CHAPTER 2

LITERATURE REVIEW

2.1 References to Previous Research

Lusardi and Mitchell (2014) define financial literacy as “people’s ability to process economic information and make informed decisions about financial planning, wealth accumulation, debt, and pension.” Money management skills, awareness of savings and borrowings, self- control and budgeting are also associated with financial literacy. Studies show that people’s financial understanding influences their financial decisions (Lusardi and Mitchell, 2014), and people must have a good understanding of complicated financial concepts, such as compound interest rate and inflation, to make suitable financial decisions that influence them over the short, medium and long term.

Individuals who have a high level of financial literacy make better decisions about their personal finances. Independent of their salary, they prioritize their expenses and know how to make ends meet. When they have to face a personal crisis like losing a loved one, losing their job or going through a divorce, they suffer like everyone else. However, they have a higher chance of overcoming such an emergency’s financial damages, e.g. they can access their rainy day funds or rely on adequate insurances (Lusardi et al., 2010), make contracts to prepare for emergencies or rely on adequate insurances (Lusardi et al., 2010).

Financially literate families know how important it is to save and invest in their own house or their children’s education (Van Rooji et al., 2011). People with higher level of financial literacy are more likely to invest in financial markets and stocks and less likely to become financial scam victims (Van Rooij et al., 2011; Yoong, 2011). Countries with financially literate citizens grow stronger and are wealthier (Bryant, 2013). Overall, financial literacy matters on different horizons. Individuals are required to be financially literate to make sophisticated financial decisions with respect to savings, investing, borrowing and other financial choices. Higher level of financial literacy of individuals is also linked with a lower risk in their financial decisions, such as borrowing and debt (Lusardi et al., 2017), loan (Moore, 2003), savings and investment (Idris et al., 2016), and financial behavioral biases, such as overconfidence (Baker et al., 2019) and more concern about retirement planning (Lusardi and Mitchell, 2011b; Alessie et al., 2011).

Moreover, lower numerical ability is highly related with mortgage misconduct and insolvency (Gerardi et al., 2013; Skagerlund et al., 2018). Besides, greater knowledge on debt, such as debt concepts and higher ability to calculate the future payments, is linked to higher chances of paying credit cards in full and lower chances to be overindebted (Akin et al., 2012; Lusardi and Tufano, 2015). It is also documented that people with more financial knowledge show a higher level of diversification in their savings.

As well, financially literate people are more likely to be perceptive about selecting mutual funds (Hastings and Ashton, 2008). The association between financial literacy and ability to manage unexpected crisis is proved by previous studies (e.g. Hasler et al., 2018). The drawbacks of financial insensitivity are highly crucial. For instance, individuals who do not understand the complicated notion of interest compounding pay more transaction fees, are overindebted and suffer from greater interest rates on loans (Lusardi and Tufano, 2015).

2.2 Empirical Literature

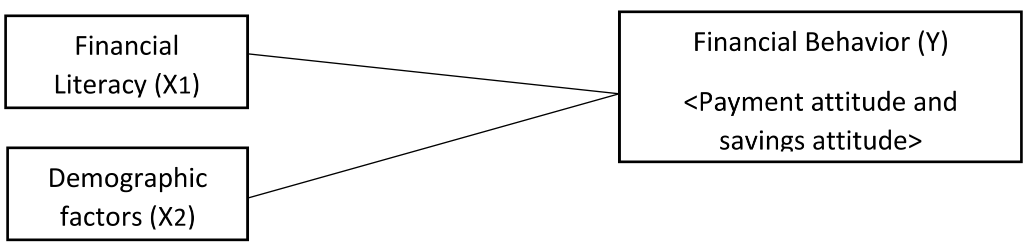
Several studies investigated the relationship between financial literacy and sociodemographic factors (e.g. Kadoya and Khan, 2020; Baker et al., 2019; Setyowati et al., 2018). A significant relationship between financial literacy and gender is found by various researchers (Hsu et al., 2021; Klapper and Lusardi, 2020; Farrer et al., 2019; Preston and Wright, 2019; Potrich et al., 2018; Greimel-Fuhrmann and Silgoner, 2018). Women are less financially literate than men; however, education and encouragement improves their level of financial literacy significantly (Farrer et al., 2019). Lin et al. (2019) investigated the association between sociodemographic factors and level of debt and found out that men are not more enthusiastic to debt than women are.

Klapper and Lusardi (2020) discussed the low level of financial literacy among women worldwide and emphasized that women continue to show lower financial literacy than men while controlling for age, country, education and income in multivariate regressions. With respect to the association between financial literacy and age, most of the studies reported a significant impact of age on financial literacy. Younger individuals tended to have lower level of financial literacy and financial knowledge than older ones (Yoshino et al., 2017; Volpe et al., 2002). Lusardi and Mitchell (2011a, b) identified a non-linear relationship between financial literacy and age. Moreover, risk perception varies based on individual employment status, income, marital status, and education (Keese, 2012). Financial literacy score differs with individuals' level of education, age, income and gender (Volpe et al., 2002).

A number of other factors potentially influence the individuals' financial literacy. For example, financial education programmes show a positive effect on financial behavior (Lusardi and Mitchell, 2009; Elliehausen et al., 2007). Other studies found out that financial education programmes had a limited success in improving financial literacy (Mandell, 2008; Braunstein and Welch, 2002). Among the remaining key determinants of financial literacy, research has provided evidence of a significant effect of financial experience. It is argued that financial experience can make individuals more responsive to financial education (Frijns et al., 2014). Literature advocates that financial experience plays a key role in individuals' motivation to become financially literate (Mandell, 2008; Frijns et al., 2014).

2.3 Conceptual Framework

The following conceptual framework was developed for the current research based on theories and prior research findings:



2.4 Research Hypotheses

Based on the framework and the previous research, the tentative answers proposed as research hypotheses are as follows:

H1. Financial Literacy is related to improve payment attitude among woring adults in Indonesia

H2. Financial Literacy affects individual's tendency to save among working adults in Indonesia