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25th Anniversary of 401(k) Plans: FAQs

25th Anniversary of 401(k) Plans: Frequently Asked Questions

Why is November 10, 2006, regarded as the 25th birthday of the 401(k)?

Subsection (k) of Section 401 of the Internal Revenue Code—the tax code—was added in 1978. It was written to address a narrow tax issue that had pitted the Internal Revenue Service (IRS) against employers who wanted to offer tax-favored profit-sharing plans, used mainly by executives. But when the IRS issued regulations telling businesses how to use Section 401(k), the rules made it clear that ordinary workers could make contributions from their regular wages or salary. Those regulations were issued on November 10, 1981—the birthday of the 401(k) plan. (Those original proposed regulations were six pages long. The latest version of the 401(k) regs, issued in 2004, run to 57 pages.)

How does a 401(k) work?

The concept of a 401(k) plan is simple: A worker sets aside a percentage of his or her pay in a special account. The contribution is tax-deferred, so a typical worker in the 25 percent marginal tax bracket can contribute $100 while only sacrificing $75 in take-home pay.

Often, the employer matches some or all of the worker's contribution. (For example, an employer might match all of a worker's contribution up to 3 percent of pay, and half the contribution on the next 3 percent. If the worker puts in 6 percent of pay, the employer puts in 4.5 percent.)

In most 401(k)s, the worker decides how the contributions are invested, in a mix of mutual funds or savings products selected by the employer. Earnings on the account (dividends, capital gains, or interest) are not taxed until the money is withdrawn, usually in retirement. Early withdrawals—before age 59½–are subject to a tax penalty.

What are the trends in pension coverage?

In 1980, before 401(k) plans, traditional defined benefit pension plans had 30 million active participants. By 2005, that figure had shrunk to 21 million. Meanwhile, 401(k) plans have grown to 47 million active participants.

Why have 401(k) plans grown while traditional pension plans have declined?

Workers and employers have adopted 401(k) plans in part because they are flexible and portable.

Traditional "defined benefit" pensions generally base their benefits on formulas that favor long service with one company. Most of a worker's benefits accrue in the last few years of work. By contrast, 401(k) accounts grow more steadily over time, so workers are not penalized if they change jobs. For this reason, younger and more mobile workers tend to place more value on defined contribution pension benefits. Academic research has shown that worker demand for portable benefits is an important factor in the shift from DB to DC pension plans.

Academic research shows that 401(k)s have gained ground because:

- Industries where firms typically offer traditional pensions have seen declines in their employment, while employment has grown at firms that typically offer DC plans.
- Some firms that have traditional pensions have added 401(k)s as well.
- Firms that have not previously offered a pension plan, particularly recently created businesses, tend to adopt 401(k) plans.

The latest data available on plans shows that in 2002, 90 percent of 401(k) plans were "stand-alone"—that is, they were the only

retirement plan offered by their sponsors. Of those stand-alone plans, 59 percent had been created since 1995.

What has the mutual fund industry contributed to the development of 401(k) plans?

Mutual funds offer diversified, professionally managed investments that 401(k) savers can use to seek the best balance of return and risk for their individual situations. Fund companies have also pioneered many of the services—such as call centers and online account service—that help make 401(k)s more popular.

Mutual fund companies have helped educate 401(k) participants on how to invest their accounts, with an emphasis on the crucial role of asset allocation—selecting the right mix of stocks, bonds, and money-market investments to achieve their goals—and rebalancing, to keep their accounts on track.

To make 401(k) investing easier, mutual funds have created innovative products, such as lifestyle and lifecycle funds. Lifestyle funds offer a mix of investments tailored to a savers' preferred risk level, while lifecycle funds offer a mix that is automatically rebalanced to reduce risk as the saver ages. The Profit Sharing/401(k) Council of America reports that, in 1996, only 12 percent of 401(k) plans offered these options. Now, almost half (48.5 percent) do. These funds are rising in popularity with workers, particularly new workers: 42.8 percent of 401(k) participants hired within the last two years hold these or other balanced funds.

How many investment options does a typical 401(k) plan offer?

According to Hewitt Associates, the average number of investment options rose from six in 1995 to 14 in 2005.

How many options does the typical 401(k) saver use?

Analysis from several sources agree that the typical 401(k) saver uses only a few of the plan's options. The Vanguard Group says that participants in the plans for which it keeps records use, on average, three of the 19 options they are offered. Fidelity Investments says that 401(k) participants hold an average of 3.7 of the 20 options they are offered in plans for which Fidelity is recordkeeper.

Can 401(k)s provide significant retirement income?

Yes—especially as the system matures and workers spend more of their careers in 401(k) workplaces. A study by EBRI and ICI projects that more than half of today's young workers who participate in 401(k) plans can expect to replace more than half of their pre-retirement income. And that's before the all of changes in the 2006 Pension Protection Act are implemented.

What does the 2006 Pension Protection Act (PPA) mean for 401(k)s?

The Act, passed and signed into law in August, contains several provisions that will cement 401(k)'s central role in America's retirement system. The Act:

- Makes permanent the updated 401(k) and IRA contribution limits passed in 2001 and ensures the limits will increase with inflation;
- Preserves catch-up contributions for workers age 50 or older;
- Encourages employers to offer automatic enrollment in 401(k) plans;
- Makes permanent the Roth 401(k) option;
- Encourages employers to put default contributions into balanced funds and other investments suited for a long-term retirement horizon, and
- Makes it easier for financial firms to give 401(k) participants investment advice.

What effect will automatic enrollment have on 401(k) participation?

The experience of employers implementing automatic enrollment shows that automatic enrollment can boost participation in 401(k) plans from 66 percent of eligible employees to 92 percent.

What effect will updated contribution limits have on 401(k) balances?

Consider a worker, now 40 years old, who started making 401(k) contributions in 2002, when the higher limits took effect. Using the maximum tax-deferred contribution levels, including catch-up contributions after the worker turns 50, the worker could accumulate an account balance of more than $1.1 million by age 65. If those higher limits and catch-up contributions had been allowed to expire, the account balance would only be $888,000—a difference of $215,000.

Taken together, what effect will the PPA's changes have on workers' 401(k) savings?

The impact is large. Assume that companies adopt automatic enrollment, placing 6 percent of employees' pay into a balanced lifecycle fund. EBRI/ICI research shows that the median low-income worker eligible to participate in a 401(k) could accumulate enough 401(k) assets to replace 52 percent of his or her pre-retirement income. That's up from a 23 percent replacement rate without the PPA's changes.

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