Fact Sheet

# Higher Initial Contribution Levels in Automatic Enrollment Plans May Result in Greater Retirement Savings: A Review of the Evidence

David C. John and William R. Shiflett
*AARP Public Policy Institute*

**Automatic enrollment in retirement plans has proved to greatly increase the proportion of workers who save for retirement. Unfortunately, the commonly used initial contribution rate of 3 percent typically does not provide sufficient savings. Several studies show that increasing the initial contribution rate to at least 6 percent of earnings provides greater retirement security—and does so without affecting participation levels.**

Under automatic enrollment, an employee is enrolled in a retirement savings plan without taking any action on his or her part, with a predetermined amount of money deducted from pay and placed in a prespecified investment choice. The employee nevertheless has full control over these decisions and can save more or less, change investments, or even decide not to save at all by opting out. In short, while automatic enrollment ultimately provides all of the flexibility of traditional enrollment, the crucial difference between the two is that automatic enrollment bypasses the opt-in process by making retirement plan participation the default option for new employees.

Automatic enrollment takes advantage of the fact that an employee is likely to take the path of least resistance by sticking to the default option. With automatic enrollment, 90 percent of eligible employees participate in the retirement plan.[1] Without automatic enrollment, participation is about 70 percent—mainly older employees and higher-paid workers. Younger employees, women, minorities, and lower-paid workers are less likely to participate. Without coverage by a payroll deduction retirement plan, about 5 percent of employees save for retirement on a consistent basis.

In the same way that automatic enrollment can increase employee retirement plan participation, it can influence the percentage of pay that employees will save. **In other words, employees automatically enrolled under a certain initial contribution rate are more likely to maintain that rate.**

## Inadequate Contributions

While automatic enrollment greatly increases the number of people who save for retirement, shortcomings remain.

### *The 3 Percent Standard*

About half of automatic enrollment 401(k) plans start their employees' saving at 3 percent of their pay, a rate that is likely to result in

AARP® Real Possibilities
Public Policy Institute

inadequate savings for many workers. One team of researchers found that 50 percent of employees at a Fortune 500 health care company maintained their initial 3 percent contribution rate for one year following their automatic enrollment in a 401(k). After two years, 40 percent of employees maintained their initial contribution rate—even with a 50 percent employer match on the first 6 percent of contributions after one year of tenure.[2]

### *Phantom Endorsement*

Many people, particularly low-income plan participants, may see the initial contribution rate as indicating the appropriate amount to save for retirement. In a company with a 12 percent initial contribution rate, researchers found that automatically enrolled participants with lower incomes remained at that rate even though, according to the researchers, it resulted in savings that were higher than needed for their income level.[3] Further evidence of this endorsement effect was found in another company, where 70 percent of employees earning below $20,000 annually maintained their initial contribution rate of 3 percent while only about 33 percent of employees earning between $70,000 and $79,000 maintained that level of saving.[4] While saving 3 percent of pay is better than nothing, such an endorsement is likely to result in insufficient savings at retirement.

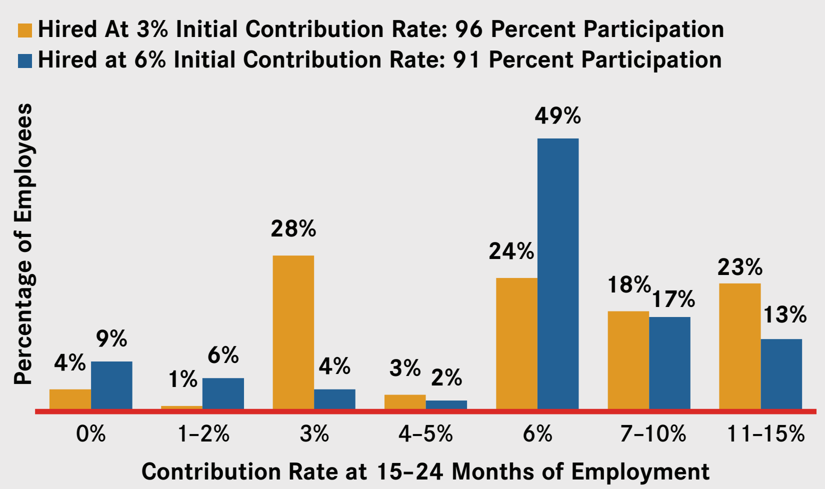
## Promising Solutions

Plan administrators may fear upping their default contribution rates from the typical 3 percent could negatively affect participation. Facts show that this is not necessarily so.

**Several studies show little difference in participation rates when employers automatically enroll workers at an initial rate of 3 percent compared with a rate greater than 3 percent.** One study of a medium-size US chemical company, for example, found that automatic enrollment retirement plan participation was approximately 96 percent with an initial contribution rate of 3 percent, and 91 percent with an initial contribution rate of 6 percent (see figure 1).[5] In another company, participation rates were almost identical between employees hired under a 3 percent rate and a separate group of employees hired under a 4 percent rate. At another company, participation rates were also practically identical for employees hired under a 3 percent rate that increased to 6 percent at one year of tenure. Researchers concluded that initial contribution rates have little influence on participation rates under automatic enrollment.[6]

**Some employers are increasing initial contribution rates above 3 percent.** The Plan Sponsor Council of America (PSCA) found that for the year 2014, more than 40 percent of automatic enrollment plans had an initial contribution rate

FIGURE 1
**Automatic Enrollment of Employees Under Different Initial Contribution Rates**

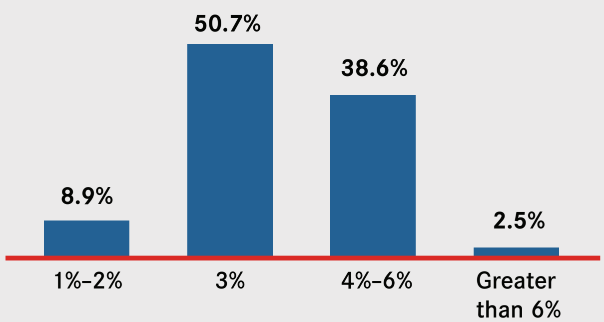



***Source:*** *John Beshears, James J. Choi, David Laibson, and Brigitte C. Madrian, "The Limitations of Defaults" (paper presented at the 12th Annual Joint Conference of the Retirement Research Consortium, Washington, D.C., August 2010), http://www.nber.org/aging/rrc/papers/orrc10-02.pdf.*

***Note:*** *Due to rounding, percentages may not sum to 100 percent or to the aggregate participation percentages.*

above 3 percent (see figure 2).[7] While the survey is not a random sample and therefore is not necessarily representative of all employers, the PSCA's survey captures 592 profit- sharing, 401(k), and combination plans, including about 52 percent with automatic enrollment, comprising a total of 8.8 million eligible employees and $785 billion in assets.

FIGURE 2
**Percentage of Plans Using Different Default Contribution Rates**




***Source:*** *Plan Sponsor Council of America,* 58th Annual Survey of Profit Sharing and 401(k) Plans *(Chicago, IL: Plan Sponsor Council of America, 2015), 66–71.*

***Note:*** *Due to rounding, percentages do not sum to 100 percent participation.*

1 James J. Choi, David Laibson, Brigitte C. Madrian, and Andrew Metrick, "Defined Contribution Pensions: Plan Rules, Participant Choices, and the Path of Least Resistance," in *Tax Policy and the Economy*, vol. 16 (Cambridge, MA: National Bureau of Economic Research Inc., 2002), 67–114.

2 Brigitte C. Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *The Quarterly Journal of Economics* 116, no. 4 (2001): 1149–87.

3 John Beshears, James J. Choi, David Laibson, and Brigitte C. Madrian, "The Limitations of Defaults" (paper presented at the 12th Annual Joint Conference of the Retirement Research Consortium, Washington, DC: August 2010), http://www.nber.org/aging/rrc/papers/orrc10-02.pdf.

4 Madrian and Shea, "Power of Suggestion."

5 John Beshears, James J. Choi, David Laibson, and Brigitte C. Madrian, "The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States," in *Social Security in a Changing Environment* (2009), http://www.nber.org/chapters/c4539.pdf: 173.

6 Choi, Laibson, Madrian, and Metrick, "Defined Contribution Pensions."

7 Plan Sponsor Council of America, *58th Annual Survey of Profit Sharing and 401(k) Plans* (Chicago, IL: Plan Sponsor Council of America, 2015), 66–71.

Fact Sheet 452, April 2017


601 E Street, NW
Washington DC 20049

Follow us on Twitter @AARPpolicy
on facebook.com/AARPpolicy
www.aarp.org/ppi

For more reports from the Public Policy Institute, visit http://www.aarp.org/ppi/.

AARP Real Possibilities
Public Policy Institute