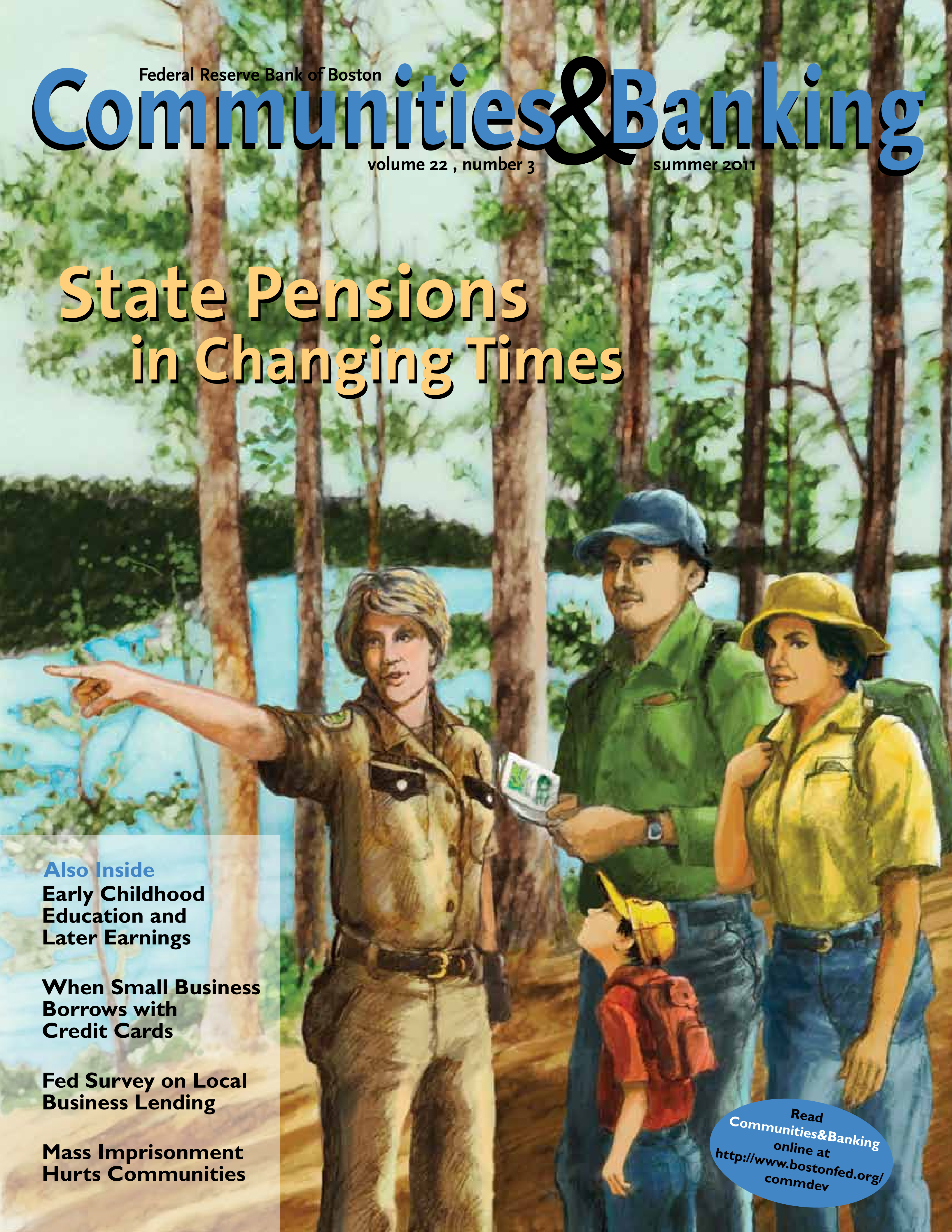
Federal Reserve Bank of Boston

Communities&Banking

volume 22 , number 3 summer 2011

State Pensions in Changing Times



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Cover illustration: Barry Maguire

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State Pensions

in Changing Times

by Richard Woodbury
Maine State Senator

With the age distribution of the population bulging around older age groups, financial pressure is increasing on nearly all retirement-income programs. The pressure is motivating policy reexamination and reform in, for example, the private sector's employer-provided pensions, Social Security, state and local pension plans, and retirement-income programs outside the country. Given the topic's importance, this author conducted a study, specifically on the impact that demographic changes were having on the pension plans for state employees in New England.[1]

How State Pension Plans Work

All New England states offer traditional defined-benefit pension plans to state employees. Under defined-benefit plans, an employee's pension entitlement consists of continuing salary-like payments through the post-retirement years. The amount is based on the employee's preretirement salary, years of service, and retirement age.

As illustration, Maine's benefit formula provides for "normal retirement" beginning at age 62 with a pension that is 2 percent of the employee's final average salary per year of service. A full-career employee hired at age 22 would have 40 years of service at age 62 and could retire with a pension equal to 80 percent of her preretirement salary, in this case averaged over the highest three years. An employee hired at age 40 would have 22 years of service at age 62 and could retire with a pension equal to 44 percent of his previous salary. An employee hired at age 50 would be eligible for a 24 percent pension at age 62. Once retired, the pension rate is inflation-adjusted annually and continues for the retiree's lifetime. Life expectancy at age 62 is 19 years for men and 22 years for women.

Although the general structure is similar across the New England states and across the multiple plans within states, there is variation in the benefit amounts, the ages of eligibility, the adjustment factors for retiring at different ages, and so on. For long-service employees in particular, pension payments

Defined-benefit pension plans can be reformed to be age-neutral by making actuarially fair adjustments in the benefit amount for retiring at different ages.

can be substantial, and the eligibility age for retirement young.

The full-career employee hired at age 22, for example, is eligible for "normal retirement" at age 55 in Vermont, age 60 in both Connecticut and New Hampshire, age 61 in Massachusetts, and age 62 in Maine and Rhode Island. By age 62, a full-career employee would have accrued an annual pension benefit of 55 percent in Connecticut (the percentage of preretirement salary), 60 percent in Vermont, 61 percent in New Hampshire (67 percent before age 65), 75 percent in Rhode Island, and 80 percent in Maine and Massachusetts.

The benefits are proportionately smaller for employees who do not spend their full careers in state employment. For an employee hired at age 40, for example, workers taking normal retirement would receive 29 percent of salary beginning at age 62 in Connecticut, 40 percent at age 64 in Vermont, 44 percent at age 65 in Rhode Island, 44 percent at age 62 in Maine, and 63 percent at age 65 in Massachusetts.

Importantly, the higher-benefit plans in Maine and Massachusetts are substitutes for Social Security, rather than supplements. No Social Security taxes are paid, and no benefits are accrued from state employment in either plan. (If these state workers earn money from additional jobs, the associated Social Security benefits may be reduced by the Government Pension Offset and Windfall Elimination Provisions of Social Security.) In Connecticut, New Hampshire, Rhode Island, and Vermont, the state pension benefit is in addition to Social Security.

The Demographic Pressures

The pressure on state pension programs is a result of both financial and demographic factors. The financial factors include historical underfunding, recent financial market declines, and strained economic conditions. Most pension plans are substantially underfunded relative to the benefit obligations that plan participants have accrued. The demographic factors include increased individual life expectancy and the baby-boom generation's move into retirement ages.

What distinguishes the next 20 years is the position of the baby-boom generation (born between 1946 and 1964) in the population's age profile. Right now, most baby boomers are still in the prime of their working careers: earning income, paying taxes, contributing to retirement systems, and partially supporting a comparatively smaller population of older retirees. But in 20 years, most boomers will be drawing retirement benefits themselves. This is the essence of the unfunded liabilities that will come due. (See "New England Adult Population Projections.")

According to U.S. Census Bureau projections, New England's younger working-age population (age 21-44) is projected to *decline* by 1 percent by 2030, the more established working-age population (age 45-64) is projected to *decline* by 11 percent, and the senior population (age 65+) is projected to *grow* by 65 percent.[2]

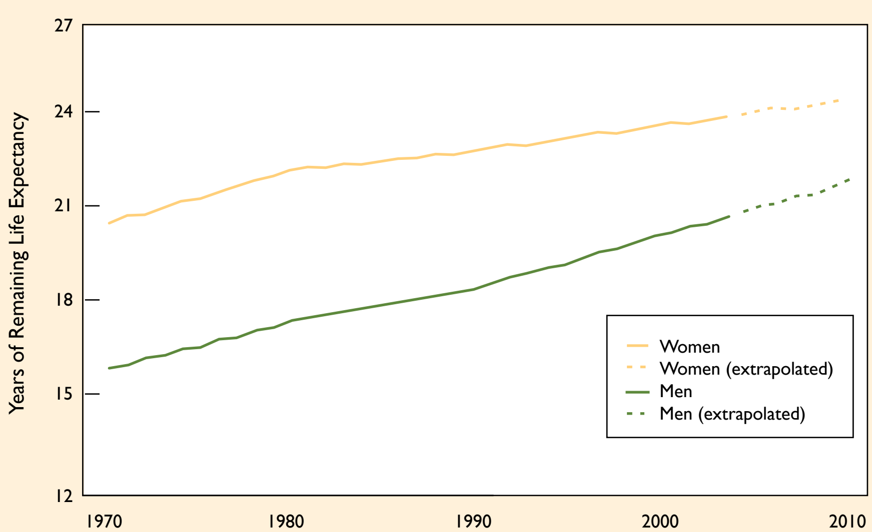
Trends in life expectancy compound the demographic impact of the baby-boom generation.[3] (See "Years of Remaining Life Expectancy.") Cumulatively, the life expectancy of 60-year-old men rose from 16 years in 1970 to nearly 21 years in 2004. The life expectancy of 60-year-old women rose from 20.6 years in 1970 to 24 years in 2004. These trends equate to an increase in life expectancy at age 60 of one to two months every year, a trend showing no sign of changing.

Demographics and Reform

In confronting state pension systems' funding challenges, it is important to differentiate among (1) the unfunded liability for benefits that have already been accrued, (2) the newly accrued benefits being earned by currently participating workers going forward, and (3) the pension system one would design for newly hired workers, based on current population demographics and life expectancies. Legal and moral obligations will prevent any major reduction in the benefits that employees have already accrued from past work. More substantive reforms to pension systems can be imposed going forward.

Many categories of reform have been proposed, and in some states, enacted. These reforms may include increased employee contributions, reduced benefit rates, shifts from traditional pension plans to defined-contribution systems, reintegration with Social Security, redefinition of the salary base on which benefits are determined, limits on the inflation adjustment of benefits, older eligibility ages for early or normal retirement, or more steeply reduced benefits

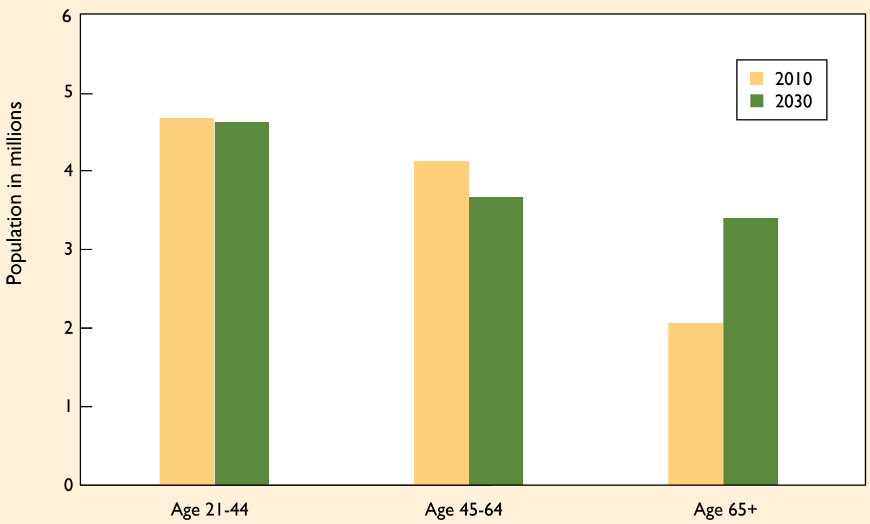
Years of Remaining Life Expectancy at Age 60 in the United States



Source: National Center for Health Statistics. Extrapolations by author.

New England Adult Population Projections by Age Category

2010 and 2030



Source: U.S. Census Bureau

for those choosing early retirement.

A particular consequence of increasing longevity is the lengthening period over which pension benefits are being paid. This motivates reforms that move back the eligibility ages for benefits to reflect rising life expectancy. Social Security is phasing in its own increase—moving the normal retirement age from 65 to 67—and could go further.

What duration of later life should pension systems be structured to support? What is the average number of years that pension benefits will be paid to retiring workers? (See "Expected Number of Years of Pension Benefits.") If pension benefits begin at age 55, for example, states will pay them for an average of 25 years for men and 28 years for women. If pension benefits begin at age 62, states can expect to pay them for 19 years for men and 22 years for women. If benefits begin at age 70, states will pay them for an average of 14 years for men and 16 years for women.

Other approaches make policies more flexible to retirement at any age. The shift to age-neutral policies has already occurred in much of the private sector, where savings-based retirement systems such as 401(k) plans have largely replaced defined-benefit plans. What is generally lost in these plans is the annuitized payment stream of traditional pensions and their implicit insurance against outliving one's resources.

Defined-benefit pension plans can be reformed to be age-neutral by making actuarially fair adjustments in the benefit amount for retiring at different ages. Under that approach, the discounted cost of the payment stream is calibrated to be the same, regardless of when the payments begin. So if an employee starts claiming a benefit a year earlier, for example, the payment rate is reduced by an amount that compensates for the additional year the employee would receive the payments. Similarly, if an employee delays retirement, the payment rate rises to reflect its shorter duration.

Whatever reforms are implemented, a critical consideration is the changing demographic context in which pension systems operate. People are living longer and healthier lives. For new employees in particular, the challenge is designing a pension system that reflects current demographics, health, life expectancy, and workforce objectives going forward.

Richard Woodbury, *an economist, is a Maine state senator and former visiting scholar with the New England Public Policy Center at the Federal Reserve Bank of Boston.*

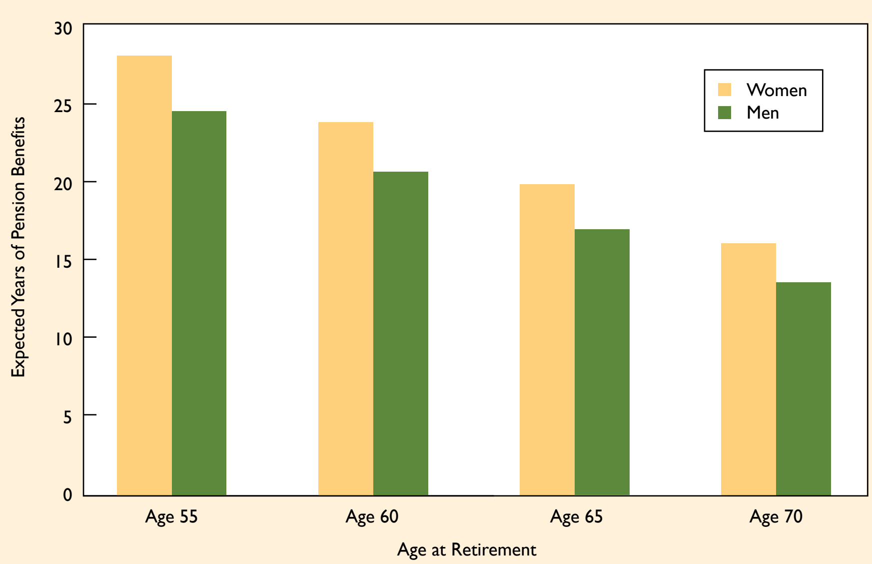
Endnotes

1 Richard Woodbury, "Population Aging and State Pensions in New England" (NEPPC research report 10-1, Federal Reserve Bank of Boston, June 2010).

2 U.S. Census Bureau, "State Interim Population Projections by Age and Sex: 2004 - 2030," www.census.gov/population/www/projections/projectionsagesex.html.

3 Author extrapolations of National Center for Health Statistics, U.S. Centers for Disease Control and Prevention, "United States Life Tables, 2004," www.cdc.gov/nchs/data/nvsr/nvsr56/nvsr56_09.pdf.

Expected Number of Years of Pension Benefits Based on Retirement Age, 2004



School Quality & Income Inequality

The Long-Term Effects of Early Childhood Education

by Raj Chetty and John N. Friedman
Harvard University

U.S. public schools vary significantly in quality, partly because most of their funding comes from local property taxes. As a result, spending per student in an overall wealthy state like Connecticut is nearly twice that in a poor state like Mississippi. The question is: Do disparities in school spending perpetuate income inequality by giving higher-income students access to higher-quality schools?

Tennessee's STAR

Although state and local policymakers have been concerned about the apparent differences in school quality across districts for years—and many states have implemented school finance equalization to try to address the concerns—there have not been any estimates of the actual long-run implications of these differences.

In a recent paper, we looked into that question, presenting new evidence on the long-term impacts of early childhood education.[1] We analyzed data from Project STAR—the largest and most widely studied education intervention conducted in the country.[2]

STAR was an experiment in 79 Tennessee schools from 1985 to 1989. Some 11,500 students and their teachers were randomly assigned to either a small class with an average of 15 students or a regular-sized class with an average of 22 students. In general, students remained in their randomly assigned classes in grades K-3 until the experiment concluded, and all students returned to regular-sized classes in 4th grade.

Previous work has shown that small classes increased students' standardized test scores by about 5 percentile rank points in grades K-3. And students who had better teachers also scored higher on tests in those grades. But the longer-run effects were less impressive: The benefits from small class attendance fell to 1 to 2 percentile points in grades 4-8, as did the benefits from having a better teacher. This "fade out" effect has made some researchers skeptical about the long-run benefits of early childhood education.

Longer Tracking

We investigated the long-term effects of early childhood class quality by tracking the students in STAR over a 25-year period, until they were around 27 years old. We were able to measure outcomes such as earnings, college attendance, home ownership, and savings for 95 percent of the students in the experiment.

To start, we found that being randomly assigned to a small class improved students' adult outcomes relative to schoolmates who attended normal-sized classes. Small-class students went on to attend college at higher rates and to do better on measures such as retirement savings, marriage rates, and neighborhood quality. Small-class students did not have statistically different earnings levels as of ages 25 to 27, but earnings advantages may emerge over time as their careers develop and they reap the increasing benefits of higher rates of college attendance.

The larger surprise came from our findings that K-3 classroom quality has a big effect on adult outcomes. Classrooms vary in many ways beyond just size. Some have better teachers, some have better peers, and some just have better "classroom chemistry." While we can't measure each of these classroom attributes directly, we can create a quality proxy using classmates' test scores. This measure captures teacher quality, peer quality, and any other factor that may have affected the quality of a child's classroom experience. Classmates doing well on tests suggests an effective environment (remember, students were randomly assigned to classrooms, so there were no differences in student abilities across classrooms before the experiment started).

Using this measure, we found strong evidence that being assigned to a higher-quality classroom led to improvements in a broad range of adult outcomes. Even though the effect of better classes on standardized test scores quickly faded in later grades, being assigned to a higher-quality classroom was an important predictor of later earnings. Remarkably, we also found substantial improvements on virtually every other measure of success in adulthood that we examined. Students who were randomly assigned to higher-quality classrooms were eventually more likely to attend college, to own a house, to save for retirement, and to live in a better neighborhood.

Why does class quality improve adult outcomes despite having little effect on test scores in later grades? One possibility is that the effect works not through academic ability but through improved *non-cognitive* skills. We found that students in higher-quality classes not only scored higher on academic tests but also on teacher-rated measures such as class participation, playing well with others, and not disrupting the class. Although the academic gains fade in later grades, the improvements in noncognitive measures persist over time. Perhaps these students earn more in the labor market not because of their mastery of arithmetic or spelling but because they learned to play nicely and share.

Inequality

We now return to the question that motivated our analysis: Do differences in school quality perpetuate income inequality in the

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United States? Because we can link students to parents in our data, we can measure the intergenerational transmission of income directly in the STAR data. Consistent with earlier research, we find that children of richer parents grow up to earn substantially more themselves.[3] A $10,000 increase in parents' incomes is associated with a $1,100 increase in a child's annual income between 25 and 27. But how much of that effect relates to school quality—that is, how much smaller would the dollar figure be if all children had access to schools of the same quality?

Our results from Project STAR imply that moving from a below-average (25th percentile) to an above-average (75th percentile) class raises earnings by approximately $750 (5 percent) per year. In the STAR data, we find that parents with $10,000 more of household income send their children to schools that are 0.7 percentage points higher in school quality by our test score measure.

Under certain strong statistical assumptions, this 0.7 percentage point increase in class quality would lead to a $33 increase in students' annual earnings *just from kindergarten.*[4] If class quality in grades 4 to 12 has the same effect as it does in grades K-3, then $423, or roughly 40 percent of the total correlation between parents' and children's incomes, comes through school quality. That is, if school quality was unrelated to income in the United States, the intergenerational transmission of inequality would *fall by 40 percent.*

The 40 percent calculation should be interpreted with a great deal of caution because there is still much to learn about how education affects students' outcomes in the long run. For instance, we have assumed that school quality in all grades has the same long-run effect as that in kindergarten. Future work may reveal that the effect of education increases or decreases as children age, and each year's school quality may be a complement or substitute (rather than adding up as we implicitly assumed). Furthermore, our results speak only to the effect of aggregate class quality. Future research may reveal that some aspects of class quality, such as high-performing teachers or peers, are more important than others.

Nevertheless, these results demonstrate that local financing of schools (and disparities in the ability to hire the best teachers or keep classes small) may contribute substantially to the growth of income inequality in the nation. Therefore, tax-policy reforms at the state or especially the federal level that generate more-uniform school quality could help substantially. Consider the benefits if, for instance, the government were to offer tax credits to offset expenditures for primary and secondary schools similar to the Hope Scholarship Credit that offsets spending on higher education. Or what if tax credits were available for investment in local schools similar to the New Markets Tax Credit program, which provides incentives for starting new businesses in underserved areas? Given the tremendous long-term impact of early childhood education, exploring such policies could significantly change the persistence of poverty and inequality in the United States.

Raj Chetty, *a professor of economics at Harvard University, is co-director of the Public Economics Group at the National Bureau of Economic Research.* **John N. Friedman** *is an assistant professor of public policy at the Harvard Kennedy School and faculty research fellow at the National Bureau of Economic Research.*

Endnotes

1 Raj Chetty, John N. Friedman, Nathaniel Hilger, Emmanuel Saez, Diane Schanzenbach, and Danny Yagan, "How Does Your Kindergarten Class Affect Your Earnings? Evidence from Project STAR" (NBER working paper no. 16381, 2010).

2 Other studies have evaluated the long-term outcomes of nonrandomized interventions such as HeadStart or smaller-scale randomized interventions such as those in the Perry or Abecedarian preschools. Their results are broadly consistent with those reported here. See Eliana Garces, Duncan Thomas, and Janet Currie, "Longer-Term Effects of Head Start," *American Economic Review* 92 (2002): 999-1012; James J. Heckman, Seong H. Moon, Rodrigo Pinto, Peter A. Savelyev, and Adam Yavitz, "The Rate of the Return to the High Scope Perry Preschool Program," *Journal of Public Economics* 94 (2010): 114-128.

3 See Gary Solon, "Intergenerational Income Mobility in the United States," *American Economic Review* 82 (1992): 393-408; and Frances A. Campbell, Craig T. Ramey, Elizabeth Pungello, Joseph Sparling, and Shari Miller-Johnson, "Early childhood education: Young adult outcomes from the Abecedarian Project," *Applied Developmental Science* 6 (2002): 42-57.

4 See Raj Chetty and John N. Friedman, "Does Local Tax Financing of Public Schools Perpetuate Inequality?" (National Tax Association proceedings, forthcoming).


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by Margaret Somer
Massachusetts Small Business
Development Center

The Impact of Credit Card Policies on Small Business

Even in a good economy, some small businesses have difficulty accessing bank loans. They may be a service business without collateral or a start-up without a track record. Perhaps they have not been profitable in the first year or two and can't yet show the ability to repay a loan. Many then turn to credit cards.

True Stories

Numerous small firms have found their credit card works well as an unsecured line of credit. But sometimes, even if payments are made on time, the approach backfires. Fees are unpredictable. Interest rates may go up. The businesses' credit limit may be reduced, and that can lead to a lower credit score. Several New England cases are illustrative.

Commercial Cleaning Firm

Since 1991, Anna has run a family-owned, commercial cleaning firm with 11 part-time cleaners. While waiting to receive customer payments, she would manage cash flow by drawing on personal and business credit cards for cleaning materials, equipment, and payroll. In 2008, she had a very good credit score, 715. She carefully paid all bills on time, including credit cards, home mortgage, and business and personal expenses.

Anna typically drew down about $10,000 in total on a credit limit of $25,000. But when the recession hit, the credit card landscape changed. Congress began to prepare for rules reforming card companies' policies. And in the interim, without reviewing the history of individual small businesses, many banks cut the limits for thousands of such borrowers.[1] Anna's credit limit was dropped to the amount of her outstanding debt, $10,000. She suddenly appeared to have borrowed 100 percent of her credit limit, and lost her borrowing flexibility.[2] That caused her credit score to decline to 620. Her cards, formerly with 2 percent to 5 percent interest rates, now had rates of up to 30 percent. Her monthly cost of doing business skyrocketed; cash flow was negative. Nevertheless, to this day her credit reports show no late payments.

Anna's attorney advised her to file for bankruptcy. She subsequently restarted the business, and her credit score is improving. Today she is working hard to get beyond the stigma and financial setbacks of bankruptcy.

Framing and Fine Art Shop

Barbara and Mike bought a framing and art store in 1993. The business developed a strong following among local artists seeking a showcase and customers buying local artwork or framing services. The owners worked long hours but enjoyed the work.

Barbara and Mike maintained an excellent credit score, in the 800s. But in 2004, Mike died suddenly, and Barbara had to take over. She used a merchant account, allowing her to accept customers' payments by credit or debit card. She paid her bank $500 for a credit-card swipe machine. Over time, despite her good payment history, the number and amounts of fees and charges increased. The unpredictability made it challenging to know how much cash was available to manage the business.

Merchant accounts typically charge a monthly management fee and two charges per card transaction—a fee and a percentage of each transaction. The frame store's credit card statements from April through June 2010 showed numerous additional charges including a monthly service charge, a swipe-machine charge (though she owned her machine), settlement statement fees, interchange transaction fees, and batch fees. Barbara asked a bank employee for an explanation of the charges, but he said he could not explain them all.

Barbara had signed up for store debit card services when the bank explained that payment would go instantly to her business bank account, with no fees. She purchased a debit card machine outright but was still billed monthly for it. Over time, the bank began to take longer to credit transactions to her account and started adding charges for each debit.

The recession made cash flow even tighter, so in June 2010, she cancelled her merchant accounts. Nevertheless, the bank continued to charge her the monthly merchant account fee and said she owed $150 for the swipe machine she had already purchased. The errors took months to straighten out. Ultimately, like many other small businesses, Barbara began accepting only checks and cash.

Regional Magazine

An experienced journalist, Scott decided to start a regional magazine in 2006. Revenues came from advertising, subscriptions, single-copy sales, reprints, and design services. Although he was unable to obtain bank financing, his excellent credit score and his $250,000 card limit enabled him to use credit cards to finance operations. He eventually charged more than $200,000, supplemented by $100,000 in loans from family and friends. Sales grew from $220,000 in 2007 to $385,000 in 2008 to $400,000 in 2009—and as of this writing, an estimated $450,000 in 2010.

The improving outlook did not come without pain. In 2009, most of Scott's credit card rates jumped to more than 30 percent. The minimum due on his monthly payments went from $300 to $1,200. The sharp and unanticipated increase threw the company off balance. Scott's rising costs hampered his cash flow and credit score, slowing improvement in his company's financial position. Ultimately he was unable to make payments, and on the advice of legal counsel, he stopped them. He began a Chapter 11 filing for bankruptcy reorganization. Because the credit cards had been personally guaranteed, a personal bankruptcy was unavoidable.

Credit-scoring companies should not drop a reliable business's credit score just because a credit card company changed its policy and cut credit limits.

The business reorganized primarily by cutting staff, with the remaining employees taking on a double workload. The reorganization plus the slowed economy remained a constraint on growth. But in late 2010, growth stabilized, and the company became profitable and emerged from bankruptcy.

What Can Work

In 2010, President Obama and Congress worked with credit card companies to review and reform credit card policies. In spring 2010, new legislation was passed. Key elements will improve the situation for businesses using their personal credit cards for business.

The May 2010 credit card reform provides guidelines and limits on increases and changes in interest rates, charges, and fees. A 2010 stimulus package expanded access to capital for thousands of small companies. Congress is also expected to address issues with business credit cards.

More should be done to protect the 90 percent of U.S. businesses that come under the Small Business Administration's definition of a small business.[3] Issues needing attention include both merchant accounts and small companies' use of credit cards to pay bills. Banks and credit card companies could help—and in turn, protect local economies—by making case-by-case decisions based on users' payment histories. Sweeping changes based on regional or industry trends have damaged many good companies. Also, credit-scoring companies could reconsider dropping a reliable business's credit score just because a credit card company changed its policy and cut credit limits.

At the same time, small businesses need to maintain a good credit rating, maintain clear financial statements (including reporting profitability), and seek a long-term banking relationship. At that point, they can refinance credit card debt with a lower rate and a more predictable bank loan. Small retailers, such as convenience stores, might provide an automatic teller machine so customers can pay in cash. Store owners concerned about the quality of check payments might use a scanner to deposit the check into their account and thus know instantly if the check is valid.

Companies can work with an accountant and a credit-counseling organization to develop a new strategy for managing cash, paying down debt, and building a clear business financial history. It is usually beneficial for a business to maintain a merchant account with the same bank that handles their business accounts.

The 90 percent of American companies with fewer than 10 employees provide jobs, tax revenue, and goods and services for communities. Affordable financing is critical to their survival and growth. Continuing to reform credit card policy can make a meaningful difference.

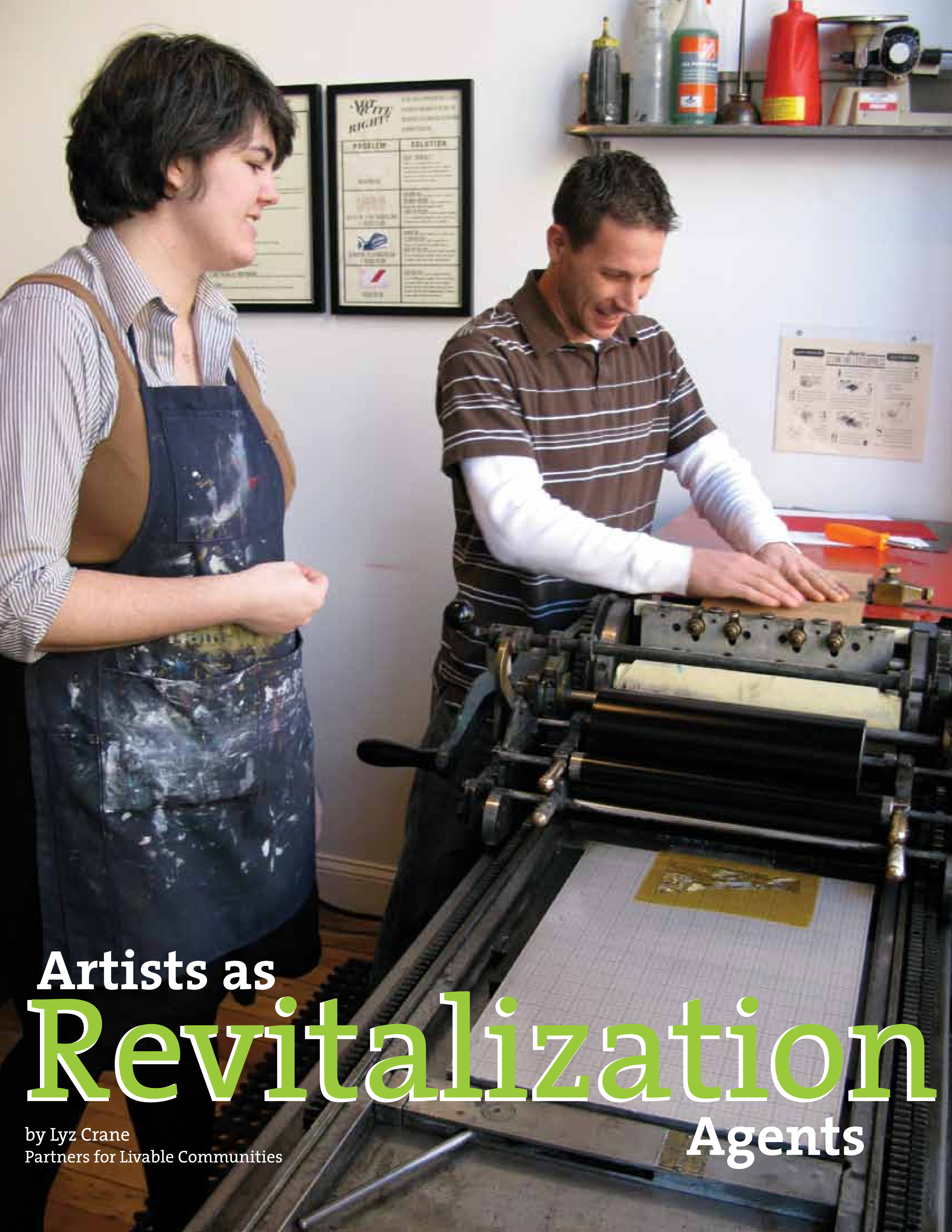
Margaret Somer *is the regional director of the Northeast office of the Massachusetts Small Business Development Center, based at Salem State University.*

Endnotes

1 Eileen A.J. Connelly, "Mixed Blessing: Credit Card Reform May Shock Some," Associated Press, February 22, 2010, http://abcnews.go.com/Business/wireStory?id=9906985.

2 When borrowers use all of their available credit, it lowers their score and raises their interest rates.

3 See www.census.gov/epcd/www/smallbus.html.



Artists as Revitalization Agents

by Lyz Crane
Partners for Livable Communities

Providence recently embarked on a rebranding campaign. Once called "The Renaissance City," today it is "The Creative Capital." The change reflects the presence of a large number of local artists, extensive cultural networks developed out of entities such as the Rhode Island School of Design and arts incubator AS220, and several mayors' initiatives employing the arts for economic and social development.

Concentrations of artists in a community often translate into more public art projects, civic beautification efforts, and cultural events.

Recognizing Revival

The common wisdom about the role of artists in community revitalization is that they move into communities where space is affordable, they create thriving creative spaces, and then they—and any other residents who were part of the community previously—get priced out as the real-estate market seeks to take advantage of newly hot neighborhoods.

Although that scenario has some basis in reality, the role of arts in community development is really more complex. Artists can be involved in many facets of community revitalization, and these days they are often likely to be a part of a larger civic strategy. *The Wall Street Journal* took notice of that phenomenon in a 2009 article describing struggling cities in which artists may take advantage of cheap space with the help of local officials: "What began as a grass-roots movement, with artists gravitating to cheaper neighborhoods and making improvements, is now being embraced by city officials as a tool to revive neighborhoods reeling from vacancies and home foreclosures."[1]

The role of arts in community development is no longer solely the purview of artists acting on their own. A growing number of practitioners, researchers, funders, elected officials, and traditional community development and financing organizations are taking a close look at culture-driven community revitalization. We at the national organization Partners for Livable Communities often find ourselves mediating between civic practitioners, unfamiliar with the language of arts but recognizing the value, and arts practitioners seeking to enhance their relevance and connection to surrounding communities.

The new efforts are widespread, encompassing nonprofit arts organizations, commercial arts presenters, and a complex ecosystem of creative workers enhancing natural cultural districts and developing new cultural districts. The New England Foundation for the Arts (NEFA) has been one of the most aggressive groups to map and quantify the cultural sector as a whole. Their web site, www.CultureCount.org, serves as a database of arts activity for the entire region. They have regularly put together studies quantifying the economic effects of the cultural sector in the region, such as:

- the total expense for all cultural nonprofits in New England, approximately $3.6 billion;
- the total revenue for all cultural nonprofits in New England, approximately $4.5 billion; and
- the total number of cultural nonprofits in New England, 19,183 (performing and visual arts groups, museums, libraries, and the like).[2]

Within this ecosystem, artists have a unique role to fill. According to research by NEFA based on the 2000 U.S. Census, there are 225,750 people in the cultural workforce in New England, equating to 3.11 percent.[3] In 2009, NEFA received approximately $330,000 from the American Recovery and Reinvestment Act to distribute in support of preserving these important arts jobs.

New England artists live in large cities, small towns, and rural areas. Their effect is felt not just by communities in need of revitalization but in all communities in which they live.[4] Artists contribute to quality of life by animating public spaces and creating cultural connections. They work in partnership with community organizations to enhance specific economic, social, and physical development strategies. And they contribute to the economy through their business enterprises.

That economic output is sometimes termed the *artistic dividend* and can be quantified through occupational characteristics and products produced and exported. Richard Florida's 2002 work *The Rise of the Creative Class* made cities and towns aware of the economic value of artistic insight and creative thinking and launched intense competition to lure all sorts of creative workers. Researcher Ann Markusen, who has quantified and qualified many of these effects, describes both primary and secondary benefits:

> Many artists are self-employed. Some contribute to their economies by porting their work directly out of the region and spending the resulting income locally. Others enable productivity and marketing gains by unrelated area businesses, through contracting their skills in writing, performing, and visual art. Yet others, through their demands for inputs, evoke innovation on the part of their suppliers that broadens their business.[5]

In just one example of impressive cooperation, an initiative called "From Rustbelt to Artist Belt" brought together multiple sectors to harness the power of artists in the Midwest.[6]

In addition to serving as economic generators and community cultural connectors, artists frequently bring about changes in the physical fabric of communities. For example, they may locate live-work space in unused or underutilized buildings. Organizations such as Massachusetts-based ArtistLink have helped old industrial towns to renovate a significant amount of warehouse space into galleries and live-work space. ArtistLink has helped develop more than 65 projects in 30 communities.[7]

Artist spaces, sometimes located within a cultural district, can have important benefits for all concerned. In a recent study of 23 artist-space developments, almost half were positioned as community economic-development and social-improvement strategies. The others were positioned as viable business strategies or services for artist

Photographs: Courtesy of AS220

needs. Because there is little capacity in the arts world to develop such spaces without help, they are often created by community development corporations or coalitions of civic and arts partners. These types of projects increase career opportunities and infrastructure for artists while building their relationships with the broader community. They decrease blight and animate neglected spaces, increase arts-participation opportunities for residents, contribute to local pride, and catalyze other economic gains in their communities.[8]

Furthermore, when there are concentrations of artists in a community, more public art projects, civic beautification initiatives, and cultural events may result. NEFA helped Lowell, Massachusetts, to leverage the value of its growing arts community to install public art works along 1.7 miles of trail next to the Concord River Greenway. And in Danville, Vermont, the Vermont Arts Council, the Vermont Council on Rural Development, and the Vermont Agency of Transportation partnered to help artists create aesthetic strategies for improving local traffic safety.

Challenges and Opportunities

Major challenges for artist-based development revolve around the support systems for the artists and the areas in which they locate. Many civic actors and communities are experimenting with cultural districts and artist subsidization, but not all projects are completely successful. Whether artists develop the space on their own or someone else develops it with artists in mind, artists who do not become owners can soon find themselves being priced out. Longtime residents of the surrounding community can be priced out, too—unless they have a real estate ownership stake. Revitalizing without too much gentrifying is a balancing act. Moreover, artist-space management is often supported by nonprofit entities that developers create, and many developers fail to plan adequately for how a nonprofit will be supported once they have moved on.

Communities interested in exploring artist-based revitalization can help ensure greater success by researching the presence of artists locally and regionally to determine market demand prior to starting a project, talking with experienced artist-space developers such as ArtistLink to avoid common pitfalls, and encouraging ongoing, substantial connections between artists and community members to create a sense of shared investment in the future.

Lyz Crane *is a senior associate with Partners for Livable Communities, http://www.livable.org, a national organization based in Washington, DC.*

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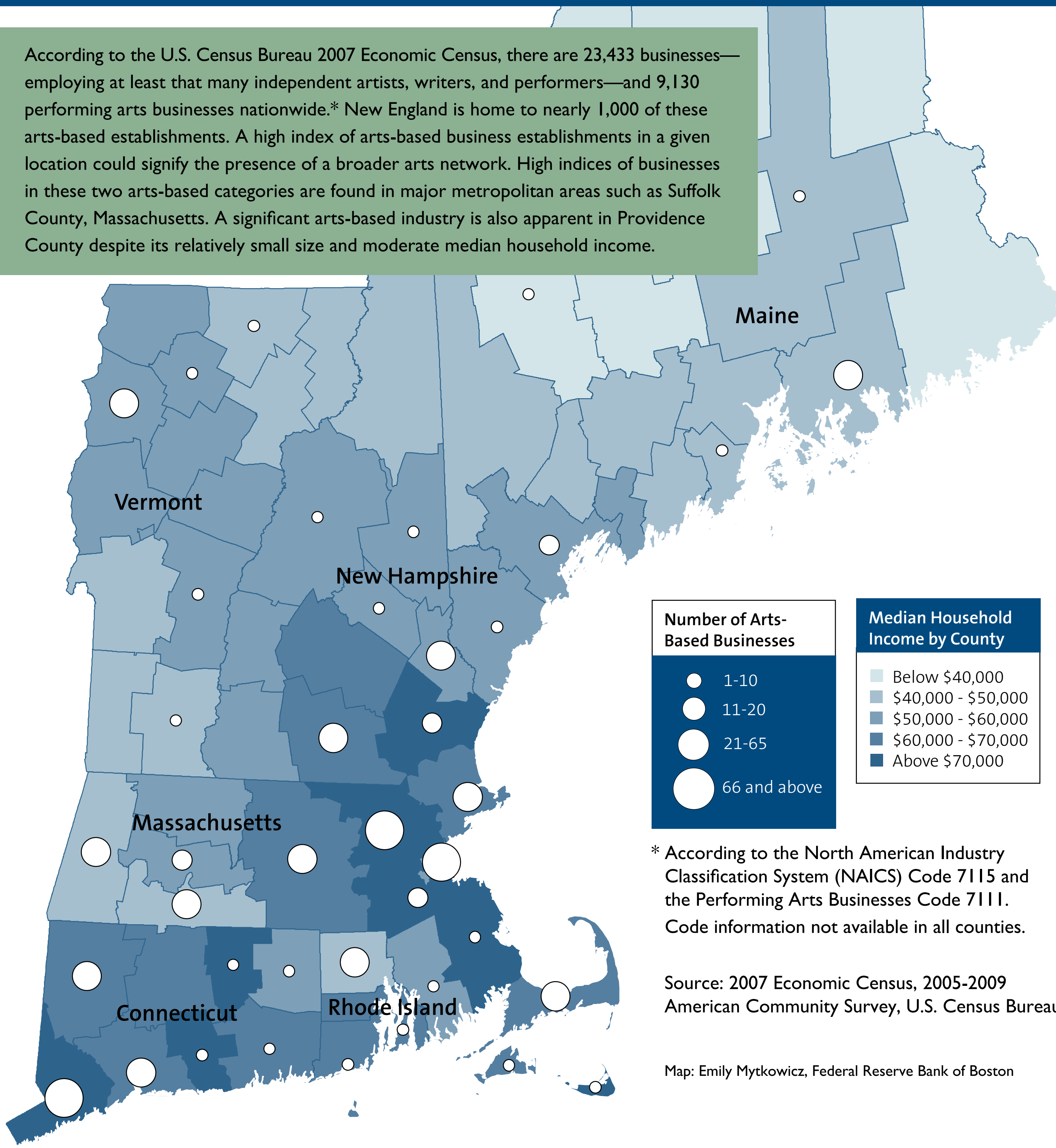
Mapping New England

Potential for Arts-Based Economic Development

Number of Arts-Based Businesses and Median Household Income, by County

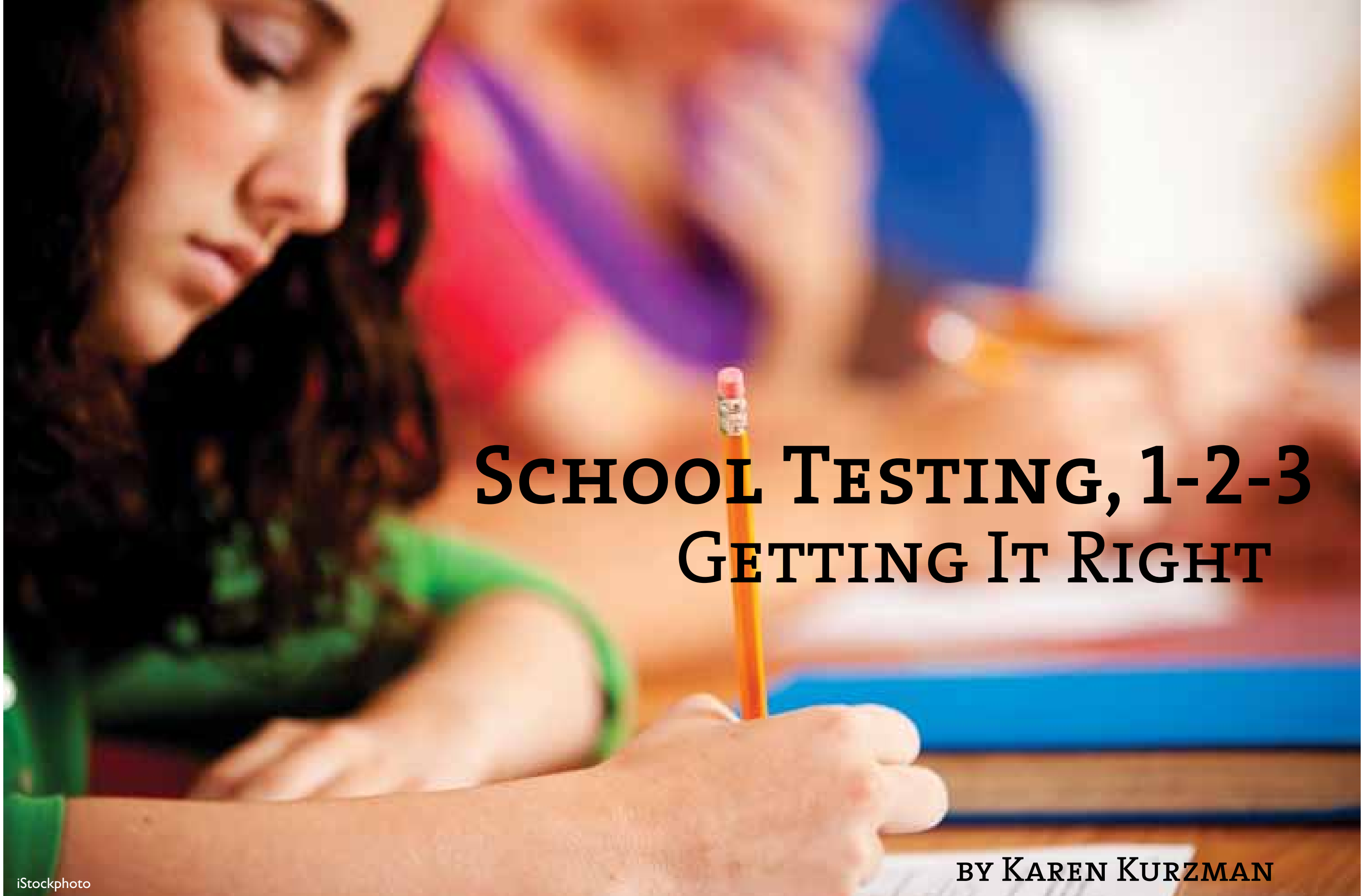
According to the U.S. Census Bureau 2007 Economic Census, there are 23,433 businesses—employing at least that many independent artists, writers, and performers—and 9,130 performing arts businesses nationwide.* New England is home to nearly 1,000 of these arts-based establishments. A high index of arts-based business establishments in a given location could signify the presence of a broader arts network. High indices of businesses in these two arts-based categories are found in major metropolitan areas such as Suffolk County, Massachusetts. A significant arts-based industry is also apparent in Providence County despite its relatively small size and moderate median household income.



* According to the North American Industry Classification System (NAICS) Code 7115 and the Performing Arts Businesses Code 7111. Code information not available in all counties.

Source: 2007 Economic Census, 2005-2009 American Community Survey, U.S. Census Bureau

Map: Emily Mytkowicz, Federal Reserve Bank of Boston



School Testing, 1-2-3
Getting It Right

by Karen Kurzman

Increased student testing has stirred up intense feelings for years. There are those, like former U.S. House Education and Workforce Committee chair Bill Goodling, who believe testing has been overdone. "If testing is the answer to our education problems, it would have solved them a long time ago," he once wrote.[1] Others believe needed improvements in education will come only through the accountability that testing can provide. William Bennett and Rod Paige, Secretaries of Education under Ronald Reagan and George W. Bush, respectively, hold that a national test can "go a long way toward assuring America a more well-educated population and a bright future."[2]

But national testing is here to stay, and all but five states are collaborating to revolutionize how it is delivered and to ensure that it that leads to better educational outcomes.[3] The 45 states include all those in New England.

Deeper Accountability

Every few decades, it seems, an alarm is raised about our educational system. In the 1950s, the launch of the first Earth-orbiting artificial satellite, the Soviet Union's Sputnik, suddenly made U.S. science and math education look deficient. In 1983, a report called *A Nation at Risk: The Imperative for Educational Reform* caused renewed anxiety.[4] In 2010, the OECD published an International Student Assessment comparing the knowledge and skills of 15-year-olds in participating countries.[5] It ranked the United States 14th out of 34 countries for reading skills, 17th for science, and a below-average 25th for mathematics.[6] Secretary of Education Arne Duncan reacted strongly: "This is an absolute wake-up call for America."[7] Once again, the public demanded accountability.

A Nation at Risk

A Nation at Risk led to the focus on national testing. A landmark event in U.S. educational history, it inspired reforms at all government levels for years, including the 2001 No Child Left Behind (NCLB) law.

NCLB requires states to hold schools accountable for outcomes. They must administer yearly tests to all students in grades 3 to 8 in reading and math. Science must be tested once in elementary, middle, and high school. There are consequences for states that fail to follow the requirements and for any unimproved school receiving the federal Title I funds meant to improve the economic achievement of the disadvantaged.

When such a school fails to meet yearly progress goals for two or more consecutive years, parents may transfer their children to other schools. When it fails to meet goals for three or more consecutive years, students are eligible for state-approved supplemental educational services, including tutoring. If a Title I school fails for four consecutive years, the district must implement one or more corrective actions, such as replacing school staff, implementing a new curriculum, or appointing outside experts as advisers. Schools may demonstrate improvement through drop-out rates, goal setting, and the like, but NCLB relies heavily on the end-of-the-year test.

Change in the Classroom

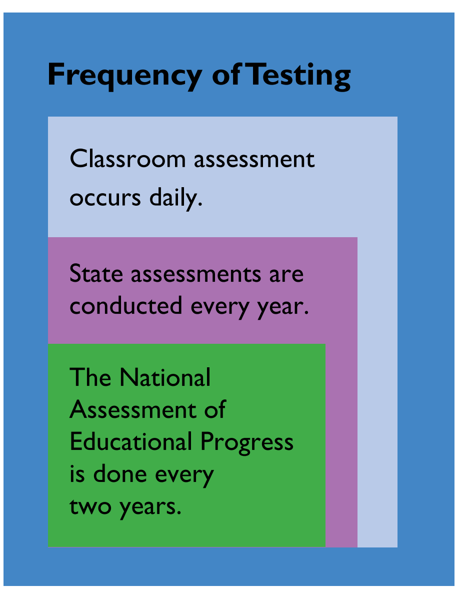
Even with NCLB, there is not as much standardized testing going on in classrooms as people think. (See "Frequency of Testing.") A federal test called the National Assessment of Educational Progress (NAEP), which covers reading and math, is administered nationwide at grades 4, 8, and 12 only every two years. Offering data at the state level only, it provides a common metric.

Individual states may also test in subjects such as civics, the arts, economics, geography, writing, and science. States schedule approximately two weeks annually for assessments. Most are given in classrooms by classroom teachers, who are able to offer prompt feedback and further instruction to students if necessary.

In fact, classroom assessment is leading the way for improvements in evaluation methods. In the past, tests were given mainly as a summary of accomplishment: students learned content; teachers gave a test and a grade; the class moved on to more content. That is called *summative assessment*. Today testing is a means of informing and improving instruction (*formative assessment*). Teachers use assessments to check students' work every day, using observation, checklists, quizzes, writing samples—whatever provides insight into what the student has absorbed. Most important, teachers use test results to determine what they will teach next and to whom. Formative assessment drives instruction and is key to student achievement.

New England Leadership

When No Child Left Behind came on the scene, the states of Vermont and Rhode Island were administering a common test called the New Standards Reference Exam. Officials realized the test would not meet the new federal standards, so they collaborated to find a test that would, agreeing to make it as formative as possible and as relevant and instructive as classroom-performance assessments. The states wanted students not just to do math, but to solve problems and explain their thinking. They wanted students to read good literature and be able to write in a rhetorically effective way about what they had read. They wanted them to demonstrate superior skills and depth of content knowledge, not just superficial facts.



A drawback was that reading and scoring that type of test could not be done through a multiple-choice scanner. Rhode Island and Vermont knew it would take hundreds of people and thousands of dollars. To hold down costs, they encouraged the other New England states to participate. New Hampshire answered the call. The three states went forward, established common standards, and developed a common yearly assessment that included problem solving, mathematics, writing about both fiction and nonfiction, and composing a full essay at grades 4, 8, and 10. It was a huge change from prior state assessments.

An even greater transformation is ahead. With the advent of national standards called the Common Core State Standards, states are racing to ensure their assessments match up.[8] Two efforts to create common assessments for multiple states are being funded by the U.S Department of Education's Race to the Top grants. The Partnership for Assessment of Readiness for College and Careers (PARCC) consists of 26 states, including New Hampshire, Massachusetts, and Rhode Island. The Smarter Balanced Assessment Consortium (SBAC) was formed from a merger of three consortia in January 2010 in response to the Race to the Top competition. Today SBAC involves 30 states, including Vermont, Maine, Connecticut, and New Hampshire (which joined SBAC in addition to PARCC).

Both groups are concentrating on developing innovative, state-of-the art computer assessments that will provide common metrics for evaluating student performance in multiple states. The government has awarded each one $176 million to accomplish its goals. The groups will offer the required summative exams twice a year. Additionally, SBAC intends to provide optional formative exams and extra tools for teacher use during the year to determine whether students are meeting the standards. The information is expected to help teachers understand what students are learning and not learning on a daily basis so they can adjust their instruction.

PARCC will anchor assessments in college and career readiness and will be constructed by higher-education leaders and faculty from nearly 200 two- and four-year colleges. Students will take parts of PARCC's computer-based assessments at key times during the school year, closer to when they learn the material, which will allow educators to adjust instructional practices or give extra support to students who need it.

The upshot is that testing is going to evolve; it is going to look different. But it is growing because it is a critical tool for state, school district, school, teacher, and student improvement. Assessments provide information that can drive instruction and produce educational benefits at every level. With the current efforts to make testing increasingly beneficial to learning and school improvement, both the Bill Goodlings and Bill Bennetts will be satisfied, no child will be left behind, and our nation will not be at risk.

Karen Kurzman *is co-principal at the Block Island School in Rhode Island and the owner of Abecedarian, which provides professional development in literacy. She is a founding member of the Vermont Writing Collaborative, a nonprofit organization dedicated to teaching the art of writing.*

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by Prentiss Cox
University of Minnesota Law School

Keeping the Baby, If Not the Bathwater

Learning the Right Lessons from the Subprime Crisis

The 2008 financial collapse reached sectors of the mortgage market that had performed well and were not involved in the practices that caused soaring foreclosure rates. One corner of that market was home lending by state housing finance agencies. HFAs administer affordable housing programs, including federal and state initiatives that help families who lack significant resources become first-time homeowners.

Affordable Advantage

The bond markets that allow state HFAs to make such loans collapsed in late 2008. In response, Fannie Mae injected capital into state HFA programs. As part of its effort, it created the Affordable Advantage program in cooperation with the National Council of State Housing Agencies. Under it, Fannie Mae bought low-down-payment—$1,000 would qualify—single-family residential loans from state HFAs. The loans were to be strictly underwritten. A good credit profile and sufficient income to repay the loan were essential.[1] In 2010, Massachusetts, Minnesota, Idaho, and Wisconsin agreed to pilot the program.

But a few months later it was all over. Critics of government involvement in the mortgage market seized on Affordable Advantage as a symbol for the type of lending that caused the crisis. The Federal Housing Finance Agency, the oversight agency for Fannie Mae, concluded the program was a mistake.[2]

Affordable Advantage had run into public officials' confusion of over the causes of the crisis. It is important to learn the *right* lesson from catastrophes, and the learning curve from the mortgage meltdown has been abysmal. One would not stop using a stove to cook food in response to a neighbor's house burning down. Neither should we stop all mortgage lending that has a feature in common with the reckless loans that defaulted.

Two misconceptions from the crisis seem to underlie the demise of Affordable Advantage: (1) mortgage lenders should avoid any home loan that has a risk characteristic typical of the nonprime home loans that defaulted; and (2) government home-ownership programs caused the mortgage crisis.

Refuting Misconceptions

Affordable Advantage critics suggest that no government mortgage program should allow a low-down-payment loan, given the problems during the meltdown. The argument for prohibiting all such loans overlooks the context in which many of the problem loans were originated. The private market loans that massively defaulted combined multiple risk characteristics, such as unverified income, low credit scores, and negative amortization. The risk-laden loans were originated in an almost unregulated environment rife with inflated appraisals, forged documents, and hard-sell tactics.

The prudent reaction to excessively risky and unsupervised lending is to require appropriate and long-term risk management. Making home loans with a low down payment does increase risk, especially if the borrower puts *no* money down.[3] But the proper question is whether the public benefits from creating home ownership opportunities outweigh the added default risk when lending occurs in a well-managed underwriting environment.

The other fallacy is that government programs encouraging home ownership were the prime culprit for mortgage market problems. The argument that Community Reinvestment Act lending requirements caused the crisis has been thoroughly discredited.[4] Many critics have tried to blame Fannie Mae and Freddie Mac, but no fact-based analysis has linked any specific Fannie or Freddie affordable-housing initiative to the meltdown. Even the primary Fannie and Freddie role of securitizing mortgages likely did not cause the distress in real estate and mortgage markets—a conclusion reached even by staunch critics of the agencies.[5]

The experience of state HFAs belies the misconceptions. State FHAs make or guarantee single-family home loans to higher-risk borrowers who generally lack access to private mortgage financing but nevertheless repay loans. The typical HFA borrower is a first-time homebuyer with modest income who buys a modest house. In 2008, the average income for state FHA home loans backed by mortgage revenue bonds was $46,518, and the average mortgage loan was about $130,000.[6] Borrowers are disproportionately young and female.[7] About 46 percent obtain down-payment assistance from their HFA.


gettyimages

Unlike the private subprime mortgage-loan industry, state HFAs have a long history of careful underwriting and support for borrowers. For example, almost every state requires homeownership counseling as part of the lending process.

These agencies have an excellent record of loan performance relative to the borrower's risk profile. Consider two of the four states that participated in Affordable Advantage. Despite being only for lower-income borrowers, loans originated through the Minnesota Housing Finance Agency had a lower rate of foreclosure than the overall foreclosure percentage for Minnesota.[8] And a second-lien loan program for higher-risk borrowers in Massachusetts has operated successfully for 20 years. (See "SoftSecond Success.")

The quiet and successful work of state HFAs is an enduring lesson for both the public and private sectors in how to effectively manage higher-risk mortgage-lending programs. We do not know if Affordable Advantage would have been a successful program had it continued. It is disappointing, however, that the program's premature end probably was the result of public officials misreading the mortgage crisis.

Prentiss Cox *is professor of clinical law at the University of Minnesota Law School.*

SoftSecond Success

Twenty years ago, a grassroots group of lower-income Boston homebuyers worked with public officials and bankers to design an affordable, sustainable mortgage product to address urban redlining patterns. Thanks to members of the Massachusetts Affordable Housing Alliance's Homebuyers Union, the first SoftSecond program loan, funded by banks and administered by the quasipublic Massachusetts Housing Partnership (MHP), closed in 1991. The SoftSecond program features a conventional first and a "softer" second mortgage—both funded by the bank—that combine with a shallow public subsidy to help lower-income buyers qualify for a mortgage. As of this writing, another 15,074 homebuyers have purchased their first home using the SoftSecond program.

The experiment worked. Bankers still lend (the program had a record year in 2009); state officials have expanded the program even when public funds have been scarce; and SoftSecond loans still serve a need in the marketplace. (More than 40 percent of all loans in recent years have been in the 10 communities with the highest percentage of foreclosed homes.) The program's delinquency and foreclosure statistics also tell a compelling story—and one that policymakers should note as they tackle reform of secondary-market agencies and the future of the Community Reinvestment Act. The SoftSecond foreclosure rate is at 1.01 percent whereas, overall, Massachusetts loans have a 3.18 percent rate. The SoftSecond delinquency rate is also lower than statewide averages, even though the SoftSecond serves borrowers making below area median income—60 percent of the area median on average.

What is the source of SoftSecond's success? Simplicity. MHP's SoftSecond features pre- and post-purchase counseling by community-based organizations, low down payments and low monthly payments (thanks to aggressive pricing and targeted public support), and sensible underwriting that manages risk without shutting out the underserved populations it seeks to serve. Banks that are SoftSecond lenders, public officials, homebuyers, and community organizations all have a stake in creating successful outcomes. Indeed, the long-term retained risk to lenders is a model that should guide regulators and lawmakers in the coming debates. "Homeownership done right" is not just an aspirational slogan, it is a reality from our most recent past.

Thomas Callahan *is the executive director of the Massachusetts Affordable Housing Alliance. He is based in Dorchester.*

Endnotes

1 Minnesota's Affordable Advantage required a $1,000 minimum down payment, a credit score of 680 or greater, total housing expenses of 45 percent of income or less, and a mandatory homebuyer education class. See http://www.mnhousing.gov/idc/groups/homes/documents/webcontent/mhfa_010016.pdf.

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by Robert DeFina and Lance Hannon
Villanova University

Mass Imprisonment

Long-Term Harm versus Short-Term Good


iStockphoto

Most people, even most critics of mass-incarceration policies, seem to believe that prisons prevent crime. The notion that building more prisons makes us safer is sometimes called a "ruthless truth" since prisoners cannot commit crimes when locked away.[1]

Commentator James Q. Wilson once put it in terms of good and evil, "Wicked people exist. Nothing avails except to set them apart from innocent people."[2] And when others argue that incarceration is not the most effective way to fight crime, they imply that prisons reduce crime to some extent.

Many observers contend that mass imprisonment as a way to control crime is both inefficient and uncivilized, especially when applied to crimes such as nonviolent drug offenses. As most research shows, there is only a modest crime-reducing benefit from the quadrupling of the national incarceration rate over the last 35 years, a trend mirrored in New England. (See "New England's Imprisonment Rate.") Even that benefit has probably been overestimated, given that measurement efforts have historically ignored prison's potentially criminogenic effect. The popular press has not ignored such possibilities, however. As journalist John Rentoul writes:

> Prison only works in the crude sense that criminals cannot commit crimes—against the rest of us, at least—while they are in jail. When they come out, they are more likely to commit crimes than they were before they went in. So, unless sentences are so long that they cancel out the effect of prison in preparing criminals for a life of crime, prison does the opposite of working.[3]

The problem, Rentoul suggests, is not simply that the experience of incarceration may increase recidivism. The larger issue is that incapacitation works only for the time that people are behind bars. The majority of prisoners go on to spend most of their lives on the outside. Thus at any point in time, the number of ex-convicts living in society will be much larger than the number of prisoners incapacitated behind bars. This large and growing population of ex-offenders gives rise to three concerns.

First, although the prison system claims success for incapacitating dangerous individuals, its harsh conditions might make the prisoners more likely to offend once released. Second, the mass reentry associated with mass imprisonment can destabilize the communities that absorb the influx of reentrants, setting the stage for crime in the broader community. Third, prison's incapacitation effect is limited to people currently behind bars, whereas the crime-*causing* effects will reflect the much larger population of people who were ever incarcerated. So, any full assessment of prison's effects on crime must account for the detrimental impacts of past incarcerations. A handful of very recent empirical social science studies, having taken those three issues into account, conclude that the high incarceration rate has *caused* more crime than it prevented.

Crime Colleges

Good policies solve problems without creating problems. If the public knew, for example, that a software company created and spread a virus while selling products to disinfect computers, it would demand free antivirus software and put the company out of business. But if uninformed about the source of the virus, people might purchase and praise the company's product while lamenting the need for it.

Outside the criminal justice system, the importance of solving self-created problems has long been recognized—for instance, in determining the effectiveness of military interventions.[4] Only recently have social scientists started examining whether prisons partially create the problems they exist to solve.[5] Formerly, data showing that many of those entering prison have been there before—or that crime rates are associated with the number of ex-inmates reentering society—were interpreted to prove that offenders should be incarcerated longer.

An alternative interpretation is that being incarcerated hardens offenders, enhances their criminal skills, and further stigmatizes and alienates them. In other words, prisons can cause crime.

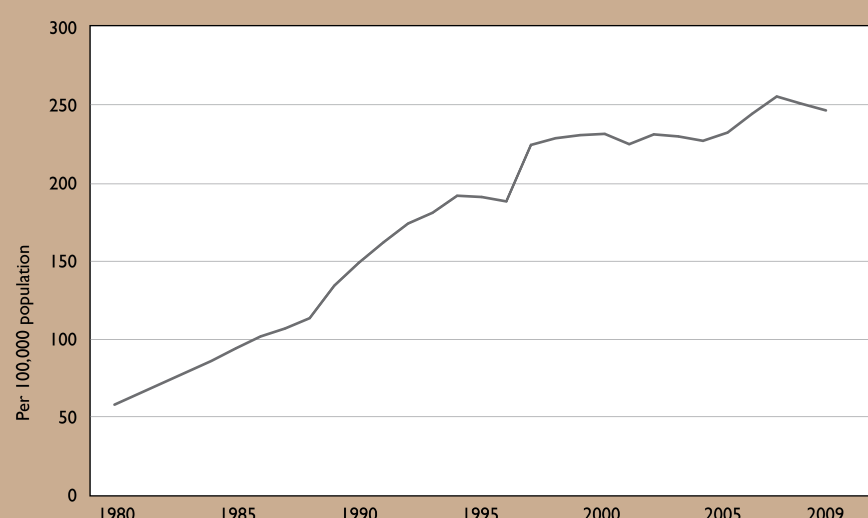
To address this complexity, researchers have started to use statistical modeling techniques that look at the crime-reducing effects of prison and isolate those effects from prison's criminogenic effects. They increasingly focus on subtracting out the crime problems caused and then suppressed by prison from incarceration's total incapacitation benefits. Sophisticated analyses indicate that much of what was previously seen as a crime-*reducing* benefit was actually evidence of crime-*inducing* conditions.

Increased Supply of Ex-Convicts

Putting more people behind bars means that eventually more ex-convicts enter society. Because about 95 percent of those currently incarcerated will return to their communities, recent work on the potential crime-increasing effects of mass incarceration has focused on barriers to successful reintegration.[6]

The scarlet letter associated with a prison record usually means lower wages and

New England's Imprisonment Rate Has More Than Quadrupled in the Past 30 Years



Source: Department of Justice, Bureau of Justice Statistics, annual year-end census of prisoners in state and federal correctional institutions in CT, MA, VT, NH, RI, and ME. Data for 1981 to 1983 are unavailable.

Until now, measurements of the value of prisons to society have ignored prison's potentially criminogenic effects.

less long-term employment. Ex-inmates are further alienated from mainstream society through laws that block their right to vote and to access social-safety-net programs, such as food stamps and Temporary Assistance for Needy Families (TANF).[7] All this increases ex-inmates' offending rate, as they are more likely to find some measure of acceptance in criminal subcultures.

High reentry rates and recidivism are one source of higher crime rates, but so is the population churning that results when large numbers of people are removed from and ultimately sent back to communities. That can disrupt institutions important for social control, making crime more likely. When a neighborhood is in constant flux, it is harder for people to know and trust one another—and to collectively mobilize for the common good. Without a sense of collective identity and efficacy, people are less likely to help one another and more likely to focus on self-interest.[8]

Furthermore, evidence suggests that neighbors who have never experienced prison directly are significantly affected by the population turnover. Particularly in areas with high incarceration and reentry rates, residents generally exhibit diminished respect for government authority and police. The lessened legitimacy of law also leads to higher crime rates—often through lack of cooperation with policing efforts.[9]

Doing the Math

Theoretically, the crime-reducing effects of incarceration and the crime-promoting effects of incarceration have different timing. The crime-reducing effect largely hinges on the number of people incapacitated in the current year. Its criminogenic impact via reentry, in contrast, depends on the number of people released from prison in the current year *and all past years*. Until recently, researchers focused only on how current-year incarceration practices are related to current-year crime rates, biasing the results toward finding an overall crime-reducing impact, although of a relatively small magnitude.

Our own research has concluded that, when the statistical models include past-year effects, any property-crime-reducing benefits of increased incarceration are wiped out by the crime-promoting effects of more ex-inmates in society.[10] Worse still, when past-year effects are appropriately accounted for, the mass incarceration of the last few decades has increased the type of crime the public fears most—violent crime.

Thus, a look at the whole picture makes clear that high incarceration rates are a greater part of the problem than the solution. On a positive note, that means we can significantly reduce violent crime through reform of the criminal justice system. Such reform may include alternatives to incarceration for certain crimes and circumstances. The use of drug courts and associated drug treatment programs is an example of a harm-reduction strategy that is increasingly gaining favor among policy analysts. By using incarceration more judiciously, we can make things better simply by not continuing to make things worse.

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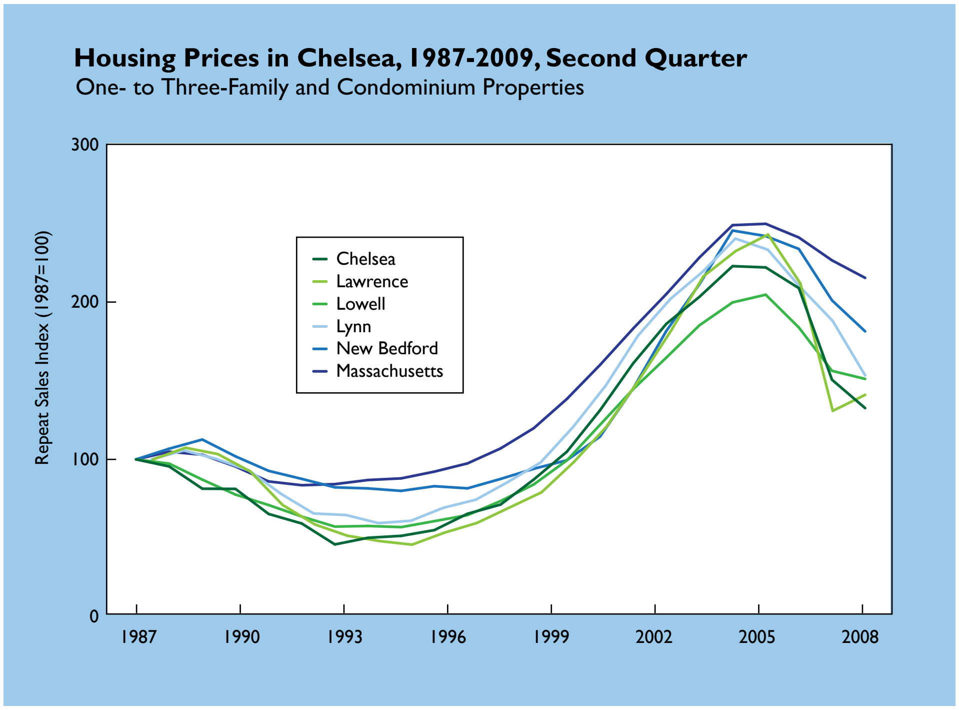
by Lynn Fisher, Lauren Lambie-Hanson,
and Paul S. Willen

Chelsea Combats FORECLOSURE

Chelsea Park. Photographs: Elvis Glavas, Courtesy of the City of Chelsea

It is an accepted fact in the current policy debate that the U.S. housing crisis has damaged communities. Falling house prices and high foreclosure rates are typically associated with increased stocks of bank-owned properties and vacancies (also called "real estate owned," or REO, properties). As neighborhoods become destabilized by vacancies, owners may choose not to invest in their properties or even to sell. They may just leave the community. A recent case study of foreclosures, house prices, and investment in Chelsea, Massachusetts, provides both good and bad news about what can happen.[1]



A Lower-Income Community

Located just north of Boston, Chelsea is home to 34,356 residents. As of the 2000 Census, all of Chelsea's census tracts fell below 80 percent of the Boston metropolitan statistical area (MSA) median family income. More than 56 percent of residents are Latino. Chelsea's land mass is small, about two square miles, making it one of the 50 most densely populated municipalities in the country. According to 2008 census data, there are 12,798 housing units in Chelsea. Its housing stock is old, with almost two-thirds (8,158 units) built before 1940. Only 4,609 of those units are occupied by their owners. Because more than half of Chelsea's housing units are in two- to four-unit buildings, a single foreclosure often affects multiple households.

The bad news is that Chelsea has been hard hit in the housing crisis, experiencing large declines in house prices and many foreclosures. According to repeat-sales indices, by 2009 house prices had fallen by nearly 48 percent from their peak in 2005. The price estimates are not driven by foreclosure sales, as both foreclosure auctions and the sales of bank-owned properties were excluded from the sample studied. Such dramatic price falls, remarkably, are not unprecedented in Chelsea. In fact, through 2009 the descent in this current housing cycle has been significantly short of the price drop that occurred during the last cycle. Between 1987 and 1993, Chelsea's house prices fell by 57 percent.

Collapsing house prices in the current cycle have led to an explosion in foreclosure activity. Between 1998 and 2005, annual foreclosure numbers in Chelsea were in the single digits every year. In 2005 foreclosures started to rise, and in 2008 there were 125 foreclosures, or more than five times more than the 24 total foreclosures occurring in the eight-year period between 1998 and 2005. If short sales are included, the numbers are much higher. Between 2006 and 2009, 357 homeowners left their homes through either a foreclosure or a short sale. According to the tax records, there are about 4,500 condominiums and one- to three-family properties in Chelsea, meaning that roughly 8 percent of the city's owners have lost their properties since the mortgage crisis began. Virtually every residential block in the city has seen at least one foreclosure.

Even for homeowners not directly affected by foreclosure, falling prices have a deleterious effect. No matter which price index is used, anyone who bought after 2000 owns a home that today is worth less than they paid. Since the typical homeowner is highly leveraged, falling prices have completely wiped out the down-payment investment for most homeowners who purchased since the beginning of the decade.

Buyers, however, benefit from lower prices. For first-time homebuyers, falling prices represent an opportunity to get into the housing market that was not present in 2005. But repeat buyers of homes are also sellers, so the reduction in purchase prices is potentially offset by the reduction in the value of their current property.

Making the Best of It

How has Chelsea dealt with falling house prices and foreclosures? Here the news is better. The picture is of a fundamentally viable community coping reasonably well with a bad situation. What would be worrisome is if the foreclosure crisis pushed Chelsea over the proverbial tipping point and transformed it into a dying community in which no one wanted to buy, stay, or invest. Fortunately, there is little evidence that any such dynamic is developing.

For one thing, the stock of bank-owned properties appears to be under control. REO properties, often left vacant, are one of the main avenues by which foreclosures are thought to damage communities. Lenders evict homeowners, then have trouble selling the properties, which in turn may be subject to vandalism and theft of appliances, wiring, and pipes. During 2008, there was some initial evidence of growing REO stocks in Chelsea because lenders' ability to sell distressed properties was not keeping pace with the rise in new foreclosures. But starting in 2009, two changes took place. Lenders rapidly increased their sales of distressed properties. More important, they made increasing use of short sales, meaning that properties were transferred from one *bona fide* homeowner to another and never entered the bank-owned portfolio.

Second, homeowners appear to be investing in their properties despite the collapse in house-price appreciation. Ordinarily, the fear would be that a plunge in house prices and the growing number of homeowners with little or no equity would result in their having little or no long-term interest in maintenance. But Chelsea's building permit data tell a different story. After a dramatic fall in 2008—which may have been exacerbated by wider credit-market problems—the city's permit activity returned to its 2005 level by the beginning of 2009. Among recent buyers there has been little fall-off in property investment. Thus, contrary to some predictions, Chelsea's homeowners have lost equity but not an ongoing interest in their homes.

Third, long-term homeowners appear to remain committed to Chelsea. An exodus of homeowners would be one potential piece of evidence that residents consider Chelsea fatally wounded. In particular, one would expect such a trend concentrated among the homeowners who could most easily leave, the ones who still had positive equity in their homes despite recent price

Chelsea homeowners seem to be investing in their properties despite the collapse in house prices.

falls. In fact, the opposite effect is evident. Owners with more than five years of tenure typically account for 75 percent of all sales in Chelsea, but in 2008 their share dropped to less than half. The exodus was of those owners who purchased at the market peak in 2005, not the city's long-term residents.

This picture of Chelsea is of a community under enormous economic stress but displaying a fair amount of resilience. Chelsea's location means that, ultimately, its viability depends on that of its big next-door neighbor, Boston. So long as Boston is healthy, there will be demand for real estate in a nearby residential community. Fears that the foreclosure crisis would tip Chelsea into long-term decline do not seem to have been well founded.

Although Chelsea is probably not unique, it may not be possible to generalize these findings for the rest of the country or for other cities in Massachusetts. Location is the key issue when making comparisons with other low- and moderate-income municipalities. For similar cities in the industrial Midwest, the collapse of manufacturing has raised questions about their long-term viability. It is likely that an analysis of a city adjacent to a metropolis other than Boston would not paint such an optimistic scenario.

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Endnote

1 See Lynn Fisher, Lauren Lambie-Hanson, and Paul S. Willen, "A Profile of the Mortgage Crisis in a Low- and Moderate-Income Community" (paper no. 10-6, Federal Reserve Bank of Boston Public Policy Discussion Paper Series, 2010), http://www.bos.frb.org/economic/ppdp/2010/ppdp1006.pdf.

Chelsea with a view of the Tobin Bridge.

Chelsea police station.

Economic Education & Financial Literacy

The time has come to revisit economic education and financial literacy efforts and to arm people with the deeper thinking skills they need for assessing new and unexpected situations.

Economic education and financial literacy have long had a place on the list of things deemed to be good for us, right up there with healthy eating and regular exercise.[1] But let's be honest. Most of us aren't going to give up bacon and climb on a treadmill unless we experience a health crisis, nor are we likely to get serious about studying economics and learning the fine points of consumer credit unless we perceive an immediate and compelling need.

Survey after survey reveals that most Americans don't know as much as they should about basic economic concepts and the essentials of managing money, yet financial literacy and economic education initiatives often fail to get much beyond the talking stage.[2] Tight budgets and time constraints have kept them from making their way into the educational mainstream.

Simpler Times

Beyond those obvious barriers is something most people have been reluctant to acknowledge publicly: In the past, formal training in financial literacy and economic principles wasn't really necessary. During the second half of the 20th century, conditions were such that most Americans were able to survive, and even thrive, despite minimal knowledge of economics and little or no training to manage their finances. Economic and financial choices were fewer and less complex.

Take the example of applying for a home mortgage. In 1960, or even 1990, the application process may have been scary for the first-time buyer, but it was fairly straightforward, defined by tradition and government regulation. Buyers had to come up with a substantial down payment—often 20 percent—and their monthly payments couldn't exceed a certain percentage of income. Lenders even held to the quaint practice of verifying a borrower's income and employment status. Anyone who didn't have the down payment or didn't meet the income requirements didn't get a loan. It was that simple.

In some ways it was also easier for a young person to avoid falling into the consumer debt trap. Banks were less willing to put credit cards in the hands of 20-year-olds, and education loans were small enough to repay within a reasonable amount of time, before the next generation went off to college. Informal social taboos against spending, borrowing, or consuming to excess provided an extra layer of restraint. "Don't charge Christmas!" was a widely accepted maxim of financial folk wisdom. And every family had at least one member who had lived through the Great Depression and whose mission in life was to remind everyone within earshot that good times don't last forever.

Today's Reality

But the realities of the 21st century global economy are far different from those of mid-20th century America. Somewhere along the way, jobs became less secure, financial dealings became more complicated, and Americans decided that the economy works best when government "gets out of the way" and allows markets to function with minimal regulation. We also chose, in ever increasing numbers, to slip the bonds of caution, self-discipline, and self-denial. The old ethic of "Use it up, wear it out, make it do, or do without!" gave way to "Shop 'til you drop!"

As a result, there are now fewer safeguards and restraints to protect us from ourselves and others. Ours has become a self-service world, in which the phrase "Buyer, beware!" has taken on renewed significance.

True, the recent financial crisis has prompted lenders to tighten their standards, but there's no telling how long their caution will last. And, yes, Congress responded to the crisis by creating the Consumer Financial Protection Bureau, but it remains to be seen how much actual power and influence the CFPB will be able to exercise.

In any case, the ability to make sound financial decisions and the capacity to understand basic economic concepts have become essential survival skills. Educators, parents, and politicians largely agree on the need to help more people acquire those skills. But beyond that, consensus is more difficult to achieve.

Financial literacy proponents want to focus on helping people learn to make financial choices that will lead to using money wisely and building wealth. They also emphasize skills and training to help consumers avoid the pitfalls of the marketplace. But they don't always agree on what to teach or how best to teach it, nor do they all agree on how much government regulation, if any, is needed to protect consumers.

Proponents of economic education have their own internal differences. One camp favors the straightforward teaching of basic economic concepts. Another promotes the virtues of entrepreneurship. Others would use economic education to advance a specific agenda: free trade is good (or bad), government regulations are good (or bad), higher taxes, lower taxes—you name it, and they're for it … or against it.

Which approach is best? Perhaps that question is best set aside for now.

Alfred Marshall Revisited

Rather than spending an inordinate amount of time and energy debating an issue that has no simple solution, we might do better to adopt the view of Alfred Marshall, who

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saw economics as the study of humankind "in the ordinary business of life." Marshall fell out of favor during the mid-20th century, but his words are well suited to serve as a peg on which to hang the many hats worn by economic and financial educators.

The best chance for delivering effective economic and financial education may lie in helping people to make the connections between economics and the ordinary business of life—connections that include the ability to make sound financial decisions, build wealth, safely navigate the hazards of the marketplace, *and* evaluate the increasingly complex policy decisions we face as citizens.

But in an age of increased time pressures and scarce resources, how and where do we proceed?

In some ways, financial literacy might seem to be an easier sell and a better fit for these turbulent times. The need is immediate and apparent. Anyone who ventures into the marketplace—the young, the middle-aged, the elderly—ought to know as much as possible about managing money and using credit wisely.

But is that enough? Isn't there more to economic life than "getting and spending"?

If people are taught only to shop wisely and manage money sensibly, when all is said and done, they will be little more than smart, financially comfortable *consumers*. Whereas if they also learn to use economics as a framework for analyzing the world around them, they will be smart, financially comfortable *citizens*.

If, for example, someone tells them that protectionism is the answer to their uncertainties over globalization, they will be able to assess the true cost of propping up an industry that may be outmoded or inefficient. Or when times get tough, and someone comes along promising simple solutions that will return them to a golden age that never was, they will be equipped

At the Boston Fed's Economic Adventure, visitors gain access to economic education, financial capability, and skills for evaluating information. Photograph: Heidi Furse

to pose the appropriate questions with a certain degree of skepticism.

Of course, there are limits to what economic and financial education can accomplish. The ultimate goal is not to turn everyone into a trained economist or a certified financial planner, but rather to provide citizens with a basis for making their own assessments.

In broad terms, if financial literacy and economic education efforts are successful, they will enable citizens to:

1. Evaluate the true cost of something, whether it's a consumer product, a financial instrument, or a government policy.
2. See the connections between actions and outcomes.
3. Spot a snake-oil salesman who is peddling a "fabulous deal" that's too good to be true … or a seemingly simple solution to a complex societal problem.

We face difficult economic and financial choices that require a greater level of sophistication on the part of our citizens. A basic grasp of economics and personal finance will not only improve our ability to function in the marketplace and build wealth for the future, it will also help us to sensibly engage—as voters, taxpayers, and consumers—with the big issues of our time.

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Endnotes

[1] Financial literacy focuses mainly on the knowledge and concepts each of us ought to know in order to manage money effectively and build wealth—things such as the mechanics of compound interest, the basics of investing, the prudent use of credit. Economic literacy deals more with how all of us function in the marketplace, or as Alfred Marshall described it, "in the ordinary business of life." Perhaps the most fundamental economic principle deals with scarcity and choice—the fact that limited or finite resources influence the choices we makes as individuals and as a society. In recent years, yet another term—"financial capability"—has entered the mix. It refers to a person's ability to effectively use the knowledge and concepts associated with financial literacy.

[2] The following surveys are just three among many that indicate most Americans don't know as much as they should about basic economic concepts and the essentials of managing money: *Financial Capability in the United States,* FINRA Investor Education Foundation, 2009, http://www.finrafoundation.org/resources/research/p120478; *The Financial Literacy of Young American Adults*, The Jump$tart Coalition for Personal Financial Literacy, 2008, http://www.jumpstart.org/survey.html; and *What American Teens & Adults Know About Economics*, The Council for Economic Education, 2005, http://www.councilforeconed.org/cel/results.php.

Survey of Community Banks Explores Credit Crunch

Restricted access to credit, especially decreased availability of bank credit to small businesses, is often cited as a potentially important factor in amplifying the recent recession's effects and contributing to the weakness of the subsequent expansion. *The 2010 Survey of First District Community Banks*, conducted by the Federal Reserve Bank of Boston in May 2010, examines how the supply of, and demand for, bank credit changed in late 2008.[1] The 2010 survey tries to explain how much community banks were willing and able to lend to local businesses that once were customers of large banks but lost access to credit in the financial crisis. In addition, it assesses to what extent the Small Business Administration (SBA) lending programs improved access to credit for small businesses.

The main finding is that community banks tightened lending standards for commercial loans moderately following the most acute phase of the crisis. The tightening was more severe for new customers than for those that already had a relationship with the responding bank. The survey results also suggest that the SBA programs were somewhat effective at promoting business lending among New England community banks, especially among SBA-preferred lenders.

Tightening of Bank Credit

Responses to the survey questions pertaining to changes in loan applications and originations during the fourth quarter of 2008 suggest moderate tightening of bank credit. More than 40 percent of respondents reported that the dollar volume of new originations remained essentially unchanged. However, there were more banks (40 percent) reporting a decrease in origination volume than an increase (16 percent). The most frequent response (43 percent) to the question about changes in the total number of applications for term loans and lines of credit was that overall applications were unchanged, but more bankers (41 percent) reported that applications decreased than reported that applications increased (16 percent).

According to data provided by respondent banks, applications for loans rose from 2006 to 2007 but fell from 2007 to 2010. The number of term loans originated started falling later in 2008, with the decline decelerating in 2010. The rate of decline for line-of-credit originations, however, accelerated rapidly, reaching more than 20 percent in 2010. The steeper decline is consistent with the researchers' hypothesis that, during the economic downturn, banks were more reluctant to grant new or renew existing lines of credit than to originate term loans.

The survey results provide preliminary evidence that businesses that had relied on large commercial banks for credit turned to community banks as large banks cut back on lending after subprime-induced balance sheet losses led to capital constraint. The tightening of business lending at the respondent community banks was more severe, however, for new customers. The respondents reported that everything else being equal, in 2008 and 2009, the bank was more likely to grant credit to customers with an existing relationship.

Also, the median approval rate for lines of credit and term loans fell more for applications from new customers than for overall applications between 2008-2009 and 2009-2010.[2] And the tightening of underwriting standards for both was reported to be greater for new customers than for existing customers.[3] The patterns suggest that community banks became tougher with new applicants after the shock of seeing Fannie Mae and Freddie Mac being taken into conservatorship in late 2008—identified by the representative bankers as the most relevant event of the financial crisis for local community banks.

SBA Programs

The survey also attempts to assess whether the SBA lending programs were effective in improving the availability of bank credit for small businesses during the crisis. SBA lending programs—many of them expanded by the American Recovery and Reinvestment Act of 2009—are meant to facilitate lending to small businesses. Key provisions in the ARRA include the following: the elimination of the up-front guaranty fee for loans with maturities greater than 12 months, and the extension of SBA guarantees to lenders up to 90 percent of the loan value for most 7(a) loans.[4] Additionally, thanks to permanent changes to the 504 Certified Development Company loan program, small businesses seeking to expand should be able to refinance existing loans used to purchase real estate and other fixed assets.[5]

Most respondents (106 banks, or 78 percent) indicated that they participated in at least one of the SBA programs. Furthermore, 35 percent of the respondent banks were SBA-preferred lenders, to which the SBA has delegated loan approval, closing, and most servicing and liquidation authority and responsibility. The survey asked the banks to estimate the percentage increase in the dollar value of business loans since 2008 made possible by the availability of SBA programs. Among the banks that

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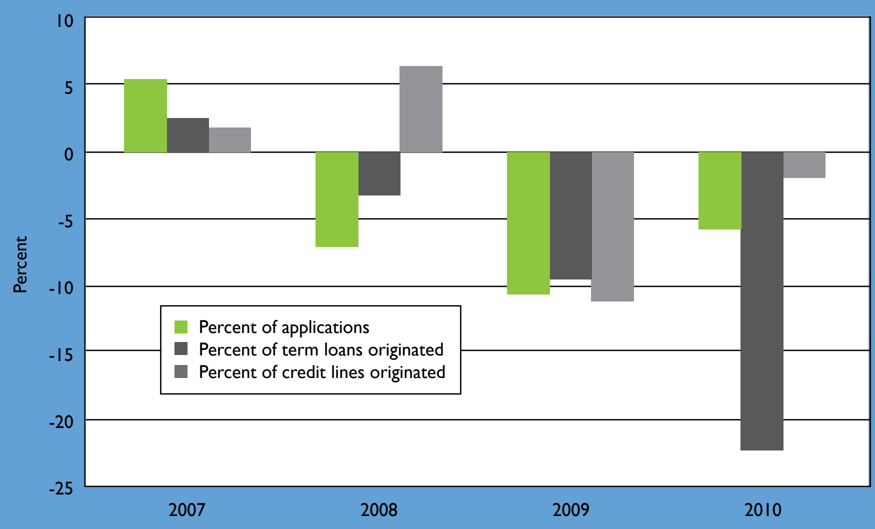
Growth Rate in Percent of Loan Applications and Originations



Note: Median of the balanced panel of 47 banks that reported data for all the sample years

responded, 38 percent reported that the SBA programs made no difference. The median increase in business loans attributed to SBA programs was 5 percent and the mean 11.38 percent. Unsurprisingly, SBA-preferred lenders were less likely to report that SBA programs made no difference (18 percent) and attributed higher value to the SBA program. The results suggest that the SBA programs were somewhat effective at promoting business lending among community banks in New England, especially among SBA-preferred lenders.

Implications

In summary, survey results suggest that New England's community banks tightened credit after the onset of the financial crisis, with the tightening greater for new customers than for existing customers. Tighter underwriting standards for new customers make sense from an individual bank's point of view. The bank may have private information regarding the credit worthiness of existing customers and a vested interest in the relationship. They may also worry about adverse selection. It is difficult to ascertain whether a business's line of credit was not renewed by another bank because that bank developed balance sheet problems or if the other bank had private information indicating that the business was a poor risk.

It is less obvious why underwriting standards for new customers should have been tightened more than for existing customers during the last two years. One possibility is that the community banks believed that information asymmetry had become more severe, since larger banks are likely to shed their most problematic customers. Another possible reason is that community banks wanted to slow the growth of their assets in the face of a rather uncertain economic outlook, while protecting their investment in relationships with existing customers.

Overall, community banks do not appear to have been able or willing to offset the contraction in the credit supply stemming from large banks' actions. The survey responses do provide some evidence in support of the efficacy of SBA lending programs in boosting the supply of credit to small businesses. This suggests that further expansion of the SBA programs could be effective in increasing the supply of credit to small businesses.

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Acknowledgments

The author wishes to acknowledge the contributions of Judit Montoriol-Garriga, Robert K. Triest, and J. Christina Wang.

Endnotes

1 This article draws from Jihye Jeon, Judit Montoriol-Garriga, Robert K. Triest, and J. Christina Wang, *Evidence of a Credit Crunch? Results from the 2010 Survey of First District Banks* (public policy brief 10-3, Federal Reserve Bank of Boston, 2010), http://www.bos.frb.org/economic/ppb/2010/ppb103.pdf. Of the 268 banks receiving the questionnaire, 135 responded. The response rate for qualitative questions was far higher than for quantitative questions. Ninety-two percent of the banks (124 banks) provided answers to at least one of the qualitative questions. Only 62 percent (84 banks) answered one or more of the quantitative questions, and only 33 percent of them (44 banks) answered all of the quantitative questions.

2 The median approval rate was calculated for only 41 banks whose answers were coherent. For other respondents, which were excluded from the calculation, the reported number of lines of credit originations plus the reported number of term-loan originations exceed the reported number of applications for both types of contracts.

3 In regard to underwriting standards for lines of credit, most (57 percent) of the responding banks indicated that standards for existing customers remained basically unchanged, with nearly all the rest reporting that they had tightened standards somewhat (37 percent) or considerably (5 percent). By comparison, just 40 percent of respondents reported that standards for new customers were unchanged, whereas 51 percent reported that they had tightened somewhat for new customers, and 9 percent responded that they had tightened considerably. The responses to the questions about underwriting standards for term loans are similar but reflect somewhat less tightening.

4 The 7(a) loan program provides loan guarantees to approved banks and other approved lenders in order to help small entrepreneurs start or expand businesses. The SBA expanded the eligibility criteria for 7(a) loans in May 2009.

5 The 504 program provides small businesses with long-term, fixed-rate financing to acquire fixed assets for expansion or modernization.

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