

# **Entitlement Reform and the Future of Pensions**

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### Abstract

Reform of retirement and health care entitlements is inevitable, but its ultimate format remains uncertain. Any entitlement reform should take advantage of the additional resources provided by economic growth and the rise in demand for and supply of older workers. Recognizing the potential from those two forces argues for constructing reforms aimed largely at three goals: better orientation of public-sector retirement resources to needier and older populations; removal of obstacles to increased employment of older workers; and private-pension reform that provides the long-sought second tier of support in older ages.

Keywords: Federal budget, entitlements, pension reform, Social Security, Medicare, health care, health cost growth

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## Entitlement Reform and the Future of Pensions

The United States retirement system is in a state of flux. Large public health programs, notably Medicare and Medicaid, are a cornerstone of American retirement. Unfortunately, these programs are on an unsustainable path due to the aging of the population and prolonged growth in costs for both the federal government and retirees themselves. Social Security's future solvency, while less of a budgetary challenge than the major health programs, is also in doubt, with adjustments to either revenue or benefits required to bring the program into long-term balance. At the same time, the decades-long transformation of the private, employer-based retirement system is nearly complete, with most private savers working to accumulate liquid assets for retirement rather than credit towards a lifetime pension.

All three systems affecting the elderly—health, Social Security, and employer-based retirement plans—have not been reformed substantially in decades. Indeed they have adapted too slowly to fundamental changes in the broader demographic and fiscal landscape. Close to one-third of all adults are scheduled to be on Social Security for one-third of their adult lives, and only a modest percentage of households has private assets at time of retirement near the value of their government health and retirement benefits. As a result, all of the growth in government spending over the next two decades is scheduled to go for Social Security, Medicare, and Medicaid and interest on the debt.

To be clear, we believe there are viable and feasible reform options, but agreeing on them requires shifts in both policy priorities and federal law. To this end, we offer a series of policy suggestions which could result in an environment that would better protect the most vulnerable retirees and minimize adverse effects on the middle class and the economy as a whole.

## **Budget Pressures and Entitlement Reform**

The federal budget continues to be plagued by long-term pressures. The combination of growing and unprecedented spending on major entitlement programs, porous income and corporate tax codes riddled with tax subsidies, the absence of interest in any new major source of revenues (such as an energy tax or a national value-added tax), rising expected interest payments, the long, slow recovery from the Great Recession, and limited ability to further cut non-entitlement spending all point to a situation that requires entitlement reform, as at least part of any long-term solution.

One metric of budget pressures is the federal debt as a share of the gross domestic product (GDP). Federal debt has risen from 28 percent of GDP in 1970 to 72 percent of GDP today, with a steep rise between 2007 and 2012, when the tax base shrank and federal expenditures rose in an effort to reverse the economic recession.<sup>1</sup> Looking forward, the outlook is bleak without a reversal in policy: the Congressional Budget Office (CBO) predicts that federal debt to GDP will steadily rise to 100 percent by 2038 (CBO 2013c).

Economists have been unable to identify a precise threshold at which the debt-to-GDP ratio begins to cause severe economic harm, but evidence suggests that the United States will not be able to maintain the level predicted by CBO without suffering some adverse economic consequences. Reinhart and Rogoff (2010) note that nations can expect significant economic harm once their debt-to-GDP ratios exceed 90 percent. Other work suggests that Reinhart and Rogoff's calculations were mistaken (Herndon, Ash, and Pollin 2013), and that sluggish economic growth causes high debt, not the other way around (Dube 2013). Nevertheless, while the exact empirical relationship between growth and debt is not well established, several studies have noted other

adverse economic effects from debt such as higher interest rates, interest costs even if rates remain steady, and reduced private saving (Elmendorf and Mankiw 1999; Gale and Orszag 2004).

The squeeze on other government functions is among the reasons that health and retirement programs are at the forefront of long-term deficit reduction focus. Major health programs and Social Security increasingly dominate the federal budget and national spending, with their spending as a share of GDP rising to 8 percent and 6.2 percent by 2038, respectively, leaving little room for other initiatives such as transportation, education, and infrastructure investment. Even defense spending, which received a massive share of the federal budget for the first decades after World War II, is expected to comprise just 12 percent of federal spending in 2024. Meanwhile, interest spending, perhaps the one ‘non-negotiable’ aspect of the federal budget, is expected to skyrocket from 6.4 percent of federal spending in 2012 to 14.7 percent in 2024.

Recent legislation has modestly improved the short-run budget outlook but achieved deficit reduction largely through increased tax rates on upper-income taxpayers and steep cuts to discretionary spending. The Budget Control Act of 2011 (BCA) instituted \$2.2 trillion in deficit reduction between 2012 and 2021, mostly by means of caps on discretionary spending and automatic cuts in spending (mainly discretionary) through ‘sequestration’.<sup>2</sup> A little over a year later, Congress passed the American Taxpayer Relief Act (ATRA), which forestalled the bulk of a very large scheduled increase in taxes during recovery from the recession by extending most expiring tax cuts for all but the highest-income taxpayers, although it also removed \$620 billion from the deficit when measured relative to ongoing policy.<sup>3</sup> The end result of these two bills was a modest improvement in the short-run budget outlook achieved through higher tax taxes on upper-income taxpayers and cuts in discretionary spending. The low-hanging fruit has now been plucked, but the long-term pressures remain.

Asking the middle class for higher tax burdens or cuts in entitlements has proved to be a tough sell by Congress to the American public; there seems to be mixed public appetite, at best, for either strategy. On taxes, an American Enterprise Institute 2010 survey conducted prior to the increased tax rates on upper-income taxpayers, found that Americans were split on whether it was more important to reduce the deficit (47 percent) or cut taxes (46 percent) (Bowman and Rugg 2012). A Washington Post survey of around the same time was less ambiguous, reporting that 60 percent of Americans supported higher taxes on households with more than \$250,000 in income as a deficit-reduction strategy (Teixeira 2012).

Americans appear more unified in their distaste for cuts to Social Security and Medicare. For example, one study found that only 13 percent of Americans favored cutting Social Security as a way to reduce the federal deficit, and 72 percent strongly opposed Social Security cuts as a deficit-reduction strategy (AARP 2010); another study found that 75 percent of Americans indicated that ‘we should consider increasing Social Security benefits’ (Tucker et al. 2013). Lastly, it is unclear whether the American public is convinced that deficit reduction is even a top priority, with 69 percent of respondents to a 2013 Pew Research poll answering that maintaining Social Security and Medicare benefits trumped deficit reduction as a national priority (Pew Research Center 2013). Of course, for many of those polled, cuts in Medicare and Social Security might affect them or their family, whereas tax increases on higher-income taxpayers would be borne by someone else.

### **The Inevitability of Entitlement Reform**

In spite of polls indicating limited public support for any cost-bearing by the middle class, solutions to the long-term fiscal imbalance will almost certainly include reform to the entitlement

programs from which they benefit. Other solutions are generally insufficient to fix the problem in isolation. For example, Urban-Brookings Tax Policy Center researchers estimated that in order to reduce annual fiscal deficits to 2 percent of GDP through upper-income tax increases alone would require raising the top two statutory tax rates to over 50 percent (Altshuler, Lim, and Williams 2010). Cuts to non-entitlement programs have already been a major part of short-term deficit reduction, with sequestration-led cuts and supposed lack of any new major appropriation driving down discretionary spending to just 5.2 percent of GDP by 2024. Lastly, while the growth in economy-wide health costs is an important contributor to the rising debt-to-GDP ratio, the debt is still projected to rise to 112 percent of GDP if excess cost growth—the growth rate of per-capita health spending in excess of GDP growth—falls to zero (Auerbach, Gale, and Harris 2014). In short, while taxes, non-entitlement spending, and health costs play an important role in projected deficits, reaching long-term fiscal balance is a nearly impossible goal without also addressing entitlement spending.

Part of the challenge with cutting entitlement spending is that these programs are tied closely to the aging of the population. The United States is expected to undergo an unprecedented surge in old-age citizens over the next four decades: by 2050 one-fifth of Americans will be age 65 or older, compared to just 12 percent in 1950 (CBO 2013*c*). In addition, the share of Americans age 85 or older will rise to 4 percent by 2050—a ten-fold increase since 1950 (CBO 2013*b*). Population aging is the largest factor in explaining the growth in Social Security, Medicare, and Medicaid, accounting for over half (54 percent) of the growth in these programs between 2013 and 2038 (CBO 2013*c*).

Indeed, the United States has already seen a pronounced increase in health spending: inflation-adjusted health spending increased by nearly 400 percent between 1980 and 2011—from

roughly \$400 billion in 1980 (in \$2011) to \$2.7 trillion in 2011 (Council of Economic Advisors 2013). Most of this increase can be attributed to factors other than aging of the population and population growth. This rise in health spending, projected to continue into the future, has translated into rapidly rising public health expenditures. Excess cost growth accounts for 28 percent of the growth and the expansion of Medicaid and the exchange subsidies—subsidies for low- and middle-income households who purchase health insurance through health care exchanges—accounts for 19 percent of the growth. While recent data have provided some cause for optimism, Steuerle (2013) shows that a slow-down in cost growth in excess of the rate of growth of GDP does not necessarily mean a slow-down in the percent of the growth in income being absorbed by health care alone.<sup>4</sup> For example, if health care grew to 30 percent of GDP and then stabilized at that level, there would be no ‘excess cost growth’ but health care would still absorb 30 percent of all income growth.

We caution against the notion, however, that slowing the rate of entitlement spending growth is the only mechanism for achieving fiscal balance. While we have little hope that discretionary spending cuts can meet their currently scheduled target for decline, reform could also include adjustments to tax revenue, by either raising tax rates or limiting tax expenditures.<sup>5</sup> CBO projections show federal revenues as a share of GDP at 18.4 percent, well below the levels experienced in the late 1990s and just a notch above the average level from 1950 to today.

### **Structural Transformation of the Private Retirement System and its Consequences**

The private pension system, which is also a key pillar in the American retirement system, similarly faces an uncertain future. In 2013, retirement assets totaled \$21.9 trillion—amounting to more than one-third of all household financial assets (ICI 2013). That includes \$2.9 trillion held in

private sector defined benefit (DB) plans, \$5.6 trillion held in defined contribution (DC) plans, and \$6.2 trillion held in Individual Retirement Accounts (IRAs). In 2000, when total assets held for retirement equaled only \$11.6 trillion, comparable figures were \$2 trillion in DB plans, \$2.9 trillion in DC plans, and \$2.6 trillion in IRAs.

This phenomenal growth in assets held in DC plans and IRAs (which largely represent assets rolled-over from DC plans) reflects a fundamental shift in the private pension system. Beginning roughly in the mid-1980s, private sector employers began terminating their DB plans. From a high point of over 175,000 plans in 1983, only some 45,000 plans remained by 2011 (Department of Labor 2013). Over 80 percent of those plans were small plans, covering fewer than 100 participants. Large plans with more than 1,000 participants, however, account for most private sector DB plan participants. The Pension Benefit Guaranty Corporation (PBGC), which insures most but not all private sector DB plans, reported that in 2011, there were over 33 million insured participants (representing 90 percent of all participants), but fewer than 40 percent of those were active workers in 2010. The remaining 60 percent of workers had either retired or changed jobs. The PBGC reported that the percentage of private sector wage and salary workers covered by insured DB plans fell from a high of over 30 percent in 1980 to a current low of 14 percent in 2010 (PBGC 2012).

Beginning in 1992, 401(k)-type plans became the engine driving the growth in retirement plan assets. By 2011, the number of these plans more than tripled to over 500,000, and the number of participants eligible to contribute also tripled to 66 million workers (Department of Labor 2013).<sup>6</sup> These plans are more attractive to employers than DB plans due to their limited long-term financial commitment, reduced regulatory and fiduciary burden, and lower costs of plan

sponsorship. The net benefits to employees are less clear cut, with employees taking on significant saving and near-total investment responsibility in exchange for greater control over their accounts.

The 401(k)-type plan system is still maturing, although it is some 30 years old. The ability of some participants, especially those who save consistently, to accumulate significant retirement savings indicates that the 401(k) system has the potential to evolve into a robust second tier in the American retirement system. To date, however, benefits of 401(k) plans have accrued primarily to older, longer-tenured, higher-paid employees at large companies. Recent policy changes to the DC model, such as offering automatic enrollment, automatic escalation in contributions, less complex investment menus, less expensive investment options, and more financial education may make the 401(k) plan a more efficient engine of retirement savings over time. Nevertheless, this will mainly help those employees who have a plan at work, save, invest well, and do not withdraw early.

Critics of the current system point to its all too evident present inadequacies, notably its failure to provide all employees with a plan and failure to generate for many employees adequate savings for retirement (Munnell, Fraenkel, and Hurwitz 2012). They also point out that the current tax treatment of retirement accounts, the second largest tax expenditure after health care, is expensive and inequitable. (Tax expenditures operate like government spending for designated purposes but through targeted tax breaks.) In 2013, the tax expenditure for pension contributions and earnings was \$137 billion, representing 0.9 percent of GDP. Moreover, 66 percent of the benefits of this exclusion accrued to the top 20 percent in income, while only 2 percent and 5 percent, respectively, accrue to those in the 10–20 percent and 20–40 percent income groups (CBO 2013a). The saver's credit, in contrast, is designed to assist low- and middle-income savers but it is small compared to other incentives, costing just \$1.2 billion in 2014 (Office of Management and Budget 2014).

Retirement assets represent the largest financial asset of most households. Retirement accounts represented 38 percent of assets, the single largest financial asset held by households in 2010, up from 29 percent in 2001. But only a slight majority of households owns such an asset, and the share fell in the wake of the Great Recession. Between 2007 and 2010, ownership of such accounts decreased, with steeper declines for middle-income, middle-aged households; by contrast, balances for upper-income households increased (Bricker et al. 2012).

The dispersion in retirement account balances is reflected in the sources of income for retirement-age Americans. Today, Social Security is the dominant income source for elderly Americans in the bottom half of the income distribution. In 2013, for Americans 65 and older, Social Security payments comprised 85 percent of income for those in the bottom income quartile and 83.5 percent of income for those in the second income quartile. Other income sources were relatively insignificant. Those in the bottom income quartile received 6.6 percent of income from SSI and public assistance, while those in the second income quartile received 6.2 percent of income from pensions (Poterba 2014). Income from earnings and assets were very low for each of these income groups.

In sharp contrast, elderly Americans in the top half of the income distribution received substantial income from accumulated saving. The third income quartile still depended on Social Security payments—making up 56.5 percent of income—but also received nearly 30 percent of income from pension and asset income. Those in the top income quartile depended even more on income from accumulated saving, with 35.6 percent of income coming from pension and asset income (Poterba 2014). On average, those in top half of the income distribution depend on income from saving—both within and outside of retirement accounts—for retirement security, while those in the bottom half of the income distribution do not.

## **Trends in Labor Force Participation**

When it comes to discussions of reform of either private or public retirement systems, there is a tendency among the mathematically trained—economists, actuaries, and accountants, along with pension, finance, and business professionals—to stress the financial side of the issue. Yet many of the problems that affect both systems relate largely to labor market trends. Today, workers enjoy retirement for close to one-third of their adult lives, Social Security benefits are received on average eleven years longer than when benefits were first paid in 1940, and private retirement assets must similarly last much longer. Meanwhile, the combination of additional years in retirement and the decline in the birth rate means that close to one-third of adults are expected to be on Social Security soon. A related concern is that the employment rate among all adults has been declining recently (even independent of the Great Recession), and it is scheduled to continue to decline with the aging of Baby Boomers.

Retiring so many people for so long is simply not viable, which is a problem plaguing developed countries around the world. This labor market issue is not going to be solved by financial manipulations. To provide income in retirement at the same relative level as before retirement, roughly speaking, people would need to save around one-third of their incomes each year. Alternatively, it would require a Social Security tax rate of about 33 percent if government were required by itself to provide that level of income support.<sup>7</sup>

On the positive side, labor force participation trends suggest that longer work lives are becoming more common in the United States, so some adjustment is already starting to occur. For most of the second half of the 20th century, the average age at retirement among men declined substantially. In 1950, about 70 percent of men age 55 and older were in the labor force, but only

about 40 percent were still working by the mid-1990s. Labor force participation by women exhibited very different patterns during the same period as they expanded their presence in the labor force. The participation rate of women aged 24–54 essentially doubled between 1950 and 2000, while that of similarly aged men declined slightly. For both older men and women, however, the mid-1990s began a period of pronounced uptick in labor force participation. Increases for men largely occurred among men in their 60s, while women of all age groups increased their labor force participation (National Academy of Sciences 2012).

Projections of labor force participation through 2050 anticipate that the role of older workers will increase substantially, as the supply of young (age 16–24) and prime age (age 25–54) declines. Older workers are expected to offset some of this decline, and one projection shows their labor force participation increasing from about 12 percent in 1990 to 24 percent around 2020 and then continuing to grow to more than 27 percent by 2050 (National Academy of Sciences 2012). Steuerle and Quakenbush (2012) have argued that this figure may be low, drawing on historical Social Security projections that have consistently underestimated future labor force participation among older workers. The projection error derives from ignoring labor demand for older workers in the face of a reduced opportunity for employers to hire younger workers.

Demand, however, can play an uneven role. Age discrimination in employment is one key variable. The Age Discrimination in Employment Act, enacted almost 50 years ago, is designed to protect workers over age 40 from workplace discrimination, but subsequent court decisions have made it difficult for plaintiffs to pursue litigation successfully. The United States Equal Employment Opportunity Commission reports an increasing case load of age discrimination claims, yet some two-thirds of claims are denied at the agency level (EEOC 2013).

The jobless rate for workers age 55 and over reached record highs in the Great Recession. Unemployment seems to be a larger issue here than continuation of employment. Although the rate of unemployment for older workers is below that of younger workers, older workers who became unemployed spent more time looking for work. Almost half remained jobless for 27 weeks or longer, compared to close to 30 percent of workers age 16–24, and over 40 percent of workers between age 25–54 (BLS 2010).

One focus of research on the labor demand side has been on the service industry, which comprises about one-third of the United States employment base. Between 1980 and 2010, employment among workers age 65–74 increased by 40 percent, with 30 percentage points of that growth attributable to the service industry alone (Maestas et al. 2013). Specifically, a one-percentage point gain in labor demand in the service industry in this age group led to a one percent increase in staying on the job, about a seven percent increase in returning to the labor force, and a three percent decrease in retirement. There is also evidence of a four percent increase in wages for workers staying on the job and an 11 percent increase for those returning to the labor force, along with reduction in claiming Social Security benefits of 14 percent at age 62, seven percent at age 63, and 11 percent at 64. In other words, employer demand for older workers in an industry that offers less physically demanding work, flexible hours, and greater interaction with people leads to increased work and longer labor force participation.

In terms of older workers' labor supply, recent research indicates that education and health status are key variables. While older workers at all educational levels increased their labor force participation between 2000 and 2010, workers with at least a college education were much more likely to continue to work. Less-educated workers responded less, perhaps because their jobs

lacked appeal, perhaps because of a higher Social Security replacement rate, and perhaps because of a higher probability of chronic health issues or more physically taxing work (Johnson 2013).

Psychological as well as economic factors seem to have been influential in promoting longer work. Discussions about what is or should be the ‘full retirement age’ in the media and in communications from the Social Security Administration have raised the profile of this issue. The public is becoming increasingly aware of the advantages of working longer and delaying receipt of Social Security benefits for greater financial security in retirement (Butrica, Smith, and Steuerle 2006; Song and Manchester 2007; Steuerle and Cushing-Daniels 2010).

### **Steps to a More Secure Retirement**

Fortunately, the United States confronts its future in a relatively strong position. The nation remains rich, with a GDP of more than \$140,000 per household, and government spending and tax subsidies (at all levels) of \$55,000 per household (Steuerle 2014). Those numbers are expected to continue to grow over time, doubling perhaps in three or four decades, even assuming a below-average rate of growth. To take better advantage of our options, we can therefore exploit the additional resources made possible by economic growth, and the increased demand for older workers. Three major types of policy changes deserve serious consideration. First, the growth in public old-age benefits over time can be targeted to the most vulnerable elderly, particularly those in the bottom third or half of the lifetime income distribution. Second, public pension reforms can encourage longer work lives and orientation of benefits to the oldest ages. Third, private pension reform can also recognize increased longevity and demand for older workers while simultaneously making workplace saving more automatic and accessible for workers, particularly at small- and medium-sized firms.

**Increasing Social Security's progressivity and limiting the rate of benefit growth for those with greater means.** Social Security's progressive rate schedule reveals that it is intended to provide more to those in greater need. Yet some research has shown that benefits are not as progressive as one might think; indeed, excluding disability insurance, it is not clear that the system as a whole is progressive at all, given that annuitization favors those in better health, and other regressive factors, such as the design of spousal and survivor insurance (Steuerle, Carasso, and Cohen 2004; Brown, Coronado, and Fullerton 2006; Steuerle, Smith, and Quakenbush 2013). Nevertheless, it would be quite easy to design a minimum benefit or similar feature that could insure that those with lower lifetime incomes, say, the bottom two quintiles, would receive a higher level of lifetime and annual benefits than they receive now.<sup>8</sup> This can be achieved in a Social Security system with benefits either larger or smaller than the ones currently scheduled. The key reform would orient some of the future growth in Social Security benefits towards those with lower lifetime incomes.

Whatever benefit cuts or tax increases are enacted to restore some long-term actuarial balance, almost inevitably they will be paid for by those with the most means. Without recommending any particular proposal, it is worth noting that such reductions in benefits (or increases in taxes) have side effects that need to be taken into account. For instance, if a slower rate of benefit growth were extended downward to those near the middle of the income distribution, and minimum benefit changes did not extend upward to them, then private pension reform becomes even more imperative. Also, if lifetime benefit growth rates are slowed through annual benefit cuts in all ages (e.g., an increase in what is called the 'normal retirement age' in Social Security), the incentives for work likely will be lower than such changes as an increase in the early

retirement age or the reallocation of lifetime benefits more toward later years. Put another way, that share of benefit cuts in very old age may do little for labor force participation.

**Encouraging longer work and shorter retirement.** Employment patterns are significantly influenced by aging, but aging itself is a bit of a misnomer, since it is composed of two very different forces. Living longer does not by itself put additional pressure on government programs or private retirement; typically it only does so if those additional years of life, largely due to better health, are accompanied by an increase in years of government-supported retirement and no corresponding increase in labor. A decline in the birth rate, however, does mean an increase in the percentage of the population eventually moving into more dependent older years. Its influence on current employment rates remained hidden until Baby Boomers started attaining their 60s.

Government (and private pension) policy oriented toward need would tackle the increase in the percentage of the population who will be in, say, the last 10 years of life when ability to work decreases and health limitations rise. That does not mean that such policy needs to keep extending benefits for more and more years as people live longer. Indeed, if old age is defined by something like being in the last 10 years of life on an expected basis, then Social Security has moved over the years to being more and more a middle-age retirement system, one that provides ever smaller shares of benefits over time to true old age.

Given trends outlined in this paper, three changes in the design of public retirement programs deserve strong consideration. First, the earliest retirement age could increase, while years of support on average could be capped at current levels or even decreased. It is possible to protect vulnerable populations with minimum benefits and disability programs, without providing so many years of support to middle- and upper-income and healthy families. The perverse nature of today's unreformed system becomes apparent when upper income people receive, for example,

five more years of additional Social Security support at \$30,000 a year (or the actuarial equivalent if they work longer) to provide five or fewer years of additional support at \$10,000 to those with low incomes.

To the extent these changes lead to higher labor output, the economic benefits extend far beyond Social Security: higher GDP, higher personal income, and higher tax revenues. It is the one reform that allows for both higher benefits and lower tax rates, all other things being the same. For example, an increase in the early retirement age generally increases Social Security taxes and benefits in tandem because of the actuarial adjustments, but it simultaneously increases personal income, along with income and Medicare taxes.

Yet another way to increase labor output is to backload benefits in Social Security, providing a lower up-front benefit for most in exchange for higher benefits payable at older ages. For instance, a lower benefit could be provided until average years of remaining life expectancy approach about 10, and then the benefit could rise thereafter. This could be done without reducing benefits, on average, for those in lower income classes, through higher minimum benefits and similar adjustments discussed above. In addition to beneficial effects on personal income and non-Social Security taxes, back loading also converts Social Security into a system that provides most protection when needed, in the later years of life, not late middle age.

Signals from public benefit plans also matter for private behavior, even when there are few or no changes in net economic incentives. Here, we have referred to the early 60s as late middle age, at least as measured by average life expectancy. Evidence is mounting that Social Security communications telling people they are ‘old’ and entitled to support at age 62, or that ‘normal’ retirement is at age 66 today, have a significant influence on retirement decisions beyond any change in net economic incentives (Cushing-Daniels and Steuerle 2010). Refining those signals

can have enormous influence on behavior, not just on near-retirees but on financial planners and employers who often follow those signals in designing, offering, and planning private retirement options.

**Expanding the private pension system.** Assuming, as is likely, that the 401(k)-type plan will continue to be the dominant plan type for the foreseeable future, its expansion calls for three elements: (1) access to a plan at work for more workers; (2) an improved rate of contributions and return on investments; and (3) mechanisms to secure income in retirement years. Few would argue with the merits of such changes, but it is important to recognize that their success would entail substantial revenue cost to the government. While such costs are unlikely in the current environment of deficit cutting, we believe they can easily be accommodated in the broader context of Social Security reform because at that point the government is already going to be reallocating trillions of dollars of benefits and taxes for very long periods of time. Traditionally, Social Security reform tries to achieve balance for at least for the 75 years.

Access to a retirement plan at work has long been recognized as the single most important element in improving the private pension system, yet many workers, particularly those who need retirement savings the most, remain outside the system. Legal reforms now offer employers tax credits for sponsoring a plan, special plans with little or no discrimination tests like the auto-enrollment safe harbor 401(k) plan, and reduced fiduciary liability through participant investment discretion and the use of QDIAs as investment options. Yet there has been no appreciable increase in the percentage of employers, particularly small to mid-size employers, willing to offer plans. Small- and medium-size employer reluctance to do so is understandable because of the costs associated with complexity (partly due to all the choices available), dealings with accountants and planners, and potential fiduciary responsibilities.

One clear obstacle to expanding pension coverage is the voluntary nature of the United States pension system. Imposing a mandate on employers to sponsor a plan, proposed on and off for the last 50 years or so, may not be a realistic policy option in today's political climate. Imposing a soft mandate in the form of a 'play or pay' requirement in the spirit of the Affordable Care Act's employer mandate also seems politically infeasible. But it may be feasible to attract small and mid-size employers to a simple plan that expands participation by lower-paid workers. For example, in exchange for a range of benefits, the proposed 'Super Simple' 401(k) plan requires participating employers to provide a minimum contribution and include all employees through auto-enrollment at a moderate contribution rate. With an additional savers credit contribution from the government, lower-paid employees could receive total annual contributions of, say, eight percent of income, a healthy start to accumulating significant assets. In exchange, the Super Simple would have minimal rules, higher allowed levels of salary deferral contributions, and little or no fiduciary liability for employers (Perun and Steuerle 2008).

Creative possibilities also exist if we re-conceptualize the role of the employer as plan sponsor in the 401(k) plan system. In the old DB plan system, it was necessary to have an employer-centric system where plan sponsorship entailed significant legal obligations to ensure that employers made good on their pension promises. In a DC plan system where the majority of the risks and responsibilities for saving fall on workers, where independent financial services companies provide investments, and where professional administrators manage the plan, it is self-defeating to continue to insist that employers as plan sponsors remain the ultimate guarantors of the plan and all its functions.

There is increasing recognition that the next bold move in the evolution of the 401(k) plan system could be to transform employers into facilitators of their employees' saving. This merely

requires activating an employer's payroll system to transfer employee contributions to a saving plan run by an external entity. Such a system has been in place for decades in the 403(b) plan universe where employers typically make supplemental savings plans available to their employees. In such plans, employers are not fiduciaries, and their primary responsibility is to transfer elective contributions, limited in amount as in the 401(k) world, to the plan chosen by the employee.

The MyRA plan, recently announced by the Administration, represents a small step towards such a transformation of the role of the employer in the for-profit world. Granted, the MyRA account would not have all the bells and whistles of a full-fledged saving plan, but it could provide a badly-needed 'starter' account for small savers. A more substantial proposal which revitalizes the old payroll deduction IRA that has been in the code for decades is the 'Auto-IRA' proposal endorsed by the Obama Administration. Utilizing an auto-enrollment, payroll-deduction model, the Auto-IRA would also release employers from the obligations of a plan sponsor or fiduciary.

A related proposal for USA Retirement Funds would create a new retirement plan system for uncovered workers, in which the role of the employer would be limited to enrolling workers and facilitating payroll deduction contributions. USA Funds would be administered by a board of trustees who would act as fiduciaries, and also engage professional money managers and plan administrators. Finally, several states have decided to enter the pension arena on behalf of private sector workers lacking a plan at work. California has adopted the Secure Choice Retirement Savings Trust statute to build such a system if research and design results indicate that implementation is feasible.

The chief drawback of most of these proposals is that they all lack employer contributions, since under current law, employers who contribute to a plan become fiduciaries. Yet without

employer contributions, it will be difficult for these plans to generate assets sufficient for a secure retirement through employee savings alone. Assuming that these new plans have robust regulatory structures, changing pension law to accommodate employer contributions without attaching imposing fiduciary duties could be considered.

In summary, the private pension system has morphed from a DC to a DC system without much thought or pre-planning. With so many proposals for change to today's system to make it more inclusive and productive, there is now an opportunity for serious pension reform as well. A key consideration should be a revised role for the employer in today's employee-centric saving system, focusing on facilitating employee savings supplemented by employer contributions.

## **Conclusions**

Long-term pressures on the broader economy almost inevitably affect considerations of retirement system reform, whether public or private. Today, those pressures include a continuing decline in the adult employment rate and the corresponding rise in demand for older employees as other sources of labor become more scarce; public retirement and health entitlement programs so out of balance that they are starting to crowd-out education and other spending; the tendency to provide more years of retirement support simply as people live longer; the growth in the percentage of the population that is truly old because of a drop in birth rates; and private retirement plans that are inadequate for most, along with the gradual evolution of defined contribution plans to employee-centric models.

We have noted ways that entitlement reform can accommodate those forces while allowing private pension system reform to come along hand-in-hand and fill other gaps in the future needs of households. Regardless of particular approach, the ultimate measures of success include

improved financial security for those retiring with near or below poverty incomes, an increase in the percentage of the middle- and lower-income population with significant private financial assets in retirement, and an enabling of greater labor force participation to increase both individual incomes and government revenues to help achieve these goals.

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<sup>1</sup> The debt to GDP ratio doubled between the end of 2007 and the end of 2012, rising from 36.3 percent in 2007 to 72.6 percent in 2012.

<sup>2</sup> Kogan (2012) provides a discussion of the mechanics of BCA.

<sup>3</sup> ATRA avoided steep increases in tax payments by permanently extending several ongoing tax cuts that had been scheduled to expire, many of which had been extended annually, sometimes retroactively. Major components include a permanent extension in the alternative minimum tax patch; extension of income tax cuts originally enacted during the Bush administration for taxpayers with incomes below \$450,000 if married and \$400,000 if single; and a 40 percent estate tax rate coupled with a \$5 million exemption indexed to inflation. See Harris, Steuerle, and Quakenbush (2013) for further details.

<sup>4</sup> The growth in Medicare, Medicaid, and out-of-pocket medical spending declined precipitously in the five years spanning 2006 to 2011 relative to the prior five years (Holahan and McMorrow 2013).

<sup>5</sup> 'Tax expenditures' refer to deductions, credits, exclusions from income, and special tax rates on other forms of income that reduce tax liabilities for some households.

<sup>6</sup> By 2012, the share of employers who sponsored a 401(k)-type plan had risen to 60 percent, up from 51 percent in 2009 (Copeland 2013). Overall, participation by employees offering such a plan was 43 percent in 2012, up from roughly 35 percent in 2009.

<sup>7</sup> Some calculations indicate that a lower level of income in retirement is feasible because some costs, such as transportation, are lower, but these calculations usually fail to include health care, where average costs under current practices rise dramatically in older age and either government or the individuals themselves must cover those costs (Skinner 2007).

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<sup>8</sup> It turns out that many of those with limited lifetime incomes, particularly women, have only a scattered work history, so such a minimum benefit needs to be designed both around low lifetime earnings subject to tax (the base for the current rate formula), as well as some other accommodations such as some minimum credit for some years of child rearing.