# PURE: A Proposal for More Retirement Income Security

Christian E. Weller
Economic Policy Institute
1660 L Street NE
Suite 1200
Washington, DC 20037
(202) 331-5525
cweller@epinet.org

**Acknowledgements**

I would like to thank Ross Eisenbrey, Jeff Faux, Karen Ferguson, Ron Gebhardtsbauer, Teresa Ghilarducci, Neil Gladstein, Daniel Halperin, Shaun O'Brien, Peter Orszag, and Robert Scott for helpful comments on earlier versions of this proposal. I am also grateful for the excellent research assistance provided by Laura Singleton. All errors are my sole responsibilities. The views expressed in this proposal should not be attributed to the Economic Policy Institute.

# I. Introduction

Saving for retirement is a story of good and bad news. The good news is that people live longer. The bad news is that most households have insufficient savings to retire with a decent standard of living. Most experts agree that retirement income equal to 75-80% of a worker's pre-retirement income is adequate for a decent standard of living. But 40% of households near retirement cannot even replace 50% of the income they had before retirement, and less than 40% can replace 75% of their pre-retirement income.

To raise retirement savings for most households, three issues need to be tackled:

- Coverage is woefully inadequate, leaving many workers without even the opportunity to build up pension wealth.

- The pension system is skewed towards high-income earners. Hence, many low and moderate-income households that have pensions do not have enough savings for a decent standard of living in retirement.

- The risks of retirement savings are growing, thus raising the chance that savings will not be there when a worker retires. Rising coverage, more retirement wealth for most low and moderate-income households, and lower risks will increase the adequacy of retirement savings for low and moderate-income households.

One part of the retirement system, Social Security, addresses all three problems. But since its inception, Social Security was meant to be a safety net – the first tier in a three-tiered retirement pyramid with private pensions and personal savings on top. Workers with average lifetime earnings can expect benefits equal to 42% of their earnings at the normal retirement age. To afford a decent standard of living, most workers need twice that amount and hence substantial additional retirement savings.

The additional retirement funds should primarily come from pensions since the alternative of private savings is substantially less promising[1]. Retirees over 65 received on average 11% of their income from their savings in 2000; 23% of households over 65 received less than $250 per year from their savings; and the median household received $1,921 per year from savings (SSA, 2002). Moreover, the personal savings rate dropped to an average of 5% during the 1990s, its lowest level during the post-war era. Put differently, savings are not enough to cover the retirement needs of most households, and they are likely to decline given low savings rates. However, improving private pensions holds the potential, to generate sufficient retirement savings for many households, especially low and moderate income households, who often have little wealth (Wolff, 2002a). Already savings incentives, such as 401(k) plans, tend to raise wealth for low income households more than for high income households (Engen and Gale, 2000).

[1] The term of pensions refers to all employer-sponsored private retirement plans.

Relying on pensions as the primary force to improve retirement income security, does not imply that Social Security's benefits could not be improved, e.g., through higher minimum benefits and improvements for spousal benefits, but priority should be given to building pension wealth as an addition to Social Security. It also does not imply that private pensions could serve as a substitute for Social Security. Social Security remains a more secure and more cost effective basic insurance benefit.

However, promoting pensions in addition to Social Security offers a few advantages over increasing Social Security benefits. In particular, pensions can be used as recruitment and retention tools by employers, and they can be more easily modified than Social Security to address workers' varying retirement needs. And, under certain circumstances, improved pension coverage and retirement wealth could lead to increased personal and greater national savings.

If pensions are not seriously reformed, many households will face serious hardships. A long retirement is a reality for many workers due to improved life expectancies, but due to health constraints, age discrimination, depreciated skills, and care-giving responsibilities, many workers are not able to work longer. Without additional retirement income, many retirees will face economic hardships, such as lack of adequate housing, clothing or food, which will have to be compensated for through public assistance[2]. Congress has made a commitment to helping households build enough pension savings as witnessed by pension subsidies of more than $100 billion per year[3]. Yet, these large efforts have failed to deliver on their promise since most households continue to be inadequately prepared for retirement.

This reform proposal consists of three pillars; each intended to address one of the policy goals, such that the adequacy of retirement savings for most households can be increased effectively:

- Private pension coverage should be mandatory, supplemented by a small mandatory employer contribution.

- Retirement wealth for low and moderate-income households should be created through direct and matching government contributions.

- Retirement savings should be secured through prudent investment rules for defined contribution plans and easier access to defined benefit plans.

## II. Background: The Existing Pension System

Although the private pension system is characterized by a number of intricate rules and regulations, there are a few basics to keep in mind. For instance, the private

[2] Women are particularly at risk as they live longer, are more inclined to care for an older spouse and have fewer employment opportunities, and tend to accumulate smaller pensions due to lower lifetime earnings.
[3] Some of these subsidies will be recouped in the future as retirees will pay taxes on part of their pension income. Nevertheless, from today's budgeting perspective, these constitute tax expenditures.

pension system is voluntary, and it is employer centric. The employer can decide to sponsor a pension plan or not and to exclude some employees, and, depending on the type of plan, the employee can decide to participate or not. According to the U.S. Department of Labor (2000), 58% of the private sector workforce worked for an employer who sponsored a pension plan, but only 46% participated in a pension plan.

## II.1 Defined Benefit Plans

Traditionally, most pension plans were defined benefit (DB) plans. Under a DB plan, the employee is guaranteed a benefit upon retirement, usually based on years of service, age and final earnings. The benefit formula is designed such that employees accrue most of their benefits during their last years of service. Employees are typically not immediately vested in their DB plan, but the maximum vesting period is five years under existing regulations[4]. Accrued benefits for private sector DB plans are insured by the Pension Benefit Guaranty Corporation (PBGC).

Another form of DB plans are so-called cash balance plans. Under a cash balance plan, the employee accrues benefits in direct proportion to his or her current earnings. Essentially, a worker's (hypothetical) pension account is credited with an amount equal to a fixed share of a worker's wage each year, and the account balance is assumed to increase at a pre-determined interest rate. In comparison, under a traditional DB plan benefits are related to final (and presumably above average) earnings. As a result, younger workers accrue higher pension wealth under a cash balance plan than under a traditional DB plan, and vice versa.

Though workers pay indirectly for pensions through lower wages, the funding of the plan's liabilities (promised benefits) is the employer's responsibility. Should a fund become overfunded because the plan's assets performed better than expected or received more contributions than needed to fund actual benefits, employers are generally not required to increase benefits and hence they do not have to make further contributions to the DB plan as long as the plan remains overfunded. Current regulations, in fact, limit the amount of overfunding a plan can have and still receive tax benefits, effectively discouraging the employer from contributing to an overfunded plan. Some DB plans, especially collectively bargained multi-employer plans, differ from this in one important aspect. Here, the union and the employer negotiate employer contributions and guaranteed benefit levels. If a multi-employer plan becomes overfunded, benefits may increase, depending on the approval of the plan's trustees.

## II.2 Defined Contribution Plans

Since the early 1980s, though, a smaller share of workers is covered by traditional DB plans, and a rising share of workers is covered by defined contribution (DC) plans. The share of households with a DC plan rose from 7.9% in 1983 to 47.8% in 1998, whereas the share of households with a DB plan fell from 67.8% to 45.9% during the

[4] Employers may use an alternative graded vesting schedule under which a worker vests gradually, with 100% vesting occurring as late as 7 years after the worker first becomes employed.

same period (Wolff, 2002a). Similarly, the share of private sector workers covered by a DB plan as their primary pension plan fell from 38% in 1978 to 21% in 1998, while the share of private sector workers with a DC plan as their primary pension plan rose from 7% to 27% during the same period (DOL, 2001)[5].

The main characteristic of DC plans is that the risks, though not the control, associated with this type of savings rest with the employee, not the employer. Under the most common DC plan, so-called 401(k) plans – named after the provision in the tax code – private sector employees contribute a share of their income to an individual account, whose investment choices, vendors, and fees are controlled by the employer, if the employer chooses to sponsor such a plan. Employers usually contribute, either on a matching basis or on a direct contribution basis, to their employees' accounts. Employees are generally responsible for their accounts' investments, within some limits that can vary by plan. Occasionally, plans are directed entirely by trustees or fiduciaries. Employee and employer contributions are generally pre-income tax contributions[6], but there is a contribution maximum. The biggest distinguishing feature between DC and DB plans is that there is no guarantee of future benefits under a DC plan, since the employee assumes all investment risks, and since there is no PBGC-type insurance. Similar DC plans exist for public sector workers and for private sector employees in some non-profit organizations.

All workers can, within certain limits, contribute to an Individual Retirement Account (IRA). The tax advantages of IRA contributions are greater for workers who are not participating in an employer sponsored qualified plan. The contribution limits to IRAs, though, are substantially lower than the dollar contribution limits for employer-sponsored DC plans. Aside from their contribution limits, IRAs operate very similarly, although employees generally have more investment options.

## III. Basic Problems

The majority of households have inadequate savings to maintain its standard of living in retirement. Generally, retirement savings are considered adequate if they allow the household to replace about 75-80% of its pre-retirement income, defined as the average of the last three years of earnings. The accepted difference between pre-retirement and retirement income stems from a number of factors, such as lower taxes for retirees or fewer work and housing-related expenditures. However, most households can expect to retire on significantly less income than that. For instance, Wolff (2002) found that less than 40% of households were able to replace more than 75% of their pre-retirement income in 1998, 43% of households were not even able to replace half of their pre-retirement income, and 19% of households could expect to retire in poverty in 1998. Moreover, the inadequacy of retirement savings has worsened in recent years. Whereas 44% of households could replace 75% of their pre-retirement income in 1989, only 39% of households could in 1998 (Wolff, 2002).

---

[5] Similar trends towards increased DC plans and declining DB plans can be observed in the public sector.
[6] Employee contributions are still subject to FICA taxes.

There are three fundamental reasons for the failure of the pension system to assure adequate retirement income.

First, millions of workers lack pension coverage. Pension coverage means that an employee accrues pension benefits by either contributing, or having the employer contribute, to a DC plan or by building up benefits under a DB plan[7]. For two decades, the share of private sector wage and salary workers covered at their work place by a pension plan has stagnated at about 46%. Coverage is lower for minority workers: in 2000, 43% of blacks and only 29% of Hispanics had coverage in a pension plan. Given this coverage failure, it is no surprise that many households will never have any pension benefits. Wolff (2002) found that more than one-fourth of households in the age group between 47 and 64 had no pension benefits accrued during their working careers (Wolff, 2002).

There are several explanations for this widespread lack of coverage. Many employers – especially small employers -- simply choose not to offer a pension plan to any of their employees. Other employers offer a plan to some employees but choose to exclude others. The law potentially permits an employer, for example, to provide a pension to salaried employees but not to hourly workers, or to workers in one location, but not in another. Further, some features of pension plans, such as vesting, age, and minimum tenure and hours worked requirements, can exclude workers from participating. Moreover, even if an employer offers a DC plan to all employees, some employees may not contribute because they do not have sufficient discretionary income or otherwise choose not to contribute (Joulfaian and Richardson, 2001)[8]. The tax incentives for plan contributions are modest or nonexistent for low and moderate-income households, but they can be substantial for higher income households.

Second, retirement wealth is unequally distributed. Arthur Kennickell et al. (2000) found that only 25% of families earning between $10,000 and $25,000 in 1998 had any retirement account from a current of past job, whereas 87% of households with incomes over $100,000 did. There are a number of reasons why low and moderate-income households have disproportionately fewer retirement savings than higher income households[9], even when the employer sponsors a retirement plan. For instance, many households do not have enough income to save for retirement, even if they have the opportunity to do so. In 2000, the bottom 20% of households had incomes of less than $25,000 (Mishel et al., 2002), but a family typically requires more than $35,000 per year to cover its basic needs (Bernstein et al., 2000), leaving little money for retirement savings. Ed Wolff (2002b) reports that the 40% of households with the lowest incomes had negative financial wealth, i.e., they owed more than they owned, in 1998. Further, there are larger tax incentives for higher income earners to save with a tax-advantaged plan, such as a 401(k). Contributions to 401(k) accounts are not subject to income taxes

[7] In this paper, the term coverage is used synonymous with participation.
[8] Lawrance (1991) and McCarthy (1995) found that low-income households were less likely to save than higher income households were.
[9] Also, minorities have less adequate savings than whites, and households with higher incomes and more wealth tend to increase their pension wealth over time disproportionately faster than other households (Mitchell and Moore, 1998; Mitchell et al., 2000; Wolff, 2002a, 2002b).

until they are withdrawn. Since federal income taxes are relatively higher for higher income earners, there is a larger incentive for high-income earners to take advantage of 401(k) s than for lower income workers. This is reflected in the share of tax subsidies accruing to high-income earners. For instance, Peter Orszag and Jonathan Orszag (2001) found "that two-thirds of the existing tax subsidies for retirement saving (including both private pensions and IRAs) accrue to the top 20 percent of the population". Lastly, some pension plan features, such as minimum vesting periods, prevent workers from earning a pension. Consequently, workers who leave a work place before reaching the minimum vesting period, forfeit any pension savings attributable to employer contributions.

A worker whose employer does not offer a pension plan will have a difficult time accumulating sufficient retirement wealth to provide adequate retirement income. The tax-sheltered retirement savings device Congress created – the IRA -- has been most helpful to upper income savers, for the same reasons that DC plans have been most beneficial to high-income earners. Higher income earners have fewer income constraints and stronger tax incentives to contribute. Only 6% of all workers eligible to contribute to an IRA did actually contribute to one in 1996. Moreover, only 2% of tax payers earning less than $25,000 in 1996 contributed to an IRA, whereas 22% of tax payers with incomes above $75,000 contributed to an IRA (Smith, 2002). Unsurprisingly, for those who own an IRA, but not a 401(k), the average account balance is almost twice as great for those earning more than $60,000 as for those earning between $12,000 and $30,000 a year (Copeland, 2002).

The third fundamental problem is that households are facing increasing risks with their retirement savings, mainly because of the growth of DC plans (Weller and Eisenbrey, 2002)[10].

For one, there are a number of financial market risks that are borne by employees under DC plans. One risk is the chance of misjudging the market and investing in a losing asset. There is also the possibility that markets will stay down for long periods of time, generating low rates of return even for the savviest investor. During the 20-year period ending in 1981 the real rate of return was less than 1% a year, while during the 20-year period ending in 1999 it was 12.5%. Such market swings mean that two people of similar means who invest similar amounts can end up with vastly differing retirement savings. After 40 years of contributing to a hypothetical account invested solely in stocks, a worker retiring in 1966 could have replaced 100% of her career-high earnings, whereas a similar worker retiring in the late 1970s could have replaced only a little more than 40% (Burtless. 2000). Moreover, stock markets are driven to some degree by fads, such as the Internet bubble of the late 1990s, thus enticing investors to put too much money in one basket. Further, there is the risk that the information that investors rely on is manipulated as recent corporate scandals painfully illustrated. In particular, misleading accounting statements attracted investors to presumably good investments that later turned out to be losing propositions.

[10] Additional risks include the risk that people cash-out of their retirement plans when they leave a job, thus reducing their life time accumulation, and the risk that households outlive their savings.

Lastly, there is the chance that violent swings in the market will lead people to save too little over the course of a lifetime. For instance, Gregory Mankiw and Stephen Zeldes (1991) found that savings by households that owned stocks were more volatile than consumption of households that did not, and that the volatility of savings varied with excess stock market returns.

It seems that the swings in savings, though, are different in reaction to a stock market up turn than they are in a market downturn. When stock prices rise, households increase their consumption and reduce their savings (Poterba and Samwick, 1995; Ludvigson and Steindel, 1999; Poterba, 2000). Ideally, this should also work in reverse – when the market falls people should start saving more to make up for the loss of assets, and when the market falls a lot people should start saving even more. However, market declines often go hand-in-hand with a weak economy, and households do not have enough money to save more (Weller, 2002). Similarly, after a market crash, households are often skittish about re-entering the market, thereby not saving enough. Instead, households are likely to spend more out of a declining income. Hence, the so-called wealth effect appears to be asymmetric. Thus, greater volatility in household savings means a greater chance that households will not save enough.

## IV. Policy Responses

In the following discussion, proposals are evaluated on their potential effectiveness to increase coverage, raise retirement wealth for low and moderate-income households, and reduce the risks of retirement savings. In each case, the proposals can range from ineffective to somewhat effective to very effective in potentially achieving their goals[11].

Many proposals to increase coverage have been based on the assumption that employers would offer pensions if their cost were reduced, especially the administrative costs[12]. To reduce costs, the simplification of pension rules was proposed as well as the pooling of resources. One of the more comprehensive proposals to simplify existing regulations was made in Pamela Perun and Eugene Steuerle's (2000) proposal to modify the Employee Retirement Income Security Act (ERISA). The options to pool resources include Dean Baker's (1999) proposal for Universal Voluntary Accounts (UVA). Administrative costs are not a major obstacle, however. Congress has already established uncomplicated, extremely low-cost methods of providing pensions, specifically aimed at smaller employers, but the results in terms of increased coverage have been disappointing. Simplified Employee Pensions, known as SEPs, and SIMPLE-IRAs are easy to set up and entail no reporting beyond an annual statement for employees showing the amounts contributed. And in fact, most of the reasons not to offer a plan given by small employers in an annual survey conducted by the Employee Benefits Research Institute have nothing to do with administrative cost but with the employer's perception that employees prefer wages or other benefits over pensions.

---

[11] See the appendix for an overview of the proposals cited here.

[12] Costs of 401(k) plans can be substantial. PWBA (1998) estimated that small plans pay about 1-1.4% of their assets in fees. There also seems to be a growing trend to pass the plan's expenses on to participants.

It would be more effective to make pension coverage mandatory than to seek new ways to lower costs or simplify regulation. Peter Orszag (2002), for instance, has proposed making enrollment in existing pension plans automatic, leaving it up to the employee to opt out of a plan. By taking advantage of employee inertia (Madrian and Shea, 2000), coverage may increase somewhat. But this proposal would do nothing, of course, for workers whose employers do not offer a pension plan. Hence, mandatory pension coverage, whereby all employers of a certain size have to enroll their employees in a pension plan would be more successful in improving coverage. Rep. Richard Gephardt proposed mandatory access to pension plans in his Universal and Portable Pension Act, which could help to improve coverage since more workers would be able to participate in a pension plan. Similarly, proposals that would offer low-wage workers direct government contributions, such as former President Clinton's USA Account proposal, would help to increase the number of households with retirement savings substantially by offering low and moderate-income workers a strong incentive to be covered or automatically cover them. Even more effective in raising coverage would be proposals that combine mandatory access to pensions with mandatory employer contributions, such as former the Mandatory Universal Pension System (MUPS) proposed by President Carter's Commission on Pension Policy (PCPP, 1981).

Most households already have some pension, but most, particularly low and moderate-income households, still have inadequate pension wealth.

Proposals to raise pension wealth by eliminating contribution limits for DC plans would do nothing for most households. For instance, Theodore Groom and John Shoven (2000) proposed to eliminate current limits on DC plan contributions. However, this proposal would have no impact on the pension wealth of most Americans who either do not have a pension plan or who are not contributing at the current limit. Less than 6% of employees contributed the maximum when contributions were capped at $10,500. Presumably, even fewer will reach the current limit of $11,000, or the new limit of $12,000 starting in 2003.

Proposals to shorten vesting periods and increase portability should allow workers to accrue pensions more easily, especially workers who frequently switch jobs. Also, proposals that would allow for a transition from traditional DB accruals to cash balance plans without harming workers with a lot of seniority could help to raise pension wealth for young workers, while protecting older workers' pensions. These changes to pension rules could provide modest help to increase pension wealth for employees working for an employer who offers a pension plan, but they will have no effect on the retirement wealth of those workers who do not.

Proposals that would help to lower the costs of pension accounts could also have a limited effect on pension wealth. For instance, Dean Baker's (1999) Universal Voluntary Accounts could be effective in lowering the costs of pension accounts. This could have some marginal benefit in terms of raising benefits since lower costs would mean automatically higher savings. It could also help to increase coverage slightly by lowering the costs for employers, especially small businesses. Due to the fact that financial markets are usually characterized by economies of scale, low and moderate-income households, and small businesses stand to gain disproportionately more from a low cost proposal than others do.

In comparison, direct and matching government contributions may be a very effective way to increase retirement benefits (Halperin and Munnell, 1999). Although there is no direct experience with direct government contribution plans and only limited experience with matching contribution programs, it seems reasonable to assume that they will be effective in raising retirement savings for low and moderate income households for two reasons. For one, savings incentives have already been found to be more effective in raising wealth for low income than for high income households (Engen and Gale, 2000). Moreover, if participation is not voluntary, as would be the case with direct government contributions, the findings on savers' inertia suggest that household wealth would also rise (Madrian and Shea, 2000). For instance, former President Clinton proposed direct and matching government contributions for low and moderate-income households in his USA Account proposal. Also, former Vice President Gore proposed government matching contributions with substantially larger matches for low-income households than for higher income households. However, matching contributions still rely on some savings from low-income households – often a non-trivial hurdle to wealth creation.

Instead of or in addition to government contributions, pension wealth could be very effectively created through mandatory employer contributions. Former President Carter's President's Commission on Pension Policy, for example, proposed a minimum mandatory employer contribution of 3% of payroll for every employee over the age of 25 who worked more than 1,000 hours. Such a proposal would clearly help to raise retirement wealth for all workers that aren't currently receiving employer contributions of 3% or more.

Not only do pension coverage and pension wealth have to be increased, but pension savings have to be secured, too. Proposals that could have a limited effect on reducing the risks inherent in pension plans are ideas that call for greater transparency. Such proposals include a call for increased employee participation on the board of trustees of pension plans, as Sen. Edward Kennedy has proposed. Greater transparency, though, can only work to reduce risks if many participants can collect and interpret the available information. Since both information collection and interpretation are very time consuming, not many participants will incur these costs, thereby rendering greater transparency ineffective.

Providing more secure pension choices could have a positive, though limited, effect in lowering the risks associated with pension plans. Such proposals include a choice between guaranteed benefits and variable investment returns, or even mandate a minimum guaranteed benefits, as proposed by Reps. Nancy Johnson and Earl Pomeroy in their Secure Assets for Employees Plan (SAFE) Act of 1997[13]. Also, proposals that would make DB plans more attractive and hence presumably give employers and employees more access to a more secure pension choice could help to reduce risks somewhat. Proposals to improve the attractiveness of DB plans, either single employer or multi-employer plans, include opening up collectively bargained multi-employer plans to non-unionized employers and offering tax incentives for small employers (Gordon, 2000). The effectiveness of these proposals is likely to be limited, however, since they rely on voluntary choices by employers or employees.

Lastly, proposals that would explicitly or implicitly force DC plans to diversify their assets are probably more effective tools to lower the risks associated with this type of plan. For instance, mandatory diversification of DC plans, similar to the rules regulating DB plans, is a proven way to reduce the risks inherent in pension plans (Weller and Eisenbrey, 2002). A different approach would be to offer PBGC-type insurance for DC plans. This would logically require that DC plans diversify their assets in a fashion similar to DB plans, in order to avoid moral hazard problems. Diversification of plan assets required by pension regulations would clearly help to reduce the risk exposure of plan assets.

## V. An Alternative Proposal

A successful pension reform proposal has to accomplish three things. First, it has to increase pension coverage substantially, second, it has to raise retirement wealth for low and middle-income workers, and third, it has to secure pensions, so that they will be there when a worker retires. This proposal incorporates many of the most promising ideas of previous proposals and extends them, where appropriate.

The answer has to be to conceptualize the American retirement system anew. The goal should be to ensure, as a minimum, that low-income workers, those currently earning between $10,000 and $20,000 per year, can replace about 75-80% of their pre-retirement income with Social Security benefits and income from private pensions. To achieve this, a successful pension reform program needs to have the following characteristics:

- It must substantially increase pension coverage. Based on past experience, this requires mandatory coverage, instead of voluntary participation.

- It must improve retirement savings for low and moderate-income households. This requires that the government make a basic annual contribution for low and moderate-income households in the form of direct contributions or by employers through mandated contributions.

- It should minimize the risks to the accumulated savings.

[13] In the case of the SAFE proposal, the choice was given to the employer, but the choice could as easily be given to the employee.

Based on these principles, a specific proposal can be designed. The logic of the proposal is to first ensure universal coverage, then to increase retirement wealth for low and moderate-income households and finally to safeguard retirement wealth.

### V.1 Mandatory Coverage

- A new retirement account, Personal Universal Retirement (PURE) account, is created for each employee. To lower the administrative burden on employers, a PURE account number can be established at birth, but no later than the start of one's first employment – not unlike Social Security numbers. Upon employment, workers can designate an existing pension as their PURE account or they can open a PURE account instead.

- At the time of hire, employers must enroll each employee in a retirement account. Such a retirement account could be a qualified DC or DB plan or a PURE account.

- The federal government administers the PURE accounts through an independent agency, such as the Federal Retirement Thrift Investment Board (FRTIB), which administers the federal Thrift Savings Plan, to keep costs to a minimum.

- Professional fund managers, who are selected by the FRTIB, invest the funds of PURE accounts according to worker's instructions. The investment options are the same as for the TSP to keep administrative costs to a minimum by allowing the FRTIB to reap further economies of scale. Currently, TSP offers two fixed income funds – one investing in treasuries and one investing in corporate bonds. It also offers three stock funds: a broad index fund that measures the S&P 500, a small capitalization fund and an international stock fund.

- The PURE account is compatible with other pension plans. Workers can roll over balances from other qualified plans into the PURE account upon leaving an employer who offers a pension plan.

- Vesting of account balances is immediate and PURE accounts are fully portable.

- Employees and employers can contribute additional funds to the PURE accounts. Additional pre-tax contributions by employees are capped at the current IRS limits for 401(k) plans, currently $11,000 per year. All regulatory and tax treatments that apply to 401(k) plans would also apply to PURE accounts, including non-discrimination rules and the taxation of withdrawals.

The PURE accounts would be established as a complement to existing DC plans[14]. In particular, PURE accounts are a low cost option for workers who are either working

[14] There are concerns that universal accounts administered by the government will offer employers, who are currently offering DC plans, an incentive to eliminate or weaken their existing plans, and hence their contributions. Consequently, existing rules that may be beneficial to low and moderate income employees,

for an employer who does not offer a pension plan or for workers who want to avoid high costs in the private markets and who are only looking for a limited set of investment choices. However, other DC plans will continue to exist for workers who want more investment choices and who are willing to pay for them.

The creation of PURE accounts is a necessary extension of the proposal to make pension coverage mandatory. The costs of individual accounts for low-wage workers could be prohibitively expensive in the private market since it would create a large number of very small accounts. To reduce the costs for employees, the government needs to offer employees the opportunity to establish an account with a federal agency.

### V.2 Employer and Government Contributions

- Employers are required to contribute at least 3% of gross earnings of an employee to a qualified pension plan or to a PURE account. These contributions would be on a pre-income tax base, but they would be subject to FICA.

- The government will make direct contributions for low-wage workers to PURE accounts or other qualified plans, as directed by the worker. Workers earning more than $5,000 and less than $20,000 per year will receive $300 if they are single filers. If they are joint filers, they will receive $600 dollars if they earn between $5,000 and $40,000 per year. For single heads of households, the direct contribution is also $300, but workers will receive this contribution if they earn between $5,000 and $30,000. For single filers earning between $20,000 and $40,000 per year, the contribution will be $300 minus 1.5 percent of income over $20,000; for joint filers earning between $40,000 and $80,000, the contribution will be $600 minus 1.5% of income above $40,000; and for single heads of household earning between $30,000 and $50,000 contributions equal $300 minus 1.5% of income above $30,000. The income limits and contributions are adjusted for inflation each year

- Contributions from low-wage workers are matched by the government up to certain limits. Contributions are matched at a ratio of 1-for-2 up to a maximum contributions of $200 for single filers earning less than $20,000, and single heads of households earning less than $30,000, but more than $5,000[15]. For joint filers earning between $5,000 and $40,000, the match would be 1-for-2 up to a maximum of $400. For single filers earning between $20,000 and $40,000, and for single heads of household earning $30,000 to $50,000 the match would be 1-for-3 up to a maximum of $200. Also, for joint filers earning between $40,000 and $80,000, the match would be 1-for-3 up to a maximum of $400.

---

most notably non-discrimination rules, would no longer apply. However, if PURE accounts are combined with mandatory employer contributions (see section V.2) this concern should be alleviated.

[15] These matches are somewhat more generous than the temporary low-income credit for retirement contributions under the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, but substantially less generous than the matches proposed by former Vice President Al Gore under his Social Security Plus proposal (ABC, 2000).

- Direct and government matching contributions can be made to newly created PURE accounts or to any other qualified plans as directed by the employee. Hence, direct and matching contributions could be made to DC and DB plans. To ensure that employees can direct their contributions to existing DB plans, existing plans would have to allow for the purchase of additional service credits. The rate at which an employee can purchase additional service credits has to be at least the rate at which the employer can increase benefits under a DB plan or at which new small employers can enter a multi-employer plan[16].

The estimated initial costs are slightly higher than the estimated $38 billion first year costs for President Clinton's USA Account proposal (Gebhardtsbauer, 1999). The total initial costs for the direct and matching contributions are estimated to range from $43 to $48 billion, depending on how many people take advantage of the matching contribution (table 1). In particular, the direct contribution is estimated to amount to $37.6 billion, whereas the matching contributions are estimated to amount to $5 billion with a take-up rate of 50%, to $7 billion with a take-up rate of 67% and to $10 billion with a take-up rate of 100%.

The costs of this proposal need to be put in perspective. For 2003, the government is expected to subsidize private pensions with $53 billion in foregone tax revenues for employer plans, $59.5 billion for 401(k) plans, and $6.8 billion for Keogh plans. Hence, the government is currently spending $119 billion, plus another $18.6 billion to subsidize IRAs -- more than three times the cost of the proposed contributions -- with little effect on the retirement wealth of low and moderate-income families.

The additional revenues to pay for the direct and matching government contributions could come from two sources[17]. First, already scheduled tax cuts could be eliminated. According to the Citizens for Tax Justice (2002) 80% of the benefits to the richest 1% of households from President Bush's tax cut will come into effect due to changes in the tax code after 2005. That is, if future tax cuts for the richest 1% of households are not implemented, the federal government will have an additional $380 billion in revenue at its disposal between 2005 and 2011, or more than enough to pay for the proposed direct and matching contributions. Second, reducing tax subsidies for existing pension programs (rather than carrying out currently scheduled increases) could cover a small share of the government contributions. In particular, contribution limits – increased under EGTRRA - for tax subsidized DC plans, such as 401(k) plans, and for

---

[16] This may require regulation of the interest rate that pension plans can use in their calculation for purchasable service credits to avoid that plans use an excessively low rate. However, this seems to be a minor concern. If employers give their employees a bad deal on purchasing service credits, employee could put their additional funds in PURE accounts. Considering the benefits many employers reaped from their DB plans during the late 1990s, employers have an incentive to attract the additional funds into their DB plans by offering an adequate interest rate. Further, in multi-employer plans, the union presumably acts as advocate for its members ensuring that service credits can be purchased at a reasonable rate.

[17] Additional sources of funds could come from additional employer taxes after permitting employers to exclude low wage employees from qualified plans (Halperin and Munnell, 1999), or from eliminating the temporary savers credit. JCT (2001) estimates the costs of the nonrefundable tax credit to be $7.6 billion between 2003-and 2006.

IRAs could be repealed or gradually reduced. For instance, if future increases in contribution limits were not enacted, tax subsidies in the form of foregone tax revenues would be about $2 billion less per year than expected (JCT, 2001).

Perhaps the most controversial element of the PURE proposal is the mandatory 3% employer contribution. First, low levels of mandatory contributions may bear the risk that employers who already offer pension plans will reduce their contribution to the mandatory minimum and, presumably, lower level. Similar fears arose about the future of DB, when 401(k) plans were introduced. However, the evidence suggests that the decline of DB plans was due to a number of factors, such as sectoral shifts in the economy or the decline of unions, and not necessarily to displacement by DC plans (DOL, 1998; Gordon, 2000; Medoff and Calabrese, 2001; Poterba, Venti and Wise, 2002). As long as employers will still use pension plans as a tool to attract and retain workers (Ghilarducci, 2001), the risk that a low mandatory contribution rate would result in the dilution of existing pension plans appears small.

Another issue is that a mandatory employer contribution could result in less employment and decreased wage growth, especially for low-wage workers. Any disemployment effects are likely to be very small. First, many employers already offer pensions to their employees, often contributing substantially more than the proposed minimum of 3%. Hence, the mandatory minimum contribution would affect almost exclusively employers who currently do not now contribute to a pension plan.

Moreover, it is likely that the labor demand for low-wage workers, who would disproportionately benefit from a mandatory minimum contribution, is relatively inelastic, which suggests that higher labor costs will not have a large negative effect on employment. Similar arguments are often made in opposition to increases in the federal minimum wage, but there is no evidence that past minimum wage increases had discernible employment effects in the low-wage labor market (Card and Krueger, 1995; Rassell, Bernstein, and Boushey, 2001).

It is possible that an increase in non-wage labor costs could have the countervailing effect of lowering wage growth[18]. But a few things, should be kept in mind about the potential substitution effect between benefit increases and wage growth that will likely limit any potential adverse effects on employer profits. First, the effect would be static i.e., after the mandatory contribution rate is increased, there is no reason to believe that wage or employment growth will be permanently lower. Second, the after tax wage effect would likely be a good deal smaller than 3 percentage points, since the mandatory contributions would be pre-tax contributions. And if the substitution were a real concern for the low-wage labor market, the minimum wage could be raised (and indexed) to counter this substitution effect.

[18] The time period during which Social Security taxes were increased, which could serve as an example of the likely impact of a mandatory minimum, was also a period during which wage growth slowed markedly, largely because of other factors, such as a recession and increased overseas competition (DOL, 1998).

The effects on the competitiveness of U.S. businesses are likely to be very small from the mandatory minimum contribution. Only employers who do not already offer a pension plan with a contribution of at least 3% will be affected by this change. In other words, the proposal will have little effect on the competitive situation of employers domestically. Moreover, it will change the competitive situation of overseas producers only marginally. Already domestic producers are competing with producers from such low-wage locales as China, Vietnam, or Mexico, who enjoy an advantage over domestic producers in the form of wages that are only a small fraction of domestic wages. Marginal changes in the compensation of U.S. workers will not offer a meaningful incentive for production to move overseas.

### V.3 Retirement Savings Security

- Diversification is mandatory under DC plans. No plan can hold more than 10% of a single security across all of an individual participant's assets.

- All DC plans must offer an investment choice that would provide a minimum guaranteed benefit.

- Transparency for plan participants has to be increased, so that insider trading, fraud, and misleading accounting practices that can adversely influence the value of retirement savings, can be detected. One possible option is to require that all pension plans must have participant representation on their board.

- Also, when DB plans are converted to cash balance plans, workers must be given a choice of the old or the new plan.

### V.4 Benefits of PURE Proposal

The program is designed to help low and moderate-income families. So, how much would these families benefit from the PURE program? Table 2 details the benefits for low, average and high-income single workers who are 25, 35, and 45 years old in 2002. In particular, the real replacement ratio from each source of retirement savings, Social Security, employer mandatory contributions and government direct and matching contributions is detailed. The generation that would have a full working life under the new system, today's 25-year olds, would have a replacement ratio of 84% for low-income workers, 65% for average income workers and 57% for high-income workers.

The replacement ratios for married joint filers, assuming a single earner couple and single life annuities, are detailed in table 3[19]. Because of Social Security's spousal benefits and the progressive nature of the government contributions, low earner couples will enjoy replacement ratios of over 100%. However, it is important to keep in mind that such examples are likely to be very rare since they presume that one spouse in a low earner family has no or only a small earnings record over a 40 year period. Under this

[19] Assuming a dual income earner couple with the same earnings would show the same replacement ratios as for a single earner.

scenario, couples with one average lifetime earner will be able to afford a decent standard of living relative to their pre-retirement earnings.

Lastly, the replacement ratios for single heads of households are detailed in table 4. Due to the higher income limits, as compared to single filers, the main beneficiaries are single heads of household with average lifetime earnings. Otherwise, the replacement ratios are the same as for single filers.

In general, the proposal generates adequate replacement ratios for low-wage workers and close to adequate replacement ratios for average lifetime earners. For workers who are older today, the replacement ratios from the PURE proposal are lower since these workers have shorter savings periods. Also, the replacement ratios from Social Security and the government matching program both decline with income since both programs are meant to disproportionately benefit low-income workers.

## VI. Conclusion

Since improvements in retirement income security have been elusive, it is time to change our thinking on retirement policy. Pension coverage should be mandatory, as should be a minimal employer contribution. Further, the government should help provide a basic minimum of savings for low and moderate-income workers. Lastly, safeguards need to be put in place to secure the retirement savings of working families. Without a serious reorientation of our retirement policy, we will continue spending more than $100 billion in foregone tax revenue to subsidize a system that fails the majority of households.

The $45 billion annual cost to the federal government of this effort is large but appropriate. The alternative of business as usual is not a no-cost option. On the contrary, most of the benefits from the current $138 billion government subsidy accrue to a small share of households – those who least need the help in saving for retirement.

The life expectancy of older workers is likely to continue rising for the foreseeable future. However, improvements in the health status of older workers are less certain, suggesting that many workers, especially at the lower end of the income spectrum, will be unable to meet their retirement needs by working longer. Thus, as the share of the elderly is increasing, the nation’s retirement income needs are growing, too. Unless we are willing to accept rising old age poverty for the foreseeable future, we need to address the inadequate retirement savings of a growing share of households sooner rather than later.

**References:**

Baker, D., 1999, Pensions for the 21st Century, New York, NY: The Century Foundation.

Bernstein, J., Brocht, C., and Aguilar-Spade, M., 2000, How Much is Enough? Basic Family Budgets for Working Families, Washington, D.C.: Economic Policy Institute.

Calabrese, M., 2001, Universal Savings Accounts, paper presented to the Pension Rights Center's Conversation on Coverage conference, Washington, D.C., July 24-25, 2001.

Card, D., and Krueger, A., 1995. Myth and Measurement: The New Economics of the Minimum Wage. Princeton, NJ: Princeton University Press.

Citizens for Tax Justice, 2002, Year-by-Year Analysis of the Bush Tax Cuts Shows Growing Tilt to the Very Rich, CTJ Report, Washington, D.C.: Citizens for Tax Justice.

Copeland, C., 2002, IRA and 401(k)-Type Plan Ownership, EBRI Newsletter Vol. 23, No.6, Washington, D.C.: Employee Benefits Research Institute.

Ell, D., 2000, The "Perfect" Retirement Plan, paper presented to the Pension Rights Center's Conversation on Coverage conference, Washington, D.C., July 24-25, 2001.
Gebhardtsbauer, R., 1999, Universal Savings Accounts, February 1999, Washington, D.C.: American Academy of Actuaries.

Engen, E. and Gale, W., 2000, The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups, NBER Working Paper No. 8032, Cambridge MA: National Bureau of Economic Research.

Ghilarducci, T., 2001, De-linking Benefits from a Single Employer: Alternative Multiemployer Models, paper prepared for the 2001 Pension Research Council Symposium "Benefits for the Workplace of Tomorrow", April 2001, Philadelphia, PA: Pension Research Council.

Gordon, M., 2000, ERISA at 25: Has the Law Kept Pace with Evolving Pension and Investment World?, Testimony before the Subcommittee on Employer/Employee Relations, Education and the Workforce Committee, U.S. House of Representatives, Washington, D.C., February 15, 2000.

Groom, T. and Shoven, J., 1999, How the Pension System Should Be Reformed, paper presented to the Brookings/SIEPR/TIAA-CREF conference "ERISA after 25 Years: A Framework for Evaluating Pension Reform", Washington, D.C., September 17, 1999.

Halperin, D., and Munnell, A., 1999, How the Pension System Should be Reformed, Paper prepared for the Brookings Institution Conference on ERISA after 25: A Framework for Evaluating Pension Reform, September 1999.

Joint Committee on Taxation, U.S. Congress, 2001, Estimated Budget Effects of the Conference Agreement for H.R. 1836 [1], Washington, D.C.: U.S. Congress.

Kennickell, A., Starr-McCluer, M., and Surette, B. J., 2000, Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances, Board of Governors, Federal Reserve System, Washington, D.C.

Lawrance, E., 1991, Poverty and the Race of Time Preference: Evidence from Panel Data, Journal of Political Economy 99, No1: 54-77.

Ludvigson, S., and Steindel, C., 1999, How Important is the Stock Market Effect on Consumption, Economic Policy Review (Federal Reserve Bank of New York) 5, No.2: 29-52.

Madrian, B, and Shea, D., 2000, The Power of Suggestion: Inertia in 401(k) participation and Savings Behavior, Quarterly Journal of Economics 116, No.4: 1149-87.

Mankiw, G., and Zeldes, S., 1991, The Consumption of Stockholders and Nonstockholders, Journal of Financial Economics 29, No.1: 97-112.

McCarthy, J., 1995, Imperfect Insurance and Differing Propensities to Consume Across Households, Journal of Monetary Economics 36, No.2: 301-327.

Medoff, J., and Calabrese, M., 2001, The Impact of Labor Market Trends on Health and Pension Benefit Coverage and Inequality, Washington, D.C.: U.S. Department of Labor.

Mitchell, O.S., and Moore, J.F., 1998, Can Americans Afford to Retire? New Evidence on Retirement Saving Adequacy, Journal of Risk and Insurance 65, No.3: 371-400.

Mitchell, O.S., Moore, J.F., and Phillips, J.W., 2000, Explaining Retirement Saving Shortfalls, in Mitchell, O., Hammond, B., and Rappaport, A., eds., Forecasting Retirement Needs and Retirement Wealth, Philadelphia PA: University of Pennsylvania Press.

Moore, J. F., and Mitchell, O. S., 2000, Projected Retirement Wealth and Saving Adequacy, in Mitchell, O., Hammond, B., and Rappaport, A., eds., Forecasting Retirement Needs and Retirement Wealth, Philadelphia PA: University of Pennsylvania Press.

Office of Management and Budget (OMB), 2002, Analytical Perspectives, Budget of the United States Government, Fiscal Year 2003, Washington, D.C.: OMB.

President's Commission on Pension Policy (PCPP), 1981, Coming of Age: Toward a National Retirement Income Policy, Washington, D.C.: U.S. Congress.

Orszag, P., 2002, Retirement Security, presentation to Campaign for America's Future's conference "Reclaiming America", Washington, D.C.: April 11, 2002.

Orsazg, P., and Orszag, J., 2001, Would Raising IRA Contribution Limits Bolster Retirement Security for Lower– and Middle-Income Families?, CBPP Briefing Paper, Washington, D.C.: Center on Budget and Policy Priorities.

Pension Welfare Benefits Administration (PWBA), 1998, Study of 401(k) Fees and Expenses, Washington, D.C.: PWBA.

Poterba, J., 2000, Stock Market Wealth and Consumption, Journal of Economic Perspectives 14, No. 2: 99-119.

Poterba, J., and Samwick, A., 1995, Stock Ownership Patterns, Stock Market Fluctuations, and Consumption, Brookings Papers on Economic Activity 2:295-372.

Poterba, J., Venti, S., and Wise, D., 2002, The Transition to Personal Accounts and Increasing Retirement Wealth: Macro and Micro Evidence, paper presented at the annual meetings of the American Economic Association, Atlanta, January 2002.

Perun, P., and Steuerle, E., 2001, ERISA at 50: A New Model for the Private Pension System, The Retirement Project Occasional Paper Number 4, Washington, D.C.: The Urban Institute.

Purcell, P., 2001, Pension Sponsorship and Participation in 2000, Congressional Research Service Report, October 05, 2001, Washington, D.C.: Congressional Research Service.

Rasell, E., Bernstein, B., and Boushey, H., 2001, Step Up, Not Out - The Case for Raising the Federal Minimum Wage for Workers in Every State, EPI Issue Brief No. 149, Washington, D.C.: Economic Policy Institute.

Smith, P., 2002, Complexity in Retirement Savings Policy, National Tax Journal, forthcoming.

Social Security Administration (SSA), 2002a, Income of the Population 55 and Older, 2000, Washington, D.C.: SSA.

Social Security Administration (SSA), 2002b, The 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Washington, D.C.: SSA.

Social Security Administration (SSA), 1997, The 1994-96 Advisory Council to Social Security, Washington D.C.: Social Security Administration.

Stein, N., 2000, The Pension 2000 Proposal, presentation to the Pension Rights Center's Conversation on Coverage conference, Washington, D.C., July 24-25, 2001.

U.S. Congress, 1997, H.R. 1656: The Secure Assets for Employees (SAFE) Plan Act, 105th Congress, House of Representatives.

U.S. Congress, 2000a, H.R.5546 To Amend the Internal Revenue Code of 1986 to Improve Retirement Security of American Families, 106th Congress, House of Representatives, October 25, 2000.

U.S. Congress, 2000b, H.R.5549 To Amend the Employee Retirement Security Act of 1974 to Improve Retirement Security of American Families, 106th Congress, House of Representatives, October 25, 2000.

U.S. Congress, 2001, H.R. 1836 The Comprehensive Retirement Security and Pension Reform Act of 2001, 107th Congress, House of Representatives.

U.S. Congress, 2002a, H.R. 4482 Universal and Portable Pension Act of 2002, 107th Congress, House of Representatives, April 18, 2002.

U.S. Congress, 2002b, S. 1992 Protecting America's Pensions Act of 2002, 107th Congress, Senate, March 06, 2002.

U.S. Congress, 2002c, H.R. 3762 Pension Security Act of 2002, 107th Congress, House of Representatives, February 14, 2002.

U.S. Department of Labor (DOL), Bureau of Labor Statistics, 1998, Employment Cost Indexes 1975-1997, Washington, D.C.: Department of Labor.

U.S. Department of Labor (DOL), ERISA Advisory Council, 1998, Report of the Working Group on Retirement Leakage: "Are We Cashing Out Our Future?", November 13, 1998, Washington, D.C.: U.S. Department of Labor

U.S. Department of Labor (DOL), Pension and Welfare Benefits Administration, 2001, Private Pension Plan Bulletin, Abstract of 1997, Form 5500 Annual Reports, Winter 2001, Washington, D.C.: Department of Labor

U.S. Department of Labor (DOL), Office of Inspector General, 2002, PWBA Needs to Improve Oversight of Cash Balance Plan Lump Sum Distributions, Washington, D.C.: Department of Labor.

U.S. Office of Management and Budget (OMB), Budget of the United States Government, Fiscal Year 2003, Analytical Perspectives, page 107.

Weinstein, P., 2002, Universal Pensions: A Common-Sense Approach to Retirement Security in the New Economy, PPI Policy Report, Washington, D.C.: Progressive Policy Institute

Weller, C., 2002, The Recent Stock Market Boom and Bust and Retirement Income Adequacy, EPI Technical Paper, forthcoming.

Weller, C., 2001, Can Workers Afford a Higher Retirement Age?, EPI Technical Paper No. 255, Washington, D.C.: Economic Policy Institute.

Weller, C., and Eisenbrey, R., 2002, No More Enrons – Protecting 401(k) Plans for a Safe Retirement, EPI Issue Brief No. 174, Washington, D.C.: Economic Policy Institute.

Wolff, E., 2002a, Is the Equalizing Effect of Retirement Wealth Wearing Off?, unpublished manuscript, New York University.

Wolff, E., 2002b, Retirement Insecurity: The Income Shortfalls Awaiting the Soon-to-Retire, Washington, D.C.: Economic Policy Institute.

**Table 1**
**Cost Estimate for Direct and Matching Government Contributions**

| Take up Rate | Total | Direct Contributions | Matching Contributions |
|---|---|---|---|
| 0.50 | 42.8 | 37.6 | 5.2 |
| 0.67 | 44.6 | 37.6 | 7.0 |
| 1.00 | 48.0 | 37.6 | 10.4 |

Notes: The income limits described in the text hold. The population totals in each income category are taken from the CPS, March 2001. The share of single filers is assumed to be 47%, the share of joint filers is assumed to be 39% and the share of single heads of household is assumed to be 14% based on IRS Publication 1304 data for 1999. It is assumed that joint filers earn half of the reported combined annual income.

**Table 2**
**Maximum Replacement Rates with PURE Proposal, Single Earners**

| Age in 2003 | 25 | 35 | 45 |
|---|---|---|---|
| Year of full retirement | 2046 | 2036 | 2026 |
| Low earner | | | |
| • Earnings at retirement ($) | 24,815 | 22,238 | 19,949 |
| • Replacement from Social Security (%) | 55.5 | 55.4 | 55.5 |
| • Replacement from mandatory employer contributions (%) | 14 | 9 | 5 |
| • Replacement from government matches (%) | 14 | 10 | 6 |
| • Total real replacement (%) | 83.5 | 74.5 | 66.5 |
| • Total benefits ($) | 20,720 | 16,567 | 13,266 |
| Average earner | | | |
| • Earnings at retirement ($) | 55,146 | 49,417 | 44,797 |
| • Replacement from Social Security (%) | 41.3 | 41.3 | 41.3 |
| • Replacement from mandatory employer contributions (%) | 14 | 9 | 5 |
| • Replacement from government matches (%) | 4 | 2 | 2 |
| • Total real replacement (%) | 59.3 | 52.3 | 48.3 |
| • Total benefits ($) | 32,702 | 25,845 | 21,637 |
| High earner | | | |
| • Earnings at retirement ($) | 88,234 | 79,069 | 70,932 |
| • Replacement from Social Security (%) | 34.1 | 34.1 | 34.1 |
| • Replacement from mandatory employer contributions (%) | 14 | 9 | 5 |
| • Replacement from government matches (%) | 0 | 0 | 0 |
| • Total real replacement (%) | 48.1 | 43.1 | 39.1 |
| • Total benefits ($) | 42,440 | 34,078 | 27,734 |

Notes: All dollar figures are in 2002 dollars. Replacement rates are defined as retirement benefits relative to the average of the final three years of earnings. Low, average and medium earnings are taken from the 2002 Social Security Trustees Report. For private market investments, a real rate of return of 4% is assumed. Continuous work histories until full retirement are assumed. It is assumed that workers contribute the maximum matching amounts. All figures are for single workers with no dependents.

**Table 3**
**Maximum Replacement Rates with PURE Proposal, Single Earner Couple**

| Age in 2003 | 25 | 35 | 45 |
|---|---|---|---|
| Year of full retirement | 2046 | 2036 | 2026 |
| Low earner | | | |
| • Earnings at retirement ($) | 24,815 | 22,238 | 19,949 |
| • Replacement from Social Security (%) | 83.3 | 83.3 | 83.3 |
| • Replacement from mandatory employer contributions (%) | 14 | 9 | 5 |
| • Replacement from government matches (%) | 28 | 20 | 12 |
| • Total real replacement (%) | 125.3 | 112.3 | 100.3 |
| • Total benefits ($) | 31093 | 24973 | 20001 |
| Average earner | | | |
| • Earnings at retirement ($) | 55,146 | 49,417 | 44,797 |
| • Replacement from Social Security (%) | 62.0 | 62.0 | 62.0 |
| • Replacement from mandatory employer contributions (%) | 14 | 9 | 5 |
| • Replacement from government matches (%) | 8 | 4 | 4 |
| • Total real replacement (%) | 84.0 | 75.0 | 71.0 |
| • Total benefits ($) | 46322 | 37063 | 31806 |
| High earner | | | |
| • Earnings at retirement ($) | 88,234 | 79,069 | 70,932 |
| • Replacement from Social Security (%) | 51.2 | 51.2 | 51.2 |
| • Replacement from mandatory employer contributions (%) | 14 | 9 | 5 |
| • Replacement from government matches (%) | 7 | 5 | 3 |
| • Total real replacement (%) | 72.2 | 65.2 | 59.2 |
| • Total benefits ($) | 63705 | 51553 | 41992 |

Notes: All dollar figures are in 2002 dollars. Replacement rates are defined as retirement benefits relative to the average of the final three years of earnings. Low, average and medium earnings are taken from the 2002 Social Security Trustees Report. For private market investments, a real rate of return of 4% is assumed. Continuous work histories until full retirement are assumed. It is assumed that workers contribute the maximum matching amounts. All figures are for single workers with no dependents.

**Table 4**
**Maximum Replacement Rates with PURE Proposal, Single Heads of Household**

| Age in 2003 | 25 | 35 | 45 |
|---|---|---|---|
| Year of full retirement | 2046 | 2036 | 2026 |
| Low earner | | | |
| • Earnings at retirement ($) | 24,815 | 22,238 | 19,949 |
| • Replacement from Social Security (%) | 55.5 | 55.5 | 55.5 |
| • Replacement from mandatory employer contributions (%) | 14 | 9 | 5 |
| • Replacement from government matches (%) | 14 | 10 | 6 |
| • Total real replacement (%) | 83.5 | 74.5 | 66.5 |
| • Total benefits ($) | 20,720 | 16,567 | 13,266 |
| Average earner | | | |
| • Earnings at retirement ($) | 55,146 | 49,417 | 44,797 |
| • Replacement from Social Security (%) | 41.3 | 41.3 | 41.3 |
| • Replacement from mandatory employer contributions (%) | 14 | 9 | 5 |
| • Replacement from government matches (%) | 6 | 4 | 3 |
| • Total real replacement (%) | 61.3 | 54.3 | 49.3 |
| • Total benefits ($) | 33804 | 26833 | 22085 |
| High earner | | | |
| • Earnings at retirement ($) | 88,234 | 79,069 | 70,932 |
| • Replacement from Social Security (%) | 34.1 | 34.1 | 34.1 |
| • Replacement from mandatory employer contributions (%) | 14 | 9 | 5 |
| • Replacement from government matches (%) | 0 | 0 | 0 |
| • Total real replacement (%) | 48.1 | 43.1 | 39.1 |
| • Total benefits ($) | 42,440 | 34,078 | 27,734 |

Notes: All dollar figures are in 2002 dollars. Replacement rates are defined as retirement benefits relative to the average of the final three years of earnings. Low, average and medium earnings are taken from the 2002 Social Security Trustees Report. For private market investments, a real rate of return of 4% is assumed. Continuous work histories until full retirement are assumed. It is assumed that workers contribute the maximum matching amounts. All figures are for single workers with no dependents.

## Appendix: Summary of example pension reform proposals

There are numerous proposals to reform pensions. In this section, a few proposals that exemplify the range of options are summarized.

Each of the proposals is chosen because it contains a unique feature. Rep. Gephardt's proposal calls for mandatory pension coverage. In comparison, Theodore Groom and John Shoven's proposal is an example of reliance on voluntary accounts. Pamela Perun and Eugene Steuerle's ERISA at 50 proposal showcases an idea to simplify pension rules, and Dean Baker's proposal is selected because it is characteristic of proposals to establish universal accounts and take advantage of economies of scale. Former vice president Al Gore's proposal is an example of matching contributions from the government; former president Clinton's USA Account proposal is an example of direct contributions from the government. In the wake of the recent Enron scandal, proposals have focused on making assets in defined contribution plans safer, such as Sen. Kennedy's Protecting America's Pensions Act of 2002. Lastly, a few proposals have aimed at reviving defined benefit plans. For example, Rep. Nancy Johnson and Rep. Earl Pomeroy's SAFE plan proposal would create a hybrid between defined benefits and defined contributions with a minimum guaranteed benefit. Teresa Ghilarducci summarizes options to improve multi-employer DB plans. Lastly, former President Carter's plan for a second tier to Social Security is described because it recognized the need for mandatory coverage and mandatory employer contributions.

To make the comparison between plans easier, several characteristics of each plan are highlighted: coverage, contributions, pension savings instruments, and each proposal's innovation, along with a summary description of the proposal. Each proposal is also evaluated in terms of improving coverage, raising retirement wealth for low and moderate-income workers and securing retirement wealth. Only the Groom-Shoven proposal has a potentially negative effect on retirement wealth security.

**<u>Rep. Richard Gephardt's Universal and Portable Pension Act of 2002 (H.R. 4482).</u>**

**Proposal's innovation:**

Every employer with more than 20 employees must offer access to a qualified pension plan.

**Coverage:**

Every employer with more than 20 employees would be required to offer a salary reduction arrangement.

**Contributions:**

Contributions would remain voluntary within pre-defined limits.

**Pension savings instruments:**

The Act would establish a new pension savings vehicle, Universal Retirement Savings Accounts. Employees, who are currently not covered by a pension plan, could contribute to these accounts or roll over their existing balances in Individual Retirement Accounts (IRAs). The new accounts would be managed like IRAs.

**Proposal summary:**

Most employers would have to offer, at a minimum, the option of a salary reduction arrangement, unless there is already a qualified pension plan, such as a 401(k) plan. Small employers, with fewer than 100 employees, would receive a tax credit. Each employee can contribute up to an annual limit – $3,000 for 2002, 2003, and 2004, $4,000 for 2005, 2006, and 2007, and $5,000 thereafter. The contributions would be invested in newly created Universal Retirement Savings Accounts. Refundable tax credits up to $2,000 per year would be provided for contributions to the accounts for taxpayers earning $80,000 a year filing a joint return or less than $40,000 filing alone. Banks and other financial institutions would manage these accounts.

**Similar proposals:**

N/A.

**Proposal evaluation**

This proposal could have a strong impact on coverage and retirement wealth creation for low and moderate-income households, but no impact on the security of retirement wealth.

**<u>Pension reform proposal by Theodore Groom, Groom Law Group, and John B. Shoven, Stanford University.</u>**

**Proposal's innovation:**

This is a broad attempt to reduce regulation, seeking to eliminate limits on contributions and benefits, to abolish non-discrimination rules, and eliminate the Pension Benefit Guaranty Corporation.

**Coverage:**

Coverage under this proposal would be voluntary.

**Contributions:**

The Groom-Shoven plan advocates the elimination of limits on contributions, especially on 401(k) plans, and for the elimination of benefit payments.

**Pension savings instruments:**

The plan does not advocate the creation of new pension savings instruments, but instead seeks to reform regulation for existing pension plans.

**Proposal summary:**

The proposal seeks to reform the pension system by eliminating a number of rules and regulations. 1) Non-discrimination rules should be eliminated and each feature of a plan should be available to all workers. 2) Limits on employer contributions and benefits under qualified plans should be eliminated. 3) Current liability limitations on funding should be eliminated. 4) Anti-reversion rules should be liberalized, such that employers would have to pay less excise taxes in case of plan termination. 5) Minimum distribution requirements should be eliminated. 6) The regulatory role of the Department of Labor and the Pension Benefit Guaranty Corporation should be reduced. This could include the elimination of the PBGC. 7) Financial education, e.g., by reducing plan sponsor liabilities, should be encouraged.

**Similar proposals**

Rep. Portman (R-OH) and Cardin (D-MD) also advocated higher contribution limits in their Comprehensive Retirement Security and Pension Reform Act of 2001.

**Proposal evaluation**

This proposal will decrease coverage and retirement wealth for low-income workers, and could have a negative effect on the security of retirement wealth.

**Pamela Perun's, Urban Institute, and Eugene Steuerle's, Urban Institute, proposal for ERISA at 50: A New Model for the Private Pension System.**

**Proposal's innovation:**

Rules governing pension plans, both DB and DC plans would be simplified.

**Coverage:**

Coverage under this proposal would be voluntary.

**Contributions:**

Contributions are voluntary within existing limits. The proposal also includes the possibility for government matching contributions for low and moderate-income workers.

**Pension savings instruments:**

The proposal would reduce the number of existing pension savings vehicles to DB plans, one type of defined contribution plan, and Individual Retirement Accounts (IRAs).

**Proposal summary:**

The proposal would simplify the rules for DB plans by reducing the rules and incentives for retirement ages that are different from Social Security by coordinating the normal retirement age with that of Social Security, by reducing early retirement subsidies and by reducing late retirement penalties. The proposal would provide incentives for DB plan coverage for part-time workers and for a minimum portable pension benefit for short-term workers. It would also allow workers to purchase a larger benefit or additional years of service. The proposal would simplify DC plans by establishing a single plan for all types of employers and a single eligibility standard. The same rules on withdrawals, on portability, on the deductible limit for employee and employer contributions, and on the FICA tax treatment for all DC plans should be established. Lastly, the limit on employee contributions to IRAs should be coordinated with that for DC plans.

**Similar proposals:**

Other plans have also advocated a streamlining of DC plans, such as Ell's (Groom Law Group) Perfect Retirement Plan, Weinstein's (Progressive Policy Institute) Universal Pensions, or Calabrese's (New America Foundation) Universal Savings Accounts.

**Proposal evaluation**

The proposal could have some impact on coverage and pension wealth for low and moderate-income households, but no effect on retirement wealth security.

## Dean Baker's, Center for Economic and Policy Research, Universal Voluntary Accounts proposal

### Proposal's innovation:

Every worker would have the opportunity to invest voluntarily in a low cost account, which can minimize costs by taking advantage of economies of scale.

### Coverage:

Coverage under this proposal would be voluntary.

### Contributions:

Contributions would be voluntary within existing 401(k) limits.

### Pension savings instruments:

This proposal seeks to create a new, additional pension savings instrument, a Universal Voluntary Accounts that would be administered by the government.

### Proposal summary:

The proposal would establish a new type of savings account, the Universal Voluntary Account. Every worker could voluntarily contribute to this account. The account would be managed by an independent agency of the government. By taking advantage of economies of scale, the administrative costs would be minimized.

### Similar proposals:

The idea of centrally managed voluntary accounts can also be found in other proposals. Baker's Universal Voluntary Accounts proposal is explicitly modeled on the late Robert Eisner's proposal to reform Social Security. Other proposals, most notably former president Clinton's USA Accounts proposal, included an option for centrally administered accounts. Similarly, Sen. Jeffords and Bingaman's Pension ProSave proposal included a federal clearinghouse.

### Proposal evaluation

The proposal could have a modest, positive effect on coverage, wealth creation for low and moderate-income households and on retirement wealth security.

**<u>Former President Bill Clinton's USA Account proposal</u>**

**Proposal's innovation:**

The government would make direct contributions to low and moderate-income workers.

**Coverage:**

Coverage under this proposal would be voluntary, but the government would automatically set up accounts for low and moderate-income households.

**Contributions:**

The government would make direct and matching contributions for low and moderate-income workers. Existing contribution limits would remain intact.

**Pension savings instruments:**

The proposal would create a new type of account, Universal Savings Account, as a low cost alternative for everybody.

**Proposal summary:**

The government would make direct contributions to the USA Accounts of $300 ($600) for single (joint) filers reporting $5,000-$20,000 ($5,000-$40,000) in annual income, and $300 minus 1.5% of income over $20,000 for single filers reporting $20,000-$40,000 ($40,000-$80,000). For single heads of households, the direct contribution are equal to those of single filers, but the income limits increase to $5,000-$30,000 and $30,000-$50,000, respectively. There would be matching contributions of 100% up to $350 ($700) for single (joint) filers reporting $0-$20,000 ($0-40,000). Single heads of households receive a 100% matching contribution up to $350 if they report income $0-$50,000 annually. Beyond the top income limits matching contributions are phased down to 50%, but never exceed $350 for single filers and single heads of households and $700 for joint filers. Single filers with incomes over $50,000, joint filers with more than $100,000 or single heads of households with income in excess of $75,000 receive no contributions. The contributions can be made to USA Accounts or into existing 401(k) or other DC plans.

**Similar proposals:**

Daniel Halperin, Harvard University, and Alicia Munnell, Boston College, have also proposed direct government contributions.

**Proposal evaluation**

The proposal would likely have a strong, positive effect on coverage and on wealth creation for low and moderate-income households, and a lesser effect on retirement wealth security.

**Former vice-president Al Gore's Social Security Plus proposal**

**Proposal's innovation:**

The government would make matching contributions.

**Coverage:**

Coverage under this proposal would be voluntary.

**Contributions:**

The government would make matching contributions up to specific income limits. Existing contribution limits for employees to other plans would remain intact.

**Pension savings instruments:**

The proposal would create new accounts, Retirement Savings Plus, that would be managed by the private sector.

**Proposal summary:**

The government would make matching contributions to Retirement Savings Plus accounts. The total annual account contribution from an individual and the government combined is capped at $2,000. For single (married) households, the government match is 3:1 up to $15,000 ($30,000) annual income, 1:1 for incomes between $15,000 and $30,000 ($30,000-$60,000), and 1:3 for incomes between $30,000 and $45,000 ($60,000 and $90,000). The accounts would be administered in the private sector, not by the government. To limit administrative costs, there would only be a limited number of investment options. Similar to IRAs, account balances could be used for education, home purchases, or medical expenses.

**Similar proposals:**

Other proposals have also included matching government contributions for low and moderate-income earners, such as Perun and Steuerle's ERISA at 50, Calabrese's Universal Savings Accounts, and Orszag's Progressive Pension Package.

**Proposal evaluation**

The proposal would likely have a positive impact on coverage, on retirement wealth of low and moderate-income households and on retirement wealth security.

## Sen. Edward Kennedy's  Protecting America's Pensions Act of 2002

**Proposal's innovation:**

Investment options for 401(k) plans would be limited and employee participation in DC plans would be strengthened.

**Coverage:**

Coverage under this proposal would be voluntary.

**Contributions:**

Contributions would be voluntary within existing 401(k) limits.

**Pension savings instrument:**

This proposal would not create a new pension savings instrument, although it includes an incentive for employers to offer DB plans.

**Proposal summary:**

The proposal is intended to reduce the risk in DC plans. Employers can either offer employer stock as matching contributions or as investment options, but not both. The exception is a DC plan for an employer who also offers a substantial DB plan. In addition, the proposal includes a provision for employee trusteeship of DC plans. Moreover, the proposal would improve financial information of plan participants.

**Similar plans:**

Rep. Boehner's Pension Security Act of 2002 would increase asset diversification away from employer stock without improving employee participation or financial information.

**Proposal evaluation:**

The proposal is unlikely to affect coverage or retirement wealth for low and moderate-income households, but it may have a positive effect on retirement wealth security.

**Rep. Nancy Johnson (R-CT) and Rep. Earl Pomeroy's (D-ND) Secure Assets for Employees (SAFE) Plan Act of 1997**

**Proposal's innovation:**

The proposal creates a hybrid between a DB and DC plan -- a minimum level of benefits are guaranteed and employees have the possibility of receiving higher benefits if investment returns exceed the assumed rate of return.

**Coverage:**

Coverage under this proposal would be voluntary.

**Contributions:**

An employer can elect to contribute 1%, 2%, or 3% of an employee's earnings to a SAFE account each year. Contribution limits to other retirement accounts remain intact.

**Pension savings instruments:**

The proposal would create a new pension savings instrument, so-called SAFE accounts, for employees of small employers.

**Proposal summary:**

Small employers could establish SAFE accounts for their employees and contribute 1%, 2% or 3% of earnings for each employee. Employers could change the contribution rate depending on their financial situation, but the contribution rate has to be the same for each employee. The benefits are relatively safe since they are funded through an individual retirement annuity or through a trust whose investments are restricted. For the employee, minimum benefits are guaranteed using an assumed rate of return. The employer has to maintain full funding of the plan. Account balances can be rolled over to an IRA or to another SAFE account.

**Similar proposals:**

Douglas Ell's, Groom Law Group, Perfect Pension Plan would offer employees the choice between guaranteed benefits and a variable rate of return.

**Proposal evaluation:**

The proposal could have a positive effect on coverage, wealth creation for low and moderate-income households and on retirement wealth security.

**<u>Michael Gordon, ERISA at 25</u>**

**Proposal's innovation:**

The proposal includes options to make access to multi-employer DB plans easier for non-participating employers.

**Coverage:**

Coverage under this proposal would be voluntary.

**Contributions:**

Contributions would be voluntary within existing limits.

**Pension savings instruments**

The proposal does not advocate the creation of new pension savings instruments, but instead seeks to make multi-employer plans, especially multi-employer defined benefit plans, more attractive.

**Proposal summary:**

The proposal would promote incentives for employers to create or join existing multi-employer plans. Such incentives could include permitting non-unionized employers to join multi-employer defined benefit (Taft-Hartley) plans. Also, the government could use tax incentives for employees and small employers to participate in statutorily designed and approved multi-employer plans.

**Similar proposals:**

Teresa Ghilarducci, University of Notre Dame, also endorses mechanisms to create and broaden the appeal of multi-employer plans. Also, Sens. Jeffords and Bingaman's Pension ProSave proposal would essentially mimic some multi-employer features for small employers through a national clearinghouse, although it is focused on DC, rather than DB plans.

**Proposal evaluation:**

The proposal could have a positive effect on coverage and retirement wealth creation for low and moderate-income households, and a strong effect on retirement wealth security.

**Former President Carter's President's Commission on Pension Policy' Minimum Universal Pension System (MUPS)**

**Proposal innovation:**

A universal second tier to Social Security would be established that is prefunded.

**Coverage:**

Coverage would be mandatory

**Contributions:**

Contributions would be a mandatory 3% of wages and salaries paid by the employer.

**Pension savings instruments:**

The plan would establish MUPS accounts that could be administered by the employer, similar to the current 401(k) plans, or by the Social Security Administration.

**Proposal summary:**

A compulsory DC plan would be established for every worker. Employers would contribute 3% of wages and salaries for each worker over the age of 25 who had one year of service and 1,000 hours with the current employer. The pension accounts would be administered by the employer or by the Social Security Administration. The account balances would be immediately vested and they would be portable between employers.

**Similar proposals:**

A number of other proposals include universal accounts, but only Rep. Gephardt's proposal included mandatory coverage. Further, Robert Eisner's proposal included a provision to place universal accounts with the Social Security Administration.

**Proposal evaluation:**

The proposal would have a strong direct effect on coverage and wealth creation for low and moderate-income households, and it could have some effect on the security of retirement wealth.

## Table A-1: Summary Characteristics of Pension Reform Proposals

| | Coverage | Contributions | Pension savings instruments | Proposal's innovation | Effect on coverage | Effect on wealth creation | Effect on wealth security |
|---|---|---|---|---|---|---|---|
| Gephardt | Mandatory | Voluntary | New Universal Retirement Savings Accounts for currently uncovered workers | Mandatory pension coverage | ++ | + | ~ |
| Groom and Shoven | Voluntary | Expanded contribution limits | No new instrument | Reduce or eliminate regulation | ~ | ~ | ~/- |
| Perun and Steuerle | Voluntary | Voluntary, plus government matching contributions for low and moderate-income earners | Reduce the number of existing instruments through streamlining | Simplification of rules and regulations | + | + | ~ |
| Baker | Voluntary | Voluntary | Universal Voluntary Accounts, centrally administered by the government | Government administered universal accounts | + | + | + |
| Clinton | Voluntary | Direct and matching government contributions | Universal Savings Accounts, centrally administered by federal government | Direct government contributions | ++ | ++ | + |
| Gore | Voluntary | Matching government contributions | Retirement Savings Plus accounts, administered by private sector | Matching government contributions for low and middle income earners | + | + | + |
| Kennedy | Voluntary | Voluntary within existing limits | No new savings instrument | Reduced risk by limiting use of employer stock | ~ | ~ | + |

| | Coverage | Contributions | Pension savings instruments | Proposal's innovation | Effect on coverage | Effect on wealth creation | Effect on wealth security |
|---|---|---|---|---|---|---|---|
| | | | | and proposed employee participation in trusteeship | | | |
| Johnson and Pomeroy | Voluntary | Voluntary employer contributions | SAFE plans, administered by private sector for small employers | Hybrid plan since it mixes guaranteed benefits with possible higher returns | + | + | + |
| Gordon | Voluntary | Voluntary within existing limits | No new instrument | Increase incentives for employers to create or join multi-employer plans | + | + | ++ |
| Carter | Mandatory | Mandatory 3% employer contribution | Some new MUPS accounts to be placed with Social Security Administration | Mandatory employer contribution | ++ | ++ | + |

Source: See text for discussion of individual proposals and issues. "~" indicates no effect, "+" indicates some positive effects, "++" indicates a strong positive effect, and "-" indicates some negative effects.