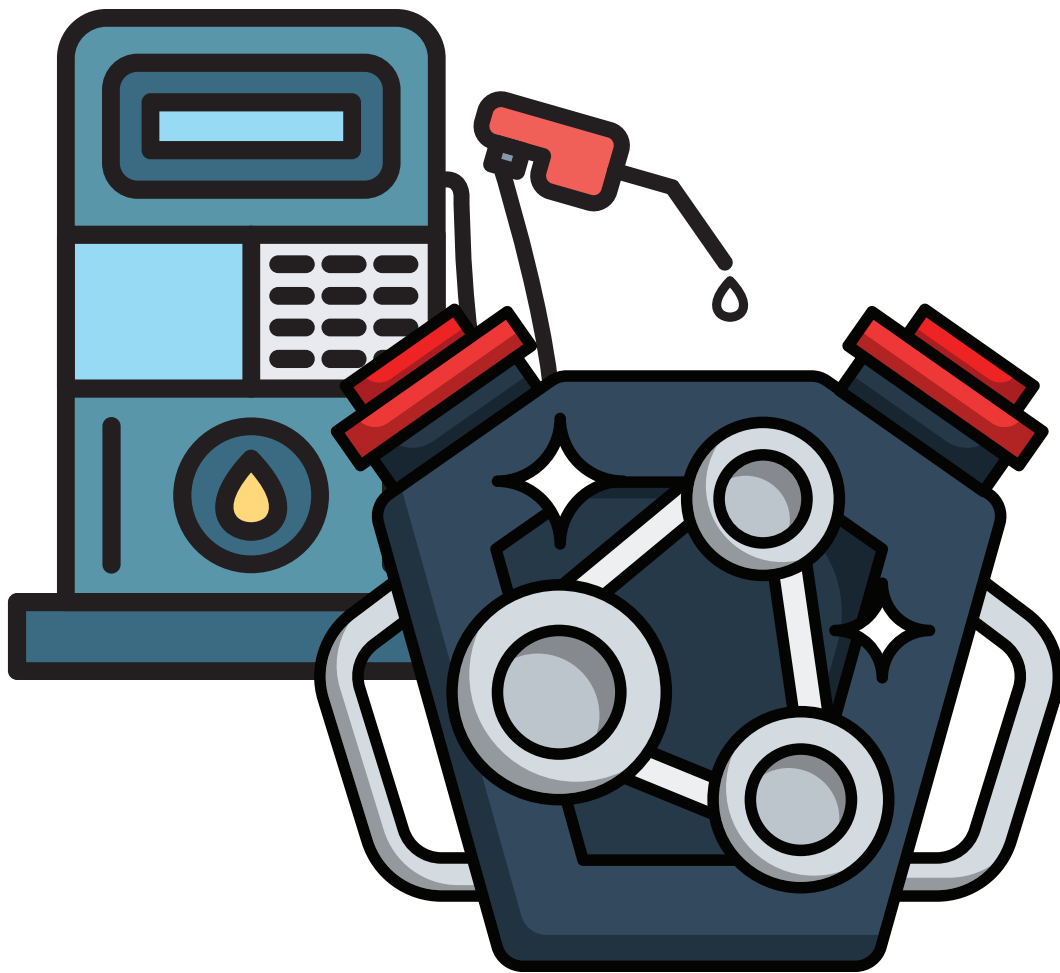


## Testing a Social Welfare Theory of Financial Capability: Personal and Governmental Capabilities

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## SUMMARY

This research brief introduces a **social welfare theory of financial capability**. The authors propose that financial capability extends beyond individual attributes to include **governmental capabilities**, such as **financial inclusion**, **income-generating functioning**, and **wealth-generating functioning**. The study utilizes longitudinal data from the **Panel Study of Income Dynamics (PSID)** to examine how these four components—**financial literacy**, **financial inclusion**, **income**, and **wealth**—collectively form financial capability among college graduates. While the model generally aligns with data and predicts **asset poverty** and **life satisfaction**, the analysis reveals that the effectiveness of financial capability as a predictor varies by **race**, suggesting that systemic inequalities disproportionately impact Black individuals' financial outcomes. The authors argue that **redistributive social welfare policies** are necessary to create a **meritocratic environment** where all citizens can pursue financial happiness.

### Brief Citation

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# A Social Welfare Theory of Financial Capability

From a capabilities' perspective, functionings are what an individual can do (i.e., current performance/behavior) and who they are (i.e., identities). Essentially, they are the actions and states of being that a person achieves.<sup>1</sup> While capabilities are a set of functionings that represent the real opportunities or freedoms people have for achieving functionings.<sup>2</sup> The authors extend functioning and capabilities to institutions; specifically, the government. For example, the government can achieve the state of being a meritocracy (i.e., a functioning).

More specifically, the paper posits that **financial capability is a higher-order construct that consists of both personal and governmental capabilities.** This expands upon previous definitions that exclusively focused on an individual's personal capability.<sup>3</sup> The core argument is that because people live in society, their capabilities are not solely determined by their individual actions, but also by what they can achieve with the assistance of government.



## Personal Capabilities

These are the set of functionings associated with being **financially literate**. This includes an individual's financial knowledge and skills. From this perspective, being financially literate means an individual can understand (use knowledge) and effectively manage (use skills) institutional resources such as financial inclusion, income, and wealth for the purpose of pursuing their financial happiness.

## Governmental Capabilities

This component of financial capability is the government's responsibility to ensure all citizens have the conditions to pursue their financial happiness. It consists of three key functionings:

- **Financial inclusion-generating functioning**  
Ensuring every individual is part of a financial institution that can build wealth on their behalf to achieve financial goals.
- **Income-generating functioning**  
Ensuring every individual has enough income to meet basic needs and spark saving.
- **Wealth-generating functioning**  
Ensuring every individual has enough wealth for institutions to efficiently produce wealth for them over a long enough period for development to occur.

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<sup>1</sup>Sen, A. (1999). *Development as freedom*. Oxford University Press.

<sup>2</sup>Ibid

<sup>3</sup>Sherraden (2013) puts emphasis on how institutions shape personal capabilities, which was a significant contribution to the field. However, she still understands the ability to act as something determined by individuals (Sherraden, 2013; Xiao, Huang, Goyal, & Kumar, 2022).

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## Personal and Governmental Capabilities Interact

The paper argues that financial capability is **not what a person can do and be independently, but what they can do and be with the assistance of institutions, income, and wealth.** These three elements (financial institutions, income, and wealth) are considered powerful “tools” that are instrumental in shaping and augmenting a person’s financial potential.

### Direct and Indirect Impact

Governmental capability impacts an individual’s financial capability directly by influencing what they can achieve (e.g., wealth generating more wealth, institutions building wealth) and indirectly by influencing the development of personal functionings. The inherited properties of wealth, for instance, can become internalized as personal characteristics, promoting the development of personal financial capabilities.

### The “Fuel” Analogy

The relationship is likened to a car engine needing fuel. A person can have excellent personal financial capabilities (the “best car engine”), but without institutional support, income, and wealth (the “fuel”), their personal capabilities cannot fully develop or effectively get them to their financial destination. It is the **interaction between personal and governmental capabilities that enables individuals to pursue their financial goals and happiness.**

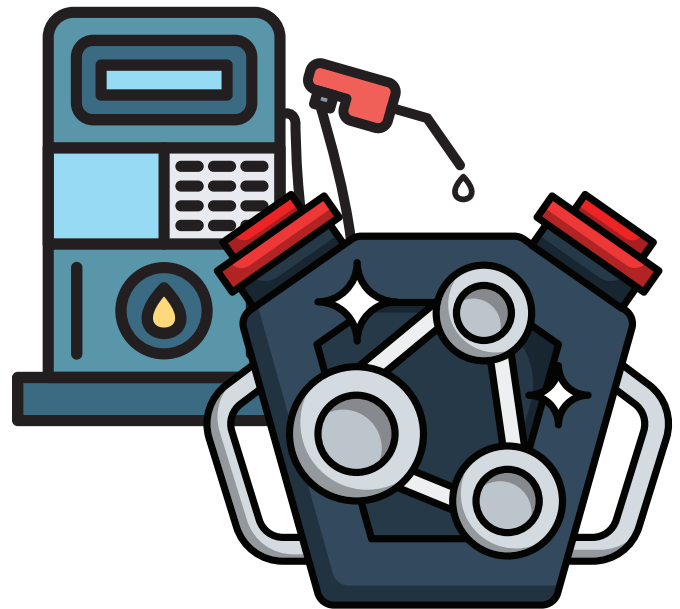
### Interdependence

The sources state that **without sufficient governmental functioning, a person cannot be said to be financially capable, even if they possess very high levels of**

**personal capability.** Conversely, being governmentally capable is not enough; individuals also need to be personally capable (financially literate) to effectively utilize these institutional resources.

### Meritocracy and Inequality

The theory suggests that in a society where significant inequality exists, like the U.S., governmental capabilities become more crucial in determining a person’s real opportunity to act. While social psychology theories like self-efficacy assume meritocratic conditions where personal capabilities are determinative, the current reality of unequal resource distribution means that governmental capabilities also play a large role. The paper posits that when society truly achieves a meritocracy, governmental capabilities would fade into the background, and personal capabilities alone would explain differences in behavior and outcomes.



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# Multigroup Confirmatory Factor Analysis (CFA) Findings

The study conducted a multigroup CFA by race to assess the latent construct of financial capability.

- For **White college graduates**, all four indicators—financial literacy, financial inclusion, income, and wealth—meaningfully contributed to measuring the underlying financial capability construct. Financial inclusion carried the heaviest weight.
- **In stark contrast, for Black college graduates, none of these indicators contributed meaningfully to financial capability** (their standardized loadings were not statistically significant).
- The global fit indices for the model applied to Black college graduates fell below acceptable ranges, further indicating that the measure of financial capability is not trustworthy across racial groups in the same way.

## Reasons for Non-Invariance (as posited by the authors)

One explanation is that the researchers were only able to measure financial capability effectively using the indicators among White graduates, but not among Black graduates.

An alternative explanation suggests that the financial capability indicators are **not meaningful among Black graduates** due to varying challenges and opportunities faced by individuals of different racial backgrounds.

- This is attributed to the “gross inequality Black individuals have faced in the mainstream economy” over time, including substantial disparities in financial literacy, financial inclusion, wealth, and income.
- The descriptive data in the study supports this, showing that asset-poor Black college graduates have **much lower levels of financial literacy, financial inclusion, income, and wealth** compared to their White counterparts.
- The theory suggests that the “tools” necessary for financial capability (institutions, income, and wealth) are either “unavailable altogether, or in such limited quantity that they are rendered ineffective as predictors of their outcomes” for Black individuals due to this inequality.

## Predictive Power and Inequality

While the expanded definition of financial capability is a strong predictor of avoiding asset poverty for White college graduates across all measures, for Black college graduates, it is only a statistically significant predictor for “Asset Poverty 3” and “median net worth of U.S. households”. These measures require higher levels of net worth. This suggests that **only when Black individuals attain a sufficiently high level of all four components of financial capability does it become predictive of their financial outcomes.**

The concept of a “meritocracy,” where differences in outcomes are due to individual effort and ability rather than inherited advantage, is undermined by such inequality. In a true meritocracy, governmental capability might become less central, and personal capability alone would explain differences in outcomes. However, given the current high levels of inequality in America, governmental capabilities are crucial

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## Policy Implications

This expanded view implies that efforts to reduce government assistance are misguided because governmental assistance is a necessary collective good that augments what individuals can do on their own, helping both individuals and society reach their full potential.

Policies designed to increase financial inclusion, income, and wealth are needed, particularly for groups facing significant inequality, to ensure that financial capability becomes a strong predictor of positive financial outcomes.