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By Brian Grow & Keith Epstein

Online Extra: Cutting the Cost of Poverty

Scholars are taking a fresh look at the financial problems of the working poor, and have some new suggestions on how to address them

Poverty fighters have long focused on government aid, the minimum wage, and tax credits. Yet poverty is still a persistent problem. Now, a growing number of scholars and mayors of large cities are questioning the heavy focus on putting money in the pockets of the poor. The new emphasis is on the other side of the economic equation: reducing the exorbitant costs paid by low-income families.

"Public policy should instead focus on increasing the income and assets of low-income households in the years ahead," argues Michigan law professor Michael Barr. "High cost financial services can make it harder for working families to get out of poverty, and may push some households over the financial edge."

Here are some possible solutions:

ATTRACTING BANKS. One goal is to attract more mainstream companies with affordable products to neighborhoods they have traditionally shunned.

New York has lured 26 banks and thrifts to 31 poor areas by channeling state funds into startup deposits for those financial outlets, a creative twist on the traditional business development grant or tax break. Texas and California are planning similar programs.

Last fall, San Francisco started a campaign to steer consumers away from check-cashers and pay-day lenders. The city worked with banks and credit unions to make it easier for low-income households to open checking accounts. The city and the Federal Reserve Bank of San Francisco each donated personnel to manage the program.

"Check cashing drains savings. Now you can open a bank account," declares one ad for the program, called "Bank on San Francisco." McCann Worldwide developed the ads, sprinkled through the city. So far, 2,260 accounts have been opened.

José Cisneros, San Francisco's treasurer, oversees the program. He likes the idea of building a financial connection, not just handing out money or tax credits. "We're giving people a way out of the spiral," says Cisneros, a former Bank of Boston executive. "At least they can keep more of the money they earned, and perhaps see it grow the way we all like to see it grow."

EDUCATING CUSTOMERS. Poor workers often get themselves into trouble by making bad choices. "Lower-income neighborhoods are actually swimming in credit, but there's nothing to help them navigate through the pool," observes Brookings Institution researcher Matt Fellowes. For example, many low-income families turn to for-profit tax-preparation services, even though IRS offices charge about $30, and community groups will do their taxes for free.

Now, dozens of states are enacting laws requiring that young people be taught about checking accounts, interest rates, and credit scores. Illinois, Kentucky, and Georgia mandate that high school students pass a financial-literacy class.

ENGAGING THE TAX MAN. One prime method of redirecting wealth involves the Earned Income Tax Credit, a government program that guarantees refunds to the working poor. Yet recipients often quickly spend what they receive, while tax preparation firms siphon off fees for advance loans against the tax credit.

Instead, Michigan law professor Barr says the IRS could help direct the money to a bank. Rather than simply cutting a check or opening the door to expensive loans on anticipated refunds, the IRS could encourage millions of tax-credit recipients to save by opening an opt-out, direct deposit, tax refund bank account that earns interest, says Barr.

REGULATING THE LENDERS. Deterring the practices of some aggressive companies is also critical. About 15% of subprime mortgage borrowers actually could qualify for cheaper loans, according to Peter Zorn, vice-president of housing analysis and research at Freddie Mac, the mortgage purchaser.

Often drawn by aggressive marketing, "they walk through the wrong door," Zorn says, and never hear of better alternatives. Now, Congress is debating new rules for subprime mortgage lenders, and state legislatures are considering no fewer than 40 bills so far this year to regulate pay-day lenders and check-cashers.

"Credit is a dual-edged sword," observes Harvard law professor Elizabeth Warren. "Access to credit gives low income families a private safety net when something goes wrong. It means they can put groceries on the table even when they don't have a paycheck this week. But that safety net comes at an extraordinary cost. The credit itself can end up sinking them financially."

Instead, she suggests a regulatory structure that encourages better terms from the private sector. "It's effectively a deregulated wild west game right now, in which the bad actors drive the market," she insists. "Regulation—putting in a floor about permissible behavior—would help the good actors in the marketplace."

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