



## Halting the Loss of Millions of Dollars in Earned Income Tax Credit Benefits from Ohio

Each year the Earned Income Tax Credit (EITC) helps millions of low- to moderate-income working families. The EITC is a refundable tax credit that is designed to supplement wages and reward work. Depending on income level, marital status and the number of dependent children, taxpayers can claim a credit up to \$4,716 for the 2007 tax year. Regrettably however, a significant percentage of EITC claimants rely on paid tax preparers. Paid tax preparation businesses, in particular, place working families at greater financial risk by aggressively marketing the use of Refund Anticipation Loans (RALs). RALs are short-term, high-interest loans that are based on a client's anticipated refund amount. According to data from the Internal Revenue Service (IRS), tax preparation fees, RALs and other commercial products used to access tax refunds drained \$104 million in EITC benefits from working Ohio families in tax year 2005.<sup>1</sup>

Fortunately, the growth of free tax preparation sites in recent years has provided families with an appealing alternative to commercial tax preparers. In Ohio, the Franklin County EITC Coalition is an example of a group of nonprofit, business and government organizations that came together in October 2006 to serve this very function. The purpose of the coalition is to promote a financially stable community by: raising awareness of the EITC, other tax credits and public benefits; providing low- to moderate-income workers with free, high quality tax assistance and connecting tax payers with financial education opportunities. For tax year 2006, the coalition completed 1,762 returns, which brought in \$793,948 in EITC refunds to the greater Columbus community. When factoring in the amount of money each client saved by visiting a free tax site and not a paid preparer, an additional \$495,122 remained in the pockets of low- to moderate income working families. In total, the Franklin County EITC coalition helped to recoup \$1,698,520 in total refunds, money that was undoubtedly re-invested into the local economy.

## Tax Credit Benefits Reach Millions of Our Most Vulnerable Children

The Earned Income Tax Credit (EITC) lifts more children out of poverty than any other program. In 2005, the most recent year for which data are available, the EITC lifted 4.4 million Americans above the poverty line, including 2.4 million children. Without the crucial income supplement that the EITC provides, it is estimated that the child poverty rate would have been one-fourth higher.<sup>2</sup>

In addition, the EITC also infuses substantial money into the local economy.<sup>3</sup> Surveys show that most EITC recipients use their refunds to meet short- to medium-term needs such as repairing their car, catching up on rent and utility bills, and purchasing clothes for their children.<sup>4</sup> According to data from the Internal Revenue Service (IRS), more than 797,000 Ohio taxpayers received the EITC in tax year 2005, representing a \$1.4 billion investment in Ohio families, individuals and the communities in which they live, work and play.

The limited studies that have attempted to measure the economic impact of the Earned Income Tax Credit on local economies signal substantial potential for these monies to contribute to growth and productivity. An analysis of EITC population and participation rates by researchers in San Antonio concluded that increasing the number of EITC claims would be highly beneficial, with each additional dollar received generating roughly \$1.58 in local economic activity.<sup>5</sup> Another study in Baltimore found that EITC benefits generate almost \$600,000 in local income and property tax revenues.<sup>6</sup>





Yet, despite these encouraging statistics the ability of the EITC to reduce poverty and revitalize our communities has not been fully realized. For tax year 2005, in Ohio, tax preparation fees, RALs and other commercial products used to access tax refunds, diverted \$104 million in EITC benefits to commercial tax preparers and lending institutions; \$3 billion was diverted nationally. Figure 1 highlights the losses endured by counties with the highest percentage of RAL purchases among EITC claimants. Of significance, three of the five counties hit hardest by RALs are clustered in the Appalachia area of Southern Ohio—often considered the most impoverished region of the state.

**Figure 1**

**Ohio Counties with the Highest Percentage of Refund Anticipation Loan (RALs) Purchases, Tax Year 2005**

City	Number of Tax Returns	Number of EITC Tax Returns	% of EITC Returns That Used Paid Preparers	% of EITC Returns with a RAL*	Dollars Lost to Tax Preparation RACs and RALs**
PIKE	10,548	2,493	58.7%	42.0%	\$ 329,700
VINTON	4,849	1,183	68.7%	41.1%	\$ 173,340
FAYETTE	12,359	2,297	69.0%	41.0%	\$ 339,570
JACKSON	13,261	3,019	65.0%	39.6%	\$ 424,680
CLARK	63,785	10,882	66.7%	38.2%	\$ 1,547,100
ADAMS	12,445	3,025	80.9%	37.9%	\$ 486,270
HAMILTON	395,087	61,597	67.3%	37.3%	\$ 8,793,510
SCIOTO	30,193	7,095	68.0%	36.5%	\$ 1,007,490
MARION	28,633	5,110	63.9%	36.1%	\$ 691,650
ROSS	32,531	5,821	71.8%	35.4%	\$ 845,130
HIGHLAND	18,971	3,617	74.9%	35.3%	\$ 540,240
SHELBY	22,906	3,109	78.0%	35.1%	\$ 479,490
LAWRENCE	25,639	6,173	67.8%	35.0%	\$ 861,690
CLINTON	22,359	3,527	65.4%	34.6%	\$ 475,890
BUTLER	158,948	20,166	68.3%	34.5%	\$ 2,830,200
CRAWFORD	22,233	3,608	67.5%	34.0%	\$ 498,090
HOCKING	11,981	2,331	62.9%	33.9%	\$ 303,480
LUCAS	197,825	34,820	63.8%	33.0%	\$ 4,642,290
GALLIA	12,875	2,789	73.7%	32.8%	\$ 408,480
BROWN	17,627	3,137	74.5%	32.7%	\$ 459,270
MUSKINGUM	41,203	7,803	69.8%	32.7%	\$ 1,094,010
ALLEN	46,860	8,204	64.8%	32.6%	\$ 1,097,910
MONTGOMERY	254,631	40,012	61.5%	32.6%	\$ 5,179,200
CHAMPAIGN	17,552	2,486	70.0%	32.3%	\$ 348,090
MIAMI	50,816	6,710	68.3%	32.1%	\$ 920,370
<b>OHIO TOTALS</b>	<b>5,349,583</b>	<b>796,636</b>	<b>64.6%</b>	<b>29.8%</b>	<b>\$ 104,097,120</b>
U.S. TOTALS	130,354,745	22,053,667	70.9%	26.8%	\$ 3,029,007,780

SOURCE: Internal Revenue Service SPEC Information Database, Tax Year 2005 (December 2007). CDF calculations.

Notes: \* Of those who receive a refund

\*\* Calculated based on a \$150 average tax preparation fee, a \$100 average RAL fee and a \$30 average RAC fee

## Tax Preparation Fees

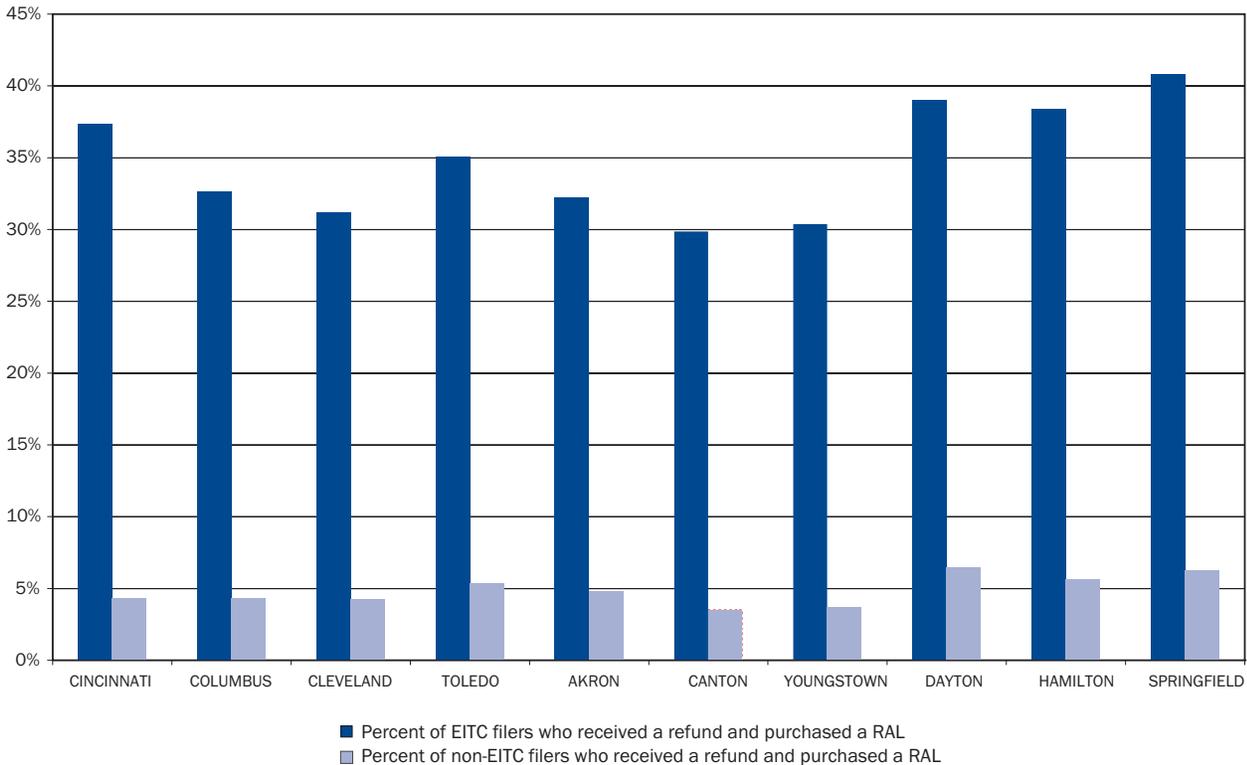
For millions of tax filers both the complex federal and state tax laws and the time required to compile the necessary documentation and prepare and file tax returns often seem onerous. As a result, a significant portion of U.S. tax filers each year ultimately turn to commercial tax preparation services and private tax consultants to prepare their federal and state tax returns. This is especially the case among low-income filers. For tax year 2005, almost 65 percent of EITC recipients in Ohio paid to have their returns completed professionally. Those tax preparation fees drained, in total, \$77,311,650 in EITC benefits from the pockets of these families and individuals.

## Refund Anticipation Loans

The availability of Refund Anticipation Loans (RALs) and other financial products intended to accelerate receipt of tax refunds also accounts for the substantial redirection of EITC investments. These short-term loans, based on the filer's expected tax refund, often have triple-digit interest rates. Ultimately, they end up costing the client a sizeable portion of his or her income. For tax year 2005, for example, taxpayers who purchased a RAL typically paid \$100 to receive their refund the same day or within a few days, as most RALs offer. In sum, these fees represented a \$23 million loss in EITC benefits for hardworking families and individuals across Ohio.

In addition, Ohio EITC recipients are more than seven times as likely to purchase a RAL as taxpayers who did not file for the credit. According to IRS data, an estimated 230,000—almost 30 percent—of EITC tax filers in Ohio who received refunds for the 2005 tax year purchased a RAL, whereas only 4.0 percent of non-EITC taxpayers in Ohio who received refunds purchased a RAL that same year. Perhaps this wide disparity could be attributed, at least in part, to the aggressive marketing of RALs to the working poor within their communities. Figure 2 illustrates the disproportionate usage of RALs by EITC families in the state's largest metropolitan areas. It is estimated that the typical EITC recipient in Ohio who obtains a RAL loses 8.3 percent of their federal refund in tax preparation and RAL fees.

**Figure 2**  
**EITC v. Non-EITC Filers Who Purchased Refund Anticipation Loans (RALs)**



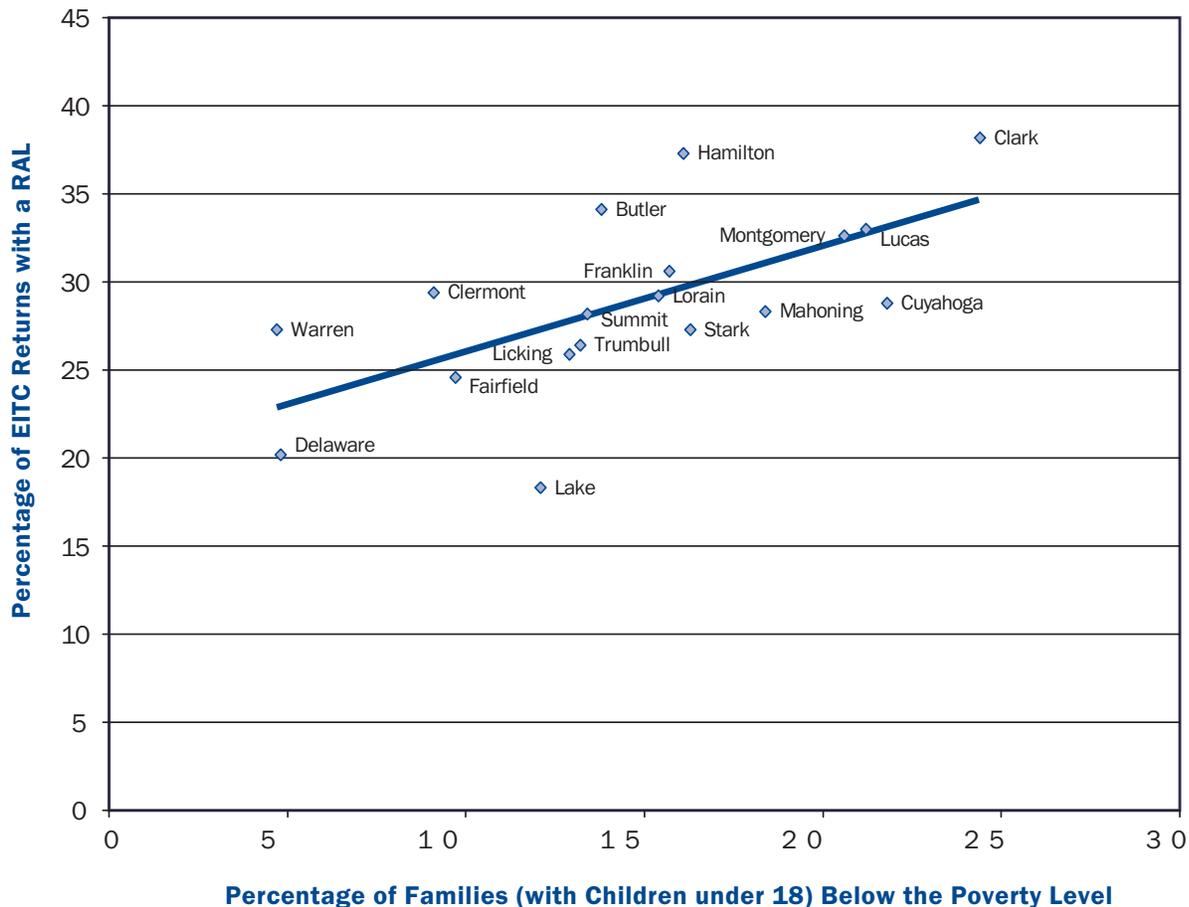


### Predatory Lending

Furthermore, not only are EITC recipients more likely to purchase these short-term, high-interest loans, but amongst EITC recipients, it is the most impoverished that are being sold RALs at the highest rate, as evidenced in Figure 3. The following scatter plot illustrates a positive correlation ( $r=0.63$ ) between poverty level and the percentage of EITC recipients that purchased a RAL amongst 18 of Ohio's most populous counties, for which 2005 poverty data is available. In other words, EITC claimants from the most impoverished counties in Ohio are the most likely to purchase these high-interest loans. Of significance, EITC claimants in Warren, Clermont, Butler, Hamilton and Clark Counties appear to have purchased RALs at a higher rate than the identified relationship would predict. In addition to highlighting the need for legislation to counteract these predatory lending practices, these findings lend evidence in support of the need for further anti-RAL advocacy and outreach efforts in these communities.

Figure 3

Percentage of Families Below the Poverty Level v. Percentage of EITC Returns with a RAL



Pearson's  $r = 0.63$

Source: U.S. Census Bureau, 2005 American Community Survey; Internal Revenue Service SPEC Information Database, Tax Year 2005 (December 2007). CDF Calculations.

— regression line

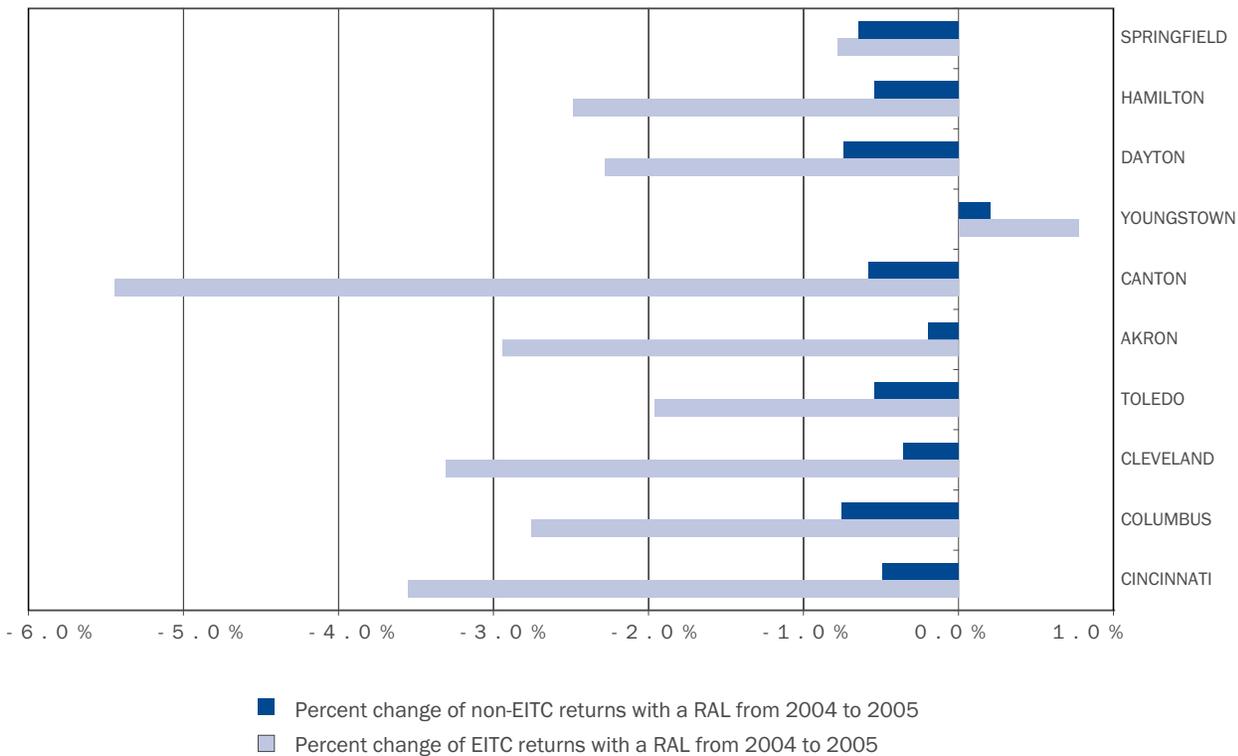


## Promising Trends

Despite these negative findings, promising trends are emerging. As indicated in Figure 4, RAL usage among EITC recipients dropped in 2005 across Ohio's major urban areas (with the exception of Youngstown). While the exact reasons for this decline are not known, likely reasons include: better reporting of data, increased education and awareness, and anti-RAL advocacy.<sup>7</sup>

Additionally, though progress has been slow, modest steps have been taken recently to reduce the negative impact of RALs on low-income families and communities. "Pay stub" or "holiday" RALs, which posed additional costs and risks to taxpayers, have been almost entirely eliminated. These RALs were available to taxpayers prior to receiving their W-2s and were taken out against their expected refund. Under considerable pressure from community groups and consumer advocates, all of the major RAL banks announced in the spring of 2007 that they would stop offering these types of loans.<sup>8</sup> And more reductions in RAL usage may be on the horizon. The IRS has announced it is considering restricting the sharing of tax return information with those who market RALs and other financial products sold to access tax refunds.

**Figure 4**  
**Percent Change in RALs from 2004 to 2005 for EITC and Non-EITC Filers**



### Other Products

A proportion of EITC recipients purchase other types of financial products to access their refunds. New data from the IRS also allow us for the first time to determine how many taxpayers received a Refund Anticipation Check (RAC), a non-loan financial product in which an account is temporarily opened for taxpayers to receive their refund—although they do not receive their refund any sooner than the IRS sends it. An estimated 17.3 percent of Ohio EITC recipients obtained this service for tax year 2005, thereby draining nearly \$4.0 million from their EITC benefits.

### Maximizing EITC Benefits for Working Families

While millions of families and individuals across Ohio have benefited immensely from the EITC, these same taxpayers lost an estimated total of \$104 million to commercial tax preparation fees, RALs, and other products used to access tax refunds for tax year 2005 alone. Government officials and community leaders have within their power the ability to formulate public policies that address the root causes and mitigate the effect of RALs and costly tax preparation fees on lower-income communities.

It is essential that low- and modest-income families benefit fully from the existing EITC. The stakes are high. Indeed, the EITC holds significant potential to substantially supplement earnings for the 2007 tax season. Maximum benefit levels include:

- \$4,716 for families with two or more children;
- \$2,853 for families with one child; and,
- \$428 for individuals between the ages of 25 and 64 with no children.

In addition, many working families who are EITC recipients are also eligible for other federal tax credits such as the Child Tax Credit (CTC), an income supplement for those working families with children with incomes above \$11,750. It can contribute as much as \$1,000 for each child claimed in 2007. Overall, it has been estimated that the CTC adds as much as 40 percent to EITC-eligible taxpayers' refunds.<sup>9</sup>



## Recommendations:

To maximize EITC benefits, the Children's Defense Fund recommends the following key measures:

### 1. Strengthen Consumer Protections

In Ohio, EITC and RAL legislation has failed to gain solid traction. Low-income families cannot continue to lose significant portions of their intended EITC benefits. This year lawmakers must take action to adopt policies that protect consumers, such as establishing licensing requirements for commercial tax preparers, ensuring full disclosure of RAL fees and interest rates, and placing a cap on the interest rates and fees that banks can charge for RALs.

State Representative, Mike Foley, has sponsored a bill, intended to regulate Refund Anticipation Loans and Refund Anticipation Checks.<sup>10</sup> This legislation would protect the working poor of Ohio who are often the victims of high interest RALs.

### 2. Expand Access to Free Tax Assistance

A substantial share of taxpayers in Ohio still pay to have their taxes completed and filed. Alternatives have emerged to reduce the cost of tax filing for low-income individuals and families. The most important of these are free tax preparation sites—particularly Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs—the numbers of which have grown significantly in recent years. These sites typically offer electronic filing and direct deposit of refunds, allowing taxpayers to get their money in two weeks or less without fees. With the money saved, families can enhance their own financial stability by paying bills, purchasing needed household items and/or increasing savings. Substantial scaling up of such efforts is essential. Elected officials and community leaders must find ways to build and maintain free tax preparation networks across the state by investing in the VITA and TCE programs, as well as other free tax assistance centers.

*VITA sites have been established in a number of counties throughout Ohio; next tax season call the IRS at 1-800-829-1040 to find out if there is a VITA site near you.*

### 3. Connect Working Families to Mainstream Financial Services

A high priority is improving the financial literacy of low-income families in Ohio. Free or low-cost checking and savings accounts, credit counseling opportunities, and financial education programs offer working families the tools to build a better financial future. Public-private partnerships should be promoted and established to ensure that working families have easy access to these resources.

### 4. Institute a State EITC in Ohio

State Representative Mike Foley sponsored legislation which proposes an Ohio EITC equal to 5 percent of the federal credit in 2009 and 10 percent in subsequent years.<sup>11</sup>

As the vast majority of poor children live in families with a working parent, the institution of a state EITC in Ohio could importantly further supplement wages and help lift our most vulnerable families out of poverty. Twenty-three states and the District of Columbia currently have a state EITC in effect.<sup>12</sup> In addition, New York City and Montgomery County, Maryland, offer local Earned Income Tax Credits. Research indicates that tax refunds can be used to help low-income families meet their immediate and medium-term needs while stimulating local economies.



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## Footnotes

- <sup>1</sup> IRS SPEC Return Information Database, Tax Year 2005 (December 2007). All figures contained in this report have been retrieved from the 2005 SPEC database unless otherwise noted. CDF calculations. Note that tax returns for tax year 2005 occurred in calendar year 2006.
- <sup>2</sup> Greenstein, Robert, *The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor*, Center on Budget and Policy Priorities, August 17, 2005.
- <sup>3</sup> Berube, Alan, *Using the Earned Income Tax Credit to Stimulate Local Economies*, The Living Cities Policy Series, 2006.
- <sup>4</sup> Rhine, Sherrie L.W., et al, *Householder Response to the Earned Income Tax Credit: Path of Sustenance or Road to Asset Building?* Federal Reserve Bank of New York, 2005.
- <sup>5</sup> *2004 Update: Increased Participation in the Earned Income Tax Credit in San Antonio, Texas Perspectives*, 2004.
- <sup>6</sup> *The Importance of the Earned Income Tax Credit and Its Economic Effects in Baltimore City*, Jacob France Institute, 2005.
- <sup>7</sup> *Positive Improvements for Tax Refund Loans, but Consumers Still Warned to Avoid Them*, National Consumer Law Center, January 2008. See also Chi Chi Wu, *One Step Forward, One Step Back: Progress Seen in Efforts Against High-Priced Refund Anticipation Loans, but Even More Abusive Products Introduced*, National Consumer Law Center, January 2007.
- <sup>8</sup> *Positive Improvements for Tax Refund Loans, but Consumers Still Warned to Avoid Them*, National Consumer Law Center, January 2008.
- <sup>9</sup> Berube, Alan, *Using the Earned Income Tax Credit to Stimulate Local Economies*, The Living City Policy Series, 2006.
- <sup>10</sup> Ohio Legislative Service Commission, *House Bill 156*, 13 March 2008. [http://www.legislature.state.oh.us/BillText127/127\\_HB\\_156\\_Y.pdf](http://www.legislature.state.oh.us/BillText127/127_HB_156_Y.pdf)
- <sup>11</sup> Rothstein, David, *Dollars that Make Sense: The EITC in Ohio*, Policy Matters Ohio, 13 March 2008. [http://www.policymattersohio.org/pdf/DollarsThatMakeSense2007\\_04.pdf](http://www.policymattersohio.org/pdf/DollarsThatMakeSense2007_04.pdf)
- <sup>12</sup> Rothstein, David, *Re: States with EITCs*, E-mail to the author, 11 April 2008.



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