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Modelling financial satisfaction across life stages: A latent class approach ☆

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ABSTRACT

We explore the determinants of financial satisfaction using a modelling framework which allows the drivers of financial satisfaction to vary across life stages. Given that financial satisfaction is measured as an ordered variable, our modelling approach is based on a latent class ordered probit model with an ordered probit class assignment function. Our analysis of household survey data indicates that four life stages are supported by the data. Our results suggest that such flexibility is important in understanding the drivers of financial satisfaction over the life cycle since there is a substantial amount of parameter heterogeneity across the four classes.

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1. Introduction and background

Over recent years, there has been increasing interest in the determinants and implications of wellbeing and overall life satisfaction from a number of disciplines including economics and psychology, as well as from policy-makers across a range of countries. Rather than the potentially opaque concept of "happiness", research tends to discuss individuals' subjective wellbeing: that is, how they feel about themselves and their lives (Dolan, Peasgood, & White, 2008). There is evidence that individuals' incomes have a positive yet diminishing role in their overall subjective wellbeing (Dolan et al., 2008). In

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Australia, for example, longitudinal data indicates that life satisfaction has declined from 2001 to 2010, a period of strong economic performance (Ambrey & Fleming, 2014); such a finding is consistent with the international evidence (see, for example, Blanchflower & Oswald, 2004). When we consider the components of subjective wellbeing, however, we find that financial satisfaction has an important influence on overall life satisfaction (see, for example, Easterlin, 2006; Van Praag & Ferrer-i-Carbonell, 2004). Thus, in order to understand the determinants of wellbeing and overall life satisfaction, it is important to identify what influences financial satisfaction. Consequently, there has been increasing interest in exploring the determinants of financial satisfaction.

While research on the determinants of financial satisfaction nevertheless remains relatively scarce, ‘‘findings on the association between money and happiness have implications for investor behavior…[but there is] limited direct research on money and happiness pertinent to investor behavior'' (Xiao, 2014, p. 184). Therefore, the motivation for the research presented in this paper also draws from the Behavioural Finance literature on feelings. Our feelings about our finances determine our investment choices. Dissatisfaction with one's finances is psychologically arousing (see Foote, 2000, p. 237) and drives action to remedy matters to achieve financial satisfaction. People who are satisfied, on the other hand, have little incentive to change (Isen, 1987). Studies show that individual investors should be dissatisfied with their portfolios; they tend not to be economically optimal (Barber & Odean, 2013). Furthermore, financial satisfaction is more than a consequence of the decisions we make or a spur to making those decisions, it is a core input in making those decisions (Loewenstein, Hsee, Weber, & Welch, 2001; Schwarz, 1990). Given the same objective information, financially satisfied and dissatisfied people will make different financial decisions.

Theories on changes in the drivers of financial satisfaction appear in the economics literature as early as Ando and Modigliani (1963), with their introduction of life-cycle theories to financial behaviour. Ando and Modigliani (1963) hypothesised that individuals may be more comfortable with debt when they are young and their income is low, as they expect their future income to be much higher, and to be able to pay off the debt at a later stage. While theories of financial behaviour have been discussed in great detail since then (for example, by Laibson, 1997; Loewinstein & Prelec, 1992; Nagatani, 1972; Shefrin & Thaler, 1988; Thaler, 1994), the premise of individuals having different marginal utilities from various financial circumstances has remained. For example, Davies and Lea (1995) consider degrees of financial satisfaction among indebted university students, and argue that the life-cycle hypothesis might help explain unchanged satisfaction among students whose debt vastly outweighs their present earning capacity. In addition, heterogeneity in financial satisfaction has been studied across other dimensions, including religion (van Praag, Romanov, & Ferrer-i-Carbonell, 2010), race and gender (DePianto, 2011) and retirement pathways (Elder & Rudolph, 1999).

Not surprisingly, given the extent to which income varies over the life cycle, the role of income in determining financial satisfaction has attracted considerable attention in empirical studies in the existing economics literature, with, in general, a positive, albeit moderate, influence being reported (see, for example, Johnson & Krueger, 2006; Xiao, Tang, & Shim, 2009). However, as pointed out by Plagnol (2011), evidence for a number of countries suggests that financial satisfaction increases with age, (see, for example, Plagnol & Easterlin, 2008) whilst income over the life-cycle is characterised by an inverted U-shaped pattern peaking mid-life. Such findings suggest that the pattern of financial satisfaction over the life-cycle may not follow that of income alone. Thus, financial satisfaction is found to be relatively high amongst older retired individuals despite lower levels of income generally being observed at this stage of the life-cycle. In a comparison of life course patterns associated with financial satisfaction and household income, Plagnol (2011) comments that ‘‘it is impossible to reconcile these two life course profiles with the assumption that income is the primary determinant of financial satisfaction'' (p. 52). Studies have thus sought to expand the set of explanatory variables included in models of financial satisfaction, incorporating additional controls such as household assets and liabilities (see Plagnol, 2011).

Given the findings in the existing literature, an interesting line of enquiry relates to exploring the drivers of financial satisfaction for individuals at different stages of their lives. For instance, the influence of income may be apparent at early stages of the life-cycle, as compared to its effect at later stages when individuals may have, for example, paid-off mortgage debt and accumulated financial assets. The finding of a modest influence of income in the existing literature may reflect a more restrictive econometric approach which does not allow the influences of financial satisfaction to vary with life stages. In this paper, we thus extend the literature on modelling financial satisfaction by applying a latent class approach, which allows the determinants of financial satisfaction to vary across life stages.

The novelty of our modelling approach is that it is based on an ordered latent class specification, whereby the natural ordering in the class specification is in accordance with the individual's age (discretised into ‘‘life stages''). Not only is this approach well-suited to the question at hand, it also represents, to the best of our knowledge, the first application of such a model.[1] Indeed, the analysis of our household survey data indicates that four life stages are supported by the data. The results suggest that such flexibility is important in understanding the drivers of financial satisfaction over the life cycle since there is a substantial amount of parameter heterogeneity across the four classes.

[1] From a purely statistical perspective, not driven by any underlying economic motivations as here, Brown, Greene, and Harris (2014), also consider an ordered set-up within a latent class framework.

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