Financial literacy and financial planning: Evidence from India

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Abstract
In this study we report findings about financial literacy and financial planning behavior based on a financial advisory program in India. We evaluate survey responses to three standard questions previously used to measure financial literacy. We then break down the data across particular demographic and socioeconomic groups and compare responses. Finally, we examine the investment behavior, liability choice, risk tolerance and insurance usage of program participants. We find that the vast majority of respondents appear to be financially literate based on their answers to questions concerning interest rates (numeracy), inflation, and risk/diversification. However, we do find variation across demographic and socioeconomic groups. We are also able to obtain additional information about the financial tendencies of the program participants (including risk tolerance, investment preferences, investment goals, etc.) and to relate those tendencies to financial literacy.

1. Introduction
In recent years there have been growing concerns about the financial astuteness of consumers as research suggests they often make what appear to be welfare-reducing decisions. Many individuals do not hold a checking account (Hilgert et al., 2003); have large outstanding credit card balances when cheaper forms of credit are available (Gartner and Todd, 2005); accept payday loans with astronomical APRs even in the presence of other, cheaper, credit sources (Agarwal et al., 2009b); sub-optimally choose credit contracts (Agarwal et al., 2006); fail to refinance mortgages when it would be optimal to do so (Agarwal et al., 2008a); and fail to plan for retirement, reaching it with little or no savings (Lusardi and Mitchell, 2006). A leading explanation for this behavior is that consumers are not financially literate—they lack sufficient information about financial concepts and instruments to make informed financial decisions. A growing literature has evaluated both the state of financial literacy and the effectiveness of financial education programs aimed at improving financial decision-making. Much of this research...
analyzes mortgage market behavior because mortgage debt is typically the largest liability for most consumers and errors in decisions about this debt could have lasting implications. We add to that literature by reporting the findings of a survey concerning financial literacy and financial planning in India. Specifically, following Lusardi and Mitchell (2006), we ask consumers in India three basic questions about interest rates (numeracy), inflation, and risk diversification to evaluate their financial literacy and then observe how that relates to their investment, insurance and liability management decisions.

In recent years the Indian government, particularly the Reserve Bank of India, has been aggressively working to increase the financial knowledge of the general population. The goal is similar to that set out by the OECD: “to help consumers “develop the skills and confidence to become more aware of financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being” (OECD, 2005). The concern is that India has a large population that does not have the rudimentary skills to make basic financial decisions. Nor, in many cases, do they have adequate access to financial services. It has been estimated that only about five percent of Indian villages have a commercial bank branch. Similarly, over 40 percent of the adult population have no banking account; a number which grows to over 60 percent in rural areas (Thorat, 2007). This lack of financial literacy and lack of financial access are both pressing problems for the Indian population and could lead to welfare reducing financial decisions.2

In response, the Reserve Bank of India has introduced Financial Literacy and Counseling Centers (FLCC) to provide consumers with the tools to make better credit choices (Reserve Bank of India, 2008). They have also targeted schoolchildren to cultivate financial literacy at an early stage via interactive websites (Reserve Bank of India, 2007).2

We evaluate the financial literacy of a select group of Indians that participate in an on-line investment service provided by Yogi Financial Advisory Services. We evaluate their literacy and then relate the findings to their other investment activity. In the next section we briefly review the literature on financial literacy. We then discuss the survey questions and the investment company used to collect the survey data. In Section 4 we discuss our empirical results. The final section concludes.

2. Review of the literature on financial literacy

Early studies to measure adult financial literacy were conducted during the 1990s on US data by private firms utilizing surveys that covered material specific to their corporate interests (Volpe et al., 2006).4 Perhaps the most useful early studies assessing overall financial literacy were those conducted on high school and college students. The Jump$tart Financial Literacy Survey administered the same exam to randomly selected high school seniors every other school year between the 1997–98 class through 2008.5 The exam included 31 questions on income, money management, saving and investment, spending and credit, and was intended to capture financial competence in a broad set of areas. Jump$tart’s findings were not encouraging: students scored an average of 57 percent in 1997–98 (with 60 percent being a passing score), and scores declined by several percentage points in subsequent years (2000–2008)

Other research evaluated financial literacy among adults in more specific contexts. For instance, there is an extensive literature on the relationship between financial literacy and planning/saving for retirement. This literature, as discussed below, yields two broad, but important findings. First, after controlling for a broad range of economic and demographic characteristics, more financially literate individuals are more likely to plan for retirement, and those who plan have greater net worth upon reaching retirement. Second, causation goes from literacy, to planning to wealth.

Individuals accrue retirement assets both individually as well as through Social Security and employer-sponsored pension programs. To figure out how much to save for retirement, individuals must know their expected dates of retirement, expected lifespan, and Social Security and/or pension entitlements. They must then take into account the expected rate of return on saving and the desired standard of living in retirement to determine the necessary savings rate. This planning process requires knowledge of Social Security and pension plan characteristics, as well as the ability to perform calculations involving compound interest and monthly accumulation. In practice, this can be a difficult process, as illustrated by Mitchell (1988), and Gustman and Steinmeier (2005).

Mitchell (1988) examined employee knowledge of company pensions and found that many workers were unaware of important features of the plans. She compared pension characteristics reported by individuals from the Survey of Consumer Finances (SCF) to actual administrative data. Only half of employees who were required to contribute to their pensions reported doing so, and only half of those whose employers contributed realized that they did so. Over one-third of respondents did not know about early retirement provisions and, among those who did, two-thirds described them inaccurately.

Gustman and Steinmeier (2005) confirm these findings using the 1992 Health and Retirement Survey (HRS), showing that a majority of those surveyed could not accurately report their Social Security or pension entitlements. Only 27 percent of respondents gave estimates within 25 percent of their actual Social Security benefits. Interestingly, only 16 percent of respondents with pensions gave estimates within 25 percent of their actual pension entitlements.

2 Although it is difficult to quantify, international indices of the level of economic literacy find that the general Indian population scores relatively low in the analysis (Jappelli, 2010).

3 This push for national education programs aimed at improving financial literacy has also been emphasized in other countries; see OECD (2014).

4 This review draws on the more detailed discussion of Agarwal et al. (2011).

5 See Mandell (2009) for a more detailed discussion of the Jump$tart results. In 2010, the survey was modified to strengthen the methodology. Survey responses are not directly comparable thereafter.
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