PENSION RIGHTS CENTER

PROTECTING AND PROMOTING RETIREMENT SECURITY
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STATEMENT OF THE PENSION RIGHTS CENTER

ON

TAX REFORM OPTIONS: PROMOTING RETIREMENT SECURITY

BEFORE THE

COMMITTEE ON FINANCE

U.S. SENATE

SEPTEMBER 15, 2011

Mr. Chairman, Members of the Committee, thank you for this opportunity to testify today. My name is Karen Friedman, and I am the Executive Vice President and Policy Director of the Pension Rights Center, the only consumer organization working exclusively to protect and promote the retirement rights of workers, retirees, and their families.

We commend you for holding this hearing today to examine tax reform options to promote retirement security. Given the enormous challenges facing the country, this hearing might be subtitled, "How to better use the tax system to rebuild and revitalize the American dream for workers and retirees." Because that's what it's about, isn't it? At a time when the economy is in a tailspin, and middle-class American families are facing challenges as never before in recent history, we want to make sure that those who have worked hard and played by the rules are able to retire with adequate income and dignity. This has always been a fundamental shared ideal in this country.

Yet too many people are facing a bleak retirement. Half of all private-sector workers have no pensions or retirement savings plan to supplement Social Security – and this has been a stubborn fact for more than a quarter of a century. And too many employers who sponsor pension plans that provide lifetime, guaranteed incomes are freezing, terminating, and otherwise cutting back those plans and replacing them with less-secure 401(k) plans. Thirty years ago, one out of two private-sector workers participated in defined benefit plans, and now that figure is closer to one in five. And 401(k) plans have left most workers with insufficient assets for retirement.

The fact is, while 401(k) plans can work as supplemental savings plans, they do not work well as the primary retirement vehicle for most Americans. 401(k) plans, unlike guaranteed pension plans, put all the risks and responsibilities onto individuals, who then have to decide whether to participate, how much to contribute, what to invest in, how to resist withdrawing the money before retirement, and finally, figure out how to make the money last. That's a lot to put on someone who is struggling to hold onto a job, pay for escalating health expenses, keep a house afloat, and a family above water. Even before the stock market crash, 401(k) plans were not addressing the nation's retirement needs. In 2007, half of all households had less than $45,000 in their accounts. For those approaching retirement, the median account balance was just about $98,000 – not nearly enough to last throughout retirement.

Public opinion polls reflect America's mounting anxiety. According to the National Institute on Retirement Security, 84 percent of Americans are concerned that current economic conditions are impacting their ability to achieve a secure retirement, with more than half (54 percent) of Americans very concerned. In a recent Gallup poll, the top financial concern for most Americans was not having enough money for retirement, surpassing concerns about paying for healthcare or paying the mortgage. And in a poll conducted for the Allianz life insurance company, a majority of mid-career workers said the fear of not having enough money for retirement was greater even than their fear of death.

This fear is captured in the heartbreaking stories we at the Pension Rights Center hear every day from people across the country. People like Shareen Miller, a home health care aide in Virginia. Shareen, who makes only $12 an hour, tells us that she and her husband together have been able to sock away only $100,000 in their 401(k) plans, and she worries that one health care crisis could wipe out their retirement savings. There's Karen O'Quinn, who is in her late 40s. She was laid off from corporate America, leading to a foreclosed home. She doesn't have a dime for retirement. David Muse, a sound technician, puts it bluntly, "I will be forced to work until I either fall apart…my health totally crumbles or I die. For me there is no retirement."

All of this taken together – the statistics, the polls and the stories – add up to the Retirement Income Deficit facing the nation, an urgent deficit that must be addressed by Congress. According to the nonpartisan Center for Retirement Research at Boston College, the Retirement Income Deficit facing Americans is an astounding $6.6 trillion. That number represents the gap between what people have saved as of today and what they should have saved to achieve a level of sufficiency in retirement. To arrive at this number, the Center on Retirement Research used a conservative methodology based on the one it uses to calculate the National Retirement Risk Index. The Center only looked at households in their peak earning years, between 32 and 64 years old, and assumed that people would continue to earn pensions, that they would contribute to 401(k)s, and that they would continue receiving Social Security benefits under today's formula. The Center also factored in the value of home equity as a source of income for retirement. Cutting Social Security would only add to the Retirement Income Deficit the country is facing.

So what are the solutions to the massive and urgent Retirement Income Deficit? We would say there is not one solution but many that need examination. And there is no question that restructuring the tax system can contribute to a solution.

Let's look at the nation's current investment in employer-provided retirement plans – both 401(k)-type plans and defined benefit plans – as well as Individual Retirement Accounts, which often hold roll-over money when an employee leaves a job. The costs come through tax incentives for these plans, which Congress's Joint Committee on Taxation says will cost about $123 billion in lost revenue to taxpayers this year.[1] Tax expenditures just for 401(k)s, IRAs, and Keoghs add up to $70.2 billion. The reason Congress conferred preferential tax treatment is because policymakers recognize how hard it is for people to save for retirement – particularly

[1] Table 1, Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014, December 15, 2010.

low- and moderate-income workers. These incentives are meant to encourage employers to set up plans and to encourage employees to save. However, the incentives end up disproportionately benefitting the nation's most affluent employees, who would almost certainly save for retirement even without tax incentives. Two-thirds of the value of tax expenditures for retirement savings plans goes to households in the top income quintile according to the Urban-Brookings Tax Policy Center. Many experts call the current inequities "upside-down" incentives because they help those who least need help.

So the U.S. Treasury is foregoing billions of dollars every year to encourage retirement saving, but the end result is that, despite these expenditures, fewer than half of all Americans are covered by retirement plans, many fail to contribute, and, among those who do, most contribute too little, pay too much in fees, invest poorly, and sometimes withdraw their money before retirement age. While some of these problems can be addressed by automatic features – automatic enrollment and automatic escalation of contributions – the fact is, while such features have merit, they are not a panacea and do not address the structural flaws of 401(k) plans as retirement vehicles. Those most in need of a supplement to Social Security are likely to opt out or contribute too little. And all are vulnerable to market downturns and to wrong guesses when it comes to figuring out how to make their money last through retirement.

While we recognize there is no one magic bullet to address the major problems in the retirement system, we would like to offer today some ideas for this Committee to consider. I will divide our ideas into two buckets: the first is short-term, meaning they can be done now to make existing plans work more efficiently and more equitably; the second bucket is long-term and comprehensive, and includes elements necessary for a secure and adequate system for future generations of retirees.

As I discuss potential solutions, I want to emphasize that we believe that this should be a time for re-envisioning the tax system as a means to promote retirement security, not for retrenchment.

Reforms that could help increase savings in the short-term under existing plans

- Expanded and refundable Saver's Credit: The Internal Revenue Code currently includes a Saver's Credit to encourage low- and moderate-income workers to contribute to a 401(k) plan or IRA. However, the credit is quickly phased out, and many low- and moderate-income taxpayers who do not pay income tax fail to qualify for the credit. Others qualify for a credit that is far too small to be much of an incentive to save for people living near the poverty line. There is a need to make the credit "refundable," which means that those at the lower-end of the wage spectrum who contribute to a retirement account would actually get a check from the government to put into their account. There should also be consideration of modifying the current phase-out provisions to make the credit a more powerful savings incentive for hard-working, moderate-income taxpayers. These ideas were generally endorsed by the Conversation on Coverage, a seven-year common-ground dialogue convened by the Pension Rights Center involving businesses, unions, financial institutions, consumer, and retiree groups.

- Reverse match: 401(k) plans currently permit an employer to make matching contributions for employees who contribute to a 401(k) plan. The problem is that people whose financial circumstances prevent them from contributing receive no employer contribution. Some experts have suggested that the 401(k) plan rules be modified to allow the employer to initially make a contribution to the plan for all participants (as a percentage of compensation) and then allow those participants who can afford to make contributions to match a multiple of the employer's contribution on a tax-deferred basis. (For example, if a 2:1 employee match was permitted, and an employer contributed three percent of pay, employees could contribute an additional six percent of pay, for a total contribution of nine percent.) This is an idea that should be on the table, if we are serious about wanting to expand the number of lower- and moderate-income taxpayers who receive benefits from 401(k) plans. As a minimum, such an idea should be explored for Simplified Employee Pensions (SEPs) to allow employees to match their employer's contribution on a tax deferred basis.

- Incentives for defined benefit plans. While some experts write off defined benefit plans as "dinosaurs," there are still millions of employees participating in these plans, and there are good reasons to find ways to preserve and encourage them. In defined benefit plans, employees are automatically enrolled, they do not have to make investment decisions, and the benefits are generally paid out at retirement as annuities that the employee and spouse cannot outlive. Employees bear neither investment nor mortality risk. Yet employers today prefer 401(k) plans because they are less expensive to fund and operate, and because they avoid contribution volatility due to market and interest rate fluctuations. The Conversation on Coverage developed a new type of simplified pension plan, the Plain Old Pension Plan[2], which could minimize funding volatility, and, thus, be attractive to both employers and employees. These types of plans should be encouraged, but there are rules under current law that would have to be changed to make them feasible. The Internal Revenue Code could also be designed to provide targeted tax incentives for small employers to adopt and maintain these simplified defined benefit plans. These ideas should also be discussed.

- Tax reform to limit leakage. One of the most serious and intractable retirement-savings problems for 401(k) plans and IRAs has been leakage: people withdraw the money in

[2] The Plain Old Pension Plan was designed to make it easy for small- and medium-sized employers to provide a defined benefit pension plan to their employees. The plan is a simplified career-average pension plan that provides predictable funding obligations for employers and allows them to provide benefits to longer-service employees for the work they performed before the plan was established. The plan allows employers to give "bonus benefits" when the company has a flush year and cut back to a basic benefit in leaner times. The plan also provides a guaranteed stream of lifetime income to retirees.

their retirement accounts before retirement. Under current law, experts are almost unanimous in identifying leakage as one of the most serious problems for low- and middle-income workers. Yet the main tax provision to control leakage is a 10 percent excise tax on certain pre-retirement use of retirement savings, which has served primarily as a steep and unfair additional tax on the poor and the middle-class, while doing little to actually control the problem. Thoughtful tax reform, however, can be used as a potent weapon against leakage. Congress could create voluntarily designated 401(k)s and IRAs that once designated could not be accessed prior to retirement—and use carefully targeted tax incentives directed at both employees and employers to encourage the use of such "lock-down" accounts. Moreover, the Saver's Credit itself might be locked down so that that the credit amount is not available until retirement. The design blueprint and rules for such accounts, and the creation of effective tax incentives for them, would present various challenges, but we think they are challenges worth undertaking.

Envisioning a better system

The Pension Rights Center, while examining short-term reforms, also is spurring a more comprehensive debate to envision a better system for future generations. The fact is that regardless of the amount of tax incentives provided to employees and employers, the end result is that coverage is still too low, people have not saved adequately, and benefits are not secure.

For this reason, the Center also believes that, while working to improve the current system, we should also begin to consider a new system on top of Social Security that covers everyone and that provides adequate and secure income. The question is, with the amount of money we are now spending now to encourage retirement savings, can we do better and create a system that ensures that all Americans can retire with adequate income?

To that end, the Center, along with the AFL-CIO, the Economic Policy Institute, the National Committee to Preserve Social Security and Medicare and the Service Employees International Union, launched a new initiative called Retirement USA to start the country dreaming big on the retirement front. This initiative now has 28 supporting organizations, including unions, retiree groups, and think tanks. We developed 12 principles that we think should underlie a new system and that borrow from the best parts of defined benefit plans and 401(k) plans. As a starting point, we all believe that any new private retirement savings program must build on top of an unreduced Social Security system. Social Security must be maintained and strengthened, because it is doing an unparalleled job of providing a basic foundation of income for retirees.

The key principles for a new system are:

(1) Universal Coverage. *Every worker should be covered by a retirement plan.* A new retirement system that supplements Social Security should include all workers, unless they already are in plans that provide equally secure and adequate benefits.
(2) Secure Retirement. *Retirement shouldn't be a gamble.* Workers should be able to count on a steady lifetime stream of retirement income to supplement Social Security.
(3) Adequate Income. *Everyone should be able to have an adequate retirement income after a lifetime of work.* The average worker should have sufficient income, together with Social Security, to maintain a reasonable standard of living in retirement.

Subprinciples for a new retirement system include shared responsibility – employers and employees should both contribute and the government should subsidize the contributions of lower-income workers. We also believe that pooled, professionally managed assets are key to a secure retirement, that there should be no leakage and benefits should be paid as a lifetime annuities. (The complete list of Retirement USA principles is attached).

These are not unreachable ideals, and there are many plans and proposals that we have looked to in developing our principles and ideas for a new system, both here and abroad. For instance, TIAA-CREF, the plan for academics and educators, has employer contributions, uses pooled investments, and pays out benefits as lifetime annuities. The Guaranteed Retirement Account, developed by Professor Teresa Ghilarducci and the Economic Policy Institute, requires shared contributions by employees and employers into accounts that would guarantee a minimum rate of return and benefits paid out as annuities. The ERISA Industry Committee has proposed a plan in which contributions would be pooled and professionally invested, there would be no leakage, and benefits would be paid as annuities. And, if we look to other countries, the Netherlands has an interesting model in which employees' savings are pooled and there is shared risk among employees and retirees – rather than all of the risks being borne by individuals or employers.

What differentiates most of the systems described above from proposals to simply incentivize individuals to contribute more to 401(k) plans and IRAs is that they require contributions to be pooled and paid out only at retirement in the form of lifetime payments. Most include employer and employee contributions and minimize the amount of investment and mortality risk shouldered by individual workers. All of these features would ultimately lead to the right system for this country.

We are not saying, get rid of the current system. No, let's fix it as much as possible. But we have to recognize the shortcomings of what we have and envision something better. While encouraging savings is a worthy goal, 401(k) plans are not a substitute for good secure pensions. Future generations of workers deserve a better private retirement system – one that supplements Social Security and that is universal, secure, and adequate.

I have been struck recently by news coverage of Steve Jobs. Just about every article I've read describes him as a "visionary thinker," someone who marched forward without looking at polls or consumer research and pursued his vision, and, in so doing, built a world-class company.

Today I am asking that we all try to become the Steve Jobs of retirement policy. We need to dream big to get where we need to be. While the economy is in turmoil, we must be even more creative in deploying our tax system and other mechanisms to meet the challenges of our workforce and our retirees. While the nation is focusing on making sure people have jobs while they are able to work, we can also start thinking of ways to make sure that people have a secure retirement when they become too old to work. After all, when people have adequate and secure retirement incomes they can continue to buy goods and services in their communities and nationally – and this can only be a boon to the economy.

Thank you. I would be pleased to answer any questions you may have.