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Financial Knowledge Overconfidence and Early Withdrawals from Retirement Accounts

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Sunwoo T. Lee (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=2872550)
York University

Sherman D. Hanna (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=1202897)
Ohio State University (OSU)

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Abstract


Early distributions from retirement accounts could endanger future retirement income security, and the U.S. has restrictions to discourage them, including possible tax penalties. On the other hand, tapping one's retirement assets may be rational when an individual encounters financial hardship. With the 2020 Coronavirus Aid, Relief, and Economic Security Act (CARES Act), early distribution from retirement accounts became an even more attractive option to individuals. In this study, we examined factors related to individuals' decision of taking hardship withdrawals and plan loans, focusing on financial knowledge and overconfidence in financial knowledge, using the 2018 National Financial Capability Study dataset. We found evidence that people may be making early withdrawals without understanding possible consequences. Objective financial knowledge was negatively related to hardship withdrawals and plan loans, but the subjective assessment of financial knowledge was positively related to hardship withdrawals. Respondents with financial knowledge overconfidence (high subjective and low objective knowledge) were more likely to take early withdrawals than those with other combinations of objective and subjective knowledge. We discuss implications for public policy and financial education and advice.

Keywords: early withdrawals, financial knowledge, hardship withdrawals, overconfidence, retirement plan loans

JEL Classification: D12, D14, G41, G51, G53

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