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TAX CODE KNOWLEDGE & BEHAVIORAL RESPONSES AMONG EITC RECIPIENTS:
POLICY INSIGHTS FROM QUALITATIVE DATA

Laura Tach, Cornell University
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Motivation

• The structure of the EITC offers (dis)incentives for marriage, childbearing, and labor supply.

• Prior research exploits variation (across states, over time) to estimate causal effects of the EITC on these outcomes.
  • Mostly observes reduced-form behavioral responses.
  • Does not observe the *mechanisms* behind these behavioral responses (or lack thereof).
The Present Study

• We use qualitative data to ask:

  • What type of incentive structure do EITC recipients perceive?

  • How do these perceptions influence behavioral responses?
Data: Sample

- In-depth semi-structured qualitative interviews with 115 EITC recipients in Boston, MA
  - Recruited from non-profit and for-profit tax preparation sites and Head Start Centers, Jan-April 2007
  - Short surveys at random sampling intervals about size and intended uses of tax refund (N= 332)
  - Stratified random sample of 120 respondents with children contacted for in-depth qualitative interviews 6 months later
  - Final N = 115 completed interviews, lasting 2.5 hours on average
Data: In-Depth Interviews

- **Structured questions**: knowledge of EITC and other aspects of tax code, how they spent refund, and detailed accounting of all sources of income and all expenses in a month. Observed tax forms for those who had them.

- **Open-ended questions**: how respondents learned about taxes, decision-making processes behind spending of refund and decisions related to work and family, meaning of refund in their lives, strategies to make ends meet.
Understanding “The Refund”

- 90% had heard of the EITC and knew they received a large tax refund because of it.
- Many knew they received it because they worked but didn’t make much money (70%) or had children (38%).

- **What do you know about the EITC?**

  - “[I]f you make under a certain amount, then…if you qualify for it, you’ll get it. I’m not really sure how much it is or anything. I’m pretty sure I got it.”
  
  - “[T]he only thing I know is because I am not paid so well and because I am a family of two with my son that [I qualify].”
  
  - “Well the only thing I knew about it, to be honest with you, I just felt that, you know, they always promoted it if you’re a single parent. But obviously children are involved. There’s gotta be a child. So, that’s…the extent of it for me.”
Understanding “The Refund”

• Most knew (roughly) the total amount of their tax refund check, but few (<10%) knew amount from the EITC.

How much did you receive from the EITC?

“Well, I got, I think five- I don’t know exactly, it was five something from federal, which is the bigger one, and then it was like a thousand from state.”

Do you know if some of that is from the EITC?

“Yeah, that’s what I think…because that’s the only way I would get that much money back…because they don’t even take that much out of me to get that much back. Or is it called Unearned Income? I thought it was called Unearned Income.”

Actual amount from respondent’s tax return:

Federal: $3,942 ($1,371 EITC, $623 CTC)
State: $762 ($206 EITC)
Like “winning the lottery”

- Lack of “visibility” and association with children and work created a notable absence of stigma associated with EITC receipt.
  - Not seen as a government handout

- Instead, the EITC was described as:
  - a “bonus”
  - like “winning the lottery”
  - a “reward” they “earned” for working and having children
Structure of the EITC

• How will next year’s EITC (refund) change if you:
  a) made more money
  b) got married (if single) or divorced (if married)
  c) had another child

• Evaluated predictions based on whether their prior year’s family earned income placed them in the phase-in, plateau, or phase-out range of the credit, their marital status, and their number of children.
# Predicted Refund Change if Earnings Increased

<table>
<thead>
<tr>
<th></th>
<th>Phase In (&lt;=$8,051)</th>
<th>Plateau: ($8,051-$16,800)</th>
<th>Phase Out (&gt;= $16,801)</th>
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<tr>
<td>Don't Know</td>
<td>18.8</td>
<td>9.5</td>
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<tr>
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<td>63.6</td>
<td>47.6</td>
<td>45.8</td>
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<tr>
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<td>18.2</td>
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<td>38.1</td>
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<tr>
<td>No Change</td>
<td>4.8</td>
<td>1.4</td>
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</table>

**Phase In** (<=$8,051)

**Plateau**: ($8,051-$16,800)

**Phase Out**: (>= $16,801)
Earnings: Behavioral Response

- Employment situations in the low-wage labor market were precarious and unstable
  - Very difficult to control how much one worked

Would working more change your refund?

“Probably, if I had more consistent hours… I work for a temp agency, so the stability’s not there. I could work for six months, then be off for four because there’s no work.”
Earnings: Behavioral Response

• BUT, they did alter behavior in other ways to maximize refund: “claiming zero”
  • > 28% claimed zero dependents or exemptions

• Precautionary savings mechanism
  “Will it [the refund] be less or more? I don’t know… I already pay so much out of my paycheck for taxes, don’t want to pay more money [at tax time], so that’s why I claim zero… I know that extra money will come back to me.”

• Forced savings mechanism
  “If I put three kids…I get my extra $100 in my paycheck, I won’t save that. File with zero, that’s your money. I know at tax time I will have that big $5,000 and I will need it for something.”
Predicted Refund Change if Married/Divorced

Currently Married
Currently Unmarried

<table>
<thead>
<tr>
<th></th>
<th>Currently Married</th>
<th>Currently Unmarried</th>
</tr>
</thead>
<tbody>
<tr>
<td>Don't Know</td>
<td>41</td>
<td>44</td>
</tr>
<tr>
<td>Increase</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Decrease</td>
<td>18</td>
<td>30</td>
</tr>
<tr>
<td>No Change</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Depends</td>
<td>23</td>
<td>8</td>
</tr>
</tbody>
</table>

% of Respondents
Marriage: Behavioral Response

- Most common response to this question was laughter!
  - Idea of marriage was so distant (and suitable partners so lacking) that they hadn’t even considered it
  - Among these single parents, little desire to comingle finances even if they married
Marriage: Behavioral Response

• BUT, they did alter behavior in ways other than marrying/divorcing: “filing separate”
  • Many (> 25%) believed they could continue to file as head of household when they married

“Everyone can file separately… everyone gets their own money back.”

“I don’t know how married couples file… A lot of them end up owing. Or some of them put, because they don’t want to owe, they file separate. I would probably file separate.”

“I could still be his wife, but we’d file separate… I mean I need that refund money regardless… If it wasn’t beneficial for me, I’d file my own taxes.”
Predicted Refund Change if Additional Child

Don't Know  Increase  Decrease  No Change

One  Two  Three +

<table>
<thead>
<tr>
<th></th>
<th>One</th>
<th>Two</th>
<th>Three +</th>
</tr>
</thead>
<tbody>
<tr>
<td>Don't Know</td>
<td>10</td>
<td>16</td>
<td>9</td>
</tr>
<tr>
<td>Increase</td>
<td>80</td>
<td>76</td>
<td>74</td>
</tr>
<tr>
<td>Decrease</td>
<td>0</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>No Change</td>
<td>10</td>
<td>9</td>
<td>14</td>
</tr>
</tbody>
</table>
Childbearing: Behavioral Response

- Clear perception of incentives
  - Due in part to simplicity of Child Tax Credit – idea of $1,000 per child was pervasive
- Clear understanding that it costs more to raise a child, so incentive is weak

- BUT, they did alter their behavior in other ways: “claiming kids”
  - Divide up who claimed children across family members to maximize refunds (> 29%)
  - Non-resident biological fathers, resident boyfriends, grandparents
  - Relationship, age, and residency requirements of EITC did not correspond to the ways in which family members provided support for children across households or over the course of a year
Conclusions

• EITC filers perceive “the refund” as a whole, not the EITC

• Behavioral responses are not necessarily weak; they just respond in ways other than altering work status or family structure.
  • Perceptions of incentive structure are weak for labor supply (intensive) and marriage, but strong for childbearing.
  • Structural barriers in low-wage labor and marriage markets prevent people from altering their actual behavior
  • But, they alter their *filing* behavior to maximize their refunds: claiming zero, filing separate, and claiming kids
  • Most noncompliance did not seem to be attempts at fraud

• Tax code related to marriage and children does not reflect how resources are allocated among low-income households.
Thank you!
## Descriptive Statistics

<table>
<thead>
<tr>
<th>Category</th>
<th>Sample</th>
<th>National Population</th>
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</thead>
<tbody>
<tr>
<td><strong>Number of Qualifying Children</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zero</td>
<td>0%</td>
<td>21%</td>
</tr>
<tr>
<td>One</td>
<td>26.3%</td>
<td>38%</td>
</tr>
<tr>
<td>Two or More</td>
<td>72.8%</td>
<td>41%</td>
</tr>
<tr>
<td><strong>Tax Filing Status</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Head of household/Single</td>
<td>71.3%</td>
<td>75%</td>
</tr>
<tr>
<td>Married filing jointly</td>
<td>28.7%</td>
<td>25%</td>
</tr>
<tr>
<td><strong>Mean 2006 Income</strong></td>
<td>$26,652</td>
<td>NA</td>
</tr>
<tr>
<td><strong>Mean 2006 Salary and wages</strong></td>
<td>$22,644</td>
<td>$15,452</td>
</tr>
<tr>
<td><strong>Total 2006 Tax Refund</strong></td>
<td>$4,686</td>
<td>NA</td>
</tr>
<tr>
<td>2006 EITC Refund</td>
<td>$2,633</td>
<td>$1,926</td>
</tr>
<tr>
<td><strong>Location in EIC Schedule</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Phase-In</td>
<td>12.2%</td>
<td>25%</td>
</tr>
<tr>
<td>Plateau</td>
<td>19.1%</td>
<td>33%</td>
</tr>
<tr>
<td>Phase-Out</td>
<td>68.8%</td>
<td>42%</td>
</tr>
</tbody>
</table>
Take-Aways from the Research

- No one understands how taxes work, or can predict how changes would affect their refund.
- It is not clear that the EITC works at all as an incentive, and if so, in what direction.
- Households have little control over employment or earnings.
- The reality of families does not match official tax statuses and dependency rules.
- People see taxes as something you maximize, not a single answer.
- Some systems people use to maximize their refund are perfectly legal, others are not – and no one knows the difference.
- People are eager to save, and jerry-rig the tax process as a savings mechanism.
What policy questions does the research raise?

- Are encouraging work and rewarding work distinct policy goals?
- Does it matter if people understand the EITC – so long as it helps them?
- To what extent does the EITC act as an incentive simply by making work possible?
- What policies make sense given what people can and cannot control?
What policy questions does the research raise?

• How can we make tax status and dependency definitions better reflect how families see themselves, and how families actually work?
• Would different tax status or dependency definitions do a better job of achieving the goals of the EITC?
What policy questions does the research raise?

• How can we simplify the tax system to address the confusion between options and fraud?
• Do we want a tax system that has a single answer or where you find the way that gives you the biggest refund?
What policy questions does the research raise?

- Are there additional ways to take advantage of the lack of stigma in tax-based supports?
- Are there ways to leverage loss aversion to incentivize certain behaviors?
- Are there other behavioral insights that are relevant here?
What policy questions does the research raise?

• How can the tax process better support the savings goals of low-income households?
• How can we better support savings outside of the tax process?
• Are there other ways to leverage the tax process to help households manage their finances and achieve their financial goals?
David Marzahn

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Initial Takeaways

• Study aligns with CEP's experience regarding the complexity of the tax code.

• EITC, a valuable tax credit, serves as an income supplement & is perceived positively by recipients.

• Unbundling tax code and understanding interplay of tax benefits and tax credits almost impossible for the typical taxpayer.

• Since 2007 tax code immeasurably more complex: expanded EITC, expanded Child Tax Credit, new refundable American Opportunity Tax Credit plus one-time ARRA tax credit.

• Withholding has become a proxy for forced savings, coupled with tax credits & benefits.
Practical Considerations

- Cannot underestimate the IRS role in adequately informing taxpayers about how their tax refund or tax liability is determined.

- By all measures, IRS gets a failing grade with respect to adequately educating taxpayers; Congress, performs even poorer.

- Tax preparers provide critical interface with taxpayers but often have misaligned incentives to "truly" inform & educate taxpayers.

- Lack of licensing and/or certification requirements for commercial preparers means that their ability to provide consistent tax advice is lacking.

- The "forced savings" behavior of low-income taxpayers has costly consequences:
  - larger refunds feed into rush to get returns prepared in January and high cost of tax prep & use of predatory settlement products;
  - falling behind in paying bills in latter part of year increases penalties, fees and may reduce credit scores.
Policy Considerations

- Lack of stigma associated with EITC is a positive; however, is the tax code the best means to deliver income supports?

- The high rate of error & fraud in the EITC is driven by the complexity of the tax code and having taxpayers rely on word of mouth for tax advice.

- The lack of understanding of how the tax code actually operates plays into negative perceptions of government and undermines civic engagement in budget deliberations.

- Simplifying the tax code is clearly necessary.
Opportunity

• It's high time to have the IRS consider a tax disclosure statement based on the new disclosures required for credit cards (see card disclosure on the last page).

• The tax disclosure could:
  -- explain why they're getting a refund versus taxes owed;
  -- explain the source of their refund: individual tax credit, overwithholding, etc.;
  -- explain the connection of a child or dependent to the tax credit;
  -- suggest how to address overwithholding by reviewing their W4 Forum.
A New Twist: CEP & City of Chicago EITC Pilot

- Current structure of tax code and EITC, specifically, feeds into "forced savings" mentality but also carries high costs.

- Hypothesis: allow taxpayers to claim a portion of the EITC as advance payments may improve liquidity and reduce reliance on predatory products.

- CEP is working with City of Chicago and operating a pilot with 500 participants, each able to claim up to $2,000 in advance EITC.

- Rigorous evaluation, conducted by University of Illinois, will track behavior and attitudes among participants and assess the operational roll-out of the pilot.

- Final report expected May, 2015; if evidence is clear, may call for reforms to EITC.
**CARD DISCLOSURES**

| **Annual Percentage Rate (APR) for purchases** | 0.00% for 7 months from date of account opening. After that, 17.24% variable. |
| **Other APRs** | Cash advance APR: 25.24% variable. Default APR: 29.99% variable. See explanation below.* |
| **Variable rate information** | Your APRs may vary each billing period.** |
| | The purchase APR equals the Prime Rate plus 13.99%. |
| | The cash advance APR equals the Prime Rate plus 21.99%. |
| | The default APR equals the greater of (1) the U.S. Prime Rate** plus up to 23.99% or (2) up to 29.99%. |
| **Grace period for repayment of the balance for purchases** | At least 20 days if you pay the total balance in full by the due date every billing period. If you do not, you will not get a grace period. |
| **Method of computing the balance for purchases** | Average daily balance. This includes new purchases. |
| **Minimum finance charge** | 50 cents. |
| **Annual fees** | None. |
| **Fee for foreign purchases** | 3% of the U.S. dollar amount of each purchase made outside the U.S. whether made in U.S. dollars or in a foreign currency. |
| **Other fees** | Balance transfer fee: 3% of each balance transfer; $5 minimum. |
| | Cash advance fee: 3% of each cash advance; $5 minimum. |
| | Late fee: | $15 on balances up to $100 |
| | $29 on balances of $100 up to $250 |
| | $39 on balances of $250 and over |
| | Over-the-credit-line fee: $39 |

*How can your actions trigger the default APR? If you default under any card agreement you have with us because you
  - do not make the minimum payment when due,
  - go over the credit line, or
  - make a payment to us that is not honored,
all your APRs may increase to the default APR as permitted by law. We set your default APR by reviewing (1) the seriousness of your default with us and (2) your credit history.

**How do we calculate variable rates?** For each billing period we use the Prime Rate published in The Wall Street Journal two business days before the Statement/Closing Date.

**When can we change the rates, fees, and terms of your card agreement?** We may change the rates, fees, and terms of your card agreement from time to time as permitted by law. We will give you advance notice of the changes and a right to opt out to the extent required by law.
Q & A

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Dave Marzahl
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Please join the Center for Financial Security in April for our next webinar on

Youth Financial Literacy Programs
(More Information on Date to Come)

www.cfs.wisc.edu/
Please contact Hallie Lienhardt
hebennett@wisc.edu or 608-890-0229 with questions.