Multiple Myopias, Multiple Selves, and the Under-Saving Problem

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Design frontiers of savings policy debate

Many (though not all) analysts believe millions of Americans under-save for retirement, defined in terms of own lifetime welfare. Recent debate re. how to respond concerns the following three policy choices:

(1) Voluntary vs. mandatory saving – e.g., income tax "incentives" for retirement saving vs. mandatory saving under Social Security. ("Washington consensus": increase savings incentives but cut Social Security benefits?)

(2) How to encourage voluntary saving – e.g., income tax "incentives" vs. nudges such as automatic enrollment.

(3) Actuarial "fairness" and portfolio choice for mandatory saving – e.g., Social Security private accounts. (Bush 2005, Paul Ryan when he's not being cagey)

NB: One can't debate the efficacy of income tax "incentives" for retirement saving without raising broader income tax vs. consumption tax issues.

A taxonomy of (some) possible explanations for too-low retirement saving

(a) <u>Naïve myopia</u> (the Grasshopper & the Ant). Solution: mandatory saving if one would undo any other kind. (But does myopia also affect whether one will go to the trouble of undoing a pro-saving default?)

(b) <u>Sophisticated myopia</u> (Odysseus & the Sirens). Solution: ability to choose voluntary saving in advance of "temptation."

(c) <u>Regret aversion re. "active" choices</u>. Solution: offer the defaults that are most likely to get it right; or perhaps require active choice?

(d) <u>Procrastination</u>. Solution: require active choice?

(e) <u>Inattentiveness</u> (with lagged adjustment, systematic error?). Solution: choose good defaults, try to induce attention?

(f) <u>Multiple selves</u> (-> difficulty in defining wellbeing). Solution: ???

How do we know one has under-saved?

Short answer: we don't, if for behavioral reasons we can't confidently deduce intertemporal consumption preferences from behavior.

But there's a strong case that consumption-smoothing is usually optimal.

Not all of the explanations for under-saving involve cognitive myopia or other irrationality.

E.g., say one doesn't opt in to an employer plan due to "active regret aversion." Rational to avoid the risk of triggering emotions of regret?

But you've under-saved if this reduces your utility from the timing of market consumption. Bundling problem from choice architecture (if we're right about true preferences!).

Hyperbolic discounting vs. other multiple selves problems: easy to say all past & future selves should "outvote" the current one – but is it always so clear?

Further conceptual problems

Suppose I'd neither opt in nor out of my employer's retirement saving plan – but that I do adjust current consumption to match take-home pay.

Presumably I'm making labor supply decisions – how should we assume I am thinking about the value of my job?

Is it based on the amount I can spend? How do I value the accumulating retirement savings, in the case where I am participating?

A naïve myope who lacked even the patience to change the default might look only at current spending. (But why even go to work if one is that impatient?)

A sophisticated myope (if unable to change the default, say due to also having active regret aversion) might value the retirement savings *more* than current cash.

Labor supply effects are potentially a big issue both for mandatory saving (e.g., Social Security) and for nudges that "work." (Although note that, for many workers, short-term elasticity is low.)

Two recent empirical studies: (a) Chetty et al (2012)

Rightly has gotten much attention. Not just well-done, but w/ Danish data can observe saving outside employer retirement plans.

Model: (a) Active savers optimize based on robust preferences, not influenced by default settings, adjust voluntary saving for changes to mandatory saving, observe subsidies but may just shift between pockets.

(b) Passive savers swayed by defaults, don't plan to adjust voluntary saving for changes to mandatory, don't observe subsidies. Might or might not adjust consumption when they save due to a nudge or mandate.

Key findings: (a) 85% passive savers, 15% active savers;
         (b) passive savers *do* adjust consumption (rule-of-thumb spenders who observe bank balances, not on rigid consumption paths);
         (c) active savers respond to income tax "incentives" almost entirely by shifting between pockets.

Chetty et al conclusions

(1) Nudges "work," as does mandatory saving even if not in a corner.

(2) Incentives don't work, waste hundreds of billions of $$ in foregone U.S. income tax revenue.

Some caveats and extensions:

(a) How do we know that the passive savers are better-off with more saving? (Obviously, not from revealed preference.)

(b) What are the labor supply effects? (An observational problem: naïve myopes would work less due to substitution effects, more due to income effects – opposite for sophisticated myopes?)

(c) Is the policy experiment raising workers' taxes by hundreds of billions of $$? (Presumably this would not go wholly unnoticed.)

Note that income tax savings "incentives" actually provide neutral lifetime treatment of retirement saving, if same MTR at all times.

Behavior-based efficiency argument for income taxes over consumption taxes, where they raise same revenue but i-tax nominally has lower rate??

(b) Bronchetti et al 2013

A nice complement to studies (Chetty et al, et al) that find nudges efficacious – because here they are not.

Field experiment with tax refunds for low-income filers at VITA sites: opt-in vs. opt-out (of a kind) for the receipt of U.S. savings bonds instead of cash.

Default choice has no effect, possibly reflecting strong preexisting intentions re. use of refunds.

Such intentions could be pro-saving (e.g., paying down high-interest credit card debt).

Little scope for procrastination (no option to do "nothing" instead of "something"). And annual tax refunds may attract focused attention.

Is this actually a significant "nudge"? They're not entirely well-defined (e.g., exhortation vs. inertia).

Back to the design frontiers

(1) <u>Voluntary vs. mandatory saving</u> – Insofar as nudges stick, how much does it matter which of these 2 approaches we use? Is the key question whether changing the default is a good filter for who "should" save more?

Suppose we increase nudges but cut the same people's expected Social Security benefits…

(2) <u>How to encourage voluntary saving</u> – Good case for "nudging" more via defaults, "incentivizing" less (?).

But how should we think about the labor supply effects, and is the claim that hundreds of billions of $$ in tax increases wouldn't be noticed?

(3) <u>Actuarial "fairness" and portfolio choice for mandatory saving</u> – We may be skeptical re. how much this matters – but we don't understand how passive savers value / think about the extra retirement saving!

(4) <u>Income tax versus consumption tax</u> – Behavioral evidence may aid the former – but how much?