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OBAMA RETIREMENT PLAN FALLS SHORT

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Tucked into the blueprint for financial regulatory reform[1] released last week is an outline of the president's proposals for strengthening retirement plans and encouraging retirement savings. Though some of the proposals in the Department of Treasury's white paper are welcome and overdue, they should not be mistaken for the kind of comprehensive reform that is needed to fix a system in crisis.

Barring a dramatic turnaround in stock and housing prices, the Baby Boomers will be the first generation in modern U.S. history to have less retirement security than their predecessors, a reversal that many experts trace to the shift from employer-provided pensions to individual savings accounts. Yet despite the clear failure of the 401(k) experiment, the administration is still focusing on incremental reforms that would expand and tweak the current system rather than squarely address its failures.

Placing the burden of saving on households, not employers

In a sign of the times, the administration takes as a given that the primary responsibility for retirement falls on households rather than employers. The white paper points to the low personal saving rate of recent years and notes that "tens of millions of U.S. households have not placed themselves on a path to become financially prepared for retirement." There is no mention of the role employers have played in shrinking retirement by abandoning pensions and shifting the burden to individuals.

The White House plan is two-pronged. First, it would require many employers who do not offer retirement plans to set up automatic payroll deductions into Individual Retirement Accounts (IRAs), using inertia to boost participation by having workers opt out rather than opt in. Second, it would expand eligibility for the Saver's Credit and make it refundable, giving low- and moderate-income families who owe little or no income tax an incentive to save.

Ignoring the root causes of the retirement crisis

Among the problems the president's plan does *not* address is the fact that workers bear enormous investment risks with 401(k)s and IRAs. The white paper does not even mention that trillions of dollars in retirement savings and housing

wealth have evaporated in the wake of two burst asset bubbles, leaving many older workers who had hoped to retire clinging to scarce jobs or swelling the ranks of the unemployed.

As noted, the president's plan simply accepts that the role of employers is now largely reduced to facilitating employee saving in tax-favored accounts. Even when the economy was growing strongly, workers made the lion's share of contributions to 401(k)s, a trend that has only worsened over time. The white paper does not mention that employers ranging from AARP to Zygo Corporation have suspended their 401(k) matches during the current downturn.

The administration's plan would make our system of tax subsidies for retirement savings slightly less inequitable, but that is different from making it fair or even progressive. Currently, 70% of subsidies for individual savings accounts go to taxpayers in the top fifth of the income distribution. Though an expanded Saver's Credit would make the distribution somewhat less skewed, subsidies would continue to flow disproportionately to the wealthy, who can easily shift funds to tax-favored accounts.

Do-it-yourself model fails even on its own terms

Since it fails the fairness test, the individual savings account model is usually justified on efficiency and libertarian grounds: subsidies are supposed to leverage private savings, and to do so in a way that is less heavy-handed than one-size-fits-all solutions such as expanding Social Security or requiring employers to provide retirement benefits.

This argument does not bear up under close scrutiny. First, tax incentives do not necessarily increase net saving—they simply increase saving in tax-favored accounts. Wealthier families, especially, can shift funds or reduce saving in other ways. As a result, subsidies for retirement savings grew in recent decades even as the savings rate declined.

The efficiency claim is also belied by the high fees charged by 401(k) providers, a problem exacerbated by the fact that these fees are not transparent and that plan providers are selected by employers, yet most fees are paid by workers. But even if these problems were corrected, individual accounts would remain more expensive to manage than pooled pension funds.

What about the claim that a do-it-yourself system leads to savings levels and portfolios tailored to individual preferences? There is little evidence that workers manage their retirement savings effectively. To the contrary, most 401(k) participants underestimate their savings needs and tend to take an all-or-nothing approach to risk rather than maintaining balanced investment portfolios.

Homo economicus

In any case, the idea that individuals are rational optimizers is an argument for *no* government intervention, rather than for taxpayer-subsidized savings schemes, except to the extent that subsidies overcome barriers to saving. Yet under the current system, those who face the biggest barriers receive the least help. And because tax breaks must be paid for, the system robs Peter to pay Paul. Though there is nothing inherently wrong with redistributive tax schemes, this one redistributes to the well-off and does not achieve its aims.

Far more people are dismayed than thrilled at the prospect of being amateur financial analysts. No amount of financial education will meaningfully change that, any more than health education is a substitute for professional medical care. Sophisticated investors who want to tailor their risk-return profile can achieve similar results by balancing low-risk retirement benefits with higher-risk investment strategies pursued outside the retirement system.

401(k)s and IRAs work best as supplementary plans

If there is a case to be made for tax-subsidized savings accounts, it is as the top layer in a multi-tiered system that begins with a base of secure retirement benefits: 401(k) plans were once rightly viewed as a way to *supplement* pensions, not replace them. Once adequacy is achieved, there is a point beyond which some households would be better off with lower taxes or higher wages than with additional Social Security or pension benefits. At that point, it can make sense to provide

incentives to overcome shortsightedness and other barriers to saving, rather than expanding a universal system like Social Security. But with Social Security replacing less than 40% of pre-retirement earnings on average, and only one in five private-sector workers covered by a secure defined-benefit pension, the current system is nowhere near the point where we should be expanding risky voluntary savings rather than secure universal benefits.

The choice that's missing: a secure pension

The white paper also cites the need to "restore more lifetime income throughout the retirement system." But no one has figured out how to do this in the context of an individual account system. While the system allows workers to pursue such ill-advised investment strategies as loading up on own-employer stock, it does not provide access to affordable annuities that would provide the same secure lifetime benefits as traditional pensions. There are many reasons for this, but perhaps the most intractable is the problem of adverse selection: since those most likely to purchase life annuities are those who expect to live the longest, this drives up the price of annuities, further reducing the number of participants who choose annuities, and so on. (A similar problem occurs in markets for individual health insurance, where those most likely to purchase coverage are the sickest.)

Similarly, the white paper mentions the need to reduce leakage from retirement accounts without explaining how this can be achieved. The hitch is that most people will not save much in these accounts if they cannot borrow or withdraw the funds.

A bolder vision is needed

The president has health care on his plate. And incremental retirement reforms can be worth pursuing: in particular, making the Saver's Credit refundable is a long-overdue patch to a system that currently provides no help at all to low-income workers who want to save for retirement. Another no-brainer, mentioned in passing in the white paper, is requiring plans to offer a handful of standardized, low-cost investment options. This proposal, however, is not likely to survive the legislative process without a bigger lift from the president, since, unlike expanded tax credits, it would be strenuously opposed by the financial industry.

The administration's plan lets the retirement crisis go to waste, to paraphrase chief of staff Rahm Emanuel. In fact, it does not even acknowledge that a crisis exists, defining the problem narrowly and offering proposals designed to avoid treading on powerful toes. But no one should confuse political expediency with practicality: the current system is enormously wasteful, unfair, and ineffective, and will leave most Americans at risk of facing a choice between poverty and working into advanced old age—assuming they have a choice.

Endnotes

1. U.S. Department of the Treasury. 2009. "Financial Regulatory Reform: A New Foundation." Washington D.C.: Department of the Treasury, pp. 74-75.