

## EMPLOYER-BASED RETIREMENT INCOME—THE IDEAL, THE POSSIBLE, AND THE REALITY

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*Based upon his presentation at the University of Illinois College of Law's Elder Law Lecture, Professor Daniel Halperin provides a clear outline of goals for the future of employer-based retirement plans, which currently fall below ideal expectations and leave low- and moderate-income workers with inadequate savings for retirement. Professor Halperin argues for tougher standards regulating the private employer-based plans and additional government subsidies to retirement savings for low-income workers in order to make these goals possible. His proposals include widening coverage by requiring that all employees be eligible, limiting the role of integration with Social Security, restricting testing for discrimination by comparing projected benefits, preserving benefits for retirement by immediate vesting, and transferring investment risk to employers.*

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## Introduction

The Enron debacle and the recent stock market decline have served as a wake-up call for many employees. They now realize that their retirement savings may be inadequate to finance their current standard of living.<sup>1</sup>

This is not surprising. Providing adequate savings for retirement is extraordinarily difficult. An individual desiring to continue her pre-retirement standard of living would have to predict her earnings path (including earnings at retirement), the performance of the stock market over her lifetime, the point that she would wish to retire (assuming her health would permit), and her life expectancy at that point. If at a latter time in her career a worker recognizes that savings are inadequate, there may be insufficient time to make the necessary correction.

Perhaps because of this difficulty, we do not leave individuals to freely choose whether or not to save for retirement. Rather, we view the potential plight of the retired as a public policy concern. The Supplemental Security Income (SSI) program provides a minimum level of income to everyone over sixty-five regardless of their prior work history.<sup>2</sup> Social Security, in effect, mandates a certain level of savings, or a reduced level of current spending, in order to have funds available at retirement. In addition, there are tax incentives for retirement savings.

SSI assures that the retired have at least sufficient income for a subsistence standard of living. Because of this program, low-income workers who, in the absence of other resources, would be eligible for SSI benefits would not have an incentive to save. Mandating savings through Social Security eliminates this moral hazard, which could make the SSI program far more expensive.<sup>3</sup>

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1. Jonathan Clements, *Don't Think the Market Will Pump Up Your Nest Egg; You'd Better Start Saving*, WALL ST. J., June 12, 2002, at D1; *The Nest-Egg Blues: Got the Jitters About Your Retirement Savings? These Experts Discuss How to Regain Your Financial Balance*, WALL ST. J., June 24, 2002, at R10; David M. Walker, *GAO Testimony at Finance Committee Hearing on Retirement Security*, TAX NOTES TODAY, Feb. 28, 2002, LEXIS 2002 TNT 40-71.

2. The SSI program guarantees a minimum level of income for needy aged, blind, or disabled individuals, SOC. SEC. ADMIN., SUPPLEMENTAL SECURITY INCOME, PUBLICATION NO. 05-11000, PART ONE (2001), <http://www.ssa.gov/pubs/11000.html> (last visited Apr. 6, 2003).

3. See ALICIA H. MUNNELL, *THE FUTURE OF SOCIAL SECURITY 11-12* (Brookings Inst. 1977).

Social Security, however, provides more than subsistence income for many workers. The maximum benefit is now approximately \$20,000 per year.<sup>4</sup> On the other hand, Social Security has never been sufficient to fully replace employment income, even at the lowest levels of earnings.<sup>5</sup> I believe that we ought to guarantee full replacement for the lowest earners and probably should at least increase benefits for other low-income individuals. However, the level of benefits that should be provided by Social Security is a matter of judgment and many would argue that individuals generally ought to have flexibility over the level of spending throughout their lifetimes. In any event, even though this may be *ideal*, at least for low-income workers, it is unlikely that future Social Security benefits will achieve full income replacement. Because payroll tax revenues dedicated to Social Security are in the long run insufficient to provide for promised benefits,<sup>6</sup> it is more likely that future benefits will be less than the level of benefits currently promised by the program.<sup>7</sup>

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4. Soc. Sec. Admin., Benefit Examples for Workers with Maximum Earnings, at <http://www.ssa.gov/OACT/COLA/exampleMax.html> (Oct. 18, 2002).

5. Social Security is said to replace about sixty percent of pre-retirement earnings for low-wage employees, forty-five percent for average earners, and thirty-four percent for those whose wages have always been equal to at least the maximum amount subject to annual payroll taxes. See, e.g., C. EUGENE STEUERLE & JON M. BAKIJA, RETOOLING SOCIAL SECURITY FOR THE 21ST CENTURY 78. These figures are high because they assume retirement at age sixty-five when the majority retire earlier, many at sixty-two, accepting as much as a twenty percent reduction in annual benefits. These calculations also assume that individuals always earn at the same level while most workers receive promotions over their lifetime. Such promotions cause the actual replacement level to be lower than stated.

6. SOC. SEC. ADMIN., 2001 OASDI TRUSTEES REPORT, [http://www.ssa.gov/OACT/TR/TR01/II\\_Conclu.htm#79298](http://www.ssa.gov/OACT/TR/TR01/II_Conclu.htm#79298) (Mar. 19, 2001).

7. Maintaining the current level of benefits still raises the issues of whether it is appropriate to increase the retirement age at which full benefits will be paid, and also whether it is appropriate to provide for some portion of the benefits through individual defined contribution accounts rather than the current defined benefit system. See *infra* Part III.

A more complex question relates to the use of “wage indexing” to adjust benefits across cohorts. Under the current system, replacement rates under Social Security remain constant across generations even though the real income of the workforce is increasing. Thus, the average worker gets the same replacement rate even though the real earnings of the average worker increase. This is so because benefits are indexed to wages. Some would suggest that benefits be indexed to prices instead. This would cause replacement rates to decline overall, but under some versions of price indexing, the replacement rate for a given level of real wages would remain constant. See PRESIDENT’S COMM’N TO STRENGTHEN SOC. SEC. STRENGTHENING SOCIAL SECURITY AND CREATING PERSONAL WEALTH FOR ALL AMERICANS 119 (2001), at [http://www.csss.gov/reports/Final\\_report.pdf](http://www.csss.gov/reports/Final_report.pdf). For a criticism of the price-indexing approach, see Sen. Joseph Lieberman & Sen.

Individuals, however, are not left entirely to their own devices to provide for the difference between Social Security and pre-retirement earnings. There are tax incentives for employer-based pension plans<sup>8</sup> and, to a lesser extent, for Individual Retirement Accounts (IRAs).<sup>9</sup> In essence, these arrangements allow assets to grow tax-free while other investments are subject to tax.<sup>10</sup> Still, many workers have little, if any, private savings. Given their immediate needs and low tax bracket, even a tax preference will not sufficiently encourage savings among low- and moderate-income workers. For example, only a small minority of households earning less than \$25,000 have taken advantage of the opportunity to establish an IRA.<sup>11</sup>

Thus, although it is certainly not *ideal*, for now, achieving full replacement of pre-retirement earnings for low-income workers seems to depend upon employer-based plans. Employers have traditionally viewed pension plans as a means of managing the workforce. The promise of a pension can facilitate both retention of workers and re-

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Jon Corzine, *Lieberman, Corzine Release on Their Social Security Resolution*, TAX NOTES TODAY, Mar. 25, 2002, LEXIS 2002 TNT 57-64.

8. I.R.C. § 401 (West 2002).

9. *Id.* §§ 219, 408, 408(a). The maximum deductible contribution to an IRA is currently \$3000. It is scheduled to increase to \$5000 in 2008 and be indexed for inflation thereafter. Individuals fifty years and older receive an extra \$500, \$1000 in 2006. *Id.* § 219(b)(5)(A). The maximum deduction for contributions to an employer-sponsored defined-contribution plan is \$40,000 (indexed for future inflation). *Id.* §§ 415(c)(1), 415(d)(1). An additional amount is allowed for elective contributions by individuals age fifty and over. The additional amount is now \$2,000, and will rise to \$5,000 in 2006 and be indexed thereafter. *Id.* § 414(v). In order to maintain the incentive for employer-based plans, it is important to limit the contributions to individual plans and maintain a significant differential between allowable contributions to IRAs and the permissible level of contributions to employer plans. For this reason, the Administration's 2004 Budget proposals for \$15,000 of annual tax favored savings for all individuals, regardless of income level, is disturbing. The proposal is found in OFFICE OF MGMT. AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT OF THE UNITED STATES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2004: ANALYTICAL PERSPECTIVES 77 (2003), available at <http://w3.access.gpo.gov/usbudget/fy2004/pdf/spec.pdf> (last visited Apr. 6, 2003).

10. For a general discussion of how to analyze the impact of the timing of income and deductions, including a proposal for the treatment of nonqualified deferred compensation, see Daniel Halperin, *Interest in Disguise: Taxing the Time Value of Money*, 95 YALE L.J. 506 (1986) [hereinafter *Time Value*].

11. For example, in 1995, only fifteen percent of households earning between \$10,000 and \$25,000 established an IRA. See Daniel I. Halperin & Alicia H. Munnell, *How the Pension System Should be Reformed* 54 (Sept. 17, 1999), available at <http://www.brook.edu/dybdocroot/es/events/erisa/99papers/erisa10.pdf> (last visited Feb. 10, 2003). Unfortunately due to a delay in the publication of the volume in which it is to appear, that paper has not yet been published. This website presents the article in the form submitted at the time of the conference.

irement of less productive workers. Workers who desire to save would welcome the opportunity for tax-free appreciation and, possibly, access to better investment opportunities and more fairly priced annuities that an employer plan may offer.<sup>12</sup> Thus, they would favor a reduction in cash wages in return for an employer-provided pension.

Because the establishment of a pension plan does not, therefore, imply an overall increase in compensation, it may seem strange that employers sometimes resist pension coverage for all or part of their workforce. Why not take advantage of the favorable tax treatment of retirement savings only available through employer-based plans? The problem is, however, that many employees would be “reluctant savers” and would resist a reduction in cash wages, even for subsidized retirement savings. If other employers are paying compensation solely in cash, employers who establish plans must provide equal cash compensation for reluctant savers in order to compete. Therefore, they cannot afford to maintain plans covering all workers unless the value of the tax savings for the willing savers, the higher earners, enables employers to reduce the compensation of this group sufficiently to fund the additional cost of unappreciated coverage for reluctant savers.<sup>13</sup>

Thus, left on their own, employers would establish plans only for a select group of employees. However, the tax preference for employer-based plans is limited to so-called qualified plans which benefit a broad cross-section of employees. In general, contributions or benefits (as a percentage of pay) cannot discriminate in favor of highly compensated employees and against the lower paid.<sup>14</sup> By so limiting the tax preference, we hope to rely on the desire of the higher paid for

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12. Daniel I. Halperin, *Special Tax Treatment for Employer-Based Retirement Programs: Is It “Still” Viable as a Means of Increasing Retirement Income? Should It Continue?*, 49 TAX L. REV. 1, 8–11 (1993) [hereinafter *Special Tax Treatment*].

13. See Joseph Bankman, *The Effect of Anti-Discrimination Provisions on Rank-and-File Compensation*, 72 WASH. U. L.Q. 597 (1994); Joseph Bankman, *Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable?*, 55 U. CHI. L. REV. 790 (1988); *Special Tax Treatment*, *supra* note 12, at 14–16; Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419, 429–34 (1984). Employers may also be concerned about administrative costs and potential fiduciary liability.

14. I.R.C. §§ 401(a)(3), 410(b) (2000). In 2003, “highly compensated” includes employees earning over \$90,000. *IRS Announces Pension Plan Limitations for 2003*, TAX NOTES TODAY, Oct. 21, 2002, LEXIS 2002 TNT 203–19.