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Support for a Tax-Time Savings Policy: Interest in Deferring Tax Refunds with Matched Incentives

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The Earned Income Tax Credit

The Earned Income Tax Credit (EITC) is regarded as one of the largest antipoverty policies in the United States and currently benefits more than 27 million households annually.[1] In addition to lifting more than 6 million low-income households above the federal poverty line,[2] it is highly regarded for incentivizing people to enter the labor force.[3] Unlike traditional cash benefits that are distributed in multiple payments throughout the year, benefits from the EITC are received as a single, lump payment in the tax refund. The timing of the payment—once a year, early in the year, as part of the tax refund—has potential implications for the EITC's utility in low-income households, which may cope with volatile incomes and unexpected financial emergencies throughout the year. A one-time payment received in February may be unavailable to help address a financial crisis that strikes a family in October.

Emergency Savings

The Pew Charitable Trusts recently reported that about 60% of households in a nationally representative sample experienced a financial shock over the previous 12-month period, and the median cost of the household's most expensive shock was $2,000.[4] When these shocks come, many struggle to weather them: About half of American households report being unable to come up with $2,000 within 30 days.[5] Lack of emergency savings forces many to resort to high-cost alternative financial services such as payday loans.[6] Households with inadequate funds to cover unexpected expenses are also at risk for material hardship and difficult tradeoffs; some skip necessary medical care and postpone bill payments to meet such expenses.[7] Policies that enable households to build emergency savings have the potential to cushion them from the compounding setbacks precipitated by financial shocks.

Rainy Day Proposal

Given the need to promote saving for emergencies and the cash windfall offered by the tax refund, policymakers and advocates have proposed several policies to increase savings at tax time.[8] The Corporation for Enterprise Development (CFED) recently proposed a Rainy Day EITC program that would incentivize tax filers to delay receiving a portion of their EITC for 6 months: Filers who deferred receipt of 20% of the credit would receive a matched bonus of 50% of the delayed portion (i.e., 10% of the EITC). For example, a filer due a $1,000 EITC would agree to wait 6 months for 20% of it ($200) and would receive an additional $100 as a bonus. We assessed interest in this model by piloting a question in a 2015 survey of low- and moderate-income taxpayers, including EITC recipients. We also determined whether tax filers knew if they benefited from the EITC. In addition, we examined the prevalence of financial shocks during the 6 months before and the 6 months after respondents filed their returns.

Refund to Savings Data

The Refund to Savings initiative is an ongoing research project currently in its fourth year of data collection.[9] In cooperation with Intuit, Inc., the makers of TurboTax, academic researchers are testing the use of mechanisms from behavioral economics to encourage and facilitate the depositing of tax refunds directly into savings accounts. The experiment is embedded in TurboTax Freedom Edition, a version of self-preparation tax software that is free for qualified low- and moderate-income households: those earning less than $31,000, those eligible for the EITC, and those with members serving on active duty in the military. Half of TurboTax Freedom Edition users who filed returns between January and April 2015 were invited to participate in a Household Financial Survey as part of the 2015 Refund to Savings study. The survey included a detailed assessment of participants' assets, liabilities, and demographic characteristics as well as their intended use of the tax refund. After obtaining participants' consent, we merged these survey data with the administrative tax data available from TurboTax. Six months after filing taxes, respondents to the first survey were invited to participate in a follow-up wave of the Household Financial Survey. The follow-up included a similarly thorough assessment of the balance sheet, questions about use of the tax refund, and queries about the experience of unexpected financial shocks during the 6-months after filing.

Sample Characteristics

The analytic sample consisted of 8,840 respondents to the 6-month follow-up of the 2015 Household Financial Survey. Most respondents (91%) who began the survey ultimately completed it. Respondents could decline to answer any item, so the number of persons providing data varies across the items analyzed. Tax data were available for 86% of the sample (n = 7,635). Most respondents (95%) qualified to use TurboTax Freedom Edition by having a household adjusted gross income less than $31,000. The median adjusted gross income for respondents' households was $13,723, and the mean was $15,112. The median amount of tax refund was $829, and the mean was $1,549. Sample members are further distinguished by filing status: 77% filed as single, 11% filed as head of household, and 12% filed as married filing jointly. The median age of respondents was 28 years, and the mean was 32.6 years.

About 37% of the sample received some EITC; among EITC recipients, the median amount was $496, and the mean was $1,562. Although the average refund of EITC recipients ($2,754) was much larger than that of nonrecipients ($826), the proportion of EITC recipients who deposited the refund directly to a savings account was smaller than the proportion of nonrecipients who did so (12% vs. 16%; x^2 = 19.3; p < .001). Most respondents (93%), regardless of EITC status, chose to direct deposit their tax refunds into a bank account; only 7% opted for a paper check. Slightly more than half of the sample was female (54%); women comprised a greater proportion of EITC recipients than of nonrecipients (58% vs. 52%; x^2 = 31.95, p < .001). Most respondents did not claim dependents (80%), but about half of EITC recipients did so, and 93% of households with dependents received the EITC.

Interest in Deferred Tax Refund

To gauge public interest in delaying tax refunds with an incentive, we posed the following question to respondents in the 6-month follow-up of the Household Financial Survey:

> **Many people get a financial boost from tax refunds but find themselves short on funds later in the year. Imagine a program that offers one bonus dollar for every two dollars of refund you wait 6 months to receive. Your total tax refund would be larger, but you would have to wait 6 months to receive some of it.**
>
> **Say you completed your taxes and had a $2,000 refund. Which of these options would you choose to do?**
>
> ○ Get **$2,000** at tax time. **Total $2,000** at the usual time you receive your refund.
>
> ○ Get **$1,600** at tax time and **$600** in 6 months. **Total $2,200**, but required to wait 6 months for the second payment.

Out of 8,258 individuals who answered this item, 85% selected the second response option, indicating the preference to defer a portion of the refund for 6 months and to receive a $200 bonus. Among respondents whose tax data indicated that they received the EITC (n = 2,675), 82% expressed a preference for deferring a portion of the refund (see Figure 1).

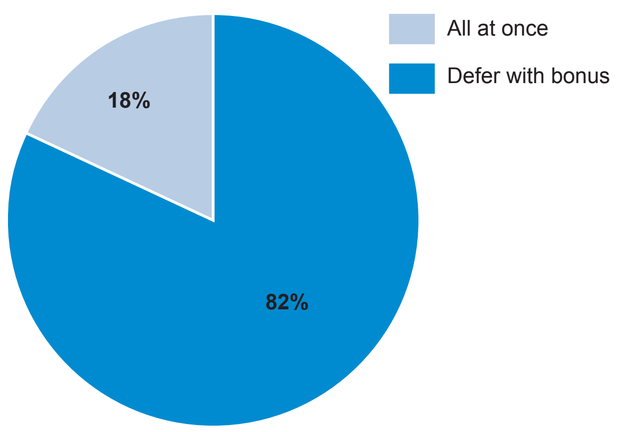

Figure 1. Preference among Earned Income Tax Credit recipients (n = 2,675): receiving a $2,000 tax refund all at once at the usual time versus deferring receipt of 20% for 6 months in exchange for a 10% ($200) bonus.

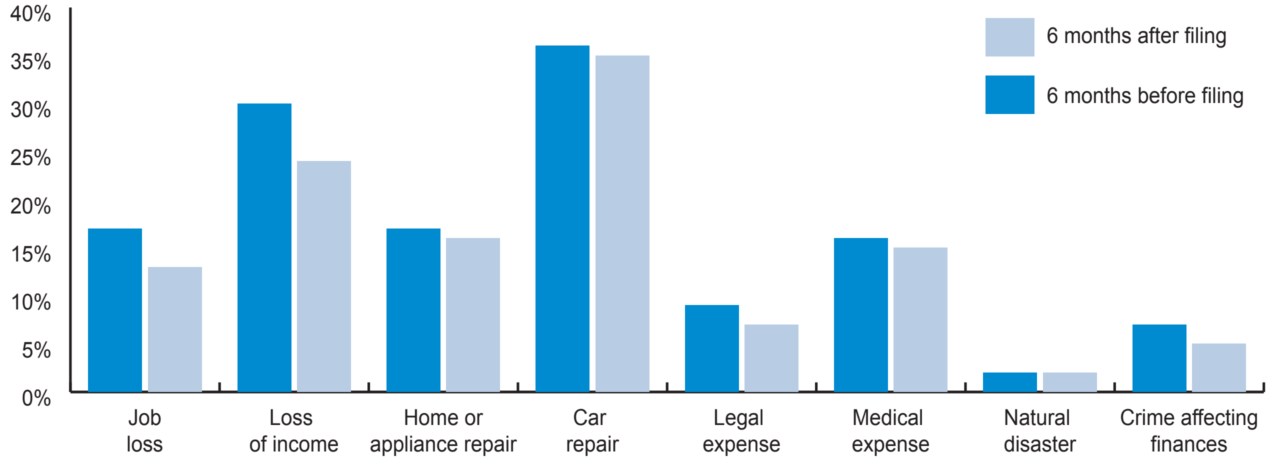

Figure 2. Unexpected financial shocks experienced by Earned Income Tax Credit recipients in the 6-month periods before and after filing taxes (n = 2,610).

EITC Awareness

To determine the extent to which respondents were aware, 6 months after filing, whether they received the EITC, we asked them the following:

Off the top of your head: did you receive any Earned Income Tax Credit (EITC) as part of your tax refund?

- ○ Yes
- ○ No
- ○ I don't know

We compared responses to this item with tax data that indicated whether the EITC was received. Among 2,722 EITC recipients who answered this question, about a third did not realize that they received the credit. About 65% accurately reported that they received the credit, 18% said that they did not (although tax-return data showed that they did), and 17% said that they did not know. Those who were aware that they received the EITC had significantly larger credits: The average amount of EITC received by recipients who were aware was $2,018, compared with $537 for those who erroneously said that they did not receive the credit (t = -17.09; p < .001) and $878 for those who were unsure (t = -12.66; p < .001).

Among 4,536 respondents whose tax return indicated that they did not receive the EITC, 69% accurately reported that they did not receive the credit, 29% were unsure, and 3% thought that they received it. These results suggest that a majority of these self-preparing tax filers were aware of whether they receive the EITC but that a substantial proportion of recipients did not realize that they benefit from it.

Financial Shocks

Both the baseline (tax time) and 6-month follow-up waves of the Household Financial Surveys queried respondents about financial shocks they experienced over the 6 prior months. The survey asked about unexpected job loss; loss of income; major house or appliance repair; major repair to an owned vehicle; legal expenses; major out-of-pocket medical expenses (e.g., from hospitalization or an emergency-room visit); expenses due to natural disasters, such as storms, earthquakes, or floods; and crimes affecting one's finances (e.g., robbery, vandalism, or fraud).

About half of respondents (53%) indicated that they experienced a financial shock during the 6 months before filing taxes, and half (51%) reported a financial shock in the 6 months after filing. Overall, about 70% of the sample experienced a shock over the 12-month period. Two thirds of those who reported at baseline that they experienced a shock in the previous 6 months went on to experience another shock in the subsequent 6 months (i.e., shocks were a risk factor for having additional shocks).

The rate at which EITC recipients reported experiencing shocks was even higher: 66% of EITC recipients reported experiencing one of these events during the 6 months prior to filing taxes, and 59% reported experiencing one during the 6 months after filing taxes. The baseline rates at which recipients reported specific kinds of financial emergencies were similar to the follow-up rates, but job loss and loss of income tended to happen more frequently in the 6-month period before filing (see Figure 2).

Future Directions

The deferred refund question posed in our survey primed respondents to contemplate needing funds later in the year, only assessed interest in a single rate of matching, and specified a hypothetical refund amount of $2,000. In the 2016 Household Financial Survey, we will test different levels of matched bonus (including no match) as we continue to explore taxpayers' interest in deferring the tax refund, and we will use respondents' actual refund amounts to approximate more closely the sums under consideration. We will also examine the potential effects of variations in the item's wording. For example, we will examine whether respondents' interest in deferring the refund depends upon the prompt to think about later need for funds, and we will test whether responses are affected by dubbing the matched incentive a "bonus."

Conclusions

The evidence presented above suggests that EITC recipients have great interest in deferring a portion of the tax refund for 6 months if they receive an incentive for doing so. Policymakers considering tax-time savings policies should take this strong support into account; however, there are caveats: The analytical sample was not intended to be nationally representative, and the responses are potentially influenced by the amount of incentive as well as by the wording of the choices. Also, interest expressed in response to a hypothetical question may not translate to actual tax-filer behavior. Notably, in 2010, the Internal Revenue Service advised discontinuation of the Advance EITC option because of extremely low participation rates.[10] However, the low uptake was due at least in part to the added demands and perceived risk of estimating the amount of future EITC.[11]

For this low- and moderate-income sample, financial shocks were common during the 6 months before and after filing taxes. The prevalence of these shocks clearly signals that these households need access to emergency savings throughout the year. About 70% of our sample reported experiencing a financial shock in a year's time—close to the 60% annual rate of shocks recently reported by the Pew Charitable Trusts in a nationally representative sample.[12] An infusion of funds from the combination of a deferred EITC and an incentive bonus, received 6 months after tax filing, could help households cope with shocks that occur in the second half of the year. Notably, households that did not receive the EITC also reported frequent shocks throughout the year. This suggests the need for policies that enable filers to defer any kind of tax refund, not just refunds due to EITC.

About a third of EITC recipients in our sample were unaware that they benefitted from the credit, though those who were unaware tended to have smaller EITC amounts. The lack of awareness is potentially advantageous because people who benefit from this policy do not feel touched by the stigma commonly associated with receiving government benefits. But lack of awareness could also be detrimental to policy support and uptake: Recipients who are unaware of their benefits may not be especially motivated to back the policy, and filers who do not use supportive software to complete their own returns may fail to claim the credit despite qualifying.

Policymakers should consider additional efforts to encourage and enable low- and moderate-income households to save for emergencies. The recently available, federally backed retirement savings account, myRA, is potentially useful as both a short- and long-term savings container for low- and moderate-income households.[13] Taxpayers can directly deposit their refunds into the accounts. Similar to a Roth IRA, the myRA holds posttax funds, and there is no penalty for early withdrawal. The absence of fees and low initial and monthly contribution requirements make myRA accessible to households that might not otherwise qualify for or be interested in such a savings account.[14] Measures proposed as part of the Financial Security Credit Act of 2015 expand access to the Saver's Credit for low- and moderate-income households. The change is designed to incentivize taxpayers to save money, including their refunds. Under current law, filers may only claim the Saver's Credit if they use a retirement account, and the credit is nonrefundable. The new legislation would allow households to choose from numerous savings vehicles and makes the credit refundable. Each of these efforts has the potential to encourage taxpayers to save their refunds and may enable them to be better situated to handle unforeseen financial shocks down the road.

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End Notes

1. Center on Budget and Policy Priorities (2016).
2. Center on Budget and Policy Priorities (2016).
3. See, e.g., Eissa and Liebman (1996).
4. Pew Charitable Trusts (2015).
5. Lusardi, Schneider, and Tufano (2011).
6. Lusardi et al. (2011); Grinstein-Weiss, Russell, Tucker, and Comer (2014).
7. Grinstein-Weiss et al. (2014).
8. Edin, Greene, Halpern-Meekin, and Levin (2015); Financial Security Credit Act of 2015.
9. Grinstein-Weiss et al. (2015).
10. U.S. Government Accountability Office (2007); Pub. L. No. 111-226 (2010).
11. U.S. Government Accountability Office (2007).
12. Pew Charitable Trusts (2015).
13. Cramer, King, Schreur, and Sprague (2014).
14. U.S. Department of the Treasury (2015).

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