

Behavioral Economics and Asset-Building:

How Understanding the Psychology of Financial Behavior Can Empower Participants and Improve Program Outcomes

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What is Behavioral Economics?

The financial decisions people make often defy what traditional economic theory would consider “rational.” We gamble on the lottery and spend more on vacation than we would at home; we take \$5 today instead of waiting for \$10 next week; and we continually promise to start saving “tomorrow.” This “irrationality” is not limited to certain communities or income levels. But as with many things, its consequences can be worse for those who have little financial leeway.

Behavioral economics is a field of study that seeks to make sense of this irrationality – to understand why we make certain choices and to learn how we can make better ones. Perhaps the central insight of behavioral economics is that *there are no neutral choices*. Every decision is influenced by the context in which it is made, and the things that influence decisions are more subtle and powerful than we recognize.

The good news is that the more we understand the psychology of financial decision-making, the more we can adjust our approach and create a context that *supports* asset-building. Below is a summary of some behavioral economics findings that can be of use in our work:

- ***The power of defaults.*** A default is the choice we make when we do not choose. And because people are often lazy, procrastinating, confused or just reluctant to make decisions, the default option often becomes the most common choice.
- ***Loss aversion.*** Perceived loss can be substantially greater than perceived gain. In other words, you feel worse about losing \$20 than you feel happy about finding \$20. So people’s choices will be skewed towards avoiding the possibility of loss.
- ***Proliferation of choices.*** We tend to think that more choices are always better. But in fact, when faced with multiple alternatives, people become overwhelmed or confused and are less likely to choose any of the options.
- ***Hassle factors.*** We are remarkably sensitive to hassles, even seemingly minor ones like walking an extra block or having to look up a telephone number. Each additional hassle makes us less likely to do something – even something we want to do.
- ***Appealing to the right identity.*** People think about themselves in a variety of different ways – as a parent, worker, poor person, woman, etc. – and they will make different choices in the same situation when they have different “identities” in mind.
- ***Short-term timeframe.*** Short-term gains or losses are more powerful motivators than anticipated final states of wealth. So we respond more strongly to the chance to get something today than to a potentially bigger payoff down the road.
- ***Mental accounting.*** People compartmentalize money into distinct categories and have different propensities to save or spend from different mental accounts. So we might be very good about not touching the rent money, but will blow “found” money on a night out.
- ***Lotteries are fun!*** There is something appealing about a chance to win – and a big potential payoff is more enticing than a guaranteed smaller sum. So for the same cost, people may respond more to lottery-style bonuses than matching funds.

- **Peer influence.** People are more influenced by peers than by “experts.” So information presented in small groups is more effective than one-on-one, and people are more likely to agree or identify with something if others agree or identify with it too.
- **The best laid plans...** Long-term goals are important, but the immediate context is more powerful. You may be saving for something, but it’s hard to say no to the thing in front of you now. Or you may really want to attend a program, but tonight you are just too tired to go.
- **Cognitive load.** In an unfamiliar or uncomfortable situation, fewer mental resources are available to process information, so decisions become even less likely and more dependent on outside context (making all of the above bullets even truer).

Applying Behavioral Economics to Asset-Building Programs

Asset-building programs have typically focused on content – financial education, counseling, services and products. Behavioral economics teaches that we should look at context as well. We can increase the effectiveness of programs by creating an environment that helps people make more productive financial choices. We can set better defaults, reduce the number of hassles, appeal to the right identities and create more compelling incentives. *This is an extremely powerful idea: that by making relatively small (and inexpensive) programmatic changes, we can create a context more conducive to success.* It is also an idea with the potential to be incredibly empowering for the communities we serve. Because when the context is supportive, decision-making is easier and more productive. People will be better able to set and achieve their own financial goals – and will be more able to sustain success over time.

There are many different ways that we might think about using the lessons described above to promote success in asset-building programs. Some involve savvy marketing to increase participation and retention. Others more fundamentally affect the way programs are designed. Below are just a few ideas for translating the research into program action:

Reframe outreach messages.

- Talk about what people have to lose by not participating. This can be as simple as saying “don’t miss this opportunity” or a stronger message like “don’t waste \$500 by not calling today.”
- Emphasize short-term costs and benefits (get \$20 for signing up) as opposed to – or in addition to – longer-term ones (own a home someday).
- Do outreach through small group meetings and publicize that other community members have enrolled and succeeded.

Restructure incentives.

- Create short-term costs/benefits rather than (or in addition to) long-term ones. So match savings at every \$50 rather than only at \$1,000.
- Use a lottery approach. To encourage submission of follow-up data, enter those who submit in a monthly sweepstakes. Or rather than a \$100 savings match, offer a 1-in-10 chance at \$1,000.

Simplify everything!

- Review your process map and cut out as many steps as possible. For example: Is a separate orientation or assessment session really needed? Can you enroll people at the point of outreach?
- Streamline procedures. Pre-fill applications for bank accounts or other services using the information you already have, so clients can just sign and submit them.
- Revisit eligibility requirements them. Use a single income limit rather than a complicated test; go by broad neighborhood boundaries rather than unnatural zip code divisions.
- Limit the number of options. For example, offer two savings programs – six months (for short-term goals) or 2 years (for long-term goals) – rather than 10 programs for car, home, debt, etc.

Use positive identities and mental accounts.

- Preface messages with references to identities – head of family, working taxpayer – that are in line with financial empowerment. Be aware that an identity of “poor, incapable, irresponsible” may loom in the background and can derail success.
- Emphasize that your program is for people like them, and that asset-building is not only for the rich. Stress a credit union’s community roots or the targeted focus of a new loan product.
- Help participants identify mental accounts that are meaningful to them and name savings based on goals: call it the “better car” or “new refrigerator” account rather than just a “savings account.”
- Set up the program so people make decisions for the future – such as how much they will save once they start a new job – and then put in place mechanisms to set those decisions in motion.

Make it automatic.

- Integrate important elements so everyone gets them. For example, open savings accounts as part of a financial education class, not something they need to do later on their own.
- Use direct deposit to make saving automatic – and self-sustaining – rather than forcing people to repeatedly make the difficult decision not to spend cash.
- Review your entire process map and see where there are opportunities to change defaults. For example, establish standard monthly savings goals that people can change if needed.
- Automatically enroll people in the program. You might simply assign financial education graduates to a financial coach, or “pre-approve” job training participants for credit assistance.

Deciding What to Try

To determine which of these ideas to try and what they should look like, two approaches can be useful. The first is to *review your program model to see what makes sense*. A program using matched savings might try having smaller, more frequent incentives. A program that focuses on financial education might try to reframe its message to promote identities that will fit with the idea of saving. Multi-step programs might look for ways to simplify processes and institute better defaults.

The second approach is to *look at your program’s “funnel” to see where there are the problems*. Document the number in your target group; the percent who express interest; the percent who show up; the percent who are successful in each component; etc. Maybe a lot of people express interest, but few enroll. Or maybe many complete the first step, but few transition to the next. Look for ideas that will target the points of greatest attrition or weakest outcomes.

Because we do not know how the academic research applies to the low-income asset-building field, we do not know to what extent any of these ideas will be effective. Some seem obvious, like simplifying program requirements to reduce hassles. Others are less clear, like whether a loss message will increase participation, or whether people will respond more strongly to a lottery-type incentive. For those types of approaches, it can be useful to track the results with a mini-pilot before adopting changes program-wide.

Note: The Annie E. Casey Foundation is supporting pilots to test some of these ideas. Results should be available in mid-2009.