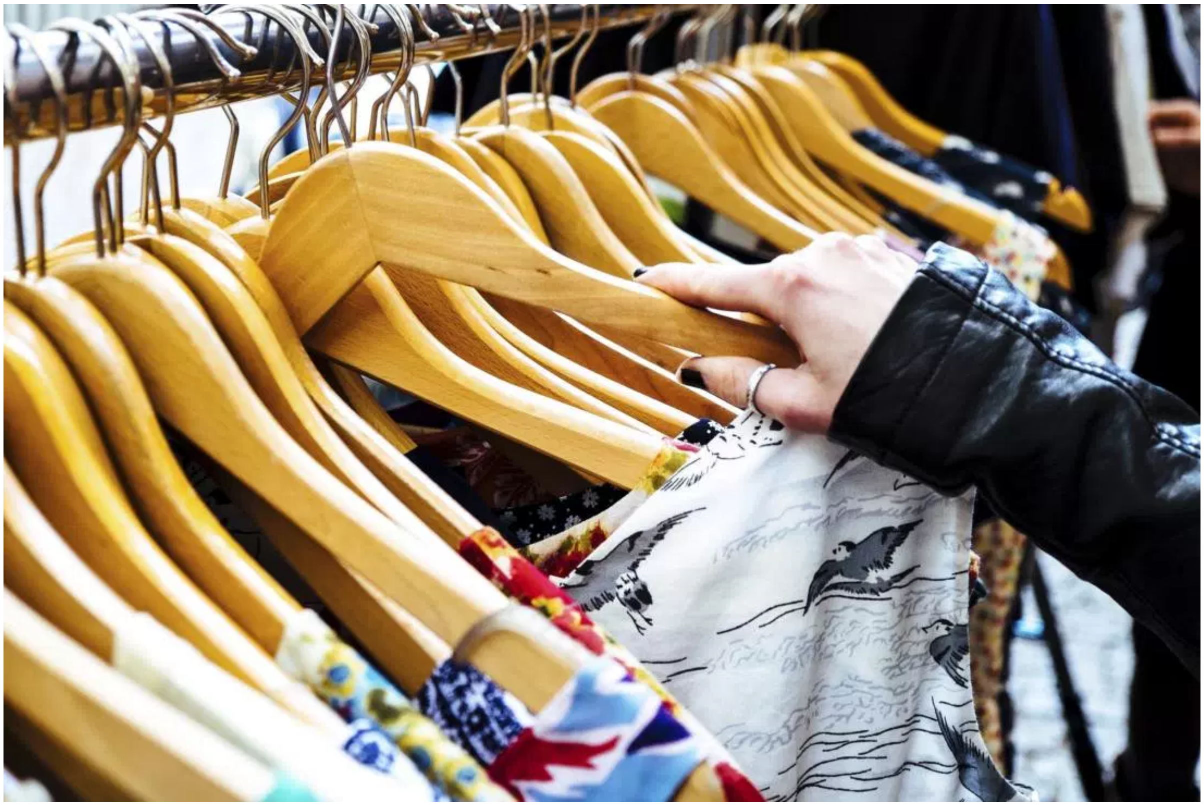
The Science Behind Why You Don't Save (And What To Do About It)



By now, you've probably heard the news that nearly half of Americans can't come up with just $400 to cover an emergency expense without selling something or borrowing money. This fact is even more alarming when combined with data on long-term savings—nearly half of people age 55 and older have no retirement savings at all, other than Social Security.

The short- and long-term savings crisis isn't only an issue facing low-income Americans—it is also a reality for many middle class households. Needless to say, too many of us are living on the edge.
So what is the problem? Why don't we save?

It's not, as you might guess, just because many Americans are too poor to set money aside. Certainly, a lack of resources makes it hard (and in some cases, impossible) to save, but research shows that for many of us, the problem lies elsewhere.Over the last few decades, behavioral economists like ourselves have used insights from psychology and economics to understand what prevents people from saving, and we have designed and tested ways to help people save more. What we've found is that psychological obstacles prevent us from making choices that will benefit us in the long run. In other words, contrary to conventional economic thought, our choices are not always reasoned-out.
One problem is that we tend to prioritize our current desires over our long-term goals. This type of "present bias" often leads us to give into the temptation to blow our paycheck on exciting purchases that provide instant gratification (e.g., a fabulous new device or outfit, a boozy dinner out) rather than setting funds aside for a rainy day.

Another problem is that we get caught up in our busy lives and fail to take action on issues that do not require immediate attention, such as preparing for a retirement many years in the future. Small hassles—like filling out a form—can prevent us from doing important things, like signing up for an investment account.When budgeting, we are actually fairly good at estimating what we'll spend on ordinary items like our mortgage and groceries, but research shows we also tend to underestimate the frequency of "special occasions." So when a wedding anniversary comes up, or we're presented with an exciting but expensive opportunity, we splurge, thinking of it as a rare occurrence. But these "rare occurrences" aren't as rare as we think. When we fail to factor all these exceptions into our budgets, we overspend, also making it harder to save.Fortunately, there are ways to use our understanding of the psychology of (imperfect) decision making to our advantage. One way is to take advantage of people's tendency towards inaction by making saving "automatic."
Research has shown, for example, that automatically enrolling employees in retirement plans and setting the default contribution rate above zero—typically at 2-6% —increases people's retirement savings. (Many people once thought that a higher default contribution rate would reduce participation in savings plans, but we know now that it doesn't.)

We have also learned that more people participate in auto-escalation savings programs—where contributions gradually increase over time—when auto-escalation is the default.If defaulting people into automatic ("opt-out") savings programs can help them set money aside for retirement, how can we apply these lessons to address the crisis of too little savings for emergencies?For answers, we might look to a country where formal savings rates are among the lowest in the world—Afghanistan. Researchers tested a program there in which a large employer informed workers that, unless they chose to opt out, 5% of their paycheck would be automatically deposited into a mobile savings account.
Employees in this program were 40% more likely to accumulate short-term savings than employees who had to opt in—an effect equivalent to providing matching savings contributions from the employer equal to 50% of worker contributions. Even after all incentives were removed and the study had ended, 45% of employees continued to contribute to their accounts.

Given the severity of the short-term savings crisis, why aren't employers offering their workers short-term savings accounts with opt-out, automatic contributions each pay period? For one, employers may be concerned that regulatory barriers prevent them from implementing such a program. Similar concerns discouraged employers from adopting automatic enrollment into retirement savings programs until the Department of Labor and Department of the Treasury came out in support of the idea in 1998. Labor and Treasury could issue a similar set of guidelines today encouraging automatic enrollment in emergency savings plans.Still, even if that happens, not everyone struggling with a lack of short- and long-term savings can rely on their employer to help them save, particularly not in the age of the "gig economy." Therefore, we need banks and other financial service providers to innovate by using insights from behavioral research to design products that facilitate saving. Here are a few suggestions:

- Banks could default their clients' direct deposits into emergency savings. For clients who have paychecks directly deposited into their checking accounts, banks could automatically divert some income into an emergency savings account, unless clients opt out. (This would, of course, require some protections against overdraft on checking, to protect people from negative consequences of setting aside savings.)
- Banks could label these default savings accounts "emergency savings." Evidence suggests labeling can facilitate a process in which people place money into different mental categories and are loathe to use it for

purposes besides the labeled one.

- For clients who decline to enroll in a labeled emergency savings account immediately upon opening a checking account, banks could offer the opportunity to have emergency savings contributions from a checking account automatically kick in at a future date. People are more willing to agree to a difficult but virtuous behavior if the start date is in the future.
- Banks could take advantage of the "fresh start effect". At the start of new cycles, like the beginning of a new week, month, or year, we feel our past failings can be swept under the rug ("That was the old me, and this is the new me"). At these moments, we're extra motivated to tackle tough goals. Our research shows that the "fresh start effect" can spur new patterns of productive behavior and that birthdays in particular are an ideal time to encourage increased savings. Financial institutions could focus on marketing savings accounts to clients at fresh starts.
- Banks could convert debt repayment behavior into savings behavior: For example, borrowers at some Montana credit unions set up automatic withdrawals for their loan payments. Once the loan was paid off, the credit unions offered those borrowers the option to have the same payment amount automatically deposited into a savings account according to the same payment schedule. This is one promising possibility, among others, that has been tested by Innovations for Poverty Action, but more research is needed—particularly with larger financial institutions—on how to harness the power of defaults to help people save.

Many of the thorniest problems we face today—how we eat, spend our time, make tradeoffs between giving into temptation and preparing ourselves for tomorrow—are guided by psychological quirks rather than perfect, optimized decision making — and savings is no exception.

Understanding the psychology of imperfect savings decisions is valuable because it suggests solutions to the current short- and long-term savings crisis. Psychologically-informed financial products and programs can help us make the right decisions for our future selves.

Whether the strategies we've outlined here help us handle an unexpected bill next week or support ourselves in retirement 30 years from today, it's a win-win-win to deploy them: good for us, good for banks, and good for our economy as a whole.

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