POLICY BACKGROUNDER No. 161
For people with limited time and a need to know.

For Immediate Release
April 15, 2004

Saving and Investing: A Challenge for Women

by Celeste Colgan and John Goodman

"Nearly half of all working families have no retirement savings account."

In recent years, we have heard a lot about increasing inequality in the distribution of income. To some commentators this inequality reflects institutional unfairness in our society. However, careful studies have shown that the greatest degree of inequality exists among senior citizens, and the single most important cause of that inequality is not differences in preretirement income but differences in the degree to which people with the same income save rather than consume.[1] Clearly, some people are not saving enough. According to the "Survey of Consumer Finances," conducted every three years by the Federal Reserve:[2]

- Nearly half (47 percent) of all families with at least one worker between the ages of 21 and 64 have no retirement savings account.
- Of the 47.8 million workers who do have an account, the median balance (half are larger, half are smaller) is $27,000.

Among workers nearing retirement the picture improves only slightly:[3]

- Nearly one-third (30 percent) of workers age 55 to 64 have no retirement savings account.
- Among those who do, the median balance is about $55,000.

To put that in perspective, $55,000 at retirement will provide a pension annuity of about $400 a month. While the failure to save enough is a characteristic of men as well as women, it appears to be a bigger problem for women. For example, one study found that:[4]

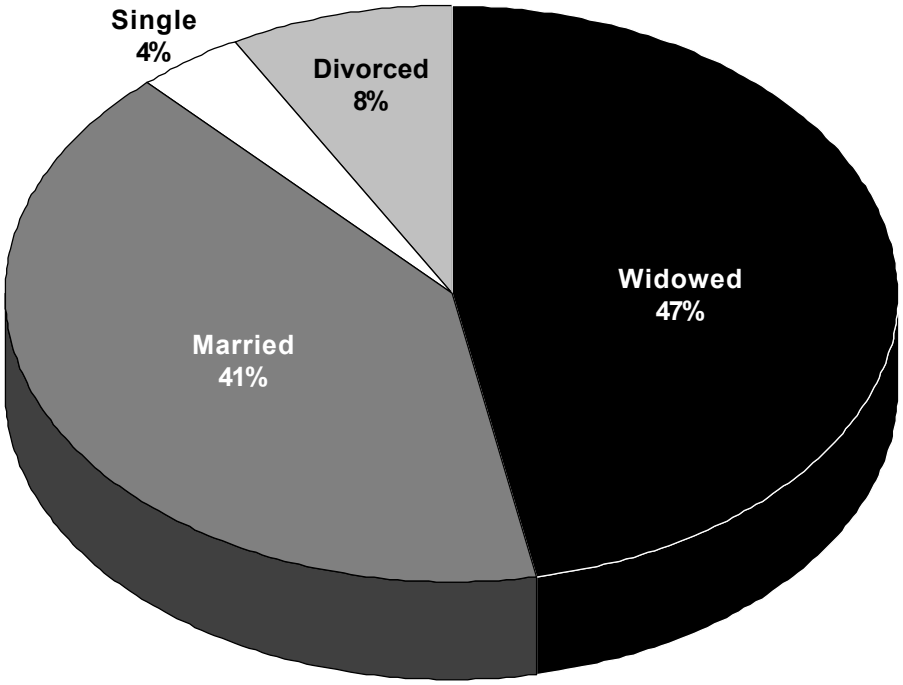
- Among employees ages 18 to 62, the average balance in 401(k)s and similar accounts for women was half that of men.
- Among those nearing retirement age, the average balance for women was only 20 percent that of men's.

ISBN #1-56808-134-0

"Widowed, divorced and single women are more likely to face poverty in retirement."

FIGURE I

Marital Status of the Female Population Age 65 and Older, 2000



Source: Congressional Budget Office.

Insufficient retirement savings means having an inadequate retirement income to sustain oneself. More women than men face this problem, partly because they are more likely to live alone. In fact, nearly half of all women over age 65 are widows.[5] [See Figure I.] This is important because compared to two-person households, one-person households have smaller retirement savings, smaller Social Security benefits and less personal savings. Consider that:[6]

- Divorced men and women ages 65 and over are more likely to fall below the poverty line than those who are married — that probability is even greater for those who are widowed, separated or were never married.
- Of seniors living in poverty, almost three-fourths are women. [See Figure II.]

Why do women have such difficulty supporting themselves in retirement? Largely because retirement programs are linked solidly with employment. Our entire tax-advantaged retirement system is designed to support steady, full-time employees of firms that offer generous benefit packages.

Nowhere does the gender difference in workforce behavior play a more significant role than in a woman's ability to accumulate retirement assets. Women tend to choose jobs that better fit with raising children. They are more likely to drop out of the workforce to take care of family, to work in industries with family-friendly policies, to work part-time, and to choose flexible work hours over higher salaries. As a result, they often fail to accumulate adequate financial resources for their retirement years. A woman who doesn't maintain a steady job over many years will find that our retirement savings system is of little benefit.

Resources for Retirement

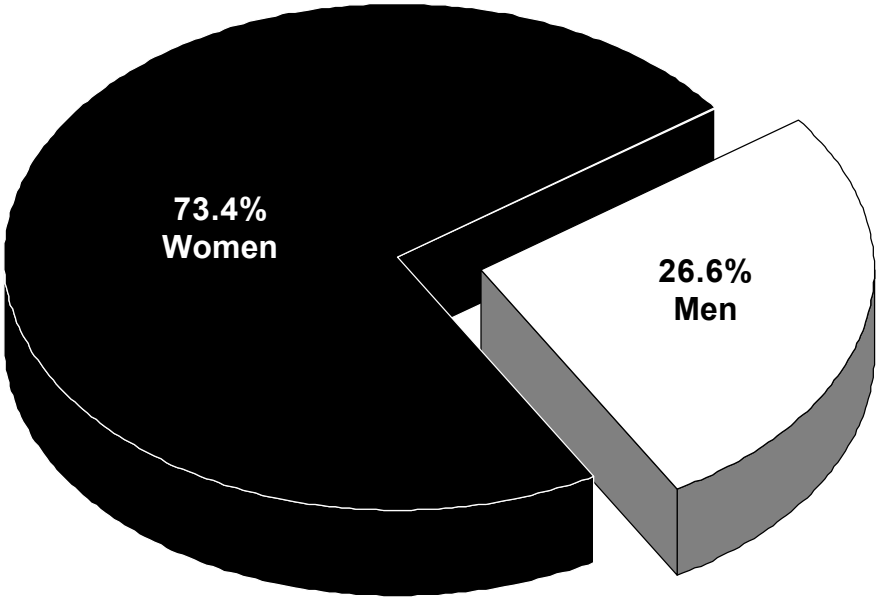
Financial planners tell us that workers typically accumulate retirement assets from three sources: personal savings, Social Security and employer-sponsored retirement plans. Unfortunately, many women — because of their life choices and workforce behavior — fall short of building up these resources.

Personal Savings. Saving money independent of employer-sponsored plans is a challenge for everyone, but for women — who are likely to be earning less or earning nothing —saving rarely happens. Putting discretionary income into a personal retirement savings account competes with more

"Nearly three-fourths of the elderly living in poverty are women."

FIGURE II

Percentage Distribution of Elderly Persons in Poverty



Source: C. Eugene Steuerle, "Divorce and Social Security," National Center for Policy, NCPA Brief Analysis No. 291, May, 21, 1999.

immediate needs: money for preschool, medical emergencies, children's college expenses or any of the many unplanned events in family life.

Tax-advantaged savings can produce more than twice as much income as comparable taxable investments, depending on one's tax bracket (see the cautions below). An Individual Retirement Arrangement (IRA) is one of the best ways to save.

For example, the Spousal IRA allows the spouse of a wage earner to set aside up to $3,000 of pretax income each year that can grow tax free until it is withdrawn during retirement.[7] While this is a viable option for married couples, the contribution limit is meager compared to allowable contributions to employer-sponsored plans. So why isn't the limit higher? It should be. Because IRA deposits expand the nation's capital stock and therefore our national income, the government gets a great deal of the money back as tax revenues. In fact, several studies have concluded that IRA tax incentives more than pay for themselves.[8]

"Because of their workforce behavior, women have difficulty accumulating retirement assets."

Home Ownership. When interest rates are low — as they have been recently — people are often drawn to home ownership as an investment vehicle. Moreover, federal policies encourage home ownership. It is part of the American Dream. Under the current tax code, if a primary residence is sold for more than its cost basis, the sellers can usually pocket the profits from the sale tax-free. Thus, many stay-at-home moms and working couples reckon their important second job is to increase their home's value. They remodel, landscape and repair with the idea of collecting cash or trading up when they sell. Home equity is the principal asset of a large number of current retirees.[9]

Social Security. As a supplement to other assets, Social Security benefits are welcome, but it is a bad idea to depend on Social Security for one's primary source of retirement income. Because of the falling ratio of workers to retirees, projected benefit levels for future retirees are unsustainable with payroll tax rates under current law. The national debate about the future of Social Security has fostered well-justified skepticism.[10] If current trends prevail, benefits may be greatly reduced in future years. In fact, polls show that young people are convinced they are more likely to see a UFO than receive their Social Security benefits.[11]

Even if Social Security keeps all its promises, the benefits are simply not enough to provide seniors with financial independence. The average monthly Social Security benefit today is about $621 for women and $810 for men. The benefit for a 35-year-old accountant who earns about $30,000 per year will be about $1,292 per month, assuming that she continues to work full time until she retires.[12] This means that if she has made no other income provisions, on the day she retires she must live on 50 percent of her former wages. And things could be worse. She may have had interruptions in her employment; she may have taken maternal leave or reduced her hours to fulfill family needs. As a

result, her Social Security benefit will be significantly smaller than 50 percent of her working income. It is no wonder that twice as many women as men retire in poverty. Given these prospects, it is more important than ever that we have a sound private retirement savings system — one that meets the diverse needs of American workers.

Employer-Sponsored Retirement Plans. While employee benefits are noncash compensation to the employee, they cost the employer just as much as cash wages. In fact, if there were a law that made employee benefits illegal, employers could increase all employee wages and salaries by about the same amount that they now spend on benefits.

So why don't employers simply pay higher wages and forget the benefits? One very important reason is the tax law. In general, employers can spend more on untaxed benefits than employees can spend on their own. In fact, in the area of retirement savings there are large differences between the amount of tax-free savings available to people at their workplace and what they can do on their own. Thus, employer-sponsored retirement plans have become a coveted part of employee compensation. They have also evolved from a defined monthly retirement benefit into a retirement savings plan for workers.

Defined-Benefit Plans. Following World War II, many large employers chose to provide a form of retirement support called the *defined-benefit plan*. Under these plans, employees acquire pension benefits, sometimes for the rest of their lives, based on a combination of wages and years of service to the company. The plans consisted of a promise by an employer to provide a specific monetary sum. Under defined-benefit plans, when employees commit their entire working lives to a single employer, their pension is typically 60 to 70 percent of final pay. Today, however, employers have virtually stopped establishing new defined-benefit plans. Four important factors have contributed to that development:

First, although defined-benefit plans work well for people who work continuously for the same employer, they do not work well for employees who switch jobs. Why? Although they could be designed differently, most defined benefit plans calculate benefits using formulas that are "back-end loaded." That means the 40th year of employment is weighted a lot more heavily than, say, the 10th year. For example, consider a woman who works for four different companies — each for 10 years — and all four have identical pension plans. Upon retirement, she will get four separate pension checks, but her combined income will be less than half of what it would have been if she had stuck with just one company for the full 40 years. In fact, even if they remain fully employed for their entire work lives, both men *and* women sacrifice substantial pension benefits under this system if they switch employers frequently.

"Employer-sponsored defined benefit pensions worked well for employees who stayed at one job throughout their career."

Second, for much of the post-World War II period, employers were not required to set aside funds for their pension plans. Like today's Social Security

system, the pension promises of many employers were not backed by any saving or investment. This meant that many defined-benefit pensions were only as secure as the company that established them. If the employer went broke, employees could lose some or all of their benefits. For example, after Studebaker filed for bankruptcy in 1963, autoworkers received only 15 percent of the pension benefits they had been promised.[13]

"Defined benefit retirement plans are risky because they depend on the employer's financial success."

Third, federal legislation made defined benefit plans unattractive to employers. In response to the problem of bankrupt companies defaulting on their pension promises, Congress passed legislation (called ERISA) that required employers to fund their defined-benefit pension plans.[14] The law also created the Pension Benefit Guarantee Corporation (PBGC), which insures private pension plans. This insurance does not work like insurance in a normal market, however. Federal law requires all companies with defined-benefit pension plans to pay premiums to the PBGC. However, the premiums are not risk-adjusted; thus the premiums paid by those who are at risk of default are much lower than their actual risk would warrant. Those plans that are fully funded and at virtually no risk of default are charged premiums that are too high. Thus, one way to think of this system is to see it as socializing the risks of pension default by overcharging healthy plans and undercharging sick plans.[15]

Not surprisingly, new companies seeking to create pension plans for their employees have had a strong incentive to avoid the PGBC scheme and its excessively high premiums.

Ironically, the very 1974 act that sought to regulate and reform the private pension system provided an alternative.[16] It allowed the creation of *defined-contribution* plans (described below), of which the most notable is the 401(k) plan.[17]

Finally, defined benefit plans offer prospective retirees a promise that has become increasingly expensive to honor. These plans were founded on actuarial assumptions made up to 60 years ago, but today's retirees live much longer. In order for employers to fully fund a defined-benefit plan today, employees have a choice: accept less in wages (so that more of their compensation can go to the pension fund) or accept lower monthly benefits during retirement. Given such a tradeoff, not all employees will make the same choices. In their efforts to find a system that allows workers more flexibility and greater choice, employers found that for the same cost, they could discard the one-size-fits-all approach and create a new system that appeals to the diverse preferences of newer and younger workers in a more dynamic labor market.

Defined-Contribution Plans. Unlike defined-benefit plans, defined-contribution plans promise no specific benefit at the time of retirement; rather, benefits are linked to market behavior. The employee has ownership rights over the assets in a specific account and is entitled to the full accumulation.[18] The

employee chooses an amount to put into the plan, and after a vesting period, the employer typically matches that amount. For example, a common plan would invite an employee to contribute 4 percent of her gross compensation, before taxes. After a "vesting" period, say, of three years' employment, the employer matches those contributions, dollar for dollar. Federal law governs the total amount an employee is permitted to set aside before taxes. In 2003, an employee could shelter up to $12,000.[19]

Historically, professional managers invest the funds of defined-benefit plans. In 401(k) plans, employees make their own investment choices — although the employer typically limits the range of available options. And as long as the employees are fully "vested," they do not lose the employer match if they change jobs. The amount of compensation they have contributed always remains in their account. Today more than half of all workers with an employer-provided retirement savings program participate in a defined-contribution plan.[20]

Defined-contribution plans place the responsibility for saving and investing on the employee. They better accommodate a dynamic, highly skilled workforce that has no expectations of a paternalistic employer. Gone are the days when an employee expects a company to take care of her and her family in old age in exchange for her loyalty and steadfastness on the job. The last half of the 20th century produced a different employer-employee dynamic. Today's employee knows from day one that she is likely to trade up, to use her current job to gain experience for the next. All else being equal, the employer match for her 401(k) will be an important component of her decision to accept the next job. The catch is that she must do well in her investment vehicles. She is in control and she assumes the risks.

Which Plan is Less Risky? At first glance it might seem that the defined-benefit plan is less risky, since it avoids two problems: (1) the risk of not investing well over your work life and (2) the risk of having a longer life expectancy and outliving your accumulated assets. Defined-benefit pensions are supposed to pay regardless of the market's performance, and keep right on paying as long as you live. However, employees lose benefits if they switch jobs, and they generally cannot pass on the benefit as part of their estate. Defined-contribution plans eliminate these two risks. Aside from vesting issues (discussed below), 401(k) owners can take their total accumulation with them when they switch jobs, and if they die early, the assets in their account become part of their estate.

"Defined contribution plans are portable between jobs."

Richard Hinz, Director of Pensions Research at the U.S. Department of Labor, conducted a simulation for 100,000 representative American workers and concluded that when all risks are considered, defined-contribution plans are actually less risky than defined-benefit plans. Given the odds that employees will leave their employers and that their compensation will flatten out before

their careers end, a plan that bases benefits on tenure with the company and final salary simply will not pay out as well as one that simply grows with capital markets.[21] However, as we shall see, even 401(k) plans could be improved with just a few simple changes in federal law.

In any event, women are more likely than men to participate in a defined-contribution plan. This is because defined-benefit plans are usually found in unionized, large-employer industries where employment tends to be dominated by males. Among women with an employer-provided retirement plan, enrollment in defined-contribution plans is twice that of defined-benefit plans.[22]

Problems with Employee Retirement Plans

While defined contribution pension plans have solved some of the problems of the older system, they have created a new set of problems on their own. Let's take a closer look.

Problem: Vesting Requirements. The idea behind vesting is that employees must work for an employer for a certain number of years before they obtain full rights to the promised retirement benefits. Therefore, an employee who leaves before fully vesting in a defined-benefit plan will receive a smaller pension during retirement. In defined-contribution plans, employees are automatically entitled to whatever they have contributed. But they typically are not entitled to the full amount of an employer's matching contribution until they have logged a minimum number of years of service. At one time, it was not unusual for employers to require 10 or 15 years of service before vesting was complete. Today the law requires vesting periods to be no longer than seven years.[23] But even a short, say, three year vesting requirement has a disparate effect on women[24] and interferes with a dynamic, highly mobile workforce.

Why have vesting at all? One could argue that a vesting period makes sense. Vesting allows an employer to recover some of the administrative costs connected with employees who pop in and out of employment. In today's competitive job market for highly skilled workers, however, many employers have dropped vesting requirements altogether, choosing to match employees' contributions from their first day on the job. By contrast, other employers see long vesting requirements as a way to reward employees who are "loyal" (that is, who don't leave to work for a competitor), and to punish those who are not. Thus, vesting requirements remain an important recruitment and retention tool.

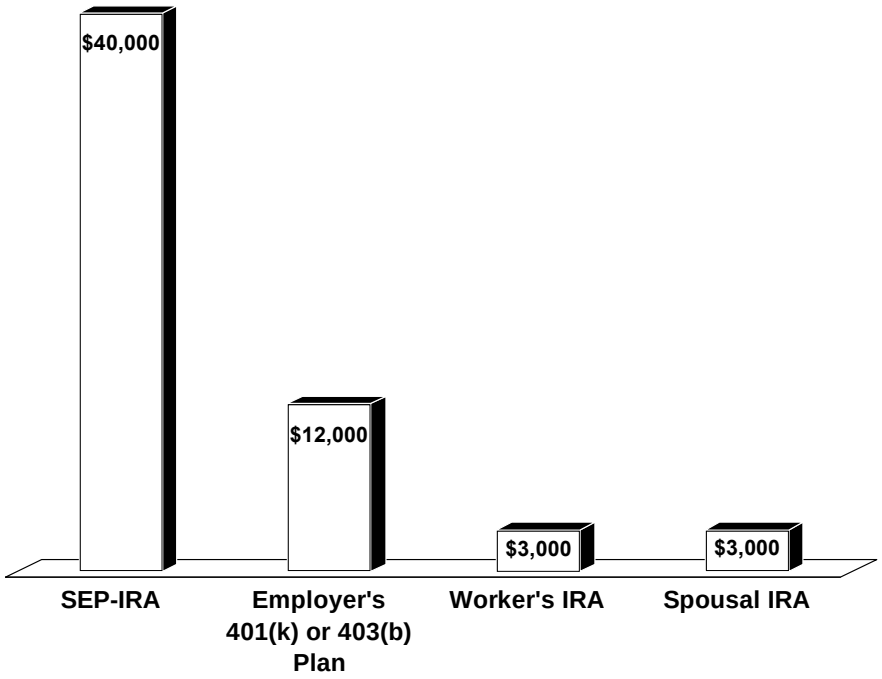
"Vesting requirements disadvantage women, who are more likely to switch jobs."

In a free labor market, employees and employers would be able to strike any compensation bargain to which both agree. If it makes sense to reward long-term employment, employers should be free to do that. Today's retirement plans, however, involve something more than voluntary exchange. The ability to build up funds tax-free involves a taxpayer subsidy, and the social purpose of that subsidy is to encourage the private sector to make private provision for retirement income needs.

"Individuals with no employer plan can deposit only $3,000 each year."

FIGURE III

Limits on Contributions to Tax-Favored Savings Plans in 2003



Source: The Economic Growth and Tax Relief Reconciliation Act of 2001.

Employers who exact onerous vesting requirements are using a tax-subsidized vehicle created to achieve a socially desirable end in order to achieve a purely private, corporate end. In pursuing their own goals, these employers actually hinder the achievement of the social goal. Vesting requirements not only undermine the social goal of encouraging people to build a reasonable retirement income, they also interfere with the labor market mobility that our modern economy requires.

Problem: Arbitrary Limits on Contributions. One of the most remarkable characteristics of our retirement system is the arbitrary limits placed on tax-deferred saving opportunities. As Figure III shows,

- Some people are able to deposit as much as $40,000 per year in tax-deferred savings plans.[25]
- Others are limited to the $12,000 maximum in contributions allowed to a 401(k) plan.[26]
- Yet individuals who do not have access to an employer-sponsored plan, including those who are not in the labor market at all, are limited to an annual $3,000 maximum contribution to an IRA account.[27]

These limits are especially important to women for three reasons: (1) women are more likely to work in industries where employer-provided retire-

ment plans are less prevalent; (2) even if their employer offers a retirement plan, they are less likely to qualify because they are part-time or temporary workers; and (3) women are more likely to move into and out of the labor market.[28]

Even a small break in employment can have a major impact on the assets that accumulate in a defined-contribution plan. Consider, for example, a woman who takes five years out of the labor force for child rearing, say, between the ages of 25 and 35. If she returns to the workforce and works until retirement, she is likely to find that her 401(k) accumulation at retirement will be 20 to 30 percent smaller due to her absence.[29] Moreover, her absence would have significantly limited her ability to contribute to an IRA.

If it is socially desirable for some people to save for their own retirement, presumably it is just as desirable for others. There is no socially justifiable reason why the amount of tax-free savings a person is allowed should be conditioned on where or if he or she is employed.

Problem: Poor Investment Choices. Defined-contribution plans not only allow employees to make their own investment choices, they virtually require it. While many employees cherish this freedom, others view it as an unwelcome burden. Moreover, employees nationwide appear to do a very poor job investing their own money. A study of 503 employers by Watson Wyatt company found that from 1990 through 1995:

- The defined-benefit plans averaged an annual rate of return 1.9 percentage points better than the 401(k) plans — 10 percent versus 8.1 percent.[30]
- To illustrate the difference, consider investing $4,000 a year for 30 years: at 10 percent, the account will grow to about $690,880. At 8.1 percent, however, the account will grow to only $480,224 — a difference of $210,665![31]

One might suppose that investment results would be highly sensitive to the type of work employees perform; that is, more financially sophisticated employees would be likely to command better investment returns. But this is not necessarily the case. A study by the National Center for Policy Analysis examined the 401(k) performance of financial service firms' employees — who specialize in investing other people's money and/or giving investment advice. It found that over a four-year period ending in 1998, none of the financial service firms' *own employees'* average 401(k) earnings came close to matching the performance of the stock market as a whole or as a mixed portfolio of stocks and bonds.[32]

Even employees of financial services firms make poor investment choices."

Why is the performance of 401(k) plans so poor? There are a number of reasons, but the most important is that all too often unsophisticated investors make one or both of two bad investment decisions: (1) they invest in their employer's stock, and/or (2) they invest in what they perceive is "safe."

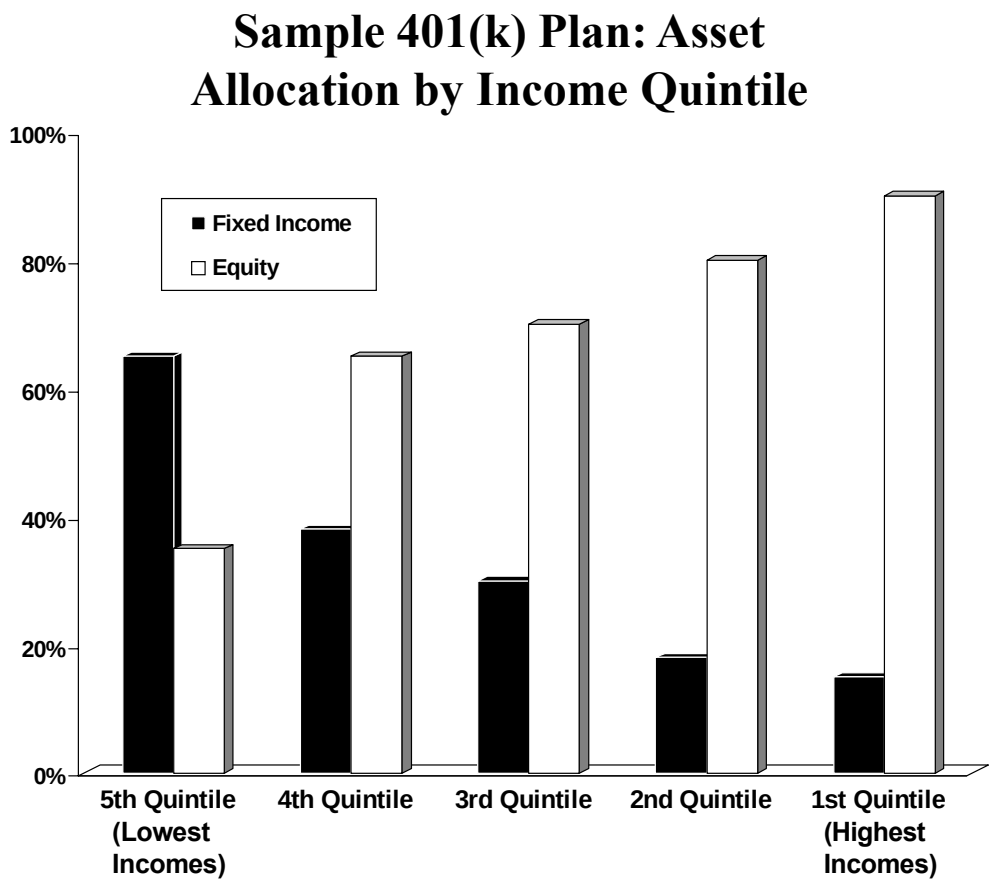
Enron's case, in which employees heavily invested in an employer's stock suffered large losses, is not unique. A recent survey found that in 40 of 105 larger public companies, more than half of 401(k) assets were invested in the employer's own stock.[33] As the experience of Enron employees makes clear, putting all your financial eggs in one basket is a risky, unsafe strategy, even if the basket is your own trusted employer.

The other mistake employees make is to be too conservative. They invest in securities that are safe, but pay a low rate of return. This is especially true of lower-paid employees. Figure IV shows the 401(k) choices of the employees of a private company, grouped by the employees' incomes. As the figure shows:[34]

- Almost two-thirds of the assets invested by employees in the lowest-pay quintile (bottom fifth) were in a money market fund or bond fund.
- By contrast, about 85 percent of the assets invested by employees in the highest-pay quintile were in stocks.

"Lower income workers tend to make the most conservative investments, which lowers their retirement income."

FIGURE IV



Source: Brooks Hamilton and Scott Burns, "Reinventing Retirement Income," National Center for Policy Analysis, NCPA Policy Report No. 248, December 2001, Figure III, p. 13.

To put this in perspective, compare two portfolios, one consisting entirely of stocks, the other of bonds. Based on historical averages, the all-stock portfolio will accumulate 10 times as much wealth as the all-bond portfolio over the course of a work life.[35]

Interestingly, other things equal, there are important differences in the investment behavior of men and women. On the one hand, a number of studies have found that women are more risk averse. Given a choice, they are significantly more likely to choose bonds over stocks.[36] On the other hand, men are more likely than women to engage in frequent portfolio changes. Ultimately, such excessive trading reduces the net returns on men's investments by a full percentage point, relative to women.[37] Part of the problem, according to a number of psychological studies, is that men are excessively confident in their own abilities. As one economist put it, "Men tend to think their successes are the result of their own skill rather than dumb luck."[38]

"One-third of low income workers in 401(k) plans accept the default investment option, which often has lower yields than other choices."

Problem: Getting Reliable Investment Advice. Surprisingly, a number of employees in 401(k) plans do not actually make an investment choice. For example, at least one-third of the lowest-paid employees depicted in Figure IV invest their funds in the "default" option, either by choosing it or by letting the employer choose for them. In these cases, the employees' investments are simply "defaulted" into a money market fund.[39] Why don't employers "default" employees into portfolios that make more sense for retirement planning? The answer is simply that due to the fear of lawsuits, employers invariably choose the most conservative investment alternative. For the same reason, most employers refrain from giving their employees investment advice.[40]

Many books have been written on investing; indeed, an entire industry exists to give investment advice. But in fact, the nonprofessional investor doesn't need to read books or pay broker fees in order to make wise, long-term investment decisions. A mountain of economic research points to the simple conclusion that the best and most prudent strategy for the nonprofessional is to invest in the market as a whole. And one of the simplest, most efficient ways to do that is through an "index fund."

Take the 15-year period ending on December 31, 2001. Fifteen years ago, an investment in the Vanguard 500 Index would have averaged an annual rate of return of 13.56 percent. This rate of return is considerably better than the average in all other types of mutual funds. It is almost a point and a half better than the average equity fund's return. *Dallas Morning News* financial columnist Scott Burns calls this the "couch potato" approach to investing. His investments consistently do better than the mutual funds managed by professional analysts.[41]

It is very hard to beat the market. In fact, most people who try to beat the market, including most professional fund managers, do worse than the market as a whole. So an unsophisticated investor willing to settle for whatever

return the market pays, will actually do very well over time. In fact, this untrained investor will do better than the vast majority of professionals!

For this reason, a simple change in the law would greatly improve the performance of the 401(k) plans for millions of Americans. The change would give employers a safe harbor against lawsuits if they:[42]

- Default employees who do not make an investment choice into an index fund or similar broadly diversified portfolio.
- Encourage employees who do make choices to make similar investments.

Problem: Tax Deferral May Not Always Be A Good Idea. Before turning to solutions, we need to pause and consider the results of another recent study by the NCPA.[43] Most people believe — and almost all investment advisers reinforce the belief — that deferring taxes through 401(k)s, IRAs and similar accounts will reduce their lifetime taxes. There are two reasons for this belief. First, tax deferral is like an interest-free loan. Instead of giving money to the government, the taxpayer is allowed to use it, invest it and pay the government much later in life. Second, most people expect that they will be in a lower tax bracket after they retire since their incomes will be lower. So tax deferral means shifting those payments from high tax bracket times (now) to lower ones (later, presumably in retirement).

"Tax-deferred accounts are not the best option for low- and moderate-income families, who face higher tax rates when they retire."

The problem is that the second of these assumptions is wrong for most low- and moderate-income families. Why? The Social Security benefits tax. In order to address the dire financial prospects of Social Security, Congress has enacted a tax on Social Security benefits. This tax is confusing and often misunderstood, but regularly surprises current Social Security beneficiaries and will reduce the amount of benefits paid to large numbers of future beneficiaries.

This is nominally a tax on Social Security benefits, but as a practical matter it turns out to be a tax on other income. For example, seniors pay taxes on 85 percent of their benefits if their other income exceeds $34,000 (singles) or $44,000 (couples). And during the retirement years "other income" will mean income from pensions and savings accounts. This means that for every dollar of income earned over the threshold, seniors must pay taxes on $1.85. A retiree who is in the 28 percent tax bracket, for example, is burdened with an effective marginal tax rate of 52 percent.

Today only about one-fifth of seniors pay the Social Security benefits tax. But the impact of this tax will grow over time because the tax thresholds are not indexed to inflation and eventually will be paid by virtually all young people during their retirement years.[44]

Indeed, most people who are currently in their twenties, earning less than $100,000 a year, will be in a higher tax bracket during their retirement

years than during their working years. Tax deferral in these cases means moving the payment of taxes from the time when they are in a lower tax bracket to a time when they are in a higher bracket. And the effect of being in a higher bracket during the retirement years can more than swamp the effects of the interest-free loan.

"Roth IRA funds can be withdrawn tax-free in retirement."

On the brighter side, researchers find that regardless of the amount invested, people almost always gain if they can invest through a Roth IRA.[45] Like a regular IRA, Roth IRAs allow tax-free growth. However, deposits to the Roth IRA are made with after-tax dollars and withdrawals are tax free. For most people, the Roth IRA allows taxes to be paid at the time of life when the taxpayers are in the lowest tax bracket.

The Bush Tax-Cut Bill. President Bush's 2001 tax cut bill addressed a number of these issues. The act gradually raises the allowable contribution to IRAs and Roth IRAs from $2,000 to $5,000 per person by 2008. This will narrow somewhat the arbitrary difference between the maximum allowed contribution to 401(k) and IRA accounts. The act also will allow employers to offer a 401(k) plan that is taxed like a Roth IRA, beginning in 2006. However, all these provisions are scheduled to disappear and the nation will revert to the old tax rules after 2010!

What Can Be Done?

Our retirement system is in desperate need of reform. These reforms will affect both men and women. But some of the needed reforms have special relevance for women, because women often take different roles in our economy:

- Accumulating retirement assets is more important to women than men because women live longer and are more likely to live alone during their retirement years.
- Because women switch jobs more frequently, they are more adversely affected by vesting periods than men.
- Because they are more likely to work part time, women are less likely to receive the benefits employers offer full time workers.
- Because they are more likely to invest in IRAs than employer-based retirement savings, arbitrary contribution limits adversely affect women more than men.
- Women are more likely than men to be adversely affected by a system that discourages employers from providing sound investment advice because they are more likely to need and take that advice.
- Because more women than men work for low to moderate wages, they have less access to the tax advantages of the Roth IRA.

The details of reform are less important than the goals. In general, a well-functioning retirement system that meets the needs of men and women, married and single, should strive to:

- Create retirement plans that are personal and portable, traveling with people as they move from job to job.
- Eliminate rules that arbitrarily punish people who work part-time, switch jobs frequently, or move in and out of the labor market.
- Eliminate arbitrary ceilings on retirement savings plan contributions that unfairly favor people in some industry sectors over others.
- Establish procedures that encourage people to invest wisely and prudently over the course of a work life.
- Establish a system for taxing retirement income that does not unfairly penalize people because of changes in their tax bracket over time.

"Details are less important than the goals of reform."

Some of the reforms contained in the Bush tax cut in 2001 are a step in the right direction. Much more needs to be done.

Celeste Colgan is a senior fellow with, and John Goodman is the president of, the National Center for Policy Analysis.

Notes

[1] B. Douglas Bernheim, Jonathan Skinner and Steven Weinberg, "What Accounts for the Variation in Retirement Wealth Among U.S. Households?" National Bureau of Economic Research, Working Paper No. W6227, October 1997. http://papers.nber.org/papers/W6227.

[2] Data for 2001. See Patrick J. Purcell, "Retirement Savings and Household Wealth: A Summary of Recent Data," Congressional Research Service, December 2003.

[3] Ibid.

[4] See Vickie Bajtelsmit, Alexandra Bernasek, and Nancy Jianakoplos, "Gender Differences in Defined Contribution Pension Decisions," *Financial Services Review*, Vol. 8 (1999), p. 5.

[5] Vickie Bajtelsmit, "Women as Retirees," *Women's Agenda: Ideas to Reform Institutions,* National Center for Policy Analysis, March 2002, pp. 75-98.

[6] C. Eugene Steuerle, "Divorce and Social Security," National Center for Policy Analysis, NCPA Brief Analysis No. 291, May 21, 1999.

[7] Internal Revenue Service, publication 590, "Individual Retirement Arrangements." The contribution limit is $3,500 for people age 50 and over.

[8] Bruce Bartlett, "The Case for Expanded IRAs," National Center for Policy Analysis, NCPA Brief Analysis No. 139, 1994; Alan Reynolds, "Should IRAs be Expanded?" NCPA Brief Analysis No. 340, September 2000. These and other studies show that decreased government revenues would be made up with expanded investments in the domestic economy.

[9] Steven F. Venti and David A. Wise, "Aging and Housing Equity: Another Look," NBER Working Paper No. 8608, November 2001. Retirees rarely cash out of their home equity to finance retirement; instead, most use the asset as a reserve for catastrophic circumstances.

[10] For a fuller discussion of Social Security and women, see Matt Moore, Anna Frederick and Adrienne Aldredge, "Social Security, Women and Working Families," Brief Analysis No. 466, February 19, 2004, National Center for Policy Analysis. http://www.ncpa.org/pub/ba/ba466/

[11] Survey conducted by the Luntz Research Companies/Mark A. Siegel and Associates for Third Millennium, September 1994. http://www.thirdmil.org/publications/surveys/surv7.html.

[12] www.mysocialsecurity.org is a Web site sponsored by NCPA. Here you may calculate your own Social Security benefit based on your age and earnings.

[13] See the discussion of this and other examples in Edward J. Harpham, "Private Pensions in Crisis: The Case for Radical Reform," National Center for Policy Analysis, NCPA Policy Report No. 115, January 1984.

[14] The law was the Employee Retirement Income Security Act (ERISA) of 1974.

[15] The existence of federal pension insurance does not guarantee all pension promises will be kept, because the PBGC sets a maximum amount it will pay to each retiree. For example, after Braniff filed for bankruptcy in 1982, retired teamsters receiving monthly pension checks of $665 saw their benefits reduced to $434. Retired machinists saw their monthly pension checks cut from $700 to $590. Harding Lawrence, former CEO of Braniff, was counting on a $306,000-a-year pension. Under the bail-out, his pension was reduced to $16,568 a year. See Harpham, "Private Pensions in Crisis," p. 7.

[16] However, at the time ERISA was passed it is doubtful that Congress anticipated the explosive growth of 401(k) plans. This is why Department of Labor analyst Richard Hinz calls the 401(k) the "accidental pension." See "A Matter of Definition," *The Economist*, February 16, 2002, p. 3.

[17] The counterpart of the 401(k) for nonprofit organizations, including colleges and universities, is the 403(b) plan. Employers may also establish a Savings Incentive Match Plan for Employees (SIMPLE). Self-employed individuals can take advantage of a Simplified Employee Pension (SEP) plan, or a Keogh Profit Sharing plan. According to some analysts, the new tax law also allows the self-employed to set up a "one-person 401(k) plan." See Karen Damato, "The One-Man Band Gets a 401(k) Gift: A Lucky Benefit For the Self-Employed," *Wall Street Journal*, August 17, 2001.

[18] Withdrawals without penalty may be made at age 59 1/2. Other than "hardship" withdrawals approved by an employer, withdrawals before age 59 1/2 are subject to a 15 percent penalty on top of normal income taxes.

[19] Unless the employee is over 50; then she may take advantage of a "catch-up" provision that allows her to shelter $14,000 for 2003.

[20] More than 48 million workers have accumulated more than $1.8 trillion in defined-contribution plans. See Abstract of 1997 Form 5500 Annual Reports, U.S. Department of Labor, Pension and Welfare Benefits Administration, "Private Pension Plan Bulletin," No. 10 (Winter 2001).

[21] "A Matter of Definition."

[22] Bajtelsmit, "Women as Retirees."

[23] Plans must have vesting standards no more stringent than one of two schedules: 100 percent vesting after 5 years of participation (with no vesting prior to that time), or vesting of 20 percent after 3 years of service and an additional 20 percent after each subsequent year of service until 100 percent vesting at the end of 7 years of service. See Employee Benefit Research Institute, *Fundamentals of Employee Benefit Programs,* 5th ed. (Washington, D.C.: EBRI, 1997), pp. 42-43.

[24] K. Ferguson and K. Blackwell, *The Pension Book: What You Need to Know to Prepare for Retirement* (New York, N.Y.: Arcade Publishing, 1995), pp. 37-47.

[25] Employer plus employee total annual contributions to a SEP-IRA (Simplified Employee Pension Plan) is limited to $40,000 per year, or 25 percent of the employee's compensation, whichever is less. The Economic Growth and Tax Relief Reconciliation Act of 2001 raised the previous $30,000 limit to $40,000 in 2002.

[26] Employee contributions to 401(k)s, 403(b) and other tax deferred accounts were limited to $12,000 in 2003. The Economic Growth and Tax Relief Reconciliation Act of 2001 incrementally raises the maximum annual individual contribution by $1,000 per year to $15,000 by 2007.

[27] In 2003, individuals who do not participate in an employer-sponsored plan could contribute $3,000 ($3,500 if age 50 and older) to an IRA. The Economic Growth and Tax Relief Reconciliation Act of 2001 incrementally raises the maximum contribution to $5,000 by 2008. While this limit will increase under current law, it is still only about a quarter of the contribution allowed to an employer-sponsored plan.

[28] Bajtelsmit and Bernasek, "Why Do Women Invest Differently Than Men?" *Financial Counseling and Planning*, Vol. 7, 1996, pp. 1-10.

[29] Bajtelsmit, "Women as Retirees."

[30] "Investment Relations: Defined-Benefits vs. 401(k)," Watson Wyatt Insider, September 1998.

[31] Brooks Hamilton and Scott Burns, "Reinventing Retirement Income," National Center for Policy Analysis, NCPA Policy Report No. 248, December 2001.

[32] Ibid.

[33] Brooks Hamilton, "Learning Our Lesson from Enron," *Washington Times*, February 2, 2002.

[34] Hamilton and Burns, "Reinventing Retirement Income," p. 12.

[35] For example, Vickie L. Bajtelsmit, "Conservative Pension Investing: How Much Difference Does It Make?" *Benefits Quarterly,* Vol. 12, No. 2, 1996, pp. 35-39.

[36] See the review of the literature in Vickie L. Bajtelsmit and Alexandra Bernasek, "Why Do Women Invest Differently Than Men?" *Financial Counseling and Planning*, Vol. 7, 1996, pp. 1-10; and in Bajtelsmit, "Women as Retirees."

[37] Brad Barber and Terrance Odean, "Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors," *Journal of Finance*, Vol. LV, No. 2, April 2000, pp. 773-806. http://faculty.haas.berkeley.edu/odean/papers/returns/returns.html

[38] Hal R. Varian, "Economic Scene: Investor Behavior Clouds the Wisdom of Offering Wider Choice in 401(k)s," *New York Times*, February 14, 2002.

[39] Hamilton and Burns, "Reinventing Retirement Income," p. 13.

[40] Only about a third of large, multisite corporations who are members of the Profit Sharing Council of America give investment counseling to employees, usually through online resources. Half of all members provide such advice, up from 35.2 percent in 2000. Source: David Wray, President, Profit Sharing Council of America.

[41] See for example, Scott Burns "Go Index Funds for the Long Term," *Dallas Morning News*, February 12, 2002.

[42] See the discussion in Hamilton and Burns, "Reinventing Retirement Income," pp. 17-19. Hamilton and Burns also discourage preretirement, lump sum distributions. A 1988 *Current Population Survey* found that women were 40 percent more likely than men to receive such a payment. Only half of each group rolled the payment over into another savings or retirement plan. See also Bajtelsmit and Berask, "Why Do Women Invest Differently Than Men?" p. 5.

[43] Jagadeesh Gokhale and Laurence J. Kotlikoff, "Tax-Favored Savings Accounts: Who Gains? Who Loses?" National Center for Policy Analysis, NCPA Policy Report No. 249, January 2002.

[44] For the explanation of the Social Security benefits tax and how it affects marginal tax rates, see Stephen J. Entin, "Reducing the Social Security Benefits Tax," National Center for Policy Analysis, NCPA Brief Analysis No. 332, August 2000.

[45] Gokhale and Kotlikoff, "Tax-Favored Savings Accounts."

About the NCPA

The NCPA was established in 1983 as a nonprofit, nonpartisan public policy research institute. Its mission is to seek innovative private sector solutions to public policy problems.

The center is probably best known for developing the concept of Medical Savings Accounts (MSAs). The *Wall Street Journal* called NCPA President John C. Goodman "the father of Medical Savings Accounts." Sen. Phil Gramm said MSAs are "the only original idea in health policy in more than a decade." Congress approved a pilot MSA program for small businesses and the self-employed in 1996 and voted in 1997 to allow Medicare beneficiaries to have MSAs. And a June 2002 IRS ruling frees the private sector to have a flexible medical savings account and even personal and portable insurance. A series of NCPA publications and briefings for members of Congress and the White House staff helped lead to this important ruling.

The NCPA also outlined the concept of using tax credits to encourage private health insurance. The NCPA helped formulate a bipartisan proposal in both the Senate and the House, and Dr. Goodman testified before the House Ways and Means Committee on its benefits. Dr. Goodman also helped develop a similar plan for then presidential candidate George W. Bush.

The NCPA shaped the pro-growth approach to tax policy during the 1990s. A package of tax cuts, designed by the NCPA and the U.S. Chamber of Commerce in 1991, became the core of the Contract With America in 1994. Three of the five proposals (capital gains tax cut, Roth IRA and eliminating the Social Security earnings penalty) became law. A fourth proposal — rolling back the tax on Social Security benefits — passed the House of Representatives last summer.

The NCPA's proposal for an across-the-board tax cut became the focal point of the pro-growth approach to tax cuts and the centerpiece of President Bush's tax cut proposal. The repeal by Congress of the death tax and marriage penalty in the 2001 tax cut bill reflects the continued work of the NCPA.

Entitlement reform is another important area. With a grant from the NCPA, economists at Texas A&M University developed a model to evaluate the future of Social Security and Medicare. This work is under the direction of Texas A&M Professor Thomas R. Saving, who was appointed a Social Security and Medicare trustee. Our online Social Security calculator (www.mysocialsecurity.org) allows visitors to discover their expected taxes and benefits and how much they would have accumulated had their taxes been invested privately.

An innovative nationwide volunteer campaign called Team NCPA (www.teamncpa.org) is under way to raise awareness of the problems with the current Social Security system and the benefits of personal retirement accounts. Former Sen. Daniel Patrick Moynihan (D-N.Y.), speaking at an NCPA Sumners Lecture, said that there is no serious proposal anywhere in the United States that would cut benefits for current retirees.

In the 1980s, the NCPA was the first public policy institute to publish a report card on public schools, based on results of student achievement exams. We also measured the efficiency of Texas school districts. Subsequently, the NCPA pioneered the concept of education tax credits to promote competition and choice through the tax system. To bring the best ideas on school choice to the forefront, the NCPA

and Children First America published an Education Agenda for the new administration, policy makers, congressional staffs and the media. This book provides policy makers with a road map for comprehensive reform. And a June 2002 Supreme Court ruling upheld a school voucher program in Cleveland, an idea the NCPA has endorsed and promoted for years.

The NCPA's Environmental Center works closely with other think tanks to provide commonsense alternatives to extreme positions that frequently dominate environmental policy debates. A pathbreaking 2001 NCPA study showed that the costs of the Kyoto agreement to halt global warming would far exceed any benefits. The NCPA's work helped the administration realize that the treaty would be bad for America, and it has withdrawn from the treaty.

NCPA studies, ideas and experts are quoted frequently in news stories nationwide. Columns written by NCPA scholars appear regularly in national publications such as the *Wall Street Journal*, the *Washington Times*, *USA Today* and many other major-market daily newspapers, radio talk shows, television public affairs programs and public policy newsletters. According to media figures from Burelle's, nearly 3 million people daily read or hear about NCPA ideas and activities somewhere in the United States.

The NCPA Internet site (www.ncpa.org) links visitors to the best available information, including studies produced by think tanks all over the world. Britannica.com named the NCPA Web site one of the best on the Internet when reviewed for quality, accuracy of content, presentation and usability. NCPA Web sites average 4 million hits per month.

What Others Say about the NCPA

"...influencing the national debate with studies, reports and seminars."

- TIME

"Increasingly influential."

- EVANS AND NOVAK

"I don't know of any organization in America that produces better ideas with less money than the NCPA."

- SEN. PHIL GRAMM

"Oftentimes during policy debates among staff, a smart young staffer will step up and say, 'I got this piece of evidence from the NCPA.' It adds intellectual thought to help shape public policy in the state of Texas."

- FORMER TEXAS GOV. (NOW PRESIDENT) GEORGE W. BUSH

The NCPA is a 501(c)(3) nonprofit public policy organization. We depend entirely on the financial support of individuals, corporations and foundations that believe in private sector solutions to public policy problems. You can contribute to our effort by mailing your donation to our Dallas headquarters or logging on to our Web site at www.ncpa.org and clicking "An Invitation to Support Us."

ISBN #1-56808-134-0