Shifting Our Retirement Savings Into Automatic

By RICHARD H. THALER

MANY problems are so complex that even if we had the money to fix them, we wouldn’t know how to do it. Fixing inner-city schools, reducing obesity, creating peace in the Middle East are just a few examples.

But some problems are frustrating in another way: we know how to fix them and we can afford to fix them, but we drop the ball. That’s the situation with a crisis facing many Americans: saving enough for retirement.

Here is one measure of the problem: A Boston College economist, Alicia H. Munnell, and her colleagues have estimated that more than half of Americans are saving too little to support an adequate lifestyle if they plan to retire at 65. Why is the situation so serious? One reason is that traditional pension plans — in which employees have almost no decisions to make — are being supplanted by defined-contribution plans like 401(k)’s. In these plans, employees have to decide for themselves how much to save and how to invest their money. For many people, being asked to solve their own retirement savings problems is like being asked to build their own cars.

To fix this, we need to do two things. First, make payroll retirement savings plans available to everyone. Then, add empirically proven design features to them, making it easier for workers to make good choices. In other words, improve the plans’ choice architecture.

Payroll savings plans are vital because they are essentially the only way that middle-class Americans reliably save for retirement. Your grandmother probably knew that the best way to save is to put money aside before you have a
chance to spend it. That approach has always worked — and is a core idea embedded in these plans.

In the past, homeowners used another form of forced saving, building home equity by paying off their mortgages. But the ease of refinancing has eroded the norm that people should pay off these loans by the time they reach retirement age. Among households with someone over 60, mortgage debt has grown drastically in recent decades. (Here’s a savings tip: If you are over 45, use today’s low interest rates to refinance with a 15-year mortgage.)

Given the importance of payroll savings, it’s alarming that only about half of the American work force has access to a retirement savings plan in the workplace — and that number falls to 42 percent in the private sector, according to Boston College research.

The Obama administration has proposed a simple solution to this problem: the automatic I.R.A. This plan, originally proposed by scholars at the Brookings Institution, would require any employer that doesn’t offer its own plan to enroll workers automatically into individual retirement accounts, with the option to opt out. The burden on employers would be tiny, and the benefit to workers could be life-changing.

The concept puts to work part of what we behavioral economists, along with industry experts, have learned about effective 401(k) retirement plans over the past couple of decades. The operative word common to many best practices is “automatic.”

When employees are first eligible for a retirement savings plan, they should be enrolled unless they choose to opt out. This solves the procrastination problem that keeps roughly a fifth of workers who are eligible for a plan from joining, even when the employer is matching some of their contributions. Companies that adopt automatic enrollment find that few employees opt out initially, or later.

But we should move beyond automatic enrollment alone. That’s because most companies set a low default savings rate for new enrollees, often at just 3 percent of their income. Of course, employees can choose a different, higher rate, but many just accept the default percentage and stay with it indefinitely.
My colleague Shlomo Benartzi, a business professor at the University of California, Los Angeles, and I devised a successful solution to this problem that we call Save More Tomorrow. Under it, a worker can join a plan in which their savings contributions are increased, say, one to two percentage points a year, each time the employee gets a raise. In the first company that tried this plan, the savings rate more than tripled in three years.

Some companies find that linking savings increases to pay increases puts a burden on their payroll and human resource departments. Such companies can avoid this problem by using a generic version of the plan, called automatic escalation, that steps up savings rates each year until the employee hits a predetermined maximum.

In a recent report in Science magazine, Professor Benartzi and I estimated more than four million people were using some form of automatic escalation, and had collectively increased annual savings in the United States by over $7 billion a year. This is significant progress, but we could do much better.

Many employees don’t know that their workplace has such an option, and finding out how to enroll can be hard. This helps explain why only 11 percent of eligible workers have signed up for it. Promoting automatic escalation and making sign-up easy, or even automatic (with the ability to opt out, of course), could greatly increase enrollment. In our original study, in which a financial adviser was available to explain the plan and, importantly, fill out the appropriate forms, nearly 80 percent of workers who were offered the plan took it.

THE third piece of the automatic plan involves investments. Retirement savers tend to be relatively passive investors, often sticking with whatever asset allocation they selected on the day they joined the plan. But those who do make changes often do so at exactly the wrong time: they buy high and sell low.

Although the stock market has doubled in the past few years, 401(k) investors have collectively been selling stocks to buy bonds during this period. (Note that in January this year, there was a sharp reversal, with investors pouring money into stocks. This might make some trend watchers nervous about future stock market returns!)
A solution to bad market timing is to offer a default investment vehicle, like a target-date mutual fund, that automatically rebalances an investor’s portfolio, both cyclically as the market rises and falls, and as the client ages, reducing stock holdings as retirement approaches. Of course, it is essential that these target-date funds have reasonable fees.

For evaluations of how corporate plans stack up, consider the ratings offered by services like BrightScope.com. If you aren’t happy with what you find, complain to your company’s management. And if you are part of management, get busy.

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