Our most irrational financial habit? Cheaping out on retirement saving

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Dan Ariely's job is to figure out why you won't pay attention to perfectly good financial advice such as spending less and saving more.

Mr. Ariely is a professor of psychology and behavioural economics at Duke University in North Carolina and a co-founder of Toronto-based BEworks, a management consulting firm that uses behavioural science in its work. His mission: Find out why people make bad decisions about money and figure out ways to get a better outcome. I recently spoke to Mr. Ariely to find out why people keep making the same money mistakes, despite readily available advice from the media and financial-literacy initiatives.

To start, can you provide a quick definition of behavioural economics?

In standard economics, we assume that people are perfectly rational, that they always take everything into account and they always, always, always make the right decision. In behavioural economics, we don't make any assumptions. Instead, we just observe how people actually behave. We find people often behave irrationally, and that has all kinds of implications for policy, for savings, for health and so on.

What do you consider to be the most irrational aspect of how people are handling money these days?

The most irrational is, probably, not saving enough for retirement. Think about someone who works from age 30 to 65 – that's 35 years – and then is going to live to 90. That's another 25 years. This means that for every year of work, you need to save for almost one year in retirement. That's a lot.

Why don't people better grasp the need to save?

Saving is not really saving – it's delayed spending. Our real question in financial terms is, how do we want to allocate our money between now and later? This idea of now versus later is incredibly challenging for human nature. You could argue that it's inhumane to even ask people to think long-term.

What do people misunderstand about retirement saving, specifically?

We did a study where we asked people from all walks of life how much of their final salary would they need to retire. They all said 70 per cent. Then we said, tell us how do you want to live when you retire? We priced [their answers] out and it came out to 130 per cent of their income. Working is actually very cheap. It keeps you busy for eight hours a day plus traffic, and they give you free coffee. When you retire, every day is like a weekend.

Financial literacy is often mentioned as a solution to personal finance problems such as high debt and low savings. What's your sense of how well finlit works?

My sense of financial literacy is that it's a lot of work without much impact. There was a study that came out a few years ago that showed that for the US$700-million or US$800-million a year the U.S. is spending on financial literacy, the improvement in financial behaviour is 0.1 per cent. I was pessimistic going into [this study], but it's much worse than I thought.

What have you learned about how people can make budgeting work to improve their financial behaviour?

People who have a monthly budget end up spending more than people who create a weekly budget. At the beginning of the month, you feel really rich. So what do people do? They start spending very quickly. And then, you run out of your allocated budget. With a weekly budget, you understand the trade-offs better. We also found that it's better to start a budget on a Monday than a Friday. You start on Friday, you blow your money on the weekend and then you run out.

What's harder – changing your financial or eating habits?

Money in some ways is easier than food. You have to make good decisions about food all the time, many times a day. With money, there are things like automatic deductions [for savings] that you only have to do one time.

It's becoming clear that social media promotes a fear of missing out (FOMO) that pushes people to spend in an effort to keep up. How do we break that cycle of behaviour?

One approach is to automate savings more. Create a tool to take money out of your chequing account the moment your salary is deposited. You would feel that you are less wealthy and you would make better trade-offs on saving and spending.

This interview has been edited and condensed.