Shifting Demand for Alternative Financial Products

Instant Tax Refunds and Their Use by Military Personnel

C. Eugene Steuerle and Jessica F. Compton

Predominantly used by the economically disadvantaged, the alternative financial industry involves tens of billions of dollars of annual transactions. Over the years, federal and state regulators have attempted to promote consumer protections that modify the costs and risks associated with products such as payday loans, auto-title loans, and rent-to-own transactions. Regulators may use prohibitions, disclosures, and APR caps in hopes of curbing product use and shifting consumer demand to more mainstream savings and credit products. Evidence demonstrates that some regulations are associated with a reduction in the supply of alternative financial service products. However it is not clear that regulation of one alternative financial product influences consumer demand for other financial products (McKernan, Ratcliffe, and Kuehn 2010).

In this fact sheet, we provide one example of how consumers shift their use among varying alternative financial products. In general, dwindling supply of a good can lead consumers to look for a substitute. Our evidence shows that this type of substitution does occur between two similar alternative financial products: refund anticipation loans (RALs) and refund anticipation checks (RACs). These products enable individuals to pay for tax preparation through their anticipated refunds. By receiving a loan against their refund, RAL users can walk out the same day with their refund rather than wait for the IRS. RAC users receive their refund in about the same amount of time as tax filers with direct deposit but still often use a RAC, particularly as a way of paying their tax preparation bill.

Provisions in the Military Lending Act, which passed Congress in 2006, prohibit financial service providers from issuing loans with APRs of over 36 percent to members of the military and their dependents. As a consequence, RAL use dropped dramatically the following year, but RAC use among military members increased dramatically. Using individual-level tax data, we measure the use of RACs and RALs among military members prior to and after implementation of the act. Compared to use in tax year 2005, RAL use among military members dropped precipitously by over 90 percent (figure 1) in tax year 2008. Among all tax filers, RAL use only decreased by 15 percent. During the same time period, RAC use among military members increased by over 50 percent, which is over twice the 20 percent increase among all tax filers. Nearly 16,000 military members continued to use RALs in 2010 while RAC use increased to more than 370,000.

Since 2007, further directives from bank regulators and the IRS’s removal of a debt indicator (that helped banks sort out which clients were better risks) have led to market exits of six predominant RAL-providing banks and rendered five major tax preparer chains and countless independent tax preparers unable to provide clients with RALs. From 2005 to 2010, combined use of RALs and RACs stayed relatively steady (figure 2). Yet, RAL use only accounts for 9 percent of total use in 2010 compared to 51 percent in 2005.

These findings do not necessarily mean that all individuals who previously used RALs shifted to RACs or that the many individuals who stopped using RALs were influenced only by the regulation. It does demonstrate the significant influence that policy can have
on the behavior of individuals who rely on alternative financial products.

In some cases, regulation that causes substitution shifts can be good for consumers—the removal of soda pop from vending machines at schools may mean that students drink more water to quench their thirst. However, we would also want to know the extent to which they start imbibing fruit juices with high sugar content.

Because product fees, compounded accumulated interest, and process fees all cost consumers money, further research is required to know the extent to which shifting demand out of RALs—or out of any particular alternative financial product—saves consumers money or leaves them better off over time. For instance, tax preparation fees might be raised as preparers lose the funds formerly provided by RALs.
Policymakers may want to look toward other strategies for providing consumer protection in the arena of RALs and RACs. For instance, might splitting refunds in new ways allow tax preparers to receive their fees from taxpayers without resorting to RACs? Additionally, annual percentage rates are harder for consumers to interpret on short-term loans. A fixed cost allocated over 10 days might have a significantly lower APR than one allocated over 8 days, but that would not be a very meaningful calculation.

Notes

1. The debt indicator was a service that helped tax preparers and banks mitigate risk.

References


Given the chance, many low-income families can acquire assets and become more financially secure. Conservatives and liberals increasingly agree that government’s role in this transition requires going beyond traditional antipoverty programs to encourage savings, homeownership, private pensions, and microenterprise. The Urban Institute’s Opportunity and Ownership Project policy fact series presents some of our findings, analyses, and recommendations. The authors are grateful to the Annie E. Casey Foundation and the Ford Foundation for funding the Opportunity and Ownership Project.