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RETIREMENT SAVINGS IN THE U.S.: RECENT POLICY DEVELOPMENTS AND INITIATIVES

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Many effects of COVID-19 are still unfolding, including its impact on retirement savings. Americans typically rely on three major sources of income during retirement: Social Security benefits, funds from employer-sponsored retirement plans, and individual savings. However, the relative importance of each component not only evolves over time, but also differs significantly across households. Despite persistent policy support and tax incentives, surveys and studies constantly report a substantial number of households unprepared for retirement, and policymakers continue to find ways to encourage saving.[1] This article reviews recent policy developments related to retirement savings, proposals to enhance the current system, emerging trends in economic research, and additional considerations.

The Three Pillars of Retirement Income

When it comes to sources of retirement income, Social Security benefits are usually the first that come to mind. Recent statistics reveal that, on average, Social Security benefits represent 33% of income for the elderly, with an average monthly benefit of $1,514 (or $18,168 per year).[2] However, for one in five retirees, Social Security benefits constitute over 90% of their income. For one-person households in this group who collect average benefits, this means they are just 50% above the federal poverty line.[3]

Besides, the system itself is in dire financial condition. Although COVID-19's economic impact on Social Security trust funds is not yet published, the most recent trustees report estimates the funds will be exhausted in 2034. If no change is made, the Social Security system will then be able to pay about 76% of scheduled benefits.[4] This does mean that today's young workers need to be more mindful about their own retirement income security.

Over the last few decades, the landscape of employer-sponsored savings plans also shifted from defined benefit–style pension plans to defined contribution–type accounts, such as 401(k), 403(b), and other qualified retirement plans. In March 2020, about 11% of private industry workers were covered by a defined benefit pension, and 47% were covered by a defined contribution savings plan.[5]

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[1] For instance, a Government Accountability Office (GAO) publication found that in 2016, 29% of households aged 55 and older had no retirement savings and no defined benefit pension, 20% of these households had a defined benefit pension but no other retirement savings, and 26% had retirement savings but no pension. For details, see: https://www.gao.gov/assets/700/697898.pdf.

[2] Social Security Administration (SSA), Social Security Fact Sheet, June 2020, https://www.ssa.gov/news/press/factsheets/basicfact-alt.pdf.

[3] The federal poverty line for one-person households is $12,880. As such, the income level for 150% of the poverty line is $19,320. For an individual who collects $18,168 in social security benefits per year, constituting 90% of his income, his annual income is approximately $20,187, slightly ($867) above 150% of the poverty level of $19,320. Two-people households do fare better; however, Social Security benefits will be taxable for married filing jointly households with income over $32,000 and income over $25,000 for other filing statuses. For federal poverty line information, see https://aspe.hhs.gov/poverty-guidelines.

[4] SSA, The 2020 OASDI Trustees Report, April 22, 2020, https://www.ssa.gov/OACT/TR/2020/.

[5] Bureau of Labor Statistics (BLS), National Compensation Survey, Table 2: Retirement benefits: Access, participation, and take-up rates, private industry workers, March 2020,

This trend is driven by a combination of demographic-related cost concerns and workers' increasingly shorter job tenures. The Bureau of Labor Statistics (BLS) reported in 2016 that the median job tenure was just over four years, and a typical worker had 12 jobs before retirement. The greater job mobility increases demand for benefit portability while also shifting the retirement-saving responsibility to workers.

Finally, the individual savings plans, including tax-preferred instruments (such as the Individual Retirement Accounts [IRAs] and annuity contracts) and taxable accounts, are also gaining importance. Approximately a third of U.S. households own IRAs, collectively holding an asset balance of $9.2 trillion in 2017, higher than that of defined contribution accounts ($7.7 trillion) or private-sector defined benefit plans ($3.1 trillion).[6] The vast majority of IRA assets (over 90%) come from 401(k) account rollovers when employees separate from their employers.[7] These statistics not only reiterate the importance of workers' own roles in ensuring their retirement income security, but also demonstrate that workplace savings plans continue to be an important venue, or literally the starting point, of workers' retirement savings.[8]

Tax Incentive or Nudge: If You Build It, They Will Come?

There is voluminous research about retirement saving due to its potential impact on retirees' financial well-being. The issue will be even more critical in coming years as the U.S. population continues to age: by 2030, all baby boomers will be over age 65.[9] At a high level, the research about retirement savings deficiency focuses on two dimensions: First, do workers have access to tax-preferred retirement savings plans at their workplaces, and second, how to encourage workers to save more for retirement?

The issue regarding coverage is important because workers who do not have retirement savings plans through work—disproportionally part-time, lower-income, or small-business workers—are most susceptible to income insecurity at retirement. Some researchers show a high percentage of lower-income workers near retirement contribute to employer plans

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https://www.bls.gov/ncs/ebs/benefits/2020/employee-benefits-in-the-united-states-march-2020.pdf.

[6] Sarah Holden and Daniel Schrass, The Role of IRAs in US Households' Savings for Retirement, 2020, ICI Research Perspective Vol. 27, No. 1, Investment Company Institute, January 2021, https://www.ici.org/pdf/per27-01.pdf.

[7] GAO, Additional Data and Analysis Could Provide Insight into Early Withdrawals, GAO-19-179, March 2019, https://www.gao.gov/products/GAO-19-179.

[8] Both the IRA and the 401(k) accounts are tax-favored, and arguably the most commonly known retirement savings vehicles. The major differences between IRAs and 401(k) accounts include: (1) 401(k) plans are usually more complicated and more costly to establish and administer than IRAs; (2) employer contribution is available for 401(k) plans but not IRAs; (3) loans may be available under 401(k) plans but not IRAs; (4) contribution limits are lower under IRAs than 401(k) plans; and (5) 401(k) plans but not IRAs are regulated by the Employee Retirement Income Security Act of 1974, which sets minimum standards and provides protection for workers in these plans.

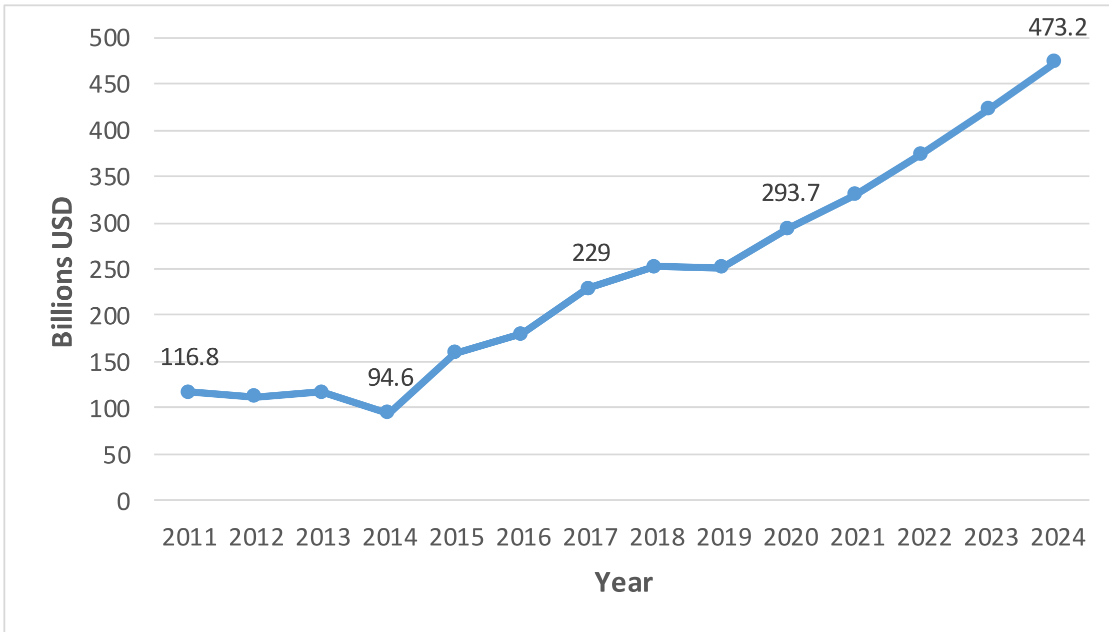
[9] U.S. Census Bureau, "Older People Projected to Outnumber Children for First Time in U.S. History," March 13, 2018, https://www.census.gov/newsroom/press-releases/2018/cb18-41-population-projections.html.

when they are provided access, suggesting expanding workplace plans enhances retirement saving. As a result, policymakers have been focusing on increasing access for these workers, including provisions in the recent Setting Every Community Up for Retirement Enhancement (SECURE) Act (discussed further below) that make it easier for long-term part-time workers to be included in workplace retirement plans and for smaller employers to group together and offer retirement plans.

A second dimension focuses on encouraging workers to increase their retirement savings amounts. Because tax incentives have been used as a major tool to stimulate retirement saving for decades, a reasonable starting point is to ask whether tax incentives promote retirement savings in a cost-effective manner, and who the main beneficiaries of these policies are.

According to data from the Joint Committee on Taxation, the costs of providing retirement savings–related preferential tax treatments have grown rapidly (Figure 1).[10] In 2020, the tax benefits associated with the IRAs as well as pension contributions and earnings were over $290 billion, which increased from $117 billion in 2011. The most recent projection shows that the costs will be $473 billion in 2024, a 60% increase over four years.

Figure 1. Tax Expenditures on Retirement Income Security in the U.S.: 2011–2024



Data Sources: Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024 (JCX-23-20) and similar publications from corresponding years; author's summary.

[10] The tax expenditures are calculated as a sum of three items: credit for certain individuals for elective deferrals and IRA contributions, net exclusion of pension contributions and earnings, and individual retirement arrangements.

Tax incentives associated with retirement savings cost the government substantially, but whether or not they are effective in stimulating additional savings has been the subject of a long debate. On the one hand, some studies find evidence that assets in these accounts are new savings and that the overall savings do increase as a result of these incentives. On the other hand, some conclude these savings are simply shifts from other accounts, so there is no overall increase in household savings.[11]

A related issue is whether these benefits are well-targeted—in other words, whether or not these policies help the households most likely to suffer from insufficient income at retirement. If these incentives are mainly used by workers who will save for retirement even without these benefits, there is limited reason for providing them—the policies will only lead to lower tax revenue without making a significant difference on income security.

Although workers are more aware of the importance of retirement saving as they approach retirement age, researchers find that workers with high savings deficiency are less likely to be attentive to tax incentives when making saving decisions; as such, tax subsidies do not significantly increase their savings.[12] Some even conclude the current tax incentives can be cut in half without substantially affecting the aggregate amount of retirement savings.[13] Although the debate regarding the effectiveness of tax incentives on retirement saving is unsettled, tax incentive amounts grow over time while the concerns related to retirement savings insufficiency persist. This shows that in their current form, at least, tax incentives alone are insufficient to resolve the retirement savings issues.

Researchers therefore turn their attention to non-tax measures; specifically, they study whether behavioral "nudges," or imbedding mandatory requirements in retirement plans, will increase saving. The results are promising, especially for individuals with the largest savings deficits.[14]

Auto-Enrollment and Auto-Escalation

Among these nudges, auto-enrollment and auto-escalation features have received the most attention. Auto-enrollment means that instead of letting plan participants decide whether to opt in to employer-sponsored retirement plans, employers will enroll all new participants in retirement plans as a default but allow them to opt out. Empirical studies show this minor change greatly increases the number of workers enrolled, especially among the young and low-wage workers.

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[11] Steven Sass, Can We Increase Retirement Saving?, Center for Retirement Research at Boston College, IB 16-15, September 2016, https://crr.bc.edu/briefs/can-we-increase-retirement-saving/.
[12] Raj Chetty et al., "Active vs. Passive Decisions and Crowd-Out in Retirement Savings Accounts: Evidence from Denmark," *Quarterly Journal of Economics* 129, no. 3 (2014): 1141–1219.
[13] John Friedman, Tax Policy and Retirement Savings, January 30, 2016, https://budgetmodel.wharton.upenn.edu/issues/2017/2/27/tax-policy-and-retirement-savings.
[14] The Pension Protection Act of 2006 encouraged but did not require auto-enrollment and auto-escalation features to be included in retirement plans; however, many big plan sponsors voluntarily adopted these features.

The second mechanism is auto-escalation, which by itself means gradually increasing the default contribution rate to the retirement savings account over time, such as raising the contribution rate by 1% per year until it reaches a certain percentage. The effects of this feature are especially prominent when combined with auto-enrollment. Studies show many auto-enrolled workers retain the default contribution rate, and the auto-escalation feature ensures they save more over time.

Employer Matching

These behavioral studies indicate that policymakers can design plans to encourage saving by taking advantage of people's inertia. Two other behavioral mechanisms that generate support, although not as powerful as auto-enrollment and auto-escalation when it comes to increasing retirement savings, are employers' matching contributions and target date funds.

For workplace retirement plans, employers can make tax-deductible contributions to employees' 401(k) accounts. The most common mechanism is through employer matching contribution, where employers also contribute when employees deposit funds to their retirement savings accounts. Studies show that while the matching contribution has positive effects on savings, it has a lesser impact on participation and contribution than the auto-enrollment and auto-escalation features.

Although the employer matching essentially constitutes "free money" up for employees to grab, not all workers take advantage of the match.[15] Among employees who are able to contribute, researchers found the matching threshold tends to serve as a strong anchor for participants as to how much to contribute. Some therefore suggest that if the goal is to maximize overall savings, the better design is to have a lower matching rate but a higher matching threshold.

There is evidence that as auto-enrollment increases retirement plan participation, employers tend to reduce matching, but not to stimulate employee saving. Some state this is because employers seek to control costs, while others indicate that employers use retirement plan participation as an identifier. Workers who enroll tend to be thrifty and thus more dedicated workers. As such, matching contribution serves as a tool that employers use to reward these workers. When most employees participate, it is hard to identify who is thrifty; therefore, using retirement plan participation as a personnel management tool is less valuable.[16]

[15] Joyce Beebe, "The Perfect Match," *Baker Institute Blog*, December 20, 2019, https://www.bakerinstitute.org/research/perfect-match/.
[16] Sass, Can We Increase Retirement Saving?

Target Date Funds

Once enrolled in a retirement plan, many workers are overwhelmed by the universe of funds as eligible investment options, let alone the need to consistently manage their investments or rebalance the asset allocation. As a result, the target date funds (TDFs) were introduced and have been widely adopted. The assets in TDFs increased from $158 billion in 2008 to $1.1 trillion in 2018, a seven-fold growth over a decade.[17]

The popularity of TDFs stems from workers wanting to make fewer decisions. Many TDFs are labelled with the year a worker is expected to retire. Once a worker decides his or her retirement date and selects the corresponding TDF, there is no need to choose a specific asset allocation. If an employer incorporates the auto-enrollment and auto-escalation features in workplace plans and designates funds to TDFs, workers essentially do not have to make any decision and the default options will still ensure workers save for retirement.

Although most of the investment management process is on autopilot, workers still need to understand the asset mix, rebalancing strategy as the fund matures, and the associated expenses. For example, even if two TDFs have the same retirement year, the asset allocations or rebalancing strategies may not be identical. In addition, if a TDF invests in other funds, participants typically have to pay management expenses of those underlying funds on top of the TDF expenses.

From a risk perspective, TDFs take more aggressive investment positions when workers are young, and migrate to more conservative instruments as workers approach retirement. However, even when workers are close to their retirement age, the funds are not completely risk-free—during the Great Recession, many TDFs did lose value due to their stock market exposure.

Essentially, the trade-off of being hands-off is that the funds treat all workers with the same retirement date as having identical risk profiles. In reality, some workers may have higher risk tolerance even when approaching retirement because they have other assets available, and others may prefer portfolios that provide stable distribution. Overall, a TDF is a great foundation for workers to build their retirement savings, but they still need to tailor the investments to their own circumstances as their life situations evolve and financial needs change.

[17] Jeff Brown, "What We've Learned About Target Date Funds, 10 Years Later," *Wall Street Journal*, May 5, 2019, https://www.wsj.com/articles/what-weve-learned-about-target-date-funds-10-years-later-11557108540.

SECURE Act

A recent piece of legislation that changed how Americans approach retirement saving is the Setting Every Community Up for Retirement Enhancement (SECURE) Act, passed in December 2019.[18] The SECURE Act includes several provisions that altered the rules governing tax-preferred retirement savings plans. For instance, it increases the age a taxpayer needs to reach to start taking the required minimum distribution (RMD) out of their IRAs from 70 1/2 to 72, and the age limit for making contributions to the IRAs is eliminated. These provisions potentially give account holders more time to grow their retirement accounts before they need to begin dissolving and paying taxes on their lifelong savings.

Certain well-intended provisions are not as well-received. The SECURE Act eliminated the "stretch IRA" by mandating most inherited retirement account balances be distributed (and therefore taxed) within 10 years after the account owner's death. Although the congressional intent is not to have tax-preferred retirement savings accounts become wealth transfer tools, some wonder if this provision essentially encourages lavish consumption and punishes taxpayers who are frugal and wish to leave a modest bequest to their family.

The SECURE Act also expanded the retirement benefit coverage to more small-business employers and part-time workers, as these groups historically had lower coverage than workers in larger-business and full-time settings. Specifically, the law makes it easier for small-business employers to join the multiple employer programs (MEPs), which reduce the costs of administrating retirement plans and potentially provide more investment options.

In addition, the SECURE Act increases start-up tax credits for small-business employers who set up work-sponsored retirement plans from $500 to $5,000 per year for three years. It also provides a $500 credit for small-business employers who incorporate auto-enrollment features into their retirement plans.

For part-time workers, the law requires that if an employee works for a company for three years and at least 500 hours each year, the worker will be able to participate in the employer's retirement program. This provision became effective in January 2021, which means these employees will be eligible in January 2024 after satisfying the three-year vesting period requirement. This also means the employers need to track part-time workers' hours from 2021 to 2023 to determine eligibility.

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[18] Joyce Beebe, "The SECURE Act: The Good, the Bad, and the Ugly," *Baker Institute Blog*, January 7, 2020, http://blog.bakerinstitute.org/2020/01/27/the-secure-act-the-good-the-bad-and-the-ugly/.

CARES Act

As a result of the financial turmoil inflicted by the pandemic, the Coronavirus Aid, Relief, and Economic Security (CARES) Act allows affected workers to withdraw up to $100,000 from their retirement plans without paying the 10% early distribution penalty.[19] The withdrawals are still subject to tax, but the CARES Act allows the resulting tax to be paid over a three-year period instead of all during the year of distribution. The distribution can also be repaid over a three-year period without additional tax consequences. Furthermore, for employer-sponsored plans that allowed participant loans, the CARES Act authorizes increased loan amounts and a longer repayment period.[20]

Preliminary data shows the CARES Act provisions did not generate a substantial outflow of retirement funds. At the end of September 2020, several large retirement plan administrators reported that 5% to 7% of participants had tapped into their workplace accounts. For instance, Fidelity reported 5.2% of participants (1.3 million workers) withdrew an average of $10,000 from their accounts, a modest amount compared with the average 401(k) account balance of approximately $110,000.[21] This is consistent with a Federal Reserve survey, which showed that as of July 2020, an average of 9% of workers (15% of unemployed and 7% of employed workers) took funds from their retirement accounts.[22]

However, it may be premature to conclude the pandemic does not affect Americans' retirement financial security. For instance, although not as many participants withdraw funds from large plan administrators, this may not be true for employees who establish plans with smaller administrators. Workers in certain industries, such as hospitality, food and beverage, and airline, are potentially more heavily impacted than others. In addition, even for workers who do not take these distributions, their decisions about their retirement date may have been affected by the pandemic. Workers close to retirement may decide to retire early out of health concerns, or they may instead worker longer to make up for reduced wages; both have financial implications for their retirement income.

[19] Joyce Beebe, "How Does the CARES Act Help Recent College Graduates and the Class of 2020?," *Baker Institute Blog*, April 16, 2020, https://blog.bakerinstitute.org/2020/04/16/how-does-the-cares-act-help-recent-college-graduates-and-the-class-of-2020/. (The IRS released Notice 2020-50 in June 2020 to clarify certain procedures.)
[20] Not all retirement plans allow loans. For those that do, participants can borrow up to 50% of the vested account balance or $50,000, whichever is less. The loans need to be repaid within five years. The CARES Act adjusted these limits to the lesser of $100,000 or 100% of the vested balance. It also allows loan repayment to be within six years.
[21] Sharon Epperson, "Few Workers Take Advantage of Covid-19 Rules for 401(k) Plan Withdrawals," *CNBC*, December 15, 2020, https://www.cnbc.com/2020/11/16/few-workers-take-advantage-of-covid-19-rules-for-401k-withdrawals.html. (The plan administrators in the news story include Fidelity, Vanguard, and T. Rowe Price.)
[22] Federal Reserve, Update on the Economic Well-Being of U.S. Households: July 2020 Results, September 2020, https://www.federalreserve.gov/publications/files/2019-report-economic-well-being-us-households-update-202009.pdf. (These numbers include loans and cash-outs from retirement accounts, and include both taxable and tax-preferred accounts.)

As mentioned, workplace plans are only one of three pillars that provide workers financial support during retirement; individual savings have gained importance. Financial advisors have long advised against early withdrawals from dedicated retirement savings, which means that workers may exhaust other financial resources—such as borrowing from families or taxable savings, or simply stopping contributions—before taking funds out of their 401(k) accounts.[23] Workers may also withdraw from their IRAs before dissolving their 401(k) accounts prior to retirement, potentially because there are fewer restrictions associated with withdrawing from IRAs; some may also have more sizable IRA balances due to one or multiple rollovers.[24]

SECURE Act 2.0

Whether or not there is a pandemic, safeguarding retirement income security remains important. In October 2020, the Securing a Strong Retirement Act of 2020, dubbed the SECURE Act 2.0, was introduced to further refine the retirement saving mechanism for workers.[25] The bill proposes more than 30 changes to existing rules, some modifying those in the SECURE Act.[26]

One notable provision is that the proposal would require workplace plans to automatically enroll employees when they are eligible. It requires a minimum 3% initial contribution and increases by 1% annually until it reaches 10% of payroll, unless participants opt out of the auto-enrollment and auto-escalation features.

For older workers, this proposal further increases the RMD age from 72 to 75. The RMD is waived if one has less than $100,000 in IRAs or 401(k) accounts. It also allows individuals over 60 to have higher catch-up contributions. For younger workers, the proposal formally allows them to pay down student loans instead of contributing to the retirement accounts but still benefit from employers' matching contribution.[27]

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[23] "In COVID-19 Crisis, Older Americans Are More Resilient Than Younger Generations, Edward Jones and Age Wave Research Finds," *PR Newswire*, August 4, 2020, https://www.prnewswire.com/news-releases/in-covid-19-crisis-older-americans-are-more-resilient-than-younger-generations-edward-jones-and-age-wave-research-finds-301105104.html.

[24] Cheryl Cooper and Zhe Li, Saving for Retirement: Household Decision-making and Policy Options, R46441, Congressional Research Service, July 2, 2020, https://fas.org/sgp/crs/misc/R46441.pdf.

[25] Securing a Strong Retirement Act of 2020, H.R. 8696, 116th Cong. (2020), https://www.congress.gov/bill/116th-congress/house-bill/8696?s=1&r=1. Another earlier proposal, the Retirement Security & Savings Act, S. 1431, 116th Cong. (2019), has many overlapping provisions with H.R. 8696. For details, see: https://www.portman.senate.gov/newsroom/press-releases/portman-priorities-help-americans-save-retirement-included-new-brady-neal.

[26] U.S. Congress, Ways and Means Committee, Securing a Strong Retirement Act of 2020, Section by Section Summary, October 27, 2020, https://waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/2.0Sectionbysection_final.pdf.

[27] Several large companies have been offering similar benefits to their employees but this provision, if it becomes law, will codify the benefit. For details, see Beebe, Joyce 2018. *The Current Student Loan Landscape and Recent Developments*, Baker Institute Report no. 12.14.18. Rice University's Baker Institute

Building on the initiative of the SECURE Act, the proposal increases tax credits for small businesses that offer retirement plans. It also reduces the eligibility requirement for part-time workers: as long as a worker provides service for two consecutive years at 500 hours per year (instead of three years from the SECURE Act), the worker is eligible to participate in the workplace plan. In addition, the proposal increases the Saver's Credit, a retirement savings tax credit for low- and middle-income individuals, to encourage saving.

A major concern for this proposal is the cost. Unlike the SECURE Act, which is generally revenue-neutral (mostly by eliminating the stretch IRA),[28] the SECURE Act 2.0 does not have obvious revenue-raising provisions. If policymakers eventually need to drop certain provisions out of cost concerns, there are no universally agreed-upon items that take priority over others. Some practitioners argue that retirement savings tax benefits for small businesses have been available but not widely utilized; therefore, they are not sure whether the MEPs or additional tax benefits will be impactful.[29] Others worry that the Saver's Credit may similarly have limited effects because the take-up rate has been low.[30]

What is Not in the Proposal?

Both the SECURE Act and the proposed extension generated momentum to encourage retirement saving, and the provisions in the CARES Act provided liquidity options during the pandemic. This section discusses several considerations that drew attention but were not included in the recent proposal: early withdrawals during non-pandemic times, emergency savings accounts, the automatic IRA, and the simplification of retirement plans.

Early Withdrawals

It is critical to discuss approaches to increase retirement savings, but it is equally important to address the potential leakage when funds leave the retirement savings system prematurely. A Government Accountability Office (GAO) study reported that in 2013, nearly $70 billion of funds left retirement savings accounts before the account holders reached 59 1/2, consisting of $39.5 billion from IRAs and $29.2 billion from 401(k) accounts. These participants collectively paid $6.2 billion in additional taxes in 2013 as a result of the early distributions.[31] Although this seems to be a small amount in comparison with the overall $17 trillion balance of 401(k)s and IRAs, it is concerning because account holders with certain characteristics are more likely to withdraw early, and therefore suffer from retirement income deficiency.

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for Public Policy, Houston, Texas, https://www.bakerinstitute.org/media/files/files/f34ecd01/bi-report-121418-cpf-studentloans.pdf.

[28] Jane Gravelle, The SECURE Act and the Retirement Enhancement and Savings Act Tax Proposals (H.R. 1994 and S.972), IF 11174, Congressional Research Service, May 24, 2019, https://fas.org/sgp/crs/misc/IF11174.pdf.

[29] John Manganaro, "SECURE Act Passed by Full Congress," *Plan Sponsor*, December 19, 2019, https://www.plansponsor.com/secure-act-passed-full-congress/.

[30] Warren Rojas, "Retirement Plan Payout Updates Ripe for Lawmaker Action in 2021," January 11, 2021, *Bloomberg Law*, https://news.bloomberglaw.com/daily-labor-report/retirement-plan-payout-updates-ripe-for-lawmaker-action-in-2021?context=article-related.

[31] GAO, Additional Data and Analysis Could Provide Insight into Early Withdrawals.

Generally, account holders who work for smaller employers, have substantial household debt, earn lower income, reserve low emergency cash savings, or work part-time are more likely to withdraw from their accounts ahead of time. New participants who have been saving for less than three years and participants who are close to retirement age (45–54) are also more likely to withdraw from their accounts early. Many borrowers are serial borrowers, which means they may take out new loans to repay old ones or initiate multiple loans over time. For these borrowers, they not only have reduced retirement savings, but also have lower disposable income during work years as a result of loan repayments.[32]

In terms of timing, the outflows of funds coincide with financial hardship and job changes. As such, it is critical to understand the current early withdrawal mechanism and associated tax consequences before discussing how to improve the phenomenon.
Under current rules, 401(k) plan sponsors (employers) have certain flexibility when it comes to allowing participants to access their savings before retirement age. They can typically do so by permitting loans and hardship withdrawals.[33]

For loans, the plans can set rules about the number of loans and amount of borrowing within federal limits. The loans are generally not treated as early withdrawals unless participants fail to repay before the specified time frame. In addition, if the loans are not cleared when a participant leaves the employer, the outstanding balance is treated as a withdrawal and the worker must pay income and early distribution taxes.

In addition, participants facing immediate and heavy financial needs can make hardship withdrawals, which are exempt from the 10% additional tax. Among the $29.2 billion 401(k) early withdrawals in 2013, hardship withdrawals accounted for $18.5 billion, over 63% of the total amount. Plan sponsors can designate their own list of acceptable hardship withdrawals; however, many follow the Internal Revenue Service (IRS)'s "safe harbor" list, which includes six major categories. These include: (1) certain medical expenses, (2) costs directly relating to the purchase of a principal residence, (3) tuition and related educational fees and expenses for postsecondary education, (4) payments to prevent eviction from or foreclosure of a primary residence, (5) funeral expenses, and (6) certain expenses to repair damage to the employee's principal residence. [34]

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[32] Other characteristics for workers prone to early distribution include: lower accumulated account balances (less than $5,000), high school education or less, households that are very large (7 people or more) or very small (individuals who live alone), widowed, separated, or divorced households, and minority households. See GAO, Additional Data and Analysis Could Provide Insight into Early Withdrawals.
[33] "Retirement Topics – Exceptions to Tax on Early Distributions," IRS, last updated January 19, 2021, https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions.
[34] "Retirement Topics – Hardship Distributions," IRS, last updated May 15, 2020, https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-hardship-distributions.

A major decision comes when an employee leaves the current job, at which point the worker needs to decide what to do with the accumulated assets. Generally, the worker has three options: the first is to do nothing and leave the balance in the existing plan. The second option is a direct rollover, where the worker can transfer funds directly into a qualified employer plan (most commonly a plan offered by the new employer) or an IRA. Finally, the worker can have the funds distributed to his or her own taxable account, and roll the distribution into a new qualified employer plan or an IRA within 60 days. Alternatively, the worker can keep the funds and pay taxes associated with the distribution. The last scenario, commonly known as "cash-out," means the funds will no longer be tax-preferred and is a major leakage of the employer-sponsored retirement plans. Approximately one-third of the early withdrawals are a result of cash-outs.[35]

Researchers and policymakers agree that premature withdrawals from the retirement savings system compromise retirement income security; however, there is no agreement as to how to address the issue. Some believe lawmakers should limit the hardship withdrawals, and removing the postsecondary education and home purchase expenses from the safe harbor list are good starting points. They argue that these expenses are either voluntary or predictable or that there are other tax benefits workers can utilize for similar purposes. For instance, workers can plan and save ahead for buying a house, and current federal income tax already allows mortgage interest deductions.

On the other hand, some state that permitting early access to retirement savings encourages plan participation, increases contributions, and provides workers means to address their urgent financial needs instead of resorting to costly alternatives such as payday loans or high-interest credit cards. Therefore, these researchers suggest additional flexibility, such as allowing IRA loans or letting workers roll 401(k) loans into IRAs to keep the funds in the retirement savings system. A recent example is that the SECURE Act allows penalty-free withdrawals for the birth or adoption of a child, further expanding the access to retirement savings.[36]

[35] Besides cash-outs and hardship withdrawals, loan defaults are a major source of early distribution that constitute at least $800 million of early withdrawals. However, researchers indicate this amount is likely underestimated, as plan sponsors may deduct outstanding loans from participants' account balances at job separation (loan offset).

[36] Birth- or adoption-related early withdrawal is not considered hardship withdrawal; it is a new type of distribution.

Emergency Saving within Employer Retirement Plans

Many workers who took hardship withdrawals do use the funds for immediate emergencies, such as preventing immediate eviction or foreclosure or covering out-of-pocket medical expenses. Most of them do not take money from retirement accounts to fund lavish lifestyles; instead, retirement funds are their insurance against sudden economic blows and often their only source of savings.

Some researchers therefore advocate incorporating an emergency savings feature into the 401(k) plans.[37] This essentially means that a portion of workers' retirement contributions will first be earmarked as emergency savings. Once the predetermined emergency savings limit is reached, all subsequent contributions will be attributable to retirement savings. When an emergency arises, workers may withdraw from the emergency savings to address their needs. A portion of subsequent contributions will again go back to replenish the emergency savings until reaching the desired level. Supporters claim that because most workers are aware of the importance of retirement savings and already use it for emergency purposes, putting the emergency savings feature into retirement plans helps balance short-term needs with long-term retirement income security.

Proposed incentives for emergency savings are not new. Over the last two decades, Universal Savings Accounts (USAs) and similar ideas that promote personal savings accounts for workers who do not have employer-sponsored retirement plans have been discussed.[38] The USAs are essentially general savings accounts available to workers, with no minimum contribution requirements and no tax or penalty for withdrawals anytime. Presidents Clinton, Bush, and Obama have historically supported the idea.[39]

Whether or not the emergency savings features are formally incorporated as part of the retirement saving mechanism, the tax-preferred retirement funds already increasingly resemble emergency savings that can be tapped for life events: under current rules, workers can use funds to cover the birth or adoption of a child, educational expenses, certain housing-related expenses, medical expenses, funeral expenses, and (eventually) retirement.

Automatic-IRA

Encouraged by the success of 401(k) auto-enrollment, some researchers support expanding a similar mechanism to IRAs, covering workers whose employers do not offer retirement plans. Specifically, an automatic-IRA (auto-IRA) requires employers who do not provide workplace plans to offer their employees payroll-deductible features, which allow workers to withhold a portion of their paychecks and deposit funds into their IRAs directly.

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[37] GAO, Additional Data and Analysis Could Provide Insight into Early Withdrawals.
[38] Saving for the Future Act, S. 1053, 115th Cong. (2019), https://www.congress.gov/bill/116th-congress/senate-bill/1053.
[39] Robert Bellafiore, "The Case for Universal Savings Accounts," Tax Foundation, February 2019, https://taxfoundation.org/case-for-universal-savings-accounts/.

The auto-IRA idea was first proposed over a decade ago, and has gained traction fairly recently at the state level. In March 2020, about 5% of the private industry workers had access to payroll deduction IRAs.[40] Opponents question the effectiveness of the mechanism, whereas supporters argue auto-IRAs will be able to close the coverage gap for workers who do not have access to employer plans. Seven states (California, Colorado, Connecticut, Illinois, Maryland, New Jersey, and Oregon) and one city (Seattle) have recently adopted jurisdiction-wide rules to require auto-IRAs, and other states may follow.[41]

Simplification

Many recent provisions focus on enrolling new participants and expanding plan coverages to facilitate savings. However, with higher job mobility and shorter tenure, coordination across different types of plans is increasingly important.

For instance, there are 14 major types of retirement savings plans listed on the IRS website.[42] Each plan has different qualification requirements, contribution limits, and governing tax rules, and some may further be separated into subcategories with their own rules. Although some plans are more commonly used than others, there is certainly room for improvement when it comes to simplifying the participation, coordination, and account management rules for sponsors and employees.

Besides simplification efforts across plans, the individual plan features should also be easy to implement. A recent example is the birth or adoption benefits provision in the SECURE Act, where plan sponsors may allow new parents to withdraw up to $5,000 per parent from their tax-preferred retirement savings accounts without penalty, and participants can repay the funds anytime, even several years after the distribution.[43] Although this provision offers flexibility to new parents, some practitioners worry that allowing workers unlimited time to repay will deter employers from offering the benefits due to the potential administrative complexity. The Treasury may provide additional guidance on this matter.

[40] BLS, National Compensation Survey, Table 40. Financial benefits: Access, private industry workers, March 2020, https://www.bls.gov/ncs/ebs/benefits/2020/employee-benefits-in-the-united-states-march-2020.pdf.
[41] Alicia Munnell, "Opinion: Auto-IRA Programs Are Closing the Coverage Gap," *Marketwatch*, December 18, 2020, https://www.marketwatch.com/story/auto-ira-programs-are-closing-the-coverage-gap-2020-12-18.
[42] "Types of Retirement Plans," IRS, last updated September 23, 2020, https://www.irs.gov/retirement-plans/plan-sponsor/types-of-retirement-plans.
[43] "SECURE Act Leaves Questions about Distributions for Birth, Adoption" (Revised), *Mercer*, September 28, 2020, https://www.mercer.com/our-thinking/law-and-policy-group/secure-act-leaves-questions-about-distributions-for-birth-adoption.html.