Voluntary Retirement Savings: Motivations, Incentives and Design

30 October 2019

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World Bank

Pensions Core Course

Organization

- Why are complementary pension systems important?
- How are these systems provided?
- What are the incentives and other design issues to make these work?
- How can we deal with the "decumulation challenge?"

Why Consider Voluntary Pensions?

- A. Provide benefits for special groups
- B. Easier for the government to administer
- C. Improve long term economic outcomes through greater efficiency
- D. Less risk for workers than relying on government
- E. More fair way to provide benefits

Motivations for Complementary and Funded Pension Systems

Primary

Supplement Coverage and Benefits from Public schemes

Engage hard to reach groups

Diversify pension asset portfolio – complement wage based benefits with benefits linked to financial markets

Enhance public acceptance of reforms to public system – provide additional benefits with low fiscal exposure

Alter labor market incentives and behavior – Sorting and retention of workers

Secondary

Increase national savings and possibly growth

Catalyst for savings/financial market participation

Support capital market development

What do you need to create a voluntary private pension system?

- A. Complex and sophisticated retirement investments products
- B. Lots of rich people who would otherwise spend their money on luxury goods instead of saving for retirement
- C. Big tax incentives to get people to save
- D. Employers or labor unions to manage the plans
- E. Weak or limited public pension system

Enabling Conditions for Implementation and Sustainability

Pension specific legal framework that addresses:

- Contribution flows, investment management, governance of funds
- Members rights and dispute resolution (consumer protections)
- Auditing, valuation and reporting on assets
- Performance measurement and benefit projections
- Regulation and supervision

Institutional

- Reliable custodian and asset management institutions
- Trading, pricing and payment systems
- Accounting standards and independent auditing
- Accessible and credible adjudication of disputes

Employer Perspective

Why Offer a Plan? Why not just pay more or offer other benefits?

- Being seen as an attractive, top-tier employer
- Retention of employees / long term workforce management
- Tax advantages, other motivations

Importance of Enabling Conditions to Employer

- “Reliable custodian and asset management institutions”
  - Critical to provide confidence that employee (or employer) assets were going to be well cared for
- Access to multiple asset classes (to include non-domestic assets)

Specialized or Sanctioned Retail Funds

- **IRAs (Individual Retirement Accounts) in the United States**
  - Simple registration of existing financial institutions with tax authority to enter market
  - Essentially no limitation on investment profile or fees
  - Tax exemption with low limitations
  - Exclusion from tax preference based on income level and participation in employer sponsored tax subsidize arrangement
- **Informal Sector Mobile Platforms in Africa**
  - Mbao Pension program in Kenya
  - Multiple examples in Ghana – My Own Pension (MTN), People's Pension Trust, others
  - Often actively supported by regulator
  - Informal sector associations key supporters of these efforts

Public Interface Hybrid

- **Voluntary Tier of Mandatory Pillars (Latin America, Central & Eastern Europe)**
  - Additional contribution to specialized "pension companies"
  - Utilize same regulatory and transfer structure
- **Swedish Premium Pensions**
  - Allocation of portion of social insurance tax
  - Central public clearinghouse
  - Asset management open to all registered vendors
  - Vendor blind to retail customer
- **NPS in India**
  - Centralized record keeping
  - "Points of Presence" distribution
  - Limited set of licensed investment options
- Proposed State mandatory IRA programs in the US

Private Interface Hybrid

- **Majority of US 401(k) plans (Participant Directed)**
  - Employment based platform with payroll deductions and contribution sharing
  - Tax preference with specific limits
  - Employer selects suite of options – worker directs investment
  - Financial firms bundle record keeping and investment services on fee basis
- **Lithuanian, Slovenia Voluntary Funds**
  - Closely controlled licensing of funds (Based on EU UCIT framework
  - Employer or Union brings group of workers to funds
  - Asset allocation, fees and other elements closely controlled

Firm or Vocational Group

- **Former British Empire (UK, US, Australia, Kenya, Tanzania, India, South Africa, etc)**
  - Employer managed trusts with minimal limitations
  - Both DB and DC
  - Defined benefits forms an endangered species, DC moving towards hybrid forms
  - Risk exposure of employer and inefficient cash wage deferred benefit trade-offs driving change
- **Netherlands**
  - Quasi voluntary nature produces high coverage (>90%)
  - Collective management insulates employers from some risks
  - Risk management / Benefit tradeoffs imposing challenges
- **Enterprise Annuities in China**
  - Alternative hybrid with employer sponsorship but licensed intermediation (Trustee, Asset managers)
  - Effectively DC in current form

One Firm's Choices

- Globally
  - General trend toward DC in most countries
    - Attractive to the company – known liability
    - Generally more attractive to young/new employees
  - Principle was to always "grandfather" existing employees unless new plan was a better plan
- Region / Country specific situations
  - Enterprise Annuity studied in China – not pursued
  - Switzerland DC conversion reversed

Discussion: Intermediaries of tomorrow?

- Emerging Challenge – who will these be?

OPINION › COMMENTARY

In the gig economy, the U.S. will soon face a crisis in retirement savings

About one third of all private-sector employees do not have access to workplace savings plans, according to the Bureau of Labor Statistics' 2017 national compensation survey.

The Future of Social Protection

WHAT WORKS FOR NON-STANDARD WORKERS?

OECD

THE CHANGING NATURE OF WORK

Incentives and Other Design Issues

Economic Motivations

Limitations of Public System

Tax subsidies

Start up or matching provisions

Behavioral Issues

Defaults: Auto enrollment and active decision

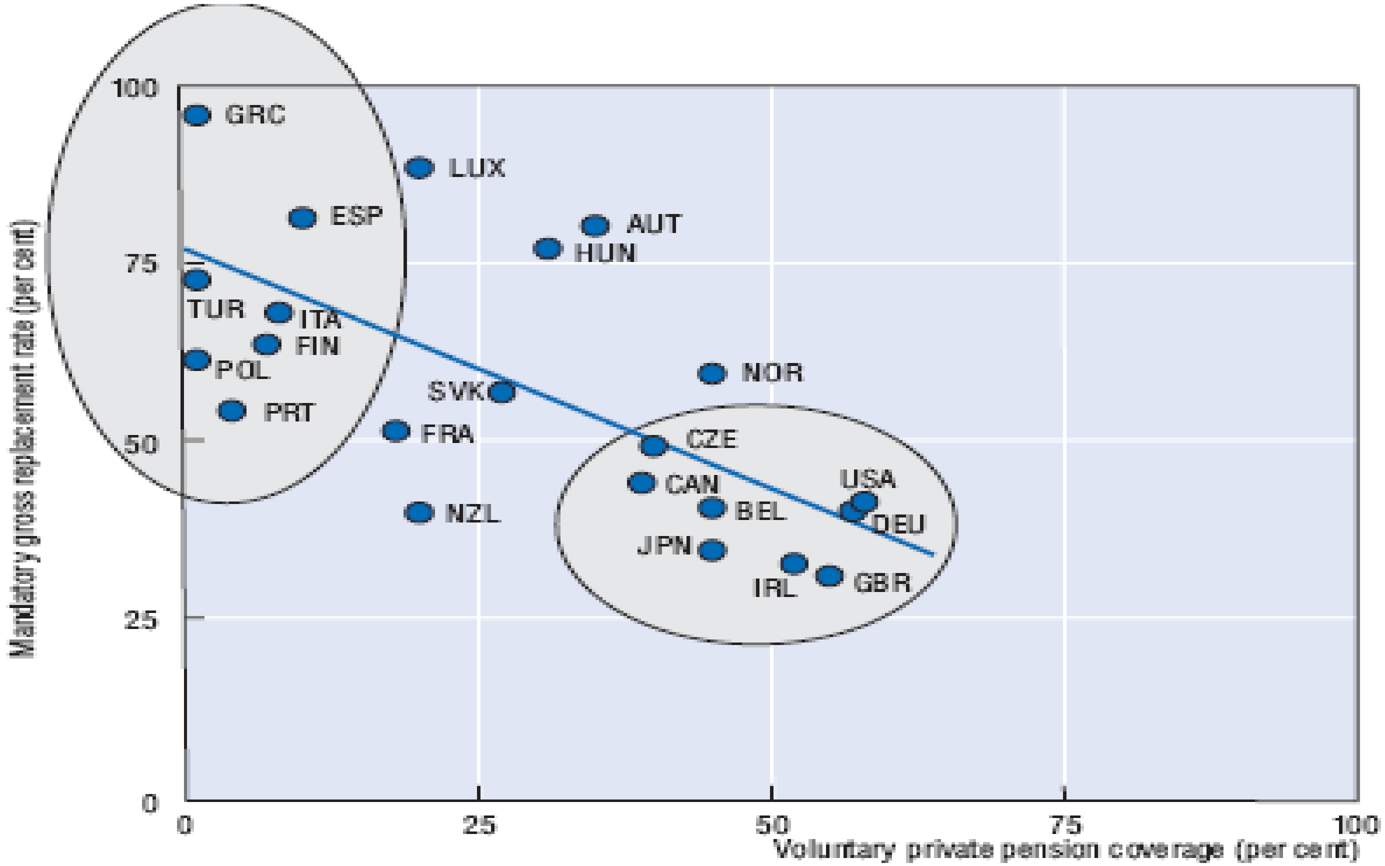
Programmed Deferrals

Financial Literacy and Trust

Marketing and Information

Generosity of the Mandatory System is the Strongest Incentive:

Income Replacement Rates and Voluntary Coverage in OECD



Source: OECD, Pensions at a Glance, 2007

Tax Preferences Can Also Have Indirect Objective

Availability of preferential tax treatment can be linked to minimum standards or design of pension system

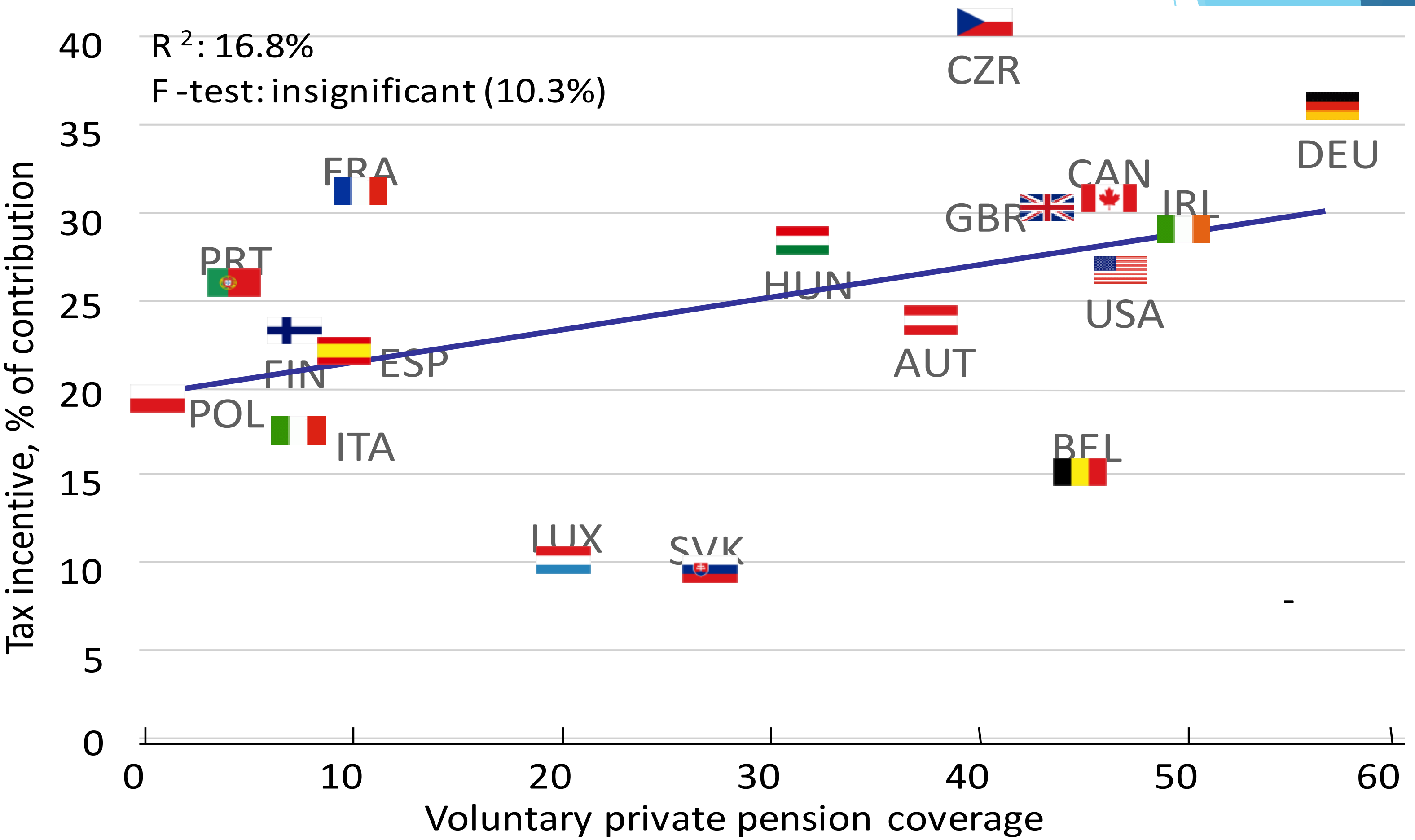
Common approach in Anglo Saxon countries with occupational systems – limit minimum value, terms and distribution of pension benefits to prescribed standards to receive tax treatment.

Principle is to link interests of higher income workers and/or owners to moderate or low income - create incentive to extend complementary coverage.

Some Key Policy Question for Tax Incentives

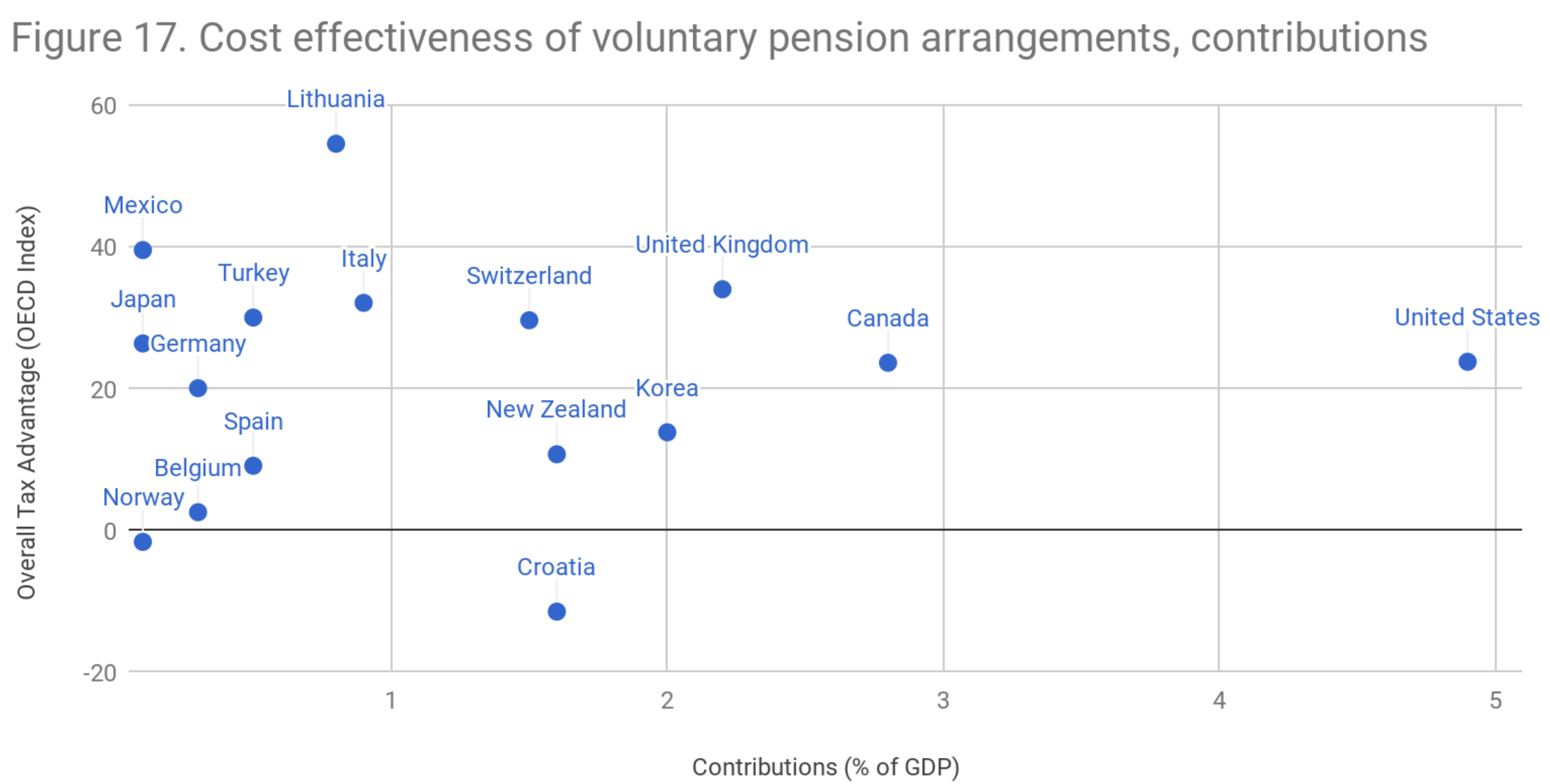
- Do they create high levels of coverage?
- Does it expand the pension system to produce net additions to retirement savings?
- Does it add to overall national savings levels?
- What is the distirbution of tax benefits?

Value of Tax Incentives Does Not Predict Coverage of System in OECD



Source: Whitehouse and Antolin, OECD, 2007

Level of Contributions is Not Strongly Related to the Value of Tax Incentives



How fair is the distribution: The Case of the United States

Distribution of Value of IRA and DC Plan Tax Subsidies

Income Quintile	***% or Units***	***Share of total***	***Average Value***
Lowest	2.0	0.2	$6
Second	12.7	2.9	$78
Middle	25.0	8.2	$218
Fourth	43.0	19.3	$513
Highest	61.0	69.3	$1,838
Total	28.7	100.0	$531

Source: Urban Institute-Brookings Tax Policy Center, 2004

Does it create new savings: “crowd out” or “crowd in”?

- **Studies of the 401(k) system in the US are contradictory**
  - Some find very high substitution through both decreased private savings and leverage suggesting tax arbitrage and substitution
  - Other find conclude net positive additions but at moderate levels – Some estimates (Engen and Gale 2000) estimate that at best 30% represent net additions to savings
- **Many other more complex issues arise from secondary effects (eg form of assets, how government finances tax subsidies)**
- **Preliminary analysis of developing countries and mandatory systems find some net additions**
- **Key factor may be level of development of financial markets - suggests higher potential for substitution in US and Europe**

Coverage in Voluntary Systems

- **Factors Associated with Coverage within systems**
  - **Income of workers – Strongest predictor in nearly all settings**
  - **Age of worker – signficant increases at about age 35 - 50**
  - **Size of Firm has similar effect – very low participation in firms below 25 and informal sector**
  - **Job Tenure**
- **All of the factors however interact to create more complex puzzle**
- **Mitigated by presence of union, employee organization and industry wide funds**
- **Association of factors with coverage is only moderate – many workers with high expected participation do not – others with low expected probability participate. This suggests many other influences**
- **Limits of “rational economic” model to explain patterns of coverage and participation have led to increased inerest in behavioral issue**

Design and Behavioral Issues

- Start up or Matching Provisions
- Defaults: Auto enrollment and active decision
- Programmed Deferrals
- Financial Literacy and Trust
- Marketing and Information

Start Up Incentives and Matching Contributions

- Likely the most direct and easily understood incentive - immediate high percentage rate of return
- Common practice in U.S. 401(k) plans - contribution matching of ½ of employee contributions up to 6% of pay
- Studies of effects however are mixed:
  - Show range of effects from very small to 25% increase in contributions
  - Seem to be related to composition of the group
- More effective at getting workers to join and for low income workers than increasing longer term savings
- Some contradictory effects - may actually reduce worker contribution levels through substitution or providing reference point.
- Key issue is interaction with other factors - Initial evidence is that effects are small when combined with other factors

Behavioral Incentives "Escape From Freedom"

Automatic enrollment – Series of studies of US and UK show that requiring workers to "opt out" or make active decision within specified time frame increases participation by up to 60% in first year and 15 to 30% over longer terms

- Several studies conclude that automatic enrollment has greater overall effect than matching contributions over longer term
- Strongest effect among younger and low wage (Nessmith, Utkus and Young, 2007)

Default investment choices – When these provided have strong effect on initial choices with significant persistence – Workers seems to view as implicit investment advice

Deferred Savings Decisions - Evaluation of program in which savings is taken from future salary increase (Benartzi and Thaler, 2003) finds much higher long term savings rates

Financial Literacy, Trust and Information

- Level of financial literacy has been found to have effect on participation in retirement savings similar to financial incentives
- Consistent with earlier findings (Munnel et al 2001) report that planning horizon of individual is significant factor in participation in employer sponsored retirement savings
- Experiment with provision of tax credit in US (Duflo et al 2005) indicates that use of incentive increases greatly with explanation and advice – Provider of advice found to be significant factor
- Trust in financial institutions is important – Person expressing lack of trust did not respond to economic incentives even with efforts to explain immediate value of savings
- Provision of information has some effects -in Swedish Premium Pension system majority made active choices when information program was in place – 60% chose default in later period
- Lusardi (2004) found greater effect of seminars for less educated

Two Paradoxes: Choice and Liquidity

Choice increases participation ..But too much choice lowers rates of participation and Investment decisions

- One study (Papke 2004) finds that ability to choose investments raises participation in savings and amounts saved by 3 to 8%
- Another (Iyengar et al) finds that and additional 10 investment choices decreases participation rates by 1.5 -2%

Availability of loans increase participation but ability to cash out dissipates retirement savings

- One study (Munnel et al 2001) finds that loans increase savings by 1% of earnings – another (GAO 1997) find increases savings rates by a third
- Experience over 20 years indicates that half of workers take cash out when changing jobs – although now about 80%of the money is ultimately saved for retirement purposes
- The greater the amount of the fund balances the less is cashed out.

Employer Perspective on DC Menus

- **Globally**
  - **Strong belief in menu discipline - limited choices tended to be less overwhelming for employees**
  - **Key asset classes for that country available, but no more**
  - **Lifecycle or “Target Risk” approach utilized where possible**
- **How did this play out?**
  - **Typically 6-10 unique menu offerings**
  - **Heavy dependence on indexed offerings where available due to cost efficiency for participants**
  - **Vast majority of employees stayed in the default**

Suggested Explanations for Observed Behavior

- Reluctance to make decisions in the face of uncertainly – Seeking reference points – Safety of the crowd
- Present Orientation – “Hyperbolic Discounting”
- Inertia and Procrastination – “Endowment Effect”
- Nominal Loss Aversion – fear of loss greater than desire for gain (Kahnemann and Teversky)
- Information Overload – Inability to make decision with too many choices
- Signaling and Framing Effects – Choices interpreted as providing advice -Employer or Government perceived as endorsing choices

Some Interesting Innovations

- NEST – UK default scheme to enable reforms in 2008 Pension Act
- Prize linked savings
- Reister Pensions in Germany –
  - Tax exemption and fixed subsidy with additional subsidies for number of children
  - No withdrawals until age 60
- State level plans in the US that mandate employer offer and payroll deductions
  - Currently facing challenge due to resistance from employers and private asset managers

Kiwi Saver (New Zealand) – Integration of Many Lessons Learned

- Integrated employment based system from 2007 – Employer based contribution flow and licensed providers
- Three entry points, Auto Enrollment, Voluntary Employer, Direct to Provider
- Choice of employee contribution – 3% to 10% with default rate of 3%
- 3% required employer contribution
- Limited opt out for auto enrolled – 2 to 8 weeks but potential for contribution holiday after one year – no opt out for voluntary
- Lock in to age of eligibility for public benefits (65) except for home purchase exception (includes eligibility for subsidy) or hardship
- TTE tax treatment with cap for qualified provider products
- Public clearinghouse for contribution flows
- Specified slate of investment choices and default
- Initially a one time $1,000 “kick start” public contribution but eliminated in May 2015

Discussion: the decumulation challenge

- Emerging Challenge – how do we do this in a DC centric world?
- William Sharpe, Nobel Laureate: decumulation as "nastiest, hardest problem in finance"
- Richard Thaler, Nobel Laureate recently suggested annuity buy-ins for US social security system
- What to do in the absence of inflation-indexed government securities?

Some General Conclusions

- Size and perception of public system matters a lot
- Tax incentives are effective but not sufficient condition – greatest effect on higher income groups creates distributional hazards
- Evidence is that “rational economic” model only partially explains outcomes
- Behavior issues are very important – Inertia, financial literacy, loss aversion, information and trust – especially for lower income groups
- How and by whom choices are presented is very important