

Economics 70 Syllabus

Personal Finance: Making Better Decisions and Building a Better Financial System

**Tuesday and Thursday 10:30-11:45am
September 5-December 5, 2023
Northwest Building B103**

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Office hours: Thursdays 3:30-5:00pm

Course Description

People face a daunting array of problems in managing their financial lives. Taking out student loans, managing bank accounts and credit cards, financing a home purchase with a mortgage, and saving for retirement are all major challenges. There is evidence that many people lack the skills they need to meet these challenges. This course has three goals. The first objective is to give participants a basic grounding in financial literacy: principles of finance that we can use in our own lives. The second objective is to introduce research on the ways in which households use the financial system, emphasizing common financial mistakes and financial products that seem prone to misuse. We will learn to read papers from the academic economics literature, focusing on the papers' central ideas and empirical findings. The third objective is to explore ways in which the financial system can be improved to make it easier and safer to use. We will discuss the role of financial advisers, technological solutions ("fintech"), and public policy interventions including disclosures, default choices ("nudges"), and regulations restricting access to financial products.

Course Prerequisites and Pass-Fail Policy

This course has no prerequisites. There is no cap on the enrollment. Students are welcome to take this course pass-fail.

Learning Objectives

At the end of this course, you will have

1. A basic grounding in financial concepts, with the ability to learn more on your own, and the ability to make simple financial calculations relevant to personal finance.
2. Awareness of the financial circumstances of ordinary American households, based on empirical evidence presented in professional research papers in economics.
3. Exposure to the debate over strategies for building a better personal finance system.

Course Requirements

1. Class participation through attendance at lectures and sections, questions, comments, and class polling using Learning Catalytics software (ungraded).
2. Weekly assignments (20% of the course grade). Assignments will be made available on Canvas each Thursday and will be due by midnight on the following Wednesday. Assignments will not be accepted late without instructor's permission (rarely granted), but grade will be based on best 10 out of 12 assignments.
3. Two in-class midterm exams, on Thursday September 28 and Thursday November 2 (each 25% of the course grade).
4. An in-class final exam on Tuesday December 5 (30% of the course grade).

Required Books

Jack R. Kapoor, Les R. Dlabay, Robert J. Hughes, and Melissa M. Hart, 2023, *Personal Finance*, 14th ed., McGraw-Hill.

Jonathan Morduch and Rachel Schneider, 2017, *The Financial Diaries: How American Families Cope in a World of Uncertainty*, Princeton University Press.

Helaine Olen and Harold Pollack, 2017, *The Index Card: Why Personal Finance Doesn't Have to Be Complicated*, Penguin.

Additional Recommended Books

George Akerlof and Robert Shiller, 2015, *Phishing for Phools: The Economics of Manipulation and Deception*, Princeton University Press.

Richard H. Thaler and Cass R. Sunstein, 2008, *Nudge: Improving Decisions about Health, Wealth, and Happiness*, Yale University Press.

Financial Commentary

Matt Levine's Bloomberg Opinion column Money Stuff, available by email subscription at <http://link.mail.bloombergbusiness.com/join/4wm/moneystuff-signup>.

Course Outline

Part I: What Is Personal Finance?

1: Finance and financial literacy (1 lecture)

- Idea of the course
- What is finance?
- Introduction to household balance sheets
- Financial literacy quiz

Kapoor et al, Chapter 1 (excluding appendix).

Olen and Pollack, Introduction.

John Campbell, 2016, “Restoring Rational Choice”, Ely Lecture to the American Economic Association, *American Economic Review: Papers & Proceedings* 106, 1-30, section I (pages 1-7).

FINRA National Financial Capability Study financial literacy quiz,
<http://www.usfinancialcapability.org/quiz.php>.

2: Planning and budgeting (2 lectures)

- Balance sheets and cash flow statements
- Budgets
- Cost of living and taxes
- Time value of money

Kapoor et al, Chapters 1 (appendix), 3, and 4.

Olen and Pollack, Rule #1.

3: Behavioral finance: what people get wrong (2 lectures)

- Present bias, self-aware and self-unaware
- Commitment devices and mental accounting
- Anchoring and reference points
- Overconfidence
- Financial ignorance and financial mistakes

Sumit Agarwal, John Driscoll, Xavier Gabaix, and David Laibson, 2009, “The Age of Reason: Financial Decisions over the Life Cycle and Implications for Regulation”, *Brookings Papers on Economic Activity*, Fall, 51-101.

John Campbell, 2016, “Restoring Rational Choice”, Ely Lecture to the American Economic Association, *American Economic Review: Papers & Proceedings* 106, 1-30, sections II.A and II.B (pages 9-14).

Ulrike Malmendier and Stefan Nagel, 2011, “Depression Babies: Do Macroeconomic Experiences Affect Risk Taking?”, *Quarterly Journal of Economics* 126, 373-416.

Part II: Making Better Decisions

4: Short-term saving and borrowing (2 lectures)

- The economists’ framework: time preference and consumption smoothing
- The need for an emergency fund
- Banking and savings vehicles
- Forms of short-term credit: bank overdrafts, credit cards, and payday loans
- Credit reports and credit scores
- Debt management

Kapoor et al, Chapters 5 and 6.

Morduch and Schneider, Chapters 1-6.

Olen and Pollack, Rule #2.

Michael Stegman, 2007, “Payday Lending”, *Journal of Economic Perspectives* 21(1), 169-190.

Midterm exam 1 covers sections 1-4

5: Risky financial investments (3 lectures)

- Decisions under uncertainty
- Participation and how much risk to take
- Diversification
- Stocks, bonds, mutual funds, and exchange traded funds (ETFs)
- Alternative investments
- Market efficiency

Kapoor et al, Chapters 13-16.

Olen and Pollack, Rules #4 and #5.

Brad Barber and Terrance Odean, 2000, “Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors”, *Journal of Finance* 55, 773-806.

6: Investing in education and entrepreneurship (1 lecture)

- Student loans
- Risky human capital: equity compensation and partnership
- Financing startups

Kapoor et al Chapter 7 (appendix).

Susan Dynarski, 2017, “The Case for Protecting Student Loan Borrowers”, EconoFact memo, <https://econofact.org/the-case-for-protecting-student-loan-borrowers>.

Neil Swidey, 2016, “Work Hard. Go to College. Get Ahead. ... and Other Bad Advice We’re Giving Low-Income Students.” *Boston Globe Sunday Magazine*, May 22.

Funding a startup: <https://binged.it/3j2Hc01>.

7: Durable goods and housing (2 lectures)

- Rent or lease vs. buy
- Choosing a mortgage
- Mortgage refinancing

Kapoor et al Chapters 8, 9, and 17.

Olen and Pollack, Rule #7.

John Campbell, 2016, “Restoring Rational Choice”, Ely Lecture to the American Economic Association, *American Economic Review: Papers & Proceedings* 106, 1-30, section IV.C (pages 24-25).

8: Saving for retirement (2 lectures)

- The life-cycle framework
- Defined benefit vs. defined contribution pensions
- Retirement savings vehicles

Kapoor et al, Chapter 18.

Olen and Pollack, Rule #3.

Alicia Munnell, Wenliang Hou, and Geoffrey T. Sanzenbacher, 2017, “Do Households Have a Good Sense of their Retirement Preparedness?”, Center for Retirement Research brief, http://crr.bc.edu/wp-content/uploads/2017/02/IB_17-4.pdf

Jonathan Skinner, 2007, “Are You Sure You're Saving Enough for Retirement?” *Journal of Economic Perspectives* 21(3), 59-80.

Midterm exam 2 covers sections 5-8

9: Risk management and insurance (2 lectures)

- Theory of insurance
- Property risks
- Health and longevity risks
- Alternatives to insurance

Kapoor et al, Chapters 10-12.

Olen and Pollack, Rule #8.

Jeffrey R. Brown, Jeffrey R. Kling, Sendhil Mullainathan, and Marian V. Wrobel, “Why Don’t People Insure Late-Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle”, *American Economic Review* 98, 304-09.

Justin Sydnor, “(Over) Insuring Modest Risks”, *American Economic Journal: Applied Economics* 2, 177-99.

Part III: Building a Better Financial System.

10: Conflicts of interest (1 lecture)

- Price dispersion and the reward to shopping
- Complexity and hidden fees (shrouded equilibrium)
- Compensation of financial advisers and salespeople
- Pathologies: frauds, Ponzi schemes, and insider trading

Olen and Pollack, Rule #6.

Dan Bergstresser, 2017, “What is at Stake in the Battle over the Fiduciary Duty Rule?”, EconoFact, <http://econofact.org/what-is-at-stake-in-the-battle-over-the-fiduciary-duty-rule>.

John Campbell, 2006, “Household Finance”, Presidential Address to the American Finance Association, *Journal of Finance* 61:1553-1604, section V (pages 1585-1590).

Claire Célerier and Boris Vallee, 2017, “Catering to Investors Through Security Design: Headline Rate and Complexity”, *Quarterly Journal of Economics* 132, 1469-1508.

Council of Economic Advisers, 2015, “The Effects of Conflicted Investment Advice on Retirement Savings”, https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf.

Sendhil Mullainathan, Markus Noeth, and Antoinette Schoar, 2012, “The Market for Financial Advice: An Audit Study”, National Bureau of Economic Research Working Paper 17929.

11: Financial education and financial technology (2 lectures)

- Alternative financial education curricula
- Evidence of educational effectiveness
- Technology: robo-advisers, mobile borrowing and investing, cryptocurrencies

Council for Economic Education, 2013, National Standards for Financial Literacy, <http://councilforeconed.org/resource/national-standards-for-financial-literacy/>.

Justine Hastings, Brigitte Madrian, and William Skimmyhorn, 2013, “Financial Literacy, Financial Education, and Economic Outcomes”, *Annual Review of Economics* 5, 347–73.

Annamaria Lusardi and Olivia S. Mitchell, 2014, “The Economic Importance of Financial Literacy: Theory and Evidence”, *Journal of Economic Literature* 52, 5–44.

12: Disclosures and nudges (1 lecture)

- Principles for disclosure design
- Theory of nudges
- Retirement savings defaults: a success story
- Overdraft protection: a cautionary tale

Marianne Bertrand and Adair Morse, 2011, “Information Disclosure, Cognitive Biases, and Payday Borrowing”, *Journal of Finance* 66, 1865-1893.

George Loewenstein, Cass Sunstein, and Russell Golman, 2014, “Disclosure: Psychology Changes Everything”, *Annual Review of Economics* 6, 391-417.

John Beshears, David Choi, David Laibson, and Brigitte Madrian, 2008, “The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States”, in S.J. Kay and T. Sinha eds. *Lessons from Pension Reform in the Americas*, Oxford University Press, 59-87 (www.nber.org/chapters/c4539.pdf).

Cass R. Sunstein, 2016, “Nudges that Fail”, unpublished paper, Harvard Law School.

(Optional: Richard H. Thaler and Cass R. Sunstein, 2008, *Nudge: Improving Decisions about Health, Wealth, and Happiness*, Yale University Press, Chapters 1-8.)

13: Consumer financial protection (1 lecture)

- Theory of paternalistic intervention in financial markets
- The history and politics of the Consumer Financial Protection Bureau
- Examples of successful consumer financial protection

Olen and Pollack, Rule #9.

Elizabeth Warren, 2007, “Unsafe at Any Rate”, *Democracy* (5),
<http://democracyjournal.org/magazine/5/unsafe-at-any-rate/>.

Jeb Hensarling, 2017, “How We’ll Stop a Rogue Federal Agency”, *Wall Street Journal*,
February 8.

John Campbell, 2017, “Consumer Financial Protection: In Need of Protection”, EconoFact
memo, <http://econofact.org/consumer-financial-protection-in-need-of-protection>.

Final exam covers sections 9-13 as well as earlier material