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Universal Voluntary Accounts: A Step Towards Fixing the Retirement System

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Executive Summary

Most older workers are ill-prepared for retirement, with few financial assets to rely upon other than their Social Security. The main reason is the collapse of the system of defined-benefit (DB) pensions. Less than 20 percent of the private sector workforce is currently covered by a DB plan, and this number is declining rapidly.

Defined-contribution (DC) plans, such as 401(k) accounts, have not come close to filling the gap. Nearly half of all workers don't even have access to a pension at their workplace (DB or DC). The Federal Reserve Board's most recent Survey of Consumer Finances found that 53 percent of near retirement age workers (ages 45-54) had accumulated less than $48,000 in financial assets.

This paper outlines a proposal for a system of universal voluntary accounts (UVAs). UVAs would be state sponsored, but privately managed, defined-contribution accounts. The accounts would be open to every worker in a state.

Such a system would accomplish three important goals:

1. It would provide every worker in a state with access to a defined-contribution pension at his or her workplace. They would be able to make contributions directly from their paychecks and employers could also contribute, if they chose;

2. It would provide a fully portable system that a worker could carry with him or her from job to job, as long as he or she remained in the state; and

3. It would provide a low-cost system with administrative costs that are far lower than in many existing DC plans. In current plans, as much as 20 percent of contributions can be eaten up by administrative costs.

A system of UVAs would be especially helpful to small businesses, since it would allow small businesses to offer pensions to their workers with virtually no administrative burden and zero risk.

Polling research has shown that the idea of UVAs is extremely popular among Democrats, Republicans and Independents, with more than 80 percent of those surveyed expressing approval. There also has been interest in the establishment of a UVA type system from policy analysts across the political spectrum, as the failings of the current pension system are becoming increasingly evident.

Introduction

The retirement system in the United States is badly tattered. The traditional thinking has been that retirement income should be a three-legged stool. The first leg would be Social Security, which provides a core retirement income to nearly the entire workforce. The second leg would be a defined-benefit pension (DB), which would provide a substantial supplement to Social Security. The third component would be income from the savings that workers managed to put aside on their own.

The picture of the three-legged stool no longer fits the reality of the 21st century workforce. Less than 20 percent of the private sector workforce has a traditional DB pension, and this number is falling rapidly. Few, if any, firms are starting DB plans and the firms that do still have DB plans are shedding workers and freezing their plans at an alarming rate. There is little reason to believe that the decline in DB plans will be reversed.

Defined-benefit plans have to a large extent been replaced by defined-contribution (DC) plans. DC plans are essentially a personal saving option with the difference that the money is deducted directly from workers' paychecks and that most DC plans include an employer-side contribution. However, DC plans have not come close to filling the gap created by the dwindling of the DB system. Only half the workforce even have access to a pension at the workplace (DB or DC) and most of those who have DC plans manage to accumulate very little wealth during their working years. Among the 94 percent of families headed by someone between the ages of 45 and 54 who had any financial assets at all, the median holdings was just $48,000 in 2004.[1] This means that 53 percent of these near retirement families had managed to accumulate less than $48,000 in financial assets. This figure includes assets in DC plans (although not DB plans), as well as any personal savings they had outside of their retirement accounts. If current trends continue, most workers will not have much besides Social Security to support themselves in retirement.

Unfortunately, most of the public debate on retirement income has focused on Social Security, the leg of the stool that is relatively solid. According to the most recent projections from the non-partisan Congressional Budget Office, the system can pay all scheduled benefits for the next 40 years with no changes whatsoever. Even after 2046, when the system is first projected to face a shortfall, the system would always be able to pay a higher benefit (in 2006 dollars) than what current retirees receive. Furthermore, the projected shortfall is smaller than the Social Security shortfalls that the country dealt with each of the decades from the 1950s through the 1980s, so maintaining full scheduled benefits (if Congress were to elect to follow this route) would not be a difficult task.

Given the relative financial health of Social Security, the private pension system clearly poses the more urgent problem. This paper describes a simple plan – a system of universal voluntary accounts (UVAs), invested privately but administered through state governments, that can be an important

1 Bucks, B, A. Kennickell, and K. Moore, 2006. "Recent Changes in U.S. Family Finances: Evidence From the 2001 and 2004 Surveys of Consumer Finance." Federal Reserve Bulletin, January 1-38, Table 5, [http://www.federalreserve.gov/pubs/bulletin/2006/financesurvey.pdf].

first step in solving the pension plan.[2] This system would immediately accomplish three important goals:

1. It would provide every worker in a state with access to a defined-contribution pension at his or her workplace. They would be able to make contributions directly from their paychecks and employers could also contribute, if they chose;
2. It would provide a fully portable system that a worker could carry with him or her from job to job, as long as he or she remained in the state; and
3. It would provide a low-cost system with administrative costs that are far lower than in many existing DC plans. In current plans, as much as 20 percent of contributions can be eaten up by administrative costs.

In addition, UVAs are small-business friendly. The overwhelming majority of workers at large firms have pensions, while the overwhelming majority of workers at small businesses do not. The reason is that many small business owners lack the time, expertise and comfort level necessary to provide their workers with a pension. The UVA system will allow every small business owner to provide a pension to their employees with virtually no time or effort on their part, and zero risk. Employers will also be able to contribute to these pensions on their workers' behalf, if they choose. Since workers value pensions, UVAs will assist small business owners in retaining workers who might otherwise be attracted by pension plans offered by larger employers.

While UVAs will not provide a full solution to the problem of ensuring workers a decent retirement, they are an important first step. They will put in place a structure from which a fuller solution can be constructed.

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2 This is paper is based on a proposal drafted in 1999 for the Century Foundation, "Pensions for the 21st Century," [http://www.tcf.org/list.asp?type=PB&pubid=231].

The Benefits of Universal Voluntary Accounts

This plan for UVAs combines goals that both liberals and conservatives have sought in structuring retirement policy. Conservatives have argued that everyone should have their own personal accounts so that they can have some sense of ownership. Liberals have been concerned that many workers will not have adequate income to provide a decent retirement. By making a universal system of accounts available to workers on a voluntary basis, UVAs should help to advance both goals. This is one reason that UVA-type proposals have drawn support from across the political spectrum. In fact, Mark Iwry, an official in the Clinton administration, recently co-authored a paper with David John, an economist with the Heritage Foundation, that advocated exactly this sort of system of voluntary accounts.[3] The Conversation on Coverage, a multi-year project to increase pension coverage that includes representatives of business, labor, the financial industry and academia, developed a similar proposal through a consensus process.

The idea of a system of UVAs has also received very strong backing in polling and focus groups in Washington State.[4] All demographic groups viewed the idea of a system of portable pensions administered through the government positively, with the proposal garnering the approval of more than 80 percent of those polled. While the support was strong regardless of party affiliation, UVAs actually received the strongest support from Republicans, nearly 90 percent of whom viewed the idea positively.

The benefits of such a system are straightforward. Every worker in the state can immediately have access to a pension to which they can contribute from the day they start their job. Currently, most firms require a vesting period, which is often two to three years. As a result, many workers do not stay at a job long enough to vest in a pension, and even if they do, they may have gone several years with making no contribution. In an economy that can require frequent job changes, many workers may go through their career never working at a job where they have stayed long enough to vest in a pension.

In addition to allowing workers to contribute to a pension as soon as they start working, UVAs will also allow workers to keep the same pension, as long as they remain within the state. Often workers withdraw their retirement savings when leaving a job, especially if they have only accumulated a small sum in their accounts. Since workers will be able to contribute to the UVAs as long as they remain in the state, there is no reason for them to withdraw their funds when they change jobs. This will make it easier for workers to accumulate a sizable sum to support their retirement.

The potential cost savings from UVAs can be substantial, and this can make an important difference in workers' retirement income. President Bush's Social Security Commission estimated that a simple system of individual accounts, like those established under the UVA system, could be managed at a cost of 0.3 percent of the funds accumulated in the account. By comparison, the average for private

[3] Iwry, M. and D. John, 2006. "Pursuing Universal Retirement Security Through Automatic IRAs." Washington, D.C.: Heritage Foundation, [http://www.heritage.org/Research/SocialSecurity/wp20060212.cfm].

[4] Economic Opportunity Institute, 2004. "Washington Voluntary Accounts and Public Opinion," Seattle, WA: Economic Opportunity Institute, [http://www.eoionline.org/WVA/WVA-PublicOpinion2004.pdf].

sector DC plans is over 1.0 percent and a recent study by the Government Accountability Office found that many plans charge fees of more than 1.5 percent annually.[5]

If a worker contributes $1,000 annually to a DC plan with an annual fee of 1.5 percent, she will have accumulated $54,900 toward retirement after 35 years. By contrast, if the same worker contributes $1,000 annually for 35 years to a UVA system with a fee of 0.3 percent annually, she will have accumulated $69,400, or 26 percent more. In addition, if workers want to receive their retirement money in the form of an annuity (an annual payment that continues throughout the worker's retirement), private financial firms will typically charge fees equal to 5 to 10 percent of the account's value to cover their costs. President Bush's Social Security commission assumed that a centralized system administered through the government could convert private accounts to annuities at almost no cost.

The combined savings from annual administrative costs and annuity fees can easily add 30 to 35 percent to the money that workers have available in retirement. This is a remarkable gain that can be obtained simply by eliminating waste in the current system. Insofar as the UVAs also facilitate increased contributions from workers and employers, and discourage withdrawals from accounts when workers change jobs, the impact on retirement savings will be even larger.

Finally, UVAs should relieve small employers of the anxiety of dealing with pensions or the risk of losing workers if they do not offer pensions. While there have been important steps taken in recent years to simplify the process whereby firms can offer pensions,[6] many employers still find the process more complicated than they want to deal with, as demonstrated by the fact that most small employers still do not offer pensions. It is entirely reasonable that small employers would not want to take the time to determine what sort of pension structure and which provider would be best for their firm. They are trying to run their businesses, not manage retirement plans. The UVA system allows small businesses to escape this burden altogether.

Under the UVA system, employers are only obligated to pass along deductions that workers opt to make from their paychecks. This involves no more paperwork than is required to deduct the unemployment insurance contributions from workers' paychecks. If employers opt to make their own contribution to workers' accounts, they can do so in accordance with the federal rules governing DC accounts. Employers are not required to contribute on their workers' behalf. The only requirement imposed on employers is that they pass along contributions that workers choose to have deducted from their paychecks. This requirement is necessary to ensure that the accounts are fully portable as workers change jobs.

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[5] Government Accountability Office, 2006. "Private Pensions: Changes Needed to Provide Plan Participants and Department of Labor Better Information on Fees," Washington, D.C.: Government Accountability Office, GAO-07-21, [http://www.gao.gov/new.items/d0721.pdf].

[6] For example, the SIMPLE IRA was introduced by the Clinton administration to minimize the paperwork required of small businesses to establish small retirement accounts for their workers. It had a limited impact on pension access.

The Mechanics of Universal Voluntary Accounts

The model for the UVAs system is the federal employees' Thrift Savings Plan (TSP), which was also the model for the accounts proposed by President Bush's Social Security commission. The idea is to provide a simple low-cost system of accounts that has a small number of investment options and limited opportunities to switch between these options. The basic options would include an equity fund, a bond fund, and a money market fund. It is possible to add two or three additional funds without having a substantial impact on costs, but offering a large range of funds would raise the costs considerably. There would also be limited opportunity to switch funds between accounts, with workers being allowed to switch their allocation no more than once or twice a year.

While these restrictions may sound excessive - some workers may want to be more actively involved in managing their accounts - the purpose of the UVAs is to provide workers with a low-cost option that is not currently available. Workers who want accounts that provide more options and which they can actively manage by frequently shifting their funds are not required to contribute to the UVA system; they can invest their money elsewhere.

Following the design for the system of accounts developed by President Bush's Social Security commission, the money would originally be collected through a state administrative structure, possibly piggybacking on the existing system that manages the retirement system for state employees. Of course, if combining systems in this way proved useful, it would simply mean taking advantage of administrative efficiencies in running the UVAs; there would be absolutely no co-mingling of the funds.

The actual investment of the funds would be contracted out to a private firm that would get the contract on a competitive bid that would cover a long period of time (5-10 years). With an open competitive bid process, and the winner holding a long-term contract, there should be minimal opportunities for political interference in the investment of the funds held by the system. Since the system is likely to accumulate a substantial amount of assets after a reasonable period of time, the cost of investing among a limited set of index funds should be low. (The TSP pays just 1 basis point of assets, or 0.01 percent, to the firm that invests its funds.)

Firms would be obligated to make payments of the money deducted from their workers' paychecks at regular intervals. Workers would receive periodic statements reporting on the size of their accumulations and also informing them of their opportunities to switch between funds. (It would be desirable to have a default investment that includes a mixture of equities, bonds, and money market funds for workers who do not make an investment choice or who do not act to renew their choices after a long period of time.)

The rules on withdrawals would be similar to 401(k) type accounts. Workers would also be free to rollover UVAs into other retirement accounts, such as IRAs, and vice-versa. Loans against UVA accounts can be allowed (keeping with the rules for 401(k) type accounts), but this does add significantly to the administrative cost. If loans are allowed, then the rules should be structured so that the costs of administering the loan are borne by the individual who borrows against her account, not the system as a whole.

When the worker reaches retirement age, the default should be that the fund is converted to an annuity at whatever age the worker chooses to start drawing on it. Workers can opt to take out the money along the same schedule as would apply for other DC accounts, but the purpose of the account is to increase retirement income. This means that the norm should be that workers get most or all of their accumulation as annuity.

Extensions of the UVA System

While the UVA system would substantially increase retirement income for many workers, it would not by itself fill the gap for many workers between the income provided by Social Security and the income needed for a decent retirement. However, there are additional steps, building on the UVA structure, that would get closer to this goal.

At the top of this list would be instituting a system of default contributions by workers under which workers would contribute a specific sum to a retirement account (a company-provided plan or a UVA), unless they specifically requested that they get this money in their paycheck instead. Recent research has shown that workers have a strong tendency towards inertia in dealing with retirement accounts.[7] If the default situation is that they don't contribute, then most workers don't make the effort to sign up for their company's retirement plan. This is true even in cases where the company will provide a match, so that workers are effectively leaving money on the table. Alternatively, if the default situation is that workers make a contribution to their retirement plan, then most workers opt to stick with this default, allowing a percentage of their paycheck to be deducted for their retirement account.

If a state implements a UVA system, then it can also require employers to deduct a modest amount (e.g. 3 percent) from workers' paychecks to be paid into either the UVA system or a company provided pension system. Workers who decided that they wanted this money to be paid to them in their monthly paycheck instead would have the option of opting out of the system by requesting this switch from their employer. Workers would of course also have the option of contributing more than the amount designated as the default, and employers could also opt to make the default contribution themselves on their workers' behalf. A default contribution would raise retirement savings further at a very minimal cost in terms of the additional administrative burden it would impose on employers.

A second step that states could take to increase retirement savings would be to have a modest public contribution that could be designed to help lower-paid workers. This contribution could be made in the form of a tax refund for states that have income taxes, or otherwise simply a check that would be deposited each year in a UVA or other retirement account. The contribution could be a modest sum (e.g. $300) that is phased down to zero for middle income and higher income taxpayers. (A phase out for higher income workers would be more difficult to design in the case of states without income taxes.) In this way, it would be analogous to the Earned Income Tax Credit, except the money would go into a retirement account instead of being paid directly to the worker.

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[7] See Orzag, P., E. Duflo, W. Gale, J. Liebman, and E. Saez, 2005. "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block," Washington, D.C.: Brookings Institution, *Retirement Security Project Policy Brief* #2005-5, [http://www.brookings.edu/scholars/porszag.htm].

This sort of modest payment will not provide a huge retirement benefit, but even a payment of $300 a year can provide an accumulation of $20,000 (adjusted for inflation) after 35 years. This would be sufficient to provide an annuity at age 65 of more than $1,500 annually. This would likely be a substantial increase in retirement income for a worker who may have earned an average of $15,000 annually during their working lifetime.

Of course, any payment directly into the accounts would require revenue, and in many states facing budget crunches, even small amounts of revenue can be hard to find. This is one reason that the UVA system is so attractive. Apart from some minimal start-up expenses (which can be recovered once the system is up and running), the system should be essentially self-financing. The participants will be charged fees that cover all costs related to running the system, so the program should be revenue neutral. Once the UVA system is in place, if budgets allow for funds to be committed for the purpose, then it is always possible at some future date to provide for subsidies to low-income workers.

Another improvement of the UVA system would be to offer a defined-benefit option. This would be a fairly simple matter administratively, although there may be some legal obstacles under current law. Essentially, a defined benefit would allow a worker who contributes a certain amount from their paycheck at a given age to guarantee themselves a retirement annuity of a fixed sum. The administrator of the accounts would effectively be assuming the market risk themselves and offering the worker an average rate of return (minus expenses) over their working lifetime. For example, a worker who contributed a one time sum of $1,000 for a defined-benefit option at age 35 could receive an annuity of $200 (adjusted for inflation) a year beginning at age 65.[8] The annuity would rise to $240 a year if the worker waited until age 67 to begin collecting it.

While a single year's contribution would not secure a very large annuity, a lifetime of contributions could provide a substantial boost to a worker's retirement income. For example, a worker putting aside $1,000 annually for 35 years (as described earlier) would be able to get a retirement annuity of $6,600 a year at age 65 using the same conservative assumptions as in the earlier calculation. If she waited until age 67 to begin collecting, the annuity would rise to almost $8,000 a year.

In the case where a low-income worker received a government subsidy of $300 annually for 35 years, he would be able to get a retirement annuity of almost $2,000 a year at age 65 and almost $2,400 a year at age 67. Again, these are not large sums, but the median income for a household over age 65 is currently just $26,000 and more than a third of older households have an annual income of less than $18,000.[9] Increasing the income of retirees at or below the median by $2,000-$2,400 per year would likely make a substantial difference in their standard of living.

A defined-benefit option in the UVA system works in exactly the same way as defined-benefit pensions do in the private sector. They remove market risk for workers, which will instead be assumed by either financial institutions or the state government. In principle, a large long-lived entity like a state government can assume market risk because it will survive through up and down

[8] This calculation assumes a 4.0 percent real rate of return, minus expenses of 0.3 percentage points annually while the worker is employed. It assumes a post-retirement return of 3.0 percent and a life expectancy at age 65 of 19 years (approximately the life expectancy projected by the Social Security trustees for 2035).

[9] United States Census Bureau, 2006. Annual Demographic Survey, March Supplement, HINC-02 [http://pubdb3.census.gov/macro/032006/hhinc/new02_001.htm].

markets. Individual workers, on the other hand, will only retire once, and if they happen to retire during a down market, they have no options to borrow against a future life. A defined-benefit option will also facilitate planning by workers, since they will know with some confidence the amount of retirement income that they will get with a specific contribution to their accounts.

A final improvement of the UVA system would be its potential extension to other states. Legislators and/or governors in several states have expressed considerable interest in establishing UVA systems in their states. It is likely that if the system is implemented in one or several states and proves effective, then it will quickly spread to other states and possibly be adopted on the national level.

There would be two important advantages from having the system spread to other states. The first is that if the system is adopted in more than one state it could allow for some greater economies of scale. Once a state has adopted a successful model, having worked through problems that will only be apparent with the implementation of the system, other states will be able to immediately design their system along the lines of what proved successful elsewhere. This would be true for the financial intermediaries as well. They will be able to structure their services around an existing model that had already been demonstrated to work. Over time, as more states adopt UVA systems and the design is improved, the administrative cost should decline. Of course if the system is adopted nationally, then the costs would decline even more as the amount of money being managed would increase considerably.

The other advantage of having the UVA program extended to other states, or be adopted nationally, is that it would allow workers to stay within the system if they left the state, but moved into another state that also had a UVA system. Most workers do not typically change states when they change jobs, but it is not uncommon for workers to move across state lines, especially in cases where metropolitan areas overlap state boundaries. If UVA systems can be coordinated so that workers can stay within the system when they cross state lines, this will increase the likelihood that workers will be able to continue contributing to their pensions.

Conclusion

There is wide agreement among policy experts that the country's pension system is seriously inadequate. Close to half of the workforce does not currently have the option to contribute to a pension at their workplace and even most workers with pensions fail to accumulate substantial resources for retirement. This proposal for state-sponsored systems of universal voluntary accounts could substantially increase workers' ability to accumulate funds to support their retirement. The plan gives workers a low-cost and simple saving option, while imposing minimal burdens on employers. For this reason, it is especially appealing to small businesses, since it allows them to offer workers a pension with minimal administrative work and no financial or legal risk.