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The Geography of Financial Literacy

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Abstract

This report explores how well equipped today's households are to make complex financial decisions in the face of often high-cost and high-risk financial instruments. Specifically it focuses on financial literacy. Most importantly, it describes the geography of financial literacy, i.e., how financial literacy is distributed across the fifty US states. It describes the correlation of financial literacy and some important aggregate variables, such as state-level poverty rates. Finally, it examines how much differences in financial literacy can be explained by states' demographic and economic characteristics. To assess financial literacy, five questions were added to the 2009 Financial Capability Study, covering fundamental concepts of economics and finance encountered in everyday life: simple calculations about interest rates and inflation, the workings of risk diversification, the relationship between bond prices and interest rates, and the relationship between interest payments and maturity in mortgages. An index of financial literacy was constructed based on the number of correct answers provided by each respondent to the five financial literacy questions. The financial literacy index reveals wide variation in financial literacy across states. Much of the variation is attributable to differences in the demographic make-up of the states; however, a handful of states have either higher or lower levels of financial literacy than is explained by demographics alone. Also, there is a significant correlation between the financial literacy of a state and that state's poverty level. The findings indicate directions for policy makers and practitioners interested in targeting areas where financial literacy is low.

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