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Household financial planning and savings behavior

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ABSTRACT

Greater personal responsibility toward financial decision-making is being advocated on a global basis. Individuals and households are encouraged to take a more active approach to personal finance. In this paper, we examine behavioral factors, which lead households toward savings and financial planning across a panel of 1253 Dutch households. In line with the available literature, we find that an individual's propensity to save decreases with age and is higher among the financial literate. Moreover, we find that saving behavior varies across generations, and is significantly dominant among baby boomers. This generation effect, however, weakens once we account for more individual specifics. Our results offer evidence for parental influence, and for the effects of the psychological and behavioral metrics of numeracy, self-efficacy, locus of control and future orientation. A good understanding of these personality variables helps to explain why some take financial responsibility while others do not.

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1. Introduction

During the past decade, governments around the globe have started advocating a new and responsible approach to personal finance, to encourage households to be more in charge of their own financial wellbeing.[1] The 2008 global financial crisis and the recession that followed have hit families hard, and

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[1] See World Bank's 'World Development Report 2015: Mind, Society, and Behavior' for a full and rich discussion of how policy makers are changing their ways in making institutions and consumers more responsive to the behavioral factors driving people's financial decisions.

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have shifted government policies away from promoting cheap financing – more often used for increased consumer spending – toward enhancing consumer awareness of individuals' long term financial needs and resources. This political shift increases the importance of households' ability to take financial responsibility and to save for their future needs.

Now that we enter a future in which more personal savings are needed to finance our upcoming needs regarding health and pensions, we need to understand why some of us are good at saving, while others fail. A recent study by Cronqvist and Siegel (2015) analyzed individual saving behavior using Swedish data on identical and fraternal twins. Their results report that genetic variation explains about 35 percent of the variation in savings rates across individuals. The remainder appears to be a function of parent–child transmission influences and the environment. In this paper, we empirically investigate a wide series of household backgrounds and personality variables to help explain this 65 percent of the cross sectional variation in individual savings behavior that is non-genetic.

Theoretical life cycle models predict that consumers smooth consumption over their lifetime, assuming that consumers are forward looking and make plans for their future. However, whether households are actually able and ready to manage their long-term financing responsibly is doubtful. Campbell (2006) pointed out that it is often difficult for consumers to exhibit carefully reasoned and informed economic decisions. Lusardi and Mitchell (2007) show that 45 percent of baby-boomers in the age bracket 51–56 have undertaken little or no retirement planning at all, and as a result they enter their golden years with low levels of wealth.

Empirically, we have learned that saving rates increase substantially with income. Dynan et al. (2004) report saving rates below 10 percent for the lowest U.S. income quintile, numbers that increase with income to over 20 percent for the fifth quintile. Typically, three sources have been identified for these differences in saving rates across income groups. Hubbard et al. (1995) identify differing budget constraints as the reason why lower-income households save less – lower income groups have fewer incentives to save, as they are more likely to depend on welfare programs in future bad states of the world. Bernheim (1995) provided early evidence that financial literacy is correlated with the level of education and income. In other words, differing budget constraints and differing levels of financial literacy are very likely to explain part of the variation of saving rates over income. Recently, Binswanger (2010) added a third source of savings heterogeneity among households – the loss aversion invoked by the insurance goal of savings. This loss aversion differs greatly across and within income groups and can lead bounded-rational household to over, or indeed under, save, depending on their personal dominance of the insurance goal of saving.

We extend the current analyses on financial decision making by exploring a wider set of explanatory factors that help to explain household savings and investment behavior in the cross section and that can help to enhance financial responsibility levels in the future. We construct survey questions with which we measure various socio-economic backgrounds and beliefs for a set of 1253 Dutch households. Our analysis focuses on explaining why some of these households save or invest, while others do not. We start explaining this difference by looking at a set of well described household characteristics – demographics, income, skills and education, including financial literacy. We then extend this analysis by incorporating factors that capture a respondent's youth and financial upbringing to assess the effectiveness of homemade financial education. Finally, we involve a wide set of metrics to incorporate the personal variations in numeracy, self-efficacy, locus of control, and future orientation. Our extended survey puts us in the unique position to simultaneously analyze and weigh the effects of household demographics, skills, upbringing, and personality.

Our results show that the willingness to save reflects a time preference (captured by the willingness to sacrifice present wellbeing for future results) and is stronger among younger households with high levels of financial literacy. We also detect significant traces of clustering across generations, as saving for later is more popular among the post war baby-boom generation who share an era of economic hardship during youth, than among those who were born and raised either before or after them. We also find evidence for parental and grandparental influence, as well as endowment effects in our data. But perhaps the most striking results of our analysis relate to the psychological and behavioral variables within our analysis. Respondents who keep a tight household administration, who have a strong locus of control and who have a positive economic outlook, are more prone to postpone immediate consumption for the sake of future needs. We also test whether the same results can account

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