Inclusion in Asset Building: Research and Policy Symposium

The EITC and USAs/IDAs: Maybe a Marriage Made in Heaven?

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2000

Working Paper 00-18

Center for Social Development

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September 2000

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This paper was commissioned for the *Inclusion in Asset Building: Research and Policy Symposium*, Center for Social Development, Washington University in St. Louis, September 21-23, 2000.

The symposium was sponsored by the Ford Foundation and the George Warren Brown School of Social Work at Washington University. The organizers and editors were Michael Sherraden and Lisa Morris.

The author would like to thank Steve Ferazzi, Bob Haveman, and Ann Winkler for comments on this paper, Kati Foley, Esther Gray, Martha Bonney, and Ann Wicks for their help in assembling the paper; Katherin Ross Phillips and Michael O'Connor for their contribution to the Chicago Study of the EITC, and finally, the Center for Social Development and the MacArthur Network on the Family and the Economy for their support. Earlier versions of this paper was presented at the Center for Social Development Symposium on Asset Building Policy on September 2000, and at the Annual Conference of the Association for Public Policy Analysis and Management (APPAM) in Seattle on November 2000. The author alone is responsible for all errors of comission and omission.

I. Introduction: The Case for Asset-Based Transfer Policy

> "The poor are just like the rest of us, except they don't have as much money." Harold Watts, 1971 (and others)

The motives that underlie the desire to save and accumulate assets are not very well understood. Economic theories about saving (e.g., the "life cycle hypothesis") are not well borne out by empirical evidence. Rates of saving differ substantially across nations with similar levels of economic development (e.g., high in Japan and Germany compared to the United States), suggesting that cultural as well as economic factors determine savings. Finally, one influential economist argues that the United States is a nation driven by "luxury fever," which pushes our consumption desires beyond our savings capacity (Frank 1999). In fact, the evidence is that both net worth *and* consumer/household debt have grown in America over the past two decades (Wolff 2000).

It should perhaps come as no surprise that public policy toward the poor has changed from one of penalizing asset accumulation and saving (via liquid asset tests for "means"-tested programs targeted at the poor) to one of encouraging asset building. There is recent qualitative and quantitative evidence that the poor do indeed desire to accumulate assets and to save for specific purposes (Edin 1998; Romich and Weisner 1999; Sherraden 1991; Smeeding, Ross, O'Connor, and Simon 1999; Smeeding, Ross Phillips, and O'Connor 2000; Beverly, Tescher, and Marzahl 2000).

However, desire and action are often two different realities (Thaler 1990; Shefrin and Thaler 1992). Motives, goals, and aspirations of savers, particularly low-income savers, may differ from those of policymakers and policy analysts. Hence, the congruence and interactions of two or more sets of policy instruments may be difficult to predict *ex ante*. It is with these hesitations in mind that we begin.

This paper is about the possibility of linking the savings desires of the low-income population to two or more policy instruments: first, generous federal and state income tax provisions aimed at low-income families—The Earned Income Tax Credit (EITC); and second, a set of proposed policy instruments that subsidize savings behavior for low-income households through the tax code and other mechanisms, which we call Universal Savings Accounts-Individual Development Accounts (USA/IDAs). The EITC offers low-income families a clear-cut opportunity to accumulate assets and to build positive net worth. The USA-IDA legislation hopes to build on this motivation and to assist financially and logistically to meet these goals. We call this interaction "asset-based transfer policy."

Our study reviews some recent evidence on desired savings among EITC beneficiaries as well as some of the difficulties of designing an effective asset-building policy for this population. We first review the EITC and the evidence on savings desires among a sample of more than 800 recipients surveyed in Chicago in 1998. Then we delve into the possible rationales for savings and some of the new policies for promoting asset accumulation among the poor. This leads us to some suggestions for making a more complete assessment of the design, feasibility, and

effectiveness of an asset-based transfer policy for low-income families and its interaction with the EITC.

II. The EITC and Asset Accumulation

The largest United States cash income support program for low-income families is the Earned Income Tax Credit (EITC). In 1998, the EITC was expected to cost the federal government $30.5 billion according to the Council of Economic Advisers (1998).[1] More than 19.7 million taxpaying units benefited from the EITC in 1998; roughly 80 percent of total benefits were returned to claimants in the form of an IRS tax refund check. Though state EITCs were not studied because Illinois (the sample site) did not have a state EITC program in 1998, at least 11 states currently have their own Earned Income Credit program (Johnson and Lazere 1999). These state-level tax instruments supplement the federal EITC, adding to both the impact and the total outlays for the EITC (Greenstein and Shapiro 1998).

Despite its enormity, very little is known about the impact of the EITC on the families who receive it. Unlike other income-transfer programs, the EITC is received by almost all families (99 percent of recipients) as an annual, lump-sum, tax refund check paid sometime in the spring of the year *after* earnings are received. Moreover, the EITC is administered by the Internal Revenue Service (IRS) via the personal income tax system, thus permitting eligible clients to self-select for benefits without a formal review and certification of eligibility (Liebman 1998a). For these reasons, the EITC is likely to have very different effects from a benefit received monthly over the year in which the qualifying income is earned, or a benefit administered by the social welfare programs. As a result, the EITC offers an opportunity to observe behavioral response to a lump-sum transfer and its disposition for purchases and, particularly, for savings.

EITC Background

The EITC was enacted in 1975 to provide refundable tax credits to low-income workers, and originally to refund some fraction of their Social Security taxes (Eissa and Hoynes 1999). It was significantly expanded in the Tax Reform Act (TRA) of 1986 and the Omnibus Budget Reconciliation Acts (OBRA) of 1990 and 1993. By 1999 a maximum federal refundable tax credit of $3,816 was available to low-income households with two children and earned income between $9,540 and $12,460.[2] Participation rates in the EITC were estimated to be about 85 percent in 1990 (Scholz 1990, 1994), but may have increased since then as the maximum benefit and income ceiling have increased and eligibility standards have been broadened.[3] The most significant changes in the EITC over the past decade have taken place in benefit generosity to families with two children. The 1993 OBRA expanded the maximum credit for families with two children from $1,511 in 1993 to $3,816 in 1999, and higher in subsequent years. The result is a 40 percent earnings subsidy for low-earnings families in 1999 compared to a 19.5 percent subsidy in 1993. The EITC now helps families with two children and incomes of up to $30,585 compared to $23,050 in 1993. Because of this growth, the EITC benefits a wide range of families, from those who might be cycling on and off welfare (TANF) to those with near median incomes. Faced with this broad range of beneficiaries, we would expect to find different types of effects for different types of recipients. In fact, these differences may be quite important for

asset-building policies, as different subgroups of EITC recipients may have very different reasons for saving.

Among lower income families, EITC is not counted as TANF income in most states (Meyer and Rosenbaum 1998), nor is it counted toward Food Stamps or Medicaid eligibility in the month that it is received.[4] The EITC therefore offers a powerful work incentive for low-income earners with children, e.g., the TANF population. And low-income earners in Milwaukee, Wisconsin, involved in the New Hope Experiment seem to understand the relationship between work and the size of the tax refund as being linear, i.e., "more work, more money" (Romich and Weisner 1999). One recent econometric study (Meyer and Rosenbaum 1998) concludes that the EITC has been the foremost driving force in explaining increased hours worked by former welfare mothers over the 1993-1996 period. While other TANF changes—the enhancement of earnings disregards, sanctions and limits on benefit receipt—and a strong growing economy with low unemployment also helped put more welfare mothers to work, there is little doubt that the EITC played a large role in reducing the welfare rolls (see also Council of Economic Advisers 1998; Blank, Card, and Robbins 1999).

Of course, as with all targeted income supplement programs, what goes up with rising earnings (benefits) must at some point decline (phase out). The federal EITC for families with two or more children in 1999 declines at a rate of 21.06 percent per dollar earned from $12,460 to $30,580 (Figure 1). While there have been no studies of the effect of the phase out on single earners, Eissa and Hoynes (1999) find that the phase out reduces work effort by married women by a noticeable amount. Thus, higher earning families in the "phase-out" region of the EITC respond differently than do lower earnings units in the "phase-in" or "plateau" ranges.

If we count it as "income" in the year that it accrues, the EITC also has a powerful anti-poverty effect, reducing child poverty by 2.4 million in 1996, or a one-seventh reduction in poor children. It is the largest single program removing children from poverty (Greenstein and Shapiro 1998). According to the Census Bureau, the EITC removed 4.3 million persons of all ages from poverty in 1997, more than double the 1993 amount (Council of Economic Advisers 1998). Among the working poor, some 30 percent of children who would otherwise be poor (based on earnings and other sources of income) were lifted from poverty by the EITC. And by itself, the EITC offsets between one-fourth and one-third of the declining share of national income received by the poorest fifth of all households with children from 1976 to 1996 (Liebman 1998).

In sum, recent studies have shown that the EITC increases work effort of low-income families by supplementing earnings, thus raising net incomes and reducing poverty. But these studies treat the EITC as an income subsidy and for the most part ignore its delivery mechanism and its effect on savings.

Economic and Behavioral Effects[5]

Because of its unique administration and "lumpy" character, the EITC offers a rare opportunity to examine the direct economic impact of the program on recipients.[6] The lumpy nature of the EITC arises from several forces. First of all the EITC can be taken as a transfer during the year.

If employees fill in a W-5 withholding form submit it to their employers they can receive up to 60 percent of the maximum allowable amount of the EITC scaled to their monthly or weekly checks. The maximum amount of refunds in 1998 was $26 per week (O'Connor 1999a). However, 99 percent of recipients do not use this option, and instead receive a lump sum amount when they file their income tax in the following year (Scholz 1994). There are several possible explanations for such behavior, including: (a) employers' unwillingness to participate in the program; (b) employees' unwillingness to inform the employer due to stigma effects or fears of lower pre-tax wages; and finally, (c) employees' desire for the forced savings aspects of the EITC. There is some evidence that recipients prefer the forced savings aspects of the EITC (Romich and Weisner 1999; Olson and Davis 1994). However, the relative impacts of these factors, and perhaps others, have yet to be examined, and our study sheds little or no light on the question of why clients receive EITC benefits in the current form.

Regardless of the reason for type of benefit receipt, the lumpy nature of the EITC benefit and its recent rapid increases in benefit generosity create a rare and different opportunity to study the effects of the program on household finances—both on expenditure patterns and on asset behavior (i.e., debt, credit, and savings).[7] In fact, before the recent papers by Smeeding, Ross, O'Connor, and Simon (1999), Smeeding, Ross Phillips, and O'Connor (2000), and Beverly, Tescher, and Marzahl (2000), very little had been written on the effects of the EITC on household financial behavior or how households use EITC benefits, despite the fact that benefits received can be as high as 50 percent of the previous year's income, for example, in states with high state supplements (DeParle 1999).

Small studies (200- to 300-person telephone interviews) have shown that the EITC is used to pay overdue utility bills (e.g., Gallup Poll 1993), but not much else has been written on this topic. One important *New York Times* news story (Rimer 1995) suggested that some recipients made interesting and creative use of the EITC to improve transportation to and from a job, to move to a safer neighborhood, or to put children into better schools. However, the extent to which these uses are typical or idiosyncratic was not examined by Rimer. A recent ethnographic study of 42 low-income families in Wisconsin examines the use of tax refunds (Romich and Weisner 1999).[8] The authors conclude that families use lump-sum tax refunds to improve family well-being and to make large purchases. Throughout the year, low-income families in the Romich and Weisner study seem to alter their market and nonmarket labor supply in order to help smooth the flow of economic resources. Souleles (1999) studied the response of households to income tax refunds more generally and concluded that roughly 20 percent of tax refunds were used for purchases of durable goods.

Chicago Study of EITC Usage

The data in Smeeding, Ross, O'Connor, and Simon (1999) were drawn from a sample of 7,000 low-income Chicago area taxpayers who utilized the free tax preparation services provided by the Center for Law and Human Services (CLHS) in the winter and spring of 1998. The CLHS has ten centers in the Chicago metropolitan area in which any low-income taxpayer can receive free assistance from professionally qualified volunteers in preparing their tax return. From January through April 1998 we interviewed low-income taxpayers in general, and EITC beneficiaries in particular, at these sites. More than 90 percent of taxpayers interviewed were

willing to discuss their refunds. This produced a sample of 826 tax returns which CLHS calculated would generate *both* a federal tax refund *and* the EITC as part of that refund. About one-quarter (208) of these families also completed a follow-up phone interview six weeks after filing to verify their receipt of the EITC and to answer again the same questions posed to them earlier on their use of the EITC.[9]

Uses of the EITC

The purpose of this study was to examine two important types of usage for the EITC: (a) making ends meet and (b) improving social mobility. Respondents were given several categories of future purchases: for goods or services, for paying off existing bills, or for saving the refund for future anticipated or unanticipated needs. While several other bundles of categories of uses could be created, we initially selected these two particular categories.

First of all, the EITC is targeted on low-income working families with children; more than one-half of those in our sample received one or more means-tested transfers in 1997-98. Our data suggest that our sample head of household population is largely made up of former welfare mothers who in 1998 found formal jobs, or increased hours worked at existing jobs and are, in effect, trying to make ends meet. These mothers, most of whom were much less attached to the labor force in earlier times, may have unmet consumption needs or may use the EITC mainly to spread their consumption over the year.

Recent studies show that typical household expenses make up over 100 percent of welfare clients' incomes, the rest being made up from borrowing or from unreported earnings (Edin and Lein 1997). Among these types of households, Edin and Lein have shown that the move from informal unreported work to formal work adds to expenses (e.g., child care, transportation), which reduces or negates the positive impact of higher earned income and may leave the household in no better economic circumstances than when they were on welfare. More recently, Loprest (1999) reports similar findings. Among welfare mothers, Edin (1998) found that living day-to-day (or month-to-month) was the typical way of life and that formal asset-building, saving, or even formal contact with financial institutions (e.g., banks or use of credit cards) was a rare event. Despite their poor economic circumstances, Edin found that many interviewees were aware of and interested in accumulating assets or using earned income to improve their social mobility (Edin 1998). Yet the majority were struggling just to make ends meet (see also Loprest 1999). Among such types of potential recipients, the EITC could be seen as a way to buy durables, pay off outstanding bills, and meet other urgent consumption needs. To the extent that the EITC helps meet current consumption needs, it may be no different than other types of income subsidies, child care subsidies, and similar benefits (e.g., Food Stamps) in terms of its impact on recipients.

While the majority of Edin's sample were credit constrained and had little leverage to borrow money, many still expressed a strong interest in having access to credit and accumulating savings for durable purchases (Edin 1998). Many of them, however, also realized that saving EITC benefits in formal settings such as bank accounts would negatively affect their eligibility for welfare benefits. Hence, low-income workers tend to avoid banks. Because of these and other cultural factors, many low-income families may be "credit constrained" in that they either lack

access to formal credit markets or, having access, they are not credit-worthy enough to obtain a bank loan. For populations similar to these, and in particular among those who are struggling to move from welfare to something better, the EITC and its lumpiness presents an opportunity to make extraordinary types of purchases that they might not otherwise be able to make, or to save for "big ticket" items such as homes, cars, or college.

The literature on assets and the poor (e.g., Sherraden 1991; Bird, Hagstrom, and Wild 1999; Edin 1998; Oliver and Shapiro 1995; Shapiro 1998) suggests that even low-income families are willing to make sacrifices by postponing current consumption to improve their long-run economic well-being when presented with appropriate incentives and opportunities to save. Because of its large size relative to current income, the EITC presents an opportunity for otherwise credit constrained low-income families to move beyond current consumption and to use the EITC for asset building purposes. Shapiro (1998) refers to this as "asset building" or "improving social mobility." This term was used to describe several types of asset-enhancing uses of the EITC for improving longer term economic mobility and well-being. Many of these uses are consistent with both Edin's (1998) findings and with those found by Rimer (1995)and Romich and Weisner (1999) in their more limited set of interviews, and since verified by Beverly, Tescher, and Marzahl (2000).

Moving and Housing. For instance, recent studies indicate that significant numbers of low-income central city residents would move to safer neighborhoods if they could afford to do so (e.g., Ludwig, Duncan, and Hirschfield 1998). Recent studies based on the Moving to Opportunity (MTO) experiment verify that low-income central city residents who participate in MTO overwhelmingly (70 to 75 percent of movers) choose to move away from violence and crime when given the chance (Ludwig, Duncan, and Hirschfield 1998). Chicago has a number of dangerous inner city neighborhoods, including those in which we sampled our interviewees (e.g., Sampson, Randenbusch, and Earls 1997). Because moving a household requires both direct moving expenses and demonstrates ability to pay rent (e.g., first and last months rent), the EITC might provide such an opportunity. Alternatively, residents who have a growing stake in their neighborhood could use the EITC to repair or improve their home. In fact, 6 percent of our sample were homeowners who were paying off mortgages, and many of them claimed this as a priority use of the EITC. Finally, the desire to own their own home may have an important longer-term effect on asset accumulation among EITC clients.

Automobiles and Transportation. Increasingly, studies of welfare to work are finding that owning or having access to a reliable means of transportation is a key to reducing the time costs of work-related travel, and thus enabling a job seeker to expand the area of job search to obtain higher wages and improve economic well-being. The EITC also provides an opportunity to purchase, upgrade, or repair a car, or to make a downpayment on a better car, or to pay for car insurance. Since lack of transportation is a serious impediment to job search, employment, and job mobility, the EITC may provide a critical bridge to a higher level of economic well-being via a dependable source of transportation (Ong 1996). Danziger et al. (2000) find that 47 percent of their sample of low-income welfare recipients do not own or have access to a car, but for those who do, the marginal effects of car ownership on earnings are equivalent to the marginal effects of completing high school in terms of higher future earnings. Edin (1998) also reports that her sample of fathers could use cars to begin self-employment as informal taxi drivers, as pickup and

delivery agents, or as "junkers."[10] Hence, an opportunity to purchase a car or a truck, insure a car, repair a car, or pay off a car loan increases the opportunity to work more and at better paying jobs.

Human Capital. The EITC also presents a source of funds for human capital investment both for tuition and as an alternative to student loans or to pay off former student loans, either for the recipient or their children.[11] In effect, a $1,000 to $2,000 EITC is a good substitute for a tuition voucher to a parochial or private school in communities where public schools are inadequate. Recipients can also use EITC benefits to improve their children's early learning by improving the quality of their child care or for other for child-related learning enhancing expenses. The EITC can also pay the recipient's tuition at a local community college or trade school.

Saving. Another important use of the EITC which improves social mobility is saving for specified purposes (Thaler 1990). Movement from welfare or government safety nets to self-protection via own precautionary savings is an important indicator of upward social mobility. Making regular car payments and paying off bank loans, medical bills, or credit card bills are all uses of EITC that help establish or improve a credit history. Repaying informal loans or sharing EITC refunds with family members is also indicative of social capital building and maintenance of nongovernmental means of support in case of emergencies. In fact, a growing number of American policymakers feel that saving is a worthy activity that should be subsidized for low-income Americans in the same way that tax deductions for IRAs, 401(k)s, and pensions subsidize saving for others (Boshara 1999; Seidman 1999). If the EITC effectively subsidizes saving as well as work, it has a double benefit for society, as we investigate more fully below.

Classifications of Bundles. Smeeding, Ross, O'Connor, and Simon (1999) separated their EITC categories of use into two corresponding "bundles." In their sample, payment of regular bills (rent, utilities, food, groceries, clothing, personal expenses), and purchases of clothing were classified as expenses for making ends meet. So were purchases of household appliances or household furniture, as well as other personal or regular household expenses.

Using the EITC to improve social mobility included all forms of debt repayment, savings, and other expenditures that were easily identified as increasing chances for improved mobility, including all forms of work-related expenses. These included payment of credit card, automobile, or personal debt. They also included human capital building (e.g., tuition payments, medical bills), expenses for cars (purchases, repairs, insurance), moving expenses, and home improvements. Sharing money with family members was also classified as an equity expense in that it built social capital.

Results

Here we review the results of the Chicago study with a particular eye toward asset accumulation and desired savings behavior. A more complete set of results is found in Smeeding, Ross, O'Connor, and Simon (1999), and for families with children only in Smeeding, Ross Phillips, and O'Connor (2000).

Priorities. First, respondents were asked to list up to three priority uses of the EITC benefit. Of the 826 respondents, 617 or 74.7 percent had at least one top priority use for the EITC, while 40 percent also had a second priority and 12 percent a third priority use as well. These priorities are summarized in Figure 1. They indicate that bill paying was the single highest priority use of the EITC for almost one-half of all beneficiaries, with purchases coming in second across all priority levels. Across all three priority levels, between 75 and 80 percent of respondents would use the EITC to pay a bill or make a purchase of some commodity. Clearly the EITC helps make ends meet; this result was fully expected.

However, almost one-half of all respondents (49 percent) also stated that they would save some or all of their EITC check.[12] Purposes for saving were mixed. Less than 40 percent claimed they were saving to pay off current or future bills, while more than 80 percent were saving for at least one equity building purpose such as purchasing a car, home, or education for themselves or their children. Beverly, Tescher, and Marzahl (2000) have similar findings, with only 21 percent of their EITC savings plan participants stating that precautionary savings were their first priority use for savings.

Smeeding, Ross, O'Connor, and Simon (1999) identified three key uses of the EITC that enhance social mobility: moving, paying tuition, or purchasing or repairing a car. Each of these uses is also summarized in Figure 1. While moving seems to be an all-or-nothing decision (with only 3 percent listing it as a secondary or tertiary preference compared to 4 percent who list it as a primary preference), paying tuition or purchasing/repairing a car are more evenly spread across the preference scale. Altogether, 16 percent of the sample stated they would use the EITC to pay tuition while 22 percent would make a car-related use of the refund. These uses suggest that the EITC also plays a large role in improving social mobility, a finding that the authors did not expect. All other priority uses of the EITC are summarized in the final columns and amount to only 11 percent of primary priorities and 14 percent of secondary priorities. The separately identified categories, upon which we focus below, seem to be driving the results.

Specific Uses. Combining priority uses across all respondents so that all persons stating each use (i.e., as a first, second, or third priority) are represented and bundling them as suggested in the previous section of the paper, Smeeding, Ross, O'Connor, and Simon (1999) arrived at the best overall snapshot of EITC use (Table 1). Several important patterns are evident in this table.

- ***More than one-half of all beneficiaries had a social mobility related use for the EITC.*** This use increased with income and benefit level, peaking for those with the maximum benefit (Panel B). Moving, transportation, and saving all peaked in the plateau range and declined slightly in the phase out range. Tuition expenses increased slightly as incomes rose.
- ***Making ends meet was an important use of the EITC for almost one-half of the sample*** (Panel C). Utilities and rent were higher priorities than were food and clothes.
- ***As expected, the lowest income households in the phase-in range had higher immediate needs than did those in the phase-out range***. Utilities and rent dominated food and clothes as consumption needs for this group.
- Less than 20 percent of the sample had no plans for the EITC, with those in the phase-in range most likely to not state a use (Panel D). Both this data and anecdotal evidence

(DeParle 1999) suggests that these were likely to be lower income persons who did not expect a refund to begin with.

- If we were to prioritize usage according to our designated bundles of uses, we find that while those who would make both types of use are evenly spread across the range of refunds at 21 to 23 percent of respondents, about one-third would make social mobility uses only while one-quarter would use the EITC check only to make ends meet. Both bundles follow predictable patterns across the EITC range, with those in the phase-in region having making ends meet as the highest priority while those at the plateau or in the phase-out ranges placing a higher priority on uses that improve longer run social mobility.

Thus, there are some suggestions that the determinants of EITC usage vary in predictable ways.

Access to Credit. If we are to study savings behavior among EITC beneficiaries, it is important to understand how EITC recipients relate to financial institutions. The ability to safely protect assets until they are needed seems important to long-term mobility. Low-income respondents who use check cashing services and who have no formal relationship to financial markets, i.e., no checking or savings accounts, and no credit cards, loans, or mortgages, are less likely to be able to keep a large EITC refund intact for future needs. In general, they will be less likely to benefit from federal asset-building policies.

In fact, access to financial and credit markets differs markedly across the income ranges of beneficiaries in the Smeeding, Ross, O'Connor, and Simon (1999) study (see Table 2). Only 40 percent of those in the phase-in range had one or more of the types of financial affiliations listed above. Only 24 percent had a checking account. In contrast, almost 73 percent of those in the phase-out region had some contact with financial markets. Checking and savings accounts, credit card usage, and bank loans all increase across the EITC range. In contrast, use of a check cashing service declined steadily across the income ranges, with 57.8 percent of those in the phase-in range using such services, and 44.3 percent of the plateau group. Many of our respondents did, however, indicate that they wanted to open a checking or savings account with their EITC check once it was received.[13] Preliminary comparisons indicate that these breakdowns are similar to those found by other researchers using national samples to investigate use of credit cards and checking and savings accounts among low-income populations (e.g., Bird, Hagstrom, and Wild 1999; Carney and Gale 1999). Caskey (2000) and Hogarth and Lee (2000) report that approximately ten million households nationwide are "unbanked," largely minority renters with no savings, and with younger household heads. Clearly, bringing banking services to this population, many of whom receive the EITC, will be a crucial future task for those promoting asset-building policies.

Discussion

Altogether, the findings of Smeeding, Ross, O'Connor, and Simon (1999) suggest that knowledge of EITC is high, that the large majority of people who receive the EITC expect it, and that most of those people have at least one use related to building social mobility for the EITC. Yet many recipients have little or no formal ties to financial markets and many rely on informal services to cash their refund checks. Thus, while the EITC offers some hope as a vehicle for tax-financed asset accumulation policy, we have not yet achieved that goal. And, as others have

suggested, additional subsidies for tax-funded savings, which EITC participants favor, are liable to be needed.

This study was the initial exploration of the ways in which families used our largest targeted income transfer program, the EITC. As far as we know, it is the only such study to date, though others have urged similar studies (e.g., Hotz and Scholz 2000). The EITC is unique because of both its tax administered nature and because of its "lumpiness" and once a year nature. This lumpiness may provide a key vehicle to overcome a short-term liquidity crisis and to provide recipients with opportunities to move beyond support of current consumption to meet more strategic longer term goals. It may also provide a vehicle for asset-building policies. While debt payment and consumption spreading behavior was to be expected, more than one-half of EITC recipients used their refunds to improve their social mobility. The large majority of EITC recipients were aware of the program and were able to articulate several specific uses for their refund, including investments in higher current and future earnings such as schooling, transportation, and moving.

Savings Policy Implications

If we wish to encourage social mobility uses for the EITC, Smeeding, Ross, O'Connor, and Simon (1999) found that they were positively related to having formal contact with financial institutions. As the federal government increasingly moves toward electronic benefit transfer (EBT) over the next several years, both formal relations with banks and the financial literacy that is required should be encouraged by policymakers (Stegman 1999). Opening a checking account offers a safe means of storing the EITC until priority uses can be sorted out. In turn, checking and savings accounts offer the possibility for having both precautionary savings and for longer term asset building. Public policies that permit or encourage asset accumulation for low-income households are obviously important here and could further strengthen ties with formal financial institutions.

Legislation to create special subsidized savings accounts for special purposes such as home ownership, post-secondary tuition, or retirement have recently appeared on the policy agenda (Boshara 1999). Universal Savings Accounts (USAs) and Individual Development Accounts (IDAs) are currently in the experimental stage. If we believe that asset accumulation is an important part of upward social mobility, only those with formal ties to financial intermediaries will be able to take advantage of these efforts. It may be useful in some cases to offer outright subsidies to EITC beneficiaries to open savings accounts for specified purposes (e.g., Seidman 1999), thus providing an incentive to open a bank account and to save for a specific goal.

The EITC helps meet current consumption needs but also offers avenues for upward social mobility. The findings of the Chicago study suggest that increased incentives for savings, greater access to credit markets, and federal programs to match low-income savings for specified purposes (e.g., home purchases or schooling) could lead to greater savings and work effort by the low-income, low-wage population, and hence to greater levels of self-insurance and self-sufficiency. The importance of the EITC for promoting savings-based policy cannot be understated. Without the EITC, almost one-half of its recipients could not have met their first priority use for the EITC, while the large majority of the rest could meet their primary need only

to a lesser extent or with some delay. Hence, the EITC provides an important source of support for working poor families. As such, the EITC appears to be our most effective federal program for leading low-income families on a path toward true economic independence. The question we must further investigate is how the EITC interacts with other recent legislative actions, existing programs, and new proposals to promote asset accumulation among low-income populations.

III. Linking the EITC and Savings: Promises and Pitfalls

Can the EITC and USA/IDAs interact to provide a significant, combined effect on the asset position of low-income households? The first (and last) thing to be said is that if the EITC is good policy, and USA/IDAs are good policy, then the two should co-exist in any case. The interaction among the two is bound to be positive, even if small. It is not clear that USA/IDA policy should be tied at all to the EITC. However, if the USA/IDA design can help EITC recipients meet their needs while also achieving its goals, the combined effect might be large, and the two together might make for better policy. The problem we face is that at this time we can only speculate about this interaction.

First, realize that asset accumulation policy for low-income families is liable to be a more complicated venture than one might believe (Shefrin and Thaler 1992; Thaler 1990). For instance, Smeeding, Ross, O'Connor, and Simon (1999) also found that about one-quarter of their sample have credit cards and of these, 80 percent had credit card debt averaging about $2,400. Yet only 18 percent of these respondents listed paying off credit card debt as a priority use for the EITC refund they received. Clearly, promotion of financial literacy is another consideration for asset accumulation policy.

Hotz and Scholz (2000) suggest that further research of this type in a dynamic context if sorely needed. Most families who receive the EITC in one year receive it in the next. Indeed, more than one-third of the Smeeding, Ross, O'Connor, and Simon (1999) sample stated that they received the EITC last year. The dynamics of the EITC may therefore help families to move to economic independence. Of course, changes in employment, marriage and cohabitation, divorce or separation, family living arrangements, and various other factors could also affect transition. Following a sample of recipients over time would shed additional light on these topics and more clearly identify the pathways from dependency on means-tested transfers to economic independence, the use of savings, and the potential for the EITC as a basis for asset-building policy. However, absent such evidence, we must build our analyses on the data that we have at present.

The Promise

Clearly there is potential for the EITC to be linked to asset-building policy (Seidman 1999; Beverly, Tescher, and Marzahl 2000). President Clinton has proposed legislation to further expand the federal EITC with an even larger benefit for families of three or more. The list of states offering some added EITC benefit is growing, with even Illinois now beginning such a policy. Cherry and Sawicky (2000) propose combining the EITC with refundable child tax credits, thus further strengthening the structure of tax credits for low-income households and removing some of the labor supply disincentives in the current program. Moreover, there has

been no increase in the fraction of households selecting the early payment option for the EITC, suggesting that lump-sum transfers at a fixed time will grow even larger in future years. Hence, the possibility for linking the EITC to savings-based policy is ever increasing.

What are the savings goals of low-income households? For the low-income population in the peak EITC benefit ranges of roughly $9,500 to 12,500, it seems that the desire to become economically independent, to avoid returning to welfare, to accumulate human capital via more and better education for their children and themselves, and to accumulate durables (including cars and homeownership) are the primary goals.

The recent proposals for subsidized savings accounts and other asset-based policies clearly intend to build assets among the poor. The tax code is used to subsidize savings and asset accumulation for high-income households; why not for low-income units as well? As mentioned earlier, these proposals come in two basic varieties: savings for retirement, e.g., President Clinton's Universal Savings Accounts (USAs); and Individual Development Accounts (IDAs), which subsidize savings for other purposes. We cannot be sure of the success of such policies because no one has attempted to carry out such an asset-building policy on a large scale. And while the EITC evidence in the Chicago Study, as well as the Beverly, Tescher, and Marzahl (2000) study, suggests that low-income families have the desire to save, one must question how successful the EITC and savings linkage might be.

Potential Pitfalls

First we need to better understand the motives for saving among the poor and their linkage with legislated purposes for saving via USA/IDAs. The EITC population is largely a low-income group. According to IRS data for 1996, of the 19.5 million filers who claimed the EITC, 7.8 million claimed one child while 8.0 million claimed two or more children (Internal Revenue Service 1999). Over 97 percent of the total cost of the credit for tax year 1996 ($28.2 billion) went to the 82 percent of the filers who claimed one or more eligible children (Internal Revenue Service 1999). National samples from 1997 also divide EITC beneficiaries into two major groups: (a) about 70 percent are single parents filing as heads of households, or single persons; (b) almost 30 percent are low earning two-parent households (U.S. Congress 1998, Table 13-13, p. 871). Other IRS data suggest that 18 percent of filers in 1996 were single filers without children (Internal Revenue Service 1999). Assuming the same fraction of single filers in 1997 as in 1996, this means that 52 percent of national filers were single-parent heads of households in 1997. In contrast, almost one-half of all recipients are in the phase-out range (above $12,400 in 1999), with most of these in two-parent households.

Hence, the largest EITC credits go to young families with children, most of them single parents. In the income ranges where the EITC is the highest ($12,000-$15,000 annual gross earned income per year) families are more likely to be struggling to escape poverty than to achieve secure middle class status. At higher income ranges, the EITC subsidy quickly shrinks both as the program phases (at 21 percent) and as federal income tax liability grows (at 15 percent). Thus, most recipients of the EITC in the $20,000-$25,000 income and above range receive either small tax refunds, or pay lower taxes and receive no April tax filing bonus. While this group is

more likely to participate in a USA/IDA plan, their impetus from the EITC refund is liable to be small.

Therefore, it seems that the families most able to finance long-term savings do not get a large EITC bonus. At the same time, those closest to welfare and those with the least stable familial situations (low-income, single parents) are liable to receive the greatest EITC bonuses. Thus, much of the attraction of using the EITC has to be contrasted to the savings intentions of truly low-income mothers with young children who receive the bulk of large EITC payments.

Designing USA/IDAs for EITC Beneficiaries. If EITC-linked savings policies are aimed at lower income households because of the EITC structure, we must therefore ask what drives their savings intentions. While there are few studies of these motives, there is some evidence of the desires of EITC recipients for different types of savings (Beverly, Tescher, and Marzahl 2000; Beverly and Sherraden 1999; Hogarth and O'Donnell 1999). Clearly, low-income households have a desire for precautionary savings. Short-term liquidity is important for expected and unexpected future bills, particularly for those just leaving welfare. Further, low-income households save for specific goals: a first or better car; a first home; and to start a business (see also Davis and Lemieux 2000). Many also save to pay for their education or that of their children. Finally, after all of these priorities are met, low-income families may choose to save for retirement.

It seems that this list of savings priorities is both judicious and sensible, especially for single parents. But if so, few large EITC beneficiaries will save for retirement. Thus while EITC-based savings incentives may be useful for some type of savings plans such as IDAs, they are liable to be less useful as vehicles for add-on retirement savings accounts such as USAs. Not only do savings needs differ among those with and without children, but once children have grown to age 18 and retirement savings became a priority, the maximum value of the EITC drops precipitously. Vice President Gore seems to recognize this dilemma, since his "retirement savings plan" (with tax credits to match client savings up to a 3-to-1 ratio) would allow for withdrawals for college tuition, a first home, or catastrophic medical expenses as well as for retirement. This is not to say that matched pension accounts are not a good idea (as demonstrated by Orszag and Greenstein 2000), but that retirement savings accounts do not seem to match well with the savings needs of EITC recipients who receive large lump-sum amounts.
Finally, plans that tie up personal savings for specified periods in order to receive subsidies vitiate the use of these savings for short-term needs. While a large fraction of EITC recipients may be enticed to participate in an IDA-type scheme, the time and use limitations may clash with their short-term needs for emergency bill paying or durables purchases due to job loss, car breakdown, or related costly "emergencies." There is a long literature on low-income women's tendencies to cycle on and off welfare, and the immediate use of savings may be to avoid cycling back to welfare. However, subsidized IDAs are not designed for such uses. Perhaps the Beverly, Tescher, and Marzahl (2000) study can help us to better understand if EITC recipients can maintain their IDA-like accounts throughout the current year.

IV. Making Policy: Linkages between Low-Income Families and Asset-Building Policies

Low-income families need and want to build assets. Financial institutions offer a safe place to keep assets and to monitor their growth. They also provide an institution for maintaining the fidelity and public accountability demand required of an IDA/USA type program. Linkages to the EITC may provide both an opportunity and a natural linkage to savings. Indeed, EITC recipients might well find that financial institutions, which offer safety features, and public programs that subsidize asset accumulation (with a large match for participation) offer an attractive use for part of their EITC refund. However, such schemes are liable to be complex conceptually, personally, and administratively. In this section of the paper we close by suggesting some of the most important considerations for an EITC-based savings incentive policy.

Untaxing Assets

Before we even begin to encourage savings by the poor, we need to stop discouraging asset accumulation in "means"-tested benefit programs. The recent literature finds strong evidence that social insurance in general, and means-tested programs in particular, discourage savings (e.g., Hubbard, Skinner, and Zeldes 1995; Gruber and Yelowitz 1997; Powers 1998; Neumark and Powers 1998). The fact that so few lower-income clients have checking or savings accounts could be because the asset tests associated with welfare receipt and/or Medicaid receipt discourage saving or opening bank accounts. In most states the EITC is not counted toward TANF for benefit determination; however, it is counted toward asset limits after two months for Medicaid and SSI. While many states have eased liquid asset tests for TANF clients, Food Stamp asset limits for most families remain relatively low, thereby penalizing savers who fear losing their jobs and having to reapply for aid. Low limits on the maximum value of a car ($5,000) in Food Stamps are liable to have similar effects on eligibility, even when the literature clearly suggests that automobile ownership is a key positive determinant of earnings levels. However, while Food Stamp asset limits are relatively low, the EITC is exempt from counting against Food Stamp asset limits for 12 months after receipt, a much longer period than in the cases of SSI or Medicaid. The negative effects of participation in means-tested programs on savings and equity building deserve further investigation.

Ill-conceived policies to limit eligibility to clients whose automobiles are worth less than $4,650 should be re-evaluated in Food Stamps, while at the same time Medicaid, SSI, and TANF might mimic Food Stamps by exempting the EITC from asset tests for 12 months instead of two. The passage of the 2000 Hunger Relief Act would eliminate the federal limits on car value for Food Stamps and allow states to set their own value limits on an automobile. While this would be a step in the right direction, a better thing would be to either eliminate the limits entirely or to set them at much higher levels (e.g., $12,000 or above).

While many USA/IDA-type savings accounts are explicitly excluded from consideration by these programs, it seems wise to change the program rules themselves if we are to build assets more generally, and to promote long-term economic independence. Asset transfers should be seen as a way to transform societies, not for meeting emerging needs. Raising asset limits in

"means"-tested programs would allow households the opportunity to build flexible unsubsidized precautionary savings balances that might be the first step to longer term USA/IDA-like schemes.

Financial Literacy

The widespread usage of expensive check-cashing outlets; the popularity of short-term loans from tax refund vendors (e.g., H&R Block) at 200 percent interest rates; and the persistence of credit card borrowing at 19 to 25 percent interest rates, while at the same time "saving" at 1 to 2 percent interest in bank checking and savings accounts, all suggest that the need for financial literacy among low-income households in general and EITC beneficiaries in particular is great. While a few pilot programs have begun to educate the welfare-to-work population on financial literacy, a longer term and more general education policy is needed. Financial literacy is a good investment in the type of forward-looking society that would adopt tax-based savings incentives in a meaningful way.

Financial Institutions

One must also question the willingness and cost to financial institutions for maintaining and monitoring USA/IDA and EITC schemes. From a financial perspective, these accounts are liable to be high cost and low revenue, particularly if banks are required to enforce withdrawal policies for specific purposes. While long-term saving arrangements at fairly low rates of interest offer banks a chance to benefit from time-tied savings plans like IDAs and USAs, the costs of administering these accounts is high because of their relatively small size and because of the chance of early withdrawal. Davis and Lemieux (2000) report that the average savings of participants on the American Dream (IDA) Demonstration Project was $286, and the average total account balance (with subsidies) was $845. Many participants also make in-person monthly deposits and withdrawals, consistent with the Beverly, Tescher, and Marzahl (2000) study. Hence, these are fairly high maintenance accounts.

Moreover, if USA/IDA withdrawal policies are to be enforced, banks must monitor use of withdrawals and obtain "proof" of legitimate usage of funds. Despite the impending onset of Electronic Benefit Transfer (EBT), the for-profit banking community in particular, and even more low-income friendly credit unions and community-oriented banks, will incur real costs in administering USA/IDA plans and in bringing the "unbanked" into the financial world. These costs have to be taken into account by policymakers.

Conclusion

The evidence presented here suggests both motive and desire for low-income families to save. The EITC and its lump-sum nature offers a natural opportunity for beneficiaries to use part of their refunds for targeted asset building. However, a number of important questions need be addressed before we can determine if this marriage of policies between the EITC and IDA/USAs is indeed a heavenly one. In particular, further consideration of the design of USA/IDA-type asset accumulation policies to be congruent with the savings desires of low-income beneficiaries, particularly those who benefit from the EITC, seems a good next step. The potential is there, but the case is not yet strong for such a linkage.

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Table 1. Important Uses of the Refund within EITC Range

Panel	Category	Percent of Respondents within EITC Range			
		Phase-In	Plateau	Phase-Out	Overall
A	Households receiving EITC	46.0	15.5	38.5	100.0
B	Any Improving Social Mobility Use	46.1	65.6	59.8	54.4
	Move	3.7	10.2	3.5	4.6
	Car/transportation	10.8	24.2	13.8	14.0
	Save	22.4	34.4	32.1	28.0
	Tuition/school	7.1	10.9	11.3	9.3
C	Any Making Ends Meet Use	50.8	46.1	45.9	48.2
	Utilities	32.9	37.5	31.1	32.9
	Rent	29.5	32.0	30.2	30.1
	Food	16.6	15.6	21.7	18.4
	Clothes	22.1	14.8	17.6	19.3
D	Plans for EITC				
	None	24.2	10.2	17.6	19.5
	Improving social mobility only	25.0	43.8	36.5	32.3
	Making ends meet only	29.7	24.2	22.6	26.2
	Both	21.1	21.9	23.3	22.0
	Total N	380	128	318	826

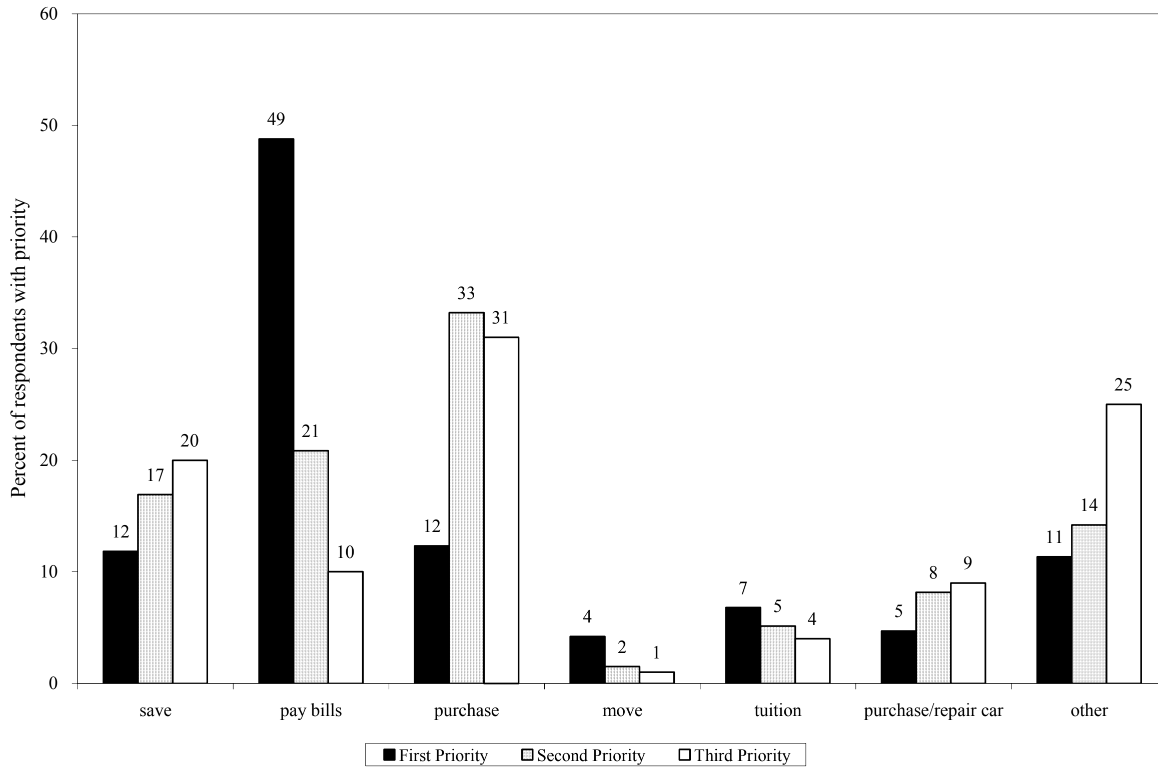
Source: Smeeding, Ross, and O'Connor (1999). Totals may not add due to rounding.

Table 2. Access to Financial and Credit Markets by EITC Range

Assets and Formal Credit	Percent of Respondents within EITC Range			
	Phase-In	Plateau	Phase-Out	Overall
	A. Percent with Different Forms			
Checking account	24.0	36.7	49.7	35.8
Savings account	16.1	28.9	42.1	28.1
Credit card	16.6	27.4	37.7	26.4
Bank loan	1.8	2.3	5.0	3.2
Mortgage	3.7	2.3	10.1	5.9
Any of the above	40.0	59.4	72.6	55.6
	B. Percent Using a Check Cashing Service for Their EITC			
	57.8	44.3	34.2	44.3

Source: Smeeding, Ross, and O'Connor (1999).

Figure 1
Self-Reported Important Uses of Refund[1]



Notes

1. Food Stamps, TANF, and Supplemental Security Income (SSI) were all budgetarily smaller programs in terms of total costs for 1998.
2. The EITC is also available to single persons but at a much lower level. In contrast to the treatment of families with children, the level of EITC benefit for single filers has not changed in real terms since 1994.
3. While higher benefits and word-of-mouth might have increased participation in the EITC since 1990, other factors work in the opposite direction. In 1991, the IRS began requiring a new form, Schedule EIC, in order to claim EITC. Previously, the IRS would calculate and issue the credit based on information in the form 1040. The participation rate might therefore have dropped somewhat in the early 1990s. Our interviews showed that over 20 percent of EITC recipients were not expecting a refund. Many of these individuals would not have filed at all but for the CLHS tax program and others like it. See O'Connor (1999) for a more detailed analysis.
4. However, after two months, any savings from the EITC are counted toward liquid asset tests in TANF, SSI, and Medicaid. EITC does not count against Food Stamp asset limits for 12 months (U.S. Congress 1998). This point is discussed later in the paper.
5. The remainder of this section of the paper is based on Smeeding, Ross, O'Connor, and Simon (1999).
6. Liebman (1998a) studies the issue of compliance to the EITC and focuses on administrative issues. He finds increased compliance with EITC rules and regulations due to IRS rule changes and audits of returns in the 1990s. We do not deal with these topics below.
7. Ideally, one would like to separate the economic effects of the EITC using a counterfactual group to parse out behavioral affects with a comparison group of some type. Because the EITC is a national program open to all low-income, low-wage taxpayers, there is no natural control group. One could examine year-to-year changes in outlays using, for instance, the Consumer Expenditure Survey (CEX), e.g., Barrow and McGranahan (2000). However, the CEX does not collect tax data and is not designed for assessing the effects of the EITC in respondents. Further, nonparticipants of the EITC are likely to be a nonrepresentative and biased group. As a substitute, Smeeding, Ross, O'Connor, and Simon (1999) devised the questions regarding ability to make spending or saving decisions if the tax refund was not given. These are reported on below.
8. Romich and Weisner (1999) do not have access to tax returns but they estimate that 36 of their 42 families are eligible for the EITC. The larger sample (N=826) and direct knowledge of EITC receipt in Smeeding, Ross, O'Connor, and Simon (1999) complement the analyses of Romich and Weisner (1999) and Rimer (1995). It is encouraging that these findings are generally similar.
9. Smeeding, Ross, O'Connor, and Simon (1999) rely on the 826 questionnaires filled out at the time of the tax filing. The 208 call-back interviews provided verification of intended usage of these refunds. Call-backs were limited to those with refunds of $1,000 or more and we obtained a 50 percent response rate. About 90 percent of the call-backs received the refund amount calculated by the CLHS. Differences were due to federal inquiries regarding legitimacy of the returns, or lower refunds due to school loans or child support

payments that were outstanding. Among this 90 percent there was a high (85 percent) correspondence between intended use of refund (sample used here) and actual usage (once the check arrived), with no systematic change in the distribution of tax return usage by type of use. Call-back interviewees were remarkably consistent in their preferences for EITC usage in the phone interview compared to the face-to-face interview.

10. Edin (1998) reports that some of the men in her sample purchase trucks to use for informal salvage operations for trash dumping ("junkers") or for local moving, shipping, and delivery services.
11. In fact, in other call-back interviews, we found a small number of EITC returns (less than 3 percent) which were reduced by the Internal Revenue Service because of money still owed on guaranteed student loans.
12. While 82 percent of the EITC participants in the Beverly, Tescher, and Marzahl (2000) study who would have participated in their EITC-savings did not do so, most who did were "unbanked." It could be that the large number of nonparticipants did not take advantage of the EITC savings plan because they realized that it would not be possible to tie up their EITC check long enough to collect the up to $100 bonus promised at year's end for participants.
13. This finding helped inspire the recent Beverly, Tescher, and Marzahl (2000) study.