H&R Block's Refund Anticipation Loan: A Paradox of Profitability?

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Some firms comprehend the enormous potential that exists for providing services to the growing low income segment. Operating in the low-income market has numerous complications, such as designing an efficient distribution and servicing system, offering simple and "easy to consume" products, and training a sales force. In addition, vendors of products for the poor often must enter into a contentious, long-standing and irresolvable debate about appropriate levels of profit and consumer protection. Regardless of the merits of these debates, firms can find themselves bedeviled by complicated interactions with non-customers, including consumer advocates, the press, courts and regulators. The experiences of H&R Block, a $4.2 billion income tax preparation and financial services firm headquartered in Kansas City, Missouri, illustrate some of these costs. Block sells a highly profitable "Refund Anticipation Loan" (RAL) product to clients opting to pay a fee to receive their tax refund in just one day. RAL consumers are typically from low income households under considerable financial stress. While RALs may serve a specific need and are highly demanded (Block sold over 4 million in 2004), Block faces pressure from consumer advocates to lower the pricing of the product or to exit. This situation illustrates a number of hard questions with broad application: How much profit is "too much"? Who is the arbiter of such a decision? To the extent that "consumer advocacy" is costly, what are the implications for firm entry and exit into the low-income market and for the prices of goods and services sold to the poor? If large, profitable and visible firms are targeted for advocacy activities, what are the implications for consumers? How should firms seeking to sell goods and services to the poor behave?

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[1] David Rose is also an employee of H&R Block, serving as Assistant Vice President of Competitive Strategy. However this paper is not endorsed by H&R Block and does not necessarily reflect the views of the organization.

Introduction

At a recent meeting, a big city mayor angrily confronted an executive of H&R Block: "Why do you charge poor people $130 to do tax returns. At our VITA sites, we do them for free!" At a meeting in Chicago, the leader of a large volunteer tax site refused to shake the hand of a Block executive. In a meeting in Washington, a senior banking regulator railed about the 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. While much of the financial service world has moved away from serving low income consumers, Block has embraced its low income clientele and it processes taxes that deliver over $35 billion of refunds to its customers. Block customers are fairly happy with their experience with the firm, as witnessed by satisfaction scores in the high 80s (out of 100) and 70 percent customer retention. Yet, Block is open to substantial criticism, primarily around a product that consumers demand, but activists and regulators abhor: the refund anticipation loan (RAL). This product gives consumers near immediate access to their federal income tax refunds, 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 (Block serves an additional three million customers with its software and online "do it yourself" tax products). 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? How can you *justify* earning such profits by selling to the poor? While 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, Block's experience suggests that when a business tries to tap into that fortune, it must not only sell and deliver products that consumers want at a price they will pay. Rather, our commercial fortune-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 manifests itself ultimately in costs which can make firms reconsider whether serving the poor is a good use of their resources, time and reputation.

In this piece, we discuss the paradox of profits, which at its heart revolves around societal norms about "fair" prices charged to the poor. In Part two of this piece, we discuss how economists, philosophers, religious thinkers, regulators and courts have approached the question of "fair" prices and profits. In Part three, we show how this social debate has played out in connection to Block's RAL product. In Part four, we discuss potential unintended consequences of the paradox of profits. In brief, the public scrutiny around the profits and the poor impose a larger burden on certain firms, such as larger firms, more public firms, and firms with multiple product lines. As a result, in equilibrium, where public scrutiny is highest, the poor may be served by smaller, non-public firms that try to avoid detection. This outcome may not be in the best interest of the poor. In Part five, we discuss how large firms can address the paradox of profits head-on, using the example of Block's recent strategic initiatives to engage its potential critics.

2. A Long-Standing Debate: Profiting from the Poor

The question that Block executives faced, "Are your prices and profits too high?", has a long history. While economists see prices and profits as merely determined by supply and demand curves, the question of "fairness" is one that vendors to the poor have faced throughout history with few definite answers. While the concept of "fair levels of profits" has been considered from economic, religious, and governmental perspectives, no definition is widely accepted. It is important to appreciate this longstanding historical context because it provides the framework within which this unresolved debate plays out.

Economic Perspectives

The idea of "fair" levels of profits would be foreign to most graduate students in economics programs. Economists see profits as playing a constructive role in the economy, guiding capital to its best uses. Schumpeter provides justification for profits as motivating innovation.[2] Adam Smith and John Stuart Mill saw a role for profits as compensating for risk.[3] More generally, the desire for profits might also motivate economic activity, driving individuals to run firms effectively.[4] Finally, profits could

[2] Israel M. Kirzner, "The Nature of Profits: Some Economic Insights and Their Ethical Implications," in *Profits and Morality*, ed. Cowan and Rizzo (University of Chicago Press: Chicago, IL, 1995), p. 33.
[3] Kenneth Arrow, "Why Profits are Challenged," in *New Challenges to the Role of Profit*, ed. Benjamin Friedman (Lexington Books: Lexington, MA, 1978) p. 53 and David Parker and Richard Stead, *Profit and Enterprise: The Political Economy of Profit* (Harvester: New York, 1991), p. 44.
[4] Arrow, 52.

serve as an efficient allocator of scarce resources, ensuring that productive capacity is always utilized in the most effective way.[5]

Marxist economists would hold that all profits are excessive in that they are created by exploiting labor to produce surplus value.[6] Yet, even within Neo-classical economists, there is scope for believing that profits are "too high" at times when there is substantial market failure. Market failure can result when competition does not exist or when there are severe information asymmetries. Insufficient competition could result from factors such as high barriers to entry, due to scale economies, governmental rules or high first mover advantages. Information asymmetries could lead to market failure in that supply or demand curves might not reflect all relevant information, and thus prices and profits could be different from a "first best" outcome. Kenneth Arrow has argued that profits may have little to do with the motivations of individuals. Among other objections, he cites Veblen's theory that most business decisions are made at fairly low levels in the firm, by actors divorced form any direct profit reward. Arrow also counters the efficiency argument, holding that instances of large scale unemployment expose an important failing in that regard.[7]

Public Policy Perspectives

Economists are hardly the only ones to think about profits. Rather, to understand discussions of "excessive profit," we examine three other perspectives, beginning with the governmental. The question of "What constitutes a fair level of profits?" has

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[5] Robin Cowan and Mario J. Rizzo, "Fundamental Issues in the Justification of Profits," in *Profits and Morality*, ed. Cowan and Rizzo (University of Chicago Press: Chicago, IL, 1995), p. 6.
[6] See: Karl Marx, *Capital : A Critique of Political Economy Vol. I*; translated from the third German edition by Samuel Moore and Edward Aveling ; edited by Frederick Engels., (London : Electric Book Co., c2001).
[7] Arrow, 57.

received much attention by government, particularly regarding profits earned by private firms during war times. While we are primarily concerned here with the idea of "unfair or excessive profit," it is worth noting that this debate has been wider ranging, encompassing discussion of the proper role of profit making of any kind during war time. The position that individuals and companies should not profit at all in war time gained particular currency in the wake of World War I, and by 1936, the Democratic Party platform called for "taking the profits out of war."[8]

However, most government intervention in this area has focused on "unfair profits." Commonly called "profiteering," this activity can include trading with the enemy, privateering, graft, the sale of shoddy goods, and the charging of prices well above the pre-war norm.[9] We focus on the last of these, not because the others are insignificant (indeed review of such activities during wars from the Revolution on shows them to be widespread) but because activities such as graft and abetting the enemy are morally suspect independent of the level of profit earned.[10]

Stuart Brandes, in his thorough history of American war profiteering, defines this latter type of "unfair" profit making as occurring when "a vendor raises his prices to take advantage of a seller's market arising from the sectoral shifts that develop as a result of military purchasing."[11] During war times, the government's purchasing need is often sudden and tremendous. While the government might command great purchasing power under ordinary circumstances, in war time the urgency of its need may undercut that bargaining position. In effect, its demand curve suddenly becomes completely inelastic

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[8] Stuart D. Brandes, *Warhogs: A History of War Profits in America*, (University Press of Kentucky: Lexington, KY, 1997), p. 221.
[9] Brandes.
[10] For a more complete description of this argument see: Cowan and Rizzo.
[11] Brandes, 7.

and under these circumstances, the notion of a “market clearing price” is strained. The challenge for government has been in translating that descriptive definition into an enforceable code.

As early as the Revolution, the US Government has endeavored to regulate “excessive profits.” George Washington railed about the “monstrous evils” of merchants overcharging the military and the Continental Congress established early profit benchmarks (at 2.5% above cost).[12] The Civil War saw accusations of collusion in price setting on the part of small arms manufacturers and railroad companies and the effort by government to renegotiate contracts once levels of producer profit were known.[13] World War I produced the first “excess profits tax,” of between five and eight percent on munitions, with later revisions rising to 12.5%, and then to 60% of all return above 33% on invested capital.[14] Cost-plus contracts were also introduced during World War I, with the government contracting for the construction of training facilities at cost plus $250,000.[15] Between the wars, the Vinson Trammell Act imposed an excess profits tax of 100% on all profits above 10% of costs for ship construction and 12% of costs for airplane construction.[16] This approach was modified with the introduction “normal profit” benchmarks in 1940 (calculated as a function of the average profit of the firm over the four years preceding the war and an assumed normal rate of return on capital of six percent).[17] In addition, World War II saw the passage of the Renegotiation Act and the

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[12] George Washington, letter to James Warren, March 31st, 1779, in *George Washington: A Collection,* compiled and edited by W.B. Allen (Indianapolis: Liberty Fund, 1988, www. http://oll.libertyfund.org/ (accessed May 17th, 2005) and Brandes, 8.
[13] Brandes, 69, 74, 84.
[14] Brandes, 135, 172.
[15] Brandes, 149.
[16] Brandes, 228.
[17] Brandes, 239.

creation of the Renegotiation Board, which allowed the War Department to renegotiate contracts it had with contractors.[18]

Neither public discontentment over perceived "excessive profits" nor governmental efforts to regulate such profits is a thing of the past. In 2003, Senator Patrick Leahy introduced an amendment fundamentally re-affirming the Renegotiation Act, imposing a criminal penalty for war profiteering, defined as "'materially overvaluing' any good or service with the specific intent to 'excessively profit' from the war and relief or reconstruction activities."[19]

While "profiteering" and "price gouging" have generally been used to refer to excessive profit making by private firms during war times, the later term has come to be used more widely. Most recently, in the aftermath of Hurricane Katrina, gas stations have been accused of "price gouging." The Federal Trade Commission began an investigation of the issue in late September of 2005, and soon afterwards the Attorney General of New Jersey brought suit.[20] Inelastic consumption demands in the wake of war or natural disasters are considered in appropriate bases for firms to profit.[21] The public's response is perhaps due in part to a fundamental discomfort with "windfall profits." Defined by Cowan and Rizzo as "profits [which] arise purely from changes in external

[18] Alfred Buehler, "The Taxation of Corporate Excess Profits in Peace and War Times," *Law and Contemporary Problems*, 7(2), 1940; 291-300; Lichter v. U. S. , 334 U.S. 742 (1948) www.findlaw.com, (accessed May 17th, 2005).

[19]War Profiteering Prevention Act of 2003," introduced by Sen. Patrick Leahy, S 1813, 108th Congress, 1st Session, http://thomas.loc.gov/cgi-bin/query/z?c108:S.1813:

[20] Ronald Smothers, "Gas Stations Violated Pricing Law, New Jersey Says," *The New York Times*, 27 September 2005, www.factiva.com (last accessed September 28th, 2005), Dow Jones Newswire, "FTC Investigates Claims of Gas-Price Gouging," *The Wall Street Journal*, 22 September 2005, www.factiva.com (last accessed September 28th, 2005).

[21] Taking governmental action against oil companies to restrain their profits is not a new idea. In the 1970s and 1980s, the "Oil Windfall Profits Tax" attempted to reign in "excessive" profits. For a more detailed description of instances of federal regulation of windfall oil profits see Michael Knoll, "The Crude Oil Windfall Profit Tax Act of 1980," *Resources and Energy* 9, 1987 and "General Explanation Of The Crude Oil Windfall Profit Tax Act Of 1980" (H.R.3919, 96th Congress; Public Law 96-223, Prepared By The Staff Of The Joint Committee On Taxation).

circumstances…- the events causing the profits is a complete surprise to the profit maker," these profits are often viewed as undeserved.[22] The profit maker has taken no purposeful risk, invented no new product, exerted no effort.

Religious Perspectives

Christianity, Islam, and Judaism all address the topic of "excessive profits" primarily through the lens of usury. The principal texts of all three religions have been interpreted to mandate its outlaw. In the case of Judaism, passages from the Old Testaments books of Exodus, Leviticus, and particularly Deuteronomy, give rise to this prohibition. A key passage from Deuteronomy was most responsible for shaping Jewish law on usury (taken to mean any interest charge, not just high rates of interest). The language, "Unto a stranger thou mayest lend upon usury; but unto they brother thou shalt not lend up on usury," was classically interpreted to suggest an injunction against a Jew lending at interest to another Jew but the allowance of lending at interest to a gentile. Over time, this prohibition has lapsed, as lending at interest between Jews has come to be sanctioned by religious law.[23]

A less prominent strain of Jewish religious scholarship more directly addresses the question of excess profit. The important Talmudic scholar Maimonides offers specific guidance on profit, arguing that the prices of essential items should be held at affordable levels and that profit should not exceed 20% on these items.[24] Friedman cites similar prohibitions on transactions in which "the retailer sells an item for a price that is

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[22] Cowan and Rizzo, 5-6.

[23] Susan L. Buckley, *Teachings on Usury in Judaism, Christianity, and Islam* (Edwin Meller Press: Lewiston, NY, 2000), p. 2-4.

[24] Noam J. Zohar, "A Jewish Perspective on Access to Healthcare," *Cambridge Quarterly of Healthcare Ethics,* 7, 1998, 260-265.

one-sixth higher than what is generally accepted as a fair price," with this applying particularly to "staples such as wheat, oil, or wine."[25]

While the Old Testament explicitly addresses the subject to usury, the New Testament is far less clear. A few fairly ambiguous lines from Luke form much of the basis upon which Christian scholarship on usury is based. However, despite this lack of clarity, Christianity developed stricter standards against usury than Judaism, generally prohibiting all lending at interest. This prohibition, began to erode with allowance of interest charges upon default, and then, under attack from John Calvin, began to disappear all together.[26]

Calvin argued that the principal biblical passage on usury, in Deuteronomy, was far more ambiguous than had been represented. In essence, Calvin argued that usury (understood to be interest, not necessarily exorbitant interest) was not in fact outlawed by biblical injunction and is only inappropriate when the rate is very high, when making frequent loans, and when lending to the poor.[27] This position found wide support in the legal and business communities of the time, and while the debate continued, the opposition to usury had weakened so considerably that by the early 1800s, the Catholic Church formally allowed the imposition of interest on loans.[28]

The Islamic prohibition on usury, referred to as "Riba," is supported by several passages in the Qur'an. These passages are unequivocal in their condemnation, but, the precise definition of "riba" is not made completely clear.[29] Generally, "riba" has been

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[25] Hershey H. Friedman, "The Impact of Jewish Values on Marketing and Business Practices," *Journal of Macromarketing*, Vol. 21(1), June 2001, 74-80.
[26] Buckley, 95, 120.
[27] Benjamin Nelson, *The Idea of Usury: From Tribal Brotherhood to Universal Otherhood* (University of Chicago Press: Chicago, IL, 1949), p. 73.
[28] Nelson, 74 and Buckley, 164.
[29] Buckley, 190.

taken to mean “unjustified enrichment,” but it has come to be defined more narrowly as the charging of interest on a loan.[30] However, the more general sense of the word has been subject to some analysis. Mittlestadt notes that “riba” can be understood a unfair profit and Ghazanfar references the Mediaval Islamic scholar Al-Ghazali as saying that state intervention is justified when excessive profits are derived from the sale of necessities with normal profits being approximately 5 -10% of a good’s cost.[31]

Consumer Advocacy and Legal Perspectives

More currently, the concepts of what constitutes “fair” prices or profits is a topic on which media commentators, consumer advocacy groups, and litigators have much to say. Beginning in the 1960s, academic researchers and consumer advocates began to focus on the prices that low-income consumers paid for certain basic goods. David Caplovitz’s seminal work, *The Poor Pay More,* spurred this line of inquiry with an examination of the prices of consumer durables. Examining both the price of goods and the financing arrangements through which these goods were purchased, Caplovitz concluded that poor consumers often paid more than wealthy consumers for identical goods.[32] Following Caplovitz, a number of researchers conducted similarly motivated analyses of food prices and a relatively large literature on this topic had developed over the past 30 years. The large majority of this work has examined the prices charged on comparable food stuffs in low income and high income neighborhoods to determine

[30] Faud Al-Omar and Mohammed Abdel-Haq, *Islamic Banking: Theory, Practice & Challenges* (Oxford University Press: Karachi, 1996), p. 7.
[31] John D. Mittlestaedt, “A Framework for Understanding the Relationships between Religions and Markets,” *Journal of Macro-Marketing*, Vol. 22, No. 1; and S.M. Ghazanfar, “The Economic Thought of Abu Hamid Al-Ghasali and St. Thomas Aquinas: Some Comparative Parallels and Links,” *History of Political Economy*, 32(4) 2000.
[32] David Caolovitz, *The Poor Pay More* (The Free Press of Glencoe: New York, 1963).

whether low-income consumers pay higher prices. The conclusions have been mixed, while generally finding some evidence that non-chain stores charge higher prices than large grocery chains and that these higher priced outlets are disproportionately located in low-income areas.[33] More recently, consumer groups have studied the pricing of financial products such as payday loans, rent-to-own contracts, and pawn agreements. These reports have documented rates of interest as much as 600% APR on some payday loans and prices of consumer durables two or three times that of the underlying goods in the case of some rent-to-own contracts.[34]

In general, these studies seem to assume that high prices are indicative of high profits. While some researchers of food prices have been able to consider the store-level economics of some grocers, there is little data on actual levels of profit margins and so the assumption that prices are an accurate proxy for profits is not well founded.[35]

To explain why prices (and profits?) are higher for the poor, researchers offer a number of explanations. First, the lack of competition in low-income markets and the limited ability of low-income consumers to search for lower prices are often cited,

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[33] For useful reviews of this literature see: Donald Sexton, "Comparing the Costs of Food to Blacks and Whites: A Survey," *Journal of Marketing*, 35 July 1971, 41-46; Alwitt and Donley, "Retail Stores in Poor Urban Neighborhoods," *The Journal of Consumer Affairs,* 31 (Summer 1997), 139-164; Philip R. Kaufman, James M. MacDonald, Steve M. Lutz, and David M. Smallwood, "Do the Poor Pay More for Food? Item Selection and Price Differences Affect Low-Income Household Food Costs," USDA, Food and Rural Economics Division, Economics Research Service, Report No, 759; Lashawn Richburg Hayes, *Do the Poor Pay More? Three Essays on the Existence of a Poor Price Differential*, PhD Dissertation, Princeton University, 2000.

[34] Jean Ann Fox, "Unsafe and Unsound: Payday Lenders Hide Behind FDIC Bank Charters to Peddle Usury," Consumer Federation of America, March 2004, www.consumerfed.org (accessed April, 2005) and Robert D. Manning, *Credit Card Nation: The Consequences of America's Addiction to Credit* (Basic Books: New York, 2000), p. 214.

[35] See for example: Loraine Donaldson and Raymond S. Strangeways, "Can Ghetto Groceries Price Competitively and Make a Profit?" *The Journal of Business*, 46(1) 1973, 61-65; Bruce Hall, "Neighborhood Differences in Retail Food Stors: Income Versus Race and Age of Population," *Economic Geography*, 59(3) 1983, 282-295; Robert King, Ephraim Leibtag, and Ajay S, Behl, "Supermarket Characteristics and Operating Costs in Low Income Areas," USDA Agricultural Economic Report, No. 839.

particularly in the grocery literature. Second, the lack of adequate disclosures and a more general lack of consumer knowledge are also put forward as a reason for these prices.[36] For example, some argue that "ill-informed and generally immobile consumers," permit exploitive behavior by merchants.[37] Third researchers and consumer advocates argue that some products, particularly financial products such as payday loans and overdraft protection, are structured and marketed in such a way that they force consumers into cycles of debt – that they are effectively addictive.[38] Put simply, monopolistic conditions, poor information, and addictive products enable merchants to charge high prices, but these underlying practices are market failures, and so the prices (and presumably profits) generated are also unjustified.

However, a second type of objection to these profits is based on the outcome, not on the cause of these profits. Some hold that private firms should not be permitted to derive substantial profits from poor and vulnerable consumers with insubstantial resources, simply as a matter of fairness. This point of view is discernable in the Consumer Federation of America's admonishment regarding overdraft protection customers that "these are also the same people, of course, who cannot afford to be paying excessive fees on a regular basis" and in the Progressive Policy Institute's claim that high

[36] See generally Alan R. Andreasen, *The Disadvantaged Consumer* (The Free Press: New York, NY, 1975).
[37] Frederick D. Sturdivant, "Better Deal for Ghetto Shoppers," *Harvard Business Review*, March-April 1968.
[38] Michael A. Stegman and Robert Faris, "Payday Lending: A Business Model that Encourages Chronic Borrowing," *Economic Development Quarterly*, Vol. 17, No. 1, February 2003; Jean Ann Fox and Edmund Mierzwinski, "Rent-A-Bank Payday Lending," Consumer Federation of America and US Public Interest Research Group, November 2001, available online at www.consumerfed.org; Center for Responsible Lending, "Overdraft Loans Trip Borrowers in Debt," CRL Issue Brief No. 18, September 17th, 2004, available online at www.responsiblelending.org.

cost lending to low income borrowers is designed to "extract the greatest profit and, as a consequence, cause the greatest financial harm to the borrower."[39]

Kenneth Arrow provides some background and context for this second idea - that profits are unfair and can be excessive in so far as they promote inequality. He cites a lineage of utilitarian philosophers who called for economic equality as a condition for maximizing individual benefit. Arrow then points out that profit is likely associated with increasing inequality in the distribution of income.[40]

Legal scholars approach this topic from slightly different grounds. In certain instances, sellers of goods and services owe fiduciary duties to the buyers, by virtue of vast differences in information and expertise. Professionals such as doctors and lawyers, as well as investment managers, may be held to higher standards and cannot rely merely on "caveat emptor." They must demonstrate fiduciary duties of care and loyalty toward these clients.[41] As to be expected, there is much uncertainty about how to translate these duties into practice, e.g., what level of prices is fair under these circumstances. As an example of this debate, there are lawsuits pending arguing that mutual funds have charged fees that are excessive and thereby breached their fiduciary duties.[42]

This short review of centuries of debate over the fair level of profits should underscore that those selling to the poor—or to anyone in times of emergency—must

[39] Consumer Federation of America and the National Consumer Law Center, "Appendix: Bounce Protection: How Banks Turn Rubber in Gold by Enticing Consumers to Write Bad Checks," 2003 available online at http://www.consumerfed.org/pdfs/bounceappendix012803.pdf; James Carr and Jenny Schuetz, "Financial Services in Distressed Communities," Progressive Policy Institute, 2001.
[40] Arrow, 51.
[41] Tamar Frankel, "Fiduciary Duties," in *The New Palgrave Dictionary of Economics and The Law* 127, Peter Newman ed., 1998.
[42] For news coverage of litigation over fees, see Sean Murphy, 2005, "Mutual Funds Under Scrutiny: An Overview of Recent Litigation," *Securities Litigation & Regulation Reporter* 10 (21); Andrew Caffrey, "Lawsuits Challenge Unequal Fund Fees; Fidelity, Putnam among Defendants," *The Boston Globe*, August 18, 2004; Bruce Masters, "Alliance Struggles to Settle with Regulators; Size of Firm, Weight of Evidence May Make Deal a Model for Money-Management Firms," *The Washington Post*, December 17, 2003.

realistically expect scrutiny about the prices they charge, the profits they earn, and the appropriateness of the products they offer. This debate persists, despite the lack of unanimity, even in one culture, as to what is a "fair" price or level of profits. In the next section, we see how this debate has played out for one firm.

3. H&R Block and its Refund Anticipation Loan Product

H&R Block is a $4.2 billion income tax preparation and financial services firm headquartered in Kansas City, Missouri. Block's clientele is disproportionately drawn from less-affluent consumers. Block has provided these consumers with certain financial services in conjunction with their tax preparation. We study one of these product offerings: Refund Anticipation Loans sold to clients opting to pay a fee to receive their tax refund rapidly. RAL users are typically low-income households under considerable financial stress. While RALs are profitable to Block, serve a specific need, and are highly demanded (Block sold over four million in 2004), the firm is widely criticized by consumer advocates for offering these products. Below, we discuss Block's experiences with the RAL product, describing the product and analyzing the economics from the perspective of low-income consumers and H&R Block. We go on to describe the extensive criticism directed at the RAL product and the implications for Block.

Background on H&R Block

Founded in 1955 by Henry and Richard Bloch, H&R Block grew into a $4.2 billion revenue financial services company over its 50-year history. Although the $2 billion tax preparation unit still accounts for the lion's share of revenues, business units such as RSM McGladrey (accounting services for medium size businesses), H&R Block Mortgage (subprime mortgages for the low- to moderate-income market), and H&R Block Financial Advisors (middle market personal financial advisory services) represent important portions of the company's revenues and strategy of becoming "America's Financial Partner."

With the exception of RSM McGladrey, Block's strategy is to leverage existing relationships with tax clients to provide a low cost means of acquiring clients in its other business units. Block's distribution system consists of over 11,000 retail offices (largely in strip malls but also inside of retailers such as Wal-Mart) and a field force of 80,000 seasonal employees working from January through April each year. To put Block's retail footprint in perspective, it touches 16 million filers each year, or approximately 16% of U.S. households. Most Americans live within 10 miles of a Block office. For comparison, the largest U.S. bank has 33 million customers and 6,000 physical locations.[43] Wal-Mart is reported to serve 138 million customers per week in its 3,600 physical locations in this country.[44]

Demographically Block's tax preparation client base skews towards low-income households, as shown in Figure 1 below. Over 57% of its retail customers are in households with income under $30,000. Block serves roughly one in three households in the U.S. with income below $30,000. The company's existing distribution capabilities – tax professionals, locations, and ready information access – give it a platform upon which it can offer other financial and advisory services.

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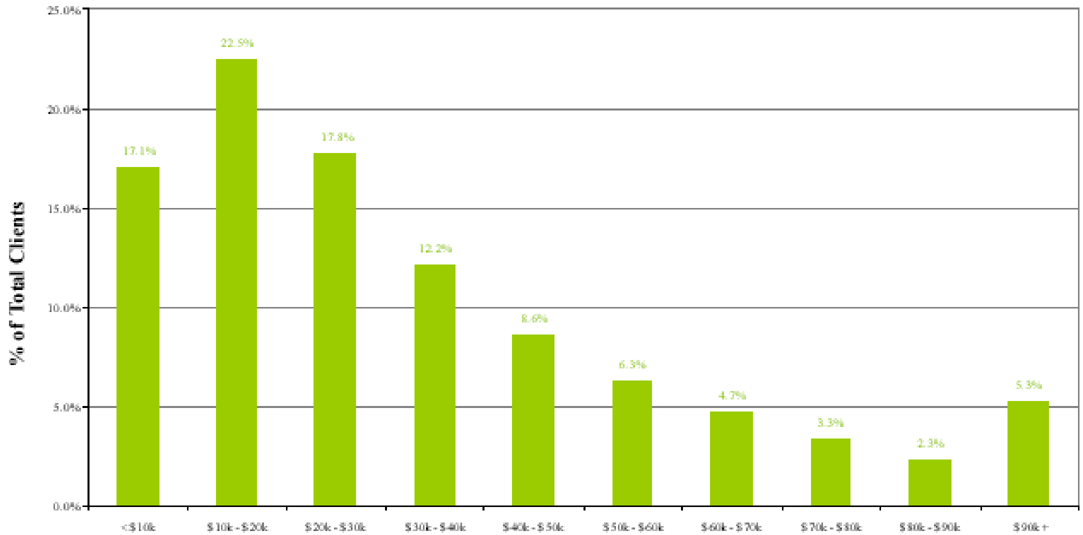
[43] Bank of America reports 33 million consumer households (Bank of America, 2004 Annual Report) and 5,889 branches (Bank of America, 2004 4Q Investor Fact Book).
[44] Wal-Mart, "Wal-Mart Facts Sheets," available online at http://www.walmartfacts.com/doyouknow/ (last accessed November 11, 2005).

Figure 1 Income Distribution of H&R Block US Tax Preparation Clients



Because it serves a high share of the low income households in the U.S., Block has been active in developing products and services targeted at this underserved (by "mainstream" financial services providers) segment. For example, Block offers clients the opportunity to deposit their refunds directly on to a debit card, allowing its unbanked clients (approximately 40 percent) to avoid costly check cashing fees. Block offers low cost savings products as well, which can be opened from a client's tax refund. These include a qualified IRA account as well as a traditional debit card-based savings account. Although these products are generally more palatable to consumer advocates, demand (and profits) is much less versus RALs.

Refund Anticipation Loans

In the mid-1980's, after 30 years in the tax business, H&R Block's unit growth rate had stagnated. Although the company faced little competition on a national level, tens of thousands of small local tax preparation firms were offering services identical to Block's. The IRS provided a considerable jolt to this market when, in 1985, it introduced its "e-filing" initiative. This policy change was designed to encourage tax filers (often through commercial tax preparation firms) to submit completed tax returns to the IRS electronically. For the IRS, this change had the potential to bring down both data entry costs and error rates (previously the IRS had to hand-enter all the information from a return). For Block, the change to e-filing represented an opening to provide for a new product that could generate revenue and distinguish the firm from its many competitors. In 1986, Block rolled out the Refund Anticipation Loan (RAL), a proprietary product developed by Block and its partner Taxpayer Financial Services, a division of HSBC.

RALs offered clients the ability to receive their check more quickly than had previously been possible. Prior to 1986, all tax returns were mailed to IRS processing centers around the country, which in turn remitted them to filers, who could wait months for their check. With electronic filing, check processing speed increased substantially and in 1986, an electronic filer could expect to receive his or her check in 2 – 3 weeks. RALs allowed clients to get their checks still faster, in as few as two days. Electronic filing had allowed Block to connect its systems directly to the IRS. This direct connection provided Block with the ability to quickly determine if any liens or other commitments against a client's tax refund were present, and if not to make the loan with the assurance the loan would be repaid directly from the client's federal tax refund.

In addition to generating a new revenue flow from product sales, RALs also allowed Block to distinguish itself in a crowded field. No other firm had the scale to offer RALs as doing so required both system integration and access to large amounts of capital (millions and sometimes billions of dollars are loaned during the tax season). In the 10 years following the introduction of the RAL, Block added one to two percentage points on its annual client growth rate, considerable in an industry growing at approximately the rate of population growth. By 2002, over four million RALs were sold annually by Block.

Product Structure

The millions of H&R Block clients who purchase a RAL each year in effect buy a very short term loan, generally one with a principal balance around $2,800 with a term from 10 days (assuming the client would have otherwise e-filed his return and received a refund via direct deposit) to 30 days (assuming a client would have otherwise mailed his return to the IRS and received a paper check in the mail). Currently, the product allows clients to speed up the receipt of their refund check to one to two days.

From a client perspective, the process involves three steps; discussion, enrollment, and pick-up. First, if the client is due a refund, the H&R Block tax professional preparing the client's return presents various options for receiving the refund to the client (in most cases, if the client is a repeat customer, she will ask for the RAL directly). At this point a client is fully advised of the cost of the RAL versus other methods of receiving his refund.[45] In fact, the client is encouraged to forego the RAL in

[45] Clients also have the option of purchasing a Refund Anticipation Check, which has somewhat lower costs and does not deliver the funds as quickly, or an Instant RAL, which is more costly than a traditional

lieu of less costly methods, such as receiving his refund via direct deposit if a bank account exists.[46] If the client agrees to purchase the RAL, the tax professional works with the client to complete a fairly extensive set of paperwork that includes disclosures with respect to the APR and other fees. Finally, the return is submitted to the IRS and if the return clears the debt indicator (a measure provided by the IRS identifying any debts such as back taxes or child support used by Block and its partner HSBC to minimize losses), the client is asked to return sometime in the following two days to pick up a check.

Operationally, the fulfillment of the RAL is complex. Essentially a client allows HSBC to receive the refund directly from the Treasury and use the proceeds to settle the client's loan. However, the IRS requires that all refunds received by direct deposit be routed to a bank account owned by the filer. Block and HSBC comply with this rule by opening up a temporary bank account in the name of the RAL purchaser, drawing the account number from a list of dedicated accounts. The IRS is instructed to direct deposit the refund to this account. Following deposit, the account is "swept," the value of the loan and fees are debited, the account is closed, and the account number is recycled into the pool of RAL purchaser accounts. Meanwhile, after enrolling, the client is asked to return to the Block office in one to two days to pick up a check for the amount loaned.

An average client who purchases a RAL can expect to pay about $90 for the loan, but fees vary depending on loan amount and which RAL product is purchased (the "classic" RAL delivering the federal tax refund in one to two days or an "instant" RAL

RAL, but which delivers the funds even faster. Clients may also opt not to purchase any such "settlement product" and decide to receive their refund by direct deposit or by paper check.

[46] Beginning in 2003, Block printed this recommendation on the "Block Advantage", a printout of recommendations provided to each client suggesting ways to reduce tax liabilities and build assets, among other tailored financial advice

delivering the federal tax refund the same day).[47] 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 (for a RAL of between $200 and $500) and $77 (for a RAL of between $2,001 and $5,000). It appears that these charges are somewhat reduced in the case of RALs sold in partnership with Block. Fees ranged from $29.95 (for a RAL of between $200 and $500) to $109.95 (for a RAL of between $3,701 and $9,999).[48] Given an average loan of $2,800 and an average loan period of 11 days, these fees represent an APR of approximately 91%. [49]

The RAL Market

RALs have proven very attractive to consumers. Overall the market has grown at approximately 10 percent annually, although growth has slowed in recent years. During the 1990's, Block increased the number of RALs it sold and also expanded its market share. In 2000, Block sold nearly 4.5 million RALs (representing well over 50% of the market); however, since the number of RALs sold by Block has decreased while the overall market has expanded, Block's share of the RAL market has declined. Despite these declines, Block still sold nearly 4.3 million RALs in 2004, and demand remands strong. More than a quarter of the roughly 16 million annual retail clients sought RALs, a percent that had remained essentially unchanged between 2002 and 2004 (at 26.9%,

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[47] Email communication to authors from H&R Block.

[48] Chi Chi Wu and Jean Ann Fox, "Picking Taxpayers Pockets, Draining Tax Relief Dollars," National Consumer Law Center and Consumer Federation of America, 2005, available online at http://www.nclc .orginitiatives/refund_anticipation/content/2005RALreport.pdf (last accessed November 11, 2005).

[49] Calculation is ($75 finance charge/($2,800 loan amount- $75 finance charge))*(365 days/11 days) = 91.33% per the RAL loan agreement

27.5%, and 26.3% in 2002, 2003, and 2004 respectively).[50] The share of Block clients purchasing a RAL is lower than that of its main retail competitor – Jackson Hewitt. Data from Jackson Hewitt's 2005 Annual Report suggests that 40% of the company's clients purchased a RAL and 80% purchased some kind of settlement product (such as an expedited refund check).[51] In February 2003, Block CEO Mark Ernst observed that "refund anticipation loans are a product that…consumers love."[52]

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 and money transfers. In many of these respects, RAL purchasers are like the majority of Block's LMI clients.

Data from a recent household survey on individuals who reported having purchased a RAL from any source (not limited to Block) support the demographics released by Block. RAL purchasers tended to have lower educational attainments (30% of respondents without a high school degree had purchased a RAL versus 23% of those who graduated from high school, 12% of those who had graduated from college, and 18% overall) and lower incomes (25% of those with household income of under $50,000 reported purchasing a RAL). In addition, respondents with children were more likely to have purchased a RAL (26%). Larger share of African Americans (28%) and Latinos (21%), than whites (17%) purchased a RAL.[53]

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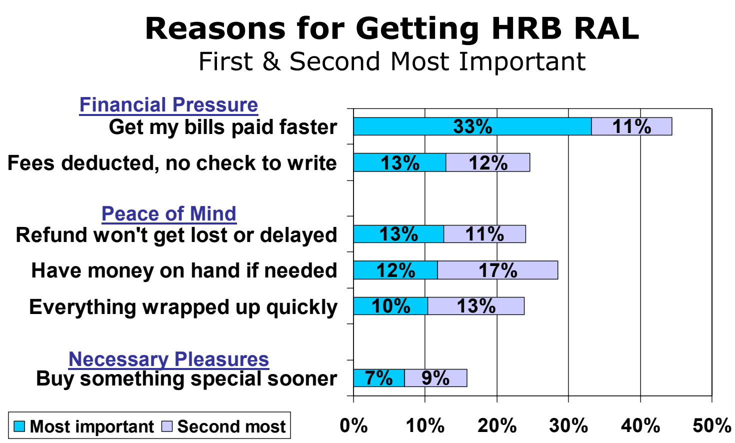
[50] H&R Block, 2004 Annual Report available online at http://www.corporate-ir.net/ireye/ir_site.zhtml?ticker=HRB&script=700 (last accessed November 7, 2005).
[51] Jackson Hewitt, 2005 Annual Report, available online at http://library.corporate-ir.net/library/17/177/177359/items/163879/AR2005.pdf (last accessed November 7, 2005).
[52] Mark Ernst, interview by Christine Ramos and Pat Kiernan, *The Money Gang*, Cable News Network, February 25, 2003 http://lexis-nexis.com (accessed June 30, 2004).
[53] Wu and Fox, 2005.

This demographic profile is largely reflective of the intended market for RALs. The product was designed specifically to address the financial needs of low income consumers. These needs include the ability to receive money quickly in order to pay existing debts, the ability to have tax preparation fees deducted from the tax refund check (no out of pocket expenses), and emotional benefits have having money on hand if needed. Figure 2 shows the data on the reasons why Block clients opted to purchase RAL.

Figure 2 Reasons for Getting a RAL from HRB



Source: H&R Block consumer research

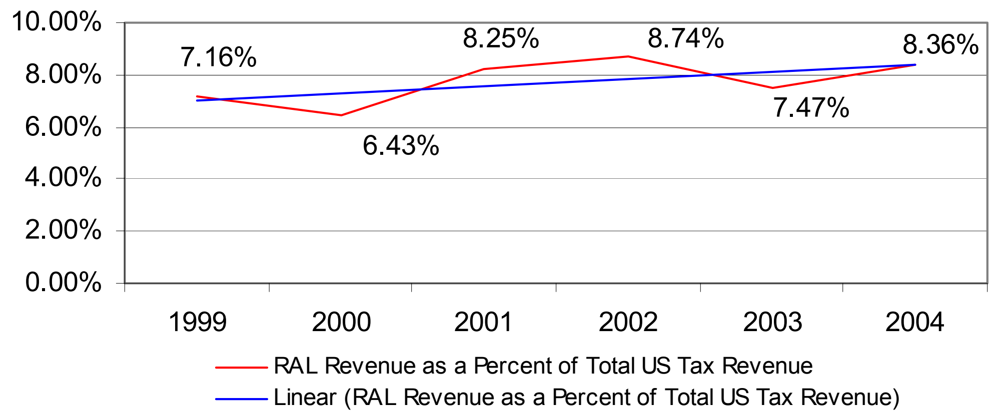
RAL Economics

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.[54] As a share of total revenue from all US tax sources, including retail tax preparation fees,

[54] H&R Block, 2004 Annual Report; Peter Tufano and Daniel Schneider, "H&R Block and Everyday Financial Services," Harvard Business School Publishing, Case Study No, (205-013).

online and software sales, and other tax-related products, RAL revenues have maintained their share, and have trended up slightly. See Figure 3.

Figure 3 RAL Revenues as a Percent of Total US Tax Revenue 1999 - 2004



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

While Block is the most visible merchant of RALs, operationally, it is simply the retailer of a loan product developed by HSBC, which holds a patent on the RAL process.[55] The structure of Block's contract with HSBC originally granted Block a flat fee per loan originated plus any fees that Block assessed on the RAL separately. Following the 2001 tax season, Block renegotiated to participate in the upside of the loans in exchange for taking on a share of risk. Block was permitted to purchase a 49.9% and 25% interest in loans originated in company and franchise offices respectively. Though Block waived this right in 2003, it did participate in the loans in 2004.[56] The current contract expires in 2006.

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[55] Patent Number: 4,890,228 (initially assigned to Beneficial Management Corporation, acquired by Household Bank and later HSBC).
[56] H&R Block, 2004 Annual Report.

When Block first introduced RALs, they promised to be a revenue source and also a means of differentiating from the company's many competitors. Over time, the latter benefit has eroded as it has become easier and cheaper for other tax preparation firms to enter the RAL market. This wide entry is due mainly to the increased number of electronic return originators (tax preparers who can file returns electronically), growing at over 15% annually. In 2003 there were over 100,000 EROs. Banks such as HSBC, Santa Barbara, Bank One, Mellon, River City, and Republic, have all developed proprietary RAL products which they attempt to sell through tax preparers, offering these tax preparation offices a set fee per loan. In 2004, HSBC alone offered RALs through 8,100 non-Block offices.[57]

Though RALs no longer allow Block to distinguish itself from its competitors, they do offer another benefit that was not originally anticipated. Clients who purchase additional products from Block one tax year are, all else being equal, slightly more likely to return to Block for tax preparation the following year. Retention differentials are economically significant for Block given the high cost of recruiting new clients. The company 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 (50%) and is unlikely to return (6%-7.5%).[58]

RAL Costs. The primary costs of offering RALs are in the operational expenditures by HSBC and in the losses from delinquency. Operationally, Block and HSBC face the cost of maintaining the systems which link individual offices to the IRS, the cost of printing forms, training staff, and operating a customer service infrastructure.

[57] Wu and Fox, 2005.
[58] Tufano and Schneider, 2005.

Block must maintain the technology used to print the RAL checks and HSBC must open, sweep, and close the accounts (though this is explicitly covered by an account opening fee). Block and HSBC also incur the cost of borrowing the funds for the loans.

The largest single cost is that of bad debt. 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 against the refund recipient. These can include offsets for unpaid child support payments, back taxes, and student loan debts. Because Block now participates in the risks of the loan pool, these "bad-debt" costs are relevant to the discussion. Block and HSBC, as described earlier, take steps to try to minimize these losses. The primary check is an examination of a filer's debt indicator, which is provided by the IRS and offers an assessment of any offsets that the IRS may make against the filers refund. However, while the use of the debt indicator undoubtedly cuts losses, Block reports that it is not infallible and occasionally does not capture the extent to which the refund may be reduced. Despite any possible problems with the debt indicator, Block still reports relatively low loss rates (under 100 basis points) compared with other short-term debt 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).[59]

One "missing" cost for Block with its RAL product is customer acquisition. By offering the product to its existing customers, Block does not need to create a new distribution channel for this lending product. Were a non-tax preparer to offer a product similar to RALs to customers, it would need to market the product directly to them, and

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[59] Mark Flannery and Kathryn Samolyk, "Payday Lending: Do the Costs Justify the Price?" 2005, available online at http://www.chicagofed.org/cedric/files/2005_conf_paper_session1_flannery.pdf (last accessed April 21, 2005).

the costs of customer acquisition would likely be enormous. For example, Block estimates it costs approximately $10 to open a new IRA account for an existing tax client, while banks spend as much as $200 to acquire a new account[60].

We believe that the RAL product is like many others that can be offered to the poor; if one is able to find a low cost distribution channel, the costs of the product itself can be supported through pricing. If one had to create the distribution channel from scratch, the costs of delivering the product might be so high so that no consumer would choose to buy it.

RAL Profitability. Block reported net income in 2004 of $697.9 million, up nearly 20% from 2003 and nearly 61% from 2002. Much of that growth was due to Block's profitable mortgage business, which had increased revenues from $339 million in 2002 to $678 million in 2004. While in terms of revenue, RALs were a relatively small part of the business, making up only 5% of revenues in 2002, in terms of earnings, RALs were quite important. For example, the 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.[61]

Analysts estimated that Block had pre-tax margins of roughly 28-31% on its core tax preparation business, 46-58% on its mortgage business, and given losses in its investment and business services divisions, company wide pre-tax margins of 24-30%. On its RAL business specifically, margins are generally between those of Block's tax business and its mortgage business. Although some analysts estimate RAL margins near

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[60] Stone, Adam, PR News, "After some well-placed deposits in media, bank campaign shows positive returns", March 1, 2004

[61] Gutek, Chris, and Sharat Shroff, "Closer Look at RALs: We've Been Too Conservative," Morgan Stanley Equity Research, September 30, 2002)

50% (extrapolating from Block's agreement with HSBC), after considering the full costs of technology, training and other infrastructure, the profit margin is lower yet still attractive. RALs are a profitable part of the Block business, and a demanded product by consumers. It would seem that this is the proverbial win-win-but this naïve supposition is far from correct.

Criticism and Response

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

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 they 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 have not realized that they are in fact entering into a short-term loan agreement. In 2005, the Consumer Federation of America surveyed several thousand households and asked filers who reported purchasing a RAL, "Was your rapid or speedy refund the kind that involved a loan?"[62] The authors of the CFA report that only 30% of respondent reported that the product they purchased involved a loan, suggesting that very large majorities of

[62] While it is possible that some consumers answered in the negative correctly, if they had received a RAC, this seems fairly unlikely given the filtering questions used by CFA to identify RAL purchasers. Specifically, CFA asked if each respondent if he or she had purchased a service that "allow(s) you to get your federal income tax refund in one to three days." The authors of the study point out that only a RAL product allows such rapid turn-around.

RAL purchasers were unaware that the product was a form of debt.[63] Grass roots efforts, led by groups such as the Association of Community Organizations for Reform Now (ACORN) have targeted Block over RALs as well. In 2004, ACORN organized a campaign against Block in 16 states. The campaign, though not successful in terms of hurting Block's business that tax season, most likely affected Block's reputation. 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 was selected due to its size and name recognition. Smaller campaigns have been launched against Block's competitors, but the activities have generated far less media coverage as the firms lack the same brand recognition and consumer awareness.

RALs have led to twelve – mostly class actions – lawsuits brought against Block which allege that the company failed to make adequate disclosures to clients and engaged in deceptive advertising and sales practices. A more fundamental objection has been raised about the rates charged on the loans. As discussed earlier, annualized APR's reach as high as 156%, a rate that many consumer advocates argue is usurious. RALs are, however, sold by nationally chartered banks, a designation that allows these institutions to avoid state lending rate caps. While it appears that this charter status has allowed RAL originating banks to avoid legal consequences, substantial equity and fairness issues have been raised about the practice.

To date, Block has successfully defended against some claims, but has paid out substantial settlements in others. Of these, a Texas case, Haese v. H&R Block, resulted in the largest payment so far, with Block recording pre-tax expense of $43.51 million. The uncertainty regarding RAL-related litigation has created downward pressure on

[63] Wu and Fox, 2005.

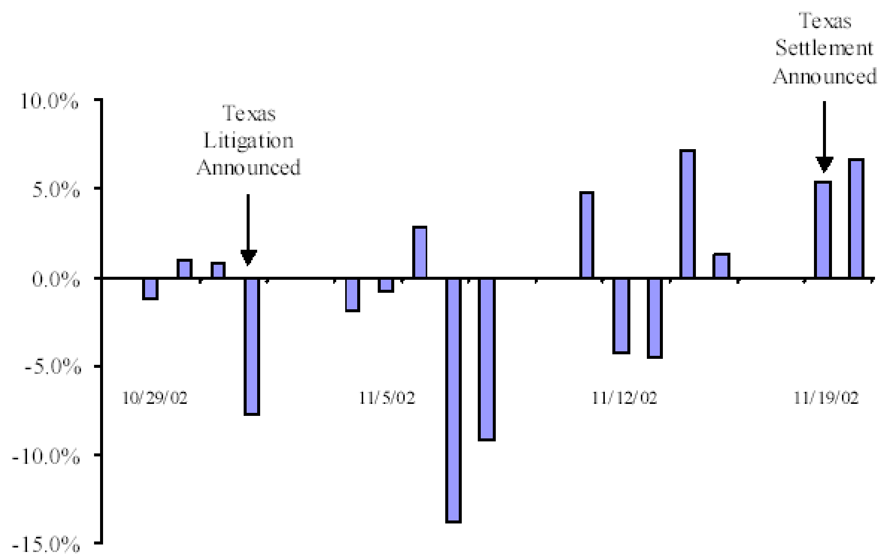
Block's market value, with most analysts citing the risk of litigation as one of the largest investment risks[64]. Not surprisingly, the announcement of lawsuits has resulted in wide swings in Block's market value. For example, when the Texas litigation was announced in November 2002, Block's stock declined 30 percent in a six-day period, accounting for over $2 billion in market value. 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 for Block.[65] However, smaller declines on November 12th and 13th appear to be associated with questions about Block's earnings from its mortgage division.[66] Although the stock did regain some of this loss as the uncertainty around the lawsuit subsided, litigation risks continue to place a black cloud over the stock in the investment community. See Figure 4.

[64] For example, Morgan Stanley analysts Chris Gutek and Sharat Shroff liststhe RALs as a risk, noting that "RAL is a high-margin product that has also hurt Block's reputation" (Gutek, Chris, and Sharat Shroff, "Closer Look at RALs: We've Been Too Conservative," Morgan Stanley Equity Research, September 30, 2002)

[65] Josh Freed, "Judge Says He Will Rule Against Block in Refund Loan Case," The Associated Press, November 7, 2002.

[66] Joseph T. Hallinan, "H&R Block's Mortgage-Lending Business Could be Taxing," *The Wall Street Journal*, November 12, 2002.

Figure 4 H&R Block Stock Price, 10/29/02 – 11/19/02



Together, these advocacy and legal critiques have pushed state and federal policy makers to introduce legislation that would curtail, if not outright ban, RAL sales. For example, bills in Connecticut (pending), Seattle (pending), New York City, Illinois, Minnesota, North Carolina, and Wisconsin impose additional disclosure requirements on tax preparers selling RALs. Federal legislation introduced in the House and Senate would ban RALs that are made on the basis of expected EITC refunds.[67] Although Block has made considerable investments in improving disclosures and enforcing compliance to best practices across its network (through the appointment of a Vice President of Compliance), much uncertainty remains with respect to the role of RALs in the company's strategy.

4. Stepping Back: The Implications of a "Profits" debate

[67] Wu and Fox 2005; Chi Chi Wu and Jean Ann Fox, "All Drain, No Gain: Refund Anticipation Loans Continue to Sap the Hard-Earned Tax Dollars of Low-Income Americans," available online at http://www.consumerfed.org/pdfs/RefundAnticipationLoanReport.pdf (last accessed September 24, 2004).

On its face, Block's experience with RALs reflects the essence of the problem we are trying to understand in this chapter. A firm may engineer a product to meet its customer needs, set pricing in concert with its costs and market demand, and may enjoy high levels of customer satisfaction and profit levels. Market forces may be at work that lead to entry by competing firms offering similar products. Yet the firm is subject to criticism and legal pressure for offering this product. Without judging the merits of these criticisms, and rising above the specific case study, what are the potential implications of the centuries-long debate, as played out in this instance over Block's RAL product?

Our discussion is grounded in Hirschman's observations on exit, voice and loyalty, contained in his 1970 book of that title.[68] Hirschman noted that consumers (or more generally members of an organization) have two fundamental choices when dissatisfied. They can exit, which for a consumer might mean no longer buying the product or they can use their voices to publicly air their grievances. Hirschman writes:

(1) Some customers stop buying the firm's products…: this is the exit option.
(2) The firm's customers…express their dissatisfaction directly to management or… through general protest addressed to anyone who cares to listen: this is the voice plan.[69]

Hirschman argues that the consumer's choice is likely to be mediated by his or her degree of loyalty to the firm; "The likelihood of voice increases with the degree of loyalty. As a rule then, loyalty holds exit at bay and activates voice."[70] Hirschman considers consumer advocates simply as a "new channel of communication."[71] However, it seems that these

[68] Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States (Cambridge, MA: Harvard University Press, 1970).*
[69] Hirschman, p. 4.
[70] Hirschman, p. 77-78.
[71] Hirschman, p. 42.

advocates are more than that and fundamentally differ from customers. Because they likely do not purchase the product in question they 1) lack the option of "exit" and 2) have no loyalty to the firm. What arises is in some ways peculiar. Like customers, consumer advocates have sufficient motivation to invest time and resources in shaping firm behavior. However, unlike customers, their options are limited and they are uninhibited by loyalty. Consumer ad*voc*acy is indeed just an expression of a *voice* activity, both derived from the same Latin root. We extend Hirschman's pathbreaking work, applying it to the specific context of voice activities directed at firms that sell goods and services to the poor.

1. Firms serving the low- and moderate-income market must be prepared to enter into a debate about the fairness of their profits.

As we have made clear above, many voices have opined around questions of poverty, profits and prices. This debate is characterized by its subject, which is the economics of the product and the product's "appropriateness," and by its participants, who are likely to include not only the firm and its customers but also other groups who try to act in the interests of consumers. The RAL case study provides an example of the content of this debate. Block was challenged on the pricing of its product, which was alleged to be excessive and, by indirect implication, the company was challenged on the profits it derived from selling RALs (though these are difficult for an outsider to gauge precisely). Block was also challenged on the appropriateness of the RAL product as consumer advocates questioned the value that consumers derived from receiving their refund a few days earlier than otherwise.

The debate over another financial product marketed to low-income consumers, the pay-day loan, has played out similarly. The product has an average loan term of about two weeks and appeals primarily to credit-constrained borrowers. Payday lenders, such as First Cash Financial Services, ACE, and QC Holdings, have been criticized for the price of their product – generally $18 per $100 borrowed. But, the appropriateness of the payday loan has also been questioned. Consumer advocates have argued that the loans are addictive and "trap borrowers in a cycle of repeat loans" – essentially tapping into society's general unease with products, such as alcohol and tobacco, that are habit forming.[72]

In Hirschman's work, consumers had the choices of exit or voice. However, certain principal participants in this debate, consumer advocates, are far more limited in their options because they are not customers. They may act in what they believe is in the best interests of consumers, but they themselves are not consumers. Thus, essentially, they have only one alternative – voice. Firms selling products to the poor surely understand that this voice may not be silent (nor are we suggesting that it be silenced.)

2. "Voice" can take the form of media criticism, proposed boycotts, and attempted legal and regulatory action and can lead firms to incur direct and indirect costs.

To use Hirschman's language, "voice," regardless of its legal or other merits or its ultimate outcome, can force a firm to incur material costs. These costs can be reputational costs, marketing costs, diversion of management time, legal costs and judgments. Many of these costs are apparent in Block's experience with the RAL

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[72] Fox and Petrini, "Internet Payday Lending," Consumer Federation of America, 2004, available online at http://www.consumerfed.org/pdfs/Internet_Payday_Lending113004.PDF (last accessed April 21, 2005).

product. For instance, reputational costs can affect a firm like Block in two ways. Block places a large premium on its brand and takes pride in its 98% brand awareness. These "voice" actions could sour the opinion of current RAL purchasers, with sales implications beyond RALs and extending to the purchase of tax preparation and other products. In addition, while the majority of Block's clients are low- and moderate-income, a sizable portion are not. If Block's reputation suffers, these higher-income clients might be less likely to patronize the company, depriving it of significant revenue. A company such as Block, which has a financially diverse clientele, might then be especially sensitive to reputational costs. This potential loss is not just theoretical; empirical research has suggested a positive relationship between a firm's reputation and its financial performance.[73]

In addition, as we note above, responding to "voice" activities can lead to legal bills, public relations and advertising costs and may direct management focus away from other business issues. From the perspective of firms offering the controversial products, this increases the costs of doing business.

There are possible corporate benefits to voice activities as well. Hirschman notes that unlike exit, voice can provide specific information about the aspects of a product about which consumers are dissatisfied. This targeted information could conceivably substitute for expensive market research and lower firms' costs.

3. "Voice" activities can have effects on both supply and demand, and in turn on prices and quantities.

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[73] Roberts and Dowling, "Corporate Reputation and Sustained Superior Financial Performance, *Strategic Management Journal*, September 2002, 1077-1093

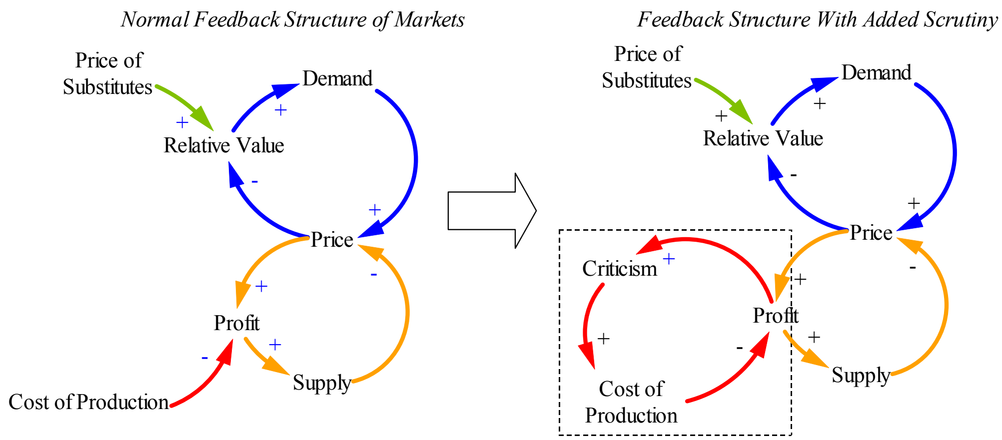
"Exit" simply affects demand in that consumers stop buying a product. However we can see that voice activities, including those by non-consumers, may affect both supply and demand. Economists posit that prices are determined by the intersection of supply and demand curves. In this instance, a portion of a product's costs are determined neither by a traditional production function, the degree of competition, nor the preferences of consumers (or would be consumers.) Rather, product costs may be influenced by parties who are not consumers, but who seek to act on their behalf. Their actions could influence the costs that firms incur, and hence indirectly affect supply. They could also bring in new supply. Finally, they could also have a direct impact on demand. Below we discuss various possible outcomes.

a) Supply-side effects: Increased public scrutiny could either lead to reduced supply, unless new information induced new firms to enter the market.

When firms' costs increase, micro-economic theory would suggest that the industry supply curve would shift downward, i.e., for any given price, firms would be volunteer to deliver less product. In business terms, firms might pass higher costs onto consumers in the form of higher prices, might demand higher prices to compensate for the riskiness of the contentious business, or exit as the result of the greater risk and uncertainty attached to these businesses. To the extent that the "voice" activities above lead to an increase in costs, we would therefore expect that supply would shrink, and unless demand were also to change, this would lead to higher market-clearing prices and lower levels of sales. Figure 5 illustrates this possibility.

Figure 5: Interaction of Voice Activity and Profits

As profits increase, large firms face increased criticism and potentially higher costs (legal, regulatory, etc.) when selling to the poor; this decreases the supply of products relative to the case where no criticism is present



Source: John Sterman, *Business Dynamics*, Irwin McGraw-Hill, 2000, p. 170

Note: The positive and negative signs indicate the polarity between variables. If positive, if one variable increases the other increases; if negative, if one increases the other decreases

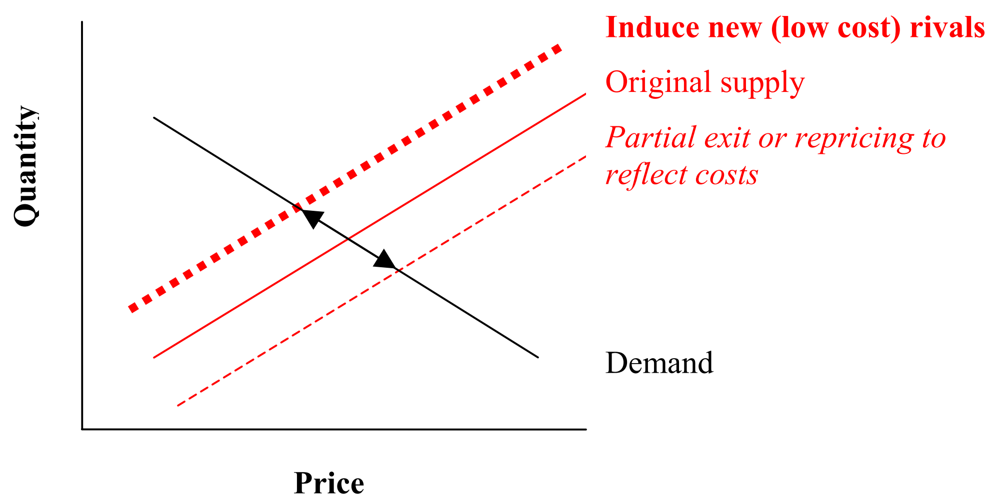
It is also possible that this public discussion could indirectly increase supply. Though most of the attention to the economics of products such as RALs is focused on high prices, rather than actual profits, it is possible that just the public discussion of this market could arouse the interest of new entrants, who might drive prices down. The revelation of the "high" levels of price could bring in new rivals with lower costs and hence the ability to charge lower prices and still earn profits. This is the premise behind Prahalad's fortune at the bottom of the pyramid, i.e., the revelation of the profit potential of poorer customers will attract new, low-cost entrants. Prahalad explained this idea in a 2002 article in the *Harvard Business Review:*

> There's a real opportunity for companies, particularly big corporations with economies of scale and efficient supply chains, to capture market share by

offering higher quality goods at lower prices while maintaining attractive margins.[74]

Under this scenario, voice leads to lower prices for consumers and constitutes a beneficial outcome. Figure 6 shows the possible outcomes.

Figure 6 Impact of voice activity on supply



Whether supply shrinks or grows is an empirical question. We see this as a fertile area for research. Put plainly, in the wake of active voice activities (largely consumer advocacy), do we observe higher or lower supply?

(b) Demand Side Effects.

It is entirely possible that demand will fall as a result of the same forces the drive market exit by firms. Consumer advocates often mount public education campaigns designed to inform consumers. Most recently, in the financial arena, consumer education

[74] C.K. Prahalad and Allen Hammond, "Big Picture: Serving the World's Poor, Profitably," *Harvard Business Review*, September 2002.

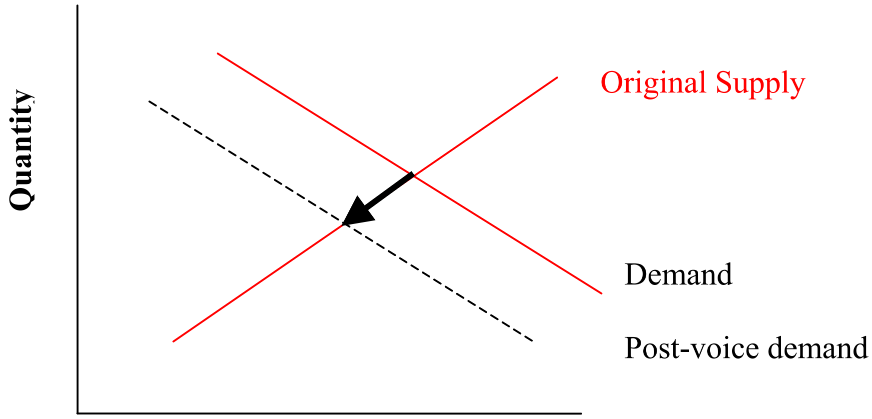
has focused on helping consumers to avoid costly credit card debt and high-cost predatory mortgages.[75] Just as public discussion might induce new entry of new suppliers, it could depress demand, either by making consumers aware of substitute products or practices, alerting them to the hidden costs of products they otherwise demanded, or changing their attitudes toward the product in the first place. For example, teens exposed to anti-smoking consumer education advertising were more likely to have negative views about smoking and about tobacco companies.[76] If demand were to fall, then one would expect that prices would fall with quantities, holding supply constant. [77] Figure 7 shows the possible outcome of suppressed demand.

Figure 7 Impact of voice activity on demand

[75] For instance, see Freddie Mac's "Don't Borrow Trouble Campaign" against predatory mortgage lending. Freddie Mac has partnered with local governments and advocacy groups to educate consumers about these high-cost loans (http://www.dontborrowtrouble.com/).

[76] M.C. Farrelly, C. Healton, K.C. Davis, P. Messeri, J.C. Hersey, M.L. Haviland, "Getting to the truth: evaluating national tobacco counter-marketing campaigns" *American Journal of Public Health*, 2002;92:901-7.

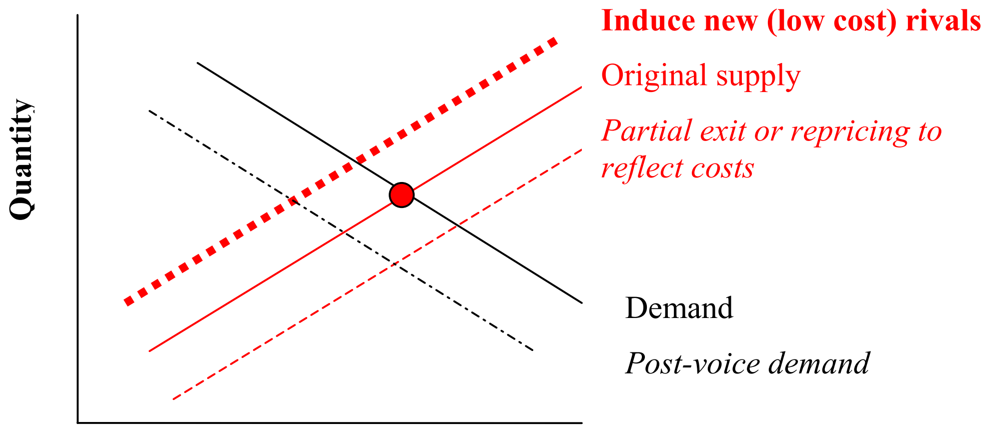
[77] For the sake of completeness, we should note that advocacy could in theory lead to increased demand, as the product were made more visible to consumers.



Price

(c) Joint impacts on supply and demand. With so many moving parts, and so much indeterminacy, it is impossible to draw any conclusions about whether voice activities, largely in the form of consumer advocacy, will have an effect on price and quantities. Both will be affected by the relative elasticities of supply and demand to the public debate. Figure 8 shows the possible outcomes. Of course, if the debate leads to regulatory or legal controls on price, then prices will conform to these rules and presumably quantities will adjust.

Figure 8 Joint impact of voice activity on supply and demand



Price

4. Voice activities, if strategically directed, may affect which types of firms serve the poor.

Consumer advocates, like everyone else in society, have limited resources. They must use these resources carefully. We suspect that targets of greater and more forceful voice activities may be firms that are otherwise (a) more visible, (b) earn greater profits (or at least appear to by dint of high prices), or (c) are larger. Such behavior stands to reason if critics wish to maximize the press attention they receive, the volume of sales they can affect, and the funds potentially available in the event of legal suit. If we are correct, then the costs will rise more for these firms than for other firms.

The result should be that 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, i.e., firms which can fly under the radar screen. If the impact is such that the lower cost firms (largest and most profitable) are differentially targeted for voice activities, then costs and prices will rise as they exit as smaller less efficient firms are left to serve the market. Also, as these activities are increasingly conducted by less visible firms, the harms to which the voice was addressed may be more difficult to remedy. Of course, it is also possible that the discussion will lead to lower prices, if the remaining firm's reservation price (the profitability of its next most profitable business) is lower than that of the business in question.

As a result, rather than leading to lower costs and greater transparency, the result of criticism and advocacy could be that the products in question are offered at higher costs and prices, by firms that less susceptible to public pressure in the first place. In essence, if this line of reasoning holds, the social welfare implications would be likely to be negative.

5. Leveraging the Debate

It would be relatively easy—but incorrect—to conclude from the propositions above that we believe that criticism of business is inherently bad, or that all consumer advocacy in its many forms, is counterproductive. To the contrary, we fully acknowledge the positive dimensions of a public debate on business issues. Our goal was simply to highlight intended and unintended consequences of public debates over acceptable levels of profits by business, and the implications for businesses whose customers are poor. In this final section, we discuss ways to leverage the public debate for the benefit of all.

Publicly identify opportunities for business to serve poorer customers. As we mentioned above, public discussion can spotlight areas where there are opportunities for new business entrants to serve unfilled needs of poorer consumers, and in doing so, earn acceptable levels of profits. One noteworthy example of this use of public discussion is C. K. Prahalad's book, *The Fortune at the Bottom of the Pyramid.* The book seeks to incite businesses to look closely at the profit opportunities that exist from BOP customers. In doing so, it uses the mechanism of public discussion to encourage entry. This encouragement in effect lowers the cost of entry, as some of the "market research" that an entrant might do has been completed at no charge to the potential entrant. Academics, non-profits, and government agencies could serve similar functions. For example, D2D Fund, founded by one of the authors, seeks to identify opportunities to serve the poor in the financial services sector, to conduct R&D in the form of pilots, and then to make this information broadly available to potential entrants and policy makers.

Focus attention on products and services that aid poorer customers. The media and consumer advocates often use their scarce resources to identify firms that they perceive are harming poor customers. Protecting those who have no voice, or do not have skills or ability to recognize the harm they are suffering, is a laudable goal. However, a portion of attention can be devoted to highlighting firms 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 does this quite well, by highlighting a number of businesses, such as Proctor & Gamble, Unilever, Cemex and ICICI, whose business with the poor is a proverbial win-win.[78] This very conference performs a similar service, highlighting businesses which serve the poor, yet do so in a way that is economically sustainable. More generally, it is important that we create forums where firms who serve the poor well—and profitably—can receive kudos for work well done. These best practice role models should be profiled in business schools, trade associations, policy discussions and the media more generally. In addition, by using voice proactively—to let potential consumers know about "good" products and firms—advocates can lower the marketing costs of these firms and possibly help to lower the prices consumers face.

Block has adopted a strategy of informing others how it serves low income consumers. These initiatives include more disclosure of its activities (such as through this chapter), through cooperating with academics and policy makers, through attending

[78] C.K. Prahalad, *The Fortune at the Bottom of the Pyramid; Eradicating Poverty Through Profits,* (Wharton School Publishing: Upper Saddle River, NJ, 2004).

meetings of policy makers, academics and community activists, through assuming a visible profile in D.C., 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. These forums provide opportunities to highlight the positive contributions of the firm to aiding its less advantaged customers.

Enter into the debate about profitability and consumer protection. The undiscussable question: "How much profit is too much?" needs to be discussed openly in "safe" settings. There are many different perspectives that one can use to approach this question, including philosophical, ethical, legal and economic arguments. It would be unrealistic to think that there is "an answer" to this question. However, in the absence of an open dialogue about the question, the unintended consequences we detail above may persist. Without some transparency, it is impossible to know whether a certain level of profitability and profits is even high relative to another. For example, if the level of RAL profitability or pricing is "too high," why are consumers still happy to take up this service? What are the competing sources of unsecured borrowing, and how do these prices compare to RALs? How much of the costs and pricing are fixed versus variable costs, and what is the implication for the scale at which these businesses should operate? In the business value chain, which firms are the ones that are earning the highest profits? How does one incorporate the risks borne by firms, 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.[79] 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 gross margins of up to 70% are not inconsistent with the fiduciary duty that boards owe to fund shareholders.[80] 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, businesses that work with these groups may be able to lower their costs of doing business, for example, by leveraging "soft" marketing by their partners or their intimate knowledge of the LMI customer. Second, within these partnerships, the "debate" over pricing and profits can be informed and carried out. The businesses can better understand the perspective of their customers;

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[79] The Economist, "Hedge funds: The new money men," Feb 17th 2005, www.economist.com, accessed May 17th, 2005.
[80] See John P. Freeman & Stewart L. Brown, "Mutual Fund Advisory Fees: The Cost of Conflicts of Interests," *Journal of Corporation Law,* Spring 2001. Vol. 26, Iss. 3; p. 609.

advocates can better understand the constraints faced by organizations that cannot meet budget shortfalls by soliciting donations. Third, when these partnerships produce positive outcomes for both, they 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 alone 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 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 positive press in several high-profile publications such as The San Francisco Chronicle[81], The Wall Street Journal[82], and The New York Times.[83] From the firm's perspective, they highlight the fact that the firm is actually serving the needs of their low income clients – and advancing their interests in city, state, and federal governments.

Research the implications of the consumer debate on public welfare. In section four, we intentionally noted that many of the propositions we were discussing were open

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[81] Rachel Gordon,"San Francisco Bonus for Families Earning IRS Tax Credit," *The San Francisco Chronicle,* February 3, 2005
[82] Brody Mullins, "H&R Block Proposal Could Help Unite Congress on Social Security," *The Wall Street Journal,* May 10, 2005
[83] Anonymous, "H&R Blockbuster," *The New York Times,* May 17, 2005.

empirical questions. 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? Do large firms with lower costs serve the poor, or are they disproportionately served by smaller firms with higher costs? What is the incremental cost of serving certain classes of customers? 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 it 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.

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In a free society, open and public debate is essential. In this chapter, we identify one long-standing debate: What level of profits is fair? This question has particular relevance to firms selling products to the poor as we believe a paradox may exist; the potential for profits is necessary to encourage private firms to develop and market products and services to the poor, but the existence of profits can create additional costs for these firms in the form of damaged reputation, litigation and the other forms described in this paper. Therefore we posit that the nature and contentiousness of the debate over this question may lead to intended and unintended consequences. We highlight the various potential outcomes which call for additional empirical study to establish the welfare implications. Just as there is are studies of corporate social responsibility or corruption, it may be useful to explicitly study the implications of where well meaning citizens from different backgrounds confront firms over what levels of profitability or prices are justified. In addition to calling for additional research, we also identify ways in which public debate might be more enlightened to encourage firms to better serve the poor.

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