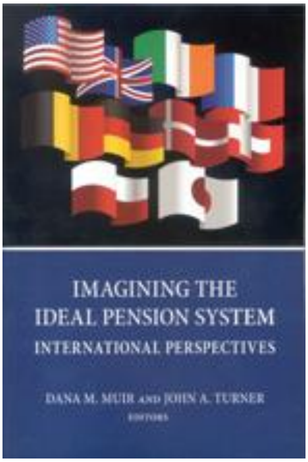
Imagining the Ideal U.S. Pension System



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Chapter 2 (pp. 19-44) in:
Imagining the Ideal Pension System: International Perspectives
Dana M. Muir and John A. Turner, eds.
Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 2011
DOI: 10.17848/9780880993920.ch2

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International Perspectives

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2011

W.E. Upjohn Institute for Employment Research
Kalamazoo, Michigan

Library of Congress Cataloging-in-Publication Data

Imagining the ideal pension system : international perspectives / Dana M. Muir, John A. Turner, editors.
p. cm.
"This book is based on the 2010 conference of the European Network for Research on Supplementary Pensions (ENRSP), held at the Economic Policy Institute in Washington, D.C., on September 10, 2010"—Foreword.
Includes bibliographical references and index.
ISBN-13: 978-0-88099-381-4 (pbk. : alk. paper)
ISBN-10: 0-88099-381-2 (pbk. : alk. paper)
ISBN-13: 978-0-88099-382-1 (hbk. : alk. paper)
ISBN-10: 0-88099-382-0 (hbk. : alk. paper)
1. Pensions. I. Muir, Dana M., 1958- II. Turner, John A. (John Andrew), 1949 July 9- III. European Network for Research on Supplementary Pensions.
HD7091.I464 2011
331.25'2—dc23
2011038440

W.E. Upjohn Institute for Employment Research
300 S. Westnedge Avenue
Kalamazoo, Michigan 49007-4686

Cover design by Alcorn Publication Design.
Index prepared by Diane Worden.
Printed in the United States of America.
Printed on recycled paper.

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Imagining the Ideal U.S. Pension System

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Pension systems evolve over time as the economic and demographic environment in which they operate changes and as human institutions and ideas develop. Their structure is influenced by competing political forces, with differing ideological goals and economic interests. The ideal pension system from the perspective of workers may differ from that of employers, and indeed, not all workers nor all employers hold the same views. Systems in different countries may differ because of different national values, philosophies, and economic histories.

This chapter focuses on the long-run goals that different actors have for the U.S. pension system and the differing views on the ideal U.S. pension system. It examines the underlying values and philosophies of different actors affecting the U.S. pension system, with a focus on pensions in the private sector that supplement the national social security system, which are referred to as the private pension system. This private system includes both employer-provided pensions and individually provided pensions. The chapter critiques the current system and suggests policy options for improvements that would move the current system toward an ideal system.

The primary goals of the U.S. pension system from the perspective of workers arguably are to provide secure and adequate retirement income and to cover most workers. In all three respects, the U.S. system needs better solutions. With the decline in defined benefit plans and the increasing reliance on defined contribution plans, some analysts believe that future retirees will have less secure and less adequate retirement income than current retirees.

This chapter is structured as follows. First, it discusses the necessity of balancing the interests of workers and employers in a voluntary pension system. Second, it examines several recent pension policy initiatives. Third, it discusses policy issues relating to the goals of increased coverage, sharing of risks, and adequacy in the U.S. pension system. Fourth, it examines the extent to which other goals play a role in policy debates. Fifth, it presents specific proposals for reforming defined benefit plans and 401(k) plans, the major type of defined contribution plan. Sixth, it presents conclusions.

U.S. PENSION POLICY IN A VOLUNTARY PENSION SYSTEM

American exceptionalism is the concept that the American culture places a much higher weight on individualism—individual freedom and individual responsibility—than do the cultures in most other high-income countries. In those countries, social solidarity, shared responsibility of workers and employers, and the responsibility of the state are given more prominence (Muir 2006). This difference causes the American pension system to differ in some ways from those in other countries, with a greater emphasis on individual choice and individual responsibility.

The United States has a voluntary pension system, which limits the ability of policymakers to make changes that would be in the interest of workers but would increase the costs or risks borne by employers. Employers are not required to provide a pension plan. Any change within this voluntary framework that reduces risk for workers while increasing risk for employers, or that makes benefits more generous for workers while raising costs for employers, may ultimately not serve the interest of workers because it may lead employers to not offer pensions. Employers, however, have other ways of adjusting to increased risks or increased costs in pension plans, but these adjustments also may be adverse to the interests of workers. For example, employers may hire fewer workers, pay less generous wages, or provide less generous benefits in other forms.

Public policy in a voluntary system thus can have the adverse effect of causing employers not to provide pensions. However, these considerations do not imply that no changes should be made that raise costs to employers or that increase the risks they bear. Often, such changes can be made within a balanced package that takes into account the interest of employers by reducing their risks and costs in other ways. Thus, when considering policy options, an option should not be considered in isolation and rejected because of its particular allocation of costs and risks. Such an option could be part of a balanced package of changes that takes into account the interests of both employers and employees.

INITIATIVES FOR THE IDEAL PENSION SYSTEM

In recent years, a broad consensus has emerged that changes are needed in the U.S. pension system, though a consensus as to what those changes should be has not developed. Several organizations have been active in encouraging discussion of the ideal pension system. The Society of Actuaries' Retirement 20/20 initiative (Retirement 20/20 2011) has established principles for the ideal pension system. The Pension Rights Center, which is a pension participants' rights organization, along with a number of other organizations, has established the Retirement USA initiative, which has also established principles for an ideal pension system (Retirement USA 2011). Both groups have held conferences and have issued calls for proposals for new types of pension plans. The ERISA Industry Committee (ERIC), an employers' group, has also issued a proposal for reform—a report titled *A New Benefit Platform for Life Security* (ERIC 2009). The Retirement Security Project, associated with the liberal think tank the Brookings Institution, has focused on reforming 401(k) plans using insights from behavioral economics about the importance of the choice of defaults by plan sponsors (e.g., Iwry and Turner 2009).

Retirement 20/20

Retirement 20/20 has focused on the development of new types of pension plans. To evaluate proposals for new types of plans, it has an elaborate rating system with four key criteria:

1) The plan is self-adjusting to maintain adequate funding and automatically adjusts to changing economic and demographic conditions.
2) The plan aligns roles of different stakeholders with their skills.
3) The plan recognizes new norms for work and retirement, so that it could support flexible work arrangements, such as phased retirement or return to work after a trial retirement.
4) The plan is appropriately aligned with markets and uses market mechanisms effectively to hedge risks.

The Retirement 20/20 initiative recognizes four stakeholders: participants, employers, markets, and society.

Retirement USA

The Retirement USA initiative has three key principles—the retirement system should provide universal coverage, pension benefits should be secure, and pension benefits should be adequate. It has nine other core principles.

1) **Shared responsibility.** Retirement should be the shared responsibility of employers, employees, and the government.
2) **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.
3) **Pooled assets.** Contributions to the system should be pooled and professionally managed to minimize costs and financial risks.

4) **Payouts only at retirement.** No withdrawals or loans should be permitted before retirement, except for permanent disability.
5) **Lifetime payouts.** Benefits should be paid out over the lifetime of retirees and surviving spouses, domestic partners, and former spouses.
6) **Portable benefits.** Benefits should be portable when workers change jobs.
7) **Voluntary savings.** Additional voluntary contributions should be permitted, with reasonable limits for tax-favored contributions.
8) **Efficient and transparent administration.** The system should be administered by a governmental agency or by private, nonprofit institutions that are efficient, transparent, and governed by boards of trustees that include employer, employee, and retiree representatives.
9) **Effective oversight.** Oversight of the new system should be by a single government regulator dedicated solely to promoting retirement security.

ERISA Industry Committee (ERIC)

In its proposal, ERIC argues that the issues of health security and income security in retirement are so deeply intertwined that any broad revisions should address both components of retirement security. ERIC uses 11 basic principles to evaluate potential benefit plan systems. Employers could continue to offer their current plans rather than developing plans to fit within what ERIC terms a “new benefits platform.” The platform for retirement benefits has three parts: a guaranteed benefit plan (modeled on defined benefit plans and including the possibility of hybrid plans), a retirement savings plan (modeled on 401(k) plans), and a short-term security account (which could be used for life event expenses or saved for retirement).

ERIC’s proposal envisions benefit administrators who would compete at an individual participant level to provide plan services. This structure is intended to create economies of scale by developing larger pools of plans than individual employers, particularly small employers, could develop on their own. The benefit administrators, not employers, would assume the primary fiduciary and contractual obligations to employees. This feature would reduce legal and administrative burdens on employers. Tax treatment of benefits would be uniform for all workers. Employers would be permitted to retain their current benefit plans rather than being required to switch to the new benefits platform.

COVERAGE, RISK SHARING, AND ADEQUACY

This section examines policy issues in the U.S. pension system concerning extending coverage, risk sharing between employees and employers, and the adequacy of benefits.

Increased Coverage and Participation

A worker is covered by a pension plan if the worker has the option of participating in the plan. A worker is a plan participant if the worker actually is accruing future pension benefits. The distinction between coverage and participation arises in 401(k) plans, where not all workers who are covered participate because they do not contribute, which some plans require for participation.

Few countries with voluntary pension systems similar to the U.S. system have achieved participation rates greater than 50 percent of the workforce. Countries that have higher participation rates generally have mandates (Australia, Switzerland) or widespread collective bargaining (Sweden), neither of which applies in the United States (Turner 2010). Only about half of the U.S. private sector workforce participates at any point in time in an employer-provided pension.

Workers not covered tend to be low-wage, part-time, young, nonunionized, and work for small employers and in the service industry. Women and minorities tend to have lower coverage rates than men and whites.

Many U.S. policymakers and policy experts have long wished to improve the coverage provided by the private sector employer-sponsored pension plans. The federal government has enacted numerous reforms having that goal over the past 30 years. A variety of policy issues apply to reforms targeted at increasing coverage.

The following sections consider policy options for increasing pension coverage and participation.

Mandates

The policy value placed on individualism and individual responsibility is held by many people and limits the options for raising coverage. Underlying many of the policy debates in the United States is the issue of mandates versus free choice. Some people oppose mandates on employers and favor a labor market with less intervention by the government. Those opposing mandates argue they are an unwanted government intrusion in the labor market, interfering with the ability of workers and employers to freely negotiate employment contracts.

Some policy experts argue that universal coverage is neither necessary nor desirable because Social Security provides a high replacement rate for low-wage workers. They argue that the low level of benefits paid to these workers by Social Security is due to the low wages on which the Social Security benefit is based. Thus, according to this view, the proper focus for reform should be on improving wages.

Others, such as the Retirement USA initiative, argue that the goal of the private pension system should be universal coverage, based on the rationale that everyone needs a supplement to Social Security. The generosity of Social Security is being reduced, with benefit cuts due to the legislated increase in the Normal Retirement Age (rising to 67 in 2022) for Social Security, and with Medicare tax increases that are paid out of Social Security benefits. The reductions in Social Security benefits increase the importance of supplemental pension benefits.

Those favoring mandates argue that mandates are the only way to achieve a substantial improvement in pension coverage. Some argue that the mandate should include mandatory annuitization of account balances and no preretirement withdrawals.

Mandates can have different options, including whether employers should be mandated to provide a pension, whether they should be mandated to contribute to a pension or just offer one for employee contributions, and whether mandates should exclude small employers including household employers of domestic help, such as nannies and housekeepers. Often, proposed mandates exclude small employers because the administrative burden on them is greater than on larger employers with human resources departments and benefits specialists. Some people who work at small employers may be covered by pension plans if they are employees of a larger company that provides a service instead of being employed directly by the small employer.

Given that the entire U.S. workforce has access to a tax-favored pension plan—those not covered by an employer plan can contribute on a tax-deferred basis to an Individual Retirement Account (IRA)—the question arises as to what the justification is for more aggressive government policies on coverage by plans sponsored by private sector employers. The counterargument is that few people who lack a pension plan actually set up IRAs.

Paternalism ultimately is a justification for much of retirement income policy. Many people do a poor job of saving for retirement on their own. Even if they have the opportunity to participate in a tax-favored pension plan, such as an IRA, they do not voluntarily do so. That argument takes on greater weight as a reason for aggressive government policies intended to increase pension coverage with the cutbacks in Social Security.

One soft mandate in the United States is found in what are referred to as nondiscrimination rules. These rules require firms that provide a pension to treat lower paid and higher paid workers similarly in terms of percentages of both groups covered and the generosity of the benefits provided relative to wages.

Incentives

Raising pension coverage has proven to be more difficult than once thought by policy experts. Tax incentives to encourage participation in a pension have long been an aspect of the pension system. With the passage of the Employee Retirement Income Security Act of 1974 (ERISA), all workers have had access to a tax-favored pension in that any worker not otherwise participating in a pension plan can make a tax-deductible contribution to an IRA. In the late 1990s, the Roth IRA was established. This type of IRA expanded the options available to some workers, who pay taxes on their contributions but receive their benefits tax free. In a traditional IRA, the pattern is reversed, with qualifying workers not paying taxes on contributions, but receiving taxable benefits. Yet, even with this expansion in options, relatively few workers have set up accounts in either type of IRA for the purpose of contributing to them. Account balances in IRAs have grown considerably, but that is largely a result of contributions from rollovers from 401(k) plans made by workers changing jobs.

Many employers have added a further incentive for workers to participate in the defined contribution plans they provide by matching contributions in 401(k) plans. Some employers do this because of nondiscrimination rules, which require that a minimum percentage of low-wage workers participate or that the employer provide either a contribution to all employees or a minimum matching contribution. Still, roughly a quarter of workers who have the opportunity to participate in those plans forgo both the tax incentive and the matching contribution (Turner and Verma 2007).

New types of plans

A major example of reforms to improve coverage has been the enablement of new types of pension plans. Some reforms have provided new types of pensions for small employers, such as the Simplified Employee Pension and the Savings Incentive Match Plan, recognizing that the pension coverage rate for small employers is low and that the administrative and compliance costs per employee of providing pensions are higher than they are for large employers. These reforms have sought to reduce the regulatory burden placed on small employers relative to large employers. Based on limited data available, it appears that the rate of participation in Simplified Employee Pension plans has never exceeded 2 percent of all employees who participate in pension plans at small employers (EBRI 2009, Table 10.1c).

Ironically, the most popular type of pension plan currently in the United States in terms of the number of workers participating, the 401(k) plan, was not established to improve coverage. Instead, it was an unexpected outgrowth of a technical amendment expected to have limited consequences. When employers provide a defined benefit plan, workers are automatically covered, but when they provide a 401(k) plan, worker coverage generally depends on the willingness of the worker to contribute to the plan. Thus, the problem of workers not participating in a pension plan is due both to employers not offering plans and workers not always participating when offered.

Automatic enrollment and defaults in 401(k) plans

In recent years, as an outcome of the development of behavioral economics, attention has focused on psychological, rather than economic, reasons for why some workers do not participate in pension plans. This approach has led to the development of the use of defaults to encourage participation in 401(k) plans. With this approach, workers are covered by default, with the option to opt out, rather than the traditional approach, where the default is that workers are not covered unless they take an action to enroll. Once covered, inertia may keep workers covered, though the long-term effects of defaults are not known, and may be considerably less favorable than expected, especially for low-income workers, who tend to cash out their pensions at job change.

In recent years, legislation (the Pension Protection Act of 2006) and regulations have facilitated employers' ability to offer automatic enrollment, where newly hired employees are automatically enrolled but have a period of time in which they can opt out without penalty. While some data for a few firms show a large short-term effect of automatic enrollment increasing the percentage of workers participating, longer term studies taking into account leakage due to cash-outs at job change have not been conducted to analyze the longer term effects. Automatic enrollment may result in some low-wage workers paying tax penalties because they accumulate account balances that they did not really want and that they liquidate at job change.

Recent discussion has focused on requiring that employers offer pension plans and that those plans have automatic enrollment.

Conflicting goals

Other policy goals have conflicted with the goal of raising coverage. The effects of these goals on policy outcomes may account in part for the failure of reforms that were intended to raise coverage.

First, the government has attempted to limit the tax loss (sometimes called tax expenditure) for providing pensions, in particular by limiting contributions to fund defined benefit plans and limiting the generosity of benefits provided to higher income workers, typically high level executives. Because of the limitation applicable to high-income workers in tax-favored defined benefit and defined contribution plans, employers have developed nonqualified plans (plans with more limited tax preferences) for those workers. As a result, company executives have less of a stake in the plan for rank-and-file workers, and the rank-and-file plans may be less generous than they otherwise would be. In an ideal pension system, the interests of the executives of a company with respect to the company pension plan would be aligned with the interests of the rank-and-file workers.

Economists argue that the cost of providing pension benefits is ultimately borne by workers through reduced wages and other nonpension compensation, even if the expense is directly paid for by employers. This concept is viewed with skepticism by many non-economists. While that relationship between wages and pensions is clearly visible in the context of collective bargaining, where negotiators bargain for more generous pensions in exchange for less in other forms of compensation, most economists believe that it also occurs in other labor market contexts as well. Thus, if low-wage workers were covered by a pension, their already low wages would be reduced even further, only constrained by minimum wage laws. Raising the costs of employing workers by providing them with pension benefits could lead to a reduction in employment for low-wage workers to the extent that their wages could not be reduced due to minimum wage laws. It could lead to a reduction in other benefits, such as vacation time or health benefits for those who have those benefits.

To deal with these potential problems, proposals to extend coverage to low-wage workers often involve a government subsidy of the cost of the coverage, so that the cost would not be borne by either the employee or the employer, but by taxpayers. The United States currently has the Saver's Credit for low-wage workers. It is a tax credit that benefits low-wage workers who have a tax liability, but it does not benefit the many low-wage workers who are exempt from paying income taxes because of their low income. For this reason, advocates have long argued for a refundable Saver's Credit that would be paid even to workers who owe no personal income taxes.

In sum, increasing pension coverage in the United States has proven to be difficult. The difficulties arise in part because of the voluntary nature of the U.S. pension system. Conflicting goals have doubtless also played a role. However, the ideal U.S. pension system would have higher coverage than that provided by the current system.

Risk Sharing

Risk is a fundamental aspect of pension systems. Because pension plans promise to pay benefits at a future date, risk is inherent. The risks include financial market risk associated with the investments of the plans, portability risk experienced by job changers and workers who are laid off, interest rate risk associated with converting investments into annuities, longevity risk associated with the length of life after retirement, and inflation risk for the accrual of pension benefits and the value of pension benefits in payment. Also, in the context of a voluntary pension system, participants face risks as to plan terminations or freezes, and other plan amendments by employers.

The policy goal of risk sharing is to allocate risks between workers and plan sponsors in a way so that they are borne by the party best able to do so, taking into account the costs of risk bearing and the degree of risk aversion of workers and employers. Diversification is a fundamental concept in the sharing of risks. By diversifying through combining risks that are not perfectly correlated, risks can be reduced. This applies both for financial market risks and demographic risks.

One aspect of diversification of risks for workers in pension systems is to increase the number of workers who participate in both a defined benefit and defined contribution plan. Workers are subject to different risks in defined benefit and defined contribution plans. In defined benefit plans, they are subject to labor market risks, such as that of being laid off. This is a risk because the wages used to calculate benefits in the United States are not price indexed up to the point of retirement, so they erode in value with inflation. In defined contribution plans, workers are subject to capital market risks on the investments in their account. By participating in both types of plans, they are able to diversify and reduce the total amount of risk that they bear.

Another concept in risk bearing is that risks should be borne by the party who can most easily bear them. Idiosyncratic life expectancy risk is the risk that an individual will live longer than expected. Idiosyncratic life expectancy risk is a major risk for individuals in defined benefit plans that are not indexed for inflation. Sponsors of large defined benefit pension plans, however, can more easily bear this risk through having a pool of many participants.

Cohort life expectancy risk is the risk that on average people in a birth cohort will live longer than expected. Cohort life expectancy risk is expensive for defined benefit plan sponsors to bear because they cannot diversify it away. However, it can relatively easily be borne by individual workers because improvements in life expectancy tend to occur gradually over time and because workers are the prime beneficiaries of the improvements. This risk is not borne by plan sponsors in defined contribution plans because those annuities are determined by taking into account cohort improvements in life expectancy. Cohort life expectancy risk is currently borne by plan sponsors in defined benefit plans, but defined benefit plans could be structured so that it is borne by participants.

In sum, risk sharing is a complex topic involving issues of risk diversification and consideration of which party is best able to bear risks. Policies relating to risk sharing need to take into account the voluntary nature of the U.S. pension system and that shifting nondiversifiable risks to employers reduces specific risks that workers bear but may increase the risk that employers will terminate plans, reduce employment, or decrease wages or other benefits. Arguably, in an ideal pension system, risk sharing could be improved by shifting cohort life expectancy risk to workers in defined benefit plans.

Adequacy

The percentage of old-age individuals living in poverty is high in the United States compared to the levels in many other OECD countries. That result occurs in part because the U.S. Social Security program provides a relatively low replacement rate as compared to that in many other OECD countries.

Replacement rates are a common measure of benefit adequacy, but policy analysts differ as to what level they should be. Many people view a replacement rate of between 70 and 80 percent of preretirement earnings as adequate, but some argue for replacement rates between 80 and 90 percent (Mitchell and Turner 2010), and indeed some argue for even higher replacement rates because of the cost of medical care in old age (VanDerhei 2006). Others, however, argue for a lower replacement rate, noting that workers raising children need a relatively low replacement rate, perhaps 65 percent, to maintain their preretirement standard of living in retirement.

Part of the debate over adequacy is whether the goal should be to maintain the individual's preretirement standard of living or to match the standard of living for a particular cohort group such as current workers in the individual's job or industry. As the U.S. population ages, the question of adequacy becomes intertwined with the intergenerational support issue. If the system of pension support is not prefunded, current workers may demand a greater voice in what constitutes an adequate pension benefit.

Adequacy refers not only to benefits received at the point of retirement, but also to benefits received during the length of retirement. Most policy experts feel that more Americans should annuitize at least part of their 401(k) plan account balances (Iwry and Turner 2009). However, relatively few experts have opted in favor of mandating the annuitization of account balances, though some policy experts favor that approach.

In sum, while the measures for improving coverage and the allocation of risk are relatively straightforward, the issue of adequacy involves determining standards for which there is not agreement among policy experts. This lack of agreement may be partially the result of the need for more research to determine how standards of adequacy would differ among people in different situations, such as childless couples as compared to single parents or couples facing the expenses of raising children. Nonetheless, in the view of many policy experts, the ideal U.S. pension system would involve higher levels of pensions for older Americans, which implies the commitment of greater resources to the pension system, and a lower percentage of older Americans living in poverty.

OTHER GOALS

In addition to the three primary goals of coverage, risk sharing, and adequacy, a number of other goals play a role in the development of the U.S. pension system.

Defined Benefit versus Defined Contribution Plans

An issue in the policy debates is the role of defined benefit plans versus defined contribution plans and hybrids in the ideal pension system. This issue actually may be more about how to reach goals than about the goals themselves, but because of its importance, it is highlighted here. Some analysts appear to consider the decline in defined benefit plans as an inevitable outcome because those plans are dinosaurs that are unable to adapt to changing business and employment conditions. A number of policies could be considered, however, based on the alternative view that the endangered status of defined benefit plans is due in part to policy decisions that have caused changes in their regulatory environment. Further, some people argue that defined benefit plans should form the main part of the private pension system, and that 401(k) plans and other defined contribution plans are not really pension plans but rather are savings plans. Although defined benefit plans currently have few champions, labor unions still tend to favor defined benefit plans.

Others favor 401(k) plans because of the large element of individual responsibility they entail, exactly the reason some people do not like them. Policy experts who favor 401(k) plans argue that managing those plans is not too complex for most people, and investment of financial assets is a skill that people should be expected to have. Others argue that people have busy lives, and they should not be expected to become financial experts. The empirical evidence indicates that many people do a poor job of managing their 401(k) plans in terms of the amount they contribute and the investments they choose (Turner 2003).

A major debate is occurring over the appropriate role for 401(k) plans. There is widespread recognition of the shortcomings of these plans—poor investment choices made by participants, many of whom have the opportunity to participate but do not do so, failure to provide annuitized benefits, and high level of risk placed on participants. A number of commentators have called for the retirement of 401(k) plans.

Opinion differs, however, as to what changes are needed for 401(k) plans. Some favor a focus on fixing these plans, and making them more like defined benefit plans in some respects, for example, by requiring that they provide annuities, have automatic enrollment, and provide appropriate default investment vehicles. Others favor looking for new types of plans, preferably hybrid plans that combine the best features of traditional defined benefit and defined contribution plans.

Distributional Issues

The system of providing tax subsidies for pensions has come under heavy criticism. Because the U.S. tax system is progressive, with higher income persons paying higher marginal tax rates, the tax subsidies for pensions, per dollar contributed, are higher for high-income than for low-income persons. This could be remedied by providing tax rebates that are equal across income classes per dollar contributed, a change many people view would move the U.S. pension system toward an ideal system. Others argue that the higher tax subsidies for individuals with higher marginal tax rates appropriately incentivize those individuals to participate in pension plans. In some plans, such as 401(k) plans, the nondiscrimination rules then require the plan to incentivize sufficient numbers of lower paid employees to participate in the plan to meet the minimum requirements of those rules. Thus the tax subsidies, though unequal, support increased plan participation and align the interests of higher and lower paid employees.

Dealing with Increasing Longevity

Life expectancy has increased in the United States, as in many other countries. However, there has been little discussion of pension policy adjustments that might be made in response to this increase. For example, the idea of encouraging people to work longer and take their pension at a later age has received little attention, other than by a few academics. While Social Security in the United States has raised its Normal Retirement Age from 65 to 67, with the adjustment currently being phased in over a 22-year period, private pension plans are more limited in their ability to make similar adjustments (Muir and Turner 2007). Other adjustments could include an increase in the earliest age at which benefits can be received and an increase in the age at which benefits must be taken.

Financial Literacy

Given the role of individual decision-making in the 401(k) system, where workers generally must decide how to invest the account balance of their individual account from a menu of options, greater emphasis is being placed on financial literacy and on financial education for pension participants.

Some, however, oppose this approach and argue instead that less responsibility be placed on workers when making financial decisions about their pension investments. With this approach, pensions would be collectively managed by professional managers, rather than being managed by individual participants. Economies of scale would result in reduced costs, and professional management would result in better investment choices.

In addition, some argue that financial education is not effective. Although some workers may be helped, financial education often seems to have no effect on the workers' decisions.

POLICY RECOMMENDATIONS

This section discusses policy recommendations for 401(k) plans, which are by far the most prevalent type of defined contribution plan, followed by policy recommendations for defined benefit plans.

Policy Recommendations for 401(k) Plans

Since the 1980s, the role of 401(k) plans has changed from being mainly supplementary plans, offered by employers who also offered a defined benefit plan, to often being the only plan employers provide. However, the regulation of 401(k) plans has lagged in recognizing their increasingly important role.

Regulating 401(k) plans as retirement plans

One approach to regulating 401(k) plans has been called the "DB-ification" of 401(k) plans. This approach calls for changes in 401(k) plans that would make them more like defined benefit plans. These changes include automatic enrollment of employees as the default (with an opt-out option), default investment in life cycle or target date funds, and an automatically increasing contribution rate. Automatic enrollment, however, may result in some low-wage workers paying tax penalties because they accumulate account balances that they did not really want and that they liquidate at job change.

Clear disclosure of costs

Participants in 401(k) plans are frequently unaware of the investment and administrative costs they bear in their 401(k) plans. An underlying premise of the 401(k) system is that workers are capable of making good decisions concerning investments. However, good decisions are not possible if workers do not have easy access to information concerning fees. This information is available for many workers through the prospectuses of the mutual funds they invest in, but research has shown that most people find prospectuses confusing and do not read them when making financial decisions (Turner and Witte 2008).

Increased fee transparency also may encourage employers to offer lower cost investment options in 401(k) plans. If employers seriously consider the more transparent fees when choosing plan options, the resulting competition may drive down fees across the investment industry. Thus, even if participants do not scrutinize fees, increased fee transparency and increased scrutiny by employers in choosing options may lower investment costs.

Some policy experts recommend that the fees participants pay in dollars, as well as the expense ratio for investment expenses, should be disclosed on the annual and quarterly account statements they receive. This type of disclosure is done in Australia for plan administrative fees and by the Janus mutual funds for investment costs. Advocates of increased disclosure believe that the information can be provided in a low-cost way simply by providing a standardized disclosure of the level of fees paid in dollars annually for an account of $10,000. Disclosures should be kept simple, so that they will be understandable to participants.

Opponents argue that many participants will not benefit from such disclosure because they will not take it into account when making decisions. In addition, participants may not understand the implications of the disclosure. Opponents also believe that standardizing fee disclosures for a given account balance may be misleading to individuals with substantially different account balances. This is especially true to the extent flat fees are charged rather than percentage fees based on asset balances. Disclosure advocates respond that, with increasing account balances, more experience with investing, and better financial education, larger numbers of workers would benefit from more extensive disclosure.

In October 2010, the U.S. Department of Labor (DOL) issued new disclosure requirements for 401(k) plans. Plans are required to disclose administrative fees charged to the accounts and charges for individual expenses, such as charges for taking a loan from a plan account. In addition to performance and benchmark information, for investments that do not have a fixed rate of return, plans must report the total annual operating expenses of the investment both as a percentage of assets and as a dollar amount for each $1,000 invested. Thus the DOL appears to believe that, despite the added costs resulting from additional disclosure, the additional disclosure will be of sufficient value to plan participants.

Clear disclosure of benefits

Employees may not understand the relationship between 401(k) account balances and future retirement benefits. This situation could be addressed by requiring employers to report annually to employees how much their current 401(k) balance would provide in monthly payments at retirement age, based on reasonable assumptions. This could be done by providing an example, based on an account of $10,000, a stated life expectancy, and a stated retirement age. This low-cost approach would provide workers an idea of how their account balance would translate into a retirement benefit. Research in behavioral economics has demonstrated the low level of financial knowledge of many Americans, and improved disclosure of this type would help some workers have a better idea of how much they need to save to meet their retirement goals.

Opponents of this type of required reporting of 401(k) account balances are skeptical of the extent to which such increased reporting would affect participant behavior given the strength of the inertia effects that have been reported by behavioral economists. The disclosure of projected monthly benefits also may be misleading and confusing because they will be heavily dependent on assumptions, including life expectancy and interest rates. Those assumptions may create expectations that the lump sum account balance can be annuitized at retirement to achieve the projected monthly benefits. In fact, the assumptions may change over an employee's working career and annuity rates may depend on a variety of factors that are not knowable until retirement.

Leakage

Preretirement disbursements of pension money are particularly a problem in 401(k) plans. Many policy analysts argue that the tax-favored nature of the money means that it should not be available to participants until retirement. Opponents of locking up retirement account balances fear that lack of access to the money would decrease the willingness of employees to make voluntary plan contributions. If some access is permitted in limited circumstances to meet this concern, then at a minimum, account balances over a minimal threshold should not be distributed on job change.

Dealing with market meltdowns

Workers age 50 and older have higher allowed contributions to 401(k) plans than younger workers. These contributions are called "catch up" contributions, based on the idea that older workers may not have saved adequately for retirement. Catch up contributions might be allowed for all workers during an economic downturn, so that they could compensate for the losses in their defined contribution plans. Opponents of permitting such contributions for all workers argue that they could result in a windfall for young workers whose account balances have many years to recover. The increased cost of the tax incentives for all workers also may be politically unacceptable during an economic downturn.

Policy Recommendations for Defined Benefit Plans

Defined benefit plans have declined considerably in their role in the U.S. pension system. Nonetheless, relatively little importance has been placed in policy debates on policies that might reverse this trend. Most people appear to have accepted the decline in defined benefit plans, without considering the role that public policy might have played in that decline. A number of policies could be considered to address this issue.

Equal tax treatment

Differing from most countries with private pension systems, private sector defined benefit plans in the United States are the only major type of pension plan that does not permit employee tax-deductible contributions. Employee tax-deductible contributions are permitted for 401(k) plans and for defined benefit plans for state and local government employees. Non-tax-deductible employee contributions are permitted for private sector defined benefit plans, but those contributions do not make economic sense, and are consequently rare, because of the alternative of relying on employer contributions, which are tax deductible.

Extending tax deductibility of contributions to private sector defined benefit plan participants would help level the playing field between defined benefit plans and 401(k) plans. The tax deductibility of employee contributions appears to be a major reason for the popularity of such contributions in 401(k) plans. Permitting employees to make tax-deductible contributions to defined benefit plans would reduce the direct costs of those plans that are borne by employers and shift costs onto employees. Among countries where defined benefit plans play a major role in their pension system, the United States is practically unique in not permitting tax deductibility of employee contributions. In most countries with defined benefit plan systems, employee contributions play a major role in financing the plans.

Dealing with rising life expectancy

The increase in life expectancy appears to have contributed to the decline in defined benefit plans because defined benefit plans lack the flexibility to deal readily with this continued increase in cost to employers (Muir and Turner 2007). In the United States, some plans have reduced their benefits, but generally this change is only done for new hires and thus has limited effect on the plan sponsor’s costs.

A policy innovation, following the example of the Notional Defined Contribution plan in Sweden, would be to permit life expectancy indexing of benefits at retirement. This policy would reduce both costs and risks for employers.

For each new retirement cohort, the generosity of the plan would be adjusted downward to reflect the trend toward greater life expectancy. Under U.S. law, this innovation currently would not be allowed because it would violate the anti-cutback rule, which is defined in terms of annual benefits. If it were redefined to take an economist's perspective and use lifetime benefits as the measure, life expectancy indexing would not constitute a cutback in lifetime benefits. This feature would shift cohort life expectancy risk to workers, who are better able to bear this risk than are employers.

Linking interests of management to workers

The tax system could be used to encourage broader coverage through defined benefit plans. For example, to tie the interests of management to those of workers, the allowable maximum income considered for determining defined benefit plan benefits could be raised in plans that provide coverage to all full-time workers. Another option, possibly in combination with the first, could require that employers provide similar plan features for rank-and-file workers as they provide for executives.

One change to align the interests of management with the interests of the rank-and-file was made in recent years to the funding requirements of defined benefit plans. If a company's defined benefit plan is insufficiently funded and certain other criteria are met, then the company is prohibited from making contributions to non-tax-qualified plans for specified executives.

Funding rules

Volatility in employer contributions to defined benefit plans has increased due to changes in funding rules that restrict the timing of employer contributions. Funding rules prohibit employers from contributing to defined benefit plans in years when plan overfunding exceeds a certain level. Even though employees continue to accrue benefits, plan sponsors cannot contribute toward the increased liabilities of their plans in those years.[1] This prohibition on contributions generally occurs when the stock market and companies are performing well. Because pension plans are long-term commitments and because of the fluctuations in the stock market, plan sponsors then are required to make contributions at a later date. This requirement generally occurs when the stock market and companies are performing poorly. The resulting temporal pattern of contributions not only increases the volatility of contributions, it forces plan sponsors to contribute on a schedule exactly opposite to what they would choose.

To reduce the volatility and timing problem of employer contributions for defined benefit plan funding, both the maximum and minimum contribution requirements can be eased. For example, plans could be allowed to contribute 25 percent of normal cost any year, regardless of funding level, which would permit them to contribute in years when the plan was overfunded. They would still have minimum requirements in years the plan was underfunded, but those requirements should be less onerous and more within the employer's control because of the added funding they could make in years the plan was overfunded.

Volatility could also be reduced by higher target funding levels with longer time periods to reach them. With higher target funding levels, the likelihood that plans would become underfunded would be reduced. An alternative approach would be to use a three-year moving average of funding ratios to smooth changes in funding ratios and thus smooth contributions. This approach has been proposed in Canada.

Lost pensions

The lost pension problem is a problem for workers who are laid off or who change jobs (Blake and Turner 2002). It can be difficult for a worker to track down a pension from a former employer, particularly if that employer has gone out of business. Both the United Kingdom and Australia have made significant efforts to assist people facing this problem.

In the United States, the Pension Benefit Guaranty Corporation (PBGC) maintains a missing participants list for defined benefit plans that the PBGC has acquired and for terminated defined benefit plans. Legislation enacted in 2006 requires the PBGC to extend that program to include former participants in defined contribution plans and in other less common types of plans. The PBGC has not yet issued regulations on the extension of the program. At this time, however, it appears that the program still will not cover some potentially lost participants such as those in non-terminated defined benefit plans.

CONCLUSIONS

Pension policy is an evolving product of social institutions and the economy. With the decline in defined benefit plans and the increasing role of 401(k) plans, improvement is needed in the way pensions are provided to U.S. workers. The regulation of 401(k) plans needs to be updated to recognize that they generally are no longer supplementary plans, perhaps retaining the current, less-stringent regulation, when they are supplementary plans. Policies need to be enacted to strengthen defined benefit plans by making them more flexible and improving the ways they are funded, for example, by allowing employers more flexibility to make contributions to plans during times of high asset values and high interest rates. Such a change could help address the issue of the volatility of employer contributions to defined benefit plans. Improvements in risk sharing could be enabled by legislation, such as permitting plans to shift the risk of improvements in cohort life expectancy to workers.

Note

1. Depending on interest rate movements, plan liabilities might not increase.

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