

Use of the Earned Income Tax Credit by Rural Working Families

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Abstract

The Federal Earned Income Tax Credit (EITC) provides cash-strapped and credit-constrained rural working families the opportunity to increase their purchasing power. Qualitative and quantitative methods were used to analyze data from a sample of 237 rural working mothers who participated in a multi-state study. Two-thirds of those eligible claimed the EITC. The rural families used the EITC to pay bills and loans, improve access to transportation, purchase various consumer durables and non-durables, establish savings and build assets, engage in leisure activities, and make human capital investments.

Introduction

The Federal Earned Income Tax Credit (EITC) is a refundable tax credit designed to supplement the wages of working low-income families. Enacted by Congress in 1975, it was intended to be a small temporary program to provide an incentive to work and to offset the burden of Social Security taxes. After numerous expansions and, at \$37 billion in 2003, it has become the largest federal aid program targeted toward working poor families (National Low Income Housing, 2005).

The tax credit's benefits are significant: it increases families' purchasing power, it is a powerful incentive for single mothers to increase labor force hours (Meyer & Rosenbaum, 1998), it reduces income inequality by supplementing the wages of low-income families (Berube & Forman, 2001), and it is the single largest program that has decreased child poverty (Blank, 1999; Greenstein & Shapiro, 1998). In recent years, policymakers have encouraged asset building among low-income families (Edin, 1998; Smeeding, Phillips, & O'Connor, 2000), and the EITC is considered a vehicle by which they may save.

High poverty and persistent poverty are disproportionately found in rural areas, with remote rural areas experiencing the highest poverty (Weber & Jensen, 2004). Time limits imposed by recent welfare reform legislation require welfare-dependent individuals in rural areas to seek employment. Working low-income rural families are entitled to the EITC and, as long as they remain in the labor force and have not reached their phase-out point, they continue to receive the tax credit.

In spite of the many positive benefits of the EITC, few studies exist on the behavior of rural families surrounding the tax credit. In this paper, we examine how the EITC affects the consumption patterns of rural working families.

Background

The EITC provides many benefits to working families, and larger percentages of eligible families claim the tax credit than other more traditional assistance programs such as Transitional Assistance to Needy Families (TANF), Food Stamps, and Medicaid (Berube & Forman, 2001). Families in large cities are the most likely to receive the EITC, followed closely by families in rural areas (Berube & Tiffany, 2004). Given the income differential and the prevalence of low-wage jobs in rural areas, families here stand to gain significantly more from the credit, making it a major source of income support. In fact, after the expansion of the credit, the adjusted poverty rate among female-headed families in nonmetropolitan areas declined from 49% in 1992 to 35% in 1999 (Lichter & Jensen, 2002). Rural families in the South are even more likely to earn lower incomes and receive less cash assistance than those in any other part of the nation. As a result, the share of these families receiving the tax credit is well above the national average (ERS, 1996) and, consequently, the positive impact on them cannot be underestimated.

Families who qualify for the EITC can select between advance payments and a lump sum payment. If families receive it as advance payments, it will increase household income flow and utility; however, more than 98% receive a lump sum payment (McCubbin, 2000; Romich & Weisner, 2000; Scholz, 1994). Smeeding (2000) has suggested explanations for this behavior: employers may be unwilling to participate in the program, employees may

be reluctant to inform the employer because of the stigma attached to it or the fear of lower pre-tax wages, and employees like the forced savings aspect of the EITC. The use of the credit to purchase consumer durables is yet another reason why families prefer a lump sum payment (Barrow & McGranahan, 1999). Finally, a lump sum tax refund can be treated as windfall income, something they cannot do with a small monthly advance payment.

How might poor working families use their EITC payments? In a study of Chicago families, Smeeding, Ross, O'Connor, and Simon (2000) found that between 75% and 80% of the families used the refund to pay a bill, the single highest priority for almost half of them, or make consumer purchases, the second highest priority. At the same time, about half of them reported that they saved some or all of their refund for uses such as paying bills, purchasing consumer durables, and making educational investments in themselves or their children. A significant finding of this study was that the EITC also played an important role in improving the social mobility of its recipients, defined by the authors as purchasing or repairing a car, paying for education, and moving. In another study, 21% of the respondents who used the EITC for savings indicated that their first priority was to establish precautionary savings (Beverly, Tescher, & Marzahl, 2000).

Using Consumer Survey Expenditure data, Barrow and McGranahan (1999) found evidence of expenditure seasonality for families that receive the EITC. These families tended to spend more on all expenditures, including big-ticket consumer durables, in February, the modal month of the EITC payments, than in other months. An ethnographic study of 42 working Wisconsin families found that they used the lump sum EITC payments and tax refunds to purchase large-ticket consumer goods, accumulate assets, and create savings. Expenditure on children was a priority item, followed by purchase of furniture and a variety of other consumer durables, and finally, making improvements in their transportation and housing situations (Romich & Weisner, 2000).

One way of explaining household consumption patterns is by using Shefrin and Thaler's (1988) behavioral life-cycle (BLC) hypothesis. They proposed the addition of three aspects of behavior into Modigliani and Brumberg's (1954) life-cycle theory of saving: self-control, mental accounting, and framing. According to the BLC, self-control is costly, and individuals will use a variety of means to postpone making a decision or having to exert self-control; hence, they would prefer receiving the EITC as a lump sum rather than as an advance, particularly since the lumpy nature of the credit supports the purchase of large consumer goods. Mental accounting occurs when consumers separate funds into "wealth," considered less tempting to spend, and "income"; hence, a lump sum will be seen as different from advance payment in the form of additional income received in a paycheck. Finally, consumers "frame" a lump sum bonus differently from regular income even though the bonus is anticipated; hence, the marginal propensity to save from a lump sum (wealth) is greater.

Data

The sample consists of 299 rural low-income families from 23 counties in 13 states who participated in a multi-state project, NC-223/NC-1011, "Rural Low-Income Families: Tracking Their Well-Being and Functioning in the Context of Welfare Reform."³ To be eligible for the study, families had to have annual incomes at or below 200% of the federal poverty line and at least one child under the age of 13. To find participants who would welcome interviewers into their lives, we recruited them through programs that serve low-income families such as the Food Stamp Program; Supplemental Program for Women, Infants, and Children (WIC); food pantries; survival centers; and welfare-to-work programs. This method of selection has resulted in a sample of convenience. Although the results cannot be generalized to the entire rural population, nevertheless, because the participants were recruited broadly from various agencies that offer support programs, this study provides an extremely useful account of how rural working families view and use the EITC.

Trained interviewers collected in-depth qualitative and quantitative data from the mother, during face-to-face interviews at a site of the respondent's choice. Where necessary, interviews were conducted in Spanish. The semi-structured protocol included questions on a variety of areas including socio-demographics, employment, objective and subjective measures of income. Respondents were asked if they received the EITC and, if so, how much. They were also asked how the tax credit was used, although not the exact amount spent on each item purchased. Respondents' tax returns were not checked; therefore, we could not be certain if they received the EITC. From the size of the reported refunds, however, it is clear that benefits were received. Many of the mothers could not distinguish between the EITC and regular tax refunds. The figures used in this study, therefore, reflect the combined amounts for the EITC and tax refund, similar to the situation faced by Romich and Weisner (2000).

Of the 13 states that participated in this study, six (Indiana, Maryland, Massachusetts, Minnesota, New York, and Oregon) provide a state EITC in addition to the federal tax credit. The other seven (California, Kentucky, Louisiana, Michigan, Nebraska, New Hampshire, and Ohio) do not.

Sample Description

Of the 299 mothers who participated in the study, 237 qualified for the EITC, because either they or their spouse was in the labor force in the preceding year. Table 1 presents the socio-demographic information of the mothers who qualified for the tax credit. Over two-thirds (71%) of them were between the ages of 25 and 45; the median age was 27 years. About two-thirds (63%) of the rural families who were eligible for the EITC were White, 25% of them were Hispanic, and 6% were Black. Slightly over two-thirds (68%) of the mothers were married or living with a partner, and 14% were divorced or separated; the rest (18%) were single. Twenty-nine percent of the rural mothers had one child, another 29% had two children, and finally, 42% had three or more children. The modal level of education was more than high school. Slightly more than two-thirds (69%) of the mothers were employed; 95% of spouses or partners were employed. Median monthly income of the rural families who qualified for the EITC was \$1,476.

Results

Although 237 families were entitled to the EITC payment, only 62% (147 families) claimed it. Most of these rural mothers did not distinguish between the EITC and tax refunds; the combined amount for both EITC and tax refunds ranged from \$200 to \$6,000, with the median amount received being \$2,294. Table 1 also provides a comparison of socio-demographic characteristics between those who were eligible for the EITC and those who ultimately claimed it. Rural working mothers who claimed the tax credit were slightly older (median age, 29 years), more likely to be White (71%), more likely to be a high school graduate, slightly more likely to have one or two children (62%), and more likely to have a lower monthly median income (\$1,310).

There were a variety of reactions from the mothers regarding the EITC; some recognized it immediately, some required prompting, and some could not distinguish it from their regular tax refund. While there were mothers who remembered the exact amount they received, others could provide only an estimate. Some of the mothers were not sure if they received or qualified for the tax credit, or they were generally confused about it, such as this mother from Louisiana:

Um, No ma'am. No I don't, I had W-2 forms but I didn't file because I was told you know, I wasn't going to have, you know a income back. And so I didn't uh, worry about it.

Although the respondents were not asked if the EITC was received as a lump sum or as an advance payment, it is evident that the overwhelming number of these rural families received it as a lump sum. This is consistent with the findings of others (McCubbin, 2000; Romich & Weisner, 2000; Scholz, 1994).

Table 1
Socio-Demographic Characteristics of EITC Eligible Rural Mothers

Characteristic	EITC Eligible (n=237) %	EITC filing (n=147) %
Age		
Under 25	27.4	30.1
25-45	70.8	68.5
Over 46	1.8	1.4
<i>Median age</i>	<i>27.0</i>	<i>29.0</i>
Ethnicity		
White, non-Hispanic	62.6	70.5
Hispanic	25.1	14.4
Black	6.4	8.2
Other	5.9	6.9
Marital Status		
Married/living with partner	68.2	58.5
Divorced/separated	13.9	19.0
Single	17.8	22.5
Education		
More than high school	44.7	30.6
High school	28.9	36.1
Less than high school	26.4	33.3
Number of Children		
One	29.2	31.3
Two	28.8	30.6
Three or more	42.0	38.1
Mother's Working Status ^a		
Working	68.6	61.9
Non-working	31.4	38.1
Spouse/Partner's Working Status		
Working	95.0	85.0
Non-working	5.0	15.0
Monthly Income of Employed Families		
<\$1,000	26.8	32.9
\$1,000-\$1,499	19.6	25.2
\$1,500-\$1,999	21.2	21.7
\$2,000-\$2,500	18.5	10.5
>\$2,500	13.9	9.8
<i>Median income</i>	<i>\$1,476.00</i>	<i>\$1,310.00</i>

^a Eligibility for EITC is based on the working status of either the mother or the spouse.

Rural Families' Usage of the EITC

Based upon the response from the mothers, seven categories of EITC usage were identified: (1) pay bills and loans, (2) improve access to transportation, (3) purchase consumer non-durables, (4) establish savings and build assets, (5) purchase consumer durables, (6) enjoy the benefits of windfall income, and (7) increase human capital. Respondents could have purchased items in any number of expenditure categories.

Table 2

EITC Usage of Rural Families (n=147)

Usage	n	%
Pay bills and loans	65	44.2
Improve access to transportation	35	23.8
Purchase consumer non-durables	30	20.4
Establish savings and build assets	27	18.4
Purchase consumer durables	16	10.9
Enjoy benefits of windfall income	16	10.9
Increase human capital	5	3.4

Note. Families could have used the tax credit to purchase items in more than one expenditure category.

Pay bills and loans. Bill paying is a regular activity for most families, regardless of their financial status. For low-income families, however, this often poses a substantial burden because they have to stretch their limited income simply to get by. As a result, sometimes their bills accumulate. An infusion of cash from the EITC is, therefore, extremely helpful in meeting their financial obligations. The most commonly cited usage of the EITC by these rural families was to pay bills; almost 44% of the sample indicated they used all or part of their tax credit to pay a variety of bills including utilities, cable, and credit cards. It is clear that paying bills, current and past due, is a priority for rural families such as this New Hampshire mother:

Yup, paid bills. Bought a little bit of extra food for the house. Uhm...I had thought about getting a car, but, at the time, I found the bills and stuff were more important to pay.

Three percent of the rural families used the refund to pay some of their bills ahead of time, which may ease their anxieties about having the necessary funds when their bills are due. One Minnesota mother remarked:

I try to get my monthly stuff down, 'cause it's so tight from month to month. So, anything I can pay a year's worth at a time I do in February.

One way that low-income families meet their living expenses is by borrowing, often from family members. Usually the only way they are able to repay these loans is when they receive an influx of cash such as the tax credit. As a result, in addition to paying off bills with their EITC refund, several families used it to pay back loans extended to them.

Improve access to transportation. Reliable transportation is essential for low-income adults to seek and maintain employment as well as for job mobility. The importance of cars to low-income families has been established by Danziger et al. (2000) and Edin (1998). Lack of reliable transportation, however, is a serious problem for many. This is particularly true for families who live in rural areas and, if they lack a reliable vehicle, cannot depend on public transportation because it is often not available. Hence, this becomes a significant threat to their well-being, especially since any trip such as one to a job, a doctor, or a grocery store is difficult. The EITC, therefore, can be an important source of funding for families when it comes to a vehicle, whether it is used for purchase or repair, to make a down payment, to pay a loan, or for insurance.

About one-fifth (21%) of our rural families spent their EITC refund on various transportation-related expenses. The largest percentage (40%) of them used part of their EITC funds to purchase a car, van, or truck⁴. One Indiana mother reported the purchase of two trucks in addition to a car:

Let's see. My husband bought one car to play with...two trucks because one was not quite right when he got it, so he got another one and have some mechanical work done to it so we can get back and forth to work and I can start up my van.

About one-third (37%) of the rural families used their tax refunds for vehicle repairs while 11% used their refunds for a down payment on a car. Other transportation-related expenses included new tires or license plates (11%), car insurance payments (9%), and paying off car loans (6%).

Purchase consumer non-durables. The infusion of cash from the EITC provides working families the opportunity to take care of immediate consumption needs. This was true for 19% of our sample that spent part of their EITC on child-specific expenditures, such as clothes, toys, and school supplies, clothes for adults, extra food, and other unspecified small items. The demand for children's clothing was extraordinarily high; about 81% of the rural mothers spent their refund checks on this. Clearly, a lump sum refund is helpful to parents whose growing children require that they buy several clothing items at one time. Addressing this particular need, one Minnesota mother remarked:

Clothing. Oh my goodness did I spend money on clothing. Spent like six hundred bucks on clothing just for my daughter. Then she outgrew it all already. It's like man I can't win for nothing.

Establish savings and build assets. Saving or putting money aside for future needs is a worthy goal for all families. Low-income families, in particular, need an emergency cushion because, if faced with an unexpected expense or sudden loss of income, they may not be able to approach a financial institution. The EITC payments enable working rural families to save for emergency spending as well as for building assets. Sixteen percent of the rural sample used part or all of their EITC payment for savings or to build assets. Twenty-one percent of them were homeowners; 30% of those who put their money aside in savings ultimately used it for a variety of house-related expenses including fixing the roof, paying for house insurance and property taxes, and making a down payment on a house.

The value of the EITC to rural families also lies in its ability to allow them to get by, as evident in the comment of this Oregon mother:

...So on earned income I've had like \$3700 back that year. Which was nice 'cause then I had Micah and we lived off of that for, shoot it probably started and was gone when I had to go back to work. About 8 months. I did the right thing with it...

Purchase consumer durables. Because of limited income and little or no access to credit, low-income families find it more difficult to acquire big-ticket items such as consumer durables. The lumpy nature of the EITC refund checks can help these families to afford these items. In the case of our sample of rural families, the median monthly income is \$1,310, and the average refund is \$2,294. Thus, the refund represents a substantial amount of additional income for these families; as a result, 10% of them chose to purchase a variety of durable goods with their tax refund. These included furniture, such as entertainment centers, bedroom sets, living room furniture, and kitchen tables; household appliances including refrigerators, washing machines, and dryers; and finally, entertainment equipment, such as DVD players and televisions. Of these, the most common purchase was furniture, especially beds for the children. Often, the durables were purchased along with various other items, as is the case with this Indiana mother:

Um well we...I got new tires on the car. We got the boys bunk beds. I got new carpet. We went to the grocery store. We all went and got some new clothes.

Enjoy benefits from windfall income. Even though the EITC is anticipated by many of these families, when it arrives, it feels as if they have received a windfall. With very little discretionary income to spend otherwise, the EITC allows them the opportunity to enjoy some pleasures of life. In this way, low-income families have the same aspirations as middle and high-income American families who like to take a vacation or treat their children to something special, like the Minnesota mother who took her children, for one night, to a Holiday Inn 15 miles away:

Whirlpool. We usually order in a pizza. You know, but it is something to look forward to once a year.

Among our rural sample, 10% spent part of their EITC refund as windfall income. The overwhelming majority (87%) who used their tax refund in this manner went on a vacation to places such as North Carolina, New York City, and the Bahamas.

Increase human capital. Investing in human capital is a wise use of resources for poor families. For adults, it could help pay for tuition at a college or technical school because this may lead to better and higher-paying jobs.

For children, the benefits of human capital investment may include better performance in school. Of the seven expenditure categories, however, the EITC was the least often used for human capital investment. Only 3% of rural families made such an investment, perhaps because in rural areas there are fewer colleges and schools and few, mostly low-paying, jobs available. Rural residents may, therefore, wish to use their tax refund in more profitable ways.

Of those who invested in human capital, 40% used the tax credit to pay off their student loans; 60% bought a computer. Using their EITC payments from two years, one Massachusetts family managed to purchase three computers:

R: ...Margo got her computer because the year before, my husband and Chase both got...

I: So you've got three brand new computers in the house?

R: Theirs is a year old. Hers is brand new.

Rural Families Use of EITC and The Behavioral Life Cycle

Rural families used the EITC to build assets and savings and to make large purchases including vehicles, furniture, and computers. According to Shefrin and Thaler's (1988) behavioral life cycle (BLC) theory, households tend to separate money into mental accounts, thus providing them greater self-control over what they consider wealth. Rural families' use of the EITC is consistent with the BLC theory; it suggests individuals are more likely to use current income (paycheck income) for current consumption, while wealth (lump sum EITC) will be put into savings or used for larger consumer goods. This is clearly illustrated by a rural mother from Minnesota who kept her income and the tax credit in separate mental accounts, framing her lump sum bonus differently from regular income:

...I would rather – with earned income credit, that's a 50% increase, almost, over my wages, if I got twelve thousand a year. So, I'm thinking I really need to control how I spend my money, so that I can keep living at twelve thousand a year, and afford that... And keep getting that extra bonus of the earned income credit...

Besides the purchase of large items, the rural families used their EITC in other ways as well. They paid bills, both current and past due, and, in the case of a few families, even paid their rent several months ahead. In addition, they used the refund to purchase consumer non-durables, particularly children's clothing. Finally, they treated their refund as windfall income, using it for a vacation. Expenditures of this nature are not entirely incongruent with the BLC theory. Most low-income families cannot get ahead or simply make ends meet with their regular paycheck income. As a result, some of them will allow bills to accumulate even under threat of financial ruin, put off buying clothing, and never contemplate a vacation. Therefore, it is conceivable that rural families would consider the infusion of cash from the lump sum EITC "wealth" to the extent it enables them to meet their overdue financial obligations and affords them more essentials and, even, some luxuries.

Conclusion

During the normal course of the year, the regular paycheck income of low-income rural families does not stretch to cover their day-to-day expenses as well as enable them to save and make large consumer purchases. The EITC affords these otherwise cash-strapped and credit-constrained rural families an opportunity to increase their purchasing power and their savings potential. This was the case for the two-thirds (62%) of working rural mothers who claimed the EITC. They used their tax credit to pay bills and loans, improve their access to transportation, purchase a variety of consumer durables and non-durables, establish savings and build assets, engage in leisure activities, and make human capital investments.

Several policy issues should be addressed, both at the federal and state levels. First, not all working rural families claimed the tax credit. In our sample, approximately one-third (38%) of the eligible families did not file for the EITC and there was confusion about the EITC, even among those who received it. More should be done to publicize the benefits of the EITC program to working families.

Second, families should be made aware that the advance credit option is also available to them. Only one rural family in our sample reported receiving the advance credit. The advance credit option increases monthly cash flow and, as a result, could assist many families struggling with limited income. However, this option may be a distinct drawback for those families who, unable to exert self-control, may not be able to save and/or make large purchases. Regardless of which option families eventually select, it would be helpful to them if both options and their implications were explained so they can make an informed choice.

Third, a few families reported that they used the services of a commercial tax preparer. The fee for the service is a burdensome expense for low-income families. A few of the rural families chose the Rapid Refund method even though it reduced the size of their refund. While not all commercial tax services are predatory, it may not be in their best interest to advise the families to wait for their refunds. From a policy point of view, it would be desirable to provide or, if already available, publicize free tax advice service offered by local community volunteers.

It is clear from the results of this study that the EITC affects the consumption pattern of rural families in a variety of important ways. Future research should address the impact of the EITC on the economic well-being and, ultimately, the quality of life of rural families.

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³ Information on the NC-223/NC1011 project is available on line at www.ruralfamilies.umn.edu.

⁴ It is not clear if these respondents made an outright purchase of the vehicle or if only a down payment was made.