

CONSUMER LAW MYOPIA

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People make mistakes with debt, partly because the chance to buy now and pay later tempts them to do things that are not in their long-term interest. Lenders sell credit products that exploit this vulnerability. In this Article, I argue that critiques of these products, particularly those that draw insights from behavioral law and economics, have a blind spot: they ignore what the borrowed funds are used for. By evaluating financing transactions in isolation from the underlying purchase, the cost-benefit analysis of consumer financial regulation is truncated and misleading. I show that the same bias that causes someone to take an exploitative loan may also imply that the loan benefits them by causing them to purchase a product or service that they should, but wouldn't otherwise, buy. I demonstrate the importance of this effect in a study of tax refund anticipation loans. I find that regulation curtailing these loans reduced the use of paid tax preparers and the take-up of the earned income tax credit, which is the second largest federal transfer to low-income households.

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INTRODUCTION	3
I. BIASED DEMAND FOR CREDIT	7
A. TEMPTED TO DO THE RIGHT THING	11
B. CREDIT CARDS.....	17
C. MORTGAGES.....	20
D. PAYDAY LOANS.....	22
II. TAX RETURN PREPARERS AS LENDERS.....	25
A. REFUND LOANS	27
B. TAX PREPARERS.....	29
C. DEMAND FOR RALS.....	31
D. THE DISAPPEARANCE OF RALS	32
III. DATA AND SUMMARY STATISTICS	33
A. COUNTY DATA	33
B. TAX PREPARER DATA.....	34
IV. ANALYSIS AND RESULTS.....	37
A. EMPIRICAL APPROACH	38
B. REGRESSIONS.....	41
C. RESULTS.....	42
1. <i>The Effect of RALs on RACs</i>	42
2. <i>The Effect of RALs on Demand for Paid Preparers</i>	43
3. <i>The Effect of RALs on EITC Claims</i>	43
V. CASE STUDY DISCUSSION.....	44
A. FREE TAX PREPARATION.....	47
B. SIMPLIFICATION.....	48
C. ADVANCE EITC	49
D. A PUBLIC OPTION.....	50
VI. EXPLOITING FINANCIAL INTERMEDIARIES.....	51
A. GETTING BORROWER PSYCHOLOGY RIGHT.....	52
B. CREDIT CONTEXTUALIZATION IN TWO STEPS	54
CONCLUSION	57
TABLES.....	59

INTRODUCTION

Behavioral economics has contributed more to our understanding and regulation of consumer credit transactions than any other area of economic life.¹ This is both important and justified. It is important because consumer finance is central to the functioning of a modern economy, what president Obama called the lifeblood during the height of the financial crisis in 2009.² Consumer credit is also important to individuals and families who manage household budgets, because the receipt of income and payment of expenses are rarely contemporaneous. And yet, credit transactions are fraught. They reflect and perpetuate wide differences in individuals' economic opportunities and vulnerability to financial adversity. Credit is more expensive for the poor, and this fact creates a patina of exploitation and abuse over credit transactions that has resulted in extensive state and federal regulation.

The influence of behavioral economics on consumer credit regulation is justified because consumer credit is characterized by two features that raise doubts about consumers' ability to make borrowing choices that are in their best interests. The first feature is complexity. The terms of consumer debt often have complex fee structures, repayment terms, and consequences of default that are burdensome to evaluate.³ Of course, complexity is not unique to credit products. The second feature, however, is constitutive of debt itself: a tradeoff between current and future purchasing power. It is the essence of debt that the borrower exchanges her promise to pay amounts in the future for the ability to consume more now. This intertemporal tradeoff is one that individuals often struggle to make properly, and the challenge is especially great for individuals who are subject to "present bias" and who are therefore inclined to borrow impulsively and on terms that they subsequently regret. Both complexity and intertemporal choice are topics in which behavioral law

¹ See, e.g., Ryan Bubb & Richard H. Pildes, *How Behavioral Economics Trims its Sails and Why*, 127 HARV. L. REV. 1593 (2013); Quinn Curtis, Andrew Hayashi, and Michael A. Livermore, *Tacking in Shifting Winds: A Short Response to Bubb and Pildes*, 127 HARV. L. REV. F. 204 (2013).

² Address Before a Joint Session of Congress, 1 PUB. PAPERS 145, 147 (Feb. 24, 2009).

³ For a discussion of the importance of complexity and faulty borrower comprehension in consumer credit markets, see Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707 (2006). Unfortunately, interventions to increase consumer financial literacy do not appear to help remedy these problems. Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV. 197 (2008); Lauren E. Willis, *The Financial Education Fallacy*, 101 AM. ECON. REV. 429 (2011). Because financial education and disclosure have proven to be largely ineffective, Professor Willis has provocatively argued for an alternative known as "performance based consumer law." Lauren E. Willis, *Performance-Based Consumer Law*, 82 U. CHI. L. REV. 1309 (2015).

and economics scholarship traffics in common intuitions and draws on strong empirical evidence to make recommendations about how to regulate for imperfectly rational consumers.⁴

In this article, I focus on arguments about consumer finance regulation that derive research on present bias, which can be thought of as a sort of myopia that causes people to focus on the present and neglect the future. I argue that consumer law scholarship that draws on these insights has, itself, been myopic. People borrow money in order to buy things, and this scholarship has neglected to consider what borrowed funds are used *for*.⁵ By focusing on the terms of the loans, in isolation from the good or service that is purchased with the proceeds, consumer law scholarship has missed a crucial part of the analysis. Integrating the benefits of the underlying purchase into an evaluation of the credit transaction can upend standard conclusions about the effects of present bias and relocate efforts to improve consumer welfare from the regulation of financial products to the circumstances that create demand for high cost credit in the first place. I report results from a study of tax refund anticipation loans (RALs) that shows how these admittedly exploitative credit products increase the use of paid tax preparers and the take-up of the earned income tax credit by low income households. The net effect for these present biased taxpayers is that being exploited may make them better off.

Why is it important to consider the purchase that motivates a credit transaction when evaluating the benefits of that transaction to present-biased consumers? The answer is that many goods and services are characterized by significant upfront costs but deferred benefits that are only realized in the future. Present-biased consumers tend to undervalue products with this temporal pattern of costs and benefits. Durable goods, such as homes, cars, and appliances, are like this. Purchasing durable goods involves a significant

⁴ I am unaware of any data about the intuitive appeal of complexity and impatience as explanations for why people struggle to evaluate credit contracts. Nevertheless, I trust that most readers, particularly those with home mortgages, will be inclined to agree that understanding all the terms of a secured loan, even when one is trained in law or economics, demands a great deal of time and effort. It is unsurprising then that some do not even make the effort. Judge Posner famously declined to read the “boilerplate” on his own home mortgage. David Lat, *Do Lawyers Actually Read Boilerplate Contracts?*, ABOVE THE LAW (June 22, 2010, 2:42 PM), <http://abovethelaw.com/2010/06/do-lawyers-actually-read-boilerplate-contracts-judge-richard-posner-doesnt-do-you/>. I also expect that most of us identify with the present-biased individual, who procrastinates when it comes to unpleasant tasks and acts impulsively when it comes to food or leisure. For a review of the literature, see Lee Anne Fennell, *Willpower and Legal Policy*, 5 ANN. REV. L. & SOC. SCI. 91 (2009).

⁵ Some researchers do think it is broadly relevant what consumers do with the loan proceeds, but none evaluate the bundled loan and purchase together from the perspective of a biased consumer. See, e.g., Shmuel I. Becher, Yuval Feldman, and Orly Lobel, “Poor Consumer (s) Law: The Case of High-Cost Credit and Payday Loans.” (2018)]

outlay at the time of purchase in exchange for a stream of consumption benefits that are realized over time. In fact, all sorts of choices present this same temporal pattern of immediate costs and future benefits. Applying for social welfare benefits can require an upfront investment of time and effort in exchange for benefits that are received in the future. For example, the earned income tax credit (EITC), which is the second largest federal transfer to low income households, is only available to individuals who file a tax return and complete the burdensome EIC schedule.⁶ The key point is that when the deferred costs and immediate benefits of certain exploitative credit products are added to the immediate costs and deferred benefits of durable goods and services, the bundled transaction may be one that is appealing to a present-biased individual *and* makes them better off. The exploitative loan in a sense tempts the present-biased individual to do something that is in her interest, but she wouldn't otherwise do.

The results from this analysis sound a note of caution about decontextualizing the choices that consumers make. At the most general level, this Article shows that if consumer law is to help imperfectly rational consumers, it is not enough to show that certain goods or services would only be purchased by consumers acting on a bias that operates against their own interests. It must also consider what other choices such a consumer is likely to make that depend on that product, and how the exploitative product fits into the overall way that they have arranged their lives. The personal affairs of present-biased individuals are likely to be characterized by a variety of biased decisions that may be interconnected in important ways. Although the entire constellation of choices made by a present-biased individual will leave them worse off than if they made the same choices as a rational individual, this does not imply that changing any one choice to the one that a rational person would make will leave them better off.⁷

The second contribution of the paper is about the regulation of consumer finance specifically. Any regulation of the substantive terms of

⁶ On the difficulties of filing for the EITC, see, e.g., Michelle Lyon Drumbl, *Beyond Polemics: Poverty, Taxes, and Noncompliance*, 14 EJOURNAL TAX RES. 253, 275-77 (2016); Francine J. Lipman, *The Working Poor Are Paying for Government Benefits: Fixing the Hole in the Anti-Poverty Purse*, 3 WIS. L. REV. 461, 464 (2003); George K. Yin et al., *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program*, 11 AM. J. TAX POL'Y 225, 254-56 (1994). In her latest annual report to Congress, however, the National Taxpayer Advocate noted that the IRS has been working to improve EITC outreach and education. NATIONAL TAXPAYER ADVOCATE, 2017 ANNUAL REPORT TO CONGRESS 144 (2018).

⁷ Law and Economics scholars will recognize this as an application of the general theory of the second best to intra-personal choice. R. G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956); Richard G. Lipsey, *Reflections on the General Theory of Second Best at its Golden Jubilee*, 14 INT. TAX & PUB. FIN. 349 (2007).

consumer credit must distinguish between different kinds of loan products and the uses to which the loan proceeds are put. Specifically, secured debt that is used to purchase goods and services with deferred benefits is importantly different in its effects on present-biased consumers than unsecured debt that can be used change the timing of consumption generally. When we integrate the loan terms with the purchase that necessitated the loan, we see that the net effect of the bundled transaction might be positive or negative on present-biased consumers. If the effect is positive, prohibitions on loan terms that tempt present-biased individuals might hurt those the ban is meant to help.

Third, and at the level of most direct application, the results of my empirical study have very specific implications for the regulation of refund anticipation loans and refund anticipation checks (RACs). The results sound a warning to regulators about the effects of eliminating these products. Refund anticipation loans disappeared almost entirely following a regulatory change in 2011, a change that was celebrated by consumer advocates. The near elimination of RALs reduced the use of paid tax preparer and take-up of the earned income tax credit, and increased demand for RACs. RACs have remained popular and in recent years RALs have made a comeback, but both have been a target of ongoing opposition from advocates and concern from regulators.⁸ Thus, understanding the role they play in affecting tax compliance and the take-up of important social benefits is important and timely.

To be clear, present bias is not the only reason to be suspicious of certain credit transactions and the purpose of my analysis is not to provide an all-things-considered appraisal of high-cost credit products. Complexity, unrealistic optimism about repayment prospects, and other biases may create a wedge between the financial products people choose and the ones that are in their best interests.⁹ I agree with scholars who emphasize the problem of complexity and the potential role for regulation in that area. But when regulation is motivated by appeals to these biases, regulators and scholars must consider not just how they affect demand for a particular product, but how that product is likely to fit into the life of someone who exhibits that bias more generally.

⁸ Tax refund anticipation loans are resurgent, albeit in smaller amounts than before. For a sense of the magnitude of this resurgence, there were 35,000 refund loans made in 2014 and approximately 1 million loans made in 2016. Kevin Wack, *Tax Refund Loans Get a Second Life*, AM. BANKER (June 15, 2016, 2:49 PM), <https://www.americanbanker.com/news/tax-refund-loans-get-a-second-life>

⁹ Overly optimistic borrowers may borrow too much or too little. See Richard M. Hynes, *Overoptimism and Overborrowing*, BYU L. REV. 127 (2004).

Part I explains the present bias framework for thinking about credit transactions and describes three, economically important, high-cost credit products for which models of present bias have been used to explain consumer demand. I show how integrating the underlying purchase transaction into the analysis of these products can change our conclusions about their benefits. In Parts II-V, I report and discuss the results of an original study of the effects of regulating refund anticipation loans. The results illustrate the theoretical effects I describe in Part I, provide direct empirical evidence that is relevant for law and policy around this financial product, and raise hard questions about the intermediating role of the private sector between individuals and the government. In Part VI, I describe a framework for thinking about the regulation of consumer credit products, paying special attention to refund anticipation loans.

I. BIASED DEMAND FOR CREDIT

The price of consumer credit can vary dramatically depending on the remedies available to the borrower in the event of default, the degree of competition among lenders, and characteristics unique to the borrower such as her income and wealth.¹⁰ Credit is more expensive as the risk of default increases. Because borrowers with lower incomes generally pose higher default risks, their price for credit tends to be higher.¹¹ The landscape of credit products that are commonly used by low-income households includes payday loans, certain credit cards with low introductory (teaser) interest rates, and sub-prime mortgages, among others. Traditionally, scholars operating in the law and economics tradition have taken a relatively sanguine view of high-price consumer credit under the assumption that the price reflects the cost to the lender of providing that credit and the assumption that the individuals who avail themselves of these credit products are acting in their best interests.¹²

However, recent scholarship on high-price consumer credit that draws

¹⁰ Victor Stango & Jonathan Zinman, *Borrowing High versus Borrowing Higher: Price Dispersion and Shopping Behavior in the U.S. Credit Card Market*, 29 REV. FIN. STUD. 979 (2016).

¹¹ See Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and Its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589 (2000); Matthew J. Rossman, *Counting Casualties in Communities Hit Hardest by the Foreclosure Crisis*, 2016 UTAH L. REV. 245, 257.

¹² See, e.g., Robert L. Clarke & Todd J. Zywicki, *Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau*, 33 REV. BANKING & FIN. L. 235, 259-60 (2013). For a review, see Richard Hynes & Eric A. Posner, *The Law and Economics of Consumer Finance*, 4 AM. L. E. R. 168 (2002).

on research from psychology and economics is skeptical that everyone who borrows on these terms is acting in their own best interests. Scholars in this area argue that these high-price credit products can exploit individuals' cognitive biases or limitations in ways that makes those individuals worse off.¹³

Why would someone make the mistake of taking out a loan that will leave them worse off? There are generally two sources of error that scholars point to. The first is consumers' limited ability to simply understand the terms of many loans. Largely for this reason, Oren Bar-Gill and Elizabeth Warren argue that credit products should be subject to comprehensive safety regulation.¹⁴ They focus on consumers' inability to understand the terms of debt products – mortgages in particular – and note that consumer confusion about these products can persist because there are relatively few opportunities for borrowers to learn from their mistakes.¹⁵ Although misunderstandings of complex consumer credit is likely widespread, some scholars argue that borrowers may make mistakes in taking on debt even if they are fully aware of the contractual terms, by failing to properly appreciate the long run costs associated with the loans.¹⁶

The fundamental nature of consumer credit is that consumers receive money with which to purchase goods and services that they want now, while putting off the costs of paying for those things until some point in the future. There are a variety of reasons why individuals might be willing to incur significant interest and other charges in order to make this trade (cash now in exchange for a larger cash payment in the future), and not all of them serve the borrower's interests. The intertemporal character of debt transactions implicates some of the better substantiated and theorized biases in individual decision-making.¹⁷ One explanation for high-price borrowing is that people are excessively optimistic, expecting that the burden of repaying the debt in

¹³ Marianne Bertrand & Adair Morse, *Information Disclosure, Cognitive Biases, and Payday Borrowing*, 66 J. FIN. 1865 (2011). For surveys of the cognitive biases that can impair a borrower's judgment, see Debra Pogrund Star & Jessica M. Choplin, *A Cognitive and Social Psychological Analysis of Disclosure Laws and Call for Mortgage Counseling to Prevent Predatory Lending*, 16 PSYCHOL. PUB. POL'Y & L. 85, 96-105 (2010); Eyal Zamir, *The Efficiency of Paternalism*, 84 VA. L. REV. 229, 267-75 (1998).

¹⁴ Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008).

¹⁵ *Id.*

¹⁶ Annamaria Lusardi & Peter Tufano, *Debt Literacy, Financial Experiences, and Overindebtedness*, 14 J. PENSION ECON. & FIN. 329 (2015); Lauren E. Willis, *Decision-Making and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 776-80 (2006).

¹⁷ Another reason for work in this area is the proliferation of such products in the last 25 years. Neil Bhutta, Paige Marta Skiba & Jeremy Tobacman, *Payday Loan Choices and Consequences*, 47 J. MONEY CREDIT & BANKING. 223, 223 (2015).

the future will be lighter than the cost of paying out-of-pocket now.¹⁸ Another explanation (and that one that has been most influential in the behavioral law and economics literature) for how fully-informed individuals might make seemingly irrational choices about the tradeoff between the present and the future is that those individuals are subject to present bias. Such individuals discount the well-being of their future self and underestimate the pain that their future self will experience when they must pay back the loan.¹⁹ Individuals with present bias treat the present very differently than any other period in their life; they constantly procrastinate and put off unpleasant tasks believing that they will get around to them tomorrow, and they act impulsively to satisfy their appetites in the present.²⁰

Present bias is a theory about how people make intertemporal tradeoffs in consumption, not cash, so some assumptions must be made to apply the theory to understand demand for high price credit products with low upfront costs and high back end costs. Scholarship that applies economic models of present bias sometimes conflates temporal patterns of cash flows and consumption, but they are only equivalent in certain circumstances. Specifically, cash is only equal to consumption when the household is living hand to mouth. To see why, consider first a household's preferences over cash flows.

Given a choice between receiving \$100 today or \$100 a year from now, a household will generally value the hundred dollars today more than hundred dollars a year from now. Why? One reason is the risk that the promised payment a year from now will not in fact be fulfilled. The second reason is that the hundred dollars received today can be invested at some positive rate of return such that it will be worth more than \$100 a year from now. Thus, whether the household wants to spend the money on consumption now or later, they would rather have it now, and the degree to which they prefer having it now depends on both the credit risk of the promisor and the rate of return that the household could earn on \$100 today. Note that neither of these factors are particular to the household itself; the investment return and the credit risk of the promisor have nothing to do with the household's preferences about consuming now or later.

Consider now an individual's preferences over the consumption of goods and services. For example, how does someone think about whether they prefer a vacation today or a vacation a year from now? How does an

¹⁸ Bar-Gill & Warren, *supra* note 12, at 55-56.

¹⁹ GEORGE AINSLIE, BREAKDOWN OF WILL 27-47 (2001); David Laibson, *Golden Eggs and Hyperbolic Discounting*, 12 Q.J. ECON. 443 (1997).

²⁰ Ted O'Donoghue & Matthew Rabin, *Doing It Now or Later*, 89 AM. ECON. REV. 104 (1999); Robert H. Strotz, *Myopia and Inconsistency in Dynamic Utility Maximization*, 23 REV. ECON. STUD. 165 (1956).

individual compare a fine meal received next week as compared with a fine meal received in six months? Preferences between goods and services at two different points of time are governed not by market rates of return, but by the preferences of the individual herself. In contrast to preferences over cash flows, preferences over consumption at different points in time are unique to individuals and the goods and services under consideration. Although it might seem quite intuitive for an individual to prefer a fine meal in one week from that same fine meal in six months, it wouldn't be irrational for an individual to prefer the latter. They might simply enjoy the anticipation of looking forward to that meal, such that they would rather receive it a little further out into the future. By contrast, anyone who prefers more money to less will prefer to receive cash now instead of later.

It is typically assumed that individuals prefer consumption sooner rather than later, if only because there is some chance that they will not be around to enjoy consumption at that later date. The rate at which future consumption is discounted may be high or it may be low, but it is generally assumed to be positive. The scholarly literature on present bias formalizes a very particular way that individuals discount future consumption. Individuals with present bias generally prefer consumption at date t a little more than at same consumption received at date $t + 1$, but when they actually arrive at date t their preferences change so that they dramatically prefer consumption now rather than one period later. Thus, the preferences of the individual for consumption at time t as compared with time $t + 1$ change over time and, for that reason, they are irrational from an economic perspective.²¹

An illustrative pattern of such preferences is the following. Given the choice by his employer between a week of vacation a month from now and ten days of vacation two months from now, Andrew might decide that the extra three days of vacation is worth the wait and choose the ten days of vacation. However, if Andrew is asked again a month from now and he is given the choice between seven days of vacation immediately or ten days of vacation in a month, Andrew might decide he just can't wait any longer and would in fact prefer the seven days of vacation now. This change in his preferences means that he would be willing to pay some amount of money to change his choice to an immediate vacation. His preferences between the two vacations depend on when he is asked. These sorts of preferences, which lead to impulsive behavior and procrastination, are both intuitively familiar to most of us and have been well substantiated in the economics literature.²²

²¹ EYAL ZAMIR & DORON TEICHMAN, BEHAVIORAL LAW AND ECONOMICS 10 (2018) (“[E]conomic rationality assumes . . . that people's preferences are exogenously given and do not change over time.”)

²² See, e.g., George-Marios Angeletos et al., *The Hyperbolic Consumption Model: Calibration, Simulation, and Empirical Evaluation*, J. ECON. PERSPECTIVES, Summer 2001,

Individual preferences over cash flows and consumption are only equivalent when households consume whatever cash they have on hand. The most extreme case, in which households are living entirely hand to mouth, is generally limited to the very poorest households. Nevertheless, many households are in fact much more liquidity and credit constrained than is typically appreciated,²³ so that the amount of cash they have on hand at any one time can have surprisingly large effects on important decisions with long lasting consequences. There is accumulating evidence that liquidity constraints can have outsized effects beyond what would seem to be rational, affecting college enrollment,²⁴ mortgage default,²⁵ and household consumption generally.²⁶ Much of the legal scholarship on present bias implicitly assumes that households are living hand to mouth because they apply present bias discounting to cash flows. Whether this is accurate or not depends on the context, but it is important to appreciate this, often implicit, assumption. In the remainder of the paper I assume that users of high-priced credit products are severely cash constrained, so that present-bias is a potential explanation for the popularity of high-priced credit products with low upfront costs, such as subprime mortgages, credit cards with teaser rates, and payday loans.

A. Tempted to Do the Right Thing

If the primary reason that people take out high-priced credit products is that they are present biased, then this would seem to be a knockdown argument against those products and in favor of stringent regulation and perhaps outright prohibition. The appealing logic of the marketplace is that when two informed and rational parties enter into a consensual exchange then they are each left better off than they were before. This is true even when the terms of the transaction favor one of the parties, by allocating a greater share of the surplus or total benefits of the transaction. Thus, if the structure of

at 47; Marieke Bos, Susan Payne Carter & Paige Marta Skiba, *Balancing Act: New Evidence and a Discussion of the Theory on the Rationality and Behavioral Anomalies of Choice in Credit Markets*, in RESEARCH HANDBOOK ON BEHAVIORAL LAW AND ECONOMICS 101 (Joshua C. Teitelbaum & Kathryn Zeiler eds. 2018); Susan Payne Carter & Paige Marta Skiba, *Pawnshops, Behavioral Economics, and Self-Regulation*, 32 REV. BANKING & FIN. L. 193 (2012).

²³ Greg Kaplan, Giovanni L. Violante & Justin Weidner, *The Wealth Hand-to-Mouth*, BROOKINGS PAPERS ON ECON. ACTIVITY, Spring 2014, at 77.

²⁴ Michael F. Lovenheim, *The Effect of Liquid Housing Wealth on College Enrollment*, 29 J. LAB. ECON. 741 (2011).

²⁵ Nathan B. Anderson & Jane K. Dokko, *Liquidity Problems and Early Payment Default among Subprime Mortgages*, 98 REV. ECON. & STAT. 897 (2016).

²⁶ Andrew T. Hayashi, *The Quiet Costs of Taxation: Cash Taxes and Noncash Bases*, 71 TAX L. REV. 781 (2018).

high-price credit products generally reflects the costs to the lender and borrowers are acting in their best interests when they take out these loans, we should wary of regulating, and perhaps shrinking, a market that makes everyone better off (even if the distribution of gains is not what we would most like).

But if credit products like payday loans, subprime mortgages, title loans and tax refund anticipation loans primarily effect a mere transfer of resources from the relatively low-income households that use them to lenders rather than create value from a mutually beneficial exchange, and if we think that borrowers are making decisions that are harmful to their own economic interests, then this appealing logic does not hold and there is at least a *prima facie* case for consumer protection regulation. In this section I argue that it is only a *prima facie* case. In fact, there are a variety of circumstances in which an individual would take out a high-priced loan only because she is present-biased, a loan that is costlier than another loan with more conventional terms, and yet she would be strictly worse off if the high-priced loan was prohibited and only the cheaper loan was available. The rest of this section explains how this is possible.

Consider a present-biased individual who is cash constrained so that she lives hand to mouth and consumes entirely out of her cash on hand. She is present biased because she applies a discount factor β , which is between 0 and 1, to all costs and benefits that she experiences in the future. For the sake of simplicity, I assume that she does not also discount future costs and benefits depending on how far into the future they are, so \$10 spent on consumption yields the same benefit in one year as it does in two years. For this individual, there is only now and later. Adding conventional assumptions about exponential discounting would not change the analysis.

Now suppose that our individual is faced with the choice between two loans for \$50 with five-year terms. The first loan is amortized; she makes a series of equal payments each of which is comprised in part of interest and in part of principal. Specifically, the value of each payment to her in terms of foregone consumption is \$8 in the current year and for each of four years after that. Under the terms of the second loan she pays nothing until the end of the fifth year when she makes a single payment of \$65. The benefits and costs of the two loans are shown in the table titled “Preferences Over Two Loans” below, along with the net benefit or “utility” that the individual anticipates from the two loans, which depends on the discount factor β . A fully rational individual in this framework does not discount the future. For such an individual β is equal to 1, and the seventh column shows the value that she would place on the two loans. The last column shows how a fully present-biased individual, for whom β is equal to 0, would value the two loans.

Preferences Over Two Loans

	Year					Utility	Rational	Bias
	1	2	3	4	5			
<i>Loan 1</i>								
Benefit	\$50					$42-\beta 32$	\$10	\$42
Cost	-\$8	-\$8	-\$8	-\$8	-\$8			
<i>Loan 2</i>								
Benefit	\$50					$50-\beta 45$	\$5	\$50
Cost	\$0	\$0	\$0	\$0	-\$45			

A rational individual will prefer Loan 1 to Loan 2 because the total value of consumption from the cash flows under Loan 2 are greater. On the other hand, the present-biased individual will prefer Loan 2 because she does not look beyond the current year.²⁷ More generally, an individual will prefer Loan 2 as long as she is sufficiently biased, which will be the case whenever β is less than $8/13$.

The important difference between these two loans, and the reason that the rational and the present-biased individuals have opposing preferences, is the difference in the timing of costs and benefits. The rational individual cares only about the total amount of consumption facilitated by the loan. The present-biased individual cares only about maximizing her immediate access to cash and completely ignores any costs incurred in the future. Not also that although the biased individual would choose Loan 2 over Loan 1, she prefers Loan 1 to no loan at all, because her net benefit from Loan 1 is greater than 0. Thus, if Loan 2 were banned then the biased individual would take out Loan 1, which is in fact the best outcome for her.

But present bias does not only affect choices among credit products. As discussed above, present bias applies to how people make choices when there are intertemporal tradeoffs in consumption, not (in general) cash flows, and so it is only when the two are equivalent that the theory applies to consumer credit. Nevertheless, the effect of present bias on regular purchasing decisions has not generally been a point of emphasis in the literature. This is an important omission because some of the most important examples of credit products that exploit present-bias are ones that facilitate the acquisition of durable goods.

Durable goods are commodities that generate benefits for the owner

²⁷ The two extreme cases of perfect rationality and complete present bias are for illustrative simplicity and the conclusions I draw in this example do not depend on these extreme cases.

over time.²⁸ Quintessential examples include cars, houses, appliances, and furniture. It is the essence of durable goods that they confer benefits over time. When they are acquired without financing, they also require a current cash outlay to purchase. Thus, durable goods invert the temporal pattern of costs and benefits associated with borrowing. Consider the example of a durable good given in the table “Preferences Over Durable Goods”, which shows the sequence of costs and benefits (both reported in dollar terms) derived from acquiring the durable good. The good is purchased for \$60 at the beginning of year 1 and provides the owner with \$16 of consumption benefits each year. Evaluated at the beginning of year 1, the utility from owning the durable good is $-\$44 + \beta \64 . A fully rational consumer who does not discount the future benefits of owning the good will expect to derive \$20 in net benefit from the purchase. A completely biased individual (i.e., for whom β is equal to 0) will only give weight to the costs and benefits in year 1, and on this basis would not purchase the good because the perceived net benefit to such an individual is $-\$44$.

Preferences Over Durable Goods

	Year							
	1	2	3	4	5	Utility	Rational	Bias
<i>Durable</i>								
Benefit	\$16	\$16	\$16	\$16	\$16	$-\$44 + \beta \64	\$20	$-\$44$
Cost	$-\$60$							

The case of durable goods is complementary with the case of high-price credit products. Whereas the immediate access to cash and deferred costs associated with credit cards offering low teaser rates, or mortgages with escalating payments, tempts people to buy a credit product they probably shouldn't, the immediate costs and deferred benefits associated with a durable good discourage present-biased individuals from buying something that they should. Consider, for example, that in the previous example, that any individual with present bias of β of less than $8/13$ would choose Loan 2 over Loan 1. Any person with this same degree of present bias will also decide not to buy the durable good in the example above, because they are too focused on the present. Thus, the more present-biased an individual is, the less likely she is to invest in durable goods and the more likely she is to borrow money at higher rates when the costs of repayment are pushed put

²⁸ KENYON A. KNOPF, A LEXICON OF ECONOMICS 86 (1991).

into the future.²⁹

But what if the financing and the durable good are bundled together, as they frequently are, with the proceeds from the loan used to purchase the good? The table below shows the case in which each of Loans 1 and 2 are used, along with a \$10 down payment, to purchase the durable good. The table shows the time pattern of net benefits when the loans are aggregated with the durable good. From a rational consumer's perspective, there is a positive net benefit from purchasing the durable good using either of Loan 1 or Loan 2, but the net benefit is greater if it is purchased under the terms of Loan 1.

Preferences Over Financed Durable Goods

	Year					Utility	Rational	Bias
	1	2	3	4	5			
L1+Durable								
Net Benefit	-\$2	\$8	\$8	\$8	\$8	$-\$2 + \beta \32	\$30	-\$2
L2+ Durable								
Net Benefit	\$6	\$16	\$16	\$16	-\$29	$\$6 + \beta \19	\$25	\$6

Note now that the biased individual will purchase the durable good by taking out Loan 2, since her perceived net benefit of \$6 from this arrangement is greater than that from buying the good with financing from Loan 1 (-\$2) and also greater than that from not doing anything at all (\$0). However, the biased individual will *only* purchase the durable good if Loan 2 is available. If Loan 2 is not available, then the individual will do nothing,

²⁹ Present bias compounds a built-in market bias against durable goods that arise from imperfections in financial markets. Professor Rampini shows that durable goods are more expensive than nondurable goods because they are harder to finance; their resale value cannot be fully pledged so more durable assets are more likely to be rented than purchased with credit. Adriano A. Rampini, *Financing Durable Assets*, 109 AM. ECON. REV. 664 (2019). Professor Rampini argues that credit-constrained households are discouraged from buying durable goods because “durable goods force households to save, making households with low net worth reluctant to buy [them]. Such households buy ‘low-quality’ non-durable goods because these are cheaper to them as these goods have a smaller up-front cost, whereas households with high net worth buy ‘high-quality’ durable goods because these are cheaper to them since they are less constrained which means that the opportunity cost of the additional funds required to purchase durable goods is lower.” Id. at 697.

because her perceived net benefit from financing the purchase with Loan 1 is negative. Although the best outcome for our biased individual, and the outcome that a rational individual would achieve, is to finance the purchase of the durable good with the proceeds from Loan 1, she is still better off buying the durable good under the Loan 2 terms than not buying the good at all, because the net benefit from this transaction is positive.

How it is that a loan that is objectively worse for the biased individual than another loan can make her better off than if that loan were not available? The key is that Loan 2 converts the temporal pattern of costs and benefits associated with the durable good (which from a rational perspective she should buy) from one that is unappealing to her (current net costs and future net benefits) to one that is appealing to her (current net benefits and future net costs). The individual is effectively tempted through the financing to do the right thing with respect to the durable good purchase.

It is straightforward enough to see from the example above that, as at theoretical matter, we would expect present-biased individuals to under-consume durable goods. This is not just a theoretical possibility. There is empirical evidence that people fail to consider the long run cost savings, such as reduced electricity consumption, from investment in energy saving durable goods.³⁰ And this result is not limited only to the case of durable goods. Any good or service that requires a current outlay of time, money or effort to acquire and which yields future benefits is potentially one that is under-consumed by present-biased individuals, but which would become attractive to them if financed using the kind of deferred repayment terms that are characteristic of seemingly exploitative credit products. One important category of transactions includes those undertaken by citizens claiming social welfare benefits. Doing this is often a burdensome and time-consuming task with benefits that are only received in the future.³¹ In Parts II-V, I study the role that refund anticipation loans play in converting the temporal pattern of current costs and future benefits that come from filing a tax return to a pattern of current benefits and future costs, which is both appealing to taxpayer and which likely leaves them better off than if they did not have access to refund loans. In the rest of this part I summarize some of the credit products that

³⁰ Hunt Allcott, *Consumers' Perceptions and Misperceptions of Energy Costs*, 101 AM. ECON. REV. 98 (2011); Hunt Allcott, Sendhil Mullainathan & Dmitry Taubinsky, *Energy Policy with Externalities and Internalities*, 112 J. PUB. ECON. 72 (2014). But see James M. Sallee, *Rational Inattention and Energy Efficiency*, 57 J.L. & ECON. 781 (2014) (arguing that it is rational for consumers to pay limited attention to energy efficiency when buying durable goods).

³¹ See Linda G. Mills & Anthony Arjo, *Disability Benefits, Substance Addition, and the Undeserving Poor: A Critique of the Social Security Independence and Program Improvements Act of 1994*, 3 GEO. J. ON FIGHTING POVERTY 125, 128-30 (1996) (outlining a Social Security disability application process that can take up to seven years).

have been most often associated with present bias and discuss how the argument I have just outlined applies to those cases.³²

B. Credit Cards

Credit card debt is expensive, and Americans have a lot of it. The average American household has \$8,284 in credit card debt, and the aggregate amount of credit card debt as of January 1, 2018 was more than one trillion dollars.³³ Americans pay nearly \$104 billion per year in interest and fees.³⁴ The cost and amount of credit card borrowing is difficult for traditional economic models to explain, and there are a variety of puzzles surrounding the use of credit cards that call into question that traditional rational actor model.³⁵

For example, many individuals pay high rates of interest on their credit card debt at the same time that they also hold assets that yield lower rates of return.³⁶ Why don't they sell some of these assets and use the proceeds to pay down credit card debt? The net effect would be an improvement in their financial condition. Present bias is typically offered as an explanation for liquidity puzzles of this kind.³⁷ Credit card debt is typically

³² Although I do not discuss them in in this Part, car title loans are also studied by scholars applying insights from behavioral economics. These scholars suggest that the main concern with car title loans is that borrowers underestimate the costs of the title loans, and that borrowers are overoptimistic and present biased, which can lead them to be delinquent on their payments. Kathryn Fritzdixon, Jim Hawkins & Paige Marta Skiba, *Dude, Where's My Car Title: The Law, Behavior, and Economics of Title Lending Markets*, 2014 U. ILL. L. REV. 1013 (2014). The authors of this study report that 19% of their borrowers are present biased, while 30% have high discount rates but are not irrational. *Id.* at 1047. Another example is the use of collateralized loans made by pawnshops. One study finds that consumer behavior is consistent both with consumers who are present biased but are aware of this fact and can take steps to manage it, and with consumers who are fully rational. Susan Payne Carter & Paige Marta Skiba, *Pawnshops, Behavioral Economics, and Self-Regulation*, 32 REV. BANKING & FIN. L. 193 (2012).

³³ Alina Comoreanu, *Credit Card Debt Study: Trends & Insights*, WALLET HUB, Dec. 10, 2018, <https://wallethub.com/edu/credit-card-debt-study/24400/>.

³⁴ Hannah Rounds, *Average Credit Card Debt in the U.S. in 2018*, MAGNIFY MONEY, July 16, 2018, <https://www.magnifymoney.com/blog/news/u-s-credit-card-debt-by-the-numbers628618371/>.

³⁵ George-Marios Angeletos et al., *The Hyperbolic Consumption Model: Calibration, Simulation, and Empirical Evaluation*, J. ECON. PERSPECTIVES, Summer 2001, at 47.

³⁶ Sumit Agarwal et al., *Do Consumers Choose the Right Credit Contracts?*, 4 REV. CORP. FIN. STUD. 239 (2015). (citing David B. Gross & Nicholas S. Souleles, *Do Liquidity Constraints and Interest Rates Matter for Consumer Behavior? Evidence from Credit Card Data*, 117 Q. J. ECON. 149 (2002).) ("about one third of the credit card borrowers have substantial assets in checking and savings that are beyond levels reasonably needed for cash transactions.")

³⁷ David Laibson, Andrea Repetto & Jeremy Tobacman, *A Debt Puzzle*, in KNOWLEDGE,

used for consumption, with individuals tending to increase their debt balances whenever their credit allowance increases, suggesting that the people who spend until they approach their credit card limits want to consume a large fraction of each additional dollar of cash they can earn or borrow.³⁸ This kind of behavior is consistent with present bias, and indeed there is evidence that present-biased individuals have more credit card debt, even controlling for borrowing constraints, demographics, and disposable income.³⁹ The fact that these individuals may simultaneously hold some liquid assets alongside mountain credit card debt is consistent with a precautionary approach to savings, in which households keep some cash on hand to prepare against the risk that they are required to make an unexpected cash expense.

Moreover, there is direct evidence that consumers often choose credit cards that are more expensive than the alternatives. Credit cards are offered with a variety of fees and rates. Given the choice, a rational consumer would choose the credit card that minimizes their total costs, given their expectations about how likely they are to have to carry a balance and therefore pay the interest rate. In fact, many consumers do this reasonably well. Agarwal et al. (2010) report evidence that, given the choice between a card with a high fee and a low interest rate, and another card with no fee and a high interest rate, the majority of consumers choose the contract that minimizes their total costs.⁴⁰ Nevertheless, the authors find that roughly 40% of consumers choose the incorrect contract.⁴¹

Scholars and regulators tend to be most suspicious of credit cards with low initial interest rates (teaser rates) and higher back end fees, in part because this fee structure, which has low costs early on and much higher costs later, seems designed to exploit errors or imperfections in consumer rationality such as present bias. Oren Bar-Gill argues that a “combination of behavioral biases... [r]esults in the underestimation of future borrowing.”⁴² Professors Bar Gill and Warren argue that one of these biases is “imperfect self-control”, by which they means present bias, and they draw on other work arguing that consumers’ preference for credit cards with low teaser rates is precisely because those “consumers are aware of their imperfect self-control and see credit arrangements that would help them pre-commit to borrow

INFORMATION, AND EXPECTATIONS IN MODERN ECONOMICS: IN HONOR OF EDMUND S. PHELPS 228 (Philippe Aghion et al. eds. 2002).

³⁸ Gross and Souleles, *supra* note 34.

³⁹ Stephan Meier & Charles Sprenger, *Present-Biased Preferences and Credit Card Borrowing*, 2 Am. Econ. J: Applied Econ. 193 (2010).

⁴⁰ Agarwal et al., *supra* note 34.

⁴¹ The likelihood of choosing the wrong contract falls as the magnitude of the error increases, and consumers who make large errors are more likely to switch to the correct contract. *Id.*

⁴² Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2003).

less.”⁴³

To be clear, there are other possible reasons why cards with low teaser rates are so popular. One reason is that households may underestimate the likelihood that they will need to borrow using that credit card.⁴⁴ Consumers who are subject to excessive optimism “tend underestimate the likelihood of adverse events that might necessitate borrowing.”⁴⁵ If one doesn’t think that one will ever have to pay interest on a credit card balance, it matters little what that interest rate is. Professors Bar-Gill and Bubb argue that many credit cards impose high long-term costs and low short-term prices and that “imperfectly rational consumers still have difficulty understanding the cost of credit card borrowing.” They argue that consumers should be told what the expected cost of credit will be based on predicted usage, and that regulation should address low teaser rates as well as high backend fees.⁴⁶

My argument in this paper is that credit products with low initial costs and higher backend costs are less pernicious, and may in fact be beneficial, when they are used to finance the purchase of a good or service with deferred benefits. Credit cards, of course, can be used for just about everything. Consumers use their credit cards at least 34% of the time when shopping at department stores, gas stations, supermarkets, and when eating out.⁴⁷ They are most likely to use their credit cards when online shopping or booking online travel. Some of these purchases, such as eating out, and buying groceries and gas are clearly in the category of nondurable goods that are immediately consumed, but credit cards can also be used to buy durable goods and pay for services such as tax preparation, that have deferred benefits. However, data on the high rate of credit card use with online retailers cannot distinguish between the purchase of durable goods, such as appliances, and nondurable goods. Because credit card debt is not necessarily used to finance the acquisition of a durable good, the tempting features of low teaser rates and higher backend fees are less likely to make present-biased consumers better off. Given the choice between using revolving credit to purchase immediate consumption and durable good, the present-biased individual will be tempted to use the money to purchase immediate consumption.

⁴³ Bar-Gill & Warren, *supra* note 12.

⁴⁴ Ausubel, Lawrence M. Ausubel, *The Failure of Competition in the Credit Card Market*, 81 AM.N ECON. REV. 50 (1991).

⁴⁵ Bar-Gill, *supra* note 40.

⁴⁶ Oren Bar-Gill & Ryan Bubb, *Credit Card Pricing: The Card Act and Beyond Symposium: Financial Regulatory Reform in the Wake of the Dodd-Frank Act*, 97 CORNELL L. REV. 967 (2011).

⁴⁷ Jason Steele, *Credit Card Use and Availability Statistics*, CREDITCARDS.COM (Aug. 23, 2017), <https://www.creditcards.com/credit-card-news/credit-card-use-availability-statistics-1276.php>.

C. Mortgages

Dwarfing credit card debt by more than an order of magnitude, there was \$9.1 trillion of outstanding balances on home mortgage loans in 2018.⁴⁸ This number include both loans used to purchase homes as well as home equity loans, which are often, but not always, used for home renovations. This number also includes loans with a wide variety of terms, such as the conventional 30-year fixed mortgage under which the principal of the loan is amortized over 30 years so that the homeowner is obligated to make a series of equal payments, to more exotic loans with terms such as a variable rate of interest or even where the interest and principal on the loan are deferred so that the borrower need not pay anything at all in the initial period early in the life of the loan. Loans with adjustable rates (ARMs) have historically enjoyed some popularity, despite the risks of adverse interest rate moves. In one study, 25% of those surveyed said that they would prefer an adjustable-rate mortgage to a fixed rate loan.⁴⁹ ARMs are even more popular with young respondents and those with low incomes, those with only a high school education, and with Hispanics and African Americans.⁵⁰

Many of the loans with these more exotic features were made in the run up to the financial crisis to borrowers who posed a greater risk of default. Such loans were known as subprime loans. Professor Bar-Gill argues that subprime loans target “imperfect rationality borrowers.”⁵¹ They target the imperfectly rational because of two key features that distinguish them from the traditional 30 year fixed rate loan: deferred costs and complexity.⁵² Costs are typically deferred through “small down payments and high LTVs [loan-to-value ratios], escalating payments, and prepayment penalties.”⁵³ The complexity arises from the wide variety of fees and the circumstances in

⁴⁸ *Household Debt and Credit Report (Q3 2018)*, CTR. FOR MICROECONOMIC DATA, N.Y. FED. RESERVE BANK, <https://www.newyorkfed.org/microeconomics/hhdc.html> (last visited Jan. 11, 2019).

⁴⁹ Michael Finke et al., *Characteristics of Recent Adjustable-rate Mortgage Borrowers*, 16 J. FIN. COUNS. PLAN. 17 (2005).

⁵⁰ ARMs were preferred by: 32% of respondents 18-24 years old; 33% with incomes less than \$25,000; 29% with a high school diploma; 21% with college degrees; 37% of Hispanics; 31% of African-Americans; and 23% of Whites.” Id.

⁵¹ Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073 (2008). See also Kathleen C. Engel, & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255 (2001); Kathleen C. Engel & Patricia A. McCoy, *THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS* (Oxford University Press, 2016).

⁵² Bar-Gill, *supra* note 49.

⁵³ Id.

which they are imposed.⁵⁴ As with credit cards, Bar-Gill asserts that present-bias and optimism explain the demand by consumers for products with large deferred costs. Optimistic borrowers expect that they will be in a better position to make payments in the future than they are now. Present-biased borrowers, of course, underweight all future costs in their cost/benefit calculations.

In contrast to credit cards and other revolving lines of credit, the most important characteristic of home purchase loans is that the proceeds must be used to purchase a particular good, specifically a house. Homes are the most economically important consumer durable, and they are most households' most important asset. By purchasing a home, a homeowner acquires the right to live in it. Thus, if the home is paid for in cash, the purchaser swaps the ability to use that cash for current consumption with a stream of housing consumption that they will enjoy over time. The primary alternative to homeownership for most households is to rent. Under a residential rental agreement, the renter generally makes periodic cash payments in exchange for the right to live in the property for that period, so cash outlays are roughly contemporaneous with the renter's enjoyment of the housing.

Buying a home, on the other hand, is a risky investment; it places a large amount of the purchaser's buying power in one asset, which yields only deferred benefits. Those benefits are the ability to live in the home rent free, and the accumulated equity that can be extracted when the home is ultimately sold. In this way, housing acts as a savings vehicle. Of course, the value of the property when the homeowner decides to stop living in it is uncertain, but the risk of homeownership is not one-sided. Owning a home also hedges the homeowner against fluctuations in the cost of renting.⁵⁵ Economically, the longer a household expects to live in a home the more important this hedge against rent risk becomes, and the relatively less important becomes the risk around its future value when the household sells the property.⁵⁶

Present-biased consumers undervalue homeownership. At least part of the purchase price of a home must be paid up front, or at least in any case in which the home is not 100% financed. Thus, in all but a relatively trivial number of cases, a homebuyer must have saved enough to make some down payment. Present-biased individuals have difficulty saving and are disinclined to use liquid assets for things other than immediate

⁵⁴ Id.

⁵⁵ Todd Sinai & Nicholas S. Souleles, *Owner-Occupied Housing as a Hedge Against Rent Risk*, 120 Q. J. ECON. 763 (2005). ("Unlike standard assets, houses effectively pay out annual dividends equal to the ex post spot rent, and so provide a hedge against rent risk. Hence considering asset price risk in isolation fails to account for households' entire risk position.")

⁵⁶ Id. at 765.

consumption.⁵⁷ In exchange for an upfront cash payment, a homebuyer acquires an asset that they can use to save for retirement or bequest, and they also receive the periodic rental value of the property as housing consumption. Both of these benefits are deferred until the in the future. Because most home loans are used to acquire or make substantial renovations to a consumer durable (i.e. a house), the temporal pattern of costs and benefits of these loans should be integrated with the pattern of costs and benefits of the durable to determine whether present-biased individuals are likely to be made worse off by the loan.

D. Payday loans

Every year, roughly 2.5 Americans take out a payday loan, and in 2016 aggregate loan volume was approximately \$40 billion and fee revenue was \$8 billion.⁵⁸ Payday loans are short-term loans of between one and two weeks for generally no more than \$1,000.⁵⁹ The loans are very expensive, often costing 10 to 20% of the principal amount,⁶⁰ and one scholar estimates the all-thing-considers cost of such loans (the annual percentage rate or APR) to be between 400% and 600%.⁶¹ What explains the high cost of such short term loans?

Asymmetric information is an important feature of the payday lending market. Specifically, borrowers who choose larger loans tend to be more likely to default (adverse selection).⁶² Payday loan borrowers also tend to be very credit constrained, with consumption needs that outstrip their cash on hand. Professors Dobbie and Skiba find that payday borrowers will borrow between \$0.39 and \$0.44 per additional dollar of credit that they are offered.⁶³ By comparison, credit cardholders borrow between \$0.10 and \$0.14 of each additional dollar of credit they are offered.⁶⁴ The high rate of borrowing when additional credit is available suggests that payday borrowers have a very high

⁵⁷ David Kamin, *Getting Americans to Save: In Defense of (Reformed) Tax Incentives*, 70 TAX L. REV. 545 (2017); David Laibson, Andrea Repetto & Jeremy Tobacman, *Self-Control and Saving for Retirement*, in SOCIAL SECURITY REFORM: FINANCIAL AND POLITICAL ISSUES IN INTERNATIONAL PERSPECTIVE 73, 74-75 (Robin Brooks & Assaf Razin eds., 2005); Daniel Shaviro, *Multiple Myopias, Multiple Selves, and the Under-Saving Problem*, 47 CONN. L. REV. 1215 (2015).

⁵⁸ *Principles and Interest: Short-Term Lending*, Economist, Apr. 8, 2017, at 67.

⁵⁹ Bhutta et al, *supra* note 15, at 227.

⁶⁰ Id.

⁶¹ Paige Marta Skiba, *Tax Rebates and the Cycle of Payday Borrowing*, 16 AM. L. & ECON. REV. 550 (2014).

⁶² Will Dobbie & Paige Marta Skiba, *Information Asymmetries in Consumer Credit Markets: Evidence from Payday Lending*, 5 AM. ECON. J. APPLIED ECON. 256 (2013).

⁶³ Id.

⁶⁴ Id.

demand for credit.⁶⁵

Are borrowers acting rationally when they take out a payday loan? Direct evidence on this question is scarce, but many payday loan borrowers have capacity on their credit cards when they take out payday loans, even though the annualized interest rates on payday loans are extraordinarily high.⁶⁶ These individuals often have large monetary losses as a result of using a payday loan rather than a credit card. At the same time, these borrowers have been observed to approach their credit card limits in the period leading up to taking out a payday loan, suggesting that their alternative sources of credit may have been drying up.⁶⁷

Payday loans are subject to a variety of state regulations, including substantive limitations on price and amount, and regulations on the process of origination. According to Bhutta et al. (2015),⁶⁸ the principal amount of payday loans is typically limited to no more than 50% of the applicant's after-tax paycheck. One of the most controversial features of payday loans is the ability of borrowers to pay only loan fees on the due date and roll over the loan principal until the following due date.⁶⁹ Concerns about rollovers have led states to limit the number of rollovers, although lenders do not always comply with these limitations.⁷⁰ In terms of the application process, applicants are required to provide identification and address verification, along with a recent paystub and checking account statement.⁷¹ As of 2012, 14 states prohibited payday loans in their entirety.⁷² Professor Skiba concludes that although limitations on rollovers are appropriate, complete prohibitions are misguided and in fact larger loans can be more helpful for borrowers.⁷³ Although the cost of payday loans is high, sometimes the cost of not having access to credit is greater, including overdraft fees and utility shut offs.⁷⁴

What are payday loans used for? Payday loans are generally used to cover ordinary living expenses, although sometimes they are used to cover emergency expenses such as car repairs or medical costs. One study reports

⁶⁵ See Richard Hynes, *Payday Lending, Bankruptcy, and Insolvency*, 69 WASH. & LEE L. REV. 607 (2012) (testing the effect of payday loans on proxies for welfare).

⁶⁶ Sumit Agarwal, Paige Marta Skiba, & Jeremy Tobacman, *Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles?*, 99 AM. ECON. REV. 412 (2009).

⁶⁷ Id.; Bhutta et al., *supra* note 15.

⁶⁸ Id.

⁶⁹ Id. at 228; Bar-Gill & Warren, *supra* note 12, at 44.

⁷⁰ Bhutta et al., *supra* note 15, at 228

⁷¹ Id. at 227.

⁷² Paige Marta Skiba, *Regulation of Payday Loans: Misguided Regulation in the Fringe Economy Symposium*, 69 WASH. & LEE L. REV. 1023 (2012).

⁷³ Id.

⁷⁴ Id.

that, among first time borrowers, “69 percent used it to cover a recurring expense, such as utilities, credit card bills, rent or mortgage payments, or food; 16 percent dealt with an unexpected expense, such as a car repair or emergency medical expense.”⁷⁵ If they were unable to get a payday loan, respondents to the study survey said that they would cut expenses, sell possessions, delay paying other bills, or rely on friends and family to help see them through.⁷⁶ The terms of payday loans do not restrict the use to which the funds can be put, so it is unsurprising that they are used for a variety of purposes. Given the modest size of these loans, however, it is unlikely that large consumer durables would be a significant use of the loans.

Among these three kinds of controversial, high price, loans, home purchase and home equity renovation loans are the ones that regulators should be most wary of evaluating in isolation from the underlying purchase. Excess demand for debt created by the terms of a subprime mortgage may be just the thing that a present-biased individual needs to finance a home purchase that is in their best interest, but they wouldn’t otherwise make. The same logic applies to seller financing of cars, appliances, and energy efficiency enhancing home improvements. In fact, the logic extends beyond the purchase of goods to the purchase of services as well. In Parts II-V, I report evidence that high price loans may help present-biased individuals avail themselves of tax preparation assistance that results in larger refunds of the earned income tax credit (EITC) than they would otherwise obtain.⁷⁷ The stakes are high. The EITC is one of the largest social transfer programs for low-income households and has been shown to have positive effects on infant health,⁷⁸ the decision to work, poverty, childbearing and marriage.⁷⁹

⁷⁵ PEW CHARITABLE TRUSTS, PAYDAY LENDING IN AMERICA: WHO BORROWS, WHERE THEY BORROW, AND WHY (2012), <https://www.pewtrusts.org/en/research-and-analysis/reports/2012/07/19/who-borrows-where-they-borrow-and-why>.

⁷⁶ Id.

⁷⁷ There have been very few empirical studies of RALs and RACs. The study that is closest in spirit to this one is Maggie R. Jones, *A Loan by Any Other Name: How State Policies Changed Advanced Tax Refund Payments*, (CARRA Working Paper Series, No. 016-04, June 2016), <https://www.census.gov/content/dam/Census/library/working.../carra-wp-2016-04.pdf>. Jones examined the effect of disclosure regulations and interest rate caps on RALs and RACs. Jones finds no effect of disclosure laws on the availability of RALs, but does find evidence suggesting that state interest rate regulation may have driven households to cross state borders to obtain these products.

⁷⁸ Hilary Hoynes, Doug Miller & David Simon, *Income, the Earned Income Tax Credit, and Infant Health*, 7 AM. ECON. J. ECON. POL’Y 172 (2015).

⁷⁹ Reviews can be found in V. Joseph Hotz & John Karl Scholz, *The Earned Income Tax Credit*, in MEANS-TESTED TRANSFER PROGRAMS IN THE UNITED STATES 141 (Robert A. Moffitt ed. 2003) and Nada Eissa, & Hilary Hoynes, *Behavioral Responses to Taxes: Lessons from the EITC and Labor Supply*, in 20 TAX POLICY AND THE ECONOMY 74 James Poterba ed. 2006).

II. TAX RETURN PREPARERS AS LENDERS

Paid tax return preparers stand between many households and the U.S. Treasury. These households find that completing an individual income tax return is too burdensome to do on their own, and so tax return preparers satisfy a market demand that, if unmet, could result in lower tax compliance rates and higher rates of non-filing. At the same time, many preparers also sell to their customers financial and nonfinancial products that are paid for out of the taxpayer's tax refund and that some believe are exploitative. National tax preparation chains, such as H&R Block and Jackson Hewitt, as well as used-car dealers and payday lenders, all provide tax preparation services and generally attempt to bundle some other good or service with those services. Uneasiness about the financial products sold by paid preparers has led to increasing regulation of the tax preparer industry.

Regulation of the financial products sold by tax return preparers has largely been done at the state level and within a consumer protection framework. Refund anticipation loans (RALs), in particular, have drawn a great deal of criticism from consumer groups and the crowning achievement of their efforts came in 2011 when a regulatory change nearly extinguished the market for RALs. The demise of RALs has been viewed as a victory by consumer protection advocates, who believe that the loans are harmful to the people who use them. Like payday loans and car title loans, RALs have very high APRs and tend to be purchased by low-income individuals. And so, like those loans, they raise suspicions of exploitation. Consumer advocates argue that their terms are unfair, and taxpayers would be better off without them. RALs are unquestionably expensive, but a more elusive question is whether the households who use RALs are acting in their own best interests. If they are, then the disappearance of RALs, distasteful though they seem, may have been harmful for those households.

But focusing on the consumer protection concerns arising from financial products such as RALs neglects the fact that these products are economic complements with tax preparation assistance, and interventions into those financial product markets could affect the use of tax preparers, with collateral effects on tax compliance and the take-up of transfers such as the earned income tax credit or the health insurance premium tax credit. What distinguishes RALs from other high-cost credit products such as payday loans is that RALs are closely linked to the tax system, to the collection of taxes and the distribution of benefits through tax law. Because RALs are bundled with tax preparation assistance, the price and availability of RALs is likely to affect the use of paid preparers, and the decision to use a paid preparer has consequences for tax compliance. Thus, an evaluation of the elimination of

the RAL market should consider any effects on the use of paid return preparers, income tax return filings rates, and tax compliance generally.

In Part IV, I report the first evidence of the effect of the RAL market on the demand for tax preparation assistance and the collateral effects on EITC take-up and demand for an alternative credit product, known as a refund anticipation check (RAC). I find that eliminating RALs is associated with reduced demand for tax preparation services, decreased rates of EITC take-up, and substitution of RACs for RALs. I find that 80% of RAL borrowers shifted to a RAC, while 10% of RAL borrowers shifted to self-preparation and 5% stopped claiming the EITC.

There are several challenges to identifying the causal effect of RALs on EITC take-up and other tax filing outcomes, rather than merely identifying correlations that could be attributable to other factors. First, taxpayer characteristics that are associated with low incomes, EITC eligibility, credit constraints, and the need for tax preparation assistance are also likely to affect demand for RALs. Second, since RALs are secured by tax refunds, generally EITC refunds, an increase in EITC claims will tend to cause an increase in RALs. As a result, it could be that changes in EITC claims drive the change in RALs, rather the other way around.

My solution to these problems is to take advantage of a large regulatory intervention by the IRS that caused the near total disappearance of the market for refund anticipation loans in 2011. On August 5, 2010, the IRS announced that it would no longer provide lenders with a “debt indicator,” which revealed to lenders whether the refunds that secured RALs would be subject to garnishment for child support or other debts. Without the debt indicator, the number of RALs in 2011 fell by 84% from the prior year and the maximum amount of a loan was cut by lenders from \$10,000 to \$1,500. The regulatory change was national in application but had different effects across the country depending on the number of taxpayers who were RAL users before 2011. The effect on RAL use was greatest, of course, in places where RALs were most popular before 2011.

The data do not allow me to differentiate between rational taxpayers, who would be harmed by an intervention that reduces the set of filing options available to them, and taxpayers who may be made better off by eliminating RALs because they are subject to some self-defeating bias. However, the high degree of substitution from RALs to RACs and the reduction in EITC claims suggest that many of the taxpayers who previously obtained RALs place a high value on paid preparation assistance and are either credit constrained or extremely impatient in the early months of the calendar year.⁸⁰ I report survey

⁸⁰ When one form of high-interest credit is unavailable, individuals shift to other forms of high-interest credit. Neil Bhutta, Jacob Goldin & Tatiana Homonoff, *Consumer Borrowing after Payday Loan Bans*, 59 J. L. & ECON. 225 (2016).

evidence corroborating this. These results suggest that regulators should be wary about current efforts to curtail the market for RACs, since this product provides one of the last financing options for taxpayers who need tax assistance but are otherwise credit constrained and do not have cash on hand.

Consumer regulation of financial products sold to taxpayers must work hand in hand with tax administration, taking into account the effect of changing price and supply of the regulated products on the demand for preparation assistance, and the changes in compliance that may follow from inducing more taxpayers to prepare their own returns.

A. Refund Loans

Refund anticipation loans are short-term loans, usually of one to two weeks. Tax return preparers help originate the loans for the financing entity (usually a bank) with which they work, and often acquire an economic interest in the pool of loans. A taxpayer who takes out a RAL will have her tax refund directly deposited in a checking account owned by the institution, and the proceeds of the refund will be applied to pay off the principal of the loan, interest and loan origination fees, as well as fees for the tax preparation itself. If the refund is less than the amount owed on the loan plus fees, then the taxpayer is liable for the difference. The following short summary of how RALs work appears in H&R Block's Annual Report for 2009:

RALs. RALs are offered to our U.S. clients by a designated bank primarily through a contractual relationship with HSBC Holdings plc (HSBC). An eligible, electronic filing client may apply for a RAL at one of our offices. After meeting certain eligibility criteria, clients are offered the opportunity to apply for a loan from HSBC in amounts up to \$9,999 based on their anticipated federal income tax refund. We simultaneously transmit the income tax return information to the IRS and the lending bank. Within a few days after the filing date, the client receives a check, direct deposit or prepaid debit card in the amount of the loan, less the bank's transaction fee, our tax return preparation fee and other fees for client-selected services. Additionally, qualifying electronic filing clients are eligible to receive their RAL proceeds, less applicable fees, in approximately one hour after electronic filing using the Instant Money service. A RAL is repaid when the IRS directly deposits the participating client's federal income tax refund into a designated account at the lending bank.

At their peak, in 2002, there were 14.1 million RAL applications filed. In 2010, the year before the debt indicator was eliminated, H&R Block originated 2.1 million RALs, with an average amount of \$3,000 and terms of between ten and eleven days. Each loan issued through H&R Block cost the taxpayer about \$62, or 2.1% of the loan principal. In 2010, Jackson Hewitt charged \$51 in fees plus 4% of the loan amount. Depending on the preparer and lender, total tax preparation and RAL fees could approach \$500.⁸¹

RALs have been especially common in low-income communities. Taxpayers who file their returns early in the year, many of whom are EITC claimants, are most likely to use RALs and other tax-related financial products. As a result, critics have long argued that RALs are a drain on funds intended for low-income households, particularly the EITC. In 2008, 63% of RAL customers were EITC recipients and 44% of EITC recipients obtained a RAL or RAC, as compared with only 7% of taxpayers who did not receive the EITC. The Urban Institute reports that the median adjusted gross income of RAL borrowers was less than \$20,000, and that a quarter of taxpayers with incomes between \$10,000 and \$25,000 used a RAL. The National Consumer Law Center (NCLC) calculates that RAL loan fees, preparer add-on fees, and tax preparation fees cost at least \$292 per EITC taxpayer for a total drain on the EITC program of \$1.5 billion in 2010. A series of reports by the NCLC and the Consumer Federation of America also found that African American and Latino taxpayers disproportionately receive RALs, and in 2008 the New York State Division of Human Rights sued Jackson Hewitt and Liberty Tax Service for targeting minorities for RAL sales.

Refund anticipation checks (RACs) would not, at first glance, appear to be a substitute for RALs; they do not allow the taxpayer to access her refund immediately. With a RAC, the taxpayer's refund is deposited by the U.S. Treasury into an account opened at a participating bank, for a fee. The taxpayer is disbursed the refund from that account only when the refund has been deposited. H&R Block's annual report describes their RAC product as follows:

RACs. Refund Anticipation Checks are offered to U.S. clients who would like to either: (1) receive their refund faster and do not have a bank account for the IRS to direct deposit their refund; (2) have their tax preparation fees paid directly out of their refund; or (3) receive their refund faster but do not qualify for a RAL under the existing credit criteria. A RAC is not a loan and is provided through a contractual relationship

⁸¹ Leslie Book, *Refund Anticipation Loans and the Tax Gap*, 20 STAN. L. & POL'Y REV. 85 (2009).

with HSBC.

RACs have a couple of features that are relevant for the purpose of comparing them with RALs. The first is that they allow the taxpayer to have her refund directly deposited into a checking account, which allows her to receive it more quickly than if she had to wait for a paper check to be mailed. A refund that is sent by direct deposit generally arrives a week before a refund check is received in the mail. The second feature is that RACs allow taxpayers to defer paying tax preparation fees, because they are subtracted from the refund when it is disbursed to the taxpayer. One can think of some portion of the cost of a RAC as representing interest on the cost of borrowing the tax preparation fees, and so both RALs and RACs represent a loan of the tax preparation fee.

Tax preparation firms have historically differed in their reliance on revenues from financial products such as refund anticipation loans and refund anticipation checks. For example, consumer advocates have noted that Jackson Hewitt is more reliant on fees from RALs and other financial products than H&R Block. This difference is reflected in the segmentation of the market and the different clientele served by the firms. In 2010, H&R Block sold a RAL or RAC to 40% of its clients. In 2008, Jackson Hewitt sold a financial product to 91% of its customers and derived 26% of its revenues from financial product fees. Liberty Tax, the third largest individual return preparer, derived 29% of its revenues from RAL and RAC fees in 2009.

B. Tax Preparers

More than half of all taxpayers use a paid professional to help prepare their tax return, and more than 60% of EITC claimants use a paid preparer. Use of a paid preparer is especially common among Hispanic and African American households, households with lower educational attainment, and lower incomes. What explains the demand for paid tax preparation assistance? Taxpayers cite a lack of understanding of tax law, the amount of time that it would take to file tax returns without help, and the belief that using a preparer will reduce the likelihood of an audit.⁸² Thus, some of the demand for paid preparation appears to be caused by the complexity of the income tax and the burden of complying with filing obligations. In fact, these two concerns are something that EITC-eligible taxpayers have in common with high-income taxpayers with sophisticated business dealings.⁸³ In light

⁸² *Id.*

⁸³ Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers*, in *THE CRISIS IN TAX ADMINISTRATION* 148 (Henry J. Aaron & Joel Slemrod eds. 2004); Joel Slemrod & Nikki Sorum, *The Compliance Cost of the U.S. Individual Income Tax System*,

of the importance of tax complexity as a source of demand for tax preparation assistance, it is unsurprising that tax compliance varies with the use of preparation assistance.⁸⁴

There is evidence that the availability of tax preparation assistance affects the likelihood that a taxpayer will claim the earned income tax credit and that taxpayers will adjust their reported incomes in response to the incentives it creates.⁸⁵ An IRS audit of EITC claims for tax years 2006-2008 found that, among low-income filers who reported knowing about the EITC, 80% of those who used a paid preparer claimed the credit whereas only 70% of those who prepared their own return did so.⁸⁶ One likely cause of the effect of paid preparation on EITC claims is that tax professionals can navigate the complexity of the EIC schedule and form 1040, which has been shown to be a deterrent to take-up of the EITC.⁸⁷ Another cause is the high-powered incentives that preparers have to obtain a refund for their clients. If tax preparers develop a reputation for obtaining refunds for their clients, they are likely to attract additional customers. Moreover, if preparers file a refund claim for the clients then they may also be able to sell RALs, RACs, or other nonfinancial good or services to the taxpayer client to be purchased with the proceeds of these refunds. These incentives make it less likely that preparers

37 NAT'L TAX J. 461 (1984).

⁸⁴ James E. Long & Steven B. Caudill, *The Usage and Benefits of Paid Tax Return Preparation*, NAT'L TAX J. 35 (1987); Steven Klepper & Daniel Nagin, *The Role of Tax Preparers in Tax Compliance*, 22 POL'Y SCI. 167 (1989); Steven Klepper, Mark Mazur & Daniel Nagin, *Expert Intermediaries and Legal Compliance: The Case of Tax Preparers*, 34 J.L. & ECON. 205 (1991); Brian Erard, *Taxation with Representation*, 52 J. PUB. ECON. 163 (1993); Sagit Leviner, *The Role Tax Preparers Play in Taxpayer Compliance: An Empirical Investigation with Policy Implications*, *The*, 60 BUFF. L. REV. 1079 (2012).

⁸⁵ Raj Chetty & Emmanuel Saez, *Teaching the Tax Code: Earnings Responses to an Experiment with EITC Recipients*, 5 AM. ECON. J. APPLIED ECON. 1 (2013); Raj Chetty, John N. Friedman & Emmanuel Saez, *Using Differences in Knowledge Across Neighborhoods to Uncover the Impacts of the EITC on Earnings*, 103 AM. ECON. REV. 2683 (2013).

⁸⁶ *Why Do Low-Income Families Use Tax Preparers?*, TAX POLICY CENTER BRIEFING BOOK, <http://www.taxpolicycenter.org/briefing-book/key-elements/poor/paid-preparers.cfm> (last visited Jan. 17, 2019). I do not evaluate whether all of the increase in EITC claims associated with paid preparation is meritorious. There is some evidence of a correlation between audit adjustments and RAL applications. Book, *supra* note 78. Wojciech Kopczuk & Cristian Pop-Eleches, *Electronic Filing, Tax Preparers and Participation in the Earned Income Tax Credit*, 91 J. PUB. ECON. 1351 (2007) find that tax preparers increased EITC take-up following the introduction of electronic filing, although Marsha Blumenthal, Brian Erard & Chih-Chin Ho, *Participation and Compliance with the Earned Income Tax Credit*, NAT'L TAX J. 189 (2005) do not find an effect of tax preparation on EITC claims.

⁸⁷ Saurabh Bhargava & Dayanand Manoli, *Psychological Frictions and the Incomplete Take-Up of Social Benefits: Evidence from an IRS Field Experiment*, 105 AM. ECON. REV. 3489 (2015). It is likely that some complexity is part of an optimal transfer system. Henrik Jacobsen Kleven & Wojciech Kopczuk, *Transfer Program Complexity and the Take-Up of Social Benefits*, 3 AM. ECON. J. ECON. POL'Y 54 (2011).

will overlook a potential EITC claim, but it also enhances the risk of fraudulent claims.

C. Demand for RALs

The profit motive explains why tax preparers sell RALs and RACs, but what explains why taxpayers want them? On the one hand, these products make it possible to borrow the cost of tax preparation and receive refunds more quickly; tax preparers assert that they would lose tax preparation customers if they did not sell these credit products. These are real benefits that a rational taxpayer might decide are worth the cost. On the other hand, consumer advocates argue that these products exploit unsophisticated filers and that they offer little benefit at a high cost.⁸⁸ Certainly, RAL and RAC use is correlated with low incomes, youth, head-of household filing status, EITC receipt, and lower educational attainment, but these factors are all predictive of credit constraints that explain why a taxpayer may need to borrow the cost of tax preparation, as well as potentially being indicators of financial sophistication.⁸⁹ Households with an adjusted gross income (AGI) below \$45,000 are more likely to use RALs, but RAL take-up is highest in the \$5,000 to \$10,000 AGI range.⁹⁰ Among low and medium-income households, unbanked households are more than twice as likely as similar banked households to take out a RAL, and many respondents say that they take out the RAL to get the money sooner and pay down other debt, or to pay tax preparation fees.⁹¹ For other taxpayers, the relationship between tax preparation and the RAL is reversed: some taxpayers go to preparers primarily for the loan, and view the tax return filing fee as part of the cost of the RAL.

One challenge of evaluating whether RALs benefit taxpayers is that the costs of a RAL can easily be determined, but the benefits of a RAL to the borrower generally cannot. One study by the Urban Institute reports that there may be considerable benefits for RAL borrowers from receiving a tax refund even a couple of weeks earlier than they otherwise would; borrowers use them to discharge financial obligations and defer payment of tax preparation fees that they may not otherwise be able to finance. RAL and RAC

⁸⁸ Brett Theodos et al., *Who Needs Credit at Tax Time and Why: A Look at Refund Anticipation Loans and Refund Anticipation Checks*, URBAN INSTITUTE (Feb. 24, 2011), <http://webarchive.urban.org/publications/412304.html>.

⁸⁹ Gregory Elliehausen, *Consumer use of tax refund anticipation loans*. Credit Research Monograph #37, Credit Research Center, McDonough School of Business, Georgetown University (2005).

⁹⁰ Theodos et al., *supra* note 85.

⁹¹ Michael S. Barr & Jane K. Dokko, *Third-Party Tax Administration: The Case of Low- and Moderate-Income Households*, 5 J. EMPIRICAL LEGAL STUD. 963 (2008).

applications are overwhelmingly filed in the first few weeks of filing season and there is evidence that many customers become delinquent on rent, utilities and other expenses over the winter holidays with the expectation of receiving their RAL in late January or early February and using it to get current on these other obligations.⁹² Deferring payment of these already delinquent liabilities another couple of weeks could be very costly, potentially leading to eviction or utilities being cut off. The liquidity constraints of these households make even paying tax preparation fees burdensome. Half of those surveyed in the study said that paying the tax prep fees was an important motivator in taking out a RAL or RAC.⁹³

In addition to present bias and credit constraints, two important variables that influence the relative benefits of tax financial products and the use of paid preparers are whether consumers have a checking account into which they can have their refund directly deposited and whether they have internet access that they can use to e-file their return. Direct deposit provides a one-week timing benefit over receiving a refund check by mail, and unbanked taxpayers may also incur check cashing fees if they receive a paper refund check. E-filing provides an even larger timing benefit; it allows taxpayers to get their refunds at least three weeks earlier than they would by paper filing. Survey evidence suggests that these timing benefits are important. RAL borrowers often lack a bank account or are mistrustful of banks, and are motivated by post-holiday financial strain, unexpected expenses, the inability to pay cash for tax preparation assistance and an inability or unwillingness to add credit card debt to pay for tax assistance.⁹⁴

D. The Disappearance of RALs

In 2011, the market for RALs disappeared almost entirely. RAL applications fell by 84.5%, from 6.85 million to 1 million, and by 2013 there were only 69,100 RAL applications. This precipitous decline was caused by a single regulatory change and two other market disruptions in the supply of RALs. The regulatory change was that the IRS stopped providing to preparers a debt indicator, which revealed whether a RAL applicant would have their refund garnished for back taxes, other government debts such as federally-funded student loans, and child support arrears. The Federal Deposit Insurance Corporation subsequently notified the banks providing RAL financing that making loans without the debt indicator was unsafe and unsound. In addition, JPMorgan, which had provided financing to 13,000 independent preparers, exited the RAL market. HSBC, which had provided

⁹² Theodos et al., *supra* note 85.

⁹³ *Id.*

⁹⁴ *Id.*

financing to H&R Block's clients, was forced out of the market by the Office of the Comptroller of the Currency, which prohibited it from making the loans. As a consequence, in 2011, only three small, state-chartered banks made RALs: Republic Bank & Trust, River City Bank, and Ohio Valley Bank/Fort Knox Financial Services. Even for banks that continued to make RALs, the loss of the debt indicator reduced the size of the maximum RAL that the banks would provide. For 2011, the maximum loan available from Republic Bank was \$1,500 and from River City Bank it was \$750. Previously, RALs had been offered up to \$10,000.

In response to the pressure of reduced RAL revenues, Jackson Hewitt and Liberty Tax began charging additional fees for any RALs that they facilitated. Ultimately, the loss of RALs had a significant effect on Jackson Hewitt, which was heavily reliant on revenue from the product. In addition to the loss of RAL fees, Jackson Hewitt lost 15% of its retail customers because it was unable to provide RALs at half its locations. Its business fell by 8% in markets where it remained able to provide RALs, suggesting that some of the decline in its business was due to other factors, but the decline was 21% in markets where it was unable to provide RALs suggesting that the inability to provide refund loans has a significant effect on their tax preparation business. In Parts III and IV, I test this claim more rigorously, and examine some of the collateral effects of the elimination of the RAL market.

III. DATA AND SUMMARY STATISTICS

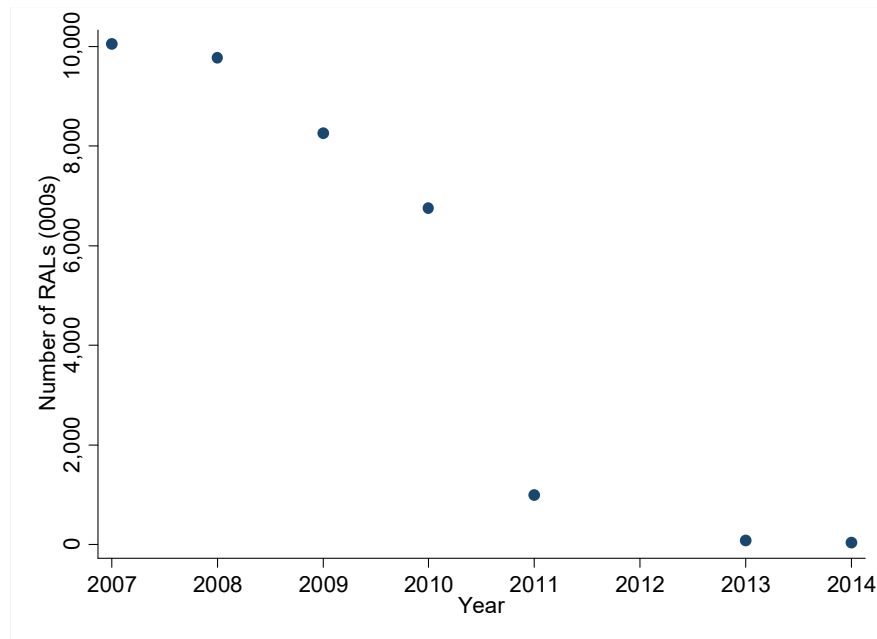
My empirical analysis of the relationship between RALs and tax return preparation and EITC take-up is based on annual tax return data from the IRS' Statistics of Income Division. These data were aggregated to the county level and merged with information on county demographic characteristics from the U.S. Census and Bureau of Labor Statistics. I also collected data on the locations of paid tax preparer offices for the three largest national tax preparation chains. This study is the first to exploit detailed location data of paid tax preparers.

A. County Data

Data on aggregate tax return filings at the zip-code level were provided by the Brookings Institution, which obtained the data from the IRS. These data include the number of filings in thirteen different brackets of adjusted gross income, the number and amount of EITC claims, the number of self-prepared returns, and the number of refund anticipation loans and refund anticipation checks issued. Figure 1 shows the number of RAL

applications by year for 2007-2014, and illustrates the precipitous and discontinuous decline in RALs for the 2011 filing season. Data on RALs and RACs are unavailable for 2012.

Figure 1: RAL Applicants by Year



The zip code level data were aggregated up to the county level using information provided by the Department of Housing and Urban Development. This was done so that my analysis could take into account information on population, racial demographics, and poverty and unemployment that is only available at the county level. Allocation of zip codes across county boundaries, where necessary, was done according to the share of residential addresses in each county. Estimates of local population demographics and poverty rates were obtained from the U.S. Census and employment data were taken from the Local Area Unemployment Statistics series generated by the Bureau of Labor Statistics.

B. Tax Preparer Data

I obtained data on the locations of the three largest national tax preparer chains from AggData LLC, which has collected location data from the websites of H&R Block, Jackson Hewitt, and Liberty Tax at least annually since January 2010. Individual tax preparation locations have detailed location information, include zip codes.⁹⁵ As discussed above, the

⁹⁵ In certain years, AggData collected location data more than once and when this was

three national chains differ in the degree to which they rely on revenues from financial products sold in connection with tax preparation. Figure 2 shows that in counties where Jackson Hewitt offices make up the majority of national chain preparer offices, the average share of taxpayers applying for a RAL was greater than in counties where H&R Block or Liberty Tax is dominant. Although the gap between counties where different preparers were dominant disappeared by 2013, there remained a one percentage point gap in 2011, reflecting the fact that Jackson Hewitt was able to secure limited RAL financing in that year.

Figure 2: RAL Applicants by Majority Tax Preparer

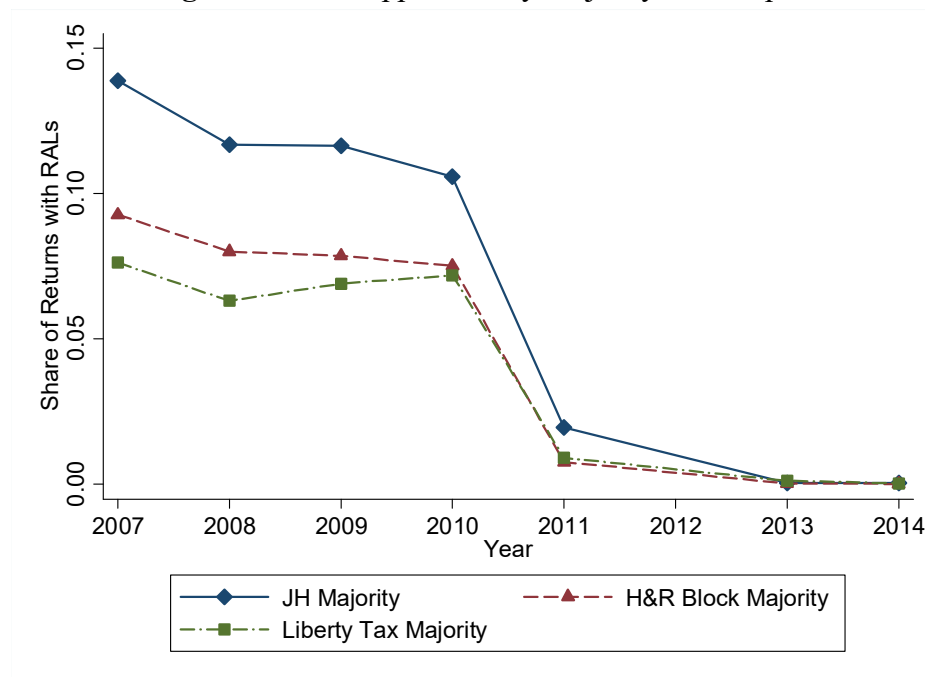


Table 1, in the Appendix, shows summary statistics for U.S. counties in 2009, the tax year generally corresponding to the 2010 filing season. Counties are divided into three groups (terciles), according to the percentage of taxpayers who applied for a RAL, and each row reports the average characteristic of counties in each group. Counties where RALs are more popular tend to have more EITC and child tax credit claims and a higher share of refunds. RAL use is associated with more RAC use and lower rates of self-preparation as well as higher rates of direct bank deposits for refunds and

the case I used the locations listed on the first collection date after January 1. For the two filing seasons that are the focus of this study, these dates are January 14, 2010 and January 20, 2011.

lower filing rates overall. Counties with high rates of RAL use also tend to be smaller and poorer, with higher unemployment rates and lower labor force participation, and with higher shares of black and Hispanic residents. Interestingly, high RAL-use counties tend to have more tax preparers despite being smaller than low RAL-use counties. Differences in the supply side of tax preparation services are also apparent. Jackson Hewitt is the dominant tax preparer in 20% of the high RAL-use counties, but it is the majority preparer in only 3.6% of the low RAL-use counties. Figures 3 and 4 shows the counties where RALs were common in 2010 and the very few counties in 2011 in which RALs were still available.

Figure 3: 2010 Refund Loans by County as Share of Returns

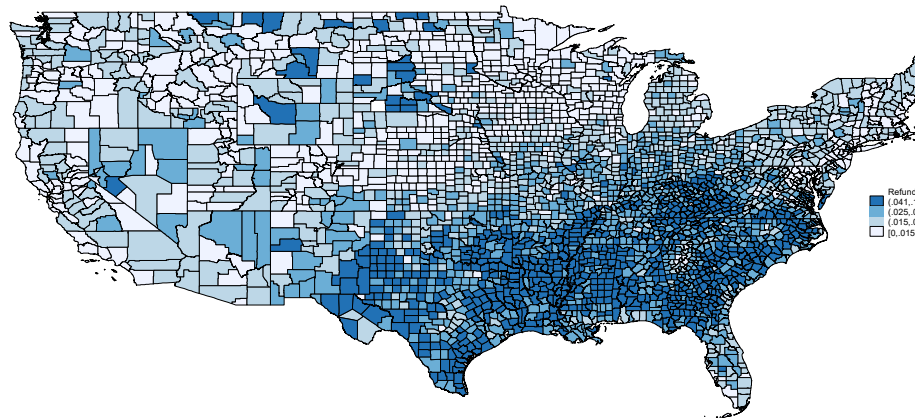
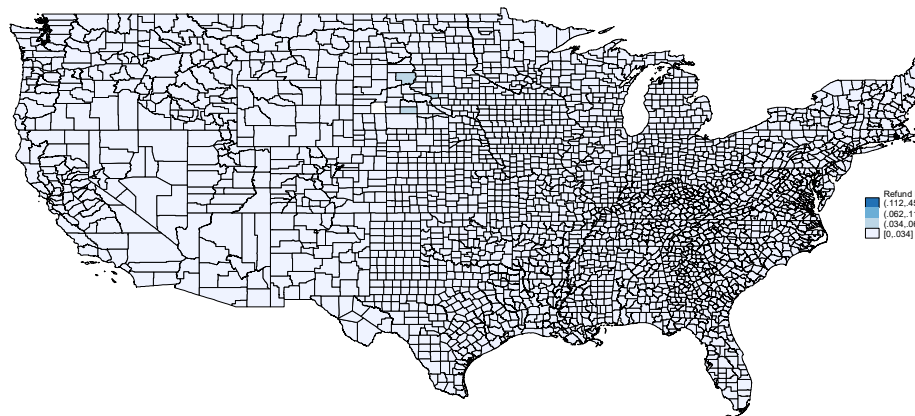


Figure 4: 2011 Refund Loans by County as Share of Returns



Thus, before 2011, RAL use was positively correlated with RAC use,

the number of EITC claims, and the share of tax return filings with less than \$30,000 in adjusted gross income, and it is negatively correlated with the share of returns that are self-prepared.⁹⁶ Of course, the strong correlation between the demand for RALs and RACs and the number of EITC claims and low-income taxpayers may be attributable to these taxpayers being severely credit constrained, present biased, or something else. Clearly, the mere correlation of these variables is not enough to conclude that RALs have a causal effect on RAC use, EITC take-up, or demand for paid tax preparation assistance.

Table 2 compares the counties that had RAL application rates of more than one percent in both 2010 and 2011 to show the effects of eliminating the debt indicator and the characteristics of counties in which RALs were still available after 2010. Recall that among the three national tax preparer chains Jackson Hewitt was the only one that was able to make RAL loans in 2011. The few counties in which RALs were still available are those where demand is likely the highest. These are smaller counties in which 29.8% of filers claim the EITC and 84% claim a refund. Unemployment and poverty rates are higher and residents of these counties have lower incomes and have more than twice as many black residents, on average, as counties with high RAL use in 2010. In 2011, Jackson Hewitt was the majority tax preparer in nearly 20% of the counties where RAL were still available and a dominant Jackson Hewitt presence in a county in 2010 made it more likely that RALs would be available in that county in 2011.

IV. ANALYSIS AND RESULTS

As discussed in Part III, refund loans correlate with a variety of economic and demographic factors that make it difficult to isolate the effect of RALs on EITC take-up. Fortunately, a regulatory change that took effect for the 2011 filing season provides just the kind of natural experiment that makes it possible to disentangle the effect of RALs from other factors driving the use of paid tax preparers and EITC claims. Before 2011, the IRS provided tax return preparers with a debt indicator that revealed whether a RAL applicant would have their refund garnished for back taxes, other government debts such as federally-funded student loans, and child support arrears. On August 5, 2010 the IRS announced that it would not provide tax preparers' partner financial institutions with the indicator for 2011.

This decision was the result of a process that began in January 2008, when the IRS issued a request for comments about whether it should limit the information it made available to lenders to facilitate the sale of certain

⁹⁶ These correlations are all statistically significant at conventional levels.

financial products. The IRS was specifically concerned about whether these products (the profitability of which depend on taxpayers' refunds) encouraged preparers to file false refund claims. The elimination of the debt indicator was a national policy change that affected all tax return preparers and financial institutions. However, the large variation across counties in the share of taxpayers using RALs means that the number of taxpayers affected by the change varied widely by county.

There were two other disruptions to the supply of RALs in 2011. In addition to the elimination of the debt indicator, JPMorgan Chase voluntarily stopped providing RAL financing for the numerous small tax preparers with which it had historically worked, and the Office of the Comptroller of the Currency (OCC) ordered HSBC, which provided the loans for H&R Block's clients, to stop making the loans as well. Jackson Hewitt's stock jumped 30% when news of the OCC's decision was released. Thus, in 2011, only three small banks stood ready to make RALs. Jackson Hewitt continued to offer RALs at only some locations, and the small preparers that had relied on JPMorgan, and H&R Block, which had worked with HSBC, were excluded from the market entirely.

A. Empirical Approach

I use the elimination of the debt indicator and the other disruptions to the supply of RALs in 2011 as a natural experiment to test the effect of RALs on the number of taxpayers who pay for tax preparation services, the number of EITC claimants, and the demand for RACs. Before 2011, the number of RALs varied considerably by county because of differences in the demographics of the local taxpayer population. In 2011, however, RALs were unavailable almost everywhere because of supply-side disruptions that took effect at a national level. My empirical approach exploits this national policy change by implementing what is known in the empirical legal studies literature as "difference-in-difference" research design. This approach compares the change in EITC claims from 2010 to 2011 (the first difference) between counties with high RAL use in 2010 and counties with low RAL use in 2010 (the second difference). If there is a larger decline in EITC claims in counties that had high RAL use in 2010 than the decline in counties that had low RAL use in 2010, then I attribute this to the elimination of the RAL market. The key empirical assumption in this approach is that the trends in my outcome of interest are not different for counties that had high RAL use before the debt indicator was eliminated. Figures 5a-5c provide evidence that this assumption is valid. The figures show the average value of the outcomes of interest for the years 2007-2011, for each of five groups of counties, broken up by the RAL use in those counties in 2010.

Figure 5a: RACs by Year and 2010 RAL Use

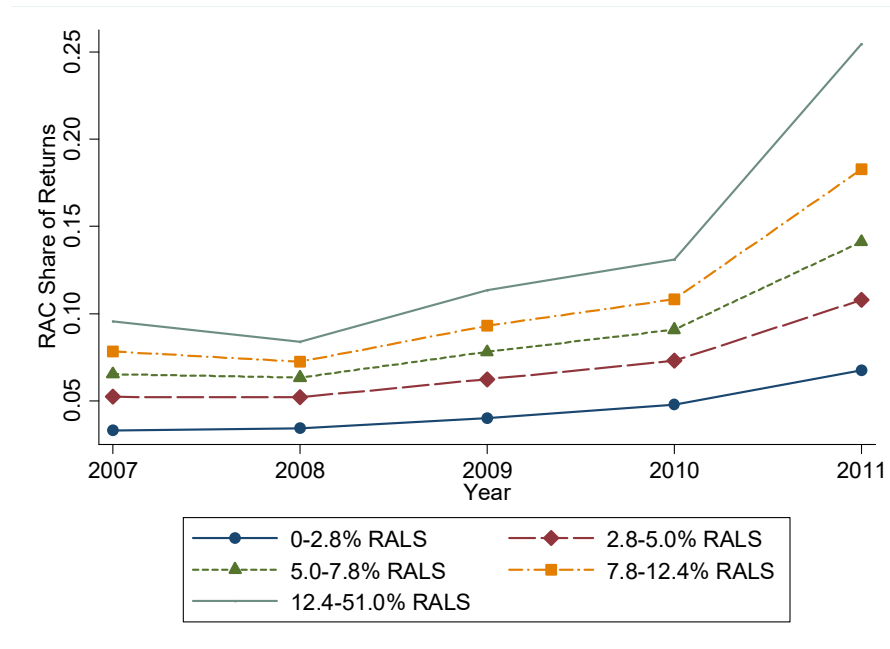


Figure 5b: EITC by Year and 2010 RAL Use

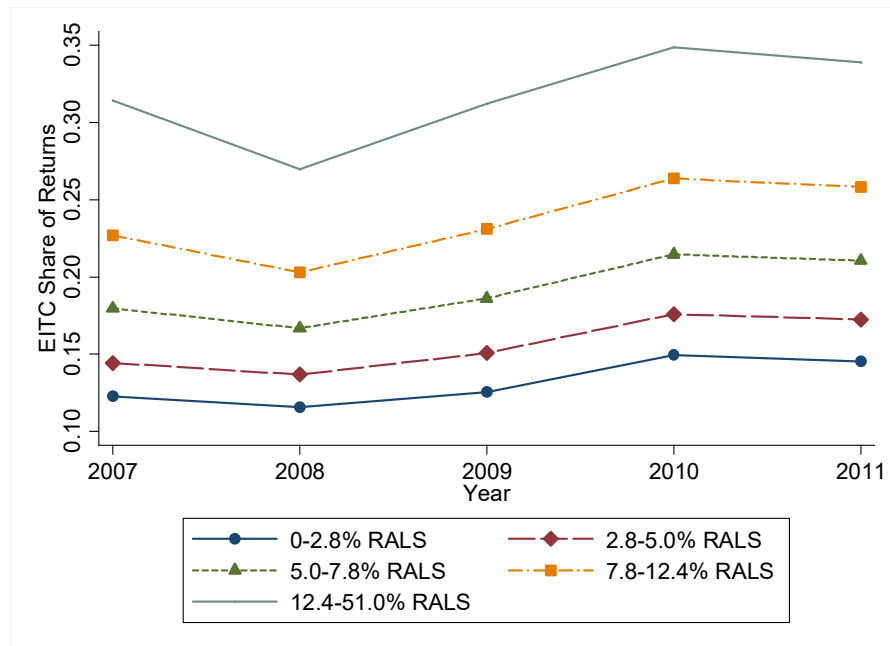


Figure 5c: Self-Prep by Year and 2010 RAL Use

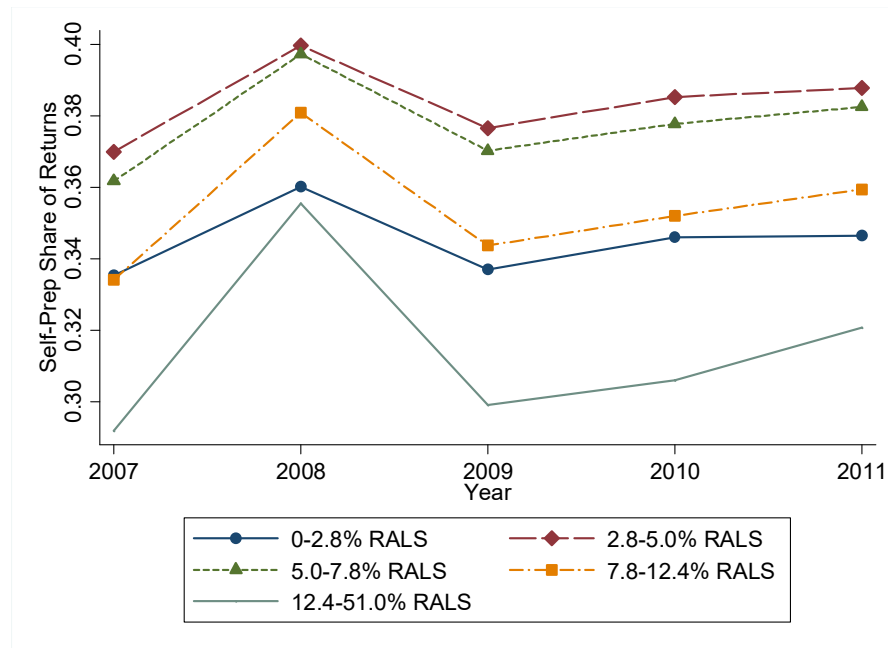


Figure 5a shows the trends in the share of RAC applicants by year for the years 2007-2010; the trends seem to be the same regardless of the popularity of RALs. However, there is a noticeable jump in the number of RAC applicants in 2011 for those counties with the most RALs in 2010. This is the first evidence that eliminating the RAL market caused taxpayers to substitute to RACs. Figure 5b shows that the pre-2011 trends of EITC claims track each other fairly closely. A close inspection suggests that the decline in EITC claims in 2011 may have been greater in counties with the most RALs in 2010, but the effect is much subtler than the effect on RACs. In 2011, EITC participation rates did drop in 39 states, an unusually large decline in participation compared with the declines in 2010 and 2012 of five states and eighteen states, respectively.

Figure 5c shows the trends in the share of self-prepared returns. The large jump in the number of self-prepared returns for 2008, particularly among the counties with the most RALs, is due to the 2008 federal tax stimulus payments which were only distributed to eligible taxpayers who filed a return for the 2007 tax year. This caused a large increase in the number of filers who were not otherwise obligated to file a return. Focusing on the change in number of self-filers from 2009-2010, the trends appear similar. However, in 2011 there was a general increase in the share of self-prepared returns across all counties, but the largest increase was concentrated in counties where at least 12.4% of filers had a RAL in 2010. Taken together, the visual evidence suggests that counties that had high rates of RAL use in 2010 were not trending differently in these key outcomes variables before the

elimination of the debt indicator.

B. Regressions

I test the effects of RALs by implementing the difference-in-difference empirical strategy through two different statistical regression models using county-level data.⁹⁷ In the first regression model I focus on the 2010 and 2011 tax years and test the effect of changes in RALs from 2010-2011 on changes in tax filing outcomes, such as EITC take-up, while controlling for demographic and local economic changes over the same period.⁹⁸

In my second regression model, I include the 2009 filing season as well as the 2010 and 2011 filings seasons.⁹⁹ I cannot also include the 2008 filing season because the surge of tax filings prompted by stimulus payments made in that year make the population of returns in that year incomparable to

⁹⁷ To test the robustness of my results I estimated regression equations similar to those reported here at the zip code level. Because of the greater number of zip codes, the hypothesis tests at this unit of analysis have much more power, but economic and demographic controls are not available. The estimates for the effect of RALs on RACs differ slightly in magnitude but corroborate the county-level estimates: declines in RALs caused a roughly 72% offsetting increase in RACs from 2010-2011, and the effects were stronger in areas where Jackson Hewitt or H&R Block was the dominant preparer. The zip code analysis also indicates that the decline in RALs caused taxpayers to shift toward self-preparation and that the effect was larger in zip codes where Jackson Hewitt or H&R Block was the majority preparer. The estimate for the effect of Liberty Tax as the majority preparer is of the same sign, but the scarcity of counties where Liberty Tax was dominant makes the estimate too imprecise to be statistically significant at conventional levels.

The estimated effect of RALs on EITC claims are of the same direction, and of similar magnitude, and are statistically significant at the zip code level. The estimates for the interaction terms indicate that the positive effect of RALs on EITC claims is larger in counties where Jackson Hewitt or H&R Block is the majority preparer, by 2.2 and 2.7 percentage points, respectively. Taken together with the effects on self-preparation, these results are consistent with the decline in EITC claims being concentrated in the population of taxpayers who shifted away from paid preparation assistance.

⁹⁸ Specifically, I model the change in the outcome of interest from 2010 to 2011 in each county c as a function of the change in RALs and change in economic and demographic characteristics X : $\Delta DV_c = \alpha + \beta \Delta RAL_c + \Gamma \Delta X_c + \epsilon_c$. Each variable in the estimating equation is the difference in the level value of the variable from 2010-2011. The variable ΔRAL_c is the change in the share of tax returns in county c for which a RAL was obtained and DV_c is either the change in number of RACs, self-prepared returns, or EITC claims as a share of all returns filed. The coefficient β is the parameter of interest, and the causal effect of RALs on the dependent variable under the assumptions of the model.

⁹⁹ In this case I estimate the equation $DV_{c,t} = \alpha + \gamma_c + \beta_1 POST + \beta_2 RAL_{2010} + \beta_3 POST \times RAL_{2010} + \Gamma X_{c,t} + \epsilon_{c,t}$. The variable $POST$ is a dummy variable for the year 2011 and RAL_{2010} is a continuous variable measuring the share of returns for which a RAL was obtained in 2010. β_3 is the parameter of interest in the model.

other years.

Although the overwhelming cause of the change in RALs in 2011 was the elimination of the debt indicator, which affected all counties and caused the almost complete disappearance of the RAL market, there remained a limited supply of RALs in some regions depending on the dominant tax return preparer in the area. H&R Block lost its financing partner in HSBC while Jackson Hewitt and Liberty Tax remained able to make limited RALs in some regions. For this reason, I also estimate the effect of RALs separately depending whether the dominant preparer was H&R Block, Liberty Tax, or Jackson Hewitt.¹⁰⁰

C. Results

Tables 3-5 show the parameter estimates for the effect of refund anticipation loans on refund checks, self-prepared returns, and EITC claims, respectively. Columns I and II of each table report the estimates for equations (1) and (2), and columns III and IV include estimates for the interaction terms of RALs with the majority tax preparer in each county. Coefficient estimates for the demographic and economic controls and number of returns filed are omitted, but I summarize those estimates in the text. Equation (2) was estimated using a quadratic year trend. The results suggest that, when RALs were eliminated, roughly 80% of RAL applicants switched to RACs, 10% of taxpayers switched to self-preparation, and 5% stopped claiming the EITC.

1. The Effect of RALs on RACs

Table 3 reports estimates of the effect of RALs on RACs. The estimate on ΔRAL in column I is the primary number of interest; a one percentage point decline in RAL use caused a 0.8 percentage point increase in RAC use in 2011, on average. This estimate is virtually the same when I estimate the second regression model described above. For this second model, the estimate of interest is in the row labeled “Post10#RAL10.” In column II, this number indicates that every one percentage point increase in RAL use in 2010 within a county is associated with 0.8 percentage point increase in RAC use in 2011. Columns III and IV show estimates of how the effect of RALs differs according to the dominant tax preparation firm in the county (*i.e.*, the firm, if any, with more than half of the offices in the county attributable to the three national chains).

The coefficients of these effects reveal that the substitution from RALs to RACs was stronger in counties where Jackson Hewitt or H&R Block

¹⁰⁰ Specifically, I interact the RAL variable with categorical variables indicating whether one of the three preparers was the majority preparer in the county.

was the dominant tax return preparer as compared with counties where there was no dominant preparer. It is possible that Jackson Hewitt and H&R Block marketed RACs more aggressively than other preparers or that they had relationships with banks that made them better able to offer this product than smaller preparers whose relationships with the banks were limited to the refund loan market. On the other hand, in counties where Liberty Tax was the dominant preparer, there was significantly less substitution to RACs. I cannot tell using these data whether this is due to differences in changes in demand for RACs relative to RALs in Liberty Tax counties, or differences in Liberty Tax's business practices.

The estimated relationships between RAC use and demographic and economic factors are generally consistent with the summary statistics. RACs are more common in counties with higher shares of black and Hispanic residents, and are increasing in measures of economic hardship such as the unemployment rate and decreasing in median income.

2. The Effect of RALs on Demand for Paid Preparers

Table 4 reports the estimates for the effects of RALs on the share of filers who prepare those returns themselves, rather than through a paid preparer. The coefficient of -0.101 in column I corresponds to a 0.1 percentage point increase in the share of returns that are self-prepared for every percentage point decrease in the share of filers obtaining a RAL.

The estimate this effect varies somewhat across the different regression models represented in Table 4, between 0.088 and 0.131, but the estimates are all statistically significant, meaning that the estimated relationship between RALs and the use of paid preparers is very unlikely to have arisen by chance. If we interpret these estimates together with the estimated effect of RALs on RAC demand, this suggests that more than 90 percent of the taxpayers who took out RALs in 2010 switched to RACs or abandoned tax preparation the following years when RALs were no longer available. There is no strong evidence that the effect of the RALs on demand for paid preparation services differs depending on the majority tax preparer in the county.

3. The Effect of RALs on EITC Claims

RALs provide an inducement for taxpayers to use a paid preparer, and they also provide the preparer with an incentive to claim the refundable EITC on the taxpayer's behalf. Thus, eliminating RALs could reduce the number of EITC claims either because taxpayers who prepare their own returns are less likely to claim the EITC than ones who go to a paid preparer, or because

paid preparers are less motivated to seek an EITC refund for the taxpayer.

Table 5 reports estimates of the effect of RALs on the share of returns for which the earned income tax credit was claimed. In column I, I report that the effect of a one percentage point decline in RALs as a share of returns filed is a roughly 0.05 percentage point decline in EITC claims. In column II, I report the estimates from my second regression model, which includes a longer time period before 2011. The estimated effect is 0.016 percentage points. The difference in these estimates is likely because the underlying trends in EITC claims in the period before 2011 are not perfectly parallel; they differ a little depending on the use of RALs in 2010. Although this means that the assumption for the difference-in-difference approach does not hold perfectly, in fact, EITC claims were increasing at a slightly *faster* rate in counties with higher level rates of RAL use in 2010. This has the effect of biasing the estimated effect of RALs of EITC take-up towards 0, suggesting that the true effect of eliminating RALs is actually likely larger than 0.05.

The data do not permit me to identify whether the decline in EITC claims is attributable to taxpayers who began to prepare their own returns and failed to complete the EIC schedule, or those who continued to use a paid preparer. If one assumes that the decline in EITC take-up is concentrated among those who shifted to self-preparation, the estimates suggest that taxpayers are 50% less likely to claim the EITC as a result of self-preparation than with the use of a paid preparer.¹⁰¹ This is in line with prior research. Recall that the IRS audit described in Part II found a 10 percentage point reduction in EITC claims for those who decide to preparer their own return. As with the self-preparation estimates, there is no strong evidence that the effect of RALs on EITC claims varies with the identity of the preparer in the county. This is expected if the decline is concentrated among non-filers.

V. CASE STUDY DISCUSSION

Until 2011, most taxpayers had five mutually exclusive options: use a paid preparer and get a RAL, use a paid preparer and get a RAC, use a paid preparer and get neither, file a return without assistance, or don't file a return. Eliminating RALs necessarily increases the number of taxpayers who choose the latter four options, but it is hard to know *a priori* which of those remaining options will be most appealing to the taxpayer who formerly used refunds loans. The answer depends on the perceived costs and benefits of each option, and there is reason to expect that RAL users would switch to RACs or forego paid preparation altogether.

¹⁰¹ To the extent that the decline in EITC claims is associated with taxpayers who continued to use a paid preparer, 50 percent is an overestimate of the effect of self-preparation on EITC take-up.

The benefits of both RACs and RALs are the earlier receipt of tax refunds, and the costs are the out-of-pocket fees. All costs and benefits of a RAL are experienced immediately; a taxpayer receives her refund, net of fees, generally within a day of filing her taxes. If the taxpayer gets a RAC, the out-of-pocket cost of tax preparation is deferred (along with the RAC fees) until the refund is deposited into the checking account set up on the taxpayer's behalf by the preparer. If the taxpayer pays for tax preparation without a RAL or RAC, she must pay that cost at the time of filing but will not receive her refund for another two or three weeks, depending on whether she has a bank account into which her refund can be directly deposited. Finally, if she prepares her return herself, she will receive the maximum possible refund (net of fees), but she must incur the immediate time and hassle cost of preparing her own return and the timing of her refund will depend on her banking status and method of filing. For example, if the taxpayer does not have ready access to online filing, she must file a paper return, which will delay her refund by an additional three weeks. Thus, the benefits of going to a paid preparer include not just the avoided time and hassle costs of self-preparation, but also the benefits of electronic filing for those taxpayers who would otherwise file paper returns. In 2010, 47 percent of tax returns were still filed on paper.

While the RAL generally provides only a current net benefit (the refund, net of the cost of the loan and the cost of tax preparation), and the RAC provides only a future net benefit, the other two filing options offer the combination of a current cost (either the time spent preparing one's return or the out-of-pocket cost of paid preparation) and a larger future benefit. The sequence of costs and benefits implicates the time preferences of the taxpayer. A taxpayer will choose a RAL or RAC if she has a high discount rate for future benefits.

Consider the following example of the taxpayer's choice. Assume that the taxpayer is entitled to a \$2,000 refund and that the price of tax preparation is \$150, the price of a RAL is \$100 and the price of a RAC is \$30. With either a RAL or a RAC the refund will be deposited by the Treasury one week from filing, but with a RAL the funds are advanced to the taxpayer immediately. Therefore, a taxpayer will prefer a RAL to a RAC only if she prefers \$1,750 today to \$1,820 in one week. This is a high rate of discounting. On an annualized basis, the taxpayer's time preferences become stark: she will be indifferent between \$2,000 in one year and \$260 today.¹⁰² A taxpayer with such preferences who is already banked and has access to e-filing will prefer a RAL to self-preparation if the hassle costs of self-preparation are at least

¹⁰² The discount rate that makes someone indifferent between \$1,820 in a week and \$1,750 now is 4%. The present value of \$2,000 at this rate is $\frac{\$2,000}{1.04^{52}} = \260 .

\$173.¹⁰³ If she is unbanked and must file by paper, then she will need to wait four weeks to get her refund and in that case she will always prefer a RAL to self-preparation.¹⁰⁴ Since taxpayers who prefer RALs tend to discount the future relatively heavily, when RALs are eliminated they will tend to choose RACs, because self-preparation and paid preparation both require paying immediate costs (in time and hassle or in cash) in exchange for future benefits. This is consistent with the high degree of substitution from RALs to RACs that we observe in the data.

From a welfare perspective, removing any filing option, such as filing with the aid of a RAL, can only make rational individuals who would have chosen that option worse off.¹⁰⁵ Arguments against RALs tend to suggest that consumers are making a mistake in purchasing them, and that the products are exploiting some sort of cognitive error or bias, although these arguments tend not to be explicit about the nature of that bias. One natural candidate explanation for RAL demand that might justify intervention in the market is if taxpayers are present-biased and credit constrained. The behavioral and welfare effects of eliminating the RAL market depend on the preferences of the taxpayers. Eliminating RALs would be expected to cause both rational and present-biased taxpayers to switch to RACs and some biased individuals to switch to self-preparation, with positive welfare effects for biased individuals who should optimally have either a RAC or only tax preparation services, and negative effects for some biased individuals who should be preparing their own return and for rational taxpayers. Accounting for the net effect of eliminating RALs would require identifying the proportion of taxpayers of each type in the filing population which I cannot do with my data, but which is worthy of further study.

Although I have focused on the effects of RALs on present biased individuals, there are salutary effects of encouraging even non-present biased individuals to obtain tax preparation assistance. My results are consistent with arguments made by Jacob Goldin, who argues that “efforts to increase EITC take-up should focus on inducing EITC-eligible individuals to file a tax return using an APM [assisted preparation method].”¹⁰⁶ APMs assists

¹⁰³ The present value of \$2,000 received in one week is $\frac{\$2,000}{1.04} = \$1,923$ and the value of the RAL option is \$1,750. The difference is \$173.

¹⁰⁴ The present value of \$2,000 received in four weeks is $\frac{\$2,000}{1.04^4} = \$1,710$ which is less than the value of the RAL option.

¹⁰⁵ Moreover, the near-disappearance of most of the RAL market in 2011 coincided with a 50% increase in the cost of RALs for those taxpayers who were still able to obtain one from Republic Bank, creating a negative price externality for those taxpayers.

¹⁰⁶ Jacob Goldin, *Tax Benefit Complexity and Take-up: Lessons from the Earned Income Tax Credit* 27-34 (Stan. L. & Econ. Olin Working Paper No. 514, 2018), https://papers.ssrn.com/sol3/papers.cfm?abs tract_id=3101160.

taxpayers with the with computational complexity of preparing a return, which he argues is an important reason for the low takeup of certain tax benefits. If he is correct that “efforts to increase the EITC take-up rate should primarily focus on getting EITC-eligible non-filers to file their return,”¹⁰⁷ then the vitality of the RAL and RAC market may have an important role to play even if computational complexity, rather than present-bias, is the dominant reason for low EITC take-up.

The discussion thus far has assumed that the primary concern with the delivery of social benefits, and the EITC in particular, is low take-up. Of course, if the overarching policy goal is the delivery social benefits to those who are entitled to them, there is a converse problem of individuals who are not entitled to benefits fraudulently claiming them. It is also clear that this concern about fraudulent claims was part of the motivation for the IRS’s elimination of the debt indicator.¹⁰⁸ Reducing the strong incentives that tax preparers had to file earned income tax credit claims on behalf of their clients was expected to reduce the number fraudulent claims. It seems likely that the elimination of the refund loan market had both effects: reducing the number of meritorious claims as well as reducing the number of fraudulent claims. I cannot distinguish these in the data. The relative importance of these two kinds of errors is a political judgment, which the federal system has frequently resolved in favor of reducing fraudulent claims at the expense of meritorious ones. In light of the problem of fraudulent claims, perhaps there is another way to increase take-up without also providing preparers with a strong incentive to lure (or manufacture) EITC claimants. In the remainder of this part I briefly discuss several interventions that might both increase take-up and reduce the costs incurred by present biased taxpayers in claiming the EITC.

A. Free Tax Preparation

The Internal Revenue Service already makes available free tax preparation service through its Vita program. Free tax preparation services are available for people who make \$54,000 or less, persons with disabilities, and taxpayers with limited English-language fluency.¹⁰⁹ However, Vita tax

¹⁰⁷ Id.

¹⁰⁸ The earned income tax credit schedule that must be completed by taxpayers is notoriously burdensome, with the stated justification being that detailed disclosures are necessary in order to reduce rampant the ITC fraud. See, e.g., STEVE HOLT, AM. ENTER. INST., *THE ROLE OF THE IRS AS A SOCIAL BENEFIT ADMINISTRATOR* (2016), <https://www.aei.org/wp-content/uploads/2016/07/The-Role-of-the-IRS.pdf>; Gabe Rubin, *EITC Fraud Is a Matter of Debate*, MORNING CONSULT, Jan. 20, 2016, <https://morningconsult.com/2016/01/eitc-fraud-is-a-matter-of-debate/>.

¹⁰⁹ *Free Tax Return Preparation for Qualifying Taxpayers*, INTERNAL REVENUE

preparation serves only about 3.5 million taxpayers each year,¹¹⁰ or less than four percent of eligible taxpayers.¹¹¹ The availability of free tax preparation has only declined over time.

A renewed commitment to increasing the availability of free tax preparation assistance would almost certainly increase the filing rate and, in all likelihood, the take-up rate of the earned income tax credit. However, even if taxpayers do not need to pay anything out-of-pocket for tax preparation assistance, there is still the burden of collecting relevant information, and finding time to sit down with a Vita preparer. These costs are borne immediately but the benefits associated with a tax refund are not received until a future date. Thus, even free preparation will not be very effective at attracting present-biased taxpayers. Moreover, unless free tax preparation is coupled with access to a checking account or other method that helps expedite the receipt of the refund, free tax preparation may look less attractive than even paid preparers. Of course, the costs of increasing free tax preparation services must be compared against the costs of alternative solutions, including the status quo with its large role for private tax preparation. It is far from clear that the wider availability of free tax preparation assistance would be more effective at encouraging tax filing and EITC claims by present-biased taxpayers than the current state of affairs, in which, tax preparation is costly, but the benefits of the tax refund are immediate.

B. Simplification

Another way to encourage tax filing and EITC take-up would be to simplify the process of completing a tax return and completing schedule EIC, including the important determination of whether the applicant has a “qualifying child.” Low income taxpayers cite anxiety about the complexity of filing a return as one of the reasons for seeking paid preparation assistance, and the reason that they are discouraged from preparing their own returns.¹¹² Thus, simplification may lead to more self-prepared returns and perhaps more EITC claimants among those who prepare their own returns.

SERVICE, <https://www.irs.gov/individuals/free-tax-return-preparation-for-you-by-volunteers> (last updated June 5, 2018).

¹¹⁰ TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, RESULTS OF THE 2018 FILING SEASON 30 (Dec. 19, 2018).

¹¹¹ INTERNAL REVENUE SERVICE, STATISTICS OF INCOME: INDIVIDUAL INCOME TAX RETURNS COMPLETE REPORT 2016, at 25 (2018) (reporting that more than 91 million returns were filed in 2016 with adjusted gross income under \$50,000).

¹¹² ALAN BERUBE ET AL., THE PRICE OF PAYING TAXES: HOW TAX PREPARATION AND REFUND LOAN FEES ERODE THE BENEFITS OF THE EITC (Brookings Institution Center on Urban & Metropolitan Policy, May 2002), <https://www.brookings.edu/research/the-price-of-paying-taxes-how-tax-preparation-and-refund-loan-fees-erode-the-benefits-of-the-eitc/>.

Simplification (particularly of the tax law) always sounds good in the abstract. Of course, complexity is sometime necessary to tailor the law to its intended purposes. For example, one could imagine providing a refundable tax credit of a specified amount to everyone who earns any wages at all in a given year. This would be a very simple alternative to the EITC, but it would not be well targeted to those who may need it most, such as single-parent households and those with modest incomes. As the underlying normative criteria for providing benefits become more complicated, so does the law. It is plausible that simplification of the EIC schedule would lead to greater error rates in the distribution of the EITC credit or increases in the rate of fraud. For these sorts of reasons, the optimal amount of legal complexity is not generally the minimal amount of complexity.¹¹³

Even if the tax filing and EITC application process can be simplified without introducing much error or fraud, this is only likely to go so far, particularly for present-biased individuals. The fundamental temporal ordering of costs and benefits that play such an outsize role for biased taxpayers is unchanged. So long as the benefits of filing a return are deferred for a period of weeks, the cost-benefit calculus will still be relatively unattractive.

C. Advance EITC

If filing a return and completing the burdensome EIC schedule is a significant barrier for present-biased individuals to claim the earned income tax credit, one possible remedy is to advance those individuals an estimated portion of their EITC credit at regular intervals through the year, in installments. Economically, receiving the earned income tax credit refund over the course of the year increases the present value of those payments (although only very modestly), but more importantly it provides EITC-recipient households, which are typically very credit constrained, with liquidity when they need it.¹¹⁴

Nevertheless, the advance EIC program has historically been extremely unpopular, with many low-income taxpayers refusing to enroll in the program. Government agencies have struggled to explain low take-up of the advance EIC program,¹¹⁵ and interventions designed to reduce the

¹¹³ See Louis Kaplow, *A Model of the Optimal Complexity of Legal Rules*, 11 J.L. ECON. & ORG. 150 (1995)

¹¹⁴ Nicholas S. Souleles, *The Response of Household Consumption to Income Tax Refunds*, 89 AM. ECON. REV. 947 (1999); Lisa Barrow & Leslie McGranahan, *The Effects of the Earned Income Credit on the Seasonality of Household Expenditures*, 53 NAT. TAX J. 1211 (2000).

¹¹⁵ United States Government General Accounting Office (GAO). 1992. Earned Income Tax Credit: Advance Payment option is not Widely Known or understood by the Public.

information, administrative and stigma costs of the advance EIC have had only modest effects on a very low level of overall take-up, increasing participation from 0.35 to 1.2%.¹¹⁶ When asked, taxpayers have often expressed concern that they might have overestimated their eligibility and therefore be obligated to repay the excess when they file their tax return.¹¹⁷

Moreover, the modest increase in the present value and acceleration of the timing of the receipt of earned income tax credit benefits is unlikely to be very attractive to present-biased taxpayers. The key distinction for present-biased individuals is the difference between now and later. The difference between later and a little bit later still does not loom nearly as large, and so these timing benefits are unlikely to increase EITC take-up overall. Changing the timing of EITC benefits seems unlikely to have much of an effect on take-up.

D. A Public Option

If interventions to lower the upfront cost of tax preparation will have only have modest effects for present-biased taxpayers, we must consider ways to accelerate the benefits of filing, to replicate the temporal pattern that has so successfully been made available through refund anticipation loans. A natural option is to couple greater access to Vita tax preparation with government funded refund anticipation loans. The federal government has already shown its willingness to extend credit to such taxpayers through its experiment with the advance earned income tax credit, and there is much less risk in extending this credit at the time of filing because the taxpayer's eligibility can be determined with a high degree of certainty at that time.

One advantage of having the federal government, rather than the market, provide refund loans is related to the different incentives facing the government when originating these loans. Whereas for-profit preparers have an incentive to file returns that claim EITC refunds even if those claims may not be meritorious, in order to pay for the high-priced anticipation loans, a government lender presumably would not have those same incentives. Thus, providing government funded refund anticipation loans may induce higher rates of take-up without also encouraging fraudulent filings.

On the other hand, the strong incentives for tax preparers to submit

Report to Congressional Committees, GAO/GGD-92-26. Washington, DC, February.

¹¹⁶ Damon Jones, *Information, Preferences, and Public Benefit Participation: Experimental Evidence from the Advance EITC and 401 (k) Savings*, 2 AM. ECON. J. APPLIED ECON. 147 (2010).

¹¹⁷ Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533, 582 (1995); U.S. GEN. ACCT. OFF., GAO/GGD-92-26, EARNED INCOME TAX CREDIT: ADVANCE PAYMENT OPTION IS NOT WIDELY KNOWN OR UNDERSTOOD BY THE PUBLIC (1992).

returns claiming refunds of federal income tax have benefits as well. These incentives may make it less likely that they will overlook deductions or other features of the taxpayers' circumstances that entitle them to the EITC. A government loan originator will not have those same incentives, and therefore may be less likely to increase EITC take-up. Moreover, the partnerships between some of the large national tax preparation chains and their financing partners may work very efficiently at delivering refund loans, due to fierce competition within this industry. It is far from clear that the government could provide the financial infrastructure necessary to deliver refund anticipation loans at lower cost than the private sector. An overall cost/benefit assessment of a public option is beyond the scope of this paper, but if a significant number of EITC claimants are present-biased, then it seems likely that ensuring a high degree of EITC take-up will require either providing such an option or tolerating a private market for these loans.

VI. EXPLOITING FINANCIAL INTERMEDIARIES

As the case of refund anticipation loans illustrates, the policy evaluation of even unambiguously exploitative financial transactions can be more nuanced than it first appears. We must determine what the debt is being used *for* to determine whether the borrower would be better off without the loan. The brief discussion of a public option for RALs in the previous section suggests that the profits of financial intermediaries shouldn't be understood as a uniquely pernicious leak in the delivery of those benefits, but instead should be viewed as one expression of the costs of delivery and not necessarily the most expensive one. Moreover, these costs are symptomatic of a system of taxes and transfers that is too burdensome for individuals to navigate themselves.

Identifying the least cost mechanism for delivering benefits such as the earned income tax credit requires interrogating all aspects of the delivery process. The demand for refund anticipation loans and other high-price credit products arise from households' circumstances, psychology, and the institutionalized system of taxes and transfers. The best solution is likely to involve reducing this demand for RALs by providing more efficient EITC delivery mechanisms rather than driving up the costs of RAL supply through regulation or prohibition. A thorough cost-benefit analysis of financial products like RALs must therefore be based explicitly on the reasons that buyers have for using these products and whether they are behaving rationally but out of a financial distress, or instead acting in ways that are against their own interests. It must also analyze high-price consumer credit in context, both the context of the borrower's economic affairs and in the context of market for goods and services or social transfers that are financed. In this

Part, I describe how such an analysis can proceed.

A. Getting Borrower Psychology Right

The first step to less myopic regulation of consumer debt is to get the borrower's psychology right. From one perspective, RALs and RACs are exploitative of taxpayers' financial circumstances. That is, taxpayers may be better off with a RAL or RAC than without one, but the price that they pay for these products is too high and they are not made as well off as they should. The right solution, on this account, is simply to lower prices and increase the gains from the transaction that accrue to the borrowers. In general, market competition may be the best way to achieve this goal, as competition tends to drive the costs of a financial product down to the lender's costs and eliminate inefficiencies in contractual terms.¹¹⁸

The mere fact that RALs and RACs are costly does not mean that these products are not worth the cost, either to borrowers or to the system of federal taxes and transfers as a whole. Some advocacy groups argue that RAL and RAC fees siphon federal transfers away from their intended beneficiaries. This is true, in a sense, but the important question is whether these costs are smaller than the costs of the alternatives, and whether those alternatives will generate comparable rates of take-up. In addition to overcoming the temporal pattern of immediate costs and future benefits associated with filing a tax return, RALs have the added benefit of encouraging the use of professional tax preparers, which can help taxpayers navigate the complexity of filing a federal tax return. Filing a tax return and completing the EITC schedule is both complex and daunting for many low-income households, such that that may not do so unless they have tax preparation assistance.¹¹⁹ If taxpayers are rational then the monetary cost of tax preparation is less than the cost of preparing their own returns. In these cases we should accept, if not celebrate, financial market participants that reduce the economic costs of delivering

¹¹⁸ The more competitive is the market for tax preparation services the more the cost of tax preparation is an underestimate of the cost individuals preparing their own returns. Monopolists, and firms that are able to price discriminate may be able to extract more consumer surplus, in which case being deprived of the good will not make consumers as worse off as in a perfectly competitive market, where consumer surplus is maximized. Nevertheless, there is also evidence that supply-side competition may not have these effects when consumers are biased. Paul Heidhues & Botond Köszegi, *Exploiting Naivete About Self-Control in the Credit Market*, 100 AM. ECON. REV. 2279 (2010); Ioana Chioveanu & Jidong Zhou, *Price Competition with Consumer Confusion*, 59 MGMT. SCI. 2450 (2013); Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121 Q. J. ECON. 505 (2006).

¹¹⁹ Goldin, *supra* note 103; Leslie Book, David Williams & Krista Holub, *Insights from Behavioral Economics Can Improve Administration of the EITC*, 37 VA. TAX REV. 177, 188 (2018).

social benefits to rational taxpayers, even if they charge fees for doing so. At the same time, the fees that preparers charge should be a signal to us of the magnitude of the complexity and other costs that make self-preparation unpleasant for so many households.

If taxpayers cannot be trusted to make rational borrowing decision then, of course, our cost-benefit analysis must change. One possibility is that taxpayers use paid preparers because they are mistaken about how difficult it would be to prepare their own returns. In that case, it might be best to nudge them or even coerce them into preparing their own returns since it would be in their own best interest. It is worth noting that no one seems to endorse these sorts of radical interventions. We do not question the judgment of individuals who decide that they would rather pay cash to avoid the time and anxiety of preparing their own tax return and get expert advice about how to do so. And yet we do question the rationality of individuals who purchase high-priced credit products including RALs and RACs, even though there are good reasons even for rational individuals to take out a RAL or a RAC, including allowing the taxpayer to borrow the cost of tax preparation. Very low-income taxpayers may lack the cash on hand to pay for tax preparation assistance. For such individuals, eliminating the availability of RACs and RALs could make it impossible for them to get that help.

The possibility I explore in this article is that RALs and RACs exploit present bias. Even in this case, these products may make those biased individuals better off. Assertions to the contrary typically rests on the unstated assumption that biased individuals who could not obtain a RAL would pay for tax preparation services out of pocket and receive their refund in full when it is distributed by the Treasury department. However, as I have argued, without the temptation of a RAL or RAC to induce them to file a return with a paid preparer the taxpayer would face the choice between paying for a paid preparer out of pocket, diligently preparing her own return, or preparing her own return in a cursory way or not filing at all. If the taxpayer chooses one of the latter two options, she might not do the paperwork necessary to claim the EITC.

Thus, against the backdrop of imperfect rationality, and the possibility that the taxpayer might not claim the EITC because the burden of doing so is immediate while the benefits are in the future, perhaps RALs and RACs are not so bad after all. From this perspective, the usefulness of RALs and RACs could be viewed as an illustration of the counterintuitive logic of the second-best.¹²⁰ The key intuition from this line of research is that remedying individual defects in the conditions that are necessary to achieve the *best* outcome may not make for a *better* outcome.

¹²⁰ Lipsey & Lancaster, *supra* note 6.

For example, suppose that steel manufacturing is characterized by monopoly, and that the harmful emissions of the production process impose an externality on the surrounding neighbors. The best outcome might be one in which steel production has many competitive suppliers and the emissions are subject to a tax that aligns private incentives with the public interest. However, fixing only one of these problems could make things worse overall. An antitrust action that leads to greater competition among steel manufacturers would result in lower prices and greater output, but it will also exacerbate the emission problem because of the increased production. The net effect of an improvement in the supply of steel and a worsening of the pollution cannot be determined in the abstract, and must be evaluated on a case by case basis. Similarly, the best outcome for a present biased individual who uses RALs may be to use a paid preparer and not purchase any financial products, but removing the option of taking out a RAL may exacerbate the adverse effects of her present bias and cause her not to obtain a refund at all.¹²¹ Since policy changes typically happen in a piecemeal fashion, it is crucial to understand the particular biases that can lead to poor borrowing choices so that we can anticipate what will taxpayers will do if those choices are limited.

B. Credit Contextualization in Two Steps

Developing consumer law that operates in the interests of consumers requires opening the lens through which we evaluate financial transactions to view those transactions in the context of how they fit into consumers economics affairs. It also means viewing these transactions in the context of the economic ecosystem that creates the demand for them. I suggest in this section that a more thoroughgoing evaluation of consumer products with apparently exploitative features should proceed in two steps. The theme of this two-part analysis is that once we are committed to a model that explains why a product should be regulated or prohibited because it exploits consumers' inability to make decisions that are in their best interest, we must

¹²¹ An important distinction that is made in the behavioral economics literature which I do not discuss here is between naïve and sophisticated individuals with present bias. Sophisticates know that they are biased while naïfs do not. Sophisticates are able to anticipate what they will do if they are put in situations where they are tempted, and can take actions that prevent that from happening. Most famously, Ulysses tied himself to the mast knowing he would be unable to resist the siren song. HOMER, THE ODYSSEY 306-07 (Emily Wilson trans., W. W. Norton & Co. 2018). Thus, there is a market for goods and services that help individuals overcome their biases. Refund anticipation loans are not marketed on this basis, but they have salutary effects on severely present biased individuals. What is noteworthy, is that they benefit both sophisticates (who know they need the temptation of a RAL to obtain an EITC refund) and naïfs (who do not).

carry over that same model of consumer behavior to the other decisions that they make in thinking about how prohibiting that product will affect them.

The first step simply is to be explicit about identifying the model of consumer decision making that we think generates demand for the product in question. When consumers are acting rationally, there should be a high bar for justifying the regulation of the substantive terms of the product or service. If buyer and seller are rational, then the exchange leaves both of them better off than they were before. Although we might consider regulating the terms of trade in order to affect redistribution between the buyer and the seller, there are compelling arguments that redistribution is best handled through the tax system.¹²² Even where redistribution provides a partial justification for regulating the substantive terms of trade, regulators must also be wary that this shift does not cause the market for such goods or services to contract or disappear.

However, when consumers are operating subject to some sort of bias or error, it is possible that they will make purchasing decisions that are not in fact in their best interest. Here, we must be explicit about exactly what sort of error or bias afflicts the consumer in order to understand what led them to desire a product that was bad for them to begin with. For then we must ask what *that type* of consumer will do without the prohibited product. For example, consider an individual subject to present bias. Such a consumer may be inclined to take out loans at very high rates of interest that she will subsequently regret, because she cannot resist the temptation of spending now and paying back later. This model of consumer behavior predicts a very particular pattern of choices but does not imply that our consumer is irrational in all respects. For example, if our consumer were choosing between two credit cards with identical terms except that one had an annualized interest rate of 200% and the other had an annualized interest rate of 250%, there is no reason to think that such a consumer would choose the one with the higher rate. Her bias is between current and future consumption only.

What then would we expect such a consumer to do if we banned the credit card with the 200% annualized rate of interest? If our present bias is strong enough, we would expect her to switch to the credit card with the higher rate of interest. We would not expect her to switch her psychology and suddenly become patient simply because the first credit card was no longer available. This seems obvious; however, the point is easily neglected if one

¹²² Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994); Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor?: Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEGAL STUD. 821 (2000); Louis Kaplow, *Taxation and Redistribution: Some Clarifications*, 60 TAX L. REV. 57 (2007). But see Zachary Liscow, *Is Efficiency Biased?*, 85 U. CHI. L. REV. 1649 (2018).

adopts a piecemeal approach to exploitative financial products, identifying exploitative products and prohibiting them without considering what will happen in their absence. Scholars have observed that when certain high-interest credit options are heavily regulated, consumer switch to other, costlier alternatives.¹²³

This step of the analysis also requires thinking not just about how behaviorally biased consumers will substitute across products and services at a given point in time, but also how putatively exploitative products and services are connected with downstream decisions. This is illustrated by the case of refund anticipation loans. If the only individuals who take refund anticipation loans are those who exhibit present bias, then we must ask how those present-biased individuals will make decisions about tax return filing in the absence of a refund loan inducement. My study indicates that decisions about paid preparation are sensitive to the availability of refund anticipation loans and refund checks. If the failure to use a paid preparer would be against the present-biased consumers' interests, then we must ask whether such consumers are better off preparing the returns themselves or using paid preparers at a relatively high cost. Of course, all of this complicates the regulatory analysis significantly. Goods and services, including goods and services purchased by biased consumers, have substitutes and complements. Regulating the terms or prohibiting the availability of a good or service will have a collection of collateral effects on those substitutes and complements some of which may be good for the consumer and some of which may not.

The second step is to place the product not in the context of the consumer's own financial affairs and in light of their individual biases, but in the context of the broader economic and legal system in which demand for the product arose and the pathologies of that system. Doing this allows us to ask what demand for this product tells us about the system. The key is to recognize that when individuals incur significant costs to purchase goods or services, this tells us something about consumers opportunity costs. Specifically, the amount they pay is a lower bound on how much they will otherwise have to pay, one way or another, to achieve the same outcome. For example, a taxpayer who spends \$400 for tax preparation services is telling us that it's worth at least (and perhaps very much more than) \$400 to her to not have to prepare her own return. The lesson that we should take from the ubiquity and expense of paid tax preparation is not that tax preparation assistance is bad, but that the perceived burden of preparing and filing a return is too much for a typical individual to bear.

One of the most valuable features of markets is their ability to reveal through prices information about consumers wants and the supply of

¹²³ See, e.g., Bhutta et al., *supra* note 77.

solutions for those wants. Eliminating markets, including markets for expensive credit products, deprives us of valuable information. The price of refund anticipation loans, for example, tells us just how valuable it is for certain taxpayers to access their tax refunds as soon as they are available, rather than wait even a few weeks. Using the high price of certain credit products as information encourages us to consider a much wider array of solutions to the problem that is revealed by the high-priced loan. Opening the aperture of our lens to view the entire system of taxes and transfers as providing the underlying causes of RAL popularity allows us to inventory all of the ways that we might set about transferring to low-income households a wage subsidy that targets families with children. The best solution may involve substantive reforms to the EITC itself, including eligibility simplification, or it may involve procedural changes in the way that the EITC is delivered. In any event, it is by viewing high-price credit as a symptom rather than only as a disease that we can consider the various ways that households are driven to overpay for consumer credit and have the best chance of identifying the least-cost intervention to improve consumer welfare.

CONCLUSION

In this paper, I exploit a change in the regulation of refund anticipation loans to identify the effect of the RAL market on the supply and demand for paid tax preparation, EITC take-up, and the use of RACs. Nearly eliminating RALs increased the use of refund anticipation checks and reduced the use of paid tax preparers and EITC claims. The implication for tax administration policy is that decisions to regulate tax preparers and limit the scope of their businesses must take into account the effects on taxpayer compliance and EITC take-up that may follow from inducing more taxpayers to prepare their own returns.

Consumer groups, which argued persistently for the elimination of RAL market, have set their sights on RACs, which they also view as exploitative. The framework in this paper provides reasons to be especially cautious about eliminating the RAC option, because it is the sole option available to taxpayers that allows them to file with assistance without incurring immediate out-of-pocket costs. In the absence of this option, individuals who heavily discount future cash flows, or are credit-constrained and cash-poor, may prepare and file only cursory and inaccurate returns, or not file at all. More generally, the welfare effects of financial products that resemble RALs, such as payday loans and other alternative financial products, are often evaluated in isolation from the other choices (such as filing a tax return) that may be dependent on that borrowing. Determinations

about whether these products are beneficial must take these collateral consequences into account.

The example of refund anticipation loans is illustrative of a larger problem in the evaluation of consumer credit products by scholars operating in a behavioral law and economics framework: these evaluations fail to consider what the credit is being used *for*. When the credit product is secured by a durable good, such a home, automobile, appliance, or any other good or service with deferred benefits, the very features that make a loan exploitative may be the ones that make present-biased consumers better off by tempting them to do something that is in their interests.

* * *

TABLES

Table 1

2009 County Summary Statistics by Tercile of RAL Use

	2010 Share of Returns with RALs		
	0-4.3%	4.3-9.2%	9.2-51.0%
Share of Returns			
EITC	15.8	21.4	31.9
Child Tax Credit	16.2	17.7	19.0
Additional CTC Claims	11.4	15.3	22.7
Education Credit	6.9	6.2	5.2
Refunds	76.5	81.6	84.7
Direct Deposit	50.9	57.4	61.6
RALs	2.4	6.4	14.6
RACs	5.7	9.0	12.3
Self-Prepared	36.4	37.5	32.2
1040	71.8	66.6	62.0
1040a	16.6	21.5	26.6
1040z	11.0	11.6	11.1
AGI <\$30k	46.6	51.1	57.2
AGI >\$100k	9.7	7.5	5.4
Number of Returns	61,030	44,363	15,761
Share of Population			
Black	2.8	6.4	17.9
Asian	1.9	1.1	0.6
Hispanic	6.1	8.6	9.9
Labor Force	53.5	49.1	44.8
Tax Returns Filed	42.9	40.7	36.3
Population	143,501	108,056	41,829
Unemployment Rate	7.6	9.3	10.2
Poverty Rate	11.9	15.3	21.7
Median Income	\$49,941	\$43,436	\$35,430
Number of Lib. Tax Offices	0.09	0.15	0.11
Number of JH Offices	0.24	0.54	0.79
Number of H&R Block Offices	0.87	1.27	1.43
Total Offices	1.20	1.96	2.34
Liberty Tax Majority	0.1	0.2	0.2
Jackson Hewitt Majority	3.6	11.1	19.4
H&R Block Majority	59.5	57.7	52.1

Table 2

Summary Statistics for Counties with RAL Rates >1%

	2010	2011
Share of Returns		
EITC	23.5	29.8
Child Tax Credit	17.8	18.9
Additional CTC Claims	16.8	21.4
Education Credit	6.1	6.2
Refunds	81.4	84.2
Direct Deposit	57.3	64.1
RALs	8.2	2.4
RACs	9.3	21.7
Self-Prepared	35.5	35.8
1040	66.3	63.1
1040a	22.0	24.6
1040z	11.4	12.2
AGI <\$30k	52.0	55.2
AGI >\$100k	7.5	6.6
Number of Returns	41,479	29,331
Share of Population		
Black	9.4	18.9
Asian	1.1	0.8
Hispanic	8.4	9.7
Labor Force	48.8	45.3
Tax Returns Filed	39.9	37.4
Population	100,552	74,216
Unemployment Rate	9.1	10.2
Poverty Rate	16.5	21.0
Median Income	\$42,604	\$37,858
Number of Lib. Tax Offices	0.12	0.19
Number of JH Offices	0.55	0.82
Number of H&R Block Offices	1.24	1.21
Total Offices	1.91	2.23
JH Majority Preparer	11.9	19.1
JH Majority Preparer in 2010	11.9	23.5

Table 3

Effect of RALs on RACs

	I	II	III	IV
Δ RAL	-0.809*** (0.007)		-0.768*** (0.012)	
Post10		-0.008*** (0.001)		-0.006*** (0.001)
RAL10		0.109*** (0.014)		0.131*** (0.018)
Post10#RAL10		0.805*** (0.009)		0.743*** (0.016)
JH Majority Preparer			-0.003 (0.002)	0.025*** (0.003)
H&R Majority Preparer			-0.002* (0.001)	0.005*** (0.001)
Liberty Majority Preparer.			0.004** (0.002)	-0.009*** (0.003)
Post10#JH Maj.Prep.				-0.002 (0.002)
Post10#H&R Maj.Prep.				-0.004*** (0.001)
Post10#Lib. Maj.Prep.				0.003 (0.002)
JH Maj.Prep.#RAL10				-0.175*** (0.032)
H&R Maj.Prep.#RAL10				-0.024 (0.019)
Lib Maj.Prep.#RAL10				0.087*** (0.032)
Post10#JHMajPrep#RAL10				0.076*** (0.028)
Post10#HRMajPrep#RAL10				0.096*** (0.019)
Post10#LibMajPrep#RAL10				-0.145** (0.056)
JH Maj.Prep.# Δ RAL			-0.058* (0.032)	
H&R Maj.Prep.# Δ RAL			-0.062*** (0.015)	
Lib. Maj.Prep.# Δ RAL			0.091* (0.046)	
Observations	3,135	18,803	3,135	18,803
R-squared	0.908		0.910	
Demographic Controls	YES	YES	YES	YES
Economic Controls	YES	YES	YES	YES
Number of Counties		3,136		3,136
Time Trends		YES		YES

Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1

Table 4

Effect of RALs on Self-Preparation of Returns

	I	II	III	IV
Δ RAL	-0.101*** (0.008)		-0.088*** (0.012)	
Post10		-0.007*** (0.001)		-0.003** (0.001)
RAL10		-0.501*** (0.034)		-0.311*** (0.050)
Post10#RAL10		0.131*** (0.009)		0.124*** (0.017)
JH Majority Preparer			-0.001 (0.002)	0.064*** (0.009)
H&R Majority Preparer			-0.002** (0.001)	0.030*** (0.006)
Liberty Majority Preparer.			-0.008 (0.009)	0.016 (0.016)
Post10#JH Maj.Prep.				0.002 (0.003)
Post10#H&R Maj.Prep.				-0.007*** (0.002)
Post10#Lib. Maj.Prep.				-0.005 (0.027)
JH Maj.Prep.#RAL10				-0.509*** (0.077)
H&R Maj.Prep.#RAL10				-0.301*** (0.055)
Lib Maj.Prep.#RAL10				0.587* (0.300)
Post10#JHMajPrep#RAL10				0.009 (0.030)
Post10#HRMajPrep#RAL10				-0.000 (0.021)
Post10#LibMajPrep#RAL10				-0.065 (0.321)
JH Maj.Prep.# Δ RAL			-0.039* (0.021)	
H&R Maj.Prep.# Δ RAL			-0.014 (0.016)	
Lib. Maj.Prep.# Δ RAL			-0.151 (0.113)	
Observations	3,135	21,936	3,135	21,936
R-squared	0.120		0.126	
Demographic Controls	YES	YES	YES	YES
Economic Controls	YES	YES	YES	YES
Number of Counties		3,136		3,136
Time Trends		YES		YES

Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1

Table 5

Effect of RALs on EITC Claims

	I	II	III	IV
Δ RAL	0.052*** (0.004)		0.043*** (0.008)	
Post09		-0.008*** (0.000)		-0.007*** (0.001)
RAL09		0.633*** (0.017)		0.626*** (0.026)
Post09#RAL09		-0.016*** (0.004)		-0.019*** (0.007)
JH Majority Preparer			0.001 (0.001)	0.008** (0.004)
H&R Majority Preparer			0.002** (0.001)	-0.005*** (0.002)
Liberty Majority Preparer.			0.004 (0.003)	-0.016*** (0.005)
Post09#JH Maj.Prep.				0.001 (0.001)
Post09#H&R Maj.Prep.				-0.001 (0.001)
Post09#Lib. Maj.Prep.				-0.005 (0.004)
JH Maj.Prep.#RAL09				-0.056 (0.039)
H&R Maj.Prep.#RAL09				0.024 (0.026)
Lib Maj.Prep.#RAL09				0.061 (0.102)
Post09#JHMajPrep#RAL09				-0.008 (0.014)
Post09#HRMajPrep#RAL09				0.007 (0.010)
Post09#LibMajPrep#RAL09				0.133*** (0.044)
JH Maj.Prep.# Δ RAL			0.003 (0.012)	
H&R Maj.Prep.# Δ RAL			0.018* (0.009)	
Lib. Maj.Prep.# Δ RAL			-0.014 (0.042)	
Observations	3,135	21,936	3,135	21,936
R-squared	0.128		0.133	
Demographic Controls	YES	YES	YES	YES
Economic Controls	YES	YES	YES	YES
Number of Counties		3,136		3,136
Time Trends		YES		YES

Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1