RETIREMENT INCOME INSTITUTE
Alliance for Lifetime Income

Who Should Read This Insight:
Employers, financial professionals, retirement investors, and researchers.

Institute Research Agenda Topic:
Understanding differences in consumer behavior and decision-making.

Insight: BOOSTING FINANCIAL LITERACY TO IMPROVE RETIREMENT PLANNING

Definitions of **bolded key terms** are at the end of this article.

ANNAMARIA LUSARDI, *PhD, is University Professor of Economics and Accountancy at The George Washington University. She also is the Academic Director of the Global Financial Literacy Excellence Center (GFLEC), the Director of the Italian Financial Education Committee, and a Research Fellow of the Retirement Income Institute. To learn more about her work, visit www.gflec.org*

Authors, Titles and Publication Dates of the Articles Addressed in the Insight
Lusardi, Annamaria, and Olivia S. Mitchell. 2017. "How Ordinary Consumers Make Complex Economic Decisions: Financial Literacy and Retirement Readiness." Quarterly Journal of Finance 7 (3): 1–31. https://www.worldscientific.com/doi/abs/10.1142/S2010139217500082

Annamaria Lusardi, The George Washington University School of Business. Olivia S. Mitchell, The Wharton School, University of Pennsylvania. Olivia Mitchell, PhD, is the International Foundation of Employee Benefit Plans Professor and Professor of Insurance/Risk Management and Business Economics/Policy at the Wharton School of the University of Pennsylvania. She also serves as the Executive Director of the Pension Research Council and Director of the Boettner Center on Pensions and Retirement Research, also at the Wharton School. To learn more about Dr. Mitchell's work, visit https://bepp.wharton.upenn.edu/profile/mitchelo/.

IDEAS IN THE INSIGHT YOU CAN PUT INTO ACTION

This article finds that financial literacy is strongly tied to retirement planning behavior. Unfortunately, the level of financial literacy is low, even among those close to retirement. Employers could promote workplace financial wellness programs and other initiatives to boost employees' retirement readiness. Financial professionals and policymakers could promote school-based financial education in order to better prepare the next generation of workers.

PRINCIPAL INSIGHTS

Annamaria Lusardi and Olivia S. Mitchell's article analyzes the relationship between financial literacy, as measured by the understanding of retirement-relevant concepts, and retirement planning, which is a key determinant of savings and of wealth accumulation. It finds that both financial literacy and retirement planning are lacking in the U.S. population, even among those who are 10 to 15 years away from retirement. This finding is important because financial literacy is a key driver of retirement planning and, by extension, of financial security.

Today's retirement landscape has seen the phasing out of employer-provided defined-benefit plans in favor of employee-managed defined-contribution plans such as 401(k)s. This change means that employees are more responsible than ever for planning for their retirements and making complex financial decisions about current and future consumption, yet many employees spend little time thinking about retirement. Using the data from an internet-based survey of adults that follows respondents over time in 2009, this article finds that about 30% of respondents have given little or no thought to retirement. And this statistic obscures disparities among demographic groups. Among respondents under age 50, 38% have spent little to no time thinking about retirement. Respondents who are over age 50 are much more likely to have thought about retirement, but even so about one in six respondents in this age group has spent little to no time thinking about it. Women and individuals without a college degree are less likely to have spent a substantial amount of time thinking about retirement.

To explain this lack of planning, the authors explore new measures of financial literacy to assess respondents' understanding of retirement-relevant financial topics. Previous studies relied on basic measures of financial literacy, such as the Big Three financial literacy questions, which assess individuals' capacity to do simple calculations, their knowledge of the workings of inflation, and their understanding of risk. These are considered to be basic personal finance concepts. But the research reported in this article, in addition to measuring basic financial knowledge, also looks at more-sophisticated concepts, such as the difference in risk and expected return between bonds and stocks, how the stock market works, and basic asset pricing (for a total of 13 questions). An understanding of these more-sophisticated concepts is needed to make decisions related to retirement planning.

The survey results analyzed in this article show that, particularly when it comes to more-sophisticated financial concepts, financial literacy is lacking in the population. The proportion of respondents' answers that were correct was high for each of the basic financial literacy questions, but decreased a lot for the more sophisticated questions. For example, only 32% of respondents know about the relationship between bond prices and interest rates. A sizeable fraction of respondents responded, "Do not know" to the complex financial literacy questions. Sophisticated financial literacy is not only low overall, but is particularly lacking among some demographic groups, notably the young, those with less education, and women. Even older respondents heading into retirement scored only slightly higher than their younger counterparts, however. This lack of financial literacy casts doubt on people's ability to make complex retirement planning decisions, despite the expectation that they do so.

When financial knowledge is linked to retirement planning, the article finds that financial literacy—in particular, knowledge of complex financial concepts—is a strong predictor of retirement planning behavior: those who have higher financial knowledge are much more likely to plan for retirement. The importance of financial literacy in predicting retirement planning remains strong even after controlling for demographic factors including age, race, education, and income.

These findings corroborate previous research that has associated financial illiteracy with a lower likelihood of investing, more expensive borrowing behavior, and a failure to minimize costs (e.g., failure to refinance mortgages or to find low-cost investment options). Successful retirement planning is simply much more difficult and less likely to happen if individuals do not understand the concepts underlying effective retirement planning.

The article also finds that financial education in school is associated with higher levels of financial literacy. Thus, the development of financial education programs aimed at increasing the financial literacy of individuals could be a way to strengthen retirement planning and financial security in America.

To learn more, visit the Retirement Income Institute at
www.allianceforlifetimeincome.org/retirement-income-institute

KEY TERMS ARE SOURCED FROM THE ALLIANCE FOR LIFETIME INCOME'S ANNUITIES LANGUAGE GLOSSARY AND INVESTOPEDIA

defined-benefit plan: *A defined-benefit plan is an employer-sponsored retirement plan where employee benefits are computed using a formula that considers several factors, such as length of employment and salary history.*

defined-contribution plan: *A defined-contribution plan is a retirement plan that's typically tax-deferred, like a 401(k) or a 403(b), in which employees contribute a fixed amount or a percentage of their paychecks to an account that is intended to fund their retirements.*

financial professional: *A qualified person who can help you understand your options and make financial decisions to work toward your financial goals.*

retirement investor: *Someone who invests his or her own retirement savings, regardless of type.*