



Do optimists plan for retirement? A behavioural explanation for non-participation in pension schemes



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ABSTRACT

This paper investigates the relationship between financial optimism and non-participation in pension schemes in the UK. We show that financial optimism reduces the probability of employees joining employer run pension schemes and also the probability of the self-employed subscribing to private pension plans.

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“The man who is a pessimist before 48 knows too much; if he is an optimist after it he knows too little”.

—Mark Twain's *Notebook*, 1902–1903

1. Introduction and background

Over 11 million people in the United Kingdom do not save sufficiently for their retirement (Department for Work and Pensions, 2012). A recent survey found that British retirement saving shortfall to be by far the worst among all 15 countries surveyed, with retirement savings only covering 37% of the required retirement provision (Twigg, 2013). By not contributing into pension schemes taxpayers lose tax relief available on pension payments and additional employer contributions. As individuals are also under-saving to secure themselves enough retirement income (Banks et al., 1998), inadequate pension contribution has become an increasingly critical factor as governments and individuals struggle to eliminate the problem of old-age poverty.

The decision on retirement savings is a function of a complex set of factors (Agnew, 2010). In addition to rational explanations, behavioural biases can have effects on non-participation. The effect of behavioural issues, such as optimism, has attracted researchers'

attention since the seventies. Prior research has shown that optimism has a significant impact on decision making in various social domains including finance and business related fields (Weinstein, 1980; Lee et al., 1991). While optimism helps us sustain motivation and encourages us to overcome difficulties, it leads us to neglect risks (Weinstein and Lyon, 1999). Having a positive outlook about the future could result in a lower tendency to worry about the potentially negative consequences of risky decisions. Optimists may not be able to overcome their optimistic views and limit risk-friendly decisions, even though risky investments may lead to loss of wealth (Brunnermeier and Parker, 2005). Nofsinger (2005) suggests that optimism could be a strong influence on decision-making processes and that it encourages investors to hold risky portfolios.

This study extends previous literature on optimism by exploring the correlation between financial optimism and decisions on pension participation. Although optimism has been found to affect financial decisions and the tendency to ignore risks, prior studies have not investigated whether optimism plays a role in pension decisions. Our research questions are: (a) are optimistic employees more likely to not join employer pension schemes and, (b) when employer pensions are not available for the self-employed, are they less likely to pay into private pension schemes if they are optimistic.

The British Household Panel Survey (BHPS) is used as the longitudinal data source in this study. We provide evidence that participation in employer pension schemes significantly declines

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Table 1
Pension participation.

Sample 1 (employed):		Sample 2 (self-employed):	
	Frequency (%)		Frequency (%)
Employer runs a pension scheme	12,302 (61.5)	Paid into private personal pension	5,547 (36.7)
Employer does not run a pension scheme	7,711 (38.5)	No payment into private personal pension	8,755 (58.0)
Total valid	20,013	Total valid	14,302
<i>Where employer runs a pension scheme:</i>			
Member of employers pension scheme	7,556 (61.4)		
Not member of employers pension scheme	4,688 (38.1)		
Total valid	12,244		

when employee optimism level increases. We also find that the probability of participating in private pension plans is lower for optimistic self-employed respondents in the survey.

2. Data and methodology

The BHPS surveyed 10,300 individuals from 5500 households since 1991 by following the same households over consecutive years of the survey. We focus on the working population in the survey and extracted two samples from the full panel to investigate the relationship between optimism and pension participation. *Sample 1* contains respondents who started new employment within the same year before the survey took place. This gives us the opportunity to observe an employee's financial optimism level when they join a new firm and decide whether to "opt-in" to their employer's pension scheme. *Table 1* suggests that under 40% of employees join pension schemes when they start new jobs as less than two-thirds of employers run pension schemes. *Sample 2* contains respondents from the full panel who stated that they are "self-employed". This enables us to examine whether optimists are less likely to pay into private pension schemes when employer-run pensions are not available. Over half the self-employed surveyed do not have a private personal pension as summarised in *Table 1*.

We define optimism as the overestimation of the positive outcome in an individual's future financial situation relative to a rational expectation. This is consistent with definitions for optimism found in psychology and social sciences (Weinstein, 1980). We use answers to the following two BHPS questions on individuals' opinion on their financial situation for our measures. Values for financial expectation (E) and realisation (R) were directly obtained from these questions.

Question 1: Looking ahead, how do you think you will be financially a year from now, will you be Better off, worse off than you are now, Or about the same? (denoted as financial expectation, represented by E) and *Question 2: Would you say that you yourself are Better off, or worse off financially than you were a year ago, Or about the same?* (denoted as realisation, represented by R).

Our first financial optimism measure $Optimism^{(-)}$ for year t is calculated as the difference between E_t and R_{t-1} , where R_{t-1} stands for the reported change in financial situation during the past year. With $Optimism^{(-)}$, the historically realised return R_{t-1} is used as a benchmark and we assume that R_{t-1} captures unbiased expected individual financial return characteristics and information at time t . $Optimism^{(-)}$ indicates that a respondent is either irrationally optimistic since she ignores her historical return, or she is rationally optimistic if she has private information that is not disclosed in the survey, or a combination of both scenarios. Our second measure $Optimism^{(+)}$ is calculated as the difference between E_t and R_t , where R_t represents the reported change in financial situation during the current year t (collected in year $t+1$). $Optimism^{(+)}$ suggests that a respondent is either irrationally optimistic since her actual realisation is less than her expected return, or she was rationally

optimistic if the forecasting error is due to the effect of unforeseeable information exposed during year t . $Optimism^{(+)}$ can be understood as a forecasting error and is similar to the definition of "unrealistic optimism" in some previous research (Arabsheibani et al., 2000; Coelho, 2010). However, the limitation of $Optimism^{(+)}$ is that what transpires in reality after a financial decision is often not "rationally expected". Individuals might make perfectly rational expectations based on the information they have at the time of forecasting (as with $Optimism^{(-)}$), but new information exposed during year t may be completely unforeseeable at time t and therefore should not affect our classification of the optimistic bias of the forecast (Balasuriya, 2012). Using both $Optimism^{(-)}$ and $Optimism^{(+)}$ could offset each other's theoretical advantages and disadvantages in capturing optimism.

Table 2 contains aggregate data of optimism and variables on pension participation from both employed and self-employed samples. While around half of the sampled population are neutral ($Optimism = 0$), the number of extreme optimists ($Optimism = 2$) are more than three times that of extreme pessimists ($Optimism = -2$). This indicates that in a representative sample of the British population, people tend to be exceedingly more optimistic than pessimistic. Pessimists tend to work for firms that run pension schemes more than optimists. Extreme optimists report a pension subscription rate over 10% less than extreme pessimists. These initial statistics indicate a tendency that with an increase in optimism, pension participation decreases for both the employed and self-employed.

3. Regression results and discussion

We further investigated the relationship between financial optimism and pension participation using logistic regression, with participation in pension schemes as the dependent variable. A number of control variables are used as independent variables to capture demographic and employment-related influences on pension participation.

Table 3—Sample 1 reports logistic regression results on pension subscription on the year an individual started working with a new employer when employer pension schemes were available. Results show that apart from income, optimism is the most important factor contributing to non-participation in pensions. Extreme pessimists are almost twice as likely to join pension schemes as extreme optimists (reference variable). Even moderately optimistic ($Optimism = 1$) employees are over 20% more likely than extreme optimists to take part in pension schemes. Individuals whose realised financial situation turns out to be much worse than expected ($Optimism^{(+)} = 2$) are the least likely to participate in pensions.

Although *Table 3—Sample 1* reveals that optimists are significantly less likely to join employer pensions in the year they commence employment, we do not rule out the possibility that individuals may join employer pension schemes later in their

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