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Financial Literacy among the Young

Annamaria Lusardi, Olivia S. Mitchell, and Vilsa Curto* September 2009

Individual workers and retirees are increasingly being asked to take on responsibility for managing their own financial well-being, especially regarding retirement saving and dissaving patterns. But as we have documented in several of our papers, financial illiteracy is widespread in large segments of the U.S. population. For example, using questions we devised for the 2004 Health and Retirement Study (HRS), we show that older individuals (age 50 and over) are deficient in terms of knowing about basic economic and financial concepts, such as the working of interest rates, inflation, and risk diversification. To explore the sources of economic information driving household decision-making, this paper focuses on financial literacy among younger people. We seek to learn what skills and information they acquire before they enter the labor market and engage in financial contracts. We compare this information with results for the older sample examined previously.

To do so, we analyze financial literacy questions we have been able to add to Wave 11 of the National Longitudinal Survey of Youth (NLSY), fielded in 2007–08. Respondents in this sample were 23–27 years old in 2007. To be able to compare across different age groups, we used the same questions devised for the 2004 HRS module on financial literacy for these younger adults. There is substantial value in examining young people's financial literacy before they engage in some of their most important financial decisions, including saving, investing in financial markets, starting to contribute to a pension plan, and borrowing to buy a home.

The three key questions seeking to assess respondents' level of financial literacy, which were replicated in wave 11 of the NLSY, are as follows:

- Suppose you had $100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow: more than $102, exactly $102, less than $102?
- Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, would you be able to buy more than, exactly the same as, or less than today with the money in this account?
- Do you think that the following statement is true or false? "Buying a single company stock usually provides a safer return than a stock mutual fund."

The first two questions, which we refer to as the "interest rate" and "inflation" questions, indicate whether respondents are knowledgeable about fundamental economic concepts and possess basic financial numeracy.

**Annamaria Lusardi is a professor of economics at Dartmouth College. Olivia S. Mitchell is the International Foundation of Employee Benefit Plans Professor of Insurance and Risk Management at the Wharton School of the University of Pennsylvania. Vilsa Curto is a researcher at Harvard University. This Research Brief is based on MRRC Working Paper WP 2008-191.*

The third question, which we call the "risk diversification" question, evaluates respondents' knowledge of risk diversification, a crucial element of an informed investment decision.

Our results confirm that there is widespread illiteracy among the young. Lack of knowledge about basic financial concepts is pervasive; while the young display some numeracy, a large majority is underinformed about inflation and risk diversification. In this sample of young respondents, only 45 percent were able to respond correctly to all three questions. Moreover, illiteracy is particularly acute among some specific groups such as women, Blacks, and Hispanics, as well as those whose peers have low educational attainment. Financial illiteracy can also be linked to other important characteristics such as talents and ability, smoking when young, and quality of education. While talents and ability are an important component of financial literacy, they do not account for all the wide differences in literacy across demographic groups. We also find that illiteracy is linked to parental background. Specifically, those with low-educated parents and whose family did not own stocks, a home, or retirement saving plans, are less likely to be financially literate. These findings show that some financial knowledge is transferred in the home from parents to their children.

Our findings have several implications for policymakers. First, we show that young people lack basic financial knowledge; thus, they may face difficulties in engaging in financial decisions, particularly those that require understanding of complex financial instruments such as stocks or mortgages. Second, we note that financial illiteracy varies across demographic groups. Third, financial literacy is correlated with family background: those who are financially literate are more likely to have parents with high educational attainment or parents who own stocks. For these reasons it may be useful and sensible to devise programs that reach segments of the population who are most in need of opportunities to acquire financial knowledge.

University of Michigan Retirement Research Center
Institute for Social Research 426 Thompson Street Room 3026 Ann Arbor, MI 48104-2321
Phone: (734) 615-0422 Fax: (734) 615-2180 mrrc@isr.umich.edu www.mrrc.isr.umich.edu

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