Backgrounder

Published by The Heritage Foundation

No. 2477
October 14, 2010

Automatic Retirement Savings—Paving the Path to Personal Financial Security

David C. John

Abstract: *Savings plans offered by employers are a good way to save for retirement, and most Americans enroll in them at some point. But unless enrollment is automatic, that point is often too late in the worker's life to build up a sum large enough for a comfortable retirement. Currently, about a quarter of all employees end up with a retirement income so low that they are completely dependent on Social Security. Studies show that workers who are automatically enrolled in 401(k) or similar plans start saving earlier, save more, and make better investment choices than those whose companies put the onus on them to decide to enroll. With a Social Security crisis looming, the time is now for companies across America to make all retirement-plan enrollments automatic—so that today's younger workers will enjoy financial security when they retire.*

Automatic enrollment in 401(k)-type retirement-savings plans, along with automatic escalation of contributions, helps employees at all income levels save earlier, save more, and provides better investment options than plans without that mechanism.

Adequate retirement savings are crucial. Even if Social Security *were* fully funded,[1] the program does not provide anywhere near the level of income necessary for a comfortable retirement. Most retirement planners recommend that a worker's retirement income equal between 70 percent and 80 percent of his or her pre-retirement income. For a median income worker, Social Security replaces approximately between 40 percent and 50 percent of a

Talking Points

- Automatic enrollment in employer-sponsored retirement plans helps employees save for retirement earlier—and more—than they otherwise would.
- Automatic escalation of contributions helps employees save enough for a financially secure retirement.
- The best results come from a combination of both mechanisms. Under automatic enrollment, an individual retains complete control over all aspects of retirement saving.
- Surveys show that employees strongly support automatic enrollment and escalation even if they decide not to participate. Americans value how automatic enrollment and automatic escalation simplify the process and promote earlier saving.
- Given the funding problems faced by Social Security, making retirement saving simple and easy for all employees is a necessary step that will greatly increase the retirement security of today's younger workers.

This paper, in its entirety, can be found at:
http://report.heritage.org/bg2477

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

worker's average earnings over the five years prior to retirement.[2] This leaves a median income worker to fund an amount equal to at least 30 percent of his or her current income from a combination of retirement savings, pension plans, and other investments.

Financing this amount of annual income for the rest of their lives requires workers to build substantial amounts of savings before they retire. Traditional retirement theory suggests that a worker can afford to annually withdraw an amount equal to only 4 percent plus the inflation rate from his or her retirement savings without running out of money. This means that a worker with $100,000 in retirement savings could safely withdraw only $250 per month plus inflation from an account equally invested in stocks and bonds. A new study[3] suggests that even then the worker will still run out of money before he or she dies in about 15 percent of all cases.

If a worker chooses an annuity or similar instrument that guarantees regular payments until the end of his life, he can receive higher amounts, but such an annuity requires significant savings. A 70-year-old man can expect to pay $100,000 for an annuity income of roughly $780 a month ($9,360 annually).[4] For a 60-year-old, monthly income drops to roughly $625 ($7,500 annually) in return for $100,000. Since most retirees will need several times that amount of income, they must start to save early and continue to save throughout their working lives or face the very real probability that retirement will be a time of financial hardship and stress.

Automatic Enrollment Helps Workers to Save. A traditional 401(k) plan requires workers to make several key decisions before they can save the first cent for retirement. First, they must decide to join the 401(k) plan, then, how much to save, and finally, how to invest those savings. Workers rightly see those decisions as important ones, and recognize that making a wrong choice could damage their retirement outlook. As a result, they typically postpone the start of retirement savings for several years, and even then workers often save too little given the age at which they began, or make investment decisions that are unlikely to build a large enough nest egg by their retirement date. Information and training sessions are available, but often workers fail to take advantage of these resources or find that the information provided is too technical. The result is lower participation rates and retirement savings that are too small to provide adequate retirement security.

Automatic enrollment reverses the traditional way that people sign up for a 401(k) retirement plan by placing them in the plan, saving a set percentage of their income, and investing in a specific automatic investment choice unless the worker decides otherwise. The worker continues to have full control and can change the contribution amount and investment option, or even stop saving completely, at any time. Studies show that automatic enrollment especially helps the four groups of people most likely to undersave for retirement: women, younger workers, minorities, and lower-paid workers.[5] Under automatic enrollment, participation for these groups rose from less than 20 percent to more than 80 percent.

Automatic Escalation Ensures that Workers Save Enough. While automatic enrollment enables

1. For more information on Social Security's finances, see David C. John, "2009 Social Security Trustees Report Continues to Show the Urgency of Reform," Heritage Foundation *WebMemo* No. 2439, May 13, 2009, at *http://www.heritage.org/Research/Reports/2009/05/2009-Social-Security-Trustees-Report-Continues-to-Show-the-Urgency-of-Reform*.
2. Olivia S. Mitchell and John W. R. Phillips, "Social Security Replacement Rates for Alternative Earnings Benchmarks," University of Michigan Retirement Research Center *Working Paper* No. 2006-116, May 2006, at *http://www.mrrc.isr.umich.edu/publications/papers/pdf/wp116.pdf* (October 7, 2010).
3. Christopher O'Flinn and Felix Schirripa, "Revisiting Retirement Withdrawal Plans and Their Historical Rates of Return," Social Science Research Network, May 16, 2010, at *http://ssrn.com/abstract=1641382* (October 7, 2010).
4. The exact amount depends on the age of the purchaser, the prevailing interest rate environment, and the annuity provider. For a discussion of immediate annuities, see Retirement-Income.net, "Retirement Income Planning Basics: Immediate Annuities," 2008, at *http://www.retirement-income.net/Immediate_Annuities.html* (October 8, 2010).
5. Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *The Quarterly Journal of Economics*, Vol. 116, No. 4 (November 2001), pp. 1149–1187.

a worker to start saving at an earlier age, it does not guarantee that he or she will save enough for a secure retirement. Many 401(k) plans automatically enroll workers at a contribution rate equal to 3 percent of income even when the company matches a higher level of savings.[6] Employers believe that a low initial contribution encourages employees to remain in the 401(k) plan. While participants have the ability to increase the percentage that they save, most simply leave it at the initial level. While 3 percent of income is a good place to start saving, a worker needs to save more in order to guarantee a comfortable retirement. An individual who starts saving when he or she is young should be saving anywhere from 7 percent to 10 percent, while someone who starts saving later in life may have to save a much higher proportion of her income, or retire later.

Automatic escalation of contributions is a simple program that enables employees to gradually save a higher proportion of their income for retirement by increasing their contribution rates when they receive a raise. Under automatic escalation, when a worker receives an annual raise, part of it is used to increase his or her contribution by 1 percent of pay; the rest goes into the paycheck. Thus, if a worker received a 3 percent raise, his or her gross take home pay would go up by 2 percent, while the 401(k) contribution would climb by 1 percent.

The mechanism works because employees do not feel any loss of income. Instead, they experience a modest rise in living standards at the same time that their savings rate climbs. Over the years, their total 401(k) contribution rises to a level that can guarantee them retirement security. The worker has full authority to stop the gradual increase in contributions at any time, as well as having the ability to increase or decrease the rate or even to stop contributing entirely.

A Combination of Automatic Features Will Produce the Best Results. The best results for a worker's experience in a 401(k) retirement savings plan come from a combination of automatic enrollment for new workers and non-participating employees, combined with an adequate employer match and an automatic escalation feature. These features are common among plans offered by larger employers, and their use is growing in smaller ones as well.

An April 2010 report by the Employee Benefit Research Institute[7] estimated that without automatic enrollment, the lowest 25 percent of workers measured by annual income would retire with a mere 0.08 percent of their last year's pay, an amount that leaves them completely dependant on Social Security. However, the report shows that if all 401(k) plans were to use the same automatic enrollment features as that of the larger plans, the same lowest 25 percent of workers would retire with savings of between 5.0 times and 5.33 times their earnings just before retirement, an amount that can be converted into a comparatively decent level of retirement income. Combined with Social Security benefits, this level of retirement income should provide a comfortable retirement.

The top 25 percent of workers measured by income show a similar increase in the amount of retirement savings after automatic enrollment: Their amount of retirement savings rises from an estimated 2.41 times their final annual earnings to between 9.15 times and 9.81 times their final earnings. These workers will also be able to convert their retirement savings into income levels that ensure retirement security.

Workers Like Automatic Features and Start Saving Earlier

An October 2009 survey by Prudential Insurance found that 74 percent of American workers would rather be automatically enrolled into a 401(k) plan than use the traditional method;[8] 65 percent support automatic contribution escalation.

6. For instance, a company may automatically enroll new participants at 3 percent of pay, but match employee contributions up to 5 percent. The 3 percent automatic enrollment contribution stems from the Pension Protection Act of 2006, but that law also allows a company to set a higher or lower initial contribution level.

7. Employee Benefit Research Institute, "The Impact of Automatic Enrollment in 401(k) Plans on Future Retirement Accumulations: A Simulation Study Based on Plan Design of Large Plan Sponsors," April 2010, at *http://www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=4495* (October 7, 2010).

Even more telling, a 2007 Retirement Made Simpler study[9] shows that workers who have been automatically enrolled strongly support the mechanism and start saving before they would have otherwise. According to the study, 97 percent of workers who had been automatically enrolled and remained in the plan were satisfied with the procedure, while 90 percent of those who had been automatically enrolled and then opted out due to individual circumstances felt the same way. Eighty-five percent of those participating in the 401(k) plan said that they had started to save for retirement earlier than they had otherwise planned, while 95 percent felt that automatic enrollment made saving for retirement easy. Finally, 98 percent of those who were automatically enrolled and remained in the plan were glad their company offered automatic enrollment, as were 79 percent of those who had opted out. This last number is key, as it shows that even if workers decided that their specific circumstances did not allow them to remain in the company's 401(k) plan, they still valued automatic enrollment.

Automatic Enrollment and Escalation: Both Increase Retirement Savings

Workers know that they need to save for retirement, and strongly value the way that automatic enrollment and automatic escalation simplify the process and enable them to start saving earlier. Since participants always maintain control over enrollment and escalation, they have the ability to tailor their participation to meet their own specific circumstances. Given the funding problems faced by Social Security, making retirement saving simple and easy for all employees is a necessary step that will greatly increase the retirement security of today's younger workers.

*—**David C. John** is Senior Research Fellow in Retirement Security and Financial Institutions in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*

8. Prudential, "The New Economic Reality and the Workplace Retirement Plan," January 2010, at *http://retirementmadesimpler.org/Library/New_Economy_WorkPlace_Retirement.pdf* (October 7, 2010). Percentages differ from the earlier survey in part because the Prudential survey includes workers who have been automatically enrolled as well as those who have not.
9. Retirement Made Simpler, "Resources and Research: How Do Employees Feel About Their Auto 401(k) Plan?" 2010, at *http://retirementmadesimpler.org/ResourcesAndResearch/HowEmployeesFeel.shtml* (October 7, 2010).