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Individual financial decisions in retirement saving plans: the role of participant-direction

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Abstract

Workers with individual retirement saving accounts often make decisions about contribution rates and asset allocation that affect ultimate retirement income. This paper presents econometric evidence from two data sets on the role that participant investment choice plays in asset allocation, contributions, and account balances. My preferred estimates indicate that participants with investment choice are 36 percent more likely to make an annual contribution. These participants are estimated to invest 13 percentage points more in stocks, contribute between one and three percentage points more of salary, and have at least $9000 more in their account than comparable participants without investment choice.

JEL classification: H31; J26; G23

Keywords: Retirement saving; Investment choice; Defined contribution pension plans

1. Introduction

The trend toward defined contribution (DC) pension plans, and the striking growth of 401(k) plans in particular, has vastly expanded the number of individuals with some discretion regarding their retirement assets. In 1997, the most recent year for which the U.S. Department of Labor, Pension and Welfare Benefits Administration (2001) has released detailed information from Internal Revenue Service (IRS) Form 5500 filings, about 82 percent (28.2 million) of the 34 million participants in 401(k) plans had some control over their investments. These participants owned over $1.04 trillion in assets,

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accounting for 83 percent of 401(k) assets. Self-direction of retirement saving accounts will become increasingly common as traditional defined benefit plans are supplemented with or replaced by defined contribution plans. Many state and local governments, traditional defined benefit providers, are considering adoption of 401(k)-type plans. In 1998, for example, the state of Michigan switched from a traditional defined benefit plan for new state government employees to a DC plan.

In the traditional defined benefit (DB) plan, participants are automatically included after meeting a participation standard, and they typically do not make participation, contribution, or investment decisions. Their pension benefit is based on earnings history and years of service. In contrast, participation in a defined contribution plan often requires active involvement by the individual participant. DC plans are individual accounts that may only be created once the employee makes a (usually pre-tax) contribution. Participants decide how much to contribute subject to plan and IRS limits. Often the employer will match the contribution up to a pre-determined limit, or the employer's contribution may vary annually with profits. Participants usually direct the investment of their own contribution, and often that of their employer. This is typically the case for a 401(k) plan.[1]

Asset allocation choices that participants make, or that their employers make for them, can determine in part the rate of return on retirement assets, and therefore the adequacy of retirement income. Unfortunately, there is limited evidence concerning the effect of participant investment choice on financial decisions in saving plans. Several recent papers relate demographic characteristics to investments in stocks or bonds, but only for populations that uniformly control their investments. This paper uses participant-level data from the 1992 National Longitudinal Survey of Mature Women (NLS-MW) and the 1992 Health and Retirement Study (HRS) to estimate the effect of pension asset self-direction on investment choices. I use the NLS-MW to examine determinants of asset allocation. I use both the NLS-MW and HRS to examine the effect of choice on participation, the size of contributions to the pension plan, and ultimate account balances.

Understanding the role that plan characteristics play in individual account retirement plans is critical as more workers rely on this type of retirement plan. For example, in many 401(k) plans the employer contribution is made in company stock. This structure may encourage employees to hold extremely risky portfolios—their pension assets as well as their human capital in one company. Further, the behavior of participants in self-directed individual retirement accounts can inform the questions concerning the degree of individual autonomy that should be allowed in the proposals to privatize all or part of Social Security.

The next section presents some survey evidence on the prevalence of participant direction and the choices presented to plan participants. Section 3 briefly summarizes research findings to date on investment patterns at the participant level. Section 4 provides econometric evidence on the effect of choice on investment patterns, employee contribution rates, and defined contribution plan balances. I discuss the possible endogeneity of the choice variable in the regression models. I rely on the proxy variable approach to this

[1] There are other types of savings and thrift plans, beside the 401(k) form, that have participant direction. See Wiatrowski (2000) for a detailed comparison.