For 25 years, employers increasingly have turned to defined-contribution (DC) pension plans, partly because they are cheaper to administer and reduce their risks of funding pension coverage. But DC plans benefit employees as well. In nominal terms they provide a less stable replacement of preretirement earnings than do defined-benefit (DB) plans, but they offer more flexible funding methods—for example, they can protect against real-income erosion through inflation-hedged portfolios. Because DC plans are fully funded and have simpler benefit-payout rules, they make annual pension wealth accrual more transparent and predictable than do DB plans. In addition, DC plans can more easily allocate assets according to workers’ desires to make bequests and buy annuities.

Almost 80% of U.S. workers have some type of pension. In the 1990s, as the share of full-time employees covered by DC plans rose, the share covered by DB plans fell. Most DC plans offer five or more investment choices. The law caps total contributions (employer plus employee) at $30,000 or 25% of compensation, whichever is less, and caps employees’ (elective) contributions at $10,500. Limits imposed by employers tend to be more restrictive; most allow maximum contributions of 15% of earnings or less; only 10% permit contributions to exceed 20% of earnings.

DC plans can be a flexible way to seek retirement security, but their success depends on how they are used. Penalty-free withdrawals before age 59.5 are legally permissible only if based on a long-term schedule. Most plans permit discretionary withdrawals before age 59.5, albeit with a penalty. Many accept only hardship reasons (like home purchases, medical costs, or unexpected legal expenses), but a significant fraction accept any reason.