Policy Report

Using Tax Refunds to Promote Asset Building in Low-Income Households: Program and Policy Options

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ABSTRACT

The federal income tax system has become an important vehicle for social policy. Although tax expenditures are skewed toward middle- and high-income households, tax transfers to low-income households increased substantially during the last decade. It is now common for low- and moderate-income working families to receive federal refunds of $2,000 or more. Research shows that many families view lump-sum tax refunds as "assets." Thus, there are compelling reasons to leverage tax refunds for asset building. This paper offers specific recommendations for linking tax refunds with programs and policies that promote saving and asset accumulation in low-income households.

Keywords: Tax refunds, federal tax credits, asset accumulation, savings

INTRODUCTION

Middle- and high-income households have long benefited from an array of tax exclusions, deductions, and credits that amount to large subsidies for asset accumulation (Howard, 1997; Sherraden, 1991). Lower tax rates on capital gains, deduction for home mortgage interest and contributions to Individual Retirement Accounts (IRAs), and exclusions for employer contributions to retirement plans are prominent examples of tax policies that promote asset accumulation for the non-poor.

Low-income households often receive little benefit from these policies, either because they have little or no income tax liability or because they do not meet the eligibility requirements. (Many do not own homes, for example, or do not have jobs with retirement benefits.) However, low-income households may receive sizeable income tax refunds as a result of two federal tax credits—the fully refundable Earned Income Tax Credit (EITC) and the partially refundable Child Tax Credit (CTC). When a credit is refundable, any portion of the credit that exceeds tax liability is transferred to the tax filer as an income tax refund.

CTC and EITC benefits are substantial. For the 2001 tax year, 26 million tax filers claimed $26.6 billion in child credits (U.S. Department of the Treasury, 2002a). For tax year 1999, federal EITC claims totaled over $31 million, almost double the amount allocated for the Temporary Assistance for Needy Families (TANF) program. Spread throughout the year, the maximum 2003 credit of $4,204 is equivalent to $81 a week.

Largely because of the CTC and EITC, income tax refunds for low-income families have increased substantially. A family that received a refund of a few hundred dollars in the mid-1980s might now receive a few thousand dollars. While many low-income families use refunds to finance routine expenses, refunds are also used in ways that promote longer-term economic well-being. For example, some families save a portion of refunds, some purchase cars, and some move to better housing (Beverly, Tescher, Romich, & Marzahl, 2002; Romich & Weisner, 2000; Smeeding, Phillips, & O'Connor, 2000). Because families often view refunds as assets rather than income, tax refunds may be leveraged to promote saving and asset accumulation in low-income households. This paper presents a rationale for using tax refunds to promote saving and asset accumulation and offers several specific program and policy options. We begin with background information on the EITC and CTC.

BACKGROUND

Many low-income households qualify for both the EITC and the CTC, but there are notable differences between the credits. Here, we discuss history, structure, participation, and compliance for each credit. We also note the effect of nonrefundable credits on EITC and CTC refunds.

The Federal Earned Income Tax Credit[1]

History

The EITC was created in 1975 to offset the burden of Social Security and Medicare payroll taxes for low-income working people with children.[2] At that time, the credit equaled 10 percent of earned income, and the maximum value was $400 ($1,367 in 2003 dollars). In 1978, the credit was made permanent, and an advance-payment option was created, allowing EITC-eligible individuals to receive a portion of their credits through their paychecks. Major expansions of the credit enacted in 1986, 1990, and 1993 increased benefits to low-income workers with children and created a small credit for childless low-income workers. The latest expansion, enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16, "Tax Relief Act"), increases benefits for married families with children and will be phased in between 2002 and 2008 (Greenstein, 2001).

Structure

The EITC is available to low-income tax filers (individuals or families) with earnings. It is intended primarily for parents of children under age 19, but low-income workers without children may receive a small credit. The amount of the credit initially rises with earnings, then reaches a plateau, and finally decreases with each additional dollar earned. Table 1 shows the full range of EITC benefits for tax year 2003. The average EITC benefit in 1998 was $1,500 for families with one child, and $2,300 for families with multiple children (Johnson, 2001).

Table 1. Federal Earned Income Tax Credit Parameters, Tax Year 2003

Family Size	Credit	Maximum Benefit	Phase-Out Rate	Phase-Out Range
With two or more children	40% of first $10,510	$4,204	21.06%	Married: $14,730–$34,692 Not Married: $13,730–$33,692
With one child	34% of first $7,490	$2,547	15.98%	Married: $14,730–$30,666 Not Married: $13,730–$29,666
With no children	7.65% of first $4,990	$382	7.65%	Married: $7,240–$12,230 Not Married: $6,240–$11,230

Source: Internal Revenue Service, 2002

[1] Several states have earned income credits (Johnson, 2001). When these credits are refundable and generous (e.g., 15-25 percent of the federal EITC), they may help families accumulate assets. In this paper, however, we focus on the federal credit.
[2] For more on the history of the EITC, see Hotz and Scholz (2001) and Liebman (1998).

Participation

About one out of every six families filing federal income tax returns claims the EITC (Johnson, 2001). In 2000, 86 percent of EITC filers earned less than $30,000 (U.S. House of Representatives Committee on Ways and Means, 2000). Research suggests that 80 to 86 percent of eligible workers received the EITC in 1990 (Scholz, 1994).[3] Illiteracy, language barriers, distrust of eligibility notices issued by employers or the Internal Revenue Service (IRS), and fear of filing taxes due to underpayment in the past or outstanding child support payments are factors that could prevent eligible individuals from claiming the EITC. Additionally, those who have no tax liability may not be aware that they can claim the credit (U.S. House of Representatives Committee on Ways and Means, 2000).

Using data from the 1999 National Survey of America's Families, Phillips (2001) estimated that almost two-thirds of low-income parents (those with incomes below 200 percent of the federal poverty line) knew about the EITC. However, very poor parents, welfare recipients, Food Stamp recipients, and low-income Hispanic parents were less likely than others to know about the credit.

Advance payment option: As noted above, workers with children may receive EITC benefits incrementally, through their paychecks. Currently, families may receive in advance up to 60 percent of the projected total credit for a family with one child ($1,528 in 2003). Advance payment appears to be an attractive option because it can help families smooth consumption and cope with mid-year budget shortfalls. However, almost 98 percent of EITC refunds are distributed as lump-sum payments (Hotz & Scholz, 2001).

Two small studies suggest that few workers know about the advance-payment option (Olson & Davis, 1994; Romich & Weisner, 2000). Even when researchers described the option, many participants in these studies expressed uncertainty. Some were afraid that they would end up owing money. Others liked receiving a lump sum and doubted that they could accumulate such large sums of money on their own.

Compliance

While the EITC has traditionally received bipartisan support, concerns about error and fraud have eroded support in recent years, especially among Republicans. The IRS estimated that between 27 and 32 percent of EITC claims filed for the 1999 tax year should not have been paid. Twenty-five percent of errors involved claiming an ineligible child, 21 percent were the result of income misreporting, and 17 percent involved the wrong person claiming the eligible child in families with complicated living arrangements (IRS, 2002).

The rules defining qualifying children can be difficult to understand and apply, especially in divorced and separated families (see Center on Budget and Policy Priorities, 1998; Hotz & Scholz, 2001). One study estimated that about half of EITC noncompliance originates in households without children and is primarily the result of erroneous claims by noncustodial parents (Liebman, 2000). Many tax experts agree that the EITC is one of the most complex provisions of federal income tax, and EITC error rates among those who self-prepare and those

[3] More recent research estimates that 75 percent of eligible households claimed the EITC in 1999, but the data used in this study have been questioned (see Burman & Kobes, 2002).

who use paid preparers are about the same (O'Connor, 2001). Since 1995, the IRS has implemented new measures to reduce the EITC error rate, and the Tax Relief Act of 2001 simplified eligibility criteria (Greenstein, 2001).

Despite these efforts, a 2002 study by the Office of Management and Budget concluded that audits of EITC claimants were ineffective, and the IRS proposed new measures to address EITC noncompliance in 2003. Under a new "precertification" requirement, EITC claimants who fall into a "high-error" category will be required to provide documentation to verify that they are eligible for the credit.[4] The high-error category includes single fathers, stepparents, foster parents, grandparents, aunts, uncles and other relatives raising EIC-qualifying children. Under a precertification pilot program, 25,000 tax filers who claimed the EITC on their 2002 federal returns will be required to precertify for the credit in 2004 (Goldwyn, 2003).

The Federal Child Tax Credit

History

The CTC was created in 1998 as a tax credit worth $400 per child. At that time, it was partially refundable to families with three or more children whose payroll taxes exceeded the value of their EITC. Under the Tax Relief Act, the credit became partially refundable for other families. The Tax Relief Act also legislated a gradual increase in the credit, to $1,000 by 2010. Under the Jobs and Growth Tax Relief Reconciliation Act of 2003, this increase was accelerated, making the credit worth $1,000 per child in 2003 and 2004. In July and August 2003, The Treasury Department mailed checks to most people who claimed the CTC for 2002, as an advance payment reflecting this increase.[5] If the accelerated increase is not extended beyond 2004, the credit will equal $700 in 2005 and gradually increase to $1,000 by 2010, then return to $500 beginning in 2011.

Structure

To be eligible for a CTC, a single or married person must have a Social Security Number or Individual Taxpayer Identification Number and must claim an exemption for at least one dependent child under age 17. The credit begins to phase out when modified adjusted gross income exceeds $55,000 for married individuals filing separately, $110,000 for married couples filing jointly, and $75,000 for other households. There is no limit on the number of qualifying children.

To be eligible for a refund, an individual must have taxable earned income above $10,500. The refundable portion equals the *lesser* of two amounts: (1) the amount of CTC remaining after

[4] To document relationships with children, claimants will have to submit marriage certificates. To prove that children lived with them for at least six months of the year, claimants will have to submit documents such as school or medical records listing both the filer's and the child's name and address and showing when these individuals lived together (Walsh, 2003).
[5] See Lee and Greenstein (2003) for discussion of families who did not benefit from the 2003 increase.

eliminating tax liability, or (2) ten percent of the family's earned income over $10,500.[6] In 2005, the latter is scheduled to increase to 15 percent (Lee & Greenstein, 2003).

To illustrate the parameters for 2003, consider a family with two qualifying children and $25,000 in earned income in 2003. This family owed $330 in federal income tax. After this tax liability is subtracted, the family has $1,670 of "potential" CTC remaining ($1,000 x 2 = $2,000; $2,000 - $330= $1,670). Ten percent of the family's earned income over $10,500 is $1,450. The refundable portion equals the lesser of these two values, so this family is eligible for a refund of $1,450. The family also qualifies for a federal EITC of $2,041, making their total refund $3,491. (Unpublished analysis by the Center on Budget and Policy Priorities, personal communication from John Wancheck, September 15, 2003).

Participation

For tax year 2001, about 26 million families received $26.6 billion in child credits, including $4.9 billion refunded to 8.5 million taxpayers (U.S. Department of the Treasury, 2002a). For the same year, the Treasury Inspector General for Tax Administration estimated that over 611,000 taxpayers failed to claim CTC credits totaling $238 million (U.S. Department of the Treasury, 2002c).

Compliance

Because the CTC is fairly new, there is little published information about compliance. For electronically prepared tax returns, the error rate is probably quite low because both the non-refundable and refundable portion of the credit are automatically calculated. For paper returns, erroneous claims may occur due to confusion over the age limits for eligibility. (Children under the age of 19 qualify for the EITC, but only children under the age of 17 qualify for the CTC.) Research shows that mistakes related to qualifying children are a common error for several tax credits and exemptions (IRS Taxpayer Advocate Service, 2001).

Effect of Nonrefundable Tax Credits on EITC and CTC Refunds

While the EITC and CTC are the only refundable credits for low-income taxpayers, refund amounts are influenced by a number of nonrefundable credits and deductions. For example, the Child and Dependent Care Credit (CDCC) is a large nonrefundable tax credit available to workers who pay for the care of a child, spouse, or other dependent adult. In 2002, qualifying families with one dependent child or adult were eligible for a maximum CDCC of $3,000, and those with more than one dependent child or adult were eligible for a maximum credit of $6,000 (Joint Committee on Taxation, 2001b). Beginning in 2002, low-income workers were also eligible for the new Saver's Tax Credit, worth up to 50 percent of a maximum $2,000 contribution to retirement plans or Individual Retirement Accounts (IRS, 2001). These and other nonrefundable tax benefits reduce a low-income filer's tax liability, resulting in higher EITC and CTC refunds.

[6] Families with three or more qualifying children receive special consideration because some would receive larger refunds under CTC rules in effect before 2001 than under current rules. These families are permitted to calculate refunds using both sets of rules and claim whichever amount is higher.

RATIONALE FOR USING TAX REFUNDS TO PROMOTE ASSET BUILDING

This section provides evidence to support the argument that tax refunds can and should be used to promote asset building in low-income families. The rationale is three-pronged: First, research shows that low-income families do save in well-designed asset-building programs. Second, many families already view lump-sum tax refunds as “assets” rather than “income.” Third, the tax system has become a major mechanism for redistribution of resources, and policies that transfer resources through the tax system are likely to receive more political support than direct expenditure policies.

Low-Income Families Save in Existing Asset-Building Programs

Leveraging tax refunds for asset building in low-income households makes sense only if low-income families can save and accumulate assets. Aggregate data show that most low-income households have low or negative saving rates and limited or negative net worth (e.g., Carney & Gale, 2001; Davern & Fisher, 2001). Low-income families clearly face resource constraints that make saving difficult. Still, data from numerous small studies demonstrate that many low-income individuals value saving and assets. And, many manage to save and hold assets at least for short periods of time, until events such as childbirth, job loss, or vehicle breakdown occur (e.g., Beverly et al., 2002; Caskey, 1997a; Edin, 2001; Finn, Zorita, & Coulton, 1994; Romich & Weisner, 2000; Smeeding et al., 2000).

Sherraden (1991; 1994; Beverly & Sherraden, 1999) has argued that low-income families would accumulate more wealth if they had access to well-designed asset-building programs. In fact, research suggests that low-income individuals can save and accumulate assets in Individual Development Accounts (IDAs). IDAs are special savings accounts designed to help low-income and low-wealth individuals build assets to reach life goals and achieve long-term security. Account-holders receive matching funds as they save for purposes such as buying a first home, attending job training, going to college, or financing a small business (Edwards & Rist, 2001).[7]

The most rigorous research on IDAs comes from the American Dream Demonstration (ADD), a multi-method evaluation of IDAs conducted at 13 IDA sites across the U.S. As of December 31, 2001, the 2,364 ADD participants had monthly deposits (net of unmatched withdrawals) averaging about $19. With a match rate of 2:1, the average participant accumulated assets at an annual rate of about $700 (Schreiner, Clancy, & Sherraden, 2002). In multivariate analysis, Schreiner et al. found that income was not strongly related to saving. These findings suggest that some low-income families will save and accumulate assets if given the right incentives and institutional supports.

Families View Refunds as Assets

Theory and research suggest that people view lump-sum refunds as assets rather than income. According to the behavioral life-cycle hypothesis (Shefrin & Thaler, 1992; Thaler, 1990), people

[7] The federal government has supported IDAs by establishing and administering a five-year demonstration of IDAs (under the Assets for Independence Act of 1998) and by allowing states to exclude IDA savings from eligibility calculations for public welfare benefits (under the Personal Responsibility and Work Opportunity Reconciliation Act of 1996). In addition, in 2000, there were over 40 state-level IDA programs and over 400 community-based programs in 49 states (Edwards, 2002).

tend to view "irregular" income differently than wage and salary income, especially when the irregular in-flows are large. This theory predicts that people who receive sizeable tax refunds will consider saving at least some portion of their refunds or using refunds to make "special" purchases, rather than financing routine expenses.

There is evidence that low-income families do indeed think about and use tax refunds differently than wage and salary income. Smeeding et al. (2000) found that 33 percent of a sample of 650 EITC recipients planned to save at least a portion of their tax refunds; 16 percent planned to purchase a car, repair a car, or make car payments; 13 percent planned to purchase furniture or household appliances; 10 percent planned to pay educational expenses; and 5 percent planned to use their refunds to purchase homes or move. Consumer Expenditure Survey data suggest that low-income families often use tax refunds to purchase consumer durables, such as furniture and vehicles (Barrow & McGranahan, 2000). Two smaller studies by Beverly et al. (2002) and Romich and Weisner (2000) also provide evidence that low-income families use tax refunds to purchase and repair cars, buy furniture, move, and save.

With these patterns in mind, some scholars have argued that people refuse the advanced EITC payment option because they want to be "forced" to accumulate lump-sums (Edin, 2001; Romich & Weisner, 2000; Smeeding et al., 2000). This, in turn, suggests that a variety of asset-building initiatives might be even more effective if linked to tax refunds.

Tax System is Major Mechanism for Redistribution

A final reason for linking tax refunds to asset-building programs is the recognition that the tax system has become a major mechanism for transferring resources to low-income families (Rogers & Weil, 2000). The trend toward redistributing resources through tax expenditures is likely to continue (Rogers & Weil, 2000; Sammartino, Toder, & Maag, 2002). Administrative expenses are usually much lower for tax credits than for programs such as TANF or Medicaid.[8] These efficiency advantages lead many policy-makers—particularly fiscal conservatives—to prefer refundable tax credits over other transfer programs. Tax credits are also compatible with a preference for limited government because they are viewed as incentives rather than mandates and because they allow politicians to take credit for reducing taxes (Howard, 1997). For all of these reasons, in the foreseeable future, the most promising mechanism for transfer programs will likely be the tax system, and asset-building programs that are not channeled through the tax system may not gain political support.

[8] The IRS spent $7.3 billion in 1998 to collect taxes from 122 million taxpayers and 5 million corporations. In the same year, the U.S. Department of Agriculture spent about $4 billion to administer $21 billion in Food Stamp benefits (Sammartino et al., 2002).

RECOMMENDATIONS FOR LINKING TAX REFUNDS TO ASSET-BUILDING INITIATIVES

For the reasons noted above, there is a strong case for linking tax refunds to asset-building initiatives. This section offers four key strategies and provides examples of program and policy options for each strategy.

Strategy #1: Reduce the Burden of Tax Preparation and Filing for Low-Income Families

Rationale

Before thinking about saving and investing tax refunds, low-income taxpayers must first claim the credits they have earned. Increases in the size and number of tax credits targeted at low-income families have made tax returns more complex, placing heavy burdens on low-income taxpayers and the IRS (Forman, 2001; Joint Committee on Taxation, 2001a). In a recent study funded by the American Tax Policy Institute, O'Connor (2001, p. 233) noted that successive amendments to the federal EITC have created "a thicket of rules, exceptions and exceptions to exceptions that directly affect the overall need for tax preparation assistance" (p. 233). Prior to 1990, the IRS calculated the EITC for filers, but last year filers were provided with 50 pages of instructions and six worksheets to calculate benefits. Confusion over multiple definitions of "qualifying child" and eligibility rules for the EITC ranked as the second and third "most serious problems encountered by taxpayers" in 2001 (IRS Taxpayer Advocate Service, 2001).

Given this complexity, it is not surprising that EITC filers rely heavily on commercial tax preparers. In tax year 1999, 68 percent of EITC filers used commercial preparers, compared to about half of all filers (IRS, 2002). Free tax preparation sites sponsored by the IRS and AARP file only about 2 percent of all EITC claims (O'Connor, 2001). While commercial tax preparers offer fast, convenient services, the cost is high. On average, national tax services such as H&R Block and Jackson Hewitt charge at least $100 for tax preparation and electronic filing, and an additional $75 to $100 for a refund anticipation loan (Berube, Kim, Forman, & Burns, 2002).[9] The proposed precertification requirement described above is expected to increase reliance on commercial tax preparers, and these companies are preparing to provide precertification services for a fee.

Options

1. Simplify tax provisions affecting low-income taxpayers

The Joint Committee on Taxation (2001a) recently completed a large study to identify recommendations for simplifying the federal tax system. One of the leading recommendations related to families with children was to adopt a uniform definition of "qualifying child" for the dependency exemption, EITC, CTC, CDCC, and head of household filing status. According to Berube et al. (2002), one goal should be to create simple, one-page worksheets that allow low-

[9] Refund anticipation loans (RALs, often marketed as "rapid refunds") provide loans in the amount of refund—minus large fees—within a couple days of filing. Commercial tax preparers typically charge $30 to $90, resulting in annual interest rates of 67 to 774 percent. In 2000, an estimated 4.3 million EITC recipients received their tax refunds through RALs (Wu, Fox, & Renuart, 2002)

income filers to calculate credits on their own. Others have proposed a single "super credit" to replace these overlapping and confusing credits (Glenn, 2000; Sawicky, 2002). At the time of this report, the Senate had passed legislation to create a uniform definition of qualifying child, but the House of Representatives had not (Joint Committee on Taxation, 2003).

2. Increase funding for free tax preparation services

The IRS promotes free tax preparation for low-income tax filers through two types of volunteer clinics: Volunteer Income Tax Assistance (VITA) clinics, sponsored primarily by local community organizations, and Tax Counseling for the Elderly (TCE) clinics, sponsored by AARP. The IRS provides both types of sites with volunteer training, free electronic-filing software, and bulk quantities of forms and publications. TCE sites, which number about 10,500 nationally, also receive about $3 million annually in grants from the IRS; VITA sites, which number almost 8,000 nationally, receive no IRS funding (O'Connor, 2001).

The productivity of VITA and TCE sites is greatly limited by inadequate funding. In particular, despite the IRS' push to receive 80 percent of returns electronically by 2007, few sites are equipped for electronic preparation and filing, due largely to lack of funds to procure computers capable of electronic filing. Electronic filing has several advantages for both tax preparers and taxpayers: 1) it reduces the amount of time required to prepare returns; 2) it reduces tax table and math errors; 3) it reduces the amount of paperwork taxpayers must submit to the IRS; and 4) it reduces the period of time between filing and receipt of refunds by seven to ten days. While the advantages are clear, electronic filing does place additional costs and burdens on VITA sites in terms of equipment, skills, and technical support. Thus, if these sites are to remain the primary source of free assistance for low-income filers, they must be funded at a much higher level. One recent study suggests that $100 million would be an appropriate level of support (O'Connor, 2001). Federal and state governments might share this cost. For example, the federal government could require states with income taxes to provide matching funds for taxpayer clinics.

3. Support the development and use of simple tax preparation software

To provide low-income taxpayers with affordable tax preparation and electronic filing on the scale that is needed, governments and private foundations could provide financial support and technical assistance to nonprofit organizations to develop, market, and use simple tax preparation software. Two examples of this type of initiative are the I Can! Earned Income Credit Project and the Quicken Tax Freedom Project.

The I Can! Earned Income Credit Project is sponsored by the Legal Services Corporation and the IRS. The Legal Aid Society of Orange County, California created a simple software program (available in Spanish and English) to help low-literacy, low-income workers claim federal EITC benefits. In 2003, the Society provided software, training, and technical support to at least 60 organizations assisting low-income filers (Legal Aid Society of Orange County, 2002).

The Quicken Tax Freedom Project is funded by the Intuit Financial Freedom Foundation. Lower-income households can use Quicken® TurboTax® to file federal and state tax forms at no charge. In 2003, the service was available to taxpayers who were eligible for the EITC or who had adjusted gross incomes of $27,000 or less. In 2001, over 1 million participants used the service

(Intuit Financial Freedom Foundation, 2002). While this is clearly a valuable resource for EITC filers, many lack Internet access or the technical skills required to make use of the free software. The tool is readily available to organizations interested in helping low-income families file tax returns, but examples of such initiatives are hard to find.

4. Establish partnerships with the commercial tax preparation industry

A fourth option to reduce the burden of tax preparation and filing for low-income families is for governments and nonprofit organizations to work more closely with the commercial tax preparation industry. In 2002, the Department of the Treasury announced an agreement between the IRS and a consortium of commercial tax preparers to provide free online tax preparation and filing services (IRS, n.d.) under a new IRS "Free File" initiative. During the 2003 tax season, eligible households could prepare and file federal returns free of charge, using commercial software accessed through the IRS web site. Eligibility requirements were set by participating companies and typically pertained to age, income, and eligibility to file Form 1040EZ. Sixteen companies participated in the Free File Alliance in 2003, but the outcomes of this collaboration are still unclear. One concern is that businesses may have used confidential taxpayer information to market financial products, including subprime mortgages (Consumer Federation of America, 2003). It will be important to evaluate whether this initiative increased the availability of free tax preparation and electronic filing services for low-income filers and other groups of taxpayers—while also protecting privacy and other consumer interests.

Strategy #2: Relax Asset Limits for Federal and State Benefit Programs

Rationale

Means-tested welfare programs typically provide benefits only to those with limited assets (see Table 2). Most programs exclude the value of a home, household goods, and a vehicle when computing assets. Under current law, EITC benefits are not counted toward asset limits for Food Stamp eligibility until 12 months after receipt, but they are counted toward eligibility for Medicaid, Supplemental Security Income (SSI), and federally-funded housing programs two months after receipt (Center on Budget and Policy Priorities, 2003b).

Table 2. Asset Limits for Means-Tested Welfare Programs, 2002

Program	Asset Limit
Food Stamps	$2,000
Supplemental Security Income	$2,000 for individuals $3,000 for couples
Federally-funded housing assistance	$5,000
Medicaid	Varies by state
TANF	Varies by state

Source: Corporation for Enterprise Development, 2002

While asset limits help ensure that assistance is targeted to those who lack other resources, they may also reduce saving by low-income families. For example, a family that receives over $2,000 in EITC benefits could be forced to spend some of this money within two months in order to remain eligible for Medicaid. Those with savings in addition to EITC benefits will be forced to spend a greater percentage of their EITC benefits. A recent review of related research (Orszag, 2001) identified three studies suggesting that asset limits reduce saving by low-income families and one study suggesting that asset limits have little or no effect.

Options

1. Raise and index asset limits and publicize these changes

The federal government has not substantially revised asset limits since the mid-1980s. While states currently have no authority to revise asset limits for SSI, they can liberalize asset limits for TANF, Medicaid and Food Stamp programs through amended plans and waivers (Corporation for Enterprise Development, 2002). Some states have not yet exercised these options.

Asset limits for federally-funded programs could be raised—perhaps to $5,000 —and indexed to inflation. In addition, states could liberalize asset limits to the full extent allowed by federal law. Finally, all changes to asset limits should be publicized broadly. At least one study suggests that many low-income individuals believe asset limits to be much more restrictive than they are (Marlowe, Godwin, & Maddux, 1996).

2. Exempt funds in restricted savings accounts from asset calculations

Federal law requires that assets in certain restricted savings accounts (e.g., IDAs funded under the Assets for Independence Act of 1998) be excluded from asset limits in federal means-tested programs (Corporation for Enterprise Development, 2002). Funds in all types of restricted savings accounts, including IRAs, 401(k)s, and educational savings accounts, could be excluded from asset calculations. Funds in restricted accounts are intended for asset-building and thus aim to promote self-sufficiency and longer-term economic well-being. Families—especially low-income families trying to build assets—should not be expected to deplete these accounts when short-term crises arise, especially because penalties are imposed for early withdrawal.

Strategy #3: Promote Saving Out of Tax Refunds

Rationale

As noted above, research suggests that many low-income families view refunds differently than wage and salary income and that a fair number plan to save or purchase assets with their refunds. Therefore, promoting saving out of tax refunds is a promising strategy. In addition, people are probably more interested in saving products or programs when they anticipate having money available (Beverly et al., 2002). Because low- and moderate-income taxpayers often receive substantial tax refunds, tax season is an opportune time to promote saving and participation in saving programs.

Options

1. Launch a national campaign to promote saving out of tax refunds

In March 2001, the American Savings Education Council (ASEC, n.d.) publicized a "Save It, Don't Spend It" message that included tips for making the most out of tax refunds. The Department of Treasury could partner with ASEC, the Consumer Federation of America, and other national groups to promote a similar message more broadly through extensive print and broadcast media. One model for this campaign might be the "Choose to Save" public education program created by the Employee Benefits Research Institute and ASEC (n.d.). This campaign includes public service announcements on radio and television, advertisements in printed media, and advertisements on public transit.

2. Fund free financial education programs and promote them at tax preparation clinics

Another way to promote saving out of tax refunds is to promote free financial counseling and education at tax preparation clinics. One of the largest VITA sites in the country, sponsored by Community Action Project in Tulsa, links interested EITC recipients to a series of classes for first-time home buyers (Smith, 2002). This initiative capitalizes on pre-existing and specific saving motives. Other financial education programs might aim to increase saving by teaching budgeting and debt-reduction techniques. When the organizations providing tax assistance do not have the capacity to provide financial education, they could partner with other organizations, such as Cooperative Extension branches, housing counseling agencies, consumer credit counseling services, credit unions, and local banks.

3. Allow individuals to open low-cost savings accounts with tax refunds

In 2001, 29 percent of families in the lowest income quintile did not have a bank account (Aizcorbe, Kennickell, & Moore, 2003). This statistic is troubling because the "unbanked" pay more for routine financial transactions such as check-cashing and bill-paying (Caskey, 1994; Consumer Federation of America, 1997; Doyle, Lopez, & Saidenberg, 1998) and have trouble building positive credit histories (Caskey, 1997a). When asked why they do not have accounts, unbanked individuals often name economic barriers, including opening-deposit requirements (Caskey, 1997b). The opening-deposit barrier can be overcome if unbanked individuals are encouraged to open low-cost savings accounts with their tax refunds.

One of the first programs to use this approach was the Extra Credit Savings Program (ECSP), a collaborative effort by ShoreBank and the Center for Economic Progress (CEP). Between January and April 2000, CEP offered free tax preparation and electronic filing at a ShoreBank branch on Chicago's South Side. Eligible individuals—those who met EITC income guidelines—were invited to open no-fee, no-minimum-balance savings accounts by arranging to have their 1999 federal tax refunds directly deposited. Funds in ECSP accounts earned market interest, and a no-fee ATM card was available (ShoreBank and the Center for Law and Human Services, 2001).

In the first year, 89 people (20 percent of those filing taxes at the ShoreBank site) opened ECSP accounts. In dollar terms, saving in ECSP accounts was short-term and fairly limited. However, there is some evidence that linking refunds with low-cost savings accounts is an effective outreach tool for the unbanked. Sixty percent of ECSP participants were unbanked at the time of enrollment, and for this group the most important account feature was the ability to use a tax refund as the opening deposit. Interviews showed that the ECSP offer tapped into pre-existing desires to have accounts and to save but that few unbanked participants were actively looking for accounts. Other evidence suggests that the program encouraged some unbanked individuals to develop *on-going* relationships with banks. For example, over half of unbanked participants used their accounts for something other than short-term storage of tax refunds, and 17 percent arranged to have paychecks directly deposited into their ECSP accounts in the first four months (Beverly et al., 2002).

4. Encourage contributions to restricted savings accounts

While ECSP-type accounts are likely to appeal to those who want traditional savings accounts, some low-income families may prefer more restricted accounts. Research suggests that many people (of all income levels) have trouble resisting temptations to spend savings (e.g. Beverly, Romich, & Tescher, in press; Kennickell, Starr-McCluer, & Sunden, 1997). Those who are saving for long-term goals might prefer a fairly illiquid savings vehicle.

Linking tax refunds with IDAs is one promising option. As mentioned above, IDAs aim to help families save for particular investments, and other withdrawals are discouraged (Edwards, 2002). Programs that link tax refunds to IRAs and 529 plans also have promise. These initiatives are likely to appeal to families who already plan to invest portions of their refunds in home repair or purchase, education, microenterprise, or retirement, but not all households planning these type of investments would be willing to commit refunds to a restricted account. At the same time, each of these restricted accounts provides a financial incentive (IDAs provide matching funds, and IRAs and 529 plans receive favorable tax treatment.) If these incentives were publicized and direct links were created between refunds and restricted accounts, some low- and moderate-income families would presumably choose to participate. Federal and state governments could probably increase saving for long-term goals if they provided additional matching funds when low-income filers used refunds to contribute to restricted accounts.

Both public and private organizations have recognized the asset-building potential of tax credits like the EITC. Through the nationwide Community Based Partnerships program, the IRS is partnering with community organizations to (1) conduct EITC outreach campaigns; (2) provide free tax preparation assistance; and (3) encourage participation in financial education and saving programs, including IDAs (Thomas, 2002). The National Tax Assistance for Working Families Campaign sponsored by the Annie E. Casey Foundation has related objectives (Skricki & Fernandez, 2002). These and similar initiatives could also encourage IRA or 529 plan contributions.

Strategy #4: Encourage Direct Deposit of Refunds

Rationale

The final strategy proposes a *mechanism* for promoting saving out of tax refunds: direct deposit. Direct deposit makes sense for at least three reasons. First, it helps people overcome the self-control problems mentioned above. Direct deposit of tax refunds allows tax filers to precommit to opening an account or contributing to a savings vehicle *before* they receive their refunds, when spending temptations are not as strong. Once funds have been deposited in savings accounts, they may be "protected", either because individuals view savings as "off-limits" or because there are withdrawal restrictions (Beverly, Moore, & Schreiner, 2003; Beverly et al., 2002).

Second, direct deposit greatly decreases the time between filing a return and receiving a refund. When an individual files electronically and arranges for direct deposit, she can receive her refund in as few as 10 to 14 days. If the combination of electronic filing and direct deposit were available widely and publicized broadly, the demand for costly refund anticipation loans would probably decline.

Finally, increasing the use of direct deposit would lower costs for financial institutions and the IRS. Financial institutions would save because direct deposit transactions are less expensive than transactions with tellers. The IRS would have substantially lower check-production and postage costs.[10]

Direct deposit is currently available to those who provide routing and account numbers on their tax forms. However, there are barriers to the widespread use of direct deposit. First, as noted above, many low-income families do not have bank accounts. Second, an individual may not want to commit her entire refund to a single account, especially if this account has withdrawal restrictions. The options described below would help overcome these barriers.

Options

1. Make Electronic Transfer Accounts available to all low-income tax filers

Electronic Transfer Accounts (ETAs) are low-cost accounts currently available only to those who receive federal welfare, wage, salary, and retirement payments. ETAs were created to increase the direct deposit of federal payments. These accounts have a maximum monthly fee of $3, a maximum overdraft fee of $10, and no minimum balance (except as required by state or federal law). Account-holders can make four free withdrawals and four free balance inquiries each month. There are no check-writing privileges (U.S. Department of the Treasury, n.d.). Participation by financial institutions is voluntary. The Treasury Department pays institutions a one-time set-up fee of $12.60 for each ETA account opened (U.S. Department of the Treasury, 2002b).

Over time, similar accounts could be offered to all tax filers with incomes below a certain threshold. Instead of making up-front deposits to open accounts, individuals could arrange for direct deposit of income tax refunds. Even if demand were initially small, it could increase steadily through the outreach efforts of EITC campaigns nationwide.

This initiative would be very similar to the Extra Credit Savings Program described above. Evidence from the ECSP suggests that this initiative would not substantially increase saving and asset accumulation in the short-term. However, by changing the way participants think about tax

[10] In fact, the desire to reduce costs was the initial impetus for the federal government's move toward electronic payment of benefits (Stegman, 1999).

refunds, spending, and financial institutions (Beverly et al., 2002), the initiative might increase saving and asset accumulation over time. In addition, ETA accounts (unlike ECSP accounts) restrict withdrawals. This restriction may help families save tax refunds for longer periods of time. It is also likely to reduce account-maintenance costs for financial institutions.

2. Allow direct deposit of refunds to multiple accounts

A second way to promote direct deposit of tax refunds is to allow taxpayers to electronically transfer refunds to multiple accounts. This option is sometimes referred to as "bifurcation."

To understand why bifurcation is important, imagine a low-income individual who is saving for college while trying to pay off $3,000 in credit card debt. Suppose she is expecting a federal income tax refund of $3,450. Currently, she can choose to receive a check for the entire amount or have the entire amount electronically transferred to a single account. What if she could instead direct $1,000 to her debt repayment plan, $1,450 to her restricted education savings account, and the remaining $1,000 to her checking account—all in a single action? Bifurcation would allow her to precommit funds to saving and debt repayment plans before the money is in-hand, when spending temptations are less strong. However, she would not have to transfer her entire refund to restricted accounts. Instead, a designated portion of her refund would be available to spend as she later chooses.

D2D Fund, Inc., has proposed a tax-refund bifurcation tool (Dailey, 2002). Based on a tax tool developed by Vanguard that allows investors to direct tax refunds to multiple investment accounts, D2D's proposed tool would enable EITC filers to precommit some portion of their tax refunds to savings vehicles, using the same automatic savings method available to higher-income taxpayers and investors. As noted above, many EITC recipients in the study by Smeeding et al. (2000) said they planned to spend portions and save portions of their refunds. Thus, a tool like the one proposed by D2D would probably increase the use of direct deposit.

SUMMARY AND CONCLUSIONS

Research cited above shows that families tend to view tax refunds, at least in part, as "assets" rather than "income." And, recent changes to the tax code have substantially increased income tax refunds for low-income families. These two factors give rise to promising opportunities to facilitate saving and asset accumulation by linking tax refunds to asset-building initiatives. This paper suggests four strategies to achieve this objective.

Implementing these strategies will require active intervention on the part of federal and state governments and, often, partnerships among public, nonprofit, and financial organizations. Although each strategy alone may increase saving and asset-holding, employing multiple strategies would almost certainly yield optimum outcomes. Thus, we encourage state and federal policy-makers to adopt an integrated approach to asset building, by implementing several of the program and policy options suggested here. A truly comprehensive approach would also include policies that increase income, thereby increasing ability to save.

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