E. Roe and Ethan S. Wozniak. An evaluation of the effectiveness of the R2A programs in Tulsa, OK and New York City, NY offered during the 2005 tax season, April 2005. (PDF) http://www.d2dfund.org/downloads/2005-04_Eval_Refund_Splitting.pdf

[14] "Treasury Launches Pilot Program of Prepaid Debit and Payroll Cards for Fast, Safe and Convenient Tax Refunds." January 13, 2011. U.S. Department of the Treasury.

[15] A payroll card is similar to a debit card and enables employers to pay employees who do not have bank accounts. The employees receive their pay through direct deposit and can use the card to make purchases or to withdraw cash from ATMs (usually for a fee).

At the local level, New York City's Department of Consumer Affairs developed an innovative program that relied on incentives to encourage tax-time savings. Launched in 2008, the $aveNYC program offers a 50 percent match to low-income taxpayers who open a savings account at tax time, direct deposit part of their refund into the account, and don't withdraw the deposit for one year. The evaluation of the program found that three quarters of participants kept their account open for the entire year, and 80 percent of those who received the match opted to roll over their account for another year.[16] $aveNYC demonstrated that by applying principles of behavioral economics, including limiting choices and the use of incentives, asset-building programs can actually change behavior. Jonathan Mintz, the director of the Department of Consumer Affairs, described the program as "…making it easy to do what people know is already important to do."[17] Due to promising results in its first three years, the program expanded in 2011 to three additional cities and rebranded itself SaveUSA. Newark, NJ, Tulsa, OK, and San Antonio, TX are offering matched savings up to $500 for select filers at VITA sites.

In Minneapolis, MN, a coalition of community groups and credit unions led by AccountAbility Minnesota launched a pilot to respond to the need for short-term credit – a key reason lower-income families use RALs. Started in 2005, the Express Refund Loan and Savings (ERLS) offered affordable RALs that were linked to free tax assistance and direct deposit into a savings account. The loans were offered for between $5 and $25, and relied on the debt indicator from the IRS. The alternative RAL saved clients an average of $296 when compared to the cost of a traditional RAL and paid tax preparation. However, with the IRS' elimination of the debt indicator, AccountAbility Minnesota was unable to continue the ERLS program, although it still offers free savings accounts, prepaid debit cards, and financial education in conjunction with free tax assistance.

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[16] Mahon, Cathie. "Innovations in Savings: the $aveNYC Account." PowerPoint presentation. New America Foundation, April 21, 2009.
[17] Lee, Jennifer. "A Government Hand in Helping the Poor Save." *New York Times City Room* Blog. August 10, 2009.

CONCLUSION

Given the number of households that claim the EITC, tax time provides a unique opportunity to connect lower-income families to responsible financial services and boost their savings. Policymakers have implemented a series of changes to the tax filing process to make saving easier, and regulators are limiting the ability of tax preparers to offer costly products such as RALs. Still, more is needed to link the EITC to asset building, and local pilots and programs offer a unique opportunity to study what works and provide insights into savings behavior among lower-income households. Hopefully, evaluations of programs like $aveNYC and Minnesota's ERLS pilot can provide the foundation for new policies that can take asset building at tax time to scale, thereby benefiting millions of families across the country.