BRETT ARENDS'S ROI

# Opinion: This 401(k) bait and switch costs the average American worker $26,000

Vesting schedules hurt younger and lower-paid workers the most

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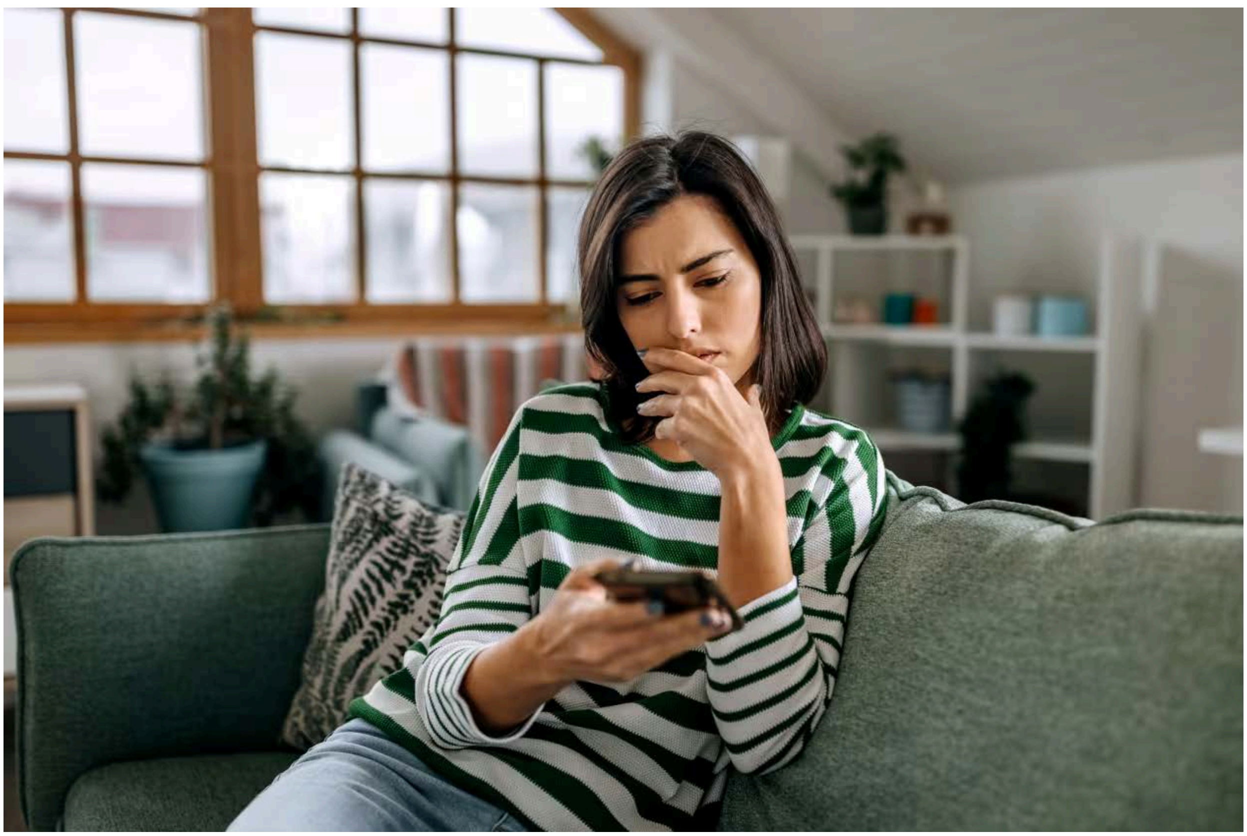

Wait — where did that company match go?
PHOTO: GETTY IMAGES

I'm sorry, but it's simply outrageous.

A company hires you, and among the promises it makes to get you in the door is that you'll see a generous flow of "matching dollars," from the stockholders to you, into your 401(k) plan.

But what you may not realize is in the fine print: If you leave the company before a certain period has elapsed, the stockholders will take back some or even all of those dollars. You may not even get a nickel.

And that period isn't counted in months. It can be as much as six years long.

This bait and switch at the expense of the working stiff goes under the innocent-sounding label "vesting schedule," and its defenders say it's all legal and it's all disclosed.

Legal? Sure, but so what? America has the best Congress money can buy. Companies want, companies get.

Disclosed? Sure. Somewhere in the thick sheaf of papers — all written in legalese — that you have to sign on your first day on the job.

Anyone who thinks these 401(k) vesting schedules are a racket designed to benefit companies at the expense of the rest of us will find plenty of supporting ammunition in a new research paper.

It is written by Guillermo Carranza, who is completing his doctorate in economics at Yale, and Aaron Goodman, an economist at Vanguard, the employee-owned finance giant. It is based on a gold mine of data: The 1,400 401(k) employer plans for which Vanguard has acted as record-keeper since 2010. And it's a doozy.

An astonishing 30% of all "separations" — quits, layoffs and firings — take place before 401(k) matching contributions fully "vest," meaning the employer can take the money back, the researchers found.

The average worker affected lost 40% of their final 401(k) account balance as a result of this maneuver. No, really.

And the average dollars lost works out to $26,000 by the time a person turns 65.

About half of all plans administered by Vanguard use vesting schedules, the researchers report.

And it's getting worse. "The forfeiture rate has risen over time," Carranza and Goodman write, "in part because employment spells have become shorter."

From 2010 to 2022, the median period of employment for members of a 401(k) plan administered by Vanguard dropped from four years to two, they report. Meanwhile, they note, “most vesting schedules last between three and six years.”

The people most often affected by this trick are lower-paid workers and younger, entry-level workers, because they are mostly likely to cycle in and out of jobs in a short period of time.

“In 2022, the forfeiture rate is roughly 25 percentage points higher for participants ages 18-30 than for those ages 50-60,” they write, adding: “Participants in the bottom income quintile similarly display forfeiture rates about 20 percentage points higher than those in the top quintile.”

By no coincidence whatsoever, lower-paid workers and younger, entry-level workers are also comparatively less likely to be financially sophisticated, which makes them ripe for the picking.

Paging P.T. Barnum!

So much for the idea that 401(k) plans are designed to help everyone. We already knew that 401(k) plans benefit higher earners more than lower earners, for two simple reasons. First, you have to be able to afford to defer the money — something that’s more possible at an income of $150,000 than $50,000 or even less. Second, you get a tax break on your contributions, and the higher your tax bracket, the bigger dollar value that has.

But this vesting racket makes the gap even worse.

“Because forfeitures are concentrated among lower-income participants, a primary effect of vesting requirements is to make the distribution of 401(k) compensation more regressive,” Carranza and Goodman write.

The main argument in support of these vesting schedules is that they supposedly encourage workers to stay with their employers longer, which in turn is supposed to benefit everybody, because it gives employers more incentive to invest in training and it means workers become more experienced and better at their jobs.

But the research blows that idea up, too. The researchers looked at everyone in Vanguard-administered 401(k) plans who left their employers from 2010 to 2022. “Our second set of empirical analyses test whether vesting schedules exert a causal retention effect,” Carranza and Goodman write. “Using a subset of participants who begin employment spells during the 2010-2022 period, we study the retention question with two different identification strategies and in each case find a null result: vesting schedules do not appear to have any effect on participants’ separation decisions or ultimate employment tenures.”

In other words, vesting had no effect on keeping people in their jobs for longer.

This isn't the first exposé that reveals how 401(k) contribution vesting is being used by employers to benefit themselves at the expense of their workers. Research published earlier this year by Samantha Prince at Penn State Dickinson Law found that workers lost a staggering $1.5 billion from this vesting maneuver in 2022 alone.

"We really need to eliminate vesting schedules," Prince says. "Vesting schedules exacerbate retirement insecurity for the lower-income workers in our society."

Employers say they don't benefit from these savings because they can't pocket the money workers forfeit. It's a crazy argument. This is a shell game: Companies simply use that money to lower the amount that they pay out in matching contributions to other employees.

In other words, the employers don't pocket the $1.5 billion. They use it to offset the $1.5 billion they would have spent, and they pocket that $1.5 billion.

Hey, I'm not taking water from your side of the pond. I'm taking it from my side of the pond!

A few years ago, Michael Doran at the University of Virginia School of Law said that the tax-advantaged retirement system, including things like the 401(k), amounted to a "fraud." It was basically a tax break for higher earners, he argued.

MarketWatch's Bob Powell challenged that view.

But if you really want to make sure 401(k) plans are designed for everyone, getting rid of those vesting schedules would be a great start.

## About the Author

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Brett Arends is an award-winning financial writer with many years experience writing about markets, economics and personal finance. He has received an individual award from the Society of American Business Editors and Writers for his financial writing, and was part of the Boston Herald team that won two others. He has worked as an analyst at McKinsey Co.