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Financial Capability Depends on More than Knowledge and Skills–and Public Policies Can Help

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Citing low performance on financial literacy tests, policy makers – and recent U.S. Presidents – have called for financial literacy for all Americans. They cite research showing that only a third of adults can correctly answer basic questions about how savings and finances work.

By itself, however, low financial literacy cannot account for the fact that 9 million U.S. households (7% of all households) lack a bank account, nearly two-thirds (64%) lack an emergency savings account that would cover three months of expenses, and just over half (56%) worry they will run out of money in retirement. Low financial literacy does not explain why 30% of people living in low-income communities have no credit records. Nor can lack of financial savvy explain why more than 40% of Black and Hispanic respondents reported making late payments on student loans, or why the 12 million people who borrow with payday loans and the 2.5 million who borrow using auto title loans pay about $12 billion in fees each year. Inadequate financial literacy certainly cannot explain why whites on average hold three times the retirement savings of black and Hispanic families.

The precarious state of household finances for so many Americans suggests that financial capability involves people's access to financial opportunities. It is not enough for people to know what they might do. To be financially capable, people must be able to act – and the United States needs financial services and policies that help them reach financial goals.

Why Access to Financial Services Matters

Consider two high school students - Jaya and Signe - who are enrolled in a required financial education course. Both are good students and each has a part time job. Both are members of families and neighborhoods that are struggling financially; and both girls' parents rely mostly on "alternative" financial services such as check cashing stores and payday lenders. Yet despite all these similarities, their level of financial capability differs.

- *Jaya's story*: An attentive student, Jaya follows the lessons from her financial education class, and tries to open a checking account. She quickly discovers she earns too little to avoid fees, so she takes the teller's advice and opens a savings account. This goes well until school starts in the fall, when she reduces her work hours to allow more time for school. Failing to track her account closely, Jaya realizes that after a few months her savings balance has fallen below the minimum and incurred steep fees. She is discouraged. She thinks the bank is unfair. Earlier, her mother had warned about using the bank, saying "You can cash your check at the grocery store for a lot less." Now Jaya follows her mother's advice. She withdraws the rest of her savings from the bank, saving at home instead. This experience leaves Jaya with a negative view of banks; she feels that banks are for other people.

- *Signe's story*: Signe also takes a financial education course, but she also happens to live in a state that opens a Child Development Account for every child at birth. At account opening, the plan offers a "seed" deposit of $500. Moreover, a local nonprofit, in partnership with a local financial institution, makes low-fee bank accounts available to working students, and helps the students build their Child Development Account. When Signe takes the required high school financial education class, she already knows about saving for college since she's been accumulating funds for that purpose and receiving financial statements for as long as she can remember. Signe has a positive view of financial institutions. In addition, since her savings have been accumulating for 18 years, she feels a sense of security and confidence about her future options.

Clearly the contrasting capabilities of these two girls have to do with more than just knowledge. Although Jaya has a job and attended a financial education class, she lacks opportunities that might make it possible for her to build assets. Her financial capability is low. By contrast, Signe has financial capability not only because she took a class but also because also she has access to opportunities - a job, financial accounts, and subsidized college savings. Over time she has gained knowledge and skills because her opportunities allow her to use what she learned in class.

How America Can Spread Financial Capabilities

These individuals are hypothetical, but the scenarios are not. Jaya's experience is typical, but Signe's experiences are spreading as more communities and nonprofits help youth build savings and learn to manage their finances. States such as Maine and Connecticut offer Child Development Accounts to all babies born in their borders. Experimental studies suggest that a Child Development Account with assets can raise mothers' educational expectations for their children, mitigate material hardship, and improve the treatment and development of children.

Financial capability is indispensable for managing individual life prospects in the 21st century. In the past, people could succeed in a cash economy, but today people must manage income and consumption, handle credit, and build and protect assets. Credit cards and good credit scores are important for all families. Economic status and race or ethnicity should not dictate whether people develop financial capability – and inclusive public policies can make a difference. Lifelong asset accounts for all new babies, accompanied by later opportunities for financial education, would spread opportunities across the life span. Automatic savings programs, like those for part of an income tax refund, could help families prepare for emergencies and ease the challenge of ups and downs in household incomes. Basic, low-cost, and accessible financial products and services, such as transaction accounts and small dollar credit, would give families safe ways to manage their financial lives. In many ways, U.S. tax policies, which currently support retirement and housing wealth for upper income families, could be reformed to enable lower income families to build a foundation of wealth as well.

Read more in Margaret Sherraden, "Financial Capability," *Encyclopedia of Social Work*; Jin Huang, Youngmi Kim, Michael Sherraden, and Margaret Clancy, "Unmarried Mothers and Children's Social-Emotional Development: The Role of Child Development Accounts," *Journal of Child and Family Studies*, 26, 1, (2017): 234-247; "Effects of Child Development Accounts on Early Social-emotional Development: An Experimental Test," *JAMA Pediatrics*, 168, 3, (2014): 265-271; "Impacts of Child Development Accounts on Change in Parental Educational Expectations: Evidence from a Statewide Social Experiment," 81, 1, (2015): 99-137; Jin Huang, Youngmi Kim, and Michael Sherraden, "Material Hardship and Children's Social-Emotional Development: Testing Buffering Effects of Child Development Accounts," *Child: Care, Health, and Development*, 43, 1, (2017): 89-96; Jin Huang, Michael Sherraden, and Jason Q. Purnell, " Impacts of Child Development Accounts on Maternal Depression: Evidence from a Randomized Statewide Policy Experiment," *Social Science & Medicine*, 112, (2014): 30-38; and Margaret Sherraden, Amanda Moore McBride, with Sondra G. Beverly Striving to Save: Creating Policies for Financial Security of Low-Income Families, (University of Michigan Press, 2010).