FOCUS ON RETIREMENT PLANNING

Behavioral economics: Why 'now' trumps retirement saving

By JOSEPH MASTRIANI
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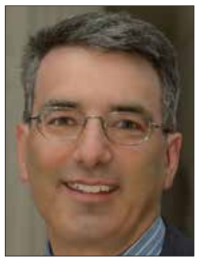
There is nothing quite like being awarded the Nobel Prize in economics for attracting media attention.

Richard Thaler, professor of economics at the University of Chicago, recently was awarded by the Royal Swedish Academy of Sciences for his pioneering work in the field of behavioral economics.


Mastriani

Thaler has been credited for moving economics toward a more realistic understanding of human behavior and for using the resulting insights to improve public policies, notably a sweeping shift toward the automatic enrollment of employees in retirement savings programs.

In his book "Misbehaving – The Making of Behavioral Economics," Thaler outlines three reasons why people often act irrationally when it comes to making financial decisions as well as failing to save for retirement:

Inertia or failure to act, which explains why people do not begin to start saving even when they have the opportunity.

Loss aversion, which explains why people avoid taking actions perceived as reducing their paycheck.

The lack of self-control that contributes to choosing actions that provide immediate gratification rather than planning for the future.

IMMEDIATE NEEDS TAKE PRIORITY

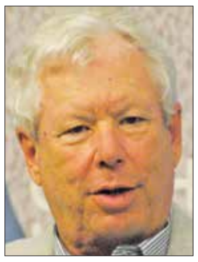
Much of the study of behavioral economics shapes people's ideas on planning for retirement.

In his writing "Behavioral Biases and the Hierarchy of Retirement Needs," Michael Kitces argues that "we tend to 'mentally account' for money into various buckets of current income, current assets and (assets for) future income."

Further, he says, "the way we mentally account for income and assets also has an intrinsic hierarchy of priorities – first, we need to cover our current income needs, then our current assets and finally our savings toward future income needs."

UNPOPULAR CHOICES

And just as Maslow proposed his hierarchy of needs theory back in the 1940s and ranked humans' fundamental needs ranging from the physiological to the psychological, Kitces says we do the same with our money.


Author and Nobel Prize winner Richard Thaler: Lack of self-control leads to taking immediate gratification rather than planning for the future.
PHOTO/CHATHAM HOUSE

First, we pay current expenses (groceries), then fund short-term financial reserves (checking accounts) and finally put savings toward future income (investment retirement accounts).

This hierarchy helps explain why some types of retirement income choices, such as deferring Social Security benefits as opposed to collecting at 62, tend to be unpopular – despite retirees routinely stating that their biggest fear is outliving their retirement assets.

'EARLY RETIREES'

The concept of loss aversion can also explain why nearly half of current Social Security recipients are considered "early retirees."

Many retirees worry that even though Congress would not allow it to become insolvent, the Social Security Trust Fund will not be able to continue providing benefits at its current state.

For this reason, these people believe that once they reach 62, each month they are not collecting Social Security benefits is money lost. Unfortunately, the decision to collect early could affect the payment of spousal benefits for years after the beneficiary has died.

To address these issues, the future solvency of Social Security might benefit from further research in the field of behavioral economics.

BETTER EQUIPPED

Through his Nobel Prize-winning work, Thaler has shown us that as human, we are predictably irrational when making financial decisions.

And once armed with this understanding, we can be better equipped to address our personal biases and face these financial challenges down the road.

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