The Limitations of Defaults

JOHN BESHEARS, JAMES J. CHOI, DAVID LAIBSON, AND BRIGITTE C. MADRIAN

A wide range of evidence has documented that economic outcomes can be powerfully influenced by default options – the options that are selected on behalf of an individual when the individual does not affirmatively make selections herself. In decision domains as diverse as e-mail marketing, organ donation, automobile purchases, and retirement savings and investment, individuals are likely to accept the default passively, so the policymaker or manager who chooses the default is often able to choose the modal outcome that is implemented.

In this paper, we study the limitations of defaults. Given the effectiveness of defaults in a variety of settings, it is natural to ask how far the influence of defaults can extend: to what extent will individuals more actively resist a default when it begins to conflict with their best interests? We also examine the closely related issue of which employees are more likely to be influenced by defaults.

To shed light on these questions, we analyze data on the defined contribution retirement savings plan of a firm in the United Kingdom. Eligible employees at the firm are automatically enrolled in the plan upon hire at a 12% default contribution rate, with contributions invested in a default asset allocation that is a mix of bonds and equities. In other words, an employee who does not actively elect otherwise will contribute 12% of every paycheck to the plan on a before-tax basis, invested according to the default asset allocation. This default contribution rate is considerably higher than the default contribution rates that have been examined in the past, which are typically in the range of 2% or 3% and sometimes as high as 6%.

The default contribution rate at the firm we study is not only a particularly aggressive default option but also a suboptimal choice for all employees. The firm contributes to employee accounts by matching employee contributions between 12% and 18% of pay on a one-for-one basis. This discontinuity makes the 12% default rate suboptimal for any possible employee preferences about saving. Even an employee wanting to save about 12 percent would be better served by switching back and forth between a lower contribution rate (eg. 6%) and a higher contribution rate (eg. 18%) to take advantage of the employer match.

Using data on employees hired at the firm between July 2006 and June 2007, we analyze the extent to which employees opt out of this unattractive default. By twelve months of tenure, only 25% of employees have passively stayed at the 12% default contribution rate. This compares with estimates from our earlier work on firms with more modest default contribution rates, where the comparable fraction of employees remaining at the default rates were over 60 percent. This suggests that defaults can quickly lose much of their power as they become more aggressive.

Still, a meaningful fraction of individuals is slow to opt out of the default even in this more extreme example. On the question of which employees are more likely to remain at the default, we find that...
employees who remain at the 12% default contribution rate after twelve months of tenure have lower salaries on average than employees who elect nearby contribution rates. The evidence suggests that barriers to active decision-making, such as procrastination or a lack of relevant knowledge, play an important role in the tendency of low-income employees to opt out of defaults more slowly than high-income employees. The particularly powerful impact of defaults on individuals with low human capital implies that variation in defaults across decision domains may cause these individuals to exhibit seemingly contradictory preferences. Policymakers may wish to keep these individuals in mind when setting defaults.

The full working paper is available on our website, www.nber.org/programs/ag/rrc/books&papers.html as paper NB10-02.

JOHN BESHEARS is Assistant Professor of Finance at Stanford University Graduate School of Business and an NBER Faculty Research Fellow.

JAMES CHOI is Assistant Professor of Finance at the Yale School of Management and an NBER Faculty Research Fellow.

DAVID LAIBSON is Harvard College Professor at Harvard University and an NBER Research Associate.

BRIGITTE MADRIAN is the Aetna Professor of Public Policy and Corporate Management at Harvard’s Kennedy School of Government and an NBER Research Associate.

This research was supported by the U.S. Social Security Administration through grant #10-M-98363-01-2 to the National Bureau of Economic Research as part of the SSA Retirement Research Consortium. The findings and conclusions expressed are solely those of the author(s) and do not represent the views of SSA, any agency of the Federal Government, or the NBER.