Improving Retirement Saving Using Behavioral Economics

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The Making of Behavioral Economics

MISBEHAVING

The Three Savings Crises in Illinois

1. Underfunded public pension plans.

2. Participation and savings rates in DC plans are too low.
3. Some workers (2.5 million?) do not even have access to workplace savings.

All require attention. The Illinois Secure Choice Plan is aimed at problem 3.

Why don't people save enough?

- Some are so poor they have trouble even paying the bills.
- But even for those who could afford to save, we know that saving can be difficult.
- What does behavioral economics have to say about this problem?

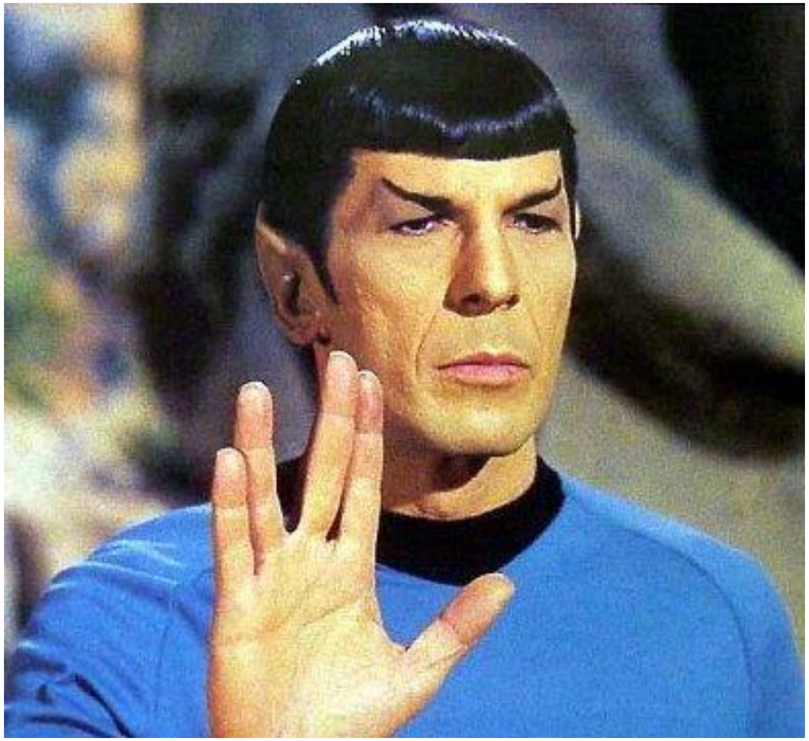
What is behavioral economics?

The phrase "behavioral economics" appears to be a pleonasm. What "non-behavioral" economics can we contrast with it? The answer to this question is found in the specific assumptions about human behavior that are made in neoclassical economic theory.

– *Herbert Simon*

- The core assumption of classical economics is that agents choose by optimizing.
  - Is that accurate?

Econs and Humans



How do Humans differ from Econs

- Humans can find figuring out how much to save and how to invest daunting.
- Humans have self-control problems.
  - We eat too much.
  - We exercise too little.
  - We consumer now rather than put money away for latter.
- How can we help?

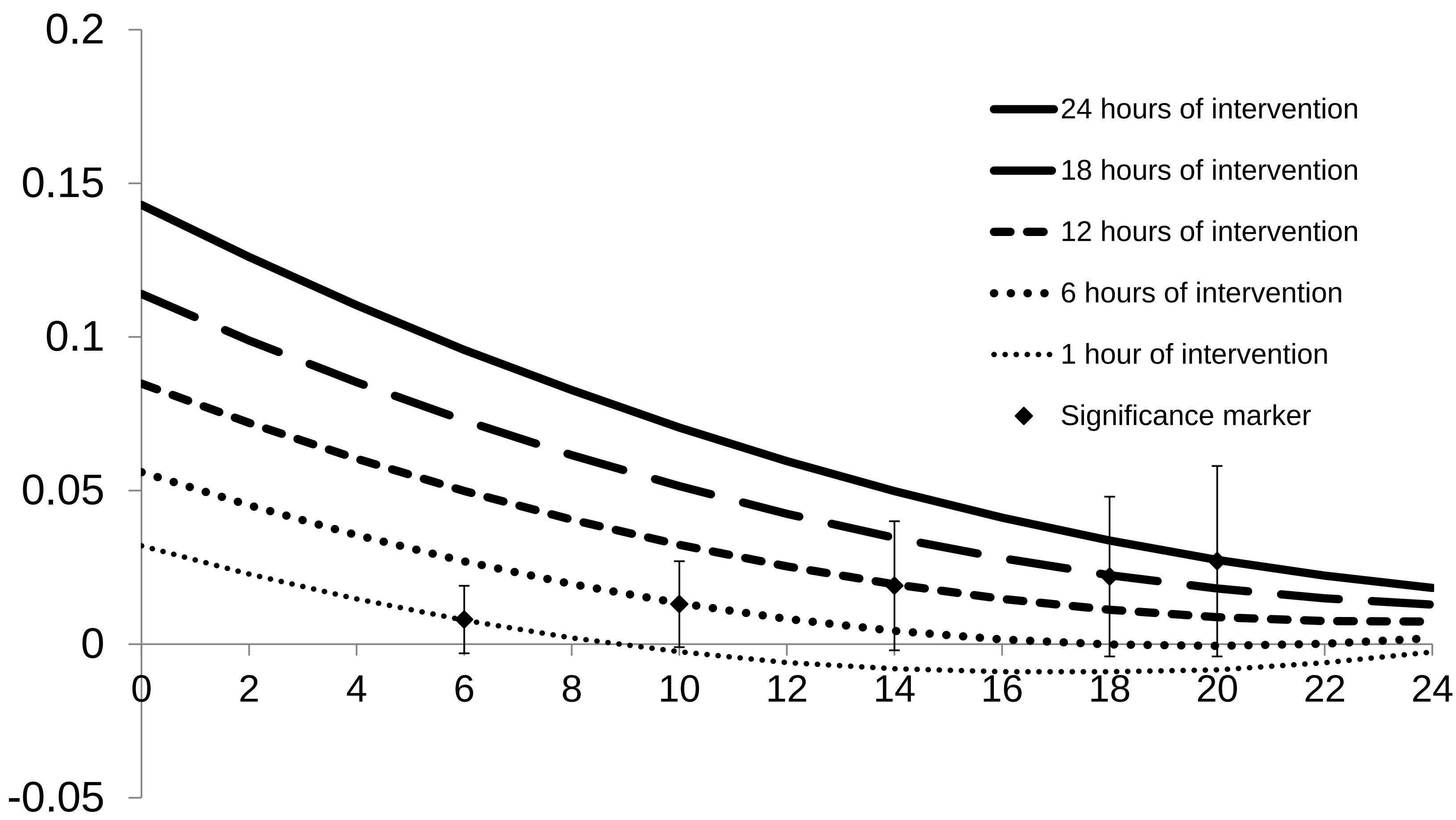
What About Financial Education?

- Financial literacy is dreadful.
  - Many don't know the difference between a stock and a bond.
  - Many think one stock is safer than a mutual fund.
  - Many think that investing in the firm where they work is safer than in a mutual fund.
- So including financial literacy in high school curricula is certainly useful.
- Compound interest at least as important as trigonometry.

However, …

- There is NO evidence that financial education improves outcomes.
- New meta-analysis of 168 papers on the efficacy of financial education on financial actions finds tiny effects.

Intervention Decay: The Case for "Just-in-time" Financial Education



So What to Do Instead

- My mantra: if you want to encourage someone to do something, “**Make it Easy**”.
  - Find out what the barriers are to people accomplishing their goals, and then remove them.
- For retirement saving we know that the only effective way that non-wealthy Americans save is at the workplace.
  - If you don’t see it, you don’t spend it.

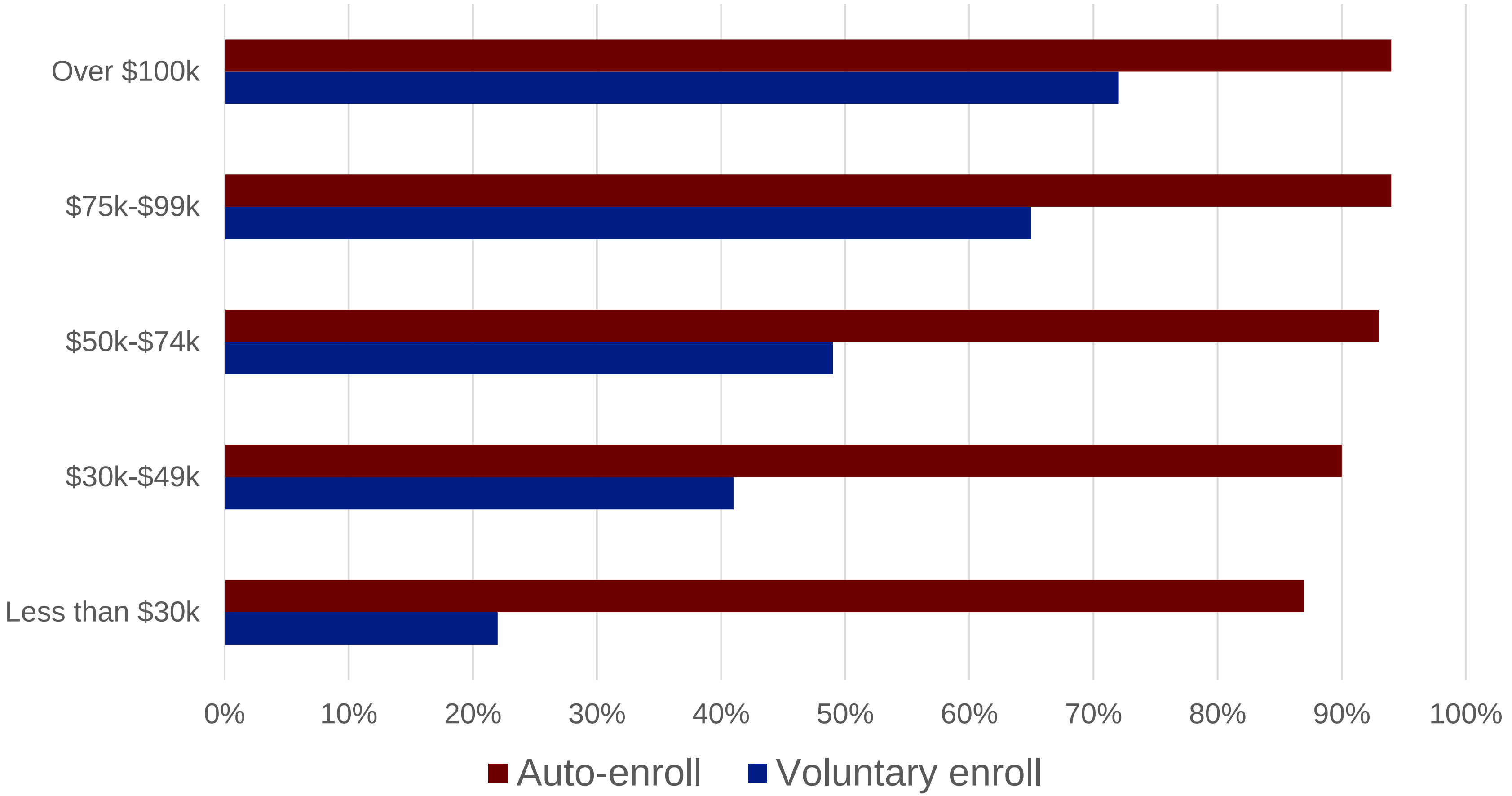
First Step: Make it Easy for Employers

- Starting a 401(k) plan can be a costly nuisance.
- The plan sponsor has a fiduciary responsibility to assure the plan is managed appropriately.
- This scares off many small firms.
- The Secure Choice plan solves this problem by centralizing the administration.
- Any payroll service company should be able to add this easily.

Next Step: Make it Easy for Workers

- Automatic enrollment is essential.
- Opt out rates around 10% but no one is forced to do anything.
- This is being successfully implemented nation-wide in the UK.

Participation rates by employee income (Vanguard Defined Contribution plans)



*Vanguard

But We Need to Do More

- The default saving rate of 3% is too low.
- We should add automatic escalation or Save More Tomorrow.
  - Increase contributions 1-2% every year until some cap is reached.
- More than 50% of all large employers in the U.S. now use both automatic enrollment and automatic escalation.
- Still, this is a great start.