

MRRC RESEARCHER



Olivia S. Mitchell discusses her MRRC supported research with Justine Hastings

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How Financial Literacy and Impatience Shape Retirement Wealth and Investment Behaviors

MRRC: Could you provide a brief overview of your working paper?

OSM: My research with Justine Hastings examines two competing explanations for why consumers have trouble with financial decisions. The first is that too many people fail to understand simple economic concepts such as compound interest, and financial illiteracy can partly explain why they do not save. The second is that impatience, or what we call present-bias, can help explain suboptimal financial decisions. For example, people who persistently choose immediate gratification instead of taking advantage of larger long-term payoffs get into trouble on many fronts. Thus we show that both impatience and financial illiteracy are strong predictors of wealth and investment in health.

MRRC: Are people who are financially literate simply those who are more educated? Are you measuring something other than education level?

OSM: People most likely to be impatient are often the least-educated, lowest-paid, and older. Our analysis controls on educational attainment and still detects distinct and independent effects of impatience and financial literacy. So no, it is not just education that matters. One must be financially savvy, make financial plans, and be able to execute the plans as well.

MRRC: What can be done to make financial decisions more user-friendly for individuals who may not be really savvy about money and investing?

OSM: Our work shows that the way financial information is framed can help, particularly for the least savvy. For instance, showing workers the gains they could make if they saved in the lowest-cost pension fund is more powerful than showing them losses. Showing them how much more their account will be worth in dollars (or pesos, in Chile) has a greater impact than showing them expense charges in percentage points. At the same time, enhancing financial literacy and patience can have wider spillover effects, since we found that those who were most patient and efficacious in carrying out long-term plans not only had more retirement wealth but also were more likely to undertake health investments such as annual checkups, regular exercise, and so forth.

MRRC: Could you tell us a little about the data you used?

OSM: This project used the Chilean Social Protection Survey (Encuesta de Protección Social), a nationally representative longitudinal survey modeled on the Health and Retirement Study in the US, with input from three University of Pennsylvania researchers in collaboration with the University of Chile in Santiago. For this special study, we offered respondents a gift card to fill out a questionnaire, which would be activated for about US\$8 if it were completed immediately; if the respondent preferred to do it later and mail it in in the envelope provided, the gift card would be activated with a higher amount. Respondents who delayed received a 20–60% return if they actually returned the questionnaire within four weeks. The experiment permits us to identify three different types of respondents: the impatient who took the lower gift-card amount immediately, the efficacious deferrers who chose the later amount and returned the survey for the higher amount, and the inefficacious deferrers who opted for the later higher amount but then failed to send in the questionnaire so as to activate their cards.

MRRC: What can this study tell us that we didn't know before?

OSM: Society is increasingly moving to more “individual responsibility” with the growth of personal pension accounts, vouchers for education, choice over healthcare, and such. At the same time, employers and the government are less likely to take on responsibility for our choices. We have shown that additional guidance and financial literacy training can go a long way in helping people make sensible decisions and execute them in good time.

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MRRC: Are there ways to teach patience and financial literacy? Is it worthwhile?

OSM: Impatience has been linked in a range of studies to be associated with children's disciplinary problems, eating disorders, and other problematic behavior. Conversely, children who can defer gratification tend to be more successful in school and in life afterwards. There are 'tricks' that people can use to teach youngsters the ability to defer gratification, which include helping them to devise strategies for waiting – thinking of things to do while waiting, finding something to distract, and so forth. There is also research suggesting that peers have a potentially powerful effect – if your friends all save and invest, you are more likely to do so too. Our other research has shown that there are strong causal links leading from financial literacy to retirement planning and wealth accumulation. Moreover, high school students who live in states where financial literacy was mandated and the school systems devoted resources are also more likely as young adults to plan and save more, suggesting that financial literacy can be enhanced.

MRRC: You and your research partners have conducted a few studies regarding pensions and retirement savings plans in Chile. How can the experience in Chile inform US retirement policy?

OSM: Our results should interest policymakers seeking to determine how to better shape the environment in which individuals undertake saving and investment choices. For instance, we show that it may be useful to facilitate decision-making, particularly among the less-educated, and to help people commit to and carry out long-term financial decisions. As households are expected to exert more control over their retirement accounts and other assets, this raises concerns about whether consumers can make optimal investment and saving decisions. Further, the development of ever more complex financial products probably makes it difficult for consumers to understand them and use them sensibly. What we have shown is that participant awareness of higher net-return funds can be greatly enhanced when information on fees is simplified in terms of likely gains from selecting higher net return funds.

MRRC: What are your next steps in this line of research?

OSM: The impact of fund fee framing is largest for the least financially literate and the lowest-educated groups. By contrast, choices made by the financially well-informed tend to be less responsive to the way in which information is presented, since those individuals tend to better understand the financial concepts necessary to translate annual percentage rates into costs and benefits. In the future, a field test of such policies would be the next step to level the playing field across socioeconomic groups and enable participants to commit to take actions now for greater gains later. ■



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