A Non-libertarian Paternalist's Reaction
to
"Libertarian Paternalism is Not an Oxymoron"
by Cass R. Sunstein and Richard H. Thaler

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Federal Reserve Bank of Boston 48th Annual Conference
"How Humans Behave: Implications for Economics and Economic Policy"
Chatham, MA
June 8-10, 2003

There is something comforting about the whole field of behavioral economics because it shows us we are not alone. We are not the only ones who pay $350 up front and $100 per month to join a health club so that we will exercise. We don't view that payment as a sunk cost, but as an impetus to tread the mill. We are not the only ones who got more pain than pleasure from the ups and downs of our 401(k) plans. We are not the only ones who will walk away from a coveted antique plate because the dealer won't come down $5, only to pay an extra $50 for just the right pair of Ferragamo shoes. We are not the only ones who ask the bartender to take the nuts off the bar or the waitress to take the bread off the table. In short, we are frequently irrational and inconsistent, and don't always act to maximize our financial well being. And that is fine, because so is almost everyone else.

I. The Behavioral Assumptions

In short, I fully buy the premise behind Sunstein and Thaler's paper on libertarian paternalism. People do have ill-formed preferences; they are subject to inertia and susceptible to suggestion; defaults often create endowment effects. And the examples pertaining to pensions are particularly dear to my heart since I have just finished a book with Annika Sundén on 401(k) plans (Munnell and Sundén 2003 forthcoming).

In fact, pensions provide a couple of additional examples that the authors could add to their repertoire. The first pertains to defined benefit plans. In the old days, men worked and women stayed at home. When it came time for men to retire and start collecting their monthly benefits, they could choose between a single-life or joint-and-survivor annuity. Husbands typically selected the single-life annuity, probably because it

pays higher monthly benefits. The wives, who typically outlived their husbands, then lost all pension income when their husbands died. In 1974, ERISA required that all pension plans that provide annuities automatically pay married couples in the form of a joint-and-survivor annuity. (The 1984 Retirement Equity Act toughened this protection, by requiring the spouse's notarized signature when the joint-and-survivor option was rejected.) Instituting the default significantly increased protection for wives. Using 1982 data from the New Beneficiary Survey, researchers found that 62 percent of married men whose pensions had commenced after 1974 indicated that they had elected a pension that would continue to their widow compared to 48 percent for married men whose pension began before 1974 (Holden and Nicholson 1998).

The second example pertains to 401(k) plans and the issue of company stock. A number of studies show that workers do not try to offset the presence of an employer match in company stock by reducing their own purchases of the stock (Benartzi 2001, and Liang and Weisbenner 2002). Instead, the evidence shows just the contrary, workers in firms that match with company stock tend to put more of their own money in company stock. Employees appear to take stock matches as an authoritative endorsement that company stock is a good investment. The pension world is replete with such anomalies.

II. Libertarian Paternalism and 401(k) Plans

Let me say a word about 401(k) plans, because they provide an interesting area for applying libertarian paternalism. The advent of 401(k) plans has shifted virtually all the responsibility for retirement income from the employer to the employee. The employee has to decide whether or not to join the plan, how much to contribute, how to

invest the contributions and when to re-balance, what to do about company stock, whether to roll over accumulations when changing jobs, and how to use the money in retirement.

The evidence indicates that at every step along the way a significant fraction of participants make serious mistakes. A quarter of those eligible to participate in a plan choose not to do so. Less than 10 percent of those who do participate contribute the maximum. Over half fail to diversify their investments, many over-invest in company stock, and almost none re-balance their portfolios in response to age or market returns. Most importantly, many cash out when they change jobs. And very few annuitize at retirement. Changes are clearly needed if 401(k) plans are to be a reliable vehicle for providing retirement income.

Automatic enrollment provides a partial solution, but it has run into some problems (Choi et al 2001a and 2001b). One is that the contribution rates for automatic enrollees have been set much lower than those typically selected by 401(k) participants. Because workers are creatures of inertia, they generally do not increase contributions. In addition, workers also tend to stay with the default investment option, and in fact interpret this option as investment advice from the firm. Even workers who subsequently changed their allocations used the default option as an "anchor" against which to evaluate other investment choices.

Employing the principles of libertarian paternalism, we believe that this inertia can be leveraged by setting all the defaults in 401(k) plans to desirable outcomes. This would eliminate the cost for participants of trying to figure out what to do, and it would help workers avoid mistakes by pointing them in the right direction. Of course,

individuals could opt out at any stage, allowing them the flexibility to make different decisions if their circumstances warrant it.

Our suggestion for the defaults is that all eligible participants be automatically enrolled; their contributions set at the level that maximizes the employer match; the portfolios of 30-year-olds be allocated to 70 percent stocks and 30 percent bonds and automatically re-balanced as they age; investments in company stock be restricted; lump-sum distributions automatically roll over; and retirement benefits paid in the form of a joint-and-survivor inflation-indexed annuity. Thus, in some ways I am more of a libertarian paternalist than the authors.

III. The Issue of Choice

Before I get to the areas of disagreement, let me say a word about choice. Even though the authors characterize themselves as pro-choice, they do not appear to support the notion that more choice is better. I agree. But psychologists and economists sometimes argue differently. Many psychologists contend that having personal choice increases motivation, sense of control, performance, and general feeling of satisfaction. Many economists claim that more choice is better, as it allows individuals to balance marginal cost and marginal utility and move to an optimal position.

Recent studies, however, have challenged this accepted wisdom. One fascinating study by two psychologists noted that most of the choice studies involved a relatively small number of options (Iyengar and Lepper 2000). They were interested in finding out what happens as the range of choice expands significantly and the difference between the options becomes smaller. They conducted three experiments. In the first, they set up

tasting booths for jam in a gourmet supermarket on two consecutive Saturdays. On one Saturday, they offered 24 different flavors of Wilkins & Sons jams, and on the other Saturday, they offered 6. Customers were permitted to taste as many as they wanted and were given coupons for one dollar off the purchase of any jam. Predictably, the booth with 24 flavors attracted more shoppers. Sixty percent of passing shoppers stopped at the booth when 24 jams were displayed compared to 40 percent when 6 were on display. However, only 3 percent of those visiting the extensive choice booth ended up buying jam, versus 30 percent of those visiting the limited choice booth. More choice seemed attractive to shoppers, but a profusion of choice made it difficult for them to make the decision to buy.

The results from the two other experiments were equally telling. In one, students in an introductory social psychology class were told they could write a two-page essay for extra credit. One group of students was given 6 potential essay topics and the other was given 30. The question was how many students would do the assignment and how the quality would vary between the limited-option and extensive-option group. As it turned out, a statistically significant larger percentage of the limited-option group wrote an essay, and the quality of their essays was somewhat better. In other words, limited choice led to better performance.

The final experiment involved the sampling of chocolates. One group selected from a limited array of chocolates, one from an extensive array, and the control group sampled a chocolate chosen for them. The goal was to measure their satisfaction with the process, their enjoyment of the chocolate, and their purchasing behavior. People reported enjoying the process of choosing a chocolate more from a display of 30 than from a

display of 6. Despite their greater initial enjoyment, however, participants in the extensive display group ended up more dissatisfied and regretful of their choices than the others, and they were subsequently less likely to select chocolates rather than cash for their participation in the project.

All three experiments suggest that people in extensive choice situations enjoy the process – they sample jams and they like the array of chocolates – but they also end up feeling more responsible for their choices and find them more difficult – they do not buy the jam and they do not select chocolates as compensation. Perhaps people become increasingly unsure of the right option as the array of possibilities expands. This is what the authors describe as "cognitive overload." If excessive choice creates difficulties with trivial decisions about jams and chocolates, it could be quite demotivating in situations where the costs of making a 'wrong' decision are much more significant, such as investing 401(k) money. As such, I was not totally clear what the authors were saying about the wisdom of the number of investment options in the new Swedish pension system.

IV. Some Disagreements

Finally, let me turn to two aspects of the Sunstein-Thaler argument with which I disagree. The first is the notion that libertarian paternalism is applicable universally. Pensions again are a good example. In the case of 401(k) plans, which serve as a secondary tier in our retirement system, steering people in the right direction and allowing them to opt out may be just fine. I do not believe that such an approach is appropriate, however, for the provision of minimal "safety net" types of guarantees, such

as Social Security. The most obvious problem is that the system is redistributive. If opting out were an option, high-income people who gain little would leave and thereby deplete the monies available to subsidize the low-income participants.

The more fundamental issue is that the time between action and result under the Social Security system is extraordinarily long and the implications especially severe. People in their 20s may decide that they don't give a damn if they starve at 85. But as they approach their 80s, they will care a great deal. And if they have not provided for themselves, someone else will have to step in and foot the bill. That someone could be family, charity, or a welfare program supported by the general populace. That is not a good outcome. Thus, well-designed defaults may be an appropriate response for non-essential programs, but they are not sufficient for basic protections. Mandatory participation is required. That is, *real* paternalism is sometimes a good thing.

The second issue relates to the notion of the government or the authority that imposes rules. The paper seems to treat this entity as if it emerged from the heavens and imposed restraints. The same sentiment seems to be reflected in President Bush's frequent quip "It's not the government's money; it's the people's money." No one imposes taxes on us; no one compels us to go to school, drive on the right, or participate in Social Security. These are constraints that we impose on ourselves. We are the government. Or, as Pogo put it, "them is us." We vote for the representatives and occasionally even participate actively in the process. Who are these people the authors refer to as the "planners"?

V. Conclusion

Let me close. Behavioral economics is not only comforting; it is fun. I also think that pensions and saving are interesting and fun! Thus, I found this to be a delightful paper. And I think that the notion of setting defaults to desired outcomes and plans such as "Save More Tomorrow" (Thaler and Benartzi 2003) can have a much bigger impact on saving than all the exhortation and tax incentives in the world.

On a broader note, clearly the authors care deeply about the welfare of the population as a whole, and reject the social Darwinism of some of their critics. Their "libertarian paternalism" approach may serve as a bridge between the libertarians on the right and New Deal traditionalists on the left, and that bridge could help rebuild the national consensus on social and economic policy.

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