



“Refund Anticipation Loans” in Wisconsin

Little Gained and Much Lost for Low-Income Workers and Local Economies

Executive Summary

In 2003, nearly eleven percent (277,951) of tax filers in Wisconsin claimed the Earned Income Tax Credit (EITC) – a federal tax credit aimed at lifting the working poor out of poverty.ⁱ Of those, 22.1 percent (61,356) received their refunds through what is known as a refund anticipation loan (RAL) – a short-term loan secured by a tax filer’s expected refund and aggressively marketed to the poor by many paid tax preparation firms. Many more RALs were taken out in Wisconsin in all, but this report focuses specifically on the impacts RAL proliferation is having on the EITC and those who receive it.

The costs of RALs for the working poor and their families are significant. Those taking out RALs paid an average of \$130 in fees to be able to receive their tax refunds anywhere from a few days to a couple of weeks earlier than they would have otherwise – resulting in effective annualized interest rates of anywhere from 70 to 700 percent, depending on the size of the refund.ⁱⁱ Costs rise even further for those paying for tax preparation and check cashing.

Using only the RAL fee results in an estimated eight million dollars being siphoned off from EITC recipients’ tax refunds in Wisconsin in 2003 alone. In the process, the effectiveness of the EITC, one of the federal government’s largest and most successful anti-poverty investments in history has been diminished.

Local economies are also shortchanged when RAL fees divert EITC dollars. Money flowing into low and middle-income neighborhoods can have a multiplier effect of 1.5 to 2 per dollar. In other words, the estimated \$3 million paid in RAL fees by federal EITC recipients in Milwaukee actually had the effect of denying that city between \$4.5 and \$6 million in total economic activity.

The reasons for RAL use are several, including tax code complexity, heavy marketing by tax preparation firms in poor communities, a desire on the part of tax filers to receive their refunds more quickly, and the fact that many EITC recipients do not have bank accounts into which they could have their refunds directly deposited.

For this report we examined recently released data from the Brookings Institution’s Metropolitan Policy Program relating to federal EITC and RAL usage in and across Wisconsin. Recognizing that federal, state, and local governments, as well as financial institutions and community organizations alike have a role to play, we recommend the following steps be taken to shore up the benefits provided by the federal and state earned income tax credits, both for the low-income workers and their families, and also for their local economies:

- ❖ Increase tax preparation assistance for low-income tax filers.
- ❖ Expand current efforts to increase bank accounts among low-income residents.
- ❖ Simplify the EITC tax forms and instructions.

EITC and RAL Use in Wisconsin

The EITC is a federal refundable tax credit available to low-income workers throughout the country. Over 277,000 Wisconsinites received the EITC in 2003 (for the 2002 tax year), representing 10.9 percent of all tax filers in the state. Federal EITC credits statewide totaled over \$440 million. Wisconsin has its own EITC, in addition to the federal credit, which brings the total state and federal investment in the EITC in Wisconsin to over \$500 million.

Eligibility for the federal EITC – and the size of the refund – depends on household income and family size. For instance, for the 2004 tax year, workers raising one child and with income below \$30,338 (or \$31,338 for married workers) qualify for an EITC refund of up to \$2,604. Those with more than one child and with income below \$34,458 (or \$35,458 for married workers) qualify for an EITC refund of up to \$4,300. Workers not raising children and with income below \$11,490 (\$12,490 for married workers) may receive up to \$390 for tax year 2004.

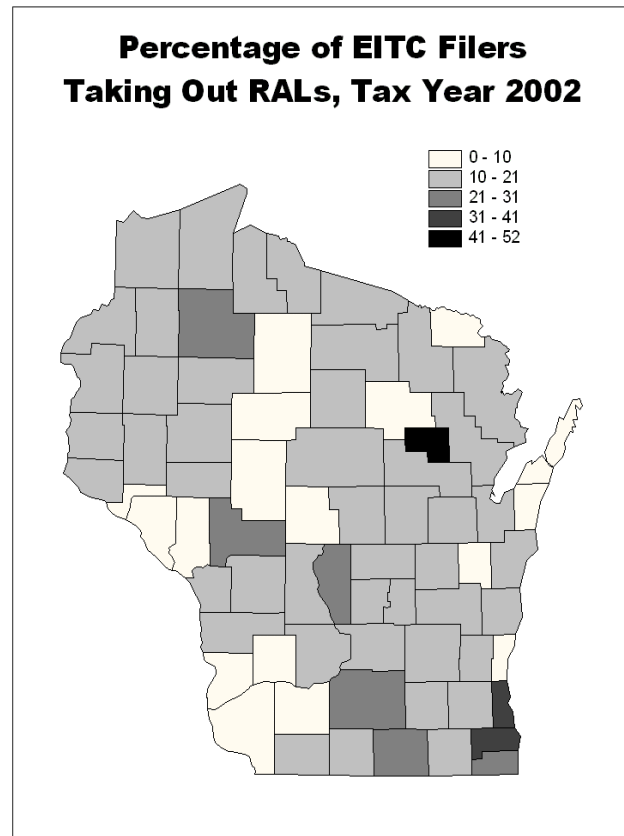
RALs are a high-cost financial product sold by most professional tax preparers. The loans are secured by the tax filer’s expected refund, which is then assigned to a bank partnering with the tax preparation firm. A temporary account is set up at that bank to receive the refund from the government. The loan is paid to the tax filer within a day or two, and the refund arrives at the bank within a week or two.

Of those claiming the federal EITC, 22.1 percent statewide received their refund through the use of an RAL in 2003. EITC recipients constitute slightly more than a tenth of tax filers in Wisconsin, but account for well over half of the approximately 113,000 RALs in the state in 2004.

RAL usage rates differ greatly from one county to another. Of the state’s seventy-two counties, only nine had a higher percentage of EITC filers taking out RALs than the statewide average. The map to the right

| Table 1. Wisconsin Counties with Above Average RAL Usage Rates, as a % of EITC Filers, Tax Year 2002 | |
|---|--------------------------------|
| County | % of EITC Returns w/RAL |
| Menominee | 51.8 |
| Milwaukee | 35.0 |
| Racine | 31.7 |
| Sawyer | 31.0 |
| Kenosha | 28.0 |
| Rock | 27.7 |
| Adams | 25.6 |
| Jackson | 25.2 |
| Dane | 22.4 |

illustrates RAL usage as a percentage of EITC filers around the state, with the table showing those counties with above average RAL usage rates.



When examining the geographic distribution of EITC and RAL use at the zip code level we found that those areas with a high level of RAL use are also areas with above average EITC claimants, as seen in the table on the next page. Twenty-one of the 25 top zip codes of RAL use were areas which had above average numbers of EITC claimants.

Of the 61,356 RALs taken out in Wisconsin by federal EITC recipients in 2003, 23,758 (38.7 percent) were taken out in the City of Milwaukee.

Other urban areas of the state with concentrations of low-income workers also exhibited high RAL numbers, including Beloit, Janesville, Kenosha, Madison, and Racine. Although a high percentage of the RALs taken out statewide were taken out in a relatively small number of zip codes in the City of Milwaukee, RAL proliferation exists wherever low-income workers reside.

Another specific issue to note is the high levels of RAL use in several communities within or bordering several of the state’s Indian reservations, including in the municipalities of Neopit, Couderay, Odanah, Keshena, Hertel, and Lac Du Flambeau.

Heavy RAL use in communities with concentrations of the working poor should come as no surprise as tax preparation firms that offer RALs, check cashing, electronic filing, and other products specifically – and by their own admission – target poor communities.

Earlier research by the Brookings Institution showed that zip codes with high EITC use have fifty percent more electronic tax preparations service storefronts per filer than low EITC use zip codes.ⁱⁱⁱ

Table 2. Wisconsin’s Zip Codes (25) with Highest Percentage of EITC Filers Taking Out RALs, Tax Year 2002

| Zip Code | City | County | % of Returns W/EITC | % of EITC Returns w/RALs |
|----------|-----------------|-----------|---------------------|--------------------------|
| 54150 | Neopit | Menominee | 46.1 | 56.4 |
| 54828 | Couderay | Sawyer | 25.3 | 52.8 |
| 54861 | Odanah | Ashland | 45.6 | 52.8 |
| 54135 | Keshena | Menominee | 36.9 | 50.2 |
| 53744 | Madison | Dane | 16.7 | 50.0 |
| 53206 | Milwaukee | Milwaukee | 51.8 | 49.2 |
| 53205 | Milwaukee | Milwaukee | 55.8 | 47.8 |
| 53141 | Kenosha | Kenosha | 27.8 | 46.5 |
| 53404 | Racine | Racine | 25.9 | 46.0 |
| 54845 | Hertel | Burnett | 18.8 | 45.5 |
| 53208 | Milwaukee | Milwaukee | 32.1 | 45.4 |
| 54538 | Lac Du Flambeau | Vilas | 29.0 | 44.3 |
| 53725 | Madison | Dane | 33.1 | 44.2 |
| 53233 | Milwaukee | Milwaukee | 30.0 | 43.1 |
| 53210 | Milwaukee | Milwaukee | 38.0 | 42.8 |
| 53212 | Milwaukee | Milwaukee | 35.0 | 42.3 |
| 53403 | Racine | Racine | 20.5 | 42.3 |
| 53204 | Milwaukee | Milwaukee | 36.3 | 41.7 |
| 53548 | Janesville | Rock | 25.5 | 41.5 |
| 53708 | Madison | Dane | 20.5 | 41.5 |
| 53224 | Milwaukee | Milwaukee | 23.5 | 41.1 |
| 53209 | Milwaukee | Milwaukee | 29.0 | 39.7 |
| 53225 | Milwaukee | Milwaukee | 23.7 | 39.5 |
| 53216 | Milwaukee | Milwaukee | 30.6 | 38.5 |
| 53218 | Milwaukee | Milwaukee | 32.3 | 38.0 |
| 53234 | Milwaukee | Milwaukee | 26.7 | 37.9 |

RAL Costs Paid by the Consumer and the Local Economy

Typical RAL costs are about \$130 according to research by the National Consumer Law Center and the Consumer Federation of America. Additional fees exist for filing returns electronically, for check cashing, and other services offered by these firms. The money spent on tax preparation and loan fees can equal that paid for several weeks of groceries for some poor families. The benefit of the RAL

itself is minimal, with the loan recipient receiving their refund just a few days to a couple of weeks earlier than they otherwise would. The short duration of the loan and the high fees relative to the amount of the loan combine to produce astronomical annual interest rates, into the hundreds of percent in some instances.

The high costs associated with RALs are certainly born by the low-income workers and their families, and are also born by the local economy to which those funds would otherwise have flowed. Nearly \$8 million were siphoned off from Wisconsin federal EITC claimants' refunds in 2003 through RAL fees alone (using the \$130 estimate) – \$3 million in the City of Milwaukee.

The total economic impact of a transfusion of funds into a community is known as an “economic multiplier.” Quite simply, total economic output will increase by more than just the amount of money invested because the money invested (spent) spurs other economic activity. If, for example, \$100 is spent in a community, in addition to the first \$100 that has traded hands there is the added effect of supporting whatever jobs revolve around those products bought or services paid for with that \$100 – transporting the product, advertising, and so on.

The exact multiplier in any community is based on a number of factors. Research has been conducted, however, which has shown that funds flowing into a low or middle-income community can produce an economic multiplier of between 1.5 and 2, meaning that for every \$100 spent, between \$150 and \$200 of total economic activity will occur. Using that range means that between \$4.5 million and \$6 million of potential economic activity was foregone when RAL fees siphoned off \$3 million from the refunds of Milwaukee's federal EITC claimants in 2003 – assuming nearly all of the fee charges leave the local community.

Effect of the EITC is Diluted

The federal government spent over \$36 billion in EITC refunds for more than 20 million families in 2003 – representing a significant investment in helping the working poor raise themselves and their families out of poverty. Wisconsin, like fourteen other states and a small number of municipalities, has its own earned income tax credit program in addition to the federal EITC. In fact, Wisconsin spent over \$78 million in state EITC refunds in fiscal year 2004-05. When EITC dollars are siphoned off to pay RAL and other tax preparation fees, this public investment in low-income workers is not “returning” what it could.

What Drives the Market for RALs?

Despite the high costs associated with RALs, over sixty thousand Wisconsin federal EITC claimants took out RALs in 2003. The reasons for this are not difficult to understand.

RALs are aggressively marketed to the poor. Tax preparation storefronts have become a common site in poor neighborhoods throughout the state, along with rent-to-own and check cashing outfits. By their own admission, the large tax preparation chains target poor communities because of the likelihood of the residents there being eligible for the EITC. The result is that RALs have become a significant source of revenue for professional tax preparers. In fact, revenue from “fast cash” products like RALs raised by the nation's largest tax preparation firms rose from \$138 million in 1998 to \$357 million in fiscal year 2001.^{iv}

Secondly, the prospect of receiving a tax refund quickly is no doubt especially attractive when the amount of money expected is a significant amount for the filer and immediate expenses are looming. If a tax filer has a bank account, he or she could receive their refund rather quickly by having it directly deposited. The fact is, however, that many of those seeking the EITC do not have bank accounts, making the RAL especially attractive to them. Furthermore, the fees for tax preparation and filing and an RAL are often deducted automatically from the refund, with nothing owed by the consumer “upfront.”

Of course, another factor is that the tax code is complicated. The 2003 EITC instruction book, for instance, was 56 pages long and included 6 separate worksheets. So even for tax filers with no complicated investments or other involved financial transactions to disclose, filling out tax forms is difficult. Paid tax preparers represent an easy and potentially quick way to receive a refund.

Poor disclosure is often cited as a reason for the proliferation of RALs despite the high costs. This may be the case in some states. Currently, Wisconsin state regulation of RALs is considered relatively robust. Wisconsin statutes require that professional tax preparers have those requesting RALs sign a form in which the tax preparer discloses the following information: the RAL fee, any fee for electronically filing the tax return, total dollar amount of all charges and fees, length of time until the RAL is received, length of time it would take to electronically file and receive the refund without the RAL, that the customer is responsible for repayment of the RAL if the income tax refund does not arrive or is lower than expected, and the annual percentage rate of the loan.

An area of future research, however, could be an examination into how these relatively strong state regulations are actually being implemented by professional tax preparers.

Recommendations for Decreasing Reliance on RALs

Several states and municipalities around the country have taken steps to control the spread of RALs in their communities.

We recommend the following steps be taken to help curb their use in Wisconsin.

1. Increase Tax Preparation Assistance for Low-Income Tax Filers

The Internal Revenue Service trains VITA volunteers (Volunteer Income Tax Assistance). Less than one in ten EITC recipients take advantage of this service, however, with about two-thirds of EITC recipients choosing to pay a professional tax preparer. Even a small expansion in the VITA program, if coupled with increased outreach concerning the service, could reach many more low-income workers throughout the state.

Likewise, many Low-Income Taxpayer Clinics (LITCs) exist around the country, at law schools, accounting schools, technical colleges and so on. Community organizations can take the lead in sponsoring a VITA or LITC site, or in spreading the word of their availability through an outreach campaign. Local governments could also play a role by dispersing information regarding these free tax preparation services available in their respective communities.

2. *Expand Current Efforts to Increase Bank Accounts Among Low-Income Residents*

One of the primary reasons low-income workers turn to RALs is their lack of a bank account. If a tax filer has a bank account he or she can have their refund directly deposited and receive it in a matter of days instead of weeks. There are several barriers, however, to possessing a bank account including poor – or nonexistent – credit history and lack of understanding of the usefulness in having an account. Distrust of financial institutions such as banks also runs strong in many communities.

Not only does having a bank account make RALs less attractive, they bring about other benefits as well, including the building of credit history and making it easier for account holders to save money over time.

One option would be to use VITA and other tax assistance sites as an opportunity to communicate the importance of obtaining an account. It would also present an opportunity to have individuals actually apply for accounts right at the VITA sites.

The Wisconsin Department of Revenue is currently working with the Wisconsin Credit Union League on a project aimed at reaching out to low-income workers and immigrants and helping them establish bank accounts into which they can have their tax refunds deposited. While this project is at an early stage, it is just the kind of effort that could pay real dividends for low-income workers and their local communities as well. The Department and the Wisconsin Credit Union League are to be applauded for their efforts.

Local governments and credit unions around the state should be notified of the program and play a role in increasing awareness of its benefits for consumers. Since time and resources, both at state agencies and private organizations are always limited, those communities with the highest concentrations of EITC recipients and RAL users should be targeted.

3. *Simplify Tax Forms and Instructions*

The federal EITC and child tax credit forms could be simplified to allow more low-income workers to fill out and submit their own taxes. While this is a role played by the IRS, state and local officials as well as interested organizations and individuals can raise the issue of tax form complexity with their federal representatives in an effort to influence IRS action.

Conclusion

The EITC – perhaps the most significant effort to move low-income workers out of poverty – has by many counts been successful. High-cost financial products such as refund anticipation loans diminish the credit's impact, however. A concerted effort to increase free and low-cost tax preparation assistance for the poor, to “bank the unbanked”, to increase the consumer's awareness of less expensive options, and to streamline tax forms and instructions, would shore up the benefits of the federal EITC and similar state credits, and would benefit thousands of low-income workers throughout the state of Wisconsin.

John Keckhaver
Wisconsin Council on Children & Families
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Footnotes:

ⁱ All EITC and RAL data presented in this report are from tax returns filed in 2003 (tax year 2002) unless otherwise noted, and can be found on the Brookings Institution website at www.brookings.edu/metro/eitc. This interactive website contains a database from which tables can be created for all states and by zip code, municipality, county, and metropolitan area.

ⁱⁱ According to the January 2004 report *All Drain, No Gain: Refund Anticipation Loans Continue to Sap the Hard-Earned Tax Dollars of Low-Income Americans*, by the National Consumer Law Center and the Consumer Federation of America, the likely prices for RALs in 2004 (for someone getting the average \$2,100 refund) were expected to be around \$132 (a loan fee of \$100 which includes a \$25 fee to set up a bank account used to receive the consumer's tax refund from the IRS to repay the RAL and a system administration fee averaging \$32).

ⁱⁱⁱ *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC*, by Berube, Kim, Forman, and Burns, May 2002, available at <http://www.brookings.edu/metro/publications/berubekimeitcexsum.htm>. The IRS maintains a searchable database of commercial electronic return originators (EROs), including addresses.

^{iv} This total is derived from those revenues raised for such products by H&R Block, Household International (which during that time period acted as the lending partner for all of the RALs for H&R Block), and Pacific Capital Bancorp (which played the same role for Jackson Hewitt, one of the nation's largest tax preparation firms). See the Brookings Institution's May 2002 report, *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC*, by Berube, Kim, Forman, and Burns, for this and more information involving revenues raised by the companies involved in RAL lending.