



TAX TIME—THE RIGHT TIME: Federal Policy Recommendations to Help all Americans Save and Build Assets

By Anne Stuhldreher, Senior Research Fellow, Asset Building Program

EXECUTIVE SUMMARY

Last tax season the IRS sent refund checks averaging \$2,057 to 100 million tax filers. These cash infusions are often the best chance people have to save some money in any given year. This is particularly true for lower income families. Over 20 million lower income families—one in six taxpayers—received an average \$1,700 boost to their refund from the Earned Income Tax Credit (EITC), a refundable tax credit designed to reward work.

While tax refunds are certainly valued by American families, an enormous opportunity is being missed. Many families may spend rather than save their refunds because they do not have an easy way to convert a portion of these tax windfalls into savings and appreciating assets. Recent research finds that many Americans—including lower income ones—can and will save their refunds if offered appropriate incentives and a clear way to do so. The key challenge for policymakers is to facilitate and incentivize savings of tax refunds into existing—and possibly new—savings products. And for the estimated 8.4 the million Americans who do not have bank accounts, tax time is an opportunity to help them open accounts to receive their refunds electronically, to take their first step to enter the financial mainstream, and begin to save.

While non-governmental and financial institutions play key roles, this paper focuses on what can be done by Congress, the IRS and the U.S. Treasury Department to enable more lower-income Americans to convert their refunds into savings. The following table summarizes these recommendations:

Policy Objectives	Recommendations
1) Use tax returns to connect tax refunds to savings products.	<ul style="list-style-type: none"> • Encourage the IRS to allow tax refunds to be split among three accounts. • Provide a matching deposit if a low-income taxpayer saves part of their tax refund in a targeted savings account. • Allow parents to save in a newly created “Children’s Savings Account.”
2) Help unbanked households open checking and savings products through the tax filing process.	<ul style="list-style-type: none"> • Enable people to open various savings accounts directly on their income tax forms. • Make Electronic Transfer Accounts (ETAs) available to all low-income tax filers. • Allow filers to purchase savings bonds with part of their tax refunds. • Provide free web-based tax preparation software to tax filers. • Strengthen Community Reinvestment Act (CRA) service test to encourage more retail banking activities.
3) Strengthen the existing Savers Credit.	<ul style="list-style-type: none"> • Make the credit refundable. • Extend and smooth the phase out rate. • Make the credit permanent.
4) Set goals and performance measures for the IRS to promote savings amongst tax filers.	<ul style="list-style-type: none"> • Increase the number of tax returns that are sent by direct deposit to tax filers’ bank accounts. • Increase the percentage of tax filers that open IRAs as part of the tax filing process and/or deposit refunds into IRAs.
5) Revise asset limits in public assistance programs.	<ul style="list-style-type: none"> • Revise the asset limits for relevant federal benefits so that they do not discourage saving.

INTRODUCTION

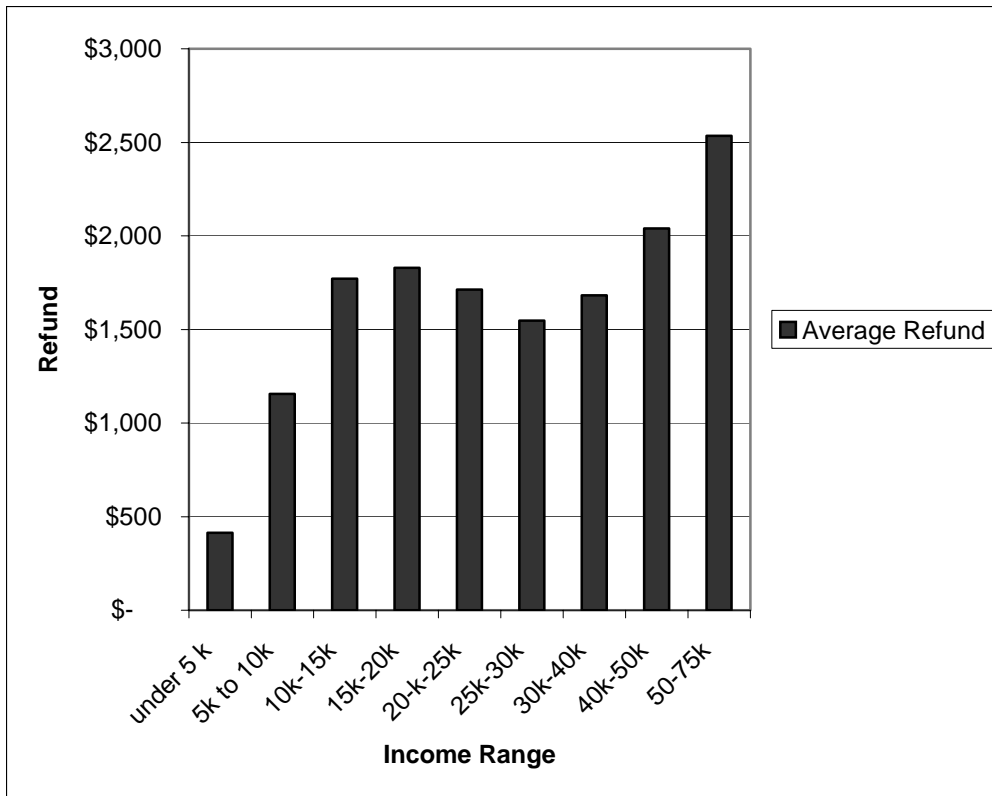
Last tax season the IRS sent refund checks averaging \$2,057 to 100 million tax filers.¹ These cash infusions are often the best chance people have to save some money in any given year. While tax refunds are certainly valued by American families, an enormous opportunity is being missed. Many families may spend rather than save their refunds because they cannot easily convert a portion of these tax windfalls into savings and appreciating assets. Recent research indicates that many Americans—including lower income ones—can and will save their refunds if offered clear way to do so and appropriate incentives.² The key challenge for policymakers is to facilitate and incentivize savings of tax refunds into existing—and possibly new—savings products.

This issue brief will provide policy recommendations to help people use their tax refunds to increase their level of savings. Many of these recommendations can help Americans at all income levels to save. However, the analysis focuses on the segment of lower income tax filers who currently may not save but could, because of sizeable refunds attributable to the Earned Income Tax Credit (EITC), a fully refundable tax credit, and the Child Tax Credit (CTC), a partially refundable tax credit.

The brief has four parts. First, an overview of tax refunds is provided with a focus on how refundable tax credits increase tax refunds for lower income people. Second, a discussion follows on what prevents lower income people from saving and converting their tax refunds into appreciating assets. Third, a summary is given of community programs and research that indicates lower income people can and will save part of their tax refunds. And finally, federal policy recommendations are proposed that will encourage people to save and invest their refunds.

I. INCOME TAX REFUNDS: WHO GETS HOW MUCH?

Historically, about seventy-seven percent of tax filers receive refunds. The size of their refund is affected by the tax filer's tax rate, exclusions and deductions claimed to reduce their taxable income, credits claimed to cut the actual tax bill, and the amount of tax regularly withheld from their paychecks. The average tax refund increased \$97 to \$2,292 for the 2003 tax year.



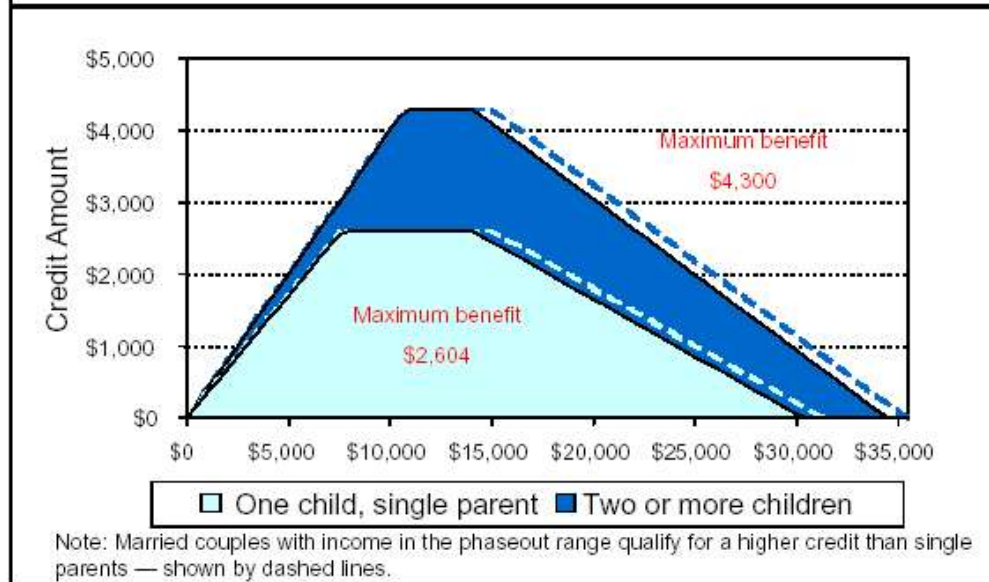
Source: Campbell and Parisi 2003.

For Americans who earn from \$30,000 to \$50,000 annually, average tax refunds range from \$1,700 to \$2,000. For lower income Americans, whose incomes range from \$10,000 per year to \$25,000, refunds average \$1800. The refund amounts are higher than would be anticipated for lower income Americans partially because of their ability to receive two tax credits, the fully refundable EITC and the partially refundable CTC. Since these credits are refundable to a degree, they can eliminate the taxes an individual owes and still provide him with a refund, even if his tax liability is zero. For example, a low-income parent may only owe a few hundred dollars in taxes and could still receive an EITC refund of a few thousand dollars.

The Earned Income Tax Credit (EITC)

The EITC is designed to reduce the tax burden on low-income workers, supplement their wages, and encourage work. People earning up to \$35,458 can claim the EITC for the 2004 tax year. The credit is aimed mainly at parents with children under the age of 19. People with children and lower incomes—between \$10,500 and \$14,000—can receive the largest credits, up to approximately \$4,300. The credit amount initially increases with earnings, reaches a plateau, and decreases with each additional dollar earned. Low-income workers without children can get a small credit of a few hundred dollars.

The Federal Earned Income Tax Credit in Tax Year 2004



Source: Joseph Llobrera and Bob Zahradnik (2004). *A Hand Up: How State EITCs Help Working Families Escape Poverty in 2004*. Washington, DC: Center on Budget and Policy Priorities.

For tax year 2002, the average credit size was \$1,747. After adjusting for inflation, the average EITC has remained steady since 1997.³ For the tax year 2001, tax filers with adjusted gross incomes (AGIs) of \$15,000 or less received 67 percent of EITC dollars and 77 percent of refundable EITC dollars.

The EITC is now the largest of federal programs to help the non-elderly poor and removes more children from poverty than any single federal program. Furthermore, recent studies have shown that the EITC effectively increases the work efforts of low-income families.⁴ In particular, the EITC has been found to increase work participation among single parents.⁵ By helping low-income workers retain enough earnings to stay off of welfare, the EITC also reduces welfare dependency.⁶

For 2004, the federal government estimates that the EITC will decrease incoming taxes by \$5 billion (the effect on receipts) and that it will pay out \$33.5 billion in EITC refunds (the effect on outlays). Spending on the EITC has increased 900 percent since its inception in 1976 while spending for Aid to Families with Dependent Children (AFDC)/Temporary Assistance for Needy Families (TANF)—the former and current federal cash welfare programs—has grown more slowly, just 32 percent since 1976.⁷

Child Tax Credit (CTC)

The CTC was created in 1998 to help offset the costs of raising children. Eligible tax filers can reduce their tax bill by up to \$1000 for each qualifying child. Eligibility begins to phase out at \$75,000 for single head of households and at \$110,000 for married couples filing jointly. In 2001, twenty-six million families claimed \$24.3 billion in CTC refunds. Seventy-six percent of CTC expenditures go to families making more than \$30,000 a year. In contrast, almost 100 percent of the benefit of the EITC goes to individuals making less than \$35,000 per year.⁸

The CTC is partially refundable. Tax filers that have any CTC remaining after their income tax liability has been eliminated may receive a refund of the lesser of two amounts: (1) the amount of the tax filer's CTC that remains or (2) ten percent of the individual's earned income over \$10,500.

In response to the complexity of the calculating the refundable portion of the CTC, the Center for Budget and Policy Priorities describes several scenarios for potentially eligible individuals in its publication entitled *Facts About the CTC: Tax Time Can Pay Even More For Working Families*:

Maxine is a single parent with a 13 year-old child. She earned \$15,000 in 2003 and owes \$190 in income tax. Her maximum CTC of \$1,000 is first used to eliminate her income tax, leaving \$810 of it remaining ($\$1,000 - \$190 = \810). Ten percent of Maxine's earnings over \$10,500 is \$450. Maxine is eligible to receive a CTC refund for the lower amount, or \$450. She is also eligible for an EITC of \$2,344, bringing her total refund to \$2,794.⁹

For the CTC, \$7.4 billion will be paid out to eligible families in 2004 after their tax liability is reduced to zero. For 2004, the credit will decrease taxes that otherwise would be owed to the federal government by \$38 billion. Like the EITC, expenditures for the CTC have grown faster than those for TANF. The CTC has grown 66 percent since it began in 1998, as opposed to a 32 percent increase in TANF since 1976.¹⁰

II. WHY DON'T LOWER-INCOME PEOPLE SAVE THEIR TAX REFUNDS?

It is a common misperception that low-income people simply do not make enough money to save. While millions of Americans at all income levels do not save adequately, the degree to which people save is influenced by factors beyond income. People also save in response to institutions and structures. In fact, as discussed below, research indicates that a segment of the low to moderate income population can and will save if the opportunity is well facilitated and they have incentives to do so. There are a number of factors explain what prevents many lower income people from saving their tax refunds.

1) There are few support structures in place that encourage lower-income people to save.

Americans save when it happens automatically, requires little effort, the savings opportunity is well structured, and/or they have incentives to do so. For example, people are more likely to save who have money regularly and automatically taken out of their paychecks and deposited in 401(k) plans—which enjoy tax incentives and possibly matching incentives from their employers.¹¹ Presently, only about half of all workers—the vast majority of them higher-income—have an employer-provided retirement plan. Currently, refunds cannot be directly deposited in such plans. Moreover, 1999 data show that only 10 percent of tax benefits for retirement savings reach households earning \$50,000 or less per year.

2) Many low-income tax filers may not have a safe place—such as a checking or savings account—where they can save their refunds.

Only 35 percent of EITC filers receive their refunds by direct deposit into checking or savings accounts,¹² which suggests that a high number may not have accounts. In fact, twenty-two percent of low-income families in general—over 8.4 million families earning under \$25,000 per year—are “unbanked,” meaning they lack a basic checking or savings account, and have no or limited relationships with providers of mainstream financial services.¹³ Banks often avoid low-income communities. And lower-income people often avoid banks because they find their savings and checking products unappealing—due to high fees, mandatory minimum balance requirements, and other restrictions. Stated simply, low-income people will be hard pressed to develop savings and assets if their financial services needs are met through check cashers, pay day lenders, and other “alternative” financial services providers. But bank accounts provide a low-cost, quick, and safe way for people to get and store their refunds in the short term. And in the long-term, a checking or savings account will help the unbanked to begin a meaningful relationship with a financial institution, which in turn can provide them access to additional opportunities to save and accumulate assets.

3) Highly priced Refund Anticipation Loans (RALs) and tax preparation services can siphon off dollars that could be saved.

Over two-thirds of EITC filers pay someone or some institution to complete their returns,¹⁴ most likely because the instructions for the EITC are very complex. Furthermore, for the 2001 tax year, 43 percent of EITC filers took out a Refund Anticipation Loan against their refund.¹⁵ These short-term, high-cost loans secured by and repaid from a consumer's tax refund allow people to receive their refunds in as quickly as one to two days. An estimated

\$1.75 billion in EITC refunds in 1999 were paid to tax preparers, who, in addition to national chains such as H&R Block and Jackson Hewitt, include a highly fragmented array of individuals that set up shop each tax season. A tax filer getting an EITC refund of \$1,500 can spend, on average, more than ten percent of it on tax preparation, electronic filing, and a refund loan.¹⁶

4) For many filers, refunds are already “spent” before they are received.

Not surprisingly, many people have pressing bills or credit card debts that absorb all of their refund and leave little left over to save. For many low-income families, the EITC is an indispensable resource to make ends meet and pay down debts. These pressing needs often inhibit families from saving as much of their refund as they might like. According to a 1999 study, bill paying was the single highest priority use of the EITC for almost one-half of all recipients. Forty-eight percent said they would use the EITC to pay for rent, utility bills, food or clothing.¹⁷

Furthermore, many EITC filers are struggling to pay down credit cards. In the 1990s, credit card debt increased 53 percent, with 76 percent of families at all income levels holding credit cards with average debt load of \$4,126.¹⁸ For lower income families, those earning less than \$10,000, credit card debt grew an astonishing 184 percent, raising their average household debt to \$1,837. For families making between \$10,000 and \$25,000, their average household credit card debt is \$2,200, a 42 percent increase between 1989 and 2001.

5) EITC filers may fear they will lose other benefits if they save their refunds.

Many state and federal means-tested program, such as TANF, Medicaid, and Supplementary Security Income (SSI), link eligibility to asset limits. To receive some benefits, people are not allowed to have more than a few thousand dollars in savings. These asset tests work as savings disincentives and their complexity often confuses benefits recipients. In most states, the EITC is not counted as additional income to determine eligibility for TANF benefits. It is, however, counted as savings toward asset limits approximately two months after it is received for TANF, Medicaid and SSI.¹⁹ Rules vary by benefit, but many filers may decide not to save their refund just to play it safe. One researcher suggests that many EITC filers may spend down their refunds for this reason.²⁰ Many states are experimenting with raising or eliminating asset tests.

III. WILL LOW-INCOME PEOPLE SAVE THEIR REFUNDS?

Despite these obstacles, recent initiatives by community groups and companies demonstrate that low-income people will save their refunds, if they are offered financial products and services that are simple, affordable, and well-structured.

Three of the most notable efforts include:

1) Refunds to Assets. Tulsa, Oklahoma. For the 2003 Tax Season, Doorways to Dreams Fund and Community Action Project of Tulsa County offered EITC filers the opportunity to split their refunds—some could be put away in a savings account and the rest would come back in a refund check for their immediate needs. Currently, tax filers have one choice: the entire refund must be directed to one place in a lump sum. By making it easier for EITC filers to save right on their tax forms, to split their refunds into money to save and money to spend, substantial new savings resulted. Of the approximately 516 people with average incomes of \$13,440 who were offered the opportunity, about one-third wanted to participate. According to researchers at the Harvard Business School and the University of Kansas, people deposited \$606 on average—47 percent of their refunds—into savings accounts. Seventy-two percent of these individuals had no prior savings. Assuming a similar take-up rate to the one in Tulsa, this simple change to the tax filing process could generate up to \$4 billion in savings amongst EITC filers nation wide—at no cost to taxpayers.²¹

2) H&R Block. Express IRAs. H&R Block, which provides tax preparation assistance to approximately one in four EITC recipients, recently introduced several products to help lower income people to save. The company now offers Express IRAs, low cost savings vehicles that require a minimum investment of only \$300. Over 245,000 clients with no prior savings accounts have saved over \$140 million in these new IRAs.

3) Community Food Resource Center Free Tax Preparation Program. New York City. For the 2002 tax season, the Community Food Resource Center provided free tax preparation services to 8,600 low-income New Yorkers. The Center partnered with banks and credit unions to offer no cost savings accounts to the 35 percent of their filers who lack checking and savings accounts. Twenty-seven percent of these unbanked tax filers opened accounts and deposited refunds that averaged \$1,200. Four months after tax season ended, over two thirds of the filers (whose accounts were still being tracked) still had their accounts open, with an average balance of \$255.

Other research findings also suggest that low-income people can save more of their tax refunds if given access to incentives and institutional support structures. Researcher Timothy Smeeding examined how EITC filers use their refunds to make ends meet and improve their social mobility. In his 1999 study of 826 EITC filers surveyed in Chicago, he found almost half (49 percent) stated that they wanted to save some or all of their refund. People confirmed that they wanted to use their refunds for both short and long-term goals, with a stronger preference for long-term goals. More than 80 percent said they were saving for longer-term goals such as buying a car, home, or education for themselves or their children.²²

Additional analytical work found that people may view their lump sum refunds more as assets than income, and therefore may be more willing to save them.²³ People may think about their refunds differently than their wages and may consider saving them for a variety of purposes. For this reason, ninety-eight percent of EITC filers forgo the EITC advanced payment option—where filers could get part of their refund in advance (up to \$86 per week) in their weekly paycheck—because they want to be “forced” to save.

IV. POLICY RECOMMENDATIONS

Several bills are pending in the US Congress to make the EITC and CTC stronger resources for working families. These proposals would help more people obtain the EITC and the CTC, develop better-priced alternatives to Refund Anticipation Loans and curb their spread, and protect the rights of lower income taxpayers. Other institutions—including the National Community Tax Coalition, the Center for Budget and Policy Priorities, and the Consumer Federation of America—are taking the lead in advancing these bills and efforts. These efforts deserve strong support.

The recommendations here aim to help tax filers convert their refunds into savings and appreciating assets; they are listed under the following five separate action areas:

1. Use tax returns to connect tax refunds to savings products.
2. Help unbanked households open checking and savings products through the tax filing process.
3. Strengthen the existing Savers Credit to make it refundable and permanent.
4. Set goals and performance measures for the IRS to promote savings amongst tax filers.
5. Revise asset limits in public assistance programs.

1) Use tax returns to connect tax refunds to savings products

- ***First and foremost, encourage the IRS to allow tax refunds to be split among three accounts.*** Every year the IRS sends out refund checks averaging \$2,300 to 130 million-plus taxpayers. Right now, taxpayers have one choice: the entire refund comes back in one lump sum. If it is easier for people to save right on their tax forms, to split their refunds into “money to save” and “money to spend,” people will save more, perhaps much more.

When a tax filer learns that she’s getting a \$2,000 refund, she should be able to use her income tax form to direct \$500 to her IRA or savings account and put the remainder in her checking account. She should be able to make these choices before her refund money is in hand and spending temptations are too hard to resist.

Under this proposal, people could deposit their refund into IRAs, 529 College Savings accounts or a variety of other savings accounts. By allowing people to split their refunds into three accounts, married couples filing jointly could divide their refunds between a checking account for immediate consumption, and one tax-

preferred savings vehicle for each spouse. Research has indicated that even low-income tax filers, those who few expect to save but have the most need to do so, would use this “splitting” option to save more.

The IRS committed in their budget to make this change. No legislation is required for them to do so. Appropriate political pressure should be applied to make this idea a priority for next tax season.

- ***Provide a matching deposit, up to \$500 per year, if a low-income taxpayer saves a portion of their tax refund in a targeted savings account (such as a 529, Roth IRA, or any tax-preferred savings account).*** If a low-income taxpayer were willing to set aside up to \$500 of their tax refund in an after-tax savings product they would be eligible for a one-to-one federal match, not to exceed \$500 per year, which would be directly deposited by the government into that account. This matched IRA could be justified as providing EITC recipients with similar opportunities for tax-favored savings enjoyed by higher income workers. While legislation would be necessary to provide the matching deposit, no new refundable tax credits, and no new financial products would be required.
- ***Allow parents to save in a newly created “Children’s Savings Account (CSA).”*** Parents who wish to begin saving for their children’s futures could do so in this account which could be created with a slight modification to Roth IRA rules to put an account in the name of a child with a parent as a custodian. Under no circumstances could the money be accessed prior to age 18, at which point it automatically converts into a standard Roth IRA with all of its applicable rules and restrictions—including tax- and penalty-free withdrawals for post-secondary education and first-home purchase. If a low-income parent or guardian diverts a portion of their tax refund into a CSA, that contribution would be eligible for a government-provided match not to exceed \$500 per year. Legislation would be required to authorize the CSA and matching funds but, no new refundable tax credits would be necessary.

2. Help unbanked households open checking and savings products through the tax filing process.

The tax system can be a gateway to the financial system. Owning a checking or savings account is the first step into the array of mainstream financial services, which enable people to save and build assets. The tax filing process offers an opportune time to help millions of un-banked individuals take this first step, open accounts, and receive their refunds electronically, the quickest and cheapest way to receive them. And lower income people could be assisted over one of the most formidable barriers to entering the financial mainstream: the minimum account balances required by financial institutions to open accounts.

There are a variety of ways to help the unbanked open accounts through the tax filing process.

- ***Enable people to open bank accounts, IRAs, and College Savings 529 plans directly on their income tax forms.*** With a check of a box, filers could open a checking, savings, or IRA account directly on their tax forms.

The IRS could achieve this goal in a few possible ways. Through a RFP (Requests for Proposals) process, the IRS could contract with one or more national financial institutions to provide low-cost, quality accounts. Or, the IRS could create and maintain a web-based directory of financial institutions that open low or no cost accounts online for tax filers. The directory’s URL address would be printed on all tax forms and would be searchable by zip code. When an individual is completing their tax forms—either by themselves or with a free or paid preparer—the filer’s zip code would be entered into the directory to obtain a list of area banks and/or other financial institutions that open low cost accounts online. The individual could then open a checking, savings, and/or IRA to receive their refunds. Financial institutions would be free to list any accounts that they consider “low cost.” The IRS’s role would not be to judge what accounts are low cost or not, but rather to be a “connector” between the supply of low cost accounts and the demand of consumers, in this case tax payers. The Taxpayer Abuse and Prevention Act (S 2947/HR5340) would provide low and moderate income taxpayers with the opportunity to open a low-cost bank account on their tax forms in which their refund could be deposited. This legislation, introduced in the House and the Senate in the Fall of 2004, aims to guard EITC recipients against predatory loans such as refund anticipation loans and expand opportunities for them to join the financial mainstream and facilitate saving.

The state of Missouri created a similar directory so TANF recipients could search for local banks that provide low or no cost accounts to receive their TANF checks by direct deposit. The state undertook this reform when the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA) mandated that all states convert food stamp benefits from paper coupons to Electronic Benefits Transfer (EBT) systems by 2002. Ideally, a similar federal directory could create a sense of competition amongst financial institutions that would compete to receive taxpayer refunds, which average \$2,300, well above the required minimum balance for most accounts.

- ***Make Electronic Transfer Accounts (ETAs) available to all low- income tax filers.*** ETAs are low-cost accounts for recipients of Federal payments such as Social Security and Veterans' benefits. The U.S. Department of the Treasury designed the ETA for individuals to receive *recurring* Federal payments electronically and easily. EITC refunds, since they are a one time "payment," are not an eligible use. Congress should reform ETAs to allow them to be opened for EITC filers so that their refunds can be directly deposited into these low cost accounts. The Taxpayer Abuse and Prevention Act also proposes this expanded use of ETAs.
- ***Allow filers to purchase savings bonds with part of their tax refunds.*** People do not need accounts to buy savings bonds. Ideally, they would be able to use part of their refund to purchase savings bonds directly on their tax form. The process to buy savings bonds is relatively simple, but could be made even easier for savers. Peter Tufano, a professor at the Harvard Business School and a founder of the Doorways to Dreams Fund, recommends that the rules governing savings bonds be changed to make them more useful for asset building by low-income families. For example, the bond holding periods could be shortened for smaller denominations; people could be allowed to exit the bonds in case of emergency; the interest rate could increase the longer they are held, etc.²⁴ Furthermore, this proposal could allow low-income individuals to accumulate the savings to meet minimum the balance requirements in IRAs.
- ***Provide free web-based tax preparation software that helps tax filers complete their returns, open appropriate savings and tax preferred accounts, and develop a plan for long-term financial aspirations.*** Currently, the IRS does not provide its own tax preparation software to the public. In 2002, the IRS entered into a three-year agreement with a group of private computer-software companies—the Free File Alliance--to provide free electronic filing for at least 60 percent of all taxpayers who file individual tax returns. Many of these companies then market Refund Anticipation Loans and other products to these individuals who are seeking a free service. Fee-maximization--rather than the individual's long-term financial future--is the main concern of many of these companies.

When this agreement expires, the IRS could develop public tax preparation software that could offer a user-friendly, non-commercial, free service for people to file their returns online and—through a series of interactive questions—help people to save and plan for their futures. Since there's a compelling public interest to increase the national savings rate and the tax preparation process provides a natural gateway to get people saving, the IRS should have its own free service along side the private services.

If this recommendation is politically unfeasible, given Congress's strong statement that they do not want the IRS to compete with private tax preparers, the Service should make changes to the free tax preparation services provided by the Free File Alliance, so that 1) the free services are easier for eligible tax filers to access and navigate; 2) the marketing of Refund Anticipation Loans is limited; and 3) options to open IRAs online are included.

- ***Strengthen Community Reinvestment Act (CRA) service test to encourage more retail banking activities.*** Created in 1977, the Community Reinvestment Act is intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound banking operations. Strengthening the service portion of the test could create greater incentives for banks to open accounts for EITC filers and other lower income consumers. Banks are examined by regulators and receive "grades" in three areas: lending, investment, and service. According to analysis conducted by Michael Stegman of the University of North Carolina's Center

for Community Capitalism, the service test, which measures a bank's delivery of retail banking and community development services, is administered subjectively and is considered to be an "easier" part of the test than the lending and investment tests, which are more rigorous and performance-based. Stegman suggests several reforms to make the service test more performance-based, including developing specific standards and benchmarks for retail banking services.²⁵

3. Strengthen the existing Savers Credit to make it refundable and permanent.

The 2001 tax bill (EGTTRA) authorized a voluntary individual tax credit—the Savers Credit—to encourage low-income workers to contribute to existing retirement products (IRAs, 401Ks, SIMPLEs, etc.) Individuals with adjusted gross incomes below \$50,000 can receive a tax credit equal to 10%, 20%, or 50% of the first \$2,000 in retirement account contributions made each year. However, because the credit is not refundable, and because it offers a modest matching contribution for those above a very low-income threshold, it benefits only a small proportion of those technically eligible.

In an April 2004 paper entitled "The Savers Credit: Issues and Options" William Gale, Mark Iwry and Peter Orszag suggests five ideas to improve the credit: (a) make it refundable; (b) instead of a 50 percent credit that phases down to 20 percent and then 10 percent for joint filers with Adjusted Gross Incomes (AGI) over \$30,000, the 50 percent credit should be expanded to cover joint filers with significantly higher incomes within the middle income range, for example, up to \$60,000, phasing out at about \$70,000 to \$75,000;²⁶ (c) the phase-down of the credit should be smoothed, to resemble the phase-down of IRA eligibility by income, instead of the "cliffs" now in effect; (d) instead of sun-setting after five years (in 2006), the savers credit should be made permanent; and (e) the credit should be indexed to inflation.

Furthermore, the highest match rate for the Savers Credit should be correlated with the EITC eligibility thresholds. This would facilitate marketing and public education efforts to promote the credit. Finally, tax preparers should be encouraged and/or required to explain the amount of credit lost if the taxpayer doesn't save part of their refund.

4. Set goals and performance measures for the IRS to promote savings amongst tax filers.

The Treasury and IRS should develop performance measures and track progress toward goals to: (a) increase tax returns that are sent by direct deposit to tax filers' bank accounts; and (b) increase the percentage of tax filers that open IRAs and or deposit into IRAs as part of the tax filing process or deposit refunds into IRAs. Through their Annual Performance Plan, the IRS has a set of performance goals to help gauge their success in providing taxpayers assistance and education. They have a goal to have 44% of returns filed electronically in FY2004, but they don't have one regarding electronic payments. They should adopt one, and then set a performance target.

The first performance measure would be driven by a goal that a certain percentage, for example, 80 percent, of all filers will receive their refunds by direct deposit. Sending refunds electronically would not only decrease costs for the IRS but would spur more filers to open bank accounts, which are needed to receive refunds sent by direct deposit. However, this recommendation is subject to an important clarification—only refunds sent by direct deposits to specified accounts should count toward this goal. Refunds sent to the temporary accounts set up for Refund Anticipation Loans would not count.

The second performance measure would be driven by a goal that a certain percentage, for example 30 percent, of tax filers will open IRAs in connection with the tax filing process or deposit refunds into IRAs. Finally, the IRS should also set a deadline to achieve these goals, for example, by 2009, to enable the agency to work with financial institutions.

5. Revise asset limits in public assistance programs.

Many low-income people may not save their tax refunds—or other sources of income—for fear that they will lose their benefits from programs such as TANF, SSI, and Food Stamps. The application of low asset limits to determine eligibility for benefits are a huge disincentive for saving.

As described in Section Three, in most states, the EITC is not counted as additional income to determine eligibility for TANF benefits. It is, however, counted as savings toward asset limits two months after it is received for TANF, and for Medicaid and SSI as well.²⁷ In general, the asset limits for these federal benefits should be revisited and revised so that they do not discourage saving.

One of the great policy achievements of the 1990s was that nearly all states raised their assets limits as part of their TANF plans. In addition, the majority of states have raised their asset limits on Medicaid above the federal minimum and 44 states have waived asset limits for providing Medicaid for children. While merited, however, it would be difficult to raise and standardize asset limits across all federal programs, given that the rules, decision-making authority, and flexibility vary greatly among programs and states: some are set at the federal level (SSI), some at the state level (TANF), and still others set by a combination of federal and state decision-making (Food Stamps and Medicaid). Furthermore, the rules fall under the jurisdiction of several congressional committees on different reauthorization timelines. However, there are two asset limit issues that are important, and achievable in the near term:

- ***Specify that restricted savings are disregarded.*** When creating or scaling up any restricted savings policy for the poor—such as for Individual Development Accounts—specify in the authorizing legislation that any amounts saved (along with any matching deposits and earnings on the entire account) in the restricted account are disregarded in determining eligibility for any means-tested program.
- ***Specify that all retirement assets are disregarded.*** Clarify that defined-contribution savings plans are disregarded in determining eligibility for means-tested programs prior to retirement. Presently, the law excludes balances in defined-benefit plans, but not defined contributions plans—even if the applicant has to pay a penalty for early withdrawal, he or she is expected to drain their IRA, 401(k), etc. balances before qualifying for public benefits.

MORE INFORMATION

Anne Stuhldreher or Reid Cramer
Asset Building Program, New America Foundation
1630 Connecticut Avenue, NW 7th Floor
Washington, DC 20009
202-986-2700
202-986-3696 - fax
stuhldreher@newamerica.net/cramer@newamerica.net
www.newamerica.net and www.assetbuilding.org

REFERENCES

Barr, Michael S. (2004). *Banking the Poor: Policies to Bring Low-Income Americans Into the Financial Mainstream*. Washington, DC: Brookings Institution.

Berube, Alan (2004). “EITC Data Background 1997-2002.” Presentation prepared for Annie E Casey Foundation Meeting. Washington, DC: Brookings Institution.

Berube, Alan, Anne Kim, Benjamin Forman, and Megan Burns (2002). *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC*. Washington, DC: Brookings Institution.

Beverly, Sondra G. and Colleen Dailey (2003). *Using Tax Refunds to Promote Asset Building in Low-Income Households*. St. Louis: Center for Social Development at Washington University.

- Beverly, Sondra G., Jennifer Tescher, and David Marzahl (2000). *Linking Tax Refunds and Low-Cost Bank Accounts*. St. Louis: Center for Social Development at Washington University.
- Beverly, Sondra G., Daniel Schneider and Peter Tufano (2004). *Splitting Tax Refunds and Building Savings: An Empirical Test*. Preliminary Draft.
- Carasso, Adam and Eugene Steuerle (2003). *Growth in the Earned Income Credit and Child Tax Credit*. Washington, DC: Urban Institute and Brookings Institution Tax Policy Center.
- Campbell, David and Michael Parisi (2003). *Individual Tax Returns 2001*. U.S. Internal Revenue Service. <http://www.irs.gov/pub/irs-soi/01indtr.pdf>.
- Center on Budget and Policy Priorities (2004). *Facts about the Child Tax Credit*. Washington, DC.
- Center on Budget and Policy Priorities (2004a). *Facts About the Earned Income Tax Credit*. Washington, DC.
- Choi, James, David Laibson, and Brigitte Madrian (2004). *Plan Design and 401(k) Savings Outcomes*. National Tax Journal Forum on Pensions.
- Ellwood, David (1999). [*The Impact of the EITC and Social Policy Reforms on Work, Marriage, and Living Arrangements*](#). Washington, DC: Joint Center for Poverty Research. Working Paper and [*National Tax Journal*](#), December 2000
- Gale, William G., J. Mark Iwry, and Peter R. Orzag (2004). *The Savers Credit: Issues and Options*. Washington DC: The Brookings Institution.
- Gitterman, Daniel, Kendra Davenport Cotton, and Christopher Howard (2003). *Tax Credits for Working Families: The New American Social Policy*. Washington, DC: The Brookings Institution.
- Grogger, Jeffrey (2003). [*Welfare Transactions in the 1990s: The Economy, Welfare Policy, and the EITC*](#). Cambridge: National Bureau of Economic Research. Working Paper No. 9472
- Llobrera, Joseph and Bob Zahradnik (2004). *A Hand Up: How State EITCs Help Working Families Escape Poverty in 2004*. Washington, DC: Center on Budget and Policy Priorities.
- Meyer, Bruce and Dan Rosenbaum (1999). *Welfare, the EITC, and the Labor Supply of Single Mothers*. Cambridge: National Bureau of Economic Research. Working Paper No. 7363; and *Quarterly Journal of Economics*, August 2001.
- Schreiner, Mark, Margaret Clancy and Michael Sherraden (2002). *Savings Performance in the American Dream Demonstration. Final Report*. St. Louis: Center for Social Development at Washington University.
- Silva, Javier and Tamara Draut (2004). *Borrowing to Make Ends Meet: The Growth of Credit Card Debt in the 90s*. New York: Demos.
- Smeeding, Timothy M. (2000). *The EITCs and USAs/IDAs: Maybe a Marriage Made In Heaven?* St. Louis: Center for Social Development at Washington University.
- Stegman, Michael, Kelly Cochran, and Robert Faris (2002). *Creating a Scorecard for the CRA Service Test*. Washington DC: Brookings Institution.
- U.S. Internal Revenue Service (2004). *Tax Stats at a Glance*. Washington, D.C. <http://www.irs.gov/taxstats/article/0,,id=102886,00.html>.

-
- ¹ U.S. Internal Revenue Service (2004).
- ² See Mark Schreiner, Margaret Clancy, and Michael Sherraden (2002); Sondra G. Beverly, Jennifer Tescher, and David Marzahl (2000); and Sondra G. Beverly, Daniel Schneider, and Peter Tufano (2004).
- ³ Berube (2004).
- ⁴ Joseph Llobrera and Bob Zahradnik (2004).
- ⁵ Bruce Meyer and Dan Rosenbaum (2001) and David Ellwood (2000).
- ⁶ Jeffrey Grogger (2002).
- ⁷ Adam Carasso and Eugene Steuerle (2003). Page 401.
- ⁸ Daniel Gitterman, Kendra Davenport Cotton, and Christopher Howard (2003).
- ⁹ Center for Budget and Policy Priorities (2004).
- ¹⁰ Adam Carasso and Eugene Steuerle (2003).
- ¹¹ James Choi, David Laibson, and Brigitte Madrian (2004). The authors conclude that plan design can have an important effect on various savings outcomes. See also Richard H. Thaler and Shlomo Benartzi (2003).
- ¹² Alan Berube (2004).
- ¹³ Michael S. Barr (2004). Page 1.
- ¹⁴ Ibid.
- ¹⁵ Ibid.
- ¹⁶ Alan Berube, Anne Kim, Benjamin Forman, and Megan Burns (2002). Page 5.
- ¹⁷ Timothy M. Smeeding (2000).
- ¹⁸ Javier Silva and Tamara Draut (2004)
- ¹⁹ Center for Budget and Policy Priorities (2004a). Page 11.
- ²⁰ Smeeding (2000). Page 5. Rutgers Sociologist Katherine Edin, in her interviews with TANF recipients, found that many spend down their refunds for fear of jeopardizing their benefits.
- ²¹ Sondra Beverly, Daniel Schneider, and Peter Tufano (2004).
- ²² Smeeding (2000).
- ²³ Sondra G Beverly and Colleen Dailey (2003). Pages 6-7.
- ²⁴ Peter Tufano and Daniel Schneider (2004).
- ²⁵ Michael Stegman, Kelly Cochran, and Robert Faris (2002).
- ²⁶ There should be corresponding increases for individual and head of household filers.
- ²⁷ Center for Budget and Policy Priorities (2004a). Page 11.