Expanding Retirement Saving

Statement of

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"Helping Americans Prepare for Retirement:
Increasing Access, Participation and Coverage in Retirement Savings Plans"
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The views expressed are solely those of the author and do not represent the views or policy of the Center for Retirement Research at Boston College.

Chairman Hatch, Ranking Member Wyden, and Members of the Committee, thank you for the opportunity to testify today about "The Savings & Investment Bipartisan Tax Working Group Report."

This testimony underlines the importance of the Working Group's recommendations to broaden coverage and encourage retirement saving by lower-paid workers. But it also argues that we are facing an enormous retirement income challenge and therefore need even bolder changes.

This testimony proceeds as follows. The first section describes the retirement landscape, where more than half of working-age households are at risk of inadequate retirement income.[1] The second section discusses the extent to which the Working Group's proposals – which focus on the coverage gap and contributions by lower-paid workers – would ameliorate the situation. The third section recommends some broader solutions: 1) make 401(k) plans automatic and reduce leakage; and 2) enact national auto-IRA legislation. The final section concludes that the Senate Finance Committee could make an enormous contribution to heading off the coming crisis.

The Coming Retirement Crisis

To address the adequacy of retirement preparedness, the Center that I direct has developed a National Retirement Risk Index (NRRI), which relies on data from the Federal Reserve's *Survey of Consumer Finances*.[2] The NRRI compares projected replacement rates for working households ages 30-59 to target replacement rates that permit them to enjoy the same consumption in each period before and after retirement (see Figure 1). The Index measures the percentage of all households that fall more than 10 percent below their target.

The most recent NRRI results show that about half of all households are at risk, up from about 30 percent in 1983 (see Figure 2). So the problem is widespread and is getting worse over time.

Why do we have such a serious retirement income problem today when recent generations have retired in relative comfort? The reason is that baby boomers – and those who follow – will face a much different retirement landscape than their parents. The problem is twofold: 1) households will need more retirement income; and 2) they will receive less support from the traditional sources of Social Security and employer-sponsored plans. And today, as in the past, half of private sector workers do not participate in any type of retirement plan at a given point in time.

The Need for Retirement Income Is Growing

Today's workers will need more income when they retire because retirement spans are getting longer, health care costs are rising, and interest rates are very low.

Turning first to retirement spans. The number of years spent in retirement depends both on when people retire and how long they live in retirement. After declining for many decades, in the mid-1980s the average retirement age stabilized and then gradually increased from 62 to 64 for men. However, the latest evidence shows little change in average retirement ages

[1] For more details, see Ellis, Munnell, and Eschtruth (2014).
[2] For details on the NRRI methodology, see Munnell, Hou, and Webb (2014).

over the past several years, suggesting the trend toward later retirement may be running out of steam.[3] Meanwhile, life expectancy at 65 is continuing to rise steadily (see Table 1). On balance, the retirement period has been getting longer over time, from 13 years in 1960 to about 20 years today (see Figure 3).

Second, while retirees have health insurance coverage through Medicare, they still face substantial out-of-pocket costs for premiums (Parts B and D), deductibles, co-payments, and routine health services that are not covered by Medicare. Part B out-of-pocket costs alone have more than doubled since 1980, accounting for 15 percent of the average Social Security benefit today (see Figure 4). For individuals who require more than a brief stay in a nursing home, long-term care costs represent an additional expense.

Third, real interest rates have fallen dramatically over the past two decades, and today's rates continue to hover around historic lows of 1 percent (see Figure 5). Therefore, retirees need a much bigger nest egg than in the past to generate a given amount of income.

These factors combined mean that people are going to need to accumulate substantially more retirement income now than in the past.

Traditional Sources of Retirement Income Are Providing Less Support

At the same time that people need more retirement income, traditional sources are shrinking. Both Social Security and employer-sponsored retirement plans will provide less support than in the past. This trend is especially worrisome because people save virtually nothing outside of these two vehicles.

Social Security. Social Security benefits are the foundation of the retirement income system. But, under current law, these benefits are already shrinking in their ability to replace pre-retirement income for three reasons.

First, the gradual rise in the program's "Full Retirement Age" from 65 to 67 is cutting benefits across the board. For those who continue to retire at 65, this cut takes the form of lower monthly benefits; for those who choose to work longer, it takes the form of fewer years of benefits. For the typical earner who retires at 65, the replacement rate will drop from about 40 percent today to 36 percent once the transition is complete.

Second, Medicare premiums, which are automatically deducted from Social Security benefits, are rising faster than benefit levels. As a result, Part B premiums alone are estimated to increase from 5.4 percent of the average Social Security benefit for someone retiring in 1990 to 10.4 percent for someone retiring in 2030.

Third, more benefits will be subject to taxation under the personal income tax. Individuals with more than $25,000 and married couples with more than $32,000 of "combined income" pay taxes on up to 85 percent of their Social Security benefits. In 1985, only about 10 percent of beneficiaries had to pay taxes on their benefits, but the percentage of people subject to tax has

[3] Munnell (2015).

been increasing over time because these thresholds are not indexed for growth in average wages or even inflation. Today, almost 40 percent of households pay taxes on their benefits, and by 2030 more than half of households are expected to be subject to this tax.

The combined impact of these factors will reduce Social Security replacement rates for the average worker retiring at 65 by nearly a quarter – from a net 40 percent in 1985 to 30 percent by 2030 (see Figure 6).

And these reductions are happening without any changes in current law. If benefits are cut back further to address Social Security's long-term financial shortfall, replacement rates will drop even more.

Employer-Sponsored Retirement Plans. With declining replacement rates from Social Security, employer-sponsored retirement plans become much more important.

For those lucky enough to work for an employer providing a retirement plan, the nature of these plans has changed dramatically from defined benefit plans to 401(k)s. This shift means that the employee rather than the employer makes all the decisions *and* bears all the risks. Not long after the advent of 401(k) plans, it became clear that participants were accumulating only modest balances in these accounts.

As a result, in 2006 policymakers tried to make 401(k)s function more effectively through the Pension Protection Act (PPA). The PPA encouraged 401(k) plan sponsors to adopt automatic mechanisms that have proven effective at boosting participation (auto-enrollment) and contribution rates (auto-escalation). However, the effects of the PPA appear to have played themselves out, and today fewer than half of participants have access to auto-enrollment and a much smaller fraction have auto-escalation.

As a result, 401(k)s are still far short of being a broadly effective retirement savings vehicle.[4] For example:

- About 20 percent of those eligible *still* do not participate in their employer's plan.

- Typical contribution rates fall short of what most workers will need in retirement, and only about 10 percent of participants make the maximum contribution allowed.

- Many individuals make investing missteps, such as putting their money in mutual funds with high fees, which can substantially shrink their assets over time. For example, an additional 100 basis points in fees over a 40-year period reduces final assets by about one fifth.

- About 1.5 percent of assets leaks out of 401(k) plans each year when participants cash out as they change jobs, take hardship withdrawals, withdraw funds after age 59½, or default on loans.

[4] Munnell (2014).

As a result, in 2013, the typical working household approaching retirement with a 401(k) had only $111,000 in combined 401(k) and IRA balances (see Table 2). This amount translates into less than $400 per month, adjusted for inflation, which will not provide a sufficient supplement to Social Security benefits.

And Half of Private Sector Workers Do Not Participate in a Plan

Unfortunately, those workers covered by a 401(k) plan are the lucky ones. Only about half of private sector workers – at any particular time – are participating in any form of employer-sponsored plan, and this share has remained relatively constant over the last 30 years. The lack of universal coverage means that many American workers move in and out of plan participation and a significant percentage will end up with nothing but Social Security. The size of the pension participation gap has recently become controversial.

While the Working Group report got it right, some commentators downplay the problem, citing a Labor Department survey of employers – the *National Compensation Survey* (NCS) – showing that about 80 percent of workers have access to a plan. However, household surveys consistently show that participation rates are in the 40–55 percent range. What accounts for the differences? The answer depends on who, and what, is being measured.

To reconcile the numbers, it helps to compare the NCS employer survey to a Labor Department survey of households – the *Current Population Survey* (CPS) (see Table 3). The NCS shows that, in 2012, 78 percent of employers, public and private, *offered* pensions to full-time workers ages 25–64. Excluding public sector workers (who essentially have universal coverage) lowers the figure slightly to 74 percent. Add in part-time workers (who, after all, will still need to save for retirement) and the number drops to 64 percent. Finally, using the percentage of workers who actually *participate* in a plan, rather than those who are *offered* one, reduces the total to 48 percent. This figure compares to 43 percent for the same definition in the CPS, still a difference but only a modest one. In the end, it seems reasonable to conclude that only about half of private sector workers participate in a retirement plan.

The Working Group Proposals

The Working Group's report is aimed primarily at reducing this coverage gap and encouraging saving among lower-paid workers. The report discusses four main types of proposals.

First, several proposals would broaden access to potentially low-cost Multiple Employer Plans (MEPs) by getting rid of the requirement that 1) participating employers must share a nexus and 2) one "bad apple" hurts the entire barrel (i.e. a single employer who violates a requirement can disqualify the entire plan). Indeed, MEPs may be a useful vehicle for expanding coverage; making them more available is a positive and appealing step, provided that small employers are protected against unscrupulous actors.

Second, a group of proposals, aimed at small businesses, offer increased financial incentives to start new plans, additional incentives for auto-enrollment, and credits for employer contributions.

Other proposals encourage higher matches, less leakage, and the portability of lifetime income. All these proposals would have a positive impact, albeit very small.

Third, a proposal to increase coverage for long-term, part-time employees is a great idea.

Finally, a proposal to enhance the Saver's Credit by increasing eligibility and making the credit refundable is extremely important. We have been doing a lot of work at the state level, and an expanded Saver's Credit could be a very helpful component of the state auto-IRA proposals.

The question is the extent to which these proposals will solve the coverage problem and increase contributions. I fear that their impact will be modest. Making MEPS more accessible does not mean that employers will take advantage of the options. Policymakers have tried to close the coverage gap in the past by introducing streamlined products that can be adopted by small businesses. For example, the SIMPLE plan, which is administered by the employer's financial institution, does not require the employer even to file an annual financial report. These simplification initiatives, however, have clearly not reversed the trend toward declining coverage (see Figure 7).

This outcome is not surprising given that administrative and cost considerations are not the main reasons cited by small businesses for not offering plans (see Figure 8). More important concerns are too few employees, lack of employee interest, unstable business, and other factors. For these reasons, the Working Group's increased financial incentives to set up plans are also likely to have little effect.

The Working Group's proposal to expand the Saver's Credit and make it refundable has the potential for a real impact. To achieve this impact, however, low-wage workers have to make contributions to a retirement account. At this point, relatively few do, because many lack coverage. Expanding coverage, coupled with auto-enrollment, is the only realistic way to achieve this goal. Many states are in the process of setting up their own auto-IRA programs, and the expanded Saver's Credit could be seen as a matching contribution from the government that could encourage workers not to opt out once they are auto-enrolled.

Bolder Steps

Given the enormity of the retirement savings crisis, though, we need bolder steps. Within the context of the Working Group report, the two most important changes would be to make the 401(k) system work better and enact auto-IRA legislation at the national level so that each state does not have to set up its own plan.

Make 401(k)s Fully Automatic

The most important policy change would be requiring all 401(k)s to be fully automatic, while continuing to allow workers to opt out if they choose. Plans should automatically enroll *all* of their workers – not just new hires – and the default employee contribution rate should be set at a meaningful level and then increased until the combined employee contribution and employer

match reach 12 percent of wages. The default investment option should be a target-date fund comprised of a portfolio of low-cost index funds.

Separately, the problem of 401(k) leakages needs to be addressed more fully. Recommended changes on this front include tightening the criteria for hardship withdrawals to limit them to unpredictable emergencies; raising the age for penalty-free withdrawals from 59½ to at least 62; and prohibiting cash-outs when switching jobs. These changes would go a long way to making 401(k)s a more robust mechanism for retirement saving. Participants would retain access to their funds in emergencies through loans.

Cover Those Without a Plan

The Working Group recognizes the importance of the coverage gap, but financial incentives alone will not solve the problem. We need to automatically enroll uncovered workers into a retirement savings program. Once employers are required to provide coverage either under a plan that they choose themselves or under a new auto-IRA program, they may become more interested in adopting a MEP, with its low cost and easier accessibility.

As I have noted, many states are setting up their own auto-IRA programs, but it makes much more sense to pass auto-IRA legislation at the national level. Interestingly, anecdotal evidence suggests that opposition towards a national plan among some financial services companies may be softening, as they would prefer a uniform plan to 50 different state plans.

Conclusion

The retirement income landscape has been changing in a way that systematically threatens the retirement security of millions of Americans. The Senate Finance Committee could build on the proposals in the Working Group report to make two bold changes – make 401(k)s plans automatic and cover the uncovered through auto-enrolling workers (both full time and career part-time) into a national auto-IRA program. Combine these changes with the expansion of the Saver's Credit and this Committee will have gone a long way towards averting a retirement income crisis.

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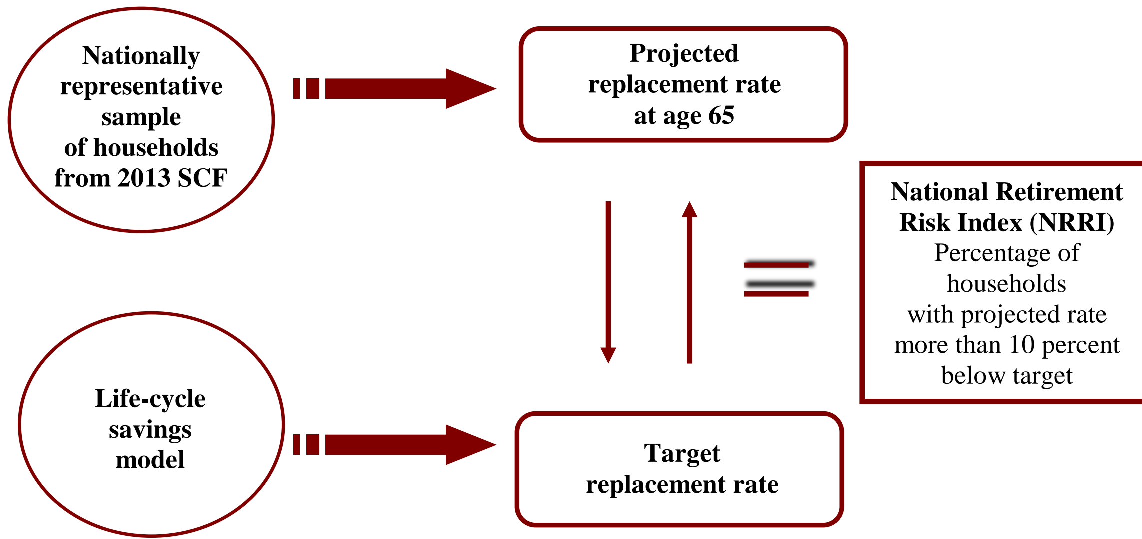
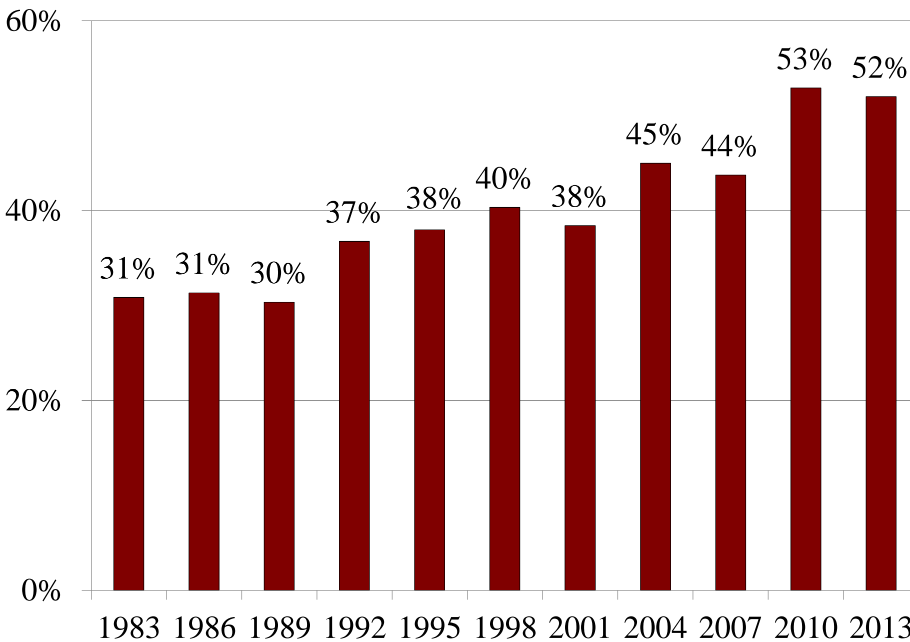
Figure 1. *Overview of the National Retirement Risk Index*



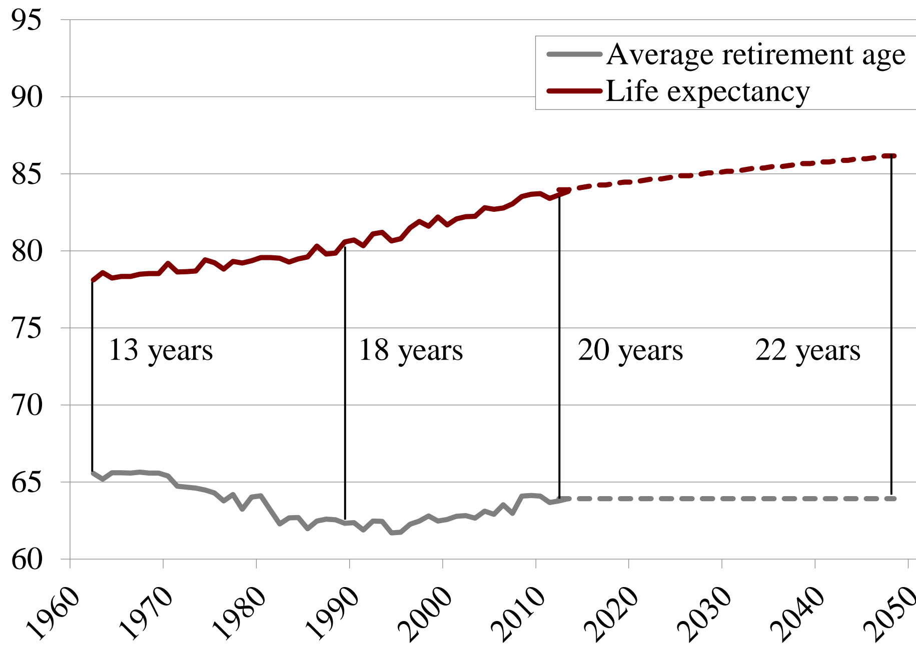
Note: SCF is the *Survey of Consumer Finances*, conducted triennially by the U.S. Board of Governors of the Federal Reserve System.
Source: Author's illustration.

Figure 2. *The National Retirement Risk Index, 1983-2013*



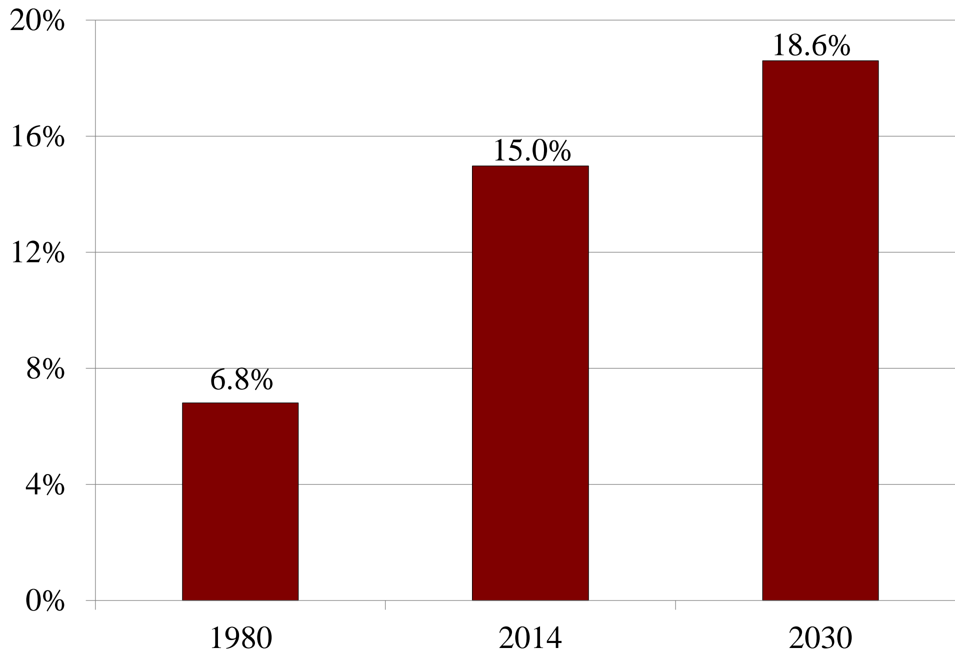
Source: Munnell, Hou, and Webb (2014).

Figure 3. *Average Years in Retirement for Men, 1960-2050*



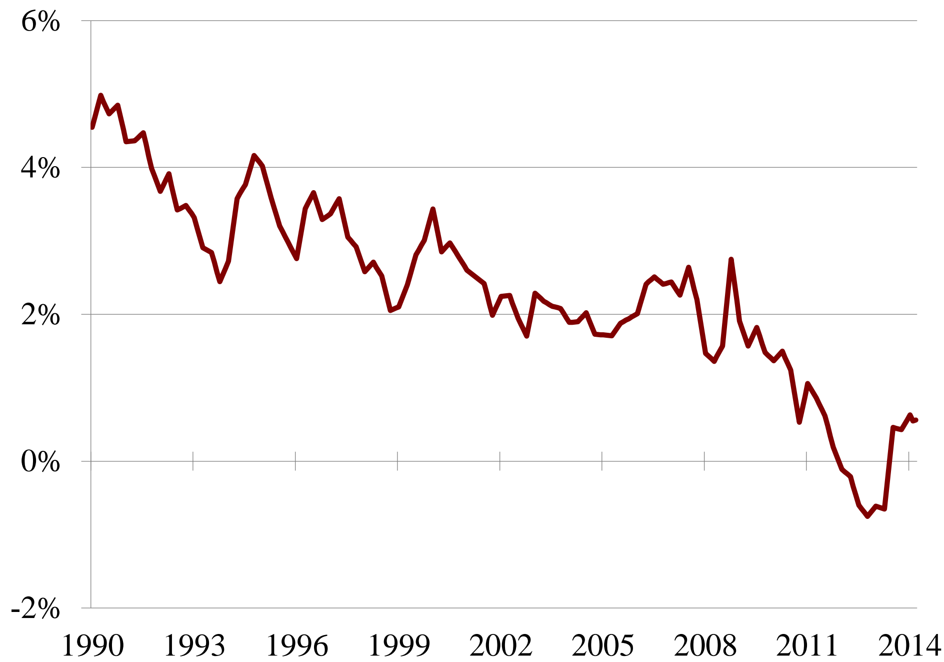
Sources: Author's estimates from U.S. Census Bureau (1962-2012); and U.S. Social Security Administration (2014).

Figure 4. *Medicare Part B Out-of-Pocket Payments as Percentage of Average Social Security Benefits, 1980, 2014, and 2030*



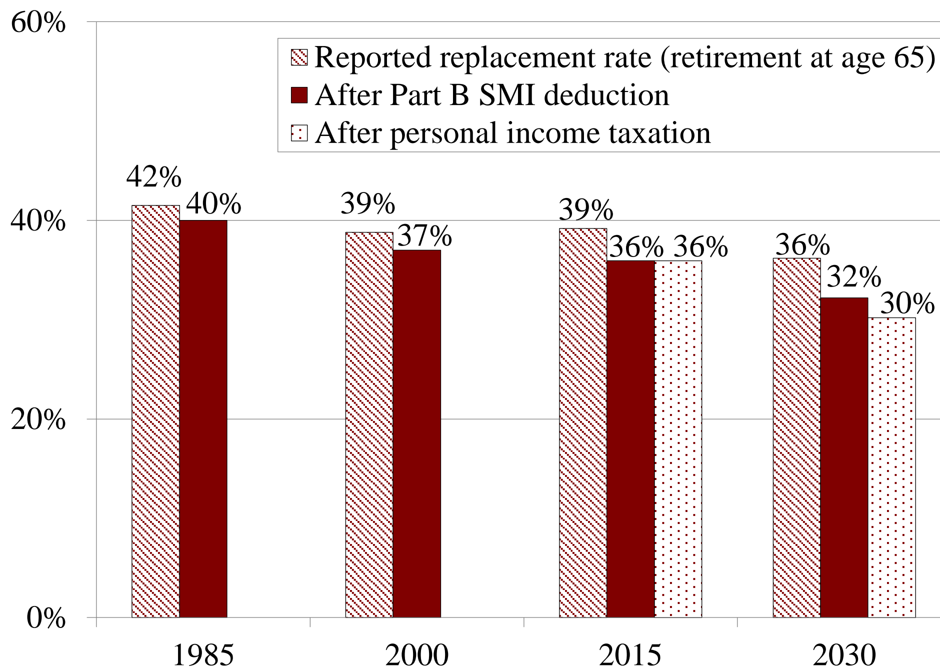
Source: Centers for Medicare & Medicaid Services, Office of the Actuary (2014).

Figure 5. *Real Interest Rate, 1990-2014*



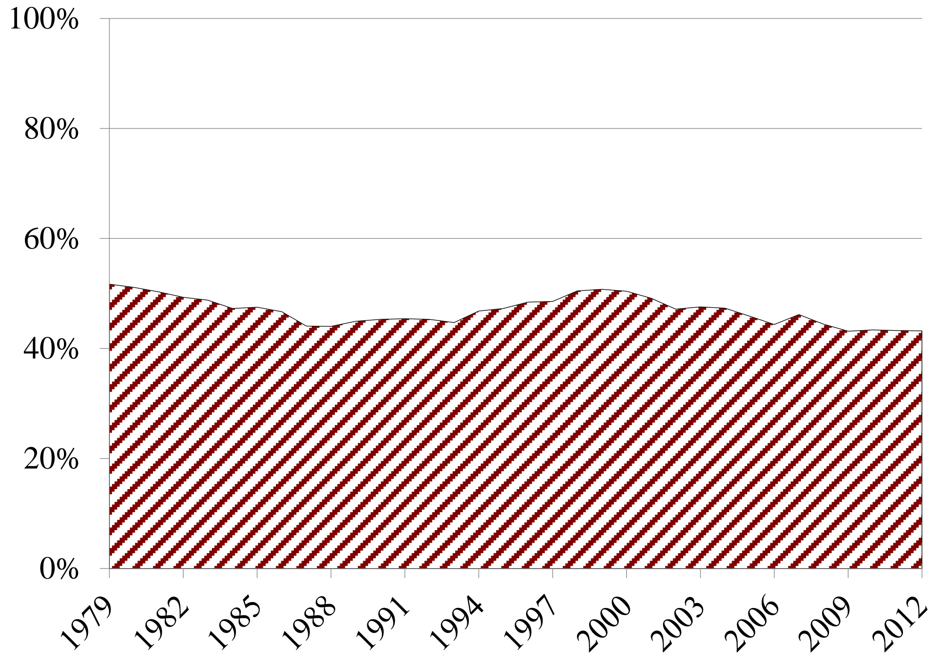
Sources: U.S. Board of Governors of the Federal Reserve System, Selected Interest Rates (2013); Haubrich, Pennacchi, and Ritchken (2011); and unpublished estimates from Richard Kopcke.

Figure 6. *Social Security Replacement Rates for Average Earner Retiring at Age 65, 1985, 2000, 2015, and 2030*



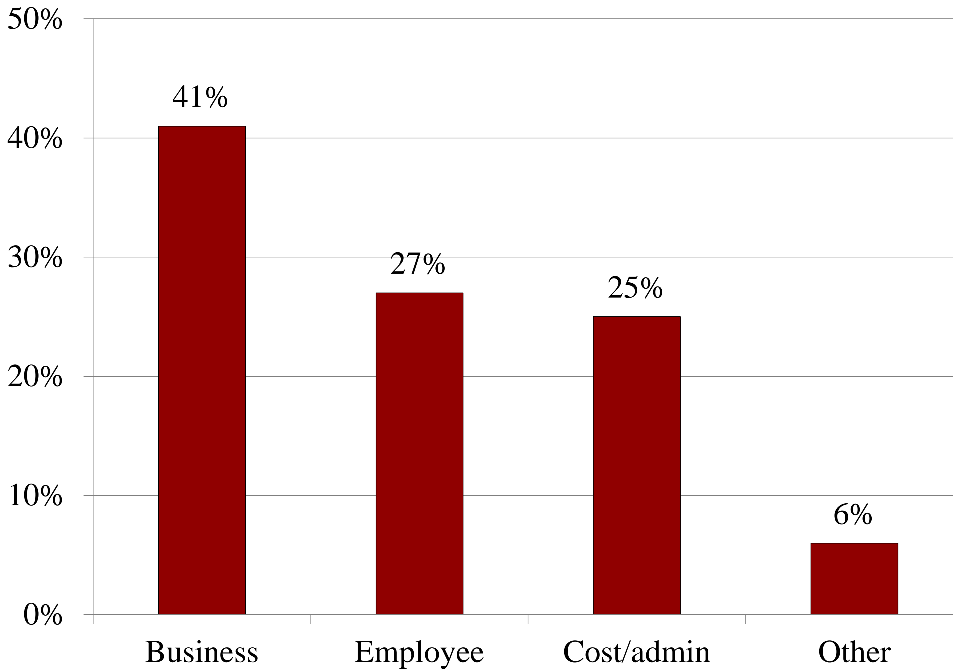
Sources: Author's calculations using unpublished data from Centers for Medicare and Medicaid Services (2014); and U.S. Social Security Administration (2014).

Figure 7. *Percentage of Private Sector Workers Ages 25-64 Participating in an Employer-Sponsored Pension, 1979-2013*



Source: U.S. Census Bureau (1979-2013).

Figure 8. *Most Important Reasons Cited by Small Employers for Not Offering a Plan, 2003*



Source: Employee Benefit Research Institute (2003).

Table 1. *Life Expectancy at Age 65 for Men and Women, 1960, 1980, 2000, and 2020*

Year	Men	Women
1960	13.2	17.4
1980	14.7	18.8
2000	17.6	20.3
2020	19.7	22.0

Source: U.S. Social Security Administration (2014).

Table 2. *401(k)/IRA Balances for Median Working Household with a 401(k), Age 55-64, by Income Quintile, 2013*

Income range (quintiles)	Median 401(k)/IRA balance	Percentage with 401(k)
Less than $39,000	$13,000	22%
$39,000-$60,999	$53,000	48
$61,000-$90,999	$100,000	60
$91,000-$137,999	$132,000	65
$138,000 or more	$452,000	68
Total	$111,000	52

Source: Author's calculations from U.S. Board of Governors of the Federal Reserve System, *Survey of Consumer Finances* (2013).

Table 3. *Percentage of Workers (25-64) with Pensions in the CPS and NCS, 2012*

Category	CPS	NCS
Employer offers, public and private, full-time	63 %	78 %
Employer offers, private, full-time	59	74
Employer offers, private, full-time and part-time	52	64
Employee participates, private, full-time and part-time	43	48

Note: CPS is the *Current Population Survey*. NCS is the *National Compensation Survey*.
Source: Munnell and Bleckman (2014).