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American Retirement Savings Could Be Much Better

By Rowland Davis and David Madland August 2013

Introduction and summary

The personal retirement-savings plans that most Americans use, such as 401(k)s and Individual Retirement Accounts, or IRAs, are unnecessarily costly and needlessly risky. But instituting another kind of retirement plan that combines the best elements of both defined-contribution and defined-benefit plans—such as the Center for American Progress’s proposed Secure, Accessible, Flexible, and Efficient, or SAFE, Retirement Plan,¹ or the related USA Retirement Funds proposal from Sen. Tom Harkin (D-IA)²—could provide a more secure retirement at a far lower cost, according to a new analysis by the Center for American Progress.

These two proposals, also known as collective defined-contribution plans, improve upon the 401(k) model in a number of ways. As described in greater detail in a fall 2012 report, titled “Making Saving for Retirement Easier, Cheaper, and More Secure,”³ CAP’s SAFE Retirement Plan combines elements of a traditional pension—including regular lifetime payments in retirement, professional management, and pooled investing—with elements of a 401(k), such as predictable costs for employers and portability for workers. (see text box)

Our actuarial analysis finds that CAP’s SAFE Retirement Plan significantly outperforms both 401(k)s and IRAs on cost and risk measures. The results of our study are striking:

- **The SAFE Plan costs only half as much for workers.** A worker with a SAFE Plan would have to contribute only half as much of their paycheck as a worker saving in a typical 401(k) plan to have the same likelihood of maintaining their standard of living upon retirement.
- **The SAFE Plan reduces risk dramatically.** A worker with a SAFE Plan is nearly 2.3 times as likely to maintain their standard of living in retirement as a worker with a typical 401(k) account making identical contributions.

The makings of a SAFE Retirement Plan

Some of the plan's key features include the following:

- Plans would be organized as nonprofit organizations run by independent boards with significant participant representation. Their sole objective would be to maximize long-term benefits for all participants.
- Plans would be available to all workers regardless of whether their employer offered retirement benefits prior to the introduction of the plan.
- Investments would be professionally managed. SAFE Retirement Plan boards would be able to contract with professional investment-management providers.
- Benefits would be portable when workers change jobs and would be payable for life.
- Each worker would select a plan, and his or her employer would only need to facilitate enrollment and any required payroll deductions. If employers make contributions, employer costs would be fixed as a percentage of pay, and employers would not be faced with administrative or fiduciary obligations.
- The risks of the SAFE Retirement Plan 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 SAFE Retirement Plan would not be guaranteed, the plan would be far less risky for workers and retirees than a 401(k), with a higher likelihood of achieving target benefit levels.
- The plan would also be much more efficient than a 401(k) in achieving required investment returns at a low cost.
- This hybrid model would not require employers to take on the risk of guaranteeing returns as they must with traditional pensions, nor would it impose any additional costs or risk on government.

The results of our study are relevant not only to federal policymakers, but also to state leaders considering new types of retirement plans for workers in their states.⁴ The SAFE Retirement Plan improves retirement-saving outcomes through two primary paths:

1. Eliminating the glaring inefficiencies common in 401(k)s and IRAs, including their high fees and the behavioral mistakes that workers saving in individual accounts commonly make, such as failing to diversify investments.
2. Mitigating risk to individual participants. In the typical 401(k) and IRA, individuals are left to fend for themselves and are fully exposed to many risks during their working years and in retirement. In the SAFE Plan, risks are shared among workers and among retirees, providing a kind of insurance that reduces risks for all participants.

While some individuals have been able to save significant sums with 401(k)s and IRAs, the weaknesses of these plans have been apparent for some time. These problems are only being fully recognized now, however, as the first generation to primarily depend on defined-contribution plans such as the 401(k)—as opposed to traditional pensions—starts to retire. Less than half of all workers have a retirement plan at work,⁵ and even the typical near-retirement worker with a 401(k) plan only has enough money in their retirement accounts to provide a monthly check of \$575⁶—nowhere near enough money for a secure retirement. These retirees are still subject to great risks: The vast majority of retirees must hope that they don't outlive their small pool of money, and many retirees worry that inflation will erode their purchasing power.

Social Security, of course, provides an essential baseline of income for retirees and must be strengthened so it can continue to do so for generations to come, as the Center for American Progress has already proposed.⁷ But Social Security was never intended to be people's only source of income in retirement. To maintain their standard of living, retired Americans also depend on workplace retirement plans such as 401(k)s, pensions, and, to a smaller degree, private savings.

The cost and risk advantages of the SAFE Retirement Plan are discussed at length below. We first describe the various challenges inherent in saving for retirement and explain why most 401(k)s and IRAs are not as well suited to handle these challenges as a SAFE Retirement Plan. We then describe in more detail how a SAFE Retirement Plan would operate. Finally, using two models based on historical and projected data, we demonstrate how a SAFE Plan performs under many different economic conditions and show that the typical worker would fare much better in a SAFE Plan than in even the best 401(k) plan.

The bottom line is that the current 401(k) system is so inefficient and risky that there are many ways to dramatically improve outcomes for participants that would lower both the costs and risks that workers and retirees face. The SAFE Retirement Plan incorporates a number of these improvements and offers a substantially better way to save for retirement.

The Center for American Progress is a nonpartisan research and educational institute dedicated to promoting a strong, just, and free America that ensures opportunity for all. We believe that Americans are bound together by a common commitment to these values and we aspire to ensure that our national policies reflect these values. We work to find progressive and pragmatic solutions to significant domestic and international problems and develop policy proposals that foster a government that is “of the people, by the people, and for the people.”

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