The Future of Retirement Income Adequacy and Employer Pensions

Testimony of

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Thank you for inviting me to share my views on the role of employer pensions in ensuring income adequacy for retired Americans. I'll define how economists are changing the definition of retirement income adequacy, discuss the influences shaping employer sponsored pensions in the United States, and place the benefit design and existence of public employee pensions in the context of overall declining retirement income security for most Americans.

RETIREMENT AND PUBLIC OPINION

We are back to the future. At the beginning of the last century (and after the establishment of Civil War pensions) public sector pension plans provided a template for future plans in the private sector by creating portable defined benefit plans with broad participation. With the recent erosion of pension structures that guaranteed a safe and secure retirement income for many working Americans, there is much interest in how public plans work and what institutions can preserve them and spread the model to others.

Let us not lose sight of our successes. One of the hallmarks of the American system of social insurance -- which include generous tax breaks, employer pension plans, disability, and Social Security -- is that working people, rich and poor alike, can afford to retire.

Indeed that the rich and poor can have a healthy period of old-age leisure is the success of a civilized society.

This success has come about through efficient and responsible pension institutions and through the contributions of employers, employees, and indirectly through government tax preferences and subsidies for retirement plans in the private and public sectors.

Yet, there is a sea change in retirement security and the public know it.

The upcoming retirement crises may be one of several areas where "the people" are ahead of the politicians. Among the findings of recent polls (see, for example, a study from McKinsey & Company.[1]) are that responders say they want the government to guarantee retirement income more than they want government guarantees for jobs. And higher income and whites were more anxious about their retirement future and feared "things" were going to get worse than were lower income or minorities. (See Appendix)

In addition, for the first time since Gallup[2] conducted the survey in 1995, the number of individuals planning to work beyond 65 years-old now outnumbers those who are planning to retire before that age. Yet, this desire may only be a wish, dissonant with reality. Sadly, during the worst recession since the great Depression, the unemployment rates for old workers are increasing the fastest. Whether to work or not is not in the sole control of older people.

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[1] http://www.mckinsey.com/clientservice/financialservices/pdf/Winning_the_Retirement_Race.pdf
[2] http://www.gallup.com/poll/127514/americans-projected-retirement-age-continues-creep-up.aspx
http://inthesetimes.com/working/entry/5917/gallup_poll_finds_americans_are_planning_to_retire_later/

In sum, many Americans are quite insecure about their retirement futures. They either don't have the capacity to calculate all the unexpected events that will affect their financial future – divorces, unemployment, illness, layoffs, and they don't have the financial expertise to manage a portfolio better than the professionals managing DB plans.

Americans' insecurity about retirement also comes from self-knowledge. Americans know they don't have the expertise and they know they may have to take out lump sums from their retirement accounts in order to survive recessions or pay for a child's college tuition, etc. and after doing so there won't be enough left.

TRENDS IN RETIREMENT ADEQUACY

According to the Center for Retirement Research at Boston College[3] a growing share of working-age households are at risk of being unable to maintain their pre-retirement standard of living in retirement. The Center for Retirement Research estimates that 51 percent of households will likely not have enough income to maintain their living standards in retirement. If health care and long term care costs are included, the share of households "at risk" increases to 65 percent.

Over the past 30 years, workplace pensions – which only covered about 50% of the workforce – have changed form in a crucial way. Defined benefit plans have been retrenched or terminated and replaced with DC plans. And new, large firms are only offering DC plans. Public employees are the only sector where DBs are prevalent.

There are a number of ways to assess the impact and motivations for the switch in design. Most experts do not attribute the rise of 401(k) plans to workers' desire. There popularity is mostly a "second best" phenomenon, where people consider a 401(k) plan to be better than nothing. When workers have had a choice they choose DB plans.

First, we can assess the impact of the switch by looking ahead. One recent study[4] did just that. It used simulations to answer the question about whether pension security would erode even further if one third of public pension plans switched to a DC system and all private employers froze their DB plans. the answer is that over 1 out of 4 people retiring in the next 15 – 20 years, (people called the "last wave boomers" because they were born at the end of the baby boom -- between 1956-1965 – would have lower family incomes than they would have otherwise at age 67. Also the predictions are that if there is a big move to DC plans from DB plans only 11% of "the last wave boomers" would see their incomes increase wherein most of the income gains would be under 5%, and those gains would be reduced by an increase in the assumption of risk.

[3] The National Retirement Risk Index, 2010.
http://crr.bc.edu/special_projects/national_retirement_risk_index.html
[4] Butirca, Iams, Smith, Toder 2009.

The second way to assess the impact is to look backwards. A number of studies have shown that when employers switch to DC plans their expenses fall and less is accumulated to back up an expected benefit.[5]

Therefore, DB pension plans yield higher benefits than DC plans. (below I discuss studies where DCs save money for the employer.)

WHAT IS THE TARGET: RETIREMENT INCOME ADEQUACY?

The consensus opinion about income needs in retirement had been 70% and was based on two assumptions about social norms and standards. One: that most people want to and should be able to preserve preretirement living standards into retirement; and, two: that income and wealth gaps should not be encouraged to grow after retirement.[6]

The old consensus about adequacy was that the percentage of preretirement income needed in retirement to maintain living standards varies with income because higher income workers pay a higher percentage of preretirement income in work related expenses – especially in taxes and saving for retirement. So that high income individuals – defined here as the top 20% -- need a lower replacement rate than lower income workers (defined as the bottom 40%). For middle class workers 80% of preretirement income is the standard. Since people have more time in retirement, it is assumed that they will replace expensive activities with time intensive activities (more home meals etc.).[7]

However, the presumption that people need less income in retirement has been challenged by the fact uninsured health costs are higher in retirement and over half of the elderly are retiring with mortgage. Therefore there is an emerging new consensus is that middle and high income people need close to 95% to 100% of income to maintain living standards because more elderly are in debt and still paying mortgages and that health care costs are increasing.

RETIREMENT AGE AND RETIREMENT TIME AND SOCIAL NORMS

There is an attempt to change norms in the US about retirement age and time. The hope is that people working more will save money for pension systems and that the economy will grow and

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[5] Towers Watson. 2009, Ghilarducci and Sun 2006.

[6] There is a consensus of opinion that low income workers need more income in retirement than while they were working because their preretirement income was at the poverty level. Low income workers should have replacement rates higher than 100% of preretirement pay. There is some support to raise incomes of the very poor and very old – this group is among the most "deserving poor" – but the responsibility for this group is generally out of the hands of employer pensions.

[7] Reno, Virginia P. and Joni Lavery. 2007

people will like the work. The debate about working longer confuses longevity with working ability, ignores the fact that employers hire workers and the workers cannot make work decisions by themselves, and that improved longevity and wellness in old age is not distributed equally.

Higher income white males have enjoyed the largest increases in longevity: the use of statin drugs and reductions in cigarette smoking are key factors. See table below.

Longevity Improvements Are Not Evenly Distributed Mortality Expectations for those age 65				
	white men	white women	black men	black women
1950	12.8	15.1	12.9	14.9
2006	17.1	19.8	15.1	18.6
Improvement 1950 – 2006	34%	31%	17%	25%

There is also concern that longevity improvements will decline with increases in obesity and disorders related to obesity.

Overall longevity for 65 year olds has increased approximately 25% since 1950; the economy (GDP per capita) has increased 244%. Overall time spent in retirement has increased to be sure as employer pensions and Social Security expanded. Society has chosen to use the increases in prosperity to increase retirement time.

SOULTIONS TO INADEQUACY: MORE SAVINGS IN A GOOD PENSION SYSTEM

People need to save more. The AON Consulting Group has been analyzing the needs of retirees since its first report for the Presidents Commission on Pension Policy in 1980.

Savings Rates are Inadequate for Most of the Population

Source Aon. 2008

	Actual Savings of People 50-64	Required Savings (Percent of pay that needs to be saved each year until age 65, if saving starts at age 25 (this assumes a 7.7% return)

Annual Income	Savings rates computed from the Consumer expenditure Survey	If savings starts at age 25	If savings starts at age 55
$30,000	2.79%	4.2%%	32.8%
$50,000	4.05%	4.1%	31.9%
$90,000	5.57%	5.8%	44.9%

Only if people saved continuously starting at age 25 only the highest income earners come close to saving enough for retirement. In sum, the rise of the 401(k) system has given rise to a paradox. The institutions that were to help people save have been coincident with a dramatic decrease in retirement savings.

Let's talk more about these failed institutions. Over the past 30 years, private employers have experimented with individually- directed private accounts – 401(k) type plans. The experimentations lessened employers' expense (Towers Watson 2009) and eroded pension savings accumulations. There is little data showing that pension design changes meet employers' needs to attract and retain selected employees.

There is very little "definition" to "defined contribution" plans. Employers stop and start contributions and vary the matches. Also benefit disbursements from defined contribution (DC) plans fluctuate along with the stock market and are very erratic (Watson Wyatt 2008.) For these and other reasons, 401(k) plans are implicated in the decline of retirement income security for middle income workers. Firms who handle 401(k) plans assets admit there business models focus on the top earners. If the tax breaks for 401(k) and IRA were reduced or eliminated the top 1% would shoulder 48% of the subsidy loss and general revenues would increase by over $100 billion to spend on more retirement plans, or youth programs or bridges to somewhere. (Burman et. al. 2004, 2009)

PUBLIC SECTOR PENSIONS

- There are a few common elements experts say efficient, effective, sustainable, and fair retirement pension systems should have. Compared to 401(k) plans in the private sector, public sector plans have more of these characteristics:

- employers and employees share the pension costs,
- the pension is adequate,
- assets are managed professionally
- money management is pooled so that the fees are low and the advice professional;
- government subsidies go to the people who need it most,
- the payout is in the form of annuities and at retirement,

- every worker is covered,
- a person’s pension savings are not lost when changing jobs.

Employers’ needs are often bypassed when discussing retirement plans. But, I can’t emphasize this point enough; the pension systems sponsored by employers must meet employer’s needs. In the public sector the employer are the taxpayers. The state revenue crises caused by recession-induced pension plan asset value losses and tax revenue losses must be solved with corrections to revenue increases. Many pension benefits were paid for by nonexistent revenue and should be rolled back. A change in pension design may be more expensive and have unforeseen negative consequences on personal relations and human capital preservation.

CONCLUSIONS

One of the biggest hurdles to spurring retirement savings is that half of workers don't have access to a retirement account through their employer. Many work for small businesses, which often lack resources to navigate the relevant regulations. To help these workers, the federal government should provide "off-the-shelf" options that businesses can offer to workers with limited regulatory burdens. Another form of help would be to require more pensions savings as public sector pensions do.

A popular reform proposal is to require that workplace retirement plans should also enroll workers automatically. The Government Accountability Office (2009a) reported last fall that auto-enrollment increased participation in employer-sponsored plans to as high as 95 percent but that the savings rates were insufficient for retirement adequacy. There is also evidence that people may accommodate increased savings at work by taking on more debt somewhere else in their portfolio or save less in other ways.

So policymakers can nudge individuals toward saving more. But the nudges are expensive. Before proposing a $50 Billion saver’s tax credit, the Obama administration should analyze whether the nearly $170 billion in tax subsidies for 401(k), IRA and other retirement accounts are as effective as they could be in promoting savings. Policy changes to improve workplace pension may be to mandate an increase a savings rates of 5%. Another GAO (2209b) report laid out 4 alternatives. There are good solutions to improve the financial security of middle class working Americans.

Retirement needs and expectations are based on social norms and practical considerations. No modern nations have found it practical to make individuals save for their own retirement in individual accounts to fund retirement. If we do the consequence is an increase in elderly poverty rates and a continuing decline in living standards for older Americans, many who have worked 40 or more years.

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Appendix: Public Opinion and Retirement Security

Notes from a meeting about the results of several polls done for a Foundation and major magazine and think tanks. May 2010

Eight Key Findings of Survey Research

Freedman identified eight things from the public survey and other research that he believes is compelling and relevant to Retirement USA.

1. **People have a dramatic passion for certainty in their lives.** We gave people the choice between a job with pension and health care or a job that pays more. A big majority of 65 percent preferred a job with a guaranteed pension and health care while 21 percent preferred a job that pays more.
2. **Retirement security is a big priority for most people**. When we gave people the choice between a guaranteed pension and health care versus a job for life, overall in the largest survey we did, the most popular choice was a guaranteed pension.
3. **People are anxious about retirement**.
4. **People are living the uncertainty in a dramatic way**. When we look at income quintiles: If you make less than $50,000 a year, and ask if they are saving enough, huge majorities know they are not saving enough, up to 80 percent.
5. **People aren't saving enough because they can't afford it**. Surveys found they are not saving enough because they do not earn enough to save.
6. **People think that things are going to get worse**. When you ask what it will be like in 20 years, by 51 percent to 14 percent, people said it will be worse. Higher income people thought it was going to worse more than low income people and whites thought it would get worse more than the minorities.
7. **Workers are not convinced they will receive Social Security when they reach retirement age**. About 44 percent of people not now on Social Security said they were somewhat or very confident they would receive Social Security benefits when they reached the age of eligibility. Only 10 percent were very confident they will get it.
8. **Workers expect Social Security to be important to their retirement income**. People had a different view of Social Security when we asked them, "how important is it to your retirement to get Social Security?" Here we found that 79 percent said it would be important to their monthly income.