Transcript

Institute for Research on Poverty Podcast with Damon Jones

Hosted by David Chancellor

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[Chancellor] This is our December 2012 podcast so, with tax season just around the corner, it's a good time to think about tax refunds. A lot of us like the idea of getting money back after we do our taxes. Yet, most accountants would advise people to set up their withholding so that they pay about what they will owe and have either a very small refund or payment at the end of the year. Low-income households that are eligible for the Earned Income Tax Credit, along with other refundable credits, are very, very likely to get a refund and, sometimes, this refund can make up a significant part of a household's yearly income. It would seem like a problem that these big refunds function contrary to standard financial advice. So, I turned to Damon Jones, an economist at the University of Chicago's Harris School of Public Policy to learn more about how these refunds work for low to moderate income families.

[Jones] You can imagine a family with two children, low income, earning $14,000—they can get something in the ballpark of a $5,000 EITC and they may also get some refundable child tax credits as well so you hear stories from these tax preparers that people are coming in and getting refunds of several thousand dollars. So this tends to be the biggest check that someone will receive all year and it's all concentrated at one time during the year.

[Chancellor] Of course, there's a lot of variation here depending on earnings, family sizeMost EITC recipients will receive a reasonably significant tax refund. I asked Jones what sort of effects this lump sum might have on spending patterns throughout the year for people that get big refunds—and particularly, if this structure leads to more debt accumulation.

[Jones] So, if you know that you were getting this refund at the end of the year, then if you wanted to smooth your consumption then you would borrow or reduce some of your savings until you get your refund. What you do find is that if you survey people when they get their refund and you ask them what they're going to do with this pay check, they do report – a significant share report that they they're going to pay off some bills. But the other thing that's interesting is if you ask people 'Do you expect to get a refund next year?' they will say yes and then you say 'what are you going to do next year with your refund?' And then they'll say 'I'm going to pay off my bills again.' And so, there's a sense in which for some people, this has become like a standard—maybe increasing their debt and then paying it off once they get their EITC or their tax refund.

[Chancellor] Jones says that if these households are letting bills fall behind, they are likely to face finance charges and interest.

[Jones] There is other research that shows that knowing that everyone is going to get their refund during this season—that can work to the advantage of companies and firms because they know when people are going to get their paycheck so you can respond in certain ways when you know that people have this pent up demand that they're going to be able to act on once they get these refunds so there's some research that shows, for example, subprime loans for used vehicles tend to—the interest rates that are offered—tend to be higher during the tax refund season.

[Chancellor] But, it's possible that saving up by withholding might allow people to put down a larger down payment on a reliable vehicle, for example, so they can avoid higher interest charges and monthly payments. Professor Jones says that some people overwithhold to get past other savings roadblocks.

[Jones] If you have any issues with trying to build up savings on your own or if you have some competing interests within the household over how to use resources, the withholding or overwithholding can help to implement a plan that you otherwise wouldn't be able to do to save up some money–having a relative maybe ask to borrow some money frequently, you can say "I don't have it" because it's in my withholding.

[Chancellor] But even so, we can probably still say that it would be "better" if people that receive big refunds could somehow have those payments spread out over the year so they could use the money when they needed it. Until 2010, a program called the Advance EITC did just this.

[Jones] The Advance EITC was for families that are expecting to get this refundable tax credit during the next tax season. There was a form that they could fill out with their employer and it would allow them to get part of their EITC with each paycheck – sort of in real time so get your benefits as you go.

The thing was, is that participation in that program was very low—it was never higher than 4% --maybe about 2%.

[Chancellor] The lack of participation probably owed to a lot of factors—lack of awareness of the program, difficulty in predicting just what you're going to owe, stigma about discussing benefit receipt with your employer, and for some people, a preference for bigger, less frequent payments.

[Jones] So maybe one compromise would be to offer an early payment but at a lower frequency. So maybe quarterly or something like that. And there are a lot of policy advocates in this field that are interested in this idea of periodic payments for these refundable tax credits.

[Chancellor] But, Jones points out that part of the problem with a system like this is that there are higher administrative costs to dispersing more frequent payments and there is the question of what to do in the event of an overpayment—which could happen easily due to changes in a household or a work situation that might alter a person's final tax burden.

[Jones] Interestingly, this is going to be an issue as well for healthcare reform—so there are some features in the Affordable Care Act that involve people receiving sort of credits throughout the year. And at the end of the year when these things are resolved, they may have to pay these things back so there's a similar possibility that we can make errors in giving people credits ahead of time that aren't—that at the end of the year we realize that we've overpaid them and how do we get that money back?

[Chancellor] While thinking about tax withholding and refunds is good idea for most taxpayers, the stakes are a lot higher for a household that might be making it from paycheck to paycheck. Although the "standard" financial advice would suggest that a big lump sum payment isn't the best option, there are definite downsides to the alternatives and, at the end of the day, it's not readily apparent that recipients of the EITC and other credits would prefer a different system. Thanks to Damon Jones for talking about this topic with us. You've been listening to a podcast from the Institute for Research on Poverty.