

PERSPECTIVES

Mandatory Retirement Savings

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Nudges toward voluntary defined-contribution retirement savings have transformed many nonsavers into savers but have left many behind. The author argues that it is time to switch from libertarian-paternalistic nudges to fully paternalistic shoves. He advocates a retirement savings solution centered on a paternalistic second layer of mandatory private defined-contribution savings accounts in a retirement savings pyramid, above the paternalistic first layer of Social Security and below the libertarian third layer of voluntary savings.

Savers are on their way to adequate retirement income, whereas nonsavers are likely to subsist on Social Security benefits. Libertarian-paternalistic nudges have moved many nonsavers into defined-contribution retirement savings but have left many behind, including those with limited access to such savings plans. It is time to switch from nudging to shoving nonsavers into savings plans and to replace libertarian-paternalistic voluntary defined-contribution accounts with fully paternalistic *mandatory* defined-contribution accounts for all.

These mandatory savings accounts would be private accounts, much like current 401(k) accounts and IRAs except that they would be mandatory and unavailable for distribution before retirement age. They would constitute a paternalistic middle layer in a retirement savings pyramid, above the paternalistic layer of mandatory Social Security and below the libertarian layer of voluntary savings. Mandatory savings accounts would provide a great benefit to nonsavers who fail to accumulate sufficient retirement savings while adding no burden for savers because they would largely replace voluntary 401(k) and IRA savings. Indeed, mandatory defined-contribution accounts would benefit savers by alleviating the burden on adult children who support destitute nonsaving parents and the burden on taxpayers who support destitute nonsavers through taxes and transfer payments.

Mandatory defined-contribution savings plans exist in several countries outside the United States and at universities in the United States. These plans hold lessons about plan features that

we would be wise to adopt and flaws that we would be wise to avoid.

Savers, Nonsavers, Self-Control, and External Control

Many savers accumulate much more than they need in retirement. Poterba, Venti, and Wise (2011) found that most savers barely tap their retirement savings accounts, such as 401(k) plans, much less deplete them. But nonsavers are in trouble. Jacobe (2012) reported on a Gallup poll that revealed that Americans underestimate their likely reliance on Social Security: Among nonretirees, only 33% expected Social Security to be a major retirement funding source, but 57% of retirees reported that Social Security is a major source of retirement funding.

Income is the source of savings, yet even high incomes do not ensure savings because spending temptations abound. Each of us is born with the capacity for self-control, just as we are born with the capacity for language, but some are born with a greater capacity than others. Analyzing the saving behavior of identical and fraternal twins, Cronqvist and Siegel (2010) found that genetics account for approximately one-third of the differences in saving behavior. The effect of parents on their children's saving behavior is strongest when children are in their 20s but disappears by middle age.

Conscientiousness, closely related to self-control, is one of the Big Five factors of personality, along with extraversion, openness, agreeableness, and neuroticism. Conscientious people do not buy things on impulse, spend too much money, or buy things they do not really need. Duckworth and Weir (2011) noted that conscientiousness is

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the personality factor most closely related to academic achievement, job performance, marital stability, and longevity. They found that conscientious people accumulate more wealth than less conscientious people, even after accounting for differences in income, education, and cognitive ability.

A mandatory retirement savings plan bolsters savings by limiting the income available for spending, replacing self-control with outside control, and imposing conscientious behavior on those lacking conscientiousness.

The Changing Retirement Savings Pyramid

The U.S. retirement savings pyramid used to be composed of Social Security as the bottom layer, defined-benefit pensions as the middle layer, and personal savings as the top layer. Social Security is mandatory and personal savings are voluntary. Voluntary defined-contribution savings plans have now replaced many defined-benefit pension plans as the second layer of the retirement savings pyramid.

Yearning for the good old days of defined-benefit pension plans leaves the impression that a time when everyone was covered by a comfortable pension blanket indeed existed. But such days never existed, surely not for everyone. Butrica, Iams, Smith, and Toder (2009) noted that only 38% of workers participated in defined-benefit pension plans in 1980. The portion of workers participating in such plans had declined to 20% by 2008.

We may bemoan the passing of defined-benefit pension plans, but we cannot save them. Corporate defined-benefit pension plans will continue to shrivel rather than thrive, and so will public sector defined-benefit pension funds, especially now that we know the extent of their underfunding—trillions of dollars—and the inherent conflicts they pose. Beshears, Choi, Laibson, and Madrian (2011) noted that although defined-benefit pension plans are still the primary type of retirement plan for all levels of state and local government, 11 states and Washington, DC, have defined-contribution components in their retirement plans and some states have recently decreased the generosity of their defined-benefit plans.

Nudging Nonsavers toward Voluntary Savings

Much effort has gone into increasing retirement savings by choice architecture, nudging nonsavers into saving through the prescriptions of Thaler and Sunstein (2008). Automatic enrollment is a prominent feature of choice architecture, and Madrian and Shea (2001) found that it increased participation

in a defined-contribution plan. Yet, more than 20% of employees with incomes lower than \$20,000 did not enroll even when enrollment was automatic. Moreover, Bronchetti, Dee, Huffman, and Magenheim (2011) found that nudges are largely ineffective among the poor. In a field experiment, they divided low-income tax filers into two groups. People in the first group could opt in to receive some of their federal tax refund in the form of U.S. savings bonds. People in the second group were nudged toward saving; a fraction of their tax refund was automatically directed to U.S. savings bonds unless they actively chose to opt out. Bronchetti et al. found that the opt-in default had no impact on saving behavior, likely because low-income people had plans to spend their refunds rather than save them.

Employees of companies without defined-contribution savings plans, employees who do not enroll in available defined-contribution savings plans, employees who enroll but contribute little, and employees who cash out before retirement are doomed to live in retirement on little beyond Social Security benefits.

The lack of financial literacy hampers nonsavers, perhaps obscuring the likelihood of destitution in retirement. Lusardi and Mitchell (2005) found that financial literacy is lacking among older Americans and that the financial literacy of women, minorities, and those without college degrees is particularly deficient. Financial literacy is no better outside the United States. Yet, as Willis (2011) noted, research fails to demonstrate that financial education leads to greater financial literacy, better financial behavior, or improved financial outcomes.

Mandatory Defined-Contribution Savings Plans in Australia, Israel, and the United Kingdom and at U.S. Universities

Superannuation is Australia's mandatory defined-contribution retirement savings plan. Currently, employers contribute 9% of employee earnings on behalf of their employees. This level will gradually increase to 12% by 2019–2020. Employees can voluntarily contribute to the superannuation program beyond the mandatory 9%, and such contributions average 3%. Tax provisions encourage people to withdraw their money gradually after age 60, rather than in a lump sum.

Most Australian superannuation funds are managed on a for-profit basis by financial institutions or on a not-for-profit basis by employers or a combination of employers and trade unions. Employees can choose among funds, but fund costs are generally high. Bird and Gray (2011) estimated that employees

would have earned an additional 2–3 percentage points annually if they were to substitute low-cost index funds for high-cost active funds.

The mandatory defined-contribution retirement savings program in Israel totals, at a minimum, 18.33% of employee earnings. It is composed of three parts: an employer contribution ranging from a minimum of 5% of earnings to a maximum of 7.5%, an employee contribution ranging from 5% to 7%, and an additional employer contribution of 8.33% that serves as severance pay if an employee is laid off but is available to retiring employees who are not laid off. Israeli employees can choose among investment options managed by for-profit institutions and can negotiate fees. Employees receive their retirement savings in the form of annuities but can receive them in a lump sum if they provide evidence of sufficient resources beyond mandatory savings to sustain them in retirement.

The U.K. National Employment Savings Trust (NEST) is a mandatory defined-contribution retirement savings plan introduced in October 2012. According to Pechter (2012), the typical NEST participant is expected to be a nonsaving, relatively young, and low-income male. Employers are required to contribute to NEST at least 2% of employee earnings in the 2012–13 tax year, and employees are required to contribute at least 1%. Mandatory contributions are scheduled to reach a total of 8% by 2018, composed of 3% from employers, 4% from employees, and 1% from the government. Although employees can refuse auto-enrollment in NEST, they are automatically enrolled every three years.

The default offerings of NEST are 46 target-date funds (TDFs) set in one-year intervals, making portfolio transitions smooth relative to portfolio transitions in the United States, where TDFs are typically set in five-year intervals. Centralized investment management is one feature of NEST, and very low fees is another. Investment and administration fees paid by NEST participants total 30 bps.

U.S. universities and certain other not-for-profit institutions have had defined-contribution retirement savings plans, typically 403(a) and 403(b) plans, for much longer than 401(k) and IRA plans have existed. The Carnegie Foundation for the Advancement of Teaching established the Teachers Insurance and Annuity Association (TIAA) in 1918, reflecting Andrew Carnegie's concern about college teachers' retirement savings. The College Retirement Equities Fund (CREF) supplemented the TIAA fixed-income fund starting in 1952. TIAA-CREF continues to provide defined-contribution plans at universities but has been joined by other providers, such as Fidelity and Vanguard.

Formally, the defined-contribution retirement savings plans at universities are not mandatory, but they resemble mandatory plans because employers make "core" contributions with no requirement that employees make contributions. Ragnoni (2012) reported that core employer contributions average 10.1% at private universities and 9.5% at public ones. Some universities also mandate contributions by employees, averaging approximately 5%, for a total of approximately 15%. The expense ratios of TIAA-CREF's funds are relatively low, and some other providers offer funds with very low expense ratios, including index funds with expense ratios lower than 10 bps.

A Mandatory Defined-Contribution Retirement Savings Plan

I advocate a mandatory defined-contribution retirement savings plan with the following features:

1. Combined mandatory contributions by employers and employees amounting to a minimum of 12% of earnings, equal to the percentage set in Australia for 2019–2020. A minimum of 15%, common at many U.S. universities, would be even better.
2. Administration by companies offering 401(k) and similar plans but with an added central agency to administer plans for employees whose employers do not provide defined-contribution retirement savings plans.
3. Default offerings of well-diversified target-date funds set in one-year intervals, as in the U.K. NEST program.
4. Fees not exceeding 30 bps, as in the U.K. NEST program. Low fees would naturally discourage offerings of active funds promising positive alphas. Although it is possible for a small group of investors to enjoy positive alphas at the expense of other investors who suffer negative alphas, it is inconceivable that on average, the very large group of owners of retirement savings accounts would receive positive average alphas. Instead, money destined for retirement savings would likely be squandered in the pursuit of positive alphas.
5. No borrowing from retirement savings accounts and no cashing out of accounts before retirement age. Retirement savings would be paid in annuities unless, as in Israel, beneficiaries could show that they have sufficient resources to sustain themselves in retirement even if they withdraw their retirement savings in a lump sum.
6. Enhanced financial literacy through education at high schools and elsewhere. Financial

literacy promotes wise financial decisions, but people's retirement income should not be hampered by poor financial literacy.

Conclusion

The retirement savings problem in the United States and many other countries is acute, and attempts to nudge nonsavers toward voluntary defined-contribution savings have left many behind. Moreover, many have no access to voluntary defined-contribution savings plans. It is time to switch from libertarian-paternalistic nudges to fully paternalistic shoves and replace libertarian-paternalistic voluntary defined-contribution savings plans with fully paternalistic mandatory defined-contribution savings plans. Mandatory

defined-contribution plans would constitute a second layer in a retirement savings pyramid, above a first layer of Social Security and below a third layer of voluntary savings.

People with no income will continue to have no source for savings, and stock market crashes and raging inflation can decimate accumulated savings. But the problem of retirement income is severe, and solutions must be identified, debated, and implemented.

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This article qualifies for 0.5 CE credit.

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