

Commentary: Kevin Milligan

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This work by Thomas Crossley, Carl Emmerson, and Andrew Leicester, provides a timely and comprehensive review of the state of knowledge on savings and savings incentives. They begin by setting the stage with the traditional models of saving centred on basic microeconomic theory. In recent years, behavioural economics has strongly influenced thinking about saving. Most usefully, the authors proceed to integrate this more recent behavioural work with the traditional approach. The analysis and conclusions provide a contemporary and insightful guide for future research. Both practitioners in government and researchers in academia should find it highly useful.

Their work inspires three questions in my mind. How do we know there is a savings problem? Can or should we use behavioural economics to design better savings incentives? What are the distributional impacts of savings incentives? I expand on these three questions, and then follow with a conclusion with some cautions on behavioural policy design.

How do we know there is a savings problem?

Many attempts have been made to measure savings adequacy in the economics literature. The results of these attempts tend to be highly variable.²⁹ Part of the difficulty arises in projecting paths for incomes and consumption well into the future. To understand why a family saves what it does today, one must accurately divine that family's projections

29 To cite just one article, Banks, Blundell, Disney, and Emmerson (2002) provide a guide to the literature.

for the future paths of incomes, consumption, and policy. This is challenging.

Beyond the difficulties in projecting adequacy, evidence for a worsening saving problem is also not evident when one looks at the well-being of seniors. The goal of savings policy is to ensure adequate wellbeing in retirement. Incomes in retirement have been rising in the UK; measures of poverty dropping for much of the last 20 years (Jin, Joyce, Phillips, and Sibieta, 2011). Using these metrics as the ultimate measure of adequate saving, there is no evidence of a growing saving problem. Of course, tomorrow's retirees may not match the performance of today's retirees—especially if future retirees are more dependent on volatile equity and housing markets.

How could behavioural models be used to design savings incentives?

In the traditional model, taxes on saving have their impact by changing after-tax rates of return; altering the price that translates current consumption into future consumption. However, behavioural research suggests that the framing, timing, and presentation of savings choices may matter more than rates of return. To the extent this is true, it presents a tremendous opportunity to redesign financial incentives.

Providing tax relief for capital income as a method to stimulate savings relies on the rate of return to saving being the pivotal margin considered in the saving decision. Increasing the marginal rate of return to saving can be very costly to the Treasury, as much inframarginal tax relief must be dispensed in order to affect the margin. However, if factors such as the framing, timing, or information provision about savings opportunities are more important, then the tax dollars foregone through providing tax relief on the rate of return may not be so pivotal and can be at least partially withdrawn.

To be concrete, imagine that the most important factor in generating a lifetime pattern of savings is getting a potential saver to commit to opening an account. Once an account is open, perhaps the monthly statements from the bank do a good job of eliciting a regular savings deposit. If this is so, getting someone in the door of the bank now becomes a most important margin. What barriers exist to opening an account? One barrier to opening an account may be the cost of acquiring information

about how and where to do so. Even with this information in hand, the psychic cost of sitting in a banker's office filling in paperwork should not be underestimated. If account opening is the critical margin, then reallocating the tax benefit from tax relief on investment earnings in the future to compensating the costs of opening an account should produce more savings.

The recently-cancelled Child Trust Fund (CTF) discussed by Crossley, Emmerson, and Leicester conforms well to this framework. The benefit was front-loaded through a grant. This grant was credited when the account is opened, aligning the benefit with the psychic cost.

What are the distributional impacts of savings incentives?

Saving is concentrated among higher income earners. In part, this may reflect the crowd-out of savings by social insurance at lower income levels. For example, if public pensions are adequate to sustain a lower-income lifestyle through retirement, no additional saving may be contemplated by the family. The lower saving by those with lower incomes may also reflect the fact that meager incomes may be depleted entirely by providing the necessities of life, leaving little extra for savings. Whatever the cause, it is clear that savings incentives can have perverse distributional impacts when looked at in a point in time.

One solution to this potential problem is to target savings incentives to income. The downside of any targeting of course is that there must be an income range over which the incentives are phased out. This increases the marginal burden on households with incomes lying in the phase-out range.

A second problem with targeting financial incentives is the question of figuring out the true barrier to saving by lower income families. Given the prevailing patterns of saving, it is likely that lower income families will have lesser access to peer-provided information about saving and may also face higher psychic costs of the formalities of opening up accounts. If so, then changes to financial incentives that affect the marginal return to saving will be ineffective. That is, it is not enough to simply target the same financial incentives to lower income families. A different policy package may be necessary—perhaps one that targets behavioural rather than financial incentives.

Concluding thoughts

I will close my comments by echoing some of the warnings expressed by Glaeser (2006). The potential gain to having well-designed incentives that embody known behavioural motivations may be great. But reaping this harvest relies on imperfect governments—consisting of humans subject to the same psychological weaknesses as other citizens—designing these incentives well. Glaeser (2006) argues that not only may errors be greater under more centrally-designed choice frameworks, but also the errors made may be harder to correct. Added to these concerns about the nature of policy errors is a worry about the potential capture of ‘behavioural’ regulations by industry, in the spirit of Stigler (1971).

None of these concerns mean we should not pursue policies that incorporate knowledge about behavioural economics. They do however caution us to ensure any new policy structure is robust to the persistence of imperfect policy decisions by those charged with policy design.

References:

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