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Chapter Author: Jeffrey R. Brown

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Comment Jeffrey R. Brown

This chapter provides powerful evidence about a deceptively simple idea: “defaults matter.” The chapter nicely summarizes the large and growing literature (the lion’s share of which was authored by various combinations of the current authors) about the power of default options to influence a wide range of behaviors related to retirement security.

Specifically, the authors provide evidence about how defaults influence behavior along every major dimension of the financial planning process related to retirement, including: (1) the decision of whether to participate in a 401(k) plan; (2) how much to contribute, conditional on participating; (3) what portfolio allocation to choose for those contributions; (4) what to do with the money when one leaves an employer; and (5) how to withdraw the money at retirement.

The foundation for this chapter is a large set of individual research projects that analyze a variety of natural or designed experiments to determine the effect of default options on individual behavior. To varying degrees, the underlying studies are individually compelling. Taken as a whole, the combined evidence is undeniable and overwhelming.

After providing this careful review of the existing evidence, the authors then explore several potential explanations for why defaults have such a strong effect on individual behavior, in contrast to the standard neoclassical model. These explanations include the following:

1. There are low average levels of financial literacy. Many studies indicate that most U.S. citizens are unable to correctly answer fairly basic questions about investment characteristics, such as whether a money market fund holds stocks or whether an individual employer’s stock is more or less risky than a diversified stock fund.

Jeffrey R. Brown is the William G. Karnes Professor of Finance at the University of Illinois at Urbana-Champaign, and a research associate of the National Bureau of Economic Research.

2. Individuals view the default option as an endorsement, that is, as implicit investment advice from the plan sponsor.
3. Defaults provide a shortcut through the tremendous complexity facing individuals trying to make these decisions on their own.
4. Individuals are biased toward the present, and defaults help them to circumvent procrastination.

My suspicion is that all of these factors matter both individually and in combination. Nonetheless, the logical next step in this literature is to determine the relative importance of these factors and whether that ranking is the same in all contexts. Understanding the underlying determinants is of more than academic interest—it is also important for assessing whether there are other interventions that may influence behavior and possibly lead individuals to make more active decisions that may improve individual welfare.

The role of default options is particularly important in the context of retirement planning for at least two reasons. First, developing an optimal life-cycle savings and investment plan is extremely complex, particularly when one accounts for the many sources of uncertainty that one faces (e.g., earnings, rates of return, inflation, health status, medical expenditures, and longevity). The advice of “experts” is not necessarily the solution to the complexity problem, given the numerous and conflicting sources of investment advice available in the marketplace. Second, unlike many other contexts where one can “learn by doing,” the opportunity to learn from one’s mistakes is limited in this context. The reason is that an individual may not realize their mistakes until it is too late to fix them. For example, it does one little good to learn at age seventy that they should have saved more at age fifty.

The authors suggest that the alternative to a default option is to enforce an active decision. My view differs in a subtle way: even with active decision enforcement, there is still a default option. The default is to simply accept whatever penalty or punishment is meted out for a failure to actively decide. More important than the semantics is that the active decision enforcement approach still does not overcome some of the problems that led to the power of defaults in the first place, such as problems associated with a lack of knowledge or the inability of some to grapple with the complexity of the choice set. Thus, my own conclusion from this chapter and the underlying literature is that there is always a default option (although it is not always well-specified) and that intelligent policy design must, therefore, pay careful attention to the behavior that the default will engender.

Perhaps out of modesty, the authors do not discuss in this chapter just how influential and pervasive the idea that “defaults matter” has become in policy circles over the past few years. For example, only in current decade has it become standard for analyses of Social Security personal ac-

count reform proposals to explicitly distinguish whether participation in the personal accounts is on an “opt-in” or an “opt-out” basis, largely because policymakers and analysts now understand that this distinction will likely lead to significantly different participation rates. As another example, the Pension Protection Act, which was signed into law in August 2006, includes numerous changes to the nation’s pension laws that are designed to pave the way for employers to adopt “automatic enrollment” in 401(k) and similar plans. In a related effort, the Department of Labor proposed new regulations in September 2006 that will set the framework that plan sponsors must work within when determining the investment portfolio that individuals can be defaulted into when they are automatically enrolled in a 401(k) plan. There is little question in my mind that the academic literature on the power of defaults has helped generate a tremendous (and largely bipartisan) enthusiasm for “automatic enrollment” approaches in the discussion of retirement policy in the United States.

Looking to the future, the one area of this body of work that has received the least attention, at least relative to its importance to overall retirement security, is the payout phase. The importance of this area is underscored by the large literature exploring the large potential welfare gains from annuitization. A basic empirical fact about the private pension system in the United States is that the vast majority of 401(k) plans do not even offer plan participants an option to annuitize their accounts at retirement. In other words, the current default option is to leave wealth in an unannuitized form. My normative judgment (which has been influenced by the annuities literature) is that this is a suboptimal default option because it leaves individuals suboptimally exposed to longevity risk.

Designing an annuitized default option for the payout phase poses a more difficult policy challenge than most other aspects of the retirement planning process, however, because of the “irreversible” nature of most existing annuity products. For example, we know that there will always be some individuals for whom an annuity is not an attractive option, such as those who are terminally ill or those with very strong bequest motives. If these individuals are automatically annuitized at retirement, their welfare could be substantially reduced if there is no way for them to undo the annuity contract once they have entered into it. This makes the downside risk of being defaulted into an annuity much larger than the downside of being automatically enrolled into a 401(k) plan, which can easily be reversed if the individual later decides to do so.

These difficulties, however, should not lead one to think that “no annuitization” is the better default. For example, one could imagine designing a default with two features. First, make the annuitization gradual, or laddered, such as by converting 20 percent of the account balance into an annuity each year for five years. In addition to helping to smooth out asset price and interest rate fluctuations, such an approach gives an individual

the opportunity to opt out of the annuity on at least part of their wealth. If a person had 20 percent of their wealth automatically annuitized, this would “focus the mind” on the benefits and costs of doing so. At that point, if they realize that full annuitization is not optimal, they can avoid it on the remaining 80 percent of wealth. A second feature would be to allow a limited period of reversibility, such as 6 months after annuitization. Reversibility would allow individuals an opportunity to “undo” the annuitization if they were opted in and subsequently realized they did not want this. Keeping the time period short would limit the selection costs and administrative costs that such an approach would impose on the system.

In summary, the body of evidence discussed in this chapter makes it clear that default options matter at nearly every step in the financial planning process. Going forward, the research agenda in this area should seek to distinguish between the alternative hypotheses for *why* defaults matter. With this knowledge in hand, policymakers and plan designers will be able to more finely tune the policy levers that may increase average welfare of plan participants.