



## REVIEW OF KEY RETIREMENT INCOME MECHANISMS IN THE UNITED STATES

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### **Abstract**

The article describes the major financial mechanisms that are used to generate retirement income in the US (United States). Financing retirement has become an increasingly important topic with recent news about the financial troubles of ZUS (Social Insurance Institution) in Poland and Social Security in the US. Due to strong economic and demographic pressures, saving for retirement has become even more significant. Each retirement income mechanism is discussed in terms of historical backgrounds, functions, advantages, disadvantages, or survey data. The article's objective is to provide a concise summary of Social Security, pensions, financial investments, and 401(k) retirement plans while offering some policy and behavioral recommendations. The 401(k) plans are discussed in more detail since along with Social Security they form the foundation of retirement income for many individuals who are employed in the non-public sector.

**Keywords:**retirement, Social Security, ZUS, pensions, investments, saving

### **Introduction**

Preparing for retirement is a major goal for today's workers. Due to economic, demographic, and educational challenges saving for retirement has become an increasingly more important element of personal financial planning. Although each European country differs somewhat in its approach to retirement preparation, the general theme of an employee's reliance on a strong social network of government-provided retirement benefits is generally present throughout Europe. The retirement system of the US serves as an enlightening contrast to the perhaps already-familiar retirement systems that are present in such countries as the UK (United Kingdom), France, Italy, or Spain. Analyzing the various retirement mechanisms in the US can also provide opportunities for alleviating retirement challenges worldwide.

## 1. Social Security

Social insurance itself originally developed from European roots. In ancient Greece, accumulating olive oil was used as a method to ensure future survival, while during medieval European times feudalism ensured economic security<sup>7</sup>. In Middle Ages Europe even charitable works were viewed as protection for the future<sup>7</sup>. Relatives and land, especially for large families and farmers, also functioned as economic safety methods<sup>7</sup>. In other words, charity, family, labor, and assets were the customary forms of economic protection<sup>7</sup>. Although mostly originating on the European continent, such systems of financial protection were surely present as well to some extent in other agricultural societies throughout Africa and Asia. Such primitive social insurance concepts evolved throughout history and paved the way for the rise of Social Security.

Social Security developed in the US for multiple reasons and serves numerous functions. With such trends as rising life expectancies, fall of the extended family structure, urbanization, and industrialization, the US government was essentially forced into enacting a social insurance framework for its citizens<sup>7</sup>. The US was certainly not the first nation on this scene as “in 1935, there were 34 nations already operating some form of social insurance program”<sup>7</sup>. The official Social Security legislation was enacted on 14 August 1935<sup>6</sup>. What may be surprising is that Social Security offers numerous benefits other than retirement insurance (see Appendix A). In general, the system is designed to protect individuals and their families, elderly people, individuals with disabilities, and children<sup>8</sup>. Similarly to ZUS, Social Security plays a vital part in providing financial security to millions of individuals.

## 2. Pensions

Pensions are a source of retirement income offered by private and public entities. Technically known as DB (Defined Benefit) plans, pensions determine retirement benefits using an employee’s years of service and history of pay<sup>5</sup>. In this discussion, *pensions* refer to these guaranteed-income retirement plans. Railroad companies were pension pioneers, and non-public employees enjoyed pension coverage rates of 12% (1940), 17% (1945), and 55% (1975)<sup>5</sup>. New legislation, such as ERISA (Employee Retirement Income Security Act) (1974) and the 1983 Social Security amendments, greatly increased pension costs for employers<sup>5</sup>. Since exact retirement benefits are unknown until an employee retires, unpredictability is another cost that is faced by the pension provider<sup>5</sup>. Employers, in an effort to reduce administrative costs and transfer market risks to employees, have steadily eliminated pensions (see Appendix B)<sup>5</sup>. Although today pensions are considered a luxury good, especially for older employees these plans are still essential.

The pension system offers several benefits and drawbacks. An employer can adjust pension benefits, such as by permitting an early retirement age, to better control its workforce<sup>1</sup>. Some pensions even allow benefits for “retired” part-time workers, or they permit workers to delay retirement in an effort to receive larger benefits at a later time<sup>1</sup>. For workers, pensions offer predictability and security without the worries of managing an individual retirement account on a regular basis. However, some drawbacks of pensions include high market risks and administrative costs for employers, as well as difficulties in workforce control as a pensioned workforce tends to be less dynamic. Workers cannot save additional amounts in a pension, and they may develop unhealthy saving attitudes since employers bear most responsibility for pension management. Pensions are no longer the key retirement income option.

### 3. Financial investments

To provide for retirement income, an array of possible financial instruments exists. Stocks or pieces of ownership in a corporation offer returns via annual dividends or value appreciation. Bonds or lending instruments used to raise revenues offer returns via regular interest payments. Bank accounts, including checking, saving, and CD (Certificate of Deposit) arrangements, offer minimal interest but typically immediate liquidity. Even credit cards can be used to fund retirement expenses, but due to their exorbitant interest rates and fees they need to be used with caution. Other retirement income options include entrepreneurship investments, real estate dealings, or currency exchanges. Some retirees can even capitalize on collecting or selling valuable or rare objects, but such ventures require physical space as well as costly insurance. The variety of financial investment choices is extensive.

Yet only a few financial instruments are appropriate for providing stable, long-term retirement income. Although the many investment options mentioned above can provide significant returns, they are often also associated with high risk and volatility. When selecting investment options, retirees need to account for market, investment, management, political, demographic, and economic risks<sup>1</sup>. Retirees also need to consider their goals for retirement. Still, if used sparingly and in conjunction with traditional retirement plans, these financial ventures can increase diversification and somewhat reduce overall market risk. These miscellaneous financial assets require an introduction, however, since some investment options like stocks and bonds are the foundation of 401(k) plans.

### 4. 401(k) plans

In contrast to DB plans, DC (Defined Contribution) plans focus on the individual saver. According to this system, “contributions are used to purchase assets, which are accumulated in the account as are the returns earned by those assets”<sup>1</sup>. In other words, an employee regularly sets aside a voluntary portion of her pay and contributes into a DC plan, where the funds are used to purchase pooled assets in the hope of gaining long-term returns. Using such an individual-account saving system encourages employees to manage their own finances in preparation for retirement. Such an invitation can be advantageous because it can develop an increased focus on personal financial management and proactive saving behaviors. However, the DC organization is less predictable and more risky for the individual saver than its DB counterpart. Individuality is the trademark of DC plans.

Employees enjoy a wide variety of DC plans. Governmental and public institutions often provide pensions, but they can also permit concurrent saving in DC plans. Educational and religious organizations offer their own types of DC plans too. Plans vary based on annual employee contribution limits, types of allowable investment options, employer objectives, employee classifications, governmental regulations, and so on. Although a summary of the many types of DC plans that are available is beyond the scope of this discussion, it is useful to highlight perhaps one of the most popular plan types for non-public employees. Variety in the DC market is reflective of the many different kinds of public and private employers.

The history of 401(k) plans is not extensive. Prior to their establishment, TSPs (Thrift-Savings Plans) permitted workers to save after-tax funds<sup>3</sup>. During the 1950s CODAs (Cash Or Deferred Arrangements) allowed workers to save their bonuses on a tax-deferred basis<sup>3</sup>. From such plans, as well as continual legislative updates, laws forming 401(k) plans were setup in 1978, with official regulations coming into effect on 10 November 1981<sup>3</sup>. The latter date is significant because on that day regulatory agencies allowed regular pay (and not only bonuses) to be saved in the plans<sup>3</sup>. Several new rules throughout the years have changed how 401(k)

plans operate<sup>4</sup>. Despite quite a few changes over the past several decades, 401(k) plans have continually reaffirmed their advantages.

The 401(k) plans function based on the principles of accumulation, growth, and withdrawal. An employee chooses the percentage of pay or dollar amount to accumulate, and that amount is deducted from each paycheck and invested in the plan. Once in the plan, the funds automatically purchase shares of specific investment options that the employee has chosen. Over the employee's working life, the account balance grows due to market value appreciation, regular dividend payments, and the rule of compounding. During the withdrawal phase, once the employee is retired or has left the employer, assets are liquidated and the funds are sent to the employee. Depending on plan provisions and account balance, withdrawals can occur partially, fully, or periodically (an arrangement not unlike receiving Social Security benefits). With the three stages of the 401(k) plan lifecycle, employees need to focus on long-term results.

Relating back to the discussion on financial investments, 401(k) plans offer a wide variety of investment options. Although most 401(k) plans agree to stock, bond, and fixed interest funds, some also present specialty funds such as employer stocks or funds targeted to a specific retirement age or economic sector. Among 356 401(k) plans, only 53% of employers offered workers investment option suggestion services<sup>10</sup>. Among the 181 employers offering such services, in 2012 67% of employers used advisers and 40% used computers to give the advice<sup>10</sup>. Concerning investment options, among 335 employers the three most frequently used options by participants included lifecycle (68%), domestic stock (67%), fixed interest (47%), money market (27%), global stock (21%), lifestyle (17%), managed accounts (14%), and employer stock (9%)<sup>10</sup>. See Appendix C for a summary of the amount of investment options available per plan. Investment option variety is certainly an attractive feature of 401(k) plans.

The advantages of 401(k) plans for employees are numerous. A few tangible benefits include convenience, interest compounding, investment option variety, loans, tax advantages, and employer contributions<sup>9</sup>. Due to the power of compound interest, plan balances can increase rather quickly. As an example, assuming an annual contribution of \$5,000 for a decade with an 8% annual rate of return and a starting age of 55 and an ending age of 65, at retirement (age 65) the participant would collect \$78,000<sup>9</sup>! The 401(k) plans also offer customization, where employees can choose their contribution levels and investment options. This way the saving process can align itself with an employee's individual financial goals. Most modern 401(k) plans also offer online and mobile device access, as well as paperless transactions, all of which improve employee account access and awareness. Advantages of 401(k) plans are quite wide-ranging.

Other reasons exist for using 401(k) plans to save for retirement. For an employer, the plan can serve as an employee attraction and retention device. When evaluating employment offers, an employee is more likely to choose to work for an employer that offers a 401(k) plan benefit. Plus 401(k) plans are a cost-saving measure when compared with traditional pensions. An employer can also enjoy the plan's flexibility because different features can be customized (to some extent) to the employer's workforce and its demographics. For example, eligibility conditions, types of investment options, and withdrawal methods can all be adjusted to the employer's specific needs and objectives. The employer even enjoys tax advantages. Regardless of reason, 401(k) plans are productive investments for corporations.

In today's unpredictable financial environment, 401(k) plans play an important role in providing retirement income to many employees. Among 1,000 401(k) plan participants, 87% agreed that the plan is a required benefit when searching for new employment<sup>2</sup>. In fact, 90% of participants stated that reliance on self is vital when considering retirement income, while reliance on government scored only 3%<sup>2</sup>! Looking at the role of 401(k) plans in retirement savings (excluding Social Security), 17% of participants affirmed that the 401(k) plan was the

lone foundation of retirement savings, while 45% indicated that it was the greatest foundation of retirement savings<sup>2</sup>. As pensions continue to decline, 401(k) plans will play an increasingly greater role in securing retirement income.

## 5. Recommendations

Many economic, demographic, and educational challenges certainly impact retirement preparation. Historical events such as economic crises, military conflicts, and political elections have made the economy even more unpredictable. Rising life expectancies together with falling mortality rates continue to strain Social Security, where a smaller amount of workers continues to support a greater number of retirees. Unfortunately many employees lack the financial knowledge and skills that are necessary to successfully utilize their 401(k) plans. Common retirement planning mistakes include over-relying on emotions when choosing investment options, withdrawing funds too early, saving insufficiently, ignoring the inflation rate, and not planning<sup>4</sup>. While far from comprehensive, the recommendations below form a strong start to enhancing employee participation in and knowledge of 401(k) plans. A few of the most important participant-level recommendations include the following:

- Promote regulatory protection and expansion of 401(k) plans through the political process.
- Account for longer life expectancies during retirement income planning.
- Take advantage of employer brochures and online resources to increase 401(k) plan knowledge.
- Realize that Social Security may not be able to provide sufficient retirement income.
- Start 401(k) plan participation on the first day of employment to improve long-term growth.

## Conclusions

With fewer workers supporting an increasing number of retirees, finding long-range solutions to sustain and improve retirement systems is an economic imperative. Social Security provides retirement benefits from the federal government, but its future benefits may be unpredictable and insufficient. Pensions give guaranteed retirement benefits to recipients, but with their high administrative costs and disadvantageous risk structure they are no longer effective options for employers looking to be globally competitive. A variety of financial investments can be initially attractive due to their rates of return, but many of these investments cannot offer the inflation-combating, stable returns that retirees seek. Especially 401(k) plans are effective retirement income instruments. These plans offer employees the ability to voluntarily contribute funds, grow monies in the financial markets, and withdraw assets upon retirement. Participants who follow some practical recommendations can increase their retirement preparedness.

## Appendices

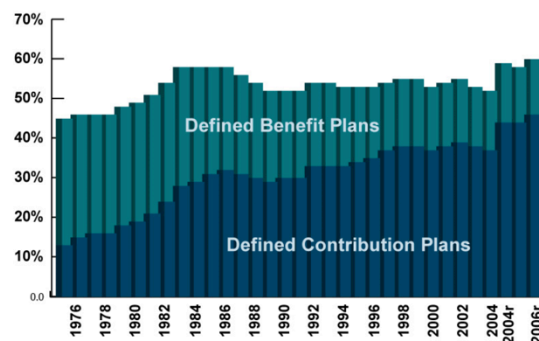
### Appendix A: Social Security programs

Retirement insurance
Survivors insurance
Disability insurance
Hospital and medical insurance for the aged, the disabled, and those with end-stage renal disease
Prescription Drug Benefit
Extra Help with Medicare Prescription Drug Costs
Supplemental security income
Special Veterans Benefits
Unemployment insurance
Public assistance and welfare services:
Temporary assistance for needy families
Medical assistance
Maternal and child health services
Child support enforcement
Family and child welfare services
Food stamps
Energy assistance

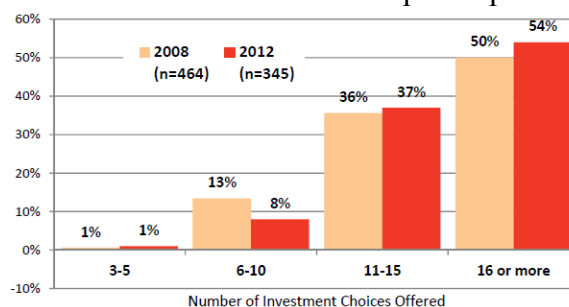
Source: United States Social Security Administration. "Social Security Handbook." Social Security. SSA, n.d. Web. 3 Oct. 2015.  
[http://ssa.gov/OP\\_Home/handbook/handbook.01/handbook-0100.html](http://ssa.gov/OP_Home/handbook/handbook.01/handbook-0100.html)

### Appendix B: Decline of DB plans

Percent of Employees Actively Participating in Employer Pension Plans By Type of Plan (1975 - 2006)



Source: Melp. "A Brief History of Retirement In America." *The Next Hill*. Melp, 18 Oct. 2009. Web. 3 Oct. 2015. <http://www.thenexthill.com/a-brief-history-of-retirement-in-america-part-1.htm>

**Appendix C: Amount of investment options per 401(k) plan**

Source: WorldatWork. “Trends in 401(k) Plans and Retirement Rewards.” *WorldatWork*. WorldatWork/American Benefits Institute, Mar. 2013. Web. 3 Oct. 2015. <http://www.worldatwork.org/waw/adimLink?id=71489>

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## **PRZEGLĄD KLUCZOWYCH MECHANIZMÓW GENEROWANIA DOCHODÓW EMERYTALNYCH W STANACH ZJEDNOCZONYCH**

### **Streszczenie**

Artykuł opisuje główne mechanizmy finansowe, które są wykorzystywane do generowania dochodów emerytalnych w Stanach Zjednoczonych. Finansowanie emerytur staje się coraz ważniejszym tematem w kontekście coraz częstszych informacji o kłopotach finansowych ZUS i Social Security. Z powodu silnych nacisków ekonomicznych i pogarszającej się sytuacji demograficznej oszczędzanie na emeryturę staje się jeszcze bardziej istotne. W artykule zostały omówione mechanizmy tworzenia dochodów emerytalnych od strony środowiska historycznego, funkcji, zalet, wad, lub danych ankietowych. Celem artykułu jest przedstawienie zwięzłego podsumowania Social Security, emerytur, inwestycji finansowych, oraz planów emerytalnych 401(k) oraz przedstawienie kilku autorskich rekomendacji. Plany emerytalne 401(k) są omówione bardziej szczegółowo, ponieważ wraz z Social Security stanowią podstawę dochodów emerytalnych dla wielu osób, które są zatrudnione w sektorze niepublicznym.

**Słowa kluczowe:** przejście na emeryturę, Social Security, ZUS, emerytura, inwestycje, oszczędności

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