

# Restructuring the EITC: A Credit for the Modern Worker

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## Executive Summary

### Can a restructured Earned Income Tax Credit payment improve household financial stability?

Financial instability – the inability to meet monthly expenses regularly – is a growing problem for many American households. Despite recent attention from policy makers, there has been little real action to address the issue. Income volatility, which drives financial instability, is threatening the social mobility and independence of working families, and neglecting this issue will only lead these families further into debt.

Many working families are filling the gap between their monthly income and expenses by going without necessities, using high interest credit and predatory short term loans, and borrowing from family and friends. Programs like the Earned Income Tax Credit (EITC) provide a much needed financial boost during the tax season, but this once-a-year payment structure fails to reduce income volatility. Unsurprisingly, a 2012 study found that 84% of EITC recipients used a portion of their tax refund to pay overdue bills and debt, while only a small percentage was able to allocate any of their refund to savings.<sup>1</sup>

### Is it possible to make the financial support provided by the EITC available to families over the course of the year, and would that improve their financial stability?

The Chicago EITC Periodic Payment Pilot, led by the Center for Economic Progress (CEP) with support from Chicago Mayor Rahm Emanuel, tested the feasibility and utility of a periodic EITC payment structure. Participants received half of their estimated 2014 EITC refund in four payments during the year. Participation was restricted to taxpayers with at least one qualifying child who received an EITC for 2013 of at least \$600 and had no tax controversy or federal debt that would interfere with receiving a tax refund. The study evaluated the administrative feasibility and taxpayer desirability of a periodic payment along with improved household financial stability.

## Findings

### *Periodic EITC payments are administratively feasible.*

A majority of our participants were able to make income and household predictions that provided reasonably accurate estimates of future EITC receipt. Only 3 of 229 (1.3%) participants who completed the pilot overestimated their refund, resulting in a balance due at tax time. All participants were able to provide initial bank account or prepaid debt card information to receive the payments electronically and keep the direct deposit information updated throughout the year.

### *Taxpayers prefer periodic EITC payments to a single tax time payment.*

Ninety percent of those who received the periodic payments reported having a preference for them over any other payment method. In the control group that did not receive the periodic payments, half reported interest in an alternative to the normal once-a-year EITC payment.

### *Periodic EITC payments improve financial stability.*

Participating households reported a number of positive benefits from EITC periodic payments. Participants had more disposable income at certain points in the year and experienced less stress in meeting monthly expenses. Eighty-six percent of the periodic payment funds were used to pay down debt, pay current bills, and purchase necessities. Importantly, the share of participants planning to save a portion of their 2014 tax refund doubled from the year before, suggesting that periodic payments might improve recipients' capacity for saving at tax time.

## Recommendations

### *Adopt periodic EITC payments to improve household financial stability.*

The IRS should assume a role in establishing a periodic payment framework and seek any administrative or Congressional authority needed to proceed.

### *Use existing mechanisms for taxpayer awareness.*

Tax preparers, both commercial and Volunteer Income Tax Assistance programs, are equipped to determine taxpayer eligibility and promote a periodic payment. Tax preparation software can determine eligibility and market the benefits of participation to taxpayers filing their own returns.

### *Expand the pilot study to inform policy change.*

This study found that an EITC periodic payment model is feasible and beneficial. With IRS cooperation, CEP welcomes the opportunity to conduct and/or inform an expanded study that broadens the demographic representation, test additional payment options and assessing administrative requirements to inform future policy change.

## 1. Introduction

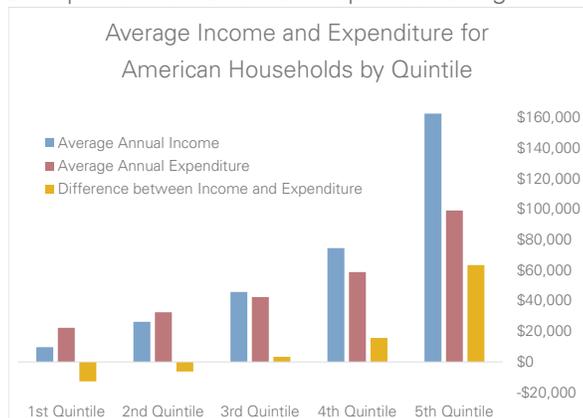
### Employment Instability & Financial Instability

Fundamental changes in the labor market have reduced the financial stability traditionally provided by employment. Despite increased national productivity, the real hourly compensation of the typical American worker has remained roughly the same since 1979. In recent years, low-wage industries have experienced the most job growth while workers in those industries have seen the largest decline in wages. In addition to finding more jobs that pay less, 64% of US households report having unstable work schedules, and the lowest income workers face the most irregular work schedules. Of 18,000 low-income Illinois and Chicago households who filed tax returns with the Center for Economic Progress (CEP) in 2015, only a slight majority (54%) of primary earners had just one employer in 2014, while 32% had two or more employers, 3% were self-employed and 11% were either unemployed, disabled or retired. Employment instability also affects clients in CEP's Financial Capability program, which provides financial coaching for several hundred individuals each year. Clients regularly report that their erratic work schedules, fluctuating hours and limited benefits cause fluctuations income that create significant barriers to establishing a weekly or monthly budgets and consistently making ends meet.

For many, employment instability leads directly to income volatility and financial instability – the inability to meet monthly expenses regularly. Nearly half of Americans regularly experience significant fluctuations in their income, and 55% either break even or spend more than they make in a typical month. According to Bureau of Labor Statistics data for 2013, households in the lowest two income quintiles spent \$12,735 and \$6,284 more than their income, respectively.

Financial instability forces families, especially those with children, to take on debt to pay rent and purchase basic necessities. Low and moderate income households are increasingly financing their basic living expenses with credit cards and carry an average credit card debt of \$7,145. More than one in four pay interest rates above 20%. If they made only the minimum payment, it would take just over 13 years to pay off \$7,145 at a 20% interest rate. For low-income families, this puts precautionary savings beyond reach. A Bankrate survey found that 27% percent of Americans reported having no emergency savings at all, and an additional 23% lacked savings to cover three months of expenses. An unexpected expense or loss of income due to unemployment or reduced hours is potentially devastating for these households.

Financial instability affects more than just a family's financial bottom line; it has lasting impacts on childhood development. In one study, children who lived in families that went from being above the poverty line to below had lower math and reading ability than children in families that did not experience poverty over the same period. This effect was evident even when controlling for demographic and family background.

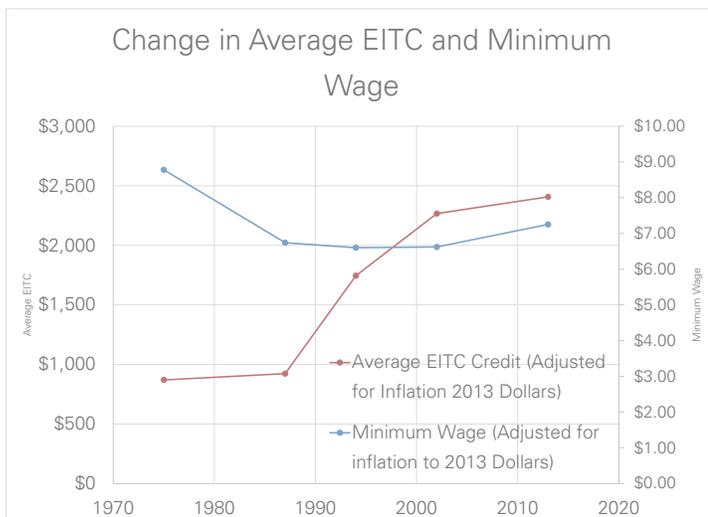
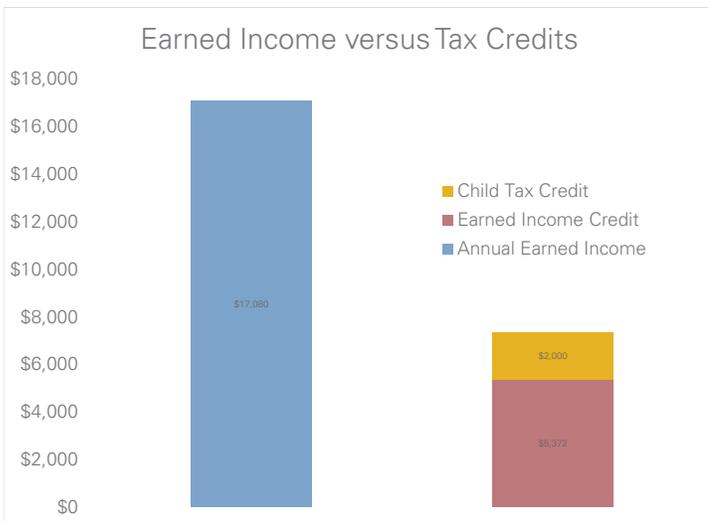


## The Earned Income Tax Credit Lifeline

Celebrating its 40th year in 2015, the Earned Income Tax Credit (EITC) has been marked by strong bipartisan support and numerous expansions under both Democratic and Republican administrations. The maximum credit for families with three or more children has grown from \$400 in 1975 to \$6,143 for the 2014 tax year, an increase of over \$4,300 when adjusted for inflation. The average EITC in 2013 was \$2,407, and for low income families it is often worth much more.<sup>11</sup> A single mother with two children making \$17,080 a year could receive a tax refund in excess of \$7,372, an amount equal to 43% of her annual earned income and constituting 30% of her total income. In this case, the EITC and the Child Tax Credit (CTC) together effectively lift the family to 124% of the federal poverty level.<sup>12</sup> In 2013, the EITC and CTC lifted 9.4 million people out of poverty while providing a financial boost to 22 million more.<sup>13</sup>

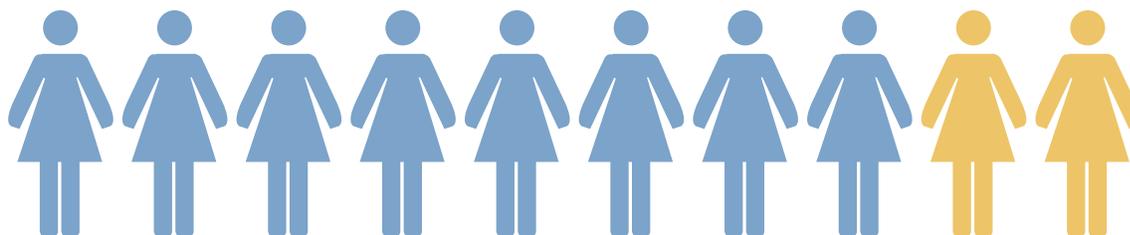
The EITC has become one of the largest and most important safety net programs for working families.<sup>14</sup> Given that the minimum wage has lost buying power since 1975, the growth in the value of the EITC has been critical wage supplement for low-income families. The tax refund, and in particular the EITC, is more than an annual financial lifeline. Multiple studies find that EITC recipients use their tax refund to invest in their future by purchasing a car, investing in education, and saving for a down payment on a house.<sup>15</sup> This duality of purpose – meeting immediate needs while also investing in the future – makes it an essential program.

However, many other EITC recipients have fallen behind on rent, have unpaid bills or acquired credit card debt in order to make ends meet during the rest of the year. For these families, a once-a-year payment can help them catch up, but it is unlikely to help them meet ongoing expenses. Structured as a once-a-year refund, the increasing value of the EITC, while critical in lifting families out of poverty, is ineffective in smoothing income and expenses throughout the year. As the one of the largest providers of free tax and financial services in the country, CEP saw an opportunity to ask if an EITC periodic payment model would be attractive to recipients, and if this alternative payment structure would improve household financial stability throughout the year.



## 2. Rethinking the EITC Payment Model

Many EITC households are caught in a spiral of debt due to income volatility and basic expenses that exceed their monthly income. As tax refunds have grown due to the expansions in the EITC and other credits, CEP has observed that providing a large annual lump-sum refund, absent substantial income support during the year, creates an unhealthy and unproductive cycle of scarcity and abundance. Parents forgo everyday necessities, delay paying bills, and accumulate high interest debt to fill the monthly gap between income and expenses. As a result, many families must use the EITC to pay bills and debt accumulated during the previous year. One study found that 61% of EITC recipient households that rely on credit cards for basic living expenses use their tax refund to pay down credit card debt, while another found that 84% use a portion of their tax refund to pay bills and debt.<sup>17</sup>



8 out of 10 EITC Recipients use a Portion of Their Refund to Pay Bills and Debt

In light of this data, low-income working families could clearly benefit from income support at regular intervals throughout the year. From 1978 to 2010, EITC recipients had an option to receive advance payments of their EITC through their paycheck with their primary employer, but the option was discontinued due to low uptake. Reasons for low uptake included reliance on uninformed or uninterested employers to promote the option, the administrative burden on employers, inadequate IRS outreach efforts, employee and employer awareness, misplaced recipient fear of having to repay the credit at tax time, and even fear that it would incent employers to lower wages.<sup>18</sup>

One alternative is periodic payment of the EITC during the tax year, as has been put forward by poverty researcher and EITC expert Steve Holt. This approach provides a portion of the EITC refund in periodic advance payments paid directly

to the taxpayer by the IRS in larger amounts than the smaller weekly or bi-weekly payments that were available through the employer-based advance. Limiting periodic payments to no more than 50% of the expected credit during the year would preserve a reasonably large tax refund for most EITC recipients and protect against an overpayment of the credit in advance.<sup>19</sup>

Building on CEP's mission as a trusted provider of tax and financial services for low-income families and drawing on the interest and support of Chicago Mayor Rahm Emanuel, the organization, in January 2014, launched an 18-month EITC periodic payment pilot to answer the following questions: Is the alternative payment model administratively feasible? Is it attractive to recipients? Most importantly, can an alternative payment model improve the household financial stability of recipients?

## The Chicago EITC Periodic Payment Pilot

The Chicago EITC Periodic Payment Pilot was made possible by a group of dedicated partners who believed in testing an alternative disbursement method of the EITC. These partners initially included the Center for Economic Progress and the Office of Chicago Mayor Rahm Emanuel. They expanded to include, the University of Illinois at Urbana-Champaign (UIUC), the Chicago Housing Authority (CHA), the Chicago Department of Family and Support Services (DFSS), and Advent Financial (who was acquired by Novation Companies halfway through the pilot). The Center for Economic Progress was the primary administrator of the pilot and facilitated the periodic payments to participants. The UIUC served as the primary evaluator of the pilot, and conducted extensive research and analysis to measure the pilot's success. The CHA provided the necessary capital to serve as a loan pool of funds utilized to make the periodic EITC payments and assisted with recruiting participants. DFSS and the Office of the Chicago Mayor served as program funders and advisors throughout the pilot, helping with the creation of the original eligibility requirements and providing advice on program administration. Advent Financial facilitated the periodic electronic payments to the participants.

CEP enrolled 343 CHA residents to receive four periodic payments in May/June, August, October, and December 2014. Eligibility was restricted to taxpayers with at least one qualifying child who received an EITC for 2013 of at least \$600 and had (based on IRS Record of Account transcripts) no tax controversy or federal debt that would interfere with receiving a tax refund. The periodic payments would total half of the expected 2014 EITC, up to a maximum of \$2,000. Periodic payment amounts ranged from \$80 to \$500. The payments constituted a loan to be repaid in 2015 from the 2014 tax year refund. To facilitate repayment, participants were expected to have their 2014 return prepared by CEP.

### Participant Demographics

Female: 97%

Single: 96%

African American: 89%

From 2013 tax returns (medians):

Income: \$17,089

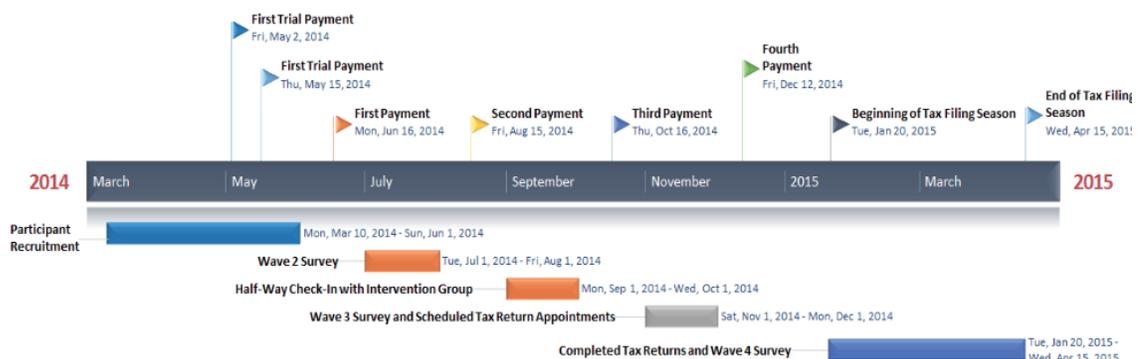
EITC: \$4,478

Refund: \$6,467

To assist with the evaluation, CEP recruited a control group of 164 CHA residents and CEP clients. UIUC surveys of both groups asked about finances, employment, living arrangements, stress, community, and family. There was a baseline survey at enrollment, a July survey after participants had received their first payment, a November survey after the third periodic payment, and a final survey administered January to April 2015 after tax returns were filed. UIUC also conducted focus groups and interviews to add richness to the quantitative survey data.

## EITC Pilot Calendar

Most (335 of 343) participants received all four periodic payments. However, only two-thirds (229) completed the pilot by repaying the periodic payment loan and providing tax return and survey data. In most cases, this was because the participant chose not to have her 2014 tax return prepared at CEP. Project findings are based on pilot project completers.



## Limitations and Challenges

Due to the funding structure of the pilot, only CHA residents could participate. Therefore, the participant population was likely not representative of the general EITC-recipient population. The failure of one-third of participants to complete the project introduces uncertainty into interpreting the results. There is no indication that those who decided not to return have their taxes prepared at CEP and repay their advance payments loans were significantly distinct from those who did. A desire to use a tax preparer with whom a participant had a prior relationship or to file taxes more quickly than they could be accommodated by CEP's tax sites were likely factors. Working with the UIUC evaluation team, CEP attempted to control for the loss of participants in the final data.

## 3. Findings

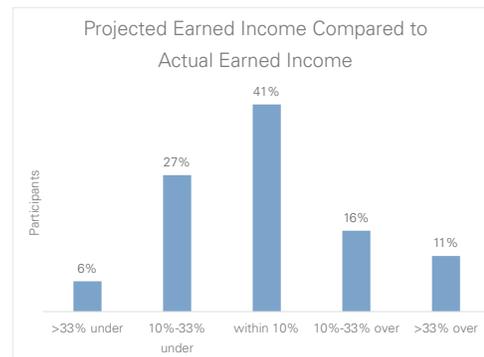
### Periodic EITC payment is administratively feasible.

#### EITC Eligibility

The screening process was very successful at predicting continued EITC eligibility. All but one of the pilot completers claimed the credit (the exception was due to an unexpected filing status change).

#### Estimation

At enrollment, participants had to project what their income and household configuration would be at year-end. Although a substantial number of participants were reasonably accurate in their income projections, over half were off by more than 10%:

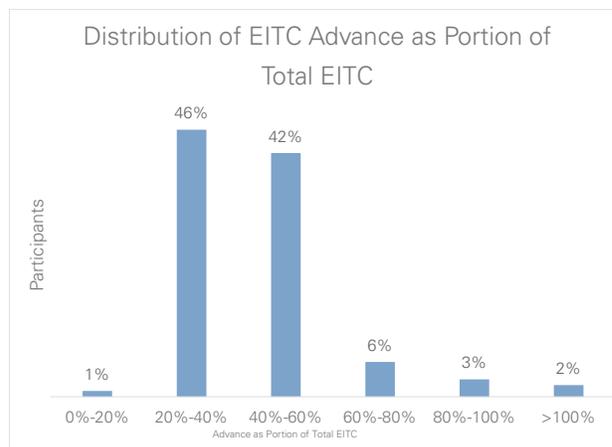


Much higher percentages were able to predict correctly their marital (filing) status (98%) and the number of children who would qualify for the EITC (84%).

\$1,500 for 15 participants (7%) and underestimates by more than \$1,500 for 13 households (6%).

The pilot used the participant estimates to calculate the projected 2014 EITC (and determine the periodic payment amount). For a majority of participants (57%), the estimated EITC was within \$500 of the actual amount claimed. There were some outliers, with overestimations of more than

For 90% of participants, the periodic payments totaled less than 60% of the actual credit claimed, a dramatic success which affirms the need for a rigorous eligibility determination and screening process. The \$2,000 cap on periodic payments played a role in skewing the advance rate lower.



### Overpayments and Balances Due

The key concern with estimating EITC amounts is that a participant would receive too much of their credit in advance and owe money at the time of filing. Only four participants (1.7%) received excessive advances through periodic payment, though for three this meant a balance due tax return. With the exception of one participant who was actually ineligible for the EITC, the balance due did not exceed \$122.

### Direct Deposit as Delivery Mechanism

All participants were able to provide account information for either a traditional bank account or a prepaid debit card. A number of participants needed to change their account information during the year, which they did by submitting a new direct deposit form at least one week prior to the issuance of the subsequent payment. Fifty participants (14.6%) changed their account information at least once during the administration of the pilot, and four (1.2%) changed their account information twice. Only twenty of 1,348 direct deposit transfers (1.5%) were unsuccessful on initial attempts, and these were due to data entry or transmission errors.

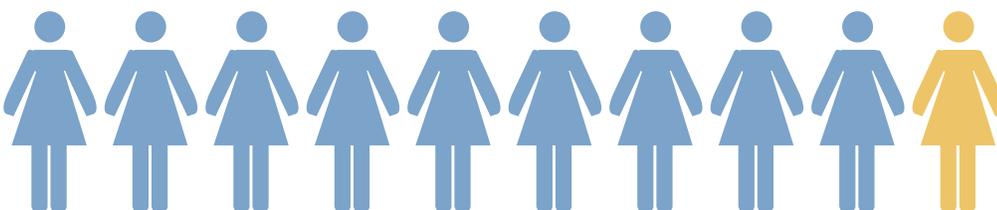
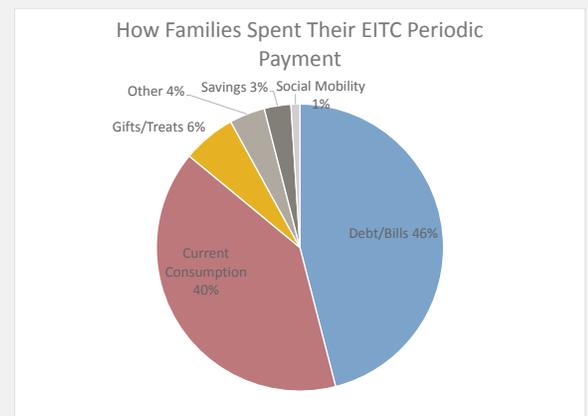
### EITC recipients prefer periodic EITC payments to a single tax time payment.

Ninety percent of participants expressed a preference at project completion for the periodic payment model over a single lump-sum. They were overwhelmingly positive about their experience. One remarked that it is “nice to have extra money to attend to and balance out monthly expenses and to be in a position to save for emergencies and rainy days.” In the months since the completion of the pilot, CEP has had numerous inquiries from participants seeking to obtain advances on next year’s EITC.

### Periodic EITC payments improve financial stability.

#### Payments Help Households Make Ends Meet

The EITC periodic payments provided a buffer against household income volatility and financial instability. In October, participants were three times more likely than the control group to report having more disposable income compared to the same time the previous year. Over the year, they used most of the advances to cover debt and pay bills and meet everyday expenses such as groceries, household items, and transportation. The periodic payments appeared to enable some participants to focus on savings at tax time; compared with the prior year, payment recipients were more than twice as likely to report saving a portion of their refund.



9 out of 10 participants expressed a preference for period payments over a single lump-sum.

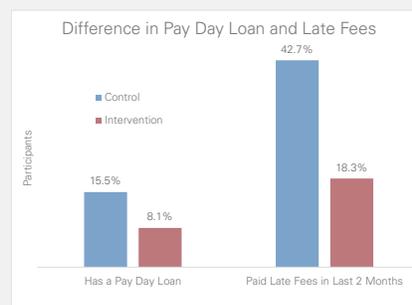
## Periodic EITC payments improve financial stability.

### *Payments Diminish Debt Accumulation and Late Fees*

At enrollment, both the payment and control groups had similar rates of borrowing from family and friends. At project completion, the control group reported borrowing from family and friends at nearly twice the rate of the EITC periodic payment recipients. At the final survey, control group participants were almost twice as likely to report having a payday loan, and there was a 45% reduction in pay day loan usage among intervention group participants between the baseline and final surveys. Analysis of a small sample of credit reports and transcripts of the focus groups provided evidence that the payments lessened accumulation of new debt. At project completion, those in the control group were more than twice as likely as the payment group to report having paid late fees in the prior two months.

### *Payments Appear to Reduce Financial Stress for Improved Mental Health*

The EITC periodic payments appeared to provide a buffer against a number of financial stresses. At project completion, control group members were twice as likely as those who had received payments to report higher levels of stress regarding their ability to make ends meet compared to the prior year. The Personal Health Questionnaire (PHQ8) revealed a difference in reported depressive symptoms between the two groups, with over twice as many in the control group indicating depressive symptoms. These differences cannot be attributed to the EITC periodic payments due to the absence of baseline data, but the significant difference does highlight an area of inquiry for future research.



## 4. Recommendations

The pilot provides strong evidence that a periodic EITC payment could help improve the financial stability of working families. Furthermore, participants who received periodic EITC payments in 2014 and 2015 found it to be attractive option. Based on its experience leading the EITC pilot, and building on its work with tens of thousands of low-income taxpayers, the Center for Economic Progress calls for creating an advance EITC periodic payment option and promoting it to working parents with children.

### Administration

The IRS, as the administrator of the tax code, needs to assume a lead role in establishing a periodic payment framework and seeking any administrative or Congressional authority needed to proceed. CEP's experience with the Chicago EITC Periodic Payment Pilot argues for limiting eligibility to taxpayers who:

- 1) File tax returns with qualifying children;
- 2) Received the EITC for the previous year;
- 3) Have consistently met their tax filing obligations;
- 4) Will receive at least \$600 in EITC;
- 5) Can predict with an acceptable level of confidence that they will receive the EITC again for the current tax year; and
- 6) Are willing to report economic and family changes during the year in order to modify prepayment amounts. To minimize administrative costs, payments would be directly deposited by electronic fund transfer to established accounts.

The IRS would need to make several processing changes in order to effectively administer such a program. At the time of tax filing, taxpayers would request to participate in the program by filing an additional tax form that includes computation of their estimated EITC for the upcoming year. The IRS would need to be able to:

- 1) approve participation in the program no later than the end of May in order for payments to commence by June;
- 2) have successfully provided a refund via direct deposit to the taxpayers for the prior years' tax return;
- 3) have a mechanism for account management to allow for updates to the taxpayers' EITC eligibility amount and direct deposit information; and,
- 4) develop a method for reconciliation of the advance payments on the year's tax return.

## Taxpayer Awareness & Education

A major benefit of the tax return being the point of entry to receiving EITC periodic payments is that tax preparers could notify a taxpayer of their potential eligibility. A tax preparer is in a better position to determine and explain eligibility for a tax credit than an employer. For taxpayers who prepare their own tax returns, prompts and queries embedded into tax software can notify them of their potential eligibility and the benefits of participation.

In addition, the IRS could communicate annually with taxpayers who have consistently received the EITC for multiple years. Marketing and awareness campaigns, conducted by private and non-profit sector partners, could highlight the potential use of periodic payments. Due to the tendency for individuals to resist change, we strongly advocate marketing and awareness campaigns that highlight specific benefits of the new payment option, such as helping meet expenses that occur periodically throughout the year like summer programs for children, back to school clothes and fees, heating bills during peak months, and gifts during holiday seasons.

## Moving Forward

CEP believes that for many families a periodic payment model, with payments made in advance of normal disbursement of the annual tax refund, is preferable to a lump sum refund at the end of the year. Our pilot has demonstrated how it would allow taxpayers to use periodic EITC payments during the year to mitigate financial instability and debt accumulation. We remain dedicated to rigorous inquiry into alternative disbursement methods of the EITC and anticipate that further research would identify different payment models and potentially different timing.

Regardless of future studies, the evidence from CEP's pilot is clear: spreading out a portion of the tax refund payment makes sense. CEP stands willing to conduct an expanded pilot to recruit a larger and more demographically diverse group of EITC tax filers, provide an opportunity to test various payment options, assess administrative feasibility more completely, better understand consumer preferences and demand, and continue to evaluate the impact on household financial stability. It is critical that any changes to the EITC are carefully researched and that taxpayers provide input and feedback in order to best meet their needs.

**It is unacceptable to accept the status quo in which wages stagnate and workers face growing employment volatility and financial instability. The continued growth of the average tax refund for EITC recipients presents an opportunity to address these problems. Ignoring this opportunity to create a more efficient tax policy will continue to erode the financial stability of millions of struggling American families.**

## 5. Conclusion

The EITC lifts millions of households out of poverty each year, but the current disbursement method is poorly suited to help recipients year round. Low income workers experience monthly fluctuations in income and expenses and rely on high-cost credit, predatory lending and financial assistance from family and friends to make ends meet. While the EITC provides a critical boost during the tax season, it does little to improve financial stability year round. A periodic payment option can provide the financial benefit of the EITC when recipients need it. It is administratively feasible, attractive to taxpayers and could improve the financial stability of millions of American families.



The Center for Economic Progress (CEP) helps low-income working families as a trusted provider of tax and financial services. As one of the nation's largest free tax preparation programs, operating under the IRS Volunteer Income Tax Assistance (VITA) mantle, CEP has served more than 370,000 families since 1990 and generated \$560 million in federal and state tax refunds. CEP also operates a legal clinic, representing hundreds of taxpayers annually in controversies with the IRS. Additionally, CEP has built a growing menu of financial capability services that help participants improve their confidence and attitudes concerning money management, demonstrate improved financial habits, increase savings, reduce debt and improve credit. CEP's tax and financial services reach more than 24,000 families and individuals each year, and we mobilize more than 900 volunteers who give their time and talents to make this possible.

CEP has a long-standing commitment to and interest in the EITC as a core tax policy that positively impacts the financial well-being of low-income families. Working at the state level, CEP helped to establish the Illinois EITC in 1990 and facilitated its expansion in 2012. At the national level, CEP has leveraged its data and experience in serving tens of thousands of EITC taxpayers by testifying before Congress and working with multiple administrations to both maintain and grow the credit while ensuring that eligible taxpayers continue to have access. CEP also worked with Illinois' Governors and Chicago Mayors Daley & Emanuel to build awareness and knowledge of the EITC, encouraging low-income workers to claim the credit whether they file through CEP, or through a paid preparer.

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- <sup>1</sup> Ruby Mendenhall et al., *The Role of Earned Income Tax Credit in the Budgets of Low-Income Households*, 2012.
- <sup>2</sup> Economic Policy Institute, *The Wedges Between Productivity and Median Compensation Growth*, 2012.
- <sup>3</sup> National Employment Law Project, *An Unbalanced Recovery: Real Wage and Job Growth Trends*, 2014
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- <sup>5</sup> The Pew Charitable Trusts, *Americans' Financial Security*, 2015
- <sup>6</sup> <http://www.bls.gov/cex/tables.htm>
- <sup>7</sup> Amy Traub and Catherine Ruetschlin, *The Plastic Safety Net: Findings from the 2012 National Survey on Credit Debt of Low and Middle Income Households*, 2012.
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- <sup>10</sup> Kristin Moore et al., *Poverty and Welfare Patterns: Implications for Children*, 2002.
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- <sup>18</sup> For further details on low utilization of the Advance EITC, see: Timothy Smeeding, Katherin Ross Phillips, and Michael O'Connor, *The EITC: Expectation, Knowledge, Use, and Economic and Social Mobility*, 2000; Steve Holt, *Beyond Lump Sum: Periodic Payment of the Earned Income Tax Credit*, 2009; Damon Jones, *Information, Preferences, and Public Benefit Participation: Experimental Evidence from the Advance EITC and 401(k) Savings*, 2010.
- <sup>19</sup> For full background on the Periodic EITC Payment, see Steve Holt, *Periodic Payment of the Earned Income Tax Credit*, 2008.
- <sup>20</sup> The PHQ8 was added to the third and fourth surveys, therefore there is no baseline data available. The differences between the intervention and control groups did not substantially change between the third and fourth surveys. Therefore, the presented differences cannot be attributed to the EITC periodic payments but the significant difference does highlight an area of inquiry for future research.