

The Importance of a Private Retirement System

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Thank you for inviting me to testify today.

My name is Monique Morrissey. I am an economist at the Economic Policy Institute and author of *The State of American Retirement: How 401(k)s Have Failed Most American Workers*, an interactive chartbook accessible through EPI's website, www.epi.org.

Before I move on to the topic of our private retirement system, I would like to say a word about Social Security. Social Security is the cornerstone of our retirement system, but it is not enough. Benefits replace slightly less than 40 percent of pre-retirement earnings for a middle-class worker, and this share is declining. Most experts think we need to replace 70–80 percent of our income in retirement.¹ So Social Security benefits currently provide roughly half of what a middle-class worker needs.

In theory, therefore, most workers, with the help of their employers, should be accumulating retirement savings and pension benefits sufficient to replace 30–40 percent of their pre-retirement income—that is, enough to roughly double their Social Security benefits. For workers who do not have traditional pensions, this suggests they should be accumulating savings equal to roughly 10 times their pre-retirement income.²

If this seems like an unattainable goal to you, you are not alone.

The Boston College Center for Retirement Research estimates that fewer than half of working-age households are on track to accumulate sufficient savings and benefits to maintain their pre-retirement standard of living (Munnell, Hou and Webb 2014). The Center uses conservative assumptions, such as assuming every penny of savings, including home equity, is tapped in retirement.

Moreover, the share of households at risk of seeing a significant drop in living standards at retirement is growing as younger households fall further behind. This is a historic reversal. Until now, each generation had more retirement security than the last due to a gradual expansion of Social Security benefits and coverage.

Now, however, Social Security's replacement rate is eroding due to benefit cuts enacted in 1983 that are

gradually being implemented. This includes an increase in the normal retirement age that is equivalent to a 13 percent benefit cut, and an increase in the share of benefits subject to income tax as limits on untaxed benefits are not indexed to inflation.

These benefit cuts were implemented in 1983, right around the time 401(k) plans came on the scene. In hindsight, these cuts were a mistake.

Policymakers are beginning to realize this. Last year, almost every Democratic senator supported a budget amendment calling for Social Security expansion, and both Democratic presidential candidates support expansion. Republicans, meanwhile, appear to be retreating from previous calls to cut benefits. The Republican presidential candidate has said he will protect benefits, though he appears to be under pressure to reverse his position. (While Republican voters strongly support Social Security, their big-money donors do not.) This is a big shift from when I started working at EPI 10 years ago, when the question was not whether to expand Social Security or leave it alone, but rather how much to cut benefits.

What has changed? There is a growing recognition that the 401(k) revolution has failed. A quarter century after participation in 401(k)-style plans surpassed that in traditional pensions, most Americans have little or nothing saved in retirement accounts. Pension benefits remain six times as important to seniors as retirement account distributions.

It should be no surprise that 401(k)s were a bust. They were designed to supplement, not replace, pensions. They shift most of the cost and all of the risk of retirement on to workers. They are inefficient compared with pensions, which pool longevity and investment risk at no cost to workers or employers. 401(k) participants also face higher fees and earn lower net returns.

The problem is often defined as people not saving enough, but many people have rational reasons for avoiding a high-cost, high-risk system. Tax incentives for retirement saving are upside down—worth much more to taxpayers in higher tax brackets who can afford to take on more investment risk. Low-income workers often receive little or no help from their employers or the government, yet face penalties if they need to access savings before retirement.

401(k) plans magnify inequality. While 401(k)s have failed the overwhelming majority of Americans, some groups have fared worse than others: lower-income, black, Hispanic, less-educated, and unmarried Americans. For these groups, the typical working-age family or individual has no savings at all in a retirement account. And while women appear to be closing some gaps with men, their longer lifespans and lower lifetime earnings still put them at greater risk in old age. Only the financial services industry and the top 1 percent of Americans, for whom 401(k)s serve as a tax shelter more than a retirement vehicle, have an interest in maintaining the current system.

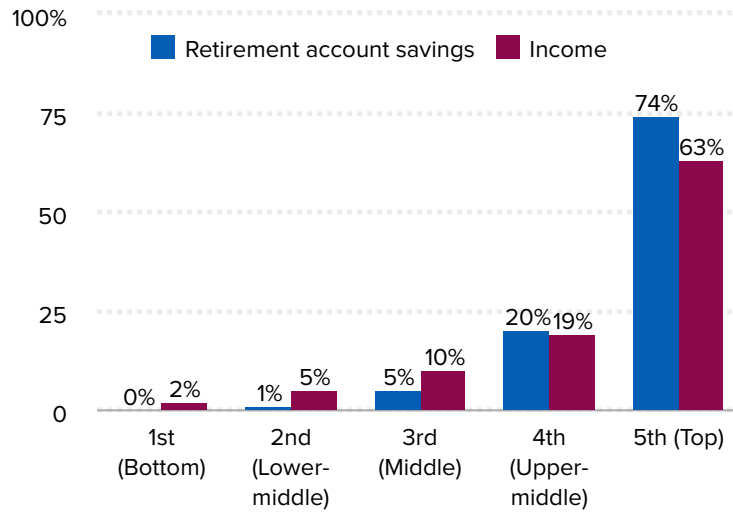
[Note: The following charts are from Morrissey (2016).]

Figure A

Despite rules intended to ensure that high-income families do not disproportionately benefit from tax subsidies for retirement saving, our savings-based retirement system does not simply reflect, but also magnifies, inequality. The bottom 60 percent of working-age families receive 17 percent of total income but hold 7 percent of retirement account balances. Meanwhile, the top 20 percent receive 63 percent of income and hold 74 percent of retirement account balances (numbers in chart may not add up to totals due to rounding).

401(k)s magnify inequality

Share of total retirement account savings and total income for families age 32–61 by income quintile, 2013



Note: Based on "normal income," which may differ from actual income if a family's income in the past year was unusually high or low. Retirement account savings include 401(k)s, IRAs, and Keogh plans.

Source: EPI analysis of Survey of Consumer Finance data, 2013.

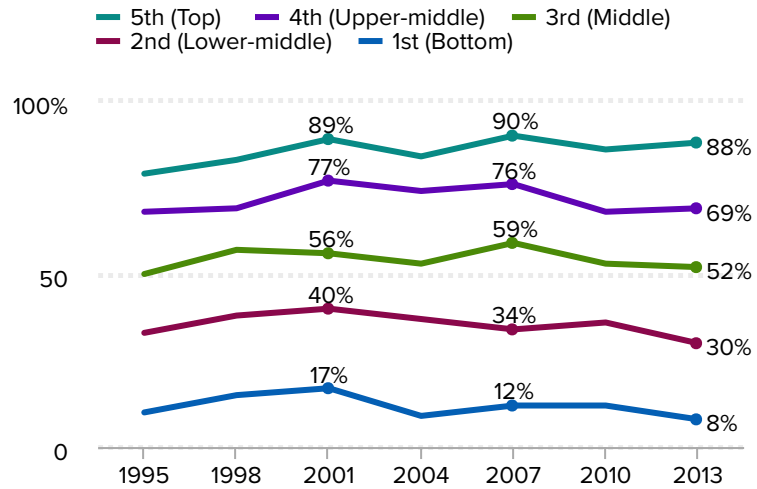
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Figure B

Almost nine in 10 families in the top income fifth had savings in retirement accounts in 2013, compared with less than one in 10 families in the bottom income fifth. This reflects a growing disparity in the new millennium as the share of families with retirement account savings declined significantly for all except the top income group.

High-income families are 10 times as likely to have retirement accounts as low-income families

Share of families age 32–61 with retirement account savings by income quintile, 1995–2013



Note: Retirement account savings include 401(k)s, IRAs, and Keogh plans. Family-income quintiles are based on "normal income," a measure that ignores temporary fluctuations and is not available for years prior to 1995.

Source: EPI analysis of Survey of Consumer Finance data, 2013.

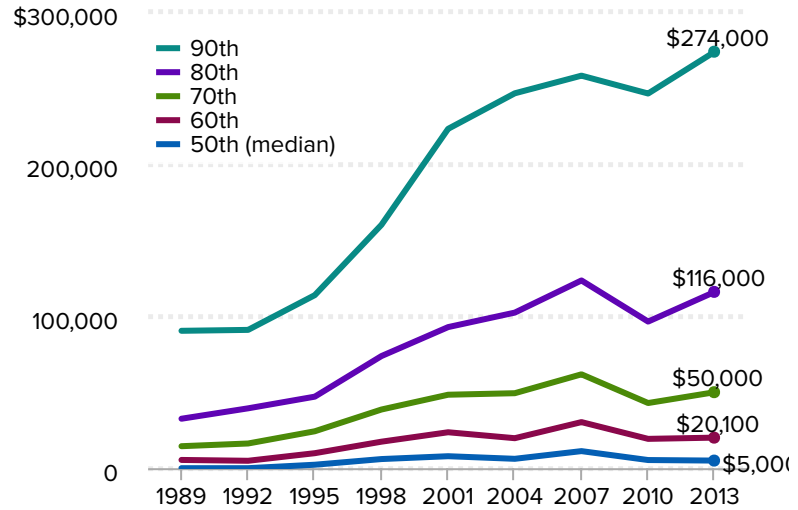
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Figure C

Nearly half of working-age families have nothing saved in retirement accounts, and the median working-age family had only \$5,000 saved in 2013. Meanwhile, the 90th percentile family had \$274,000 and the top 1 percent of families had \$1,080,000 or more (not shown on chart). These huge disparities reflect a growing gap between haves and have-nots since the Great Recession as accounts with smaller balances have stagnated while larger ones rebounded.

The gap between the retirement ‘haves’ and ‘have-nots’ has grown since the recession

Retirement account savings of families age 32–61 by savings percentile, 1989–2013 (2013 dollars)



Note: Retirement account savings include 401(k)s, IRAs, and Keogh plans. Scale changed to accommodate larger values.

Source: EPI analysis of Survey of Consumer Finance data, 2013.

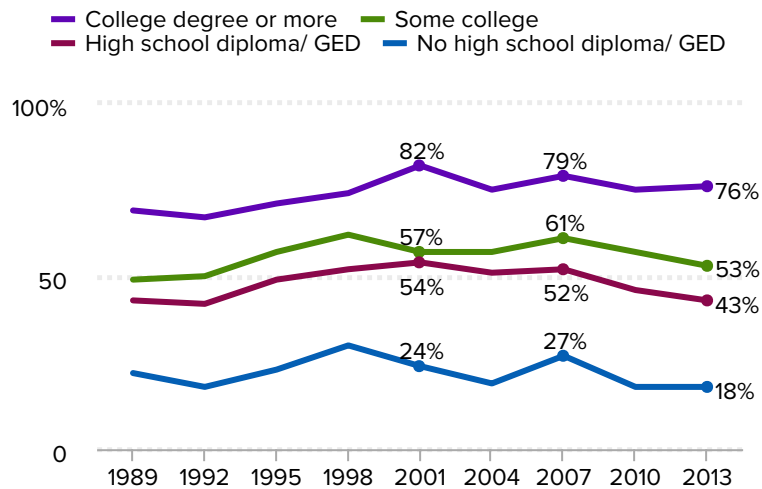
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Figure D

The share of families with retirement account savings increased across education groups in the 1990s and declined across groups in the 2000s. However, the decline was steeper for less-educated groups. Over three-fourths (76 percent) of families headed by someone with a college degree or more education had savings in retirement accounts in 2013, compared with 43 percent and 18 percent, respectively, of families headed by someone with and without a high school diploma or GED.

College-educated families are much more likely to have retirement savings

Share of families age 32–61 with retirement account savings by education, 1989–2013



Note: Retirement account savings include 401(k)s, IRAs, and Keogh plans. "College degree" includes associate degrees.

Source: EPI analysis of Survey of Consumer Finance data, 2013.

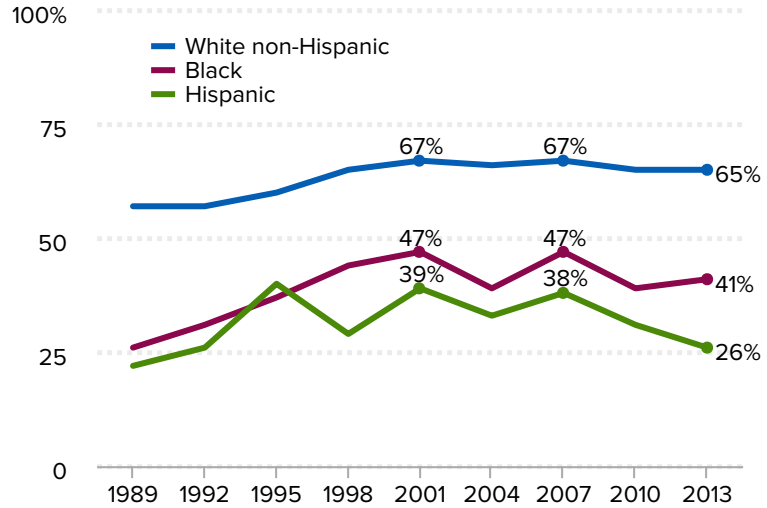
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Figure E

The share of Hispanic families with retirement account savings plummeted in the wake of the Great Recession, from 38 percent in 2007 to 26 percent in 2013, while the share of black families with retirement savings fell from 47 to 41 percent. In contrast, almost two-thirds (65 percent) of white non-Hispanic families had retirement savings in 2013, a share only slightly below the 2007 peak (67 percent).

Most black and Hispanic families have no retirement account savings

Share of families age 32–61 with retirement account savings by race, 1989–2013



Note: Retirement account savings include 401(k)s, IRAs, and Keogh plans.

Source: EPI analysis of Survey of Consumer Finance data, 2013.

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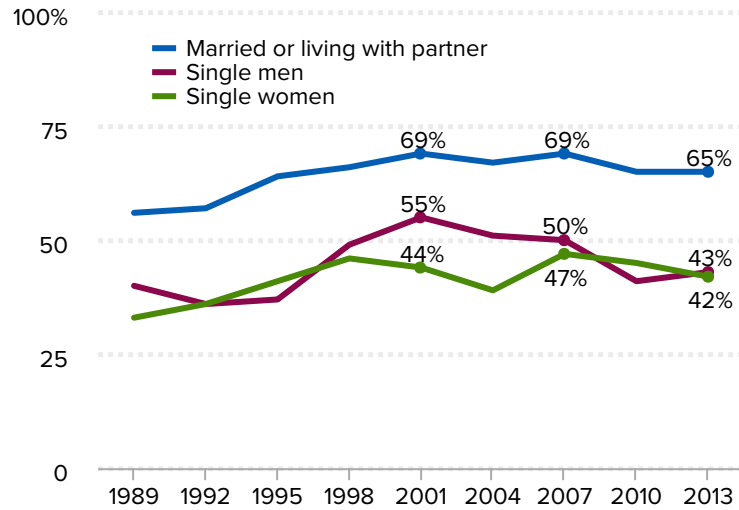
Figure F

Nearly two-thirds (65 percent) of married couples had retirement account savings in 2013, compared with 43 percent of single men and 42 percent of single women.

Though all groups saw declines in the new millennium, the share of single men with retirement savings declined the most. Single women remain more vulnerable in retirement than single men due to lower lifetime earnings and longer lifespans.

Single people are less likely to have retirement savings

Share of families age 32–61 with retirement account savings by gender and marital status, 1989–2013



Note: Retirement account savings include 401(k)s, IRAs, and Keogh plans.

Source: EPI analysis of Survey of Consumer Finance data, 2013.

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Inequality is not news—we have learned to expect it. The surprising thing is that we used to have a fairly egalitarian retirement system and no longer do. Social Security is and has always been a great equalizer, and traditional pensions at least do not exacerbate inequality. Before the 401(k) revolution, black workers were almost as likely to participate in pensions as white workers, and high school–educated workers were almost as likely to participate as college-educated workers. This remains true for workers lucky enough to participate in these pensions. But there are now more than twice as many workers in 401(k)-style plans as traditional pensions, and as we have seen, participation in 401(k) plans is very unequal.

What needs to be done? First and foremost, we need to reverse Social Security cuts and expand benefits across the board. To do this, we need to raise revenues, starting by lifting the cap on taxable earnings. As Warren Buffet has pointed out, he faces a lower tax rate than his secretary because earnings above \$118,500 are not subject to Social Security tax. I am also in favor of very slowly increasing Social Security contributions for all participants, split equally between employers and employees, to offset increases in life expectancy.

Second, we need to defend pensions for those who still have them. This includes most public-sector workers, since government employers are in a better position than many of their private-sector counterparts to provide pension benefits decades into the future—at least if elected officials keep up with required contributions. (Pension underfunding, incidentally, has little to do with pensions—it is simply a way to get around balanced budget requirements.)

Third, we need new solutions for workers whose employers are not in a position to provide traditional pensions. States are experimenting with hybrid plans that provide workers with some of the advantages of pensions without requiring employers to take on long-term liabilities. The California Secure Choice Plan, for example, is a good model, especially if California adopts a reserve fund to provide intergenerational risk smoothing.

In short, we face a looming retirement income crisis brought on by ill-timed Social Security cuts and a shift from secure pensions to risky, high-cost, and highly unequal 401(k) plans. However, this crisis can be averted if policymakers rise to the challenge of fixing our do-it-yourself retirement system. I thank the Philadelphia City Council for addressing this issue.

Endnotes

1. Social Security's replacement rate is somewhat higher for lower-income workers and somewhat lower for higher-income workers due to a progressive benefit structure. However, lower-income workers need a higher replacement rate to maintain their standard of living in retirement because they will see less of a decline in expenses after retirement.
2. This rule of thumb is sensitive to interest rate and other assumptions.

References

Morrissey, Monique. 2016. *The State of American Retirement: How 401(k)s Have Failed Most American Workers*. Economic Policy Institute.

Munnell, Alicia H., Wenliang Hou, and Anthony Webb. 2014. *NRRI Update Shows Half Still Falling Short*. Boston College Center for Retirement Research, Issue Brief #14-20.