The “golden years”: who gets there and how?

An American dream is that, after a worklife of four or five decades, we will have won a hard-earned retirement, pension (or at least annuity) in hand, ready to enjoy our “golden years.” But not as many as we would like actually realize that dream: far too many seniors live entirely on Social Security or on some combination of Social Security and meager savings. Why is this so? In “Financial Literacy and Retirement Planning in the United States,” (National Bureau of Economic Research, Working Paper 17108, June 2011), Annamaria Lusardi and Olivia S. Mitchell attribute the situation to a failure to plan for retirement, based on a widespread lack of knowledge of even the rudiments of economics and finances.

The authors rated Americans' financial knowledge through the use of three simple multiple-choice questions. As an example, here is one of them:

> 1) 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
> Do not know
> Refuse to answer

The respondents' answers to the three questions demonstrated that “a discouragingly low number” of Americans could be said to be even minimally financially literate, especially “given the question's simplicity and the fact that respondents did not have to make a calculation but could merely select from a set of answers” (p. 4). The number of correct answers improved with the age of the respondent, but not by much. Across all age groups, 46 percent got the first two questions (but not the third) right and just 30 percent got all three questions right. Financial literacy was lowest among those under age 35 and those older than 65.

A statistically significant finding is that women were less financially literate than men and were more likely than men to state that they could not answer a question—the latter finding being “indicative of very low levels of knowledge” (p. 6). As might be expected, financial literacy is positively correlated with educational attainment: those without a high school diploma are the least financially literate, and the number of correct answers to the questions rises with the respondent's education level.

Among racial and ethnic groups, Hispanic and African-American respondents were less financially literate than White and Asian-American respondents. The lower financial literacy of Hispanics may be related to their tendency not to hold checking accounts and their avoidance of banks in general. (The direction of the putative causality is uncertain.) The results on racial and ethnic groups support similar findings in the literature.

An interesting finding is that respondents appear to believe that they are more financially literate than they really are: almost 70 percent believe that they are above the median with regard to financial knowledge, a percentage that far exceeds what the questions show about their actual knowledge. The young, however, seem more self-aware than older respondents: those in the youngest age group (age 25–34) rate themselves the lowest of any age group, whereas 27 percent of respondents age 65 and older give themselves the highest possible self-rated score; furthermore, the older respondents' average self-rating is higher than that of any other age group. This misplaced confidence “may explain why older people often are offered less financially attractive deals than other groups” (p. 8).

Finally, respondents were asked whether they “ever tried to figure out how much [they] need to save for retirement” (p. 9). On a discouraging note, just 43 percent answered this question in the affirmative—and that merely meant that they had at some time *tried* to do so, not that they in fact did figure out how much they needed.

To learn whether financial literacy and retirement planning were correlated, the financial literacy of those who planned for retirement was compared with the financial literacy of those who did not so plan. Those who got all three financial literacy questions right were found to be much more likely to have tried to figure out how much they needed to save for retirement. The authors then used a multivariate model to examine the links between financial literacy and retirement planning in detail. Under two distinct measures of financial literacy, an ordinary least squares regression showed a positive, statistically significant coefficient. That is to say, financial literacy is positively linked to planning for retirement. For instance, those who answered all three financial literacy questions correctly were almost 10 percentage points more likely to plan for retirement than those who got at least one question wrong, and those who answered one or more financial literacy questions correctly were 4 percentage points more likely to plan than those who got none right. □