Economic Policy Institute

EPI ISSUE GUIDE

Retirement Security

Revised September 2006

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Employment Benefits Research Institute (home page)

National Women's Law Center (home page)

Pension Rights Center (home page)

Urban Institute (home page)

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RETIREMENT SECURITY

Facts at a Glance

Revised September 2006

Overview

Unless otherwise specified, data on workers participating in workplace retirement plans refer to workers age 21-64, and data on households approaching retirement refer to households headed by someone age 55-64.

Retirement security is based on three supports.
Most descriptions of our retirement system include the metaphor of a three-legged stool. Its three legs are Social Security, pensions, and private savings, such as mutual funds, real estate, and savings accounts. However, only Social Security provides a guaranteed, inflation-proof benefit for the majority of Americans. More importantly, the other two legs, pensions and savings, are weakening.

How much retirement income is enough?
One way to think about retirement income is as a share of pre-retirement income. Often, retirees do not require the same income as they did when they were working, because they are no longer saving for retirement and because taxes are lower, work-related expenses disappear, family sizes shrink, and mortgages are paid off. Generally, a replacement rate of 75-80% of pre-retirement income is considered adequate, though rising retiree healthcare costs have led some to question this rule of thumb. Furthermore, replacement rates do not address the question of whether retirement income meets an absolute standard of need. For a worker who had inadequate income during his or her career, even a replacement rate of 80% of pre-retirement income will be inadequate.

With fewer workers covered by traditional pensions, Social Security is more important than ever.
Only half of all workers participate in any workplace retirement plan at all. In 1983, the vast majority (88%) of these workers were covered by defined-benefit pensions. By 2004, only a minority (37%) had traditional pensions, as employers shifted responsibility for retirement saving to workers through 401(k) plans. This leaves Social Security as the only guaranteed source of retirement income for most workers (Munnell and Sundén 2006).

Single women and minorities face retirement insecurity.
In 2001, 60% of single women (never-married, divorced, or widowed women) aged 47-64 anticipated retirement incomes below twice the poverty line, compared to 33% for single men and 16% for married couples in that age range. Similarly, 57% of African American and Hispanic households in that age range

looked ahead to retirement incomes below twice the poverty line, compared to 23% for non-Hispanic whites (Weller and Wolff 2005). Gaps in private pension coverage explain a large part of these differences.

Many households experience a sharp drop in living standards after retirement.
In 2004, 27% of households approaching retirement were likely to have retirement incomes less than half of their working incomes (Mishel et al. 2006). The share of households anticipating a severe drop in income after retirement is higher for African American and Hispanic households (39%) than for non-Hispanic whites (24%). It is also higher for households headed by workers with less than a high school degree (47%) and those headed by high school graduates (29%) than it is for college graduates (21%).

The post-World War II generation may be better off than their parents in retirement, but later generations are likely to be worse off.
The early baby boomers—people born between 1946 and 1954—have more savings and expected retirement benefits than previous generations at a similar stage in their lives. But in the absence of major policy reforms, they will be the last generation to have more retirement security than their parents. Later baby boomers (born 1955-64) and Generation Xers (born 1965-72) appear less prepared for retirement than were their predecessors, despite the boost to investments from the stock market and housing booms (Weller and Wolff 2005; Gale and Pence 2006; Munnell et al. June 2006). A study by the Center for Retirement Research projects that the typical late boomer and Generation X retiree will be able to replace only 69% and 65% of their pre-retirement incomes, respectively, compared to 77% for early boomers (Munnell et al. June 2006).

Social Security

Social Security is the cornerstone of our retirement system.
Social Security is by far the most important source of retirement income for the majority of retired Americans. Almost every worker is covered and will get at least some income from Social Security. Social Security provides 73% of the typical retiree's income, compared to 17% from pensions and 10% from savings and other sources (Munnell and Sundén 2006). A key feature of Social Security is that retirees cannot outlive their Social Security benefits nor see them eroded through inflation.

Social Security alone cannot ensure retirement security.
Social Security was always meant to be a basic insurance benefit, and workers need to have pensions or additional savings to maintain their standard of living in retirement. Social Security replaces 43% of the average worker's pre-retirement income, about three-fifths of what is needed (EPI analysis of Social Security Administration 2006, Table VI.F10).

Social Security provides a higher share of retirement income for low-income households.
Social Security benefits are based on years worked and earnings in each of those years. Because benefits are mildly progressive, the replacement rate rises to about 58% of pre-retirement income for low-income workers (workers with career earnings at 45% of the national average) (Social Security Administration 2006, Table VI.F10).

Social Security has reduced poverty among the elderly.
The official poverty rate for seniors age 65 or older fell from 35% to 10% between 1960 and 1995. The decline in poverty among older Americans is largely due to an expansion in Social Security benefits (National Bureau of Economic Research 2004). Though used to illustrate changing trends, the official poverty line is an imperfect measure of poverty, since even families earning twice that amount have

difficulty meeting basic needs like food, housing, and health care. In 2001, 27% of households approaching retirement faced retirement with incomes less than twice the poverty line (Weller and Wolff 2005).

Workplace Retirement Plans

Fewer than half of workers participate in a workplace retirement plan.
An analysis of Census Bureau (Current Population Survey) data by the Employee Benefit Research Institute found that only 48% of workers ages 21-64 participated in a workplace retirement plan in 2004, down from 52% in 2000. (Copeland 2005).Other surveys show participation flat or even rising slightly in recent years, but all agree that the rate has hovered around 50% since the early 1990s (Sanzenbacher 2006). This stagnation reflects a drop in male coverage due in part to a decline in unionized jobs with large manufacturing firms, while participation for women has actually increased slightly as more women have higher-paid, full-time jobs with benefits (Munnell et al. 2004). Over three-quarters (76%) of government workers participate in a retirement plan, compared to 43% of private sector workers (Copeland 2005).

Disparities in coverage exacerbate inequality.
Hours worked, income level, and education are key factors that influence retirement coverage, whether in traditional pensions or 401(k) plans. In 2004, 72% of workers who earned $40,000 or more participated in a retirement plan, compared to 51% of those earning between $20,000 and $39,999 and 19% of those making under $20,000. Likewise, 53% of full-time workers participated in a retirement plan, compared with just 21% of part-time workers. And 63% of college graduates participated, compared to 42% of high-school graduates and 21% of workers with less than a high school degree (EPI analysis of Copeland, 2005).

Traditional pensions provide retirees with a guaranteed income for as long as they live.
There are two basic types of workplace retirement plans: defined-benefit (DB) plans and defined-contribution (DC) plans. With traditional DB pensions, retirement benefits are determined in advance, usually based on an employee's years of service and their final average earnings in the years before retirement. Once earned, benefits are irrevocable and guaranteed, up to a limit, by a federal pension insurance program. Most DB pensions also include disability benefits.

In contrast, 401(k)s typically provide no guaranteed retirement income.
Defined-contribution plans like 401(k)s are tax-advantaged savings plans set up by employers. They were originally designed as add-ons to traditional pensions, though now they are often the only retirement plan offered by employers. 401(k) accounts are managed by the participants themselves, who choose from a number of investment options, typically stock, bond, money market mutual funds, or company stock. Instead of a monthly pension check, participants typically get a lump sum when they retire, the size of which depends on how much they set aside, how well their investments did, and whether they borrowed or cashed out any of the money in their accounts

401(k) plans are replacing traditional pensions.
An analysis of Federal Reserve data by the Center for Retirement Research found that in 2004, 80% of workers participating in a retirement plan were in a DC plan, up from 38% in 1983. This shift mirrored the decline of traditional DB pensions, which covered 37% of participating workers in 2004, down from 88% in 1983. (The totals sum to more than 100 because some workers participate in both kinds of plans.) (Munnell and Sundén 2006).

Retirement benefits for the typical worker are shrinking.
In 2001, the median combined value of DC plan assets and expected DB pension benefits was just $48,000

for households approaching retirement, down from $55,000 in 1983 (Weller and Wolff 2005). The drop-off occurred despite rising incomes, a stock market boom, and increasing employee contributions.

Unlike traditional pensions, which employers pay for, employers are not required to contribute to 401(k) accounts.

Traditional defined-benefit pensions in the private sector are funded by employers—though workers may contribute indirectly by accepting lower wages in return for pension benefits. Historically, employer contributions have averaged about 7% of payroll costs (Munnell et al. March 2006). In contrast, employers do not have to contribute to 401(k) accounts, unless this is required under a union contract. As a result, about 9% of 401(k) participants shoulder the entire cost themselves (Holden and VanDerhei 2001).

Workers shoulder most of the cost of 401(k) plans.

The most common 401(k) arrangement is an employer match of 50 cents for each dollar contributed by the employee, up to 6% of earnings (Munnell and Sundén 2004). In this case, the maximum employer contribution is 3% of payroll and workers shoulder at least two-thirds of the total cost. Thus, 401(k) plans are cheaper for employers than traditional pensions for the simple reason that employees pay for most of the retirement benefit themselves. Perhaps not surprisingly, 21% of eligible workers choose not to participate in a 401(k), and only 11% of participants contribute the maximum amount (Munnell and Sundén 2006).

Promoting retirement saving through tax deferrals disproportionately benefits high-income households.

The IRS allows 401(k) participants to invest pre-tax income, deferring taxes until retirement; assuming no change in the tax rate, the benefit is equal to the investment earnings on the deferred taxes. The value of this tax break depends on the marginal tax rate paid by a household, which is higher for high-income households. Thus, a family in the top (35%) tax bracket gets a tax break three and a half times more valuable than a family in the 10% tax bracket, even if they contribute the same amount to their 401(k). Because high-income households get bigger tax breaks, and because it is much easier for them to save, the Tax Policy Center estimates that 70% of tax breaks for 401(k)s go to the top 20% of households ranked by income (Burman et al. 2004).

These tax breaks appear to have little impact on retirement savings.

Tax breaks for retirement savings have been on the rise since the early 1990s, but the savings rate has plummeted. The Tax Policy Center has calculated that by 2003, the value of tax breaks for retirement plans actually exceeded the total amount of personal savings, which includes contributions to retirement plans (Bell et al. 2004). Since high-income households tend to save anyhow, the primary effect of current policies may be to cause households to shift assets to tax-deferred accounts, rather than to increase retirement saving. Studies have shown that whatever modest impact on savings does occur may be limited to lower-income households who reap little of the tax breaks designed to promote individual accounts, and appear to be more influenced by employer matches and the convenience of automatic deductions (Chernozhokov and Hansen 2004; Engen and Gale 2000; Munnell and Sundén 2004).

Most 401(k) participants save only a fraction of what they need for retirement.

One rule of thumb says that workers who start saving in their early or mid-30s should set aside 9% of their earnings into a 401(k) plan, including any employer contribution (other experts advise much higher set-asides). Factoring in assumptions about investment returns, wage growth, and inflation, the Center for Retirement Research calculates that workers who do this will have a nest egg equal to six and a half times their salary when they retire. But few workers are on track to meet this modest goal. The study found that in 2004, actual savings for a typical worker were, depending on the age group, roughly 20-40% of expected

accumulations, with relatively higher savings rates for younger workers (EPI analysis of Munnell and Sundén 2006 and Munnell and Sundén 2004). The study included IRA assets, which are largely comprised of funds rolled over from 401(k) accounts.

Participants often cash out their 401(k) accounts.
One factor contributing to the ineffectiveness of 401(k)s as a savings vehicle is the fact that, until recently, roughly half of 401(k) accounts were cashed out when workers changed jobs—even though these funds were subject to income tax and, in many cases, a 10% early withdrawal penalty. About 14% of participants also have loans outstanding from their 401(k)s (Munnell and Sundén 2004). A new rule requiring employers to roll over most small 401(k) balances into Individual Retirement Accounts (IRAs) may ameliorate this problem, though workers willing to pay the penalty can still cash out their savings at any time (Munnell and Sundén 2006).

401(k)s shift investment risk to employees.
The retirement wealth of 401(k) participants depends on investment returns, which have fluctuated widely over time. For example, someone who invested in the stock market in 1960 would have seen the real value of their investment shrink by a third over 20 years, while someone who invested in 1980 would have seen their savings multiply five times in the same amount of time, based on inflation-adjusted S&P 500 returns. The fact that returns can be negative over a 20-year time span belies the common assumption that long-term investors can ride out a slump. Returns are even more volatile in the short run: someone who retired in early 2000 would have a nest egg more than twice as big as someone who retired in late 2002—again based on real S&P 500 returns. The 2000-02 stock market collapse was compounded by falling long-term interest rates, which, among other things, lowered annuity incomes.

401(k) plan assets are poorly diversified.
For the most part, investment decisions related to an employee's 401(k) account are left up to the employee, who typically lacks the investment savvy and resources of a professional pension manager. Having control over their retirement savings may be empowering to some workers, but most appear little interested in monitoring their portfolios to ensure appropriate savings rates or diversified portfolios. 401(k) participants tend to have an all-or-nothing strategy when it comes to risk: for example, investing exclusively in stocks or in money market funds. A conservative investment strategy is especially common among low-wage workers, who are understandably cautious with their modest nest eggs (Munnell and Sundén 2004). While this may make sense on an individual level, on a societal level it compounds the problem that low-income workers benefit less from 401(k) plans even if they set aside the same amount.

Many 401(k) participants still have substantial investments in company stock.
As the Enron scandal vividly demonstrated, investing in company stock is usually a poor investment strategy because a worker's financial future is already closely tied to the company's performance, and investing heavily in any single stock is risky. Nevertheless, 22% of 401(k) assets remained in company stock in 2005, with one in five participants holding half or more of their balances in company stock (Hewitt Associates 2006). Whereas traditional pension funds are prohibited by law from holding more than 10% of assets in company stock, companies with 401(k)s may even require workers to retain matching contributions in the form of company stock.

Investment returns are higher—and administrative costs lower—with defined-benefit plans.
Traditional pensions are more cost effective than 401(k)s, because professional fund managers earn higher investment returns than individual investors, while administrative costs are kept low by pooling funds. The Center for Retirement Research estimates that investment returns were 7.9% for DB plans between 1985-2001, versus 7.1% for DC plans, despite the fact that DB plan assets were less concentrated in equities

(Munnell and Sundén 2004). Due to compounding, this small-sounding difference translates into a 25% larger nest egg over 30 years. The problem is exacerbated by investment management and administrative fees, which are about 0.4 percentage points higher for mutual funds than for traditional pensions, not even counting additional fees assessed by 401(k) providers (McCourt 2006; Collins 2003). The higher fees for 401(k)s are because accounts are smaller and individually managed, and because 401(k) fees are usually paid by the participant even though the employer selects the provider (McCourt 2006; Hamilton et al. 2006).

Pension funds help other investors and the economy by monitoring corporate management and promoting reforms.

Pension funds took the lead in pressing for corporate reforms in the wake of the Enron scandal. They also monitor companies in their investment portfolios. These actions have a beneficial impact on the economy. For example, a recent study found that underperforming companies placed on an annual watch list by CalPERS, the country's largest public pension fund, saw improvements in share price that translated into $3 billion in gains for investors nationwide between 1992 and 2005 (Barber 2006).

401(k) plans shift longevity risk to workers.

Traditional defined-benefit pensions and Social Security take the form of lifetime annuities. This means retirees get a monthly check for life. In contrast, 401(k) benefits typically take the form of lump sum payments, which means retirees can outlive their savings.

Traditional pensions help employers manage employee turnover and retirement.

The vesting and benefit structure of traditional pensions can be tailored to meet an employer's recruitment and retention needs, while encouraging the orderly retirement of older workers. In contrast, 401(k) plans allow external factors, including investment returns, to play a greater role in retirement decisions.

401(k) plans offer some advantages to younger, mobile workers.

In recent years, workers have become increasingly mobile, and some employers are placing more value on broad experience rather than firm-specific skills. This makes 401(k)s more attractive to mobile workers because workers can—at least in theory—accrue retirement savings over the course of their careers, whereas traditional pension benefits generally accrue disproportionately to workers who retire after many years with the same employer. Furthermore, workers can roll over and consolidate 401(k) balances when they change jobs, whereas workers who vest in more than one DB pension will typically receive separate retirement checks from each plan. For these reasons, many DB plan sponsors are changing their vesting and benefit structures to attract more mobile workers, while others are looking to hybrid plans that preserve the fixed benefit structure of traditional pensions while being more advantageous to mobile workers.

Savings

The personal savings rate has fallen.

The personal savings rate has been falling since the 1980s, but rising stock and housing prices have boosted the value of investments, leaving wealth-to-income ratios stable for people across age groups (Delorme et al. 2006). However, conventional wealth measures do not account for the decline in traditional pensions. Workers should be saving more to make up for this decline, as well as for rising health care costs and longer life expectancies.

Most retirement savings take the form of brick and mortar.

In 2004, more than four out of five households approaching retirement owned their own homes. The median value of net home equity was $70,000—the biggest component of the retirement nest egg after Social

Security (Bucks et al., 2006; Weller and Wolff 2005). Historically, buying a home was the most important way to save for retirement. Home ownership also stabilized housing costs for retirees, though this is becoming less and less true, as home equity loans have reduced the savings role played by mortgage payments, while adjustable-rate mortgages have exposed people to additional risk.

Tax breaks for IRAs disproportionately benefit high-income workers.
Individual Retirement Accounts (IRAs) are similar to 401(k)s except that they are not set up by employers. IRAs were originally supposed to target families with moderate incomes and those who did not have access to workplace retirement plans. In practice, however, IRAs are mostly used by higher-income families to roll over funds from 401(k) accounts. Since these rollovers are not subject to IRA income limits or contribution caps, and since the rules were relaxed for newer “Roth” IRAs, the Tax Policy Center estimates that 60% of tax breaks for IRAs went to the top 20% of households ranked by income (Munnell 2003; Burman et al. 2004). As with 401(k)s, there is little evidence that IRAs encourage new saving, as funds are merely shifted from other accounts to take advantage of tax breaks.

Healthcare

Healthcare costs are a major source of financial insecurity for older Americans.
Healthcare costs have risen two to three times faster than inflation in recent decades, which disproportionately affects older Americans, especially those not yet eligible for Medicare. Seniors age 65 and older are partly insulated from cost increases through Medicare, but out-of-pocket costs, especially for prescription drugs, can still be substantial. The share of retirees 65 and older relying entirely on Medicare—that is, not covered by supplemental insurance—has risen rapidly: from 34% in 1996 to over 40% in 2002 (Weller et al. 2004).

Fewer employers are providing retiree healthcare.
In 2002, only 34% of large firms (firms with more than 200 employees) offered health coverage to retirees, a sharp drop from 1988, when 66% offered retiree health coverage. The rate is even lower (5%) for small firms (Weller et al. 2004). Meanwhile, those companies still offering retiree health benefits have tightened eligibility standards, slashed benefits, and increased the share of costs borne by retirees (Weller et al. 2004).

The decline in coverage particularly affects those not yet eligible for Medicare.
Individual coverage can be prohibitively expensive or—for those with preexisting medical conditions—may not be available at any cost. Numerous studies have shown that older workers often delay retirement in order to remain insured, though this is not an option for those in poor health (Weller et al. 2004).

But healthcare costs are high even for seniors covered by Medicare.
The Employee Benefits Research Institute estimated that in 2003, a 65-year-old without employer-provided retirement health-care coverage would need $164,000 in savings to cover medical expenses (including Medigap premiums, Medicare B premiums, and out-of-pocket expenses) until age 85. This conservative estimate does not include the cost of long-term care, and assumes premiums will rise by only 7% a year (Fronstin and Salisbury 2003).

Many workers are forced into early retirement because of health issues.
A recent survey by McKinsey & Company found that people may be overly optimistic about their ability to work into their 60s. While 45% of baby boomers say they expect to work past 65, the average retirement age is 63 for men and 62 for women (Rotenberg 2006; Munnell et al. June 2006). Working longer—at least

in a job with comparable pay and benefits—is often not a choice for those who develop health problems or are laid off late in their careers. About 40% of workers are forced to retire earlier than planned, with health—or health of a family member—the reason cited for over half of these early retirements (Rotenberg 2006). Though early retirement can have negative financial impact on all workers, workers with traditional pensions are generally better protected than others since three-fourths are in plans that have disability benefits (Bureau of Labor Statistics 2005).

Prescription drug costs remain a burden for retirees.
The new Medicare prescription drug program has not solved the problem of high drug costs. Due to poor plan design—notably a rule preventing the government from negotiating lower drug prices—studies have found that drug prices offered by the private plans are generally no lower than those at low-cost pharmacies like Costco (Reitman 2006). This is true despite a $1,124 government subsidy per enrollee, plus a $250 deductible and annual premiums averaging $324 a year. Though the program will save money for seniors with exceptionally high drug costs who choose their plan carefully, it is not surprising that many eligible seniors have thus far declined to enroll.

Policy Implications

Retirement policies should promote saving *and* insure against risk.
Tax-subsidized individual retirement accounts—whether 401(k)s or IRAs—have failed to increase saving and were never designed to pool risk. Many high-income savers simply shift funds to these accounts to take advantage of tax breaks; meanwhile workers who really need these benefits may see their investments collapse or outlive their savings. The rationale for subsidizing retirement savings is to help people maintain their standard of living in retirement, yet current policies have failed either to stem the decline in employer-provided pensions or to protect people against risk.

Tax breaks for retirement plans amount to over a thousand dollars per working-age American, over half of it for individual accounts.
The Office of Management and Budget estimates that the present value of federal revenue losses for tax subsidies for defined-benefit pensions, 401(k)s, IRAs and other retirement plans was over $191 billion in 2005, or $1,076per person age 20-64. Over half of that ($110 billion, or $620 per working-age person) was for individual accounts like 401(k)s and IRAs, which disproportionately benefit high-income households and do little to encourage saving (EPI analysis of Office of Management and Budget 2006 and U.S. Census Bureau 2006). To put this in perspective, this is more than the total (2005-10) projected cost to the federal budget of hurricane relief following Katrina and Rita (Congressional Budget Office 2006). Ironically, the value of these tax breaks may be falling, not because of any change in retirement policies, but because recent cuts in tax rates have lowered taxes on all investment earnings (Munnell 2005).

Instead of tax breaks for the wealthy, we could provide every person age 65 and older with an additional $4,500 a year at no additional cost.
We should raise the bar for retirement subsidies, requiring that they be at least as effective in raising retirement incomes as direct transfers. For the same cost as tax breaks for individual accounts like 401(k)s and IRAs ($110 billion in 2005), we could buy every 65 year old an annuity worth approximately $375 per month for life, or $4,500 per year (EPI analysis of Office of Management and Budget data, using the Thrift Savings Plan's annuity calculator). (The actual amount would probably be higher, since this estimate is based on the current price of annuities purchased by individuals through the federal government's Thrift Savings Plan, and the cost of annuities would fall if everyone were covered.)

Subsidies should be greater for low- and middle-income workers.
Social Security aside, government programs to promote retirement security are administered through the tax system and private employers, and disproportionately benefit high-income workers. This is true not just for individual accounts like 401(k)s, but also for traditional pensions. However, the problem is compounded by making 401(k) participation voluntary and largely self-funded, since it is much harder for low- and middle-income workers to save. It makes more sense to have programs like Social Security that replace a greater share of pre-retirement income for low- and middle-income workers, both because this goes toward meeting basic needs and because higher-income people tend to live longer and would otherwise capture the lion's share of the benefit.

Public policies should promote reliable, lifelong retirement benefits.
Leaving aside the fact that most of the tax breaks for 401(k)s and IRAs go to high-income households who would save anyway, it is a bad idea to subsidize such high-risk, low-return plans. As noted earlier, investment returns on individual accounts are usually lower than returns earned by professional pension fund managers, and are further eroded by high fees. With these accounts, workers who retire after a stock market slump or who outlive their savings are simply out of luck. We should instead support policies that promote guaranteed, lifelong retirement incomes, especially programs like Social Security that provide inflation-adjusted benefits.

The marketplace alone cannot provide retirement security.
While anyone with money can invest in a mutual fund, it is very difficult for most people to attain the retirement security of a defined-benefit pension if their employer, union, or government does not provide one. Anyone who tries—say, investing in risk-free Treasuries and purchasing lifetime annuities—will find the cost prohibitive, whereas pension funds are able to manage risk while keeping costs manageable simply by pooling funds.

It is difficult to make a lump sum last a lifetime.
Even 401(k) participants who are able to set aside enough money and are lucky with their investments may have difficulty converting a lump sum disbursement into a steady income stream that will last through retirement. Few 401(k) plans offer lifetime annuities, and those that do tend to be expensive, as are those purchased through IRAs. This is partly because annuities are a kind of insurance, and people who choose to buy insurance tend to be people who are at higher risk (of living longer, in this case). Put another way, the cost of annuities would fall if everyone were covered because insurance companies charge more today knowing that individuals who choose annuities are healthier and will live longer than average. Because of this self-selection problem, a pension fund—or the government—can provide annuitized benefits to groups for less than what individuals can purchase on their own, just as employers or the government can provide group health insurance for less than what individuals can purchase on their own.

Group solutions are cheaper than individual ones.
Social Security and large pension funds keep costs down through economies of scale, but that's not the only way they provide retirement security at a lower cost than with individual accounts. Unlike individual savers, who need to prepare for the possibility that they might live to be 90 or even 100, pension funds need only set aside enough to cover the average lifespan. Pension funds also lower costs by pooling investment risk: individuals need an extra cushion to guard against the possibility that their retirement will coincide with a market downturn, whereas pension funds pool the retirement funds of people who retire at different times.

The U.S. system is unusual among industrialized countries.
Compared to most other industrialized countries, the United States relies heavily on employers to provide

pensions, healthcare, and other forms of social insurance. The U.S. system emerged in the wake of the New Deal and World War II as a way for corporations to ward off pressure for broader social change and avoid wartime wage controls. Welfare capitalism never worked well for most workers outside of large unionized firms, and is now wearing thin even in industries that once led the way in employee benefits

Employer-provided benefits are eroded by competition.
Though benefits improve employee recruitment, retention, and productivity, they do not necessarily pay for themselves from the point of view of the company, even if society as a whole gains. Increasingly, companies that provide retirement and health benefits must compete against those who do not provide those benefits to the same degree, if at all, and effectively pass these costs onto government. This recently prompted a landmark Maryland law requiring large employers like Wal-Mart who were not spending at least 8% of their payroll on health insurance to pay the balance into a state fund for uninsured workers—a small step in the right direction. On a global scale, countries that provide pension and health benefits primarily through government are able to compete globally because of cost efficiencies.

The government and unions serve an essential role.
Unlike private companies, federal, state, and local governments are here to stay. Likewise, multi-employer plans set up by unions can outlast the demise of individual firms. Governments and multi-employer funds can pool risk and take advantage of economies of scale. They can also help individuals make sense of complicated financial decisions. Left to fend for themselves, many people are overwhelmed by the array of complicated financial instruments. This results in high marketing costs and leaves room for unscrupulous sellers who pitch high-priced, inappropriate financial products to unsophisticated investors.

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Economic Policy Institute

RETIREMENT SECURITY

Frequently Asked Questions

Revised September 2006

Why do single women have less retirement security?
Single men and women generally have less retirement security than married couples (Weller and Wolff 2005). This problem is especially acute for single women (never married, divorced, or widowed women) who get much less retirement income from traditional pensions or 401(k)s.

While male and female workers are now covered at similar rates—49.4% of men and 47.2% of women participated in a workplace retirement plan in 2004—there is a significant gap in lifetime coverage for men and women generally because women are more likely to have worked part-time and to have taken time off to raise children or for other reasons (Copeland 2005; Shaw and Hill 2001).

Because of this, the average single woman over 65 had employer retirement benefits worth only $28,800 in 2001, compared to $81,600 for single men and $162,000 for married couples (Weller and Wolff 2005).

Though single women also have less income from Social Security than single men or married couples, the difference is not as pronounced as the difference in workplace retirement plans due to the progressive nature of Social Security benefits and the fact that widows and some divorced women receive spousal benefits.

Why do minorities have less retirement security?
As with single women, a big factor is unequal access to workplace retirement plans.In 2004, 29% of Hispanics and 46% of African Americans participated in workplace retirement plans, compared to 53% of white workers (Copeland 2005).

Will Social Security be there when I retire?
Estimates by the Social Security trustees (who are political appointees) and the non-partisan Congressional Budget Office (CBO) predict that the Social Security trust fund will be solvent until 2040 (trustees) or 2052 (CBO) even if Congress does nothing. In other words, Social Security can pay full benefits for a long time to come.   The trustees' estimates in particular are based on pessimistic assumptions, including productivity, population, and economic growth projections below current and historical levels. Even if these pessimistic forecasts turn out to be true, a shortfall would emerge gradually and could be largely resolved by removing the cap on earnings subject to the Social Security tax. (For more information, see EPI's Social Security

Issue Guide.)

How will demographic trends affect our retirement system?
As in most industrialized countries,Americans are living longer and having fewer children. As a result, the ratio of workers to retirees is projected to fall from around 4 to 1 in 2005 to 2 to 1 in 2050, and funding for Social Security retirement benefits is projected to rise from 4.4% of GDP in 2000 to 6.2% in 2050, according to the Organisation for Economic Co-operation and Development (OECD 2005; Government Accountability Office 2005). Nevertheless, OECD pension expert Monika Queisser says, “I can’t think of any developed country that has a state pension system in better shape than the U.S.” (Forsythe and Fitzgerald 2005). In fact, most OECD countries are already spending more on public pensions (7.6% of GDP on average) than the United States is projected to spend in 2050 (EPI analysis of OECD data; Government Accountability Office 2005).

Relative to most OECD countries, the United States has a higher birthrate, more immigration, and a later retirement age; it also pre-funds a portion of future retirement benefits. All these factors, plus the relative meagerness of our public pension system, make the approaching demographic challenges highly manageable compared to Europe, where pensions tend to be generous and the population is shrinking. The problem in the United States isn’t whether the retirement policies are affordable, it’s whether they are adequate: the United States has almost twice the share of seniors living on less than half the median income as other OECD countries (EPI analysis of OECD data; Government Accountability Office 2005). It is also important to note that productivity growth allows countries to devote a shrinking share of GDP to meeting retirees’ basic needs, even in Europe and other countries with slowly shrinking populations.

What explains the shift from defined-benefit to defined-contribution plans?
When given a choice, workers overwhelmingly choose traditional DB pensions over 401(k)s, because most 401(k)s are rightly viewed as a second-rate benefit. Not long ago,only an ailing company would take the drastic step of freezing its pension and switching to a 401(k) plan, but this cost-cutting measure has increasingly been adopted even by profitable companies (Munnell et al. March 2006).

One explanation for this shift is the weaker bargaining power of workers, who have also seen wages languish despite rapid productivity growth in recent years. The falling unionization rate is a key factor, given the role unions play in educating members about the importance of pensions and negotiating retirement benefits: about 44% of workers covered under a collective bargaining agreement participate in a defined-benefit plan, compared to 18% of those not covered under a union contract (EPI analysis of Copeland 2006). Another explanation is the fact that retirement benefits for senior executives are increasingly separate from those of other employees. Executives are able to provide good benefits for themselves and poorer benefits to non-management employees.

Rising healthcare costs have also been blamed for the erosion of other employee benefits, but this does not explain why retirement benefits have been the particular target of cost-cutting measures. One explanation is that the financial industry earns higher fees from individual accounts than from managing pension funds, and thus has an incentive to promote DC plans. Regulatory and tax code changes have tilted the playing field against DB plans in recent years (Gebhardtsbauer 2003) and pension reform legislation still in the pipeline may hasten the flight from DB to DC plans.

Some employers may be catering to a younger, mobile workforce, rather than trying to retain experienced workers. And stinting on retirement benefits does not have an immediate and obvious impact on workers’ living standards, as would cutting wages or increasing health insurance co-pays, especially since studies

have shown that people are overly optimistic about their retirement prospects (Helman et al. 2006).

Why are 401(k) balances so low?
As noted earlier, a study by the Center for Retirement Research found that the typical worker had only 20-40% of expected accumulations in his or her 401(k) and IRA accounts (the study assumes workers should set aside at least 9% of earnings beginning at age 35). One explanation is that some 401(k) participants, especially older workers, also have defined-benefit pensions from current or past employers and do not need to set aside as much. However, this only explains part of the apparent shortfall. Other explanations include the fact that some participants have not always been eligible for (or have not always have participated in) a 401(k) plan; contribute less than 9% of their pay; earn low investment returns (the study assumed a 7.6% rate of return); or have cashed out some of their 401(k) savings (Munnell and Sundén 2004; Munnell and Sundén 2006).

Do the Pension Benefit Guarantee Corporation's woes spell doom for traditional pensions?
The stock market lost almost 40% of its value between 2000 and 2002, and has yet to fully recover. This has affected both 401(k) balances and pension funds, though the latter have received more attention because employers must make up the shortfall (whereas 401(k) participants are simply out of luck). An increase in bankruptcies among DB plan sponsors—who not only faced higher pension contributions but were also clustered in ailing sectors like airlines, auto parts, and steel—has caused the Pension Benefit Guarantee Corporation (PBGC), the federal agency that insures private-sector pensions, to run a $23 billion deficit. By one estimate, future losses could cost an additional $92 billion (Cohen 2006). Though substantial, this is less than the annual cost of subsidies for 401(k)s and IRAs, most of which benefit high earners and do little to encourage retirement saving. Still, the PBGC's woes, and accounting changes that are expected to lower the reported net worth of companies with traditional pensions, highlight the problem of relying on employers to voluntarily provide retirement benefits.

An extra $4,500 a year doesn't sound like much. Aren't I better off with a 401(k) or IRA?
Not unless you're one of the lucky few.More than half of all households have no 401(k) or IRA, and even those who do have one do not benefit much since most of the tax breaks go to families in the top fifth of the income distribution. While $4,500 a year (or $3,360 with cost-of-living adjustments) may sound like a modest amount, it would be a substantial boost for most people, since the typical retiree relies on $12,000 in Social Security benefits for most of his or her annual income.

What is the Saver's Credit?
The Saver's Credit, which is limited to lower-income families, provides a tax credit for 401(k) and IRA contributions. The credit is equivalent to a dollar-for-dollar match on the first $2,000 contribution for low-income households—individuals earning $15,000 or less and married couples earning $30,000 or less. (There are somewhat less generous credits for individuals earning $15,001-$25,000 and couples earning $30,001-$50,000.) Though the Saver's Credit is far from perfect—structured as a non-refundable tax credit, it does not help families who earn too little to pay income taxes—it does partly compensate for the regressive nature of the current system which provides far larger tax benefits to high-income families who contribute to retirement accounts than to low-income families. However, the Saver's Credit is scheduled to expire at the end of 2006 and had not been extended at time of writing (Horney et al. 2006; Gale et al. 2005).

What is a cash balance plan?
A cash balance plan is a hybrid between a traditional pension and a 401(k) plan. Cash balance plans avoid one of the main problems of traditional defined-benefit pensions: the fact that the benefit structure is weighted against mobile workers. But they also share one of the disadvantages of 401(k)s: benefits are

usually paid out as lump sums and retirees can outlive their savings. Despite some controversy over their impact on older workers, cash balance plans have grown in popularity, and about one in five large employers now sponsors one (Cahill and Soto 2003).

With cash balance plans, as with traditional defined-benefit pensions, the employer bears the entire cost as well as the investment risk, and benefits are guaranteed by the PBGC. However, unlike traditional pensions, benefits are based on total earnings, not final earnings, which means workers accrue benefits at a steady pace throughout their careers instead of seeing the value of their benefits escalate only if they retire after many years with the same employer. Another advantage of cash balance plans—from the employer's point of view—is that costs are somewhat more predictable, though generally no lower than for traditional pensions.

Unlike 401(k)s, cash balance plans must offer an annuity option to retirees, but the available evidence—from 401(k) plans that do offer annuities—suggests that few retirees will take this option, and that some retirees may therefore outlive their savings.

Another issue that has arisen around cash balance plans is that older workers can see a drop in anticipated benefits when employers switch from defined-benefit pensions to cash balance plans, even if other workers benefit from the switch. This has understandably led some workers to file age discrimination lawsuits—though the Pension Protection Act of 2006 gave the green light to future conversions. However, making the switch to a cash balance plan optional, as some employers have done, is a solution that discriminates against no one.

These issues notwithstanding, cash balance plans are an enormous improvement over 401(k)s, because guaranteed, employer-provided benefits are almost always better for workers than risky, employee-funded plans. For mobile workers who manage their savings well after retirement, cash balance plans may also be preferable to traditional pensions.

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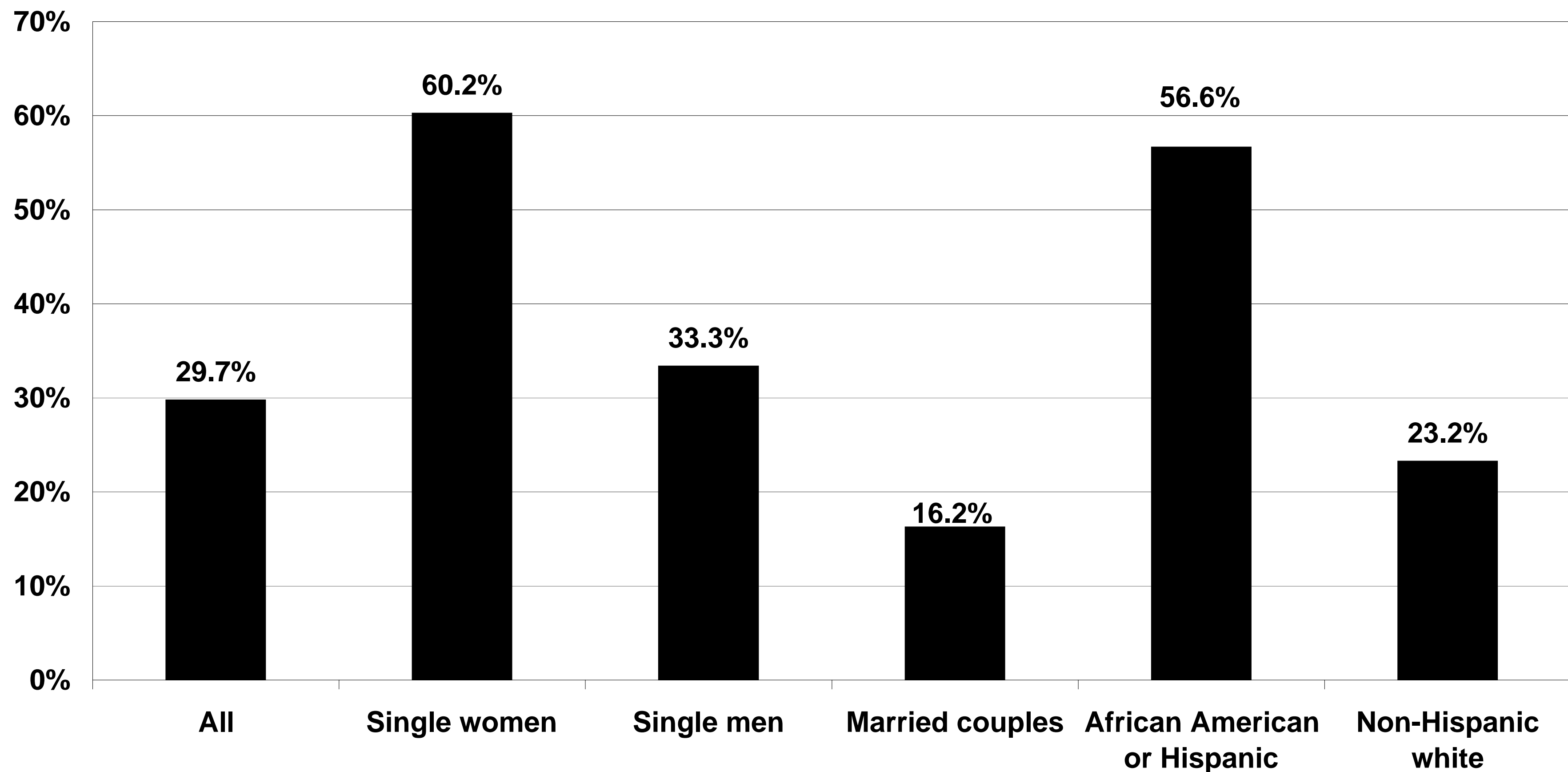
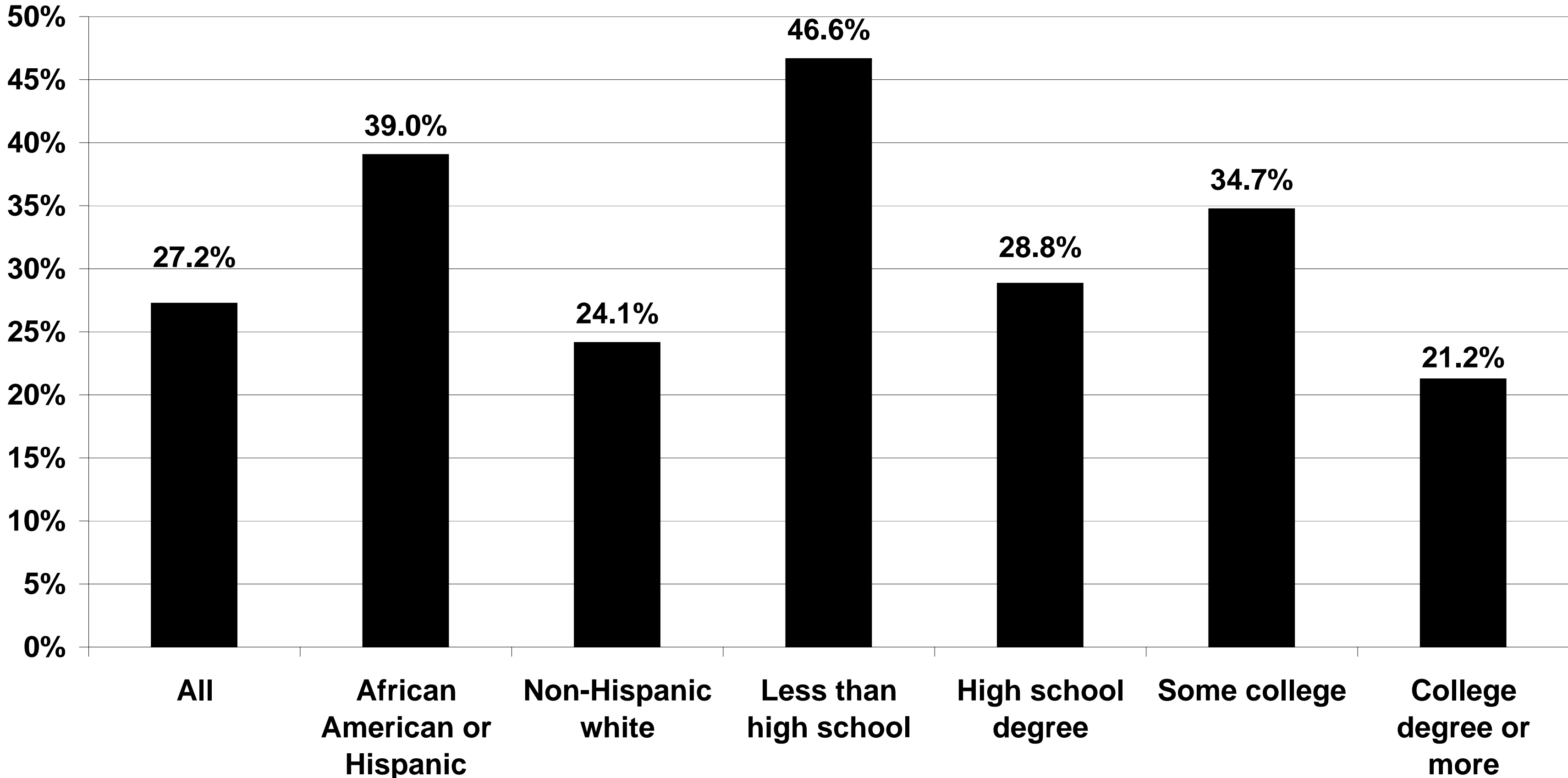


Note: Households approaching retirement are those with a head of household aged 47-64. Households are classified by the race/ethnicity of the head of household. "Single" includes divorced and widowed. Expected retirement income is based on wealth holdings and expected pension and Social Security benefits.

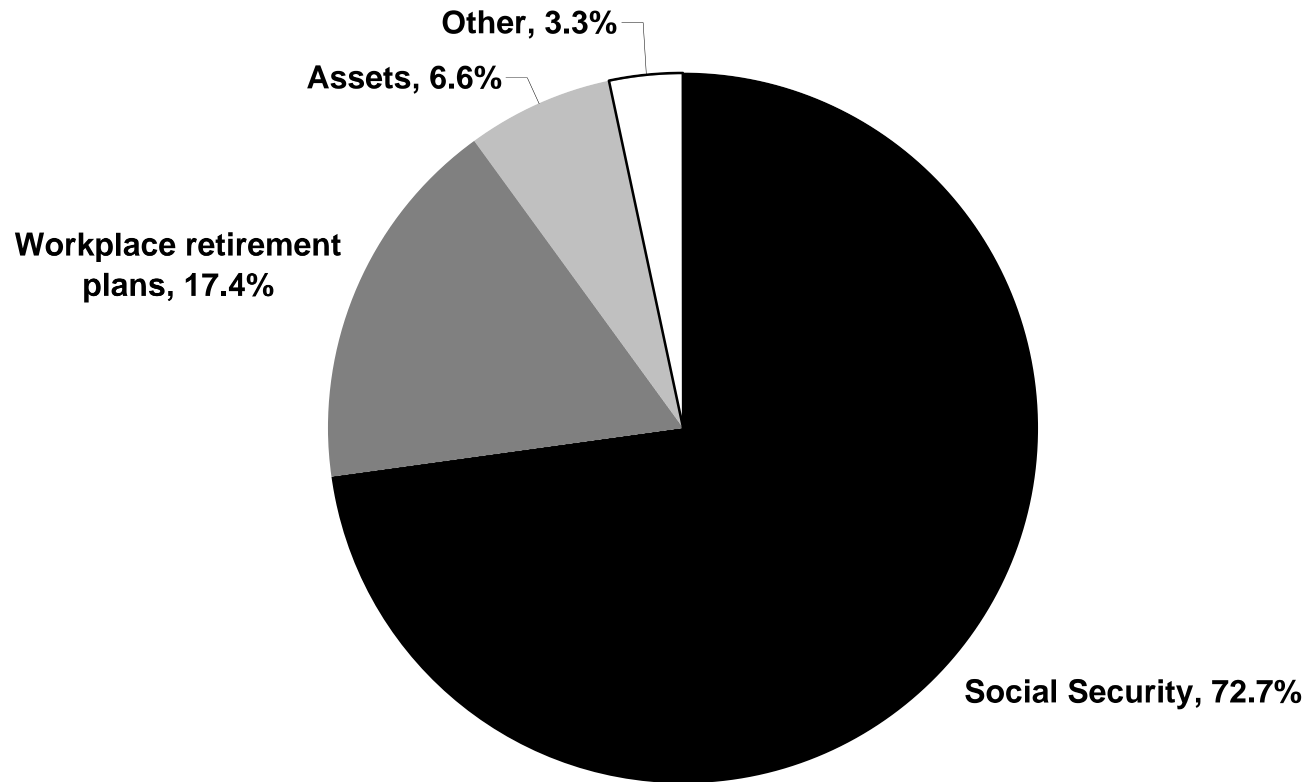
Source: Weller and Wolff (2005).



Note: Households approaching retirement are those with a head of household aged 47-64. Households are classified by the race/ethnicity and education of the head of household. Retirement income is based on wealth holdings and expected pension and Social Security benefits.

Source: Mishel, Bernstein, and Allegretto (2006).

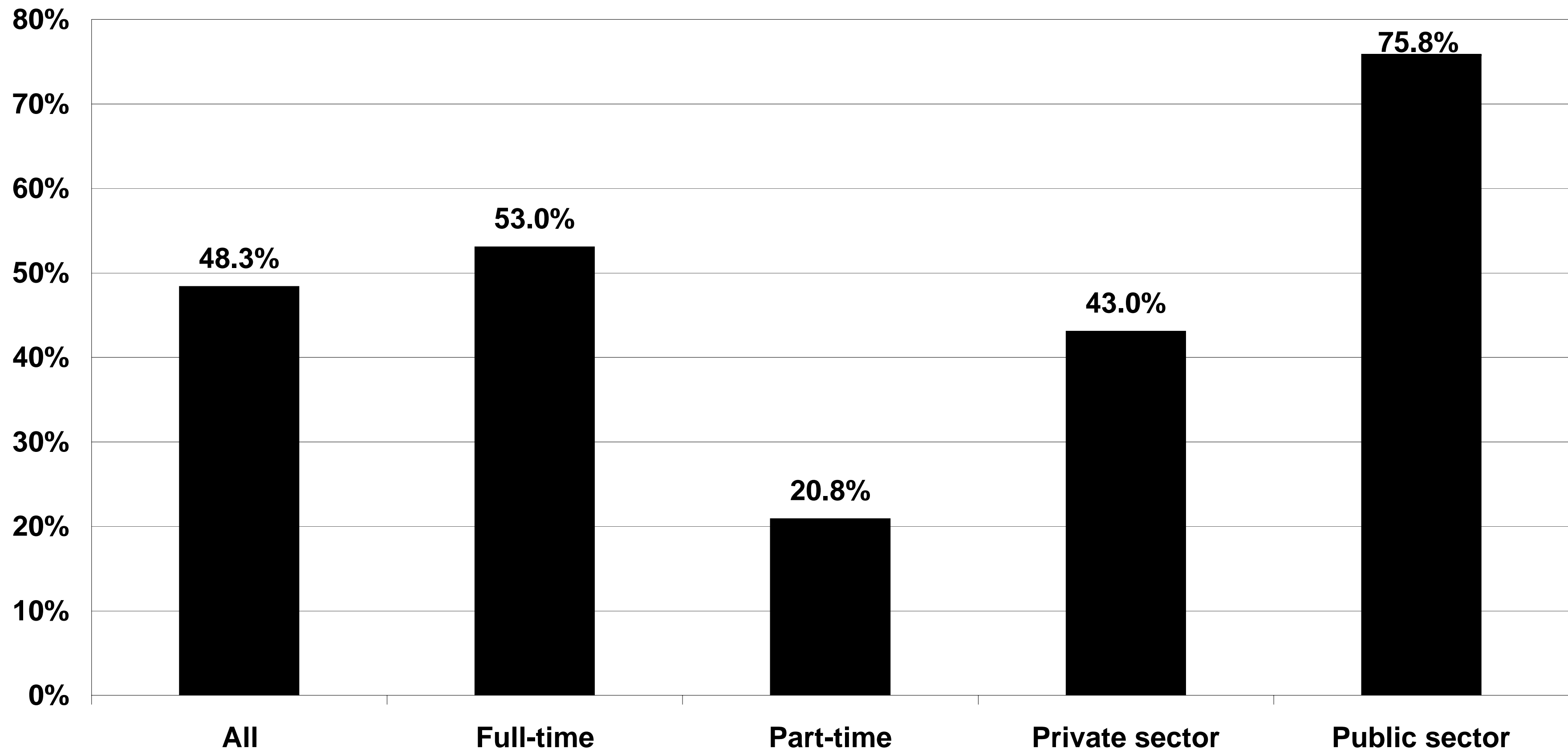
Retirement income sources, 2004



Note: Breakdown shown is for non-earned retirement income of households headed by someone 65 and older, middle income quintile. Income from workplace retirement plans includes income from defined-benefit and defined-contribution plans.

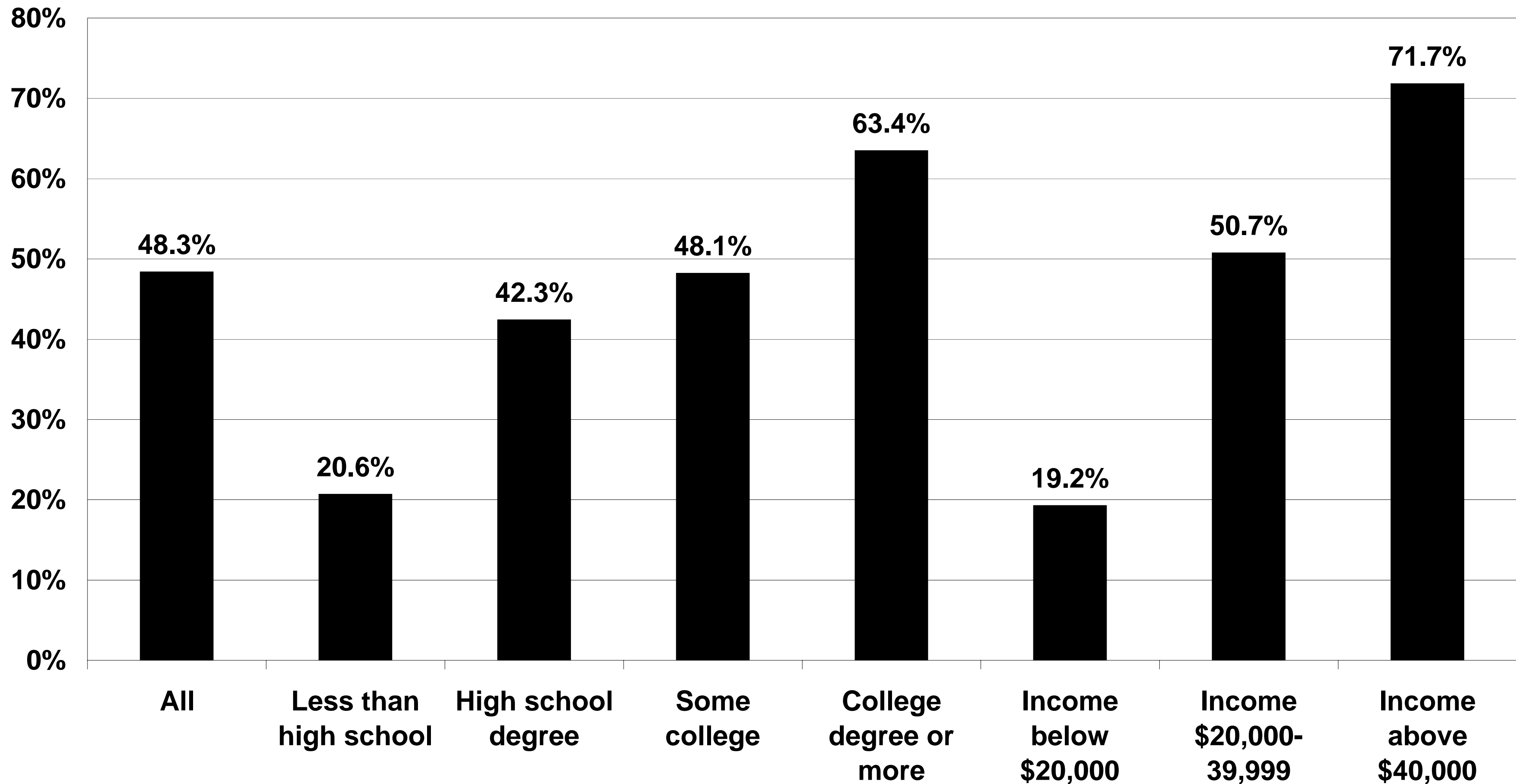
Source: Munnell and Sunden (2006).

Workers participating in workplace retirement plans by job type, 2004



Note: Figures are for wage and salary (not self-employed) workers ages 21-64. "Full-time" and "part-time" includes part-year workers.

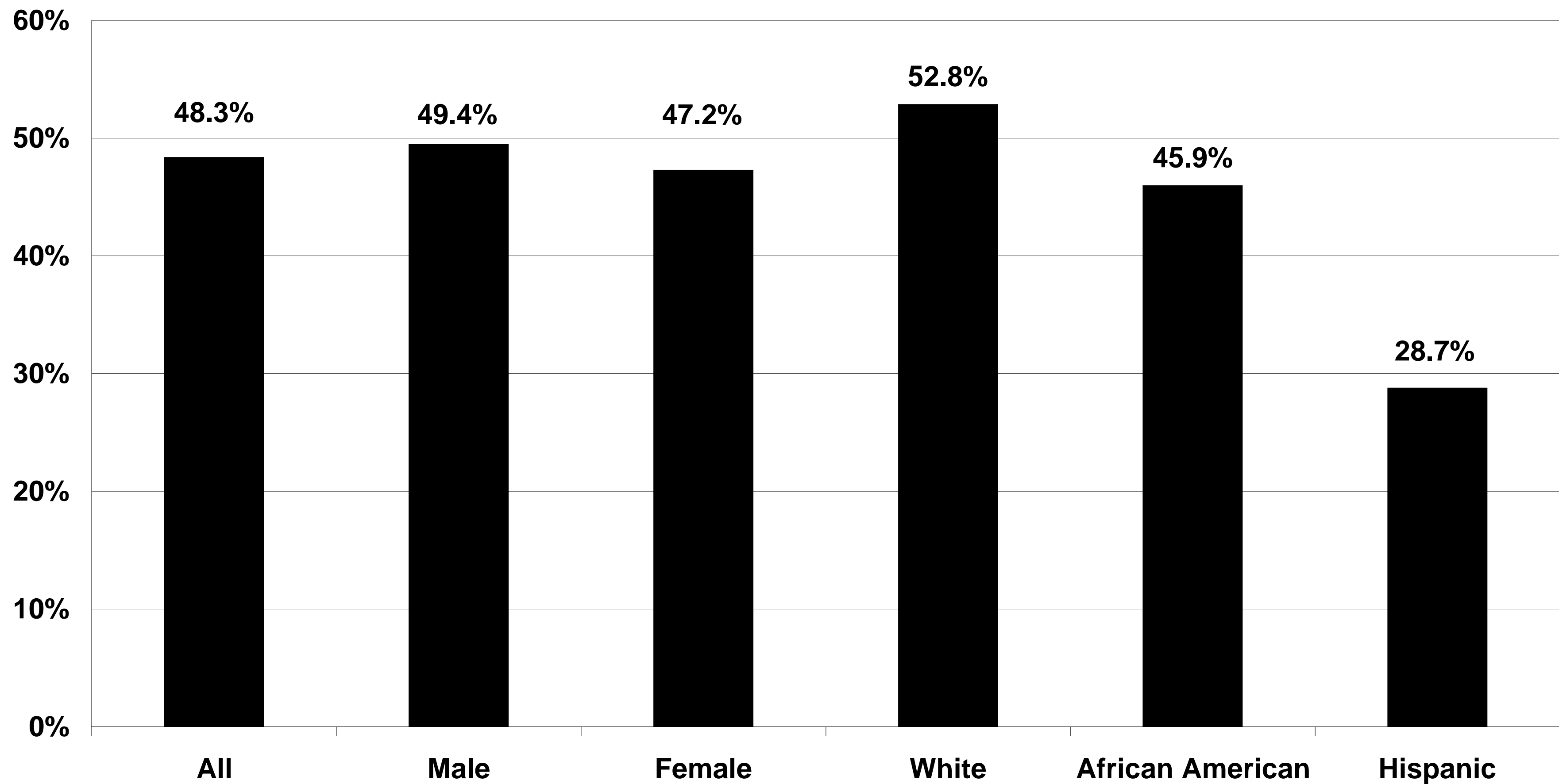
Source: Copeland (2005).



Note: Figures are for wage and salary (not self-employed) workers age 21-64.

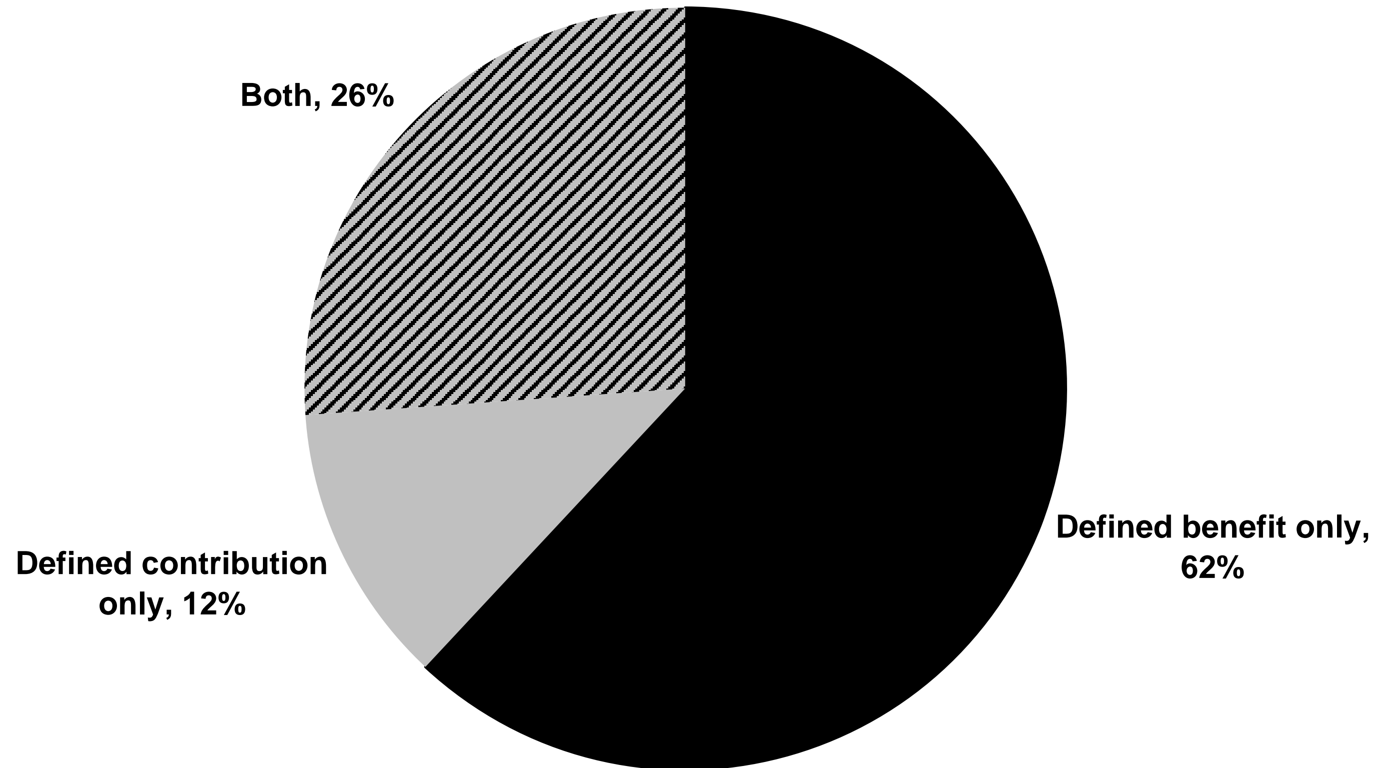
Source: Copeland (2005).

Workers participating in workplace retirement plans, by gender and race, 2004



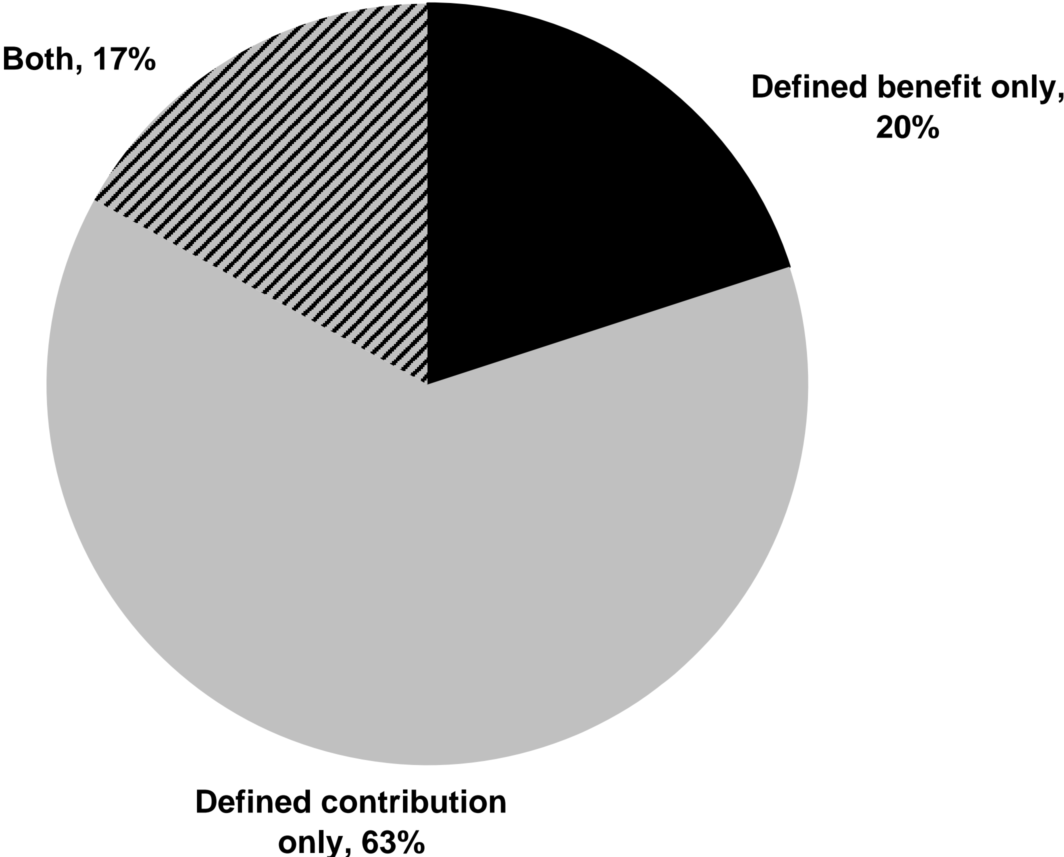
Note: Figures are for wage and salary (not self-employed) workers ages 21-64.

Source: Copeland (2005).



Source: Munnell and Sunden (2006).

Participation in workplace retirement plans: defined benefit vs. defined contribution, 2004



Source: Munnell and Sunden (2006).