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Statement

Before the

Senate Finance Committee

Hearing on
"New Directions in Retirement Security Policy: Social Security, Pensions, Personal Savings, and Work"

by

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STATEMENT OF PAUL J. YAKOBOSKI
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SUMMARY

- The good news in the 1998 Retirement Confidence Survey (RCS) is that working Americans have become more focused on their retirement. Forty-five percent have tried to determine how much they need to save by retirement, up from 32 percent in 1996. The increase is particularly striking among baby boomers.
- 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.
- 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.
- Sixty-three 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. What motivates individuals to begin saving for retirement? The top two motivators are negative in nature—having observed someone not prepare and then struggle in retirement and the realization that time was running out to prepare for retirement.
- The 1998 RCS reveals that most working Americans could do more in terms of saving for retirement. Fifty-five percent of those not saving for retirement say it is reasonably possible for them to save $20 per week for this purpose. 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.
- The findings demonstrate the continuing need for broad-based educational efforts designed to make retirement savings a priority for individuals. The good news in the 1998 RCS is the evidence that education can have a real impact at the individual level.
- 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. The same cannot be said of workers at small enterprises.
- Why don't more small employers sponsor retirement plans? Small employers identified three main reasons for not offering a plan. 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. The second main reason cited by small employers for not offering a plan is administrative costs. The third main reason is uncertain revenue, making it difficult to commit to a plan.
- 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. However, they 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.
- 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. 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. 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 whether workers are taking full advantage of the opportunities afforded them. In many instances, unfortunately, the answer is "no."
- 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.

- 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 normal retirement age 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. 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 about how participants in employment-based plans will alter their behavior and how these adjustments will affect their retirement security.
- Modeling results from the 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. 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.

STATEMENT OF PAUL J. YAKOBOSKI
SENIOR RESEARCH ASSOCIATE
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BEFORE THE SENATE FINANCE COMMITTEE
JUNE 18, 1998

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 25–99 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 contribute 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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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 Note s (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

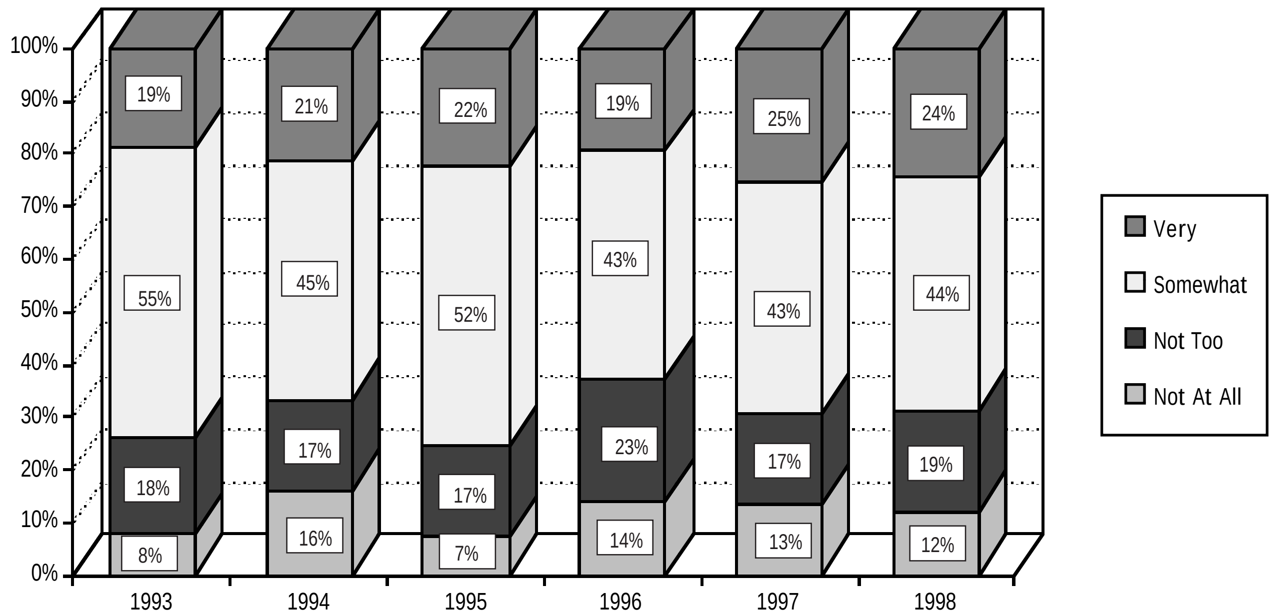
Civilian Nonagricultural Wage and Salary Workers, Ages 16 and Over, with Any Retirment Plan Coverage, 1993

	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

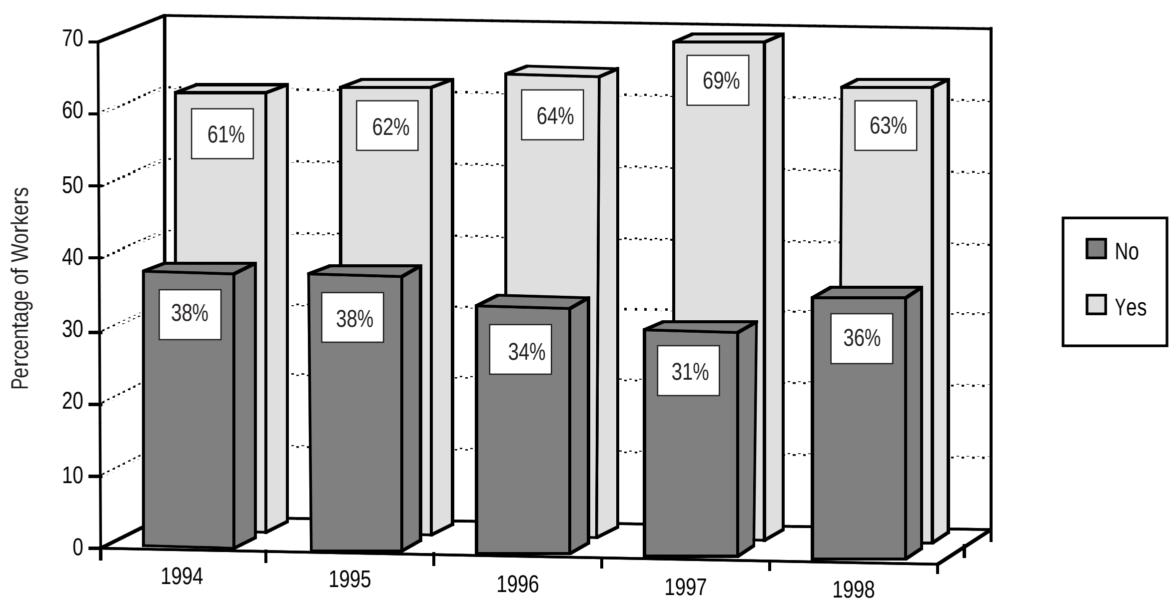


Source: 1998 Retirement Confidence Survey.

Figure 2

Workers Personally Saving for Retirement

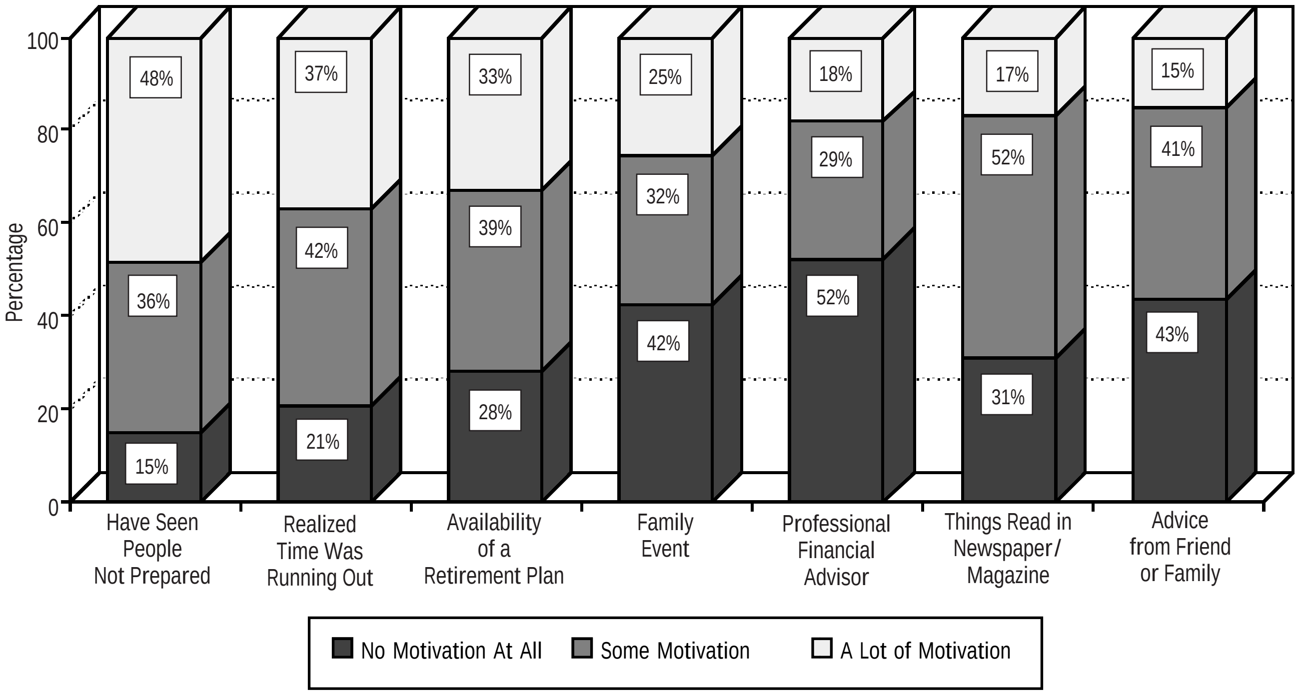
Have you personally saved any money for retirement, not including Social Security taxes or employer-provided money?



Source: 1998 Retirement Confidence Survey.

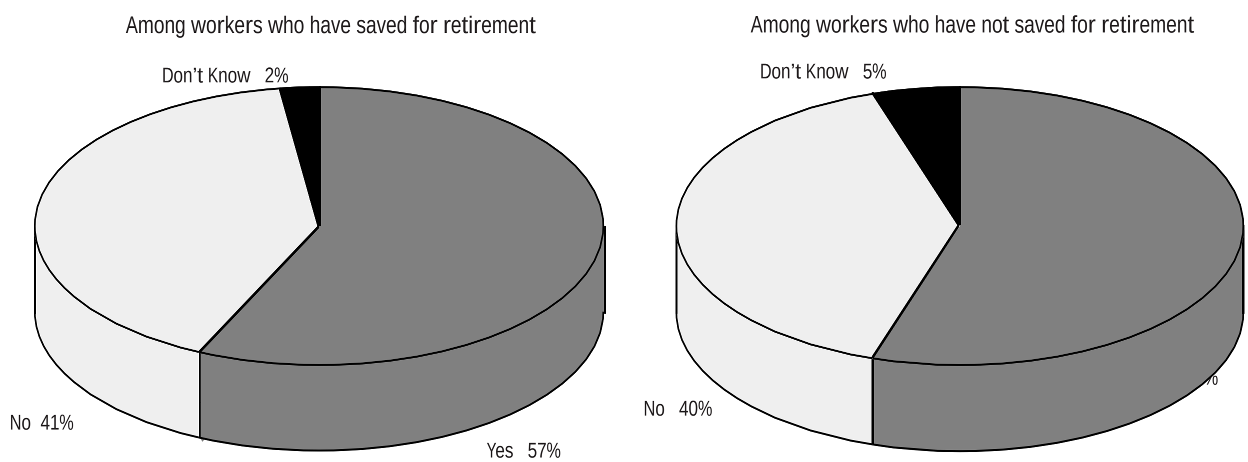
Figure 3
Motivational Factors in Saving for Retirement—Workers

Among workers who have saved for retirement



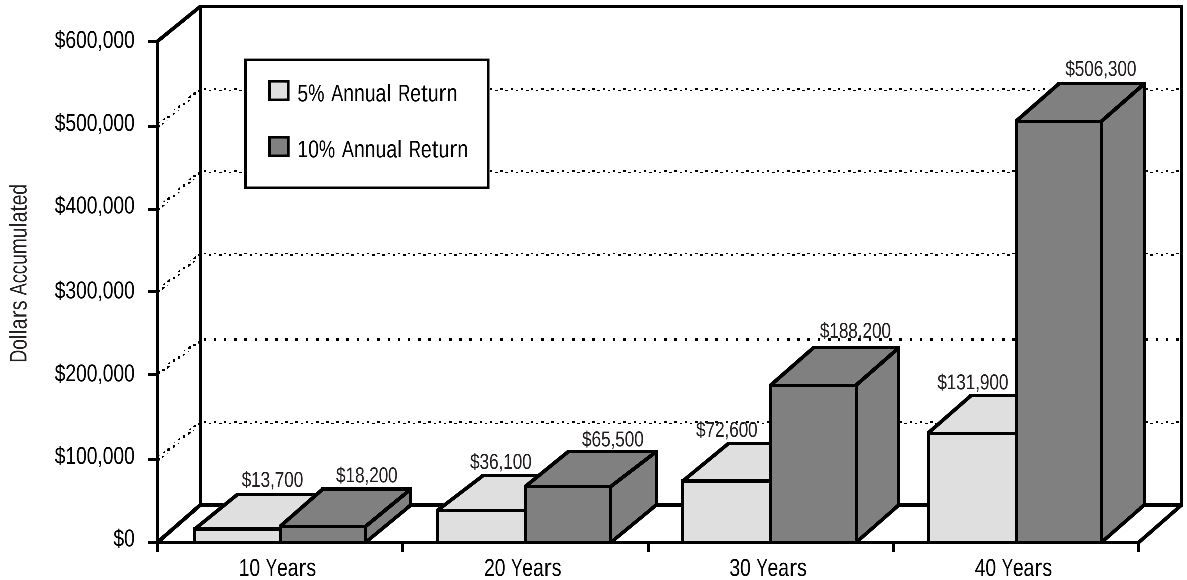
Source: 1998 Retirement Confidence Survey.

Figure 4
Could You Save $20 Per Week More for Retirement?



Source: 1998 Retirement Confidence Survey.

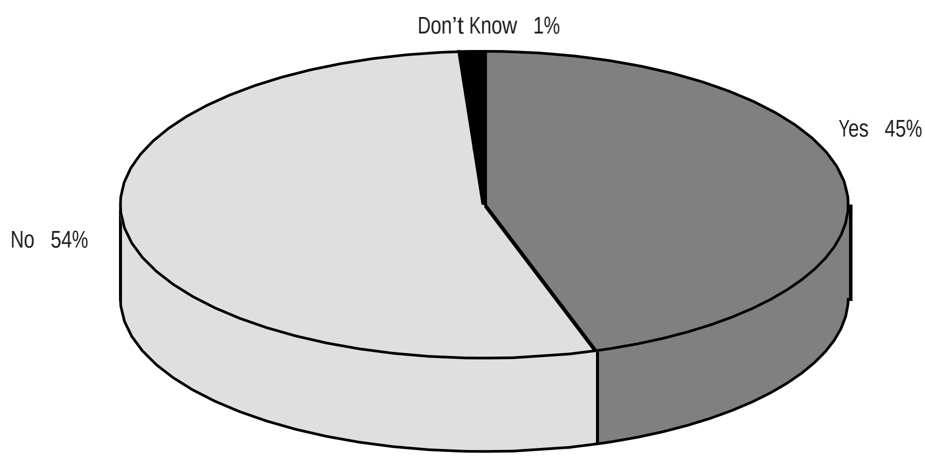
Figure 5
Impact of Saving Another $20 per Week



Source: Employee Benefit Research Institute calculations.

Figure 6
Retirement Needs Calculation—Workers

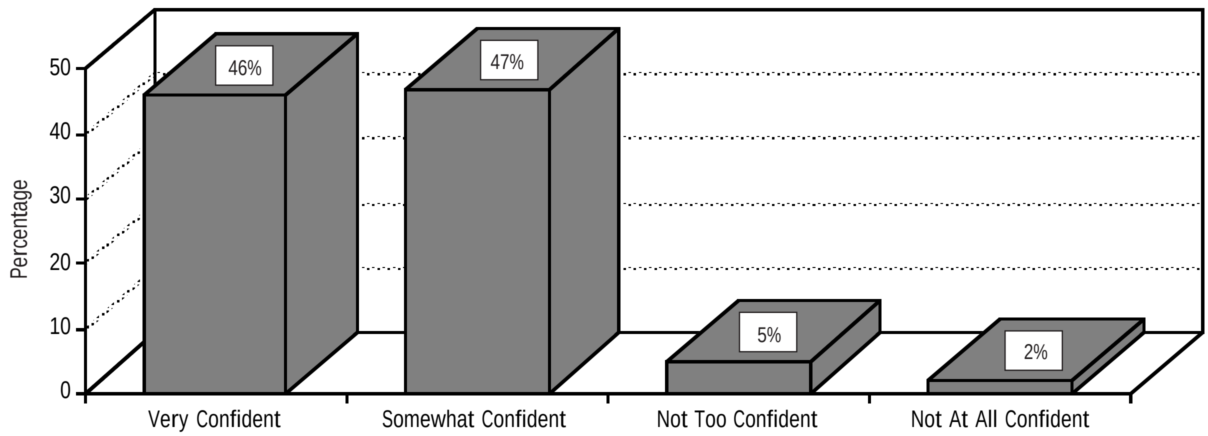
Have you tried to figure out how much money you will need to have saved by the time you retire so that you can live comfortably in retirement?



Source: 1998 Retirement Confidence Survey.

Figure 7
Workers' Confidence in Investing Retirement Savings Wisely

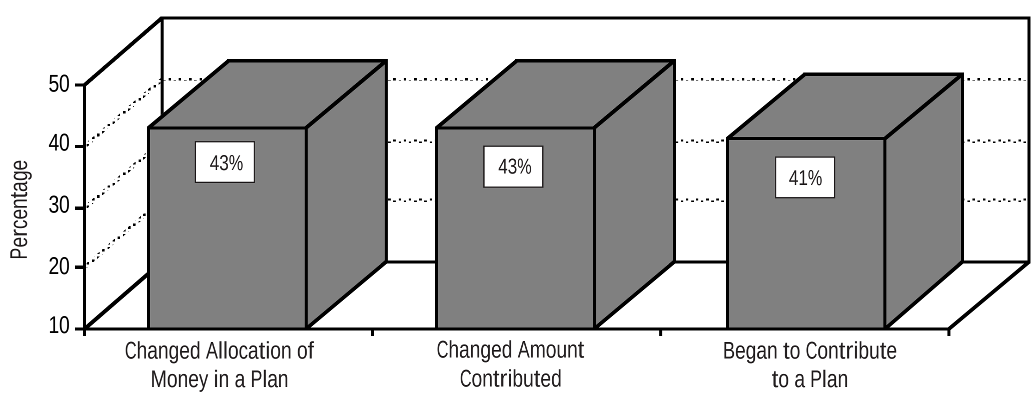
Among those who have saved for retirement



Source: 1998 Retirement Confidence Survey.

Figure 8
Actions Resulting from Employer-Provided Information on Retirement Saving and Planning

Among workers who were provided information

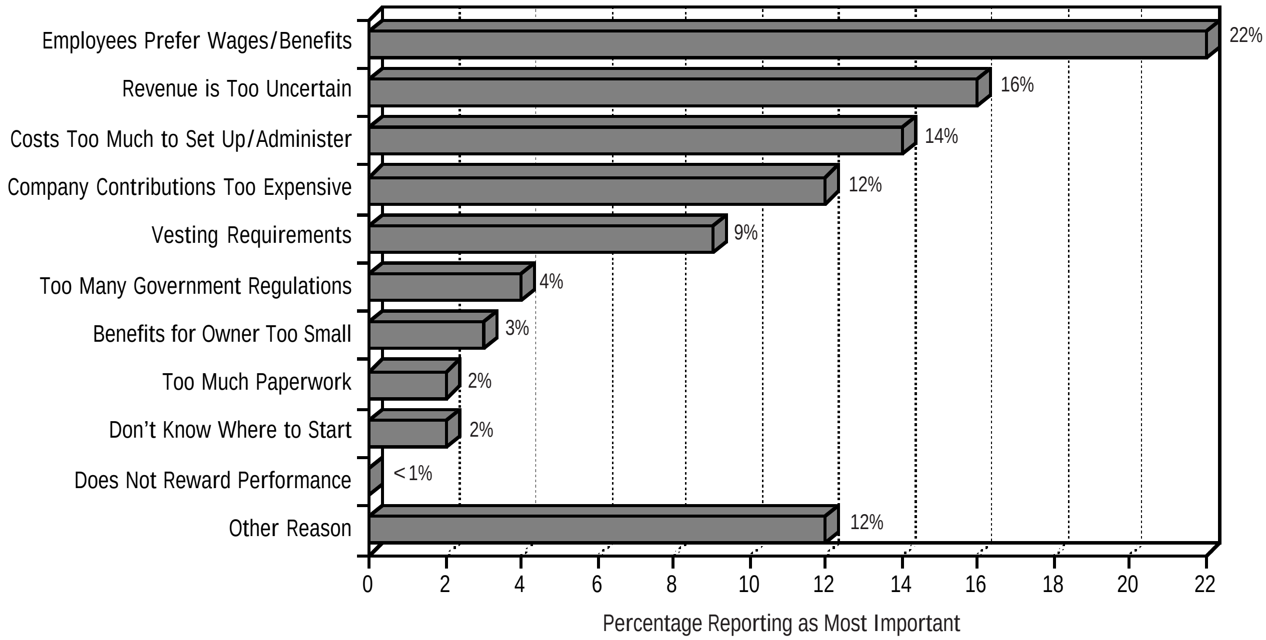


Source: 1998 Retirement Confidence Survey.

Figure 9

Most Important Reason for NOT Offering a Retirement Plan

Among small employers without a retirement plan

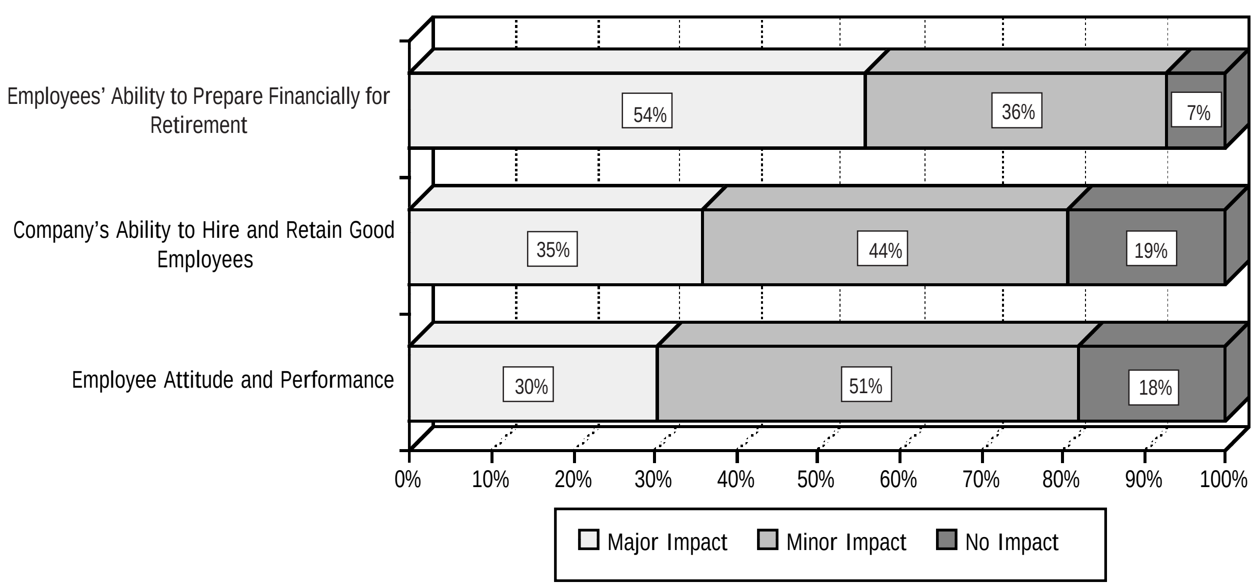


Source: 1998 Small Employer Retirement Survey.

Figure 10

Impact of Offering a Retirement Plan to Employees

Among small employers with a retirement plan



Source: 1998 Small Employer Retirement Survey.