Study of Life Cycle Stage and Standard of Living as Determinants of Wealth Creation

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The research attempts to study the consumer behaviour, theories defining investment decision making aspects and its influence on saving and asset building. The research attempts to understand how an individual seeks economic security at each stage of life, generates income. The research indicates that to maintain a standard of living throughout the life cycle stage the individual's capacity to earn and spend changes. Also, as the individual advances in life cycle, the responsibilities increase and life goals and priorities change. The research joints the dots through the behavioural concepts and indicates how wealth creation happens for an individual.

Keywords*:* Economic Security, Standard Of Living, Life Cycle Stage, Wealth Creation

1. Introduction

Wealth creation is a continuous process of a long duration. An individual's wealth may include wealth inherited from the family and the wealth that he has 'built' over a period of time. Wealth is ones ownership created out of the earnings in a life, which an individual uses and treasures for personal need, satisfaction, safety, luxury and future. Also, wealth addresses many aspects like growth and income, risk and return, spending and security and wealth transfer and wealth control. *Patrick Sullivan, David Lazenby (2002).* Thus wealth is something which is left out of total assets of an individual after deducting liabilities.

Wealth creation process is guided by numerous factors. Demographic, socio-economic, cognitive and emotional factors are few which influence wealth creation process. Life cycle of an individual changes along with the situations like earning capacity, spending requirements, saving habits, investment priorities and wealth creation. Each stage of life cycle has a different set of responsibilities and requirements, which influences an individual's wealth creation. Also, standard of living changes with the life cycle, as the standard of living changes, the wealth creation perspectives also change.

2. Concept of Wealth and Determinants of Wealth

"If you earn a good income each year and spend it all, you are not getting wealthier, you are just living high," says Thomas J. Stanley and William D. Danko, co-authors of *The Millionaire Next Door*

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2.1 Concept of Wealth

Wealth is ones ownerships created out of earnings in a life, which an individual uses and treasures for personal need, satisfaction, safety, luxury and future. Wealth addresses many aspects like growth and income, risk and return, spending and security and wealth transfer and wealth control. *Patrick Sullivan, David Lazenby (2002).* Thus wealth is something which is left out of total assets of an individual after deducting liabilities.

Also, financial characteristics, such as income and asset ownership, are also associated with saving and wealth. *Acs and Danzinger (1993)* defines the total income as various forms of asset ownership as the combination of different assets built by the investor and the savings accumulated throughout an individual's life.

Wealth creation is a systematic plan which starts from setting financial goals of an individual, to deciding the time horizon for which one is ready to cease investment and start enjoying the money invested. According to *Rita D. Conley (2009),* financial wealth requires an accumulation of assets. Assets are items that a person owns and which holds a certain value. Asset that grows- irrespective of the pace of growth, can be termed as wealth. *Rita D. Conley (2009)* concluded that acquiring assets that earn money or appreciates in value over the time; can accumulate wealth for an individual. Thus assets like an individual's investments which are income-producing assets such as savings accounts, retirement plans, rental property and other investment products like stocks and bonds are wealth creating assets.

As discussed by *Patrick Sullivan, David Lazenby (2002),* wealth planning involves merging of the disciplines of accumulation and distribution. It addresses the three most critical issues of wealth planning; first being creating, followed by growing and preserving wealth and saving or preserving. Growing and preserving the wealth means creating wealth for the life as it moving ahead to meet the increasing needs. Saving or preserving of wealth involves securing the period of life when the earnings are shrinking and expenses are increasing.

The research by *Patrick Sullivan and David Lazenby (2002)* addressed the dilemma arising at three different stages of life cycle. The first being an individual's dilemma of accumulating enough for the later stages, the second stage being the planning for the maximization of wealth to support the lifestyle and other objectives and the third being planning for the distribution of wealth at death.

2.2 Determinants of Wealth

2.2.1 Savings

The concepts of saving and asset building are of great importance to the individuals, the households and to the country's economy, due to which they are of immense interest to policymakers and scholars across disciplines. The savings rate of a country has been found to be strongly correlated with investment and growth rates *(Attanasio & Banks, 2001).* From the economy perspective, it is one of the drivers of sound financial system of a country. Savings and assets are important because, unlike income, they are what individuals and families accumulate and own over time *(Chowal, Masa1 and Ansong, 2012).* From the perspective of individuals and household, the mechanism decides the economic security for the entire life span as it relates income, savings and the asset owned. The volume of saving decides the investment level for an individual which relates to the wealth creation theory.

Warneryd *(1999),* defines saving as difference between net worth at the end of the period and the net worth at the beginning of the period. Also, while investment is the single most factors for the development of wealth, it is savings which provides the basis for investment *(Bhardwaj, N Sharma, & D Sharma, 2013).* Savings appears to be crucial variable indicating the capacity or willingness of an individual to forego current consumption by channeling a part of the resources for wealth creation. As discussed by *Bhardwaj, N Sharma, & D Sharma, (2013),* investment in its broadest sense means the sacrifice of certain present value for (possible uncertain) future value.

2.2.2 Income and Age

Economic theories put primary emphasis on the level of income and the age of the individual investor as predictors of saving and wealth accumulation. Among other factors, the age of the head of the family also influences the investment pattern and wealth creation of the family *(Modigliani & Ando, 1957).* Also, the age of the dependents also influence the level of savings and investment; where in the researchers found that the percentage of young dependents had a negative effect on savings, thus reducing the level of savings, whereas, the percentage of the elderly had a significant positive effect on savings *(Bersales & Mapa, 2006).* The young dependents increase the expenditures whereas elderly dependents play the role of a facilitator.

2.2.3 Education

With higher education, the employability improves which provides better earning possibilities. Thus, the level of education has been found to be a significant predictor of savings and wealth creation *(Kibet et al., 2009; Bersales & Mapa, 2006).* Supporting the same theory occupation, which can be predicted by a person's level of education, is also found to be a significant predictor of savings (*Kibet et al., 2009).*

2.2.4 Other Determinants

Behavioural economists and economic psychologists have discussed the role of self-control, motives, and other personality characteristics on saving and wealth building behaviour of individuals *(Katona, 1975; Thaler & Shefr in, 1981; Warneryd, 1999).* Social stratification also influences the wealth creation of an individual; which has been supported by the research work of *(D'Souza (1981)* and *Sorensen (2000),* who emphasized on the role of social stratification in influencing the saving and asset accumulation of an individual. *Barnewall (1987)* adds that an individual investor's investment behaviour can be segregated on the basis of lifestyle characteristics, risk aversion behaviour, control orientation and occupation.

Statman *(1988)* provides deeper understanding of the rationale of consumer behaviour, the cognitive process as well as the emotional state which influences an individual. *Statman (1988)* observed that individuals involve in investment behaviour for both cognitive and emotional reasons. Their behaviour results out of the thought that they think they have information and it adds to their self-satisfaction and joy thinking about the benefit that the investment will bring to them. The consumers experience fear and feel unsafe when they think of an uncertain situation. It comes naturally that humans prefer to stay in 'familiar' situations. Thus the consumers stay away from situations that make them feel unsafe.

3. Life Cycle Stage and Wealth Creation

The perception of individual towards investment and wealth can be understood from three different perspectives namely neoclassical economics, economic psychology, and behavioural economics. *(Chowal, Masal and Ansong, 2012).*

The neoclassical economic theory is based on the assumption that the individuals are rational beings and have perfect knowledge and access to perfect markets. It includes two prominent neoclassical economic theories include: 1) the Life Cycle Hypothesis (LCH; *Modigliani & Ando, 1957)*; and 2) the Permanent Income Hypothesis (PIH; *Friedman, 1957).* Both theories assume that individuals and households are concerned about long-term consumption opportunities and therefore, explain saving and consumption in terms of expected future income. Thus the saving and consumption decisions are extremely influenced by the future scenario. The individuals are concerned about the future income; which they want to be stable and secure. Thus the desire to have a secured future affects their present saving and consumption patterns. The Life Cycle Hypothesis (LCH) proposes that savings will smooth consumption whereas income varies by age. Thus concluding that savings regularly and considerably is important as income is not going to be constant throughout the life. A main idea of the Life Cycle Hypothesis (LCH) is that working people are savers, whereas children and retired people are not. Thus, differences in consumption and saving among households are attributed to age differences *(Modigliani & Ando, 1957).* When an individual is working, he/she uses their income to provide for the household consumption, while at the same time they are saving to build a fund to be utilized when they retire.

On the other hand, the PIH (Permanent Income Hypothesis) suggests that savings decisions are based on income being perceived as either permanent or temporary in nature. Households mainly spend the permanent income, while the temporary or transitory income is channeled into savings. Individuals may find it difficult to manage the consumption pattern in a given permanent income. Easing this issue, one very important contributor to consumption pattern is the ability to borrow funds to smooth the consumption requirement *(Friedman, 1957).*

The life cycle stage influences the risk bearing capacity of an investor. A good number of educated investors in the later stage of their life cycle prefer to have a safe investment structures in terms of their future requirement, thus prefer to take moderate risk *(Rajarajan, 2000; Ranjith, 2002; and Singh, 2003).*

The life cycle hypothesis proposes that consumption and saving patterns of an individual is strongly related to the stage an individual is in the life cycle, which is generally related to the age. *Modigliani and Ando (1957),* and *Modigliani and Brumberg (1954)* supported the theory of consumption and income, relating it to life cycle stage of an individual. They proposed that at each stage the consumption varies and so does the income. During early stages the consumption is high as the individual has started fulfilling the financial responsibilities; on the other hand the income though initially low, is consistent. Young households are expected to have negative saving since they typically have relatively low earnings and incur debt for education, home purchase, and other expenses. As the individual proceeds ahead in the life cycle, the added responsibilities and desire for better standard of living increases the consumption; at the same time the income also increases. During this period the saving is expected to be positive because individuals pay their debts and begin to save for retirement. During the later stage of life cycle for most people, is the most substantial and enduring "income fluctuation," period. The retirement stage, the individuals are expected to spend money saved previously. Thus, differences in consumption and saving among households are believed to be partly the product of age differences, and the pattern of saving and spending which creates an inverted U-shaped pattern *(Ando and Modigliani 1963; Modigliani and Ando 1957; Modigliani* and *Brumberg 1954).*

3.1 Criticism to the Neoclassical Economic Theory

Rosenzweig (2001) presented that although research works suggest that neoclassical economic theories can predict savings behaviour of households in developing countries, the application of LCH (Life Cycle Hypothesis) and PIH (Permanent Income Hypothesis) to explain savings behaviour of low-income households in developing countries can be problematic. The argument being that the base assumption of PIH (Permanent Income Hypothesis) that households are freely able to save and borrow to smooth their consumptions may not be true in developing countries where low-income households have very limited access to a well-developed insurance and credit market. Adding to it, differentiating permanent income from temporary income may not be apparent in many parts of the developing countries where household income is nominal and irregular.

Furthermore, the LCH (Life Cycle Hypothesis) may not be effective in predicting long-term savings in low-income settings in developing countries because many households, particularly rural households, include more than two adults, and adults of different generations. Since the life-cycle of the household (where the age life cycle of all family members are different) is not the same as the life-cycle of the individual, it is not clear whose age matters for savings decisions. This argument was supported by Deaton & Paxson (2000).

The insertion of psychological factors on savings research has been the subject of interest and investigations by early economic thinkers such as Jevons (1965) and Marshall (1961). Although they recognized that savings depend on economic factors, particularly income and its size and frequency, they also believe that there are various psychological characteristics that influence the temptation to spend the income by foregoing saving. Although fewer research have been done on psychological determinants of saving behaviour, there are some established psychological models on savings behaviour which includes those by Katona (1975), Olander and Seipel (1970), and Lindqvist (1981).

Katona (1975) defines the theory of saving behaviour as partly determined by income and partly by some independent intervening factors. The two important factors are the 'ability to save' and 'willingness to save'. Ability to save refers to those who can save; which means an individual's capacity to save after bearing all the day-to-day expenses, whereas willingness to save is related to the degree of optimism or pessimism of economic conditions wherein the individual may have the ability to save but the decision to save depends on many independent factors. Thus, ability to save does not ensure savings because savings also depend on an individual's willingness to save.

Lunt & Livingstone (1991) discusses the evidences that suggest that personality characteristics, including optimism and pessimism about economic condition influence the saving behaviour of an individual investor. The personality characteristics like confidence, ability to take risk, level of involvement and approach towards the investment opportunity, plays an important role in investment decisions of an individual. Also, the perceived locus of control (Perry & Morris, 2005), perceived ability to save (Sherraden, McBride, & Beverly 2010), and future orientation (Webley & Nyhus, 2006) are associated with saving behaviour.

4. Standard of Living and Wealth Creation

While studying the individual behaviour towards wealth and notion of wealth building, social stratification theory needs to be taken into consideration. Society is made by the people who live with each other. Each society has a different set of characteristics, which are a result of an economically conditioned power called classes. People prefer to stay with a group which is similar to them from many perspectives and most importantly from the economic situation or position (D'Souza, 1981; Weber, 1967). Also, class and social stratification explains the factors affecting savings behaviour. Among households, class relates to the possession or lack of possession of resources (economic or otherwise) which may be necessary for individuals and households to save and build their assets. Each individuals and families have different level of access to information, resources, and services that can help them save and accumulate assets over time.

An individual seeks economic security and well-being for oneself and the family at each stage of life. As explained by Beverly et al. *(2008),* an individual generates income; which is a resource generated out of his effort or returns earned from the capital he holds. To sustain or to maintain a standard of living, the earned income is utilized on the current consumption requirement.

5. Conclusion

Individuals, even though differ from each other on many parameters, they do make an effort to save some portion of the income earned, which is their savings. These savings is invested by the individual in different investment options which may generate desired return for them. The investment choices made by the individual may vary on the basis of age of an investor and objectives of investment. Thus the asset becomes a source of present and future consumption and provides security for the contingencies that may arise in the future scenario of uncertainty. As the process of accumulating and investing results in wealth creation, the asset creation decisions taken by individuals can help them to increase their economic horizon through thoughtful decisions (Beverly, 2008).

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