Statement On

Retirement Income Security In The United States

of

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on
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Before the Subcommittees on
Social Security and Oversight of the Committee on
Ways and Means
U.S. House of Representatives

*The views expressed in this statement are those of Dallas Salisbury and should not be attributed to the Employee Benefit Research Institute, its officers, trustees, sponsors, or other staff.

Dallas Salisbury is President of the Employee Benefit Research Institute, a nonprofit, nonpartisan, public policy research organization. Before joining EBRI he served in senior career policy research positions at the U.S. Department of Labor and the U.S. Pension Benefit Guaranty Corporation. This statement draws heavily from research studies conducted, published, and copyrighted by EBRI.

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## Summary

Mr. Chairmen, it is a pleasure to appear before you today, and I commend you for the joint study of your Subcommittees on Retirement Income Security in the United States.

The statement that I have submitted for inclusion in the record provides responses to each of the major questions and subquestions set forth in the hearing announcement.

I wish to stress seven points made in my full statement.

First, our nation has nurtured a retirement income system that is highly valued by the citizenry.

Second, our nation has nurtured a retirement income system that is dramatically improving the economic status of our retired population. Nearly all retirees have income from Social Security. A growing number have income from employer pensions: in 1982 among new Social Security beneficiaries 56 percent of married couples and 42 percent of unmarried individuals had employer pension income--compared to 35 percent and 15 percent, respectively, of all current retirees.

Third, our nation has nurtured a retirement income system made up of components that complement each other in design. Social Security uses a benefit formula that gives the highest income replacement to those who earn the least. Employer pensions fill the gap for those with moderate and high earnings, who receive less from Social Security. For example, if you refer to Table 2 on page 6 of my statement, you will see that among those retirees in the lowest income quartile, 22 percent have pension income, compared to 64 percent of those in the highest quartile.

Fourth, employer-provided pensions now provide benefit accruals to over 70 percent of full-time workers. They do it with a tax deferral; not a tax exemption. And they do it with a tax incentive that provides its greatest benefit, relative to total taxes paid, to those at low and middle income levels (please refer to Chart 2 and Table 5 on pages 16 and 17 of my statement). Of those covered by employer pensions over 76 percent earned less than $25,000 in 1983.

Fifth, this system has led to almost universal--98 percent--employer-provided pension protection among workers in firms employing over 1,000 employees; and very significant--80 percent--protection among firms employing over 250 employees; in unionized firms 82 percent of workers are protected; among workers age 45-64, 65 percent are protected.

Sixth, your Subcommittees can readily identify where the system of employer-provided pensions is not now prominent: nearly 82 percent of all noncovered employees work for employers with less than 500 employees; 68 percent work for firms with less than 100 employees. Eighty-nine percent are in nonunionized jobs; 44 percent are under age 35; 51 percent have been on their current job less than five years.

Seventh, experience since 1974 indicates that individual efforts to save for retirement are not a replacement for protection through an employer. Of those without employer-provided pensions, only 12.3 percent have established Individual Retirement Accounts.

In conclusion, I note that the Congress has provided a structure of laws and incentives that have combined to create a very successful retirement income system. There is room for improvement, but the data show that the combination of Social Security and employment based programs has accomplished a great deal in terms of the economic security of our retired population. EBRI is now in the process of publishing a major study titled The Changing Profile of Pensions in America which we will happily provide to you and your staff to aid you in your work on this subject.

I would be pleased to take any questions you might have, and offer EBRI's full support to the Committee as you proceed with your review. EBRI does not make recommendations for or against legislation the Congress may be considering, but we are pleased to make available to you and the Committee all the pertinent facts that may bear on your decisions.

## Full Statement

### Introduction

Chairman Pickle and Chairman Jones, I think it especially appropriate for the Employee Benefit Research Institute (EBRI) to be providing background information for this hearing on a subject of special importance to today's workers and retirees. EBRI is a nonprofit, nonpartisan research organization based in Washington, DC. EBRI does not make recommendations for or against legislation the Congress may be considering, but we are pleased to make available to you and the Committee all the pertinent facts that may bear on your decisions.

In an April 1985 survey conducted by Hamilton and Staff, 58 percent of full-time workers rated the existence of a pension plan at work as being "very important." Only 15 percent of those polled felt that Social Security would be a <u>major</u> source of retirement income. Sixty-four percent believed they would have enough money in retirement, though most of these apparently believed that employer-sponsored pensions would enable them to achieve that goal. When asked if they would have enough to retire with a reduced pension, only 24 percent answered "yes." A full 82 percent of employees agreed with the statement that: "If employers did not provide benefits, the government would end up paying." The answers to these survey questions reflect the importance of employer-sponsored pensions to the American worker--and why this Committee is concerned about them.

The system of employer-sponsored pensions is becoming increasingly more important to the provision of retirement income nationwide.

The role of employers in providing pensions has increased dramatically, especially in the aftermath of World War II. Twenty-five thousand private employer-sponsored retirement income and capital accumulation programs existed in 1950 with accumulated assets of $12.7 billion. The participation rate for nonagricultural wage and salary workers was 25 percent.

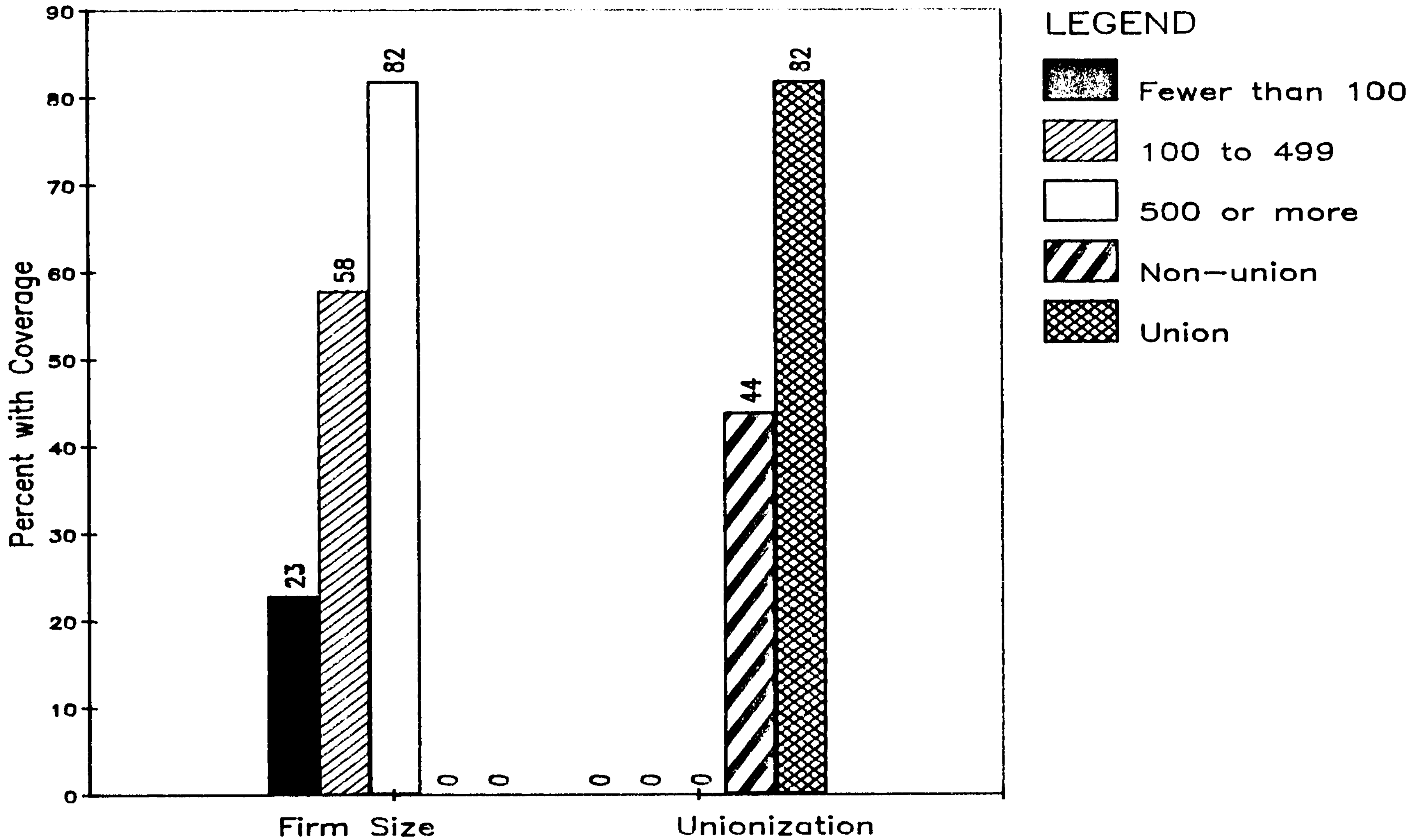
Over 800,000 private employer-sponsored retirement and capital accumulation plans exist today with accumulated assets exceeding $925 billion. Were private pension plan assets to grow at the same rate as they have since 1968, which is highly questionable for a number of reasons, they would reach $7.5 trillion by the year 2,000, according to some very rough estimates by EBRI. Today, there is an additional $300 billion in assets in state and local plans, which could grow to $2.7 trillion by the year 2,000, again according to our very rough estimates. The coverage rate for private nonagricultural wage and salary workers is more than 50 percent (see Chart 1) and over 80 percent for public-sector employees.

In 1950, the percentage of retirees receiving pension income was negligible. By 1962, 16 percent of retired married couples and 5 percent of unmarried retirees received pension income. By 1982, a Census Bureau survey found 33 percent of over-age 65 married couples and 15 percent of unmarried retirees had private pension income. The Social Security Administration recently found that among new beneficiaries substantial numbers of retirees had pension income from an employer-sponsored plan: 56 percent of married couples had pension income--38 percent with private pension, 21 percent with public pension; and 42 percent of unmarried beneficiaries had pension income--27 percent with private pension and 16 percent with public pension.

For the "newly retired" couple in 1981, in cases where only the husband receives a benefit, the average Social Security check was $671 per month; those with pensions received an additional $656. When both the husband and the wife received benefits, the monthly Social Security check rose to $836

## Chart 1

Percent of Non-Farm Private Employees with Pension Coverage, by Firm Size and Unionization, May 1983




Source: Employee Benefit Research Institute

and the pension income rose to $899. The pension income was greater than the asset income, which added $539 per month.

As these statistics indicate, the retirement and capital accumulation plan system has grown significantly over the past 35 years in terms of participants, assets, benefit recipiency, and benefit amounts.

Now, I will turn to the specific questions you presented in the announcement of this hearing.

**1a. What is retirement?**

Retirement, according to the Random House dictionary, is to "withdraw from office, business, or active life." This can be a mandatory or voluntary event. Webster's is in general agreement: "to withdraw from one's position or occupation." The event of retirement is frequently identified with age, such as the "normal" retirement age under a pension program or the "mandatory" age of retirement.

Increasingly, retirement is marked as the point of eligibility for a pension from a particular job or from Social Security. For most, it represents the transition to a period during which earned income is no longer essential for the majority of one's income, even though it does not involve "withdrawal from active life" for most initial retirees today.

**1b. What level of work activity separates the working from the retired?**

An individual can be "retired" and still work a large number of hours per week. The truer measure is whether the individual economically needs to be working given the presence of pension income, and the type of work they are doing. The individual termed "fully retired" would not do compensated work.

**1c. What should the role of post-retirement earnings be in a retirement income security system?**

The nation should strive for a retirement income system that provides a reasonable enough level of income to retirees, at an age which is deemed reasonable for retirement, that they are not required to work. Why? Because the percentage who cannot work increases with each higher age group.

**1d. Do demographic and economic changes expected over the next 30 years warrant a change in the definition of retirement itself?**

The answer is not as simple as yes or no, since it is so dependent on health status and individual circumstances. Even though life expectancy is increasing (mortality experience), the jury is out on health status generally (morbidity). The nation will continue to be well served by a system that allows significant flexibility so that demographic and economic change can be accommodated, and, by a system that has a significant component that is "advance funded."

**2a. What are the major sources of retirement income today?**

The major sources of retirement income for elderly households are common among married and unmarried households, but the recipiency rates differ.

Table 1

Income Sources for Elderly Households, 1982

| | Married % | Unmarried % |
|---|---|---|
| Social Security | 92 | 89 |
| Employer Pensions | 49 | 26 |
| Property Income | 77 | 61 |
| Earnings | 36 | 12 |
| Other | 13 | 18 |

Source: March 1983 Current Population Survey

Table 2

Percent receiving retirement benefits other than social security: Retired-worker beneficiaries receiving first payable benefit in June 1980–May 1981, by PIA quartile, sex, and marital status

| Sex and marital status | Total | PIA quartile: Low | Second | Third | High |
|---|---|---|---|---|---|
| | Percent receiving— | | | | |
| | Own public or private pension or IRA or Keogh benefit | | | | |
| Total | 43 | 22 | 32 | 56 | 64 |
| Men: | | | | | |
| Married | 55 | 58 | 34 | 52 | 63 |
| Unmarried | 42 | 20 | 20 | 57 | 64 |
| Women: | | | | | |
| Married | 25 | 10 | 32 | 59 | 66 |
| Unmarried | 44 | 24 | 34 | 64 | 71 |
| | Own private pension | | | | |
| Total | 27 | 3 | 14 | 42 | 51 |
| Men: | | | | | |
| Married | 36 | 2 | 7 | 39 | 52 |
| Unmarried | 26 | 1 | 4 | 43 | 48 |
| Women: | | | | | |
| Married | 14 | 3 | 18 | 44 | 41 |
| Unmarried | 27 | 6 | 21 | 48 | 48 |
| | Own public pension | | | | |
| Total | 16 | 18 | 18 | 15 | 12 |
| Men: | | | | | |
| Married | 19 | 56 | 29 | 15 | 10 |
| Unmarried | 17 | 19 | 17 | 18 | 13 |
| Women: | | | | | |
| Married | 11 | 7 | 13 | 14 | 26 |
| Unmarried | 16 | 19 | 13 | 15 | 24 |
| | Own IRA or Keogh benefit | | | | |
| Total | 2 | (1) | 1 | 2 | 3 |
| Men: | | | | | |
| Married | 2 | (1) | (1) | 2 | 4 |
| Unmarried | 1 | 1 | 0 | 0 | 4 |
| Women: | | | | | |
| Married | 1 | (1) | 2 | 2 | 2 |
| Unmarried | 1 | (1) | 1 | 2 | 1 |

[1] Less than 0.5 percent.
Source: Appendix table A.

Source: U.S. Social Security Administration, *Social Security Bulletin*, Vol. 48, no. 5, Table 3 (Washington, DC: U.S. Government Printing Office, 1985), p. 10.

A recent report from the Social Security Administration indicates that new beneficiaries have more supplementation of Social Security at all income levels than the population of all retirees, and that supplementation frequency increases with income as the income replacement value of Social Security decreases ("Income of New Retired Workers by Social Security Benefit Level"). This data is presented in Table 2.

**2b. To what extent do retirees now depend on pension plans, Social Security and savings for retirement income?**

The tables cited above indicate the degree of receipt. The relative dollar value of alternative sources of retirement income is shown by data from the Survey of Income and Program Participation Current Population Reports (Household Economic Studies Series P-70, No. 4). Table 3 presents information for the second quarter of 1984 on the 84 million households surveyed on the relative value of alternative sources of income. Table 4 shows how earnings and benefit levels vary by income level and provides a view of the way in which alternative income sources fit together.

Table 3

Income Sources and Levels, 1984 Second Quarter

| Source | Number (millions) | Mean Monthly Income | Mean Amt. of Source | % of Tot. Income |
|---|---|---|---|---|
| Social Security | 23.5 | $1,590 | $562 | 35.3 |
| Private Pension | 7.2 | $1,902 | $394 | 20.7 |
| Fed Pension | 1.7 | $2,643 | $944 | 35.7 |
| Mil Pension | 1.3 | $3,555 | $1,014 | 28.5 |
| St/L Pension | 2.5 | $2,211 | $573 | 25.9 |

Source: Survey of Income and Program Participation

**2c. What is the desirable "mix" for the various sources?**

Social Security provides a floor of income protection for retirees. At the lowest income levels, for full career workers this can mean near total income replacement. For the highest earning quartile it might mean less than 25 percent of final pay. Employer-sponsored pensions in both the public and private sectors now provide additional income for a growing number of retirees. The President's Commission on Pension Policy (1980) recommended a set of target replacement rates for full career workers. On an after tax basis these ranged from 86 percent for the married couple earning $6,500 in the year before retirement to 55 percent for the married couple earning $50,000. Employer plans are frequently designed with a 60 percent target in mind (a common formula is 2 percent per year assuming 30 years of service).

Table 4 shows that the mean Social Security benefit paid to the lowest income retiree couples is equal to the mean earnings amount, while for the highest earners the Social Security benefit may represent only 10 percent of final earnings.

**3a. How can we define "adequate" retirement income security?**

Ideally individuals should be able to maintain a relatively constant life style after they retire, as compared to pre-retirement. The replacement rates noted above were designed to do this at alternative income levels after adjusting for reduced expenses and taxes. This could be termed "adequate." Further, "minimum" adequacy might be guided for the lowest income individuals and households as the benefit levels under Supplemental Security Income, unemployment compensation, or worker's compensation.

**3b. What is a desirable level of post-retirement income in terms of replacement of earnings?**

Table 4

**Households, by Income Level, Receipt of Earnings, and Income From Selected Nongovernment Sources: Monthly Average, Second Quarter 1984**

| Source of income | Total | Monthly income | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | Under $600 | $600 to $1,199 | $1,200 to $1,999 | $2,000 to $2,999 | $3,000 to $3,999 | $4,000 to $4,999 | $5,000 and over |
| All households.......... | 84,002 | 12,375 | 15,466 | 18,936 | 17,461 | 9,569 | 4,718 | 5,478 |
| Earnings: | | | | | | | | |
| Number with................. | 61,505 | 2,564 | 8,705 | 15,314 | 16,070 | 9,114 | 4,541 | 5,197 |
| Mean amount................. | $2,394 | $343 | $773 | $1,377 | $2,198 | $3,133 | $3,996 | $7,025 |
| Property income: | | | | | | | | |
| Number with................. | 57,722 | 4,438 | 8,750 | 12,990 | 13,725 | 8,322 | 4,343 | 5,156 |
| Mean amount................. | $255 | $36 | $109 | $135 | $161 | $219 | $304 | $1,263 |
| Company or union pensions: | | | | | | | | |
| Number with................. | 7,238 | 520 | 2,176 | 2,296 | 1,264 | 477 | 233 | 273 |
| Mean amount................. | $394 | $119 | $219 | $375 | $452 | $561 | $674 | $1,670 |
| Social Security or railroad retirement: | | | | | | | | |
| Number with.................. | 23,508 | 5,299 | 6,929 | 5,491 | 3,132 | 1,391 | 577 | 690 |
| Mean amount.................. | $562 | $351 | $554 | $664 | $666 | $640 | $676 | $720 |

B Base less than 200,000.

Source: U.S. Bureau of the Census, Current Population Reports, Series P-70, No. 4, Economic Characteristics of Households in the United States: Second Quarter 1984, Table E (Washington, DC: U.S. Government Printing Office, 1985), p. 5.

The 60 percent replacement target noted above is generally viewed as reasonable, as long as there is a minimum payment program such as Supplemental Security Income available to take care of those who have not worked enough to earn work-related benefits.

**3c. To what extent should our retirement system guarantee that level of income in retirement, and to what extent should individuals bear the responsibility and risk for providing for themselves?**

Government policy should provide a floor of income on a mandatory basis. This is accomplished in this country through Social Security and other social programs. Social Security provides an "adequate" benefit for low-income, full-career workers by using a weighted and redistributional formula. This same formula means that higher income individuals receive a much lower benefit relative to income. A pay-as-you-go program should not be used to fill the "gap" for these persons. The government should provide incentives to encourage persons to save to supplement Social Security, even those at low income levels, due to high retiree medical and long term care expenses.

These incentives can be most effective when tied to employment. The federal government has recognized this by establishing military and civil service retirement systems. State and local government and private employers have done the same. These programs represent forced savings for retirement. Most state, local and private programs are advance funded so that present taxpayers, workers and stockholders pay for their own benefits. Above some retirement income level the government should require effort at the individual level without further incentive. (The law now specifies a limit on what employers can offer under Internal Revenue Code section 415. Individuals have to provide for themselves beyond this limit.)

**3d. How close to that level of adequate retirement security are we today?**

We are at that level (in terms of the targets set by the President's Commission) for full-career low-income workers, near that level for average income workers with a full-career attachment to the work force, and at a level of sufficiency for most higher income workers who have retired in recent years. Recent government reports indicate that the overall elderly poverty rate (14.1 percent) is lower than that for children (22 percent).

For those who have had limited attachment to the work force we still have a great distance to go -- almost one-half of all widows who are black and older than 65 were considered poor in 1983. This, however, is a test of our social commitment to those who have not worked, not a test of our employment-based programs.

**4a. What role does federal tax policy play in retirement income security?**

Tax policy plays a central role in retirement income security. Employees, whether they be federal, state and local government, or private sector, have a preference for forced savings, particularly forced savings on which taxes are deferred until benefits are received. Employers have provided these programs for decades as a means of allowing work-force adjustments while maintaining individual dignity. They have been encouraged to do so by the current tax treatment of contributions up to a certain level as deductible expenses.

Tax policy has also helped to assure that most workers at all earnings levels would have the opportunity to participate in programs so that Social Security benefits would be supplemented if they, alone, did not provide adequate benefits. Nondiscrimination standards in the law and restrictions on "integration" have resulted in broad-based participation and benefit receipt.

**4b. What were the current income tax code provisions concerning qualified pension plans, cash and deferred arrangements, etc., designed to do?**

These provisions of the law were designed to increase capital formation and to encourage workers to increase their level of saving; to provide a means for workers to have assets to allow lifestyle transitions upon termination of employment; to allow employers to restructure work forces while allowing workers to maintain a standard of living and their dignity; to supplement Social Security and in the process to keep additional demands from building on that program; and to provide an advance-funded component of the retirement income system.

These varied objectives were to be fulfilled by different types of plans:

The first category of plans were strictly called pensions prior to 1974. These plans were specifically designed to provide retirement income as a stream of payments. Private employers generally pay all contributions in these plans. These plans include defined-benefit pension plans and defined-contribution plans which require payment of benefits in the form of an annuity.

The second category of plans are identified in ERISA as those which provide for capital accumulation until termination of employment. These plans were specifically designed to provide savings for use on a discretionary basis upon retirement or upon other separation from a job. These plans include defined-benefit and defined-contribution plans which pay out as a lump-sum distribution.

**4c. Are they achieving those goals currently?**

A number of different types of plans have developed since 1921 to fulfill these two sets of goals: retirement saving and capital accumulation.

Defined-benefit plans are plans which promise a certain final benefit. Private sector employers make all contributions and in the event of investment shortfalls the employer makes up the difference to assure the payment of promised benefits. 94 percent of these plans always pay benefits as a stream of payments; 6 percent allow lump-sum distributions in certain circumstances. As of the end of 1984 there were approximately 250,000 of these plans with 40 million participants.

Money purchase plans are plans which promise a certain contribution by the employer. The worker absorbs investment gains and losses. These plans generally encourage workers to select an annuity rather than a lump-sum distribution. The TIAA-CREF teachers retirement system is the equivalent of a money purchase plan which only pays benefits in annuity form. As of the end of 1984 there were approximately 180,000 of these plans in operation in the private sector.

Profit sharing plans are plans which usually "promise" a given percent of pay contribution to an individual employee account, with the dollar amount varying with corporate profitability. The worker absorbs investment gains and losses. Some of these plans allow the worker to chose to take a portion of the contribution allocation as current salary rather than leaving it in the plan. Profit sharing plans generally pay benefits as a lump sum. Profit sharing plans are designed to increase worker productivity and worker interest in efficiency and profitability as well as to produce capital accumulation.

Thift-savings plans represent an employee and employer partnership towards the goal of capital accumulation. Employees make contributions with after-tax dollars and employers generally provide a matching contribution into an allocated account for each worker. The employer contribution is not taxed as income to the employee until received. These plans meet an objective of individual savings, with funds generally paid out as lump-sum distributions.

Cash or deferred arrangements are increasingly referred to as salary reduction plans or by their code section, 401(k). The plans also represent an employee and employer partnership toward the goal of capital accumulation. Employees make contributions with pre-tax dollars and many employers provide a matching contribution into an allocated account for each worker. The employer contribution is not taxed as income to the employee until received. These plans meet an objective of individual savings, with funds generally paid out as lump-sum distributions.

Individual retirement accounts have been available to all workers since 1982. These accounts allow workers to contribute up to

$2,000 (plus $250 for a nonearning spouse) on a pre tax basis, with investment earnings receiving tax deferred treatment. During each year of general availability approximately 13 million tax returns have included contributions to IRAs.

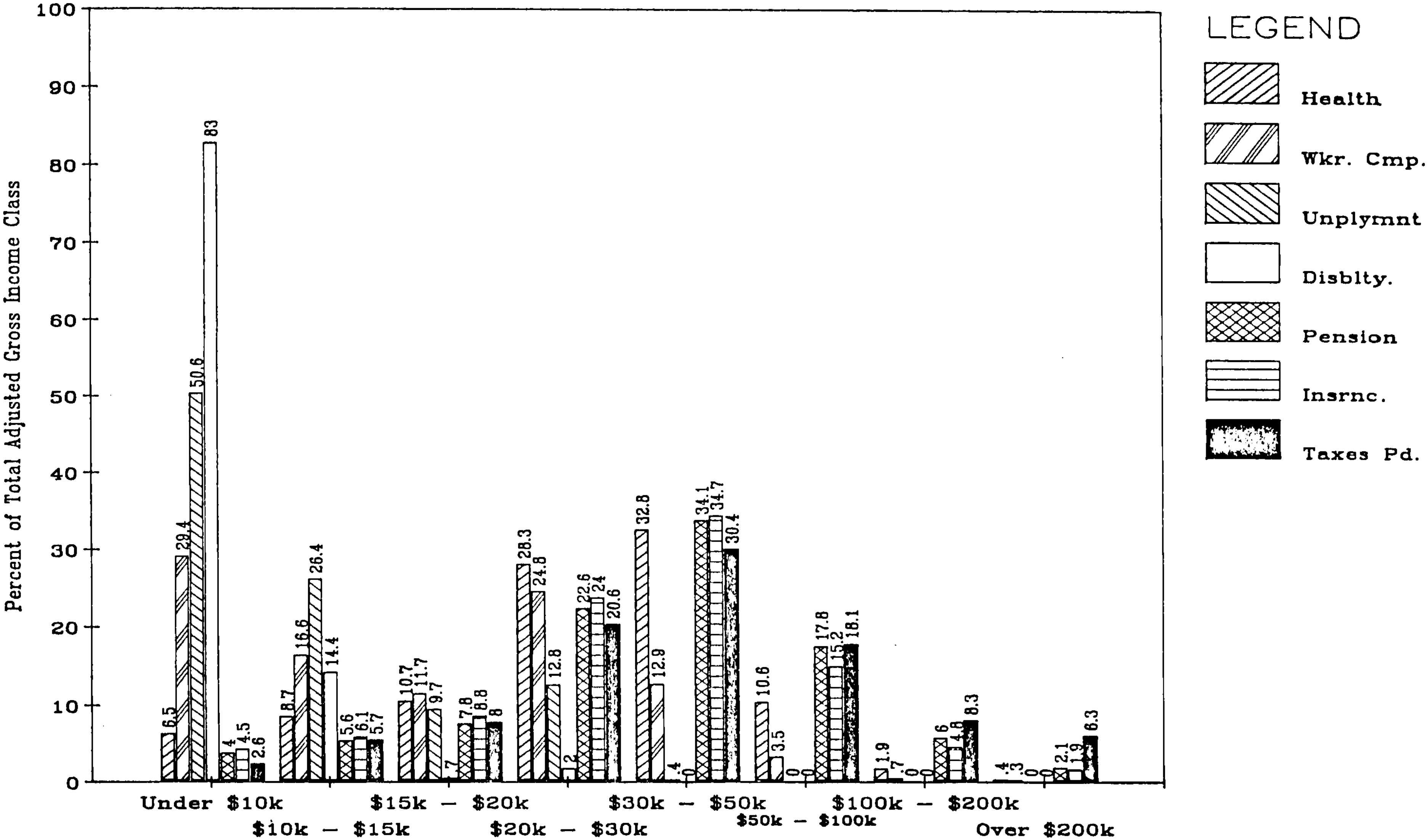
Each of these plans is responding to the goals set out for it in the tax law, as the tax law is currently written. If other goals are desired, then current tax policy has to be modified.

**4d-i. How efficient is the current structure in distributing tax benefits?**

A number of studies have been done to assess horizontal and vertical equity of the tax provisions. The Treasury Department conducted such a study in 1982 (Chart 2). Chart 2 and Table 5 show that the tax value of employee benefit incentives parallels tax payments, with low income persons getting more of the value of the tax reductions than their share of tax payments, and the highest paid getting less. In other words, a change in the tax treatment of benefits would lead to a regressive result. More recent studies by economists Deborah Chollet and Sophie Korczyk confirmed these findings, as did a Congressional Budget Office (CBO) analysis of the health care tax cap proposal published in 1983.

Private retirement program tax expenditures form the single largest category of tax expenditures in the federal budget. They arise from the deferral of taxes paid on: (1) pension and retirement saving contributions and (2) earnings on these contributions. The dollar value of the tax expenditure demands that equity and efficiency questions be explored. A major new study by Dr. Korczyk, <u>Retirement Security and Tax Policy</u>, assesses these incentives in a <u>lifetime</u> context. She finds that the economic value to the government is significantly greater than looking at tax expenditure numbers alone would imply. As much as 72 percent of the

# Chart 2
## Benefits
## Revenue Loss and Taxes Paid




Source: Employee Benefit Research Institute

Table 5

**Revenue Loss for Major Benefits and Taxes Paid by Income Class as Percent of Total Adjusted Gross Income Class, 1981[a]**

| Adjusted Gross Income Class | Exclusion of Employer Contributions for Medical Insurance & Medical Care | Exclusion of Worker's Compensation Benefits | Exclusion of Untaxed Unemployment Insurance Benefits | Exclusion of Disability Pay | Net Exclusion of Pension Contributions & Earnings[b] | Exclusion of Insurance Premiums[c] | Percent of Total Taxes Paid |
|---|---|---|---|---|---|---|---|
| Less than $10,000 | 6.5% | 29.4% | 50.6% | 83.0% | 4.0% | 4.5% | 2.6% |
| $ 10,000 to $ 15,000 | 8.7 | 16.6 | 26.4 | 14.4 | 5.6 | 6.1 | 5.7 |
| $ 15,000 to $ 20,000 | 10.7 | 11.7 | 9.7 | 0.7 | 7.8 | 8.8 | 8.0 |
| $ 20,000 to $ 30,000 | 28.3 | 24.8 | 12.8 | 2.0 | 22.6 | 24.0 | 20.6 |
| $ 30,000 to $ 50,000 | 32.8 | 12.9 | 0.4 | - | 34.1 | 34.7 | 30.4 |
| $ 50,000 to $100,000 | 10.6 | 3.5 | - | - | 17.8 | 15.2 | 18.1 |
| $100,000 to $200,000 | 1.9 | 0.7 | - | - | 6.0 | 4.8 | 8.3 |
| $200,000 and over | 0.4 | 0.3 | - | - | 2.1 | 1.9 | 6.3 |

SOURCE: EBRI calculations based on U.S. Congress, Congressional Budget Office, Revising the Individual Income Tax, July 1983 (Washington, D.C.: U.S. Government Printing Office, 1983), Table 9, pp. 62 and 63.

NOTE: Percents may not add to 100.0 percent due to rounding.

[a] 1981 income levels and 1982 law.
[b] Includes the exclusion of contributions and earnings for employer plans and plans for the self employed and others.
[c] Includes premiums for group-term life insurance and accident and disability insurance.

real (i.e., inflation-adjusted) value of taxes deferred during the pension participants' working career is ultimately repaid as income tax during retirement.

Chart 3 and Table 6 show that Treasury tax expenditure statistics, calculated on a cash-flow basis, leave the impression that the proportion of current tax deferrals permanently lost to the Treasury is very large. Treasury statistics imply that 83 cents out of every deferred dollar is permanently lost, with the other 17 cents accounted for by current tax payments by retirees. When examined in a lifetime context, the proportion of deferred taxes lost to the Treasury ranges from 14 cents out of every dollar to 40 cents, depending on whether or not one adjusts for inflation and interest on deferred taxes and on the interest factor used.

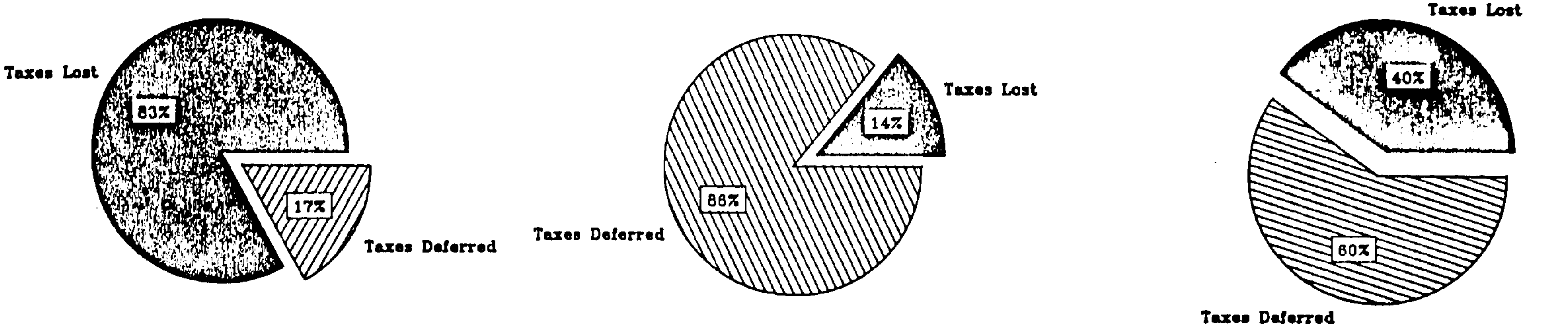
One factor that has not generally been considered in discussing changes in the tax treatment of employee benefits, however, that could involve a significant shift in the incidence of the income tax is the increasing cost, and therefore value of benefits, as workers age. This would represent a major effect of tax policy change.

Employee benefits such as defined-benefit pensions and health insurance are almost always discussed as a flat dollar cost per employee or as a level percentage of pay per employee. Employee representatives, employees, and employers have been content with this approach since the actual distribution of cost <u>does not</u> affect either the taxes to be paid by the employee or the employer. As a result, the only attention given to date to <u>actual</u> per employee cost variation has been undertaken very recently to assess: (1) approaches to health care cost containment and (2) possible disincentives to hiring or keeping on older workers. These recent studies show very significant cost variation by age (Chart 4 and Table 7).

Chart 3

Pensions

Revenue Lost Vs. Deferral




Treasury Cash Flow | Lifetime – Nominal | Lifetime – Real/Discounted

Source: Employee Benefit Research Institute

Table 6

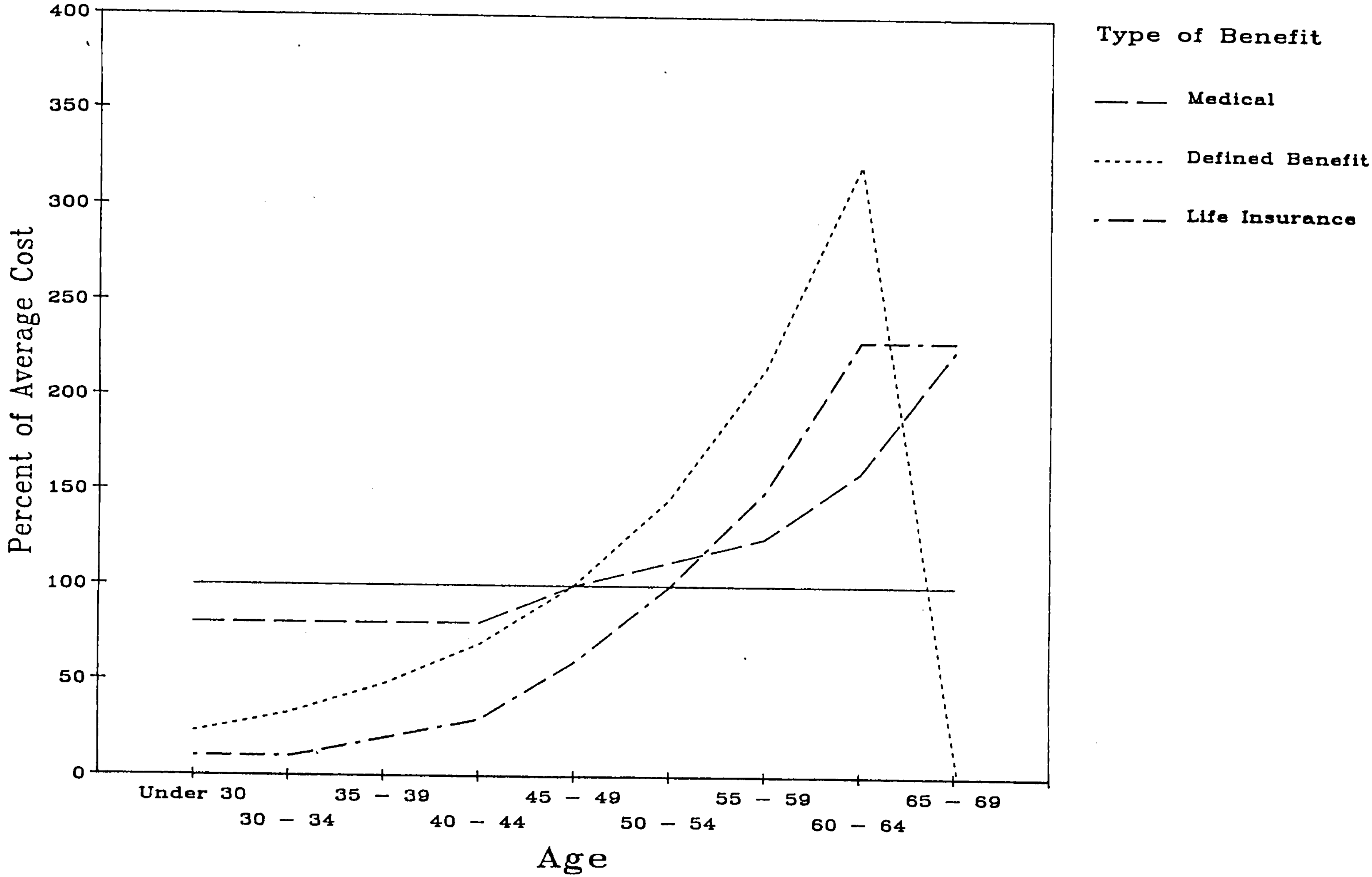
How Much of Pension-Related Tax Deferrals is Lost to the Treasury?

| Method Used | Taxes Lost | Taxes Deferred |
|---|---|---|
| Treasury Method | 83% | 17% |
| Lifetime Method: | | |
| Nominal dollars a/ | 14 | 86 |
| Real dollars b/ | 28 | 72 |
| Discounted for interest: c/ | | |
| at pension rate | 40 | 60 |
| at federal rate | 36 | 64 |

SOURCE: Sophie M. Korczyk, Retirement Security and Tax Policy (Washington, DC: Employee Benefit Research Institute, 1984).

a/ Before adjusting for inflation.
b/ After adjusting for inflation.
c/ Interest rate used to discount taxes paid in retirement to the year of retirement.

# Chart 4
## Benefit Cost by Age




Source: Employee Benefit Research Institute

Table 7

Summary of Cost Factors by Age for Use in Costing Benefit Plans

| Age Group | Medical Cost Factor as % of Average Cost | Defined Benefit Cost Factor as % of Average Cost | Life Insurance Cost as % of Pay for One Times Pay |
|---|---|---|---|
| Under 30 | 80.0% | 23.0% | 0.1% |
| 30-34 | 80.0% | 33.0% | 0.1% |
| 35-39 | 80.0% | 48.0% | 0.2% |
| 40-44 | 80.0% | 69.0% | 0.3% |
| 45-49 | 100.0% | 100.0% | 0.6% |
| 50-54 | 112.5% | 146.0% | 1.0% |
| 55-59 | 125.0% | 216.0% | 1.5% |
| 60-64 | 160.0% | 323.0% | 2.3% |
| 65-69 | 225.0% | * | 2.3% |

SOURCE: The Costs of Employing Older Workers (Washington, DC: U.S. Special Committee on Aging and the Employee Benefit Research Institute, forthcoming).

Note: Same life insurance cost is assumed for 65-69 as for 60-64 because it is assumed that the benefits will be reduced to equal cost; regulations allow a 30% reduction.

If benefits are not reduced, assume costs at 65-69 are about 30% higher.

Defined contribution costs are the same by age.

Does this cost variation make a tax policy difference? The answer will be yes if employee benefits were to be subjected to income tax or FICA tax. Employees would come to recognize the inequity involved in paying taxes without reference to the true economic value of the benefit being provided. This could lead to demands for a system of taxing based upon the actual dollar value of the benefit provided or a move to tax the benefits paid instead of the premium. This would require a total restructuring of the way in which benefit programs are run.

Present approaches to health insurance pricing and delivery were developed in the present tax environment. A major change in that environment will have a major effect on those approaches and structures. Nearly all of the government and academic research done on this subject to date assumes that a change in tax policy will not change the method of providing or pricing benefits.

Finally, econometric estimates of private health insurance suggest that significant numbers of persons now covered would not choose to purchase health insurance if it were not available from an employer and largely paid for by the employer.

The previously referenced analysis by the Treasury Department shows that for employer-sponsored plans the tax benefits are distributed across the income spectrum in close relationship to income. The lowest income groups receive more of the tax benefit than the proportion of taxes they pay,while higher income workers receive less of the tax benefit than their share of tax payments. According to analysis by the Treasury Department the "tax subsidy" is distributed evenly across the income spectrum, with 76 percent of the value going to those earning less than $50,000, as compared to 6 percent in the case of tax exempt municipal bonds and approximately half for capital gains. In other words, the system is efficient given our progressive tax structure.

**4d-ii. How efficient is the current structure in assuring pension coverage across income levels?**

Coverage is efficiently spread across income levels. Among full-time employees over the age of 25, 70 percent are covered by a pension and 37 percent currently are entitled to a vested benefit. Of all civilian workers age 14 to 64, 52 percent are covered and 24 percent are entitled to a vested benefit. Nearly 83 percent of all nonagricultural wage and salary workers earn less than $25,000 per year. Pension coverage and vesting follow this pattern, with 76 percent of those covered and 70 percent of those vested earning less than $25,000. While the proportion of those earning over $50,000 participating in a retirement program is high, these persons represent only 2.89 percent of all pension participants.

There are still many workers not covered by a pension plan, but they are almost entirely accounted for by the reluctance of small employers to offer pension plans. Among medium and large employers, nearly all full-time workers are covered by a plan.

Individual retirement accounts are most frequently opened by individuals who have an employer-sponsored pension, as well, and the distribution is much more weighted toward high income individuals than coverage or vesting in employer-sponsored plans.

The absolute number of workers covered by pension and capital accumulation plans has continued to grow, but due to the large number of new jobs being created by small businesses, the percentage of the total work force covered by plans has declined. The primary reason: small business does not provide pension coverage at the high rate found in large businesses (see Chart 1). If this does not change, then pension coverage is nearly as high as it can ever be expected to climb. The United Kingdom, for example, has had 50 percent of the work force covered by employer pension plans for twenty years.

It is difficult to increase coverage and participation. Last year, for example, Congress enacted the Retirement Equity Act (REA), which reduced the age for participation from 25 to 21, and the age for counting service for vesting from 22 to 18. EBRI estimates that these changes increased participation by 530,000 workers--or about 1 percent--and increased vesting by 300,000--or about 1 percent. In short, only 5.6 percent of the 9.5 million workers between the ages of 21 and 25 worked for employers with plans _and_ worked at least 1,000 hours per year _and_ had been on the job for one year. The improvements from REA are real, but such minimum standard changes are no replacement for increases in coverage through new plan creation among small businesses.

Forty-nine million of 88 million nonagricultural wage and salary workers were covered by employer-sponsored programs in May of 1983 (56 percent). Most covered workers earn relatively modest salaries. Over 76 percent of all covered employees and 70 percent of all vested employees earned less than $25,000 a year in 1983 (see Table 8).

When one considers those that ERISA required to be included in employer plans--i.e., those between the ages of 25 and 64 working 1,000 hours per year and on the job at least one year--the base drops to 54 million workers, of which 38 million (70 percent) are covered by a private or public employer-sponsored plan (see Table 9).

Who is covered by an employer-sponsored plan is not a gamble. Coverage is a function of very predictable factors: in larger firms of more than 500

TABLE 8: EMPLOYMENT, COVERAGE AND VESTING: DISTRIBUTION BY EARNINGS FOR NONAGRICULTURAL WAGE AND SALARY WORKERS, MAY 1983

| EARNINGS | Number of Workers (000's) | | |
|---|---|---|---|
| | Employment | Coverage | Total Vested Benefits |
| Total | 88,214 | 49,530 | 28,708 |
| $1-4,999 | 10,014 | 2,433 | 358 |
| $5,000-9,999 | 15,323 | 5,747 | 2,023 |
| $10,000-14,999 | 17,827 | 10,328 | 5,484 |
| $15,000-19,999 | 13,101 | 9,422 | 5,874 |
| $20,000-24,999 | 10,283 | 8,159 | 5,641 |
| $25,000-29,999 | 5,515 | 4,365 | 3,048 |
| $30,000-50,000 | 6,611 | 5,547 | 4,071 |
| $50,000 and over | 1,615 | 1,371 | 1,106 |
| Not reported | 7,924 | 2,158 | 1,105 |
| | Percentage Distribution Within Earnings Group | | |
| | Employment | % Covered to Employed | % Vested to Employed |
| Total | 100.00% | 56.15% | 32.52% |
| $1-4,999 | 100.00 | 24.29 | 3.57 |
| $5,000-9,999 | 100.00 | 37.51 | 13.20 |
| $10,000-14,999 | 100.00 | 57.93 | 30.76 |
| $15,000-19,999 | 100.00 | 71.92 | 44.83 |
| $20,000-24,999 | 100.00 | 79.34 | 54.85 |
| $25,000-29,999 | 100.00 | 79.14 | 55.26 |
| $30,000-50,000 | 100.00 | 83.91 | 61.57 |
| $50,000 and over | 100.00 | 84.90 | 68.50 |
| Not reported | 100.00 | 27.23 | 13.94 |
| | Percentage Distribution Across Earnings Groups[a] | | |
| | % Employment | % of Coverage | % of Total Vesting |
| Total | 100.00% | 100.00% | 100.00% |
| $1-4,999 | 12.47 | 5.14 | 1.30 |
| $5,000-9,999 | 19.08 | 12.13 | 7.33 |
| $10,000-14,999 | 22.20 | 21.80 | 19.87 |
| $15,000-19,999 | 16.32 | 19.89 | 21.28 |
| $20,000-24,999 | 12.81 | 17.22 | 20.43 |
| $25,000-29,999 | 6.87 | 9.21 | 11.04 |
| $30,000-50,000 | 8.23 | 11.71 | 14.75 |
| $50,000 and over | 2.01 | 2.89 | 4.01 |

SOURCE: Preliminary Employee Benefit Research Institute tabulations of the May 1983 EBRI/HHS CPS pension supplement.

[a] Percentages exclude 9.0% of employees whose earnings are not reported.

TABLE 9: EMPLOYMENT, COVERAGE AND FUTURE BENEFIT ENTITLEMENT BEFORE AND AFTER THE RECESSION, MAY 1983 AND MAY 1979

| | Employment (000's and % of Employed) | Coverage (000's and % of Employed) | Future Benefit Entitlement (000's and % of Employed) |
|---|---|---|---|
| 1983 | | | |
| Civilian Employment (All employees & self-employed) | 98,964<br>100.00% | 51,530<br>52.07% | 24,095<br>24.35% |
| Nonagricultural Wage and Salary Workers | 88,214<br>100.00% | 49,530<br>56.15% | 22,217<br>25.19% |
| Nonagricultural Wage and Salary Workers age 25 to 64 only | 68,252<br>100.00% | 42,463<br>62.21% | 20,934<br>30.67% |
| Nonagricultural Wage and Salary Workers age 25 to 64, working 1000 hours or more | 61,586<br>100.00% | 40,702<br>66.09% | 20,476<br>33.25% |
| ERISA Work Force (age 25 to 64, working 1000 hours or more, one year of tenure or more) | 54,363<br>100.00% | 38,057<br>70.01% | 20,027<br>36.84% |
| 1979 | | | |
| Civilian Employment (All employees & self-employed) | 95,372<br>100.00% | 53,445<br>56.04% | 22,633<br>23.73% |
| Nonagricultural Wage and Salary Workers | 85,181<br>100.00% | 52,019<br>61.07% | 21,399<br>25.12% |
| Nonagricultural Wage and Salary Workers age 25 to 64 only | 63,201<br>100.00% | 42,576<br>67.37% | 19,836<br>31.39% |
| Nonagricultural Wage and Salary Workers age 25 to 64, working 1000 hours or more | 58,009<br>100.00% | 40,830<br>70.39% | 19,522<br>33.65% |
| ERISA Work Force (age 25 to 64, working 1000 hours or more, one year of tenure or more) | 49,736<br>100.00% | 36,890<br>74.17% | 18,941<br>38.08% |

SOURCE: Preliminary Employee Benefit Research Institute tabulations of the May 1983 EBRI/HHS CPS pension supplement and May 1979 DOL/SSA CPS pension supplement.

employees--82 percent of nonfarm private employees are covered; in unionized firms--82 percent of workers are covered; among those 45-64 years of age--65 percent are covered; and of workers in durable goods manufacturing, nearly 80 percent of the ERISA work force is covered, versus an unusually low 34 percent coverage of the ERISA work force in the business service sector.

Firm size and union status are clear predictors of whether an employer-sponsored pension plan will be available.

The statistics allow noncovered workers to be sorted into seven categories (see Chart 5). About 15.4 percent of noncovered workers own their own businesses. These self-employed workers appear to provide retirement protection for themselves through their investment in their business.

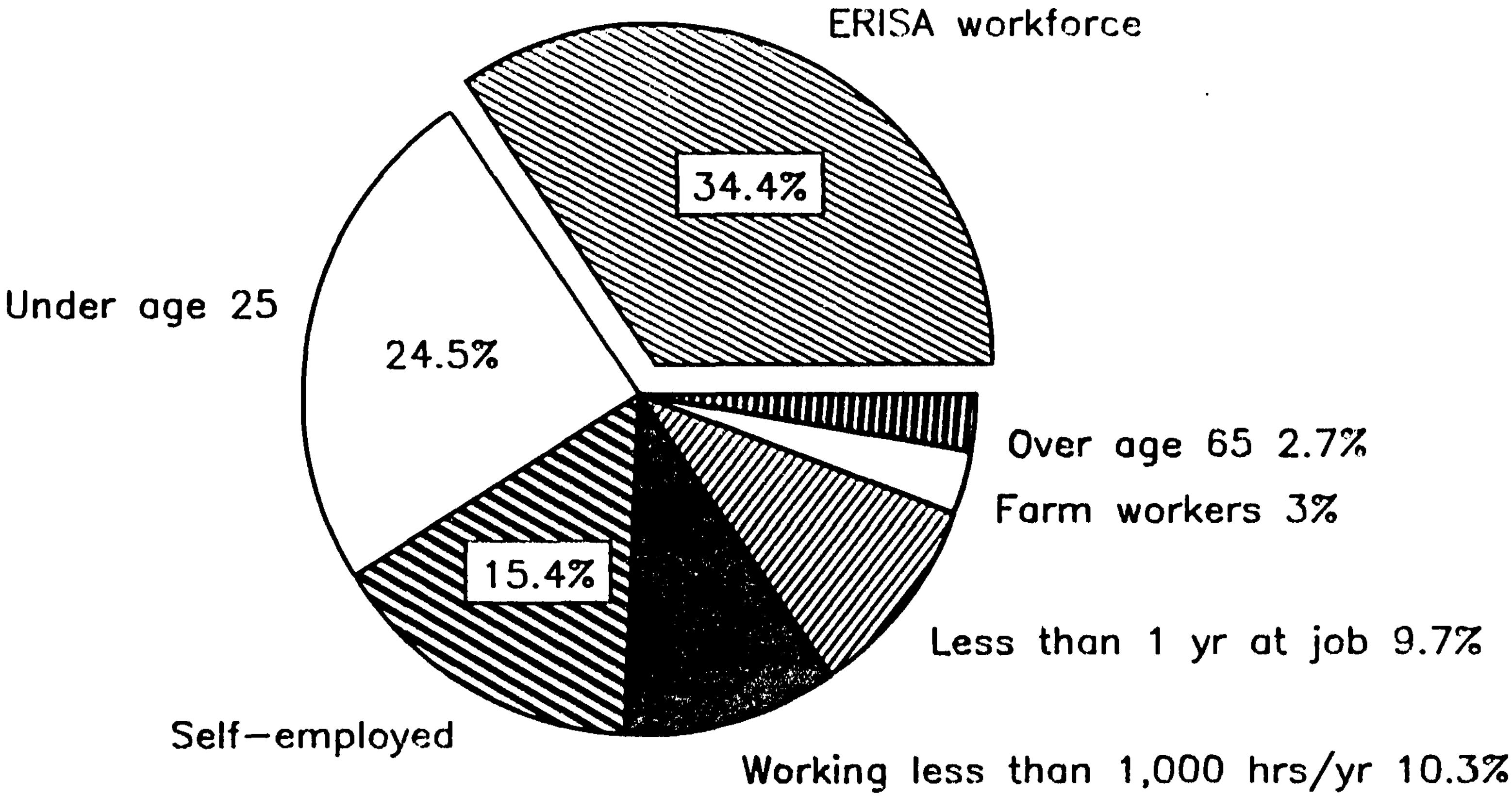
Three percent of noncovered workers are in agriculture. Their coverage rate is the lowest of all noncovered groups at just over 10 percent. Many agricultural employees are low-wage seasonal workers, employed on more than one farm. They frequently face a complex set of other labor market problems.

Nearly 25 percent of all noncovered workers in 1983 were under 25 years of age. This age group was not subject to ERISA participation standards according to the 1974 law. Young workers are more likely to have short years of service and to work part-time schedules.

Workers 65 years of age and older are also a special case; 2.7 percent of all noncovered workers fall into this group. ERISA states that defined-benefit plans may exclude all new employees within five years of normal retirement age. Furthermore, benefit accruals have not been required beyond the normal retirement age (usually age 65), although many employers do provide post-65 pension accruals.

## Chart 5

Percent Distribution of Employees Lacking Pension Coverage Across Employment Categories, May 1983




Source: Employee Benefit Research Institute

Note: "ERISA workforce" consists of all employees not included in other categories (employees meeting ERISA participation standards).

Workers without coverage who were on the job less than a year account for 9.7 percent of the noncovered, and those who usually worked less than 1,000 hours a year accounted for another 10.3 percent of all noncovered workers. ERISA standards state that pension plans only need credit a year of service to employees who work 1,000 hours or more under the plan.

Those workers meeting all 1983 participation standards, except that their employers did not sponsor a plan, made up the remaining 34.4 percent of all noncovered workers. This last group represents 16 percent of total employment.

Nearly 82 percent of all noncovered employees work for employers with less than 500 employees; 68 percent work for firms with less than 100 employees. Eighty-nine percent are in nonunionized jobs; 44 percent are under 35; 51 percent have been on their current job less than five years (see Table 10).

Vesting represents having a nonforfeitable right to a payment from the retirement or capital accumulation plan. This payment may be in the form of an annuity or lump-sum payment. If the accrued value is less than $3,500 upon separation from service, the worker can be required to take the lump sum.

Nearly 58 percent of all those covered by an employer-sponsored plan today have a vested benefit in the plan at their current employment. Reduction to a five-year vesting standard, EBRI estimates, would vest approximately 1.9 million additional workers, increasing the percentage of covered workers with vested benefits to 62 percent. Defined-benefit plans, which currently have more than 40 million participants, now commonly use the ten-year "cliff" vesting standard allowed in ERISA. Defined-contribution plans, with approximately 28 million participants, use many different

TABLE 10

THE DISTRIBUTION OF COVERED AND NONCOVERED WORKERS
IN THE "NEAR-ERISA" WORKFORCE
AGES 25 THROUGH 64 WORKING 1000 HOURS OR MORE
BY SELECTED CHARACTERISTICS, MAY 1983

| | Covered Workers (000's) | Distribution Across Groups | Workers Not Covered[a] (000's) | Distribution Across Groups |
|---|---|---|---|---|
| FIRM SIZE[b] | | | | |
| Less than 100 employees | 6,215 | 17.4% | 12,352 | 68.1% |
| 100 to 499 employees | 5,545 | 15.6 | 2,465 | 13.6 |
| 500 or more employees | 23,869 | 67.0 | 3,314 | 18.3 |
| Total | 40,702 | 100.0 | 20,894 | 100.0 |
| UNION STATUS | | | | |
| Union | 15,223 | 38.2 | 2,163 | 10.6 |
| Nonunion | 24,627 | 61.8 | 18,155 | 89.4 |
| Total | 40,702 | 100.0 | 20,894 | 100.0 |
| EARNINGS[d] | | | | |
| Less than $10,000 | 4,107 | 10.4 | 6,711 | 34.6 |
| $10,000 to $24,999 | 24,545 | 62.1 | 10,374 | 53.5 |
| $25,000 or more | 10,866 | 27.5 | 2,309 | 11.9 |
| Total | 40,702 | 100.0 | 20,894 | 100.0 |
| AGE | | | | |
| Less than 35 | 14,588 | 35.8 | 9,095 | 43.5 |
| 35 and over | 26,133 | 64.2 | 11,800 | 56.5 |
| Total | 40,702 | 100.0 | 20,894 | 100.0 |
| HOURS | | | | |
| Less than 2000 | 7,525 | 18.5 | 5,481 | 26.2 |
| 2000 and over | 33,176 | 81.5 | 15,413 | 73.8 |
| Total | 40,702 | 100.0 | 20,894 | 100.0 |
| SEX | | | | |
| Women | 16,335 | 40.1 | 9,932 | 47.5 |
| Men | 24,367 | 59.9 | 10,963 | 52.5 |
| Total | 40,702 | 100.0 | 20,894 | 100.0 |
| TENURE[e] | | | | |
| Less than 5 years | 10,613 | 28.0 | 8,328 | 51.3 |
| 5 to 9 years | 9,734 | 25.7 | 3,958 | 24.4 |
| Ten years and over | 17,518 | 46.3 | 3,830 | 23.6 |
| Total | 38,017 | 100.0 | 16,116 | 100.0 |

[a]Includes workers with no coverage, workers who do not know whether they have coverage and workers with no coverage information reported.

[b]Percentages exclude 12.7 percent of employees for whom firm size is not known.

[c]Includes workers who are not covered by a union contract, workers who do not know whether they are covered under a union contract, and workers with no reported information on unionization.

[d]Percentages exclude 4.4 percent of employees whose earnings are not reported.

[e]Total excludes 11.2 percent of employees who have worked at their current job for less than one year, doesn't include d/r.

SOURCE: Preliminary tabulations of EBRI/HHS May 1983 CPS pension supplement.

schedules, with the average vesting period being six years. Most public employer pension plans use five-year vesting.

This vesting level in current employment plans is complemented by benefit entitlement--vested status--earned under plans from previous employment. About 6.6 million workers reported entitlement to a pension benefit from a previous employer's plan in May 1983.

The number of individuals with vested benefits from current and former employment will continue to grow as the system matures and the work force continues to age. As an increasing number of employers adopt supplemental defined-contribution plans with shorter vesting schedules than the ERISA ten-year standard, an increasing number of workers will achieve vested status.

A reduction in the vesting minimum standard from ten years to five years would increase defined-benefit plan costs by between 2 and 7 percent of payroll, were the employer to maintain the same benefit formula. EBRI estimates indicate that the result could be many more workers being eligible for small benefit amounts. Under current law, the workers could be required to accept these small benefit amounts as immediate lump-sum distributions upon separation from employment. Under these current rules, data indicate that these amounts are generally consumed, rather than used to increase retirement income (see Table 11). In other words, faster vesting will only increase retirement income if workers are required to roll over distributions into another retirement plan.

**4e. Should these provisions be designed to encourage exclusively retirement income security, or are other goals equally important?**

Capital formation and savings are important to the nation. While studies indicate that IRAs are not yet adding to savings, employer-sponsored

TABLE 11

The Use of Preretirement Lump-Sum Distributions
by Purpose and Amount
(as Reported May 1983)

| | Total | less than $5,000 | $5,000 - $9,999 | $10,000 - $19,999 | Over $20,000 |
|---|---|---|---|---|---|
| TOTAL RECIPIENTS[a] (000's) | 6,594 | 5,533 | 583 | 218 | 154 |
| Percent Distribution[a] | 100.0% | 84.2% | 8.9% | 3.3% | 2.3% |
| ALL USES[b] | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |
| Total Saving | 32.0% | 26.0% | 57.6% | 78.9% | 87.3% |
| Retirement Program | 4.4 | 2.4 | * | * | * |
| Insurance Annuity | * | * | * | * | * |
| Housing Purchase | 10.1 | 9.3 | 12.5 | * | * |
| Other Investment | 16.8 | 14.0 | 29.9 | 45.9 | * |
| Total Consumption | 71.4% | 76.6% | 51.9% | 42.6% | * |
| Car Purchase | 4.8 | 4.8 | * | * | * |
| Vacation | 3.2 | 3.1 | * | * | * |
| Other Use | 63.4 | 68.7 | 40.9 | * | * |

a Recipients by lump sum amount are less than total recipients and percentages are less than 100 percent because of the omission of "don't know" and "no response" to the survey question on the value of the lump-sum distribution.

b Percentages may add to over 100 percent because recipients may have used lump sum distribution in more than one way.

* Number of workers too small for rates to be calculated reliably.

plans are reported to increase savings by at least 35 percent. The Congress must determine how important this capital formation is to the economy. It is clear from the data presented above that the system is producing significant retirement income in the presence of many plans that pay benefits in forms other than annuities.

If capital formation itself is not a sufficient goal to justify tax incentives, then capital gains and other preferences need to be reexamined as well. If this is the case, then retirement savings, as a narrower goal than under current law, would still merit tax preferences for employer plans if Social Security is to be maintained: both public support and economic well being are intertwined in this family of programs.

**4f. How does this system of tax incentives for qualified pension plans as well as for increased savings through cash or deferred compensation plans and individual savings accounts fit in with current debate over basic tax reform?**

The Administration argues in its proposal for tax reform that only retirement income merits tax incentives and that present rules should be modified to turn savings plans into retirement income plans. There is no comprehensive rationale put forward by the Administration in support of such a change in policy. Additionally, the Administration proposal maintains IRA limits at their current individual level, expands the spousal IRA, and reduces significantly what can go into cash and deferred arrangements through salary reduction. The argument appears to be that these programs are less efficient than employer-sponsored and funded plans where participation is mandatory.

Ideally, fundamental changes in tax incentives which have been the law since 1921 should not be changed without this Committee's careful review.