NATIONAL CENTER FOR POLICY ANALYSIS

Ten Ways to Wreck Your Retirement

Policy Report No. 320 by Pamela Villarreal March 2009

Personal retirement accounts are a valuable tool in building a retirement nest egg. The recent fall in the stock market has caused some savers to cash out their savings. This is unfortunate because the stock market has rebounded after every fall, and those who are not in the market at the bottom will lose out as it rises. There are other practices that can derail even the best laid retirement plans. This study addresses 10 of them.

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Executive Summary

1. **Don't Make Saving a Habit**. Young workers may think they have plenty of time to save later, but setting aside a little bit of money on a regular basis throughout one's working years produces a greater nest egg than setting aside a large amount later on.

2. **Leave Matching Funds on the Table**. Not taking advantage of an employer's matching contributions to a 401(k) account is like turning down a raise. An employee who turns down a dollar-for-dollar 401(k) account match of up to 5 percent of his salary is passing up a 5 percent bonus paid with untaxed dollars.

3. **Borrow against 401(k) Savings**. This is a surefire way to set back one's retirement plan by thousands of dollars through lost compound interest. A $25,000 loan today can cost more than $175,000 in lost retirement interest income over 30 years!

4. **Cash Out 401(k) Savings**. Cashing out a 401(k) account when changing jobs means that more than one-third of the balance can be eaten up in taxes and penalties.

5. **Jump In and Out of the Market**. In 2008, 401(k) plans lost an estimated $2 trillion in value. But this "loss" would have been on paper only, were it not for the fact that many workers essentially locked in their losses by selling their equity funds during the recent downturn.

6. **Rely on Home Equity**. Purchasing a home and selling it years down the road does not always produce a significant profit on which

to retire. Even before the housing bubble burst, the average home was a mediocre investment. One dollar invested in stocks in 1963 would have grown to $12.36 by 2006, while the same dollar invested in a house would have grown to only $1.79.

7. **Do Not Diversify Savings**. Relying on one type of investment is a recipe for disaster. It is important to consider diversifying among asset types (stocks, bonds, money market funds), as well as diversifying within each type of asset (rather than holding one stock or bond).

8. **Underestimate Longevity**. More people are living longer. This means that retirees should have strategies to ensure they don't outlive their money, including working past retirement age, annuitizing retirement account money, and staying at least partially invested in stocks.

9. **Ignore Inflation**. When a household's income, combined with half of their annual Social Security benefits, exceeds a certain threshold, a portion of their Social Security benefits are subject to federal income taxes. The thresholds are not indexed. Over time, inflation pushes more and more retirees into the income range where they must add 50 cents of benefits to their taxable income for every dollar their income exceeds the threshold. This means their marginal tax rate will be 50 percent higher!

10. **Stay in Debt**. Entering retirement debt-free is essential to being able to maintain a comfortable standard of living.

About the Author

Pamela Villarreal is a senior policy analyst with the National Center for Policy Analysis. Villarreal is an expert on retirement, Social Security, economic growth and tax issues and has authored studies and analyses on specific topics, including the danger of 401(k) borrowing, Social Security disability, the expiration of tax cuts and the future of Social Security and Medicare.

Introduction

People have a great deal of control over whether their retirement will be comfortable or straitened. Millions of Americans are preparing for retirement by saving in tax-favored retirement accounts — principally Individual Retirement Accounts (IRAs) and employer-sponsored 401(k) plans. But savers must be aware of common practices that can derail even the best-laid retirement plans. In fact, there are 10 surefire ways people can wreck their retirement.

1. Don't Make Saving a Habit

Over the next 23 years, 78 million baby boomers will retire. Many are concerned that they will not have enough retirement income to avoid a fall in their living standards upon retirement. However, many baby boomers are depending on Social Security as the primary source of retirement income — and even high-income workers expect the program to provide 30 percent or more. This is a mistake because Social Security is designed to replace only a fraction of preretirement income [see the sidebar, "Americans' Dependence on Social Security"].

> *"Saving a small amount regularly when young is easier than catching up in middle age."*

Unless individuals save, they will likely experience a decline in their living standards upon retirement. But many workers wait until they are middle aged to start saving for retirement. In 2005, according to the Employee Benefits Research Institute [see Figure I]:[3]

- Less than one-quarter (23 percent) of 35- to 44-year-olds owned an IRA, and 37.2 percent participated in a 401(k)-type plan.
- Among workers ages 45 to 54, 28.5 percent owned an IRA, and 38.8 percent participated in a 401(k)-type plan.
- Among baby boomers 55 to 64, 32.6 percent owned an IRA and 22.3 percent participated in a 401(k) plan.

But, are the children and grandchildren of baby boomers doing enough now to prepare for retirement? No.

- Among workers ages 21 to 24, only 3.2 percent owned IRAs while 9.3 percent participated in a 401(k) plan.

Americans' Dependence on Social Security

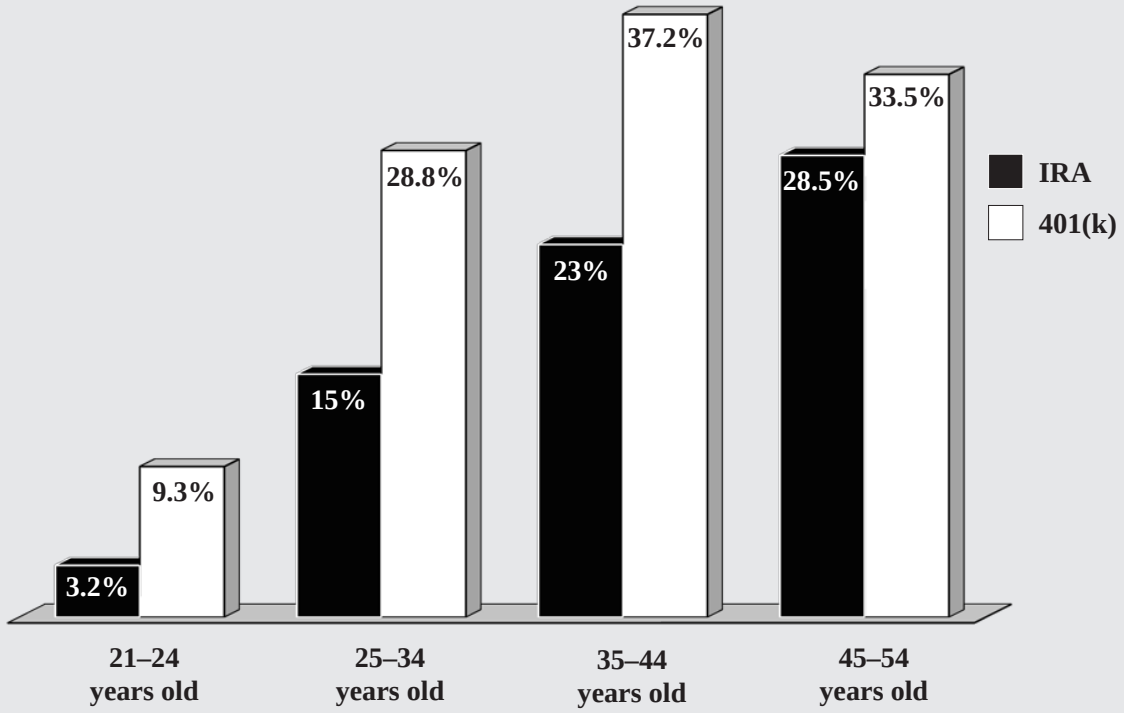
Today, it is unlikely that any nonretired person who watches TV, reads a newspaper or has an elderly parent, truly believes that Social Security income will allow them to maintain their standard of living at retirement without need for *any* additional saving. Sadly, many people will retire, having paid payroll taxes year after year but putting little or nothing away into retirement savings. According to the Social Security Administration:[1]

- Sixty-four percent of current retirees depend on Social Security for half or more of their income.
- One-third of beneficiaries rely on Social Security for 90 percent or more of their retirement income.
- One-in-five rely on Social Security benefits for all of their retirement income.

It is unlikely that benefits will be cut for current retirees. But according to the Social Security Trustees Report, the current unfunded liability of the system is $15.8 trillion (not including Medicare). Bringing Social Security into actuarial balance today would require an immediate benefit cut of 20 percent.[2] As time passes, the unfunded liabilities of the system grow, making future tax increases and/or benefit cuts more likely.

FIGURE I

Worker Participation Rates in Retirement Plans (2005)



Source: "Ownership of Individual Retirement Accounts (IRAs) and 401(k)-Type Plans," *Notes*, Employee Benefit Research Institute, Vol. 29, No. 5, May 2008.

- Among workers 25 to 34, 15 percent owned an IRA and 28.8 percent participated in a 401(k) plan.

Delay Is Costly. Under current law, today's 25-year-old will not be eligible for full Social Security benefits until age 67. It is easy to put off saving for retirement because there is "plenty of time," but procrastination can significantly reduce potential retirement savings. A 25-year-old who waits 10 years to save is forgoing a decade's worth of interest compounding. Regularly setting aside a little bit of money early in one's career produces a greater nest egg than setting aside a large amount later on.

For instance [see Table I]:

- A 25-year-old who puts away $100 a month for 40 years at a 7 percent nominal interest rate will have more than $260,000 by age 65.

- However, if the employee waits until age 45, doubling his contributions to $200 a month will yield a balance of only $104,000 by age 65.

Furthermore, saving consistently is just as important as saving early. It is tempting to stop or reduce contributions to a retirement account when the market is down. But contributing a fixed amount of money on a regular basis to a particular fund (called dollar-cost averaging), is important in order to maximize long-term returns. When the market is up, a regular contribution will purchase fewer shares. But, when stocks and fund prices are low, an employee's contributions will purchase more shares.

Policies That Help: New Default Options. Making the decision to start saving, selecting a fund and choosing a level of contributions requires effort, whereas making no decision requires no effort. Thus, when required to choose to opt into retirement savings plans, many people choose not to make any choice. People make better choices when options are designed to make it easier for them to do so.[4] The federal Pension Protection Act of 2006 allows company-sponsored 401(k) plans to automatically enroll employees in 401(k) plans.[5] In companies that offer automatic enrollment, 90 percent of employees participate, compared to only 68 percent participation in plans where employees must choose to participate.[6]

Furthermore, the new law allows 401(k) plans with automatic enroll-

ment to put employees' contributions into a default fund, typically a mix of stocks and bonds, unless they choose another plan or opt out. Employers also have what is called a safe harbor — legal protection from liability for the outcomes of employees' investments, even if they are enrolled in the default option. Additionally:[7]

- Under the default option, the employer sets the minimum employee contribution for the first year at 3 percent or more of pay, not to exceed 10 percent.
- The minimum contribution increases to 4 percent of earnings the second year, 5 percent the third year and 6 percent in the fourth year.
- The plan sponsor is required to match, dollar for dollar, the first 1 percent of pay contributed by each employee, and match 50 cents per dollar of additional contributions up to 6 percent of each employee's pay.[8]

Thereafter, under plans with a default option, when employees receive raises, the dollar amount of their contributions (and the employer's match) increase to maintain the same savings rate. Employees can opt out at any time.

Results of Automatic Enrollment. The new pension act has encouraged an increasing number of companies to adopt auto-enrollment. According to data from the mutual fund giant Fidelity Investments:[9]

- Overall, 16 percent of companies with 401(k) plans adopted auto-enrollment in 2008, up from just 2 percent in 2006.

Retirement Savings Accounts

There are many ways to save for retirement, including traditional savings and money market accounts. However, the best way to save for retirement is through savings plans that offer specific tax advantages, such as 401(k)s and Individual Retirement Accounts (IRAs). Regular 401(k)s and IRAs allow individuals with wage income to set aside pretax dollars in savings and investments which are withdrawn and taxed during retirement. Roth IRAs and Roth 401(k)s, on the other hand, allow individuals to set aside and invest after-tax dollars that are withdrawn tax-free during retirement.

While all of these plans offer tax incentives for savings, there are some significant differences among them:

- Whereas 401(k) plans are available only through employers, IRA accounts are opened by individuals.
- The limit on 401(k) contributions is $16,500 for 2009, with a "catch up" contribution of an additional $5,500 for those age 50 and older.
- IRAs have a maximum contribution limit of $5,000 ($6,000 for age 50 and older).
- There are no income limits on individuals who are eligible to contribute to a 401(k); however, there are limits on IRA contributions.

Additionally, a tax-deductible spousal IRA can be established for a marriage partner who is out of the workforce or whose employer does not offer a retirement plan, provided the amount contributed is no greater than the couple's wage income.

Roth accounts have annual contribution limits similar to regular accounts — $5,000 for Roth IRAs, and $16,500 for Roth 401(k)s. However, the accumulated after-tax contributions and interest in Roth accounts can be withdrawn tax-free at retirement. Furthermore, there is no age limit at which an individual must stop contributing to a Roth account, and there is no mandatory withdrawal age for Roths, whereas seniors must begin withdrawing funds from their regular accounts at age 70-and-one-half.[10] [See the discussion on mandatory withdraws under "Understimate Longevity."]

TABLE I

Saving while Young versus Waiting for Middle Age*

If you contribute this much per month starting at age 25	You will have this much at age 65	If you contribute this much per month starting at age 45	You will have this much at age 65
$50	$131,204	$100	$51,995
$100	$262,395	$200	$103,988
$200	$524,776	$400	$207,973
$300	$787,157	$600	$311,958

*Assuming a 7 percent nominal rate of return.

Source: Author's calculations using EconEdLink Compound Interest Calculator.

- Nearly half of 401(k) plan participants (47 percent) are in a plan that offers auto-enrollment.
- Three-fourths of company plans (74 percent) that offer auto-enrollment also offer plans that automatically increase employees' annual contributions as their pay rises, but only 5.5 percent of participants are enrolled.

Recommended Improvements. Employees of firms that do not offer 401(k)s, and the self-employed, can establish IRAs. [See the sidebar, "Retirement Savings Accounts."] However, the current annual limit of $5,000 on IRA contributions is less than one-third the limit for 401(k)s. Federal rules should be changed so that the tax advantages and contribution limits of IRAs are the same as 401(k)s.

2. Leave Matching Funds on the Table

In the past, many employees received a defined benefit pension from their employer or union that provided a monthly retirement income based on salary and years of service. However, defined benefit plans now cover only 20 percent of private-sector employees — just half the rate of three decades ago.[11] To the extent these plans are funded on a pay-as-you-go basis — requiring periodic contributions from the company or union — the benefits they promise depend on the continued solvency of the firm or industry. Many of these plans are underfunded and some have been terminated, with employees receiving only a fraction of the benefits promised.[12]

Pensions have been largely replaced by defined contribution plans — 401(k)s. But employers have not taken a complete "hands off" approach to retirement funding. Sixty-nine percent of employers match 401(k) contributions, up to a specified percentage of employees' pay.[13]

Unfortunately, many employees are not saving the maximum amount matched by their employers.[14] This is a missed opportunity. A match is part of an employee's implicit salary. For example, an employee earning $50,000 a year who is eligible for a dollar-for-dollar match of up to 5 percent of salary could receive $52,500 in compensation by contributing the maximum amount eligible for the match. Additionally, both the employee and employer contributions are tax deferred. Thus, for example, an employee who is single would save $750 in current taxes.[15]

Policies That Help. The 2006 pension law allowing employers to automatically enroll employees in 401(k) plans (described in the previous section) may help individuals realize the value of employer matching contributions.

For savers who do not have access to 401(k)s or an employer-provided match, America's best-

kept tax secret is the Saver's Credit. This little-known tax break for lower-income and middle-income households provides a federal income tax credit of up to 50 percent their contributions to a retirement account.[16] The maximum amount of the credit is $2,000 per household, and the percentage of the contribution matched by the credit depends on household income.[17] In 2007, the Internal Revenue Service began increasing the income limit on the Saver's Credit by $500 annually. For those who are 18 or older, not a dependent on someone else's tax return and not a full-time student, this can be a substantial incentive to save. For instance:

TABLE II

Loss Over Time from Borrowing against a 401(k) Plan

401(k) Account Balance Before Loan	Monthly Contribution (Before Loan)	Average Rate of Return on 401(k) Account (nominal)	Amount of Loan (Payoff Period 5 years)	Interest Rate on Loan	Total Amount Lost after 30 Years
$10,000	$100	7 percent	$5,000	5 percent	($35,479)
$20,000	$200	7 percent	$10,000	5 percent	($70,957)
$30,000	$300	7 percent	$15,000	5 percent	($106,436)
$40,000	$400	7 percent	$20,000	5 percent	($141,914)
$50,000	$500	7 percent	$25,000	5 percent	($177,392)

Source: Author's calculations using the NCPA 401(k) borrowing calculator, available at http://www.retirementreform.org/401kcalculator/d401kwa1_1.php.

- A married household filing jointly with an adjusted gross income of less than $31,000 would receive $2,000 for contributing $4,000 to an IRA.

- A single filer with an adjusted gross income of less than $15,500 would receive $1,000 for contributing $4,000 to an IRA.

As with a 401(k) employer match, not taking advantage of the Saver's Credit is like turning down a wage increase. But unlike employer matching, the credit amount is returned to the tax filer as a refund, and there is no requirement that it be contributed to the retirement account. Most tax filers who receive the credit simply spend it. This is unfortunate, because the credit could made a substantial difference in their retirement savings.

> *"The Saver's Credit matches up to 50 percent of a lower income worker's savings."*

Suppose, for instance, a single individual with an income of $15,000 a year puts 10 percent ($1,500) into a traditional IRA. He is eligible for the full 50 percent match of the Saver's Credit, thus saving $750 a year in taxes. If he qualifies for the credit for a full 5 years, and contributes the credit to his retirement account:

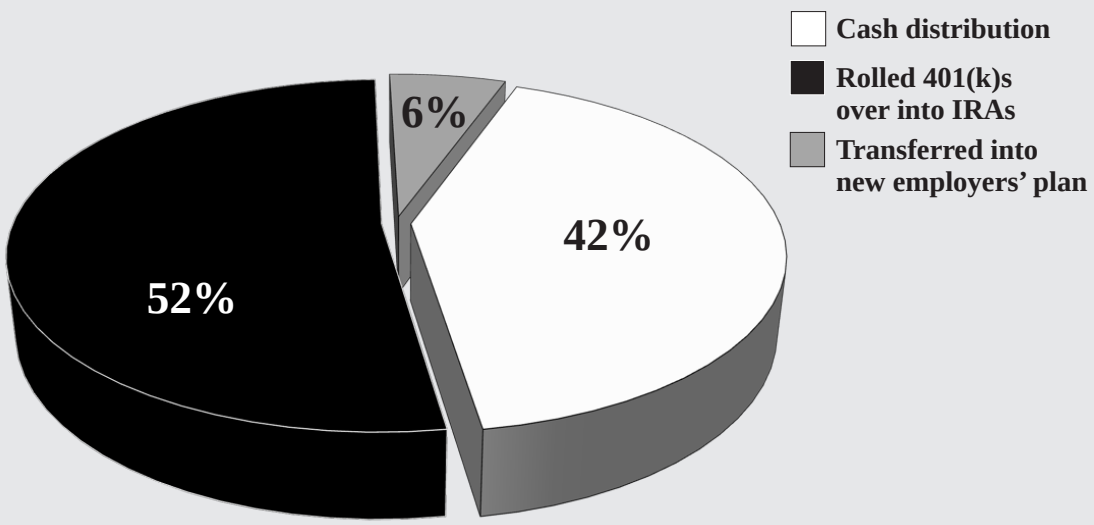
- With the Saver's Credit and a 7 percent nominal rate of return, he would have about $13,000 in his IRA.

- Without the credit, he would have only $8,900.

Recommended Improvements. The Saver's Credit can only be used against a positive tax liability, and most low-income earners pay little or no income tax. President Obama

FIGURE II

What Happens to Employees' 401(k)s When They Leave Their Jobs?



Source: "Hewitt Data Shows U.S. Employees Cash Out of 401k Plans When Changing Jobs," Business Wire, November 2003.

has proposed making the Saver's Credit refundable so that even if a qualified household owes no income taxes, they can still receive up to $1,000 for saving in a qualified retirement plan. In any event, the connection between the credit and savings should be strengthened by requiring individuals receiving the credit to deposit the money in a retirement account.

3. Borrow against 401(k) Savings

About 85 percent of 401(k) plans allow employees to borrow against their account balances. An increasing number of account-holders are exercising this option as their balances rise. But many employees do not realize how much retirement savings they forgo when they borrow from their 401(k).

How Borrowing against a 401(k) Works. Borrowing provisions vary among plans. Many allow participants to borrow for almost any reason, whether to pay off credit card debt or make a home down-payment. Plans with loan provisions generally allow an employee to borrow up to half of a vested account balance, but not more than $50,000. Federal law requires that the borrower be charged a "reasonable rate" of interest, which is normally fixed at the prime rate (what banks offer their best customers) plus 1 percentage point. In addition, some plan administrators charge a small fee. The loan must be repaid within five years, or 15 years if it is for a first-time home purchase.

The Opportunity Cost of Borrowing. The problem with a 401(k) loan is the loss of compound interest and dividends that would have accrued if the money had not been borrowed. Moreover, the interest paid back to the account is unlikely to equal the interest earned by 401(k) investments.

Consider what happens when an employee who is 30 years from retirement borrows from his 401(k) account and pays the loan back in five years. Assuming the loan interest rate is 5 percent and the rate of return on the account is 7 percent, as Table II shows:[18]

- An employee who contributes $100 a month and borrows $5,000 will lose more than $35,000 in contributions and accrued interest over 30 years.
- An employee who contributes $300 a month and borrows half of his $30,000 account balance ($15,000) will lose about $106,000 over 30 years.

- Finally, an employee with an account balance of $50,000 who contributes $500 a month and borrows $25,000 will lose approximately $177,000 over 30 years!

Another way to think of this loss is in terms of how much less a retiree would receive in a monthly annuity. An employee with a $50,000 account balance who borrows $25,000 at least 30 years prior to retirement would lose more than $950 a month in retirement income — for the rest of his life!

Penalties for Default. In addition to the opportunity cost of borrowing, the consequences of defaulting on a 401(k) loan can be severe:

> *"Borrowing half of a $50,000 balance can reduce one's retirement income by more than $950 a month 30 years later."*

- If the borrower fails to repay the loan, the entire principal amount will be subject to both federal and state income taxes.
- If the borrower is younger than 59-and-one-half years, the defaulted loan is counted as an early withdrawal, subjecting the borrower to a 10 percent penalty on the principal amount.
- If the borrower quits working or changes jobs, the remaining loan balance must be paid back quickly (usually within 60 to 90 days) or the loan is considered to be in default.

Furthermore, while the loan itself is not taxed, payments on the loan are deducted from the employee's paycheck after taxes. Thus, an

Reverse Mortgages

Reverse mortgages are a relatively new type of financial instrument governed by federal law. They are sold by private lenders and allow people age 62 and older to access the equity in their homes in the form of a monthly payment, lump sum or line of credit. Unlike a home equity loan, which requires monthly payments, reverse mortgages are not paid back until the borrower either sells the home or moves out.[30] There are many advantages to a reverse mortgage:

- Unlike a home equity loan, which requires the borrower to have a certain debt-equity ratio, any homeowner can obtain a reverse mortgage.
- A homeowner can qualify regardless of income.
- There is no income tax on the amount borrowed.
- The money can be used for any financial need, and if it is used, for instance, to pay the nursing home expenses of one spouse, the other spouse can live in the home for the rest of his or her life.
- Once the borrower dies or moves out, the amount owed on a reverse mortgage cannot be greater than the value of the home — even if the house has depreciated in value.

The downside is that the borrower's heirs do not inherit the house, even if the balance on the reverse mortgage is less than the value of the home.

The minimum age at which one can obtain a reverse mortgage is 62; however, the older the borrower, the greater the percentage of equity that can be borrowed. This is based on the assumption that older borrowers will die before they exhaust all the equity in their homes. For instance, a 75-year-old can borrow up to 70 percent of the home's appraised value, and an 85-year-old can borrow up to 80 percent of a home's appraised value.[31]

employee must use a greater portion of his income to repay a loan than if the same amount of money were contributed to a tax-deferred account. For example, someone in the 15 percent tax bracket would need to earn about $12,265 in pretax dollars to pay off a $10,000 loan, not including interest and administrative fees. Often the high cost of repaying a loan will cause the employee to stop making regular 401(k) contributions. Some plans do not allow tax-deferred contributions to the 401(k) until the loan is repaid.

The option of borrowing against a 401(k) is attractive; however, potential borrowers should be wary. A small loan now can equal a huge loss in future retirement security.

4. Cash Out 401(k) Savings

In today's rapidly changing economy, very few employees remain with the same company for decades. Unfortunately, most job benefits, such as health insurance, are not portable. However, employees can keep their 401(k) accounts, and any of the company's matching funds that have vested (meaning an employee has a right to the contribution, typically after a period of two years or more).[19] What happens to these funds when employees leave jobs? According to a 2003 survey by Hewitt and Associates:[20]

- When employees with 401(k) accounts changed jobs, 42 percent cashed them out, instead of rolling the balance over into an IRA or a new 401(k). [See Figure II.]
- The largest percentage of cash-outs occurred among employees in their 20s.
- Furthermore, those who were most likely to cash out had balances of less than $5,000.

Cashing out a $5,000 balance may seem trivial, except that it is subject to a 10 percent penalty ($500) and a federal income tax of up to 33 percent if the employee is younger than 59-and-one-half years old.

> *"Cash distributions of 401(k) funds before retirement are penalized heavily."*

The Cost of Cashing Out a 401(k). Cashing out a retirement account is costly. Consider a 25-year-old single male employee with no children earning $32,000 a year.[21] He has a $20,000 401(k) balance. If he leaves his job and does not roll the account into a qualified retirement plan, such as an IRA, he will pay roughly $6,500 in taxes and penalties to receive the distribution.[22]

It is worse for older employees, who are likely in a higher income tax bracket. Consider a 50-year-old married female employee whose combined household income is $200,000 a year. When she leaves her job, her 401(k) account balance is $100,000. Assuming she is in the 33 percent tax bracket, taking a distribution will cost her more than $40,000 in taxes and penalties.

It is tempting to spend rather than roll over a 401(k) into an IRA when leaving a job, especially if an employee has debts to pay. But it is important to consider other options before taking the distribution. If the employee converts a 401(k) into an IRA and finds later he needs the money for an emergency, federal tax law allows "hardship withdrawals," as defined by the IRS, for the following:[23]

- Medical bills that exceed 7.5 percent of an employee's income.
- Costs relating to the purchase of a primary residence.
- Costs relating to secondary education (tuition, room, board) for the employee, spouse or a dependent.
- Costs that prevent the eviction of an employee from his primary residence, or foreclosure on the primary residence.

Even in the above cases, however, taxes and a 10 percent penalty still apply.

Policies That Help. When an employee leaves a job, a provision of the Economic Growth and Tax Relief Reconciliation Act of 2001 mandates automatic rollover of his 401(k) account into an IRA if the

balance is $1,000 to $5,000. It does not mandate automatic rollovers for account balances smaller than $1,000 or larger than $5,000. The range was based on evidence showing that employees with small plan balances are most likely to take cash distributions. The account balance can be left in the employer's plan if the plan was set up to allow it. The employee has to request a distribution of the funds.[24]

Recommended Improvements. Balances in 401(k)s have grown tremendously. The average size of 401(k) accounts increased from $37,323 in 1996 to $61,346 in 2006. For workers in their 20s, the average account balance ranges from $4,491 to $18,564, depending upon the number of years they have worked for the same employer.[25] Raising the limit on account balances that are automatically rolled over to $20,000 would reflect the average balances of employees in their 20s (those who are most likely to cash out their retirement plans) and ensure that more employees are covered by the default option.

5. Jump In and Out of the Market

Due to the stock market decline beginning in 2008, many retirement savers jumped out of their equity funds and moved to safer investments. Reportedly, 401(k) plans lost about $2 trillion. But this "loss" would have been on paper only, were it not for the fact that many workers essentially locked in their losses by selling their equity funds after stock prices fell.

Long-Term Rate of Return on Stocks. Savers abandon stock funds during downturns mainly out of panic, or because they become impatient waiting for upturns. But time is on the side of savers, especially the young. Consider:[26]

- Averaged annual returns for Standard & Poor's Index of the 500 largest publicly-traded companies, the S&P 500, reached a 20-year low of –36.58 percent in 2008.
- Despite this low, for the 20-year period as a whole (1988 to 2008), the S&P 500 still averaged an annual return of 10.61 percent, after adjusting for inflation.

Even older savers who are 5 or 10 years away from retirement will experience significant losses through panicked decision-making. If investing in new funds helps a saver sleep at night, it is much better to do so with new savings contributions.

Pitfalls of Trying to Time the Market. There are many strategies for "timing the market," that is, selling stocks and buying bonds, or vice versa, in order to maximize one's rate of return (or prevent losses). One way is to use a moving market average to determine the best time to be invested in stocks or cash.[27] Of course, these strategies are used more when purchasing stocks directly, as opposed to purchasing a bundle of stocks in the form of an equity fund.

Unfortunately, people tend to take their money out of stocks after the value has declined, and put money in the market after stock prices have been bid up. Similarly, they invest in money market funds after interest rates have declined, rather than when interest rates are rising. Thus, it is possible to make the wrong decision multiple times, putting money into the market at the wrong time and taking it out at the wrong time. This can result in negative returns.

> *"Over the last 20 years, including 2008, the inflation-adjusted return on the S&P 500 stock index averaged 10.61 percent annually."*

For their basic retirement funds, however, experts say that rather than attempt to time the market, those saving for retirement should buy and hold. Index funds are considered safer long-term investments because they guarantee average market returns. Over any 5- or 10-year period between 1963 and 2005, the market has averaged nearly 6 percent, after adjusting for inflation.[28]

6. Rely on Home Equity

In an ideal world, a couple purchases their first home when they are young, trades up to a larger home as their income rises, uses

their working years to pay off their mortgage and then downsizes to a smaller home when they retire and the kids are gone. Ostensibly, selling the large home and using its appreciated value to live on will get them through their retirement years. However, this is not necessarily the case.

Home equity is unlike other, more liquid investments, which makes it problematic as a source of retirement income. Selling a home requires more time, cost and effort than selling bonds, stocks or mutual funds. Moreover, the housing market does not fluctuate as quickly as the stock market. So retirees who wish to downsize during a housing slump may end up waiting months or even years to sell their house at a profit.

Finally, the rate of return on housing is often overrated. Consider returns on home equity compared to other investments. According to Fidelity Research Institute:[29]

- From 1963 to 2005, stocks and bonds outperformed the appreciation in home values during every 5- and 10-year period.
- During this time, stocks averaged a real rate of return of 5.95 percent, compared to 1.35 percent on home values.
- Simply put, one dollar invested in stocks in 1963 would have grown to $12.36 by 2006, while the same dollar invested in realty would have grown to only $1.79.

Nonetheless, 20 percent of people 55 to 75 years of age plan to use their home equity to finance their retirement. Of those that have accessed the equity in their home, 8 percent have done so with a reverse mortgage [see the sidebar, "Reverse Mortgages]. But the recent drop in

Double-Dipping Social Security[39]

A Social Security provision allows retirees who have been receiving benefits to withdraw their application for benefits and then reapply for a higher level of benefits. An individual can file Form 521 (Request for Withdrawal of Application) to:

- Repay the Social Security retirement benefits received with no interest charged;
- Claim an income tax credit for past Social Security benefit taxes paid; or
- Deduct the amount of the benefits that have been taxed from taxable income (if itemizing).

Consider retirees Peter and Kate, both of whom are now 70. Peter and Kate claimed their Social Security benefits at age 62 and are now each receiving a reduced benefit of $13,250 each year (in 2008 dollars). Had they waited until their normal retirement age (65 in their case) to collect benefits, Peter and Kate would now each receive $18,928 a year. Had they waited until age 70 (this year) to apply, their benefit this year would have been $20,693, thanks to the delayed benefit credit.

Peter and Kate now have a choice. They can choose to pay back the Social Security benefits they have received over the past eight years. In return they will each receive the much higher benefit for the rest of their lives. If they take this option:

- Each would repay $94,556 to Social Security.
- They would then each begin receiving $20,693 a year — the same as if they had waited until age 70 to begin receiving benefits.

As a result they would have approximately 56 percent more in real Social Security benefits every year for the rest of their lives.

home prices and rise in foreclosures shows that even home values aren't safe from cyclical ups and downs.

7. Do Not Diversify Savings

There are two ways to diversify retirement savings: among asset types and within asset classes.

Diversifying among Assets. Putting money into a variety of lower-risk and higher-risk, higher-return assets is an ideal way to get a solid rate of return while cushioning against market volatility. Playing it safe and investing completely in bonds may help risk-averse investors sleep at night, but the low rate of return may be quite surprising when it comes time to cash in retirement savings. Conversely, a total allocation in stocks may cause an investor to panic during market downturns and often results in the individual moving money to safer assets. An investor can experience a permanent financial loss from selling stocks when prices are low.

For retirement savers who are uncertain how to allocate their 401(k) or IRA contributions between assets, there are many offerings that don't require a lot of financial expertise.

Balanced Funds include a mix of investments — stocks and bonds, usually in a ratio of 60/40.[32] These funds enable the risk averse to stay in the stock market but have bond funds for a cushion in the midst of downturns. According to the Employee Benefit Research Institute, a growing percentage of 401(k) plans offer balanced funds, and more participants are opting for balanced funds:[33]

- At the end of 2007, 47 percent of 401(k) participants held assets in balanced funds, compared to 41 percent at the end of 2006.
- Of those who held balanced funds, 16 percent held more than 80 percent of their accounts in balanced funds.

> *"Balanced funds reduce the risk of investing in stocks but have higher growth rates than bond funds."*

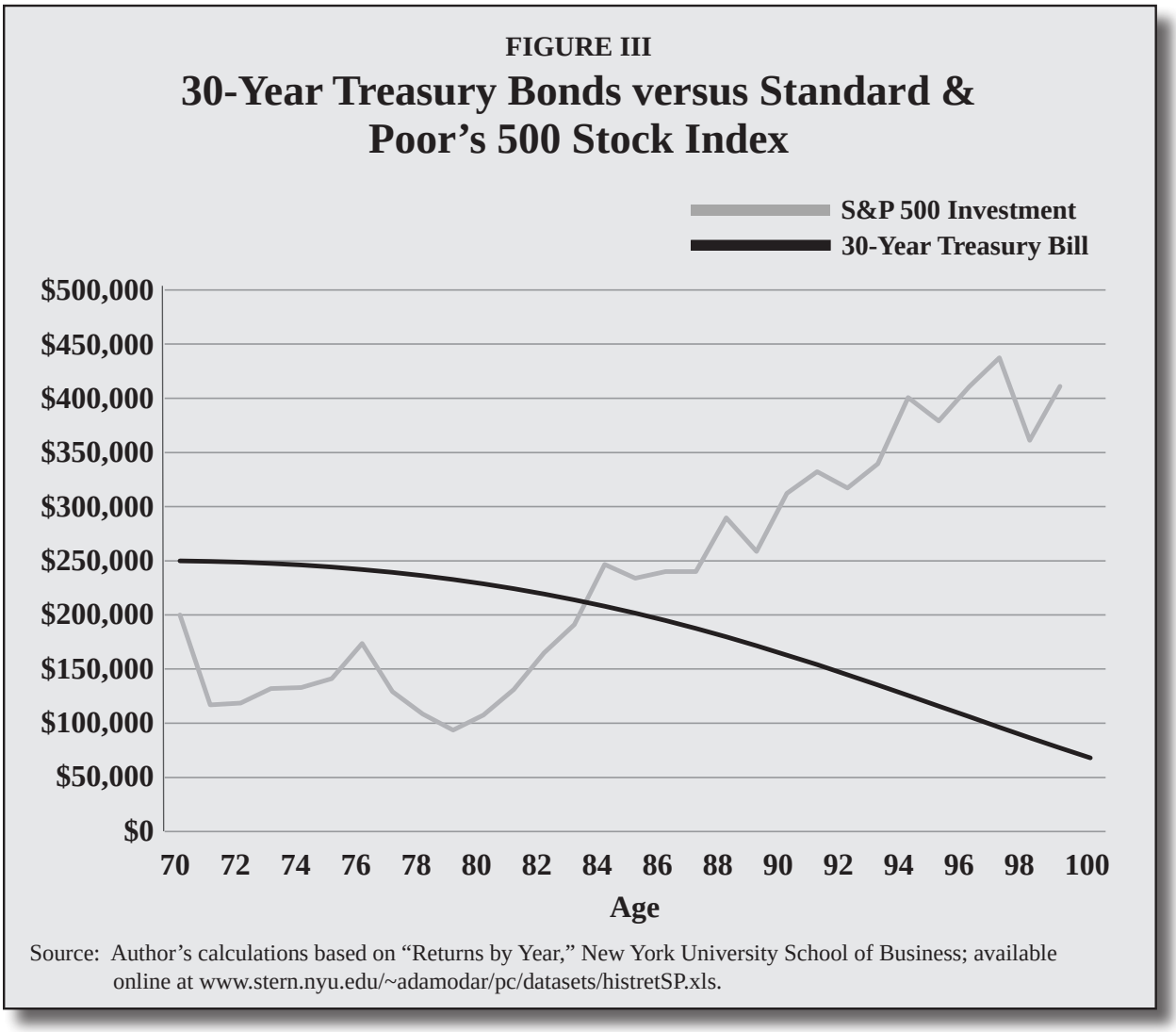
Lifecycle funds (also known as target-date funds), are a subset of balanced funds. In these funds, the mix of assets changes automatically as the participant ages. Thus, as an individual gets closer to retirement, the fund will be invested in safer returns (bonds). But different brands of funds may allocate their assets differently even if the target retirement year is the same.

Diversifying within Asset Classes. Just as important as diversifying among assets is diversifying *within* asset classes. Take stocks, for example. The downfall of companies such as Enron has shown that investing retirement savings in one stock (particularly one company's stock) can wipe out retirement savings overnight. Thus, it is important to invest in a variety of equities or mutual funds containing equities.

Index Funds are mutual funds designed to track the performance of a specific market or basket of stocks, such as the S&P 500. Index funds are managed by computer, not fund manager, so their costs are typically lower than other mutual funds. However, there are many stock indices, so it is wise to invest in more than one type of index fund. Funds that track the S&P 500, for instance, may provide stable dividends but lack the growth returns of index funds that contain stock in smaller companies. Index funds are also available for a variety of bonds, such as corporate, U.S. Treasury, foreign government and state and municipal bonds.

In addition, some mutual funds concentrate their holdings in a specific industry, such as real estate or banking. Other funds specialize in the stocks of small, lesser-known companies that have growth potential (typically small-cap or growth funds). The overall goal is not to rely on one fund, one industry or one type of asset.

Managed Funds versus Index Funds. Managed funds charge savers to invest their funds in stocks that are chosen by analysts. Some managed investment funds charge substantial fees that reduce the saver's rate of return. Furthermore, managed funds that outperformed the market in some years — provid-



401(k) automatic enrollment provisions. According to Fidelity, 90 percent of automatic enrollment participants have at least some of their investments in lifecycle funds. Of these participants, 68 percent are completely invested in lifecycle funds. While these types of fund are not for everybody, and many people enroll in other options, balanced types of funds offer some diversification among stocks, bonds and cash.

ing greater returns than the market as a whole or various stock indices — don't perform as well in other years.

In order to compare managed funds to a passive investment strategy that aims to track the average performance of the market, financial advice columnist Scott Burns introduced the "Couch Potato" portfolio almost 20 years ago. It consisted of investing half of one's money into a common stock fund (mirroring the S&P 500), and half of one's money into a intermediate bond fund (mirroring the Shearson Lehman index), then rebalancing every year so that the account remained divided into half stocks, half bonds.[34] The Couch Potato portfolio has evolved as many more types of mutual fund products have become available, but the bottom line is that a passive investment strategy such as this will achieve greater returns than managed funds.

Policies That Help. Many companies offer balanced or life-cycle funds as the default under new

8. Underestimate Longevity

When Social Security began paying regular monthly benefits to retirees in 1940, the life expectancy of 65-year-olds was 12.7 years for males and 14.7 years for females.[35] Actuaries estimated that about 54 percent of adult males and nearly 61 percent of adult females would live to the full retirement age of 65. However, today's female boomers

who expect to retire in 2011 at age 65 will live an additional 20 years or more, on average. Men the same age will live an additional 17 years, on average. And an increasing percentage of the elderly population is living to age 100.

So what does this mean? It means that planning is necessary to provide a steady stream of income and ensure that one doesn't exhaust one's assets.

Option: Keep Working. One way to continue accumulating assets and/or benefits into retirement is to keep working. According to the Current Population Survey, an increasing number of people age 65 and older are choosing to work well past their full retirement age:

- Over the past 30 years, the proportion of workers age 65 and older has grown from 13 percent to more than 15 percent. The most significant increase occurred among individuals age 75 and older.
- Additionally, more senior employees are choosing full-time rather than part-time employment, giving them additional income-producing years during which to save for their later retirement years.

Option: Delay Claiming Social Security Benefits. Some who choose to work past their full retirement age wait until age 70 to take their Social Security benefits. They receive a delayed benefit credit, which can increase their annual Social Security benefits by up to 20 percent or more, compared to claiming benefits at the full retirement age.[36] The delayed benefit credit received by age 70 is about the same, whether an individual reached full retirement age at 65 (for those born prior to 1937) or (for those born later) reaches full retirement at some point up to age 67. However, taking retirement benefits at age 62 imposes a greater percentage reduction in benefits for those who reach full retirement age at 67.

> *"An increasing number of people work past their full retirement age to raise their retirement income."*

Option: Claim Social Security Benefits Early. There are many cases where households begin taking early retirement benefits at age 62, but continue working. In households where at least one adult aged 62-to-64-years receives Social Security benefits, nearly 46 percent report wage, salary or self-employment income.[37] However, working while receiving early retirement benefits can subject a worker to the earnings penalty:[38]

- In 2009, for every dollar of income earned above a threshold of $14,160, 50 cents in Social Security benefits is withheld.
- For example, a 62-year-old part-time worker earning $20,000 annually would lose almost $3,000 annually in benefits.

When a worker reaches full retirement age, the benefit reductions are restored in an actuarily fair way, but workers with shorter life expectancies are still penalized. There is no longer any earnings penalty on work past the full retirement age.

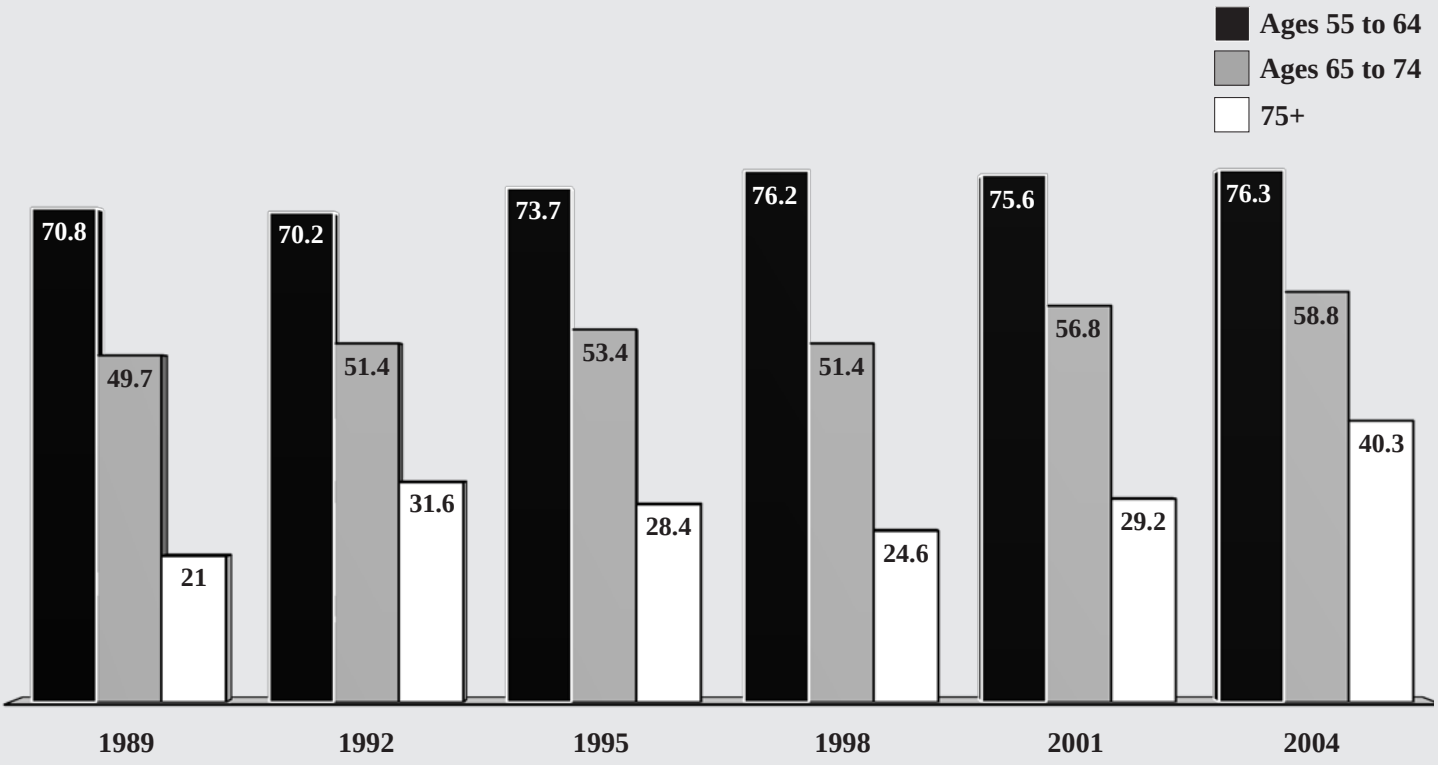
Option: Repay Benefits and Reapply. Some people who take early retirement benefits may decide later they would rather have higher benefits for the rest of their lives. But all is not lost. A provision in the tax code allows individuals to pay back their early retirement benefits and reapply at a later date. [See the sidebar, "Double-Dipping Social Security."]

Option: Annuitize. Retirees can take distributions from their retirement accounts over time, in programmed withdrawals, or take a lump-sum distribution. The account balance can be used to purchase a lifetime, inflation-protected annuity, with survivor benefits for a spouse. Annuities ensure that a senior has a steady monthly income for life. There are many different types of annuities with fixed and variable interest rates. Administrative fees vary as well, so it is important to check before buying.

Option: Keep Investing for the Long-Term. Conventional wisdom says that as people get older, they should move to investments that promise a guaranteed rate of return, such as government bonds. The supposition is that once a person hits retirement age, they need a fixed income to reduce their chances of outliving their money. But if a 65-year-old retiree lives until age

FIGURE IV

Percentage of Families with Debt, Ages 55 and Older



Source: 2004 Survey of Consumer Finances, 1989-2004 surveys.

80, 85 or beyond, he or she would be considered a long-term investor; thus, older retirees should leave some of their nest egg in higher-return investments.

Problem: Mandatory Minimum Withdrawals from Accounts. The IRS requires that seniors begin withdrawing a minimum mandatory amount from their retirement accounts by April 1 following the year they turn 70-and-one-half, and each year thereafter. The amount is determined by a formula that adjusts for life expectancy at each age. But the stock market has experienced a significant drop in recent months. Suppose an individual who is invested in stocks received a distribution from his account on March 31, 2008, based on what his balance was on December 31, 2007. The amount withdrawn was a greater percentage of the March 31 balance, leaving the account holder with less money to accrue interest in future years.

Fortunately, based on S&P 500 Index returns over the past 30 years, the minimum withdrawal requirement would not reduce the principal the senior has contributed to the account, if it is invested in stocks. Furthermore, the account balance will still rise over time. In fact, the retiree would have more money in the account at age 100 than when the distributions began. Figure III shows, for example, the effect of the mandatory minimum withdrawal on a retiree with $200,000 invested in stocks. What should be of greater concern is how this rule affects seniors with bonds or money market funds that earn lower interest rates.

Recommended Improvements. Because retirement accounts balances took such a hit this year, Congress temporarily suspended the mandatory distribution require-

ment for 2009, but it will affect these seniors in coming years. With much longer life expectancies, it is unreasonable to require seniors to withdraw and pay taxes on money they may not need when they are 71. The age at which seniors are required to begin withdrawals should be either raised or repealed. Several years ago, the House Ways and Means Committee introduced a bill to raise the minimum distribution age to 75 — this should be revisited.

9. Ignore Inflation

Just when a boomer thinks he has reached the point where he can retire comfortably, along comes inflation to wipe out a good chunk of that retirement stash. For instance, 10 years ago, *The Millionaire Next Door* described how the most unlikely people were able to attain a net worth of at least $1 million. But that $1 million 10 years ago has now lost 20 percent of its value. Thus, today's millionaire would need $1,267,000 to have the same equivalent wealth as a millionaire 10 years ago. In 30 years, a new retiree would need more than $3 million!

How does inflation affect retirement assets? Consider the rate of return on the following assets, after adjusting for inflation and taxes:[40]

- From 1926 to 1999, the average annual real rate of return for short-term U.S. Treasury bills was –0.5 percent.
- During the same period, the average annual real rate of return on long-term government bonds was 0.4 percent.
- However, common stocks yielded an average of 4.7 percent.
- Small company stocks yielded an average real rate of return of 5.6 percent.

> *"Tax-exempt municipal bonds are not always tax-exempt!"*

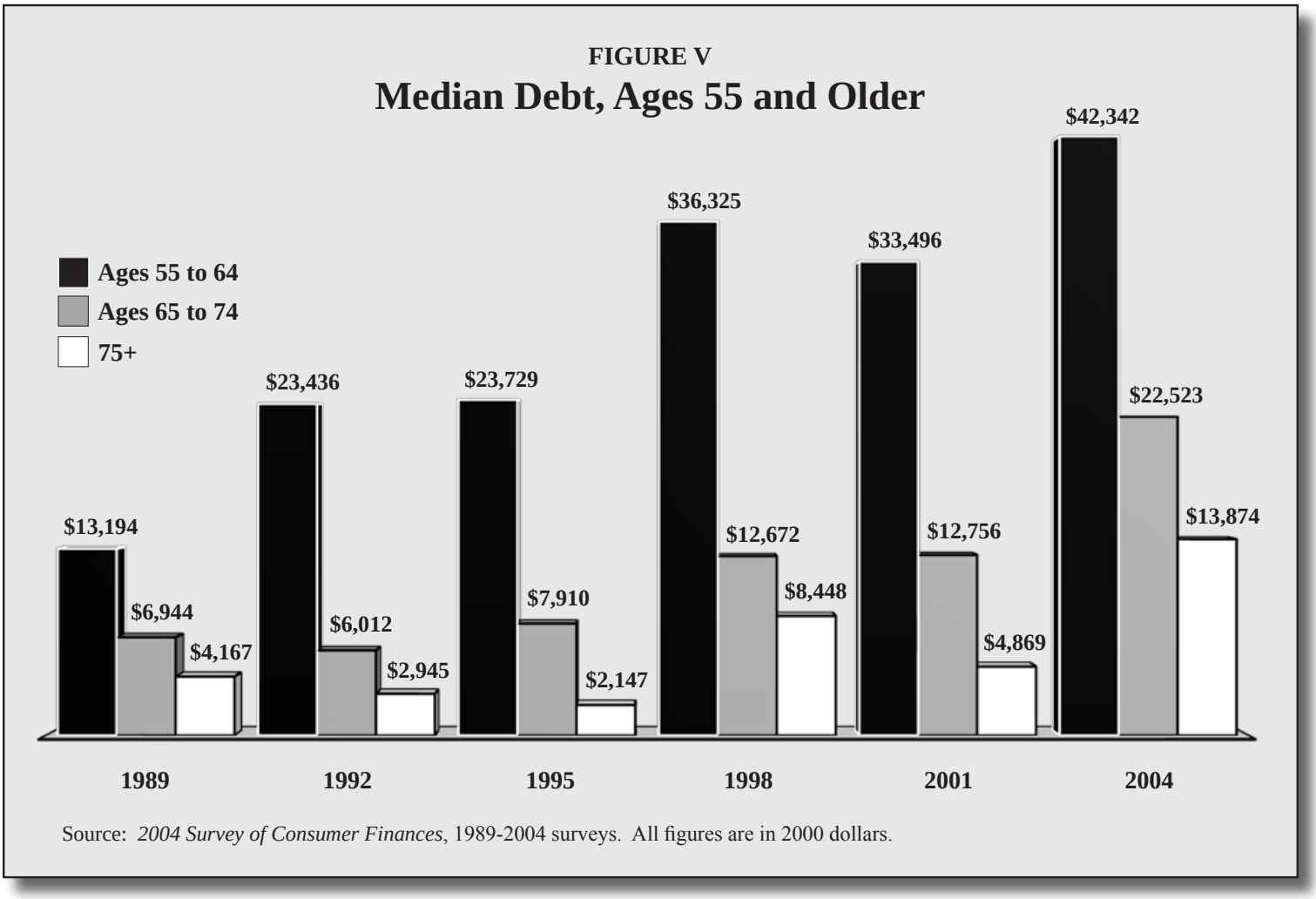
Even inflation-indexed bonds do not guarantee a consistently high rate of return because it is the principal amount of the bond, not the interest, which is adjusted for inflation.

The Trouble with Bonds. The recent turmoil in the stock market scared many retirement savers into moving their money out of stock funds and into government bond funds. Bonds guaranteed by the United States government have historically been one of the safest investments, pay a consistent, albeit small, rate of return and are protected from the ups and downs of stock prices.[41] Conventional wisdom often claims that bonds are preferable because the stock market is too risky; that only those with large nest eggs can invest in the market; and that, as one grows older, a greater percentage of investments should move from stocks into bonds. But this advice can be detrimental in today's climate. Here's why:

1) *Depending on market conditions, bonds may yield very little.* As the stock market has tumbled, many investors are rushing to buy U.S. Treasury bonds. Money spent on purchasing bonds becomes available for the government to borrow. But the demand for bonds is so great right now that various Treasury bonds are paying less than 1 percent. Some pay close to zero percent.[42]

2) *Inflation-adjusted bonds are not fail-safe.* Inflation-adjusted bonds, also called Treasury Inflation Protected Securities, pay a fixed interest rate, but the principal amount rises to adjust for inflation. Thus, the interest is paid on the higher principal value. In terms of preserving purchasing power, inflation-adjusted bonds are preferable to conventional bonds. But they still do not compare to stocks when it comes to the return on investment, so these bonds may be even less favorable for households in a higher income tax bracket.

3) *Tax-exempt municipal bonds are not always tax-exempt.* Savers who are less concerned about the rate of return on their investment and more concerned about their tax burden may invest in municipal bonds, which are generally tax-exempt. If they are purchased on the secondary market (from one holder to another before maturity), rather than directly from the issuer, however, they are subject to regular



Source: *2004 Survey of Consumer Finances*, 1989-2004 surveys. All figures are in 2000 dollars.

federal income taxes. Moreover, certain municipal bonds are subject to the alternative minimum tax (AMT), which is designed to ensure that wealthy individuals with many deductions pay taxes on at least some of their gross income, regardless of its source. For instance, private activity bonds are issued by state and local governments to finance projects by private entities, such as airports and stadiums, and are included in income that is subject to the AMT.[43]

The Social Security Benefits Tax. Social Security benefits are also subject to taxes. The Social Security benefits tax inflicts some of the highest marginal tax rates in the federal tax code. Although nominally a tax on Social Security benefits, it is really a tax on other retirement income. Because of the benefits tax, the retirement savings of the vast majority of current and future retirees are much less valuable.

Taxes are imposed on up to half of benefits for single retirees with incomes higher than $25,000 and for couples with incomes above $32,000.[44] These retirees must add 50 cents of their Social Security benefits to their taxable income for every dollar by which their income exceeds the threshold until half their benefits are subject to taxation. Thus, when retirees earn $1.00 in wages or investment income, they must pay taxes on $1.50. As a result, the marginal tax rate on their income is 50 percent higher than for young people with the same income.

As income rises, the tax becomes more onerous. Single retirees with incomes above $34,000 and couples with incomes higher than $44,000 must add 85 cents in benefits to taxable income for every dollar of income above these thresholds until 85 percent of their benefits are subject to the tax. Thus, when these retirees earn $1.00, they must pay taxes on $1.85. As a result, the marginal tax rate on their income is 85 percent

higher than for young people with the same income.[45]

Over time, inflation will push more and more retirees into the income range where they must add 50 cents in benefits to their taxable income for every dollar by which their income exceeds a certain threshold. This means their marginal tax rate will be 50 percent higher!

Recommended Policy Improvements. To eliminate the detrimental effects of the Social Security benefits tax, Congress should repeal it. If there is an argument for taxing these benefits, the correct way to tax them is to adjust the tax for inflation and to include a portion of Social Security benefits in ordinary income and subject them to ordinary income tax rates. Middle-income seniors would pay taxes on some portion of their Social Security benefits the same way they pay taxes on IRA withdrawals and pension benefits — at the same tax rate faced by younger taxpayers.

10. Stay in Debt

Decades ago, it was assumed that families approaching retirement did so with little or no debt: The mortgage was paid off and there were no more child care expenses. The kids had grown up, moved out and graduated from college. But this is no longer the case. Demographic and social trends, such as women having their first child at an older average age, means that many households may still be putting their kids through college when they previously would have been saving for retirement.[46]

Other factors, such as the demand for larger homes, may send retirees into their golden years with massive mortgage debt. Consider that in 1950 the average household had 292 square feet of living space per resident; by 2006 that had tripled to more than 900 square feet per resident.[47]

Who Is in Debt? According to the *2004 Survey of Consumer Finances* (the most recent available): [See Figure IV.]

- Among preretirement adults ages 55 to 64, more than three-quarters (76.3 percent) had some type of debt — including mortgage or other residential property, credit card debt, lines of credit or installment loans — up from 70.8 percent in 1989.
- Among seniors ages 65 to 74, nearly 59 percent have debt, compared to less than 50 percent in 1989.
- However, among seniors age 75 and older, 40.3 percent have debt, almost double the percentage in 1989.

Moreover, the debt carried by households (adjusted for inflation) has increased since 1989 [see Figure V]:

- For adults ages 55 to 64, the median debt in 2004 was $42,342 (in 2000 dollars), more than three times as high as in 1989.
- For adults ages 65 to 74, the median debt was $22,523, five times the amount in 1989.
- Adults age 75 and older carry the lowest amount of debt among the age cohorts. However, their average debt has grown to $13,874 — 3.3 times the amount in 1989.

These statistics do not indicate how much debt among the 55-to-64 age group is carried over to the retirement years. But chances are, the more debt a household has at 55, the more it will have at 75.

Policies That Help. Unfortunately, there is little that can be done at a state or national government level to help households get out of debt. For individuals burdened with debt, credit counseling and loan consolidations at a lower interest rate may help. But lower interest rates can encourage even more borrowing. Truth be told, effective debt and budget management begins at home.

Conclusion

There are many more ways to damage one's retirement, and even the best-laid plans can be derailed by unforeseen events. These events may arise from personal circumstances or from public policy changes to elderly entitlement programs. No one, not even the best economists, can predict which way the wind will blow in terms of tax or benefit changes and the exact costs associated with them. But uncertainty alone is no reason to *not* plan at the household level, which is where everyone who wants a secure retirement must begin.

Endnotes

1. "Income of the Population 55 or Older, 2006," Social Security Administration, Publication No. 13-11871, February 2009.

2. "The 2008 OASDI Trustees Report," Social Security Administration. Available at http://www.ssa.gov/OACT/TR/TR08/trTOC.html.

3. "Ownership of Individual Retirement Accounts (IRAs) and 401(k)-Type Plans," *Notes*, Employee Benefit Research Institute, Vol. 29, No. 5, May 2008.

4. See Richard Thaler "Psychology and Savings Policies," *American Economic Review*, Vol. 84, No. 2, May 1994, pages 186–192.

5. Before the Pension Protection Act, state laws could prohibit companies from implementing automatic enrollment plans. The new federal law supercedes state prohibitions.

6. "Automatic Enrollment Boosts 401(k) Participation, But…," November 21, 2006. Available online at http://hr.blr.com/news.aspx?id=19329.

7. "Regulation Relating To Qualified Default Investment Alternatives In Participant-Directed Individual Account Plans," U.S. Department of Labor. Available online at http://www.dol.gov/ebsa/newsroom/fsQDIA.html.

8. The Automatic Enrollment Plan provides a "Safe Harbor" clause that also exempts employers from nondiscrimination testing provided that certain requirements on employer matching contributions are met. Nondiscrimination testing requires that higher- and lower-compensated employees contribute roughly the same percentage of their income to 401(k) accounts. If highly-compensated employees contribute far more than is allowed compared to their lower-compensated counterparts, the plan must distribute excess contributions to large contributors, which are then subject to federal income tax. For further details, see, "The Pension Protection Act of 2006," Hay Acquisition Company, 2006. Available online at http://www.haygroup.com/downloads/us/Hay_Group_PPA_2006_-_New_Rules_for_Retirement_Plans.pdf.

9. Pamela Everhart, "Early Progress with Auto Features in 401(k) Plans," Fidelity Investments, February 12, 2009.

10. Congress has temporarily suspended the mandatory withdrawal age.

11. "Employers Abandoning Pensions," *Cellular South*, January 27, 2008. Available at www.cellularsouth.com.

12. The Pension Benefit Guaranty Corporation (PBGC), created in 1974, is a federal corporation that insures the pensions of private corporations. The PBGC does not receive tax dollars, but is funded by insurance premiums paid by these corporations, investment income and assets from companies that have defaulted on pensions. See "Pension Benefit Guaranty Corporation: Protecting America's Pensions." Available online at http://www.pbgc.gov/.

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14. It appears the employer match is little motivation for additional savings. According to an NBER study, increasing the match rate by 25 cents per dollar of contribution raises the participation rate by 3.75 to 6 percentage points. Gary V. Englehardt and Anil Kumar, "Employer Matching and 401(k) Saving: Evidence from the Health and Retirement Study," National Bureau of Economic Research, Working Paper No. 12447, August 2006.

15. Based on expected 2009 tax rates.

[16] For tax year 2009, the Saver's Credit can be claimed by married couples filing jointly with incomes up to $55,500; heads of household with incomes up to $41,625, and married individuals filing separately and singles with incomes up to $27,750. See "Plan Now to Get Full Benefit of Saver's Credit; Tax Break Helps Low- and Moderate-Income Workers Save for Retirement," Internal Revenue Service. Available online at http://www.irs.gov/newsroom/article/0,,id=200742,00.html.

[17] The credit phases out as income increases up to $55,500 for married households, and $27,750 for singles, who would both receive credits of 10 percent.

[18] It is assumed that the plan allows an employee to make tax-deferred contributions to his account while paying off the loan. In Table II, however, it is assumed that the borrower makes no additional contribution beyond the difference between his loan payment and his previous monthly contribution. For example, the employee who contributes $300 a month and borrows $15,000 is actually paying $16.93 a month in tax-deferred contributions and $283.07 a month in loan payments.

[19] Federal Employee Retirement Income Security Act (ERISA) rules require full vesting after 7 years (or earlier if the employer chooses), meaning that an employee gets the entire employer matching contribution after 7 years of employment. But the Pension Protection Act requires that employers participating in automatic enrollment plans must vest their employees' nonelective contributions after 2 years of service.

[20] "Hewitt Data Shows U.S. Employees Cash Out of 401k Plans When Changing Jobs," Business Wire, November 2003. Available at http://findarticles.com/p/articles/mi_m0EIN/is_2003_Nov_5/ai_109737076.

[21] Based on the median income for a 25- to 34-year-old males in 2006. See "Historical Income Tables - Table P-5. Regions — People by Median Income and Sex," U.S. Census Bureau, Current Population Survey.

[22] This assumes that the employee's combined wage income and 401(k) distribution, after the $3,500 personal exemption, puts him into a 25 percent tax bracket.

[23] "Retirement Plans FAQs regarding Hardship Distributions," Internal Revenue Service, U.S. Department of the Treasury. Available online at http://www.irs.gov/retirement/article/0,,id=162416,00.html.

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[26] "Returns by Year," New York University School of Business. Available online at www.stern.nyu.edu/~adamodar/pc/datasets/histretSP.xls.

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[28] "The Equity You Live In: The Home as a Retirement Savings and Income Option," Fidelity Research Institute.

[29] Ibid.

[30] "Reverse Mortgages. Get the Facts before Cashing in on Your Home's Equity," *Facts for Consumers*, Federal Trade Commission, June 2005. Available online at http://www.ftc.gov/bcp/edu/pubs/consumer/homes/rea13.shtm.

[31] "How Much Can You Borrow," Reverse Mortgage Lenders Organization. The Federal Housing Authority recently announced they would set a maximum borrowing limit of $417,000 with an effective target date of November 1, 2008.

[32] "U.S. Balanced," available online at www.maxfunds.com.

33. Jack Van Derheil et al., "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007," Employee Benefit Research Institute, Issue Brief No. 324, December 2008.

34. For more information on Scott Burns' Couch Potato portfolio, see the Web site www.assetbuilder.com.

35. The Social Security Act was signed into law in 1935, but taxes were not collected until 1937. Monthly benefits began in 1940. See "Social Security History" at http://www.ssa.gov/history.

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37. "Income of the Population 55 or Older, 2006," Table 2A2, Social Security Administration, Publication No. 13-11871, February 2009.

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39. For more information see Laurence J. Kotlikoff, "Double-Dipping Social Security," National Center for Policy Analysis, Brief Analysis No. 625, August 26, 2008.

40. "Real Rate of Return," CPS Insurance Services. Available online at http://cpsinsurance.com/annuity/client_handouts/Real%20Rate%20of%20Return%20BW.pdf.

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43. "What is the Alternative Minimum Tax?" Franklin Templeton Investments, Available online at https://www.franklintempleton.com/retail/jsp_cm/education/fund_basic/tax_free/what_is_amt.jsp#anchor4.

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The NCPA is a nonprofit, nonpartisan organization established in 1983. Its aim is to examine public policies in areas that have a significant impact on the lives of all Americans — retirement, health care, education, taxes, the economy, the environment — and to propose innovative, market-driven solutions. The NCPA seeks to unleash the power of ideas for positive change by identifying, encouraging and aggressively marketing the best scholarly research.

Health Care Policy.

The NCPA is probably best known for developing the concept of Health Savings Accounts (HSAs), previously known as Medical Savings Accounts (MSAs). NCPA President John C. Goodman is widely acknowledged (*Wall Street Journal*, WebMD and the *National Journal*) as the "Father of HSAs." NCPA research, public education and briefings for members of Congress and the White House staff helped lead Congress to approve a pilot MSA program for small businesses and the self-employed in 1996 and to vote in 1997 to allow Medicare beneficiaries to have MSAs. In 2003, as part of Medicare reform, Congress and the President made HSAs available to all nonseniors, potentially revolutionizing the entire health care industry. HSAs now are potentially available to 250 million nonelderly Americans.

The NCPA outlined the concept of using federal tax credits to encourage private health insurance and helped formulate bipartisan proposals in both the Senate and the House. The NCPA and BlueCross BlueShield of Texas developed a plan to use money that federal, state and local governments now spend on indigent health care to help the poor purchase health insurance. The SPN Medicaid Exchange, an initiative of the NCPA for the State Policy Network, is identifying and sharing the best ideas for health care reform with researchers and policymakers in every state.

NCPA President John C. Goodman is called the "Father of HSAs" by *The Wall Street Journal*, WebMD and the *National Journal*.

Taxes & Economic Growth.

The NCPA helped shape 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 in summer 2002. The NCPA's proposal for an across-the-board tax cut became the centerpiece of President Bush's tax cut proposals.

NCPA research demonstrates the benefits of shifting the tax burden on work and productive investment to consumption. An NCPA study by Boston University economist Laurence Kotlikoff analyzed three versions of a consumption tax: a flat tax, a value-added tax and a national sales tax. Based on this work, Dr. Goodman wrote a full-page editorial for *Forbes* ("A Kinder, Gentler Flat Tax") advocating a version of the flat tax that is both progressive and fair.

A major NCPA study, "Wealth, Inheritance and the Estate Tax," completely undermines the claim by proponents of the estate tax that it prevents the concentration of wealth in the hands of financial dynasties. Actually, the contribution of inheritances to the distribution of wealth in the United States is surprisingly small. Senate Majority Leader Bill Frist (R-TN) and Senator Jon Kyl (R-AZ) distributed a letter to their colleagues about the study. In his letter, Sen. Frist said, "I hope this report will offer you a fresh perspective on the merits of this issue. Now is the time for us to do something about the death tax."

Retirement Reform.

With a grant from the NCPA, economists at Texas A&M University developed a model to evaluate the future of Social Security and Medicare, working under the direction of Thomas R. Saving, who for years was one of two private-sector trustees of Social Security and Medicare.

The NCPA study, "Ten Steps to Baby Boomer Retirement," shows that as 77 million baby boomers begin to retire, the nation's institutions are totally unprepared. Promises made under Social Security, Medicare and Medicaid are completely unfunded. Private sector institutions are not doing better — millions of workers are discovering that their defined benefit pensions are unfunded and that employers are retrenching on post-retirement health care promises.

Pension Reform.

Pension reforms signed into law include ideas to improve 401(k)s developed and proposed by the NCPA and the Brookings Institution. Among the NCPA/Brookings 401(k) reforms are automatic enrollment of employees into companies' 401(k) plans, automatic contribution rate increases so that workers' contributions grow with their wages, and better default investment options for workers who do not make an investment choice.

The NCPA's online Social Security calculator allows visitors to discover their expected taxes and benefits and how much they would have accumulated had their taxes been invested privately.

Environment & Energy.

The NCPA's E-Team is one of the largest collections of energy and environmental policy experts and scientists who believe that sound science, economic prosperity and protecting the environment are compatible. The team seeks to correct misinformation and promote sensible solutions to energy and environment problems. A pathbreaking 2001 NCPA study showed that the costs of the Kyoto agreement to reduce carbon emissions in developed countries would far exceed any benefits.

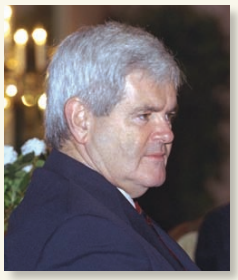
Educating the next generation.

The NCPA's Debate Central is the most comprehensive online site for free information for 400,000 U.S. high school debaters. In 2006, the site drew more than one million hits per month. Debate Central received the prestigious Templeton Freedom Prize for Student Outreach.

Promoting Ideas.

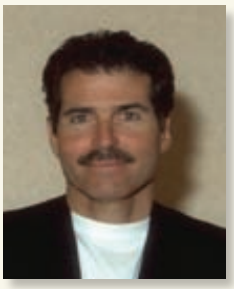
NCPA studies, ideas and experts are quoted frequently in news stories nationwide. Columns written by NCPA scholars appear regularly in national publications such as the *Wall Street Journal*, the *Washington Times*, *USA Today* and many other major-market daily newspapers, as well as on radio talk shows, on television public affairs programs, and in public policy newsletters. According to media figures from Burrelle's, more than 900,000 people daily read or hear about NCPA ideas and activities somewhere in the United States.

What Others Say About the NCPA



"The NCPA generates more analysis per dollar than any think tank in the country. It does an amazingly good job of going out and finding the right things and talking about them in intelligent ways."

Newt Gingrich,
former Speaker of the U.S. House of Representatives



"We know what works. It's what the NCPA talks about: limited government, economic freedom; things like health savings accounts. These things work, allowing people choices.We've seen how this created America."

John Stossel,
co-anchor ABC-TV's *20/20*

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

Phil Gramm,
former U.S. Senator

"Thank you . . . for advocating such radical causes as balanced budgets, limited government and tax reform, and to be able to try and bring power back to the people."

Tommy Thompson,
former Secretary of Health and Human Services

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 onto our Web site at www.ncpa.org and clicking "Donate."