The New York Times

October 5, 2013

Financial Literacy, Beyond the Classroom

By RICHARD H. THALER

EVEN if we grade on a very generous curve, many Americans flunk when it comes to financial literacy. Consider this three-item quiz:

• Suppose you had $100 in a savings account and the interest rate was 2 percent a year. After five years, how much do you think you would have if you left the money to grow? More than $102, exactly $102 or less than $102?

• Imagine that the interest rate on your savings account was 1 percent a year and that inflation was 2 percent. After one year, would you be able to buy more than, the same as or less than you could today with the money?

• Do you think this statement is true or false: “Buying a single company stock usually provides a safer return than a stock mutual fund”?

Anyone with even a basic understanding of compound interest, inflation and diversification should know that the answers to these questions are “more than,” “less than” and “false.” Yet in a survey of Americans over age 50 conducted by the economists Annamaria Lusardi of George Washington University and Olivia S. Mitchell of the Wharton School of the University of Pennsylvania, only a third could answer all three questions correctly.

This is particularly troubling given the inherent complexity of our modern economy. Whether in taking out a student loan, buying a house or saving for retirement, people are being asked to make decisions that are difficult even if they have graduate training in finance and economics. Throwing the financially illiterate into that maelstrom is like taking students currently enrolled in driver’s education and asking them to compete in the Indianapolis 500.

A popular approach to this problem is to work harder to improve financial literacy — for example, by including household finance in the basic high school curriculum. One reason to think this solution will have big payoffs is that people who are more knowledgeable about financial matters, as measured by a test, perform better at tasks like saving for retirement and staying out of debt. This may seem a straightforward argument in support of financial literacy courses. Unfortunately, it isn’t.

The problem is that measured financial literacy is highly correlated with other factors, most notably higher education in general, so it’s hard to sort out causes. (The ability to solve the Sunday crossword puzzle is probably also positively correlated with good financial outcomes.) So to see whether a financial education curriculum is likely to pay dividends, we should review specific efforts to shore up financial skills in those who are deficient, and not just measure what people already know.

A new paper by three business school professors — Daniel Fernandes of Erasmus University in the Netherlands and the Catholic University of Portugal, John G. Lynch Jr. of the University of Colorado and Richard Netemeyer of the University of Virginia — presents a discouraging assessment of attempts to teach people how to deal with money. Their article uses a technique called meta-analysis, looking at results from 168 scientific studies of efforts to teach people to be financially astute, or at least less clueless.

The authors' conclusions are clear: over all, financial education is laudable, but not particularly helpful. Those who receive it do not perform noticeably better when it comes to saving more, for example, or avoiding ruinous debt. Even more depressing, the results of efforts aimed at low-income people are particularly weak. Those who need the help most seem to benefit the least.

DON'T get me wrong. I am all for trying to teach household finance in schools, starting as early as possible. And when it comes to high school, I think learning about compound interest is at least as important as trigonometry or memorizing the names of all 50 state capitals. If we try enough approaches, and evaluate what works, we may improve such programs' effectiveness. But we shouldn't fool ourselves into thinking that adding a household finance class to a high school curriculum will in itself create knowledgeable consumers who can understand today's wide array of financial products.

In some ways, the finding that financial education doesn't provide long-term payoffs is hardly surprising. After all, how much do you remember from your high school chemistry class? Unless you use chemistry at work, you probably don't recall much about ionic bonding. In the meta-analysis, even the most time-intensive programs — those with more than 24 hours of education and training, almost the length of a college course — had no discernible effects just two years later.

It would be premature to conclude that all efforts at improving financial literacy are futile. But it is a fair conclusion that simply doing more of the training commonly used now will not produce significant results. So what else might we try? Although no approach offers a panacea, three types of efforts seem worthy of more attention.

The first is what Professor Lynch, one of the authors of the meta-analysis, calls just-in-time education. Because learning decays quickly, it's best to provide assistance just before a decision is made. High school seniors should receive help in how to think about a student loan, and how to make sure that the education bought with the loan offers good prospects for repayment. Just-in-time education can be offered at other crucial moments — when taking out a mortgage or figuring out when to retire. But unless such education is compulsory, many of the consumers most in need of help don’t take advantage of it. And we need to be sure not to confuse self-serving marketing with objective advice.

Another approach is to offer simple rules of thumb to help people cope. Because few people can calculate how much they need to save for a comfortable retirement, it might help to offer simple guidelines like “invest as much as possible in your 401(k) plan,” “save 15 percent of your income” or “get a 15-year mortgage if you are over 50.”

One example comes from a field experiment involving microentrepreneurs in the Dominican Republic. Of those who expressed an interest in receiving help, some were offered training in basic accounting principles while others were given simple rules of thumb. The accounting education did not have apparent effects, but simple rules — like keeping personal money and business money in separate drawers — led to better outcomes. This seemingly trivial concept helped small-business owners keep better track of how their businesses were faring.

The third approach, and the one I believe offers the best prospects of immediate help, is to make our financial system more user-friendly. You don’t need to be a computer scientist to use a smartphone. If we made choosing a suitable mortgage as easy as checking the weather in Timbuktu, fewer households would find themselves underwater when real estate markets tumble.

In the case of 401(k)’s, many companies have made their employees significantly better off by providing a well-designed default investment option, like a low-fee target-date fund. Most unsophisticated investors are better off using that option than trying to be their own portfolio managers.

The same principle can be used in other areas, from credit cards to checking accounts. The financial services industry — either on its own or as required by government regulators — needs to find ways to make it easier for people to make sound decisions. And those financial firms that engage in fraudulent practices should be prosecuted and stopped.

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