Reducing the High Costs of Being Poor

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Subcommittee on Housing and Community Opportunity
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Madam Chair, and other members of the Committee, thank you for the invitation to testify today about the higher prices that lower-income individuals often pay for necessities and the private- and public-sector responses needed to bring down those higher costs of living. Price premiums tacked onto goods and services pose a serious obstacle for lower-income workers that are trying to convert scarce dollars into economic mobility. Fortunately, steps that a select group of states, cities, and private-sector partners have taken in recent years provide a roadmap for a new federal agenda that will lower these costs of living for households across the country.

I want to make three points.

First, moderate- and low-income households often pay higher prices for basic necessities, from basic financial services to cars to mortgages.

Second, these higher prices curb the ability of moderate- and low-income households to convert their wages into economic mobility and erode the efficacy of federal work-support subsidies, including the $42 billion Earned Income Tax Credit.

Third, federal policymakers can lower these higher prices by a) reducing the real higher costs of doing business with low-income consumers, b) curbing market practices that unnecessarily drive up prices, and c) boosting the ability of consumers to find the lowest possible price in a market for a good or service.

1. Evidence of the High Cost of Being Poor

Community leaders and economists have both recognized for decades that the poor often pay more for basic necessities.[1] But, until recently, there had not been any serious attempt to quantify the full range of these higher prices or their market causes, which stunted the development of a federal policy agenda designed to bring down these prices.

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[1] David Caplovitz. 1963. *The Poor Pay More: Consumer Practices of Low-Income Families*. New York: Free Press; Burton H. Marcus. 1969. "Similarity of Ghetto and Nonghetto Food Costs." *Journal of Marketing Research* 365.

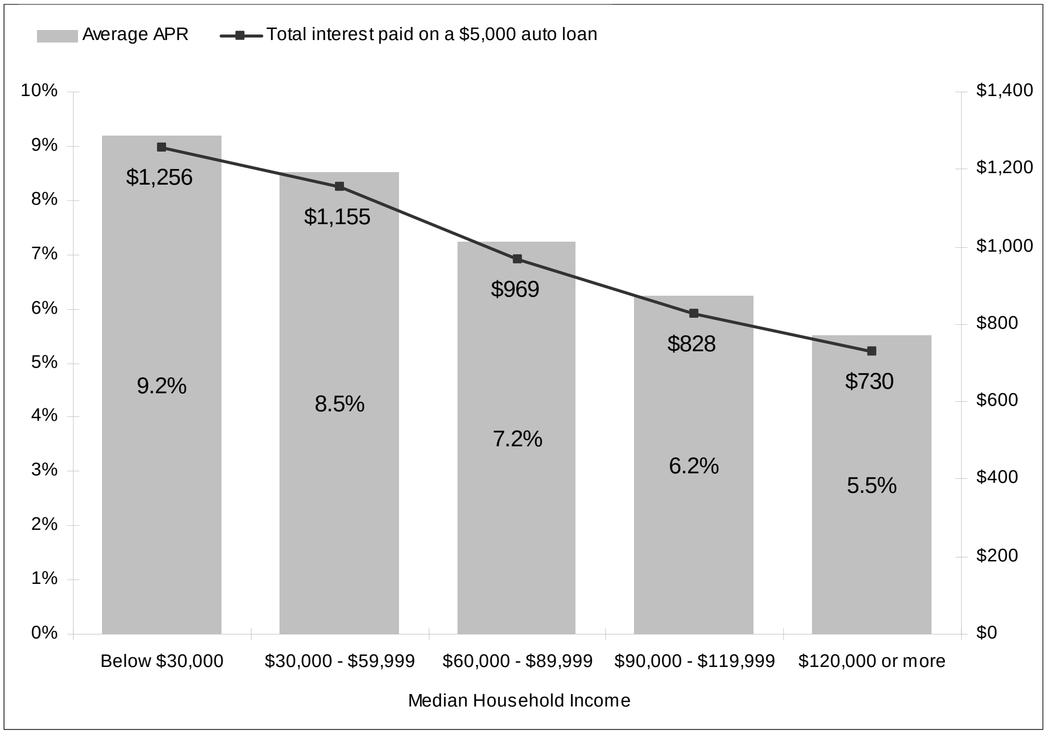
In response, the Annie E. Casey Foundation asked the Brookings Institution in 2004 to measure these high costs of being poor and develop private- and public-sector policies needed to bring down these prices.[2] With their principle support, we have now completed a national assessment of these higher prices, as well as state and local assessments.[3] Together, this evidence indicates that moderate- and low-income households often pay higher prices for goods and services that collectively add up to hundreds, sometimes thousands, of dollars in extra costs of living for individual households, depending on the mix of goods and services that they purchase. We summarize a sample of this evidence below.

- *Cashing Checks:* Whereas most middle- and higher-income households use low- or no-cost bank accounts to deposit their checks, lower-income households are much more likely to use non-bank businesses that charge fees. In particular, about $1.5 billion in fees were paid in 2007 to cash checks at one of 26,019 non-bank check-cashing establishments, which charge a national average of 4.64 percent of the face value of each payroll check for a service most banks reportedly do not charge account holders for. The estimated 10 million households that lack a basic transaction account (e.g., checking account, savings account, money market, or call account) at a bank represent the core customer base for these businesses. Of these households, the median income in 2004 was about $17,000, over 50 percent included at least one full-time worker, and about half had never owned an account.[4]

- *Short-term Loans:* Whereas most middle- and higher-income households use credit cards for short-term cash advances, moderate- and low-income households are much more likely to use expensive, non-bank payday lending businesses. In particular, about $6.5 billion in fees were paid in 2007 at one of 22,894 non-bank payday lending establishments, which charge a national average APR of 390 percent in the 38 states that allow these businesses, compared to a reported national credit card cash-advance APR average of 21 percent. Available data suggest that households earning less than $50,000 represent the majority of customers.[5]

[2] Founded in 1948, The Annie E. Casey Foundation makes grants that help states, cities, and neighborhoods fashion more innovative, cost-effective responses to meet the needs of vulnerable children and families. More information is available on their webpage, www.aecf.org.
[3] Two recent reports include: Matt Fellowes. 2006. *From Poverty, Opportunity: Putting the Market to Work for Working Families*. Washington, DC: The Brookings Institution; and Matt Fellowes, Mia Mabanta, Terry Brooks, and Valerie Salley. 2007. *The High Price of Being Poor in Kentucky*. Washington, DC: The Brookings Institution.
[4] Matt Fellowes and Mia Mabanta. 2008. “Banking on Wealth: America’s New Basic Retail Banking Infrastructure and Its Wealth-Building Potential.” Washington, DC: The Brookings Institution; Bankrate.com.
[5] Fellowes and Mabanta 2008; Bankrate.com.

Figure 1. Average Auto Loan APR, by Household Income



Source: Brookings analysis of the Federal Reserve's 2004 Survey of Consumer Finances

- *Car Loans:* Whereas most middle- and higher-income households pay a prime rate for car loans, moderate- and lower-income households are much more likely to pay subprime rates. In particular, households earning less than $30,000 a year in 2004 paid an average APR of 9.2 percent for their loan, while households that earned more than $60,000 paid an average APR of around 6.5 percent.[6]

- *Car Insurance:* Scholars found that drivers from low-income neighborhoods pay anywhere from $50 to over $1,000 more than drivers from high-income neighborhoods to insure the exact same car and driver, across a sample of 12 metropolitan areas taken in 2004 that collectively included 23 percent of the U.S. population.[7]

- *Mortgages:* Whereas most middle- and higher-income households pay a prime rate for mortgages, moderate- and lower-income households are much more likely to pay subprime rates. In particular, households earning less than $30,000 a year in 2004 paid an average APR of 6.9 percent for their loan, while households that earned more than $60,000 paid an average APR of around 5.8 percent.[8]

[6] Fellowes 2006.
[7] ibid.
[8] ibid.

Figure 2. Distribution of Mortgage APRs, by Household Income

Distribution of Mortgage APRs, by Household Income

	Typical APR on First Mortgage, by Income Group		
Household Income	25th Percentile	Mean	75th Percentile
Below $30,000	5.4%	6.9%	7.8%
$30,000 - $59,999	5.5%	6.5%	7.0%
$60,000 - $89,999	5.3%	6.0%	6.5%
$90,000 - $119,999	5.1%	5.9%	6.3%
$120,000 or more	4.9%	5.5%	6.0%
Total	5.3%	6.2%	6.8%

	Typical APR on Second Mortgage, by Income Group		
Household Income	25th Percentile	Mean	75th Percentile
Below $30,000	7.0%	9.8%	10.0%
$30,000 - $59,999	5.8%	7.9%	10.0%
$60,000 - $89,999	4.5%	7.1%	8.5%
$90,000 - $119,999	4.5%	6.4%	8.0%
$120,000 or more	4.5%	6.0%	6.5%
Total	4.8%	7.2%	8.8%

Source: Brookings analysis of the Federal Reserve's 2004 Survey of Consumer Finances

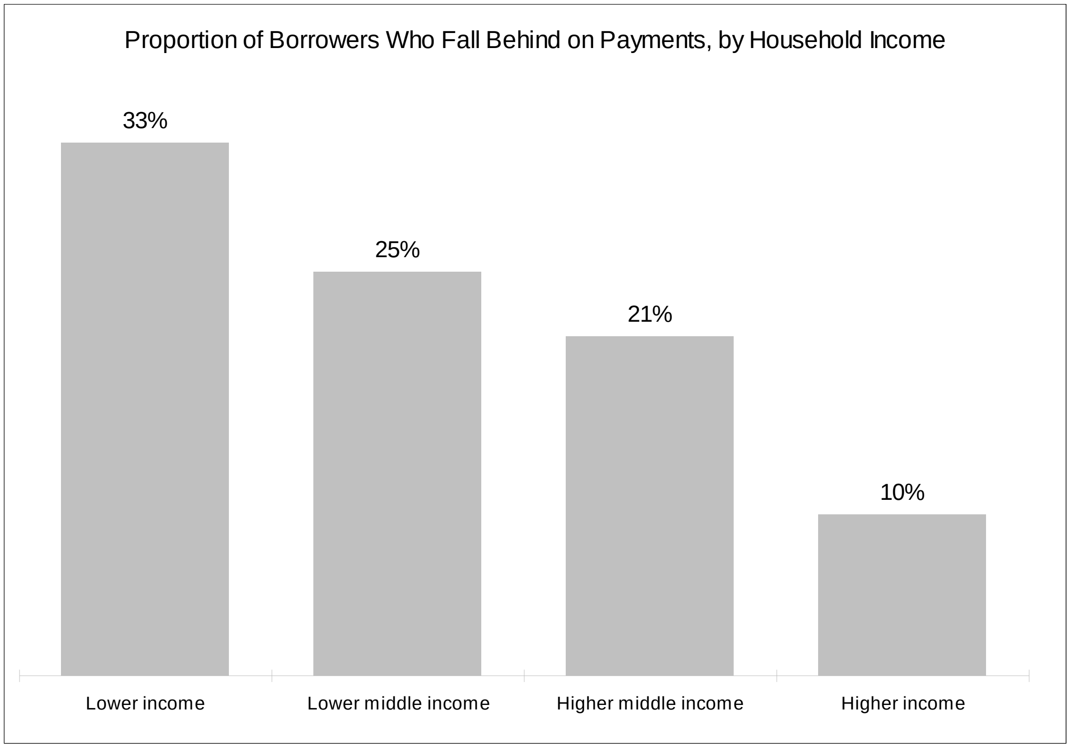
- *Furniture and Appliances:* Whereas most middle- and higher-income households pay for furniture and appliances with credit cards or cash, lower-income households are much more likely to use rent-to-own establishments, which research has found can add several hundred dollars onto the costs of basic household items like televisions and refrigerators. Nearly 60 percent of the customers of these businesses earn less than $25,000 a year.[9]

- *Grocery Prices:* Whereas middle- and higher-income neighborhoods tend to include mid-to-large grocery stores greater than 10,000 square feet in size, lower-income neighborhoods tend to have small grocery stores that charge comparably higher prices. In particular, the average grocery store in a neighborhood with a median income less than $30,000 is 2.5 times smaller than the average grocery store in a neighborhood with a median income greater than $60,000, across a sample of 12 metropolitan areas.[10]

[9] James M. Lacko, Signe-Mary McKernan and Monoj Hastak. 2000. "Survey of Rent-to-Own Customers." Federal Trade Commission, Bureau of Economics Staff; State of Maryland, Office of the Attorney General, www.oag.state.md.us/consumer/edge109.htm; State of Wisconsin, Department of Financial Institutions, www.wdfi.org/wca/consumer_credit/credit_guides/rent-to-own.htm.

[10] Fellowes 2006. Of 132 different grocery products assessed, 64 percent were more expensive in stores smaller than 10,000 feet compared to larger stores.

Figure 3. Proportion of Borrowers Who Fall Behind on Payments, by Household Income



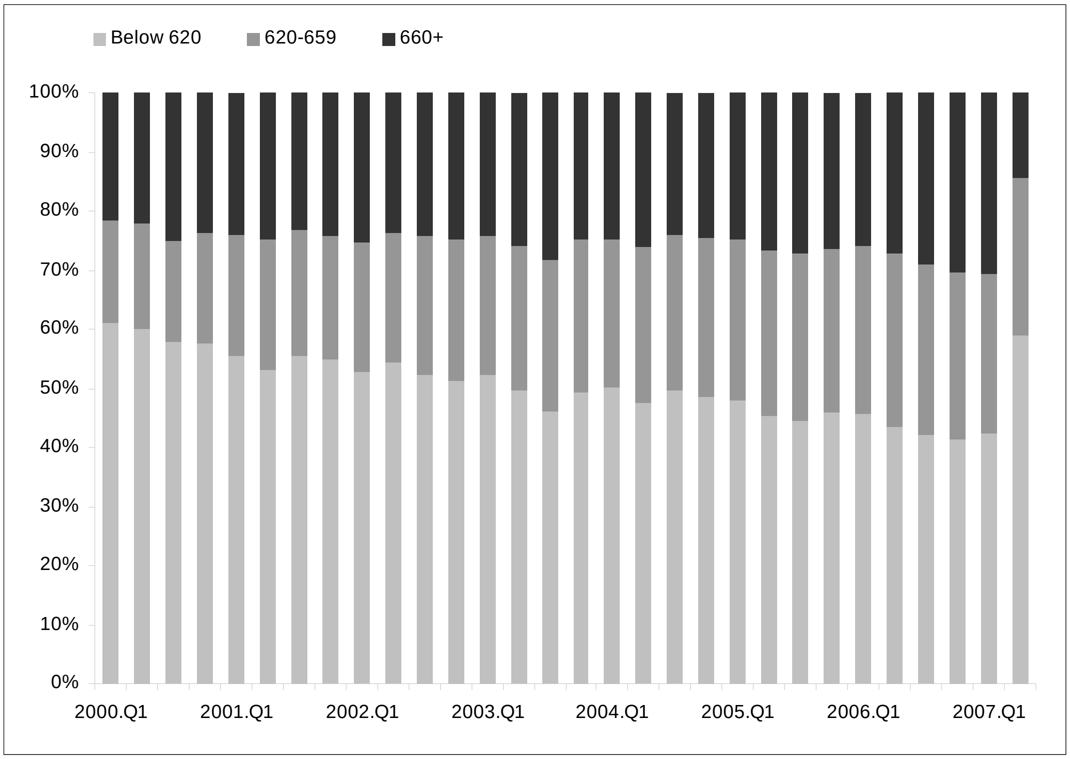
Source: Brookings analysis of the Federal Reserve's 2004 Survey of Consumer Finances

2. Causes of the High Cost of Being Poor

That lower-income households often pay higher prices for basic goods and services is the consequence of three market dynamics. First, lower-income households and neighborhoods tend to represent higher costs for businesses, which drive up prices and ward off some businesses from serving this demographic. For instance, the Federal Reserve's 2004 Survey of Consumer Finances indicates that over 30 percent of households in the bottom income quartile reported to have fallen behind on a bill at some point over the past twelve months, compared to about 10 percent of households in the top income-quartile.[11] Similarly, low-income households have less money to spend than those with higher incomes, which means that some retail businesses must serve more people to achieve a similar profit margin. Businesses rationally respond to these higher costs of doing business by passing them on to low-income consumers in the form of higher prices or by steering clear of these markets. Importantly, these higher costs can also contribute to perceptions of higher costs even in cases or in areas where they might not actually exist, which can decrease retail presence and competition, further increasing prices.

[11] Fellowes 2006.

Figure 4. Distribution of Subprime Loan Recipients, by FICO Score Range



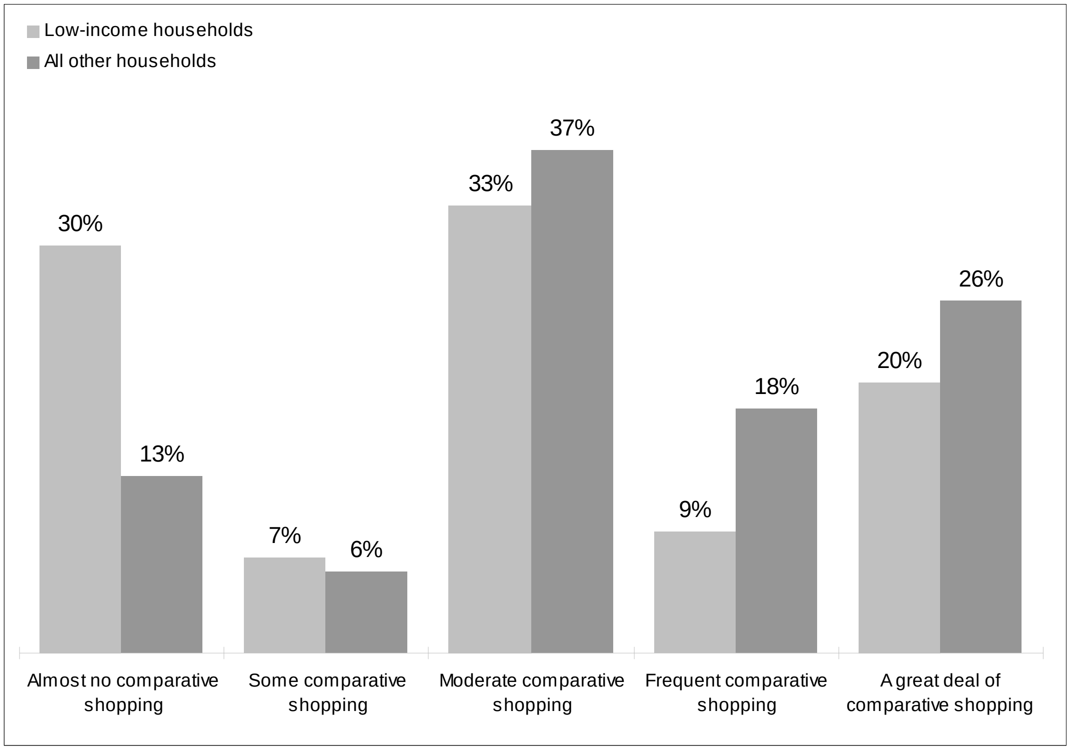
Source: First American LoanPerformance via the Wall Street Journal ("Subprime Debacle Traps Even Very Credit-Worthy," 12/3/07)

Second, in the vacuum left by some businesses avoiding low-income markets, lower-income consumers tend to attract more businesses that charge unusually high prices, either because of an expensive business model or because of excessive profit margins. For instance, nearly 63 percent of non-bank check cashers and 68 percent of payday lenders are located in census tracts that have moderate or low median incomes relative to the national distribution.[12] Although these businesses sell many of the same basic financial services as banks, their business models are more expensive because they rely on far fewer sources of revenues compared to banks. With fewer revenue streams to depend on, non-banks must cover their capital costs – like employees, utilities, and brick and mortar branches – by selling comparable products at much higher relative prices. There are also businesses that serve this demographic group and charge unreasonably high prices. For instance, of the estimated 7.5 million first-lien, subprime mortgages outstanding as of mid-2007, anywhere between 15-50 percent of those were originated to households that had credit scores qualifying them for a lower-priced mortgage.[13] That lower-income households were much more likely as a group to buy subprime mortgages compared to higher-income households, suggests that they were more likely to have unnecessarily paid these higher mortgage prices.

[12] Fellowes and Mabanta, 2008.

[13] Mortgage Bankers Association and First American Loan Performance, quoted from Matt Fellowes. 2007. "The Economic Power of Uncertainty: Assessing the Role of Consumer Credit Bureaus." Speech at the Federal Reserve Board in Washington, DC on December 14, 2007 (available at www.brookings.edu).

Figure 5. Proportion of Low-Income and Non-Low-Income Borrowers Who Do Comparative Shopping



Source: Brookings analysis of the Federal Reserve's 2004 Survey of Consumer Finances

Third, higher cost businesses and practices can flourish because lower-income consumers tend to be less informed consumers than those with higher-incomes, which leads them to purchase higher cost goods and services than might be available. For instance, the 2004 Federal Reserve Survey of Consumer Finances indicates that about 36 percent of households earning less than $30,000 report that they do almost no comparative shopping when buying major credit or loans, compared to just about 13 percent of all other households.[14] Other studies have found that lower-income households are much less likely as a group to understand the importance that credit reports and scores now play in influencing prices for loans, credit, and insurance.[15] Together, this lower level of knowledge about markets for goods and services can put lower-income households at a disadvantage in the marketplace relative to higher-income households, which can lead to their being charged higher prices.[16]

[14] Fellowes 2006.

[15] See annual survey administered by Providian Financial and the Consumer Federation of America; or General Accountability Office. 2005. "Credit Reporting Literacy: Consumers Understood the Basics but Could Benefit from Targeted Educational Efforts." GAO-05-223.

[16] For an assessment of the role that information plays in price-setting, see Jeffrey R. Brown and Austan Goolsbee. 2002. "Does the Internet Make Markets More Competitive? Evidence from the Life Insurance Industry. *Journal of Political Economy*, 110.

3. Policies that Lower the High Cost of Being Poor

To lower these higher costs of living, federal policymakers must address each of their causes. Steps that a select group of states, cities, and private-sector partners have taken in recent years to do this provide a roadmap for a new federal agenda.[17]

Policy Response #1: Lower Costs of Doing Business with Lower-Income Consumers

Policymakers must first take steps to lower business costs in lower-income neighborhoods through a targeted income or in-kind subsidy. This support can take a number of different forms. For instance, Pennsylvania responded in 2005 to a lack of large grocery stores in mostly lower-income neighborhoods by passing a $20 million subsidy that covers various costs associated with building grocery stores. This modest expenditure, paired with federal tax incentives and private funding, has since attracted over 20 new large grocery stores in previously underserved markets throughout Pennsylvania, bringing lower prices and a more full selection of food items.[18] Similarly, the city and state of New York responded to a high density of expensive non-bank check-cashing businesses in low-income neighborhoods by agreeing to transfer more than $100 million in government revenue for deposit in new bank branches that open in these neighborhoods. More than 30 new bank branches have opened with this support. According to an analysis of 15 of these new branches between May 2005 and April 2006, more than 20,000 checking and savings accounts were opened and $84 million in loans were originated.[19]

Business costs can also be lowered by reassessing how those costs are measured. For instance, numerous studies by Social Compact have found that demand for goods and services in lower-income markets is often underestimated by traditional market demand methods and data, which can depress competition in low-income markets, driving up prices for goods and services. Once properly measured, these data have been used to help attract businesses into lower-income markets where there is more demand than previously thought.[20] Similarly, a growing number of states have questioned how insurance companies measure risk in lower-income neighborhoods. According to Florida's former General Counsel to the Office of Insurance Regulation, for instance, they believed that "the lowest income strata [had] the worst credit scores, and [were] paying higher rates as a result of that." That concern prompted the former Bush administration to demand that insurance companies prove that the use of credit scores in insurance rate algorithms did not statistically discriminate against low-income drivers.[21]

[17] Many of these ideas for federal policy reform are assessed at more length in Matt Fellowes. 2007. "Putting the Market to Work for the Poor." *Harvard Law and Policy Review.* 1(2).
[18] For more information please see: Pennsylvania Fresh Food Financing Initiative, www.trfund.com/anancing/realestate/supermarkets.html.
[19] For more information please see: New York State Banking Development Districts, www.banking.state.ny.us/bdd.htm.
[20] For more information please see: Social Compact, www.socialcompact.com.
[21] Quoted in Harriet Johnson Brackery, "Insurers, State Duel over Role of Credit Scores in Auto and Home Insurance Rates," Sun-Sentinel, July 13, 2006, at A1.

Finally, leaders are striving to lower business costs by providing in-kind support. For instance, San Francisco launched a major marketing campaign on behalf of banks in 2006 to open up low-cost bank accounts for 20 percent of the population that lacked a bank account – a population that had previously relied on expensive, non-bank check cashers. They met that goal within one year and have since doubled the number of accounts that they want to open. Now, that program has inspired cities across the country to replicate their efforts, and California recently announced that it will be the first state in the country to also replicate this program.[22]

Together, this state, local, and private sector innovation demonstrates that costs of living can be lowered for lower-income families by lowering related business costs. It also provides guidance for how the federal government can similarly strive to lower the high costs of being poor. For instance, the U.S. Treasury Department or one of the banking regulatory agencies could replicate and expand the San Francisco program to help connect lower-income consumers to low-cost, appropriate bank accounts, just as nearly a dozen cities and the state of California are preparing to do. Similarly, numerous institutions have suggested that the federal government capitalize a starter bank account for every newborn in this country, just as an entrepreneur in Maine has vowed to do for every child born in that state.[23] This would potentially provide our next generation of workers with a connection to banks that millions of the current generation of workers lack, paying higher prices as a result. The federal government could also play an important role helping businesses better understand market demand in lower-income markets, which will draw more businesses and price-lowering competition into these markets.

Policy Response #2: Curb market practices that unnecessarily drive up prices

When more businesses can retail goods and services in low-income markets at competitive rates, policymakers can then responsibly take steps to weed out the practices that unnecessarily drive up prices. There are many examples of state and local activity that can inform this type of federal policy response. In the auto market, for instance, California recently became the first state in the country to pass legislation that protects consumers from price-inflating practices by prohibiting auto dealers from adding undisclosed items to a contract and limiting the ability of banks to provide kickbacks to dealers that inflate auto loan prices.[24] The federal government could establish a similar floor for allowable activities in this industry that prevents unnecessarily high prices from being charged to customers, which we have found lower-income consumers much more likely to pay.

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[22] For more information please see: Bank on San Francisco, www.sfgov.org/site/bankonsf_index.asp; William J. Clinton and Arnold Schwarzenegger. "Beyond Payday Loans." *Wall Street Journal*, op-ed, January 24, 2008.
[23] For more information please see: Finance Authority of Maine, www.famemaine.com.
[24] For more information please see: California House Assembly, Bill #68, 2005-2006 Legislation, Regular Session.

In the financial services market, scholars have proposed that the Internal Revenue Service follow California's example of automatically filling out tax forms for households with relatively simple tax forms during a pilot initiative in 2006. That service would eliminate the need of some lower-income households to pay to have their tax returns prepared for them because they lack the expertise to complete these forms on their own – a service they are more likely as a group to pay for compared to higher-income households.[25] There are also now a number of bills circulating in Congress to reign in some of the practices in the mortgage market that may have led to unscrupulously high prices. And Congress could extend the same small dollar loan protections afforded to military personnel in 2006 legislation to non-military personnel.[26]

Policy Response #3: Boost the ability of consumers to find the lowest possible price in a market for a good or service

Lower-income consumers that are better equipped to seek out and bargain for lower prices can also lower the high costs of being poor. One approach is to make financial education more available in K-12 schools by making a basic financial skills test a graduation requirement. Idaho, Illinois, Kentucky, Georgia, New York, and Utah, for instance, all require high schools students to take a financial education course before graduating.[27] Congress could use federal testing requirements, like the No Child Left Behind Act, to encourage schools in more states to also teach basic financial education skills to students.

Unfortunately, federal policy directed at improving the financial sophistication of adults is difficult to recommend at this point because we lack appropriate information about what type of specific interventions work, and how policymakers can help scale those interventions across the country.[28] In response, I, along with colleagues at the New America Foundation and the Center for Financial Services Innovation, am currently developing a legislative proposal designed to help expand our knowledge of what type of policy interventions are needed to help improve the ability of more American households to convert their wages into economic mobility. This proposal will be released in June 2008 and I would be happy to share it with the Subcommittee in advance of that release.

In closing, I want to thank the Subcommittee for holding this important hearing and for inviting me to be part of it. I look forward to working with the Subcommittee to further develop a federal agenda that lowers these high costs of being poor.

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[25] For more information please see: Austan Goolsbee. 2006. "The 'Simple Return: Reducing America's Tax Burden Through Return-Free Filing." Washington, DC: The Brookings Institution.
[26] For more information please refer to the 2007 National Defense Authorization Act.
[27] For more information please see: National Council on Economic Education. 2005. "Survey of the States: Economic and Personal Finance Education in Our Nation's Schools in 2004."
[28] For more information please see: Matthew Martin. 2007. "A Literature Review on the Effectiveness of Financial Education." Working Paper, 07-3. Federal Reserve Bank of Richmond.