

# Save More Tomorrow

## A Simple Plan to Increase Retirement Saving

Research by Richard H. Thaler | By Jessamine Chan

Professor Richard Thaler's Save More Tomorrow plan allows employees to allocate a portion of their future salary increases toward retirement savings.

In the past decade, there has been a rapid shift among employers from defined benefit plans to defined contribution plans. As a result, employees now bear much more responsibility for their retirement savings.

Under defined benefit pension plans, retirement benefits depend on how long an employee has worked at a given company and his or her salary at the time of retirement. Firms using these plans are essentially doing the saving for their employees. Under defined contribution plans, which are much easier for companies to administer, employees must take the initiative to join. Retirement benefits depend on how much the employee decides to contribute and how he or she chooses to invest that money.

While defined contribution plans such as 401(k) plans offer increased flexibility for those who enroll, studies have found that some employees at firms that offer only defined contribution plans contribute little or nothing to them.

"As we've switched over from defined benefit plans to defined contribution plans, we've turned over responsibility for enrollment and contribution decisions to individuals, many of whom don't have expertise in this area," says **Richard H. Thaler**, Robert P. Gwinn Professor of Behavioral Science and Economics. "Now that employees have to save for themselves, many of them just aren't doing it."

Combined with the long-standing problem of the low U.S. savings rate, this recent shift to defined contribution plans means that most middle-class American workers will be even less prepared for retirement than before.

To tackle the problem of inadequate retirement saving in defined contribution plans, Thaler and Shlomo Benartzi of the Anderson School at UCLA have developed a plan called Save More Tomorrow (SMT), described in their recent paper "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving."

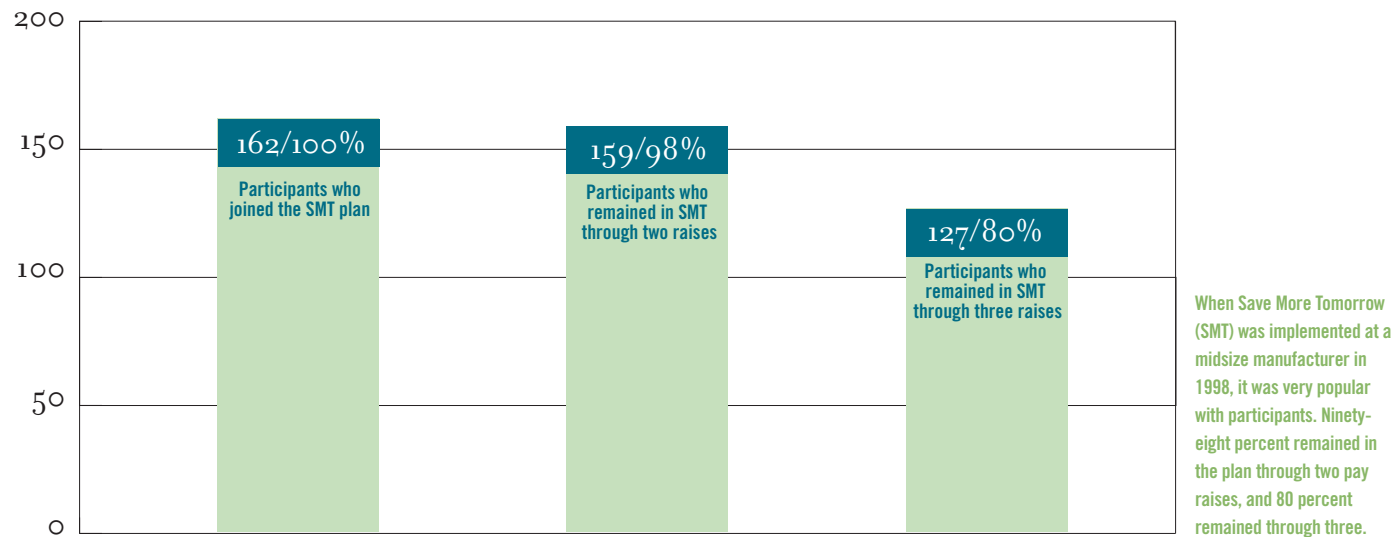


Richard H. Thaler is Robert P. Gwinn Professor of Behavioral Science and Economics. A member of the GSB faculty since 1995, Thaler's research focuses on behavioral economics and finance and the psychology of decision making.

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“Our goal was to design a program to help those employees who would like to save more, but lack the willpower to act on this desire,” write Thaler and Benartzi.

Using principles drawn from psychology and behavioral economics, the plan gives workers the option of committing themselves now to increase their savings rate later. Once employees join, they stay in the plan until they opt out.

The SMT plan has four basic components: First, employees are approached about increasing their contribution rates approximately three months before their scheduled pay increase. Second, once they join, their contribution to the plan is increased beginning with the first paycheck after a raise. Third, their contribution rate continues to increase on each scheduled raise until the contribution rate reaches a preset maximum. Fourth, the employee can opt out of the plan at any time.

The first implementation of the SMT plan yielded dramatic results. The average saving rates for SMT plan participants more than tripled, from 3.5 percent to 11.6 percent, over the course of 28 months.

### Turning Negatives into Positives

What makes the SMT plan work? In order to design a savings plan that would be both effective and easy to use, Thaler and Benartzi took into account several major roadblocks to saving.

One reason households aren’t saving enough is the basic problem of figuring out how much to save. According to the life-cycle theory of saving, households decide what level of consumption they would like over their lifetime, and then borrow or save to attain that amount. The theory suggests that individuals borrow when they are young, due to lower incomes at the early stage of their careers,

and then save for retirement during their prime working years.

“Figuring out how to achieve this life-cycle savings rate requires being able to perform fairly sophisticated bits of economic analysis,” says Thaler. “The truth is that most of those calculations are quite hard even for an economist to perform.” The SMT plan helps people approximate the life-cycle savings rate if they are unable to do so themselves.

A second issue that impedes saving is self-control. “By inviting employees to join a few months before their raise, the plan takes advantage of the fact that for most of us, our self-control intentions about the future exceed our implementations in the present,” says Thaler. “For example, given the option of going on a diet three months from now, many people will agree. But tonight at dinner, that dessert looks pretty good.”

In developing the plan, the authors also addressed the issue of procrastination, which can lead to what economists refer to as inertia. For example, even those who actively take part in 401(k) plans may never bother to increase their savings rate over time or change their allocation of funds among stocks and bonds. By making future increases automatic, the plan eliminates the need for additional actions or self-control on the part of the participant.

The reason the SMT plan works so well is that inertia is powerful. Once people enroll in the plan, few will ever get around to opting out. When employees reach the maximum allocation, they keep saving at the maximum until they actively request to change it.

“We knew people intended to save more but never got around to it because of inertia. So we thought, ‘Let’s build inertia into the plan and make it work for us,’” says Thaler.

The final issue hindering saving is loss aversion, the tendency for people to weigh losses significantly more heavily than gains. Because the SMT plan is tied to pay increases, participants will never see their paycheck go down, and thus there is less loss aversion.

### Save More Tomorrow in Practice

The SMT plan was first implemented in 1998 at a midsize manufacturing company. The company suffered from low participation rates in its defined contribution plan as well as low saving rates. Since the company did not have a defined benefit plan, management was concerned that some of the workers might not be saving enough to support themselves when they retired. The company was also constrained by U.S. Department of Labor antidiscrimination rules that restricted the proportion of benefits that can be paid to higher-paid employees in the firm. Since the lower-paid workers were the ones typically saving little or nothing, the executives were not able to contribute the maximum normally allowed to their own plan.

With the help of an investment consultant, the company decided the specific details of how the plan would work. Each employee at the company was offered the opportunity to meet with the investment consultant. Of the 315 eligible participants, all but 29 accepted the meeting offer. Based on information from the employee, the consultant discussed how much of an increase in savings would be economically feasible and then used commercial software to compute a desired saving rate. For employees reluctant to adopt substantial increases, the consultant limited the increase to 5 percent.

Of the 286 employees who talked to the consultant, only 79 (28 percent) were willing to accept his advice. For the rest of the participants, the consultant offered a version of the SMT plan, proposing that they increase their saving rates by 3 percent per year, starting with the next pay increase. This was quite aggressive advice, because pay increases were barely more than this amount. The pay increases were scheduled to occur roughly three months later. With the 3 percent a year increases, employees would typically reach the maximum tax-deferred contribution within four years.

The plan proved to be extremely popular with the participants. Of the 207 participants unwilling to accept the 5 percent saving rate, 162 employees (78 percent) agreed to

join the SMT plan. Virtually everyone (98 percent) remained in the plan through two pay raises, and 80 percent of the participants remained in the plan through three pay raises. Furthermore, even those who withdrew from the plan after the second or third pay raise did not reduce their contribution rates to the original levels, they merely stopped future increases from taking place. So even those workers were saving significantly more than they were before joining the plan.

### Gathering Momentum

Several subsequent implementations of the SMT plan have taken place since the study was first conducted. While the first company was willing to spend the money to hire a consultant, subsequent implementations have had to be less expensive. In these cases, employees were introduced to the plan via letters, posters in cafeterias, and the occasional special lottery to give them incentives to join. Most of these recent implementations have used a 2 percent increase, so as long as the employee’s raise is more than 2 percent, they will still have extra money for themselves.

“The plan is most effective with in-person enrollment, when there is a person who can help the employees fill out the form and take it out of their hands,” says Thaler. “If the employee has to return a form in the mail, participation rates fall off.”

Interest in the plan has been growing rapidly. Thaler and Benartzi are currently working with the Vanguard Group, an investment management company, on implementing the SMT plan at U.S. divisions of Koninklijke Philips Electronics N.V. The authors have also held discussions with Hewitt Associates, an outsourcing and consulting firm that focuses on human resource management.

Thaler suggests that the plan may one day become standard operating procedure in most 401(k) plans. “We’re giving this idea away for free. All we ask for is the data,” says Thaler. ■

This article was originally published in the summer issue of *Capital Ideas*, a quarterly publication highlighting faculty research at Chicago GSB. For more information, or to request a copy of Thaler’s paper, visit [gsbwww.uchicago.edu/news/capideas/](http://gsbwww.uchicago.edu/news/capideas/) or e-mail the editor at [capital.ideas@gsb.uchicago.edu](mailto:capital.ideas@gsb.uchicago.edu).