Statement
Before the Committee on the Budget
U.S. House of Representatives
Hearing on
The Economic and Social Health of the Elderly in America
by
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STATEMENT OF DALLAS SALISBURY
EMPLOYEE BENEFIT RESEARCH INSTITUTE

SUMMARY

◆ Employment-based pensions paid benefits of $219 billion in 1988, compared with $1.4 billion in 1950. During this period, Social Security retirement benefits payments grew from $652 million to $148 billion. In 1990, employment-based plans held more than $2.9 trillion in assets that will flow as benefits in the decades ahead. By 1988, 14 percent of married couples and unmarried persons aged 65 and over had income from government employee pensions (compared with 9 percent in 1976), and 29 percent had income from private pensions or annuities (compared with 20 percent in 1976).

◆ Employer-sponsored pension plans represent an important source of retirement savings for most working Americans. According to Employee Benefit Research Institute (EBRI) tabulations of the May 1988 Current Population Survey employee benefit supplement, in May 1988, 62 million civilian workers, or 54 percent of all such workers, worked for an employer that sponsored a pension plan. Three-fourths of all workers covered by an employer plan, or 47 million workers, actually participated in the plan; two-thirds of these participants, or 32 million workers, were entitled to a benefit at retirement. Data on the income replacement level provided by private pensions are not generally available. Typically, private plans are targeted to replace 60 percent of earnings for high earners and 80 percent for low earners after 30 years of service, in combination with Social Security. Coverage in other nations can be compared with that in the United States. Germany replaces 42 percent of earnings, Great Britain 29 percent, Canada 28 percent, and Japan 38 percent.

◆ The gap in private-sector pension coverage for workers is largely among small employers. Among those working in firms with fewer than 100 employees, 27 percent have an employer-sponsored pension, compared with 79 percent of those working for firms with 100 or more employees and more than 90 percent of employees in firms with 5,000 or more employees. These patterns have been observed for some time and can be expected to continue.

◆ Pension availability varies significantly by state, with the highest coverage in Virginia at 69 percent and the lowest in Florida at 46 percent. Among the most populous states, California is at 57 percent, Texas is at 53 percent, and New York is at 64 percent. Choice of trade or profession leads to wide variations as well. Aircraft manufacturing is at 92 percent, compared with eating and drinking retail establishments at 18 percent. These patterns have existed for some time and can be expected to continue.

◆ There has been an increasing trend toward the establishment of defined contribution plans, especially with the advent of 401(k) cash or deferred arrangements and employee stock ownership plans. By 1987, defined contribution plans represented 73 percent of all plans, up from 68 percent in 1975. By comparison, defined benefit plans represented 28 percent of all plans in 1987, down from 32 percent in 1975.

◆ Pension portability should be considered along with preservation if accrued retirement benefits are to be translated into retirement income following a preretirement job change. Today, nearly all defined contribution plans provide for lump-sum distributions of vested retirement benefits when workers leave jobs. More than 40 percent of private defined benefit plans provide for lump-sum distributions, and the number is growing each year. However, individuals do not generally rollover distributions (13 percent did in 1988). Legal changes (such as mandatory five-year vesting), which have increased the number of lump sums, have served to discourage pension sponsorship. Small businesses prefer to pay longer-service workers extra cash rather than watch pension dollars walk out the door with short-service workers.

◆ Pension simplification and preservation proposals recently set forth by the Bush administration, and those introduced in the House and the Senate, could have some effect on pension coverage and participation.
STATEMENT OF DALLAS SALISBURY
PRESIDENT
EMPLOYEE BENEFIT RESEARCH INSTITUTE
BEFORE THE COMMITTEE ON THE BUDGET
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I am pleased to appear before you this morning to review the economic security of the elderly, the various federal programs and policies that impact the elderly, and the degree to which income security is affected by private pensions. I will focus explicitly on the role that private pension systems play in providing retirement security. My name is Dallas Salisbury. I am president of the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, DC.

EBRI has long been committed to the accurate statistical analysis of public policy benefits issues. Through our research, we strive to contribute to the formulation of effective and responsible health, welfare, and retirement policies. Consistent with our charter, we do not lobby or advocate specific policy solutions.

Private Pensions and Retirement Security

Today's Retirees Have Significant Pension Income

Employment-based pensions paid benefits in 1988 of $219 billion, compared with $1.4 billion in 1950. Social Security retirement benefits payments grew during this period from $652 million to $148 billion. At the end of 1990, employment-based plans held more than $2.9 trillion in assets that will flow as benefits in the decades ahead.

The average retiree aged 65 and over today has greater economic security than members of any previous generation. Median elderly family income was $12,173 in 1988, compared with $5,630 in 1978. Other sources of income have also grown in dollars and frequency of recipiency. By 1988, 14 percent of married couples and unmarried persons aged 65 and over had income from government employee pensions (compared with 9 percent in 1976) and 29 percent had income from private pensions or annuities (compared with 20 percent in 1976). The proportion of aged families with income from personal assets rose from 56 percent to 68 percent, with the likelihood that lump-sum distributions from pension plans produced some of this asset income growth.

Pensions are a valuable supplement to Social Security and are clearly income related. Four percent of those reporting total cash retirement income of less than $5,000 reported pension or annuity income, compared with 44 percent of those with income of $20,000 or more (16 percent of those with income of $5,000 to $10,000; and 40 percent of those with income of $10,000 to $20,000). Government pensions showed a comparable range, with 2 percent of those with income of less than $5,000 receiving pensions, and 28 percent of those with income of $20,000 or more receiving them. The median value of private pensions or annuities among recipient families was $3,586, or 29 percent of income for all families. Among recipients, 6.7 percent reported annual benefits above $13,000. Social Security accounted for 100 percent of the income of 13
percent, 90 percent or more for 23 percent, and 50 percent or more for 55 percent. Private pensions or annuities were 1 percent to 19 percent of income for 14 percent of the elderly, 20 percent to 39 percent for 10 percent, 40 percent to 59 percent for 4 percent, and more than 60 percent for 1 percent. Government pensions were 1 percent to 19 percent of income for 4 percent of the elderly, 20 percent to 30 percent for 4 percent, 40 percent to 59 percent for 4 percent and more than 50 percent for 3 percent. Again, however, the supplemental importance of pensions varied by total income. This relative percent, 40 percent to 59 percent for 4 percent and more than 50 percent for 4 percent. Government pensions were 1 percent to 19 percent of income for 55 percent. Private pensions or annuities were 1 percent to 10 percent, 90 percent or more for 23 percent, and 50 percent or more for 4 percent.

Taken together, the data show that supplementation of Social Security income is what allows a retiree to achieve a higher standard of living in retirement. As Professor Tim Smeeding noted at an EBRI-ERF Forum: "Reliance on any one source of income—even if it is Social Security—can be a sign of economic dependence and insecurity."1

Income Replacement

Data on the income replacement level provided by private pensions are not generally available. Typically, private plans are targeted to provide 60 percent replacement for high earners and 80 percent for low earners after 30 years of service, in combination with Social Security. The large employer that provides both a defined benefit and a defined contribution plan traditionally has not included any defined contribution benefit in the calculation, but this is also beginning to change. As a result, future formulas in defined benefit plans are likely to provide less, as supplemental defined contribution plans provide more. As a case in point, when federal employees were given the new "thrift" plan, the defined benefit plan was made less generous than the old Civil Service Retirement System.

Tomorrow's Retirees: Trends in Pension Coverage

Employer-sponsored pension plans, as shown above, represent an important source of income for many retired Americans. According to EBRI tabulations of the May 1988 Current Population Survey employee benefit supplement (CPS EBS), in May 1988, 60 million civilian workers (public and private), or 59 percent of all such workers, worked for an employer that sponsored a pension plan. Three-fourths of all workers covered by an employer plan, or 45 million workers (44.2 percent), actually participated in the plan; two-thirds of these participants, or 30 million workers (29.5 percent), were entitled to a benefit at termination of employment or retirement. In 1979, 61.1 percent were covered by an employer-sponsored plan, 49.5 percent participated, and 25.1 percent were entitled to a benefit.

Pension availability varies significantly by state, with the highest coverage in Virginia, at 69 percent, and the

lowest in Florida, at 46 percent. Among the most populous states, California is at 57 percent, Texas is at 53 percent, and New York is at 64 percent. Choice of trade or profession leads to wide variations as well. Aircraft manufacturing is at 92 percent, compared with eating and drinking retail establishments at 18 percent. Firm size is also a major factor. Among those working in firms with fewer than 100 employees, 27 percent have an employer-sponsored pension, compared with 79 percent of those working for firms with 100 or more employees, and more than 90 percent of employees in firms with 5,000 or more employees. These patterns have been observed for some time and can be expected to continue.

There has been a trend toward the establishment of defined contribution plans, especially with the advent of 401(k) cash or deferred arrangements (established under the Revenue Act of 1978) and employee stock ownership plans. By 1987, the number of defined contribution plans represented 73 percent of all plans, up from 68 percent in 1975. By comparison, defined benefit plans represented 28 percent of all plans in 1987, down from 32 percent in 1975. Of 42 million active participants in 1987, 28 million were in primary defined benefit plans (66 percent), compared with 27 million of 32 million (87 percent) in 1975. More than 27.5 million workers were covered by 401(k) plans in May 1988, up from 7.1 million in May 1983. These figures represented 24.2 percent and 7.1 percent of all workers, respectively. Participation grew from 2.7 million workers (2.7 percent of all workers) in 1983 to 15.7 million (13.8 percent of all workers) in 1988.

An increasing number of workers are relying on 401(k) plans as their primary employer-based retirement plans, especially 401(k) participants at small firms. The 1988 CPS EBS found that more than 49 percent of 401(k) plan participants reported that this was their primary employer pension plan. Among 401(k) participants working for employers with 250 or more employees, 43.5 percent had a primary 401(k); this proportion increased to 79.5 percent for 401(k) participants in establishments with fewer than 10 employees.

For the future, we can expect: (1) the absolute number of workers entitled to a pension annuity or lump-sum distribution will grow, (2) the proportion of active workers with entitlement will grow, and (3) both the number and proportion of new retirees with income attributable to private pension annuities or lump-sum distributions will grow. However, should the movement to defined contribution plans and modification of defined benefit plans to lump-sum payouts continue, we can also expect the proportion of workers participating in plans to hold steady or to decline. Why? Because participation rates are lower when the employee has a choice. Moreover, there is a tendency to spend small lump-sum distributions rather than to save them.

Can New Initiatives Help Expand Pension Coverage?

Pension simplification and preservation proposals recently set forth by the Bush administration and those introduced in the House and the Senate could have some effect on pension coverage and participation.
First, small employer incentives. Small employers have never sponsored pension plans in large numbers. Not even when tax rates were very high for both individuals and corporations and legislation and regulation were light. Small employers, and those who work for them, have placed a higher priority on health insurance if any benefit is provided. With health care costs rising and health benefit mandates being discussed, the addition of pensions by small employers is likely to occur only at the margins. This growth will only occur if simplified programs are actively marketed.

Second, simplification. The proposed technical and definitional changes could reduce administrative costs. But some of the proposed changes, such as a proposal to allow certain employers to elect an alternative full funding limitation based solely on the accrued liability of the plan, may have unintended effects. While it may encourage employers with young work forces to fund and sponsor defined benefit plans, it may have the opposite incentive for firms with older work forces.

Third, preservation. Making rollovers more likely and more advantageous from a tax perspective would increase pension dollars available at retirement. The foregoing trends have made pension dollars increasingly portable. They have also made preservation less likely. The new proposals would increase the realization of preservation for retirement in this environment of growing pension cash portability.

Tomorrow's Retirees: Inflation Protection

Retirees have inflation protection from adjustments in Social Security and may have it in the realization of real rates of return on preserved and invested lump-sum distributions. With the combined trends toward (1) growth in defined contribution plans and (2) increasing use of lump-sum distributions in defined benefit plans, the importance of what happens to lump sums grows in terms of (a) base retirement income and (b) postretirement inflation protection. Public employee pension plans nearly always pay in annuity form and provide for some level of automatic inflation adjustments. Private employee defined benefit plans that pay an annuity do not make automatic inflation adjustments. Based on recent surveys, the largest plans do adjust over time for about one-half of inflation, but this practice appears to be declining.

A policy dilemma for those who might seek indexing of defined benefit annuities, even if prospectively for future retirees, is that indexation would probably increase the movement to lump-sum distributions in defined benefit plans and encourage a faster shift to defined contribution plans (assuming the movement was still legal).

How Do We Compare with Our Trading Partners?

The United States, Japan, Germany, Canada, and Great Britain have particularly extensive voluntary private pension systems. All are advance funded and are provided tax incentives by the government. Japan is currently working to encourage expansion of private employment-based pensions to help finance the retirement of a quickly growing retiree population. These nations are also
working to reduce the scope of the state Social Security benefit levels, in response to demographics that the United States will not face until well into the next century.

Coverage in these nations can be compared with that in the United States. Germany replaces 42 percent of earnings, Great Britain 29 percent, Canada 28 percent, Japan 38 percent.

France, Switzerland, and the Netherlands have mandatory programs and near universal coverage. The Swiss and Dutch programs are advance funded, while the French system is pay-as-you-go.

Today's Retirees—At an Historic High in Noncash Income

Noncash income is exceptionally important, with Medicare, Medicaid, other health care "subsidies," and implicit rents on owner-occupied homes being the most important.  

Health Care Is the Most Important Direct Noncash Benefit

Per capita personal health care spending among the elderly grew to $5,772 in 1988, more than three times the level for the population as a whole. Out-of-pocket spending per capita among the elderly reached $1,697 in 1988, compared with $1,059 in 1984 and $522 in 1977 (Medicare premiums absorbed an additional $241 in 1988). Total personal health care expenditures for the elderly reached $175 billion in 1988, an increase of 46 percent since 1984. Health "insurance" financed 71 percent of the expenditures—effectively producing a supplement to cash income. The percentage of income expense represented by health costs varies dramatically by income, with past research finding that the poor and near poor spend 16 percent of cash income, compared with 2 percent for the top 20 percent of retiree households by income.  

The percentage of income spent on health care out-of-pocket today is higher than when Medicare and Medicaid were established, and the relationship can only be expected to worsen in the future as reductions in retiree medical insurance protection continue. The government financed 64 percent of elderly personal health spending in 1977, 67 percent in 1984, and 58 percent in 1988. Medicare payments dropped from 49 percent in 1984 to 40 percent in 1988, and physician payment changes are expected to drop this percentage further. On the one hand, this comes at a time when we "celebrate" individual out-of-pocket spending increases as a positive control on health consumption. On the other hand, it comes when retirement cash income programs are under pressure, and retirees may not have the added cash.

In 1988, 11.4 percent of retirees had health insurance (other than Medicare) from an employer, and an additional 3.2 percent had

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such protection through their spouse's employer plan. For workers aged 40 and over, the numbers are 16.5 percent and 11.8 percent, respectively. As noted previously, Medicare supplementation is frequently related to income. Among workers aged 40 and older with incomes between $10,000 and $15,000, 8.8 percent have an employer promise, compared with 53 percent of those at $50,000 or more. Yet, at the other end, the very poor can qualify for the "first dollar" protection of Medicaid for both acute care and long-term care. The question: will future generations of retirees have sufficient cash income to meet the growing cost of medical care? And, since long-term care is the elderly's largest out-of-pocket expense, will approaches be found to finance it? Private pension income can make a difference, as the initial section of this testimony indicates.

The Future of Social Security

There is no doubt that the Social Security program will continue to pay benefits to retirees for a long time to come. Today, the greatest controversy is over reducing tax rates, not the program's long-term viability. At current payroll tax rates, cash flow into the trust will exceed annual benefit payments until the year 2016. Including interest accumulations and "cashing" them in to make benefit payments, the trust fund is secure until the year 2028. Since, under normal circumstances, I will not be gone until the year 2034, this is a matter of personal concern. My parents can and do view it as a purely academic issue. My young nieces and nephews view it a bit more personally.

The question: can anyone in public office be expected to worry about something that promises to be healthy for another 25 years when there are many immediate problems available? For those working today, building future private pension income could prove very important.

The Future of Medicare

There is also no doubt that the government will be in the business of health protection for vulnerable populations. This leaves a great deal of room for modification of the present Medicare program, however. The definition of vulnerable might not include the full 34.3 million persons who were covered in 1990. Or, in line with the Bush administration's proposal that high-income retirees pay 75 percent of the cost of Medicare Part B instead of the current 25 percent, protection may be provided at a higher cost.

A new report from the Health Technical Panel to the 1991 Advisory Council on Social Security presents the long-term challenge clearly. It projects that tax and premium income will exceed outgo as early as 1996, and maintenance of the program at present benefit levels will require a steady increase in taxes as a percentage of taxable payroll (from 4.38 percent in 1990 to 8.11 percent in the year 2060) and spending as a percentage of GNP (from 1.97 percent today to 6.8 percent in the year 2060). In 1990, this equated to $3,012 in spending per enrollee, compared with $1,169 in 1970 (in constant 1989 dollars).

This does not consider the economic need for long-term care funding. Compared with current annual expenditures of approximately $35 billion, demand is expected to hit $100 billion per year between the years 2016 to 2020.

The question: will future retirees have sufficient cash income to meet health expenditure needs? What are the implications of a movement away from annuity streams and toward lump-sum distributions for future retirement income?

Challenges to Individuals in Meeting Future Needs

The individual faces a steep hill ahead in terms of building the resources to meet future needs. The proportion of the U.S. population aged 65 and over is projected to grow from approximately 12 percent today to more than 22 percent after the year 2030. This means that the relative number of active workers paying Social Security taxes to support beneficiaries will be reduced in the future. An alternative for the nation is to go back to much later retirements, but that would require a set of policy changes that do not appear on the radar screen today. The ability of people to do even that much in the future will be strained.

Paying More to Stay Even

First, workers have less available income for savings as they are required to pay a larger portion of health benefit expense.

Second, they are once again being asked to contribute directly from cash compensation dollars to fund retirement income with the growth of employee contribution defined contribution programs.

Third, they are faced with expense pressures in other parts of the household budget as the relative cost of housing and higher education rises.

Fourth, they are faced with higher interest expense as the world becomes one in which credit cards arrive unapplied for in the mail box at interest rates that can run more than twice the prime rate.

Fifth, they have and will continue to have less discretionary income as the payroll tax cost of government programs continues to climb. The cost of OASDHI, which today is 14.98 percent of covered payroll, will rise to 33.15 percent by the year 2060 if present benefit levels are maintained and intermediate assumptions are accurate over the decades.

The question: with these discretionary income pressures, will more or fewer individuals save in the future for retirement? And, will individuals save or spend lump-sum distributions when they change jobs (or, "save" them by paying off credit card debt)? And, will retirees be able to manage investments and cash flow well enough to make retirement lump-sum distributions "last a lifetime"?

Americans Are Worried About Affording Retirement

EBRI has commissioned the Gallup Organization to undertake a series of public opinion surveys on economic security. A number of the findings are significant to this discussion.
First, Americans regard health insurance as the most important employee benefit.
• 73 percent hold the opinion that employers should be required to provide health benefits to their retirees.
• 49 percent hold this view even if it means receiving a lower pension benefit.

Second, employees are realistic about pressures on the future and the need for retiree medical protection and cash income.
• 71 percent expect Medicare to pay lower benefits when they retire than it does today.
• 53 percent would be willing to pay higher payroll taxes to assure the same level of Medicare benefits with 44 percent willing to accept a lower cash benefit from Social Security in order to maintain Medicare.
• 64 percent say they would not retire before Medicare eligibility if their employer did not provide retiree medical protection and 88 percent say they would buy protection if they were forced to retire.
• 70 percent think that employers should be required to provide retirement benefits as part of every employee's compensation. This support drops to 46 percent if it means lower salaries.

Third, those who could benefit the most from retirement saving do not report doing it.
• 54 percent of those aged 18 to 34 report having begun to save for retirement, compared with 78 percent of those over age 55.
• 42 percent of those earning less than $20,000 report saving for retirement, compared with 87 percent of those earning more than $75,000.

Fourth, significant numbers say they would consume a lump-sum distribution equal to three months pay.
• 50 percent of those aged 18 to 34 and 47 percent of those earning less than $20,000 would save a lump-sum distribution, if it were given directly to them.
• 85 percent of those aged 18 to 34 and 81 percent of those earning less than $20,000 would save the lump-sum if the employer automatically rolled it over into an individual retirement account.

The public wants to retire by an average age of 61, to maintain their preretirement life style, and to have both retiree medical and long-term care protection. Yet, many are not saving when tax effective opportunities exist, and one-half or more do not continue to favor programs when they carry an explicit cost. The education challenge is indeed significant.

What Will Present Pension Coverage Produce?

For some years, EBRI and others have made use of estimates from the Pension and Retirement Income Simulation Model (PRISM) to assess future retirement income. A "base case" simulation that assumes that a retiree given the option of an annuity will always take it would see pension recipiency grow from 40 percent of those
retired in 1988 to 77 percent of those retired in the year 2020. Private pension receipt would increase from 28 percent to 66 percent in the year 2020. Private defined benefits would be paid to 57 percent of retirees, and 33 percent would have income from private defined contribution plans.

This base case simulation may overstate the choice of annuities and thus regular supplementation of Social Security. Therefore, we adjusted lump-sum payments and consumption to an "extreme" that might result from present trends. Under these more "conservative" assumptions, pension recipiency still increases to 70 percent, and private pensions increases to 60 percent.

At the other extreme, we ran simulations assuming that all defined benefit and all defined contribution payments were made in annuity form. With this change, recipiency rises to 84 percent, private pensions to 75 percent. The difference between this "extreme" and the base case indicates that the base case may overstate. Defined benefit recipiency in the private sector rises from 57.2 percent to 58.9 percent, indicating that the base case assumes almost no lump sums. Available data indicate that this is not the case. Defined contribution annuity recipiency increases, on the other hand, from 32.8 percent to 51.9 percent. The base case may still overstate annuitization but by far less.

However, these numbers do provide a picture of the impact that pension design and pension law might have on the economic well-being of tomorrow's elderly.

The question: will plan design trends and lump sums significantly change what the baby boom receives? And, can sufficient retirement planning education be undertaken to assure the preservation of a high proportion of lump-sum distributions?

Conclusion

The employment-based pension system in the United States is a model for the rest of the world. It has contributed to the high economic status of the current generation of retirees' and holds great promise for the future. It has provided a high return on investment for employers, individuals, and the government. A close eye on the implications of change and a careful hand on adjustments that may be necessary to keep it on course should assure a sound pension future.