

# Should We Replace the Current Pension System with a Universal Pension System?

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BY JONATHAN BARRY FORMAN

*By almost any measure, the current voluntary pension system should be viewed as a failure, and should be replaced with a mandatory universal pension system. This feature article explores why the system is a failure and offers a proposed solution to the problem.*

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The United States has a “voluntary” pension system. Employers are not required to have pension plans, and many do not. The bottom line is that only about half of American workers have a pension plan, and most of those are at the upper end of the income distribution. For example, of the 157 million Americans workers in 2006, just 78.6 million (50.0 percent) worked for an employer (or union) that sponsored a retirement plan, and just 62.3 million (39.7 percent) participated in that plan. [Craig Copeland, *Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2006* (Washington, DC: Employee Benefit Research Institute Issue Brief No. 311, 2007)] And while 64.7 percent of workers with annual earnings of \$50,000 or more participated in a plan in 2006, only 16.2 percent of workers earning between \$10,000 and \$14,999 participated that year. The current pension system is also costly to administer. It costs the U.S. Treasury around \$120 billion a year in lost revenue, [Executive Office of the President and Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009* (Washington, DC: U.S. Government Printing Office, 2008), table 19-1] and hoards of pension lawyers, accountants, actuaries, and investment advisors have made pension plan complexity into a cottage industry. [See, for example, Jonathan Barry Forman, *The Future of 401(k) Plan Fees*, in *New York University Review of Employee Benefits and Compensation—2007, 9-1-9-18* (Alvin D. Lurie ed., 2007)] Worst of all, the current system simply cannot be counted on to meet the retirement income needs of American workers and their families.

By almost any measure, the current voluntary pension system should be viewed as a failure, and I believe that we should replace it with a mandatory universal pension system. For example, in 1981, the President's Commission on Pension Policy recommended adoption of a Minimum Universal Pension System (MUPS). [President's Commission on Pension Policy, *Coming of Age: Toward a National Retirement Income Policy (1981)*] Basically, the proposal would have required all employers to contribute at least three percent of wages to private pensions for their workers. The proposal drew little interest at the time. Recently, however, there has been renewed interest in mandated pensions. [Jonathan B. Forman, *Universal Pensions*, 2 *Chapman L. Rev.* 95, 114-116 (1995); World Bank, *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth* 74 (1994); Estelle James & Dimitri Vittas, *Mandatory Saving Schemes: Are They*

the Answer to the Old Age Security Problems?, in *Securing Employer-Based Pensions: An International Perspective* 151 (Zvi Bodie et al., eds. 1996); *see also* Lee A. Sheppard, *Toward a Rational Pension Policy*, *Tax Notes*, Oct. 19, 1987, 235, 237-238; Thomas C. Woodruff, *Employer Mandates to Increase Private Pension Portability and Participation*, in *Social Welfare Policy at the Crossroads: Rethinking the Roles of Social Insurance, Tax Expenditures, Mandates, and Means-Testing* 69 (Robert B. Friedland et al., eds., National Academy of Social Insurance 1994)]

The simplest design for a mandatory pension system would be to piggyback a system of individual retirement savings accounts (IRSAs) onto the existing Social Security withholding system. For example, we might collect another 10 percent of payroll from every American worker and place that money into individual retirement savings accounts. These individual accounts could be held by the government, invested in a broadly diversified portfolio of stocks, bonds, and government notes, and annuitized on retirement. Like current pensions and Individual Retirement Accounts (IRAs), these individual accounts should be tax-favored; that is, contributions should be deductible, earnings should accumulate tax-free until retirement, and withdrawals should be taxable.

### Methodology

For a recent conference at Harvard Law School [The Sixth Annual Capital Matters: Managing Labor's Capital Conference, Harvard Law School, Cambridge, MA, April 16-18, 2008], my colleague Adam Carasso (then with the New America Foundation and now the Chief Economist for the Budget Committee for the House of Representatives) and I modeled just such a 10-percent-of-earnings Universal Pension System (UPS). We assumed that, starting on January 1, 2007, every employee or self-employed worker would be required to contribute 10 percent of covered payroll to an individual account. That is, we assumed that the Universal Pension System would apply to the same wage base as current Social Security payroll taxes (\$97,500 in 2007). For ease of modeling, we assumed that all workers under age 70 who would normally participate in Social Security—plus all federal, state, local, and non-profit employees—would contribute to the Universal Pension System.

Following earlier work, we assumed that these individual accounts would earn a three percent real rate of return (six percent nominal rate of return with a three percent inflation rate)—about the same as what the

Social Security Trustees assumed in their 2007 report. We also assumed 1.1 percent annual, real wage growth in the long term, consistent with the Social Security trustees. Also, all amounts contributed, plus all investment returns, *must* remain in the account until age 65 and then *must* be annuitized. There is a one-time annuity conversion fee equal to 0.3 percent of accumulated assets. We do not explicitly address here whether a Universal Pension System would be federally or individually administered, although the choice could have a large impact on system costs.

We used the Urban Institute's Steuerle-Bakija-Carasso (SBC) Social Security lifetime benefit calculator to illustrate how much typical workers would accumulate under the Universal Pension System by age 65. The model calculates lifetime tax contributions and benefits for both the current Social Security system (Old Age and Survivors Insurance only, not Disability Insurance) and one with a piggybacked Universal Pension System for cohorts turning 65 in 2005, 2025, 2045, and 2065. Accumulated Universal Pension System balances are annuitized, and replacement rates are calculated. [For more details about our methodology, see Adam Carasso & Jonathan Barry Forman, *Tax Considerations in a Universal Pension System*, 118 *Tax Notes* 837-840 (Report in Brief, February 18, 2008); and Adam Carasso & Jonathan Barry Forman, *Tax Considerations in a Universal Pension System* (Urban-Brookings Tax Policy Center Discussion Paper No. 28, 2007), [http://taxpolicycenter.org/UploadedPDF/11593\\_universal\\_pension\\_system.pdf](http://taxpolicycenter.org/UploadedPDF/11593_universal_pension_system.pdf)]

### Results

Using the Steuerle-Bakija-Carasso model, we looked at the retirement income and replacement rates of Social Security and Universal Pension System benefits. For example, a single man with average lifetime earnings who turned 65 in 2025 is scheduled to receive a Social Security benefit of \$17,289 in his first year of retirement (in 2007 dollars). A single, average-wage man could also expect to receive a Universal Pension System individual account benefit of \$8,424 that year (Table 1), for a total retirement income of \$25,713. (For the reader's convenience, the key numbers in Tables 1-2 are in boldface.)

Note that the definitions of "low," "average," "high," and "tax max" come from the Social Security Administration. In our model, an average-wage worker is someone who is assumed to work every year from age 22 through age 64, retiring on her 65th birthday,

Table 1: Individual Account Benefit in First Year of Retirement								
Year Cohort Turns 65	Single Male				Single Female			
	Low	Avg	High	Tax Max	Low	Avg	High	Tax Max
2005	-	-	-	-	-	-	-	-
2025	3,791	8,424	13,478	20,552	3,457	7,683	12,293	18,746
2045	11,627	25,839	41,342	63,121	10,689	23,754	38,007	58,029
2065	16,549	36,775	58,840	89,994	15,318	34,039	54,462	83,298

In 2007 dollars. Assumes survival to age 65. Individual accounts assumed to earn a 3 percent rate of return.

Table 2: Individual Account Replacement Rates Only (IA As A Percent of Final Wage)								
Year Cohort Turns 65	Single Male				Single Female			
	Low	Avg	High	Tax Max	Low	Avg	High	Tax Max
2005	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2025	16.9	16.9	16.9	16.8	15.4	15.4	15.4	15.3
2045	41.7	41.7	41.7	41.7	38.3	38.3	38.3	38.3
2065	47.9	47.9	47.9	47.9	44.4	44.4	44.4	44.4

and to earn the average wage in the economy every year (\$40,462 in 2007). A low-wage worker earns 45 percent of the average wage in every year; a high-wage worker earns 160 percent of the average wage in every year; and a tax max wage worker earns right at the Social Security taxable maximum wage (\$97,500 in 2007) in every year. While these are highly idealized wage earning patterns, they are useful for demonstrating the impact of various Social Security and pension reforms.

The rewards of a Universal Pension System would be seen over the long term, however. For example, consider what happens to a single man with average earnings who reaches age 65 in 2065, by which point a universal pension system would be mature. He could expect a Social Security benefit of \$25,710 (in 2007 dollars)—provided that action is taken to restore solvency to the Social Security system. And he could expect an individual account benefit of \$36,775 (Table 1), for a total retirement income of \$62,485.

Another way to value retirement benefits is to measure the fraction of workers' final year wages they would replace. In 2065, for example, that single man's \$25,710 Social Security benefit would replace 33.5 percent of his final wage, and his \$36,775 individual account benefit (Table 1) would replace 47.9 percent (Table 2), for a total replacement rate of 81.4 percent.

Because women have longer life expectancies than men, a woman who accumulates the exact same individual account balance as a man will have to stretch that balance out across more years of retirement, on average, and so will see a lower annual Universal Pension System benefit and overall replacement rate. For example, an average-wage single woman retiring at 65 in 2065 would see a smaller *annual* individual account benefit of just \$34,039 per year (Table 1) and a smaller replacement rate of just 44.4 percent of final wages (Table 2). No doubt, there would be judicial and political pressure to equalize annuity benefits for men and women. [See *Arizona Governing Comm. for Tax Deferred Annuity and Deferred Compensation Plans v. Norris*, 463 U.S. 1073 (1983); *Los Angeles Dept. of Water and Power v. Manhart*, 435 U.S. 702 (1978).] This equalization could be accomplished, for example, by mandating unisex annuitization or, alternatively, by permitting gender differentiation and affirmatively subsidizing the annual annuities paid to women; however, this paper does not offer any estimates of these possibilities.

## Conclusion

Our current patchwork of public and private pension arrangements has always left the poor with the short stick, and the looming insolvency in Social

Security threatens to extend this insecurity to the middle class. When one also factors in the looming shortfall in Medicare and the impending substantial increases in both health insurance premiums and out-of-pocket medical spending, the retirement picture is gloomy for most American workers. A universal system of 10-percent-of-earnings individual accounts could provide significant, additional retirement resources for most American workers and especially for those millions of low-income workers who currently lack access to an employment-based pension plan. In the long run, a 10-percent-of-earnings Universal Pension System could replace an additional 47.9 percent of final wages for men retiring at 65 and 44.4 percent of final wages for all women.

To be sure, we would certainly need to make a gradual transition from the current pension system to a Universal Pension System. At the outset, we should require all employers to offer pension plans, 401(k) plans, or, at least, payroll-deduction IRAs. Even with universal access, however, many workers simply will not save for retirement. In the end, we will need

to establish a mandatory universal pension system. We could start by requiring workers to contribute another two or three percent of earnings to individual accounts. Then, over a decade or so, we could gradually increase the required contribution level up to ten percent of earnings, and, at the same time, we could phase out the current voluntary pension system.

Of course, we would probably need to provide targeted subsidies to help low-income workers achieve anything close to a 10-percent-of-earnings contribution level. We might, for example, use a refundable version of the current saver's tax credit to provide matching contributions to low-income workers. Alternatively, we could use refundable rebates or earned income tax credits to deliver subsidies to low-income workers.

All in all, a system of universal, add-on individual accounts would help us bridge the gap between the retirement American workers expect and the retirement that the current system can provide. The time has come to replace the current voluntary pension system with a mandatory Universal Pension System. ■