U.S. DC plans are leakier than those abroad, study shows

By Editorial Staff *Thu, May 21, 2015*

In a new paper, a group of researchers from the National Bureau of Economic Research point out that it's a lot harder for plan participants in Australia, Canada, Germany, the United Kingdom, and Singapore to tap their accounts before they retire.

The defined contribution retirement plan regime in the U.S. is a notably leaky vessel. Participants commonly borrow from their 401(k) plans. Job-changers can cash out their small balances or roll the money over to an IRA. In case of dire need, penalty-free early withdrawals can be arranged.

The impact is significant: For every dollar that goes into the DC accounts of savers under age 55 (not counting rollovers), 40 cents flows out (not counting loans or rollovers).

It's not like that overseas. In a new paper, a group of researchers from the National Bureau of Economic Research point out that it's a lot harder for plan participants in Australia, Canada, Germany, the United Kingdom, and Singapore to tap their accounts before they retire.

"The United States stands alone with respect to the high degree of liquidity in its DC system. Penalties for early withdrawals are relatively low, and early withdrawals are slightly subsidized as income falls transitorily," they write.

"In Germany, Singapore, and the United Kingdom, withdrawals from general funds in employer-based DC plans are essentially banned no matter what kind of transitory income shock the household realizes," the paper says.

"By contrast, in Canada and Australia, liquidity in employer-based DC plans [depends on the situation]. For a household that normally earns US$60,000, DC accounts are completely illiquid unless annual income falls substantially, at which point the DC assets may be accessed."

Why is the U.S. so different? One theory, not mentioned in the paper, is that the U.S. system is entirely voluntary; the public might not be willing to participate at all if they couldn't access their money.

Another possibility: in the U.K., a share of the government tax expenditure for the plan goes directly into each participants' accounts. In the U.S., the tax expenditure shows up merely as a smaller tax liability at the end of the year. It might be easier to tolerate tighter government controls on liquidity if the government's contribution to the account is clearly visible.

The U.S. system was allowed to be as leaky as it is, the authors speculated, because, 30 years ago, most people didn't anticipate that DC plans to be more than a "top up" supplement to income from defined benefit plans. It's only with the decline of DB, because of lack of portability and expense to sponsors, that DC emerged as the primary private source of retirement income—and that leakage from DC became a serious threat to retirement security.