Testimony of Dean Baker

Before the House Committee on Education and Labor

Hearing on Strengthening Worker Retirement Security

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Thank you, Chairman Miller for inviting me to share my views on the problems of the current system of retirement income, and ways to improve it, with the committee. My name is Dean Baker and I am the co-director of the Center for Economic and Policy Research (CEPR). I am an economist and I have been writing about issues related to retirement security since 1992.

My testimony will have three parts. The first part, which will be the bulk of the testimony, will explain how the current crisis has jeopardized the retirement security of tens of millions of workers. The second part will briefly reference some of the longstanding inadequacies of our system of retirement income, reminding members of problems with which they are already quite familiar. The third part will outline some principles that may guide the committee in constructing legislation to improve retirement security.

How the Current Crisis has Jeopardized Retirement Security

The collapse of the housing bubble, coupled with the plunge in the stock market, has exposed the gross inadequacy of our system of retirement income. CEPR's analysis of data from the Federal Reserve Board's 2004 Survey of Consumer Finance (SCF), indicates that the median household with a person between the ages of 45 to 54, saw their net worth fall by more than 45 percent between 2004 and 2009, from $150,500 in 2004, to just $82,200 in 2009 (all amounts are in 2009 dollars).[1]

This figure, which includes home equity, is not even sufficient to cover half of the value of the median house in the United States. In other words, if the median late baby boomer household took all of the wealth they had accumulated during their lifetime, they would still owe more than half of the price of a typical house in a mortgage and have no other assets whatsoever.[2]

The situation for older baby boomers is similar. The median household between the ages of 55 and 64 saw their wealth fall by almost 38 percent, from $229,600 in 2004 to $142,700 in 2009. This net worth would be sufficient to allow these households, who are

[1] We used the 2004 SCF, because the micro data from the 2007 is not yet available. This analysis, by my colleague David Rosnick and myself, will soon be available on the website of the Center for Economic and Policy Research, www.cepr.net.
[2] These calculations exclude wealth in defined benefit pensions.

at the peak ages for wealth accumulation, to cover approximately 80 percent of the cost of the median home, if they had no other asset.

Even prior to the recent downturn, the baby boom cohorts were not well prepared for retirement. Most members of these cohorts had been able to save far too little to maintain their standard of living in retirement. They would have found it necessary to work much later into their lives than they had planned, or to accept sharp reductions in living standards upon reaching retirement.

The situation of the baby boomers has been made much worse by the economic and financial collapse of the last two years. Ironically, the sharpest decline in wealth took place in an asset that many were led to believe was completely safe, their house. Real house prices have fallen by more than 30 percent from their peak in 2006 and will almost certainly fall at least another 10-15 percent before hitting bottom.[3]

The plunge in house prices has been especially devastating, both because it was by far the largest source of wealth for most baby boomers, and also because of the high leverage in housing. The fact that housing is highly leveraged is, of course, a huge advantage to homeowners in times when prices are rising. If a homeowner can buy a $200,000 house with a 20 percent down payment, and the house subsequently increases 50 percent in value, the homeowner gets a very high return, earning $100,000 on a down payment of just $40,000.

However, leverage also poses enormous risks. In this case, if the home price falls by 20 percent, then the homeowner has lost 100 percent of her equity. This is exactly the sort of situation confronting tens of millions of baby boomers at the edge of retirement. They just witnessed the destruction of most or all of the equity in their home. Our analysis of the SCF indicates that almost one fourth of late baby boomers who own homes have so little equity that they will need to bring cash to settle their mortgage at their closing. In a somewhat more pessimistic scenario, almost 40 percent of the home-owning households in this cohort will need to bring cash to a closing.

The collapse in the housing equity of the baby boom cohort in the last two years will have enormous implications for their well-being in retirement. Instead of having a home largely paid off by the time they reach their retirement years, many baby boomers will be in the same situation as first time home buyers, looking at large mortgages requiring decades to pay down. Furthermore, the loss of equity in their current homes will make it far more difficult for baby boomers to move into homes that may be more suitable for their needs in retirement. Millions of middle class baby boomers will find it difficult to raise the money needed to make a down payment on a new home.

[3] This is based on data from the Case-Shiller 20 City index. The peak level was reached in May of 2006. Most data is from November of 2008. These data are based on sales prices, which means that they reflect contracts that were typically signed 6 to 8 weeks earlier. This means that the most recent data is close to 5 months out of date at present. With prices in the index falling at a rate of more than 2 percent monthly, house prices may already be close to 10 percent lower than the level indicated in the November data.

While the focus of pension and retirement policy has usually been pensions and Social Security, it is important to recognize the role of housing wealth for two reasons. First, the massive loss of housing wealth due to the collapse of the housing bubble is likely to be a factor that has an enduring impact on the living standards of the baby boom cohorts in their retirement years.

The other reason why Congress should recognize the importance of housing wealth is that this pillar of retirement income is not as secure as it has often been treated. In other words, the risks associated with housing wealth have generally not been fully considered in evaluating the security of retirement income. While it is reasonable to hope that the economy will not see the same sort of nationwide housing bubble for many decades into the future, if ever, there will nonetheless be a substantial element of risk associated with homeownership, since there will always be substantial fluctuations in local housing markets. This means that workers who have much of their wealth in their home already face substantial risks to their retirement income even before considering their financial investments.

Here, also, the baby boom cohorts have received a very unpleasant surprise in the last two years as stock market has plunged by more than 40 percent from its peak in November of 2007.[4] While the data does not yet allow us to determine exactly how badly the baby boom cohorts have been hit by this decline, it is virtually certain that they felt the biggest impact, simply because they had the most wealth to lose. The Fed's data show that at the end of 2007, more than 70 percent of the assets in defined contribution pension plans were held either directly or indirectly in the stock market.[5]

The baby boomers' losses on their stockholdings will compound the losses incurred on their homes. Of course, most baby boomers had managed to accumulate relatively little by way of stock wealth even prior to the market collapse of the last year and half. In 2004, the median household headed by someone between the ages of 55 to 64 had accumulated less than $100,000 in financial assets of all forms, including holdings of stock and mutual funds. Median financial wealth for this age group had fallen to just over $60,000 in 2009 following the collapse of the stock market. The younger 45 to 54 cohort had median financial wealth of just $40,000 in 2004. This had fallen to less than $30,000 in 2009.

To summarize, our system of retirement income security was completely unprepared for the sort of financial earthquake set in motion by the collapse of the housing bubble and its secondary impact on the stock market. Older workers were already inadequately prepared for retirement even prior to these events. The events of the last two years now leave most of the baby boom cohorts facing retirement with very little to depend on other than their Social Security and Medicare benefits.

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[4] This refers to the decline as measured by the S&P 500, which is a much broader measure than the Dow Jones Industrial Average.

[5] This is taken form the Flow of Funds Table, L.118c, lines 12 plus 13, divided by line 1, available at http://www.federalreserve.gov/releases/z1/Current/z1r-6.pdf.

While a full picture of retirement income would also incorporate estimates of the income that these workers will receive from defined benefit pensions, the vast majority of workers in these age cohorts will receive little or nothing from traditional defined benefit pension plans. Defined benefit plans have been rapidly declining in importance for the last quarter century. This pace of decline is increasing with the downturn as many companies that still have defined benefit plans lay off workers and others freeze benefit levels to conserve cash.

Other Problems with the Defined Contribution Pension System

The prior discussion highlights the problem of risk for which the current defined contribution system was completely inadequate. I will just briefly note some of the other problems that have been frequently raised in prior years.

Inadequate coverage – In spite of efforts to simplify the process for employers, most businesses still do not offer workers the opportunity to contribute to a pension at their workplace. Almost half of private sector workers are not currently contributing to a pension plan at their workplace. The primary reason that workers do not contribute is because their employer does not offer the option. The Bureau of Labor Statistics reported a take up rate of 83 percent in their most recent survey.[6]

The lack of coverage is overwhelmingly a small business issue. Two thirds of the workers employed in firms with more than 100 workers are contributing to a pension. Just one-third of the workers in workers employing less than 50 workers are contributing to a pension.

Lack of portability – In the modern economy, workers change jobs frequently, either by choice or necessity. When workers leave a job with a pension, they generally cannot simply roll over their accumulated funds into a plan operated by their new employer (if there is one). While recent legislation has sought to promote rollovers into IRAs, it is still too early to know how effective these rules will be. Until we have a fully portable pension system, changing jobs still provides an opportunity for leakage of funds from retirement accounts.

High Fees – While some pension plans are very efficient, many plans charge annual fees in excess of 1.5 percentage points. These fees can substantially reduce retirement savings. For example, a 1.0 percentage point difference in fees can reduce retirement accumulations by almost 20 percent over a thirty-five year period. Private insurance companies will charge between 10 percent and 20 percent of the value of an accumulation to convert it into an annuity. This further reduces workers' retirement income.

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[6] Bureau of Labor Statistics, "Employee Benefits in the United States, 2008," available at http://www.bls.gov/news.release/pdf/ebs2.pdf.

Principles for a New Pension System

The events of the last two years have brought home the extent to which the current pension system exposes workers to risk both in the value of their pension and also their housing wealth. The federal government has the ability to shield workers from this risk, at very little cost to taxpayers.

Before discussing principles for expanding retirement security, it is important to note the security that the government already does provide through Social Security and Medicare. With the collapse of retirement savings over the last two years, as well as the plunge in housing equity, the baby boom cohorts will be hugely dependent on these two social welfare programs. It is, therefore, more essential than ever that Congress maintain the integrity of these programs and ensure that the baby boom cohorts can at least count on the benefits that they have been promised.

The main lesson of the last two years is that, in addition to the problems stemming from inadequate coverage and high costs, the current pension system subjects workers to far more risk than has been generally recognized. The government can solve all three problems by allowing workers the option to contribute to a government run pension system that would provide a modest guaranteed rate of return.

The system would be a universal system like Social Security, however it would be voluntary. To try to maintain high rates of enrollment, there can be a default contribution from all workers of 3 percent, up to a modest level, such as $1,000 a year. Workers could be allowed to contribute some additional amount, for example an additional $1,000 per year, that would also earn them the same guaranteed rate of return.

The system should also be structured to encourage workers to take their payouts in the form of annuities, except in the case of life threatening illness. For example, a nationwide system could easily offer free annuitization, while charging a modest penalty (e.g. 10 percent) to workers who take their money out of the account in a lump sum.

Ideally, there would be tax subsidies for low- and moderate-income workers that would make it easier for them to put aside 3.0 percent, or more, of their wages. However, if budget limitations make subsidies impractical, there is no reason that Congress could not move ahead to establish a structure and consider adding subsidies at some future date.

The guaranteed return should be set at a level that is consistent with a long-term average return on a conservatively invested portfolio. Such a guarantee should pose little new risk to the government. As recent events have shown, in extreme cases, the government will step in to protect savings, as it did when it opted to guarantee money market funds, even where it has no legal obligation to make such a commitment. Guaranteeing a modest rate of return over a long period of time should present very little additional risk to the government.

The funds in this system would be kept strictly separate from the general budget. The investment would be carried through by a private contractor in a manner similar to the way in which the Federal Employees Thrift Saving Plan current invests the savings of federal employees.

Even a modest contribution could make a large difference in the retirement security of most workers. For example, at a 3 percent rate of return, a worker who saved $1,000 a year for 35 years would be able to get an annuity of $4,200 a year at age 65. This would be 14 percent of the wage of a worker who earned $30,000 a year during their working lifetime. Such a sum would be a substantial supplement to their Social Security benefits. A contribution of $2,000 a year would be sufficient to provide an annuity that is almost equal to 30 percent of this worker's earnings during their working career.

The formulas for this sort of plan can be altered in any number of ways, but the point is that Congress can enormously increase the retirement security of tens of millions of workers simply by making a system with a defined rate of return available to them. This could be done at no cost to the taxpayers.

Conclusion

The events of the last two years have shown how exposed workers' retirement income is to market risk. The collapse of the housing bubble has called attention to the fact that the value of not only their pensions, but also their homes, fluctuate with the market, while their homes are an even more important asset for most workers.

While fully restoring the lost wealth of the baby boom cohorts may not prove feasible, Congress can take effective steps to create a better retirement system for future generations. This can be done at no cost to taxpayers, simply by having the government assume market risk by averaging returns over time. There are no economic or administrative obstacles to going this route, it is simply a question of political will.