Individual Choices in Retirement Savings: Where Do We Stand?

Elsa Fornero

(University of Turin and CeRP)

International Investments and Pensions, April 2005

When it comes to pensions, in many European countries workers are hardly accustomed to taking personal decisions. The main reason for this lies of course in the disproportionate share of public pension schemes – characterised by a very limited area of discretionary choices – in the provision of retirement income. Participation in *social security* is compulsory; the payroll *tax rate* is fixed by law and does not change, normally, according to age or needs; exit requirements allow limited possibilities of choice by the worker, retirement age being either established by law (*legal* retirement age) or strongly influenced by formulae which heavily penalise job prosecution after the minimum requisites have been met (early retirement rules). Nor is the fruition of benefits much left to individual's preferences: little choice is allowed to workers with respect to, for example, the composition of benefits (as for survivors' benefits and supplementary insurance) or to the time profile of the annuity and in particular to its indexation mechanism (to prices or to wages). Finally, the PAYG feature of public systems does not allow, by definition, any investment decision on the part of the individual, the systems' reserves (*if any*) being motivated by the solvency requirement of the system and not attributable to single individuals.

The pension reforms of the last 10-15 years have significantly modified this picture, by increasing workers' responsibility in planning for their retirement. By reshaping social security in a way that has generally strengthened the correlation between contributions and benefits and reduced the redistributive task of the scheme, reforms have increased the scope for individual decisions. In particular, this is the case of the Notional Defined Contribution (NDC) system first adopted by Sweden and Italy and recently introduced by many other European countries, which – being based on *actuarial principles* – can easily accommodate many dimensions of personal choice, such as a flexible retirement age or different profiles of the annuity for a given "notional capital".

By pursuing a better risk diversification, reforms have gone further, in the direction of either introducing or giving a new impulse to private funded schemes, both of the occupational and of the individual type. Within the former, the traditional Defined Benefit (DC) plans, characterised by more constraints, are giving way to the more flexible Defined Contribution (DC) plans, which allow for a greater activism on the part of workers as to whether or not to participate, how much to contribute, how to invest the accumulated funds, which part of the accrued wealth to convert into an annuity at retirement and which part to draw as a lump sum. Obviously, individual accounts are characterised by a wider scope for personal choice not only in the area of savings formation but also in the area of asset allocation; however, administrative and management costs are much higher than in collective schemes.

If widening the area of individual choice and responsibility is generally a good thing, the "bad news" is that workers seem to make little use of their increased discretion. Taking Italy as an example, legislation has variously tried, in the last 10 years, to encourage workers to participate in newly created pension funds, also by granting fiscal advantages to the diversion of flows of severance pay (a form of deferred compensation, which the worker is entitled to cash as a lump sum whenever she leaves her job, for whatever reason). Although the objective was to facilitate the financing of private pensions with resources already provided for and not by necessarily demanding new savings, the law has not been very effective, in that only a small fraction of workers have opted for participation and, among those who have, there is little evidence of *active choices* been made in terms of both contributions and asset allocation.

Since this passivity may be a legacy of the inertia embedded in past rules, the law is now about to change the default option, by establishing automatic diversion of severance pay flows unless the worker explicitly opts out (i.e. declares that she wants to continue with the present regime of severance pay, providing a small but guaranteed return and no obligation to buy an annuity).

This situation is not an Italian peculiarity, having been observed in the majority of other countries where workers have some degree of freedom in their retirement savings, such as in Sweden and in the United States (United Kingdom seems to portray a situation of greater activism, but also of mistakes made possible by some weakness in the regulatory framework).

Is scepticism towards individual's decision-making ability therefore justified? Unfortunately, the answer to this question seems positive in most cases. Inertia and procrastination seem to characterise individual behaviour. Empirical evidence shows that, even in countries generally highly favouring individual choices (such as the Anglo-Saxon countries), the majority simply does not choose, rather letting the default option apply. In Sweden, for example, the government tried to promote a policy based on "libertarian paternalism" (as defined by two American scholars, Richard Thaler and Cass Sunstein), with the purpose of creating the condition for "gently" pushing short-sighted individuals towards responsible decisions, without limiting too strongly the freedom of far-sighted individuals. It turned out that more than 90% of the participants chooses the default option, while only a small percentage opts for portfolio diversification. The key issue is that, if the majority tends to choose the default option, this has to be designed very carefully, so as to avoid being entrapped in bad choices, such as too low contribution rates or too risky and insufficiently diversified portfolio composition.

These considerations lead to two (preliminary) conclusions, which are relevant for policy purposes. The first is that an important role in pension reform should be given to aspects of education, both with respect to savings formation (to overcome individual myopia and help individuals to accumulate an *adequate* amount of resources) and asset allocation (to encourage choices compatible with an *appropriate* diversification of risks).

The second is that much care should be given to the design of default options, given that defaults (even bad ones) work as an *attractor*. The problem is complicated by the fact that having a few defaults can cause distortions and deadweight losses when individuals are characterised by a high degree of heterogeneity. In general, one should favour highly transparent solutions; with a management limited to few options, in order to reduce costs; and a clear structure linked to market guarantees.

Up to now pension reforms have privileged the aspect of macroeconomic sustainability of expenditure. It is time to move to microeconomic choices, i.e. towards encouraging individuals' savings and financial education. Apart from being an essential ingredient of a well-functioning market, it will also help re-establishing both sustainability and confidence in the public system.

It is a very difficult path, so far hardly brought to the public debate. Now it's about time to start discussion, in order not to regret, ex-post, another lost occasion.

References

Benartzi, S. and R. Thaler (2001), "Naïve Diversification Strategies in Defined Contribution Saving Plans", *American Economic Review*, 91(1), March, pp. 79–98.

Choi, J., D. Laibson, B. Madrian and A. Metrick (2001), "For Better or For Worse: Default Effects and 401(k) Savings Behavior" in D. Wise (ed.) *Perspectives in the Economics of Aging*, Chicago, IL: University of Chicago Press, pp. 81–121.

Cronqvist, H. and R. Thaler (2004), "Design Choices in Privatized Social-Security Systems: Learning from the Swedish Experience", *American Economic Review* , 94(5), May, pp.424–28.

Munnell, A. and A. Sundén (2004), *Coming Up Short: The Challenge of 4018(k) Plans*, Washington, DC: The Brooking Institution Press.

Thaler, R. and C. Sunstein (2003), "Libertarian Paternalism", *American Economic Review*, 93(2), May, pp.175-79.