

Restoring Retirement Security:
The Market Crisis, the “Great Risk Shift,” and the Challenge for Our Nation

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Thank you Chairman Miller and members of the House Committee on Education and Labor for the opportunity to share with you my views on the current financial crisis and the future of our nation's embattled framework for providing retirement security.

My name is Jacob Hacker, and I am a professor of political science and co-director of the Center for Health, Economic, and Family Security at the University of California at Berkeley. I have devoted much my career to studying America's distinctive public-private system for providing economic security, including retirement security.

Without mincing words, that retirement security is in peril. Increasingly, Americans find themselves on a shaky financial tightrope, without an adequate safety net if they lose their footing. A major cause of this precariousness is what I call the "great risk shift."¹ Over the last generation, we have witnessed a massive transfer of economic risk from broad structures of insurance, whether sponsored by the corporate sector or by government, onto the fragile balance sheets of American families.

Retirement security is perhaps the clearest example of this shift. A generation ago, if a worker had been offered a retirement plan by his or her employer, it would have been a traditional guaranteed pension that looked much like Social Security. Today, those workers who are lucky enough to receive a pension—and roughly half the workforce continues to lack a pension at their job—are almost universally enrolled in individual account plans like 401(k)s, in which returns are neither predictable nor guaranteed.

The current financial crisis has cast in stark relief the financial market risks that workers face in their 401(k) plans. But market risks are not the only risks transferred to workers by 401(k)s. And fixing 401(k)s will require more than simply encouraging greater savings and more diversified investments. It will require rethinking and rebuilding the private pension system to fit the needs of a transformed American economy.

In my remarks, I would like to review some of the major evidence that Americans planning for retirement are at increased economic risk. After laying out the problem, I call for bold action to restore a measure of shared risk in private retirement planning. My remarks are divided into four parts, each encapsulating a simple core point:

- I. Our traditional tripartite framework of retirement security (government, employers, individuals) has broken down as employers have backed away from guaranteed retirement benefits.
- II. This breakdown has resulted in a private pension system that works extremely poorly for lower- and middle-income Americans.
- III. The main way in which this system works poorly is with regard to protecting Americans against the major risks they face in planning for retirement.
- IV. Because it takes so long for retirement pension systems to mature, the problems we see in our system today represent only the tip of the iceberg.
- V. Restoring a measure of shared risk will require fundamental reform of the 401(k) system, not simply the encouragement of more or smarter investments.

I. America's Distinctive—and Endangered—Framework of Retirement Security

America's framework for providing retirement security was historically referred to as a "three-legged stool": Social Security, private pensions, and personal savings. Each leg was supposed to carry an important part of the weight of securing workers' retirement. For lower-income workers, Social Security was far and away the most important leg of the stool. But for middle- and higher-income workers, tax-favored private pensions were assumed to be vital for achieving a secure retirement—especially after the Employee Retirement Security Act of 1974 put in place rules designed to ensure that defined-benefit pension plans would be properly run, broadly distributed, and secure.

The problem is that this unique employment-based system is coming undone, and in the process risk is shifting back onto workers and their families. As recently as twenty-five years ago, more than 80 percent of large and medium-sized firms offered a defined-benefit plan; today, less than a third do, and the share continues to fall.² Companies are rapidly "freezing" their defined-benefit plans (that is, preventing new workers from joining the plan), and shifting them over to alternative forms (such as the so-called cash-balance plan) that are more like 401(k)s. For workers fortunate enough to receive a pension, 401(k) plans have become the default source of private retirement protection.

401(k) plans are not "pensions" as that term has been traditionally understood: a fixed benefit in retirement. They are essentially private investment accounts sponsored by employers. As a result, they greatly increase the degree of risk and responsibility placed on individual workers in retirement planning. Traditional defined-benefit plans are generally mandatory and paid for largely by employers (in lieu of cash wages). They thus represent a form of forced savings. Defined-benefit plans are also insured by the federal government and heavily regulated to protect participants against mismanagement. Perhaps most important, their fixed benefits protect workers against the risk of market downturns and the possibility of living longer than expected (so-called longevity risk).

None of this is true of defined-contribution plans. Participation is voluntary, and many workers choose not to participate or contribute inadequate sums.³ Plans are not adequately regulated to protect against poor asset allocations or corporate or personal mismanagement. The federal government does not insure defined-contribution plans. And defined-contribution accounts provide no inherent protection against market or longevity risks. Indeed, some features of defined-contribution plans—namely, the ability to borrow against their assets, and the distribution of their accumulated savings as lump-sum payments that must be rolled over into new accounts when workers lose or change jobs—exacerbate the risk that workers will prematurely use retirement savings, leaving inadequate income upon retirement. And, perversely, this risk falls most heavily on younger and less highly paid workers, the very workers most in need of protection.

As private risk protections have eroded, in sum, workers and their families have been forced to bear a greater burden.⁴ Rather than enjoying the protections of pension plans that pool risk broadly, Americans are increasingly facing retirement risks on their own. This transformation has at once made retirement savings less equal and more risky.

II. Unequal Retirement

Today, the three-legged stool of retirement security is wobbly for all but the well off. Social Security still provides a guaranteed foundation of retirement security for low- and middle-income workers. But private pensions no longer provide the risk protections they once did, and private retirement savings are virtually nonexistent among less affluent workers.⁵

The incentives for higher-income Americans to save have ballooned with the expansion of tax-favored investment vehicles like 401(k)s. Yet most Americans receive modest benefits from these costly tax breaks. According to a 2000 analysis, “Treasury data show that two-thirds of the existing tax subsidies for retirement saving (including both private pensions and IRAs) accrue to the top 20 percent of the population. Only 12 percent of these tax subsidies accrue to the bottom 60 percent of the population.”⁶

These skewed incentives are reflected in 401(k) account balances. It is often claimed that the “average” American has tens of thousands of dollars in a 401(k), but in fact roughly three-quarters of account holders have less than the widely cited average of \$60,000. The median among account-holders is less than \$20,000.⁷ And all these figures include only those who *have* 401(k)s, when only half of workers have access to a defined-contribution pension plan, and only around a third contribute to one. Overall, around 70 percent of defined-contribution pension and IRA assets are held by the richest fifth of Americans.⁸

Even those who do contribute adequately tend to make common investing errors, like putting their money in low-yield bonds, neglecting to rebalance their accounts periodically, and over-investing in their own company’s stock. As Professor Bernatzi points out in his testimony, these errors reflect well-understood biases in retirement planning that are deeply ingrained in the human psyche. Studies suggest, for instance, that simply automatically enrolling workers in 401(k)s, rather than requiring that they opt in, doubles initial participation in 401(k) plans, increasing it to nearly 90 percent.⁹ Because of how they are subsidized and structured, 401(k)s are almost tailor-made to produce insufficient retirement savings for ordinary workers—and, indeed, this is one reason they are relatively inexpensive for employers to run.

Much ink has been spilled comparing the returns of 401(k)s and old-style pensions (according to a study of returns between 1985 and 2001, defined-benefit pension plans have actually won, earnings returns that exceed those of their upstart competitors by about 1 percent a year).¹⁰ But the central issue for retirement security is not the return, but the risk. Retirement wealth has not only failed to rise for millions of families; it has also grown more risky, as the nation has shifted more of the responsibility for retirement planning from employers and government onto workers and their families.

III. Risky Retirement

The private retirement fortunes of all but today's oldest workers are dependent on the fate of 401(k)s. And this means, in turn, that these private retirement fortunes are dependent on the future of financial markets. As the recent gyrations of the stock market starkly reveal, financial markets provide an inherently risky basis for retirement planning.

To be sure, there is nothing that requires that 401(k)s be invested in stocks. Workers are free to buy bonds or a conservative mix of stocks and bonds, and indeed a significant share of workers invest their 401(k)s too conservatively for their age (not surprisingly, these tend to be lower-income workers).¹¹ Still, stocks do deliver a higher overall return. The problem is that this return comes with higher risk, and 401(k)s place all of this higher risk on workers, offering little of the investment guidance and none of the protections against economic loss that are inherent in defined-benefit pensions.

The risks posed by 401(k)s go beyond investment risks to encompass nearly all of the managerial and savings responsibilities imposed on workers. Consider one of the most distinctive features of defined-contribution plans: the ability of workers to take their pension as a "lump sum" (that is, in the form of cash) when they leave an employer. As a means of protecting retirement wealth, this is of considerable benefit to workers who change jobs frequently—but only if they save the money. Unfortunately, "most people who receive [lump sum distributions] do not roll over the funds into qualified accounts," such as IRAs and other 401(k)s—despite the fact that they must pay taxes on all their benefits, as well as a penalty of 10 percent if they are younger than 55.¹²

A clue to the source of this seemingly irrational behavior is provided by research on what affects workers' use of lump sum distributions. Workers who are laid off are 47 percent less likely to roll over their distributions. Workers who move to get a new job are 50 percent less likely. And workers who leave work to care for a family member are 77 percent less likely. "Overall," as one economist concludes, "the evidence suggests that pension assets have been used to buffer economic shocks to the household."¹³

Finally, it is not so easy to turn a retirement account into a lifetime guaranteed income of the sort that Social Security and defined-benefit pensions provide. To protect oneself against this risk requires purchasing an annuity. Yet most people do not use their 401(k) accounts to buy an annuity—in part because of inherent weaknesses of the annuity market, in part because their balances are too small to make the transaction worthwhile, and in part because they discount the possibility that they will outlive their assets.

IV. Assessing the Consequences

The true effects of the 401(k) revolution on income in retirement have yet to be seen. We will only know them with certainty when today's younger workers start retiring. But the signs are already troubling. Among Americans aged 64 to 74 in 2005 (that is, born between 1931 and 1941), nearly a third lost 50 percent or more of their

financial wealth between 1992 and 2002—a rate of wealth depletion that will soon leave them confronting a complete exhaustion of their assets, a much-reduced standard of living, or both. The rate of wealth depletion was even higher among those who reported they were in poor health.¹⁴

At the same time, debt is rapidly growing among families with heads older than 55. Between 1992 and 2004, the median debt level among older families with debt rose from \$14,498 to \$32,000 (in 2004 dollars), with the largest percentage increase occurring among the oldest of the aged (75 or over). The share of older families with debt also rose substantially—from 53.8 percent to 60.6 percent—and, again, most the increase was due to the growing problem of indebtedness among the oldest elderly.¹⁵

These results suggest that, while much attention has been paid to the accumulation of assets *for* retirement, far less has been devoted to the issue of how Americans managed their assets *in* retirement. Defined-benefit plans and Social Security ensure that workers receive a relatively stable income as long as they live. There are no such guarantees when it comes to IRAs and 401(k) plans, and every reason to think that many retirees will exhaust their accounts well before they die.¹⁶

A more complete—and even more worrisome—picture of how risky retirement has become for Americans is provided by the “Retirement Risk Index,” a comprehensive measure of retirement security exhaustively prepared by researchers at Boston College and first released in 2006. According to the index, the share of working-age households that are at risk of being financially unprepared for retirement at age sixty-five has jumped from 31 percent in 1983 to more than 43 percent in 2006. Younger Americans, who have borne the brunt of the transformation of retirement protections, are far more likely to be at risk than older Americans. Roughly *half* of those born from the mid-1960s through the early 1970s are at risk of being financially unprepared, compared with around 35 percent of those born in the decade after World War II.¹⁷ The least financially prepared are low-income Americans—in every age group.

V. Restoring Retirement Security

The promise of private pensions at their heyday was a secure retirement income that, when coupled with Social Security, would allow older Americans to spend their retired years in relative comfort. That promise is now in grave doubt. But reforms to our pension system could make private retirement accounts work better as a source of secure retirement income for ordinary workers and their families.

In the context of the financial market crisis and increased private risk-bearing, securing our one guaranteed system of retirement security, Social Security, is all the more essential. But even with a secure Social Security system, today’s workers will need other sources of income in retirement. 401(k)s as they are presently constituted are not the solution. Too few workers are offered them, enroll in them, or put adequate sums in them—a reflection of perverse incentives built into their very structure. Instead, we

should create a universal 401(k) that is available to all workers, whether or not their employer offers a traditional retirement plan. Employers would be encouraged to match employer contributions to these plans, and indeed government could provide special tax breaks to employers that offered better matches to lower-wage workers.

Since universal 401(k)s would be offered to all workers, there would cease to be any problem with lump-sum payments when workers lost or changed jobs. All benefits would remain in the same account throughout a worker's life. As with 401(k)s today, this money could only be withdrawn before retirement with a steep penalty. Unlike the present system, however, 401(k)s would be governed by the same rules that now protect traditional pension plans against excessive investment in company stock. Moreover, I believe that the default investment option under 401(k)s should be a low-cost index fund with a mix of stocks and bonds that automatically shifts over time as workers aged to limit market risk as workers approach retirement.

After my criticism of 401(k)s, it may come as surprise that I think Universal 401(k)s are the best route forward. But the difference between universal 401(k)s with strong incentives for contributions and the present system are profound. What is more, I would recommend one dramatic additional change that would fundamentally improve 401(k)s, transforming them into a source of guaranteed retirement income: Under this proposal, 401(k) accounts would be converted into a lifetime guaranteed income at retirement—unless workers specifically requested otherwise and could show they had sufficient assets to weather market risk. These new annuities could be provided by private firms under strict federal rules or directly by the federal government. Interestingly, this proposal is not so different from an idea that was seriously considered by the developers of the Social Security Act in 1935, who argued that the post office should sell low-cost annuities to those who needed them. In essence, universal 401(k)s along these lines would bring back something close to a guaranteed private pension.

To help workers' plan ahead, moreover, 401(k) balances should be reported to account holders not simply as a cash sum, but also a monthly benefit amount that workers would receive when they retired if they had average life expectancy—just as Social Security benefits are reported.

The reforms that we need should be bold, swift, and guided by a commitment to shared fate. Today, when our fates are often joined more in fear than hope, it is sometimes hard to remember how much we all have in common when it comes to our economic hopes and values. Indeed, we are more linked than ever, because the great risk shift has increasingly reached into the lives of all Americans. What recent market events remind us of is that, in a very real sense, all of us are in this together. Reforms to our embattled framework of retirement security should reflect that.

Again, thank you Chairman Miller and members of the committee for the opportunity to share my views.

Notes

¹ Jacob S. Hacker, *The Great Risk Shift: The New Economic Insecurity and the Decline of the American Dream*, rev. and exp. ed.m(New York: Oxford University Press, 2008).

² John H. Langbein, "Understanding the Death of the Private Pension Plan in the United States," unpublished manuscript, Yale Law School, April 2006.

³ Alicia H. Munnell and Annika Sundén, "401(k) Plans Are Still Coming Up Short," Center for Retirement Research Issues in Brief Number 43b, Boston College, March 2006, available online at www.bc.edu/centers/crr/issues/ib_43b.pdf.

⁴ Incidentally, none of these effects was foreseen or intended. When Congress added Section 401(k) to the tax code in 1978 to resolve some longstanding disputes over profit-sharing plans offered by employers, no mention was made of the change, except a brief note in the congressional report on the 1978 legislation indicating that the effects would be "negligible." Joint Committee on Taxation, General Explanation of the Revenue Act of 1978, 95th Congress, Joint Committee Print (1979), 84.

⁵ According to a recent analysis of families with earnings between two and six times the federal poverty level (\$40,000 to \$120,000 for a family of four) and headed by working-age adults, more than half of middle-class families have no net financial assets whatsoever excluding home equity, and nearly four in five middle-class families do not have sufficient non-housing assets to cover three quarters of essential living expenses for even three months should their income disappear. Essential living expenses include food, housing, clothing, transportation, health care, personal care, education, personal insurance and pensions. Jennifer Wheary, Thomas M. Shapiro and Tamara Draut, *By a Thread: The New Experience of America's Middle Class* (New York: Demos, November 2007), available online at <http://www.demos.org/pubs/BaT112807.pdf>.

⁶ Peter Orszag and Jonathan Orszag, "Would Raising IRA Contribution Limits Bolster Retirement Security For Lower- and Middle-income Families or Is There a Better Way?" Center on Budget and Policy Priorities, Washington, D.C., May 2000, available online at www.cbpp.org/4-12-00tax.htm

⁷ Employee Benefit Research Institute, "401(k) Plan Asset Allocation: Account Balances, and Loan Activity in 2006," EBRI Issue Brief No. 308 (August 2007, available online at www.ebri.org/briefs/pdf/EBRI_IB_08-20073.pdf.

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⁹ Brigitte C. Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *The Quarterly Journal of Economics*, Vol. 116, No. 4 (2006), 1159.

¹⁰ Alicia H. Munnell and Annika Sunden, *Coming Up Short: The Challenge of 401(k) Plans* (Washington, D.C.: The Brookings Institution, 2004), 75-77.

¹¹ Munnell and Sunden, *Coming Up Short*, #.

¹² Leonard E. Burman, Norma B. Coe, William G. Gale, "What Happens When You Show Them the Money: Lump Sum Distributions, Retirement Income Security and Public Policy," Prepared for Second Annual Joint Conference for the Retirement Research Consortium (2000), available online at <http://www.bc.edu/centers/crr/papers/SV-2%20Burman%20Coe%20Gale.pdf>.

¹³ Gary Engelhardt, "Reasons for Job Change and the Disposition of Pre-Retirement Lump Sum Pension Distributions," Unpublished, available online at <http://www-cpr.maxwell.syr.edu/faculty/engelhardt/econletters.pdf>.

¹⁴ Craig Copeland, "Changes in Wealth for Americans Reaching or Just Past Normal Retirement Age," Employee Benefits Research Institute Issue Brief No. 277 (2005), 18.

¹⁵ Employee Benefit Research Institute (EBRI), *Debt of the Elderly and Near Elderly, 1992-2004* (Washington, D.C.: EBRI, September 2006), available online at www.ebri.org/pdf/notespdf/EBRI_Notes_09-20061.pdf.

¹⁶ Jeffrey R. Brown, "How Should We Insure Longevity Risk in Pensions and Social Security," Center for Retirement Research, An Issue in Brief 4 (August 2000), available online at http://www.bc.edu/centers/crr/issues/ib_4.pdf.

¹⁷ Alicia H. Munnell, Francesca Golub-Sass, and Anthony Webb, *What Moves the National Retirement Risk Index? A Look Back and An Update* (Boston: Boston College Center for Retirement Research, January 2007), available online at http://crr.bc.edu/images/stories/Briefs/ib_57a.pdf.