Financial Literacy: The Time Is Now

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It's more essential than ever to educate Americans of all ages about how money works. Can new efforts finally make a difference?

When it comes to financial matters, Americans are functionally illiterate.

That's the growing consensus among policymakers and educators, many of whom contend that the country's lack of financial sophistication is one cause of its current economic problems.

Advocates for financial literacy are seizing on the economic crisis as an opportunity to confront the issue directly. Thanks to the recession, they're getting a response from governments, nonprofits, schools, and employers.

Perhaps that's because there is plenty of evidence that, when it comes to money, Americans really don't know what they're doing. The recession has produced thousands of anecdotes of Americans buried in debt, stuck in foolish mortgages, or stung by huge investment losses.

Those misfortunes can strike people with PhDs in economics, of course. But surveys show Americans also fail to grasp important abstract ideas about money.
Boomers Fail Finance 101

Take the concept of compound interest, the notion that interest isn't a one-time event. It builds on itself over time. That compounding is the bane of those in credit-card or mortgage debt, but it benefits long-term investors. When the University of Michigan 2004 Health & Retirement Survey asked a simple math problem requiring a knowledge of compound interest, only 18% of baby boomers got it right.

Another basic concept for investors is diversification. Only about half of respondents correctly said that investing in a pool of stocks, or a mutual fund, is safer than investing in just one stock. And, says Wharton School of Business professor Olivia Mitchell, since the question was posed as a true-or-false statement, many of the correct respondents were probably just guessing.

Some financial blind spots have direct consequences. Women, who live longer than men, are more likely to underestimate their predicted life spans. In retirement, Mitchell says, "that puts them at much greater risk for running out of money."

Students and Workers Score Poorly

Young people are equally confused about financial topics. In a 2008 survey by the Jump$tart Coalition for Personal Financial Literacy, just 17% of high school and 19% of college students knew that, over an 18-year span, stocks tend to provide better returns than government savings bonds or bank checking and savings accounts.

Things don't get much better up the age ladder. The 2009 Retirement Confidence Survey, conducted by the Employee Benefits Research Institute, found that 47% of workers think they will need less than $500,000 for a comfortable retirement. "Which is just not realistic," says Ken McDonnell, the institute's program director. "Consistently, we found that individuals don't have a realistic understanding of how to save for retirement."

None of this is new. Economists have been lamenting for years Americans' low savings rate. The U.S. personal savings rate, about 11% in 1981, had fallen to near zero in recent years.

But in an era of relative prosperity, as home values and stock prices moved higher, Americans' lack of crucial financial knowledge didn't attract as much notice.
Literacy Advocacy Gains Support

When talking about financial literacy, "10 years ago everyone would nod their heads," says Laura Levine, executive director of the Jump$tart Coalition, which advocates for financial education for students. But "it wasn't a priority for anyone. There weren't many opponents but there also wasn't an enormous amount of support."

Now, she says, "our time has come."

It's all become clear, not just to financial experts but to the general public: Americans weren't saving enough. They got themselves into sticky financial situations, like credit-card debt. They signed expensive mortgages, subprime or otherwise, that they didn't understand.

For years, the Center for Working Families in Atlanta has taught low-income people how to build up savings through its Moving to Wealth program. It's now easier to convince people to save for a rainy day, says the center's president and chief executive, David Jackson, "because people are seeing the rainy day."

But today's world of money is complex, and many important lessons about personal finance aren't so obvious. Advocates of financial literacy say Americans need to be educated. And they're proposing a range of strategies to do that.
Federal Funding for Education

"A lot of people are making decisions not understanding their full consequences," says Matthew Greenwald, who as chief executive and president of research firm Matthew Greenwald & Associates has interviewed thousands of people on the topic of retirement. "Right now, because of a lack of financial literacy, people have undersaved and put their financial security in jeopardy."

A President's Advisory Council on Financial Literacy issued a 57-page report in January just before President Barack Obama took office. Among other recommendations, the council said states and the federal government should mandate financial education from kindergarten to grade 12, and require college students to take a financial literacy course before taking out student loans.

One of several bills in Congress addressing the issue would devote $250 million per year to financial education, with the money split between K-12 schools and colleges. "I have been amazed at the number of people who told me they had no idea what they were signing and what it meant in the long run," says Senator Patty Murray (D-Wash.), one of the bill's sponsors. "We need to give people basic skills about how to manage their finances."

Funding has been a problem on the federal level. The Financial Literacy & Education Commission established a Web site, MyMoney.gov, and a phone hotline (888 MY-MONEY) to help Americans with financial questions. But a report from the U.S. General Accountability Office in April lamented the commission's "limited resources" and lack of an independent budget.
Who and What to Teach?

There is considerable debate about what aspects of financial literacy to teach—and where to do the teaching.

"If we're going to make a wholesale change to our attitude about money and saving, we do have to start with kids," says Jump$tart's Levine.

On the state and school district level, groups are pushing for more emphasis on financial education. In July, New Jersey approved a law making financial education a specific graduation requirement. Only three other states have similar requirements, though 18 other states require financial literacy to be incorporated in other subjects.

One weak link in the push for more financial literacy training for young people is teachers, who often lack financial savvy themselves. "You get a real multiplier effect if you get a teacher prepared well," says Joseph Peri of the Council for Economic Education.
Workplace Initiatives

Other experts on retirement are excited about the possibility of employers providing Americans with better financial advice and education. They point to IBM's retirement planning options as a model.

"Employers have a vested interest in employees making good decisions," says Robert Clark, a professor at the North Carolina State University College of Management. "If you're trying to hit older workers, the best place to do that is in the workplace."

"There have been a lot of different programs to boost financial literacy, but not a lot of serious evaluation," says Wharton's Mitchell. "It's hard to tell exactly what works."

To help study this issue, the Social Security Administration is spending up to $5 million per year to establish a Financial Literacy Research Consortium.

When it comes to financial literacy, a lot is happening, but there is not one national agenda—yet. As a movement, "we're at that state where we're just getting organized," says Ted Beck, president and chief executive of the National Endowment for Financial Education. "We're getting a lot of well-meaning people to work together."
Obama's Proposed Consumer Agency

The Obama Administration hasn't addressed the topic of financial literacy in a significant way. But it has proposed a Consumer Financial Protection Agency. "The agency will have the power to set standards so that companies compete by offering innovative products that consumers actually want—and actually understand," Obama said in June.

The agency seems designed to limit the number of traps that the financially illiterate can fall into. That's a good goal as long as it doesn't go too far, says Phillip Swagel, a Bush Administration Treasury official who is now a professor at Georgetown University's McDonough School of Business. He worries that Obama's proposal puts too little emphasis on education and too much on heavy-handed paternalism.

"It's a tough balance," he says. "When do you step in and save people from themselves? And when do you let them take risks?"

But even if you provide Americans with comprehensive financial education, will they listen? Will it actually result in smarter financial choices?

Financial education is a little like telling people how to lose weight, says Wharton's Mitchell. "It's one thing to teach," she says. "It's another to get people to execute."

Even if you use regulations to protect people from foolish financial choices, even if you teach them the intricacies of taking out a mortgage or setting up a 401(k), the U.S.'s movement from a nation of spenders to a nation of savers is by no means assured. Those pushing for financial literacy know they face a long road ahead.