

**Washington  
Voluntary Accounts  
A Proposal for Universal  
Pension Access**

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### **About the Author**

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### **About the Economic Opportunity Institute**

The Economic Opportunity Institute is a nonpartisan, nonprofit, public policy institute focused on creating economic security and economic opportunity for working Americans and their families. The institute builds a bridge to economic security through research, policy, and public dialogue.

The Economic Opportunity Institute is currently developing pragmatic policies in the following areas: Social Security, retirement security, early learning and care, health care, family leave, taxes and public revenue, and worker advancement.

# CONTENTS

Issue Summary	3
Introduction and Context	4
Recent Trends in Pension Coverage and Policy	5
The Pension Problem	6
Who Lacks Pension Coverage	7
What About IRAs?	9
The Next Step: WVAs	10
Potential Impacts	13
Conclusion	15
Appendix A: Existing Defined Contribution Pension Vehicles	16
Appendix B: Findings from Focus Groups	17
Appendix C: Washington State Deferred Compensation Investment Fund Options	19
Appendix D: Details of Participation Estimates	20
Appendix E: WVAs and Public Opinion	21



## **Issue Summary**

As the baby boomers reach retirement age and life spans lengthen, the issue of retirement security is gaining increasing prominence. Social Security has been the subject of innumerable talk show segments, political debates, and newspaper editorials. Corporate scandals involving previously high-flying companies like Enron and WorldCom temporarily shifted the focus to 401(k)s and highlighted the risks of concentrating significant retirement assets in a single stock.

Despite all of the attention, the most significant problem of the current retirement system has been conspicuously overlooked in the public debate. That is, half of American workers – over 69 million working adults – do not have access to a private pension, either a traditional defined benefit pension or a workplace-based retirement savings plan.

Certain categories of workers are particularly unlikely to have pension coverage. These include:

- Small business employees – 73% of workers employed by businesses with fewer than 25 employees do not have a pension.
- Low-income workers – 82% of workers with annual incomes of less than \$20,000 lack pension coverage.
- Part-time and temporary workers – 79% of workers who worked part-time or part of the year do not have a pension.

The crux of the pension problem is that many businesses find it unaffordable to implement and maintain a pension plan. This paper will propose a solution to this problem in the form of a state-sponsored, universal, portable, 401(k)-style program called Washington Voluntary Accounts (WVAs).

WVA investment funds would be well diversified, which would prevent an Enron-style meltdown from devastating participants. Conservative investment options, such as bond funds and a savings pool, would also be available to investors who wanted to guard against market fluctuations.

WVAs would have a positive impact on:

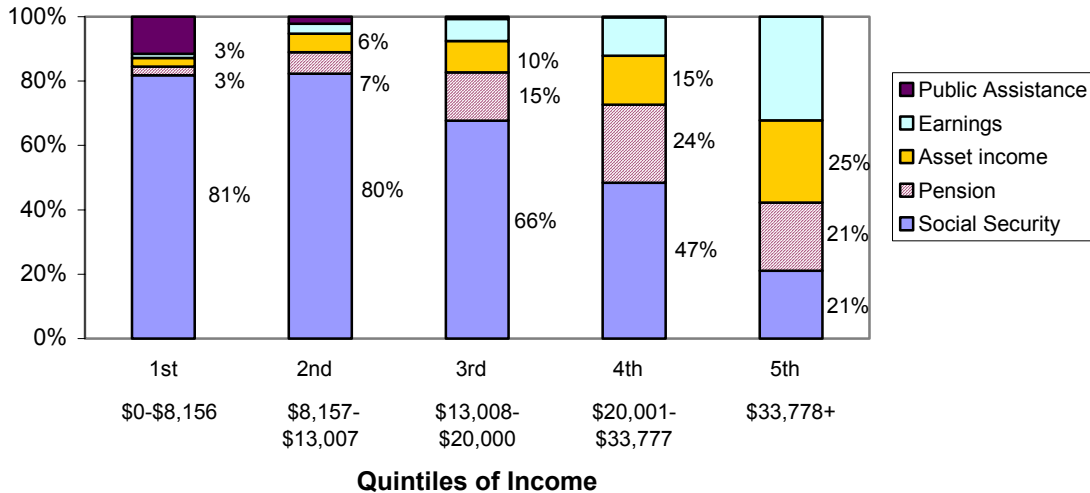
- Retirement security – WVAs would help the nearly 1.5 million Washington workers who don't currently have access to a pension to save for a more secure retirement.
- Business competitiveness – WVAs would improve the competitiveness of many businesses, and particularly small businesses, that are currently unable to offer pensions.
- Economic performance – WVAs would improve the personal saving rate and reduce future government costs for senior services.

## Introduction and Context

Social Security is the most important source of income for the majority of retired Americans (See Figure 1). With its progressive benefit structure, spousal and survivors' benefits, annual cost of living adjustments, and guarantee of benefits for life, Social Security provides a solid foundation in retirement.

Thanks largely to Social Security, poverty among seniors has fallen from 35% in 1959 to 10% in 2001. And while much has been made about a purported crisis in Social Security financing, the most recent Social Security Trustees' report indicates that Social Security is on solid footing into the foreseeable future.<sup>1</sup>

**Figure 1: Sources of income for Senior Households, by Quintiles of Income**



Social Security income alone, however, is typically not enough to provide a truly comfortable and secure retirement. Few seniors collecting Social Security fall below the official poverty line, but many live close to it. According to the U.S. Census Bureau, nearly 7% of Washington seniors (39,000 individuals) have incomes below the poverty line, while approximately 18% of Washington seniors (101,000 individuals) have incomes below 150% of the poverty level.<sup>2</sup>

Looking forward, senior poverty is expected to increase. New York University economist Edward N. Wolff notes that between 1989 and 1998, a time of strong economic growth, the proportion of workers who expected not to have enough income to live comfortably in retirement increased. The proportion of households headed by a person age 47 to 64 who could expect to live below the poverty line in retirement increased from 17.2% in 1989 to 18.5% in 1998. Moreover, the proportion of middle-aged households who could expect to replace at least half of their pre-retirement incomes declined from 70.1% in 1989 to 57.5% in 1998.<sup>3</sup>

Even as the adequacy of retirement income for many is decreasing, the proportion of retirees is increasing. Given current trends in birthrates, immigration, and life

expectancy, demographers expect the proportion of elderly in the U.S. to continue to grow. As people live longer, they are also spending more years in retirement.

These income and population statistics highlight the importance of a healthy pension system to augment Social Security.<sup>4</sup> Unfortunately, half of workers do not have access to a pension at any given point in time. Over their working lives, many of these workers are never able to accumulate pension assets. In 1998, only 43% of senior households received income from a pension. Workers nearing retirement are facing similar prospects: over 40% of American households headed by a 45- to 64-year-old hold no assets in a pension plan.<sup>5</sup>

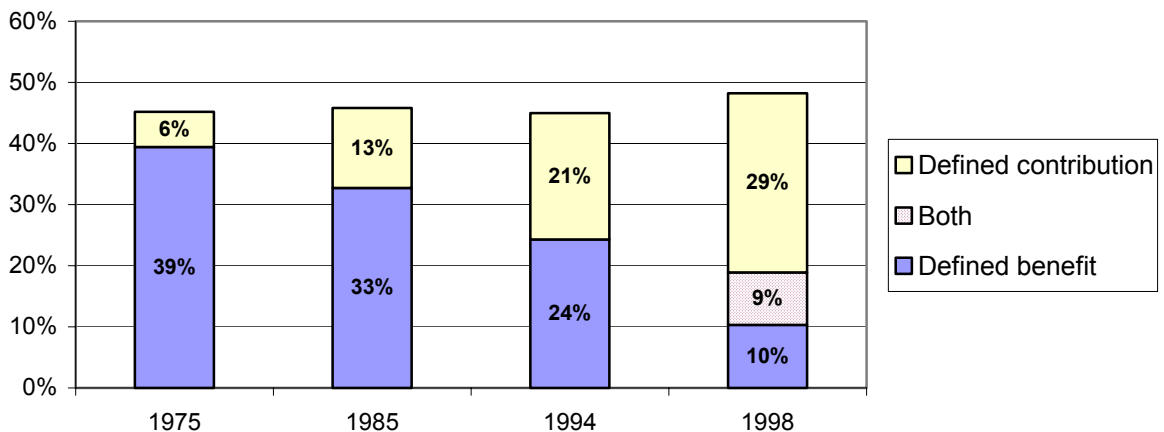
### Recent Trends in Pension Coverage and Policy

Access to pensions expanded during the 1950s, but the percentage of workers covered by retirement plans has hovered a little below 50% for the past three decades. The latest figures show a modest rise in pension coverage in the late 1990s, as the economy boomed, then a slight drop off in 2000.<sup>6</sup>

Since 1975, the type of pension plan offered by private employers has been changing. Most pensions for the previous generation were "defined benefit" plans, where retirees were guaranteed a percentage of their pre-retirement wages, based on their length of time with the company. Employers bear the risk of any investments with this type of system, and the federal government both regulates and guarantees these plans.

Most public sector workers still have defined benefit plans for the bulk of their pensions, but in private industry defined benefit plans are rapidly giving way to "defined contribution" plans, like 401(k)s, where workers make investment decisions, bear the risks, and have no guaranteed return.<sup>7</sup> This transition has been accompanied by a decline in the amount employers contribute to workers' pensions, from an average of \$1.18 per hour in 1979 to \$0.79 in 2000.<sup>8</sup>

**Figure 2: Percentage of Workers with Defined Benefit and Defined Contribution Plans, 1975-1998<sup>9</sup>**



Congress has approved a number of defined contribution pension vehicles over the years with significant tax breaks for both employers and workers to encourage their participation (see Appendix A for a full list). Individual Retirement Accounts (IRAs) were introduced in 1974, with literally thousands of options for investment. Workers without an employer-provided pension can contribute up to \$3,000 to their IRA in 2002 (\$3,500 if over age 50), and deduct the contribution from income before taxes.<sup>10</sup>

In 1978, Congress gave employers the option of creating 401(k) retirement plans. These have become increasingly popular among employers, who consider them less costly to operate than defined benefit pensions.<sup>11</sup> And while traditional pensions are clearly less risky for employees, workers who switch jobs may appreciate the fact that 401(k)s are more portable than traditional defined benefit plans. For 2002, 401(k) contributions are limited to \$11,000 for workers (\$12,000 if over age 50), while the total employee/employer cap is \$40,000.

Congress created new options oriented to small businesses in the 1990s. SIMPLE IRAs are available to companies with 100 or fewer workers, and offer workers benefits over individually created IRAs. Employers are required to contribute and employees can contribute up to \$7,000 per year. The employees' contributions are deducted automatically from their checks before taxes, as with other retirement plans. SEP IRAs allow considerably higher contributions, up to \$40,000, and are intended both for small companies and self-employed workers.<sup>12</sup>

Unfortunately, even with these newer options most smaller companies do not provide retirement benefits for their employees. While most full-time workers in government or large companies participate in a retirement plan, coverage falls rapidly with firm size, and part-time workers usually are not covered.<sup>13</sup>

As part of President Bush's tax cut legislation that was signed into law in June 2001, contribution limits for both IRAs and 401(k)s were raised. The law does little to improve the retirement security of the average worker, however, as only about 3% of households contribute to IRAs, and only 5% of workers with 401(k)s contribute up to the maximum. The law did not offer any major new vehicles or eliminate existing barriers to pension access.<sup>14</sup>

## **The Pension Problem**

Under current retirement policy, pensions are employment-based. Pension coverage, in other words, is at the discretion of employers. If an employer decides that a pension plan does not fit the company budget, employees are left without coverage.

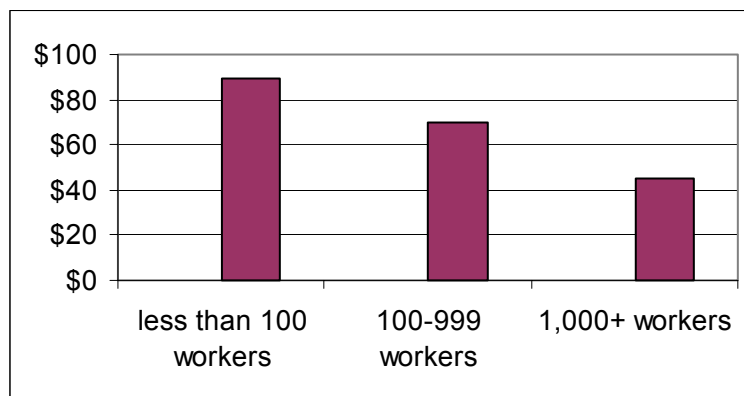
The crux of the pension problem is that providing pension coverage is simply not affordable for many businesses. For a business implementing a 401(k) pension plan, start-up is expensive in terms of time and money. In addition to mastering the intricacies of federal pension law, firms looking for an appropriate plan must choose from among the approximately 1,500 third party administrators and over 3,000 firms offering asset-management services.<sup>15</sup> For a large company that has staff specializing in employee benefits, this may not be an undue burden. A small business owner, however, may find it impossible to dedicate the necessary time to this search. Small firms may also be



priced out by initial set-up fees, which range from \$500 to \$3,000 and are generally fixed regardless of business size.<sup>16</sup>

Recurring administrative costs, including preparation of tax forms and record keeping, may also be burdensome, particularly for smaller businesses. According to a study of 401(k) fees sponsored by the U.S. Department of labor, administration accounted for 7% of costs of large plans, but 14% of costs medium-sized plans.<sup>17</sup> For firms with fewer than 100 employees, the average cost per worker to administer a 401(k) plan is \$89, twice the amount per worker it costs firms with more than 1,000 employees, and 27% more than it costs firms with between 100 and 1,000 employees.<sup>18</sup>

**Figure 3: Cost Per Worker of 401(k) Plans, by Size of Firm**



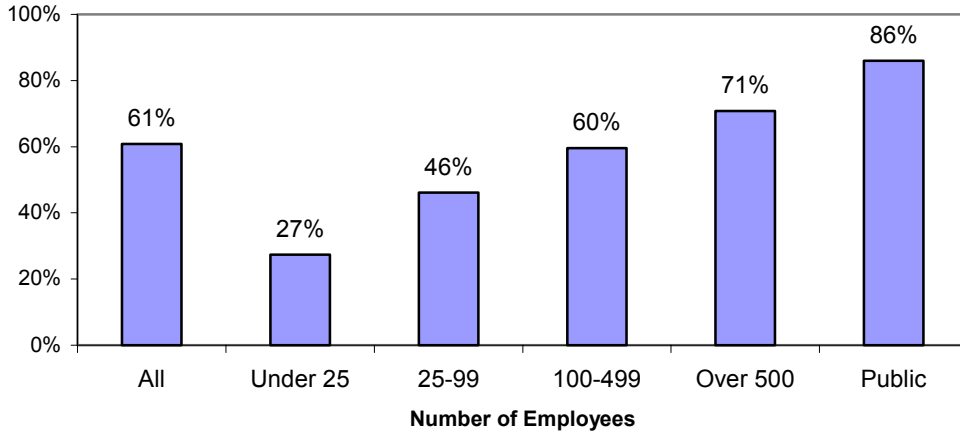
Even employers that do offer pensions may exclude some workers, at least partly to save on costs. The Internal Revenue Code (IRC), which governs pension plans, permits firms to exclude employees who have been with the firm for less than a year and still maintain favorable tax status. Because a year is defined as 1000 hours during a 12-month period, many part-time and seasonal workers never qualify for pension coverage. The IRC also permits firms to exclude 30% of non-highly compensated employees.

### **Who Lacks Pension Coverage?**

The pension problem disproportionately impacts certain segments of the workforce. The following categories of employees are particularly unlikely to have access to an employer-based pension:

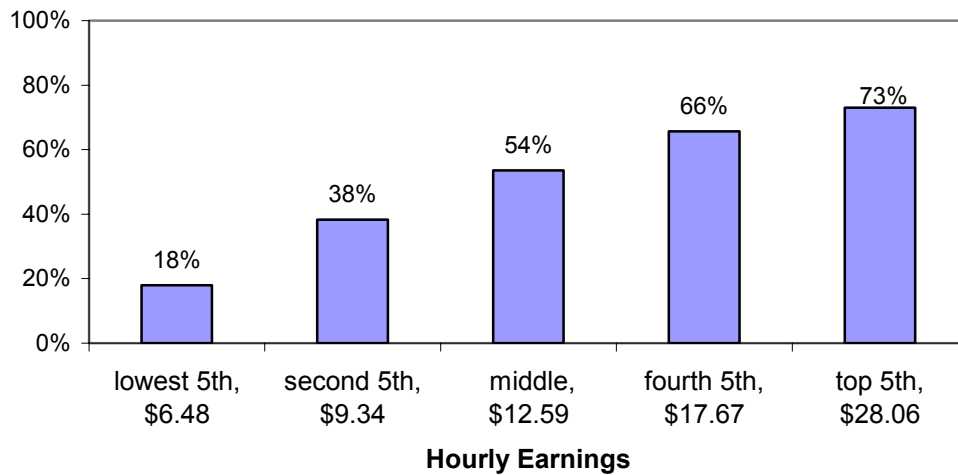
- **Small Business Employees:** Administrative and cost hurdles prevent many small businesses from offering pension benefits to employees (see Appendix B for a fuller discussion). Looking at full-time, full-year workers, 73% of those working for businesses with 25 or fewer employees did not participate in a pension in 1999, while 29% of those employed by companies of 500 or more did not participate.

**Figure 4: Pension Plan Participation Rate of Full-Time Workers by Employer Size, 1999<sup>19</sup>**



- Low-Income Workers:** Nationally, 82% of the lowest fifth of earners lack pension access. Approximately 27% of workers in the highest fifth of earners do not have access to a pension.

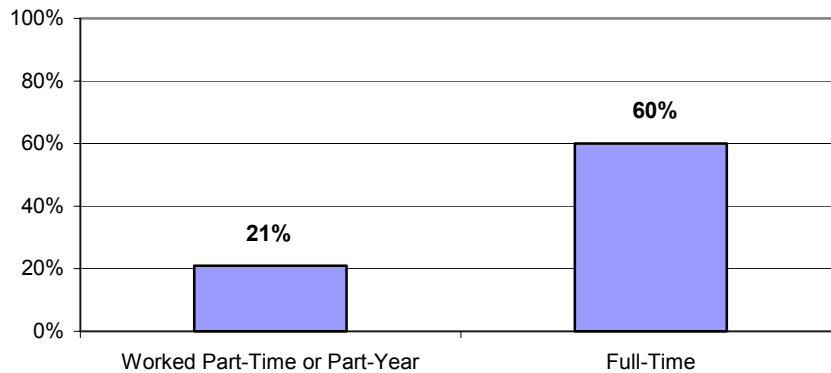
**Figure 5: Pension Coverage for Private Sector Workers by Earnings, 2000<sup>20</sup>**  
*(Ages 18-64, working at least 20 hours/week, 26 weeks/year)*



Low-income workers often work for companies that do not offer pensions. Others work for companies that do offer pensions, but are excluded from participation (IRC provisions permit employers to exclude 30% of non-highly compensated workers from plans).

- **Part-Time and Temporary Workers:** Approximately 79% of part-time and temporary workers lack pension coverage compared to 40% of full-time, year-round employees.

**Figure 6: Pension Coverage by Employment Status, 1998<sup>21</sup>**



Like low-income workers, many part-time and temporary workers are employed by companies that do not sponsor pension plans.<sup>22</sup> Others may not qualify for coverage because they have not worked for the requisite time period. A recent survey of employers sponsoring 401(k) plans found that the mean service requirement was 10 months.<sup>23</sup>

## What About IRAs?

In theory, workers without a pension plan at work can invest up to \$3,000 annually in a tax-deferred IRA account, and an additional \$3,000 to the account of a non-working spouse. These funds can be invested in a wide range of mutual funds, banks, or brokerage firms. For the sophisticated investor with significant assets, the range of options can be an advantage, but many working Americans lack the time and resources to give investing their full attention. Numerous private companies market their own investment portfolios aggressively, and separating the key information on fees and earnings from the hype can be a challenge even for the knowledgeable investor.<sup>24</sup>

Traditional IRAs also don't offer the advantage of payroll deductions. Rather than making one decision and having the money automatically saved, workers must save up themselves, and then make lump sum investments. This can be especially difficult for workers with lower wages, who need the money for routine expenses to meet their families' immediate needs.

## **The Next Step: WVAs**

Washington could accomplish universal pension coverage by implementing an individual-based pension program that would augment the current employment-based retirement system. The individual-based Washington Voluntary Accounts (WVA) proposal laid out in this section is based on a plan outlined by economist Dean Baker, Co-Director of the Center for Economic and Policy Research.<sup>25</sup>

### **The Basics**

WVAs would be structured as a defined contribution, 401(k)-style program. Any worker who wanted to participate could elect to have tax-deferred contributions deducted directly from each paycheck. Employers could also choose to contribute to employee accounts independently, or match employee contributions. Accounts would be portable, meaning that workers could easily continue contributing to their pension after a job change.

The WVA program would be administered by the Washington State Department of Retirement Systems (DRS), which currently oversees 10 statewide retirement plans for nearly 475,000 participants. DRS would handle a number of WVA administrative functions in-house, but would also contract with private companies to provide some services, such as record keeping and investment education services. Web-based tools developed by DRS could be used to report participants and pay member contributions.

The DRS administrative structure is very efficient – a 1998 analysis found that the annual per capita administrative expense was \$39, which was 33% below the average of other peer state retirement systems and well below the typical cost in privately run 401(k) plans.<sup>26</sup> By utilizing the Department's administrative expertise and pooling the small investments of many workers, WVA participants would benefit from similar low expenses.

### **Investment Options**

Participants in WVAs will be offered investment options similar to those currently offered public employees participating in state defined contribution programs. Currently the state deferred compensation program offers a choice of 11 funds, ranging from conservative options that guard against market fluctuations to aggressive funds with high potential risks/rewards (see Appendix C for a detailed description).

Providing a pre-selected and screened set of investment options to workers will both reduce administrative costs of the program and reduce the amount of time and energy workers must spend in order to make informed decisions about their investments.

## **WVAs, Enron, and the Stock Market**

The collapse of companies like Enron and WorldCom devastated many investors in recent months, particularly employees of these companies who had large amounts of company stock in their retirement portfolios.

Investors in Washington State's Deferred Compensation program, however, were impacted very minimally by these business failures. Investors in WVAs would similarly be largely unaffected by the failure of any single company or small group of companies.

The reason for this is that funds controlled by the Washington State Investment Board are highly diversified. This helps to protect investors from business collapses, like we saw with Enron and WorldCom.

The recent decline in the overall stock market has resulted in short-term losses in 9 of the 11 state deferred compensation funds. Losses for the year ranged from 0.2% (Washington State Short-Horizon Fund) to 32% (Fidelity Growth Company Fund). Two of the more conservative funds available to participants increased in value. The Washington State Bond Fund gained 7.7% and the Savings Pool gained 6.3% for the year. It should also be noted that over the past 10 years no deferred compensation fund has lost money.

### **Projected Participation**

Decisively forecasting potential participation in WVAs is difficult given that a pension program of this scope has never been implemented in the U.S. No state, at present, offers universal pension coverage. Extrapolating from data on take-up rates in employer-sponsored 401(k) plans and using relatively conservative assumptions, we estimate that 323,000 households, or approximately 35% of those who currently lack coverage, will participate (see Appendix D for details of participation estimates).

Participation rates are not expected to reach these levels immediately, however. Usage will likely lag initially as employees and employers learn about WVAs through marketing programs and word-of-mouth.

### **Implementation**

Implementing WVAs will require movement on two tracks. On one track, legislation establishing WVAs will have to be passed at the state level. Representative Jim McIntire introduced House Bill 2627, which would establish the WVA program, during the 2002 legislative session. Seventeen members of both political parties signed on as cosponsors. The bill failed to move out of committee, however, as the legislature concentrated on dealing with fallout from the state recession and budget deficit during the 60-day session. A revised bill is expected to be introduced in the Washington State House and Senate in 2003.

On the second track, implementing WVAs will require federal authorization. Because WVAs are a new type of pension vehicle, Congress will have to pass authorizing

legislation allowing participants to benefit from the tax incentives afforded participants in existing plans.

Implementing WVAs will require a commitment of \$5 to \$10 million over 5 years, according to DRS estimates. This funding will be used to:

- Develop the details of the plan and gain IRS qualification
- Develop marketing and educational material for employees and employers
- Assist employers in automating systems for reporting contributions and payments
- Modify DRS information systems
- Fund staff to monitor, maintain and service the new system
- Subsidize participant administrative costs until plan assets reach an appropriate baseline

Due to the severity of Washington's ongoing budget problems, state funding of WVA startup costs is unlikely to be feasible in the near term. To address the urgent and growing problem of inadequate pension coverage and retirement wealth, the federal government could provide startup funds for WVAs. Washington's program could then serve as a template for other states, or could be replicated at the national level.

### **Key Elements of Washington Voluntary Accounts**

**Plan type:** Defined Contribution

**Administration:** Washington State Department of Retirement Systems

**Automatic deductions:** Worker contributions deducted directly from each paycheck.

**Matching contributions:** Employers could opt to contribute to employee accounts

**Investment options:** Pre-selected menu of stock, bond, money market, or a combination of funds.

**Projected Participation:** 323,000 households

**Portability:** Workers changing jobs could carry their WVA account with them, and continue investing with little or no interruption.

**Oversight:** Washington State Investment Board and the Joint Committee on Pension Policy

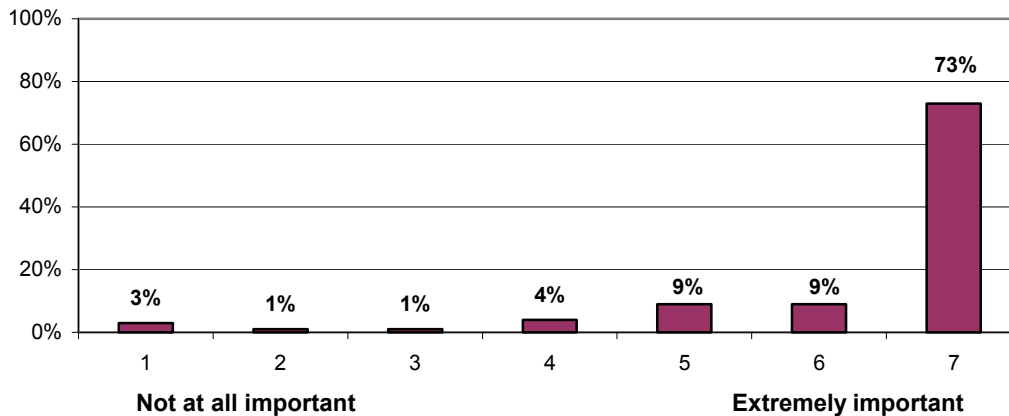
## Potential Impacts of WVAs

By providing universal, low-cost, administratively streamlined, portable pension coverage, the WVA program would likely improve business competitiveness, retirement security, and economic performance.

### Business Competitiveness

Workers generally place a very high priority on pension access. In a 2002 survey of 401 Washington residents, 73% of respondents rated the importance of having “some kind of retirement plan in addition to Social Security” as a 7, on a scale of 1 to 7. An additional 18% rated it a 5 or 6 (see Appendix E for detailed poll results).

**Figure 7: Importance of having a Retirement Plan in Addition to Social Security**



Given the importance workers place on pensions, businesses that are not able to provide coverage are placed at a competitive disadvantage. They will likely lose the best workers to businesses that do provide pensions. WVAs, then, would help to level the playing field. Small businesses, which are less likely to be able to afford to offer a pension plan, would particularly benefit from WVAs.

### Retirement Security

While workers clearly understand the importance of pension coverage, would they participate if they had access to WVAs? Many assume that low-income workers, in particular, would be unlikely to take advantage of a defined contribution program.

National research, however, indicates that a substantial percentage of workers would participate in a pension if given the option. Of all households with access to a 401(k), 86.4% participate. Among lower-income workers, close to 70% of households earning \$10,000 to \$25,000, and 42.7% of households earning less than \$10,000, participate.<sup>27</sup>

Employers taking an innovative approach may boost participation rates even higher. 7-Eleven Inc., for example, recently simplified its pension enrollment system and saw participation increase from half of all employees to three-quarters. Rather than requiring employees to complete enrollment forms to begin participating, the company now automatically begins deducting 3% of an employee's pay after one year of service and depositing it in a 401(k) account. Workers can opt out or change the amount deducted if they choose.<sup>28</sup>

If, as our conservative estimates project, even 35% of households not currently covered by a pension choose to participate in WVAs, a significant proportion of Washington families will improve their retirement security. Not only will WVAs serve as an important source of retirement income, but because defined contribution pension assets can be used to pay for emergency medical services, first home purchases, and post-secondary education expenses, they will also augment the current economic security of low and middle-income participants.<sup>29</sup>

### **Economic Performance**

Savings promoted by WVAs could improve Washington State's overall economy in both the medium and long-term.

First, expanding pension access could raise the personal saving rate.<sup>30</sup> The U.S. personal saving rate has dropped off significantly in recent years, and has fallen to its lowest level since the Great Depression. After averaging 8% through the 1980s and early 1990s, the saving rate fell to 4% in the late nineties and to 2.2% in 2001.<sup>31</sup> Initial projections suggest that contributions to WVAs would total over \$900 million annually. While this is a relatively small amount of money in terms of the national (and even the state) economy, WVAs would be a start. If WVAs could subsequently be replicated in other states or at the national level, the impacts on the U.S. personal saving rate could be significant. This would help the economy, since saving funds investment, which fuels future economic growth.

Second, by helping workers to build up retirement resources, WVAs would reduce future demand for government assistance among seniors. Workers with adequate savings are less likely to need extensive help with housing, medical care, and other necessities during retirement. This would free up resources for other state responsibilities such as education and infrastructure improvements.



## **Conclusion**

Social Security forms a solid foundation for workers in retirement. Maintaining the defined benefits and the guarantees of this highly successful program is crucial to the long-term economic security of all Americans. But it is important to do more than protect Social Security. Large gaps in the private pension system must also be addressed. About half of workers currently do not have access to an employer-based pension. Small business employees, low-income workers, and part-time and temporary workers are particularly unlikely to have access to a workplace-based retirement savings plan.

Washington Voluntary Accounts would address many of the problems of the current pension system. WVAs would be individual-based, as opposed to employer-based, giving all workers access. WVAs would also be portable, benefiting an increasingly mobile workforce. By offering a simple, administratively streamlined pension vehicle, WVAs would help small businesses to compete with the larger companies that are currently able to afford pension plans. WVAs would also encourage workers to save, improving their retirement security. From a macroeconomic perspective, WVAs would increase personal saving, boosting investment, and fueling economic growth.

Washington Voluntary Accounts are an innovative and precedent-setting proposal. For a small upfront cost Washington could make a leap forward in pension policy, improving the retirement security of workers, leveling the playing field for businesses, and sparking the economy.

## **Appendix A: Existing Defined Contribution Pension Vehicles**

### **401(k) Plans**

Congress added Section 401(k) to the Internal Revenue Code in 1978, to allow workers to put a portion of before-tax salaries into employer-sponsored retirement savings plans. According to a recent Employee Benefit Research Institute estimate, 55 million U.S. workers were enrolled in 401(k) plans in 1999, with a total of \$1.5 trillion invested.<sup>32</sup> A multitude of plans are offered by a broad array of banks and investment companies. Workers typically have a range of options in which they can choose to invest with varying levels of risk. The maximum that workers can contribute annually to a 401(k) in 2002 is \$11,000. Employers can match for a maximum combined contribution of \$40,000 or 100% of pay, whichever is less. If the money is withdrawn before age 59½, a 10% penalty as well as taxes are owed, unless the money is used for certain purposes of extreme financial need. Typically, allowable withdrawals include purchase of a primary residence, college tuition, or unreimbursed medical expenses. Workers can also borrow from their 401(k)s under certain circumstances. The federal government regulates 401(k) plans and sponsors to assure that fiduciary responsibilities are being met, but neither the government nor employers guarantee either the principle or returns on investments.<sup>33</sup>

### **403(b) Plans**

403(b) plans are similar to 401(k)s but are exclusively for employees of non-profit organizations, including hospitals and educational institutions. The maximum employee contribution is based on a complex formula, but can be no more than \$11,000 in 2002. The combined total of employee/employer contributions is capped at \$40,000 or 100% of compensation, whichever is less. Like 401(k)s and other pension vehicles, contributions are tax-deferred and significant restrictions are placed on withdrawals before age 59 and a half except under certain very specific circumstances.<sup>34</sup>

### **IRAs**

**Traditional IRA** – An Individual Retirement Account (IRA) is set up as a trust or custodial account through a bank, credit union, savings and loan, or other entity approved by the IRS. While only 3% of taxpayers made IRA contribution in 1998, 28% of American families had a total of \$2 trillion invested in IRA accounts at the end of that year.<sup>35</sup> For 2002, contributions are limited to \$3,000 per year for an individual. Spouses can each contribute up to \$3,000, even if one is not working. Workers not covered by an employer-sponsored pension can deduct contributions from pre-tax income. Disbursements must begin no later than age 70 and a half. Withdrawals before age 59 and a half are subject to 10% additional tax, unless used for a first-time home purchase, qualified higher education expenses, or medical expenses exceeding 7.5% of income.

**Roth IRA** – Established in 1997, taxes in Roth IRAs are paid up front. Earnings and withdrawals are then tax-free. As with traditional IRAs, annual contributions are limited to \$3,000 in 2002. Withdrawals cannot be made before age 59 and a half without penalty unless for first-time home purchase or some college expenses. Withdrawals do not have to begin by any certain age.

**SEP (Simplified Employee Pension) IRAs** – For 2002, employers can make deductible contributions to an IRA for an employee of up to 25% of income or \$40,000, whichever is

less. Employers must set up IRAs for all employees. Employer contributions are not mandatory, but if they are made, they must be according to a set formula that does not discriminate in favor of highly paid employees. Self-employed individuals can also set up a SEP IRA, allowing them to shelter considerable income from taxes.

**SIMPLE IRAs (Savings Incentive Match Plan for Employees)** – SIMPLE IRAs were established in 1996 as part of an overhaul of the IRA system, in order to encourage small business participation. Under SIMPLE IRAs, the employee agrees to a salary reduction, which the employer then contributes to the employee's IRA. Employers must make matching contributions, or else contribute a standard amount to all eligible employees whether or not the employees also contribute through a salary agreement. The maximum employee contribution for 2002 is \$7,000, with an additional \$7,000 employer match, up to 3% of the employee's compensation.

### **Other Plan Types**

**Deferred Compensation** - Under section 457 of the Internal Revenue Code, workers of state and local governments and tax-exempt employers can set aside pre-tax money in retirement plans sponsored by the employers, up to limits set by the IRS.<sup>36</sup>

**Keogh Plans** - For self-employed people and small business owners, Keogh plans allow employers to make tax-deductible contributions to a range of plans, including in their own behalf.

**"Money Purchase" Plan** – The employer puts in fixed percentage regardless of whether the employee does, usually used primarily to supplement 401(k)s and other pensions. Money purchase plans are good for lower income workers (compared to 401(k)s where the percentage of employer contribution varies.)<sup>37</sup>

## **Appendix B: Findings from Focus Groups**

EOI contracted with Evans-McDonough to conduct two focus groups on Washington Voluntary Accounts on November 13, 2001. Participants were small business owners and managers in King County, one group representing businesses with 5 to 25 employees, the other with 25 to 100 employees. The businesses included a range of occupations, including a computer company, a wood door manufacturer, a feed store, a real estate agency, an architectural firm, a telephone answering service, and two courier services.

### **Key findings:**

- One third of the smallest businesses and 4 of 5 of the larger businesses currently had some kind of retirement program for employees.
- All participants thought that retirement savings programs were important, assigning values between 7 and 11 on a scale of 1 to 10.
- Businesses that didn't offer retirement programs cited administrative difficulties, costs for small companies, difficulties in comparing options, and lack of interest by employees.
- 17 out of 18 participants supported Washington Voluntary Accounts even if employers were required to make and forward payroll deductions for workers who wanted to participate, 7 with reservations.
- Particularly attractive aspects of WVAs:
  - Transferability for a mobile workforce
  - Providing an entry place for younger, less knowledgeable workers
  - Low costs and fewer administrative hassles for businesses
  - A range of investment options that are pre-screened
  - Giving small businesses a way to fulfill their responsibilities as employers
- Reservations about WVAs:
  - State mandate (but benefits generally outweighed)
  - Skeptical about state government (though also believed state administration would make program more accessible to workers who needed it most)
  - Larger professional firms saw no need for their employees
  - Government competition with private companies

**Appendix C: Washington State Deferred Compensation Investment Fund Options<sup>38</sup>**

Fund	Risk/Reward	Investments	Returns as of 6/30/02		
			1 year	5 year	10 year
Savings Pool	Low	Insurance company and bank investment contracts	6.3	6.6	6.8
Washington State Bond Fund	Low	Intermediate investment grade corporate bonds	7.7	7.1	7.3
Washington State Short-Horizon Fund	Low	Targets composition of 29% stocks, 46% fixed income and 25% cash	-0.2	N/A	N/A
Washington State Mid-Horizon Fund	Low/Moderate	Targets composition of 54% stocks, 46% fixed income	-4.6	N/A	N/A
Calvert Social Investment Fund	Moderate	Approximately 60% stocks and 40% bonds or other fixed income investments that meet social criteria	-11.4	3.0	6.7
Washington State Long-Horizon Fund	Moderate	Targets composition of 80% stocks and 20% fixed income	-10.4	3.6	9.4
Fidelity Equity-Income Fund	Moderate/High	At least 65% income-producing common and preferred stocks with the remainder in various domestic and foreign instruments, including bonds for income	-10.2	5.2	12.3
U.S. Stock Market Index Fund	Moderate/High	Index fund that invests in more than 2,500 stocks of small, medium, and large U.S. companies	-16.8	4.0	11.2
Fidelity Independence Fund	High	Primarily common stocks, although investments not restricted	-18.5	7.0	11.4
Fidelity Growth Company Fund	High	Common stocks and securities convertible to common stocks in companies viewed as having significant growth potential	-32.0	4.8	12.0
Fidelity Overseas Fund	High	Normally at least 65% of assets in foreign securities	-11.9	-0.3	5.4

## Appendix D: Details of Participation Estimates

### High Participation Estimate

At the high end, take-up rates for WVAs would mirror participation rates in employer-sponsored 401(k) plans. According to a July 2000 analysis by the Employee Benefit Research Institute, 86.4 percent of households who are offered only 401(k)-type plans by their employers participate in them.<sup>39</sup> Thus, if we assume that participation rates in WVAs will be identical to private sector participation rates, we would expect 86.4 percent of workers who don't have access to pensions to participate. According to this high estimate, 807,816 households will participate in WVAs, with take-up rates moderate among low-income families and increasing with household income.

#### WVA Participation Rates: High Estimate

Earnings	Households lacking pension access	% households taking up	# households taking up
<\$10,000	167,724	42.7%	71,586
\$10,000-\$25,000	309,280	68.8%	212,770
\$25,000-\$50,000	306,310	84.5%	258,717
\$50,000-\$100,000	151,362	93.2%	141,073
\$100,000+	44,980	97.5%	43,857
<b>Total</b>	<b>934,451</b>	<b>86.4%</b>	<b>807,816</b>

### Moderate Participation Estimate

While WVA participation rates on par with those in the employer-sponsored 401(k) market are conceivable, such estimates likely overstate potential usage. Workers targeted by the program—those who are not offered pensions by their employers—tend to be slightly younger and have less job tenure than covered employees. These workers are less likely than older and more established employees to participate in a pension plan even if one is offered.<sup>40</sup> Whether employers choose to contribute to their workers' account will also affect participation levels.<sup>41</sup>

Given these caveats, a lower take-up rate is probably more realistic. Taking into account such variables as age, job tenure, and pension match, we estimate that participation in WVAs will be equivalent to 40% of the rate seen in employer-sponsored 401(k) programs. At this level of participation, approximately 323,000 Washington State households will be expected to use WVAs to save for retirement.

#### WVA Participation Rates: Moderate Estimate

Earnings	Households lacking pension access	% household taking up	# households taking up
<\$10,000	167,724	17.1%	28,634
\$10,000-\$25,000	309,280	27.5%	85,108
\$25,000-\$50,000	306,310	33.8%	103,487
\$50,000-\$100,000	151,362	37.3%	56,429
\$100,000+	44,980	39.0%	17,543
<b>Total</b>	<b>934,451</b>	<b>34.6%</b>	<b>323,126</b>

## Appendix E: WVAs and Public Opinion

A poll of 401 Washington state residents over age 18 was conducted by the Evans McDonough Company between January 18 and 22, 2002.

- 91% agreed that it is important for people to have some kind of retirement plan in addition to Social Security in order to have economic security in their old age.
- 82% said they would favor a new, government sponsored 401(k)-style retirement plan open to all workers and employers, and portable as workers moved from job to job.
- Strong majorities of all demographic and political groups supported the proposal.

	Favor Washington Voluntary Accounts
Total	82%
Male	81%
Female	84%
Employed	85%
Unemployed	87%
Retired	74%
Age 18-24	87%
Age 25-44	84%
Age 45-64	82%
Age 65+	77%
Puget Sound	82%
Other West. WA	86%
East Washington	80%
Democrat	86%
Independent	74%
Republican	91%

## Endnotes

<sup>1</sup> Social Security Trustees 2002 Annual Report, [www.ssa.gov](http://www.ssa.gov); see also Marilyn Watkins, "Social Security Trustees Report 2002: A Report on Success," Economic Opportunity Institute, March 2001, [www.eoionline.org](http://www.eoionline.org).

<sup>2</sup> U.S. Census Bureau, "People 65 Years and Over by Ratio of Income to Poverty and State: 1998-2000," <http://www.census.gov/hhes/poverty/65+inctopov.html>.

<sup>3</sup> Edward N. Wolff, *Retirement Insecurity: The Income Shortfalls Awaiting the Soon-to-Retire*, (Washington, D.C.: Economic Policy Institute, 2002) p.1.

<sup>4</sup> Income from personal savings could also augment Social Security benefits, but recent data show that most workers save very little outside their pensions. See Federal Reserve Board, "Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances," Federal Reserve Board Monthly Bulletin, January 1997.

<sup>5</sup> Arthur B. Kennickell, Martha Starr-McCluer, and Brian J. Surette, "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances," *Federal Reserve Bulletin*, January 2000, Table 5.B., p. 11, [[www.federalreserve.gov](http://www.federalreserve.gov)].

<sup>6</sup> Employee Benefit Research Institute, "Fewer American Workers Are Saving for Retirement," 2001 Retirement Confidence Survey, News Release, May 10, 2001. According to Mishel, Bernstein and Schmitt, workers with pension coverage in private industry declined from 51% in 1979 to 47% in 1996. *State of Working America, 1998-99*, (Ithaca: Cornell University Press, 1999), p. 147. Another study showed pension coverage increasing from 48% in 1988 to 53% in 1998. U.S. General Accounting Office, "Pension Plans: Characteristics of Persons in the Labor Force Without Pension Coverage," August, 2000, p. 4. An EBRI study based on the Current Population Survey shows the percentage of wage and salary workers participating in employment-based retirement plans increasing from 44.4% in 1994 to 46.8% in 1999. Craig Copeland, "Retirement Plan Participation: Full-Time, Full-Year Workers Ages 18-64," *EBRI Notes*, Employee Benefit Research Institute, January 2001, p. 2.

<sup>7</sup> U.S. Department of Labor, ERISA Advisory Council, "Report of the Working Group on Small Business p. 11, <http://www.dol.gov/dol/pwba/public/adccoun/smrpt1.htm>; Jack VanDerhei and Craig Copeland," The Changing Face of Private Retirement Plans," EBRI Issue Brief Number 232, April 2001.

<sup>8</sup> Lawrence Mishel, Jared Bernstein, Heather Boushey, *State of Working America, 2002-03*, (Ithaca: Cornell University Press, 2003), p. 140.

<sup>9</sup> Data from Employee Benefit Research Institute, "EBRI Retirement Income Research: 2000 Findings, Pension Coverage and Sponsorship," August Research notes; and U.S. General Accounting Office, "Pension Plans: Characteristics of Persons in the Labor Force Without Pension Coverage," August 2000.

<sup>10</sup> Depending on income and status, some deductions may also be allowed even if covered by a pension plan. Internal Revenue Service (IRS), "Publication 590, Individual Retirement Arrangements (IRAs)," Chap. 1. [[www.irs.ustreas.gov/basic/forms\\_pubs/pubs/](http://www.irs.ustreas.gov/basic/forms_pubs/pubs/)]; David Langer, "Staking Social Security," *The Christian Science Monitor*, October 30, 2000.

<sup>11</sup> Alicia H. Munnell and Annika Sundén, "Private Pensions: Coverage and Benefit Trends," Prepared for "Conversation on Coverage," Washington D.C., July 24-25, 2001.

<sup>12</sup> IRS, "Publication 590, Individual Retirement Arrangements (IRAs)," Chaps. 4 and 5 [[www.irs.ustreas.gov/basic/forms\\_pubs/pubs/](http://www.irs.ustreas.gov/basic/forms_pubs/pubs/)]. Even with these newer options, of businesses with fewer than 100 employees that do offer plans, the majority still offer 401(k)s. Employee Benefit Research Institute, "The 1999 Small Employer Retirement Survey," p. 17.

<sup>13</sup> EBRI, "U.S. Retirement Income System," December 1998, p. 5; Judy Markland, "The No-Growth in Pension Coverage Problem: Myths about the Role of 401(k) Plans," *Landmark Strategies*, September 1996, p. 4, [www.lmstrategies.com/p&i.html](http://www.lmstrategies.com/p&i.html).

<sup>14</sup> *Seattle Post Intelligencer*, May 3, 2001, "House votes to raise IRA, 401(k) limits;" Jane Bryant Quinn, "Retirement proposals won't aid workers," *Seattle Post Intelligencer*, September 14, 2000; Peter R. Orszag et al, "Proposed Pension Changes Would Overwhelmingly Benefit Corporate Executives and Owners," Center on Budget and Policy Priorities, July 17, 2000; EBRI News Release, May 2, 2001, "Retirement Data Available to Media."

<sup>15</sup> U.S. Dept. of Labor, Pension and Welfare Benefits Administration (PWBA), "Study of 401(k) Plan Fees and Expenses," April 13, 1998, by Economic Systems, Inc., Section 2.7.4.

<sup>16</sup> PWBA, "Study of 401(k) Plan Fees and Expenses," Section 3.3.1.

<sup>17</sup> PWBA, "Study of 401(k) Plan Fees and Expenses," Section 3.3.2.



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- <sup>18</sup> Judy Markland, "The No-Growth in Pension Coverage Problem: Myths About the Role of 401(k) Plans," September 1996, <http://www.lmstrategies.com/p&i.html>.
- <sup>19</sup> Copeland, "Retirement Plan Participation," EBRI, p. 3.
- <sup>20</sup> Mishel, et al, *The State of Working America 2002-03*, p. 126 and 143. Hourly wages are 2000 figures for the 10<sup>th</sup>, 30<sup>th</sup>, 50<sup>th</sup>, 70<sup>th</sup>, and 90<sup>th</sup> percentiles.
- <sup>21</sup> U.S. General Accounting Office, "Pension Plans: Characteristics of Persons in the Labor Force Without Pension Coverage," August, 2000.
- <sup>22</sup> General Accounting Office, "Pension Plans: Characteristics of Persons in the Labor Force Without Pension Coverage," August 2000.
- <sup>23</sup> Pension and Welfare Benefits Administration, "Study of 401(k) Plan Fees and Expenses," Section 2.3.2, April 13, 1998.
- <sup>24</sup> See, for example, the websites of the Vanguard ([majestic4.vanguard.com](http://majestic4.vanguard.com)) and Citicorp Investment Services ([www.citibank.com](http://www.citibank.com)).
- <sup>25</sup> Dean Baker, "Pensions for the 21st Century," (Washington, D.C.: The Century Foundation, October, 1999).
- <sup>26</sup> DRS, "Comprehensive Annual Financial Report, for the Fiscal Year Ended June 30, 1999," p. 6.
- <sup>27</sup> Bureau of Economic Analysis, "Annual Personal Saving as a Percentage of Personal Income," October 2002, <http://www.bea.gov/bea/dn/saverate.xls>.
- <sup>28</sup> *New York Times*, "Workers are enrolling in 401(k) plans, ready or not," published in the *Seattle Post-Intelligencer*, August 28, 2000.
- <sup>29</sup> Withdrawals from most defined contribution pension plans prior to age 59½ are taxed as ordinary income and subject to a 10% tax, except if used to pay medical expenses over 7.5% of Adjusted Gross Income; medical insurance premiums during a period of unemployment; first-time home purchase; or post-secondary education expenses.
- <sup>30</sup> Economists debate the extent to which 401(k) accounts increase savings, as opposed to shifting the form savings take. For a presentation of the argument that retirement savings programs have increased national savings, see Mitchell, Poterba, and Warshawsky, "New Evidence on the Money's Worth of Individual Annuities." The counter argument is presented in Eric M. Engen, William G. Gale, and John Karl Scholz, "The Illusory Effects of Saving Incentives on Saving," *Journal of Economic Perspectives* 10, no. 4 (Fall 1996): 113-38.
- <sup>31</sup> Bureau of Economic Analysis, "Annual Personal Saving as a Percentage of Personal Income," October 2002, <http://www.bea.gov/bea/dn/saverate.xls>.
- <sup>32</sup> Kronson, Marc, "Employee Costs and Risks in 401(k) Plans," U.S. Bureau of Labor Statistics, *Compensation and Working Conditions*, Summer 2000, p. 12.
- <sup>33</sup> Fidelity.com, "Withdrawals from a 401(k) retirement plan" [[www.401k.com/401k/pfp/rp/withdraw.htm](http://www.401k.com/401k/pfp/rp/withdraw.htm)]; MSN Money Central, Retirement & Wills, 401(k): General: Quick Reference.
- <sup>34</sup> Fidelity Investments, "About Workplace Savings Plans," "Contributions and Distributions" [[www.403b.com/non-profits/faqs/wpsqunf.htm](http://www.403b.com/non-profits/faqs/wpsqunf.htm)]
- <sup>35</sup> EBRI News Release, May 2, 2001, "Retirement Data Available to Media."
- <sup>36</sup> Sec. 457. Deferred compensation plans of State and local governments and tax-exempt organizations [[www.fourmilab.ch/ustax/www/t26-A-1-E-II-B-457.html](http://www.fourmilab.ch/ustax/www/t26-A-1-E-II-B-457.html)]; Washington State Department of Retirement Systems, Deferred Compensation Program Overview [[www.wa.gov/DRS/dcp/dcpview.htm](http://www.wa.gov/DRS/dcp/dcpview.htm)].
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- <sup>38</sup> DRS, "Investment Performance as of 6/30/2002," [http://www.sib.wa.gov/FundsUnderMgmt/Funds\\_DC.htm](http://www.sib.wa.gov/FundsUnderMgmt/Funds_DC.htm); DRS, "Deferred Compensation Program: Investment Fund Options," August 2002.
- <sup>39</sup> EBRI, "Personal Account Retirement Plans," July 2000. Data specific to Washington State derived by extrapolating from national statistics.
- <sup>40</sup> See Even, W. and Macpherson, D. "Employee Participation in 401(k) Plans." Department of Labor, 1999.
- <sup>41</sup> See Bassett, W., Fleming, M., and Rodrigues, A., "How Workers Use 401(k) Plans: The Participation, Contribution, and Withdrawal Decisions," *National Tax Journal* v. 51, n. 2 (June 1998): 263-289.