The purported goal of this chapter is to analyze employee preferences over a defined benefit versus a defined contribution retirement plan in a way that would inform such a choice in a Social Security system with a voluntary defined contribution component. The authors note that looking at participation rates in employer-sponsored defined contribution plans for guidance may not be very informative because the choice between participating or not in such a plan is a tradeoff between current versus future consumption, whereas the decision to allocate part of one’s Social Security contributions to a defined contribution account is a trade-off between how to fund future consumption. To assess preferences for being in a defined benefit versus a defined contribution plan, the authors look to the 1998 introduction of a defined contribution option in the Illinois State University Retirement System which had traditionally offered only a defined benefit pension plan. Unfortunately, the results of their analysis are largely uninformative about the preferences that individuals might have for diverting part of their Social Security contributions to a defined contribution account, for reasons that I will outline below. Although the authors are largely unsuccessful in achieving their primary aim, they nonetheless document many interesting patterns that speak more generally to how individuals make decisions. These will also be discussed below.

There are several reasons why the analysis of the natural experiment in this chapter is largely uninformative on the question of individual preferences for a defined contribution component to Social Security. First, the natural experiment allows employees to choose between three options: a “traditional” defined benefit plan, a “traditional” defined contribution plan (the self-managed plan or SMP), and a portable defined benefit option that shares some features of both a defined benefit and a defined contribution plan but that is largely branded to employees as a modified defined benefit plan. Using the fraction of employees who choose the defined contribution SMP plan in this context as an indicator of preferences for a defined contribution option in the Social Security system is problematic as doing so requires assuming that the presence of the portable defined benefit option is irrelevant to the choice between the traditional defined benefit and the SMP plan. It is, however, highly unlikely that the fraction of employees choosing the defined contribution SMP plan is unaffected by whether the portable defined benefit option is available.

Second, the natural experiment analyzed in the chapter gives individu-
als an all-or-nothing choice: employees are wholly committed to one of the three options. They cannot choose to have part of their contributions allocated to the defined benefit plan and part allocated to the SMP. In contrast, the personal account proposal of President Bush’s Commission to Strengthen Social Security does not give individuals an all-or-nothing option; rather, individuals are only allowed to redirect a part of their Social Security contributions to a personal account. Thus, the overall portfolio risk associated with choosing the defined contribution SMP plan in the natural experiment is very different from that of choosing to participate in a personal account under Social Security.

Third, employer contributions to the defined benefit plan in the natural experiment are higher than are employer contributions to the defined contribution SMP plan. Thus, the choice between the plan in the natural experiment is not only between the defined benefit versus defined contribution characteristics of the plans, but also in the effective level of compensation that employees receive under the two plans.

Fourth, an important component of the benefits received upon retirement is retiree health insurance, but the receipt of retiree health insurance is contingent upon actually choosing to annuitize benefits under the defined contribution SMP plan or the portable defined benefit plan. This makes the traditional defined benefit plan more attractive than would be the case if employees had a preference to take a lump sum at retirement rather than to annuitize (as might be the case for employees with a shorter life expectancy). The choice in the natural experiment thus confounds preferences over a defined benefit versus a defined contribution plan with preferences over annuitization and retiree health insurance.

Finally, the results in the chapter suggest that even in the absence of any bias from the four factors described above, employees in the natural experiment probably do not well understand the choices that they face as many fail to make any choice at all and are defaulted into the traditional defined benefit plan as a result. In this context, it is very difficult to infer much from employee preferences at all. If the default plan had been different, it is likely that the fraction of employees in each of the plans would have been very different (see, for example, Madrian and Shea 2001; Choi et al. 2004). A more informative natural experiment would have required all employees to make an active decision about which plan to participate in (Carroll et al. 2005).

If we cannot learn much about actual preferences over participation in a defined contribution plan from the analysis of the natural experiment in the chapter, what can we learn? The chapter corroborates existing evidence on the importance of defaults in saving plans and other outcomes (Madrian and Shea 2001; Choi et al. 2004; Yang 2005). The authors find that 56 percent of employees overall are defaulted into the defined benefit plan. Furthermore, the authors find that the fraction of employees de-
faulting into the defined benefit plan is much higher after the initial marketing blitz associated with the plan change has subsided, which is consistent with results about the importance of the default investment option under the private account component of the Swedish Social Security system (Palme, Sundén, and Söderlind 2007). While some of these defaulted employees probably did have preferences over the traditional defined benefit plan, it is likely that many did not. The key piece of evidence supporting this contention is that employees who defaulted into the traditional defined benefit plan have the highest rate of departure prior to being vested, and yet this plan is arguably the worst plan for those employees who leave with short tenure.

The chapter also provides some very intriguing evidence on how complexity impacts decision-making outcomes. Employees of the State University Retirement System who arguably have or have access to the most information and expertise on the relative merits of the three plans make very different elections than other employees in the system. Only 10 percent of these employees are defaulted into the defined benefit plan (versus 56 percent overall). Forty-nine percent actively elect the portable defined benefit plan (versus 19 percent overall), and only 5 percent choose the defined contribution SMP plan (versus 15 percent overall). The chapter finds, perhaps not surprisingly, that employees who are likely to find the choice between the three plans the most complicated, namely, younger and lower-income employees, are more likely to be defaulted into the traditional defined benefit plan. Surprisingly, the group most likely to elect the defined contribution SMP plan, the academic staff at universities, are presumptively more financially literate than most other employees even though the chapter makes the case that the portable defined benefit plan ought to dominate the SMP plan for almost everyone. The familiar axiom, a little knowledge is a dangerous thing, may very well be true here. The results are certainly in line with those of Choi, Laibson, and Madrian, (2006); Beshears et al. (2006); and Duflo et al. (2006) that complexity may lead individuals to make suboptimal savings choices.

Collectively, these results raise as many questions as they answer and provide many avenues for future research. If the default matters for outcomes, and one default is not predominantly the best for most employees, how should the Illinois State University Retirement System choose its default pension plan? If employees were forced to choose among the plans, which plan would they actually choose? If employees were provided with either better or different information about the plan options, how would their choices change? If the outcomes observed depend on factors such as which plan is the default and how information is presented, can we really hope to learn anything about employee preferences, and if so, what conditions would need to prevail?
References


