RETIREMENT USA

Working for a ***Universal***, ***Secure***, and ***Adequate*** Retirement System

Design Issues Paper

Retirement USA is a national initiative that is working for a new retirement system, which, along with Social Security, will provide universal, secure and adequate income for future retirees. The initiative has developed *12 Principles for a New Retirement System* to provide a framework for a future system in which employers, workers, and the government would share responsibility for the retirement security for all American workers. The Principles are included as an appendix to this paper.

Retirement USA was convened by five organizations – the AFL-CIO, the Economic Policy Institute, the National Committee to Preserve Social Security and Medicare, the Pension Rights Center, and the Service Employees International Union. Twenty-one other organizations support the Retirement USA principles and are coming together to raise awareness about the need for comprehensive reform for the future. A list of conveners and supporters is attached.

These issue papers are part of Retirement USA's effort to promote discussion on a range of proposals that could lead to a universal, secure, and adequate retirement system. The issue papers cover five broad topics – universality, adequacy, security, design, and administration – and present options for designing features of a system that can provide an adequate and secure retirement for all American workers.

The papers were prepared for Retirement USA by Pension Rights Center staff and consultants. The principal authors were Jane Smith, Policy Associate; Norman Stein, Senior Policy Advisor; and John Turner, Consulting Economist. Editors were Henry Rose, Special Counsel; Nancy Hwa, Communications Director; and Karen Ferguson, Director. Invaluable insights and technical comments were provided for individual papers by Monique Morrissey, economist at the Economic Policy Institute; Alicia Munnell, director of the Center for Retirement Research; Daniel Halperin, professor at Harvard Law School, and Ben Veghte, research associate at the National Academy of Social Insurance.

The Pension Rights Center gratefully acknowledges the support of the Rockefeller Foundation and The Atlantic Philanthropies for the preparation of these papers.

RETIREMENT USA ISSUES PAPER

DESIGN

This paper is one of five focusing on issues to be addressed in meeting Retirement USA's 12 Principles for a New Retirement System. These papers address the topics of universality, security, adequacy, design, and administration.

This paper focuses on issues related to the design of a retirement income system that would provide adequate and secure retirement income for all working Americans. The paper focuses on seven of the Retirement USA principles. These are: shared responsibility; required contributions; pooled assets; payouts only at retirement; lifetime payouts; portable benefits; and voluntary savings.

I. SHARED RESPONSIBILITY AND REQUIRED CONTRIBUTIONS

Retirement USA's principle of shared responsibility provides that "Retirement should be the shared responsibility of employers, employees and the government." The related principle of required contributions states: that "Employers and employees should be required to contribute a specified percentage of pay, and the government should subsidize the contributions of lower-income workers." These are the two key Retirement USA principles for the design of a new system.

A new universal, adequate, and secure retirement income system for private sector workers who do not participate in a retirement plan, or whose current plan will not provide a secure and adequate retirement income, could be a structured in a variety of ways. Most likely it will have a mix of features now found in pension and retirement savings plans. Pension plans typically place all of the responsibilities and risks of retirement savings on employers. Retirement savings plans, such as 401(k)s, place these responsibilities and risks primarily on individuals.

Retirement USA calls for a sharing of responsibility between employers, employees and the government. Shared responsibility includes sharing the contributions made into the retirement system and sharing the risks of financial market downturns. These costs and risks should not be born wholly by either employers or employees. The government can provide subsidies for low-wage workers. It can also share financial risk if guarantees are provided to protect against severe financial failures.[1]

[1] See Security issues paper for discussions of risk sharing between employers and employees and options for providing guarantees.

Employer and Employee Contributions

The principles assume that the contributions of employers and employees would be equal and that they would be a percentage of pay that would be the same across all income levels – except for self-employed persons who would pay both the employer and employee rates. Employers providing a plan that is sufficiently generous and meets other Retirement USA criteria would be exempted from being required to contribute to the new system.[2]

A key design decision will be determining the level of employer and employee contributions. This determination will necessarily be tied to the definition of adequate retirement income,[3] as well as to probable financial return, the likelihood of obtaining such a return, and the mechanisms used to compensate for differences between expected and actual investment return.

In addition, the amount of total investment return will be sensitive to the timing of plan contributions. One alternative would be to set contributions so that they are an even percentage of salary over an employee's career; another would be to frontload contributions, so that higher contribution percentages are made for younger employees. A front-loaded approach would increase the amount of investment return for employees that are covered by the system for most of their career.

A related issue is whether there should be a minimum age for required contributions or a minimum related to hours of work or annual salary. Such minimums are often instituted to deal with the administrative expenses of maintaining small accounts. Small accounts also result in costs for fund managers in locating former employees for whom they no longer have valid addresses.

Finally, there are issues related to the timing of contributions, particularly those that would be made by smaller firms and household employers. Whereas larger employers can easily forward their contributions and those of their employees to a fund every pay period, it might be possible to provide that smaller firms make contributions with quarterly tax payments. The rules for household employers could be the same as for Social Security – payments once a year with income tax returns.

[2] See Universality issues paper for a discussion of options for determining whether current plans are comparable to a Retirement USA program.
[3] See Adequacy issues paper for a discussion of benchmarks for measuring adequacy.

Government Contributions

Another question is how to structure government contributions on behalf of lower-income workers. Here key questions are

(1) Who would be defined as low-income, and whether the levels would vary with the age of the participant.
(2) How much the government's contribution would be and whether the amount would be a flat amount for everyone or decline as income levels increase.
(3) Whether the mechanism for providing the government contribution would be a direct contribution to the plan or a tax credit for either or both the employer and the employee, and, if for the employee, whether it would be refundable.

II. POOLED ASSETS

Retirement USA's principle of pooled assets provides that "Contributions to the system should be pooled and professionally managed to minimize costs and financial risks."

Pooling of assets allows for investments in a broadly diversified portfolio, thus providing greater protection against financial market ups and downs than individually invested funds.[4] A pooled fund also can be managed for the long-term since it can spread risk over generations.

Economies of scale in asset management make it much less costly to manage the investment of a pooled account of millions of dollars than to manage many individual investment accounts with the same total value. The savings in asset management fees can be passed on to participants in the form of lower charges and higher account balances or benefits.

In a Retirement USA system, workers with a single provider would have the same portfolio. This arrangement would help to insure that funds have sufficient resources to diversify broadly. However, an issue to be addressed is whether there could be multiple Retirement USA funds, each with a different mix of investments.[5] If there are multiple funds, the designers of a new system would need to specify whether and to what extent a worker could choose the investment fund.

Other issues relate to the number of investment managers that would be hired by fund administrators and how they would be chosen. The Thrift Savings Plan for federal

[4] See the discussion of different approaches to risk sharing in the Security issues paper.
[5] See discussion of alternative structures in the Administration issues paper.

government workers uses a bidding process to choose managers, based in part on how low their fees are. Because the amount of assets available for investment by each manager would be very large, economies of scale would ensure that fees would be kept at a minimum.

III. Lifetime Payouts Only at Retirement

Retirement USA's principle of payouts only at retirement provides that "No withdrawals or loans should be permitted before retirement, except for permanent disability." The related principle of lifetime payouts states that "Benefits should be paid out over the lifetime of retirees and any surviving spouses, domestic partners, and former spouses."

Payouts at Retirement

Pre-retirement loans, withdrawals, and cash-outs reduce the amount of assets available for retirement. A new Retirement USA system would not allow these "leakages" because they contribute to inadequate retirement savings. The only exception to the prohibition of pre-retirement payouts would be payouts in the case of permanent disability.

The justifications for participants giving up liquidity include the tax subsidy that they receive and the improved retirement security that results from keeping the money in. Since all taxpayers would be paying higher taxes or receiving less in government services due to the new system's tax exclusion or tax credit, it would be appropriate for these savings to be earmarked for retirement. While there are needs for many other kinds of savings – housing, education, medical costs, and living expenses following the loss of a job – these shorter-term needs tend to be more immediate and pressing, making them easier to anticipate and satisfy.

A question that will have to be addressed is the age at which payouts should begin. The minimum early retirement age at which benefits could be received would need to be established. Currently, retirement savings plans allow penalty free withdrawals at age 59-1/2 and many pension plans have an early retirement age of 55 or earlier. Most would argue that given increases in life expectancy, those ages are too low for most individuals.[6] Others would argue that even these relatively young ages may be too high

[6] Some policy analysts have suggested that retirement age should be set back gradually as life expectancies increase. If this is not done, they contend, the costs of a retirement system will grow over time as participants enjoy increasingly longer periods of retirement. They point out that a one-year increase in life expectancy will increase costs by approximately 2.5 percent and that pushing back retirement age will give individuals on average the same length of retirement as earlier age cohorts.

for some, particularly for those in occupations involving hard physical labor.[7] In addition, some individuals may be financially secure enough to retire at relatively early ages.

An alternative approach would be for payouts to begin after a specified period of years regardless of age. For example, if the period of years were 40 years, individuals who started work immediately after high school would be able to start their payouts earlier than those who delayed the start of employment until after graduate school.

Payouts for Life

In a Retirement USA system, benefits will be paid out over the lifetimes of retirees and any surviving spouses, domestic partners, and former spouses.[8] A decision will need to be made as to whether payments should only be in the form of annuities or whether a lifetime stream of payments using estimated life expectances should be permitted.[9]

Although not stated expressly in the principles, the conveners of Retirement USA are in agreement that annuities should be provided on a unisex basis. Still to be decided is whether lump-sum payouts could be permitted for individuals with very small account balances or benefits. In these cases, the costs of the annuity could equal or even exceed the payout amount.

Recently, there has been much discussion over flexibility in retirement options. Although payments would begin at retirement, a new system could provide options for gradual withdrawals and multiple choices. For example, one option might be that a worker could choose an immediate annuity with half an account balance and three years later choose a different payout option for the balance of the account.

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[7] A related but quite different concern is the extent to which delayed retirement should increase benefits. In a retirement savings-type program, delayed retirement would be rewarded by increased contributions and investment earnings. In a plan offering fixed benefits, an alternative to increasing benefits for delayed retirement would be to have the plan credit amounts that would have been paid to the participant if she retired at normal retirement age and allow that sum to be withdrawn as a lump sum when the participant actually leaves the workforce.

[8] Survey data indicate that many people underestimate their life expectancy. They also appear to not adequately take into account the probability of living past their life expectancy. For a healthy couple age 65, there is a 25 percent probability that at least one of them will be alive at age 97. Retirees who do not take their benefits in the form of a lifetime payout risk outliving their assets.

[9] Retirement USA does not allow for an individual to receive an account balance and then figure out how much to withdraw over his or her lifetime. If a stream of payment option is included in the new system, the draw-downs will be prescribed by federal law and based on life expectancy tables published by the government. This raises the question of where the “extra” money would go if an individual and his or her spouse dies before the expected ages. Would it go back into the fund or to heirs?

Issues relating to partial retirement will also need to be resolved. Could a person receive a payout while still working? If so, would there be a requirement that hours of work be reduced below a normal work week?

Form of Payouts

The simplest way lifetime benefits are provided is through purchase of an annuity at retirement, but some options involve annuities combined with other forms of benefit payout, such as a phased withdrawal initially, followed by an annuity that starts payment at a later age.

The acquisition of an annuity could occur at a single point in time, such as at retirement, or it could occur in a phased manner, such as while working or during retirement. Phasing or delaying the purchase of an annuity could reduce the risk that a financial market downturn (resulting in low interest rates at the time of retirement) could result in reduced lifetime payments.

Another set of issues are raised as to the type of annuity. Should the new system provide all retirees an inflation protected annuity?[10] If so, to what extent will this reduce payout amounts?[11] Is there a way of ensuring that these amounts will be guaranteed?[12]

Benefits at Death and Divorce

Payments to survivors can be provided at different levels of generosity relative to the payment received by the retiree while alive. Since individual circumstances vary, a new system could follow the current practice of most pension plans by allowing couples to choose among survivor benefit amounts. These range from 50 percent to 100 percent of the worker's benefit amount. In the case of working couples one partner may have a much larger income than the other and thus a greater retirement benefit. As long as

[10] There are three basic ways to calculate the amount of periodic payment under an annuity: a fixed payment for life, an inflation-adjusted payment for life, and an investment-adjusted payment for life (often referred to as a variable annuity). There are various mechanisms to adjust for inflation, some of which fully compensate annuitants for increases in the cost of living and some of which have caps.

[11] Inflation-adjusted annuity payments have a disproportionate cost on those with shorter lives, who sacrifice larger initial periodic payments for inflation adjustments that they will not receive because of their earlier deaths. Apart from inflation, there is considerable evidence that the cost of living increases for retirees, independent of inflation. For example, as retirees age, they often incur larger medical costs and may also incur expenses for require various forms of assistance with tasks that they earlier could perform for themselves (or that a healthy spouse might have been able to do for them). An annuity could protect against this by providing for escalating payments irrespective of inflation.

[12] See Security issues paper.

there is a requirement that both partners consent to the option selected, a range of choices can enable the household to maximize its benefits.[13]

An alternative approach is for contributions of both partners to be divided equally and paid into separate accounts during their work lives. At retirement each partner would receive an annuity or stream of payments from their own account. The partners could also be given an option to pool their individual accounts and purchase a joint-and-survivor annuity.

Former spouses would be treated as under current private retirement plans. State domestic relations courts would determine whether retirement funds accumulated during a marriage were marital assets and determine how they should be divided and whether survivor's benefits should be awarded. The Retirement USA fund or funds then would honor court orders.

III. Portable Benefits

Retirement USA's principle relating to portable benefits says "Benefits should be portable when workers change jobs."

Portability offers administrative convenience to workers, allowing them to take their pension and retirement savings plan benefits with them when they change jobs. With portability, worker's earned benefits, even small benefit amounts, can be combined so that workers can easily determine how much of a benefit they have earned to date. Portability also can help preserve the value of a traditional pension which can be eroded by inflation if it remains frozen at its value at the time a worker leaves a job.

A Retirement USA system would be completely portable regardless of where an employee has worked. Depending on the administrative structure of the new system, there could be transfers among funds at an employee's option, or a single centralized administrative structure where all contributions would go regardless of where the employee worked.[14]

If the system consists of multiple funds, issues would be whether employees would have the option of leaving their funds in a fund selected by a former employer, and if so,

[13] In the case of a private pension, money purchase plan, or annuity provided as part of a 401(k) plan, spousal consent is required before benefits can be paid in a form other than a joint-and-survivor annuity. This requirement does not apply to accumulations in a 401(k)-type plan or a profit sharing plan paid out at retirement or on termination of employment.

[14] See Administration issues paper.

whether multiple accounts could be consolidated at retirement in order to arrange for lifetime payments from one fund. This might be of particular interest to couples interested in combining assets into one account as a way of ensuring equal payouts over their joint lives. Similarly, transferability away from a particular fund might be desirable at death or divorce.

IV. Voluntary Savings

Retirement USA's principle allowing for voluntary savings states that "Additional voluntary contributions should be permitted, with reasonable limits for tax-favored contributions."

Retirement USA would allow employers and employees to make voluntary contributions above those that are required. These contributions would be permitted on a tax-favored basis, with limits on the total amount of the contributions.

An important decision will be the maximum amount of voluntary savings that would be permitted on a tax-deferred basis. A balance will need to be struck between encouraging additional saving and not providing excessive tax breaks to higher-income workers who do not need tax incentives to encourage them to save for retirement. The maximum limit presumably would be both in terms of percentage of pay and in terms of a maximum dollar limit, whichever was lower.

The maximum percentage of pay and maximum amount of voluntary savings could be age-based, with older workers having a higher maximum. Another option would allow an individual to make voluntary contributions to support another person's retirement. These contributions could be for a spouse, a domestic partner, a child, a grandchild, or possibly anyone else. A question would be whether the maximum limit on voluntary savings would be the limit for the individual making the contribution or that of the person whose retirement savings are increased by the contribution.

RETIREMENT USA

Working for a ***Universal***, ***Secure***, and ***Adequate*** Retirement System

Principles for a New Retirement System

Universal Coverage. *Every worker should be covered by a retirement plan in addition to Social Security.* A new retirement system should include all workers unless they are in plans that provide equally secure and adequate benefits.

Secure Retirement. *Retirement shouldn't be a gamble.* Workers should be able to count on a steady lifetime stream of retirement income to supplement Social Security.

Adequate Income. *Everyone should be able to have an adequate retirement income after a lifetime of work.* The average worker should have sufficient income, together with Social Security, to maintain a reasonable standard of living in retirement.

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Shared Responsibility. Retirement should be the shared responsibility of employers, employees and the government.

Required Contributions. Employers and employees should be required to contribute a specified percentage of pay, and the government should subsidize the contributions of lower-income workers.

Pooled Assets. Contributions to the system should be pooled and professionally managed to minimize costs and financial risks.

Payouts Only at Retirement. No withdrawals or loans should be permitted before retirement, except for permanent disability.

Lifetime Payouts. Benefits should be paid out over the lifetime of retirees and any surviving spouses, domestic partners, and former spouses.

Portable Benefits. Benefits should be portable when workers change jobs.

Voluntary Savings. Additional voluntary contributions should be permitted, with reasonable limits for tax-favored contributions.

Efficient and Transparent Administration. The system should be administered by a governmental agency or by private, non-profit institutions that are efficient, transparent, and governed by boards of trustees that include employer, employee, and retiree representatives.

Effective Oversight. Oversight of the new system should be by a single government regulator dedicated solely to promoting retirement security.

Retirement USA

Working for a Universal, Secure, and Adequate Retirement System

Retirement USA Steering Committee

AFL-CIO
Economic Policy Institute
National Committee to Preserve Social Security and Medicare
Pension Rights Center
Service Employees International Union

Supporters of the Retirement USA Principles

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American Federation of State, County and Municipal Employees
American Association of University Women (AAUW)
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