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A new look at temptation

Everywhere in the world, people both rich and poor struggle to save and invest for tomorrow rather than splurging on the things they want today. From text messaging reminders, to providing piggy banks, to giving away little motivational presents, IPA investigates ways to help people meet their financial goals and avoid temptation. However, Research Affiliates Abhijit Banerjee and Sendhil Mullainathan have a new paper that suggests we may need to rethink the economics and psychology of temptation.

In the past, economists have offered two basic explanations for why the poor may fail to save or invest as much as they might. The first is that they are simply impatient: consumption today is worth much more to them than consumption tomorrow. The second explanation is that people have inconsistent preferences about consumption over time. For instance, a person might prefer a Snickers bar today over a Snickers tomorrow, but be pretty indifferent between Snickers 20 days from now and 21 days from now – even though both comparisons are between one day and the next. The problem is that when that 20 days from now arrives, 21 days from now becomes tomorrow, and the person reverts to their today vs. tomorrow preferences. We let ourselves get away with indulging today, naively thinking that in the future we'll be more restrained. In this way, we always save less than our reflective "long-term self" would want.

Either approach – impatience or inconsistent impatience – could explain why we see low savings among the poor. It might also explain willingness to pay for short term loans that finance consumption today at the cost of a very steep interest rate. The problem is that these explanations require that the poor be naturally much more impatient or inconsistent than the rich.

Banerjee and Mullainathan offer a different explanation, one which shows how temptation might interact in a unique way with poverty. Suppose, they argue, that there are certain goods that people are tempted by, such as candy, or coffee, or cigarettes. Then suppose that as people get richer, they spend a decreasing proportion of their income on these goods; not a smaller *absolute amount*, but a smaller *proportion*. (There's only so much money you're likely to spend on cigarettes, no matter how rich you get.) Finally, suppose you're realistic enough to know that you'll be just as tempted in the future by these items as you are today.

In sum, your “long term self” knows that you will spend money on temptation goods in the future, but places no value on that spending. (Your long term self doesn’t *like* the fact that you’ll spend money on cigarettes, even though your today self wants it.) Knowing that you will spend this money amounts to a “temptation tax” on future wealth. This is a disincentive to save for the future. Why save today? After all, your future self will just squander the money on cigarettes!

But as you get wealthier, the effective “tax rate” is lower, because temptation goods are a smaller proportion of your income. With a lower tax rate, your disincentive to save shrinks. Perversely, if you expect to be wealthier in the future, you have a greater incentive to save and invest! Banerjee and Mullainathan show that this can create a poverty trap. When you expect to be poor in the future, you are less likely to save and invest, which keeps you in poverty. When you expect to be wealthy in the future, you are more likely to save and invest, which makes you wealthier still.

This new model of temptation represents a pretty fundamental shift from the old economic explanations. Rather than assuming that people are inconsistent and naïve about their spending preferences, it assumes that they are foresighted and realistic. The researchers argue that it can explain much of the seemingly myopic behavior we observe among the poor: lack of savings, borrowing again and again at high interest rates, and turning down high return but small investment opportunities. It also offers an explanation that doesn’t rely on the assumption that the poor are inherently different in some way from the rich – they’re just reacting to different circumstances.

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