The Responsiveness of Retirement Distributions to Early Withdrawal Penalties

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Abstract: Tax-preferred savings accounts, including funds in employer-sponsored plans such as 401(k)s and Individual Retirement Accounts (IRAs), represent a growing share of retirement assets and receive tax preferences in exchange for a reduction in liquidity of those assets. In particular, withdrawals prior to age 59 ½ are subject to a 10% penalty unless funds are used for certain exceptions. Despite the apparent reduction in liquidity, recent estimates suggest that a significant proportion of funds in the 401(k)/IRA system are withdrawn prior to age 55, a phenomenon known as "leakage." In this study, we aim to understand the relationship between distributions from defined contribution savings accounts and the early withdrawal penalty by analyzing the daily age pattern of distributions in the neighborhood of the sharp increase in the early withdrawal penalty when an individual turns 59 ½.

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