

Children's Defense Fund

Policy Report



Halting the Loss of Billions of Dollars in Earned Income Tax Credit Benefits in the State of Mississippi

April 2008

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 the most recent year for which data are available, the EITC lifted 4.4 million Americans in the United States 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.¹

According to the most recent year of available data from the Internal Revenue Service (IRS), over 370,000 Mississippi taxpayers received the EITC for the 2005 tax year. Yet, nearly \$60 million dollars were lost statewide to tax preparation fees, Refund Anticipation Loans (RALs) and other commercial products used to access tax refunds. The highest concentration of funds lost was in the poverty-stricken Mississippi Delta and the hurricane-recovering Gulf Coast—two locations that can ill afford to lose extra money that could be used to lift families out of poverty.

EITC Boost to Local Economies

The EITC is one of the most effective work support tools to assist families who work full- or part-time but earn low wages. The EITC means real money in the pockets of eligible individuals and families. In Mississippi, the poorest state in the United States, the funds generated from the EITC serve as an extra economic boost to local communities, especially to poverty-stricken areas of the Mississippi Delta and the hurricane ravaged Gulf Coast. 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.ⁱⁱ

Figure 1: Total Dollars Lost to Tax Preparation Fees, Refund Anticipation Loans (RALs) and Refund Anticipation Checks (RACs) in Mississippi Cities with the Highest Number of Returns Filed, Tax Year 2005

City	Number of Tax Returns	Number of EITC Tax Returns	% of EITC Returns Using Paid Preparers	% of EITC Returns That Received a RAL*	Dollars Lost to Tax Preparation, RALs and RACs**
Jackson	73,587	31,541	67.8%	43.0%	\$ 4,749,810
Gulfport	30,736	9,349	75.8%	36.8%	\$ 1,468,410
Hattiesburg	29,958	8,851	77.3%	41.5%	\$ 1,446,840
Brandon	27,061	3,805	69.0%	32.1%	\$ 533,040
Meridian	25,075	8,228	83.3%	47.9%	\$ 1,469,280
Biloxi	21,879	4,893	72.7%	29.8%	\$ 707,940
Vicksburg	20,890	7,055	81.1%	42.0%	\$ 1,189,200
Columbus	20,092	6,463	61.2%	46.0%	\$ 920,880
Tupelo	18,701	5,149	79.2%	47.1%	\$ 870,360
Olive Branch	17,678	2,462	71.0%	35.2%	\$ 358,950
Mississippi Totals	1,130,867	370,490	75.7%	42.6%	\$ 59,772,330
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.

The limited studies that have attempted to measure the economic impact of the EITC on local economies signal substantial potential of 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.ⁱⁱⁱ Another study in Baltimore found that EITC benefits generate almost \$600,000 in local income and property tax revenues.^{iv} Unfortunately, cities such as San Antonio and Baltimore do not benefit fully from increasing EITC participation rates because of the billions of dollars of EITC benefits intended for working families that are diverted to commercial tax preparers and lending institutions.

Billions Lost Annually in EITC Benefits Paid to Working Families

Increased education and advocacy to expand knowledge of the EITC and promote its greater application has helped millions of working families to claim these key benefits they have earned. Yet the significant poverty reduction potential of the EITC investment continues to fail to be fully realized. For tax year 2005, tax preparation fees, RALs and other commercial products used to access tax refunds diverted \$3 billion in EITC benefits nationwide to commercial tax preparers and lending institutions.

Figure 2: Mississippi Counties with the Highest Number of Tax Returns Filed, Tax Year 2005

County	Number of Tax Returns	Number of EITC Tax Returns	% of EITC Returns Using Paid Preparers	% of EITC Returns That Received a RAL*	Dollars Lost to Tax Preparation, RALs and RACs**
Hinds	103,395	38,538	67.2%	41.6%	\$ 5,712,750
Harrison	71,648	18,943	74.2%	32.7%	\$ 2,845,170
Desoto	60,805	11,538	71.9%	37.9%	\$ 1,739,100
Rankin	54,583	10,258	69.8%	34.1%	\$ 1,472,010
Jackson	47,923	12,243	76.0%	32.9%	\$ 1,876,980
Forrest	38,342	10,965	76.8%	39.5%	\$ 1,760,640
Madison	37,053	8,534	57.7%	36.9%	\$ 1,112,640
Lee	36,300	10,457	79.6%	46.0%	\$ 1,760,790
Lauderdale	31,610	10,201	82.8%	47.1%	\$ 1,805,310
Jones	24,449	7,735	79.8%	45.2%	\$ 1,304,820
Lowndes	24,096	7,695	62.7%	46.2%	\$ 1,114,830
Washington	21,363	10,464	76.8%	51.9%	\$ 1,821,690
Warren	21,187	7,146	81.0%	42.0%	\$ 1,203,450
Pearl River	19,499	5,589	77.8%	30.6%	\$ 856,770
Pike	16,339	6,895	70.5%	42.0%	\$ 1,065,120
Marshall	16,206	5,953	85.5%	50.4%	\$ 1,088,100
Panola	14,912	6,131	77.0%	49.6%	\$ 1,039,650
Oktibbeha	14,829	4,249	71.9%	45.8%	\$ 675,840
Lafayette	14,296	3,254	75.9%	37.0%	\$ 502,860
Bolivar	13,959	6,443	81.3%	44.2%	\$ 1,104,360
Monroe	13,558	4,480	83.9%	50.1%	\$ 805,290
Alcorn	13,400	3,761	84.6%	44.7%	\$ 655,920
Neshoba	12,635	4,331	83.8%	48.5%	\$ 768,900
Adams	12,608	4,896	82.9%	36.7%	\$ 824,970
Copiah	12,337	4,755	71.6%	41.6%	\$ 735,810
Mississippi Totals	1,130,867	370,490	75.7%	42.6%	\$ 59,772,330
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). Calculations by CDF.

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. A number of factors underlie this substantial redirection of EITC investments. First is the heavy dependence on external providers for tax preparation. For millions of tax filers both the complexities of federal and state tax laws and the time required to compile the requisite documentation and prepare and file tax returns often seem onerous. Hence, 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, nearly 76 percent of EITC recipients in Mississippi

paid to have their returns completed professionally, compared to 57 percent of non-EITC recipients across the nation. Nationally, tax preparation fees drained about \$2.3 billion in EITC benefits from low to modest income families. For families on the margins of poverty, or currently in poverty that are living paycheck to paycheck, spending \$150 to have their taxes prepared and electronically filed is a significant amount of money.

Refund Anticipation Loans. In order to accelerate receipt of their tax refunds, EITC recipients nationwide are more than six times as likely to secure a Refund Anticipation Loan (RAL) as taxpayers who did not file for that credit. According to IRS data, an estimated 5.6 million EITC tax filers in the United States or 27 percent of all EITC filers who received refunds for the 2005 tax year took out RALs, whereas only 4.1 percent of non-EITC taxpayers who received refunds purchased RALs the same year. This wide disparity is attributable at least in part to the aggressive marketing of RALs to the working poor within their communities. Yet these short-term loans that are based on the filer's expected tax refund often have triple-digit interest rates. Ultimately they can end up costing the client a sizeable portion of his or her refund. Unfortunately, it is those working families and individuals who most need their hard-earned income that are often sold short-term, expensive RALs.

In tax year 2005, for example, a taxpayer purchasing a RAL typically paid \$100 solely to get his or her refund the same day or within a few days, as most RALs offer. Nationwide, these fees represented a \$565 million loss in EITC benefits. Combining the costs of tax preparation and RAL fees, the typical EITC recipient in the U.S. who obtains a RAL loses an estimated 8.1 percent of his or her federal refund. In Mississippi, nearly 76 percent of EITC recipients used a paid preparer, while about 43 percent of recipients obtained RALs. This means needy Mississippi families and communities lose about \$60 million in tax preparation fees, RALs and other commercial products used to access tax refunds.

In most cases, RALs are paid off once the IRS processes the tax return and transfers the funds. But RAL loans can actually place families in greater financial risk since they are responsible for paying the interest accruing on the loan if the IRS denies part of the refund for any reason or withholds it temporarily for audit purposes. According to a report from the National Taxpayer Advocate, nearly 75 percent of the tax returns frozen by the IRS because of suspected fraud belonged to low-income taxpayers claiming the EITC, although well over half of all frozen refunds were ultimately found to be free of fraud. Given their often pressing financial needs, it is unlikely EITC families budget for this possibility. It is also shown that many families do not comprehend that they are taking out a loan. Families could end up in debt just by taking out a Refund Anticipation Loan. This was the case with a Mississippi taxpayer named "Ann." Ann went to a local tax preparer that specialized in RALs. She has used the service and received RALs for several years. Recently the company the tax preparer used was charged with several claims of identity theft and wire fraud. Ann, a single mother, was charged over \$400 for the preparation of her taxes and for the RAL, and was promised a refund check for over \$5,000 and that it would be back to her in two weeks. She has not received her refund and recently found out from the IRS that she owes over \$2,000 in back taxes from 2004. Following these revelations, "Ann" declared that she would use a VITA site for future tax preparation.

But promising trends are emerging. For tax year 2005, RAL usage among EITC recipients dropped for the second year in a row. While the exact reasons for this decline are not known, likely contributors include better reporting of data, increased education and awareness, and anti-RAL advocacy.^v

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 — RALs that 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.^{vi}

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 marketing RALs and other financial products sold to access tax refunds.

Other products. A proportion of EITC recipients purchase other types of financial products to access their refunds. New data from the IRS reveals for the first time 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 19 percent of EITC recipients nationwide obtained this service for tax year 2005, thereby draining \$120 million from their EITC benefits.

Extensive usage of tax preparation services, RALs and other commercial products used to access tax refunds also detrimentally impacts local economies in Mississippi and across the country. Figure 1 shows the total dollars lost in Mississippi's cities with the highest number of returns filed, while Figure 2 highlights Mississippi counties with the highest number of returns filed. Figure 3 provides an overview of Mississippi counties with the highest percentage of RALs purchased; the largest concentration in Mississippi Delta counties and the Mississippi Gulf Coast, the poorest region and hurricane recovery areas of the state, respectively.

Maximizing EITC Benefits for Working Families

While millions of families and individuals across the country have benefited immensely from the EITC, these same taxpayers lost an estimated total of \$3 billion in fees from commercial tax preparation, 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.

This 2007 tax season, 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 with these current maximum benefit levels:

- \$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. Overall, it has been estimated that the CTC adds as much as 40 percent to EITC-eligible taxpayers' refunds.^{vii}

Recommendations

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

Restructure Mississippi Tax System. According to the Mississippi Economic Policy Center report, *Putting the Pieces Together: A Taxpayer's Guide to the Mississippi Budget*, Mississippi's tax system is regressive. The top 20 percent of income earners (who earn an average of \$103,400 annually) pay the lowest percentage of their income towards state and local taxes, an estimated 7 percent of their income. The bottom 40 percent of earners, typically families that qualify for the Earned Income Tax Credit and are most likely to receive RALs, pay the highest percentage of their income towards state and local taxes. The bottom 20 percent of earners (who earn an average of \$7,000 annually) pay 10 percent of their income in state and local taxes, and the next 20 percent of earners (with average earnings of \$15,100) pay 11.5 percent of their income. Mississippi's personal income tax functions more like a flat tax— people earning \$30,000 a year are in the same tax bracket as people earning \$250,000 a year. Even working families with wages below the federal poverty line are subject to the state income tax.

Strengthen consumer protections. Over the course of recent sessions of Congress, 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.

Expand access to free tax assistance. A substantial share of taxpayers nationwide 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 country by investing in the VITA and TCE programs, as well as other free tax assistance centers.

Connect working families to mainstream financial services. A high priority is improving the financial literacy of low-income families. 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.

Institute state EITCs nationwide. Since the vast majority of poor children live in families with a working parent, the institution of state EITCs nationwide could importantly further supplement wages and thus also help lift our most vulnerable families out of poverty. Only 22 states and the District of Columbia currently have a state EITC in effect. 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.

Mississippi lost nearly \$60 million dollars to commercial tax preparers and rapid refund vendors in 2005— money that could have been used to help lift low- to moderate-income families out of poverty and boost the economy of the poorest state in the union. Much more can and should be done on the local, state and national levels to ensure that all EITC dollars make it into the pockets of working families. The Children's Defense Fund's efforts to educate and assist families are making a difference in the lives of working families.

Figure 3: Total Dollars Lost to Tax Preparation Fees, Refund Anticipation Loans (RALs) and Refund Anticipation Checks (RACs) in Mississippi Counties with the Highest Percentage of EITC Returns with RALs, Tax Year 2005

County	Number of Tax Returns	Number of EITC Tax Returns	% of EITC Returns Using Paid Preparers	% of EITC Returns Receiving a RAL*	Dollars Lost to Tax Preparation, RALs and RACs**
Tunica	5,244	2,843	88.4%	54.4%	\$ 551,070
Issaquena	331	181	48.6%	54.2%	\$ 23,970
Benton	2,524	956	80.6%	54.1%	\$ 170,730
Sharkey	2,180	1,193	41.1%	53.3%	\$ 143,490
Tallahatchie	4,663	2,560	78.3%	52.8%	\$ 449,730
Noxubee	4,494	2,304	77.9%	52.6%	\$ 400,500
Washington	21,363	10,464	76.8%	51.9%	\$ 1,821,690
Jasper	7,305	3,018	83.5%	51.5%	\$ 546,180
Marshall	16,206	5,953	85.5%	50.4%	\$ 1,088,100
Monroe	13,558	4,480	83.9%	50.1%	\$ 805,290
Winston	7,132	2,597	85.8%	50.1%	\$ 476,160
Yazoo	9,573	4,222	77.6%	49.9%	\$ 725,370
Kemper	3,439	1,535	87.7%	49.8%	\$ 287,370
Panola	14,912	6,131	77.0%	49.6%	\$ 1,039,650
Grenada	9,209	3,229	80.8%	49.3%	\$ 564,930
Newton	7,419	2,604	70.5%	49.2%	\$ 411,480
Attala	7,412	2,759	76.2%	48.6%	\$ 457,710
Neshoba	12,635	4,331	83.8%	48.5%	\$ 768,900
Holmes	8,094	4,514	62.9%	48.4%	\$ 670,140
Clay	8,113	3,066	79.7%	48.4%	\$ 533,580
Clarke	6,659	2,349	82.1%	47.5%	\$ 409,260
Claiborne	3,447	1,824	81.5%	47.5%	\$ 320,790
Sunflower	9,692	5,396	67.0%	47.3%	\$ 837,150
Tate	10,207	3,080	75.3%	47.3%	\$ 508,050
Lauderdale	31,610	10,201	82.8%	47.1%	\$ 1,805,310
Mississippi Totals	1,130,867	370,490	75.7%	42.6%	\$ 59,772,330
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). Calculations by CDF.

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.

Endnotes

ⁱ Greenstein, Robert. *The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor*. Center on Budget and Policy Priorities. August 17, 2005.

ⁱⁱ 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.

ⁱⁱⁱ *2004 Update: Increased Participation in the Earned Income Tax Credit in San Antonio*. Texas Perspectives. 2004.

^{iv} *The Importance of the Earned Income Tax Credit and Its Economic Effects in Baltimore City*. Jacob France Institute. 2005.

^v *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.

^{vi} *Positive Improvements for Tax Refund Loans, But Consumers Still Warned to Avoid Them*. National Consumer Law Center. January 2008.

^{vii} Berube, Alan. *Using the Earned Income Tax Credit to Stimulate Local Economies*. The Living Cities Policy Series. 2006.