

H&R Block's Refund Anticipation Loans: Perilous Profits at the Bottom of the Pyramid?

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**H&R Block's Refund Anticipation Loans:
Perilous Profits at the Bottom of the Pyramid?***

Vendors of products for the poor often must enter into a contentious, long-standing, and irresolvable debate about appropriate levels of prices and profits. H&R Block's experience demonstrates the costs of selling a profitable product to the poor. Block sells "Refund Anticipation Loans" (RALs) to its tax preparation clients who pay extra to receive loans based on their tax refunds in just one or two days. RAL consumers are typically from low income households. While RALs are highly demanded, Block faces pressure from consumer advocates to lower the pricing of the product or to exit. Its ongoing attempts to address these issues may prove enlightening for firms hoping to secure fortunes at the "Bottom of the Pyramid."

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INTRODUCTION

At a recent meeting, a big city mayor angrily confronted an H&R Block executive: “Why do you charge poor people \$130 to do tax returns. At our volunteer sites, we do them for free!” At a Chicago meeting, the leader of a large volunteer tax site refused to shake hands with a Block executive. In a meeting in Washington, a senior banking regulator railed about Block “ripping off consumers.”

Again and again, this story plays out. H&R Block, the nation’s largest tax preparation firm, serves over 19 million filers each year, of which 57% have annual household incomes below \$30,000. It delivers roughly 22% of the federal Earned Income Credit payments. While many financial service providers have “fired” poorer consumers, Block embraces its low income clientele, helping them secure tax refunds of \$35 billion annually. Block customers are reasonably satisfied, with Block’s satisfaction scores in the high 80s (out of 100) and 70 percent customer retention. Yet, Block is open to substantial criticism for a product that consumers demand, but activists and some lawmakers abhor: the refund anticipation loan (RAL). This product gives consumers near immediate access to funds albeit in a costly manner.

Consumer demand for RALs is strong, with over four million of Block’s 16 million retail office customers choosing the product. RALs are profitable for Block as well, contributing over \$100 million to earnings annually. Yet a product that its users and Block shareholders both seem to like creates so much trouble that Block executives debate whether or not they should continue to offer it. At the heart, offering RALs opens them up to difficult questions: How can you *justify* charging poor people so much for this product and earning such profits by selling to the poor? Many would urge business

to serve poor customers, holding out the promise of the “fortune at the bottom of the pyramid,” to use C.K. Prahalad’s description. However, Block’s experience reminds us that our commercial treasure-seeker must also answer—in public—some hard questions: Is your price “fair?” Are your profits “too high?” Asked by consumer advocates, regulators, and the media—but not necessarily by consumers—these questions form what we call “the paradox of profits.” Put simply, a business cannot serve the poor unless it is profitable. Yet, firms that profit by selling to the poor are subject to criticism that can result in costs which can make firms reconsider whether serving the poor is a good use of their resources, time, and reputation.

The questions that Block executives faced, “are your prices and profits too high?” and “are you selling the wrong products?” have a long history. While economists see prices and profits as merely determined by supply and demand curves, the question of “fairness” is one that businesses have faced throughout history with few definite answers. The question has appeared regularly in a governmental context – around issues such as war time profiteering and price gauging. In addition, Abrahamic religious traditions historically mandated against usury, and the Islamic prohibition on “riba” continues to shape business policy. Professionals such as doctors and lawyers, as well as investment managers, must demonstrate fiduciary duties of care and loyalty toward their clients. Norms about appropriate levels of profits have recently been discussed in the context of consumer protection as advocates and scholars study if the poor pay higher prices than do well-off consumers. These inquiries raise a fundamental ethical question – should private firms be permitted to derive substantial profits from poor and vulnerable consumers with insubstantial resources? This question has remained unsettled for centuries.

In the next section, we see how this debate has played out for H&R Block. We then draw on the case to discuss how firms can address the paradox of profits head-on, using the example of Block's recent strategic initiatives to engage its potential critics.

H&R BLOCK AND ITS REFUND ANTICIPATION LOANS

Background on H&R Block

Founded in 1955 by Henry and Richard Bloch, by 2005 H&R Block had grown into a \$4.2 billion revenue financial services company. The \$2 billion tax preparation unit accounts for most of revenues, with the rest coming from its accounting services, subprime mortgage, and personal financial advisory divisions. The firm's explicit strategy is to be "America's Financial Partner"—especially a partner of the less affluent.

Block's primary strategy is to leverage existing relationships with tax clients to inexpensively acquire clients in its other business units. Block's distribution system consists of over 12,000 offices and a field force of about 100,000 seasonal employees. Block prepares tax returns for 16 million filers through its retail offices each year, or approximately 16% of U.S. households. For comparison, the Bank of America reports 33 million customers and 6,000 physical locations (Bank of America 2004). Wal-Mart is reported to serve 138 million customers per week in its 3,600 U.S. locations (Wal-Mart 2005).

Block's tax preparation clients tend to have low incomes. Over 57% of its retail customers are in households with Adjusted Gross Incomes (AGI) under \$30,000 (representing 33% of all U.S. households with incomes below \$30,000) and approximately 40% of clients are unbanked. The company's existing distribution capabilities – tax professionals, locations, and ready information access – enable it to

offer other financial and advisory services that might appeal to its many low-income customers who are underserved by “mainstream” financial services providers. For example, Block clients can deposit their refunds directly on to a debit card and avoid costly check cashing fees. Block offers IRAs and savings accounts as well, which can be opened with a client’s tax refund. Although these products are generally more palatable to consumer advocates, demand (and profits) is much less versus RALs.

Refund Anticipation Loans: Product Structure

The millions of H&R Block clients who purchase RALs each take out very short term loans, averaging \$2,800, secured by their refunds. The loans allow clients to speed up the receipt of funds to one to two days.²

From a client’s perspective, the RAL transaction begins when the H&R Block tax professional presents various options for receiving funds. (If the client is a repeat customer, she will often ask for the RAL directly). At this point a client is advised of both delivery times and costs for a RAL versus a refund.³ Prepared scripts encourage the client to first consider less costly methods, such as receiving her refund via direct deposit if a bank account exists. If the client chooses a RAL, she and the tax professional review the Annual Percentage Rate (APR) and other fees. Finally, an application is submitted to the lending bank (HSBC) and the return is submitted to the IRS. The IRS then provides a Debt Indicator (a measure identifying offsets such as for taxes, child support, or other debt) which is used by the lender to minimize losses. If the transaction is approved, the client returns within two days to pick-up a check.

Operationally, the fulfillment of the RAL is complex. Under the client’s instruction, the refund travels from the Treasury to HSBC, which uses the proceeds to

settle the client's loan. Because the IRS requires that all refunds received by direct deposit be routed to a bank account owned by the filer, HSBC complies by opening up a temporary bank account in the name of the RAL purchaser. The IRS direct deposits the refund to this account in 8-15 days, which is then "swept" to debit the loan amount and fees. The account is then closed.

An average Block RAL client pays about \$90 for the loan. Block's partner, HSBC, discloses that it charges \$27.95 to open the temporary bank account and then adds a financing charge of between \$7 and \$77 (for a RAL of between \$200 and \$5,000). Total fees were somewhat less for Block RAL clients, ranging from \$29.95 to \$109.95 (for a RAL of between \$200 and \$9,999) (Wu and Fox 2005). Given an average loan of \$2,800 and an average loan period of 11 days, these fees represent an APR of approximately 110%.⁴

The RAL Market

Block CEO Mark Ernst observed that "refund anticipation loans are a product that...consumers love" (Ernst 2003). This preference is manifested in strong demand. In 2000, Block sold nearly 4.5 million RALs (representing well over 50% of the market) and sold nearly 4.3 million RALs in 2004. More than a quarter of its 16 million annual retail clients sought RALs, a percent that was essentially unchanged between 2002 and 2004 (ranging from 26.3% to 27.3%) (H&R Block 2005). The share of Block clients purchasing a RAL is lower than that of its main retail competitor; Jackson Hewitt reports that 40% of its clients purchased a RAL (Jackson Hewitt 2005).

The typical consumer who purchases a RAL from Block has a household income below \$30,000. Most use some form of "alternative financial services" such as check

cashing, payday loans or money transfers. In many of these respects, RAL purchasers are like the majority of Block's LMI clients and data from a recent survey of RAL users (not limited to Block) confirm this view (Wu and Fox 2005). Overall, eighteen percent of respondents had purchased a RAL. Purchasers tended to be:

- Less well educated - 30% of respondents without a high school degree and 23% of those with only a high school diploma had purchased a RAL but just 12% of those who had graduated from college had done so.
- Less well off - 25% of those with household income of under \$50,000 reported purchasing a RAL.
- Ethnic minorities - 28% of African Americans and 21% of Latinos had purchased a RAL versus just 17% of whites.

A second survey (Elliehausen 2005) finds lower rates of RAL purchase, but that purchasers were still disproportionately low-income and less educated. This demographic profile reflects the RALs' consumer-value proposition. RALs enable cash-strapped consumers to receive money quickly to pay existing debts, have tax preparation fees deducted from the loan (no out of pocket expenses), and have money on hand if needed. Figure 1 shows the data on the reasons why Block clients opted to purchase RALs.

FIGURE 1 ABOUT HERE

RAL Economics

RAL Revenue. RALs represent an important source of revenue for Block. In 2004, they generated \$175 million in revenue, approximately 8.4% of total revenues from US tax operations. Over the last six years, RAL revenues have increased fairly steadily,

from \$90.1 million in 1999 to \$133.8 million in 2001 to \$139.1 million in 2003 (Tufano and Schneider 2005). As a share of total revenue from all US tax sources, RAL revenues ranged between 6.43% and 8.74%. See Figure 2.

FIGURE 2 ABOUT HERE

While Block is the visible merchant of RALs, operationally, it retails a loan product developed by HSBC, which holds patents on the RAL process. Block renegotiated its 10-year contract with HSBC to move from receiving a flat fee per loan to participating in the upside of the loans in exchange for taking on a share of risk.

When Block first introduced RALs, the product was hoped to deliver both revenues and a means to differentiate the firm. Over time, the latter benefit has eroded as other tax preparation firms offered RALs. This trend is due mainly to the increased number of electronic return originators (tax preparers who can file returns electronically). The number of EROs has been growing at over 15% annually to 100,000 EROs in 2003. While EROs cannot offer RALs without a bank partner, banks such as HSBC, Santa Barbara Bank & Trust, Bank One/JP Morgan Chase, River City, and Republic, have all developed proprietary RAL products. In 2004, HSBC offered RALs through 8,100 non-Block offices (Wu and Fox 2005) in addition to Block offices.

Though RALs may not differentiate Block, they do offer a valuable, but unanticipated, side benefit. Block clients who purchase multiple services are slightly more likely to return to Block for tax preparation the following year. Retention differentials are economically significant given the high cost of recruiting new clients. Block estimates that it spends \$115 million annually on marketing to replace the five million clients it loses each year, a cost that is steadily rising as Block increases the share

of the US population that has been to Block at one time (50%) and is unlikely to return (6% - 7.5%) (Tufano and Schneider 2005).

RAL Costs. The primary costs of offering RALs are operational expenditures and losses from delinquency. Block and HSBC maintain systems that link individual offices to the IRS. Block must train its staff, slow down its tax prep process to explain and consummate the RAL purchase, and operate a customer service infrastructure to support RALs. Block must maintain the technology used to print the RAL checks and HSBC must open, sweep, and close the accounts. The lender also incurs the cost of borrowing the funds for the loans.

The largest single cost is that of bad debts. While a check from the U.S. government has no credit risk, the size of a refund check can be smaller than originally estimated on a filer's tax form. These differences can be due to errors, or to various hold-backs on the refund due to legal claims such as unpaid child support payments, back taxes, and student loan debts. HSBC takes steps to try to minimize these losses through examination of a filer's "Debt Indicator," which is provided by the IRS and offers an assessment of any offsets that the government may make against the filer's refund. However, while the use of the debt indicator cuts losses, it is an imprecise measure. Nevertheless, Block and its partner report relatively low loss rates (under 100 - 150 basis points) compared with other short-term credit products. For instance, a recent study of two large monoline payday lenders found annual loss rates of 15.1% (as a ratio of losses to total revenue) (Flannery and Samolyk 2005).

RAL Profitability. While RAL fees represented less than 4% of Block's \$4.2 billion in 2004 sales, it's estimated that they accounted for 7 - 10% of Block's pre-tax net

income. RALs also made a disproportionate contribution to Block's growth rate. The company-wide compound annual growth rate of Block's operating income from 1998 to 2002 was 19%, with RALs accounting for more than three percentage points of the growth (Guttek and Shroff 2002).

Analysts estimated that Block had pre-tax income margins of roughly 26-30% company-wide, 28-31% on its core tax preparation business, 46-58% on its mortgage business, and it sustained losses in its investment and business services divisions. RAL margins are generally between those of Block's tax business and its mortgage business. Although some analysts estimate RAL margins near 50% (extrapolating from Block's agreement with HSBC), however after considering the full costs of technology, training and other infrastructure, the profit margin is probably lower, yet still attractive.

RALs are a profitable part of the Block business, and a product demanded by consumers. It would seem that this is a proverbial win-win, but this naïve supposition is far from correct.

RAL Criticism

Whereas the company interprets the high level of demand and consumers' willingness to accept RAL pricing as indicative of the high value consumers place on RALs, consumer advocates have interpreted this demand quite differently. The "high" price of RALs, combined with suspicions about "high" profit margins, has led to substantial criticism of Block. This criticism has taken two forms; complaints (and calls for boycotts) from consumer advocates and costly litigation.

Groups such as the Consumer Federation of America (CFA) and the National Consumer Law Center (NCLC) contend that few RAL purchasers realize that they are

entering into a loan and allege that there are not adequate disclosures made at the point of sale. These groups point to survey data that suggests that many RAL purchasers did not realize that they were in fact entering into a short-term loan agreement (Wu and Fox 2005).

Grass roots efforts, led by groups such as the Association of Community Organizations for Reform Now (ACORN), target Block and RALs. In 2004, ACORN organized a campaign against Block offices in 16 states. The protests in front of Block offices were covered by 29 newspapers, 34 TV broadcasts, and two radio broadcasts. Although other national tax preparation firms sell RALs, Block felt it was singled out due to its size and name recognition. Smaller campaigns have been launched against Block's competitors as well. In 2003 ACORN held protests outside of 30 Jackson Hewitt offices across the U.S. and in 2005 protesters converged at the headquarters of Liberty Tax (ACORN 2005; ACORN 2004). However these activities have generated far less media coverage.

RALs have led to twelve – mostly class action – lawsuits against Block alleging that the company made inadequate disclosures to clients and engaged in deceptive advertising and sales practices (generally based on conduct prior to 1996). More fundamental objections are raised about the rates charged on these short-term loans. Annualized APR's can reach as high as 156%, a rate that some consumer advocates deem usurious. RALs are sold by nationally chartered banks, a designation that allows these institutions to avoid state lending rate caps but not criticism about equity and fairness.

Block successfully defended against most claims, but paid out a substantial settlement in a Texas case, Haese v. H&R Block, resulted in a pre-tax expense of \$43.51

million. The uncertainty regarding RAL-related litigation has depressed Block's market value, with most analysts citing the risk of litigation as a key concern.⁵ For example, when the Texas litigation was announced in November 2002, Block's stock declined 30 percent in a six-day period, accounting for over \$2 billion loss of market value. While the stock regained some of that value, even after the positive rebound, the stock suffered a nearly \$1.5 billion market-adjusted loss. Similarly, stock price drops on November 7th and 8th came on the heels of an announcement by the judge in the case of a ruling unfavorable to Block (Freed 2002). Although the stock rebounded as the legal uncertainty subsided, litigation risks remain a black cloud over the stock. See Figure 3.

FIGURE 3 ABOUT HERE

In addition, policy makers have introduced legislation to curtail, if not ban, RAL sales. Laws in nine states and several cities impose additional disclosure requirements on RALs. Federal legislation introduced in the House and Senate would ban RALs that are made on the basis of expected EITC refunds (Wu and Fox 2004; Wu and Fox 2005). Although Block has made considerable investments in improving its disclosures and enforcing compliance to best practices across its network, much uncertainty remains with respect to the role of RALs in the company's strategy.

ADDRESSING THE PARADOX

Block's experience with RALs reflects the essence of a more general conundrum. A firm sells a product that meets customer needs, and enjoys high levels of customer satisfaction and profit levels. Its success encourages entry by competing firms. Yet the

firm faces criticism and legal pressure for offering the product to low income users and “profiting from the poor.” The “fortune at the bottom of the pyramid” is a like the treasure sought in an adventure film—fraught with traps and dangers.

In Block’s case, criticism of RALs revolves around a host of issues: appropriateness, disclosure and pricing. However, we suspect that most critics would be silenced if RALs were offered at no charge. Put most simply, critics believe that Block and its partners charge the poor “too much” for RALs and earns profits that are simply “too high.” In a companion piece, we briefly chronicle the long history of the debate over “too much” and “too high.” In simplest terms, this debate has been active for centuries. Economists, moral philosophers, religious thinkers, political scientists, consumer advocates, politicians, legal scholars, judges and others have offered contradictory advice. On questions of “fairness,” there are no simple answers.

This is of little help to Block. Organized consumer advocacy directed at RALs surely results in legal expenses, marketing costs, and diversion of management time. More important however, is possible reputational damage. Block enjoys 98% brand awareness, but perversely, faces high costs to acquire new customers. Also, given its name recognition, Block may suffer from adverse media attention that sours not only current RAL purchasers, but also other existing and prospective customers. This potential loss is not just theoretical; empirical research has suggested a positive relationship between a firm’s reputation and its financial performance (Roberts and Downing 2002).

Block is subject to what some have called “brand-jacking.”⁶ Consumer advocates, as well as members of the media, have limited resources and must budget them carefully. Targets of greater and more forceful advocacy and media attention may

be firms that (a) are more visible, (b) earn greater profits (or at least appear to by dint of high prices), or (c) are larger. To maximize impact, large well-known firms or brands are targeted. In this instance, Block feels singled out for legal and media attention, while believing that other RAL providers “fly under the radar screen.”

In our companion piece, we discuss the industrial organization implications of this hypothesis. In brief, we hypothesize that these phenomena can lead to circumstances where certain types of firms serving the poor may enjoy a comparative advantage. These firms are ones that are less visible, appear less profitable, and are smaller. Costs and prices will rise as larger and more profitable firms exit, leaving smaller and less efficient firms to serve the market. As an unintended consequence, rather than leading to lower costs and greater transparency, media criticism and advocacy could lead to higher costs and prices.

We are not seeking pity for profitable firms. Criticism about profits is a legitimate and expected cost of doing business in a capitalist system with free speech. In this chapter, we focus instead on various strategies that firms, their critics, and other responsible members of a civil society can use to leverage this debate for the good of all.

Publicly identify opportunities for business to serve poorer customers—and how this benefits these consumers. C. K. Prahalad’s book, *The Fortune at the Bottom of the Pyramid* challenges businesses to discover profit opportunities that exist among poorer customers. Prahalad suggests that public discussion could lower the cost of entry by providing free “market research” to potential entrants and his book serves this function. Academics, non-profits, and government agencies could serve similar functions. For example, D2D Fund identifies opportunities to serve the poor in the financial services

sector, conducts R&D in the form of pilots, and makes this information broadly available to potential entrants and policy makers. In a similar way, Block has begun to focus attention on the opportunities to serve the poor by highlighting the costs that its customers face to transform their refunds into cash (via check cashers) and the opportunities for refund-time savings.

Focus positive attention on products and services that aid poorer customers. The media and consumer advocates generally target firms for criticism, not praise. This provides little positive feedback for those that do serve the poor in a manner that is beneficial for both customer and firm. Again, *The Fortune at the Bottom of the Pyramid* book—and this volume—achieve the latter goal by highlighting Proctor & Gamble, Unilever, Cemex and ICICI, whose business with the poor is a proverbial win-win. Best practice role models should be profiled in business schools, trade associations, policy discussions and in the media. In so doing, advocates can lower the marketing costs of responsible firms and perhaps lower the prices consumers face.

Block has adopted a strategy of informing others how it serves low income consumers. These initiatives include disclosure of its activities, through cooperating with academics and policy makers, through attending meetings of policy makers, academics and community activists, and joining boards of industry groups aimed at addressing the problems of the poor. For example, Mark Ernst, the Chairman and CEO of Block joined the Aspen Institute's Initiative on Financial Security's Advisory Board.

Enter into the debate about profitability and consumer protection. It is important that the question: "How much profit is too much?" be debated outside of court-rooms or in media headlines. Like most difficult issues, reasonable people may disagree—but that

makes it even more critical to have reasoned debate. In the RAL context, consumer advocates question the value that consumers derive from receiving their refund “a few days” earlier than otherwise. Useful debate might include discussion of what the competing sources of unsecured borrowing are, and how the prices of those products compare to RALs, and the cost structure of delivering RALs. How does one incorporate the risks borne by firms—including litigation risk, or capital investments made by them, in our definition of “fair” profits? Should the concept of fair profits be determined “ex ante” rather than by simply arguing “ex post” that the most successful businesses enjoy excess profits? A more fundamental question is “Who has the right to say whether prices or profits are too high?”

As part of this debate, we need to establish a sense of context. The prevailing terms for promoters of hedge funds is “2 and 20.” They receive 2% of the money under management each year plus an additional 20% of the capital appreciation earned by the fund (The Economist 2005). For a large hedge fund, we suspect that these revenue levels would correspond to gross margins well above 100%. In the mutual fund industry, courts have held that pretax margins of up to 70% are not inconsistent with the fiduciary duty that boards owe to fund shareholders (Freeman and Brown 2001). The RAL business generates pretax profits far below either of these, and the tax preparation business even lower. Yet there is a sense of outrage around profits for tax preparation and RALs that does not extend to purveyors of mutual or hedge funds. What determines a “fair” level of profitability, beyond that which consumers and competition will support? And whose sense of fairness matters? While it would be naïve to think that we can resolve these issues, we need to create forums where they can be debated rationally.

Use partnerships with non-profits and governments. Partnering with non-profits and governments can have three salutary effects. First, by leveraging “soft” marketing by their partners or their intimate knowledge of the LMI customer, it may be less costly to deliver products. Second, within these partnerships, the “debate” over pricing and profits can be informed and carried out via “case studies.” For-profit businesses can better understand the perspective of their customers; advocates can better understand that for-profit partners cannot meet budget shortfalls by soliciting donations, and their partnerships become the venues for the debate. Third, when successful these partnerships become powerful examples of the power of business (and collaborative partnerships) to serve the poor, and can encourage broader activity.

Block has realized the power of these partnerships and in 2004 Block implemented six new programs with various partners:

1. Partnering with Operation Hope in Los Angeles to help improve financial literacy in low-income inner-city neighborhoods as well as increase access to financial services
2. Partnering with the Texas Children’s Health Insurance Program (CHIP) to increase access to benefits in the rural areas of the state
3. Partnering with a non-profit organization in Tulsa, Oklahoma providing free tax preparation services for low-income residents of the city
4. Working with the city of San Francisco (including donation of funds) to increase the awareness and uptake of the Earned Income Tax Credit (EITC)
5. Partnering with the Miami Mayor’s office to increase EITC awareness in the city, and
6. Conducting a pilot in St. Louis, Missouri (working with scholars at Harvard, U.C. Berkeley, M.I.T. and the Brookings Institution) to test alternative policies for increasing saving in low-income households.

These programs are generating positive business results as well as better understanding of Block’s strategy in several high-profile publications such as The San Francisco Chronicle, The Wall Street Journal, and The New York Times (Gordon 2005; Mullins

2005; New York Times 2005). From the firm's perspective, they highlight the fact that the firm is actually serving the needs of their low income clients. This serves to advance the firm's interests in city, state, and federal governments.

Research the implications of the consumer debate on public welfare. In our companion piece, we raise—but do not answer—questions about the role of consumer advocacy. When does consumer advocacy lead to entry, lower prices and enhanced welfare? When does it backfire and lead to exit, higher prices and reduced welfare? What is the incremental cost of serving certain classes of customers? How do we reconcile the demands of consumers and those of consumer advocates, which may not be the same. There are strong opinions, but precious little data, to answer some of these hard questions. For example, in assembling data on various contentious financial products, we found a large amount of advocacy literature—from both consumer advocates and business defenders—but less neutral research without an obvious point of view. Academia can serve an important purpose in working to provide objective data that can inform this set of discussions. Businesses and advocacy groups can help by jointly cooperating with third-party researchers.

Block has recently seen how independent research can inform public policy and business practice. In early 2005, Block conducted a pilot program in St. Louis, Missouri (working with researchers from U.C. Berkeley, M.I.T., Harvard's Kennedy School and the Brookings Institution) to test alternative policies for increasing saving in low-income households. This work provided new insights for policy makers about the impact of matching programs on stimulating savings among the poor. It also provided Block with insights about how to motivate its salesforce. In 2006, Block is conducting additional

experiments which hopefully will provide additional insights into the intersection of public policy with other aspects of its business.

Block is a firm embroiled in a long-standing debate: What level of profits is fair? The “paradox of profits”—if it exists—is that profits are necessary to encourage private firms to serve the poor, but profits themselves can create additional costs for these firms in the form of damaged reputations, public attacks, associated litigation and the other forms. Without attacking or defending Block, we seek to use its example to bring the question of “fairness of profits” into the open. A debate in a well-lit room, informed by substantial evidence seems far preferable to optimistically hoping that those who serve the poor will be lauded, or that cynically assuming that reputable people can never profit from serving the poor.

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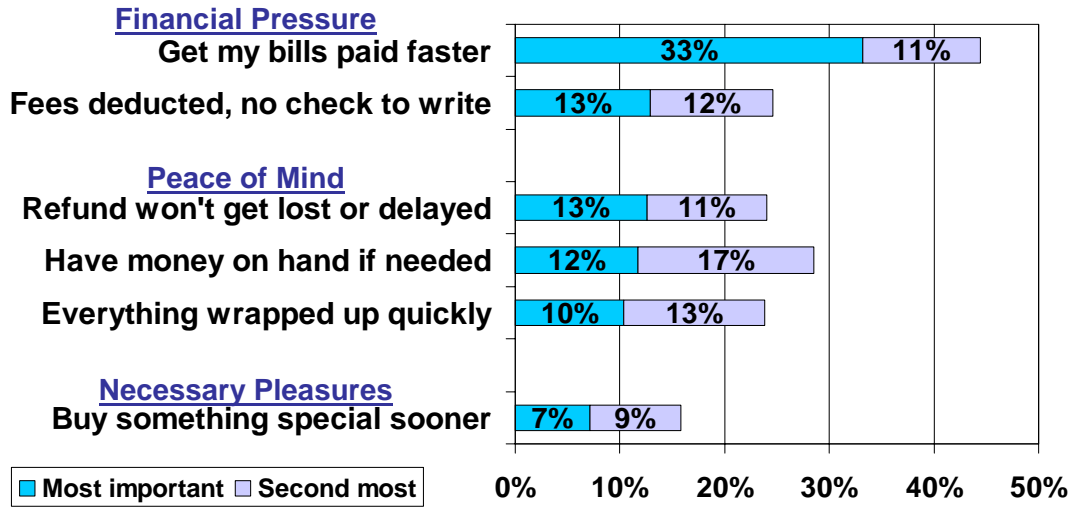
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Figure 1 **Reasons for Getting a RAL from HRB**

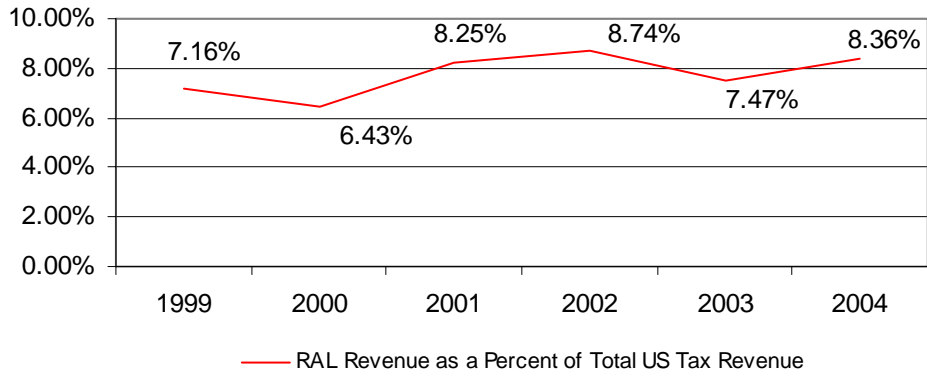
Reasons for Getting HRB RAL

First & Second Most Important



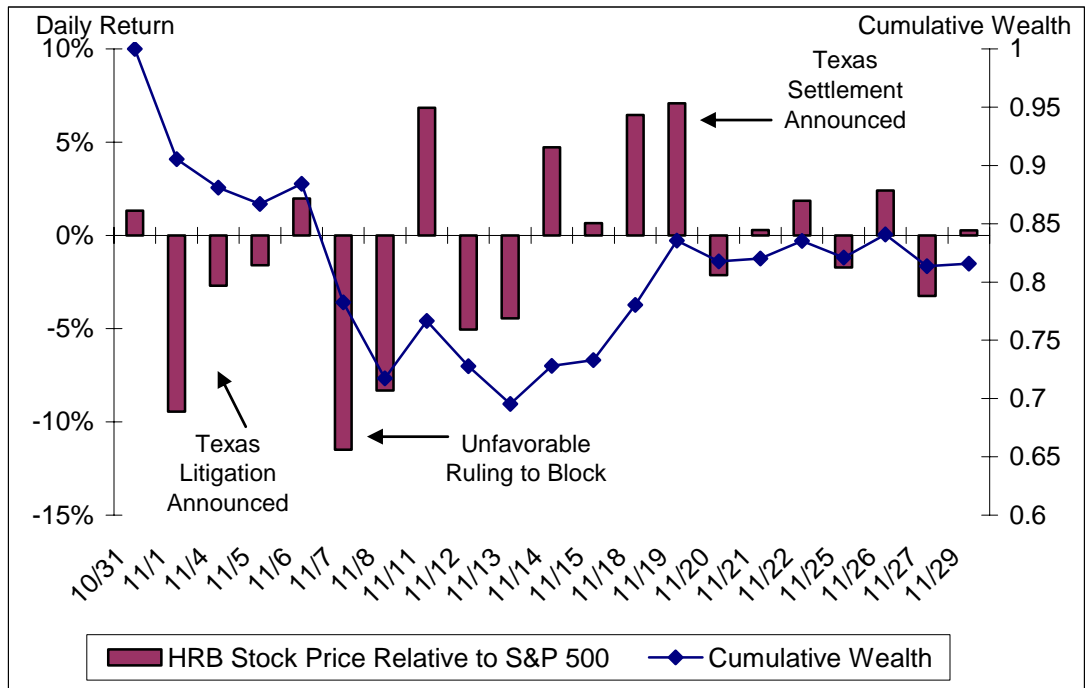
Source: H&R Block survey of 1,700 refund clients conducted in July 2003

Figure 2 RAL Revenues as a Percent of Total US Tax Revenue 1999 - 2004



Source: H&R Block 10-K, 1999 -2004.

Figure 3 H&R Block Daily Stock Returns, net of S&P 500, 10/25/02 – 11/29/02



Notes: The bars and left scale shown the net daily return, which is calculated as daily return on HRB stock less return on the S&P 500. The line and right scale shows the cumulative excess wealth over this period, which is the product of one plus the net daily returns from the day before the litigation was announced.

Source: www.finance.yahoo.com

¹ David Rose is also Assistant Vice President of Competitive Strategy at H&R Block. However this paper is not endorsed by H&R Block and does not reflect the views of the organization.

² From a client's perspective, the loan "term" may seem like the time from when the money is received versus when the consumer might *otherwise have expected it* (1 – 8 weeks depending on if a filer chose direct deposit or mail). However, the actual loan is paid off in an average of 11 days

³ Clients also have the option of purchasing a Refund Anticipation Check, which delivers funds more slowly at lower cost, or an Instant RAL, which delivers the funds faster, but is more costly, than a RAL. Clients may also opt not to purchase any such "settlement product" and decide to receive their refund by direct deposit or by paper check.

⁴ The Truth in Lending Act requires that the interest rates be stated in annualized terms. Calculated this way ($(\$90 \text{ finance charge}/(\$2,800 \text{ loan amount}- \$90 \text{ finance charge})) \times (365 \text{ days}/11 \text{ days})$) the APR is 110%. Alternatively, one can express the cost of a RAL as 3-4% of a tax refund.

⁵ For example, Morgan Stanley analysts note that "RAL is a high-margin product that has also hurt Block's reputation" (Guttek and Shroff, 2002)

⁶ Thanks to C.K. Prahalad for calling attention to this term. When used in this context, brand-jacking refers to the practice by activists of targeting the leading brand in an industry in order to maximize the efficacy of their actions, and with the hope that any changes implemented by the brand leader will diffuse through the remainder of the industry. See "Runner-up, up and away," *The Economist* (14 December, 2005) for a recent discussion of this phenomenon.