Trends in Retirement Security

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Mr. Chairman and other members of the Committee, thank you for the invitation to testify to you today regarding retirement security. I currently serve as Director of The Hamilton Project at The Brookings Institution, an initiative dedicated to developing policies that promote broad-based growth and opportunity. Enhancing retirement security is an important part of our efforts.

Preparing for retirement is substantially more complicated for today's workforce than it was for yesterday's workers. Old mechanisms to secure retirement income, such as defined benefit pension plans, are being displaced by new savings vehicles such as defined contribution plans. This change offers major opportunities but leaves many families at risk of falling behind. As this change continues many families risk being left behind. Social Security benefits, meanwhile, provide an increasingly important bedrock for retirement security.

The challenge could not be more stark. The personal saving rate has been negative for six straight quarters, the first time it has gone negative since the 1930s. A negative personal saving rate not only threatens the economic wellbeing of working families, it also endangers our entire economy. Low national saving leads the United States to borrow nearly 7 percent of GDP annually from foreign countries. This high current account deficit increases the chances of an economic crisis that could adversely affect the economic security of all Americans. And it requires that a fraction of our future national output be devoted to repaying foreign lenders, rather than raising the living standards of future generations of workers and retirees.

At the individual level, many families are approaching retirement with very little in the way of savings. According to Survey of Consumer Finances data, two-third of families headed by a worker between the ages of 55 and 64 had under $88,000 in their retirement savings accounts in 2004. To put this in perspective, $88,000 would be enough to purchase an annuity paying just $653 per month.

There is wide variation in retirement savings and many families are accumulating substantial assets that will be enough to ensure a comfortable retirement. But is safe to

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say that at least one-third of families are not adequately preparing for retirement, according to a number of studies by economists. And it is this latter group which most needs – and can most benefit from – supportive public policy initiatives.

Financial planners generally recommend that retirement income replace about 70 percent of pre-retirement income. Social Security gets the typical family about halfway to this goal. For a typical worker retiring at age 65, Social Security replaces 40 percent of pre-retirement income. As the normal retirement age rises to 67, the replacement rate for workers retiring at 65 will fall to 36 percent. For the plurality of families that claim benefits starting at age 62, the replacement rates are even lower.

In practice, Social Security makes up more than half of retirement income for 70 percent of people over age 65. It is the only source of retirement income for a quarter of the people above age 65. In addition, Social Security benefits have several important features that make them a uniquely important part of retirement security: in particular, benefits are inflation-indexed, last until death, are not subject to market risk, and cover virtually the entire workforce.

But while Social Security has remained the core tier of retirement security, the rest of the system has changed rapidly. The percentage of workers participating in a pension plan has been roughly constant – at 50 percent – for at least the last twenty-five years. But the types of pension plans workers are participating in have changed dramatically. In 1983, 88 percent of workers with pension coverage were offered a defined benefit plan that would provide a retirement benefit linked to earnings and tenure, not to the individual investment portfolio of the worker. By 2004 that percentage had fallen to 37 percent. For defined contribution plans, (for example, 401(k)s, in which retirement benefits are linked to the performance of an investment account) the trend is almost the exact opposite. In 1983, 38 percent of workers offered a pension were offered a defined contribution plan while in 2004 it was 80 percent. And the trend away from defined benefit plans in corporate America continues apace. In 2006, IBM, Verizon, and a number of other prominent companies stopped offering defined benefit plans to new employees.

The shift to defined contribution plans creates two types of risks for workers. The first type of risk is easy to understand – the risk that a worker's chosen investments will perform poorly. This risk is mostly unavoidable in a defined contribution context (although some steps could reduce risks, such as not investing primarily the stock of one's employer). And policymakers would not want to eliminate this risk since the flip side of stock market risk is the high average returns in the stock market. Over the past century, equities have outperformed bonds by nearly 5 percentage points annually. Although there is no guarantee the equity premium will persist in the next century, and stocks are much more volatile than bonds, the fact that the percentage of families holding stocks, directly or indirectly, has risen from 40 percent in 1995 to 48 percent in 2004 is a good thing. The challenge we face is helping the other 52 percent of Americans enjoy the benefits of investing in stocks – without weakening the core tier of retirement security.

The second risk, associated with defined contribution plans is more troubling – but also completely fixable. Traditional defined benefit plans do not require workers to make many choices. Participation is generally automatic and nearly 100 percent of workers who are eligible for a defined benefit plan participate. In contrast, defined contribution plans shift the burden of decision-making to workers, leaving them in charge of making choices about whether to participate, how much to set aside for retirement, how to manage these funds, and how to roll them over into another retirement vehicle when they leave their job. And the evidence clearly shows that many workers make sub-optimal choices in all these respects. As Brookings economist William Gale says, "You don't have to be a mechanic to drive a car, and you shouldn't need a Ph.D. in financial economics to navigate the pension system."

In essence, while defined contribution plans present a tremendous opportunity for the workers who participate, make smart choices, and invest during strong markets, they also present a substantial risk to workers who fail to participate, make the wrong choices, or invest during weak markets. The Pension Protection Act of 2006 will improve matters for many employees by making it easier for companies to set up an automatic 401(k), but it is only a first step of many that can be taken to help families prepare for retirement.

By far the biggest challenge today's workers face is not being offered any pension plan at all. In 2006, 40 percent of private workers were working for a company that did not have any form of pension coverage. These workers have to save on their own, without the administrative, tax and financial advantages afforded by a company pension plan.

Finally, low- and moderate-income families face unique retirement security challenges. While Social Security benefits are progressive and provide a larger benefit for every dollar contributed by a low-income worker, one feature of particular importance to low-income workers has eroded in recent years: the special minimum benefit. Enacted in 1972, the special minimum benefit was designed to provide a robust floor for people who worked hard and contributed all their lives. Because it is not indexed to wage growth, the benefit has eroded over time and today few workers benefit and within a few years none will.

Another challenge faced by low- and moderate-income workers is that even if they manage to set aside modest retirement savings, they may be forced to deplete these savings before they can get help during times of hardship, such as a temporary period of unemployment or a major illness. Assets tests for Food Stamps, Medicaid, Temporary Assistance for Needy Families (TANF), and Supplemental Security Assistance (SSI) mean that low-income families can face a higher effective tax rate on their saving than high-income families. To make matters worse, many of the assets tests are not indexed for inflation and balances in some defined contribution plans count towards some of the asset tests, even though the defined benefit plans they replaced did not.

Working Americans need new policies for the modern era of retirement planning – policies that make pensions work better for the workers that have them, and policies that ensure more workers, and ideally all workers, have a pension.

The Hamilton Project, as well as the Retirement Security Project, are working to develop such policies. I look forward to discussing some of them in response to your questions.