INCREASING THE ATTRACTIVENESS OF LOW INCOME BANK ACCOUNT HOLDERS: POTENTIALS OF LIMITED SCOPE BANKING AND TAX INCENTIVES

Preliminary Working Paper

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Research performed in the United States over the last several decades has made a convincing case for the adage that "The poor pay more." Many low income individuals live in urban areas. These residents are often forced to shop in small neighborhood stores, paying higher prices because of these stores' lack of economies of scale, high costs of real estate, and costs of security incurred in neighborhoods with high crime rates.

Low income households tend to be especially hard hit in accessing banking services. Families and individuals with limited or poor credit histories and low income are typically not attractive to banks which, in turn, resist offering bank accounts to these consumers. As a result, many of these families end up cashing their paychecks and/or government checks with check cashing services that often charge a significant percentage of the check amount in return for providing immediate cash. Consumers whose income is converted into cash may then end up also having to pay fees for money orders to pay landlords and utilities that either do not have conveniently located payment sites or do not accept cash. In addition, consumers whose whole month's income is converted into cash risk loss and theft of their money.

The need to spend a large proportion of household income on check cashing and related services frequently fuels a vicious cycle as the household, unable to pay urgent expenses toward the end of the month, may need to sacrifice significant future income to pay for short term loans.

It is understandable that banks are reluctant to open bank accounts for individuals who offer limited profit potential and significant possibilities for loss. Through desperation from their economic plight or from poor record keeping, these households might be feared to write a disproportionate number of checks for which there are insufficient funds their accounts.

To encourage banks to offer bank accounts to low income consumers, then, two obstacles will need to be reduced: (1) the modest, or even negative, profit potential of these consumers and (2) the large perceived risk of overdrafts.

Society has long recognized, through programs such as the Earned Income Credit, that low income households may need public support to make ends meet. Thus, it may make fiscal sense to extend appropriate tax incentives to banks that elect to make bank accounts available to low income consumers. From the perspective of enlightened self interest, society bears a considerable burden from the plight of low income households (e.g., neighborhood crime and loss of jobs that result from an inability to afford reliable transportation). Aside from the benefits that such a program would provide for low income households, subsidizing (directly or indirectly) bank accounts for this group may, in fact, end up saving public funds or at least significantly reducing the net effective cost of the subsidy.

Risks to banks that result from low income account holders' limited liquidity can be considerably reduced by offering accounts that feature a more limited scope of services than those issued to general customers. Most consumers who deposit their paychecks into banks expect an account whose services include check-writing. This, however, is a feature that banks may be reluctant to provide to low income consumers. Although check writing privileges would ideally be desirable for all customers, sacrificing this option as a way to increase the likelihood of being able to open a bank account is arguably a very compelling tradeoff.

To create bank accounts for low margin consumers, administrative costs must be minimized. However, a modest amount of setup might allow customers to pay their regular monthly bills without the need to write checks. Accounts could be set up as follows:

- Income checks would be deposited directly into the account, thus maximizing the speed by which the money is transferred and is made available for the use.
- Transfer information from participating landlords and utilities would be entered by the bank when an account is set up. When funds become available, then, the customer could access either a traditional ATM or a similar network set up for this purpose, transferring money to landlords and utilities.
- The remaining amount in the account could be withdrawn in cash at any time through an ATM card.

Since the paperwork for filing income tax reports can be very challenging, it is possible that, at a modest additional cost, tax related information (e.g., dependents and their social security numbers) could be entered into the account record.

Individuals whose entire income is received through this account system might then be able to file their income tax returns through an ATM or other system, allowing free and fast access to refunds which could be deposited directly into the account. Alternatively, information could be made accessible, with a password issued to the account holder, by volunteer organizations that would be able to help in the tax return filing process.