MRRC
RESEARCHER Q&A

Olivia S. Mitchell and Annamaria Lusardi discuss their MRRC-supported research

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Q: How would you describe your MRRC-supported work?

A: Our objective was to assess whether workers display basic financial literacy. Increasingly, workers are in charge of making decisions about their retirement wealth, but we know little about whether they are well equipped to make these decisions. To address this issue, we have devised questions to measure whether workers understand interest compounding, the effects of inflation, and risk diversification. These are three of the basic concepts necessary to make any saving or investment plans. Our findings paint a rather bleak picture. Most of the respondents surveyed in our module display little or no financial literacy. In fact, only one third of respondents were able to answer correctly our three basic questions and half of our sample could not make simple calculations about interest rates and inflation. Consequently, we also find that the large majority of workers have not made any plans for retirement. Only one third of workers have ever tried to figure out how much they need to save for retirement, but many could not devise a plan. These findings are rather alarming, particularly in view of the pending insolvency of Social Security and the shortcomings of many pension plans.

Q: Do you find any difference in the behavior of women?

A: We find that women display lower financial literacy than men. This is true for all of the questions we considered, i.e. interest compounding, inflation, and risk diversification. Most importantly, differences in financial literacy remain significant even after we control for differences in age, race and ethnicity, and education attainment. These findings are important since women live longer than men and are likely to spend some years in their lifetime being the single financial decision-maker in the household. This may be another reason why many women suffer poverty at retirement, particularly following the death of a spouse.

Q: How are your findings relevant for Social Security policy?

A: As workers take up the responsibility about their retirement, it is critically important to pay attention to the fact that saving decisions are very complex and workers have difficulties grasping basic economic and financial concepts. We believe that the provision of help and financial advice can play a critical role in any policies or reforms aimed to promote household financial security.

Q: What are your next steps in this line of research?

A: We are currently examining whether financial literacy has any effects on savings and portfolio choice. This is not an easy question to address. First, it is not clear how the causality goes: does financial literacy affect wealth or does wealth induce people to educate themselves about financial matters?

Second, are some people underinformed because they do not need to know? For example, some have little saving and nothing to invest, or believe they will be supported at retirement by Social Security and pensions.

In addition we will assess whether retirement planning affects savings. In previous work, we found that retirement planning had a large impact on both savings and portfolio choice. In this work, we can assess whether the effect of planning is mediated by the effect of financial literacy.

Sources:

Financial Literacy and Planning: Implications for Retirement Wellbeing by Annamaria Lusardi and Olivia S. Mitchell, MRRC Working Paper WP 2005-108.

The Impact of Financial Education on Savings and Financial Asset Allocation by Annamaria Lusardi, MRRC Working Paper WP
2003-061.

Olivia S. Mitchell is the International Foundation of Employee Benefit Plans Professor of Insurance and Risk Management, and the Executive Director of the Pension Research Council, at the Wharton School of the University of Pennsylvania. Her current research analyzes public and private retirement pensions as well as links between wealth, health, and retirement. Her co-authored article on Social Security reform won the 1999 Paul Samuelson Award for Outstanding Writing on Lifelong Financial Security from TIAA-CREF.

She was a member of the President's Commission to Strengthen Social Security; she co-chaired the Technical Panel on Trends in Retirement Income and Saving for the Social Security Advisory Council; she was a panel member for a National Academy of Sciences forecasting/modeling study; and she participated in a Social Security privatization panel for NASI.

Annamaria Lusardi is Associate Professor of Economics at Dartmouth College. She is also a Research Associate at the National Bureau of Economic Research, a member of the Technical Review Committee for the Bureau of Labor Statistics' National Longitudinal Surveys Program, and a member of the Academic Advisory Board of the Center for Private Equity and Entrepreneurship at the Tuck School of Business.

Professor Lusardi's main area of research are saving, Social Security and pension, entrepreneurship, and macroeconomics. She has worked with both US and international data. She is the author of numerous articles analyzing the impact of risk on wealth accumulation, the effects of liquidity constraints on occupational choice, the importance of planning costs, the effects of financial literacy and financial education, and the behavior of saving across countries.

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