What Drives Financial Overconfidence among Young Adults?

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Financial overconfidence – where subjective financial knowledge exceeds objective financial knowledge – can results in mistakes that adversely affect economic well-being. Financial overconfidence is particularly acute among younger adults. According to the 2015 National Financial Capability Study, one out of five adults ages 18 – 34 are financially overconfident. While on average younger adults' financial literacy is substantially lower than that of older Americans, nearly the same proportion rate themselves to be financially knowledgeable. This may be problematic as financial mistakes made early in life can affect long-term financial stability.

Considerable prior research has examined the effects of overconfidence on financial behaviors. These papers find that individuals who overestimate their financial standing or their financial knowledge were more likely to engage in poor financial behaviors (e.g. not budget, not save, and use alternative financial services) than individuals who are not overconfident (Perry, 2008; Robb, Babiarz, Woodyard, & Seay, 2015). Many studies also separately assessed the impact of subjective and objective financial knowledge on financial behaviors (e.g. credit cards, savings, and money management) using cross-sectional or experimental data. Most papers found that subjective knowledge may have greater associations with financial behavior, especially among young adults (e.g. Robb & Woodyard, 2011; Xiao, Tang, Serido, & Shim, 2011; Hadar, Sood & Fox, 2013; Allgood & Walstad, 2016; Henager & Cude, 2016). Two papers that used longitudinal data found mixed results when it came to impacts of objective financial knowledge, but both papers found higher subjective financial knowledge is associated with improved financial behaviors (Serido, Shim & Tang, 2013; Xiao, Ahn, Serido, & Shim, 2014).

While considerable research has examined how overconfidence affects financial behavior, relatively little is known about what factors contribute to overconfidence, whether individuals become less likely to be overconfident following financial difficulties, and how overconfidence changes over time. Accordingly, the overarching research questions of this project is: What are the antecedents of overconfidence, and how does it change over time with respect to financial education, economic shocks, or evidence of bad financial behaviors?

Methods

This study employs longitudinal data of young adults' finances from the Arizona Pathways to Life Success for University Students (APLUS) to investigate what factors contribute to overconfidence and how it changes over time with respects to financial education, adverse financial practices, and individual-level economic shocks. The sample size in the APLUS is 2,098 respondents, but we concentrate on those completing at least two waves, leaving 1,584 observations. We classify an individual as overconfident if they self-assessed their financial knowledge to be higher than the sample median but scored lower than the median on objective financial knowledge. We first examine which characteristics

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are associated with objective financial knowledge, subjective financial knowledge, and financial overconfidence using standard linear regression models. Second, we run individual fixed-effect models to examine how time-varying demographics, financial education in adulthood, and bad financial behaviors impact knowledge and overconfidence over time. We cluster standard errors at the individual level and include wave fixed effects in all individual fixed-effect models. Then, we conduct robustness checks with differing definitions of overconfidence to see if results remain when measures vary.

Preliminary Findings and Next Steps

Preliminary results suggest that 1) high school financial education (particularly seminars) are associated with overconfidence via increases in subjective financial knowledge; 2) financial education in adulthood may increase both objective financial knowledge (marginally significant) and subjective financial knowledge; and 3) individuals learn from financial mistakes, and overconfidence may temper accordingly. Subsequently, we will examine if there are heterogeneous trajectories among those that received financial education in high school and will examine robustness to alternative definitions of overconfidence. A completed paper will further discuss results, robustness checks, limitations, and implications for financial education interventions.

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