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Economics focus

Pensions by default

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Behavioural finance offers a tempting alternative to voluntary and forced saving for old age

GOVERNMENTS around the world want workers to save more for their pensions. Alarmed at the impending strains on public budgets as the post-war baby-boom generation nears retirement, they are anxious to limit the load on already stressed tax-financed pay-as-you-go pension systems.



But in turning this policy goal into reality they face an awkward dilemma. Left to their own devices, many workers do not save enough for their retirement, if they save at all. Exhortation falls on deaf ears; even generous tax incentives are ignored. But if the voluntary approach is ineffective, compulsion is an invidious alternative. Although individuals will control the savings they are forced to make, many will resent mandatory contributions and regard them as a tax increase.

Politicians would love to avoid this dilemma. Fortunately for them, economists are now offering them a way to do that: simply make enrolment into funded pension schemes automatic. At present, most workers have to opt in to retirement-saving plans. With automatic enrolment, they have to opt out. This flick of the switch makes pension saving the default option while retaining the voluntary principle.

The simplicity of the policy is deceptive. It is grounded in some quite subtle findings of behavioural finance. This branch of economics, which draws upon psychology and experiments, shows that people are not always rational, especially when it comes to saving. Although they may want to save for old age, they never get around to it because they lack the self-control to put their good intentions into effect in the short term.

The economic interpretation of this tendency to procrastinate is that in trading off present and future consumption people apply a higher discount rate in the short term than in the long term, rather than the same rate assumed in mainstream economics. Given the choice between \$1,000 now and \$1,100 next year, an individual may well take the money at once. But, asked to choose between \$1,000 in 2025 and \$1,100 in 2026, the same person might choose to wait a little longer for the larger sum.

Behavioural finance also shows the surprising extent to which people are swayed by the way that choices are framed. If, when they come to invest, most of the funds offered by the retirement plan are equities, then they will put most of their savings into stocks. If, on the other hand, most of the funds offered are bonds, then they will put most of their money into bonds.

What this suggests is that re-framing decisions about retirement saving through better-designed default rules

can be surprisingly effective. Automatic enrolment puts the onus on the worker to opt out rather than to opt in. This is a change of form rather than substance. Yet in one American firm, this switch raised the enrolment rate into its 401(k) plan—the main vehicle for employer-sponsored retirement saving—from 49% of newly eligible employees to 86%.

Save more today

Once workers are enrolled, pre-commitment can be used to raise saving rates. For example, Richard Thaler, of the University of Chicago, and Shlomo Benartzi, of the University of California, Los Angeles, have proposed a programme (called "Save More Tomorrow") that makes use of the lower discount rates people apply to future saving decisions than to those in the present. A study of one firm by Mr Thaler and Mr Benartzi has shown that pre-commitment by workers to allocate a portion of their future pay rises to their pensions raised their average contribution rate from 3.5% of pay to 13.6% over a 40-month period.

The success of such private-sector schemes is prompting interest among government reformers too. New Zealand is leading the way. From April 2007, all new employees will be automatically enrolled into "KiwiSaver", a retirement-saving scheme run by the tax authority, at a default contribution rate of 4% of pay. Workers have three weeks to opt out. If they stay in, they can take contribution breaks. They can save at a higher rate of 8% and choose a fund manager, although there will also be a default option for their investments.

Britain may follow New Zealand's lead. An independent commission reviewing the country's troubled pension system has been considering compulsory savings. However, the government is already taking steps to encourage automatic membership of company pension schemes. A more ambitious national programme, along the lines of New Zealand's reform, could be a politically alluring alternative to compulsion when the commission reports at the end of November.

There are potential snags. American companies that put new employees automatically into 401(k) plans generally choose a low contribution rate and a safe but low-return investment fund. This is because they want to avoid blame if things go wrong. If governments press for retirement saving by default, they will have to wrestle with this conundrum as well.

Furthermore, it is uncertain whether individuals will respond to a national scheme with the same readiness that they do to corporate plans. One interpretation of workers' responsiveness to employer-sponsored automatic enrolment is that they see it as an endorsement by the company—which is, of course, precisely the worry that many firms have about it. But the evidence, in Britain at least, is that employees in occupational schemes are much more likely to trust employers about pensions than they are governments.

These snags are unlikely to put politicians off. After all, in formulating pension policy they are also susceptible to the psychological flaws highlighted by behavioural economics. The temptation is always to procrastinate. Not the least of the attractions of automatic enrolment is that the policy addresses the politics as well as the economics of pension reform.