

## Chapter 5

# Savings Policy and Decisionmaking in Low-Income Households

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Theories about poverty, held both by social scientists and by regular folks, typically fall into one of two camps: those who regard the behaviors of the economically disadvantaged as calculated adaptations to prevailing circumstances, and those who view these behaviors as emanating from a unique “culture of poverty” that is rife with deviant values. The first view presumes that people are highly rational, hold coherent, well-informed, and justified beliefs, and pursue their goals effectively, with little systematic error and no need for help. The second view attributes to the poor a variety of psychological and attitudinal shortcomings, presumed to be endemic, that render the views of the poor misguided and ill informed, their behaviors impulsive and lacking, and their choices fallible, and that leave them in need of paternalistic guidance.

Both camps are likely to capture some important elements some of the time. There are, no doubt, important circumstances in which people—the poor included—are methodical and calculating, and other circumstances in which they are fallible or misguided. But both camps fail to explain important phenomena. We propose an alternative perspective, one largely informed by recent behavioral research. According to this perspective, the behavioral patterns of the poor may be neither perfectly calculating nor especially deviant. Rather, the poor may exhibit fundamental attitudes and natural proclivities, including weaknesses and biases, that are similar to those of people from other walks of life. One important difference, however, is that in poverty the margins for error are narrow, so that behaviors shared by all often manifest themselves in the poor in more pronounced ways and can lead to worse outcomes (see Bertrand, Mullainathan, and Shafir 2004, 2006).

Whereas the “rational” view assumes that the poor are doing as well as they can and ought to be left to their own devices, the “culture of poverty” perspective is motivated by the impulse to change how the poor function. In contrast, the central gist of the “behavioral” perspective is that much of the time the poor are not functioning optimally, nor are they any more in need of behavioral change than everyone else. Instead, it is the interaction of fundamental behavioral proclivities with the

### Insufficient Funds

context in which they function that produces the particularly destructive circumstances in which the poor often find themselves. According to this behavioral view, people who live in poverty are susceptible to many of the same impulses and idiosyncrasies as those who live in comfort, but whereas people who are better off function in the midst of a system—composed of consultants, reminders, cooperative employers, “no-fee” options, incentive awards, and automatic deposit—that is increasingly designed to facilitate their decisions and improve their outcomes, people who are less well off typically find themselves without easy recourse to such “aids” and often are confronted by obstacles—institutional, social, and psychological—that render their economic choices all the more overwhelming and their economic conduct all the more fallible.

In what follows, we explore some insights provided by a behaviorally more realistic analysis of the economic conditions of the poor. Our perspective draws on empirical research on judgment and decisionmaking and is supplemented by lessons from social and cognitive psychology. We first review the psychological insights and then consider their implications for a variety of financial products and services that feature prominently in the financial context of the American poor. Of course, insights generated by experimental research and empirical observation need to be carefully tested and evaluated before they can be relied on to shape policy. Even when an intervention succeeds in shaping some intended outcomes, there is always the possibility that other, unforeseen patterns will emerge. Bearing that in mind, we propose some guidelines for thinking about the future design and regulation of financial services.

## THE BEHAVIORAL PERSPECTIVE

### The Importance of Context

Human behavior proves to be heavily context-dependent, that is, a function of both the person and the situation. One of the major lessons of modern psychological research is that situation exerts impressive power; we have a persistent tendency to underestimate that power relative to the presumed influence of personality traits. Various studies have documented the stunning capacity of situational factors to influence behaviors that are typically seen as reflective of deep personal dispositions. In his now-classic obedience studies, for example, Stanley Milgram (1974) showed how decidedly mild situational pressures sufficed to generate persistent willingness on the part of regular people to administer what they believed to be grave levels of electric shock to innocent subjects. Along similar lines, John Darley and Daniel Batson (1973) recruited seminary students to deliver a practice sermon on the parable of the Good Samaritan. While half the seminarians were told that they were ahead of schedule, others were led to believe that they were running late. On their way to give the talk, all participants passed an ostensibly injured man slumped in a doorway, coughing and groaning. Whereas the majority of those with time to spare stopped to help, a mere 10 percent of those who were running late

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stopped; the remaining 90 percent stepped over the victim and rushed along. In contrast with these participants' ethical training and biblical scholarship, the contextual nuance of a minor time constraint proved decisive in the decision to stop and help a suffering man.

### The Role of Construal

A simple but fundamental tension between classical economic analyses and modern psychological research is captured by the role of "construal." Agents in classical economic analyses are presumed to choose between options in the world, objectively represented. People do not respond directly, however, to objective circumstances; rather, stimuli are mentally construed, interpreted, understood (or misunderstood), and then acted upon. Behavior is directed not toward actual states of the world but toward our mental representation of those states; moreover, mental representations do not bear a one-to-one relationship to the thing they represent, nor do they necessarily constitute faithful renditions of actual circumstances. As a result, many well-intentioned interventions can fail because of the way in which they are construed by the targeted group—for example, "as an insulting and stigmatizing exercise in co-option and paternalism" (Ross and Nisbett 1991) or as an indication of what the desired or expected behavior might be, or of what it might be worth. Thus, people who are rewarded for a behavior they find interesting and enjoyable can come to attribute their interest in the behavior to the reward and consequently to view the behavior as less attractive (Lepper, Greene, and Nisbett 1973). In one classic study, for example, children who were offered a "good player award" to play with magic markers, which they had previously done with great relish in the absence of extrinsic rewards, subsequently showed little interest in the markers when these were introduced as an unawarded classroom activity—in contrast with children who had not received an award and showed no decrease in interest.

### Mental Accounting and Finances

One domain that is of great relevance to our present topic and where construal can prove of great consequence is that of mental accounting. Mental accounting research documents the variety of ways in which the assumption of the fungibility of money fails, leading people to view cash, credit, and debit differently depending on the "mental account" in which the money is perceived to be. People's representation of money systematically departs from what is commonly assumed in economics. According to the fungibility assumption, which plays a central role in theories of consumption and savings, "money has no labels"; all components of a person's wealth can be collapsed into a single sum. Contrary to this assumption, people appear to compartmentalize wealth and spending into distinct budget categories, such as savings, rent, and entertainment, and into separate mental accounts,

### Insufficient Funds

such as current income, assets, and future income (Thaler 1985, 1992). These mental accounting schemes lead to differential marginal propensities to consume (MPC) from one's current income (where MPC is high), current assets (where MPC is intermediate), and future income (where MPC is low). Consumption functions thus end up being overly dependent on current income, and people find themselves willing to save and borrow (at a higher interest rate) at the same time (Ausubel 1991).

A variety of other experimental findings are relevant to a better understanding of financial behaviors, but a full summary of those findings is beyond the purview of the present brief exposition. To list just a few, people are loss-averse—the loss of utility associated with giving up a good is greater than the utility associated with obtaining it (Tversky and Kahneman 1991)—and loss aversion yields “endowment effects,” wherein the mere possession of a good can lead to higher valuation of it than if it were not in one's possession (Kahneman, Knetsch, and Thaler 1990). This, in turn, leads to a general reluctance to depart from the status quo, because the disadvantages of departing from it tend to loom larger than the advantages of the alternatives (Knetsch 1989; Samuelson and Zeckhauser 1988). People often also fail to ignore sunk costs (Arkes and Blumer 1985), fail appropriately to consider opportunity costs (Camerer et al. 1997), and show money illusion, wherein the nominal worth of money interferes with a representation of its real worth (Shafir, Diamond, and Tversky 1997). Furthermore, people often prove weak at predicting their future tastes or at learning from past experience (Kahneman 1994), and their intertemporal choices exhibit poor planning (Buehler, Griffin, and Ross 1994) and high discount rates for future as opposed to present outcomes, yielding dynamically inconsistent preferences (Loewenstein and Prelec 1992; Loewenstein and Thaler 1989).

An understanding of such proclivities may be further harnessed to help make sense of behaviors that might otherwise appear perplexing, and this understanding may also help produce more desirable behaviors and outcomes. For example, numerous studies of middle-class savings show that, as a consequence of faulty planning and procrastination, saving works best as a default. Thus, participation in 401(k) plans is significantly higher when employers offer automatic enrollment (Madrian and Shea 2001), and because participants tend to retain the default contribution rates, savings can be increased as a result of agreeing to increased default deductions from future raises (Benartzi and Thaler 2004). As we discuss later, the poor tend to have little recourse to just this kind of default savings and saving programs, but the general notion that context can be designed so as to ameliorate outcomes is a central and important one.

### Channel Factors

As it turns out, the pressures exerted by apparently trivial situational factors can create restraining forces that are hard to overcome, or they can promote inducing forces that can be harnessed to great effect. What is particularly impressive is the fluidity with which construal occurs and the sweeping picture it imposes.

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Alongside the remarkably powerful impact of context is a profound underappreciation of the effects of construal. When interpreting others' behavior, we tend to exhibit the “fundamental attribution error”: we overweight the influence of internal, personal attributes and underappreciate the influence of external, situational forces. As explained by Lee Ross and Richard Nisbett (1991), where standard intuition would hold that the primary cause of a problem, or the particular weakness of a group of individuals, is human frailty, the social psychologist would often look to situational barriers and to ways to overcome them.

The behavioral perspective, with its emphasis on context and construal, suggests that in opposition to major interventions that prove ineffectual, seemingly minor situational changes can have a large impact. Kurt Lewin, in the middle of the last century, coined the term “channel factors.” Certain behaviors, Lewin (1952) suggested, can be facilitated by the opening up of a channel (such as an a priori commitment or a small, even if reluctant, first step), whereas other behaviors can be blocked by the closing of a channel (such as the inability to communicate easily or the failure to formulate a simple plan). A well-known example of a channel factor was documented by Howard Leventhal, Robert Singer, and Susan Jones (1965), whose subjects received persuasive communications about the risks of tetanus and the value of inoculation and were told where they could go for a tetanus shot. Follow-up surveys showed that the communication was effective in changing beliefs and attitudes. Nonetheless, only 3 percent actually took the step of getting themselves inoculated, compared with 28 percent of those who received the same communication but were then also given a map of the campus with the infirmary circled and urged to decide on a particular time and route to get there. Related findings have been reported in studies of the utilization of public health services: a variety of attitudinal and individual differences rarely predict who will show up at a clinic, whereas the mere distance of individuals from a clinic proves to be a strong predictor (Van Dort and Moos 1976.) Consistent with this interpretation, Derek Koehler and Connie Poon (2006) argue that people's predictions of their future behavior overweigh the strength of their current intentions relative to situational or contextual factors. As it turns out, seemingly inconsequential contextual features can have a profound influence on the likelihood that intentions will be translated into action. (It is worth noting the complicating implications of these and related findings for standard assumptions of revealed preference: Did the students in the study conducted by Leventhal and his colleagues “want” to get the inoculation? And which observed preference is the “right” one—the 3 percent observed in the control condition or the 30 percent observed when handed a map?)

Individual psyches can be understood as “tension systems” (Lewin 1951), composed of coexisting proclivities and impulses, in which incentives, if they run against substantial opposing forces, will have little influence, whereas other interventions, when the system is finely balanced, can have a profound impact. In other words, big interventions can sometimes have negligible effects, whereas apparently small manipulations can make a big difference.

The basic insights outlined here have important corollaries for our present concerns. For one, they suggest that the same tendencies and weaknesses express

## Insufficient Funds

themselves differentially in diverse circumstances. For example, the tendency to avoid action and resort to the status quo leads to inferior outcomes when context is structured so that the most beneficial outcomes require action, and this tendency leads to more desirable outcomes whenever the default is set naturally to produce them. Similarly, the same tendencies and weaknesses have different repercussions in different circumstances. A person who is well off but fails to formulate a farsighted plan may have a more modest though still comfortable nest egg upon retirement, whereas a poor person who exhibits similar failures may end up with too little cash to pay a phone bill, accrue large fines for reconnection, become increasingly unable to pay bills, and descend further into poverty.

In this chapter, we examine the specific implications of the behavioral perspective for the financial lives of the poor at three different levels. At the individual level, how does this perspective affect their choices about savings and borrowing? At the institutional level, what does this perspective say about how financial services ought to be designed? And at the regulatory level, what are the implications of this perspective for how financial services ought to be regulated?

Individual psychology is relevant at each of these levels. It directly affects the choices and actions that compound to generate a pattern of saving and borrowing. It affects how individuals respond to various features of a financial product, from its pricing to the transaction costs in acquiring it to its intertemporal consequences. It also gives us a different perspective on the channels by which financial services can affect behavior. All of these insights generate implications for design. Finally, since individual psychology generates deviations from the traditional economic model, it also provides different rationales and guidance for regulation, and not always in the direction of traditional consumer protection. Interestingly, by helping to elucidate specific psychological mechanisms, individual psychology undercuts some of the previous motivations for consumer protection.

## INSTITUTIONAL FINANCIAL ACCESS FOR THE POOR

### The Role of Financial Access

Financial services may provide an important pathway out of poverty. Such services facilitate savings to mitigate against shocks and promote asset development, and they facilitate borrowing to purchase durables or help weather tough times. In short, financial services allow individuals to smooth consumption and invest (for more on the financial instruments used by low-income Americans, see Barr 2004, this volume). Improvement of financial services, then, provides two key advantages. First, for individuals who already have access to these services, improvement would lower the costs they pay. For example, improved financial services may enable them to use a credit card rather than the more expensive payday lender. Second, individuals who have not had access to financial services would get the direct benefits of access, such as the ability to borrow to smooth shocks (such as health shocks).