Remarks on Retirement Security

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Expanded prepared remarks

Thank you, Jim, for that introduction and thanks also to the Bipartisan Policy Center and the Concord Coalition for hosting this event and for all of the work you do to bring people together around some of the most important problems we face as a country.

The first baby boomers became eligible for Social Security in 2008 and the retirement boom will continue to grow in the coming years. At the same time, the retirement landscape has been transformed with the rise of 401(k) plans and Individual Retirement Accounts (IRAs), which offer many attractive advantages but also contain substantial opportunities for mistakes, from unintentionally failing to participate to losing a substantial portion of one's retirement savings to high investment fees. These developments highlight the importance of the discussion we are having today on America's retirement security.

My remarks will touch on three broad topics: the state of retirement readiness, the importance of Social Security in providing a foundation for retirement security, and the President's retirement agenda as reflected in both legislative proposals and in ongoing administrative actions.

The State of Retirement Readiness

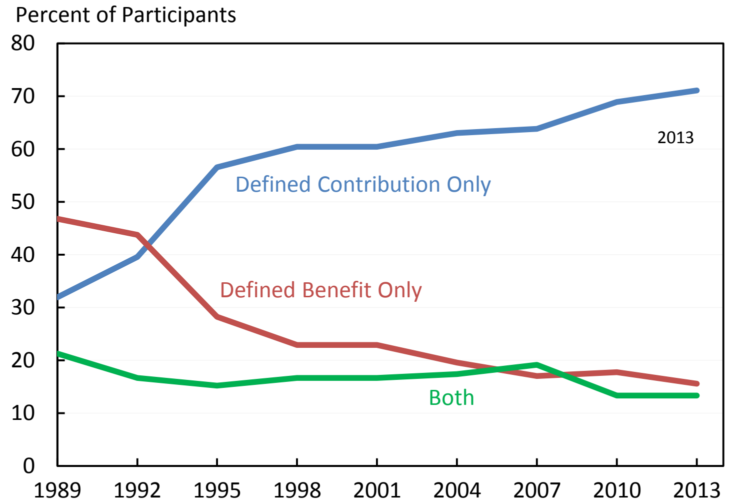
I will begin with a brief assessment of the adequacy of retirement savings. Americans' retirement income comes from many sources. Social Security provides the basic foundation for retirement security through the provision of universal, guaranteed benefits. Building on that foundation, a system of tax-preferred retirement plans provides additional opportunities for savings explicitly designated for retirement. And finally, families accumulate additional private savings in a wide variety of financial and non-financial assets. For the middle class, the most important form this additional savings takes is home equity.

While this landscape is familiar today, it is markedly different from the landscape that existed in the past. Though the overall share of workers participating in any type of retirement plan has shown little net change over the last 25 years, the share of workers covered by traditional, defined benefit pension plans—which offer a guaranteed income stream in retirement—has fallen sharply. Today the majority of workers participating in a retirement plan at work are covered only by a defined contribution plan, such as a 401(k). As shown in Figure 1, the share of workers participating in a retirement plan who had a traditional pension fell from nearly 70

[1] Greg Leiserson led the preparation of this speech with assistance from Brian Moore.

percent in 1989 to less than 30 percent in 2013. The share of workers with only a defined contribution plan increased from about 30 percent to about 70 percent.

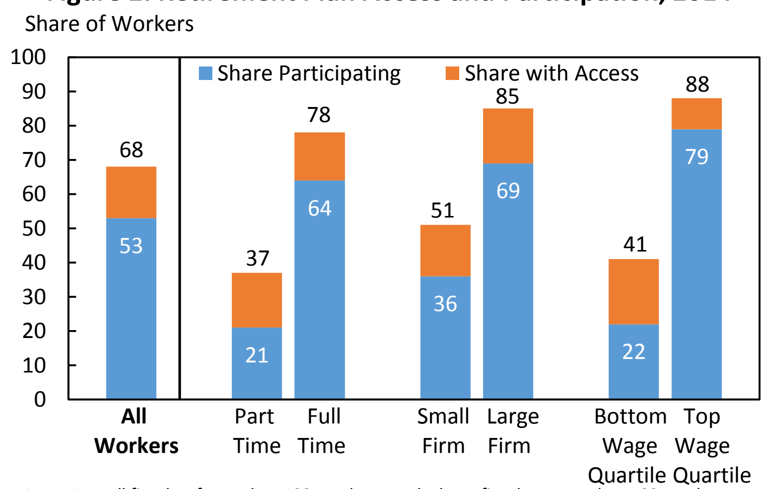
Figure 1: Retirement Plan Participants by Plan Type 1989-2013



Source: Boston College Center for Retirement Research; CEA calculations.

This dramatic transition from defined benefit to defined contribution plans has affected only those covered by a retirement plan at work. However, only about half of the workforce has coverage. Most of those without coverage lack access to any workplace retirement plan. Access and participation rates vary significantly by the demographic and economic characteristics of workers, with access and participation particularly low for part-time workers, workers at smaller firms, and low-wage workers, as shown in Figure 2. In addition, access and participation rates are lower for younger workers, Latino workers, and workers with fewer years of education.

Figure 2: Retirement Plan Access and Participation, 2014



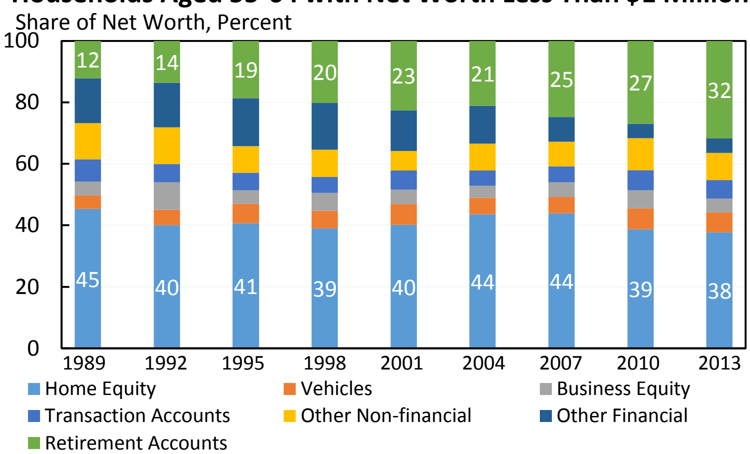
Note: A small firm has fewer than 100 emplyees and a large firm has more than 100 employees.
Source: Bureau of Labor Statistics.

Coverage is not an end in itself. Rather, coverage is a tool to help Americans achieve a secure retirement. And even among the population with coverage, the amount of money saved for retirement is often very low. According to the 2013 Survey of Consumer Finances, about 40 percent of households with head age 55-64 had no retirement savings accounts, and among households with head age 55-64 and retirement accounts the median balance was about $100,000.

In addition to saving through employer plans, Americans also save through tax-advantaged Individual Retirement Accounts (IRAs). IRAs are particularly important for older Americans, many of whom roll over workplace retirement plans to an IRA upon separation from their employers. Since their creation in 1974, IRAs have grown to hold more than $7 trillion of retirement wealth—most of which derives from rollovers from workplace retirement plans—and now account for nearly one-third of all retirement assets. In addition, IRAs serve a critical role in the retirement landscape as they offer tax incentives for saving to workers without access to a plan at work, including workers at small businesses or those working part-time.

While the relatively low levels of savings in retirement accounts raise concerns about retirement adequacy, the value of assets in these accounts has increased markedly over the last 30 years. Figure 3 shows the composition of net worth for households with head age 55 to 64 and net worth less than $1 million between 1989 and 2013. Retirement assets accounted for 12 percent of net worth in 1989. By 2013 their share of retirement net worth had more than doubled, to 32 percent. The share of other financial assets in net worth decreased between 1989 and 2013, possibly reflecting some shifting of financial assets that had been held outside retirement accounts into retirement accounts. Even so, the combined share of retirement accounts and other financial assets in 2013 exceeded the combined share in 1989.

Figure 3: Components of Net Worth for Select Years, Households Aged 55-64 with Net Worth Less Than $1 Million



Notes: $1 million threshold specified in 2013 dollars and adjusted for inflation in earlier years.
Source: Survey of Consumer Finances; CEA calculations.

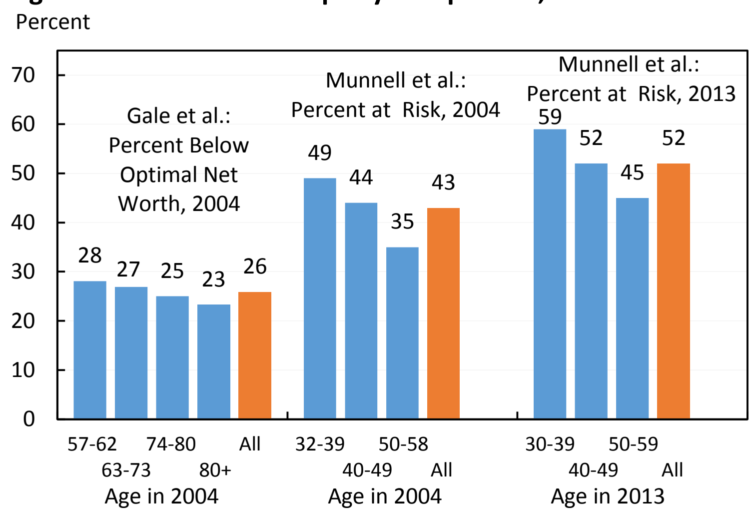
This figure also emphasizes the importance of looking beyond formal retirement accounts in assessing retirement readiness. In every survey since 1989, home equity is the largest single contributor to net worth for households nearing retirement. This remains true even after the sharp decrease in housing prices associated with the Great Recession.

Of course, one important limitation of the Survey of Consumer Finances for assessing retirement adequacy is that it does not present dollar values of accrued benefits under traditional pension plans. In addition, the figure that I have just shown provides little insight into the dispersion in retirement readiness across the population.

From an economic perspective, the question of retirement readiness relates to the household's ability to enjoy a standard of living in retirement commensurate with that enjoyed during working years. Achieving a constant standard of living means that different households need to save different amounts—there is no single amount of savings that can guarantee a secure retirement.

Putting together a complete picture of households' retirement readiness requires a significant amount of work to collect all of the relevant data and some fairly heroic assumptions. And there is no single right way to do it. Fortunately, numerous researchers have attempted the feat. Unfortunately, as one might expect, they have come to rather different answers.

Figure 4: Retirement Adequacy Comparison, Select Measures



Source: Gale et al. (2009); Munnell et al. (2015).

Figure 4 summarizes the results of two groups of economists who have tackled this question. The first set of bars present the results of the economists Bill Gale, Karl Scholz, and Ananth Seshadri. This group of researchers built a life-cycle model and used that model to compute optimal wealth targets for every household according to its assumptions. They then compared each household's actual wealth to its target wealth. They found that roughly 25 percent of households were below their target wealth levels and that younger households were slightly less likely to achieve their optimal wealth target. Among households with wealth below their target, the median deficit was about $32,000.

Researchers at the Boston College Center for Retirement Research, led by Alicia Munnell, took a different approach and computed projected replacement rates and target replacement rates for each household using data from the Survey of Consumer Finances. They then used these computations to construct a retirement risk index, which they update every three years when the Federal Reserve releases new survey results. In their most recent update, using data for 2013, they estimate that 45 percent of households with head age 50 to 59 are at risk of an insecure retirement. They define a household to be at risk if its projected replacement rate is more than 10 percent below its target replacement rate. These results are shown in the bars at the far right of the figure. The same approach using data for 2004 yielded a slightly more optimistic assessment of adequacy, with only about 35 percent of households at risk. The 2004 results are slightly closer to the results found by Gale, Scholz, and Seshadri for that year and are shown in the middle panel of the figure.

The assumptions driving the differences between these two approaches to assessing readiness make for an interesting, if somewhat technical, study in the importance of assumptions in driving results, and I do not intend to reconcile them or pick a favorite in my remarks today. However, at the risk of being a two-handed economist, I would note that neither side has a monopoly on definitive arguments for each of their assumptions. But in either scenario tens of millions of Americans are unprepared for retirement, a fact that warrants our attention as policymakers. A particular focus in this regard is those who do not own a home and who lack access to a retirement plan at work. In addition, low- and moderate-income households face scarce resources for all potential uses, including retirement savings.

While the adequacy of retirement savings is a central concern of retirement policy, it is not the only one. Families prepared for retirement may still struggle with retirement challenges. For example, a person who is prepared for retirement, but only after realizing a sub-par return on her retirement savings because of excessive fees caused by conflicted advice, was forced to save more and sacrifice more to get to that point. As another example, families experiencing especially high out-of-pocket health costs may find they have to lower their standard of living in retirement, even if they had saved adequately for a typical situation.

The Importance of Social Security

In his 2011 State of the Union Address, the President stated, “We should also find a bipartisan solution to strengthen Social Security for future generations. We must do it without putting at risk current retirees, the most vulnerable, or people with disabilities; without slashing benefits for future generations; and without subjecting Americans’ guaranteed retirement income to the whims of the stock market.”

The key question is what improves the national welfare and ensures opportunity and security for all Americans. Ensuring that our fiscal future is sustainable is necessary to achieving that goal, but it is not sufficient and it is not an end unto itself. Instead, our goal should be strengthening Social Security and improving its ability to deliver retirement security for Americans, which, to be sure, includes extending its solvency to prevent abrupt and dramatic benefit reductions.

The retirement background I have been discussing provides three insights that can help guide us in thinking about the ways in which Social Security reform can affect retirement security. And, to be clear, while my remarks today focus on the retirement aspect of Social Security, Social Security is about much more than retirement. For example, it also provides disability and survivors' insurance, protecting all of us against the possibility that we will not be able to work or that an early death will leave our family with reduced means of support.

First, both of the approaches to assessing retirement adequacy I have been discussing find that while many Americans are prepared for retirement, a substantial fraction are not. Thus, we should always be looking for opportunities to help the least-prepared population improve their saving and to reduce the number of Americans without adequate preparation as much as possible. Social Security already targets assistance to the most vulnerable workers. For example, it replaces a larger share of a worker's previous earnings for workers at lower earnings levels. But benefits could be improved for low-income workers or those with a more uneven work history, measures that have been included in a wide range of Social Security reform proposals—including the one developed by the Bipartisan Policy Center.

Second, while the two adequacy analyses I have discussed treat uncertainty in different ways, the core results presented are about expectations as one nears retirement. One of the most valuable features of Social Security is the insurance it provides against difficult-to-insure risks, including longevity, inflation, temporarily low earnings, and private company default. Reforms that can improve the protection that Social Security offers against these and other risks can offer substantial gains. Such reforms can even improve adequacy with no net increase in benefits by reducing the need for potentially inefficient precautionary savings.

And third, the underlying economics of the more optimistic assessments of adequacy do not necessarily reduce concerns about reductions in Social Security benefits. This possibly counterintuitive result arises because the more optimistic assessments do not arise from higher estimates of wealth but from lower estimates of desired retirement spending. The two sides in the adequacy research debates do not disagree on how much wealth people *have*—they differ primarily on how much retirement income people are likely to want and thus how much wealth they *need*. The harm of deep benefit reductions is least in a world where not only is everybody well prepared for retirement but also where Social Security accounts for only a small fraction of retirement income. According to these assessments of adequacy, we do not live in that world. Under the Munnell view, we live in a world facing a very serious adequacy challenge. Under the Gale view, that challenge is somewhat smaller, but Social Security accounts for a large share of what is needed. In either case, deep cuts to Social Security would be particularly damaging.

So as we think about the future of Social Security, we should look for ways to improve the program for those least prepared for retirement and increase the protection it offers against difficult to insure risks, and we should evaluate potential reforms in light of a comprehensive assessment of retirement adequacy.

The President's Retirement Savings Agenda

Finally, I want to turn to the retirement savings agenda reflected in the President's Budget and the Administration's ongoing administrative actions, focusing on the system of tax-preferred, defined contribution accounts that has grown up over the last 30 years. In addition to the defined contribution plans I will be discussing today, the Administration also understands the importance of defined benefit plans for millions of workers and has been focused on strengthening and improving both single and multiemployer pension plans and further strengthening the Pension Benefit Guarantee Corporation.

Defined contribution plans offer an important opportunity for many Americans to accumulate wealth and are an important element of the retirement system. But, as I noted at the outset, not all Americans have access to a workplace retirement plan. And even if you have access to a plan, you can face numerous complicated choices with opportunities for mistakes at every stage in the process—from whether or not to participate to what investment options to choose to how take withdrawals in retirement. Making all of this easier and more automatic has been a goal for policymakers since the late 1990s. Through its legislative proposals and administrative actions, the President has proposed a cohesive agenda to address these issues by expanding access, facilitating accumulation, expanding the array of distribution options, and making the system as a whole work better.

Expanding Access to and Participation in Workplace Retirement Savings Plans

A critical element of the President's retirement agenda is the automatic IRA, which is based on a bipartisan proposal developed by researchers at the Brookings Institution and the Heritage Foundation. The evidence is clear: workers with an easy and automatic way to save for retirement overwhelmingly do so, and workers without such an option do not. The auto-IRA leverages what we know works to ensure that the overwhelming majority of Americans have access to a retirement plan at work, while retaining workers' ability to opt out if necessary. The Treasury estimates that implementing auto-IRAs would increase the number of workers with access to a retirement plan by about 30 million people. Moreover, the fiscal costs associated with the proposal reflect tax benefits for incremental savings—it has little if any additional costs associated with windfalls for savings that would have happened regardless—making it a particularly efficient tax incentive.

This year's Budget also includes a new proposal that would provide for a more modest expansion of access to retirement plans by ensuring that long-term, part-time workers can contribute to their employer's retirement plan. Only 37 percent of part-time workers have access to a workplace retirement plan. That is partly because employers offering retirement plans are allowed to exclude employees who work fewer than 1,000 hours per year, no matter how long they have worked for the employer. This legislative proposal would expand access for part-time workers by requiring employers that offer plans to permit employees who have worked for the employer for at least 500 hours per year for three or more years to make voluntary contributions to the plan.

The Budget also proposes tripling the existing tax credit for small employers that adopt a new retirement savings plan for the first time and providing tax credits to encourage 401(k) sponsors to adopt automatic enrollment.

Since the beginning of the Administration, we have taken important steps to translate expanded access into expanded participation. These legislative proposals are only one part of that agenda. They complement the Treasury's current actions to make retirement saving easier by creating a simple, risk-free, no-minimum-balance, and no-fee *my*RA savings vehicle, as directed by the President in last year's State of the Union address. *my*RA is a Roth IRA offered by the Treasury with a single investment—a new, user-friendly type of U.S. savings bond that entails no risk to principal and can generally be expected to keep up with inflation. *my*RA is designed to encourage Americans who lack access to workplace retirement plans to begin a lifelong habit of saving by providing an easy and affordable way to save until balances reach a level that is viable in private-sector IRAs. Treasury is currently beginning to implement *my*RA on an incremental basis.

All of these efforts augment the Administration's continuing actions to encourage firms to establish and enhance opt-out and other automatic systems for retirement savings that are a proven way to increase the take-up of 401(k) plans, including automatic escalation of contributions. Several weeks ago, Treasury took the latest steps to promote automatic enrollment and automatic contribution increases by simplifying and streamlining administrative provisions for plan sponsors using these features.

Addressing Conflicts of Interest in Retirement Investment Advice

The auto-IRA proposal and the *my*RA initiative both build on the existing IRA structure. The IRA is a powerful vehicle for wealth accumulation. At the same time, the IRA is not what it could be. The set of financial products that can be held in an IRA is vast, including savings accounts, money market accounts, mutual funds, exchange-traded funds, individual stocks and bonds, and annuities. Selecting and managing IRA investments can be a challenging and time-consuming task, frequently one of the most complex financial decisions in a person's life, and many Americans turn to professional advisers for assistance. However, financial advisers are often compensated through fees and commissions that depend on their clients' actions. Such fee structures generate acute conflicts of interest: the best recommendation for the saver may not be the best recommendation for the adviser's bottom line.

Earlier this year, the Council of Economic Advisers released a report on the impact of conflicted payments on America's retirement savers. We concluded that conflicts of interest lead to annual losses of about $17 billion for IRA investors. IRA investors are at a particular risk for conflicts of interest because, unlike with employer plans, there is no fiduciary responsible for selecting plan investment options. These losses provide the motivation for the Department of Labor's recent proposed rule to expand consumer protections regarding retirement investment advice and to ensure that advisers put their clients' interest first. This proposed rule would update the basic rules governing investment advice, which are largely unchanged since 1975. It would expand the definition of fiduciary investment advice to cover the prevalent forms of advice today, which are provided in contexts that largely did not exist in 1975. At the same time, it would offer an unprecedented exemption from certain restrictions that fiduciary status usually imposes, so long as advisers meet appropriate conditions relating to the advice they provide and put in place policies and procedures to prevent conflicts. This approach would ensure that advisers provide advice that is in their clients' best interest while also providing sufficient flexibility to allow firms to adopt the business practices that allow them to best serve their customers.

Improving Distribution Options and Facilitating Retirement Income

These efforts to improve access, participation, and accumulation are complemented by a sustained effort to encourage retirement plans to improve distribution options. The Treasury has issued a series of regulations and other guidance to foster the creation of a retirement income culture. These projects include the recent finalization of rules permitting for the first time the offering of longevity annuities (deferred annuities that begin payment at older ages to efficiently protect retirees from the risk of outliving their retirement savings) in 401(k) plans and IRAs and guidance making clear that plan sponsors can include deferred income annuities in target date funds used as a default investment. More broadly, this past year Treasury has expanded its initiative to promote "401(k) 3.0", 401(k) plan designs that are more effective and that function more like traditional pension plans, including by offering payouts as annuities and including certain disability benefits. In addition, the Department of Labor continues to work towards a proposal for a lifetime income illustration on defined contribution plan statements.

In addition to these administrative actions, the Administration has proposed to dramatically simplify compliance with the required minimum distribution rules in order to make it easier to manage retirement assets and income. We propose to permanently exempt from the age 70 ½ required minimum distribution rules a majority of America's seniors—individuals with aggregate IRA and tax-favored retirement plan accumulations of less than $100,000 at age 70 ½. We also propose to harmonize the required minimum distribution rules for Roth IRAs with those for all other tax-favored accounts by conforming them to match.

Reforming or Ending Ineffective Tax Subsidies

Finally, the Administration has proposed several policies that would ensure that tax-preferred retirement accounts serve their intended purpose: to enable working and middle-class Americans to achieve retirement security—not to provide additional tax-planning strategies for the wealthy.

The most significant proposal would limit the tax benefit of the exclusion or deduction for retirement savings to 28 cents on the dollar, partially addressing the current upside-down incentives for retirement savings by ensuring that households making above about $250,000 do not receive tax benefits for savings that greatly exceed what typical middle-class households get. This measure is part of a broader proposal to limit all deductions and exclusions for high-income households to 28 percent.

Another proposal would prohibit additional contributions to or accruals of benefits under a tax-preferred retirement or pension plan once an individual's combined balances are sufficient to finance an annual income of $210,000 in retirement for the lifetime of the saver and a spouse (about $3.4 million at age 62). Once this level has been reached, individuals would be able to continue to earn an investment return on their assets and could save more in any taxable form that they so desire.

The Budget also includes a proposal to limit the ability of taxpayers to perform a Roth conversion of nondeductible IRA balances, which allows high-income taxpayers to make a backdoor Roth contribution when they would not otherwise be allowed to make one. These backdoor Roth contributions effectively increase the contribution limits for high-income taxpayers, and are particularly valuable for those who have already contributed the maximum allowable amount to a workplace retirement plan.

From an economic perspective, the goal of tax subsidies for retirement accounts is to encourage additional savings. However, the public interest in subsidizing additional retirement savings is modest at best for individuals who have already accumulated large balances. Moreover, since many of these individuals are over the caps on contributions, the existing tax incentives have no marginal impact and thus reflect only a transfer from the Federal government to the wealthiest and most prepared for retirement.

Conclusion

The U.S. retirement landscape has changed markedly over the last 40 years, and that evolution will certainly continue over the next 40 years. While estimates of the fraction of Americans at risk of reduced living standards in retirement vary dramatically, all of the analyses suggest that a significant fraction of Americans will be unable to maintain their pre-retirement living standards.

Social Security provides the foundation for Americans' retirement income security and is increasingly the only source of guaranteed retirement income most Americans have. That promise must be maintained and we must work to strengthen and improve the program with a particular focus on the most vulnerable.

Building on that foundation, the President has pursued a cohesive retirement agenda through legislative proposals and administrative actions to support Americans' retirement savings at all stages of the process: access to retirement plans, participation, accumulation, and distribution.

Thanks again for the opportunity to speak on this important topic.