Saving Retirement in the Face of America's Credit Crises:

Short Term and Long Term Solutions

Oral Testimony

Committee on Education and Labor

The Impact of the Financial Crisis on Workers' Retirement Security

1:00, 2181 Rayburn House Office Building

Tuesday October 7, 2008

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As Congress reacts to the modern financial order changing forever, we should also realize that individual retirement plans based on that financial order, have also changed forever. In the last few weeks, we've been confronted with older worker and retirees' lives being turned upside down; their panic tops-off an already existing state of chronic anxiety about retirement futures. Much of both – the panic and anxiety - is caused by the corrosive effects of 401(k) and 401(k) – like plans[1], including IRA plans. 410(k) plans have not expanded pension coverage, increase the savings national rates; though they did add to the profits and growth of the financial sector and extracted ever increasing tax breaks from the Treasury.

Short Term Solution to the Retirement Crises

Short term, I propose that since 401(k) accounts and the like are financial institutions -- the bank about where 38% of the workforce[2] can intend to save for their retirement -- Congress let workers trade their 401(k) and 401(k) - type plan assets (perhaps valued at mid-August prices) for a Guaranteed Retirement Account composed of government bonds (earning a 3% return, adjusted for inflation). When the worker collects Social Security, the Guaranteed Retirement Account will pay an inflation adjusted annuity, based on the accumulated funds.

How would this work? Take a 55 year old who had $50,000 in his 401(k) account in August and faces job loss and eroded assets because of the erosion of his retirement accounts.[3] Let him swap out the $50,000 for a guarantee of $500 per month[4]. The

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[1] 401(k) – type plans are defined contribution plans include and include the following: 401(k) plans [about 80% of participants in defined contribution plans are in 401(k) plans]; profit sharing plans; money purchase plans; individual retirement accounts; and 403(b) plans which are 401(k) plans for employees in the public sector.

[2] Center for Retirement Research Boston College. 2004. "Eligibility and Participation in 401(k) Plans by Age, 2001 and 2004" http://crr.bc.edu/frequently_requested_data/frequently_requested_data.html accessed October 4, 2009.

[3] Note the macroeconomic destabilizing effects of 401(k) plans -- and all defined contribution plans – when asset values go down; people increase their job search just when jobs become scarce. This makes the recession worse.

[4] This is what the annuity would pay at a 3% inflation rate and a 3% real return.

economy is probably in a recession, but a guaranteed income from his former 401(k) removes a source of financial anxiety, and -- this is not trivial – it end fruitless discussions with brokers and financial sales agents, who are also desperate for more fees and are often wrong about markets.

Long Term Solution to Eroding Retirement Income Security

Because there is a long run retirement crises, not in Social Security, but in the heavily tax-subsidized, private, voluntary, and commercial tier of our nation's retirement income security system, about half of workers will not have enough income after age 65 to replace, the bare necessity, 70% of their pre-retirement income according to Boston College's Retirement Risk Index. The erosion is primarily caused by Congressional bias towards 401(k) plans, their fundamentally flawed design and little regulation.

Going forward, I propose Congress establish universal Guaranteed Retirement Accounts and the federal government deposit $600 (inflation indexed) in those Guaranteed Retirement Accounts every year for every worker.

Every worker (not in an equivalent defined benefit plan) would save 5% of their pay into their Guaranteed Retirement Account to which the government pays a 3% inflation-indexed guaranteed return. Workers would earn pension credits based on these accumulations.

The 5% target comes from the basic math that an average earner saving 5% of pay over a life time with a guaranteed 3% rate of return plus inflation would supplement their Social Security benefits to achieve a 70% replacement rate at retirement. In other words had GRA been in effect instead of 401(k) plans an average earner reaching 65 today would have accumulated enough to pay about 1% for every year of service. (This rate is equivalent to the average defined benefit pension plan payout because it its inflation indexed.)

This basic math, though, comes up against the basic reality that many Americans can not afford to save that much. That is why workers' contributions would be mitigated by a $600 a year contribution from the federal government indexed for inflation which will be paid for by scaling back substantially the tax breaks for 401(k) type accounts. The $600 defrays the expense for most low and middle class workers (it pays for all the

contribution for a minimum wage worker). Employers could top it off, pay a portion, and workers could add to it.

Advantages of a GRA?

First, this is a fiscally responsible plan. Rearranging tax breaks is revenue neutral, efficient and fair because the current tax breaks.[5] High-income earners get a much higher subsidy than anyone else because they are more likely to have a 401(k) and contribute more.[6] This design has shocking results: 6% of taxpayers with incomes over $100,000 per year get 50% of the tax subsidies.[7] And, for all this effort, the nation gets no extra savings and workers no extra retirement security (see Appendix). At most, this complicated system creates economic activity when accountants happily transfer money between taxed accounts to tax-sheltered accounts and tax payers foot the bill.

Worse, the inefficiency is growing: the value of tax expenditures for DC plans is projected to grow 49 percent while those for traditional plans are projected to fall by 8.9 percent between 2009 and 2013. The sooner we admit that our 30 year experiment with 401(k) accounts has failed the sooner we can use these precious government subsidies efficiently and equitably.

Second, GRAs are responsible because they are prefunded. A government agency connected to the Thrift Savings Plan and Social Security (for administration efficiency) governed by trustees representing workers, business, and the public, invests the GRA contributions in a range of assets, like the sovereign wealth funds of Alaska, Alabama, New Mexico Wyoming, and many other nations do to ensure the federal government can

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[5] The GRA plan as written is budget neutral. If we allow tax breaks for the first $5000 in voluntary 401(k) contributions the plan will cost $25 billion. But know that accounts that allow hardship withdrawals are savings for hardship which is different from retirement income security.

[6] Because the tax subsidies come in the form of tax deductions and not credits they are regressive. For example, if a lawyer earning $200,000 makes a $1000 contribution to his 401(k) plan, he reduces his income tax by $350. If his receptionist, earning $20,000, makes the same $1000 contribution (which is much less likely), she will save only $150 in taxes.

[7] A good paper on the distributional effects of the tax expenditures for DC plans is Burman, Leonard E.,William G. Gale, Matthew Hall, and Peter R. Orszag. 2004a. Distributional Effects of Defined Contribution Plans and Individual Retirement Accounts. Washington, D.C.: Urban-Brookings Tax Policy Center.

pay a 3% inflation-indexed rate of return to the Guaranteed Retirement Account lifetime annuities.

Third, GRAs are universal;

Fourth, GRAs provide adequate retirement income and encourages people to save more;

Fifth, the money is locked away until retirement;

Sixth, the payout is for a person's life;

Seven, every America has the opportunity to save in a low cost, professionally managed account with guaranteed returns.

GRAs are better than automatic IRAs. Automatic IRAs add complicated requirements on small and medium sized employers. Automatic IRAs expand the risks workers already face in individual retirement account plans: the risks they won't save enough because of high fees and wrong in investments choices; the risk financial markets tank, the risk of inflation eroding income and that you will out-live your money. Automatic IRAs cause deadweight losses to the economy because, net of fees, 401(k) and other individual retirement accounts are among the lowest earning among all financial vehicles. Add the risks of preretirement - withdrawals, moral hazard, and adverse selection Automatic IRAs would entrench inefficiency and risk and a dollar of retirement income becomes more expensive to fund. Automatic IRAs are worse than nothing.

Disadvantages of GRAs

Scaling back 401(k) deductions going forward may put pressure on vendors to lower fees and boost returns. Also people like the option of saving at work for hardships. Fine, Congress may to subsidize precautionary savings but don't call them retirement accounts. Put them in a separate category.

Should we mandate savings in a recession? Yes, as long as fiscal policy provides for short term stimulus. No one is proposing we suspend Social Security taxes in recessions. Households need a source of disciplined savings over the business cycles; it is

not the job of households to go in debt and spend wildly to get us the nation out of recessions. This ethos – debt-led consumer spending -- got us in the trouble we are in.

Predicted Popularity of Guaranteed Retirement Accounts

Even before the financial crises of September 2008, workers are catching on that Congress needed to provide more secure sources of retirement income security.

Surveys show less than 50% of people think they will live comfortably in retirement and, crucially, that they bear personally responsibility for their supplements to Social Security benefits. Though they accept the responsibility -- they want the government to help.[8] Over 77% of people support mandated pensions.

In 2006, HSBC bank asked 21,000 workers in 20 nations what the government should do about the expense of aging societies- on average, workers preferred compulsory savings to any other policy. A third of Americans wanted the government to force them to save more for retirement; far fewer; 16% would support a tax increase; and, only 9% wanted the government to reduce benefits.[9]

In October 2007, a whopping 91% of Americans told a Wall Street Journal poll that the government should do something to secure retirement and 41% said they were not hearing enough from the Presidential candidates about retirement income issues.[10]

Conclusion

American workers know we have a short term and long term pension crises but it is not with Social Security but with the voluntary, self-directed, commercial- account - based pension system. The loss of retirement security is a reversal of fortune and the result of very specific flawed governmental policies that have been biased toward 401(k) plans, rather than the result of technological change or the logical consequences of global

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[8] Madland, David. 2008. "Reforming Retirement: What the Public Thinks." For the Georgetown University conference on "The Future of Retirement Security." Held October 3, 2008. department of History

[9] HSBC Bank. "How should governments finance ageing populations" http://www.hsbc.com/1/PA_1_1_S5/content/assets/retirement/2006_for_news_release_final.pdf.) HSBC. 2007. "The Future of Retirement: What People Want." http://a248.e.akamai.net/7/248/3622/7d1c0ed7aa1283/www.img.ghq.hsbc.com/public/groupsite/assets/ retirement_future/2006_for_what_people_want.pdf (accessed online February 2, 2007).

[10] Bright, WSJ.com November 2007 online Harris personal finance poll

economic trends. That is the good news. Government policies eroded pensions government can help secure workers' retirement futures. If you implement the short term 401(k0 asset swap and Guaranteed Retirement Accounts, we can look back at the financial crises and bailout and know Congress did permanent good for workers' retirement income security.

Table 1

Tax Subsidies for Retirement Plans	**2009 $ Billion**	**2009 growth to 2013 estimated**
DB plans	$45.67 Billion	-8.9%
401(k) (325 B) Individual retirement plans and Plans covering partners and sole proprietors ("Keogh Plans")	$75. 70 Billion	49.5%

EBRI calculations Original data from Executive Office of the President, Office of Management and Budget, *Analytical Perspectives, Budget of the Untied States Government, Fiscal Year 2009* www.whitehouse.gov/omb/budget/fy2009/

Appendix:

The Savings Paradox

Savings rates should be higher now than at any time in the history of the United States. The American workforce has never been more educated and people with more education save more. Middle-aged workers save more than any other age group and there are an estimated 73 million baby boomers in the U.S. who are between age 48 and 63 in 2008. High income people have higher savings rates the richest Americans have gained the most income since the 1990s. Further, as national income grows the demand for normal goods grow because when people have money they buy more of what they want Ipods, better health, and retirement “leisure:” witness the 1960s and 1970s, when, as the economy grew, older people lived longer AND retired earlier.[11] And, in an attempt to further increase retirement savings Congress has relentlessly expanded tax breaks for retirement savings since the 1980s.

The value of the favorable tax treatment for retirement savings is at an all-time high 110 B, while its effectiveness is at an all time low.

To be clear, saving is hard. Humans often lack the foresight, discipline, and investing skills required to sustain a savings plan. But human characteristics haven’t changed as much as retirement savings as eroded.

The deep decline in national savings rates showed up in the 1990s when employers started to reduce their contributions into defined benefit pension plans[12], these plans were a main driver of national savings. The expansion of 401(k)-type plans did not boost savings for three reasons: they supplanted already existing defined benefit plans, were cheaper for the employer, and did not expand pension coverage to people who had

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[11] Ghilarducci, Teresa. 2008. *When I am Sixty Four: The Plot Against Pensions and the Plan to Save Them.* Princeton University Press, Princeton, NJ. Chapter 1.

[12] Bosworth, Barry, and Lisa Bell. 2005. The Decline in Saving: What Can We Learn from Survey Data?” Unpublished draft written for the 7th Annual Joint Conference of the Retirement Research Consortium, “Creating a Secure Retirement” (Washington, DC, August 11-12, 2005). <http://www.bc.edu/centers/crr/dummy/seventh_annual.shtml>.

no pension plan. This is surprising: although 401(k) - type plans are growing,[13] they don't expand pension coverage. Instead, they replace existing traditional pension plans. When groups of workers who ordinarily don't have pensions get them -- poultry workers, janitors, home-health care workers, etc. -- it is most likely because they are included in a newly negotiated collectively-bargained defined benefit plan.[14]

Defined benefit plans are institutionalized, contractual forms of saving that happen automatically at work. Workers have little discretion about whether to save or spend. Workers can't opt out, decide how much to invest, or take out lump-sum payments without difficulty. Even though 401(k) plans do not increase pension coverage nor secure retirement income, people like their portability and like to watch their individuals accounts grow. People do not like the financial and investment risks, or the risks of outliving their money, inherent in 401(k) accounts.

Therefore we understate the true spending on pensions because the U.S. Gover**n**ment maker uses "tax expenditures" – the value of the tax code's exemption of income generated for certain activities – to encourage workers and the nation's business owners to spend their income in socially approved ways.

In 2007, Social Security and Medicare cost $800 billion. Tax expenditures for retirement plans – traditional employer pensions (defined benefit plans), 401(k) plans, Individual Retirement Accounts, other savings vehicles dedicated for disbursement at older ages, and exemptions of Social Security and other federal pensions from tax – totaled over $156 billion in 2007.[15]

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[13]. 401(k) – type plans are defined contribution plans include and include the following: 401(k) plans [about 80% of participants in defined contribution plans are in 401(k) plans]; profit sharing plans; money purchase plans; individual retirement accounts; and 403(b) plans which are 401(k) plans for employees in the public sector.

[14] From 1999- 2005, the correlation between defined benefit coverage growth rates and pension coverage growth rates was 79%, while the correlation between defined contribution and pension coverage growth rates was a negative 10%. Ghilarducci. Teresa. 2006. "Future Retirement Income Security Needs Defined Benefit Pensions." Center for American Progress. www.americanprogress.org/kf/defined_benefit_layout.pdf

Back in 1981, Congress rejected President Carter's Pension Commission's call to reconsider the social value of these tax breaks and create a mandatory universal pension system (MUPS). Because they are designed to meet a social goal there were always conditions on these tax breaks. When the federal income tax was implemented in 1913, employer pension contributions were given special tax treatment only if the managerial plans included most of the rank and file. This is in direct acknowledgement that the tax breaks were targeted to the wealthy. The wrangling -- over how many tax breaks that higher income employees get in exchange for how many lower paid workers are in employer pension plans -- continues to this day and is part of a healthy process of assessing if the federal government tax breaks have the intended effects. Instead, in that same year, Congress satisfied the lobbyists for executives and made way for 401(k) plans by creating a section of the tax code which allowed workers to save, pre tax, in plans at work. After Wall Street firms and consultants successfully marketed 401(k) plans, the rest -- to use a shop-worn phrase -- is a history we all know: 401(k)-type plans replaced traditional defined benefit (DBs) pensions.-- over 63% of pensions are DC plans; whereas, in 1975, most pensions were DBs.

[15] Employee Benefit Research Institute. 2008. "Facts From EBRI: Tax Expenditures and Employee Benefits: Estimates from the FY 2009 Budget." EBRI, 1100 13th St. NW #878, Washington, DC 20005. February

In 2004, taxes not collected on pension contributions and earnings equal a fourth of annual Social Security contributions and, at over $114 billion, are perversely larger than household saving of over $102 billion.[16] The tax breaks were supposed to expand pension coverage and increasing retirement security.

Pension tax breaks are deductions from income; high-income earners get more breaks than low-income workers. If a lawyer earning $200,000 makes a $1000 contribution to his 401(k) plan, he reduces his income tax by $350. If his receptionist, earning $20,000, makes the same $1000 contribution (which is much less likely), she will save only $150 in taxes. The Brookings Institution and Urban Institute calculate that the 3% of taxpayers with incomes over $200,000 per year get 20% of the tax subsidies.[17] And, for all this effort, the nation gets no extra savings. At most, this complicated system creates economic activity when accountants happily transfer money between taxed accounts to tax-sheltered accounts and tax payers foot the bill. The value of tax expenditures for 401(k) plans is projected to grow 49 percent while those for traditional plans are projected to fall by 2.1 percent between 2009 and 20013. [18] (The estimated tax expenditures for 401(k) plans, Individual Retirement Accounts, and Keogh plans in 2009 is estimated to be $75.1 billion and for defined benefit plans $45.7 billion.)

In sum, the shift towards 401(k) plans increases tax expenditures, does little to expand retirement savings, and favors workers who need the help least. All told, the tax subsidies are not meeting a public purpose. The top heavy benefits for 401(k) plans create a sad paradox: since 1999, tax expenditures for retirement plans grew by 20%, while retirement plan coverage fell.

401(k) plans Exist Because They are Cheaper for Employers; but they Earn Subpar Returns

If 401(k) plans are so bad why are there so many of them? Though workers don't gain much from 401(k) plans, some employers and Wall Street firms do. I followed 700 firms over 17 years and found that firms that adopted a 401(k) lowered pension expenses by 3.5 – 5% without sparking worker complaints.[19] Since 401(k) plans are voluntary, many (about 20%) workers who can don't bother to contribute "leave money on the table" by not accepting the employer match. Employers' contributions are 26% lower

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[16] See Bell, Elizabeth Adam Carasso and C. Eugene Steuerle, "Retirement Savings Incentives and Personal Savings,"Tax Notes, December 20, 2004.for this provocative insight.

[17] A good paper on the distributional effects of the tax expenditures for DC plans: Burman, Leonard E.,William G. Gale,Matthew Hall, and Peter R. Orszag. 2004. "Distributional Effects of Defined Contribution Plans and Individual Retirement Accounts."Washington, D.C.: Urban-Brookings Tax Policy Center.

[18] Employee Benefit Research Institute. 2008. "Facts From EBRI: Tax Expenditures and Employee Benefits: Estimates from the FY 2009 Budget." EBRI, 1100 13th St. NW #878, Washington, DC 20005. February

[19] Ghilarducci and Sun 2006. How **Defined** Contribution Plans and 401(k)s Affect Employer **Pension** Costs: 1981-1998." With Wei **Sun**. Journal of **Pension** Economics and Finance, 5(2): 175-196

than they would be if everyone participated.[20] Employers could pay the match to every worker, as they do under defined benefit plans. Because workers have to trigger the match, and some don't, 401(k) plans boosts profits at the expense of retirement income security. Firms find sponsoring 401(k) plans is more profitable than sponsoring defined benefit plans. For firms, defined contribution plans are less costly, less risky, and can be funded with their own stock, not with hard cash.

Wall Street firms collect over $40.5 billion annually in 401(k) fees.[21] Yet, brokers and human resources often tell workers the fees on their accounts are zero. A good way to see what workers lose when they invest in a 401(k) plan rather than a group–based pension fund is to compare what each earns after fees are subtracted. A comprehensive study by Dutch and Canadian researchers Ron Bauer and Keith Ambachtsheer[22] found that U.S defined benefit plans – where individuals do not direct their own accounts – earned a 2.66% higher return NET of fees on equities than did retail mutual funds. In Canada, the skim was even higher; the retail mutual funds earned 3.16% less. (These shortfalls are the averages for the 25 year period between 1980 and 2004.) The gap makes sense – investing in retail funds means investors pay for advertising, shareholder profits, and glossy brochures. Add the fact that workers buy high and sell low – because people follow the leaders and buy stock as its rising in value and sell when its falling -- and you have self-directed accounts earning much less. This isn't just a leakage, it's a levee break. Hidden from view, workers are unwittingly transferring huge sums of money to financial firms.

The unpublished report confirmed that the GRA 3% real rate of return was a conservative long-run estimate under a range of plausible investment strategies that a government agency could undertake and not take any substantial risk of underperforming.[23]

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[20] I used information from Munnell and Sundén. 2004. Munnell, Alicia, and Annika Sundén. 2004. *Coming Up Short: The Challenge of 401(k) Plans.* Washington, DC: Brookings Institution Press to get participation rates, average contribution levels by earnings, the distribution of employees by earnings (Calculated from the CPS (2003) to make the three billion dollar estimate. The average savings per worker is $156, calculated for their sample of over 800 employees in one firm that the employer saved over $250 per older worker who did not participate in the 40(k) even when they were eligible. Choi, James J., Laibson, David I. and Madrian, Brigitte C.,$100 Bills on the Sidewalk: Suboptimal Investment in 401(K) Plans(August 2005). NBER Working Paper No. W11554. Fidelity's (2004) annual report documents employers' match behavior.

[21] There are $2.7 trillion in 401(k) assets Employee Benefit Research Institute. 2007. "401(k) Plan Asset Allocation, Account Balances, and Loan Activity" An Information Sheet from the Employee Benefit Research Institute (EBRI). www.ebri.org/pdf/InfSheet.QDIA.23Oct07.Final.pdf. The average fee is over $700 per year and average fees are 1.5% of assets which equals $40.5 billion.

[22] Ambachtsheer, Keith, Bauer, Rob. 2007. "Losing Ground." *Canadian Investment Review*; Spring, Vol. 20 Issue 1, p8-14.

[23] My report for the Economic Policy Institute explains the GRA plan in depth Ghilarducci, Teresa 2007. "Guaranteed Retirement Accounts Toward Retirement Income Security" Economic Policy Institute, 1333 H Street, NW Suite 300, East Tower Washington, DC 20005-4707 (202) 775-8810, Economic Policy Briefing Paper #204, November 20.