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**Article**

## The 2010 Martin Feldstein lecture

NBER Reporter Online

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National Bureau of Economic Research (NBER), Cambridge, Mass.

*Suggested Citation:* Ferguson, Roger W. (2010) : The 2010 Martin Feldstein lecture, NBER Reporter Online, National Bureau of Economic Research (NBER), Cambridge, MA, Iss. 3, pp. 1-5

This Version is available at:

<https://hdl.handle.net/10419/61962>

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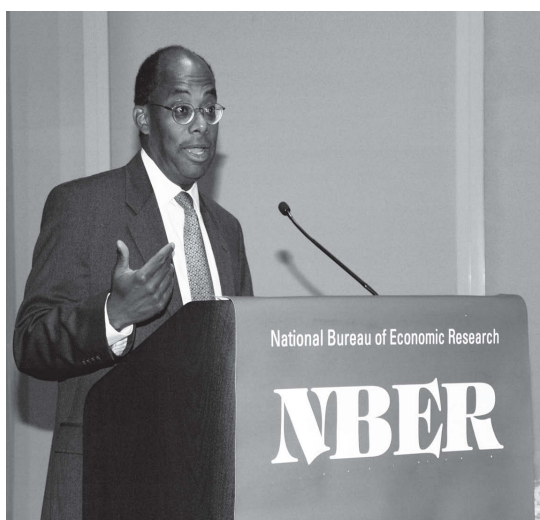
# NBER Reporter

NATIONAL BUREAU OF ECONOMIC RESEARCH

Reporter OnLine at: [www.nber.org/reporter](http://www.nber.org/reporter)

2010 Number 3

## The 2010 Martin Feldstein Lecture



*Roger W. Ferguson, Jr.*

### Remarks by Roger W. Ferguson, Jr.\*

I am honored to deliver the 2010 Martin Feldstein lecture. It is especially appropriate that I will be discussing the issue of retirement security, because throughout the course of his distinguished career, Martin Feldstein has improved our understanding of the U.S. Social Security system and of retirement policy more broadly.

We clearly are at a pivotal moment in the national discussion on retirement security. Over the past 30 years, the responsibility for funding retirement and the associated risks have shifted from employers to individuals. Today, Americans are recovering from a deep plunge in financial markets and a recession that left people less confident about their ability to achieve financial security.

In discussing the future of retirement security in America, I will examine how we arrived at the current situation, outline a few core features that could be built into a retirement security plan or system, and consider the question that is increasingly asked by researchers: how can we design retirement plans that increase the likelihood of generating an adequate and secure lifetime income?

### The Changing Retirement Landscape

The contours of the U.S. retirement system have changed substantially over the past few decades, as the defined benefit pension systems that previous generations relied on for secure retirement income have become increasingly rare. According to the Employee Benefits Research Institute, only 33 percent of employees working for large and medium businesses had access to a defined benefit pension plan in 2008 — down from 84 percent 30 years ago.<sup>1</sup> In their place, a patchwork of individual accounts has placed greater responsibility and risk on individual workers.

Initially envisioned as a way for Americans to supplement

*\* Roger W. Ferguson is President and Chief Executive Officer of TIAA-CREF. This is a written and abbreviated version of the Martin Feldstein Lecture given on July 28, 2010. A video of the full lecture is at [http://www.nber.org/feldstein\\_lecture\\_2010/feldsteinlecture\\_2010.html](http://www.nber.org/feldstein_lecture_2010/feldsteinlecture_2010.html)*

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the pensions made available by their employers, 401(k) plans have instead become most workers' primary means of saving for retirement. As a result, 401(k)-type products have fostered a focus on asset accumulation rather than income in retirement.

The decline in financial markets in 2008 and the ensuing global recession have caused many Americans — especially those nearing retirement — to question whether they will be financially secure after they stop working. Indeed, can they stop working and enjoy anything approaching the standard of living to which they are accustomed?

The evidence is mixed, but for many people the answer seems to be no. Last year, research from McKinsey and Company found that the average American couple will face a savings gap of \$250,000 at the time of retirement.<sup>2</sup>

Why has the 401(k) framework failed to adequately prepare workers for retirement? Its shortcomings include:

- Lack of participation among many eligible workers;
- Insufficient employer and employee contributions;
- The failure or inability of many participants to implement an appropriate asset allocation strategy;
- The failure to preserve assets for retirement;
- And a lack of annuitization of accumulated assets in retirement to produce a lifelong income stream.

Fundamentally in the 401(k) context, retirement risk burdens — funding, investment, longevity, and mortality — fall disproportionately, often entirely, upon workers who are not equipped to manage such risks.

On the other hand, employers have benefited over the past three decades by jettisoning defined benefit pensions. For instance, it was only by reshaping their retiree health and savings plans that the big three U.S. auto manufacturers could avoid extinction. And in the public sector, where defined benefit plans are still common, employers are encouraging newly hired workers to select defined contribution retirement options.

While the decline of defined benefit pensions and the rise of defined contribution plans have removed an element of security from most Americans' retirement equation, the resulting individualized retirement system is more closely aligned with the way Americans work today.

With more frequent job changes, including spells of independent work, it makes less sense for Americans to have their retirement savings tied to a single employer.

So, three facts emerge:

- First, defined benefit pension plans proved too expensive for the vast majority of American businesses, and the tide now appears to be turning in the public sector as well;
- Second, defined contribution retirement plans, which shift responsibility to individuals, offer less security than defined benefit plans and put much emphasis on asset accumulation rather than retirement income planning;
- And third, Americans' work patterns have changed, so that portability and individual control are attractive to workers.

Given these facts, the challenge for policymakers, financial services companies, economists, and employers is how to design retirement systems that offer flexibility and individual choice, yet still provide genuine security to individual savers. In a sense, these retirement plans would be grounded in the realities of the present, while incorporating a measure of security associated with the past.

## Core Elements of Retirement Security

Which factors are most critical to enjoying a secure retirement? While there are many individual needs, three elements are core: sufficient retirement plan funding by participants and sponsors; appropriate diversification and asset allocation; and guaranteed lifetime income in the form of a low-cost, relatively transparent annuity.

### *Sufficient Funding*

Recent research has clearly demonstrated the overriding importance

of retirement plan contribution levels relative to other factors for ensuring an adequate level of retirement income.<sup>3</sup> Workers who want to maintain a standard of living close to what they enjoy at the end of their working years should be aiming to replace at least 70 percent of their final salary in retirement. This means that individuals should save at least 10–15 percent of their gross annual income, measured by the combined contribution of both employers and employees.

Currently, contributions average less than 6 percent of pay for non-highly compensated workers and 7 percent for highly compensated workers. Sponsor contributions average about 3 percent of wages.<sup>4</sup> Half of American workers do not have access to an employer-sponsored plan. Among those who don't have a workplace retirement plan, fewer than 10 percent have an individual account, such as a traditional or Roth IRA.

Asset retention is another concern. Savings can only grow if they remain in the plan. Because they allow for loans, hardship withdrawals, and lump-sum distributions when workers change jobs, 401(k) plans are replete with opportunities for savings to leak out and be used for other purposes.

A major expense looming for retirees — one that requires advanced planning and saving — is health care. Without an employer-sponsored health plan, a couple retiring at age 65 today is projected to need between \$200,000 and \$800,000 to supplement Medicare and cover out-of-pocket health care expenses during retirement.<sup>5</sup> That is a staggering sum for most people — and it reinforces the need to accumulate adequate savings for retirement.

### *Appropriate Diversification and Asset Allocation*

The second core element of a retirement security plan is appropriate diversification and asset allocation. Fifteen to 20 fund options typically give savers the ability to create

well-diversified investment portfolios. More choices could be confusing and might actually lead people to choose less-diversified investments.<sup>6</sup>

Workers often lack the knowledge to choose appropriate investments and to diversify their savings. Olivia Mitchell of the Wharton School and Stephen Utkus of Vanguard have written that plan participants tend to use “a naïve heuristic (avoid extremes, pick the middle option) rather than maintain a consistent set of well-ordered risk preferences to select from the investments offered.”<sup>7</sup>

Participant confusion underscores the need for reliable, independent advice. Historically, there has been a legislated firewall between plan administration and plan advice. Recent legislative and regulatory changes have lowered the firewall and, as a result, the defined contribution market has been moving to provide individualized investment advice. The percentage of 401(k) plans offering investment advisory services has increased from 37 percent in 2005 to about 50 percent in 2009.<sup>8</sup>

### *Guaranteed Income*

The third core element of a retirement security plan is guaranteed lifetime income.<sup>9</sup> Guaranteed income in the form of annuities — whose guarantee is subject to the claims-paying ability of the insurance company writing the contract — could re-introduce the element of security that has been missing from most private sector 401k plans for the past three decades.

Annuities can be made available within a retirement plan as an accumulation vehicle, as a distribution option upon retirement, or through both the accumulation and distribution phases. Individuals also have the option of purchasing an annuity outside their retirement plan.

A good rule of thumb is to annuitize at least enough savings, so that, combined with Social Security, a retiree will have an income stream to meet his or her basic expenses in

retirement—housing, utilities, taxes, food, and health care to the extent those costs are knowable. In addition, ideally the value of these annuitized payments should be protected—at least partially—against erosion by inflation.

Incorporating these three core elements—sufficient funding, appropriate asset allocation, and guaranteed income—into retirement plans would enhance efforts to help all Americans save for a secure retirement.

### ***Behavioral Aspects of the Retirement Challenge***

Even if we design retirement plans that encourage sufficient savings, appropriate diversification, and opportunities to turn savings into guaranteed income, will individuals take advantage of these options?

Behavioral economists have been examining how system design can influence participant behavior. Much of the literature has focused on overcoming, or leveraging, apparently negative tendencies—such as inertia and risk aversion—with new plan features and approaches, including auto-enrolling workers in a plan and framing choices in a way that motivates optimal decision making.

According to the Government Accountability Office, auto-enrollment can increase participation rates to as high as 95 percent.<sup>10</sup> The Employee Benefits Research Institute reports that auto-enrollment has increased the number of near-retirees who are on track to have enough money to pay for basic expenses and health care costs—from about 41 percent in 2003 to a little over half today.<sup>11</sup>

However, automatically enrolling individuals in a retirement plan is not necessarily a panacea. Some research has suggested that while participation rates increase when employers auto-enroll employees, the default contribution levels tend to be fairly low, and employees often remain at these low contribution levels and in very con-

servative funds.<sup>12</sup> To overcome this second-stage inertia, plan sponsors increasingly are adopting auto-escalation policies: automatically increasing an individual's contribution rate over time.

One such effort is the Save More Tomorrow program, developed by Richard H. Thaler of the University of Chicago and UCLA's Shlomo Benartzi. The program allows workers to schedule automatic increases in their savings rate for future dates. In Thaler and Benartzi's first case study, participants increased their set-aside rate from 3.5 percent to more than 13 percent. Benartzi recently has written that more than half of large employers in the United States now offer the program.<sup>13</sup>

If we accept that at least partial annuitization—or the purchase of guaranteed lifetime income—is the optimal choice for people entering retirement, how can we influence their decision-making and encourage them to move in that direction? Employers have been reluctant to include annuities as a distribution option. And, all 401(k) plans offer a lump-sum distribution option, but only 14 percent offer the ability to annuitize assets.<sup>14</sup> A commonly cited reason for plan sponsors' reluctance to offer annuities is fiduciary uncertainty. Regulatory clarity could go some way toward encouraging more employers to make annuities available.

If annuities are more widely available, will employees purchase them? Paul Yakoboski of the TIAA-CREF Institute has found that retirees who have annuitized their retirement savings are more than twice as likely, compared with retirees who have not annuitized, to have saved through an annuity in a defined contribution plan while working. Furthermore, recommendations of financial advisors have a measurable impact on the decision to annuitize.<sup>15</sup>

Jeffrey Brown of the University of Illinois and his collaborators have explored how the decision to annui-

tize is affected by the way the choice is framed. According to their research, survey participants are more than three times as likely to prefer a life annuity to a savings account when the choice is framed in consumption terms rather than in investment terms. They explain: "When consumers think in terms of consumption, they perceive the life annuity as offering valuable insurance against the risk of outliving one's resources. However, when they think in investment terms, they view life annuities as increasing risk without increasing return, because of the potential for variation in the total value of payments based on how long they live."<sup>16</sup>

The desire to avoid what is perceived as a loss has been identified as a powerful motivator for individuals. Recently, Columbia University's Eric Johnson uncovered what he calls "hyper loss aversion" among retirees, who were up to five times more loss averse than the average person.<sup>17</sup> Interestingly, this hyper sensitivity to loss does not translate into a desire to purchase guaranteed income. Instead, Johnson has found, retirees who exhibit hyper loss aversion are *less* likely to annuitize because they see giving up immediate control of their savings as another type of loss.

### **The Need for Further Research**

Despite actions taken to increase savings and highlight the benefits of guaranteed income, a distressingly large fraction of people pay little heed. Annamaria Lusardi of Dartmouth College and Jason Beeler of Harvard University found that in the year before the financial crisis, 30 percent of Baby Boomers—the people closest to retirement—had given no thought to retirement planning.<sup>18</sup>

How can we reach the nonplanners? And how can we reach more of the individuals who are planning, but who lack the knowledge to make informed decisions and may feel paralyzed by the process? We need fur-

ther research to drive innovations in retirement plan design, to aid policymakers in strengthening the legal and regulatory framework that supports retirement planning, and to cultivate broader financial knowledge in America.

Among the questions needing further exploration:

- What is the appropriate mix of automatic plan features with education or advice?
- At what point in a career is it advisable for a participant to stop being an “auto-bot” and become a planner who saves and invests according to his or her plan?
- And how much of their income should people save? Consensus on this figure has been elusive, but if we can clarify the goal for most workers, we may have more success in helping people reach that benchmark.

Economists are making an essential contribution to the future of retirement by exploring not only how rational people *should* act given a certain set of facts, but also how they *do* act, as individuals prone to biases, passions, and proclivities that are perhaps even more determinative of their actions than reason is. With a clear view of the possibilities and limitations of retirement plan design and a stronger understanding of how people make financial decisions, we can point the way toward a more secure financial future.

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<sup>1</sup> EBRI Databook on Employee Benefits, *Chapter 10: Aggregate Trends in Defined Benefit and Defined Contribution Retirement Plan Sponsorship, Participation, and Vesting*, updated December 2009.

<sup>2</sup> “Restoring Americans’ Financial

*Security: A Shared Responsibility,” McKinsey & Company, October 19, 2009.*

<sup>3</sup> Brett P. Hammond and David P. Richardson, “A New Look at Retirement Savings and Adequacy: Individual Investment Risk Management and the Asset Salary Ratio,” prepared for the Pension Research Council Annual Meeting, April 30, 2009.

<sup>4</sup> 51st Annual Survey of Profit Sharing and 401(k) Plans, Profit Sharing/401k Council of America, 2008.

<sup>5</sup> Employee Benefit Research Institute (EBRI), June 2009.

<sup>6</sup> Roderick Crane, Michael Heller, and Paul J. Yakoboski, “Defined Contribution Pension Plans in the Public Sector: A Best Practice Benchmark Analysis,” TIAA-CREF Institute, April 2008.

<sup>7</sup> Olivia S. Mitchell and Stephen P. Utkus, “Lessons from Behavioral Finance for Retirement Plan Design,” in *Pension Design and Structure: New Lessons in Behavioral Finance*, O.S. Mitchell and S.P. Utkus, eds., Oxford University Press, July 2004.

<sup>8</sup> Hewitt Associates, “Trends and Experience in 401(k) Plans,” 2009 survey.

<sup>9</sup> Lifetime income is a guaranteed stream of income subject to the claims-paying ability of the issuing insurance company.

<sup>10</sup> U.S. Government Accountability Office, “Retirement Savings: Automatic Enrollment Shows Promise for Some Workers, but Proposals to Broaden Retirement Savings for Other Workers Could Face Challenges,” report GAO-10-31, October 23, 2009.

<sup>11</sup> The EBRI Retirement Readiness Rating™: Retirement Income Preparation and Future Prospects, Issue Brief No. 344, July 2010.

<sup>12</sup> J.J. Choi, D.Laibson, B. C.

Madrian, and A. Metrick, “For Better or For Worse: Default Effects and 401(k) Savings Behavior,” NBER Working Paper No. 8651, December 2001.

<sup>13</sup> Shlomo Benartzi, “Behavioral Finance and the Post-Retirement Crisis,” introduction to Behavioral Finance and the Post-Retirement Crisis, prepared and submitted on behalf of Allianz in response to Department of the Treasury/ Department of Labor Request for Information regarding lifetime income options in retirement plans, April 2010.

<sup>14</sup> Hewitt Associates, “Trends and Experience in 401(k) Plans,” 2009 survey.

<sup>15</sup> Paul J. Yakoboski, “Retirees, Annuitization, and Defined Contribution Plans,” TIAA-CREF Institute, April 2010.

<sup>16</sup> Jeffrey R. Brown, Jeffrey R. Kling, Sendhil Mullainathan, and Marian V. Wrobel, “Framing and Annuities,” TIAA-CREF Institute, January 2009.

<sup>17</sup> Shlomo Benartzi, “Hyper Loss Aversion: Retirees Show Extremely High Sensitivity to Loss, But Shy Away from Guarantees that Require Giving Up Control” based on interview with Eric Johnson in Behavioral Finance and the Post-Retirement Crisis, prepared and submitted on behalf of Allianz in response to Department of the Treasury/ Department of Labor Request for Information regarding lifetime income options in retirement plans, April 2010.

<sup>18</sup> Annamaria Lusardi and Jason Beeler, “Saving Between Cohorts: The Role of Planning,” in *Redefining Retirement: How Will Boomers Fare?* B.C. Madrian, O.S. Mitchell, and B.J. Soldo, eds. Oxford University Press, 2007.