Stanford Center on Longevity

A **LONGEVITY** BRIEF

10 THINGS YOU SHOULD

KNOW

About Psychological Science and Behavioral Economics to Improve Financial and Health Outcomes with Employees and Customers

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TAKE-HOME POINTS

- The communication of savings plans and financial products often assume that employees and customers are rational actors, ignoring that it's quite common for our emotions to significantly influence decisions and actions.
- Psychological science and behavorial economics are effective ways to help guide employees and customers to better decisions.
- The MORE Design can be used to help improve financial security and health outcomes.

INTRODUCTION

One of the challenges of the longevity revolution is that many people are reaching their later years in poor health and/or without adequate financial resources.[1,2] These conditions are often the accumulated result of sub-optimal decisions over the course of people's lives. Psychological science and behavioral economics can help employees and customers make better decisions that will improve their financial security and health across the life span.

Here are five general observations and five behavioral economics phenomena that should be taken into account when developing and communicating retirement and benefit programs.

FIVE GENERAL OBSERVATIONS ABOUT DECISION-MAKING CHALLENGES

1. Contrary to conventional economic theory, people tend not to be rational actors who make decisions logically. Instead, people are influenced by a variety of psychological and behavioral biases, heuristics, gut feelings, tendencies, and cognitive barriers that impede their ability to make purely rational decisions.[3] Because of these limitations, people often make decisions that go against their best economic interests.

2. People need to be engaged and motivated to address a specific challenge or decision before they will focus their time and attention to it. Many financial literacy efforts assume (incorrectly) that people automatically care about a specific problem or decision and will spend time and effort to address it.[4]

3. It is well-established that people make decisions based on a combination of deliberative reasoning and intuitive or emotional factors.[5] Yet many financial literacy efforts only address the "rational" side of the decision-making process providing only facts, figures, and strategies. These purely educational efforts are only effective for people who are already engaged and motivated, and who have sufficient information processing skills. This could be a very small portion of the target population for many savings plans and financial products. Motivational interventions are therefore needed to address the emotional and social factors that influence decision-making. These interventions can supplement the factual and logical messaging at each step in the process.

4. Employers and financial institutions face a basic decision about the degree to which it's appropriate to apply their judgment to and influence over their employees and customers. Sometimes, employers and institutions may want to develop and implement solutions that would otherwise be difficult for their employees and customers to devise on their own; these organizations might "do it for" their employees and customers by "doing the math" and setting up solutions that involve little decision-making on the part of employees or customers. In other situations where freedom and flexibility are paramount, it may be more appropriate for organizations to use psychological science and behavioral economics to nudge and guide employees and customers to effective decisions.[6] These approaches represent a range of complementary tools that can be deployed in a selective manner; for example, employers may decide to apply more judgment and control over the company's retirement contributions that are made on behalf of employees, while enabling more freedom and flexibility with employees' own contributions.

5. Psychological science and behavioral economics research is sufficiently robust to help employers and institutions guide their employees and customers to more effective decisions. However, because we are dealing with humans, the most we can expect is to "significantly move the needle" in a favorable direction for a target population. The degree of precision that's possible in the physical sciences (such as physics and chemistry) isn't realistic at the level of individuals' decision-making. The MORE Design serves as a guide to employers and institutions who want to deploy the research from psychological science and behavioral economics to improve outcomes with their employees and customers.[7,8]

FIVE BEHAVIORAL PHENOMENA TO IMPROVE DECISION-MAKING

1. Loss aversion: When facing decisions with uncertain outcomes, people tend to place greater emphasis on avoiding losses than pursuing gains.[9] Loss aversion can cause people to choose a course of action that minimizes the odds of a loss and forgo the opportunity for a potential gain, even if the magnitude of the potential gain far exceeds the potential loss. For example, many investors might avoid investing in the stock market because of the fear that their savings might lose value, even though investing in stocks can give them the potential to realize significant gains.

2. Framing: Decisions can be described in positive or negative terms that are objectively identical but can have diverging influences on choice outcomes.[10] For instance, milk can be described as 98% fat free (positive frame) or 2% fat (negative frame). Framing can be combined with loss aversion by describing the potential outcomes as either losses or gains.

3. Hyperbolic discounting: Standard models in economics assume that individuals discount future rewards, which means that individuals prefer to receive a good sooner rather than later. Hyperbolic discounting describes time-inconsistent discounting and behavior, where individuals make choices today that their future self would prefer that they hadn't made, and that their future selves, in the absence of commitment devices, may well overturn.[11] For example, time-inconsistent individuals may decide today to exercise tomorrow, but when tomorrow comes, they change their mind and decide to work out the day after.

4. Inertia (aka Status Quo Bias): If people aren't motivated to take action or make a decision, they often do nothing and allow the status quo to continue.[12]

5. Social norms: People can be influenced by decisions and actions that their peers make.[13] For example, employees might be influenced to hear that their work colleagues are contributing significant amounts to their 401(k) plans, or are adopting healthy exercise habits. There's evidence that good behaviors — like quitting smoking, staying fit, or being happy — pass from friend to friend almost as if they were contagious viruses.[14]

With some important retirement planning decisions, employees and customers might feel too overwhelmed to spend the time and effort that is needed to analyze and implement effective solutions on their own. In addition, it may be hard for them to overcome hyperbolic discounting and other biases they may have. Therefore, designing effective defaults is one powerful way to overcome these biases and take advantage of inertia and social norms to guide employees and customers to decisions deemed to be appropriate by an employer or financial institution.[12] In addition, individuals may interpret a default as a recommended course of action by someone who is more knowledgeable.

For example, many 401(k) plans have boosted participation and savings rates among workers through automatic enrollment in their plans. As a result of this success, plan sponsors are now seeking methods to use the power of defaults to help older workers decide how to deploy their savings in retirement.

This summary provides only a brief introduction to the robust findings regarding decision making from psychological science and behavioral economics research; there are numerous other phenomena to be considered when designing and communicating retirement and benefits programs.

For insights into a structured approach to applying psychological science and behavioral economics phenomena to the design and communication of retirement and benefit programs, see the companion brief T*he MORE Design: Using Psychological Science and Behavioral Economics to Improve Outcomes with Employees and Customers*.[7] Additional details and a step-by-step approach to address the above observations and factors are addressed in a more comprehensive paper: The MORE Design: Integrating Psychological Science and Behavioral Economics to Engineer Better Outcomes with Human Resource, Benefits, and Retirement Programs.[8]

ACTION STEPS

1. Assess the behavioral economics phenomena that might be influencing the decisions made by your employees and customers.
2. Investigate how plan design and communication programs can be enhanced using principles from behavioral economics and psychological science.

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The mission of the Stanford Center on Longevity is to redesign long life. The Center studies the nature and development of the human life span, looking for innovative ways to use science and technology to solve the problems of people over 50 in order to improve the well-being of people of all ages.

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