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Financial Literacy Strategies

Where Do We Go From Here?

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The evolution of market economies has dramatically broadened the opportunities of consumers, workers, investors, and firms. The sheer variety of goods and services that are easily accessible (for a price) would be breathtaking to people living just a century ago. At the same time, the multitude of choices can be bewildering. Increasingly, taking best advantage of available opportunities places heavy demands on the ability of actors to make sensible choices. The rising complexity affects nearly all market decisions, from choices about food, whether consumed at home or in restaurants; to choices about clothing, electronic equipment, transportation, and housing; to choices about career pathways; and to choices about savings and investing.

Viewed in this light, the widening array of alternatives in the financial marketplace is part of the larger process operating in the economy as a whole. Nonetheless, financial decisions are particularly vexing to many of today's families and to many businesspeople as well. Perhaps the confusion has arisen because of the speed at which financial markets and new financial instruments have emerged, or because of the higher levels of sophistication and the longer time horizons required for sound financial decisions. Moreover, the added complexity is taking place just as households face increased responsibilities for financial decisions and for insuring their own financial well-being. As lengthening life spans are making retirement planning a higher priority, the shift from defined benefit to defined contribution pensions is increasing both the freedom and the responsibility of workers to make choices. The expanding availability of credit options is providing individuals with more capacity to invest in education and owner-occupied housing and to separate the timing of consumption from the timing of income. At the same time, bad decisions can mire households in debt and lead to much lower living standards than households would enjoy, had their financial decisions been more sensible.

For the new financial freedom to help most people, they must understand their choices and the likely implications of alternative choices. Unfortunately, many Americans have a weak grasp of basic personal finance principles. One survey covering overall financial concepts found that nearly two-thirds of American adults and high school students did not know that money loses its value in times of inflation (Jump$tart 2004). General attitudes toward spending and saving behavior are troubling as well. Results from the same survey revealed that only a quarter of Americans feel very well informed about managing household finances (Jump$tart 2004). Low-income families are especially vulnerable to misinformation.

What is lacking is not information (e.g., who is charging what for a mortgage?), but rather the ability to interpret the information (e.g., how well do alternative mortgage strategies fit my needs?). Many people even seem unable to recognize the future burden they will experience by borrowing at very high interest rates. Without knowing all of the circumstances of individual cases, it is difficult to determine how many people are making poor decisions. But, given the apparently weak financial knowledge of a large segment of the population, the high rates of consumer bankruptcy, and the large share of the population poorly prepared for retirement, there are reasons for concern.

Financial Education and Financial Literacy Programs

Recognizing the importance of knowledge about financial decisions, a number of public agencies, private foundations, school systems, and employers have begun to sponsor financial literacy programs. The Congress has passed Title V of the Fair and Accurate Credit Transaction Act (the FACT Act), which established the Financial Literacy and Education Commission. The U.S. Department of the Treasury's Office of Financial Education is the lead agency charged with coordinating financial literacy efforts within the executive branch of the federal government. The Federal Reserve Board posts a great deal of material that programs and individuals can use to foster financial education on bank accounts, consumer credit, mortgages, leasing vehicles, and personal finance. In addition, Federal Reserve banks around the country sponsor education programs on a variety of topics, including the Money Smart program created by the Federal Deposit Insurance Corporation (FDIC).

Some private financial institutions target clients or potential clients. Visa and the American Bankers Association offer financial education programs free to educators, consumers, and bankers. The Jump$tart Coalition focuses on students, while the National Community Reinvestment Coalition tries to reach low- to moderate-income people. Some financial education programs are attached to other asset-building initiatives, such as homeownership programs (Braunstein and Welch 2002) and savings programs like Individual Development Accounts (IDAs) for low-income individuals (Schreiner, Clancy, and Sherraden 2002).

The concerns over insuring adequate financial literacy are not unique to the U.S. Recently, the Organisation for Economic Co-operation and Development published a report, *Improving Financial Literacy,* that defines financial education, examines the state of financial knowledge in various countries, assesses financial education for retirement saving and credit and debt, and suggests future directions (OECD 2005). The report finds that financial illiteracy is a widespread problem reaching most countries, certainly those on which there are reliable data (i.e., Japan, Korea, Australia, and the U.S.). Although many countries have financial education programs, few have been well evaluated (for a U.S. overview, see Lyons et al. 2005). The report also points out that, in some cases, financial education should not be the only tool for improving financial decisions. To affect some decisions can require countering such behavioral factors as inertia and lack of willpower with automatic mechanisms, like automatically enrolling individuals in pension programs unless they opt out.

Financial Education in High Schools

The returns to a well-designed financial education program might be quite high. If a one-semester course at the high school level—or about 10 percent of a year's schooling—led to only a 0.5 percent improvement in financial well-being, the returns would rival the 6–7 percent rates of returns to earnings from a full year of schooling. One likely and unusually unnoted side effect of financial education is improved job readiness for students.

Financial literacy proponents often see high school students as one of the most appropriate populations to educate; they are a captive audience (as class attendance is mandatory) and, importantly, a young one. Ingraining savings behavior in students might well decrease the financial mistakes they may make later in life. High school curriculums provide a ready-made infrastructure for reaching a wide audience with relative ease—at least compared with community groups and other organizations, which need to spend some effort reaching out to their intended populations (Morton 2005). And few dispute the gap in students' financial education; the need, according to available data, is great. A Visa USA 2004 survey found that 56 percent of parents believe that high school graduates are "totally unprepared" to manage their personal finances responsibly; another survey found that only 20 percent of teens think that their knowledge of money management is either good or excellent; and another reports that only 35 percent of students say they learn about money management in school (Jump$tart 2005). Average financial literacy scores on the Jump$tart survey of 12th graders declined from 1997 to 2004. Surprisingly, scores vary little with ownership of securities, with having a bank account, and with the extent to which students discuss money matters with parents.

Partly in response to these trends, the number of public schools required to include financial literacy in their curricula has increased over time. As of 2004, forty-nine states require economics in their curricular standards and fifteen states require that students take an economics course to graduate. Thirty-eight states have reported the mandatory inclusion of personal finance standards, while seven of these states have made education in personal finance a graduation requirement.

Despite these increased efforts, questions remain about what share of high school students are exposed to financial education programs and whether such programs lead to increased financial knowledge or more responsible financial behavior. Much of the short-run analysis of financial education among high school students has been conducted by Lewis Mandell of the University of Buffalo, who manages the Jump$tart survey. Among other results, Mandell (2005b, 7) examined the relationship between financial literacy programs, financial knowledge, and saving behavior. He found that financial education and experience *do not* appear related to financial literacy, what he calls a "very disheartening result, particularly among financial educators who believe that a solution to the problem of financial illiteracy is personal finance education, particularly if it is standardized, mandated and tested."

Other evidence suggests a more optimistic picture. According to an evaulation of the High School Financial Planning Program sponsored by the National Endowment for Financial Education (NEFE), students taking the program reported significant improvement in their financial knowledge at least up to three months later. Teacher surveys of student knowledge taken before and after the program indicate that students improved their knowledge of critical areas, including understanding of the career/income relationship, consumer credit, car insurance, and the time value of money. Moreover, about 60 percent reported changing their savings behavior (increasing savings) as a result of the program (Boyce and Danes 1998).

Mixed evidence emerges from another study of financial education impacts. A multivariate analysis performed by Mandell (2005a) shows that a full course in personal finance does not affect financial literacy, but discernibly raises self-reported levels of thrift as well as actual indicators of thrift, including having a savings account.

The positive impact of financial education on behavior may even persist for a long time. Using surveys of 30–49-year-olds in 1995, Bernheim, Garrett, and Maki (2001) looked at the impacts of the presence and timing of state-mandated financial education requirements. They found the requirements led to more students taking financial education and, subsequently, having higher savings and net worth. Self-reported savings rates were approximately 1.5 percent higher for students entering a high school grade five years after the imposition of a financial education mandate than for students not present when this mandate was instituted. Compared to the overall population, the rate of saving out of income for students exposed to the mandate was 4.75 percent higher. Net worth, albeit much more difficult to measure, increased by roughly one year's worth of earnings for students exposed to the mandate; their net-worth-to-earnings ratio was also 9 percent higher than that of students who were not exposed.

These surprisingly large impacts suggest that financial knowledge imparted on the young may continue into middle age. Bernheim, Garrett, and Maki's (2001) long-run conclusions bring a kind of consistency to the Jump$tart survey results—financial education, while not affecting financial knowledge, sometimes affects financial behavior, even later in life, when the chances to apply this education through experience increase (Mandell 2005a).

However, financial literacy levels remain low, especially for the less-educated and low-income populations in the U.S. and other countries (OECD 2005). Survey evidence on both financial education and financial practices suggests American adults need help. In 2004, between 25 and 56 million adults were unbanked (Jump$tart 2005) and consumer debt is now equal to 110 percent of disposable income (Jump$tart 2004). A survey conducted by FleetBoston in 2003 found that only 27 percent of respondents felt well informed about managing their household finances, and fewer than half felt they were good role models for their children regarding spending and saving (Jump$tart 2005). These results are especially disturbing given that many individuals rely on the experiences of family and friends to shape their financial knowledge and behavior (see, for example, Hilgert and Hogarth 2003 and Morton 2005).

The OECD reports that consumers very often feel more confident than their knowledge justifies, implying that financial educators need to help consumers recognize the limits of their information and the desirability of learning more.

Perspectives on the Content of Financial Education Programs

Since financial education programs seem to raise savings, why not simply expand them? One reason is the naturally uneasy feeling about evidence suggesting that financial education increases savings but does not raise financial literacy. If people are no better informed about financial matters after a class, why does it influence them to save more? Moreover, might weaknesses in knowledge lead to later financial blunders in any event? Before doing more to promote or require financial education programs, we should develop ways to improve their effectiveness and their accuracy. Some questions on financial literacy tests are flawed—a warning sign about the material being taught.[1] We should strive not only for effective teaching methods, but for content that is correct—not misleading—and that will lead to sound decisions about matters relevant to those taking the courses.

But, how do we get there? The first step should be to clarify the goals of the financial education and potential tradeoffs. Is the primary goal to increase financial knowledge or to influence financial decisions? Although ideally financial education programs would achieve both, the approach may vary depending on which goal we wish to emphasize.

A focus on educational outcomes usually involves teaching high school students about an ambitious set of topics and using standardized tests to determine student learning. The list of topics varies from one standard to another, but often includes complex issues such as "dollar cost averaging" and the difficult concepts involved in reading a mutual fund prospectus. One strength of the approach is that high school students are a captive, nearly universal audience for the education effort. Another is that introducing the concepts at this stage of life may prevent early and long-lasting mistakes and prevent bad habits from developing. On the other hand, some curricula include lessons that are incorrect and few teachers are well qualified to teach financial topics to high school students. As noted above, the evidence suggests that even students completing the programs have shown little gain in their knowledge of financial realities. But, limited success in the past is no reason to abandon the effort. Of the many potential topics taught in high school, the basics of economics and personal finance should rank very high. But, no one should underestimate the challenge of ensuring teachers are properly prepared and that what they teach is properly vetted and sensibly limited to important, accessible topics.

A second perspective is to focus directly on the goal of affecting financial decisions and financial outcomes. The emphasis would be on issues of clear relevance to the students or of relevance in the immediate future. The teaching approach would involve a great deal of hands-on learning and would raise financial topics partly as a means to personal goals. In discussing retirement issues, the teachers could begin with students' payroll stubs, explain the rationale for FICA taxes, and describe how their (and their employers') contributions are part of an intergenerational compact that will qualify them for a retirement income. A class for high school students could consider financial decisions of likely relevance. A car, for example, is an asset most students would like and might buy in the near future. The lessons could deal with the both the benefits and the costs of car ownership (including gas, upkeep, and insurance), the car as a durable good, the advisability of financing the car purchase with credit, and why credit might make sense for a car purchase but not for basic living expenses. The discussion of car insurance would provide a good opportunity for students to learn broad concepts directly applicable to their lives. If well-treated and examined in some depth (i.e., students themselves would work out various calculations), one would expect that students will likely remember and use this information.

How to examine the financial consequences of human capital investment and career decisions should be central to any program for high school students. These matters are complicated, but working out calculations illustrating the potential returns to investing in oneself may be the most important element of financial education. Again, care must be taken to avoid giving students misleading or incorrect information. For example, studies typically report the returns to college among those attending college and not the returns to the marginal student. Still, students should see human capital investments as similar to financial investments in terms of meeting living standards over the long term. The lessons should illustrate why borrowing to fund human capital investments may be appropriate, given the durable nature of increased human capital.

We realize that examples of this kind are already included in high school curricula. But, they are too often embedded in long lists of desirable finance standards that include abstract topics quite distant from students' lives. A focused approach on a limited number of highly relevant topics may prove more effective.

The general approach of focusing financial training on real-life experiences can and should be extended beyond high schools. Training should consider a variety of key transition points, such as buying a home, moving out of a parent's home, taking a student loan, taking a small business loan, and starting a job and facing options for pensions and health insurance. Often, programs already exist for providing financial education linked to such decisions, but they may not reach an important segment of the population. Linking financial training with the timing of decisions takes place in many venues. They include community organizations, places of employment, welfare programs, credit unions, and, most recently, as part of programs offering Individual Development Accounts. Ideally, programs in these venues should identify the most important issues that arise at various decision points and help people avoid mistakes and missed opportunities.

One extension beyond educating people at decision points is to link education with steps that deal directly with behavior. For example, instead of simply discussing the reasons people should have bank accounts, financial education programs have made agreements with banks to provide special account options and to sign people up on site. Other programs take a recess, give participants bus fare and directions to a bank, and allow them to open accounts.

Another innovation becoming widely known is the use of default options to encourage savings and safe investments. Some employers are enrolling new workers in 401(k) pension programs when they start work and requiring them to take concrete steps to opt out of such arrangements. Other approaches involve having people commit in advance to allocating a portion of their future salary increases toward retirement savings. Thaler and Benartzi (2004) find, in one implementation of this plan through four annual raises, that 78 percent of those offered the plan enrolled, that most remained in the plan through the fourth pay raise, and that the average saving rate increased in response to participation from 3.5 percent to 13.6 percent over the course of 40 months.

Although evidence is scanty, some studies have attempted to examine the impact of providing education at these "teachable moments" (times when people are about to make a specific financial decision). Others have emphasized behavioral strategies, especially at key decision points. We now turn to studies of these approaches.

Evidence on Effects of Financial Education at Teachable Moments

Since experience seems to be an important component of education, linking financial learning to teachable moments might well do the most to increase knowledge and improve the quality of financial decisions. Currently, organizations are reaching out to individuals and households by providing training based on specific transactions, such as purchasing a home or vehicle, or applying for credit. For example, 93 percent of banks in a recent Consumer Bankers Association survey reported that they require credit counseling for individuals applying for mortgage lending programs (Morton 2005). Employers can also offer financial education in conjunction with participation in a retirement plan.

Despite the promising opportunities these programs offer, the fact remains that reaching out to individuals or households via the "teachable moments" platform is difficult. Since the type of transactions that support teachable moments education are more oriented toward adults than high school students, the groups that need financial education are more likely to have very different cultural and financial experiences and work and family demands (Morton 2005). In addition, given the large amount of unbanked adults in the United States, a lack of relevant venues may prevent even the most targeted education programs from reaching their ideal audience (Burhouse, Grambell, and Harris 2004).

One piece of recent evidence for high school seniors calls the teachable moments strategy into question. In a study using the Jump$tart surveys, Mandell (2006) compared the responses of students who had taken a course in personal finance with those who had not, grouping the responses of students by whether or not they have had firsthand financial experiences. He examined 11 questions that directly relate to the experiences of high school seniors, such as the use of credit and debit cards, vehicle financing, and higher education expenses. He found no systematic relationship between course-related improvements in financial knowledge and financial experience, such as having a credit card, a checking account, and a car. Although on some dimensions students with financial experience learned more from courses than did the overall youth population, other tested topics (like debit cards) either showed mixed results or results that ran against the hypothesis—what Mandell calls "Just-in-Time Instruction." Mandell concludes that, at least for high school students, "relevance by itself is not the answer" to improving financial knowledge and/or behavior (9a).

But, this conclusion may itself be incorrect. Mandell admits that we know little or nothing about what was taught in these courses. Perhaps the courses did not address the issues appearing on the tests, or did so ineffectively. Moreover, the questions used to judge knowledge could have varying interpretations. For example, consider the question, "If you had a savings account at a bank, which of the following would be correct concerning the interest that you would earn on this account?" One of the choices, "Earnings from savings account interest may not be taxed," was viewed as an incorrect answer. In fact, interest earnings for those below the tax threshold (which may be the case for many students) will go untaxed while earnings from work are taxed from the first dollar. Finally, the Mandell analysis does not examine whether or not well-executed courses aimed at affecting immediate financial choices and behavior actually do so.

Several other studies on targeted counseling speak more directly to the "teachable moment" hypothesis. Hirad and Zorn (2001), for example, examined data on approximately 40,000 mortgages under Freddie Mac's Affordable Gold program to determine whether pre-purchase homeownership counseling programs lower mortgage delinquency rates. The authors found that borrowers who receive counseling are about 13 percent less likely to become 60-day delinquent than borrowers with equivalent characteristics who do not. While the authors did not examine the affect of counseling on the timing of delinquency or the severity of any loss that may occur, they conclude that pre-purchase homeownership counseling can increase the success of lending programs.

Elliehausen, Lundquist, and Staten (2003) explored the impact of credit counseling on subsequent borrower behavior. Analyzing 10 different measures of borrower credit performance, they concluded that borrowers who received counseling "generally improved their credit profile" over the three years following instruction when compared with similar borrowers who did not undergo counseling. Specifically, counseling had a positive impact on creditworthiness; cultivated improved financial behaviors regarding credit characteristics like total debt, account balances, and bank card usage; and lowered delinquency experiences.

Evaluations of workplace programs also show that financial education positively influences savings. In examining the effects of financial education in the workplace, Bayer, Bernheim, and Scholz (1996) find that participation in and contributions to voluntary savings plans increase when employers offer retirement seminars. Further, this effect is even more pronounced in lower-income populations. For lower-wage employees, retirement plans offered with frequent seminars result in a participation rate 11.5 percent higher than for those plans offered without seminars. For highly compensated employees, there is a 6.4 percent difference. Kim, Kratzer, and Leech (2001) support this finding, noting that employees who received financial education counseling increased their 401(k) participation. The effectiveness of these programs was likely the result of combining financial education with a direct institutional outlet for applying it.

Lusardi (2004) examines the impact of meetings on retirement or retirement planning on older individuals' financial and total worth. She finds large impacts, especially among those at the bottom of the net worth distribution. Their net worth rises by close to 30 percent as a result of behaviors in response to attending a retirement seminar.

Other studies report favorable behavioral results from financial education programs linked to services for low-income households. In an evaluation of the American Dream Demonstration and IDA participants, Schreiner and his colleagues (2002) show that, in conjunction with saving through the IDA program, participants who also took financial literacy courses contributed higher net monthly savings deposits. In addition, classes did not need to be very long—the authors report about 8 to 10 hours—to generate potential savings benefits.

Attaching financial literacy programs to other welfare programs may be one of the best strategies for reaching the unbanked population, although program participants will still, to some extent, be self-selecting. One study dealing with program impacts on financial literacy examined a program operating in the context of an existing social welfare program: the Illinois Department of Human Services, along with the Financial Links for Low-Income People (FLLIP) coalition, has recently created personal finance and asset-building programs under the state's Temporary Assistance for Needy Families system. Using the financial education curricula developed by FLLIP, several nonprofit organizations offered a free, 12-hour financial education course for Illinois welfare recipients and other adults with children under 18 and incomes up to 200 percent of the federal poverty level. The curriculum covered an array of topics, from spending choices and understanding credit, debt, and taxes to using financial institutions, insurance, and job benefits. In addition, FLLIP sponsored an IDA program that included a 10-hour financial education course and 6 hours of asset-specific training. A summary evaluation noted that about one-third of participants did not "graduate" from the training program, and that noncompletion rates were nearly three times higher at the "education-only" sites than at the IDA sites. Follow-up surveys indicated that participants improved their budgeting, payment, credit card, and loan practices (Anderson, Scott, and Zhan 2004).

Implications for the Future of Financial Education

Finance can be a complicated subject requiring sophisticated mathematics, a deep understanding of economics, and a recognition that psychological factors influence actual choices in the context of risk. Few can comprehend the complex models that optimize portfolios to achieve the most favorable risk-return tradeoff. And yet, in modern economies, people must make frequent decisions that represent important financial concepts—they must choose when and how much to borrow, when and how much to save, whether to buy and how to finance purchases of homes and consumer durables, and how to plan for uncertain contingencies and for retirement. Of course, the largest impacts of these decisions fall on the individuals making them and their families. However, the general public is often affected as well, because bad decisions will worsen the plight of many families and arouse altruistic concerns, will require added taxes to care for such families, and will increase external costs by raising risks and associated interest rates and by requiring more use of legal and other social resources to deal with bankruptcies.

While the reliance on individuals to make their own financial decisions has increased in most modern economies, the worry is that too many are ill prepared. Not surprisingly, many governments are trying to increase their citizens' financial knowledge.

The question is, what approaches can best promote financial knowledge and sound financial decisions? A sensible education approach must delineate which skills are necessary for every adult to master, which provide a framework for adults to engage in continuous learning, and which require financial specialists. We would suggest selecting a modest number of important topics that all high school students and adults can learn well, instead of trying to deliver an ambitious agenda of financial concepts. Ideally, the selected topics would have relevance, and would allow for learning by doing and for behavioral approaches that not only improve knowledge, but also stimulate people to choose wisely.

In our view, the specific topics and behavioral strategies should vary with the target group. For example, high school students might focus on the concepts of time horizons, comparing borrowing rates and rates of return, and common life cycle choices. Applications of these concepts could involve making decisions about investing in human capital (including financing requirements; purchasing, financing, and maintaining a car) and learning how withholding funds from wages for payroll taxes both transfers funds to the elderly and disabled and helps others qualify for disability, survivors insurance, and retirement benefits.

Education concerning credit and debt issues can be critical for helping people avoid excess indebtedness, mortgage delinquencies and foreclosures, bankruptcies, and excessively costly borrowing. The proliferation of credit and debt instruments, often with extensive information from written provisions and salespeople, can overwhelm borrowers. The OECD (2005) suggests designing at least two program approaches, one on the basics of budget management and another for people who understand credit to some extent, dealing with how to choose among credit instruments. Another suggestion is to build up consumers' confidence so they can challenge financial intermediaries about the credit provisions in various contracts. Doing so will require programs that simply financial concepts and make them apply to real-life situations.

One major challenge is how best to develop financial literacy policies for unbanked members of society. The OECD (2005) points to community-based programs, delivered in informal environments with local trainers as having the potential for drawing more low-income people into the financial mainstream. The report favors trying to convince individuals about the advantages of having a bank account and then following up with direct help for setting up accounts and ongoing budget management training. The approach should emphasize preventing mistakes and promoting long-term learning. One potential problem not addressed in the OECD study is that asset limits for public benefit programs might discourage saving (Chen and Lerman 2005).

As the U.S. and other countries move forward to expand financial education and to encourage behavioral change, developing a serious research and evaluation effort is important (Lyons et al. 2005). Large numbers of programs are already offering training in financial literacy. But which are providing cost-effective services, for improving both knowledge and financial decisions? Some experimental studies have been conducted, but without plans for replicating the findings and diffusing the activities. The U.S. Department of the Treasury, which has responsibility for improving financial literacy, should partner with foundations, the Federal Reserve, and a few private sector organizations dealing with financial literacy to produce a serious research and evaluation plan linked to long-term goals and actions. The evaluations should employ both experimental and nonexperimental techniques and should deal with costs, knowledge impacts, and impacts on behavior. Where appropriate, the financial education programs should be linked with other initiatives aimed at helping people achieve a decent living standard. These might include programs aimed at teen pregnancy prevention, marriage and relationship skills training, and preventing criminal behavior. Whether provided alone or in combination with other initiatives, financial literacy programs have the potential to achieve significant and cost-effective improvements in economic welfare.

Notes

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1. Consider, for example, the following question taken from a poll commisioned by the National Council on Economic Education (2005). Respondents are asked to complete the sentence, "The existence of the stock market . . ." The correct answer from multiple choices is ". . . brings people together who want to buy stocks with people who want to sell stocks." This is either trivial or misleading.

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