CHAPTER 1

Introduction:
The Coming Age of Retirement Insecurity

by Jacob Hacker

We live in the waning days of the Golden Age of Retirement. Today's retirees are living in a world that is, in a very real sense, already gone: a world of widespread retirement security created by public and private policies that pooled a substantial amount of risk across workers and generations. Unfortunately, their children and especially their grandchildren are coming of age in a fundamentally different world—one that involves much greater individual risk and responsibility and which promises much more unequal retirement prospects. With limited savings and less secure benefits, younger workers face a new world of retirement (in)security.

A generation ago, if a worker had been offered a retirement plan by his or her employer, it would have been a traditional guaranteed pension—also called a Defined Benefit (DB) pension—that looked much like Social Security. Today, those workers who are lucky enough to participate in an employer-sponsored retirement plan are mostly enrolled in Defined Contribution (DC), individual account plans like 401(k)s, in which returns are neither predictable nor guaranteed.

A generation ago, the assumption was that Social Security would provide a strong foundation of retirement planning for decades to come. Today, despite reforms in the late 1970s and early 1980s, the program is projected to run short of the funds necessary to pay full benefits sometime in the next quarter century. And while there are fixes that would preserve the basic structure of Social Security as it currently exists—none of them without trade-offs—there are also calls to fundamentally transform the system by reducing benefits, further raising the retirement age, and converting the program into a system of private accounts.

In these respects and others, retirement security provides a powerful example of a larger economic transformation that I call the "Great Risk Shift." Over the last generation, economic risk has shifted from broad structures of insurance, whether sponsored by the corporate sector or by government, onto the fragile balance sheets of American families (Hacker, 2008b). As a result, Americans increasingly find themselves on a shaky financial tightrope, without an adequate safety net to catch them if they fall. This shift has occurred across nearly all major facets of Americans' economic lives—their jobs, their health care, their balancing of work and family, their assets, and, yes, their retirement—and it has fundamentally reworked Americans' relationships to their employers, their government, and each other.

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As sweeping as the Great Risk Shift has been, however, we can chart a different future. To be sure, nothing will quickly reverse decades of erosion in traditional sources of guaranteed retirement income for those who are near retirement. Most private sector employers are loathe to return to DB pensions, and the U.S. faces difficult choices with regard to social insurance programs in an era of increased austerity. And yet the decisions that we as a society make today could usher in a new era of broad retirement security for coming generations of retirees—if our policies are updated to reflect new social and economic realities, and restore broad risk sharing in a way that is both fiscally sustainable and socially equitable. Much of this work must happen at the federal level. At the same time, states can serve, and are serving, as a proving ground for innovative new policies, particularly with regard to retirement savings for private-sector workers.

This volume brings together rigorous academic and policy research in order to inform these choices for California policymakers, employers, and workers. Taken together, the contributions address the following questions. What retirement prospects do California workers face? What are major obstacles for US workers and firms in providing for adequate and secure retirement income? How can state level policies improve retirement prospects for California workers who lack access to an adequate workplace pension?

In order to provide a context for these issues, this Introduction explores why American retirement security as we have come to know it is in peril—why we have transited from the Golden Age to a much more uncertain and unequal world. Central to this story is the replacement of the traditional "three-legged stool" of Social Security, traditional private pensions, and private savings with a much more wobbly "two-legged stool" of Social Security and private savings (both inside and outside of individual DC retirement accounts). The second part of the Introduction considers several alternative responses to the increased shift of retirement-income and health-cost risks onto workers. The final section outlines the research articles in this volume.

1. THE GOLDEN AGE AND ITS DISCONTENTS

To grasp the foundations of the Golden Age requires understanding America's distinctive public-private system for providing economic security. We often assume that the United States does little to provide economic security compared with other rich capitalist democracies. This is only partly true. The United States does spend less on government benefits as a share of its economy, but it also relies far more on private workplace benefits, such as health care and retirement pensions. Indeed, when these private benefits are factored into the mix, the U.S. framework of economic security is not smaller than the average system in other rich democracies; it is actually slightly larger (Hacker, 2008a). Moreover, private employment-based benefits are extensively subsidized through the tax code—mainly, through the forgiveness of income and payroll taxes on non-cash compensation.[1] With the help of hundreds of billions of dollars in tax breaks, American employers serve as the first line of defense for millions of workers buffeted by the winds of economic change.

From a Three-Legged Stool to a Two-Legged Stool

America's framework for providing retirement security was historically referred to as a "three-legged stool." Social Security, private pensions, and personal savings—each "leg" was supposed to carry an important part of the weight of securing workers' retirement. For lower-income workers, Social Security was far and away the most important leg of the stool, providing a lion's share of retirement income (Frolik & Kaplan, 2010, pp. 282-3). But for middle- and higher-income workers, tax-favored private pensions were assumed to be vital for achieving a secure retirement—especially after the Employee Retirement Income Security Act of 1974 put in place rules designed to ensure that DB pension plans would be properly run, broadly distributed, and secure (Purcell & Staman, 2009).

The problem is that this unique employment-based system is coming undone, and in the process, risk is shifting back onto workers and their families. As recently as 25 years ago, more than 80% of large and medium-sized firms offered a DB pension; today, less than a third do, and the share continues to fall (Langbein, 2006). Companies are rapidly "freezing" their defined-benefit plans (that is, preventing new workers from joining the plan) and shifting them over to alternative forms (such as the so-called cash-balance plan) that are more like 401(k)s. For workers fortunate enough to participate in an employer sponsored retirement plan, 401(k) plans have become the default vehicle for private retirement savings.

The expansion of 401(k)s has not led to an overall increase in employer sponsored retirement plan coverage. Instead, 401(k)s have largely substituted for traditional pension plans, and the share of workers offered any plan at their place of work has actually declined. In 1979, just over half of private wage and salary workers aged 18–64 who worked half-time or longer were covered by an employer sponsored retirement plan. Thirty years later, the share had fallen to less than 43% (Economic Policy Institute, 2011). For younger private workers, even college-educated workers, traditional pensions are essentially unavailable; they are lucky if they have access to a 401(k).

The one exception to this story is, of course, the public sector, where DB pensions remain the norm—almost certainly because of the much higher rates of unionization in the public sector than in the private sector (Munnell, Haverstick, & Soto, 2007, pp. 2-3). Recently, these pensions have become a source of controversy for two reasons. First, in part because of the severe downturn of 2007–2008, many states' plans are substantially under-funded (Dalton, 2011). The scale of this shortfall is frequently overstated and funding ratios have improved with recovering stock values. But states will nonetheless have to increase contributions to plans going forward (which currently represent a little less than 4% of state expenditures) or reduce future outlays (which is difficult given union contracts) to achieve adequate funding (Lav & McNichol, 2011, pp. 3-4). It is crucial to note, however, that "state and local plans do not face an immediate liquidity crisis; most plans will be able to cover benefit payments for the next 15–20 years" (Munnell, Aubry, & Quinby, 2010, p. 14).

The second reason for controversy is more political than economic. As private DB pensions have disappeared, the argument that the public sector should follow suit becomes increasingly powerful. Yet assessing the virtue of such a shift requires examining the shortcomings of 401(k)s and other DC plans alongside the financial problems faced by public DB plans.

401(k) plans are not "pensions" as that term has been traditionally understood, i.e., a fixed benefit in retirement. They are essentially private investment accounts sponsored by employers. As a result, they greatly increase the degree of risk and responsibility placed on individual workers in retirement planning.

Traditional DB plans are generally mandatory and paid for largely by employers (in lieu of cash wages) (Frolik & Kaplan, 2010, p. 361-363). Thus, they represent a form of forced savings. DB plans are also insured by the federal government and heavily regulated to protect participants against mismanagement (Ibid.). Perhaps most important, their fixed benefits protect workers against the risk of market downturns and the possibility of living longer than expected (so-called longevity risk) (Broadbent, Palumbo, & Woodman, 2006).

None of this is true of DC plans. Participation is voluntary, and many workers choose not to participate or contribute inadequate sums (Munnell & Sundén, 2006, pp. 2-3). Plans are not adequately regulated to protect against poor asset allocations or corporate or personal mismanagement (see Stabile, 2002). The federal government does not insure DC plans, and DC accounts provide no inherent protection against market or longevity risks (Jefferson, 2000). Indeed, some features of DC plans—namely, the ability to borrow against their assets, and the distribution of their accumulated savings as lump-sum payments that must be rolled over into new accounts when workers lose or change jobs—exacerbate the risk that workers will prematurely use retirement savings, leaving inadequate income upon retirement. Perversely, this risk falls most heavily on younger and less highly paid workers, the very workers most in need of protection.

As DB pensions vanish, Social Security is the only guaranteed pension left for the vast majority of private sector workers. Yet the role of Social Security has declined in the last 20 years. The wealth represented by expected Social Security benefits fell in the 1980s and 1990s, due both to the maturation of the program and cutbacks that occurred in the late 1970s and early 1980s (Wolff, 2002). Looking forward, Social Security is expected to replace a smaller share of pre-retirement income than it did in the past (CBO, 2005). That is true even if Social Security pays promised benefits—an assumption that is safer than many believe but still hinges on favorable economic and demographic trends and some adjustments in the program (Ibid.; Sanders, 2011; AARP, 2010).

In essence, we have moved from the traditional three-legged stool of retirement security to a much more wobbly two-legged stool—Social Security and private savings (inside and outside of 401(k)s). Rather than enjoying the protections of pension and retiree health plans that pool risk broadly, Americans are increasingly facing these risks on their own. The greatest impact has been on the middle class, which relied much more much more heavily on DB pensions than either poor or affluent households. As private risk protections have eroded, in short, retirement savings has become at once less equal and more risky.

Unequal Retirement

Public and private pensions were designed to provide a secure retirement income after a lifetime of labor—once only the province of the best-off workers—through a public-private partnership that included even workers of modest means. Today, Social Security still provides a guaranteed foundation of retirement security for low-and middle-income workers. But private employer sponsored retirement plans no longer provide the risk protections they once did to a large chunk of less-affluent households. Moreover, private retirement savings are virtually nonexistent among moderate-income families.[2]

This is not a coincidence. The incentives for higher-income Americans to save have ballooned with the expansion of tax-favored investment vehicles like 401(k)s. But because the tax breaks for these benefits are skewed toward higher-income Americans, most Americans receive modest benefits from these costly tax breaks. In 2011, tax breaks for retirement pensions and accounts cost the federal government over $140 billion in forgone tax revenue. Roughly 80% of these tax subsidies for retirement saving accrue to the top 20% of the population. Only 7% accrue to the bottom 60% of the population (Hanlon, 2010).

The reasons for this stark disparity are threefold. First, lower-income Americans face much lower marginal tax rates, making tax exclusions and deferments worth much less to them. Second, lower-income Americans are least likely to have access to tax-favored accounts (and low-wage employers have less reason to provide such accounts, because the tax advantages for their workers are so much more limited). And third, lower-income Americans have the least discretionary income to contribute to tax-favored accounts. Living paycheck to paycheck, they need the greatest incentive and assistance to save. Instead, the tax benefits for retirement are structured so that they provide the greatest rewards to higher-income workers (Ibid.).

These skewed incentives are reflected in 401(k) account balances. It is often claimed that the "average" American has tens of thousands of dollars in their 401(k), but in fact, roughly three-quarters of account holders have less than the widely cited average of $60,000 (Van Derhei, Holden, Copeland, & Alonso, 2007, p. 13). The median among account-holders is less than $20,000 (Ibid., p. 15). Additionally, all these figures include only those who *have* 401(k)s; only half of workers have access to a DC plan and only around a third contribute to one (Dietz, 2006). Overall, around 70% of DC plan and IRA assets are held by the richest fifth of Americans (Progressivity and Savings, 2004).

Much ink has been spilled comparing the returns of 401(k)s and old-style pensions. But the central issue for retirement security is not the return, but the risk. Retirement wealth has not only failed to rise for millions of families; it has also grown more risky, as the nation has shifted more of the responsibility for retirement planning from employers and government onto workers and their families.

Risky Retirement

The private retirement fortunes of all but today's oldest workers are dependent on the fate of 401(k)s. This means, in turn, that private retirement fortunes are dependent on the future of financial markets. As the recent gyrations of the stock market reveal, financial markets provide an inherently risky basis for retirement planning.

To be sure, there is nothing that requires that 401(k)s be invested in stocks. Workers are free to buy bonds or a conservative mix of stocks and bonds, and indeed, a significant share of workers invest their 401(k)s too conservatively for their age (not surprisingly, these tend to be lower-income workers) (Munnell & Sunden, 2004, pp. 75-77). Still, stocks do deliver a higher overall return (Uccello, 2000, pp. 10, 14). The problem is that this return comes with higher risk, and 401(k)s place all of this higher risk on workers, offering little of the investment guidance and none of the protections against economic loss that are inherent in DB pensions.

The risks posed by 401(k)s go beyond investment risks to encompass nearly all of the managerial and savings responsibilities imposed on workers. Indeed, by far the greatest problem posed by 401(k)s is the simplest—they encourage insufficient savings. This contrasts with DB pensions. Because of their typical universality within workplaces and usually substantial employer contributions, DB pensions represent a powerful form of forced prefunding of retirement. Savings in 401(k)s, by contrast, are much more spotty, even when workers have them and employers match their contributions. Bluntly put, leaving virtually all contribution and investment decisions to workers is a recipe for retirement income shortfalls. As behavioral economists have extensively documented, workers "are slow to join advantageous plans, make infrequent changes, and adopt naïve diversification strategies" that leave them without enough income on which to retire (Thaler & Benartzi, 2007, pp. 16-17).

A telling example of the risks is provided by one of the most distinctive features of DC plans: the ability of workers to take their account balance as a "lump sum" (that is, in the form of cash) when they leave an employer. This benefits workers who change jobs frequently—but only if they save the money. Unfortunately, "[t]he vast majority of people who receive lump sum distributions do not roll over the funds into qualified accounts" (Burman, Coe, & Gale, 2001, p. 4), such as IRAs and other 401(k)s—despite the fact that they must pay taxes on all their benefits, as well as a penalty of 10% if they are younger than 55 (p. 1).

A clue to the source of this seemingly irrational behavior is provided by research on what affects workers' use of lump sum distributions. Workers who are laid off are nearly 47% less likely to roll over their distributions (Engelhardt, 2003, pp. 333, 337). Workers who relocate to get a new job are 50% less likely to roll over their contributions; workers who leave work to care for a family member are 77% less likely (Ibid., p. 337). "Overall," as one economist concludes, "the evidence suggests that [DC] pension assets have been used to buffer economic shocks to the household" (Ibid., p. 334). Workers are beggaring long-term retirement security to deal with short-term shocks.

Finally, it is not so easy to turn a retirement account into a lifetime guaranteed income of the sort that Social Security and DB pensions provide. To protect oneself against this risk requires purchasing an annuity. Yet most people do not use their 401(k) accounts to buy an annuity—in part because of inherent weaknesses of the annuity market, in part because their balances are too small to make the transaction worthwhile, and in part because they discount the possibility that they will outlive their assets (Restoring Retirement Security, 2008).

The Fallout

The true effects of the 401(k) revolution on income in retirement have yet to be seen. We will only know them with certainty when today's younger workers start retiring. But even before the recent economic downturn, the signs were troubling. Among Americans aged 64–74 in 2005 (that is, born between 1931 and 1941), nearly a third lost 50% or more of their financial wealth between 1992 and 2002—a rate of wealth depletion that will soon leave them confronting a complete exhaustion of their assets, a much-reduced standard of living, or both. The rate of wealth depletion was even higher among those who reported they were in poor health (Copeland, 2005, p. 18).

At the same time, debt is a rapidly growing among families with heads of household older than 55. Between 1992 and 2007, the median debt level among older families with debt rose from $15,923 to $43,000 (in 2007 dollars), with the largest percentage increase occurring among the oldest of the aged (75 or over). The share of older families with debt also rose substantially—from 54% to 63% (Copeland, 2009, pp. 2-3).

A significant part of this rise is represented by credit-card debt—the most costly form of credit for most consumers. During the 1990s, credit-card debt grew by around half among all consumers, but it grew by 200% among seniors aged 65–69. Research on the cause is limited, but the basic realities are clear: relatively fixed and modest incomes alongside rapidly rising medical costs. In addition, during this recent severe downturn, many older Americans found themselves in the position of providing financial support to their children (Harkness, 2010).

These results suggest that while much attention has been paid to the accumulation of assets *for* retirement, far less has been devoted to the issue of how Americans manage their assets *in* retirement. DB pensions and Social Security ensure that workers receive a relatively stable income as long as they live. There are no such guarantees when it comes to IRAs and 401(k) plans, and there is every reason to think that many retirees will exhaust their accounts well before they die (Brown, 2000, p. 2).

The other side of the coin of wealth depletion is asset accumulation—and retirement savings in 401(k)s—is, ironically, both inadequate and excessively at risk. The risk of market volatility has been driven home by the stock-market gyrations of recent years. Just between mid-2007 and October 2008, an estimated $1 trillion in retirement wealth was lost in 401(k)s and individual retirement accounts (The Effects of Recent Turmoil, 2008). A 2009 survey found that two-thirds of adults aged 50–64 years lost money in mutual funds, individual stocks, or 401(k) accounts, with the vast majority losing more than 20% of their investments; most who had no losses had no investments (Morin & Taylor, 2009).

To be sure, we cannot yet know how sustained these losses will be. After all, the market has recovered markedly since the stock market downturn of 2007 and 2008. Moreover, those nearing retirement are potentially the most vulnerable to market risks insofar as they have the least time to recover losses before they retire. The point is that market volatility is a serious threat to retirement security, and coping with it is left almost entirely up to 401(k) holders. As with rising debt levels of the aged, what we know is that even among those with at least one foot in the Golden Age of retirement, retirement insecurity is becoming more common.

What we also know is that these signs of strains are only the tip of an emerging iceberg, for they appear amid a long term decline in the retirement-preparedness of younger Americans. According to researchers at Boston College (Munnell, Webb, & Golub-Sass, 2009), the share of working-age households that are at risk of being financially unprepared for retirement at age 65 has risen from 31% in 1983 to 43% in 2004, and a projected 51% in 2009. Younger Americans are far more likely to be at risk than older Americans: roughly half of those born from the mid-1960s through the early 1970s are at risk of being financially unprepared, compared with 35% of those born in the decade after World War II. In every age group, low-income Americans are the least financially prepared.

2. RESTORING RETIREMENT SECURITY

The promise of private retiree benefits at their heyday was a secure retirement income that, when coupled with Social Security, would allow older Americans to spend their retired years in relative comfort. That promise is now in grave doubt. But reforms could strengthen social security and make private retirement accounts work better as a source of secure retirement income for ordinary workers and their families—in a way that is consistent both with Americans' basic priorities for retirement policy and with the imperatives of long term fiscal responsibility.

Strengthening Social Security

In the context of the financial crisis and increased private risk-bearing, securing our one guaranteed system of retirement security, Social Security, is all the more essential. To do this, however, will require addressing Social Security's funding shortfall. Although the program has run a surplus since the early 1980s, it will soon start drawing down this surplus—which requires remitting special bonds held by the program (and thus will increase strains on the rest of the federal government) (Frolik, 2008). If no changes are made in the program, it is projected to be able to pay around three-quarters of promised benefits after the mid-2030s (Social Security and Medicare Board of Trustees, 2010). This is a far cry from bankruptcy, but it does require changes to the program to place it on a stronger long-term foundation.

The last two decades have been consumed by a debate over "privatization" of Social Security—that is, its whole or partial replacement by mandatory individual savings accounts (see generally Ferrara and Tanner, 1998; Tanner, 2004). Private accounts by themselves, however, would make Social Security's finances worse not better. This is because Social Security is a pay-as-you-go system, with younger workers' contributions to the program financing benefits for current retirees. If these contributions were instead diverted into private accounts, the funds needed to pay promised benefits would have to come from somewhere else, or, more precisely, from new taxes, new benefits cuts, new borrowing, or some mix of the three. The only way to pay these "transition costs" is to take something away from someone—retirees in the form of lower benefits, all Americans in the form of higher taxes or reduced spending on other valued ends, or future generations in the form of new government debt.

Even more important, privatization proposals would seriously undermine Social Security's role as an insurance program. The program was originally designed to pool risk across millions of citizens and use the power of government to guarantee against the major threats to family income during retirement. It offers a guaranteed benefit that is more generous to families with low lifetime incomes, to families whose heads are disabled or pass away, and to those who have the good fortune to live a long time after retirement (elderly widows are the chief example) (Hacker, 2008b, p. 132). The program also protects all families against the risk of large drops in their assets due to stock market or housing price instability, as well as the risk of unexpected inflation, which can devastate families on fixed incomes (Marmor and Mashaw, 2001).

In contrast, privatization would replace guaranteed benefits with the returns on workers' accounts, which could vary greatly from person to person. Those disabled before retirement, those who end up living a long time after retirement, those with low incomes, those who retire when the stock market drops—all might end up with less than they would have enjoyed had they received the guaranteed benefit. In short, a social insurance program would be replaced by a system that shifted much more risk onto the shoulders of individual workers and their families, which is precisely the transformation that has taken place in the private sector with such negative consequences for retirement income and security.

Fortunately, dealing with the future financial threats to Social Security does not require abandoning the core elements of the program: guaranteed lifetime benefits paid on retirement, provided as a right, and linked to lifetime earnings. The funding shortfall within the program—substantial, but hardly insurmountable—could be closed by making Social Security benefits and the payroll taxes that fund them modestly more progressive and by tying benefits to future longevity so that fortunate generations that live longer than the last receive slightly less from the program than now promised (see, e.g., Diamond & Orszag, 2005).

What this means in detail should be up for debate, but four important considerations should guide these discussions. First, the early retirement age for Social Security (now 62) should only be raised in tandem with increased longevity of the least advantaged workers. This is because most of the gains in average life expectancy over the last generation have been enjoyed only by higher-wage workers, while less affluent workers are not living markedly longer than they used to (Manchester and Topoleski, 2008). Absent an increase in early retirement age, moreover, raising the age at which full benefits are received (now 65 and slated to rise to 67 in future years) amounts simply to a blunt cut in benefits, since workers can receive reduced benefits before the normal retirement age (SSA, 2011).

Second, the financing of Social Security should be made more progressive. As wages have grown more unequal over the last generation, more and more of the highest wages are exempt from the Social Security payroll tax—which is capped at around $100,000 in annual earnings (SSA, 2010). Because of the progressive benefit structure (high-income workers receive the lowest rate of return from the program), raising the cap results in far more revenue flowing into the program than new spending on benefits. In fact, eliminating the payroll tax cap would by itself close the long-term Social Security funding shortfall (Reno and Lavery, 2005). Removing the cap completely would weaken the link between contributions and benefits and likely create substantial opposition from high-income taxpayers. Nonetheless, it should be significantly raised.

Third, there is a strong case for taxing capital income as well as wage income—as was recently done for the Medicare portion of the payroll tax, which, importantly, is not capped like the Social Security tax (Frolik & Kaplan, 2010, p. 58). Another alternative would be to dedicate a portion of a restored estate tax, one that would tax a larger portion and share of the richest estates than the current tax, to Social Security's long-term financing.

Finally, serious consideration should be given to investing a portion of the Social Security trust fund in private equities. Certainly, there are risks to direct public investment in the stock market. Other countries, however, have successfully created models for passive investment that have allowed them to increase the returns of the prefunded portions of their system (Social Security Privatization, 1999). The advantage of such pooled investment—which is similar to what traditional DB pensions do, but on a broader scale and with a much greater capacity to spread risk—is that it allows for the diversification of market risk, both across individuals and over time, something that cannot be done with voluntary private accounts.

Strengthening the Private Retirement Savings System

Even with a secure Social Security system, today's workers will need other sources of income in retirement. Yet 401(k)s as they are presently constituted are not the solution. Too few workers are offered them, enroll in them, or put adequate sums in them—a reflection of perverse incentives built into their very structure—and they place too much of the risk of retirement planning onto individuals, with too little information and insurance to help families build a secure retirement.

At the federal level, proposals for reform fall into three main camps: incremental fixes to 401(k)s at one end, complete replacement of 401(k)s with an alternate tier of mandated savings in a federally sponsored program at the other end, and large-scale 401(k) reform in the middle of the spectrum.

The incremental approach is exemplified by the Pension Protection Act of 2006, which tried to encourage employers to automatically enroll their workers in 401(k)s.[3] The research is clear that workers required to opt out of 401(k)s rather than opt in are much more likely to participate in plans

(Randall, 2009). So far, however, results of the Act have been mixed, with surprisingly few employers adopting automatic enrollment (See Brown, 2010). Moreover, automatic enrollment does little to address other key concerns with 401(k)s, including the skewed tax subsidies for them, low contribution rates, leakage from the system due to lump-sum distributions, and, most fundamental of all, the reality that many employers do not offer a 401(k) at all.

On the other side of the spectrum, thoughtful pension experts have proposed to replace tax breaks for private retirement accounts with a system of mandatory, government managed accounts with a guaranteed rate of return that would supplement Social Security, forming a “second tier” of compulsory retirement savings (Munnell, 2009, pp. 23-24; see also Ghilarducci, this volume). Contributions would be mandatory, but unlike Social Security, benefits would be fully prefunded and there would be no redistribution from high-income to low-income workers. Most proposals in this category call for converting today’s regressive tax subsidies into a flat credit deposited into workers’ accounts in order to more effectively help low- and middle-wage workers save. Cash-out would be prohibited or highly restricted. Like Social Security, spouses would legally share benefits. These proposals generally envision that 401(k)s would gradually cease to exist, or become a tertiary tier for more affluent households to save additional sums without the benefit of guaranteed returns or tax subsidies.

Besides their mandated contributions, two key features of these proposals require mention. First, while workers could see their individual account balances, their funds would be pooled and invested by professionals rather than individually managed by workers themselves. Second, workers’ savings would be partially or fully protected from the risk of market fluctuations through a guaranteed rate of return, with the government bearing market risk. The risk depends on the level and extent of the guarantee, and there is some debate about how to value that risk. Proponents argue that this risk must be weighed against the consequences if a large number of workers retire without having adequate income.

In terms of large-scale 401(k) reform, there have been several proposals for “universal 401(k)s” that have received substantial notice in recent years (Center for American Progress, 2011). My own, more robust version of such a proposal (Hacker, 2008; Hacker, 2011) would allow all workers to save in a single account throughout their working life, whether or not their employer offers a traditional pension plan. Employers would be encouraged to match employer contributions to these 401(k)s, and government could provide special tax breaks to employers that offered better matches to lower-wage workers. The plan features automatic enrollment, and a default contribution rate sufficient to finance retirement along with Social Security. Existing tax breaks for 401(k)s would be replaced with a flat retirement savings credit that would be placed in the accounts of all workers. Workers would contribute to this plan with after-tax dollars, and earnings on these contributions would not be taxed until withdrawals were made (Medill, 2011, pp. 104-5).

Unlike the present system, these universal 401(k)s would be governed by the same rules that now protect traditional pension plans against excessive investment in company stock. Moreover, the default investment option would be a low-cost index fund with a mix of stocks and bonds that automatically shifts over time as workers age to limit market risk as workers approach retirement—commonly known as a target or life-cycle fund. To help workers plan ahead, moreover, 401(k) balances would be reported to account holders not simply as a cash sum, but also a monthly benefit amount that workers would receive when they retired if they had average life expectancy—just as Social Security benefits are reported.

3. CALIFORNIA'S RETIREMENT SECURITY CHALLENGE

Because Social Security and 401(k)s are based in federal policy, meaningful policy reform to strengthen workers' retirement security must happen at the national level. Nonetheless, states can serve as important laboratories for policy innovation, as well as contribute to a better retirement security framework with their own policies. States and local governments have a huge stake in improving workers' retirement income prospects, not least because declining retirement security among older Americans is likely to greatly strain state and local budgets in the coming decades.

With the national context laid out, the remainder of this volume looks at the retirement security challenge for state policymakers and stakeholders,

The first two articles provide critical original data analysis on California retirement realities. In "California Workers' Retirement Prospects," Sylvia Allegretto, Nari Rhee, Joelle Saad-Lessler, and Lauren Schmitz analyze official data on California residents to profile income and poverty among current retirees, identify workplace retirement plan coverage trends, and project workers' retirement income prospects. They find that Social Security provides a critical buffer against poverty among today's retirees, but that the retirement future of the state's workforce appears bleak. Less than half of civilian workers are covered by any kind of employer sponsored retirement plan at their primary job, and most of this group is covered by a 401(k) type plan. Startlingly, nearly half of today's workers will be poor or near-poor if they retire at age 65, given current patterns in workplace retirement plan coverage, earnings, savings, and debt. This has profound implications for the state of California.

Some argue that the solution to this dilemma, and to rising pension and social insurance costs for employers and government, is for workers to delay retirement well into their late 60s. Such proposals are founded on increasing average life expectancy. At the same time, the length of time that a worker can expect to live past his or her working years has direct bearing on the quality of life in retirement. Christina A. Clarke and Amal Harrati review a substantial body of research demonstrating that life expectancy gains have unevenly distributed, and that there is a widening longevity gap by race, education, and income. They present original research highlighting marked inequality in mortality by race and class (as measured by neighborhood soecioeconomic status) among California residents, a pattern that holds not just at birth but during prime working years and at retirement age. Racial differences in life expectancy are most pronounced between Asians and Blacks. The authors also find that socioeconomic disparities in life expectancy are marked among Whites and among Blacks; and that though this class difference diminishes between birth and adulthood, it persists to a significant degree at ages 45 and 65. In other words, the number of years that a California worker can expect to live after prime working age and after age 65 varies significantly depending on his or her race and socioeconomic status. This is a critical factor that needs to be considered in the retirement age debate.

In light of the shortcomings of the current system of providing for retirement security, the next three articles in this volume explore various solutions through which workers' retirement income can be improved.

In "The Business Case for Defined Benefit Pensions," Beth A. Almeida and Christian E. Weller outline the labor market reasons for employers to favor DB pensions and—in light of the the sharp decline DB pensions in the private sctor—explores plan design features that could make them more attractive to employers. They review research on labor recruitment, retention, and productivity and DB pensions, concluding that the deferred compensation structure of DB pensions may help employers recruit workers who are more likely to be loyal and to support the organizational mission; keep employees in mid-career, when they are most productive; and encourage older, less productive employees to exit at the right time for the employer. They identify key plan features that could facilitate employer support for DB pensions and which advantage multi-employer and public sector pensions: stand-alone entities separated from employer operations, regular contributions, and economies of scale. They observe that DB pension coverage could be expanded via a coordinating mechanism that aggregates private employers into similarly structured plans.

In "Designing a More Attractive Annuitization Option: Problems and Solutions," Anthony Webb addresses the problem of converting individual account balances into a secure income stream and assesses the potential role of annuities in a publicly sponsored retirement plan. While traditional pensions provide lifelong monthly benefits to workers, 401(k)s provide lump sums. Workers could theoretically convert some or all of their account balance into a lifelong income stream by purchasing annuities from private insurance carriers, but these annuities are unattractively priced for individuals who anticipate living to average life expectancy for their age and gender. Webb highlights the reasons for market failure in private annuities, and considers the value of annuitization to low-wage workers, most of whose retirement wealth is already annuitized through Social Security and who may not expect to live very long. He argues that a publicly sponsored retirement savings program could offer more attractive returns on annuities by creating a group annuity market and reducing administrative costs.

Finally, in "High Performance Pensions for All Californians," Theresa Ghilarducci proposes two new policies with which the State of California could help private sector workers lacking a pension meet three key goals of retirement security policy: adequate savings, managed investment risk, and steady lifelong income during retirement. The first policy is to establish California Guaranteed Retirement Accounts (CGRAs), which would provide a guaranteed average real return of 2–4% on contributions and offer low-cost annuities. Ghilarducci argues that this is best done through a large, established public pension fund like CalPERS or CalSTRS that already has economies of scale and investment expertise, although a more feasible route might be to have the Treasurer's Office administer a plan through private financial firms, with the state offering a guaranteed return investment vehicle as an option to workers if it is willing to bear a degree of risk. Based on a Monte Carlo scenario using historical financial market data, Ghilarducci argues that a real return of 3% runs minimal risk to the state of ever having to use general revenues to pay CGRA benefits. The second policy is to replace state income tax deductions for retirement contributions with a flat $145 tax credit towards every worker's retirement savings, at no extra expense to the State of California, in order to create a fairer tax subsidy that encourages broader retirement savings participation.

4. CONCLUSION

Over the last generation, America's public-private framework for providing retirement security has come undone. The "three-legged stool" of retirement security (Social Security, private defined-benefit pensions, and private savings) has given way to a much less stable two-legged stool (Social Security and private savings) that is also being forced to bear the increasing burden of health care costs in old age. It is fashionable to say that these changes are inevitable, that they reflect inexorable demographic and budgetary challenges that dictate ever more risk-shifting onto Americans. This is false. The picture of retirement that we see today is indeed a vision of the past. If we do not act, future retirees will face a more unequal and risky retirement than do those living in the waning days of the Golden Age of Retirement. But that does not mean that we cannot develop a new image of retirement for the future that, like the old, provides people with the means to enjoy broad economic security both during their working lives and during retirement.

* * *

Endnotes

[1] See 26 U.S.C. §§ 105(b), 106(a) (2010); and Joint Committee on Taxation (2008, 14).

[2] According to a recent analysis of families with earnings between two and six times the federal poverty level ($40,000 to $120,000 for a family of four) and headed by working-age adults, more than half of middle-class families have no net financial assets whatsoever, excluding home equity, and nearly four in five middle-class families do not have sufficient non-housing assets to cover three-quarters of essential living expenses for even three months should their income disappear. Essential living expenses include food, housing, clothing, transportation, health care, personal care, education, personal insurance, and pensions (Wheary, Shapiro, and Draut, 2007).

[3] The Money Alert, Pension Protection Act overview. Retrieved March 10, 2011 from http://www.themoneyalertcom/PensionProtectionAct.html.

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