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Time to Address the Retirement Savings Crisis

David C. John

Americans' ability to build a secure retirement is increasingly in danger. In addition to Social Security's rapidly approaching fiscal problems and underfunded traditional defined-benefit pensions, the retirement savings system is available to only about half of the workforce and needs other improvements before today's workers can create sufficient retirement income. The longer this situation goes unaddressed, the greater the probability that millions of future retirees will face poverty or other financial hardships.

This is not a small issue. Social Security, the foundation of retirement income, is so underfunded that every retiree faces 25 percent benefit cuts in just over 20 years.[1] In addition, many taxpayers face massive tax increases to pay for underfunded state and local government pension plans.[2] However, the biggest problem may be the retirement savings system, and the need to improve this crucial aspect of retirement security receives scant press and virtually no legislative action.

This is definitely not to say that the retirement savings system is so broken that it must be replaced. The fact is that the existing 401(k)/IRA system provides a solid foundation for retirement security. The growth of such features as automatic enrollment and automatic escalation has made it easier for millions more to participate and make appropriate investment choices. But the system does need significant reforms so that all Americans can have the opportunity to participate, be assured that they will have a comfortable retirement, and have the information they need to avoid nasty surprises.

Improving Participation. Only about half of all employees age 25–64 work for employers that offer them either traditional pensions or retirement savings plans. Estimates of the exact number vary, with those that exclude part-time or younger workers showing a higher coverage. But the sad fact is that millions of Americans don't have access to the simplest and most effective way to provide for their retirement security.

While younger employees and those who work for smaller employers are the most likely to lack access to a 401(k)-type plan, that population varies, and it includes mid-career workers who have joined a smaller business. If not everyone has the ability to save for retirement from the start of their careers until they reach retirement age, Americans have only a scant chance of saving enough for a moderately comfortable future. There are simple, low-cost solutions, such as the Automatic IRA,[3] that will help to fix this problem, but unless Congress acts soon, it will be too late for thousands who are already in the workforce.

Improving the Amount Saved. Even those who do participate in a retirement savings plan often fail to save enough. One of the causes is automatic enrollment plans,[4] which start savers off with initial contributions equal to 3 percent of income. A recent study[5] shows that plans that start employee savings deductions at 6 percent of income are likelier to help participants to build sufficient savings than those that start them at lower contribution levels.

This increase is very unlikely to reduce the number of savers, as other studies[6] show that increasing

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The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

the initial savings level to 6 percent results in the same participation rates as those with lower initial contributions.

Improving Information About Outcomes. Most Americans have only a limited knowledge of investing and need better and understandable information to avoid nasty surprises. For instance, most have little idea how much they will receive from Social Security and whether the amount they are saving will be enough for a comfortable retirement. They also have little idea of how much income they will receive from their savings, as most plans report only a lump sum.

Until recently, Social Security provided all unretired workers over the age of 25 with an annual statement of their expected benefits. However, in a shortsighted attempt to save money, Social Security stopped sending these statements. In addition, the Department of Labor is working to ensure that all savers receive an annual disclosure of how much retirement income they can expect to receive from their employer-sponsored retirement savings plans. It needs to finish its work and enable this disclosure, but an even better idea would be to combine that information with the Social Security benefit estimates in one statement, probably from the 401(k) provider. That way, employees would have a better idea of their total retirement income and could take steps to increase their savings if necessary.

Ensuring That Savings Do Not Run Out. Another crucial problem is that savers without guaranteed lifetime income products[7] (such as annuities) stand a good chance of running out of money. Good products are available either for immediate income upon retirement or for income starting once a retiree reaches a certain age, such as 80 or later, but federal tax laws and regulations on employers limit their use.

In addition, most Americans really don't understand these products and are reluctant to use them. Eliminating unnecessary legal barriers, combined with making some level and form of guaranteed lifetime income an automatic choice on retirement unless the employee declines them, would protect older retirees from the stress of outliving their savings.

A Retirement Savings System for the Future. When other improvements are combined with the above reforms, the existing 401(k)/IRA retirement savings system will provide almost all Americans with a secure retirement income without the need for some form of a centralized government-managed savings giant. The retirement savings system of the future would enable all Americans to save for retirement in a private plan that is simple and easily understood. Employees would begin to save at the start of their careers, and their savings would automatically follow them from job to job using the same deduction level and general investment choices.

A key to success will be the much broader use of automatic features[8] such as automatic enrollment, investment options, escalation to an appropriate savings level, and even choice of an optimal withdrawal strategy. The individual will have full control but will be able to take advantage of automatic guidance if he or she so desires.

A retirement plan does not need to be overly complex for the saver. A simple system that uses automatic features to get savers started and allows them to assume greater

1. See David C. John, "Social Security Finances Significantly Worse, Says 2012 Trustees Report," Heritage Foundation *Issue Brief* No. 3577, April 23, 2012, http://www.heritage.org/research/reports/2012/04/social-security-finances-significantly-worse-says-2012-trustees-report.
2. See David C. John, "States Created Their Pension Problems, and States Should Solve Them," Heritage Foundation *WebMemo* No. 3462, January 17, 2012, http://www.heritage.org/research/reports/2012/01/state-and-local-government-problems-with-public-pension-plans.
3. See David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs and Account Simplification," Heritage Foundation *Testimony*, April 17, 2012, http://www.heritage.org/research/testimony/2012/04/pursuing-universal-retirement-security-through-automatic-iras-and-account-simplification.
4. For instance, many companies automatically enroll new participants at a contribution rate equal to 3 percent of pay, a level that stems from the Pension Protection Act of 2006, even though that law also allows a company to set a higher or lower initial contribution level.
5. Employee Benefit Research Institute, "2012 Health Confidence Survey: Americans Remain Confident About Health Care, Concerned About Costs, Following Supreme Court Decision," September 2012, http://www.ebri.org/publications/notes/index.cfm?fa=notesDisp&content_id=5110 (accessed October 17, 2012).
6. John Beshears et al., "The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States," National Bureau of Economic Research *Working Paper* No. 12009, January 2006, http://www.nber.org/papers/w12009.pdf?new_window=1 (accessed October 17, 2012).
7. By law, annuities are products that can be offered only by insurance companies. However, other types of companies are developing phased-withdrawal products with similar features.
8. See David C. John, "Automatic Retirement Savings—Paving the Path to Personal Financial Security," Heritage Foundation *Backgrounder* No. 2477, October 14, 2012, http://www.heritage.org/research/reports/2010/10/automatic-retirement-savings-paving-the-path-to-personal-financial-security.

control at a later date if they desire to do so is far preferable to one that requires so many initial decisions that busy employees end up doing nothing.

The Danger of Doing Nothing. Even if Social Security were fully funded and could pay all of its promised benefits, almost all retirees would still need a great deal of additional income from savings or pensions. The longer retirement savings reforms are delayed, the more likely that a future Congress will face demands for additional taxpayer-provided retirement benefits.

It takes decades to build a sufficient level of retirement savings for a comfortable future, and for many employees, the clock is already ticking. Millions more could build the needed amounts if they could start to save soon. An improved retirement savings system could provide retirement security—but only if the next Congress and Administration make it a priority.

*—**David C. John** is Senior Research Fellow in Retirement Security and Financial Institutions in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*