
JONATHAN B FORMAN, University of Oklahoma

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Achieving Retirement Income Adequacy with Add-On Social Security Accounts

Presented by Jon Forman at:
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Law and Society Association
Annual Meeting
July 7, 2006 Baltimore, MD

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

Coverage rates for low-income and non-white groups much lower
Stresses on 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
- Global competitiveness
Results of Stresses

- Social Security benefits to fall ~25% across the board after 2041
- Medicare insolvent in 10-15 years
- Employers curbing DBs and retiree health benefits
- Greater longevity and danger of outliving one’s personal savings
- Pressure to tap home equity to finance retirement
Trends in Saving

- Personal savings rate negative in 2005
- Aggregate tax subsidies for savings exceed personal savings (figure 1)
- Current run-ups in housing and equity markets driving surge in wealth
- For 1st 7 income deciles, Soc. Sec. and Medicare comprise majority of retirement benefits (figure 2)
- Many two-earner couples accumulate more overall, despite less generous pensions
- But also, more single-headed households
Figure 1. Retirement Savings Incentives Versus Personal Savings, 1985-2005

Billions of 2005 dollars

Note: Tax expenditures are not strictly additive. The cash flow measures above do not reflect the present value of pension subsidies. Source: The Urban Institute, 2006. Based on data from the Office of Management and Budget, Analytical Perspectives (prior to 1990, Special Analyses), Budget of the United States Government, various years. Personal savings data from the Bureau of Economic Analysis NIPA Table 2.1.
Figure 2. Average Value and Composition of Household Wealth, Ages 51-61, by Wealth Decile

Fiddling with Current Law

- Pension portability
- Automatic enrollment (opt-out vs. opt-in)
- Refundable saver’s credit
- Realigning skewed tax incentives
- Matched savings accounts (like IDAs)
- Split EITC deposits into 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 (MUPS)

- **Why**: Current system unable to finance the retirement most Americans will expect

- **What it is**: 3% of payroll, mandatory, add-on individual accounts taxed like IRAs

- **What it would do**: At maturity, replaces 14.5% of wages for men, 13.3% for women

- **What it wouldn’t do**: Repeal or replace any element of the current system
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 3% 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
MUPS: Investment & Administration Issues

- Many ways to arrange account investment and administration

- At one extreme, could 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 portfolio (smart default provided), can change investments periodically, and bear all investment risk – like a DC. (More choice but high admin costs).
Tax Considerations

- EET, TEE, TTE, ETT – “E” = exempt, “T” = Tax
- Our MUPS 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 is a refundable Saver’s Credit with parameters indexed to inflation
Methodology

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

- We 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 3% of payroll up to Social Security taxable maximum
- 3% annual real return. One-time 0.3% annuity conversion cost
- We model for Social Security shortfall
Hypothetical Accumulations – 2005 Dollars

Tables 1 and 2 of this paper

### OASI BENEFIT IN FIRST YEAR OF RETIREMENT
**paper Table 2**

<table>
<thead>
<tr>
<th>Year Cohort</th>
<th>Single Male</th>
<th>Two-Earner Couple</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Low</td>
<td>Avg</td>
</tr>
<tr>
<td>Turns 65</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>9,007</td>
<td>14,848</td>
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<tr>
<td>2025</td>
<td>9,948</td>
<td>16,394</td>
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<tr>
<td>2045</td>
<td>12,222</td>
<td>20,082</td>
</tr>
<tr>
<td>2065</td>
<td>15,197</td>
<td>24,996</td>
</tr>
<tr>
<td>(Shortfall)</td>
<td>9,205</td>
<td>15,124</td>
</tr>
<tr>
<td>2065</td>
<td>10,949</td>
<td>18,009</td>
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### INDIVIDUAL ACCOUNT BENEFIT IN FIRST YEAR OF RETIREMENT
**paper Table 3**

<table>
<thead>
<tr>
<th>Year Cohort</th>
<th>Single Male</th>
<th>Two-Earner Couple</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Low</td>
<td>Avg</td>
</tr>
<tr>
<td>Turns 65</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2025</td>
<td>1,150</td>
<td>2,555</td>
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<tr>
<td>2045</td>
<td>3,427</td>
<td>7,615</td>
</tr>
<tr>
<td>2065</td>
<td>4,696</td>
<td>10,436</td>
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</table>

In 2005 dollars. Assumes survival to age 65. Individual accounts assumed to earn a 3% real rate of return. Source: Authors' calculations using Steuerle-Bakija-Carasso Social Security Hypothetical Wage-Earner Model.
Hypothetical Accumulations - % of Final Wage

Tables 4 and 5 of this paper

### OASI REPLACEMENT RATES: (PIA AS A % OF FINAL WAGE)  
(paper Table 5)

<table>
<thead>
<tr>
<th>Year Cohort</th>
<th>Single Male</th>
<th>Two-Earner Couple</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Low</td>
<td>Avg</td>
</tr>
<tr>
<td>Turns 65</td>
<td></td>
<td></td>
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<tr>
<td>2005</td>
<td>53.9</td>
<td>40.0</td>
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<tr>
<td>2025</td>
<td>47.1</td>
<td>35.0</td>
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<tr>
<td>2045</td>
<td>46.6</td>
<td>34.5</td>
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<tr>
<td>2065</td>
<td>46.8</td>
<td>34.7</td>
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(Shortfall)

<table>
<thead>
<tr>
<th>Year Cohort</th>
<th>Single Male</th>
<th>Two-Earner Couple</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Low</td>
<td>Avg</td>
</tr>
<tr>
<td>2045</td>
<td>35.1</td>
<td>26.0</td>
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<tr>
<td>2065</td>
<td>33.7</td>
<td>25.0</td>
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### INDIVIDUAL ACCOUNT REPLACEMENT RATES: (IA AS A % OF FINAL WAGE)  
(paper Table 6)

<table>
<thead>
<tr>
<th>Year Cohort</th>
<th>Single Male</th>
<th>Two-Earner Couple</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Low</td>
<td>Avg</td>
</tr>
<tr>
<td>Turns 65</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>2025</td>
<td>5.4</td>
<td>5.4</td>
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<tr>
<td>2045</td>
<td>13.1</td>
<td>13.1</td>
</tr>
<tr>
<td>2065</td>
<td>14.5</td>
<td>14.5</td>
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Assumes survival to age 65. Individual accounts assumed to earn a 3% real rate of return. Source: Authors' calculations using Steuerle-Bakija-Carasso Social Security Hypothetical Wage-Earner Model.
Hypothetical Accumulations – Subsidy – % of Final Wage

Table 9 of this paper

<table>
<thead>
<tr>
<th>Year Cohort Turns 65</th>
<th>Single Male (Low)</th>
<th>Two-Earner Couple (Low-Low)</th>
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<tbody>
<tr>
<td></td>
<td>Base</td>
<td>Match</td>
</tr>
<tr>
<td>2005</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>2025</td>
<td>5.4</td>
<td>6.5</td>
</tr>
<tr>
<td>2045</td>
<td>13.1</td>
<td>15.6</td>
</tr>
<tr>
<td>2065</td>
<td>14.5</td>
<td>16.2</td>
</tr>
</tbody>
</table>

Assumes survival to age 65. Individual accounts assumed to earn a 3% real rate of return. Source: Authors' calculations using Steuerle-Bakija-Carasso Social Security Hypothetical Wage-Earner Model.
### MUPS Revenue Effects

Table 7 of this paper

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**Revenue Effects of Three Options for a Mandatory Universal Pension System (MUPS) by Calendar Year, 2006-15**

*(paper Table 9)*

<table>
<thead>
<tr>
<th>Option</th>
<th>Average</th>
<th>2006-10</th>
<th>2006-15</th>
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</thead>
<tbody>
<tr>
<td>1 3% MUPS</td>
<td>-40.2</td>
<td>-153.6</td>
<td>-402.0</td>
</tr>
<tr>
<td>2 #1 with Match</td>
<td>-49.4</td>
<td>-189.9</td>
<td>-493.8</td>
</tr>
<tr>
<td>3 #1 with Grant</td>
<td>-46.8</td>
<td>-179.5</td>
<td>-468.2</td>
</tr>
</tbody>
</table>


(1) Calendar years. Figures are in billions of nominal dollars.

(2) All options are assumed to take effect starting in 2006 and extend through the 10-year window to 2015. All dollar figures specified in option descriptions assumed to be in 2005 levels. A fully-refundable Saver’s Credit is used for the subsidy and grant options.

ALL NUMBERS ARE PRELIMINARY.
Caveats

- In this version, we do not model a savings offset – but workers compelled to contribute to a MUPS would reduce other savings.
- A MUPS is regressive (without a subsidy) – may discourage work or pressure low-income finances.
- Does not (directly) address imbalance in Social Security.
- Would place new filing burdens on workers, employers, and government agencies.
Conclusions

- Benefits from public, employer, and private savings will fall, absent increases in contributions.
- An add-on, 3% of payroll MUPS could add 14.5% of final wages for men, 13.3% for women, 14.5% for one-earner couples, and 13.9% for two-earner couples.
- Even more for low-income workers, if there are subsidies.
Conclusions, cont’d

- A MUPS provides every worker with a pension
- A MUPS could raise national savings – while a fix to Social Security would not
- Cost is $40 - $50 billion annually – well less than extending the 2001-04 tax cuts
- Costs could be offset by reducing these tax cuts or through repeal, consolidation, or emendation of other tax subsidies for savings