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State IDA Policy Briefs

Promoting Asset Building through the Earned Income Tax Credit

This is the first in a series of policy briefs written and produced by the Center for Social Development (CSD) at Washington University in St. Louis and the Corporation for Enterprise Development (CFED). The purpose of these briefs is to provide information to state and federal policymakers, state governments, policy advocates, and state coalition leaders regarding how to creatively use state policies to support asset-building initiatives, such as Individual Development Accounts.

Each brief will be based on a longer research paper by either CSD or CFED and will provide readers with options for action and resources to consult for further information.

This series is made possible by generous support from the Ford, Charles Stewart Mott, and Annie E. Casey Foundations.

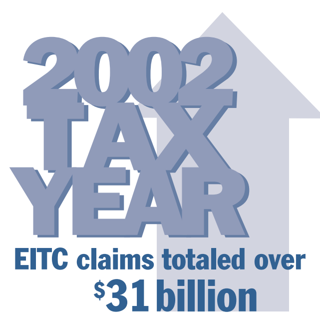
This first policy brief provides an overview of the Earned Income Tax Credit (EITC), a rationale for using the EITC and other tax refunds to promote asset building, and recommendations for more effectively linking tax refunds to state asset-building initiatives. This brief is based on the paper, *Using Tax Refunds to Promote Asset Building in Low-Income Households: Program and Policy Options*, written by Sondra Beverly and Colleen Dailey, published in 2003 by the CSD. The original paper examines how tax refunds can be used as a tool to promote savings and asset building in low-income households. The paper may be accessed through CSD's website at http://gwbweb.wustl.edu/csd/Publications/2003/PolicyReport-TaxRefund.pdf

Definitions

- **Individual Development Account:** A matched savings account designed for low-income individuals. Use is restricted to high-return investments, such as buying a home, starting a business, or paying for post-secondary education.
- **Earned Income Tax Credit:** Designed to supplement the after-tax earnings of low- and moderate-income working families.
- **"Refundable" Tax Credit:** Designed to refund to filers any portion of the credit that exceeds their tax liability.
- **Pre-Certification:** A proposed requirement to address the perception of error or fraud in the administration of the federal EITC. Would require all EITC claimants, except married taxpayers filing jointly and single mothers, to show, in advance, that they are eligible for the credit.

Introduction

In addition to raising revenue, the income tax system at the state and federal levels has long been used to meet important social policy goals, such as investing in home ownership, saving for retirement, and donating to charity. While certain tax-based policies tend to benefit only higher-income households, often helping these families build assets, tax-based subsidies are also available to low-income families. In fact, in the last decade, tax-based subsidies to reward employment have substantially increased refunds to low-income households. And while many families use these refunds to finance routine expenses, many view these lump-sum funds as assets and use them to promote longer-term economic well-being.



A handful of tax expenditures target low-income households, but the most widely used are the federal Earned Income Tax Credit (EITC), state EITCs (offered in 17 states and based on the federal credit), and the partially refundable Child Tax Credit.[1] The benefits low-income families gain from these tax-based subsidies, particularly the EITC, are substantial. In the 2002 tax year, federal EITC claims totaled over $31 billion. The Center on Budget and Policy Priorities estimates that 21 million families and individuals (or one in seven families) who file federal income tax returns claim the federal EITC—which raises roughly 4.8 million people, including 2.6 million children, above the poverty line.[2] Given this, a strong case exists for states to promote specific programs and policies that leverage the refunds available through the EITC for asset building among low-income families.

The Earned Income Tax Credit

History

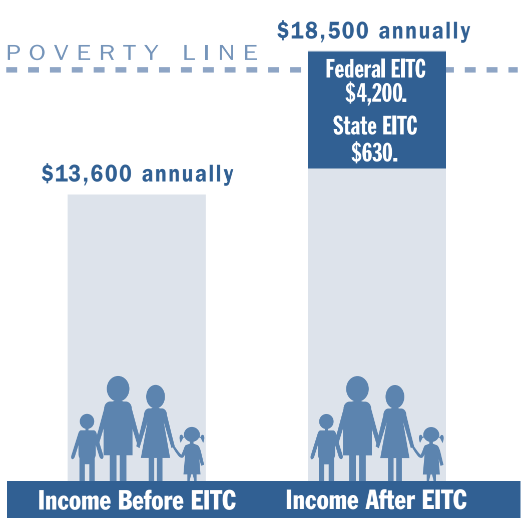
The EITC was created in 1975 to offset the burden of Social Security and Medicare payroll taxes for low-income workers with children. In 1978, the credit was made permanent and an advance-payment option was created, allowing EITC-eligible individuals to receive a portion of their credits through their paychecks. Major expansions of the credit were enacted in 1986, 1990, and 1993. 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 by 2008.[3] Several states also have legislated EITCs in recent years.[4]

The federal EITC is fully refundable, meaning tax filers receive any portion of the credit that exceeds their tax liability.

Structure

The EITC is intended primarily for parents with children under the age of 19, but a small credit is also available for low-income workers without children. The federal EITC is fully refundable, meaning tax filers receive any portion of the credit that exceeds their tax liability. For example, a family of four (including two children) with a full-time, year-round worker earning $7 per hour would earn about $13,600 per year, a figure that is several thousand dollars below the official poverty line. In 2003, that family would have qualified for a federal EITC of approximately $4,200 and if that family lived in a state with an EITC set at 15% of the federal credit, it would have received an additional state credit worth $630. Together, these tax refunds would total $4,830, increasing the family's total cash income to almost $18,500, slightly above the poverty line.[5]

The EITC Raises Families Above the Poverty Line



	State EITC	Refundable
Alabama	No	No
Alaska	No	No
Arizona	No	No
Arkansas	No	No
California	No	No
Colorado	Yes	Yes
Connecticut	No	No
Delaware	No	No
Florida	No	No
Georgia	No	No
Hawaii	No	No
Idaho	No	No
Illinois	Yes	No
Indiana	Yes	No
Iowa	Yes	No
Kansas	Yes	Yes
Kentucky	No	No
Louisiana	No	No
Maine	Yes	No
Maryland	Yes	Yes
Massachusetts	Yes	Yes
Michigan	No	No
Minnesota	Yes	Yes
Mississippi	No	No
Missouri	No	No
Montana	No	No
Nebraska	No	No
Nevada	No	No
New Hampshire	No	No
New Jersey	Yes	Yes
New Mexico	No	No
New York	Yes	Yes
North Carolina	No	No
North Dakota	No	No
Ohio	No	No
Oklahoma	Yes	Yes
Oregon	Yes	No
Pennsylvania	No	No
Rhode Island	Yes	Yes
South Carolina	No	No
South Dakota	No	No
Tennessee	No	No
Texas	No	No
Utah	No	No
Vermont	Yes	Yes
Virginia	No	No
Washington	No	No
West Virginia	No	No
Wisconsin	Yes	Yes
Wyoming	No	No

Source: Center on Budget and Policy Priorities

Participation

In 2002, 21 million U.S. families and individuals claimed the federal EITC.[6] However, a significant number of eligible families still do not claim the credit because of illiteracy, language barriers, and fear of filing taxes due to underpayment in the past or outstanding child support payments. Additionally, those who have no tax liability may not be aware that they can claim the credit.[7]

Compliance

The EITC has traditionally received bipartisan support but concerns about error and fraud have eroded that support in recent years. The Internal Revenue Service (IRS) estimated that in the 1999 tax year, 25% of errors resulted from tax filers claiming an ineligible child, 21% from income misreporting, and 17% from non-qualified filers claiming eligible children in families with complicated living arrangements.[8] In 1995, the IRS implemented new measures to reduce the EITC error rate and the Tax Relief Act of 2001 simplified eligibility criteria.[9] Despite these efforts, noncompliance still occurs.

A "pre-certification" requirement has been proposed to address compliance issues. All EITC claimants except married taxpayers filing jointly and single mothers will now be required to show, in advance, that they are eligible for the credit. It was previously estimated that almost four million of all EITC claimants would be required to pre-certify by 2004. However, new estimates predict that only 25,000 will need to pre-certify in 2004 under a pilot program.

Rationale for Using Tax Refunds to Promote Asset Building

Tax refunds can and should be used to promote asset building in low-income families. Three primary factors make the case for this strategy:

- Low-income families often save in existing asset-building programs.
- Families view refunds as assets.
- The tax system is a major mechanism for redistribution.

Low-income families often save in existing asset-building programs

Though some research shows that most low-income households have low or negative savings rates and limited or negative net worth,[10] data from numerous small studies reveal that many low-income individuals value saving and assets.[11]

Michael Sherraden, author of *Assets and the Poor: A New American Welfare Policy*, has argued that low-income families would accumulate more wealth if they had access to well-designed asset-building programs.[11] In addition, research found that low-income individuals can save and accumulate assets in Individual Development Accounts (IDAs)—matched savings accounts for purposes such as buying a first home, financing a small business, or going to college—and that income levels were not strongly related to saving.[13]

21 million
U.S. families and individuals claimed the federal EITC in 2002

Strong support currently exists for IDAs. The federal government is administering a five-year demonstration (under the Assets for Independence Act of 1998) and allowing states to exclude certain 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 more than 20 state-level and over 500 community-based IDA programs in 49 states.[14] These research findings and the success of IDA programs suggest that low-income families will save and accumulate assets given the right incentives and institutional supports.

Research found that 33% of 650 EITC recipients planned to save a portion of their tax refunds.

Families view refunds as assets

Theory and research suggest that people view lump-sum refunds as assets rather than income. According to one theory (the behavioral life cycle hypothesis) people tend to view "irregular" income (such as tax refunds) differently than regular wage income and people who receive sizeable tax refunds consider saving at least a portion of it rather than financing routine expenses. Research found that 33% of 650 EITC recipients planned to save a portion of their tax refunds. This suggests that a variety of asset-building initiatives might be more effective if linked to tax refunds.[15]

The tax system is a major mechanism for redistribution

The tax system has become a major mechanism for redistributing resources to low-income families and this trend is likely to continue in the future.[16] Administrative expenses are usually much lower for tax credits than for programs such as Temporary Assistance for Needy Families (TANF) or Medicaid. The IRS spent just $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.[17] Hence, many policymakers prefer refundable tax credits to other to more traditional spending programs, like TANF, for example. 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.[18] Therefore, in the foreseeable future, asset-building programs that are not channeled through the tax system may not gain significant political support.

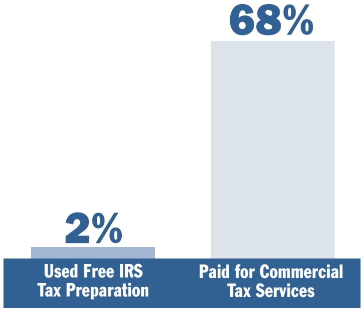
Recommendations for Linking Tax Refunds to State Asset-building Initiatives

With an economy still struggling to shake off the recent recession, many states continue to operate in a tight fiscal environment. However, providing state funds to expand the number of families that receive the EITC is a cost-effective strategy for bringing additional resources into local and regional economies. Moreover, using EITC refunds to support wealth creation is a promising strategy for leveraging greater support for emerging asset-building initiatives at the state level. States should consider the following strategies for linking tax refunds to their asset-building initiatives.

Reduce the burden of tax preparation and filing for low-income families

Increases in the size and number of tax credits (including the partially refundable federal Child Tax Credit) available to low-income families have made tax returns more complex, placing heavy burdens on low-income taxpayers and the IRS.[19] Many EITC tax filers, therefore, rely heavily on commercial tax preparers who offer convenient but expensive services. In tax year 1999, 68% of EITC filers used commercial preparers compared to about half of all filers.[20] Free tax preparation sites sponsored by the IRS and American Association of Retired Persons (AARP) file only 2% of all EITC claims.[21] In addition, the added complexity of the proposed pre-certification requirement will increase the demands on the limited supply of free tax preparation assistance and may increase reliance on commercial tax preparers who provide this service for a fee.

Low-Income Tax Filers Rely on Expensive Commercial Preparers



> *Providing state funds to expand the number of families that receive the EITC is a cost-effective strategy for bringing additional resources into local and regional economies.*

Options

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. However, the productivity of VITA and TCE sites is greatly limited by inadequate funding. Few sites are equipped with computers capable of electronic-filing, which would reduce errors and the amount of time needed to prepare returns. Thus, funding from both the federal government and states is required at a much higher level if these sites are to remain as primary sources of free assistance for low-income filers.

A number of local coalitions are linking free tax preparation and IDAs. The Annie E. Casey Foundation has launched a national campaign to increase the number of high-quality tax preparation sites that offer electronic preparation and filing. Currently more than 20 cities and rural areas are participating in the initiative. States could further assist these efforts by providing funding to increase networking and training opportunities for these sites. (See www.eitc.info for information.)

This brief is based on the paper, *Using Tax Refunds to Promote Asset Building in Low-Income Households: Program and Policy Options,* which may be accessed through CSD's website at http://gwbweb.wustl.edu/csd/Publications/2003/PolicyReport-TaxRefund.pdf

Support development and use of simple tax preparation software: State governments and private foundations could provide financial support and technical assistance to develop, market, and train service providers to use simple tax preparation software that would provide affordable tax preparation to low-income tax payers on the scale required. An example of this type of initiative is the I Can! Earned Income Credit Project sponsored by the Legal Services Corporation and the IRS for taxpayers with low literacy levels. Alternatively, states and foundations could provide funding to encourage nonprofits to provide technical assistance and training on the use of more sophisticated products, like Intuit's Tax Freedom Project, which makes Turbo Tax for the Web (federal and state) available for free to all those who qualify for the EITC or have an adjusted gross income of $27,000 or less. (See www.taxfreedom.com for more information.)

Promote saving out of tax refunds

As noted, research suggests that many low-income families view refunds as a way to promote long-term well-being and that a fair number plan to save or purchase assets with their refunds. Because low-income taxpayers often receive substantial refunds, tax season is an opportune time to promote participation in saving programs.

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Options

Link with national campaigns to promote saving out of tax refunds and consider establishing statewide campaigns: In March 2001, the American Savings Education Council (ASEC) publicized a "Save It, Don't Spend It" message that included tips for making the most out of tax refunds.[22] The Department of Treasury could partner with ASEC, the Consumer Federation of America (CFA), and other national groups to promote a similar message more broadly through extensive print and broadcast media. One particularly successful social marketing campaign to promote saving is CFA's "America Saves" model, which has been successfully implemented in cities such as Cleveland and Charlotte. Statewide America Saves campaigns also are being planned in Georgia, Florida, Illinois, Kentucky, New York, and Tennessee.

Provide state funds to promote free financial education programs 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. If the organizations that sponsor these clinics do not have the capacity to provide financial education, they could partner with other institutions, such as Cooperative Extension branches of state universities, credit unions, and local banks.

Encourage individuals to open low-cost savings accounts with tax refunds: In 2001, 29% of families in the lowest income quintile did not have a bank account.[23] When asked why they do not have accounts, unbanked individuals often name economic barriers, including requirements related to opening deposits.[24] These individuals are likely to overcome this barrier if they 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, a collaborative effort by ShoreBank and the Center for Economic Progress.[25] More recently, PNC Bank partnered with the Nehemiah Gateway Community Development Corporation to make free savings accounts available to EITC filers across Delaware in 2003.

Encourage contributions to restricted savings accounts: Accounts similar to those in the Extra Credit Savings Program are likely to appeal to individuals who want traditional savings accounts. However, some low-income families may prefer more restricted savings accounts for long-term goals. One option for these families is to link their tax refunds to accounts such as IDAs, Individual Retirement Accounts, and state college savings 529 plans. Federal and state governments could increase saving levels for long-term goals by providing additional matching funds when low-income filers use refunds to contribute to restricted accounts.

Encourage direct deposit of refunds

Direct deposits of federal tax refunds allow tax filers to pre-commit to a savings vehicle before they receive their refunds. Direct deposits also allow individuals to receive refunds in as few as 10 to 14 days, greatly reducing the time between filing a return and receiving the refund. Finally, direct deposits would lower costs for financial institutions and the IRS. While this is a promising strategy, barriers exist to direct deposit. For example, many low-income families do not have bank accounts and many do not want to commit their entire tax refund to a single account, especially if the account has withdrawal restrictions.

Options

Make Electronic Transfer Accounts (ETAs) available to all low-income tax filers: Currently available only to those who receive federal welfare, wage, salary, and retirement payments, ETAs are low-cost accounts created to increase the direct deposit of federal payments. Over time, similar accounts could be offered to all tax filers with incomes below a certain threshold. Instead of having to deposit money up-front to open accounts, individuals could arrange for direct deposit of their income tax refunds. This initiative would be very similar to the Extra Credit Savings Program, which provides evidence that the way participants think about tax refunds, spending, and financial institutions might change.[26] Evidence also suggests that saving and asset accumulation may increase over time.

Allow direct deposit of state income tax refunds (including EITC) in multiple accounts: Another 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" and would give individuals the freedom to spend and/or save their refunds as they choose.

Conclusion

Recent changes to the tax code have substantially increased tax refunds for low-income families. Research shows that families tend to view tax refunds, at least in part, as assets rather than income. These two factors give rise to promising opportunities to facilitate higher rates of saving and asset accumulation by low-income individuals and families through linking tax refunds to asset-building initiatives.

Implementing the strategies discussed in this brief will require active intervention on the part of state and federal governments and, often, partnerships among public, nonprofit, and financial organizations. Although each strategy alone may increase saving and asset holding, employing multiple strategies would likely yield optimum outcomes.

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The Corporation for Enterprise Development is a nonprofit organization that creates economic opportunity by helping the poor save and invest, succeed as entrepreneurs, and participate as contributors to and beneficiaries of the economy. By helping individuals and communities harness latent potential, the Corporation for Enterprise Development builds long-term models to help people move from poverty to prosperity while strengthening the overall economy. The Corporation for Enterprise Development identifies and researches promising ideas, collaborates with the private and public sectors to test them, and helps drive the application and adoption of proven concepts.

Established in 1979, the Corporation for Enterprise Development works nationally and internationally through its offices in Washington, DC, Durham, North Carolina and San Francisco, California.

The Center for Social Development (CSD) is a research and policy center that promotes innovation and study of social development, including: building assets of individuals, families, and communities; investing in people and increasing labor force participation and productivity; enhancing social skills and family stability; promoting strong communities, active citizenship, mutuality, and interracial harmony; and creating responsive and effective community organizations.

Established in 1994, CSD is part of the George Warren Brown School of Social Work at Washington University in St. Louis, MO.