URBAN INSTITUTE

Brief Series • No. 27 • May 2010

Are Early Withdrawals from Retirement Accounts a Problem?

Barbara A. Butrica,
Sheila R. Zedlewski,
and Philip Issa

Policymakers are searching for ways to increase retirement savings outside of Social Security, such as by promoting automatic enrollment in employer 401(k) plans and individual retirement accounts (IRAs). Setting aside funds regularly is not enough, however, to guarantee sufficient retirement savings. Workers must also avoid unnecessarily dipping into their savings before retirement. Many 401(k) participants cash out their balances when they leave their jobs, for example.[1] Others dip into retirement accounts to cover high-expenditure needs that arise throughout their lives. It is crucial, then, that the rules governing access to these accounts before retirement properly balance family needs during periods of financial stress against safeguards that prevent spending the money on nonessential consumption.

This brief examines early withdrawals from retirement savings plans. We review the rules regarding access to 401(k) and IRA funds and analyze withdrawals by individuals ages 25 to 58 between 2004 and 2005. We also examine how withdrawals are associated with life-changing events, including adverse shocks (such as job loss, onset of poor health, and divorce or widowhood) and life-course investments (such as job changes, home purchases, postsecondary education, and the birth of a child). Our data come from the 2004 Survey of Income and Program Participation (SIPP).[2]

We find that early withdrawals are infrequent but represent a significant loss to retirement savings. However, withdrawals are strongly correlated with adverse events such as unemployment and the onset of poor health, as well as family investments such as primary home purchases. We estimate that about 40 percent of retirement savings losses are associated with these types of events and another 10 percent of leakage is associated with job changes. Unfortunately, more vulnerable individuals, especially those with no other financial assets and those with less education, not only have the least amount of savings in retirement accounts, but also the highest withdrawal rates. This combination helps explain why these groups typically end up with little else than Social Security in retirement. The results highlight the need to strengthen our retirement and general savings policies.

Early Withdrawal Rules

IRAs and 401(k)s now hold most retirement assets outside of Social Security, with balances exceeding $6 trillion in 2009 (Butrica and Issa 2010).[3] These assets will continue to grow, especially as private-sector employers continue to shift from traditional defined benefit pension plans to 401(k) plans. Individual retirement savings accounts are more susceptible to leakage than the traditional defined benefit plans, despite efforts by employers and the federal government to discourage early withdrawals. Employees usually can withdraw funds from their 401(k)s when significant financial needs arise or cash out their plans when they leave their jobs. Access to IRA balances is easier.

Most employer plans allow workers to withdraw savings to meet pressing financial needs (principal home purchase, unreimbursed medical costs, postsecondary school tuition, or prevention of home foreclosure). Plans usually limit withdrawals to employee contributions (excluding earnings on these contributions). Federal rules require employees and employers to wait six months after withdrawing funds before contributing again. Withdrawals before age 59.5 are subject to a 10 percent tax penalty (as well as regular income taxes). Tax penalties do not apply to withdrawals related to total disability, death, or medical costs that exceed 7.5 percent of adjusted gross income.

About half of employer plans allow employees to borrow from their 401(k) accounts for any reason. Loans must not exceed the greater of $10,000 or one-half of the vested balance up to $50,000 and must be repaid within 5 years (or 15 years for home purchase). About 18 percent of eligible employees had an outstanding loan in 2007 (Holden, VanDerhei, and Alonso 2009).

The federal government sets additional rules for participants who leave their jobs. Employers may compel departing employees to cash out retirement accounts with less than $1,000, but must roll over balances between $1,000 and $5,000 to an IRA or another employer 401(k) plan unless the employee requests a lump-sum payment. Employees must submit written requests to cash out balances over $5,000. New regulations require employers to alert departing employees about the consequences of preretirement cashouts.

Withdrawals from IRAs are simpler and more liberal. An individual may withdraw without penalty for a first-time home purchase (up to $10,000), postsecondary education for any family member, and medical expenses in excess of 7.5 percent of adjusted gross income. Other withdrawals before age 59.5 are subject to a 10 percent tax penalty.

Account Ownership

About half of adults between the ages of 25 and 58 lived in families who owned retirement accounts in 2004 (table 1). Ownership varied significantly by education, race, and other financial assets. Nearly three in four (72.0 percent) college graduates owned retirement accounts in 2004 compared with about one in two (51.6 percent) of those with some college, two in five (41.7 percent) of high school graduates, and only one in six (15.8 percent) of high school dropouts.[4] Whites more often owned retirement accounts than either blacks or Hispanics. As expected, adults in wealthy families were much more likely to own retirement accounts than those less prosperous. For example, over eight in ten adults in families in the top financial assets quartile owned an account, twice as often as those in the bottom assets quartile and those with negative or zero financial assets.

Balances in retirement accounts exhibit similar patterns. In 2004, median balances among owners with a college degree were more than six times as high as balances for those without a high school diploma ($22,583 compared with $3,728). Median balances for whites were about three times as high as those for Hispanics and about double those for blacks. Balances also increased with other financial assets.

Withdrawals

Overall, 8.3 percent of retirement account owners made at least one withdrawal between 2004 and 2005 (table 2).[5] Withdrawals were more likely among blacks, those without college degrees, and those with little or no other assets. For example, 13.0 percent of black owners lived in families that withdrew from their accounts compared with only 7.8 percent of white owners. Also, 12.0 percent of owners with zero or negative assets (comprising about half of this sample) withdrew, compared with only 4.5 percent of those in the top asset group.

Nearly twice as many 401(k) owners as IRA owners withdrew between 2004 and 2005. High school graduates and Hispanics especially reported higher withdrawal rates from their 401(k) plans than their IRAs. The increased leakage from 401(k) plans probably reflects the temptation to withdraw retirement savings at job separation and the special financial needs associated with involuntary job separations such as unemployment or disability. Differences in withdrawal probabilities between 401(k) and IRA

TABLE 1. The Share of Adults Ages 25 to 58 in 2004 and the Share Who Lived in Families with IRAs or 401(k)s

	Percent all	Percent who owned	Balances among owners: Mean	Balances among owners: Median
All	**100.0%**	**51.2%**	**$35,775**	**$15,526**
Education				
< High school	11.1%	15.8%	$14,453	$3,728
High school	23.5%	41.7% ***	$25,556 ***	$11,146 ***
> HS, not yet bachelor's	36.7%	51.6% ***	$29,694 ***	$12,442 ***
≥ Bachelor's	28.8%	72.0% ***	$47,615 ***	$22,583 ***
Race				
Non-Hispanic white, other	75.3%	58.0%	$38,571	$17,494
Non-Hispanic black	11.6%	32.8% ***	$20,506 ***	$7,764 ***
Hispanic	13.1%	28.3% ***	$17,517 ***	$5,853 ***
Financial assets quartile				
Negative or zero	53.2%	39.5%	$22,300	$8,799
Bottom	11.7%	40.3%	$23,338	$9,241
Second	11.7%	62.3% ***	$32,418 ***	$15,268 ***
Third	11.9%	73.7% ***	$43,135 ***	$21,528 ***
Top	11.5%	81.4% ***	$66,549 ***	$41,920 ***
Weighted observations (000s)	130,967	130,967	62,728	
Unweighted observations	32,195	32,195	15,795	

Source: Authors' calculations of the 2004 Survey of Income and Program Participation (SIPP).

Notes: Sample includes individuals between ages 25 and 58 in 2004 who were present during the entire 24 months between 2004 and 2005. Financial assets exclude IRA and 401(k) balances. All results are weighted.

Mean is statistically different from the value for those in the first category of the subgroup at the 90 percent level*, 95 percent level **, and 99 percent level***.

accounts may also reveal savings preferences. Individuals who establish IRAs (whether after job change or through individual savings) may value savings more than those who have only 401(k) savings.

Withdrawals represented a relatively large share of savings for those who withdrew. Average withdrawal amounts accounted for 20.9 percent of average account balances (table 3). Those with less than a high school education and Hispanics withdrew larger shares of their retirement assets than others—over 30 percent of their accounts during the two-year period. Similarly, those with lower assets withdrew significantly higher shares of their assets than those with higher assets. As noted earlier, these same groups started with relatively low balances in 2004. However, considered over all retirement account owners, withdrawals represented only 1.5 percent of retirement savings, a small share, at least in a two-year period.

Events Associated with Withdrawals

Retirement account withdrawals were significantly related to families' changing circumstances (figure 1). Adults in families with IRAs or 401(k)s who lost a job, experienced the onset of poor health, switched jobs, or purchased a home were more likely to withdraw than their counterparts who did not experience these events. After other differences (e.g., age, education, and income) are controlled for, individuals who lost their jobs were 6.8 percentage points more likely to withdraw

TABLE 2. Share of Adults Ages 25 to 58 Who Lived in Families With IRAs or 401(k)s in 2004 Who Withdrew from Their Accounts between 2004 and 2005

	IRA or 401(k)	IRA	401(k)
All	**8.3%**	**4.0%**	**7.8%**
Education			
< High school	9.3%	5.4%	9.3%
High school	9.0%	3.5%	9.5%
> HS, not yet bachelor's	10.4%	5.4%	9.7%
≥ Bachelor's	6.0% ***	3.1%	5.2% ***
Race			
Non-Hispanic white, other	7.8%	3.8%	7.4%
Non-Hispanic black	13.0% ***	7.4% ***	11.8% ***
Hispanic	8.9%	3.6%	9.0%
Financial assets quartile			
Negative or zero	12.0%	7.0%	11.1%
Bottom	10.5% *	4.7% **	10.8%
Second	6.6% ***	3.0% ***	6.3% ***
Third	3.9% ***	2.3% ***	3.0% ***
Top	4.5% ***	2.0% ***	4.1% ***
Weighted observations (000s)	66,996	37,460	53,543
Unweighted observations	16,853	9,470	13,520

Source: Authors' calculations of the 2004 Survey of Income and Program Participation (SIPP).

Notes: Sample includes adults ages 25 to 58 in 2004 who were present during the entire 24 months between 2004 and 2005, and who lived in families owning IRAs or 401(k)s in 2004. Financial assets exclude IRA and 401(k) balances. All results are weighted.

Mean is statistically different from the value for those in the first category of the subgroup at the 90 percent level*, 95 percent level **, and 99 percent level***.

from their retirement accounts than those who didn't lose their jobs. Switching jobs added 4.5 percentage points to the probability of withdrawing over this two-year period, buying a home added 4.0 percentage points, and poor health onset added 2.3 percentage points. Any adverse event increased the likelihood of withdrawing more than any investment event. The birth of a child was negatively associated with a withdrawal. The relationship between withdrawals and all these events was strongest among families with negative or zero assets (not shown).

Job losses accounted for 12 percent of total retirement savings dollars lost during this period and the onset of poor health explained another 12 percent (figure 2).[6] Another 10 percent of retirement savings lost was associated with job switches. Withdrawals for home purchases and college expenses, both allowed without incurring tax penalties, accounted for 8 and 5 percent of withdrawals, respectively.

The events we can measure accounted for just over half (52 percent) of total retirement savings leaked between 2004 and 2005. Some of the money leaked may be attributable to adverse events or investments that we cannot observe. For example, IRAs and most 401(k) plans allow withdrawals for high medical costs. Of course, the onset of poor health accounts for some of these expenses indirectly. Also, extremely high medical expenses among owners in this age group are relatively rare, suggesting that a large share of retirement savings is lost unnecessarily.

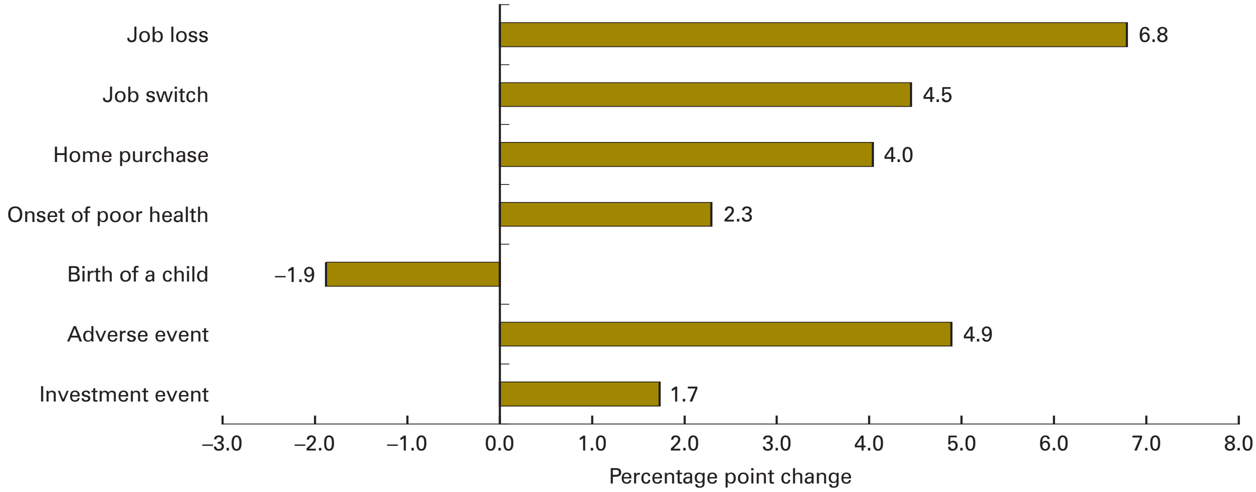
TABLE 3. Percent of Aggregate Account Balances Withdrawn among IRA and 401(k) Owners Ages 25 to 58

	Among withdrawers	Among owners
All	20.9%	1.5%
Education		
< High school	31.5%	2.5%
High school	22.2%	1.9%
> HS, not yet bachelor's	23.2%	2.3%
≥ Bachelor's	17.6%	0.9%
Race		
Non-Hispanic white, other	21.0%	1.4%
Non-Hispanic black	16.1%	3.1%
Hispanic	37.1%	2.1%
Financial assets quartile		
Negative or zero	25.3%	3.3%
Bottom	21.0%	2.4%
Second	20.4%	1.4%
Third	14.8%	0.5%
Top	14.2%	0.6%
Weighted observations (000s)	5,118	62,728
Unweighted observations	1,287	15,795

Source: Authors' calculations of the 2004 Survey of Income and Program Participation (SIPP).

Notes: Sample includes adults ages 25 to 58 in 2004 who were present during the entire 24 months between 2004 and 2005, who lived in families owning IRAs or 401(k)s in 2004 with positive balances, who withdrew from their IRAs or 401(k)s between 2004 and 2005, and whose withdrawal amounts were not missing. Financial assets exclude IRA and 401(k) balances. All results are weighted.

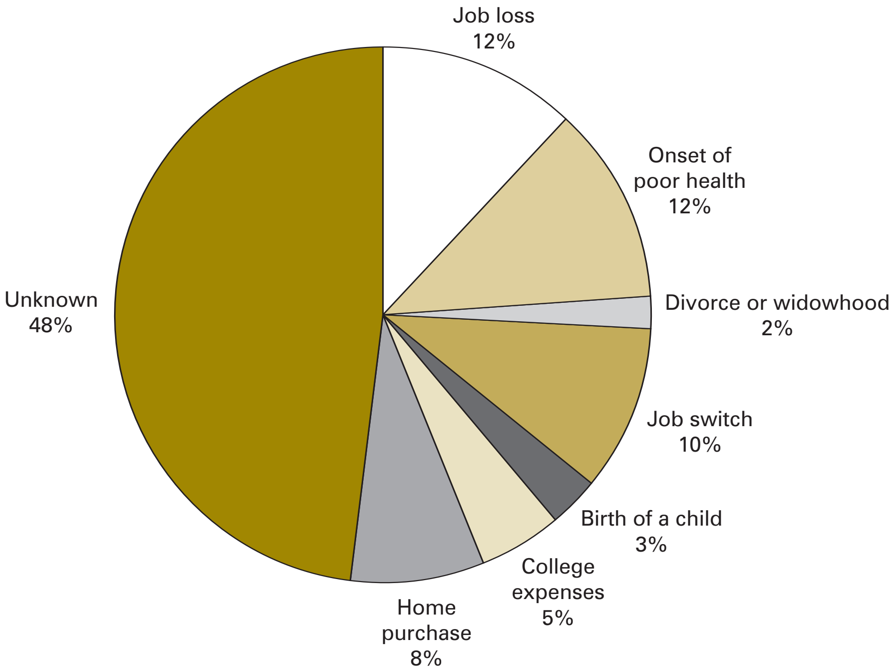
FIGURE 1. Percentage Point Change in the Probability That Adults Ages 25 to 58 Living in Families with IRAs or 401(k)s Withdrew from Their Accounts between 2004 and 2005, by Event



Source: Authors' calculations of the 2004 Survey of Income and Program Participation (SIPP).

Notes: Sample includes 16,853 adults ages 25 to 58 in 2004, who were present during the entire 24 months between 2004 and 2005, and lived in families with IRAs or 401(k)s in 2004. Withdrawals and events occurred at some point between 2004 and 2005, though they did not necessarily coincide. Results are based on a probit regression that controls for age, sex, education, race, marital status, income, and financial assets.

FIGURE 2. Percent of Aggregate Dollars Leaked from IRAs and 401(k)s between 2004 and 2005, by Event



Source: Authors' calculations of the 2004 Survey of Income and Program Participation (SIPP).

Notes: Sample includes 1,287 adults ages 25 to 58 in 2004, who were present during the entire 24 months between 2004 and 2005, and lived in families with IRAs or 401(k)s in 2004 that withdrew from their accounts between 2004 and 2005. Events also occurred between 2004 and 2005, though they did not necessarily coincide with withdrawals. Withdrawals tied to multiple events are split equally among those events. All results are weighted.

Policy Implications

Our findings suggest that retirement accounts play a broad role in fulfilling families' savings needs, especially among lower-income and more vulnerable groups that do not have other options. Retirement account owners with limited education, those who are black, and those with low financial assets are much more likely to withdraw from their accounts than their counterparts. These groups start out with less and more often tap into what they have saved. However, adverse events, including job loss and disability, and investments to purchase a home are strongly associated with retirement account leakage. These are legitimate and compelling reasons to tap into savings. Nonetheless, the withdrawals represent a significant loss in retirement savings, especially when extrapolated over a longer period than the two-year window we can observe.

The results raise questions about whether retirement account withdrawals should be further discouraged and whether policymakers should make a stronger push toward encouraging savings outside of these accounts. Recent changes that require employers to automatically roll over retirement account balances above $1,000 at job change unless the employee requests a payment move in the right direction. Perhaps this rule could be extended to smaller balances. The Pension Protection Act of 2006 also requires employers to send a stronger message to departing employees about the consequences of cashing out their retirement savings. Yet too many restrictions on withdrawals could discourage participation in retirement savings plans.

Instead, the results highlight the need for an integrated savings policy that encourages families to save both for preretirement and retirement needs. Policies that offer savings opportunities for low-income families such as individual development accounts and the new opportunity to automatically deposit an earned income tax credit in a savings account provide such incentives. At the same time, we need to boost retirement savings. More workers need pension coverage at the workplace along with automatic enrollment provisions. Alternatively, increased retirement savings could be mandated through an add-on to Social Security as proposed by some lawmakers rather than focusing on voluntary retirement savings plans.

Acknowledgments

This brief was funded by a generous grant from the Ford Foundation. The authors are grateful to Richard Johnson and Signe-Mary McKernan for valuable comments on an earlier draft.

Notes

1. Purcell (2009), U.S. GAO (2009), and Verma and Lichtenstein (2006) estimate the loss of retirement savings at job change.

2. Details are reported in Butrica, Zedlewski, and Issa (2010).

3. We use the term 401(k) to refer to all employer plans that set up individual accounts in workers' names, such as 403(b) plans and simplified employer plans.

4. As shown in Butrica, Zedlewski, and Issa (2010), 401(k) ownership is more common than IRA ownership among this age group, but the patterns we report here by education and other characteristics are similar.

5. In the SIPP, all IRA and 401(k) owners are asked if they withdrew from their accounts. In a separate topical module, all workers are asked if they ever cashed out or rolled over a lump-sum distribution. We include these cashouts in withdrawals but exclude balances rolled over into another retirement account.

6. These shares of aggregate dollars leaked from retirement accounts between 2004 and 2005 refer to the aggregate dollars lost as reported in the SIPP. Retirement account ownership reported on the SIPP compares well with results from the Survey of Consumer Finances, but balances fall short of aggregate dollars owned by this age group.

References

Butrica, Barbara A., and Philip Issa. 2010. "Retirement Account Balances." Fact Sheet on Retirement Policy, January. Washington, DC: The Urban Institute.

Butrica, Barbara A., Sheila R. Zedlewski, and Philip Issa. 2010. "Understanding Early Withdrawals from Retirement Savings Accounts." Retirement Policy Discussion Paper 10-02. Washington, DC: The Urban Institute.

Holden, Sarah, Jack VanDerhei, and Luis Alonso. 2009. "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2008." *Research Perspective* 15(2). Washington, DC: Investment Company Institute.

Purcell, Patrick. 2009. "Pension Issues: Lump-Sum Distributions and Retirement Income Security." Washington, DC: Congressional Research Service.

U.S. Government Accountability Office (GAO). 2009. "401(k) Plans: Policy Changes Could Reduce the Long-Term Effects of Leakage on Workers' Retirement Savings." Washington, DC: U.S. Government Accountability Office.

Verma, Satyendra, and Jules Lichtenstein. 2006. "Pension Lump-Sum Distributions: Do Boomers Take Them or Save Them?" Washington, DC: AARP Public Policy Institute.

About the Authors

Barbara A. Butrica is a senior research associate in the Urban Institute's Income and Benefits Policy Center.

Sheila R. Zedlewski is the director of the Urban Institute's Income and Benefits Policy Center.

Philip Issa is a research associate in the Urban Institute's Income and Benefits Policy Center.

THE RETIREMENT POLICY PROGRAM

http://www.retirementpolicy.org

The Retirement Policy Program addresses how current and proposed retirement policies, demographic trends, and private-sector practices affect the well-being of older individuals, the economy, and government budgets.

The Urban Institute
2100 M Street, NW • Washington, DC 20037-1231 • (202) 833-7200 • paffairs@urban.org • http://www.urban.org