

Stronger nests, bigger eggs

New public policy options to promote retirement income security

BY GARY BURRIS

Without dramatic changes to our country's private-sector pension and retirement saving system, most workers will not be able to save enough for a comfortable retirement. A significant change is needed to help businesses and workers increase retirement savings.

We all have an interest in having workers approach their retirement years with sufficient savings and investments in place to help secure their independence and self-sufficiency. States should develop programs that build on the systems already in place in state government in order to aid all businesses in starting retirement plans and help workers begin setting aside money for retirement.

Who is – and who isn't – saving for retirement

There were 158 million workers in the U.S. in 2007. Of those, only 52%, or 81.9 million, worked for an employer or union that sponsored a pension or retirement plan. Overall, just 41.5% of workers – 65.6 million people – were covered by those plans.¹

The number one reason workers do not have a pension or retirement plan is that their employer does not offer one. Even workers whose employer offers a plan may not participate because they are ineligible or elect not to participate.

Despite the fact that there are numerous routes available for both employers and employees to set up retirement accounts, most small and medium sized business owners and managers have not set up retirement plans for their workers and most individual workers are not regularly contributing to retirement accounts.

The result is that the majority of workers are not regularly saving for retirement. While some workers may have one or more accounts that were set up at one time or another, most accounts are quite small, and workers are not making regular contributions to them.²

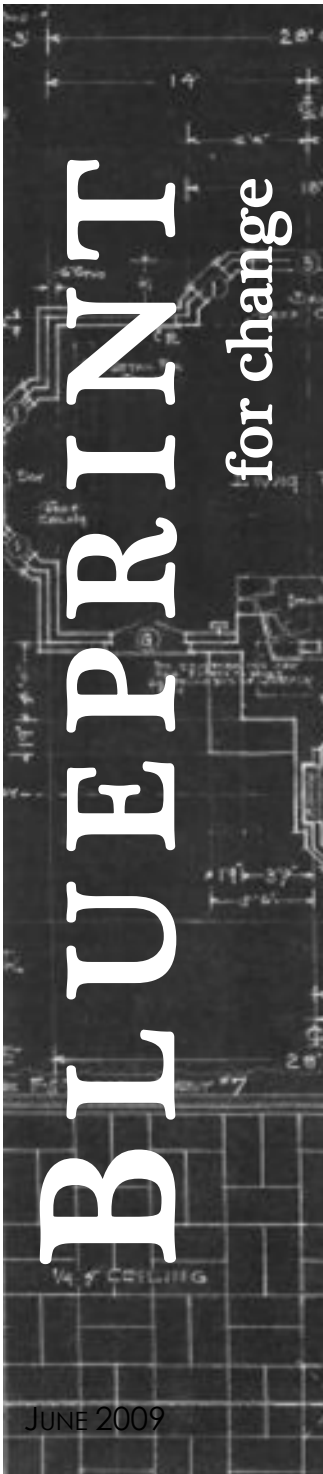
Definitions

Pension or defined benefit plan:

A plan that provides a specific monthly amount typically based on length of employment and salary.

Retirement plan or defined

contribution plan: A plan where employers and/or employees contribute money into an individual account that is invested. The money accumulated from the contributions and growth of the investment is available at the time of retirement.



Some workers are particularly unlikely to have pension or retirement plan coverage. These include:

- Low-income workers – 83% of workers with annual incomes of less than \$20,000 lack pension or retirement plan coverage.
- Part-time and temporary workers – 75% of workers who work part-time or part of the year do not have a pension or retirement plan.
- Small business employees – 80% of workers employed by businesses with fewer than 25 employees do not have a pension or retirement plan.³

New plan choices have not improved coverage

Over the past 30 years, the 401(k), so named for the tax code provision that enables these plans, has become the preferred option for large companies. Other plans were designed to provide low-cost options for small businesses beyond the 401k and traditional defined benefit pensions, including Payroll Deduction Individual Retirement Accounts (IRAs), Simplified Employee Pensions and S.I.M.P.L.E. IRAs.

But instead of extending coverage to a greater share of the workforce, these new “defined contribution” options have simply replaced more efficient “defined benefit” pensions.⁴ The percentage of private sector employees working for employers that offer a pension or retirement plan has remained between 50-60%, ranging from a high-water mark of 59% in 2000, to a low point of 50.7% in 1987 – just below the 2007 rate of 52.7%. Employee participation rates were 39.8% in 1987 and only 42% in 2007.⁵

There are two main reasons why business owners and their employees are not setting up and contributing to retirement accounts:

- The complexity of retirement investment options
- High costs and hidden fees for start-up, administration and participation

The complexity of retirement investment options

For a small- or medium-sized business owner, starting a retirement plan can be daunting. One of the most difficult decisions is choosing a company to administer the plan. There are many different investment companies, banks, and insurance companies, each with products geared towards retirement. According to the Employee Benefit Research Institute, which has conducted a survey of small business owners examining retirement plan sponsorship, researching which plan to offer and selecting a company to administer it costs employers a great deal of time.⁶ Small employers who are working long hours trying to make their small company successful are quickly overwhelmed by the choices.

Workers face similarly difficult decisions about where to invest contributions toward their retirement savings. If the employer does have a plan available, individual workers often overinvest in a specific type of fund and infrequently rebalance their portfolio. Research on the frequency of these two fundamental

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errors suggests individual investors often have difficulty making sound investment decisions.

In theory, workers without employer-provided plans could invest in Individual Retirement Accounts (IRAs), U.S. Treasury bonds, or insurance products. In reality, the complexity of these choices makes it difficult for most people, who do not have a strong understanding of saving and investing alternatives, to identify poor options and to determine which options best fit their needs. Overwhelmed with the number of choices and the complexity of financial markets and investment vehicles, and justifiably skeptical of the financial services industry given recent events, most people do not set aside money for retirement.

Congress recognized the difficulty smaller employers have in establishing retirement plans and developed an easier alternative for small business. The SIMPLE Individual Retirement Account was designed to make it easier for small employers to start a plan at their place of employment. When an employer establishes this plan their employees can contribute to their own individual account. Employers are able to choose to either match dollar-for-dollar, up to 3% of an employee's compensation or provide a contribution of 2% of compensation to each employee, whether they participate or not. Currently, up to \$10,500 per year may be contributed per employee. This type of account is open to businesses with less than 100 employees and has streamlined reporting requirements.

Unfortunately, very few businesses are taking advantage of this option. Only 8% of workers in firms with less than 100 employees participated in a retirement plan in 2005.⁷ One reason may be that while a SIMPLE IRA does reduce or eliminate some of the paperwork and requirements for administering a plan, it does not eliminate a key decision: whether to give employees a choice of companies to manage their investment, or have the business select a company to manage all accounts. In either case, someone is faced with selecting from numerous options, which tends to lead toward inaction.

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High costs and fees for start-up, administration and participation

The costs associated with retirement plans, including start-up, operations, administrative fees, and participant fees, is a second reason more business owners and workers are not setting up retirement accounts. For businesses with fewer than 100 employees, a 401(k)s is typically too expensive to operate. A 401(k) is a type of deferred compensation program that allows an employee to contribute a portion of their salary to a retirement account before paying taxes on their salary. An employer may make a contribution, match the employee's contribution or both. This type of plan has many provisions including a plan document and requires fiduciary decisions by the plan sponsor. The cost per employee is much higher for small businesses than large corporations, due to the fixed costs of these plans and the lack of economies of scale that larger workforces enjoy.

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are concerned with costs associated with starting a plan, including the time required to research which plan to offer and selecting a company to administer the plan which limits efforts to set up retirement plans.⁸ And there are other costs associated with starting and running a retirement plan. Contributions are a requirement of certain types of plans that some employers want to avoid. Fees have been a major concern and topic of recent discussion. Many fees are hidden – difficult for even experts to identify – so much so that the US Congress held a hearing on that very problem in 2007.⁹ Another concern facing small business owners and individuals are high fees typically charged to manage small accounts. Charges for transactions and for account maintenance can eat up most or all earnings and can even cut into the principal invested.

Overcoming barriers to retirement savings

The first barrier noted above – complexity – can be overcome by designing a program to support employers and workers that are new to investing for retirement. Employers need a plan that is very easy to start up, and beginning investors need a few basic, distinct, and easy to understand investment options – preferably combined with automatic payroll deduction. Such a program would dramatically increase the number of workers saving for retirement.

The second barrier – high and hidden fees and costs – can be addressed by creating a retirement investment program that offers low-fees, clearly and honestly declared. Overall costs can be minimized through structural features such as simple start-up process, automatic enrollment, and payroll deduction. Limited investment choices that reduce plan changes and resulting transaction costs have the added benefit of reducing complexity.

A state initiative to promote retirement income security

State government has an interest in supporting citizens saving for retirement; what's more, the infrastructure to make retirement investment much simpler for small and medium sized businesses and for employees is already in place, via the experience of running public retirement systems and existing mechanisms used to invest millions of public sector pension dollars.

A “Universal Voluntary Retirement Account” (UVRA) program can promote future retirees’ economic security by enabling all workers, including and especially low- and moderate- income workers or workers employed by small businesses, to save for retirement at their workplace.

Such a system would need to be separate from those for public employees, but they could operate in parallel, using similar criteria and management mechanisms. The accounts could be created through a new system within state government, or by contracting out to the private sector. In either case, the program can be designed to meet the needs of employers and workers in a specific state.

One possible design is a defined contribution plan with a pre-selected menu of investment options, tax-deferred payroll deductions, and retirement account portability between jobs. A two-tier system might have:

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1. Workplace based individual retirement accounts open to all workers; and
2. A deferred compensation 401 (k) or SIMPLE IRA-type program open to all employers who choose to participate for their employees.

There are several key components from which an UVRA program can be built. For each state the type of investment vehicles, the state role, and the features of the program may differ substantially. Possible features include: automatic enrollment, default investments, payroll deduction, pre-tax contributions, job portability, and low fees.

In Washington State, the legislature funded the design of an UVRA program called Washington Voluntary Accounts. If enacted, it will enable all workers to put aside pre-tax dollars through payroll deductions into an investment portfolio vetted by the state.

Washington Voluntary Accounts will be completely voluntary for workers and portable between different places of employment within the state. The program will also enable small business owners who lack the resources to research and establish their own retirement savings plans to provide a retirement plan for their workers – with all the economies of scale that large corporations currently enjoy. The result will be the creation of substantial assets to supplement future income, enabling workers to live with financial independence after retirement.

UVRA design considerations

Limited choice and default investment

Plan design is the key to providing easy to understand options for the average worker, as people can be easily overwhelmed with the complexity of investment options.¹⁰ In fact, research shows too much choice lowers workers enrollment in plans.¹¹ A universal retirement account should provide a few basic options from which to choose, in conjunction with basic financial education, in order to help new investors better allocate their retirement contributions.

Each worker should be presented with a default investment – that is, an automatic decision about where a worker's contribution goes in the case the worker makes no decision, with the option to modify that selection anytime in the future.

Such a default could be set up in several ways. One would be a more conservative or very safe approach, in which the automatic choice is a fund that is designed to at least keep up with inflation and perhaps return small additional amount. These are sometimes referred to as "principal preservation accounts." Contributions are invested in high rated bonds, money market accounts and other stable investments.

A second approach might be what are often called "life cycle" funds, in which workers choose a fund based on their target retirement date. For example, a worker who is 38 years old in 2008, and plans to retire at age 70 in 2040, would choose a life cycle fund for that target year. It would utilize a mix of investments that varies over time. In the near term the fund leans toward riskier investments

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that offer the opportunity for larger returns. As the worker ages, the fund automatically changes the mix of investments to preserve capital and eventually generate regular income after retirement.

Automatic enrollment

The most important benefit of automatic enrollment is that it gets workers started investing. When people start putting money into their retirement accounts, they tend to continue to invest. People who don't start now or when starting a new job, most often don't begin investing. If state voluntary retirement accounts allow or encourage automatic enrollment, participation and savings rates will rise and the program will better achieve its goals.¹²

Officials in private companies began using automatic enrollment in 1984 as a way to increase participation,¹³ and it has dramatically increased the number of employees that participate in their company's retirement plan.¹⁴ The Pension Protection Act provides additional support for employers to use this strategy to get employees started with saving and investing for retirement. Since its passage in 2006, the use of automatic enrollment has increased dramatically.

Vanguard reports that in August of 2008, more than 300 plans they administered in 2007 had automatic enrollment. This is triple the number from 2005.¹⁵

Payroll deduction

Deducting funds electronically from a worker's paycheck provides several benefits. First, workers are less likely to feel a loss of income when the money does not come into their personal accounts and then back out, and so are more likely to participate. Second, employers for the most part already have electronic systems in place to directly deposit paychecks and pay various taxes. Adding an electronic payment by the worker for a retirement plan can happen at minimal cost to the employer. Third, it reduces the cost of administering the program by relying on an electronic rather than a labor-intensive paper process.

Pre-tax contributions

UVRAs offer several tax benefits for workers. First, workers are able to put their earning into retirement savings prior to it being taxed, lowering their tax bill. Second, the money that would have been paid in taxes is put to work growing the nation's economy through investment.

Setting money aside for retirement prior to paying taxes has major benefits over time. The money that would have been paid in taxes is instead earning returns in an investment. In retirement, most people's income requirements are much lower, so when withdrawals are made, they are taxed at a lower level than they would otherwise have been.

Portability

Today's worker is expected to hold an average of more than 10 jobs during their lifetime.¹⁶ A mobile workforce needs to be able to continue to invest in retirement savings from job to job. The Universal Voluntary Retirement Account is designed to be able to follow the worker when he/she changes jobs.

UVRA ADVANTAGES
INCLUDE: AUTOMATIC
ENROLLMENT, PAYROLL
DEDUCTION, PRE-TAX
CONTRIBUTIONS, JOB
PORTABILITY AND LOW
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Low account fees

The fees that are charged on defined contribution plans are of profound concern; congressional committees have recently held hearings on hidden fees in 401 (k)s, in which fees may average as much as 2-3% or more. State government officials will be able to use the economies of scale realized from many investors to negotiate low fees.

Summary

Americans have less retirement wealth than their parents' generation. Federal and state governments will face a crisis of senior poverty in coming decades unless the Congress and states act to promote retirement savings.

Universal Voluntary Retirement Accounts provide a simple, easy solution to the retirement savings dilemma facing today's workers. The program offers a convenient way for individuals to save for retirement and enables small businesses to remain competitive by offering a retirement savings program for their employees. UVRAs can provide IRAs for any individual worker who chooses and small employer plans for businesses that wish to offer that option to their employees.

UVRAs are modeled after successful deferred compensation plans currently available to state employees. Administrative systems are in place in state retirement systems. This proposal offers a convenient, simple solution to help provide long-term financial security for retirees.

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