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אוניברסיטת בן גוריון - 12440

hen it comes to the economy, most of us are just plain stupid

Basic misconceptions about the world of finance lead most people to make poor decisions that affect their lives, says a prominent Israeli psychologist

Efrat Neuman

If you're reading this article, there is a good chance that you're interested in economics and finance. You might play the stock market, or are at least considering it. If you're an Israeli over the age of 30, you most likely have a mortgage, as well as car and property insurance, and you might also be saving for your own and your children's future.

If you're reading this article, there's also a good chance that your understanding of economics is much less proficient than you think it is. That, in any event, is the conclusion of research by David Leiser, a psychology professor at Ben-Gurion University of the Negev, who examined how people understand economics and make economic decisions.

"My studies show there is an incorrect understanding of events. People are expected to understand, but they do not," says Leiser. "It's not just a lack of knowledge, but knowledge that is distorted, and erroneous understanding from the ground up, from things we deal with every day to our understanding of how the national and international economic systems function.

"People have their own understanding of the financial world. For example, interest rates were raised in the United States last week. How many people really understand the significance of such a step? What are the implications of this in the short and the long term? When reporters write about pensions, they refer to actuarial considerations, but how many of their readers understand what this term means?"

In the financial press, there are analyses of events such as interest-rate decisions, and in recent years the general news media are devoting more attention to financial matters that are relevant to us all. Leiser believes this is not enough. Sometimes, he says, this actually results in confusion.

"From what I see around me, the media preoccupation with the economy has only increased the level of anxiety. People come to me and ask me what to do with their long-term savings," he says.

Leiser gives the example of pensions. "I investigated, using focus groups and questionnaires, what people understand about pensions. I found that people generally relate to two incorrect models. The first is the piggy bank model, according to which each month you put money into it and at retirement age you take the money, and that's your pension. The second is the contract model, according to which the state tells you, work for 40 years and then you'll get a percentage of 'something,' it could be your last, or your average, monthly wage.

David Leiser

Pension as partnership

"Except for economists, you will hardly find people mentioning that this pension is affected by factors such as life expectancy, return on investment and, most of all, that it's a partnership with the other people in the fund. Then the person reaches retirement age with a mistaken understanding, and he is told that all sorts of things happened.

"The return achieved by his pension fund was not high enough, the population pyramid changed (increased life expectancy), so he will get much less than he expected. The saver does not understand this, and thinks he has been robbed in broad daylight. After all, he had a contract. He put the money in the piggy bank every month; he did his part. He develops a sense of injustice and mistrust, and thinks they stole money from him. This distorted perception of reality creates a distrust between the people and the financial institutions and regulators."

This incorrect understanding is also expressed in relation to the compensation fund the employer pays into every month. This component, amounting to between 6% and 8.3% of salary, is set aside by the employer and is designed to protect employees in the event of termination or changing workplaces. The convention is to think that the compensation component of the compensation belongs to the employee, whether he chooses to quit or if he is fired. But while unemployment benefits are paid by the state, the employee himself pays for the compensation component — that is, it comes out of his pension savings. The compensation component usually amounts to about one-third of pension savings, so anyone who withdraws it as severance pay in the event of dismissal or resignation prior to retirement, wipes out one-third of his pension.

"We are now beginning a study on withdrawing compensation. People treat compensation as if it were accident insurance — compensation that can and should be spent, because in any case it's not part of the regular budget. Many people withdraw their compensation money, and do not realize they are damaging their future pensions. The history of the concept and the unfortunate term itself give them the impression that it's compensation for being fired. So they take the money and renovate their kitchen, and have no idea that they are losing 30% of their pension.

"We are now examining in a study the impact of changing the name, whether instead of calling it 'withdrawal of compensation' we call it 'early withdrawal of pension funds, with approval' would cause people to behave differently, and not withdraw the compensation money."

Leiser, 63, has a bachelor's degree in math from the Hebrew University and a doctorate in psychology from the University of Geneva, where he was a research assistant to the renowned developmental psychologist Jean Piaget. He was a visiting lecturer at the University of Chicago and a fellow at the Max Planck Institute for Psycholinguistics in Nijmegen, Holland, before joining the faculty of Ben-Gurion University in 1979. He is also president of the economic psychology chapter of the International Association of Applied Psychology.

Leiser explains that people develop a shallow understanding of subjects that offer an illusion of understanding. One of the invalid biases that his research found is called the good-begets-good heuristic. People tend to divide economic variables into "good" and "bad" categories, and think that when a given "good" variable "increases," then all the other "good" economic variables will rise as well. Of course, the opposite also holds true.

Leiser gives an example: "When we asked people about the relationship between inflation and unemployment, we realized that 85% of respondents believe that a rise in unemployment leads to a rise in inflation. Why? Because both parameters are "bad," so they go together. In practice, however, in most cases the relationship is actually the opposite. When unemployment rises, people don't get wage hikes, or their salary actually declines, and inflationary pressures are weakened. This question has been tested in other countries and the results were the same. This insight has macroeconomic implications."

Poor comparisons

Another bias stems from the fact that people seek out metaphors and comparisons. "People tend to compare the national economy to an economy that is familiar to them, that of a family. Their conclusion is that you have to manage your income and

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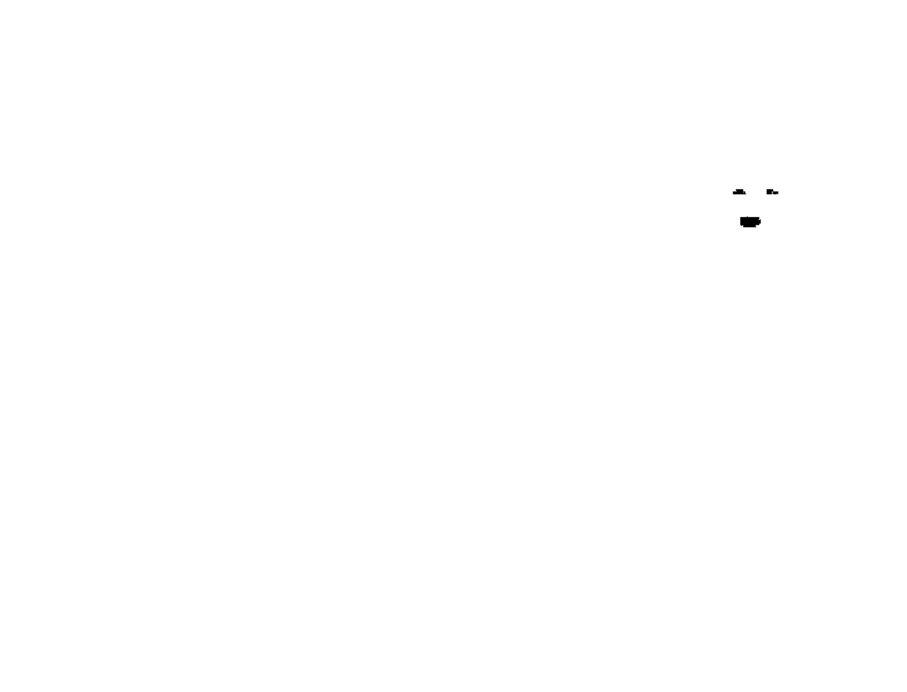

Federal Reserve chief Janet Yellen announcing this month's historic rate hike. *Reuters*

expenses in a balanced way. Economists do not agree, since a government sometimes needs to spend more and sometimes less, depending on the state of the economy. Income and expenses in a household are independent of each other, but the government can spend more money in order to stimulate the economy, make various investments, and this will increase tax revenue. In the end, spending more can actually help the state meet its targets."

The third bias that Leiser mentions leads people to understand the economy in terms of intentionality. "If people do not understand some economic process and why it happens, they are inclined to assume that someone deliberately caused its results. This tendency is very human. We all tend toward intentional thought, and not only in the economic realm. Sometimes it's true, sometimes not. When the situation is complex and it is unclear what caused what, people tend to assume that someone is profiting from it, so he wanted it to happen and made it happen. I tested this bias in the United States and in Switzerland as well, and it was tested by others in France. It turned out that it exists in these countries, too."

The public's understanding is also tied to its confidence in the state. "In public policy it is important to understand the customer, the citizen, the taxpayer. It's possible to send the message that anyone who does not pay taxes will be punished, and you can make people understand that it's important to pay taxes because they benefit from the services the taxes pay for. In Jerusalem, for instance, last year

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we received a brochure listing what our property taxes paid for. When people can see where their money goes, it's easier to persuade them to pay their taxes on time. Studies have found that when it comes to taxes, it's important to increase trust without letting up on enforcement."

Economics is a behavioral science. Researchers consider economic theories through people's behavior and associate it with their preferences. Leiser believes that people's economic beliefs, as well as their expectations, affect their daily behavior. In consequence, this affects the direction of the economy.

"Economics isn't like the weather," says Leiser. "The fact that we expect a heat wave will not affect whether or not we have one. The economy is different. The public's expectations have an impact. Economic crises affect the confidence of the players. When people expect higher inflation, it increases the likelihood that it will happen, because they behave accordingly and raise prices. After the 2008 financial crisis there was a lot of interest in the issue of trust, and when people tried to address the causes of the crisis that befell them, they instinctively pointed an accusing finger at people, not the system.

"Fortunately, economists have begun to give serious consideration to how people understand key data or develop expectations. There is still a lot we don't know, and for several years many researchers have been studying how the general public understands the economic world."

Leiser notes that the Finance Ministry has come to recognize the importance of making information more accessible to the public and more transparent. It is also co-funding the Pensions, Insurance and Financial Literacy Research Center at Ben-Gurion University, which was founded a year ago. Heading it, in addition to Leiser, are the economist and former deputy governor of the Bank of Israel Avia Spivak and Rami Yosef, an actuary — both BGU professors.

How do you teach people to better understand economics?

"Teaching financial and economic literacy is necessary and welcome, of course, but we must be realistic. In most cases true understanding will not be reached. The regulator must recognize the wrongs and protect the public from exploitation. At the same time, people should be aided in making informed decisions."

Leiser believes that only objective advice can accomplish this. "In Britain today, pension advice is mandatory, and it's funded by the state. I think the state must ensure that those who sell the pension product are not the ones who advise the client. In other words, the consultant will not be able to sell you anything. Pensions are indeed complicated, and people should know that they do not understand — and be able to get objective advice."