Building A Better Mind - Psychology's Relationship with Financial Capability

Research Project Team Members Jeremy Claure, Valerie Carrillo, and Amaya Estevez

Bright Minds, Fresh Ideas Think Tank, a NAF Future Ready Lab

Virtual Summer Internship

Powered by FPP

July 28, 2020

Introduction

It can be unanimously agreed that all American Citizens will have to manage their financial well-being at some point during their adult life. However, time and time again the majority of young adults are ill-prepared to take on the responsibility of managing their financial well-being. Not only does this lack of preparation appear in the current generation of young adults, but has remained a constant and increasing trend in young people. American business magazine *Forbes* displayed alarming data from the New York Fed and Equifax, stating that "Americans 18-29 years old owe $1.05 trillion in debt.", which consists of student loans, auto loans, credit card debt, and mortgage debt. Additionally, unwise financial decisions seem to be steadily increasing in young adults, best exemplified by researcher Machteld Hoeve (2020)."For example, in the U.S.A., young adults with a credit card spent on average almost a fourth of their income servicing debt in 2004 compared to about a fifth in 1992 [4]." If young adults are struggling to grasp these fundamental financial basics, it could greatly affect their later life due to companies not offering as much care to workers and social security safety dwindling. The dangers of this lack of financial capability can be attributed to having poor financial psychology. Financial psychology consists of many factors that influence your financial decisions. With this being said, Psychology drastically affects a young adult's Financial Capability by impacting what they think, what they feel, and what they do with their money.

Financial Exposure

Tools such as credit cards and student loans can become burdens without knowledge. Credit cards are a convenient way to finance expenses quickly and are often taken for granted. They are used to "make purchases, balance transfers and/or cash advances and require that you pay back the loan amount in the future." (Bank, 2020). Credit cards are used by tens of thousands of people all across the world and are a big part of people's everyday life. “Currently credit cards have a strong influence on the lifestyle of people. However, the indiscriminate use of credit cards can have a considerably harmful effect on well-being (Mendes-Da-Silva et al., 2012)”. Being that individuals are able to be financially safe with credit cards, without the proper education it can lead to financial hardship. When a student decides to apply for financial support in college, such as a loan, they often forget that every dollar you borrow you must pay back with interest which could lead to a tremendous amount of debt in their near future. Credit card debt and student loans play hand in hand with each other, the reason being is because “the related pressures of credit card debt intensify the consequences of student loan borrowing and may compromise students' ability to complete their degree” (Robb, 2010). Students will then feel discouraged which can later affect them psychologically.

Furthermore, gaining financial literacy positively affects your financial psychology. Financial literacy is held in high regard due to the simple fact that with more knowledge on how to manage one's finances, more options that one might not have known otherwise. Author and professor of the Washington School of Business, Annamaria Lusardi, goes as far as to say that financial literacy is an “essential indicator” (2019) of financial decisions, and young people seem to be aware of this. In a survey conducted on medium-size private universities, researchers Christine Harrington and Walter Smith (2016) discovered “85.5% of students sampled either agree or strongly agree that learning about personal finance topics while in college will improve their ability to make good financial decisions in the future.” Despite this, personal finance courses are mandatory in less than half the country (Ranzetta, 2020). When put as a mere option or not even offered in schools, the public education system fails to provide students opportunities to educate themselves. Building upon this shortfall, the financial literacy classes seem to be ineffective at bettering a person's financial decisions because the knowledge of a one year class decays over time (Fernandes et al., 2014). What all of the data points show is that many young adults will end up suffering from poor financial knowledge because its importance and concepts are not adequately ingrained into the minds of our youth, and because of this young adults automatically forfeit possible tools they could have become well-versed in.

Environment

The labeling of the socioeconomic status of a young adult can affect their psychological well-being and their perception of money. Social class determines whether the knowledge of financial capability will be extensive or not. "People in the highest SES bracket, generally referred to as the upper class, likely have better access to numerous things such as education and healthcare effectively meaning that they have access to people in powerful positions who have specialized knowledge" (Lumen, 2020). The upper-class's specialized knowledge can lead to a young adult's exposure to the topic of financial capability. However, others who are in a middle or working class do not have the same opportunities. Society has a stereotype where if it is known that your social class is low, you have no hope of ever escaping and will simply just stay where you are. This is a cycle that is often broken when a young adult is educated on finance. Creating generational financial freedom is essential to upcoming young adults. "Low-income and working-class students face many challenges related to the costs and affordability of higher education; yet, little is known about the financial decisions made by these groups of students while they are enrolled in higher education and how their decisions might differ from middle/upper-class students." (Soria, 2014). The people a young adult surrounds themselves with can also affect their psychology. Home life is a crucial part of anyone's independence, growth, development and future stability. Parental influence is very important when it comes to financial behavior. “Parental influence and self-discipline positively associate with responsible financial behavior. We also investigate the moderating role of gender and observe that financial knowledge and parental influence improve women's financial behavior more than men, whereas being thorough has a larger impact among males” (Tang, 2015). Being educated on financial capability from a parental figure when young, can teach a young adult more when going out in the real world and experiencing real financial issues. A young adult's environment is a factor you simply cannot ignore when it comes to its effect on their psychologically.

Background

Race and gender affects the psychological traits imposed on young adults. Certain races have more financial freedom than others. For example, Asians and Whites are typically more financially stable than African American and Hispanic people. Statistics taken from the United States Census Bureau, Current Population Survey, 2018 and 2019 Annual Social and Economic Supplements display, Asian Americans make on average $87,194 yearly while African Americans make on average $41,261 (Weller, 2019). African Americans have had a long history of oppression and injustice in America. For example, “They continue to face systematically higher unemployment rates, fewer job opportunities, lower pay, poorer benefits, and greater job instability.”(Weller, 2019). These factors have driven a majority of African Americans today into a financial crisis. On the contrary, Asian have had the opposite effect and lived prosperous lives in the U.S. For example, the graph displays Asians as having the highest income.

Race/Ethnicity of Household Head	2017 Median Household Income (2018 dollars)	2018 Median Household Income
All races/ethnicities	$62,626	$63,179
Asian	83,376	87,194

White, not Hispanic	**69,851**	**70,642**
Hispanic (any race)	**51,389**	**51,450**
Black	**40,324**	**41,361**

United States Census Bureau, ***Current Population Survey, 2018 and 2019 Annual Social and Economic Supplements*****.**

Asian Americans have been largely unaffected by past societal issues in the U.S. which has allowed them to become more financially capable than any other race.

Another way background affects financial capability is gender. It is widely known all around the world that women tend to make less than men. "Narrowing the gender gap would foster greater stability in the banking system and enhance economic growth. It could also contribute to more effective monetary and fiscal policy" Gender roles play a big part in financial capability because women are often not paid as much as men which can affect the way they think and feel" (Čihák & Sahay, 2019). In America, women make 79 cents on the dollar compared to men. The gender disparity is due to factors such as societal issues, career differences, children, and family. Women have been looked at as housewives in the past while men were looked at as the workers of a family, which has not been the case in recent times as cultural changes have seen a large increase of women in the workforce. In spite of this, women are still paid less than men overall. "Part of the reason for the gender pay gap is that women are more likely to take a break during their careers to have children or to seek lower paid positions that offer more flexibility to make it easier to manage a family. However, this explanation does not fully account for the gap."(PayScale, 2020). The contributions of gender and education, experience, and occupation, as we can see from the controlled gender pay gap. Since minorities and women tend to make less money, they feel as if there is a system made to work against them in the workplace.

This leads to negative psychological effects and can drastically affect; confidence and spending habits.

Financial To Psychology

Financial Capability plays a big role in one's Psychology. Young adults who are less educated with finance tend to make detrimental choices, which can create a domino effect on their mental state in a negative way. In an article from, 'Four Powerful Benefits of Financial Self-Awareness', it stated, " we found that a higher degree of self-awareness about one's finances translates into feedback about past successes and failures with money, lower uncertainty about the strengths and weaknesses of the current finances, and clarity regarding how to move forward. We pointed out that "once one knows their [financial] situation, they will feel confident in how to maintain and improve it."(Dholakia, 2019). This clearly demonstrates that someone who is knowledgeable about their financial circumstances will have positive psychological qualities such as confidence, contentedness, diligence, and consistency. People who are less financially stable tend to be more sensitive to financial choices than people who are more financially capable. For example, in an article titled, 'How Money Changes the Way You Think and Feel', says " A lot of what we see is a baseline orientation for the lower class to be more empathetic and the upper class to be less [so],"(Gregoire, 2018). This displays the disparities between people who are more financially capable compared to those who aren't as financially capable. This indicates that people who are lower class tend to be more willing to learn and care for their knowledge about financial capability, then people who are relatively upper class who tend to be more mindful of their spending habits. These sources coincide with each other because they all mention how financial capability affects your psychology.

Psychology To Finance

Conversely, Psychology also has a profound effect on your Financial Capability. Financial Capability itself is defined as a “suite of behavior” determined by financial literacy and psychological factors (Think Forward Initiative, 2017). For example, Factors such as responsibility (Pickhardt, 2015) could influence a desire to become financially literate, therefore strengthening your Financial Capability. Building upon the different factors, Ning Tang (2015) and her team of researchers strongly agree and expand on this idea by also adding that other factors include their optimism, impulsivity, control, and their overall approach to difficult situations. Both sources demonstrate that your thought process can heavily affect your Financial Capability, which is why it is important to keep a healthy psychological thought process. Factors such as the ones listed are all derived from the knowledge you possess, the environment you are surrounded by, and your background, which is why it is important to learn effective habits at building a strong mindset because of how greatly it affects your financial capability.

Psychology and Financial Capability’s Cyclical Relationship

Since Psychology and Finance both affect each other, it is evident that these two concepts have a cyclical relationship. What this means is that if a young adult were to lack even one of these areas, the other would suffer as well. For example, if a young adult were to not receive financial knowledge in their home then they could be left unprepared for utilizing tools such as student loans and credit cards, and because of this they could feel discouraged to finish their college degree (Robb, 2010), thus depriving of possible knowledge they could have gained as well as possibly lower their self-esteem and heighten their financial stress. Furthermore, easily believable scenarios such as the financially incapable college student can allow dangerous psychology afflictions like Learned Helplessness to creep in. In short, Learned Helpless is a mental state in which its subject meets consistent negative consequences and eventually learns to stop trying to better its circumstances, even if it is in an escapable situation. (Nolen, 2020). It could be theorized that persons who believe they cannot bring themselves out of financial debt stay complacent in living in poverty. Scenarios like these clearly demonstrate just how much psychology affects our views, feelings, and decisions with money, which in turn affect various areas of our lives.

Counter Argument

While many would think that incorporating finance into the education system is crucial, many also believe it would not be helpful for students. Jamming information into a child's brain would not benefit them in the real world, and making finance a required course will simply stress students more instead. "The mind is not like a computer that can store arbitrary amounts of information. Instead, we tend to retain only what is useful for navigating our current circumstances. For example, if you learn the abstruse mathematics of car leases to prepare for negotiation at the dealership, you might be surprised to find how little you remember when renewing the lease years later. Financial education tends not to stick if it is not useful right away. Many curricula are flawed in precisely this way, teaching high scholars about mortgages or debt management" (Fernbach, 2018). The United States is far behind in important subjects such as mathematics, English, and science when it comes to the ranking of other countries. If the U.S were to prioritize in giving students a course in finance that would be yet another subject to fall behind in. "At a time when basic classroom subjects like writing, reading, mathematics, science, and history are being discarded or underfunded by state public education authorities, toughening the requirements on the teaching of personal finance would be a waste of time and money" (Madsen, 2017). Even if the U.S were to consider putting financial literacy as a required course, would there be enough teachers qualified enough to teach the subject? "Given the woefully high levels of financial illiteracy in America, making such a course standard and required in high schools might sound like a fine idea. There's just one big risk: Those teachers could lead their students astray" (Colemen, 2018). If the sole provider for the education of financial literacy are teachers who barely understand the topic themselves, it can lead more students into debt and loans. This is a risk that cannot be taken.

Solution

Financial capability is an extremely important life skill that everyone should learn at a young age to prepare them for adulthood and prevent negative psychological effects. Most schools do not include financial literacy within their curriculum and completely disregard finance as a subject. This leads to students coming out of high school unprepared for the real world and leaves them feeling lost in a world of finance. Things such as loans, credit, interest, investments, 401k, and stocks are unfamiliar words to the average high school graduate. An implementation plan that can be enforced in schools and academies across the nation are; financial education programs that offer the nation that includes financial counseling, financial coaching, and financial therapy. (Peeters et al., 2018). These can be incorporated by going to school board meetings, talking to the superintendents of school districts, petitioning, and voting for government officials that support the implementation of these programs. For example, the Government of Canada is teaching middle scholars basic finance skills and terminology that the average American high school graduate does not know. (Rooney, 2017). An additional solution to solve young adults from being uninformed about financial literacy is to encourage parents to engage in teaching their kids about finance. The problem with this is most parents also do not know as much about financial literacy due to the lack of financial programs in school as stated before. Schools aren't teaching young adults financial literacy and eventually those young adults become parents who are clueless and are unable to teach their kids about finance. The root of the problem lies within the schools and their inability to teach finance. This causes a cycle of people in America being incapable of solving financial issues which in turn leads to bad choices which leave people in an inescapable financial mess. This is where psychology comes into play. People who make bad financial choices end up depressed or stressed and that greatly affects their mental state. Learning financial capability in school is a lot more important than most people think. It would make young adults more financially capable, and in turn, decrease the amount of psychological issues associated with bad financial choices.

Relationships between Psychology and Financial Capability.

Conclusion

Psychology is an element to take into account when dealing with a young adult's financial capability. There are numerous factors to take in when trying to prevent young adults from being uninformed about financial capability and being psychologically affected by it. For example the ``education system can implement making financial literacy a required course for students. This class can allow students to be more responsible about their finances in the future. Since students aren't being exposed to this material, many psychological effects can occur such as anxiety, depression, and insecurity. The influence of these effects can produce horrible financial decisions which cause debt in America. If schools taught financial courses, the psychological effects stated previously would not be as prevalent as they are now. Mandatory finance classes would lead to more informed young adults who can make better financial decisions, lead to less psychological issues that are common in today's world, and decrease the national debt that is increasing in America. With fierce advocacy for a psychological solution for financial capability, the U.S. can put itself on the right track for financial capability for young adults.

References

Bank, U. (2020, March 19). Activate your U.S. Bank credit card. Retrieved July 16, 2020, from https://www.usbank.com/credit-cards/how-credit-cards-work.html

Čihák, M., & Sahay, R. (2019, March 13). Women in Finance: An Economic Case for Gender Equality. Retrieved July 16, 2020, from https://blogs.imf.org/2018/09/19/women-in-finance-an-economic-case-for-gender-equality/

Coleman, H. (2019, April 18). Why It's A Mistake Teaching Financial Literacy In Schools. Retrieved July 27, 2020, from https://moneyqanda.com/mistake-teaching-financial-literacy-in-schools/

Dholakia, U. (2019, October 28). Four Powerful Benefits of Financial Self-Awareness. Retrieved July 20, 2020, from https://www.psychologytoday.com/us/blog/the-science-behind-behavior/201910/four-powerful-benefits-financial-self-awareness

Dholakia, U. (2019, October 28). Four Powerful Benefits of Financial Self-Awareness. Retrieved July 20, 2020, from https://www.psychologytoday.com/us/blog/the-science-behind-behavior/201910/four-powerful-benefits-financial-self-awareness

Educators Council, N. (2019, April 02). Why Isn't Personal Finance Taught in School: Data. Retrieved July 22, 2020, from https://www.financialeducatorscouncil.org/why-isnt-personal-finance-taught-in-school/

Fernandes, D., Lynch, J., & Netermeyer, R. (2014). (PDF) Financial Literacy, Financial Education, and Downstream Financial Behaviors. Retrieved July 22, 2020, from https://www.researchgate.net/publication/259763070_Financial_Literacy_Financial_Education_and_Downstream_Financial_Behaviors

Fernbach, P., & Sussman, A. (2018, October 27). Teaching people about money doesn't seem to make them any smarter about money – here's what might. Retrieved July 22, 2020, from https://www.marketwatch.com/story/financial-education-flunks-out-and-heres-whats-being-done-about-it-2018-10-10

Gregoire, C. (2018). How Money Changes the Way You Think and Feel. Retrieved July 27, 2020, from https://greatergood.berkeley.edu/article/item/how_money_changes_the_way_you_think_and_feel

Hoeve, Machteld, et al. "A Systematic Review of Financial Debt in Adolescents and Young Adults: Prevalence, Correlates and Associations with Crime." PLoS ONE, vol. 9, no. 8, 2014. Gale Academic OneFile, https://link.gale.com/apps/doc/A418138474/AONE?u=orla26340&sid=AONE&xid=b4f50734 . Accessed 15 July 2020.

Lumen. B.,(2015). Boundless Sociology. Retrieved July 27, 2020, from https://courses.lumenlearning.com/boundless-sociology/chapter/the-impacts-of-social-class/

Lusardi, A. (2019). Financial literacy and the need for financial education: evidence and implications. Swiss Journal of Economics and Statistics, 155(1), NA. Retrieved from https://link.gale.com/apps/doc/A570876151/AONE?u=orla26340&sid=AONE&xid=e56e7d9d

Madsen -Portsmouth Daily Times, W. (2017, June 01). No: Better we get back to basics. Retrieved July 14, 2020, from https://www.portsmouth-dailytimes.com/opinion/16393/no-better-we-get-back-to-basics

Mendes-Da-Silva, W., Nakamura, W. T., & de Moraes, D. C. (2012). Credit card risk behavior on college campuses: evidence from Brazil. BAR - Brazilian Administration Review, 9(3), 351+. Retrieved from https://link.gale.com/apps/doc/A298615009/AONE?u=orla26340&sid=AONE&xid=3c09ec1b

Nolen, J. (2017, December 28). Learned helplessness. Retrieved July 27, 2020, from https://www.britannica.com/science/learned-helplessness

P. (2020). Gender Pay Gap Statistics for 2020. Retrieved July 16, 2020, from https://www.payscale.com/data/gender-pay-gap

Peeters, N., Rijk, K., Soetens, B., Storms, B., & Hermans, K. (2018). A Systematic Literature Review to Identify Successful Elements for Financial Education and Counseling in Groups. Journal of Consumer Affairs, 52(2), 415+. Retrieved from https://link.gale.com/apps/doc/A550093678/AONE?u=orla26340&sid=AONE&xid=7a9d19a0

Ranzetta, T. (2020). NGPF Blog. Retrieved July 22, 2020, from https://www.ngpf.org/blog/advocacy/how-many-states-require-students-to-take-a-personal-finance-course-before-graduating-from-high-school-is-it-6-or-is-it-21/

Robb, C. A., & Pinto, M. B. (2010). College students and credit card use: an analysis of financially at-risk students. College Student Journal, 44(4), 823+. Retrieved from https://link.gale.com/apps/doc/A248733618/AONE?u=orla26340&sid=AONE&xid=1dbc59d6

Rooney, J. (2017). Teach Children about Money . Financial Consumer Agency of Canada. https://www.canada.ca/en/financial-consumer-agency/news/canadas-financial-literacy-blog/teach-children-about-money.htm

Smith, W., & Harrington, C. (2016). College student interest in personal finance education. Retrieved July 22, 2020, from https://go.gale.com/ps/i.do?p=AONE&u=googlescholar&id=GALE%7CA555411101&v=2.1&it=r&sid=AONE&asid=86526972

Soria, K., Weiner, B., & Lu, E. (2014). Financial Decisions among Undergraduate Students from Low-Income and Working-Class Social Class Backgrounds. Retrieved July 27, 2020, from https://ir.library.louisville.edu/jsfa/vol44/iss1/2/

Spencer, R. (2015). Blog: The psychology of financial capability and what it means for education. RSA. https://www.thersa.org/discover/publications-and-articles/rsa-blogs/2015/05/the-psychology-of-financial-capability-and-what-it-means-for-education#

Tang, N., Baker, A., & Peter, P. (2015, March 25). Investigating the Disconnect between Financial Knowledge and Behavior: The Role of Parental Influence and Psychological Characteristics in Responsible Financial Behaviors among Young Adults. Retrieved July 27, 2020, from https://onlinelibrary.wiley.com/doi/abs/10.1111/joca.12069

Think Forward. (2017). The Psychological Dimensions of Financially Capable Behaviour. Retrieved July 27, 2020, from https://www.thinkforwardinitiative.com/research/the-psychological-dimensions-of-financial-capability

United States Census. (2020, July 16). List of ethnic groups in the United States by household income. Retrieved July 16, 2020, from https://en.wikipedia.org/wiki/List_of_ethnic_groups_in_the_United_States_by_household_income

Weller, C. (2019). African Americans Face Systematic Obstacles to Getting Good Jobs. Retrieved July 22, 2020, from https://www.americanprogress.org/issues/economy/reports/2019/12/05/478150/african-americans-face-systematic-obstacles-getting-good-jobs/