# JOINT ECONOMIC COMMITTEE DEMOCRATS

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# IMPROVING DEFINED CONTRIBUTION PENSION PLANS

## Introduction

Over the past two decades, the percentage of private sector workers participating in any type of pension plan has held relatively steady at 50 percent.[1] However, the nature of pension coverage has changed dramatically over that period.

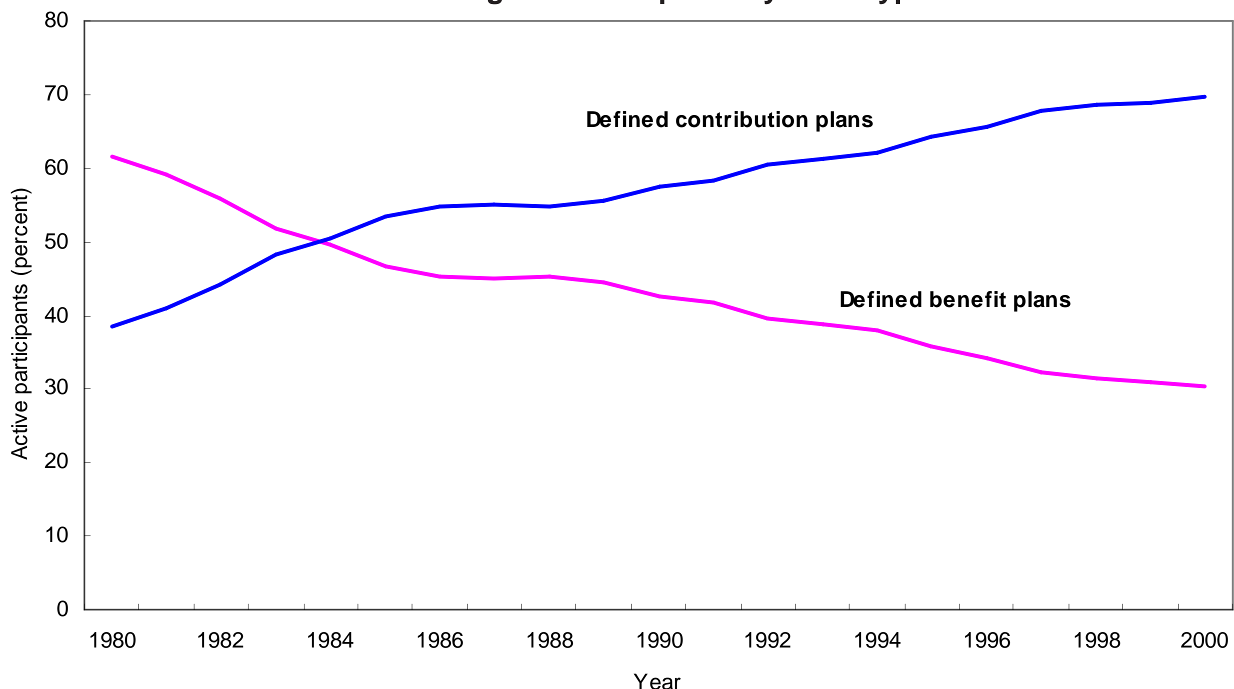
In 1980, over three-fifths of workers in any kind of pension plan were in a traditional defined benefit plan that was managed by their employers and that promised them a fixed benefit based on their years of service and salary (**Chart 1**). Now, over two-thirds of private pension participants are in a defined contribution plan in which they have the main responsibility for managing their retirement accounts and their benefit depends on how much they and their employers contribute to the plan and how well their investments perform.[2]

While defined contribution plans have certain advantages over defined benefit plans, they also shift most of the risk and nearly all of the responsibilities for planning onto individual

Chart 1

**Defined Contribution Plans Have Become the Dominant Form of Private Pensions**

**Percentage of Participants by Plan Type**




Source: U.S. Department of Labor, Employee Benefits Security Administration, Private Pension Plan Bulletin, Abstract of 2000 Form 5500 Annual Reports.

employees. Workers must decide whether to participate, how much to contribute, how to invest the contributions, what to do with their account balances when they change employers, and how to collect benefits when they retire. These can be difficult decisions for busy and financially inexperienced workers and the wrong decisions could put their retirement security at risk. One way to ease the burden and reduce that risk is to incorporate some of the advantages of defined benefit plans into the defined contribution system.

### Positive Features of Defined Contribution Plans

From the employee's perspective, the biggest advantage of defined benefit plans is that they provide a steady, predictable stream of retirement benefits. The employer is responsible for investing the pension funds and bears the costs if returns fall short of promised benefits.[3] Employees under a defined benefit system can, however, lose significant pension income when they change employers. Defined contribution plans, in contrast, provide more portable benefits, both because the vesting periods are shorter and because benefits accrue more evenly throughout one's career. For workers in a highly mobile workforce, the portability of defined contribution plans may outweigh the investment risks inherent in managing their own retirement accounts.

Workers may also prefer defined contribution plans because, in addition to their portability, they are a more tangible employee benefit, particularly for young workers years away from retirement. Participants receive regular statements showing their individual account balances and control their investment allocations. Defined contribution plans also allow employees access to their account balances prior to retirement, although pre-retirement withdrawals are subject to income tax and an additional tax penalty.

### Concerns about the Defined Contribution System

Theoretical simulations suggest that workers could accumulate just as much if not more retirement wealth under defined contribution plans as they could under traditional defined benefit plans. These findings are based on the assumptions that workers save continuously over their careers, contribute a steady percentage of their earnings each year, and invest in a mix of stocks and bonds.[4]

In practice, however, workers' actual account balances are significantly lower than those simulations would predict. In 2001, for example, among working-age households with some type of retirement account, the median value of all accounts was only $27,000 (**Table 1**). Even among those households closest to retirement, who had the highest level of savings, the median value was only $55,000.

These numbers suggest that, despite some of the advantages to employees of defined contribution plans, most workers lack the experience and financial education to manage the

Table 1

**Retirement Account Balances by Age in 2001**

| Age of Household Head | Percentage with Accounts | Mean Value, All Accounts | Median Value, All Accounts |
|---|---|---|---|
| *21 to 34* | 51.2 | 19,123 | 7,000 |
| *35 to 44* | 66.0 | 65,583 | 29,000 |
| *45 to 54* | 69.0 | 132,741 | 48,000 |
| *55 or older* | 69.8 | 189,779 | 55,000 |
| *All households* | 63.2 | 95,943 | 27,000 |

Source: Congressional Research Service (CRS) analysis of the Federal Reserve Board's Survey of Consumer Finances, as reported in Patrick Purcell, "Retirement Savings and Household Wealth: A Summary of Recent Data," CRS Report for Congress RL30922, updated June 28, 2004.
Notes: Includes households with an employed head or spouse ages 21-64. Includes single persons as well as families. Includes all individual retirement accounts and all defined contribution plan account balances from both current and past employment. Does not account for any retirement benefits from defined benefit plans.

risks and responsibilities inherent in such plans. At each decision point, many workers make choices that if ill-informed, could jeopardize their retirement security.

*Low Participation Rates.* Participation in defined contribution plans is generally voluntary, and many workers who are eligible to participate in a pension plan choose not to. Data on 401(k) plans—the most prevalent type of defined contribution plan—indicate that more than a quarter of eligible workers do not participate.[5] Confusion and inertia are the primary reasons given for not participating.

*Low Contribution Rates.* Among workers who participated in defined contribution plans in 2001, the median employee contribution rate was only 6 percent of earnings. For the typical worker, a 6 percent contribution rate is far below the maximum employee contribution limit ($10,500 in 2001 and $14,000 in 2005). In fact, less than 10 percent of workers contributed the maximum amount.[6] Depending on the age at which workers start participating and their investment decisions, contribution rates of 6 percent and lower are likely to yield inadequate retirement income.[7]

*Poor Investment Decisions.* Although some workers appreciate having more control over their retirement planning, research shows that most participants in defined contribution plans make investment decisions that are either too conservative or too risky.[8] Many fail to diversify and are heavily invested in their own company's stock. Once they make their initial investment decisions, few participants rebalance their portfolios as they age or in response to returns on their investments.

*Early Withdrawals.* A key difference between defined benefit and defined contribution plans is that defined contribution plans often allow participants to access their benefits prior to retirement. Workers may borrow against their account balances while they are still working, or they may cash out their account balances when they change employers. Both pre-retirement distributions and loans that are not repaid are subject to income tax and an additional 10 percent penalty. Despite the tax and penalty, however, less than half of 401(k) participants who change employers roll over their distributions to another qualified retirement plan; the majority cash out their balances.[9] Although the ability to access account balances may increase both participation and contribution rates, it also means that some workers end up with significantly lower retirement savings than they would have without such access.

*Risks at Retirement.* Participants in defined contribution plans face an additional risk when they retire. Whereas defined benefit plans are generally required to pay out benefits as a lifelong annuity, most defined contribution plans pay out benefits in a single lump sum. Retirees must therefore decide how to allocate their balances over their entire retirement. Because people are uncertain about how long they will live, they risk either outliving their resources or being too cautious to the point of hardship. While retirees could purchase annuities on their own to eliminate those risks, the individual market for lifetime annuities is not well developed and expenses are high.

For workers who have the wherewithal to manage the increased risks and responsibilities associated with defined contribution plans, such plans may improve their retirement benefits. For most workers, however, the rise of defined contribution plans poses significant risks to their retirement security. Yet defined contribution plans are likely to become even more dominant in the future. Younger workers today are more likely than older workers to participate only in a defined contribution plan,[10] and employers are over four times more likely to offer defined contribution plans than defined benefit plans.[11] Given these trends, improvements to the defined contribution system are essential.

**Improving the Defined Contribution System**

There is no way to fully protect participants against the investment risks inherent in defined contribution plans. However, applying some of the advantages of defined benefit plans to defined contribution plans would help mitigate some of the risks. In particular, setting automatic default options at each decision point would remove much of the decision-making burden and confusion associated with managing individual accounts. At the same time, workers who want to take a more active role in their retirement planning would not be bound by the default settings.

*Automatic Enrollment.* Under automatic enrollment, employees are notified that a specified percentage of their earnings will be deferred into an account unless the employee cancels the enrollment within a given period. Research on 401(k) plans indicates that automatic enrollment dramatically

increases participation rates.[12] The increase is particularly likely to benefit younger workers and low-income workers, who tend to have the lowest participation rates.

One problem with automatic enrollment is that the default investment allocation is generally too conservative and the default contribution rate is too low for most workers to accumulate adequate retirement savings.[13] Easing employers' concerns about fiduciary liability might encourage them to adopt more balanced default investment allocations. Encouraging employers to adopt automatic contribution rate increases—tied, for example, to annual raises—is another promising strategy to increase retirement savings.[14] A small but growing number of firms offer automatic enrollment and automatic escalation features in their defined contribution plans.[15]

Several bills have been introduced to encourage automatic enrollment. The 401(k) Automatic Enrollment Act of 2005 (H.R. 1508, Emanuel), the Retirement Savings and Security Act of 2005 (S. 1359, Smith, Conrad), and the Save More for Tomorrow Act of 2005 (S. 875, Bingaman) each provide incentives for employers to adopt automatic enrollment, provide for automatic increases in employee contributions, and limit employers' fiduciary responsibility in selecting default investments.

*Lifecycle Funds.* Effective in August 2005, the Thrift Savings Plan for federal employees offers five different funds with a professionally determined portfolio based on the employee's target retirement date. These "lifecycle" funds are automatically adjusted to a more conservative mix as the retirement date approaches, freeing participants from the burden of rebalancing their portfolios in response to age or investment performance. Along with legislative changes addressing fiduciary liability, this development may further encourage employers to offer balanced default investment options for their employees, regardless of whether or not they choose to adopt automatic enrollment.

*Automatic Rollovers.* Requiring employers to set a default option that preserves savings would help minimize pre-retirement withdrawals from defined contribution plans. For example, plans that do not automatically permit employees to keep their balances in the plan when they leave could be required to roll the account into an IRA unless the employee requests the funds directly. Making it easier for departing employees to continue paying regular payments on loans from their accounts would also help preserve retirement savings. Most plans require employees to pay back outstanding loans in full when they leave the company. This increases the likelihood that employees will default on their loans and be further away from rebuilding their retirement savings.

*Automatic Annuitization.* To help retirees manage the risk of outliving their savings during retirement, employers should be encouraged to provide annuities through their plans. Plan-based annuities would likely provide better benefits than annuities purchased in the individual market. S. 1359 and H.R. 1508 would clarify liability rules to promote plan-based annuities. S. 1359 would also provide tax incentives for retirees to purchase annuities on the private market.

**Conclusion**

Despite certain advantages over traditional defined benefit plans, defined contribution plans expose workers and retirees to greater investment risk and responsibility for managing their retirement savings. As a result, the rise of defined contribution plans raises significant concerns about the financial prospects of future retirees. Yet the trend away from defined benefit pension plans is likely to continue. Adopting some of the advantages of traditional defined benefit plans would improve the private pension system by removing some of the risks and responsibilities associated with defined contribution plans.

**Endnotes**

[1] Joint Economic Committee Democratic staff calculations from the U.S. Bureau of the Census, March Current Population Survey, various years.

[2] From 1980 to 2000, the number of pension plans increased from 489,000 to 736,000, with most of the growth concentrated among small plans (with less than 100 participants). All of the net growth was in defined contribution plans, which doubled in number from 341,000 to 687,000. In contrast, the number of defined benefit plans shrank, from 148,000 to only 49,000, so that by 2000 defined benefit plans represented only 7 percent of all plans. (Because the majority of defined benefit participants are in very large plans, they represent a much larger proportion of total participants (30 percent) than the proporation of defined benefit plans to all plans.) See U.S. Department of Labor, Employee Benefits Security Administration, Private Pension Plan Bulletin, Abstract of 2000 Form 5500 Annual Reports.

[3] However, as demonstrated by recent experiences in the airline industry and elsewhere, employers may pass on their investment risks by changing future benefit formulas or, in extreme cases, terminating their plans.
[4] Munnell, Alicia H. and Annika Sunden, *Coming Up Short, The Challenge of 401(k) Plans,* Washington, D.C.: The Brookings Institution, 2004.
[5] Ibid.
[6] Ibid. In 2001, the maximum employee contribution was $10,500. The maximum combined employer and employee contribution was the lesser of 25 percent of compensation or $35,000.
[7]Simulations assuming continuous employee contributions of 6 percent compensation, a 3 percent employer matching contribution, and a 7.6 percent nominal rate of return on investments, suggest that an employee who starts saving at age 35 would enjoy retirement income equal to about 46 percent of preretirement compensation. The replacement rates fall as starting age increases. Munnell, Alicia H. and Annika Sunden, *Coming Up Short, The Challenge of 401(k) Plans*, Washington, D.C.: The Brookings Institution, 2004.
[8] Munnell, Alicia H. and Annika Sunden, *Coming Up Short, The Challenge of 401(k) Plans,* Washington, D.C.: The Brookings Institution, 2004.
[9] Ibid.
[10] Purcell, Patrick, "Retirement Savings and Household Wealth: A Summary of Recent Data," Congressional Research Service, Report for Congress RL 30922, updated June 28, 2004.
[11] U.S. Department of Labor, Employee Benefits Security Administration, National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2004.
[12]Choi, James, David Laibson, and Brigitte Madrian, "Plan Design and 401(k) Savings Outcomes," *National Tax Journal*, vol. 52(2), June 2004.
[13] Purcell, Patrick, "Automatic Enrollment in 401(k) Plans," *Journal of Pension Planning and Compliance,* Summer 2005,Vol. 31, Iss. 2.
[14] Thaler, Richard and Shlomo Benartzi, "Save More Tomorrow ™: Using Behavioral Economics to Increase Employee Savings," *Journal of Policital Economy,* vol. 112(1), February 2004.
[15] Hewitt Associates, "Trends and Experience in 401(k) Plans," June 2005.

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