



Rational and behavioural predictors of pre-retirement cash-outs



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ABSTRACT

Given the worldwide concern that individuals are not saving sufficiently for retirement, many governments are taking action to try and rectify this tendency. A key focus area is implementing policies to dissuade individuals from accessing accumulated retirement funds when changing jobs. While traditional economic theories assume that individuals act rationally and make optimal decisions without outside intervention, current policy interventions support behavioural theories of decision-making where sub-optimal choices occur due to limitations in human decision-making. Therefore, interventions are based on the assumption that individuals act irrationally. Despite these interventions, many individuals still access their funds suggesting that current interventions may not be sufficiently aligned with the factors influencing decision making in this environment.

The main research objective of this study was to test empirically both rational and behavioural factors that could potentially influence retirement preservation decisions, to determine which factors were the best predictors of whether an individual preserved funds when changing jobs. A research instrument was designed using a combination of existing psychometric measures and customised questions to form an analytical survey. This was used to test the factors that predicted the preservation decisions of a sample of 256 academic and non-academic personnel at a tertiary education institution in South Africa.

The study found that behavioural factors play an important role in predicting preservation decisions. In particular, behavioural factors related to bounded rationality, due to the computational complexity of the decision-making environment, emerged as important explanatory variables, indicating that interventions such as decision support and guidance may assist individuals in making optimal decisions.

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1. Introduction

Should policy makers intervene in individual retirement decision-making, and if so, what form should such intervention take? From hard-line paternalistic interventions to more liberal “nudges”, the debate is on-going as to the role government should play in ensuring that individuals retire with sufficient savings. Given the worldwide concern that individuals are not saving sufficiently for retirement, many governments are taking action to reverse this trend. A key focus area is dissuading individuals from accessing accumulated retirement funds when changing jobs, as the problem of low levels of preservation is increasingly recognised as a crucial issue that may result in insufficient savings at retirement (South Africa, National Treasury, 2007; United States, Working Group on Retirement Plan Leakage, 1998).

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In light of these concerns, governments have attempted to decrease withdrawals through policy intervention (John & Iwry, 2008; South Africa, National Treasury, 2013). In a number of countries, such as Australia, Canada and the United Kingdom, pension withdrawals are strictly regulated and in most cases pre-retirement withdrawals are prohibited, while in other countries, such as the United States, pension withdrawals prior to retirement are discouraged through the use of taxes and penalties (Bassett, Fleming, & Rodrigues, 1998; South Africa, National Treasury, 2012). In South Africa taxes are used to discourage withdrawals. The system is based on cumulative withdrawals, providing for an initial tax free amount of R22,500 and a sliding scale of taxes for withdrawals above this amount ranging from 18% to 36% (Stiglingh, Koekemoer, van Schalkwyk, Wilcocks, & de Swardt, 2013). As part of a broader retirement reform process, the South African government's aim is to introduce mandatory preservation, however the proposal is still under discussion and an implementation date has not yet been finalised (South Africa, National Treasury, 2014).

While traditional economic theories assume that individuals act rationally and make optimal decisions without outside intervention, the policies initiated by various governments appear to contradict these traditional theories in that they assume that intervention is required. This approach is more in line with behavioural theories of decision-making, which assume that limitations in human decision-making can lead to sub-optimal choices. Therefore, the policies are put in place based on the assumption that individuals act irrationally and will, if left to their own devices, take a cash payout as they do not have the requisite self-control needed to save for retirement. However the current interventions which use tax penalties do not appear to be effective for the majority of those who face cash-out decisions. Studies in the United States have found that between one half and two-thirds of employees take a cash payout of accumulated retirement funds when moving jobs (Bassett et al., 1998; Engelhardt, 2002; Munnell, Golub-Sass, & Muldoon, 2009). Research in South Africa has also found that the majority of individuals do not preserve retirement funds when switching employers, instead they choose to take a cash payment (Sanlam Employee Benefits, 2013; South Africa, National Treasury, 2007).

In theory, the reasons for choosing to take a cash payout rather than preserving retirement funds when leaving a job could be driven by either rational or irrational factors. Rational reasons would focus on the predictions of the life-cycle hypothesis (LCH) linked to consumption smoothing and liquidity constraints (Amromin & Smith, 2003; Love, 2007), while irrational reasons could be driven by behavioural factors such as bounded willpower linked to self-control problems or bounded rationality stemming from the computational complexity of the decision-making environment (Desai, 2011; Jolls, Sunstein, & Thaler, 1998; Monahan, 2004; Thaler, 1994) and would therefore be more in line with the behavioural life-cycle hypothesis (BLCH) (Shefrin & Thaler, 1988).

While a number of theoretical papers have been written about the potential influence of behavioural factors on decision-making both in the accumulation and decumulation phases of retirement (Benartzi, Previtro, & Thaler, 2011; Monahan, 2004; Thaler, 1994), to date, empirical studies of retirement savings decisions have generally focussed on testing these theories in the context of enrolment decisions, contribution rates and asset allocation decisions (Benartzi & Thaler, 2007). None to our knowledge comprehensively test the influence of behavioural factors in the context of retirement preservation decisions. Existing empirical tests of factors that influence preservation decisions have focussed almost exclusively on demographic and socioeconomic variables to explain preservation decisions (Amromin & Smith, 2003; Bassett et al., 1998; Engelhardt, 2003; Hurd & Panis, 2006; Moore & Muller, 2002; Munnell et al., 2009; Poterba, Venti, & Wise, 1998), with some information related to education levels and financial planning horizons providing superficial insights into behavioural aspects. These studies do not, however, explicitly consider the role played by behavioural factors. This omission is perhaps due to the difficulty in obtaining information about behavioural constructs such as bounded willpower and bounded rationality in the existing surveys and data sets which have been used for these analyses.

Therefore, the problem that emerges is that there is a lack of understanding of all the factors which play a role in retirement preservation decisions. The current regulatory interventions in retirement preservation decisions assume irrationality in the decision-making process. However, despite the presence of taxes, high cash-out levels are still observed, suggesting that current interventions may not be aligned with the underlying factors that drive decisions. By assessing which factors predict whether an individual preserves funds when moving jobs, greater insight may be obtained regarding more appropriate interventions.

The main research objective of this study was to test empirically both rational and behavioural factors that could potentially influence retirement preservation decisions in order to determine which factors were the best predictors of whether an individual preserved funds when changing jobs. The contribution that this study consequently makes is both in the design of a research instrument that explicitly accounts for behavioural factors in retirement preservation decisions and the subsequent empirical testing of this instrument to ascertain the importance of behavioural factors in these decisions.

The first part of this paper outlines why there is a renewed focus on the rationality of the individual decision-maker. The factors that potentially play a role in retirement preservation decisions are highlighted and the implications for interventions are discussed in the context of a conceptual model. Thereafter the method selected to test the conceptual model empirically is explained. The final part of the paper contains the results and a discussion of the theoretical and practical implications of the research.

2. Theoretical framework

One of the key international trends in the retirement industry over the past few decades has been the move from a defined benefit to a defined contribution approach to retirement saving. This move has seen increased responsibility being

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