Are Tax-Time Financial Products Good for the Poor?

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Andrew T. Hayashi, *The Effects of Refund Anticipation Loans On the Use of Paid Preparers and EITC Take-up*,Virginia Law and Economics Research Paper No. 2016-9 (2016), available at SSRN.

The conventional wisdom about refund anticipation loans, at least among many academics, is that they are predatory lending products that benefit big businesses at the expense of the poor. Andrew Hayashi turns this notion on its head in his insightful paper, *The Effects of Refund Anticipation Loans on the Use of Paid Preparers and EITC Take-up.*

Hayashi's piece makes two important contributions to our understanding of tax-time financial products. First, he undertakes an empirical study that shows that curtailing refund anticipation loans (RALs) resulted in a decline in the use of tax return preparers, which in turn may have led to a drop in tax return filing and earned income tax credit (EITC) claims. Second, Hayashi discusses the welfare implications of RALs — an analysis that has been largely absent from the literature — and highlights the possibility that, on balance, they benefit taxpayers. Both of these insights have important implications for future policy, particularly for how we might regulate current and future tax-time products like refund anticipation checks.

The bad reputation of RALs is not entirely undeserved. Indeed, these loans were typically peddled by tax return preparers to their low-income clientele, and generally required repayment from the taxpayer's refund at a high rate of interest plus fees, in some cases equivalent to as much as 700% on an annual percentage rate basis. A number of consumer advocate groups pushed for the elimination of RALs and, in 2010, a regulatory change virtually eliminated the RAL market (but for a small number of exceptions).

Hayashi's empirical study focuses on this moment of regulatory change to examine the collateral effects of eliminating RALs in 2010. Using IRS data, he studied trends in the use of tax-time lending products, tax return preparers, and EITC claims in 2011, the year immediately following the elimination of RALs. He found that 80 percent of taxpayers formerly using RALs simply replaced them with another tax-time product: the refund anticipation check (RAC). Although RACs do not immediately accelerate the taxpayer's refund like a RAL, they allow unbanked taxpayers to receive a direct deposit of their refund in a temporary bank account, and they also allow taxpayers to borrow their tax preparation fee (to be repaid from their refund with interest and fees).

Hayashi's study also revealed that 10 percent of former RAL users switched from using preparers to self-preparation in 2011. Additionally, approximately 5 percent of former RAL users stopped claiming the EITC. Although the decline in EITC claims could potentially have come from those taxpayers who continued to use a preparer, it's plausible that the shift away from preparer assistance may also have led to the decline in EITC claims. As Hayashi notes, other studies have demonstrated a positive correlation between tax preparation assistance and EITC take up.

Looking at the bigger picture, then, it appears RALs may have encouraged the use of tax preparation assistance. And, it appears that tax preparation assistance encourages taxpayers to file returns and claim the EITC. Thus, an important collateral consequence of curtailing RALs may be that we have deterred some taxpayers from filing and claiming vital benefits to which they are entitled. As Hayashi argues, these collateral consequences should not be overlooked by policymakers. Potential non-filing and failure to take-up government benefits like the EITC are a serious cost that must be weighed against the benefits of regulating tax-time lending products.

Hayashi's paper makes another important contribution to the debate over RALs and RACs. It carefully discusses the

costs and benefits of these products and points out that taxpayer preferences for them may not be irrational, notwithstanding high interest rates and fees. One important reason taxpayers take out RALs and RACs is that these products allow them to borrow their tax preparation fees when they cannot otherwise come up with the funds for tax assistance. Taxpayers might rationally prefer tax assistance because they lack Internet access and/or because of the time and complexity involved in self-preparation. Both products also help taxpayers access their refunds more quickly (although the timing advantage with a RAC is less immediate). Quicker access to refunds, in turn, may help taxpayers pay down debt sooner, which could be vital for individuals who are behind on payment of necessities like rent and utilities.

Thus, as Hayashi points out, some taxpayers may rationally prefer RALs and have been made worse off from a welfare standpoint as a result of their elimination. Other taxpayers, however, may be exhibiting some form of cognitive bias – present bias, for example – in their preferences for RALs. These taxpayers may be better off either self-preparing or paying out of pocket for tax preparation assistance, yet may have been tempted to take out a RAL because they wanted their funds sooner. In that case, regulation of RALs may be beneficial. The problem, Hayashi rightly notes, is that we don't have data on the proportion of taxpayers that are acting rationally and irrationally.

This means that the answer to the question of whether tax-time products are bad for taxpayers overall is "we don't know," which is notably different than "yes" (the answer which I admittedly would have given before I read Hayashi's piece). What's perhaps most telling from Hayashi's study is that a large majority of former RAL users still exhibit preferences for tax-time financial products, now in the form of a RAC, which is their only option at present for financing tax preparation fees. The welfare effects of switching from a RAL to RAC are also uncertain, Hayashi notes. Taxpayers who rationally chose RALs over RACs will be made worse off, while others (those whose bias led them to choose a RAL) may be made better off with a RAC.

Hayashi cautions regulators to think carefully before regulating RACs out of existence. Although charging low-income taxpayers fees that are deducted from an EITC refund certainly appears distasteful, this may be a vital mechanism to keep some individuals engaged in the tax system. If we don't like this mechanism, it may be time to revisit the larger issue of how and when we deliver benefits like the EITC to the poor.

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