



How real people make long-term decisions: The case of retirement preparation[☆]

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ABSTRACT

Large variations in retirement wealth are common, with some households accumulating hundreds of thousands of dollars and others accumulating next to nothing. We examine to what extent formal planning or simple rules of thumb contribute to these differences in wealth accumulation. In particular, we investigate whether those who follow simple rules of thumb or those who come up with more complete plans accumulate more wealth than those who take an unsystematic approach. We test this empirically using a specifically designed survey about retirement preparation. We find that people who rely on a rule of thumb behave like literal planners. However, people without any systematic approach save substantially less. Our results, taken together with evidence from psychology, suggest that financial planning advice based on simple rules of thumb may be helpful for those who currently take no systematic approach.

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1. Introduction

Households differ markedly in their wealth accumulation for retirement. Attempts to understand these differences, such as Ameriks et al. (2003), Bernheim et al. (2001), Beshears et al. (2008), Laibson et al. (1998), Lusardi and Mitchell (2007), Saez (2009) and Scholz et al. (2006) have taken various approaches. People may differ in their budget constraints, information, discount rates, the functional form of their discount rates (such as hyperbolic discounting), whether they engage in planning, or their financial literacy. In this paper, we consider the role of what we will dub decision processes, i.e. the steps one takes to make a choice.

Bernheim et al. (2001) suggest that the extent to which accumulated retirement wealth varies across households is difficult to reconcile with the classical life cycle model. Traditionally, economists assume that choices are the outcome of optimization over consumption in the presence of a budget constraint. Agents are assumed to identify the choice that leads to the highest satisfaction out of all feasible choices. In many domains, this optimization process is fairly straightforward, most notably for choices that do not involve long time horizons or substantial uncertainty. In contrast, in the domain of life cycle

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saving, literal optimization requires engaging in contingent planning and backward induction. Indeed, most economists agree that people do not literally engage in optimizing in this domain. Rather, there is consensus that people's behavior should be understood "as if" determined by an optimization process (Friedman, 1953). Interestingly, though, economists have remained surprisingly vague about what the "as-if" metaphor would mean in practice. In other words, economists have paid little attention to how real people actually arrive at the retirement savings decisions that they make.

A growing literature has started to fill this gap. In particular, Ameriks et al. (2003), and Lusardi and Mitchell (2007) provide evidence that those who *plan* for their retirement accumulate more retirement wealth. What remains an open question is which precise aspect of planning, i.e. which *decision process*, leads to the positive relationship between "planning" and the accumulation of retirement wealth. Is it calculating a detailed savings plan? Or could it be that a simple rule of thumb may also work as a "plan" to boosting wealth accumulation?

We define a *decision process* to consist of a series of steps that one takes to make a choice. In this paper, we consider three potential prototypes of decision processes people may adopt when deciding about their retirement savings. We dub the first prototype the literal *planning* approach. This relies on careful intertemporal budget calculations, perhaps based on financial software or expert advice. We dub the second prototype the *rule-of-thumb* approach. In contrast to the literal planning approach, some individuals may not actually engage in any formal planning process. Rather, they may follow some simple rules of thumb such as putting aside a fixed percentage of their monthly earnings. Finally, some individuals may not engage in any planning at all nor consciously follow any specific rule. We dub the latter the *unsystematic* approach.

Crucially, individuals' decision processes may differ in terms of the degree of their sophistication and therefore how costly they are to implement. Gathering detailed information for working out a careful plan may require a substantial amount of time. In contrast, copying a simple rule of thumb from a friend or simply maximizing the company match for a 401(k) plan does not require a large time investment. Importantly, the costs of working out a careful plan may differ across individuals. It may require little effort for someone with substantial mathematical or accounting skills. On the other hand, it may be very burdensome for people with low planning skills and to those with a high disutility from thinking about economic issues.

Decision processes should be distinguished from *preferences* over consumption profiles. Intertemporal preferences determine the optimal choice of lifetime consumption profiles. However, finding out the choice that maximizes intertemporal preferences may be costly due to bounded rationality. As a result, individuals may make choices that differ from the preference-maximizing ones. Individuals may use simplified planning or rules of thumb as a procedure to come up with a savings choice. Individuals with identical preferences over intertemporal consumption streams may easily make different choices if they differ in terms of cognitive abilities or the propensity to plan, and hence in their decision making process.

In this paper, we investigate how the three prototypes of decision processes, literal planning, a rule of thumb, and the unsystematic approach, contribute to differences in wealth accumulation. Bernheim et al. (2001) posit that observed variation in wealth at retirement is likely to be caused by deviations from "rational, farsighted optimization" and that differences are more consistent with a rule of thumb. However, previous research has not had access to data that could directly measure whether individuals follow a plan based on farsighted optimization or instead follow a simple rule of thumb or even exhibit an unsystematic approach to life cycle saving.

For our analysis, we use a novel data set that has been collected for the purpose of this study. These data allow us to categorize individuals according to the three prototypes mentioned above by means of specifically designed survey questions. We first examine whether all of the three prototypes can actually be observed. We investigate their relative frequency as well as the determinants that lead individuals to adopt either prototype. The main topic of the paper is then to explore whether all three prototypes of decision processes lead to comparable savings outcomes or whether they are associated with systematic differences in outcomes.

Our data come from a detailed survey module on decision behavior that we fielded with the American Life Panel at the RAND Corporation. Our module consists of questions on how individuals proceed when making their retirement savings decisions, as well as questions on choice outcomes and individual characteristics. In contrast to our survey module, traditional economic data sets typically contain only the latter two.

We present two main findings. First, the planning and rule-of-thumb approaches are associated with substantially higher retirement wealth accumulation than the unsystematic approach. Second, we do not find any statistically significant difference between the outcomes for planners and rule-of-thumb savers. Thus, rule-of-thumb types behave as if they were planners. In Section 2, we discuss evidence from psychology of how even a *randomly* assigned rule of thumb can change behavior. In light of this evidence, our results suggests that a rule of thumb may be an effective device for retirement saving for individuals who find working out a careful plan too demanding.

Our paper is closely related to the papers of Ameriks et al. (2003) and Lusardi and Mitchell (2007). Both investigate the role of planning for wealth accumulation and find that planning does indeed have an economically significant effect on wealth accumulation. A crucial difference between these two papers and our own is our aim to investigate multiple decision processes rather than just "planning." In particular, we address the question whether adopting a simple rule of thumb leads to a similar amount of wealth accumulation as working out a careful plan. This question is important from a policy perspective; advice in the form of a simple rule of thumb is by definition simpler than a plan and may be an effective way to help those who do not have a sophisticated plan. Overall, our finding is that those who do not work out any plan but simply rely on a rule of thumb behave in a similar way as proper planners. In contrast, those following an unsystematic approach save substantially less. This suggests that treating both rule-of-thumb and unsystematic-approach people just as one single "non-planning" category as in the analysis of Ameriks et al. (2003) and Lusardi and Mitchell (2007) may not

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