

Helping Americans Save  
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Chairman Bennett and other members of the Committee, thank you for inviting me to participate in this panel on Helping Americans Save.

I am Richard H. Thaler, a professor of behavioral science and economics at the University of Chicago's Graduate School of Business. I am an economist by training, but for the last 25 years I have been exploring ways to incorporate the findings of modern psychology into economic analysis.

As you all know, America's personal saving rate is hovering near zero. Furthermore, as the population ages, there will be growing difficulty in financing Social Security, and future generations face a very likely prospect of having to finance a larger fraction of their retirement on their own. I thus applaud the attention you are drawing to the important question of how to help Americans save. And, I come bearing good news. By incorporating simple lessons of psychology, and a little common sense about human nature, it is actually quite easy to help Americans save.

By tradition, governments are advised by *economists* on policy matters such as saving. Unfortunately, the traditional economic models that economists rely upon for their advice are not very helpful, in two main respects. First, they assume that households are capable of making the complex calculations necessary to determine how much to consume and how much to save, and, as important, that the households have the requisite willpower to delay consumption in the way the conventional model predicts they should in order to provide for the future. Since the time of Adam and Eve real humans (as opposed to the imaginary creatures populating economics text books) have had difficulty resisting temptation.

Another problem with the standard economic model is that it does not give policy makers any guidance as to *how* to increase savings. The only variable under the control of policy makers is the after-tax interest rate. But the theory does not tell us whether raising this rate (say, by making saving tax free) will increase or decrease savings rates. (The problem is that increasing the return to saving has offsetting effects: it makes saving more valuable, but means that households do not have to save as much to achieve any particular savings goal.)

In contrast, by studying actual humans, we learn that there are lots of ways to increase savings. Here are some useful findings that we might want to incorporate in a plan to get people to save more.

1. Many Americans realize that they should be saving more. One survey finds that two thirds of the participants in 401(k) plans think they are saving too little.
2. Self-control restrictions are easier to adopt if they are not implemented immediately. Many of us here are planning to begin diets *next month*, not today at lunch.
3. Money that is put into designated retirement savings accounts tends to stay there (compared, say, to money in an ordinary savings account).
4. People are “loss averse”—losses hurt more than gains feel good.
5. There is enormous inertia in retirement plans (and elsewhere!). For the vast majority of participants, once they join the 401(k) plan, they rarely make changes, either to their contribution rate or to the asset allocation. So, although participants agree they should save more, many never get around to doing it.

We can think about this list two ways. First, it can be considered a diagnosis, an explanation of why the savings rate is so low. Second, and more helpfully, it can provide the ingredients for the cure. What can we do to help Americans save more?

One simple step that has been adopted by some organizations is called “automatic enrollment”. The idea is simple. In the usual 401(k) plan, when an employee first becomes eligible to join the plan, he or she receives a form that says, “if you want to join the plan, please fill this out, and make some choices”. Under automatic enrollment, the employee receives a similar form, but it says “you are now eligible for the plan, and *unless you return this form, we are going to enroll you automatically*”. Notice that under a standard economic analysis, these two set-ups are virtually identical. The cost of filling in a form is small relative to the long-term benefits of joining the plan, especially when the firm provides a “matching investment”. Nevertheless, automatic enrollment can have huge effects. In one company studied by Madrian and Shea<sup>1</sup>, when automatic enrollment was adopted, the enrollment rate by new workers jumped from 49 percent to 86%. That is the good news. The bad news is that under automatic enrollment, companies must select some default savings rate and investment plan, and employees tend to adopt and stick with these default levels. So, in the company studied by Madrian and Shea, where the default savings rate was 3 percent, all of which was invested in a money market account, most employees who were defaulted into these choices still were sticking with them N years later. This is unfortunate, because virtually every expert who has studied the problem concurs that 3 percent is not a high enough contribution rate, and a money market account is not a suitable long-term investment vehicle for 100 percent of one’s retirement account.

My collaborator, Shlomo Benartzi from UCLA, and I have developed a better plan that can be adopted in conjunction with, or separately from, automatic enrollment. We call our plan Save More Tomorrow, also known as the SMarT plan<sup>2</sup>. Under SMarT, participants are contacted a few months before their next pay increase with the following

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<sup>1</sup> See Brigitte C. Madrian and Dennis F. Shea, “The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior,” *Quarterly Journal of Economics*, November 2001, pp. 1149-1187.

<sup>2</sup> Richard H. Thaler and Shlomo Benartzi, “Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving” *Journal of Political Economy*, February 2004, Part 2 S164-S187.

offer. They can commit themselves now to increasing their savings rates later, when they get their next raise, say by two or three percentage points. Also, their contribution rates will continue to go up whenever they get a pay increase until they either reach some specified maximum, or opt out of further increases. Notice that this plan incorporates the psychological principles I mentioned above. People are asked to join in a few months, not now, and by linking the savings increases to pay increases, they never have to experience a cut in their take home pay.

We have now implemented this plan in several companies, but let me report on the results from the first company to adopt the idea, a mid-sized manufacturing company in the Chicago area. The company was concerned that their employees were not saving enough for retirement, so they hired a financial consultant and made him available to meet one-on-one with every worker. The consultant had a computer with software that could help calculate how much the employee should be saving. Because the employees were not good savers, the software typically recommended that the employee immediately increase his or her saving rate to the maximum allowed. However, few employees were willing to accept this advice, so the consultant suggested an increase of 5 percentage points, say from 3 percent to 8 percent. This advice was also rejected by most employees. So, the consultant would offer these reluctant savers the SMarT plan. Specifically, their savings rate would increase by 3 percentage points at the time of every raise.

This plan proved to be popular with the employees. Over 80 percent of those offered the plan signed up. And, the effect on their savings rates was dramatic. (See Table 1). In just 14 months from the time the consultant spoke to the employees, the participants who enrolled in the SMarT plan increased their savings rates from 3.5 percent to 9.4 percent, and after two more years they were saving 13.6 percent of their salary. Their saving rates have nearly quadrupled! And this is a group that had been very reluctant savers.

The SMarT plan has now been implemented by several other employers, and companies that administer 401(k) plans, such as Vanguard, are offering the idea to their employer customers. We are optimistic that hundreds of thousands of employees will be enrolled in SMarT plans within a few years, and within a decade, the plan could reach most employees in the US. At the moment, this idea does not need any government intervention, but two steps are worth considering:

- Adopt some version of SMarT for government employees through the Thrift Savings Plan.
- Give some consideration to firms that adopt a combination of automatic enrollment and SMarT—perhaps exempt these firms from cumbersome nondiscrimination testing. Such action would simply recognize that, in implementing a SMarT plan, firms have already met the spirit of the Congressional intent that these plans should not disproportionately benefit high-earners.

There are other lessons for government to take away from our experience. First, we have shown what the recipe is (or, at least what one recipe is) for helping people to save. The key ingredients are:

1. Make it easy to join. The easier the better, and automatic enrollment is the easiest.
2. Take the contributions directly from the paycheck. If you don't see it, you don't spend it.
3. Once you get people saving, make the default option to keep saving or, even better, to keep increasing their savings.
4. Put the money into an account where people are not overly tempted to dip in on impulse.

These basic principles could be adopted in many existing and proposed tax-favored savings vehicles.

I would also like to make one other behaviorally motivated suggestion. One way many Americans do manage to save (albeit temporarily) is through tax refunds. Most Americans receive a refund when they file their tax returns. Unfortunately, that money is often spent quickly when the refund check arrives (or even quicker, via a tax refund loan). One way to get more of that money into long-term savings would be to allow refunds to be deposited directly into an IRA and still qualify for a tax credit for the previous year. In other words, people who in March of 2004 are now filing their 2003 tax return, and claiming a \$1500 refund, could send those funds directly to an IRA account. For traditional deductible (not Roth) IRAs, the actual amount deposited would be increased by the tax payers marginal tax rate. So, for a taxpayer in the 25% bracket, they would be given the choice of getting a \$1500 refund or making a \$2000 IRA contribution. That could be an attractive inducement to save.

My principle conclusion is a simple and optimistic. We can succeed at helping Americans save more by employing a combination of basic psychology and common sense.

**Table 1**

**Average Saving Rates for the First Implementation of SMarT**

	Participants who did not contact the financial consultant	Participants who accepted the consultant's recommended saving rate	Participants who joined the SMarT plan	Participants who declined the SMarT plan	All
Number of participants initially choosing each option.*	29	79	162	45	315
Pre-advice	6.6%	4.4%	3.5%	6.1%	4.4%
1 <sup>st</sup> Pay Raise	6.5%	9.1%	6.5%	6.3%	7.1%
2 <sup>nd</sup> Pay Raise	6.8%	8.9%	9.4%	6.2%	8.6%
3 <sup>rd</sup> Pay Raise	6.6%	8.7%	11.6%	6.1%	9.8%
4 <sup>th</sup> Pay Raise	6.2%	8.8%	13.6%	5.9%	10.6%

\* There is attrition from each group over time. The number of employees who remain by the time of the 4<sup>th</sup> pay raise is 229.