

**Written Statement**  
**for the**  
**House Committee on Ways and Means**  
**Hearing on the Retirement Policy Challenges and Opportunities of an Aging Society**  
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## Written Testimony of Dallas Salisbury

Chairman Thomas and members of the committee: My name is Dallas Salisbury. I am president and chief executive officer of the nonpartisan Employee Benefit Research Institute (EBRI). I am pleased to appear before you today to testify on retirement policy challenges and opportunities for our aging society. All views expressed are my own, and should not be attributed to EBRI. I have personally worked on retirement and pension issues since joining the Labor Department in 1975 as it was organizing to fulfill its responsibilities under the Employee Retirement Income Security Act of 1974 (ERISA). I was later on the staff of the Pension Benefit Guaranty Corporation, before joining EBRI in 1978.

Established in 1978, EBRI is committed exclusively to data dissemination, policy research, and education on financial security and employee benefits. EBRI does not lobby or advocate specific policy recommendations; the mission is to provide objective and reliable research and information. All of our research is available on the Internet at [www.ebri.org](http://www.ebri.org)

### What Are Retirement Programs Delivering?

The announcement of this hearing underlines the changing demographics of our country in the decades ahead and the absence of savings by most Americans.

The need to do better as a nation is made clear by the financial status of today's retiree population. One-quarter of current retirees rely *totally* on Social Security for their income, and have no outside resources. Two-thirds rely *primarily* on Social Security for their income. One-third have annuity income from a pension plan: About 13% have annuity income from prior public-sector employment and 20% from prior private-sector employment. Overall, today's workers are saving more than those who went before them, but they are not saving enough—and many are not saving at all.

The hearing announcement referenced individual retirement accounts (IRAs). Research shows that at the height of IRA usage in 1986, just over 16% of taxpayers made contributions; but currently, more recent tax data show that less than 3% of taxpayers now contribute in any year. Research also shows that the primary source of new dollars flowing into IRAs is from rolling over lump-sum distributions from both defined benefit and defined contribution employment based retirement plans, which are the primary source of individual savings in the nation today.

Research shows that:

- About 10% of all workers ages 21 to 64 now own only an IRA.
- About 21.7% own only a defined contribution plan personal retirement account.
- About 9.2% own both.

In the case of IRAs, this does not represent an increase since the 1990s. For personal retirement accounts at work it represents a 19.3% increase, from 18.2% to 21.7%.

Average and median account balances in all plans have continued to grow. The most recent research available finds *average* 401(k) balances for the employee's current employer (and ignoring any balances still residing with previous employers or rolled over to IRAs) at over \$51,000 (compared with \$37,000 in 1996), and *median balances* at about

\$18,000 (compared with \$11,600 in 1996). For workers with more than 30 years of service and now in their 60s, average balances are now about \$168,000.

Research updated this month finds that a current 401(k) participant who is assumed to always work for employers offering a 401(k) plan could reasonably expect 401(k) balances and IRA rollovers for money originating in 401(k) plans to replace between 51% (for those in the lowest income quartile) and 67% (for those in the highest income quartile) of final five-year average income. This is in addition to between 52% (for the lowest income quartile) and 16% (for the largest income quartile) of income coming from Social Security. That research underlined the challenges of our mobile workforce, showing an alternative hypothetical scenario in which workers are assumed to randomly change jobs without regard to the existence of a 401(k) plan for subsequent employers. In that case, the replacement rate from 401(k) balances and IRA rollovers for money originating in 401(k) plans is closer to 25% of final income.

Recent news stories about the termination of United Airlines' pension plans have focused new attention on defined benefit pension plans. When ERISA was enacted, these were the primary source of retirement coverage for American workers. About 27% of private sector workers were active participants in these plans in 1984 compared to 20% today. The actual number of workers participating in these plans has remained at about 23 million to 26 million over that period, while the private workforce increased by 29 million

The actual number of workers participating in these plans has increased from 23 million to 26 million in that period, but the private-sector workforce increased by 29 million over this same period.

Among the growing number of workers who are saving at work through programs like the Federal Thrift Savings Plan (TSP) and 401(k)s, research has now documented a number of things:

- More than a quarter of those who *could* participate in a savings plan do not—but automatic enrollment with an opt-out could dramatically increase participation and final retirement income. Recent research suggests that for today's young low-income workers, automatic enrollment would increase median final replacement rates from 401(k) plans and IRA rollovers of money originating in 401(k) plans by 61%.
- Less than 8% contribute as much as they could legally contribute. Extrapolation of the research findings above suggests that a default to a high initial contribution rate, or a base automatic contribution by the employer, could increase final account balances, assuming that a choice of a higher default contribution rate will not be offset by a decline in participation.
- Many participants in plans do not diversify their investments, and more than three-quarters make no changes in their allocations and do not rebalance—but the 2005 Retirement Confidence Survey found that large numbers would welcome pre-diversified investment options like those now being implemented in the Federal Thrift Savings Plan.
- Surveys indicate that even among investors, large numbers do not know the difference between a stock and a bond.
- Surveys find that the public does not know when they will be eligible for Social Security, how long they are likely to live, how much they need to save for retirement, and much more.

- 401(k) plan data show that more than half of participants have less than \$18,000 in their accounts.
- Someone who turns 65 this year and has no other source of income than the average \$10,000-a-year Social Security benefit would need about \$140,000 to purchase an immediate indexed annuity that would pay out that amount. That gives you an idea of how small most savings are in America, even among those who have savings.

With changing demographics, projected financing shortfalls in public programs such as Social Security and Medicare, and a transfer in responsibility for retirement savings and distribution decisions from employers to individuals, there is a greater need than ever before for all individuals to actively plan and save for their long-term personal financial security. Without action on the part of individuals, we could at least experience greater income difficulties for Americans as they age, and at worse a dramatic decline in the standard of living of retirees and an increase in elderly poverty. Therefore, financial education—and the financial literacy to which it leads—are of great national importance.

### **Have the Nation and Work Force Radically Changed?**

The nation and the work force have not changed as much over recent decades as the headlines and magazine covers would often have us believe. In the so-called “good old days,” about one-third of workers spent an entire career with just one employer; today, that is down to about 18% of the work force. At the height of defined benefit pension coverage, about one-third of retirees had pension income in retirement; today, among recent retirees, it is now about 31% and declining—and this decline will continue over decades. *In other words, most workers have always had to save for themselves in order to have income on top of Social Security in retirement.* Today, we do more to make that possible than at any other time in history, and we know more than ever about how to get workers to undertake voluntary savings. Mandated savings, like that which occurs in a defined benefit retirement program such as Federal Employee Retirement System (FERS), avoids leaving the results to chance; but as programs like the Federal Thrift Savings Plan (TSP) have shown, we now know that the right combination of education, payroll deduction, automatic features in savings programs, and pre-diversified investment options can increase participation and savings.

### **What Can Data and Surveys Tell Us About Social Security Reform?**

First, as I already noted, Social Security is either the *only* or the *primary* income source for the majority of American retirees.

Second, for a growing number of workers, Social Security will be the *only* annuity income protection they have against the risk of outliving their money. At 91, my father has had a much longer life than he anticipated, and with each passing year Social Security becomes increasingly important to Dad and Mom. Few plan their spending in anticipation of living to that 10% probability. My Mom and Dad saved and made intelligent annuity decisions, but they did not expect to be alive this long. At birth their average life expectancies were below age 50, and by the time they hit 65, their average life expectancies were still well shy of 80.

Third, Social Security annuities and pension annuities save the marriages of retirees’

children. This pay-as-you go system automatically transfers funds from working kids to their parents without guilt. More important, it does it without having to negotiate with your spouse on a monthly basis how much money to send to your respective “in-laws.” Just think for a moment about how that monthly session would go for you or your children.

Fourth, Social Security does not allow access to funds for reasons other than death, disability, or retirement. We know from IRAs and defined contribution plans (like the Federal Thrift Savings Plan) that, given a chance to borrow or take hardship withdrawals, millions will do it—thereby eating into their future retirement savings.

Decades of data underline that compulsion in savings and distribution produce better retirement income results than open individual choice. If the policy objective is choice, that does not matter. If the policy objective is life-long retirement income adequacy, it does matter.

### **What Do Data and Research Tell Us About Individual Account Design?**

First, that either mandatory participation or a default into a savings account gains the highest levels of participation.

Second, that a matching contribution increases the amount that workers will contribute.

Third, that individuals, given choices, will place a high percentage of assets in “safe” investments, many will concentrate a significant percentage of their 401(k) portfolio in company stock, and a significant percentage appear not to have changed their mix of investments once set in place—but individuals have a high rate of acceptance of investment options that automatically diversify and rebalance the account.

Fourth, that individuals will generally take a lump-sum distribution at retirement, rather than an annuity, if given a choice, due to what economists describe as the “wealth illusion.” Surveys indicate there is an absence of understanding of life expectancy and the primary pooling virtue of an annuity, and the fact that a lump-sum will only last you until average life expectancy, whereas an annuity (pooled with other retirees) can provide a monthly payment as long as you live.

Fifth, rules that require funds to be left in a retirement plan or rolled over at job change will dramatically increase account balances at retirement and the income replacement they will provide.

Different policy objectives would lead to different conclusions on which of these design features to select, but the research is available to allow design to be matched to objectives.

### **Social Security Reform Alternatives: Comparing Benefits**

A major issue Americans need to understand while making decisions about savings and work place retirement programs relates to what and when Social Security will pay. Social Security is the most widely recognized and utilized retirement income program in the United States. As I noted, it is the only source of income for 25% of retirees, and the primary source of income for 66% of retirees. Whatever results from Social Security reform, Americans will need to understand how the program works and how it affects their overall financial future. This won’t be easy to do: Even though Americans have been getting annual benefit statements for years, only 18% of respondents in the 2005 Retirement Confidence Survey knew the age at which they would be eligible for full benefits. Clearly, most people do not read or understand their Social Security benefit statements.

There are a number of Social Security reform scenarios under consideration. Given the projected funding shortfall currently facing Social Security, the promised benefit is not projected to materialize (with intermediate assumptions), unless changes are made by either reducing benefits or raising revenues.

EBRI research shows how people in different stages of the life cycle will fare under various courses of reform. If the nation settles on including some sort of individual accounts in Social Security, EBRI research shows the only way to achieve greater returns, other than taking a reduction of benefits, is to ensure the accounts are invested in diversified portfolios and not simply more “safe” bond funds, assuming past returns are an indication of future returns. However, government regulation tells us that we should not assume that the past is an indicator of the future, so there is still a risk related to future outcomes. Our research compares “Model 2” from the President’s 2001 Commission to Strengthen Social Security (which appears to have the principles for an individual account plan favored by the Bush administration)<sup>1</sup> with three basic options:

- Current-law benefits with taxes raised to cover the shortfall over the 75-year actuarial period, by removing the existing \$90,000 wage cap and including all workers.
- Maintain current benefits until the revenue shortfall occurs, and then impose a “cliff” benefit cut.
- A gradual reduction in current-law benefits.

Under current law, a 30-year-old person (born in 1975) and currently making around \$16,500 a year would receive an initial annual Social Security retirement benefit of \$11,200 in today’s dollars.<sup>2</sup> Here is how that individual would fare under the three basic options compared with the projected \$11,200 initial annual current-law Social Security benefit:

- Under the cliff benefit cut, where the cut begins in 2042, this individual’s benefit would still be \$11,200, since he or she would reach the normal retirement age before the steep cut goes in effect.
- If, instead, benefits were cut gradually, so that one generation doesn’t face the full impact of the funding deficit, this individual’s benefit would fall to \$9,600.
- Under Model 2, if approximately half of the individual account was invested in the equity market and historical rates of return were achieved, the annual benefit would be \$12,500. Instead, if the entire account were invested in Treasury bonds to avoid the risk of investing in the equity market, the annual benefit would be \$10,400.

As this shows, even if a person invested a portion of their payroll tax in an individual account, certain investment allocations would actually result in a *reduced* benefit over other options.

However, for a 20-year-old born 10 years later (in 1985) and currently earning the same amount, the initial Social Security benefit under current law would be \$12,500 a year. What then?

- Because this individual will reach the normal retirement age *after* the date when Social Security’s revenues will fall below its costs, the steep reduction caused by the cliff benefit cut option would reduce his or her initial benefit to \$7,700.
- If the benefit reductions were gradual, the benefit would be \$9,800.

- Under Model 2 individual accounts, the benefit would range from \$10,800 to \$15,700, depending upon the investment of the account assets.

Again, any benefit an individual account provides would fluctuate widely according to early decisions this individual makes.

What about a higher-income, older individual? For example, a 50-year-old individual (born in 1955) and currently earning about \$72,500 would have a current-law benefit of \$23,200—the same benefit as waiting until the revenue shortfall. Under the gradual reduction in benefits, her or his benefit would be \$22,900. Under Model 2 individual accounts, this person’s annual benefit would range from \$21,000–\$21,300, depending on the investments. So, this individual would be better off not contributing to an individual account.

What about someone who is born in 2015? Assuming this individual has average annual earnings of \$55,000 in 2005 dollars, his or her current-law benefit would be \$36,500. Under the cliff benefit cut option, the benefit would fall to \$22,700, and under the gradual reduction in benefits to \$24,500. The individual account plan would provide benefits ranging from \$19,500–\$31,700, depending on the investments. Again, early decisions about investing will greatly impact this person’s standard of living long after they are made.

The bottom line: There are some significant differences in outcomes, which depend on when someone is born, how much he or she earns, and how any funds in an individual account are invested. Nevertheless, a few basic conclusions can be drawn from this analysis:

- Lower-income people are more likely to do better under an individual account plan structured like Model 2 than are higher-income individuals, relative to the other options.
- Twenty-something-year-olds and younger individuals (born in 1985 and after) will benefit the most from reform action now, as opposed to waiting.
- Model 2 benefits with historic equity rates of return, are the *average* level of many possible scenarios; because there can be wide variations around an average, the resulting benefit could vary significantly from this average benefit.
- Everyone, regardless of age, income, and personal retirement goals, should be educated on issues of savings, life expectancy, investment allocation, and the basics of Social Security.

The benefits and replacement rates presented above are for very specific individuals who have steady earnings. They are not the benefits individuals should expect if they have a very different earnings pattern. Full results of this research were published in the May 2005 *EBRI Issue Brief* and can be accessed at [www.ebri.org](http://www.ebri.org).

## **Conclusion**

Unfortunately, no matter how you look at the statistics, the bottom lines are the same:

1. Financial literacy in the nation is not good.
2. Most Americans are not planning for their future by taking control of their current financial situation and saving for retirement and other life events.
3. To change that, we need to sustain and expand the national effort to increase the number of savings programs, the rates of participation, the preservation of balances upon job change, and the preservation of balances over the full life cycle.

America is a land of great opportunity. However, many of its citizens are passing on their often one-time chance to build wealth and to have financial security by spending beyond their means, not properly planning for life's unexpected events, failing to invest in their own retirement savings, making bad decisions about debt, and not participating in their employers' retirement plans. We feel the greatest shame is that these actions are often done out of simple ignorance.

The financial security of the nation, including the financial well-being of my parents, their four children, their six grandchildren, and their six great-grandchildren, depend on it.

Mr. Chairman and members of the committee, I commend you for exploring these topics, and thank you for the opportunity to meet with you today.



## Appendix

### **401(k) Accounts: What the EBRI/ICI Database Shows**

To understand Americans' retirement plan investment activity and decisions, EBRI maintains the EBRI/ICI 401(k) database. This is the world's largest repository of information about individual 401(k) plan participant accounts. As of Dec. 31, 2003, the EBRI/ICI database includes statistical information on 15.0 million 401(k) plan participants, in 45,152 employer-sponsored 401(k) plans, holding \$776.0 billion in assets. The 2003 EBRI/ICI database covers approximately 35% of the universe of 401(k) plan participants, 10% of plans, and 41% of 401(k) plan assets. The EBRI/ICI data are unique because they cover a wide variety of plan record keepers and, therefore, a wide range of plan sizes offering a variety of investment alternatives. In addition, the database covers a broad range of 401(k) plans, from very large corporations to small businesses.

The most recent findings from this database indicate the portion of 401(k) balances invested in equities increased in 2003, reflecting the strength of equity prices. Beyond the market-driven changes, 401(k) plan participants do not appear to have made significant asset reallocations or to have made changes in their loan activity. Buoyed by strong equity market returns and ongoing contributions, 401(k) account balances increased in 2003. Among participants with accounts since year-end 1999, the average account balance increased 29.1% by from 2002 to 2003. The principal findings as of year-end 2003 are as follows:

#### ***Asset Allocation***

- On average, at year-end 2003, 45% of 401(k) plan participants' assets were invested in equity funds,<sup>3</sup> 16% in company stock, 9% in balanced funds, 10% in bond funds, 13% in guaranteed investment contracts (GICs) and other stable value funds, and 5% in money funds.
- Equity securities—equity funds, the equity portion of balanced funds, and company stock—represented 67% of 401(k) plan assets at year-end 2003, up from 62% in 2002, generally reflecting the strong performance of the equity markets relative to fixed-income securities.
- Other asset allocation patterns do not seem to have been affected by the strong stock market performance:
  - ▶ Younger participants still tended to hold a higher portion of their accounts in equity assets and older participants tended to invest more in fixed-income assets.
  - ▶ The mix of investment options offered by a plan, particularly the inclusion of company stock or GICs and other stable value products, significantly affects the asset allocation of participants in a plan.
  - ▶ About 13% of the participants in these plans held more than 80% of their account balances in company stock.

#### ***Changes in Asset Allocation Over Time***

Knowing how people currently participate and allocate their employment-based retirement savings, we need to know what workers do over time. Research shows that few participants make changes in their asset allocations over time. Allocations in equity funds from 1999 to 2002 were generally constant. Reports from individual 401(k) administration firms suggest that nearly 90% of participants make no changes over time.

### **Annual EBRI Retirement Confidence Survey**

For the 15<sup>th</sup> year in 2005, EBRI and Matthew Greenwald & Associates have conducted the country's most established and comprehensive study of the attitudes and behavior of American workers and retirees towards all aspects of saving, retirement planning, and long-term financial security, the *Retirement Confidence Survey (RCS)*. This annual survey is a random, nationally representative survey of 1,000 individuals age 25 and over. The survey contains a core set of questions that is asked annually, allowing key attitudes and self-reported behavior patterns to be tracked over time. We also add special questions each year.

This year's findings shed light on a number of issues relevant to financial literacy related to retirement planning and savings. We found that:

- Employers with a retirement plan can help their workers achieve investment diversification through the investment options they offer. Employers looking to help employees make more informed investment allocations may be able to do so more efficiently by offering lifestyle or lifecycle funds. Among participants not currently offered these types of funds, 23% say they would be *very likely* to participate in a lifecycle fund, 21% would be *very likely* to participate in a lifestyle fund, and 15% would be *very likely* to participate in a managed account.
- Half or more think they would be *much more* or *somewhat more* likely to participate if there was a provision that automatically raises workers' contributions by a fixed amount or percentage when they receive a pay raise (55%).
- A third said a managed account would persuade them to participate (35%).
- Automatic enrollment in 401(k) plans, as opposed to waiting for the worker to sign up, could also increase plan participation and savings. Non-participants appear to accept automatic enrollment—40% say they would be *very likely* to stay in the plan if their employer automatically enrolled them in one, and 26% would be *somewhat* likely to do so.
- Workers are more likely to save through the work place than on their own. More than 8 in 10 eligible workers say they participate in a work-place retirement savings plan (82%); 38% of workers have an individual retirement account (IRA). Promoting plans that allow automatic withdrawals from individual bank accounts may not significantly increase nonwork-place savings. In this case, ignorance is not the issue: Nearly 7 in 10 of those who do not currently use automatic withdrawals for retirement savings are already aware that they have this option (68%).

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<sup>1</sup> See the President's Commission to Strengthen Social Security report for a further discussion of this model, as well as the other models that were offered by the commission at [www.csss.gov/reports/Final\\_report.pdf](http://www.csss.gov/reports/Final_report.pdf).

<sup>2</sup> The \$10,000 annual salary is 27 percent of the average wage, \$16,500 is 45 percent of the average wage, \$36,500 is 100 percent, \$55,000 is 150 percent, \$72,500 is 200 percent, and \$95,000 is 260 percent. Each worker maintains this percentage of the average wage throughout his or her career.

<sup>3</sup> "Funds" include mutual funds, bank collective trusts, life insurance separate accounts, and any pooled investment product primarily invested in the security indicated (see page 6 for definitions of the investment categories used in this paper). Unless otherwise indicated, all asset allocation averages are expressed as a dollar-weighted average.