

Payday Lending: Perfunctory Or Predatory?

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ABSTRACT

Payday lenders are becoming more common across America as they meet the unique needs of consumers unable or unwilling to use the services of more traditional lenders. But many have claimed that certain of their practices are unethical. Do payday lenders take advantage of those less fortunate in our society? Are their fees exorbitant, or are the fees merely a fair return given the risk the payday lenders are incurring? This case looks at these and other issues surrounding the payday lending industry.

Keywords: payday lending, finance, interest rate, ethics

INTRODUCTION

In the last 15 years, cities around America have seen a dramatic rise in the number of payday lending stores open for business. Today there are over 22,000 payday lenders operating in the 39 states where payday lending is legal. To put that number in perspective, there are 13,700 McDonald's and 7,300 Burger Kings in the U.S.—simply put, there are more payday lenders than McDonald's and Burger Kings combined (Weston).

But why? As traditional financial institutions tighten up loan requirements and drop smaller, less profitable loans from their books, payday lenders feel they are filling a substantial need in the communities they serve. They make the process of getting a short-term loan without a lot of paperwork and credit requirements easy for those who use their services. It works like this:

A customer brings in their most recent pay stub which ought to show an after tax income of at least \$200 a week, a check book, and a driver's license or state I.D. The lender provides a short-term loan of around \$500. The customer leaves behind a personal check dated for their next payday (typically two weeks) for the lender to cash when the loan comes due. There is no credit check done on the customer and no collateral is necessary (Nelson). With this arrangement, the difference between the face value of the check and the amount of cash received by the borrower represents the service charge or interest on the loan. The payday lender agrees not to deposit the check for a predetermined period of time, typically two weeks or until payday. On the due date, the payday borrower with sufficient funds can allow the lender to deposit the original check or pay the loan off with cash. In most cases borrowers do not have the funds to pay off the original loan. When that is the case, the common option will be to process a "rollover" or "renewal."

Critics of the payday lending industry charge that this is nothing more than legalized loan sharking, and that the industry preys upon the poor, minorities, the uneducated, and those with little to lose. They cite that those who use payday lenders typically cannot pay when the loan is due and must consequently "rollover" or "renew" the original into another loan, effectively extending the loan for additional two-week periods in exchange for cash payments of additional interest and extension fees. In either form, the new loan must be enough to pay the original loan plus the new fees. The fees associated with the original loan under this arrangement, when expressed as an annual percentage rate ("APR"), are astronomical, anywhere from 390% to 7,300%, depending on the state's interest rate cap. Between the mounting fees of the rollover and the exorbitant interest rates, a customer simply cannot get ahead and will fall deeper into this loan trap, much to the financial benefit of the payday lender.

Payday Lending: Perfunctory

The payday lending industry typically asserts that payday loans are designed to meet short term emergency cash needs and are not supposed to be used to fund long term financial obligations. They argue that their high fees are commensurate with the value of the services they provide to their segment of borrowers. Because they must operate a high density of stores and these stores must be kept open beyond normal business hours, their operation costs are abnormally high. Additionally, the industry faces a high incidence of loan defaults. Regardless of the type of loan market the industry is serving, they argue that loan defaults raise their cost of doing business relative to traditional lenders. If excessive profits are possible in the payday lending industry, the argument goes, competitive market forces should bring the costs, and therefore the payday loan rates, down to their equilibrium levels.

The Community Financial Services Association of America (CFSA) is the national association for the payday lending industry. They represent 164 member companies, which constitute more than half of the payday lenders in the U.S. In order for a member company to join CFSA, they must be in compliance with the CFSA's Mandatory "Best Practices" (Schlein and Medsker).

Member Best Practices includes full disclosure to comply with the Truth-in-Lending Act which must disclose the cost of the service, in terms of its Annual Percentage Rate and its corresponding dollar amount. CFSA member businesses must also comply with rules regarding truthful advertising, a customer's right to rescind on the loan within a specified time frame, use appropriate collection methods, and limit the number of rollovers, as dictated by state law (RTO Online).

In 2008, the newest addition to CFSA's Best Practices, is the display of prominently featured posters (at least 18" X 22" in size) which disclose the actual Annual Percentage Rate (APR) of the payday loan. The poster is to be conspicuously posted in CFSA member businesses for potential customers to see. It is CFSA's goal that their member companies are held to a high standard and that they surpass all rigorous state laws when it comes to rate disclosure and compliance.

Although their Annual Percentage Rates are high, CFSA points out that their rate in comparison to financial institutions and credit card companies' fees isn't as shocking as it may first appear. For example, a \$100 payday advance with a \$15 fee amounts to a 391% APR. Taking that same \$100 as a bounced check averages a \$54 Non-Sufficient Funds and Merchant Returned Check Fees which amounts to a 1,409% APR. Again, that \$100 as a credit card balance with a \$37 late fee amounts to a 965% APR (CFSA). William Webster, the CEO of Advance America, the largest payday lending player in the U.S. states, "Payday lenders are required by law to treat their whole fee for a two-week loan as interest, causing it to show up as a steep annual percentage rate, while banks can call their fees 'non-interest income'" (Forbes).

CFSA also refutes their critics' claims of taking advantage of the poor, the uneducated, the financially "unserved" or "underserved", and the elderly. A 2001 study (Elliehausen and Lawrence) found that:

- The majority of payday lending customers earned between \$25,000 and \$50,000 annually
- 68% of those are under the age of 45
- 42% are homeowners
- 94% are high school graduates with 56% having a college degree
- 100% have steady incomes and an active checking account

The industry finds that they typically are helping those who are younger and have a limited understanding of finances, people who are already deeply in debt, people who are living "pay check to pay check", and those with a history of using high-risk lending services such as pawn brokers and check cashing outlets (Payday Today). To help combat the barrage of negative information and misinformation about the payday lending industry, CFSA has set up a website called Payday Pundit. The website is designed to help educate those who are seeking out the truth about payday lending. CFSA is using this platform to dispel rumors, correct media errors, comment on the short-term lending industry as a whole, and give legislators and the public a better understanding about the payday lending industry (PR Newswire).

Many users of payday lenders would argue that the payday lending industry is not taking advantage of them. The anti-payday lending lobby does not represent their views and may not have their best interest at heart. Those who feel they use payday lenders responsibly aren't comfortable with the idea that someone who likely has never had financial difficulty should tell them where they can and can't borrow money.

Payday lending provides a much needed service for working people who may find themselves caught short between paychecks. Without a regulated industry for short-term loans, there may be undesirable consequences such as an increase in bounced checks, a higher number of late payments, or more families forced to go without basic necessities between paychecks. Although payday lenders may not be traditional lenders, they are a fast and easy option for those who need access to additional short-term funds.

Payday Lending: Predatory

"Plugging a hole in a dam with chewing gum is a good analogy for using a payday loan to solve a financial problem," comments Steve Bucci of Bankrate.com (Bucci). "Solving long-term problems with quick fixes is rarely a bargain." Critics of payday lenders argue that despite the fast relief payday lenders offer their patrons, it can be a financial disaster in the long-term.

Most borrowers have difficulty coming up with the necessary cash to pay off their first loan in the short span of two weeks. They simply have no other option but to rollover their payday loan into a larger payday loan. The Center for Responsible Lending found in a 2005 survey that 90% of payday lending borrowers engaged in five or more payday lending transactions a year, with 62% of borrowers engaging in a dozen or more transactions a year (Coombes). There seem to be very few payday lending customers who use the service only once. Additionally, another study by the Center for Responsible Lending found that, "...[A]nalysis shows that borrowers who receive five or more payday loans in a year account for 91% of payday lender's revenue" (Ernst, Farris, King).

If that weren't enough, the Federal Reserve has found that getting into debt is getting more expensive for low income people. In 1989, the difference in loan rates between a low income household (defined as \$30,000 or less) and a high income household (defined as \$90,000 or more) was an average 16.8%. In other words, a lower income family paid an average loan rate 16.8% higher than a high income family. By 2004, that difference had spread to 56.1% (Grow and Epstein). The Federal Reserve attributes this widening gap to an increase in technology, allowing some lenders to manipulate systems to find ways of "creatively" lending money to the poor at rates far beyond what traditional lenders would charge.

Further, many studies have found that payday lenders set up shop in very strategic areas within the states in which they are allowed to operate. Research has found that payday lenders typically are found in poorer neighborhoods, around military bases, and as one study suggests, in areas with a large evangelical Christian majorities (Maffly). This study, which focused on ZIP codes, found the bulk of payday lending activity in the states of Utah, Mississippi, South Carolina, and Alabama.

Race and poverty also seem to be a primary factor in payday lending disparity. African Americans were 2.8 times more likely than white borrowers to receive sub-prime financing. In Milwaukee, Wisconsin, a large urban area, they were 4.3 times more likely (Droque). Milwaukee is one of the highest rated cities in the nation for racial disparity in non-traditional (i.e. payday) lending. In the year 2000, 46% of all loan refinances made to African-Americans in the Milwaukee area were sub-prime loans (Droque). It should be noted that this figure includes payday lending rollovers and loan financing to non-traditional lenders such as car title cash loans.

Wisconsin is one of the two states in the U.S. not to have an interest rate cap on lending, and has found itself awash in payday lenders throughout the state. The Wisconsin Department of Financial Institutions had licensed 2 payday lenders in 1995, and as of 2004 has licensed 346 (Radatz). In Wisconsin, the Department of Financial Institutions must license non-bank or credit union entities that charge an average annual interest rate of 18.0% or higher. The average payday lender in Wisconsin charged 542.2% and found its customers coming back an average of 12 times per year (Radatz).

The 2003-2004 Wisconsin State Legislature passed the 2004 Assembly Bill 665 which would have provided specific regulation of payday lenders. Governor Jim Doyle vetoed the bill on the grounds that it was “toothless” and called upon the legislature to “make real changes in the regulation of payday lending. . .that will ensure the protection of Wisconsin consumers” (Fox).

Not surprisingly, consumer groups have found that the number one special interest group to contribute to Wisconsin’s election campaigns is out-of-state payday lenders. Assembly Bill 612 and Senate Bill 96, both introduced in 1999 and both aimed at limiting the power of payday lenders in the state, died in committee. Two of the representatives, Senator Kimberly Plache of Racine, and Representative Jon Erpenbach of Middleton, were credited with killing the bills. They were found to be the number two and number three top dollar recipients, respectively, of campaign money from the payday lending industry from contributions given between 1997 and 1999 (Wisconsin Democracy Campaign).

The Federal Deposit Insurance Corporation (FDIC) is the regulatory insurer of most banks around the U.S. The agency has recently embarked upon a two year pilot program to help banks compete with the payday lending industry. The program is offering loans to customers of up to \$1,000, and with extended payment schedules with rates not exceeding 36%. The participating banks are encouraged to have low or no origination (application) fees and no prepayment penalties (Gores). Thirty banks from seventeen states have been selected to participate in the project. FDIC Chairman Sheila Bair said the aim of the program is “. . . to establish profitable and affordable alternatives to payday loans and other high-cost loans that are harming consumers and communities across America” (Gores).

The Wisconsin Credit Union League is also getting in on the act. Their recently launched “People’s Payday Alternative Loan” or People’s PAL. This program is designed for credit union members to borrow up to \$500 at a cost of \$9.25 per \$100 borrowed, which they estimate to be a 50% savings over Wisconsin’s payday lenders. The members are also given 30 days to pay off the loan, more than twice the usual time for a payday lender’s loan to be paid. Further, if a member uses the People’s PAL successfully more than three times in six months, the member is eligible to apply for a “Next Step Loan” which is more like a traditional loan with its rates and terms. The Next Step Loan will report on a member’s credit report, allowing them to build up their credit and move them into traditional financing in the future (Wisconsin Credit Union League).

Many payday lenders see this sort of competition as a way for them to get a slice of the profitable pie. However, most traditional financial institutions see it differently. North Carolina State Employees’ Credit Union has been offering an alternative to payday lending since 2001. Their program is designed to charge members a 12% interest rate with 5% of the loan’s proceeds going into a savings account for the user. Each month, North Carolina State Employees’ Credit Union has more than 40,000 people using this product, and its members have thus far accumulated \$10 million in their savings accounts (Kirchhoff). It is the hope of traditional lenders to see an increase of former payday lending borrowers using these new programs.

It is also the hope of consumer advocates that these innovative and non-traditional programs will drive customers away from payday lenders. With the many regulations and laws that traditional financial institutions face, advocates see this as an opportunity for people to get out of the payday lending trap and into short-term loan financing with community benefit. Jim Blaine, CEO of North Carolina State Employees’ Credit Union, doubts that his service will completely shut down payday lenders for good. Blaine foresees that the comfort and non-intrusiveness of the payday lending application and process will continue to be a draw for many, despite the high rates and outrageous fees. Says Blaine, “People are so embarrassed to talk about their finances . . . it’s not an exception. The normal thing is living payday to payday” (Kirchhoff).

CONCLUSION

Ironically, what was stated as the reason for the spread in payday lending (the lack of short-term loans at traditional financial institutions) is what may drive some payday lenders to someday go out of business, now that more traditional short-term loans are coming back. Whether or not the initiatives put forth by banks and credit unions will be “too little too late” to stem the rise of payday lenders is yet to be seen.

Financial literacy (or the understanding of basic financial concepts) is at an all time low in the U.S. In 2001 surveys (Elliehausen and Lawrence) found:

- 66% of high school seniors failed a basic economic test
- Only 32% of parents speak to their children regularly about finances
- 43% of adults in the U.S. with the lowest level of financial literacy live in poverty, compared to only 4% of those at the highest level of financial literacy
- The likelihood of being on welfare is inversely proportional to financial literacy levels
- The personal savings rates of Americans went negative for the first time in 1998. The amount of that negative savings rate has increased every year since.

Given the status of financial literacy in the U.S., it is little wonder that non-traditional lenders have cropped up with tempting offers of granting easy credit regardless of the cost. Whether or not they are filling a legitimate need in their communities, or taking advantage of those with little to lose, is a matter of interpretation and perspective. Senator Dick Durbin, (D-IL) introduced S500 in late February of 2009 and Representative Jackie Speier (D-CA) followed suit in the House in March of 2009, introducing H.R. 1608, to place a 36% APR cap on combined payday loan fee and interest (Public Favors). This rate is similar to usury caps already enacted in many states, and is the same as the cap already in place for military personnel and their families. Additionally, Ohio, Arkansas, New Hampshire, and Arizona are among states that recently revoked legal exemptions from usury caps their lawmakers once gave payday lenders. However, 35 states have yet to pass reforms that would stop such practices.

CASE QUESTIONS

1. Are the users of payday lenders being exploited?
2. Is it ethical to let borrowers continue to escalate in their indebtedness to a payday lender?
3. Is a large poster at payday lending stores prominently displaying the APR of the loan enough by way of informing consumers?
4. Is the practice of payday lending in the best utilitarian interest? That is, does payday lending provide for the greatest good for the greatest number?
5. Do payday lenders treat their customers equitably? Is it ethical that “low income households” should be charged a higher rate than a “high income household”?
6. Given the low state of financial literacy, do payday lenders have an obligation to explain the terms of loans in “plain English” (in a way that everyone can clearly understand the terms)? Is their obligation any greater than it would be for a traditional financial institution?
7. Is it ethical for payday lenders to make contributions to politicians or political parties? Is your answer different for traditional banks and credit unions?

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TEACHING NOTES

1. Are the users of payday lenders being exploited?
2. The people who use payday lenders are at a disadvantage. Most times, people go to a payday lender when they are desperate or feel they have no other option. They are getting what they need in the short-run, but may be putting themselves at a disadvantage to their financial futures in the long-run. An APR doesn't really mean much to a person unless it's clearly spelled out what it actually means in real terms. All lenders should be very clear about the APR and fees a person will be charged on a loan. It should be plainly stated in a reasonable person's terminology. Payday lenders ought to also stress the quick turnaround time in which they expect the loan to be paid back, and find out if it is even *possible* that a person would be able to meet that obligation in two weeks flat.
3. Is it ethical to let borrowers continue to escalate in their indebtedness to a payday lender?
4. People who are "desperate" often can't afford (both literally and figuratively) to think about the long-term. A rational payday lender will know that they do not want to lend money to a person who cannot pay it back. Payday lenders should look at the two week window to see if a person can realistically pay their obligation off in such a short amount of time. If it seems quite doubtful, perhaps they shouldn't lend the maximum amount. Alternatively, they might just lend a smaller amount to help the person get by, giving them the ability to pay back in two weeks.
5. Is a large poster at payday lending stores prominently displaying the APR of the loan enough by way of informing consumers?
6. One should ask the question, are the customers walking into the store even paying attention to posters, or are they just focused on getting the money they need right away? Some would claim "let the buyer beware." Others take a more encompassing view and claim that it is the company's responsibility to make sure the customer fully understands all aspects of the loan, even if not required by law.
7. Is the practice of payday lending in the best utilitarian interest? That is, does payday lending provide for the greatest good for the greatest number?
8. It would depend on who was asked. If a borrower from a payday lender, or a payday lender, was asked, then they would most likely say that payday lending is in the best utilitarian interest of all. However, ask an anti-payday lending advocate, and they would disagree. The two groups' views vary primarily because of the way each would assign utility to the various outcomes of payday lending. These two sides are clearly in an adversarial battlefield. The activist might have trouble seeing the person's immediate desperation for the cash; whereas the customer might not see how this could harm them in the long run. Setting up a more discursive dialogue between the groups might help alleviate the confusion and arrive at a more consistent utilitarian conclusion.
9. Do payday lenders treat their customers equitably? Is it ethical that "low income households" be charged a higher rate than a "high income household"?
10. In reality, if payday lenders are being discriminatory in terms of the rate they charge based on income, then they are in violation of the Truth-in-Lending Act. It can be hard to make a blanket statement about the payday lender's equitable treatment of people, since some would argue that the underlying cause which brought the person to a payday lender in the first place makes each situation unique. Ultimately, most would argue that the question of equity hinges on data. Given the adversarial nature of payday lenders and their detractors, it's hard to say whose data is more correct; therefore, it's impossible to settle the question of equity.

11. Given the low state of financial literacy, do payday lenders have an obligation to explain the terms of loans in “plain English” (in a way that everyone can clearly understand the terms)? Is their obligation any greater than it would be for a traditional financial institution?
12. The Truth-in-Lending Act doesn’t require any institution to do more than go over the very basic terms of the loan. Ethically, companies should make sure the borrower fully understands all aspects of the provisions of the loan. And this should be in a format that is understandable to the individual given their unique nature (financial literacy, spoken and/or written language understood, etc.)
13. Is it ethical for payday lenders to make contributions to politicians or political parties? Is your answer different for traditional banks and credit unions?
14. It’s a very fine line between what constitutes “correct” in the business-government intersection. Many would argue that it is unfair for wealthy companies to influence politicians in ways that ordinary citizens, without similar capital assets, are able to do. Others would suggest that companies are important stakeholders in governmental issues and thus should have an equal "seat at the table," which would include the ability of making financial contributions.