Economic Research Division

The True Cost of Financial Exclusion

Connor Hays, November 2018

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Abstract

The true cost of lack of access to credit extends far beyond the inability to finance additional consumption in the short term. Being in a position without credit quite often leads to individuals finding themselves in a financial spiral marked by a cascading effect of punitive fees, high interest rates, and mounting debt burdens. All of which bury individuals even further away from financial freedom and inhibits their ability to accumulate any level of substantive long-term wealth.

These insidious financial traps are brought into existence, enabled, and ultimately reinforced by the extremely inegalitarian distribution of wealth and income in the United States, inequalities of which are on the precipice of reaching the historical highs last seen in 1929 on the eve of the Great Depression. Current inequalities in the distribution of income and wealth are all too reminiscent of the extreme disparities and unprecedented accumulation of wealth on the part of the industrialists and financiers that defined the Gilded Age at the end of the nineteenth century on into the turn of the twentieth century.

Socioeconomic inequalities are secured within, and reproduced across, generations by capital and financial resources that are distributed inequitably across class, race, and gender demographics. Not only does this inequitable distribution of, and access to, capital lead to debt spirals and poverty traps that make day-to-day life an anxious and precarious affair for the bottom half of the population, and increasingly for the middle-class as well, but it also shuts off access to the fundamental gateways necessary to increase earnings, accumulate wealth, and improve physical, material, and mental well-being in the long run.

Introduction

To understand the true cost of lack of access to credit and financial services, or rather the prevalence of financial exclusion, an analysis of the underlying economic mechanisms that both give rise to and reinforce these debt and poverty traps must be undertaken, as well as an attempt to grasp the long-term economic outcomes for both the individuals and socioeconomic groups who are sucked up by them.

This analysis must necessarily take into account the role of capital and income; class, race, and gender; and greater macroeconomic forces. All too often, analyses of differential economic outcomes ignore structural and institutional realities altogether, instead choosing to focus on the micro-foundations of individual behavior and decision-making. Not only does this approach place an unwarranted emphasis on individual agency, but it also fails to take into account the import of exogenous constraints, and their influence, on the behavior and decision-making of borrowers and private economic actors.

The unsavory practices of predatory lenders and alternative high-fee financial service providers exploit individuals lacking the necessary financial resources and education to understand the system in which they find themselves, a foreseeable consequence of a banking and financial sector operating wholly unencumbered of regulatory oversight and enforcement. Beyond navigating the day-to-day financial obstacles, constraints, and traps that at-risk individuals and households face in making ends meet, they are also tasked with calculating the risks and rewards of long-run borrowing in an uncertain economy.

Within this framework, financial exclusion shows itself to be a feature, not a bug, of the current economic system. A profit maximization strategy in and of itself, one whereby a veritable assortment of economic actors seek to extract profits and appropriate wealth from the most marginalized of groups; the poor, young, and/or stateless. Rising inequality in the distribution of wealth and income makes this reality all the more salient. The historical roles of capital and income in the driving of economic divergence within the

United States is integral to understanding the forces that give rise to this economic reality.

Of course, taking on debt is predicated on increased returns in the future: an investment in education to increase future wage earnings; a mortgage to finance homeownership under the assumption of appreciation in housing prices and the building of equity; the funding of an entrepreneurial pursuit or small business. When these returns become uncertain or altogether obviated, then the risk of taking on debt in the pursuit of a better future becomes prohibitive for all but the upper-class.

As a result, inequitable access to credit acts to trap low and middle-income individuals and households in positions of such precarity that it invariably leads to the curtailing of economic opportunity, degradation of mental and physical well-being, elimination of access to even the most basic of material resources, and the further entrenchment of inequality. Financial exclusion, often by class, race, and/or gender, proves itself to be a dynamic force that perpetuates the vicious cycle of poverty, whereby poverty begets poverty, which is all too often reproduced from one generation to the next, ultimately acting as a fundamental inhibitor of intergenerational socioeconomic mobility.

The Role of Capital

Capital, which in the context of this paper will be used interchangeably with wealth, is composed of real assets, such as residential real estate, and financial assets, such as stocks, bonds, and cash. Wealth of private individuals is therefore the sum of these assets less financial liabilities, i.e. debt. Capital, and thus wealth, is a stock, a measure of total net assets at a specific point in time. An understanding of current economic conditions and the historical role of capital proves to be informative.

The relative import of capital in the developed nations has increased significantly in recent decades, as per capita output, i.e. productivity, and demographic growth have slowed, in concert with an increase in the

concentration and accumulation of capital and its resultant share of national income. Prior to this recent phenomenon, the relatively equitable access to capital, in tandem with the redistribution of wealth and income that emerged in the aftermath of the Great Depression and the implementation of New Deal policies in the mid-1930s, gave rise to and drove growth of the fundamental building block of wealth accumulation for the middle-class – homeownership.

Homeownership, and the slow but steady accumulation of wealth in the form of the residential real estate equity that it engenders, allowed for the rapid increase in the share of national wealth that middle-class households, defined as the 40 percent of the wealth distribution that falls between the bottom 50 percent and the top 10 percent, enjoyed in the postwar economic boom between 1945 and 1975.[1] This structural adjustment in the distribution of wealth was one of the most significant economic shifts of the twentieth century. Thomas Piketty, in his groundbreaking work *Capital in the Twenty-First Century*, refers to this as the "emergence of the patrimonial middle-class," an event of extraordinary historical import.

There is no doubt that the shocks of the two world wars, as well as the Great Depression and its resultant economic policies, helped to flatten the economic hierarchy and set the stage for the emergence of an economy that provided unprecedented economic gains for the lower and middle-classes. Historically low housing prices, mixed with the relatively egalitarian distribution of, and access to, capital, allowed families to purchase homes en masse during the economic boom in the aftermath of World War II, hence the landed middle-class.

Wealth inequality reached its nadir in the mid-1980s, after dropping precipitously from the late 1920s, following the stock market crash of 1929, up through 1986, as wealth was exposed to repeated shocks from recession, wars, and policy. During this period, the top decile, i.e. the top 10 percent, of the wealth distribution saw its share of total wealth contract from 84.4

[1] Thomas Piketty, *Capital in the Twenty-First Century*, Cambridge: Belknap Press of Harvard University Press, 2014.

percent in 1928 to 63.6 percent in 1986.[2] At the same time, the bottom 90 percent saw its share rise from 15.6 percent to 36.4 percent. Given that, historically, the bottom 50 percent holds zero net wealth, the bottom 90 percent is representative of wealth for the middle-class. As for the top centile, i.e. the top 1 percent, it saw its share collapse from 51.4 percent at its peak in 1928 to 25.1 percent at its nadir in 1986.

The relatively egalitarian distribution of wealth of this period, from 1945 to 1985, especially in contrast to the concentration of wealth that existed on the eve of World War I, and the explosive growth in homeownership for the middle-class was made possible by easy and abundant access to capital and financial resources and fueled all the more further by high saving rates coupled with high per capita income growth rates. At the same time, high levels of inflation depressed the real debt burden of borrowers. This fruitful confluence of events allowed for an abundance of low-risk mortgages and widespread economic prosperity.

While households, and the burgeoning middle-class, benefited from the compression of income and wealth inequality during this period, a sharp reversal began in the mid-1980s. Since 1986, the bottom 90 percent of households share of total wealth fell from its peak of 36.4 percent back down to 22.8 percent in 2012, the latest year that data is available. Meanwhile, the top 10 percent saw its share explode, rising to account for 77.2 percent of all wealth in the United States. The top 1 and 0.1 percent emerged even better, owning 41.8 and 22 percent of all wealth respectively.

To make this disparity even clearer, the top 160,000 households (the top 0.1 percent of the wealth distribution) own as much wealth as the bottom 144 million households (the bottom 90 percent). Households in the bottom 90 percent are worth on average $84,000, while households in the top 0.1 percent are worth on average $72 million. At the very top of the distribution, the top .01 percent, made up of 16,070 households, own on average $371 million and account for 11.2 percent of all wealth.

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[2] Emmanuel Saez and Gabriel Zucman, "Wealth Inequality in the United States Since 1913: Evidence from Capitalized Income Tax Data," *Quarterly Journal of Economics*, Vol. 131(2), May 2016, pp. 519-578, https://doi.org/10.1093/qje/qjw004.

The declining share of wealth of the bottom 90 percent, i.e. the middle and lower classes, since the mid-1980s can primarily be attributed to a drastic decrease in savings in confluence with a precipitous increase in mortgage, student loan, and credit card debt. As saving rates plummeted, debt skyrocketed. Household debt, expressed as a percentage of national income, grew from 50 percent in the 1980s to nearly 100 percent in 2009, having a major impact on household wealth for the bottom 90 percent, given that household wealth is the sum of all real and financial assets less debt.[3] The result being a calamitous contraction of net wealth for the bottom 90 percent of households.

In concert with rising household debt, disparities in saving rates across the wealth distribution diverge and compound quite rapidly. As of 2012, the bottom 90 percent of households save on average 0 percent of income annually, the top 10 percent save 25 percent of their income annually, the top 1 percent save 36 percent, and the top 0.1 percent save 54 percent. Thus, a snowball effect, a feedback loop of higher saving rates for high worth individuals, which leads in turn to greater concentration of capital income, and thus to even greater levels of concentration of wealth at the very top of the distribution, mostly the top 0.1 and .01 percent. Inexorably, wealth becomes concentrated to a much higher degree than income. As the old adage goes, the rich get richer.

The fall of the middle-class was precipitated all the more rapidly by the financial crisis of 2007-08, which lead to a significant decrease in homeownership. During the 2000s, in the run-up to the financial crisis, the saving rate for the bottom 90 percent fell to an incredible -8 percent. Homeownership rates for households fell from a high of 69 percent on the eve of the financial crisis to a low of 62.9 percent in the second quarter of 2016, dealing a critical blow to middle-class wealth.[4] As housing prices plummeted between 2007 and 2008, average household wealth for the

[3] Board of Governors of the Federal Reserve System, Z.1 Financial Accounts of the United States, 7 June 2018, https://www.federalreserve.gov/releases/z1/20180607/html/default.htm.

[4] U.S. Bureau of the Census, Housing Vacancies and Homeownership, 26 April 2018, https://www.census.gov/housing/hvs/files/currenthvspress.pdf.

middle-class cratered from nearly $130,000 to less than $100,000 in the span of a year, settling in around $84,000 by 2010. As a result, average household wealth for the bottom 90 percent of families was lower in 2012 than in 1986.

To give an even clearer picture of the impact of homeownership on household wealth, those households in 2016 who owned their own home had a median net worth of $231,400 while those who rented had a median net worth of $5,000.[5] Black households were all but left out of the middle-class expansion. Median net worth for black households was $17,100 in 2016, down from $24,400 in 2007. Standing in stark contrast to the median net worth of white households of $171,000.

Latinx households haven't fared much better, with a median net worth of only $20,600 in 2016, down from $24,400 in 2007. For all the benefits of homeownership that came in the postwar period, wealth accumulation for the middle-class was primarily relegated to white households, no doubt a result of pervasive redlining, banking, and lending discrimination that black and Latinx communities have faced for decades.

Exclusion from the housing market, and consumer credit market, has depressed the wealth and economic well-being of black and Latinx households to a breathtaking degree. And when black households were not excluded, reverse redlining in the housing boom of the 2000s specifically targeted black communities for sub-prime mortgages and predatory lending, exploiting the lack of financial education in these communities and taking advantage of the euphoria surrounding the housing market to rope in unwitting borrowers to take on adjustable rate mortgages.[6]

Homeownership, higher education, and the ability to absorb financial shocks are all fundamental to long-term wealth accumulation and economic well-being. Access to, and ownership of, capital resources in a free-market

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[5] Board of Governors of the Federal Reserve System, "2016 Survey of Consumer Finances," 31 October 2017, https://www.federalreserve.gov/econres/files/BulletinCharts.pdf.

[6] Barbara Ehrenreich and Dedrick Muhammad, "The Recession's Racial Divide," *New York Times,* 12 September 2009, https://www.nytimes.com/2009/09/13/opinion/13ehrenreich.html.

economy is necessary for all three. Rapidly rising wealth inequality and the divergence between the bottom 90 percent and the top 1 percent makes the role of capital all the more germane to long-term economic outcomes and will no doubt continue to drive disparities in wealth, income, and well-being across class, race, and gender.

The Role of Income

Income, in contrast to capital, is a flow. It includes both labor income, typically referred to as wages, and capital income, such as dividends, rents, and interest. Capital income is primarily the domain of the very top of the income distribution. In terms of the capital-labor split, the labor share of national income in the United States was 60 percent in 2014, with capital and profit shares accounting for the remainder.[7] The labor, or wage, share, once thought to be stable and constant across time, has been on the decline since the early 1980s.

Again, turning to the work of Emmanuel Saez, Gabriel Zucman, and Thomas Piketty on the distribution of income in the United States proves to be informative. By using distributional national accounts that take into account tax, survey, and national account data, the trio is able to capture a much clearer view of income inequality in the United States.[8] It should be noted that the unit of observation for the distribution of income is the individual, in contrast to the unit of the household used above to analyze the distribution of wealth.

While individuals enjoyed a relatively egalitarian distribution of income over the postwar period, similar to the distribution of wealth, since the tail end of the 1970s, income inequality has exploded, and intergenerational earnings mobility has waned. Wages for the bottom 50 percent of the distribution have fully stagnated, with real pre-tax income growing 0 percent annually on

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[7] Loukas Karabarbounis and Brent Neiman, "The Global Decline of the Labor Share," *Quarterly Journal of Economics*, Vol. 129(3), February 2014, pp. 61-101, https://doi.org/10.1093/qje/qjt032.

[8] Thomas Piketty, Emmanuel Saez, and Gabriel Zucman, "Distributional National Accounts: Methods and Estimates for the United States," *Quarterly Journal of Economics*, Vol. 133(2), May 2018, pp. 553–609, https://doi.org/10.1093/qje/qjx043.

average from 1980 to 2014. For those at the very bottom of the distribution income collapsed, with real income for the bottom 20 percent decreasing by 24 percent overall. Meanwhile, the real annual average growth rate of pre-tax income from 1980 to 2014 for the top 10 percent was 2.4 percent, 3.3 percent for the top 1 percent, 4.3 percent for the top 0.1 percent, and 5.2 percent for the top .01 percent.

At the middle of the distribution, stagnant real wages have made it near impossible for households to save and the relentless push towards deregulation that began in 1980 has led to an increase in fringe lending institutions and the inevitable rise of predatory lending. At the top of the distribution, rapidly rising incomes add to the snowball effect. Given the same starting point, income determines divergence in wealth. Individuals who benefit from high incomes also have the good fortune, as it were, of being able to save at higher rates, whereas those at the bottom of the income distribution save at much lower rates, if they are able to at all.

While the middle-class fared much better than the lower-class from 1980 to 2014, with real pre-tax income growing by 1 percent annually, for a cumulative increase in purchasing power of 42 percent, the divergence continues to be striking. The top 1 percent saw a cumulative increase in purchasing power of 204 percent, the top 0.1 percent saw an increase of 320 percent, and the top .01 percent saw an increase of 453 percent. Contrast this to cumulative growth for the previous period of 1929 to 1980 and the shift becomes even clearer.

The bottom 90 percent saw their total purchasing power increase at a greater rate than all income groups from 1929 to 1980, with cumulative growth of 70 percent between 1929 and 1945, and 105 percent between 1946 and 1980. Overall, economic growth was for these generations rather equally distributed. From the stock market crash of 1929, through the Great Depression and World War II, on through the postwar era, the United States economy very much was one for the middle-class, and even in some ways for the lower-class as well.

To highlight these shifts since 1980, the bottom 50 percent of the income distribution has seen its share of national income shrink from 20.1 percent to 12.5 percent. Meanwhile, the top 1 percent saw its share expand from 12 percent to 20 percent. The lower-class, the bottom 50 percent of the income distribution, by definition, earns less than the median income. This class is composed of 117 million adults in the United States, who make on average $16,600 per year. As of 2014, the top 1 percent earned on average 81 times more than the bottom 50 percent, $1.3 million to $16,600 respectively. It is no wonder that 40 percent of Americans report that they do not have the funds necessary to cover an unexpected expense of $400 or greater.[9]

More worrisome is the fact that research has shown a strong inverse correlation between income inequality and intergenerational mobility, known as the Great Gatsby Curve, with earnings mobility decreasing as income inequality increases.[10] Given that the United States has the highest degree of income inequality in the world, it directly follows that the United States also suffers from the lowest degree of intergenerational mobility in the world. The empirical evidence bears this out. While there does indeed appear to still be a statistically significant amount of mobility in the middle of the income distribution, those born in the bottom decile and the top decile, i.e. the bottom 10 percent and the top 10 percent of the income distribution, are highly likely to occupy the same position in the distribution as their parents.

Which is to say, their position in the earnings hierarchy is relatively sticky. For instance, for sons born to fathers who fall in the bottom 10 percent of the income distribution, the probability they end up falling in that same bottom decile in adulthood is slightly greater than 20 percent while the probability of making their way to the 9th decile is roughly 2 percent. This has occurred in tandem with banks and lenders becoming more risk-averse and tightening access to capital across practically all consumer credit markets. Leaving the vast majority of the lower-class, and a not insignificant portion of the

[9] Federal Reserve Board of Governors, “Report on the Economic Well-Being of U.S. Households in 2017,” May 2018, https://www.federalreserve.gov/publications/files/2017-report-economic-well-being-us-households-201805.pdf.

[10] Miles Croake, "Income Inequality, Equality of Opportunity, and Intergenerational Mobility," *Journal of Economic Perspectives*, Vol. 27(3), Summer 2013, pp. 79-102, https://doi.org/10.1257/jep.27.3.79.

middle-class, in a situation where they can not only barely afford to make rent, purchase groceries, and fill up on gas, but also without access to the credit they so desperately need to help bridge the gap between paychecks and pursue opportunities that will help them make their way up the earnings hierarchy.

This reality is further exacerbated by rapidly rising costs for health care and education, which have placed near unsustainable strain on middle and lower-class budgets. For those who are able to obtain student loans, the debt burden takes a significantly longer period of time to pay off than in the past, eats up large portions of income over the course of the loan, and is offset by less future income growth than for previous generations. As for cost of health care, given the above stated trends and realities, lower-class individuals are all but certain to fall into a cycle of never-ending debt when seeking nearly any kind of care, leading many to simply forego health care until the issue has become so pernicious that they end up in the ER or, in cases that have become far too common, it leads to death.

Gender inequality shows up clearly in the data as well, with men earning 1.7 times as much as women in 2014. The top of the income distribution is comprised of mostly men, with women accounting for only 16 percent of the top 1 percent of earners and 11 percent of the top 0.1 percent earners. Which is to say, 84 percent of those who earn more than $458,000 are men, and 89 percent of those who earn more than $1.96 million are men. To take this line even further, given that the top 1 percent is composed of 2.34 million adults, 1.96 million men make $458,000 or more in the United States, while only 375,000 women make $458,00 or more.

Of positive note, while men earned 4 times as much as women in 1962 that number has fallen to 1.7 times in 2014. However, the gender gap increases with age, as men aged 20 to 34 make 1.3 times more than women of the same age cohort, while men aged 55 to 64 earn 2 times more than women of the same age cohort. At the median, working-age men earn $35,000 and women earn $20,000. The rise of women’s share of labor income, and the resultant drop in the gender gap, has helped mitigate inequality to a degree, although the increase in earnings of women began to level off in the 1990s.

For the bottom 90 percent of the population, capital income only accounts for 10 percent of their annual income on average, while the rest is accounted for by labor. The composition of income shifts rapidly as you move up the income distribution. The top 10 percent derive roughly 40 percent of their annual income from capital, while the top 1 percent derive 60 percent, and the top 0.1 percent derive 70 percent of their annual income from capital.

For 99 percent of the population, income is primarily obtained through labor. For the top 1 percent, more income is derived from capital than from labor. As wealth becomes more concentrated, it follows that capital income becomes further concentrated, playing a more significant role in earnings for those at the top of the income distribution. For only a very small group of individuals does capital play a primary role in income generation.

Rapid increases in concentration of income at the top of the distribution have primarily been driven by capital income from equity and bonds over the course of the past fifteen years, and income inequality has nearly returned to its peak of 1928 due to unprecedented growth of top incomes since the early 2000s. As profit has steadily increased, and the profit share of national income has grown, this income has been primarily distributed to the top 1 percent through dividends, equity options, stock buybacks, and capital gains.

Much of the rise in top incomes can be contributed to the rise of super managers, increases in the retained earnings of corporations, rapid market consolidation, wage suppression, and the deregulatory movement that was pursued in earnest beginning in the mid-1970s. The surge in top incomes is one of the key drivers of the rapid increase in wealth concentration at the top of the distribution, while stagnant wages for the bottom 90 percent of the population have led to near nonexistent saving and unsustainable borrowing, severely exacerbated all the further when these individuals find themselves on the fringes of the traditional banking and lending industry.

Access to Credit

Household credit markets are primarily comprised of mortgages, student loans, auto loans, and credit cards. Extensions of credit, once consumed, are defined as liabilities for households and individuals, i.e. debt. The ability to obtain credit, as well as the principal amount and its rate of interest, is often dependent on the borrowers' credit score. The Consumer Financial Protection Bureau estimates that 26 million individuals are credit invisible in the United States, making their way without a credit history with one of the main three credit bureaus.[11] With that, an additional 19 million have insufficient history to produce a credit score, classified as unscorable. In total, nearly 20 percent of the adult population in the United States is credit invisible or unscorable.

Consumer credit has traditionally served to smooth consumption over the course of one's lifetime and help absorb exogenous shocks to individual finances, whether that be the need for car repairs or an unexpected emergency room visit. Mehrsa Baradaran, Associate Professor at the University of Georgia School of Law and author of *How the Other Half Banks,* notes that, "Reasonable credit not only serves as a bridge over financial trouble, but for millions of Americans, credit provides the only means to build assets, start a business, or get an education."[12]

With a large percentage of Americans earning and saving very little, the need for consumer credit becomes of increased consequence to helping finance these expenses. With stagnant wages, in concert with rapidly rising health care and higher education costs, and more risk-averse and expensive lending, it is not only the 117 million individuals who make up the bottom half of the income distribution who will more than likely find themselves at the mercy of debt traps but increasingly middle-class families with below average credit scores as well. Baradaran speaks to this reality directly, "So

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[11] Consumer Financial Protection Bureau, "Data Point: Credit Invisibles," May 2015, https://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf.

[12] Mehrsa Baradaran, *How the Other Half Banks*, Boston: Harvard University Press, 2015.

although inexpensive credit allows half the American public to improve their economic prospects, very costly credit is crushing the other half."

Of course, without a credit score, individuals face significant barriers to obtaining credit. If they are able to access credit it is in small amounts and comes with a premium in terms of steep interest rates, punitive fees, and draconian repayment schedules. Inequitable access to credit affects low-income individuals, people of color, the young, and immigrants to a disproportionate degree. Almost 30 percent of individuals in low-income communities are credit invisible, while only 4 percent of individuals in high-income communities are credit invisible. As for black and Latinx individuals, 15 percent are credit invisible, compared to 9 percent for whites. When looking at the young, 80 percent of individuals aged 18 to 19 years do not have a credit score.

Credit invisibility of the young immediately disadvantages individuals from low-income households in their pursuit of increasing future earnings. In its earliest manifestation, credit inequality comes in the form of inequitable access to higher education, as individuals from low-income families must decide whether to take on crushing levels of student loan debt or are simply excluded from the pursuit of higher education altogether, while high-income and high-wealth families are often able to fund their children's educations with preexisting wealth, income, or easy and cheap access to credit.

These dynamics drive even further divergence in household wealth and are aggravated by the need for parental co-signing in student loan agreements, often putting credit for postsecondary school out of reach for a disproportionate share of prospective students from low-income and low-wealth families. Lack of credit history for freshly minted high school graduates makes this issue all the more salient, given that 80 percent lack a credit score. Inequitable access to higher education as a result of differences in financial resources afforded to individuals across class, and especially racial, groups is one of the key mechanisms by which inequalities are reproduced across generations.

While household debt reached unprecedented levels in the mid-2000s, ultimately culminating in a debt-to-GDP ratio of nearly 100 percent on the eve of the financial crisis, since 2009 household debt has contracted, with the ratio of falling back down to 76 percent as of the first quarter of 2018. Overall, total outstanding household debt now stands at $15.26 trillion, with mortgage debt accounting for $10 trillion, student loan debt for $1.5 trillion, and other forms of consumer credit accounting for the rest. Meanwhile, credit inquiries for the previous six months, an indicator of demand for consumer credit, have reached their lowest level in the history of the data.[13]

Household financial well-being, however, is dependent on a variety of factors, including savings, income, debt, creditworthiness, and so on, and is often gauged by assessing aggregate measures such as household saving rates, consumption rates, and borrowing rates.[14] Regardless of the approach, it is clear that households in the United States are nearly as financially fragile as they can be. Over 25 percent of households are certain they cannot come up with $2,000 within 30 days no matter the methods, while 19 percent of households would have to pawn possessions or take on payday loans to come up with the necessary funds. Overall, 50 percent of households believe they would most likely not be able to handle a financial shock of this magnitude, a shock which is not all that uncommon.

As for the consumer credit necessary to managing this fragility, the lack of local bank branches, poor or nonexistent credit scores, and a general lack of access to traditional lenders in low-income communities have led many to turn to the fringe lending market to finance unexpected expenses or to simply make ends meet. As should come to no one's surprise, predatory payday and auto title lenders have quickly come to fill the void, popping up on the corners of marginalized and disadvantaged neighborhoods with near ubiquitous regularity. Peddling their capital in minuscule amounts at oppressive rates to the already dispossessed by having them sign over their

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[13] Federal Reserve Bank of New York, "Quarterly Report on Household Debt and Credit," May 2018, https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2018Q1.pdf.

[14] The Brookings Institution, "Financially Fragile Households: Evidence and Implications," *Brookings Papers on Economic Activity*, March 2011, pp. 83-150, https://www.brookings.edu/wp-content/uploads/2011/03/2011a_bpea_lusardi.pdf.

bank account credentials, employer information, or automobile titles, under terms that no one would ever deem fair nor transparent, payday lenders prey on the desperation of borrowers trying to survive until their next paycheck.[15]

While chartered banks fall under strict state and federal regulations, they have all but abandoned low-income communities en masse, leaving a vacuum to be filled by the less scrupulous. Fringe lenders operate unencumbered from nearly all regulatory oversight and enforcement, offering loans with exorbitant interest rates knowing full well that most borrowers will be unable to repay, all the while pinging them with late fees, collection fees, maintenance fees, convenience fees, and whatever other schemes of appropriation they can dream up that borrowers can be counted on to neither understand nor fight. And when the debt has inevitably been passed off and made its way through the collections process, with all of its associated fees, the process invariably culminates in local courts handing down orders for the garnishment of wages.

Payday lending emerged in the 1990s to fill the void left by traditional banking and lending institutions in the small, short-term loan market. The payday industry exploded in the early 2000s, as the number of lenders grew from 10,000 to 22,000 in the span of just four years. Since then, the market has consolidated rapidly, leaving just a few major lenders who often collude on the tactics employed to milk their borrowers. Short term payday loans offer breathtakingly exploitative terms and rates, with some two-week loans carrying effective annual interest rates upwards of 400 percent.[16] Over 80 percent of payday loans are immediately followed up by another loan within two weeks, often part of a seemingly never-ending sequence of ongoing loans.[17] In 2013, half of all loan sequences were at least 10 loans long and

[15] Pew Charitable Trusts, “How Borrowers Choose and Repay Loans,” February 2013, http://www.pewtrusts.org/en/research-and-analysis/reports/2013/02/19/how-borrowers-choose-and-repay-payday-loans.

[16] Federal Deposit Insurance Corporation, “Payday Lending: Do the Costs Justify the Price?” *Center for Financial Research Working Papers,* June 2005, https://www.fdic.gov/bank/analytical/cfr/2005/wp2005/2005-09.pdf.

[17] Consumer Protection Financial Bureau, “Data Point: Payday Lending,” March 2014, https://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf.

resulted in borrowers paying over $458 in fees for the year, with a median of 6 loans per year.

Others turn to auto title loans, often using their primary source of transportation, and thus livelihood, as collateral in order to obtain credit. Desperate borrowers who have no recourse but to sign over their titles sometimes find their cars being towed off not because of failure to repay but due to oversight of some obscure fine print that no sane person would find to be of particular consequence. Once transportation is lost, unemployment follows shortly thereafter. Others make regular trips to the pawn shop, receiving pennies on the dollar when times get tough, while the lucky ones are extended negligible lines of credit by card companies who have their own intricate fee schedules and variable interest rate provisions, terms which even consumer protection agencies stocked with financial experts have a hard time parsing.

All in all, among a litany of draconian measures, individuals lacking in credit, existing on the fringes of the banking sector, and living paycheck to paycheck are all but invariably met with punitive overdraft fees from banking institutions, usurious interest rates that make paying off debt nigh impossible, and predatory lending practices that take advantage of lack of both financial expertise and the time necessary to reason through the potential ramifications.

When individuals are able to obtain credit, discrimination not only by class but by race invariably makes its way into the equation. Lending discrimination has acute consequences for black and Latinx households and reaches far beyond the housing market and its historical discriminatory methods of redlining. Reverse redlining, a particularly odious form of financial predation whereby black and Latinx borrowers are specifically singled out for higher interest rates, additional fees, and other race-based premiums, has become increasingly prevalent since the early 2000s as the housing market began to heat up and sub-prime mortgages were being handed out in prodigious numbers.

Discriminatory lending is not just a historical curiosity, it is still very much practiced today. In April, the United States Senate voted to overturn a Consumer Financial Protection Bureau guidance reinforcing that the Equal Credit Opportunity Act pertained to, and prevented, auto lenders from racial discrimination.[18] Previously, auto lenders would often overtly discriminate based on race, leading to notably higher interest rates for black and Latinx borrowers. Reports cited by the CFPB found that two out of three non-white car buyers were on the receiving end of higher interest rates given similar financial standing to that of white buyers, with those borrowers incurring additional costs in excess of $2,600 on average over the course of their loans.

Study after study has shown that access to *cheap* and *safe* credit and banking greatly increases individual financial well-being and long-term economic prosperity. Credit serves as a cushion to absorb personal economic shocks and pursue life ambitions. This is especially true for the poor. When low-income communities are given access to cheap credit they flourish economically. When only given access to expensive credit it leads to increased economic hardship.[19] Access to safe credit is integral to low-income families escaping poverty. And when families are able to escape poverty, and achieve a meaningful degree of financial stability, it affects not just their material well-being but also their physical and mental well-being as well.

Low-income individuals are constantly thinking about their financial situations, leaving less mental resources for other concerns. On average, low-income individuals preoccupied with financial concerns exhibit a loss in functioning similar to a 13-point dip in IQ, controlling for other variables, similar to the loss of a night's sleep on mental ability. In 2013, researchers, in an aptly titled paper "Poverty Impedes Cognitive Function," found that

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[18] Alan Rappeport, "Senate Votes to Ease Restrictions on Auto Lending Discrimination," *New York Times*, 18 April 2018, https://www.nytimes.com/2018/04/18/us/politics/senate-auto-lending-discrimination.html.

[19] Brian T. Melzer, "The Real Costs of Credit Access: Evidence from the Payday Lending Market," *The Quarterly Journal of Economics*, Vol. 126(1), February 2011, pp. 517-555, https://doi.org/10.1093/qje/qjq009.

poverty places increased cognitive strain on individuals, reduces effort, and decreases attention, leading to increasingly poorer decisions as a result.[20]

Their conclusion, that poverty-related concerns consume significant cognitive resources and severely impair judgement and decision-making processes, shows just how important financial resources are on mental well-being, and how financial hardship in and of itself can lead to poverty. As financially strapped individuals are constantly devoting high amounts of mental energy to juggling their financial affairs in order to survive day-to-day, it leads to increased stress, reduced attention, and poorer decision-making, whereby deteriorating mental health and increasingly strained cognitive capacity prevents individuals from effectively making their way out of the traps they find themselves in.

Socioeconomic inequality, and the lack of wealth, income, and credit that it entails, does not just affect cognitive function, it also induces structural changes in the brain. Upper-class individuals aged 35 to 64 years benefit from more gray matter and brain network segregation than their lower-income cohorts, both of which are correlated with increased memory capacity and lower rates of dementia. These anatomical differences do not exist between income groups earlier in life, implying a significant degree of causality.[21] It would seem that long periods of sustained poverty adversely impact brain anatomy. Low-income individuals thus typically perform lower on verbal memory, processing speed, and executive function tests.

Given the extraordinary levels of wealth and income inequality that currently exist, and that do not appear to be in abatement any time soon, the gravity of credit inequality quickly becomes all the more salient. Poverty traps are self-reinforcing in nature, and often caused both by low-income and lack of access to credit. This effect is further compounded by exclusion from homeownership, historically the foundation of middle-class wealth

[20] Anandi Mani, Sendhil Mullainathan, Eldar Shafir, and Jiaying Zhao, "Poverty Impedes Cognitive Function," *Science*, Vol. 341(6149), August 2013, pp. 976-980, https://doi.org/10.1126/science.1238041.

[21] Olga Khazan, "How Income Affects the Brain," *Atlantic*, 15 May 2018, https://www.theatlantic.com/health/archive/2018/05/how-income-affects-the-brain/560318/.

accumulation. Beyond stunting long-term socioeconomic outcomes and exacerbating existing inequities, lack of access to credit introduces a high level of day-to-day financial precarity into many families lives. Economic inequality induces poverty, and ultimately, poverty begets poverty.

Financial Exclusion

As of 2015, 7 percent of American households lack a bank account, approximately 9 million households made up of 23.2 million individuals. Along with the unbanked, 19.9 percent of American households are considered underbanked, approximately 24.5 million households comprised of 67.4 million individuals.[22] Of all households, 15 percent use money orders, 6.5 percent use check cashing services, 2 percent resort to payday loans, and 1.3 percent rely on particularly insidious auto title loans. When looking at just unbanked households, the numbers rise precipitously, with 42.3 percent making use of money orders, 30.3 percent using check cashing services, 3.6 resorting to payday loans, and 2.3 percent taking on auto title loans.

For low-income households who do have access to a traditional bank account, many are unable to meet the minimum balances necessary to avoid monthly maintenance fees, while others choose to forego traditional banking altogether in order to avoid the seemingly inevitable and never-ending onslaught of overdraft fees, bounced checks, and delayed ACH transfers. Those who find themselves unbanked, or underbanked, are often left constantly shifting between an amalgamation of money orders, check cashing services, and pre-paid debit cards to manage their finances and meet their financial obligations.

It is estimated that for families earning $25,000 a year, roughly $2,400 of their income is spent on financial services, while upper-middle and upper-class families are able to avoid these fees altogether. Alternative banking service fees are inherently regressive, placing greater burden on low-income

[22] Federal Deposit Insurance Corporation, “2015 FDIC National Survey of Unbanked and Underbanked Households,” 20 October 2016, https://www.economicinclusion.gov/surveys/2015household/.

individuals and eating away at income at a much higher rate, all the while depressing overall wealth. What little income is left for saving, if any at all, is either held in cash, which is privy to inflation and decreases in purchasing power, or savings accounts that effectively offer negative yields for those so inclined. And increasingly not many are inclined when the typical annual percentage yield hovers around .06 percent, with many major banks savings accounts offering annual percentage yields as low as .01 percent. Of course, savings accounts also require minimum daily balances and place limits on monthly withdrawals, so those who find themselves needing to dip into savings to meet unexpected obligations are often hit with additional obstacles and fees.

As a result of the current economic climate, lower and middle-class saving has been mostly relegated to pension contributions, with the stock and bond markets all but out of reach for 90 percent of the population. As such, capital gains from stock ownership and practically risk-free bond ownership are the domain of the top of the income and wealth distributions. Not only is the stock market not indicative of the economy on the whole, but it is also not indicative of the economic well-being of the vast majority of the populace. Economic inequality and precarity makes any asset outside of cash and checking accounts off limits to those who need funds to be as liquid as possible. Brokerage accounts, and mutual funds, often require minimum investment amounts and charge flat fees for trades, which put in place prohibitive barriers for individuals who only have relatively small amounts to save and invest. As such, most are simply excluded.

Of course, these financial products have traditionally been out of reach of the lower-class at any rate, whose lives are less defined by accumulating wealth and more so by protecting what little income they are currently able to earn. Overdraft fees have become particularly insidious in this regard. Extortionate overdraft fees, not to mention the recurring headaches induced by this rather unscrupulous scheme, quickly eat into already meager income. Major banks have even been known to settle and post transactions by highest charge first, “high-to-low,” resulting in account holders incurring multiple overdrafts for small purchases such as coffee and gas.

Frequent overdrafters, those with ten or more overdrafts per year, are often credit constrained, suffer from low credit scores, and do not have access to credit cards.[23] Frequent overdrafters have a median day-to-day checking account balance of $345, median monthly deposits of $2,050, and median credit score of 585. Of note, the median age of frequent overdrafters is 36.5, while the median age of those with no overdrafts is 46.3. Only 57 percent of those with frequent overdrafts have a credit card, while 86.6 percent of those with no overdrafts have a credit card, plotting a strong link between a lack of credit and the increased prevalence of overdrafts.

Checking account holders with very low credit scores, or who lack a score altogether, fare the worst when it comes to overdrafts. The group of individuals with low credit scores, with a median score of 532, account for 20.5 percent of frequent overdrafters, incur roughly 17 overdrafts per year, carry negative balances for 7.5 business days at a time, and have available credit to the tune of $41. As for those lacking a credit score, they account for 24.5 percent of frequent overdrafters, incur roughly 20 overdrafts per year, only 6 percent have a credit card, and they typically carry negative balances for 7.9 business days at a time.

Overall, 27 percent of checking account holders incur at least one overdraft per year.[24] On average, those who experienced overdrafts paid $225 in related fees per year. As such, 6 percent of individual checking accounts are involuntarily closed each year due to unpaid negative balances. All told, the commercial banking industry earned $12.6 billion in non-sufficient funds and overdraft fees in 2011, accounting for 61 percent of their consumer checking account revenue. Other analyses place that number as high as $32 billion.

With the median overdraft fee being $34 in 2012 and reaching as high as $45 per transaction in some instances, it is clear that the annualized interest

[23] Consumer Financial Protection Bureau, "Data Point: Frequent Overdrafters," August 2017, https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/201708_cfpb_data-point_frequent-overdrafters.pdf.

[24] Consumer Financial Protection Bureau, "Study of Overdraft Programs," June 2013, https://files.consumerfinance.gov/f/201306_cfpb_whitepaper_overdraft-practices.pdf.

rate on such inconsequential lending is far beyond being reasonable and fair. And to further exacerbate the plight of those with set payment schedules, banks sometimes charge extended overdraft fees for negative balances that persist for a specific period of time. Given that frequent overdrafters often carry negative balances for over a week, they are often assessed these extended fees. Where minimum wage employers offer direct deposits only, under the guise of efficiency and convenience, wage laborers resign themselves to the fact that a good portion of each paycheck will go to covering negative balances pushed into the hundreds of dollars by overdraft fees.

When checking accounts are foregone entirely, and workers receive their pay by physical check, check cashing services become the de facto standard. Check cashing services cost roughly 2 to 5 percent of check value, in contrast to 0 percent for deposits into and withdrawals out of checking accounts. Once checks are cashed, individuals often resort to loading cash onto pre-paid debit cards in order to make daily purchases, pay bills online, and access the conveniences that debit cards provide. It is estimated that the annual flow of cash onto pre-paid cards in the United States is now close to $570 billion. Pre-paid cards present their own headaches and constraints, with individuals often having to travel long distances to find locations to load cards and make withdrawals from partnered ATMs, getting hit with additional withdrawal fees, and eating into what little leisure time low-wage laborers have left.

When moving money in the other direction, individuals are hit with additional fees for purchasing money orders, which are often used to pay rent and utilities. Individuals usually find themselves making several trips to a hodgepodge of stores on payday, just to juggle their finances, either due to being unable to open a bank account or the desire to avoid draconian overdraft and monthly maintenance fees. Of course, all of this activity is predicated on the automobile and the transportation it provides. Low-income individuals and families are at the mercy of old and dilapidated cars that provide the necessary transportation in order to continue functioning in society, spending greater portions of their income on gas, repairs, and high-mileage car purchases than higher-income households. The slightest car

problem can send the hardest working household into a financial spiral whereby they are unable to get to work, access financial services, and pay for basic necessities, and driving them into the outstretched hands of fringe lenders who all too willingly exploit their desperation.

Once in the firm grasp of a debt trap, engendered by financial exclusion, inequitable access to credit, and rampant income and wealth inequality, individuals find themselves in what one could only call a vicious cycle of debt peonage. Forced by circumstance and desperation to work ever greater hours, for meager pay, so as to make debt payments, cover negative balances, and keep the gears churning. Economic structures are built to punish financial hardship, not alleviate it. As the lower and middle-classes have faced significant economic downturn in recent years, banks, lenders, and other financial intermediaries have employed ever greater predatory practices, extortionate fees and terms, and increasingly clever tactics to siphon off what little disposable income and wealth the bottom 90 percent has left.

Conclusion

The banking and financial system is frictionless for the haves, maddening for the have-nots. For those that have wealth it has never been easier to move, save, and hide. For the rest, daily life is marked by an exhausting, and regressively costly, game of managing and putting to use meager income using whatever hodgepodge of financial services one can get access to. In an economy increasingly predicated on nothing more than simply transferring money from one place to another, one built on the omnipotence of the banking and financial sector, whole swaths of individuals and families have been relegated to the fringes of the economy. While its workings may be dull and arcane for most, it is of significant consequence that its dynamics, functions, and goals be both understood and managed by the population on the whole, for its outsize impact on the livelihoods of all cannot be over stated.

Credit, when well-managed, equitable, and inclusive, creates productive economic activity. It extends economic opportunity to those who may not have the means today, allowing them to finance consumption of resources necessary for survival, pursue opportunities for increased earnings, and contribute to society in new and meaningful ways. In order for credit to be effective in this mission, it must be deployed at reasonable rates and contracted at fair terms. It must enable and empower citizens, not disable and enslave them. Bankers, and other lenders, must not be allowed to charge extortionate rates of interest to the common borrower, nor prey on the marginalized and disadvantaged. Sustainable debt must take into account the constraints of both finite human and natural resources.

However, if it is unable to achieve these functions, then the purpose of the banking system to serve as a mediator of trust and risk becomes altogether moot. Rather, it becomes the pretense by which the system serves to enrich itself at the expense of the common good. No longer can the banking and financial system be considered productive when its main source of revenue becomes that of pure speculation, and it is at that point a programme for the democratization of credit must be undertaken. Trust is the backbone upon which the banking system, and thus credit and debt, is built. When that trust is lost the consequences become calamitous.

As for the predatory lending of fringe institutions, who charge usurious rates of interest on credit by which the price of money becomes preciously dear, there need not be obfuscation of their intent. For in these cases the profit motive comes first, and the risk is but a byproduct of that motive, and it is then the true cost of credit becomes painfully clear. And when a borrower has no other option, when they have no choice as to the terms of the credit they so desperately need, is when a seemingly equal social contract between two parties becomes rife for exploitation. It is under these auspices that borrowers fall prey to an endless spiral of debt, which invariably occurs for millions of households and individuals.

As a glut of capital swirls around and accumulates at the top of society, as it continues to be put to speculative rather than productive use, the system becomes sustained not by growth in productivity, wages, and innovation, but

rather by the continued appropriation of wealth from the bottom 90 percent. Although it should need not have to be said, the hollowing out of the lower and middle-classes is neither sustainable nor efficient, neither moral nor desired. The result is continued and pervasive instability and conflict.

An economy, and in particular its banking and financial systems, should serve the interests of its people, providing equitable and widespread stability, opportunity, and prosperity. Financial services and resources should be accessible to all who look to improve their lot in life, who look to contribute to the storied history of human endeavor. Only then can we begin to move beyond a society so deeply scarred by widespread impoverishment, rampant inequality, and the social and political upheaval it breeds.