# Lessons from a Living (DC) Experiment

By Kerry Pechter *Thu, Mar 28, 2019*

*Israel has found that even a mandatory defined contribution system can't resolve all of the behavioral, economic, or administrative issues that prevent low-income and minority workers from saving for retirement. (Photo: Mahane Yehuda market in Jerusalem.)*

Much of the retirement debate in the US today swirls around the "coverage gap." That's shorthand for the fact that, at any given time, as many as half of the full time employees in the US don't have access to an employer-sponsored retirement plan at work. Low-income and minority workers are most likely to fall into that gap.

To shrink the gap, some states have moved to require companies without plans to enable their workers to enroll in state-sponsored IRAs. At the federal level, some large 401(k) service providers want to bundle dozens or even hundreds of small companies and their workers into low-cost "open multiple employer plans."

Israel has addressed the coverage problem since 2008 with a nationwide mandatory defined contribution (DC) program. All employers and employees must contribute a combined 12.5% of the employee's pay to a tax-favored savings vehicle of the employee's own choosing. Employers must also contribute an additional 5% of pay to an unemployment fund that, if unused, can supplement pension savings. Self-employed workers must now contribute too.

Israel and the US are very different, of course. In population, Israel is only a shade larger than New York City. Its fertility rate, fueled by large orthodox Jewish and Arab families with stay-at-home moms, is higher, so as a nation Israel is demographically younger than the US. Its basic old age pension is relatively skimpy when compared with Social Security.

But, in terms of retirement challenges, Israel resembles the US. Ten years ago, a large percentage of its workforce, especially low-income and minority employees at small companies, weren't participating in a formal tax-deferred plan. With life expectancies rising and the danger that large numbers of elderly would need public assistance, the government had to decide whether to enhance its tax-funded pension or require more private saving. It chose the latter option.

With a Social Security funding shortfall looming in 2034, the US will find itself at a similar crossroads relatively soon. Could some of the lessons that Israel has learned from its decade-long experiment with mandatory DC apply here in the US? As *RIJ* learned from talking with several of Israel's retirement experts, mandatory DC is no panacea. A savings mandate can't magically resolve all of the behavioral, economic, or administrative issues that prevent low-income and minority workers from saving. For some workers, it could make life worse.

**Are Israel's reforms a success?**

One of the original advocates of mandatory DC in Israel was Avia Spivak, a now-retired pension specialist at Ben Gurion University of the Negev in Beer Sheva, the largest city in Israel's arid south. His research for the Bank of Israel showed that poor people in Israel weren't saving. *RIJ* asked Spivak if he thought mandatory DC in Israel has been a success.

Avia Spivak

"It's a mixed bag," Spivak said in a recent phone interview. "From a coverage standpoint, yes. On the one hand, 70% or more of Israeli employees are now covered by a plan. This is compared to 35% to 40% before 2008.

"Coverage, as you might expect, is associated with higher socioeconomic status. In the first [lowest] quintile of wealth, fewer people are covered. If you're in the lower quintiles, you don't get the income tax benefit from saving because you're below the tax floor. The first problem for defined contribution systems is enrollment. We solved that with the mandatory pension," he said.

Coverage and participation rates are just half of the story, however. Savings at retirement will, ideally, support a retiree's pre-retirement lifestyle. *RIJ* asked Spivak if Israelis are now saving enough to retire on.

“It’s not clear whether [mandatory DC has been] successful in that way or not,” he said. “The amount saved so far in the new pension funds is not what we expected. That’s a real problem. The newness or immaturity of the system explains part of that, but there are still specific people, age 40 or more, who haven’t saved enough. Given the number of years that have passed [since 2008], the size of the funds is less than you’d expect. Money may have gone into other forms of long-term saving. But we don’t have data on that.”

The mandatory DC program, which also includes mandatory minimum contributions, target-date default funds, and mandatory partial annuitization of money saved under the program since 2008, was introduced gradually and has been embraced in Israel, according to Spivak.

“Some economists criticized [mandatory DC at the beginning],” he said, “but it has been very popular. When I run satisfaction surveys, 75% to 80% of the people surveyed say they are satisfied or very satisfied with the system. In the same surveys, we asked people if they would prefer to manage their retirement funds themselves. Only 20% said they would.”

**For low earners, the system can backfire**

By all accounts, the mandatory system is working well for well-paid, well-educated employees, many of whom had defined benefit pensions coverage before 2008. The system hasn’t necessarily been as effective among low-income and minority workers at small companies.

Research shows that mandatory savings can backfire on workers, especially on those who earn just above than minimum wage. Like low-income workers in the US, they benefit little or not at all from the tax **incentives** that Israel offers savers. Economic analyses also suggest that all of the mandatory contributions (17.5%), including the employer contribution, come out of their pay, unless they already earn the minimum wage. At retirement, they may receive a lower safety-net pension than if they hadn’t saved at all.

Adi Brender

These have been among the research findings of Adi Brender, an analyst at the Bank of Israel who spoke with *RIJ* recently. In a 2011 paper, he wrote: “The mandatory pension arrangement has a particular negative effect on workers whose income is below the tax threshold and those whose spouses do not work.”

“There is a large group of workers whose income remains low for most of their working lives and their spouses do not work,” Brender found. “Since the NII pensions [the universal means-tested old age insurance] provide a reasonable solution for these workers during retirement, saving for retirement is not desirable for them. These workers are the vast majority of the mandatory pension’s target group.”

Maya Rosen

Nadav Steinberg, another economist at the Bank of Israel, told *RIJ*, “Everyone agrees that for people with low salaries, mandatory defined contribution might be problematic. Statistically, there are two populations who are relatively low income, the ultra-religious Jewish men and Arab women, because they have a lower rate of employment relative to the rest of the population.”

Two other aspects of Israel’s retirement program have also encountered difficulty. In Israel, participants are free to choose from a range of savings vehicles and providers. These include (roughly in order of risk, expense and sophistication) pension funds (which allow investment in guaranteed-return government bonds), “provident funds” (similar to mutual funds) and “manager’s insurance” (a more expensive, more personalized bundle of life, retirement and disability insurance). As in the US, target date funds, chosen by the employer, may be used as a default investment for employees who don’t choose an investment.

Reports on the success of this policy are mixed. Competition among providers is said to have brought fees down, but at least one source claimed that fees are reported to have rebounded a bit as providers compete on brand strength rather than price. One source claims that it's easy for employers to send salary deferrals to many different investment providers, but another says that small employers might simplify their payroll chores by encouraging workers to use a target-date fund chosen by the employer.

Employers might even avoid participation in the mandatory program,  Brender's research suggested, because they recognize that saving may not be in the best interest of low-paid employees who are already living hand-to-mouth. In short, mandating DC doesn't magically eliminate or solve every administrative, economic or behavioral issue that stands in the way of full pension coverage and the achievement of an adequate retirement income.

Nadav Steinberg

"There's the law and then there's what actually happens," said Maya Haran Rosen of the Bank of Israel. "The law says that the employee chooses his or her investments and the employer can't influence their choices.

"But the employer can choose certain funds as the default fund, and people tend to take the default," she added. "Conflicts of interest can also occur and the employer might prefer it if the employees choose a specific fund where there are less operational costs for him. There are now new default funds for the general public with very low administrative fees that are open for everyone, including low earners, and we can see a reduction of the average fees for all the population."

**Room for improvement**

Every prudent-sounding rule seems to create winners and losers. Recognizing that mandatory saving would have little impact on longevity risk without mandatory annuitization, Israel insists that participants annuitize at least enough of their post-2008 tax-favored savings to produce a monthly income of 4,400 shekels or about $1,200. The rest of savings can be taken as a lump sum (with different tax treatment of annuitized wealth and lump-sum payouts).

This seemingly prudent policy will effectively require most of Israel's low-income retirees to annuitize *all* of their post-2008 savings. For high-earners, it may counter-productively create a problem known in behavioral finance as "anchoring."

Orly Sade

"Once regulators impose a minimum level for the annuitization amount, individuals may 'anchor' to that number. They may view that as an educated suggestion," said Orly Sade, a pension specialist at Hebrew University in Jerusalem. "If you set the standard amount too low, then people who were considering taking higher percentage of their savings in an annuity prior to that law, might anchor to that value and take a smaller percentage of annuity, after the initiation of the law.

"Eventually this may be lower than what they need," she told *RIJ*. "My research with Abigail Hurwitz and Eyal Winter from the Hebrew University suggests that the public views the constraint as a message. If you put in a low constraint, annuitization will converge on it. We aren't sure why they set the annuitization amount at about 4,000 shekels. Maybe it was relatively close to the minimum wage."

Interestingly, the reluctance to annuitize retirement savings that researchers have found in the US and other countries—the "annuity puzzle"—barely exists in Israel, Avia Spivak has written. “Withdrawal preferences in Israel differ from those documented in other countries, as expressed by the tendency to prefer annuitization over receipt of a lump sum,” he and his co-authors wrote in a 2015 paper.

“Israelis seem to trust the system,” Spivak told *RIJ* in an interview. “That may seem a little odd, but this is Israel.” Israelis, despite their internal political divisions, are unified by external military threats and quite literally rely on the government for their security. “We trust the system because we have to trust the system,” he said. “This system is the lesser of all evils. But there’s room for improvement.”