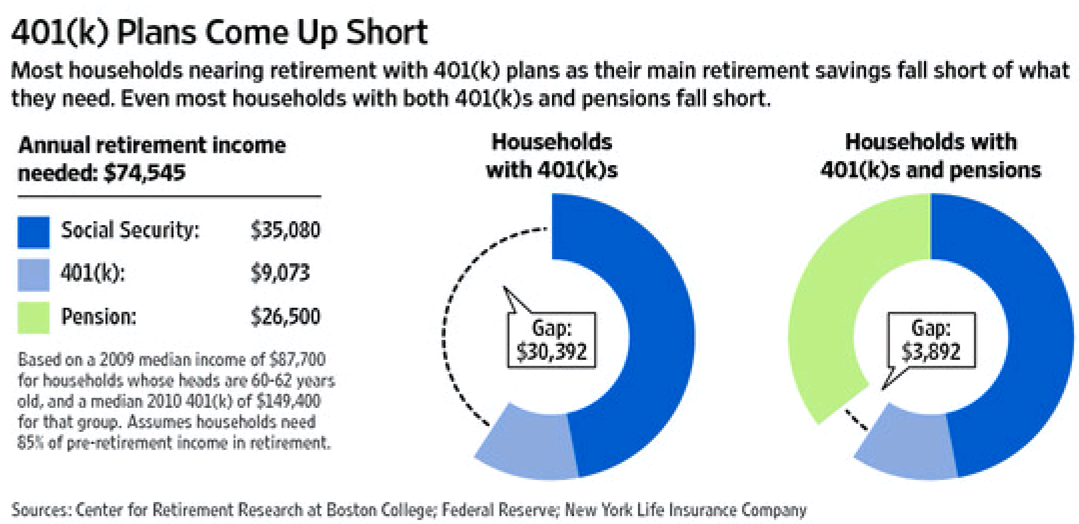
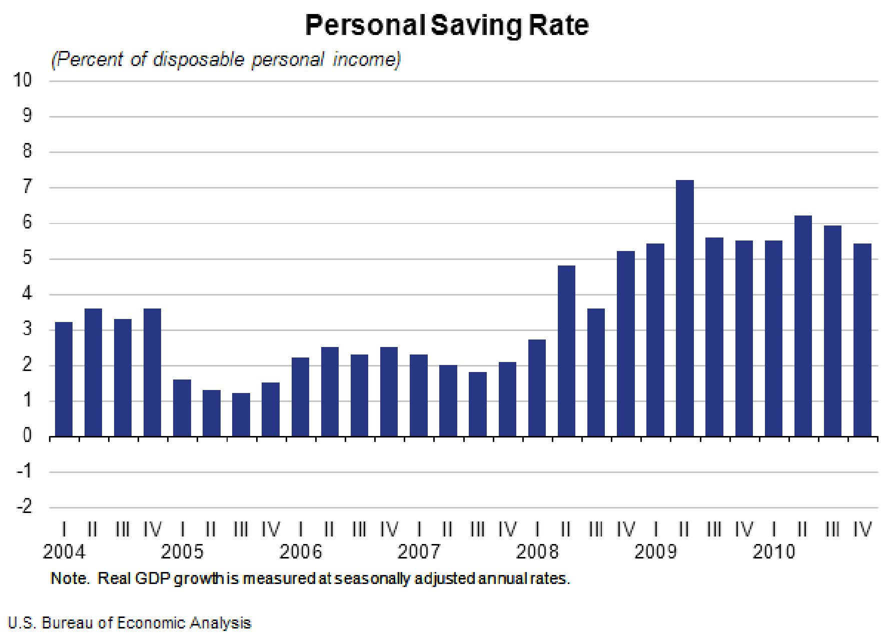
Mitchell's Musings 2-21-11: Is Retirement Based on 401k OK?

The chart below comes from an article in the *Wall Street Journal* of 2-19-11 with the title "Retiring Boomers Find 401(k) Plans Fall Short." The article is at http://online.wsj.com/article/SB10001424052748703959604576152792748707356.html?mod=WSJ_hp_LEFTTopStories

However, the title and chart pretty much tell the tale.



The tax code provides a strong incentive to save through 401ks, IRAs, and similar plans. In addition, private employers often provide matches to the employee contribution. Nonetheless, Americans don't do a great job of saving. As the chart on the next page shows, prior to the Great Recession, the personal saving rate in the U.S. (which *includes* saving through pension arrangements) was floating around in the 1-4% range, down from 9-10% in the late 1970s. The Great Recession pushed up the rate somewhat – since saving is the mirror image of consumption – but the resulting 5-6% saving rate range is hardly a mark of personal thriftiness. And it is likely to fall as the economy (slowly) recovers.

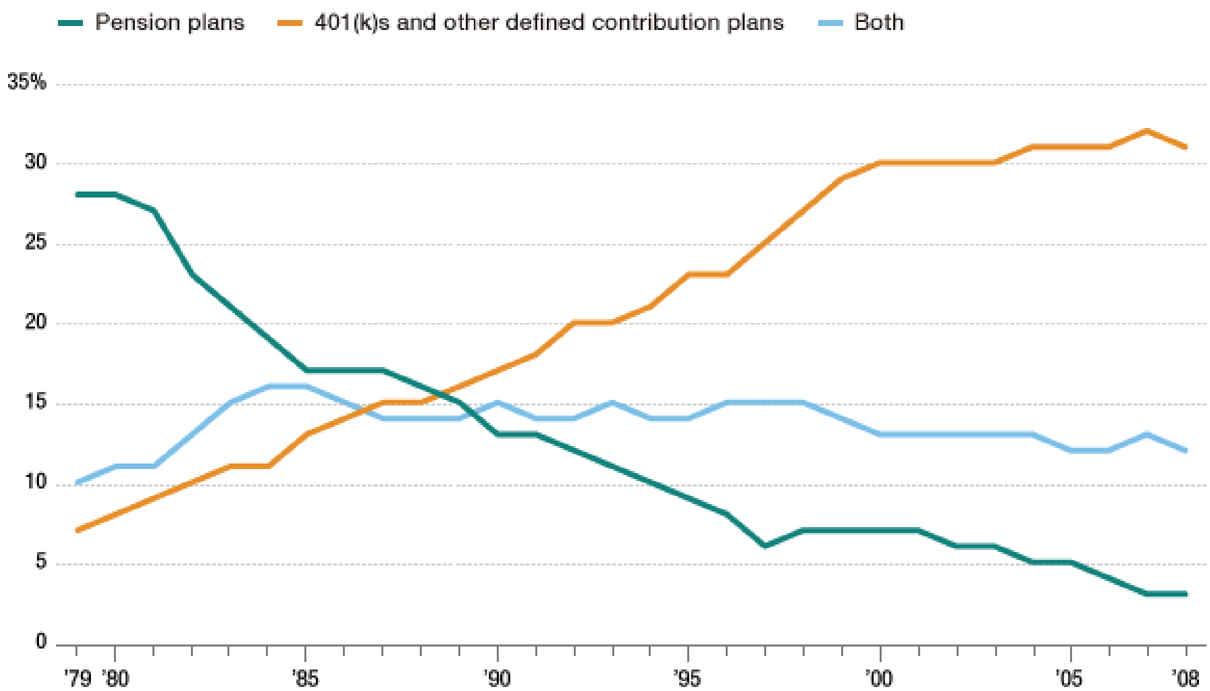


Recent efforts – following the insights of "nudge" economics – involve making enrollment in 401k-type plans the default option for new hires. That is, it has been found that if workers have to check a box indicating they want to join their employer's 401k plan, they are less likely to do so than if they have to check a box saying they don't want to join. While the nudge approach may be a triumph for behavioral economics, what it really shows is that folks are not very good at planning for the future. If workers were rational in the traditional economic sense, the default setting should not affect their choice. Checking a box, one way or the other, is essentially costless.

Behavioral economists have also discovered that even when folks do elect to save, they are not especially good at investing. If employers offer three options, say, company stock, a mutual fund, and a bond fund, workers are likely simply to divide their contributions into one third segments for each. There are partial remedies for this tendency, such as life-cycle funds that automatically move away from stocks and towards fixed investments as workers age. But for any given worker, it is difficult to diversify away from the risk that – by the luck of the draw – even a life-cycle fund in his/her particular age cohort won't perform particularly well.

Plans in which employers make a contribution or a match – but leave it to employees to invest – are known as defined contribution plans. In contrast, those plans which promise an eventual retirement benefit based on a formula (typically relating to age, tenure, and earnings history) are known as defined benefit. The employer is supposed to contribute adequately to a trust fund – and invest the monies in the trust appropriately – so as to finance the promised benefit. Defined benefit plans, in principle, solve the saving problem and the investment problem for the employee. In principle, those who are trustees of such plans are supposed to ensure that adequate funding goes into the trust fund. In principle, those who handle investment decisions for such plans are more expert than ordinary employees. They also, in principle, solve the cohort problem, since workers of all different cohorts are mixed together.

However, as the chart below indicates, in the private sector, coverage by defined benefit plans has been declining and defined contribution plans have been in the ascent. Typically, those workers in the private sector still covered by defined benefit plans are unionized. And the union sector in private employment has been in decline since the mid-1950s.



Source: Employee Benefit Research Institute. EBRI's estimates for 1998-2008 were done using Department of Labor and Current Population Survey data. Credit: Alyson Hurt / NPR

Source: http://www.npr.org/templates/story/story.php?storyId=124131819

Defined benefit plans remain prominent in the public sector, which also has a notably higher unionization rate than the private sector. However, such plans typically pre-date the era of public sector unionization. Nonetheless, the current controversy over the use and underfunding of public defined-benefit pensions has become intertwined with a more general attempt – notably in Wisconsin – to ban collective bargaining in government.

Defined benefit plans do need to be adequately funded and administered. In the end, although there are legal constraints on the ability of governmental employers to reduce promised pension benefits, the promise is based on a trust fund and inflow of revenue – typically from both employer and employee –

to maintain the fund. Pension experts have a concept known as the "normal cost" of the pension. Essentially, the normal cost is an estimate of what needs to be put away in a given year to fund that year's incremental promises of future benefits. If good practices are followed, there is no reason why a defined benefit plan cannot be operated successfully.

Sadly, good practices were not followed in notable cases. When this happened in the private sector, the liabilities fell on the federal government, because private defined benefit pensions are federally insured. There are problems related to the perverse incentives in the private sector to "put" (in financial jargon) the liability on the feds. These perverse incentives need addressing. And there clearly need to be reforms in the way state and local defined benefit plans – which are not federally insured - are operated.

With all that said, the move away from defined benefit is precisely the wrong direction for the American retirement system to be headed. The 401k approach to encouraging saving has not succeeded in raising the long-term personal saving rate. Indeed, the era of the 401k has seen a general decline in such saving. The traditional notion of retirement planning was at one time said to be a three-legged stool. There would be Social Security (which is defined benefit) as the first leg – a kind of minimum safety net. There would be employer-provided defined benefit plans as the second leg. And there would be individual saving (which is really what a 401k is) as the third leg.

Those critics who don't like defined benefit pensions as a concept – in part because they associate such pensions with unions - typically don't like Social Security as a concept either. Unfortunately, a one-legged stool is at best precariously balanced. There is an illusion that if Social Security and defined benefit pensions would just go away, the liabilities they represent would also vanish. Demographics and the lessons of history say otherwise. But I will muse about that proposition in a future edition of this blog.