**Death by a Thousand Cuts:**

**Financial Innovation and Income Inequality**

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 **Abstract**

Financial innovations come in a spectrum of sizes and complexities. This paper deals with the sorts of small-scale, noncomplex innovations which are frequently used by low and lower-middle class individuals. These come in many versions and a given individual may use five or ten. While no single one of these innovation likely makes a significant difference in income inequality they may--cumulatively--cost a household thousands of dollars a year. When taken across millions of households, the effect is to materially increase inequality. Small-scale financial innovations are not just a case of making the less well-off even worse off; the money moves up the ladder.

 **Introduction**

 The term *financial innovation* typically conjures images of complex, opaque securities engineered by investment bankers and involving huge sums of money---derivatives, mortgage backed securities, CDO’s, CDS’s, and so forth. More generally, a financial innovation is simply a new way of apportioning money, credit or risk. These need not be complex or opaque and may involve small sums. The present paper focuses on such smaller financial innovations and their effects on members of the lower and lower-middle classes. Income inequality is closely connected with disparities in educational attainment (Rajan 2010). Hence, financial innovations promoted to the low and lower-middle classes are inevitably aimed at those less well equipped to understand the services or their financial consequences.

 Payday loans with their exorbitant interest rates and fees were relatively scarce a decade or two ago but are now ubiquitous in the US. Examples of longer standing include check cashing fees, credit card fees and late charges, and bank overdraft charges. More recent innovations include subprime mortgages, auto title loans, and pension advances. There are dozens of such products on the market which collectively exact a considerable toll on their users. While most of these innovators are sold by for-profit businesses, governments are behind some innovations. State-sponsored lotteries are differentially patronized by the lower and lower-middle classes and act as a sort of tax on heavy users. Such gambling is highly profitable and the proceeds help in funding education, effectively taking from the less well-off to mitigate school taxes for the better-off.

The next section outlines small-scale financial innovations. Subsequent sections overview the impact of interest and other costs on inequality; the role of consumer psychology in seeking credit is outlined. Discussion and conclusions follow.

 **Small-scale Financial Innovations**

Despite numerous differences, the smaller-scale financial innovations discussed here share two basic factors in common with large-scale innovations such as securitized mortgages. First, and foremost, the motive for creating the innovation is financial gain for the innovator. Second, the innovators and marketers of these innovations are not the intended customers. Inequality benefits some groups at the expense of others (Dugger and Peach 2009). All of the costs outlined below, in addition to many more, fall differentially heavily on the lower and lower-middle classes as opposed to the upper and upper-middle classes, who seldom use these innovations.

As would be expected, financial innovators do what they can to increase usage and boost profits. The firms research high-potential customers, locate offices in areas convenient to them, conduct door-to-door solicitations, advertise through various media, and reward repeat users. Using the standard marketing tools of market segmentation, some innovations are made to be more suited to low income employed, while others are tailored for low income unemployed; some are aimed at homeowners, some at military or public sector employees, and still others at retirees[[1]](#endnote-1).

Example: Payday Loans

Also known as “deferred presentment agreement” or “delayed deposit check” loans, a typical payday loan transaction involves amounts of $100 to $400 for a period of 7-30 days and an interest charge of $15-20 per $100 borrowed for two weeks. On an annualized (APR) basis, these fees amount to a rate of 400-1000%. The process involves a borrower writing a postdated check for the amount of both principal and fee, to be cashed by the lender on the borrowers next payday. The application process is much quicker and simpler than applying to a traditional bank, and is far more certain of funding for low income borrowers (Stegman 2007).

About 75% of payday loan customers had incomes below $50,000 (Lawrence and Elliehausen 2008). Because of relatively low incomes in combination with high service charges, many borrowers pay an outsized percentage of their income to finance companies. Around 30% of payday loan customers spend 20%+ of their income to service the loans. Among loan customers, 36% had some college but no degree while 45% had a high school diploma or less (Lawrence and Elliehausen 2008)[[2]](#endnote-2).

The first stand-alone payday loan operation appeared in 1993, and the industry subsequently peaked in 2006 at about 24,000 stores (Rivlin 2010). Although further growth was indicted by customer demand, 16 states and DC either restricted or banned payday loans (Wann and Wann 2012)[[3]](#endnote-3). The estimated volume of payday loans in 2012 was over $29 billion from storefront operations, plus another $14 billion from internet operations (*Economist* 2013); this is up from $8 billion in 1999 (Stegman 2007). Finance charges generated at 2012 volumes are estimated at $4.5-5 billion; profit margins net of expenses are thought to be well above 20%[[4]](#endnote-4).

 Although the industry emphasizes its services as solutions for client’s *temporary* financial difficulties, almost 60% of borrowers have trouble meeting their cash needs at least half the time, that is, they are in a more-or-less permanent cash crisis (Pew 2013). Around 75% of borrowers are unable to repay the loan on the original due date, and so roll over the debt or patronize another payday lender to pay off the first (Wann and Wann 2012). When a payday loan of $325 is rolled over eight times, the total repayment amount would be $793 (Center for Responsible Lending 2013). This situation results in a “roll over trap,” in which borrowers paid an estimated $3.4 billion in 2005 (Stegman 2007). Since there are roll over fees in addition to extra periods at high interest rates, this is a highly profitable business. It is therefore unsurprising that the lenders incentivize employees to promote repeat borrowing (Stegman 2007).

 **Debt, Interest, Fees and Inequality**

As noted above, many small-scale financial innovations involve personal debt, a situation which has a differential impact on lower income households. The ratio of consumer debt to income has been increasing most at the bottom of the income scale and least at the top (Holt and Greenwood 2012). In 2004, households classified as poor had a mean debt load equal to 59% of income while households at the median income level had a debt load of just 23% (Pressman and Scott 2009). Consequently, interest payments and various associated fees take a larger share of income at the lower end.

The role of consumer debt in inequality has begun to receive much deserved attention. After accounting for interest on consumer debts (plus home equity loans used for consumption purposes) the rate of increase in families which fall below the middle class has risen significantly (Scott and Pressman 2013). A *debt poor* household is one whose income is above the nominal poverty level but whose interest obligations leave them with an effective income below the poverty level (Pressman and Scott 2009). The percentage of the US population who fall into this category increased from 0.2% in 1980 to 1.3% in 2007.

Ordinary credit cards are both a payment device and a credit facility. Credit cards represent an instance of expanded use of credit among low and lower-middle class groups. Competitive pressures among lenders and slower growth among traditional card users have lead credit card companies to concentrate on lesser qualified individuals in order to continue their growth (Hyman 2011). The percentage of households in the lowest income quintile with a credit card increased from 11% in 1977 to 43% in 2001 (White 2007). Whereas those in high income categories are more likely to pay their credit card bills in full each month, those in lower income categories are much more likely to pay the minimum or to pay late, thereby incurring high interest payments and/or fees. Cash advances from a credit card can be used to pay down a payday loan, and vice versa. Such behavior can place the debtor in a state of ongoing financial distress (White 2007). Small-scale financial innovations are part and parcel of financial management schemes for lower income individuals.

 **Consumer Psychology and Decision Making**

Veblen (1899/1965) observed that each class tends to emulate the one above it, giving a persistent motive to consume at the highest feasible level. This is no less true of lower classes than upper. In a society characterized by increasing inequality, the tendency toward emulation places an increasing strain on the lower levels to maintain a respectable position. This is thought to account for at least a portion of growing debt-to-income levels observed at lower levels. The emulative motive in spending explains an otherwise puzzling result: household indebtedness has been found to be more sensitive to changes in income inequality than to changes in interest rates (Christen and Morgan 2005). Consciously or unconsciously, the appearance of respectability through symbolic consumption is a powerful force. Of course, winning the lottery seems an appealing way to move up a notch or two.

Greater inequality means that consumers at lower levels must spend ever more to emulate the consumption standards of those above them (Wisman 2009). There is a strong positive correlation between income inequality and household debt-to-income ratios. Conspicuous consumption appears to be the determining factor in this relationship: the inequality effect is strongest for non-revolving debt, typically used to finance consumer durables---which are more visible than nondurables--- such as autos (Christen and Morgan 2005).

Consumption spending reduces saving and increases debt. Hence the disproportionate rise in credit card debt among households with incomes under $25,000 due to emulative spending (Frank 1999). Hence also the rolling over of “temporary” payday loans. A 500%+ APR may not seem unreasonable for two weeks in order to get an individual past a temporary cash crisis. But extending for five or ten rollovers, which is not uncommon, is a personal financial disaster in the making. Many small-scale financial innovations take advantage of a cognitive tendency to heavily discount the future in favor of present consumption. Someone who fails to pay off a payday loan in order not to defer other consumption risks falling into a chronic condition which is quite costly in the long run. The same is true of rolling over credit card debt--- a hyperbolic discounting as opposed to a more balanced discounting (White 2007). Some 80% of payday loan customers cannot recall the APR on their loan, focusing instead on the $15-20 fee per $100 which evidently strikes them as being within reason (Lawrence and Elliehausen 2008).

 Inequality along with a misplaced belief in the likelihood of upward mobility results in emulative consumption and, ultimately, in yet higher inequality. The spending-equals-success mentality has great effect in the presence of a belief in the possibility of upward mobility. The rich regard inequality as being due to merit while the poor admire the rich for their attainments (Tawney 1952). For an increasing portion of the population upward mobility is an illusion; but it is the hope of upward movement that propels spending.

 **Implications and** **Discussion**

 Four points pertaining to small-scale financial innovations receive consideration in this section.

Customer Benefits

First, it is not to be denied that some small-scale financial innovations represent a legitimate service to individuals who are under real and immediate financial distress. Participation, at least initially, is voluntary albeit often compelled by imperatives of social standing, as noted above. Payday loans for example can be a significant benefit for someone who would not qualify for a personal loan at a traditional bank and has exhausted other means (Bertrand and Morse 2011). If the main alternative is a loan shark, a payday loan would indeed seem the better choice. Most borrowers think payday loans take advantage of them, but also say that they provide needed relief at times (Pew 2013).

Governments

As noted above, small-scale financial innovations exercise a differential expense for the low and lower-middle classes. One motivator for continued innovations is a result of governmental attempts to regulate or ban some of the current crop of innovations. Innovators will continue to innovate in response to opportunities being closed off. Many of these regulatory initiatives stem from the state level and are designed to mitigate harm to customers.

At the federal level, however, policy has been oriented differently. Historically, politicians have found it easier to use expanded credit as a more convenient fix for problems associated with income inequality than to institute longer term structural remedies such as improving the educational system (Rajan 2010). In general, economic inequality has had sever and corrosive effects on political representation and policymaking (Bartels 2008). Instead of dealing with the core problem of widening income inequality, legislators and business interests have instead pushed increased credit availability as a means to rectify income inequality (Hyman 2011). By promoting wider credit availability for all, the US Congress has generally failed to consider whether everyone ought to have more credit. A notable recent example of such policy-making was the extension of credit to subprime borrowers, with the resultant subprime mortgage implosion and economic disaster.

 The Marketization of Credit

The distribution of economic resources is primarily a social phenomenon (Atkinson and Bourguignon 2000). That is, there are alternative mechanisms within social groupings which may receive approval for allocating or reallocating economic resources, and these may change from one era to another. From a sociological standpoint it should be noted that many activities involving money, including temporary loans, were formerly securely confined within the province of friends, family, neighbors, and ethnic or craft associations. Transfers of money were not market-mediated events, but were based on personal relationships and reciprocity. Importantly for the consideration of inequality, the circulation of this money stayed within the boundaries of a small social circle---it did not end up in the pockets of distant parties.

 Industrialization brought an “avalanche of social dislocation,” promoting markets and individualism in place of reciprocity (Polanyi 1944/2001). For small temporary loans, a gray area arose which relied less on family and friends but yet was not a legitimate market. By the late 1800’s, loan sharking became a growing business among the working class (Hyman 2011). Although the loan shark might be personally known to the borrower, most of the profits flowed to unknown and distant financiers. Today, reliance on credit cards and payday lenders has created a fully anonymous market for credit, in which most of the profits flow to individuals far removed from the actual loan transactions themselves.

Follow the Money

 Lastly, for the upper and upper-middle classes who sell and finance these financial innovations, there are numerous benefits. Upper and upper-middle groups benefit through multiple opportunities: ownerships of the innovating businesses, investors’ stock and bond holdings in these business and the banks that finance them, and investors’ ownership of high-interest instruments such as securitized credit card loans. Indeed the avenues of participation are so numerous that many investors may not even be cognizant of their involvement. The better-off also benefit from lower school taxes in locations where state-sponsored lottery profits are used to subsidize education. Capital income (eg. dividends, interest, rents, etc) has been found to contribute significantly to income inequality (Frabdorf, Grabka and Schwarze 2011).

 **Conclusion**

 Small-scale financial innovations do not simply make the poor poorer, they make the rich richer. It is a case of moving money from the bottom of the pyramid to the top (Stiglitz 2012). In 2005 alone, banks, thrifts and credit unions collected over $37 billion in late fees, overdraft penalties and other service charges (Stegman 2007). The transfer of wealth from lower to higher is a “negative trickle-down” phenomenon (Holt and Greenwood 2012). The bulk of inequality in the US stems from rising income at the top and stagnant or declining income at the middle and bottom, seemingly independent events or at least not obviously connected. Small-scale financial innovations can be seen to directly transfer wealth from bottom to top.

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 **Endnotes**

1. One of the newer financial innovations specifically targets low income senior citizens. Pension “advances” are a type of loan, for which the individual receives cash in return for signing over all or part of their future monthly pension checks. The marketers generally target retirees in governmental plans such as military personnel, police or teachers, also those in private defined benefit plans. The effective interest rates, not highly visible, are several times that charged on credit cards (*New York Times* 2013). Another innovation aimed at retirees is the reverse mortgage, which can provide cash to homeowners over age 62 who are facing a shortage of cash. [↑](#endnote-ref-1)
2. 2 As behooves them, payday loan companies understand customer characteristics and spending habits well, adjusting their marketing strategies accordingly. The companies heavily target neighborhoods with incomes in the $20,000-40,000 income range (Stegman 2007). They specifically target individuals with jobs but low incomes, including military personnel, and those with poor credit histories (Wann and Wann 2012). Larger firms use advertising campaigns through a variety of media such as TV, direct mail and yellow pages (Stegman 2007). [↑](#endnote-ref-2)
3. The payday loan business exhibited characteristics of the diffusion process that is typical of the spread of financial innovations (Redmond 2003). The industry was characterized by a pattern of relatively slow growth initially, followed by rapid growth, then declining rates of growth. In Florida, for instance, growth rates of payday loans peaked at 34% in 2003, and were 21% in 2005, followed by 13% in 2008 (Anderson and Jackson 2010). [↑](#endnote-ref-3)
4. Similarly to investment banks and other financial engineers, payday lenders continue to innovate to meet changing circumstances (Redmond 2013). Internet operations were developed in order to make loans in states which banned payday stores. Some lenders have partnered with bankers licensed in other states in order to circumvent local usury restrictions (Stegman 2007). [↑](#endnote-ref-4)