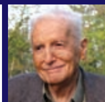

www.Retirement-USA.org

RETIREMENT USA

Working for a ***Universal***, ***Secure***, and ***Adequate*** Retirement System

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OCTOBER 21, 2009

CONFERENCE REPORT

RETIREMENT USA

Working for a *Universal*, *Secure*, and *Adequate* Retirement System

TOWARD A UNIVERSAL, SECURE, AND ADEQUATE RETIREMENT SYSTEM

by Monique Morrissey

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Foreword

The American dream of a secure retirement is disappearing for millions of workers and their families. Retirement USA is committed to working toward a new retirement system that, along with Social Security, will provide a *universal*, *secure*, and *adequate* income for future retirees. The organizations participating in Retirement USA share a common set of beliefs:

- **America needs a new approach to retirement security.** Even before last year's stock market crash, our existing patchwork system was failing to provide secure and adequate retirement income for all too many workers.
- **Retirement security should be a shared responsibility.** The current system puts far too much responsibility on workers. Employers and government must also do their part.

- **We shouldn't fix what isn't broken.** While our existing retirement system is failing many workers, millions of other workers are covered by plans that provide secure and adequate retirement income for them and their families. These plans must be preserved and strengthened.
- **We cannot wait any longer.** While other urgent concerns, particularly health care, presently dominate the national debate, it is not too early to begin working on a new approach to retirement security.

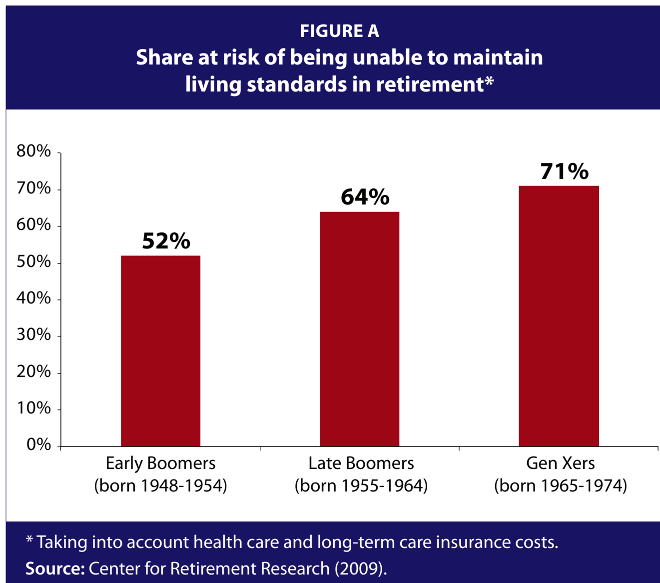
Retirement USA is not advancing a specific proposal at this time. Instead, we are offering a set of 12 principles, which we view as the fundamental building blocks for a new retirement system that, together with Social Security, will ensure a secure and adequate retirement system for all American workers. The 12 principles have already spurred a range of new and creative proposals that we hope will be the beginning of a national discussion about the need for a far-reaching, comprehensive approach to retirement security. We invite everyone concerned about this issue to join this discussion.

Retirement USA

Conveners: AFL-CIO, Economic Policy Institute, National Committee to Preserve Social Security and Medicare, Pension Rights Center, Service Employees International Union.

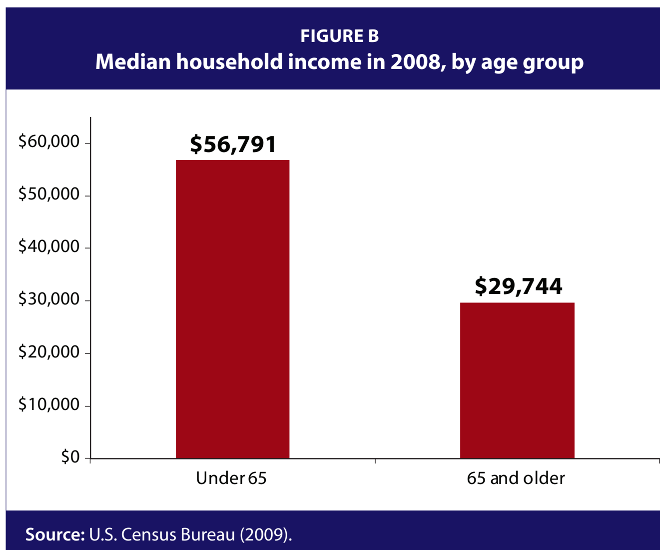
Supporters of the principles: Alliance for Retired Americans, American Association of University Women, Association of BellTel Retirees, Inc., American Federation of State, County and Municipal Employees, Campaign for America's Future, Dēmos, National Association of Senior Legal Hotlines, National Caucus and Center for the Black Aged, Inc., National Consumers League, National Women's Law Center, OWL – The Voice of Midlife and Older Women, United Food and Commercial Workers International Union, Wider Opportunities for Women.

INTRODUCTION



A historic reversal

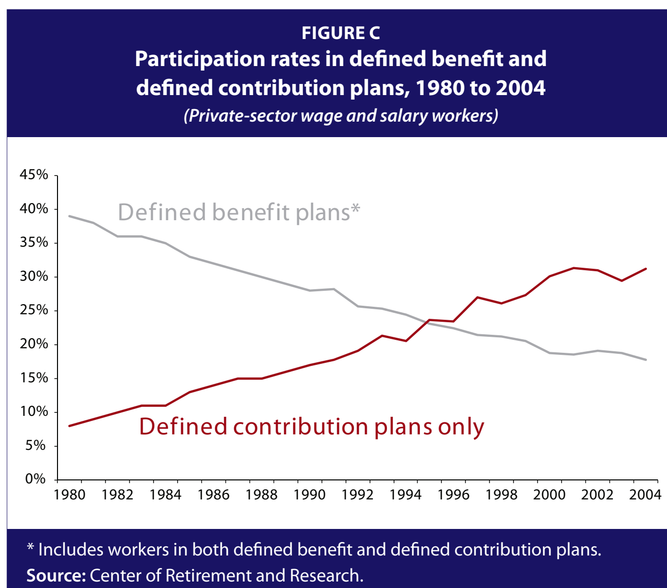
Most Americans working today will enjoy less retirement security than their parents (**Figure A**),[1] a reversal linked to the decline in employer-provided pensions and exacerbated by the stock market collapse, which slashed the incomes of millions of retirees and forced many older workers to push back their retirement.



All workers need a pension

Social Security guarantees a secure lifetime benefit to nearly all retired Americans,[2] but it does not provide sufficient income to maintain their pre-retirement standard of living in retirement. The average Social Security retiree benefit is below $14,000 a year,[3] less than a minimum-wage income for a full-time worker. The median income of older households is less than $30,000, roughly half that of younger households (**Figure B**).[4]

Shifting the burden to workers



Fewer than half of all workers participate in a retirement plan at work. Meanwhile, millions with 401(k)-style plans have too little saved in them. These plans were initially viewed as a way to supplement traditional defined benefit pensions, but are now more often the only retirement plan workers have, if they have one at all (**Figure C**). Thus, the burden of achieving retirement security has shifted from employers onto workers, who bear all of the risk and most of the cost of 401(k)s.

Patchwork or comprehensive solution?

The market downturn has highlighted the serious shortcomings of our private retirement system. But this patchwork system was full of holes even before the downturn. The question is whether we should keep adding patches, or whether we should rethink the current system as a whole. Defined benefit plans remain the soundest vehicles for building and safeguarding retirement security and they must be preserved and strengthened. However, in recent years, the focus has been on adding tax incentives and promoting incremental reforms designed to help individuals make better saving and investment decisions in individual accounts. Though many of these reforms are sensible, they fail to address the most serious flaws in the system. They suggest that workers are to blame for their predicament, when even those who save diligently and invest carefully are struggling. They also accept that the role of employers is merely to facilitate saving by employees.

Principles for reform

Three overarching goals should guide policy makers in designing a future retirement system: *universality*, *security*, and *adequacy*. In order to meet these goals, a plan must adhere to the following 12 principles:

CORE PRINCIPLES

Universal coverage. Every worker should be covered by a retirement plan in addition to Social Security. A new retirement system should include all workers unless they are in plans that provide equally secure and adequate benefits.

Secure retirement. Retirement shouldn't be a gamble. Workers should be able to count on a steady lifetime stream of retirement income to supplement Social Security.

Adequate income. Everyone should be able to have an adequate retirement income after a lifetime of work. The average worker should have sufficient income, together with Social Security, to maintain a reasonable standard of living in retirement.

SUPPORTING PRINCIPLES

Shared responsibility. Retirement should be the shared responsibility of employers, employees and the government.

Required contributions. Employers and employees should be required to contribute a specified percentage of pay, and the government should subsidize the contributions of lower-income workers.

Pooled assets. Contributions to the system should be pooled and professionally managed to minimize costs and financial risks.

Payouts only at retirement. No withdrawals or loans should be permitted before retirement, except for permanent disability.

Lifetime payouts. Benefits should be paid out over the lifetime of retirees and any surviving spouses, domestic partners, and former spouses.

Portable benefits. Benefits should be portable when workers change jobs.

Voluntary savings. Additional voluntary contributions should be permitted, with reasonable limits for tax-favored contributions.

Efficient and transparent administration. The system should be administered by a governmental agency or by private, non-profit institutions that are efficient, transparent, and governed by boards of trustees that include employer, employee, and retiree representatives.

Effective oversight. Oversight of the new system should be by a single government regulator dedicated solely to promoting retirement security.

Outline of a new system

This report is organized around the three core principles—universality, security, and adequacy. It describes the shortcomings of the current system and presents a range of options for reform based on experiences in other countries. These examples are not meant to suggest an endorsement of any particular approach. However, some features are essential:

- All jobs must come with benefits that provide a steady retirement income for life. As currently structured, Social Security is not enough. Relying primarily on tax incentives to encourage employers to provide benefits or individuals to save is ineffective and helps those who least need it.
- Investment and longevity risks must be spread, not just shifted from employers to workers. Here too, government can play a role, and so can multiple-employer plans.
- Responsibilities must be shared. A do-it-yourself system does not work, but neither does a system that places the entire burden on employers. Government must also be involved, especially to offset the cost of contributions for lower-income workers.
- Finally, the key to achieving adequacy is maintaining steady contributions and preserving funds for retirement by preventing pre-retirement loans and withdrawals and limiting fees.

TYPES OF RETIREMENT PLANS

Defined benefit pensions[5]

Traditional defined benefit pensions, the most common type of retirement plan until the 1990s, provide retirees and their spouses with a guaranteed income for as long as they live. Retirement benefits are determined in advance, typically based on an employee's years of service and final average salary in the years before retirement. Once earned, benefits are irrevocable and guaranteed, up to a limit, by the federal Pension Benefit Guaranty Corporation (PBGC). Defined benefit pensions are usually funded by employers, though some public sector workers contribute to their pensions. Unlike 401(k)-type plans, they generally provide benefits to all full-time workers in a line of business.

Defined contribution plans[6]

The most common kinds of defined contribution plans, such as 401(k)s, are savings plans set up and administered by employers but with individual savings accounts managed by participants. Participants choose from a number of investment options. Employers are not required to contribute to these accounts, though a common arrangement is an employer match equal to half the employee contribution up to a specified level (often 6%).[7] Instead of a monthly pension check, participants typically receive a lump sum when they retire, the size of which depends on how much they set aside, their investment return, and whether they borrowed or cashed out any of the money in their accounts. Congress never intended 401(k)s to serve as primary retirement plans for ordinary workers. Congress added Section 401(k) to the Internal Revenue Code in 1978 primarily to give financial sector employees and others who receive year-end bonuses the option of deferring these bonuses into profit-sharing plans. Over time, however, employers began using these plans to offer tax-advantaged retirement savings plans to other employees as well.

Individual Retirement Accounts (IRAs)

Traditional IRAs are tax-favored savings plans available to individuals who do not participate in an employer plan or, if they do, whose incomes do not exceed certain thresholds. However, the distinction between employer-sponsored and individual plans is blurry because employers do not necessarily contribute to 401(k)s and because most funds in IRAs have been rolled over from 401(k)s. In addition, some types of IRAs are specifically designed to allow employer contributions.

Cash balance plans

Cash balance plans are hybrid plans with features common to both defined benefit pension and defined contribution plans. Like defined benefit pensions, they are employer-provided plans with pooled and collectively managed funds. Benefits, however, are communicated to employees as individual account balances. Annual benefit accruals are a fixed share of earnings for all workers and earn a specified rate of return, which may be fixed or variable (tied to returns on Treasury securities). Though some participants opt to annuitize their balances at retirement, benefits are more commonly paid out in lump sums.

UNIVERSALITY

» ***Principle: Universal coverage***

Every worker should be covered by a retirement plan. A new retirement system that supplements Social Security should include all workers unless they are in plans that provide equally secure and adequate benefits.

What is a universal system?

A universal retirement system is one where all jobs come with retirement benefits and all workers participate.[8] The United States is unusual among industrialized countries in its reliance on tax incentives to encourage employers to provide benefits and individuals to save. While some employers provide secure and adequate benefits, the majority put most of the responsibility on workers or offer nothing at all.

Achieving universal coverage

No nation yet has been able to craft from tax incentives, education, and workforce management concerns a retirement system that covers all or even most of its workers. In the United States, after half a century of experience, employer-based retirement plans cover fewer than half of all private sector workers. Furthermore, employers who provide secure pension benefits must compete against those who do not, a problem that does not occur in countries where such benefits are mandated or provided by the government. Only systems that are universal by design, such as Social Security or a mandatory pension system, can provide secure and adequate retirement benefits for all workers and their families.

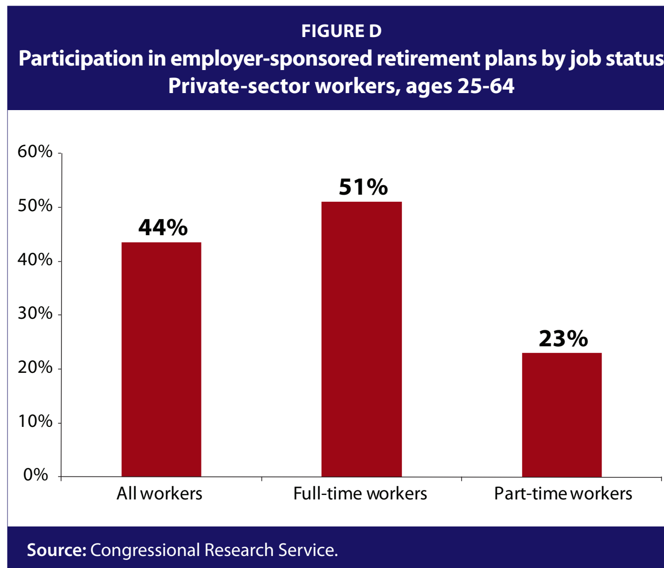
Carve-out for secure pensions

Although the situation is bleak for many workers, one in five full-time private-sector workers still has a secure defined benefit pension.[9] Many of these are union members who have forgone wage increases in order to keep these plans, which are tailored to different workforces and also designed to meet the specific needs of different employers. Any new retirement system should preserve and strengthen existing secure and adequate retirement plans.

Social Security is largely universal, but not sufficient

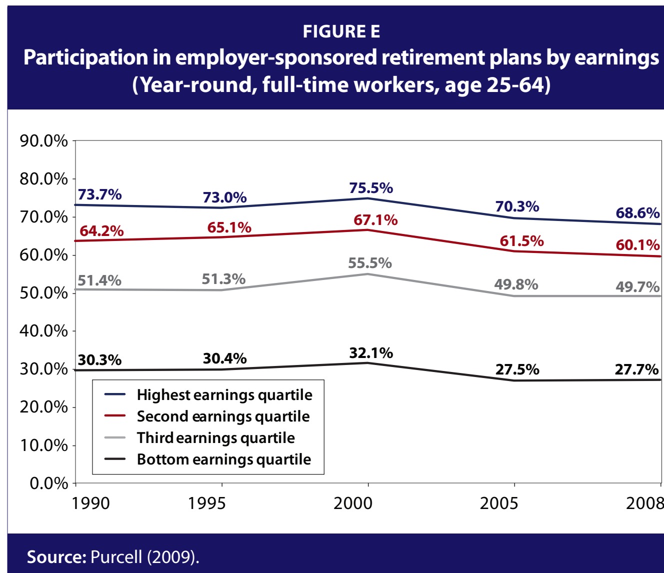
Social Security is the cornerstone of our retirement system, and two-thirds of retirees rely on Social Security for more than half of their retirement income.[10] But the average Social Security benefit replaces less than 40% of pre-retirement earnings, and the replacement rate will continue to decline as scheduled benefit cuts take effect (an increase in the normal

retirement age from 65 to 67, equivalent to an across-the-board benefit cut, is gradually taking effect over a 22-year period beginning in 2000).[11]



Employer-based plans have low participation rates

Social Security was designed to provide a foundation, to be supplemented by employer pensions and savings. But fewer than half (44%) of private-sector workers participate in an employer-sponsored plan (**Figure D**),[12] and most of these are 401(k)-style plans that are neither secure nor adequate.



Low-income workers lack coverage

Low-income workers are the least likely to have retirement benefits. Only 28% of full-time workers in the bottom fourth of the earnings distribution participate in a retirement plan at work (**Figure E**),[13] and most will reach retirement age without any employer-sponsored retirement coverage over their working lives.[14] These workers are both less likely to be covered under a plan

and to participate if they are covered.

The United States trails other countries in retirement security

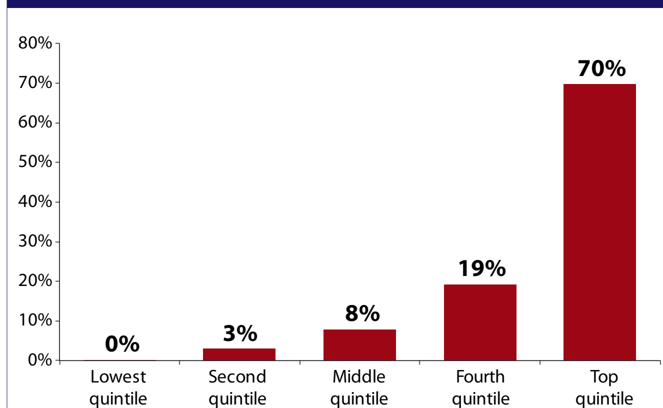
The United States differs from most industrialized countries in the low level of benefits provided by our Social Security system and our reliance on employers to voluntarily provide pensions or sponsor retirement savings plans to supplement Social Security. It has one of the lowest replacement rates from universal retirement systems among the 30 member countries of the Organisation for Economic Co-operation and Development (OECD), a measure that includes social security systems as well as other universal or mandatory pensions. Since employer-based plans are not filling the gap, the United States is also among the OECD countries with the highest share of seniors with less than half the median income (**Table 1**).[15]

TABLE 1
United States lags other countries in retirement security

10 OECD countries with lowest replacement rates for low earners	10 OECD countries with lowest replacement rates for median earners	10 OECD countries with highest share of seniors with incomes below half the median
Japan (51%)	Mexico (38%)	Korea (45%)
Mexico (56%)	Japan (40%)	Ireland (31%)
United States (58%)	United Kingdom (44%)	Mexico (28%)
Germany (59%)	Ireland (46%)	Australia (27%)
United Kingdom (64%)	**United States (47%)**	**United States (24%)**
Slovak Republic (66%)	New Zealand (47%)	Greece (23%)
Ireland (68%)	Korea (49%)	Spain (23%)
Korea (69%)	Australia (59%)	Japan (22%)
Switzerland (69%)	Germany (61%)	Switzerland (18%)
Portugal (73%)	Finland (62%)	Portugal (17%)

Source: OECD (2009).

FIGURE F
Tax benefits for individual account plans, by income quintile



Source: Burman et al. (2004).

Taxpayers pay a high price to benefit those already secure

The current system not only performs poorly for many workers, it also comes at a high cost to taxpayers. Subsidies for retirement plans are one of the three biggest categories of tax expenditures, along with subsidies for health care and homeownership. The Office of Management and Budget estimates that the cost of tax breaks for contributions to 401(k)-type plans was $72 billion in 2008.[16] The tax benefits to those who participate in defined contribution plans are tied to a participant's income tax rate. As a result, lower-income taxpayers receive modest or no subsidies for each dollar contributed, while more affluent workers, who would save without a tax subsidy, receive the most generous tax benefits.[17] Moreover, higher-paid workers are more likely to participate in 401(k)-style plans. As a result, 70% of the tax breaks for individual account plans go to the top 20% of households by income, according to the Tax Policy Center (**Figure F**).[18]

SECURITY

» ***Principle: Secure retirement***

Retirement shouldn't be a gamble. Workers should be able to count on a steady lifetime stream of retirement income to supplement Social Security.

What is a secure system?

A secure retirement system is one where workers know that the benefits they are counting on will be there when they retire, and will last over their lifetime and those of their spouses or partners. Our current system is not secure because participants in 401(k)-style plans can see their account balances buffeted by negative investment returns and can outlive their retirement savings.[19] Workers with traditional pensions typically fare better, but are still at risk of losing coverage before retirement and receiving lower-than-anticipated benefits.[20]

Impact of market collapse

The recent plunge in the stock market vividly illustrates the financial risk that workers and retirees bear. The market lost more than half of its value between October 2007 and March 2009,[21] draining more than $2 trillion from defined contribution plans.[22] With two-thirds of account balances invested in equities,[23] the average participant saw a third or more of his or her retirement savings evaporate in little over a year. Though the market has since rebounded, account balances are still well below their peak at time of writing.

» *Principle: Pooled assets*

Contributions to the system should be pooled and professionally managed to minimize costs and financial risks.

Traditional pensions shield workers from investment risks

Participants in defined benefit pensions do not generally face investment risks unless their plan becomes underfunded and their accrued benefits exceed amounts guaranteed by the Pension Benefit Guaranty Corporation. In defined benefit plans, assets are managed by professional asset managers who pool the funds of workers who retire during bull and bear markets. By spreading risks across generations, they are able to provide benefits based on earnings and years of service rather than market performance.

401(k) participants must choose between high risks or low returns

Individual investors may have dramatically different outcomes depending on whether they retire during bull or bear markets. Investing only in fixed-income securities may seem to be a way for 401(k) participants to avoid investment risk, but this strategy means not only forgoing the benefits of diversification but also locking in low returns rather than simply risking them. Most experts therefore recommend that individual investors maintain balanced portfolios with both stocks and bonds. However, because individual accounts expose participants to risks that defined benefit plans can spread across generations, individual investors are forced to choose between higher risks, lower returns, or some combination of the two.[24]

Even cautious investors face risks

Even 401(k) participants who make relatively conservative investment allocation decisions over a long time horizon are subject to unacceptable risks. Gary Burtless of the Brookings Institution has estimated that a 401(k) participant who contributed 4% of her wages over 40 years and invested the funds in a portfolio split equally between long-term government bonds and stocks would be able to replace a quarter of her pre-retirement earnings if she retired in 2008. This replacement rate is only half as much as a similar worker who retired in 1999, but much better than a worker who retired in 1974, who would have a dismal replacement rate of only 18%.[25] Similarly, simulations by Patrick Purcell of the Congressional Research Service indicate that 401(k) participants who adopt a lifecycle approach—gradually reducing their exposure to stocks as they approach retirement—also face a significant risk of not being able to maintain their standard of living in retirement.[26]

A nation of financial analysts?

Participants in 401(k) plans must make their own investment decisions and bear the risk of adverse investment performance. But most 401(k) participants do not have the financial expertise to manage their investments. It has been extensively documented that participants fail to optimally diversify and often make poor investment decisions. They tend to have an all-or-nothing approach to risk, with 21% investing more than 80% of their 401(k) balances in stocks, either directly or through mutual funds, and 38% investing none in stocks.[27] And despite the lessons of Enron, one in 10 401(k) participants still has funds invested in his or her employer's stock—often a significant amount—in part because employers are still allowed to contribute company stock instead of cash to these accounts.[28]

» *Principle: Lifetime payouts*

Benefits should be paid out over the lifetime of retirees, and any surviving spouses, former spouses, or domestic partners.

Insuring against longevity risks

Pooling also allows defined benefit pension funds to insure individuals against the risk of outliving their savings, paying benefits over the lifetimes of retirees and their spouses.[29] Unlike 401(k) participants and other individual savers, who need to prepare for the possibility that they might live to age 90 or even 100, pension funds need only set aside enough to cover average life-spans. Lifetime pensions also address the problem that many people underestimate their chances of living a long time and spend down their savings too quickly.

Adverse selection in annuity markets

401(k) participants can convert account balances into lifetime streams of income at retirement by purchasing annuities. However, this is expensive because insurance companies assume that only someone with a higher-than-average life expectancy would purchase a life annuity. This problem is exacerbated by the fact that the annuities market is difficult for non-experts to navigate, so unsophisticated investors can be at the mercy of unscrupulous sales practices. The situation is analogous to health insurance, where similar problems cause individual plans to be much costlier than group plans.[30] For this reason, many countries require annuitization for most retirement account balances.[31] Even the United Kingdom, which is similar to the United States in its reliance on voluntary defined contribution plans, requires that at least 75% of account balances be annuitized.[32]

Pension sponsors take on long-term liabilities

While 401(k) plans are risky for workers, traditional defined benefit plans require employers to take on long-term liabilities. Contributions can vary significantly from year to year depending on the returns earned on pension assets and other factors.[33] Although benefits are funded in advance, and pooling can insure against some financial and longevity risks, employers who sponsor traditional pensions still face the possibility of a sustained market downturn or a faster-than-anticipated increase in group life expectancy. This is a particular challenge for small businesses, which are rarely in a position to promise benefits decades into the future. But even large employers may find themselves in a bind following a market downturn, especially those in shrinking industries or where productivity gains have reduced the ratio of active workers to retirees.

Multiple-employer plans

Just as financial risks can be minimized by diversifying across asset classes and across time, multiple-employer plans can weather the ups and downs of individual employers. Multiple-employer plans, designed to be portable among participating employers, often represent workers in sectors with smaller, transient companies such as the construction industry, and in occupations with mobile workers such as college professors. Most workers in the Netherlands participate in multiple-employer defined benefit pensions.

The future is uncertain

No one knows if future stock and bond returns will match historical averages or whether inflation has been permanently tamed. Likewise, longevity is hard to predict, affected by behavioral trends and medical advances, among other factors. This argues for making conservative assumptions and adopting prudent funding and investment practices. It may also call for mechanisms for intergenerational risk sharing, lest one generation's retirement security become another's financial burden.[34] However, as a policy matter, in contemplating any new system for retirement income, it may be preferable to put more risk on workers than on retirees, whose options are more limited.

MECHANISMS FOR SHARING RISK

The key to a robust system is flexibility and risk sharing. Though participants should have secure enough benefits to be able to plan for retirement, this does not necessarily mean that they should bear no risks at all. Plans designed to share risks between employers and employees are often hybrid plans that borrow from both the defined benefit and defined contribution models. Three of these kinds of plans—in the Netherlands, Sweden, and Switzerland—are briefly described below.[35] Risks may also be assumed by the government, which can, for example, play a role in smoothing risk across generations, either directly—in government-administered plans—or by providing guarantees.

Collective defined contribution plans: The Netherlands

Trust built up over years can make it easier for employers, workers, and retirees to negotiate changes. The Netherlands, a country with strong unions and a history of cooperative labor-management relations, has a tradition of collectively bargained defined benefit pension plans that cover most citizens. In the last decade, a new type of plan has been introduced—the collective defined contribution plan—which balances the need for secure lifetime benefits with stable employer contributions. In the event of a severe or prolonged market downturn, balance may be restored three ways: first, though benefits are normally indexed to wage increases and inflation, indexation may be suspended for both active workers and retirees.[36] Second, under more extreme circumstances, even benefit accruals may be trimmed. Finally, though employer contributions are fixed over a specific time horizon (typically five years), these can be increased in the next period.[37] In exchange for sharing some of the risk with participants, Dutch employers pay higher contributions into these plans than they do into defined benefit pensions.

Notional defined contribution plan: Sweden

The Swedish notional defined contribution plan[38] is a pooled and collectively managed system with a benefit structure similar to cash balance plans in the United States, except that the rate of return is set equal to real wage growth and benefits are annuitized at retirement and adjusted for changes in life expectancy. These features help stabilize the system, ensuring that benefits keep pace with the standard of living

but that increases in life expectancy do not create a shortfall. However, the system may still become underfunded in the wake of a market downturn, so the system is designed so that indexation of benefits is automatically suspended when the system becomes underfunded.[39]

Guaranteeing investment returns: Switzerland

Another way to address the problem of financial risk is to guarantee a minimum rate of return, as TIAA-CREF has been doing voluntarily for 90 years in the United States[40] and as hybrid plans in Switzerland[41] are required to do. The government can potentially perform this smoothing function for more risk-averse investors with shorter time horizons—whether individuals or pension funds.[42] Such guarantees allow participants to count on a minimum rate of return while potentially reaping some of the benefits of investing in diversified portfolios that include stocks. The goal is to smooth returns over time, so that even if the guarantee is fairly low—it is currently 2% in Switzerland—workers approaching retirement know their retirement savings are secure. The challenges lie in designing a mechanism that allows for excess returns to be distributed while maintaining a cushion for stability, and in choosing a guarantee that is high enough to provide a meaningful floor yet low enough to be sustainable (Switzerland recently had to lower the guarantee in the wake of the market downturn).[43]

Investment risk in a public system: The Canada Pension Plan

A related challenge is faced by government plans that need to achieve targeted rates of return over the long term. The Canadian social security system includes a tier—the Canada Pension Plan[44]—that is invested in a diversified investment portfolio, similar to private pension plans in the United States. The long-run return on these assets must be at least 4.2% to meet benefit obligations without raising contribution rates. The Canada Pension Plan automatically raises contributions and suspends cost-of-living adjustments for retirees when the plan becomes underfunded, unless the system's stewards institute rate increases or benefit cuts. Making retirees bear the brunt is intended to spur policy makers to action.

Tying benefits to life expectancy

Another long-term risk that cannot be completely eliminated through diversification or hedging is cohort longevity risk—the risk that life expectancy at retirement will increase faster than pension actuaries have projected. One option for both public and private pensions is to link benefits to life expectancy in order to keep the system in balance.[46] However, if benefits are already inadequate, it is better to increase revenues than to cut outlays. Because life expectancy is increasing faster among higher-income workers in the United States,[47] tying benefits to average life expectancy would also tend to shorten the retirements of low-income workers, who are also physically less able to keep working into their late 60s. In addition, such measures make it more difficult for workers to plan for retirement and may reduce the appeal of defined benefit pensions.

ADEQUACY

» *Principle: Adequate income*

Everyone should be able to have an adequate retirement income after a lifetime of work. The average worker should have sufficient income, together with Social Security, to maintain a reasonable standard of living in retirement.

What is an adequate system?

An adequate retirement system maintains retirees above a basic needs benchmark, such as a poverty measure[48] or minimum wage income, or alternatively, replaces a share of pre-retirement income to prevent a significant decline in living standards at retirement. Most experts believe that many retirees may be able to maintain their standard of living with a replacement rate below 100% (typically 70% or higher for middle-income workers) because certain expenses are lower after retirement.[49] Most OECD countries attempt to do both—provide a basic benefit and achieve a target replacement rate—often through separate pension tiers. Thus the net replacement rate, after taxes, for OECD countries is 72% for median earners and 82% for low earners (those earning half the median income). The United States meets neither type of adequacy standard, because, according to OECD estimates, the net replacement rate in the United States is 47% for median earners and 58% for low earners.[50]

Pensions cover fewer workers, and 401(k) balances are very low

Workers who participate in defined benefit pension plans for most of their careers are usually able to maintain their living standards at retirement. But traditional pension plans cover fewer and fewer workers in the private sector. Meanwhile, 401(k) account balances are very low. In 2007, near the peak of the stock market, half of households[51] approaching retirement (age 55-64) had less than $98,000 in retirement savings accounts[52]—and that is if they had an account in the first place (the median account balance for *all* households in this age group was less than one fifth of that amount).[53] This amount, $98,000, is enough to purchase a joint and survivor annuity worth $5,400 a year, replacing just 10% of these households' median income.[54]

A fraction of what is needed

Many older workers can also count on receiving defined benefit pension benefits in retirement. But even younger workers, who are less likely to be covered by defined benefit pensions, have much lower 401(k) account balances than they will need to maintain their standard of living in retirement. Alicia Munnell and Annika Sundén of the Center for Retirement Research have estimated that account balances are about 20-40% of what participants of all ages should have in their retirement accounts based on age and earnings benchmarks.[55] Similarly, the Government Accountability Office has projected that defined contribution plans will replace about 22% of earnings at retirement, with 37% of workers reaching retirement age with zero plan savings.[56] These estimates predate the market's decline.

Fees drag down 401(k) returns

The Center for Retirement Research estimates that net investment returns were a full percentage point higher for defined benefit pension plans than for 401(k)-type defined contribution plans between 1988 and 2004, despite a lower concentration of funds invested in equities.[57] With compounding, this small-sounding difference can translate into a 30% larger nest egg at retirement.[58] One reason for this poor performance is that most 401(k) participants bear much higher investment costs than those paid by defined benefit pension plans. A survey of 80 providers found that annual fees could range from about 0.5% to 2.5% of assets for 401(k) plans.[59] Employers have little incentive to look for low-cost providers since these fees are mostly passed on to participants, and weak disclosure rules mean that most participants are unaware of how much their investment returns are being eroded. An individual account system is also inherently more costly to manage than pooled funds, though defined contribution plans where funds are pooled and professionally managed have lower fees.

Inefficiency greatly increases costs

Because 401(k)s are an inefficient way to fund retirement, contributions must be nearly twice as high to achieve comparable results.[60] To attain a 40% replacement rate (80% with Social Security) for a worker who retires at 65 after 40 years of work, employer and employee contributions to a 401(k) would need to equal 14.5% of earnings, nearly double the 7.7% contribution rate required for a worker in a traditional pension. This difference is based on three assumptions: that pooled and professionally managed assets yield higher returns net of investment and administrative fees (7% rather than 6%); that 401(k) participants will gradually reduce stock allocations until they are invested only in fixed-income securities with a 5% yield at retirement; and that individual savers need to prepare for the possibility of a longer-than-average life expectancy at retirement (25 years rather than 21).[61]

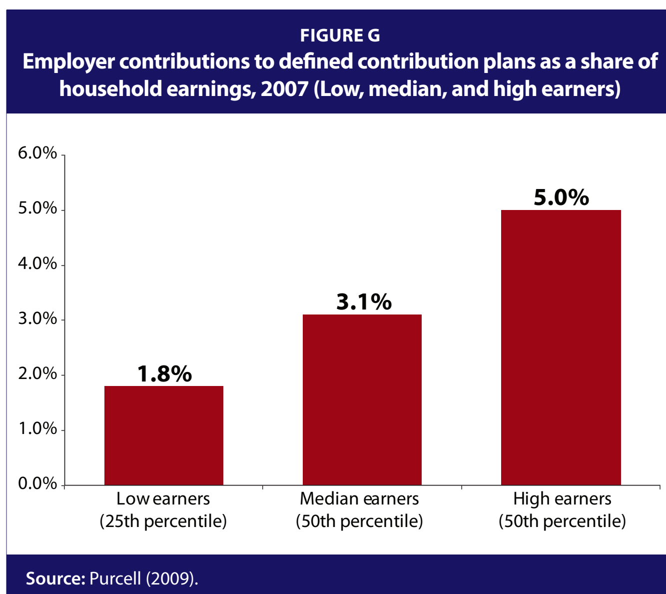
» *Principle: Required contributions*

Employers and employees should be required to contribute a specified percentage of pay, and the government should subsidize the contributions of lower-income workers.

Spotty and unequal contributions

Employers and employees can reduce or stop 401(k) contributions at any time, and many companies have suspended their 401(k) match in the current downturn.[62] Employer-provided retirement benefits also tend to magnify inequality, since low-income workers are more likely to work for employers who offer less generous benefits or no benefits at all.[63] In addition, low-income workers can less afford to participate even if they are offered a plan. As a result, high earners receive employer contributions that are more than double, as a share of earnings, the contributions received by low earners (**Figure G**).[64]

FIGURE G
Employer contributions to defined contribution plans as a share of household earnings, 2007 (Low, median, and high earners)



Source: Purcell (2009).

Making retirement affordable

As noted earlier, most of the tax benefits of 401(k)-style plans go to wealthy households. Whether or not the federal government needs to devote additional resources to retirement, current subsidies need to be more fairly distributed, because low-income workers can little afford additional contributions besides what they already pay into Social Security.[65] The Urban-Brookings Tax Policy Center estimates that the value of tax subsidies for private retirement plans is $875 per person, enough to fully cover a 5% contribution for workers earning up to $17,500 and to partly offset the cost of cost of contributions for workers making more than that.[66] Because tax subsidies are unequally distributed even among households in upper tax brackets, a more egalitarian subsidy would benefit the majority of taxpayers, not just those at the bottom of the income distribution.

» *Principle: Payouts only at retirement*

No withdrawals or loans should be permitted before retirement, except for permanent disability.

Pre-retirement leakages

Another problem with 401(k) plans is pre-retirement loans and withdrawals. In a voluntary system, attempts to discourage workers from tapping into funds before retirement must be balanced against the need to encourage them to contribute in the first place. One study found that nearly half (45%) of participants who changed jobs cashed out their 401(k) accounts,[67] and another found that nearly one in five (18%) eligible participants had loans outstanding from his or her account.[68] A recent report by the Government Accountability Office estimated that cash-outs, hardship withdrawals, and loan defaults drained nearly $84 billion from retirement accounts in 2006.[69] Such leakage also affects the retirement security of spouses, who may not agree with the decision to tap into savings. For these reasons, many countries, including the Netherlands and the United Kingdom, prohibit early withdrawals.[70]

» *Principle: Shared responsibility*

Retirement should be the shared responsibility of employers, employees, and the government.

Employer contributions

While defined benefit pensions are generally more cost-effective, employers may be able to reduce costs with 401(k) plans by shifting responsibility for retirement onto workers, who shoulder nearly two-thirds of the costs on average.[71] Employers also save money because many workers do not participate.[72] The United States and the United Kingdom[73] are unusual among advanced economies in that workers generally bear more than half of the cost of their retirement plans. Even in Australia and Ireland—two other countries that rely heavily or primarily on defined contribution plans—employers bear at least half the cost. In Ireland,

the average contribution to defined contribution plans is 10%, split equally between employers and employees.[74] In Australia, a 9% employer contribution to a defined contribution plan is mandatory.[75]

WHERE DO WE GO FROM HERE?

Advantages of comprehensive reform

Retirement USA is premised on a simple theme: *all* working Americans should receive a secure and adequate income in retirement. We need a comprehensive solution that addresses interrelated problems. For example, a system that places most of the burden for retirement saving on individuals will always have to wrestle with the problem of pre-retirement loans and withdrawals (simply plugging these leaks will not work, because many workers would stop contributing to the system). A system that relies on tax incentives to promote individual retirement savings will necessarily tend to favor high-income workers who can afford to save more and who benefit the most from these tax breaks. Conversely, a truly universal system would need to shield low-income workers from out-of-pocket costs or wage cuts.

Going on autopilot?

One option currently receiving much attention would be to require employers who do not offer retirement plans to set up automatic payroll deductions into individual account plans, using inertia to boost participation by having workers opt out rather than opt in. While companies that have voluntarily adopted automatic enrollment have been very successful at boosting participation in 401(k) plans, this does not tell us what would happen if all employers were required to adopt this approach. If payroll deduction became mandatory without a minimum employer contribution, many employers would likely reduce their existing match.[77] In fact, even employers who have voluntarily embraced automatic enrollment appear to have minimized costs by specifying low default contribution rates, with the result that the average deferral has fallen in many of these plans.[78] Another problem with automatic enrollment is that many low-income workers, who receive meager or no tax benefits and can little afford to contribute to these accounts, may later change their minds and be subject to a 10% excise tax for withdrawing funds before retirement.

Limits to autopilot approach

The autopilot approach would also not address glaring problems with 401(k)s and IRAs: that they place all of the risk and most of the cost on individuals; that high fees and

pre-retirement loans and withdrawals erode savings; and that retirees can outlive their nest eggs. Nor does it directly address the problem of upside-down tax subsidies, though some advocates of this approach have proposed ways of making these tax subsidies somewhat less regressive.

Are there advantages to a voluntary system?

Tax breaks are supposed to leverage private savings, and to do so in a way that is less heavy-handed than one-size-fits-all solutions. In this view, a do-it-yourself system leads to savings levels and portfolios tailored to individual preferences. But the idea that individuals are rational optimizers is an argument for no government intervention, rather than for taxpayer-subsidized savings schemes. Furthermore, one person's tax break is another person's higher tax. Sophisticated investors who want to tailor their risk-return profile can achieve similar results by balancing low-risk retirement benefits with higher-risk investment strategies pursued outside the retirement system.

» *Principle: Voluntary savings*

Additional voluntary contributions should be permitted, with reasonable limits for tax-favored contributions.

401(k)s and IRAs best as supplementary plans

Individual savings plans like 401(k)s and IRAs work best as the top layer in a multi-tiered system that begins with Social Security and other secure benefits. Once adequacy is achieved, there is a point beyond which some households would be better off with lower taxes or higher wages than with additional Social Security or pension benefits. At that point, it can make sense to provide incentives to overcome shortsightedness and other barriers to saving, rather than expanding a universal system. Some workers are already fortunate enough to have both traditional pensions and 401(k) plans. But we are nowhere near the point where we should be expanding risky voluntary savings rather than secure universal benefits.

A centralized or decentralized structure?

The Netherlands and Australia rely primarily on networks of multiple-employer structures to provide near-universal coverage.[79] Another option is a centralized system, such as increasing Social Security benefits or adding an additional tier to Social Security—though not in individual accounts. In a centralized system, administrative costs are low, benefits are easily portable, and it is easy to ensure equal treatment among participants. Such a system is also less vulnerable to industry or regional downturns. However, a large government fund invested in corporate stocks or bonds would "own the market" and would either have to be a passive

investor or would require measures to shield investment decisions from political pressure. Funds in the Canada Pension Plan, for example, are managed by an independent board that operates at arm's length from the federal and provincial governments.[80]

Who is minding the store?

While passive investment in low-cost index funds is usually the best choice for individual investors, this is true only because someone else is paying attention.[81] Institutional investors who actively manage their investments play an essential role in achieving what economists call allocative efficiency (steering funds to the most productive investments) as well as good corporate governance (ensuring that CEOs work on behalf of shareholders and not just themselves).This is one argument for building a network of independent multiple-employer plans. A middle ground would be to rely on a decentralized network of multiple-employer plans but with a central plan as a backup, as in Switzerland.[82]

» *Principle: Portable benefits*

Benefits should be portable when workers change jobs.

Pensions and mobile workers

Defined benefit pensions are often designed to promote employee retention,[83] as the value of accrued benefits typically increases over time relative to pay,[84] at least up to a designated early or normal retirement age. In addition, participants may not be vested for five years.[85] This, combined with the fact that benefits are not usually adjusted for inflation in private sector plans, means mobile workers are somewhat at a disadvantage even if they are fortunate enough to participate in defined benefit pensions throughout their careers. In theory, defined contribution plans can be better for mobile workers, but account balances are low to begin with and funds are often drained when workers are between jobs.

Tie benefits to career or final earnings?

Though defined benefit pension formulas in the United States are often based on years of service and final pay, benefits can also be based on career earnings, as with Social Security and cash balance plans. In such plans, mobile workers accrue the same benefits as workers who stay with the same employer for their entire careers, all else equal. They can also make it easier for employers to gauge required contributions. On the other hand, these plans are not designed to promote employee retention and can make it harder for workers to plan their retirements. Some countries, including the Netherlands and Switzerland, have plans where benefits are based on career earnings but that do not have some of the disadvantages of cash balance plans in the United States, notably the fact that benefits are usually withdrawn in lump sums.[86]

Portable benefits

The simplest way to ensure that benefits are easily portable from job to job is to enroll everyone in a centralized plan. Another is to rely on notional individual accounts (even if funds are pooled and invested together) in order to make it easy to transfer funds. In practice, however, individual account balances are as likely to be withdrawn as to be transferred to other accounts. And because people tend to perceive account balances differently than pension benefits, it might be politically difficult to prevent pre-retirement leakages and require annuitization of benefits in any account-style system. An alternative way to ease portability and avoid penalizing mobile workers might be to standardize accounting practices and adopt career-average benefit formulas in any newly established multiple-employer pensions.

» *Principle: Efficient and transparent administration*

The system should be administered by a governmental agency or by private, non-profit institutions that are efficient, transparent, and governed by boards of trustees that include employer, employee, and retiree representatives.

Fostering trust in the system

Negotiating compromises is easier when there is trust. This implies that all stakeholders should have a say in the system. Currently, most private retirement plans in the United States do not have employee or retiree representatives in their governing structures (notable exceptions are multi-employer "Taft-Hartley" plans negotiated by unions with a group of employers and jointly governed by union and employer representatives). Shared governance is the norm in other advanced economies, with pension boards typically divided evenly between employer and employee representatives.[87]

Not-for-profit administrative structure

A new pension system should be administered by one or more entities that have as their sole concern providing retirement income for participants—either a government agency or agencies, or a network of non-profit plans. In the current private system, the employer typically administers the system and delegates investment and management to third-party providers, who may have other business relationships with the employer as well as an interest in promoting their own investment products. Moreover, employers have little incentive to bargain over administrative and investment fees, which are typically paid by plan participants. Such a system creates conflicts of interest and also tends to be self-perpetuating as the financial sector lobbies to prevent more effective regulation.

» *Principle: Effective oversight*

Oversight of the new system should be by a single government regulator dedicated solely to promoting retirement security.

A unified regulatory regime

Regulatory oversight of the private retirement system in the United States is fragmented among government agencies with different policy goals, including the Department of Labor, the Pension Benefit Guaranty Corporation, the Securities and Exchange Commission, and the Internal Revenue Service. Though there are advantages to assigning different responsibilities to competing agencies rather than attempting to balance conflicting interests behind closed doors at a single agency, this has led to turf wars and uncoordinated—sometimes conflicting—requirements placed on actors. In any case, many of these regulatory functions would become moot, or at least less pressing, in a system that met the principles outlined in this report.[88]

CONCLUSION

The time for reform is now

When it comes to retirement security there is no quick fix. It will take years to develop and implement comprehensive reform that will provide universal coverage and secure and adequate benefits. The time to start work on a new approach is *now*. To those who say "Not when the economy is in trouble," we remind them that the Social Security system was enacted and implemented during the worst economic crisis in the history of our country—the Great Depression. If we fail to undertake this task when the shortcomings of the current system are most apparent, we imperil the retirement security of future generations of retirees.

Toward a 21st century retirement system

Traditional pensions work well for many workers, but they expose employers to long-term risks and cost volatility. Meanwhile, 401(k) plans have failed to provide most workers with adequate and secure retirements. We need a retirement system for the 21st century, perhaps one that combines elements of both defined benefit and defined contribution plans in order to minimize—not simply shift—costs and risks. Another alternative is to expand Social Security benefits. Expanding this efficient and effective program would be the preferred approach of many members of the Retirement USA coalition.

Protecting those with secure benefits

We also need to make sure that the millions of current workers fortunate enough to be in good plans are protected, particularly those who are nearing retirement. Worker and retiree organizations, consumer groups and policy makers must redouble their efforts to strengthen Social Security, preserve existing defined benefit pension plans, improve 401(k)s, and expand retirement plan coverage.

Adhering to core principles

While there are innumerable ways of expanding pension coverage and participation in retirement savings plans, most of these approaches would fall short of one or more of the core goals of universality, security, and adequacy. A system based on tax incentives can serve to expand pension coverage and retirement savings, but tax incentives alone will never yield universal coverage. Universality and adequacy can only be achieved if we require the participation of all employers and employees not participating in an existing plan and specify minimum contributions. Similarly, retirement security for most workers cannot be achieved unless benefits are protected from the vagaries of the stock market and paid over the lifetime of retirees. Furthermore, these goals can never be achieved by putting all the responsibility on either employees or employers. A new and comprehensive system will require shared risks and responsibilities. Neither employees nor employers alone can do it, and the government has an essential role to play.

The political challenge

There are numerous challenges, both conceptual and technical, to creating a universal, secure, and adequate retirement system. But the greatest challenge may be political, since the current system benefits powerful interest groups. Nevertheless, the United States can and should have a retirement system that leaves no worker behind, one that ensures everyone a retirement of dignity after a lifetime of work. We are committed to the hard work of reform.

Endnotes

1. See, for example, Butrica et al. (2003); Munnell et al. (2007); and Munnell et al. (2009).
2. Public sector workers in some states do not participate in Social Security but are covered by secure pensions.
3. U.S. Social Security Administration (2009a).
4. DeNavas-Walt et al. (2009).
5. Though the word "pension" is sometimes used to refer to any retirement plan, including a 401(k) plan, the dictionary definition is "a fixed sum paid regularly to a person." An older, more descriptive definition defines a pension as "a payment, not wages, made regularly to a person (or to his family) who has fulfilled certain conditions of service, reached a certain age, etc." (Merriam-Webster online dictionary, accessed August 29, 2009; *Webster's New World Dictionary*, 1972 edition).
6. The phrase "defined contribution" plan is somewhat misleading because it is meant to contrast plans where contributions are specified but benefits vary depending on investment returns with those where benefits are specified but contributions vary—again, depending on investment returns. However, with most contribution plans, the contributions are actually variable, since the most common 401(k) arrangement is a voluntary employee contribution with an employer match, and the employer may suspend the match at any time unless it is part of a collective bargaining agreement.
7. VanDerhei and Holden (2001).
8. Retirement USA is focusing on a system that provides retirement benefits to workers and their spouses or partners. By itself, such a system would do little to help many people who spend much or all of their lives outside the labor force. Ideally, it should be supplemented by a means-tested old-age pension that would cover all seniors, as is common in many countries.
9. Purcell (2009a).
10. In 2007, 59.3% of households and 68.5% of individuals aged 65 and older depended on Social Security for more than half their income (Purcell 2008).
11. Social Security Administration (2009), Table VI.F.10. In addition to the gradual increase in the normal retirement age from 65 to 67, which is equivalent to an across-the-board benefit cut, rising Medicare premiums will further reduce the amount retirees receive.
12. Purcell (2009a).
13. Purcell (2009a).
14. Munnell and Perun (2006).
15. OECD (2009).
16. The figures cited are based on tax revenues forgone in 2008. Because contributions to retirement plans and investment returns on these contributions are not taxed until funds are withdrawn, the long-term costs of contributions made in 2008 are nearly double (OMB 2009, Tables 19-1 and 19-5). Using a slightly different methodology, the Joint Tax Committee estimates that the cost of tax expenditures in 2008 was $78 billion for defined contribution plans, IRAs, and Keogh plans (Joint Committee on Taxation 2009).
17. Experts question whether much additional savings are actually generated by tax subsidies for retirement savings plans, as subsidies for retirement savings grew in recent decades even as the savings rate declined (Bell et al. 2004). This is because people can save in tax-favored accounts while drawing down other savings,

and there is no way to ensure that tax breaks generate new saving rather than simply reduce the taxes of people who already save, primarily the wealthy.

18. Burman et al. (2004).

19. Individuals can convert lump sum balances to lifetime benefits by purchasing annuities, but this can be expensive because of adverse selection and other problems.

20. Most traditional defined benefit pensions are tied to years of service and final pay. Thus, workers who lose their jobs or whose employers freeze or terminate their pensions years before retirement will have lower-than-expected pension benefits because these accrued service credits are now tied to a lower (mid-career, not final) salary. This is true even if the worker moves to another job with similar pay and pension benefits. Employees can also lose expected benefits if their division is sold and insufficient assets are transferred to pay early retirement benefits, or if multiemployer plans become seriously underfunded.

21. The Dow Jones Wilshire 5000, for example, peaked at 15,819 on October 11, 2007 and was at 6,935 as of March 6, 2009, adjusted for dividends and splits.

22. Munnell and Muldoon (2008).

23. Holden et al. (2008).

24. Economists Peter Orszag and Joseph Stiglitz are among those who have pointed out that individual accounts are riskier than defined benefit pensions because they forgo the opportunity for time diversification. They were referring to Social Security, but the same is true of any public or private defined benefit pension system with a long time horizon (Orszag and Stiglitz 1999).

25. Burtless (2008).

26. Using measures of risk and return derived from historical data, the unluckiest 5% of participants will not have enough to replace even a quarter of their pre-retirement earnings, while the luckiest 5% will end up with four times as much—enough to replace all of their pre-retirement earnings even without Social Security (Purcell 2007). This is not as surprising as it may seem, because financial economists have long understood that lifecycle investors face the same risk-return tradeoff as investors who maintain fixed portfolio allocations. As they approach retirement and shift toward more conservative investments, lifecycle investors are as likely to lock in low returns as high ones. Simply put, aside from ordinary diversification (investing in broad indices and in different asset classes) there is no magic trick that will reduce risk for individual investors without also reducing expected returns.

27. Holden et al. (2008).

28. Holden et al. (2008).

29. The adverse selection problem can also be addressed by requiring all participants to purchase annuities from an insurance company. This also uses pooling to spread longevity risks, but in a separate insurance pool.

30. Moreover, insurance companies are subject to state regulation, and state insurance regimes vary in the amount of consumer and investment protection they provide to purchasers of annuity contracts. Though most states have guaranty funds to help pay the claims of insolvent insurance companies, the maximum amount guaranteed is $100,000 in most states (National Association of Life & Health Insurance Guaranty Associations Web site, accessed October 6, 2009, http://www.nolhga.com/factsandfigures/main.cfm/location/stateinfo).

31. Some countries, such as the Netherlands and the United Kingdom, allow small account balances or a small portion of account balances to be withdrawn as lump sums (GAO 2009a).

32. GAO (2009a).

33. This volatility increased after the Pension Protection Act of 2006 reduced the ability of employers to smooth pension contributions over time.

34. It is important to emphasize, however, that in a fully or partly advance-funded system, generational booms and busts are not by themselves major concerns. Contrary to popular belief, the projected Social Security shortfall is mostly due to adverse economic trends, such as the increasing share of wages above the taxable earnings cap, and not the retirement of the Baby Boom generation.

35. As with all examples cited in this report, this does not imply an endorsement of any of these approaches.

36. Similarly, indexation can be suspended in defined benefit plans in the Netherlands (GAO 2009a).

37. Kessler (2009).

38. The name refers to the fact that individual accounts in these plans are "notional'—in name only—as funds are pooled and collectively invested.

39. Munnell (2009).

40. TIAA-CREF's Traditional Annuity guarantees a minimum 3% interest rate to most participants.

41. Other countries where defined contribution plans offer a minimum rate of return include Belgium and Denmark (Turner and Rajnes 2009).

42. Some economists have expressed concern that any rate-of-return guarantee that provides a meaningful floor on investment returns would be prohibitively costly or risky for the government to provide based on derivative markets. However, this assumes that private-sector market participants have the same risk tolerance and investment horizons as the government. On a more practical level, there is a tension between the desire to limit risk exposure and the usefulness of such guarantees, as countries like Denmark and Switzerland that provide or mandate such guarantees have lowered them in the wake of steep market declines (Turner and Rajnes 2009).

43. GAO (2009a).

44. The Canada Pension Plan covers workers in all provinces except Quebec.

45. Monk and Sass (2009).

46. This can be done by reducing the value of benefits, as in Finland and Portugal; by raising the retirement age, as in the United States and Denmark; or by increasing the number of years participants need to contribute to the system in order to receive full benefits, as in France (OECD 2007).

47. Waldron (2007).

48. The federal poverty threshold used by the Census Bureau is widely considered too low, since it is based on the assumption that people can subsist on an income equal to three times the cost of a low-cost nutritionally adequate diet. When this formula was developed by the Social Security Administration in 1965, the cost of food was much higher relative to the cost of other basic needs than it is today. Alternative standards that have been developed include the Elder Economic Sufficiency Index developed by Wider Opportunities for Women and the Gerontology Institute at the University of Massachusetts, as well as the Modern Poverty Measure introduced by Congressman Jim McDermott on June 17, 2009.

49. Many experts question whether a 70% replacement rate is enough even for middle-class workers because of medical and assisted living expenses. In any case, most believe the replacement rate for low-income workers should be closer to 100% to meet basic needs benchmarks. Since Social Security has a progressive benefit structure, a new retirement system that provides the same replacement rate for low- and middle-income workers would provide a higher overall replacement rate for low-income workers with Social Security.

50. OECD (2009). According to the 2009 Social Security Trustees Report, the replacement rate for Social Security is 54% for low earners and 40% for medium earners at age 65. The difference between the two measures is based on the fact that the Social Security replacement rate is a gross replacement rate that does not take taxes into account, among other factors.

51. This statistic is for households and includes both private- and public-sector workers. According to another government survey, the median account balance for private-sector workers 21 and older participating in defined contribution plans was $25,000 (Purcell 2009c).

52. This includes 401(k)-style defined contribution plans, IRAs, Keogh plans, and other retirement accounts where participants can withdraw the balance of their accounts. It does not include the value of traditional pension benefits paid out over beneficiaries' lifetimes (Bucks et al. 2009).

53. Author's analysis of Federal Reserve Survey of Consumer Finances public data.

54. Inflation-adjusted joint and 50% survivor annuity estimated using the federal Thrift Savings Plan's online annuity calculator, based on a 3.75% annuity interest rate on September 10, 2009 (http://www.tsp.gov/calc/annuity/annuity.cfm).

55. Munnell and Sundén (2006).

56. GAO (2007).

57. Munnell et al. (2006a).

58. The Center for Retirement Research found that net investment returns were 10.7% for defined benefit pension plans versus 9.7% for 401(k)-type defined contribution plans between 1988 and 2004 (Munnell et al. 2006a). A thousand dollars invested in an account earning 10.7% will grow to roughly $21,000 over 30 years, versus $16,000 for one earning 9.7%. A similar result is found if you assume that households make contributions that increase steadily by 3% over 40 years.

59. Hamilton et al. (2006).

60. This still exposes 401(k) participants to financial and longevity risks not faced by participants in defined benefit pensions. For example, one in five women who reach age 65 will live to 95 and will therefore outlive their savings as modeled in this exercise. On the other hand, it leaves 401(k) participants with money for bequests if they do not live past 90 years of age.

61. Where possible, this exercise adopts the Congressional Budget Office's long-term assumptions: a 2% inflation rate, a 5% interest rate on Treasury securities, and a 4.4% annual growth in earnings (CBO 2009). Life expectancy at retirement is based on the Social Security projected cohort life expectancy in 2050: 20.4 years for men and 22.6 years for women (Social Security Administration 2009). The 7% projected rate of return on pension fund assets is somewhat lower than the average (private sector) and median (public sector) long-term rate of return assumed by pension funds (8% in both cases). This was done in order to better align the 5% real (inflation-adjusted) rate of return for pension funds with the 4.5% real return assumed by public funds in the United States; and to align the 3-4% real rate of return for defined contribution plans with the OECD's assumed 3.5% real rate of return for these plans (net of fees) (Hewitt Associates 2009; National Association of State Retirement Administrators, Public Fund Survey accessed online on September 7, 2009; and OECD 2009).

62. Walsh and Bernard (2008).

63. Workers earning $30,000 or more are nearly twice as likely to be covered under an employer plan as workers earning less than $30,000 (Copeland 2008).

64. Purcell (2009b).

65. Low-income workers pay a higher share of their incomes in payroll taxes than high-income workers, because earnings above a certain level are not taxed. However, Social Security *benefits* are progressive, and the program as a whole tends to favor low-income households.

66. The value of a revenue-neutral tax credit would actually be higher than $875 per worker, because the Tax Policy Center assumes that taxpayers would also receive a half credit per dependent child (Toder et al. 2009). This example is not intended to suggest an endorsement of a particular approach to subsidizing the contributions of low-income workers.

67. This siphons off 18% of total 401(k) assets (Munnell and Sundén 2006).

68. Unpaid balances average around $7,500 (Holden et al. 2008).

69. This amounted to approximately 3% of total assets in these accounts. This is the leakage in a single year. The cumulative effect is much greater (GAO 2009b).

70. GAO (2009b).

71. In 2006, the mean employee contribution to a defined contribution plan was 8.3% and the average total contribution was 13.2%. The median employee contribution was 5.0% and the median total contribution was 9.1% (Purcell 2009c).

72. Though some economists are skeptical that employers can unilaterally cut retirement benefits without raising wages, cost considerations do appear to be a driving force in the shift toward 401(k) plans, especially in the wake of market downturns and changes in funding rules that have caused spikes in required contributions to defined benefit pension plans (Munnell et al. 2006b; Munnell and Soto 2007).

73. GAO (2009a).

74. OECD (2009).

75. OECD (2009).

76. One of the most widely cited examples is that of United Health, which was motivated to adopt auto enrollment by its failure to meet non-discrimination rules designed to prevent highly compensated employees from disproportionately benefiting from tax-advantaged retirement benefits. United Health opted to increase participation among lower-paid workers rather than refund the contributions of higher-paid workers (Jacobius 2000; Madrian and Shea 2001). Not every employer would have chosen this path, nor is in a position to do so.

77. Most of the literature on the subject assumes that employers wish to broaden participation. But companies could ensure universal participation simply by contributing to every worker's account, and few do so.

78. Employee Benefit Plan Review (2000); Madrian and Shea (2001); and Vanguard (2007).

79. These are primarily defined contribution plans in Australia and defined benefit plans in the Netherlands, though the Netherlands also has collective defined contribution plans.

80. Monk and Sass (2009).

81. If all investors purchased index funds, the market capitalization of all companies would grow at the same rate, whether they were profitable or not. This in turn means there would be no incentive for venture capitalists and other early-stage investors to back startups with the best growth potential.

82. GAO (2009a).

83. In addition to promoting retention, formulas based on final pay may help teachers plan for retirement.

84. This is a feature of benefit formulas where the value of accrued benefits increases each year not just by an additional service credit, but also because past service credits are multiplied by a higher final salary.

85. The maximum vesting period is five years for cliff vesting, seven years for gradual vesting, and three years for cash balance plans, which are technically a type of defined benefit plan.

86. OECD (2007) and GAO (2009). Note that the multiplier must be higher for career average plans to maintain the same average levels of benefits, since earnings usually increase over the course of a worker's career. In some cases, including the U.S. Social Security system, benefits are also adjusted to take into account changing average wage levels or living standards.

87. Stewart and Yermo (2008).

88. For example, in a universal system the Internal Revenue Service would no longer need to police employers to make sure retirement benefits do not discriminate against lower-paid workers.

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