



Making Saving for Retirement Easier, Cheaper, and More Secure

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Introduction

As the first generation of workers to depend primarily on 401(k) plans—rather than the increasingly rare defined-benefit pension—starts to retire, it is abundantly clear that the private retirement system is failing too many Americans. The typical near-retirement-age worker with a 401(k) has accumulated enough money to provide a monthly retirement payment of only about \$575.¹ Making matters worse, less than half of all workers even have a retirement plan at work, and that figure has been declining over the past few decades.²

Americans, therefore, are deeply worried about their ability to retire, with half of all workers saying they are not confident they will have enough money for retirement.³ Indeed, the accounting firm Ernst & Young estimates that 59 percent of new middle-class retirees will outlive their retirement savings,⁴ while Boston College's National Retirement Risk Index estimates that 51 percent of households are at risk of having an insecure retirement, meaning they will be unable to maintain their pre-retirement standard of living.⁵

Social Security, of course, provides an essential baseline of income for retirees, and must be strengthened to ensure that it continues to do so for generations to come, as the Center for American Progress has already proposed.⁶ But Social Security was never intended to be people's only source of income in retirement. To maintain their standard of living in retirement, Americans depend upon savings accumulations in 401(k) plans and pensions and, to a smaller degree, private savings.

As a result, the failure of the private retirement system could have devastating consequences. If we continue down this path, many retirees will outlive their retirement savings, saddling their children and the country with a burden that causes significant human suffering and weighs down our economy in the near future. (see Figures 1 and 2)

To fix the problems in our private retirement system and enable far more Americans to retire with dignity and maintain their standard of living, we must make saving for retirement easier, cheaper, and more secure. We can do this by:

- Creating a new collective defined-contribution plan—a hybrid plan that takes the best qualities of both traditional pensions and 401(k) plans
- Opening up the Thrift Savings Plan—the 401(k) for federal employees that has model features such as low fees and sensible investment options

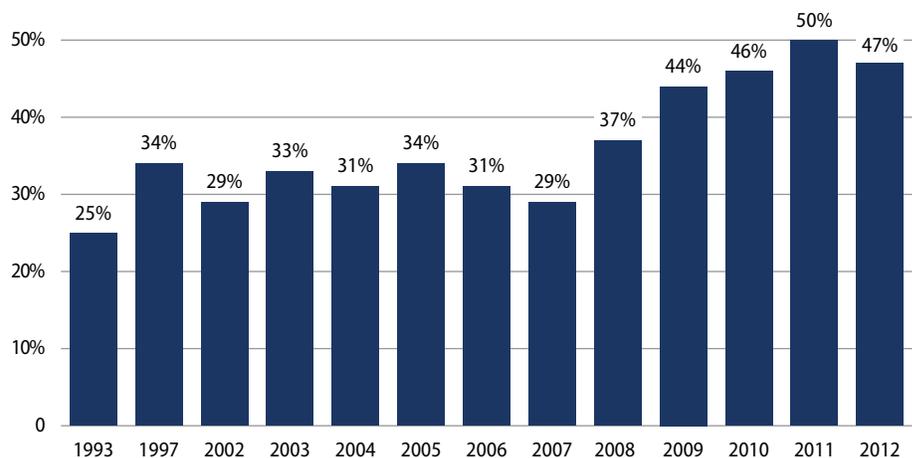
Both the collective defined-contribution plan and the Thrift Savings Plan hold distinct advantages over the typical 401(k). The collective defined-contribution plan would cut the costs of saving for retirement in half compared to a traditional 401(k), while also providing greater security.⁷ And the low fees of the Thrift Savings Plan enable a typical worker earning \$30,000 per year to save the equivalent of an additional \$750 per year compared to an average 401(k).⁸

Under the plan outlined above, all workers would be able to save under either the collective defined-contribution plan or the Thrift Savings Plan. These new retirement options would be combined with reforms to the tax code, which currently provides disproportionate benefits for high-income earners. As CAP has previously discussed, reforms would allow for more equitable savings incentives for low- and middle-income earners.⁹

Our plan would ensure all Americans have access to a quality retirement plan, significantly boosting savings and security while at the same time helping to ensure workers can retire with dignity. This issue brief describes

FIGURE 1
Workers increasingly worried about having enough money in retirement

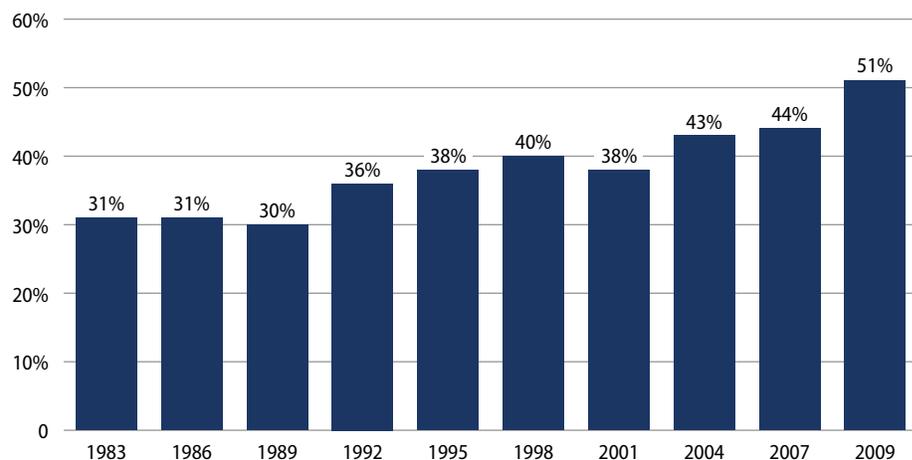
Percentage of respondents answering “not confident” (%)



Source: Employee Benefit Research Institute and Matthew Greenwald & Associates, Inc., 1993 - 2012 Retirement Confidence Surveys. Respondents were asked how confident they were in having enough money to live comfortably throughout their retirement years. Workers who are not confident is the sum of workers who responded “Not Too” and “Not At All.”

FIGURE 2
More Americans at risk of having a lower standard of living in retirement

Share of households at risk of declining living standards in retirement



Source: Alicia H. Munnell, Anthony Webb, and Francesca Golub-Sass, “The National Retirement Risk Index: After the Crash” (Chestnut Hill, MA: Center for Retirement Research at Boston College, 2009).

the collective defined-contribution and Thrift Savings Plan proposals in greater detail. Tax reforms will be the subject of a future report.

The collective defined-contribution concept

In order to understand how our proposal would work, it is helpful to first review some retirement plan basics. Retirement plans come in two basic varieties: defined contribution, the most common of which is a 401(k), and defined benefit, often called a traditional pension.

In defined-contribution plans, such as 401(k)s, employer contributions are defined by the rules of the plan—hence the name defined contribution. Retirement assets for the worker are determined by whatever is in the account—depending upon worker and employer contributions, investment performance, plan costs, and withdrawals, among other factors.

In defined-benefit pension plans, retirees receive a monthly payment based on a formula that accounts for salary and years of work, among other factors. Employers make contributions to the pension and are responsible for ensuring that money is available for promised payments. Contributions are pooled and professionally managed, and payouts last a lifetime.

The collective defined-contribution plan blurs these traditional borders. The concept combines elements of a traditional pension—such as regular payments in retirement, professional management, pooled investing, and risk sharing across generations—with elements of a 401(k)—such as predictable costs for employers and portability for workers. This model has been working well in the Netherlands and is increasingly being adopted there.¹⁰

In a collective defined-contribution plan, assets are pooled and professionally managed and payouts should last a lifetime, like a pension plan. But like a 401(k), employer contributions would be defined by the rules of the plan, so employers would have stable, predictable contributions. Savings are portable like a 401(k) because the collective defined-contribution plan maintains account balances for each individual worker.

What makes the plan unique is that the risks of not meeting target benefits would be spread among workers and retirees rather than borne solely by employers, as they are in a traditional pension plan, or individual workers, as they are in a 401(k). While payout levels in the collective defined-contribution plan are not guaranteed, the plan is far less risky for workers and retirees than a 401(k).¹¹ This hybrid approach is also much more efficient than a 401(k).

All retirement plans involve tradeoffs between costs, risk, and retirement adequacy, and involve different choices about who bears these costs and risks—employers,

employees, or taxpayers. The collective defined-contribution plan manages these tradeoffs far better than a 401(k).

The advantages of the collective defined-contribution plan fall into two categories: lower costs and lower risks. Each of these areas will be discussed at greater length below.

Lower costs of the collective defined-contribution plan

The collective defined-contribution plan would reduce the costs of saving for retirement by nearly half compared to a 401(k), according to research on pension-plan efficiency by the National Institute for Retirement Security.¹² The collective defined-contribution plan achieves these savings through three features unavailable in a typical 401(k) plan:

- Professional money management
- Long-investment time horizons
- The ability to spread risks across multiple generations

Professional money management of a retirement fund leads to higher investment returns than most 401(k) participants achieve.¹³ Though fund managers have a hard time beating market averages¹⁴ (which is why collective defined-contribution assets would be primarily invested in index funds), they typically do much better than individual investors—in large part because they are able to avoid common investing pitfalls such as failing to diversify assets and pulling money out of stocks at the bottom of the market and thus missing the rally.¹⁵

In short, professional money managers would ensure that collective defined-contribution investments are properly diversified and invested for the long term, allowing them to achieve better returns than most individual investors would earn on their own.

Similarly, pooling investment risks over longer time periods also boosts investment returns. Individuals in a 401(k) plan have to become more conservative with their investments as they age because they have less time to recover any possible losses, resulting in lower returns. But when the accounts of both older and younger workers are pooled together, fund managers can maintain a balanced portfolio that achieves higher returns. This effect, called intergenerational risk sharing, can substantially raise pension returns, according to research by economist Christian Gollier of the Toulouse School of Economics.¹⁶

Finally, pooling longevity risk across all retirees in the plan means that the plan needs only to accumulate sufficient funds to pay for the average retiree's lifespan. In contrast, an individual with a 401(k) must save enough to last their maximum life expectancy. Saving only enough for the average lifespan could leave individuals without sufficient income in their later years.¹⁷

A retirement plan with these advantages would provide the same level of benefit as a 401(k) and cost an estimated 46 percent less, according to research by the National Institute on Retirement Security.¹⁸ In dollar terms, this means a worker earning \$50,000 would need to contribute an estimated \$5,200 less in the year before retirement and thousands less in each of the other 29 working years during which they made retirement contributions to save enough for a secure retirement.¹⁹

Lower risks in the collective defined-contribution plan

Collective defined-contribution plans are also better than 401(k)s at managing many of the risks inherent in retirement planning. This is because collective defined-contribution plans are managed as a pooled asset with a long time horizon.

A long investment horizon helps mitigate the risk of the market performing poorly while a worker is saving for retirement. While an individual career may seem like a long time horizon for retirement investing, the chance that the market will perform poorly during the time a worker is most aggressively investing is still large compared to the longer time frame that the intergenerational pooling of the collective defined-contribution plan allows. A shorter timeframe increases the probability that an individual will experience a period of low growth.

Case in point: The lowest average annual return on the Dow Jones Industrial Average over a 75-year period was 3.05 percent. This is compared to a low average annual return of -0.04 percent for investments over a period of 30 years.²⁰

Furthermore, the risk that an individual in a 401(k) plan will be hurt by a big drop in the market is much greater than the risk borne by participants in a collective defined-contribution plan. This is because the risk involved in timing investments can be much more acute for an individual than for a pooled investment fund.

Take the span between December 2007 and June 2009 (the duration of the Great Recession). Workers who were near retirement—ages 55 to 64—and who had been investing in a 401(k) for 20 to 29 years saw their account balance decrease an average of 17.4 percent. Account balances have recovered slightly since then, but they are still down significantly.²¹ In contrast, estimates suggest that because of investment losses suffered during the Great Recession, the benefits provided by Dutch collective defined-contribution plans may only need to be reduced by approximately 2 percent to 3 percent.²²

Though collective defined-contribution plans would significantly reduce risk for workers and retirees compared to a 401(k) plan, they are not without risk. While participants might prefer a government guarantee, the government would not guarantee these plans for several reasons.

First, government guarantees can be costly. There is always some risk that investments will not meet expectations, raising the prospect that a guarantee leads to taxpayer-funded bailouts. The only way to avoid this possibility is to peg investment returns to the riskless rate of return by investing solely in Treasury bonds. This imposes a cost on plan participants, however, by leading to very low average investment returns and significantly increasing the amount that workers need to save for retirement.

Secondly, a government guarantee is essentially a different name for risk sharing. But risk sharing is already built into the plan: Risks are pooled among participants so that no one individual bears the inherent risks of saving for retirement alone. And with the collective defined-contribution plan, decisions about allocating costs and benefits between workers and retirees are determined by the rules of the plan and the plan's board, not Congress, where costs might be passed on to the rest of the public or future generations.

Finally, the plan is not a government program but rather a sensible retirement plan facilitated by government. Collective defined-contribution plans would be privately run retirement plans licensed and regulated by the federal government. As the Pension Rights Center²³ describes in a related proposal, these funds would be required to commit to long-term, conservative investment practices, and to meet capital and other requirements prescribed by the regulating agency.

If the economy suffers a prolonged downturn and the plan does not meet its conservative investment targets over a period of time, the board running the plan will face tough decisions. Typically, any expected cost-of-living increases in retiree benefits would be cut first, but cuts to base payouts and additional contributions from workers are also possible. As discussed previously, the stock market crash that occurred during the Great Recession led to modest benefit reductions in the Netherlands.

The opposite could also occur, should the economy do particularly well and returns be much greater than expected. In this case, decisions need to be made about how to share the unanticipated benefit. As a result, a key to the plan's success is that it is structured and run in a manner that engenders the trust of its participants—by allowing workers and retirees to nominate members to their plan's advisory board, setting conservative financial standards, and requiring regular communications with participants.

Thrift Savings Plan: A model 401(k)

Despite the advantages of a collective defined-contribution plan, some people have the background, interest, and time to invest in a 401(k)-style plan, preferring the greater control over investment and other decisions it allows. These people should have the option to invest in the Thrift Savings Plan—the 401(k) plan for federal employees—or a similar plan that matches all its model features.

The Thrift Savings Plan is a model 401(k) plan because, among other features, it includes:

- Very low fees
- Strong oversight
- Smart and limited investment options
- An annuity option

These features help savers in the Thrift Savings Plan accumulate greater assets and be more prepared for retirement than most people in a typical 401(k) plan, according to previous research by the Center for American Progress Action Fund.²⁴

The Thrift Savings Plan's low fees, for example, significantly reduce the cost of saving for retirement compared to a 401(k). The difference in fees between the Thrift Savings Plan (0.185 percent of assets)²⁵ and the typical 401(k) (roughly 1 percent of assets) may seem relatively small, but over an individual's lifetime the higher fees in a 401(k) can eat away 20 percent to 30 percent of assets.²⁶ (The fees in a collective defined-contribution plan would be similar to those of the Thrift Savings Plan, but were not included in the cost savings discussed above.²⁷) Research from the Center for American Progress Action Fund indicates that the lower fees in the Thrift Savings Plan enable the typical worker earning \$30,000 per year to save the equivalent of an additional \$750 per year.²⁸

Note that Thrift Savings Plan participants pay very low fees primarily because of the plan's design and size rather than government subsidies.²⁹ Therefore, the advantages of the Thrift Savings Plan can be replicated without cost to the government.

The proposal

Our proposal would give all workers the opportunity to save in a workplace retirement plan of their choice—a collective defined-contribution plan, the Thrift Savings Plan, or the existing plan offered by their employers.

Here's how it would work.

All employers—except for those providing a defined-benefit pension that meets certain standards—would have to give their employees the choice to enroll in a collective defined-contribution plan or a Thrift Savings Plan. Employers would not be required to make contributions, but if they already made contributions to 401(k) participants, then they would be required to provide the same level of contribution to workers who choose to save in the collective defined-contribution plan or Thrift Savings Plan.

Employee contributions would be automatically deducted to their plan of choice. Workers could choose to opt out of making contributions.

If employees do not make a choice, the collective defined-contribution plan would be the default plan because of its risk-management ability and its potential for retirement security. The collective defined-contribution plan also requires workers to make minimal decisions, making it a good default option for those who do not choose a plan type.

Plan participants would regularly receive information on their likely level of retirement benefits based on default, current, and other contribution levels, as well as details about their plans, including costs and investment performance.

Conclusion

New collective defined-contribution plans would reduce costs and improve retirement security compared to typical 401(k) plans. The expansion of the federal Thrift Savings Plan would provide a good, low-cost option for those preferring greater control over investment and other decisions. Together these reforms would ensure all Americans have access to a high-quality retirement plan and would greatly boost retirement security for millions of Americans.

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Endnotes

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- 3 Employee Benefit Research Institute, "2012 RCS Fact Sheet #1, Retirement Confidence" (2012).
- 4 Ernst & Young, "Retirement vulnerability of new retirees: The likelihood of outliving their assets" (2009).
- 5 Alicia H. Munnell, Anthony Webb, and Francesca Golub-Sass, "The National Retirement Risk Index: After the Crash" (Chestnut Hill, MA: Center for Retirement Research at Boston College, 2009).
- 6 Christian E. Weller, "Building It Up, Not Tearing It Down: A Progressive Approach to Strengthening Social Security" (Washington: Center for American Progress, 2010).
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- 10 Stichting Van De Arbeid, "Memorandum Detailing the Pension Accord of 4 June 2010" (2010). Judith Verheijden, "From Average Pay DB to Collective DC: Defining the Risk Transfer," M.Sc. Thesis, Tilburg University, 2010.
- 11 Traditional pensions also have lower costs and less risk for participants than 401(k)s but only one in five workers have such a plan and few employers are starting new pension plans in large part because they don't want to bear the risks of having to make additional contributions in assets aren't sufficient to pay for promised benefits.
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- 13 Ibid.
- 14 Ron Elmer, "College Endowment and Public Pension Fund Returns Are Not Good," Investor Cookbooks, February 9, 2012, available at <http://investorcookbooks.blogspot.com/2012/02/college-endowment-and-public-pension.html>; Sydney P. Freedberg and Connie Humburg, "Easy investments beat state's expert pension planners," *Tampa Bay Times*, July 31, 2011, available at <http://www.tampabay.com/news/politics/article1183442.ece>; Jeff Hooke and Michael Tasselmyer, "Wall Street Fees and The Maryland Public Pension Fund" (Germantown, MD: The Maryland Public Policy Institute, 2012).
- 15 Chris Flynn and Hubert Lum, "DC Plans Under Performed DB Funds" (Toronto: CEM Benchmarking, 2006); Towers Watson, "Defined Benefit vs. 401(k) Investment Returns: The 2006-2008 Update" (2009).
- 16 Christian Gollier, "Intergenerational risk-sharing and risk-taking of a pension fund," *Journal of Public Economics* 92 (6) (2008): 1463-1485.
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- 28 Davis, Kazzi, and Madland, "The Promise and the Peril of a Model 401(k) Plan."
- 29 See Ibid. for an extended discussion of TSP fees.