



Decision-making approaches and the propensity to default: Evidence and implications



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ABSTRACT

This paper examines heterogeneity in the responsiveness to default options in a large state retirement plan, focusing on individuals' decision-making approaches as well as their economic and demographic characteristics. Analyses of a survey of plan participants show that procrastination and the need for cognitive closure are important determinants of the likelihood of default. This paper also explores an important implication of defaulting—individuals who default are significantly more likely to subsequently express a desire to enroll in a different plan. The desire to change plans is also correlated with numerous economic and decision-making characteristics, including procrastination.

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1. Introduction

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 retirement plan design and policy. Compelling evidence that changing the default option dramatically increases participation and savings in 401(k) plans (e.g., Madrian and Shea, 2001; Choi, Laibson, Madrian, and Metrick, 2002, 2004)

prompted the U.S. government in the 2006 Pension Protection Act to provide safe harbor provisions for firms offering automatic enrollment in defined contribution retirement plans. In recent years, there has been a dramatic increase in the use of automatic enrollment, automatic escalation of contributions, and automatic portfolio allocation and rebalancing both in the U.S. and abroad. For example, the Plan Sponsor Council of America's (2012) 55th Annual Survey finds that 46% of surveyed defined contribution plans have an automatic enrollment feature in 2011, while Munnell and Sundén (2004) report that 7% of plan sponsors offered automatic enrollment in 1999. There have also been calls to extend the logic of defaults to the post-retirement payout phase of retirement plans by encouraging automatic annuitization (Gale, Iwry, John, and Walker, 2008).

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Although countless studies show profound effects of defaults on behavior, there is still limited understanding of why defaults have such large effects overall, and, equally importantly, why there is heterogeneity in the responsiveness to defaults. This paper provides an empirical analysis of the determinants of a default decision in a large public plan that offers an irrevocable choice among three retirement plans: a traditional defined benefit plan, a portable defined benefit plan, and a defined contribution plan. In addition to examining the full range of economic and demographic factors, analyses also shed light on the role of several relevant individual decision-making approaches identified in the judgment and decision-making literature. These include approaches in the presence of decision conflict, or uncertainty about which course of action to take (Mann, Burnett, Radford, and Ford, 1997); indecision (Frost and Shows, 1993); the propensity to regret (Schwartz, Ward, Monterosso, Lyubomirsky, White, and Lehman, 2002), and the need for cognitive closure, or the desire to come to an answer (Roets and Van Hiel, 2011). Measures of economic, demographic, and decision-approach factors that affect defaults are captured using a broad survey conducted among participants in the State Universities Retirement System (SURS) of Illinois. In all, over 6000 public university employees in the State of Illinois responded to the survey during the fall of 2012.

We first study whether individuals made an active retirement plan choice or defaulted into the traditional defined benefit plan (individuals are defaulted six months after joining the system unless they make an active election prior to that date). Approximately 27% of survey respondents defaulted whereas the remainder actively chose among the three plans. Numerous demographic and economic variables influence the propensity to default. For example, higher income and higher net worth individuals are significantly less likely to default, as are women, those with higher self-assessed investment skills, those with greater knowledge of the retirement system, and a higher education level.

With regard to decision-making approaches, results show that a tendency toward procrastination is significantly positively correlated with the likelihood of default. Numerous authors have speculated that procrastination is a plausible reason for default, although this has not been shown empirically.¹ This finding is quite intuitive: those with a tendency to procrastinate are less likely to make an active decision before the default deadline. It is also consistent with a body of economic theory that portrays procrastination as an outcome of present-biased preferences (Akerlof, 1991; O'Donoghue and Rabin, 1999). In this view, people with present-biased preferences tend to systematically overweight the cost of making a decision today, a tendency that manifests itself as procrastination.

Results also show that individuals with a strong need for cognitive closure are less likely to default. Kruglanski (1990, p. 337) defines need for closure as a desire for “an

answer on a given topic, any answer...compared to confusion and ambiguity.” A need for closure is therefore a natural factor to explore that can potentially mitigate default behavior.

Having established that individual decision-making approaches are correlated with the likelihood of default, we then turn to understanding how individuals evaluate the suitability of their retirement plan *ex post*. In addition to providing some insight into the individual welfare implications, this analysis is also useful for ruling out the possibility that procrastinators might accept the default because they believe it is the best option. For example, self-aware procrastinators might decide that the Traditional Plan is best for them because it requires less active oversight or because it removes the temptation to cash out the plan upon retirement. Survey respondents were asked, “If you could go back in time and re-do your original pension choice (assuming the rules when you joined SURS are still in place), which plan would you choose?”, and also rated the strength of their desire to choose a different plan. Results show that respondents who defaulted into the Traditional Plan are 21% less likely to want to select the same plan if given a chance to re-do their choice. This result is true even relative to those who actively chose the same plan into which others were defaulted, suggesting that it is the default behavior rather than the plan itself that is driving the desire to switch to a different plan. In addition, the proportion of those who would “strongly desire” to switch plans is significantly greater among defaulters than among active choosers.

We relate the desire to change plans to the same set of economic, demographic, and decision-making characteristics studied above. Results again show that procrastination is important: individuals who procrastinated their way into the default are significantly more likely to desire to be in a different plan, which argues against the alternative hypothesis that procrastinators default into the Traditional Plan because they believe it is the best option for them. Respondents who are buck-passers—those that are content to leave decisions to others—are significantly less likely to express a desire to switch plans.

These results are relevant for public policy, given the broad use of default options in public and private retirement plans. In particular, the findings that procrastination leads to defaults and that procrastinators are more likely to subsequently express a desire to be in a different plan are important for assessing the welfare consequences of defaults. The use of defaults is often portrayed as a Pareto improvement because a well-designed default can guide individuals into making potentially welfare-improving decisions while still providing the freedom to choose. But if individuals end up dissatisfied with the results of the default, especially in settings like ours in that the default is irreversible, then defaults may not be Pareto improving. Other authors (e.g., Carroll, Choi, Laibson, Madrian, and Metrick, 2009; Carlin, Gervais, and Manso, 2013) note that various characteristics of the choice setting will help determine whether automatic enrollment defaults are preferable to or inferior to other options, such as forced choice or voluntary choice (i.e., when enrollment requires an active choice).

¹ Brown and Previtore (2015) do not study default behavior, but do present evidence consistent with procrastinators being more likely to stick with the default portfolio allocation.

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