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Will automatic enrollment boost 401(k) savings?

In August the Congressional Budget Office updated its annual long-term projection for Social Security and noted that “future Social Security beneficiaries will receive larger benefits in retirement—and will have paid higher payroll taxes—than current beneficiaries do, even after adjustments have been made for inflation and even if the scheduled payments are reduced because the trust funds are exhausted. However, CBO estimates that “under both scenarios, those benefits will represent a smaller percentage of beneficiaries’ preretirement earnings than is the case now.”

Looking ahead, it seems certain future retirees will increasingly rely upon defined contribution 401(k)-type plans upon retirement. That means that millions of workers, with a wide range of preparation and financial literacy, are expected to make sophisticated investment decisions that will shape their future financial well-being. Policymakers are focusing greater attention on ways to increase worker participation in 401(k) type plans. The 2006 Pension Protection Act (PPA) included measures to increase contributions by creating safe harbor provisions that permit employers to offer automatic enrollment in 401k plans. For employers to qualify, contribution rates for those enrolled automatically must be at least 3 percent of salary the first year of participation, rising one percentage point per year to at least 6 percent in the fourth year.

These measures incorporate insights from behavioral economics that 401k default options have a tremendous impact on how much workers will ultimately save for retirement. In the new edited volume *Lessons from Pension Reform in the Americas*, Beshears, Choi, Laibson and Madrian examined the impact on worker savings when workers are automatically enrolled by their employers compared to when they must actively opt in to a retirement savings plan. They found that when automatic enrollment in retirement plans is the default option, participation rates are much higher than when workers have to opt-in. Furthermore, many workers view the employer default savings option as an implicit endorsement of both the contribution rate and the distribution of funds. They find that default choices are *not* neutral; they play an important role in every stage of the lifetime savings cycle, including savings plan participation, contributions, asset allocation, rollovers, and decumulation. Default options become even more crucial as defined contribution plans in the United States and the rest of the world introduce more investment options for workers.

Since the Pension Protection Act was just passed in 2006, it is still too soon to know what long-range impact it will have on retirement savings. However, a new paper by VanDerhei and Copeland models the results of automatic enrollment under PPA rules and finds that it will have a significant impact, especially for low-income workers. For the lowest-income quartile, total 401(k) balances would be only 0.1 times final earnings at age 65, compared to 2.5 to 4.5 final earnings (depending on the assumptions used) under automatic enrollment. For the top 25 percent of earners, the jump would be from 1.8 times final earnings to between 6.5 to 10.4 times final earnings.

These automatic enrollees will of course need to decide how to invest their 401(k) savings. Target-maturity date lifecycle funds, where participants select a fund based on a projected retirement date and fund managers rebalance the portfolio over time, offer one solution to problems arising from financial illiteracy, naïve portfolio diversification, and inertia. In a new working paper, Mitchell, Mottola, Utkus, and Yamaguchi find that lifecycle plans will have a more substantial impact if they are designed as the default option, with adoption rates being higher still if employers actively shift participants from existing portfolios to age-based lifecycle funds.

Automatic 401(k) enrollment and lifecycle funds can potentially boost retirement savings. The extent to which employers and workers will embrace these options from the 2006 Pension Protection Act is an open question, but the early signals are positive. At a May 2008 Employee Benefit Research Institute forum on the 2006 PPA, participants noted that an increasing number or employers, especially large ones, are adopting automatic enrollment.

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