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Testimony Supporting H.B. 5337: "An Act Establishing a Task Force to Evaluate the Utility of Creating a Public Retirement Plan"

Robert Hiltonsmith
Policy Analyst, Economic Opportunity Program
Dēmos

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Thank you, members of the Committee on Aging for the opportunity to testify today. My name is Robbie Hiltonsmith, policy analyst at Dēmos, a national, non-partisan, multi-issue policy research and advocacy organization. Founded in 2000 and headquartered in New York City, Demos works with advocates and policymakers around the country in pursuit of three overarching goals 1.) A more equitable economy with opportunity for all; 2.) Robust democracy in which all Americans are empowered to participate; 3.) A strong public sector that can provide for our common interests and shared needs. I am happy to be here today to testify in support of House Bill 5337. I'm here to today to argue that the vast majority of Connecticut workers lack the retirement security that is so vitally important to both their and the state's well-being.

According to the Current Population Survey (CPS), just 58.3 percent of all workers in Connecticut were covered by a workplace retirement plan in 2010, and just a little over half (50.4 percent) of all workers participated in a plan.[1] However, the retirement security crisis isn't just limited to the half of workers who don't participate; even many of those who are actively saving for retirement are at risk as well. Most Connecticut workers covered by a workplace retirement plan are covered only by an individual-account, 401(k)-type plan.[2] These plans place all of the risk on workers, who face the very real possibilities of losing their savings in a stock market plunge or of outliving their retirement savings. Even worse, 401(k)s often have high, hidden investment management, administration, and trading fees that can eat into their returns, making saving for retirement even more difficult. The inadequacies of 401(k)s are already showing in retirement savings data: nationally, as of 2009, 32% of families ages 45-54, the first cohort of workers to be exposed to the 401(k), had nothing saved for retirement.[3] Combined, these fees and risks mean that 401(k)s are absolutely unsuitable to be Connecticut workers' primary supplement to Social Security in retirement.

So, what risks, in particular, does being forced to depend on a 401(k) for the bulk of one's retirement income force workers to shoulder? Retirement experts generally agree that there are five major types of risk that 401(k) participants bear. Savers risk losing their savings to poor investment decisions, which experts term investment risk; high fees (contribution risk); or a turbulent market (market risk); they also risk outliving their retirement savings (longevity risk); and being forced to, or unwisely choosing to, withdraw from or borrow against their savings (leakage risk). Though many 401(k) proponents believe the private retirement market can and will mitigate these risks, nearly three decades of experience with individualized retirement would seem to suggest that the 401(k) has been a complete, utter failure.

The financial crisis and following recession of the past few years has made the magnitude of the effect of market risk on 401(k) retirement savings crystal clear. During the stock market plunge of 2008 and 2009, 401(k)s and IRAs lost a total of $2 trillion dollars in value, while the average 401(k)-holder lost over 1/3 of their savings.[4] Retiring during a market downturn generally means either doing so with vastly reduced retirement savings, which, though it may later recover, can certainly affect both long- and short-term financial planning, or postponing retirement, which in turn prevents younger workers from entering the labor force and worsens the already high youth unemployment that accompanies such downturns. Just how large of an impact can market cycles have on 401(k) balances? By my calculations, if an average worker had retired at the height of the last big stock market surge in 2000, he or she would have had over 50 percent more to live on during retirement than if she had retired in the depths of the last recession in 2009.

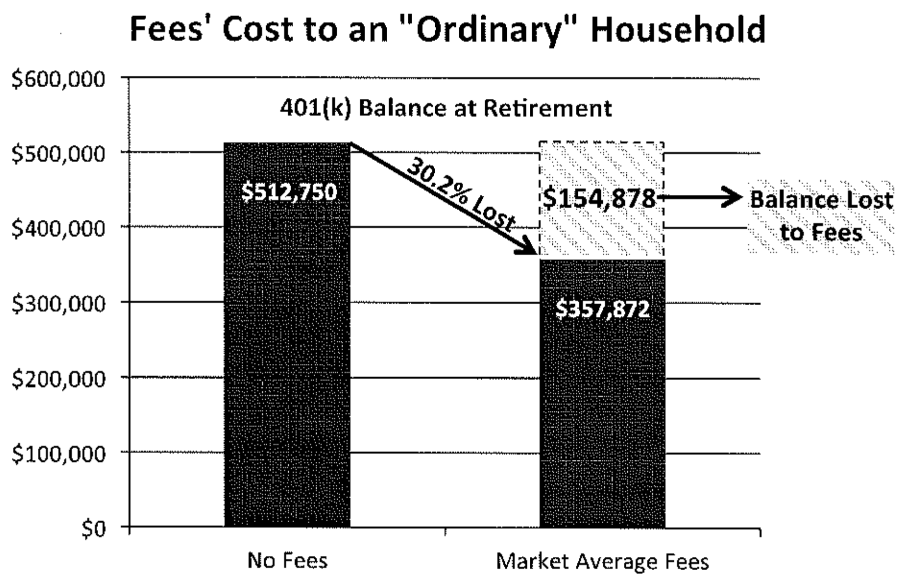
Another black mark against 401(k)s is investment risk—the possibility of participants making poor investment decisions. Though the freedom to choose one's own investments is lauded as a benefit of 401(k)s, in fact, most actual Americans are extremely ill-equipped to choose among often inscrutable investment choices. For example, in one study, 84 percent of retirement plan participants thought that higher mutual fund fees guaranteed better performance[5], even though multiple studies have shown that there is no relationship between the two. 401(k) participants, despite years of advice from their investment advisors, generally have no idea how to balance their portfolios, often adopting an all-or-nothing approach to risk. 21 percent of participants have more than 80 percent of their assets in stocks and other risky assets, far too much for anyone over 30. Another 38 percent have none invested in stocks, a far-too-conservative allocation for any age[6]. Individualized investing might seem to conform to our nation's idealized vision of freedom and individual choice, in reality, leaving the investment decisions up to financial market professionals would result in higher returns and lower risk.

Longevity risk, or the possibility 401(k)-holders outlive their retirement savings, is increasingly worrisome, and is coming to be considered the most significant risk. Though most know that life expectancies are on the rise, it's still impossible to know exactly how long we, individually, will live. When surveyed, individuals, generally, underestimate their own probabilities of living to an old age[7]. 401(k)s, by their very nature, simply provide a fixed sum to live off of in retirement; ensuring that sum lasts the rest of one's life would require exact knowledge of one's exact date of death, a grisly and impossible prospect. Investment options or contracts, such as annuities, which can mitigate longevity risk, remain, 30 years after the 401(k)'s creation, prohibitively expensive. The only way to fully eliminate longevity risk is to pool risk or assets, which, as this country's health care system so prominently illustrates, isn't done efficiently without government intervention in the market.

At first blush, the fact that 401(k)s allow account-holders to make early withdrawals or take out loans against account assets to pay for unexpected expenses might advantageous, allowing individuals to smooth over life's little financial bumps in the road. However, it turns out that these withdrawals/loans are themselves another risk, commonly referred to as leakage risk. Leakage can significantly damage workers' retirement prospects, particularly those of younger workers, who lose decades of compounded returns when they withdraw or borrow. According to Vanguard, one of the largest 401(k) providers, 3.7% of participants withdrew an average of 29% of their total 401(k) balance in 2010[8]; Even more alarmingly, 18% of all 401(k) participants, and 23% of all participants with incomes less than $30,000, had a loan outstanding at the end of the year. Ten percent of these loans, Vanguard says, are never repaid, significantly affecting retirement savings, and the interest lost during the loan period reduces account balances for repaid and unpaid loans alike. The GAO estimates that such withdrawals and loans (including between-job cashouts) sapped nearly $84 billion from retirement accounts in 2006, a number which surely rose during the recent recession.[9] Between-job leakage is actually responsible for the lion's share of this leakage, as significant pluralities of workers simply cash out their retirement plans when leaving a job, particularly younger workers. A recent AON study found that 59% of Generation Yers, and 46% of Gen Xers, cashed out their 401(k)s each time they changed jobs[10].

Finally, perhaps the largest 401(k) risk is contribution risk: the risk that workers contribute too little to their retirement over the course of their lifetimes. Workers contribute too little to 401(k)s for three main reasons: either they're simply not earning enough, they don't trust 401(k)s and the financial markets in general, or simply don't have the financial literacy to understand how plans work or how much to contribute. Employees themselves believe the first reason, lack of income, is the also the largest, and decades of stagnant wages would seem to lend credence to their claim. In a 2007 poll, 56 percent of respondents said that the reason they were not saving for retirement was because they couldn't afford to save[11]. Figures on contribution rates by race confirm this claim; those for Latinos and African-Americans, who have lower average incomes, trail significantly behind higher income whites and Asian-Americans. [12]

The variety of fees charged by the funds in which 401(k) assets are invested can, too, make it even more difficult to contribute enough to individual retirement accounts. These fees, though often seemingly innocuous single-digit percentages, actually add significantly to the risk that workers are unable to contribute enough for retirement. In reality, these fees can actually consume 1/3 or more of the gross (or before-fee) returns earned by savers' investments. Over a lifetime, these fees can add up to a significant chunk of workers' savings.



Source; Dēmos' Fee Model Estimates

According to our model, fees can cost an average household nearly $155,000, in fees or lost returns, effectively reducing the size of their nest egg by over 30 percent. How are mutual funds able to take such a large cut for their services? Mainstream economic theory provides a simple answer. When consumers of a product, such as mutual funds, do not have enough information or education to choose rationally among competing products, suppliers (funds) can charge higher prices.

And that's precisely what happens: undereducated and overworked 401(k)-holders often do not choose wisely amongst the small menu of often opaque and seemingly-identical mutual funds that their 401(k) provides. Employers, too, often lack expertise: employees in charge of many firms' 401(k)s only administer the plans part time, and thus often do not have the knowledge necessary to choose amongst nearly identical 401(k) plans, or the incentive or power to push for a plan switch if their firm's plan is on the higher end of the cost spectrum.

This litany of risks and fees makes a convincing case for what many critics have been saying for decades: this national experiment in 401(k)-based "do-it-yourself-retirement" has been, and will continue to be, an abysmal failure. The 401(k) needs to be scrapped, consigned to the dustbin of history like so many other social engineering experiments gone awry. A new system to replace 401(k)s is urgently needed. All hardworking Connecticutters need a safe, low-cost secure account to save for retirement, one that can also provide a lifetime stream of income when they retire; in other words, an account that protects workers from the severe risks and high costs of 401(k)-type plans.

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[1] Dēmos' and SCEPA's calculations of the Current Population Survey Annual Social and Economic Supplement.
[2] I use "401(k)" or "401(k)-type plan" as a shorthand to refer collectively to the many types of similar employer-based individual retirement plans, including 401(k)s, 403(b)s, 457s, and Keoghs.
[3] Federal Reserve, 2009 Panel Survey of Consumer Finances, http://www.federalreserve.gov/econresdata/scf/scf_2009p.htm
[4] Monique Morrissey, "Toward a Universal, Secure, and Adequate Retirement System", Retirement USA, 2009.
[5] Neil Weinberg and Emily Lambert, "The Great Fund Failure", Forbes, 2003, http://www.forbes.com/forbes/2003/0915/176_4.html
[6] Employee Benefits Research Institute, "401(k) Plan Asset Allocation", 2009
[7] Teresa Ghilarducci, *When I'm 64: The Plot Against Private Pensions and the Plan to Save Them*, Princeton University Press, p. 124, 2008.
[8] https://institutional.vanguard.com/VGApp/iip/site/institutional/researchcommentary/article/RetResGreatR
[9] Government Accountability Office (GAO), "Policy Changes Could Reduce the Long-term Effects of Leakage on Workers' Retirement Savings," 2009, http://www.gao.gov/products/GAO-09-715.
[10] http://www.aon.com/attachments/RetirementReadiness_2010_Report.pdf
[11] The Rockefeller Foundation, "American Worker Survey: Complete Results," 2007, http://www.rockefellerfoundation.org/uploads/files/1f190413-0800-4046-9200-084d05d5ea71-american.pdf
[12] Ariel/Hewitt, "401(k) Plans In Living Color," 2009, http://www.arielinvestments.com/content/view/1223/1173/