

The Importance of Financial Education

In October, I gave a talk to the Council for Economic Education, addressing what educators might do to help people make more informed financial choices. This issue seems particularly timely in the wake of the financial crisis, and in this column I would like to revisit the topic.

Every day, we are faced with financial decisions. But for most of us, there are only a few key choices that have the potential to fundamentally shape our financial future. In those cases, it is important that we make the correct choice — or, perhaps more importantly, avoid a really bad choice. Among those decisions are: whether to pursue higher education; whether to purchase a house and, if so, on what terms; and how to best save for retirement. I believe that financial education should focus on those key decisions, ones that will have large and potentially long-lasting effects on people's lives.

Consider education. Wage inequality has been growing in the United States since the late 1970s. While there are numerous potential causes of this trend, many research economists agree that one of the most significant is skill-biased technical change. That is, technological progress over the last few decades has increased the productivity of skilled workers more rapidly than it has of less-skilled workers. As a result, the financial returns to accumulating skills have grown sharply. Often — though not always — those skills are obtained through higher education. Investments in human capital can prove more useful if they are made at a relatively early age, giving people the opportunity to recoup their investment throughout the majority of their working lives. In addition, such training tends to build on itself, because acquiring skills early in life makes it easier to acquire additional skills later in life. The evidence is clear that, over time, higher education has become a larger determinant of lifetime earnings. This suggests that it is particularly important that high school students fully understand the returns to human capital investment as they consider which path to take following graduation.

Most households will purchase a home. It is crucial that they know how much they can afford to spend and which terms would be most desirable given the path they expect their earnings to take over their lifetimes. Homeowners should see the considerable benefit in gathering that information. But prudent regulation, such as requiring the essential provisions of a mortgage contract to be clear and explicit, can make the process easier. I think it is also important to note that homeownership itself is not a wise choice for everybody. For example, for those who value mobility and are apt to move relatively frequently to pursue better job opportunities, the search and transaction costs of purchasing a house can be prohibitively large. More critically,

purchasing a home usually means placing a considerable amount of a household's savings into a single asset that is often costly to trade. This decision may be particularly risky for a household with a variable income stream and low levels of savings, as is true of many low-income households. When one considers such factors, I think it becomes clear that renting does not necessarily mean "throwing your money away," as is commonly suggested. It is simply another way to obtain housing, one that is appropriate for some households, just as buying is for others.



Planning for retirement involves a hard set of choices as well, which, if not done carefully, can lead to painful results. In the aftermath of this recession, which has seen many workers postpone their impending retirement, the importance of accounting for a range of plausible risks should be clear. Given the differences in how people wish to live in retirement — that is, whether they want more, less, or roughly the same annual spending as when they were working — it is hard to say much in the abstract about what is an "optimal" retirement plan. But I think everyone would benefit from understanding that there generally is good reason to shift your retirement portfolio from more risky to less risky assets as you grow older. This understanding might have helped prevent some of the considerable losses in retirement funds that some consumers have unfortunately experienced.

People do not always make the best possible choice in every situation. But we can learn which decisions are likely to be especially consequential and to take appropriate care when making them. Directing our financial education efforts toward that goal, I believe, could help many people more effectively pursue their ambitions and avoid costly mistakes.

A handwritten signature in black ink, appearing to read 'Jeff M Lacker'.

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