Building an on-ramp to a culture of fiscal literacy and financial action

How Mercy Corps' Community Investment Trust is helping lower-income individuals make their first financial investment

Policy paper

How can we help people with lower incomes save and invest?

One in three Americans are not saving any money, and one in four Oregonians live in 'asset poverty' (Sparshott 2014; CFED 2015). After three months without income, individuals living in 'asset poverty' are unable to meet basic needs without assistance. Traditional advice to lower-income individuals has been to pay off credit card debt and build an emergency fund before they even consider investments, and then to consider diversified investments like mutual funds. While this is can be good advice in a general sense, it does not translate well into a program that changes financial behavior. A range of practical and psychological obstacles tend to work against making these significant changes in financial behavior, and an 'on-ramp' which helps people who have not invested to make small, concrete changes in a supportive environment to engage in long-term financial action for the first time.

This paper presents a case for looking at investment opportunities for people with lower incomes not just from the perspective of whether the opportunities are the theoretical optimum investment, but also whether they support the goal of helping to make decisions for good long term financial health more likely. This paper focuses on the individual behavioral, economic, and social aspects of Mercy Corps' Community Investment Trust (CIT)[1] program, and does not address the community benefits of the program, except to the extent that they influence individual decision-making.

When we're designing financial literacy (or financial action) training we must understand that in the real world simply delivering knowledge does little good. Mercy Corps' CIT is an investment option that accompanies a financial education program. These two elements have been designed to give high quality financial literacy training, and, for those who are a good fit, access to an investment opportunity that generates good returns at no or low risk. Beyond those basics, every element of the program has been designed to take advantage of research about how we can make it easier for people in poverty to make good financial decisions.

[1] CIT is our term for a variation on a private REIT (Real Estate Investment Trust), which was created in 1960 to facilitate the aggregation of ownership in real estate by many investors. Up until our project was formulated, private REITs were the domain of only wealthy "accredited" investors.

Good advice is not enough to change behavior – what economic, behavioral, and cognitive research tells us about behavior change

There has been significant interest in recent years in 'behavioral economics,' the study of the effects of psychological, social, cognitive, and emotional factors on economic decisions. Critically for us, this research highlights the differences between what the 'rational economic actors' of neoclassical economics might be predicted to do, and what people actually do in the real world. Neoclassical economics assumes that 'rational economic actors' have the information they need; can process this information correctly and completely; and have preferences that are not affected by anything other than payoffs of their decisions. Their preferences are assumed to be predetermined and stable across time. The considerable resilience of neoclassical models of human behavior have led to approaches on giving people more information or providing people incentives and tools to help them make better decisions in their financial life.

The assumption used to be that rational actors with better information would make better choices, but the reality is that a range of other factors have much more impact on behavior than raw financial information. These other factors include, but are not limited to, how choices are framed; preferring the present to the future; overestimating how well off finances will be in the future; valuing losses more than gains; having short attention spans or tendencies to forget; adhering to social norms; and preferring default options. These issues apply across all financial groups, but because poorer people have fewer resources, and less of a margin of error, there is a greater imperative to deploy them in the most efficient manner.

Human behavior is governed by two separate systems. One system involves making quick decisions in familiar circumstances, and the other system involves making deliberate decisions in complicated or unfamiliar circumstances (Kahneman 2011). Unfortunately, reconciling these two systems is not easy (Heath and Heath 2010; Kahneman 2011). That said, we now know quite a lot about how to make it easier to keep the two sides of our motivation in balance, and make good long-term financial decisions while also attending to our needs and quality of life in the present.

Here are five examples of the factors that research has highlighted in the last few years that influenced the design of Mercy Corps' Community Investment Trust. They highlight how design of interventions and financial offerings can strongly influence participants' decisions both in the short and long term:

1. Too many choices leads to inaction

Dean Karlan's[2] research found that many factors unrelated to the economics of a decision weighed heavily in people's decision making. For example, giving consumers only one choice of loan size, rather than four, increased up-take just as much as reducing the interest rate by 20% (Bertrand et al. 2010). Rich and poor people alike can be overwhelmed by choice - Columbia Business School psychologist Sheena Iyengar found that supermarket shoppers presented with a wider selection of jams bought less jam than those presented with a smaller selection (Iyengar and Lepper 2000).

While the CIT's financial & investment literacy training program ("Moving from Owing to Owning") offers many different options in the curriculum (depending on factors such as risk tolerance level,

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[2] Professor of economics at Yale University, President of Innovations for Poverty Action, and research affiliate at the MIT Poverty Action Lab.

amount of money available etc.), for those investors who are interested in real-estate investing through the CIT there is only one (well vetted) option offered. The curriculum, paired with an immediately available investment option connects learning with doing in a structured way. Research shows that any benefits that (may) arise from more than one choice are more than cancelled out by the reduced uptake of programs with more than one option (Iyengar and Lepper 2000; Iyengar, Huberman and Jiang 2004; Botti and Iyengar 2006; Schwartz 2009).

2. Vivid, concrete, and tangible investments are compelling

The fact that people are more strongly impacted by a potential loss than they are compelled by a gain of the same magnitude is called 'loss aversion'.[3] In the banking field loss aversion translates (somewhat counter-intuitively) into a psychological sense that spending now is 'in hand', whereas putting money into a savings or investment for the future is psychologically a 'loss'. Research suggests that people are more inclined to use savings accounts if they are named for their intended use (for example 'retirement', 'education' etc.) (Thaler 1999). Making investment choices 'vivid, concrete, and tangible' maximizes people's willingness to use them (Karlan 2010). Local real-estate investment scores highly in each of these areas, making it a compelling investment psychologically, and offering a convenient, immediate, and accessible opportunity for financial action.

3. Inertia tends to work against change

Perhaps depressingly, the best predictor of future behavior is current behavior. To overcome this tendency to revert to our habits, behavior change needs to be made easy. Even seemingly small roadblocks between a message, and the opportunity to act on it, can be significant. For example, in one experiment one group of poor farmers was offered the opportunity to place earnings in a savings account that they could open on the spot, while others were told about the account, but were not able to open it for several days. A control group was not told about the account. Fifty seven percent of farmers who immediately paid into the account bought fertilizer for the next year, compared to only 17% in the control group (Duflo, Kremer and Robinson 2006 quoted in Bauer 2014). Interestingly only 30% of the group who were told, but had to wait to open the account bought fertilizer (Duflo, Kremer and Robinson 2006 quoted in Bauer 2014). They typically reported that they wanted to, but when the opportunity came to open the account several days later they did not act. People find it hard to overcome inertia – an immediate opportunity to act, rather than an abstract intention to do it in the future helps – a lot – that's why Mercy Corps offers training to participants for whom the investment is a good fit the opportunity to enroll immediately.

4. It is hard to pay attention and stick to decisions

Keeping financial decisions high on the 'to-do list' is hard, especially when there are many competing priorities. Mercy Corps is using a variety of methods to help people stick to decisions. Perhaps for this reason, higher income people typically automate savings and retirement plans, helping them stick to goals by removing the need to regularly act. Absent these elements, structural changes to reducing obstacles and other supports can help encourage people to stick to their commitments (Hall, Galvez and Sederbaum 2014). Making sure that investments remain salient by using community networks and groups to help people remain accountable to their goals (Karlan et al. 2009). Recruiting churches, housing associations, and other social groups to help keep the issue on the agenda is one way to make sure that it remains a top priority. In addition to larger group support, each participant will be paired with an individual mentor who can help them stay

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[3] The pioneering work on this was done by Kahneman, Knetsch, and Thaler, but it has been replicated in many studies. Kahneman was awarded a Nobel Prize for his work on this and related ideas in 2002.

accountable to the plan they made. Making investment behavior regular and predictable is another factor that contributes to success – once a participant makes a budget plan and identifies their saving or investment margin they will be coached on making themselves personalized reminders.

5. What we think other people are doing is hugely influential

Social pressure is a powerful influencer of behavior. From the pioneering work on peer and authority pressure in the social psychology of the 1950s to current social media advertising, the power of peers and role models to influence behavior is enormous (Thaler and Sunstein 2008). In an experiment in Minnesota in 1996 groups of taxpayers were given four different kinds of information. Either a) that their taxes went to pay for various beneficial things, b) information about risks of punishment for non-payment of taxes, c) information on how to get help filling out their tax forms if they needed it, or d) that 90% of Minnesotans paid their taxes fully. Only the fourth item (that reinforced social norms about tax payment) had a positive effect on reported income taxes paid (Coleman 1996). Related research has indicated that stigma and stereotyped beliefs about those living in poverty can also consume mental resources and impair cognitive performance (Hall, Zhao and Shafir 2014). Mercy Corps' CIT program seeks to improve self-esteem through group formation, mobilizing the power of being part of a group of people who are challenging social stereotypes, building self-esteem and gaining a voice and power.

Research-driven design for transformational change – an 'on-ramp' to better financial decision making

Mercy Corps' CIT team believes we should not be designing financial education and other interventions solely around optimized financial instruments. Rather we need to design for the real social, economic and behavioral situations that people find themselves in. Mercy Corps' CIT program takes current best practices in behavior change and applies them to the real problems facing people on low incomes.

Criticisms of offering community-based real-estate investment to lower income people focuses on ways in which other choices might show higher effective returns on paper. Typically, critics will suggest that paying down debt, building emergency funds, and diversified financial instruments are top priorities. While this advice is not bad in theory, it fails to take into account the behavioral economic factors that result in it rarely being followed in real life. When the science of behavior is applied to changing financial practices, an 'on-ramp' to better financial decision making and literacy can be built that will help individuals and communities transform their financial futures.

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