Financial Inertia Among Low-Income Individuals—Plan Carefully When Setting 401(k) Defaults

Policy Issue

Instead of requiring employees to take the initiative to enroll in their retirement savings plan, many companies now automatically enroll employees in the plan at a default contribution rate and asset allocation. Although employees can opt out of these defaults at any time, studies have shown that automatic enrollment dramatically increases employee participation in retirement savings plans. Employees are very likely to accept the default contribution rate and asset allocation. Therefore, the chooser of the default is often able to determine the savings outcomes for a large number of employees.

Previous research has shown that low-income individuals are less likely to opt out of savings plan defaults. But are low-income individuals more susceptible to defaults in general, or have the particular defaults that have been studied to date been closer to the outcomes that low-income individuals would have actively chosen for themselves, giving them less incentive to select other choices? We present evidence that 401(k) defaults are particularly influential for low-income individuals in general, using data from three employer-sponsored defined contribution retirement savings plans.

Characteristics of Study Firms’ Retirement Savings Plans

The study used data from three employer-sponsored defined contribution retirement savings plans whose characteristics are listed below:

**Firm A:**
- Sample includes new hires from January 2005 to December 2006.
- Default contribution rate: 3 percent of employee salary.
- The default investment choice changed from a money market fund to a balanced fund in January 2006 and to target date retirement funds in September 2006.
- Sample size: 1,572 employees total.
  - Before the first default investment change: 742 employees.
  - After the first default investment change: 830 employees.
**Firm B:**
- Sample includes new hires from July 2006 to June 2008.
- Default contribution rate: 12 percent of employee salary.
- Sample size: 671 employees.

**Firm C:**
- Sample includes new hires from January 2003 to January 2008.
- Default contribution rate: before May 2005, 3 percent of employee salary; after May 2005, 5 percent of employee salary.
- Sample Size:
  - Before Group (3 percent default contribution): 2,785 employees.
  - After Group (5 percent default contribution): 3,765 employees.

**Findings**

**I. Bunching at the Default Choice**

Our first measure of the default’s influence is the extent to which people are not evenly distributed around the default, but are instead bunched at the default. We compare the tendency of employees across different income groups to bunch at the default.

The default contribution rate at Firm A is 3 percent. We take all employees who contribute 2 percent, 3 percent or 4 percent at one year of tenure and divide them into income quartiles. We then compute, within each of these income quartiles from this subsample, what fraction are at the 3 percent default.

If the contribution rate default had no impact on outcomes, then approximately one-third of each income quartile should respectively be at a 2 percent, 3 percent and 4 percent contribution rate, regardless of whether the default is close to the average desired contribution rate of the group or not. The intuition is that small movements in the contribution rate away from the default should not affect the contribution rate’s attractiveness that much, so the proportion of people who end up a small distance away from the default should be similar to the proportion of people who end up exactly at the default.³
Instead, we find that the vast majority of employees with a contribution rate in a close neighborhood of the default are exactly at the default. However, the tendency to be exactly at the default falls with income. While nearly 94 percent of the lowest income quartile is at the default, only 88 percent of the highest income quartile is at the default.

We run the same analysis on Firm B and Firm C, with substantially similar results. Low-income employees show more bunching at the default than high-income employees. This suggests that low-income employees are more influenced by defaults.

II. Opting Out of the Default Choice

Our second analysis shows that high-income employees are more likely than low-income employees to change their contribution rate away from the default when the default is more appropriate for the needs of low-income employees. Low-income employees, however, are not more likely to change their contribution rate when the default is more appropriate for high-income employees.

Employees remain at a default either because they believe that it is well-suited for them or because they suffer from inertia. The second possibility means that we cannot assess how appropriate a default is for an employee simply by looking at whether she remains at the default. We instead judge a default by looking at the types of people who actively choose its neighboring contribution rates, since these active choices are not contaminated by inertia. We reason that if the contribution rates close to the default are mostly chosen by low-income employees, then the default itself is probably most appropriate for low-income employees on average. Similarly, if the average income of employees close to the default is high, then we judge the default to be mostly appropriate for high-income employees.

At Firm C, the Before Group has a default contribution rate of 3 percent. The graph below shows that at one year of tenure, those who opt out of contribution rates of 1 percent, 2 percent, 4 percent or 5 percent have low average salaries, indicating that the 3 percent default is appropriate for low-income employees on average. Those who remain at the default have a lower average salary ($36,781) than those who opted out ($44,371), indicating that higher-income employees are more likely to opt out of a default that is better suited to low-income employees.
At the other extreme is Firm B, which has a default contribution rate of 12 percent. Using similar analysis, we find that while the 12 percent default is considerably more appropriate for high-income employees than for low-income employees, the average income of employees who stay at the default (£28,880) is significantly lower than that of those who change their contribution rate away from it (£33,739).

![Firm B Default Contribution Graph](image)

We see similar results for Firm A and the After Group (5 percent default) in Firm C. Overall, the findings indicate that the default has a stronger influence on the contribution rate for low-income employees than it does for those with higher incomes.

### III. Impact of Changing the Default Choice

Our final analysis compares how much low-versus high-income employee outcomes change when the default changes. In 2006, Firm A changed its default investment choice from a money market fund (with no equity exposure) to a balanced fund (with substantial equity exposure) and then to target date retirement funds (also with substantial equity exposure). We classify any fund with exposure to equities as “aggressive funds.” We measure the average percent of plan balances allocated to aggressive funds before and after the default investment change, separately by income quartile.

We find that while both low- and high-income employees allocate much more of their retirement savings to aggressive funds after the default investment change, the effect is larger for lower-income employees. Employees in the lowest income quartile shift from a 7 percent to a 97 percent average allocation to aggressive funds, while employees in the highest income quartile shift from 28 percent to 92 percent. This difference indicates that the default investment fund has a stronger influence on low-income employees.
Implications

Using data on the retirement savings plans of three firms, we study the impact of default options on low-income versus high-income employees. The evidence consistently suggests that low-income employees are more influenced by defaults. First, low-income employees exhibit a greater degree of bunching at the default relative to contribution rates near the default. Second, low-income employees are less likely to opt out of the default even when it is relatively inappropriate for them. Finally, the asset allocation of low-income employees is more affected by a change in the default investment fund.

The particularly powerful impact of defaults on low-income individuals may be an argument for setting defaults that conform most closely to the interests of these individuals.

For a copy of the full study, go to www.retirementmadesimpler.org/NBERStudy.