



# The Emotions and Cognitions Behind Financial Decisions: The Implications of Theory for Practice

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# Gratitude and Disclaimer

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# Presentation Overview

- Abstract
- Key articles and overview
- theoretical constructs: financial decisions.
  - Overview of each theory
  - Motivations and constraints targeted
- Implications for financial literacy education

# Project Report Abstract:

Financial decisions are compelled and constrained by non-financial factors. These include personality characteristics of individuals as well as the social environments in which decisions are made. **This paper provides an overview of theories that seek to explain how non-financial factors influence financial decisions:**

- Developmental Psychology,
- Crystallized and Fluid Intelligence,
- Behavioral Economics,
- Neuro-Brain Research,
- Culture of Poverty.

Our interest is in what these theories imply about the behavior of vulnerable, particularly low-income groups. The literature reviewed indicates the **importance of emotions and feelings in decision making**; these must be considered in developing and evaluating financial literacy education programs.

# Suggested Key Readings

Sent, Esther-Mirjam (2004), 'Behavioral Economics: How Psychology made its (Limited) Way Back into Economics,' *History of Political Economy*, 36 (4), 735-760

Knoll, Melissa A. Z. (2010) 'The Role of Behavioral Economics and Behavioral Decision Making in Americans' Retirement Savings Decisions,' *Social Security Bulletin* 70 (4), 1-23

# Prevailing View of Economic Person?

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*“Standard economic theory ...describes a formal process for making rational decisions: People consider all the options available to them. They consider the outcomes of all these options and how advantageous each outcome would be. They consider the probabilities of each of these options. And then they make a decision. But can we really do this? ...Many of decisions...are made because they “feel right.” “*

*George Akerlof & Robert Shiller. [Animal Spirits: How Human Psychology Drives the Economy, and Why it Matters for Global Capitalism.](#)*

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# “Behavioral impediments” \*

- Decision-making under ignorance
  - Avoid decisions in areas feel comparatively ignorant
    - >Relative to others and to their own knowledge in other areas
  - Rely on friends more often than those with expertise
- Distortion of information in systematic ways
  - Heuristics, rules of thumb, frequency validity
  - Status quo and default preferences
- Lack of self-control and procrastination
  - Hyperbolic discounting;

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\* From Knoll (2010)

# Emotions

- A mental state that arises spontaneously rather than through conscious effort and is often accompanied by physiological changes; a feeling: *the emotions of joy, sorrow, reverence, hate, and love*
- An emotion is defined as a collection of changes in body and brain states triggered by a dedicated brain system that responds to specific contents of one's perceptions, actual or recalled, relative to a particular object or event (Damasio 1994, 1999).

Sources: [www.thefreedictionary.com/emotion](http://www.thefreedictionary.com/emotion); Damasio, 1999

# DEVELOPMENTAL PSYCHOLOGY

*Psychoanalysis*—instinctive urges vs. social norms

*Psychosocial theory*--resolution of stage-related conflicts

*Learning Theory*--learned observable behavior

*Cognitive Development*--process between cause and behavior

# MEASUREMENT OF COGNITION

- The measurement of intelligence
  - More difficult in adults
  - Complex intelligence
- Fluid and crystallized intelligence
  - Fluid: *Experiences directly affect brain structure*
  - Crystallized: *Education and acculturation*

# BEHAVIORAL ECONOMICS

Rise of cognitive psychology

Theory Modifications

Bounded rationality →

shortcuts, heuristics

Bounded will-power

Bounded self-interest

# NEURO-ECONOMICS

Role of emotions in decision making

Activation when faced with low versus high risk

Learning from negative versus positive outcomes.

# CULTURE OF POVERTY

Culture: passing on of non-genetic traits (values, attitudes) over generations.

Persistent poverty: is economic status a cultural trait?

# Implications: Developmental Psychology

- Financial literacy is about imposing social norms— of individual responsibility for financial future.
- Social norms and individual urges may conflict.
- Behavior within families may reflect power, dependency
- Childhood experiences are key to adult financial attitudes to social/financial institutions
- Childhood experiences have lasting effects on conscious and unconscious mind
- Time matters to effectiveness of reinforcers
- Use of new information depends on existing cognition.

# Implications: Measurement of Cognition

- Complexity and diversity of learning paths.
- Importance of early learning, yet financial education can persist throughout adulthood.
- Brain studies indicate:
  - Reaction to risk is not symmetric.
  - Sequencing of options matter
  - Behavior can be patterned to become automatic
- Underlying physical differences in neural pathways affect learning and reactions to stimuli
- Expectations matter to making sense of new information

# Implications: Culture of Poverty

- Behavior influenced by social constraints and context.
- Importance of childhood experiences.
- Importance of community in developing behavioral patterns
- Vulnerable have similar values but assess options in a different context?

# Conclusions

- Financial education is psycho-socio-neuro-economics
- The brain is where information is processed, it is a complex, emotional, & physically programmed organ
- Early education within the family and community imposes norms and expectations.
- Financial education must take into account the larger context of individual and community values, misperceptions, fears and community goals.
- Vulnerability is a consequence of complex life experiences, norms, brain function.

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