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Use of Alternative Financial Services in Low- and Moderate-Income Households: Evidence from Refund to Savings

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Unable to conduct everyday financial transactions without a bank account or in need of flexible, short-term credit, many low- and moderate-income (LMI) households turn to alternative financial services (AFSs). These are financial services and products sold by companies that are not federally insured financial institutions.[1] Providers offering AFSs aim to meet the transaction and credit needs of customers who lack bank accounts or credit cards and of those who use AFSs for their convenience.[2] Transaction AFSs (TAFSs) include check cashing, money orders, bill payments, and remittances—services marketed to individuals who need to conduct everyday financial transactions but who do not have a checking account. Credit-related AFSs (CAFSs) include pawn services and rent-to-own arrangements as well as auto-title, refund-anticipation, and payday loans. The AFS sector grew briskly in the 1990s and 2000s.[3] It now is estimated to process over $300 billion in transactions annually,[4] and a quarter of all U.S. households have used an AFS in the last year.[5] The AFS sector is criticized for charging excessive interest rates and fees. Critics also assert that the industry traps low-income and racial- and ethnic-minority customers in cycles of reborrowing.[6] In response to such criticism, several states have banned or significantly curtailed various types of AFSs.[7]

This brief summarizes research on AFS use among LMI tax filers participating in the Refund to Savings (R2S) Initiative. We make an important contribution to AFS research by distinguishing the characteristics, circumstances, and experiences of AFS users from those of nonusers. We discuss findings in relation to the importance of having emergency savings. The findings also can inform efforts to promote safe and affordable credit products.

Background

The R2S Initiative is an ongoing partnership of Washington University in St. Louis, Duke University, and Intuit, Inc. The partnership is aimed at assessing savings-related outcomes of participants who are randomly assigned to a control condition or to receive behavioral interventions (e.g., prompts and anchors) delivered at tax time using TurboTax Freedom Edition online tax-preparation software. This software was offered for free to tax filers who had adjusted gross income of less than $31,000, qualified for the Earned Income Tax Credit, or were on active-duty military service and had an adjusted gross income of less than $57,000.[8] Data for the analyses summarized in this brief come from TurboTax Freedom Edition administrative records for the 2013 tax season and two waves of

- Over a third (39%) of R2S participants used at least one type of AFS in the 12 months prior to filing their taxes.
- Use of AFSs was common among R2S participants who were Black, filed as head of household, and had one or more dependents.

Washington University in St. Louis

the Household Financial Survey. Participants were invited to complete the survey's baseline upon filing their tax return and to complete the follow-up wave 6 months later. The analytic sample used for this brief consisted of R2S participants who were 18 years of age or older, completed both the baseline and 6-month follow-up Household Financial Survey, and did not have extreme values (i.e., above the 99th percentiles) for federal tax refund, credit card debt, or savings account balance (*N* = 7,504). The average age of participants was 35 years, and the average annual gross income was $18,117. Most participants were female (62%), and most were White (80%). Approximately half had at least a college degree (51%).

Prior research has found that AFS use is greater among those with lower levels of education.[9] It is also greater among those with lower income.[10] It is greater among African Americans and Latinos than among Whites,[11] and use is greater among persons who lack a bank account than among counterparts with bank accounts.[12] Despite the high fees and interest rates charged for TAFSs and CAFSs, people use them, respectively, for their convenience and as an easier way than bank loans to access short-term credit.[13] Many AFS users find it harder than AFS nonusers to meet housing needs,[14] and users are at heightened risk of filing for bankruptcy.[15]

In addition to hidden fees, CAFSs charge triple-digit annual percentage rates.[16] The average annual interest paid by payday loan customers, over $500, illustrates the cost of such services.[17]

In response, several states have banned or restricted CAFSs. Restrictions on such services are associated with reductions in the use of CAFS.[18] Other studies have shown that the bans and restrictions are not associated with use of credit products that have lower interest rates than those charged for CAFSs.[19] However, such measures are associated with increases in bank account overdrafts and late bill payments.[20]

Use of AFSs among R2S Participants

Over a third (39%) of R2S participants said that they used at least one type of AFS within the 12 months prior to survey. That is considerably higher than the estimate from another recent study, which found that a quarter of all households used an AFS within the 12 prior months.[21] Almost a third (28%) of R2S participants reported at baseline that they used at least one type of TAFS in the prior 12 months.

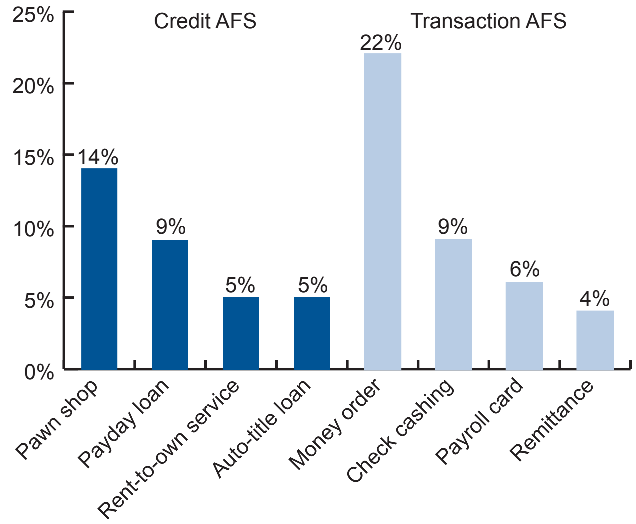

Figure 1. Use of AFSs in the 12 months prior to survey (*N* = 7,504). AFS = alternative financial service. Data are from the baseline Household Financial Survey.

Money orders were the most commonly reported type of TAFS (see Figure 1). Almost a quarter (24%) reported using at least one type of CAFS in that period. Use of a pawn shop was the most commonly reported type of CAFS.

Demographic Characteristics of AFS Users and Nonusers

We examined participant characteristics and their ties to use of AFSs in the 12 months prior to survey. The average age of AFS users was 36 years, and that of nonusers was 35. Females were more likely than males to use an AFS (see Table 1). By race and ethnicity, use of an AFS was most frequent among Black participants. Most Black participants (63%) said that they used an AFS; in comparison, this was reported by 35% of White participants and 31% of Asian participants.

Use of AFSs also differed by education and tax filing status. Nearly half (49%) of participants with a high school diploma or less used an AFS; less than a third (31%) of participants with a college degree or higher used an AFS. A majority of participants (57%) who filed as head of household (which typically indicates that the filer is a single parent with children) used an AFS. In comparison, a third of participants who filed as single reported AFS use. Also, participants with dependents were more likely to have used an AFS than were participants without dependents.

In sum, the prevalence of AFS use was greater among participants who were female, identified themselves as Black, had a high school diploma or less, filed as head of household, and had dependents than among counterparts in these demographic categories. Over three quarters of participants who had all of the above characteristics (*n* = 275) said that they used an AFS in the 12 months prior to survey.

Financial Circumstances of AFS Users and Nonusers

Income, Unsecured Debt, Refunds, and Savings

As Figure 2 illustrates, the financial circumstances of AFS users differed from those of nonusers: Users had $854 less in annual income, $1,669 less in savings, and $1,806 more in unsecured debt. However, the average refund of AFS users was $631 more than that of nonusers.

Users of AFSs were more likely than nonusers (27% vs. 11%) to have had a credit card application declined in the 12 months prior to survey. The higher credit card debt among nonusers may be due to greater access to mainstream financial products.

Table 1. Use of AFS by Participant Characteristics

Characteristic	Used AFS (%)
Gender (*n* = 7,477)	
Female	41
Male	35
Race or ethnicity (*n* = 7,475)	
White	35
Black	63
Asian	31
Hispanic	47
Other	46
Education (*n* = 7,497)	
High school diploma or less	49
Some college	47
College degree or higher	31
Filing status (*n* = 7,500)[a]	
Single	33
Head of household	57
Married	41
Has dependents (*n* = 7,503)	
No	32
Yes	51

Note: AFS = alternative financial service.

[a] Married includes married filing jointly, married filing separately, and widow (or widower). Sample sizes differ from that of the full sample (*N* = 7,504) due to missing values.

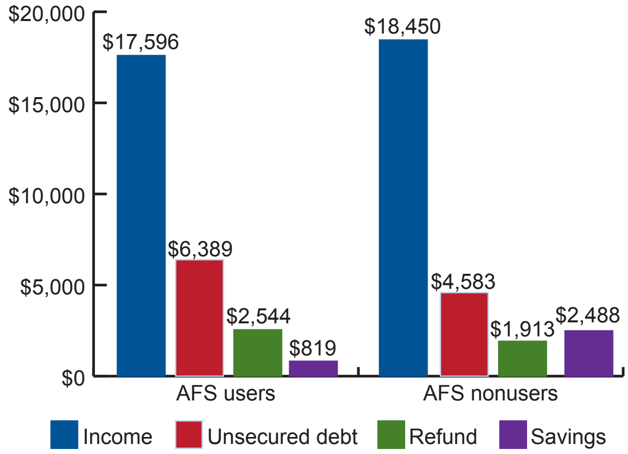

Figure 2. Income, unsecured debt, federal tax refunds, and savings of AFS users and nonusers (*N* = 7,504; Income *n* = 7,442). Data are from the baseline Household Financial Survey.

Bank Account Ownership and Prior Use of AFSs

The percentage of unbanked AFS users (7%) is greater than the percentage of unbanked nonusers (1%), but the vast majority of AFS users (89%) reported owning a checking account, and most (66%) reported having a savings account. Among participants who reported in the baseline that they had used an AFS in the past year, 64% also reported using an AFS in the 6 months after filing their taxes. Among participants who reported at baseline that they did not use an AFS in the prior year, only 15% reported in the follow-up that they used such a service in the 6 months after filing their taxes.

Financial Difficulties

For the analyses summarized in this brief, we used four indicators of financial difficulty: (a) one or more bank account overdrafts in the 12 months prior to the baseline, (b) difficulty in paying for usual expenses, (c) expenses usually exceed income, and (d) inability to come up with $2,000 in an emergency. As Figure 3 illustrates, AFS users were more likely than nonusers to report all four financial difficulties.

Material Hardships

Users of AFSs were also more likely to report experiencing material hardships (Figure 4). For example, most (71%) AFS users said that, within the year prior to the baseline, there was a time when they could not afford the type or amount of food they wanted; less than half (45%) of nonusers reported this.

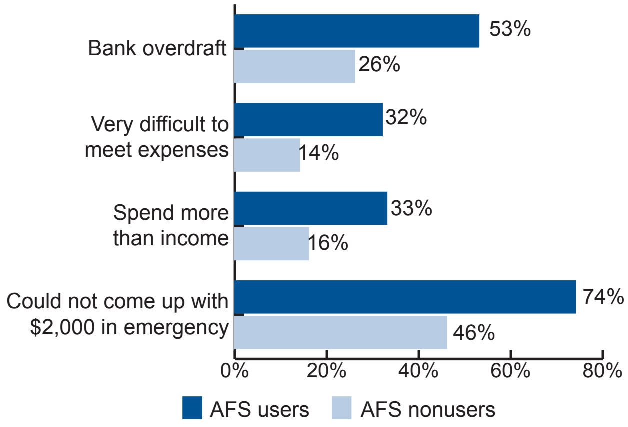

Figure 3. Financial difficulties of AFS users and nonusers (*n* varies from 7,433 to 7,504 due to missing observations). Data are from the baseline Household Financial Survey.

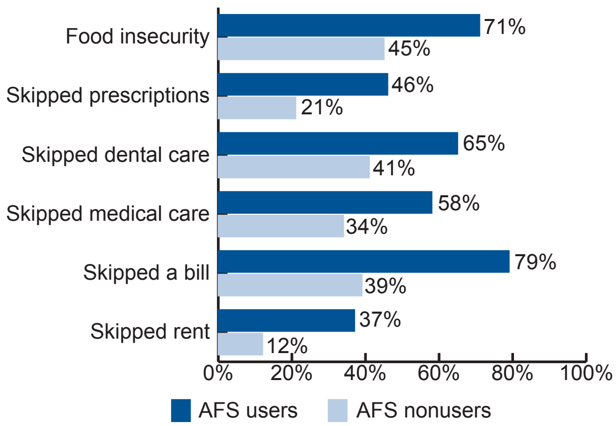

Figure 4. Material hardships of AFS users and nonusers (*n* varies from 7,494 to 7,501 due to missing observations). Data are from the baseline Household Financial Survey.

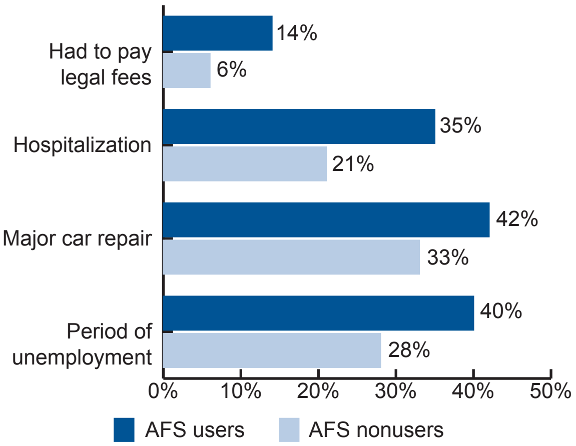

Figure 5. Unexpected major life events of AFS users and nonusers (*n* varies from 7,481 to 7,488 due to missing observations). Data are from the follow-up Household Financial Survey.

Unexpected Life Events after Tax Filing

In the 6 months after filing their taxes, AFS users were more likely than nonusers to experience financial emergencies. For example, more than a third (35%) of AFS users said that they experienced one or more episodes of hospitalization, but 21% of nonusers reported this (see Figure 5).

Conclusion

The picture that emerges from evidence in this brief is that, despite similarities between AFS users and nonusers in age and income, R2S participants who use AFSs have greater social and economic disadvantages: Users have less formal education and less in savings; they are more likely to file as heads of household (a common filing status for single parents), to have dependents, to experience financial difficulties, and to report material hardships. This constellation of challenges suggests these LMI households may turn to AFSs to help make ends meet, yet these services are inadequate to address basic needs and are expensive; high interest rates and fees may exacerbate financial vulnerability.

Policies to curtail the availability and use of AFSs, if not to eliminate them, may protect consumers from high interest rates and fees as well as from predatory lending practices. In particular, such policies may protect low-income consumers who are unbanked. However, consumer protection policies fail to address an important reason why households turn to CAFSs: to help make ends meet amidst a host of difficult financial circumstances.

Thus, two broad policy and practice strategies are needed. The first strategy is to offer LMI households additional opportunities and incentives to build emergency savings, as these would reduce demand for AFSs. For example, EARN, a San Francisco-based microsavings provider, recently launched the online Starter Savings Program to help clients establish the habit of saving.[22] Clients set a savings goal, save at least $20 a month in an existing savings account, and receive cash rewards. Another way to build emergency savings is to focus on tax refunds: R2S tax-time interventions encouraging LMI tax filers to save all or part of their refunds resulted in reduced CAFS use.[23] Additional tax-time savings initiatives include D2D Fund's SaveYourRefund promotion, which incorporates savings prizes, and the Corporation for Enterprise Development's Rainy Day Earned Income Tax Credit policy proposal. The U.S. Department of the Treasury's *my*RA program offers no-fee retirement savings accounts with tax- and penalty-free withdrawals of principal.[24] Employers can also help LMI households build emergency savings by allowing employees to directly deposit a portion of their paychecks into savings accounts.

Second, when emergency savings are exhausted, LMI households need greater access to safe, affordable credit products and services such as credit cards, paycheck advances, and the small-dollar short-term loans offered by some credit unions. Employers can play a role in helping employees avoid high cost CAFSs. For example, Vermont-based NorthCountry Credit Union partners with local companies to offer small-dollar loans, and payments on those loans are automatically deducted from direct deposited paychecks.[25] Commercial banks can also help. Through a pilot program, the Federal Deposit Insurance Corporation produced a template for banks to profitably offer safe and affordable small-dollar loans of up to $2,500 for periods of up to 90 days at annualized percentage rates of no greater than 36%.[26]

To conduct everyday financial transactions absent a checking account and access to short-term credit, many LMI households turn to AFSs. However, these services are disproportionately used by financially vulnerable households that can ill afford the high fees and interest rates of AFSs. A better approach is to help LMI households build emergency savings and access safe and affordable credit.

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Disclaimer

Statistical compilations disclosed in this document relate directly to the bona fide research of and public policy discussions concerning the use of the IRS "split refund" capability and promotion of increased savings in connection with the tax compliance process. All compilations are anonymous and do not disclose cells containing data from fewer than ten tax returns. IRS Reg. 301.7216.

End Notes

1 Bradley, Burhouse, Gratton, and Miller et al. (2009).

2 Apgar and Herbert (2006).

3 Apgar and Herbert (2006); National People's Action (2012); Karger (2007).

4 Bradley et al. (2009).

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6 Birkenmaier and Tyuse (2005); Fox (2007).

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8 Grinstein-Weiss et al. (2015).

9 Lusardi and Scheresberg (2013); Pew Charitable Trusts (2012).

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12 Barr (2012); Lusardi and Scheresberg (2013); Rhine, Greene, and Toussaint-Comeau (2006); Stegman (2007).

13 Federal Deposit Insurance Corporation (2014); Gross et al. (2012); Lusardi and Scheresberg (2013).

14 Melzer (2011).

15 Skiba and Tobacman (2015).

16 Bertrand and Morse (2011); Consumer Financial Protection Bureau (2013); Edmiston (2011).

17 Pew Charitable Trusts (2012).

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20 Zinman (2010).

21 Federal Deposit Insurance Corporation (2014).

22 https://www.earn.org/savings-programs

23 Grinstein-Weiss, Ren, Despard, Guo, and Raghavan (2015).

24 https://myra.gov/how-it-works/

25 NorthCountry Federal Credit Union (2015).

26 Miller et al. (2010).

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