Discussion Paper

Quick Credit

The Fringe Economy, the Great Recession, and the Welfare State

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Rapid growth of the "fringe economy"—check-cashers, payday lenders, buy-here-pay-here auto sales, refund anticipation loans, rent-to-own furniture and appliances, auto title loans, and pawnshops—has precipitated a volatile debate about whether such financial services represent an adaptive response to the credit needs of low- and moderate-income families or predatory exploitation of economically hard-pressed consumers.

A review of this sector's growth and its various financial service offerings suggests that the fringe economy addresses the lack of access to financial services for many poor and working class families; however, their expansion has broader implications not only for income and wealth inequality, but for the provision of social welfare benefits and thus the integrity of the welfare state. These tensions have been particularly exposed during the Great Recession and its aftermath, leading to debates over how policy should help meet the financial service needs of families with lower incomes and fewer resources as well as how to regulate this new market of financial services. The formation of an independent Consumer Financial Protection Bureau (CFPB) in the recent Dodd-Frank financial reform bill creates an immediate regulatory vehicle for intervening in this market and protecting low-income households from exploitive financial products. The policy prescriptions the new CFPB might pursue will vary depending upon the regulator's conception of the fringe economy, and could contribute significantly to strengthening the delivery of social welfare policies.

The Emergence of the Fringe Economy

Low- and moderate-income (LMI) households have long relied on financial services that have been separate from mainstream banking. As such, various financial products have evolved which have escaped state and federal regulation. For example, the proliferation of salary lenders after the Civil War served as an impetus for state usury prohibitions, contributing to Progressive Era reforms and, ultimately, the regulatory regime of the New Deal.[1] Early in the 20th century the credit abuse of poor immigrants prompted the Russell Sage Foundation to subsidize philanthropic pawnshops (known as remedial loan societies) in several large cities of which only the Provident Loan Society still exists in New York City at five locations.[2]

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[1] Phillip Longman and Ray Boshara, *The Next Progressive Revolution* (Sausalito, CA: PoliPoint Press, 2009).
[2] John Caskey, *Fringe Banking* (New York, NY: Russell Sage Foundation, 1994), p. 24.

In 1933 the Glass-Steagall Act authorized the newly established Federal Deposit Insurance Corporation (FDIC) to regulate savings institutions and limit interest rates for savings accounts as well. Decades later the 1977 Community Reinvestment Act (CRA) prohibited "red-lining," the practice of denying mortgages and other loans to entire neighborhoods of consumers suspected of being high-risk and required banks to make credit available to poor families. Just as the CRA prompted banks to serve low-income, disproportionately minority families, stagflation of the mid-1970s drove interest rates beyond traditional usury limits, prompting states to relax regulation of financial institutions. Soon, bi-partisan support grew for deregulating financial services altogether, liberal Democrats advocating for innovative financial products to bring the marginalized poor into the economic mainstream, conservative Republicans seizing the opportunity to shed the burdensome regulations that had interfered with self-correcting financial markets. The resultant 1980 Depository Institutions Deregulatory and Monetary Control Act removed interest rate caps on loans, providing a fertile ground for expansion of the fringe economy.[3]

What had been a relatively small fringe economy expanded exponentially during the final decades of the 20th century. The securitization of subprime mortgages diminished the exposure of purchasers of various financial instruments; even NINJA loans to mortgagees who had No Income, No Job, No Assets, were designed to extend capitalization of investment banks in the process landing executives whopping bonuses.[4] When American finance imploded in 2007 driving the economy into recession, subprime mortgages were widely attributed as a primary cause,[5] chiefly because financial institutions on Wall Street had bundled and sold them as securities. With the exception of alarms voiced by a coterie of critics operating under nonprofit auspices, the off-Wall Street provenance of other financial products—payday loans, check-cashing, refund anticipation loans, and the like—had allowed them to slip under the regulatory radar.

In addition to reregulating financial institutions that were "too big to fail," fall-out from the Great Recession included a reassessment of non-mainstream financial services that had proliferated. As the fringe economy expanded in scale after the 1980s, introduced new product lines, and flexed its political muscle through a trade association, its lexicon evolved accordingly. Initial reactions were negative, as the invocation of "predatory lender" by Bruce Marks when he challenged Boston's Fleet Bank for appending high fees and interest rates on loans to duped consumers in the early 1990s, attests.[6] An early study described the activities of check-cashers and pawn lenders as "fringe banking,"[7] a British term coined by economist Hyman Minsky.[8] In rebuttal, three scholars proposed the term "alternative financial services" to differentiate pawnshops, payday lenders, check cashers, and rent-to-own stores from traditional financial institutions.[9] A journalistic exposé freighted the fringe economy with terms such as "shadow banks," "financial shakedowns," and "shark bait,"[10] while an academic critique that included payday lenders, buy-here-pay-here auto sales, and subprime mortgages referred to lenders as the "fringe economy or predatory lending."[11] In 2002 the Center for Responsible Lending (CRL) was established to oppose "abusive lending practices," generating research and proposing regulatory reforms, while employing pejorative terms, such as "legal loansharking" and "the debt trap." On the defensive, as CRL and the Consumer Federation of America provided the ammunition for proponents of fair credit

[3] Raphael Bostic and Kwan Lee, "Homeownership: America's Dream?" in Rebecca Blank and Michael Barr, eds. *Insufficient Funds* (New York: Russell Sage Foundation, 2009).
[4] Michael Lewis, *The Big Short* (New York: W.W. Norton, 2010)
[5] Kathleen Engel and Patricia McCoy, "Predatory Lending and Community Development at Loggerheads," in *Financing Low-Income Communities*, Julia Sass Rubin. Ed. (New York: Russell Sage Foundation, 2007).
[6] Gary Rivlin, *Broke, USA* (New York: Harpers Business, 2010), p. 45.
[7] Caskey, *Fringe Banking.*
[8] Caskey, personal communication, June 26, 2010.
[9] Roger Swagler, John Burton, and Joan Koonce, "The Operations, Appeals and Costs of the Alternative Financial Sector," *Financial Counseling and Planning*, vol. 6 (1995).
[10] Michael Hudson, *Merchants of Misery* (Monroe, Maine: Common Courage, 1996).
[11] Howard Karger, *Shortchanged: Life and Debt in the Fringe Economy* (San Francisco, CA: Berrett-Koehler, 2005), p. 5.

practices to either pass state laws prohibiting short-term, high interest lending in North Carolina and Ohio or cap interest rates at 36 percent in the District of Columbia as did the federal Military Lending Act for military families, the Financial Service Centers Of America (FiSCA), a trade association, lobbied for less inflammatory language: "alternative financing."[12] By 2009, the FDIC published its first assessments of Alternative Financial Services (AFS) signaling its concurrence, and the usage has since become widely accepted.[13]

Distribution of Banks and the Unbanked

Explosive growth of the fringe economy was concomitant with financial deregulation. Between 1975 and 1995 the number of banking institutions dropped 35 percent from 18,600 to 12,200. As shown below, the reduction disproportionately affected savings institutions and low-income communities.

Table 1. Distribution of Banks and Savings Institutions by Relative Income of ZIP Code

Type of Financial Institution	Characteristic of ZIP Code Area	Banking Offices				
Commercial Banks	*Income (as percentage of median income)*	1975	1980	1985	1990	1995
	More than 120	6,389	8,163	9,485	10,609	11,975
	80 to 120	23,444	27,957	30,349	30,362	32,802
	50 to 80	8,258	9,451	9,917	9,333	9,504
	50 or less	1,587	1,699	1,687	1,473	1,404
Savings Associations						
	More than 120	2,862	4,690	5,319	5,322	3,671
	80 to 120	8,334	12,633	13,934	13,397	9,195
	50 to 80	2,980	4,044	4,329	3,387	2,509
	50 or less	577	689	643	536	315
All						
	More than 120	9,251	12,853	14,804	15,931	15,646
	80 to 120	31,778	40,590	44,283	43,579	41,997
	50 to 80	11,238	13,495	14,246	13,170	12,013
	50 or less	2,164	2,388	2,330	2,009	1,719

Source: Robert Avery, Raphael Bostic, Paul Calem, and Glenn Canner, "Changes in Distribution of Banking Offices," Federal Reserve Bulletin. September 1997, p. 720.

These data are notable in two respects: First, many mainstream financial institutions abandoned low-income communities for more favorable up-scale locations. The number of savings associations plummeted between 1975 and 1995; indeed, the number of savings offices per 10,000 residents in the lowest income communities dropped 39 percent in these decades. Savings and loans, organizations that might have been a source of credit for low-income families, consolidated and began dabbling in

[12] Rivlin, *Broke, USA,* p. 28.
[13] In the semantics surrounding this sector of the economy, it is important to consider subprime lending, above market rate loans. Logically, higher risk consumers would be expected to pay higher rates for loans in order to induct them into the economic mainstream, a strategy adopted by Self-Help in order to transition many minority poor families from renters to home owners. However, the structure of subprime lending with respect to the amount of fees and rate of interest as well as the consumer's understanding of the loan and ability to repay become critical in classifying whether such loans afford consumers access to credit or prey on their vulnerability.

subprime products which would adversely affect poor households.[14] Second, the loss of banking offices and savings associations followed passage of the Community Reinvestment Act in 1977, indicating that federal legislation did little to halt the retreat of financial institutions from poor neighborhoods. "The consolidation in the banking industry over the past 20 years has reduced the number of banks in low-income neighborhoods, increased the focus of banks on corporate and high-income customers, and limited banks' interest in serving consumers with small accounts or less-than-perfect credit," observed Howard Karger.[15]

Bank deregulation, in other words, left large numbers of poor Americans without a convenient banking institution for essential financial services, a vacuum that alternative financial services would quickly fill. "Check-cashing stores and pawnshops and payday lending stores, those are the poor man's institutions," proclaimed former pro football player and ad man for Advance America, Willie Green, "You go to any poor black person, and I guarantee you, they've borrowed money from a payday person, a title loan person, or a pawnshop. That's what you do if you don't have the luxury of going into a bank and borrowing money."[16]

The Unbanked

As banks and savings associations retreated from low-income areas, a significant number of consumers lost access to mainstream financial services. As shown in the table below from a recent report of the FDIC, the number of unbanked consumers lacking a savings or checking account totaled 7.7 million households or 9 million Americans; underbanked consumers who have a savings or checking account but rely on alternative financial services represents 17.9 percent of households or 21 million Americans. Access to financial services falls disproportionately on racial and minority groups as shown below.

Table II. Lack of Access to Mainstream Financial Services

	Percent of Households	
Racial/Ethnic Group	**Unbanked**	**Underbanked**
African-American	21.7	31.6
Hispanic	19.3	24.0
Native American/Alaskan	15.6	28.9
Asian	3.5	7.2
Anglo	3.3	14.9

Source FDIC National Survey of Unbanked and Underbanked Households (Washington, DC: FDIC, December 2009), pp. 3–4.

The FDIC concluded that "overall, almost 54 percent of black households, 44.5 percent of American Indian/Alaskan households, and 43.3 percent of Hispanic households are either unbanked or underbanked."[17]

Having a relationship with a mainstream financial institution is problematic for many households in ways that few affluent Americans would appreciate. The vast majority of banks, 87 percent, vet applicants for new accounts through third party screening systems, such as ChexSystem, and 25 percent reject applications if the result is negative.[18] Without a savings account at a mainstream financial institution, upwardly mobile households have difficulty building assets. "Many low-income families

[14] Binyamin Appelbaum, "Onetime Cop, Out of Business," *New York Times,* July 14, 2010, p. B1.
[15] Karger, *Shortchanged*, p. 12.
[16] Rivlin, *Broke, USA,* p. 256.
[17] *FDIC National Survey of Unbanked and Underbanked Households,* p. 4.
[18] *FDIC Survey of Banks' Efforts to Serve the Unbanked and Underbanked* (Washington, DC: FDIC, February 2009), p. 5.

are already savers, whether or not they have bank accounts. Without a connection to a formal financial institution, however, their savings will grow far more slowly and they will face more obstacles along the path to longer-term prosperity."[19] Exacerbating the problem of lack of access to financial institutions, insufficient income compels households to resort to debt to meet expenses. Average credit card debt for low- and middle-income households was $8,650 in 2005, and the average length of indebtedness was 43 months.[20]

The most comprehensive analysis of the problems encountered by low-income households unable to reconcile income with expenses and subsequently resorting to alternative financial services is the Detroit Area Household Financial Services (DAHFS) survey conducted in 2005–2006. The principal investigator, Michael Barr, concluded that:

> The financial services mismatch between the needs of LMI households and the products and services offered to them largely forces these households to choose among the high-fee, ill-structured products offered by both banking and AFS institutions. These constrained choices reduce take-home pay, making it harder to save and more expensive to borrow.[21]

The study population contended with tribulations commonly associated with poverty as shown below.

Table III. Selected Attributes of DAHFS Respondents

Characteristic	Banked	Unbanked
Median household income 2004	$25,000	$10,000
Below the poverty line	26.2%	50.5%
Lost job in last 12 months	18.9	32.8
Very difficult to live on income	23.1	37.7
Major illness/medical expense	26.1	28.8
Evicted	4.1	10.5
Utility shut-off	7.5	16.2
Phone disconnected	13.9	29.4
Filed for bankruptcy	3.9	4.1
Did not have enough food	13.1	25.9
Lacked health insurance	15.0	32.9

Source: Barr, "Financial Services," pp. 73, 81.

If life was difficult for those who enjoyed bank accounts, it was tenuous for those without. Insufficient income to cover normal household expenses coupled with unsteady employment contributed to problems paying for utilities and health care. With an average liquid asset of only $400, households below the poverty line were ill-prepared to weather an income shock. Thus, banked households had more latitude in covering the cost of an unexpected event, resorting to bank loans, short-term credit, borrowing from a credit card, and overdrawing an account, compared to unbanked families that relied on refund anticipation

[19] Ellen Seidman and Jennifer Tescher, "Unbanked to Homeowner: Improving Financial Services for Low-Income, Low-Asset Customers," (Washington, DC: Brookings Institution, 2005), p. 324.

[20] *The Plastic Safety Net* (Demos and Center for Responsible Lending: October 2005), pp. 7-8.

[21] Michael Barr, "Financial Services, Saving, and Borrowing Among Low- and Moderate-Income Households," in Rebecca Blank and Michael Barr, eds. *Insufficient Funds* (New York: Russell Sage Foundation, 2009), p. 67.

loans and pawn. Those who used one AFS tended to use other AFS providers, essentially improvising a financial service network. Often respondents relied on high cost credit to meet everyday expenses.

> Individuals reported that they took out payday loans to pay for necessities. Of those who had most recently looked into getting a payday loan, 60 percent said that they needed the money for everyday expenses such as food and gasoline or for regular bills.[22]

Researchers from the Urban Institute validated the Detroit study: Slightly more than half of low-income households have a savings account, the median value of which was $800, insufficient for a major emergency. Lack of assets to buffer a household from economic crises left many families resorting to short-term loans available from fringe lenders; over time such loans subvert household savings. "Once a vicious cycle of indebtedness takes hold, long-term asset goals evaporate," they concluded.[23]

The absence of savings in LMI households highlighted the value of assets in family economics; without the buffer afforded by a modest savings account many poor families were unable to weather frequent income shocks. Consequently, asset poverty, "the inability to cover three months of basic living expenses at the poverty level (with liquid reserves), in the event of total income loss,"[24] emerged as an indicator of household economic resilience. In 2006, the asset poverty level was about 26 percent, over twice the federal poverty level, 12 percent. It stands to reason that if families have difficulty anticipating income shocks through savings, they will rely on an informal network of relatives and friends to weather such shocks. Given the likelihood that such a support group will evidence similar socio-economic attributes however; odds are high that they will resort to borrowing. If mainstream financial institutions are not available or accessible, AFS becomes an important, if not essential, source of credit.

In 2010 the FINRA Investor Education Foundation published the first of three studies of financial capability which included several subprime loans—auto title loans, payday loans, an advance on a tax refund, pawn, and rent-to-own. "Non-bank methods of borrowing" were higher among the minority poor who were younger and less-educated as shown below:

Table IV. Users of Non-Bank Borrowing (Percent of survey respondents borrowing these products in last 5 years)

		Race/Ethnicity		Income	Education	Age
Type of Borrowing	**Total**	**Black**	**Latino**	**<$25K**	**<H.S.**	**18-29 yrs**
Taken out an auto title loan	7	4	6	5	5	7
Taken out a payday loan	5	5	11	6	8	8
Received a loan on a tax refund	8	13	9	12	13	12
Used a pawnshop	8	17	11	16	16	19
Used a rent-to-own	5	10	4	8	7	10

Source: FINRA Foundation, "Financial Capability in the United States," (Washington, DC: author, 2010), pp. 6-7.

Almost one-fourth of respondents, 23 percent, had used one of these products within the past five years, utilization that was higher for the unbanked, 44 percent, than those who had bank accounts, 20 percent.

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[22] Barr, "Financial Services," p. 91.
[23] Signe-Mary McKernan and Caroline Ratcliffe, "Enabling Families to Weather Emergencies," (Washington, DC: Urban Institute, 2008), p. 2–4.
[24] Alejandra Lopez-Fernandini, "Unrestricted Savings," (Washington, DC: New America Foundation, February 2010), p. 6.

The Fringe Economy

Marginal to the mainstream economy before the 1990s, the fringe economy has morphed into a major industry. While fringe banking institutions, such as pawnshops and check cashers, have long been a part of the nation's economic life, their role has been eclipsed by the emergence of businesses that provide an array of financial products to low- and moderate-income Americans. Such alternative financial services are attractive to unbanked American families lacking a formal relationship to a mainstream financial institution, such as a bank or credit union, an experience more common for minorities.

While 12 percent of the population is unbanked, 28 percent of African Americans and 30 percent of Hispanics use alternative financial services. [25] In recent years, the fringe economy has diversified as shown below:

Table V. Primary Sectors of the Fringe Economic, Annual Revenues

Sector	Volume (in billions of dollars)
Buy-Here-Pay-Here Auto Loans	80
Check Cashing	58
Payday Loans	48
Overseas Wire Remittances	46
Open-Loop Prepaid Cards	39
Refund Anticipation Loans	26
Money Order	17
Rent-to-Own Transactions	7

Source: Christine Bradley, Susan Burhouse, Heather Gratton, Rae-Ann Miller, "Alternative Financial Services: A Primer," FDIC Quarterly, vol. 3, no. 1 (2009), p. 39.

The FDIC reports that the fringe economy exceeds $230 billion in financial services annually.[26] An extensive array of outlets makes the fringe economy accessible to many consumers: one scholar calculated that the number of Check Cashing Outlets and payday lending outlets (33,000) exceeded the number of franchises of McDonalds, Burger King, Target, Sears, and J.C. Pennys combined (29,000).[27] An analysis of payday lending reported that "Though scarce prior to 1990, payday lenders now have more outlets in the United States than McDonald's and Starbucks combined."[28]

Rapid growth of the fringe economy has paralleled banking deregulation, leading some scholars to conclude that it has replaced more traditional forms of financial services for low-income households, often to their detriment.[29] In describing "the poverty industry," a journalist contended that the fringe economy targeted "people on the bottom third of the economic ladder—perhaps 60 million consumers who are virtually shut out by banks and conventional merchants."[30] Approximately 66 percent of unbanked families rely on alternative financial services,[31] at interest rates far above those paid by consumers relying on mainstream depository institutions, as shown on the next page:

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[25] FINRA Investor Education Foundation, "Financial Capability in the United States," (Washington, DC: author, 2010), pp. 7-8.
[26] Christine Bradley, et al., "Alternative Financial Services," p. 1.
[27] Karger, *Shortchanged*, p. 5.
[28] Paige Skiba and Jeremy Tobacman, "Do Payday Loans Cause Bankruptcy?" (November 13, 2007), p. 1.
[29] David Shipler, *The Working Poor* (New York: Knopf, 2004).
[30] Hudson, *Merchants of Misery*, p. 1. The FDIC reports that 60 million adults live in households that are un- or under-banked. See *FDIC National Survey of Unbanked and Underbanked Households,* p. 4.
[31] *FDIC Survey of Unbanked and Underbanked Households*, p. 5.

Table VI. Typical Interest Charge for Fringe Financial Products

Product	Typical Interest Rate
Pawn	161%
Payday Loans	390%
Refund Anticipation Loans	162%
Auto Title Loans	300%
Rent-to-Own Transactions	70%
Loan-sharking	1,040%

Source: Adapted from Gregory Elliehausen, "Consumers' Use of High-Price Credit Products," (Indiana State University: Networks Financial Institute: 2006), pp. 2–8.

Despite high cost of legal fringe financial products, many Americans find the terms of fringe banking institutions acceptable, certainly preferable to the consequences of default to an illegal loanshark.[32] Fringe banking transactions are prompt, staff is courteous, and hours extend into the evenings and weekends. The proliferation of payday lending has been attributed to its appeal to consumers who have had negative experiences with banks. Scanning the interior of a payday loan store, a journalist observed that "it's like banking turned upside down. Poor customers are commodities, deposits are irrelevant, bad credit makes for a good loan candidate and recessions can be boom times."[33] In a presentation to the FDIC, FiSCA described how its members responded to customers: including access:

> …to services at times and locations that are convenient to them, and that suit non-traditional work schedules that leave little free time. They need the services to be provided in languages they can understand—frequently more than just English and Spanish—by staff that makes them feel comfortable and that reflects the culture, customs and colors of the neighborhood. They need products and services tailored to their unique needs, preferences and economic circumstances, rather than being served "stripped-down" versions of what is designed for more affluent consumers.[34]

Economic Inequality

The expansion of the fringe economy has exacerbated economic inequality. The confluence of poverty, race, and absence of mainstream financial institutions, leaves low-income, minority households paying the *de facto* equivalent of a "ghetto tax"[35] or a "poverty tax."[36] Because consumers of the fringe economy are over-represented by people of color, women, and low-wage workers,[37] its expansion diminishes economic equality. Following this logic the Commission on Thrift feared that a "debt culture" would further solidify economic dualism: an "investor class," served by mainstream financial institutions essential for building wealth, and a "lottery class," whose prosperity is subverted by anti-thrift organizations.[38]

[32] In the case of loansharking the borrower uses his body or reputation as collateral for a loan, sometimes with gory consequences in case of default.
[33] Douglas McGray, "Check Cashers, Redeemed," *New York Times* (November 9, 2008).
[34] FiSCA, *Economic Inclusion: Meeting the Financial Needs of Low- and Moderate-Income Consumers Through Financial Service Centers*, Presentation to FDIC Advisory Committee on Economic Inclusion, October 24, 2007, p. 2.
[35] Erik Eckholm, "Study Documents 'Ghetto Tax' Being Paid by the Urban Poor," *New York Times* (July 19, 2006), p. A14.
[36] Mark Fellowes, *From Poverty, Opportunity* (Washington, DC: Brookings Institution, 2008).
[37] Alexes Harris and Barbara Resnick, "Payday Lending and Economic Inequality," (Seattle: West Coast Poverty Center, 2007).
[38] Institute for American Values, *For a New Thrift: Confronting the Debt Culture* (New York: author, 2008), p 8.

Increasing economic inequality has paralleled the expansion of the fringe economy. Widening disparities in both income and wealth have been evident among families registering in the lowest quintiles for the past several decades as shown below :

Table VII. Changes in the Distribution of Income, 1973-2005

Quintile	Year					Percent Change			
	1973	1979	1989	2000	2005	1973–79	1979–89	1989–2000	2000–2005
Highest	41.1%	41.4	44.6	47.7	48.1	0.3	3.2	3.1	0.4
Fourth	20.4	24.1	23.7	22.7	22.9	0.1	-0.4	-1.0	0.2
Middle	17.5	17.5	16.5	15.4	15.3	0.0	-1.0	-1.1	-0.1
Second	11.9	11.6	10.6	9.8	9.6	-0.3	-1.0	-0.8	-0.2
Lowest	5.5	5.4	4.6	4.3	4.0	-0.1	-0.8	-0.3	-0.3

Source: Lawrence Mishel, Jared Bernstein, Silvia Allegretto, The State of Working America (Washington, DC: Economic Policy Institute, 2008), pp. 59, 254–55

Notably, wealth was more inequitably distributed than income, in 2004 by a factor of 1.67.[39] Not only have the poorest households lost a share of income during the past several decades, but they have lost even more wealth. While earnings of the lowest quintile have deteriorated steadily since the 1970s, their wealth provides a more striking contrast: since the early 1960, the wealth of the lowest quintile is continually negative, reflecting debt; the best that these poorest households experience is less debt, never does the bottom quintile achieve sufficient resources to escape debt and accrue wealth. Excluding mortgages, household debt consumes "nearly 15 percent of disposable income—more than food and gasoline combined."[40]

Table VIII. Changes in the Distribution of Wealth (Household Assets minus Debts), 1962–2004

Quintile	Year					Percent Change			
	1962	**1983**	**1989**	**2001**	**2004**	**1962-83**	**1983-89**	**1989-2001**	**2001-2004**
Highest	81.0%	81.3	83.5	84.4	84.7	0.4	2.2	0.9	0.2
Fourth	13.4	12.6	12.3	11.3	11.3	-0.8	-0.3	-1.0	0.0
Middle	5.4	5.2	4.8	3.9	3.8	-0.2	-0.4	-0.9	-0.1
Second	1.0	1.2	0.8	0.7	0.7	0.2	-0.3	-0.1	0.0
Lowest	-0.7	-0.3	-1.5	-0.4	-0.5	0.4	-1.2	1.1	-0.1
	Changes in Average Wealth (Thousands of 2004 dollars)					**Annualized Growth**			
Top	$680.8	1,001.9	1,178.7	1,1711.6	1,822.6	1.8	2.7	3.2	2.1
Fourth	112.7	154.8	173.9	229.6	243.6	1.5	1.9	2.3	2.0
Middle	45.7	64.3	68.2	80.0	81.9	1.6	1.0	1.3	0.8
Second	8.0	14.5	11.9	14.9	14.4	2.9	-3.3	1.9	-1.0
Lowest	-6.1	-3.7	-21.3	-8.7	-11.4	2.4	-33.9	7.2	-9.2

Source: Lawrence Mishel, Jared Bernstein, Silvia Allegretto, The State of Working America (Washington, DC: Economic Policy Institute, 2008).

[39] Computed from Mishel, Bernstein, and Allegretto (2008), Table 5.1.
[40] Longman and Boshara, *The Next Progressive Agenda*, p. 45.

The association between greater economic inequality and the fringe economy suggests that worsening financial circumstances lead households not served by conventional financial institutions to resort to AFS providers that assure ready access to cash, but at a price: high fees and interest rates. The result is a vicious circle in which worsening poverty induces desperate households to resort to the fringe economy which exacerbates their economic plight.

Embedded inequality reduces upward mobility, especially among the minority poor. A report on mobility concluded "it is fairly hard for children born in the bottom fifth to escape from the bottom: 42 percent remain there and another 42 percent end up in either the low-middle or middle fifth. Only 17 percent of those born to parents in the bottom quintile climb to one of the top two income groups."[41] Many minority children actually experience downward mobility. Of black children with middle class parents, 45 percent fall to the bottom of the income distribution, compared to 16 percent of white children. Poor black children fare the worst: 54 percent of children in families in the bottom quintile remain there, compared to 31 percent of white children.[42] A fringe economy that adversely affects the minority poor by extracting resources from them while further distancing them from the economic mainstream would logically retard their upward mobility.

Perspectives on the Fringe Economy

Three schools of thought can be distinguished to explain the dynamic growth of the fringe economy, and among the critics, proponents, and academics, varying conceptions of this sector have implications for their policy prescriptions. The critics contend that it is unethical since, among other things, it not only violates religious strictures prohibiting usury but also common sense. Neo-classical economists argue that the fringe economy represents an adaptive response to consumer demand, evolving a differentiated market of products that expand with need. Behavioral economists view consumer irrationality in financial practices as accommodations that are functional in light of financial distress, conflicting information, and habit.

Moral objections

Religious critics claim that the fringe economy is unethical, contrary to theological and civil injunctions against usury. Restrictions on charging interest on loans were voiced by Greek and Roman philosophers as well as early Christians and Jews; Muslims continue to forbid interest charges altogether. These religious injunctions were codified in civil law through prohibitions against usury. Importing English Common Law, the Virginia Legislature thus set the ceiling on interest charged on loans at six percent in 1730, a limit in effect until 1968 when it was raised to 8 percent.[43]

Economic forces, judicial decisions, and financial deregulation have progressively loosened restrictions on usury, permitting higher interest charges on loans. Critics of the fringe economy claim that it has a pernicious influence on lower-income households, often characterizing it as "predatory" because it exploits those most in need of cash but least able to resist its temptations, the poor. The Institute for American Values contends that predatory lending ultimately subverts the nation's capacity to save.

> New financial institutions have emerged to serve Americans whose wages or economic circumstances have locked them into the lower half of the income distribution. These institutions include a number of highly profitable businesses: sub-prime credit card issuers, payday lenders, rent-to-own merchants, auto title lenders,

[41] Julia Isaacs, "Economic Mobility of Families Across Generations," (Washington, DC: Brookings Institution, 2006).
[42] Ibid.
[43] Wayne Visser and Alastair McIntosh, "A Short Review of the Historic Critique of Usury," *Accounting, Business &Financial History,* vol. 8, no. 2 (July 1998), pp. 175-89. Usury statutes are imposed by states but have no application to financial agreements involving institutions engaged in interstate commerce.

private student loan companies, some franchise tax preparers, check cashing outlets, and sub-prime mortgage brokers and lenders. Once a marginal presence on the financial landscape, these institutions now constitute a large and aggressively expanding sector. But this new sector is not pro-thrift. Quite the opposite. It is anti-thrift. And it is the growing influence of the anti-thrift sector that is dragging many American consumers into dissavings and overindebtedness.[44]

Critics of the fringe economy allege that it subverts the capacity of consumers to save, and thus impedes the upward mobility of low- and middle-income families.

If sectarian opponents cannot prohibit the fringe economy outright, secular opponents are willing to settle for rigorous regulation. Federal deregulation of financial services has required critics of the fringe economy to focus on state policies. The Center for Responsible Lending has diligently tracked state regulations, concluding that, although predatory lending may be useful for some consumers, the industry generates most of its revenues from borrowers who have been lured into a "debt trap." More than half of payday borrowers are unable to repay a first loan within a year, leading many of them to roll-over their loans.[45] Annually, more than 60 percent of payday loans go to borrowers with 12 or more transactions per year, and such churning accounts for 76 percent of payday loan volume.[46]

Neo-classical economics

According to the tenets of neo-classical economics, the fringe economy not only represents a rational elaboration of financial services, but *ipso facto* addresses an unmet economic need. Researchers of payday lending have argued that "standard economic theory suggests that consumer credit—even high-interest credit—can facilitate consumption-smoothing, and the payday loan industry insists that its loans help customers cope with short-term shocks that arise between paychecks."[47] Thus, Donald Morgan, an economist with the Federal Reserve Bank of New York and skeptic of prohibiting predatory lending, asserts that "payday lending represents a legitimate increase in the supply of credit, not a contrived increase in credit demand."[48]

Institutionally, neo-classical economists view the fringe economy as a dynamic network that responds to consumer demand like any other market. Individually, they presume that borrowers are rational actors who seek credit when income falls below expenses. As they see it, the fringe economy expands and contracts with variations in demand for credit, and financial products vary accordingly, diversifying in relation to consumer demand. Thus, under conditions of increasing demand and diversification, neo-classical economists expect fees and interest rates to drop as a result of competition.

The expansion of the fringe economy, both with respect to scale and diversification, affirms the neo-classical perspective. FiSCA notes that in 2006 75 percent of the consumers rate the value of its financial products as "excellent" or "very good," virtually the same level of customer satisfaction in 2000. Similarly, 78 percent of consumers rated service quality as "excellent" or "very good," a slight decrease from 81 percent in 2000.[49]

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[44] Institute for American Values, *Toward a New Thrift*, p. 7.
[45] Paige Skiba and Jeremy Tobacman, "Payday Loans, Uncertainty, and Discounting," (January 21, 2008).
[46] Leslie Parrish and Uriah King, "Phantom Demand," (Durham, NC: Center for Responsible Lending, 2009), p. 2.
[47] Paige Skiba and Jeremy Tobacman, "Measuring Individual-Level Effects of Access to Credit," (Spetember 7, 2007), p. 2.
[48] Donald Morgan, "Defining and Detecting Predatory Lending," (New York: Federal Reserve Bank of New York, January 2007), p. 4.
[49] Patricia Cirillo, "Survey of Customers of FiSCA Member Organizations," (Washington, DC: FiSCA, 2006), pp. 42, 43. In assessing customer perceptions of AFS, it is important to recognize that studies such as this are conducted on a sample of customers who use financial services at stores that subscribe to FiSCA's standard of conduct, a condition of membership. The perceptions of consumers of non-FiSCA member stores may vary.

The friction between moral opponents of the fringe economy and adherents to neo-classical economics has become palpable. Advocates of economic justice declaim predatory lenders as amoral and advocate tight regulation of subprime lending, if not outright prohibition. Neo-classical economists, on the other hand, argue that such Draconian action is counter-productive, effectively denying those households marginal to the economic mainstream the very financial products that can help them. Worse, prohibition in the face of continued demand increases the likelihood of organized criminal economic activity: underworld loansharking. Skeptics of predatory lending suggest that reformers simply develop better loan products: "Progressives may call for something better than either payday credit or [check] bounce protection. We are all for that, but banning payday loans is not the way to motivate competitors to lower prices or invent new products."[50] The neo-classic economic rebuttal to critics of predatory lending has been a call to deploy alternative products that resonate better with consumers, but such an option is problematic for opponents of the fringe economy if loan terms are usurious.

Behavioral Economics

A third school of thought proposes a behavioral explanation for the fringe economy. "In conventional economics, the assumption that we are all rational implies that, in everyday life, we compute the value of all the options we face and then follow the best possible path of action," offers economist Dan Ariely. However, "we are really far less rational than standard economic theory assumes. Moreover, these irrational behaviors of ours are neither random nor senseless. They are systematic, and since we repeat them again and again, predictable."[51] Richard Thaler, an economist, and Cass Sunstein, a legal scholar, plot the pedestrian implications of systematic irrationality: "The picture that emerges is one of busy people trying to cope in a complex world in which they cannot afford to think deeply about every choice they have to make. People adopt sensible rules of thumb that sometimes lead them astray."[52] John Cassidy, an economic writer for *The New Yorker* is decidedly less charitable about the human condition: "rational economic man, the all-seeing, all-knowing figure on whose shoulders much of contemporary economics has been constructed was a purely fictional character. Faced with even simple sets of options to pick from, human beings make decisions that are inconsistent, sub-optimal, and sometimes, plain stupid."[53]

Behaviorists thus bridge the conceptual gap between critics who insist that the fringe economy is unethical and those who claim it is rational: a number of factors encourage consumers to make decisions that are adverse to their long-term interests.[54] The multiplication of self-defeating choices thus subverts the prosperity of households, as researchers found when they convened a focus group from a poor minority community. Decades of exclusion from mainstream financial institutions, coupled with short-term expectations, led consumers to local social networks that afforded access to credit, an "informal cash economy that [was] familiar and comfortable and . . . an integral part of the community." The economic expectations of low-income respondents were conditioned by local traditions of pooling resources, favoring tried and true solutions, and loyalty to lenders. Such patterns support what outside observers would interpret as the self-defeating economic behavior of taking out multiple loans from fringe lenders. "People are acutely aware of the relatively high fees and the stigma [check cashers and fringe lenders] evoke, yet they are willing to pay the price to avoid possible rejection and disrespectful treatment."[55]

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50 Donald Morgan and Michael Strain, "Payday Holiday," (New York: Federal Reserve Bank of New York, 2007), p. 26.
51 Dan Ariely, *Predictably Irrational* (New York: Harper, 2008), p. xx.
52 Richard Thaler and Cass Sunstein, *Nudge* (New Haven: Yale University Press, 2008), p. 37.
53 John Cassidy, "Economics: Which Way for Obama," *New York Review of Books* (June 12, 2008), p. 32.
54 Alan Wolfe, "Hedonic Man," *The New Republic* (July 9, 2008).
55 Edna Sawady and Jennifer Tescher, "Financial Decision Making Processes of Low-Income Individuals," (Cambridge, MA: Harvard University Joint Center for Housing Studies, 2008), p. 7.

The fringe economy, according to behaviorists, is a cultural adaptation on the part of poorer Americans who have not been served by mainstream financial institutions and who tolerate penalties in the form of high fees and interest rates in order to access cash quickly. The social correlates of poverty, particularly low education, employment in the secondary labor market, and family disorganization, often make daily life chaotic and economic shocks frequent. Flexible and accessible fringe lenders offer to alleviate some of the immediate financial stress associated with poverty, and consumers find this attractive, even if they acknowledge that the long-term costs are steep. The fringe economy may be sub-optimal, if not adverse to their long-term economic interests, but it has become embedded in many low-income communities.

While the debate about the fringe economy was enjoined, AFS expanded inexorably as LMI families struggled to reconcile increasing expenses with stagnant incomes. Between 1979 and 2003, the Consumer Price Index (CPI) averaged increases of 4.2 percent annually; yet, the pre- as well as post-tax income of the poorest 40 percent of families actually fell: 3.6 percent and 3.8 percent respectively.[56] The CPI-income gap is poignant for poor households because a one percent reduction in the CPI nets low-income families an additional $6.5 billion in spending.[57] For low-income families the stress induced by the income/expense disconnect would have been about 10 percent worse had not mothers entered the labor market.[58] In the face of deteriorating economic circumstances, poorer American families might have found relief from government social programs, but the nation had entered a post-liberal era during which automatic expansion of benefits would not be forthcoming to working families. The beginning of the 21st century would find poor and working class Americans struggling to reconcile increasing household expenses with stagnant wages and diminishing support from government social programs, conditions that augured well for the fringe economy.

Implications for the Welfare State

A primary purpose of a welfare state is to protect citizens against insecurity, whether due to unemployment, poverty, illness, disability, or discrimination. In the United States this mission has been modified in several ways. Foremost, American welfare philosophy has emphasized residualism through which people are expected to meet their needs through the labor market, or, in the event that fails, by relying on family, friends, voluntary sector organizations, with government social programs only as a last resort and through temporary measures. This norm has been conditioned by structural factors, including a dynamic relationship between federal and state governance (federalism), a viable nonprofit sector (voluntarism), and the incursion of for-profit providers (commercialism). Economic prosperity has loomed large in fulfilling the expectations of the American welfare state, since a vibrant economy is not only essential for good jobs, but also surplus revenues are necessary for contributions to nonprofit organizations as well as tax revenues required by governments to meet statutory mandates.

Since its inception in 1935 with the passage of the Social Security Act, the American welfare state expanded so that, after World War II, it consumed over 20 percent of GDP and more than half of federal revenues. The ascendance of conservatism, beginning with the Reagan presidency, attenuated further growth of the welfare state congruent with liberal ambitions, although Republican presidents would sign into law initiatives that liberals applauded, such as the Americans with Disabilities Act and the Medicare Prescription Drug Benefit. By the end of the century, a Democratic president found himself acceding to

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56 CPI computation calculated from data downloaded June 29, 2010 from ftp://ftp.bls.gov/pub/special/requests/cpi/cpiai.txt; Income data from Lawrence Mishel, Jared Bernstein, and Sylvia Allegretto, *The State of Working America, 2006/2007* (Washington, DC: Economic Policy Institute, 2007), p. 68. Although poor families experienced an income increase during the 1990s, this failed to compensate for income losses during the 1980s and the period between 2000 and 2006; the average cash income for the lowest and second lowest quintiles fell 5.3 percent and 3.6 percent respectively between 1979 and 2006. Computed from House Ways and Means Committee, *Overview of Entitlement Programs* (Washington, DC: GPO, 2008), Table E-27.

57 Matt Fellowes, "From Poverty, Opportunity," (Washington, DC: Brookings Institution, 2008), p. 1.

58 Mishel, Bernstein, and Allegretto, *The State of Working America, 2006–2007*, p. 92.

conservative dictates in public policy. Checked by federal deficits as well as a Republican take-over of Congress, President Clinton attempted to reassert a liberal vector in public policy by advocating health care reform, increasing in the minimum wage, and expanding the Earned Income Tax Credit, but the Clinton administration fumbled health reform and ultimately capitulated to conservatives by terminating the cash entitlement to poor families through the Personal Responsibility and Work Opportunity Reconciliation Act. After two years in office, President Obama appears to some intent on avoiding being labeled as a liberal, often seeking support from Republican lawmakers though that has not been forthcoming, a strategy that some liberals claim impedes a progressive legislative agenda.

In the run-up to the recession that began in December 2007, government income supports for low-income families had become a mixed lot; the value of some had declined appreciably while others had increased. In 2007, the oldest of these, Unemployment Compensation, paid $31.4 billion to 7.5 million workers an average monthly benefit of $287; however, the program was inadequate insofar as only 41 percent of workers were covered and 35 percent exhausted their benefits.[59] The Supplemental Nutrition Assistance Program (SNAP), formerly Food Stamps, paid $33 billion to 26.5 million beneficiaries an average monthly benefit of $95.60 in 2007, but only 73.1 percent of eligible Americans received benefits in 2006.[60] The Child Tax Credit (CTC) allows families to claim up to $1,000 per child under 17, providing a refund to lower income households. In 2010, 35 million families claimed the CTC for $52 billion. However, CTC claims varied widely among lower income households; while almost all of the families in the second quintile benefited from the CTC, only about 40 percent of those in the lowest quintile received refunds, meaning 40 percent of poor children received no benefit.[61] The Earned Income Tax Credit (EITC) refunded $41.2 billion to 22 million families, making it the largest cash assistance program. Having three or more children qualified a family for a credit up to $5,666 in 2010, a benefit claimed by 80 percent of tax-filers.[62] Since its creation in 1996 Temporary Assistance for Needy Families (TANF) has capped benefits to poor families with children; for 2006 state and federal benefits totaled $28 billion for 1.9 million families, a 60 percent drop from 1994, providing an average monthly benefit of $396.[63] The adequacy of TANF is questionable: less than half of eligible families receive a benefit[64] that represents only 28.6 percent of federal poverty guidelines;[65] because it is not indexed for inflation, the value of benefits has declined 25 percent between 1996 and 2008;[66] and only 26.7 percent of poor children receive benefits.[67] Ostensibly, TANF was intended to transition poor mothers from welfare to work, yet, among the 22 percent of recipients who worked in 2006,[68] a low median wage ($7.15 per hour in 1999[69]) left many eligible for SNAP and Medicaid. Tax credits plus wages allowed many welfare mothers to vault out of poverty, however, the income of most flat-lined subsequently; essentially they had been promoted from the ranks of the welfare-poor to the working-poor.

Despite the scale of assistance to poor households, organizational practices and program quirks often interfere with receipt of benefits. As a group, government welfare programs provide benefits to about half of eligible families.[70] States impose asset

[59] House Ways and Means Committee, *Overview of Entitlement Programs* (Washington, DC: GPO, 2008), Table 4-1.
[60] House Ways and Means Committee*, Overview of Entitlement Programs*, 2008, Table 15-8.
[61] Urban Institute, *The Tax Policy Briefing Book* (Washington, DC: Urban Institute and Brookings Institution, 2008), pp. II-I-4.
[62] Urban Institute, *The Tax Policy Briefing Book*, p. II-I-8.
[63] House Ways and Means Committee, *Overview of Entitlement Programs*, 2008, Table 7-8.
[64] Sheila Zedlewski, "Left Behind or Staying Away?" (Washington, DC: Urban Institute, 2002).
[65]House Ways and Means Committee, *Overview of Entitlement Programs,* 2008, Table 7-24.
[66]House Ways and Means Committee, *Overview of Entitlement Programs,* 2008, Chart 7-1.
[67] House Ways and Means Committee, *Overview of Entitlement Programs,* 2008, Table 7-8.
[68] House Ways and Means Committee, *Overview of Entitlement Programs,* 2008, Table 7-25.
[69] Urban Institute, "Issues in TANF Reauthorization," (Washington, DC: Urban Institute, n.d.), p. 1.
[70] Virginia Hernanz, Frank Malherbet, and Michele Pellizzari, "Take-up of Welfare Benefits of OECD Countries," (OECD: Paris, 2004).

limits on recipients of TANF, which range from $1,000 to $3,000,[71] leaving many families ineligible simply because they own a reliable automobile necessary for work. "Bureaucratic disentitlement," the rejection of applications for assistance by capricious intake workers, takes an unknown toll on the number of applicants of public assistance.[72] An analysis of public welfare departments revealed an intake process that represented "the preferred institutional outcome of having applicants drop out of the welfare system."[73] An ethnographic study of welfare families depicted their experience in way that presaged the expansion of the fringe economy:

> Waiting and wending one's way through the government assistance bureaucracy subjects poor people to physical discomfort, emotional aggravation, and sometimes despair. When recipients of welfare are required to perform bureaucratic gymnastics that result in the denial of benefits, the "customer" is hardly satisfied. But unlike in a competitive business environment, poor consumer service has no downside for welfare bureaucrats. In fact, losing a "customer" has an upside—the welfare count is reduced, and this is a primary criterion of [welfare reform's] success.[74]

Consequently, the fringe economy complements the welfare state, albeit in ways welfare philosophers would not have intended. Fully 22 percent of FiSCA member customers use financial stores to cash Social Security and public assistance payments, as well as filing taxes electronically.[75] Of those filing for EITC refunds, 43 percent obtained refund anticipation loans,[76] the fees and interest of which consumed 6 percent of the value of the EITC in 2002.[77] When double-digit unemployment increased the numbers of workers receiving Unemployment Compensation, AFS providers were not only eager to cash their checks but arrange payday loans as well.[78]

The primary implication of the fringe economy for social welfare is its scale: in 2004 some 80 federal and state welfare programs consumed $543 billion.[79] Reconciling this figure with the fringe economy is problematic, however. If medical care and benefits to those not in the labor market are excluded, the figure approximates the $230 billion cited by the FDIC for AFS. In effect, AFS functions as an ersatz economic network for LMI households, compensating for the downsides of government social programs that are inaccessible, punitive, capricious, and slow.[80]

The integrity of government social programs, less than optimal during normal economic times, has been further abraded by the recession. An assessment of the Great Recession published by the Pew Research Center revealed that an unemployment statistic of 9.7 percent failed to capture the stress of families unable to meet day-to-day expenses. Of those unemployed, median duration of joblessness was 23 months; almost half, 46 percent, were unemployed longer than 26 weeks, the typical span of

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71 *Overview of Entitlement Programs,* 2008, Table 7-7.
72 Michael Lipsky, *Street Level Bureaucracy* (New York: Russell Sage Foundation, 1980), p. xiii.
73 Frank Ridzi, *Selling Welfare Reform* (New York: New York University Press, 2009), p. 36.
74 Terese Lawinski, *Living on the Edge in Suburbia: From Welfare to Workfare,"* (Nashville: Vanderbilt University Press, 2010), p. 67.
75 Cirillo, "Survey of Customers of FiSCA Member Organizations, p. 20.
76 Lucy Gorham, "EITC Achieves Gains But Challenges Remain," *Marketwise* (Richmond: Federal Reserve Bank of Richmond, 2007), p. 5.
77 Karger, *Shortchanged*, p. 83.
78 Robert Faturechi, "Payday Lenders Giving Advances on Unemployment Checks, "Los *Angeles Times*, March 1, 2010.
79 House Ways and Means Committee, *Overview of Entitlement Programs*, 2008, Appendix I.
80 The actual negative value of the fringe economy vis-à-vis public assistance benefits is beyond the scope of this paper; however, such an accounting would include the fees and interest payments to LMI households. Such a calculation would be difficult given variation in usage of state and federal social programs as well as variations in AFS provision. Regardless, the amount would probably be significant. CRL computed the fees for 5 million repeat payday borrowers at $3.4 billion annually. See Keith Ernst, John Farris, and Uriah King, "Quantifying the Economic Cost of Predatory Payday Lending," (Durham, NC: Center for Responsible Lending, 2004).

unemployment benefits.[81] The impact was felt disproportionately by families earning less than $30,000 per year, 55 percent of which reported they were worse off due to the recession. Accordingly, between 2008 and 2010, the number of respondents who identified as "lower class" increased from 25 to 29 percent, while the number unable to meet basic expenses increased from 7 to 11 percent. [82] The unemployed were more likely to borrow than those who had jobs, as shown below:

Table VIII. Unemployed Struggle to Pay Bills (percent reported experiencing because of recession)

Problem/Behavior	Employed	Unemployed
Had trouble paying medical bills	26%	53%
Borrowed money from family/friends	24%	50%
Had problems paying mortgage/rent	19%	44%
Used credit card debt to pay bills	15%	26%

Source: Pew Research Center (2010) How the Great Recession Has Changed Life in America.

Forty percent of families anticipated that six years or more would be necessary to restore family finances to pre-recessionary levels.[83]

A survey of the unemployed conducted by Rutgers University researchers showed that many resorted to borrowing to meet routine expenses but all too often found that inadequate.

Table VIV. Sinking Deeper into Debt, Unemployed 2010

Response	Percent
Borrowed money from family and friends	56%
Increased credit card debt	45%
Missed mortgage or rent payments	24%
Borrowed against house from bank	11%
Declared personal bankruptcy	8%
Lost home due to foreclosure	3%

Source: Debbie Borie-Holtz, Carl Van Horn, and Cliff Zukin, No End in Sight: The Agony of Prolonged Unemployment. New Brunswick, NJ: Rutgers University Heldrich Center for Workforce Development, p. 12.

Among the unemployed, a majority reported psychological distress: 65 percent were anxious, 66 percent depressed, and 55 percent were angry. In addition, unemployment interfered with other social relationships: 33 percent reported family strain, 42 percent avoidance of social relations with friends, and 46 percent with loss of contact with friends.[84] In July 2010 unemployment benefits were extended to 99 weeks, a relief for 2.5 million workers who had watched their benefits expire on June 2,[85] but by August 2010 the number of claims for unemployment benefits increased by 479,000.[86] Yet, the unemployment rate failed to capture the severity of the Great Recession for workers. Combined, the unemployment and underemployment

[81] Pew Research Center, *How the Great Recession Has Changed Life in America* (Washington, DC: 2010), pp. 7, 16, 18.
[82] Pew Research Center, *How the Great Recession Has Changed Life in America,* pp. 42, 44, 46.
[83] Pew Research Center, *How the Great Recession Has Changed Life in America*, p. 10.
[84] Borie-Holtz, et al., *No End in Sight*, pp. 34, 36.
[85] Melissa Preddy, "Unemployment Benefits Restored to Millions," *AARP Bulletin.* July 21, 2010.
[86] "Jobless Claims Hit Highest Level Since April," *New York Times*. August 6, 2010, p. B7.

rates totaled 25 percent of the labor force,[87] and the number of unemployed workers per job opening hovered between 5.5 and 6.0 through the first half of 2010.[88]

The fringe economy has become more prominent in the lives of poor families as the Welfare State provides fewer protections against economic insecurity. For many low-income families meeting daily expenses is tenuous during normal economic times. A recession that results in protracted spells of unemployment quickly exhausts the limited savings of poor families, leaving them with stark choices. Borrowing from family and friends is problematic since such social networks are likely to inhabit similar economic circumstances, leaving increased credit card debt or home equity loans as logical options. Struggling families will discover that welfare is unsatisfactory given inadequate benefit levels, protracted eligibility procedures, and time-limits. In their downward spiral, desperate families will have little choice but to consider higher priced credit options available through AFS, even if these mean sequential and multiple loans. As limited resources dwindle even more quickly due to the high fees and interest of AFS products, more Draconian decisions loom: bankruptcy, moving in with family members, or homelessness.

Extending Mainstream Financial Services to LMI Households

The experience of the Great Recession and the limited nature of the Welfare State have reinforced the need for families to be able to access high-quality and low-cost financial services. In recent years, there have been attempts by mainstream financial service providers to compete with AFS. These efforts have been limited but instructive. In 2001 the North Carolina State Employees Credit Union (NCSECU) began offering a Salary Advance Loan (SALO) of up to $500, repayable within a month, with a fee of $5 per loan. In 2003 members in SALO were required to deposit 5 percent of the value of a loan in a savings account in order to obtain future loans. Within a few years 53,000 credit union members were enrolled in SALO and taking out more than $12 million in loans, earning NCSECU $2.5 million while limiting charge-offs for unpaid loans to just 0.27 percent.[89] Similarly, a 2007 Woodstock Institute report assessed the experience of six credit unions that offered short-term credit concluding that consumers should be dissuaded from multiple loans and enroll in financial literacy education, couple loans to savings, limit APR to no more than 18 percent, process loans in less than a day, and lure borrowers into long-term relationships with credit unions. Although the profitability of short-term loans was ambiguous for credit unions participating in the study, the report concluded that "the cost structure of predatory payday loans is indefensible."[90]

In 2010 the FDIC reported findings for the Small-Dollar Loan Pilot Program, a two-year demonstration. Twenty-eight banks generated two types of loans: Small Dollar Loans (SDLs) of less than $1,000 and Nearly Small Dollar Loans (NSDLs) between $1,000 and $2,500. The experience of the banks with both loans is shown on the next page:

[87] Economic Policy Institute, "Economy Track," downloaded August 5, 2010 from www.economy track.org/unemployment.php and www.economytrack.org/underemployment.php.
[88] Heidi Shierholz, "Job Openings Improve, But Still More than 5 Unemployed Workers per Available Job," Economic Policy Institute, March 9, 2010.
[89] Peter Tufano and Daniel Schneider, "Using Financial Innovation to Support Savers," in *Insufficient Funds* eds. Rebecca Blank and Michael Barr. (New York: Russell Sage Foundation, 2009), pp. 161-62.
[90] Marva Williams, "Cooperative Credit," (Chicago: Woodstock Institute, 2007), p. 20.

Table X. Small Dollar Loan Pilot Outcomes

Feature	SDL, < $1, 000	NSDL, $1,000–$2,500
Number	18,162	16,294
Value	$12.4 million	$27.8 million
Average size	$724	$1,727
Average term	12 months	15 months
Average interest	13.09%	13.00%
Charge-off rate	6.2%	8.8%

Source: FDIC, "A Template for Success: The FDIC's Small-Dollar Loan Pilot Program," FDIC Quarterly, vol. 4, no 2, 2010, pp. 29–31

The FDIC concluded that the charge-off rate was comparable to other types of unsecured credit. Bankers who participated in the pilot used the smaller loans as bridges to other financial products. When smaller loans were linked to savings products and financial education, the charge-off rate declined.[91]

Drawing on findings of the 2001 First Accounts Program which funded 15 banks, credit unions, and community-based organizations to encourage the unbanked to establish savings and checking accounts, the FDIC inaugurated the Community Financial Access Pilot in 2009. Through the initiative, a community consultant has been assigned to eight regions "to increase financial education for low-and moderate income families and individuals." The pilot expects to have results available in 2010.[92] In 2009 the National Credit Union Foundation began promoting REAL Solutions, based on the experiences of six credit unions that had developed alternatives to check-cashing, payday loans, rent-to-own stores, and pawnshops. The REAL Solutions Toolkit addressed hours of operation, location, staffing, marketing, and consumer education as well as risk management, the development of business plans and alternative loan products.[93] Unlike the Woodstock Institute report, the Toolkit failed to provide financials on loan losses, cost per loan, and profit margin.

Despite the interest of credit unions and banks in providing financial products relevant to consumers who resort to the fringe economy, their efforts are sometimes questionable. The National Consumer Law Center questioned the propriety of Progressa Credit Union's GoodMoney program in Wisconsin, developed in collaboration with Good Will (included in the REAL Solutions Toolkit), since it charge $9.90 per $100 for two week loans, an APR of 252 percent, "not significantly better than traditional payday loans." In California Kinecta Federal Credit Union acquired Nix Check Cashing and redeployed it as a Credit Union Service Organization (CUSO): Kinecta Alternative Financial Services, Inc. Thomas Nix, the founder of the firm bearing his name, became a vice-president of the credit union and stated his strategy to expand into $300 loans which would be repaid within a month. Nix speculated that the CUSO designation would exempt Kinecta from complying with the Federal Credit Union Act 18 percent APR limit on loans.[94] Early in 2010 the Center for Responsible Lending (CRL) reported that Wells Fargo and U.S. Bank were offering payday loans up to $500 repaid by the account holder's direct deposit. Like payday loans, the fees are $10 per $100 loaned; however, due to the possibility of early payment, the APR could be much higher. While the banks advertise an APR of 120 percent assuming payment within one month, if the loan term is five days, the APR is 730 percent. CRL

[91] FDIC, "A Template for Success," p. 33.
[92] Louisa Quittman, "Community Financial Access Pilot," Personal correspondence July 30, 2009.
[93] Lois Kitsch, "REAL Solutions Toolkit," (New York: Filene Research Institute, 2009).
[94] National Consumer Law Center, "NCLC Reports Consumer Credit and Usury Edition," vol. 26, May/June 2008.

voiced alarm about these loans since, as nationally chartered financial banks, Wells Fargo and U.S. Bank, might be able to preempt state regulations as well as the Military Lending Act which caps interest at 36 percent.[95]

The experience of banks and credit unions in offering financial products to LMI households is a cautionary tale in family economics. While both types of financial institutions have field tested loans at manageable interest and default rates, the number of loans and therewith their total value is dwarfed by existing AFS providers. These cursory explorations are notable for two limitations. Foremost, pilot loans have ordinarily been made to existing account holders/members, as opposed to those without a formal relationship with the financial institution, thus these experiments have done little to reach the unbanked. Second, most of the innovative financial products are solo demonstrations, isolated incursions into the fringe economy. A more constructive infrastructure for LMI families is unlikely to evolve until a wider array of financial products is deployed, not unlike AFS as currently formatted. Arguably, the optimal approach would be preventive, one that encouraged families to establish unrestricted savings accounts against which they could draw to cushion against income shocks.[96]

Federal Reregulation

Although states have been the locus of regulation since federal financial deregulation in the 1980s, calls to reassert federal regulatory responsibility have grown as the cause of the most serious recession since the Great Depression has been widely attributed to subprime mortgage lending. In 2007 then-Harvard professor Elizabeth Warren proposed creating a consumer financial protection watchdog, parallel to the Consumer Product Safety Commission, to regulate the fringe economy. Subprime "financial products are dangerous, and any consumer who is not careful is inviting trouble," the professor argued, "And yet, dangerous or not, millions of Americans engage in billions of credit transactions, adding up to trillions of dollars every year." As conceived by Warren, this entity:

> ...would be charged with responsibility to establish guidelines for consumer disclosure, collect and report data about the uses of different financial products, review new financial products for safety, and require modification of dangerous products before they can be marketed to the public.[97]

On July 1, 2009, the Obama administration proposed creating such an agency in order to control abusive lending practices; the agency would be able to investigate any lender, levy penalties of up to $1 million per day, limit pay and benefits of corporate executives, and determine discriminatory lending practices. Predictably, the financial industry promised a lobbying blitz against rigorous regulation of its activities.[98] Subsequently, Congress enacted the Dodd-Frank financial reform bill which included the creation of an independent Consumer Financial Protection Bureau (CFPB), to be housed in the Federal Reserve. This bureau will be tasked with oversight of financial service providers, regardless of whether they are mainstream banks or members of the alternative financial sector. The potential for a substantial re-regulation of the financial marketplace creates new opportunities to consider how to both protect and meet the financial service needs of many low- and moderate-income families.

In doing so, policymakers should be cognizant that three distinct revenue streams have become essential for many families. The first consists of social welfare benefits through programs, such as Unemployment Compensation and Temporary Assistance for Needy Families, administered through the federal Department of Health and Human Services and corollary state agencies. The

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[95] Center for Responsible Lending, "Mainstream Banks Making Payday Loans, "(Durham, NC: Author, February 2010).
[96] Alejandra Lopez-Fernandini, "Unrestricted Savings," (Washington, DC: New America Foundation, 2010).
[97] Elizabeth Warren, "Unsafe at Any Rate," *Democracy,* No. 5 Summer 2007, p. 4.
[98] David Cho and Michael Shear, "Obama Presents Bill to Create Consumer Finance Watchdog," *Washington Post*, July 1, 2009.

second stream consists of tax credits dispensed through the Treasury Department which are delivered as cash refunds, such as the Earned Income Tax Credit and Child Tax Credit. The third stream consists of the resources accessed via AFS providers. Financial products in this third steam have evolved with little, if any, concern for their social and economic effects or interaction with other elements of the Welfare State. Not only have these three streams evolved independent of one another, but their crosscurrents, roiled by the Great Recession, threaten to swamp many of America's most vulnerable families.

Unregulated, the fringe economy functions at cross purposes to traditional social programs, subverting the ability of low-income households to become more economically self-sufficient. Because financial regulation is essential for understanding and controlling AFS, it serves a vital function within the American welfare state; however, regulation does not *ipso facto* generate more constructive financial products that promise to integrate LMI families into the economic mainstream. Thus, regulation alone is unlikely to restore economic justice as a focus of the Welfare State.

As important as financial regulation may be, there will still be a need for families to access credit responsibly in order to effectively manage their finances. A financial infrastructure which responds to the economic circumstances of the welfare- and working-poor is essential, and policymakers should consider ways to support the provision of responsible financial products. Two models appear as workable alternatives. An incremental approach would be to allow social program beneficiaries to take out interest-free loans which are repaid by deductions from future benefits. The "social fund" in Britain allows recipients of welfare and unemployment benefits to arrange "budgeting loans" averaging $620, lump-sum loans for appliances and other necessities, as well as "crisis loans" averaging $120, advances for emergencies, such as utility shut-offs. In two decades of operation, almost 88 percent of such loans have been repaid with less than 0.5 percent charged-off.[99] A structural approach would be to charter Community Credit Unions as alternative to welfare departments in order to provide poor families with traditional financial products, such as savings and checking, but also innovative products including micro-credit, tax preparation, financial literacy education, Individual Development Accounts, and short-term loans.[100] The successes of Self-Help Durham and Alternatives Credit Union in Ithaca attests to the viability of this approach as do the 186 credit unions now operating in poor communities which have been established through the Community Development Financial Institutions Loan Fund.

Whether current social welfare policy permits recipients to take out loans or a financial infrastructure is deployed in poor neighborhoods, an expanded opportunity structure for low-income households is essential for their prosperity. The inadequacy of existing social welfare benefits, put in sharp relief by the Great Recession, leaves poor families with few options other than resorting to AFS. "The thing about the poor people's economy is that it's recession proof," contended Allan Jones, Jr., founder of Check Into Cash, "You're always going to have people who need $100 or $200 real quick."[101] Unregulated, the fringe economy not only adversely affects the poor, but also diverts a significant portion of social welfare funds—perhaps as much as 10 percent—to companies that market financial products with high fees and interest rates. As a result too many low-income households find themselves in an economic vortex that spirals downward with increasing velocity. Instead of downward mobility, low-income families should be able to count on public policy to facilitate their prosperity. This requires policymakers to regulate the exploitive features of the fringe economy as well as deploy constructive financial products for the welfare- and working-poor.

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99 Rourke O'Brien, "A Fair Alternative to Predatory Short-Term Loans," *Los Angeles Times*, June 30, 2010.
100 David Stoesz, "Bootstrap Capitalism," *Families in Society*, vo. 88, no. 3 July-September 2007.
101 Gary Rivlin, *Broke, USA* (New York: Harpers Business, 2010), p. 77.

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