Why Are 401(k)s Balances Substantially Below Their Potential?

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Introduction

For most workers, 401(k)/IRA assets represent the main source of retirement savings outside of Social Security. These accounts can generate significant wealth, yet most workers have balances that are substantially below their potential. For example, a 25-year-old median earner in 1981 who contributed regularly would have about $364,000 by age 60, but the typical 60-year-old in 2016 had less than $100,000. This paper explores four potential reasons for this gap. First, the immaturity of the 401(k) system means that many of today's 60-year-olds did not have access to a 401(k) early in their careers. Second, the lack of universal coverage means that workers are not always in jobs that offer retirement plans. Third, participants' ability to tap their account before retirement means that accumulations leak out. Fourth, fees can significantly erode net returns on investments.

Data and Methodology

The analysis uses the *Survey of Income and Program Participation* (SIPP) linked with administrative tax records to sort out the relative importance of each component.[1] The SIPP data are accessed through the Cornell Virtual Data Center, and results are validated by the U.S. Census Bureau. These linked administrative tax records include earnings from all jobs in a given year from 1957-2014 and all deferred contributions from 1990-2014. Aside from the tax data, the survey includes information on self-

[1] Poterba, Venti, and Wise (2001) project 401(k) balances forward and examine the role in final plan balances of leakages and the lack of employer plan coverage, but their data are from the early 1990s. Munnell and Webb (2015) provide rough estimates of all four factors but focus on leakages.

reported 401(k)/IRA wealth. Since the SIPP is designed to evaluate the eligibility of households for government programs, it tends to oversample lower-income households. To ensure it is comparable to national aggregates, the SIPP sample is re-weighted.

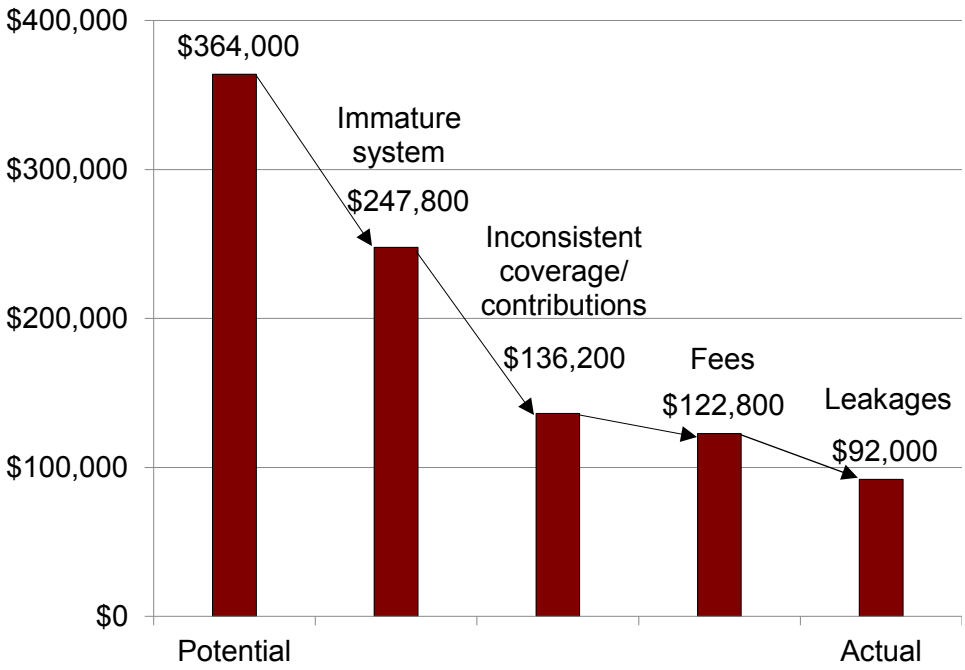
The focus of the analysis is 401(k) contributions and 401(k)/IRA balances of workers from the 2008 SIPP panel who were ages 55-64 in 2014 and had an account. Of those, only individuals who have worked at some point between ages 55-64 and have ever contributed over their working careers were included. To estimate the effect on balances from the immaturity of the 401(k) system, the analysis also compares 401(k)/IRA balances of individuals ages 55-64 to those of individuals 35-44 in 2014. This younger group consists of workers who have ever contributed.

The analysis consists of five steps: 1) estimate potential balances based on universal coverage and consistent contributions of 9 percent of earnings; 2) document actual balances; 3) calculate actual lifetime contributions and accumulated balances for each individual in the SIPP sample, assuming no leakages or fees; 4) use the contributions of the younger cohort to separate the lack of contributions from the immaturity of the system; and 5) divide the remaining difference between fees and leakages using fees data from the Investment Company Institute.

Results

The results show that immaturity of the system and inconsistent coverage/contributions account for the majority of the gap between potential and actual 401(k)/IRA balances, followed by leakages and fees (see Figure 1).

Figure 1. Impact of Immature System, Inconsistent Contributions, Fees, and Leakages on 401(k)/ IRA Balances for a Typical Worker Ages 55-64 in 2014

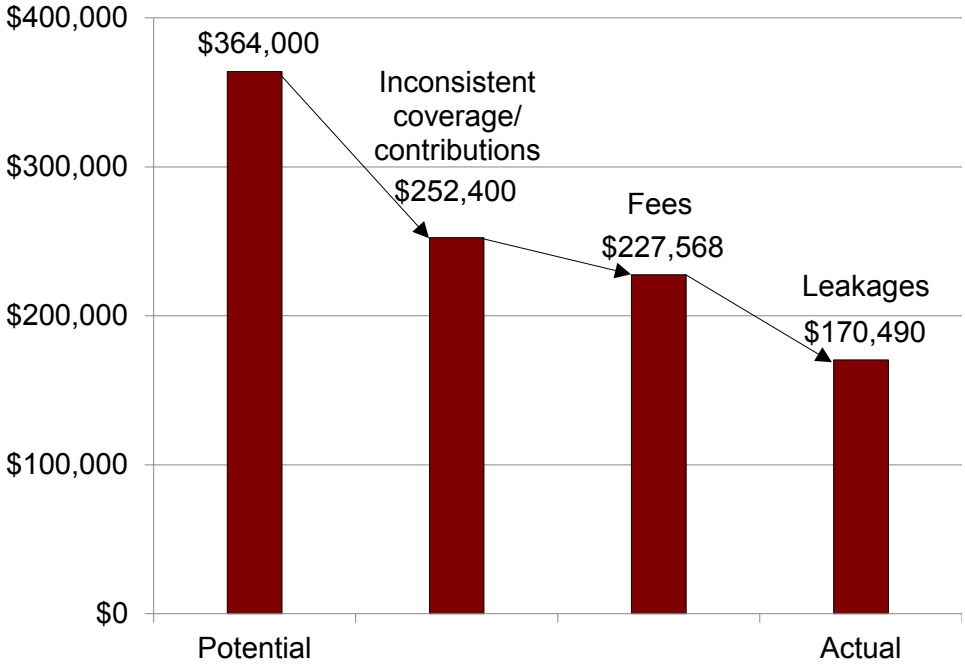


Note: Individuals must have worked at some point between ages 55-64 and contributed at least $1 to a 401(k) plan over their working careers. *Source:* Authors' calculations from SIPP 1984-1986 and SIPP-linked administrative tax data (1990-2014).

The fact that the immaturity of the system accounts for such a substantial portion of the difference between hypothetical and actual balances means that once the system matures, worker balances should be higher than they are today. Nevertheless, actual balances will still end up being less than half of the potential (see Figure 2). In a mature system, the main reason for the gap between potential and actual balances is inconsistent coverage/contributions. Three pieces of evidence support this finding: 1) the typical worker ages 35-44 in 2014 has spent less than half of his working life contributing to a retirement account 2) only 37 percent of all workers deferred earnings

into an account in 2014; and 3) contributions by age show that the majority of even young workers are not contributing earlier in their career.

Figure 2. Estimated Impact of Inconsistent Contributions, Fees, and Leakages on 401(k)/ IRA Balances for a Typical Worker Ages 55-64 in a Mature System



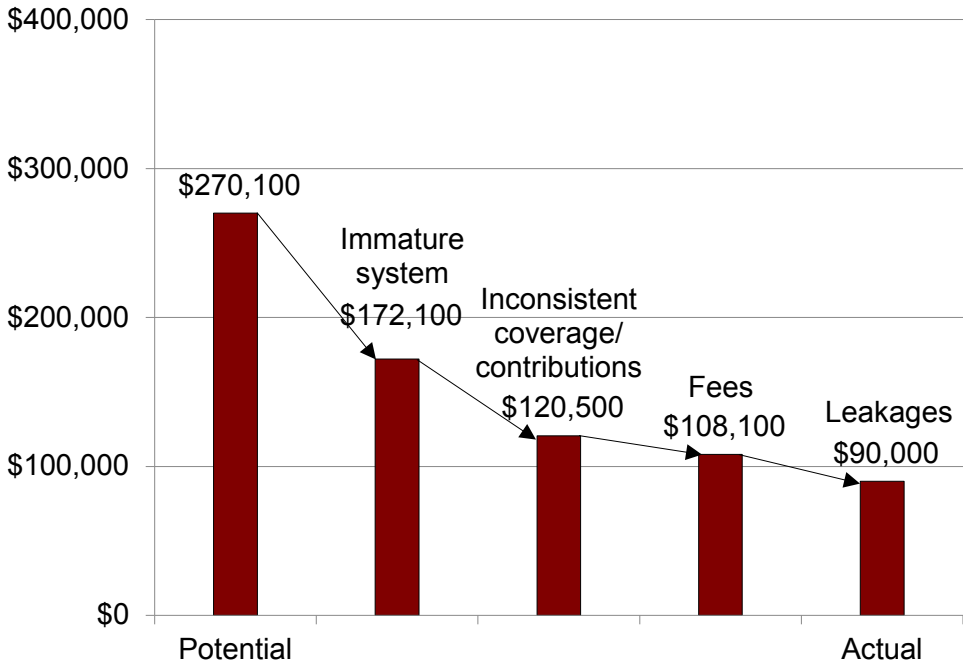
Note: Individuals must have worked at some point between ages 55-64 and contributed at least $1 to a 401(k) plan over their working careers.
Source: Authors' calculations from SIPP 1984-1986 and SIPP-linked administrative tax data (1990-2014).

One could question whether it is realistic or necessary for everyone to save in a 401(k). Specifically, many young workers do not start saving until their 30s; and workers with a defined benefit pension plan may have no need for additional saving. Therefore, the analysis included a sensitivity test that excludes these groups to determine the effect on the baseline results.

The results of this test show that under a perfect system, if workers without a DB plan began contributing at 30, they should expect to accumulate $270,100 by retirement (see Figure 3), less than estimates that include all workers. As a result, their final

holdings equal a third of the possible accumulations, compared to a quarter for all workers. However, the main culprits of the gap between potential and actual balances remain the same: the immaturity of the system and inconsistent coverage/contributions.

Figure 3. Impact of Immature System, Inconsistent Contributions, Fees, and Leakages on 401(k)/ IRA Balances for a Typical Worker Ages 55-64 in 2014, by Alternative Assumptions



Note: Assumes contributions start at age 30 and excludes workers with DB plans between ages 55-64.
Source: Authors' calculations from SIPP 1984-1986 and SIPP-linked administrative tax data (1990-2014).

Conclusion

The typical worker has less than $100,000 in 401(k)/IRA assets, instead of the $364,000 he would have if he participated throughout his career, paid zero fees on assets, and did not withdraw money prematurely. The discrepancy is somewhat less if those under 30 and those with defined benefit plans are excluded, but still significant.

The main culprits are the immaturity of the system and inconsistent contributions, followed by leakages and fees. The lack of universal coverage means that – even once the system matures – 401(k)/IRA plans will continue to fall below their potential.