Financial Literacy and Retirement Preparation

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ABSTRACT

This paper aims to identify research gap on financial literacy and retirement preparation topics and proposes several recommendations for future research. To explain the phenomenon of financial literacy and retirement preparation, this study uses theory of life cycle hypothesis in framework. The research uses a qualitative method approach by conducting a review of articles that traced throught google scholar. A literature search process held between April 2020 until August 2020 and resulted on 18 chosen articles. The outcome identifed that financial literacy has a role in preparing for retirement.

Keywords: Financial Literacy, Retirement planning, Financial Planning, and Private Pension participation, and Theory of Life Cycle Hypothesis

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1.Introduction

Existing household surveys in various countries show that most individuals are inadequate in managing their finances well (Agarwal et al., 2009; Calvet et al., 2007). In this case, to be able to use financial products and services and invest money wisely, they must have good financial literacy. At least they have basic financial knowledge and skills, and are aware of the possible risks and threats associated with their financial choices (Barbic, Dajana, et al, 2016).

Lusardi and Mitchel (2011) financial literacy as a concept of fundamental financial knowledge and the ability to perform simple financial calculations. Fundamental analysis skills and proficiency in simple financial calculations play an important role, especially in choosing investments so as to reduce possible risks. Financial literacy affects individual financial decisions in various aspects such as wealth management, share ownership, and insurance demand (Japelli and Padula, 2013; Liao et al, 2017; Lin et al, 2017; Van Roij et al., 2011b). Financial literacy is a key factor that contributes positively to retirement preparation (Bucher - Koenen and Lusardi, 2011; Lusardi and Mitchel, 2011; Van Roij et al., 2011., 2011a; Boisclair et al., 2017).

Modigliani's Theory of Life Cycle Hypothesis (LCH) has noted that one of the most important motives for setting aside money is for retirement needs. Tuan et al (2011) stated that each individual should focus on methods for strategizing financial activities such as savings,

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investment, and spending behavior in facing retirement. Actually planning finances for retirement is not an obligation for everyone, planning finances for retirement is a life choice.

Do individuals have the knowledge and skills to apply an understanding of concepts, risks, and skills to make effective financial decisions to prepare for retirement? Lusardi and Mitchell (2011) report that financially experienced people are much more likely to plan for retirement.

Several empirical studies have examined the effect of financial literacy on retirement preparation. Research conducted by Geng Niu et al (2020) in China, financial literacy has a strong and positive impact on various aspects of pension preparation consisting of planning for pension financial needs, financial planning for the long term, and private pension participation. Dajana Barbic et al (2016), this research shows that individuals who do not save sufficiently for retirement generally have low levels of financial literacy. Financial literacy is significant positively related to pension planning involving private pension funds, Klaper Leora and Georgios A Panos (2011); Dvorak & Henry (2010).

Nolan, A & Karina (2019) explained in their research that financial literacy is much higher in men, those who have a higher level of education and way of thinking, and are self-employed. Financial literacy in Finland is relatively higher, there is a positive relationship between financial literacy and retirement planning among women but not among men, Kalmi Panu & Olli (2017).

Based on the existing background and inconsistency in the results of previous research, the researcher intends to identify research gaps with the topics of financial literacy and retirement preparation and propose several recommendations for future research.

2. Literature Review

2.1 Retirement Planning

Individuals are less focused on retirement planning, Kirbis, Skreblin, et al (2011). Croatian National Bank (2016) still cannot be sure that they have made the right retirement plan. Inadequate financial levels can lead to very low living standards for future retirement. Increased life expectancy and low levels of personal retirement savings will ultimately result in greater poverty, especially among the elderly.

Retirement planning is not a necessity, it is a life choice for future preparation, but many are not ready for this, Ng, Tay, Tan & Lim (2011). Most individuals think that retirement planning is important as they approach retirement. Or if they are young and too far away to think about retirement. Even if they start saving for retirement, it's still not enough (Martin, Guillemette, & Browning, 2016).

2.2 Financial planning

Financial planning is a series of strategies in managing the allocation of funds with the aim of realizing financial expectations to be achieved in the future. Preparations will be carried out at the earliest possible time, so that it will be easier to achieve the goals that have been made previously and make better financial management. This financial planning strategy will begin with steps to find financial goals to be achieved, fundraising, analysis, problem identification, recommendations for financial and product decisions, and assistance in implementing planning and evaluating planning results (FPSB, 2007).

Financial planning can be defined as an efficient way to maintain separate funds for the purpose of securing income in old age, Magera (1999). Jamal et al (2011) stated that a lack of financial literacy has been found to be a widespread phenomenon in the world including developed countries. Individuals with lower levels of financial literacy do not receive innovative financial products, do not have sound financial planning, and they do not take financial plans with consideration and commitment seriously.

Personal financial planning is the process of managing money to achieve personal economic satisfaction. Personal financial satisfaction is the result of an organized process known as personal financial management or personal financial planning, Kapoor et al (2014).

2.3 Private Pension Participation

Insurance plays an important role in the financial well-being of society and individuals. Insurance offers protection against adverse events such as loss of income, property, and serves as an important risk management tool in the event of a crisis. However, making the decision to purchase insurance is more complex when compared to other financial products and services, Tennyson (2011). The importance of the social role played by insurance to help facilitate financial security and risk to individuals, from the government and entrepreneurs (Smith, 2009), and generally the low level of financial literacy in society, gain a greater understanding of insurance literacy which is very important, Joiner et al (2002).

Many factors have the potential to influence individual insurance decisions, one of which is financial literacy. Financial literacy is interesting because evidence shows a positive correlation between financial literacy and individual performance in financial activities such as investment and wealth accumulation, Van Roij, et al (2011).

2.4 Financial Literacy

The Indonesian Financial Services Authority (2013) defines financial literacy as the level of knowledge, skills and self-confidence related to financial institutions and their products and services, as described in parameters and index measurements. Chen, Bingzheng, et al (2018) financial literacy and pension planning have been widely explored in many countries. Financial literacy rates are often found to be lower in relatively new countries, women, and those with low income and low education. High levels of financial literacy increase the likelihood of having a retirement savings plan.

Financial literacy is usually viewed as a type of consumer or individual skill regarding how they deal with their financial problems effectively or their personal finances (Alba & Hutchison, 1987).

Financial literacy refers to developing the ability to make informed decisions on issues of basic business functions including budgeting, saving and investing, borrowing and lending, insuring, and distributing risk (Bodie, 2006). Financial literacy refers to an individual's knowledge of instruments and finance so that he or she has the awareness to make the right choices among the available options (Lusardi, 2006).

Cvrlje, D (2014) explains that financial literacy is a combination of financial knowledge and skills and is intended to increase the level of responsibility in using financial products and services and taking risks in making financial decisions. Financial literacy is people's awareness of basic financial concepts and their ability to make interpretations and evaluations based on their knowledge (Mason & Wilson, 2000). Financial literacy is the ability to make effective decisions using correct information about the management and use of money (Noctor et al, 1992).

Lusardi and Mitchel (2011) that financial knowledge and retirement planning are closely related. Financial literacy is an indication of a state of constant development that allows everyone to respond effectively to new personal facts and a changing economic environment (Kovalcikova, Smoron, and Stenk, 2011). Financial literacy has been shown to influence retirement planning behavior, consequently affecting retirement wealth, as well as the limited understanding of financial concepts that many people have (Lusardi and Mitchel, 2007, 2011; Van Roij, Lusardi and Alessie (2012).

Financial literacy is an inseparable part of life because financial literacy is a useful tool in making informed financial decisions, but from the experience of various countries it still shows relatively low numbers (Orton, 2007). Financial literacy will help avoid financial problems in the future. Avoiding low income due to errors in management, so that if there is financial knowledge and financial literacy it can help individuals in managing personal financial planning and individuals can maximize the time value of money and the benefits that individuals get will be even greater and will improve their quality of life.

2.5 Theory of Life Cycle Hypothesis

Developed by Franco Modigliani in 1957. According to Modigliani, one of the most important motives for setting aside money is to retire. In theory this suggests that during this stage of the life cycle, individuals plan their consumption and saving behavior. This theory proposes and austerity behavior reflects the desire to maintain a consistent standard of living throughout their lives (Dan, 2004).

The division of income between consumption and saving is a major constituent of the life cycle model. It has been widely used to examine savings and retirement behavior. It begins with the observation that the need between consumption and income is often uneven at various points in the life cycle.

Young individuals tend to have consumption needs that exceed their income. They have little savings, because their needs tend to be for housing and education. In middle age, income generally increases, allowing debt to accumulate and must be paid off and savings to be accumulated.

3. Discussion

Many countries have begun reforming their pension systems in recent decades. Existing studies in many countries show that retirement is limited knowledge. The involvement in pension issues is still low, individuals cannot estimate their income after retirement and they do not know how to increase the standard of living after retirement (Prast and Van Soest, 2016).

The financial literacy of both men and women is relatively the same, but men have a higher average financial literacy than women. Each male and female educational background has different financial literacy. Individuals with higher levels of financial literacy are more likely to have various forms of additional pension protection. Agnew (2013) explains that there is almost no significant difference between financial literacy for men and women.

In contrast to research conducted by Kalmi and Ruususen (2017), it is explained that financial literacy and pension preparation are stronger for women compared to men, basically because of lower labor market attachment, so that women plan to retire more than men. However, on the other hand, researchers found that women are far less financially literate than men. Not only gender, educational background, type of work / income, and age can also affect the extent to which they prepare for retirement and their knowledge of financial literacy and retirement preparation.

Financial planning in the household is important, so that it becomes more focused in enjoying retirement later. Pension does not mean not doing activities or stopping work, but financial planning is an efficient way to maintain separate funds for the purpose of securing income in old age.

When it comes to private pension participation, everyone has the opportunity to make a decision about an important aspect of their retirement savings plan. However, the existence of a private pension participation system, it still does not motivate more people to plan for retirement (Agnew et al., 2013).

4. Conclusion

Financial literacy is closely related to retirement planning, financial planning, and private pension participation. Financial literacy is an important supporting factor for retirement preparation, a follow-up is needed to increase public awareness about retirement preparation. In general, everyone has a positive attitude towards retirement planning, but only a few of them have personal retirement savings.

With a lot of research on financial literacy and retirement preparation. For further research, it is hoped that it can further examine the variables of financial welfare. Whether the level of financial literacy in society has a direct effect on financial well-being. Furthermore, it can provide training or seminars to increase awareness of the importance of financial literacy and preparation for retirement in order to improve financial well-being. Financial literacy is an important skill which enables individuals to direct the individual to an increasingly complex environment and ensure financial protection.

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