The Retirement Security Project

Common Sense Reforms to Promote Retirement Security

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Common Sense Reforms to Promote Retirement Security

By John C. Goodman and Peter R. Orszag

As the baby boomers near retirement, defects in the nation's private pension system are becoming obvious. Only about half of workers contribute to an employer-sponsored pension plan in any given year, and Individual Retirement Account (IRA) participation rates are substantially lower. Among workers with tax-preferred retirement saving plans, few make the maximum allowable contribution. And despite the many private savings incentives, many households approach retirement with meager funds.

The Evolution of Private Pensions

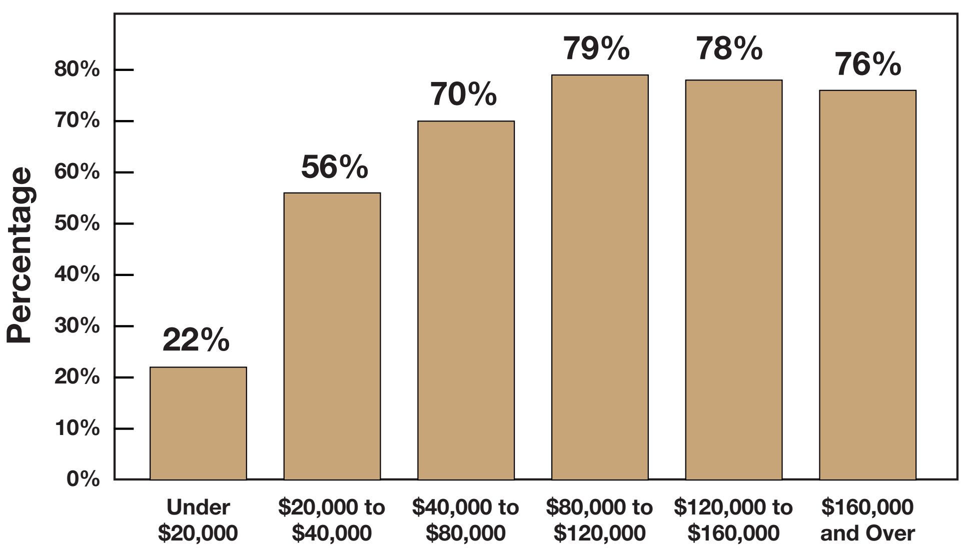
Over the past 25 years, defined contribution pension plans — such as 401(k)s — have taken the nation by storm. Created by the Revenue Act of 1978, 401(k) plans are well suited for workers who change jobs frequently or experience gaps in employment. Employers often match employees' contributions, and the funds that accumulate in the accounts are the employees' property.

Workers are responsible for choosing among 401(k) investment options. The average 401(k) plan offers employees nine actively managed investment choices, according to the Employee Benefit Research Institute (EBRI), although some offer unlimited choices. Today more than 42 million workers participate in defined contribution plans, with total assets exceeding $2 trillion. In 2001, however, the median balance in such accounts among all households headed by 55-to-59 year-olds was only about $10,000.

According to a Congressional Budget Office review, higher income workers have a much higher participation rate in tax-deferred plans than lower income workers [see the figure]:

Workers' Participation in Tax-Deferred Retirement Plans in 1997

(as a percentage of workers in each income category)



Source: Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving," August 2003.

- Only 22 percent of workers with incomes of less than $20,000 participate in tax-deferred plans.

- By contrast, the participation rate is 56 percent for workers between $20,000 and $40,000, and 70 percent for workers between $40,000 and $80,000.

- Almost 80 percent of workers with incomes of more than $80,000 participate.

Retirement Savings Mistakes

People often make mistakes when it comes to investing for retirement: most Americans don't save enough, and even those who do save typically invest in inappropriate portfolios.

Failing to Save

About a quarter of workers who are offered a 401(k) plan at work don't participate in it. Those who do participate rarely make the maximum contribution: well under 10 percent of participants contribute as much as is allowed by law. The result is that many households fail to accumulate adequate retirement savings.

Making Poor Investment Choices

Last year, thousands of Enron employees lost most of their retirement savings when the company stock price fell dramatically. Enron's case is not unique. A Hewitt Associates survey of 375 companies that offer 401(k) plans found that 55 percent of employers offer their own stock as an investment choice. Some 30 percent of plan assets were invested in employer stock. As the Enron example demonstrates, putting all of one's eggs in one financial basket is risky. And if the basket is the worker's company, these risks are magnified, since bankruptcy would endanger both the worker's retirement account and his job.

In general, workers who invest their retirement funds in their own firm (though comfortably familiar to them) take an undue risk. Many employees also invest in overly conservative assets, which are safe but pay a low expected rate of return. Lower-income workers are particularly prone to opt for this alternative. In fact, history shows that employees in the lowest-income quintile have typically invested almost two-thirds of their account balances in lower earning money market or bond funds.

Improving the System

Workers should be encouraged to invest in long-range savings plans that will create adequate retirement income. We recommend changes that would not be compulsory for either employers or employees. Instead, we propose legal and regulatory incentives to plan sponsors in return for behavior that will produce a more secure and more prosperous retirement for millions of workers: automatic enrollment, an adequate minimum contribution rate, escalating contribution rates and default investments in broadly diversified equity and bond index funds.

One of the most significant reforms policymakers could adopt to boost voluntary retirement saving would be to change the "defaults" in 401(k) plans in favor of sound retirement preparation. Evidence strongly suggests that when workers are automatically enrolled in a 401(k), participation rates are significantly higher. Yet most employers require employees to specifically opt in. Savings rates are also higher when 401(k)s commit workers to saving part of their future pay raises, rather than trying to encourage them to save at a higher rate immediately.

To encourage the adoption of plans with features proven to be effective in helping workers better prepare for retirement, policymakers should:

- Clarify that retirement savings plans with these features are permissible under state labor laws.

- Pension plans meeting the requirements outlined here should be offered targeted relief from class action complaints and special treatment under the nondiscrimination standards — detailed regulations that require plan sponsors to balance both employee participation and benefit amounts in order to distribute benefits proportionately among high and low-wage workers; our plan would provide sponsors of properly designed plans more generous treatment under these rules than other plans.

- Require that, at least as a default, when employment ends, employees' 401(k) accounts are automatically rolled over into another qualified plan or into an IRA, or remain in the previous employer's plan, rather than requiring a terminated employee to take a potentially taxable (and penalized) distribution.

- Allow plans to disburse small account balances without penalty to employees who decide to opt out soon after the automatic enrollment begins.

We also agree that, consistent with a proposal in the president's Fiscal Year 2005 budget, taxpayers who choose to direct deposit their income tax refund checks should be allowed to split the refund between accounts. The IRS currently does not allow refunds to be split between accounts, significantly reducing the portion of tax refunds that are saved, since many families are reluctant to deposit their entire refund in a tax-preferred savings account. This proposal would not require additional legislation.

American workers need savings plans that will adequately fund their retirement. We recommend changes in the current system that provide flexibility, versatility and expanded investment opportunities. These are keys to encouraging workers at all income levels to invest in their future retirement, today.

John C. Goodman is president of the National Center for Policy Analysis.

Peter R. Orszag is Senior Fellow, Economic Studies at the Brookings Institution, and Director of The Retirement Security Project.

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Mission Statement

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers.

The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

1755 Massachusetts Ave., NW, Suite 550
Washington, DC 20036
p: 202.483.1370 f: 202.483.1460
www.retirementsecurityproject.org

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