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Leveraging Tax Refunds to Encourage Saving

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Leveraging Tax Refunds to Encourage Saving

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Policy-makers from both sides of the political aisle are actively seeking ways to encourage retirement saving among middle- and low-income households. A growing body of evidence suggests that making it easy for these families to save, and presenting them with clear and effective financial incentives to do so, succeeds in generating significantly higher contributions to retirement accounts.

One of the most auspicious ways to make it easier for households to save, for retirement and other purposes, is by allowing them to directly deposit part of their income tax refund into a savings vehicle. This policy brief examines ways of encouraging households to save at one of their most "savable" moments: when they learn they will receive a substantial federal tax refund.

Currently, the Internal Revenue Service (IRS) permits refund recipients to identify a single destination for refunds. Many have called for the IRS to allow refund recipients to split their refunds, to facilitate saving in the same way that most payroll systems let employees "split" their paychecks and deposit part in savings products. The splitting proposal has been adopted by the Bush Administration and has been in the budget for the past two years. Twelve Members of Congress wrote to IRS Commissioner Mark W. Everson on January 31, 2005, requesting that the IRS adopt technical changes that would enable split refunds. On March 25, 2005, Commissioner Everson replied that the IRS was "working toward making this program available as quickly as possible" and set a deadline of the 2007 filing season. This policy brief addresses some practical issues with this idea, which are also partially addressed in an upcoming Retirement Security Project policy brief by Mark Iwry.[1] In particular, we also explore the idea of a refund-based savings option available to all at tax time—U.S. savings bonds, purchased out of a filer's refund.

This policy brief describes results from an experiment we conducted that underscores the potential benefits from this split refund proposal. The experiment was not focused specifically on retirement savings, but nonetheless provides insight into the process of saving for other purposes—as well as the steps that would be necessary to encourage households to set aside part of their income tax refund specifically for retirement purposes. The core of the experiment involved offering refund recipients the ability to "split" or "bifurcate" their refunds, i.e., to direct refunds to multiple destinations. One of these destinations was a simple bank savings vehicle.

The results were quite promising in some ways. A meaningful fraction (about 20 percent) of all refund recipients sought to save part of their refunds using our program. Nearly three-quarters of these were "greenfield" savers, who reported no prior savings. Participants reported high levels of satisfaction and many appeared to have spent their money on their predetermined goals.

At the same time, however, the vast majority of those making contributions appear to have withdrawn the funds relatively quickly. Although these withdrawals may have fulfilled various goals that households had earlier identified, they nonetheless mean that little of the deposited funds were retained as long-term savings. To the extent such retention is a goal for policy-makers, other steps may be required to make these assets more "sticky," possibly including framing them as retirement savings.

Introduction

One of the most auspicious ways to make it easier for households to save, for retirement and other purposes, is by allowing them to directly deposit part of their income tax refund into a savings vehicle.

Background

One promising way to encourage saving and asset building in low-income households is to leverage federal income tax refunds. The rationale is twofold. First, many low- and moderate-income (LMI) families receive large tax refunds.[2] In 2001, LMI tax filers received more than $78 billion in total federal refund payments, including the Earned Income Tax Credit (EITC), the Child Tax Credit, other refundable credits, and refunds from overwithholding.[3] This massive flow of funds, which takes place primarily during a few weeks in the early part of the tax season, represents a substantial portion of the inflows of an LMI family. With an average value of $1,546 in 2001, refund payments are often hundreds of dollars more than a low-income family's regular biweekly paycheck.[4]

In addition to being large, federal tax refunds are perhaps the most savable of income flows. Tax refunds differ from employment earnings and public benefits primarily because they arrive (at most) once a year. Irregular income flows—especially large ones—may be mentally defined as "assets" rather than "income."[5] In fact, research suggests that low-income families anticipate tax refunds and plan to use refunds differently than employment earnings. Although many families use at least part of their refunds to catch up on purchases and overdue bills, a sizable proportion also saves some and/or uses a portion to purchase furniture, cars, and even homes.[6]

The delay between tax filing—when an individual learns how much refund she will likely receive—and refund receipt may generate another reason that refunds are savable. This delay, which is sometimes short but often amounts to a week or two, allows an individual to *precommit* her refund to saving *before the money is in hand*.[7] The ability to precommit is very valuable if people undersave, in part because they are unable to resist spending temptations once they have the money in hand, as behavioral economists suggest.[8] As a result, programs that promote saving out of tax refunds have real potential. As early as 1994, Richard Thaler recognized the savings opportunity presented by tax refunds and argued for an additional credit for filers directly depositing refunds into Individual Retirement Accounts (IRAs).[9]

In the following sections, we recommend three ways to leverage tax refunds for saving and asset building: (1) allow refund recipients to create new accounts with their tax refunds; (2) allow refund recipients to create new accounts and split their refunds; and (3) allow refund recipients to purchase U.S. savings bonds with refunds. We focus primarily on the second of these recommendations and describe new data from our experiment on the effects of refund splitting.

Leveraging Tax Refunds: Program and Policy Options

Encourage Account Opening

Evidence that low-income families sometimes view refunds as a source of savings has led both for-profit and not-for-profit organizations to offer accounts at the time of tax preparation. These programs usually involve a partnership between a tax preparer (commercial or volunteer) and a financial institution. One of the earliest of these experiments was a partnership between the Center for Economic Progress (CEP) and Shorebank.[10] In 2000, about 450 LMI Chicago residents who used CEP's volunteer tax-preparation service were invited to open low-cost Shorebank savings accounts on site. About one-fifth of the tax filers enrolled, arranging to have their refunds directly deposited into the new accounts. This take-up rate, and the comments provided in participant surveys and interviews, reveals: (1) a desire to save and (2) demand for low-cost accounts. Most participants depleted their accounts fairly rapidly, but 14 percent maintained balances and perhaps added savings. Follow-up surveys and interviews with participants who were unbanked at the time of enrollment suggest that opening an account may have served as a first step toward savings and toward a greater connection with mainstream financial products.[11]

More recently, commercial tax preparers have encouraged individuals to open accounts with refunds. For example, in a small pilot program, some H&R Block offices have encouraged clients to open savings accounts on site with the requirement that they directly deposit their entire refund into the account. The accounts were marketed as a way to accumulate emergency savings.[12] In the 2003 tax season, H&R Block opened approximately 400 such accounts, with an average opening balance of $870. Only 2 percent of clients at the offices that offered the service opened accounts, but take-up was depressed by rigorous account-opening requirements based on a credit check.[13] H&R Block has also encouraged refund recipients to open IRAs on site. Over the four tax seasons from 2001 to 2004, the company opened approximately 420,000 "Express IRA" accounts. In 2004, the average balance on the 284,000 accounts still open was $693.[14]

In a new study, a team of researchers associated with The Retirement Security Project has been working with H&R Block to test whether augmenting refunds to provide incentives for IRA opening is effective. The preliminary results show that IRA contributions increase with the level of match funding offered.[15]

Encourage Account Opening and Refund Splitting

If people undersave because they have trouble resisting spending temptations, and if mental accounting helps people set aside money for savings, then refund splitting—physically separating funds designated for saving from funds designated for spending—may be a valuable tool to encourage saving. Currently, the IRS will send a refund to only one account, and most low-income families cannot save all of the refunds. Thus, whether the money is sent via paper check or directly deposited in a single account, the would-be saver must receive the entire refund, make a decision about saving, and then execute the savings plan while spending part of the money. This leaves them open to spending temptations.

Refund splitting, by contrast, allows the recipient to mentally and physically separate saving and spending money and make saving automatic, thereby reducing the mental energy required to save. The intention to save is further reinforced if the savings portion is directed to a savings-oriented financial product. This intention can be strengthened even more if the product imposes some restrictions on withdrawals.[16]

Some higher-income families have access to refund splitting. Vanguard, the second largest mutual fund company in the United States, allows investors to split their refunds between as many as four existing Vanguard accounts (including money market accounts with check-writing privileges that can be used as transaction accounts). Prior to tax filing, a would-be splitter files a form with Vanguard outlining the allocation of the refunds. The filer then submits a general Vanguard account number and routing number on her tax return, and Vanguard automatically splits the refund deposited

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into this account according to the previously issued instructions.[17] In 2004, Vanguard was the only company out of the 10 largest banks and 10 largest mutual funds with a formal splitting service,[18] but some customers with brokerage accounts in other firms may be able to have their brokers automatically split refunds across multiple investments. Unfortunately, LMI families are not likely customers of Vanguard (whose funds typically require a minimum investment of $3,000) or of brokerage firms.

LMI families do have access to some refund splitting, albeit of a different form. Clients who take out refund anticipation loans (RALs) split their refunds, sending some to pay the tax preparer and receiving the remainder. RAL splitting does not build assets, however, but instead satisfies the need for immediate spending. Clients opting to purchase H&R Block's Express IRA product at the time of tax preparation also have the option of splitting their refunds, directing some to the newly opened IRA and receiving some as a direct deposit or as a paper check.[19]

The Experiment and Results

During the 2003 tax season, a refund-splitting program targeted to LMI households was piloted in Tulsa, Oklahoma.[20] This program, called Refund to Assets (R2A), was a partnership of the Community Action Program of Tulsa County (CAPTC), D2D Fund (D2D), and the Bank of Oklahoma (BOk).[21] Clients at two of CAPTC's free tax-preparation sites were invited to split their refunds, sending part to a savings account via direct deposit and arranging to receive the rest by mail as a check. Participants were also able to open new savings accounts through BOk without leaving the tax-preparation site. To be eligible, clients had to be at least 18 years old, have an expected federal tax refund, and agree to a set of legal authorizations. In addition, clients wishing to open a BOk account had to pass an industry-standard credit screen (ChexSystems) and have a valid driver's license or passport.

The pilot program was offered in two periods during the tax season—during the first two weeks of February (the peak season for filing by those expecting refunds) and for two weeks in March. Recruitment and enrollment occurred on site while individuals were waiting to meet with tax preparers. CAPTC staff and/or a member of the research team used a prepared script to describe R2A, emphasizing the program as a tool to split refunds and to encourage saving. Although the script encouraged refund splitting, individuals who wanted to open new BOk accounts and deposit their entire refunds into these accounts were allowed to do so. Typically, the savings portion was directly deposited about 10 to 14 days after the date of tax filing, and the participant received the remainder as a check shortly thereafter.

In brief, about 27 percent of 516 refund recipients sought to participate in the R2A program (takers). Fifteen percent were able to participate (participants), with the remainder being foiled because they did not meet various eligibility standards, as described above. Each participant had three choices: she could split her refund and open an account, split into an existing account, or simply open an account. Among those who successfully enrolled, 56 percent used both services, 27 percent only split, and 17 percent only opened an account. For the remainder of this brief, we report on all R2A participants, regardless of services chosen, but the breakdown by service type is described in our more detailed paper on this topic.[22]

Table 1 presents various financial and demographic characteristics of participants. The 79 participants had an average age of 35, were predominantly female, and were predominantly African-American or Caucasian. Their federal tax refunds averaged $1,381. Over half of the participants held full-time jobs, and more than three-quarters worked at least part time. However, 12 percent of respondents were unemployed and currently looking for work, a figure that

Table 1:
Demographic Characteristics of R2A Participants

Income		**Federal Refund**		**Age**	
Mean	$12,297	Mean	$1,381	Mean	35
Standard Deviation	$9,264	Standard Deviation	$1,446	Standard Deviation	13
Median	$10,526	Median	$648	Median	32
Misc.		**Gender**		**Marital Status**	
Has Health Insurance	45%	Female	57%	Single, Never Married	53%
Owns Home	31%	Male	43%	Separated or Divorced	27%
Children in Household	52%			Married	16%
Receives Public Assistance	27%			Widowed	4%
Employment		**Race/Ethnicity**		**Education**	
Working Full-Time	60%	African-American	50%	Less than HS Diploma	14%
Working Part-Time	16%	Caucasian	39%	HS Diploma or GED	37%
Not Working, Looking for Work	12%	Native American	3%	Some College	33%
Not Working, Student	8%	Hispanic	5%	Associate's Degree	8%
Not Working, Other	4%	Other	3%	Bachelor's Degree	8%

Source: Beverly, Schneider and Tufano (2005)

was twice the national unemployment rate. The average adjusted gross income (AGI) was $12,297. Overall, participants might be described as the "working poor."

At the time of enrollment, participants were asked what they planned to do with their refunds. Eighty-one percent of participants said they planned to save part of their refunds. The most common savings goal, named by 16 percent of participants, was "general" savings, including responses such as "to build savings" or "just to have money." The next most common savings goals were saving for housing-related uses, saving for emergencies, and vehicle-related savings. Retirement savings was mentioned by only 5 percent of participants, although that was slightly higher than those who stated that they wanted to save for their children. The results for respondents' planned savings goals are presented in Table 2.[23]

R2A participants initially contributed substantial amounts to savings accounts. The mean participant directed $606 into savings (47 percent of her refund). The median participant directed $203 into savings (39 percent of her refund). These deposits represented 9.8 percent of the total refunds of all individuals (both participants and those who declined to use the service) approached at the tax-site.

Individuals who reported having some savings when they enrolled in the program had larger refunds and directed a larger percentage of their refunds to savings

Table 2:
Percentage of R2A Participants Articulating Specific Savings Goals

Any savings goal	81%
General savings	16%
Emergency savings	13%
Home improvement, purchase, or rental	15%
Car purchase, repair, or other	13%
Education	4%
Business	1%
Retirement	5%
Children	4%
Gifts, weddings, funerals	4%
Bills	3%
Medical	1%
Durables	1%
Move	1%
Living expenses	1%
Miscellaneous	7%

Note: This table contains data from self-administered baseline surveys of program participants. The question asked participants if they planned to save some of their refunds, use some for debt repayment, or spend some. Several spaces were provided under each option for the respondent to detail the specific use. These open-ended responses were then grouped and coded by the authors. Only the savings responses are presented here.
Source: Beverly, Schneider and Tufano (2005)

Of those who reported at baseline that they planned to save some of their refunds, 72 percent said they were still doing so.

accounts. In contrast, greenfield savers—individuals without savings at baseline—received smaller refunds and directed a smaller percentage to savings. With smaller refunds and smaller shares directed to savings, greenfield savers sent an average of $479 to savings versus $924 by existing savers.

In a follow-up survey administered three to five months after tax filing, R2A participants were asked how they had used their refunds and how much they were still saving. Of those who reported at baseline that they planned to save some of their refunds, 72 percent said they were still doing so. Among the 23 participants who planned to save and reported still saving, mean savings was 34 percent of refunds, median was 23 percent. Seventy-eight percent were still saving some portion of their refunds or had spent on a stated savings goal.[24]

These outcomes for R2A participants were examined against outcomes for a comparison group. The comparison group included filers at another CAPTC tax-preparation site who did not have access to the R2A program but said they would be interested in a program like R2A. Participants were more likely than comparison group members to say they were still saving a portion of their refunds. However, differences in amount saved (measured in dollars and as a percentage of refund amounts) were not significantly different. These findings should be interpreted with caution because there were some important demographic differences between these two groups.[25]

We also compared participants' reported savings at follow-up with their self-reports about saving out of their 2003 tax refunds. Participants reported saving more of their refunds in 2004, when R2A was used, than in 2003, when refund splitting was not available.

In addition to self-reported data on saving and spending out of refunds, the Bank of Oklahoma provided limited data for 58 of the 66 individuals who opened an account with BOk or split to an existing BOk account. Of these participants, 38 percent had closed their accounts by mid-August 2004, while 62 percent still had active BOk accounts at least through the end of November 2004.

Data on end-of-month account balances show that participants rapidly withdrew money from their accounts. This sub-sample of 36 participants initially deposited an average of $644 into their BOk accounts. The average balance dropped to $112 by August (26 weeks after most participants received their refund) and to $27 by November (38 weeks after refund receipt for most participants).

The rapid depletion of the accounts may reflect several factors. First, and most likely, the withdrawals may have fulfilled other goals of the participants, even if those goals did not involve long-term savings. Many participants articulated a variety of concrete short-term and medium-term savings goals, as listed in Table 2; it is very plausible that the funds went to meet these needs. Second, the lack of withdrawal restrictions on the accounts may have encouraged more withdrawals than would occur in other account structures, including IRAs, although more restricted withdrawal rules may also have discouraged contributions in the first place. Finally, it is possible that the households depleted their accounts to avoid disqualifying themselves from various means-tested benefit programs (like Medicaid and food stamps) with asset tests.[26]

Attitudinal questions in a follow-up survey, as presented in Table 3, suggest that R2A facilitated saving and thoughtful spending. Eighty-three percent of respondents said the service helped them spend their refunds more slowly, and 76 percent said the service helped them resist spending temptations. In addition, all respondents said they would recommend R2A to a friend, and 97 percent planned to split their refunds again next year. On average, participants said they were willing to pay $6.60 to split their refunds, and 89 percent were willing to split even if they had to wait longer to receive their refunds. These

Table 3: Responses to Follow-up Survey Attitudinal Questions for Participants

	All Participants
Percent who "strongly agree" or "agree" that:	
Service helped to save more of refund	83%
Service helped to spend refund more slowly	83%
Service helped to resist spending temptations	76%
Percent who are "very likely" or "somewhat likely" to:	
Split next year	92%
Percent "very interested" or "interested" in:	
Still splitting even if had to wait longer for refund	89%
Would recommend service to a friend	100%
Average amount willing to pay to split refund	$6.60
N	41

Note: This table contains survey data from follow-up telephone surveys of program participants. Participants were asked a series of questions designed to gauge their satisfaction with R2A and their feelings about the program's effectiveness. Participants were also asked several questions about possible future use of a splitting service. Respondents who did not split were asked hypothetical questions about their interest in splitting.
Source: Beverly, Schneider and Tufano (2005)

limited results suggest that participants perceived material benefits from the service, albeit not benefits related to long-term savings goals.

Addressing Impediments to Scale

While our small pilot suggests that there is demand for a refund-based savings program, there are impediments to taking a simple splitting program to scale. In the R2A pilot, only 27 percent of the participants split into an existing account, with the remainder opening accounts. Slicing the data another way shows that the demand for splitting alone (4 percent) was less than half the demand for splitting coupled with account opening (8 percent).[27] This suggests that the ability to open new accounts was an attractive—and perhaps essential—feature of our program.

Yet, if refund splitting is to be offered *in combination with account opening*, some practical issues must be resolved. The standard operating procedure for the partner bank in R2A—and we believe for most banks—is to deny accounts, even savings accounts, to potential savers who have prior negative bank records. We found that 42 percent of would-be R2A participants could not participate in the program because low ChexSystems scores made them ineligible for BOk accounts. Thus, participation in programs like R2A will be depressed unless the ChexSystems screen is waived or softened.

Although BOk did not waive the ChexSystems screen, the bank did forgo the $100 initial deposit requirement and the $300 minimum balance requirement for participants. This encouraged participation in R2A, but taking this program to scale will not be possible if program administrators must depend on the goodwill of individual financial institutions to waive requirements of this sort.

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These practical problems might be avoided if people can split to a savings product that is not housed in a bank.

Other account-opening issues relate to operational flow. R2A changed the flow of the tax-preparation site because account opening required an additional step with different personnel. This would not work for self-preparers or even for thinly staffed tax-preparation sites. As much as a third of all LMI returns are self-prepared, and we suspect that a meaningful fraction of the volunteer tax-preparation sites (which process 1 to 3 percent of LMI returns) might be operationally challenged by the requirements to open accounts on site.[28]

These practical problems might be avoided if people can split to a savings product that is not housed in a bank. In our experiment, splitting options were limited to bank products for two reasons. These simple products are more easily understood by savers, and opening some other products, like mutual funds, requires the in-person or telephone presence of a registered broker-dealer. Below, we suggest a different *nonbank* splitting option, U.S. savings bonds.

In our view, splitting is a necessary, but not sufficient, condition to making refund-based savings programs work. Many different types of approaches to address the issues raised above are possible. A large preparer, like H&R Block, might be able and willing to change its process flow to facilitate account opening. D2D Fund is working on other private-sector actions that could lower the operational costs and efforts for other preparers. These innovations could include enabling filers to complete the paperwork for account opening offline yet still comply with IRS direct-deposit requirements, giving refund recipients the ability to take part of their refund in a card-based product or using information technology to speed up and centralize the account-opening process.

While the IRS may offer basic splitting functionality, it should also work with the private sector to establish or clarify rules to facilitate private innovation in splitting. Our study suggests that there is demand for a wide range of destinations for refunds if split. In a follow-up survey we asked where filers might like to direct their split refunds; options included savings products, transaction accounts, and various kinds of debt repayment. The results are shown in Table 4. The IRS itself would probably wish to support splitting only to a narrow range of destinations, such as online accounts with valid bank routing and account numbers. The private sector might be willing to meet a broader set of consumer demands.

Table 4: Interest in Refund-Splitting Destinations, R2A Participant and Comparison Groups

Percent "somewhat" or "very" likely to split into:	
Savings	
Savings Account	92%
Retirement Savings Account	53%
College Savings Account	51%
Certificate of Deposit	29%
US Savings Bond	24%
Mutual Fund	21%
Transaction	
Checking Account	88%
Paper Check	65%
Stored Value Card	40%
International Remittance	22%
Debt	
Car Loan	45%
Credit Card	44%
Mortgage	42%
N	**60**

Source: Beverly, Schneider and Tufano (2005)

Getting refunds into some of these destinations might require clarification or changing of IRS rules. For example, our nonlawyer's reading of the tax code suggests that the IRS contemplates only sending funds to a separate account held by the filer.[29] Yet, many of the most robust pools of savings are held in omnibus accounts, such as 401(k) or 403(b) products, where recordkeeping systems track individuals' claims on common pools. The IRS could clarify rules so that money could be directed toward (or through) these pooled vehicles, as long as safeguards protect the interests of the refund recipient. An upcoming policy brief by The Retirement Security Project discusses other administrative issues that the IRS would need to address, including data errors, storage and processing concerns, and coordination of a split refund program with IRA contributions.[30]

A "Universal" Savings Vehicle: Savings Bonds

More importantly, as a matter of policy, it would be desirable to create a universal "savings vehicle of last resort" to ensure that all willing savers have an opportunity to save. A tax-time savings vehicle should offer market-based returns while exposing the investor to relatively low risk, be available in small denominations, be portable as people move, and be simple to explain and understand. Ideally, it will also encourage, although not force, families to frame this decision in terms of savings rather than almost immediate consumption. In a related paper, we offer a promising approach to enable everyone—regardless of account ownership—to save out of his or her refund by allowing refund recipients to receive part of their refunds in U.S. savings bonds rather than in cash.[31]

Savings bonds might be an attractive option for a number of reasons. Savings bonds were originally created to help low-income families to save and build wealth. First introduced as Liberty Bonds during World War I, and then widely marketed and sold in the 1930s and 1940s, savings bonds were "designed for the small saver—that he may be encouraged to save for the future and receive a fair return on his money." [32] The need for savings bonds persists. Mainstream financial institutions seem largely uninterested in selling savings and investment products to many low-income individuals. Banks and credit unions typically use ChexSystems scores, minimum initial-deposit requirements, and minimum balance rules to discourage small savers. Mutual funds often set high initial-purchase requirements that make it difficult for low-income savers to buy money market, stock, or bond mutual funds. On the positive side, savings bonds seem to meet all the attributes we describe above of an acceptable savings vehicle of last resort.

One proposal is to allow refund recipients be able to instruct the IRS to use a portion of their refunds to purchase savings bonds.[33] By adding a single line to the tax form, it would be possible to ensure that every American family had access to at least one savings option at the time they filed their taxes.

Our experiment gives us reason to believe that there might be some meaningful demand for savings bonds. In follow-ups, we asked participants if they would be interested in savings bonds as a destination for their funds, and approximately a quarter were interested. When we explained the terms of the bonds, about three-quarters were interested. Ultimately, the demand for this product will be known only through offering it and observing take-up. However, just directing a small share of LMI refunds to savings bond purchase would have a substantial impact on savings bond sales. If just 1 percent of the $78 billion in LMI refunds were used to purchase savings bonds, bond sales would increase by 10 percent.[34]

This idea of permitting refund recipients to buy bonds is an old one. From 1962 through 1968, the IRS allowed refund recipients to receive their refunds in either cash or savings bonds. This experiment was apparently not a success, with only about 1 percent of refund recipients using the service. This early data may not be representative, however, for two reasons. First, low-income filers receive substantially larger refunds today than in

Our experiment gives us reason to believe that there might be some meaningful demand for savings bonds.

the 1960s. Per capita tax refunds have increased from an average of $636 in 1964 (in 2001 dollars) to $1,415 in 2001.[35] The majority of low-income families now often receive sizable refunds. Second, the historical experiment was an all-or-nothing program and did not allow refund recipients to direct only a portion of their refunds to bonds. The savings bond option would likely be more appealing since filers would be able to direct a portion to savings while receiving the remainder for current expenses.

Other changes in the savings bond program would support not only a refund-splitting program, but also a revitalized savings bond program. These would include changing the minimum required holding period before bonds can be redeemed; creating a new advertising and marketing campaign; enlisting additional sales outlets for bonds; and creating a role for savings bonds as part of a family's overall wealth-building activities, as opposed to a stand-alone program divorced from other savings activities.

The proposed savings bonds are not intended to *substitute* for private-sector accounts offered by the financial sector. Rather, the savings bond alternative provides a last resort for families whom the financial sector would otherwise ignore and provides a base-case product against which the private sector could compete. If by virtue of this competition, the private sector offered better products to refund savers, this would be good policy, even if take-up on the savings bond product itself were minimal.

There are more elaborate versions of our proposal whereby the refund recipient could direct the IRS to deposit the money in a wider range of alternatives. These could include retirement savings products, discussed by Mark Iwry in an upcoming Retirement Security Project brief, or a menu such as offered by the Thrift Savings Plan to federal employees. However, giving all refund recipients the opportunity to seamlessly save in the form of savings bonds could be simple, feasible, and immediate.[36] Furthermore, enabling refund-based savings bond purchases would provide valuable information to policy-makers who might be contemplating more complex models of tax-based savings programs.

Conclusion

Allowing families to direct part of their tax refunds to a savings vehicle could transform tax time into not only a "savable" moment, but also a good time to intervene to help families take stock of their financial lives. Merchants seeking to capture refund dollars tell potential customers to spend their tax refunds with them. On April 16, 2005, one of the authors of this brief received a typical sales appeal, this one by E-mail from Travelocity, an online travel service: "We can't think of a better way to celebrate a fat refund check than with a fun, relaxing getaway. Check out some of our favorite refund-funded ideas below. . . ." We are aware of car dealers who prepared taxes for free on site, presumably hoping to convert refunds into down payments.[37] Split refunds could help to transform such appeals toward savings, since firms might see tax time as a "point of sale" not for cars and trips, but for financial products. Indeed, tax refunds could encourage financial service firms to establish new relationships with customers who otherwise might appear to be too marginal to be worth the effort.

In summary, allowing households to deposit part of their tax refunds into a savings vehicle would make the savings process much easier. The results of such a shift could be particularly beneficial if this ease-of-saving were combined with steps to encourage retention of the funds (potentially including framing the deposits as intended for retirement saving), increased motivation for commercial firms to encourage saving among middle- and low-income households, and increased incentives for these households to save.

Endnotes

1 J. Mark Iwry, "Using Tax Refunds to Increase Savings and Retirement Security," Retirement Security Project Policy Brief, forthcoming.

2 We define LMI as having an adjusted gross income of less than $30,000.

3 Internal Revenue Service, Statistics of Income, "Individual Income Tax Statistics – 2001," table 3.3 (available at http://www.irs.gov/pub/irs-soi/01in33ar.xls).

4 Ibid.

5 See, for example, Hersh M. Shefrin and Richard H. Thaler, "Mental Accounting, Saving, and Self-Control," in G. Lowenstein and J. Elster, eds., *Choice Over Time* (New York: Sage Foundation, 1992); Richard Thaler, "The Behavioral Life-cycle Hypothesis," *Economic Inquiry* 26, no. 4 (1988): 133–41.

6 See, for example, Timothy Smeeding et al., "The Earned Income Tax Credit: Expectation, Knowledge, Use, and Economic and Social Mobility," *National Tax Journal* 53, no. 4 (2000): 1187–1209; Sondra Beverly et al., "Linking Tax Refunds and Low-Cost Bank Accounts: Findings from the Extra Credit Savings Program," Working Paper no. 277 (Joint Center for Poverty Research, 2002); Lisa Barrow and Leslie McGranahan, "The Effects of the Earned Income Credit on the Seasonality of Household Expenditures," *National Tax Journal* 53, no. 4 (2000): 1211–43; Jennifer Romich and Thomas Weisner, "How Families View and Use the EITC: Advance Payment Versus Lump Sum Delivery," *National Tax Journal* 53, no. 4 (2000): 1245–66.

7 If an individual files electronically and arranges to have her refund directly deposited into a bank account, she might receive her refund 10 to 14 days after filing. Refund anticipation loans offered by commercial tax preparers provide immediate access to cash, but typically charge an effective annual APR of 250 percent in fees and interest (Alan Berube and others, "The Price of Paying Taxes: How Tax Preparation and Refund Anticipation Loan Fees Erode the Benefits of the EITC" [Brookings Institution and Progressive Policy Institute, 2002]).

8 See, for example, Shefrin and Thaler, "Mental Accounting, Saving and Self-Control," 1992; Richard Thaler, "Psychology and Savings Policies," *American Economic Review* 84, no. 2 (1994): 186–92; Richard Thaler, "From Homo Economicus to Homo Sapiens," *Journal of Economic Perspectives* 14, no. 1 (2000): 133–41. The very availability of automatic investment plans (which allow workers to deduct money from their paychecks to fund 401(k) and 403(b) accounts) and automatic monthly contributions to mutual funds suggests that the financial industry believes precommitment facilitates saving. Richard Thaler and Shlomo Bernartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," *Journal of Political Economy* 112, no. 1 (2004): 164–87; and Ashraf, Nava, Dean S. Karlan, and Wesley Yin. forthcoming. "Tying Odysseus to the Mast: Evidence from a Commitment Savings Product in the Philippines." *Quarterly Journal of Economics* describe other programs that deliberately used precommitment strategies to encourage saving. Even when formal precommitment programs are not available or are not desired, individuals sometimes create their own precommitment constraints. And at least one study suggests that some low-income workers prefer the lump-sum EITC payment over the advance payment option because it "forces" them to save (Jennifer Romich and Thomas Weisner, "How Families View and Use the EITC: Advance Payment versus Lump Sum Delivery," 2000.)

9 Richard Thaler, "Psychology and Savings Policies," 1994.

10 Sondra Beverly et al., "Linking Tax Refunds and Low-Cost Bank Accounts: Findings from the Extra Credit Savings Program" (2002).

11 Other community organizations that provide free tax-preparation services have implemented similar programs. To our knowledge, none has been evaluated as carefully as the CEP-Shorebank partnership. Our phone interviews with nine free tax-preparation programs and our interpretation of reports from two other tax-preparation programs suggest that the success of these account-opening initiatives varies considerably. The terms of accounts vary, with financial institutions occasionally waiving fees, minimum balances, or ChexSystems requirements. Product marketing also differs across programs. At some sites, bank representatives are on site and actively "sell" the accounts. At others, VITA staff are responsible for selling the accounts and must call into a partner bank to set up the account remotely.

12 Peter Tufano and Daniel Schneider, "H&R Block and 'Everyday Financial Services,'" Harvard Business School Case no. 205-013 (Harvard Business School Publishing, 2004).

13 Ibid.

14 H&R Block, "Express IRA Accounts and Assets thru FY 2005," 2005, mimeograph, in possession of authors.

[15] Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block," Retirement Security Project Discussion Paper no. 2005-5, May 2005.

[16] An interesting research question is the extent to which such withdrawal restrictions discourage some from saving in the first place. The limited literature from 401(k) plans suggests that pre-retirement liquidity has a significant effect on participation and contribution decisions.

[17] Additional information on Vanguard's splitting policy is available at http://flagship2.vanguard.com/VGApp/hnw/TcDirectDepositController?cbd (accessed March 3, 2004).

[18] This statement is based on phone interviews conducted in March 2004 with representatives from the nation's 10 largest banks and largest mutual funds by assets.

[19] Peter Tufano and Daniel Schneider, "H&R Block and 'Everyday Financial Services,'" 2004.

[20] Sondra Beverly, Daniel Schneider, and Peter Tufano, "Splitting Tax Refunds and Building Savings: An Empirical Test," Forthcoming, In James Poterba, ed., *Tax Policy and the Economy*, MIT Press.

[21] CAPTC is a large community action agency based in Tulsa. In addition to providing social services such as housing assistance, child care, health services, and emergency food and financial assistance, CAPTC provides free tax preparation to low-income households. In 2002, volunteers completed about 14,300 federal returns. D2D Fund (www.d2dfund.org) is a nonprofit organization focused on the development and testing of innovative financial products and services for low-income families. (In the interest of full disclosure, we note that one of the authors is the founder and chairman of D2D Fund.) BOk is a subsidiary of Bank of Oklahoma Financial Corporation, which operates banks in Oklahoma, Texas, New Mexico, Arkansas, and Missouri. It is the largest bank in Oklahoma.

[22] Beverly, Schneider, and Tufano, "Splitting Tax Refunds and Building Savings: An Empirical Test" (2005).

[23] We also surveyed their spending and debt-repayment goals, which are not reported here.

[24] A person who planned to save to purchase a car and, at follow-up, had done so met this broader definition of success. Someone who planned to save for the future and used part of her refund for an emergency also met this definition.

[25] Some differences suggest that the comparison group was more advantaged. Members of the comparison group were more likely to have higher incomes and to be female, white, and homeowners than R2A participants. Comparison group members were similar to participants with respect to marital status, employment, public benefits receipt, household composition, health insurance, and actual refund receipt. See Beverly, Schneider, and Tufano, "Splitting Tax Refunds and Building Savings: An Empirical Test" (2005) for more details.

[26] For a discussion of the asset tests, see Zoë Neuberger, Robert Greenstein, and Eileen Sweeney, "Protecting Low-Income Families' Retirement Savings: How Retirement Accounts Are Treated in Means-Tested Programs and Steps to Remove Barriers to Retirement Saving," Retirement Security Project Discussion Paper No. 2005-6, June 2005.

[27] If foiled participants who wanted to split are counted, the (potential) demand for splitting was 21 percent.

[28] Wojciech Kopczuk and Cristian Pop-Eleches use 1999 SOI data to report that 67 percent of EITC-eligible families used a professional tax preparer. See Kopczuk and Pop-Eleches, "Electronic Filing, Tax Preparers, and Participation in the Earned Income Tax Credit," Columbia University Working Paper, March 2005, http://www.columbia.edu/~wk2110/bin/efile.pdf (last accessed May 30, 2005). Data on the size of the VITA "market" is drawn from four sources: "Tax Administration: IRS's 2003 Filing Season Performance Showed Improvements" (U.S. General Accountability Office, 2003); *National Taxpayer Advocate 2004 Annual Report to Congress* (IRS Taxpayer Advocate Services, 2004); The Internal Revenue Service, "Tax Stats," http://www.irs.gov/taxstats/; and The Internal Revenue Service, Statistics of Income, 2001, "Individual income tax statistics – 2001, table 3.3 – 2001 Individual income tax, all returns: Tax liability, tax credits, tax payments, by size of adjusted gross income," http://www.irs.gov/pub/irs-soi/01in33ar.xls.

[29] Internal Revenue Service, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*, http://www.irs.gov/pub/irs-pdf/p1345.pdf (April 2005).

[30] J. Mark Iwry, "Using Tax Refunds to Increase Savings and Retirement Security," Retirement Security Project Policy Brief, forthcoming.

31 Peter Tufano and Daniel Schneider, "Reinventing Savings Bonds," Working Paper, 2005 (available at http://www.people.hbs.edu/ptufano/)/

32 U.S. Department of Treasury, United States Savings Bonds (U.S. Department of Treasury, 1935).

33 Peter Tufano and Daniel Schneider, "Reinventing Savings Bonds," 2005.

34 Sales of EE and I bonds in 2004 amounted to $7.9 billion. If 1 percent of the $78 billion in refunds to families making less than $30,000 per year were captured for savings bond purchase, bond sales would increase by 9.8 percent.

35 Internal Revenue Service (2001, 1964). We define LMI filers as those with incomes of less than $30,000 in 2001 or less than $5,000 in the period from 1962 through 1968 (which is approximately $30,000 in 2001 dollars).

36 Since their introduction, U.S. savings bonds have changed in ways that make them less attractive to small savers. The bonds have become harder to buy, for example, and less attractive to hold. In another piece, Tufano and Schneider, "Reinventing Savings Bonds" 2005, we make specific recommendations for policy change. These changes would improve the proposed policy to allow individuals to purchase savings bonds with their refunds.

37 Chi Chi Wu, Jean Ann Fox, and Elizabeth Renuart, "Refund Anticipation Loan Report," Consumer Federation of America and the National Consumer Law Center, 2002.

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Mission Statement

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers.

The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

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