Bloomberg's Ideas for Overhauling 401(k)s

By Kerry Pechter *Thu, Apr 21, 2022*

Bloomberg editors call the existing 401(k) program 'dysfunctional' and a 'morass.' Their critique is valid, but their suggestions are not quite new.

Bloomberg, the respected online business news source, has been publishing a series of editorials on America's "retirement crisis." They're arriving late to the discussion, which started in the 1980s.

But no one has solved the crisis—generally measured by the percentage of Americans on track for downward mobility in retirement—so Bloomberg is still early.

In the most recent **installment**, the Bloomberg editors call the existing 401(k) program "dysfunctional" and a "morass." The program, they say:

- Costs hundreds of billions of dollars a year in foregone income taxes
- Bestows most of its tax benefits on the highest-paid workers
- Fails to cover tens of millions of low-paid US workers
- Fails to help many participants accumulate enough savings
- Often charges high fees to participants

"The US can do much better, at no extra cost," the Bloomberg editors say.

Their solution, put simply, would give all US workers access to the kind of low-cost, high-match defined contribution plan (e.g., 401(k), 403(b)) that workers at many large corporations enjoy today, but government-sponsored. It would be:

Universal. Everyone with a Social Security number would be auto-enrolled, with an opt-out opportunity.

Simple. Participants would automatically start contributing 3% of pay per year to "lifecycle" (target-date funds) unless they prefer to pick from a curated list of actively managed funds.

Portable. Participants would own their accounts, which would follow them automatically from job to job.

Progressive. Contributions by the lowest earners would receive an annual government match of $1,000 or more.

Flexible. Participants could dip into their accounts for emergencies.

Income-oriented. At retirement age, "account holders are offered a small selection of simple annuities, which provide regular payments for as long as they live — a conversion that could be made automatic, with payments adjusted for inflation."

According to Bloomberg, such plans already exist, in the form of the federal Thrift Savings Plan and the UK's National Employment Savings Trust (NEST). They might also have included TIAA and perhaps Australia's Superannuation Fund.

The tax expenditure

Some of the issues Bloomberg raises have already been addressed, if not necessarily resolved, by policymakers. Many large employer-sponsored plans already have auto-enrollment, auto-investment in target date funds, and some have adopted auto-escalation of contribution rates. Congress has approved Pooled Employer Plans, which could expand coverage and take pressure off employers, and lower barriers to annuities in DC plans. State-sponsored auto-IRAs in California and Illinois are also helping expand coverage to workers at small firms.

The tax expenditure seems to be Bloomberg's prime target. The US Treasury forgoes more than $200 billion a year in income taxes. Bloomberg is not the first to ask:

- Is this tax break a subsidy?
- Is it unfair that most of the tax breaks accrue to those at the highest marginal tax rates?
- Would Americans save as much if they were required to pay income taxes on their contributions (that is, if the Roth IRA and Roth 401(k) were universal)?
- Do taxes on 401(k) and IRA distributions in retirement adequately recompense the US Treasury for the massive implied cost of tax deferral?

Bloomberg seems to underestimate the resistance to tinkering with this tax expenditure. A multi-trillion dollar retirement industry has grown up around the tax expenditure. The Obama Administration tried to cap the subsidy on savings and redistribute the tax expenditure more equitably, but industry lobbyists turned it back. If Social Security is the third-rail of American politics, the existing IRA/401(k) subsidy is the third-rail of retirement policy.

Speaking of Social Security, Bloomberg didn't explain how its DC vision would be integrated with the popular Old Age and Survivors Insurance program. Social Security is nearly universal, simple, portable, progressive, flexible (in its start date) and income-oriented. Employers provide a 6.2% match. All but the top earners rely on it for a big chunk of their retirement income.

The Bloomberg plan reminds me of plans in countries where the governments have replaced pay-as-you-go public pensions with a two part system consisting of a means-tested minimal pension (paid for by general tax revenue) and a workplace defined contribution plan to which employers must contribute but do not control.

Bloomberg appears to overlook the problems that these plans often encounter as they try to manage the transition from accumulation to decumulation; they typically need "smoothing" mechanisms to reduce disparities in individual outcomes.

If Bloomberg would like to such a system replace Social Security, I'm against their idea. Social Security works. It needs tinkering, to be sure. There should probably be a minimum basic pension, and an increase in the level of income subject to payroll taxes might offset the tax-break imbalance. But it's not yet time to retire the Old Age and Survivors Insurance program and replace it with a shiny new object.

Social Security should remain popular, even after a modest tax hike, because it does so many things that investments can't do. As I've written before: You may be able to *invest* your money better than the government can. But you can't *insure* yourself retirement against market risk, interest rate risk, sequence risk and longevity risk as efficiently as the government does via Social Security.

Each of Social Security's protections has under-appreciated financial value. DC accounts offer only risk exposure, to varying degrees; they can't provide protection from risk. And life insurance company balance sheets can't support an entire nation's longevity risk indefinitely. Uncle Sam can; that's why we have Social Security. Demographic change may make the program more or less expensive, but it's worth the price.

Though not fresh, Bloomberg's views are reasonable. Tax loopholes tend to widen with time, and the subsidy for retirement savings has grown from the size of a needle's eye to a freeway as wide as Southern California's I-5. A case can be made that tax deferral has become a bloated and unbalanced subsidy. And the complexities of tax deferral only add to the DC system’s cost.

But Bloomberg’s editors don’t acknowledge the time (and frustration) that others have spent on these same issues, and they ignore the remaining obstacles to change. In the end, your position on DC policy will probably depend on whether you’ve benefited from the 401(k)/403(b) system. My household had the good fortune to participate in low-cost plans with generous matching contributions. Everyone should be so lucky.