Encouraging Pension Participation: Some evidence from Behavioural Economics

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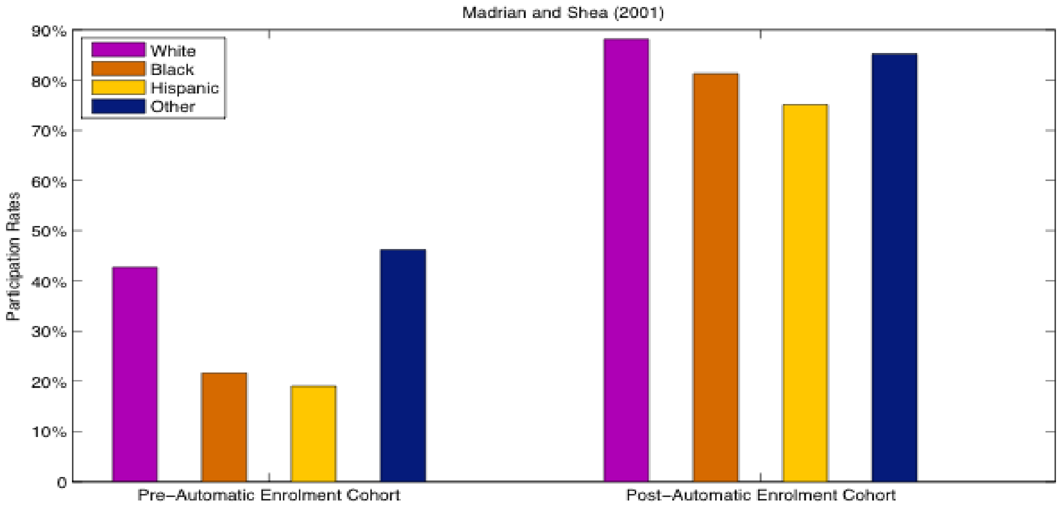
In this session:

- Overview of Behavioural Economics
- Evidence on soft-mandatory pensions
  - Automatic enrolment
  - Quick enrolment
  - Save More Tomorrow
  - Evidence from the UK
- Considerations for Ireland

Intro to Behavioural Economics

- How do people make economic decisions?
  - <u>Bounded Rationality</u>: use heuristics to decide when faced with complex decisions/ many options
  - <u>Bounded Self-Control</u>: inertia and procrastination influence behaviour even if we know best option
- Retirement savings literature is a key area of behavioural economics

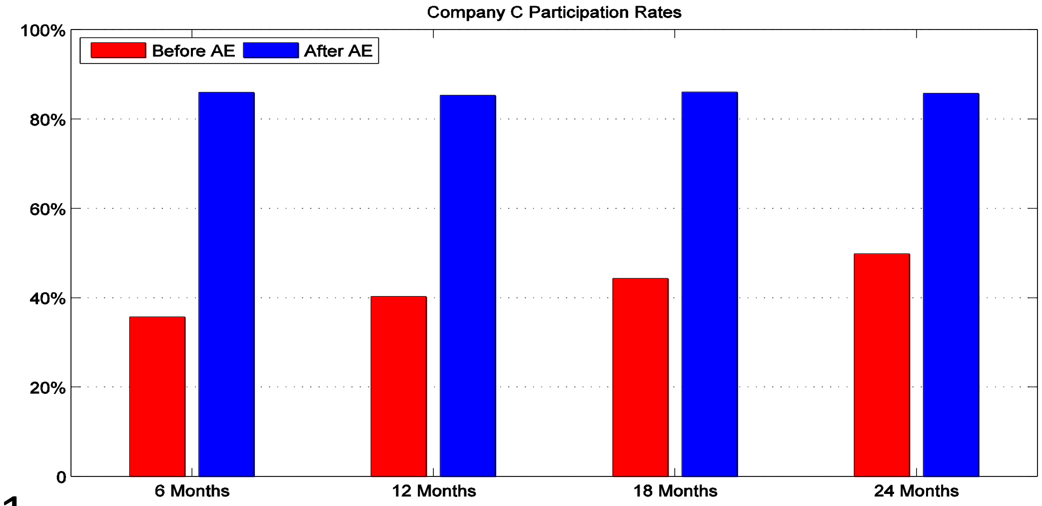
Automatic Enrolment (1)



Madrian and Shea 2001:

- Firm introduced auto-enrolment scheme after discrimination issues
- By **ethnicity**: dramatic increase esp. for Black and Hispanic employees (see graph)
- By **age**: younger people showed biggest improvement under scheme

Automatic Enrolment (2)



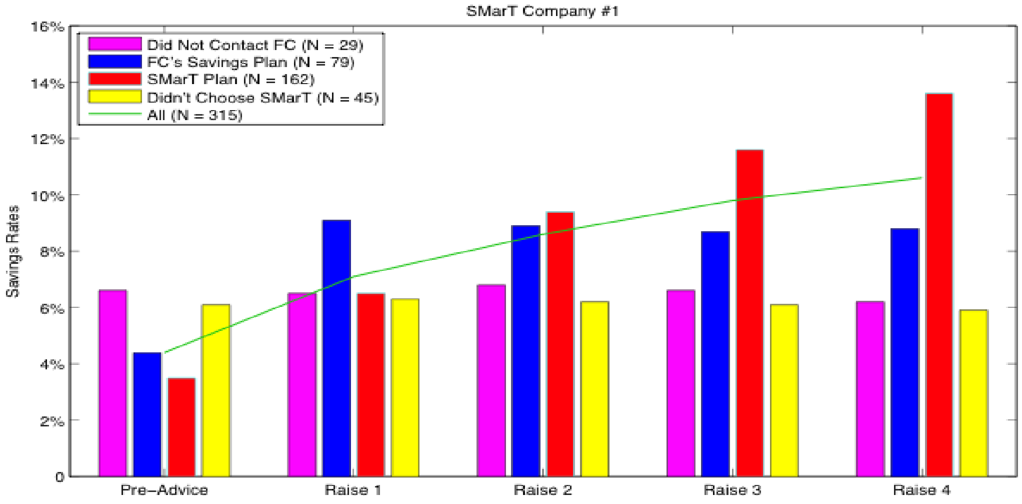
Choi et al 2001:

- Extended Madrian and Shea 2001 study – even after 2 years, automatic enrolment had **long-lasting positive effect**
- **Default inertia**: people tend to stick to the status quo
- Important to consider when setting contribution & allocation defaults

Quick Enrolment

- **Simplify complex decisions** to avoid analysis paralysis (whether to save, what contribution, what allocation…)
- Choi et al (2006):
  - Employees tick a box with **pre-defined rates and allocations** – increases participation by 10 to 20 percentage points!
- Carroll et al (2009):
  - ‘**Active Decision**’ removes issue of who chooses the default settings, require employees to choose one way or another
  - Best used when employees have very different needs and are likely to procrastinate

Save More Tomorrow (SMaRT)



Benartzi and Thaler (2004):

- Overcome **inertia**, **impulsivity** (hyperbolic discounting), **loss aversion**:
  - 1 Approach employees early before pay increase (impulsivity)
  - 2 Increase contribution right after raise (loss aversion)
  - 3 Increase contribution rates after each raise up to ceiling (inertia)
- Graph shows **significant jump in savings** for SMaRT participants

Evidence from the UK

- National auto-enrolment scheme introduced in 2012 by UK government
- Successful so far: coverage increased by 37 percentage points amongst eligible private sector workers (6.87 million workers)
- Average contributions also increased by about a percentage point
- Groups who benefitted the most: women, young people, low income earners
- Roll-out to small businesses is next – more challenging but UK government optimistic as businesses are well-informed

Considerations for Ireland (1)

- **Understanding the extent of undersaving**:
  - Are people making other provisions for their pension? Further evidence is required
- **Anchoring effects**:
  - Default settings in auto-enrolment schemes could be understood as financial advice, could lead to lower savings rates
- **High fees**
  - Work-place plans could involve high fees – especially for less financially active employees
- **Substitution effects**
  - Auto-enrolment could subtract from other savings, especially for people who are cash-constrained

Considerations for Ireland (2)

- **Complexity**:
  - Running an auto-enrolment programme may be particularly complicated for smaller businesses
- **Wage effects**:
  - Companies may reduce wages to offset the price of the work-place pension plan
- **Mandatory savings**:
  - Compulsion can be considered as an alternative model, recommended by the OECD
- **Population targeting**:
  - Should there be an age cutoff? Should self-employed people be covered?

Thank you for your attention