National Center for Policy Analysis

BRIEF ANALYSIS
No. 567
For immediate release:
Tuesday, August 15, 2006

Automatic 401(k)s: A Win for Workers

by Matt Moore

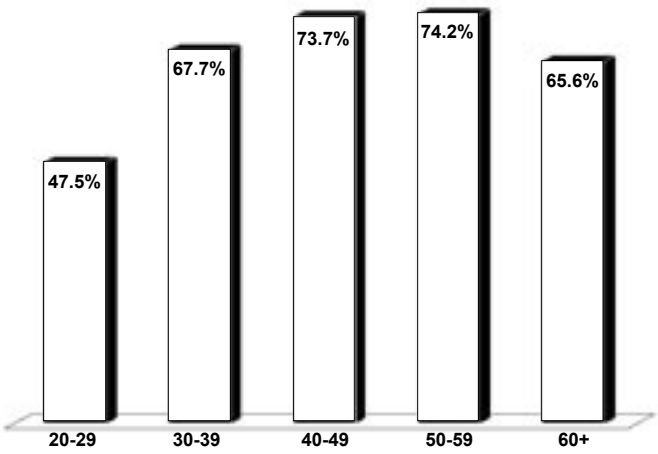
Congress has made it easier for workers to prepare for retirement by passing the Pension Protection Act of 2006. Most of the media coverage has focused on how the new act will affect corporate defined-benefit pension plans like the one for pilots at Northwest or Delta Airlines. However, the most important and far-reaching features of the bill are provisions that encourage the expansion of such employer-sponsored retirement accounts as 401(k)s and 403(b)s. These reforms — long advocated by the NCPA and the Brookings Institution — are particularly important for younger and future workers. As defined benefit plans dry up, 401(k) plans are becoming the norm.

Problem: Workers Are Not Saving Enough. About a third of employees (32.8 percent) with access to a 401(k) don't contribute, according to a new survey by Hewitt Associates, a benefits consulting firm. The participation rate is much worse among younger workers and those with lower incomes:

- Almost three-quarters of 40- to 59-year-old employees participate (73.7 percent to 74.2 percent) versus less than half (47.5 percent) of those ages 29 and younger. [See the figure.]
- Almost all employees earning more than $100,000 participate (93 percent) versus just 39.1 percent of those earning less than $20,000.

This is understandable. Younger workers are more likely to earn lower wages, pay big student loan bills and carry large credit card debts. Plus, the farther from retirement the more time there is to start saving. However, it pays to start saving early: To save $100,000 for retirement, one could invest $1,178 a year for 30 years at 6.4 percent interest. But one must sock away $7,445 annually to reach the same goal in 10 years.

Further, among employees who participate, account balances are small. The reason? Investors either save too little, put their dollars in low-risk — but low-return — investments like money market funds, or both. According to Hewitt:



Source: Hewitt Associates, "How Well Are Employees Saving and Investing in 401(k) Plans: 2006 Universe Benchmarks," April 2006.

- Of the employees who participate in their employer's plan, one in five (21.8 percent) did not contribute enough to obtain the full company match — essentially leaving free money on the table — and 30 percent contributed only enough to obtain the match.
- Last year, average 401(k) account balances grew more than 10 percent to about $76,000, but the median account balance was only $27,100.

Problem: Workers Are Making Poor Investment Decisions. In general, workers make two kinds of mistakes in their investment decisions. They tend to invest in what they know or in what they perceive is safe. What they know is their employer's stock. What they perceive is safe is a money market fund or a government bond fund. Unfortunately, the first decision leads to too little diversification and subjects the employee to too much risk. The second decision involves too little risk and produces returns that are too low to secure an adequate retirement income. More needs to be done to encourage workers to save and invest properly.

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The Pension Protection Act of 2006. The 401(k) reforms in the new pension bill encourage employees — particularly younger workers — to do what they already should be doing: saving for retirement.

The new rules take effect beginning in 2008. They do not force companies — or employees — to do anything. Rather, they provide additional protections from complex regulations to employers who offer 401(k) plans — if those plans meet specific requirements. Following are key features these qualifying plans must include.

Automatic Enrollment. Most 401(k) plans require employees to opt in, meaning workers must ask their human resources department for an application, dig through the techno-jargon and take the time to sign up. Automatic enrollment does just the opposite: new employees are automatically part of the plan and must opt out if they don't want to participate.

"Automatic enrollment will encourage employees — particularly younger workers — to save for retirement."

The idea was already catching on before the new rules were passed; one in five companies already automatically enrolls employees in their 401(k) plans, according to another recent Hewitt survey. Participation rates at companies that previously switched to automatic enrollment rose from 75 percent to 85 or 95 percent. Companies like Costco, Nordstrom, Hewlett-Packard and IBM are leading the way. It is time for the rest to follow suit.

Automatic Escalation of Contributions. It is easier to start new employees at a lower rate and then step them up, rather than require a large contribution from the start. Under the new law, contributions will automatically rise to equal 3 percent of compensation by the end of the first year, 4 percent in year two, 5 percent in year three and 6 percent thereafter. Employees still have the option of choosing different contribution levels.

Matching Contributions. An employer match essentially offers participating employees free money. An employer must match the first 1 percent of compensation the employee contributes dollar-for-dollar, and 50 cents for each additional dollar up to 6 percent of compensation (for a total of 3.5 percent), or contribute at least 3 percent of compensation to the account of every participating employee, regardless of the employee's contribution. The employer's contributions must fully vest after the employee completes two years of service.

Diversified Investment Options. The new workers investing in 401(k)s will be better off as a result of the other provisions. But, they won't maximize their saving potential if they are not investing properly. Fortunately, the law also encourages employers to offer at least three different investment options — other than employer stock — that are diversified and have different levels of risk.

Missing: Automatic Annuitization at Retirement. Unfortunately, a key provision is missing from the pension bill. Longer lifespans — and the need to draw from retirement savings for more years — increase the risk of outliving one's retirement savings. Encouraging 401(k) plans to offer a lifetime annuity as the default payout option at retirement would go a long way toward addressing this potential problem. A lifetime annuity is a financial contract with an insurance company; in exchange for a lump-sum payment — for example, the savings accumulated in a 401(k) — the insurance company guarantees regular payments for as long as the beneficiary lives. It's basically a paycheck for life.

Conclusion. Younger workers cannot depend on Social Security and Medicare to the same extent as their parents and grandparents did to support them in retirement and must rely on their own savings to get through their golden years. Automatic enrollment of new employees will help workers — particularly younger workers — build a nest egg for retirement. Congress has acted. Now it is up to employers to adopt the plan.

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