

## The Economic Impact of the Earned Income Tax Credit (EITC)\*

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### Abstract

This paper presents initial findings on the economic impact of the Earned Income Tax Credit (EITC) based on a sample of Chicago area households who filed tax forms in the spring of 1998. Respondents reported on their detailed use of the funds to pay bills, purchase new items, or save. Asset information on the households was also gathered, along with questions regarding the ability of households to make particular expenditures without the help of the EITC. Uses of the EITC are divided according to those which improve social mobility (e.g., purchase a car; pay tuition; changes housing) and those which are primarily used to make ends meet (e.g., pay routine bills, purchase food) and determinants of each are explored in a regression framework. Policy implications are drawn in conclusion. As far as we know, this is the first research to address these issues, despite the fact that at an estimated cost of \$30.5 billion in 1998, the EITC is our largest federal entitlement program.

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## 1. Introduction

The largest United States cash income support program for low income families is the Earned Income Tax Credit (EITC). In 1998, the EITC is expected to cost the federal government \$30.5 billion according to the Council of Economic Advisors (CEA 1998).<sup>1</sup> More than 19.7 million taxpaying units will benefit from the EITC in 1998, with roughly 80 percent of the benefits refunded to claimants in the form of an IRS tax refund check. Though we do not study state EITC's here since Illinois (sample site) does not have a state EITC program, 11 states currently subsidize the EITC beyond the federal subsidy, adding to both the impact and the cost of the EITC (Greenspan and Shapiro 1998).

Despite its enormity, very little is known about the impact of the EITC on the families who receive it. Unlike other income-transfer programs, the EITC is received by almost all families as a once-a-year lump sum tax refund check paid sometime in the spring of the year after earnings are counted. Moreover, the EITC is administered by the Internal Revenue Service (IRS) via the personal income tax system, thus permitting eligible clients to self-select for benefits without a formal review and certification of eligibility criteria (Liebman 1998a). Because of the form and generosity of the EITC, it is liable to have very different effects than if the benefit were received on a monthly basis over the year in which countable income was earned, and the system was administered as are Food Stamps or TANF. As a result, the EITC offers an opportunity to observe behavioral response to a lump sum transfer. Are EITC checks used to pay bills or to make new purchases, or are they primarily saved or invested? Does the EITC mainly help finance current consumption, or does it effect savings and investment behavior, helping low-income beneficiaries build assets and equity and therefore improve social mobility? The purpose of this paper is for the first time to provide an answer these questions.

Several recent authors have explored various aspects of the EITC and these are reviewed in Section II along with a discussion of the economic and behavioral effects of the EITC. We then present our study, how the data was collected, the sample examined, classification of “use bundles” for this paper, and amounts and composition of tax refunds received (Section III). Next, in Section IV, we present an overview of our results. Finally, we discuss these results, their policy implications, and other issues to be explored in future studies.

## **II. The EITC: Recent Studies and Economic Effects**

### **Program Basics and Earlier Studies of Behavioral Effects and Antipoverty Impacts**

The EITC was legislated in 1975 to provide refundable tax credits to low income workers, ostensibly to refund some fraction of Social Security taxes (Eissa and Hoynes 1998). It was significantly expanded in the Tax Reform Acts (TRA) of 1986, 1990, and 1993 such that by 1998, a maximum federal refundable tax credit of \$3,756 was available to low income households with two children and earned income between \$9,390 and \$12,260 (Table 1). Various estimates of the cost of the EITC in 1998 run from \$27.7 to \$30.5 billion compared to \$5.9 billion just ten years ago (Table 2). Participation rates in the EITC have been estimated in the 85 percent range for 1990 (Scholz 1994), but may have changed since then as the generosity of the program has increased and eligibility rules have changed.<sup>2</sup> Participation rates in other means-tested programs are well below the 80 percent level. For instance, participation rates in the former AFDC program were 62 to 72 percent in 1987, and in the Food Stamp Program, 54 to 66 percent in that same year (Blank and Ruggles 1996).

While the details of the EITC changed somewhat over the past decade, the most significant changes took place in benefit generosity, particularly since the 1993 OBRA

provisions. This law expanded the maximum credit for families with two children from \$1,511 in 1993, to \$3,756 in 1998 and subsequent years (see Figure 1 and Table 1). The result is a 40 percent earnings subsidy for families with zero earnings up to \$9,390 per year (compared to a 19.5 percent subsidy to \$1,750 in 1993). The EITC now helps families with two children and incomes of up to \$30,095 compared to \$23,050 in 1993. Because of this growth, the EITC benefits a wide range of clients from lower income families who might be cycling on and off of welfare (TANF) to lower middle income families with near median incomes. And so we would expect to find different types of effects for different types of recipients.

Among lower income families, EITC is not counted as Temporary Assistance for Needy Families (TANF) income in most states (Meyer and Rosenbaum 1998), nor is it counted toward Food Stamps or Medicaid eligibility.<sup>3</sup> The EITC therefore offers a powerful work incentive for low income earners with children, e.g., the TANF population. One recent study (Meyer and Rosenbaum 1998) concludes that the EITC has been the foremost driving force in explaining increased hours worked by former welfare mothers over the 1993-1996 period. Eissa and Liebman (1996) reach a similar conclusion using different data, and the CEA (1998, Chart 6) demonstrates that increased labor force participation among low income mothers closely tracks changes in the maximum EITC benefit level over the past decade. While other TANF changes—the enhancement of earnings disregards, sanctions and limits on benefit receipt, and a strong growing economy with low unemployment—also helped put more welfare mothers to work, there is little doubt that the EITC played a large role in reducing the welfare rolls (see also CEA 1998; Blank, Card, and Robbins 1998).

Of course, as with all targeted income supplement programs, what goes up with rising earnings (benefits) must at some point decline (phase out). The federal EITC for families with two or more children in 1998 declines at a rate of 21.06 percent per dollar earned from \$9,390 to

\$30,050 (Figure 1). While there have been no studies of the effect of the phase out on single earners, Eissa and Hoynes (1998) find that the phase out reduces work effort by married women by a considerable amount.

Other recent research (Dickert-Conlin and Houser 1998) suggests that the EITC has ambiguous effects on the decision to be a female head or to marry. Dickert-Conlin and Holtz-Eakin (1998) compare the EITC to employer-based wage subsidies finding that the EITC has high participation rates and produces increased labor force participation among groups at risk of long-run labor force detachment. Blank (1998) also finds the EITC better targeted on low income families than equivalent cost employer-based wage or earnings subsidies..

The EITC also has a powerful anti-poverty effect, reducing child poverty by 2.4 million in 1996, or a one-seventh reduction in poor children and the largest single program exiting children from poverty (Greenstein and Shapiro 1998). According to the Census Bureau, the EITC removed 4.3 million persons of all ages from poverty in 1997, more than double the 1993 amount (CEA 1998). Among the working poor, some 30 percent of children who would otherwise be poor (based on earnings and other sources of income) were lifted from poverty by the EITC. And by itself, the EITC offsets between one-fourth and one-third of the declining share of national income received by the poorest fifth of all households with children from 1976 to 1996 (Liebman 1998).

In sum, recent studies have shown that indeed the EITC increases work effort by low income families by supplementing earnings, thus raising net incomes and reducing poverty. But these studies treat the EITC only as an income subsidy and for the most part ignore its delivery mechanism and form of benefit receipt.

## **Economic and Behavioral Effects**

Because of its unique administration and “lumpy” character, the EITC offers a rare opportunity to examine the economic impact of the program on recipients.<sup>4</sup> The “lumpy” nature of the EITC arises from several forces. First of all the EITC can be taken as an intrayear transfer. If employees fill in a W-5 withholding form and have their employers submit it to the IRS, they can receive up to 60 percent of the maximum allowable amount of the EITC scaled to their monthly or weekly checks. However, over 95 percent of recipients do not use this option, and instead receive a lump sum amount when they file their income tax in the following year (Scholz 1994). There are several possible explanations for such behavior, including: (a) employer unwillingness to participate in the program; (b) client unwillingness to inform the employer due to stigma effects or fears of lower pre-tax wages, and (c) clients’ desire for the forced savings aspects of the EITC. There is some evidence that recipients might prefer the “forced savings” aspects of the EITC (Olson and Davis 1994). However, the relative impacts of these factors, and perhaps others, have yet to be examined, and our study sheds little or no light on the question of why clients receive EITC benefits in the current form.

Regardless of the reason for type of benefit receipt, the lumpy nature of the EITC benefit and its recent rapid increases in benefit generosity create a rare and different opportunity to study the effects of the program on household finances—both on expenditure patterns and on asset behavior (i.e., debt, credit, and savings).<sup>5</sup> In fact, very little has been written on the effects of the EITC on household financial behavior or on the way that households use EITC benefits, despite the fact that benefits received can be as high as 50 percent of previous years income (i.e., in states like Wisconsin with high state supplements, e.g., DeParle 1999).

Small studies (200 to 300 person telephone interviews) have shown that the EITC is used to pay overdue utility bills (e.g., Gallup Poll 1993), but, to our knowledge, not much else has

been written on this topic. One important *New York Times* news story (Rimer 1995) suggested that some recipients made interesting and creative use of the EITC to improve transportation to and from a job, to move to a safer neighborhood or to put children into better schools. However, the extent to which these uses are typical or idiosyncratic was not known until this study.

We do know something about the types of clients which the EITC serves, however. National samples of EITC beneficiaries include two major groups: (a) about 70 percent are single parents, many of whom are just cycling off of welfare or are single returns; (b) almost 30 percent are low earning two-parent households (Greenbook 1998, Table 13-13, p. 871). Almost half (47 percent) of single-parent recipients were in the phase-in or flat region of the EITC in 1994 (Eissa and Hoynes 1998; U.S. Government Accounting Office 1996), with the rest in the phase-out region. Most of these recipients file taxes as heads of households. Two-parent families are less likely to be in the phase-in or flat portions (about 27 percent) with the remainder in the phase-out range. Both groups of filers are included in our study.

### **III. The CLHS Study: Data Classifications of Use and Composition of Tax Refunds**

Our data is drawn from a sample is drawn from 7,000 low-income Chicago area taxpayers who utilized the free tax preparation services provided by the Center for Law and Human Services (CLHS) in the winter and spring of 1998. The CLHS has set up ten centers in the Chicago metropolitan area wherein any low income taxpayer can receive free assistance from CPA and legal volunteers in preparing their tax return. We employed five interviewers who visited seven of these sites from January 1998 through April 1998 to interview taxpayers in general, and EITC beneficiaries in particular. There was more than a 90 percent willingness of taxpayers to discuss their refunds with our interviewers at time of tax filing. This produced a

sample of 1,226 total interviews, 1,121 of whom were told by the CLHS that they would receive a federal refund and 846 of whom benefited from the EITC. From these we selected a smaller sample of 826 whom CLHS calculated would **both** receive a federal tax refund **and** the EITC as part of that refund. These 826 underlay the analysis below. Another 208 families also completed a second phase phone interview about six weeks after filing to verify their receipt of the EITC and again answer the same questions posed earlier on the use of the EITC.<sup>6</sup>

The CLHS database contains two types of information. First, we have access to the federal tax returns of all recipients who filed with CLHS in 1998. For our sample this includes filing status, number of dependents, and all sources of income reported to the IRS. In addition, we constructed an interview about the intended use of the EITC. The CLHS interview asked the recipient about their knowledge of and expectation of the EITC, and their priorities and usage of the EITC to pay bills (several categories), purchase items (several categories), or to save the EITC checks for future use. Respondents were also queried about their asset holdings, the effect of the EITC on their degree of work effort, and their ability to carry out their spending/saving priorities were it not for the EITC.<sup>7</sup>

While the CLHS offers one venue for data collection of this type, it is not the only such venue or vendor. Two types of paid tax preparers also help EITC recipients 65 percent of whom used tax preparer services in 1990 (Scholz 1994). One type are large, national, for-profit tax preparation services such as H&R Block. Another type are small, informal temporary services which are provided by self-employed persons. Both types differ from the CLHS in that they charge fees for tax preparation services while the CLHS does not charge fees. A second difference is that at least some of these services also offer a “quick return” service whereby clients can receive their refunds in advance of the federal returns (which usually take four to six weeks to be processed) at a high discount rate. The CLHS does not provide this service. To the

extent that clients differ by preparer type, our sample may be biased away from those with higher discount rates, and therefore perhaps away from those with greater immediate need for the EITC refund.

### **Sample Characteristics**

Our sample is just less than half African American, with 30 percent Latino/Hispanic and 20 percent Caucasian or other. About 63 percent of our sample are single parents (as determined by head of household filing status) while 15 percent were married filing a joint return and 22 percent were single-person filers. Two-thirds of our filers were female, and 56.6 percent of the sample received TANF or Food Stamps in 1997 or 1998 (Table A-1). These characteristics suggest that our client population is slightly more likely to be made up of single parents and minorities than is the national sample described above. Given the characteristics of the Chicago Metropolitan area, this is not a surprising finding.

### **Classification of Expenditure/Savings Bundles**

The purpose of this study is to assess two important types of usage for the EITC:

- Making ends meet
- Improving social mobility

The survey instrument we administer permits considerable detail for classification of EITC uses. Respondents were given several categories of future purchases for goods or services, for paying off existing bills, or for saving the refund for future anticipated or unanticipated needs. While several other bundles of categories of uses could be created, we selected these two particular categories for several reasons.

**Making Ends Meet.** First of all, the EITC is targeted on low income working families with children, with more than one-half of those in our sample receiving one or more

means-tested transfers in 1997-98. Our data suggest that our head of household population is largely made up of former welfare mothers who in 1997-98 have found formal jobs and are in effect, trying to make ends meet. These mothers, most of whom had a much lesser attachment to the labor force in earlier times, might have unmet consumption needs or may use the EITC mainly as a way to spread their consumption over the year. We hypothesize that lowest income EITC recipients, those with considerable welfare attachment, look very much like 1988-1992 era welfare populations (in Chicago; Charleston, South Carolina; Camden, New Jersey; San Antonio, Texas; and Boston, Massachusetts) studied by Kathryn Edin (Edin and Lein 1997). Edin's later and ongoing work includes a sample of both mothers and absent fathers in Philadelphia and Camden, New Jersey (Edin 1998).

These studies show that typical household expenses make up over 100 percent of welfare clients incomes, the rest being made up from borrowing or from unreported earnings (Edin and Lein 1997). Among these types of households, Edin has shown that work-related expenses and the move from informal unreported work to formal work adds to expenses (work, child care, transportation) helping reduce or negate the positive impact of higher earned income and leaving the household in no better economic circumstances than when they were on welfare. Partially in response to these findings, most states have tried to provide a number of subsidies under TANF to help reduce the costs of working, including a higher earned income disregard for TANF benefits, child care and transportation subsidies. Among these welfare mothers, Edin found that living day-to-day (or month-to-month) was the typical way of life and that formal assets, savings or even formal contact with financial institutions (e.g., banks or use of credit cards) was a rare event. Despite their poor economic circumstances, Edin did find that many interviewees were aware of and interested in accumulating assets or using earned income to improve their social mobility (Edin 1998). Yet the majority were struggling just to make ends meet. Among such

types of potential recipients, the EITC could be seen as a way to meet unpaid needs for durables, pay off outstanding bills, and meet other urgent consumption needs.

A minority of the sample of EITC beneficiaries whom we interviewed are likely to be in many ways similar to Edin's sample. But a larger minority, perhaps a majority, are quite different. Edin's samples existed largely on welfare benefits and on informal earnings. By definition, EITC clients must have positive earnings to be able to claim the EITC. While we expect our EITC sample to be better off economically than Edin's sample in terms of gross income, we also expect that the preponderance of single parents in our sample and the high fraction with prior welfare receipt, suggests that many of our clients were similar to Edin's clients. We conclude that just making ends meet is one important use of the EITC which we need to investigate. And to the extent that the EITC helps meet current consumption needs, it may be no different than other types of income subsidies, child care subsidies and similar benefits (e.g., Food Stamps) in terms of its impact on EITC clients.

**Improving Social Mobility.** While the large majority of Edin's sample were credit constrained and had little leverage to borrow money, many still expressed a strong interest in having such access to credit (Edin 1998). These clients, however, also realized that "saving" EITC benefits in formal settings such as bank accounts would negatively effect their eligibility for welfare benefits. Still, for population similar to these, and in particular among those who are struggling to move from welfare to something better, the EITC and its lumpiness presents an opportunity to make extraordinary types of purchases or expenses which they might not otherwise be able to make.

The recent literature on assets and the poor (e.g., Sherraden 1991; Oliver and Shapiro 1995; Shapiro 1998) suggests that even low income families are willing to make sacrifices by postponing current consumption to improve their long-run economic well-being when presented

with appropriate incentives or opportunities to save. Because of their large size relative to current income, the EITC presents an opportunity for otherwise credit constrained low income families to move beyond current consumption and to use the EITC for asset building purposes. Shapiro (1998) refers to these uses of funds as “asset building,” or “improving social mobility.” We adopt the latter term here to describe several types of equity enhancing uses of the EITC which are *not* for meeting day-to-day expenses, but rather for improving longer term economic mobility and well-being. Many of these uses are consistent with both Edin’s (1998) findings and with those found by Rimer (1995) in her selected interviews.

***Moving and Housing.*** For instance, recent studies indicate that significant numbers of many low income central city residents would prefer to move to safer neighborhoods if they could afford to do so (e.g., Ludwig, Duncan, and Hirshfield 1998). Recent studies based on the Moving to Opportunity (MTO) experiment verify that low income central city residents who participate in MTO overwhelmingly (70 to 75 percent of movers) choose to move away from violence and crime when given such an opportunity (Ludwig, Duncan, Hirschfield 1998). Chicago has a number of dangerous inner city neighborhoods, including those in which we sampled our interviewees (e.g., Sampson, Raudenbusch, and Earls 1998). Because moving a household requires both direct moving expenses and establishment of credibility to pay rent (e.g., first and last months rent), the EITC might provide such an opportunity. Alternatively, residents who have a growing stake in their neighborhood could use the EITC to fix their home or improve it. In fact, 6 percent of our sample were homeowners who were paying off mortgages, and many of them claimed this as a priority use of the EITC.

***Automobiles and Transportation.*** Increasingly, studies of welfare to work are finding that owning or having access to a reliable means of transportation is a key to reducing the time costs of work-related travel, increasing one’s area of job search to obtain higher wages and

improved economic well-being. The EITC also provides an opportunity to purchase, upgrade or repair a car, or to make a downpayment on a better car, or to pay for car insurance. Since lack of transportation is a serious impediment to job search, employment, and job mobility, the EITC may provide a critical bridge to a higher level of economic well-being via a dependable source of transportation (Ong 1996). Danziger et al (1998) find that 47 percent of their sample of low income welfare recipients do not own or have access to a car, but for those who do have a car, the marginal effects of car ownership on earnings are equivalent to the marginal effects of completing high school in terms of higher future earnings. Edin (1998) also reports that her sample of fathers could use cars to begin self-employment as informal taxi drivers, as pickup and delivery agents, or as “junkers.”<sup>8</sup> Hence, an opportunity to purchase a car or a truck, insure a car, or repair a car, or pay off a car loan provides an important way to overcome a significant barrier to more work itself, work at higher wages, and possibly even to self-employment. Having a car also significantly reduces the time cost of working for single mothers who must also arrange child care, physician visits, and other necessities for their children.

***Human Capital.*** The EITC also presents a source of funds for human capital investment: tuition, books, and both as an alternative to student loans and as a source of payment of student loans. These EITC-based investments may benefit either a recipient or their children. In effect, a \$1,000 to \$2,000 EITC might be seen as a good substitute for a “tuition voucher” to a sectarian or private school in cases where inner city public schools are subpar. Clients also use EITC benefits to improve their children’s early learning by improving the quality of their child care or for other for child-related learning enhancing expenses.

***Saving.*** Another important use of the EITC which improves social mobility is either saving or paying off of extraordinary bills. Movement from welfare or government safety nets to self-protection via own precautionary savings is an important indicator of upward social

mobility. Making regular car payments, paying off of bank loans, medical bills or credit card bills are all indicative of uses of EITC which help establish or improve a credit history. Repaying informal loans or sharing EITC refunds with family members also was indicative of social capital building and maintenance of other nongovernmental means of support in case of emergencies. In fact, a large majority of American policymakers felt that “saving” is a worthy activity which should be subsidized for low income Americans in the same way that tax deductions for IRA’s, 401k’s and pensions subsidize saving for the rich (Boshara 1999; Seidman 1998). If the EITC effectively subsidizes saving as well as work it has a double benefit for society.

**Classifications of Bundles.** Given these intentions, we separated our EITC categories of use into a set of “bundles” corresponding to these two key thematic uses of the EITC. In our sample, payment of regular bills (rent, utilities, food, groceries, clothing, personal expenses), and purchases of clothing were classified as expenses for making ends meet. Purchases of household appliances or household furniture were also classified as making ends meet as were other personal or regular household expenses.

Uses of the EITC which complemented social mobility included all forms of debt repayment, savings, and other expenditures which were easily identified as the increasing chances for improved mobility, including all forms of work-related expenses.<sup>9</sup> These included payment of credit card, automobile, or personal debt. They also included human capital building (e.g., tuition payments, medical bills), expenses for cars (purchases, repairs, insurance); moving expenses, and home improvements. Sharing money with family members was also classified as an equity expense in that it built social capital. The complete bundles of both types of expenses are listed in Table A-2.

Considerable time and effort were spent to reduce arbitrariness when putting these selections into bundles. Some amounts of EITC savings will no doubt be used to help make ends meet in coming months and hence may be misclassified, but then savings as a form of self protection may replace reliance on welfare to meet these expenses. Similarly, sharing benefits with extended family might be construed as continued reliance on traditional networks of support, and not improved social mobility. In these cases we may overestimate items relegated to this category. In contrast, purchases of household appliances and other durables among low income families treated as making ends meet, often produce the physical capital necessary to start small businesses (Edin 1998). In this case durable purchases classified as making ends meet are actually improving social mobility. However, these particularly controversial uses were not critical to the overall patterns which emerged from the bundles or analyses that follow.

### **Tax Refunds or EITC?**

Because our recipients could receive tax refunds other than the federal EITC due to overwithholding, it could be that overwithholding, not the EITC itself, is the driving factor in making these expenditures. Table 3 presents information on the distribution of total refunds as well as the EITC per se. We present data for three groups: all CLHS tax interviews; all those getting a refund; and our sample (all of those getting both a positive refund and the EITC). The EITC clearly is the largest source of refund for all recipients, particularly those with larger refunds (Panels B and C of Table 3).<sup>10</sup> In our sample, the average EITC payment was \$1,497, 85 percent of the average total tax refund. Above the median tax refund (\$1,715 or more in refund in our sample) the EITC was 87.9 percent or more of the total amount received. Even at the 25<sup>th</sup> percentile, the EITC was about 70 percent of the \$603 total refund received. Hence, even if we cannot separate use of the EITC per se from other withholding, the EITC is the main driving

force in our analyses and the major source of the associated economic impacts which we examine below.

## **IV. Results**

Here we report both the descriptive data on uses of the EITC and a set of initial regression results. The next section of the paper discusses the findings more generally and their policy implications. We begin with two pieces of information; knowledge of the EITC and its importance in helping meet the priorities of the household. Because of wide differences in income levels and economic circumstances of EITC households, we also classify respondents according to one of the three ranges of EITC benefit receipt: those with lower earnings that provide less than the maximum benefit are in the phase-in (or subsidy) range; those receiving the maximum are at the “plateau” level of benefits; and those with higher incomes whose EITC benefit is reduced for each added dollar of earnings in the “phase out” range (e.g., see Figure 1). Others have shown that these ranges have different effects on labor supply and other behaviors. It makes sense that they also might have different effects on uses of the EITC and other variables of interest.

**Knowledge of the EITC.** To some extent, the findings of this study are dependent on the belief that our clients expected to receive a refund and then considered how those refunds would be used. In fact, we found a surprisingly high level of both expectations of a tax refund and that the EITC program was the source of the tax refund (Figure 2). Almost 80 percent of our sample expected to receive a refund when they came to the CLHS (left side, Figure 2). Among those expecting a refund, about one-half seemed to be familiar with the EITC itself (right side, Figure 2). That is, they used the term “EITC” for the refund; or told the interviewer that the refund was “due to low income,” or because they “worked all year and have a qualifying child.”

The remaining responses scattered among other categories, particularly “received a refund last year.”<sup>11</sup> We concluded that there is a large and growing recognition of the program and its potential payoff for working households. Finally, Panel II of Table 4 indicates that expectation of refund rises across the EITC range with the highest expectation at the plateau level where the level of refund is the highest both in dollar terms and as a percentage of income. As benefit generosity has grown, so too has knowledge of the EITC. The large majority of recipients now anticipate the EITC benefit and are thus able to factor it into their household financial planning.

**Importance of the EITC.** Respondents were asked to prioritize up to three important uses of the EITC. They were then asked if they could afford to carry out their first priority in the absence of the tax refund. Almost half of the respondents (46.5 percent) said that they could not meet their first priority unless they received the EITC, with another 43.4 percent arguing that without the EITC they would be forced to spend (or save) a lesser amount or to delay their top priority for some time. While those with the lowest incomes (in the “phase in” region) were slightly more likely to have difficulty, inability to carry out first priority objectives in the absence of the EITC was evident across all three EITC ranges. Only 8 percent could definitely achieve their primary objective if they did not receive the EITC, with ability to find alternative sources of income for the stated purpose increasing with higher incomes across the EITC ranges.<sup>12</sup> These results imply that the large majority of beneficiaries could not meet their priority uses unless they received the EITC.

**Priority Uses of the EITC.** Respondents were allowed to list up to three priority uses of the EITC benefit. Of our 826 respondents, 617 or 74.7 percent had at least one top priority use for the EITC while 40 percent also had a second priority and 12 percent a third priority use as well. These priorities are summarized in Figure 3. They indicate that bill paying was the single most important use of the EITC for almost one-half of all beneficiaries, with

purchases coming in second across all priority levels. Across all three priority levels between 75 and 80 percent of respondents would use the EITC to pay a bill or make a purchase of some commodity. Clearly the EITC helps make ends meet; this result was fully expected.

However, almost one-half of all respondents (49 percent) also stated that they would save some or all of their EITC check. Above we identified three key uses of the EITC to enhance social mobility: moving, paying tuition, or purchasing or repairing a car. Each of these uses are also summarized in Figure 3. While moving seems to be an all or nothing decision (with only 3 percent listing it as a secondary or tertiary preference compared to 4 percent who list it as a primary preference), paying tuition or purchasing/repairing a car are more evenly spread across the preference scale. Altogether, 16 percent of the sample stated they would use the EITC to pay tuition while 22 percent would make a car related use of the refund. These uses suggest that the EITC also plays a large role in improving social mobility, a finding that we did not expect. All other priority uses of the EITC are summarized in the final columns and amount to only 11 percent of primary priorities and 14 percent of secondary priorities. The separately identified categories therefore seem to be driving our results. We therefore concentrate on these specific uses.

**Bundles of Use.** If we combine priority uses across all respondents so that all persons stating each use (i.e., as a first, second, or third priority) are represented and bundle them as suggested in the previous section of the paper, we arrive at our best overall snapshot of EITC use (Table 5).<sup>13</sup> Several important patterns are evident in this table.

- ***More than one-half of all beneficiaries had a social mobility related use for the EITC.*** This usage increased with income and benefit level, peaking for those with the maximum benefit (Panel A). Moving, transportation, and saving all peaked in the plateau range and declined slightly in the phase out range. Tuition expenses increased slightly as incomes rose.

- *Making ends meet was an important use of the EITC for almost one-half of the sample* (Panel B). Utilities and rent were higher priorities than were food and clothes.
- *As expected, the lowest income households in the phase-in range had higher immediate needs than did those in the phase-out range.* Utilities and rent dominated food and clothes as consumption needs for this group.
- Less than 20 percent of the sample had no top priority need or plans for the EITC with those in the phase-in range most likely to not state a use (Panel C). Both our data and anecdotal evidence (DeParle 1999) suggests that these were likely to be lower income persons who did not expect a refund to begin with.
- If we were to prioritize usage according to our designated bundles of uses, we find that while those who would make both types of use are evenly spread across the range of refunds at 21 to 23 percent of respondents, about one-third would make social mobility uses only while one-quarter would use the EITC check only to make ends meet. Both bundles follow predictable patterns across the EITC range with those in the phase-in region having making ends meet as the highest priority while those at the plateau or in the phase-out ranges seem to place a higher priority on uses that improve longer run social mobility.

Thus, there are some suggestions that the determinants of EITC usage vary in predictable ways.

Before turning to the regression results, one additional piece of background information need be examined, access to formal financial credit among the beneficiary population.

**Access to Credit.** In order to more fully understand the types of uses which recipients make of the EITC, it is important to understand their relationship to financial institutions. Usage of the EITC and ability to safely protect assets until they are needed seems important to long-term mobility. Low income respondents who use check cashing services and who have no formal relationship to financial markets, i.e., no checking or savings accounts or no credit card, loan, or mortgage, are less likely to be able to effectively prioritize uses of a large EITC check, or to effectively save it for precautionary needs.

In fact, access to financial and credit markets differs markedly across the ranges of beneficiary. Only 40 percent of those in the phase-in range had one or more of the types of financial affiliations listed above. Only 24 percent had a checking account. In contrast, almost

73 percent of those in the phase-out region had some contact with financial markets. Checking and savings accounts, credit card usage and bank loans all increase across the EITC range. In contrast, use of a “check cashing service” declined steadily across the income ranges with 57.8 percent of those in the phase-in range using such services, and 44.3 percent of the plateau group did so as well. Many of our respondents did, however, indicate that they wanted to open a checking or savings account with their EITC check once they received it. Preliminary comparisons indicate that these breakdowns are similar to those found by other researchers using national samples to investigate credit cards and checking and savings accounts (e.g., Bird et al. 1998; Carney and Gale 1998).

**Summary of Descriptive Tabular Data.** Altogether, these tabulations indicate that knowledge of EITC is high, that the large majority of people who receive the EITC expect it, and that most of those people have at least one asset building social mobility related use for the EITC. Yet many recipients have little or no formal ties to financial markets and many rely on informal financial services to cash their refund checks. In order to more carefully examine these impacts, we turn to multivariate analyses of these data.

### **Regression Results: Determinants of EITC Usage**

We use multivariate analyses to better understand how individual characteristics influence the decision to use the EITC for either “improving social mobility” or for “making ends meet.” We use a logistic regression model to determine the odds of using the refund for either of the use bundles. Independent variables are defined in Appendix Table A-3. Most of these are straightforward and need little added explanation. Single parents are determined by filing a return as a head of household; welfare clients are those receiving either TANF or Food Stamps in 1997. A recipient has access to credit if she had either a checking account, savings account, credit card, bank loan, or mortgage when she filled out her tax return as shown in Table 6.

Table 7 summarizes the results from our logistic regression models. We estimate the probability that a recipient uses a portion of the refund for “improving social mobility” and the probability that a recipient uses a portion of the refund for “making ends meet” two ways. The first three columns of each panel in Table 7 present the results from a model including all of the independent variables with dependent children entered as an interval variable. The last three columns contain the results for a model that incorporates dependent children as two dummy variables—one for having exactly one dependent child and another for having two or more children. The second specification was designed to parallel the statutory treatment of family size under the EITC. For ease of interpretation, odds ratios are presented rather than coefficients.

Panel A of Table 7 explores the effects of individual characteristics and the size of the EITC on the probability that a recipient would use some of the refund for “improving social mobility.” The results are nearly identical for both specifications. In neither model do dependent children have a significant effect on whether the recipient plans to use a portion of the refund for “improving social mobility.” Single parenting, being Hispanic/Latino, expecting a refund, and having access to credit all significantly increase the likelihood of having a social mobility use for the refund. Single parents are about twice as likely as married parents to use some of the refund for “improving social mobility” (2.5 and 1.93). Hispanics/Latinos are 2.4 times more likely than whites to have an “improving social mobility” use. Recipients who expected their refund are more than 2.2 times more likely to have a social mobility use for a portion of their refund than recipients who do not expect the refund. And having access to credit increases the likelihood that a recipient will use the refund for “improving social mobility” by more than 1.8 times. Women, on the other hand, are less likely (0.7 times less) than men to have a social mobility use. In addition to the effect of these individual characteristics, the level of the EITC increases the

probability of using the refund for an equity or social mobility purpose by 1.24 times for each \$1,000 in additional EITC benefits.

Only the expectation of a refund and the presence of dependent children significantly influence the likelihood of a “making ends meet” use for a portion of the EITC (see Panel B of Table 7). Recipients who expected a refund are 2.0 times more likely to have a making ends meet use for a portion of their refund than those recipients who did not expect a refund. Dependent children also increase the probability that a recipient will use some of the refund for making ends meet. The influence of the number of children may not be linear. When entered as an interval variable, the number of children increases the odds of having making ends meet plans for a portion of the refund by 1.2 times for each additional child. However, with the model is specified to parallel the statutory parameters of the EITC, that is with dummy variables for one dependent child and for two or more dependent children, the results change a bit. While the coefficients for both variables are greater than one—suggesting an increase in odds—only the coefficient on two more dependent children is significant. In other words, the presence of two or more children significantly increases the odds of having a making ends meet use for a portion of the EITC (1.5 times) while having only one child does not.

These results suggest that “making ends meet” is something which is perhaps universal among EITC recipients in that everyone more or less makes this type of use of the benefit, with larger families the only significant feature. In contrast, “improving social mobility” seems to be more of a discretionary use of the EITC in that many characteristics seem to influence usage of the EITC in this manner, including access to credit, size of refund, and single parent status.

## **V. Summary Research and Policy Suggestions**

This paper presents an initial exploration of the ways in which families use our largest targeted income transfer program, the EITC. The EITC is unique because of both its tax administered nature and because of its “lumpiness” and once a year nature. This lumpiness may provide a key way to overcome short-term liquidity crisis and to provide recipients with opportunities to move beyond support of current consumption to more strategic longer term uses of the EITC. The paper attempts to classify uses of the EITC according to making ends meet (supporting consumption patterns) or improving social mobility (making strategic uses of the EITC which can be expected to have longer term payoff). We find strong support for both uses of the EITC.

In particular, we were surprised that more than one-half of EITC recipients use their refunds to improve their upward mobility. Most EITC recipients are aware of the program and are able to articulate several specific uses for their refund, including investments in higher current and future earnings such as schooling, transportation, and moving. While this should be seen as a first cut at the data, nonetheless we believe that our findings have both important research and policy implications.

For instance, if we wish to encourage social mobility uses for the EITC, we find that they are positively related to having formal contact with financial institutions. As the federal government increasingly moves toward electronic benefit transfer (EBT) over the next several years, formal relations with banks (and the financial literacy that is required) should both be encouraged by policymakers (Stegman 1998). Opening of a checking account by EITC clients offers a safe means of storing the EITC until priority uses can be sorted out. In turn, checking and savings accounts offer the possibility for having both precautionary savings and for asset

building. Public policies toward asset accumulation for low income households are obviously important here and could further strengthen ties with formal financial institutions.

On the positive side, legislation to create special subsidized savings accounts for special purposes such as home ownership, post-secondary tuition, or retirement have recently come upon the policy agenda (Boshara 1999). Universal Savings Accounts (USA's) and Individual Development Accounts (IDA's) are currently in the experimental stage. If we believe that asset accumulation is an important part of upward social mobility, only those with formal ties to financial intermediaries will be able to take advantage of these efforts. It may be useful then to offer outright subsidies to EITC beneficiaries to open savings accounts for specified purposes (e.g., Seidman 1998).

Viewed from a different perspective, public policy need not discourage financial accounts either. The recent literature finds evidence that social insurance in general, and means-tested programs in particular, discourage savings (e.g., Hubbard, Skinner and Zeldes 1995; Gruber and Yelowitz 1992; Powers 1998; Neumark and Powers 1998). The fact that so few lower income clients have checking or savings accounts could be that the asset tests associated with welfare receipt and/or Medicaid receipt discourage savings or opening of financial accounts. In most states the EITC is not counted toward TANF for benefit determination; however, it is counted toward asset limits after two months. While many states have eased liquid asset tests for TANF clients, Food Stamp asset limits for most families remain relatively low, thereby penalizing savers who might otherwise lose their jobs and reapply for aid. Low limits on the value of a car are liable to have similar effects on eligibility, even when the literature clearly suggests that automobile ownership is a key positive determinant of earnings levels. Understanding the effects of participation in means-tested programs on savings and equity building deserves further

investigation, while mindless policies to limit eligibility to clients where the value of automobiles below \$5,000 should be changed.

Another important finding is that number of dependent children increases usage of the EITC for making ends meet. Within our sample, 21 percent of families with children have three or more children. We have evidence that larger numbers of children means that families have larger needs for consumption and therefore that we should consider expanding the EITC for families with three or four children, just as there is now a difference between one and two children. Several schemes for combining the EITC with refundable personal tax credits could further family size condition the EITC benefit (e.g., Cherry 1999) to help alleviate the higher current consumption needs of EITC beneficiaries and also to reduce the benefit reduction penalties in the phase-out region of the EITC.

At this stage, we have just begun to explore our data and the effect of the EITC on family finances and expenditures. We have not yet fully investigated the asset data we have also collected and its effects on EITC usage. For instance, we find that about a quarter of our sample have credit cards and of these, 80 percent have credit card debt averaging about \$2,400. Yet only 18 percent of these respondents list paying off credit card debt as a priority use for the EITC refund they receive. Further, we plan to separately investigate those who received welfare over the past year to learn of their knowledge of and use of the EITC benefits. Also we intend to investigate the prior year benefit status of current EITC beneficiaries within our sample to see if first time beneficiaries differ compared to repeated recipients of this benefits.

Beyond this sample, we would encourage further research of this type in a dynamic context. Most families who receive the EITC is one year receive it in the next. Indeed, more than one-third of our sample stated that they received the EITC last year. As families move from welfare to work to perhaps middle class status, our findings suggest that the EITC plays an

important part in assisting this move. Of course, changes in unemployment, marriage and cohabitation, divorce or separation, family living arrangements, and various other factors will also affect this transition. A longitudinal sample of recipients would shed additional light on these topics and more clearly identify the pathways from dependency on means-tested transfers to economic independence.

In conclusion, the EITC helps meet most current consumption needs and also offers avenues for upward mobility. More than one-half of all beneficiaries had at least one mobility related use for the EITC, a high and significant number. Such findings suggest that increased incentives for savings, greater access to credit markets and federal programs to match low-income savings for specified purposes (e.g., home purchases or schooling), could lead to greater savings and work effort on behalf of the low income, low wage population, and hence to greater levels of self-insurance and self-sufficiency..

Finally, it is worth reiterating that the EITC is what makes these expenditures possible. Without the EITC, almost one-half could not have met their first priority use for the EITC, while more than another four in ten could meet their need only to a lesser extent or with some delay.<sup>14</sup> Hence, the EITC provides an important source of support for working poor families. As such the EITC appears to be our most effective federal program for leading low income families on a path toward true economic independence. We hope that our further research bears out this important initial finding.

## Endnotes

1. Food Stamps, TANF, and SSI are all budgetarily smaller programs in terms of expected costs for 1998.
2. While higher benefits and word-of-mouth might have increased participation in the EITC since 1990, other factors work in the opposite direction. In 1991 the IRS began requiring a new form, Schedule EIC, in order to claim EITC. In 1990, the IRS would calculate and issue the credit based on information in the form 1040. The participation rate might therefore have dropped somewhat in the early 1990s. Our interviews showed that over 20 percent of EITC recipients were not expecting a refund. Many of these individuals would not have filed at all but for the CLHS tax program and others like it. See O'Connor (1999) for a more detailed analysis.
3. However, after two months, any savings from the EITC are counted toward liquid asset tests (Greenbook 1998). This point is discussed later in the paper.
4. Leibman (1998a) studies the issue of compliance to the EITC and focuses on administrative issues. He finds increased compliance with EITC rules and regulations due to IRS rule changes and audits of returns in the 1990s. We do not deal with these topics below.
5. Ideally, one would like to separate the economic effects of the EITC using a counterfactual group to parse out behavioral effects with a comparison group of some type. Because the EITC is a national program open to all low income, low wage taxpayers, there is no natural control group. One could examine year-to-year changes in outlays using, for instance, the Consumer Expenditure Survey (CEX). However, the CEX does not collect tax data and is not designed for assessing the effects of the EITC in respondents. Further, nonparticipants on the EITC are likely to be a nonrepresentative and biased group. As a substitute, we devised the questions regarding ability to make spending or saving decisions if the tax refund was not given. These are reported on below.
6. While we rely on the 826 questionnaires filled out at the time of the tax filing, the 208 call-back interviews provided verification of intended usage of these refunds. Call-backs were limited to those with refunds of \$1,000 or more with a 50 percent response rate. About 90 percent of the call-backs received the refund amount calculated by the CLHS. Differences were due to federal inquiries regarding legitimacy of the returns, or lower refunds due to school loans or child support payments that were outstanding. Among this 90 percent there was a high (85 percent) correspondence between intended use of refund (sample used here) and actual usage (once the check arrived), with no systematic change in the distribution of tax return usage by type of use. Phoneback interviewees were remarkably consistent in their preferences for EITC usage in the phone interview compared to the face-to-face interview.

7. These can be compared to national totals for 1997 where 29 percent are married or joint filers and 71 percent heads of households and single returns (U.S. House of Representatives 1998, Table 13-13, p. 871). Our Chicago area sample likely contributed to the higher fraction of head of household (or single) filers in our sample.
8. Edin (1998) reports that some of the men in her sample purchase trucks to use for informal salvage operations from trash dumping (“junkers”), or for local moving, shipping, and delivery services.
9. Only in our phone back interview did we ask savers what they intended to do with the savings. Less than 30 percent said they were saving for expected future bills (a consumption spending use), while more than 90 percent were saving for at least one equity building purpose (multiple responses were allowed). All forms of savings were classified as behavior which enhanced social mobility.
10. Due to overwithholding, the maximum amount of refund and use of refund can exceed \$3,656 in Panel A of Table 3. Since Illinois does not have a state EITC, the federal maximum of \$3,656 is also the state maximum in Panel B.
11. CLHS tax preparers report that with each year of their growing caseload and given repeat filers, knowledge of the EITC among tax claimants is increasing steadily. See also O’Connor (1999).
12. Most of those not responding to the priority question had a small and/or unanticipated refund which might have made the answer superfluous.
13. “Other uses” were not listed in Table 5. They totaled 16.4 percent for improving social mobility and 11.2 percent for making ends meet.
14. And this ignores the 18.4 percent who did not respond to this question, more than a third of whom had refunds in excess of \$1,000.

**Table 1. Earned Income Credit Parameters, 1975-98**  
(dollar amounts unadjusted for inflation)

Calendar Year	Credit Rate (percent)	Minimum Income for Maximum Credit	Maximum Credit	Phase Out Rate (percent)	Phase Out Range	
					Beginning Income	Ending Income
1975-78	10.00	\$4,000	\$400	10.00	\$4,000	\$8,000
1979-84	10.00	5,000	500	12.50	6,000	10,000
1985-86	14.00	5,000	550	12.22	6,500	11,000
1991	One child	7,140	1,192	11.93	11,250	21,250
	Two children	7,140	1,235	12.36	11,250	21,250
1992	One child	7,520	1,324	12.57	11,840	22,370
	Two children	7,520	1,384	13.14	11,840	22,370
1993	One child	7,750	1,434	13.21	12,200	23,050
	Two children	7,750	1,511	13.93	12,200	23,050
1994	No children	4,000	306	7.65	5,000	9,000
	One child	7,750	2,038	15.98	11,000	23,755
	Two children	8,425	2,528	17.58	11,000	25,296
1995	No children	4,100	314	7.65	5,130	9,230
	One child	6,160	2,094	15.98	11,290	24,396
	Two children	8,640	3,110	20.22	11,290	26,673
1996	No children	4,220	323	7.65	5,280	9,500
	One child	6,330	2,152	15.98	11,610	25,078
	Two children	8,890	3,556	21.06	11,610	28,495
1997	No children	4,300	332	7.65	5,430	9,770
	One child	6,500	2,210	15.98	11,930	25,750
	Two children	9,140	3,656	21.06	11,930	29,290
1998	One child	6,680	2,271	15.98	12,260	26,473
	Two children	9,390	3,756	21.06	12,275	30,095

Source: Joint Committee on Taxation; *Greenbook* (1998), Table 13-12, p. 867; Greenstein and Shapiro (1998); Council of Economic Advisors (1996).

**Table 2. Earned Income Credit: Number of Recipients and Amount of Credit, 1975-2000**

<b>Year</b>	<b>Number of Recipient Families (thousands)</b>	<b>Total Amount of Credit (millions)</b>	<b>Refunded Portions of Credit (millions)</b>	<b>Average Credit Per Family</b>
1975	6,215	\$1,250	\$900	\$201
1976	6,473	1,295	890	200
1977	5,627	1,127	880	200
1978	5,192	1,048	801	202
1979	7,135	2,052	1,395	288
1980	6,954	1,986	1,370	286
1981	6,717	1,912	1,278	285
1982	6,395	1,775	1,222	278
1983	7,368	1,795	1,289	224
1984	6,376	1,638	1,162	257
1985	7,432	2,088	1,499	281
1986	7,156	2,009	1,479	281
1987	8,738	3,391	2,930	450
1988	11,148	5,896	4,257	529
1989	11,696	6,595	4,636	564
1990	12,542	7,542	5,266	601
1991	13,665	11,105	8,183	813
1992	14,097	13,028	9,959	924
1993	15,117	15,537	12,028	1,028
1994 <sup>a</sup>	19,017	21,105	16,598	1,110
1995 <sup>b</sup>	19,335	25,956	20,829	1,342
1996 <sup>b</sup>	18,525	25,935	20,826	1,400
1997 <sup>b</sup>	18,652	26,919	21,684	1,443
1998 <sup>b</sup>	18,788 (19.7 <sup>d</sup> )	27,677 (29.8) <sup>c</sup> (30.5) <sup>d</sup>	22,452	1,473 (\$1,547) <sup>d</sup>
1999 <sup>b</sup>	18,954	28,728	23,416	1,516
2000 <sup>b</sup>	19,212	29,921	24,380	1,557

<sup>a</sup>Preliminary

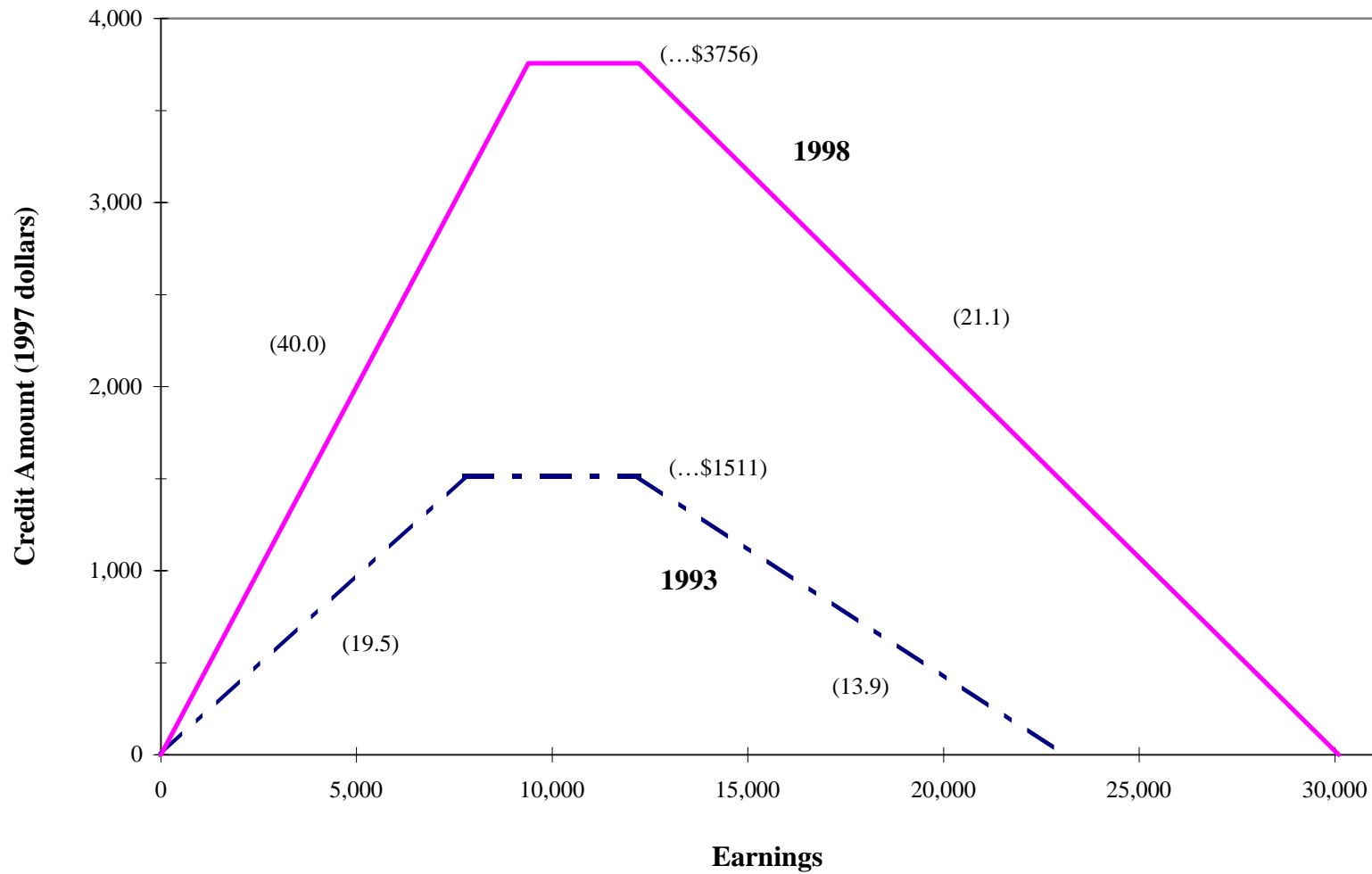
<sup>b</sup>Projected

<sup>c</sup> 1998 expected expense as reported in Eissa and Hoynes (1998) based on a more recent forecast from the Congressional Budget Office.

<sup>d</sup> Council of Economic Advisors (1998) December, 1998 forecast that 19.7 million workers expect to receive an average credit of \$1,547 in 1998.

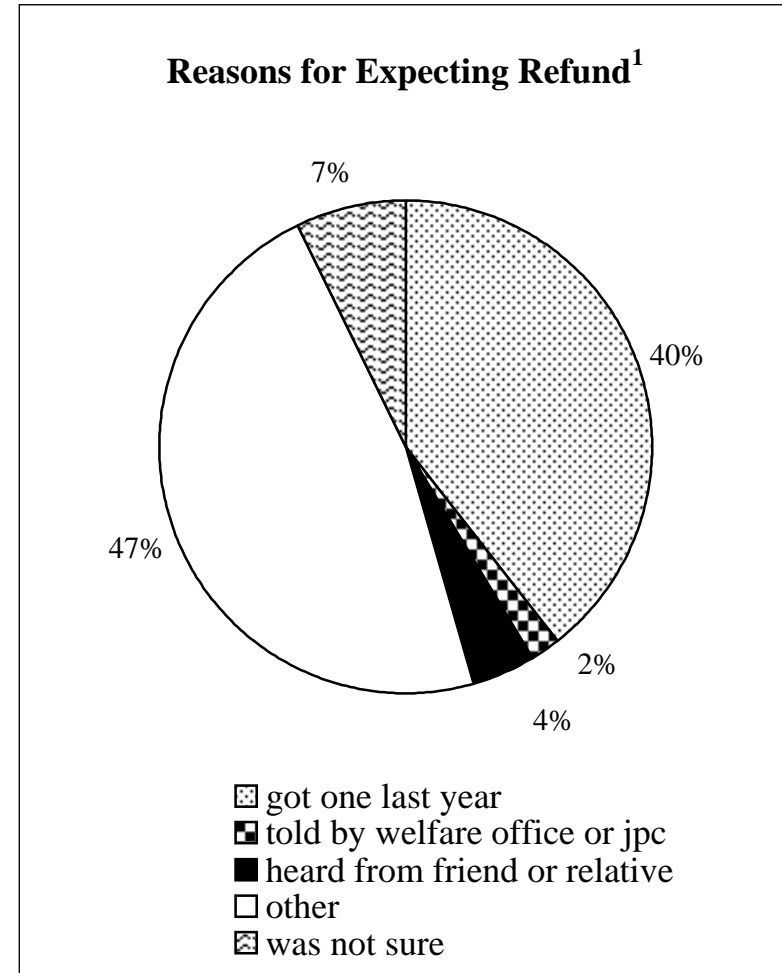
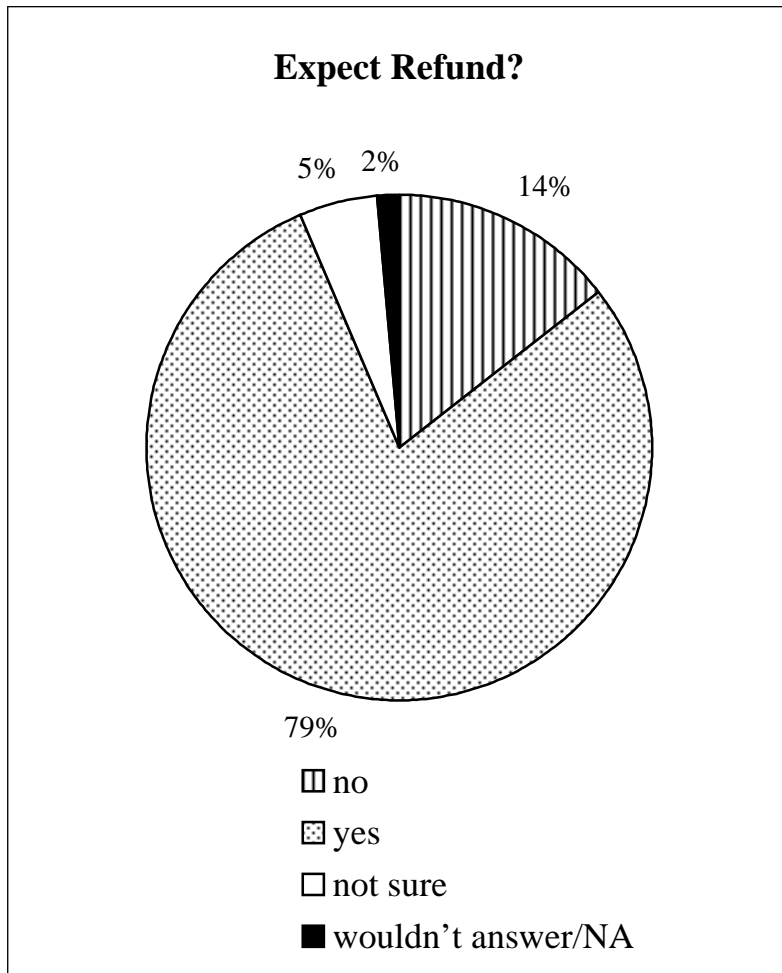
Source: *Greenbook* (1998), Table 13-17, p. 872.

**Figure 1. The Earned Income Tax Credit  
for a Family with Two or More Children in 1993 and 1998**



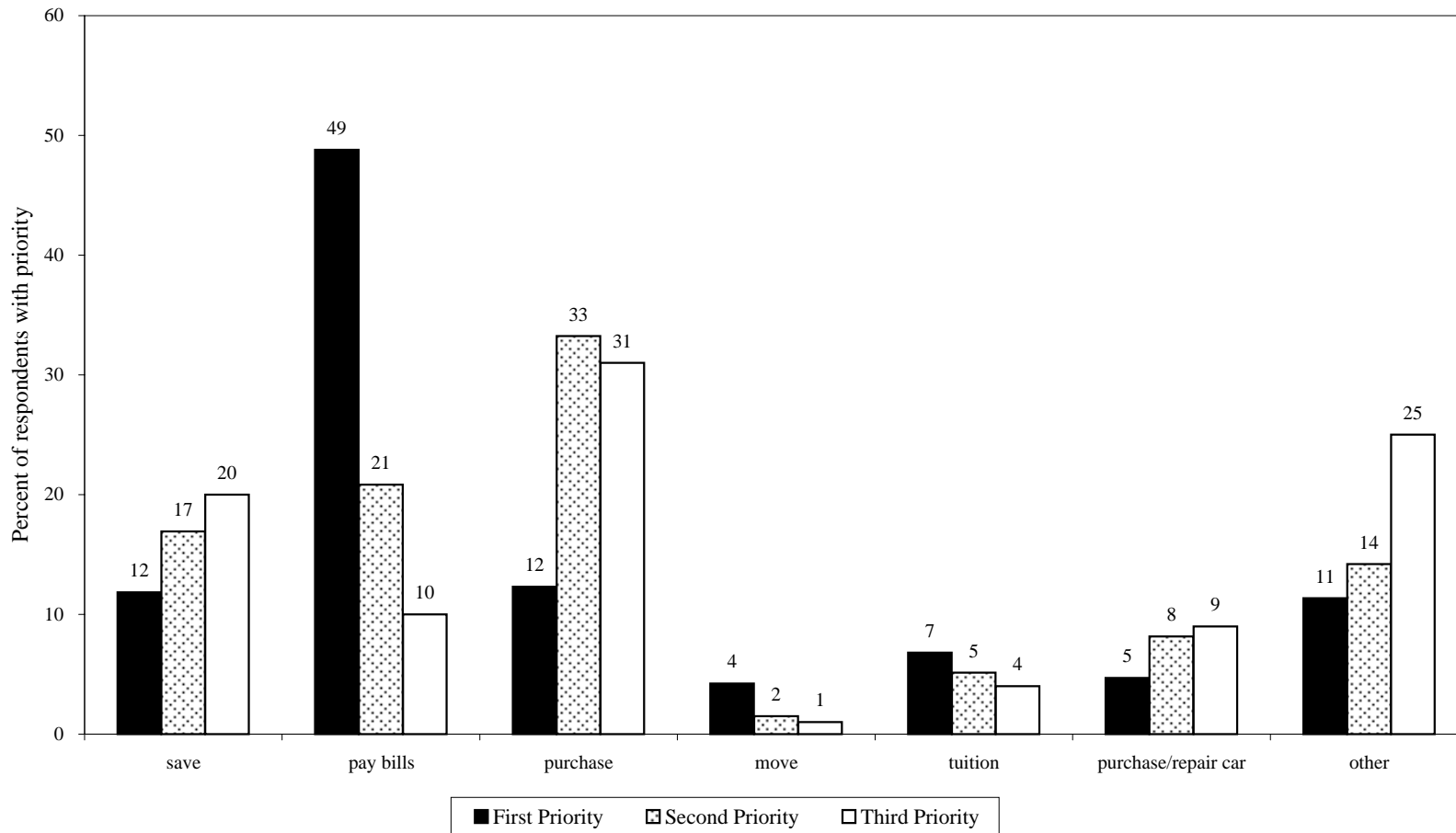
Source: CEA (1998) Chart 3.

**Figure 2**  
**Knowledge of EITC**



<sup>1</sup> For those expecting a refund or not sure.  
 Source: Author's tabulations of 1998 CLHS-EITC Survey.

**Figure 3**  
**Self-Reported Important Uses of Refund<sup>1</sup>**



<sup>1</sup> 74.7 percent of our sample respondents had a first priority use for their EITC refund; 40 percent expressed a second priority; and 12 percent a third priority. Source: Author's tabulations of 1998 CLHS-EITC Survey.

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