Regional and Community Affairs
REPORT

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The Earned Income Tax Credit Program:

Using the EITC as a Tool for Promoting Saving and Participation in the Banking System

The federal Earned Income Tax Credit (EITC) program is designed to help families out of poverty by reducing taxes for low- to moderate-income workers[1]. In New York City, where the proportion of families in poverty is higher, at 16.6 percent, than the national share of 9.8 percent, the EITC program is an especially important weapon in the fight against poverty.[2] Indeed, the refundable credits provided under the program can increase annual household income by as much as $4,204.[3]

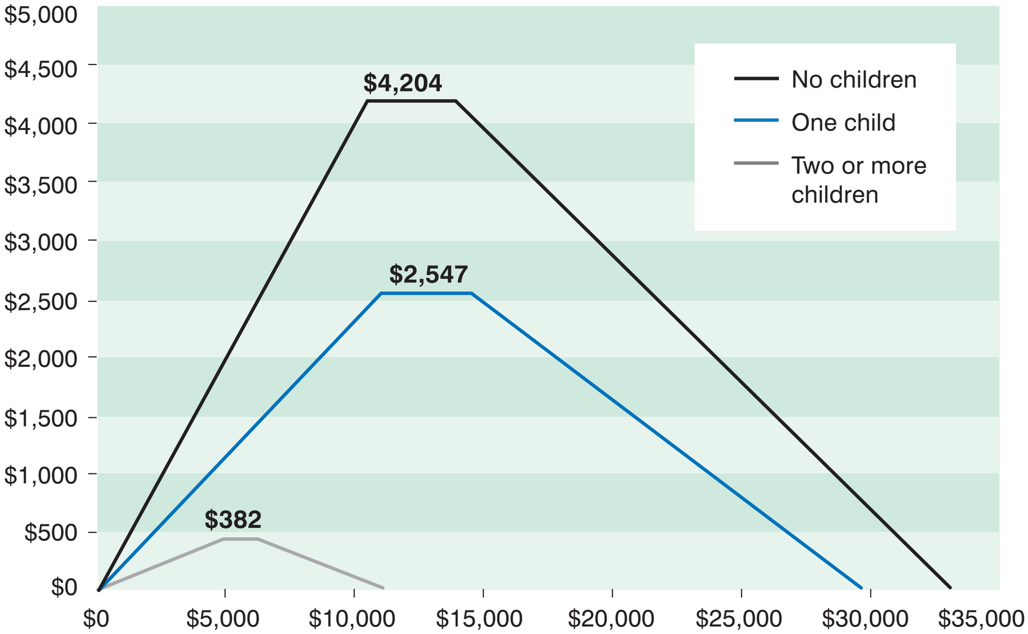
To investigate how the EITC program, in combination with other forms of assistance, might influence the spending and saving decisions of low-income workers, Sherrie Rhine, Sabrina Su, and Yazmin Osaki of the Office of Regional and Community Affairs of the Federal Reserve Bank of New York (ORCA) joined with the N.Y.C. nonprofit organization FoodChange to collect and analyze information from more than 18,000 EITC-eligible clients of FoodChange's Volunteer Income Tax Assistance (VITA) program. In addition to providing free tax preparation services to lower-income New Yorkers, FoodChange partners with financial institutions that offer savings accounts to taxpayers at these VITA sites[4]. The study shows that offering savings accounts at VITA sites can facilitate participation in the financial mainstream and promote saving among the lower-income families receiving tax credits under the EITC program. The following is a brief summary of the study and its findings. To view it in its entirety, please visit our website at www.newyorkfed.org/regional/commdev.html.

The EITC Program

The federal EITC became available to lower-income workers in 1975 to help offset the increasing burden of social security taxes.[5] Since that time, this tax program has become a central part of federal and state efforts to combat poverty while promoting workforce participation. For example, in New York State, the annual wage and salary income after payroll taxes for a single parent who has two children and earns $6.50 per hour is $12,485. Receipt of state and federal EITC raises this family's annual income to $17,764. With the current poverty threshold for a family of this size set at $15,219, it is clear that the EITC program helps lift many lower-income working families out of poverty.[6]

This tax credit generally increases with rising earned income, then levels off and declines to zero when earned income reaches a certain threshold. As Figure 1 shows, the amount of the tax credit depends on the number of children and family income. For the 2003 tax year, the maximum federal EITC was $382 for a family with no children, $2,547 for a family with one child, and $4,204 for a family with two or more children. Income requirements for the program also vary with the number of children: In 2003, earned income and adjusted gross income had to be less than $29,666 for a single taxpayer with one qualifying child ($30,666 if married and filing jointly), $33,692 for a single taxpayer with more than one qualifying child ($34,692 if married and filing jointly), and $11,230 for a single taxpayer with no qualifying children ($12,230 if married and filing jointly)[7].

Figure 1: Structure of the Earned Income Tax Credit in Tax Year 2003, Head of Household Filers*



Source: Internal Revenue Service
*Married couples filing jointly are eligible for slightly higher credit amounts in the "phase-out" range of the Earned Income Tax Credit.

Benefits of Offering Savings Accounts at Tax Preparation Sites

VITA programs were created by the Internal Revenue Service in partnership with local community nonprofit organizations to provide free tax preparation services—including EITC filing—for lower-income individuals. By participating at VITA sites, lower-income taxpayers are able to avoid tax-preparation fees and rapid refund fees charged by commercial tax preparers[8]. According to the State of New York's Office of Temporary and Disability Assistance, EITC-eligible taxpayers save between $130 and $230 by having their federal and state taxes prepared at a VITA site.

Increasingly, financial institutions are participating at VITA sites in various ways. Some offer their branch services as VITA sites, while others provide staff as volunteer tax preparers. A number of financial institutions offer savings accounts at these sites to help unbanked taxpayers (that is, taxpayers with no deposit accounts) gain access to electronic filing. Some financial institutions offer a combination of these services in their communities.

Having the opportunity to open a savings account at VITA sites or elsewhere has numerous advantages for lower-income taxpayers, especially unbanked families. Unbanked families that open a savings account can take advantage of electronic deposit and receive their refund more quickly. Relative to holding cash, putting the refund into a savings account provides consumers with FDIC insurance protection and can result in added accumulations from interest earned on these funds. Moreover, opening a savings account at a VITA site provides unbanked families with an entry point into the financial mainstream that may give them greater access to additional financial services. Finally, keeping at least a portion of the refund in a savings account helps families begin to build a cushion against unforeseen events or extraordinary expenses.

Asset-Building Challenges for EITC Recipients

Given the potential for large lump-sum refunds relative to income, EITC recipients who are financially able to look beyond basic consumption needs have an opportunity to use these funds to build their assets. However, encouraging EITC recipients to participate in programs that foster asset building may be challenging for numerous reasons. First, the *ability* of lower-income families to set aside income for asset-building purposes is unclear even when a family may *desire* to save. Second, given the structure of the EITC program, the relationship between the size of the refund and the decision to open a savings account is not clear. Families that receive the largest EITC refunds may be among those with the lowest earned incomes or largest number of children to support (for example, young families or single female heads of households with children), whereas those with the lowest EITC refunds are most likely to be at the upper edges of the lower-income threshold or to be childless. Programs that offer unbanked EITC-eligible families the opportunity to open a savings account at a VITA site may be an unbanked family's entry to the financial mainstream, an important element of the asset-building process.

Another potential complication in fostering asset building among EITC recipients relates to how EITC-sourced dollars are viewed for certain means-tested benefits programs (for example, medicaid or food stamps). In most cases, these benefits are not immediately affected. However, retaining EITC-sourced funds over time in the form of assets may jeopardize eligibility for some of these programs. Moreover, eligibility guidelines vary greatly by program and may change over time. Thus, even for those recipients who are not likely to exceed a program's resource limits, the perceived complexity and variability of these kinds of eligibility criteria may serve as a deterrent to holding assets in a deposit account[9].

Findings from the ORCA Study

ORCA conducted a study to gain a more complete picture of how the EITC program influences consumer expenditure and saving decisions[10]. Our study shows that 40 percent of the 18,498 EITC-eligible taxpayers analyzed in New York City were unbanked before the 2003 tax preparation. Statistically significant differences in many of the socioeconomic and demographic characteristics were found between the unbanked and the banked taxpayers. For example, the majority of the unbanked householders had twelve years or less of education, were of working age, had two or fewer dependents, and participated in the food stamp program. Conversely, a higher proportion of banked respondents had at least some college, earned higher income, or received a greater tax refund. Additionally, a greater proportion of banked taxpayers had their previous year's taxes prepared by FoodChange.

The research focuses on the total refund received, including EITC dollars, because of the expectation that taxpayers base their expenditure and saving decisions on *all* dollars refunded to them. For unbanked taxpayers, the average total refund was $1,105. The EITC was the source for two-thirds of this average total refund. Similarly, the average total refund for banked taxpayers was $1,785, with the larger share (55 percent) attributed to the EITC. As for income, the average for unbanked households was $8,718—38 percent lower than the average income for banked families ($14,151).

EITC Refunds Largely Used for Current Needs

Ninety percent of the total sample received a positive net refund for the 2003 tax year. The majority of which was expected to be used to repay debt or to meet immediate needs (Table 1). Paying debt was the most frequent response (25 percent of taxpayers) for both unbanked and banked taxpayers.

Slightly more than 9 percent of the unbanked and 11.7 percent of the banked taxpayers said they would save the greater part of their refund. Of those with the intention to save, 94 percent received a positive refund. Fifteen percent of the unbanked and 3 percent of the banked respondents who had both a positive refund and an intention to save opened a savings account at the tax site (Figure 2).

Evidence of Program Effectiveness

Our study identified numerous socioeconomic and demographic characteristics that significantly contributed to the likelihood that taxpayers were unbanked before coming to the tax preparation sites. We found that those who had lower levels of education, participated in the food stamp program, were in the earlier stage of their work life (between the ages of eighteen and forty-five), or who were black, Hispanic, or in the "other" racial group were most likely to be unbanked[11]. Conversely, taxpayers who had higher family income, a greater number of dependents, had their previous year's taxes prepared at one of FoodChange's VITA sites, or were Asian were least likely to be unbanked before having their 2003 taxes prepared.

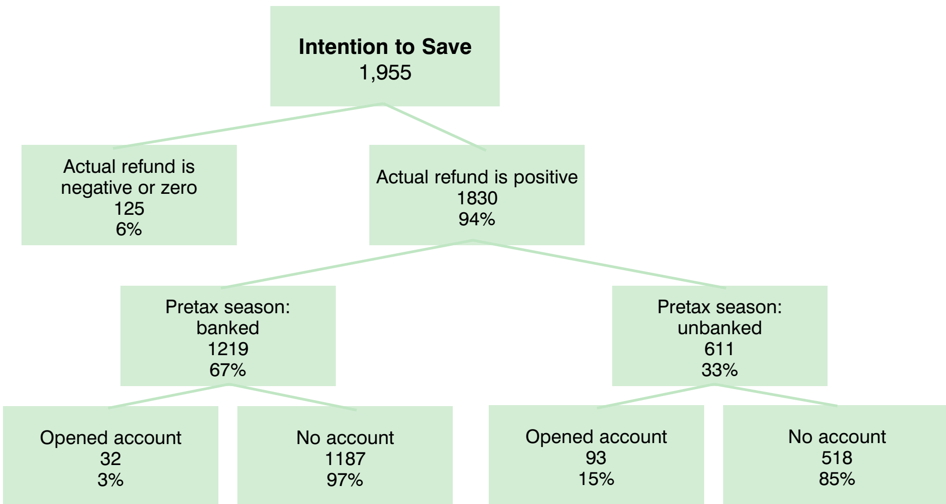
Almost 9 percent of the unbanked taxpayers opened a savings account at the tax preparation sites. Interestingly, 3.6 percent of the banked taxpayers also took this opportunity to open a savings account. The results of the study suggest that opening a savings account at the VITA site was most likely for unbanked taxpayers who received larger refunds, were in the earlier stage of their work life, were in the "other" racial category, or had their previous year's taxes prepared at a VITA site. In summary, *our findings offer evidence in support of programs aimed at facilitating mainstream financial participation and saving.*

Table 1: Expected Use of Refund by Bank Status of the Taxpayer

Variable	Unbanked	Banked	Total Sample
Debt	.247	.250	.249
Other	.239	.229	.233
Bills	.185	.210	.200
Rent	.164	.127	.142
Savings	.091	.117	.107
Family	.057	.046	.050
Home	.017	.022	.020
Sample size	**7,267**	**11,062**	**18,329**

Note: The sample excludes taxpayers that did not answer the question.

Figure 2. The Savings Account Descriptions of EITC Taxpayers Who Intended to Save Their Refund



Note: Taxpayers with an intention to save the greater part of their refund represented 10.7 percent of the total sample (1,955 of 18,329).

Future Study

This study contributes to the growing body of literature about programs that encourage participation in the financial mainstream. However, a question that cannot be answered from the 2003 study is whether the savings accounts opened by the VITA clients will be maintained over time, making it possible for mainstream participation and asset building to continue. Additional research is under way by ORCA to determine whether the accounts opened with a tax refund are a sustainable way for lower-income working families to participate in the financial mainstream, build assets, and accumulate wealth. To gain a more comprehensive understanding of the saving behavior of this population, this study which uses 2004 data will also further explore alternative ways that lower-income families may choose to save.

The scope of the new study will be expanded in several ways. First, it will include a follow-up survey of EITC-eligible taxpayers to determine whether savings accounts opened at tax preparation sites are still held by the taxpayer. This will allow us to learn more about the longer-term sustainability of accounts opened with tax refunds. Second, survey data will be collected from EITC-eligible taxpayers in the New York City area who did not participate at the FoodChange VITA sites. This additional survey data will be used to create benchmarks for comparison to the findings from taxpayer data collected at the FoodChange VITA sites. Finally, the data-gathering process at the 2004 VITA sites was streamlined to provide greater efficiencies in preparing tax returns; collecting baseline socioeconomic, demographic, tax filing, and bank status information; and opening of savings accounts. ■

[1] See Nicholas Johnson, Joseph Llobrera, and Bob Zahradnik, "A HAND UP: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2003," Center on Budget and Policy Priorities, March 2003, http://www.cbpp.org.

[2] Poverty rates are obtained from U.S. Census Bureau, 2003 American Community Survey.

[3] For the 2003 tax year, the maximum EITC refund was $382 for a family with no children, $2,547 for a family with one child, and $4,204 for a family with two or more children. See Figure 1.

[4] FoodChange was formerly known as the Community Food Resource Center.

[5] This tax legislation underwent expansions in 1986, 1990, 1993, and 2001.

[6] This example is taken from a presentation, "New York State EITC/VITA Project," given by Robert Doar, Commissioner of the Office of Temporary and Disability Assistance, State of New York, in 2004. The poverty level definitions are according to the U.S. Census Bureau. The 2004 poverty threshold for a family of two adults and a child is $15,205, and $15,219 for a family with one adult and two children.

[7] For detailed information concerning EITC eligibility for the 2003 tax year, see "IRS Outlines EITC Eligibility for 2003 Tax Year," Internal Revenue Service IRS.gov, Department of the Treasury, <http://www.irs.gov/newsroom/article/0,,id=119793,00.html>, 2002.

[8] See Anne Kim and Alan Berube, "Keep Working Families' Refunds in their Pockets," Atlanta Journal-Constitution, January 31, 2003.

[9] For information concerning eligibility for means-tested benefits for residents of New York City, see http://www.wceca.org.

[10] The full study, "Householders Response to the Earned Income Tax Credit: Path of Sustenance or Road to Asset Building," can be obtained at http://www.newyorkfed.org/regional/commdev.html.

[11] The "other" race category includes those who identified themselves as Native Americans and those who identified themselves as "other."

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