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Can Financial Literacy Enhance Asset Building?

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Even when incentives to save and invest are strong, many low- and moderate-income families lack the basic knowledge to manage their income wisely, build wealth, and avoid excessive debt.

Asset-building strategies for low- and moderate-income families typically rely on strengthening incentives to save and invest. But market incentives already exist, and simply adding to them is not enough. Families often need help to make informed and appropriate decisions, especially in today's complex financial marketplace. Even when incentives are strong, many families spend beyond their means, too few save enough for contingencies, and many do not take full advantage of generous employer contributions for their retirement. One reason is that many low- and moderate-income families lack the basic knowledge to save and invest wisely, build wealth, and avoid excessive debt. Another reason is the lack of institutional arrangements that make enrollment in savings programs the starting point or default option, encouraging sound financial decisions.[1] This brief focuses on lack of financial knowledge and education programs to increase financial literacy. Although such programs are becoming widespread and increasingly reaching some students, workers, and recipients of support programs, the field is still in its infancy.

Financial literacy and education programs must deal with an environment where people confront an increasingly complex array of choices that many are ill-prepared to make. People have to do more than simply save for contingencies and borrow to buy a house or car. Many more must deal with how much debt to accumulate when investing in a postsecondary education, or with deciding whether to obtain, and how to use, home equity loans. Unlike in the past, employer pension plans seldom guarantee workers some share of their pre-retirement earnings. Now, more people must decide how to save sufficiently for retirement, how to select an investment strategy, and how to redeem pension savings in a way that assures enough income to maintain living standards. The growth in personal bankruptcies suggests that many people are not choosing well. Meanwhile, billions of dollars are spent encouraging them to take on more debt. The low level of financial literacy in the United States may leave many ill-prepared for wolves at their door.

This brief examines financial literacy and programs to improve financial knowledge and decisionmaking. After examining survey evidence on what people believe about personal finance, we review existing financial literacy programs and make suggestions for improving financial literacy. The comments of experts who participated in a December 2004 roundtable on financial literacy convened by the Urban Institute are also reflected here.

The Financial Literacy Problem: Trends and Current Programs

Does the United States have a "financially illiterate" population? Some say yes based on the low rate of personal saving. Nearly 40 percent of American households live off 110 percent of their income (Jump$tart

Coalition 2004). Many low-income individuals lack a bank account and obtain cash using high-cost check-cashing firms. It is not uncommon for people to lose wealth by borrowing at high rates of interest while their savings yield much lower interest rates. Unwise debt and large numbers of personal bankruptcies are additional evidence of poor financial literacy.

Surveys suggest that 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 students did not know that money loses its value in times of inflation. General attitudes towards spending and saving behavior are troubling as well. Results from another survey revealed that only a quarter of Americans feel very well informed about managing household finances (Jump$tart Coalition 2004).

Low-income families are especially vulnerable to misinformation. According to some surveys, people with low-incomes are less likely than their higher-income counterparts to have any financial education (Anderson, Zhan, and Scott 2004). Low-income communities often lack such financial institutions as banks that encourage and facilitate sound financial management (Avery et al. 1997). The growing complexity of financial markets, which widens the choices people have to save, invest, and take or avoid risks, requires knowledge to work toward a sound financial position (Braunstein and Welch 2002). Having modest or no wealth at all, low-income households are particularly susceptible to financial crises (Anderson et al. 2004).

Financial Education Programs Aimed at Increasing Financial Literacy

Increasing interest in financial literacy has produced a diverse array of education programs and targeting strategies. Some see the most accessible group as high school students. School programs can provide a vehicle for delivering relevant education to a broad, captive audience. Further, learning financial responsibilities early in adulthood can help people before they get into financial trouble. According to a survey by the National Council on Economic Education, as of 2002, 48 states and the District of Columbia included economics in their education standards and 31 included personal finance. However, only 17 states required that schools actually offer an economics course; 14 states made the class mandatory. Personal finance courses fared worse, with only 4 states requiring a course in the field. The limited access of students to personal finance education counters the view of 80 percent of parents who believe that schools should provide classes on money management and budgeting (Jump$tart Coalition 2004). Still, high school coverage of economics and finance topics has risen since the survey began in 1998 (National Council on Economic Education 2003).

A wide array of government and private organizations sponsor financial literacy programs. Among the federal government agencies providing financial education are the Cooperative State Research, Education, and Extension Service; the Securities and Exchange Commission; and the Office of Financial Education within the Treasury Department. In addition, Federal Reserve banks around the country have several 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).

Education programs are becoming increasingly linked to government agencies as well. As part of a plan to increase homeownership among minorities and other underserved groups, the Bush administration made housing counseling a separate program within the U.S. Department of Housing and Urban Development (HUD) for the first time in FY 2003. In partnership with the FDIC and several other nonprofit organizations, HUD is also making financial education programs accessible through such self-sufficiency initiatives as the Welfare to Work Voucher program.

Some researchers and educators believe the United States should have a more comprehensive approach to the delivery of financial education and training. Others argue that differences in the needs of various target groups might make standardizing the curricula counterproductive. Still, program objectives and key topics are often similar across programs. The standards developed for school-based financial education programs show that students are expected to learn about income sources, money management, spending and credit, and saving and investing.[2] Achieving the standards requires students to know how to budget, to understand the role of insurance, to see the value of savings, to recognize the high potential costs of credit card debt, and to appreciate the risk-return tradeoffs that arise when investing in various financial and nonfinancial assets. Although the standards generally promote sound financial practices, a few features are controversial or incorrect. Consider, for example, "dollar-cost averaging," a technique to divide investments in risky assets into fixed monthly amounts instead of holding a fixed portfolio of risky and risk-free assets. Despite a consensus among financial economists that this technique is inefficient and involves a higher risk for a given expected return than the buy-and-hold strategy, financial education courses and advisors often recommend dollar-cost averaging (Bodie and Clowes 2003).

Does Financial Literacy Improve Financial Decisions?

Financial literacy programs generally assume that improving knowledge about finance will cause people to make wiser financial decisions. Existing research suggests that there is, in fact, a correlation between financial literacy and behavior, although the direction of causality remains unclear. As Hogarth, Beverly, and Hilgert (2003) suggest, this correlation does not necessarily mean that more knowledge improves behavior. Perhaps more experience in financial activities, or learning by doing, leads to more financial knowledge.

Still, some evidence shows that the level of financial knowledge within a household affects its inhabitants' subsequent behavior. Hilgert and Hogarth (2003) detail this link statistically by examining sources of financial experiences, knowledge, and practices in the 2001 Survey of Consumer Finances and the University of Michigan's 2001 Surveys of Consumers. By exploring consumer behavior and knowledge in cash-flow management, credit management, saving, and investment, the authors find that those who knew more in each of these areas also tended to "score" better in terms of financial practices—such households were more likely to follow sound financial behaviors. Interestingly, households that learned almost exclusively from family, friends, and personal experiences also had higher scores. Other research also suggests that, more generally, higher scores on financial literacy tests correlate with following recommended financial management practices (see, for example, Hogarth and Hilgert 2002).

What Are the Impacts of Financial Education Programs?

A modest amount of research has examined the impacts of diverse financial literacy programs. Some studies examine programs for high school or college students, while others focus on workers or low-income families. Yet few studies have estimated the effectiveness of financial

education programs in strictly increasing financial knowledge. Typically, researchers try to determine how financial education program participation affects specific financial decisions as well as wealth and assets.

Isolating a program's causal effect is difficult. Those who choose to take a financial education course may be more concerned with financial issues than nonparticipants and so would have made better decisions even without the program. One partial solution to this "selection" problem (that some types of people "select" themselves into the program) is to use a factor that increases participation in some areas or states but not in others. Bernheim, Garrett, and Maki (2001) use this approach by examining the relationship between high school financial education mandates (not individual participation) and behavioral patterns later in life. The authors find that financial education in high school is related to higher saving behaviors and greater net worth. Specifically, they find that (self-reported) savings rates are 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 in the population distribution than for those who were not. Net worth, albeit much more difficult to measure, increased by roughly one year's worth of earnings for students exposed to the mandate, whose net-worth-to-earnings ratio was also 9 percent higher than students who were not exposed. These are surprisingly large impacts.

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, frequent seminars offered with retirement plans result in a participation rate that is 11.5 percent higher than for those plans without seminars. For highly compensated employees, there is a 6.4 percent difference. The seminars' effectiveness was likely the result of combining financial education with a direct institutional outlet for applying it.

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 take advantage of potential savings benefits. Hirad and Zorn (2001) show similar results for prepurchase homeownership counseling.

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, 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 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. The evaluation of the course without the IDA indicated that, though participants had limited knowledge of basic financial issues before the class, they improved their knowledge in each category of financial literacy by the end of the course. The financial education program for IDA participants also led to increases in financial literacy. IDA participants both started and ended the program with a higher level of financial literacy than other participants. Preliminary results from a second year of evaluation indicate some positive behavior changes as well (Rand 2004).

Future Research and Policies

The financial literacy experts at the December 2004 roundtable convened by the Urban Institute made several suggestions for data collection and policy.

- **Counting participants in financial education programs.** While some programs have data on participants, information is lacking on the overall number of people who are taking, or have taken, a financial education course. Examining the relationship between the annual number served and the inflow of people who should obtain financial education would be worthwhile.
- **Fleshing out factors that make a difference.** Data from surveys deal with financial literacy and allow analyses of differences across groups. But, there are few controlled studies of the effects of financial education programs. Random assignment demonstrations and more natural experiments are needed to learn whether, and in what ways, financial education programs influence financial literacy and financial decisionmaking. Longitudinal studies that track financial decisionmaking by participants and nonparticipants could shed important light on the factors leading to financial success or to financial problems. Perhaps most importantly, demonstrations could help us learn about what works best in terms of structure and duration of the programs.
- **Looking at different measures of success.** The growth of financial literacy programs, high school mandates, and participation rates in financial education initiatives suggest the country is helping more people become financially literate. However, the demands are growing as well, as the financial marketplace is becoming more complex and more people are facing decisions about saving, borrowing, and investing. We need to look closely at what the programs are teaching and what should constitute success for various populations. While encouraging savings makes sense for most people, it may do little to increase financial security if people lack the knowledge about how to invest in low-risk assets and the implications of investing in high-risk assets.
- **Relating education to relevant and actionable activities.** In setting the appropriate tone for financial education, one must be aware of the needs of the audience, such as how they spend and save. Timing is important as well. A study by the Brookings Institution (Duflo et al. 2005) suggests that tax assistance and "information provision" can play important roles in encouraging savings. H&R Block's Robert Weinberger estimates that roughly 68 percent of EITC recipients are going to a paid return preparer.[3] Thus, tax preparers have a "teachable moment" to give EITC recipients financial tips customized to their individual circumstances.
- **Recognizing the impact of family and other cultural or psychological factors.** How people perceive the meaning of financial concepts may vary with cultural setting, financial constraints, and psychological orientation. If low-income people lack a sense of control, they may have difficulty making choices and might be steered toward simple decisions. Some may perceive a low life expectancy and may therefore have

short time horizons. Others may see benefit programs as providing sufficient income insurance without recognizing the asset limits that can require beneficiaries to liquidate their assets. One way to help low-income people apply financial concepts to specific situations facing their households is to make sure that financial educators understand the community and the participants.

- **Linking other asset-building policies with financial literacy.** Several asset-building programs, such as IDA initiatives and homeownership services, already require financial education components for their program participants. The offer of a subsidy may draw families into financial education classes and lead to positive impacts on financial health above and beyond the direct impacts of the subsidy.

Conclusions

Financial education, especially for economically vulnerable families, is an important part of an asset-building agenda. Increasingly, sponsors are linking financial education programs to tax refunds, buying a home, required registration for pensions, participation in welfare programs, and other key moments. While financial education programs have proliferated in recent years, targeted research is necessary to learn about the actual benefits of such programs and to insure they are well structured. Generally, we expect that educated consumers are more capable of making sound financial decisions to increase their families' economic security and, in turn, contribute to community economic development. The idea is to teach families not only to accumulate savings, but also to manage their assets. However, a little knowledge can be a dangerous thing. It is important not to have unrealistic expectations about what a financial education program can achieve. Financial education should complement institutional structures that make choosing sound financial strategies and sensible financial decisions easier.

Notes

1. A good example is the case of employer-sponsored 401(k) programs. When workers are forced to file a form whether they enroll or not, or when workers are automatically enrolled but allowed to opt out, a higher proportion of workers participate in the program than when workers must take action to sign up (Choi et al. 2002 and 2005).
2. See Jump$tart Coalition (2002).
3. Comments at Urban Institute roundtable on financial literacy, December 2004.

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Given the chance, many low-income families can acquire assets and become more financially secure. Conservatives and liberals increasingly agree that government's role in this transition requires going beyond traditional antipoverty programs to encourage savings, homeownership, private pensions, and microenterprise. The Urban Institute's *Opportunity and Ownership Project* held five roundtables in 2004 to explore these options. This policy brief series presents some of our findings, analyses, and recommendations. The authors are grateful to the Annie E. Casey Foundation for funding the roundtables and policy briefs and to the roundtable participants for their insightful comments.

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