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Thank you for inviting me here today to discuss how to improve retirement savings in Maryland.

My name is David Madland and I'm the Director of the American Worker Project at the Center for American Progress Action Fund, an independent, nonpartisan, and progressive education and advocacy organization dedicated to improving the lives of Americans through ideas and action.

I appreciate the opportunity to present my views on this important topic—a topic that I have been researching for some time. I have written extensively in academic and popular publications about retirement policy and am also the author of a proposal for a new private-sector retirement-plan type called the Secure, Accessible, Flexible, and Efficient, or SAFE, Retirement Plan.

In my testimony, I will discuss the many problems of our current private-sector retirement system but focus especially on how Maryland can help address these problems with proposals like the SAFE Plan, which combine elements of a traditional pension—including regular lifetime payments in retirement, professional management, and pooled investing—with elements of a 401(k), such as predictable costs for employers and portability for workers.

Social Security provides an essential baseline of income for retirees and must be strengthened to ensure that it continues to do so for generations to come, as the Center for American Progress has proposed.[1] However, Social Security was only intended to be one leg of a three-legged approach to retirement savings. Employer-sponsored retirement plans and individual savings are supposed to be the two other legs.

Unfortunately, the private-sector workplace retirement system is broken. As the first generation to rely primarily on 401(k) plans begins to retire, we can see the cracks in the system.

Boston College's National Retirement Risk Index estimates that 53 percent of households are at risk of having an insecure retirement, meaning they will be unable to maintain their preretirement standard of living.[2]

Not surprisingly, the public is deeply concerned about their ability to retire. According to a 2013 report by the National Institute on Retirement Security, 85 percent of Americans are concerned that current economic conditions are affecting their ability to achieve a secure retirement, with 55 percent saying they are very concerned.[3]

The current system is failing in a variety of ways, including a lack of coverage, high costs, and high levels of risk for savers. I'll now turn to each of these issues and discuss how the SAFE Retirement Plan would address them.

Coverage

The first major problem Maryland should address is coverage. Our current workplace retirement system allows too many workers to fall through the cracks.

In the state of Maryland, almost half of workers either do not have or do not participate in an employer-sponsored retirement plan.[4] Workers without a retirement plan at work are unlikely to save enough for a comfortable retirement. Among Marylanders aged 55 to 64, the median household without a retirement plan has only $30,000 in assets, nowhere near enough to maintain their standard of living in retirement.[5]

Some might respond that plans that allow workers to save on their own can solve this problem. Yet only 16 percent of households made contributions to Individual Retirement Accounts, or IRAs, in tax year 2011.[6]

All workers—regardless of whether their employer offers a plan—should be able to save for retirement through their paycheck in a regular and automatic fashion.

The SAFE Plan would automatically enroll workers in a plan and allow workers to opt out if they choose. Previous studies have demonstrated automatic enrollment to be an effective tool for increasing employee participation, with research finding that between 85 percent and 90 percent of workers may stay in a plan if the default is to participate.[7]

The employer's role would merely be to deduct a certain percentage of each worker's pay and send that contribution to the retirement plan. Any potential costs to employers of simply facilitating such deductions should be quite low for the majority of businesses.[8] Employers that do not offer a workplace retirement plan should be required to facilitate these payroll deductions, otherwise retirement coverage will remain low. The goal is to ensure that all workers save for retirement, regardless of the characteristics of their employer.

Costs

The excessive cost of retirement savings is the second major problem that Maryland should address. High fees and common investment mistakes make saving for retirement far more costly for most workers than it should be.

The SAFE Plan maximizes retirement savings through its low fee structure and professional fund management, which ensures a balanced portfolio and a patient investment strategy.

Professional money managers may have a hard time beating market averages,[9] but they do much better than individual investors by avoiding common investing mistakes, such as failing to diversify.[10] The SAFE Plan would also have higher returns due to the collective pooling of assets. Individuals need to become more conservative with their investments as they age, but the continued entrance of younger workers into the investing pool of the SAFE Plan allows the fund to maintain a balanced portfolio over a long period of time, thereby increasing returns. The increased returns from this phenomenon, known as intergenerational risk sharing, can raise pension returns by approximately 0.53 percentage points a year according to one study.[11]

High fees in retirement plans can eat away total accumulations in workers' accounts. Typical fees for a 401(k) plan are around 1 percent and are commonly much higher in plans with only a few participants.[12] These high fees can reduce employee savings by 30 percent.[13] Fees for IRAs are typically even higher than in a 401(k).[14] In contrast, large investment pools can have much lower fees—often around 0.25 percent of assets managed.[15]

All of these factors combined means that achieving retirement security would be much cheaper for a participant in a collectively managed fund such as the SAFE Plan’ compared to a participant in an IRA or 401(k). To ensure that participants can accumulate sufficient retirement savings, Maryland should ensure that workers can save in an efficient, low-cost plan.

Risk

The final problem Maryland should seek to address is the excessive risk born by most IRA and 401(k) participants, such as the possibility participants will outlive their savings or suffer a significant drop in the value of their account just as they are about to retire.

Providing a steady stream of income in retirement that cannot be outlived would significantly boost retirement security. Savers in an individual plan often don't have access to such an annuity. Only one in five 401(k) plans offers an annuity.[16] Even if a saver purchases an annuity themself, the cost of purchasing one in the individual market is often quite high.[17] The SAFE Plan is designed so that it provides lifetime payments at a low cost.

Similarly, savers in a 401(k) plan or IRA are unnecessarily exposed to the risk that a large market crash will happen just as they are about to retire. The typical near-retirement-age worker saw their account balances drop by 17.4 percent on average between December 2007 and June 2009, the duration of the Great Recession.[18] For many savers, this meant that they faced a lower standard of living in retirement or needed to continue working past their expected retirement age.

Plans like the SAFE Plan can spread this kind of timing risk out so that no individual saver is on their own during a market downturn by withholding some of the upside during bull markets to smooth out returns in bear markets. By spreading out the risk of a market downturn and providing a secure stream of lifetime income, collective retirement plans help workers better cope with the risks of retirement.

Conclusion

Maryland has an opportunity to significantly improve retirement security for its residents by implementing a plan with automatic enrollment, low costs, professional management, and collective savings. The opportunities for improvement are very significant.

Through automatic enrollment, Maryland could move from having only about half of workers covered by an employer-based retirement plan to having nearly all workers participating in a retirement plan.

The cost savings and risk reductions possible are equally dramatic, according to the detailed, actuarial modeling we have performed to compare the SAFE Plan to the typical 401(k) or IRA. I submit in the appendix of my testimony the full report describing the analysis, but the brief results are as follows:

A worker with a SAFE Plan would have to contribute only half as much of their paycheck as a worker saving in a typical 401(k) plan to have the same likelihood of maintaining their standard of living upon retirement.

A worker with a SAFE Plan is nearly 2.3 times as likely to maintain their standard of living in retirement as a worker with a typical 401(k) account making identical contributions.

In short, there are significant improvements to be made to the current retirement system, and Maryland can help lead the way.

Endnotes

[1] Christian E. Weller, "Building It Up, Not Tearing It Down: A Progressive Approach to Strengthening Social Security" (Washington: Center for American Progress, 2010).

[2] Alicia H. Munnell, Anthony Webb, and Francesca Golub-Sass, "The National Retirement Risk Index" (Chestnut Hill, MA: Center for Retirement Research at Boston College, 2012).

[3] Diane Oakley and Kelly Kenneally, "Pensions and Retirement Security 2013" (Washington: National Institute on Retirement Security, 2013).

[4] Joelle Saad-Lessler, Teresa Ghilarducci, and Lauren Schmitz, "Are Maryland Workers Ready for Retirement?" (New York: Schwartz Center for Economic Policy Analysis at The New School, 2013).

[5] Ibid.

[6] Investment Company Institute, "The Role of IRAs in Households' Saving for Retirement, 2012," *ICI Research Perspective* 18 (8) (2008): 1–35. Note that this figure overstates IRA contributions because it includes workplace IRAs. Also note that previous research has found even lower contribution rates. For example, see Craig Copeland, "Ownership of Individual Retirement Accounts (IRAs) and 401(k)-Type Plans, 1996–2009" (Washington: Employee Benefit Research Institute, 2011). Copeland found that only 5.4 percent of workers age 21 to 64 made contributions to traditional IRAs in 2009, despite 20.8 percent of workers in that age group owning such IRAs.

[7] Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics* 116 (4) (2001): 1149–1187; James J. Choi and others, "For Better or For Worse: Default Effects and 401(k) Savings Behavior." Working Paper 8651 (National Bureau of Economic Research, 2001).

[8] These costs should be quite low for most employers because most already utilize payroll systems capable of handling such deductions. The businesses that may see some slightly larger costs associated with such a requirement are those small businesses that do not make use of computerized payroll systems. There are, however, ways to make easier their adoption of such a deduction by, for example, offering a small tax credit in the first few years of the policy's implementation and making sure that the new deduction procedures dovetail neatly with existing federal deduction processes. For greater discussion of these issues, see J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs" (Washington: The Retirement Security Project, 2009); and Karen Harris and Michael Lezaja, "Universal Voluntary Retirement Accounts: A Financially Secure Retirement," *Clearinghouse REVIEW: Journal of Poverty Law and Policy* 43 (7) (2009).

[9] Ron Elmer, "College Endowment and Public Pension Fund Returns Are Not Good," Investor Cookbooks, February 9, 2012, available at http://investorcookbooks.blogspot.com/2012/02/college-endowment-and-public-pension.html; Sydney P. Freedberg and Connie Humburg, "Easy investments beat state's expert pension planners," *Tampa Bay Times*, July 31, 2011, available at http://www.tampabay.com/news/politics/article1183442.ece; Jeff Hooke and Michael Tasselmyer, "Wall Street Fees and the Maryland Public Pension Fund" (Germantown, MD: The Maryland Public Policy Institute, 2012).

[10] Chris Flynn and Hubert Lum, "DC Plans Under Performed DB Funds" (Toronto: CEM Benchmarking, 2006); Towers Watson, "Defined Benefit vs. 401(k) Investment Returns: The 2006–2008 Update" (2009).

[11] Christian Gollier, "Intergenerational risk-sharing and risk-taking of a pension fund," *Journal of Public Economics* 92 (6) (2008): 1463–1485.

[12] Rowland Davis, Nayla Kassi, and David Madland, "The Promise and the Peril of a Model 401(K)" (Washington: Center for American Progress Action Fund, 2010); Alicia H. Munnell and others, "Investment Returns: Defined Benefit vs. 401(k) Plans" (Chesnut Hill, MA: Center for Retirement Research at Boston College, 2006); Government Accountability Office, "Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees," GAO-07-21, Report to Ranking Minority Member, Committee on Education and the Workforce, House of Representatives, November 2006; Christian E. Weller and Shana Jenkins, "Building 401(k) Wealth One Percent at a Time: Fees Chip Away at People's Retirement Nest Eggs" (Washington: Center for American Progress, 2007); Richard W. Kocke, Francis Vitagliano, and Dan Muldoon, "The Structure of 401(k) Fees" (Chestnut Hill, MA: Center for Retirement Research at Boston College, 2009).

[13] Weller and Jenkins, "Building 401(k) Wealth One Percent at a Time."

[14] Alicia H. Munnell, Anthony Webb, and Francis M. Vitagliano, "Will Regulations To Reduce IRA Fees Work?" (Chestnut Hill, MA: Center on Retirement Research at Boston College, 2013).

[15] For example, see Alicia H. Munnell and Mauricio Soto, "State and Local Pensions are Different From Private Plans" (Chesnut Hill, MA: Center on Retirement Research at Boston College, 2007). They find that state and local defined-benefit pensions had average management fees of only 0.25 percent.

[16] Hewitt Associates, "Hewitt Study Shows More Companies Putting 401(k) Plans on Autopilot; Employers Encourage Retirement Savings by Automating and Simplifying 401k Plan Features," *Business Wire*, June 14, 2005, available at http://www.businesswire.com/news/home/20050614005209/en/Hewitt-Study-Shows-Companies-Putting-401k-Plans.

[17] Amy Finkelstein and James Poterba, "Selection Effects in the Market for Individual Annuities: New Evidence from the United Kingdom." Working Paper 7168 (National Bureau of Economic Research, 1999).

[18] Employee Benefit Research Institute, "Change In Average Account Balances (by Age and Tenure) From January 1, 2008–June 30, 2009 Among 401(k) Participants with Account Balances as of Dec 31, 2007" (2010).