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NEW DIRECTIONS IN RETIREMENT SECURITY POLICY: SOCIAL SECURITY, PENSIONS, PERSONAL SAVINGS AND WORK

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIFTH CONGRESS

SECOND SESSION

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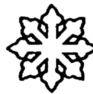

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NEW DIRECTIONS IN RETIREMENT SECURITY POLICY: SOCIAL SECURITY, PENSIONS, PERSONAL SAVINGS AND WORK

WEDNESDAY, JULY 22, 1998

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:30 a.m., in room SD–215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Grassley, Hatch, Mack, Moynihan, Baucus, Rockefeller, Breaux, Conrad, Graham, Bryan, and Kerrey.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE OF THE COMMITTEE

The CHAIRMAN. The committee will please come to order. Today the committee will hear testimony on retirement security. That is, how financially well prepared are Americans for retirement? This is a matter of real concern to many Americans, from the baby boomers who will begin retiring in just 10 years, to the youngest workers just starting their careers.

Perhaps the most discussed challenge to retirement security is Social Security's long-term solvency. According to the Social Security trustees, which include two of today's witnesses, Social Security financial problems begin in 15 years. In 2013, annual Social Security tax revenues will no longer cover benefit payments, and the program will need to call upon trust fund assets.

Preserving and protecting Social Security is a most important, and bipartisan, commitment of this committee. But today's hearing also takes a comprehensive approach to retirement security.

A careful examination of the three other types of retirement income, pensions, personal savings, and work, is important for several reasons. First, although Social Security has been an outstanding success in lifting millions of seniors from poverty, Social Security was always intended to provide only the foundation for retirement income, not a comfortable retirement. Yet, according to the Social Security Administration, Social Security is over 90 percent of the income for one-third of seniors, and over 50 percent for another third.

These data do raise important questions. For example, what can Americans do to diversify their retirement income; what can Con-

gress do to help? Second, although retirement income has been viewed as a three-legged stool of Social Security, pensions, and personal savings, work also may have a key role to play.

Not only can work provide seniors with extra income, but, as the committee will hear this morning, the retirement of baby boomers in the next century may have serious consequences for economic growth. Any comprehensive examination of retirement security must include an understanding of the impact of Federal policies on working by older Americans.

For example, an important step in this regard was taken in 1996. This committee reported legislation that was later enacted that reduced the Social Security earnings penalty, the loss of Social Security benefits because of work that discouraged many seniors from working. But more may need to be done.

Lastly, any changes to Social Security will likely have an impact on other retirement income and Congress will need to be mindful to do no harm while securing the future of Social Security.

However, there is much good news that should hopefully make the job of improving the Nation's retirement social programs easier. First, the prospects for Social Security reform brightened when President Clinton announced in his State of the Union Address in February a commitment to legislative action next year. This morning, administration officials will update the committee on their plan.

The other very good news is the economy. Just last week, the Congressional Budget Office announced a projected surplus of $1.6 trillion over the next 11 years. This surplus provides a unique opportunity to improve retirement security for Americans.

For example, there is a growing bipartisan consensus to establish personal retirement accounts for working Americans. Dedicating part of the surplus to such accounts would get them up and running.

Such accounts would give the majority of Americans who do not own any investment assets a new source of retirement security and a new stake in America's economic growth. Personal retirement accounts would demonstrate the value of saving and the magic of compound interest.

At this stage, I would call upon my good friend and colleague, Senator Moynihan.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Thank you, Mr. Chairman. Secretary Rubin is pressed, as ever, and will have to leave shortly. So I will do no more than thank you for holding this hearing.

But to add to your point. In our discussions of retirement policy now, there has emerged a new dimension appropriate to the end of this century—as the basic Social Security annuity was appropriate to the end of the last century when it began in Europe—the personal retirement account, a lifelong savings and investment system which would leave the citizen not simply with a retirement income, but an estate that would quite change the relationships in society which we have come to think of as the hierarchical relations of an industrial society. This is a wholly new idea. It is shared all

across this dais. I hope it will be listened to as a new idea, with enormous import for the years to come.

With that, I would like to listen to Secretary Rubin.

The CHAIRMAN. Thank you very much, Senator Moynihan.

So we will proceed to our panel. Indeed, it is a pleasure to welcome all three of these distinguished gentlemen. The Secretary of Treasury, Robert Rubin, has been here many times. It is a pleasure to have him again. We do understand you have to leave, so we will immediately go to your testimony. But I also want to welcome Secretary Summers, and of course it is a delight to welcome back the Social Security Commissioner, Kenneth Apfel.

With that, Mr. Secretary, would you please proceed.

STATEMENT OF HON. ROBERT E. RUBIN, SECRETARY OF THE TREASURY, WASHINGTON, DC

Secretary RUBIN. Thank you, Mr. Chairman. Thank you, Senator Moynihan.

Let me start by saying that I greatly appreciate the opportunity to be here with you this morning. I think that the issue that you are raising, which is the question really of savings, part of which goes to the question of retirement and part of which really goes to the health of our economy. It is an extremely important subject, and I would like to make a few observations with respect to savings.

In the first place, savings are obviously very important to families, for all the reasons you have mentioned. But savings are also important, in fact, critical, to the Nation at large. Savings provides the capital which funds investment, investment in turn is central to productivity, and productivity is central to achieving higher standards of living.

Our national savings rate, which, as you know, is the sum of private and public savings, has increased in the last few years from 3.1 percent of the economy GDP in 1992, to 6.5 percent last year. But, having said that, this increase has been the net of a large increase in the public savings rate, while the private savings rate has actually decreased over the past 5 years.

The public savings rate increase, in turn, reflects the move from a budget deficit in 1992 that was roughly five percent of GDP, to a projected surplus for this year. I think critical to that process was the Deficit Reduction Program of 1993.

That, in turn, generated lower interest rates and greater economic growth. What we have had is a virtuous cycle over the last five and a half years, with lower deficits generating growth and growth generating lower deficits.

Notwithstanding the recent increase in our National savings rate, it remains amongst the lowest of the industrialized nations, and is substantially lower than our National savings rate was 20 or 30 years ago.

I do not think there is any question that raising that rate, which is part of the focus of this hearing and of this committee, should be a very high priority for our Nation, especially as we approach the retirement of the baby boom generation.

New capital markets, as you know, allow us to draw on savings from abroad. In fact, net investment has substantially exceeded

savings in this country. Investment in plant and machinery are now at historic highs. But funding investment from abroad is not as desirable as funding it from domestic savings. Efficient as the global financial markets are, these markets are not perfect.

Domestic savers continue to have a preference for the home market. The result is, if you depend on foreign savings, you will have a higher cost of capital than if you can fund your investment with domestic savings.

Moreover, while foreign-funded investment clearly contributes to our economic well-being, the return on the investment goes abroad. I think, most importantly, capital is flowing into this country in recent years because of an economic policy regime that is very favorably viewed throughout the world, and because of strong economic conditions in this country. But there is always the risk that that perception will change, with the result that capital would come in less readily and the cost of capital would go up.

One conclusion from this, is the enormous importance of maintaining a sound macroeconomic environment in our country, including fiscal discipline, so that we can continue to attract capital at low cost. That is, of course, exactly the strategy that countries around the world are being advised to pursue.

Let me say, Mr. Chairman, that it is obviously very tempting, with the projected budget surplus, to cut taxes or increase spending. But I believe, instead, that it is absolutely imperative that we maintain the fiscal discipline which has been so central to our strong economic growth over the past 5 years. I believe we do that by adhering to the President's strategy of putting Social Security on a sound basis before making any other use of the surplus.

Moreover, while our surplus projections are soundly based with respect to the assumptions that are being made, this country has had almost 30 years of deficits and we have not yet had one full year in surplus. Projections are exactly that, projections, not certainties, and subject to change, even great change.

We should not commit to any policy, let alone to a large tax cut, to use the projected surplus until Social Security's long-term financial integrity has been effectively addressed. That strategy will both protect retirement security and protect the fiscal discipline that has been at the center of our economic well-being.

There is no question that fiscal discipline is the hard path, not the easy path. But in my judgment, in our judgment, it is the right path for economic well-being. Large tax cut proposals based on projected surpluses are an unsound and unwise strategy for our future.

Let me make two other observations about what will and will not contribute to increased savings, in our view. Most economic work strongly suggests that transforming the tax system to some form of consumption tax, a flat tax or a VAT, would have little impact on the savings rate.

The underlying thesis is that the savings rate is not very sensitive to the after-tax rate of return. Most academic work tends to ascribe to that view. Therefore, I do not believe there is a savings argument for reducing the progressivity of the tax system.

On the other hand, there is a broadly held view among economists that education and measures to facilitate savings do have an important impact on savings.

Examples of successful education campaigns include the savings bond campaign and the marketing of IRAs and 401(k) plans. Pension reform and IRA reforms also have facilitated savings.

I believe, Mr. Chairman, that this committee is making an important contribution to our Nation's economic health by focusing on the importance of savings in all of its many aspects.

Deputy Secretary Summers and Commissioner Apfel will be discussing various aspects of retirement savings in more detail. I look forward to working with this committee.

We all look forward to working with this committee on these extremely important issues and on maintaining our Nation's fiscal discipline, both to benefit families and to promote economic well-being in this country. Thank you very much.

The CHAIRMAN. Thank you, Senator Rubin. I understand that you do have to leave.

Secretary RUBIN. You referred to me, Mr. Chairman, as Senator Rubin.

The CHAIRMAN. I did that once before.

Secretary RUBIN. Yes. And Senator D'Amato took exception. [Laughter.]

The CHAIRMAN. Mr. Secretary.

Secretary RUBIN. Do you think it is a demotion, John?

The CHAIRMAN. I would agree with that evaluation of that title.

Just let me make one observation. It is interesting that Business Week, I think, two or three weeks ago recommended that the surplus be returned to the working people to help ensure that the economy continues to grow, so there is a legitimate difference of opinion on that issue.

I do appreciate your being here, as always, Mr. Secretary, and we look forward to working with you in the future.

Senator MOYNIHAN. Mr. Chairman, might I just say that Senator Kerrey and I have a bill and, Senators Gregg and Breaux have a bill, which would reduce Social Security payroll taxes for workers by $800 billion, while keeping the Social Security financially stable. You can choose your tax cut, but if I had to give it, I would like to give it to people who need it.

The CHAIRMAN. We look forward to working with you, Senator Moynihan, in developing and enacting a major tax cut for the American working people.

The vote has been called, so the committee will be in recess. Thank you, Mr. Secretary.

Secretary RUBIN. Thank you, Mr. Chairman.

[The prepared statement of Secretary Rubin appears in the appendix.]

[Whereupon, at 9:49 a.m., the hearing was recessed to reconvene at 10:20 a.m.]

The CHAIRMAN. The committee will please be in order.

Secretary Summers, we would like to proceed with your testimony.

STATEMENT OF HON. LAWRENCE SUMMERS, DEPUTY SECRETARY OF THE TREASURY, WASHINGTON, DC

Mr. SUMMERS. Thank you very much, Mr. Chairman. I have a longer statement to submit for the record.

The CHAIRMAN. All statements will be included as if read.

[The prepared statement of Mr. Summers appears in the appendix.]

Mr. SUMMERS. Secretary Rubin spoke in his testimony to the importance of national savings to the future of our economy and the importance of maintaining fiscal discipline.

What I would like to do is talk a little bit about those questions in the context of Social Security reform, and also in the context of the other pillars of our retirement savings system, pension saving and personal saving.

Our economy right now is as healthy as it has been in a generation. But it may not always be in such a strong position, and will certainly never be in a stronger position to face the major challenge of an aging society. When the Social Security Act was passed in 1935, American life expectancy was 62. Today, in some groups, a married couple of 65-year-olds has an even chance of seeing a survivor reach the age of 90.

As a consequence of these developments, the dependency ratio, which was 5:1 as recently as 1960, is now 3.3:1, and in little more than 30 years' time will be 2:1, and falling. There is a time to reap and a time to sow, and now is the time to sow and to prepare to meet this great challenge.

That is the case for reserving the surplus until the Social Security program has been put once again on a sound footing for this generation, the next, and the next. It is a fiscal imperative to do so, it is a broader economic imperative because of the increase in national savings that will result, and it is a national imperative to maintain Social Security as a basic public trust.

One in six of our seniors receive all of their income from Social Security; the bottom two-thirds of the population receive half of their total income from Social Security. Without Social Security, nearly half of our seniors would be in poverty.

As we think about modernizing the Social Security system, reforming the Social Security system, it is important to remember the tremendous efficiency of this system. More than 99 cents of every dollar that is collected from workers and employers by Social Security, more than 99 cents, is paid out in benefits.

As efficient as our financial services industry is, one recent study estimates that during the pay-out phase of privately provided annuities, the loss to overhead alone averages more than eight cent on the dollar.

Another study of life insurance firms found that, on a per dollar basis, expenses totaled some 16 percent of contributions.

What is crucial, is not that we prejudge this debate over Social Security, because this is a year when we need to be open to all ideas and think through these issues as carefully as we can, but that we pay attention to crucial questions: what kinds of plans will best assure an adequate stream of benefits for future retirees; will provide for a careful balancing of risk and return that can assure that Americans' future benefits are secure; that can assure that a

reform system continues to provide financial security, not just for retirees, but also for survivors and the disabled. One in three Social Security recipients is not a retiree.

That we recognize, as we make our comparisons, that we have a large and present obligation to our parents, that the lion's share of current Social Security taxes are going to meet that obligation, and that we continue to meet that obligation. Finally, that any system maintain America's hard-won fiscal discipline as we look forward to a period of budget surplus.

I might say, Mr. Chairman, that after years of hearing people in the financial community speak about the threat and problem of crowding out by budget deficits, I was gratified to hear complaints that there might not be enough liquidity in some of our bond markets because we were not selling enough bonds. How different a world it is.

As crucial as Social Security is as an element of this savings picture, it is also crucial that we work to strengthen the other two legs of the stool. Crucial, in this regard, is private pensions where one fact stands out above all: half of all American workers are not covered by a meaningful retirement plan.

One important reason is that so many employers fail to offer such plans. Another important reason is that, in many cases, there is lack of demand, a lack of demand that is remediable through education and persuasion.

We have made important progress in recent years on these issues. The SIMPLE, a new retirement savings plan introduced last year as a low-cost option for small business, is proving popular with small business owners and their employees. We have changed the law to exempt tax-exempt organizations to sponsor 401(k) plans.

Crucial proposals going forward that are contained in the President's budget and that we hope will be acted on this year include measures to encourage payroll deduction or direct deposit IRAs by allowing employers to offer workers the opportunity to make IRA contributions on a pre-tax basis through payroll deductions.

I might add that these provisions would facilitate taking advantage of the very substantial improvements in the IRA program that were achieved last year under your leadership.

Providing a new 3-year tax credit for the administrative and retirement education expenses of any small business that sets up a new retirement plan or payroll deduction arrangement.

Finally, offering new options for simpler to administer pension plans for small businesses. In these ways, I believe we can work to expand pension coverage as a complement to strengthening Social Security.

But of course, the third pillar of our retirement security system is private savings. With the economy performing so well and elder members of the baby boom generation coming closer to retirement and to their peak asset accumulation years, one might expect a high personal savings rate for the Nation. But this has not been the case. The personal savings rate hit a 50-year low last year.

We need to work together to promote personal savings. I have already referred to the impressive progress that was made with respect to IRAs in the last year. At the Treasury, we have added in-

flation indexed bonds that provide guaranteed future purchasing power to the roster of government securities, and just two weeks ago, introduced for the first time, inflation index savings bonds to provide guaranteed purchasing power for the smaller savers.

Certainly we have to look to harness new technology in making information available about savings, and the savings bond program, in particular, more readily available to all Americans.

Mr. Chairman, I believe we are discussing a set of issues that are crucial to our country and to its people. For millions of Americans in the next century, the period of retirement will be almost as long as the period of working life.

In that context, the question of saving and preparing becomes an absolutely critical one. It is not something that can be done in any single way. That is why we need a three-part system, relying on Social Security, pensions, and private savings.

It is something in which I think we all have to cooperate, Democrats and Republicans, the executive and the legislative branches of government, the young and the old, because it is a truly crucial challenge. Now when our economy is so strong is the time to meet it.

The CHAIRMAN. Thank you, Secretary Summers. Having spent the weekend hearing about how the Japanese save too much, it is too bad we cannot switch problems.

Before we go to the question and answer period, we are looking forward to hearing from our Commissioner. Mr. Apfel?

STATEMENT OF HON. KENNETH S. APFEL, COMMISSIONER OF SOCIAL SECURITY, WASHINGTON, DC

Commissioner APFEL. Thank you, Mr. Chairman, Senator Moynihan, and members of the committee. I thank you for the opportunity to testify today on the issue of retirement income policy. I ask that my detailed statement appear in the record, and I just have some short remarks to make before the committee.

The CHAIRMAN. Without objection.

[The prepared statement of Commissioner Apfel appears in the appendix.]

Commissioner APFEL. Ours is an aging society, and ensuring a sense of economic security for retired workers and their families has never been more critically important. Like most policy makers who have studied the issue, I believe we need a comprehensive retirement income policy that includes both private pensions and savings or investments, but that rests upon a solid foundation of benefits such as Social Security provides.

While Social Security does face long-term financing problems, we also need to remember that Social Security has been the most universal and dependable source of retirement income for generations of Americans.

We, therefore, should act prudently in dealing with an issue that affects the lives of so many families. We can act prudently because there is no immediate financing crisis, and we hope to work in a bipartisan basis on lasting Social Security reform.

The 1998 Trustees Report states that, "Social Security's combined trust funds increased by $88 billion in 1997, and that reserves totaled more than $650 billion at the end of last year. The

trust funds are projected to continue to grow through the next two decades, when they reach almost $4 trillion."

However, the board of trustees also states, as the Chairman rightly points out, that "benefit payments will begin to exceed tax income in 2013," not that many years in the future. Because of interest income, total income will still exceed benefit payments until 2021, at which time the trust funds will begin to decline until they are exhausted by 2032. At that point, tax revenue would be able to pay only about three-quarters of benefit obligations.

How should we address this shortfall in Social Security financing? The President has said that we need a national year-long dialogue on this issue, followed by a White House conference in December and bipartisan action early in 1999.

I believe the national dialogue is especially important. Discussions about the future of the Social Security program need to take place not only in think tanks and Congressional hearing rooms on Capitol Hill, but also in family living rooms all across America.

Over the past months, I have personally participated in dozens of public forums designed to educate the public about this program and to discuss the pros and cons of options for ensuring its future. SSA's staff has conducted more than 5,000 meetings, presentations, and other public outreach events on this issue.

We have emphasized several facts that the American people need to know. We explained that the underlying reason why changes are needed in the Social Security program is demographics, as Secretary Summers pointed out. Americans are living longer and healthier lives, and that is great news for this country.

In 1940, the average life expectancy for a 65-year-old was 12½ years. Today, it is 17½ years and rising. It is not just the number of years people are living, it is the number of people living them. Today, there are approximately 34 million older Americans. In 2030, when all of the baby boom generation has reached retirement age, there will be more than twice that many. These demographic changes will place real strains on the Social Security system.

We also remind audiences that Social Security is more than just another government program, it is one of the financial foundations for American families, and it is the most successful domestic program in our history, in my opinion. It would be hard to overstate the importance of Social Security in improving the lives of older Americans, in particular. Today, only about 11 percent of older Americans fall below the poverty line. But if Social Security disappeared tomorrow, one-half of all older Americans would be living in poverty the day after.

While I have often spoken of the need for personal savings and pensions to ensure comfortable retirement, I also know that Social Security has been the foundation for America's retirement system.

Social Security is much more than a retirement program. It provides valuable insurance protection in the event of death or disability. This protection is extremely important, especially for young families struggling to afford adequate private insurance policies. Almost one in six of today's 20-year-olds will die before retirement, and nearly three in 10 will become disabled.

I also believe it is important for Americans to understand that an adequate retirement is only assured if one complements Social

Security with savings and pension income. In 1996, only 7.5 percent of aggregate pension income went to aged individuals in the bottom half of the income distribution, and they held only 6.5 percent of aggregate savings. When I look at these facts, it seems clear that many of these same aged individuals are sitting on stools with only one leg: their Social Security.

Partly because of these facts, the President believes any potential solution to the long-range Social Security financing problems reflects several longstanding principles. Basically, Social Security reform measures should provide a foundation of support that people can always count on; it should continue to provide financial protection for vulnerable Americans, disabled workers, survivors, and others; we should maintain a universal, fair, and progressive nature of the system and maintain our fiscal discipline.

Finally, let me say that we have an historic opportunity at hand. We can and we should take action on these retirement issues while the economic times are good. We can and should take bipartisan action that will assure working Americans that they, their children, and grandchildren will be able to enjoy a comfortable retirement after a lifetime of labor.

I look forward to working closely with members of this committee and with other members of Congress in fashioning a wise and enduring retirement income policy. Thank you very much.

The CHAIRMAN. Gentlemen, it is my understanding that the Social Security trustees project a sharp decline in the real rate of economic growth over the next 20 years. Such forecasts follow from the population aging and, of course, its impact on the two engines of economic growth, labor force participation and productivity.

My questions are, do you agree with this projected trend in economic growth; and second, should protecting future economic growth be a goal of Social Security reform? If so, what specific recommendations do you have regarding the labor force participation and capital formation? Secretary Summers?

Mr. SUMMERS. Mr. Chairman, British Prime Minister Harold Wilson once advised economists in the political arena to name a date or a number, but never name both. I think that is useful advice with respect to economic forecasting.

There is no question that we can see, just from who has been born in our country already, that the growth of the working-age population is going to slow in the next 25 years. It is very likely that the trend towards increased female labor force participation that we have seen will slow in the years ahead, simply because we are reaching levels of full participation in some age groups so there is less reason to move.

Forecasting productivity growth, I think, is extremely difficult. After a period of 15 to 20 years after 1973, when the focus of the discussion was on the productivity slow-down, there have been in recent years some much more favorable indications, suggesting that information technology investments and the like are finally bearing fruit in the form of some increase in productivity growth. So, I think the long-run situation is difficult to judge.

I think we are best off making all of our plans on a conservative basis, however. In that sense, it would be unwise at this point to

assume that we could confidently project that the increases in productivity would offset the demographic factors that I mentioned.

I do think it is important in the design of Social Security to keep in touch with the economic growth objective, and that the most important way to do it is to ensure that the Social Security reforms we undertake are consistent with fiscal discipline and are consistent with increases in the national savings rate, because it is that that makes possible the increased capital formation that is a crucial part of increasing economic growth. I think the growth imperative is one of the factors that points to the significance of the fiscal discipline.

The CHAIRMAN. Mr. Apfel?

Commissioner APFEL. Mr. Chairman, the trustees presented three alternative scenarios. The intermediate assumptions, which are the ones that are the more traditional ones that the public sees in more fulsome detail, we believe are the most appropriate vehicles to be used for projecting the future.

Clearly, there is a more optimistic scenario with higher rates of productivity increases, and also a more pessimistic scenario. But the intermediate assumptions, we believe, provide the best basis for planning for the long-term future of the Social Security system. That is why we use the intermediate assumptions in our projections.

There are some that argue that we should be planning on more optimistic economic assumptions, there are some that argue that we should be using much more pessimistic assumptions. My own belief, after listening to all the experts, that the plan using the intermediate, pragmatic assumptions that were used is the best basis for assuring the future actions that we need to take to ensure the long-term solvency of Social Security.

The CHAIRMAN. Let me turn to another question. As you know, there have been proposals for aggregate investment of the Social Security trust fund in the stock market. This approach does raise a number of issues, particularly the one of whether political considerations would influence stock picking. What is the administration's view on having the Federal Government invest Social Security surpluses in the stock market?

Mr. SUMMERS. I think, Mr. Chairman, it is one of the many issues that needs to be debated back and forth during this year of dialogue about the Social Security system.

The proponents rightly emphasize that, historically, the stock market has had higher returns than other markets and rightly emphasized that, by investing it in a trust fund, one maximally spreads the risks out over time and insulates specific individuals from those risks, and point to the Federal thrift plan as an example of a successfully administered, without undue political interference, public support for investment in equities.

Those on the other side rightly raise the concern that markets go up and markets go down, and that it is easy to form too rosy a view after a period of remarkable performance like we have had in the last 16 years, and also raise questions about, if funds were invested on a large scale, what types of political mechanisms could be put in place to insulate those funds from inappropriate kinds of

selection of investments or interference in the management of companies.

I think both sides look at international experience and draw their own conclusions. At this point, these are issues we are very much involved in studying and watching, but do not have a settled position. It is obviously a very important issue.

The CHAIRMAN. Mr. Apfel?

Commissioner APFEL. I think Dr. Summers handled it appropriately. The administration has not taken a position on investing in equities. There are very real trade-offs. Potentially, if the stock market performs as it has historically, it could increase rates of return to the Social Security system and reduce the size of the changes that would be necessary in the out years.

But there are also very real trade-offs in terms of corporate governance and the government involvement in the stock market. That is really what this year ought to be about, is to try to wade through those options.

The President's forum next Monday in Albuquerque that he will be attending with the AARP and the Concord Coalition is just this issue, to talk about the pros and cons of this particular option.

So we do not have a position at this point in time. We are looking at both the pros and the cons and listening to experts on it.

The CHAIRMAN. Let me point out that five members of this committee have been working on proposals to establish personal retirement accounts in some fashion for working Americans. I have done so, my friend and colleague Senator Moynihan, Graham, Breaux and Kerrey. I wonder if the administration has given any thought on this subject. Does it have any recommendations for developing such proposals?

Mr. SUMMERS. Mr. Chairman, we have been following your work and that of other members of the committee very closely on this question, and I think that I cannot add to the eloquence of various members of this committee in speaking to the potential benefits of universal wealth accumulation and of possible individual responsibility with respect to providing for retirement security.

I would hope that, in consideration of individual accounts as a possible element in Social Security reform, that very careful attention would be paid in thinking about those in three aspects, in particular. One, the need to maximize efficiency.

As I noted in my opening statement, 99 cents out of every dollar that is contributed to Social Security is paid out in benefits. International experience, which I think could clearly be improved on, is that the leakage to administrative costs in a number of countries is as much as 20 cents or more on the dollar. That is something that I think has to be looked at carefully, in the way in which these systems are designed.

Second, it is crucial, I think, not to undercut the traditional progressivity of the Social Security system, and in particular the basic assurance that it provides to those who have low incomes through their lives, and those who encounter disability or who survive, or who find themselves to be survivors, and needs not to be something that erodes the traditional sense of social protection.

I think the third thing that has to be looked at very carefully, is the question of assurance of benefits. It is very tempting at a mo-

ment like the present when the Dow is at a level that is more than 10 times what it was just 15 or 16 years ago, to assume that individual accounts will perform remarkably well on an indefinite basis.

But experience is that there are inevitably fluctuations, and there are very weak periods in markets as well as very strong periods, and I think that has to be recognized in the design of any possible proposal.

But certainly, for the administration's part, it is one of wanting to study all of the proposals that are out there and to look at these kinds of particular elements in the context of overall plans and the extent to which the overall plans meet the President's principles in terms of the assurance of benefits, and certainly the individual account notion is one that will figure very prominently in these debates.

The CHAIRMAN. Can I construe that to say that, you support the concept? [Laughter.]

Mr. SUMMERS. Mr. Chairman, I have been studying with Professor Greenspan in the art of responding. I support its careful consideration, along with all approaches in the context of our work on this issue.

The CHAIRMAN. Let me ask one quick, final question. On several occasions the President has acknowledged the payroll tax burden, and indicated that Social Security's financial problems could be fixed with no increase in payroll tax. Does this continue to be the administration's view?

Mr. SUMMERS. Yes.

Commissioner APFEL. The President believes that Social Security reform is achievable without an increase in payroll tax rates.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Thank you. You are all pledged to ambiguity here. You have said rates, but you did not say caps, and such-like. Can I say to my friend, Secretary Summers, that the proposal that both Senator Kerrey and I have proposed does meet those three tests of low administrative cost through thrift savings plans, and we preserve progressivity and we build on the existing Social Security foundation as an annuity that is there, regardless.

I would like to move to just a slightly different subject that Mr. Apfel could help us on. You, sir, mentioned that the administrative costs of Social Security is 1 percent of outlays. It is probably a terrible thing to say, but I have been wondering whether that has been large enough.

The Commissioner says that Social Security is the most successful domestic government program in our history. Well, if it is so, sir, why do a majority of non-retired adults think they will not get it?

Commissioner APFEL. I believe this is one of the central issues facing this country, which is, how to provide assurances to the American people that Social Security is going to be there. Is it going to be there? It absolutely is going to be there, but there are going to have to be changes.

Senator MOYNIHAN. Well, sir, I am going to say to you that if a majority of non-retired adults do not think it is going to be there,

they are not going to miss it if it is taken away. That is a political view as against an actuarial one.

Commissioner APFEL. Senator, in any view, I believe that the way to restore the public confidence in the Social Security system is by taking the actions necessary to ensure a solid——

Senator MOYNIHAN. But how do you think it got lost? How did it leak out? I mean, 60 years, never a day late or a dollar short.

Commissioner APFEL. It is clear that the long-term demographic shortfalls are very real, and people have very serious concerns about the future of Social Security.

Senator MOYNIHAN. Do you think people think about long-term demographic shortfalls? I will give you a thought. In 22 years, we finally got you re-established as an independent agency.

The Social Security Administration has been so, I think, preoccupied, with sort of a professional pride that they have only a 1 percent cost of administration, that they would never spend the money on the stamp to send people paying this tax an annual report on what they had paid in taxes and what they could expect to receive in benefits; is that not right?

Commissioner APFEL. That is absolutely right.

Senator MOYNIHAN. Yes.

Commissioner APFEL. And it is through your leadership and my active, full, entire support that we are moving towards providing this information to millions of Americans a year, and by the year 2000, to all Americans.

I think the public education components of Social Security are centrally important. I have significantly expanded the number of employees within Social Security that are engaged in public education activities.

As I indicated in my testimony, we have done 5,000 forums and town meetings and events around the country this year to try to change the culture within Social Security to providing more of a public education component, PEBES. The statement you referred to as a centrally important part of that.

Senator MOYNIHAN. Personal Earnings and Benefits Statements.

Commissioner APFEL. It is a centrally important part of that.

Senator MOYNIHAN. It was a 20-year struggle. Then try to get a Social Security card that looks like a proper card. I remember the original. It was charged that President Roosevelt was introducing an identity card, and the Social Security card said, "For Social Security Purposes. Not for Identification."

By 1982, I got a little measure on an immigration bill that said they would produce a tamper-proof card. So Jose Martinez can show it to his employer and say, here is my card and I am a good fellow, legally in this country. And the employer could be able to verify the authenticity of the card.

The administration got the proposal and it got lost in HHS then; 2½ years later, back came the same card, the same piece of cardboard, but with invisible fibers instantly detectable in an FBI lab to tell you if it was counterfeit. [Laughter.] I mean, there was an administrative mentality from the 1930's that has not wanted to tell people what they felt they did not need to know because the administrators knew it. So they kept a paper card that looked like

the one Dr. Podoff was issued in 1956 and which said: "For Social Security Purposes. Not for Identification."

But one quick question, and on this subject. About 70 percent of American retirees take benefits before age 65. What do you know about that? There must be a range of reasons, but what does that suggest to you?

Commissioner APFEL. It is one of the more profound changes in labor force participation in this country, is the increase in the number of people who are retiring at age 62.

Senator MOYNIHAN. Is that because they are comfortable already, they have their house in Sarasota, or because their back hurts, or a whole range of things?

Commissioner APFEL. Well, Senator, I think there are absolutely a whole range of things. From surveys that have been done, a number of people who retire earlier than the normal retirement age, which is 65 currently, although people can retire at age 62, a number of people report some health problems, and that is clearly one variable.

The presence of the Social Security benefit at age 62, clearly, is another variable. The increase in personal savings and in retirement coverage is also a variable. So, there are a number of variables. But it is one of the more dramatic changes in this country of the 20th century.

Senator MOYNIHAN. Yes. Seventy percent of our retirees take Social Security before age 65. I wonder if we could ask you to put together a sort of paper on this for us and the range of what you know and what you might want to find out.

Commissioner APFEL. I would be more than——

Senator MOYNIHAN. Could I urge you not to fear spending a little money to find out?

Commissioner APFEL. One of the things that we are very pleased about, Senator Moynihan, is this committee's support for a major increase in our research budget to enable us to do this kind of stuff.

Senator MOYNIHAN. Thank you very much.

Commissioner APFEL. I will provide for the record the information we have on the retirement age of 62, the reasons for, et cetera.

Senator MOYNIHAN. Thank you very much.

Thank you, Mr. Chairman.

[The information appears in the appendix at page 53.]

The CHAIRMAN. Thank you, Senator Moynihan.

Senator Breaux?

Senator BREAUX. Thank you, Mr. Chairman. Thank you for holding this hearing. I think it is incredibly importantly. Hopefully, 1998 will at least become known as the year in which Social Security being considered the third rail of politics died, because people, in fact, are talking about it, people are willing to discuss options.

We are able, I think, to intellectually discuss the problem, both with seniors, with young people, and working people. They know it is a problem. We can no longer sweep it under the rug. We are actually talking about ideas that are somewhat controversial, but are ideas that need to be discussed fully and competently, and by members of both parties. Democrats cannot solve this problem by themselves, and neither can Republicans. We both tried it that way, and we get nowhere.

I would congratulate the Chairman for having this hearing. I would point out that, under Chuck Grassley's leadership in the Aging Committee, on which I am pleased to serve, we have had three hearings on this subject.

The first hearing was on defining the nature of the problem and looking at generic solutions; the second one was on individual accounts versus government investing; the third set of hearings was on the retirement age.

We had GAO reports done on each one of those issues. I would hope that you all are mindful of what we are doing, not only in this committee, but in other committees as well.

Secretary Summers, suppose you are back at Harvard and you are teaching a class on economics and this bright kid in the back of the room raises his hand and says, Professor Summers, give me your opinion on what I should do with this money I have got.

I have an option to invest it in government securities, which is giving me a 2.7 percent return and put it all in that account, or I can take it and put all but 2 percent in that account, but take the other 2 percent and invest it in a thrift savings plan with a high-option, moderate risk, and low risk account and it would be my account. It would be run by the government, but it would give me a range of opportunities to invest. Which one should I take, Professor Summers?

Mr. SUMMERS. I would probably begin with a set of wisecracks about professors not being known for their investment acumen. [Laughter.]

Senator BREAUX. But after that pause is over, what would you say?

Mr. SUMMERS. I would probably continue by asking my lawyer for a waiver with respect to any investment advice that I was going to proceed, since I suspect I am going to have more difficulty avoiding your question than I would a student's question.

I would probably advise someone who was making investments for the long term to find a prudent mix of several different types of financial assets that were invested in a low administrative cost, highly diversified way, would probably be my advice.

Senator BREAUX. Sort of sounds like the Federal thrift savings plan that all of us are in.

Mr. SUMMERS. In many ways, it is like the Federal thrift savings plan. Of course, I would also advise that my student not fail to meet any of his existing obligations in order to allocate money to whatever savings vehicle was under discussion.

Senator BREAUX. Make sure he keeps enough to pay tuition to the school. [Laughter.]

Mr. SUMMERS. My salary. Absolutely.

Senator BREAUX. All right. I asked that question because Senator Moynihan and Senator Kerrey have been actively involved in this. Senator Judd Gregg and I have introduced the CSIS proposal, which all are quite aware of, which sets up basically what I said, plus some other things that are important, including things dealing with progressivity, guaranteeing that no one who works 40 years would get less than the poverty rate to retire, which we do not guarantee now, and makes it more progressive.

I think it is a good proposal. It is not without controversy, but you are not going to solve this problem without controversy. If someone is running around the country looking for a way to solve this problem that is not going to be controversial, good luck, but it is not going to happen.

It is going to be controversial. The only way we are going to solve it, is working together on it. I appreciate what you all are doing with this dialogue, because I think it is very important.

Just for my colleagues, the Federal thrift savings plan, since 1988, when it was started, 10 years. If you look at the rate of return on the high-risk, medium-risk, and low-risk, it has averaged out about 15 percent over that 10-year period.

The government manages it, but people have a choice of what they want to do. I just think that we have to move to something like that in order to get a realistic rate of return on the trust fund assets which are so necessary if we are going to have a sound system.

So whether it is Senator Moynihan and Kerrey's proposal, or our proposal, or what have you, I think that is an important feature.

Another thing is the retirement age. We have got to make a decision. We have 16 people working for every one person in retirement in 1950. It is now down to about three and a third, and is headed for two. We cannot sustain that. That is unsustainable.

We are going to have one person working for every person in retirement and it is just not going to work. So we have to be realistic about that. In 1940, the average male life expectancy was 61 years. Today, it is 73.

So what we have done, it was proper to have about 12 years after a person retired for Social Security benefits back in 1940. How long out there are we going to have a retirement period for people to be able to have a retirement program that works? That has to be addressed as well. So those are the thoughts that we are approaching. If you have any additional comments, I would appreciate it. If not, just agree with me and we will go on from there. [Laughter.]

Mr. SUMMERS. I would say, Senator Breaux, that every one of the issues that you have discussed has trade-offs. As you pointed out, there is not a painless choice out there. What this year has been about, is to try to lay out the pros and the cons to the various alternatives and none of them has been in a vacuum of painlessness. There are serious choices out there.

Senator BREAUX. At least we are talking about it.

The CHAIRMAN. Senator Conrad?

Senator CONRAD. Thank you very much, Mr. Chairman. Thank you for holding this hearing. I do think this is, as Senator Breaux has indicated, a critically important discussion.

In fact, for the long-term economic security of our country, I do not think there are any two more important issues than what we do to reform the basic entitlements of Social Security and Medicare.

If we could get this right, we could put our country on a long-term course that would be extraordinarily important to the future economic success of our Nation. So I do not think there is any more important subject than the one you have brought to our attention today.

I would like to ask the two witnesses what you are hearing. You have been going around, listening across the country. I know you have not reached conclusions, and I am not asking for conclusions. But I am asking for some sense of the pros and cons of the major options.

Specifically, obviously, one way to go is to basically use the current system, but to shore it up, stop raiding the Social Security trust fund surpluses, pay down the debt, and basically keep the structure that we have.

The second option, is to have some part of what an individual has attributed to them under their control in personal accounts.

The third option, is that the Social Security Administration itself invest in equities, at least part of the money that they have in equities. Those are three broad options. I would be interested in just a thumbnail discussion of what you are hearing around the country with respect to those three broad options.

Commissioner APFEL. What I am hearing, Senator, is a belief that, for the greater good, we need to take whatever actions are necessary to ensure the long-term security of the Social Security system. I think there is a lot of belief in wanting the Social Security to be strong and vibrant.

When it gets to the various options, and you just laid out three classic ones, there is a great deal of disagreement, sometimes vehemence, about the various options that are out there, skepticism about any one of the three things or any of the other options that Senator Breaux laid out there.

So, I have not seen yet in my travels a consensus emerge on any one of the approaches about how to ensure the system will be there. But what I have heard very consistently, is that we have a responsibility as a Nation to move forward to ensure that we are going to have economic security for the future. What I am hearing increasingly is a belief that, yes, we have a long-term, serious problem that we need to address, and we should.

So consensus seems to be emerging on, we have a serious issue, and two, the importance of Social Security, and we need to do something. But I have yet to see the consensus emerge yet about what the various options are going to be and how to make those choices.

Senator CONRAD. In terms of individual accounts, the criticisms that I have read and heard have largely revolved around two issues, and I would be interested if these are the two that you are hearing in terms of possible criticisms.

One, the administrative difficulty, that these would be relatively modest accounts. I have seem some suggestions that it would be about $240 a year that a person would be putting in, and that the administrative cost and the administrative difficulties would be prohibitive.

The second, is the risk. That is, people go into it, obviously the stock market is high now. All of us who have followed the stock market know, sometimes the stock market plunges, at least for a short period of time. Are those the two major critiques of the individual accounts, or are there others that you have heard?

Mr. SUMMERS. I am not sure the word critique is the word I would use. Issues that are raised. I think those are two of them.

The third one, is the concern that the traditional progressivity of Social Security would somehow be undermined because individual accounts would represent a kind of privatization, is a third issue that people discuss.

To make progress from here, I think what is going to be important, and I do not think at the level of public debate we have certainly reached this point, is the analysis of specific proposals so one can actually look at the various trade-offs that are involved.

As you would expect, the plans that produced the greatest returns in individual accounts are also the plans that involve exposing individuals to the greatest amounts of risk. The plans that give people the widest array of choices are also the plans that tend to have the larger level of administrative costs. So, one has to find a balance.

I think that it is only by working towards balances in these things that we can best explore what the merits are. Certainly, the idea of a defined contribution element is one that has a great deal of resonance for people, but the idea that Social Security has to remain an absolutely basic public trust is also one that has a great deal of resonance. So the questions are really not so much what resonates, but how best to balance the different things that resonate.

Senator CONRAD. Thank you.

The CHAIRMAN. Senator Kerrey?

Senator KERREY. I am trying to balance the resonance of your answer there, Dr. Summers.

First of all, Mr. Apfel, you and I have had this discussion before and you used a couple of times in your statement that, "the President has said." Are your views identical to the President?

Are you basically here to represent the President's views? In other words, do you feel sufficiently independent, either under statute or your own intent as far as how history is going to write your role as the first——

Senator MOYNIHAN. Noting that you have a 6-year term. [Laughter.]

Commissioner APFEL. Although only two-and-a-half years left. [Laughter.] As the Commissioner of Social Security, I believe there is the measured amount of independence in the statute. The 6-year term, although there is only, as I said, 2½ years left on my first term—who knows if there is a future term—we are also an executive branch agency as well.

Senator KERREY. I have got to say, both of you are doing a wonderful job.

Commissioner APFEL. But let me say that I believe that everything that you have heard from here very much reflects the administration views and my views.

Senator KERREY. Everything that I have heard here. Is that everything that you have said, Mr. Apfel? I mean, I have heard lots of things here. I have heard what Dr. Summers has said.

Let me re-ask. You are saying, basically, that your interpretation and your intent is to be a Commissioner and you will express the President's views on Social Security; you are not going to contradict the President's views on Social Security and say the President is wrong, that I disagree.

Do you envision yourself reaching a conclusion that would be different than the President's and standing up and saying, I believe the President is wrong, here is a better solution?

Commissioner APFEL. I think we are talking in theory here, Senator.

Senator KERREY. No, no. I am definitely not talking in theory. Your testimony is definitely not a theoretical testimony. I think I have got my answer. I do not object to the answer. I would prefer more independence, and I think the law gives you that. It is your choice. It is your decision as to how independent you want to be.

You said as well in your testimony, Mr. Apfel, and I am not trying to be hostile, I am just expressing a very strong view here, that I think the public debate would be better served if you are up here presenting just an accurate assessment of what is going on.

You say, generations of Americans have benefitted from this program. But generations of Americans have benefitted very unequally from this program. I mean, an American who got Social Security in 1935 was born in 1870. An American who got it in 1955 was born in 1890. An American who got it in 1975 was born in 1910, and in 1995, born in 1930.

Each of these faced a much different program. It is very important. One of the things I hear when I go out and talk to people, they say, well, if Congress just leaves Social Security alone, it would be all right.

Commissioner APFEL. That is not true.

Senator KERREY. Well, I would appreciate it if you would tell the audience that, that it is not true. Congress has dramatically changed Social Security over those years to make it a much different program than it is today, right?

Commissioner APFEL. The Social Security program has evolved significantly over its 60 plus years.

Senator KERREY. No, sir. Plants evolve. Human beings evolve. This is not Darwinian natural selection. Congress has changed the law, sir.

Commissioner APFEL. Time, after time, after time, nearly every Congress, in at least a minor way. The significant changes that have been made to Social Security over the years, I think, have been very, very important, both the——

Senator KERREY. I would just respectfully urge, when you are bringing testimony, I would like to hear an historical analysis of how this program has been changed by Congress to reflect both the views and desires of the American people and the Congress' desires to improve the program.

One of the problems we have got, as Senator Breaux has said, is that it was relatively easy for a Congress in 1965, or 1973, or 1975 to deal with this issue because you had a larger number of people in the workforce relative to the number of people who are eligible. But that is changing.

It is relatively easy to design a program with a low payroll tax when you have 15 people in the workforce and one retiree. But as that number reduces, it is not, especially when the expectation is increasing as a result of the unbalance that is occurring in the three-legged stool.

The expectation is that they are going to get more. They are not asking us for less. Beneficiaries are not coming to us and saying, gee, Senator, could you give us a little bit less, because I understand people who are working out there are really strapped for cash and I think it would be great if you gave us less. They are asking us for more.

Now, you said in your statement that the government takes in $457 billion and it pays out. Can you describe this "government takes in" phrase? Will you open up that a little bit? The government takes in. The government taxes when it takes in, is that correct? Can you describe that a little bit to us?

Commissioner APFEL. That is right. That is the Social Security payroll tax.

Senator KERREY. Could Congress, by your calculation, cut the payroll tax 2 percent? That is an $80 billion a year tax cut. We are taking in $88 billion more this year than we need to pay the bills from people who are out there working.

Why would Congress not cut the payroll tax $88 billion, or $80 billion a year, and give people who are getting paid by the hour a little bit of tax relief? Would that interfere with your ability to administer the program?

Commissioner APFEL. No. The payroll tax revenues coming into the Social Security trust fund now are in excess of the amount of obligations that are going out each year in terms of benefits.

Senator KERREY. People who are getting paid by the hour are shouldering a disproportionate share of deficit reduction. That is my translation of what you just said. Go ahead. So we could cut the payroll tax $80 billion this year. Would you be able to write the checks this year?

Commissioner APFEL. The checks would be able to be written this year. But one of the broader questions——

Senator KERREY. How long could you write checks, Mr. Apfel, before Congress would have to change the law again?

Commissioner APFEL. I do not have the exact figure in front of me, Senator. But I believe that if the FICA tax was reduced by about 1.5 percent and no other changes were made——

Senator KERREY. This is not theoretical. This Congress is being, I do not know what you would call it, sort of perplexed right now with the proposal to cut the income tax further.

My belief is, if you look at the income tax versus the payroll tax as a burden on the average American family, the payroll tax is much higher. As I hear you looking at your cash flow needs, you do not need $457 billion to write checks.

Commissioner APFEL. If I could answer your question, Senator.

Senator KERREY. I think it would be a very healthy change, especially for current beneficiaries, to understand where the money is coming from.

Commissioner APFEL. If the Social Security payroll tax were reduced by about 1.5 percent rather than a 2032 insolvency, it would be moved forward by 12 years.

Senator KERREY. What do you mean, insolvent? What does this word insolvent mean to you?

Commissioner APFEL. Well, back in 1983——

Senator KERREY. No, no. Please, no historical analysis. What does the word insolvent mean to you? Why do you use that word insolvent, it is not insolvent.

Commissioner APFEL. In 2032, Senator——

Senator KERREY. But insolvency refers to a much different kind of situation that Social Security. Congress merely has to make a decision either to adjust benefits or adjust the payroll tax, as it did in 1983. It is not insolvent. It is not going to be insolvent in 2029. It is not going to be insolvent at that due date. It merely means that Congress is going to have to take action to change the payroll tax.

Indeed, under your Trustees Report, it is going to be a fairly healthy increase in the payroll tax or a fairly healthy cut in benefits. By your Trustees Report, at least a 33 percent increase in payroll tax or a 33 percent cut in benefits, by your own Trustees Report.

Commissioner APFEL. Those are the facts, sir.

Senator KERREY. It is not insolvent at that point, sir. It does not reach insolvency. Congress is just faced with a decision: what do we do in order to pay beneficiaries.

I would suggest, as I examine this thing, that one of the things Congress ought to be looking at, based on your report to us here this morning, if we are taxing and taking in $457 billion this year and your cash flow requirements to pay beneficiaries is $369 billion, which is $88 billion more, plus we have got a significant reserve that has been built up, why not cut the payroll tax and give that working family a tax break? We do not need it right now in order to pay the bills.

Commissioner APFEL. We do not need that to pay the bills over the next decade, or even over the next two decades. But there is an issue about paying the benefits beyond that time. One of the big issues in this debate that the Moynihan-Kerrey proposal presents——

Senator KERREY. But we are not prefunding. Are we prefunding? Are we holding the money in reserve someplace? We are not prefunding.

The idea in 1983, was that we would prefund the baby boomers. We began immediately to use it for the expenditures of general government. Immediately. We did not prefund anything, sir. What we are doing, is we are asking people who get paid by the hour to shoulder a disproportionate share of deficit reduction. That is what we are doing.

Beneficiaries, on the other hand, they suffer under the illusion, inflicted by us, very often, that all they are doing, is they have a little savings account back here and they are just getting back what they paid in. They do not understand that it is a transfer from people who are being taxed at 12.4 percent.

Thank you, Mr. Chairman.

Commissioner APFEL. If I could indicate briefly, that one of the broadest and biggest issues that confronts the Social Security reform debate is whether there should be, for the future, a significant amount of advanced funding of the Social Security system or whether it should be returned to the pay-as-you-go basis, as the

Senator from New York and Senator Kerrey has proposed. I have forgotten your State.

Senator KERREY. Nebraska.

Commissioner APFEL. I am sorry. [Laughter.] I was going to say Iowa. Sorry.

Senator KERREY. It is the gateway to Iowa. [Laughter.]

Senator GRASSLEY. He studied his history backwards; you can tell that.

Commissioner APFEL. That is right. [Laughter.] That is one of the broader issues that has to be confronted this year. The proposal from Senator Moynihan and Senator Kerrey would restore the Social Security system to purely pay as you go, then have voluntary individual accounts beyond that.

There are trade-offs to such an option, pros and cons. One of the other alternatives is to continue to have reserves and use the surpluses, potentially, for building further reserves in the Social Security system. That is one of the broader issues that I think we have to debate in this country, and I see pros and cons on both sides of the matter.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

I would like each of you to recommend to this committee what you think the mix should be in Social Security, pension plans, and private savings accounts. Should the current proportions continue; should it be significantly or modestly different in any respect?

What is our goal here, basically? We have talked a lot about reform. One part of it is the mix of those three legs of the stool. Again, do you think the current proportion is about right or should it be different?

Mr. SUMMERS. I would come at your question in a slightly different way, Senator Baucus. I think our preference would be to strengthen the pension and personal savings part of the stool.

In particular, the fact that half of Americans do not have access to meaningful pension coverage and that the personal savings rate is as low as it is, with almost no accumulation of liquid assets by a large fraction of the population, I think, are quite troubling.

So I would favor an increase in the strength of the private pension and personal savings leg of the stool, and in that sense I think we would have a more balanced system. That is in no way to denigrate or to call for a diminution in the Social Security leg of the stool.

Senator BAUCUS. Mr. Apfel?

Commissioner APFEL. Well, Social Security currently replaces roughly 40 percent of income.

Senator BAUCUS. Right.

Commissioner APFEL. Then pensions and private savings complement that.

Senator BAUCUS. Right.

Commissioner APFEL. The potential of Social Security to provide a significantly larger share than that in the future seems unlikely, given the demographic trends that we face. Therefore, as Dr. Summers said, in terms of private savings and in terms of pension coverage, these are both centrally important issues to assure long-term retirement security.

Shoring up and ensuring the long-term security of the Social Security system is very important. The potential of Social Security to do significantly more than it is doing now seems to me unlikely, given the demographic pressures that we are under.

Senator BAUCUS. I do not want to put words in your mouth. Essentially, I hear you saying that we should do all we can to shore up Social Security as we know it, but also probably in the future work a little harder on the other two legs so that, on a proportionate basis, they are probably providing a little more retirement income than Social Security.

Commissioner APFEL. Yes.

Senator BAUCUS. I agree with that.

Have you had a chance to look at the bill on pension reform introduced by Senator Graham, Senator Grassley, and myself, Dr. Summers? For example, do you have any sense that that is in the right direction or not, from your perspective?

Mr. SUMMERS. I confess, Senator Baucus, I am not intimately familiar with all of its details.

Senator BAUCUS. And I do not expect you to be intimate with it.

Mr. SUMMERS. I think, in particular, its emphasis on promoting portability of pensions and the portability provisions that it contains are very constructive and things that we could very much support.

Our general concern in this area, and I suspect some of this concern may apply with respect to your bill, is that we target our resources as much as possible on broadening pension coverage to those who do not have it, rather than deepening pension coverage for those who already are able to engage in significant tax-deferred savings.

That is for two reasons: an obvious consideration of fairness and progressivity and, in addition, a consideration of efficacy in increasing national savings, because when one provides pensions for the lower- and middle-income workers who frequently do not have it and who in most cases do not save, any saving that is contributed to those pension plans or accounts, whatever they are, is incremental national savings that otherwise would not have taken place. Whereas, when one expands the provisions for those who already have access to substantially tax-deferred savings, often it is a transfer of assets that is involved.

Senator BAUCUS. Right. How do you make small business employers to provide more pension coverage? A lot of employers, as you know, are worried about the current complexity, and perceived complexity, of the current system.

Second, a lot of employees figure, well, I think whatever compensation I get, I would rather put it someplace else rather than benefits. I think that that seems like a long-term proposition to them.

Also, some employers are worried about the revenue of their business. They are afraid that, gee, if they set up a plan, that the business might go sour. As you know, for small business, they rise and fall with some frequency and some go out of business with some frequency. Most people who do not have plans are small business employees or they are self-employed.

Mr. SUMMERS. I would hope that the proposal that is in the administration's budget—and I am afraid I do not know whether it is contained in your bill or not—for a tax credit to cover the expenses of setting up these plans and also to cover the costs of employee education, which has been found to be very efficacious, would go some significant distance, both because it would reduce the financial burden of setting up these plans, it would promote the education, and also it would provide something to market in connection with these plans.

As Senator Roth and I have discussed in the past, the evidence is that when people have something to sell—and this is one of the important reasons why the IRA has had some important impacts—that it is given a way and a reason to sell the idea of saving, that the results can often be significant.

Senator BAUCUS. Well, I agree with that. In fact, those provisions are in our bills. I also think, on the education side, the principal compounding is one that many employees, particularly younger employees, just do not understand and are not aware of. If they were to understand just how much investment can grow over a period of time, they might be more inclined to participate.

Thank you, Mr. Secretary.

The CHAIRMAN. Senator Mack?

Senator MACK. Thank you, Mr. Chairman.

Welcome to both of you. I sense a little frustration on the part of my colleague from——[Laughter]——Iowa, is it? There is a reason, I think, for the frustration. The administration has, in essence, tried to kick off this discussion.

Yet, when there is an attempt by members to seriously engage both of you in a discussion about, in essence, what you have learned, you made the point that you had 5,000 meetings, we get the sense that, after 5,000 meetings, that we are right where we started from. Every question we put out, we have not come to a conclusion on that. So there is a frustration, at least on my part, in listening to this.

Again, Dr. Summers, you made the comment that Alan Greenspan is pretty skilled at being able to respond in a way that nobody knows exactly what the conclusion is that he has drawn. Each of us makes a living from being able to do that. [Laughter.] But this is a serious issue. It is one, frankly, that I would hope, and expected, you to arrive here today in giving us a response.

Now, the only thing that we have heard so far as to where the administration stands, is no payroll tax rate increase, I think that is the way it was said. So at least one decision has been made that we have been led to believe, anyway. Does that mean that there is no decision with respect to whether retirement age would be extended under an administration plan?

Mr. SUMMERS. That is right, Senator Mack. Let me address——

Senator MACK. Let me, if I can. I will give you an opportunity in a minute. With respect to reducing benefits. Again, we have taken the payroll tax off the table. Does that mean that there is a possibility that you would be proposing a reduction in benefits?

Mr. SUMMERS. I think everything should be studied. Certainly, that is not the direction we would like to see this go.

Senator MACK. All right. Could you give me a sense where you think this is going to go?

Mr. SUMMERS. I would hope that it would go to approaches that were consistent with principles that we have been laying out in terms of preserving benefit assurance, providing the best opportunity for young savers, maintaining fiscal discipline, and so forth.

Let me say, if I could, Senator——

Senator MACK. Let me finish.

Mr. SUMMERS. I am sorry.

Senator MACK. You go ahead. I will give you a chance.

Mr. SUMMERS. Senator Mack, I can certainly see why you would be looking for what is our concrete plan or what is our specific position on these issues. But I think the judgment that the President has made is that it is best, because of the very substantial need for education in this area, for there to be a year of dialogue and that the prospects for reaching an ultimate bipartisan agreement, which is, I think, what we need if we are going to make progress in this area, are best served by everyone remaining open to everyone else's ideas through this year, and that is our objective.

Senator MACK. You can understand our skepticism on this side of the aisle about being engaged in this debate in which there is a death of the third rail. I am concerned, frankly, about whose death really will take place in this debate.

Let me make the point that, all during this time, the administration's point of view is, we are listening. Again, 5,000 meetings would say to me that something should have been learned from that experienced, other than the fact that there might be some angst out there.

Mr. SUMMERS. Senator Mack, first, I think we have taken a clear position on one very crucial issue, which is the relationship between Social Security and the broader debate about the budget surplus and believing that the surplus should be reserved until the Social Security problem over the long run has been addressed.

Senator MACK. Does that mean all the surplus?

Mr. SUMMERS. All the surplus should be reserved until we have put Social Security——

Senator MACK. The Social Security surplus, or surplus and operating surpluses; are you saying both?

Mr. SUMMERS. All the surpluses should be reserved until we have achieved a satisfactory solution with respect to Social Security.

I would also say that, while we have not taken a concrete position with respect to a specific plan, I, at least, feel that, on the basis of all the discussions that have been had, we are in a much better position to discuss, and we have tried to be as forthcoming as we can about what we have learned on the specific issues to go into making judgments about a plan, what some of the advantages and disadvantages, what some of the problems, what some of the things that need to be addressed with respect to individual accounts are, for example.

I think it serves the process much better for us to be, for example, discussing what are crucial issues that individual accounts pose rather than taking some blanket position, yes or no, on individual accounts, or yes or no on retirement age.

Senator MACK. Do you favor the concept of individuals having a greater say-so in their Social Security retirement than just sending in the money?

Mr. SUMMERS. I think that it is an attractive concept that needs to be explored in terms of the ways in which it can be effectively integrated with the wealth accumulation aspect as well.

It is a very attractive concept that needs to be explored in terms of its ability to assure that you have adequate assurance of benefits the maintenance of adequate progressivity, and that it can be done efficiently.

I think the challenge is to look at the various plans, and we have seen a variety of new ideas, even in the last several months, in terms of the design of individual account plans and their relation to the Social Security system that help us assess how that idea can be best combined with the kinds of criteria that I have spoken about.

Senator MACK. Mr. Chairman, I have two more comments. One may be a suggestion. We ought to have something installed on the walls. Remember the old "Gong Show?" Right. It goes off when we are not getting the answer to the question we have raised.

Mr. SUMMERS. Senator, may I——

Senator MACK. Just a second. I think that the reason we are finally reaching a point in which we are having a discussion on the issue of Social Security is because the average person in the country today has a better understanding of what opportunities are out there for them. Let me just read you some information here.

Since 1920, the stock market has had a real return of six percent; the bond market has had a real return of less than 1 percent. If a worker starts investing 15 percent of his income in stocks at the age of 21, he could end up retiring at the age of 53 with no decline in income.

Now, I am not suggesting that a person should take 15 percent, or 12 percent, or 13.5 percent and that all should go into an account that that individually totally controls. But what I think is happening, is the people in the country recognize that there is a better way.

I am feeling a little frustrated that there was not a little bit more open dialogue, that there was a sense that the best thing to do is not to answer questions now, let this thing play out over time, and I apologize for the expression of those frustrations this morning.

The CHAIRMAN. Senator Grassley?

Senator GRASSLEY. Basically, I think I would take a less cynical view towards this 1 year of discussion than what you have heard thus far, but I hope that a year from now my colleagues will not say—particularly my Republican colleagues—well, Grassley, you were a sucker for falling for this, for the whole year of 1998.

But let me give you a suggestion. What I am going to suggest, particularly to you, Dr. Summers, is not maybe as certain as it ought to be, because I do not have it in front of me. But I have always been pretty observant of everything the President said on these issues. And I get it from the press, and maybe that is not a very good source.

But, for instance, in Kansas City, one thing that he definitely said very strongly when he had his town meeting, was that he was not for a tax increase. I think that was pretty clear.

Now, on the subject of privatization, I got very much the feeling that he was very open to the idea. I do not think either one of you has gone as far as the President has in affirming with us that there has been, at least at the Presidential level, some strong statements made.

For instance, it ought to sound pretty good to Republicans that a President of the United States, a Democrat President, is not looking at increasing taxes on Social Security. That is a pretty positive, firm statement.

If the President of the United States is open to the subject of privatization, it is a little further than we ought to look at it, it seems to me. He does not say he is for it, but he is a little more than open to it.

Now, I just want to say that that is why I do not tend to be so cynical in my comments to you. I am willing to accept this 1-year discussion of Social Security, because I do think that there is just a terrific dearth of information about it, understanding about it.

There is a very important process of education. I guess I am willing to give the President the benefit of the doubt that he sees the need for that. He actually wants to change Social Security so that it is an important program. He is willing to look at alternatives, and all of that.

So, I am willing to give that 1 year of public education and discussion, because this is a program that is so very important for both older Americans and younger Americans. I think we want to do what we can in this process to reduce the intergenerational warfare that tends to be a part of it.

So, obviously, I hope that we do not have partisan rhetoric. That is why, a year from now, it is very important that whatever pattern the President establishes during 1988, that when we are actually discussing these things in 1999, if we do not get it done in 1999 and 2000 and throughout the Presidential candidates, so the candidates in your party, it seems to me, particularly those that are very close to this administration, ought to be thinking in terms of not demagoguing this issue, otherwise everything that Senator Mack has laid out here is a legitimate concern, and one in which I want to make sure Senator Mack does not come back and say how naive you were.

Senator MACK. I would never say that, Chuck. Never.

Senator GRASSLEY. All right. Do you want to respond to something I said? I am not quite done, but go ahead.

Mr. SUMMERS. Go ahead.

Senator GRASSLEY. All right. Now, getting to a question. The President has indicated that he intends to continue to have these nationwide meetings, and they are going to end with a White House conference in December. Normally, I would say that these White House conferences should not be an effort to make them bipartisan, because I think this whole 1 year of debate has been kind of a nonpartisan approach to it.

But I think, because this has been a highly sensitive issue, that partisanship will be involved. From that standpoint, I hope that

the President will see that this is very much a bipartisan meeting we have in December. I guess my statement to you is, to make sure that we convey to the President and other organizations that this conference needs to be so, and that the agenda must be balanced.

Comment, please. Then I have one question for Dr. Summers. I hope I can get that in very quickly, because I have to leave right away. Go ahead. No, please respond to mine, because I think it is very important.

Commissioner APFEL. The goal of the White House conference is to be as bipartisan as is absolutely possible, to have this year culminate in the White House conference this year.

It is our belief that the 1 year of public discussion is the best way to assure action next year, and that is something that is shared throughout the administration, and I believe in it, personally, very, very strongly.

The desire would be, at the end of the year, to have a bipartisan process to get to Social Security reform next year as early as possible.

Senator GRASSLEY. Dr. Summers, some of my Finance colleagues and I have been taking a hard look at the reason that small employers are discouraged from offering pension plans. We are going to hear more about this from our second panel, of course, but there have been recent polls that suggest some of the most important reasons employers are not offering plans is the burden of the cost of administering the plans.

We introduced bipartisan legislation yesterday, Senator Graham and I did, which includes some of the elements of what the President endorsed earlier this year. But, more important, we really tried to reduce the administrative cost and the burden that employers are now facing, because these burdens hurt employers who do not have a plan and make employers who currently offer a plan to wonder if this is really worth it.

Can you comment on how the administration is trying to get a handle on this issue, to go beyond some incentive in the first couple of years, like a tax credit, to actually evaluating administrative burdens on employers, and to what extent would you support the need to reassess some of these policies?

Mr. SUMMERS. The general need for reassessment, I strongly support. There are a number of elements in your bill that we strongly support, including the tax credit for the up-front costs, and we look forward to working closely with you on this issue, because advancing it is obviously very important.

If I might just, in the moment I have the mike, just thank you for your comments on the nature of our dialogue this year, and just say that I hope and trust that our positions—my position, at least—has been fully consistent with that of the President.

In talking about the pros and cons of a variety of ideas and criteria with respect to a variety of ideas, I have attempted to suggest that we are open to the possibility of them in the context of an appropriate plan.

It seems to me, if I might venture out of the economic area for one second, that the biggest risk to this process is that, in the next few months, there will be a strong temptation for people to associate other people with positions, then to attack them very fiercely.

Our best prospect for laying a sound foundation is a policy of mutual openness to each other's ideas. It is not with any intent of evasion, but rather with an objective of maintaining the predicate for the most cooperative possible solution that we have taken the approach that we have.

Senator GRASSLEY. Thank you, Dr. Summers.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bryan?

Senator BRYAN. Thank you very much, Mr. Chairman.

I think the discussion that we have had on the Social Security in America this past year has been helpful, because it is my sense that public understanding has been greatly enhanced.

The public, oftentimes, is ahead of those of us who are their elected representatives. I think most people now understand, in a very general sense, the daunting challenge that we face with the demographics.

People understand that people are living longer, and they do understand that there was a baby boom generation that began after World War II, and which will ultimately become part of the entitlement system, Social Security, and Medicare.

I must say, however, recognizing that you are not prepared to reach some conclusions on some of the specifics, and I understand and respect that, I do think we have squandered an opportunity here this morning. I do not think people that have listened to our discussion really have gained much in the way of substance from it. So, I am not asking you specifically what your conclusions may have been.

Mr. Apfel, you made the observation, which I think is correct, that with respect to some of these things that we are considering as changes in the system—and by the way, I think virtually everybody in the country understands that Social Security, sometime in the next century, will be different than Social Security today.

I think we have crossed the rubicon on that issue. That is why, perhaps, we can have this more open discussion and why I regret that I think we have missed an opportunity here this morning.

You used the term that each of these options have some trade-offs, some pluses and minuses. I think that is true. I think the American people understand that.

Without asking you to reach a conclusion, what are the trade-offs in at least two of these options? That is, a program that would involve the government investing part of the Social Security contribution into an equity portfolio—as you know, some State public retirement funds do just that and do quite well—versus the other option of allowing the individual to have some part of the Social Security contribution be invested in something that would be roughly akin to what we in Congress have, that is, a thrift savings plan or some type of 401(k). Give us the pluses and the minuses. What are the things that we need to at least be aware of as we formulate our own judgment?

Commissioner APFEL. I would be more than happy to, Senator. The government investing in trust funds and equities. The proponents have argued forcefully that, given the rates of return that people receive in the stock market, that diversifying the trust fund portfolio potentially could solve part of the long-term problem, up-

wards of half, even if, say, 20 or 30 percent of the trust fund was invested in equities. Basically, the trust fund would then grow at a larger rate, obviating the need for other changes to the system. That is a very compelling pro.

But, on the other hand, there are serious issues that this committee are aware of having to do with corporate governance issues.

Senator BRYAN. Again, in language which the public can understand. I think I know where you are going. You have given us one up side, that the rate of return, based on our historical model, would be substantially greater than it is with a long bond interest rate. All right. That is a plus. What is the minus?

Commissioner APFEL. I would also point out that what proponents argue is that, given the experience of State and local pensions investing about half of reserves in equities, given the Canadian experience, what they are now experiencing, that this is something that the United States should explore.

On the down side, the two main ones, as I pointed out, the corporate governance issues. How would the trust funds vote proxies, say? How would the whole issue of the relationship to the corporate world be resolved? Can we create as system that is enough arm's length to assure that the government is not involved in making decisions that affect corporate America?

Two, is the extent of the size of the trust funds' in equities. How much of the stock market would be involved with Social Security trust fund dollars? There is a wide range of what those numbers might be. So, those are two very strong cons that I think are very important to be talked through this year.

In New Mexico, at the AARP and the Concord Coalition forum on Monday, those pros and cons will be discussed at great length with the President.

Senator BRYAN. Can I ask, is that option still on the drawing board, is it still on the table, so to speak, in terms of being considered, or has it been rejected by the administration at this point?

Commissioner APFEL. It has not been rejected. It is clearly an option that is under consideration.

Senator BRYAN. So it is still in play. I know my time is running out. Let me just ask you one specific follow-up question to that.

Some States, as you know, have done this quite successfully. There are those that say, look, we need to bring those State retirement systems—in my own State, we have a unified State retirement system, where you have got local, county, and district, as well as State public employees, as well as the law enforcement segments, and all are part of a public employee retirement system. That seems to work very well.

Do you contemplate that it would be necessary to eliminate that, or to fold that into any changes that might be made prospectively in the Social Security system?

Commissioner APFEL. Whether the State and local workers who are now not part of Social Security should be in the Social Security system?

Senator BRYAN. Right.

Commissioner APFEL. That is also a major issue that needs to be thought through carefully. There are significant pros and cons to such a proposal as well.

On the pro side, Social Security is a nearly universal system. Ninety-five percent of all Americans pay into Social Security to pay into the intergenerational system.

The main group that is still not part of that system are some State and local workers. So to move towards universality, some would argue, would be important for the creation of a fully universal system.

The trade-off is, what are the implications for those State and local pensions in the short term, or even in the long term? Whether that will have an impact on the State and local pension systems, if States have their own systems, and a few States do have their own systems.

Understanding that fully, and also understanding whether there could be a transition issue here that can be examined, are some of the things that we need to think through this year.

Senator BRYAN. I take it you have reached no conclusion with respect to that.

Commissioner APFEL. We have not.

Senator BRYAN. All right. Then, very briefly, the pluses and minuses on the individual investment.

Mr. SUMMERS. The pluses include wealth accumulation, access to possibly high investment returns, a complementary defined contribution element to the defined benefit pension plan. The concerns include administrative costs, risk, and undermining of progressivity.

Senator BRYAN. Thank you very much, Mr. Chairman. Thank you very much, gentlemen.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman. Mr. Chairman, I was pleased that the title of this hearing is "New Directions in Retirement Security Policy." I think that the debate has been excessively restrained when it focused on the issue of Social Security reform.

The reality is that, for most Americans, Social Security is less than half of their retirement income, the other half coming from, primarily, employer-provided pensions and personal savings.

Therefore, in asking the question of what should be new directions in retirement security, at least those three components, Social Security, employer pension, and private savings, have to be looked at collectively.

With that statement, in each of these there is the tension between risk and security, how sure do you want to make the ultimate outcome at the point of retirement as opposed to how much risk you are willing to assume in order to enhance what might otherwise be that ultimate outcome.

It seems to me that, through some policies, we have made the employer retirement side a somewhat riskier side for our children's generation than it was for our parents, particularly the move from defined benefit programs to defined contribution programs.

Now, we have been in an era where the investments of those funds have tended to be very positive in their growth. Senator Mack indicated that, since 1920, the average equity growth has been 6 percent.

The corollary of that is that, in the last three or 4 years, it has been in the 20 percent plus range, which indicates that there had to be some years since 1920 when it was substantially less than 6 percent.

With that statement, could you give us your thoughts as to how you would assess the appropriate balance of risk versus security in each of the three legs that supports most Americans' retirement system?

Should Social Security be relatively the most secure, the most risky? Should all three be relatively the same, or what would be your general thoughts as to the allocation of security and risk in each of those three components?

Mr. SUMMERS. Senator, I think that is a very good question and I think it is one we all need to think about as we pose the way these things come together.

My own instinct would be that Social Security is, in a sense, the foundation, the minimum, the assurance for people, so it seems to me that uncertainties that might be tolerable with respect to someone's private savings account or their portfolio outside of their pension would certainly not be acceptable with respect to Social Security. So, I think the highest degree of safety should reside with the Social Security system.

I suspect the next highest degree of safety should reside with the employer-based system. I think that Congress has, over the years, worked very hard, through ERISA and subsequent legislation, to ensure that promises employers make their employees are kept. I think that that is, obviously, very important as a matter of trust.

I think we need to work, over time, to increase certainty with respect to other life events, and that is why the provisions contained in your bill, Senator Graham, to address portability are very welcome, because that is also working to make the pension part of a portfolio into a safer part.

I think there is more room for acceptance of risk in search of return in the personal savings of those individuals who have been able to assure an adequate retirement through Social Security and pensions, but I would caution—and here, I think I would echo the vast majority of financial planners—in saying that there is a very great danger of extrapolative expectations, and that it would be very unwise for people to make assumptions that the extremely favorable performance of markets that we have seen in the last few years will be a performance that will continue into the indefinite future.

The longer run experience, as your comment about the average demonstrated very well, is that there are periods of fluctuation and that, if I might paraphrase Newton, what goes down goes up, and what goes up, goes down, in markets as well.

Commissioner APFEL. Senator, if I could add, the need for a defined benefit in Social Security, I think, is paramount, given the importance of the three-legged stool. That benefit that you can count on, even if you have outlived your husband, even if you have outlived the actuarial tables, even if you have outlived your savings, is centrally important. That is what the Social Security system was designed to be, is a foundational benefit that you could count upon.

Is it possible that individual accounts could be part of a discussion included within Social Security? That is possible. We have not ruled it out. But the importance of that defined benefit, that benefit you can count on, that government-provided support system, I think, is centrally important to this debate, particularly given the changes in the shift-over from defined benefits to defined contributions. We need that ultimate benefit you can count on.

Senator GRAHAM. Mr. Chairman, I am not going to ask a question for a response, but just to sort of put it on the table. If there is a desire, which I believe undergirds the interest in the individual accounts within Social Security for a greater opportunity to enhance retirement benefits, but if we were to decide that Social Security is not the appropriate place to inject that additional element of risk, for the reasons that the two of you have just cited, I would be interested in your thoughts, over time, as to what could we do on the other two sides of this three-legged stool in order to provide some of those same opportunities for more expansionist, risk-assumed areas of economic enhancement in retirement.

I think the underlying desire to have a chance to do better than the statistical tables would otherwise indicate is pretty strong. The question is, where to fulfill that desire, and if not Social Security, where within this three-legged stool?

The CHAIRMAN. Well, the hour is growing late. You have been very patient. I appreciate both of you being here.

Let me just make a couple of comments. I agree, Mr. Secretary, with your statement made earlier, that whatever we do should be bipartisan. It should take the cooperation of the executive branch and the legislative, as well as the young and the old.

Having said that, I do think it is going to be very important for the White House, the administration, to provide leadership, that we are going to want to know specifically where you stand on these issues, what you think should be done. I think that is going to be an important part of the mix.

As we have heard today, I think many people were concerned that we did not get more clarity as to where the administration stands now.

One thing that bothered me, is a point that Senator Kerrey raised. You have said all surplus is off limits. You also said that nothing should be done on Social Security until next year, so that would tend to put the legislature into a box.

You cannot do anything about Social Security, but some people apparently believe that perhaps some kind of a tax cut, a refund, a rebate, should be given. So, I would have to take exception to that proposal.

But we will want to continue this dialogue, and we appreciate your being here today.

Senator MOYNIHAN. Mr. Chairman, could I say that I hope that you would agree that our witnesses have been agreeable, and our next witnesses will be equally so, because it is, after all, your birthday and these things matter when you count up the years and returns. Here you are, you are still working and not on any pension, whatever. [Laughter.]

Mr. SUMMERS. Senator Moynihan, you have taken the opportunity for me to show the results of our careful legislative research.

So, on behalf of the administration, let me join in wishing Senator Roth a happy birthday.

The CHAIRMAN. Thank you.

Senator MOYNIHAN. Thank you, gentlemen.

The CHAIRMAN. As I have said many times, I am at the age that I would just as soon forget them. [Laughter.]

We will now call forward our next panel. Today we have Dr. Rudy Penner, a former CBO director, and now a senior fellow at the Urban Institute. We are pleased to welcome Mr. Kenneth Porter, who represents the ERISA industry committee; Dr. Schieber, of Watson Wyatt Worldwide; and Dr. Paul Yakoboski, of the Employee Benefit Research Institute.

Gentlemen, it is a pleasure to welcome you. We will begin to the left. Dr. Penner, would you please proceed.

STATEMENT OF RUDOLPH PENNER, PH.D., SENIOR FELLOW, URBAN INSTITUTE, WASHINGTON, DC

Dr. PENNER. Thank you very much, Mr. Chairman, Senator Moynihan. Thank you for this opportunity to testify.

The Nation is about to experience an enormous demographic shock. Between 2010 and 2030, the over-65 population will rise by 70 percent, while the labor force will rise by less than 4 percent.

The CBO projects that Social Security benefits will be absorbing 2 percentage points more of the GDP by 2030, while Medicare and Medicaid will be absorbing six percentage points more by 2040.

Estimates of this type and the projections of the Social Security actuaries assume that the productivity of workers continues to rise at rates similar to those experienced over the past 40 years, even while the economy is enduring this massive shock.

If the economy slows in response to the demographic changes more than the actuaries predict, programs for the elderly will become much more burdensome than usually implied, and this becomes even more urgent to undertake reforms.

CBO has done simulations in which growing public deficits soak up private savings, thus leaving less capital to enhance worker productivity. The economy, thus, slows and further increases deficits, slowing growth further, et cetera, until the whole economy collapses into nothingness.

Such projections are useful in that they dramatize the risks that we face, but they are unrealistic in that they assume that neither the public nor the private sector changes policies in response to the looming disaster.

Most of the analyses of the demographic shock have focused on the burden imposed on the public sector. These same demographic trends also have important private sector implications that have not been analyzed as thoroughly. Most important, the private sector will experience a major loss of experienced workers as large waves of baby boomers retire.

There is also a danger of a severe shortage of savings to finance capital formation. As baby boomers retire, net contributions to private pension plans will decline, and there is a possibility of net withdrawals by 2020.

At the same time, government may be borrowing more private savings to finance the growing deficits that result from rapidly rising Social Security and health benefits.

In addition, it will be more difficult to make up for a savings shortfall by borrowing from abroad; almost all developed countries will be facing the same demographic problem.

When the baby boomers begin retiring in large numbers, it is important to induce older workers to work longer. That will not be easy because it flies in the face of a strong trend for workers to retire earlier and earlier.

In part, early retirement is a natural response to rising standards of living. The rest of my testimony describes a number of public and private incentives to retire early, and briefly describes reforms that might reverse the trend.

I was a member of the CSIS Commission on Retirement Policy which tackled some of these issues. It suggested public sector reforms such as increasing the normal and early retirement ages under Social Security, but I am sure that Senator Breaux has explained, and will explain further, those proposals.

If public incentives are changed in a way that complements changes in private incentives, the effects could be substantial. It is interesting to note that, in 1950, when incentives to retire were much weaker, the average age at which Social Security benefits were claimed was greater than 68, even though life expectancy at age 65 was much shorter and health was less robust. Today, the average age at which benefits are claimed is less than 64. This suggests that there is much scope for inducing longer work.

The most reliable means of leaving extra savings and capital to future generations is to continue to run a budget surplus. The resulting retirement of the national debt makes financing available to the private sector for productivity-enhancing investments.

Reducing the debt has the added advantage that it will reduce the interest burden facing the budget, and I think it makes a move to individual accounts much more feasible, whether they are mandatory as in the CSIS proposal, or voluntary as in Senator Moynihan's and Senator Kerrey's proposal.

In addition to paying down the debt, it is important to make our tax system less hostile to saving and investing. I have long favored radical reforms that would reduce the tax burden on saving and investing and increase the burden on consumption, but it is very difficult to get there from here, both technically and politically.

Less ambitious reforms would simplify and expand IRAs and other vehicles that attempt to encourage savings, eliminate or reduce the burden of the alternative minimum taxes on individuals and corporations, and consider reducing the double burden on dividends resulting from corporate and personal income taxes. My full testimony notes that rate adjustments can offset objectionable distributional effects of such reform.

I also emphasize the importance of treating different types of saving and investing equally, so that capital goes to where it is most productive rather than being allocated by tax law. Last, I note that savings incentives are most effective if done in a surplus-neutral manner.

Thank you very much.

The CHAIRMAN. Thank you, Dr. Penner.

[The prepared statement of Dr. Penner appears in the appendix.]

The CHAIRMAN. Mr. Porter?

STATEMENT OF KENNETH W. PORTER, CHAIRMAN, ERISA INDUSTRY COMMITTEE, WASHINGTON, DC

Mr. PORTER. Thank you, Mr. Chairman, and greetings from Delaware.

The CHAIRMAN. Nice to have you here.

Mr. PORTER. Mr. Chairman and members of the committee, I am Kenneth Porter, chief actuary for the company. I am testifying today on behalf of the ERISA Industry Committee, commonly known as ERIC.

My remarks focus on two of the committee's questions: what can Congress do to encourage greater pension coverage and personal savings; and second, as Congress considers Social Security reform proposals, what must it do to avoid any negative impacts on pensions, personal savings, and work?

ERIC has supplied the committee with two documents which you have before you. One, is "Getting the Job Done," a white paper on emerging pension issues, and the second, is "The Vital Connection: An Analysis of the Impact of Social Security Reform on Employer-Sponsored Retirement Plans."

ERIC's 1996 paper, "Getting the Job Done," provides strategies to increase retirement savings through employer-sponsored plans. Many of ERIC's policy recommendations were reflected in pension amendments advanced by this committee in the Small Business Job Protection Act of 1996, and Tax Relief Act of 1997.

ERIC is very pleased that the Chairman and many of the members of this committee continue to work on additional pension reform proposals, many of which build on recommendations we have made.

ERIC's newly released report, "The Vital Connection," directly addresses the committee's concern that Congress not harm pensions, personal savings, and work opportunities when it enacts Social Security reform. Indeed, discussion of Social Security reform is too often treated as though that program operates in isolation, which, of course, it does not.

ERIC's report is a road map to Social Security reform options that preserve and enhance retirement savings and, at the same time, build a more firm foundation for Social Security.

Let me identify for the committee ERIC's four principles for judging the efficacy of pension reform proposals and for determining the impact of specific Social Security reform proposals on employer plans.

First, reform proposals should provide stable rules that encourage the voluntary creation and maintenance of soundly financed employer-sponsored plans. Retirement plans are long-term commitments and they require government policies that create an environment of long-term certainty.

Second, reform proposals should maintain efficient means for individuals to acquire adequate retirement income. Workers' options include voluntary employer-sponsored plans, Social Security, individual savings, and post-career part-time or full-time work. Re-

forms must enhance these options and help to change individual behavior.

Third, reform proposals should support the dynamic needs of employers. Whether employers can continue voluntarily to assume a major role in providing retirement income to workers will depend on how readily they can continue to integrate employer retirement plans with their business needs.

Principle four. Reform proposals should encourage capital formation. Retirement savings fuels the investment that can produce long-term economic growth in the U.S. economy.

While ERIC does not endorse or reject any particular Social Security reform proposal, its year and a half study which you have before you has led it to certain conclusions.

These conclusions are: early action on reform will be critical to success; employers will need time to design, finance, and administer plans that will be effective in a new environment, and employees will need the time to accumulate benefits in those new plans.

A second conclusion. Many proposals impose financial costs that have not yet been fully examined. For example, some proposals include payroll tax increases, transition costs imposed to facilitate the changes in Social Security, or reductions in the ability of an employer plan to integrate with Social Security benefits.

The impact that increases in compensation costs will have on the workforce and on the competitiveness of American industry in today's worldwide business has yet to be examined. They need to be studied. They need to be fully understood so that we move forward on what has to be done in a cohesive manner.

The third conclusion. Both reductions in the Social Security defined benefit and the creation of Social Security individual savings accounts can reshape the plans that employers offer to their employees in the future.

Since existing employer-sponsored plans assume the existence of a Social Security system like it is today, any change to that system will have an impact on employer plans.

A fourth conclusion, is the imposition of a means test would undermine the attractiveness of employer plans. This would be an incentive for some employees not to save money for their own retirement, it would encourage employers not to offer employer plans, and it will frustrate the ability of employers who do offer plans to design plans that provide uniform benefits to all employees.

A fifth and final conclusion, is that administrative issues may prove the most critical and the most intractable in carrying out a successful reform package. Employers might find it impractical to design plans to meet the needs of workers who are in different, and perhaps in conflicting, transitional Social Security systems.

Regarding the establishment of Social Security individual savings accounts, it is critical to recognize that no universal system currently exists, either in the government or the private sector, to administer these things.

Finally, it is vital that employer-sponsored plans continue to play a role in Social Security reform. To do that, we need a succinct and cohesive national retirement policy that takes all aspects of retirement into account.

I thank you for your time.

The CHAIRMAN. Thank you, Mr. Porter.

[The prepared statement of Mr. Porter appears in the appendix.]

The CHAIRMAN. Dr. Schieber?

STATEMENT OF SYLVESTER SCHIEBER, PH.D., VICE PRESIDENT, WATSON WYATT WORLDWIDE, BETHESDA, MD

Dr. SCHIEBER. Thank you, Mr. Chairman, Senator Moynihan.

I am pleased to discuss today the status of our retirement income security system and potential new approaches to providing retirement security for American workers.

In the opening section of my prepared testimony, I make the case that pensions are the way that Americans save. The relatively low levels of non-pension financial assets among people on the threshold of retirement, at least to me, are amazing.

The median non-pension financial assets held by the very highest lifetime earnings group of people close to retirement today is only about $40,000. Total wealth, however, is significantly higher than the non-pension wealth.

Other than the wealth that people hold in their home equity and their rights to Social Security, most people hold a majority of their remaining wealth in the form of tax-qualified retirement plans.

If pensions are how America saves, it is important to understand how accessible these employer-sponsored plans are, especially given that they are offered voluntarily. The rap on employer plans, for years, has been—and we have heard it here this morning—that only half of the American workforce benefits from them.

While only half of all workers may be covered by a pension at any point in time, looking at people close to retirement age presents a different picture. There, when you consider people close to retirement, about 70 percent of the total population is receiving, or will receive, some kind of employer-sponsored benefit.

The exposure to employer-sponsored retirement benefits far surpasses those that simply look at group participation rates across the whole population. While pensions are more generally available than often thought, those left out of the system are disproportionately from the bottom end of the earnings spectrum. This is an important point to keep in mind as you think about changes to our retirement system.

The third part of my prepared testimony focuses on the remarkable potential of the 401(k) system. While these plans did not exist in 1980, by 1994, contributions to 401(k) plans exceeded those to all other private employer-sponsored retirement plans combined.

Today, more than 70 percent of workers covered by 401(k) plans participate in them. Average total contributions are nearly 9 percent of participants' annual earnings.

Projections analyzed in my prepared remarks suggest that the 401(k) plans project to be a greater source of retirement income than Social Security benefits, under current law, for the upper half of the earnings distribution of younger workers.

Considering that Social Security is underfunded by about 30 percent for such workers, 401(k) plans project to be a greater source of income than Social Security for the top three-fourths of the earning distribution for this group.

If you give workers an opportunity to save for their retirement on a reasonable basis, they clearly have demonstrated that they are willing to do it.

The fourth part of my prepared testimony focuses on how people at the end of their working careers are fixed to finance the retirement——

Senator MOYNIHAN. Dr. Schieber, could I just explain, the Chairman has briefly disappeared to vote because there is a roll call vote on. He has not been overwhelmed, as I am overwhelmed, by that remark that 70 percent of persons about to retire are covered by a pension system. That is one of those numbers that sticks with you.

Go right ahead, please.

Dr. SCHIEBER. Thank you.

The fourth part of my prepared remarks focus on how people at the end of their working careers are fixed to finance their retirement consumption needs. Here, I look at estimated wealth sources and levels for people on the cusp of retirement.

Excluding the value of residences, because many people, when they retire, do not sell their home, I look at the wealth people hold, the wealth that will generate a cash income for them during retirement. It is this cash income that retirees can take to the grocery store, the pharmacy, and so forth to meet their daily needs.

The results are shown in Table 4 of my prepared remarks, and I find them instructive. People at the bottom end of the wealth distribution hold virtually all of their wealth in the form of Social Security. Moving up the wealth distribution, Social Security becomes less important. Those at the top of the wealth distribution have almost no dependence on Social Security benefits.

The distribution reflected in Table 4 has profound implications for retirement policy considerations. From these separate observations, I draw a set of conclusions about the direction that I believe retirement policy ought to take.

First, I believe we may have reached the point where we should consider requiring all employers to make available a 401(k) plan for their workers. We would not have to require that employers subsidize a plan, only that they offer it.

Second, any Social Security reform that cuts benefits across the board is going to have a disproportionately large effect on the retirement consumption potential of workers at the bottom of the economic ladder. The people at the upper end of the ladder will hardly notice the effects of such proposals.

Proposals that significantly raise the retirement age, reduce COLAs across the board, or reduce the benefit formula on a pro rata basis, are policies of this sort.

I believe there is a better way to modify our Social Security system that is more humane and more fair. I am clearly on record as favoring a reform of our Social Security system that would require workers to save in individual accounts.

Their accumulation in these accounts would be supplemented by a Social Security benefit that would be reduced, on average, from current levels, but one that would provide a relatively larger share of total benefits to low-wage workers than the current system.

The personal security account reform proposal that I helped craft as a member of the Social Security Advisory Council has benefitted because it would expose low- and middle-wage earners to financial market risks that they do not now face in Social Security. We heard about that from the prior panel.

I believe that these financial market risks are no more dangerous to low-wage earners than policies that primarily rely on raising retirement age and cutting COLAs to rebalance Social Security. In the PSA proposal that I support, the financial market risk for low-wage workers would be largely ameliorated by the flat benefit in our proposal.

There is nothing that I can see in the current structure of Social Security that can ameliorate the risks associated with the lack of wealth diversification for people at the low end of the wage distribution. Expecting these people to diversify their own retirement wealth portfolios by participating in voluntary contributory savings plan programs, I believe, is futile.

The only way to effectively ameliorate the lack of wealth diversification at the bottom of the wage distribution is by creating a claim on wealth for low-wage workers that is based on something other than unfunded political promises.

If my PSA plan goes too far in that diversification, from a political standpoint, then we should begin with a smaller goal. But whatever you do, I urge that you give folks at the bottom of the economic ladder an opportunity to climb that ladder through some form of real wealth accumulation. Thank you.

Senator MOYNIHAN. Thank you, Dr. Schieber. Let me take the occasion to thank you for the work you did on the Social Security Advisory Council. It was an heroic and, as yet, unresolved, effort.

[The prepared statement of Dr. Schieber appears in the appendix.]

Senator MOYNIHAN. Dr. Yakoboski?

STATEMENT OF PAUL YAKOBOSKI, PH.D., SENIOR RESEARCH ASSOCIATE, EMPLOYEE BENEFIT RESEARCH INSTITUTE, WASHINGTON, DC

Dr. YAKOBOSKI. Thank you, Senator. I am pleased to appear before you this morning to discuss issues regarding the retirement income security of today's workers.

According to the 1998 Retirement Confidence Survey, working Americans are more focused on their retirement; 45 percent have tried to determine how much they need to save for their retirement, up from 32 percent just two years ago. This increase is particularly striking among members of the baby boom generation.

However, while Americans have become more focused on their retirement, this is not translated into increases in the retirement income confidence. While some may find this puzzling, a simple reason may be that, as Americans become more focused and try to determine how much money they really need to save, the answer has them worried.

Sixty-three percent of working Americans have begun to save for retirement. While this is good news, it still means that one-third of Americans are not. What motivates individuals to begin saving? The top two motivators are negative: number one, having observed

someone not prepared for retirement and then struggle; and number two, simply realizing that time was running out.

Even among those who are saving, it is fair to say that most have absolutely no idea how much money they need to save. Only 57 percent of workers who are saving say that they have tried to calculate how much they need. They are, in a sense, flying blind and hoping that things work out in the end.

The survey also reveals that most working Americans could do more in terms of saving for retirement. Fifty-five percent of those not saving say it is reasonably possible for them to save $20 a week for their retirement. That adds up to a little over $1,000 per year. In addition, 57 percent of workers who are already saving say that they could put away an additional $20 per week on top of what they already are.

When it comes to employment-based retirement plans, the voluntary system has been a tremendous success for workers at large employers. The same cannot be said for individuals at small employers. Eighty-five percent of workers at firms with 100 or more workers are covered by a retirement plan; only 30 percent of workers at small employers are covered by a plan.

Why don't more small employers sponsor retirement plans? In the 1998 Small Employer Retirement Survey, small employers gave three main reasons for not offering a plan.

The first reason cited was simply their observation that the workers prefer wages and/or other benefits instead of retirement benefits. Number two, is administrative cost and burden. Number three, is their uncertain revenue making it difficult for them to commit to a plan.

In addition, it appears that there is a fair amount of misunderstanding about retirement plans amongst small employers who do not sponsor one, especially as regards the costs of offering a plan.

If significant progress is to be made in terms of retirement plan sponsorship amongst small employers, we must address their concerns about offering plans and better educate them as to the options available.

However, the findings also show that effective policy must help make retirement planning and saving a priority for individuals who work for these small employers as well.

As regards Social Security, only 13 percent of workers expect Social Security to be their most important source of retirement income. This compares with 42 percent of current retirees who say that Social Security is their most importance source of income.

In addition, 21 percent of workers do not expect Social Security to be a source of income for them at all in their retirement.

Senator MOYNIHAN. Twenty-one percent?

Dr. YAKOBOSKI. Twenty-one percent.

Senator MOYNIHAN. Twenty-one percent do not expect to receive benefits.

Dr. YAKOBOSKI. Changes to the Social Security system are inevitable. As policymakers consider various options to reform the system, they should consider the interconnectedness of Social Security with employment-based retirement plans, issues that we have already heard discussed today: normal retirement ages, early retire-

ment ages, the integration of private plan benefits with Social Security levels.

In addition, not only is there concern as to the extent that employers sponsoring pension plans will adjust to changes in Social Security policy, but there is also debate as to how participants in employment-based plans will alter their behavior in response to Social Security changes.

In conclusion, there are no quick fixes or silver bullets that will ensure retirement income security for today's workers. Our research indicates that long-term policies aimed at improving workers' retirement income security must not only address employer concerns about offering plans, but also must educate workers about the need to make planning and saving for their retirement a priority.

The good news from our survey work, is that education can have a real impact on individual behavior and the savings decisions that they make. Thank you very much.

Senator MOYNIHAN. Thank you, Dr. Yakoboski.

[The prepared statement of Dr. Yakoboski appears in the appendix.]

Senator MOYNIHAN. I am going to have to chase out myself in just a moment. The Chairman will be back.

But there is one profoundly important statement that has been made this morning by Dr. Penner, who said,

"The most reliable means of leaving extra savings and capital to future generations is to continue to run a budget surplus. The resulting retirement of the national debt makes financing available to the private sector for investment in the machinery and structures necessary to enhance the rate of growth of worker productivity."

On the assumption that Dr. Penner still agrees with that statement——[Laughter].

Senator MOYNIHAN. Could I ask Mr. Porter, Dr. Schieber, Dr. Yakoboski, would you share that judgment?

Dr. SCHIEBER. Absolutely. When I save a dollar of my income and that dollar of my income is used to finance government debt, then it is not clear it is going to buy machinery or other capital goods that make workers more productive. If the Federal Government is not running a debt, a deficit, at the time I save that dollar, it is much more likely to go into some productive use.

Senator MOYNIHAN. Do economists not generally think there is this relationship, that a dollar saved is a dollar invested? Is that roughly acceptable to you?

Dr. PENNER. Yes. I think that is the usual assumption there. We have to worry about how much of our extra saving goes abroad.

Senator MOYNIHAN. It goes into investment somewhere.

Dr. PENNER. Somewhere. That is right.

Senator MOYNIHAN. I am going to have to run and vote now. I have heard some wonderful testimony. You have got lots to talk about. I would just comment, on this statement by Dr. Penner, Dr. Schieber said he absolutely agrees. I leave that to you with a cautionary note, Mr. Chairman. [Laughter.]

The CHAIRMAN. Thank you, Senator Moynihan.

This question is for all the members of the panel. As we have already discussed, Social Security is intended to be only the foundation of retirement income, one leg of the three-legged stool, Social Security, pensions, and personal savings. Yet today, as we all know, a majority of seniors depend heavily on Social Security.

I would like to get your views as to, what is the optimal mix for retirement security. That is, how much should people depend on each source of retirement income, and what should Congress do, if anything, to improve the balance? Dr. Penner?

Dr. PENNER. Well, I think, first of all, people should try to save enough to provide an income in retirement that enables them to maintain the level of consumption they had just before they retired. That does not mean they need the same income as before they retired, but at least enough to finance the same consumption.

I like plans that would slow the growth of Social Security benefits—most would do that by increasing the normal retirement age—and that would substitute some sort of individual account for the loss of benefits.

I think that it would give everybody private ownership in the future of America by making everybody a capitalist. It would reduce the quite extraordinary inequality of wealth holdings that we see today.

While it would increase the risk somewhat to people, that risk can be dealt with in a variety of ways. The main risk is a general fall in the stock market or inflation that erodes the real value of bonds.

People can, as they approach retirement, start shifting their portfolio in favor of debt instruments. If they are worried about inflation, they can be short-run debt instruments. Now we have indexed bonds.

So I am not very worried about the usual criticism that individual accounts are too risky, nor am I very worried about the transactions cost, because in the CSIS commission we found that you can reduce those costs enormously by having the SSA run the information and accounting system. So, I think the two major criticisms of individual accounts can be dealt with quite satisfactorily.

The CHAIRMAN. Thank you, Dr. Penner.

Mr. Porter?

Mr. PORTER. Thank you, Mr. Chairman. We talk about the stool and sometimes forget to focus on what platform it is supporting. I personally think that there is a place in everybody's portfolio for a mix of those three legs.

If you look back when ERISA was enacted, the stool of Social Security was supporting income guarantees. Most employer-sponsored pension plans were defined benefit, which also had income guarantees of one form or another, and private savings was principally the capital accumulation leg on that stool.

In the last 25 years, we have seen a succession of laws and regulations which have debilitated the defined benefit program in this country. Fortunately, in the last few years there have been changes that this committee has been very active in to help improve that.

But Dr. Schieber talked in his remarks about the tremendous change in movement from defined benefit to defined contribution, and that has represented a shift in that stool from dependence in

1975 heavily on income guarantees to a more substantial reliance on capital accumulation.

I think, in addition to looking at the three legs of the stool, we need to look at what those legs support. We have moved, as a Nation, significantly toward reliance on capital accumulation. I think that is healthy.

But, as we go into Social Security reform and to the extent some form of individual account becomes necessary, we need to think about a step change in the way we view defined benefit employer-sponsored plans so that employers that are able have the opportunity to supplement the income piece of that equation, not just the capital accumulation piece.

The CHAIRMAN. Thank you, Mr. Porter.

Dr. Schieber?

Dr. SCHIEBER. I do not have a precise response to your question, how much should come from each segment. I do know when I look at these wealth distributions that I addressed in my prepared remarks, that when I look at the bottom of the wealth distribution and 95 percent of the wealth is coming from Social Security, that that is too much.

When I look at the top, the very top 10 percent of the wealth distribution, these are people right on the cusp of retirement, 10 percent of their wealth is still coming from Social Security.

When I think of Social Security being borne on the backs of workers in the form of a payroll tax and I think of the very wealthiest members of our society still having a very substantial amount of their wealth, 10 percent of a large wealth portfolio, coming from Social Security, I suspect maybe that is too large.

Shrinking Social Security does create financial market risks, but the people at the top end of the wealth distribution ought to be able to bear those financial market risks, if anybody can.

People at the bottom deserve to have some real wealth, simply because it allows them to diversify out of the political risk that is in the current system. I think Social Security has grown to be larger than it should in our total retirement portfolio.

The CHAIRMAN. Thank you, Dr. Schieber.

Dr. Yakoboski?

Dr. YAKOBOSKI. Mr. Chairman, I do not think either that there is a simple rule of thumb for the "correct mix," as Dr. Schieber has mentioned. In reality, the correct mix or the existing mix is going to vary with worker income levels and their ability to save and provide for their retirement.

In addition, when we think about the legs of the stool and the appropriate mix and we talk about employment-based plans, we have to be aware, too, of the growing blurring of the distinction between savings and employer-sponsored plans.

Employer-sponsored plans today are often 401(k) plans, which involve individual saving out of current income. So, you have a very real blurring of this distinction that exists and we need to be careful when we discuss who should be providing what, in what proportions.

Another possibility which, by definition, does not get discussed when we consider a three-legged stool, is work. We know from our

survey efforts that 60 percent of current workers plan to work once they retire.

So the concept of even what it means to be retired is not etched in stone, it is also a blurry, fuzzy concept that is only clear in the eyes of each individual for themselves. But that is another possibility of where income will come for many people.

The CHAIRMAN. Thank you, Dr. Yakoboski.

I do have some additional questions, and it will be kept open for the submission of those questions, as well as those by other members of the committee.

I apologize for the lateness of the hour, but we have had, I cannot remember, either three or four votes, which makes it very difficult to hold a hearing of this type.

But we welcome your testimony and would greatly appreciate if you would answer the questions that we will submit to you.

Thank you very much for being here today. The committee is in recess.

[Whereupon, at 12:40 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF KENNETH S. APFEL

OPENING REMARKS

Thank you for the invitation to testify on retirement security policy, including Social Security, pensions and private savings. All three are critical to the economic well being of our nation's future retirees. This hearing is particularly well timed, since, as you know, leaders from across the country gathered in the first week of June here in Washington for the first National Summit on Retirement Savings. Established by the bipartisan Savings Are Vital to Everyone's Retirement Act (SAVER) of 1997, the meeting was the first of three, with additional summits scheduled for 2001 and 2005.

The SAVER summit presented all of us with an opportunity to reflect fully on the fact that, if we want to maintain a reasonable standard of living for our elderly, we need to take a broader national look at the entire area of retirement income security. While Social Security is a vital element, it is not the only element. I believe that any serious consideration of Social Security reform must take place within the context of all of the elements of retirement income security.

Today I will discuss with you the importance of the multi-tiered structure of retirement income and the demographic pressures that are driving the need for Social Security reform. I will also discuss the process by which the President plans to restore Social Security's long-term solvency. Finally, I will discuss with you the principles for reform to which the President is committed.

Social Security has evolved almost continuously since its inception in response to the changing needs of the American people. Today, Social Security faces serious long-term challenges, chiefly due to demographic trends like the aging of the baby-boomers and longer life expectancies. Such developments mark the beginning of yet another stage in Social Security's development as a social insurance program.

STATUS OF THE TRUST FUNDS

I'd like to take a moment to report the current status of the Social Security Old Age and Survivors Insurance (OASI) and Disability Insurance (DI) Trust Funds. As you know, the 1998 Trustees Report was released on April 28. The OASDI Trustees monitor the financial health of Social Security—our Nation's most successful family protection program.

The 1998 Trustees Report tells us that the assets of the combined funds increased by $88.6 billion, from $567.0 billion at the end of December 1996 to $655.5 billion at the end of December 1997. In 1997, the Social Security trust funds took in $457.7 billion and paid out $369.1 billion.

Under the 1998 Trustees Report's intermediate assumptions, the annual combined tax income of the OASDI program will continue to exceed annual expenditures from the funds until 2013. However, because of interest income, total income is projected to continue to exceed expenditures until 2021. The funds would begin to decline in 2021 and would be exhausted in 2032. Each of these three dates is slightly further away than estimated in the 1997 Report, reflecting the positive impact of low unemployment, low inflation, and robust economic growth.

In 2032, when the trust funds are projected to become exhausted, continuing payroll taxes and income from taxes on benefits are expected to generate more than $650 billion in revenues (in constant 1998 dollars) for the Trust Funds in 2032. This is enough income to cover about three-fourths of benefit obligations. Even with projected further increases in the cost of the OASDI program throughout the long-range

period, the tax income under present law would still be enough to cover about two-thirds of benefit obligations in 2072. And I want to stress that the President is committed to seeing to it that these scenarios never develop.

The Trustees put it this way:

> It is important to address the financing of both the OASI and DI programs soon to allow time for phasing in any necessary changes and for workers to adjust their retirement plans to take account of those changes. The importance of this is emphasized by the high priority that the President and the Congress are giving to the resolution of the program's financing problems. . . . The impact of the changes in the current program will be minimized if they are enacted soon.

CHANGING DEMOGRAPHICS

I have mentioned "demographics" in a general way, but I have some specific facts to share with you that may be helpful to our discussion today:

- In the U.S. in 1995, the elderly population (aged 65 and over) was about 34 million, making up about 12% of the population. In contrast, there were about 9 million aged people in the U.S. in 1940, and then they accounted for less than 7 percent of the population.
- And Americans are living longer. When benefits were first paid in 1940, a 65-year old on average lived about 12½ more years. Today, a 65-year old could expect to live about 17½ more years and by 2070, life expectancy at age 65 is projected to be an additional 20½ years.
- The elderly population growth rate is expected to be modest from now through 2010, but it will increase dramatically between 2010 and 2030 as the baby-boom generation ages into the 65-or-older age group. The elderly population is expected to reach 75 million by 2050, and will represent 20% of the population.
- In 1994, 60% of the elderly were women and 40% were men. Among the oldest of these (85 or older), over 70% were women and fewer than 30% were men.

Clearly, many millions of people are depending on us for strong and decisive action to preserve and protect the multi-tiered structure of retirement income security.

THE STRUCTURE OF RETIREMENT SECURITY

Social Security has worked well over the past 60 years, arguably better than any other social insurance program in the world. In 1996, 11 percent of the nation's population over age 65 was poor; without their Social Security benefits an additional 40 percent would have been poor, bringing the total percent of elderly in poverty to 50 percent without Social Security. Still, Social Security was never intended to be the only source of retirement income. Social Security was conceived as only one, albeit important, element of retirement income, along with employer pensions and private savings.

Developing an overall plan for retirement has always been desirable. In the process of the national debate on Social Security reform, we need to be sure that we look carefully at what needs to be done to strengthen employer provided pensions and private savings as well as our defined benefits program. Now, with Social Security reform at the forefront of domestic policy discussions, paying more attention to the other two legs of the retirement-income stool has become critical as we look at retirement security for the future.

ROLE OF SOCIAL SECURITY

As you know, Mr. Chairman, Social Security is America's most successful domestic program. It is hard to overstate the importance of Social Security in improving the lives of Americans. Today, Social Security provides benefits to 44 million men, women and children. In 1997, an estimated 145 million people worked in jobs covered by the OASDI program and paid OASDI contributions on their earnings, giving them peace of mind that comes from knowing that they and their families will be protected when they retire or if they should become disabled or die. Nearly 1 in 6 Americans receives Social Security benefits and 95 percent of Americans have the benefit protection provided by our programs.

Social Security is the most effective antipoverty program in history. It is the major source of income for 66 percent of beneficiaries age 65 and older, and it contributes 90 percent or more of income for about 33 percent. As previously noted, about 40 percent of beneficiaries aged 65 or older are kept out of poverty by their monthly Social Security benefits.

And Social Security is much more than a retirement program. It provides valuable insurance protection in the event of death or disability. This protection is extremely important, especially for young families struggling to afford adequate private insurance policies. Almost one in six of today's twenty year olds will die before retire-

ment, and nearly thirty-percent will become disabled. Social Security benefits for a widow and two young children average about $1,500 a month. For a disabled worker and family, the average is about $1,200 a month. While some of these families may also have employer-provided insurance or privately purchased insurance protection—many more rely heavily on the safety net that Social Security provides.

Mr. Chairman, I want to take this opportunity to clear up a misconception that I have come across time and again as I speak to people about the future of Social Security. Many Americans do not seem to understand that Social Security is an intergenerational trust. Many believe that their Social Security contributions are held in interest-bearing accounts earmarked for their own future retirement needs—but, as you know, this is not the case. Today's Social Security contributions mostly fund benefits for today's retired workers. This intergenerational trust is a fundamental element of the Social Security program.

ROLE OF PENSIONS AND SAVINGS

In 1996, 40 percent of the income of the aged came from Social Security. As for the rest, 19 percent came from employer pensions, 18 percent came from asset income (including savings), and 20 percent from earnings.

The story is even more enlightening when one looks at the proportion of income received among different income groups. Among the aged with the lowest incomes (those whose income falls within the lowest quintile), Social Security makes up about 81 percent of their income. In contrast, Social Security provides only 21 percent of the income of the aged with the highest incomes (those in the highest quintile), with 21 percent of their income coming from pensions, 25 percent from personal assets, and nearly 32 percent from earnings.

When we look at the pension element of retirement income, we see that it is stronger than it used to be—over the past 30 years, receipt of employer pensions has almost doubled. But all evidence suggests that the pension leg needs to be made even stronger. Less than half of all individuals aged 65 and older received pensions in 1994.

Also, the pension leg needs to be made stronger because pension coverage has been stagnant in recent years. As we learned at the SAVER summit, 56 percent of full-time civilian wage and salary workers participate in some kind of pension plan at work, but 44 percent do not. Pension coverage is particularly low among people who work for small employers. Eighteen percent of full-time employees who work for private organizations employing fewer than 25 workers participate in pension or retirement savings at work, compared to 62 percent of those in private organizations that employ 100 or more people.

Savings is the third element of retirement income. The savings leg appears to have become weaker over time. Despite the obvious importance of personal savings, the savings rate has declined since World War II. According to the Commerce Department,[1] it has fallen from 9.2 percent of disposable personal income in 1946 to 3.8 percent in 1997. Strengthening the savings leg is an important goal for all Americans, but we are particularly concerned about savings in the bottom half of income levels.

In 1996, only 7½ percent of aggregate pension income went to aged individuals in the bottom half of the income distribution. Only 6½ percent of aggregate savings was held by aged individuals in the bottom half of the income distribution. When I look at these facts, it seems clear that many of these same aged individuals, the ones in the bottom half of the income distribution, are sitting on stools with only one leg—their Social Security.

Do I believe we need to find ways to improve our personal savings rates? Absolutely! To improve personal savings rates, Americans would have to alter their spending behavior, which may be particularly difficult for lower-income people. We need to look carefully at the ideas that flow from this past SAVER summit, as well as the two scheduled for the future, to find ways to help people in the lower half of the income distribution save for their retirement.

President Clinton is committed to ensuring that Americans can look forward to secure retirements. He proposed and signed the Retirement Protection Act, which ensured the soundness of the defined benefit system and the Pension Benefit Guaranty Corporation, in 1994. He supported and signed the Small Business Jobs Protection act, which allowed simplified pension plans for small businesses in 1996. In

[1] This most common measure of saving is part of the Commerce Department's National Income and Product Accounts data. It is calculated by subtracting personal consumption expenditures, taxes, including payroll taxes, consumer interest payments and personal transfer payments to foreigners from personal income.

1997, he signed the Taxpayer Relief Act that raised income limits on deductible IRAs and created the Roth IRA. And in signing the SAVER Act, he has made it clear that more needs to be done.

PRESIDENT'S PROCESS FOR SOCIAL SECURITY REFORM

This Committee's close scrutiny of the stability of each of the components of retirement income security serves to underscore the importance of Social Security and of Social Security reform. President Clinton is strongly committed to strengthening the Social Security system. He is using this year to raise the visibility of Social Security reform. He has challenged every American to attend a conference or forum on the issue—or to organize and host one if none are planned in the community. And Americans are responding. This national call to action is spreading to every corner of the country. Americans have participated in Americans Discuss Social Security (ADSS) forums in Boston, Minneapolis, Tallahassee, Winston-Salem, Albuquerque, Austin, Buffalo, Seattle, Denver, Phoenix and Des Moines.

The President is actively involved in these nonpartisan discussions. On April 7, he participated in a Social Security forum in Kansas City, organized by AARP and the Concord Coalition. He participated in a 10-city videoconference to kick off the ADSS events organized by the Pew Charitable Trust. The Vice President was in Providence, Rhode Island, on July 1, and President Clinton will be in Albuquerque, New Mexico on July 27, for conferences on Social Security reform convened jointly by the Concord Coalition and the AARP. Many Administration officials, including myself, have participated in these events, as have many Members of Congress of both parties.

In December of this year, the President will host a bipartisan White House conference on Social Security as a culmination of the various conferences, forums and discussions held throughout the year. The purpose of the White House conference is to bring together the lessons learned from the national dialogue.

Following the White House conference in December, the President and his team will begin bipartisan negotiations with congressional leaders in early 1999.

PRESERVING THE SUCCESSES OF THE PROGRAM

Clearly, this national dialogue has got to be about how to address the challenges facing Social Security in the future, but it must also be about how we preserve and protect the accomplishments of the program that has served this nation so well for over sixty years.

During this national discussion, we would do well to question whether changes to the program preserve and protect these important accomplishments: whether Social Security continues to be a benefit people can count on; whether the elderly, disabled, and survivors of workers are protected from financial hardship; whether the program has low administrative costs; whether the program is universal and fair; and whether the program is maintained as a basic public trust. The dialogue about how we ensure the solvency of Social Security in the 21st century will need to include these critically important questions.

SSA will play a vital role in this dialogue by helping to make understandable the elements that will lead to long-range solvency. We have made strengthening the public's understanding of the Social Security programs one of our five strategic goals in our recently published Agency Strategic Plan. Through a comprehensive education campaign, Americans will better understand the value of Social Security, while recognizing that its benefits are intended to supplement savings, investments, and private pensions in planning for a comfortable retirement.

PUBLIC PARTICIPATION CRITICAL

As President Clinton has said, we must inform Americans about Social Security and the issues confronting it. The President's proposal to conduct regional forums to raise public awareness of the problems facing Social Security acknowledges an important truth: the broad-based participation of the American public is critical to achieving a resolution of the long-term solvency issue. An accurate understanding of the facts is needed as the foundation for public discussion. We have been focusing our efforts on educating the public about the Social Security programs to put them in the best possible position to be able to enter into public debate about options for the future of Social Security.

I am personally committed to getting the message to as many Americans as possible. I have criss-crossed this nation to participate in numerous forums and discussions with the public and with members of Congress. I have also made sure that members of my top staff were actively engaged in many of the forums around the

country. I want to be sure that all Americans understand that there is a debate going on and that each and every one of us needs to be involved.

What do I believe Americans should understand about our Social Security program? I want all Americans to understand the economic facts about Social Security. Presently, the Social Security Trust Fund takes in more money than it spends, creating reserves in the Trust Fund. These reserves were designed to help pay for the future growth in the benefit rolls in the early part of the next century.

I want all Americans to understand what Social Security has meant to older Americans. The plight of older Americans used to be a national disgrace. Now, Social Security provides them with a solid measure of economic security even if they outlive the actuarial tables . . . and their savings. It also provides many of them, and their children, the advantages that only living independently can offer.

I want all Americans to know that Social Security is more than a retirement program. I want younger people to know that not only will Social Security be there for them in the future, but it is there for them NOW in the form of disability and survivor's protection.

I want all Americans to know that Social Security was never intended to provide for all of a worker's retirement income needs. Pensions and personal savings have always been and should always be part of a sound financial retirement plan.

I want all Americans to understand that the changing demographics of the country are the primary driver of the need for change. There is an unalterable dynamic at work: by 2030, there will be nearly twice as many older Americans as there are today, putting great strains on our retirement system.

Finally, I want all Americans to understand one important fact: There are trade-offs that must be accepted for each approach to achieving solvency. These are complex issues. The advantages and disadvantages of each proposal will have to be examined and discussed. Let me remind you again that the purpose of public education is to enable members of our society to participate in an earnest and informed dialogue about this most important issue. We need to hear from Americans on this issue. Their views are clearly important because Social Security is their program.

PRINCIPLES TO BE CONSIDERED IN REFORM

President Clinton has indicated that he will judge any reform proposal by its ability to meet the following five principles:

- Reform should strengthen and protect Social Security for the 21st Century. Proposals should not abandon the basic program that has been one of our nation's greatest successes.
- Reform should maintain the universality and fairness of Social Security. For half a century, Social Security has been a progressive guarantee for citizens. It should be kept this way.
- Social Security must provide a benefit people can depend on. Regardless of economic ups and downs, Social Security must provide a solid and dependable foundation of retirement security.
- Social Security must continue to provide financial security for disabled and low-income beneficiaries. We must never forget the one out of three Social Security recipients who are not retirees.
- Social Security must maintain America's fiscal discipline. Any budget surpluses should be reserved pending Social Security reform.

Throughout the program's history, one feature of Social Security has never been altered: the fundamental commitment to offer a basic foundation of protection that ensures economic security for American families. Social Security has fulfilled this commitment well over the past six decades. The principles of universality, progressivity, dependability, financial security and fiscal discipline form an important framework for evaluating potential changes to the program.

CONCLUSION

I strongly support the President's initiatives to restore the Social Security program to long-term fiscal health. I appreciate having the opportunity to be a part of this full and open public debate. I would like to emphasize, however, that as we begin to seriously address these issues, we must continue to preserve fiscal discipline. For the sake of our children and future generations, we must not jeopardize the progress we have made in balancing the budget.

This Administration and Congress have demonstrated that they are capable of coming together in a bipartisan way to fashion solutions important to this nation. Today we have an historic opportunity to SAVE SOCIAL SECURITY. Now is the time—when the economy is strong, the budget is balanced—to begin to address the economic security for future generations of retirees. Now is the time—when the pro-

gram is not in crisis—to face the long-range solvency problem and to begin to deal with it.

As the country considers changes in our national retirement income policies, there is clearly more at stake than "just" Social Security. Social Security is the most universal and dependable portion of the retirement income that workers can rely on, but we need to remember that pensions and savings are also important sources of retirement income. Changes made to Social Security can affect these other sources of retirement income as well. It's important to consider what the effects of Social Security reform on these other sources might be.

This Administration and Congress have demonstrated that they are capable of coming together in a bipartisan way to fashion solutions important to this nation. In addition to Social Security reform, finding ways to increase overall pension coverage among workers and finding ways to encourage workers to save more for retirement can make us all better off in our "golden years." I look forward to working closely with the members of this Committee on this important endeavor.

SOCIAL SECURITY

Office of the Commissioner

September 16, 1998

The Honorable Daniel Patrick Moynihan
U.S. Senate
SR-464 Russell Senate Office Building
Washington, D.C. 20510-3201

Dear Senator Moynihan:

This letter transmits information on reasons for early retirement that you requested at the Senate Finance Committee's July 22, 1998 hearing on "New Directions in Retirement Income Policy."

As I indicated at the hearing, a large portion of retirees receive Social Security benefits before age 65. Currently, over half of American workers start receiving retirement benefits at age 62, when they are first eligible. Although men are leaving the work force at younger ages than in the 1960s, this trend leveled off in the 1980s and has remained stable since that time. Men over 65 have actually increased their participation in the workforce over the last few years. From 1970 to 1980, labor force participation rates for women also dropped, but far more modestly than for men. Since 1985, labor force participation rates for women have actually increased at all ages from 55 to 70, some rates by as much as 38 percent.

There is a wide range of reasons why individuals retire early. Although individual responses to work and retirement incentives vary, studies suggest that Americans choose to retire early for three main reasons: (1) they can financially afford early retirement; (2) poor health forces them to withdraw from the work force; and (3) suitable jobs may be unavailable to older Americans. Of these three factors, current research suggests that financial status plays a dominant role in early retirement decisions.

Enclosed is a document that provides more detail on why individuals retire early. The Social Security Administration is continuing its analysis of this issue, using new data sources as they become available.

I look forward to working with you and other Members of Congress as we continue with this national debate on the future of Social Security. Please advise me if I can be of further assistance.

Sincerely,

Kenneth S. Apfel
Commissioner
Of Social Security.

Enclosure

Why Individuals Retire Early

Summary

On average, American workers are leaving the labor force at younger ages than in the 1960s, although this trend has leveled off. From the mid 1960s to the mid 1980s, there was a substantial decline in labor force participation rates among men age 60 to 64, a moderate decline among men 55 to 59 and some decline among men 50 to 54. Since 1985, the labor force participation rate has stabilized among men 55 to 64 and *increased* among men age 65 to 70.

From 1970 to 1980, labor force participation rates for women also dropped, but far more modestly than for men. Since 1985, labor force participation rates for women have actually *increased* at all ages from 55 to 70, some rates by as much as 38 percent. This increase on the part of older women may not reflect a decision to postpone retirement, but a higher entry into the workforce among women.

Today, approximately 80 percent of Social Security beneficiaries claim retirement benefits before the age of 65, electing reduced benefits.[1] Over half of American workers start receiving retirement benefits at age 62, when they are first eligible.[2] Although individual responses to work and retirement incentives vary substantially, even among persons with common background characteristics and financial circumstances, studies suggest that older Americans choose to retire early for three main reasons:

1. they can financially afford early retirement;
2. poor health forces them to withdraw from the workforce; and,
3. suitable jobs may be unavailable to them.

To date, no comprehensive study has been conducted to conclusively determine the impact of these factors on retirement decisions. Most studies on retirement decisions use data from the1969 to 1979 Retirement History Study[3], which followed a cohort through their retirement years, but the data are now out-of-date. Future generations of retirees may not follow similar retirement patterns. Current research, however, suggests that financial status plays a dominant role in early retirement decisions. The Social Security Administration (SSA) plans to analyze data from the on-going Health and Retirement Study[4] when enough data becomes available to

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[1] Social Security Bulletin, Annual Statistical Supplement, Table 6.A.4, 1997. This figure does not include those individuals who at age 65 automatically switch from coverage under the Disability Insurance (DI) program to the Old Age and Survivors Insurance (OASI) program.

[2] Ibid.

[3] The Retirement History Study was a longitudinal study conducted by the Social Security Administration and designed to answer specific questions relevant to Social Security policy, such as why do some workers retire early and what is the replacement rate for pre-retirement income by Social Security benefits. Other topics included changes in health and economic status associated with the transition from work to retirement. The Bureau of the Census conducted the interviews and respondents were interviewed every two years over an eleven-year period starting in 1969.

[4] The Health and Retirement Study, sponsored by the National Institute on Aging, was started in 1992, with the purpose of providing more current information on retirement issues. This study is a longitudinal study of persons in

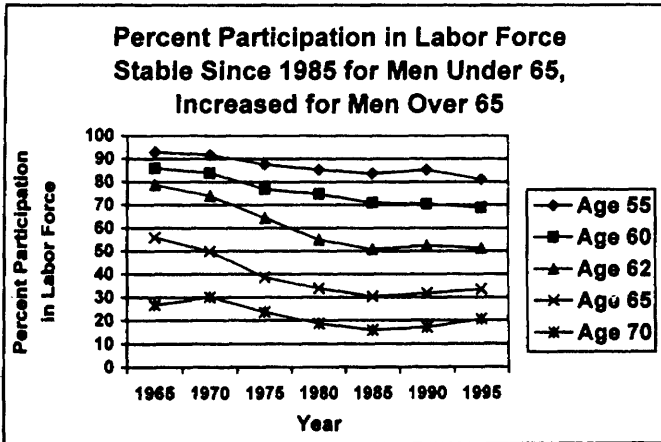
determine recent health trends and the impact these trends may have on the decision to retire. In the meantime, we are able to identify the likely causes of early retirement from the abundance of evidence currently available.

Labor Force Participation Rates Declined From 1960s, but Remain Stable Since 1980s

One way to assess retirement trends is to examine the percentage of Americans in the workforce. In 1950, nearly 50 percent of American men 65 and older were still in the work force; by the 1990s, less than 20 percent of this age group were still in the work force. Labor force participation rates of workers *under* age 65 also have declined. From the mid 1960s to the mid 1980s, there was a:

- 30 percent decline in participation rates of men age 60-64;
- 14 percent decline among men 55-59;
- 7 percent decline among men 50-54.

When looking at specific ages, the most dramatic decline occurred among 62 year olds, as shown in the chart below.



Source: For men ages 55-74, 1963-1983, taken from Philip L. Rones, "Using the CPS to track retirement trends among older men," Monthly Labor Review, February 1985, Table 1. All other data taken from unpublished tabulations from the Current Population Survey, U.S. Department of Labor, Bureau of Labor Statistics.

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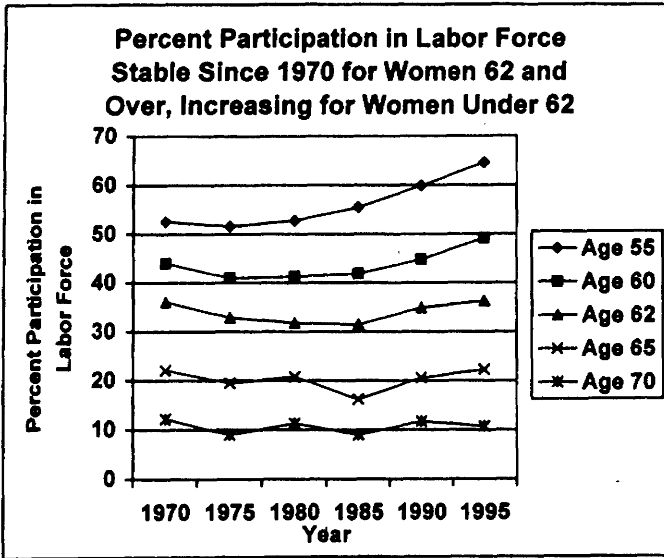
the 1931-1941 birth cohorts as they enter their retirement years. The Institute for Social Research at the University of Michigan is conducting the study. Respondents and their spouses are interviewed every other year, and interviews will probably continue until mortality overwhelms the sample. The first interview gathered information on demographics, health, housing, family, work history, disability, retirement plans, expectations, net worth, income, insurance, and widowhood. Subsequent interviews will measure the change in labor supply and health status (dependent variables) and the explanatory variables.

According to SSA researchers, these declines leveled off in the mid-1980s and have remained stable since that time. Since 1985, there has been:

- less than a 5 percent decline among men 55 to 61;
- very little change in participation among men age 62;
- less than a 2 percent drop among men 63-64;
- an *increase* of approximately 10 percent in participation for men age 65 to 69; and,
- a near 30 percent *increase* in participation for men age 70.



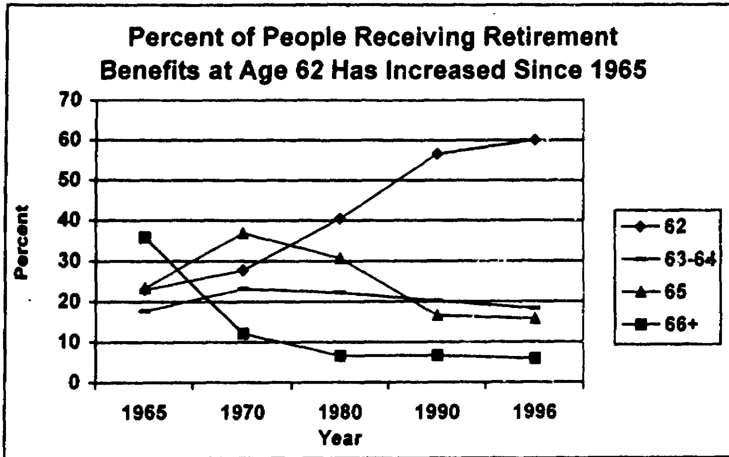
Source: Unpublished tabulations from the Current Population Survey, U.S. Department of Labor, Bureau of Labor Statistics

As the above chart shows, from 1970 to 1980, labor force participation rates for women also dropped, but far more modestly than for men.

Since 1985, labor force participation rates for women have actually *increased* at all ages from 55 to 70, with some rates increasing by as much as 38 percent. This increase on the part of older women may not reflect a decision to postpone retirement, but a higher entry into the workforce among women.

Percentage of Individuals Receiving Retirement Benefits At 62 Has Increased Since 1965

A second method of measuring retirement is analyzing when individuals first elect to receive Social Security retirement benefits. The chart below shows the percentage of individuals who receive retirement benefits at various ages.[5]



Source: Annual Statistical Supplement to the Social Security Bulletin, 1966, 1971, 1981, 1991, 1997.

Today, almost 80 percent of Social Security beneficiaries claim retirement benefits before age 65. This is a significant increase since 1965, when only about 40 percent took early benefits. Since individuals receiving retirement benefits do not necessarily choose to stop working, this chart does not conflict with the previous charts on work-force participation rates.

Older Americans Can Afford to Retire Early

Although health was considered to be the primary cause of retirement through the 1970s, later work by SSA researchers suggests that the decision to retire is based primarily on financial considerations. According to these researchers, the majority of people who take retirement benefits at the Early Retirement Age (ERA) are financially able to do so and do not do so because of poor health.

[5] These numbers do not include those individuals who at age 65 automatically switch from coverage under the Disability Insurance (DI) program to the Old Age and Survivors Insurance (OASI) program. Since DI program participants do not actually *retire* at 65, including the disabled population in the calculation would exaggerate the percent of individuals appearing to take retirement benefits at age 65. Therefore, this measure of the percentage receiving retirement benefits, excluding DI conversions, is more accurate.

Four main variables affect a retiree's financial situation and play a role in the decision to retire early:

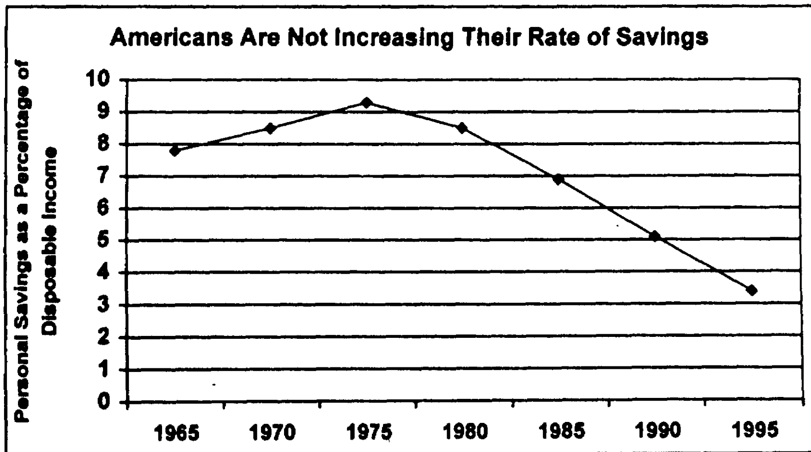
(1) the level of personal savings and investment;
(2) the availability of employer-sponsored pensions;
(3) the access to employer-sponsored health insurance in retirement; and,
(4) Social Security policy.

Each of these four variables will be discussed below.

Individuals with Higher Levels of Personal Savings and Investment Can Choose to Retire Early

The accumulation of personal savings and investments influences the retirement decision. In 1996, 18 percent of income for the elderly came from personal assets[6]. This reflects a higher savings rate for this generation during their working years than for subsequent generations. On average, however, Americans save a very small portion of their disposable income.

The chart below shows that the ratio of personal saving to disposable personal income declined from 1975 to 1995, despite the recent economic boom.



Source: *Survey of Current Business*, Department of Commerce, Bureau of Economic Analysis, August 1998.

[6] *Income of the Population Age 55 and Older, 1996*, Social Security Administration, p. 120.

The attempt to predict how the next wave of retirees, the 'baby boomers,' will fare in retirement has produced some differing, but not necessarily contradictory, conclusions. Two separate 1993 Congressional Budget Office reports concluded that baby boomers are likely to enjoy higher real incomes in retirement than their parents do, while Princeton economist Douglas Bernheim predicts that baby boomers are saving at just one-third the rate needed to maintain their lifestyle in retirement.

Employer-Sponsored Pension Plans Can Encourage Early Retirement

Since pensions serve as a partial substitute for wages, individuals who receive employer-sponsored pensions may retire early. Moreover, many companies encourage early retirement in an effort to eliminate higher-paid older employees and replace them with cheaper and younger labor. They accomplish this by lowering the minimum age of eligibility to retire and receive pension benefits or by periodically providing monetary bonuses to those who retire during a specific 'retirement window.'[7] For example, in a large-scale survey of private defined-benefit pension plans in 1995, about one-half of participating employees could potentially receive full retirement benefits prior to age 65.[8] Almost all employees could receive reduced early retirement benefits at age 55 or younger.[9] One study attributes an 18 percent decline in workforce participation among men aged 55 to 64 from 1970 to 1986 primarily to the increase in Social Security benefits in the 1970s as well as the increase in the number of employer-sponsored pensions that favored early retirement.[10]

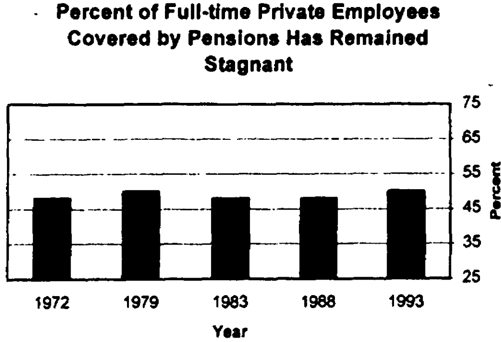
There are two basic types of employer-sponsored pensions: defined benefit plans and defined contribution plans. Defined benefit plans provide pension payments based on employer-developed formulas that usually include years of service and average wages. SSA researchers report that, as a result, employers can tailor formulas to provide incentives for early retirement. One research team recently summarized the body of empirical research on retirement and concluded, "pension effects, for those covered by defined benefit plans, are much more important than the Social Security incentives."[11]

Two trends, however, may reduce the impact that employer-sponsored pension plans have upon retirement decisions in the future, either by themselves or relative to other factors:

1. ***Stagnation of employer-sponsored pension coverage.***[12] According to SSA's Office of Research, Evaluation and Statistics (ORES), pension coverage rates have remained at approximately 50 percent of all workers since the late 1960s, as shown in the

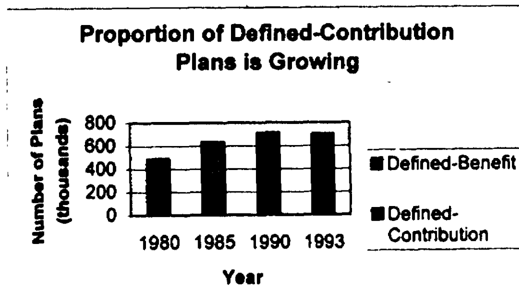
[7] Leonesio, Michael. "The Economics of Retirement: A Nontechnical Guide," *Social Security Bulletin*, Vol. 59, No. 4, (1996), p. 42.
[8] EBRI Databook, 1997, Table 21.2.
[9] Ibid.
[10] Ibid. Study conducted by Richard Ippolito.
[11] Martin, Linda G. and Samuel H. Preston, Eds. *Demography of Aging*. National Academy Press (1994), p. 77. Research team of Richard Burkhauser and Joseph Quinn
[12] "Coverage" as used here and in most of the pension literature is the number of employees who have access to and participate in a pension plan.

following chart. On the other hand, other researchers have found that coverage may have actually declined slightly in the 1980s, particularly for younger, less educated men. SSA researchers indicate that if pension coverage has fallen, there is a greater chance that workers will delay retirement because they will be less able to afford leaving the workforce.



Source: "Pension and Health Benefits of American Workers: New Findings from the April 1993 Current Population Survey," U.S. Department of Labor, Social Security Administration, U.S. Small Business Administration, Pension Benefit Guaranty Corporation, 1994.

2. ***Increasing substitution of defined contribution plans for defined benefit plans.*** Even as overall pension coverage has stabilized, the proportion of workers covered only by defined contribution plans has increased considerably. According to the Department of Labor (DOL), between 1975 and 1993 the proportion of private sector employees covered by a primary defined contribution pension plan grew from 6 percent to 20 percent. The chart below suggests that this increase in defined contribution coverage is due to the increasing substitution of defined contribution plans for defined benefit plans.



Source: Private Pension Plan Bulletin, Number 6, 1997.

Defined contribution plans, such as 401(k), and 403(b) plans, offer benefit levels that are determined by contribution rates and investment performance, and according to SSA researchers, it is more difficult for employees to predict the nature and the amount of future benefits. Moreover, employers do not typically manipulate benefit levels of defined contribution plans to promote early retirement, since it is the contribution rate that is structured. As a result, defined contribution plans have an ambiguous impact on early retirement decisions. After sustained periods of high investment returns, they might be expected to encourage early retirement; on the other hand, they might produce the opposite effect after periods of poor investment performance.

Employees with Employer-Sponsored Health Insurance Are More Likely to Retire Early

Access to post-retirement health insurance encourages early retirement.[13] Without health insurance coverage, many people would either have to sacrifice their personal retirement savings in case of illness, or forgo medical treatment. Therefore, access to affordable health care is also a factor when employees decide whether they can afford early retirement.

According to ORES, many employees do not take retirement benefits before the age at which people receive 100 percent of their retirement benefits (age 65) because Medicare will not cover them until age 65, and they may be unable to obtain private insurance, or may face prohibitively high premiums for private insurance. In 1993, 61 percent of the respondents to a joint Employee Benefits Research Institute/Gallup survey stated that they would not retire prior to becoming eligible for Medicare without employer-provided retiree health insurance.[14] If employers provide health insurance coverage for their retirees, they give them the option of retiring early without having to wait for Medicare coverage.[15] One study concludes that the presence of health benefits increases the probability of retiring by 50 percent.[16]

Although limited trend data are available, the number of employers providing health insurance coverage to their retirees is dropping. In recent years, employers have experienced higher retiree-to-active worker ratios, and the life spans of retirees are increasing while their health care costs are growing.[17] As a result, many firms are no longer offering health insurance coverage into retirement. According to one survey, in 1996 only 40 percent of large employers (more than 500 employees) offered health benefits to early retirees – a drop of 6 percent from 1993.[18] Those employers that have continued offering coverage have required that retirees pick up more of the

[13] Karoly, Lynn A. and Jeannette A. Rogowski. "The Effect of Access to Post-Retirement Health Insurance on the Decision to Retire Early," *Industrial and Labor Relations Review*, Vol. 48, No. 1 (October 1994).
[14] Employee Benefit Research Institute/The Gallup Organization, Inc. "Public Attitudes on Medicare and Retiree Health, 1993," *Summary Report* G-51, November 1993.
[15] Gebhardtsbauer, Ron. "The Future of Social Security for This Generation and the Next: Raising the Retirement Age," Testimony before the Social Security Subcommittee on Ways and Means, U.S. House of Representatives, February 26, 1998, p. 4.
[16] Study by Lynn Karoly and Jeannette Rogowski.
[17] Employee Benefit Research Institute. "EBRI Databook on Employee Benefits,", 1997, p. 305.
[18] GAO. "Retiree Health Insurance: Erosion in Employer-Based Health Benefits for Early Retirees," July 1997, web version, p. 4.

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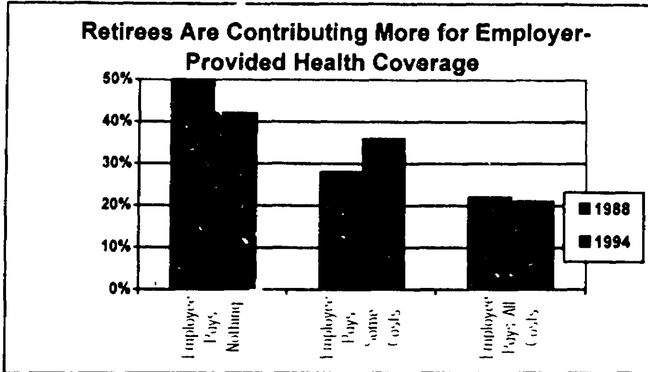
costs of the benefit.[19] The DOL reports that the percentage of retirees that were covered by employer-provided health benefits and whose employer paid the entire premium dropped from 50 percent in 1988 to 42 percent in 1994.[20]



Source: Department of Labor, Pension and Welfare Benefits Administration, as reported in GAO Report "Retiree Health Insurance: Erosion in Employer-Based Health Benefits for Early Retirees, July 1997."

As the above chart shows, more employees are being asked to share the cost of health insurance with employers. In both the 1988 and 1994 DOL surveys, individuals who declined employer-based coverage at retirement were asked to cite the reason for their decision. Of the 5.3 million retirees who discontinued employer-based benefits in 1994, 27 percent cited the expense as a factor – a 6 percentage point increase from 21 percent in 1988.[21] Should these trends continue, fewer employees would be able to afford continuing health insurance coverage and early retirement.

Social Security Provides Some Incentive for Early Retirement

As with other sources of income, Social Security provides an incentive to reduce the number of hours worked between the ages of 62 and 65. Because Social Security benefits essentially substitute for work income, beneficiaries can opt to increase the amount of time they devote to leisure activities. Researchers estimate that Social Security may be responsible for one-quarter to one-third of the drop in labor force participation over time.[22]

The tendency of most early retirees to retire at 62 and 65 rather than other years is evidence that Social Security's ERA of 62, and the age at which people receive 100 percent of their retirement

[19] GAO. "Retiree Health Insurance," web version, p. 7.
[20] "Trends in Retirement," p. 24.
[21] GAO. "Retiree Health Insurance," web version, p. 9.
[22] Quadagno, Jill and Joseph Quinn. *Does Social Security Discourage Work?*, June 1995, p. 11

benefits, age 65, do influence the decision to retire.[23] ORES suggests that since Social Security reflects accepted public policy about retirement, the eligibility ages may set societal norms that impact the retirement decision beyond the influence of actual benefit levels.

Other Social Security program features, such as the Retirement Earnings Test (RET), which reduces benefits by 33 or 50 percent per dollar earned for beneficiaries under age 70 who continue to work and earn more than certain limits, may discourage some older employees from remaining employed after age 65.[24] While this behavior on the part of older Americans would certainly be logical, a recent analysis of the topic argues that the RET plays a relatively minor role in determining the labor supply of older workers. This analysis found that the estimated change in the *timing* of retirement is small. "[F]or the average retiree with earnings above the limit, the retirement date would occur about 3 weeks earlier."[25]

While no one seems to dispute that Social Security does have an impact on the decision to retire early, many researchers have concluded that the influence of Social Security is less than other factors such as pensions, income levels, earnings opportunities, and health. Some researchers have argued that the trend toward earlier retirement was already underway at the beginning of the century, before Social Security could affect retirement choices.[26] Additional research has indicated that major changes in Social Security benefits produced small effects on retirement behavior. For example, prior to the establishment of automatic cost-of-living adjustments in 1975 and the indexing of average wages in 1977, the 20 percent real increase in benefits approved by Congress between 1969 and 1973 caused only a two-month decline in the average retirement age of men receiving these higher benefits.[27]

Health Concerns Are a Factor, But May Not Be the Primary Cause of Early Retirement

Prior to the 1970s most researchers believed that health problems were the primary cause of early retirement. Since then, though the findings are not unanimous, many researchers have concluded that most early retirements are voluntary and are based primarily on economic incentives. According to ORES, while health certainly plays a role in the decision to retire, it is not the most important factor. In fact, most men and women who claim retirement benefits at age 62 are in good health.[28]

SSA researchers report that there is preliminary evidence that health status and capacity to work have been improving since the early 1980s for older individuals. Furthermore, the takers of early retirement and postponers of retirement are relatively alike in health, indicating that some other

[23] Leonesio, Michael V. "Social Security and Older Workers," *Social Security Bulletin*, Vol. 56, No. 2 (1993), p. 47-57
[24] GAO, p. 6.
[25] Ibid.
[26] Gary Burtless, "Increasing the Eligibility Age for Social Security Pensions," Testimony for the Special Committee on Aging, United States Senate, July 15, 1998, p. 8.
[27] Ibid, p. 9.
[28] Burkhauser, Richard V.; Kenneth A. Couch; and John W. Phillips, "Who Takes Early Social Security Benefits? The Economic and Health Characteristics of Early Beneficiaries," The Gerontologist, Vol. 36, No. 6, 1996, p. 789-799.

factor(s) may be responsible for early retirement. For example, ORES reports that in 1994, 20 percent of male takers of early retirement and 21 percent of male postponers of retirement described themselves as being in poor health. ORES suggests that, in some cases, health problems may actually encourage individuals to defer retirement so they can retain employer-provided health benefits, particularly until they qualify for Medicare benefits. A recent SSA analysis of the early-1990s Survey of Income and Program Participation[29] (SIPP) shows that among employed persons aged 62 to 64, 16.1 percent of men and 14.7 percent of women report a severe disability.

Some researchers, however, have concluded that health does play an important role in the decision to retire early. Debra Dwyer and Olivia Mitchell found that health plays a much bigger role in retirement planning than economic factors,[30] and Bound, Shoenbaum, Stinebrickner and Waidmann found that health is the most important factor in the transition to retirement.[31]

Poor health can lead to early retirement by:

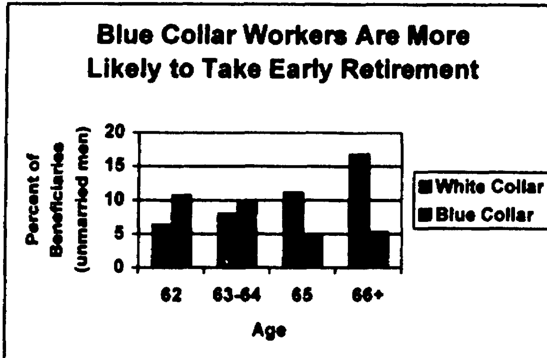
1. making work more difficult and increasing preferences for leisure;
2. lowering wages that the employee can demand; and,
3. decreasing life expectancy.

According to data from the SIPP, 22 to 31 percent of men age 62 to 67 indicate that a disability limits their ability to work.[32] ORES reports that of those individuals age 62 to 64 who are receiving early retirement benefits, 30 percent report that health prevents or limits their ability to work. ORES concludes that this group is the least likely to continue working and would be most negatively affected by an increase in the ERA. Depending on the severity of their disability, however, some of these individuals may qualify for Disability Insurance (DI). In order to assist those individuals who do not meet the current criteria for DI, but who are unable to work up to the new ERA due to poor health, some people suggest expanding the disability definition.

[29] SIPP is a longitudinal survey conducted by the Bureau of the Census every four months for a period of 32 months. Beginning in 1996, the period was extended to four years. The first SIPP was in 1984 and a new SIPP panel was started each year with rare exception. The survey uses in-person interviews to gather information on a wide range of social, economic, and demographic information, but the primary focus is on monthly income sources and participation in government assistance programs.
[30] Dwyer, Debra and Olivia Mitchell, "Health Problems as Determinants of Retirement: Are Self-Rated Measures Endogenous?", 1997, Forthcoming in Journal of Health Economics.
[31] Bound, J., M. Schoenbaum, T. Stinebrickner, and T. Waidmann, "Measuring the Effects of Health on Retirement Behavior," Unpublished Manuscript, 1997.
[32] GAO. p. 3.

Blue Collar Workers are Disproportionately Affected by Health Problems

According to the Health and Retirement Study, blue-collar workers are 80 percent more likely than white-collar workers to experience pain that affects their ability to work. Non-construction laborers and individuals holding similar jobs suffer an occupational injury risk that is twelve times that for managers and professional employees.[33] Since these health problems impede their ability to work, blue-collar workers are more likely than white-collar workers to retire before 65 as shown in the chart below.



Source: Social Security Bulletin, March 1985/Vol. 48, No.3, Table D[34]

On average construction employees tend to retire at age 58.[35] Older blue-collar workers are in less demand since physical strength is a prerequisite for these jobs. Consequently, many blue-collar workers find that their health problems prevent them from remaining in the work force even if they cannot afford to retire.[36]

In the future, the percentage of older workers expected to be in jobs with heavy strength requirements is likely to decline to between 7 percent and 9 percent by 2020, compared to 11.4 percent in 1982.[37] In 1982, the percentage of newly retired workers in jobs with medium strength requirements was 27.8 percent.[38] Therefore, including this broader definition of 'physically challenging', nearly 40 percent of older workers were in 'physically demanding' jobs in 1982. Unfortunately, there are no projections available on the percentage of workers expected to be in jobs with medium strength requirements in future years.

[33] "Report on the American Workforce," Bureau of Labor Statistics, 1994.
[34] Blue-collar as used here is defined as workers classified as handlers, equipment cleaners, helpers and laborers. White-collar as used here is defined as workers from executive, administrative and managerial occupations or from professional specialty occupations.
[35] "Construction Chartbook," Center to Protect Workers Rights, 1998, p. 19. Data taken from 1995 survey conducted by the University of Michigan Institute for Social Research.
[36] GAO. p. 7.
[37] *Social Security Bulletin* Vol. 49, No. 10, (October 1986), p. 5.
[38] Ibid, p. 11.

This shift towards less physically-demanding work, as well as medical advancements and the good health of those individuals already electing early retirement, all suggest that health related retirement should continue to decline. However, while the proportion of individuals in jobs with heavy strength requirements is declining, there is some evidence that health problems may also affect individuals in jobs that are demanding, but not in terms of physical strength. Based on recent data from the National Health Interview Survey (NHIS), researchers have concluded that among the older working-age and early-retirement population, sales and clerical workers have a higher incidence of disability than either blue-collar or white-collar workers.[39] Furthermore, based on data from the first two waves of the Health and Retirement Survey, stress and the presence of environmental hazards are the characteristics with the most persistent relationship to disability for men.[40]

Older Workers May Be Unable to Secure Suitable Jobs

Employers may be unwilling to retain or hire older workers for the following reasons:

1. higher wages and health care costs are associated with older employees;
2. average recruitment and training costs are higher for older employees, and they may leave the firm after a short period;
3. some employers have negative perceptions of older employees;[41]
4. many older employees prefer to work part-time, and companies are not willing to accommodate them.

First, employers may be unwilling to retain older workers because of the higher wages, health insurance costs and other benefit costs they incur. In fact, there is a negative relationship between an employer's provision of health care benefits and their tendency to hire older workers.[42] Part of the reason is that the Age Discrimination in Employment Act requires that employers offer workers with similar experience the same level of benefits. The cost of an older worker's employee benefits could be $10,000 more per year than a younger worker's.[43] As a result, firms have an incentive to substitute younger employees who are less costly to insure, for older employees.[44] According to SSA researchers, there is some evidence from the 1980s that firms downsizing to increase competitiveness targeted employees age 50 or older with incentives to leave the firm voluntarily.[45]

[39] "Research Grant Summary," *Social Security Bulletin*, Vol. 60, No. 3, 1997, p. 50-51. The NHIS is an ongoing household survey of the noninstitutionalized population of the U.S., designed to monitor health and health care utilization.
[40] Crimmins, part 2, p. 10.
[41] GAO. p. 6.
[42] Ibid, p. 5.
[43] Gebhardtsbauer, p. 6.
[44] Ibid, p. 6.
[45] Leonesio, Michael. "The Economics of Retirement: A Nontechnical Guide," *Social Security Bulletin*, Vol. 59, No. 4, (1996), p. 43.

Second, new employees may require significant training in learning their new jobs. If these costs are high, it is in the firm's interest to hire younger employees, who have more years left in their careers and are therefore better subjects for the firm's investment. Older workers, who have fewer years left before retirement, may provide less of a return on this investment than these young workers. As a result, firms have an incentive to discriminate against older job candidates.[46]

Third, some managers have negative perceptions about an older worker's level of productivity, ability to use new technology, flexibility, ability to learn new skills, and physical ability. Some employers believe that the negative aspects of older employees outweigh the positive contributions they might make in terms of experience, judgement, good attendance and punctuality.[47]

Finally, many recent studies have documented the increasing trend toward gradual or partial retirement. While many older workers might want to move more gradually into retirement by working fewer hours, ORES research indicates that their career employers do not provide them with this option.

As a result of these four obstacles, many older workers may have difficulty remaining in the workforce.

The demand for older workers, however, can be positive. First, the U.S. job market has historically been able to absorb large numbers of extra workers without increasing unemployment. For example, between 1964 and 1989, 50.4 million baby-boomers entered the labor market and 95 percent of them found jobs. Furthermore, the job market has accommodated students and mothers who prefer to remain in the job market, but work part-time.

There also is evidence that some of the negative perceptions employers held of older workers have dissipated. The Center for Productive Aging at Towson University conducted a survey in 1997 of 240 U.S. employers to explore their experiences with and attitudes towards older workers. Three-quarters of these employers had workers older than age 65 actively involved in the company. The results of this survey indicate that employers generally had positive attitudes regarding older workers:

- Over 80 percent said they were "reliable, did not miss time due to illness, had low turnover rates and were interested in learning new tasks, were not demanding and were not rigid nor unwilling to change."[48]
- 70 percent of the employers did not view health care costs as a barrier to hiring older employees.
- 91 percent of employers indicated that company image was not a factor.
- Only about 50 percent expressed concern over the skill level of older employees.

There is evidence that employers are starting to take advantage of the pool of older workers. Labor force participation rates are currently on the rise among older workers,[49] and 60 percent of the employers surveyed indicated that the greatest barrier to hiring workers above age 65 was their inability to locate them.[50]

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[46] GAO. p. 6.
[47] Ibid.
[48] Wagner, Donna L. "Statement of Donna L. Wagner," Testimony before the Senate Special Committee on Aging.
[49] Men over 62 and women under 62, as seen in labor force participation charts at the beginning of this paper. For men ages 55-74, 1963-1983, data taken from Philip L. Rones, "Using the CPS to track retirement trends among older men," Monthly Labor Review, February 1985, Table 1. All other data taken from unpublished tabulations from the Current Population Survey, U.S. Department of Labor, Bureau of Labor Statistics.
[50] Wagner, p. 2.

PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY

I want to thank Senator Roth for calling this hearing focusing on the nation's retirement policy. This is the first hearing that I am aware of that examines all four pillars of retirement income: Social Security; personal savings; pensions; and employment. This past year, Social Security reform has dominated the retirement income policy field.

owever, as we continue to debate the best course of action for reforming the Social Security system, it is vital that we also take a step back and not look at the Social Security program in isolation from the other streams of retirement income.

Social Security was never intended to be the sole source of income for people in their retirement years. In fact, Social Security only provides 41 percent of the average worker's pre-retirement salary. The rule of thumb is that a person needs 70 to 80 percent of their pre-retirement earnings in order to maintain their lifestyle once they retire. For that reason, private pensions, personal savings and continued participation in the workforce have always been considered integral parts of a retiree's income security in later life. Studying the dynamic interaction of each of the income streams on an individual's retirement security is a crucial element in the Social Security reform debate. After all, it does no good to improve the Social Security system if the improvement jeopardizes the other pillars of retirement income security. Then we just end up back where we started.

With the baby boom generation set to begin retirement in just a few years it is vital that we do all we can to help them prepare. According to the 1998 Retirement Confidence Survey, which I am sure Mr. Yakaboski will discuss in greater detail, both men and women expect personal savings to be the most important source of retirement income, followed by a pension. Only 12 percent of men and 10 percent of women expect Social Security to be their most important source of retirement income. Employment as an income source is the fourth item on that list. The reality for today's workers and retirees is not consistent with what people believe will happen in the future.

While a quarter of both men and women anticipate an employer-provided pension to be their most important source of retirement income, pension coverage levels have remained consistent over the last decade. That stagnation is troubling. Even more troubling is the lack of coverage in the small employer community. Senator Graham, myself and five of our colleagues on this committee have introduced a revised version of a comprehensive pension reform bill we introduced last year. In fact, the bill was such a defining force in pension policy that two other bills have been introduced with the exact same name—in order to avoid confusion we went with a different title this year. Several of the provisions of S. 889 were enacted as part of the Taxpayer Relief Act of 1997. I think this legislation does an outstanding job of addressing some of the fundamental issues which discourage new plans and discourages accumulation of retirement savings by women and lower paid workers.

I look forward to hearing the testimony of the witnesses on both panels.

PREPARED STATEMENT OF HON. ORRIN G. HATCH

- The average American today will spend one-third of their live in retirement.
- Every 50 seconds, another baby boomer turns 50.
- 30% of Americans have not yet started to prepare for retirement in any way, 47% of them take a casual approach to retirement savings, and only 23% save systematically for retirement.
- The fastest growing segment of our society is people over the age of 65, with a growth rate of 112%.

These statistics, and others, are becoming familiar to each and every one of us. The demographics of our country are changing. We are living longer, having fewer kids, and spending more time in retirement. And our work force is shrinking. These changes are forcing all of us to take a second look at the future.

This is not just an American phenomenon. In OECD countries, the number of retirement age people is expected to increase by 70 million people over the next 25 years. Over that same time period, the number of working age people is only expected to increase by 5 million. The numbers just don't add up anymore. Countries all over the world are standing at the same crossroads and struggling with the same issues—how do we redefine our retirement policies to reflect these new 21 century scenarios.

In the United States, we have heard a lot of talk about the dire need for Social Security reform. This is not just idle talk. It is real. According to the Social Security Trustees, tax revenues will no longer cover Social Security benefit payments in

2013. Cuts in federal spending, new deficits, or tax increases would then be necessary to fund redeeming the U.S. Treasury bonds held by the Trust Fund. By the year 2032, even the Trust Funds will be exhausted.

The debate over Social Security has spawned several proposals for reform that range from tinkering around the edges to total privatization. These reform proposals are all important and deserve a thorough evaluation. The hearing today is one step in that direction.

This debate, however, often seems to ignore the bigger picture. Americans need more than just Social Security when they retire. Social Security was designed to be a safety net for retirees, not set the standard of living for the elderly. It seems that Congress is not the only group forgetting that retirement security is about more than Social Security. Social Security is the only source of income for 16% of its beneficiaries. It is the major source of income for an additional 66%. We must break this single-minded approach and broaden the discussion to include the other elements of retirement security—private pensions and individual savings. I am glad to see that the Chairman has done just that in this hearing today.

We absolutely cannot ignore the importance of private pensions. More than 50 million U.S. workers have no pension coverage and nearly 1/3 of those workers who do have access to a pension plan do not contribute. Unfortunately, the complexity of the pension rules and frequent rules changes all serve to discourage employers from offering their employees pension plans. This burden is particularly heavy for small businesses with only 24% of full-time workers working in firms with less than 500 employees having pension coverage. This is why I have joined my colleagues Senator Graham, Grassley, Baucus, and others to introduce a comprehensive pension reform bill.

There is one more element that must be included in any comprehensive discussion of retirement security individual savings. We must all look toward the future and take steps to augment our retirement. Unfortunately, this is also the weakest element of our retirement systems today. Personal savings in the United States have fallen from over 9% in 1974 to less than 5% in 1996. In the long run, low U.S. saving and investment rates will inevitably result in a lower growth rate for our economy.

The statistics and trends I have stated above paint a bleak picture. All is not lost, however. It is up to us to act on this information and make the choices necessary to reverse the trends and provide retirement security for the American people in the future. We must take steps to reform Social Security to provide long-term solvency; enhance employers' ability to provide pension and savings plans; stimulate growth in personal savings; and educate the American public about the need to plan, save, and invest for retirement.

This hearing today is a look at all three of the pieces to the retirement security puzzle. I commend the Chairman for holding a hearing this broad. I thank the Members of the Administration that are here, Secretary Rubin, Deputy Secretary Summers, and Commissioner Apfel, for being here today. I look forward to your testimony and that of the second panel of distinguished experts in the retirement field. The information and insights we gain today will help prepare us to move down the road to reform.

Statement of

Rudolph G. Penner
Senior Fellow
The Urban Institute

Mr. Chairman, Senator Moynihan, and other members of the Committee, thank you for this opportunity to testify.

Introduction

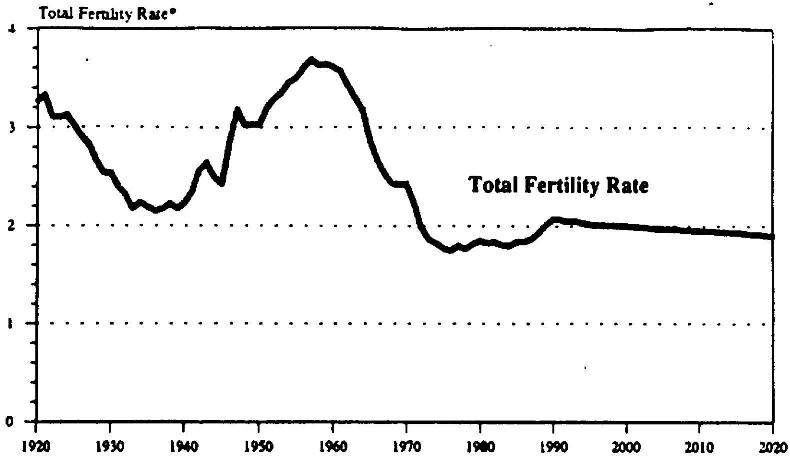
The nation is about to experience an enormous demographic shock. Between 2010 and 2030, the over-65 population will rise by 70 percent while the labor force will rise by only 4 percent. (See Charts 1 and 2.) The Congressional Budget Office (CBO) projects that Social Security benefits will be absorbing 2 percentage points more of the GDP by 2030 while Medicare and Medicaid will be absorbing 6 percentage points more by 2040. (See Chart 3.)

Estimates of this type and the projections of the social security actuaries assume that the productivity of workers continues to rise at rates similar to those experienced over the past 40 years, even while the economy is enduring this massive shock. If the economy slows in response to the demographic changes, programs for the elderly will become much more burdensome than usually implied and it becomes even more urgent to undertake reforms.

CBO has done some simulations in which growing public deficits soak up private saving thus leaving less capital to enhance worker productivity. The economy thus slows and further increases deficits, slowing growth further, etc., until the whole economy

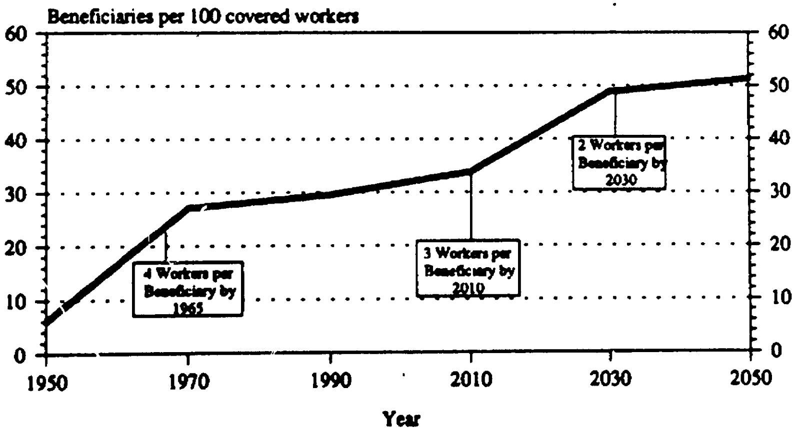
The views expressed in this Testimony are those of the author and do not necessarily reflect the views of the Trustees and employees of The Urban Institute.

Chart 1: BABY BUST, BABY BOOM, BABY BUST



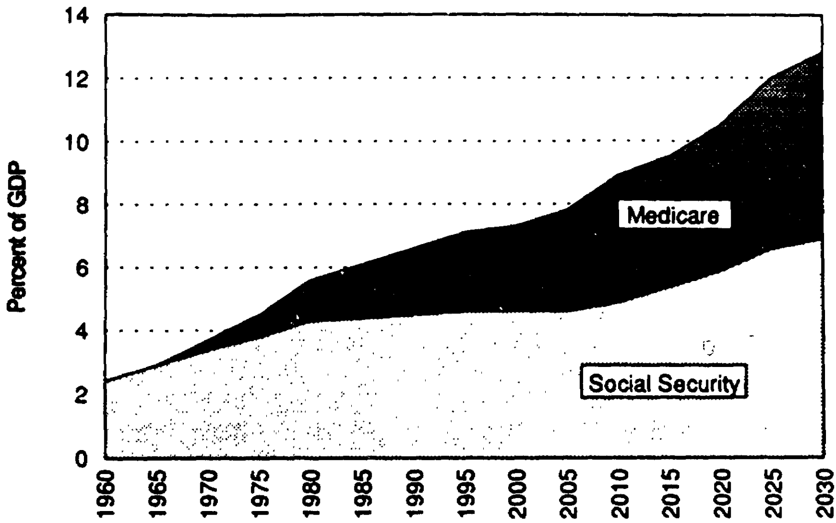
*The total fertility rate for any year is the average number of children who would be born to a woman in her lifetime, if she were to experience the birthrates by age, observed or assumed, for the selected year, and if she were to survive the entire child-bearing period.
Source: C. Eugene Steuerle and Gordon Mermin, THE URBAN INSTITUTE. Historical data from the Social Security Administration, Office of the Actuary (1992) and the annual report of the Board of Trustees of the OASDI Trust Funds (1997).

Chart 2: SOCIAL SECURITY BENEFICIARIES PER WORKER GROW



Source: C. Eugene Steuerle and Gordon Mermin, THE URBAN INSTITUTE. Based on data from the Social Security Administration, Office of the Actuary (1997).

Chart 3: PROJECTED FEDERAL BUDGET OUTLAYS FOR SOCIAL SECURITY (OASDI) AND MEDICARE (HI + SMI)



Source: "Status of the Social Security and Medicare Programs: A Summary of the 1998 Annual Reports," Washington, DC: Social Security and Medicare Boards of Trustees, April 1998, p. 9.

collapses into nothingness.

Such projections are useful in that they dramatize the risks that we face, but they are unrealistic in that they assume that neither the public nor the private sector changes policies in response to the looming disaster. Herbert Stein has said that something that cannot go on forever will stop. The interesting question is how it stops and how much pain is associated with putting on the brakes.

In any case, it is vitally important to preserve a decent rate of economic growth as the retirement of the baby boomers approaches. Presuming that we do not start eating into our seed corn, the only resources available for workers and retirees in the early 21st century will be produced at that time. We can talk about distributing those resources in different ways, but it will be too late to increase them much. The smaller the pie, the more painful will be given redistributions from young to old.

Private Sector Impact of the Retirement of the Baby Boomers

Most of the analyses of the retirement of the boomers growing life expectancy have focused on the burden imposed on the public sector. These same demographic trends also have important private sector implications that have not been analyzed as thoroughly. Most important, the private sector will experience a major loss of experienced workers as large waves of baby boomers retire.

There is also a danger of a severe shortage of savings to finance the capital formation that we need to maintain the growth of worker productivity. Private pension plans are now an important source of saving. As baby boomers retire, net contributions to pensions will decline and there is the possibility of net withdrawals by 2020.[1] At the same time, Government may be borrowing more private savings to finance the growing deficits that result from rapidly rising Social Security and health benefits. In addition, it will be more difficult to make up for our savings shortfall by borrowing from abroad. Almost all developed countries will be facing the same demographic problems, and in some, such as Japan, the problem comes sooner and is much more severe. (See Chart 4)

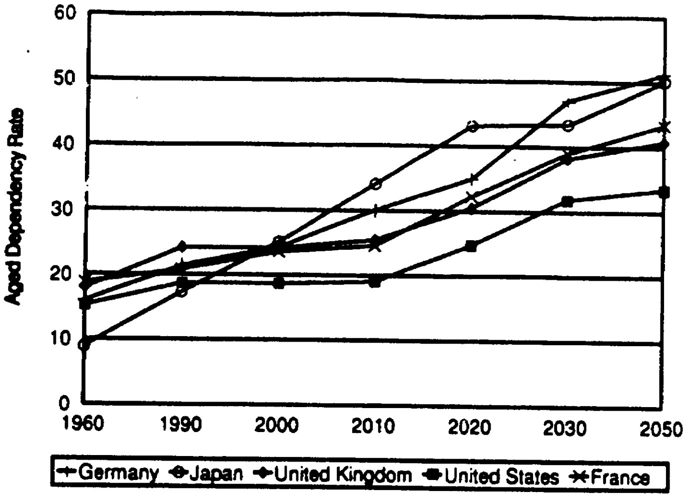
Addressing the Shortage of Labor

When the baby boomers begin retiring in large numbers around 2010, it is important to induce older workers to work longer. That will not be easy, because it flies in the face of a strong trend for workers to retire earlier and earlier. (See Chart 5) In part, earlier retirement is a natural response to rising standards of living. As people become more affluent, they are inclined to want to enjoy more leisure time.

However, the trend toward earlier retirement is also encouraged by numerous private and public incentives. The private sector has encouraged early retirement in recent decades for a number of reasons. First, the cost of health benefits soars as workers age. Second, there has been a desire to make room at the top as the bulge of baby boomers was

[1] See Schieber, Sylvester J., and John B. Shoven. 1994. "The Consequences of Population Aging on Private Pension Fund Saving and Asset Markets." NBER Working Paper No. 4665. Cambridge, MA: National Bureau of Economic Research, Inc.

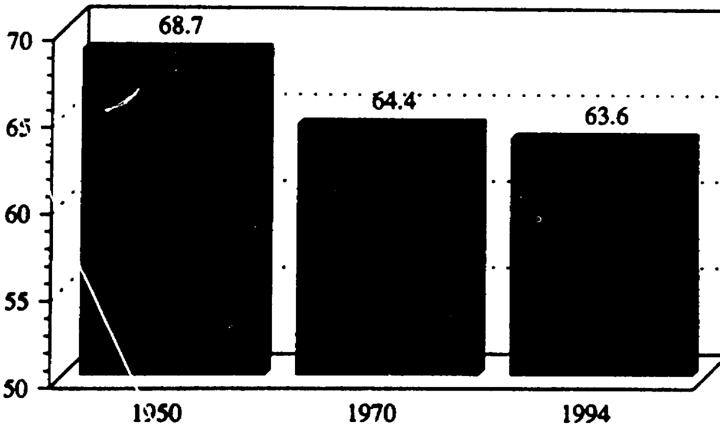
Chart 4: IMPACT OF AGING POPULATIONS IN G-5 COUNTRIES



Note: The aged dependency rate is the ratio of the number of persons over age 64 to the number of persons aged 15 to 64.

Source: Data from: Barry Bosworth and Gary Burtless, "Social Security Reform in a Global Context," In Social Security Reform Conference Proceedings: Links to Saving, Investment and Growth , edited by Steven A. Sass and Robert K. Triest. Boston, MA: Federal Reserve Bank of Boston.

Chart 5: INDIVIDUALS RETIRE EARLIER: AVERAGE AGE AT WHICH MALE WORKERS BEGIN RECEIVING SOCIAL SECURITY BENEFITS



Source: C. Eugene Steuerle and Gordon Mermin, THE URBAN INSTITUTE. Data from the Social Security Administration, Office of Research and Statistics (1995).

working its way up the career ladder. Third, it is contractually and morally difficult to cut pay as productivity declines with advancing years, and it is not worth it to retain older workers at the compensation levels associated with the top of their career. Fourth, the pursuit of productivity gains has become almost frantic in American business as foreign competition has intensified and pricing power has waned. This has provoked downsizing and often, older workers are the first to go.

For these reasons, employers have not made much of an effort to encourage later retirement. Defined benefit plans typically do not provide a significant reward for longer work and some employers actually pay older workers to retire early. Also, it is usually difficult to arrange to stay on one's career job on a part-time basis at a lower rate of compensation. Public incentives to retire early provide strong reinforcement to private incentives. The reward for working longer under Social Security is not quite actuarially fair, and there is some evidence that it is not well understood in any case. In contrast, the retirement or earnings test is very well understood and combined with the tax system, it can be highly punitive toward work. The very existence of Medicare makes it less necessary to work longer, and in addition, Medicare is not the primary payer when workers are covered by an employer-provided policy. This further encourages employers to shed older workers.

I was a member of the CSIS Commission on Retirement Policy, which tackled some of these issues. It suggested public sector reforms, such as increasing normal and

early retirement ages under Social Security, but I gather that Senator Breaux, a co-chairman of the Commission, will be explaining the proposals in detail at some later time.

Focusing here on the threat to economic growth posed by future labor shortages, the main question is whether the private sector will adapt and begin to reverse the practices that promote early retirement. They will certainly have an incentive to do so and the free market usually responds well to incentives. If public incentives are changed in a way that complements changes in private incentives, the effects could be substantial. It is interesting to note that in 1950, when incentives to retire were much weaker, the average age at which Social Security benefits were claimed was greater than 68, even though life expectancy at age 65 was much shorter and health was less robust. Today the average age at which benefits are claimed is less than 64. This suggests that there is much scope for inducing longer work. However, one would feel more confident if one heard more discussion of the problem in the private sector.

Coping with a Shortage of Capital

The most reliable means of leaving extra savings and capital to future generations is to continue to run a budget surplus. The resulting retirement of the national debt makes financing available to the private sector for investment in the machinery and structures necessary to enhance the rate of growth of worker productivity. True, some of the extra financing will simply reduce the extent to which we have to borrow from abroad, but that also raises future American incomes by reducing the future flow of interest and dividends

abroad.

Reducing the debt has the added advantage that it will reduce the future interest burden facing the budget. This means that programs, such as Social Security and Medicare, will not have to be reduced as significantly and/or tax burdens will not have to be increased as much. In addition, having a surplus makes it much easier to contemplate a Social Security reform that includes individual saving accounts. At the time of the reform, the existence of a surplus allows for tax cuts that ease the burden placed on current workers by the need to contribute both to the benefits of current retirees and to their own retirement accounts.

In addition to paying down the debt, it is important to make our tax system less hostile to saving and investing. I have long favored radical reforms that would reduce the tax burden on saving and investing and increase the burden on consumption, but it is very difficult to get there from here, both technically and politically. Less ambitious reforms would simplify and expand IRAs and other vehicles that attempt to encourage savings, eliminate or reduce the burden of the alternative minimum taxes on individuals and corporations, and consider reducing the double burden on dividends resulting from corporate and personal income taxes.

Most of the saving in our economy is done by the most affluent and therefore, tax measures that favor saving are likely to reduce the progressivity of the tax system. If this

is deemed objectionable, an adjustment can be made to marginal tax rates. The Congress is often reluctant to raise marginal rates explicitly, but it should be noted that we have often done it implicitly in recent years with phase-outs of the child and education credits and of various types of IRAs.

When considering tax reforms, it is not only important to reduce the burden on saving and investing, it is also important to treat different types of saving and investing more equally so that we utilize our saving and capital stock more efficiently. That is to say, we should allow the market to determine where our saving is invested instead of having the allocation distorted by the tax system. This is a major reason that I earlier mentioned reducing or eliminating the personal and corporate alternative minimum taxes. They can be totally arbitrary in the way that they affect different types of saving and investment.

Tax reforms aimed at enhancing saving will be most effective if they are done in a surplus neutral manner. Otherwise, the elimination of a disincentive is only advisable if the positive effect on private saving is greater than the negative effect on the budget surplus. This is a high standard to satisfy and many economists do not think that saving incentives, such as IRAs, pass the test. I happen to be on the other side of that argument, but this does not deny the fact that the reform will be more effective if done in a surplus neutral fashion.

Conclusion

There has been much discussion of the effect of the retirement of the baby boomers and longer life expectancies on the future budget burden imposed by Social Security, Medicare, and Medicaid. There has been much less discussion of the impact on the private sector as vast numbers of experienced workers retire from the labor force and capital becomes scarce because of reduced saving in pension funds and other factors. These private sector impacts threaten to diminish the rate of economic growth below the levels assumed in common budget projections. If this happens, it will be necessary to cut benefits to a greater extent than is now contemplated or to raise revenues by a greater amount.

As the nation contemplates reforms in the benefit and tax system, it is necessary to keep in mind the importance of encouraging growth by reducing impediments to working longer and saving more. Increasing the size of the pie in the future is the one sure way of improving the prospects of both the retired and working populations.

PREPARED STATEMENT OF KENNETH W. PORTER

Mr. Chairman, Members of the Committee, my name is Kenneth W. Porter. I am Chief Actuary and Manager, Du Pont Co. I am testifying before you today as Chairman of The ERISA Industry Committee, commonly known as "ERIC."

My remarks focus on two of the Committee's questions: (1) What can Congress do to encourage greater pension coverage and personal savings? And, (2) As Congress considers Social Security reform proposals, what must it do to avoid any negative effects on pensions, personal savings, and work? ERIC has supplied the Committee with two documents that respond in detail to these two questions:

(1) *Getting the Job Done:* A White Paper on Emerging Pension Issues, and

(2) *The Vital Connection:* An Analysis of the Impact of Social Security Reform on Employer-Sponsored Retirement Plans.

ERIC's 1996 paper, Getting the Job Done, provides strategies to increase retirement savings through employer-sponsored plans. Many of ERIC's policy recommendations were reflected in the pension amendments advanced by this Committee in the Small Business Job Protection Act of 1996 and the Tax Relief Act of 1997. ERIC is pleased that the Chairman and many members of this Committee are continuing to work on additional pension reform proposals, many of which build on the recommendations we have made.

ERIC's newly-released report, The Vital Connection, directly addresses the Committee's concern that Congress not harm pensions, personal savings and work opportunities when it enacts Social Security reform. Indeed, discussion of Social Security reform too often treats that program as though it operates in isolation. It doesn't.

ERIC's report is a roadmap to Social Security reform options that preserve and enhance retirement savings and, at the same time, build a more secure foundation for Social Security.

Let me identify for the Committee ERIC's four principles for judging the efficacy of pension reform proposals and for determining the impact of specific Social Security reform proposals on employer plans

(1) Reform proposals should provide stable rules that encourage the voluntary creation and maintenance of soundly-financed employer-sponsored plans. Retirement plans are long-term commitments. They require government policies that create an environment of long-term certainty.

(2) Reform proposals should maintain efficient means for individuals to acquire adequate retirement income. Workers' options include voluntary employer-sponsored plans, Social Security, individual savings, and post-career part-time or full-time work. Reforms must enhance these options and help to change individual behavior.

(3) Reform proposals should support the dynamic needs of employers. Whether employers can continue voluntarily to assume a major role in providing retirement income to workers will depend on how readily they can continue to integrate employees' retirement plans with their business needs.

(4) Reform proposals should encourage capital formation. Retirement savings fuel the investment that can produce long-term economic growth in the U.S. economy.

While ERIC does not endorse or reject any particular Social Security reform proposals, its year-and-a-half study has led it to certain conclusions. These conclusions are:

- Early action on reform will be critical to its success. Employers will need time to design, finance, and administer plans that will be effective in a new environment, and employees will need time to accumulate benefits in those plans.
- Many proposals impose financial costs that have not been fully examined. For example, some proposals include payroll tax increases, transition costs imposed to facilitate changes in Social Security, or reductions in the ability of employer plans to integrate with Social Security benefits. The impact that increases in compensation costs will have on the workforce and on the competitiveness of American industry in today's world-wide business climate has yet to be examined.
- Both reductions in the Social Security defined benefit and the creation of Social Security individual savings accounts can reshape the plans employers offer to employees in the future since employer-sponsored plans assume the existence of a Social Security benefit similar to that provided by current law.
- Imposition of a means test would undermine the attractiveness of employer plans. It would be an incentive for some employees not to save money for their own retirement; it will encourage employers not to offer retirement plans, and it will frustrate the ability of employers who do offer plans to design plans that provide uniform benefits to employees.

- Administrative issues may prove the most critical and the most intractable in carrying out a successful reform program. Employers might find it impractical to design plans that meet the needs of workers who are under different, or transitional Social Security systems. Regarding the establishment of Social Security individual savings accounts, it is critical to recognize that no universal system currently exists—either in the government or in the private sector—to maintain such accounts. Moreover, contrary to the assumption made by many current reform proposals, employers might not be equipped to administer such accounts.

Employer-sponsored retirement plans can thrive under Social Security reform, but only if that reform thoughtfully takes their needs into account. Congress must also continue the good work it began in the Small Business Job Protection Act and the Tax Relief Act to expand opportunities for saving in employer-sponsored plans and to remove the many legal and regulatory impediments that have hampered the growth of these plans in recent years.

Thank you for the opportunity to testify. I will be pleased to respond to your questions.

PREPARED STATEMENT OF HON. JOHN D. ROCKEFELLER IV

Mr. Chairman: Thank you for holding this hearing and starting a very important discussion about retirement security. For me, this is a discussion about honoring the commitment our nation has made to its seniors and others dependent on the Social Security program.

I support and commend President Clinton for his desire to "fix Social Security first" before we spend the budget surplus. This is a bold challenge and the decisions will be complicated and at times very difficult. For this reason, we must have a thoughtful and serious debate, and we must begin this debate in earnest immediately. We cannot afford to put off decisions which may be difficult, but which will be critical to the health and welfare of so many Americans.

As we start, I think it is important to remember some fimdamentals—Social Security and Medicare face long-term solvency issues, but there can be no question that these programs are success stories that have dramatically reduced senior poverty. Since their implementation, senior poverty had dropped from more than one-third of elderly Americans, to only about one in ten.

This is dramatic progress. But unless our nation develops a comprehensive strategy to maintain a strong and effective Social Security program for decades to come, we ran the risk of losing ground. We run the risk of breaking the more than 60-year commitment our government has made to help senior citizens live their final years in dignity.

Throughout this debate, we must also remember that Social Security is more than just retirement benefits. It is a program that offers protection in the face of disability and life insurance for families when tragedy strikes and a father dies too young. In fact, over six million Americans get benefits under the survivors program—almost 80,000 in my state of West Virginia—while six million disabled Americans depend on Social Security benefits—75,000 of whom live in West Virginia. While retirement is the focus of this hearing, I encourage my colleagues to keep in mind the broad scope of Social Security.

As we move forward, it is important to understand and appreciate the complexity of Social Security—and the diversity of its benefits. Most importantly, we must stay focused on the ultimate goal of our work—to continue and strengthen the progress our nation has made to improve the lives of seniors. I am certain that today's hearing will be one step forward in achieving this goal, and honoring our nation's Social Security commitment.

PREPARED STATEMENT OF HON. ROBERT E. RUBIN

Mr. Chairman, members of this Committee, I appreciate this opportunity to say a few words about the importance of savings to our economy and to make a few observations about promoting savings.

Saving is obviously important for families; it is also critical for the nation at large. Savings provides the capital that funds investment, and increased investment, in turn, is critical to greater productivity and higher standards of living.

Our national savings rate—which is the sum of private and public savings—has increased in the last few years, from 3.1 percent of GDP in 1992 to 6.5 percent last year. But this increase has been the net of a large increase in the public savings rate while the private savings rate has decreased the last five years. The public sav-

ings rate reflects the move from a budget deficit that equaled five percent of GDP in 1992 to a projected budget surplus this year. Critical to this process was the President's deficit reduction program, beginning with the 1993 Deficit Reduction Act, and the lower interest rates and greater economic growth it generated, which set off a virtuous cycle and further reduced the deficit.

Notwithstanding the recent increase in our national savings rate, it remains among the lowest of the industrialized nations and well below where we were twenty to thirty years ago. Raising our national savings rate further should be a high priority for our nation especially as we approach the retirement of the baby boom generation.

While new global capital markets allow us to draw on savings from abroad—in fact, investment rates have substantially exceeded savings rates, and investment in plant and machinery is now at historic highs—funding investment from abroad is not as desirable as funding it from domestic savings. Efficient as they are, global capital markets aren't perfect—domestic savers continue to have a preference for investing in domestic assets, and the resulting dependance on foreign capital increases the cost of capital for U.S. firms. Moreover, while foreign-funded investment provides a net benefit to our economy, the return on foreign-funded investment goes abroad. Perhaps most importantly, while capital is flowing from abroad because of our attractive environment with respect to economic policy and economic conditions, there is always a risk that this perception might change and, as a result, capital will become more expensive. One conclusion from this is the great importance of maintaining a sound macroeconomic environment, including fiscal discipline, so that we continue to attract capital at a low cost.

It is very tempting with the projected budget surplus to cut taxes or increase spending, but I believe that instead, it is critical that we maintain the fiscal discipline which has been central to our strong economic growth over the last five years by adhering to the President's strategy of putting Social Security on a sound footing. Moreover, while our surplus projections are soundly based, we have had almost thirty years of deficits, and have not yet had one full year in surplus. Projections are exactly that, projections, not certainties, and subject to change, even great change. We shouldn't commit to any policy, let alone to a large tax cut, to use the projected surplus until Social Security's long term financial integrity has been effectively addressed. That strategy will both protect retirement security and protect the fiscal discipline that his so central to our economic well being. Fiscal discipline is the hard path, not the easy path, but it is the right path for our economic well being. Large tax cut proposals based on projected surpluses are an unsound and unwise strategy for our future.

Let me make two other observations about what will and will not contribute to increased savings.

Most economic work strongly suggests that transforming the tax system to some form of consumption tax, whether the flat tax or a VAT, would have little impact on the savings rate. The savings rate is not very sensitive to the after tax return on savings. Therefore, I don't believe there is a savings argument for reducing the progressivity of the tax system.

On the other hand, there is a broadly held view among economists that education and measures to facilitate savings do have an impact on savings. Examples of successful education campaigns include the Savings Bonds campaign, and the marketing of IRA's and 401(K) plans. Pension reforms and IRA reforms also have facilitated savings.

This Committee is making an important contribution to our nation's economic health by focusing on the importance of savings. Deputy Secretary Summers and Commissioner Apfel will also be discussing various aspects of retirement saving in more detail. I look forward to working with all of you to promote savings, and to protect our nation's fiscal discipline, and thereby benefit both families and our nation as a whole as we approach a new century. Thank you very much.

Sylvester J. Schieber, Ph.D.
Vice President
Watson Wyatt Worldwide

Mr. Chairman, I am pleased to appear before the Senate Finance Committee today to discuss the status of our retirement income security system and potential new approaches to providing retirement security for American workers. I will begin today by talking about how workers save for their retirement in very general terms. Following this, I will present some data on the effective coverage of employer-based retirement systems. I will then discuss the implications of the shift toward greater and greater dependence on voluntary contributory retirement savings vehicles. After that, I will look at the wealth holdings of a group of people on the cusp of retirement. Finally, I will draw some policy conclusions from my observations.

How Americans Save for Retirement

During the 1980s, the total increase in inflation-adjusted pension assets exceeded the total real increase in the country's wealth, leading one researcher to conclude that "pensions are how America saves."[1] John Shoven's observation about the way America saves was based on a macroeconomic analysis of aggregate flows into employer-sponsored retirement plans and the changing wealth stock in the overall economy. A more recent analysis focuses on the sources of financial wealth held by householders on the threshold of retirement.

Steven Venti and David Wise have analyzed a national sample of people between the ages of 51 and 61 in 1992 who are being followed through a series of semi-annual interviews in the *Health and Retirement Study* (HRS). Among other things, the HRS interviews gather information on the source and amounts of wealth holdings of the sample households. In

[1] John B. Shoven, *Return on Investment: Pensions Are How America Saves* (Washington, DC: Association of Private Pension and Welfare Plans, September 1995).

The views in this statement are those of the author and do not necessarily reflect the views of Watson Wyatt Worldwide or any of its other associates.

addition to the survey data that is being developed on the households in the sample, the respondents' earnings histories from Social Security administrative records are also available to selected researchers analyzing the survey data. Using this rich data source Venti and Wise have looked at the wealth dispersion of people on the threshold of retirement based on their lifetime earnings levels.[2]

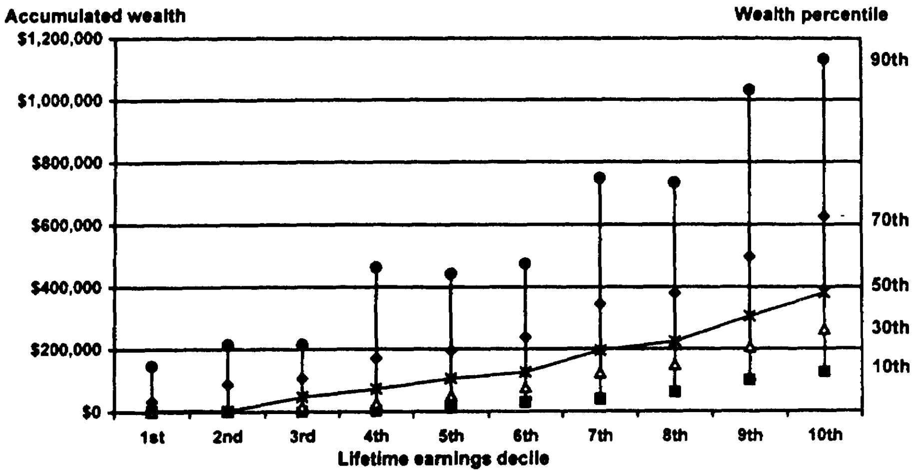
Venti and Wise distribute the HRS sample into ten equally sized deciles based on average lifetime earnings levels for each of the households. Within each of the lifetime earnings deciles, they calculate the distribution of financial wealth including IRA and 401(k) balances, other pension wealth, other personal financial assets, and business equity. The results of their analysis are shown in Figure 1. The sloped line in the figure shows the median wealth holdings in each of the household earnings deciles. Wealth in this case includes financial assets, personal retirement assets, employer-sponsored retirement assets including defined contribution balances and accrued defined benefit values, net vehicle equity, net business equity, real estate, and home equity. The definition of wealth used here does not include the value of Social Security benefits earned by workers. The vertical lines in the figure show the distribution of wealth within each earnings decile. Median wealth within the lifetime earnings categories rises from nearly zero in the bottom two deciles of the earnings distribution to nearly $400,000 in the top decile. The variances in the wealth distributions are consistently

[2] Steven F. Venti and David A. Wise, "The Cause of Wealth Dispersion at Retirement: Choice or Chance?" *American Economic Review*, (forthcoming June 1998).

greater above the median wealth levels within each earnings decile than below them. There is a broad range of wealth holding at every earnings level.

Figure 1

Distribution of Total Wealth by Lifetime Earnings Decile



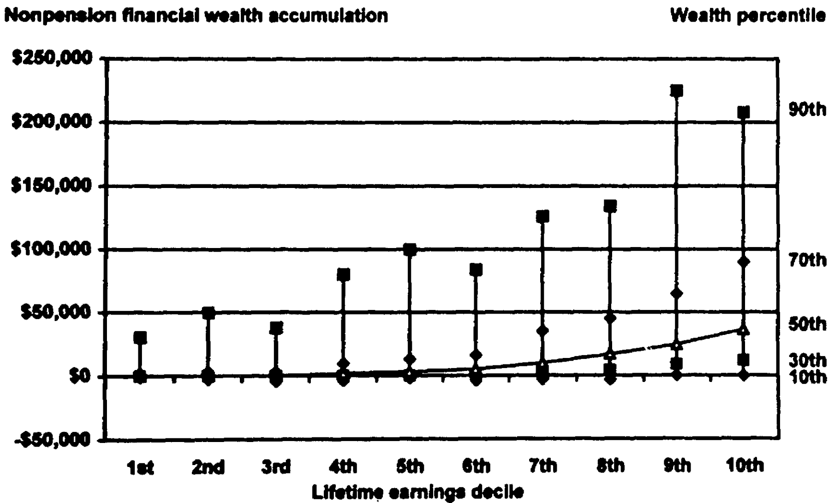
Source: Steven F. Venti and David A. Wise, "The Cause of Wealth Dispersion at Retirement: Choice or Chance?" *American Economic Review*, (forthcoming June 1998).

Figure 2 shows a similar distribution of financial wealth for these same households but not including retirement assets held in the form of IRAs, 401(k) balances, or other pension wealth. Since this is a measure of "financial" wealth, the authors also exclude the value of vehicles, business, real estate, and home equity in this case. The results are somewhat

startling. The median financial wealth, not including tax-favored retirement accounts at the fifth decile of lifetime earnings is only $3,000. Even in the 10th decile by lifetime earnings, the median financial wealth holdings are only $36,500. Financial wealth holding outside of retirement plan assets at the 90th percentile level do not reach $250,000 even for those with the highest levels of lifetime earnings. Shoven's observations that the aggregate flows into pensions account for much of the recent increase in personal wealth seems to be borne out at the household level by the story told by Venti and Wise.

Figure 2

Distribution of Nonpension Financial Wealth by Lifetime Earnings Decile



Source: Steven F. Venti and David A. Wise, "The Cause of Wealth Dispersion at Retirement: Choice or Chance?" *American Economic Review*, (forthcoming June 1998).

Coverage of the Employer-Based Retirement System

While the pension system may be how Americans save, that same system is often criticized because only about half the workforce is covered by a pension at any particular point in time. In a number of regards, observations that half of today's workers are not covered by a employer-sponsored retirement plan are misleading. First, they are person weighted, and a part-time, part-year worker who works an annualized average of eight hours a week is counted as equivalent to a full-time, full-year worker. Second, including very young cohorts of workers, many of whom have only casual attachment to the workforce, tends to inflate the perception of workers not getting benefits from the plans. Finally, many of the part-time workers who are not accruing a pension in their own right are married to someone who is. Given the structure of our income tax program, which taxes married couples primarily on the basis of their combined incomes, the tax benefits that accrue to one spouse because of pension coverage generally accrue to the other as well. This has especially become the case since the passage of the Retirement Equity Act in 1984, which expanded spouse and survivor protections originally included in ERISA.

A better way of evaluating the potential delivery of benefits is to focus specifically on a group of workers well established in their careers, who should be beginning to focus on their retirement needs. In order to do this we have focused specifically on the age group ranging from age 45 to 59. The pension status of single and married individuals in this range are shown in Table 1. The table reflects all the people in the population who fell within the age range stipulated, not just the people who were working. In 1990 there were approximately

36.4 million people in this age range. Slightly more than one-fourth of them, 27.1 percent, were single.

Among the single individuals, 3.9 percent were receiving a benefit, and another 35.7 percent were participating in a retirement pension or saving plan sponsored by their employer. Another 22.3 percent of these single individuals had not received any earned income during the year in 1990. In other words, among single individuals who had worked in the prior year, or who had previously retired with a benefit, 51 percent were receiving some form of benefit from the tax preferences favoring pensions.

Among the married individuals, 69.4 percent were receiving some benefit from the pension system. Among them, 5.6 percent already appeared to have fully retired on some form of pension, reporting that they, their spouse, or both were receiving a pension, and had no earned income in 1990. For another 6.9 percent, one or both spouses were already receiving a pension, and one or both of them were still employed and actively participating in a retirement plan. For 38.0 percent, neither member of the couple was yet receiving a pension but one or the other spouse was participating in a pension. In 18.5 percent of the married couples, both members were participating in a pension plan. Among those not covered or not receiving a pension benefit of any sort, 2.4 million individuals reported no earnings in the prior year. If the people who had not worked in the prior year and were not already receiving a pension are removed from the basis for calculating the share of the population benefiting from a pension program, 75.3 percent of the remaining married individuals were receiving some benefit.

Table 1

Marital and Pension Status of Individuals Aged 45 to 59 in 1990

	Percent with given pension status	
	Single (percent)	Married (percent)
Neither participating nor receiving	60.4	31.5
Respondent only receiving	2.8	1.9
Spouse only receiving		3.7
Both receiving		0.4
Respondent only participating	35.7	19.5
Respondent participating and receiving	1.1	1.0
Respondent participating and spouse receiving		1.0
Respondent participating and both receiving		1.4
Spouse only participating		18.5
Spouse participating and respondent receiving		0.8
Spouse participating and spouse receiving		1.4
Spouse participating and both receiving		0.0
Both participating and neither receiving		18.5
Both participating and respondent receiving		0.6
Both participating and spouse receiving		0.7
Both participating and both receiving		0.0
Total percentage with some benefit	39.6	69.4
Total persons (millions)	9.9	26.5
Total number getting some benefit (millions)	3.9	18.4

Source: Author's tabulations of the March 1991 *Current Population Survey.*

Looking at everyone within the age bracket being considered shows that 22.3 million out of 36.4 million people, or 61.3 percent, were participating in an employer-sponsored pension or saving program in some fashion. For a base population narrowed to those already

retired and receiving a pension plus those still working, 22.3 million out of 31.8 million, or 70.1 percent were included in such a retirement program. These levels of exposure to employer-sponsored retirement benefits far surpass those that simply look at current participation rates across the whole population that are generally cited by critics of the current tax treatment of pension programs.

While the exposure to pensions may be considerably greater than critical characterizations would have us believe, the fact that some segment of society may be getting to retirement without any enhancement of Social Security benefits also bears scrutiny. Table 2 shows the 1990 earnings and income of those individuals in the 45 to 59 age group completely detached from the pension system. The table indicates that the lack of pension protection as workers approach retirement is heavily concentrated in the lower-end of the wage spectrum.

In practical terms, earnings based pension programs are not very effective vehicles for people with very low lifetime earnings. The problem is that by their inherent nature, these plans provide benefits that are proportional to earnings. If earnings are low, even where workers might have a pension, the benefit that it can generate will be quite limited. Giving up consumption financed from a meager wage is hardly an effective way to make adequate retirement provision for such workers. For those people who never work or work only intermittently at low wages, a proportional wage-based pension is virtually worthless. Because of the fundamental inability of employer-based pensions to be an effective vehicle for those at the bottom end of the wage distribution, Social Security's redistributive character is vitally important. This general observation about the practical value of pensions for low-wage

workers and the redistributive character of Social Security pose important questions about how various elements of the retirement system might be modified without unduly disadvantaging particular segments of the population. We will return to this question later.

Table 2

Annual Earnings of Individuals Aged 45 to 59 in 1990 and Not Receiving Any Sort of Benefit from the Pension System

	Single (percent)	Married (percent)
Earnings ($)		
None	36.9	28.5
Less than $10,000	22.6	21.6
$10,000 – 19,999	21.1	19.2
20,000 – 29,999	9.8	12.5
30,000 – 39,999	5.0	6.9
40,000 – 49,999	1.8	4.0
50,000 – 69,999	1.7	3.7
70,000 or more	1.1	3.6
Total	100.0	100.0
Income ($)		
Less than $10,000	50.3	44.8
$10,000 – 19,999	26.2	21.3
20,000 – 29,999	11.3	13.4
30,000 – 39,999	5.5	7.5
40,000 – 49,999	2.7	4.4
50,000 – 69,999	2.0	4.4
70,000 or more	1.2	4.2
Total	100.0	100.0
Total persons (millions)	5.96	8.34

Source: Author's tabulation of the March 1991 *Current Population Survey*.

Retirement Security in the World of Voluntary Contributory Plans

No one could have fully anticipated the revolutionary shift to voluntary contributory retirement plans witnessed over the last two decades. The latest report from the Department of Labor on private pension plan disclosure filings indicates that more than half the contributions to private plans in 1994 were made to 401(k) plans.[3] These plans were just coming into existence only a decade earlier. Since these plans have become such an important part of our retirement security system, their growth raises a natural question about how much security they are likely to provide. Recent research by James Poterba, Steven Venti, and David Wise, hereafter referred to as PVW, of the National Bureau of Economic Research (NBER) gives us an interesting perspective on this matter. These authors have projected 401(k) accumulations for the cohort of workers aged 33 in 1993 who will reach age 65 in 2025.

Figure 3 shows the 401(k) coverage rates of US workers as measured by a series of national surveys done between 1984 and 1993. The pattern of increasing coverage is quite clear and follows from the rapid expansion of these plans during the early years after the enabling regulations. The reason that participation tends to tail off for older workers is that workers covered by retirement plans tend to retire somewhat earlier than those not covered simply because those covered are more likely to have the financial wherewithal to do so. As the covered population begins to retire, it leaves a residual pool of workers in which those without coverage become a relatively larger portion of that age cohort still working.

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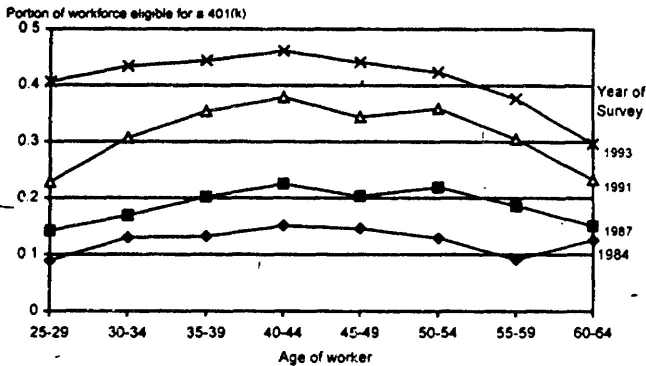
Figure 3

Coverage Rates under 401(k) Plans at Selected Years



Source: James Poterba, Steven Venti, and David Wise, authors' tabulations of the Survey of Income and Program Participation reported in "Implications of Rising Personal Retirement Saving," paper presented at a NBER Conference on the Economics of Aging (Cambridge, Massachusetts: April 1997), p. 5.

Figure 4 shows how participation rates in 401(k) plans has changed over time for those covered by such plans based on statistically representative surveys of workers in 1984, 1987 and 1993. Basically, the story seems to be that older workers figured out the relative advantages of these plans early on and the inclination to participate in them has not changed much from the beginning. Younger workers, on the other hand, improved their participation as the voluntary contributory retirement plan phenomenon evolved. Part of the explanation must be related to the improved communications programs that employers have developed

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[3] U.S. Department of Labor, Pension and Welfare Benefits Administration, *Private Pension Plan Bulletin* (Washington, D.C.: U.S. Department of Labor, Spring 1998).

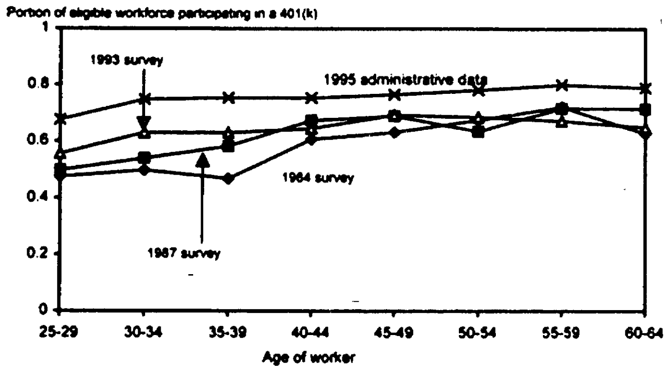
around 401(k)s over time. Part of it must also relate to the general sense of insecurity about the long-term potential of Social Security and other retirement benefit plans. The top line in Figure 4 shows administrative record data from a sample of 60 plans that Watson Wyatt has combined to analyze various aspects of 401(k) utilization. These data would not be subject to the same sort of reporting error that survey data is, which probably accounts for the consistently higher participation rates than those derived from the survey measurements. Another national survey done for the Labor Department in 1993, a special supplement to the monthly *Current Population Survey*, found participation rates for workers age 45 and above which are practically identical to the participation rates found in the Watson Wyatt sample plan data for 1995. In other words, the data measurement issues behind Figure 4 notwithstanding, both national survey data and actual plan administrative records suggest that the vast majority of the workforce offered the opportunity to participate in 401(k) plans do so.

In developing their projections of potential accumulations under 401(k) plans, PVW assumed a family contribution rate of 9 percent of pay. This assumption was based on their analysis of the 1993 CPS data where they found an average employee contribution rate of 6.0 percent and average employer matching contributions of 2.7 percent of pay. While this may seem a bullish assumption, our analysis of actual administrative records, as reflected in Table 3, corresponds closely with their survey analysis. While we find some variation in average contribution rates by age, there is only slightly more than 2 percentage points variation for workers from age 30 onward, the group being projected in the PVW analysis. Even across earnings levels, there is much less variation than one might expect. With the exception of

workers at the highly compensated levels. the variations again are only about two percentage points across the earnings spectrum.

Figure 4

Participation Rates for Covered Workers under 401(k) Plans at Selected Years



Source: James Poterba, Steven Venti, and David Wise, authors' tabulations of the Survey of Income and Program Participation reported in "Implications of Rising Personal Retirement Saving," paper presented at a NBER Conference on the Economics of Aging (Cambridge. Massachusetts: April 1997), p. 5 and Watson Wyatt Worldwide.

In developing their projections, PVW assumed that there would continue to be moderate growth in plans leading to continual increases in coverage rates and commensurate increases in participation rates. They developed their projections assuming a range of portfolio allocations from one totally in equities to a mixed portfolio, to one totally in bonds. Their results for a mixed portfolio, 50 percent in equities and 50 percent in bonds, assuming average historical rates of return is shown in Figure 5. The results of the projections suggest that for the upper half of

the earnings distribution among today's younger workers. 401(k) plans project to be a greater source of retirement income than Social Security benefits under current law. Taking into account that under current law Social Security is underfunded by about 30 percent for such workers. 401(k) plans project to be a greater source of income than Social Security for as much as the top three-fourths of the earnings distribution among younger workers. In other words. not only have 401(k) plans become extremely popular with both employers and workers over the last decade. they also project to provide significant retirement security for most of today's younger workers.

Table 3

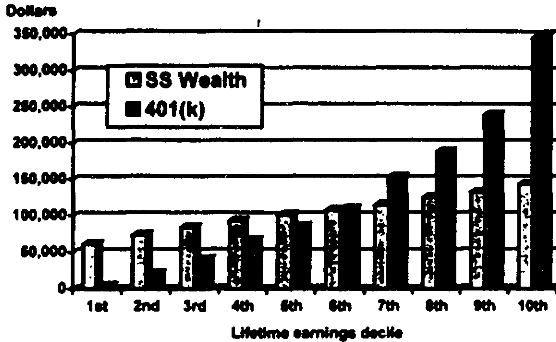
Contribution Rates during 1995 for a Selected Set of 401(k) Plans

	Contributions as a percent of pay			
	All eligible workers		Participants	
	Worker only	Total	Worker only	Total
Age group				
20 to 29	2.7	3.9	4.5	6.4
30 to 39	4.5	6.4	6.0	8.4
40 to 49	4.9	7.1	6.5	9.1
50 to 59	5.8	8.3	7.4	10.3
60 to 65	6.2	8.6	8.0	10.8
Salary Level				
$5,000-14,999	3.1	4.5	5.9	8.3
15,000-24,999	3.9	5.5	5.7	8.0
25,000-34,999	4.3	6.2	5.7	8 1
35,000-44,999	5.1	7.4	6.5	9.1
45,000-59,999	5.9	8.5	7.3	10.1
60,000-74,999	6.4	9.1	6.7	10.2
75,000-99,999	6.1	8.9	6.7	9.7
100,00 or more	4.5	6.7	5.4	7.9
Total	4.5	6.4	6.2	8.6

Source: Watson Wyatt Worldwide.

Figure 5

Projection of Average 401(k) Balances Compared to Projected Social Security Wealth under Current Law



Source: James Poterba, Steven Venti, and David Wise, authors' tabulations of the Survey of Income and Program Participation reported in "Implications of Rising Personal Retirement Saving," paper presented at a NBER Conference on the Economics of Aging (Cambridge, Massachusetts: April 1997), p. 31.

Wealth Holdings among People Close to Retirement

As noted earlier, one way to assess the effectiveness of the retirement security system is to look at the prospects of people who are approaching retirement age. In the earlier part of the discussion we looked at the extent to which such folks were actually getting into play by being covered by a retirement plan or being married to someone else who was. Here we focus on a similar group of people and consider their actual wealth accumulation. This part of the discussion is based on an analysis of data derived from the *Health and Retirement Survey*. This is a national longitudinal study financed by the National Institute on Aging and being conducted through the Survey Research Center at the University of Michigan. The sample included in this

study was drawn from the general population between the ages of 51 and 62 in 1992. Sample members are being interviewed every two years. They are asked a host of questions about their financial wealth, their participation in pension plans, their health, and so forth.

Olivia Mitchell and James Moore have used this data set to estimate the participating households' wealth levels.[4] They include four classes of wealth in their calculations. These are: 1) net financial wealth, including saving, investments, business assets, and non-residential real estate less outstanding debt not related to housing; 2) net housing wealth, or the current market value of the residential housing less outstanding mortgage debt; 3) pension wealth, or the present value of employer-sponsored retirement benefits; and 4) the present value of Social Security benefits.

I have derived Table 4 from Table 1 of their analysis. My derivation does not include housing wealth in the calculation of the wealth distributions because most homeowners do not sell their homes at retirement, or if they do, they tend to buy another one. I am interested in looking at assets in these folks' portfolio that can be expected to generate a stream of income that they can use to buy groceries, go to the movies, and so forth, during their retirement. The way I derived my table was by calculating the share of total assets in each of the categories: net financial wealth, Social Security wealth, and pension wealth. I derived the shares of wealth held for people at the one-third and two-thirds points on the wealth distributions by

[4] James F. Moore and Olivia S. Mitchell, "Projected Retirement Wealth and Savings Adequacy in the Health and Retirement Study," presented at the 1998 Pension Research Council Symposium, *Forecasting Retirement Needs and Retirement Wealth* (April 27, 1998).

interpolating the shares held at the third and fourth deciles and the sixth and seventh deciles respectively as reported in the Moore and Mitchell analysis. The results are instructive.

Table 4

Distribution of Wealth Among the Near Elderly

	Retirement Purchasing Power from:			
Position in the Wealth Holding Distribution	Personal Financial Wealth (percent)	Social Security Wealth (percent)	Pension Wealth (percent)	Total Wealth (percent)
Bottom 10th	3.4	93.6	3.0	100.0
1/3 from bottom	18.1	63.4	18.5	100.0
2/3 from bottom	29.9	35.7	34.4	100.0
Top 10th	65.2	10.2	24.6	100.0

Source: Derived from James F. Moore and Olivia S. Mitchell, "Projected Retirement Wealth and Savings Adequacy in the Health and Retirement Study," presented at the 1998 Pension Research Council Symposium, *Forecasting Retirement Needs and Retirement Wealth* (April 27, 1998).

The people at the bottom end of the wealth distribution hold almost all of their wealth in the form of Social Security. Those people one-third of the way up the distribution still hold nearly two-thirds of their wealth in that way. By the two-thirds of the way up the distribution have a rough parity in their wealth holdings between Social Security, pensions, and other financial wealth. Those at the top of the wealth distribution have almost no dependence on Social Security.

Implications of Where We Are for Where We Might Go

The first part of this discussion documented that most of the private financial asset accumulation within our society, other than the accumulation of housing equity and equity in other fixed assets, appears to be done through employer-based retirement plans. The next part of the discussion suggested that the 401(k) plan and their public and nonprofit counterparts are extremely effective retirement savings vehicles for many workers when they have access to them. One of the problems that we note, however, is that many workers today still do not have access to such vehicles or any other kind of employer-sponsored retirement plan. If we want to expand the effectiveness of the retirement system, we must create ways for those workers who do not now have access to these plans to gain such access. Policies creating vehicles like the Roth IRA certainly cannot hinder workers' access to tax-preferred retirement vehicles, but I wonder if they are enough. Maybe we are reaching the point where we should consider that all employers be required to make available a 401(k) plan for their workers. We would not have to require that they subsidize it, only that they offer it.

The immediately prior section to this conclusion focused on the skewed distribution of wealth holding among people on the threshold of retirement. I believe the wealth distribution reflected in Table 4 has profound implications for retirement policy consideration. The results in that table say to me that any Social Security reform proposals that cut benefits across the board are going to have a disproportionately large effect on the retirement consumption potential of the people who are at the bottom end of our economic ladder. The people at the upper end of tha ladder will hardly notice the implementation of such proposals. Proposals

that significantly raise the retirement age, reduce COLAs across the board, or reduce the benefit formula on a pro rata basis are policies of this sort. I believe there is a better way to modify our Social Security system that is more humane and more fair.

I am clearly on record as favoring a reform of our Social Security system that would require workers to save in individual accounts. Their accumulations in these accounts would be supplemented by a Social Security benefit that would be reduced on average from current levels, but one that would provide a relatively larger share of total benefits to low-wage workers than the current system. The Personal Security Account (PSA) plan that I helped craft as a member of the 1994-1996 Social Security Advisory Council has been criticized because it would expose low- and middle-wage earners to financial market risks that they do not now face in Social Security. I am convinced that these financial market risks are no more dangerous to low-wage earners than policies that strong Social Security supporters advocate as they attempt to maintain the current system largely intact. In the PSA proposal that I support, the financial market risks for low-wage workers are largely ameliorated by the flat benefit that I propose be offered through Social Security.

There is nothing that I can see in the current structure of Social Security that can ameliorate the risks associated with the lack of wealth diversification for people at the low end of the wage distribution. The only way to effectively ameliorate this risk is by creating a claim on wealth for low-wage workers that is based on something other than unfunded political promises. If the PSA plan that I support goes too far in that diversification from a political standpoint, then we should begin with a smaller goal. But whatever you do, I urge you not to leave the folks at the bottom of the economic ladder without some opportunity to begin to climb that ladder through some form of real wealth accumulation.

PREPARED STATEMENT OF HON. LAWRENCE H. SUMMERS

Mr. Chairman, my colleagues and I appreciate the opportunity to meet with you today to discuss new directions in retirement security policy—an issue of critical importance to every American and to the future of our economy. One of the greatest challenges that we as a nation face as we enter the 21st century is ensuring the financial security of our population as it ages. Let me applaud this Committee for addressing and focusing attention on this question at this time.

Let me focus today on the key challenge of helping working Americans prepare themselves so they can retire in good financial health. Given the salience of this issue, I will devote the bulk of my time to discussing the President's approach to the reform of Social Security. But I will end with some remarks on the other core elements of retirement savings—pensions, and private savings.

I. THE PRESIDENT'S APPROACH

Let me start by articulating the case for the President's policy of reserving the surplus until Social Security is fixed. Its basic premise is this: the economy is remarkably strong. Our budget is the healthiest it has been for a generation. But we may not always be in such a strong position. And we will certainly never be in a stronger position to face the major challenge we have ahead of us—the challenge of an aging society.

When the Social Security Act was passed in 1935, American life expectancy was 62 years. Today, I am told that a married couple of 65-year-olds has an even chance of seeing a survivor pass the age of 90. These improvements in life expectancy, and a fall in birth rates, have put us on a path of decline in the number of American workers for every Social Security beneficiary. In 1960, the ratio was 5.1 to 1. Today it is 3.3 to 1. In a little more than 30 years' time, when there will be twice as many elderly as there are today, the ratio will be just 2 to 1, and falling.

There is a time to reap and a time to sow, and now is a time to sow. Now, at a time when our economy is strong and we face a critical challenge ahead—that is a time to prepare for the challenge we face. The case for reserving the surplus until Social Security is fixed rests on three pillars.

First, it is a fiscal imperative. By acting to save Social Security first, we can ensure the long-run health of the budget. We can avoid a situation where we find ourselves facing the challenge of an aging society and its burden on the budget—at the same time as shouldering the burden of servicing large amounts of debt. It is a fiscal imperative to assure the long-run solvency of the Social Security system now, when our economy is strong.

The second pillar is the broad economic case that applies to America as a nation. In the end, what you earn depends on what you invest. We as a nation have been plagued for a long time by a national savings rate that is too low. In 1992, our net national savings rate was just 3.1 percent. With the progress that we have made in reducing the federal deficit in the past five and a half years, the savings rate last year was 6.5 percent, nearly twice what it was in 1992. But that savings rate is still only a little more than half what we achieved in the 1950s and 1960s, when the economy grew most rapidly, and it still ranks America 19th of 26 industrialized countries.

A low national savings rate is a substantial problem because the only way that we can have investment in America, financed by Americans, is by increasing our national savings rate. As Secretary Rubin has already noted, as long as the national savings rate is too low, we face an unfortunate choice between reducing investments, on the one hand, and, on the other, relying on foreign capital to finance that investment, with the trade deficits that are associated with that borrowing. That is why it is imperative for us as a country to increase our national savings rate.

By preserving the surpluses until the Social Security system's solvency has been established on a long-term basis, we act to increase national savings. This step maximizes the growth potential of our economy which is important to help the economy be as strong as it can be to face the challenge of an aging society.

Third, it is a national imperative to maintain Social Security as a basic public trust. Sixteen percent of our seniors—one in six—receive all of their income from Social Security. The bottom two-thirds of the aged population receive half of their total income from Social Security. Without Social Security, nearly 50 percent of aged Americans would be in poverty. That makes it imperative that we preserve as a basic public trust America's most effective public program—for the next generation and the next generation and the generation after that.

Social Security is effective, in large part because it is efficient. More than 99 cents are paid in benefits by Social Security for every dollar that is paid in by workers and employers. Few, if any, private systems—anywhere in the world—come close to

matching this efficiency. One recent study[1] estimates that during the pay-out phase of privately-provided annuities the loss to overhead alone averages more than 8 cents in the dollar. Another study, of life insurance firms, by the American Council on Life Insurance found that on a per-dollar basis, expenses totaled 11 percent of annual income, or 16 percent of contributions, of which nearly half went in selling costs, or agents' commissions.[2] Social Security, quite simply, is the most efficient insurance program in existence. Assuring the maintenance of this system for the next generation has to be a crucial imperative.

II. REFORM ISSUES FOR DEBATE

Mr Chairman, a vigorous national debate is now well under way on how best to rise to the challenge of strengthening Social Security—a debate that will culminate in December with the President's White House Conference. There is a great deal still to decide—and there are a great many issues still to be discussed. I will not prejudge any of those discussions today, but I would like to discuss some of the economic questions that can and must be asked of any serious proposal for reform.

The first of these is whether the reformed system continues to assure an adequate stream of benefits for future retirees. Americans need a benefit they can count on, a fail-safe source of income, regardless of economic fluctuations and regardless of their generation.

For example, various proposals call for investing Social Security funds in the stock market. This would potentially bring higher returns to workers but it would also bring higher risks. A careful balancing of risk and return would be required to assure that Americans' benefits are secure. We owe all our sons, our daughters and our grandchildren a good return. But we also owe them the guaranteed floor of protection that the program has been providing for all American workers and their families since 1940.

A second question will be whether the reformed system continues to provide financial security for survivors and the disabled. Unfavorable comparisons are often made between the returns on contributions offered by Social Security and the returns offered by the market. But we must always remember that the Social Security system is more than just a retirement system; it also offers important disability and survivors insurance. In fact, one in three Social Security recipients is not a retiree. Any reform must ensure that Social Security is in a position to continue playing these other roles in the future.

A third question would be whether the proposed reform adequately accounts for the need to continue payments to today's retirees. It is important to remember that Social Security is not advance funded. If, as some have suggested, we were to move toward such a system, in which contributions of current workers are fully saved in order to be available the workers reach retirement age, then we would have to figure out some new way to pay for the Social Security benefits paid to current retirees. This "transition problem" must be taken fully into account when evaluating any proposals for comprehensive reform.

Fourth, we will need to ask whether the reformed system maintains America's hard-won fiscal discipline. By building up reserves for the years ahead, the Social Security Trust Fund is making an enormous contribution to our future by increasing the pool of national saving. In choosing the way forward we will need to be consistent with that strong record.

As we proceed with this vital debate there will be many other issues to be discussed—and many other questions to be considered. But I hope we will all be able to agree on the importance of maintaining Social Security as a basic public trust for future generations of Americans. And I hope we will all be able to agree that until we have met that obligation to our children, we should not risk the fiscal progress that we as a country have made. Today virtually every working man and woman in America is covered by Social Security. Mr. Chairman, let us all agree that however we reform Social Security our children will be able to count on Social Security as their parents and grandparents did.

III. PENSIONS

Although much of the attention on retirement savings will focus on Social Security, we must not forget the importance of the other two legs of the retirement stool: pensions and private savings. Let me talk briefly about the state of pension coverage for American workers and the steps that this Administration has taken to encourage more retirement plan coverage for workers.

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[1] Mitchell, Poterba and Warshansky et al., NBER 1997.
[2] Cited in Mitchell, NBER, 1996.

At the present time there are shortfalls on both the supply and the demand side in the private pension market. Half of all American workers are not covered by a retirement plan. And one reason that so many employers fail to offer such plans is lack of employee demand. Even among workers whose employers offer plans, a surprising number fail to take advantage of the retirement savings benefits available to them. Nearly 40 percent of employees earning less than $50,000 a year who are eligible to save through a 401(k) plan choose not to participate in the program.

One key to remedying this situation could be increased education about the importance of retirement saving. For example, a recent study found that education provided in the workplace tended to increase worker participation in 401(k) plans. The job here will not be easy. The same study concluded that newsletters, other written material, and even occasional seminars were not particularly effective in boosting employee participation in 401(k)s. But frequent, face-to-face contact with employees was found to boost participation rates. Clearly, the issue of retirement saving is one of the more difficult and complex areas of personal finance. It could be that only a sustained effort at employee education is likely to be successful.

In the past several years Congress and the Administration have taken a number of steps to encourage employer-provided pension coverage. These efforts have focussed largely on three areas: expanding the number of people eligible for employer-provided pensions, simplifying pension laws for businesses, and making pensions more secure and portable for workers.

The SIMPLE, a new retirement savings plan introduced last year as a low-cost option for small business, is proving popular with small business owners and their employees. We have also changed the law to allow tax-exempt organizations to sponsor 401(k) plans.

To simplify existing pension rules we have repealed measures that had restricted the ability of family members of small business owners to save for their own retirement and have enacted the upcoming elimination of the overall contribution limits for employees who participate in both defined benefit and defined contribution plans. Beginning in 1999, employers will also be exempted from nondiscrimination testing for 401(k) plans if they provide specified contributions to employees under a special safe harbor arrangement.

Finally, we have enacted reforms to make pensions more secure and portable for workers, including the 1994 Retirement Protection Act, which has provided protection for the benefits of more than 40 million American workers and retirees.

The President's FY 1999 budget proposes further expansions of programs to encourage retirement savings, particularly for small businesses and for moderate- and lower-income workers not currently covered by employer-sponsored plans. These include:

- encouraging payroll deduction—or "direct deposit"—IRAs by allowing employers to offer workers the opportunity to make IRA contributions on a pre-tax basis through payroll deductions. The convenience of this arrangement, as well as peer-group reinforcement, should encourage further participation in IRAs;
- providing a new three-year tax credit for the administrative and retirement-education expenses of any small business that sets up a new retirement plan or payroll deduction IRA arrangement;
- offering a new option for a simpler-to-administer pension plan for small business.

IV. PRIVATE SAVINGS

With the economy performing so well and the elder members of the Baby Boom generation coming within reach of retirement—and hence into their peak asset-accumulation years—one might expect a high personal saving rate for the nation. But this is anything but the case. In fact, despite the rise in national saving, the personal saving rate hit a 50-year low last year, and there is clearly a risk that many Americans may not be doing enough to prepare.

This Administration is committed to providing our aging population, and future generations as well, with the tools for a financially secure retirement. Already, Congress and the Administration have taken a number of steps to increase the level of personal saving:

- with the cooperation and leadership of members of this committee, we have expanded eligibility for IRAs and created a new vehicle to encourage additional saving: the Roth IRA;
- we have added inflation indexed bonds to the roster of government-issued securities. These instruments provide savers with guaranteed protection against the corrosive effect of inflation on savings. Everyone who saw their nest egg severely diminished during the inflation of the 1970s can attest to the importance

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of this new savings vehicle. We are extremely pleased with the reception they have been accorded;

- by changing the EE bond to allow holders to receive a higher rate of return and providing monthly accrual of interest, we have taken steps to make Savings Bonds more attractive. And earlier this month, we introduced inflation-indexed Savings Bonds;
- finally, we have looked to harness new technology in making information about the savings bond program more readily available to all Americans. The Bureau of Public Debt, the agency at Treasury that issues Savings Bonds, will begin selling Savings Bonds on its home page on the World Wide Web later this year.

V. CONCLUDING REMARKS

Mr. Chairman, as Secretary Rubin mentioned earlier, any effort to increase our national savings rate must rest on three core principles: maintaining fiscal discipline; protecting the progressive structure of the tax system and strengthening Social Security. By ensuring that the surplus is reserved until Social Security is safe, we can help ensure that the Social Security system of the 21st century continues to protect generations of Americans and promote both our economy and our values. And we can help ensure that it continues to promote our hard-earned fiscal discipline.

Mr. Chairman, while we may debate the policies by which we will strengthen the pieces of the three-legged stool of retirement savings, there is no questioning the importance of strengthening all three of those legs. I look forward to working with the members of this committee and with others in Congress as we take on this critical challenge. Thank you. I would now welcome any questions.

PREPARED STATEMENT OF PAUL J. YAKOBOSKI

Mr. Chairman and members of the Committee: I am pleased to appear before you this morning to discuss issues regarding the retirement income security of today's workers. My name is Paul Yakoboski. I am a Senior Research Associate at the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, DC. EBRI has been committed, since its founding in 1978, to the accurate statistical analysis of economic security issues. Through our research we strive to contribute to the formulation of effective and responsible health and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy recommendations. I ask that my full statement and attachments be entered into the written record.

REALITY CHECK FOR AMERICA

Two weeks ago, we released the eighth annual Retirement Confidence Survey (RCS).[1] The RCS tracks the retirement planning and saving behavior of Americans, as well as their confidence regarding various aspects of their retirement. The good news in the 1998 RCS is that working Americans have become more focused on their retirement over the past few years. As evidence, 45 percent have tried to determine how much they need to save by retirement, up from 32 percent in 1996 and 36 percent in 1997. The increase is particularly striking among baby boomers. Half of older boomers (those born between 1946 and 1953) have now tried to figure out what they'll need, up 12 percentage points from 1997, while among younger boomers (born 1954 to 1964) the number is up 15 percentage points. It appears that the constant drumbeat of attention given to retirement, and retirement planning and saving, over the past few years by the media, by employers, and by policymakers is having an impact on workers. The need to plan and save for retirement has come into sharper focus on their radar screens. The discussion surrounding Social Security and possible Social Security reforms is also surely having an effect in this regard.

While Americans have become more focused on their retirement, this has not translated into increases in their retirement income confidence. Since 1993, a consistent 20 to 25 percent of working Americans are very confident that they will have enough money to live comfortably through their retirement years (figure 1). This despite a very strong economy and Americans' increased attention on the issue. Some may find this puzzling, but the reason may simply be that, as more Americans try to figure out how much money they really need to save, the answer has them worried and it has rattled their confidence. This is probably a good thing, as a reality check is the first step to positive action.

WHERE WILL MY RETIREMENT INCOME COME FROM?

When workers are asked what they expect to be their most important retirement income source, the percentage expecting it to be personal savings showed a significant drop from 1997 (from 51 percent to 39 percent) (table 1). What changed? One possibility is that as more people focus on retirement and figure out what they will need, and know what they have already put aside, confidence in their ability to save enough for retirement decreases.

Only 13 percent of workers expect Social Security to be their most important source of retirement income. This compares with 42 percent of current retirees who say that Social Security is their most important source of income. In addition, 21 percent of workers do not expect Social Security to be a source of income for them at all in retirement. So while it is good that most workers do not expect Social Security to be their most important source of retirement income—after all it was always intended to be a floor or base to build on—many are apparently overly pessimistic in that they expect to get nothing from the system. And the younger they are, the more likely they are to feel this way (44 percent of Generation X do not expect to receive income from Social Security once they retire). In addition, 26 percent of current workers expect money from employer-funded plans to be their most important source of retirement income, and 10 percent expect employment to be their most important source of retirement income.

INDIVIDUAL SAVING AND RETIREMENT PLANS

According to the 1998 RCS, 63 percent of Americans have begun to save on their own for retirement. While this is good news in that most Americans are saving for retirement, it also means that one-third are not. We also know that the one-third tend to be younger workers and workers with lower incomes, often one in the same. These savings figures have remained essentially unchanged since the question was first asked in 1994 (figure 2).

What motivates individuals to begin saving for retirement? Unfortunately, the reality is that the top two motivators are negative in nature (figure 3). Number one is having observed someone not prepare and then struggle in retirement. Almost one-half (48 percent) said this provided a lot of motivation, and an additional 36 percent said it provided some motivation. Number two is the realization that time was running out to prepare for retirement. Thirty-seven percent said this provided a lot of motivation, and 42 percent said it provided some motivation. While fear is often a great motivator and the perception is correct that a significant minority of current retirees are experiencing a retirement that is in some sense financially challenging, it would seem that these findings are a signal that more needs to be done to reach out to individuals not yet saving and help them realize the advantages of beginning early with even seemingly small amounts of money. The third ranked motivator was the availability of a retirement plan at work.

The 1998 RCS reveals room for improvement, specifically it shows that most working Americans could do more in terms of saving for retirement (figure 4). Fifty-five percent of those not saving for retirement say it is reasonably possible for them to save $20 per week for retirement. In addition, 57 percent of workers who have begun to save for their retirement say that it is reasonably possible for them to save $20 per week more than they are currently saving. While $20 per week may not seem like a lot of money, it is over $1,000 per year, and over the years this savings could make a real difference. The power of compound interest will help a 25-year-old saving $20 a week, assuming a 5 percent annual return over 40 years, to build a $132,000 nest egg. With a 10 percent annual rate of return, $20 per week for 40 years will compound into over $500,000 (figure 5). The message is clear that seemingly small amounts of money saved on a regular basis over long periods of time can accumulate into a nest egg that would make a difference in retirement.

Even among those who are saving, it is fair to say that most have absolutely no idea how much they need to save by the time they retire to fund their retirement. Less than one-half (45 percent) of all workers have tried to figure out how much they need to save (figure 6). Among retirement savers, the figure is somewhat higher at 57 percent. Therefore, even with most Americans saving for retirement, they are in a sense flying blind and hoping that things work out in the end. In addition, less than one-half of retirement savers are very confident that they are investing their retirement savings wisely (46 percent) (figure 7). Forty-seven percent are somewhat confident. It appears that many retirement savers think that they are investing their funds wisely, but they are not really sure. Therefore, many are saving but they do not know if they are saving enough, and many think they are doing a good job of investing their money but are not really sure.

EDUCATION TO THE RESCUE?

The findings demonstrate the continuing need for broad-based educational efforts designed to make retirement savings a priority for individuals. While calls for "more and better education" may seem mundane and trite to some, if we view this as a long-term challenge, education should be a major part of our efforts. The good news in the 1998 RCS is the evidence that education can have a real impact at the individual level (figure 8).

Among workers who had received educational material or attended seminars about retirement planning and savings in the past year, 43 percent reported that the material led them to change the amount they contributed to a retirement savings plan, and 43 percent changed the allocation of their money in a retirement savings plan as a result. In addition, 41 percent said it was such information that led them to begin contributing to a retirement savings plan.

Furthermore, among those receiving retirement education materials in the past year: Eighty-one percent have money earmarked for retirement in an account in their name, compared with 67 percent of those who have not received information from their employer.

- Fifty-six percent—more than one-half—have attempted to determine how much they need to save for retirement, compared with 38 percent of those who have not received information from their employer.
- Thirty-one percent are very confident in their financial preparations for retirement, compared with 22 percent of those who have not received information from their employer.
- Fifty-one percent of savers are very confident that they are investing wisely, compared with 41 percent of savers who have not received employer information.
- Twenty-four percent are not confident about their overall retirement prospects, compared with 35 percent of those who have not received information from their employer.

EMPLOYMENT-BASED RETIREMENT PLANS

The voluntary retirement system has been a success for workers at large employers. Eighty-five percent of workers at employers with 100 or more employees are covered by a retirement plan (table 2). Two-thirds of workers at large employers actually participate in a plan at work. The same cannot be said of workers at small enterprises, particularly small businesses that are "family owned," relatively young, and that tend to employ younger, lower-earning workers who do not stay with the employer for more than a few years. Over 35 million Americans work for an employer with under 100 employees, and 25 million of these employees do not have access to a retirement plan through work. At very small employers (those with under 25 employees), 20 percent of workers are covered by a plan, and at employers with 25-99 employees, 50 percent of workers are covered by a plan. At very small employers (those with under 25 employees), 15 percent of workers actually participate in a plan, and at employers with 5-99 employees, 36 percent of workers are plan participants (table 2).

Why don't more small employers sponsor retirement plans? The immediate response is typically "administrative costs," and while this is an important reason, the true picture is more complex. In our survey, small employers identified three main reasons for not offering a plan (figure 9):

- The first reason, which is a largely ignored but important fact, is what small employers see as their employees' preference for wages and/or other benefits: 22 percent of small employers cited this as the most important reason they did not offer a plan. This finding is reinforced by previous EBRI research over the years that consistently demonstrates that retirement benefits come in a distant second as a desired benefit by employees, far behind health care.
- The second main reason cited by small employers for not offering a plan is administrative costs. Fourteen percent cited cost of plan set-up and administration as the most important reason for not offering a plan, and an additional 4 percent cited too many government regulations as the most important reason for not offering a plan.
- The third main reason is uncertain revenue, making it difficult to commit to a plan. Sixteen percent cited this as the most important reason for not offering a plan.

So, while administrative issues matter, the point we need to emphasize is that other factors are also at work that need to be taken in account when discussing policy options.

In addition, it appears that there is a fair amount of misunderstanding about retirement plans among small employers who do not sponsor one, especially as regards costs. For example, the Survey found that one-third of small employers without a plan don't know that a plan can be set up for less than $2,000, and many think they are legally required to match all employee 401k contributions. The truth is, sponsoring a plan does not have to be as expensive and administratively burdensome as many apparently assume.

On the other side, small employers that do offer a retirement plan see real benefits in doing so (figure 10):

- Thirty-five percent report a major impact on their ability to hire and retain good employees.
- Thirty percent report a major impact on employee attitude and performance.
- Fifty-four percent report a major impact on their employees' ability to prepare for retirement. There are reasons to be optimistic about the prospects for increased plan sponsorship among small employers:
- Sixty-eight percent of those without a plan do not think their employees are well prepared for retirement.
- One-half of those without a plan have seriously considered it in the past.
- Seventeen percent say they are very likely, and 27% somewhat likely, to start a plan in the next two years.

The findings indicate that, if significant progress is to be made in terms of retirement plan sponsorship among small employers, we must address employer concerns about offering plans and better educate them as to the options that are available to them and what these options actually entail. However, the findings also show that effective policy must help make retirement planning and saving a priority for the individuals who work for these small employers as well.

PLAN EVOLUTION AND ITS IMPLICATIONS

Individuals today have greater opportunities to plan and save for retirement than members of any previous generation. It can be argued that retirement plans today match the reality of the work experience for most Americans better than at any time in history. The "lifetime job" has never existed for most workers. Over recent years, 1983-1996, median tenure among male workers has dropped noticeably, but this decrease was concentrated among prime-age male workers. Despite this decline, tenure in 1996 was comparable with that of decades past. Tenure levels for female workers have risen consistently over time. The fact is that there has always been a good deal of job churning in our economy.[2] Plan design and public policy have evolved over time, and this evolution means that plans are better suited to meet the needs of mobile workers.

Vesting requirements were instituted with the Employee Retirement Income Security Act of 1974 (ERISA) and have become more stringent over time.[3] The Revenue Act of 1978 codified 401(k) cash or deferred arrangements into law. The defined contribution plan market has experienced dramatic growth over time, spearheaded by 401(k) plans.4 Such plans are offered as complements to defined benefit plans among large plan sponsors and as primary retirement vehicles among smaller companies and those just instituting a plan.[5] Benefit portability on job change and the potential for workers to fully preserve benefits are key features of defined contribution plans. Hybrid plans have emerged combining features of defined benefit and defined contribution plans, including the portability features of defined contribution plans.[6]

But it is also obvious that workers today face very explicit decision-making responsibilities that will directly impact their retirement income security. So while the vehicles are there, the question remains as to whether workers are taking full advantage of the opportunities afforded them. In many instances, unfortunately, the answer is "no." As mentioned earlier, one-third of workers are not saving for retirement. Even among those without a plan at work, an individual retirement account (IRA) is an option available for tax-preferred retirement savings. In the pre-Roth IRA world, only 10 percent of those eligible to make a tax-deductible contribution elected to do so.

Among those saving, other concerns arise such as whether contribution levels are adequate and whether the money is being invested properly. For example, whether workers will accumulate adequate assets in their 401(k) plans to help fund their retirement will depend in part on the amount they contribute and how those funds are invested. EBRI analysis has provided stark evidence of the effect that plan features and legal limits can have on workers' decisions concerning their contribution levels. Older workers tend to have their contributions constrained by maximum limits (plan or legal), while many younger workers recognize the value of the employer

match, contributing just enough to take full advantage of that plan feature but no more.[7] On the investment side, a real dichotomy exists in allocation behavior among workers within similar demographic groups. A significant fraction of participants, particularly younger ones, are heavily diversified into equities, while at the same time a large percentage of their peers hold zero equities in their accounts. The data indicate that it may be the low-earning, younger participants who do not appreciate the advantages of diversifying their 401(k) portfolio to include equities. This is at the risk of accumulating insufficient assets to fund a retirement lifestyle that is desired or being able to retire when desired.[8]

In addition, preservation of the money set aside in retirement accounts until retirement is an area of concern. Research indicates that the level of retirement benefit preservation is low among many segments of the working population despite the fact that preservation rates have been increasing over time. According to EBRI analysis of Hewitt Associates' data, 40 percent of distributions to job changers in 1996 were rolled over, up from 35 percent in 1993. Rollover percentages are higher when examined by the dollars distributed, reflecting the fact that larger distributions are more likely to be preserved. Seventy-nine percent of all dollars distributed in 1996 were rolled over, compared with 73 percent in 1993. In 1996, 20 percent of distributions of less than $3,500 were rolled over, compared with 95 percent of distributions larger than $100,000.

While over three-quarters of the dollars distributed are preserved via rollover, the data indicate areas of concern. Most distributions do not result in a rollover; 60 percent resulted in a cashout. From a financial planning perspective, even relatively small sums of money can compound into nontrivial contributions to a retirement nest egg over a period of decades. Furthermore, the importance of preservation of seemingly small balances is enhanced by the fact that individuals may receive a number of these "small" distributions over the course of a career as they change jobs.[9,10]

SOCIAL SECURITY

The Finance Issues

Under current law, the Social Security program will meet the retirement of the baby boom generation in 2008, when the first boomers reach eligibility for early retirement benefits at age 62. This retirement wave will only exacerbate pre-existing demographic pressures, which are primarily the result of our aging society, maturing social insurance systems, and lower birth rates in cohorts succeeding the baby boom generation.[11] In 1983, policymakers anticipated this long-range demographic strain by increasing the normal retirement age (NRA) and by raising Social Security taxes. Recalculating tax rates, policymakers averaged the combined Old-Age, Survivors and Disability Insurance (OASDI) program's cost as a percentage of taxable payroll over a 75-year projection period, resulting in a tax rate higher than needed to fund short-term obligations.

In effect, this method of calculating the OASDI portion of FICA added a partial advance funding structure to the Social Security system that went beyond the historical practice of simply maintaining a contingency reserve. Due to the fact that since 1983, FICA taxes have been higher than needed to meet current benefit payments, "surplus" Social Security revenue has been accumulated. This revenue has been converted into Special-Issue Treasury bonds and credited to the Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) trust funds, which are maintained by the Social Security Administration. By the end of 1997, the OASDI trust funds had accumulated approximately $656 billion in assets, an amount anticipated to peak at about $3.78 trillion (in nominal dollars) by the year 2020.

Theoretically, the Social Security trust fund surplus will be drawn down as demographic pressures mount, helping younger workers pay for Social Security retiree benefits and thereby keeping future FICA taxes lower than they would be if the system were maintained on a purely pay-as-you-go[12] basis.[13] Under intermediate assumptions, reserves from the OASDI trust funds will begin to be redeemed to finance the portion of Social Security benefits obligations not funded by current FICA taxes in 2013. In the absence of reform, the 1998 Social Security Trustees' report estimates that the trust fund reserves will be depleted in 2032. At that time, FICA revenues alone will be able to finance only about three-fourths of benefit obligations for the remainder of the 75-year projection period (2029 through 2070).

Few among the general American public realize that trust fund balances are dwindling by legislative design and, therefore, falling trust fund balances are not "news." The real news about the trust funds is that they were not expected to dwindle as quickly as current projections predict. After passage of the Social Security Amendments Act of 1983, the 1983 Social Security Trustees' report projected that

the trust funds would hold 54 percent of outlays in reserve by 2060 under the second set of intermediate assumptions (Board of Trustees, 1983). In contrast, intermediate assumptions used in the 1998 Social Security Trustees' report project the OASDI trust fund balance to be exhausted by 2032.

Although legislative changes from 1983 to 1995 and more optimistic demographic assumptions had positive implications for the combined OASDI trust fund balances, these were outweighed by other factors. The markedly more negative projections in the OASDI Trustees' reports from 1983 to 1995 are fully attributable to use of stricter actuarial methodology in calculating trust fund balances, a change to more pessimistic disability and economic assumptions, and other changes. An additional contributing factor is that the period projected in the 1995 report includes 12 deficit years in which demographic pressures will be strong.[14]

Because, as a whole, the 1983 Trustees' assumptions are optimistic in retrospect, some are concerned that 1996 Trustees' projections are optimistic as well and are therefore understating the OASDI long-range financial shortfall.[15] In addition, critics of the current system argue that the trust funds are already essentially depleted because their assets are borrowed by the federal government (i.e., Congress), which uses them to finance other government operations. When the OASDI program's Treasury bonds must be redeemed in order to pay benefits, the only way for the government to repay its loans will be to borrow money from other sources, increase general taxes, or reduce other areas of government spending. In any case, assuming that trust fund assets will need to be tapped in order to pay benefits, general tax revenues are likely to rise. This leaves many to speculate that the combined OASDI trust fund "isn't really there" in the sense that the money current workers are paying today in excess of current benefit obligations is not going to help rein in overall tax rates tomorrow. Others argue that overall tax rates would be the same or even steeper in the future if the government had borrowed money from higher-interest lending sources in the private sector or had raised current income taxes instead of borrowing OASDI trust fund reserves. Conversely, some speculate that the federal government would not have expended as many resources had the Social Security Trust funds not been available.

Whatever one's perspective on the trust fund reserves' efficacy in prefunding OASDI benefit obligations, projections show that the current FICA tax rate alone will be able to cover about three-quarters of projected program liabilities by 2032 (Board of Trustees, 1998). The projected OASDI deficit over the 75-year actuarial period after 1998 is expected to be 2.19 percent of taxable payroll under intermediate assumptions;[16] that is, if payroll taxes were increased by this amount in 1996, a 17.7 percent increase, the combined OASDI program would be actuarially solvent. However, were the Congress to wait until 2022 to increase taxes without cutting benefits, taxes would have to rise to close to 17 percent of taxable payroll.[17]

As a result of this projected shortfall by 2032 of roughly one-quarter of benefits promised, numerous and diverse reform proposals have been promulgated. Depending on their supporters' beliefs about the merit and viability of the current system, these reforms range from fixing the Social Security system in very traditional ways to transforming the existing system into a fundamentally different one (Advisory Council on Social Security, 1997).[18]

Effects on the Rest of the U.S. Retirement System

The result of the Social Security debate could potentially have great impact on the design of the employment-based pension system. An increase in the NRA and/or early retirement age would probably result in adjustments in employers' willingness to retain older employees and the designation of retirement ages for employment-based pension plans.

In 1993, nearly 48 percent of employees in medium and large private establishments were covered by defined benefit pension plans using benefit formulas that were integrated with Social Security provisions (U.S. Department of Labor, 1995).[19] Hence, if Social Security benefit provisions change, the employers of approximately 7.7 million workers will most likely have to readjust their retirement plan formulas.[20] The total number of employers who would have to readjust is even higher, as the above figure does not include employees of small private firms or of the government who may also be participating in integrated pension plans. Readjusting benefit formulas for Social Security changes would entail an administrative burden in addition to any other potential burdens imposed on private pension sponsors under a new Social Security policy.

Some other considerations with respect to potential changes in Social Security policy on employment-based pension sponsors are the following:

- Would tax incentives for employment-based pensions—public and private—be reduced if Social Security costs put pressure on other parts of the federal budget?
- Will employees demand that employment-based pension plans be more generous under possible benefit cuts resulting from Social Security reform?
- Since employees who retire early sometimes receive bridge benefits from their employment-based pension plans until they become eligible for Social Security, will an increase in the NRA raise bridge costs and reduce bridge benefits as a result?
- How much in resources can employment-based pension sponsors be expected to allocate in adjusting to new Social Security policy in a time when they, too, will need to prepare and provide for demographic pressures on their own plans?
- If part or all of Social Security's current defined benefit system were reformed to include defined contribution accounts, would workers feel uneasy about not having as much of a defined benefit guarantee in retirement and therefore place pressure on employers to expand employment-based defined benefit plans in terms of benefits and sponsorship? Would employers be encouraged to abandon employment-based defined contribution plans?
- If Social Security policy changes to encourage more delayed retirement, will employer health care costs rise as a result of an older work force? If so, will this reduce the funds available for employment-based pension plans?

Not only is there concern as to the extent employers sponsoring pensions will adjust to changes in Social Security policy, but there is also debate as to how workers participating in employment-based plans will alter their behavior and how these adjustments will affect their retirement security.

- If private investment accounts are incorporated into Social Security, would workers, upon seeing large accumulations in their Social Security accounts, be less likely to invest in employment-based plans?
- If so, will this negatively impact retirement security, or will the accumulations in Social Security accounts be enough to sustain secure retirement?
- If the new Social Security program has a defined contribution component with educational efforts, will this increase workers' awareness of the necessity and benefits of saving as well as the potential effects of inflation and thereby increase worker participation in employment-based pension plans?
- If the reformed Social Security system provides lower benefits than today, will workers realize the need to increase savings in their defined contribution employment-based plans to the extent permitted by the employer?

Ultimately, changes in the Social Security system could impact all legs of the retirement income stool,[21] potentially changing its very constitution.

Costs and Benefits Under Different Generic Reform Approaches

Modeling results from the EBRI-SSASIM2 Policy Simulation Model indicate that no reform option appears to be win-win for all groups in all aspects. That is, no reform is likely to be a policy panacea for the challenges facing this aging nation. Social Security reform will necessitate major policy tradeoffs. This section summarizes who wins and who loses (and how) under the types of reform options EBRI modeled under key assumptions based on those used by the Social Security Trustees (with the exception of the mortality decline rate, which is based on the Census Bureau's mid-range assumptions). EBRI's results are based on these and hundreds of other baseline assumptions, which can be altered by the individual user of the EBRI-SSASIM2 Policy Simulation Model.

Assuming that partial privatization is administratively feasible, modeling results suggest that people born in 1976 would fare less well under partial privatization relative to maintaining the current system with tax increases—even if they invested in a mixed (life cycle) portfolio of equities and bonds (assumed to yield a nominal investment return of 7.06 percent in the simulations utilized in this report). Because the current Social Security system is largely pay-as-you go, most of what workers pay into the system funds today's benefits. These benefits have already been accrued. Unless Congress modifies the current statute, these benefits will have to be paid. But, on top of paying current benefits, workers moving to a privatized system would have to pay "twice"—once for the benefits going to today's beneficiaries and again to their own individual Social Security accounts. Paying for this transition would give persons born in 1976—those persons scheduled to pay transition taxes over their entire working lives in this report—fewer benefits for their Social Security contributions (that is, lower "payback ratios") and lower average net lifetime earnings (when Social Security contributions are subtracted) than a reform that would "simply" raise taxes enough to pay for the current Social Security system. That is, the extra money that average workers born in 1976 would have to contrib-

ute to Social Security to make the transition to a partially privatized system offsets the extra expected returns that could be earned from individual Social Security accounts.

Because transition costs are expected to be fully paid by the time persons born in 2026 retire, some persons born in 2026 would win under a partially privatized system, but the degree to which they would win is influenced by the extent to which they invest in equities and may not be that much even if they pursued a life-cycle asset allocation. On average, program taxes/contributions would be about 50 percent lower by 2060, and payback ratios would be much higher for average workers born in 2026 under the partially privatized system modeled in this report than under a reform that maintained the current system by raising taxes only. These same individuals would receive payback ratios much closer to those realized by more traditional reforms if they chose to invest very conservatively (for example, a portfolio consisting entirely of Treasury bonds that produces a nominal rate of return of 5.97 percent in our simulations).

In exchange for higher payback ratios and lower program tax/contribution rates, the potential for market risk exists in any form of privatized system, especially if assets are invested in equities. Benefits under a partially privatized system could fall to the same levels as benefits under a reform that reduces benefits to maintain current tax rates, if not lower, if the participant invests in an extremely conservative fashion or if returns on equities are not as high as those expected based on historical market performance. And, unfortunately, results indicate that increased national savings under a partially privatized system would fail for many to make up for benefit reductions and/or increased risk, as lifetime average earnings plus net Social Security benefits would be just 1.3 percent higher for men born in 2026 and 1.7 percent lower for women under a partially privatized system with equity investment than they would be if taxes were raised to fund today's Social Security program.

Who would benefit most from a partially privatized Social Security system? Modeling results indicate that any system that relies more on individual accounts (which closely connect benefits with contributions and investment returns) and relies less on the traditional defined benefit system (which redistributes income from high to low wage earners) will disproportionately benefit higher wage earners. If they invested in a mixed (life-cycle) portfolio of Treasury bonds and equities, high-wage earners would do better under partial privatization than under any of the traditional reforms modeled in this report in terms of both annual benefits and payback ratios on program contributions. Given their higher levels of wealth, higher wage earners would also, on average, stand to gain most in total dollars from the beneficial effects of economic growth that are projected to arise from a partially privatized system.

Who is worst off in terms of annual benefits under partial privatization relative to a funded current system? Those with lower earnings or less attachment to the labor force, such as low-income workers and average women—even if they were to invest in a mixed portfolio that is expected to generate a higher rate of return—would receive lower annual benefits under a partially privatized system. The working poor (defined as those earning at the poverty level over their entire working lives) would also receive lower payback ratios for their Social Security contributions, as would average women born in 1976. For lower-income earners, the returns that could be obtained by investing individual Social Security accounts partially in equities would not, on average, compensate for the additional costs of transition taxes and the reduced benefits from the current, redistributive system. In addition, lower-earning workers could be at higher risk of investing extremely conservatively and of falling into poverty if rates of return on individual account assets were below those expected based on historical averages.

Is raising taxes to fund the current system a better solution than partial privatization? Not necessarily, as funding the current system would require a 50 percent increase in Social Security (OASI) taxes by the year 2060. And, this reform would not produce the higher national saving and growth effects produced by the partially privatized system modeled in this report. Which reform is better also depends on one's view of the appropriate levels of risk, redistribution, guaranteed base benefits, and individual responsibility in the Social Security system (Olsen, VanDerhei, and Salisbury, 1997). In addition, questions of administrative feasibility and political risk (for both traditional and structural reforms) must be considered, along with the multitude of reform options that are a combination of raising taxes and/or reducing benefits (such as the NRA reform presented in this report) and/or introducing individual accounts, etc.

The simple overriding implication of these results, having been created under reasonable and widely accepted assumptions, is that all reform options involve tradeoffs

and have winners and losers among generations and among members of the same generation. Identifying these tradeoffs is the first step in giving policymakers and the public the necessary information to engage in an informed public dialogue about the choices they are facing in preparing for the financial challenges confronting the Social Security system.

THE CHALLENGE

There are no quick fixes or silver bullets that will ensure retirement income security for today's workers. It can be argued that the voluntary retirement system has been a success at large employers, where 85 percent of workers have an employer that sponsors a plan, and 66 percent of workers actually participate in a plan. The same cannot be said at the small employer level, where 29 percent of workers have an employer that sponsors a plan and 21 percent of workers actually participate in a plan. Our research indicates that long-term policies aimed at improving workers' retirement income security must not only address employer concerns about offering plans but also must educate workers about the need to make retirement saving and planning a priority. In addition, it appears that there is a need to better inform small employers about the options available to them and the true costs and potential benefits of these options.

Changes to the Social Security system are inevitable. As policymakers consider various options to reform the system, they should understand the interconnectedness of the Social Security system with employment-based retirement plans and even with individual savings. Ideally, reforms to the Social Security system would be based not only on their impact on that system but also on their impact on the retirement income security system as a whole.

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Washington, DC: Board of Trustees, 1983, 1996 and 1998. Olsen, Kelly, Jack VanDerhei, and Dallas Salisbury, "A Framework for Analyzing and Comparing Social Security Policies," EBRI Issue Brief no. 183 (Employee Benefit Research Institute, March 1997).

ENDNOTES

[1] The Retirement Confidence Survey (RCS) is sponsored by the Employee Benefit Research Institute (EBRI), the American Savings Education Council (ASEC), and Mathew Greenwald and Associates (MGA). The RCS is funded by grants from various public and private organizations.

[2] For a complete discussion of tenure patterns over time and the implications for retirement income security, see Paul Yakoboski, "Debunking the Retirement Policy Myth: Lifetime Jobs Never Existed for Most Workers," EBRI Issue Brief no. 197 (Employee Benefit Research Institute, May 1998).

[3] Prior to the passage of ERISA, there were no regulations relating specifically to vesting. ERISA established three standards that effectively required plans either to fully vest participants after 10 years of service or to partially vest participants prior to 10 years of service with full vesting occurring after no more than 15 years. These vesting requirements have become stricter with legislative changes over time. Current law requires a plan to adopt vesting standards for the employee's benefit (the balance under a defined contribution plan or the accrued benefit under a defined benefit plan) at least as liberal as one of the following two schedules: full vesting (100 percent) after five years of service (with no vesting prior to that time, known as cliff vesting), or graded (gradual) vesting of 20 percent after three years of service and an additional 20 percent after each subsequent year of service until 100 percent vesting is reached at the end of seven years of service. Benefits attributable to employee contributions to either defined contribution or defined benefit plans and investment income earned on employee contributions to defined contribution plans are immediately vested. Vesting rates (the fraction of plan participants who are vested) have been rising steadily over time. In 1965, 12 percent of plan participants were vested. In 1975, the year after ERISA was passed, 44 percent of plan participants were vested. As of 1993, 86 percent of plan participants were vested, an

increase of 95 percent since the passage of ERISA. This increase can be attributed to both the maturation of the employment-based retirement plan system and stricter vesting requirements that have been legislated over time.

[4] The number and percentage of individuals participating in private defined contribution plans is increasing relative to the number and percentage participating in defined benefit plans. The total number of participants in all defined benefit plans was 33 million in 1975. Participation increased to 40 million in 1983, and has remained in the 39 million-41 million range since that time. The total number of participants in defined contribution plans increased from 12 million in 1975 to 44 million in 1993.

[5] Despite the many changes in government regulation regarding defined benefit plans and the increased prevalence of defined contribution plans, defined benefit plans are still an important part of both the private and public retirement systems. The data in this report show that they are firmly entrenched in large companies and in plans covered by collective bargaining agreements. It is unlikely that many of these plans will be shifted—at least completely—to defined contribution plans.

[6] For a complete examination of the trends in the number of defined benefit plans and defined contribution plans and the implications of these trends, see Kelly Olsen and Jack VanDerhei, "Defined Contribution Plan Dominance Grows Across Sectors and Employer Sizes, While Mega Defined Benefit Plans Remain Strong: Where We Are and Where We Are Going," EBRI Issue Brief no. 190/ EBRI Special Report SR-33 (Employee Benefit Research Institute, October 1997). For a complete discussion of hybrid plans, see Sharon Campbell, "Hybrid Plans: The Retirement Income System Continues to Evolve," EBRI Issue Brief no. 171/ EBRI Special Report SR-32 (Employee Benefit Research Institute, March 1996).

[7] See Paul Yakoboski and Jack VanDerhei, "Contribution Rates and Plan Features: An Analysis of Large 401(k) Plan Data," EBRI Issue Brief no. 174 (Employee Benefit Research Institute, June 1996).

[8] See Paul Yakoboski and Jack VanDerhei, "Worker Investment Decisions: An Analysis of Large 401(k) Plan Data," EBRI Issue Brief no. 176 (Employee Benefit Research Institute, August 1996).

[9] Consider the following hypothetical example. An individual, age 25 and earning $25,000, begins saving for retirement by contributing 5 percent of pay to a 401(k) plan (in addition, the employer matches 50 percent of every dollar contributed by the employee). If this individual stayed with the same employer to age 65 and contributed 5 percent of earnings each year (earnings are assumed to grow at a 4 percent annual rate), then at age 65 he or she would have $866,000 in his or her 401(k) account (assuming an 8 percent annual rate of return). Now suppose this individual changes jobs at ages 30, 35, 40, and 50. Suppose that each job offers an equivalent 401(k) plan (similar investment options and a 50 percent match) in which the individual is immediately eligible to participate, and he or she continues to contribute 5 percent of earnings. Since each job lasts at least five years, the individual is fully vested, assuming a cliff vesting schedule, in all employer contributions plus earnings on those contributions in addition to his or her own contributions and earnings on those at the time of each job change. Suppose that vested 401(k) account balances are completely preserved for retirement (via rollover to an IRA or the new employer's plan, or by leaving the money in the former employer's plan) and continue to be invested such that they earn 8 percent annually. This individual would still have retirement savings of $866,000 at age 65. From a wealth accumulation perspective, this scenario results in retirement savings that are the same as if the worker had never changed jobs. What happens, however, if not every distribution is preserved for retirement? After five years, the worker in our example has a vested account balance of about $12,000. Suppose he or she cashes out this amount when changing jobs at age 30. Then, assuming the same savings behavior and full preservation on future job changes, this individual would have $676,625 at age 65, or $189,129 less than if that initial cashout at age 30 had been preserved for retirement (a difference of 22 percent). This clearly demonstrates the high cost of cashing out a "modest" 401(k) accumulation on job change relatively early in a career. Suppose that cashout occurs after the first two jobs. The individual cashes out both the vested account balances of $12,000 at the first job and $14,400 at the second job, and therefore the individual starts saving for retirement all over again at age 35. Assuming the same saving behavior and full preservation until retirement, he or she would have $520,000 at age 65. This is $346,000 less than amount accumulated with preservation of those first two distributions, a difference of 40 percent.

[10] For a complete discussion, see Paul Yakoboski, "Large Plan Lump-Sums: Rollovers and Cashouts," EBRI Issue Brief no. 188 (Employee Benefit Research Institute, August 1997).

[11] Persons born between 1946 and 1964.

[12] A pay-as-you-go system is one in which all FICA taxes collected today are used to pay for all Social Security benefits due today. That is, in a pay-as-you-go system, the only money used to pay current benefits is money collected from current workers' wages.

[13] Note that the assumption that trust fund surpluses will help future workers fund future benefits has never been unanimously accepted, although this assumption seems to have been the rationale for the 1983 Commission's surplus-generating recommendations. See Alicia Munnell and Lynn Blais, "Do We Want Large Social Security Surpluses?" New England Economic Review (September/October 1984): 5-21, and Robert Myers, "Social Security and the Federal Budget: Some Mirages, Myths, and Solutions," Journal of the American Society of CLU and ChFC (March 1989): 58-63.

[14] For example, the revised test to determine the trust funds' long-term financial condition became stricter in 1992, and the methodology used to generate the economic assumptions was also changed. See Michael Anzick, "1991 Social Security and Medicare Annual Reports Revise Insolvency Projections," Employee Benefit Notes (August 1991): 1-8. The change in assumption generation means that "assumptions for the future have been revised in a less optimistic direction" See Eugene Steuerle and Jon Bakija, Retooling Social Security for the 21st Century (Washington, DC: Urban Institute Press, 1994).

[15] In particular, program solvency is most sensitive to mortality and nativity assumptions, an area of controversial debate even within the federal government. For example, the Census Bureau's mid-range projections predict 3.6 million more persons ages 85 and over by 2050 than the OASDI Trustees' mid-range assumptions. Some academics project that numbers will be even higher. See "U.S. Population Projections: 2050 Ages 85 and Older," National Institute on Aging and Census Bureau estimates, 1996.

[16] See Board of Trustees, 1996. It is interesting to note, however, that the 1996 Social Security Advisory Council assumes an adjustment of the consumer price index of 0.21 percent, which decreases the expected shortfall from 2.17 percent of taxable payroll to 1.86 percent. See Advisory Council on Social Security, Report of the 1994-1995 Advisory Council on Social Security, Vol. I (Washington, DC: Social Security Advisory Council,1997).

[17] Ibid.

[18] The main parameters of seven such reform packages are summarized in Kelly Olsen, "Keeping Track of Social Security Reform Proposals: A Summary," EBRI Notes, vol. 17, no. 11 (November 1996).

[19] Integration with Social Security can be done in several ways, but the basic purpose of integration is to allow employers to take credit for the fact that they are financing one-half of the payroll tax assessed for the Social Security retirement benefits for their employees. In certain defined contribution plans, employers are allowed to contribute a fixed percentage of compensation for all parts up to a specified level of compensation and then a larger percentage for compensation in excess of that amount (up to the 401(a)(17) limit). The permitted disparity between the two percentages is controlled by Internal Revenue Code sec. 401(l). Integrating a defined benefit plan with Social Security is a more complicated procedure; however, the employer is allowed to indirectly increase the generosity of the benefit provisions for employees earning in excess of the maximum taxable wage base ($62,700 in 1996) in recognition of the fact that no Social Security retirement payroll tax has been paid by the employer on these wages. For a complete explanation of integration provisions, see Chapter 8 (for defined contribution plans) and Chapter 14 (for defined benefit plans) of Allen, Melone, Rosenbloom and VanDerhei, Pension Planning, Seventh edition (Homewood, IL: Richard D. Irwin, Inc., 1992). Also see Employee Benefit Research Institute, Fundamentals of Employee Benefits, Fifth edition (Washington, DC: Employee Benefit Research Institute, 1997) and James Schulz and Thomas Leavitt, Pension Integration: Concepts, Issues and Proposals (Washington, DC: Employee Benefit Research Institute, 1983).

[20] EBRI tabulation from the U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits in Medium and Large Private Establishments, 1993 (Washington, DC: U.S. Government Printing Office, 1995).

[21] The retirement income stool has traditionally been defined as having three legs: Social Security, individual savings, and private pension income. EBRI publications, beginning in 1979, have suggested that there are more "pillars," including

wages from work, government assistance, survivor benefits, inheritances, long-term care insurance, etc.

Table 1

EXPECTED MOST IMPORTANT SOURCES OF RETIREMENT INCOME AMONG CURRENT WORKERS

	1997	1998
Personal Savings	51%	39%
Employer Funded Plans	24	26
Social Security	12	13
Employment	9	10
Sale of Home or Business	a	4
Inheritance	a	2
Support from Children/Family	1	1
Other Government Programs	a	1

Source: The Retirement Confidence Survey (1997 and 1998).
[a]Not asked in 1997.

Table 2

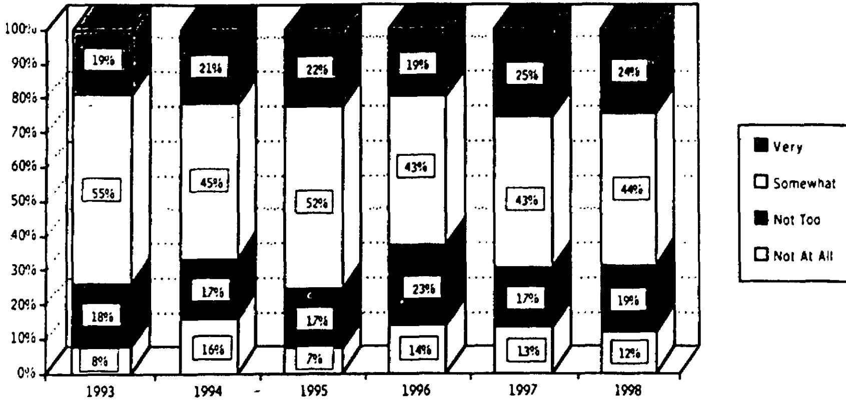
CIVILIAN NONAGRICULTURAL WAGE AND SALARY WORKERS, AGES 16 AND OVER, WITH ANY RETIRMENT PLAN COVERAGE, 1993

	Workers (1,000s)	Sponsorship Rate[a]	Participation Rate[b]
Total	105,815	64.4%	49.3%
Firm Size			
Fewer than 25	22,499	20.2	15.4
25 to 99	12,901	49.6	36.0
100 or more	62,484	84.9	66.2

Source: Employee Benefit Research Institute tabulations of the 1993 Current Population Survey employee benefits supplement.
[a]The fraction of workers whose employer or union sponsors a plan for any of the employees at the worker's place of employment.
[b]The fraction of all workers participating in an employment-based plan.

Figure 1

WORKER CONFIDENCE IN HAVING ENOUGH MONEY TO LIVE COMFORTABLY IN RETIREMENT

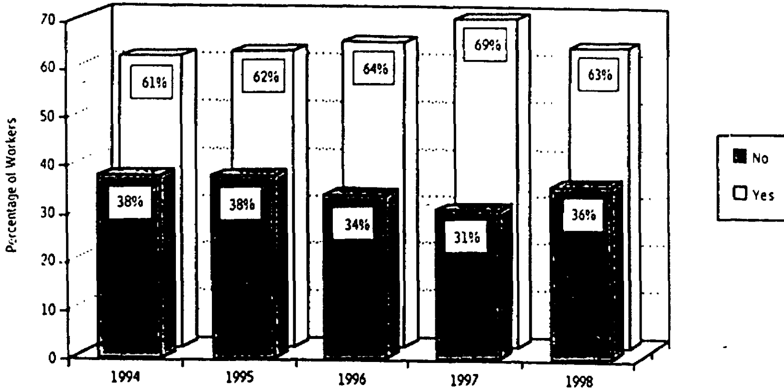


Source 1998 Retirement Confidence Survey.

Figure 2

WORKERS PERSONALLY SAVING FOR RETIREMENT

Have you personally saved any money for retirement, not including Social Security taxes or employer-provided money?

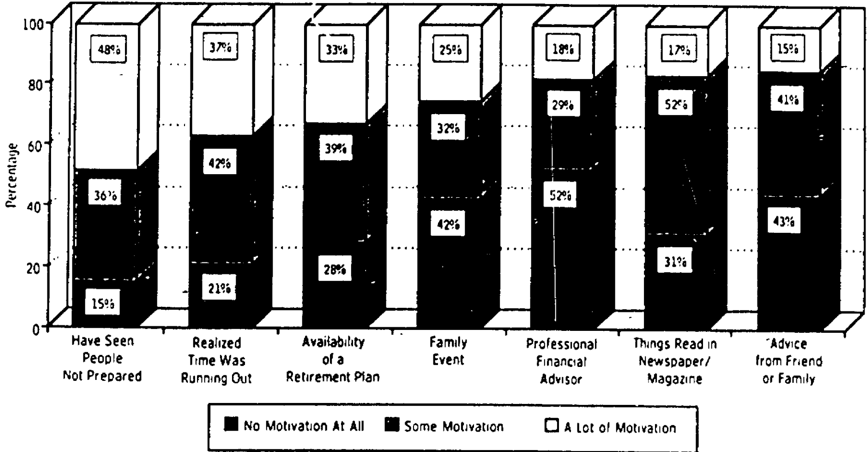


Source: 1998 Retirement Confidence Survey.

Figure 3

MOTIVATIONAL FACTORS IN SAVING FOR RETIREMENT—WORKERS

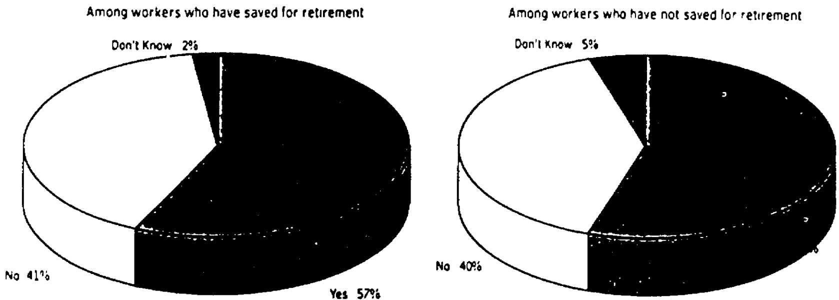
Among workers who have saved for retirement



Source. 1998 Retirement Confidence Survey

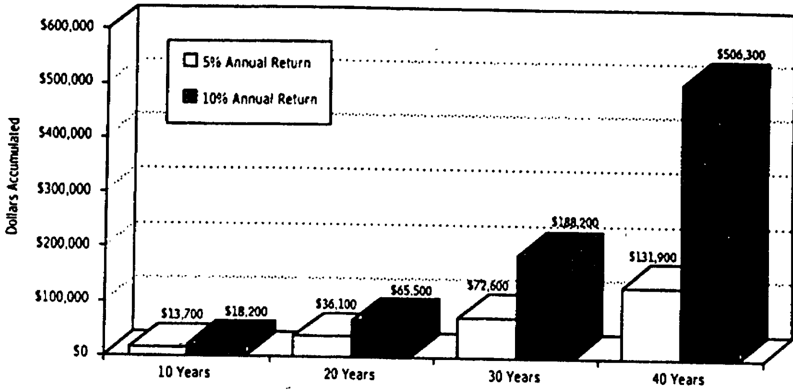
Figure 4

COULD YOU SAVE $20 PER WEEK MORE FOR RETIREMENT?



Source. 1998 Retirement Confidence Survey.

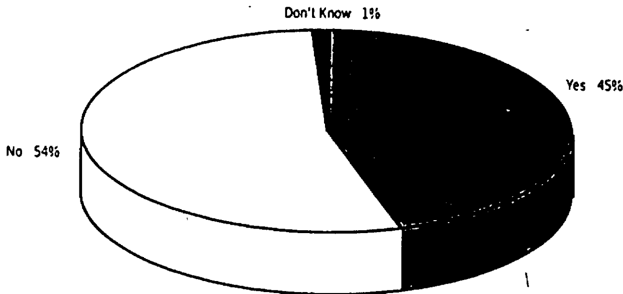
Figure 5
IMPACT OF SAVING ANOTHER $20 PER WEEK



Source: Employee Benefit Research Institute calculations.

Figure 6
RETIREMENT NEEDS CALCULATION—WORKERS

Have you tried to figure out how much money you will need to have saved by the time you retire so that you can live comfortably in retirement?

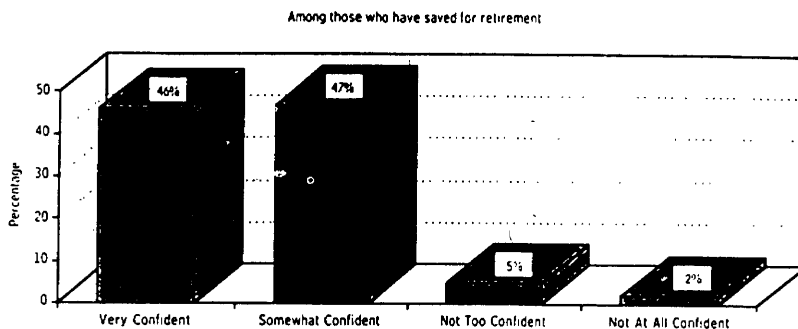


Source: 1998 Retirement Confidence Survey.

Figure 7

WORKERS' CONFIDENCE IN INVESTING RETIREMENT SAVINGS WISELY

Among those who have saved for retirement

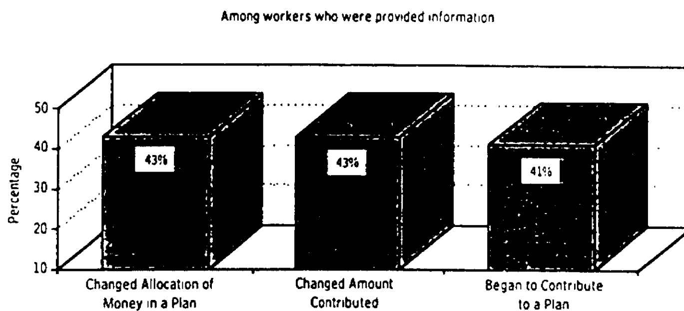


Source 1998 Retirement Confidence Survey.

Figure 8

ACTIONS RESULTING FROM EMPLOYER-PROVIDED INFORMATION ON RETIREMENT SAVING AND PLANNING

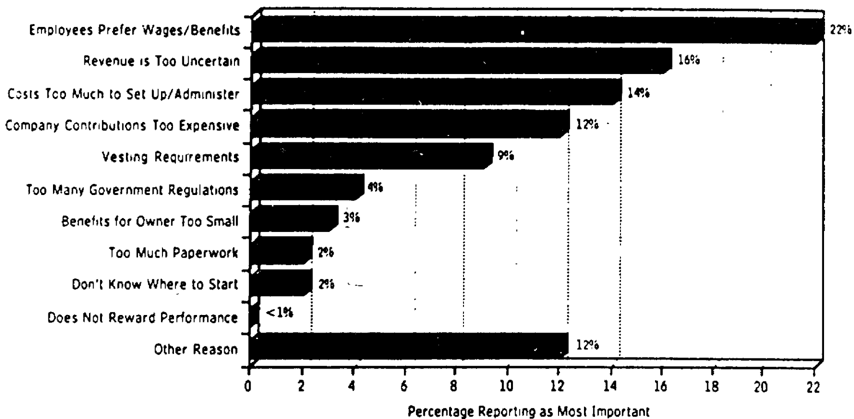
Among workers who were provided information



Source 1998 Retirement Confidence Survey.

Figure 9
MOST IMPORTANT REASON FOR NOT OFFERING A RETIREMENT PLAN

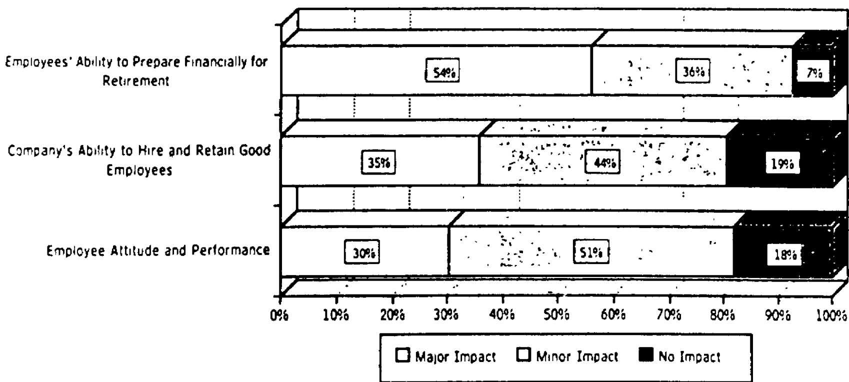
Among small employers without a retirement plan



Source 1998 Small Employer Retirement Survey.

Figure 10
IMPACT OF OFFERING A RETIREMENT PLAN TO EMPLOYEES

Among small employers with a retirement plan



Source 1998 Small Employer Retirement Survey.

COMMUNICATIONS

STATEMENT OF THE AMERICAN ACADEMY OF ACTUARIES

[SUBMITTED BY LARRY ZIMPLEMAN, CHAIR, TASK FORCE ON TRENDS IN RETIREMENT INCOME SECURITY]

The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, regulators and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance.

The American Academy of Actuaries appreciates the opportunity to present a written statement for this important hearing. The Academy is the nonpartisan pubic policy organization for the actuarial profession in the United States, and does not endorse or propose legislation. Instead, we analyze the potential effects of legislation and evaluate its advantages and disadvantages relative to current law.

We will focus our remarks on the following main points:

- Most Americans are not adequately prepared for retirement;
- America's retirement income policies need to be significantly changed;
- These changes need to occur sooner rather than later;
- Reforms need to address the fact that our problems extend beyond the baby boom generation, and;
- Only a comprehensive approach to reform that addresses all the elements of retirement income can be effective.

At the end of our statement, we will outline various options for reform that Congress can consider.

THE RETIREMENT CHALLENGE

The fact that most Americans are inadequately prepared for their retirement has been well documented over the last few years. Policy makers are aware that all three legs of the retirement income stool-Social Security, employer-sponsored pensions, and personal savings are wobbly at best. The overwhelming evidence suggests that our nation's major public programs to support the elderly—Social Security and Medicare—have significant financial problems that will likely require reductions in benefits, and further shift the burden of preparing for an adequate retirement from the government to the individual.

Today, Americans rely heavily on public programs for their retirement income. Nearly two-thirds of retired Americans rely on Social Security for at least half of their retirement income, and 30 percent receive more than 90 percent of their income from Social Security. Such reliance is perilous for the unprecedentedly large cohort of baby boomers who will begin to retire in the next decade. As you know, Social Security's trust funds are projected to be exhausted in 2032. At that point, payroll taxes are projected to be sufficient to pay only 75 percent of benefits. Returning Social Security to long-range actuarial balance without a payroll tax increase would require an across-the-board benefit cut of about 15 percent today for all current and future recipients. Reductions in Social Security benefits may only be the tip of the iceberg. Paying for health care may be a much bigger threat to the security of future retirees. Despite changes to the Medicare program last year that extended its solvency by a few years, Medicare costs continue to increase at an unsustainable rate. The cost of Medicare's Hospital Insurance program is estimated to rise from its current level of 1.69% of the Gross Domestic Product (GDP)

to 3.44% by the end of the 75-year projection period. Unless some way can be found to deliver health care more cost effectively, severe cutbacks in benefits may be necessary. Reductions in Medicare benefits will have a ripple effect. Medicare cutbacks will directly impact employer-sponsored retiree health insurance, and may reduce or eliminate this benefit for the minority who are fortunate enough to have it. Medicare reductions will also increase the cost of private health insurance policies, which are currently purchased by a little more than a third of those over age 65. Because there will be more elderly, long-term care costs will also increase substantially.

Fewer resources from Social Security and Medicare will require Americans to rely more on employer-provided pensions and their own savings to provide for a financially secure retirement. Pension and personal savings provide nearly 40 percent of all income to aged Americans, an amount that rivals that received from Social Security. Yet only one-half of working Americans have a pension plan through their employer, and 30 percent of Americans between the ages of 50 and 62 have saved $10,000 or less for their retirement. This despite the fact that individuals need personal savings of around three to four times their annual salary (in addition to an equal amount from their employer's pension plan) in order to maintain their standard of living in retirement.

The savings rates required each year to achieve these savings levels can be substantial, even if tax-favored savings vehicles, such as employer-sponsored pension plans, are used. The amount a worker would need to save to last through a retirement beginning at age 65 depends upon when the worker begins saving and the rate of return. At current rates of return, if a worker began saving 20 years before retirement, then 13 percent of wages would need to be saved each year to have enough to replace 20 percent of final earnings, indexed for inflation at 3.5 percent a year. If the worker deferred beginning saving until 10 years before retirement, the percentage would increase to 29 percent. In 1997, the "average" baby boomer is age 40 to 45, so the extra amounts needed to be saved must be started now. Unfortunately, there is no evidence that this is taking place. In fact, the U.S. savings rates are at a 59-year low.

Without meaningful employer-sponsored pensions and significant personal savings, the American dream of a comfortable retirement is likely to become more difficult to attain for many Americans. Finally, the baby boom generation will not experience the favorable trends that helped their parents. Real Social Security benefits are unlikely to be increased; Medicare will likely pay a lower share of health care expenses, and employers facing global competition are not expected to boost contributions to pension plans. In addition, demographics could drive down house values and may reduce real rates of return on other assets. The result is that future generations could need to replace at least 20 percent more of their incomes than current retirees have had to replace, or work until a much later retirement age.

ACT NOW

When taken together, the pieces of the retirement income puzzle form a potentially bleak picture for the baby boom generation and those who follow. But solutions exist, and they will be less painful if action is taken now. The public, through its elected officials, must make a choice about how much in taxes future generations of workers will be expected to pay, and how much individuals will be required to save through their own efforts or those of their employers. Individuals, families, businesses, and governments will need considerable time to adjust to changes in public programs and in private pensions and savings, so changes should be phased in. Moreover, without long phase-ins, many reforms would create large differences in benefits between successive generations of retirees. This was the case for the "notch baby" problem caused by the 1977 Social Security amendments.

It is important that Congress enact these changes now, because delay will reduce the options available and make the changes more controversial and disruptive. For example, if Congress acts now to restore Social Security to long-range actuarial balance without a payroll tax increase, it would require an across-the-board benefit cut of about 15 percent for all current and future recipients, however, waiting until 2032 would require a 25 percent reduction.

COMPREHENSIVE APPROACH

In addition to acting sooner rather than later, a comprehensive approach is required. Fixing one program or policy while ignoring the impacts on others could have unintended, and undesirable consequences. Experience has shown that changes intended to reduce costs in one program often result in shifting costs and sometimes increase overall costs. Cutbacks in social insurance programs could shift costs to employers, individuals, and public assistance programs. Raising payroll

taxes in one program may limit the ability to raise them for other programs. Other legislation, such as major tax reform proposals that are designed to increase savings by giving personal savings the same tax treatment as employer-sponsored pensions, could also have unintended consequences. Under these circumstances, most employers will probably terminate their pension plans since they would be unwilling to follow the thousands of pages of laws, regulations and court cases without any tax advantage. The Academy monograph, "Tax Reform and the Impact on Employee Benefits," addresses these and other related issues in more detail.

OUR PROBLEMS GO BEYOND THE BABY BOOM GENERATION

The Academy also encourages Congress to address the fact that the issues facing our retirement income programs extend beyond the demographic issues of the baby boom generation. While the baby boom puts pressure on our retirement income programs over the next 10-50 years, the increasing longevity of the U.S. population is a significant issue that lasts beyond the passing of the baby boom generation and is the root cause of the need to restructure our current retirement income programs. As a result of the baby boom generation, actuaries of the Social Security Administration estimate that the number of beneficiaries will more than double by 2050. Moreover, because longevity has increased, this level of beneficiaries will tend to persist at least until the middle of the 21st century despite the baby bust. Longevity, then, can be expected to permanently change the age distribution of the population, and even after the baby boom is gone, the number of people over age 65 will not drop substantially. Therefore, policies must address issues of longevity such as: Will employees be able to work longer? Will employers want to hire older workers? Will individuals be allowed to phase-in their retirement benefits to encourage gradual retirement?

As was discussed earlier, the retirement stool is in serious need of repair. The stool, however, can be fixed. Although the Academy does not recommend any particular set of solutions, here are a wide array of options that we believe merits Congress's consideration.

REFORMING SOCIAL SECURITY

The first task of reforming Social Security is to determine whether to make fundamental changes in the underlying philosophy of the program or to preserve the system in its current form. In the context of the current debate, fundamental reform means providing all or part of benefits through individual accounts that are prefunded through the use of market-based securities. One of the major advantages of this approach is that workers in the future would receive investment returns on a portion of their Social Security contributions that reflect returns in the private investment market. A major downside of these options is that workers would be exposed to investment risks. Also, it is unclear whether individual accounts are administratively feasible. In addition, these alternatives usually require a significant infusion of general revenue or a higher payroll tax rate to be paid during a long transition period. If privatization through individual accounts is to be an option it must be implemented in the near future. Each year a decision is delayed, the greater the transition costs will be.

Another alternative is to change investment procedures to permit all or part of the current Social Security surplus to be invested in corporate bond and equity markets. If current returns remained high after the added investments, they would help the program in the short run by postponing the date at which the surplus would be exhausted. However, since the date of exhaustion for the surplus would only be postponed, not eliminated, an increase in revenues or reduction in benefits would still be needed to restore the program to long-range financial viability.

It is important for policy makers to understand that merely using private investments does not solve the problem of maintaining the level of benefits for retired, and soon-to-be retired beneficiaries. For most of the baby boom generation, benefits at current levels will still not be affordable at current payroll tax rates. Private investment plans would be aimed at protecting the benefits of generations following the baby boomers.

Furthermore, although Congress might decide that private investment is desirable, it is not required. The system, as currently structured, could be brought into long-range actuarial balance through one or a series of adjustments in taxes, retirement ages, benefit levels, or a combination of these options.

On the tax side, increasing payroll taxes or the amount of wages subject to tax are the only significant options. Increasing payroll taxes can solve as much of the long-term problem as elected officials choose, and can be timed so that the flow of newly generated revenues matches the program's income needs.

On the benefits side, changing the benefit formula can produce almost any desired amount of savings, and changes can be timed to coincide with the program's revenue needs. Also, raising the normal retirement age to 70 for those reaching that age in 2037 and later would solve about half of Social Security's long-range problem. The earliest entitlement age, currently 62, could also be raised. This would save additional income, and would be reasonable if health status continues to improve along with increases in longevity. If Congress decides to raise the retirement age it should also consider whether employers are willing to keep older workers.

Reducing . ‛st-of-living adjustments (COLAs) for Social Security benefits through a reduction in the consumer price index would bring considerable savings. For example, a reduction of one percentage point would eliminate about one-half to two-thirds of the long-range deficit depending on the interaction with other economic variables. Reducing COLAs, however, would have the most significant impact on the very elderly.

REFORMING MEDICARE

As with Social Security, several options exist for changing Medicare. However, in addition to raising revenues or curtailing benefits, the options include improving efficiency by changes in the delivery of health care, and doing a better job of targeting tax dollars to needed services.

Options for raising Medicare revenues are fewer than for Social Security. For Medicare's Supplementary Medical Insurance (SMI) program, which is supported partly from general revenues and partly from beneficiaries' premiums, only the premiums can be raised. The premiums could be increased or, at a minimum, indexed to maintain the current percentage. Raising the SMI premium would, of course, absorb retirement income from other sources and, thus, reduce retirement income security overall. This is one example of how programs to support retirement are so closely interrelated that they should not be considered in isolation from each other.

As for Medicare's Hospital Insurance (HI) program, the average value of benefits could be taxed, since that value really does constitute income. This would raise significant income. Another option would be to raise the HI payroll tax rate. Unlike taxing benefits, this option places the burden on younger workers.

There is a wider range of options for reducing Medicare benefit payments, several of which would not require reducing covered services. The eligibility age could be increased to 67 in the same manner as is already scheduled for Social Security. This would eliminate a small amount of the deficit. Increasing the age to 70 would eliminate a significant portion of the shortfall. However, it could also lead to precipitous declines in employer-provided retiree health insurance. To accommodate those who retired before the higher eligibility age, either out of necessity or choice, Medicare buy-ins could be permitted beginning at a set age.

Beneficiaries could also be asked to pay a greater portion of the cost by increasing their deductibles. However, under current law, that would likely raise the cost of Medigap policies, which would pick up the extra deductibles and co-payments. As a result, this would have little impact on utilization for the more than 80 percent of Medicare eligibles with Medigap coverage.

Congress could also continue to reduce payment rates to providers. These would have to be carefully structured to ensure that providers could not largely avoid the reduction through unbundling of services and other practices that have limited the effectiveness of such changes in the past.

There is also the possibility of cutting back some covered services. This could solve a significant part of the cost problem if services of a long-term-care nature and SMI payments for durable medical equipment were reduced. However, in eliminating covered services, as well as in making other types of changes, it is important to consider the effect on other sources of payment. In the case of long-term-care services, eliminating that portion now covered under Medicare could ultimately constitute little more than a cost shift from one government program to another, in this case from Medicare to Medicaid, which already pays a much larger share of these costs.

Increasing recoveries from other insurance such as employer-sponsored insurance, auto liability insurance, and workers compensation would also help, as would expansion of the circumstances under which Medicare is considered the secondary payer. As in other areas, caution would be required. If employer-sponsored retiree health insurance were made a primary payer, employers could merely eliminate their plan.

An avenue that is already being explored but could be considered further is managed care alternatives. Properly designed, these programs can reduce utilization by eliminating unnecessary care and encouraging efficient service delivery. To be effective, programs need to be competitive and must take advantage of market incentives for minimizing costs while monitoring quality of care. With the 1997 addition of

Medicare Part C, Congress took a major step toward increasing managed care options. Experience over the next three years should add greatly to the information needed to evaluate the probable success of managed care programs in reducing the growth in Medicare costs. Congress will also have to determine whether Medicare Part C will require major modification to operate effectively or only minor refinement through more effective risk adjustment and other mechanisms for controlling adverse selection and encouraging greater private-sector competition. Along with evaluating the 1997 restructuring, Congress should continue its consideration of a voucher-type approach and the use of medical savings account-type plans.

ENCOURAGING EMPLOYER-SPONSORED PENSIONS

With reductions in Social Security and Medicare benefits likely, Congress should place added emphasis on encouraging the expansion of private pension plan coverage. The first and foremost option to encourage the creation of private pension plans is to reduce the complexity of regulations. This means that Congress should consider very carefully the imposition of any new regulation and, when changes are made, granting employers with as much time as possible to adjust. Imposing new requirements, or revising existing ones, should also involve as little disruption of plans as possible, even if this means permitting old practices to continue along with the new ones for extensive periods. Another approach, which might prove fruitful, is to encourage plan sponsors to adopt provisions Congress considers desirable by offering them a reward in the form of some other regulatory relief. For example, in exchange for a plan offering shorter vesting, partial indexing, or enhanced portability, Congress could permit less costly methods of discrimination testing or higher limits.

Another approach that might facilitate better plan funding is to remove some of the "corridor limits" on defined-benefit plan funding. These corridors increase the volatility of defined-benefit plan funding over workers' careers and may result in freezing the benefits in many defined-benefit plans, or their termination altogether, near the end of many baby boomers' careers when plan funding is increased—exactly the time when continued accruals will be most important.

To encourage coverage, Congress could consider permitting greater flexibility within prescribed simplified plans that are now available to employers. For example, since turnover can be high in smaller firms, allowing some flexibility through participation and vesting requirements might give small employers a greater incentive to adopt simplified plans. In addition, Congress could consider changes in the law to accommodate hybrid plans that include features of both defined-benefit and defined-contribution plans. These seem more in harmony with the current preferences of both workers and employers. Creation of a simplified defined-benefit plan for small employers (such as SAFE), which is exempted from most complex rules would also be an option.

The most direct way to encourage employers to adopt pension plans is to mandate them. Congress could consider requiring all employers above a certain size to offer their workers at least a contributory defined contribution plan. Participation in the plan and minimum contributions could be required for workers above some age and income level. This would not only alleviate some of the pressure on Social Security, but might be especially helpful to groups such as women, whose retirement savings are lower than the overall population.

More plans would mean more retirement savings, but to the extent possible Congress should also encourage larger individual contributions to plans. For upper-middle and higher-income workers, this could be done by raising the 401(k) contribution limits to some fixed percentage, say 50 percent, of the defined contribution plan limit. Another option would be making simple plans with higher contribution limits available to smaller employers, as well as raising the limits on the simpler, legislatively prescribed plans that already exist. It would even be possible to permit workers, and employers, to vary their contributions. For example, when workers receive large sums of money from income tax returns they might be permitted to immediately contribute these sums to plans sponsored through their employers. Contribution limits could also be varied by age to accommodate the greater savings required at older ages to reach any given retirement income. Making it easier to contribute to plans may well lead to greater coverage, as workers in smaller firms press their employers to establish simplified contributory plans for them.

Congress should also consider developing rules that would retain for retirement more of the dollars contributed to defined-contribution plans in general, and 401(k)-type plans in particular. The Academy has calculated that if an individual takes money out of his defined contribution plan while he is in his twenties, it could reduce his retirement income by one-third. To encourage workers not to spend their

retirement income prematurely, it is not necessary to raise tax penalties to confiscatory levels or to completely disallow withdrawals. For example, one option is to graduate the tax penalty for withdrawals from defined-contribution plans so that the more a worker withdraws, the higher the penalty. Alternatively, preretirement distributions could be limited to a specific dollar maximum, or to a maximum percentage of the account balance. These changes might also be combined with fewer restrictions on the amounts workers can contribute to their plans.

The American Academy of Actuaries Pension Committee has compiled a list of more than 100 options for reducing complexity in the Tax Code and encouraging coverage, and would be happy to discuss them with you further.

INCREASING OPPORTUNITIES FOR PERSONAL SAVINGS

When addressing Americans' personal savings, Congress should explore options that reflect the fact that Americans tend to save only if there are convenient vehicles that are widely marketed and subsidized. Increased IRA opportunities are the most obvious. Already, banks and other financial institutions are aggressively marketing the recently enacted Roth IRAs. However, the changes made as part of the Taxpayer Relief Act of 1997 are probably not nearly bold enough to add perceptibly to personal savings. There is no increase in the $2,000 limit on contributions, and pretax contributions remain strictly limited. It is clear from experience that IRAs are not likely to be used widely enough to increase savings unless they have higher contribution limits and can be used by all workers, regardless of other pension coverage. To be most effective, the rules must be simple and apply generally. To encourage greater savings among lower-middle-income workers, tax credits might be considered in lieu of pretax contributions. Also, greater restrictions could be placed on withdrawals for mortgages, college, unemployment, and major medical expenses.

A significant asset of many retirees is their owner-occupied homes. Targeted programs to assist groups that might otherwise not be able to own a home could be considered as an element in any comprehensive strategy for increasing retirement savings. Initiatives in this area could increase savings and assist these diverse groups by adding to their retirement assets. Congress may want to consider increasing tax incentives to financial institutions and to organizations that help nontraditional homeowners purchase homes. Policy initiatives that contribute to making housing equity accessible to retirees are also well worth exploring.

Finally, broader changes to the tax code that discourage current consumption could be considered, but as stated earlier, it would be counter productive if the proposal removes the tax incentive for employers to offer employee benefit plans.

INCREASING FINANCIAL LITERACY

Tax policy, the traditional tool for influencing private savings, may not by itself be sufficient to address current low savings rates. To be fully effective, tax policy may need to be coupled with educational campaigns on how savings translate into retirement income. Tragically, even though many Americans expect less from public programs in the future, far fewer understand the level of assets needed to support a given retirement income, how much must be saved to achieve that level, and how to factor investment return and time into asset accumulation. The education gap exists not only with the employee, but the employer as well. Many employers are unaware of the plan options that exist and the potential benefits to providing them. Congress's recent enactment of the Savings Are Vital to Everyone's Retirement (SAVER) Act is a welcome development, but much more may be needed to improve the financial literacy of American families and their employers.

IMPROVING THE POLICY-MAKING ENVIRONMENT

Finally, the Academy suggests three important changes that Congress could implement that would enhance policy making in the area of retirement income policy.

First, policy makers should consider requiring better and more complete information for their own deliberations. Elected officials would benefit significantly if the government developed a coordinated research and modeling effort to study and track retirement income trends, as well as to project future ones. For example, there is nothing comparable to the Social Security and Medicare trustees' reports for either private or public pensions. Should Congress request such a report today, important elements of the necessary data would be lacking.

Second, Congress should consider adopting a consistent basis for evaluating proposals related to retirement income. For Social Security, all proposals should be subject to tests of basic actuarial viability. These could include determining whether the 75-year actuarial balance is restored, whether the trust funds are positive at all points in time, and whether the funds remain stable over the last several years of

the projection. In addition, to help the public and policy makers understand individual impacts, there should be standardized illustrations of replacement rate and "money's worth" analysis at different income levels and perhaps by type of family unit (single individual, married couple, etc.). Consistent analyses of this type could add clarity to the debate and contribute to everyone's understanding.

Congress should also consider adopting guidelines for evaluating regulatory changes. The American Academy of Actuaries has developed a set of guidelines for Congress to consider in evaluating changes to ERISA and related tax provisions. The guidelines, which are simple in nature, vary from whether a change would encourage growth in both defined benefit and defined contribution plans, to whether it is based on sound actuarial principles.

Third, Congress and the executive branch should reexamine how tax expenditures are calculated as they apply to pensions. Under current budget rules, the Congressional Budget Office calculates probable changes in revenue that would result from any changes in rules governing public or private programs. However, the revenue changes are calculated over a budget cycle of five to, at most, ten years. Changes further into the future are not considered. Calculating revenue gains and losses over such a short time frame for pensions—which take decades to fund and from which income will be received for a decade or more—makes little fiscal sense. At best, the current system of calculating so-called tax expenditures is incompatible with a private pension system. At worst, Congress may unintentionally reduce support for private retirement plans in the future and pass on greater tax burdens to future workers.

The Academy has recently released a comprehensive report, "Financing the Retirement of Future Generations," which goes into much greater detail than our testimony. The Academy hopes this report will help move the national dialogue about retirement income security forward. We applaud the committee for addressing this vitally important issue, and are pleased to offer our assistance.

STATEMENT OF THE SOCIETY FOR HUMAN RESOURCE MANAGEMENT, ALEXANDRIA, VA

Chairman Roth, Members of the Senate Finance Committee, thank you for holding a hearing on retirement security and for the opportunity to express the views of the Society for Human Resource Management. The Society for Human Resource Management (SHRM) is the leading voice of the human resource profession. SHRM, which celebrates its 50th anniversary in 1998, provides education and information services, conferences and seminars, government and media representation, online services and publications to more than 100,000 professional and student members through out the world. The Society, the world's largest human resource management association, is a founding member of the North American Human Resource Management Association and a founding member and Secretariat of the World Federation of Personnel Management Associations (WFPMA).

The ability of current and future retirees in the United States to financially sustain themselves can either be facilitated or eroded by legislative initiatives, influenced by the short and long-term need for tax revenue. Individuals rely on three main sources to finance their retirement: (1) Income from private sources (e.g. employer-sponsored retirement and health care plans); (2) Their own personal savings; and (3) Social Security and Medicare. A critical foundation of retirement is the affordability and access to adequate health care. Economic, demographic, social, accounting and regulatory trends, as well as the demand for current income indicate that in the long-term an increasingly large proportion of retirees may not have sufficient income and medical coverage from each of the three sources when they retire.

To provide a sound foundation for retirement planning, and minimize the number of retirees on welfare, a national retirement policy is essential to guide the various governmental entities, businesses and individuals in their fiscal and health care planning. Such a policy should recognize significant trends and enable policy makers to institute and/or revise income, taxation and retiree health care funding systems to effectively meet longer-term challenges.

BACKGROUND

Today most individuals are able to retire comfortably. From 1971 to 1991, the elderly poverty rate fell from 22 percent to 12 percent. On average, workers retire earlier and live longer than in the past. However, a number of trends in the economy and workplace suggest that it may be more difficult for American workers to retire with a reasonable standard of living in the future. These trends are highlighted below.

Aging Population Increases the Need for Adequate Retirement Income and Health Care Coverage:

As the U.S. population ages rapidly and the elderly live longer, an increasing proportion of the population will depend on retirement income and retiree health care. Without reenforcing the traditional retirement support systems, the declining ratio of workers to retirees will place a huge burden on Social Security, Medicare and Medicaid. In 1990, 13% of the population was aged 65 or older, compared to 10% in 1970. The Department of Labor projects that by 2050, 22% of the population will be aged 65 or older.

Mobility Causes Inadequate Retirement Income:

Employees are likely to change jobs several times over their careers. Those frequently changing jobs, not always voluntarily, may be less likely to have adequate retirement income and employer sponsored retiree health care upon retiring since many traditional retirement programs (income and health care) provide benefits based on length of service, and vested benefits for shorter service terminations are frequently paid out in cash and not saved for retirement.

Firms Without Retirement Income and Retiree Health Care Plans:

The self-employed and employees of small firms, which create most new jobs, are less likely to have employer-provided retirement programs than employees in larger firms. According to the Employee Benefit Research Institute, in 1991, 19% of workers in firms with fewer than 25 workers were covered by an employer-sponsored retirement plan, compared to 78% of employees in companies with 1,000 or more employees. Similarly, 18% of smaller employers provide employer sponsored retiree medical coverage, while 44% of large employers provide medical coverage to retirees.

Conservative Defined Contribution Plan Investments Reduce Retirement Income:

According to the Pension and Welfare Benefits Administration (DOL), from 1975 to 1990 most of the growth in employer-sponsored plans can be attributed to an increase in the number of defined contribution plans from 207,700 to 599,200. The shift to defined contribution plans may affect retirement savings as a result of participant's conservative investment choices, which may lead to lower than expected retirement standards of living. Several studies have found that participants in defined contribution plans, which generally allow participants more discretion in investment allocation, often choose low-risk, low-return investments.

Erosion of Pre-Retirement Fund Distributions:

Based on Employee Benefit Research Institute (EBRI) data, most employees choose not to roll over their lump sum distributions, particularly small distributions, into another retirement account when they leave a job. According to EBRI's study, only 22% of lump sum distributions are rolled over into other qualified plans, while most are used to fund current consumption or other expenses. Withholding regulations implemented in 1993 may be reducing this practice somewhat, leading to more funds being rolled over into other qualified plans.

Complex Regulations Deter Employer-Sponsored Plans

The complexity of existing retirement plan regulations and the substantial administrative cost of complying with them discourage employers from establishing and maintaining retirement plans. A 1991 survey conducted by the American Academy of Actuaries found that among those actuaries whose had been involved in a plan termination in the previous year, the largest single reason (30%) cited was government regulations (including complex rules, the increasing cost of compliance, and frequent changes in the retirement plan law) as the key reason employers terminate their defined benefit retirement plans.

Accounting Standards Changes and Medical Inflation Deter Employer Sponsored Retiree Health Care:

The advent of requiring corporations to establish financial statement liabilities for retiree medical programs caused businesses to focus on this major expense. As a result, many businesses have reduced or eliminated their postretirement medical coverage. At the end of 1994, according to a recent EBRI study, fewer than 34% of retired employees are covered by employer sponsored medical plans.

Retirement Plans Are Not Significantly Under Funded:

According to a recent report by the Pension Benefit Guaranty Corporation (PBGC), which insures most private sector defined benefit plans, pension underfunding fell to $31 billion in 1994 from $71 billion in 1993, and most pension plans today are adequately funded. This represents only 1% of the $3.2 trillion held in

trust to pay current and future benefits, and in spite of cutbacks in the limits on contributions that were repeatedly enacted since 1982. Much of the underfunding may partly be due to the highly conservative assumptions used by the PBGC. Further, the Retirement Protection Act, which Congress passed in 1993, may help prevent future pension plan failures by increasing the incentives for funding underfunded plans.

Social Security and Medicare Are Not Sufficiently Funded:

The Social Security and Medicare trust funds have been viewed as sources of government program funding, causing them to be unreliable sources of retirement support. Since the Social Security system is currently generating more revenue than it pays in benefits, the government borrows the surplus revenue to fund other government programs. On the other hand, Medicare benefits already exceed the taxation revenue, causing the trust to decrease each year. However, as the population continues to age, more workers will rely on Social Security and Medicare benefits and proportionately fewer workers will be funding the benefit. The Board of Trustees for the Social Security Trust Fund advised in their 1995 Report that the Federal Old Age and Survivors Insurance (OASDI) Trust Fund will be able to pay benefits for about 36 years. Of more urgency is the funding of the Medicare Trust, which its trustees report will be depleted within 7 years.

A Source of Government Revenue:

Policymakers look to retirement funds for potential revenue, to reduce the national deficit. The Treasury Department estimated the government would have gained $64.9 billion in FY 1995 revenue if employers (including federal, state, local and private) were taxed on the value of contributions to retirement plan funds. According to EBRI, this tax revenue loss is overstated. More than half of this is attributable to public sector retirement plans. In addition, tax expenditure discussions focus on current revenue impact rather than the future value of taxes when retirement income would be paid out in future years.

Lower Income Individuals Depend Heavily on Social Security and Employer-Sponsored Plans:

Fifty one percent of all persons employed by private businesses with pension plans earned less than $25,000 and 89% earned less than $50,000. According to EBRI, because most workers earn under $50,000, retirement programs primarily benefit workers with income below this level. Individuals with fewer than 50,000 will depend most heavily in their retirement years on Social Security qualified retirement plans and Medicare, as they are least likely to have personal savings or private medical insurance.

Impact of the Growth in the Service Sector and the Contingent Workforce:

Traditionally, employer-sponsored retirement income and retiree medical plans have been more prevalent in the manufacturing than the service sector, where the proportion of employment has continued to increase. Economic and demographic shifts have also contributed to a rise in the number of seasonal, part time, and contingent workers. These individuals may comprise as much as one-third of the workforce and are less likely to participate in employer-sponsored retirement income and retiree medical plans. The above trends and current regulatory burdens have created the need to reexamine the employer, individual and federally funded retirement systems and implement a uniform and consistent national retirement policy. Below is a framework of principles and specific recommendations to guide the formulation of such a national policy.

GENERAL PRINCIPLES

SHRM believes that government shares responsibility with American workers to achieve adequate retirement income and have access to adequate medical care. Moreover, to enable employers to help support retired employees; public policy should encourage the voluntary establishment of retirement programs. To facilitate sound retirement planning, we have established the following three fundamental principles: 1. Primary Individual Responsibility for Retirement Financing: Individuals should have primary responsibility to provide for their own adequate retirement income and health maintenance funding. Individuals should be responsible for planning and building their own retirement resources, including anticipating their retirement expenses and the sources of funding to meet their needs. To this end, the government should encourage or otherwise facilitate retirement (financial) needs planning of the American worker and families, including voluntary employer education programs. Importantly, the government should encourage individuals to pro-

vide for their own retirement income and health maintenance, by making available tax-favored savings vehicles.

2. Government Responsibility for Retirement Income and Medical Coverage: Through its mandated Social Security and Medicare programs, as public policy the government shares with the American worker the responsibility for providing some reliable basic retirement income and health care for all individuals. Through taxation of, and an implied promise to, all American workers, these programs have become fundamental components of our country's retirement system. The government should also facilitate the continuation and growth of employer sponsored programs and provides consistent tax incentives and simplified regulations to encourage employers to provide retirement benefits that otherwise would be sought from the government at greater cost to society. In addition, to enable American workers to have an adequate and secure retirement, it is incumbent on the government to maintain a fiscal policy that ensures low inflation over the long term.

3. Employer's Role in Providing Retirement Benefits: Employers may find themselves voluntarily able to help workers achieve adequate retirement incomes and maintain their health during retirement, reducing pressure on government funding for retirees. Employers play key roles in providing retirement income and medical coverage through payments into the Social Security and Medicare systems and voluntarily to employer sponsored retirement income and medical plans. Upon these principles, we propose the following framework for a national retirement policy:

Specific Framework Recommendations:

Individual Responsibility for Retirement Financing

1. Regulation by Individual: To avoid retirement income inequities caused by multiple retirement plans, variability in generosity or finances of employers, dual family incomes, and complex retirement plan regulations, contributions set aside for retirement income and retiree health care should be regulated, if at all, only on an individual basis in aggregate rather than on an employer, family or retirement plan basis. Any necessary regulations should be understandable to the general public, and consistent with the long-term objective of individual financial stability.

2. Limitation on Retirement Plan Contributions: To obviate the need for nonqualified retirement plans, overly complex regulations, and excessive plan administration costs, all arbitrarily established limits on the dollar amounts which may be deferred for retirement income should be eliminated. If there are concerns that a few senior employees would inordinately benefit from tax qualified plans; limits should only be applied to a tightly defined group of policy making executives. In that all distributions would be taxed when received, this change would not affect the amount of taxes paid, but only the timing of tax revenues.

3. Regulations and Access to Retirement Plan Funds: The same regulations on administration and investment of, and restrictions on access to, funds set aside for retirement should apply equally to individual retirement plans and employer sponsored plans. Access to any plan funds for retirement income or medical expenses prior to retirement should be limited to significant life events, including purchase of a primary residence, funding of the taxpayer's higher education, demonstrable severe hardship, and other similar reasons acceptable to the plans administrators. All funds distributed prior to retirement should require a scheduled payback into the retirement plans within a reasonable time frame.

4. Facilitating Retiree Mobility: Recent federal legislation was enacted which prevents states from taxing retirement benefits based on the location earned rather than where received. To perpetuate this legislation ERISA preemption also should be applied to state tax laws to base taxation of retirement income on receipt rather than where income liability was incurred. This will more fairly align state tax revenues with the services required by retirees, will be more equitable between states, and will reduce the administrative cost of retirement plans.

5. Qualified Individual Retirement Plans: Due to increased employee mobility, the number of employees working for multiple employers and/or working for employers which don't sponsor retirement plans, and the need to facilitate employee retirement savings for years when an employee will not earn a vested retirement benefit, regulations and tax laws should be revised to:

a. Streamline the establishment of individual savings accounts for both retirement income and medical expenses during retirement.

b. Encourage self-employed individuals and small to medium size employers to provide retirement income savings and retiree medical plans,

c. Encourage personal saving for retirement, and

d. Permit retroactive contributions to individual retirement plans to makeup contributions subsequently permitted by regulatory change or plan operation (e.g. loss of vesting).

SHRM Board Approved Position, March 1991: SHRM supports efforts to permit retroactive contributions to IRA's for years for which a participant loses retirement plan vesting (e.g., short-term employment). To provide equity with married employees who each earn retirement benefits from separate employers, IRA contribution eligibility should not be precluded by a spouses qualified retirement plan coverage.

Federal Government Provided Basic Retirement Income and Medical Care

1. **Mandatory Coverage.** Coverage for every employee in a federal government retirement program (such as the current Social Security and Medicare programs) should be mandatory. Current parallel plans (e.g. Federal & State Government, & Railroad Retirement and religious body plans) should be consolidated with Social Security into one successor program to produce a single consistent approach toward a floor of retirement income.

2. **Maintenance of Benefit Levels:** It is important to avoid further erosion of currently accrued (hence earned) Social Security and Medicare benefits. This is essential to ensure workers at every level receive the total retirement income and medical protection on which they have based their financial planning, believing Social Security and Medicare benefits were promised by the government throughout their careers. Maintaining these benefits will also facilitate the affordability of employer-sponsored retirement plans, many of which assume retirees also receive federally sponsored retirement income benefits.

3. **Funding.** In order that current workers and work force entrants will be assured of some minimal retirement income and retiree health care, the Social Security and Medicare trust funds, and/or their successors, must be maintained on a financially sound basis, in line with the funding required of individual and employer sponsored plans. However, this should be 10 accomplished without shifting the funding burden substantially to employers through increased taxes.

EmployerSponsored Retirement Programs

1. **Individual Retirement Savings Accounts:** To encourage small employers to provide retirement programs, and to facilitate transfers of retirement funds between employers of all sizes when employees change employers, regulations should be simplified to permit and/or facilitate employers to place current retirement income and retiree health care contributions into an employees qualified individual retirement plan (savings) rather than necessarily establishing separate participant accounts within those employers plans, regardless of employer size.

2. **Funding Restrictions:** Reform of accounting rules (i.e. FASB) and retirement plan insurance (i.e. PBGC) should encourage faster funding of unfunded obligations and underfunded plans for retirement income and retiree health protection. For example, increasing maximum annual contributions, and using realistic or actual interest and pay assumptions would expedite funding. Public and nonprofit organizations should have identical access to plan alternatives and be subject to the same regulations as other employers. Government policy and regulations affecting retirement plans should be consistent and hence coordinated throughout all government agencies.

3. **Investment Education:** For retirement plans in which the employee bears the risk of investment return, employers should provide employees cost-effective diversified alternatives to direct the investment of those funds. In such plans, employers and plan administrators should be protected from unnecessary fiduciary liability to facilitate educating employees on the financial impact the investment choices they make could have on their retirement income. Either voluntarily or involuntarily, employers should be permitted to transfer (to other qualified plans or accounts) vested benefits following termination of employment. Similarly, employers should be permitted to distribute (to other qualified plans or accounts) all vested proceeds for any preretirement termination, regardless of the amount involved. Receiving plans should be indemnified against any disqualified funds so received. Regulations should continue to permit service based vesting schedules, permitting employers to optimize contributions for the benefit of employees who remain employed for more than a few years.

SHRM Board Approved Position, March 1991: SHRM recognizes that the lack of a comprehensive retirement plan portability policy could adversely affect the future retirement security of this nations workers and therefore supports efforts aimed at enabling participants to easily transfer funds between pension plans and retirement vehicles such as IRAs. However, portability and preservation solutions should not interfere with the voluntary nature of the current retirement plan benefit system by imposing burdensome and unnecessary obligations upon plan sponsors.