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Do EITC Recipients Use Tax Refunds to Get Ahead? New Evidence from Refund to Savings

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The Earned Income Tax Credit (EITC) is a refundable tax credit that helps meet the needs of many low- and moderate-income (LMI) households in the United States.[1] Many U.S. households lack emergency savings for unexpected expenses and financial shocks.[2] Understanding what EITC recipients do with their tax refunds is important for guiding federal policy aimed at promoting financial stability among LMI households. In this brief, we summarize findings on the use of tax refunds by EITC recipients in the Refund to Savings (R2S) initiative. We also examine the use of financial services for saving refunds and the financial shocks experienced by EITC recipients during the 6 months after tax filing.

Background

The R2S initiative involves a series of randomized controlled trials to study the effects of behavioral interventions that promote saving at tax time among LMI tax filers who use Intuit's online TurboTax Freedom Edition to file their federal returns.[3] The data used for this brief come from (a) electronic records captured by Intuit when study participants filed their federal income-tax returns during the 2013 tax season and (b) from two waves of the Household Financial Survey (HFS) conducted in 2013: a baseline survey conducted shortly after tax filing and a follow-up survey conducted 6 months later.

Better understanding how and the circumstances in which EITC filers use their refunds may inform policies aimed at increasing the financial security of LMI households. Prior research has found that EITC recipients prefer lump sum refunds over advance refund payments and see the lump sum as an aid in exercising self-control: Many view refunds as a way to accumulate money to help pay for periodic household needs.[4] Other research has found that EITC recipients use their refunds for a variety of purposes, including to support consumption, pay outstanding bills, reduce debt, and save.[5]

It is noteworthy that EITC recipients save a small portion of their refund for months after filing their return, yet they save less than they intended.[6] One study has indicated that recipients perceive the EITC as a means of reducing financial stress, increasing consumption, improving economic mobility, and enhancing social inclusion.[7]

» The average EITC was $2,191 among 2013 R2S participants who were eligible, yet these participants had far greater credit card debt—$5,000, on average

» More than a third of EITC recipients in the 2013 R2S experiment lacked savings accounts, and only 8% used direct deposit to move their refund into savings

This brief makes an important contribution to EITC research by offering details on the financial behavior and experiences of a large sample of EITC recipients. It also provides context for those details, elaborating recipients' perspectives at tax time and 6 months later. This enhanced understanding can help policymakers and practitioners better leverage tax time in their efforts to promote emergency saving among LMI households.

Characteristics of R2S Participants Who Received the EITC

Approximately 680,000 tax filers participated in the 2013 R2S experiments, 41% of these (355,946) qualified for the EITC, and the average EITC received was $2,191. The mean amount of credit card debt reported by EITC recipients was $5,082. Although few of the recipients were unbanked (7%), more than a third (34%) lacked a savings account and only 8% asked the Treasury to direct deposit their refund into a savings account.

Among R2S participants who received the EITC and completed an HFS in 2013 (*n* = 3,569), the average age was 37 years; it was 33 years among counterparts who did not receive the EITC (*n* = 4,086). Average gross income was $18,314 among EITC recipients and $17,590 among nonrecipients. Given the eligibility rules for the EITC, it is not surprising that recipients were more likely than nonrecipients to choose head of household (40% vs. 2%) or married filing jointly (28% vs. 6%) as the filing status. Recipients were less likely to file as single (33% vs. 91%) and less likely to claim dependents (67% vs. 3%).

Use of Refunds

Prior research has shown that EITC recipients use their refunds in multiple ways.[8] As Figure 1 illustrates, participants in the 2013 HFS were more likely to pay down debt (e.g., credit card balances) or support consumption with the refund than to save it. Compared with those who did not receive the EITC, EITC recipients in the 2013 HFS were more likely to pay down debt and less likely to save the refund. There are few differences between the planned use that EITC recipients reported at tax time and the refund's actual use, which they reported 6 months after filing. However, recipients used more of their refund to pay down debt than they had planned and used less than planned for spending on consumption (see Figure 2).

The data on debt payments show that it is important to examine the types of debt paid down by EITC recipients. Payments on secured debt, such as car and home loans, help reduce principal amounts owed and may increase an individual's equity. Conversely, payments on unsecured debt, such as credit card debt, only reduce liabilities. Most of the debt payments made by EITC recipients reflect a pattern of "catching up" on short-term, consumption-based liabilities (see Figure 3). This is not surprising because the average credit-card debt held by recipients is more than $5,000.

Spending

Reflecting trends observed in prior research, Figure 4 shows that EITC recipients used their refund to pay for basic necessities: 78% spent some of the refund on food and/or housing, and 66% spent some of the refund on other needs like clothing, shoes, and/or school supplies. A sizeable percentage also

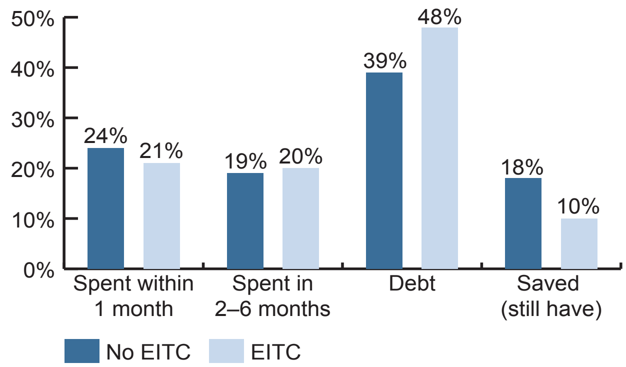

Figure 1. Use of refunds by 2013 HFS participants, reported 6 months after filing. *Note*: HFS = Household Financial Survey. The figure illustrates uses by Earned Income Tax Credit recipients (*n* = 3,569) and nonrecipients (*n* = 4,086).

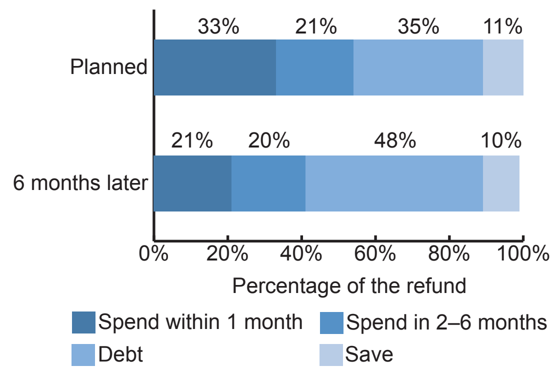

Figure 2. Planned and subsequently reported use of refunds among EITC recipients with data from both 2013 HFS waves (*n* = 3,280). *Note:* EITC = Earned Income Tax Credit. Actual uses of refunds were reported 6 months after tax filing.

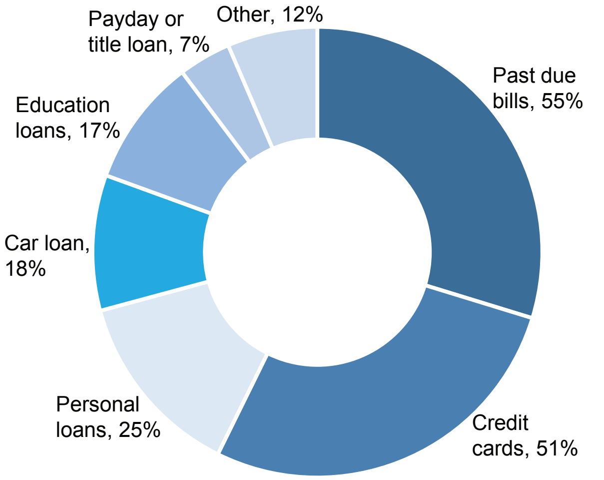

Figure 3. Types of debts repaid with refunds, by percentages of EITC recipients in the 2013 HFS who put any of their refund toward debt (*n* = 2,703). *Note:* EITC = Earned Income Tax Credit; HFS = Household Financial Survey. Percentages do not round to 100% because recipients could state more than one type of debt payment.

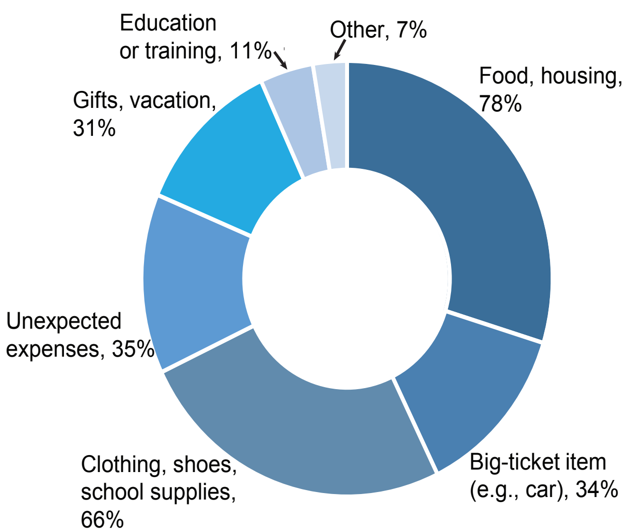

Figure 4. Expenditures of refunds by percentages of EITC recipients in the 2013 HFS who reported spending any of the refund (*n* = 2,572). *Note:* EITC = Earned Income Tax Credit; HFS = Household Financial Survey. Percentages do not round to 100% as recipients could state more than one type of expenditure.

reported spending the refund on big-ticket items like furniture. The overall pattern suggests that recipients allocate their refunds carefully, meeting essential needs that they may have difficulty addressing with regular income. A majority (63%) of recipients ranked basic necessities like food, clothing, and housing as the types of expenses on which they spent most of their refunds.

Saving and Use of Financial Services

Six months after filing their tax returns, only 10% of EITC recipients in HFS follow-up wave (*n* = 3,280) reported that they retained some of their refund as savings. Of those reporting some savings at the follow-up, most (65%) indicated that they held it in a regular savings account, and a third said that they used a checking account. Those who used a checking account may not have a savings account or may prefer to have just one account, mentally identifying a portion of the account's funds as savings. Very few recipients saved in a long-term, asset-oriented vehicle such as a retirement- (4%) or education-savings account (1%).

Data from the 2013 HFS reveal that respondents also looked outside of mainstream financial services to conduct transactions. Use of alternative financial services was common in the 12 months prior to filing tax returns. Nearly a third (29%) of EITC recipients purchased money orders at locations other than credit unions or banks. Almost a quarter (23%) used pawn shops, and 14% used payday loans and check cashing services. Credit cards were another high-cost financial service reported by respondents in the HFS, which tracked credit card debt as well as the interest rate charged on debt from respondents' highest-rate card. Among EITC recipients in the 2013 HFS follow-up, the average rate paid for debt on the highest interest-rate card was 20%. These results suggest that saving is limited among EITC recipients and that use of high-cost financial services is common. Opportunities to build assets are rare and seldom seized.

Changes in Financial Circumstances

Data from the 2013 HFS detail the experiences of EITC recipients in the 6 months following tax filing, showing that financial shocks made it difficult for many to retain substantial portions of their refunds as savings (see Figure 5). Between tax filing and the 6-month follow-up, recipients' (*n* = 3,292) liquid assets increased on average by only $364 (the median increase was $30). Although some recipients were able to increase their liquid holdings, four in 10 spent down their liquid assets.

Conclusion

Using data from the R2S initiative, this brief examines the financial characteristics, behaviors, and experiences of EITC recipients, describing the immense challenges that impede saving and

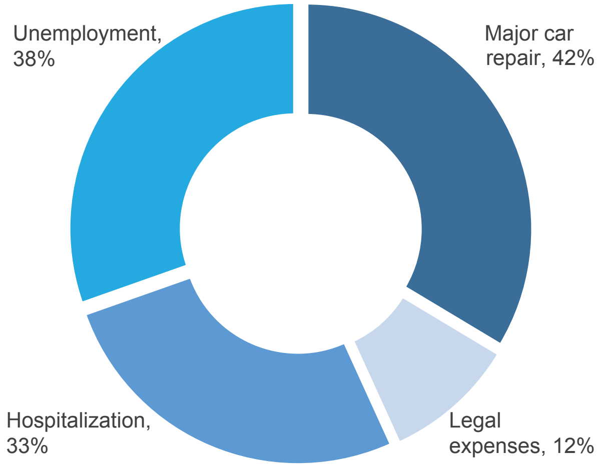

Figure 5. Financial shocks among EITC recipients in the 6 months following tax return filing in 2013 (*n* = 3,524). *Note:* EITC = Earned Income Tax Credit. Percentages do not round to 100% as recipients could report more than one type of shock; unemployment means a household member experienced a period of unemployment.

asset building in their households. Because these households have high levels of unsecured debt relative to their very limited incomes, paying down debt is a principal use of refunds.

The findings also provide support for the idea that EITC recipients are struggling to make ends meet. Many use refunds to meet basic needs and purchase important fixed assets. This makes it difficult to retain savings for longer periods of time and for longer-term purposes, particularly if they have weathered a financial shock. Paying down debt has a positive impact on household balance sheets but also affects the ability to allocate the refund for other purposes. Thus, difficulty in saving leaves households vulnerable to material hardship, continued use of high cost financial services, and reliance on credit. Those vulnerabilities are particularly acute among households that receive the EITC.

Despite these findings, it is important to note that 10% of EITC recipients in R2S still hold some of the refund in savings after 6 months. This suggests EITC recipients want and are able to save. It also suggests that they could increase saving and asset accumulation if given the right opportunities. These opportunities include tax-time savings initiatives like R2S and SaveUSA, prize-linked savings, and product innovations like *my*RA.

The evidence presented in this brief clearly suggests that EITC recipients face considerable obstacles in using federal tax refunds to build emergency savings and other assets to get ahead. Treading water, these households use refunds to repay debt and meet consumption needs, investing little for their longer-term financial security. Thus, policymakers should recognize that the EITC supports consumption in LMI households but has limited utility as a means for saving and asset building. Recipients of the EITC and LMI households in general need other incentives and institutional supports to accumulate assets. In particular, they require supports that can boost assets in ways that will increase future income and net worth, thereby promoting economic mobility.

Acknowledgments

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Lastly, we thank the thousands of taxpayers who consented to participate in the research surveys and shared their personal financial information.

Disclaimer

Statistical compilations disclosed in this document relate directly to the bona fide research of and public policy discussions concerning the use of the IRS “split refund” capability and promotion of increased savings in connection with the tax compliance process. All compilations are anonymous and do not disclose cells containing data from fewer than ten tax returns. IRS Reg. 301.7216

End Notes

1. Mendenhall et al. (2012).
2. Babiarz and Robb (2014); Board of Governors of the Federal Reserve System (2015); McKernan, Ratcliffe, and Vinopal (2009); Pew Charitable Trusts (2015).
3. Grinstein-Weiss et al. (2015).

4. Romich and Weisner (2000).
5. Halpern-Meekin, Edin, Tach, & Sykes (2015); Mendenhall et al. (2012); Shaefer, Song, and Williams Shanks (2013); Sykes et al. (2015).
6. Mendenhall et al. (2012); Spader, Ratcliffe, and Stegman (2005).
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