Does Education Really Enhance Financial Literacy?

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Abstract

Due to increasing liberalisation and globalisation across the globe today, there exists a wide assortment of financial products and services for gratifying the investment needs of the people at large. In order to take advantage of this available assortment and to squeeze the benefits arising out of such assorted options at people's disposal, it is necessary that they are well aware about these financial products and have financial knowledge for taking the right investment decisions. Financial literacy is considered to be an important skill for all consumers. Financial literacy levels in an economy decide the level of prosperity in the economy because financially literate people are not exposed to the danger posed fraudulent investment schemes. Education is said to be directly linked to financial literacy which is the cause of financially sound investment. Many other factors may affect the decision taken by a person for investment purposes such as peer groups and popularity of investment option, etc. It is argued by some researchers that even after getting education or special investment assessment courses their actions does not show a positive impact on their decisions. So the real question that is faced today by many researchers is that whether education really enhances the financial literacy or not.

KEYWORDS: Financial Literacy, Financial Competence, Financial responsibility.

INTRODUCTION

"Financial decision-making is an inherently complicated process, and with the advent of financial liberalization in most parts of the world, the supply of complex financial products has increased. With the emergence of innovative and sophisticated financial instruments, there has been increasing awareness of consumer literacy and comprehension of financial information as potential factors influencing financial market participation. This has led to a growing focus on the idea of financial literacy—the ability of individuals to assimilate and process financial information to make informed personal financial decisions" (Hilgert & Hogarth, 2002) (van Rooij, Lusardi, & Alessie, 2012) (Lusardi & Mitchell, Planning and Financial Literacy: How Do Women Fare?, 2008) (Cole & Shastry, 2009). After studying and assessing the financial literacy literature, it is perceived that there is no fixed definition of the term financial literacy. "Of the 71 studies evaluated, over 50 of them failed to define the concept of financial literacy. In the 20 studies that did provide a definition, eight separate meanings are attributed to the term financial literacy" (Huston, 2010a). "Out of the wide variety of definitions across studies; some of the definitions referred exclusively to financial knowledge while others provided a more extensive explanation, including financial knowledge and experiences as well as the competent use of this knowledge" (Hung, Parker, & Yoong, 2009).

Financial literacy is the ability to comprehend how money works in the world: how someone manages to earn or make it, how that person manages it, how one invests it and how that person donates it to help others. More specifically, it refers to the set of skills and knowledge that allows an individual to make informed and effective decisions with all of their financial resources. The absence of financial literacy can lead to making poor financial decisions that can have adverse impact on the financial health of an individual. The advantage or disadvantage of variable or fixed rates is an example of an issue that will be easier to understand if an individual is financially literate. For example, a 2 percent rate of interest compounded monthly appears to be equal to 24 percent rate of interest per annum to a financially illiterate person, but actually it is 26.8242%. Financial literacy is the possession of knowledge and understanding of financial matters. Financial literacy is mainly used in connection with personal finance matters. Financial literacy often entails the knowledge of properly making decisions relating to particular areas like real estate, insurance, investing, saving, tax planning and retirement. It also involves intimate knowledge of financial concepts like compound interest, financial planning, the mechanics of a credit card, advantageous savings methods, consumer rights, time value of money, etc.

An international study was conducted by Organisation for Economic Co-operation and Development (OECD) analysing financial literacy surveys in OECD countries. Some of its findings included:

- In Australia, 67 percent of respondents indicated that they understood the concept of compound interest, yet when they were asked to solve a problem using the concept only 28 percent had a good level of understanding.
- A British survey found that consumers do not actively seek out financial information. The information they do receive is acquired by chance, for example, by picking up a pamphlet at a bank or having a chance talk with a bank employee.
- A Canadian survey found that respondents considered choosing the right investments to be more stressful than going to the dentist.

According to the ASIC discussion paper on financial literacy in schools, financial literacy is “the ability to make informed judgments and to take effective decisions regarding the use and management of money (ASIC2003). ASIC defines the following skills and knowledge as constituting financial literacy:

• Mathematical literacy and standard literacy

• Financial understanding - an understanding of what money is and how it is exchanged, where it comes from and goes

• Financial competence - understanding of basic financial services, financial record, attitudes to spending and saving, and an awareness of the risks associated with some financial products and the relationship between risk and return; and

• Financial responsibility - the ability to make appropriate personal life choices about financial issues, understanding consumer rights and responsibilities, and the ability and confidence to access assistance when things go wrong.

Financial literacy is often linked to the concept of financial intelligence and is said to be an important requirement for an entrepreneur who wants success in his business and wants to understand, follow or compete with the world. Moreover the entrepreneur must be able to understand the financial statements including balance sheet and profit and loss statement, to be to find and understand the inter-relationship between various financial and accounting variables.

"Financial literacy is defined as measuring how well an individual can understand and use personal finance-related information" (Huston, 2010a). "Financial literacy is an individual's ability to obtain, understand and evaluate the relevant information necessary to make decisions with an awareness of the likely consequences" (Mason & Wilson, 2000) Financial literacy can be investigated in terms of three components:

1. Knowledge of personal finance
2. Understanding of financial terms and concepts and
3. The skill to utilize both knowledge and understanding to make beneficial financial decisions. (Wagland & Taylor, 2009).

FINANCIAL LITERACY AND EDUCATION

"The growth of products available in the consumer financial market has provided more choice and formal control over household financial decisions than ever before. Financial literacy education programs are generally assumed to improve consumer behaviour in relation to financial products and services. However, there is limited evidence that demonstrates the causal link between education, literacy and behaviour" (West, 2012). "Individuals need to be financially literate if they are to make informed decisions about savings, investments, debt and most importantly when considering retirement issues" (Taylor & Wagland, 2011).

Education is considered an important ingredient for the financial literacy which in turn is a pre- requisite for the effective functioning of the financial system in any economy. The increased variety of financial products & services in the modern world has resulted because of the policy of globalisation adopted by the world at large. The financial literacy of the users of such varied financial services not only results in their benefit but also contributes to the stability of the entire financial system and the economy as a whole. With the focus on financial literacy and financial education of the larger groups of people who lack education and who are financially incompetent, we can avert the plethora of problems in their personal lives as well as the problems in the financial sector as a whole. Education can help people in becoming a financially literate person who knows the basic terms related to the finance and knows simple mathematical techniques to evaluate any financial decision taken by him. Most of the basic concepts related to various investments are taught at the school and college level which can help a lot in deciding the path to be taken in future related to their investments. People having low levels of financial literacy because of low education level tend to end up in the web of financial problems. Financial burden increases indefinitely for a financially illiterate person as he is unable to analyse the actual impact of the lucrative interest rates that are assigned to loans and credit cards. These financially illiterate people constitute a major portion of the non-performing assets in the banks as they are responsible for taking wrong decision of accepting the loans with hidden costs which only financially literate people can analyse better.

Financial ignorance of people has resulted in the existence of many fraudulent schemes such as pyramid scheme, Ponzi scheme, etc.

A pyramid scheme is an unsustainable business model that involves promising participants' payments or services, primarily for enrolling other people into the scheme, rather than supplying any real investment or sale of products or services to the people. The problem is that the scheme cannot go on forever because there is a finite a number of people who can join the scheme even if all the people in the world join. People are deceived into believing that by giving money they will make more money. The fraud lies in the fact that it is impossible for the cycle to sustain itself, so people will lose their money somewhere down the line.
A Ponzi scheme is a fraudulent investment operation that pays returns to its investors from existing capital or new capital paid by new investors, rather than from profit earned by the individual or organisation running by the operation. Operators of Ponzi schemes usually entice new investors by offering higher returns than other investments, in the form of short-term returns that are either abnormally high or unusually consistent. The perpetuation of the high returns requires an ever-increasing flow of money from new investors to sustain the scheme.

"Financial literacy is related to financial behaviour and consequently to borrowing decisions of individuals. People with low financial literacy are found to be more likely to have debt problems" (Lusardi, Mitchell, & Curtoi, 2010). "Financial literacy has major implications for the welfare of individuals in the management of their financial affairs and financial stability. A financially educated society allows individuals to better make financial decisions regarding budgets, how much to spend and to save, how and where to invest their money and how to manage financial risk" (Widdowson & Hailwood, 2007). The personal financial wellbeing of a person in an economy may depend on a wide variety of factors. Some of the factors are:

- Efficient & effective regulation.
- Consumers' market power.
- Consumer protection for frauds.
- Trusted financial sector & its transparent functioning.
- Security: net welfare provision.
- Financially literate population.
- Diversified, efficient & competitive market for financial products & services.

Some people are of the view that teaching financial literacy to the students is not going to help them read a complicated, 50 page contract when they buy their first house. So why bother? "That shows a major misunderstanding. Financial literacy is a basic tool that helps people to cope with day-to-day financial management. We are living in a world with increased individual responsibility, and we're asking people to make more decisions about how to invest and borrow. We don't teach students literature so that they can write *War and Peace*. We teach literature so that they can appreciate a good book. Teaching financial literacy makes them able to frame everyday financial decisions in a more informed way" (Lusardi A.).

A research study conducted by Carlin & Robinson, 2012 evaluated the impact of financial literacy training on the students of Los Angeles. Three central messages emerged from the analysis. First, financial literacy can indeed be taught, but with important limitations. Trained students in many cases adopted the decision-making that the program stressed, but often had difficulty extrapolating the underlying principles to new settings. The second lesson is that education may have unintended consequences. The students who received the training even made some choices that were in some sense contrary to the spirit of the instruction they received. Because of this, it is probably optimal to monitor the effect of education on people's behaviour over time and adjust the education accordingly. The third lesson, and perhaps the most important one, is that education and timely decision support are not distinct channels for improving consumer financial decision-making. They interact. Decision support was better utilized among the group that received financial literacy training. Timely decision support and financial literacy training are complements, not substitutes. In this light, it is likely to be optimal in the future to coordinate educational efforts with the advice channels offered in the market to maximize people's ability to make good decisions (Carlin & Robinson, 2012).

The study conducted by West, 2012, argues that the explicit link between financial literacy and behaviour has not been established. No financial literacy study has yet clearly linked economic well-being with sustained changes in financial behaviour. Furthermore, financial literacy does not appear to be a sufficient prerequisite for good consumer financial decision making. The findings of the study infer that financial consumers belonging to different financial literacy levels behave differently about their borrowing decisions. Financial consumers with high financial literacy levels are expected not to demonstrate excessive borrowing behaviour and to demonstrate informed credit use (West, 2012).

CONCLUSION

After reviewing various researches and case studies related to financial literacy and the role of education in imparting and increasing the level of financial literacy, it is found that although a fairly high degree of positive correlation is assumed to exist between education and financial literacy, but actually, even after receiving sufficient level of knowledge to become financially literate, people lack confidence in implementing their decisions. Educational programmes organised for imparting financial literacy are not able to reflect immediate improvement in the financial literacy levels because they hesitate taking decisions according to their mental satisfaction. Financial literacy investment may not be fruitful in the short run as changing attitudes of people and their perceptions about things is not an easy job. It is found that investment done by the government in the form of organising programmes meant for imparting financial literacy is of the long term nature and their benefit will be received by the economy only in the long run. In order to make use of the financial literacy programmes, it is suggested that people should seek financial advice in the initial stages in order to boost their confidence level in taking investment decisions. Once the confidence level of financially literate people increases, they take their investment decisions without hesitation and contribute to a financially sound economy.

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