Consumer Financial Behavior: Integrating Disciplines to Understand Fundamental Economic Activity at the Household Level


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Abstract

Consumer finance is an emerging area of inquiry spanning social science disciplines. The field raises significant questions about cognition, risk-taking, self-control, rational decision making, time preferences and social theory. Arguably, researchers lacked the data, theories and methods to be able to inform society or policymakers during the credit boom of the last decade or how to respond as the Great Recession unfolded. The field of consumer finance offers potential solutions to these problems. However, current support for research in this field remains a patchwork among funders. Of greatest concern for the development of future researchers in this field is the fact that there are no systematic sources of support for the training and support of graduate students in consumer finance. Moreover work in this field remains challenging to implement because it fails to correspond to current disciplinary purviews. NSF support for cross-disciplinary collaborations, training and support of future PhDs, the collection of longitudinal data at the household level, and the development of standardized mixed-methods approaches will facilitate academic studies on consumer finance. These studies will provide insights for practitioners, policymakers and consumers themselves to potentially react to future shifts in the credit and personal finance environment.

Introduction

The Directorate for the Social, Behavioral, and Economic Sciences of the National Science Foundation (NSF/SBE) has requested papers intended to frame innovative research for the year 2020 and beyond that enhances fundamental knowledge and benefits society. Events over the last decade have highlighted the shortcomings in research examining how consumers make choices about savings, debt and financial risk-taking. Record home foreclosures, record debt to income ratios and rising income volatility have created an environment where more researchers are focusing on micro-level household data to explore the underpinnings of consumer financial behavior. The emergence of household finance and behavioral economics has provided a number of insights relevant to facets of financial behavior. This research has resulted in substantive, and widespread, positive changes in consumer financial behavior, such as the recent increase in 401(k) participation resulting from the shift to opt-out from opt-in pension plans that arose out of the finding of the importance of inertia in pension participation.
Other disciplines have also made significant contributions to the field of consumer finance. Legal scholars have explored the role of laws, and debated the need for more paternalistic regulations. Policy analysts and evaluation researchers have attempted to diagnose consumer responses to shifts in policies. Psychology has continued to offer an array of theoretical foundations and experimental evidence that could be used to explain some aspects of consumer financial behavior. The work of sociologists has deepened understanding of the context of decisions at the household and neighborhood level. The study of consumer finance is increasingly interdisciplinary, drawing on the diverse methodologies and theories used across these fields.

There are a variety of decision points throughout life that will affect an individual's ability to, interest in, and capacity to save and manage their household balance sheet in ways that result in financial security. Developing a high level of financial literacy is part of a life-long process that can begin early (as does reading literacy) and continue throughout life, but is shaped by cognitive development and life circumstances.

The term “financial literacy” continues to provoke much discussion among researchers. Indeed, the notion that people can be defined as being financially illiterate or literate is increasingly questioned. Financial knowledge operates along a continuum, like any knowledge, skill or cognitive process. Financial literacy implies not just knowledge but functioning within a particular financial context, and so literacy status may change with time and context. The study of reading literacy and companion numeracy skills can inform the definition of financial literacy. Some people may demonstrate a low level of functional reading literacy, especially as measured on standardized survey questions, yet develop relatively sophisticated strategies to cope with their lack of skills or knowledge. These might include simple decision heuristics or modeling choices on peers or trusted advisors. Acquiring higher levels of functional financial literacy provides no immunity from making what might be labeled as financial mistakes, however. Overconfidence, lack of self-control, and trusting fraudulent advisors are by no means isolated to low-functionality, financial illiterate populations. Yet some populations seem to be more vulnerable to these problems, as do people in vulnerable points in the life course. The insight that “literacy” and its measurement are contextual to particular needs, circumstances, and behavioral outcomes is an issue that deserves greater study. The literature on coping skills, decision rules, and the role of advice across diverse population groups are examples of areas where existing theories can be applied to consumer finance.

Yet, financial education—in the form of information transfer—may be necessary but not sufficient. To expand the financial security of some vulnerable populations, behavioral interventions may also be required. Strategies such as savings defaults (opt-out), direct deposit or debt management plans represent one type of mechanism where behaviors are strongly guided. These have proven to be highly effective on the margin, and for some people a way to impact financial behavior. Another complement to education is financial advice. This might take the form of a paid advisor, nonprofit counselor or financial coach. It may also be provided through family or involvement of community organizations. While these models may also deliver financial content, there is a focus on guiding decision making over strictly knowledge transfer. Highly functional financially literate individuals engage in self-actuated information seeking, including discerning the value of information, resourcefully seeking new information, and gaining confidence in financial choices. As financial choices become more complex it is
Arguably more important than ever to focus on financial skills and behaviors more than knowledge. Researchers could be exploring a growing array of projects that seek to understand how people learn and how information is developed and put to use, including contexts when information alone is insufficient.

Too often financial interventions, programs and policies are not theoretically grounded, nor evidence-based. Too often personal financial decisions, knowledge and context are shrouded and not consistently documented across publically available datasets. Few field experiments have been run to rigorously collect data to evaluate causal impacts over time. Despite a growing rhetoric that financial literacy is an important value for society, and calls for delivering high levels of financial literacy education to various populations, we truly know very little about levels of financial literacy and personal financial behavior, especially among what are perceived as more vulnerable populations. We know very little about what is the relevant financial knowledge and behavior for these groups – both now and for the future. A more intense focus on issues such as the measurement of consumer financial decisions among subgroups of the population is needed.

Yet, the field studying financial knowledge and behavior remains fractured and still embryonic. The great strides in consumer economics stemming from land grant colleges in the last century fell out of fashion as other forms of microeconomics become more dominant. Marketing and business researchers focus on specific aspects of consumer behavior, as do related fields of social psychology. The emergence of behavioral economics in the last three decades has generated new enthusiasm for consumer behavior topics, but not focused on financial decisions explicitly and not in ways that have embraced interdisciplinary work.

The creation of the National Bureau of Economic Research (NBER) Household Finance section is a positive step, as is the creation of an online journal on SSRN which attracts economics, law and policy contributions. The work of the Social Security Administration’s Financial Literacy Research Consortium is another positive step. These cooperative agreements support academic researchers to engage in short-term (typically within a fiscal year) research projects and will support some cross-disciplinary work. The formation of the Consumer Financial Protection Bureau at the federal level may highlight a new need for more research on consumer finance, and even provide a platform for federal researchers on these topics. The federal Financial Literacy Education Commission (FLEC) is poised to disseminate findings across federal agencies, but as of yet lacks any key insights to drive policies or programs. Journals in these areas are becoming more widely read and cited, although there is not yet a single journal or category of journals that captures consumer finance or financial literacy. Rather journals tend to ‘fit in’ articles in this area with articles on a wide range of topics.

The development of multi-year support from NSF can engage a new generation of researchers to conduct applied but theoretically-grounded research that helps illuminate the fundamental mechanisms that drive household financial decisions, including the types of decisions that lead to highly overleveraged households in the 2000s. Building the infrastructure of a researchers, institutions and data sources will drive transformative insights that influence a wide range of social policies, from programs like Social Security and Medicare, to financial regulation and housing.
Examples of Key Research Questions

- What determines which families recover from negative financial shocks?
- How may early life advantages and disadvantages translate into later financial security?
- Why do saving, consumption and debt levels vary across demographic groups?
- What role does information, advice and education have on consumer financial decisions?
- How does social context influence financial behavior?
- How do aging consumers or people with emerging disabilities manage financial assets and debt?
- How can technology aid consumers to make financial choices?
- Who do consumers trust for advice and how influential are these sources?
- How can mechanisms be developed to facilitate self control and adherence to financial plans?
- How can decision making processes or structures be combined with financial education initiatives to encourage higher levels of saving?

Research Capacities and Infrastructure Needed

As highlighted above, one of the key needs for building capacity in the field of consumer finance is significant sustained funding for the support and training of graduate students and early career researchers interested in this field. By creating PhD and post-doctoral training grants or fellowships in consumer finance the field will be able to attract new researchers to the field, as well as facilitate dedicated research in this area by those currently interested in consumer finance research. By creating grants for early career investigators to conduct research in the area of consumer finance a steady stream of consumer finance researchers could be assured, and significant advancements in the field encouraged.

In terms of infrastructure needed to support the growth of the field of consumer finance, funding the creation or continuation of prominent centers for consumer finance research would facilitate the interaction of consumer finance researchers, and the dissemination of research findings. Moreover, these centers could serve as the venues for the training of PhD students and post-doctoral fellows.

While supporting researchers in this field is critical to its advancement, so too is providing them with the data with which to conduct their analysis. Unfortunately, few secondary data sets contain high quality questions that can be used to assess financial literacy, financial behaviors, or financial well-being. There further exists a paucity of longitudinal data that can be used to monitor changes in these areas. Moreover, many aspects of consumer financial research lend themselves to qualitative studies or experimental studies. By providing funding for the design and inclusion of new and improved consumer finance questions in secondary data sets, the collection of new secondary data sets, the collection of qualitative data, and the conducting of
consumer finance experiments, the consumer finance researchers could be assured of having the data necessary to advance the field.