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Financial literacy and over-indebtedness in low-income households☆

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ABSTRACT

Financial literacy can explain a significant proportion of wealth inequality. Among the key components of financial literacy are numeracy and money management skills. Our study examines the relative importance of these components in the determination of consumer debt and household net worth among credit union members in socially disadvantaged areas. The main finding from our analysis is that money management skills are important determinants of financial outcomes but that numeracy has almost no role to play. This result adds to a recent US-based behavioural finance literature on the role of attention and planning in consumer finance. Findings are found to be robust when the sample is reduced to only those who have a clear role in household financial decision-making and also when controlling for potential endogeneity. Our findings have policy implications in the UK and elsewhere as credit unions across the world are important players in national financial literacy strategies.

1. Introduction

Research suggests that there is a positive correlation between poor financial literacy and debt problems. A lack of financial literacy has been found to be correlated with higher debt burdens, incurring greater fees, loan defaults and loan delinquency. Efforts to identify survey instruments have highlighted a number of different dimensions of financial literacy. Among the key components are numeracy and the money management skills of attention, budgeting and organising bills.

Our research tests the effect on financial outcomes of money management skills versus numeracy using data on over-indebted members of credit unions in areas of social disadvantage. Our research demonstrates that, for this financially vulnerable cohort, money management and not numeracy ameliorates a range of adverse debt behaviours. More specifically, we find that those with superior money management skills have reduced debt-to-income levels; are less likely to borrow from high cost lenders such as internet money lenders and high street loan shops; and are likely to have used fewer lenders in the last three years. Additionally, our research highlights that money management skills positively contribute to household net worth. These results add to a recent US behavioural finance literature which highlights the importance of self-imposed non-binding constraints such as payment reminders, budgeting and forward planning for financial decision-making.

Financial literacy variously defined in terms of numeracy or understanding of risk diversification and inflation has been associated with less sub-prime mortgage delinquency (Gerardi, Goette, & Meier, 2010), lower credit card fees (Lusardi & Tufano, 2009a, 2009b), less high-cost borrowing (Disney & Gathergood, 2013), better planning for retirement (Van Rooij, Lusardi, & Alessie, 2012), stock market participation and asset portfolio diversification (Graham, Harvey, & Huang, 2009). The evidence for causation has been less forthcoming and other aspects of financial literacy captured by money management skills could be more salient (Collard, Finney, Hayes, & Davies, 2012, Zinman, 2014). The attention that consumers pay to their financial situation significantly affects financial outcomes. A behavioural finance literature shows how reminders reduce overdraft fees and improve saving (Karlan, McConnell, Mullainathan, & Zinman, 2012; Stango & Zinman, in press). Budgeting and organising bills should aid intertemporal allocations just as listing specific sub-components of tasks corrects the ‘planning fallacy’ of systematically underestimating the time required to complete tasks (Buehler, Griffin, & Ross, 1994; Forsyth & Burt, 2008).

To date, empirical testing of the role of money management skills has been confined to a literature focusing on the psychological determinants of debt. Avoidable failures of personal money management are found to lead to arrears in household bills and higher credit card debt (Elliot, 2005; Garðarsdóttir & Dittmar, 2012; Kim, Garman, & Sorhaindo, 2003; Lea, Webley, & Walker, 1995; Norvilitis et al., 2006). Our work demonstrates that, when compared with numeracy, money management skills have a significant effect on a range of financial outcomes. The finding that money management skills mitigate adverse

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