Older Americans' Economic Security

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Lifetime Patterns of Voluntary Employee Pension Contributions

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As defined contribution plans have come to dominate the pension landscape, retirement security increasingly depends on employees' willingness to defer current consumption and save for old age. Unlike with traditional defined benefit plans, most employers that provide defined contribution plans do not automatically save on workers' behalf. Workers offered defined contribution plans must decide whether to participate, and how much to set aside from each paycheck for investment. Future retirement benefits will depend on participants' and employers' pattern of contributions and the returns earned by the contributions. Families must generally set aside funds over many years to accumulate significant retirement savings in their defined contribution plans.

A variety of different factors, however, can derail retirement saving plans. Any increase in consumption needs or loss of income can reduce contributions and threaten future retirement security. For example, the loss of a spouse—through death or divorce—or a spouse's spell of unemployment can curtail savings. The onset of health problems for workers or their family members also can disrupt saving plans, either because the family must pay expensive medical bills or because poor health forces family members to curtail their labor, lowering family income. In addition, families may wait until they pass key milestones, such as the purchase of a home or the birth of a child, before concentrating on retirement savings.

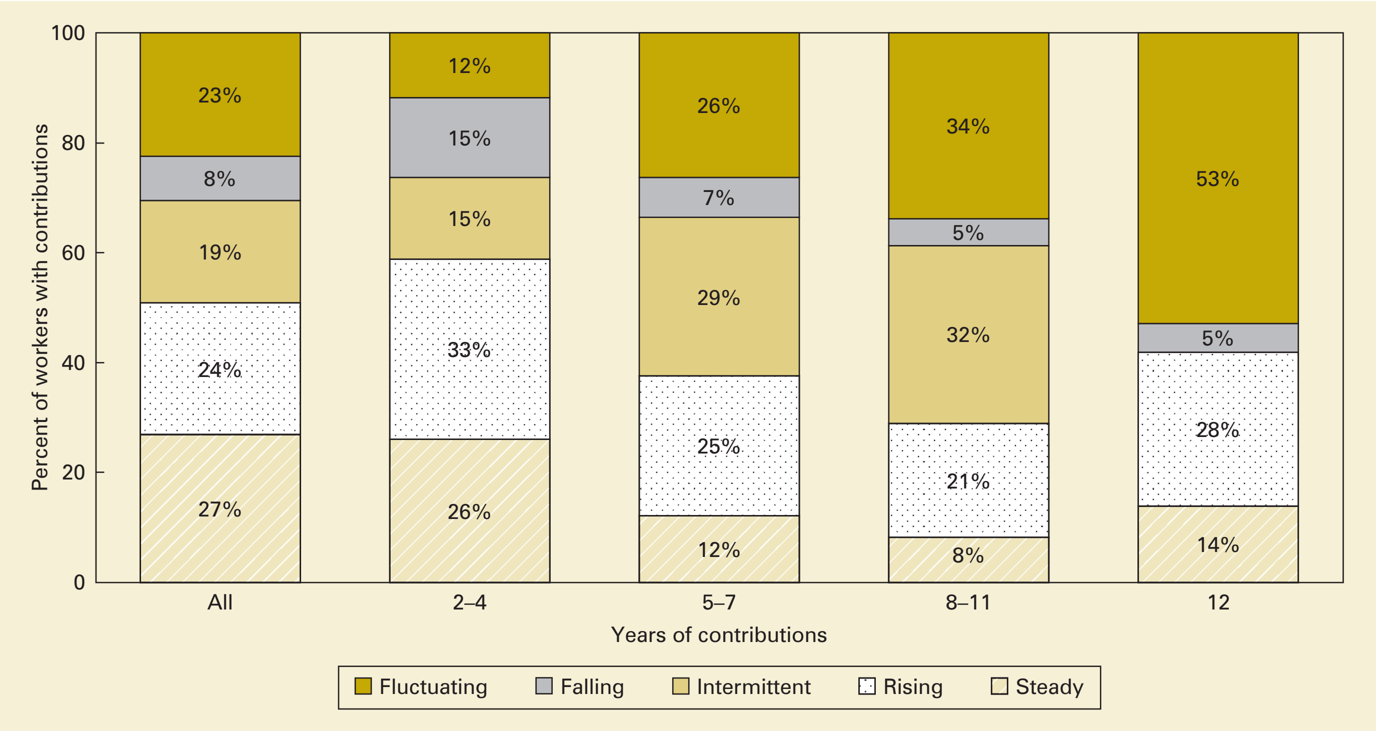
Using a newly available Census dataset that combines administrative earnings records with survey reports,[1] we find that relatively few workers take full advantage of the retirement savings options available to them. Only about one-quarter of all workers contribute to employer-sponsored tax-deferred retirement accounts. The median contribution rate equals 6 percent of earnings. Participation rates and contributions increase with age, education, and earnings.

Retirement plan participants do not simply passively accept default options. In fact, contribution rates have fluctuated quite a bit over time (figure 1). Between 1990 and 2001, only 27 percent of workers who ever contributed to an employer-sponsored tax-deferred plan contributed roughly the same share of earnings every year. And, among those who contributed in all 12 years, 53 percent exhibited fluctuating contribution rates.

Workers often revise their retirement contributions over their lifetimes. Many increase their contribution rates after they have achieved a key milestone, such as the birth of a child or the purchase of a home. With homes and families, workers may be better able (psychologically or financially) to begin preparations for retirement. Participation rates and contribution amounts decrease after job changes, because many employers do not allow new workers to participate in their retirement plans for at least the first year of employment. A spell of unemployment reduces participation but increases contribution amounts after reemployment, suggesting that many unemployed people try to "catch up" in their retirement savings when they resume work. Little evidence would suggest that other potential negative shocks to income or that increased consumption needs—such as the onset of health problems or the loss of a spouse—lead workers to curtail their retirement plan contributions. But workers could react to these financial pressures by borrowing money from their 401(k) plans or taking lump-sum distributions, which might threaten retirement security even if workers maintain their plan contributions.

With the erosion of traditional defined benefit pension plans and the growth in defined contribution vehicles, sound retirement planning increasingly depends on the commitment of individuals to invest in tax-deferred retirement accounts throughout their working lives. Policies that encourage higher participation and contribution levels throughout workers' careers could significantly enhance retirement security.

FIGURE 1. Half of All Participants Have Intermittent, Fluctuating, or Falling Contributions



Source: Urban Institute tabulations of the 1996 Survey of Income and Program Participation matched to the Detailed Earnings Record.

Notes

This brief summarizes a longer paper by Karen Smith, Richard Johnson, and Leslie Muller (2004).

1. The dataset comes from the 1996 U.S. Census Survey of Income and Program Participation (SIPP), and is linked to the Social Security Administration's Detailed Earnings Records (DER). Thus, the dataset links SIPP data on the U.S. population's demographic characteristics with DER data on the history of earnings and contributions to tax-deferred retirement plans.

Reference

Smith, Karen E., Richard W. Johnson, and Leslie Muller. 2004. "Deferring Income in Employer-Sponsored Retirement Plans: The Dynamics of Participant Contributions." Urban Institute Research Report to Boston College Center for Retirement Research. Washington, DC: The Urban Institute. http://www.urban.org/url.cfm?ID=411066.