



## FINANCIAL ILLITERACY AND RETIREMENT SAVING

*People who lack the knowledge to make informed financial decisions are at increased risk of having too little money in retirement.*

The evidence is indisputable. A significant segment of the population fails to save for retirement at all or saves significantly less than they'll need to cover even their basic expenses in the years after they leave the workforce.

Why is this happening and what can be done to remedy the situation? Those are the questions that Annamaria Lusardi and Olivia Mitchell analyzed in a 2008 policy brief that focused on the relationship between financial literacy — or lack of literacy—and financial behavior among older Americans and in specific subgroups within that demographic.

### FINANCIAL ILLITERACY

An underlying reason people don't save enough, according to Lusardi and Mitchell, is what they labeled "alarmingly low" levels of financial literacy in the US population, particularly in people over 50. When this group was surveyed on topics such as how interest rates work, the effects of inflation, and the concept of risk diversification, only 50% could answer two of three questions correctly. And just 30% were right on all three questions.

The researchers also found that only 56% of survey respondents who were early baby boomers (born between 1948 and 1954) correctly answered a question that asked them to calculate how much each of five people would receive if they split a \$2 million lottery prize.\*

\* The five people would each receive \$400,000

\*\* After two years of earning 10% interest each year, the account will have grown to \$242

### → A QUICK LOOK

- Financial literacy is an essential component of retirement planning.
- Many households are unfamiliar with even the most basic economic concepts.
- Only 30% of survey respondents ages 50 and older could answer three financial literacy questions correctly.
- Just 18% of early baby boomers responding to the survey could identify and calculate compound interest.

There was even more telling evidence of a dangerous knowledge gap in a follow-up question asking respondents to calculate how much a \$200 account would be worth after two years if it earned 10% interest each year.\*\* Only 18% answered correctly.

Since the power of compounding is a significant component of saving for long-term goals, failure to understand the underlying principle of interest earning interest may help to explain why some people don't bother to save or fail to understand the significance of saving.

### AN ACUTE PROBLEM

Financial illiteracy is a serious issue for anyone who has a mortgage or uses a credit card. But it's a particular problem as people age in Lusardi and Mitchell's view.

People must make important financial decisions — some of which are irrevocable — throughout their lives. If they do so without a firm understanding of the consequences of their choices, they may well end up with even less money than they might have otherwise. Lack of financial knowledge may also make them more vulnerable to scams that target older people, in the researchers' view.

Survey data allowed Lusardi and Mitchell to identify several subgroups within the 50+ demographic in which financial illiteracy was especially persistent, including women, African-Americans, and Hispanic-Americans. The data also confirmed that financial literacy is highly correlated with level of education: The more education a respondent had, the more likely he or she was to answer questions about economic issues correctly — and vice versa.

The authors pointed out that these findings aren't confined to their study sample and are confirmed by other research. For example, they cited a study that focused on young people deemed to be financially literate based on their scores on the Jump\$tart Coalition survey. Those students were "overwhelmingly white, male, and the children of college graduates."

The more education a respondent had, the more likely he or she was to answer questions about economic issues correctly — and vice versa.

## IS FINANCIAL EDUCATION THE ANSWER?

The persistent question is what can be done to remedy the lack of financial knowledge that appears to keep many people from preparing effectively for a financially secure retirement? Since Lusardi and Mitchell had reported a direct correlation between financial literacy and planning and saving for retirement in an earlier publication, they turned their attention in this study to the role that workplace-based financial education might play.

Their conclusion was mixed. The evidence demonstrated that when financial education is available to those who "need it most," it can be effective in motivating participants to save — though they may not always follow through or save enough to make a significant difference.

More critically, Lusardi and Mitchell argued that financial literacy programs reach too few people, are often viewed negatively as "remedial," and provide a "cure" that is inadequate for the disease. What might work better, in their view, are education programs targeted to particular subgroups. That would enable presenters to address specific "savings needs and preferences," provide support that goes beyond a seminar setting, and offer tools that participants can use to change their behavior. This customized approach, they noted, could meet the challenge of equipping more people to meet their own long-term needs, especially saving for retirement.

---

*"How Much Do People Know About Economics and Finance?" was published by the University of Michigan Retirement Research Center in 2008. Annamaria Lusardi is the Joel Z. and Susan Hyatt Professor of Economics at Dartmouth College. Olivia S. Mitchell is the International Foundation of Employee Benefit Plans Professor of Risk Management at the Wharton School of the University of Pennsylvania.*