



## How to Supplement Social Security Fairly and Effectively

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## **How to Supplement Social Security Fairly and Effectively**

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*Over the past 3 decades, the base upon which Americans obtain income for retirement has become increasingly tied to fluctuations in the financial markets. Because Social Security provides a small percentage of pre-retirement income in retirement, most of the nation's workers need a supplement to Social Security. This study demonstrates the failure of the 401(k) system and advances a bold, but realistic, solution to America's crumbling retirement system: guaranteed retirement accounts (GRAs), a universal government program that supplements Social Security by providing guaranteed rates of return, by locking up balances until retirement, and by mandating annuities at retirement—with survivor's benefits. The GRA plan is compared to other proposals, including President Obama's, which aims to expand the voluntary, commercial, individually directed account-based system.*

*KEYWORDS* aging, guaranteed retirement accounts, pension reform, pensions, social security

### INTRODUCTION

The nation's pension system cannot and does not provide retirement security for most Americans. This study presents a detailed pension reform proposal—the guaranteed retirement account (GRA)—to replace the current

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system. Over the past 3 decades, pensions have become more directly tied to financial accounts because traditional pensions have been increasingly replaced by 401(k)-type accounts in which individuals invest funds in voluntary retirement accounts that are given preferential tax treatment. This “financialization” of pensions in the United States is threatening people’s retirement security because of many risks, including poor investment choices, high fees, and employees and employers not saving enough on a voluntary basis. This means that the boomer generation will replace less income in retirement than their grandparents and parents did: Boston College’s National Income Security Index, which forecasts the likelihood retirees will have available 70% of their pre-retirement income—the minimum standard used for adequacy in retirement—and shows that 45% of Americans about to retire wouldn’t reach that goal, whereas in 1992, only 32% were at risk of not reaching that standard (Munnell, Golub-Sass, & Webb, 2007). Much of the loss of pension security stems from inadequate coverage and account balances in defined contribution (DC) accounts.

A GRA is a national system of individual accounts that supplements Social Security. Each year, employees would put at least 5% of their pay into their GRA, a government-backed savings account. Employers could pay part of that, if they wanted. The government would provide a \$600 tax credit each year (indexed for inflation) to defray the employee’s contributions. The money would earn an annual 3% interest after inflation and could be taken out only upon retirement as an annuity. It would be a safe place for people to save money, similar to what’s already available for members of Congress and federal employees. The GRA is needed because our current system of pensions and 401(k)s is not working for most Americans. 401(k)s are not guaranteed, and pensions were designed when people worked for a single employer that was around for a lifetime, without bankruptcies. Mandated annuities eliminate adverse selection. People could opt out of GRAs if their pensions met GRA standards. GRAs would help low-wage workers and the self-employed in a way that the current system does not. GRAs are a government/private-sector partnership. The Social Security Administration would collect the money, and professional investors—overseen by independent and government-appointed trustees like any pension plan, for instance, like that for Federal Reserve employees—would invest the funds in a prudent portfolio. Only the U.S. government could invest worldwide in a diversified fund that pays a 3% real return for the long term with minimal fees.

This study reviews President Obama’s proposals and critically analyzes the pitfalls of voluntary tax-incentivized, individual, commercial accounts. The next section describes GRAs in the short and long run. The political reality of Congress’s mandating a forced savings tier onto Social Security is discussed along with an overview of international changes to pension systems.

## PRESIDENT OBAMA'S PENSION PROPOSAL

President Obama has proposed to address inadequate retirement savings by expanding the number of Americans in individual retirement accounts (IRAs) and 401(k) plans, which are commercial, voluntary, individual accounts. The goal is to reach universal coverage and adequacy on an incremental basis. Ironically, the plan, devised by David John at the Heritage Foundation and Mark Iwry at Brookings Institution, was first endorsed by the John McCain presidential campaign.

Obama presented his plan in the 2009–2010 budget,<sup>1</sup> proposing that employers who do not offer retirement plans enroll employees in a “direct-deposit IRA account.” Employers without pension plans will put 3% of their workers’ pay in 401(k)/IRA-type accounts. For households earning under \$65,000, the federal government would match those savings up to \$1,000 a year with a 50% tax credit. This progressive tax credit is aimed at increasing the savings rate for low- and middle-income workers. This plan might temporarily increase the IRA or 401(k) participation rate for low- and middle-income workers, but it might not, because workers can, at any time, opt out and withdraw their own funds and not participate.

Yet, by automatically enrolling 75 million Americans who do not have pension plans or 401(k) plans or IRAs, more people are likely to be in a plan, even if they can opt out. The president’s proposal adds in tax credits that mitigate the regressivity of the tax subsidies (which take the form of tax expenditures—the value of taxes not collected because of a special provision in the tax code that favors certain activities). All retirement plans—defined benefit (DB) pensions, 401(k) plans, IRAs, etc.—have special tax provisions: taxes on contributions and earnings are deferred until a person retires or withdraws income, which is usually when tax rates are lower than at the time of contributions and fund earnings. Therefore, tax deferrals are more valuable to people with high-income tax rates than to those with low or zero tax liability. On the other hand, a tax credit is given to any taxpayer, even those with incomes so low they do not pay federal income tax. The president’s proposed tax credit means that all workers, not just those who itemize, will get some retirement savings subsidy, but Obama retains the current tax deduction, which means his plan is pricey—an extra \$25 billion in tax expenditures (more below).

The Government Accountability Office (2009) reviewed the GRA plan and Obama’s plan, along with two others, as well as approaches adopted by three European countries for their ability to address seven key pension system problems: lack of coverage, insufficient contributions, risky investment returns, lack of portability, pre-retirement leakages, high fees, and the possibility of outliving retirement savings.

The Obama plan helps expand coverage but does not make it universal; it retains, but softens, the tax regressivity; investment returns are not

guaranteed; and there are still pre-retirement leakages, high fees, and the longevity risk. In its favor, the president's plan maintains the portability of IRAs. The problems with any voluntary system that relies on tax incentives for participation (even if it is enhanced with an opt-out feature) and that is structured as individual commercial accounts are addressed in detail below.

### Drawbacks to Voluntary, Tax-Incentivized, Individual, Commercial Retirement Accounts

Individuals and employers generally do not save enough in retirement plans: The typical contribution rate is 3% to 5%; experts recommend earners save 10% to 15% of every paycheck to accumulate enough to supplement Social Security. Early withdrawals are suspected to erode retirement savings (Vanguard Center for Retirement Research, 2009), although there is no systematic database following early withdrawals from DC accounts over time. The available evidence about withdrawals comes from various studies using different data sets. Two studies conclude that income shocks such as job loss and divorce increase the likelihood of withdrawals from 401(k) (Amromin & Smith, 2003).

Account managers track withdrawals. In 2007, before the 2008 financial crises, over 50% of those eligible to take cash disbursements from their 401(k) accounts before retirement did so. "One-third of all Vanguard participants could have taken their account balance as a cash distribution because they had separated from service in the current or prior years. However, only 17% of these participants did so" (Vanguard Center for Retirement Research, 2008). After the financial crises began in 2008, early withdrawals increased. More employers reported that they noticed more of their employees taking early withdrawals for hardship from their DC plans. The number of companies reporting more hardship withdrawals by their employees increased to 44% of respondents in April 2009 compared with 35% in February of 2009. Not only do early withdrawals from IRAs and 401(k) plans impose extra tax penalties on the accounts, the funds are not earning tax-deferred returns. Both factors erode pension savings.

Employer contributions are voluntary; employers voluntarily decide to sponsor 401(k)-type plans and also then decide whether to contribute. When many companies stopped their 401(k) contributions in late 2008 (*Watson Wyatt Insider*, 2009), many workers and the public, for the first time, realized that employers were not required, beyond Social Security, to contribute to the pension and or retirement savings plans they sponsored.

There is no evidence that 401(k) plans grew because workers clamored for them at their jobs. Congress's liberalizing contributions into 401(k) plans encouraged their growth, which begs for another study about why Congress, year after year, raised contribution limits for 401(k)s while it imposed more

stringent regulations on DB plans. In 2008, for people 50 years of age or older, this limit was \$20,500, and for people younger than 50, the limit was \$15,500. The total amount that can be contributed between employee and employer contributions is the smaller amount of 100% of the employee's compensation or \$49,000 for 2009 (which is near the average wage for an American worker). Because they get the larger tax benefits, higher-income people contribute more and more often to DC plans.

According to the Urban and Brookings Tax Policy Center, 76% of government subsidies for retirement accounts go to the top 20% of earners—those earning over \$60,000 per year—and 50% of the tax expenditures go to the 6% of workers earning over \$100,000 per year for contributions up to \$20,000 per person per year (Toder, 2009). For more than 52% of Americans, tax units have earnings of less than \$40,000. This is the way the current deduction works. A lawyer earning \$200,000 makes a \$1,000 contribution to his 401(k) plan and reduces income tax by \$350. His receptionist, earning \$20,000, makes the same \$1,000 contribution (which is much less likely) and saves only \$150 in taxes. This is not effective public policy: for all this monetary effort, the U.S. savings rates did not improve and pension coverage did not expand.

The lopsided distribution of tax breaks for pensions could have been predicted from the system's origins (Burman, Gale, Hall, & Orszag, 2004). 401(k) plans are named after the section of the tax code passed in 1978 intended to help high-income management employees save on a tax-favored basis. In the United States, provisions in the tax code that favor certain kinds of activities are significant sources of government subsidies to an activity, or in this case, the 401(k) system. Taxes not collected on pension contributions and earnings equal a fourth of annual Social Security contributions and, at over \$114 billion, are perversely larger than household savings, totaling just over \$102 billion (Bell, Carasso, & Steuerle, 2004).<sup>2</sup>

The typical 401(k) management fee easily erodes over 20% of account balances (Davis, 2008; Forman, 2007). But the flip side of high fees is high levels of revenue. Products in 401(k) plans and IRAs, mostly actively managed stock and bond mutual funds, added to the profits and growth of the financial sector (Siedle, 2008).

Over \$40 billion is paid in fees annually for 401(k) administration (Employee Benefit Research Institute, 2007).<sup>3</sup> Small differences in returns and in fees can add up over time to make large differences in workers' ultimate pension benefits. A comprehensive study by Dutch and Canadian researchers Keith Ambachtsheer and Rob Bauer (2007) found that DB plans, where individuals do not direct the investment of their own accounts, earned a 2.66% higher return net of fees on equities than did retail mutual funds. The superiority in returns is due to both the reduction in fees for large institutional investors and the fact that the trustees of pension plans are better investors than the employees. In Canada, the difference between the returns

in DB plans and individual DC plans was even higher; the retail mutual funds earned 3.16% less. (These shortfalls are the averages for the 25-year period between 1980 and 2004 [Ambachtsheer & Bauer, 2007]). A 1% difference in net of fee returns over time can reduce accounts by 20% to 30%. The difference in costs is quite large because investing in retail funds means that investors pay for shareholder profits and aggressive advertising. Another way to understand the difference in cost managing DB plans and DC plans is that DB managers do not market to individuals at the retail level; they are chosen according to their performance by professional investors. Also, because employers chose the investment managers for their employees' 401(k) plans, they may have conflicts of interest from relationships with the financial firms who sponsor products in the firms' 401(k) plans for its workers (Jeszeck, 2009).

Individual-directed accounts are not well-managed by individuals; they make famous (Choi, Laibson, & Madrian, 2004) systematic investment mistakes: Behavioral economists note that investors chase winners and dump losers so that their dominant strategy is buying high and selling low. But even if workers were perfect investors and savers, one bad financial downturn, like this one, can suddenly wipe out a third or more of savings. Furthermore, individuals often withdraw pension income in lump sums when changing jobs or retiring. This places retirees at risk for what a West Virginia administrator of the teacher's fund calls "the red truck syndrome" (Levitz, 2008), referring to people making big durable purchases when receiving a large sum of money; it is one reason individuals may "outlive" their money if they have not pooled their accounts.

### Guaranteed Retirement Accounts Could Be Available for Current 401(k) Holders to Swap

If Congress set up a GRA system this year, workers could voluntarily trade their 401(k) and 401(k)-type plan assets (perhaps valued at the average value of 2008) for GRAs (Ghilarducci, 2008). The value of the assets would be converted to credits for a pension to be paid at retirement. When the worker collects Social Security, the GRA will pay an inflation-adjusted annuity based on the accumulated funds. The credits will grow based on a 3% real rate of return; a 3% interest rate adjusted for a 3% inflation rate would pay 6%. The GRA accounts are similar to existing plans available to some American workers already. GRAs are essentially a "cash balance account"—a DB plan with DC but guaranteed interest rates. GRAs are somewhat modeled after the TIAA (Teachers Insurance and Annuity Association) portion of the college professors' pension plan TIAA-CREF.

How would the swap of GRAs for a 401(k) plan work? Take a 55-year-old who had \$50,000 in his 401(k) account in August. He can swap out the \$50,000 for a guarantee of \$500 per month.<sup>4</sup>

One salubrious macroeconomic consequence of a widespread conversion to guaranteed accounts from 401(k) plans would be to diminish the financial anxiety and consumer spending withholding that came from the negative wealth shock of the 2009 recession. Secure pensions could help restore aggregate demand.

### GRAs in the Long Term

Over the longer term, GRAs could compete effectively with current DC plans, the majority of which are 401(k)s and IRAs. In GRAs, workers and employers each contribute 2.5% of salary in individual accounts managed by the Social Security Administration and a newly created investment board. Government employees, appointed by the president and Congress, invest the money in bond and equity markets, and these trustees are accountable to Congress, as is the case in Canada. The government would guarantee an annual investment return of 3% beyond inflation. The government is the only entity with a long enough time horizon to guarantee an indexed return and withstand the ups and downs of the financial markets. Since the historical rate of return is closer to 6%, excess returns could be distributed periodically as dividends. Unlike 401(k) accounts, GRAs would have no investment risk, and their administrative costs would be minimal because the contributions would be pooled and run by professionals on a not-for-profit basis. The funds are mandated and guaranteed so there is no advertising. The private investment industry will still have a role: the government trustees would hire for-profit brokers and financial institutions to invest the funds.

### Retirement Income Security Promises of GRAs

All workers, not just those working for firms that sponsor voluntary retirement plans, would have IRAs supplementing their Social Security benefits funded by a \$600 contribution from the government, plus worker and employer contributions. People would contribute constantly, not just when they are lucky enough to have three characteristics: working for a firm with a plan, being eligible for the plan, and participating in the plan. The accumulations from consistent 5%-of-pay-contributions, earning a 3% real rate of return and being paid as an indexed-annuity at retirement means that, with Social Security, the average worker will achieve a secure 71% replacement rate and the National Retirement Risk Index would show very few at risk of achieving subpar replacement rates.

The average earner, making \$39,000 per year, would accumulate \$172,300 in a GRA and get an annuity of \$5,800 per year. This is 30% of pre-retirement income. Combined with the Social Security replacement rate of 41%, the average earner would achieve a total replacement rate of 71%! A high earner (in this example with an annual income of \$62,000), because



she gets a lower Social Security benefit relative to income, would get a 64% replacement rate, and the low earner (\$17,000 per year) would get a much needed higher replacement rate of 86% (Ghilarducci, 2007).

Therefore, the United States would have a universal second tier of retirement income support that would be advance-funded on top of the pay-as-you-go Social Security system. By rearranging the tax code, the United States can obtain universal coverage and not spend any more than the treasury is spending now. The GRA plan pays for itself—it will not increase the federal deficit or require a tax increase—by eliminating all tax deductions for contributions to 401(k) plans. If contributions up to \$5,000 a year were allowed, the credit could be reduced to \$400 and the effect would still be revenue-neutral. Mandating contributions in a GRA means that all workers steadily accumulate assets to fund their golden years with the federal government's help, and the government—the only institution that can—takes on longevity, investment, financial, and inflation risk. The hard-to-see indirect subsidy for retirement savings would turn into a tax credit and retirement contribution of \$600 for everyone and actually raise national savings rates and secure Americans' retirement futures.

Despite some clear gains in terms of coverage, efficiency, and effectiveness, there is opposition to GRAs.

### Resistance to the GRA Plan

There are two key criticisms of the GRA plan: the guarantee might pose an expensive entitlement for the federal government to fund over time, and it will reduce the size of the mutual fund industry. The first is a serious public policy issue; the second is not.

The federal government promises to provide a 3% real return rate; however, there are key provisions in the plan that would allow the rate to fluctuate depending on the real growth rate in the economy. In fact, the 3% real return guarantee was selected to correlate roughly with the growth rate in real gross domestic product (GDP), in the productive base of the economy, not to fluctuations in the stock market. The intention is that the GRA board of trustees, under extenuating circumstances and after extensive hearings and consideration, could vary the guarantee rate if the economy does much better than grow at 3% real for an extended period of time or suffers long-term slower growth. The principle behind benchmarking the rate of return to the GDP real growth rate is that workers who save should earn a rate of return that reflects the talents, efforts, and resources of the same cohort of workers. A 3% real rate of return locked in stone would be inflexible and cause some risk to the treasury if GDP was considerably lower for long periods of time (Munnell, Golub-Sass, Kopke, & Webb, 2009). Independent analyses of the performance of financial markets and professionally run pension funds find that the risk that the federal government will

underperform a 3% rate of return for sustained periods of time to be low. But a low risk may be too high; this is a political question, not an economic one. There are many ways to construct a guarantee around a band of returns, and the details should be left to professionals who manage guarantees in other types of cash balance funds here and abroad.

The second source of resistance for a public option, an alternative to 401(k) plans, comes from the commercial mutual fund industry that enjoys advantages from the current system. Above, I documented the profitability of the 401(k) design for retail mutual fund firms. The loss in fee income has created a strong lobbying force against the GRA.<sup>5</sup>

Some employers may be the third source of opposition. They may enjoy the advantages that the current 401(k) system provides to pay workers less than they think they are earning. A study of 700 firms over 17 years found that if a firm adopted a 401(k), it lowered pension expenses by 3.5% to 5% and workers did not complain (Ghilarducci & Sun, 2006). Since 401(k) plans are voluntary, about 20% of workers who can avoid contributing do so and “leave money on the table” by not accepting the employer match. As a result, employers’ contributions are 26% lower than they would be if everyone participated (Munnell & Sundén, 2004).<sup>6</sup>

Given this opposition, the next section explores whether Congress would ever implement a mandated individual account tier to Social Security.

### Would Congress Ever Mandate Savings?

Most of the proposals for pension reform do not mandate savings (Mensah & Perun, 2007). The major advantages of a mandate are that workers would not have to be enticed to save by expensive tax breaks or the ability to withdraw funds at any time. There may be untapped support for mandated savings.

Surveys show that fewer than 50% of people think they will live comfortably in retirement, and at the same time, they show that workers feel personally responsible to supplement their Social Security benefits (Madland, 2008). Despite feeling responsible, they want the government to help. In 2006, HSBC Bank asked 21,000 workers in 20 nations what their governments should do about the expense of aging societies (HSBC Bank, 2007). On average, respondents preferred compulsory savings to any other policy. A third of Americans responding to the survey wanted the government to force them to save more for retirement; far fewer, 16%, would support a tax increase; and only 9% wanted the government to reduce benefits. In October 2007, a whopping 91% of respondents to a *Wall Street Journal* poll felt that the government should do something to secure retirement, and 41% said they were not hearing enough from the presidential candidates about retirement income issues (Bright, 2009).

Other experts and reforms in other countries support the notion that mandatory savings can be politically feasible. Adam Carasso and Jonathan Barry Forman (2007) have proposed a universal pension system requiring an annual employer contribution of 3% of earnings. Alicia Munnell (2009) also proposes a mandatory tier of pension saving.

In July 1, 2007, New Zealanders instituted the KiwiSaver program, a subsidized DC plan offered by private-sector providers. New labor force entrants in permanent positions, aged 18 or older, are automatically enrolled, but they can opt out. Employees contribute either 4% or 8% of gross earnings. Beginning April 1, 2008, all employers are required to contribute 1% of gross earnings in 2008, increasing 1% each year to 4% in 2011. Employers receive a tax credit of up to NZ \$20 (about US \$16) per week per employee. Workers who contribute receive a tax credit of up to NZ \$1,040 (about US \$836) a year, deposited directly into their KiwiSaver accounts (Kritzer, 2008).<sup>7</sup> Obama's proposal is similar to the KiwiSaver only in that employees can opt out, but it is not similar because employers must contribute.

On the other hand, employees cannot opt out of the Australian pension system, which is funded by 9% compulsory employer contributions. The system supplements the non-contributory basic pension paid at age 65 to all Australian residents with assets or income below a threshold, which provides a flat payment amount pegged at about 25% of the median wage. The Australian system is similar to the GRA in that coverage is mandatory, but the GRA pays out in annuities and the return is guaranteed.

In the Netherlands, the new pension plan is like the GRA in that it is a hybrid plan as well—the collective defined contribution plan. The employer must abide by a fixed contribution rate, and there are no additional obligations if the plan becomes underfunded. The fund uses the contributions to grant a conditional career-average benefit: investment risk falls on the plan and the employees and pensioners. In the Dutch system, there are no individual accounts, and employees do not make investment choices: The funds are pooled and professionally managed. This is similar to the GRA.

## CONCLUSION

After World War II and up to the 1980s, the U.S. retirement system was based on institutions established in the Great Depression and during World War II—Social Security and the employer voluntary provision of DB pensions and health insurance. By 2009, in the United States, almost all American retirees receive income from Social Security—about half from a middle tier of employer pensions, including 401(k)s—and the top 20% receive income from personal savings. The American retirement system is not a three-legged stool composed of equal parts: Social Security, employment-based pension plans, and personal wealth. The appropriate image is a pyramid, like the nutritional food pyramid, with Social Security at the base, the employer

system in the middle, and personal wealth at the top. It is the top two layers that are crumbling.

Savings rates have long been low, while the collapse of the housing market has demolished a critical pillar of wealth for many households. Meanwhile, half of all private-sector workers do not have access to pension plans or 401(k) plans at work. Many workers who are offered such plans fail to participate, and importantly, when they do participate, they do not save enough; they withdraw the funds before retirement and they are exposed to risks in the stock market as well as the risk of outliving their money when they retire. Financial markets are risky, and tens of millions of older Americans who do have 401(k) plans have recently seen those investments wiped out in a very short time, changing their retirement and work plans forever.

Just as the last Great Depression reordered the financial institutions that secured pensions, the 2009 financial crises eroded the non-Social Security layers of the pension system. Therefore, the crises may provide the opportunity to create a supplement to Social Security. This new layer of pension income could come from an advance-funded, professionally managed system—the GRA.

## NOTES

1. Obama's plan is based on the proposal by David John from the Heritage Foundation and Mark Iwry from the Retirement Security Project sponsored by the Hamilton Project. The proposal is explained most recently in their testimony to the U.S. Senate (John & Iwry, 2008). "We introduced this in 2006. . . . The McCain campaign endorsed the proposal. My colleague Mark Iwry advised the Obama campaign and they also endorsed it. It was the same identical proposal. We felt pretty good going into the November elections. Since then, the Obama administration included the automatic [IRA] in the budget, and they have explicitly endorsed the proposal" (Pichardo-Allison, 2009, p. 1).

2. Bell et al., (2004): In an unpublished memo, dated Feb. 19, 2009, to the House Labor and Education subcommittee. I used multiple regression methodology and two sources of data, The Office of Management and Budget and the Joint Congressional Committee on Taxation, to find that tax expenditures have a negative to no effect on increasing. The negative effect makes sense if savers are target savers; in other words, savers have a savings goal and the government subsidy helps them get there without reducing their current spending. Memo available from the author.

3. There is \$2.7 trillion in 401(k) assets (Employee Benefit Research Institute, 2007). The average fee is over \$700 per year and average fees are 1.5% of assets, which equals \$40.5 billion.

4. This is what the annuity would pay at a 3% inflation rate and a 3% real return.

5. <http://www.financialweek.com/article/20081102/REG/311039998/O/ISSUEINDEX>

6. Calculations are made using information from Munnell and Sundén (2004). The data on participation rates, average contribution levels by earnings, and the distribution of employees by earnings are calculated from the current population survey (2003) to make the \$3 billion estimate. The average savings per worker is derived from the \$156 estimate in Choi, Laibson, and Madrian (2005). They calculated, from their sample of more than 800 employees in one firm, that the employer saved over \$250 per older worker who did not participate in the 401(k) even when they were eligible. Fidelity's (2004) annual report documents employers' match behavior (Schwab, 2010).

7. Until March 2011, if both the employer and the employee agree, they may divide the employee's contribution. The government provides two other subsidies: a one-time tax-free payment of NZ \$1,000 (about US \$804) to each account after it receives the first contribution and a NZ \$40 (about US \$32) annual fee subsidy to each account holder (Kritzer, 2008).

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