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

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Universal Pensions

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Summary

- Low-income, single, and non-white groups have low pension participation.
- Stresses on current retirement system (public + employer + private) create a gap between the retirement Americans expect and the retirement they will experience.
- A mandatory, universal pension system will cover those without a pension and help the rest close the “expectation” gap.
“Four Pillars” of Retirement

- (1) Social Security: 95% of workforce
- (2) Employer DB and DC plans: 48%
- (3) Employer retiree health: 33% in large firms and 7% in small firms. Medicare: 95%
- (4) Personal savings subsidy programs: 17% in IRAs & Keoghs
Only Half of Americans Have Pensions

- U.S. has a voluntary pension system
- In 2006
  - Just 78.6 million (50 percent) worked for an employer (or union) that sponsored a retirement plan
  - Just 62.3 million (39.7 percent) participated
- Coverage is greater for
  - white-collar workers, full-time workers, union workers, workers at larger firms
  - older workers, whites, highly educated workers, higher-income workers
Stresses on the Retirement System

- Longer life expectancies; lower avg. retirement age
  - 1945: @65: 12.0 for men, 15.5 for women; retire at 68
  - 2005: @65, 17.0 for men, 19.7 for women; retire at 63
  - 2035: @65, 18.8 for men, 21.4 for women; retire at ?

- Lower ratio of workers to retirees
  - 1945: 41.9 workers/retiree
  - 2005: 3.3 workers/retiree
  - 2035: 2.1 workers/retiree

- Unsustainable growth in lifetime benefits relative to lifetime contributions

- Fewer one-earner households, more two-earner and single households
Top 10 Income Tax Expenditures, 2011 (billions of dollars)

<table>
<thead>
<tr>
<th>Expenditure</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health insurance exclusion</td>
<td>$177</td>
</tr>
<tr>
<td>Mortgage interest deduction</td>
<td>104</td>
</tr>
<tr>
<td>401(k) plans</td>
<td>67</td>
</tr>
<tr>
<td>Deductible nonbusiness state and local taxes other than on houses</td>
<td>47</td>
</tr>
<tr>
<td>Employer plans</td>
<td>45</td>
</tr>
<tr>
<td>Step-up of basis at death</td>
<td>45</td>
</tr>
<tr>
<td>Capital gains (except timber, iron ore, coal)</td>
<td>44</td>
</tr>
<tr>
<td>Charitable contrib. (other than health &amp; ed.)</td>
<td>44</td>
</tr>
<tr>
<td>Exclusion of imputed rental income</td>
<td>38</td>
</tr>
<tr>
<td>Capital gains exclusion on homes</td>
<td>31</td>
</tr>
</tbody>
</table>

*Source: 2011 Federal Budget, Analytical Perspectives, Chapter 16, Tax Expenditures, Table 16-3*
Fiddling with Current Law

- Pension portability
- Automatic enrollment (opt-out vs. opt-in)
- Refundable saver’s credit
- Realigning skewed tax incentives
- Matched savings accounts
- ALL LAUDABLE – BUT NONE MANDATES NEW SAVINGS
Mandatory Savings Proposals Not New

- 1981 President’s Commission on Pension Policy – add-on 3% of payroll
- 2001 President’s Commission to Strengthen Social Security, Model 1 – carve out 2% of payroll from Social Security, reduce traditional benefits
- 2005 Liebman, MacGuiness, and Samwick proposal – add-on 1.5% of payroll, carve out 1.5% from Social Security, reduce traditional benefits
A mandatory Universal Pension System (UPS)

- **Why**: Current system unable to finance the retirement most Americans will expect
- **What it is**: 10% of payroll, mandatory, add-on individual accounts taxed like IRAs
- **What it would do**: At maturity, replaces 47.9% of wages for men, 44.4% for women
UPS: Design Issues

- Many ways to design a MUPS
- Here, covers all workers under age 70 covered by Social Security—plus federal, state, local, and non-profit employees
- Employees and self-employed contribute 10% of payroll to an account – no employer contribution
- Piggy-back accounts on present Social Security withholding system
- Subsidy to low-income workers, in some options
- Withdrawals are annuitized – none before 65
UPS: Investment & Administration Issues

- *Many ways* to arrange account investment and administration

- At one extreme, pool all worker contributions in a single portfolio with a government guaranteed return (say 3% real), regardless of how portfolio performed – like a DB.
  - Less choice but low admin costs

- At other extreme, workers choose own portfolios (smart default provided), can change investments periodically, & bear all investment risk – like a DC.
  - More choice but high admin costs
UPS: Tax Considerations

- EET, TEE, TTE, ETT – “E” = exempt, “T” = Tax
- My mandatory UPS is EET – contributions and investment earnings are deductible from income taxes; withdrawals subject to income tax – like an IRA
- However, contributions and earnings ALSO deductible from payroll taxes (just like traditional employer-sponsored pensions)
- Result is slightly lower Social Security benefits
- Subsidy could be a refundable Saver’s Credit with parameters indexed to inflation
Methodology

- Relies on two models
  - Steuerle–Bakija–Carasso Social Security Hypothetical Worker model

- Calculate the *present value* of tax subsidies assuming worker’s marginal rates are the same in work and retirement
Assumptions

- Workers work every year between ages 22 and 65
- Each worker contributes 10% of payroll up to Social Security taxable maximum
  - $102,000 in 2008
- 3% annual real return
  - 6% nominal; 3% inflation
- Money must remain in the account until age 65 and then must be annuitized
  - One-time 0.3% annuity conversion cost
# Individual Account Benefit in the First Year of Retirement (2007 Dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>Cohort Turns 65</th>
<th>Low</th>
<th>Average</th>
<th>High</th>
<th>Tax Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2025</td>
<td>$3,791</td>
<td>$8,424</td>
<td>$13,478</td>
<td>$20,552</td>
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<tr>
<td>2045</td>
<td>$11,627</td>
<td>$25,839</td>
<td>$41,342</td>
<td>$63,121</td>
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<tr>
<td>2065</td>
<td>$16,549</td>
<td>$36,775</td>
<td>$58,840</td>
<td>$89,994</td>
<td></td>
</tr>
</tbody>
</table>
## Individual Account Replacement Rates (IA as a Percent of Final Wage)

<table>
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<tr>
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<th>High</th>
<th>Tax Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>2025</td>
<td>16.9</td>
<td>16.9</td>
<td>16.9</td>
<td>16.8</td>
</tr>
<tr>
<td>2045</td>
<td>41.7</td>
<td>41.7</td>
<td>41.7</td>
<td>41.7</td>
</tr>
<tr>
<td>2065</td>
<td>47.9</td>
<td>47.9</td>
<td>47.9</td>
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</tr>
</tbody>
</table>
Conclusion

☐ In the long run, a 10-percent-of-earnings Universal Pension System would replace
  ■ 47.9 percent of final wages for men
  ■ 44.4 percent for women

☐ Provide subsidies for low-income workers
  ■ Refundable saver’s tax credit
  ■ Refundable rebates

☐ Let’s replace our current voluntary system with a mandatory Universal Pension System
About the Author

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- the Professor in Residence at the Internal Revenue Service Office of Chief Counsel, Washington, DC, for the 2009-2010 academic year;
- the Alfred P. Murrah Professor of Law at the University of Oklahoma, teaching tax & pension law; and

Prior to entering academia, Professor Forman served in all three branches of the federal government. He has a law degree from the University of Michigan and master’s degrees in both economics and psychology.

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