Statement before the United States Senate
Committee on Finance
Subcommittee on Social Security

Social Security, Pensions and Retirement Security

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December 18, 2013

Chairman Brown, Ranking Member Toomey and Members of the Committee:

Thank you for the opportunity to testify with regard to Social Security, pensions and the retirement security of the American people.

I wish to make three main points in my testimony:

- First, Social Security's benefits are more adequate, but its financing less healthy, than many suspect. The principal risk to retirement security today is Social Security's insolvency. Talk of raising Social Security benefits before solvency is restored is irresponsible.
- Second, while some look back on a Golden Age in which most workers received benefits from DB pensions, they overlook the significant downsides to DB plans. I would go so far as to say that, were DB pensions the only plans available today, retirement security would be significantly reduced.
- Third, many of the positive attributes of DB plans can and are being incorporated into DC pensions. While DC plans have shortcomings, these are fixable. Problems with DB plans, by contrast, are more difficult to fix.

Social Security: How Generous?

With regard to benefit adequacy, the Social Security Administration states that:

> Most financial advisors say you'll need about 70 percent of your pre-retirement earnings to comfortably maintain your pre-retirement standard of living. Under current law, if you have average earnings, your Social Security retirement benefits will replace only about 40 percent.[1]

But there is a very basic problem with this statement: financial advisors measure "replacement rates" relative to earnings immediately preceding retirement, while the SSA measures replacement rates relative to the wage-indexed average of the individual's highest 35 years of earnings. The technicalities of this latter measure don't matter; what matters is that financial advisors' 70 percent recommended rate and Social Security's delivered 40 percent replacement rate simply aren't comparable. They are apples and oranges.

Table 1. Social Security "Final Earnings" Replacement Rates

Lifetime Earnings Quintile				
Lowest	2nd	3rd	4th	Highest
137%	77%	69%	53%	42%

Source: Springstead and Biggs (2008). Applies to retired beneficiaries age 64-66 in 2005.

In a 2008 research paper with Glenn Springstead of the Social Security Administration[2], I compared households' initial Social Security benefits to their earnings immediately preceding retirement.[3] As shown in Table 1, for a household in the middle of the earnings distribution Social Security pays a replacement rate of around 69 percent of final

[1] Social Security Administration website; "Social Security Retirement Planner: Decide When to Retire," http://www.ssa.gov/retire2/ ; see also Social Security Administration (2005).

[2] Springstead, Glenn, and Andrew Biggs. "Alternate measures of replacement rates for Social Security benefits and retirement income." Social Security Bulletin 68, no. 2 (2008).

[3] The average of earnings in the five years prior to retirement; years of zero earnings were not included in the average.

earnings, close to financial advisors' recommendations. For lower-income households, replacement rates were higher.

Does this mean that Social Security benefits are overly generous? No. But the case for a broad-based increase in Social Security benefits, as some have proposed, is weak. Benefits for low-earners probably should be enhanced, but there is little reason that households in the top fifth of the earnings distribution should be receiving half their retirement income from the government. These Americans need to save more on their own.[4]

Social Security Financing

Social Security is significantly underfunded. While not a threat for current retirees, insolvency is a major risk for people who are middle aged or younger. These are the very same people for whom we are trying to design better pensions, so it is misguided to ignore Social Security's solvency when thinking about broader retirement security. Speaking personally, nothing poses a greater threat to my own retirement security than the chance of a 25 percent legally-imposed benefit cut at the very time I plan on retiring.

To keep Social Security solvent over 75-years without reducing scheduled benefits would demand an immediate and permanent 20 percent increase in the plan's revenues.[5] But even this is too little, since it assumes that we would collect higher taxes from individuals over that 75-year period and then impose massive benefit cuts in the 76th year. This is a misleading measure of Social Security's fiscal demands and, obviously, an unfair policy to follow.

A better measure would be the revenue increases required to keep Social Security solvent over 75 years and financially healthy as of the end of that period (so-called "sustainable solvency"). This would require an even larger immediate and permanent revenue increase of around 29 percent.

The most prominent progressive Social Security reform plan, the "Strengthening Social Security Act of 2013" introduced by Sen. Harkin in March 2013, would raise taxes by nearly this amount (around 27 percent) by repealing the ceiling on taxable earnings, which will be $117,000 in 2014. However, the proposal would devote around one-third of the additional revenues to raising benefits. As a result, the Harkin proposal would address only one-half of Social Security's 75-year shortfall and extend the trust funds' solvency by only around 16 years.

In the process, this proposal would increase the top tax rate on earned income from the current rate of around 43 percent to about 55 percent.[6] Adding state income taxes, some individuals could pay two-thirds of every additional dollar earned to the government, providing significant incentives to reduce work or

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[4] For a broader outline of Social Security reforms, see Biggs, Andrew G. "A New Vision for Social Security." National Affairs. June 2013., http://www.nationalaffairs.com/publications/detail/a-new-vision-for-social-security

[5] The 2013 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds. May 2013. http://www.ssa.gov/OACT/TR/2013/index.html.

[6] This includes the increase in income tax rates to 39 percent, the phasing out of the Pease provision, and the 3.9 percent Medicare tax on high earners included in the Affordable Care Act. The average state income tax rate is around 6 percent, with top state tax rates exceeding 13 percent.

exploit tax shelters.[7] And these tax increases would effectively "tap out" high earners before we have addressed the larger problems of Medicare and Medicaid.

Defined benefit pensions

A defined benefit (DB) pension pays a specified benefit based upon a formula. For instance, the Federal Employees Retirement System is a DB plan and it pays a benefit equal to 1 percent of the worker's final earnings, multiplied by the number of years of job tenure. A defined contribution (DC) plan, by contrast, is like a 401(k): the employer makes a contribution to the worker's account – usually around 3 percent of the worker's wages – but the employee chooses how to allocate the contributions and is subject to the risk of those investments.

While some point to a supposed "Golden Age" of retirement security in which most Americans had traditional defined benefit pensions, the reality is that this Golden Age never existed.

Coverage under DB plans was never universal. Employees in large companies generally had DB plans, but smaller firms often did not offer DB plans -- or other kind of pension. Moreover, coverage under DC plans today is higher than believed. For instance, you may here that "only half of private sector employees have access to workplace retirement savings."[8] But these figures are based on surveys of individuals, who sometimes fail to report pension coverage even if they are offered and participate in one. By contrast, a 2011 study of tax records by the Social Security Administration shows that 72 percent of all private sector workers are offered a retirement plan and 58 percent of them choose to participate. Among larger firms (100 or more employees), 84 percent of workers are offered a pension plan.[9]

Participating in a DB plan does not mean getting retirement benefits from a DB plan. For an employee who remains with the same employer throughout his career, DB pensions can provide a generous, stable retirement income. But DB plans short-change individuals who shift jobs mid-career, in two ways. First, employees who change employers after less than five years on the job may fail to vest in their DB pension, meaning that they are ineligible for any benefits in retirement. Since private-sector workers change jobs about every 4.6 years,[10] this is a serious shortcoming.

Second, even employees who vest in a DB plan may fail to receive meaningful benefits. DB plans are "backloaded," meaning that benefits accrue very slowly through mid-career but then shoot up toward retirement. For instance, consider two employees: one works at the same employer for 40 years, while the second works at four employers for 10 years each. If these individuals have DC plans, they would receive approximately the same benefits at retirement. If they were offered DB plans, by contrast, the short-tenure worker would receive a benefit only around 40 percent as high as the long-tenure worker.

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[7] See Biggs, Andrew G. "The Case against Raising the Social Security Tax Max." American Enterprise Institute Retirement Policy Outlook No. 1. March, 2011.

[8] Rhee, Nari. "The Retirement Savings Crisis: Is It Worse Than We Think?" National Institute for Retirement Security. June 2013.

[9] Dushi, Irena, Howard M. Iams, and Jules Lichtenstein. "Assessment of Retirement Plan Coverage by Firm Size, Using W-2 Tax Records." Soc. Sec. Bull. 71 (2011): 53.

[10] Bureau of Labor Statistics. "Employee Tenure in 2012." http://www.bls.gov/news.release/pdf/tenure.pdf

This is not merely a theoretical problem. According to Olivia Mitchell, professor at the Wharton School and head of the Pension Research Council, only 1-in-10 employees who participate in a DB plan will collect benefits from it.[11] Simply put, a world in which workers only had DB pensions would be one with significantly reduced retirement security.

DB plans' advantages: Can they be transferred to DC pensions?

DB pensions do have several important advantages over DC plans. However, these advantages can be incorporated into DC structures to get, if not the best of both worlds, at least some of the advantages of both.

- *Participation*: Enrollment in DB plans is generally mandatory, while DC plans are optional. As a result, many employees simply fail to sign up for DC pensions. However, so-called "auto-enrollment" can significantly increase employee participation. This approach, which was authorized in the Pension Protection Act of 2006, has spread among plan sponsors. For instance, a survey conducted by the Plan Sponsor Council of America found that in 2006 only 10 percent of plan sponsors used auto-enrollment; by 2010, 24 percent of sponsors used it.[12] However, some are concerned that use of auto-enrollment has not continued to rise since then. Some analysts have suggested making auto-enrollment mandatory among employers who offer plans.[13]
- *Contribution rates*: DB plans also offer a standardized benefit level, whereas some employees contribute too little to DC plans. Even when employers offer auto-enrollment, some do so at low employee contribution levels. This could potentially *reduce* retirement saving for at least some employees, who may not bother to raise contributions above the default level. Increasing the deferral rate under auto-enrollment is a step that could relatively easily raise employee saving and increase retirement security.
- *Administrative costs*: Some argue that management costs for 401(k) plans are too high. In many cases, I agree. Some administrative costs are inevitable, and because these costs are fixed small-employer 401(k) plans have higher fees than large plans. But there is little reason why plans should offer dozens of investment options, often with high fees attached. A limited number of low-cost index funds, such as offered through the federal government's Thrift Savings Plans, would be both more understandable to participants choosing how to invest and provide higher net returns and benefits at retirement.
- *Asset allocation*: It is argued that individuals are unable to effectively manage their investments. These claims are a mix of truth and overstatement. Many individuals fail to monitor their investments and do not alter asset allocations over time. But there does not appear to be excessive "day trading" by DC pension participants. For instance, only around 3,000 of the Thrift Savings Plan's roughly 4.5 million participants took part in active trading, meaning rapidly shifting

[11] "What America's Private Retirement System Gets Right." ThinkAdvisor.com. December 6, 2013

[12] David L. Wray. "The Private Employer System Passes Its Stress Test." Spring 2011 Pension Research Council Conference at the Wharton School. May 5-6, 2011.

[13] See "Alicia Munnell: Make 401(k) Auto-Enrollment Mandatory." ThinkAdvisor.com. July 4, 2013

portfolios in attempts to time the market.[14] The introduction of "life cycle" funds, which automatically shift from stocks to bonds as an employee approaches retirement, can make asset allocation easier.

- *Annuitization*: DB plans generally pay benefits as an annuity (a monthly income for life) while DC plans usually pay out lump sums. Annuities are valuable in helping retirees avoid outliving their assets. However, most retirees already receive a substantial portion of their retirement income as an annuity through Social Security. Moreover, there is no reason DC plans cannot offer annuities as a payout option. The real problem is that, for whatever reason, individuals don't like annuities. Very few purchase annuities, and when DB plans offer lump-sum payouts many participants choose them. This may appear irrational to economists, but it is very clearly what people prefer. If policymakers wish to increase annuitization of pension balances, they must either consider incentives (say, making 401(k) balances converted to annuities permanently tax-free) or mandate annuitization.

Problem (Almost) Solved

It is tempting to conclude that the systems we have don't work and cannot work. In reality, though, simple steps could go most of the way toward fixing the shortcomings of the U.S. retirement saving system.

Consider a defined contribution pension which had

- automatic enrollment…
- at a healthy saving rate…
- invested in a life-cycle portfolio…
- composed of low-cost index funds and…
- at least partially converted to an annuity at retirement.

Such a plan would address most of the concerns raised over retirement security today, with very limited downsides for individuals and no risk to the taxpayer. Moreover, nearly all of this would be allowable under current law.

What can Congress do? First, inform yourselves of the best research available. Retirement security is burgeoning field and today we know much more about how to promote saving than we did a decade or more ago. Second, support this research where you can. The Social Security Administration's Retirement Research Consortium has done excellent work in this field. But the SSA's efforts to promote similar work on financial literacy and planning were canceled due to lost funding. Third, raise awareness of these issues among your constituents, including employers. Retirement plans are improving today largely because employers are learning what works. And fourth, fix the programs you have before thinking about enhancing them or starting new programs.

[14] See "Final Ruling: No More TSP Frequent Trading." www.myfederalretirement.com. April 24, 2008. To prevent this small cohort of active traders from increasing fund management fees for others, the TSP restricted interfund transfers to two per month.