Example: Epilogue
Implementing the New Behavioral Economics – the U.K. National Pension Saving Scheme*

In its latest proposals for pension reform, the U.K. government showed that it fully embraced the implications of the new behavioral economics for the design of public policy. It accepted the recommendation of the independent Pensions Commission for a National Pension Saving Scheme – a low-cost system of individual retirement accounts into which employees will be automatically enrolled.

In the U.K., the basic state pension provides a near-universal flat rate pension; in the future this will be topped up by an additional flat-rate element, the state second pension. Together, these will deliver a pension worth around one-third of median earnings. This will not be enough for most people to live comfortably in retirement and a key point of debate has been how to deliver additional saving on top of this. The government rejected additional compulsory pension saving on the grounds that it would not suit everyone. But nor has it left it up to individuals to make their own decisions. With automatic enrolment, the default is for individuals to be enrolled in the scheme; they can opt out if they choose to.

This policy explicitly recognizes some of the issues with individual retirement saving that have been identified by the new behavioral economics. Pensions have long been seen as an area in which problems of information availability and information processing make it unlikely that markets will work perfectly without government intervention. Retirement saving decisions are inevitably uncertain and complicated and the products themselves are complex. Until now, the main solutions were seen as providing more and better information, together with regulation to make products simpler and more transparent. The U.K.'s official government policy used to be one of "informed choice," that is, people will plan ahead sensibly given the right opportunities. Its main tactics were:

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* Example prepared by Sarah Smith, University of Bristol.

- *Activation:* enable people to make the most of pension provision and encourage availability of the right pension products
- *Education:* raise people's awareness of their options and improve financial education
- *Information:* ensure that everyone has high-quality, accurate, and timely information.

There is some evidence showing that the provision of information can be effective in stimulating retirement saving. A U.S. study by Doug Bernheim and Daniel Garrett (2003) showed that when employers ran frequent workplace seminars, participation in pensions increased and there was no reduction in other forms of saving. To have any effect, however, an information strategy is likely to be expensive. The same study found that less intensive forms of information, such as summary plan descriptions and newsletters, had no significant effect on participation. And more recent trials of workplace advice in the U.K. showed less of an impact. Low levels of pre-existing knowledge together with a lack of interest in pensions meant that there was no significant impact on pension participation, even when individuals were offered face-to-face meetings with pension providers and independent financial advisers.

The main lesson from the new behavioral economics is that the problem with pensions is not just a lack of information. In addition, individuals exhibit high levels of inertia and procrastination, evidenced in a number of ways:

- Default options matter a lot. When faced with a choice over contribution rates and investment funds, individuals typically pick the default option. And the tendency to pick the default has been shown to increase as the range of choice increases. When Sweden introduced a defined contribution premium pension with a compulsory contribution of 2.5% earnings, only 32% chose the default fund in the first year; by the second year, without intensive advertising and publicity surrounding the launch, this had increased to 90%.
- Richard Thaler and Shlomo Benartzi report the findings of a trial pension scheme called Save More Tomorrow (SMART) which had a default automatic contribution escalator, increasing contribution rates by 3 percentage points a year, unless the individual chose to opt out. They showed that those who opted for the automatic escalator experienced much greater increases in their contribution rates (Thaler and Benartzi, 2004).
- Finally, evidence from the U.S. and the U.K. has shown that the default enrolment option has a big impact on participation. The independent Pensions Commission reported trials of automatic enrolment for occupational pensions in the U.K. Schemes with automatic enrolment for new entrants had participation rates that were 20 percentage points higher – more than 90% compared to 70% (Pensions Commission, 2005: 69). A lot of the positive impact appears to work by encouraging individuals to join the scheme much sooner than they otherwise would.

The implication from the new behavioral economics is that both employers and the government have a huge role to play in shaping outcomes by framing individuals' choices. This lesson has been taken on board in the proposal for the National Pension Savings Scheme. In order to raise participation in private pensions, the government has moved to a default of automatic enrolment. Every employee without an employer pension will be automatically enrolled into a system of low-cost individual pension accounts. They will be required to contribute a minimum of 4% earnings, with employers contributing a further 3%, and the government 1%.

So, what will be the likely effect of this policy on pension saving?

- Previous studies may overestimate the effect of the introduction of automatic enrolment on participation since the decision by individual firms to switch to automatic enrolment may have been motivated by employers' desire to raise participation and may have been accompanied by an increased commitment to pensions and/or increased communications. The effect of imposing automatic enrolment on individuals and employers may be different from this and is likely to be smaller.
- As well as the default enrolment, the National Pension Savings Scheme has a default contribution rate of 8% of earnings. While many people will be encouraged to contribute more than they otherwise would, there may be others who would otherwise have a higher contribution rate.
- There is also likely to be a default investment strategy. Employers and the government may be keen to avoid an aggressive investment strategy in a default option, but there is a risk of being "too safe."

It has been argued that the greatest strength of automatic enrolment is also its greatest potential weakness. It offers the path of least resistance and should encourage participation, but may result in (sub-optimal) clustering around default contribution rates and default investment strategies. It remains to be seen how public policy informed by the new behavioral economics will work in practice.

Sources

Bernheim, B. Douglas, Garrett, Daniel M. (2003) The Effects of Financial Education in the Workplace: Evidence from a Survey of Households. *Journal of Public Economics* **87**(7/8): 1487–519, August Pensions Commission (2005) *A New Pension Settlement for the Twenty-First Century* (HMSO: London)

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