

EDITORIAL

Introduction to JPEF special issue on household finance

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Household finance addresses problems that every person has to face, even if this person forms a household of one. Borrowing to boost current consumption and asset accumulation, saving for a purchase, for retirement, or for a rainy day, and using financial instruments to manage and insure risks are key examples of important challenges in the financial domain. In order to meet their financial objectives, a broad range of heterogeneous households need to form reasonable expectations, understand complicated financial products and risks, and also screen and evaluate those who offer their advice and expertise on advanced topics.

Financial liberalization, innovation, and privatization have typically added to the opportunities that households have to meet these challenges, while the demographic transition has contributed greatly to the pressures they face. Population dynamics simultaneously reduced the pool of young workers that can support the elderly and increased the risk that the elderly will outlive any given amount of resources.

Analyzing opportunities without the challenges would be entirely unbalanced, and indeed household finance does both. Research in this young but rapidly evolving field employs a wide arsenal of research methods: analytical methods, computational modeling, survey design and analysis, microeconomic estimation and identification, and more recently experiments.

In this issue, JPEF presents a number of studies that illustrate the relevance of questions asked by Household Finance, the range of research methods applied, as well as its ability to inform choices in the policy area. Some articles in this issue study key financial choices, such as debt, pensions, bequests, and life insurance. Others focus on the process of making financial choices, such as the formation of subjective

expectations, self-control problems, financial literacy, and financial advice in the form of credit counseling. We provide a short description of the issues in what follows.

The recent financial crisis in the USA exhibited household over-indebtedness and inability to foresee the possibility of not being able to meet debt obligations. Lusardi and Tufano study the extent of debt literacy in a national sample of Americans, and they develop its link to household financial experiences and debt loads also in the context of uncollateralized consumer debt.

Financial literacy also affects asset behavior. Moreover, it is not immutably fixed but subject to choice and accumulation over the life cycle, often resulting in improved expected returns and lower costs of asset market participation. Jappelli and Padula introduce financial literacy accumulation in an intertemporal portfolio choice model in order to explore causal links between stock market participation, financial literacy, and the generosity of the social security system.

Retirement planning and handling longevity risk, namely the possibility of out-living one's resources, are crucially linked to financial literacy and awareness. Understanding these links has become even more important following government policy changes in the annuities domain, such as these in the UK's 2014 and 2015 budgets that give complete freedom to individuals to buy and sell annuities with essentially no legal constraints. Banks, Crawford and Tetlow analyze empirically the determinants of annuitization decisions for older individuals using UK's ELSA data (the UK equivalent of the Health and Retirement Survey (HRS)) and link them to financial literacy.

Financial planning and pension choices are based on individual subjective expectations. Using 2009–12 panel data for a representative sample of the Dutch population, Bissonnette and van Soest analyze consumers' heterogeneous income and pension expectations, and their evolution in the face of the recent crisis and implementation of successive reforms.

A possible alternative or complement to financial literacy is financial advice, but there is considerable evidence of reluctance to seek such advice, especially among people who might need it most. Disney, Gathergood, and Weber study an important type of financial advice, namely credit counseling, and how it relates to financial literacy. This is a challenging problem from an econometric point of view, because of the potential endogeneity of financial literacy to credit counseling as well as of the financial outcome to the level of financial literacy. Their results point to substitutability between credit counseling and financial literacy, with important policy implications.

Self-control problems can seriously influence financial behavior and financial knowledge accumulation. Love and Phelan build a computational model to study saving and portfolio decisions and financial literacy accumulation over the life cycle in the presence of hyperbolic discounting, fixed costs, and Epstein–Zin preferences. They find that such anticipated impatience of future selves leads to lower wealth accumulation and consequent postponement of entry into the stock market in the presence of fixed entry costs. When they allow for endogenous choice of investment in financial literacy, they find that hyperbolic discounters tend to invest less in developing financial literacy, given their more limited wealth accumulation, and to be thus more likely to undertake inefficient stock market investment.

Some of the risks households face can be managed through insurance products, but demand for those is subject to the tax incentives provided by the government, as well as to household preferences for bequests. The interaction between these three factors in the context of demand for life insurance is studied by Sauter, Walliser, and Winter. The authors exploit an unexpected halving of the tax exemption limit for interest and dividend income in Germany to identify the impact of changes in taxation on the demand for life insurance. They find that ownership of life insurance products increased significantly among households affected by the reform.

Together, the papers in this special issue illustrate how household finance research can be used to highlight the nature and importance of the challenges faced by today's households in the financial area, the difficulties they are confronted with, and their prospects for meeting these challenges given the policy environment they face.