ELSEVIER
Journal of Public Economics 85 (2002) 121–148
JOURNAL OF PUBLIC ECONOMICS
www.elsevier.com/locate/econbase

Participation and investment decisions in a retirement plan: the influence of colleagues' choices

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Received 29 May 2000; received in revised form 18 December 2000; accepted 22 January 2001

Abstract

This paper investigates whether peer effects play an important role in retirement savings decisions. We use individual data from employees of a large university to study whether individual decisions to enroll in a Tax Deferred Account plan sponsored by the university, and the choice of the mutual fund vendor for people who choose to enroll, are affected by the decisions of other employees in the same department. To overcome the identification problems, we divide the departments into sub-groups (along gender, status, age, and tenure lines) and we instrument the average participation of each peer group by the salary or tenure structure in this group. Our results suggest that peer effects may be an important determinant of savings decisions.

Keywords: Peer effects; Retirement saving plans

JEL classification: D83; I22

1. Introduction

Low levels of savings in the United States have generated substantial interest in the question of what determines savings decisions. A vast literature has studied the

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0047-2727/02/$ – see front matter
PII: S0047-2727(01)00098-6

impact of Tax Deferred Accounts (hereafter, TDA), such as Individual Retirement Accounts (IRAs) and 401(k)s, on retirement savings decisions,[1] and, concurrently, the impact of these plans' features on enrollment and contribution rates. A number of studies attempted to assess the effect of economic incentives on individual behavior and found mixed evidence. The presence of a matching contribution from the employer has generally been found to be correlated with higher participation rates, but the level of the match rate does not seem to matter.[2] As Bernheim (1999) points out, matching also serves as a device to focus the employees' attention. This suggests that pure economic incentives are not sufficient to explain savings behavior. Recent studies emphasize the role of non-economic factors, such as financial education and inertia. Madrian and Shea (2000a) show that default rules have an enormous impact on employees' participation, contribution, and asset allocation. When they are enrolled by default in a TDA, very few employees opt out. Further, most employees do not change the default contribution rate or the default allocation of assets. Bernheim and Garrett (1996) and Bayer et al. (1996) study the role of financial education. They present evidence that financial education tends to be remedial[3] but that it increases participation in the plan, suggesting that employees may not be able to gather the necessary information on their own.

This paper contributes to this literature by studying the role of peer effects in TDA participation and decisions related to the plan. There has never been a study of peer effects on saving decisions. This is surprising, because the theoretical literature suggests at least two reasons why peers play a role in this context. First, the plans are sufficiently subtle that their advantages are not obvious to someone who has not thought carefully about it. Even when people choose to participate, they may lack the information necessary to make investment decisions. The evidence presented by Madrian and Shea (2000a) suggests that a large proportion of people do not think about these decisions at all. The literature on informational cascades (Bikhchandani et al., 1992; Banerjee, 1992; Elison and Fudenberg, 1993) provide reasons why information (correct or not) obtained from co-workers may be an important factor in deciding whether to participate and how to invest — giving rise to peer effects. Second, savings decisions may be influenced by social norms or beliefs about social norms. By observing co-workers, people can learn about the proper behavior of their social group, as emphasized by models of conformity (e.g., Bernheim, 1994): individuals may want to maintain the same consumption level as what is common in their social group.

There is a growing empirical literature on peer effects which essentially focuses

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[1] See Poterba et al. (1996) and Engen et al. (1996) in a Special Issue of the *Journal of Economic Perspectives*.

[2] See, e.g., Papke (1995), Papke et al. (1993), and Kusko et al. (1994).

[3] Employers resort to it when they fail discrimination testing because the contribution rates of the not highly compensated employees are too low.