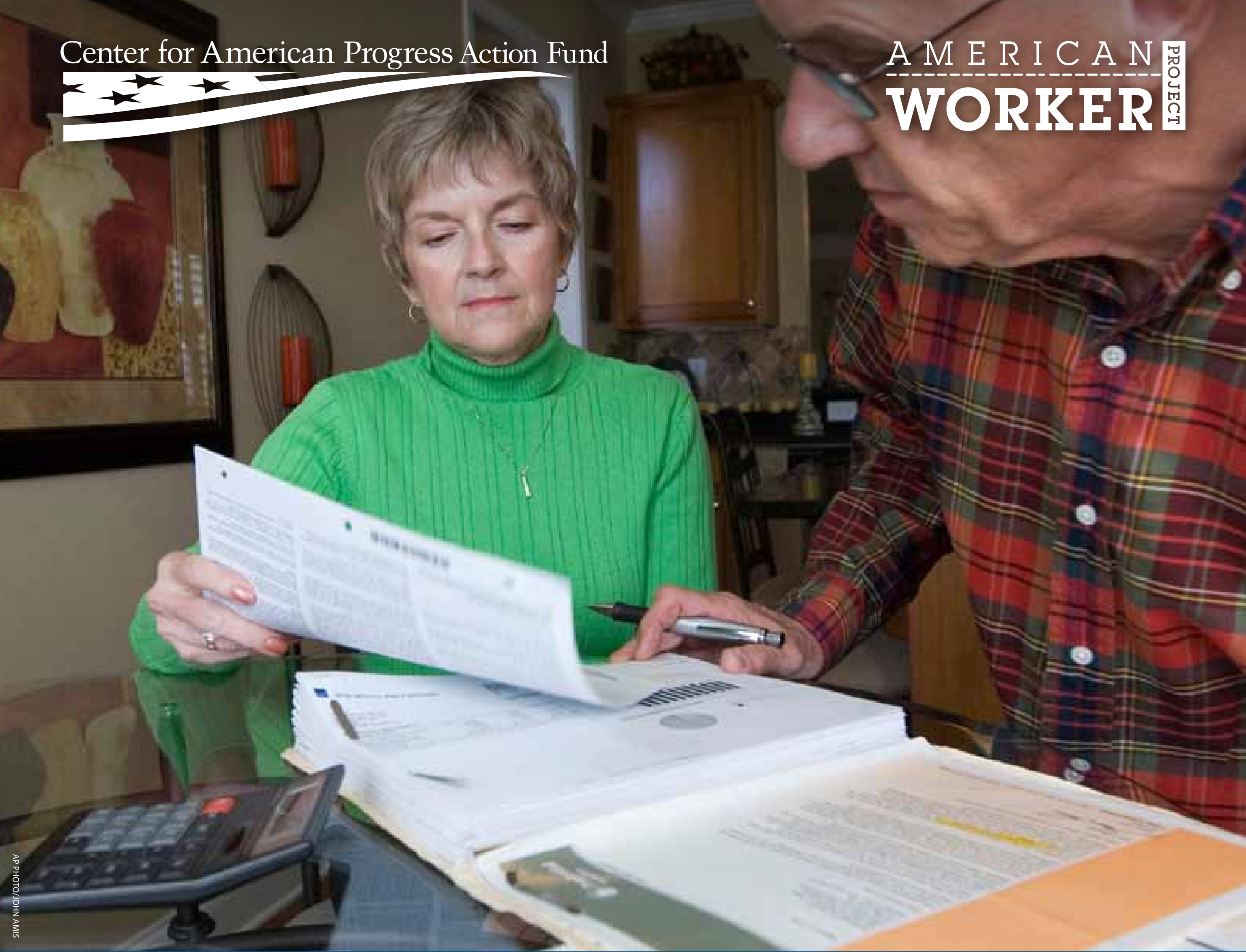
Center for American Progress Action Fund

AMERICAN WORKER PROJECT



AP PHOTO/JOHN AMIS

The Promise and Peril of a Model 401(k) Plan

Measuring the Effectiveness of Retirement Savings Plans Offered by Private Companies and the Federal Government

By Rowland Davis, Nayla Kazzi, and David Madland   April 2010

Introduction and summary

Boosting private retirement savings, especially among the half of all U.S. workers who are not enrolled in any employer-based retirement savings plan, is an exceedingly important public policy goal. Social Security, which was always designed to be a supplemental retirement savings program, simply cannot provide the levels of savings required by Americans retiring at 65 years of age and living for another 18 years on average. But today's existing employer-based savings plans are not structured well to ensure adequate retirement savings for most Americans who do boast access to these plans.

Elected officials and retirement savings experts alike recommend a number of reforms to give workers greater access to existing private financial products through their workplace, such as 401(k) savings plans and Individual Retirement Accounts. 401(k)s are the most common kind of defined-contribution plan, a type of retirement plan where retirement income is dependent upon how much money a worker accumulates in the account—based on among other things, contributions from the worker and from the employer (if any), the performance of the account's investments, and plan fees. IRAs operate in a similar fashion, though they are often set up by individuals rather than an employer. These defined-contribution plans are increasingly taking the place of traditional defined-benefit plans, which are pension plans where the amount of benefit a person receives is ordinarily based only on salary and years of service.

When 401(k) plans were created under a provision in the Revenue Act of 1978,[1] they were intended to provide workers with a means of supplementing retirement income from traditional defined-benefit pension plans, the most common form of pension plans at the time.[2] In defined-benefit plans, employers assume the investment and other risks associated with managing retirement accounts, but in defined-contribution plans like 401(k)s, risks are borne entirely by the worker. Since then, however, 401(k)s have become the primary employment-based retirement savings vehicle for many Americans. Many employers over the past three decades first offered 401(k)s as Congress intended them, as supplements to traditional pension plans, but then phased out these traditional plans in favor of 401(k)s. In the past decade, some employers began freezing their contributions to their employees' 401(k) plans, leaving workers truly on their own to save for retirement.

401(k)s have worked very well for some people, but they have proven inadequate for most Americans for two primary reasons. First, nearly half of Americans do not have access to a retirement plan at work. Some policymakers hoped that 401(k) plans would increase the number of workers covered by a retirement plan. Yet, as the number of employers offering their workers a defined-benefit pension plan has fallen dramatically in recent years, the number of employers offering defined-contribution plans has increased only enough to keep overall participation rates even. As a result, the share of Americans saving in an employer-based retirement plan has held steady over the past three decades at around half.

Second, most people who have 401(k)s don't accumulate enough retirement savings in their accounts. Experts think that in order to have a secure retirement and maintain their standard of living, retirees need to be able to depend on an annual income that is about 75 percent to 80 percent of their pre-retirement salary. Social Security replaces slightly less than 40 percent of the typical worker's income, meaning that retirees need their 401(k)s, pensions and other private savings to make up the difference.[3]

Yet most people are not accumulating anywhere near enough money in their 401(k)s to produce a stream of income equal to 35 percent of their salary. For people nearing retirement age, the median 401(k) account balance—meaning that half are larger and half are smaller—is less than $80,000.[4] Such an amount would provide the typical 65-year-old a monthly payment of around $500.[5] And these figures are based on account balances before the Great Recession decimated defined-contribution plan balances, wiping out an inflation-adjusted $2.8 trillion dollars in accumulated wealth between September 2007 and December 2008.[6]

While there are numerous policy proposals to address these issues, this report is most relevant for two categories of recommendations.[7] One set of proposals attempts to promote savings for those who don't have a retirement plan at work through expanded use of existing private retirement plans, either 401(k)s or IRAs. For example, the Aspen Institute's "America's IRA" would provide a government match for low- and moderate-income Americans who do not have access to retirement plans where they work if they contribute to a privately run retirement account.[8] Similarly, Gene Sperling, formerly a Senior Fellow at the Center for American Progress and now an official at the Department of the Treasury, has advocated for a Universal 401(k) with progressive matches and tax benefits, available to all Americans.[9]

A second set of proposals similarly attempts to promote savings for those who don't have a retirement plan at work, but directs savings into a defined-contribution plan similar to the Thrift Savings Plan, which is the defined-contribution plan for federal employees. The TSP is a 25-year-old plan that is one leg of a three-legged support system for federal employees, termed the Federal Employee Retirement System, which includes, of course, Social Security but also a defined-benefit pension plan. Proponents for this type of nationwide defined-contribution TSP include Michael Calabrese of the New America Foundation and Dean Baker of the Center for Economic and Policy Research.[10]

Though not all details have been released, the Automatic IRA proposal included in President Obama's budget appears to direct workers without retirement plans into private retirement plans, and thus belongs in the first category. However, the proposal could be adapted to fit in the second category.

The likely impact of these two different types of reforms—expanded private-sector use of 401(k)s and IRAs or alternatively a TSP-like retirement savings plan available to all Americans—is not adequately understood. This report helps fill this gap by analyzing the likelihood that workers would have a secure retirement income under both types of proposals. The report develops a model of the likely outcome of a worker saving in each type of plan,[11] highlighting the impact of certain advantages of the TSP, such as its lower financial management fees, more sensible investment options, and higher employer contributions than the typical private sector 401(k). Our model shows that:

- A typical worker is nearly two times more likely to have sufficient retirement income—an income that is 75 percent of pre-retirement levels—making identical contribution and investment decisions in the Thrift Savings Plan compared to a standard 401(k) plan because of the TSP's much lower fees and slightly higher employer contributions.

- The TSP's superiority over the typical 401(k) plan is likely to be even greater because the TSP also appears to encourage workers to engage in savings behaviors that promote retirement security, such as participating at higher rates and contributing a greater percentage of their salary toward retirement than most 401(k) plan participants.

- All told, accounting for the impact of fees and employer contributions as well as making reasonable assumptions about employee contributions and participation, a worker saving through the TSP is more than four times more likely to have sufficient retirement income compared to one saving through a standard 401(k) plan.

Yet despite the clear advantages of being able to save through the TSP, a worker doing so would still face the substantial risk of having an inadequate income in retirement if this retirement savings plan were offered to all workers. Federal employees today are generally on track to a secure retirement because they also have a supplemental defined-benefit pension plan, but few policymakers today are considering adding a defined-benefit plan to the retirement savings reforms described in this report.

That's why the second set of findings contained in this report is so alarming. Specifically, our model finds that:

- A middle-income worker earning around $30,000 a year at age 30 and making median-level annual contributions of about $2,400 (or 8 percent of pay) alongside his or her employer in a TSP has a roughly one in five chance of having inadequate income in retirement to maintain his preretirement standard of living, though the shortfall is likely to be relatively modest.

- But if a worker were able to contribute to the TSP but not receive any employer contributions—as proposed by many retirement savings plan reformers—then that worker would very likely face a shortfall in retirement. Even making the generous assumption that worker contributions in the TSP would remain the same even without an employer match, a middle-income worker making the current median-level contributions in the TSP would have only an 18 percent chance of having a secure retirement. Further, this worker would have nearly a one in five chance of facing a severe shortfall, defined as a retirement income of less than 60 percent of preretirement levels.

- Workers who contribute less than the median worker detailed above—and half of all workers today that contribute to a 401(k) plan do contribute less—have an even higher likelihood of facing an insecure retirement, with a retirement income well below 60 percent of preretirement income.

The results of our study lead us to three primary policy recommendations:

- All workers should be able to save through a national Thrift Savings Plan.

- Existing 401(k) and IRA plans require fundamental reforms to boost the level of retirement savings.

- Social Security needs to be strengthened to provide a baseline retirement savings threshold.

All workers should have access to save in the TSP, which would significantly improve retirement security compared to both the status quo and reforms that would place workers in private retirement accounts. What's more, expanding access to the TSP could be politically feasible in the relatively near term because the TSP is highly regarded by both conservatives and progressives, suggesting the potential for bipartisan appeal.

Donald Luskin, editor and columnist for the conservative National Review Online, calls the Thrift Savings Plan "a model for efficiency,"[12] and David C. John, senior research fellow at the conservative think tank the Heritage Foundation says it is "one of the most successful retirement investment vehicles ever created."[13] The TSP is also the basis for several progressive proposals for a universal retirement plan, including CAP's proposed universal 401(k) plan as well as a proposal developed by the Conversation on Coverage, a collaboration of business, labor, the financial industry, and academia.[14]

But a national TSP doesn't immediately address the longer-term and perhaps more fundamental reforms required in our nation's existing 401(k) system—reforms that may be needed to ensure Americans are able to enjoy a secure retirement. Among those reforms that should be considered, and which could be adapted to fit on top of the TSP model include:

- Setting higher default contribution levels
- Requiring contributions from employers and employees
- Encouraging retirees to annuitize assets into a secure stream of income that cannot be outlived
- Making the tax benefits for retirement savings more progressive.

Finally, Social Security needs to be strengthened and modernized so that it can continue providing all Americans with a baseline of retirement security that these reforms can build upon. Together, these three sets of recommendations would put all U.S. workers on the path toward a secure financial retirement.

This report helps shed light on the likely impact of reforms to existing 401(k) and IRA or alternatively to a national TSP plan and indicates that simply increasing access to retirement plans is not enough. Plan design matters greatly for retirement security and the TSP is considerably better at helping workers achieve a secure retirement than most private sector 401(k)s or IRAs.

The report also significantly improves our understanding of the existing TSP. Despite the praise that the TSP often receives, few have looked closely at how much retirement security would improve if all workers could save in a similar plan.[15] In the pages that follow we will detail the results of our study to demonstrate why our proposed reforms are so important to the more than 100 million working Americans today who need to save for their retirement and for the next generations who will need to save even more due to rising life expectancies in the 21st century. More than 37 million new workers are expected to enter the workforce by 2016 as more of the Millennial Generation—the largest generation ever—joins the workforce. [16] How they save for their retirement will be critical to long-term economic health and well being of our nation.

The Center for American Progress Action Fund transforms progressive ideas into policy through rapid response communications, legislative action, grassroots organizing and advocacy, and partnerships with other progressive leaders throughout the country and the world. The Action Fund is also the home of the Progress Report and ThinkProgress.

Center for American Progress Action Fund

1333 H STREET, NW, 10TH FLOOR, WASHINGTON, DC 20005 • TEL: 202-682-1611 • FAX: 202-682-1867 • WWW.AMERICANPROGRESSACTION.ORG