Public Policies to Alter the Use of Alternative Financial Services Among Low-Income households.

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A substantial number of low-income individuals make use of services within the alternative financial sector (AFS), particularly pay-day lenders and check cashing outlets. Pay-day lending has grown over the past 20 years, as has the use of Refund Anticipation Loans (RALs). Although the number of households without a checking account has fallen, currently about 12 million households do not have a checking account, and must rely on check-cashing services. Fellowes and Mabanta (2008) indicate that non-bank establishments collected $8.5 billion in fees in a recent year. The high cost of these services has led many observers to seek policies that would reduce the use of informal financial services among lower income households.[1] This paper briefly reviews the reasons why individuals utilize AFS outlets, then discusses the policy options that could affect these decisions.

I. Why do low-income households use alternative financial services?

Before turning to a discussion of policies that would reduce reliance on informal financial services, it is important to understand why individuals utilize AFS providers rather than banks or other formal financial institutions. There are five primary reasons typically discussed.

A. Formal financial institutions provide services that are ill-fitted to the financial needs of low-income households. About 40 percent of payday loan recipients have bank accounts, suggesting that their payday loan provides a service that is not available from their bank (Elliehausen and Lawrence, 2001). About half of payday loan recipients claim to have considered a bank loan; many of these said that the payday loan involved

[1] For instance, see the many reports on this topic by the Center for Responsible Lending.

an easier process; some also cited the convenient location of payday providers. Short-term loans to lower-income customers are simply not available through many local banks.

High-minimum-balance checking accounts with multiple fees may be very expensive for low-income individuals who experience frequent penalties for lower balances or for overdrafts. About half of the non-banked say either they don't have enough money to start an account or the costs of an account are too high (Berry, 2005). About half of payday loan customers say their payday loan is cheaper than the cost of returned check fees (Elliehausen and Lawrence, 2001). Caskey (2005) argues that check-cashing outlets provide much more comprehensive services than banks (including money orders), while Berry (2005) indicates that 77 percent of those using check-cashing services say they are more convenient. A significant number of low-income households use *both* formal and informal financial providers for their transactions (Barr, forthcoming.)

B. Mistrust or misunderstanding on the part of lower-income households. Not all persons use AFS providers because they provide better services. Lower-income persons may mistrust banks or misunderstand the comparative costs of informal financial services. Low-income consumers may not understand the difference in interest rates or the compounding problems in roll-over payday loans. A survey of payday loan users found that almost all of them were aware of the dollar charges on their most recent payday loan, but few knew how these translated into an annual percentage rate that would let them compare rates across providers (Elliehausen and Lawrence, 2001). Persons may be unaware of bank-based alternatives, particularly if few people within their network

regularly utilize bank services. In short, some low-income consumers may not understand the high price of many services or may not know about lower-cost options.

Some subset of lower-income persons actively mistrust banks or perceive using them as an unpleasant experience. They may feel unable to ask questions or be intimidated by tellers or bank staff who treat them brusquely. They may worry about incurring penalties or limitations on bank accounts that they don't understand or that they perceive as arbitrary and unreasonable. Berry (2005) indicates that 6 percent of the unbanked indicate they don't like dealing with banks for various 'perception' reasons.

C. Past credit problems that limit access to formal financial institutions. Past unpaid debts or past problems with overdrafts will prevent some low-income persons from qualifying for banking accounts or for bank loans. In Berry's (2005) data, 18 percent indicate they have histories that would prevent them from qualifying for an account. This could be a particular problem for immigrants (legal and illegal) who may face difficulties providing the financial documentation needed by banks. In this case, the simpler requirements of payday lenders make them the only viable source of credit.

D. *Short-term time horizons or inadequate self-discipline*. Many argue that one reason some people take out very high short-term loans, or pay high rates for immediate check-cashing, is that they have very short-term time horizons. If the value of a dollar today is worth far more than a dollar tomorrow to a low-income individual, he/she should be willing to pay a high price to avoid waiting. Future costs are also discounted at a high rate, making high interest rates acceptable.[2] A closely-related hypothesis focuses not on high discount rates, but on lack of self-control (which in turn produces high discount

[2] One can view predatory lending as a way to prey upon those with hyperbolic discount rates. See Della Vigna and Melmendier (2004).

rates.) If lower-income consumers seek immediate gratification, they will ignore future costs. Although much-discussed as a reason for high credit demand by low-income individuals, there is remarkably little evidence documenting differences in discount rates by income level.

A growing body of work in behavioral economics indicates that many people demonstrate time inconsistencies when making decisions. People (both low and high income) say they want to save, but then spent their money when they receive it. Shafir and Mullainathan (forthcoming) argue that the cost of these common human fallibilities may be greater for low-income persons, who live more marginal economic lives.

E. Unstable incomes. Finally, all of these issues may be exacerbated by the fact that the need for small amounts of short-term credit is quite high among lower-income individuals due to unstable incomes. Lower income or less-educated households experience greater income volatility (Bania and Leete, 2007; Hoynes, 2001). In part, this reflects the nature of their jobs. Work hours on low-wage jobs often vary substantially from week to week, especially in the service sector. Jobs may also be unstable. Hoynes (2001) indicates that less educated workers experience more employment cyclicality.

Household composition is also more unstable in lower-income families. Marriage is less common and cohabitors come and go with greater frequency.[3] Residential instability is more common, and is often linked with job changes. The annual rate of residential moves among poor families was 24 percent in 2002, versus 13 percent among non-poor families (U.S. Census Bureau, 2004). This type of household instability feeds into earnings and income volatility.

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[3] Seefeldt and Smock (2004) provide evidence that children in lower-income families experience more frequent parental relationship transitions.

Families can deal with instability in household income in three ways. First, they can reduce expenditures when income falls. Expenditure reductions may be quite difficult for lower-income families, however, since a higher share of expenditures in low-income households goes to necessities, such as rent or food. The 2005 Consumer Expenditure Survey indicates that households in the bottom quintile of the income distribution spend 55 percent of their income on food and housing; families in the top quintile spend only 42 percent of their income on these items.

Second, households can utilize savings to help smooth expenditures. For many reasons (not the least of which is their low income relative to needs) low-income households are far less likely to have savings than higher-income households, so this mechanism may be unavailable to them.

This leaves the third option, borrowing to smooth spending in the face of income fluctuations. Although expensive, a short-term high-interest payday loan may be a better choice than having one's phone or electricity turned off. If the marginal value of the next dollar of expenditure is higher for low-income families, their use of frequent short-term credit to help smooth expenditures may not be a surprising choice.

In summary, the need for short-term income smoothing among lower-income families may be greater than among higher-income populations. High-income families are likely to have more stable jobs, more stable household composition, greater savings, and a lower marginal value for the next dollar of spending.

This quick review suggests that there are multiple reasons why low-income individuals utilize informal financial services; this implies that there are a variety of

policy approaches that would reduce AFS usage. In the next three sections, I discuss three different policy approaches, looking at ways to attract more persons into formal financial institutions; ways to avoid high-cost and unpredictable fluctuations in expenditures among lower-income houses; and looking at policies that stabilize incomes.

II. Policies designed to encourage greater use of formal financial institutions by low-income households

The most direct way to reduce the utilization of informal financial services is to expand and market competitive services through formal financial institutions. This includes no-minimum-balance debit accounts that do not allow overdrafts; short-term loans that may mimic payday loans in some respects; or low-cost check-cashing facilities inside banks for non-customers. A key question is whether these activities can be profitable or whether they require public subsidies to persuade banks to engage in them.

A. Voluntary private sector action, perhaps in partnership with the public sector. In a variety of communities, individual financial institutions have taken leadership in providing banking services to low-income communities or low-income households. ShoreBank in Chicago is perhaps best-known for its efforts to provide banking services to low income families, but other institutions around the country are experimenting with ways to serve low income customers profitably. In the Bank on San Francisco project, the city is providing free marketing to banks and credit unions that offer products aimed at low-income customers, with the goal of opening bank accounts for 20 percent of the unbanked. Bair (2005) provides a number of examples of local credit unions or banks that offer short-term loans, explicitly designed to compete with payday lenders, for much

lower fees than found among AFS providers. Caskey (2005) describes "Starter" Bank accounts that he recommends banks offer for low-income customers.

In addition, private and public sector employers can also help increase bank account usage. Employers (particularly larger employers) can require direct deposit, arranging for banks to provide debit accounts to unbanked employees, or can help employees open bank accounts.

B. Public sector policies and programs, aimed at incentivizing financial institutions to serve to low-income households. There are a variety of public sector actions that can increase the services provided by formal financial institutions, and the utilization of these services.

First, banks can be incentivized to offer accounts designed to serve low-income persons, with low minimum balances and overdraft protection. Barr (2004) proposes First Accounts tax credit to banks, based on the number of accounts opened for low-income persons. Demonstration projects have tested tax credits and indicate they increase banking services to the unbanked. Regular CRA evaluations of banks could include an evaluation of the services they provide to lower-income customers.

Second, public assistance benefits can be provided through bank debit accounts. Benefit programs, such as cash welfare or Food Stamps, typically provide monthly income support through an electronic benefit card. Most states utilize a contractor who issues these debit cards, allowing states the 'float' on these dollars until they are spent. The alternative is to provide these benefits through a bank debit card, giving families a relationship with a local bank. (Such accounts should be retainable by families when they leave public assistance and move into work.) This is likely to be more expensive

than using a single contractor, but provides an opportunity for recipients to establish a banking relationship. It may also open up opportunities for financial education and counseling, as part of the receipt of the bank debit card.

Third, there may be ways for the public sector to support banking services in underserved areas. For instance, the First Accounts demonstration program helped defray the costs of expanded services (such as ATMs) in low-income neighborhoods (Barr, 2004). Parish, et al, (2006) discuss the utilization of Community Development Financial Institutions in communities where no other financial services are available, such as Native American reservations.

Fourth, the IRS can expand the ability of taxpayers to receive tax refunds in electronic debit accounts, especially important for EITC recipients. Beverly, et al, (2005) describes a demonstration project by ShoreBank, which indicated that over half of the unbanked participants whose refunds were placed in accounts went on to use these accounts for other purposes. The IRS may want to partner with tax preparers, such as H&R Block, who serve many low-income clients, to encourage low-cost electronically based bank accounts for refunds (Barr, 2007). Smeeding (2005) proposes ways to link EITC refund accounts with savings plans.

Fifth, a growing body of evidence suggests that low-income families can save and that certain policies can increase savings (Sherraden and Barr, 2004; Tufano and Schneider, forthcoming). This includes employer-based savings plans, government matched-savings plans, or national development or savings accounts. Savings plans help smooth expenditures without the need for short-term credit and create connections with formal financial institutions.

Sixth, there are a variety of ways to regulate and limit AFS providers. Some states have made it impossible for payday lenders to operate, limit rollovers, or limit the size of payday loans. Research on the effects of this, however, are somewhat mixed. Morgan (2007) finds that low-income households in states with higher payday loan limits do not have higher delinquency rates, although they do have marginally higher debt levels. Morgan and Strain (2007) find that households bounced more checks and filed for bankrupty at a higher rate after North Carolina and Georgia eliminated payday lending. Morse (2007) finds that areas with payday lenders recover more quickly following a natural disaster, with fewer foreclosures. On the other side, Skiba and Tobacman (2008) and Caskey (2005) indicate that the average payday loan recipient uses multiple loans and runs up quite large debt, which suggests these individuals are not using payday loans occasionally for unexpected expenditures.

While there is clear evidence that an uncomfortably high share of people roll over payday loans frequently and pay enormous interest rates, it may not make sense to ban payday lenders without a strong effort to provide short-term loans and access to low-cost financial services through the formal financial sector. In fact, there is clear evidence that greater competition appears to bring down the cost of AFS services (Flannery and Samolyk, 2005; Morgan, 2007), so that regulating the number of AFS providers may be counterproductive. *My own reading of the evidence is that strict regulations on AFS providers will not reduce the demand for short-term credit (and may even make the costs higher), unless such an effort is closely linked with efforts to provide the affordable credit and banking services low-income households through formal financial institutions.*

III. Policies to reduce high-cost expenditures among lower income households.

While providing credit through formal financial institutions may lower the debt-related costs borne by low-income households, one may also want to reduce the need for such credit. When low-income persons face large lump-sum payments this creates a need for credit and increases their use of AFS providers (as well as creating potential problems in their interactions with formal financial institutions.) Let me highlight three policies that might reduce big-ticket expenditure needs.

First, many analysts believe there is a need for more financial education programs aimed at effective money management and financial planning. The need to borrow in order to purchase consumer goods or to pay bills is sometimes the result of poor financial management. One of the key goals of many financial education programs is to encourage participants to avoid splurge spending, to shop effectively for lower-cost items and to prepare for future large-cost expenditures (such as a car) through savings and financial planning.

Unfortunately, our knowledge of how to run effective financial education programs is limited. Caskey (2006) critiques the existing work and suggests there is at best limited information that financial literacy courses may help increase savings or improve credit records. This is an area where well-evaluated demonstration programs would greatly advance our knowledge of best practices around financial education.

Second, health care expenditures remain an ongoing problem for many lower income families who have inadequate or no health insurance. Providing better health care coverage for low-income families would reduce high-cost medical debt. With very

low levels of private health insurance, and limited Medicaid eligibility[4], families often pay cash for dental or eye care. Emergency room care or community clinics may provide short-term uncompensated care, but will rarely help cover expenses for major health problems that require multiple doctor visits. Uninsured families that face health crises for family members typically run up large bills. Better health insurance coverage for low-wage families would help these families avoid emergency high-cost medical expenditures and debt.

Third, a subset of low-income families face financial problems because of their inability to resist 'temptation goods' and successful efforts to reduce addiction and abuse of such goods would greatly improve the financial circumstances of these individuals, as well as increase their work effort and economic productivity. Excessive expenditures on alcohol, other drugs, or gambling, is a cause of ongoing financial problems. The greater availability of such goods clearly increases their use. For instance, Kearney (2005) finds that non-gambling expenditures go down 2.5 percent in low-income households when state lotteries are introduced.

Drug or alcohol abuse treatment programs are often relatively costly, with high recidivism rates. Few low-cost treatment programs are readily available (Alcoholics Anonymous is an exception.) Policies that increase the price of these goods, such as so-called 'sin taxes', typically reduce their consumption but raise expenditures among those who continue to spend.[5] More controversially, policies to limit access (drugs interdiction, hours' restrictions on alcohol sales, limits on the number of casinos, etc) are

[4] Medicaid typically covers children in low-income families, the disabled and low-income elderly. It is rarely available to other adults.

[5] For instance, see Chaloupka, Grossmand and Saffer (2002) for a review of the evidence of negative price elasticities for alcohol, and Rhodes, et al. (2001) for evidence on negative price elasticities for illegal drugs.

often proposed at least in part to limit abuse and addiction. The evidence about the value of such policies is somewhat mixed, however. In short, this is a policy area where there is concern, but little sense of the most effective way to address existing problems.

IV. Policies to stabilize incomes

The less short-term income fluctuates among lower-income households, the less need for short-term credit and the more attractive low-income persons are as customers to financial institutions. Income stabilization policies can help reduce income fluctuations. I indicate four of the more important stabilization policies.

First and probably most important is *a macroeconomic policy of maintaining low unemployment*. Given the much greater cyclicality in employment and jobs among lower-wage workers, maintaining a high-employment economy is more important for this group than any other. Blank (2000) notes that a strong macroeconomy is probably the most effective long-term antipoverty strategy. As welfare reform has moved more single mother families off public assistance and into low-wage employment, even more families rely on low-wage jobs for their primary income support.

Second, it is important to *maintain high coverage within the Unemployment Insurance (UI) system*. The UI system is designed to smooth income following job loss, but only a little more than one-third of unemployed workers receive UI; lower-wage workers have higher unemployment rates but are less likely to receive UI than higher-income workers (Kletzer and Rosen, 2006; Vroman, 2007). In part, this is because lower-wage workers are less likely to be eligible for UI benefits when a job ends. UI eligibility requires working at least 6 quarters in one job; in many states, part-time work,

quits, and firing for cause are not covered. The UI system could be reformed to cover a higher share of low-wage workers and to encourage use among those eligible, making it a more effective income smoothing mechanism for lower-wage workers.

Third, *maintaining eligibility for and take-up in safety-net programs can also help stabilize income*. While relatively few working low-income persons are eligible for cash assistance, various in-kind programs help supplement earnings and smooth incomes, including food stamps, housing assistance, and Medicaid. While take-up in food stamps and Medicaid has risen, due to efforts following welfare reform to increase program use among working low-income families, large numbers of eligible persons do not receive benefits (Currie, 2006).

Fourth, the most important cash support program for low income working families is the Earned Income Tax Credit (EITC). *Expanding EITC support to low-wage workers without children would greatly increase its power as an income supplement*. The EITC provides substantial income support to low-income families with children, but low-wage workers without dependents receive only small EITC supplements. A variety of proposals to expand EITC to this group would particularly help low-wage men, many of whom help support their non-resident children (Berlin, 2007; Scholz, 2007).

V. Conclusions

There are many ways to encourage more low-income households to utilize the services of formal financial institutions. On the one hand, expanding the services that banks and credit unions provide to meet the needs of low-income persons is important; there may also be policies that make informal financial services less attractive. On the

other hand, simply focusing on banking services ignores some of the primary reasons why families seek short-term credit and immediate refund returns. Helping families save and helping them smooth their expenditure and income streams is also important, and this requires focusing on a range of policies, from economic stability to savings policies to EITC payments to financial education.

Given the many reasons why different families utilize AFS, there are multiple policies that can reduce their use. At present, it is difficult to select the most effective approaches, however. We have only limited evidence on the comparative costs and benefits of many of the policies discussed above. With many institutions around the country experimenting with better ways to provide financial services to lower income customers, it might be a particularly fruitful time to evaluate this mix of efforts, their outcomes, and their implementation challenges. It would be highly useful to have a better sense of 'best practices,' to give guidance to those city, state, and private institutions that would like to improve the financial well-being of lower-income households and provide them with greater access to formal financial institutions.

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