PENSION RIGHTS CENTER

1350 CONNECTICUT AVENUE, NW SUITE 206 WASHINGTON, DC 20036
TEL: 202-296-3776 FAX: 202-833-2472
WWW.PENSIONRIGHTS.ORG

STATEMENT OF NORMAN STEIN BEFORE THE ERISA ADVISORY COUNCIL WORK GROUP ON APPROACHES FOR RETIREMENT SECURITY IN THE UNITED STATES
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My name is Norman Stein and I teach at the University of Alabama, where I hold the Douglas Arant Professorship of Law. I am commenting today on my own behalf and for the Pension Rights Center, the only consumer advocacy group devoted solely to issues relating to retirement security. Thank you for permitting me to present these comments.

ERISA just celebrated its 35th birthday. ERISA has done a lot for the 50% of the private sector workforce that participates in employer retirement plans. It provided vesting protection, created meaningful standards for fiduciary behavior, and introduced funding standards and a federal insurance company for defined benefit plans, which at the time of ERISA was for most employees the major source of their retirement wealth. Moreover, defined contribution plans—which were often supplemental to a defined benefit plan—bore only a surface similarity to today's 401(k) plan: the employer generally funded the plan and had investment professionals manage collective plan assets. So one way of grading the retirement world at the time of ERISA enactment was this: coverage rates: C+; adequacy of plans for those covered: A-.

So where are we today, 35 years later? The coverage rate has has held stubbornly at around 50% of the workforce, even as Congress threw more and more tax incentives at the plans, tax incentives that primarily benefited the top quintile of wage earners. But the employees who are fortunate enough to be covered by a plan are more likely to be covered by a 401(k) plan than by a defined benefit plan or even an employer-paid and empoyer-invested defined contribution plan. As I will discuss, we have thus lost ground rather than gained ground since ERISA.

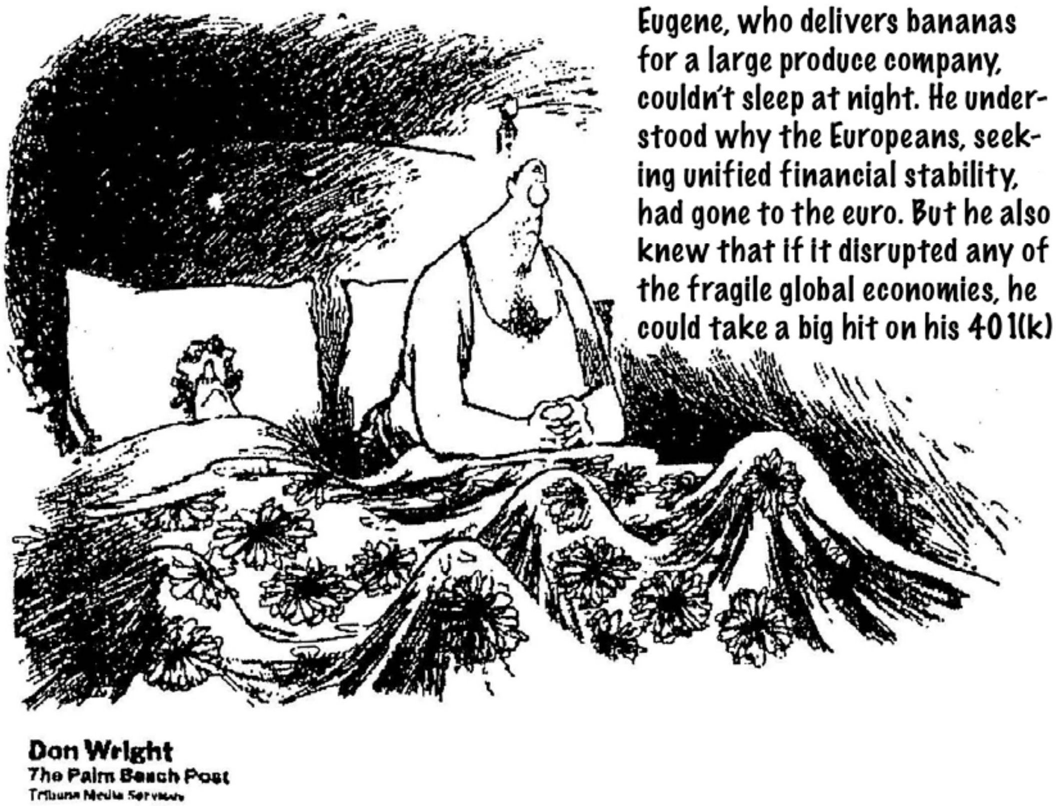
So my comments today deal with 401(k) plans, and I will be focusing on two issues: first, why section 401(k) and other voluntary savings plans have failed to implement a coherent vision of retirement policy; and second, why reforms aimed at improving 401(k) plans by making them more like defined benefit plans, and at increasing the number of retirement savings plans by mandating that employers either sponsor a tax-qualified retirement plan or offer payroll-deduction IRAs, are an incomplete solution to the formidable problems of retirement income insecurity.

But I want to begin by positing a question, which should be the first question considered in any serious discussion on our national retirement policy and the question is this: what do we want a national retirement policy to do? There are two plausible answers to this question (with a vast continuum between the two answers): first, we might want merely to provide individuals with tools—such as financial education, access to annuities, etc.—to help them individually prepare financially for retirement; or second, we might want to do all we can to ensure that all American workers have secure and adequate financial resources when they leave the workforce. We can conceptualize these competing visions as ones of individual verses shared responsibility. I tilt strongly toward the latter vision of retirement policy as the more humane and economically compelling.

But section 401(k) plans and other voluntary savings programs that are currently the backbone of our so-called retirement system advance neither of these versions of retirement policy very well. It is not that there is anything inherently wrong with tax-incentivized savings plans and section 401(k) plans have worked well for many as savings vehicles and as supplemental retirement plans. But as primary retirement plans, Section 401(k) and other voluntary savings plans suffer a long list of maladies:
(1) Section 401(k) plans are voluntary, so individuals must choose to participate (or in automatic enrollment plans, choose not to choose to not participate) and additionally must determine their level of savings.

(2) Section 401(k) plans typically require individual employees to manage their investments, allocating their contributions among various investment options. Evidence suggests that many employees allocate in suboptimal ways and that they fail to periodically reevaluate their goals or rebalance their portfolios.

I want to note here that there are also some hidden costs associated with employee management of assets, entirely apart from the investment competence issue. First, the cost of providing individualized investment education and advice to employees is a cost that must be borne by someone somewhere. And there is also a steep indirect tax on participants in terms of time and anxiety that is paid by participants. And time, like carbon-based sources of energy, is a non-renewable resource.



(3) Section 401(k) plans often impose high administrative and investment fees on participants.

(4)   Section 401(k) plans do not lock in savings until retirement and have been plagued by pre-retirement leakage. Moreover, the Internal Revenue Code imposes a 10% penalty tax on early distributions, which has amounted to a tax on those of modest means who are willing to pay the tax to access assets.

(5) Section 401(k) plans (and other qualified plans) are subsidized through substantial tax subsidies, which are sensitive to marginal tax rates. It is estimated that 70% of the tax benefits are accrued by the top quintile of taxpayers by income, and more than 8% by the top 1% of taxpayers. This is both inefficient—it provides a wasted incentive for people who are most likely to save for retirement without government paternalism—and an inequitable distribution of public resources.

(6) Section 401(k) distribution options typically require participants to manage the de-accumulation of plan assets, which creates a Hobson's choice for some participants: drawing assets down too quickly, thus running the risk of depleting resources prior to death; or drawing assets down too slowly, thus running the risk of sacrificing some lifetime consumption.

(7) Section 401(k) plans provide only modest protections for spouses of plan participants, who can often empty out their account without spousal consent.

To summarize, section 401(k) plans are not particularly well-suited as vehicles for retirement security. They do not cover enough people or provide adequate retirement resources for many of the people they do cover; they are not sufficiently effective at preserving assets until retirement; they rely on inexperienced workers to make sophisticated investment decisions; and they inefficiently concentrate investment and longevity risk on individuals.

A Martian who landed on earth to study our retirement system might well wonder how American earthlings came to design section 401(k) plans as the principal instrument for providing retirement security for workers, since they seem so poorly suited to that task. The answer is that section 401(k) plans were not the result of intelligent or any other type of design: Congress added Section 401(k) to the Internal Revenue Code in 1978 primarily to work out rules to allow employees—particularly in the financial sector—to have a choice of taking a year-end bonus in cash or deferring all or part of it into a profit-sharing plan. No one in Congress or elsewhere envisioned that section 401(k) plans would in two decades become the principal mechanism for Americans to save for retirement. But over time, employers found section 401(k) plans less expensive than traditional pension plans and employees, particularly in periods of economic bubbles, did not appreciate the significant risks they were being asked to bear.

So what should we do now to improve retirement security? The emerging orthodoxy, which I believe is far too little far too late, is two-fold: first, make some engineering adjustments to section 401(k) plans to make them function more like defined benefit plans; and second, stimulate greater retirement preparation (particularly for middle and lower income workers), through automatic-enrollment payroll deduction IRAs and an enhanced savers credit.

I want to begin here by stressing that I am not against such reforms—that would be akin to taking a stand against motherhood and apple pie. But such reforms are not the Polaris star that we can follow to a sound national retirement policy—they can only make marginal improvements to a system that is fundamentally broken. In the long run, we can and should do better.

Let’s look at some of the proposed reforms:

First, the proposals for more automatic enrollment in 401(k) plans and payroll-deduction IRAs will not result in universal coverage. And when we talk about automatic enrollment, we tend to discuss it in its purest form rather than in the form it is likely to take after emerging from the legislative sausage factory. For example, recently proposed legislation would exempt employers of fewer than 10 employees from mandatory payroll deduction IRAs—that exemption excludes 17 million employees from payroll-deduction IRAs right off the bat.

And increased coverage through automatic enrollment does not solve the leakage problem, which can be particularly severe for moderate income workers facing pressing immediate financial need.

And those who are automatically enrolled and who do not consume their savings before retirement still would be required to manage their assets and still would be subject to substantial investment risk.

Another set of reform proposals are aimed at these investment management problems: better education, more investment advice, and default investment vehicles such as target date funds. But education and advice impose real costs and will not work for everyone, and target date funds impose high fees on participants and, as we learned recently, do not immunize older Americans from substantial investment losses at a time that they can least afford them.

Turning to the problems of longevity risk, there have been various proposals to increase the use of annuities and other insurance products to protect against such risk, but moral hazard; high fees; variations in life expectancy that correlate with race, gender and age; and various behavioral factors, make me skeptical that "nudge" type strategies will have more than marginal effect on the voluntary use of insurance products to hedge against longevity risk. And in any event, the cost of an annuity is highly sensitive to monthly fluctuations in long-term interest rates, subjecting participants to substantial additional risk depending on when they convert an account balance into an annuity.

And payroll-deduction IRAs may not be the panacea we hope for: experience with regular IRAs suggest that those with modest incomes may opt out and high employee turnover among smaller employers may make such IRAs administratively problematic. And I suspect that such IRAs may serve some men and women more as rainy-day piggy banks than true retirement savings vehicles.

Expanding the saver's credit is a fine idea, but we don't yet have much evidence on how effective such a credit will be. I suspect that the biggest take-up rate will be among young educated people starting their careers rather than workers who will actually have moderate incomes throughout their careers; and I also suspect that some significant part of new savings generated by a saver's credit will eventually leak out of plans. We should also be aware that much of the tax benefit from qualified plans comes from the tax deferral on inside build-up, which means that the saver's credit does not solve the problem of the upside-down value of the tax subsidy.

Despite these concerns, these proposals share a singular virtue: they can be enacted rather quickly. But there is a danger and the danger is this: if after adopting such measures we are able to detect modest improvement to our system, we may give ourselves a collective pat on our collective shoulders, declare victory, and avoid a difficult discussion, but one that is essential to the welfare of most Americans: how to re-envision retirement policy to ensure that all working Americans can retire with a secure and adequate source of income. That is why it is important for us to begin that longerterm discussion now and recognize that the easy reforms now being proposed are insufficient to create a sensible long-term national retirement policy. The hard work must follow.

There are really only two long-term answers: some sort of hybrid system, with mandated minimum participation; pooled, professionally managed investments; no pre-retirement leakage; mandatory annuitization of at least a portion of retirement wealth; adequate survivor benefits; and some protections against severe investment loss. The other solution would be to expand benefits under the Social Security system. As you probably have heard from Stephen Albrecht, Retirement-USA is having a conference on October 21st to consider both types of proposals.

And as a footnote, we should of course do everything we can to preserve defined benefit plans where they still exist and expand them in those sectors of the economy where they still can work well. I have such a plan at the University of Alabama and I am grateful more and more every day.