

The Downside of Defaults

JEFFREY R. BROWN, ANNE M. FARRELL, AND SCOTT J. WEISBENNER

One of the most influential contributions of behavioral economics to business practice and public policy over the past decade has been to demonstrate the substantial power of default options in influencing human behavior. Nowhere is this influence more apparent than in the area of pension design and policy. Compelling evidence that shifts in default options dramatically increase participation and savings in 401(k) plans prompted the U.S. government to codify automatic enrollment in the 2006 Pension Protection Act; and in recent years, we have seen dramatic increases in the use of automatic enrollment, automatic escalation of contributions, and automatic portfolio allocation and rebalancing.

The use of defaults is often portrayed as a Pareto improvement, because it guides behavior while still providing the freedom to choose. Several papers, however, have explored conditions under which defaults are more or less likely to improve decision-making. For example, a number of papers show that poorly designed defaults can reduce welfare if employees fail to later adjust the defaults to suit their needs. Other studies show that optimal defaults for financial decisions can vary depending upon participant characteristics.

In this paper, we explore why individuals default and, in particular, what explanations for defaulting lead most often to regret later. The setting is the State Universities Retirement System (SURS) for the state of Illinois, which provides participants with a choice of three pension plans at the time of enrollment. One of the three plans – a traditional defined benefit plan – is the default plan for participants who fail to make an active choice within six months of the start of employment. The decision is complex because the three plans offer substantially different benefits and costs in both the short-run and the long-run, so that different individuals are likely better off in different plans. The financial stakes are large because the plan choice or default is a one-time, irrevocable decision that must be made in a relatively short time period.

Our findings are as follows. First, we find that the likelihood of default is higher for participants with less education, who are less confident in their investment skills, and less knowledgeable about plan parameters. Second, we find that participants' self-reported reasons for defaulting vary widely. The self-reported reasons include decision complexity, procrastination, information problems, a perception that the default is the endorsed option, a perception that the choice is economically inconsequential, and deliberately defaulting because the default plan is perceived as the best choice.

Third, we find that satisfaction with one's plan differs greatly across defaulters and active choosers. Rates of "regret" (defined as a participant indicating a preference to enroll in a different plan if given the opportunity) are significantly higher among those who default than those who make an active choice. Specifically, over 28 percent of those who defaulted would choose a different plan, whereas less than 19 percent of those who made an active choice would do so. We also show that the likelihood of regret

depends critically on the self-reported reasons for defaulting. For example, nearly half of all participants who cited “I needed more time” as a very important reason for defaulting subsequently regret their plan choice. In general, those citing time constraints, procrastination, and information problems/complexity are substantially more likely to regret being in the default plan than those who deliberately defaulted, those who viewed the default as an endorsement, and those who believed the pension choice was not important to their financial well-being.

Finally, we find that regret is frequently driven by learning. Specifically, participants who learned that others who they view as similar to themselves were enrolled in a different plan (the same plan) are significantly more (less) likely to regret their plan enrollment. We also find that participants who learn that some of their prior beliefs about their plans were incorrect are significantly more likely to regret the decision.

These findings have important implications for policy design. It is important, for example, that defaulters not be viewed as a homogenous group. For some, defaulting is simply an efficient way to elect the plan they would have chosen anyway. For others, however, being defaulted into a plan due to a lack of information, complexity or procrastination is more likely to lead to subsequent dissatisfaction. This underscores the importance of ensuring that participants are provided with salient information, decision tools, and perhaps other prompts to encourage an active decision.

The full working paper is available on our website, www.nber.org/programs/ag/rrc/books&papers.html, as paper NB12-05.

JEFFREY BROWN is the William G. Karnes Professor of Finance at the University of Illinois at Urbana-Champaign, Associate Director of the NBER Retirement Research Center, and an NBER Research Associate.

ANNE M. FARRELL is on the faculty at Miami University of Ohio.

SCOTT WEISBENNER is a Professor of Finance at the University of Illinois at Urbana-Champaign and an NBER Research Associate.

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