# Tax Filing Experiences and Withholding Preferences of Low- and Moderate-Income Households: Preliminary Evidence from a New Survey[1]

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The United States Federal income tax code has an enormous potential to shape the economic and financial decisions of taxpaying households. Tax rates, compliance laws, and the withholding system create incentives, as do the methods by which the Treasury collects tax receipts and disburses tax refunds. The role of third party service providers in this incentive structure is less well understood, even though tax preparation firms play important roles in our tax system. Nationally, more than half of taxpayers use paid preparers to submit their tax returns. Low- and moderate-income (LMI) households are among those who use the paid tax preparation system. In fact, among those who file, more than two-thirds of low-income households use paid tax preparation services. Thus, understanding the role of third party providers in the tax system is critical to understanding how our tax system functions.

Tax preparation service providers can potentially both increase and decrease social welfare. On the positive side, tax preparation firms may increase the likelihood that taxpayers will hear about and take advantage of tax incentives designed to reach them. For example, over 20 million low- and moderate-income households file for approximately $35 billion in refunds and reduced tax liability under the Earned Income Tax Credit (EITC), designed to reward work for low-income working families. On the negative side, tax preparation firms can add to the costs of the tax system and reduce the effectiveness of the EITC and other tax incentives. Tax preparation is costly in itself to tax filers, and low-income households often face additional costs associated with filing. For example, many low-income households lack bank accounts and receive a paper check by mail from the IRS; they thus must wait longer for their refund checks than banked households using direct deposit. Those unbanked households receiving a check must also pay a significant fee to cash their

Government refund checks at a check casher or other establishment. A large portion of households receving the EITC, in addition, take out costly refunds anticipation loans and similar products in order to receive the proceeds of their tax refunds more quickly. Understanding the institutional context in which tax distribution occurs, and the behavioral response to this context, is important to understanding the overall effects of the tax system.

In this paper, using preliminary data (for reasons explained below) from a unique household survey, we examine the tax filing experiences of LMI households. Our research aim is to ascertain households' current tax filing behaviors, their attitudes about the withholding system, their use of tax refunds to spend and save, and the mechanisms by which they would like to receive their refunds. We also begin to explore the extent to which households use the withholding system as a financial planning tool. More specifically, we provide preliminary evidence on whether LMI households use the withholding system as a precommitment device against overconsumption, as well as whether they use it to save and build assets.

There is little empirical evidence on the tax filing experiences of LMI households. Toward this end, we document the prevalence of the use of tax preparation services and the receipt of both tax refunds and refund anticipation loans (RALs). Finally, we describe the reasons taxpayers cite for taking out RALs and the uses to which they put their tax refunds. Based on these data, in our conclusion we suggest policy implications and present early conjectures about taxpayer preference parameters, and we will explore these conjectures in subsequent work.

We present this preliminary evidence on LMI households' tax filing experiences to inform the policy debate over tax complexity (Holtzblatt and McCubbin, 2004; Barr, 2004; President's Advisory Panel on Federal Tax Reform, 2005). In addition, we begin to assess whether the ways in which households use paid tax preparers can be viewed as decisions made by rational, optimizing agents, and whether default rules, framing, and heuristics play a role in their tax-filing decisions (Thaler, 1990).

The remainder of this paper is organized as follows. The next section presents the policy context and previous research regarding tax-filing experiences among LMI households. We then describe the survey, sampling plan, and data and present our preliminary results. We conclude with policy implications and further research questions.

## Policy Context and Previous Research

Overwithholding occurs when taxpayers remit more in tax payments during the course of the year than they owe in taxes; such taxpayers receive a refund after filing. Overwithholding occurs at many income levels and is a common phenomenon among LMI taxpayers. Given their low incomes, overwithholding by such taxpayers is puzzling. Why do low-income households not attempt to smooth their take-home pay over the year to deal with consumption needs, rather than receive a significant portion of yearly income in the form of a lump-sum tax refund?

A number of factors may influence this pattern of overwithholding among LMI households. First, it may be difficult for such households to adjust their withholding payments to match their income tax liabilities. Very few households take advantage of the advanced Earned Income Tax Credit, through which a large portion of their anticipated tax refunds could be moved back to increase regular take-home pay. The structure of the EITC and its advanced counterpart may be too complicated; employees may be reluctant to ask their employers to implement the provision; and employers may be reluctant to adjust withholding (or ignorant of how to do so). Moreover, complicated employment patterns over the year, with multiple jobs, may make adjusting withholding difficult.

Second, uncertainty about tax liability may deter income smoothing through the withholding system. Taxpayers may fear that adjusting withholding would result in an underpayment of taxes, with significant sums owed (perhaps with penalties) at the end of the tax year. For low-income households, the risk of underwithholding resulting in lump-sum tax liability may be too great. In addition, the complexity of eligibility rules for the EITC and other tax credits, particularly as such rules relate to family structure, may increase the uncertainty involved in this calculation.

Third, taxpayers' own preferences for income receipt, lump-sum tax refunds, and patterns of withholding may influence their decisions. These preferences are likely shaped in part by the institutional context within which these decisions are reached. Contextual factors may shape both preferences and behavioral outcomes. Understanding LMI households' motives for overwithholding can inform the role that tax preparers play in the tax system, as well as how the tax filing experience interacts with households' consumption and spending decisions (Shapiro and Slemrod, 1995; Souleles, 1999).

Fourth, the complexity of tax provisions related to low-income households may increase their incentives to use tax preparation services to file. These households often face conflicting and complex rules under different tax provisions for determining household status and dependents. They also worry about increased IRS audits and other enforcement measures for EITC filers, along with IRS delays in receiving their refunds (Holtzblatt and McCubbin, 2004). These factors may contribute to LMI taxpayers' use of tax preparation services, including refund anticipation loans (RALs). Tax preparation firms may, in turn, influence withholding patterns among LMI households.

The question remains whether use of tax preparation services, and overwithholding by low-income taxpayers, are on net beneficial. Commercial tax preparers are costly, and the high usage of refund anticipation loans imposes additional costs. Tax preparers may also, however, expand the take-up rate for EITC and other tax credits designed to redistribute income to households through advertising the availability of refunds and expertise in filing returns to maximize the client's use of available tax credits (Kopczuk and Pop-Eleches, 2005). Commercial tax preparers also can serve as a vehicle through which to encourage savings, including retirement savings (Barr, 2004; Duflo et al., 2005). Tax filing and refund receipt may encourage other types of saving. Research has noted the importance of mental accounts in influencing households' marginal propensities to consume (MPC) income, with a smaller MPC the larger the tax refund (Thaler and Loewenstein, 1989; Thaler, 1990; Souleles, 1999). As a large lump-sum payment, EITC and related tax refunds could present a saving opportunity for LMI households that they may not otherwise have (Souleles, 1999; Barr, 2004; Tufano et al., 2005; Duflo et al., 2005; Rhine, 2005).

Regardless of whether households intentionally overwithhold, respond to uncertainty, or simply adhere to the tax system's default rules because of inertia, LMI households do in effect utilize the institutional features of the withholding system to save in the short term (i.e., for a period of less than 1 year). There is a consensus that the poor have few assets and find it difficult to save out of current income (see Barr, 2004 for a summary). In light of high-cost financial and banking services, as well as barriers to saving facing LMI households, there is the potential for households to view the withholding system as a mechanism for saving.[4] Their attitudes about the withholding system may reflect an awareness that they are able to save by overwithholding and subsequently receive a sizeable (lump-sum) tax refund. Such households may also use the withholding system to restrain their consumption; overwithholding serves as a precommitment device against overconsumption. As we describe in more detail below, we document LMI households' withholding preferences in order to investigate whether there is a basis for believing that households use the withholding system in these ways.

In addition to reporting the withholding preferences of LMI households, an aim of this paper is to characterize the tax preparation choices of LMI households. We document the prevalence of the use of paid tax preparation services, the extent to which households take out RALs, and the cost of tax preparation and RALs. Another aim of this paper is to provide data that could be used to assess the extent to which the IRS and the Federal Government can positively reform LMI households' tax preparation experiences. Currently, the IRS is moving toward permitting taxpayers to split their refunds into more than one direct deposit account. Accordingly, taxpayers could choose to use a portion of their refunds for long-term saving, such as in a retirement account, provide for a portion of the refund to be deposited into a bank account for shorter term saving, or direct a portion of the refund to a paid preparer to pay for tax preparation services (see Barr, 2004; 2005). We provide evidence on taxpayer preferences regarding splitting their tax refunds, as well as what tax filers did with their refunds and the reasons households cite for taking out a RAL.

## Description of Survey, Sampling, and Data

The data for this paper are from a survey we designed, which was administered by the Survey Research Center (SRC) at the University of Michigan. The survey focuses on LMI individuals' experiences with formal and informal financial institutions, in addition to their socioeconomic characteristics. Because there is no such comprehensive survey about the financial services experiences and attitudes of low- and moderate-income households, the questionnaire required extensive development, pretesting, and validation. The final survey was programmed for computer-assisted, in-person interviewing. The final survey instrument is, on average, 76 minutes in length.

The sample members were selected based on a stratified random sample of the Detroit metropolitan area (Wayne, Oakland, and Macomb counties). We drew sample members from census tracts with median incomes that are 0-60 percent ("low"), 61-80 percent ("moderate"), and 81-120 percent ("middle") of the Detroit area's median income of $49,057. The sample frame includes more census tracts from the low- and moderate-income strata than the middle one. Hence, sample members are more likely to be drawn from the low- and moderate-income strata. Stratum definitions do not, however, restrict the income levels of the sample members to fall within these ranges.[5]

We completed data collection in March 2006. We interviewed 1,003 households and attained a 65-percent response rate. In order to report our results in a timely manner, this paper is based on provisional data from 927 respondents drawn from census tracts with 0-60 percent or 61-80 percent of the Detroit area's median income. We restrict our sample to respondents from these income strata because our preliminary dataset does not yet include sampling weights. By focusing our analysis on the low- and moderate-income strata, our results are representative of respondents living in low- and moderate-income census tracts in the Detroit area. Because the results we present here are provisional, data from this paper should not be cited without the express, written permission of the authors.

In this paper, we present provisional results from the tax module of the survey, which consists of 21 questions, some with multiple parts. These questions pertain to experiences the respondents had in filing their taxes. This means that we do not necessarily capture all of the experiences of the household. We opted to ask the respondent about his or her own tax experiences, as opposed to the households' experiences because of data quality concerns. Respondents who did not file a return would probably not be able to recall survey items, such as whether the household filed for the EITC or the size of the tax refund. We do not expect many discrepancies between the households' and the individuals' tax experiences since the vast majority of respondents file a tax return.

The question asked to tax filers concerning their withholding preferences reads as follows[6]:

> Next, we have a question about how people think about tax refunds. In this question, you have a choice of how you get your income. The total amount of your tax refund or money owed will be the same for each option. But you can choose whether you get the money spread out over the year or all at the end. I will read the question and your answer choices--you can read along from this page….For this question, please assume that you receive a regular paycheck from an employer. Which of the following describes how you would like to receive your income? A paycheck that is $100 smaller each month than your current one with a tax refund that is $1200 larger at the end of the year; A paycheck that is the same as your current one with no additional refund and no need to pay any additional taxes at the end of the year; A paycheck that is $100 larger each month than your current one with a tax refund that is $1200 smaller at the end of the year?

If the respondent chose the third option, we proceeded with the following followup to ascertain whether framing the question in terms of a tax refund differs from the respondent having to owe a tax liability:

> Would you want a paycheck that is $100 larger each month than your current one if you owed $1200 more in taxes at the end of the year?

We also asked respondents to state whether they were likely to take advantage of a split refund. This question reads:

> If you could get part of your tax refund right away and part of it could be deposited into a savings account or an

investment fund set aside for a special purpose, how likely would you be to use this service--very likely, somewhat likely, somewhat unlikely, very unlikely?

## Results

Table 1 presents a set of descriptive characteristics of our LMI sample members. Overall, they have the average characteristics of LMI in the Detroit metropolitan area. They comprise a socioeconomically disadvantaged group relative to the average American household. The sample is predominantly black, two-thirds female, and unlikely to be married. Roughly a third of households have less than a high school diploma or GED, and 30 percent were not employed at the time of the interview. The median household income of the sample is $20,000, which is lower than the Detroit metropolitan area's median of $49,057 and the national median of $44,684. Nearly 40 percent of households lived below the poverty line in 2004. About 27 percent of individuals and 22 percent of households do not have a bank account.

Table 2 documents the tax filing experiences of our sample. While about 70 percent of the sample filed a tax return in the last 2 years, the tax-filing experiences of our respondents reflect their socioeconomic disadvantages. About 80 percent of tax filers received a refund, and the average refund size was a little under $1,900 among those receiving a refund. Approximately 37 percent of tax filers were aware that they had applied for the EITC, and 30 percent of them reported receiving it (we expect that others were simply not aware of the specific provisions connected to the filing of their tax returns).

Our data confirm national results that find a large portion of LMI taxpayers use paid preparers.[7] In our study, 66 percent of low- and moderate-income tax filers used a paid preparer to file their returns. About 37 percent of taxpayers using a paid preparer took out a RAL or "fast refund" product, which translates to 24 percent of all tax filers or 30 percent of all tax payers receiving a tax refund. Tax preparation services are costly relative to income and refund size among this sample of LMI respondents. On average, RAL users of paid preparers paid $170 for tax preparation and RAL services, which represents 7 percent of the average refund of such households ($2,319). Among non-RAL users of paid preparers, the cost of tax preparation alone is $110, which represents 8 percent of the average refund of these households ($1,372).[8]

Banked and unbanked individuals have different tax-filing experiences, even though, conditional on filing, banked and unbanked households are equally likely to receive a tax refund. Banked households are 15 percentage points less likely to file for and receive the EITC than unbanked households. Though paid tax preparation services are nearly equally likely to be used by both banked and

**TABLE 1: Mean Characteristics of Survey Sample by Banked Status (Standard Errors in Parentheses)**

| Characteristic | All | Banked | Unbanked |
|---|---|---|---|
| Black | 71% | 68% | 80% |
| White | 17 | 19 | 12 |
| Arab | 2 | 3 | 1 |
| Other | 9 | 10 | 7 |
| Female | 66% | 65% | 67% |
| Less than HS Diploma | 31% | 27% | 40% |
| HS Diploma or GED | 23 | 19 | 32 |
| Greater than HS Diploma | 46 | 54 | 28 |
| Age | 44 (.54) | 45 (.66) | 40 (.90) |
| Born in the US | 92% | 90% | 96% |
| Single/Never Married | 47% | 40% | 63% |
| Married and Living with Spouse | 18 | 22 | 9 |
| Living with Partner | 4 | 4 | 6 |
| Separated/Widowed/Divorced | 31 | 34 | 22 |
| Household has no Children | 67% | 70% | 60% |
| Currently Employed | 52% | 56% | 40% |
| Not in Labor Force | 18 | 18 | 17 |
| Currently Unemployed | 31 | 25 | 43 |
| Participates often in Financial Decisions | 76% | 79% | 69% |
| Respondents' Monthly Earnings | 1247 (133) | 1585 (185) | 434 (52) |
| Total HH Monthly Income | 1918 (188) | 2331 (252) | 925 (197) |
| Annual HH Income in 2004 | 29,209 (1139) | 33,678 (1399) | 18,407 (1247) |
| Median HH Income in 2004 | 20,000 | 25,000 | 11,366 |
| % Below the Poverty Line | 36% | 28% | 55% |
| Sample Size | 927 | 660 | 267 |

Source: Detroit Area Household Financial Survey
Notes: Not in labor force includes respondents who said they were retired, homemakers, students, did not have the required documentation, or chose not to work. Nonemployed is the percentage of people currently unemployed who are in the labor market. Poverty guidelines come from the Department of Health and Human Services, obtained from http://aspe.hhs.gov/poverty/04poverty.shtml. Respondents are banked if they responded yes to having a checking account, a savings account, an account with a debit card but no checks, or any other account held at a bank, savings and loan, or credit union. Unbanked respondents responded no to having any of these types of accounts

unbanked individuals, the latter group is about 20 percentage points more likely to use a national chain, like H&R Block or Jackson Hewitt, rather than a local firm or accountant, to file their taxes. Moreover, unbanked households are twice as likely to take out a RAL. More than 60 percent of unbanked households using paid preparers took out a RAL, compared with 30 percent of banked households using paid preparers. These differences persist when controlling for income and employment (results not shown). These results are consistent with the notion that unbanked households are influenced in their decisions to take out a RAL because unbanked households need to wait much longer than banked households to receive their refunds. Unbanked households must wait

**TABLE 2: Average Tax Filing Experiences of Banked, Unbanked, EITC Filers, and Nonfilers**
(Standard Errors in Parentheses)

| Characteristic | All | Banked | Unbanked |
|---|---|---|---|
| Filed a Tax Return in 2003 or 2004 | 69% | 75% | 54% |
| Received a Refund[a] | 80% | 80% | 81% |
| Amount of Federal Refund | 1888 (102) | 1905 (125) | 1832 (141) |
| | | | |
| Filed for EITC | 37% | 34% | 46% |
| Received EITC | 30% | 26% | 40% |
| | | | |
| Used Paid Tax Preparer | 66% | 66% | 66% |
| Filed by Mail | 11 | 12 | 7 |
| Filed by Computer/Phone | 7 | 8 | 2 |
| Used Free Service to File | 4 | 3 | 8 |
| Got Help from a Friend | 5 | 4 | 11 |
| Other | 7 | 7 | 6 |
| | | | |
| Type of Paid Tax Preparer Used[b] | | | |
| National Chain | 44% | 40% | 60% |
| Local Firm | 24 | 26 | 18 |
| Accounting Firm | 16 | 17 | 10 |
| Other | 16 | 17 | 13 |
| | | | |
| Received RAL[c] | 37% | 30% | 62% |
| | | | |
| Cost of Tax Preparation[d] With RAL | 169 (9) | 162 (12) | 181 (14) |
| Cost of Tax Preparation[e] | 109 (7) | 109 (7) | 107 (19) |
| Sample Size | 927 | 660 | 267 |

Source: Detroit Area Household Financial Survey

[a] Percentages are based on those who have filed a tax return.
[b] Percentages are based on the sample of respondents using paid tax preparers.
[c] Percentages are based on respondents using a paid tax preparer to file taxes in 2003 or 2004.
[d] Averages are computed for respondents who took out a RAL.
[e] Averages are computed for respondents using a paid tax preparer but not taking out a RAL

about a month longer for their refund checks to arrive than banked households using direct deposit to receive their refunds. Still, unbanked households make up only 37 percent of RAL users as a whole, suggesting that banked households also use RALs in significant numbers.

Table 3 lists reasons that individuals cite for taking out RALs. About 90 percent of RAL recipients state they did so because they wanted the money faster, and most of these correlate highly with the nearly 80 percent of households who said they took out a RAL because they want pay their bills or other debts faster. That is, they borrowed to pay down other debts. To assess whether this decision is wise, we will need to compare the effective APR of a RAL with the costs incurred by respondents on outstanding debts. Given the high effective APRs of RALs in other studies, it is likely that the costs incurred on outstanding debts would have to be quite high to justify taking out a RAL to pay down such debts. Interestingly, to the extent that these individuals are paying down debt, they are in effect borrowing money in order to increase net savings. In addition, some 60 percent of households take out a RAL because they want certainty about getting their refunds. Nearly half of respondents reported that an important reason for taking out a RAL is simply to pay the tax preparer for tax preparation and filing services. That is, low incomes and liquidity constraints may prevent taxpayers from paying to file in order to receive their large, lump-sum refunds, absent taking out an expensive RAL.

Individuals without a bank account are somewhat more likely to want the money faster than those with bank accounts. Moreover, unbanked households are 20 percentage points more likely than banked households to state that they used a RAL because they wanted to pay bills or debt faster. This differential potentially reflects the differences in timing of receipt of refund by direct deposit as compared to paper check, as well as other differences other than banked status, including income and asset holdings, which will require further investigation. Unbanked households are also 11 percentage points more likely than banked households to take out a RAL in order to pay the tax preparer.

**TABLE 3: Reasons for Obtaining a RAL by Banked Status**[f]

| Characteristic | All | Banked | Unbanked |
|---|---|---|---|
| Wanted Refund Sooner | | | |
| Very Important | 55% | 54% | 59% |
| Somewhat Important | 32 | 30 | 36 |
| Not at all Important | 12 | 16 | 5 |
| Needed to Pay Tax Preparer | | | |
| Very Important | 20% | 18% | 24% |
| Somewhat Important | 29 | 28 | 31 |
| Not at all Important | 51 | 55 | 45 |
| Wanted to Pay Bills Faster | | | |
| Very Important | 61% | 52% | 78% |
| Somewhat Important | 16 | 18 | 14 |
| Not at all Important | 23 | 31 | 9 |
| Wanted to be Sure about Getting the Refund | | | |
| Very Important | 34% | 28% | 43% |
| Somewhat Important | 26 | 29 | 22 |
| Not at all Important | 40 | 43 | 34 |
| Other Reason | 11% | 9% | 14% |
| Sample Size | 155 | 97 | 58 |

Source: Detroit Area Household Financial Survey
Notes: Respondents are banked if they responded yes to having a checking account, a savings account, an account with a debit card but no checks, or any other account held at a bank, savings and loan, or credit union. Unbanked respondents responded no to having any of these types of accounts.

[f] Conditional on receiving a Refund Anticipation Loan (RAL).

Table 4 presents results on how low- and moderate-income households use their refunds. For policy purposes, it is important to assess whether there is a propensity among low- and moderate-income households to save some or all of their refunds. Tax refunds, given the size of the lump sum relative to annual income, could play an important role in most low- and moderate-income households' lives. About 80 percent of tax filers, and 56 percent of our sample of low- and moderate-income households, received a tax refund, and the average refund of those receiving one was $1,866. More than 50 percent of low- and moderate-income individuals who received a tax refund indicated that they saved all (9 percent) or a part (42 percent) of their tax refunds. Almost half of those receiving tax refunds spent the entirety of their refunds. Among those who spent some or all of their refunds (91 percent), nearly 80 percent used their refunds to pay down bills or other debts. That is, even among the group that spent some or all of their refunds, most households indicated that they used the spending to increase net savings by reducing indebtedness (for related work, see Shapiro and Slemrod, 1995).

The lump-sum nature of tax refunds may also make it useful for large asset purchases in the face of liquidity constraints or difficulties constraining consumption to save up for such purchases. About 21 percent of respondents used their refunds to buy appliances, and another 12 percent used the refunds to buy cars. Another 14 percent of respondents used the refunds to pay for their own education or their children's education, an important investment in human capital.

The propensity to save some or all of their tax refunds is high among both banked and unbanked individuals. While unbanked households are only half as likely to save all of their tax refunds, 47 percent of unbanked households saved at least some of their refunds, not too far behind the 53-percent rate for banked households. For both groups, the patterns of spending their refunds were roughly similar. That is, among those households who spent some or all of their refunds, nearly 80 percent of both banked and unbanked households stated that they used their refunds to pay down bills or other debts. Unbanked households were nearly twice as likely as banked households to say they spent their refunds to buy appliances (35 percent compared to 17 percent). Tax refund savings plans may be a way for both of these types of households to save, especially given the difficulties these families have of saving during the course of the year.

Table 4 also shows how households who do and do not receive RALs spend or save their tax refunds. RAL users are less than half as likely as non-RAL users to save the entirety of their refunds, but 5 percent of them still save all of it, and 40 percent of RAL users save some of their refunds, quite close to the 43 percent of non-RAL takers who save some of their refunds. RAL takers are 8 percentage points more likely to spend all of their refunds than non-RAL users (54 percent compared with 46 percent). Among those who spent some or all of their refunds, both RAL users and non-RAL users had similar spending patterns. About 80 percent of both groups spent some of their refunds to pay down bills or other debts. RAL takers were 13 percentage points more likely to purchase a durable good, such as an appliance or a car. Given few differences in the use of the refund between RAL takers and nontakers, however, it appears that the receipt of a RAL is not well correlated with how individuals spend the money. That is, households who wait for their tax refunds spend in similar ways to those who do not wait. As discussed earlier, we will explore in future work whether the decision to use a RAL to pay down other debt is economically justified, in part by comparing effective APRs on RALs to plausible ranges of APRs and other costs on outstanding other debts.

**TABLE 4: Use of Tax Refund by Banked Status and RAL Status**

| Characteristic | All | Banked | Unbanked | Received RAL | No RAL |
|---|---|---|---|---|---|
| Received a Refund | 56% | 60% | 43% | 95% | 48% |
| | | | | | |
| Saved all of Refund[g] | 9% | 11% | 5% | 5% | 11% |
| Spent all of Refund | 49 | 47 | 53 | 54 | 46 |
| Saved Some/Spent Some | 42 | 42 | 42 | 40 | 43 |
| | | | | | |
| Spent Refund on:[h] | | | | | |
| Bills or other Debt | 79% | 78% | 81% | 80% | 78% |
| Buy Appliances | 21 | 17 | 35 | 27 | 19 |
| Buy Car | 12 | 11 | 16 | 15 | 11 |
| Pay for Own or Children's Education | 14 | 14 | 13 | 14 | 14 |
| Other | 38 | 41 | 30 | 36 | 39 |
| Sample Size | 927 | 660 | 267 | 155 | 772 |

Source: Detroit Area Household Financial Survey
Note: Respondents are banked if they responded yes to having a checking account, a savings account, an account with a debit card but no checks, or any other account held at a bank, savings and loan, or credit union. Unbanked respondents responded no to having any of these types of accounts.

[g] Conditional on receiving a refund.
[h] Conditional on "spending all" or "spending some and saving some" of the tax refund.

The results in Table 5 also suggest that nearly half of LMI taxpayers prefer their current withholding patterns, under which they mostly receive refunds. Holding total tax liability constant, another third would like to have more withheld, further reducing current income in order to receive a larger refund. Taken together, about 80 percent of taxpayers would like to use the withholding system in order to save. A much smaller group, about 20 percent, would like less withheld in order to have higher current income. Consistent with behavioral insights about framing, this percentage drops to 6 percent if the respondents answer the question whether they would like less withheld in order to have higher current income if it means that they would owe more in taxes at the end of the year, again, holding total tax liability constant.

LMI households' view of the withholding system is, for the most part, favorable. Their preferences for overwithholding in order to obtain a lump-sum refund, however, are somewhat at odds with the finding that the sample is, on average, socioeconomically disadvantaged, incurs debt during the year that is paid down with the tax refund, and has difficulties making ends meet during the year.[9] Also, (results not shown) households who want less withholding are more likely to experience food insufficiency (21 percent versus 12 percent) and material hardship (37 percent versus 28 percent), relative to those households who want the same or more withholding. Even among households who prefer the current withholding system, tax refunds are often used to pay down past debts. It is possible that such households incur debt, knowing that they will be able to pay it back with their tax refunds. It is also possible that

**TABLE 5. Tax Receipt and Withholding Preferences of Low- and Moderate-Income Households by Banked Status**

| | All | Banked | Unbanked |
|---|---|---|---|
| Likelihood of Using Split Refund Option | | | |
| Very likely | 32% | 31% | 34% |
| Somewhat likely | 32 | 31 | 37 |
| Somewhat unlikely | 10 | 11 | 6 |
| Very unlikely | 27 | 28 | 23 |
| Respondent would like***: | | | |
| More withheld and bigger refund | 35% | 34% | 36% |
| Same withheld and same refund | 47 | 49 | 41 |
| Less withheld and smaller refund | 18 | 17 | 22 |
| Respondent would like less withheld & more taxes*** | 6% | 5% | 10% |
| Sample Size | 927 | 660 | 267 |

Source: Detroit Area Household Financial Survey
Note: Respondents are banked if they responded yes to having a checking account, a savings account, an account with a debit card but no checks, or any other account held at a bank, savings and loan, or credit union. Unbanked respondents responded no to having any of these types of accounts.
***See text for description and wording of the withholding question administered to tax filer

such households fear that they lack self-control and would take on the same level of (credit-constrained) debt even if their incomes were smoothed with lower withholding; for these households, overwithholding, combined with credit constraints, may keep overall consumption lower.

While the withholding system may make it difficult for some LMI households to smooth their consumption, other households may use the withholding system for their financial planning. At this stage of our research, based on early evidence, we conjecture that households may use the withholding system as a precommitment device against overconsumption.[10] The withholding system may provide a low out-of-pocket cost way to save and build assets.[11]

## Conclusions and Policy Implications

The key findings of this paper are threefold. First, many low- and moderate-income households are connected to the tax system. About 70 percent of the individuals in our sample filed a tax return, and 80 percent of those filing received a tax refund. This finding suggests that the tax system is critical to the financial lives of low-income households and may serve as a vehicle to integrate low- and moderate-income households into the financial mainstream.

Second, many low- and moderate-income households use a paid preparer and take out RALs, often at a high cost. Given the societal goal of rewarding work and redistributing income to lower-income households, optimal income redistribution policy would suggest that policymakers focus on ways to reduce the transaction costs associated with tax filing for low- and moderate-income households. Such steps could include measures to reduce tax complexity for low- and moderate-income filers (see, e.g., Holtzblatt and McCubbin, 2004; Barr, 2004; President's Advisory Panel on Federal Tax Reform, 2005). In addition, there are a series of measures that could be undertaken to bring low-income households into the banking system (Barr, 2004). Banked households would face fewer incentives to take out RALs because their refunds can be direct-deposited more quickly than receiving a paper check, would likely face fewer liquidity constraints, and they would face lower costs for converting the income into usable form because they would not need to cash the Government refund check. Thus, policy initiatives to bring low-income households into the banking system, such as a tax credit provided to financial institutions for providing low-cost, electronically based bank accounts to low-income households, would likely contribute to optimal income redistribution policy (Barr, 2004).

Third, the tax filing process may provide an opportunity to encourage savings. Households in our study prefer to overwithhold and state that they are likely to use split refunds. Our findings suggest that low- and moderate-income households may find savings plans that are tied to tax refunds (Duflo et al., 2005) attractive, although our data may suggest that savings plans that are not focused solely on retirement may be more desirable for many of these households. Despite the fact that most households in our study have difficulty saving regularly during the course of the year, and hold few assets, many respondents save some or part of their refunds, and those who spend it often use the refund to pay bills or other debts, thereby increasing net savings. A sizeable group of respondents also use the tax refund for lump-sum purchases, such as appliances and automobiles. These provisional data suggest that individuals may use the withholding system as a means of short-term saving and as a precommitment device against overconsumption, although alternative explanations based on uncertainty regarding tax liability are highly plausible. We will test these hypotheses using attitudinal and other data from our survey in subsequent work.

## Endnotes

1 This conference proceedings paper is excerpted and adapted from Barr and Dokko (2006). The views expressed in this paper are those of the authors and do not reflect those of the Federal Reserve System.

2 Principal Investigator, Detroit Area Household Financial Services Study, Survey Research Center, University of Michigan (2005); Professor of Law, University of Michigan Law School and senior fellow, the Brookings Institution. We would like to thank our project manager, Esther Ullman, our production manager, Sara Freeland, Terry Adams, the team at the Survey Research Center, and our Advisory Board, who worked together on sampling, survey design, and data collection. We are grateful to Chester Choi, Maria Dooner, and Robyn Konkel for research assistance. The study received generous support from the Ford Foundation, Fannie Mae Foundation, Mott Foundation, MacArthur Foundation, Annie E. Casey Foundation, and Community Foundation of Southeastern Michigan, as well as the National Poverty Center, Center on Local, State and Urban Policy, Provost, Vice President for Research, and Law School of the University of Michigan.

3 Economist, Board of Governors of the Federal Reserve System.

4 See Barr (2004), Duflo (2005), and Bertrand et al. (2005) for further discussion of these constraints and their contributions to poverty and other socioeconomic conditions.

5 With sampling weights, our sample represents the population of Detroit metropolitan area residents living in low-, moderate-, and middle-income census tracts.

6 A respondent is a tax filer if he or she filed a tax return in 2004 or 2003.

7 According to IRS data (on file with the authors), in TY2003, in Macomb, Oakland, and Wayne Counties:

59.8 percent of all tax filers used a paid preparer.

10.6 percent of all tax filers received a RAL.
17.7 percent of all tax filers who pay received a RAL.
72.3 percent of EITC filers pay for preparation services
38.0 percent of EITC filers received a RAL.
52.5 percent of EITC filers who pay received a RAL.

8 During survey development, respondents were not able to distinguish separately the amount that they paid to tax preparers for tax preparation as distinct from the cost of RALs, and so, the final questionnaire asks about combined costs. We report the total cost for tax preparation and RALs and will later impute separate costs.

9 More specifically, roughly 72 percent of the sample finds it somewhat or very difficult to live on their total household incomes. During the year prior to the survey, over half of the sample did not have sufficient incomes to meet their expenses every month.

10 In particular, individuals who want more withholding are more likely to spend some or all of their refunds. They are also more likely to report they would like an option permitting them to receive part of their refunds immediately and put part in a savings or investment fund (split refund).

11 Relative to those who want less withholding, individuals who want more withholding are more likely to use their refunds to purchase a car (13 percent versus 7 percent) or an appliance (24 percent versus 15 percent). They are also less likely to hold a credit card (42 percent versus 53 percent), and have fewer assets.

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