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Trust, happiness, and households' financial decisions

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ABSTRACT

A recent line of research highlights trust as an important element guiding the decision of households to invest into risky financial assets and insurance products. This paper contributes to this literature by identifying happiness as another key driver of the same decision. Using detailed survey data from a sample of Dutch households, we show that the impact of happiness on households' financial decisions works in the opposite direction and is more economically important compared to trust. Specifically, happiness leads to a lower probability of investing into risky financial assets and having insurance, while trust has the usual positive effect found in the literature. Furthermore, the negative effect of happiness on the ownership of risky financial assets is about 6% higher compared to the positive equivalent of trust. Similarly, the negative effect of happiness on the ownership of insurance is 3% higher than the positive effect of trust.

1. Introduction

How do human beliefs and moods shape the financial decisions of individuals? Are the effects of different types of beliefs and moods reinforcing or opposing the decision to participate in the financial markets? The answers to these questions are fundamental in describing the preferences of individuals and in providing implications of how to model personal finance and insurance decisions. In this article we attempt to dig deeper into the trust-based explanation of individuals' financial decisions and explore the mediating role of positive mood and happiness in particular. To this end, we empirically assess the separate impact and the interplay of trust and happiness on households' decisions regarding their holdings of risky financial assets and private insurance. As a result, we seek to contribute to the existing literature that considers the role of trust, but pays less attention to the role of happiness in these outcomes.

Household finance has emerged as a field on its own in financial and behavioral economics over the last decade. Guiso and Sodini (2012) provide an extensive overview of the recent theoretical advances in the field, as well as evidence of how households use financial markets to achieve their objectives. Guiso et al. (2008), among others, show that the lack of trust lowers the expected return from an investment, as prospective investors expect a higher probability of being cheated. As a consequence, individuals characterized by lower levels of trust have a lower probability of holding risky assets. At the same time the authors find that less trusting people insure themselves less; a finding which is consistent with the view that insurance is just another (risky) financial contract with uncertain future repayments. Therefore, trust matters for insurance demand since the insured has to trust that the insurance company will pay the indemnity promptly at some time in the future.

We augment this framework to show that happiness also matters for financial and insurance decisions. Experimental research highlights the role of positive mood in decision making under risk (Isen and Patrick, 1983; Ifcher and Zarghamee, 2011; Drichoutis and Nayga, 2013). As such, it seems reasonable to assume that happiness can affect people's risk attitudes and perceptions and, in turn, their financial choices.

However, on the theoretical front there is disagreement about how mood states affect risk propensity. In psychology, two models of decision making provide different explanations and predictions for the role of mood states on risk-taking. Specifically, the Mood Maintenance Hypothesis (MMH) posits that positive mood leads to risk averse behavior (Isen and Patrick, 1983), whereas the Affect Infusion Model (AIM) proposes an opposite effect (Forgas, 1995). By extension, and within our framework, we hypothesize that people tend to make financial choices (investment in risky financial

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assets and insurance purchases) that are mood congruent, in the sense that happier individuals exhibit a different risk attitude and prefer different types of financial assets than less happy ones. However, similar to the two psychology models, the precise direction of the effect of happiness on the risk-taking behavior and financial decisions of individuals can theoretically be either positive or negative.

Based on these theoretical predictions, the effect of happiness on the financial and insurance decisions of households becomes an empirical question. Thus, we carry out an empirical analysis that uses the diligent and unique survey data from the LISS panel, which is an annual survey on Dutch individuals. This data set offers the richest, to our knowledge, informational set of economic, behavioral, and cultural characteristics of individuals, thus allowing solving a number of empirical identification problems.

It is important to note that happiness, as measured in the LISS dataset (general happiness, current life satisfaction and general life satisfaction), takes a long term perspective form, and thus it probably qualifies as a mood state rather than as an emotion[1]. However, moods and emotions can mutually influence each other. According to Hume (2012), emotions can turn into moods when there is a loss of focus on the contextual stimuli (people, objects or events) that started the feelings. In the opposite direction, moods can elicit more emotional responses to contextual stimuli. In addition, Lazarus (1991) posits that happiness may be an umbrella concept that encompasses a series of related emotional states and common synonyms for happiness include joy, amused, satisfied, gratified, euphoric, and triumphant. Lazarus (1991, p. 269) concludes that "*distinguishing happiness as an acute emotion from happiness as a mood is difficult*". In this paper, since we aim to empirically assess the role of happiness on financial and insurance decisions, and given the difficulties of disentangling emotions from moods (Ekman and Davidson, 1994), we treat happiness as an affective state encompassing both emotions and moods.

We confront the difficult problem of endogeneity of trust and happiness by lagging the respective variables (to account for the reverse causality issue) and by using an instrumental variable (IV) model (to account for the omitted variables bias). The latter is an empirically challenging task given that valid instruments should influence financial behavior only through their impact on subjective well-being and trust. To this end, we use family relations and the genetic diversity in the country of origin of the interviewees to instrument the variables of interest. Research shows that family ties are a major factor in the development of lasting happiness (e.g., Amato, 1994; Furnham and Cheng, 2000a, 2000b) and very much linked to trust (Guiso et al., 2004). In addition, the genetic diversity in the country of origin of the respondents may be considered as a close proxy for the interviewee's attitude toward trust.

Moreover, and quite distinctively from previous studies, we control in the first stage of the IV model for a number of other emotional states, besides trust and happiness. In this respect, we build on the implications of the psychoevolutionary theory of emotion (Plutchik, 1980) which suggests the existence of eight primary bipolar emotions: joy vs. sadness, trust vs. disgust, fear vs. anger and surprise vs. anticipation. By including the latter two bipolar emotions in our two-stage IV model, we essentially allow our instrumental variables to have an effect on the financial and insurance decisions of households only through the instrumented variables characterizing trust and happiness and not through other emotional states. In a sense, we make progress on this difficult identification problem by bringing together the economics and the theoretical psychology literatures.

We show that trust and happiness have distinct and significant effects on financial and insurance behavior. Specifically, we find that higher trust rates foster investments in risky financial assets (e.g., stocks) and insurance purchases, a result in line with the existing literature. However, we also find that increased happiness reduces investment in risky financial assets and insurance. These effects are also economically important. Based on our preferred specifications, a one unit increase in our trust variable (scaled from 0 to 10) increases the probability of buying risky assets by 7.4 percentage points (pp) and private insurance by 7.6 pp. In contrast, happiness is associated with a 13.2 pp (10.1 pp) drop in the probability of owning risky financial assets (insurance products). These results are robust to controlling for differences in household demographics and socio-economic characteristics, as well as to alternative measures of subjective well-being.

We also provide evidence for significant heterogeneity in financial decisions of equally trusting individuals stemming from their different levels of self-reported happiness. Specifically, we find that the positive effect of trust fades away for individuals as the level of happiness increases. Importantly, it takes only a moderately high level of happiness for the impact of trust to be completely offset. Thus, our results indicate that self-reported well-being seems to be quite significant in explaining financial and insurance behavior and represents an essential component in the link between trust and financial decisions. These empirical findings reflect the divergence in theoretical arguments on the special nexus between happiness and risk aversion.

The rest of the article is organized as follows. Section 2 outlines the related literature on the economics of trust and happiness. Section 3 provides details on the data at hand and discusses the econometric specification and identification issues. Section 4 presents the empirical findings. Section 5 offers concluding remarks.

2. Related literature on trust, happiness and consumer choices

Economists have stressed the importance of cultural values and norms in the financial decision-making process of individuals for quite some time. This literature follows the Weberian school of thought and places the spotlight on the impact of cultural characteristics on personal attitudes and preferences. These, in turn, influence the financial decisions of individuals and, hence, aggregate financial-market outcomes. A number of socio-cultural factors have been identified as important determinants of households' financial decisions, including social interaction (Hong et al., 2004; Brown et al., 2008), religion affiliation and activity (Renneboog and Spaenjers, 2012), trust (Guiso et al., 2004, 2008; Georgarakos and Pasini, 2011), and mood states or affect (Guven, 2012). The purpose of this section is not to provide a comprehensive review of this literature, but rather to highlight the main channels linking trust and happiness to the financial and insurance decision-making process of individuals.

The trust-based explanation of household finances provides useful insights on the observed discrepancies in financial investments across households. Guiso et al. (2004) show that Italian households residing in social capital intensive areas (i.e., areas with higher trust rates) invest a smaller proportion of their wealth in cash and a bigger proportion in stocks. Similarly, Guiso et al. (2008), using Dutch survey data and customer survey data from a large Italian bank, find that trust has a positive and significant effect on

[1] In economics literature, the concepts of mood and emotions are often used interchangeably, while in psychology there is a clear distinction between the two: emotions are intense feelings that are directed at someone or something and have a propensity to last for a brief period of time; moods are feelings that tend to be less intense than emotions (and often lack a contextual stimulus) but last longer. Emotions and moods can be comprised in the generic concept of affect (Hume, 2012).