401(k)s Are a ‘Fraud,’ and Other New Research

By Kerry Pechter *Thu, Mar 17, 2022*

Here are five fresh, timely pieces of academic research on retirement-related topics, including the alleged unfairness of the employer-sponsored defined contribution plan savings system.

The most provocative of the five research papers in this March edition of *RIJ*’s Research Roundup has to be Michael Doran’s “The Great American Retirement Fraud.” A professor at the University of Virginia School of Law, Doran faults US tax policy for subsidizing what, in his opinion, is a deceptively regressive defined contribution system of thrift.

We also feature recent research by the Urban Institute, whose economists show that millions of Americans won’t have adequate income in retirement if the Social Security system doesn’t avoid its anticipated insolvency in 2034. Another paper, co-authored by the principal economist at the Federal Reserve, measures how the cost of managing interest rate risk and offsetting “adverse selection” affects the prices of income annuities.

Two Harvard economists, David M. Cutler and Noémie Sportiche, show that the mental and emotional stresses of the Great Financial Crisis in the US were not evenly distributed across demographic groups. Finally, Danish economists, collaborating with an American, try to solve a mystery: Why do so many people gain wealth during their “decumulation” years?

Preparing for Retirement Reforms, by Karen E. Smith, C. Eugene Steuerle, and Damir Cosic of the Urban Institute, October 2021.

Unlike the helmsmen of the ill-fated HMS Titanic, who didn’t foresee any icebergs ahead, economists watching over Social Security know that the program approaches a political-regulatory-financing iceberg of its own, circa 2034.

That’s the year that actuaries predict the Social Security program will have enough payroll tax revenue to pay only about 75% of its promised benefits. If Congress doesn’t change the rules of the program before then, every beneficiary of the Old Age and Survivors Insurance program would take a 25% benefits haircut.

In this study, economists at the Urban Institute in Washington, DC, use their Dynamic Simulation of Income (DYNASIM) microsimulation model to forecast the impact of such a reduction on the America’s overall financial readiness for retirement. The authors defined readiness as the ability to replace 75% of pre-retirement income in retirement.

The share of Social Security beneficiaries with *inadequate* income will increase from 26% in 2020 to 45% by 2090 without any reforms to the program, they found, and to 39% if Congress enacted reforms proposed by the Bipartisan Policy Center. The BPC proposes a roughly equal blend of benefit cuts and tax increases to restore Social Security to solvency.

Americans can prepare for the worst by working longer or saving more. “Working longer by one year, by two years, or in line with increases in life expectancy, would reduce the share of Social Security beneficiaries unable to replace 75% of their preretirement earnings by two to five percentage points. A person with a 50% replacement rate, for example, might increase that number to 54% with an extra year of work,” the economists wrote.

Among top-quintile lifetime earners, one more year of work could close 25% of the savings gap, while saving 10% more of earnings could close 60% of the savings gap. For bottom-quintile lifetime earners, one more year of work could close 9% of the savings gap, while saving 10% of earnings more could close 19% of the gap.

Alternately, a person could save more over the course of their working lives. But they would have to save substantially more. “The average projected income gap among those Social Security beneficiaries with income below our adequacy standard in 2065 is $13,330 in 2018 price-adjusted dollars. To fill this gap, vulnerable workers would need to save about $272,700 more on average to close their income gap for 20 to 25 years of expected retirement,” the study said.

For those, such as women who raised children at home, who had too few years of earned income to qualify for benefits, the authors noted the possibility of a minimum Social Security benefit equal to the 2025 single-person poverty income level. If enacted, it would close 41% of the savings gap among bottom-quintile lifetime earners and 25% of the gap for second-quintile lifetime earners in 2065, the report suggested.

Does Social Security face an existential financial crisis? Not necessarily. Unless offset by higher immigration or changes in the way the program is financed, a falling worker-to-retiree ratio in the years ahead will require higher taxes per worker or lower payments per beneficiary. But defenders of the program say that simple remedies, such as raising the amount of earned income subject to the payroll tax, would solve the problem. That might raise costs for highest earners, but they benefit disproportionately from tax expenditures [a tax expenditure is a tax the government doesn't collect or defers collection of] on defined contribution plans.

The Great American Retirement Fraud, by Michael Doran, University of Virginia School of Law.

Most Americans save for retirement by buying mutual fund shares with tax-deferred contributions to accounts in employer-sponsored, defined contribution plans. But the program has a weakness. Millions of workers whose employers don't choose to sponsor plans are left out.

In a recent paper, a University of Virginia law professor calls the defined contribution system a "fraud." He argues that its benefits accrue mainly to the wealthy: Because they save the most and pay the highest marginal tax rates, they benefit the most from tax incentives for saving.

"Over the past twenty-five years, the retirement savings of middle-income earners have remained flat or increased only modestly, and the retirement savings of lower-income earners have actually decreased," writes Michael Doran. "But the increases in retirement savings among higher-income earners have been so large that average retirement savings as a whole have increased, making it appear that retirement security has improved across the board."

"The supposed interest in helping lower-income and middle-income earners has been a stalking horse for the real objective of expanding the tax subsidies available to higher-income earners. The legislation has repeatedly raised the statutory limits on contributions and benefits for retirement plans and IRAs, delayed the start of required distributions, and weakened statutory non-discrimination rules—all to the benefit of affluent workers and the financial services companies that collect asset-based fees from retirement savings.

"The result has been spectacular growth in the retirement accounts of higher-income earners but modest or even negative growth in the accounts of middle-income and lower-income earners. Despite the benign but misleading rhetoric about enhancing retirement security for everyone, the real beneficiaries of the retirement-reform legislation have been higher-income earners, who would save for retirement even without tax subsidies, and the financial-services industry, whose lobbyists have driven the retirement-reform legislative agenda."

Doran argues that the system isn't making America more retirement-ready. "The most recent update of the National Retirement Risk Index, published in January of 2021, indicates that approximately 49% of all households are at risk of being unable to maintain pre-retirement living standards during retirement," he writes. "And the distribution of at-risk status is not even across different levels of household wealth: among low-wealth households, 73% are at risk; among middle-wealth households, 45% are at risk; and among high-wealth households, 29% are at risk… The number of at-risk households has increased since 2004, the first year for which the National Retirement Risk Index was calculated."

What's Wrong with Annuity Markets?, by Stephane Verani, the Federal Reserve Board, and Pei Cheng Yu, University of New South Wales, Australia.

It's a truism in the annuity industry that when prevailing interest rates go down and stay down for long periods, that life/annuity companies earn less on their bonds and must raise the prices (i.e., lower the payout rates) of single premium immediate annuities (SPIAs). (Variable annuities and index-linked annuities are not as rate-sensitive.)

It's also known that healthier people buy life annuities. Known as "adverse selection" (AS), this phenomenon compels annuity issuers to charge more for SPIAs than they would if more people with average longevity expectations purchased life annuities.

The principal economist at the Federal Reserve in Washington, DC, Stephane Verani, and an Australian business school professor, Pei-Cheng Yu, assert that the frictions from managing these two risks—interest rate risk and AS—raises the cost and lowers the supply of lifetime income annuities. Indeed, the two risks interact; rising annuity prices discourage all but the healthiest customers.

"A large share of the notoriously high life annuity price markups can be explained by the cost of managing interest rate risk. We propose a novel theory of insurance pricing that reflects both informational frictions and interest rate risk.

"We develop an algorithm for annuity valuation to decompose the contribution of demand- and supply-side frictions in annuity markups using over 30 years of annuity price data and a novel identification strategy that exploits bond market shocks and the US insurance regulatory framework.

"Our main result is that interest rate risk significantly constrains the supply of life annuities. A corollary is that the best time to sign up for a life annuity is during a time of overall financial market stress, as annuity prices are lower when investment grade bond spreads are higher!," the authors write.

"The average AS-adjusted markup is substantial and around 16%. We show that the cost of managing the interest rate risk associated with selling life annuities accounts for at least half of the AS-adjusted markup or eight percentage points," they add. "That is, in addition to the well-known cost of adverse selection, the supply of private longevity insurance is constrained by life insurers' own vulnerability to uninsurable aggregate shocks.

"A substantial fraction of annuity markups reflects insurers' cost of managing interest rate risk. The effect of interest rate risk, a supply-side friction, is likely to add to the adverse effects of other noted demand-side frictions on annuity demand including, for example, bequest motives, behavioral biases, and pre-existing annuitization, such as Social Security."

Economic Crises and Mental Health: The Effects of the Great Recession on Older Americans, by David M. Cutler Noémie Sportiche.

Can you remember your mental state during the Great Recession of 2008? Was your home foreclosed on? Did you lose your job? Were you distressed by the drop in the financial markets? Two Harvard economists searched the data to see if older people suffered more emotional pain or mental anguish that others during that difficult period.

David M. Cutler and Noemie Sportiche searched through house price data in the **Health and Retirement Study** and studied rates of depression, chronic pain severity and functional limitations, and the use of medications to treat sleep, depression, and anxiety. They found no sign that the elderly suffered. They found ample evidence that homeowners of color did.

"The mental health impacts of the Great Recession were heterogeneous and unequally distributed," Cutler and Sportiche wrote. "We find that mental health was not impacted on average, either for older adults aged 51 to 61 or for seniors aged 65 to 74.

"Instead, we find that falling house prices worsened only the mental health of those in economically vulnerable households… Black and other non-white homeowners show signs of worsened mental health across most measures. White homeowners did not exhibit worsened mental health but became more likely to take medication."

The authors were "not able to clearly identify the pathway through which house prices affected the mental health of populations." They concluded, "The mechanisms underlying mental health effects extend beyond housing wealth or foreclosures."

"As the mental health of seniors aged 65 to 74 was not affected, it is possible that mental health effects are mediated through features of the labor market or have smaller impacts among seniors because of reasonably generous social insurance programs available to this age group."

Consumption and Saving After Retirement, by Bent Jesper Christensen and Malene Kallestrup-Lamb of Aarhus University, Denmark, John Kennan, University of Wisconsin-Madison.

The wealth of retirees tends to go up rather than down, on average. That's contrary to the life-cycle hypothesis, which holds that retirees will spend down their savings to maintain their pre-retirement consumption level. An American economist and two Danish economists decided to explore the inconsistency.

"One would expect that wealth accumulated before retirement would be used to augment consumption in later life, with the implication that wealth should decline over time," wrote researchers Bent Jesper Christensen and Malene Kallestrup-Lam of Denmark's Aarhus University, and University of Wisconsin's John Kennan.

So why, they ask, do "many people choose to work full-time for about 40 years, and not work at all for the remaining 15 years or so, rather than taking more time off when they are younger, and working more when they are older"

They had more than an idle interest in this topic. Social security systems around the world might cost trillions of dollars *less* to finance (in the long run) if more people worked longer, paid taxes longer, and received their pension payments for fewer years. That is: if it were known why so many people retire early, perhaps incentives for working longer could be developed.

The trio analyzed data for Denmark's 1927 birth cohort, for which the old-age pension (OAP) claiming age was 67. To simplify the research, they focused on single people neither married nor cohabiting. They followed at group from 1995, at which point almost all of them had retired, to 2016.

Their conclusion: Some individuals are saving because they are currently in a low marginal utility state, but expect to move to a "high marginal utility state" in the future. In other words, they believed that they'd get more enjoyment out of their money by spending it later rather than sooner.

Note: The life-cycle hypothesis (LCH) is an economic theory that describes the spending and saving habits of people over the course of a lifetime, according to Investopedia. The theory states that individuals seek to smooth consumption throughout their lifetime by borrowing when their income is low and saving when their income is high. The concept was developed by economists Franco Modigliani and his student Richard Brumberg in the early 1950s. Its applicability for over-leveraged Americans in the 21st century is open to debate.

Marginal utility is the enjoyment a consumer gets from each additional unit of consumption. It calculates the utility beyond the first product consumed. If you are hungry and eat three Big Macs in a row, you are likely to enjoy the first more than the second and the second more than the third. And so on until you regret it. It's akin to the principle of diminishing returns.