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SCHWARTZ CENTER FOR ECONOMIC POLICY ANALYSIS

POLICYNOTE

POLICY OPTIONS FOR CUTTING RETIREMENT PLAN LEAKAGES

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ELEVATOR PITCH

Financial necessity is an important reason low-wage households are more likely to make pre-retirement withdrawals from their 401(k) plans. However, an increase in the tax penalty on early withdrawals may increase rather than discourage withdrawals, and a prohibition on withdrawals may decrease contributions. To ensure that all households both contribute to retirement plans and remain invested, retirement policy should both mandate contributions and prohibit pre-retirement withdrawals. Finally, if households are prohibited from using retirement savings to buffer pre-retirement shocks, policy interventions will be required to increase the financial resilience of working-age households.

KEY FINDINGS

- Many pre-retirement withdrawals are the result of economic shocks, such as job-loss or the onset of ill-health.
- Low-wage workers are more likely to experience shocks and cash out in response, exacerbating pre-existing inequalities in financial preparedness for retirement.
- Increasing the excise tax on pre-retirement withdrawals may not deter households experiencing shocks from withdrawing, and may even increase pre-tax withdrawals.
- In a voluntary system, prohibiting pre-retirement withdrawals may deter low-income workers from participating in 401(k) plans and may impose hardship on households experiencing economic shocks unless accompanied by other interventions.

TABLE 1: CASHING OUT OF 401(K) BALANCES AT JOB CHANGE BY AGE (2013)

Age	Percentage of Participants Cashing Out
20's	35%
30's	32%
40's	32%
50's	24%
60's	19%
70's	26%
All Ages	29%

Source: Vanguard (2014).

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INTRODUCTION

Recent SCEPA research, funded by the National Endowment for Financial Education (NEFE), shows that 401(k) participants at all income levels are accumulating about a third of the amounts needed to maintain their living standards in retirement. A major contributory factor is pre-retirement withdrawals, or leakages.[1] Leakages reduce average plan balances by about 20 percent. SCEPA research shows that low-wage workers are more likely to make pre-retirement withdrawals, reflecting a higher incidence of economic shocks and a greater propensity to withdraw after experiencing a shock.

This policy brief evaluates options to reduce leakages. It argues that it may be counter-productive to increase the excise tax on pre-retirement withdrawals. It may also be counter-productive to prohibit pre-retirement withdrawals unless the measure is accompanied by other policy interventions. Rather, the solution is to combine a prohibition on pre-retirement withdrawals with both a contribution mandate and policies and educational initiatives designed to ameliorate the financial vulnerabilities that drive many households experiencing financial shocks to make pre-retirement withdrawals.

MANY LEAKAGES RESULT FROM ECONOMIC SHOCKS

401(k) participants can take in-service withdrawals if they can show an "immediate and heavy financial need," or hardship. Withdrawals are subject to income tax and may be subject to a 10 percent excise tax.[2] In contrast, at job separation, participants can take a withdrawal, no questions asked, again subject to income and excise taxes.

Recent SCEPA research shows that as much as a third of all leakages are directly associated with household-level economic shocks, such as job-loss and the onset of ill-health. The indirect effects are likely considerably greater.[3] Although some households may leak as a result of fecklessness and short-sightedness, many appear to be cashing out due to financial necessity.

Households appear to use the 401(k) system for two purposes, to save for retirement and as a precaution against pre-retirement economic shocks. Households fortunate enough not to experience economic shocks arrive at retirement with their savings intact. But others, forced to break into their retirement nest egg, arrive at retirement with insufficient resources to maintain their standard of living. Their decision may be unfortunate, but nonetheless rational.[4]

CASHOUTS EXACERBATE PRE-EXISTING INEQUALITIES IN RETIREMENT INCOME

The SCEPA study found that workers in low-income households are more likely to experience economic shocks and also more likely to cash out their 401(k) plan balances in response. This is not surprising, since workers in low-income households usually have few significant financial resources outside their 401(k) plans and limited access to credit.

Thus, cashouts not only reduce retirement incomes, but also exacerbate pre-existing inequalities in retirement income.

While the amounts cashed out are often small, the long-run effects are substantial because ex-participants lose the opportunity to earn investment returns on the amount cashed out.

INCREASING THE EXCISE TAX MAY HARM LOW-INCOME HOUSEHOLDS

The Tax Reform Act of 1986 imposed a 10 percent penalty on 401(k) withdrawals prior to age 59 ½, sending a clear signal that pre-retirement withdrawals are unwise. But it is unclear whether 10 percent is the optimal level, while the excise tax may further exacerbate inequalities in 401(k) tax expenditures.[5]

According to one economic model, households withdraw funds before retirement because they have "time inconsistent preferences."[6] They understand the importance of saving for retirement and therefore enroll in their plan, willingly accepting lower consumption next month in return for higher consumption in retirement. But when next month comes around, they are now faced with a reduction in consumption that is immediate, not a month away. They now substantially discount the plan's future benefits relative to the opportunity to consume more now. If circumstances permit, they will revisit their previous decision and cash out their plan.

If this model explains the majority of withdrawals, policymakers should set the tax rate high enough to dissuade individuals with time inconsistent preferences from withdrawing. If households vary in the degree to which they discount future consumption, the optimal tax rate may be close to 100 percent.[7]

The above model assumes that households differ only in their degree of impatience and downplays the effects of economic shocks. It may be optimal for even a patient household with time consistent preferences to cash out its 401(k) if it experiences an economic shock.[8] The immediate benefit from the withdrawal offsets the long-run financial cost.

If a model that emphasizes the role of economic shocks better describes household behavior, the excise tax penalizes low-income households in two ways. First, they are more likely to cashout and pay the penalty, further skewing the government's tax expenditure on 401(k)s in favor of high earners. Second, if a household experiencing an economic shock needs to raise a specified dollar amount, net of tax, it will cash out more savings to cover the excise tax.

PROHIBITING WITHDRAWALS MAY HURT LOW-WAGE WORKERS

An alternative to increasing the excise tax is to prohibit withdrawals to protect those workers who would otherwise make the shortsighted decision to cash out their 401(k) savings. However, a prohibition on withdrawals would harm those whose immediate financial need is so great that the benefit of cashing out exceeds the long-run cost.

An additional concern is that households may respond to a prohibition on withdrawals by contributing less to their 401(k) plans. Experience with 401(k) plan loans supports this hypothesis. The absence of a loan option and a prohibition on withdrawals both decrease the liquidity of 401(k) plans. Research shows that workers eligible for a 401(k) plan that does not offer a loan option, and which is therefore less liquid, have lower participation rates than workers eligible for a plan that incorporates a loan option.[9] The reduction in participation rates is largest among low-wage workers, who may value liquidity more highly due to limited financial resources.

The reduction in 401(k) contributions would matter little if workers who contributed less to their 401(k) plans saved more in liquid taxable accounts. However, without the convenience and consistency of an automatic paycheck deduction, many low-income households might in fact save little. Even households that succeeded in saving in liquid taxable accounts would accumulate less because such accounts offer lower expected returns than typical 401(k) investments.

POLICY RECOMMENDATIONS

To date, policymakers have focused on initiatives to facilitate balance rollovers when a worker changes jobs.[10] However, the private sector is starting to address the problem of forced transfers. Currently, if a former employee takes no action, employers can transfer balances under $5,000 to an IRA. This may be better than a cashout, but these IRAs often have high fees and Department of Labor regulations require they invest in safe but low-return assets. One private sector initiative proposes establishing a clearininghouse to route these unclaimed balances to the participant's new 401(k) plan.[11] These institutions should be encouraged.

Financial education that is focused on empowering households to make wise decisions rather than on imparting knowledge about the operation of financial markets also has a role to play by alerting households to the long-term costs of short-sighted cashouts.[12]

However, these initiatives will not address the substantial share of leakages that are not the result of short-sighted decisions, but of households responding to economic shocks. To ensure all households preserve assets for retirement, we need both a prohibition on withdrawals and a participation mandate. These vital policy reforms are elements of the Guaranteed Retirement Account (GRA) proposal for mandatory, professionally-managed individual accounts to supplement Social Security. Because these proposals will reduce pre-retirement liquidity, we also require policy interventions to help households weather pre-retirement economic shocks.

ENDNOTES

1. Munnell and Webb. 2015.

2. Some distributions, for example those because of permanent and total disability, are exempt from the 10 percent excise tax (Internal Revenue Service, 2016a).

3. The study used data from the Survey of Income and Program Participation. The data only permitted the analysis of a limited number of types of shocks, required the effect to be observed over a relatively short time span, and did not contain data on shocks experienced by non-resident family members. The analysis therefore likely understates the long-run impact of all types of shocks.

4. In economic parlance, households are maximizing expected discounted lifetime utility by shifting consumption from retirement, when the marginal utility of consumption may be high, to the current post-shock period, when the marginal utility of consumption is even higher.

5. A tax expenditure is the tax revenue foregone as a result of the favorable tax treatment accorded to a particular activity.

6. As described in Laibson (1997), a household with time-inconsistent preferences is one that discounts future periods' consumption (for example, consumption next year and the year after) at the same rate of time preference, but discounts all future periods' consumption at a higher rate of time preference, relative to current consumption.

7. Beshears, Choi, Clayton, Harris, Laibson, and Madrian. (2014).

8. A household can have time consistent preferences and yet be impatient if it heavily discounts future consumption.

9. U.S. Government Accountability Office, 1997.

10. U,S. Government Accountability Office, 2014.

11. Munnell, 2015.

12. NEFE financial education material is at www.myretrementpaycheck.org.

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