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DEFERRING INCOME IN EMPLOYER-SPONSORED RETIREMENT PLANS: THE DYNAMICS OF PARTICIPANT 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 their old age. A variety of factors, however, can derail retirement savings plans. Any increase in current consumption needs or loss of current income can reduce contributions and threaten future retirement security. For example, the loss of a spouse—through death or divorce—or a spell of unemployment by a spouse can curtail savings. The onset of health problems for the worker or family members also can disrupt savings plans, either because the family must pay expensive medical bills or because poor health forces family members to curtail their labor supply, 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.

This study uses a newly available dataset that combines administrative earnings records with the 1996 Survey of Income and Program Participation (SIPP) to describe contributions to employer-sponsored retirement plans over time and examine the impact of key demographic and economic milestones on retirement savings. The results suggest that relatively few workers take full advantage of the retirement savings options available to them.

The exploratory analysis highlights the value of this dataset as a source of information on the dynamics of retirement plan contributions. Many of the results confirm findings from earlier studies. For example, the study finds that about one-quarter of all workers contribute to employer-sponsored tax-deferred retirement accounts and that the median contribution rate equals 6 percent of earnings. The study also finds that participation rates and contributions increase with age, education, and earnings, consistent with results from previous work.

However, these findings call into question the conclusions from previous studies that retirement plan participants passively accept default options and rarely adjust their retirement plan contributions. In particular, the authors find that contribution rates fluctuated quite a bit over time. Among workers who ever contributed to a tax-deferred plan through their employers between 1990 and 2001, only 27 percent 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 appear to revise their retirement contributions over their lifetimes. Many increase their contribution rates after they have achieved key milestones, such as the birth of a child or the purchase of a home. With homes and families, they may be better able (psychologically or financially) to begin preparations for retirement. The results also show that participation rates and contribution amounts decreased after job changes, reflecting the fact that many employers do not allow new workers to participate in their retirement plans for at least the first year. A spell of unemployment reduced participation, results show, but increased contribution amounts after re-employment. It appears, then, that many unemployed people try to "catch up" in their retirement savings when they resume work. Little evidence appeared that other potential negative shocks to income or increases in current 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 they 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 work lives. Policies that encourage higher participation and contribution levels throughout workers' careers could significantly enhance retirement security.

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