The Passion of Anna

By Editor Test *Wed, Dec 23, 2009*

Economist Annamaria Lusardi started studying financial literacy in 2000. She soon realized that it's not a luxury for the few. It's an empowerment tool for the many.

Soon after Annamaria Lusardi began her research into financial literacy in the United States—or rather, into the average American's lack of financial literacy—she experienced a professorial epiphany of sorts.

The Dartmouth economist realized that financial literacy is not a trivial topic, as some of her peers once scoffed. On the contrary, she sensed that anyone who can't grasp concepts like compound interest is bound to fail in a 21st century society.

"A lot of my colleagues told me that I should work on something more serious," Lusardi told RIJ in a recent interview. "But people who aren't well-equipped to make financial decisions are the ones who'll face more risk in the future."

Then came the financial crisis of 2008, and Lusardi's view became mainstream. The near-collapse of the world banking system awakened many people, including several members of the incoming Obama administration, to the fact that what Americans don't know about money can indeed hurt them—and hurt the country.

Now Lusardi and her frequent co-investigator since 2000, Olivia Mitchell, the director of the Pension Research Council at the Wharton School, are in demand. They've been called down to Washington to advise the Treasury Department's Office of Financial Education.

And last October, they and the RAND Corporation received a $3 million Social Security Administration grant to open a Financial Literacy Center at Wharton and Dartmouth, and to design and pilot new programs to raise America's financial IQ.

A few days ago, shortly after Lusardi, a native of Milan, Italy, returned from a financial literacy conference in Brazil, she answered a few questions from RIJ. Here's an edited transcript of that interview.

RIJ: Professor Lusardi, how would you describe the financial knowledge of the average American?

LUSARDI: The result of all the work I have done with Olivia Mitchell, in every age group and every survey we have discovered how little most Americans know about economics and finance.

RIJ: What makes Americans so generally deficient in financial literacy?

LUSARDI: Americans are not alone. We have done surveys in other countries and we find a lack of financial literacy everywhere. It's not that people are getting worse. It's that the world has changed. In the past, in our parents' generation, they didn't face a lot of difficult financial decisions. The biggest decision they probably made regarded their mortgage.

That situation has changed. Even at a young age, people are faced with financial decisions about credit cards. Workers are now in charge of making decisions about their pensions. They are facing complex financial markets. The world has changed and we need to face those changes.

When we talk about financial literacy, the important word is not financial but literacy. In the past it would be impossible to live in a modern society without being able to read and write. Today's it's impossible to live in a modern economic society without being able to read and write financially. Everybody's making decisions and we cannot get away without equipping people to make those decisions.

RIJ: Do you think it may be too later for the Boomers to learn more about finance?

LUSARDI: It's not too late. People are making important decisions at every age. What worries me is that making the wrong decision late in life can have dire consequences, because you don't have time to catch up. If you make a wrong decision about when to draw Social Security, or whether to annuitize your wealth, you might not be able to afford a comfortable retirement.

RIJ: But will financial education help? Even well educated people made dumb mistakes with their money during the real estate boom?

LUSARDI: The idea is not that if we educate people they will not make any more mistakes. It's like driving licenses. We require them but we can't eliminate accidents. But we must give them the basics. When I think of financial literacy, I think of things like interest compounding. If you understand that, you will know that it's important to start saving early and not to borrow at high interest rates.

RIJ: Where would financial education do the most good?

LUSARDI: In 1996, the Jump$tart Coalition for Personal Financial Literacy started doing a study of high school students every two years. They found that only a small group of students is financially literate, and that group is disproportionately composed of white males from college-educated parents. This means that if we don't introduce financial literacy in school then people will have to learn it from their families. That's fine if you come from a college-educated family. But not everyone can learn at home. So we need to provide education in school.

We also need to pay attention to specific groups. Financial literacy is lacking among women. That is a big group. Women are in charge of making a lot of financial decisions and they increasingly have to fend for themselves. Women are in the workforce, but their earnings are lower than men's, they take time off to have kids, they rely on less stable wages, and there is a high divorce rate. So accumulation for a pension is difficult.

RIJ: Rather than try to educate everyone, why not just establish good rules-of-thumb, like 'Everyone should try to postpone Social Security benefits until they reach age 70?' Or establish new practices like auto-enrollment in retirement plans.

LUSARDI: There have been statements that automatic enrollment in retirement plans is a solution to financial illiteracy. But if you are in debt you shouldn't be automatically enrolling in a 401(k) plan. You have to decrease your debt first. Or if you buy an expensive mortgage because you don't have any liquidity for a down payment, I haven't helped you by automatically enrolling you in a retirement plan.

'Everyone should take Social Security at age 70' is too crude a rule for my taste. And it's not true that everybody should wait until age 70. On the other hand, it's not obvious to me why we present the information in such a way that the default appears to be to take it at age 62.

We shouldn't be telling people that they can start at age 62. We should push them to start much later. I cannot overstate how important it is for people, if they are healthy, to try to take Social Security as late as possible.

RIJ: The retirement crisis seems to have made more people aware of financial literacy.

LUSARDI: If it wasn't for the financial crisis, I don't think we would be talking about financial literacy. It's a teachable moment. I have been working on this since 2000, and I receive few invitations to talk about it. Publishing papers was really difficult. There was a lot of skepticism that lack of financial knowledge could be so powerful.

But the crisis has shown in such a strong way that people are making mistakes. A lot of people didn't understand what they were doing. From an economist's point of view, financial literacy is a public good. If people make mistakes, and if we have to rescue them when they do, then it's really important to do prevention.

There has always been skepticism about financial literacy, but I think the financial crisis has proven us right. People can make very bad mistakes, and those mistakes have consequences for them and for society. So academics are now turning to this issue and are trying to find evidence-based research. We are very humble, we don't claim that we will be successful in solving the problem of financial literacy, but we want to give it a try.