Preserving Financial Freedom for Taxpayers

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By
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Each year, as taxpayers face the dreaded "tax day" filing deadline to send their tax returns (and the amount they owe) to the Internal Revenue Service, they use every financial option at their disposal to help them meet that deadline. Just as on other occasions when working men and women have cash-flow problems, one of the tools they use to deal with a short-term money shortage is the widely popular "payday loan."

What is a payday loan or advance? It's an important financial service used by thousands of consumers every week. It allows a person to get a small amount of cash for a short period, with the loan made against his or her next paycheck. The customer writes a personal check for the amount of the advance plus a fee, and then gets cash for that check, less the agreed-upon fee. The personal check is then held for a predetermined period – usually two weeks. At the end of the period the check is deposited.

Why is such a short-term financial option so important? **As Americans continue to be overtaxed, they lose an average annually of 35 to 40 percent of their earnings to taxes.** Paychecks continue to be ravaged by the endless array of federal, state, and local taxes. Most workers have little disposable income and little or no emergency savings. **One recent national survey by a consumer group noted 53 percent of those surveyed said they sometimes, most of the time, or always "live from paycheck to paycheck."** This percentage increases to 64 percent for those with moderate incomes (household incomes of $20,000 to $50,000) and to 79 percent for those with low incomes (household incomes under $20,000).[1]

Consumers need every possible financial tool to deal with life's emergencies. Payday advance loans are one such widely-used money management tool.

There is overwhelming evidence that payday advance loans provide a valuable service, filling a critical financial need for millions of Americans in states across the country. In one of those states, North Carolina, a recent report by the State Commissioner of Banks revealed just how well consumers like the payday loan option. **The report cited 2.9 million North Carolina transactions in 1999, with the Commissioner of Banks receiving only 12 complaints.** "It is safe to say there is a genuine need for payday advance, otherwise we wouldn't have over 1,000 locations throughout the state," Deputy Banking Commissioner Otis Meacham was quoted as saying earlier this year.[2]

As additional evidence, the Credit Research Center of Georgetown University recently released a comprehensive study highlighting the benefits of payday advance loans as expressed by customers across America. **"Our study shows that payday advance satisfies an unfulfilled demand for very short-term credit in today's market,"** wrote Dr. Gregory Elliehausen, a senior research scholar at Georgetown and co-author of the study. **"The overwhelmingly favorable response strongly suggests that payday advance companies serve a real economic need for their customers."**

The Georgetown study, *Payday Advance Credit in America: An Analysis of Customer Demand*, found that most payday advance customers (96 percent) understood the service and the fees involved, and that most (92 percent) believe payday advance is a useful service. The study also revealed that nearly all payday advance customers (91 percent) use other types of consumer credit. **Most customers who considered other credit options chose payday advance because of the quick and easy process, the fast approval, and the limited paperwork.**[3]

Payday advances are so popular because they provide a needed financial alternative to the many charges that burden consumers who are late on their rent or their monthly credit card payment. Payday loans are also far better options than bouncing a check due to lack of funds. Any fair comparison of the fees charged for the short-term, unsecured loan of cash against a future paycheck, to those charged for check bouncing or late credit card or rent payments, would show the payday loan fees to be much more attractive. To the people who need the loans, the fees are more than reasonable.

If you consider the fee charged on a typical payday loan, $30 on a $200 loan over a period of two weeks, it certainly seems fair in comparison to the alternatives. For example, that loan may prevent a late-payment-of-rent charge of $50 for rent paid five days late. It could save the consumer from a bounced check bank charge ($25) and a bad check store charge ($20). Finally, that loan might stop credit card late charges ($29 a day) that can quickly escalate into hundreds of dollars of almost instant debt. These are the alternatives, and they are clearly to be avoided. But Americans need look no further than their own recently-filed tax returns to appreciate how payday loans can serve as workable alternatives.

Again, the typical family's total tax burden to all levels of government now approaches 40 percent. Taxes are a family's single biggest expense – larger than food, clothing, and shelter combined – and federal income taxes often figure prominently in this expense.[4] But what happens when a working family comes up short on federal withholding at the end of the year, and gets stuck with owing the IRS?

Not filing is the worst possible option, carrying a 5 percent per month failure to file penalty, a ½ of 1 percent per month charge for failure to pay, possibly other civil and criminal fines, and even interest charges on some of the penalties themselves!

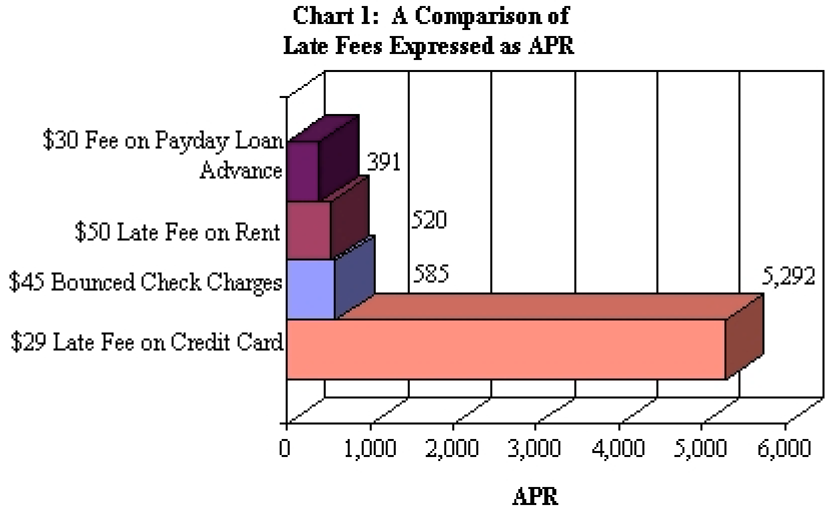
Always eager to "help" Americans pay their taxes, the IRS offers what it calls an "installment agreement" to families who can't afford to send in what they owe up-front. Assuming a family meets the three conditions for an agreement, the fee for paying in installments is $43, plus interest and a possible late payment penalty on any tax not paid by its due date (including the tax being paid in installments).[5]

Compared to payday loans, the IRS's short-term finance options could constitute a very raw deal for many taxpayers.

And yet, the narrow-minded "nanny state" opponents of these critical payday loans contend that the annual percentage rate (APR) is just too high, and that these lenders are taking advantage of their customers. Those same critics harass the payday advance companies (and thus their customers) in numerous areas, in effect conspiring to shut down their legitimate business operations. Are they right in their assertions?

Clearly they are wrong to measure the fees paid for short-term payday loans in terms of "APR," like you would measure a mortgage, or a car loan, or the annual interest on a continuing credit card unpaid balance. Payday lending could be compared to a taxicab ride from one side of the city to another. A short-term loan is like a short cab ride. You wouldn't hire a cab to travel across the country, and you wouldn't take out a short-term loan over and over for a year. Neither would you judge the per-mile cost of a short cab ride by the per-mile cost of a weekly rental car.

But, if APR is an accurate measure, then the alternatives faced by families every day should be judged by that same APR yardstick. Looking at that same payday advance of $200 over two weeks, the fee would be $30. That is expressed as a 391 percent APR. While that is still a misleading and simplistic measure, let's compare the alternatives anyway.



As Chart 1 depicts, that typical late charge on rent paid 5 days late, $50, could be expressed as a 520 percent APR. A bounced check bank fee ($25) and a bad check store charge ($20) combined is expressed as a 585 percent APR. Finally, the $29 per day credit card late payment fee would be expressed as an incredible 5,292 percent APR. According to those fair comparisons, the credit product of choice is crystal clear. The payday advance is far superior to the alternatives.

While the evidence is clear, this needed and widely-used small business continues to be attacked. Payday lenders have to contend with relentless and counterproductive do-gooders, just to stay in business. These include “consumer groups” that, in their efforts to justify their existence, unfairly target the short-term lenders as “usurers,” based on the specious APR argument. These are the same consumer groups who support every government regulation, every big government program, and every effort to increase taxes, and then lament the fact that the average citizen who pays those taxes can’t build substantial savings for emergencies. They would rather see a consumer pay an exorbitant IRS penalty for a late tax payment than to have them take advantage of a payday advance loan at a reasonable (much more so than the penalty) fee.

And there is no lack of hypocrisy in the media on this issue. Some editors have criticized these short-term financial tools with boundless moral outrage and indignation. Yet, while these self-styled “muckrakers” ply their trade on one page of the paper, a preceding page will feature a $25,000 or more display ad for a credit card that charges that aforementioned $29 a day late penalty (5,292 percent APR).

Finally, there are the politicians who are constantly striving to protect us from ourselves. Through their misguided efforts to eliminate this critical short-term solution to consumers' cash-flow shortfalls, they will bring about the very individual and family financial disasters that payday advance customers are trying to avoid. Ironically, over-regulation and bureaucratic attempts to "structure" other portions of the lending industry have met with different fiscal disasters – for taxpayers. Who can forget, for example, the federal government's bungling of the Savings & Loan (S&L) crisis, which was once estimated to have cost taxpayers up to $300 billion in depositor bailouts and institutional "thrift resolutions"? The National Commission on Financial Institution Reform, Recovery, and Enforcement, a blue-ribbon panel appointed to investigate the causes of this debacle, laid much of the blame squarely on the government's own shoulders.

In its own clumsy attempt to re-structure the marketplace, Congress created the law that chartered S&Ls as a new form of lending institution. Unfortunately, Congress also backed the S&Ls' deposits with tax dollars. Market discipline could not prevail because Congress allowed the institutions it created to privatize profits but socialize risks. In an unsubsidized environment, S&L consumers would have helped to act as "self-regulators" against institutions that invested deposits in risky portfolios. They would either demand a better interest rate or would simply move their deposits to a "safer" institution. But by raising the per-account insurance limit to $100,000, and by failing to introduce adequate risk-based deposit insurance premiums, the Commission concluded that the government created an environment in which "depositors could benefit with no meaningful risk of financial loss."6

But Congress has learned little since the S&L crisis. In another attempt to manipulate how consumers and lenders interact, lawmakers have created "Government-Sponsored Enterprises" (GSEs) like Fannie Mae and Freddie Mac. These quasi-public corporations, initially designed to facilitate greater availability of home loans, have become tax-backed competitors to truly private lenders. Worse, aside from a direct government subsidy of some $10 billion annually, Fannie Mae and Freddie Mac currently hold $1.1 trillion in debt at below-market interest rates, in a portfolio that the Congressional Budget Office concludes to be implicitly backed by taxpayers.7

Payday lenders don't receive "deposit guarantees" from taxpayers. In the true entrepreneurial spirit of self-reliance and initiative, small community lenders have developed a product, without government interference, that many Americans find convenient and helpful. But now some state and even federal officials want to go beyond sensible business practice guidelines, and do for payday loans what they did to S&Ls and GSEs: either take them over directly and hand the bill of operations over to taxpayers, or strangle them with so many petty regulations that the overarching laws of the marketplace are forever subverted. Neither of these two outcomes should be acceptable to hard-working Americans, which is why payday loans constitute a fiscal issue in which taxpayer advocates have a vital interest.

American taxpayers want more choices, not fewer. And they especially resent having their elected officials, the people they pay with their hard-earned taxes, take away choices that help them to survive. The National Taxpayers Union believes that, given appropriate information, consumers can make their own decisions and handle their own finances. Payday advance offers consumers a safe, convenient, and dignified financial alternative.

About the Author and the Organization

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National Taxpayers Union is America's largest grassroots taxpayer organization and is based in Alexandria, Virginia. To find out more about our work, please visit our website (www.ntu.org).

Notes

[1] http://www.consumerfed.org/backpage/savings.html, Savings and Wealth, "CFA Research Reveals Most Americans Have Built Little Wealth," February 20, 2001.

[2]North Carolina Commissioner of Banks, "Report to the North Carolina General Assembly on the Subject of Payday Lending," February 22, 2001, and North Carolina Deputy Banking Commissioner Otis Meacham, writing in Marcy Lowe, Ed., *Too Much Month at the End of the Paycheck*: *Payday Lending in North Carolina*, Community Reinvestment Association of North Carolina, with the Center for Community Capitalism, the Frank Hawkins Kenan Institute of Private Enterprise, and the University of North Carolina-Chapel Hill, January 2001.

[3] *Payday Advance Credit in America: An Analysis of Customer Demand*, Credit Research Center, McDonough School of Business, Georgetown University, April 2001.

[4] Tax Foundation, "New Study Profiles Total Tax Burden of Median American Family," March 9, 2000, http://www.taxfoundation.org/prmedianfamily.html.

[5] Internal Revenue Service, Publication 17, *Your Federal Income Tax, Tax Year 2000*, and Instructions to Form 9465, "Installment Agreement Request."

[6] National Commission on Financial Institution Reform, Recovery, and Enforcement, *Origins of the S&L Debacle: A Blueprint for Reform*, July 1993.
[7] Congressional Budget Office, *Federal Subsidies and the Housing GSEs*, May 2001.