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DISSERTATION

Saving for the Future

Trends, Patterns and Decision-Making Processes Among Young Americans

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This document was submitted as a dissertation in June 2012 in partial fulfillment of the requirements of the doctoral degree in public policy analysis at the Pardee RAND Graduate School. The faculty committee that supervised and approved the dissertation consisted of Gery Ryan (Chair), Joanne Yoong, and Angela Hung.

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Summary

Introduction

Since the mid-1980s the personal savings rate in the U.S. declined from nine percent to just over five percent in 2009, after having dropped as low as 2.4 percent in 2007 (Bureau of Economic Analysis, 2012). Over the same period debt has risen both in nominal terms and in relation to income. Together these widespread trends suggest that Americans may be less prepared for their financial futures than they were several decades ago. This is particularly alarming considering that saving for the future may have become more important, not less, given the rising cost of college tuition, doubts about the sustainability of the Social Security system and the widespread phasing out of pensions.

Amid these changes, a new generation has entered adulthood. As the recent financial crisis highlights, these individuals and their families are particularly vulnerable to financial insecurity. As generations before, many of today's young adults struggle to meet their financial obligations, which now often include student loan payments, credit card bills, and saving for retirement. Whether or not individuals are prepared to handle this increase in financial responsibility, they are required to do so, and precisely at a time when both the number and complexity of financial decisions have risen.

Policies need to be developed and implemented to help young adults navigate these changes and manage their present and future financial needs such that they have financial security today and upon retirement. Designing such policies requires understanding the financial circumstances of today's young adults and the process by which they make financial decisions that result in the outcomes observed. To that end, the objectives of this dissertation are to:

1. Describe young adults' financial circumstances, particularly how much and in what form they have accumulated savings for the future;
2. Describe how young adults have accumulated their savings; and
3. Identify the options for policy interventions aimed at encouraging young adults to save.

To achieve its comprehensive objectives, this dissertation utilizes a multi-disciplinary approach to analyze financial decisions and outcomes at multiple levels, i.e., event, individual, household, and cohort, and identify how contextual factors influence financial decision-making. This approach provides a more complete assessment than is possible otherwise because it can identify the influence of factors at each level and the interactions among them. Such detail is vital for designing policies that encourage savings among young adults who are heterogeneous in their preferences, knowledge, resources, needs, and behaviors, despite being members of the same generation.

Methods and data

This dissertation utilizes a range of methodological approaches to achieve the research aims. First, a conceptual model of the financial decision-making process is developed, which is then used to structure a review of the existing literature on savings and financial decision-making. Two empirical studies apply a range of quantitative analytic techniques (i.e., statistical, econometric, principal components, cluster, hierarchical, and cultural domain analysis) to identify patterns in financial

account-holding over time and across sub-groups using detailed household finance data from the Survey of Consumer Finances. Additionally, a third study uses a combination of quantitative and qualitative analytic techniques to examine data collected from a series of semi-structured interviews regarding the process of saving money. The results of each empirical chapter are synthesized and their policy implications are discussed. Finally, the dissertation proposes a framework for identifying the policy options to increase savings among young adults.

Key findings

Financial security

In recent years the financial portfolios of young adults have become more risky. A greater share of their assets carries investment risk and they hold more debt in real terms and relative to income. In a related point, many young adults report that their spending habits pose the largest challenge to saving money. More precisely, it is the price of "needs" and desire for "wants" that can inhibit savings. How young adults manage the opportunities and incentives to save, invest, borrow, and spend all impact their financial security.

Decision-making process

Young adults make decisions related to their financial needs in a process that has five phases. In the first phase an individual recognizes her[1] financial need (e.g., retirement savings, short term liquidity). In the second phase, she identifies her vehicle (or account) options, considers their requirements and makes a selection. The third phase involves implementing the vehicle choice, i.e., opening an account (or equivalent). In Phase 4, an individual makes decisions about how much money to transfer to the new vehicle and the method for doing so. In the fifth phase an individual makes an assessment of her balance and the financial vehicle itself. At the end of the progression the individual cycles between Phases 4 and 5 as she adjusts her allocation of resources periodically.

Progression from one phase to the next requires a particular decision or action be taken. An individual's flow through the phases is interrupted if a terminal decision is made or if no decision is taken. If no such interruption occurs, the individual proceeds through all five phases. When a new financial need arises, she repeats the process once again.

Account acquisition progression

Young adults tend to acquire accounts in a particular order according to the development of financial needs. As they proceed through the life course, their financial needs evolve and additional accounts are required to satisfy those needs. As new needs arise, new account types are added to the existing portfolio of accounts in a progression resembling a Guttman scale, whereby increasingly "advanced" accounts are acquired cumulatively. Initially (i.e., in Stage 1), the primary financial need is cash management. In Stage 2, individuals address liquidity constraints by acquiring short-term debt. In Stage 3, they begin to accumulate (liquid) savings. In Stages 4 and 5, individuals make long-term investments and build wealth through financial investments. For the most part, young adults add (rather than replace) accounts to existing financial portfolios as they progress through the

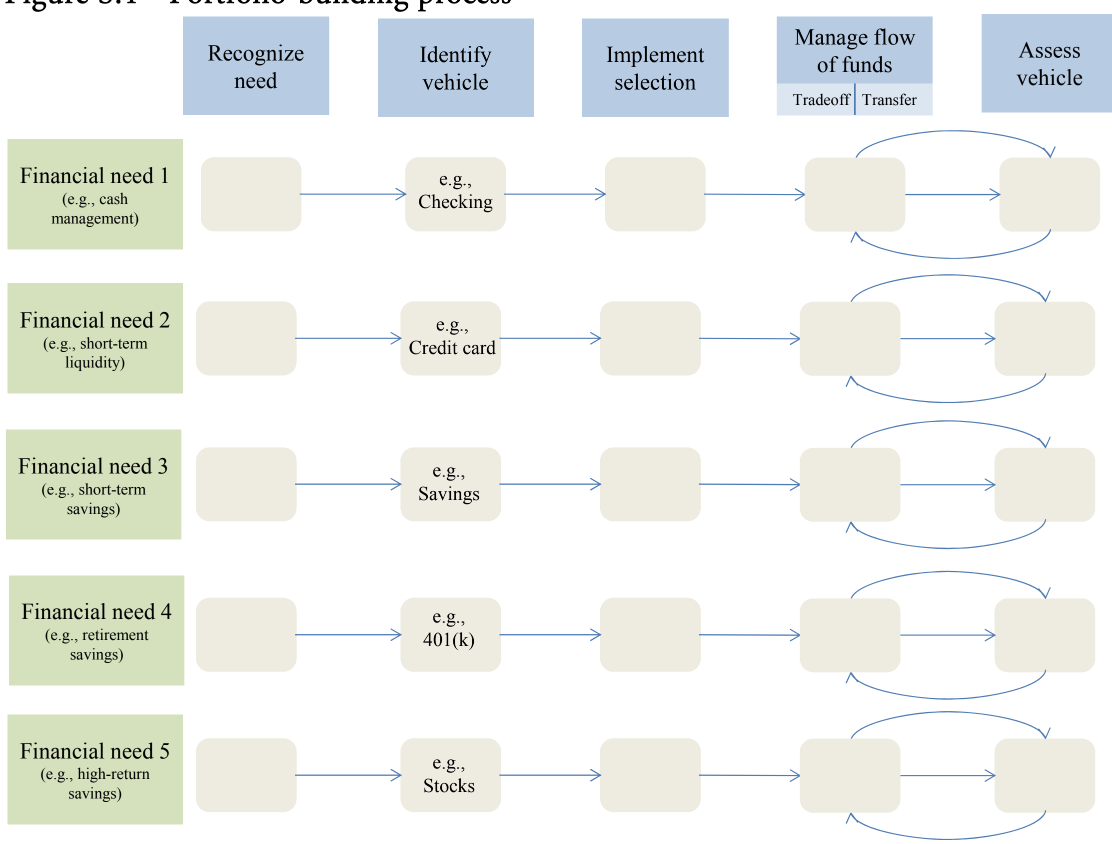
[1] The feminine pronoun is used throughout the dissertation to represent individuals universally.

stages of financial needs. As their portfolios grow, they reallocate resources across account types, eventually increasing the balance of "advanced" assets and decreasing the balance of short-term debts.

Portfolio-building process

The five phases of financial decision-making and the five stages of account acquisition intersect to form the process by which young adults build their financial portfolios. As Figure S.1illustrates, individuals proceed through the phases of decision-making with respect to their first financial need (usually cash management), and then cycle through the process again for each successive need that arises, corresponding to movements on the diagram from left to right, row-by-row. As additional accounts are added to the portfolio, Phase 4 of the decision-making process becomes more complicated. Individuals with multiple accounts must manage the flow of funds across time (i.e., between present and future consumption) and among various accounts (and financial needs), making decisions about how to allocate resources increasingly complex. This diagram represents the financial decision-making process at the individual level, but it also provides a way of interpreting the variation in outcomes observed across individuals.

Figure S.1 - Portfolio-building process



Difference in progress, not path

Significant disparities in wealth and account ownership exist, much of which can be explained by differences in the stage of account progression reached. That is, the path to building wealth is largely the same across individuals, although the level of progress varies. Some characteristics (e.g., having lower income, being younger) are associated with being at an earlier stage of the progression, and more advanced account acquisition simply comes with development in these traits over time. However, notable disparities between whites and non-whites exist that are not fully explained by differences in socio-economic characteristics and therefore do not disappear as age and income rise. While the median account value among owners differs little across racial groups, pronounced disparities in account ownership exist. This is due to differences in the pace of progress through the account acquisition stages, rather than differential portfolio-building processes between whites and non-whites.

Policy implications

The fact that most young adults make decisions, acquire accounts and build financial portfolios by a similar series of steps has significant policy implications. The universality of the process suggests that policies aimed at reducing systematic variations in outcomes (e.g., by race or gender) should target the obstacles to advancement directly rather than the characteristics associated with slower progress. This should be accomplished by targeting the precise phases of decision-making, not just the final phase in which the outcome is observed.

The results of this research can be used to guide policymaking aimed at increasing savings among young adults. In particular, the overview of the portfolio-building process, which illustrates the intersection of the decision-making and account acquisition pathways, can be used as a tool to identify the specific opportunities for policy intervention as they relate to a particular step in addressing one's financial needs. At each of these specific junctures (i.e., defined by phase and financial need), there is a wide range of policy options for promoting savings. First, they may address one or more of the phase-specific policy aims outlined in Table S.1.

Table S.1 - Policy aims

Decision-making phase	Policy aims
Phase 1: Recognize savings need	1. Raise awareness of savings need and salience
Phase 2: Identify savings vehicles	2. Ensure range of appropriate savings vehicle choices that have rules, requirements and features that promote saving 3. Raise awareness about savings vehicle options
Phase 3: Implement selection	4. Address (practical, cognitive or psychological) barriers to implementation of savings vehicle selection
Phase 4: Manage flow of funds	5. Promote greater contributions to savings by lowering practical, cognitive and psychological costs 6. Discourage withdrawals that do not adhere to the intended saving purpose 7. Make contributing easier
Phase 5: Assess vehicle and balance	8. Ensure fair banking practices among savings vehicle providers 9. Promote realistic savings needs assessments

Policies with a given aim can be designed to precisely target the practical (e.g., time, effort, financial), cognitive, and/or psychological factors that influence financial decision-making. In addition, policies may be implemented by a variety of stakeholders in the government, financial industry, or among employers. Each of these types of entities affects young adults' savings by shaping the environment in which individuals make financial decisions by creating opportunities and incentives to save (or spend) money.

To induce more savings among young adults, all relevant stakeholders must pull as many policy levers as they can and coordinate their efforts, to the extent possible. A "policy" to stimulate savings may be comprised of multiple layers of interrelated policies created and implemented by multiple entities. Some policies would necessitate coordination, while others would benefit from, but do not require it. Ideally, a central body would carry out coordination of efforts across stakeholders. Such an organization would lobby government entities, financial institutions and employers to pull savings-promoting policy levers, promote collaboration among stakeholders, and monitor progress.

Ensuring policy effectiveness and monitoring progress towards the broad aim of increasing savings among young adults would require that detailed data be collected. Existing datasets provide information on savings among those who have saved, but not on the barriers young adults face in accumulating savings. In particular, little is observed of the phases of the decision-making process. Effectively moving individuals through the decision-making pipeline requires knowing where the bottlenecks are so that policies to target them can be developed. Providing information necessary to craft appropriate policies and monitor their effectiveness would require additional data collection efforts.

Concluding remarks

Encouraging more young adults to save, or save more, for the future is necessary and will require substantial efforts. Government entities, financial institutions and employers will need to create policies promoting saving. These policies will need to be coordinated and monitored, and progress towards the goal will need to be measured. Changes may need to be made to speed progress or adapt to environmental conditions. Inducing savings among young adults will be challenging, but, the findings of this dissertation illustrate the need for additional policy interventions in this area, and suggest how policymakers might identify opportunities to expand on their existing efforts.