Literacy, Trust and 401(k) Savings Behavior

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Over the past fifteen years, a substantial body of 401(k) savings research has posited a number of reasons why employees participate or fail to participate in voluntary 401(k) arrangements. These include neoclassical explanations, such as employee budget constraints, employer matching contributions, or employee-own preferences for tax-deferred savings, as well as behavioral explanations, including procrastination, peer effects, or choice overload. Meanwhile, recent efforts to understand financial decision-making more broadly have focused on the critical role played by financial literacy, while researchers attempting to understand banking and other financial relationships have drawn attention to the role of mistrust in influencing financial choices, especially among low-income households. Overall it would appear that financial decision-making is influenced by a complex set of factors, yielding to both neoclassical and behavioral explanations.

Our current research effort is the first attempt to extend the critical issues of financial literacy and trust to the domain of 401(k) savings behavior. Moreover, it does so in the context of a rapid change occurring in the nature of the 401(k) plan participation decision. Increasingly employers offering 401(k) plans are availing themselves of a plan design strategy known as automatic enrollment, under which eligible workers have 401(k) contributions automatically deducted from their paychecks, with the legal right to opt out if they choose. While automatic enrollment plans improve plan participation rates dramatically, it is still the case that some population of eligible workers, possibly as high as 20%, choose to exercise their opt-out rights and quit an automatic enrollment plan. As a result, two types of non-savers have emerged today in the U.S. 401(k) system: “non-joiners,” those who fail to join voluntary 401(k) arrangements; and “quitters,” those who exercise their opt-out rights under an automatic enrollment plan.

The trend toward automatic enrollment raises an intriguing set of questions about the 401(k) plan participation decision: Are quitters (of automatic enrollment plans) fundamentally different from non-joiners (of voluntary plans)? Do neoclassical models help explain the variations between the two types of savers — or are broader questions of financial literacy or trust important as well? The goal of this paper is to paint a more complete picture of the participation decision in the context of both voluntary and automatic enrollment plans. We rely on administrative and survey data drawn from large firms sponsoring 401(k) plans, two offering automatic enrollment plans and one offering a voluntary plan. The survey data in particular permit us to delve into the psychological motivations behind employee savings decisions, which would be impossible to address through administrative data alone.
Perhaps not surprisingly, we find that financial literacy measures play a critical role in influencing savings behavior, whether on an opt-in voluntary or opt-out automatic enrollment arrangement. Higher financial literacy among workers is associated with higher voluntary 401(k) participation rates or lower quit-rates in automatic enrollment plans. Indeed, the marginal effects of low financial literacy appear to be economically more meaningful than the effects of higher income. Meanwhile, trust appears to be very important in influencing savings behavior in automatic enrollment plans, with participants more likely to opt out if they lack a fundamental trust of financial institutions. These findings underscore the importance of ongoing financial literacy efforts in the workplace, whether for participants in voluntary or automatic enrollment plans. It also points to the central question of trust and its role in influencing quit rates in automatic enrollment plans.