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ICI VIEWPOINTS

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No Accident: The Strengths of the 401(k) System

By Mike McNamee

First in a series of Viewpoints postings on key facts about the 401(k) and the American retirement system

Americans have saved $5.1 trillion dollars in 401(k) and other defined contribution (DC) retirement plans—plus another $5.4 in individual retirement accounts (IRAs) that are funded largely by assets rolled over from DC and other employer retirement plans. Eight out of 10 households approaching retirement have resources from an employer plan or an IRA. More retirees have private-sector pension income today than in the 1970s—and they're collecting more income. And academic research projects that 401(k) and DC plans "will increase wealth at retirement for future retirees across the lifetime earnings spectrum."

Given that record, would it matter if—as critics claim—the 401(k) system were an "accident"?

For the next several days, *ICI Viewpoints* will address key features of 401(k) plans and the broader retirement system of which they're a part. We'll puncture myths that sometimes dominate discussions of retirement policy—and provide facts that often don't show up.

First on the docket: complaints that the 401(k) system and DC plans—now the predominant means for private-sector workers to save for retirement—are "an accident"; that 401(k)s were "intended" as mere supplements to traditional defined benefit (DB) pensions; and that these plans were "not supposed" to become the primary vehicle for workplace retirement savings.

The facts: whatever their original purpose, 401(k)s have evolved to become an effective building block in providing retirement security to millions of working Americans. That evolution reflects the combined dedication of employers, government, and service and investment providers to continuously improve the tools that workers need to meet their retirement goals.

Although DC plans have existed for decades, DC plans rose to prominence only after the Internal Revenue Service issued regulations in 1981 to implement Section 401(k) of the Internal Revenue Code, enacted by Congress in 1978. Over the next 15 years, large employers mainly did view 401(k) plans as supplements to the then-dominant defined benefit (DB) pensions, and 401(k)s struggled against what a 2006 ICI study called "legislative and regulatory headwinds."

401(k) plans grew nonetheless—from near-zero in 1980 to 201,000 plans with $864 billion in assets in 1995. Unforeseen by policymakers, 401(k)s were filling a need few knew existed—the need for retirement benefits that were better suited to the average American worker.

Traditional DB plans provided little in the way of retirement benefits to workers who changed jobs frequently. With the 401(k), workers had access to retirement benefits that moved with them and continued to grow throughout their careers. Workers also valued other aspects of 401(k)s, such as investment choice and the flexibility to tailor their retirement benefits to their personal circumstances. Because workers liked 401(k)s, businesses adopted them—both as a supplemental plans, where firms already offered traditional DB plans, and as primary plans. 401(k)s were especially prevalent as primary plans at newer, emerging firms, such as the small technology companies that now make up the most dynamic portion of our economy. In fact, research shows that firms in industries with more mobile workers were early adopters of plans with portable pension benefits.

In 1996, the policy winds started to shift, as Congress encouraged employers to offer retirement plans, including 401(k)s. Legislation in 2001 increased the annual limits on DC plan contributions, allowed older workers to make "catch-up" contributions, made it easier for job changers to roll over assets among plans and IRAs, and created “Roth” 401(k)s to allow saving with after-tax dollars. This positive policy trend continued with the Pension Protection Act of 2006, which locked in the 2001 changes and encouraged innovations—notably automatic enrollment, more diversified default investment options, and automatic escalation—to increase participation and savings in 401(k)s.

These policy changes both reflected and encouraged the innovations and improved services that employers and plan service providers—including mutual fund advisers—created to make 401(k) savings more effective. It’s hard to remember, but saving through payroll deduction and employer matching contributions were one-time innovations that now are standard features in large plans. Investment education tools, target date funds, web access to daily account balances—these and other features reflect the evolution of 401(k)s, driven by employers’ desire to improve their workers’ ability to plan and save for retirement. Of course, 401(k)s and the retirement system can be made even stronger, to help more American workers accumulate more retirement savings.

The results are evident: 401(k)s are now the most common private-sector retirement plan, and play a crucial role inthe pyramid of resources that Americans depend upon to build a secure retirement.

While the development of the 401(k) system may have been unforeseen, there is nothing to criticize in the success of a system that provides portability, ownership, and innovation to a wider array of workers. These features serve the needs of America’s modern, mobile workforce and resonate deeply with America's workers—as demonstrated in survey after survey of 401(k) savers.

Did anyone have this vision for a fully formed 401(k) system in 1981? No—no more than Franklin D. Roosevelt in 1935 envisioned today’s array of Social Security benefits.

Would being “an accident” diminish the strengths and successes of the 401(k) system? Not in the least.

For more key information on retirement, please visit our Retirement Resource Center or read the other entries in this Viewpoints series:

- No Accident: The Strengths of the 401(k) System
- 401(k) Plans Work in a Balanced Approach to Retirement Security
- The Facts on Limited Access to Retirement Funds Before Retirement
- The Facts on Fees and 401(k)s
- Americans Support Their 401(k)s

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