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Politicians, Trust and Financial Literacy:

When Do Politicians Care?

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Politicians can be more or less active in pursuing financial-literacy policies. This paper explores the role of financial-literacy policy in modifying the financial-trust endowment of a given population taking the political cost-benefit analysis into account. As, in any period, each incumbent government can design and implement its own financial-literacy policy and as financial-literacy deficits are more likely in a period of financial innovation, we assume that constituencies more or less in favour of such policies are present in a given country. If this is the case, we can show that, in a democracy with political competition, the level of activism in implementing financial-literacy policies is positively associated with financial-instability risks, literacy benefits, and illiteracy costs. Moreover, preferences and constraints motivate the politician in charge. More specifically, a more longer time horizons, lower psychological attitudes towards the status quo, and a higher probability of re-election can increase financial-literacy efforts.

Keywords: financial literacy, financial trust, fintech, financial crisis, loss aversion, political competition

JEL classification: D72 (Political Processes), G28 (Financial Institutions and Services: Government Policy and Regulation), G53 (Financial Literacy), H10 (Public Economics, General), K00 (Law and Economics, General)

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1. Introduction

Trust in financial markets and institutions is key for safe macroeconomic growth. Financial trust can be defined as citizens' expectations that, on average, financial exchanges are dependable because the firms and professionals involved in the production and distribution of financial services and products are reliable in the sense that they perform actions that are beneficial, or at least not detrimental, for consumers, regardless of their financial knowledge (Sirdeshmukh et al. 2002, Guiso 2010, Sapienza and Zingales 2012, van Esterik-Plasmeijer and van Raaij 2017).

On the one hand, in a market economy, a high financial-trust endowment of a given population has several positive macroeconomic consequences (Hastings et al. 2013, Lusardi and Mitchell 2023). Moreover, given that any financial exchange entails promises (Jaffer et al 2014), and given that citizens completely and systematically understand such promises, financial literacy plays a crucial role in strengthening financial trust (Hansen 2012, van der Cruijsen et al. 2021a).

On the other hand, financial illiteracy is harmful. In the financial industry, customers cannot, without incurring some costs, verify the quality of financial services, as such services are "credence goods" (Dulleck and Kerschbamer 2006). In light of this knowledge asymmetry between producers and consumers, financial operators can be categorised as fair/skilled or unfair/unskilled (Berk and van Binsbergen 2022), and as honest or criminal (Barone and Masciandaro 2019).

All else equal, a high level of financial illiteracy allows unfair, unskilled, and criminal actors to offer their services, thereby increasing the likelihood that citizens unconsciously engage in excessive risk-taking. Moreover, emerging technologies are fuelling the capacity of unskilled and criminal actors to involve citizens in their risky and/or illegal businesses (Teja 2023).

Therefore, the recent popularity of financial literacy as a research field (Goyal and Kumar 2021, Lusardi and Mitchell 2023), including the critical views (Willis 2011, Hasting et al. 2013, Clarke 2015), is not surprising. Some researchers (Lusardi and Mitchell 2023) have argued that recent economic crises, such as the Covid-19 pandemic and the rise of inflation, further highlight the importance of financial literacy for individuals and society.

In light of the above discussion, a question arises: Is the political relevance of financial-literacy policies consistent with the importance of financial literacy in the scientific debate? In a sense, a financial-literacy paradox seems to have emerged. More specifically, despite the increasing importance of this issue in research and the fact that some governments have introduced active financial-literacy policies (Lusardi and Mitchell 2023), the concrete design and implementation of such policies appear quite heterogeneous. This paper offers a political-economy explanation for this development.

In any period, a country's incumbent government can design and implement its own financial-literacy policy. In addition, constituencies that are more or less in favour of such a public policy are present in that country. Therefore, it is possible to show that a high level of the financial-literacy policy is positively associated with financial instability risks, financial illiteracy costs, and the planning horizon of the politician in charge, such that a longer horizon and a higher probability of re-election increase financial-literacy efforts.

Notably, the literature has thus far disregarded the political-economy aspects of financial literacy. This paper complements the extant literature by proposing a general approach showing why a government may want to tackle financial-literacy challenges in a more or less active way, and demonstrating which factors might determine a government's efforts to preserve and enhance the financial-trust endowment. The role of constituencies in favour of or against financial literacy is considered, as is the role of political competition. In addition, the existence of behavioural biases is taken into account—more loss-adverse politicians prefer the status quo, which implies that inaction in pursuing financial literacy is more likely.

This paper is organized as follows. Section 2 presents the cost-benefit analysis of any politician in charge and uncovers the structural drivers that can motivate a politician's activism in financial-literacy policies. Section 3 presents the conclusions, highlights several possible avenues for future research, and points to some policy implications.

2. Politicians, the Trust Endowment and Financial-Literacy Activism

We can analyse the relationship between trust and financial-literacy policy. The starting point is the general intuition that political turnover can lead to less investment in state capacity (Besley and Person 2009, 2010, Battaglini et al. 2014). The specific assumption is that a lower probability of re-election is associated with less focus on protecting a scarce public resource (Robinson et al. 2006, Ryszka 2013, van der Ploeg 2018), such as financial trust. We offer a specific application of this general theoretical setting in which each government can influence the endowment of an exhaustible public resource (Harstad 2023).

Consider financial trust as an endowment of a public resource that can be maintained or deteriorate. Opportunistic and illegal behaviours among financial producers can trigger trust deterioration (Guiso 2010, Sapienza and Zingales 2012). Time is discrete and has an infinite number of periods. At time t, the size of financial trust in a country and for a given population is S_t. The extent of financial-trust deterioration is $x_t \in (0,1)$, where:

$$S_{t+1} = (1 - x_t)S_t. \qquad (1)$$

Given that the country is a democracy, all else equal, the elected government can view the protection of the trust endowment as its own mission and, therefore, be active in designing and implementing financial-literacy policies.

In fact, empirical evidence shows that financial literacy is positively associated with more trust in financial institutions and supervisory authorities (Hansen 2012, van der Cruijsen et al. 2021a). However, the relationship between trust and financial literacy should be empirically tested. From a logical perspective, as pointed out by Van der Cruijsen et al. (2021a), knowledgeable consumers may better understand and appreciate the services provided by financial producers, which may enhance their trust. However, increased financial knowledge could backfire, as knowledgeable consumers may be better able to identify the producers' limitations, which may reduce trust. One more channel between trust endowment and financial literacy lies in the possibility that low literacy may trigger financial crises (Boeri and Guiso 2008).

Moreover, it can useful to distinguish between narrow-scope trust and broad-scope trust (Sirdeshmukh et al. 2002, Hansen 2012, Van Esterik-Plasmeijer and Van Raaij 2017, Van der Cruijsen et al. 2021b). Broad-scope or system trust refers to citizens' expectations that the financial industry as a whole is reliable. Narrow-scope or institutional trust is defined as the fact that people trust the financial firm providing the services they use. Financial literacy can strengthen both of these types of trust (Hansen 2012, 2014, Shim et al. 2013, Van der Cruijsen and Jonker 2019, Nunez Letamendia and Poher 2020), even if the results are mixed (Shim et al. 2013, Kersting et al. 2015, Ampudia and Palligkinis 2018).

Finally, trust and financial literacy can be linked through both direct and indirect channels. For example, more financial literacy may enhance financial inclusion (Bianco et al. 2023), and, in turn, increase trust.

In light of the above discussion, we can assume that, in general, the trust endowment and financial literacy go hand in hand. For the sake of simplicity, we can also assume that the only factor that can influence trust deterioration is financial-literacy activism and that the two variables are inversely associated.

How can we describe the politicians who are part of the incumbent government? In general terms, two types of cases can be analysed. The *helping-hand view* (Pigou 1938) assumes that the politician, acting as a social planner, wishes to please all inhabitants rather than a particular constituency or lobby (Shleifer and Vishny 1998). According to the *grabbing-hand view*, politicians are motivated by a desire to please specific, well-defined voters in order to increase their support. In our case, we use the helping-hand view as a benchmark for evaluating the actual behaviour of a politician, taking into account the political costs and benefits of an economic-policy choice (i.e., acknowledging that constituencies in the population matter).

At the beginning of any period, the politicians in charge acknowledge the existence of uncertainty in the political game. The politicians in power decide on the extent of their financial-literacy activism, which will preserve the trust endowment that will be inherited by the next government. As we will see later, any activism decision carries both political benefits and costs. Therefore, the politicians in charge will discount the uncertainty of remaining in power.

Let us consider p ε (0,1) as the probability that these politicians will be in office in any later period. The lower this probability, the higher is the political competition. Assuming n identical politicians, parties, or coalitions in competition, we have:

$$p = \frac{1}{n}. \qquad (2)$$

We assume that the overall re-election probability is independent from financial-literacy performance, which seems to be a realistic hypothesis. At the same time, the politicians in charge know that their financial-literacy activism is associated with both political gains and political costs.

The politicians can implement financial-literacy policies that limit the deterioration of trust. However, doing so is not without cost given the existence of economic and political opportunity costs in designing and implementing these policies. Therefore, constituencies formally or *de facto* in favour of or against financial literacy can be present in the population.

Some citizen constituencies may view financial-literacy policies as a positive social investment that can reduce the deterioration of financial trust. These constituencies are motivated by the fact that the trust endowment can have positive macroeconomic effects. First, a higher level of financial trust increases financial stability (Guiso 2010) in normal times, and reduces the likelihood of extraordinary times caused by systemic banking and financial crises. Second, a higher level of financial trust is associated with expansion of dimensions in the banking and financial industry as a whole, with positive spillovers in terms of savings and investments (Jaffer et al. 2014).

Greater financial literacy may, in turn, be associated with better wealth allocation (Guiso and Japelli 2009, Von Gaudecker 2015, Guiso and Viviano 2015), planning (Lusardi and Mitchell 2011, Billari et al. 2023), remuneration (Deuflhard et al. 2019), and accumulation (van Rooij et al. 2011, Calcagno and Monticone 2015). Moreover, the more the link between financial literacy and macroeconomic performance seems effective or, at least, is perceived as effective, the more likely it is that public and private constituencies in favour of financial literacy will emerge.

With regard to public constituencies, the activities of the supervisory authorities will be more effective if financial literacy and trust are correlated (Van der Cruijsen et al. 2021a). The same can be true for any public institution involved in the design and implementation of financial-literacy policies. With respect to private constituencies, if we assume that skilled professionals benefit from information disclosure (Grossman 1981, Berk and van Binsbergen 2022) and that disclosure is more effective the more financial literacy is disseminated, then skilled professionals can be a financial-literacy constituency.

Therefore, let us assume that the value of financial literacy for conserving financial trust is:

$$B = \frac{b}{(1-\partial)}. \tag{3}$$

As the setting is dynamic, the lowercase letter is the pre-discounted value, while the uppercase letter is the present value, which includes the time-discount factor, where $0 < \partial < 1$. The more the politician is a myopic agent (i.e., the time discount factor is close to one), the higher the present values of the political benefits and costs will be.

Furthermore, let us assume that the value of financial literacy is:

$$B_1 > B_0 > 0;\ \Delta_b = B_1 - B_0 > 0, \tag{4}$$

where B_1 is the benefit for the politician in charge and B_0 is the benefit for a politician not in power, signalling that being in power matters for an individual. Δ is a metric measuring how the politician in charge benefits from actively in pursuing financial-literacy policies.

In order to build a complete political cost-benefit analysis, we must acknowledge that the politician in charge may benefit from financial-literacy inaction. Assume that inaction in financial-literacy policy automatically implies higher financial illiteracy and that the value of financial illiteracy is:

$$A_1 > A_0 > 0;\ \Delta_a = A_1 - A_0 > 0, \tag{5}$$

where A_1 is the benefit for the politician in charge and A_0 is the benefit for a politician not in power. Δ is a metric measuring how the politician in charge benefits from not pursuing financial-literacy policies. The benefits of political inaction can be motivated using two arguments: behavioural biases and capture.

In general, politicians prefer the status quo when loss aversion characterizes their goal functions. In such situations, inaction becomes the optimal economic-policy strategy (Alesina and Passarelli 2019). Loss-averse politicians are an extreme case of conservative players – "pigeons" – as they dislike any kind of active policy (Favaretto and Masciandaro 2016). In the behavioural literature, given the status quo, individuals perceive outcomes as gains or losses, and losses loom larger than gains (Kahneman and Tversky 1988).

Loss aversion has increasingly been viewed as relevant for explaining political behaviour (Quattrone and Tversky 1988, Berejikian 1997, Druckman and Lupia 2000, Mercer 2005), Soroka 2014, Sheffer et al. 2018). In our case, if the politicians in charge feel that activism in financial-literature policy may have more political costs than benefits, they may view inaction as the optimal strategy given the scarce availability of public resources.

Moreover, politicians can view inaction as optimal if they are captured by financially illiterate constituencies. In other words, inaction in designing and implementing financial-literacy policies may be convenient for the politicians in charge.

On the other hand, constituencies in the same population may explicitly or implicitly view financial-literacy policies as useless or costly, or even view financial illiteracy as beneficial. To understand why some individuals may view inaction in financial-literacy policy as beneficial, we must acknowledge that financial illiteracy can increase the activities of unskilled, unfair or illegal actors. If we view any financial producers that gain from interacting with naïve citizens as unskilled/unfair actors, we know that these operators will favour higher levels of financial illiteracy. In parallel, some skilled consumers would like to live in a world characterized by high financial illiteracy, as this would facilitate fraudulent conduct in networks where the melding of technology and financial services is calibrated to accommodate citizens who, on average, are naïve (Griffin et al. 2023).

In general, the relevance of such actors can depend on other policy drivers, such as financial regulation. The presence of unskilled/unfair actors in a given country can be influenced but not completely eliminated by financial-regulation devices, such as disclosure obligations (Inderst and Ottaviani 2012), licensing requirements, and certification processes. For decades information disclosure has been a crucial part of the policymaker's regulatory toolbox (Ben-Shahar and Schneider 2004).

Yet the effectiveness of such as regulation is controversial: the breadth and depth of most disclosures render them unintelligible and obscure (Bakos et al. 2014, Pollach 2005) due to consumer illiteracy (Mak 2012). Consequently unfair actors can deliberately misrepresent legal provisions to disadvantage consumers (Furth-Matzkin 2017, Wilkinson-Ryan 2017). Notably, moreover, even regulatory activity can depend on political considerations (Stigler 1971), and specifically it can be optimal for the policymaker to tolerate a certain amount of unskilled/unfair actors (Berk and van Binsbergen 2022, Kadens 2023).

If inaction in financial-literacy policy implies higher financial illiteracy, we can assume that the value of financial illiteracy is:

$$A_1 = \frac{a_1}{(1-\partial)}. \qquad (6)$$

Again the lowercase letter is the initial pre-discounted value, while the uppercase letter is the present value that includes the myopia factor. Therefore, the more the politician in charge prefers the status quo and/or is captured, the more we can assume (regardless of the potential benefits of financial literacy) that:

$$A_0 > B. \qquad (7)$$

However, the politicians know that inaction in financial literacy is not cost-free, as financial instability is more likely. We assume that the financial-instability costs are associated with the level of inaction and with the endowment of financial trust:

$$\frac{c}{2}\, x_t^2 S_t. \qquad (8)$$

The intuition is straightforward – instability costs are associated with the financial-illiteracy level taking how relevant financial trust is for a given population into account. In turn, declines in trust can be associated with systemic financial crises (Guiso 2010, Sapienza and Zingales 2012, Knell and Stix 2015) or individual crises (Van der Cruijsen et al. 2016).

Moreover, with the constant evolution of financial technologies, consumers are increasingly falling victim to producers. Therefore, regardless of the possibility of a regulatory reaction (Cornelli et al. 2023), the risk of trust deterioration is likely to increase.

As we have considered potentially relevant drivers, we can determine the politician's goal function. In order to identify a policy benchmark, we can start from the helping-hand perspective. Let us describe the social planner's choice in terms of stationary equilibrium. In equilibrium, for the politician, the helping hand's expected value, V_{HH}, is associated with the socially optimal level of a given steady-state level of inaction, x_s, which is independent from the trust endowment (Harstad 2023):

$$V_{HH} = \frac{x_s A^* + (1-x_s) b - x_s^2 \frac{c}{2}}{1-\partial(1-x_s)}, \qquad (10)$$

Where the social gain for inaction, A^*, is a weighted average of the expected gains for a politician (i.e., to be either in charge, A_1, or not in charge, A_0).

The corresponding inaction level, x^*, that optimizes the social expected value is minimized at a steady-state level $x_s = x^*$ can be either zero, or it can be positive depending on the expected costs and benefits, and given the politician's myopia:

$$x^* = \sqrt{\frac{(1-\partial)^2}{\partial^2} + 2\,\frac{(1-\partial)}{\partial}\frac{(A^* - B\,)}{c}} - \frac{1-\partial}{\partial}. \qquad (11)$$

However, the politicians in charge at any moment in time do not have the social planner's perspective. Instead, their grabbing-hand perspective implies that being part of the incumbent government matters for each of them. Consequently, it is possible to identify the optimal inaction, x_t, as well as its structural drivers.

In equilibrium, for the politician, the grabbing-hand expected value, V_{GH}, is associated with the potential gains of being in charge, all else equal:

$$V_{GH} = \frac{x_s A_1 + (1-x_s)b - x_s^2 \frac{c}{2}}{1-\partial(1-x_s)} \quad (12)$$

and

$$x_t = \frac{\left(A_1 - b - \partial v_p\,(x_s)\right)}{c}. \quad (13)$$

Actual financial-literacy activism tends to be higher when the instability costs and the literacy gains are higher. The opposite is true with regard to the financial-illiteracy gains and the myopic factor (i.e., more myopic politicians care less about financial-literacy policy).

The inaction level, x_t, that optimizes the actual expected value of the politician in charge is minimized at a steady-state level, x_p, which can be either zero or positive depending on the expected costs and benefits. Given the politician's myopia:

$$x_p = \sqrt{\frac{(1-\partial)^2}{\partial^2} + 2\frac{(1-\partial)}{\partial}\frac{(A_p - B\,)}{c}} - \frac{1-\partial}{\partial}, \quad (14)$$

where optimization takes the political-competition factor into account:

$$A_p \equiv pA_1 - (1-p)A_0. \quad (15)$$

However, in contrast to the helping-hand strategy, the inaction strategy in the grabbing-hand scenario can be higher that the corresponding steady-state level if the political gain of being inactive is higher. In fact, when:

$$\Delta_a(1-p) > 0 \quad (16)$$

then:

$$x_t = x_s + \frac{(1-p)\Delta_a}{c}. \quad (17)$$

In other words, the politician's inaction will be higher when his or her gains are higher and when political competition is high. The opposite is true when the probability of financial instability is higher.

3. Conclusion

In recent years, politicians around the world have introduced financial-literacy policies. However, such policies are highly heterogeneous. To capture the general drivers of this policy heterogeneity, this paper uses the literature on political economy and behavioural economics.

We have applied a general setup of government choices in addressing a scarce public resource to the specific case of the association between the trust endowment and financial-literacy policy. This approach has highlighted the political motivations that can explain why the politicians in charge can be more or less active in pursuing such policies.

We have considered the facts that each incumbent government can design and implement its own financial-literacy policy, and that constituencies more or less in favour of such a public policy can be present in a country. Therefore, it is possible to show that the government's level of activism in implementing financial-literacy policies is positively associated with financial-instability risks, financial-illiteracy costs, and the planning horizon of the politician in charge. With regard to the latter, a longer time horizon, lower psychological attitudes towards the status quo, and a higher probability of re-election increase financial-literacy efforts.

Future research may test the robustness of the two pillars that serve as the foundations of the present analysis. The first pillar is the positive relationship between trust and financial literacy. In this regard, the most interesting challenge would be to identify causality using experimental devices that have already demonstrated their effectiveness in disclosure (Wulf and Seizov 2022) and financial-literacy investigations (Billari et al. 2023). The second pillar is the financial-literacy activism that characterizes incumbent governments. Previous scholarship on financial literacy has failed to investigate the preferences of the main public actors (i.e., the politicians). This gap in the extant research is not without effects. A limited understanding of the goals and incentives that characterize the politicians in charge obscures the reasons why financial-literacy policies can be more or less intense in a given country. This issue can be addressed through a systematic examination of politicians' voices that relies on text-analysis techniques (Ferrara et al. 2021) or elite surveys (Ferrara et al. 2023).

Moreover, empirical explorations could help establish metrics for measuring financial-literacy activism, which could then be used to empirically test several hypotheses:

H1. Financial crises and/or financial misconduct increase financial-literacy activism.
H2. The financial industry's size and/or complexity can influence financial-literacy activism by facilitating the establishment of private constituencies that, in turn, can be formally or *de facto* in favour of or against this type of public policy.
H3. Political stability increases financial-literacy activism.
H4. Political conservatism decreases financial-literacy activism.

Finally, our study provides insights into policy implications. More specifically, we have highlighted how important public constituencies can be in a given country. The activities of the supervisory authorities will be more effective if financial literacy and trust are correlated, and the same should be true for any public institution involved in the design

and implementation of financial-literacy policy. Therefore, such supervisory and public institutions can underscore the relevance of financial education in their relationships with citizens and in their role as policy advisors (van der Cruijsen et al. 2021a). In parallel, the presence of private financial-industry constituencies explicitly in favour of helping consumers become more knowledgeable through concrete activities and investments can increase public financial-literacy activism.

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