Fact Check: Were 401(k)s Really An ‘Accident of History’?

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“401(k)s are an accident of history”: That’s the title of a 2017 article at the Economic Policy Institute, which goes on to say that “401(k)s were never intended to replace pensions.”

In a 2015 CNBC article with the shorthand title (that is, in the URL), “The 401k is a failure,” that news site cited another expert:

“‘401(k)s were never designed as the nation’s primary retirement system,’ said Anthony Webb, a research economist at the Center for Retirement Research. ‘They came to be that as a historical accident.’”

And also at CNBC, in 2017, reporter Kathleen Elkins called it an “accidental retirement revolution,” citing a recent Wall Street Journal article interviewing the so-called “father of the 401(k),” Ted Benna. Here are Elkins’ excerpts:

“The original proponents of the 401(k) plan, which has become the dominant source of retirement savings for most Americans, are rueful about the revolution they unintentionally began.

“‘[Many early backers of the 401(k)] say it wasn’t designed to be a primary retirement tool and acknowledge they used forecasts that were too optimistic to sell the plan in its early days,’ The Wall Street Journal reports. ‘Others say the proliferation of 401(k) plans has exposed workers to big drops in the stock market and high fees from Wall Street money managers.’

“Even the ‘father of the 401(k),’ Ted Benna, tells The Journal with some regret that he ‘helped open the door for Wall Street to make even more money than they were already making.’”

Here’s the story of the “invention of the 401(k)” as told by the inventor himself, that is, at the website Benna401k LLC:

“The 401K name comes from a section of the IRS code. This section was added in 1978 but for 2 years no one paid much attention to it. A creative interpretation of that provision by a smart consultant gave birth to first 401k savings plan. The government tried to repeal the 401K provision twice once it realized the enormous tax loss from the 401K provision.

“401K plans as they evolved today are a brainchild of Ted Benna, a retirement benefit consultant working for a Pennsylvania based Johnson Cos. (not Johnson and Johnson as most sites wrongly claim). He devised the plan for a client who declined to use it because of the fear that once the government realized the tax loss potential of the plan the 401k provision would be repealed. After the client rejected it, Ted Benna persuaded his own company to use it.”

But this new conventional wisdom is missing several key points:

First, the implementation of the 401(k) plan was not the “invention” of employer-sponsored retirement accounts; these had existed before. What Benna “invented” (and, let’s face it, someone else would have come up with the concept eventually) was the concept of a matched savings incentive.

Second, the United States is distinctive in offering this matched savings structure, but that’s not what caused traditional defined benefit plans to close, one after the next, in the private sector. Broader forces are responsible here.

And all of this requires a more extensive history lesson.
The early history of retirement accounts

To start with, the impression one gains from the usual reporting is that the 401(k) is the start of retirement savings accounts. That’s not true at all. Here’s an article from the New York Times, February 24, 1952 (no online link; check your local library for newspaper database access), “Profit-Sharing Retirement Plans Advanced As Result of Increased Corporation Taxes”:

“Greater interest in profit-sharing plans as a means to provide retirement benefits for employees is expected this year as a result of the high corporation taxes now prevailing. Such planning showed a marked increase in 1951.

“With the earnings outlook for many companies facing uncertainty, management is finding this method of establishing employee retirement benefits attractive. Companies which have been reluctant to adopt pension plans with fixed charges have found profit-sharing a flexible method of accomplishing retirement purposes.

“The wide fluctuation in earnings of many companies has been one of the causes of strain in the conventional type of pension plan, and it is because of this hazard that many companies are electing to adopt profit-sharing, which is linked more with current operations than the standard pension plan. Advocates of the profit-sharing retirement formula contend their method eliminates the uncertainties in company payments into retirement plans.”

Nine years later, the Times reported, on September 19, 1961 (“ Industry Cuts the Pie; An Appraisal of Profit-Sharing Plans And Their Recent Surge in Popularity”), that there were 35,000 profit-sharing plans, covering 2,000,000 workers. While a profit-sharing plan sometimes meant that companies would cut checks at the end of the year based on corporate profits, plans which deferred savings to retirement “still predominate by something like a three-to-one ratio.”

And on the cusp of the 401(k) revolution, in 1979, the Chicago Tribune reported (February 28, 1979) that “More firms eye pension plans.” The article cited Robert Krogman, vice president of Chicago Title and Trust Co., “which administers more than 130 employee benefit plans,” and reports (albeit without statistics) that retirement plans have become increasingly popular, especially among small employers offering profit-sharing plans as well as a form of pension called a “money-purchase pension plan.” This form of pension, which is almost gone from even the experts’ vocabulary, might have indeed been a routine part of retirement benefits: all it means is that the employer commits to making a fixed contribution to retirement plans, year in and year out, rather than based on profits and varying from year to year.

The tax code change

This brings us to 1978 and that tax code change. In 2014, Bloomberg provided a bit of a history lesson.

Despite the earlier numbers I just cited on the success of profit-sharing plans, IRS officials were concerned that their benefits were largely going to top executives. In response:

“They proposed regulations that would have required immediate taxation of money contributed into the plans in some cases, undercutting the whole concept.

“Congress in 1974 then froze the status quo in place for existing plans, effectively promising to set permanent policy and deferring a final decision. This was part of the Employee Retirement Income Security Act, which came to be known as Erisa.

“That created a situation where one set of rules applied to existing plans and there was no clear structure for setting up new plans.”

In the meantime, a larger tax reform was underway which resulted in the Revenue Act of 1978, which had as its primary objectives middle class and capital gains tax cuts, as well as the implementation of inflation-indexing of tax brackets. As a measure to build bipartisan support, it was proposed to add retirement savings incentives.

“Representative Barber Conable, the top Republican on Ways and Means, suggested the add-on related to profit-sharing plans that became section 401(k), [former Oklahoma Democratic Congressman Jim] Jones said. Conable, who died in 2003, had been talking to businesses such as Xerox Corp. and Eastman Kodak Co. that were major presences in his home region in upstate New York.”
Richard Stranger, a staffer and technical expert interviewed for the article, was tasked with drafting the legislative text. Bloomberg reports,

“The provision, changed and expanded in the years since, blessed the idea that employees could direct part of their salary into retirement accounts without paying taxes on it up front and established basic rules to prevent too much of the benefit from going to executives. . . .

“The issue wasn’t the focus of much intense lobbying, at least not as much as the rest of the law.

“That’s in part because people such as Carroll Savage had already done that work for much of the 1970s, helping prevent Congress from killing the plans in Erisa in 1974. They also built support for the idea that employees should be able to choose whether to accept compensation as salary or a deferred payment to be taxed only when they can actually spend it.”

And, as a brief postscript in the article:

“Stanger still shakes his head in amazement that the tax code section itself is so well-known by its number. In 1978, the plans were called cash or deferred arrangements.

“‘We thought that the acronym CODA would take off,’ Stanger said. ‘But it didn’t.’”

The aftermath: what really caused the closing of defined benefit plans?

Yes, none of what I’ll say now is new to longtime readers (after all, this was the subject of my first article on this platform).

But let’s review what else happened at roughly the same time as the 401(k) was “invented.”

In 1974, the first law dictating funding requirements for American pension plans, ERISA, was passed. Prior to this, employers were at liberty to fund their defined benefit pension plans in any manner they wished, or not at all. Subsequent laws tightened funding requirements even further in 1987, 1994, and the extensive changes of the 2006 Pension Protection Act.

And in 1985, the first set of accounting requirements, FAS 87, was published, requiring employers to account for their full pension liabilities on their financial statements.

Both of these changes caused employers to look far more closely at the costs and the risks associated with their pension plans, and whether they were getting their money’s worth in terms of the appreciation (or indifference) of an increasingly mobile workforce.

Here’s an indicator of how little this has to do with the matched-savings innovation of the 401(k): the trend towards closing defined benefit plans in favor of defined contribution plans occurred just as dramatically in the United Kingdom, for many of the same reasons. Here, too, pension funding and accounting regulations were tightened; in addition, the country began to require that pensions index deferred benefits, that is, increase the benefits of those who left before retirement, to account for inflation up to retirement, as well as adding other costly requirements. And in response, companies closed their traditional plans for new employees, and opened defined contribution plans — not with a matched savings but simply a mandatory employee contribution and an employer contribution.

Similarly, Canadian employers had historically had the same traditional defined benefit plan structure for their employees as the U.S., and, in the same fashion, Canadian employers have been closing their plans, and, again, have been promoting retirement savings accounts to their employees. And in Australia, even though the “Superannuation” retirement plan mandate allowed employers to meet their requirements with defined benefit plans, they have nonetheless closed them.

Why does it matter?
Those who promote the concept that “401(k)s were an accident” are still hanging onto the idea that employers should be guaranteeing their employees’ retirement benefits, and that something went wrong with history that we ended up in a different state of affairs.

In the first place, that’s historically illiterate: even before the decline of defined benefit plans, most employees did not benefit from them, as even the Economy Policy Institute (cited above for their anti-401(k) lament) notes that in the early 1990s, before the decline, only 35% of private-sector workers had a DB pension.

And what’s more, the notion that employers should be expected to continue to offer traditional final-pay defined benefit retirement plans, knowing what we do now about the importance of pre-funding, longevity, risk, and all the rest, is profoundly mistaken.