# Owe the IRS? No problem, some Americans say

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A new study shows the surprising way that many American taxpayers adjust their standard of living when they owe money to the IRS versus when they receive tax refunds.

Researchers found that when households received tax refunds, they immediately started spending that new money. But those same households didn't cut their spending in years when they owed taxes to the IRS.

The findings contradict economic theories that suggest people spend their tax refunds only because they need the money to buy necessities, said Itzhak Ben-David, co-author of the study and professor of finance at The Ohio State University's Fisher College of Business.

If that were true, then these households would have had to cut spending in years when they owed taxes.

"What we found is that owing money to the IRS did not disrupt normal consumption in our sample of American households," Ben-David said.

The sample in this study used a personal finance website, so they were more financially sophisticated than average consumers, he noted. But even those in the study who had had the least savings and the most credit-card debt did not reduce their spending when they owed money.

"They found ways to use money from savings accounts or other reserves to keep up their spending in years when they had to pay the IRS. They didn't cancel their vacations," Ben-David said.

The study has been conditionally accepted for publication in the *American Economic Review* and is currently online at the SSRN preprint server.

Ben-David's co-authors were Jonathan Parker, professor of finance at the Massachusetts Institute of Technology, and two former Ohio State doctoral students: Brian Baugh, assistant professor of finance at the University of Nebraska, and Hoonsuk Park, assistant professor of banking and finance at Nanyang Technological University in Singapore.

The researchers used anonymized data from a personal finance website that included details of spending habits of 196,565 American households from July 2010 to May 2015. The researchers included only households that had both received tax refunds and paid the IRS in different years to ensure the findings weren't simply the result of separate households behaving in different ways.

All households—from the most to the least wealthy—increased their spending immediately after receiving the refund, the study showed.

People consumed about 8 percent of the refunds during the month after they received them, which rose to about 15 percent over the following three months.

"We found that the spending increases the exact day on which the refund arrives," Ben-David said. "Even though they know the refund is coming, most Americans don't start spending until they have it in their account."

Even the wealthiest people in the sample spent a good portion of their refund, despite the fact that they had the money to spend without the refund.

"When they received the refund, people in our sample consumed more or less the same fraction of it regardless of the amount. People who received a big refund spent about the same fraction as those with a smaller refund—just a bigger dollar amount," he said.

The results suggest that people treat a tax refund like they would a cash bonus from work—they spend some and save some.

When households owed money to the IRS, the researchers found that they increased transfers among their accounts in the month before making their payment. For example, some moved money from savings to checking before writing a check to the government.

What they didn't do is spend less on dining out, clothing, recreation or other items in their budget.

"Americans in our sample viewed tax payments as a necessary cost like a car repair or new appliance that can come out of their savings," Baugh said.

"It is not something they had to change their usual spending for."

The findings suggest that people's behavior involving money may not follow traditional economic theories, Parker said.

If people's spending responds primarily to how much money they have available, as some prominent theories predict, consumers should spend less when they owe the IRS, which this study didn't find. Furthermore, they also shouldn't spend their refund if they already have plenty of money—but this study showed that even the wealthiest households spent a portion of their refunds.

Instead, this research supports the theory that people use very general rules of thumb to determine how they spend money. According to this "mental accounting" theory, households think of themselves as having three accounts: current income, current assets and future incomes.

These are not real accounts, but how people track their money in their minds, Park said. In this theory, people try not to touch their current assets (like retirement savings) and future income (like inheritances they expect to receive).

All their spending comes from current income. That means when their income increases—as it does from a tax refund—they treat it like a bonus from work and spend some of it and save some of it.

If they owe money, that is outside of the usual income and spending cycle, so they use other sources of funds, if available, to pay it without reducing their usual spending—just like other unexpected costs.

"This is one of the few studies that has been able to show that mental accounting does explain how people behave in real life," Ben-David said.

**More information:** Brian Baugh et al. Disentangling Financial Constraints, Precautionary Savings, and Myopia: Household Behavior Surrounding Federal Tax Returns, *SSRN Electronic Journal* (2013). DOI: 10.2139/ssrn.2370507

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