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What We Know About Retirement Savings: Why Strategic Behavioral "Nudges" Make Sense

By Angela M. Antonelli and Yijun Yin

A majority of Americans report a lack of confidence in their ability to prepare adequately for their own retirement. If they can put money away for retirement, they often do not take the time to understand how much they will need to save and, even if they do, are fearful they will never be able to save enough to last a lifetime and will need to keep working longer.

What we have come to expect from workers planning for retirement has changed significantly and not necessarily for the better. When traditional defined benefit (DB) plans were more common, a worker would make regular payroll deduction contributions to the employer who, in turn, would rely on investment experts (e.g., a Chief Investment Officer and staff) to manage and invest the funds. In doing so, these experts would worry about things like investment returns, rebalancing the portfolio, keeping fees low, and pooling risks such as longevity in order to do the best to provide the worker with a guaranteed retirement benefit.

As traditional DB benefit plans have been replaced by the much more common defined contribution (DC) systems of retirement savings, workers, if they even have access to a way to save through their employer, must now perform many of the financial tasks previously handled by the employer and its team of investment experts. For many Baby Boomers and future generations, we have to be our own Chief Investment Officers with the ability to make all the right choices.

Some will argue that this is not an unreasonable expectation, although study after study would suggest humans do not always act in their own best interests and even if they are inclined to do so, they often do not have either the information or the knowledge to be able to make informed decisions. If the pipes burst in your house, no one would expect you to repair them yourself. Car breaks down? Bring it to the mechanic. Want to build your house? Hire an architect and construction team. But when it comes to one of the most important financial decisions an individual can make – how to save and invest for retirement – we are left on our own.

Unfortunately, while economic theory tells us humans will act to maximize their well-being, a new generation of economic theory – behavioral economics – has evolved to help us understand why this is rarely the case and why policymakers might want to

consider some techniques, tools, and nudges that can help improve individual well-being.

Being Human, "Misbehaving" and Overcoming Behavioral Barriers

There are many reasons why individuals do not always act in their best interests when it comes to saving for retirement. In his book "Misbehaving – The Making of Behavioral Economics," economist Richard Thaler outlines three reasons why people often fail to save for retirement: 1) inertia or failure to act, which explains why people do not begin to start saving even when they have the opportunity; 2) loss aversion, which explains why people avoid taking actions perceived as reducing their paycheck; and 3) the lack of self-control that contributes to choosing actions that provide immediate gratification rather than planning for the future.

Because of these natural behavioral factors, a defined contribution retirement savings program often fails to overcome the following behavioral barriers and leads to less than optimal outcomes:

- **Lack of Access to Employer-Based Retirement Savings Plans.** For low- and moderate-income workers, contributing anything toward retirement is difficult because they may have student loan debt and struggle to cover day-to-day living expenses. Not having easy access to a retirement savings program makes it even more difficult to save. According to the U.S. Government Accountability Office (GAO), 84 percent of the workers who do not participate in workplace retirement savings programs reported that the main reason was not having access to a workplace retirement program, rather than a failure to participate.

- **Short-Term Horizons.** Workers at all ages and income levels are present-minded when making financial decisions. This leads them to weigh the present more ("present bias") than the future and make investment decisions today that reduce their welfare in the future. For example, individuals tend to be more concerned about day-to-day financial needs than their future financial plans. In addition, if the decision is a complex one requiring the evaluation of many alternatives, such as having to choose from a large number of different investment funds offered by their employer as part of a retirement program, inertia takes over and they may simply never take action.

- **Limited Financial Knowledge**. Not being able to understand the ABCs of finance makes the case even worse. Individuals who lack the knowledge of basic financial terms, such as compound interest are much less likely to save for retirement. In the United States, a large majority of individuals fail to understand critical financial concepts, and the situation is even worse for millennials. The importance of financial literacy has been addressed by the President's Advisory Council on Financial Literacy: "While the crisis has many causes, it is undeniable

that financial illiteracy is one of the root causes … Sadly, far too many Americans do not have the basic financial skills necessary to develop and maintain a budget, to understand credit, to understand investment vehicles, or to take advantage of our banking system. It is essential to provide basic financial education that allows people to better navigate an economic crisis …" As the GAO recently reported, without proper knowledge to figure out the numbers, a lack of information, overwhelming information, or information that is difficult to understand could all result in workers over- or under-estimating how much they need to save, to give up on saving, or unknowingly save too little.

Strategic Behavioral Nudges Make Sense

Behavioral nudges have attracted the attention of both the public and private sector. The White House has highlighted the value of bringing behavioral science insights to improve program outcomes. The Illinois Secure Choice Program and Aspen recently collaborated on how behavioral nudges can be used to improve retirement program design. According to Forbes, employers are increasingly concerned about their workers' financial well-being and are taking steps to help them better prepare for retirement.

What are some of the ways policymakers can make better use of behavioral tools and nudges:

- **Expand Employer-Based Savings.** AARP reports that workers are 15 times more likely to save if they have access to retirement savings plans through their employers. The lack of access to a workplace-based savings plan leaves an individual alone to navigate an array of complex financial products and options, uncertain about what they should choose. Too often the end result is the failure to take action and to never start to save. Research has shown when employees are offered a plan, about 70 percent voluntarily participate; when workers are automatically enrolled in a plan, with an option to opt-out, participation jumps to about 90 percent.

- **Keep it Simple, Easy, and Make the Default Automatic.** Behavioral studies tell us when faced with overly complex choices people are more likely to adopt simplifying strategies, which is to take whatever option that requires the least effort. To make savings easy, auto-enrollment with an option to opt-out and auto-escalation has been suggested and tested in a program, named Save More Tomorrow (SMT). An empirical study with 25 companies that administer retirement plans shows the SMT program has a noticeable effect in boosting annual savings. When providing financial and enrollment information, using behavior insights to design the message could make a great difference. In a program to promote retirement security for government agencies, emails redesigned by the Social and Behavioral Science Team (SBST) led 22 percent more people to re-enroll in Thrift Savings Plan (TSP) within a week.

- **Provide Financial Education Opportunities.** For individuals with limited financial knowledge and primary responsibility for saving and investing, improving financial literacy can make a difference. Many studies and reports have suggested that workplace-based plans and financial education are the most effective to improve financial literacy and thus increase retirement savings. A case study found that "the most financially savvy are also the most likely to participate in and contribute the most to their plan …" and "… employees who completed a financial education module were more likely to start contributing and less likely to have stopped contributing to the DC plan."

By better utilizing tools and nudges to improve program outcomes, states and employers can make significant progress to address the retirement saving crisis. In states like California, Connecticut, Illinois, Oregon and Maryland, policymakers are establishing programs to expand access to retirement savings programs. These policy leaders are at the forefront of applying behavioral insights to program design in a way that will help millions of Americans begin to save more for their retirement.

Angela M. Antonelli *is the Executive Director of the Center for Retirement Initiatives and* ***Yijun Yin*** *is a former Research Assistant and a graduate student at McCourt School of Public Policy.*

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