THE RETIREMENT POLICY CHALLENGES AND OPPORTUNITIES OF OUR AGING SOCIETY

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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THE RETIREMENT POLICY CHALLENGES AND OPPORTUNITIES OF OUR AGING SOCIETY

THURSDAY, MAY 19, 2005

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 10:15 a.m., in room 1100, Longworth House Office Building, Hon. Bill Thomas (Chairman of the Committee), presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
May 12, 2005
No. FC–9

CONTACT: (202) 225–1721

Thomas Announces Hearing on the Retirement Policy Challenges and Opportunities of our Aging Society

Congressman Bill Thomas (R–CA), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on the retirement policy challenges and opportunities of our aging society. **The hearing will take place on Thursday, May 19, 2005, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

Seventy-eight million Baby Boomers are heading toward retirement and eligibility for a number of Federal and State benefits, including Social Security, Medicare, and Medicaid. Those Baby Boomers and the generations that follow will live longer in retirement as the average life expectancy at age 65 has increased from about 14 years in 1940 to 18 years today, and is expected to increase to 22 years in the future. In addition, American families are having fewer children. As a result, over the next 30 years, the number of people age 65 and older will double, while the number of adults under age 65 will increase by less than 15 percent.

In preparation for the retirement of the Baby Boomers and the aging of America, Congress has a responsibility to review current retirement policies and programs to ensure that they are as strong as possible. Americans over age 65 receive, on average, 42 percent of their income from Social Security, 21 percent from pension and retirement plans, 14 percent from income on assets, and 22 percent from wages.

Pensions, personal savings, and wages were all intended to supplement Social Security income. However, only 40 percent of Americans own a defined contribution pension or an Individual Retirement Account. More than half of those with such plans have saved less than $15,000 in the account. Furthermore, the personal savings rate for Americans has declined to less than 2 percent of after-tax income. For these reasons, encouraging personal savings and strengthening other savings vehicles must be part of any debate on retirement security.

In announcing the hearing, Chairman Thomas stated, "The Baby Boom generation will redefine aging in America, just as it has every other segment of life. It is critical for Congress to review the programs that will serve an aging population and make the necessary adjustments now to provide Americans with a secure retirement."

FOCUS OF THE HEARING:

The hearing will focus on strengthening retirement security policy in order to meet the needs of an aging population.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hear-

ing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, http://waysandmeans.house.gov, select "109th Congress" from the menu entitled, "Hearing Archives" (http://waysandmeans.house.gov/Hearings.asp?congress=17). Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You **MUST REPLY** to the email and **ATTACH** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Thursday, June 2, 2005. **Finally,** please note thatdue to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman THOMAS. Good morning. As we all know, in 2008, the first of the Baby Boomers will be eligible for early retirement. With each passing year, the portion of the Federal budget consumed by those who are retiring will continue to grow. Currently, it equals about 42 percent. That is up from 28 percent in 1980. It is expected to increase to about 55 percent in the near future. I want to commend the witnesses because, Members and others who have read the testimony, there is a surprising recurrence of a theme through each of the presentations; notwithstanding there is a relatively broad political spectrum represented, either in terms of the individual who has written the materials or the assumed group that they may represent.

We focused on Social Security in the initial hearing, and I know that is what generates all the heat and light and discussions. I am very, very concerned about the question of retirement and savings, in part for this reason. I believe over the last two decades every

measure that was put into law to "assist" Americans to save—because we are all concerned about the net savings rate—was done with, as I said, honest and good intentions. The difficulty is Americans, in living their lives, don't live their lives along the neat cubbyholes in which the jurisdictions of congressional Committees is established; and that oftentimes, what was a good intention has created either a counter-force or a cancellation or a total failure in terms of limited government resources to achieve the desired result.

If politics—and I don't mean partisan politics or other kinds of politics, but politics—can be defined as the process of determining who gets what, when, and how, this hearing—and if necessary, subsequent hearings—about examining what the Federal Government had done to assist people in determining who gets what, when, and how, needs to be, I think, fundamentally examined. Because essentially, that percentage that I discussed of the Federal Government that is going to retirees goes to retirees, in a very great extent, using only one criterion, and that is age. We are already engaged in the greatest inter-generational transfer of wealth in the history of the world. I think it is entirely appropriate to examine the question of who gets what, when, and how.

It is very tempting politically to talk about groups and the fact that perhaps benefits are going to be adjusted, or that certain groups get this or get that. The Chair's goal is to challenge the Members of this Committee, from an institutional point of view. Because all those other Committees with their limited jurisdiction have performed an honest and earnest duty; but it is this Committee uniquely in the House of Representatives that has a broader jurisdiction, the entire Tax Code, under our jurisdiction in which, to the extent that we can create a meaningful and useful Federal assistance in savings, that should be our goal.

Obviously, there is going to be discussion on the changing role of defined benefits versus defined contributions; the multiplicity of saving instruments, what works, what doesn't work; government attempts to incentivize those who tend not to have appropriate wherewithal to save. I think to a certain extent there is a discussion about the Tax Code and the value of a marginal tax rate, and the behavior associated with the last dollar taxed, and to what extent do you change behavior on where and how that last dollar is taxed. I think when you talk about savings and focusing on savings, it is almost an inverse relationship in which, if we spend our time talking about people who are going to save anyway and attempt to create incentive systems that change the way in which they save, rather than allowing them to save, we are perhaps not maximizing the use of that Federal dollar.

I think it becomes important, as you move down the income scale where people do make a decision as to whether they are going to save or not, how we do it. I think it is absolutely essential at the bottom of the income level that we be as creative as we can and as inclusive as we can in setting up structures to assist people to save; that we do so in a way that those least able to save are most comfortable and have an opportunity to save. That was the theme that I thought I detected through each of your testimonies. That is

why I decided not to deliver a general theme; but rather focus on that particular area. The Chair will now recognize the gentleman from New York for any comments he may wish to make.

Mr. RANGEL. I wish this Chair had had a written statement, so that I could follow more clearly where you would like to take this Committee. We have been challenged by the President on the problems that we face in Social Security. Now you are challenging us in terms of coming up with some type of solution to the problem. Now this panel is going to challenge us to provide incentives for savings and to improve our pension benefits. It looks like the Social Security problem still remains a "third rail."

I do hope that since I couldn't find it in the Chairman's opening remarks, that the panel kind of helps me. Because I don't know what question was raised to you to respond, but I do hope that you know that many of us are here to try to avoid getting savings connected with Social Security, because we think that we should deal with that, and that it is very important, but we should deal with it separately. So, you may be taking this to health care, to housing for senior citizens, to retirement funds, and a variety of other things. I would believe, Mr. Chairman, that solvency of the Social Security system is a big enough problem for us to start to tackle. However, I will wait and see where this takes us, and maybe with the benefit of some of your Republican colleagues who understand where you are going better than I do, will have a better idea as to when we are going to deal with the problem of solvency. I would like to yield a minute to Richard Neal, before I yield to Sandy Levin during my 5 minutes.

Mr. NEAL. I thank you, Mr. Rangel. Mr. Chairman, I applaud you for holding this hearing to examine how we can make retirement more secure. I know that all of us as Democrats are interested in working with you on legislation that would help achieve that end. What concerns me, though, Mr. Chairman, is that some have suggested that your strategy is to pass a retirement bill that does not contain private accounts, and then to add them during a conference Committee. We are eager to work with you to address Social Security's financing challenges, but we cannot be party to anything that would substitute private, personal, or individual accounts for Social Security's guaranteed benefits. Before we commence this hearing on retirement security, Mr. Chairman, might you be willing to clarify for Members of this Committee and to those who are watching this Committee that you will not add private accounts to a conference report, if they are not included in a House-passed bill?

Chairman THOMAS. Tell the gentleman I will take a minute to respond to him, but I don't want to take the time of the Ranking Member, which I believe he is going to yield to the Ranking Member on the Social Security Subcommittee. Well, no, it is on your time, and your time is going. So, you use the rest of the time, and I will respond.

Mr. LEVIN. Welcome to all of you. Your testimony today is going to widen the circle of issues relating to retirement security discussed in the testimony before this Committee. Let me just say what we on this side very much believe; that efforts to widen the lens cannot blur an appropriate focus on Social Security privatiza-

tion. That was the centerpiece of the President's State of the Union address, his 60-day tour, and his recent press conference. It has also been very much stated by Members of this Committee. We responded going to the public, and the more the public has heard, the less they like the proposals.

So, now you are going to discuss with us the issues that are facing our country in the coming years. Indeed, I think this will come out; the changing picture as to pension programs in the private sector really fortifies the understanding the public has had about the strength of Social Security, a guaranteed benefit. think this will come out in the testimony; that since 1983, the number of defined benefit plans has been going down. Also, the recent pension failures I think have provided a stark reminder to the country about the importance of the Social Security guarantee. will just finish—my time is up—that we need to consider broader issues of retirement. What is standing in the way of having a truly bipartisan discussion of this is the President's demand for private accounts. We want to strengthen Social Security, not to replace it. Thank you, Mr. Chairman.

Chairman THOMAS. I thank the gentleman. will respond to my colleague from Massachusetts on his inquiry. I believe that the President has proposed some changes to Social Security; I don't believe he has demanded them. think it is incumbent upon us to at least examine, consider, and move forward. The Chair has no interest in playing "Gotcha." This is, I think, a fundamentally important issue in front of us. I think the President should be commended by placing the larger question of aging Americans and their retirement security—of which, obviously, one of the fundamental core issues is Social Security—in front of us.

I thought it was incumbent upon us, given our knowledge, jurisdiction, that if Social Security is presented to us, it would be a derogation of duty not to look at pensions and savings, and argue that only dealing with Social Security would be an adequate addressing of aging Americans' needs. It just seemed to me logical and obvious to take the opportunity, especially on the area of integration and coordination, of looking at the question of retirement. We began with the hearing looking at Social Security. We certainly are going to return to Social Security in great detail. Because as the Subcommittee examines Social Security, there are clearly some internal adjustments for particular groups currently receiving Social Security, who need to be addressed on basically a fairness theme.

I think it is entirely appropriate. believe the people who are in front of us wrote their papers with, I think—in my opinion, what I got out of it—a degree of gratefulness that we are talking about the larger picture beyond Social Security, which could afford us a chance to begin to build some links and institutionally address the issues that I think need to be addressed if we are looking at aging Americans and their retirement.

So, I would just tell the gentleman from Massachusetts I have an interest in producing a product, and I believe that my colleagues on my side of the aisle have an interest, in producing a product which is a responsible one and should elicit bipartisan support at the end of this legislative process. If it does not, that is of course

the choice of each individual Member. That doesn't say that the product shouldn't have gotten bipartisan support. This Chairman has no interest on a subject of this import to play "Gotcha" in any way.

Mr. RANGEL. Mr. Chairman, this is very interesting. I hope that you have shared your views on where you would like to go with your Republican colleagues, because this is the first we have heard of this from you. It logically follows, if you are going to use the jurisdiction of this Committee to try to get a better package for our older Americans leading toward savings and retirement, do you intend to include health care or Medicare as a part of that package; since getting old and retiring and having savings and getting health care would use all of the tools that we have to make older people's life have a better quality?

Chairman THOMAS. The Chair will respond, and then begin recognizing the panel, because it is appropriate. The Chair is pleased to hear the gentleman talk, somewhat similar to the way the Chairman talked back in January, about where we need to go. I do think, having examined Medicare in some detail just a short time ago, probably it would not be on the agenda in the timeframe we want to try to address other aspects of retirement security. However, since we didn't fundamentally address long-term care in the Medicare package, at least from our Committee's jurisdiction, which is limited in terms of content but affords us an opportunity to examine it from the Tax Code direction, that might be appropriate.

I do think the bulk of our focus should be on those areas that are within the broad jurisdiction of the Committee, principally commonly called the three legs of the retirement stool: pensions, personal savings, and Social Security. However, based upon what is occurring in the real world and what is occurring in terms of our opportunities, what used to be called pensions are looking more and more like personal savings, based upon the transitions that are occurring in the pension arena.

It is principally this Committee's responsibility. believe, as I said, we would not be fulfilling our responsibility if we simply looked at Social Security, or we simply looked at pensions, or we simply looked at savings. All of them are essential. More and more, there is a need to integrate and coordinate those areas, to maximize the opportunity for Americans, who are living longer, to have an enjoyable retirement for those years that continue to be added to Americans' lives. With that, I would like to recognize the panel. Your written testimony will be made a part of the record. You may address us in the time that you have as you see fit. It seems appropriate that I will just start to my left, your right, and recognize the Director of the Congressional Budget Office, Dr. Holtz-Eakin, welcome him, and give you the floor.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Well, Mr. Chairman, Ranking Member Rangel, Members of the Committee, the Congressional Budget Office (CBO) is pleased to have the chance to be here today to talk about coming demographic changes and their implications for the econ-

omy and for the budget. I will keep my remarks brief, and focus them around three of the charts that are included in the written testimony, and hopefully in front of you. Let me begin with the demography. It is now understood that as the Baby Boom ages, that as longevity rises in the future, and that as fertility remains below those rates which we saw in the 'fifties and 'sixties, the United States will become much older, and the ratio of those of retirement age to working age will rise and stay elevated for the foreseeable future. Now, what are the implications of this for the many potential policies that face the Congress, many of which are in the jurisdiction of this Committee? Well, lesson number one is it would be useful to anticipate these shifts and to set in place both economic reactions and also policies for those reactions, so as to minimize the difficulties. will come back to that.

Lesson two, perhaps less widely recognized, is that the native-born population has below replacement fertility rates at this point; so that for the foreseeable future, net population increase will be dictated by the rate of immigration into the United States. Immigration, as a result, is a key policy issue that will cut across economic, budget and security aspects of policymaking. Now, as we shift to an older population, the economy will undergo transformations in all of its markets. Goods markets will change. The kinds of services and products that an older population desires will rise relative to those in other areas of the economy. Labor markets will be influenced by the pace at which seniors depart into retirement and the degree to which they do it on a full-time or part-time basis. Capital markets will be influenced deeply by the saving, particularly of the Baby Boom generation, and the resultant ability to accumulate productive assets in the U.S. economy.

This suggests that it will be very important to maintain flexible economic markets going forward that will permit the shifts that are necessary to accommodate an older population, in goods markets; in labor markets, to maintain a neutrality between those who wish to continue working and those who do not, those who wish to work part-time versus those who wish to continue full-time; and in capital markets as well. Another implication is that it is important to recognize that aging, per se, doesn't matter so much if the population has pre-funded its retirement consumption. To the extent that the economy as a whole has put away resources to finance consumption, those resources will be sufficient to both pay for the consumption, and also to accommodate the withdrawal of seniors from the labor market. Then the third lesson is that we need to certainly maintain policies that support sufficient economic growth—and in particular, national saving—in order to maintain the resources to meet these rising demands.

Now, in the testimony, we go through some computations that suggest we will not automatically grow our way out of these challenges, and I refer you to those. I won't belabor them. That suggests that in fact policy choices will be at the center of the kinds of things that we do in this Nation. Now, I want to put up this chart as an example of the kinds of challenges I am referring to. This is a chart that we used for a Subcommittee hearing on long-term care services. It doesn't have to be long-term care, and it is not necessary that it be health. It is illustrative of the kinds of in-

fluences that we will see. The first is that on the demography, with the rising number of seniors 85 and older, the oldest old, and the rates of impairment, we will see in the future a rising demand for this particular kind of service in the economy.

Now, the demography will also cut another way. At the moment, the largest form of finance for this kind of service is donated care by family members and friends, 36 percent. With the smaller families in the future, and with the changing demography, it will be less easy to supply these services in that way, and they will be more likely to migrate to market provision. The second-largest form of finance at the moment, out-of-pocket payments, as a result, will have to come from those seniors themselves, if this is done through private markets. The question is: Will they save sufficiently, pre-fund these services, or not; or will the burden fall on their children or some other helper?

Alternatively, you can imagine the financing being shifted to current government programs, Medicare or Medicaid. In fact the same issues arise there. Will the Nation as a whole have pre-funded these costs, and be easily able to accommodate them; or will they be shifted to the younger generation through the tax system, to finance these programs? So, the long-term care is an example of the kinds of issues that will face the economy and the budget and policy as the demography takes place. It goes without saying that in this context it will be useful to use all economic resources efficiently, and to make sure we get the most out of the dollars that we have accumulated. We talk a little bit about that in our testimony. So, the message so far is that there are some things that are likely to happen.

Chairman THOMAS. If the gentleman would suspend briefly, without objection, the Chair would allow the witnesses to wind down for a minute or so beyond the 5 minutes.

Mr. HOLTZ-EAKIN. Thank you.

Chairman THOMAS. Because I think it is important that the message be coherent and whole.

Mr. HOLTZ-EAKIN. Thank you very much.

Chairman THOMAS. Without objection.

Mr. HOLTZ-EAKIN. I will close briefly. The first comments are about what is likely to happen. The second focus on things which could or should happen as a matter of policy and economic adjustment. My closing remarks will focus on what cannot happen. What you see in front of you is a current law extrapolation of the Federal budget. The most striking feature of this is the rising spending dominated by the mandatory programs, Social Security, Medicare, and Medicaid. There are lots of ways to draw this picture numerically, but qualitatively the same stylized facts emerge. To the extent that we maintain current programs and simply proceed on auto-pilot, spending is likely to outstrip revenues. As that happens, the increased borrowing will have a corrosive effect on the performance of the U.S. economy. Alternatively, taxes would need to be raised; which would equally be detrimental, given the levels to which the spending will rise.

It will be essential to take this path and alter it; largely because this path is a path of financing consumption, not saving through the Federal budget. And the key issue is to pre-fund and save as

a Nation for these challenges. This is not just a budgetary problem. There are mirror images of both the Social Security problem in the defined benefit world in the private sector; there are mirror images of Medicare and Medicaid and private health care costs. These are pressing economic challenges. I thank the Chairman and the Committee for holding a hearing that encompasses these, and I look forward to answering your questions.

[The prepared statement of Mr. Holtz-Eakin follows:]

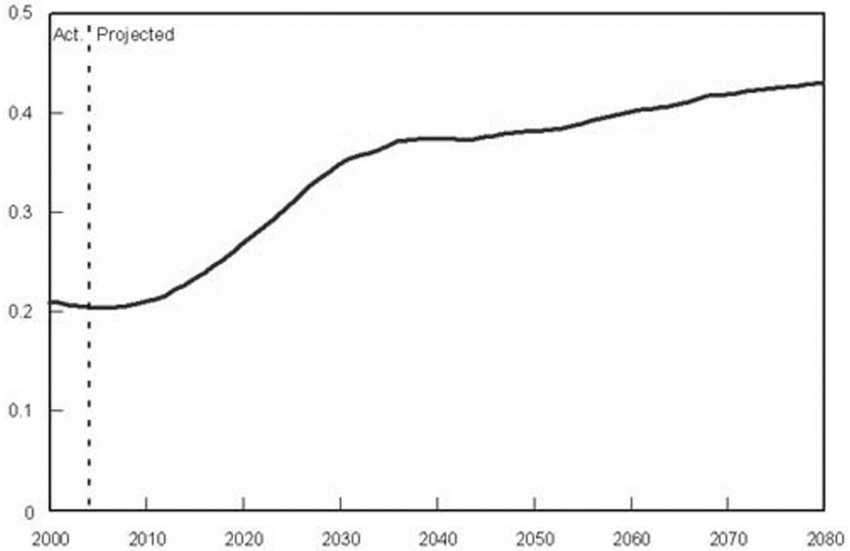
Statement of Douglas Holtz-Eakin, Director, Congressional Budget Office

Mr. Chairman and Members of the Committee, I am grateful for the opportunity to appear before you to discuss the challenges presented by projected changes in the makeup of the U.S. population. Those changes—together with, notably, rising health care costs—will produce a set of intertwined challenges for the budget and the economy. As a result, in the coming decades the United States will face economic shifts that will necessitate fundamental decisions about spending, taxation, and other economic policies that fall under the jurisdiction of this Committee.

Demographic Changes

Over the next few decades, several demographic shifts are expected to occur. First, members of the large baby-boom generation will reach retirement age. Second, life spans are projected to continue to increase. Third, fertility rates are anticipated to remain well below the levels of the 1950s and 1960s. Taken together, those developments imply a significant and lasting increase in the number of elderly people in the population (see Figure 1). Those same demographic factors are projected to lead to a sharp slowdown in the rate of growth of the labor force. In addition, families will be smaller than in the years of the baby boom, leaving fewer children to help care for elderly parents. And with fertility rates expected to remain at or below replacement rates for the native-born population, immigration is projected to account for most of the population growth in the long run.

Figure 1. Size of the Population Age 65 and Older Compared with the Population Ages 20 to 64 (Ratio)



Source: Congressional Budget Office based on Social Security Administration, *The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (March 23, 2005), Table V.A2 (intermediate assumptions).

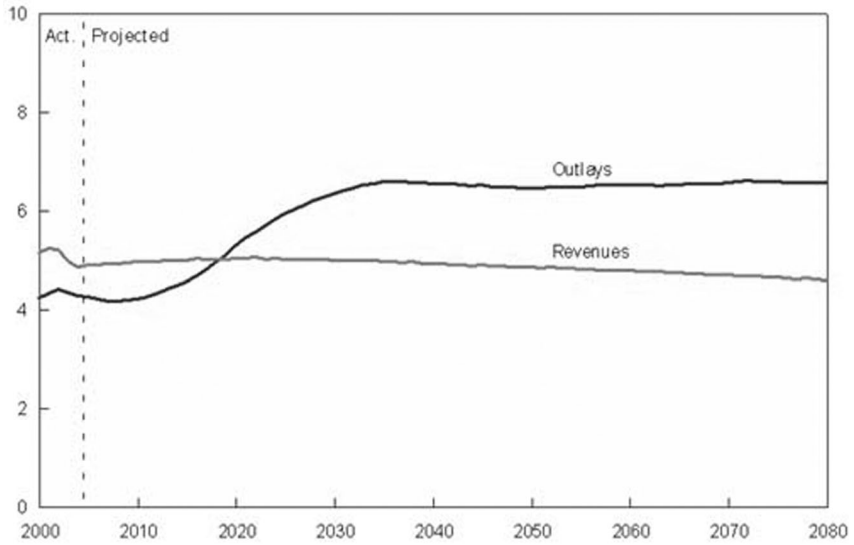
Ecomonic and Budgetary Challenges

The choices made by the growing share of older households will play a large role across the economy: the goods and services they demand will affect what the economy produces; the rate at which they choose to exit—in whole or in part—from the labor force will affect labor markets; and the decisions they make about savings will be a key determinant of the national accumulation of productive assets. By preserving flexible markets for goods, labor, and capital, the United States will probably adjust smoothly in response to market incentives. But significant challenges remain.

Some of the future economic challenges posed by demographic changes stem directly from the structure of federal programs. In and of itself, an increase in the share of the elderly in the population need not present a problem. If each individual or household adequately prepared for retirement through its own saving, a greater share of elderly in the population would place no burden on younger people or the economy in general. However, a substantial share of the elderly's consumption is currently provided by government programs such as Social Security, Medicare, and Medicaid. Those programs have made important contributions to economic well-being in the United States. However, they are largely financed not by past savings in the economy as a whole, but by contemporaneous taxes. As the share of the elderly rises, current levels of taxation will be insufficient to finance those programs as they now operate.

For example, Social Security outlays are projected to rise from 4.3 percent of gross domestic product (GDP) to 6.3 percent in the next few decades, largely as a result of the aging of the baby-boom generation (see Figure 2). Thereafter, outlays will continue to rise slowly from continued increases in people's life spans, reaching about 6.6 percent of GDP by 2080. In addition, state and local pension programs that have not been adequately funded will face pressures similar to those faced by Social Security.

Figure 2. Social Security Outlays and Revenues Under the Scheduled-Benefits Scenario (Percentage of GDP)



Source: Congressional Budget Office.

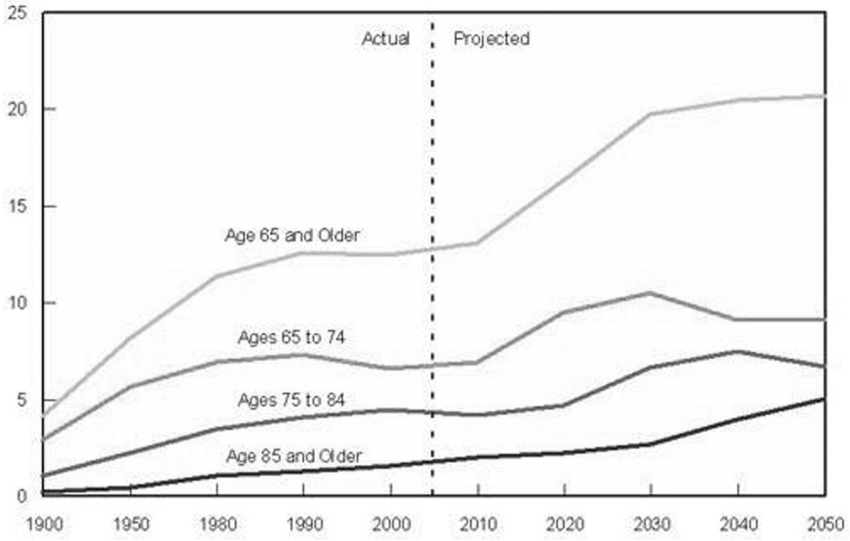
Notes: Based on the Social Security trustees' 2005 intermediate demographic and long-run economic assumptions and CBO's January 2005 short-run economic assumptions.

Revenues include payroll taxes and income taxes on benefits but exclude interest credited to the Social Security trust funds; outlays include scheduled Social Security benefits and administrative costs.

Under current law, outlays begin to exceed revenues starting in 2019; beginning in 2044, scheduled benefits cannot be paid.

The aging of the population also will lead to growth in the number of Medicare beneficiaries. That growth, along with continued increases in the cost of health care, is projected to generate a potentially dramatic rise in Medicare spending. Furthermore, the steady increase in the number of the oldest seniors (those age 85 and older)—from 1.5 percent of the population in 2000 to 5.0 percent in 2040—is projected to lead to a rise in the demand for long-term care services, including those paid for by Medicaid and Medicare (see Figure 3). That increase in demand will probably be heightened because in the future, the elderly will have fewer family members available to care for them than do the current elderly: declines in fertility imply fewer children per parent, and a greater share of women in younger cohorts work outside the home. Those trends will reduce the availability of informal care provided by family members and friends—currently the largest source of long-term care (see Figure 4).[1] Furthermore, such trends could, in turn, raise the reliance on out-of-pocket payments, necessitating greater saving unless those costs are to fall on the young.

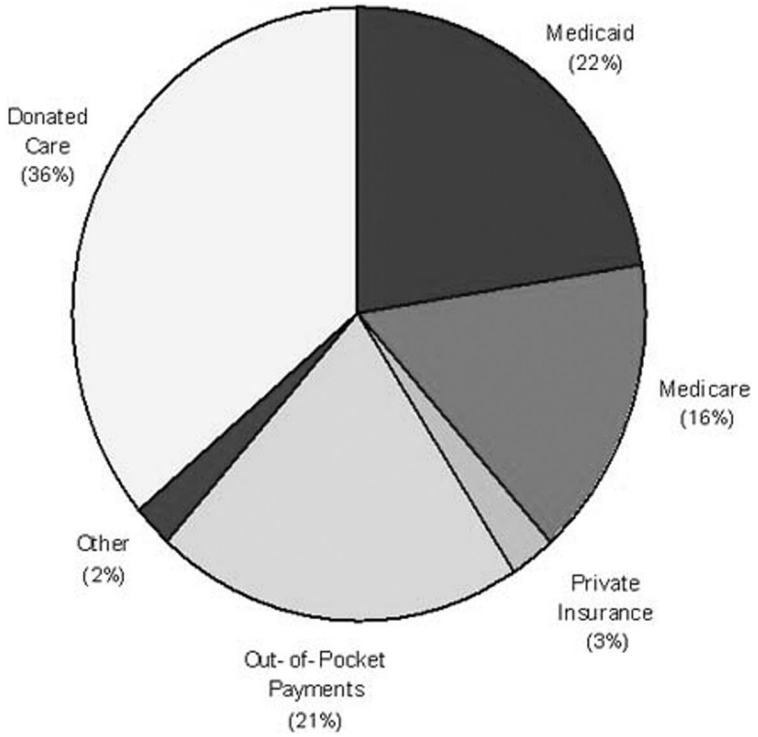
Figure 3. People Age 65 and Older as a Share of the U.S. Population (Percent)



Source: Congressional Budget Office based on Bureau of the Census, *U.S. Interim Projections by Age, Sex, Race, and Hispanic Origin,* Table 2a, "Projected Population of the United States, by Age and Sex: 2000 to 2050" (March 18, 2004), available at www.census.gov/ipc/www/usinterimproj/natprojtab02a.pdf

[1] See Congressional Budget Office, *Financing Long-Term Care for the Elderly* (April 2004).

Figure 4. Estimated Percentage Shares of Spending on Long-Term Care for the Elderly, 2004

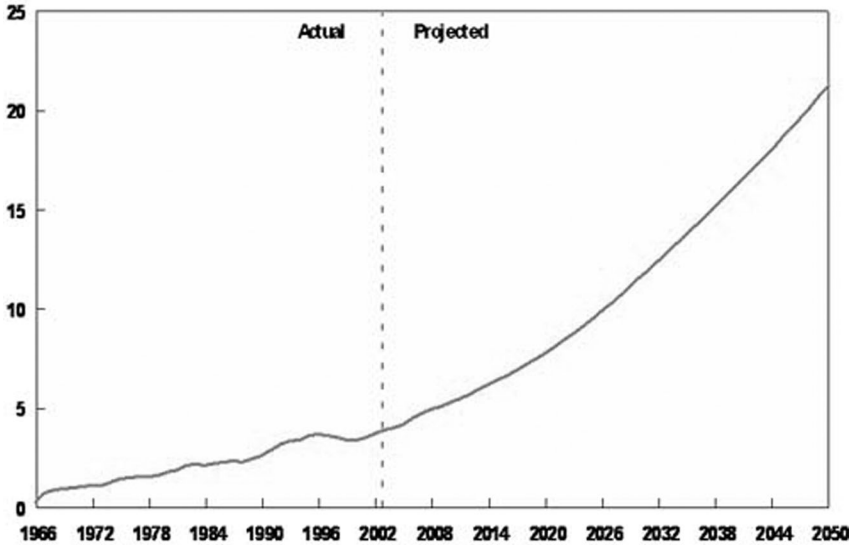


Source: Congressional Budget Office.

Given those increases in demand, if costs per beneficiary continued to rise as fast as they have in the past, overall federal outlays for Medicare and Medicaid could climb from about 4 percent of GDP to more than 20 percent by 2050 (see Figure 5). Aging and increases in health care costs may also raise the demand for spending by other federal programs, including military retirement programs and the veterans' health care system.[2]

[2] See Congressional Budget Office, *The Potential Cost of Meeting Demand for Veterans' Health Care* (March 2005).

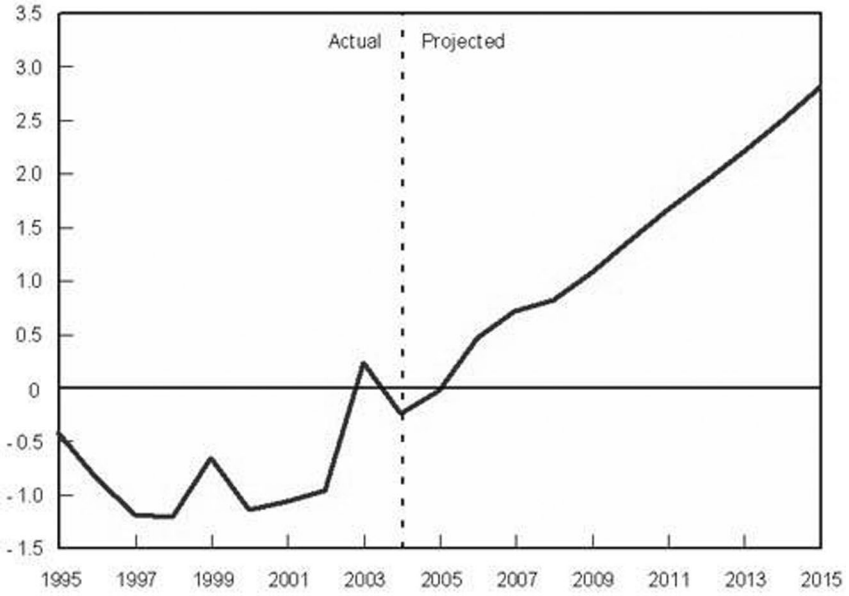
Figure 5. Total Federal Spending For Medicare and Medicaid (Percentage of GDP)



Source: Congressional Budget Office. See *The Long-Term Budget Outlook* (December 2003).

Aside from its impact on federal mandatory spending, the aging of the population presents economic challenges because retirement consumption is not always adequately prefunded by saving in the private sector. For example, many private-sector defined-benefit pension plans have not been properly funded, and an aging population can create some of the same pressures on those underfunded plans as it does on Social Security. Those pressures are projected to lead to higher net outlays for the government's Pension Benefit Guaranty Corporation as rising numbers of plans are unable to provide full benefits (see Figure 6).

Figure 6. Net Outlays for the Pension Benefit Guaranty Corporation (Billions of dollars)



Source: Congressional Budget Office.

Moreover, whether through bad luck or poor planning, many people reach retirement age without enough resources to maintain their preretirement standard of living. Studies of savings levels suggest that as many as one-quarter of the baby-boom generation have failed to accumulate significant savings.[3] Those people may experience significant declines in their standard of living upon retirement unless they receive some sort of assistance, whether from family members or government programs.

Alternatively, those individuals may choose to work longer; indeed, even those without pressing financial needs may consider that option. A relevant consideration is the degree to which private and government retirement plans are neutral with respect to the retirement age, providing neither an incentive to depart the labor force nor a requirement to extend working years.

Health care is a key part of consumption for both the young and the old. Rising health care costs threaten the current health insurance system for workers and retirees covered by private plans. Rapidly rising health insurance premiums are likely to reduce both the percentage of people who have health insurance and the comprehensiveness of the insurance held by those who are covered. As premiums rise, workers may be less willing to accept lower wage increases in exchange for keeping their health insurance. And employers may not wish to maintain increasingly costly benefits for retirees, especially since health spending for retirees does not contribute directly to a productive workforce, as might health insurance for current employees. Moreover, as noted above, given that a large portion of long-term care is now donated, an aging population may put a burden on younger generations even aside from the taxes required to finance government-funded care.

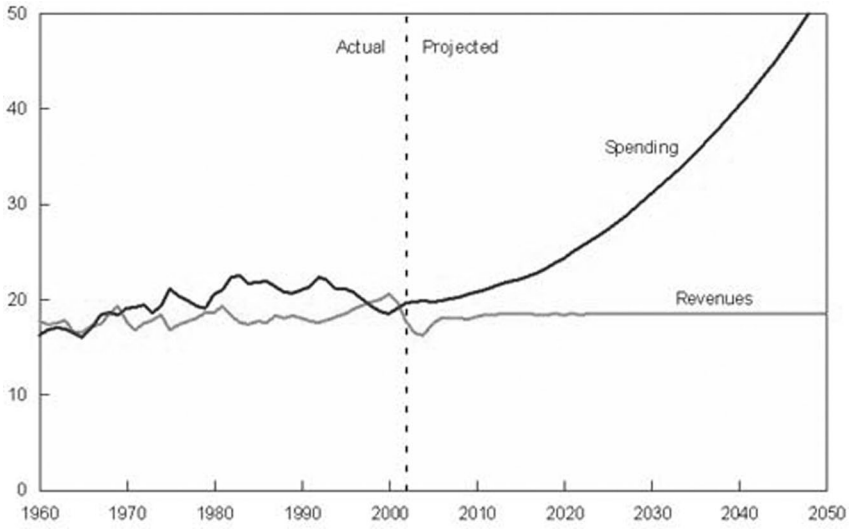
Despite those challenges, growth in productivity is currently projected to continue to raise people's living standards over time. However, it is very unlikely that productivity growth could by itself "solve" the projected budgetary shortfalls. Growth in productivity stems from two factors: growth in the amount of productive capital per worker, and technological advances that increase the amount of goods and services that can be produced by a given level of capital and labor—so-called total factor productivity (TFP). The rate of growth of TFP would have to shift upward in a very

[3] See Congressional Budget Office, *Baby Boomers' Retirement Prospects: An Overview* (November 2003).

unlikely way to close just the budgetary gap in Social Security—and that gap is only a small part of the rise in consumption demands for the economy as a whole. For example, if the future growth of TFP was a full percentage point faster than its postwar average, over three-quarters of Social Security's projected 75-year actuarial balance would be erased. However, historical data on TFP growth suggest that such a sustained high rate of growth is quite implausible, with the probability of such a shift well under 1 percent. Moreover, even under such a scenario, Social Security would eventually begin to run cash flow deficits and exhaust its trust funds.

As for the amount of capital per worker, that will depend largely on national saving and wealth accumulation. In general, however, the impact of an aging population on the budget will tend to reduce national saving. By 2050, government spending is projected to climb to well above its historic share of GDP and considerably higher than the historical average share of revenues, which is about 18 percent (see Figure 7). The levels of borrowing implied by that outlook could have a corrosive or, eventually, contractionary effect on productivity.

Figure 7. A Scenario for Total Federal Spending and Revenues (Percentage of GDP)



Source: Congressional Budget Office.

Note: CBO categorized this scenario as one of high spending and lower revenues. The scenario is explained in detail in CBO, *The Long-Term Budget Outlook* (December 2003), pp. 6–12.

Moreover, the United States is unlikely to be able to borrow such sums on a sustained basis, even from international markets (especially given that aging populations in the rest of the developed world are likely to put similar pressures on budgets in other countries). Therefore, at some point, it is almost certain that spending will have to be cut or that taxes will have to rise. To the extent that increased taxes involved higher marginal rates on labor and capital income, they would tend to discourage work and saving, and therefore reduce economic output. For example, the Congressional Budget Office (CBO) has estimated that if all projected spending was financed by higher taxes, GDP could be 6 percent lower by 2050 than if spending was cut instead. (Although those estimated effects are significant, they are small relative to the projected growth of GDP over the next 50 years.)

More generally, choices about the degree to which budgetary adjustments should be addressed by changes in taxes or spending, and about when those changes should occur, involve fundamental issues concerning the distribution of burdens within and across generations. At some point, policymakers need to make choices about who will bear the cost of bringing commitments into line with projected resources. The longer those decisions are deferred, the greater the share of the cost that will tend to be borne by future generations. In addition, exempting certain groups—such as current beneficiaries and those near retirement—from the changes increases the burden that other groups must bear. In evaluating how to distribute the impact of

policy changes, however, it is useful to note that because productivity is expected to continue to rise, future generations are projected to have a higher standard of living than current ones.

Ways to Encourage Economic Efficiency

A paramount consideration is to ensure the continued accumulation of physical capital, technologies, and workers' skills to sustain economic growth. Policies that increased overall economic efficiency could lessen the impact of bringing commitments into line with available resources. For example, tax policies that involve lower marginal rates can reduce distortions that currently tend to discourage work and saving. Of course, the goal of reducing distortions must be balanced against consideration of the fairness of the distribution of taxes.

In addition to addressing the great pressure to increase federal spending, revisiting the structure of financing those outlays may be useful as well. For example, the income tax as currently configured operates somewhat like a high-end surtax. A large fraction of lower-income taxpayers now receive a net subsidy from the income tax, while a much smaller number of high-income taxpayers pay most of the taxes (see Table 1). To the extent that that structure is embraced or extended, it may be useful to minimize the distortions imposed in raising revenue by explicitly designing the tax to reflect the economic lives of the key taxpayers. Alternatively, it may be desirable to return the tax to a broader base in the population.

Table 1. Effective Federal Tax Rates and Shares of Federal Tax Liabilities, 2002

Income Category	Millions of Households	Pretax Average Income (2002 dollars)	Effective Tax Rate for the Individual Income Tax	Pretax Share of Income	Share of Tax Liabilities Under the Individual Income Tax
Lowest Quintile	22.6	14,400	-6.0	4.2	-2.6
Second Quintile	21.5	33,600	-0.2	9.3	-0.2
Middle Quintile	22.3	51,100	3.5	14.7	5.3
Fourth Quintile	21.7	75,900	6.8	21.2	14.8
Highest Quintile	22.8	175,900	15.6	51.5	82.8
All Quintiles	111.4	69,800	9.7	100.0	100.0
Top 10%	11.6	244,500	18.0	36.4	67.4
Top 5%	5.8	350,700	20.1	26.2	54.5
Top 1%	1.1	938,100	23.8	13.4	33.0

Source: Congressional Budget Office.

Notes: A household consists of the people who share a housing unit, regardless of their relationships.

Income categories are defined by ranking all people by their comprehensive household income adjusted for household size—that is, divided by the square root of the household's size. Quintiles, or fifths, contain equal numbers of people.

Comprehensive household income equals pretax cash income plus income from other sources. Pretax cash income is the sum of wages, salaries, self-employment income, rents, taxable and nontaxable interest, dividends, realized capital gains, cash transfer payments, retirement benefits plus taxes paid by businesses (corporate income taxes and the employer's share of Social Security, Medicare, and federal unemployment insurance payroll taxes), and employee contributions to 401(k) retirement plans. Other sources of income include all in-kind benefits (Medicare, Medicaid, employer-paid health insurance premiums, food stamps, school lunches and breakfasts, housing assistance, and energy assistance). Households with negative income are excluded from the lowest income category but are included in totals.

By contrast, payroll taxes take a larger share of the income of lower earners because they are levied only on labor income and are capped. A large part of payroll taxes do not represent a pure tax on the margin, because with higher earnings, workers not only pay higher taxes but also eventually qualify for higher Social Security benefits. Therefore, the payroll tax in principle should not discourage work as much as the legislated rates would seem to imply. However, workers might not fully realize the connection between current earnings and future benefits. In that case, the payroll tax would distort work decisions more strongly. If so, it may be desirable

to moderate the extent of the payroll tax, or increase economic efficiency by clarifying the link between contributions and eventual benefits.

In general, a broader issue is whether a system that replaced the various types of taxes that are currently employed with a more integrated whole could be more efficient and fair.

Given the large scale of health care consumption, increased efficiency in that sector could yield significant benefits. From an economic perspective, a key problem with the current system is the lack of connection between those who are well-informed, those empowered to make decisions, and those who bear the cost of care. The result is that current health care spending is inefficient. For example, some regions of the country use many more medical services than others, on average, with no evident benefit in terms of health outcomes. Health insurance, depending on how it is provided, can also lead to excess spending: although insurance against uncertain health care costs has great value, to the extent that people are insured they do not face the direct cost of care and have little incentive to constrain costs. Furthermore, the tax preference given to employment-based insurance, a principal source of insurance in the U.S. population, may tend to bias the health care system toward higher spending.

At present, there is little consensus regarding clear-cut steps to improve the efficiency of the health care system. However, several incremental changes have received attention. Proponents of limiting medical malpractice awards argue that implementing such changes would reduce medical liability premiums, health insurance premiums, and the practice of defensive medicine. CBO has found that tort reforms would ultimately reduce medical liability premiums by an average of 25 percent to 30 percent from the levels that would otherwise occur, but total health care costs would fall by only about 0.5 percent. The more difficult question is whether there might be harder-to-detect, long-term shifts in practice patterns.

Another policy already being implemented to some extent for chronically ill patients is disease management. Disease management may entail various combinations of enhanced screening, monitoring, and education; the coordination of care among providers and settings; and the use of best medical practices to try to identify chronic conditions more quickly, treat them more effectively, and thereby slow their progression. Unfortunately, although a few studies indicate that disease management programs could be designed to reduce overall health costs for selected groups of patients, to date little research directly addresses the issues that would arise in applying disease management to the broader population (including Medicare patients, who tend to be older and sicker).[4]

The fact that a relatively small number of patients account for a large share of medical expenditures suggests another possible cost-reduction strategy: identify potentially high-cost patients in advance and find effective intervention strategies to reduce their spending. A CBO analysis of Medicare patients suggested some promising strategies to identify patients who are disproportionately likely to incur high costs.[5] However, such identification does not by itself restrain costs. The extent to which targeted beneficiaries reduced their spending would ultimately rest on the costs of identification and the ability to devise and implement effective strategies to change beneficiaries' use of medical services.

In short, none of the approaches discussed above alone appears to provide a silver bullet to stem rising health care costs (or increase benefits for the same cost). However, taken together, in conjunction with other changes that more closely link the quality of care with its cost, such policies could move the system toward greater efficiency.

In closing, the demographic shifts facing the United States will place a premium on the accumulation of economic resources required to provide for the needs and wants of an older population. The structures of government programs will have important influences on the ability of the economy to sustain high levels of growth.

Chairman THOMAS. I thank the gentleman. The next witness is the Honorable Hal Daub. He is here under the auspices of the Social Security Advisory Board, but some of us remember him fondly

[4] See Congressional Budget Office, *An Analysis of the Literature on Disease Management Programs* (October 2004).

[5] See Congressional Budget Office, *High-Cost Medicare Beneficiaries* (May 2005).

as a Member of Congress and a colleague on the Ways and Means Committee. Hal, welcome.

STATEMENT OF HON. HAL DAUB, CHAIRMAN, SOCIAL SECURITY ADVISORY BOARD

Mr. DAUB. Thank you very much, Mr. Chairman. Congressman Rangel, it is nice to see you; Members of the Committee. Thanks for inviting me to testify today. will briefly summarize the main points of my full statement. That statement reflects the findings and recommendations of the bipartisan Social Security Advisory Board's recent report, which I hope you each have or have received, a copy of which I'm holding in my hand; which is entitled, "Retirement Security: The Unfolding of a Predictable Surprise." And it was adopted unanimously by the board. The board's conclusions match up well with the title of this hearing and its underlying assumptions. We must deal with the Social Security issue in the broader context of retirement policy, generally. And we need to approach the very significant challenges of an aging society, as Doug just well showed, with a recognition that they are indeed challenges, but they are also opportunities to make our retirement security programs better meet their objectives. Social Security is a foundational element of our retirement security system. For some older Americans, it provides all, or nearly all, of their retirement income; and for many, it represents half or more of their income.

Important as it is, Social Security is far from the entire picture. Employment-based pensions, income from savings and other assets, and earnings from employment together provide about 60 percent of the income of the aged. Certainly, restoring the solvency of Social Security must be a high priority. And effective retirement policy must also encourage and facilitate increased availability of, and participation in, employment-based private retirement programs and the higher levels of individual savings. We need to make sure that younger workers entering the labor market fully understand that retirement security begins at that point. It is not something that just happens when you get old; rather, retirement security needs to be seen as a long-range proposition that you build during your working years so that you can have an adequate income in your retirement years.

I think this hearing very correctly recognizes that to address retirement security we need to deal in an integrated way with Social Security, Medicare, and Medicaid. For the aged, growing premiums and other out-of-pocket medical costs reduce the income available to meet other needs. Increasing medical costs limit the ability of employers to provide retiree pension and health benefits, and threaten to create immense budgetary pressures. We think of Social Security as retirement income. For many older Americans it ultimately merges with the financing of their long-term costs through the Medicaid spend-down. Is it not the time to elevate our commitment to long-term care protection to equal our commitment to expanding homeownership, and to do so by providing effective tax incentives for individuals to build that protection for their future?

So, we have many challenges to meet, if we are to continue the policy enunciated 40 years ago by the Older Americans Act of, and I quote, "An adequate income in retirement in accordance with the

American standard of living." There is no reason why that cannot be done. We have a strong economy, and a vibrant, flexible workforce. We have developed an array of instruments for retirement security that are fundamentally sound. We need to see this as a rare opportunity to review our overall retirement security system and adapt it to meet the new demographic realities of this coming century. Mr. Chairman, I would like to step aside, if I might, in my role as Chairman of the Social Security Advisory Board for a moment, and leave the Committee with an outline of a five-part proposal that I have been working on as an individual to restore Social Security solvency. The first four elements that I propose restore the 75-year solvency. They have two elements that raise revenue, and two elements that change benefits. will briefly summarize them. You have the full outline of it in your possession.

I would, to raise revenue, gradually increase the taxable maximum to cover 90 percent of the wages over the next 10 years. That is where we were in 1983. I bring into Social Security all new, prospectively, state and local employees and benefit changes. I would have a small reduction in the cost of living adjustment, never by more than 1 percent, and usually half a percent or less; and a continuation of the scheduled increases in retirement age to, very gradually, 69 and a half; and phase those increases in, with a parallel phase up of the initial retirement age to 65 and a half. That would start in the year 2023, and can be completed in the year 2042. I believe that we need to move to a mixed system that would maintain the basic Social Security guarantees, but would incorporate a modest individual account feature. I would suggest starting with workers that are under age 42, and creating for them forced savings funded by 2 percentage points of the current Social Security tax rate. My outline describes the proposals in more detail. I would be happy to discuss this proposal with any Members of the Committee. Thank you, Mr. Chairman.

[The prepared statement of Mr. Daub follows:]

Statement of The Honorable Hal Daub, Chairman, Social Security Advisory Board (former Member of Congress)

Mr. Chairman, Congressman Rangel, Members of the Committee. Thank you for inviting me to testify on behalf of the Social Security Advisory Board at this most important hearing.

In 1994, Congress passed the legislation that set up the bi-partisan Social Security Advisory Board. In that law, you gave us a number of responsibilities. One of those was to examine and make recommendations about how the Social Security programs can work with other public and private programs to assure economic security in retirement. Over its history but especially in the last year or so, the Board has been focusing its attention on that issue, and we have recently issued a report, *Retirement Security: the Unfolding of a Predictable Surprise.* [1] The report addresses that mandate and also addresses the subject of today's hearing.

First of all, I think it is important to recognize that we start this century in a lot better shape than we started the last century. For typical American workers at the start of the last century, there was no retirement policy. You commonly could expect to work until you died, and you were likely to die a lot sooner. There was very little in the way of private pension programs and no Federal programs to provide retirement income or health protection in old age.

Today we have a vastly different situation. As a result of advances in medical care and technology, older Americans are enjoying longer and healthier lives. We have the Social Security and Medicare programs to provide a base of income and health

[1] The report is available on the Board's website: www.ssab.gov and the Committee has also posted a copy

protection and enable our older citizens to leave the labor force and enjoy many years of retirement. For many of our citizens—although still not enough—that base of income and health protection is supplemented by employer-sponsored and individual pensions, savings, and health benefit plans. Many of our older citizens also have other assets to rely upon, including home ownership for more than 80 percent of those 65 and over. And we have the important safety-net programs for the needy of Supplemental Security Income and Medicaid.

So, as we look to the future, we are starting from rather solid ground. But we also know that ahead lie changes to which the Nation simply has no choice but to respond. Those changes can be viewed as a shock or surprise but, fortunately, as the Board's report says, they represent a predictable surprise. The primary challenge that we face is the aging of our society as a result of the twin demographic shifts of lower birthrates and longer lives. We currently have a workforce that has benefited from the postwar baby boom, the increased participation of women workers, and large improvements in skills and education levels. But the oldest of the baby boomers turn 60 next year and we can clearly see a future in which the ratio of the retirement age population to the working-age population will be growing substantially. Moreover, with continually increasing life spans, the population of those in their 80s and 90s and beyond will also be growing and placing increasing demands on our ability to provide health services and long-term care. And, as we all know, the costs of health care have been and continue to rise at unsustainable rates.

So we do, as a Nation, face serious challenges ahead. But, as you so aptly noted in the title of this hearing, we need to look at these challenges of our aging society also as opportunities. The various public and private programs that now combine to provide retirement security have grown up over the years without much conscious attention to how they relate to each other. I think it is fair to say that, on the whole, these programs provide our older citizens with an excellent level of retirement security. But the fact that all of these elements of our current retirement security system face the serious challenges of an aging society gives us the opportunity to reexamine them in a coherent manner, to identify the areas in which there are gaps in protection, or inappropriate targeting that may leave some of the aged with too little or, in some cases, too much protection. We can update these programs to take account of the changes that have taken place and are taking place in the composition of our society and our workforce. We can identify ways to strengthen these programs, to validate or improve their targeting, and to remove unnecessary barriers that prevent them from fulfilling their purposes.

Before looking at the individual parts of our retirement security system, however, we need to reflect on the basic question of what is the objective of our retirement income policy. Forty years ago, in 1965, Congress enunciated a national policy in the *Older Americans Act* in these terms: "An adequate income in retirement in accordance with the American standard of living." I believe that policy formulation has stood the test of time and should continue to guide us as we look to strengthening the various elements of our retirement security system. As we consider changes to various programs, we need to continually assess whether they help us as a Nation to achieve that policy goal.

The Social Security program is, of course, a foundational element in assuring America's older citizens a base of retirement security. It is particularly important for those in the lower and middle parts of the income distribution. About 30 percent of the aged get all or nearly all of their cash income from Social Security and 59 percent of the aged get half or more of their income from the program. So it is vitally important that we move promptly to restore the solvency of Social Security so that it can continue to play its role in providing a base of income security for those who are retired and so that America's workers can know with reasonable confidence what they can expect from it as they plan for their future retirement. As the Advisory Board has pointed out many times over the past several years, there are many different options for restoring Social Security solvency. But if we do not act now, the range of available options will narrow, and the ones remaining will be more difficult and disruptive.

While restoring the solvency of Social Security is a pressing need that presents significant challenges, it also give us the opportunity to examine whether some aspects of the program could be better targeted to the 21st century population it now serves. The basic construct of the program is sound, with a benefit formula that recognizes the need to replace a greater portion of the pre-retirement earnings at the lower end of the scale in order to maintain an adequate standard of living. Over the last third of a century, largely because of Social Security, the poverty rate among the aged has been cut from nearly 25 percent to a little over 10 percent. That is a remarkable achievement, but in changing the program we should look for the opportunity to do even better, and we need to look for aspects of the program that

have not done so well. For example, older women, particularly those who are widowed, divorced, or single still have poverty rates approaching or exceeding 20 percent.

We also need to remember that Disability Insurance is a significant part of the Social Security program. It provides vital income support for 8 million disabled workers and their family members, and it accounts for about 17 percent of the overall deficit in the program. As changes are made in the retirement aspects of Social Security, it will be important to make sure that those changes appropriately address the needs of disabled workers. Moreover, as we look to a future where our major challenge is the increasingly unfavorable workforce/beneficiary ratio, we must find ways to make the disability program more responsive to the desires of impaired individuals to maintain their independence and continue productive participation in the workforce.

While Social Security plays a foundational role in income security of Americans in retirement, it is, by no means, the whole story. For those over 65, Social Security benefits provide 39 percent of their income. About a quarter of the income of the aged comes from continuing participation in the workplace, and about a third comes from pension and asset income. About four out of ten aged households report having retirement income other than Social Security, and there is some reason to think that may understate the reality. It is "good news" that so many older Americans enjoy employment-based pension income in addition to their Social Security. That certainly is a major contribution to meeting the goal of an adequate income in retirement. But it could be better news. Over the past 20 years, participation in employment-based retirement plans has been fairly flat at about 50 percent despite tax incentives to participate. The percent that are covered by a plan at some point in their life is a bit higher at 60 percent but still leaves room for improvement.

There is a well-known and accelerating shift from traditional pension plans that offer defined benefits as lifetime annuities to defined contribution plans of the 401(k) variety. To a considerable extent, this reflects the changing realities of the workplace in a highly competitive, globalized economy where career employment with a single company is no longer the norm. This trend could shift somewhat in the future labor-short economy where employers may have greater need to encourage long-term employment. In any case, there currently are substantial retirement assets in both types of plans. Both are important to meeting the national goal of an adequate income in retirement. And, in both cases, there is a need to reexamine policies to encourage employers to maintain and offer these plans and to modify them in ways that will encourage increased participation by employees. Regulation is needed to protect plan participants, but there is equally a need to simplify the regulatory burden in establishing and maintaining private pensions and to clarify regulatory standards such as those surrounding hybrid plans. Funding standards need to be reexamined to encourage practices that will strengthen the funding of plans. In the case of defined contribution plans, consideration needs to be given to the many suggestions that researchers have made for ways to increase participation rates by employees and to encourage the appropriate use of plan assets to provide income in retirement.

The challenge of an aging society is something the Board has called a predictable surprise, but I think we need to worry that, for too many of our fellow citizens, it may come as a real surprise. A survey by the Employee Benefits Research Institute found that only four out of every ten workers have even tried to calculate how much they will need to live comfortably in retirement. Household savings as a percent of income has been declining for many years and now is less than 2 percent. In addition to providing tax incentives for savings, Congress and the Administration have made some admirable attempts to focus more attention on the need for savings. And the Social Security Advisory Board has spoken with some individual employers and some employer-sponsored organizations that are also trying to promote awareness in this area. But much more needs to be done. Promoting the need for lifetime retirement planning and making financial education widely available must become a national priority.

The predictable surprise that we face in retirement policy is fundamentally a result of the demographic shifts, which will alter the relationship in size of the working age population and the retiree population. We have an opportunity to moderate that challenge to the extent that we can find ways to increase the workforce by providing incentives for older workers to continue in productive employment. To a certain extent that is already happening. About a quarter of the income of those age 65 and over comes from employment. The labor force participation of older men declined steadily over most of the last half of the 20th century, but it began to level out in the 1980s and seems to be slowly rising. Some employers are now recognizing the advantages that older workers can bring to workplace and are making accom-

modations to facilitate part-time or intermittent employment. That phenomenon may strengthen as we face increasing labor shortages in the future. Still, as Congress deals with changes in Social Security and other retirement income programs, it needs to be sensitive to the importance of assuring that policies and program rules facilitate and encourage continued labor force participation of older workers.

Retirement security for older Americans involves not just the cash income from Social Security, savings, and pensions but also the very important component of health care. The challenges facing the income support program are substantial, but they are swamped by the health care issues, which involve not just the coming shift in the relative numbers of workers and beneficiaries, but also the continually rising unit costs of medical care, and the greatly increasing numbers within the aged population of those who are very old and require constant care. Regardless of how the financing is accomplished, the costs of all these programs at any given point in time have to be met from what the workforce at that time is able to produce.

Future increases in the cost of health care for the aged will put severe strains on the financing of Medicare and Medicaid, complicate the Nation's ability to finance Social Security and other budgetary priorities, and undermine the ability of employers to provide retiree health benefits. Moreover, these cost increases will also eat into the adequacy of the cash income of the aged through large escalation in premiums and other out-of-pocket costs. A July 2004 memo from the CMS Actuary projected that a typical age-65 beneficiary with typical medical costs would see premiums and out-of-pocket costs for parts B and D of Medicare rise from about 35 percent of the average Social Security benefit in 2006 to 91 percent in 2078. If we are to have a rational and successful retirement security policy, the health care part of that policy must be viewed as much more than simply a question of financing. We need to find ways to rationalize the health care system, constrain its costs, and improve the quality of care.

For many older Americans, long-term care is already a major element in their retirement security and that will be become increasingly the case as the population ages. The number of Americans aged 85 or older will grow from about 4 million at the start of this century to nearly 10 million by 2030 and over 20 million by 2050. At the same time the need for long-term care is increasing, society will face increasing challenges with respect to the supply of workers to provide such care in formal situations and the availability of family members to provide such care on an informal basis. In the recent past, the Nation has experienced substantial improvements in the availability, diversity, and quality of long-term care. Nursing home providers have shown their commitment to care quality both through their embrace of government programs and their creation of their own Quality First program. But, sustaining gains in quality will be a challenge that will depend to a considerable extent on assuring the continuing stability of funding. While some progress has been made in encouraging advance funding of long-term care through insurance, the results relative to future needs are still minimal. More attractive tax incentive policies for the purchase of long-term health care insurance seem imperative.

As we stand here at the start of a new and different century, it is clear that we face significant challenges in continuing to meet the goal America set for itself of enabling our older citizens to have an adequate income in retirement in accord with the American standard of living. But, I think it is important to realize that these challenges are not a sign of weakness but rather arise out of our Nation's strengths and successes. We are living longer and healthier lives. We have seen great improvements in medical care and technology. We have a strong economy and a vibrant workforce, which offers the men and women of this country a wide range of opportunities to pursue employment that utilizes their talents and rewards their efforts.

Much of the media coverage of the issues relating to Social Security and Medicare and the other elements of retirement security has been precisely wrong. These challenges we face are not a matter of institutional failure or partisan assignment of blame or even shared pain. This is one of those moments that come but rarely in our history, a moment when elected policymakers truly have the opportunity to consolidate our past achievements and move them to a higher plane. Our Nation's instruments of retirement security, as they have developed over the past century are a magnificent success story. Our and your challenge and opportunity is to strengthen those institutions and make the necessary changes to assure that in this coming century they will be an even greater success story. I have every confidence that the members of this Committee can work together to seize that opportunity and meet that challenge.

Chairman THOMAS. I thank the gentleman very much. Our next witness is Dr. Richard Jackson, Global Aging Initiative, Center for Strategic and International Studies. Dr. Jackson.

STATEMENT OF RICHARD JACKSON, DIRECTOR AND SENIOR FELLOW, GLOBAL AGING INITIATIVE, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

Mr. JACKSON. Thank you, Mr. Chairman, Ranking Member Rangel, Members of the Committee. It is an honor to have the opportunity to testify before you today. The aging of America promises to usher in one of the greatest social transformations that our Nation has ever experienced. Rising life spans are a great personal boon, but they also pose a great collective challenge. Graying means paying. It means paying more for pensions, more for health care, more for social services for the elderly.

According to the Congressional Budget Office's long-term projections, spending on Social Security, Medicare, and Medicaid, a large and rising share of which pays for long-term care for the elderly, is due to rise from 8 percent of the economy today to 18 percent by 2050. To put the number in perspective, just the growth alone, 10 percent of GDP, is two and a half times everything the United States now spends on national defense, even after the post-9/11 buildup. In the end, an aging America is going to have to fundamentally rethink its system of senior entitlements. In my view, a workable solution will have to reflect three fundamental new realities.

The first reality is the ongoing rise in life expectancy. If Social Security's retirement age had been indexed to longevity since the program was founded, workers would today, already today, be waiting until age 73 to begin collecting benefits. Yet far from rising, retirement ages have actually fallen significantly over the course of the post-war period. In the future, Americans are going to have to split this marvelous longevity dividend between extra years of work and extra years of leisure. The second reality is the transformation in the economic status of the elderly. As recently as the early seventies, it was possible to argue that age was a reasonable proxy for financial need. This argument is no longer plausible. Over the past three decades, the median income of households headed by adults aged 65 and over has risen by close to 50 percent, after inflation; while the median income of households headed by adults under age 45 has been at a virtual standstill.

Counting in-kind benefits like Medicare, the elderly poverty rate is now as low as the rate for younger adults, and is actually half the rate for children. An aging America will have to reconsider whether age alone is a sufficient criterion for blanket access to public benefits. The third reality is the declining viability of pay-as-you-go social insurance. The pay-as-you-go paradigm made a lot of sense back in the fifties or sixties, when there were five or six workers for every retiree. With the end of the Baby Boom, however, the demographic underpinnings of the paradigm collapsed. In the future, workers will have to pre-fund more of their own retirement income out of greater savings during the working years. Now, at the Center for Strategic and International Studies (CSIS) Global Aging Initiative, we have looked closely at the vulnerability of the

major developed countries to the rising costs of old-age dependency. am happy to report that the United States enjoys some enviable advantages.

We are actually the youngest of the developed countries today and, thanks to our relatively high rate of fertility and substantial net immigration, we will remain the youngest for the foreseeable future. We also, along with our more favorable demographics, have a relatively inexpensive Social Security system. Incredibly, several European countries spend more today on public pensions for the elderly than we will be spending in 2040 after the last of the Baby Boomers have retired. Outside the United States and the other English-speaking countries, retiree dependence on government benefits is almost absolute. In the United States, private pensions, as well as higher rates of elderly labor force participation than in most countries, help take pressure off government budgets.

None of this means that the United States can afford to be complacent. Although we spend less per capita on pensions for the elderly than most other countries do, we spend more on health care. Although we have a well developed private pension system, nearly half the private sector workforce still has no coverage at all, even a meager 401(k) that can be cashed out long before retirement. And let me wrap up here. Confronting the aging challenge will require today's adults to make difficult tradeoffs between their own future retirement income and the living standards of their children. Making these tradeoffs won't be easy, but I think that we have to make them. commend you for looking at this issue. At stake is whether an aging America will be able to meet the needs of a larger number of elderly, while still making room for the hopes and aspirations of youth. Thank you, Mr. Chairman. That concludes my testimony.

[The prepared statement of Mr. Jackson follows:]

Statement of Richard Jackson, Director and Senior Fellow, Global Aging Initiative, Center for Strategic and International Studies

Thank you, Mr. Chairman. It is an honor to have the opportunity to testify before the Ways and Means Committee today.

The aging of America promises to usher in one of the most fundamental social transformations that our nation has ever experienced. Over the next few decades, it will restructure the economy, reshape the family, and redefine our cultural self-image. Perhaps most fatefully, it will push a growing share of the nation's resources towards an ever-larger elderly population whose "entitlement" to public benefits has come to rest on age alone.

In the days of Thomas Jefferson or Abraham Lincoln, your odds of a random encounter with an elderly American were about one in forty. Today, they are about one in seven. A generation from now, they will be between one in four and one in five.

Longer life spans are a great personal boon, but they also pose a great collective challenge. Graying means paying—more for pensions, more for health care, more for social services for the elderly. According to the Congressional Budget Office, federal spending on the three major senior entitlements—Social Security, Medicare, and Medicaid, a large and rising share of which pays for long-term care for the elderly—is due to grow from 8 percent of the economy today to 18 percent by 2050. To put that number in perspective, just the projected increase in spending—10 percent of GDP—is two and one-half times everything the United States now spends on national defense, even after the post 9–11 build up.

The growth in senior entitlements should obviously be of concern to conservatives, since it is inconsistent with the goal of limited government. But it should also be of concern to liberals, whose vision of progressive government is being increasingly crowded out by retirement and health-care spending on the middle- and upper-income elderly. By 2050, according to the CBO's long-term budget projections, spend-

ing on Social Security, Medicare, and Medicaid is on track to consume three-quarters of all noninterest outlays.

In the end, an aging America will have no choice but to rethink its whole system of senior entitlements. The goal must be to fashion a new system that is capable of ensuring a decent standard of living for the old without imposing a crushing burden on the young. In my view, a fair and sustainable solution to the aging challenge will need to reflect three fundamental realities.

The first reality is the ongoing growth in life expectancy. Since Social Security was established, life expectancy at age sixty-five has risen by five years, or by roughly one month per year. Few demographers believe that the pace of improvement will slow—and a growing number expect that it will accelerate as breakthroughs in biomedicine begin to unlock the secrets of the aging process itself. Yet far from rising to reflect the new demographic circumstances, average retirement ages have fallen over the course of the postwar era. In the future, America will need to split its longevity dividend between extra years of work and extra years of leisure. Encouraging later retirement and longer worklives could achieve large fiscal savings without hurting the living standards of the elderly. It would also have enormous benefits for the economy, and, many gerontologists believe, for the elderly themselves.

The second reality is the transformation in the economic status of the elderly. Until the early 1970s, it was possible to argue that age was a reasonable proxy for financial need. This argument is no longer plausible. Over the past three decades, the real median income of households headed by adults aged 65 and over has risen by nearly one-half, while that of households headed by adults under age 45 has remained virtually stationary. Today, elderly household income per capita is about on par with the national average—and that's before taxes, where the elderly enjoy considerable advantages. Counting in-kind benefits like Medicare, the elderly poverty rate is now as low as the rate for any age group and is just one-half the rate for children. Yet most senior benefits are disbursed through programs that write checks regardless of financial need. An aging America will have to reconsider the equity and affordability of making age alone a blanket criterion for access to a public subsidy.

The third reality is the declining viability of pay-as-you-go social insurance. The pay-as-you-go paradigm made sense back in the 1950s or 1960s, when workers outnumbered retirees five or six to one. With the end of the baby boom, however, the demographic underpinnings of the paradigm collapsed. In the future, workers will have to prefund more of their own retirement income through greater savings during the employment years. Over the long run, funded systems have decisive advantages over pay-as-you-go systems in aging societies like our own. At the macro level, they can help shield government budgets from demographic pressures while maintaining adequate rates of savings and investment. At the micro level, they can offer workers higher benefits at any given contribution rate than pay-as-you-go systems can. This is why, from Germany to Australia, countries around the world are moving in the direction of greater reliance on funded retirement savings. Even Sweden, Europe's quintessential welfare state, has added a mandatory second tier of funded personal accounts to its public pension system.

At the CSIS Global Aging Initiative, we have looked closely at the "vulnerability" of the major developed countries to rising old-age dependency costs. As it turns out, the United States enjoys a number of enviable advantages. To begin with, we are now the youngest of the developed countries—and, thanks to our relatively high rates of fertility and net immigration, we are likely to remain the youngest for the foreseeable future. The UN projects that the elderly share of the U.S. population will reach 21 percent by 2050, up from 12 percent today. Meanwhile, the elderly share of the population will climb to 28 percent in Germany and to 36 percent in Italy and Japan. Although the United States will have to cope with a dramatic slowdown in workforce growth when boomers retire, Europe and Japan are heading toward a future of workforce and population decline. By the middle of the century, according to the UN, there will be 19 percent fewer working-age Germans than there are today, 32 percent fewer working-age Italians, and 33 percent fewer working-age Japanese. The Japanese government actually projects the date there will be only one Japanese left.

Along with more favorable demographics, the United States also has a relatively inexpensive Social Security system. Incredibly, several European countries already spend more today on public pension benefits for the elderly than we will be spending after the last of the boomers have retired. Thanks to a strong work ethic, flexible labor markets, and model age discrimination laws, the United States also has a relatively high elderly labor-force participation rate. As of 2000, 18 percent of

Americans aged 65 and over were still on the job, compared with 6 percent of Italians, 5 percent of Germans, and 2 percent of Frenchman.

Finally, there is our large and innovative private pension system. Outside the United States and the other English-speaking countries, the dependence of the elderly on public benefits is close to absolute. The typical French, German, or Italian retiree receives between 75 and 85 percent of his or her income in the form of a government check, compared with about 50 percent for the typical American. In the United States, private pensions, along with higher elderly employment, help take pressure off government budgets. According to Intersec, a standard source for international pension data, U.S. pension funds own roughly 60 percent of global pension assets. France, Germany, and Italy combined own just 2 percent.

None of this means that the United States can afford to be complacent. Although we spend less per capita on public pensions for the elderly than most other developed countries, we spend more on health care. Despite the size of the U.S. private pension system, nearly half the private workforce remains entirely uncovered, even by a meager 401(k) that can be cashed out long before retirement. Reform must also reckon with a powerful senior lobby—and an entitlement ethos that considers public benefits earned rights, tantamount to personal property.

Mr. Chairman, America stands on the threshold of a great demographic transformation without precedent in its history. I have focused on the fiscal dimensions of the challenge. The implications of the aging of America, however, reach far beyond the impact on public budgets. America's businesses will have to cope with a deficit of entry-level workers, while its families will have to cope with a surplus of frail elders. Slower growth in the workforce may translate into slower growth in the economy. Even the nation's ability to maintain its security commitments could be affected as armed forces experience chronic manpower shortages and defense budgets come under relentless pressure from rising retirement costs.

Confronting the aging challenge will require today's adults to make difficult trade-offs between their own future retirement consumption and their children's living standards. These trade-offs are not easy to make in a democracy that has difficulty focusing on slow-motion crises. But make them we must. At stake is whether America will be able to meet the needs of a growing number of old while still making room for the hopes and aspirations of youth.

Mr. Chairman, that concludes my testimony. Thank you again for the opportunity to share my views on this vitally important issue with you and the Committee's members.

Chairman THOMAS. Thank you very much, Dr. Jackson. Our next witness is Dallas Salisbury. Mr. Salisbury is at the Employee Benefits Research Institute. Mr. Salisbury.

STATEMENT OF DALLAS L. SALISBURY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, EMPLOYEE BENEFITS RESEARCH INSTITUTE

Mr. SALISBURY. Mr. Chairman, Congressman Rangel, and Members of the Committee, it is an honor to be here today. The announcement of this hearing underlined the changing demographics of our country, and the absence of savings by most Americans. The CBO numbers that we started with are compelling in terms of the challenges that produces, and longevity is probably the most significant of those factors, if what we are considering is retirement income adequacy and lifetime economic security. As has been previously noted, a quarter of current retirees rely entirely on Social Security; two-thirds primarily on Social Security. And the changes in the private and public pension systems as we have known them only will increase the reliance on Social Security or personal savings going forward.

One-third of today's retirees—and that is the highest number in our Nation's history—have supplementation from annuity income pensions for Social Security; 13 percent have it from public em-

ployee pensions; less than 20 percent now from private employer pensions. Of those over age 85 in the retired population today, 39 percent have pension supplementation; of those who most recently retired, only 29 percent. So, we have seen rapid and substantial decline. About 10 percent of all workers 21 to 64 now own an IRA, in spite of over 30 years of effort. About 21.7 percent own both a defined contribution account—401(k), 403(b), Federal Thrift Plan, you name it—and an IRA. And about 9.2 percent own both an IRA and another account. About 8 percent own both a defined benefit and a defined contribution account. If you look at the overall numbers, 43 percent of private workers now participate in some type of plan at work, but 57 percent do not. In the public sector, 75 percent are covered by some type of supplemental plan; 25 percent are not.

The most significant change in the system beyond that is ERISA in 1974 defined for the first time a pension plan as both defined benefit or defined contribution. Prior to that, the dictionary definition applied: a monthly annuity for life. And even in our defined benefit pension systems, we now see that over half of those plans in the private sector primarily pay individuals lump-sum distributions, not annuities. The significance of that, given the importance of increasing longevity, is that the risk of living too long is now one increasingly placed on the individual; as opposed to that risk being borne by others. Savings efforts have been effective, if one looks at growth over time. The numbers are still amazingly small. If one looks at today's 401(k) plans, the average account balance is $51,000. That is up from $37,000 in 1996. Median account balances are now at $18,000. That is up from $11,600 in 1996.

One should note that for workers with 30 years of service and aged 60, the average is now $168,000. To put that into context, those receiving an average Social Security benefit today of roughly $10,000 per year, the amount of money it would take to purchase that annuity in the private market, assuming 3 percent future indexation, would be approximately $150,000. So, individuals are far, far, far short in their accumulations of being able to match even the base Social Security average benefit. The termination of the United Airlines pension plans has focused new attention on defined benefit plans. I think it is worth noting that today about 23 million workers in the private sector are active participants in those plans. That is roughly the same 23 million in count that were in those plans some 20 years ago. So, the system has not, if you will, eroded dramatically in terms of the number of people covered, but during that same period of time, the private sector workforce has increased by 29 million workers. So, essentially, as a percentage of the workforce and of the growth of the labor force, we are seeing very little in the way of new coverage.

Why? Pensions have traditionally been available in the manufacturing industry. We know manufacturing has declined. They have traditionally been a matter of union bargaining. We know that unions have declined. They traditionally have been a function of large employers. We know that most growth in the labor market of the last decade or two has been among small employers. Finally, the most significant change is that over half of the plans, I would underline, pay lump-sum distributions. I will close on a personal

note. My father just is about to turn 92; my mother, 89. They live outside of Seattle, Mr. McDermott's area. And they did save. They accumulated. The year they retired, their Social Security income represented 18 percent of their final income. Last year, it represented 78 percent of their income. Why? Because they lived much longer than they had anticipated. The importance of a base annuity income is there in the statistics. It is important for all individuals. The defined benefit annuity and the annuitization out of defined benefit and defined contribution plans must be encouraged.

The only other income they now have is the annuity that they were required to take from a defined benefit pension plan. The lump-sum distribution from their profit-sharing plan has long since been dissipated. They sold their home on a 20-year contract. Dad assumed age 85 would be good enough; it wasn't. They owned an apartment house. They sold it on a 25-year contract. That income ended at the age of 90. So, even for those who seek to plan effectively to make the right decisions, who save aggressively, that issue of longevity, of life expectancy, of not knowing how long you will live, is a challenge and a risk that all of us face, and is a dynamic that the other witnesses have noticed drives the issues of long-term care, retiree medical, and so many other of the issues. Mr. Chairman, I commend you for putting all of these issues on the table, in terms of underlining the vital role that Social Security plays today.

[The prepared statement of Mr. Salisbury follows:]

Statement of Dallas L. Salisbury, President and Chief Executive Officer, Employee Benefits Research Institute

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

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 workforce 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 workforce. 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)[1] 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.[2] 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.

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[1] 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.

[2] 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.

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.

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,[3] 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 15th 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 an-

[3] "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.

nually, 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%).

The views expressed in this statement are solely those of Dallas L. Salisbury and should not be attributed to the Employee Benefit Research Institute (EBRI), the EBRI Education and Research Fund, any of its programs, officers, trustees, sponsors, or other staff. The Employee Benefit Research Institute is a nonprofit, nonpartisan, education and research organization established in Washington, DC in 1978. The testimony draws heavily from research publications of the Employee Benefit Research Institute, but any errors or misinterpretations are those of the witness.

Chairman THOMAS. Thank you very much, Mr. Salisbury. I don't know how old you are, but what is in one sense a very positive story is, I think, a story that more and more Americans will be telling, if we don't take seriously the job of looking at other aspects of retirement. And thank you very much for your testimony. Dr. Peter Orszag, from the Brookings Institution, welcome.

STATEMENT OF PETER R. ORSZAG, DIRECTOR, RETIREMENT SECURITY PROJECT, JOSEPH A. PECHMAN SENIOR FELLOW IN ECONOMIC STUDIES, THE BROOKINGS INSTITUTION; CO–DIRECTOR, TAX POLICY CENTER

Mr. ORSZAG. Thank you, Mr. Thomas and Mr. Rangel and other Members of the Committee. Public policies have not kept pace with the shift from defined benefit to defined contribution plans that other witnesses have already spoken about. As a result, workers bear more responsibility for their own retirement saving. We have not given them the tools and incentives they need in order to navigate this new system successfully.

In particular, the system is way too complicated. In the face of that complexity, too many people freeze, and therefore wind up not saving. You don't need to be a mechanic to drive a car, and you

shouldn't need a PhD in financial economics to navigate the pension system. Second, the incentives for too many families are weak or non-existent. The system is based on tax deductions and exclusions. Three-quarters of American families are in the 15 percent marginal bracket or below, and therefore receive very weak incentives to participate in tax-preferred accounts. Furthermore, as I will describe in a moment, we actually penalize some of those families who do save, by disqualifying them from various different benefits.

Now, all is not lost. There is a growing body of evidence suggesting the way toward improvement; including a new study that the Retirement Security Project undertook with H&R Block which showed that the combination of a transparent incentive for saving and an easy way to do so generated meaningful and very substantial increases in saving; with contributions to IRAs, for those offered a 50-percent match, that were eight times as high, on average, as contributions among those who were not offered a match. So, specifically, what should we do? What should we do to improve the accounts, the 401(k)s and IRAs that we already have? My testimony lays out four specific changes that I think would be quite beneficial.

First, we should create an automatic 401(k). You should be in the plan, unless you opt out. Your contribution rate should be increasing over time, unless you opt out. You should be invested in a diversified index fund, unless you opt out. And your funds should roll over automatically when you switch jobs, unless you opt out. Evidence suggests very strongly that these steps have substantial benefits. For example, if you are in the plan unless you opt out, participation rates, even for those lower earners below $20,000 in earnings, new employees, go from 15 percent to 80 percent. I don't think that there is a single step that we could take to boost participation as much as just simply changing the defaults.

Second, there is more than $200 billion a year in income tax refunds that are issued. That is a savable moment. That is the best opportunity for many households to put money into an IRA, and we currently make it very difficult for them to do so. It should be the easiest thing in the world to take part of your income tax refund and put it into an IRA. You should be able to check a box on your 1040, and put part of your refund into an IRA. Again, significant potential for saving there. If we got even half of those refunds saved, that would be a very substantial increase in our net national saving rate.

Third, we need to extend stronger incentives for retirement saving further down the income distribution. The study that I just mentioned shows very clearly that even low-income households will save if they are presented with incentives to do so and we make it easy for them to do so. There is the base in current law, the saver's credit, which is scheduled to expire next year. That credit should be extended; it should be strengthened; and it should be extended down the income distribution to help middle- and lower-income families, and not just middle- to upper-middle-income families.

Finally, the asset tests under many means-tested benefit programs were written at a time when 401(k) and IRA plans were sort

of supplementary pension plans that were not the base plan. Therefore, defined benefit plans are typically excluded from the asset test under Medicaid, food stamps, and Supplemental Security Income (SSI) and other programs; but 401(k)s and IRAs are often included. That means that if any moderate- to low-income households actually do save, we hit them over the head by disqualifying them the next time there is an economic downturn from those means-tested benefit programs. Doesn't make any sense. SSI, for example, exempts defined benefit plans; does not exempt 401(k)s and IRAs. It is purely a historical accident. We should fix that. Furthermore, the rules are very complicated and arbitrary. An example: In food stamps, 401(k)s are exempted, but IRAs are not. That means that if a moderate-income household follows the advice of a financial advisor and rolls the funds over from a 401(k) into an IRA when switching jobs, we disqualify them from food stamps. Doesn't make any sense. That whole area should be significantly cleaned up.

Now, I just gave you four ideas about what to do. I think there are several things that you should not do. And in particular, coming back to Mr. Thomas' comment about bang for the buck, there are various proposals that are floating around that would generate significant tax subsidies for households that are already well prepared for retirement simply to shift other saving that they would have done anyway into the tax-preferred accounts. I would include among these things the retirement savings account proposal, which is basically a Roth IRA with no income limit. The Roth IRA income limit for married couples is $150,000. If you get rid of the income limit, it is very clear where the tax benefits go. Most of those tax benefits do not correspond to increased saving. They correspond to simply asset shifting, moving money from other accounts into the tax-preferred account. You are not getting good bang for the buck there.

Similarly, increasing the contribution limits, the amounts that can be put into 401(k)s and IRAs: Only about 5 percent of 401(k) participants are at the maximum amount. Only about 5 percent of those eligible for an IRA put in the maximum amount today. Raising the maximum amount that can be put away doesn't do anything to help the bulk of the middle class and moderate-income families, who are not contributing the maximum. Furthermore, increasing those contribution limits will mostly generate, again, asset shifting. Not good bang for the buck. So, in conclusion, Mr. Chairman, there are many common-sense steps that we could take to improve the 401(k)s and IRAs that we already have, on top of Social Security. My view is that we should come together and get those reforms done. thank you for your patience and letting me go over.

[The prepared statement of Mr. Orszag follows:]

Statement of Peter R. Orszag, Joseph A. Pechman Senior Fellow, The Brookings Institution

Mr. Chairman and other members of the Committee, thank you for inviting me to testify before the Committee this morning.[1] The past 25 years have seen a dra-

[1] The views expressed here are those of the author alone. Much of this testimony is based upon joint work with Len Burman, Peter Diamond, Esther Duflo, William Gale, Robert Green-

Continued

matic shift in our nation's pension system away from defined benefit plans and toward defined contribution accounts such as 401(k)s and IRAs. Our public policies, however, have largely not been updated to reflect the increased responsibility that has been placed on workers to prepare for their own retirements. To this end, my testimony makes two central points.

First, retirement security can be substantially improved and strengthened through a series of common sense reforms that would make the defined contribution pension system easier to navigate and more rewarding for American families. A growing body of empirical evidence, including a path-breaking new study conducted by The Retirement Security Project in conjunction with H&R Block, suggests significant benefits if we make it easier for middle- and lower-income households to save for retirement and increase their incentives to do so.

My testimony highlights four key policy changes to improve retirement security for middle- and lower-income households: (a) automating 401(k) plans to reduce the decision-making burden on workers, (b) implementing split tax refunds so that workers could deposit part of their tax refund into a retirement account, (c) revamping the existing Saver's Credit so that it provides a more effective and transparent matching incentive for retirement contributions, and (d) reducing the steep and confusing implicit taxes on retirement saving often imposed through means-tested benefit programs such as Food Stamps, Medicaid, and Supplemental Security Income. Both sides of the Social Security debate can embrace these common sense reforms to make the individual accounts we already have, in the form of 401(k)s and IRAs, work better.

Second, too much of our existing tax preferences for retirement saving simply subsidize asset shifting into tax-preferred accounts by households who are already well-prepared for retirement, undermining the public policy benefit from the tax incentives. Contributions to tax-advantaged retirement accounts that are financed by shifting other assets into the accounts do not increase private saving, and the empirical evidence suggests that is often what occurs, especially among higher-income households.[2] Such households, furthermore, tend to be better prepared for retirement in any case. Policy changes to bolster retirement saving should instead be focused on middle- and lower-income households who typically have few other assets that could be shifted into tax-preferred saving and who are not fully taking advantage of existing opportunities to save.

Expanded income tax deductions, higher contribution limits, and higher income limits are all inconsistent with the objective of encouraging saving among middle- and low-income households, and would therefore only exacerbate the serious flaws in the existing system. The vast majority of middle- and low-income households are in low marginal income tax brackets, so that policies based on expanded tax deductions (as opposed to credits or matching contributions) do little to help them. Similarly, expanding income or contribution limits on tax-preferred retirement accounts would do little to help these households, since the vast majority are not contributing the maximum amounts already allowed and are also not affected by existing income limits. Instead, expanded deductions, higher income limits, and increased contribution limits are likely to result mostly in substantial asset shifting, as high-income households move saving from other forms into the tax-preferred one. In other words, such proposals are likely to represent an expensive tax subsidy for saving that high-income households would have done in any case. Since the nation's fiscal outlook is already dismal, reducing tax revenue to provide further subsidies for asset shifting among households already well-prepared for retirement seems misguided from a public policy perspective.

In addition to these two core points, my testimony highlights two others. First, ill-advised policies that result in yet more subsidized asset shifting should not be the "price" of enacting sound policies to help middle- and lower-income families. Sec-

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stein, Mark Iwry, Jeffrey Liebman, and Emmanuel Saez. I also thank the staff of The Retirement Security Project and Tax Policy Center for their contributions and assistance, Bernie Wilson and other officials at H&R Block for their work on the matched savings experiment described below, and The Pew Charitable Trusts for its support of The Retirement Security Project.

[2] Early research on 401(k)s found that the saving plans raised saving at all levels of income. Subsequent research, which has improved upon the statistical techniques of earlier work, has tended to find that 401(k) plans have not increased saving among relatively high-income households, but may have raised saving of low-income households. See, for example, Eric M. Engen and William G. Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," Working Paper 8032 (Cambridge, Mass.: National Bureau of Economic Research, December 2000), and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," Journal of Public Economics 87, no. 5–6 (2003): 1259–90.

ond, any new preferences for retirement saving, whatever their merit, should be fully offset both over the short term and the long term. The proliferation of back-loaded tax preferences for saving, in which budgetary costs are disguised in the short run, underscores the need for extending the time horizon over which proposals should be offset beyond the traditional 10-year period.

I. Increasing Retirement Security for Middle- and Low-Income Households

The trend over the past two decades away from traditional, employer-managed plans and toward saving arrangements directed and managed largely by employees themselves, such as 401(k)s and IRAs, is in many ways a good thing. Workers enjoy more freedom of choice and more control over their own retirement planning. But for too many households, the 401(k) and IRA revolution has fallen short.

The most vivid manifestation of the shortcomings of today's private pension arrangements is the simple fact that many families approaching retirement age have meager retirement saving, if any.[3] In 2001, half of all households headed by adults aged 55 to 59 had $10,000 or less in an employer-based 401(k)-type plan or tax-preferred savings plan account. These households clearly have the option to save: Most workers have accounts available to them in which they could save money on a tax-preferred basis for retirement, and almost all households lacking such an option could contribute to an IRA. The problems lie elsewhere and are essentially twofold.

The first problem is that the system is too complicated. My colleague, William Gale, has remarked that you don't have to be a mechanic to drive a car and you shouldn't need a Ph.D. in financial economics to navigate the pension system. In the face of the difficult choices presented by the current system, many people simply procrastinate making any decision, which dramatically raises the likelihood that they will not save enough for retirement within the current system.

The second problem is that for the vast majority of middle- and low-income households, existing incentives to save for retirement are weak or non-existent. (Indeed, in some cases described further below, federal policy actually *penalizes* those who save for retirement in a 401(k) or IRA.) The primary policy tool used to encourage participation in employer-based retirement plans and IRAs is a set of deductions and exclusions from federal income tax. The immediate value of any tax deduction or exclusion, though, depends directly on one's income tax bracket. For example, a taxpaying couple with $6,000 in deductible IRA contributions saves $1,500 in tax if they are in the 25 percent marginal tax bracket, but only $600 if they are in the 10 percent bracket.[4] The income tax incentive approach thus provides the smallest benefits to the middle- and lower-income families in the lower marginal tax brackets, who are the ones most in need of saving more for basic needs in retirement. Furthermore, as a strategy for promoting national saving, the subsidies are poorly targeted. Higher-bracket households are disproportionately likely to respond to the incentives by shifting existing assets from taxable to tax-preferred accounts. To the extent such shifting occurs, the net result is that the pensions serve as a tax shelter, rather than as a vehicle to increase saving. In contrast, middle- and lower-income households, if they participate in pensions, are most likely to use the accounts to raise net saving.

To address these two key problems with 401(k)s and IRAs, policy-makers should make saving for retirement easier and increase the incentives for middle- and lower-income households to save for retirement. Let me give two specific examples of how saving can be made easier, and two specific examples of how incentives could be bolstered for middle- and lower-income families.[5]

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[3] For a broader discussion of these issues, see William G. Gale and Peter. R. Orszag, "Private Pensions: Issues and Options," in Agenda for the Nation, edited by Henry J. Aaron, James M. Lindsay, and Pietro S. Nivola (Brookings, 2003), pp. 183–216; Peter R. Orszag, "Progressivity and Saving: Fixing the Nation's Upside-Down Incentives for Saving," Testimony before the House Committee on Education and the Workforce, February 25, 2004; and J. Mark Iwry, "Defined Benefit Pension Plans," Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003. These and other related publications are available on The Retirement Security Project website (www.retirementsecurityproject.org).

[4] Some of this difference may be recouped when the contributions are withdrawn and taxed, if families who are in lower tax brackets during their working years are also in lower tax brackets during their retirement.

[5] For further information on these and other common sense reforms to bolster retirement security, see www.retirementsecurityproject.org.

A. Making It Easier to Save

To make it easier for households to save, policy-makers should encourage greater adoption of automatic 401(k)s and allow part of income tax refunds to be deposited directly into a retirement account.

Automating the 401(k)

A 401(k)-type plan typically leaves it up to the employee to choose whether to participate, how much to contribute, which of the investment vehicles offered by the employer to select, and when to pull the funds out of the plan and in what form. Workers are thus confronted with a series of financial decisions, each of which involves risk and a certain degree of financial expertise. Many workers shy away from these decisions and simply do not choose. Those who do choose often make poor choices.

To improve the design of the 401(k), we should recognize the power of inertia in human behavior and enlist it to promote rather than hinder saving.[6] Under an automatic 401(k), each of the key events in the process would be programmed to make contributing and investing easier and more effective.

- **Automatic enrollment:** Employees who fail to sign up for their company's 401(k) plan—whether because of simple inertia or procrastination, or perhaps because they are not sufficiently well organized or are daunted by the choices confronting them—would become participants automatically, although they would preserve the option of declining to participate. In other words, workers would be included unless they opted out, instead of being excluded unless they opt in.
- **Automatic escalation:** Employee contributions would automatically increase in a prescribed manner over time, for example raising the contribution rate as a share of earnings whenever a worker experiences a pay increase, again with an option of declining to increase contributions in this fashion.
- **Automatic investment:** Funds would be automatically invested in balanced, prudently diversified, low-cost vehicles, such as broad index funds, life-cycle funds, or professionally managed funds, unless the employee makes other choices. Such a strategy would improve asset allocation and investment choices while giving employers reasonable protection from potential fiduciary liabilities associated with these default choices.
- **Automatic rollover:** When an employee switches jobs, the funds in his or her account would be automatically rolled over into an IRA, 401(k) or other plan offered by the new employer. At present, many employees receive their accumulated balances as a cash payment upon leaving an employer, and many of them spend part or all of it. Automatic rollovers would reduce such leakage from the tax-preferred retirement saving system. At this stage, too, the employee would retain the right to override the default option and place the funds elsewhere or take the cash payment.

In each case—automatic enrollment, escalation, investment, and rollover—workers can always choose to override the defaults and opt out of the automatic design. Automatic retirement plans thus do not dictate choices any more than does the current set of default options, which exclude workers from the plan unless they opt to participate. Instead, automatic retirement plans merely point workers in a pro-saving direction when they decline to make explicit choices of their own.

These steps have been shown to be remarkably effective, as research by Richard Thaler and others has demonstrated. For example, one of the strongest empirical findings from behavioral economics is that automatic enrollment boosts the rate of plan participation substantially (Figure 1).[7] As the figure shows, automatic enrollment is particularly effective in boosting participation among those who often face the most difficulty in saving.

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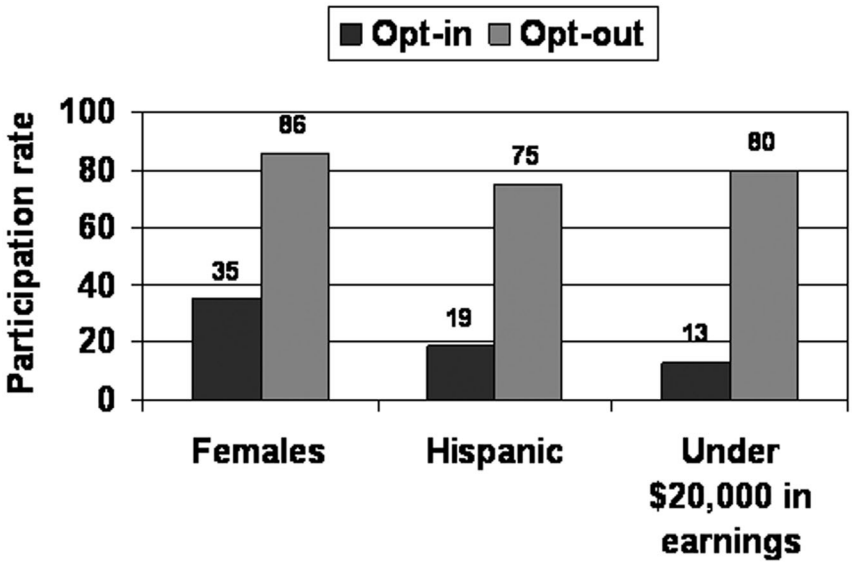
[6] William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," Retirement Security Project Policy Brief No. 2005–1, March 2005.

[7] Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Quarterly Journal of Economics 116, no. 4 (November 2001): 1149–87; and James Choi and others, "Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance," in Tax Policy and the Economy, Vol. 16, edited by James Poterba (MIT Press, 2002), pp. 67–113.

Figure 1: Effects of automatic enrollment on participation rates



Source: Madrian and Shea

Despite its demonstrated effectiveness in boosting participation, automatic enrollment is relatively new—and a small but growing share of 401(k) plans today include this feature. According to a recent survey, about one-tenth of 401(k) plans (and one-quarter of plans with at least 5,000 participants) have switched from the traditional "opt-in" to an "opt-out" arrangement.[8] Since automatic enrollment is a recent development, it may become more widely adopted over time even with no further policy changes. But policy-makers could accelerate its adoption through several measures. Some of these policy measures would be appropriate only if automatic enrollment were adopted in conjunction with other features of the automatic 401(k), especially automatic escalation:

- First, the laws governing automatic enrollment could be better clarified. In some states, some employers see their state labor laws as potentially restricting their ability to adopt automatic enrollment. Although many experts believe that federal pension law preempts such state laws as they relate to 401(k) plans, additional federal legislation to explicitly confirm that employers in all states may adopt this option would be helpful.
- Second, some plan administrators have expressed the concern that some new, automatically enrolled participants might demand a refund of their contributions, claiming that they never read or did not understand the automatic enrollment notice. This could prove costly, because restrictions on 401(k) withdrawals typically require demonstration of financial hardship, and even then the withdrawals are normally subject to a 10 percent early withdrawal tax. One solution would be to pass legislation permitting a short "unwind" period in which an employee's automatic enrollment could be reversed without paying the normal early withdrawal tax.
- Third, Congress could give plan sponsors a measure of protection from fiduciary liability for sensibly designed, low-cost default investments. If workers are automatically enrolled, their contributions have to be invested in something—and some firms are worried about fiduciary liability for these default investments. A targeted exemption from fiduciary liability given a prudent default would provide meaningful protection under the Employee Retirement Income Security Act

[8] Profit Sharing/401(k) Council of America, 47th Annual Survey of Profit Sharing and 401(k) Plans (2004).

of 1974 (ERISA), thus encouraging more employers to consider automatic enrollment. Defining a range of prudent defaults would enhance this safe harbor.

- Fourth, Congress could establish the federal government as a standard-setter in this arena by incorporating automatic enrollment and automatic escalation into the Thrift Savings Plan, the defined contribution retirement saving plan covering federal employees. The Thrift Savings Plan already has a high participation rate, but if automatic enrollment increased participation by even a few percentage points, that would draw in tens of thousands of eligible employees who are not currently contributing. The Thrift Savings Plan's adoption of automatic enrollment, along with automatic escalation, would also serve as an example and model for other employers.
- Finally, broader adoption of automatic enrollment and the other key pieces of the automatic 401(k) could be encouraged by reforming the regulations governing nondiscrimination in 401(k) plans. Many firms are attracted to automatic enrollment because they care for their employees and want them to have a secure retirement, while others may also be further motivated by the associated financial incentives, which stem in large part from the 401(k) nondiscrimination standards. These standards were designed to condition the amount of tax-favored contributions permitted to executives and other higher-paid employees on the level of contributions made by other employees. In recent years, however, employers have had the option to satisfy the nondiscrimination standards merely by adopting a 401(k) "matching safe harbor" design. The matching safe harbor provision exempts an employer from the nondiscrimination standards that would otherwise apply as long as the firm merely offers a specified employer matching contribution. It does not matter whether employees actually take up the match offer—all that matters is that the offer was made. Firms using this safe harbor may have less interest in widespread employee participation in 401(k)s than other firms, thus posing an obstacle to wider adoption of automatic enrollment. Policy-makers should consider various ways of addressing this obstacle.[9]

In sum, a growing body of evidence suggests that the judicious use of default arrangements—arrangements that apply when employees do not make an explicit choice on their own, and that could be overridden by employees at each decision point—holds substantial promise for expanding retirement saving. Retooling America's voluntary, tax-subsidized 401(k) plans to make sound saving and investment decisions more automatic, while protecting freedom of choice for those participating, would require only a relatively modest set of policy changes—and the steps taken thus far are already producing good results. Expanding these efforts will make it easier for millions of American workers to save, thereby promising greater retirement security.

Allowing part of a tax refund to be deposited into an IRA

Most American households receive an income tax refund every year. For many, the refund is the largest single payment they can expect to receive all year. Accordingly, the more than $200 billion issued annually in individual income tax refunds presents a unique opportunity to increase personal saving.

Currently, taxpayers may instruct the Internal Revenue Service to deposit their refund in a designated account at a financial institution. The direct deposit, however, can be made to only one account. This all-or-nothing approach discourages many households from saving any of their refund. Some of the refund is often needed for immediate expenses, so depositing the entire amount in a saving account is not a feasible option. Yet directly depositing only *part* of the refund in such an account is not possible.

Allowing taxpayers to split their refund could make saving simpler and, thus, more likely—especially if combined with the stronger incentives to save discussed below. The Administration has supported divisible refunds in each of its last two budget documents, but the necessary administrative changes have not yet been implemented. The Internal Revenue Service could provide a split refund option by administrative action without the need for legislation. Although implementation does raise a variety of administrative issues, none of these administrative issues presents

[9] One possibility is to change the existing rules so as to allow the matching safe harbor only for plans that feature automatic enrollment and the other key parts of the automatic 401(k). Plan sponsors currently using the matching safe harbor could be given a transition period to meet the new requirements. Another possibility is to explore a much broader reform of the nondiscrimination rules, under which automatic 401(k) plans would be given preferential treatment relative to other plans.

an insuperable obstacle, and implementation should move ahead more aggressively than currently planned.

Once refund splitting was implemented, a key obstacle that might limit participation, is the need for the tax filer to have an IRA to receive the refund. If a household does not already have an IRA, an IRA would have to be set up, which may be a significant impediment in some cases. One possibility would be to allow taxpayers who do not already have an IRA, to direct on their tax return that the government open an IRA in their name at a designated "default" financial institution that has contracted with the government to provide low-cost IRAs for this and related purposes. Another possibility, suggested by Professor Peter Tufano of Harvard Business School, is to allow tax filers to elect part of their refund to be invested in a government savings bond, which would not require an IRA to be created in their name.

In summary, allowing households to split their tax refunds and deposit part of them directly into an IRA would make saving easier. Since federal individual income tax refunds total some $228 billion a year, even a modest increase in the proportion of refunds saved could represent a significant increase in saving.

B. Increasing the incentive to save

In addition to making it easier to save, policy-makers should significantly expand the incentives for middle- and lower-income households to do so.

A new study conducted by The Retirement Security Project in conjunction with H&R Block underscores the significant effect that incentives have on retirement contributions, even among middle- and low-income households.[10] The study reports evidence from the first large-scale, randomized field experiment ever conducted regarding the effects of matching rates on the willingness of low- and middle-income families to contribute to IRAs.

Since the study may prove useful to policy-makers struggling with how to encourage contributions by middle- and lower-income households, I will briefly describe both the experimental design and the results. The experiment was run in 60 H&R Block tax preparation offices in the St. Louis metro area from March 5th to April 5th, 2005. It was built around the Express IRA (X–IRA) product offered by H&R Block, which allows clients to make IRA contributions at the time of tax preparation and to fund those contributions with part or all of their federal income tax refunds or from other sources. In effect, through its X–IRA, H&R Block allows clients to split their anticipated refund between contributions to a retirement account and other uses.

Each client preparing a tax return in one of the 60 H&R Block offices during the period was randomly assigned to one of three match rates for X–IRA contributions: zero (the control group), 20 percent, or 50 percent.[11] By randomizing the matching rate across tax filers, the study was able to identify not only the impact of the presence of a match, but also how variations in the matching rate affect both take-up and contribution levels.

Figure 2 shows the effect of the match rate on participation rates, and Figure 3 shows the effect on average contributions, among those in the different match groups. Figure 2 shows that the match had a significant effect on participation rates; participation rose from 3 percent to 17 percent as the match rate increased from zero to 50 percent.

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[10] Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block," Retirement Security Project Policy Brief No 2005–5, May 2005.

[11] Contributions were matched up to $1,000, a limit that applied separately for each spouse for married tax filers. Each client, including those in the control group, received a waiver of the $15 set-up fee for opening an X–IRA. The minimum X–IRA contribution is $300.

Figure 2: Effect of match rate on participation

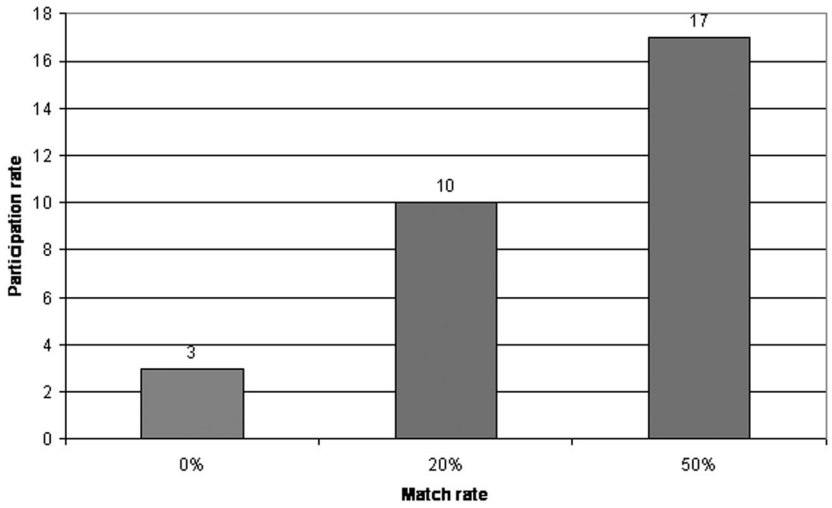
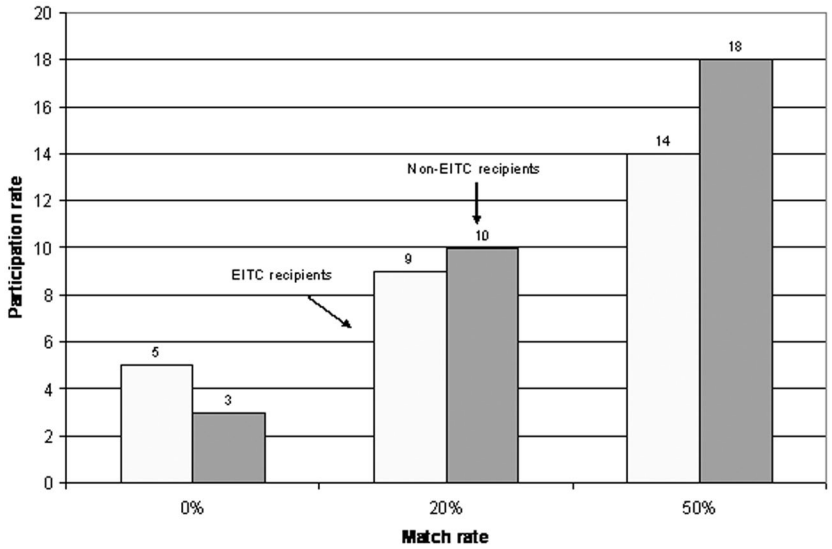


Figure 3 shows that the effects on overall amounts contributed were even stronger. Deposits made by individuals (i.e., excluding the match from H&R Block) in the match groups were between four and eight times higher than with no match.

Figure 3: Effect of match rate on average contributions

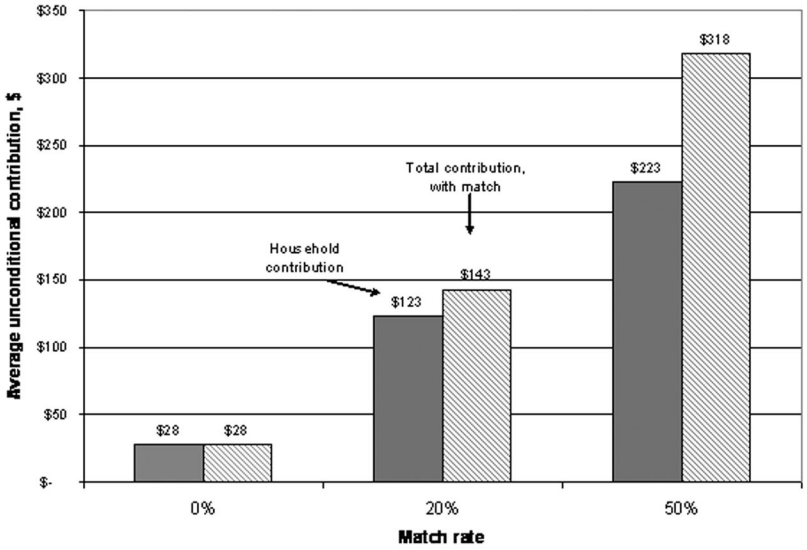


The positive effect of incentives on participation and contributions was stronger among married filers than among singles, and stronger among higher-income households than lower-income households. Nonetheless, the effects remained striking and significant even among low-income households. Figure 4, for example, splits the sample into EITC recipients and non-EITC recipients and shows the effects of the

match rate on participation; the 50 percent match generated a substantial increase in participation rates even among EITC recipients.

Interestingly, the study found more modest effects on take-up and amounts contributed from the existing Saver's Credit, which is described below and provides an effective match for retirement saving contributions through the tax code. We suspect that the differences reflect the way in which the implicit match from the Saver's Credit is presented, the complexity associated with the variation in credit rates under the Saver's Credit and its non-refundability, and the fact that the match in the experiment was highlighted and explained to clients by H&R Block's tax professionals.

Figure 4: Effect of match rate on EITC and non-EITC recipients



Taken together, the results suggest that the combination of a clear and understandable match for saving, easily accessible saving vehicles, the opportunity to use part of an income tax refund to save, and professional presentation and explanation of the match and its advantages could generate a significant increase in retirement saving participation and contributions, even among middle- and low-income households. Below I suggest ways in which the fundamental insights provided by this new research could be implemented.

Revamping the Saver's Credit

The Saver's Credit, enacted in 2001, in effect provides a government matching contribution, in the form of a nonrefundable tax credit, for voluntary individual contributions to 401(k) plans, IRAs, and similar retirement saving arrangements.[12] The Saver's Credit applies to contributions of up to $2,000 per year per individual. As Table 1 shows, the credit rate is 50 percent for married taxpayers filing jointly with adjusted gross income (AGI) up to $30,000, 20 percent for joint filers with AGI between $30,001 and $32,500, and 10 percent for joint filers with AGI between $32,501 and $50,000. The same credit rates apply for other filing statuses, but at lower income levels: the AGI thresholds are 50 percent lower for single filers and 25 percent lower for heads of households.

[12] For more detail on the Saver's Credit, see William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Saver's Credit: Expanding Retirement Savings for Middle-and Lower-Income Americans," Retirement Security Project Policy Brief, No. 2005–2, March 2005.

Table 1: Saver's Credit

AGI range for:					
Joint filers	Singles	Credit rate	Tax credit for $2,000 contribution	After-tax cost incurred by individual to create $2,000 account balance	Effective after-tax matching rate
0–$30,000	0 – $15,000	50%	$1,000	$1,000	100%
$30,001–$32,500	$15,001–$16,250	20%	$400	$1,600	25%
$32,501–$50,000	$16,251–$25,000	10%	$200	$1,800	11%

Note: Figures in table assume that couple has sufficient income tax liability to benefit from the nonrefundable income tax credit shown, and do not take into account the effects of tax deductions or exclusions that might be associated with the contributions or any employer matching contributions.

The credit represents an implicit government matching contribution for eligible retirement saving contributions. The implicit matching rate generated by the credit, though, is significantly higher than the credit rate itself. The 50 percent *credit* rate for gross contributions, for example, is equivalent to having the government *match* after-tax contributions on a 100 percent basis. Consider a couple earning $30,000 who contributes $2,000 to a 401(k) plan or IRA. The Saver's Credit reduces that couple's federal income tax liability by $1,000 (50 percent of $2,000). The net result is a $2,000 account balance that cost the couple only $1,000 after taxes (the $2,000 contribution minus the $1,000 tax credit). This is the same result that would occur if the net after-tax contribution of $1,000 were matched at a 100 percent rate: the couple and the government each effectively contribute $1,000 to the account. Similarly, the 20 percent and 10 percent credit rates are equivalent to a 25 percent and an 11 percent match, respectively (Table 1).

The results of the recent randomized experiment suggest that the presence of an easily understandable and transparent 50 percent match significantly raises participation in and contributions to IRAs. The results confirm the basic idea behind the existing Saver's Credit: offering a stronger incentive to save to low- and moderate-income households can encourage them to contribute significantly more to retirement accounts. The study also suggests, however, that the existing Saver's Credit could be made more effective in encouraging additional contributions. Some options to do so are already under active discussion among policy-makers.

First, it is possible that the credit would be more salient and effective if it were redesigned as a matching contribution that goes into the account, rather than a tax credit. As the table on the previous page shows, the current design results in a substantially higher implicit match rate than the credit rate. Instead of the current design in which a tax credit generates cash for a worker, it may be desirable to have matching contributions made directly to a worker's account.

Second, the non-refundability of the current credit complicates its presentation and substantially reduces the number of people eligible for it. In 2005, 59 million tax filers will have incomes low enough to qualify for the 50 percent credit.[13] Since the existing credit is non-refundable, however, only about one-seventh of them actually would benefit from the credit *at all* by contributing to an IRA or 401(k). Furthermore, only 43,000—or fewer than one out of every 1,000—filers who qualify based on income could receive the maximum credit ($1,000 per person) if they made the maximum contribution. These are the households who have sufficient tax liability to benefit in full from the Saver's Credit but sufficiently low income to qualify for the highest match rate. The incentives provided by a matching program for retirement contributions should be extended to lower-income working families.

One possible revamping of the credit would thus take the following form:

- **Eligibility:** Tax filers would be eligible if they have made IRA or 401(k)-type contributions and have Adjusted Gross Income below the qualifying thresholds.[14]
- **Match rate:** The government would match 50 percent of first $2,000 in contributions made by eligible tax filers to an IRA or 401(k)-type plan. Each spouse

[13] These estimates are generated by the Urban-Brookings Tax Policy Center microsimulation model.

[14] In addition, eligibility would be restricted to filers age 18 or over who are not full-time students and are not claimed as dependents on another return. These eligibility conditions are the same as the existing Saver's Credit.

in a couple filing a joint return would be eligible for a match on up to $2,000. The match would be made regardless of the tax filer's income tax liability.

- **Phase-out:** The maximum eligible contribution would fall from $2,000 to $0 linearly between $30,000 and $50,000 in Adjusted Gross Income for joint filers (the phase-out would occur from $15,000 to $25,000 for singles and married filing separately; and from $30,000 to $40,000 for heads of households).
- **Matching contribution deposited to account:** The matches would be deposited directly to the IRA and 401(k) accounts of eligible taxpayers after the tax return has been processed.
- **Anti-gaming rules:** A variety of protections could be enacted to ensure that tax filers did not "game" the system.

A matching contribution of this type offers significant potential to help correct the nation's upside-down tax incentives for retirement.

Reducing the implicit taxes on retirement saving imposed by asset tests

Another way of increasing the incentives for middle- and low-income households to save is by removing *penalties* imposed on such saving. In particular, the asset rules in means-tested benefit programs often penalize any moderate- and low-income families who do save for retirement in 401(k)s or IRAs by disqualifying them from the means-tested benefit program. The asset tests thus represent a substantial implicit tax on retirement saving.

The major means-tested benefit programs, including Food Stamps, cash welfare assistance, and Medicaid either require or allow states to apply asset tests when determining eligibility. Similarly, the Supplemental Security Income (SSI) program applies such an asset test. The asset tests may force households that rely on these benefits—or might rely on them in the future—to deplete retirement saving before qualifying for benefits, even when doing so would involve a financial penalty. As a result, the asset tests penalize low-income savers.

The asset tests represent one of the most glaring examples of how our laws and regulations have failed to keep pace with the evolution from a pension system based on defined benefit plans to one in which defined contribution accounts play a much larger role. At the time the rules were developed, defined benefit plans were the norm and were generally disregarded in applying the asset tests. In part because they were not viewed as a primary pension vehicle when the rules were written, defined contribution accounts like 401(k)s and IRAs were not exempted. Since then, the pension system has shifted away from defined benefit plans, and defined contribution accounts have become more dominant. Yet the rules have largely not been updated since, so many programs still exempt defined benefit plans while counting 401(k)s and IRAs. (As one example within the jurisdiction of this Committee, the asset test within SSI generally counts all resources "deemed accessible" to an individual. As a result, both IRAs and 401(k)s are generally counted toward the SSI asset limit, but defined benefit plans do *not* count as assets for current employees.) Treating defined benefit and defined contribution plans similarly would be much more equitable and would remove a significant barrier to increasing retirement saving by low-income working households.

The effect of counting 401(k)s or IRAs within the asset tests is not only unfair, it also likely discourages saving for retirement. Furthermore, the rules applied under the means-tested benefit programs are confusing and often treat 401(k) accounts and IRAs in a seemingly arbitrary manner. As just one example of the complexity, workers who roll their 401(k) over into an IRA when they switch jobs, as many financial planners suggest they should, could disqualify themselves from the Food Stamp program.

Asset tests in means-tested programs, as currently applied, thus constitute a barrier to the development of retirement saving among the low-income population.Disregarding saving in retirement accounts when applying the tests would allow low-income families to build retirement saving without having to forgo means-tested benefits at times when their incomes are low during their working years.[15]

II. Avoiding Further Tax Subsidies for Asset Shifting

The four common sense reforms described above could significantly bolster retirement security for millions of Americans. However, some policy-makers seem inclined to couple these proposals with a number of other provisions that would expand income and contribution limits on tax-preferred retirement accounts. Although they

[15] A forthcoming paper from The Retirement Security Project will examine these changes in more detail. Policy-makers considering introducing accounts within Social Security should also be careful to ensure that such accounts would not be counted under the asset tests included in various means-tested benefit programs.

may initially sound similar to those above, such proposals are fundamentally different: Rather than bolstering retirement security among middle- and lower-earners, proposals to increase income and contribution limits would generate significant asset shifting and be of primary benefit to households who are already disproportionately well-prepared for retirement. Policy-makers should not be tempted by a "deal" under which substantial new tax subsidies for this type of asset shifting would be created in exchange for sensible policies to bolster retirement security among middle- and lower-income households.

The problems with the Retirement Savings Account proposal

The Retirement Savings Account (RSA) proposed by the Administration is basically a Roth IRA with no income limit. (The proposal may be presented as "creating a Retirement Savings Account" rather than eliminating the income limit on Roth IRAs. The RSA, however, is virtually identical to the Roth IRA except that, unlike the Roth, the RSA has no income limit.) Simply removing the income limit on the existing Roth IRA, though, would have no direct benefit for the vast majority of American households who are already under the current income limit.

Since access to Roth IRAs currently begins to be curtailed at $150,000 for couples and $95,000 for singles, the only people who would directly benefit from eliminating the cap are married couples with incomes above $150,000 or singles with incomes above $95,000.[16] Analysis using the retirement saving module from the Urban-Brookings Tax Policy Center (TPC) model suggests that three-quarters of the tax subsidies (in present value) from removing the income limit would accrue to the three percent of households with cash income of more than $200,000. More than 25 percent of the benefits would accrue to the 0.6 percent of households with cash income of more than $500,000. More than 40 percent of households with cash income of above $1 million would receive a tax benefit, averaging $1,500 per year in present value. As noted below, it is very unlikely that such households would respond to this tax break by increasing their saving (rather than asset shifting).

Expanding the tax subsidies from Roth IRAs to high-income households would also significantly reduce revenue over the long term. The full cost, however, is not obvious during the 10-year budget window: The revenue loss on a Roth IRA does not occur when the funds are contributed (as under a traditional IRA), but rather when they are withdrawn free of tax. Therefore, the full revenue effect does not manifest itself for several decades—when the budget will already be under severe pressure from the retirement of the baby boomers.

It is thus crucially important not to be misled by the revenue changes over the first few years. Instead, the changes should be examined in terms of their ultimate effect, or their effect in present value (which transforms the future revenue losses into their equivalent amount, with interest, today). The Congressional Research Service (CRS) has estimated that eliminating the income limit on Roth IRAs will, after two decades or so, reduce revenue by $8.7 billion a year. The Tax Policy Center

[16] A frequent claim by advocates of removing the Roth IRA income limits is that eliminating the limits could allow financial services firms to advertise more aggressively and thereby encourage more saving by middle-income households. Two points are worth noting about this "advertising effect" argument. First, the advertisements used in the past (for example, prior to 1986, when there were no income limits on deductible IRAs) suggest that much of the advertising was designed to induce asset shifting among higher earners rather than new saving among lower earners. For example, one advertisement that ran in the New York Times in 1984 stated explicitly: "Were you to shift $2,000 from your right pants pocket into your left pants pocket, you wouldn't make a nickel on the transaction. However, if those different 'pockets' were accounts at The Bowery, you'd profit by hundreds of dollars . . . Setting up an Individual Retirement Account is a means of giving money to yourself. The magic of an IRA is that your contributions are tax-deductible." Second, advocates of substantial benefits from advertising point to the experience with IRAs after 1981, when access was expanded to include all wage earners, and before the Tax Reform Act of 1986, when income limits were imposed on deductible IRAs. It is true that participation rates in IRAs declined after the 1986 reform, even among those below the new income limits. But the declines were somewhat modest in an absolute sense. After all, some decline in IRAs may have been expected given the rise in 401(k) availability (which could substitute for IRAs) and the reductions in marginal income tax rates (which reduces the advantage to saving in an IRA). Data from the IRS Statistics of Income suggest that 5.0 percent of those with Adjusted Gross Income of $20,000 or less in 1984 contributed to an IRA; in 1988, 2.4 percent of those with Adjusted Gross Income of $20,000 or less contributed to an IRA. In other words, the decline amounted to only about 2.5 percent of that income group—and some decline would have been expected for the reasons just mentioned. More broadly, with respect to the pre-1986 era without any income limits, the Congressional Research Service concludes that "There was no overall increase in the savings rate—despite large contributions to IRAs." This suggests that any contributions to IRAs were mostly asset shifting from other accounts, rather than new saving.

estimates suggest a cost by 2010 of roughly $5 billion a year in present value.[17] To avoid fiscal gimmicks, policy-makers should offset the cost of backloaded new tax preferences over periods longer than the traditional 10-year budget window.

The revenue loss from removing the income cap on Roth IRAs might be worth the cost if it were likely to trigger significant increases in private saving. Instead, the result would likely be substantial shifting of assets from taxable accounts into the tax-advantaged IRAs by households with incomes above $150,000. In commenting on a similar proposal in the late 1990s, then-Treasury Secretary Robert Rubin explained, "—if you don't have income limits, then you're going to be creating a great deal of benefit for people who would have saved anyway, and all of that benefit will get you no or very little additional savings."[18]

The problems with raising the contribution limits to IRAs and 401(k)s

Another common proposal would increase the maximum amount that can be saved on a tax-preferred basis, such as by raising the *amount* that can be contributed to an IRA or 401(k). Yet only about five percent of 401(k) participants make the maximum contribution allowed by law, and only about five percent of those eligible to contribute to IRAs make the maximum contribution. Increasing the maximum contribution amounts would thus be unlikely to have much effect on the vast majority of families and individuals, since they are not currently making the maximum allowable contribution. Instead, raising the contribution limits would largely provide windfall gains to households already making the maximum contributions to tax-preferred accounts *and* saving more on top of those contributions in other accounts.

An unpublished study by a Treasury economist found that only four percent of all taxpayers who were eligible for conventional IRAs in 1995 made the maximum allowable $2,000 contribution at that time.[19] The paper concluded: "Taxpayers who do not contribute at the $2,000 maximum would be unlikely to increase their IRA contributions if the contribution limits were increased whether directly or indirectly through a backloaded [Roth] IRA." Similarly, the General Accounting Office has found that the increase in the statutory contribution limit for 401(k)s would directly benefit *fewer than three percent* of participants.[20]

Table 2: 401(k) participants making the maximum contribution in 1997

Household income (AGI)	Number of total contributors (thous.)	% of total contributors	% in income class contributing maximum
Under $20,000	2,695	7.6%	1%
$20,000 to $40,000	8,914	25.0%	1%
$40,000 to $80,000	15,020	42.1%	4%
$80,000 to $120,000	5,739	16.1%	10%
$120,000 to $160,000	1,624	4.6%	21%

[17] In addition to the revenue costs associated with removing the income limit on Roth IRAs, policy-makers should recognize that perpetuating a $5,000 maximum contribution to IRAs is expensive. The CRS has estimated that perpetuating the $5,000 contribution limit on the Roth IRA, rather than allowing it to revert to the $2,000 limit that was in effect prior to the enactment of the 2001 tax legislation, would reduce revenue in the long term by $20 billion per year.

[18] Press briefing by Secretary of Treasury Robert Rubin, National Economic Advisor Gene Sperling, OMB Director Franklin Raines, and Chair of Council of Economic Advisers Janet Yellen, June 30, 1997.

[19] Robert Carroll, "IRAs and the Tax Reform Act of 1997," unpublished mimeo, Office of Tax Analysis, Department of the Treasury, January 2000. See also Craig Copeland, "IRA Assets and Characteristics of IRA Owners," EBRI Notes, December 2002.

[20] General Accounting Office, "Private Pensions: Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans," GAO–01–846, September 2001. The GAO also found that 85 percent of those who would benefit from an increase in the 401(k) contribution limit earn more than $75,000. (These figures reflect the effects of other changes included in EGTRRA that have already taken effect, such as the elimination of the previous percentage cap on the amount of combined employer-employee contributions that can be made to defined contribution plans.)

Table 2: 401(k) participants making the maximum contribution in 1997—Continued

Household income (AGI)	Number of total contributors (thous.)	% of total contributors	% in income class contributing maximum
$160,000 and over	1,673	4.7%	40%
TOTAL	35,666	100.0%	6%

Source: Author's calculations based on Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving," August 2003, Table 2.

Other recent studies have reached similar conclusions, finding that the fraction of individuals constrained by the limits that were in place prior to enactment of EGTRRA was very small.[21] Table 2 presents information from the Congressional Budget Office on workers constrained by the previous 401(k) limits in 1997. Only six percent of all 401(k) participants made the maximum contribution allowed by law. Only one percent of participants in households with incomes below $40,000 made the maximum contribution. Among participants in households with more than $160,000 in income, by contrast, 40 percent made the maximum contribution.

Again, the problem is that most of the response to increasing the contribution limits is likely to be shifting of assets from other accounts. The expanded tax preference thus would mostly translate into subsidizing saving that would have occurred anyway, rather than encouraging new saving.

Furthermore, at least with regard to increasing IRA contribution limits, the increase in the amount of tax-free saving that taxpayers would be able to do outside of retirement plans could reduce the incentives for small and medium-sized businesses to offer qualified plans, which could *reduce* opportunities for middle- and lower-earners to save in a convenient way. With a higher IRA limit, many business owners and managers may find that they can meet all of their demands for tax-free saving without the hassle and expense of maintaining an employer-sponsored plan. According to an analysis by the Congressional Research Service, "some employers, particularly small employers, might drop their plans given the benefits of private savings accounts."[22] Higher IRA limits may thus actually reduce retirement security for middle- and lower-earners by making it less likely that they would have a convenient and easy way to save.

Conclusion

In conclusion, bolstering retirement security on top of Social Security need not be contentious and divisive. Over the past 25 years, the ways in which Americans save for retirement has changed and more responsibility has been shifted to workers, but our policies have failed to keep pace. We should make it easier for middle- and lower-income households to save for retirement and increase the incentives for them to do so, and my testimony highlights four specific ways in which this could be done. Especially in light of the nation's dire long-term fiscal gap, however, policies that disproportionately result in yet more government-subsidized asset shifting among households who already tend to be adequately prepared for retirement should not be the price of enacting proposals to improve the retirement security of millions of Americans.

Chairman THOMAS. Thank you very much for your mindfulness of the time. Dr. John Goodman has been before us before—nice to have you back—from the National Center for Policy Analysis. Dr. Goodman.

[21] See, for example, David Joulfaian and David Richardson, "Who Takes Advantage of Tax-Deferred Saving Programs? Evidence from Federal Income Tax Data," Office of Tax Analysis, U.S. Treasury Department, 2001.

[22] Jane G. Gravelle, Congressional Research Service, "Effects of LSAs/RSAs Proposal on the Economy and the Budget," January 6, 2004.

STATEMENT OF JOHN GOODMAN, PRESIDENT, NATIONAL CENTER FOR POLICY ANALYSIS

Mr. GOODMAN. Thank you, Mr. Chairman, Members of the Committee. I appreciate the opportunity to be here this morning. In just 3 years, the first of the Baby Boomer generation will qualify for early retirement. And by the time my generation is through, 77 million of us will quit working and paying taxes, and will begin drawing benefits instead. Along the way, this development will create an enormous financial strain on Social Security, Medicare, Medicaid, the Veterans Administration, and every other program for the elderly. In fact, it will be nothing short of a fiscal tsunami.

Many people think that this is a problem in the distant future. In fact, it is a problem that is already upon us. Last year, for the first time in the last several decades, Social Security and Medicare combined spent more than they took in. That means that last year, for the first time in some time, these two programs, instead of contributing to the general revenues of the budget, took from the general revenues. They took about $45 billion. Now, over the next 5 years, that number will soar. It will triple in 5 years. Five years after that, it will double. Five years after that, it will double again. And so if we look out just 15 years, to the year 2020, we are going to need $750 billion on top of the payroll tax, just to keep our commitments to senior citizens. If we threw in the amount we are going to pay for seniors under Medicaid, we would exceed a trillion dollars in just 15 years. By 2030, it is two trillion; by 2040, it is four trillion. These numbers are so large that they boggle the mind. So, perhaps the best way to view them is in terms of the money that is available to pay.

In just 5 years, we will need almost one out of every ten general income tax dollars in order to make up the deficits in Social Security and Medicare, to keep our commitments to seniors. What this means is that the Federal Government will have to cease doing one out of every ten other things that it does, in order to keep our promises. That means we are going to need 10 percent from the Defense Department, 10 percent from education, 10 percent from energy. And if we don't get all that money, we have got to raise taxes by 10 percent. By 2020, it is more than one out of every four income tax dollars; which means that we need a fourth of everything else the government is doing, or we have got to raise taxes by that much. By 2030, it is half. By 2050, it is three-fourths. And if we threw Medicaid into the equation, by the time today's college students retire, in order to keep all our promises to them, we are going to need the entire Federal budget. So, it is no surprise that many of them say in polls that they are more likely to see a UFO.

Why is this happening? It is happening because we have a chain letter approach to funding retirement benefits. Instead of saving and investing, each generation of retirees is depending upon the next generation of workers to pay its benefits. It is becoming increasingly obvious that in the 21st century a chain letter approach to paying for pension and health care benefits simply will not work. And what that means is we need to move as quickly as possible to a funded system in which each generation pays its own way. Regardless of the form we adopt, we have made promises we cannot keep. And as a consequence, in the future, future generations will

have to rely more on private savings than past generations have relied. And yet, as the need for savings grows, our savings rate is falling to shockingly low levels. Now, we at the National Center for Policy Analysis have made a number of proposals to improve and reform the private saving system. Some of them we have made with Peter Orszag of the Brookings Institution, and I would commend those to you. I have also worked with Larry Kotlikoff to make several proposals on how we could move our income tax system to a consumption-based system. And that almost by definition encourages saving and discourages consumption. Whatever we do, the ideal would be to reduce future taxpayer burdens at the same time that we increase current savings. If we could achieve the ideal, we would avert much of the pain that appears in our future. Thank you, Mr. Chairman.

[The prepared statement of Mr. Goodman follows:]

Statement of John C. Goodman, President, National Center for Policy Analysis, Dallas, Texas

In 2011, the first group of baby boomers will reach the age of 65. Some will begin claiming early retirement in just three years. By the time they are through, 77 million of them will have ceased working and paying taxes and will have begun receiving taxpayer-funded health care and pension benefits. This will create a financial train wreck for Social Security, Medicare and Medicaid and all other programs for the elderly. Other countries in the developed world face even bigger problems. In Japan, Europe and North America, the number of retirees will double over the next 25 years while the number of taxpayers will grow by only 10 percent. The economic consequences of these changes are dire: higher taxes, slower growth and lower living standards relative to what otherwise would have occurred.[1]

In the United States, we have made promises to senior citizens that far exceed what we can pay for at current tax rates. As a result, future retirees will have to rely more on private savings than previous generations. For this reason, we need programs that encourage private sector saving. The ideal would be to encourage private saving and reduce future government entitlement obligations at the same time. This could be accomplished with personal retirement accounts.

The Cash Flow Problem. In a pay-as-you-go system, what matters most is cash flow. And the cash flow drain that elderly entitlement programs portend is not a problem of the distant future, as some argue. The problem has already begun.

Social Security and Medicare have been receiving more in payroll taxes than they have been paying out in benefits for several decades. Last year, the two programs combined spent more than they took in, requiring a general revenue subsidy of about $45 billion. The magnitude of the deficits in these two programs will soar in the years to come.

For those who believe that Social Security and Medicare are in sound financial shape for decades to come, Figure I presents a sobering picture. In fact, the latest numbers from the Trustees of Social Security and Medicare are staggering. In 2010, the federal government will need $127 billion in additional funds to pay promised benefits. Five years later, the size of the annual deficit will double. Five years beyond that, it will double again. In just 15 years, the federal government will have to raise taxes, reduce other spending or borrow $761 billion to keep its promises to America's senior citizens. As the years pass, the size of the deficits will continue to grow. Without changes in worker payroll tax rates or senior citizen benefits, the shortfall in Social Security and Medicare revenues compared to promised benefits will top more than $2 trillion in 2030, $4 trillion in 2040 and $7 trillion in 2050![2]

These deficit numbers include projected inflation. Yet even in 2004 dollars, the numbers are still staggering. Valued in today's dollars, the annual Social Security deficit will top $50 billion in 2020, $250 billion in 2030 and $400 billion in 2050.

[1] Laurence Kotlikoff, Hans Fehr and Sabine Jokisch, "Aging, the Word Economy and the Coming Generational Storm," National Center for Policy Analysis, Policy Report No. 273, February 4, 2005.

[2] The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds and the 2004 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds.

Adding Medicare's deficits, the federal government will need more than $500 billion in 2020, $1 trillion in 2030 and $2 trillion in 2050 to fund elderly entitlement programs alone.[3]

Note that these estimates, which come from the latest Social Security Trustees report, do not include the growing burden of senior health care costs under Medicaid.

Deficits as a Percentage of Other Federal Revenues. The combined budget shortfalls for Social Security and Medicare are so large that it is difficult to comprehend what the numbers mean. Figure II presents the projected deficits as a percentage of federal income tax revenues. It shows that combined Social Security and Medicare deficits will equal almost 10 percent of federal income taxes in just five years. Roughly this means that, if the federal government is to keep its promises to seniors, it will have to stop doing one in every ten things it does today. Alternatively, we will have to raise income taxes by 10 percent or borrow an equivalent sum.

Ten years later, in 2020, combined Social Security and Medicare deficits will equal almost 29 percent of federal income taxes. At that point the federal government will have to stop doing almost a third of what it does today. By 2030, about the midpoint of the baby boomer retirement years, federal guarantees to Social Security and Medicare will require one in every two income tax dollars. By 2050, they will require three in every four.[4]

What about the Trust Funds? The Social Security and Medicare Trust Funds serve an accounting function, not an economic one. They work like this: When payroll tax revenues exceed expenses, special bonds are created to keep track of the surplus. These bonds are not purchased in the marketplace, however. For Social Security, they are created on paper and placed in filing cabinets in Parkersburg, West Virginia, (for Medicare, they are computer entries only) while the actual surplus payroll tax dollars are spent on other things. When tax revenues fall short of expenses, the process is reversed: the bonds are taken out of the filing cabinets and retired.

The Social Security Trust Fund currently holds about $1.6 trillion of these bonds. But the bonds cannot pay benefits. They cannot be sold on Wall Street or to foreign investors. Although they are treated as assets of the Trust Fund, they are also liabilities of the Treasury. Summing over both agencies of government, assets plus liabilities net out to zero. If the federal government had purchased assets with the Social Security surpluses, the trust funds would today represent real economic value. Instead, Social Security revenues were spent in other ways and the government essentially wrote IOUs to itself.

If a fire were to destroy the filing cabinets in Parkersburg, it would in no way diminish the capacity of the federal government to pay benefits. Alternatively, if a stroke of the President's pen were to double or triple the number of bonds in those filing cabinets, that would in no way increase our ability to pay benefits. If we could create value by writing IOUs to ourselves, Social Security would have no financial problems. Unfortunately, there is no free lunch.

Present Value of Unfunded Liability. Last year, for the first time since the inception of these programs, the Social Security Trustees did something private entities do routinely—they calculated the present value of the difference between the promises we have made and the expected revenues dedicated to keeping those promises. These calculations were made for the traditional 75-year horizon and (what economists consider the more accurate procedure) looking indefinitely into the future. These implied, unfunded liabilities are enormous:[5]

- Social Security's long-run cash flow deficit is $11.1 trillion—almost equal to the current size of the entire U.S. economy.
- The total shortfall of Medicare Part A (hospital insurance) and Part B (doctors' services) is $47.7 trillion; and the new prescription drug benefit will require $17.7 trillion.
- The unfunded liability of Medicare and Social Security combined totals more than $76.5 trillion—more than seven times the size of our economy.

This means that without ever raising taxes or cutting benefits, we need $76.5 trillion invested right now at the government's borrowing rate. And because we have

[3] Ibid.

[4] The Trustees reports express these deficits as a percent of GDP. Here they are converted to a percent of federal income tax revenues, assuming federal revenues are 10.8% of GDP, which is the 50 year average.

[5] Social Security Trustees Report Table IV.B7, and 2005 Medicare Trustees Report Tables II.B12, III.C17 and III.C23.

not made that investment, our unfunded liability under Social Security is growing at the rate of $667 billion per year. The unfunded liability under Medicare is growing at a rate of $4 trillion per year.

Moving to a Funded System. The underlying problem in the United States and throughout the developed world is reliance on pay-as-you-go finance. Every dollar that is collected in payroll taxes is spent. It is spent the very day, the very hour, the very minute it is received. No money is being stashed away in bank vaults. No investments are being made in real assets.

In a pay-as-you-go system, promises made today can be kept only if future taxpayers (many of whom are not yet born) pay a much higher tax rate than workers pay today. And even if they do shoulder a much greater burden, they would have no assurance that their benefits would be paid as the necessary tax burden grows through time. In any event, this chain letter approach to paying for retirement benefits must eventually come to an end. The question is: can we find an orderly way to transform the system that minimizes the pain.

The alternative to a pay-as-you-go system is a funded system, where worker contributions are saved and invested. Instead of depending on future generations of taxpayers to pay ever-escalating tax rates, in a funded system each generation pays its own way.

Thirty countries have already gone through the process of transforming their pay-as-you-go systems into partially or fully funded systems. These countries have acted responsibly to deal with a problem that the United States so far has refused to face.[6]

Personal Retirement Accounts. It is possible to fund a retirement system without creating individually owned and controlled accounts. After World War II, almost two dozen former British colonies set up forced savings plans (called provident schemes) as an alternative to the pay-as-you-go approach so popular elsewhere around the world. The most successful of these was established by Singapore.[7]

Despite the evolution and success of Singapore's system, in most cases provident funds have had a spotty and disappointing record. The reason: when funds were managed and controlled by governments, all too often politicians succumbed to the temptation to spend the funds rather than invest them.

Personal retirement accounts create a check on government power. By creating ownership rights and reinforcing the principle of ownership by allowing individual worker investment choices, the odds greatly increase that funds invested today will be able to pay retirement benefits tomorrow.

Chairman THOMAS. Thank you very much. To try to maximize the opportunity for all Members to inquire, the Chair will place himself on the clock, and would urge Members to heed the clock so that all could participate in the discussion. We can go in a lot of different directions, but one of the focuses I would like to try to get from as broad a number of Members of the panel as I can is the idea that what seems to be fairly self-evident is that for every dollar you can get voluntarily diverted from current consumption to future consumption, it relieves the taxpayer government cost; or at least it augments it in a way that the future doesn't look quite as difficult. The problem, of course, is to get that voluntarily diverted dollar. You have to look at the ease of decision. And what has been discussed today and has been discussed previously, and I would just like a very quick reaction—"Yes" or "No," hopefully—over whether or not someone is, I don't know the proper term, offended, opposed for policy reasons—I don't know, un-American—to the idea of an automatic enrollment with an opt-out in whatever

[6] Estelle James, "Reforming Social Security: Lessons from Thirty Countries," National Center for Policy Analysis, Policy Report No. 277, May 2005.

[7] Peter J. Ferrara, John C. Goodman and Merrill Matthews, Jr., "Private Alternatives to Social Security in Other Countries," National Center for Policy Analysis, Policy Report No. 200, October 1995.

the program is. Is anyone fundamentally disturbed by that concept?

[All Members of the panel shake their heads in the negative.]

Chairman THOMAS. The recorder can't register. The Chair would indicate all of the Members moved, almost simultaneously, with a motion to the left and right of the heads; which denotes they would not be upset by that.

Mr. DAUB. You said "disturbed," Mr. Chairman.

Chairman THOMAS. I'm sorry, disturbed. You are not disturbed. Okay. Thank you.

Mr. DAUB. It's a good idea.

Chairman THOMAS. Welcome back, Hal. Then, of course, the question is—and we will leave it for a future debate, because obviously that gets into some of the more contentions areas—how do we deal with a multiplier to benefit the savings which we have been able to put aside? And there are options, and I don't think we can look at it right now. What Mr. Salisbury pointed out—and this is where the Chair would love to have whatever research you have, or your knowledge and guidance—is the fact that we have seen a significant shift from defined benefit to defined contribution in the pension area. And obviously, to a very great extent, the savings turn into a kind of a defined contribution, unless you then make a subsequent decision to change what would otherwise be a defined contribution structure. And if the payout structure is going to be more and more critical for seniors who make an estimate and, pleasantly, fall short in terms of when they are going to die, clearly an annuity is a concept that is attractive. It was attractive under the old defined benefit program. think one of the reasons corporations are moving away from it is they don't want the responsibility.

And Dr. Orszag, to say that what we ought to do is just simply use the 401(k)—not to criticize what you are saying, and I know there is a lot of money in 401(k)s and we can deal with it in rollover or other ways—but it seems to me maybe we should be thinking about an instrument that allows a decision to be made that doesn't put a company that has voluntarily desired to continue to help its employees but doesn't want to be saddled with an annuity as concept under the defined benefit, and they shifted to a 401(k) and, lo and behold, we are going to impose on them a requirement that they provide an annuity out of a 401(k); which is looping us right back into the defined benefit problem.

However, if it is desirous to have an annuity at the end of whatever the saving structure is, either on an opt-out basis or encouragement of the insurance industry to be creative about coupling long-term care, life insurance, or other combinations that folks haven't focused on to create vehicles for choice by seniors, it moves us from the front-end choice, if we are successful, to get them to put the dollar away, to the back-end choice of how do we maximize their opportunities of using the dollars they have put away. I would prefer having the problem on the back end, because we have then solved the front end. The issue has been presented to us, what might we do in terms of being prescient and trying to deal with both ends of the problem at the same time.

I don't need extensive response now. Maybe a Member of the panel might want to respond, because my time is going to run out.

I do want written analysis or your approach to how we might deal with it. If we can induce savings—which you have provided great options—how can we then at the same time be smart and maximize the chances of those people having their savings last throughout their life, which is going to be longer and longer than people thought it was going to be? Very briefly, Dr. Goodman.

Mr. GOODMAN. I would just like to add something that was not mentioned by the panelists. And that is in the movement from the defined benefit private pension to the defined contribution 401(k) pension. What we are finding is that employees do not make good choices. They tend to make two mistakes. They tend to invest in what is safe; which is their own company stock. And that greatly increases risk. Or they tend to what they know or what is safe; which is the money market fund, where the return is too low. So, money going into these plans is not getting the return, is not building up the way it needs to buildup to replace the old defined benefit pension. And as part of Peter's set of suggestions, we would like to encourage employers, as the default option, to encourage people to go into diversified portfolios. That would reduce the risk and greatly increase the return. And then, on the annuity end, we do not have a well-developed annuity market in this country. Chile, by the way, does. Chile has a huge market, and has shown that you can have annuity markets that work. So, I think we ought to look carefully at what they have done, and see how we can encourage a similar market here.

Chairman THOMAS. Dr. Goodman, we have got unanimity in terms of the opt-out on the front end of a savings program. I think you will find that there will be much less unanimity on opting into a choice of programs. I agree that the more choice you have, it isn't empowering or freedom; it is enfeebling, and people then don't make a choice. To go so far as to put them in a particular program needs to be carefully examined. know Dr. Orszag, you have got that ongoing study, which would be helpful, not just in inducing people to save; but what is the reaction of a default program which maximizes their chances, as Dr. Goodman says, to get a decent return on what they have saved, but also, to create a decent pattern of disbursement? Very briefly, Dr. Orszag.

Mr. ORSZAG. Very briefly, on the payout stage. agree completely that this is one of the critical things we need to be looking at as we move forward in time and more people are in that stage. The first thing is, it is important to realize that for many middle- to lower-income families, where a lot of the concern is, current annuities, naturally or understandably, do not provide an overwhelmingly good deal. And the reason is that insurance companies have to price the annuities to the people buying them, who are higher-income, who tend to live longer. That means that for middle- to lower-income families, they are not a good deal; the estimate suggesting that you lose in present value something like 15 percent of the lump sum that you would transform into the annuity. So, there is a significant market issue that needs to be overcome. will in writing try to give some ideas for how to overcome that. The second point, though, is there have been proposals to provide tax preferences for annuitized income. just want to emphasize again that if you provide a tax deduction for the vast majority of families you

are not doing very much to incentivize that, because they are in the 15 or 10 percent marginal bracket. The benefits are going to go to people who are at the upper end, where there is less concern.

Chairman THOMAS. And just let me conclude very briefly that with anything we deal with, like retirement annuities and the rest, you have in essence a bell-shaped curve. think one of the responsibilities of government, at least from my perspective, is that if the market can't handle the bell-shaped curve, then the government can deal with the tails on the bell-shaped curve and let the market handle what it can. And that would be focused on the assistance to folk in the low income. I think that would be preferential to going to any kind of age relating or other problems which get us into problems that magnify the partisan differences and don't focus on the real problem. I want to thank the panel very much, and recognize the gentleman from New York.

Mr. RANGEL. Thank you, Mr. Chairman. Let me thank the panel for the quality of your testimony, as well as the recommendations that you have made. I certainly think we are all in accord that if you are looking at Social Security you have to take in consideration pensions and savings, and even the Tax Code to the extent that you are going to try to persuade people to save by providing incentives. From a realistic point of view, however, we are faced politically with the solvency of the Social Security system. And while I do believe, and everyone believes, that it is going to be important to see how we can make the system solvent and at the same time give the maximum protection to people who are living longer, our former colleague suggested some of the difficult things we have to do in terms of reducing costs, reducing benefits. We are dealing politically with a program that provides some degree of guarantee. We may have to tinker with it and do other things with it, in order to make certain that it begins to work. Are any of you suggesting that we cannot move forward to try to fix in a bipartisan way the Social Security system, without at the same time dealing with the pensions and the pension benefits and the savings, or what we now politically call the private accounts? Because that is the major political problem we are facing. Now, do any of you believe that we have to put the private accounts on the table at the same time, in order to deal with the Social Security problem?

Mr. GOODMAN. Well, Mr. Rangel, I believe that we cannot solve the problem of elderly entitlements without moving from a pay-as-you-go system to a funded system. That means we need to be saving and investing. Now, it is possible to do that saving and investing collectively, and in fact, a number of people have proposed doing exactly that. I prefer the individual accounts because I think when you have individual accounts, even if people don't have much choice about where the money is invested, they have a property right in the outcome. And there are about 30 countries now that have reformed their systems in this way. And when individuals have property rights, it is very hard for the government to take the money and do something else with it.

Mr. RANGEL. Okay. What we are dealing with here—and I don't think it can be challenged—is that the beneficiary goes into this system now with some degree of a guaranteed benefit. For those

that follow, they go in with a guaranteed benefit. Are you suggesting, Dr. Goodman, that at the end of the day you would be willing to accept a program that includes the pensions and the savings, and loses the entire guarantee?

Mr. GOODMAN. No, there is no country that doesn't have some kind of guarantee.

Mr. RANGEL. I am not talking about the other countries now. We are dealing with an election that is coming up in this country, and we have to deal with the politics of this country. And the issue before us is whether or not we cannot deal with Social Security unless we deal with the private accounts. am asking you, as economists and people who study this issue, because before we get to all of the things that I agree with the Chairman that we have to deal with, we may never get there if at the same time you have got to remove the guarantee and give us the privatization—Chile notwithstanding. I am talking about the United States of America.

Mr. GOODMAN. The quick answer is, of course you can have the guarantee. And Representative Shaw has a plan that has a 100-percent guarantee. So, yes, you can have a guarantee.

Mr. DAUB. Mr. Rangel?

Mr. RANGEL. I didn't say you could. My question is, I am going to ask, is there anyone here that believes that this Congress cannot in a bipartisan way deal with the solvency of Social Security without having on the table the private savings accounts?

Mr. DAUB. Mr. Rangel?

Mr. RANGEL. Yes, Mr. Daub?

Mr. DAUB. I, in my testimony, gave you two benefit changes and two revenue raisers that without the private account achieve the 75-year actuarial balance; the baby born today, likely to live 75 years. If you think about annuitizing a mandatory personal account of only 2 percent, you add to the potential income capability, because the FICA is already mandatory. That, we pay. So, it is just the concept of trying to tie together what you said. You could do it without the personal account, in a general way that perhaps I outlined. And there are other ways of looking at it.

Mr. RANGEL. I agree, and you should point that out.

Mr. DAUB. You could think of one other thing about Medicaid. Remember that about half the people in America today depend upon the Social Security check after age 65 for almost 100 percent of their income; and it is an offset against Medicaid. So, it is a very important piece of retirement security to figure out how on the front end you might use the mandatory FICA to advantage for those less well off, less financially well off.

Mr. RANGEL. Does anyone challenge what he has said, that we can handle Social Security in a bipartisan way without having the private accounts on the table?

Mr. DAUB. It is just better off, if you think of it.

Mr. RANGEL. I understand what you are saying. When they call it the third rail, they know exactly what they are talking about. And you can't dismiss it just because you are experts in terms of retirement income. We have to get to the point that we are talking; and we are not. just want to find out, from a professional point of view, that if, for reasons which you have no control of, private accounts are not on the table, can we deal with Social Security, with

the understanding that we have to get back to savings, we have to get back to health care, and we have to get back to a lot of other issues? Is there anyone here that can say that we can't do it unless we put the private accounts on the table?

Mr. JACKSON. Mr. Rangel?

Mr. RANGEL. You are back to Chile; aren't you?

Mr. GOODMAN. No. I do not believe you can ultimately solve the problem of elderly entitlements without moving to a funded system; which means investment and saving. And you could do it without a private account. You could have the government do the saving and the investment.

Mr. RANGEL. That is all I am asking.

Mr. GOODMAN. I would prefer that——

Mr. RANGEL. I know you prefer. And it could very well be, if the political climate wasn't what it is, a lot of people would prefer. All I am asking, and all of you agree, is that we have no excuse to move away from dealing with Social Security merely because of the private accounts. thank you.

Chairman THOMAS. The Chair didn't understand that to be the conclusion of the panel, but if the gentleman is comfortable with that conclusion——

Mr. JACKSON. May I add to that point?

Chairman THOMAS. Briefly. exceeded my time, and he exceeded his. We are both going to impose the time limit on everybody else.

[Laughter.]

Mr. JACKSON. I just wanted to say, yes, you can address the solvency problem, but solvency isn't the only problem. If all you do is raise taxes or cut benefits, you cheapen the deal—which is already a poor deal—for younger Americans. Addressing the solvency issue does not address the adequacy issues. Social Security isn't a terribly generous program. We need to ensure adequate income for future retirees.

Chairman THOMAS. Thank the gentleman. Does the gentleman from Florida wish to inquire?

Mr. SHAW. Thank you, Mr. Chairman. I am very impressed by the last statement that was made by the gentleman from New York. I think it bears repeating. If it were not for the political climate, many people would choose private accounts. I think that we would get a lot of support from the other side of the aisle, if it were not for the political climate. think that is probably the tragedy of this Congress, if indeed we walk away from Social Security reform without a solution.

Mr. Salisbury, I am reading from page 6 of your testimony, in which you define some of the things that can happen. One of the things that you say is that you could have current benefits with a cliff imposed. And you go on further in your remarks and you say, "Under the 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." Now, I know you are not advocating that position, but you are simply putting it forward. I would like to explore that date. We are going to find that we will have a decreasing surplus in Social Security for a number of years. And 2042, I am sure you chose that as that is

one of the estimates that is made as a date that we are going to be running out of Treasury bills.

In 2041 and in 2043—and you can go up and down from there—the effect is going to be the same. In 2045, '46, '47, we are not only going to find that the surplus has dried up—which the government today, the General Fund, has become addicted to—but we will also find that we are going to, beginning in 2017, have to find the money in order to pay benefits. Now, true, we will go through the mechanics of trading in the Treasury bills for cash, but the effect in 2040 and 2045 is going to be exactly the same. We are going to have to find the cash to pay benefits. Is that not a true statement?

Mr. SALISBURY. That is a true statement, Congressman. And one of the other alternatives mentioned in the testimony that we did look at was the issue of essentially phasing the benefit reduction down beginning almost immediately, in order to smooth it out, as opposed to the cliff. We also analyzed what the effects would be if you simply raised taxes to close the gap. And then we also in the same analysis noted in the testimony compared that to the Model 2 individual account with indexation proposal of the President's commission, in order to give Members an ability to look at what the long-term income and expense effects would be of four different alternative approaches to reaching financial solvency.

Mr. SHAW. I appreciate your analysis, but that is not the only choice that is out there. And Dr. Goodman, I want to get to you for a moment. I think you have very clearly pointed out that going to personal or individual accounts in no way is inconsistent with a guarantee plan. And you pointed that out very well in your testimony. Pursuing this problem of cash flow, on page 2 of your testimony you include a table showing the cash flow deficit of Social Security and Medicare. The numbers, of course, as you pointed out in your testimony very adequately, are staggering, and you don't even include the cost of Medicaid in that. Clearly, all the entitlement programs have to be addressed, and we must do that. We can't tackle all of these issues at once. And President Bush, like President Clinton before him, has made strengthening Social Security a top priority. Would you tell us more about why we need to focus on cash flow, and how that focus on cash flow informs us about the immediacy of the problem we face? And the immediacy, of course, is going to be in 2017, not 2042.

Mr. GOODMAN. Sure. In a pay-as-you-go system, the only thing that matters is cash flow. And what a lot of people forget is that ours is a pay-as-you-go system. We have not saved. We have not invested. What we call "trust funds," the Social Security and Medicare trust funds, are not real trust funds. They do not hold real assets. The funds were spent on something else. These are basically IOUs they have written to themselves. And every asset held by the trust fund is a liability of the Treasury. You sum over both parts of government, and the assets and liabilities sum to zero. So, all that matters is cash flow. And the cash flow numbers are really striking. The reason I have added Social Security and Medicare together is because I believe that if we didn't have Medicare and we didn't have Medicaid, we could probably muddle through with Social Security. We can't muddle through with all these programs. So, if you like, the strongest argument for the reform of Social Security

is the existence of Medicare. And the second-strongest argument for the reform of Social Security is the existence of Medicaid. Sum them all up and it is a burden we simply can't live with. So, if you reform one, you help the other two.

Mr. SHAW. Thank you, sir.

Chairman THOMAS. The gentleman's time has expired.

Mr. DAUB. Mr. Shaw, could I just add that disability tracks age. So, his point is a good one with respect to the FICA also covering six million Americans who are disabled.

Chairman THOMAS. Does the gentlewoman from Connecticut wish to be recognized?

Mrs. JOHNSON. Thank you very much, Mr. Chairman. I certainly believe that reforming Social Security is absolutely essential; but the world that we live in is increasingly a defined contribution world, in the rest of our pension system. And a couple of you particularly have focused on the need for incentives for annuities, for a paycheck for life. We have to find a way to recreate the private sector stability and security that defined benefit contributions did offer us. have been very interested myself in the annuities issue. How do we help lower-income people have annuities? I appreciate the importance of encouraging participation in 401(k)s and things like that; but nonetheless, at the point of retirement you still have to do something far more aggressive than we are doing to help people convert those into some kind of life-long benefit. So, there are new products coming on the market that combine annuities with long-term care, with other benefits. What can we do to focus on this issue of not only the security of Social Security, but the adequacy of our retirement benefits system?

Mr. SALISBURY. Congresswoman Johnson, if I might?

Mrs. JOHNSON. Yes.

Mr. SALISBURY. The one factor in the world of defined contribution plans today: Fewer than 20 percent of them even offer an annuity type option. So, one major change that would affect millions of individuals is to at least give them the choice out of these programs; which employers are beginning to do as they think about this issue, but it is moving relatively slowly. So, simply individuals having the alternative within a structure where the employer, by giving that option, also negotiates in essence a group annuity price so that the disadvantages that the other witnesses have mentioned are not there. There is a coalition of 46 large companies right now that have come together and are amending their plans and going into the private market to, as a group, contract so that their employees have the efficiencies of the market that they have not generally been able to get. So, I think there are movements, to take the issue a step further, of defaults. It is having it be something that must be an option out of a plan and the potential if you default to an annuity and must opt for a lump-sum distribution. Even that alone, from research that has been available, would make a substantial difference. Individuals tend to go with what is the automatic option, frankly, frequently, whatever that happens to be.

Chairman THOMAS. Will the gentlewoman yield briefly?

Mrs. JOHNSON. Yes, sir.

Chairman THOMAS. It would be ironic to create the ideal model on the opt-out on the front end and the opt-out on the back end

and do annuities, and have employers withdraw significantly from contributions on 401(k)s. So, I just think we have to be very careful about where and how we put the incentive.

Mr. SALISBURY. Mr. Chairman, I don't disagree. Mr. Chairman, the difference—and I think this is not talking about the employer having a liability for the annuity—is many insurance companies, to be blunt, would happily take on that liability. One of the differences is that, frankly, most of them will do a laddered bond portfolio that immunizes themselves, as opposed to the traditional defined benefit plan that has invested 60 to 70 percent in the equity market. So, it is a matching issue.

Chairman THOMAS. And on the margin we want to make sure that low-income individuals who may not have that support have some kind of a group structure to gain the benefits of the marketplace as well. Thank the gentlewoman.

Mrs. JOHNSON. To go back to that point that you were making, if an employer is negotiating and essentially all of his employees would agree to take at least a portion of their lump sum into an annuity, you could get a far lower rate; because then you get a true group insurance risk.

Mr. SALISBURY. That's right.

Mrs. JOHNSON. Whereas now most annuities are individual risk.

Mr. SALISBURY. That's right.

Mrs. JOHNSON. And so, as you say, you are selecting out those who have the resources, have the best health care, and so on, and are going to live the longest. So, this is very important in driving down the cost.

Mr. ORSZAG. Representative Johnson, I would just add very briefly, this is precisely one of the reasons why I think we need to be very careful, even for middle earners, in significant reductions in the Social Security benefit level. Because that is something that already provides an inflation-protected lifetime annuity. The second point I would make is that a lot of individual account plans, at least on paper, stipulate some annuitization requirement. I would be very careful about relying on that requirement, because it is not clear at all to me that it will be sustained over time. We have examples in other countries, including the United Kingdom, of something that was put in place in law, and then over time comes under pressure because you have, grandma at age 75, saying she has got a $100,000 account, being forced to annuitize, and it comes under a lot of pressure. And once you start allowing exceptions, the whole thing falls apart.

Mrs. JOHNSON. Thank you. I do think it has been just generally overlooked that the President said no one should have at least a Social Security benefit below the poverty income. And there are plenty of seniors out there now having a Social Security benefit below the poverty income. And we do have to be very sensitive to the really minimal nature of our Social Security benefit for the majority of participants. Thanks.

Chairman THOMAS. I thank the gentlewoman. Does the gentleman from California wish to inquire?

Mr. STARK. Thank you, Mr. Chairman. It is difficult, again, to inquire of a stacked jury here, in the face of the messages that

come forth. Medicare was mentioned earlier. And my Republican colleagues lack complete credibility on the issue of Medicare. They are not to be trusted with entitlement programs. When they act, they make things worse. They appeal to the public with false claims of crisis, and then work in a partisan fashion to offer a so-called solution that basically is privatization. Then they cook the books, or hide the numbers, or lie to us about the numbers, to obfuscate the true effects of their policy. So, I would ask if there is anybody—and Mr. Rangel was asking before—who really thinks that you can save Social Security without privatization. Is there anybody here who thinks that it wasn't a cynical and diabolical plan to demolish all of our entitlements, and thereby hurt 60 percent of the lowest-income people in this country, by giving away $3 trillion dollars in unneeded tax cuts? And now to come back and say, "Oh, goodness, gracious me. We don't have any money for the poor folks. We have taken care of about the 1 percent of the richest folks."

And most of my Republican colleagues—most of whom have never earned a nickel outside of the public trough—sit here and yap about free enterprise. And their acquaintance with it is minimal, at least—unless they inherited their money; in which case, they were probably all for the inheritance tax. just think it is disgusting to hear them talk, and to hear all of the witnesses, except Dr. Orszag, yap on, about how they are going to help the average person's retirement in this country, when it is quite obvious that they really don't give a damn about them. would yield the balance of my time to Mr. Levin.

Mr. LEVIN. I wanted to ask some questions. Then my time will come after, I guess, the next two on the Republican side.

Chairman THOMAS. I would tell the gentleman, the Chair is more than happy to allow him then to have his time. So, that you can take the two and a half minutes now, and the five that you have. So, you will get your full time.

Mr. LEVIN. I will wait. I will wait.

Chairman THOMAS. Well, but we don't have saving time. Either you get it—it is two-twenty now—or it is gone. So, you might as well take the two-twenty, and then you will get your five. And it will be split. Yes, you can.

Mr. LEVIN. I will take the rest of his time, and then wait my turn. So, let me just say a word about the whole environment, the discussion that is presented here today. It is useful to have this discussion about the entire retirement picture. And it would be a very different environment, I think, if the private accounts had not been the thrust of the approach by the President to Social Security. It stands in the way of a bipartisan approach to these issues. And really, the reason it is such a political issue is because of the policy choices that were made by the President; the policy choice being, coming before the Congress and the people of this country and saying, "What I want to do with Social Security is to turn it into—" what he called "individual or personal accounts," and we call them "private accounts or privatization."

So, it is the policy choices that affected the political atmosphere. And my time is almost up, but I want to drive that point home, because it stands in the way of our having the kind of discussion

that is needed about these long-term retirement issues. will come back to it. And to prepare you, Dr. Holtz-Eakin, I want to talk to you about your testimony. And there isn't much talk in your testimony about the whole issue of the deficits; the whole issue of the interest that results from paying interest, this huge amount of interest, on these debts. And so the pay-as-you-go system has been dramatically undermined by fiscal irresponsibility. And we talk about pre-funding. What we are doing is eating up the resources of the future through fiscal policies of today.

Chairman THOMAS. The gentleman's time has expired, the gentleman from California's time. The Chair intends to recognize the other gentleman from California, Mr. Herger, for his time, and then recess the Committee until 12:15. The Chair understands that we have a single vote, and we are currently in that roll call vote. Which means Members have a generous seven or 8 minutes to wolf down lunch, and anticipate your return at 12:15. The gentleman from California.

Mr. HERGER. Thank you very much, Mr. Chairman.

Dr. Orszag, your written testimony discusses some details of your 401(k) proposal, including automatic investment. You state, "Funds would be automatically invested in balanced, prudently diversified, low-cost vehicles, such as broad index funds, life-cycle funds, or professionally managed funds, unless the employee makes other choices. Such a strategy would improve asset allocation and investment choices."

Dr. Orszag, who would decide exactly what type of funds and what portfolio allocation would be appropriate? And how would you define "legitimate, professionally managed funds"?

Mr. ORSZAG. The firm would be able to choose which fund would be the default fund. Regulations would be required, presumably from the Department of Treasury or the Department of Labor, on broad guidelines for exactly what qualified. So, for example, we could have a reasonable definition of what "broadly diversified" means, that, clearly, any index fund would qualify. We can have a reasonable definition of what "low cost" means. You could even define a basis point charge that could not be exceeded in order to qualify for this safe harbor. Basically, regulations would have to define the contours of what was permissible. And then the firm would be able to choose within those contours.

Mr. HERGER. Which is actually something similar to what Federal employees have at this time, what they have an opportunity to invest in.

Mr. ORSZAG. The types of funds would be similar to the Thrift Savings Plan Fund, yes.

Mr. HERGER. Very good. What benchmark or rule of thumb would determine how much risk would be appropriate for a young worker, versus a near retiree? And also, should employer stock be allowed to be a portion of the default investment?

Mr. ORSZAG. To answer the second question first, I think one of the major problems that we face in terms of lack of diversification in 401(k) plans is over-investment in employer stock. Investing in a single stock is a mistake, because you are not diversified. Investing in your own employer's stock is doubly problematic, because that is where your wages are coming from, also. So, we need

to be aggressively moving away from a system in which there is such over-investment in employer stock. I see a big advantage of this default investment approach, that gradually we would be moving away from that. Any kind of professionally managed fund, any kind of life-cycle fund, any kind of diversified index fund, will move workers away from an over-concentration in employer stocks. Surely, they should be included, for example, in the index; but not disproportionately so. I would——

Mr. HERGER. Thank you——

Mr. ORSZAG. Okay. Thank you.

Mr. HERGER. No, go ahead.

Mr. ORSZAG. Oh, on the first question, many of the professionally managed accounts automatically take into account not only age, but other risks that the workers face. A life-cycle fund, obviously, is geared to the worker's age. The only option that I think would still make sense as a default, that doesn't explicitly take age into account, is a simple index fund. And that would be one of the reasons, perhaps, that firms would not be as likely to choose that as the default.

Mr. HERGER. Thank you. I appreciate that, Mr. Chairman.

Chairman THOMAS. Thank the gentleman. Our Committee will stand in recess until 12:15.

[Recess.]

Chairman THOMAS. The Committee will reconvene. Guests will please find their seats. The Chair is aware that there are some Members of the panel who have been kind enough to give us a major portion of the day. Since they have to be somewhere else by this evening, there is going to be a need to leave us prior to the last Member having exhausted themselves on the last possible question. So, the gentleman from Michigan is recognized.

Mr. LEVIN. Thank you very much, Mr. Chairman.

Dr. Holtz-Eakin, I mentioned I wanted to talk just a minute or two about your testimony and about the whole issue of deficits. And there has been a lot of talk about pre-funding, and one of the problems is that we are, I think, creating this huge debt with the interest, and really impinging on future generations. So, if you would, just comment briefly on how you think this fits into this whole picture.

Mr. HOLTZ-EAKIN. Well, I think that the intent was to convey the notion that you need to pre-fund in an economic sense. You have to save as a nation, build economic resources to finance consumption in the future. At this point, the Federal Government is running a deficit that is largely driven by the structural policies. There is very little left that would eliminate that from better economic performance. And to the extent that we leave a continuous mismatch between outlays and receipts, that will act in opposition to saving. It will lower national saving, on average. And it will ultimately have some detrimental impact on our economic performance. And the debt that you would see accumulating would be a legacy of that inability to save as a nation and pre-fund for the future.

Mr. LEVIN. Thank you very much for your candid answers, as always.

Mr. Salisbury, I just hope that everybody on this Committee will read all of your testimony, and re-read it, and also will perhaps pay special attention to your discussion about Social Security and the example within your family, and what a guaranteed benefit has meant and what its reduction or elimination would mean in terms of the independence of seniors. A lot of us hope to live a long time. And one of the strengths of Social Security is that it is there as long as you live. So, again, we very much appreciate your testimony, as we do everybody else's.

I would like to ask Dr. Orszag, you said a few words about some of the proposals on savings and pensions. The proposal that has been embraced by the President in terms of Social Security has some major cuts for middle-income families, people whose annual wage average income, average earnings, would be 20,000 bucks and above in today's dollars. So, if you would—you said just a brief word—talk to us about the proposals that have come forth. Well, just talk to them about it, because I don't, from what you said in your study, see how the main advantages would be for these same middle-income wage earners who would under the change in indexing see a major, major reduction in their Social Security plus the offset. So, talk a bit, very candidly, about your assessment of what has been proposed so far in savings accounts legislation.

Mr. ORSZAG. Mr. Levin, you mean by the Administration?

Mr. LEVIN. Yes.

Mr. ORSZAG. Yes. Two points are worth making. First, additional retirement saving on top of Social Security can't replace the existing benefit structure, precisely because Social Security benefits last as long as you are alive; are protected against inflation, protected against financial market fluctuations; and are preserved for retirement in other times of need. So, even thinking about this sort of trade-off is somewhat misguided, because the two are not perfect substitutes.

Furthermore, the Administration's approach—which involves basically, for example, with the retirement savings accounts, eliminating the income limit on Roth IRAs—provides direct benefits only to those households with, for example, joint filers with incomes above $150,000. Three-quarters of the benefits go above $200,000. A quarter of the benefits go above $500,000. So, basically, very substantially, almost entirely all of the benefits are going to the very top of the income distribution. As you noted, there are in the Social Security piece benefit changes that are affecting a much wider part of the population. So, there is a very significant mismatch, even if you accepted the logic—which I don't—of these being sort of inherently tradable. There is a very significant mismatch between where the benefits are going under the RSA proposal, and where many of the reductions are targeted within the traditional Social Security program.

Mr. LEVIN. Thank you. My 5 minutes are up. Thank you.

Chairman THOMAS. Thank the gentleman very much. Does the gentleman from Louisiana, Chairman of the Social Security Subcommittee, wish to inquire?

Mr. MCCRERY. Yes, Mr. Chairman. Thank you. Mr. Chairman, I will not respond to the bulk of Mr. Stark's comments that he made earlier. One point that he made I will respond to, and that

is by calling this panel a jury-rigged panel. The minority was given every request they made for this panel. Had they wanted more witnesses, we certainly would have acknowledged that. In my Subcommittee hearing 2 days ago, the minority asked for two witnesses out of five on a panel. That wish was granted. We are trying very hard to have a dialog, a discussion about the issues. wish that the minority would spend as much time talking about the substance of the issues as they do complaining about things like Mr. Stark did.

Dr. Holtz-Eakin, in your answer to Mr. Levin about pre-funding, could we structure personal accounts and Social Security in a way that would represent pre-funding under your definition?

Mr. HOLTZ-EAKIN. It is certainly the case that individual accounts are one example of a pre-funded approach to a retirement benefit. And that is an important policy choice, to think about the degree to which there is pre-funding in the system as a whole.

Mr. MCCRERY. Thank you. Dr. Jackson, on page 3 of your testimony you state that pay-as-you-go made sense in decades past, when the number of workers significantly outnumbered the number of retirees. And then you say, with the end of the Baby Boom, the demographic underpinnings of that paradigm collapsed. Would you tell us more about what you believe the benefits of pre-funding are and, based on your global research, how have other countries moved to pre-funding their retirement systems?

Mr. JACKSON. The funded approach has both macro and micro benefits. At the macro level, a funded system can help shield government budgets from demographic pressure. It can also help maintain adequate rates of savings and investment, which is one of the greatest challenges an aging society faces. In a pay-as-you-go system, you are taxing the current wages of workers. In a genuinely funded system—by "genuinely funded," a system that has raised national savings, and hence the growth path of the economy—you are ultimately paying benefits out of new wealth that wouldn't otherwise have existed. So, there are important macro benefits to funding. There are also important micro benefits. At the micro level, a funded system can pay a higher benefit at any given contribution rate than a pay-as-you-go system can, because the return to capital is generally higher than the return on a pay-as-you-go system; particularly in an aging society where the ratio of contributors to beneficiaries is rapidly declining. There is a transition during which that may not be true; but ultimately, once one has paid that transition, that will be true. There is a bigger bang for the buck.

Mr. ORSZAG. Mr. McCrery?

Mr. MCCRERY. Just a moment. Let me just follow up, then I'll give you a chance, Dr. Orszag. Is piling up Treasury notes in the Social Security trust fund pre-funding the system?

Mr. JACKSON. Well, I believe that it is not. It is a transaction, as has been said, that is internal to government. What is an asset to the trust fund is a liability to Treasury. The trust fund is not without meaning; it has a political meaning. It constitutes formal budget authority. It is a promise that Congress will raise taxes on my children. It does not have any fiscal or economic significance.

Mr. MCCRERY. Thank you. Dr. Orszag?

Mr. ORSZAG. I would just emphasize a very important distinction between a "funded pension system" and increasing national saving. The latter is the key. We can do all sorts of things to make it look like we are "funding," that don't actually translate into higher national saving in particular.

Mr. MCCRERY. That is why I asked the question the way I did to Dr. Holtz-Eakin.

Mr. ORSZAG. Right. I agree.

Mr. MCCRERY. I said, can we structure personal accounts in a way that would be pre-funding under his definition. And his answer was "Yes." I am well aware of that, Dr. Orszag.

Mr. ORSZAG. Okay.

Mr. MCCRERY. Thank you.

Chairman THOMAS. Thank the gentleman. Does the gentleman from Maryland wish to inquire?

Mr. CARDIN. Thank you, Mr. Chairman. want to thank all of our witnesses for their testimony. I found it very helpful. I particularly appreciate Mr. Salisbury giving us a real, live example of the problems. We see these numbers and statistics, and it is hard to visualize real-life people. And it is interesting; I hadn't focused on the fact that when we look at that pie chart that shows that one-third of our retirees rely exclusively on Social Security, and for two-thirds it is their primary source of income, I never realized that that is a changing number by age. It is not a person who comes into the system relying upon Social Security for two-thirds, and then stays that way the rest of their lives; it changes over time. And we have seen a dramatic change, as our Chairman has pointed out, in retirement security during these last 10 years. And certainly, over the last 75 years there have been very dramatic changes in saving and opportunities.

One of the disturbing trends, of course, is that there are fewer and fewer opportunities for guaranteed benefits. The defined benefit world is becoming smaller. And even within the defined benefit world, the risk factors have gotten much higher. The pension guarantee fund is under funded; companies are going into bankruptcy; companies are freezing plans and converting plans. So, for all those reasons, many of us—and I am sorry that my former colleague, Mr. Portman, is no longer with us, at least in Congress—but there have been many of us on this Committee that have worked together to try to increase the other two legs of that retirement stool: private savings and private retirement. But as much as we want to increase opportunities there, it is going to be virtually impossible for us in the private side to have what Social Security provides.

Guess my comment, or question, to you is that, under today's mechanism, the Social Security represents about one-third of an individual's final income when they retire, on average. I know it changes by income level. guess my concern is, looking at what is happening in the real world, we are trying to preserve that one-third. Some are saying perhaps we could change that, based upon income, and let people rely on it less. I disagree with that. But maybe we are taking the wrong tack. Maybe we should be trying to increase the amount of guaranteed benefits, through some mechanism; rather than just saying the status quo is adequate. I would appreciate any comments here.

Mr. GOODMAN. I think it is important to realize that, although we say Social Security is a guaranteed benefit, it is really not. It is guaranteed on paper, but it is a political promise. And since it is not backed up by funding, as the financial pressure——

Mr. CARDIN. Dr. Goodman, let me agree with you that Congress can always change the law any year. There is no way you can change that. I would suggest that Social Security is the safest form of retirement security available today, and it is funded, many of us believe, for at least 36 years, and many of us think maybe beyond that. I guess my point is, obviously, anything can change, but if I were to go to Las Vegas and take odds as to what is going to be there tomorrow for me, whether it would be my employer retirement plans or my 401(k)s or my Social Security, I think Social Security would get the best odds. Dr. Orszag?

Mr. ORSZAG. I think we need to be thinking about this system in terms of two tiers: a foundation provided by Social Security, and then other required savings; which, as Chairman Thomas noted, is increasingly becoming just 401(k)s and IRAs, as the DB world becomes smaller and smaller. In that context, I don't think it makes sense to take that first tier, Social Security, and dramatically reduce it, both to restore solvency and then also to pay back the funds required to offset the cost of individual accounts. That is precisely why I don't think that significant reductions in Social Security benefits make any sense.

Mr. DAUB. If I could just——

Mr. CARDIN. Mr. Daub?

Mr. DAUB. You could argue in a vacuum about 36 years ahead, but I just think we should also remember that the Social Security benefit, guaranteed or secure, risk-free as any comparatively, is a benefit that is accumulated over a long period of one's working lifetime.

Mr. CARDIN. Right.

Mr. DAUB. And so it is just not there when we get to be, if we are lucky enough to live so long, 62 or 66 years old.

Mr. CARDIN. Right.

Mr. DAUB. So, to get that security in income in retirement is a long-range proposition. And we don't want to wait so long that the choices are fewer and the risk are greater.

Mr. CARDIN. Right. agree with that. I think we should take steps now. I guess my point was that this does represent a guaranteed income source that is inflation adjusted, that is there. The formula will keep giving you one-third of your replacement income. And there is nothing else out there on the horizon that comes even close to it.

Mr. DAUB. It is about 42 percent average, yes.

Mr. CARDIN. Thank you, Mr. Chairman.

Chairman THOMAS. I would suggest to the gentleman, although I don't think we have talked about it here, one of the things that you can do on the margin that kind of splits the difference on the problem is to begin to look at the question of longevity, and how fair it might be to deal with utilizing an index of longevity; notwithstanding the fact that you can't, at least in Social Security, raise ethnicity, gender.

Mr. CARDIN. Right.

Chairman THOMAS. But perhaps a base structure which allows a stretching out to assist in the problem of not knowing for sure how long.

Mr. CARDIN. I agree, but remember Mr. Salisbury's parents. They were well-off when they retired. They bet that they would live a certain number of years, and they have outlived what they thought they would live. And now there would be a problem if they didn't have Social Security at its current level.

Chairman THOMAS. And the percentage of Social Security is greater vis-a-vis those other products that ran out of gas, by virtue of not being an annuity.

Mr. CARDIN. Right.

Chairman THOMAS. think focusing on those other products becoming annuitized is an area where I think we would make great headway.

Mr. CARDIN. I agree.

Chairman THOMAS. I thank the gentleman. Would the gentleman from Michigan wish to inquire?

Mr. CAMP. Thank you, Mr. Chairman.

Mr. Salisbury, I notice in your written testimony that in 1986, 16 percent of taxpayers made contributions to IRAs. And more recent data, as you say, show that that is less than 3 percent, and that much of the new money in IRAs is rollovers from other pension plans. You also go on to say that of those invested in IRAs or 401(k)s, only 6 to 8 percent have reached the max. My question is, how do we get more people to contribute to IRAs? What recommendations do you have there? And how do we have more people contribute the maximum? How do we increase that maximum amount? And is that by increasing the maximum deduction, or allowing a 100-percent deduction of a contribution, or any other ideas you may have?

Mr. SALISBURY. The change in 1986 that dropped the reduction down dramatically was the combination of lower marginal tax rates and a limitation on the availability. And it goes to some of the comments Dr. Orszag made about the maximum effect of these incentives being at the highest income levels. The other points other witnesses made: the research that is out there. And there is some research that we just completed that is referenced in my testimony. Default enrollment makes a substantial difference, default contribution rates. And basically, starting somebody at a high rate, many of them will tend to stay there. Our most recent retirement confidence survey, which is mentioned in the testimony, tested public opinion on these issues. And overwhelmingly, the public said, "I would find default into the plan acceptable. I would find default in a diversified portfolio acceptable. I would find default into a high contribution rate acceptable."

There is a proportion that doesn't find it acceptable, that would not participate. But in the most recent numbers we ran for the lowest-income 25 percent by income, you would increase the ultimate benefit out of the plan by 61 percent at median, the replacement rate, by going with these default arrangements. And when we then added an analytic. Assume that between 1996, when our database starts, to 2003—and this is 15 million 401(k) participants—that all of those individuals had been defaulted into a so-called "lifestyle

fund," meaning a mixed-asset allocation, as compared to what they had actually made as choices. And that replacement rate increase, instead of 61 percent, would be 81 percent.

And in the highest-income 25 percent, interestingly, the defaults would have decreased their replacement by 6 percent; unless you move them into the lifestyle funds and counteracted their investment choices, in which case they would have had 10 percent more at the end of the train as well. So, defaults can make a difference. A majority of the public finds them acceptable. And they do lead to better outcomes. I would add the final point that Congressman Cardin and the Chairman made. Defaulting individuals into a partial annuity would likely also be acceptable to a substantial number; maybe not to all. But it would deal with some of the longevity issues as well. So, you would get accumulation, you would get better returns, and you would get better longevity income.

Mr. CAMP. Okay. Thank you very much. Thank you, Mr. Chairman.

Chairman THOMAS. Would the gentleman yield briefly on his time?

Mr. CAMP. Yes, I will.

Chairman THOMAS. I do caution, and I think I am correct in cautioning us, in doing comparisons between periods and savings. Because to me all it proved was that in 1986 people were willing to say "Yes," if you incentivized them to the point that it didn't cost them anything and they got something. And when we changed the law, fewer people were willing to put savings away, when they actually didn't get it totally free with no strings attached plus a bonus. When you peg these various years, yes, we proved a point, but I don't think it is helpful; and then measuring subsequent savings from a point when people actually said, "Yes, if you are going to give it to me." That is the only point I want to make. That has to be made in terms of comparisons between periods.

Mr. SALISBURY. I totally agree with your point.

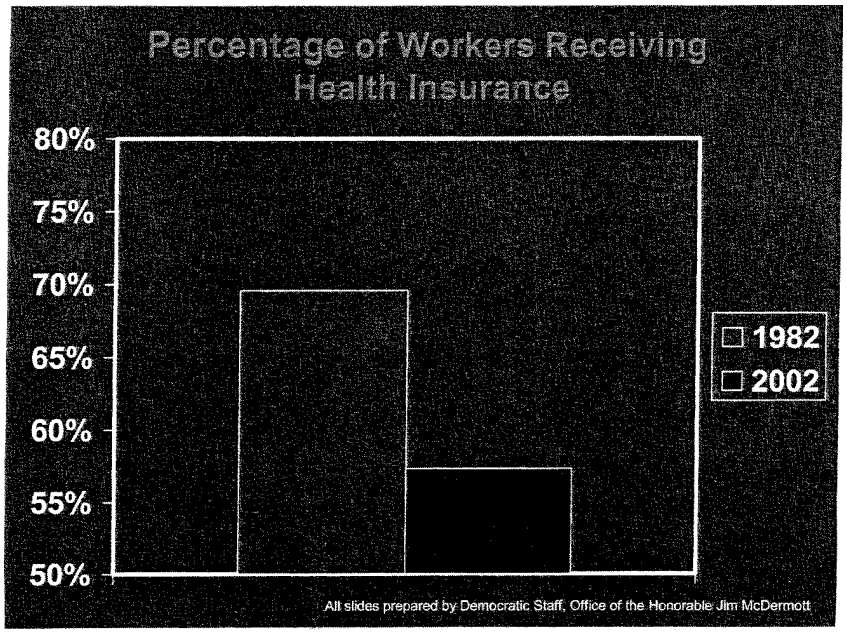
Mr. ORSZAG. And at the same time, there was the growing spread of 401(k) plans, which was seen as a substitute in the eyes of some people for an IRA.

Chairman THOMAS. Yes.

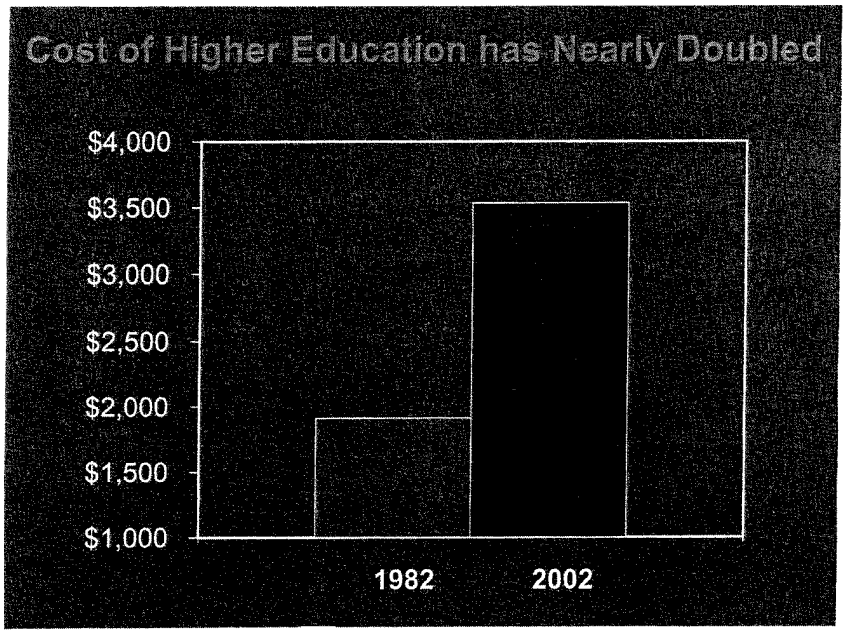
Mr. ORSZAG. And so that also would have diminished IRA participation, even apart from this.

Chairman THOMAS. Yes. You had other cars on the track. I do think that we established the fact that people will say "Yes" if you give them something for nothing. And that is always nice to know. The gentleman from Washington.

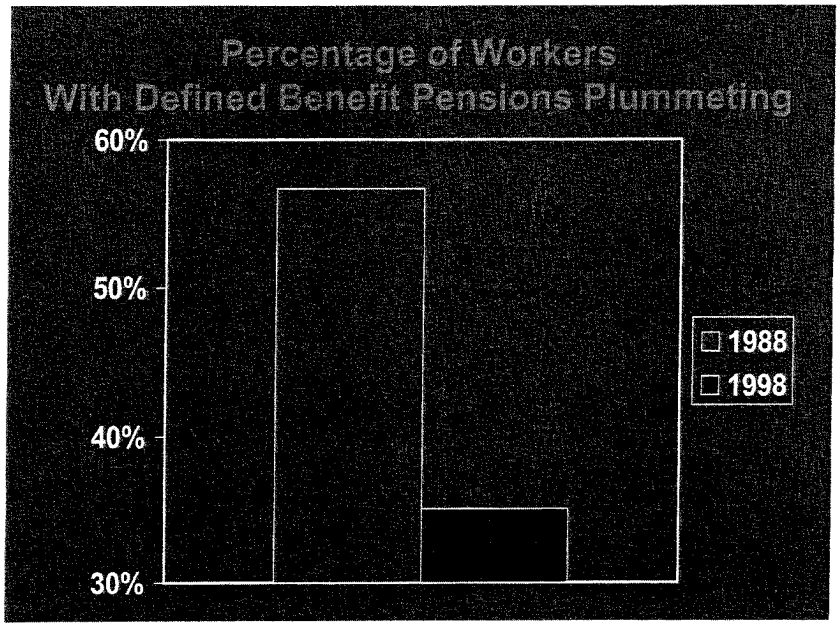
Mr. MCDERMOTT. Thank you, Mr. Chairman. I appreciate your letting America see and hear the President's plan to pulverize Social Security. I want to talk about the middle class. Just a week ago, our witnesses testified that the President's plan guts the benefits, and here we go again. It is the latest trend in the American experience with the Republicans in charge.



Mr. MCDERMOTT. First, let's go to the first chart here. If the Members and the audience could turn to your right, you are looking here at the percentage of workers receiving health insurance in 1982: almost 70 percent. Then you go to 2002, and you see what has happened to the middle class. They are in trouble. Twenty-5 percent less workers get their benefits. Twenty-5 percent more workers are out there in the individual market looking for health insurance, the most expensive place to be; and it is the number one cause of bankruptcy. Next chart.



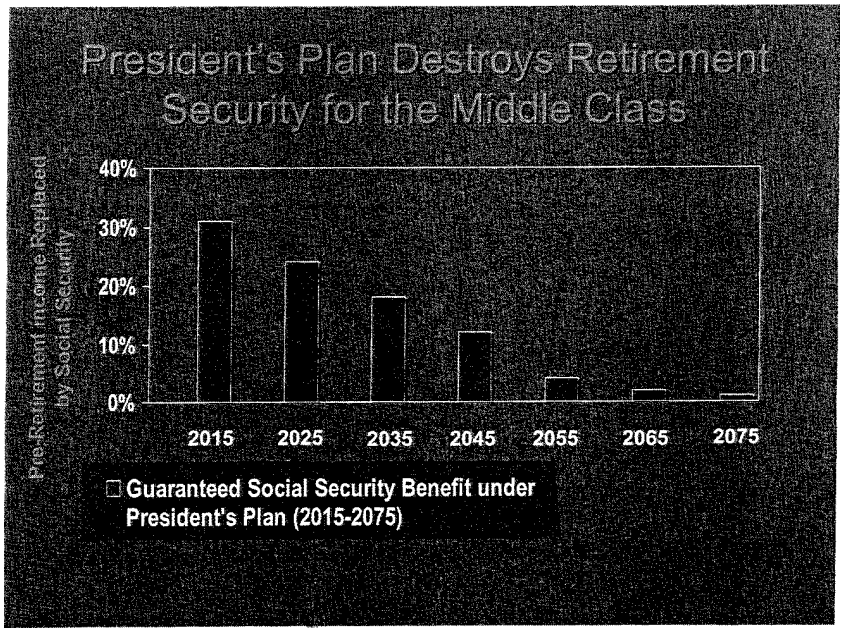
Mr. MCDERMOTT. This chart shows where their children are going to school, and what tuition is for a year in 1982. The next chart will show you what has happened to tuition. After adjusting for inflation, it is nearly twice what it was 20 years ago. Now, the next chart.



Mr. MCDERMOTT. In 1988, the percent of workers receiving a defined benefit pension program, like the one like United Airlines employees just lost, those flight attendants who have been flying for 38 years—it is all gone; it is over in that pension guarantee program, if that has any money—it was nearly 60 percent added in that era. Today, employers are largely giving up these plans, and they have gone to defined contributions, which transfer retirements to the workers away from the employers. And you can see where we are today.

So, we now have an ownership society. You are on your own to educate your kids; you are on your own to get your health care benefits; you are on your own to get your pension benefits. We don't want to do anything in the government level. The personal retirement security today is more tied to the stock market than ever, if you look at that chart. And defined benefit plans are now available to a fraction of the workers that enjoyed them just a couple of decades ago. As we learned last week, the President and his supporters are proposing massive cuts to Social Security, the one guarantee they had. They come in here, and they want to take away that benefit and say, "Go to the stock market. Maybe you could do better." Now, I find these trends rather disturbing. And it seems to me, instead of pooling the risk and diversifying among individuals, it seems we are concentrating on family units and individuals. Mr. Orszag, as an economist, isn't it typically better to spread the risk and be diversified, than to be all in your own hands?

Mr. ORSZAG. As a general principle, yes. would actually make one quick point; which is that I think the government's role as the sort of risk manager for individuals, so that individuals or individual households don't face undue risk themselves, is absolutely critical. And if we unwind it too much—and in fact, I think we should be moving in the other direction—if we unwind it too much, there will be a backlash in which families facing too much risk themselves will be unwilling to take the steps that lead to strong economic growth: making the investments, moving for new jobs, and doing the other things that lead to a dynamic economy.



Mr. MCDERMOTT. I think that my last slide sort of says it all. The Democrats do not just oppose the privatization of Social Security; we oppose the entire Republican agenda that takes us away from a country of "we" and toward a country of "me." Now, whether

it is health care, or education, or retirement security, Democrats are opposed to the Republican plan to shift all the important risks of life onto the back of the individual and away from our society. Our country will only thrive if we work together, if we take risks together, and if we find the common good. And given what is happening to the middle class, I would like to hear you explain to me how the middle class is going to have more money to put into whatever program we come up with here. How, when they now have to pay twice as much to educate their kids at community college, and they have to buy their own insurance out in the private market, and they don't have a guaranteed program at work? Where are they going to get the money to put into these programs?

Mr. DAUB. Mr. McDermott, I think that you have an interesting point that does need to be explored. And it may be helpful to think about the fact that we not only have the tsunami of the age wave coming at the system, but we have fewer workers that will shoulder whatever load this is next year, or 20 or 30 years from now, in terms of the FICA tax, or in terms of paying general revenue income taxes to support the variety of programs. So, that ratio of fewer workers, and putting higher taxes on fewer workers, is an important issue I think, and why, at least from the Social Security Board's point of view, we have asked you all to take a broader look, one the Chairman suggests, that interrelated with Social Security are health security in retirement, as well as cash income in retirement.

Mr. MCDERMOTT. You are talking about higher taxes. I don't remember my mentioning that. It seems to me that what we are doing here is eroding the base of Social Security and then saying we are going to ask people to save more. That is like me asking my 95-year-old mother, "Why don't you have any retirement left?"

Mr. DAUB. Well, you may be right, if we look at the idea that we can sustain the same statutory benefit levels, called a guarantee, in 2017 or 2042, on a ratio of fewer workers, without cutting benefits and without raising taxes. It doesn't seem to me—or with a combination of both—that there are anything but three choices: either cut benefits, and/or raise taxes, or do both; with fewer people producing the dollars that have to be paid out to a growing number of people that are not in the workforce.

Mr. MCDERMOTT. I am sorry I can't go on with this discussion.

Chairman THOMAS. The gentleman's time has expired. And Mr. Salisbury, and shortly Mr. Daub, beg the indulgence of the Committee, but they are going to have to leave. The Chair thanks them for the time they were able to provide. The Chair would recognize the gentleman from Illinois. Would he be willing to yield to the Chair briefly?

Mr. WELLER. I would be happy to yield to the Chair briefly.

Chairman THOMAS. Thank the gentleman. If we would put up the first slide that Congressman McDermott had, quickly. That is the last one. Right there.

[Slide.]

Chairman THOMAS. The timeframe for this slide was 1982 to 2002. Of those 20 years, seven of them were Republican majority control of the House. Obviously, with a little math, the remainder of those years were Democratic. Next slide.

[Slide.]

Chairman THOMAS. 1982 to 2002, seven of those years were the Republican majority. The remainder of the 20 were the Democrats. Next slide.

[Slide.]

Chairman THOMAS. 1988 to 1998, that is a ten-year period. Three of those 10 years were under the Republican majority. I have no problem pointing out the true problems facing Americans, but represented in the way it was, I do believe we needed to have that pointed out on the slide.

Mr. MCDERMOTT. Well, if you would let me talk, Mr. Chairman——

Chairman THOMAS. Thank the gentleman. Gentleman from Illinois?

Mr. MCDERMOTT. Could I get a minute, Mr. Chairman?

Chairman THOMAS. No.

Mr. WELLER. Thank you, Mr. Chairman, and I am reclaiming my time.

Mr. MCDERMOTT. Not a single——

Mr. WELLER. Reclaiming my time, Mr. Chairman.

Chairman THOMAS. Your staff didn't tell you what you were doing. That's a problem you have got to work out with your staff. But showing 3 years of Republican control causing all that problem, when you have all the rest—I am more than willing to share the burden of the problem. That is why we are here. I hope you will share the burden of addressing the problems in a bipartisan way. The gentleman from Illinois.

Mr. WELLER. Thank you, Mr. Chairman. And thank the panel for being with us today. And thank you for the opportunity to participate in this. particularly want to note that the focus of this hearing is, of course, to look at the broad challenges facing retirement security. It is a given we need to fix Social Security. We have some financial problems long-term with Social Security under the current trends, and we need to fix it. But as we move forward on that solution—and like the Chairman, I hope we can find a bipartisan solution—it is important to look at some of the other options. And one option I would like to put forward, which I would like to hear the thoughts of the panel on, beginning with Mr. Holtz-Eakin, is an idea which I have revived in this Congress, which was an idea that was put forward in a bipartisan way back in the nineties. And that is something called a "Kid Save Account." It had bipartisan support. Then-Senators Kerrey, Moynihan, and Breaux were Democrat lead sponsors on the legislation. Rick Santorum and Chuck Grassley, of course, current Members of the Senate, were the Republican lead sponsors on that. We have introduced the bill, H.R. 1041, and I think it offers an opportunity particularly for every child born in America, regardless of their income, to have an opportunity for a savings vehicle.

The way the idea works is, at birth every child gets a $2,000 loan from the Social Security Administration. That would be linked to inflation, so over time it would be adjusted. The money would be deposited in a personal account that could not be touched until retirement. It would be managed by the Thrift Savings Plan, the same program every Member of Congress and every U.S. Senator—

and of course, my local mailman—all have available and trust. And their parents would initially decide how that would be invested; whether in a bond or equity fund. And it would grow untapped over a lifetime. And according to an outside analyst, the opportunity for growth is there. And that $2,000, even though that initial loan would be repaid at age 30, would have the potential to grow to at least $50,000, estimated, over that young American's lifetime. would just like to hear if each of the panelists would give me their thoughts. Number one, are you familiar with the idea, the Kid Save? And what are your thoughts on the feasibility of this particular add-on account which I am offering in this debate? Mr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. Well, I will not pretend to be intimately familiar with it. That is the first description I have heard. I think the key point of view from the aggregate performance of the economy is what else goes on when that loan is made by Social Security to the individual, because that in and of itself is a wash. There is no net new national saving. It may have policy merits at the level of individuals in terms of the accumulation, the ownership, the risk bearing that is there. But in the absence of some additional national saving on a year-by-year basis, the economy will not grow and would not in and of itself enhance our capacity to meet all the needs, public and private.

Mr. WELLER. Mr. Daub?

Mr. DAUB. It has merit in the same framework of creating a combination of a Social Security benefit over time that has a limited rate of return over time and featuring a way, if mandatory—I assume—I don't know the details of it, but this is going to be a mandatory contribution to the account, right? And if that is the case, over time at the margin that takes the market at a higher yield on average every 10 years. When you add the two together at the end of the day, you should end up with a greater benefit than the current table will pay over the next 75 years to a retiree.

Mr. WELLER. I would note, Mr. Daub, before I ask the next witness just to comment, that the Thrift Savings Plan over the last 11 years that I have been in the Congress has grown about 4 percent a year if the money was in a bond fund and about 8 percent a year in the equity, the S&P 500 index fund. Social Security, it is estimated you get about 0.8 of 1 percent return on your initial investment.

Mr. DAUB. And my salary when I was here before, today has over doubled as a Member of Congress relative to the income ration and then the contribution made to the private pension plan called the FERS account, which you referred to.

Mr. WELLER. Mr. Jackson?

Mr. JACKSON. Let me just echo, I think, Doug Holtz-Eakin's comments. I think the proposal has merit. I think there is certainly a significant benefit, the familiarizing of lower-income households or middle-middle-income households of the benefits of savings and doing that at as young an age as possible. However, if all we are doing is taking a dollar of Federal revenue and moving it into a private account, then this child has a compounding asset in the private account and a compounding liability in terms of additional Federal debt. So, in terms of the overall economy, that would be

a wash. So, it is important that accounts of this kind be genuinely funded, in which case I think they have significant benefit.

Mr. WELLER. Of course, it would be a loan which they would repay at age 30, and looking at very conservative compounding, it would grow to about 50,000 over a lifetime.

Mr. ORSZAG. Mr. Weller, I have two reactions. I think there are proposals in this area that are worth exploring, but actually the way you phrased this specific proposal I think shows some of the limitations. In particular, what we would be encouraging people to do at that point is effectively invest on margin. You are borrowing from the government at the bond rate and then investing in the stock market in the hope that your return on the stock market will exceed that on bonds. In general, I don't think that encouraging even middle- to low-income people to invest on margin is the right way to expose them to the stock market and to asset accumulation. Instead, I think a lot of ideas that we were talking about earlier in trying to get IRA participation up and 401(k) participation is more promising, both from a microeconomic perspective and from a macro one.

Mr. GOODMAN. I think that you need to substitute this private saving for taxpayer promises on down the line. So, if you accumulate $50,000 over a work life, that ought to substitute for $50,000 of taxpayer promises. And if you make that addition to your proposal, then you are solving the long-term problem of unfunded political promises.

Mr. WELLER. Okay. Well, you have been very generous, Mr. Chairman. Thank you.

Chairman THOMAS. The Chair thanks the gentleman for yielding.

Does the gentleman from Missouri wish to inquire?

Mr. HULSHOF. I do, Mr. Chairman. Thank you. I want to commend the gentleman from Maryland, who spoke earlier. He has certainly earned the respect and the credibility of Members because of his work in the pension area. agree with, Mr. Chairman, your comments as well as the Chairman of the Social Security Subcommittee. I think it is much better to have a dialog than to be subjected to a diatribe. know Mr. Salisbury had to leave, and I know how blessed he feels to have parents in their longevity. Having a social insurance program, however, there are others as far as a financial perspective—I use my own case as a case in point. My father did not take early retirement and died at the age of 69. My mother had survivor's benefits for 17 months, and then she died at the age of 69. And if you take a look at what they paid into the Social Security system, they did not get out of the system what they paid in. And so that is the very essence, of course, of having a social insurance system as we have. Now, I have heard a lot of discussion about a guaranteed benefit and protection against inflation. My daughter, who is 5, the only thing that—right now, at least under current law, the only thing that is guaranteed is—and I will adopt the gentleman from Washington's rhetoric. My daughter will have massive cuts. Social Security will be pulverized—again, to use a word from the gentleman from Washington—under the current system. And so, again, that is my opening salvo, if you will, and I want to also commend Dr. Orszag. You, sir, you and

Peter Diamond are to be commended for laying out tough choices. In fact, Mr. McDermott inquired of you, as he was showing us his slides—and, again, I think that was when we heard the massive cuts from the President's plan. But you provided him a general response, and I want to be a little more specific about the plan that you and—I assume it is Dr. Diamond, is it not?

Mr. ORSZAG. It is.

Mr. HULSHOF. —have put together as far as tough choices. I appreciate that you described your plan as a balanced approach, but let me inquire. The Social Security actuary's numbers indicate that your plan achieves solvency partially through payroll tax increases. Is that true?

Mr. ORSZAG. Yes, it is.

Mr. HULSHOF. Your plan also reduces benefits for some individuals and raises them for others. Is that also a correct assessment?

Mr. ORSZAG. It reduces benefits, and for some small groups of particularly vulnerable beneficiaries, there are benefit increases.

Mr. HULSHOF. Are there any workers under your plan—and I am not being critical. Are there any workers under your plan held harmless from benefit reductions relative to what is promised under current law? Are any workers held harmless?

Mr. ORSZAG. As a group, the disabled beneficiaries and young surviving children are held harmless over the next 75 years.

Mr. HULSHOF. And let me echo that point as Mr. McCrery—we had a hearing 2 days ago with vulnerable populations in the Subcommittee. And, again, putting aside the rhetoric that we heard from some Members on the Subcommittee, I think the consensus is that there is a special category, the disability, for instance, category that we too look to to hold harmless. But other than those category of beneficiaries, as far as the retirement aspect is concerned, no category is held harmless under your plan. Is that right?

Mr. ORSZAG. That is correct.

Mr. HULSHOF. And does your plan gradually reduce benefits for both low- and middle-wage workers relative to what is promised under current law?

Mr. ORSZAG. Yes, it does.

Mr. HULSHOF. And, again, I am not going to throw in an adjective such as "massive," but I think, again, the point is simply this: that as we—first of all, for those that recognize that there is, in fact, a challenge—President Clinton used the word "crisis" in my home State in 1998. But, nonetheless, as we move forward and for those who wish to engage in a dialog rather than a diatribe, I am not sure what constructive benefit comes from the rhetorical flourishes. And, again, I think I would much prefer working with those Members who recognize that this needs to be a bipartisan solution. Again, I salute you for putting—do you have a follow-up? In the few minutes that I have, yes, I will let you expand.

Mr. ORSZAG. If the Chairman will indulge me, two things are worth noting. Obviously you all are the politicians and I am just a policy analyst, so I will defer to you. But it seems pretty clear to me what needs to happen in order for us to move forward in a bipartisan way on Social Security reform. And at least from the Administration, I don't see the necessary step being taken. I am just making a factual statement as opposed to a normative one. The

second point that I would make is the benefit changes that are in our plan—and I would emphasize our plan is basically the only plan that achieves sustainable solvency, that is, long-term solvency, with no general revenue transfers at all. So, it is the only really completely honest plan out there, and, therefore, it is completely politically unviable. But even in that context—even in that context—because we are willing to dedicate some additional revenue to Social Security, the benefit changes are much less severe than in the absence of additional revenue. That is a critical question. I think that having a strong foundation is worth the price of dedicating additional revenue to Social Security, and that is the debate we should be having.

Mr. HULSHOF. Thank you, Mr. Chairman.

Chairman THOMAS. Dr. Orszag, which of those ideas of yours would you be willing to leave at the doorway?

Mr. ORSZAG. I am sorry?

Chairman THOMAS. Which of those ideas of yours would you be willing to leave at the doorway before we have a useful dialog?

Mr. ORSZAG. I think——

Chairman THOMAS. Just pick one. I don't care which one. I am forcing you to leave one of your ideas at the doorway before we have a meaningful dialog.

Mr. ORSZAG. I am happy to leave any single idea of mine at the doorway before we have a useful dialog, but I think we all know that——

Chairman THOMAS. And that justifies the fact that you said you were not a politician.

[Laughter.]

Chairman THOMAS. The gentleman from Massachusetts.

Mr. NEAL. Thank you, Mr. Chairman.

Dr. Goodman, I arrived in Congress during the middle of the S&L crisis, and indeed it was a crisis. And as part of your testimony earlier, you suggested that you were concerned that some people might not fully understand sophisticated investment policy, and as a result, they might make some wrong choices. And part of the S&L issue, at least in some measure, part of the S&L issue, as they were deregulated, meant that a lot of people never understood something as simple as the $100,000 limit that was guaranteed by FDIC at the time. Would you care to talk a little bit more about your concerns or suspicions about those, particular lower-income Americans, as it might relate to making those individual choices?

Mr. GOODMAN. Sure. Just briefly on the S&L crisis, what caused the crisis was that you had a Federal guarantee for entities that were virtually bankrupt, and so they went out and gambled.

Mr. NEAL. I acknowledge that, but that is part of the concern that you might have with those that—I know that the New York Times on Sunday ran an interesting piece about some unsavory annuity salespersons and what they had done to some people who were exceedingly vulnerable, even though they had been very successful in life. But part of the S&L issue from people that sat across my desk was that they had no understanding that their deposits were only insured up to $100,000. So, if they had been saving it for retirement, only to discover that if they had $180,000 of

$200,000 or $220,000, FDIC only took care of $100,000, that was sort of, a pretty cold reality for them.

Mr. GOODMAN. Right. Well, directly to your question, I am concerned about the choices people make, and I think there is lots of evidence that investing their own money, people in 401(k) plans are not always making the wisest choices. They tend to make two mistakes: they invest too much in what they know, which is their employer's stock, and what is safe, which are money market funds. And that means too much risk and too little return. And all the evidence points to the fact that if we could just encourage people to be in balanced portfolios, they would have less risk and higher returns. So, we think—and I think Peter and I both agree on this—that we need reforms that encourage the private sector to do those things. Now, if we have personal accounts under Social Security, we also need to restrict the options available to people there, for the same reason.

Mr. NEAL. Great point. Now, I can say this: that based upon what I have witnessed in Washington for the last few years, you can be sure that during the run-up of the dotcoms, the same people who would be arguing for restraint during that period of time 4 or 5 years ago would be arguing for more risk. And that is the concern that I have. can tell you about those very voices in this town that would have been saying open up those opportunities for people to more risk because look what has happened, it is guaranteed that it is going to take place.

Mr. GOODMAN. Well, I can just tell you that among the economists who have looked at this, it is virtually unanimous. We all feel like that if people are going to invest Social Security money in the market, it needs to be a balanced portfolio. We may disagree about whether to do it, but everybody seems to agree on that.

Mr. NEAL. Thank you, Dr. Goodman. Dr. Orszag?

Mr. ORSZAG. I would just add on this point, if the investment choices are to be restricted to index funds through, as the Administration calls it, a central administrative authority, a government agency, many of the issues that have been raise with regard to political interference of having the trust fund directly invest in the stock market arise almost in exact parallel with regard to choosing the index funds. There would be people, government administrators, who would be choosing the index funds. So, you would be forcing people to go into an index fund that was partially in tobacco stocks and partially in firms that sponsor abortions and all sorts of other things. And then if you start exempting those firms out of the index fund, you quickly drive up the administrative costs. So, there are a lot of practical questions that come with the simple we will just put them into index funds as part of Social Security that I do not think have been fully explored.

Mr. NEAL. Thank you. Just a quick follow-up. Chairman Rostenkowski at the time was in constant conflict with me as a Member of this Committee over individual retirement accounts. It was interesting that Chairman Thomas raised the same concerns today that I used to raise and that Chairman Rostenkowski used to object to, simply that by expanding individual retirement account opportunities and other pension benefits, that it was the wealthy that took advantage of it. And it seemed as though Chairman Thomas

and I were in agreement on that today. Would you talk a little bit more about how to get to those who really need to begin saving?

Mr. ORSZAG. And, again, it is not just that the high-income people take up the opportunity to contribute funds, but that those contributions are not actually typically a net addition to saving. They are simply transferring saving that would have occurred anyway or that already had occurred in other forms into the tax-deferred accounts. Therefore, focusing on raising income limits or increasing the contribution limits is a very misguided way of trying to maximize our bang for the buck in terms of providing incentives for new saving. Instead, a lot of the things that are in my testimony focused on middle and lower earners is the right way to go, making it easier and increasing the incentives for middle and lower earners to contribute.

Mr. NEAL. Thank you. Thank you, Mr. Chairman.

Chairman THOMAS. Thank you. Does the gentleman from Kentucky wish to inquire? And would the gentleman yield very briefly?

Mr. LEWIS OF KENTUCKY. Yes, I will be happy to, Mr. Chairman.

Chairman THOMAS. Dr. Orszag, I appreciate your effort to push the argument that the structure of collective funds, for example, under Clinton, would produce a result exactly the same as a government agency——

Mr. ORSZAG. I said similar.

Chairman THOMAS. Similar, used for disbursal. It is amazing to me then that under Medicare with government moneys, people are able to choose their own doctors. Carrying your argument to the end of the analogy, you should not be able to choose your own doctors. We should be able to choose the doctors for you.

Mr. ORSZAG. Mr. Chairman, what I was saying is that in order to keep administrative costs low, the point——

Chairman THOMAS. I understand that, but we have very low administrative costs in Medicare, and people still get to choose their doctors.

Mr. ORSZAG. The evidence is clear. Sweden actually does what I think you may be talking about, which is it is a government—a centralized authority that lets you choose——

Chairman THOMAS. The gentleman from Kentucky is worried about how long we are going to continue the dialog, but I do believe——

Mr. ORSZAG. Your administrative costs go up.

Chairman THOMAS. The point you have made is one you need to be aware of. It does not necessarily drive you to the conclusion that you arrived at as something you need to worry about. Is that a fair agreement that we can continue to talk on that point?

Mr. ORSZAG. I would be happy to respond in more length in writing, but the key point is the administrative costs go up as you open up more and more options, and the possibility for——

Chairman THOMAS. We started talking about options and how too many options is not freedom, but chaos. The gentleman from Kentucky, thank you very much.

Mr. LEWIS OF KENTUCKY. Thank you, Mr. Chairman. Earlier, my colleague Mr. Stark said that he felt like that Republicans had a diabolical plan to destroy entitlements. And let me suggest that

if we do nothing, in fact, if we just forget this and do nothing to address the entitlement problem, entitlements will be destroyed. It is just a matter of time. And, Mr. Goodman, you talked about that in your testimony, that by the year 2020, just 15 years from now, all the revenue going into the Federal Treasury will be consumed by entitlements and there will be nothing left over for discretionary spending. Mr. McDermott was worried about education. Well, there goes the education funding; not only education funding but defense funding; not only defense funding but—well, we can just go on and on. Everything was within the discretionary pie. And by the year 2040, 2041, the only funding that will go into the Federal Treasury will be just on interest on the debt, nothing left over for entitlements period. So, there go the entitlements, there goes discretionary spending, there goes the economy, there goes our kids' future. So, we have to address this problem, and that is my question. How soon do we need to start addressing this? It seems to me like 15 years is not very far out.

Mr. GOODMAN. I want to draw your attention, everyone's attention to Figure 7 of Douglas Holtz-Eakin's testimony. It is on page 13, Figure 7. I hate to admit this, but I think it is a better graph than my graphs. What he shows is what is happening to spending and what is happening to revenues, and you can see there the spending line is going off the chart and revenues projected to the future, it looks like they remain constant, about 18 percent of GDP, but spending goes up by mid-century and is above 50 percent of GDP. So, all this talk about how Social Security benefits are guaranteed and all these other entitlements being——

Mr. LEWIS OF KENTUCKY. It is ridiculous.

Mr. GOODMAN. —guaranteed, this line going up the page is mainly entitlement spending. That is what that is. It is not guaranteed. The funding is not there. But if you found a way to fund these programs, then you could have a real guarantee, a guarantee that actually meant something.

Mr. LEWIS OF KENTUCKY. That is right. Eventually there will be no way you can tax your way out of it. You cannot grow the economy out of it.

Mr. GOODMAN. That is right.

Mr. LEWIS OF KENTUCKY. The only way you can do it is address it through trying to get people investing in ways that will provide compound interest to take care of the future for our kids and grandkids.

Mr. DAUB. If you would go to the Social Security Advisor Board, www.ssab.gov, have your staff do that, we are a bipartisan board created by this Congress in 1994, and we have done an immense amount of work on the issue of sooner rather than later and what the consequences are for each year that has gone by. We started talking about it in 1998, said we had a 14-year window; 7 of those years have gone by. And your choices become fewer, your options become fewer, and the cost of the transfers required for guarantees and every other sort of Rube Goldberg kind of idea become very extreme. So, your point is well taken, and there is a lot of information that has been done by economists. Everybody may have a different point of view about how to cobble together a solution, but your point is the best one that can be made.

Mr. LEWIS OF KENTUCKY. Well, let me just say, this is not a Democrat or Republican problem. This is an American problem, and it is a threat to our country as much as any external enemy. Thank you.

Mr. MCCRERY. [Presiding.] Does the gentleman from Texas, Mr. Johnson, wish to inquire?

Mr. JOHNSON OF TEXAS. Thank you, Mr. Chairman. Thank you all for being here. I appreciate it. Earlier, just so the charts that were introduced by Representative McDermott are not taken as facts, I want to point out that there are no sources listed for his information other than his personal staff. I think I could probably ask all of you the same question and you would come up with correct answers, and I appreciate that. But defined benefit pension plans are going down, but I don't think that, they started at 60 percent, nor do I think that they are above 30 percent today. And the President's plan, he talks about destroying retirement security for the middle class. I cannot use the Texas word, but it is not true. So, Mr. Goodman, or Dr. Goodman, you talk about two ways to prefund the retirement system: investments managed and controlled by the government or by individuals. would like to know what you think about the down side of government-invested versus personal accounts as a preferred way to pre-fund investment.

Mr. GOODMAN. Well, after World War II, there were about two dozen former British colonies that established provident funds. These were four savings plans, and they were different from the pay-as-you-go system that we have in this country and that most other countries established. So, workers put money into the funds. In most of these countries, the governments controlled the money and made the investments. Now, the country that did the best of this sort of technique was Singapore. Singapore did very well. They have used the capital to grow, and it is one of the real growth stories around the world. But the other two dozen or so did not do well, and part of the reason is it was tempting to politicians to take the money and do something else with it.

So, I think if you want to make sure that the capital is there, that it is invested, and that you have really secured the benefits, you need to give people property rights. And that is why I like the individual accounts. In most of the proposals that are out there, we are not giving the worker much choice of investment. Most of these proposals are for some form of forced savings. But the key thing about it is it establishes a property right. People can leave it to their heirs. They understand it is part of their estate. This is, I think, an important part of the reform—not necessary, but I think there are huge advantages of individualizing this.

Mr. JOHNSON OF TEXAS. Well, and personal accounts, in my view, kind of force people to provide for their retirement. And where there is no exact definition of how the government is going to pay for the obligations in the future, as a matter of fact the bonds in the file cabinet in West Virginia represent only a call on future American taxpayers. And so far in all our history, American taxpayers have never defaulted, but we have never been asked to make good on such a large obligation before either. So, it is imperative, I think, that we find another way to do it, and other than personal accounts, I wonder, Mr. Holtz-Eakin, if you could tell me

what you think the other way to do it is to guarantee those funds are paid to the people when they retire.

Mr. HOLTZ-EAKIN. The current system is one that relies on the sovereign power to tax to make good on the commitments in Social Security and all other programs.

Mr. JOHNSON OF TEXAS. The good faith of the American Government.

Mr. HOLTZ-EAKIN. A future system would depend crucially on the nature of the property right that Mr. Goodman has described, whether that sovereign power to tax would stand behind any commitment or not.

Mr. JOHNSON OF TEXAS. And you think the government will, and so do I, but we feel and I think everyone feels the way to get people savings that belong to them, that is theirs, that is inheritable for their future is with personal retirement accounts. Mr. Goodman, Dr. Goodman, do you care to comment?

Mr. GOODMAN. No. I totally agree with you. About 30 countries now have done this in a better way. They have created the individual accounts where there is a property right, and investment choices are made by individual workers. Some are better than others, and we have put out a whole study, examining these 30 countries and giving our opinion on what are the best options. But, yes, these 30 countries have all recognized that we need to go to a funded system, and the best way to go to a funded system is with personal retirement accounts.

Mr. JOHNSON OF TEXAS. Thank you. Thank you, Mr. Chairman.

Mr. MCCRERY. Thank you, Mr. Johnson. Mr. Becerra, do you wish to inquire?

Mr. BECERRA. Mr. Chairman, I would be willing to yield to Mr. Tanner because—I was inquiring of staff, but I would be willing to yield to Mr. Tanner, who is prepared to go next.

Mr. MCCRERY. If you want to, you would then take Mr. Tanner's place in line, which is at the end.

Mr. BECERRA. Oh, then I think I will go next.

Mr. MCCRERY. That is your choice.

[Laughter.]

Mr. BECERRA. Thank you, Mr. Chairman, and my apologies, Mr. Tanner. Gentlemen, thank you very much for your testimony and your patience. I know it has been a long hearing with votes intervening. Let me ask a couple of questions with regard to just the numbers that are out there, because I think it is so important that we get a sense of where we are.

My understanding is that today we have through the FICA tax workers contributing to the Social Security system quite a bit of money, in the several hundreds of billions of dollars, and we are paying out quite a bit of money to those who are currently retired and receiving survivors' benefits and receiving disability benefits, again, quite a bit of money. At the end of the year, we are netting more in receipts, in revenues from those who are working and paying into the system than we are having to pay out. My understand is that the amount of surplus for this year, for example, is somewhere around $160 to $170 billion when you include the interest that is being earned on the money that is in the surplus.

My understanding is as well that we take that money that is in surplus, that Social Security has that it is not needing to spend today because it has enough to pay beneficiaries, and we are seeing the operating side of the Federal budget exchange that money, take that cash, and give the Social Security Administration Treasury certificates, Treasury bonds in its place. That becomes part of the Social Security trust fund. That money that has been taken by the operating side of the Federal Government is used for any number of purposes—spending on our various programs, to make up for the loss of revenues as a result of the tax cuts that were passed, to pay for the supplemental appropriations for the war in Iraq, and so forth.

At some point Social Security will redeem those Treasury bonds to help pay for the cost of benefits to those who are retired, and if all estimates are fairly accurate, that will begin to occur sometime around 2017, 2018. If we were to not have a Federal Government spending those Social Security surplus dollars on non-Social Security activities and instead use them to reduce the size of the national debt, the amount that we pay interest on, or perhaps to set up a separate account, as we have seen it called in the past, the lockbox, to reserve that money specifically for Social Security, would we be in better shape for Social Security in the long run to be able to pay benefits to those who are entitled to receive those benefits? ask that of anyone who wishes to respond.

Mr. GOODMAN. Absolutely, because what we are doing now is we are taking the surplus and spending it. We are either spending it on tax cuts or other spending programs. And now what you are suggesting is instead to use those same dollars and invest them. You used the example of buying Government securities, but we could do better than that. We could buy a portfolio that reflected the market as a whole.

Mr. BECERRA. But we would take a little bit of risk hoping for a better return. But as a collective investment, you are saying we might be able to get a better return than just putting——

Mr. GOODMAN. Absolutely, invest in the economy as a whole. Absolutely that would help the future because that is savings and investment.

Mr. BECERRA. Thank you.

Mr. JACKSON. I concur, but the problem is there is no procedural way to enforce that lockbox. Respectfully, if the government owns the money, the government will find some way to spend the money, to borrow against it or otherwise neutralize the savings.

Mr. BECERRA. That gets me to another question I wanted to ask, and that is, when we talk about guarantees, am I correct to say that today or in 50 years, if the laws of this country remain the same, people who were paying into the Social Security system are guaranteed benefits by law?

Mr. JACKSON. Absolutely. Social Security is a legislated entitlement, so long as the underlying statute remains in force.

Mr. BECERRA. Now, let me ask you this: In terms of someone who has a 401(k), the folks at Enron who were investing their retirement moneys in Enron who today have found their company go bankrupt and now are unemployed and had their pension moneys

invested in 401(k) stock in Enron, they are not guaranteed repayment of their money, are they?

Mr. JACKSON. Social Security beneficiaries face the political——

Mr. BECERRA. The question I am asking now has to deal with Enron employees, or former employees, I guess we can call them, since they are no longer employed by Enron, who had much of their 401(k) retirement money invested in Enron stock, and now Enron having declared bankruptcy, now paying pennies on the dollar, those employees do not have a guarantee that they will ever receive what they were expecting to receive in terms of retirement benefits through their 401(k) plan invested in Enron stock.

Mr. JACKSON. They have no more guarantee than my children have that they will receive their Social Security benefits.

Mr. BECERRA. I thought you just told me that there was a guarantee—unless you are saying that someone in Congress is going to change the law——

Mr. JACKSON. Congress has changed the guarantee repeatedly since 1983 and always making the system less generous.

Mr. BECERRA. It would take an act of Congress. So, until the politicians change it, there is a guarantee in Social Security.

Mr. GOODMAN. May I answer your question?

Mr. BECERRA. I yield back.

Mr. GOODMAN. May I answer your question?

Mr. BECERRA. Actually, I have run out of time.

Mr. MCCRERY. The gentleman's time has expired.

Mr. BECERRA. I thank the Chairman for yielding me additional time.

Mr. MCCRERY. You are quite welcome. I do want to clear up one thing, though, Dr. Holtz-Eakin, because Mr. Becerra last week 2 days ago in our Subcommittee hearing raised this same question about the surplus being spent for other things. And, again, he used the figure $160 billion. That includes interest that is credited on paper to the trust fund. It is not cash, is it?

Mr. HOLTZ-EAKIN. That is correct.

Mr. MCCRERY. And so what it the actual cash surplus that we are spending on other things from the Social Security trust fund?

Mr. ORSZAG. It is about $90 billion.

Mr. HOLTZ-EAKIN. I think it is 80 or 90——

Mr. ORSZAG. The interest in 2005 is supposed to be $91 billion.

Mr. MCCRERY. I believe the cash amount is $69 billion.

Mr. BECERRA. Mr. Chairman, may I inquire something of the——

Mr. HOLTZ-EAKIN. This year.

Mr. MCCRERY. This year.

Mr. HOLTZ-EAKIN. 2004 or 2005.

Mr. MCCRERY. 2005 is projected to be $69 billion cash that will come from——

Mr. HOLTZ-EAKIN. It is clearly in the right ball park. We can get the exact number for the record.

Mr. MCCRERY. That is the Social Security actuary's estimate. CBO's may be slightly different.

Mr. HOLTZ-EAKIN. It happens.

[Laughter.]

Mr. MCCRERY. But, in any event, you cannot count the interest that is credited to the trust fund when you are talking about cash transfer from the trust fund to general revenues.

Mr. BECERRA. But, Mr. Chairman, if I can clarify, if I understand what you are saying, I think I recognize what you are saying in terms of the actual transaction that occurs. The cash that is being received in excess of what is needed to pay out is about—I think we just said about $69 billion or so.

Mr. MCCRERY. Right.

Mr. BECERRA. But there is interest that on a daily basis is accruing to the trust fund from all the other surpluses that have been deposited through Treasury bonds.

Mr. MCCRERY. That is correct.

Mr. BECERRA. think most people would say, wait a minute, if I put money in a bank and I am told I am going to earn interest, it may not see it as money that I put in, but it is still money I am earning. So, I hope we are still saying that it is still money that Americans have earned on their Social Security moneys that they——

Mr. MCCRERY. The trust fund is credited on paper with that amount in interest, but it is not cash that the general fund can spend.

Mr. BECERRA. Right, but it is backed by the same full faith and credit that the principal balance——

Mr. MCCRERY. Yes. No question about it.

Mr. BECERRA. Okay. Thank you, Mr. Chairman.

Mr. MCCRERY. Yes, sir. Thank you. Mr. Beauprez?

Mr. BEAUPREZ. Thank you, Mr. Chairman. Gentlemen, thank you very much for being with us today. This has been a great panel and a good exercise. I feel compelled to respond to the gentleman, Mr. Stark, from California earlier who, I think, if I heard him correctly, implied that everybody on this side of the dais somehow was here by the good favor of some generation that came before us, the luck of birth or some inheritance. I assure you that whatever I have in my balance sheet, I earned it, sitting under cows and taking risks as a businessman, and I am rather proud of that. So, I think I have some sense from personal experience of what I am about to address and probably take a little different direction than we have been going.

I learned a lot from personal experience, but I also learned a lot from watching my father, who had but an eighth-grade education, but I submit to you was a fairly wise man. he thought that there was quite an advantage in owning what you wanted to call your own and taking considerable personal responsibility for your own outcome and your own food, shelter, and clothing, as well as those who you brought in the world, the four children that he brought in, including myself, obviously.

I learned a lot from him. He did work very, very hard and very, very long to own something, first a house, and then a little piece of dirt that he called a farm, and some cattle and some equipment, and he provided for himself. It seems to me, the point I would make, that as the Chairman has done, the Chairman of this Committee has attempted to do, I think, in this dialog we are having about Social Security reform, to expand that to retirement security

reform, I think it is very analogous to the lesson my Dad tried to teach me all my life, that you save for, frankly, the unknown. It is the ultimate uncertainty how long we are going to be here and how much it is going to cost us to maintain ourselves here.

Quite naturally, I think here on Capitol Hill within this Committee we look for government solutions, but I think part of those Government solutions are sound, broad, expansive economic policy that address the possibilities for ownership, because given the opportunity, I think the masses of people out there right now—I used to run a bank. I was always perplexed how difficult it was to get deposits. Why don't people want to come in and open a savings account that pays them 1.2 percent interest, or a CD that might pay all of 2 or 2.5 percent interest? Why do they seem compelled to do other things with it, like buy a house? Homeownership is at an all-time high in this country. I think that is a good thing. Over the history of our country, that would, I think, prove to be one of the wisest investments anyone could make for their own security.

My question to you all, and I will just invite whomever to respond: I think what you have said over and over again here today collectively is that, as you are planning for retirement, a funded as opposed to an unfunded liability—and I will say the liability here is the expectation that you are going to need some kind of resources out there to sustain your needs and your lifestyle. So, that a funded liability is preferred to an unfunded liability. What are we missing in the macro here? Some have suggested that the tax cuts that I think were an attempt to get the economy going again were a bad idea. Some have insisted that we, in fact, take a possibility of funding some of the Social Security liability off the table before we even discuss it. I find that a bit preposterous. But tell me what are we missing in the macro sense that might stimulate and address this possibility of funding that future liability?

Mr. DAUB. Let me quickly here, because I do have to go, as the Chairman said a minute ago. I have to catch a plane. I am sorry that I cannot stay longer. I will take the lead from your comment about how we incented home ownership in this country. I said in my prepared remarks just briefly, with detail in my extended remarks that, for example, we should incent the ownership of a long-term health care insurance policy in the same way that we revere and have incented home ownership. And if we did that, you would take the pressure off of the need for an increasing percentage of public funds to be moved around in Social Security, Medicare, and Medicaid. And it could be done, for example, just in 30 seconds, with an idea that says that whether it is a 401(k) or a 403(b) or TIAA-CREF or whether it is a mutual fund or an IRA, Roth or regular IRA, whether it is an MSA or an HSA, the gain of dividends or income that is either tax-deferred or tax-free, Roth IRA, could be used to buy a long-term care insurance policy, health insurance policy, with content restrictions, 36 months, home health, and you have to start it by the time you are age 50 to get your tax break. And those particular funds have already been calculated as revenue foregone in the Tax Code. We already have those savings instruments in place. The revenue has already been foregone, so if you just take the gain and use it for that purpose, you would move

a huge amount of pressure in the next 20 years off of the need. And it would take 20 years to do it, but it would be a way to start.

Mr. ORSZAG. If I could just have the Chair's indulgence for 30 seconds, I think the thing that has been overlooked is precisely what Mr. McCrery and I discussed earlier, which is simply issuing debt to finance individual accounts does not raise national saving. It should not be referred to as "funding" in any way. And so, therefore, what we are really talking about is are we willing to raise revenue to have additional revenue going into individual accounts or have some offsetting other changes to raise national saving, because in the absence of that it is a mirage and we are playing—it is like a cruel hoax on the American public.

Mr. MCCRERY. Well, we didn't exactly agree on the specifics of what you just said. I agree that it is not net national savings if you don't come up with a new revenue source to fund them. But it is technically funding in isolation of the Social Security system.

Mr. ORSZAG. Yes, but I think——

Mr. MCCRERY. Which is it not now.

Mr. ORSZAG. I agree, but the distinction is that type of funding is not particularly important.

Mr. MCCRERY. I agree—well, I cannot say that yet. Mr. Doggett?

Mr. DOGGETT. Thank you very much, Mr. Chairman. And with due respect to the thoughtful testimony of our diverse witnesses, I really believe that this hearing should be more truthfully entitled the hearing on thin sugar coatings, because Chairman Thomas has made it clear that perhaps the next time that this Committee convenes, within a matter of a very few weeks, less than a month, he will have his proposal out there, the centerpiece of which would appear to be individual accounts that result in significant cuts to future Social Security beneficiaries. It is a plan to replace Social Security as it has served generations of Americans over the last many decades, and it is based on an ideological commitment that our colleague from Washington referred to a few minutes ago that the solution to all the problems in our society is me, not we, that we cannot come together and find community solutions to problems like how we assure the dignity for our seniors in their golden years.

This morning, we had an opportunity to see again that that is the central purpose of this gathering, just simply how you will find a way to provide enough cover for the dismantling and replacement of Social Security by adding on a variety of other retirement issues when Chairman Thomas responded to Mr. Neal's question—or didn't respond to Mr. Neal's question that if there weren't sufficient votes in this Committee or in the House to institute and impose these private accounts and the privatization of Social Security here, would he guarantee us that it will not be done in conference Committee, as is being widely discussed here in the halls of Congress. And, of course, we got no answer to that, indicating just as with the President's continual pursuit of private accounts, that is exactly where they are headed. Just this time last week, the lead witness for this Republican plan to cut Social Security benefits, Mr. Posen was sitting here and he did not discuss it at that time, but he came over here to Capitol Hill yesterday and indicated that he thought this private individual account program that the President is advo-

cating, the House Republicans have come behind, is a mistake and that it ought to abandoned and that we ought to pursue strengthening Social Security and looking at the alternative ways of strengthening and preserving Social Security first before getting into the question of privatizing Social Security, as the President has insisted we must do. Indeed, he has insisted that it be a precondition to any negotiations and discussions on Social Security, as our Ranking Member indicated last week.

I believe that if the goal is to encourage the participation of more Americans who do not have participation now in retirement plans of any kind in having a retirement to supplement Social Security, if that is the goal rather than the ordinary typical objective of this Committee for years, which is to comfort the comfortable, if it really is the goal to help people who don't have retirement get a more secure retirement, then this Committee and this Congress has done a pretty lousy job, because there were reports earlier this year that we now have more being expended in tax expenditures drawn out of the Treasury as incentives for retirement plans than total retirement as a result of those incentives. In other words, it costs the Treasury more money to have all these great incentives and promotion for individual retirement initiatives than gets saved. And the reason for that is because many of the comfortable simply find a way to shift, as is a reasonable step for anyone who has got the resources to do it, to shift savings they otherwise would have into tax-benefited plans. And, therefore, we have not targeted our resources toward helping those who need retirement the most. Now, Dr. Orszag, you referred to another study, and I think, though I don't want to cause him any harm by praising them, that H&R Block is to be commending for participating in this study. I have just read kind of the summary of it, but I want to ask about that attempt. It sounds a lot like the kind of incentives that we proposed here in this Committee, I think a proposal that Mr. Cardin had some years ago. Of course, every Republican Member voted against it when we proposed doing something to help those who lacked retirement plans to supplement Social Security. But you are referring to a plan where incentives were given to the working poor and to middle-class families to be able to set up individual retirement accounts.

Mr. ORSZAG. That is right. There is a common hypothesis out there that middle- and low-income households will not save because they do not have any disposable income. And so this was a randomized experiment, sort of the gold standard of these kinds of analyses, in which individuals were offered different match rates, and what you saw was that a 50-percent match rate which was clear, transparent, and well presented generated a very substantial and meaningful increase in saving, in contributions to IRAs, even among moderate to lower owners.

Mr. DOGGETT. So, there are ways to try to target relief to those who need it the most in terms of retirement security without dismantling the Social Security system, as President Bush and our leadership here in the House would want to do.

Mr. ORSZAG. I think we need to make it easier for households to save and increase the incentives for middle to lower earners to

do so, and there will be a significant response if we succeed in making those policy changes.

Mr. DOGGETT. Thank you very much.

Mr. MCCRERY. Thank you, Mr. Doggett. I would point out to the gentleman from Texas that I do not believe the leadership in the House, nor anyone on this Committee, has said any such thing, that we wish to somehow reduce the benefits of the most needy under Social Security. In fact, we are listening carefully, as we did in my Subcommittee on Tuesday. The whole Subcommittee hearing was dedicated to vulnerable populations under Social Security and how they should be protected. So, I take the gentleman's point. I appreciate his contribution to the discussion, and we will certainly endeavor to heed the gentleman's advice.

Mr. DOGGETT. Well, let me just say, Mr. Chairman, you may confuse two points I am making. One of them is that when it comes to incentives to encourage people to plan for their retirement outside of Social Security, I don't think—and that has not, I think, been a focus of your work on Social Security.

Mr. MCCRERY. Not yet.

Mr. DOGGETT. —that this Committee has done a very good job this year or in any prior year, and the data shows that it is costing us more than we——

Mr. MCCRERY. That is a different point. The gentleman, though, made a reference to the leadership of the House in wanting to take Social Security benefits away from the most needy, and no one has suggested that.

Mr. LEVIN. Well, let me just say I think some people have.

Mr. MCCRERY. I am sure some people have.

Mr. LEVIN. Including people—including Republicans on this Committee.

Mr. MCCRERY. Including Dr. Orszag and his——

Mr. LEVIN. No, no.

Mr. MCCRERY. Yes, he—you were not here, unfortunately, for the questioning from Mr. Hulshof, and Dr. Orszag said that for retirement benefits there was no cohort that would be held harmless from reductions in benefits under his plan. So, that is true. There are those who have suggested that.

Mr. LEVIN. And that is across the board——

Mr. MCCRERY. believe Dr. Orszag is the witness requested by the minority. Now, Mr. Pomeroy, would you like to inquire?

Mr. POMEROY. Yes, Mr. Chairman. Thank you. I think this has been an absolutely superb panel, and I commend each of you for your participation in its. It seems to me that within this panel we have been able to see dimensions of the debate. On the one hand, the macroeconomic visions, especially spoken to by Dr. Jackson and Dr. Goodman about difficulty in sustaining what we have got going forward. On the other hand, we also had information, especially from Dr. Orszag and Dallas Salisbury, regarding how all this lands on the individual, the microeconomic impact of all of this. think obviously that is where this Committee has to spend a lot of time thinking about, because if we form a response, it is only for the government—from the Government perspective, we may very well be at odds with what the individual needs by way of protection. Specifically, Dallas Salisbury said—I want to go across the panel

and hear your reactions to it—that the risk of living too long is increasingly being borne by individuals. Dr. Goodman, quickly please, agree?

Mr. GOODMAN. Sure, but it is not because of a change in Government——

Mr. POMEROY. Okay. Dr. Orszag—I am not asking about that. Actually, you and I could have quite a visit about that, but I am not going to—that is not my——

Mr. ORSZAG. Yes.

Mr. POMEROY. Is the risk of living too long being increasingly borne by individuals?

Mr. ORSZAG. Yes.

Mr. POMEROY. Dr. Jackson?

Mr. JACKSON. Yes.

Mr. POMEROY. Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. I guess yes. Who else would bear it?

Mr. POMEROY. All right. I believe that this is something we really have to worry about. There is a 50/50 chance a couple at the age of 65, one of them is going to reach the age of 92; and there is a 25-percent chance one of them is going to reach the age of 97. And so things that do not really look at how we continue to meet the income needs of these people through their longevity expectation would fall far short of what the American people require. And in the end, if we do not get it right, we are going to have to build public service systems to deal with those that are very old, very sick, and very broke. And so we might as well get it right. But to me this is not a matter that ought to be driving an ideological wedge between the sides of the aisle here. People are living longer. How do we deal with it?

It is my belief that the way we deal with it is shoring up an income stream so they have a cash flow that is dependable through their life expectancy. How do you do that? Well, essentially, the key is an annuitized payment, a regular payment delivered. How do you do that? We have 20 million people receiving the benefit of defined benefits plans—pensions, the old pensions. It is a smaller amount than before, but it is still a significant number. I do not believe the Department of Labor places a public policy importance on continuing pensions. I believe they pay more attention to shrinking the exposure of the Pension Benefit Guaranty Corporation. I believe that their proposals are wrong-headed and would reduce pension coverage, thereby reducing the annuity coverage. I think that this Committee needs to help straighten that out. Pensions ought to be continued to the extent we can.

Second, we need to save more. I think that we could maybe have bipartisan agreement on this Committee for the automatic enrollment proposal Dr. Orszag has talked about and others have talked about. I think maybe we could make some headway there. I also think we need to look at helping people convert a defined contribution plan so it has the defined benefit-like annuity stream. We ought to make annuity purchasing more affordable, more attractive to people at the time they enter retirement years with their nest egg. That certainly lays then the longevity risk off of their shoulders and into a pool, a better way to manage that risk.

I also think inevitably we need to understand that Social Security plays an incredibly important role here. Social Security, as a defined benefit annuity that you cannot outlive, inflation adjusted, it is an absolutely key part of the longevity puzzle, and that proposals that move toward privatizing inevitably—well, may have some—you can certainly sketch out some benefit to the Treasury. But for the individual, it leaves them even more exposed than they are now. And we have panel consensus that people are carrying more and more risk now. Any meaningful solution should not take the risk people now have and make it worse by in the end reducing the security of Social Security for them. And so I think as a matter of policy priority going forward, this panel has illustrated the task in front of us. Dr. Orszag?

Mr. ORSZAG. I would just add that especially as the pension system has evolved from a defined benefit one toward a defined contribution one, I understand concerns that you and many other people have about that. It makes ever less sense to engineer the same transformation within the core tier of retirement income provided by Social Security. In other words, having that defined benefit foundation is more valuable as the pension system on top of that foundation has evolved toward a 401(k)——

Mr. POMEROY. Exactly. The exchange——

Mr. MCCRERY. The gentleman's time has expired. The gentleman's time has expired.

Mr. POMEROY. Can somebody comment?

Mr. MCCRERY. The gentleman used his entire 5 minutes to make a speech, which I appreciate, but his time has expired. Ms. Hart?

Mr. POMEROY. I yield back.

Ms. HART. Thank you, Mr. Chairman. My colleague mentioned to me, when did living to an old age become a risk? think one of the things that the panel neglected to mention when talking about retirement security and the real demographic changes, one of them is that, unfortunately, people are not taking responsibility for their parents. That is a problem, and maybe we ought to think about what Government can do to encourage families to be families. But that is an issue that maybe we will have to address another time.

Defined benefit plans, which were very common for a very long time, and especially in areas like mind, are falling apart in the news every day. We see that. Increasingly, 401(k)-type plans are becoming more the rule. I held a forum about 10 days ago in my district—actually, I did not hold it. I was a speaker, along with a Democrat colleague and an economist. And it was before the local organization for Certified Employee Benefit Specialists. And the most alarming thing that came out of that forum was their number one concern, they said that in practical terms people are not taking advantage of the 401(k) retirement plans that are being offered to them. To some extent, they are, but not nearly as much as they should; that they are not putting enough aside or taking enough advantage, even, surprisingly, of the kinds of plans where the employers are matching their contributions to meet the kind of benefits that they should have for retirement. I guess my question to the panel is: Specifically in 401(k)s and plans that, we are becoming increasingly dependent upon, the people will become increas-

ingly dependent upon, what can we do to encourage more participation? Anybody from the panel.

Mr. ORSZAG. I think the answer is very clear. I think we know what gets participation up, and it is changing the default so that workers are in the plan unless they opt out as opposed to having to sign up. It is as simple as that. You see very, very substantial increases in participation, and, again, this is, I think, something that we can get bipartisan agreement on, and we can make the changes that would help encourage more firms to have that kind of opt-out system instead of putting all of the onus on workers to sign up for the plan.

Ms. HART. Okay. Anybody else? Dr. Goodman?

Mr. GOODMAN. Well, Peter and I have made this proposal together. There is also another very important component, and that is encouraging those who are in those plans to have the right kind of portfolio, a balanced portfolio. No one is forced to do that, but they should be encouraged to do that. And if they do not choose one on their own, that should be the default, because how you invest is as important as whether you invest.

Ms. HART. The issue that was discussed earlier about people going into what they think is safe company stock, that sort of thing.

Mr. GOODMAN. Exactly.

Ms. HART. Okay. Thanks.

Mr. HOLTZ-EAKIN. Congresswoman?

Ms. HART. Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. If I could make the economist's point, which I must, about the fact that, 401(k)s or defined contributions are compared to defined benefits. And let me just say, since it is the jurisdiction of this Committee, that one of the issues with defined benefit plans is that if the playingfield is not level, they will wither away inevitably. And it may be that some workers want their compensation in that form and prefer it to the defined contribution, and others may not. But the question is: Does the policy leave the playingfield level? At the moment I would say a concern would be that many of the DB plans went down because the industries they are in have changed dramatically. And if it is the case that in the rethinking of the funding rules or the premiums in the PBGC you charge new plans that are in good shape the costs of what is sunk and over and done, you will overcharge them for their insurance, and you inevitably will make DB plans less available. And that is a key——

Ms. HART. I think that is the point that Mr. Pomeroy made. It is fair.

Mr. HOLTZ-EAKIN. I think it merits reflecting.

Ms. HART. Okay. Dr. Jackson is quiet.

Mr. JACKSON. I think there is an obvious way to increase worker participation in defined contribution savings plans, which would be to include a defined contribution savings component. would make this on a mandatory basis within the Social Security system, just to circle the debate back around. I also wanted to make the point that I think it is a non sequitur to argue that shifting to a defined contribution or to a personal account basis necessarily increases longevity risk. It depends on whether you are allowed to

cash that out as a lump sum and spend it. Certainly account balances could be—mandatory annuitization of account balances could be required. So, I thought that needed clarification.

Ms. HART. Thank you. also want to refute something that Dr. Orszag said earlier, and briefly, Mr. Chairman, if I may.

Mr. MCCRERY. Briefly.

Ms. HART. Borrowing to set up accounts, personal accounts under Social Security, isn't a hoax of any kind. I think borrowing to just throw more money into a pay-as-you-go plan which provides people with no security for the future really is where you have a hoax. It is really like borrowing money to buy a house. You end up with a real asset, whereas under the current plan, you just do not get that.

I yield back, Mr. Chairman.

Mr. MCCRERY. Mr. Thompson?

Mr. THOMPSON. Thank you, Mr. Chairman. I would like to thank all the panel Members for being here. In Mr. Salisbury's written testimony—and I think it was reiterated by the Chairman in his opening comment—there was much said about people not taking full advantage of all of the retirement options that are currently available in the marketplace. And given this, I am having a real hard time understanding how privatizing Social Security is going to enhance or even protect retirement security. They already have options that they are not taking advantage of, and to provide more, I do not understand how we get to where some think we are going.

Moreover, while I greatly appreciate some of the things that my colleagues and friends on the other side of the aisle are talking about, specifically this increase in personal ownership, I do not believe it is particularly forthright to minimize the corresponding increase in risk. There is a lot of talk about increase in personal ownership but very little about that corresponding risk that is associated with that. think this becomes even more germane now when you have situations such as the United action earlier, United Airlines action earlier this week, and many folks are saying that this may be just the prelude to other old-time industries and what may be happening down the line. So, in saying that, I guess I'll ask my first question, and I was hoping Mr. Salisbury would be here, so, Dr. Orszag, so I guess you get the question because he left early. But in his testimony, he said, and I will read this: "Decades of data underlying the compulsion in savings and distribution produced better retirement income results than open individual choice. If the policy objective is choice, that doesn't matter. If the policy objective is lifelong retirement income adequacy, it does matter." Do you think that the goal of Social Security is to provide people with adequate lifelong retirement? And given that people are saving very little, do you think that fewer people will achieve this lifelong income adequacy without some sort of guaranteed annuity such as Social Security?

Mr. ORSZAG. One of the primary goals of Social Security is to provide the foundation for an adequate and comfortable retirement. Regardless of what we do to the Social Security program, more will be required for the vast majority of the workforce on top of Social Security, and that is why I think it makes sense, in addition to

shoring up the system, to encourage more retirement saving on top of that foundation rather than within it.

Mr. THOMPSON. And also in some of the written testimony, and also in these hearings that we have had in the last couple of weeks, a lot has been made of the personal debt that people in the workplace have incurred. And the numbers are absolutely staggering. The average family has about $10,000 to $12,000 in credit card debt, and it just seems to be exacerbating the situation on almost a daily basis. How hard is it going to be for people to achieve retirement security with this level of debt? There has got to be some nexus between the two.

Mr. ORSZAG. Again, I think it underscores—that is just one aspect of the fact that people are not—too many people are not saving adequately for their own retirement, and that is one manifestation of it. And the flip side, by the way, with regard to the Government and coming back to the comments about whether—characterizing different kinds of systems, having the government issue more debt to create what appears to be a funded system, we can call it either a hoax or something else, but it is not actually contributing anything to making the future economy more productive or providing resources in the future for future retirees.

Mr. THOMPSON. Thank you. Director Holtz-Eakin, I saw one of the most interesting charts that I have seen to date. It comes from one of Dr. Orszag's colleagues where they show Tom and Jane, who basically have the same program in a privatized account. They have the same return, the same investment. The difference is that each has one bear year. Jane has her bear year in the first year, and Tom has his bear year in the year before his retirement. And as a result, according to this chart, Tom's investments really take a tumble, and he retires with a lot less than Jane. Is this accurate? And is this something that could actually happen in real life? And if it did, what would that mean for the person who has the bear year in their last year as opposed to their first year where they can recover?

Mr. HOLTZ-EAKIN. Certainly there are risks that are unpredictable in any investment, and the timing of those risks will determine the cumulative return. If the cash-out date is fixed and you are hit with an adverse shock during a fixed cash-out date, then you will suffer the consequences. You will have no way to shift that risk in any way. So, the alternatives are to find a mechanism to shift it, either within yourself, wait later to cash out, or to have a mechanism to shift it across people, so shift through time using the government or some private entity to borrow and lend.

Mr. JACKSON. We would be foolish as individuals to have all of our money in equities in the year before retirement, and I think Congress would be foolish to fashion a personal accounts reform that allowed individuals to do that. Personally, I would like to see some sort of a life cycle or life balance approach be made mandatory. That said, it is entirely possible to structure portfolio allocation shifting from equities when you are young into bonds when you are older that protects retirees and near-retirees against a stock market crash on the magnitude of——

Mr. THOMPSON. So, this would only be a portion of——

Mr. MCCRERY. The gentleman's time——

Mr. JACKSON. Sir, I haven't——

Mr. GOODMAN. May I have 10 seconds?

Mr. MCCRERY. Yes.

Mr. GOODMAN. In the Chilean system, you can, up to 10 years prior to retirement, lock in an annuity. And even after the retirement period, you do not have to lock it in on that day. You can just go along with your fund and wait until things get better. So, it is not the case that you have to on a single day lock in to whatever the market is offering.

Mr. MCCRERY. I thank the gentleman. Mr. Chocola?

Mr. CHOCOLA. Thank you, Mr. Chairman.

Chairman THOMAS. Would the gentleman from Indiana yield briefly?

Mr. CHOCOLA. Certainly.

Chairman THOMAS. I thank the gentleman. And when we talk about a bear year, I immediately think of an Oriental calendar in terms of whether you are a bear or an ox or whatever. The irony of that, of course, is based upon the changes that have been made, for example, the age change in 1983 or any other period, especially some of the changes we are talking about now, you could be in the Social Security system and, in essence, have a "bear year" based upon which year you were born, because changes go into effect and somebody on the other side of that bear year does not get as much in terms of benefits as the person on the other side. And to the degree you have accounts which move from aggressive when you are younger to very conservative when you are older, that bear year, the year before you retired, could very well have less of an effect in an open market pattern than inside Social Security based upon the kind of conditions we would make from year to year. So, I think it is useful to talk about bear years, but there is no free lunch. I thank the gentleman for yielding.

Mr. CHOCOLA. Thank you, Mr. Chairman. Just real quick, Dr. Holtz-Eakin, you pointed out the defined benefit plans have changed in large part because of the industries that sponsored them have changed. So, long as you had a prudently designed defined contribution plan that did not have too much of one company's stock in it, it is not tied to the fate of the employer, is it?

Mr. HOLTZ-EAKIN. That is correct. They are portable across firms, and so it would not be tied to the firms' fortunes. In the interest of balance, had those plans been fully funded, the same would be true. They would not be tied to the fortunes of the firm or the industry per se.

Mr. CHOCOLA. Thanks. In my relatively short time—I appreciate all your patience for sticking around. Those of us sitting here in the middle of the front row really appreciate patience a lot.

[Laughter.]

Mr. CHOCOLA. I have not been in government that long, and what I have learned in my short term in government is the enemy of good Government is 30 seconds. And this is much more than a 30-second problem to discuss. And so we kind of become subjected to sound bites when it comes to discussing solutions, and one of the sound bites we hear—and we have talked about this already today—is that there are rock solid guaranteed benefits under the

current system. Do any of you want to argue that that is, in fact, true?

Mr. ORSZAG. I think that there is a very solid guarantee that is provided in the defined benefit form from the current system, precisely because I don't think—coming back to Mr. Thomas' comments, you do not see very drastic changes. Any changes that are made are always very, very gradual and, therefore, anticipated well ahead of time. And so for anyone who is nearing age 60 or 61 or 62, at that point it is guaranteed. You do not get that kind of guarantee under any kind of account system.

Mr. CHOCOLA. I think the Supreme Court said there is no legal right and that we can change the benefits. But let me——

Mr. ORSZAG. You could also change the tax law on accounts. So, it is easy to——

Mr. CHOCOLA. Let me—one of the other sound bites is that we tend to hear criticism of a single element in a vacuum, of personal accounts or progressive indexing. You pick whatever the suggested solution might be. When, in fact, I think a broad retirement fix is needed, it is going to take a package of good ideas to address this issue responsibly. Then if you want to talk about the wisdom of a broad retirement fix or a package of good ideas and probably the lack of wisdom of focusing on one element in a vacuum.

Mr. GOODMAN. I would, starting with this issue of what is really guaranteed, and I want to point everybody's attention again to Figure 7 on page 13 of Doug Holtz-Eakin's testimony. And whatever we have done in the past, it did not matter very much because spending was pretty close to revenue so we could handle it. But we are about to hit the tsunami, and the spending line is going off the page, and it is almost all entitlement spending. Well, there is no way you can say that is a guarantee because you do not have the revenue, and that is the future we are looking at. So, yes, you need a broad approach and it needs funding and it needs funding of the public programs, but it needs additional funding in the private sector.

Mr. ORSZAG. would just add, if we are not going to get Social Security reform done this year because of disagreements over accounts within Social Security, we could at least make the 401(k) and IRA system work a lot better. Why don't we just come together and do the stuff we agree on?

Mr. CHOCOLA. Well, Dr. Goodman, we are running out of time, but you have talked about 30 other countries have created property rights, which is more of a guarantee, a property right, I would say. Do you have any quick kind of comments on lessons we should keep in mind and have learned from what other countries have or haven't done?

Mr. GOODMAN. Yes. The guarantee from the private accounts comes from the fact that funds are in the accounts. So, defined contribution funds are always funded, by definition, and they are replacing promises, the unfunded promises of governments. And the reason 30 countries have done this is because they realized they could not keep their promises, and they did not want to reach a point where people were without any retirement funds.

Mr. JACKSON. Two points, two lessons. One, make the system mandatory. It is difficult to see what the purpose of being able to

opt in or opt out or what the purpose of choice is in a system that is fundamentally designed to protect people against bad choices. Mandatory I think is important. And, second, wise regulation, the kind of portfolio allocation rules that we were talking about, the kinds of annuitization rules that we were talking about. Countries that have enacted these have had a better experience than countries that have not.

Mr. HOLTZ-EAKIN. If I could just remind the Committee as they head into what may be thinking about legislation, you can only think of a plan in its completeness, and the details matter, and you cannot evaluate any tiny aspect of it in isolation. It is really important to look at the whole, evaluate the whole and see how all the pieces interact.

Mr. CHOCOLA. Thank you all. I yield back, Mr. Chairman.

Mr. MCCRERY. Mr. Emanuel?

Mr. EMANUEL. Thank you, Mr. Chairman. To pick up on what a number have said in the sense have we looked at both the Social Security side of retirement and the non-Social Security side of retirement, and then also expanding the debate on the whole notion of retirement security, as we all know, more and more people in retirement days are spending more and more of their Social Security checks and retirement checks on their health care. So, looking at the health care portion as well as how to save for retirement should be part of this. Now, in the art of politics and the art of compromise and trying to get something done rather than not, I want to pick up on what Mr. Orszag and others have said about the kind of non-Social Security retirement. Because if you look at the political landscape—and you cannot remove politics from a political process, and that is, we should take what we can get done, get that done, and then come back or form a debate that is not politicized.

Now, having been the sponsor of both, I think, the direct deposit of tax refunds into savings accounts, because there is one time that you can get a great deal of money put into savings. The automatic enrollment in 401(k), we all talk about that. R.R. Donnelly in Chicago went from about a 53-percent participation, when they installed the automatic enrollment went up to 94-percent participation, and the greater increase was among support staff and those making in the moderate-income level. That is where they got the dramatic increase. And not only that, the automatic enrollment includes, as you get, obviously, pay increases, and so forth, you go from a 3-percent contribution, 4-percent, it automatically steps up. also believe the life cycle-type funds is a proper way to structure an investment through people's lives. Then also, I believe—these are ideas that I have sponsored and introduced, but also working with Congressman Cardin on this last one, what is called the saver's credit, the Federal Government matching based on H&R Block's kind of program that they did.

There are going to be Republican ideas on RSAs, LSAs, et cetera. We have enough room there and enough bipartisan to deal with that. It would make a major contribution to retirement security. Now, someone had talked about long-term care. You and I, Mr. Chairman, both of you, we have talked about the Business Week story of 3 weeks ago where they talked about a product out in the

private market where people are buying life insurance with a long-term component. It already exists out there without messing with the Tax Code. It is something we can talk about doing here and making that easier.

I would argue that besides long-term care, if we are going to look at retirement security, one of the things we need to look at is allowing direct negotiations for prescription drug prices by Medicare. Prescription drug prices are going up 3 times, 4.5 times, on average, higher than inflation. And if we are going to deal with retirement security because of the health care cost as part of retirement, we have to deal with the price of prescription drugs. And so Republicans want to bring long-term care, open to that. We are going to bring or want to discuss also how we deal with the price of prescription drugs, which is a bigger bite out of the retirement security. Now, in 1983—I always like to remind people of this—one of the things that was taken off the table was privatization, and then that Commission came together, and you got an agreement that saved Social Security and strengthened Social Security for over 75 years.

Now, some say you should not take anything off the table. I don't know. A lot of people have taken revenue off the table. I don't know why we have to include privatization. Some people took revenue off the table, so other people do not like privatization because it changes the basic nature. would say as a person who represents well over 28,000 employees from United Airlines in his district, you go talk to those folks, they like the retirement security of Social Security today because they saw everything they had wiped away in one signing of the pen.

And so we can get agreement on the non-Social Security retirement security things. I welcome the Chairman's challenge to all of us. That is doable; it is within reach. We should not politicize this. I will accept that as the Chair of a political apparatus. But we should not include Social Security where there has been too much disagreement because of the insistence of an idea that the former head of GAO, who sat here, who was also a member of the Social Security panel, said would weaken Social Security and accelerate the funding crisis of Social Security. He said it here in this room. So, I welcome the challenge to deal with retirement security in its comprehensive nature, putting also the pricing of prescription drugs and how we pay for them on the table alongside long-term care. I leave time for the Chairman, who usually does comment at the end of my time.

[Laughter.]

Mr. MCCRERY. That is very kind of the gentleman, and I would love to, except Mrs. Tubbs Jones has been waiting patiently. So, I am going to call on Mrs. Tubbs Jones, and then I will comment on what the gentleman said.

Chairman THOMAS. Oh, shoot, I was going to lay dental on the table as well.

[Laughter.]

Mrs. TUBBS JONES. Thank you, Mr. Chairman. I want to echo the comments of my colleague Mr. Emanuel. I have four—and I have said this in every hearing and I know you are tired of hearing this, but my father is a United Airlines employee, my sister works

for United, my brother-in-law worked for United, my niece works for United. So, I am real concerned about what happens with United Airlines. But, as important, let me ask this question: Have any of you in the process of your long-term thinking about pensions factored in how much in debt the Pension Guaranty board is and the likelihood of greater debt that it is going to be in based on companies who probably want to follow the line of United with regard to their pensions. Have you speculated at all?

Mr. JACKSON. I think the PBGC calculates its exposure under different scenarios, and it is significant.

Mrs. TUBBS JONES. But my question was: Have you factored in that exposure in all the discussions you are having about how we handle pensions and retirements? Mr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. Well, the statutory obligation of the PBGC stops when they run out of assets. The question is whether in the event of greater pension bankruptcies than that the Congress would have to pick up some of the funding of those pensions. If so——

Mrs. TUBBS JONES. So, speculate for me, since you are—that is what your job is.

Mr. HOLTZ-EAKIN. The economic value of the guarantee now is something that looks like on the order of over $100 billion. It is a big number.

Mrs. TUBBS JONES. A hundred billion?

Mr. HOLTZ-EAKIN. Yes.

Mrs. TUBBS JONES. How much is the Social Security shortfall? Over 75 years, $3.75 trillion, right? Yes? No?

Mr. HOLTZ-EAKIN. In the ball park.

Mrs. TUBBS JONES. Yes, so, let's roll that—give me that billion again?

Mr. HOLTZ-EAKIN. A hundred billion, roughly.

Mrs. TUBBS JONES. A hundred billion as of right now?

Mr. HOLTZ-EAKIN. At the table right now.

Mrs. TUBBS JONES. As of right now, so speculate that it is going to be greater than Social Security if the companies line up like United.

Mr. HOLTZ-EAKIN. No. No, it will not. It will not exceed Social Security.

Mrs. TUBBS JONES. Because?

Mr. HOLTZ-EAKIN. That is the current—that is the comparable number, a hundred billion versus, $3.5 trillion. The non-comparable thing——

Mrs. TUBBS JONES. One is right now—the hundred billion is current. The $3.75 trillion is 75 years out, right?

Mr. HOLTZ-EAKIN. Both of these are let's look forward over some horizon, 75 years, what will the costs be, the apples-to-apples comparison.

Mrs. TUBBS JONES. That is what you are saying the Pension Guaranty board is factoring in, all the steel people who went belly up and everybody else.

Mr. HOLTZ-EAKIN. If I—not they—factored in the likely economic costs of those guarantees, that is roughly what it would be.

Mr. GOODMAN. May I say something——

Mrs. TUBBS JONES. Compare the liability then, if you are saying we as Congress have to up the ante on the Pension Guaranty board if it goes any further, is Social Security a greater guarantee than the Pension Guaranty board or a lesser guarantee, using the term "guarantee" as we are using it in this discussion.

Mr. HOLTZ-EAKIN. In the government context, the guarantee is——

Mrs. TUBBS JONES. It is comparable——

Mr. HOLTZ-EAKIN. —the ability to go get the money from the taxpayers and the Social Security guarantee is much, much larger. It is an order of magnitude larger.

Mrs. TUBBS JONES. Not magnitude. I am asking you what is the greater guarantee——

Mr. HOLTZ-EAKIN. Billions versus trillions.

Mrs. TUBBS JONES. Okay. I am going to bet on Social Security paying me, or I am going to be on the Pension Guaranty board paying me. Which is—what is the better bet?

Mr. HOLTZ-EAKIN. If we do the exercise you said, which is we speculate that we would go past the statutory authority of the PBGC, then they are comparable in their——

Mrs. TUBBS JONES. But right now——

Mr. HOLTZ-EAKIN. An order of magnitude——

Mrs. TUBBS JONES. We cannot go——

Mr. HOLTZ-EAKIN. —bigger.

Mrs. TUBBS JONES. If we do not go past the statutory guarantee, Social Security is a better bet.

Mr. HOLTZ-EAKIN. The PBGC is capped. They have a limited liability.

Mrs. TUBBS JONES. All right. Thanks. Let me change the subject for a moment. I have pending a piece of legislation that has not been scored for me yet that would give people who purchase annuities with their lump sum payment a tax credit or a tax benefit. What is your position with regard to that, Mr. Salisbury?

Mr. ORSZAG. I am Mr. Orszag. But do you give a tax——

Mrs. TUBBS JONES. Orszag, I am sorry. I am sorry, Mr. Orszag.

Mr. ORSZAG. That is all right. Do you give a tax deduction or a tax credit?

Mrs. TUBBS JONES. A tax deduction.

Mr. ORSZAG. Okay. Well, the problem with that is that it provides a very small benefit to the vast majority of the population and a very significant benefit to the upper tier of the income distribution.

Mrs. TUBBS JONES. So, you think it does not do any good to provide that to people?

Mr. ORSZAG. Basically, no.

Mrs. TUBBS JONES. Okay. You don't think it will encourage people to purchase an annuity?

Mr. ORSZAG. I think it will encourage high-income people to purchase annuities, and that is not exactly where I am most concerned.

Mrs. TUBBS JONES. My legislation is focused more on mid-income than higher-income, and I am going to have to have a con-

versation with you at a later time because I am about to run out of time.

Mr. ORSZAG. Okay.

Mrs. TUBBS JONES. My last question is—where is my last question? I guess I am going to yield back my time because in my discussion with you, I forgot what my last question was going to be.

[Laughter.]

Mrs. TUBBS JONES. Oh, no, I remember what it was. Mr. Chairman, can I do this? I personally am opposed to joining State retirement pensions with Social Security, but have any of you talked about that or thought about that in the process of trying to shore up Social Security? If so, why?

Mr. ORSZAG. I have not, and I think many economists who have looked at the Social Security actuarial deficit have explored whether including newly hired State and local workers in the system would be beneficial. I think the argument in favor of it is that the system is supposed to be a collective one, a collective social insurance program, and State and local workers are the most significant remaining gap in that coverage. Obviously, there are counterarguments against doing that also.

Mrs. TUBBS JONES. Could I ask Mr. Jackson to respond real quickly?

Mr. JACKSON. Yes, well, there would certainly be a near-term benefit to Social Security's finances because you would be bringing in the workers who were paying the contributions, but the workers would eventually become beneficiaries. So, in the long run, the positive impact of Social Security's finance is not that significant. I certainly concur with Peter that the rationale for doing that would be that Social Security is a collective challenge and that perhaps we should all bear some part of the cost of fixing it. That will not make me very popular in many——

Chairman THOMAS. Would the gentlewoman yield briefly on her question?

Mrs. TUBBS JONES. Mr. Chairman, I do not have any more time, but I would love to yield to you, yes.

Chairman THOMAS. Oh, I think we have time.

Mrs. TUBBS JONES. Okay.

[Laughter.]

Chairman THOMAS. I am puzzling with her statement that she would prefer that those risky schemes that invest in the stock market and other risky securities at the State level not be put into the absolute guarantee structure of Social Security, but she is willing to leave those State and local people out there in those risky investment scheme structures.

Mrs. TUBBS JONES. Do I get a chance to respond?

Chairman THOMAS. Sure.

Mrs. TUBBS JONES. Mr. Chairman, I don't think that the State and local programming, as compared to the Social Security programming, is the same thing. I think that the people who are enrolled in State and local programs recognize what their risks are, recognize what they are involved in or getting involved in, and that was a commitment that they made at the time. First, there are the people who are working in Social Security programming—excuse

me, who are Social Security retirements don't make that. Understand that the people who are in State and local retirement programs took a big hit around the Enron, WorldCom, and a lot of them are questioning whether they would want to remain in——

Chairman THOMAS. Would the gentlewoman want to run a pilot program or perhaps create the opportunity of an option and that the State and local can choose their risky schemes with Enron or they can choose to go into Social Security and we will let those people vote with their feet?

Mr. MCCRERY. They already have that option, Mr. Chairman, as you——

Chairman THOMAS. I think they voted with their feet. I thank the——

Mrs. TUBBS JONES. But, Mr. Chairman, I am not interested in that pilot program, but I have other pilot programs I am interested in, and I would love to discuss them with you.

Mr. ORSZAG. If I could be so foolish as to intervene in this discussion, there is a significant difference, which is that the State and local programs are defined benefit programs. The risks that are entailed in those equity investments are, therefore, not necessarily borne entirely by the workers themselves.

Mr. MCCRERY. United was a defined benefit plan, too, Dr. Orszag.

Mr. ORSZAG. I think that illustrates why defined benefit programs, perhaps, sponsored by governments are better in some——

Chairman THOMAS. I thought that was why you—you referenced it. I thought that was why you prefaced it that you should not be so bold to go into the area, because the response was exactly right on.

[Laughter.]

Mr. MCCRERY. I would welcome you to wade into this.

Mrs. TUBBS JONES. Thank you, Mr. Orszag, for the help.

Mr. MCCRERY. The more, I think, compelling illustration is what the Chairman pointed out. Those people who have a choice choose those risky schemes, not the guaranteed benefit of Social Security. I have already been visited by scores of public employees from my State begging me not to include them in this guaranteed benefit program. So, I think that is the more compelling point. Mr. Chairman, you may want to do this, also, but I want to thank every Member of this panel. I thought today's hearing was excellent. You all brought to the table some very interesting and some compelling thoughts and ideas, and the Members of the Committee I thought did a good job in bringing those out and in some cases actually discussing them, and that is very positive. So, I want to thank you for your patience in staying with us all day and for the quality of your presentations.

Chairman THOMAS. The Chair wishes to echo the comments of the Subcommittee Chair.

Mr. MCCRERY. Without objection, the hearing is concluded. The hearing is adjourned.

[Whereupon, at 2:30 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of Walter Welsh, Americans for Secure Retirement

Mr. Chairman and distinguished members of the committee, on behalf of Americans for Secure Retirement, I welcome the opportunity to submit for the record our statement on policy recommendations to help Americans plan and save for their golden years. Americans for Secure Retirement is a broad-based coalition of life insurance companies, industry groups, and organizations—including women, farmers, Hispanic-Americans and small businesses—committed to promoting policies that provide Americans with a more secure and stable retirement. We are pleased that this committee recognizes the scope of the challenges facing Americans as they plan for retirement, and the importance of examining the full range of potential approaches that can be tapped to improve retirement security for millions of Americans.

I am sure that every member of this committee is well aware of the shift in demographics our country is experiencing. These shifting demographics define the challenges families and policymakers alike must tackle. Today, the life expectancy of a 65-year-old is close to age 83, more than four years longer than in 1960. In fact, half of all retirees will live beyond average life expectancy. And unprecedented numbers will be living into their 90s and past 100. The likelihood of living longer compounds both the savings and financial management challenge for individuals and families: retirees not only need to save more, they also need to manage these resources effectively so they provide a sufficient income to sustain a steady standard of living for 20 to 30 or more years.

For many retirees, Social Security will be the main source of income in retirement. Unfortunately, while there is no denying the value of this program, the fact is that on average, Social Security currently replaces only about 42 percent of preretirement income. Moreover, Social Security is subject to a maximum level, and today that level is approximately $22,000 per year. Financial planners have traditionally recommended at least 70–80 percent to maintain a retiree's standard of living.

Thus, while the future of Social Security is a very important retirement security issue, it is certainly not the only one. A key question for the Congress is how to ensure that all Americans—including those that don't have workplace retirement options—have sufficient tools available to help them both accumulate savings and generate guaranteed, sustained income for as long as they live. *In short, to achieve retirement security, Americans need a steady paycheck for life that supplements their Social Security benefits.*

Historically, many retirees have depended on pension plans to supplement their Social Security benefits. Most recent statistics indicate that today only about 42 percent of the 151.1 million workers in the U.S. are enrolled in an employer-based retirement plan. Participation in traditional defined benefit plans, which were a staple of retirement benefits in the past, has decreased sharply. The percentage of full-time employees in medium and large private establishments who are covered by defined benefit plans has fallen from 80 percent in 1985 to just 36 percent in 2000 as the trend shifts from offering defined benefit plans to defined contribution plans (e.g. 401(k) plans). Moreover, it is increasingly difficult for those who participate in defined contribution plans to convert their account balances to a steady stream of income that will last throughout retirement.

According to Jeffrey Brown, a former senior economist for the White House Council of Economic Advisers and current assistant professor of finance at the University of Illinois at Urbana-Champaign's College of Business and author of *The New Retirement Challenge*, "these [pension plan] changes represent an historic shift in our retirement landscape, and together place more responsibility on individuals to manage their savings so that they last for a lifetime. It is important for us, as a nation, to find ways to encourage retirees to secure additional and reliable sources of lifelong income so that they can achieve lifelong financial security."

For women, minorities, small business owners, and farmers, the retirement challenges will be increasingly more troubling for a number of reasons, but particularly because, compared with other segments of the population, they have less access to and lower participation rates in employer-based retirement plans.

Women live longer than men, spend more time in retirement and are widowed more frequently. A typical 65-year-old woman has a 31 percent chance of living to age 90 or older, as compared to only 18 percent for a typical 65-year-old male. Today, nearly 60 percent of older American women are single, with more than 45 percent widowed. In contrast, only 25 percent of elderly men are single. Social Security payments to women are on average lower than for men because women on average spend less time in the workforce, and their lifetime earnings are lower. A working woman still earns, on average, only 76 cents for every dollar earned by a man.

Over the long term, this income disparity translates into lower retirement savings and Social Security payments. Furthermore, many women work part time for all or part of their working years and therefore accrue less Social Security benefits, and fewer still participate in employer-provided retirement plans. In fact, less than a third of part-time workers, who are disproportionately women, participate in employer-sponsored pension plans. Forty-four percent of female workers lack a pension from any employer, compared to 36 percent for male workers. This small sampling of data illustrates the concerns for women retirees in America and, we believe, obligates us to implement policies to better assist the majority of this country's population.

Minority groups, such as Hispanics, also face significant challenges. Hispanic-Americans have less workplace pension coverage than workers overall. Only 22 percent have retirement savings plans to which their employers contribute money or stock, compared to half of workers overall.

Farmers are in the same situation. As compared with non-farm workers, farmers are less likely to participate in employer-sponsored retirement plans, further limiting their sources of retirement income. Just 30 percent of agricultural workers in America work for an employer with some form of retirement plan. Even more startling is that less than one quarter of agriculture workers participate in any retirement plan. That means the vast majority of farm workers have no other guaranteed sources of retirement income beyond Social Security. Further illustrating the challenges many women will face in retirement, farm wives are particularly vulnerable to declining standards of living in their golden years. According to the USDA, two-thirds of rural persons age 60 or above earning less than $10,000 were women and by age 85 the statistic jumps to four-fifths. These troubling statistics underscore the need for a comprehensive national policy to help all Americans, because while some groups are better off than others, everyone will need to plan wisely to live comfortably post-retirement.

Thus, in our view, a central challenge for policymakers is not only the need to make retirement options that complement Social Security in providing steady, lifetime benefits more accessible to Americans. It is also important to ensure these opportunities reach the populations that have the least access to employer based retirement programs, or get the least from these and Social Security. For these reasons, we encourage consideration of an economic incentive for Americans to provide themselves with a steady stream of income for life. Beyond Social Security and defined benefit plans, this can only be achieved through ownership of a lifetime annuity. Lifetime annuities are the only retirement vehicle that can successfully address the dual risks of longevity and investment risk.

An annuity is a financial product that can provide lifetime payment at regular intervals, such as monthly. These lifetime payments begin when the retiree determines that the payments are needed and continue for the lifetime of the retiree and, if selected, his or her spouse. These lifetime payments are personal insurance that eliminates the risk of outliving one's assets. Americans for Secure Retirement encourages increased use of lifetime annuities as part of a sound retirement plan and urges this committee to provide tax incentives to encourage Americans to include them in their retirement savings portfolio.

Americans for Secure Retirement supports legislation introduced and pursued by members of this committee called *The Retirement Security for Life Act*, H.R. 819, which provides a strong impetus for people to use non-qualified (individual) annuities that provide regular payments for as long as the retiree lives. Broadly, we support the annuitization of retirement savings, and welcome the growing attention and support of this concept among policymakers and the public.

The Retirement Security for Life Act takes a sensible approach to encouraging Americans, especially those whose employers don't offer traditional pensions, to use non-qualified annuities. The bill provides a meaningful incentive by allowing Americans to exclude 50 percent of the taxable income portion of the annuity payout. We believe this will be a significant enough incentive to spur the use of annuities and give annuitants a steady stream of income throughout their time in retirement.

We are encouraged by this committee's demonstrated interest in fixing America's retirement system and look forward to helping you in these efforts. Thank you.

Statement of George Avak, California Retired Teachers Association

Chairman Thomas and members of the Committee, my name is George Avak and I am president of the California Retired Teachers Association. We are a non-profit

organization with 53,000 members, and we represent the interests of the 170,000 retirees who receive a pension from the California State Teachers Retirement System (CalSTRS). I want to thank you for convening these hearings on alternatives to strengthening Social Security, America's fundamental safety net for retirees.

We believe that a basic premise of strengthening Social Security is to keep faith with its promise of ensuring that older Americans do not fall into poverty at the end of their working lives.

The CalSTRS system is not integrated with Social Security, so many of our members are victims of the Windfall Elimination Provision and the Government Pension Offset. These two penalties remove that financial safety net and we find our members suffering from unexpected income losses late in life. Many women are plunged into poverty when their husbands die and they are denied any survivor's benefits from Social Security due to the Government Pension Offset. Other teachers find their summer work, when they typically paid into Social Security in order to support their families during the school-year break, is discounted in retirement when they receive thousands of dollars less than they would have if they had not been teachers.

The underlying assumption seems to be that teachers have their own pension and that should protect them from poverty. The sad truth is otherwise. CalSTRS conducted analyses in 1998 and 2005 on the adequacy of the pension benefit they provide, and in both instances found many lagging behind the amount of income they need to maintain an adequate lifestyle in retirement. Even with long years of teaching service, California educators who retired before 1998 were only able to replace about 58 percent of their income—far below what experts consider to be adequate. The typical female retiree receives less than $2,000 a month from her teacher's pension, hardly sufficient in a high-cost state like California. Unlike Social Security, which provides full cost-of-living increases annually, teachers' pensions in California are only protected at 80 percent of their original purchasing power.

In addition, many of our members only found out about the WEP and GPO when they filed for their benefits. By then, it was too late to make alternative financial plans to ensure a secure retirement. Worse, many others mistakenly receive benefits for years and then are forced to pay back all money received—in one instance more than $40,000. In most instances, these people relied in good faith on estimates of benefits provided by the Social Security Administration itself. The Social Security Administration itself has admitted that it overpays upwards of $335 million a year in mistaken benefits. If Social Security doesn't know who is affected by these penalties, how can we expect that those subject to them will understand them?

Beyond the policy itself, you have to understand the personal financial suffering many people have endured because of these penalties. We have collected many, many such stories from our members and I want to share some of those with you today.

Ruth Benjamin of San Diego had planned on Social Security payments of approximately $800 per month when she retired, because that is what the Social Security Administration told her to expect. Instead, due to the GPO, she receives only $216 per month plus a teacher's pension of about $700 per month. Her husband is a retired New York City Police Department officer, who receives a police pension of approximately $1,500 per month plus a Social Security benefit of $1,000 per month. In their retirement planning, they opted to take a higher police pension without survivor's benefits because they believed Ruth would be adequately provided for with her teacher's pension and Social Security. Now, if she becomes a widow, she will have to survive on income of less than $1,000 per month due to these penalties.

Wanda Moore of Fresno was married for 38 years to her husband, a barber. He paid into Social Security for 40 years and died before collecting any benefit. She was initially told she would receive a survivor's benefit of $496 per month from Social Security before that payment was eliminated under the GPO because of her teacher's pension.

Carol Huntsman of San Diego began her teaching career at age 36 and was only able to teach for 20 years before retiring in 1996 with a monthly pension of $700. The twenty previous years she had worked in Social Security-covered employment was reduced in value by 60 percent, or $223 per month under the WEP. Fortunately in 2000 her teachers' pension was increased under a law that provided minimum pensions to teachers with 20 years or more of service.

Georgia Beno of Santa Ana taught for 32 years before she retired in 1989. She receives a pension of about $2,100 a month now. But she lost $900 a month income from Social Security when her husband died in 1999 and she was told she was ineligible for a survivor's benefit. Since then, her health insurance and rent and other expenses continue to increase. She hasn't taken a vacation in four years, digs into

her savings each month to meet expenses and still has to rely on her family to help pay her bills.

Claire M. Koronkiewicz of Palm Springs taught for 30 years in California before retiring in 1986. Today she receives a teacher's pension of about $1,800 per month, after taxes. Her husband, a Purple Heart veteran of General Patton's 3rd Army, had a modest income as a worker in the floral industry in Los Angeles for 30 years. He died at age 65 after receiving three years of Social Security benefits. Claire was told she was eligible for $374 per month in survivor's benefits—before that was eliminated under the GPO. Since then, she has had to sell her home because it was too expensive to maintain and has dipped into her savings earlier than planned to meet her living expenses.

Marylyn McInnes of Visalia taught for 31 years before retiring in 1998. Her husband owned his own carpet cleaning business for 15 years and, as a self-employed individual, paid both the employee and employer shares of the Social Security tax. He received Social Security for 2 years before he died. When Marylyn applied for her widow's benefit, she was told she did not qualify because of her teacher's pension and she lost $400 a month in income.

Elbert Bade of San Diego had a 20-year career in the U.S. Air Force. When he retired from the Air Force, he had a choice of a second career as a teacher or in the aerospace industry. Unaware of the GPO and WEP, he figured his future retirement income—assuming money from a teacher's pension and Social Security—and determined that he could afford to become a teacher. He taught for 23 years and retired in 1997. When he applied for Social Security, he was informed of the penalties and saw his retirement income reduced by $8,400 a year. "Teaching's a great career and very satisfying but no one tells you they're going to jerk your Social Security because you were a teacher," he told us.

What all of these people have in common is that they worked hard at public service jobs all of their lives. They raised families and took care of themselves. They recognized they wouldn't receive a full Social Security benefit, but they believed they would receive what they had earned and been promised.

There is yet another unintended consequence of these penalties. California, like many states, faces severe teacher shortages in the years ahead—an estimated 100,000 new teachers will be needed in the next 10 years just to replace retirees; more will be needed to accommodate our growing population. Many of our best teachers come from other professions. Typically they are unaware that they are giving up significant Social Security benefits in retirement to make a switch to public service, often at a lower salary than they were receiving from their first career. An estimated 50,000 current teachers fit this profile, and will retire with 20 years of less teaching service. That means a substantially smaller teachers' pension and a significant loss of Social Security income. They willingly make the sacrifice in salary during their working life; they are forced to sacrifice in retirement.

We recognize that there are financial challenges facing Social Security, if not a crisis. We appreciate, however, that growing numbers of Congressional Representatives understand that these penalties have not had the intended effect, that they penalize hard-working people of modest means. I would note that 251 Congressional Representatives have already signed on to HR 147, which would repeal these penalties. Any reform of the Social Security system must restore its foundation in fairness. On behalf of the California Retired Teachers Association, I would say that you can do no less.

Statement of Bruce E. Thompson, Jr., Merrill Lynch and Co., Inc.

Merrill Lynch commends the members of the Committee for undertaking a comprehensive review of the critical retirement savings challenges facing our aging society. For some time now, we at Merrill Lynch have been urging Congress to take steps to encourage Americans to save more.

In just three short years, the first of the 77 million Baby Boomers will become eligible to receive retirement benefits, and numerous studies have shown that far too many of them are not saving enough for a secure retirement. Only one-third of Baby Boomers believe they are prepared financially for a secure retirement, and millions of Americans have no savings at all. With the U.S. personal saving rate at a near-historic low of less than 1 percent, we need to take action to strengthen our nation's retirement system.

In a new Merrill Lynch White Paper, "Retirement Solutions for the 21st Century: Bridging America's Savings Gap," we recommend ten steps that Congress should

take to help increase the future retirement security of all Americans. The White Paper contains more than 50 specific proposals for increasing savings and retirement security in 10 distinct areas, including:

- Expand and Simplify IRAs
- Expand and Simplify 401(k) Plans
- Encourage and Protect Defined Benefit Plans
- Eliminate Barriers to Investment Advice
- Facilitate New Models for Retirement
- Increase Savings for All Workers
- Encourage Saving for Retiree Health Expenses
- Promote Lifetime Saving
- Improve and Expand Financial Education
- Remove Complex and Arbitrary Rules

Each of the White Paper's broad proposals addresses problems that prevent Americans from taking full advantage of the saving opportunities available to them. Each section also recommends specific actions that Merrill Lynch believes the federal government should take to make it easier for people at all income levels to save more.

We recognize that policymakers are debating the difficult issues surrounding proposals to overhaul the Social Security System. At the same time, as the Baby Boom generation nears retirement age, we urge Congress to act to strengthen the other elements of our nation's retirement system

Retirement Solutions for the 21st Century

Bridging America's Savings Gap

April 2005

For some time now, we at Merrill Lynch have been urging Congress to take steps to encourage Americans to save more.

Americans today are saving less than at almost any time since World War II, and we are saving far less than other industrialized nations. The U.S. personal saving rate, which exceeded 10 percent in the 1970s and 1980s, has plummeted to a near historic low level, dropping to less than one percent today.

In just three short years, the first of the 77 million Baby Boomers will become eligible to receive retirement benefits, and numerous studies have shown that far too many of them are not saving enough for a secure retirement. Only one-third of Baby Boomers believe they are prepared financially for a secure retirement, and Baby Boomers, on average, have only about the equivalent of one year's household income saved.

The nation's defined benefit system is in distress, providing traditional pension plan coverage to only 20 percent of working Americans. The defined contribution system has expanded over the last 20 years, with trillions of dollars being saved in IRAs and 401(k)s. But millions of Americans have no savings at all and millions more are not saving enough to achieve a secure retirement.

We believe that policymakers should act to address the shortfall in retirement savings. We recommend ten steps that Congress should consider to help increase the future retirement security of all Americans:

- **Expand and Simplify IRAs**
- **Expand and Simplify 401(k) Plans**
- **Encourage and Protect Defined Benefit Plans**
- **Eliminate Barriers to Investment Advice**
- **Facilitate New Models for Retirement**
- **Increase Savings for Lower- and Moderate-Income Workers**
- **Encourage Saving for Retiree Health Expenses**
- **Promote Lifetime Saving**
- **Improve and Expand Financial Education**
- **Remove Comples and Arbitrary Rules**

We recognize that policymakers are debating the difficult and controversial issues surrounding proposals to overhaul the Social Security system. These are critical issues that affect all generations. Social Security is the foundation of our retirement system, and Congress needs to act to ensure its financial solvency.

At the same time, as the Baby Boom generation nears retirement age, we urge Congress to act promptly to strengthen the other elements of our nation's retirement system. For many people, the gap in savings will be bridged by new versions of retirement, as many boomers continue working in retirement. But it is undeniable that more retirement saving is needed.

With the Baby Boomers moving toward their senior years, the employment-based retirement system has become less of an "employer-paid" program and more reliant on individual savings. The average tenure of employment continues to decline and is now less than five years on average. Many employers faced with this situation are not likely to promote and fund "career" retirement programs, such as traditional defined benefit plans, which are designed to benefit long service employees.

Small businesses now provide the majority of new employment opportunities in the U.S. Yet approximately 80 percent of these small businesses are not starting retirement savings programs, primarily because retirement is not among the most pressing needs they face. Making payroll, managing labor, and providing health insurance all take a higher priority.

The shift away from traditional defined benefit plans and the rise of small business employment means that the employment-based system provides adequate retirement savings to a diminishing percentage of the workforce. This trend is troublesome because payroll deduction programs and employer contributions clearly have a positive impact on individual saving. Similarly, it seems evident that the purchasing power of employer plans reduces investment costs and offers better saving opportunities. As a result, the current employment-based system must be strengthened and expanded if we are to encourage broader and adequate retirement saving in the new labor market.

In the end, however, retirement success for the Baby Boom generation will require rethinking—in addition to retirement legislation—other public policies that historically may not have been closely linked to retirement security. After all, Baby Boomers are faced with caring for their aging parents while they face college expenses for their children. For this reason, all options to increase savings must be explored.

The implementation of the ten steps we recommend would begin building a culture of saving that America needs in order to achieve retirement security in the demographic and global economic climate of tomorrow.

Expand and Simplify IRAs

The Problems:

Complex Rules. Since they were created in 1974, Individual Retirement Accounts (IRAs) have proven to be very successful. By the end of 2003, individuals had accumulated $3 trillion in IRAs, and IRAs have become the single largest component of the nearly $12 trillion U.S. retirement market. More than 45 million U.S. households, or 40.4 percent of all U.S. households, owned IRAs in 2004. However, the elimination of the universal IRA in 1986 along with the increased complexity caused by constantly changing eligibility and contribution rules have discouraged the use of IRAs as a retirement savings vehicle.

Uncertain Future. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) greatly expanded individual retirement savings opportunities, but these improvements will sunset at the end of 2010 unless extended or made permanent.

Disparate Treatment. IRAs are treated less favorably than employment-based retirement arrangements in a number of significant respects. This disparate treatment penalizes workers who are not covered by an employer plan.

The Solutions:

Provide a Universally Available IRA. The Internal Revenue Code imposes a number of limits and phase-outs on IRAs based on income, retirement plan participation, and marital status. Proposals that simplify accessibility to retirement savings, such as the Retirement Savings Accounts (RSAs), encourage retirement saving and should be considered. In addition, employees who are not covered by employment-based plans should be able to contribute more to IRAs.

Make the 2001 IRA Improvements Permanent. The 2001 IRA improvements have greatly increased savings opportunities, including increases in permitted IRA contributions and catch-up contributions for those over age 50. They should be made permanent as soon as possible.

Fully Protect IRA Savings in Bankruptcy. Most employment-based retirement plan assets are exempt from the claims of creditors in bankruptcy. Although the Supreme Court recently provided bankruptcy protection for certain retirement assets, the protection of some retirement savings in bankruptcy remains uncertain. Congress should extend the treatment of qualified plan assets in bankruptcy to all IRA assets.

Allow Disabled Persons to Make IRA Contributions. The Internal Revenue Code limits the amount that an individual may contribute to an IRA in any tax year to the lesser of the maximum contribution limit or an individual's compensation.

Disabled individuals who are unable to work generally cannot make IRA contributions because they do not have compensation. To facilitate saving, the compensation limit for disabled individuals should be eliminated.

Create a Correction Program for IRAs. The Internal Revenue Service maintains a correction program that allows employment-based retirement plans to correct defects and therefore preserve the tax-advantaged status of the plan. There is no comparable program for IRAs. Congress should direct the Secretary of the Treasury to establish an IRA correction program that would allow IRA owners and beneficiaries to rescind IRA distributions made in error.

Expand and Simplify 401(k) Plans

The Problems:

Further Promotion of 401(k) Plans Is Needed. For nearly 25 years, the 401(k) plan has enabled millions of working Americans to save trillions of dollars for their retirement future. Today, thousands of companies sponsor 401(k) plans for more than 37 million working Americans. As of the end of 2003, 401(k)s held nearly $2 trillion in assets, making it one of the most effective wealth-building tools ever conceived. But a number of reforms are needed to improve the effectiveness of 401(k) plans.

Lack of Permanence. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) greatly expanded retirement savings opportunities, but these improvements will sunset at the end of 2010 unless extended or made permanent.

Too Few Small Business Plans. Small employers are often focused on covering their payroll, managing labor, and providing health insurance access. Retirement plans for the small employer can be perceived as an additional administrative burden. This leaves countless individuals without access to a retirement plan.

Low Participation Rates. Where an employer does offer a plan, participation in voluntary retirement plans remains too low. Average plan participation rates have fallen from an estimated all-time high of 80 percent in 1999 to 70 percent in 2003. The lowest participation rates are found among lower- and moderate-income workers who can least afford to forego preparing for retirement. One of the greatest barriers to participation is inertia—failing to take steps to sign-up for participation.

The Solutions:

Make the 2001 401(k) Improvements Permanent. Make the 2001 401(k) Improvements Permanent. The EGTRRA improvements have greatly increased savings opportunities, including increases in 401(k) contribution limits and catch-up contributions for those over age 50, and should be made permanent.

Provide Incentives for Automatic Enrollment. Employers that have adopted automatic enrollment arrangements have been able to use inertia to expand saving. Automatic enrollment—whereby an employee automatically contributes a certain amount unless the employee specifically elects otherwise—has a powerful effect on participation, particularly among lower- and moderate-income workers. To date, however, few employers have implemented automatic enrollment programs because there are few incentives to establishing these programs and because of uncertainty surrounding the application of ERISA and State law. Congress should provide incentives to establish automatic enrollment programs, including arrangements that provide for automatic increases, and should clarify the application of state law and ERISA to these programs. The employer should also have the option of applying the automatic enrollment and automatic increase options to existing participants as well as to newly hired employees.

Provide Small Employers with a Starter Plan. A plan in which the employees of many small businesses could be covered by financial institutions that agree to assume fiduciary and administrative responsibility would greatly expand small business retirement plans. These arrangements would function like payroll deduction individual accounts and would be universally available to all employees and employers. Coupled with an automatic enrollment feature, these plans have the potential to dramatically increase retirement coverage. From the employer's perspective, all that would be necessary would be remitting payroll deductions to the fiduciary financial institution. From the employee's perspective, they would receive the benefit of economic scale and large group pricing.

Apply Simple and Consistent Vesting Rules. The American workforce is increasingly mobile and the average term of employment is less than five years. However, present law allows employers to require five years of service before employees have a vested interest in employer non-elective contributions. Vesting of employer contributions should be continually adjusted to mirror the realities of the labor market. Consistent vesting of all employer contributions will simplify plans and help ensure that our retirement plans keep pace with an increasingly mobile workforce.

Encourage Additional Saving. Employer purchasing power in terms of asset management and administration should benefit those wishing to deposit more after-tax funds to their retirement savings. These programs, especially when used in an automatic deposit program, can greatly expand opportunities to save for Baby Boomers reaching their peak savings years and for dual income couples. Congress should enact legislation encouraging the expansion of 401(k) programs to allow additional after-tax employee contributions.

Encourage and Protect Defined Benefit Plans

The Problems:

Lack of Permanent Rules. Congress has twice enacted temporary rules for measuring pension liabilities and the most recent measure expires at the end of 2005. Until a permanent funding regime is enacted, employers cannot make long-term business plans. This instability and uncertainty has caused many employers to either freeze their plans or close them to new employees.

Volatile and Unpredictable Funding Requirements. Under the current funding rules, pension contribution obligations can fluctuate wildly from year to year. Volatile and unpredictable obligations make planning very difficult and employers often cite volatility as the single biggest impediment to maintaining a defined benefit plan.

Restrictive Limits on Contributions. Current tax rules discourage employers from building a reasonable funding cushion during good economic times. Without a funding cushion, employers cannot insulate themselves from the risk that contributions will have to be severely increased in poor economic times.

Legal Uncertainty. Hybrid defined benefit plans, such as cash balance and pension equity plans, cover more than seven million Americans and deliver valuable retirement benefits. Yet the uncertain legal status of hybrid plans, along with other pressures in the defined benefit system, has prompted many employers to freeze or terminate their plans, and others are considering these actions.

The Solutions

Create a Stable Defined Benefit System. Employers need permanent funding rules in order to make informed business decisions. Congress needs to create a stable defined benefit system and enact a permanent measure of liability as soon as possible.

Advance Rules that Encourage Plan Funding. Barriers to adequate funding must be eliminated so that employers can fund their plans when they have the capacity to do so. Congress should revise the tax law to allow employers to make greater tax-deductible contributions in order to build a reasonable funding cushion.

Eliminate Barriers to Fully Considered Investment Decisions. Pension funding and related investment decisions have significant implications for employers. These decisions affect cash flow through future contribution obligations and directly impact financial statements. Yet there is uncertainty about whether plan fiduciaries can take into account the impact investment decisions have on the plan sponsor. ERISA needs to be modernized to reflect that funding and investment decisions need not be made in a vacuum.

Protect Employer Flexibility in Plan Design. The flexibility to utilize varied pension plan designs, including cash balance and other hybrid plan designs, is imperative if we are to maintain a vital defined benefit plan system. Hybrid plan designs have been one of the few bright spots in the declining defined benefit system. Congress must provide companies with the legal certainty that hybrid plans do not violate age discrimination laws.

Eliminate Bariers to Investment Advice

The Problems:

Lack of Expertise and Engagement. Workers and retirees are increasingly responsible for investing their own retirement assets. Yet many lack the knowledge necessary to make prudent investment decisions. Even participants who are relatively knowledgeable may lack the time to make and update investment decisions in a consistent and well-informed manner.

Barriers to Offering Investment Advice. Many participants are uncomfortable making investment decisions without assistance and there is an enormous demand for investment advice. Few plans, however, offer the type of personal advice that participants want because ERISA rules place unnecessary burdens on providing investment advice.

Absence of Incentives for Investment Advice. Tax rules make it difficult for employers to offer retirement planning advice, including investment advice, to em-

ployees who want advice. These tax rules have created a significant disincentive to offering investment advice.

Obstacles to Diversification. Some plans force employees to hold large portions of their retirement assets in company stock. This policy flies in the face of standard diversification principles.

The Solutions:

Eliminate Barriers to Providing Investment Advice to Retirement Plan Participants. ERISA generally prohibits investment advisors who are otherwise plan service providers from providing advice to participants regarding their plan assets. Often, advisors provide advice on other assets but are forced to ignore plan assets because of technical issues under the ERISA-prohibited transaction rules. Other participant protections, including fiduciary standards and meaningful disclosure, can ensure that employees receive unbiased advice. The lack of investment advice in retirement plans is a significant barrier to retirement security and Congress should enact legislation allowing participants to obtain investment advice from regulated financial entities.

Provide Incentives That Will Encourage Employers to Offer Retirement Plan Participants Access to Investment Advice. Retirement planning advice (including investment advice) provided to employees on a nondiscriminatory basis is excluded from taxable income. However, employees who are offered a choice between cash compensation and investment advice are taxed as if they elected the cash even if they elect investment advice. The inability to offer employees a choice is a significant barrier to offering investment advice. Employees who choose investment advice should not be taxed and Congress should enact legislation exempting these elections from taxation.

Provide Incentives for Automatic Investment Management. Another barrier to retirement plan participation is fear of making the wrong investment decisions. Participants are often uncomfortable managing their retirement assets. Yet many defined contribution plans default the assets of participants into less than optimal funds which earn a low rate of return, but are chosen because many fiduciaries are uncomfortable making long-range decisions as a default investment. Congress should make it clear that a fiduciary can facilitate professional management of retirement assets in these situations and can take into account the known characteristics of the participant in establishing default investments.

Expand Diversification Rights. Current law allows plans to require employees to hold company stock contributed by the employer until age 55 or after five years of service. Diversification rights should be more aligned with the principles of investment diversification for all employees, not just those reaching a certain age, or certain tenure with the employer. Congress should ensure that employees have the right to direct all investments in the plan consistent with generally accepted diversification standards.

Facilitate New Models for Retirement

The Problems:

Outdated Rules. As the average life expectancy of Americans grows longer, retirees increasingly risk outliving their assets. Retirement plan rules that have not kept pace with changing circumstances force individuals to begin receiving distributions from retirement plans and IRAs at a time and in an amount that may be unwise. With Americans living longer than ever in retirement, such rules threaten to deplete retirement assets too quickly.

Barriers to Lifetime Payouts. IRA and retirement plan rules discourage individuals who may need earlier access to retirement savings from choosing a lifetime payment stream rather than a lump sum distribution. Again, with Americans living longer than ever in retirement, such rules threaten to deplete retirement assets too quickly.

Obstacles to Portability. Significant improvements have been made in facilitating retirement asset portability but rules restricting retirement asset portability remain. These rules create arbitrary and significant barriers to consolidating retirement assets.

Inappropriate Incentives to Retire. As the Baby Boomers approach retirement, many may continue working during a phased retirement. Today, continuing to work in a part-time capacity may negatively impact accrued retirement benefits with an employer. In addition, some employers view older workers as consuming greater amounts of employee benefits and consider them more expensive than younger workers to employ.

The Solutions:

Recast Distribution and Life Expectancy Rules. Current guidelines should be reviewed to incorporate the impact of increased longevity. Rules that discourage premature spending of retirement benefits should be strengthened. Moreover, as individuals live longer in retirement, distribution of their retirement income should reflect the increased longevity, and avoid forced distributions that exceed a sustainable withdrawal rate. For example, current law requires that individuals begin receiving distributions from retirement plans and IRAs generally no later than the year in which they attain age 70-1/2. The age at which minimum distributions are required has been unchanged for decades and there is an increasing risk that the minimum distribution rules deplete retirement assets too quickly. Congress should evaluate whether the complexity engendered by the minimum distribution rules is justified and consider repealing the rules that require lifetime minimum distributions. At a minimum, Congress should update the minimum distribution rules to reflect the increased life expectancy of today's workers.

Accommodate the Needs of Older Workers. In addition, retirement distributions from IRAs and other retirement plans must start at age 70-1/2 even if the individual continues to work. Those rules should be changed to conform to the minimum distribution in employer plans which delay the application of the minimum distribution rules until retirement for those who are still actively employed with the employer maintaining the plan.

Allow Non-Spouse Beneficiary Rollovers. When a retirement plan participant dies, employment-based retirement plans typically provide that remaining plan benefits must be distributed promptly in a lump sum. Non-spouse beneficiaries who are not permitted to roll over distributions can be forced to receive plan benefits immediately and incur an immediate tax liability. This problem does not exist if retirement assets are held in an IRA at the time of death, because IRA beneficiaries may maintain the inherited IRA and receive distributions in accordance with the minimum distribution rules. There is no good rationale underlying this disparate treatment; non-spouse beneficiaries of retirement plans should be allowed to roll over retirement benefits to an heir.

Expand Portability. The portability provisions between various types of defined contribution programs should encourage employees to roll over their prior employer balances to their new employer, if they prefer not to roll them into an IRA. This will allow them to take advantage of employer purchasing power and to prevent "leaving the assets behind" with their old employer. This practice can be accomplished by providing incentives to employers to encourage acceptance of rollover balances from newly hired employees.

Tap the Resource of Older Workers. Rules that limit flexibility for older workers need to be reconsidered. In certain circumstances, current rules make it more expensive for employers to hire an older worker, and discourage older workers from continuing employment. For example, older workers working past certain "normal" retirement age might be allowed to choose to receive more cash compensation at the price of a lower benefit accrual under a defined benefit arrangement. Allowing for older employees to lock in their accrued benefit and switch to a part-time or reduced-time work schedule would make the option to remain in the workforce more attractive. Tax incentives should be considered for employers that retain older workers with flexible work arrangements and flexible benefits packages.

Increase Savings for Lower- and Moderate-Income workers

The Problems:

Low Saving Rate. Americans in general and lower- and moderate-income workers in particular are not saving enough to achieve a secure retirement. In fact, the national saving rate has been approaching historic lows and is one of the lowest among industrialized nations.

Lack of Permanence. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) greatly expanded retirement savings for lower- and moderate-income workers, but these improvements will sunset at the end of 2006 unless extended or made permanent.

Regulatory Barriers. Burdensome and unnecessary regulations act as a disincentive for employers to voluntarily sponsor retirement plans for their employees. Such regulations present an even greater hurdle for small employers that must generally incur greater than average costs to sponsor a plan and can least afford the risk of fiduciary liability.

The Solutions:

Make the Savers' Credit Permanent. EGTRRA created a new non-refundable tax credit for certain individuals who make elective contributions to workplace re-

tirement plans and IRAs. This "Savers' Credit" has appreciably increased savings among moderate- and lower-income workers and should be made permanent.

Expand the Savers' Credit. The maximum contribution eligible for the Savers' Credit is $2,000 and the credit rate depends upon the taxpayer's income. In addition, many of those otherwise eligible for the original Savers' Credit do not owe federal tax and so cannot benefit from a non-refundable tax credit. Expanding the credit and making it refundable will ensure that this important saving incentive will remain a prominent part of our nation's package of retirement saving incentives.

Reduce Administrative Burdens. Small employers are often deterred from offering a retirement plan by the administrative burdens and fiduciary liability that typically accompany plan sponsorship. Congress should enact a simplified retirement plan to expand coverage among the class of employers with the lowest coverage rates. One option would be a plan administered by financial institutions that agree to assume fiduciary responsibility. Such a plan would have the potential to significantly increase saving if it is coupled with an automatic enrollment program that uses inertia to incentive-ize saving.

Encourage Saving for Retiree Health Expenses

The Problems:

Lack of Incentives to Save for Retiree Health Costs. There are few incentives to encourage Americans to save for their health care expenses in retirement. The absence of a tax-preferred individual savings vehicle dedicated to retiree health expenses makes it difficult for Americans to focus and plan for health care costs in retirement. In addition, a pervasive lack of understanding regarding the benefits offered by Medicare combined with retirement policies that do not emphasize the need to plan for retirement health care needs leads many to believe that saving for health care expenses in retirement is unnecessary.

Obstacles to Flexible Pay Arrangements. There is a labor shortage in today's economy; a large demand for skilled workers is coinciding with an aging workforce and a diminishing number of new entrants into the workforce. Moreover, demographic trends indicate that this shortage will become more acute as our population ages. A clear way for an employer to address this need for workers is by retaining its own older employees. There are, however, significant challenges to overcome in retaining older employees. One challenge is that older workers tend to value certain benefits more than others. The tax rules governing retirement plans and health plans, however, prevent employers from offering employees the opportunity to choose the mix of benefits that is best suited to their circumstances. Cafeteria plans begin to move compensation in this direction, but limits on the scope of these plans hinder their value. The result of the current system is a failure to deliver the maximum value.

Lack of Adequate Incentives for Employers to Maintain Retiree Medical Plans. Under current law, there are limited incentives for employers to maintain retiree medical plans. Additionally, opportunities to pre-fund retiree health costs are limited. As a result, employers are increasingly unwilling to offer retiree medical benefits.

The Solutions:

Create a Health IRA. There is no individual savings vehicle for retiree medical expenses and each year fewer employers offer retiree medical benefits. As retiree medical expenses continue to grow, more and more retirees are finding themselves spending an escalating portion of their retirement savings on health expenses. Individuals should be able to contribute to individual health IRAs to be used to pay medical expenses on a tax-exempt basis after a stated age. In addition, individuals should be able to use retirement plan distributions on a pre-tax basis to pay for their share of the cost of retiree health plan coverage.

Permit Additional Retiree Health Contributions to HSAs. Current law generally provides that an individual who is covered by a high deductible health plan may contribute to a health saving account (an "HSA"), which is a tax-exempt individual account maintained by a custodian or trustee for the benefit of the individual. The maximum amount that may be contributed is an amount equal to the amount of the high deductible. Because HSA contributions are ordinarily used to pay current medical expenses, HSAs work poorly as a vehicle for saving for retiree medical expenses. Employees should be able to contribute an additional amount to an HSA that cannot be used before retirement in order to pre-fund future medical expenses.

Eliminate Rules that Deter Individuals from Continuing to Work After Retirement. Rules that limit flexibility for older workers should be changed. For example, the defined benefit system allows for payments to an employee who is working only in limited circumstances. These barriers to phased retirement should

be eliminated. In addition, barriers to hiring older workers should be eliminated and employers should be allowed to offer fair and flexible compensation packages that better meet the needs of those older workers.

Encourage Employers to Maintain Retiree Health Plans. Today, an employer wanting to prefund retiree health benefits has two inadequate options—401(h) accounts and voluntary employee beneficiary associations (VEBAs). A section 401(h) account is generally an account maintained within a defined benefit plan for retiree medical benefits that cannot exceed 25 percent of the total employer contributions. Section 401(h) accounts, however, are not available to the vast majority of defined contribution plans, including 401(k) plans. Similarly, retiree health prefunding through VEBAs is subject to a series of draconian restrictions. The lack of effective pre-funding arrangements has contributed to the decline in employer's willingness to maintain retiree health plans. Section 401(h) accounts should be allowed in section 401(k) plans and the limits on contributions to VEBAs should be eased.

Promote Lifetime Saving

The Problems:

Low Saving Rate. The U.S. personal saving rate has dropped to a near historic low level. The low level of saving means there is less money available to expand long-term economic growth and there are high levels of financial insecurity for millions of Americans.

Obstacles to Accumulation. Mutual funds are the primary savings vehicle for millions of American households. Over the past two decades, millions of small, middle-income investors have participated in our capital markets through mutual funds. However, the tax treatment of mutual funds significantly reduces the investment return for millions of mutual fund shareholders.

Uncertain Future. The lower tax rates on dividends and long-term capital gains are scheduled to expire at the end of 2008. The increasing uncertainty created by the possibility of rising tax rates on dividends and capital gains in future years may reduce the beneficial effects of the lower rates.

The Solutions:

Reduce the Anti-Saving Bias. The tax code currently affords preferential tax treatment that encourages many forms of consumption, rather than optimizing savings incentives.

Eliminate Barriers to Saving. Mutual fund investors are required to pay capital gains taxes on the shares of stock sold by their mutual funds even if investors sold none of their mutual fund shares. Allowing mutual fund investors to defer payment of capital gains taxes until they sell their shares would increase the ability of millions of middle-income Americans to save for their retirement.

Make the Capital Gains and Dividend Tax Rates Permanent. Congress should not wait until 2008 to address the capital gains and dividend tax rates. The lower tax rates on dividends and capital gains have been tremendously successful in boosting dividends and investments in our economy. Congress should act now to make these changes permanent and keep the maximum tax rate for both dividends and long-term capital gains at 15 percent.

Promote Education Savings. Encourage employer sponsorship of 529 payroll deduction programs to assist not only in traditional college funding but also to encourage adults to continue lifelong learning before and after retirement. These programs, if employer contributions were allowed, could take the place of tuition reimbursement programs for adult workers over time.

Improve and Expand Financial Education

The Problems:

Financial literacy is deficient across all generations and socio-economic levels. The National Council for Economic Education Studies (NCEE) reports nearly two-thirds of American adults and students do not understand basic economic principles such as "inflation" and "national debt."

Financial literacy curriculums are not being taught in schools. NCEE says only four states require students to complete a course that includes personal finance before graduating high school. In a nationwide survey of 4,000 high school students, sponsored by the Jump$tart Coalition for Personal Financial Literacy, that asked questions on income, spending, money management and saving, more than 65 percent of the students failed the exam.

Decisions made early in life can threaten an individul's financial security later in life. A Nellie Mae analysis indicates the average college student has more than four credit cards, with forty-five percent of them carrying debt of more than

$3,000. The report also found that almost half of college students have paid late fees and almost ten percent have had cards cancelled because of late payments. Bankruptcies for those 18-to-25 years old numbered 150,000 in 2000.

The Solutions:

Encourage participation in private sector programs. There are many financial literacy programs and curricula designed for all age groups by the private sector, but there needs to be a concerted effort to encourage school districts and teachers to incorporate them into their class plans.

Support states' efforts to improve financial literacy requirements in schools. In 2003, six states adopted legislation requiring integration of personal finance into K–12 instruction. This was done with little accompanying financial burden because of the large amount of no—or low-cost education materials and free teacher training. More states need to be encouraged to adopt financial literacy requirements in schools.

Support the efforts of the Congressional Financial and Economic Literacy and Education Commission, the U.S. Treasury Department's Office of Financial Education, and the Congressional Financial Literacy Caucus. The Commission was created by Title V of the Fair and Accurate Credit Transactions Act and the Office of Financial Education in May of 2002. It works to promote access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on saving, credit management, home ownership and retirement planning. The Congressional Financial and Economic Literacy Caucus, formed in February 2005, will work to increase public awareness of poor financial literacy rates across the country and work toward improving those rates.

Promote Innovative Education Solutions. Many companies are committed to innovatively helping our next generation reach their full potential. As an illustration, Merrill Lynch's Investing Pays Off® (IPO®) curriculum has been specially developed as a tool for volunteers, parents and educators to teach young people the foundations for business and financial success. The IPO® curriculum is available, free of charge, at http://www.ml.com/philanthropy/ipo/.

Remove Complex and Arbitrary Rules

The Problem;

Complex and Arbitrary Rules. Retirement plan rules are complex and arbitrary. As a result, employers—especially small employers—are unwilling to voluntarily sponsor retirement plans for their employees. Such rules not only make compliance difficult and errors likely, but they also greatly increase costs.

The Solutions:

Simplify Corrective Distributions of Excess Contributions. Employers who voluntarily sponsor retirement plans for their employees should not be penalized unfairly when excess contributions are made and corrected within a reasonable period of time. Compliance with the myriad of rules, limitations, and nondiscrimination requirements is extremely difficult. In many cases, it may not be realistically possible to complete all corrective distributions within 2-1/2 months of the plan year in spite of best efforts. By allowing plan sponsors to have six months after the plan year to make corrective contributions, the rules will provide needed flexibility. In addition, by providing that corrective distributions of excess contributions will be taxable in the year of receipt, the proposal would significantly decrease complexity.

Eliminate Barriers to Charitable IRA Contributions. Individuals who wish to donate IRA assets to charity must first include taxable amounts in income and then claim a deduction. Limits on deductible charitable contributions create barriers to charitable giving that should be eliminated. These barriers actually discourage retirement saving for those without heirs. Retirement age individuals should be able to exclude direct transfers from IRAs to charities before or after death without regard to the limits on deductible charitable contributions.

Repeal the Top-Heavy Rules. Under current law, plans must satisfy stringent nondiscrimination requirements ensuring that the plan covers and provides meaningful benefits to rank-and-file workers. In addition to the nondiscrimination requirements, plans must also satisfy an entirely separate set of requirements that serve the same purpose as the nondiscrimination requirements. The additional set of requirements, the "top-heavy rules," are complicated and superfluous. The nondiscrimination requirements are more than adequate to ensure that rank-and-file workers are receiving sufficient benefits.

Elimiate the "Half-Year" Rules. A number of IRA and retirement plan rules turn on half-years, e.g., 59-1/2, and Congress should round these years to whole numbers, e.g., 60, to make it easier for individuals to understand the rules.

Statement Yung-Ping Chen, University of Massachusetts-Boston, Boston, Massachusetts

Mr. Chairman and Members of the Committee: I appreciate the opportunity to present for your consideration a statement on "How to Create a Social Insurance Program for Basic Long-Term Care Coverage." For the record, my name is Yung-Ping Chen. I am a professor of gerontology and the Frank J. Manning Eminent Scholar's Chair in Gerontology at the University of Massachusetts Boston. My academic and professional background in the field of Social Security and economics of aging includes the following: member of the technical panel of actuaries and economists of the 1979 Advisory Council on Social Security; delegate or consultant or both to the 1971, 1981, 1995 White House Conferences on Aging and the 1998 White House Conference on Social Security; and faculty appointments at several colleges and research organizations. I am a founding member of the National Academy of Social Insurance and a fellow in the Gerontological Society of America. The statement I am presenting today, I should indicate, is based on my research that was supported by the Home Care Research Initiative of the Robert Wood Johnson Foundation. However, the views I express are my own and do not necessarily represent the positions of any organization with which I am affiliated.

Mr. Chairman, you are right to highlight long-term care as a national policy issue, as you broaden the discussion of reforming Social Security to include other retirement policy challenges and opportunities for our aging society. I applaud you for the vision you are introducing to the Congress and the nation.

Long-term care—health, social, and personal services performed at home, in the community, or in a nursing home or assisted-living facility—embodies many personal, family, and societal issues in an aging society. The need for long-term care will grow with the "aging of the elderly." In 40 years, those 85 or older are estimated to more than triple, outpacing the growth rate of those 65 to 84, which will double.

A key policy question for long-term care is whether the current system of paying for it can be expected to meet future needs, a system that relies heavily on personal payment and public welfare (Medicaid) and only lightly on social insurance and private insurance.

Long-term care may carry with it substantial, even catastrophic, costs to an individual or a family. But only a small proportion of people need an extensive amount of this care during their lifetimes.

Therefore, this contingency is best protected by insurance. But insurance is in limited use, as just noted. A system relying on Medicaid and personal payments to cover the bulk of the costs is problematic. Medicaid has been subject to cuts and partial restoration of cuts over the years, and personal payments may impoverish people and they have.

As a possible remedy, some analysts propose expanding Medicare to include long-term care. Others advocate a new social insurance program for it. Given current and projected federal budget deficits, new tax dollars are even harder to come by

Others have promoted private long-term care insurance as a solution. Limited income tax deductibility already exists for insurance premiums, but few people buy private long-term care insurance policies.

Personal savings can certainly help, but not many individuals can amass sufficient financial resources over a lifetime to pay for the care of a long duration. For others who may experience unemployment, illness, or disability during working years, chances for accumulating substantial wherewithal are especially slim.

Mr. Chairman and Members of the Committee, I believe a better way could be found by (1) more widespread use of insurance in both public and private sectors, and (2) linking several sources of funds that already exist in each sector to generate the needed dollars to pay for social insurance and private insurance.

The new method I propose is one in which social insurance and private insurance will pay for the bulk of the costs, supplemented by personal payments. I call it a "three-legged-stool" funding model.

How then do we find public and private dollars for a new social insurance program and for the purchase of private insurance? Since many people seem unable or unwilling to devote new resources for long-term care, I suggest using our existing

resources more efficiently by trading resources dedicated for one purpose for another purpose. I call it the "trade-off principle."

Applying the trade-off principle in the public sector, we could divert, say, 5 percent of a retiree's Social Security cash benefits (not payroll taxes) to fund a social insurance program that provides basic long-term care. I call this a "Social Security/Long-Term Care (SS/LTC) Plan." With this plan, retirees themselves are trading some income protection for some long-term care protection. This would enhance a retiree's total economic security. Low-income beneficiaries, though covered by the program, will be exempt from the trade-off. This program could pay for one year of nursing home care or two years of home care.

Participation in the SS/LTC plan could be mandatory with an opting-out provision. So, people would be automatically enrolled in this plan upon receipt of Social Security retirement benefits, but they may opt-out of it within a reasonable timeframe. Or people may be given a one-time opportunity to join SS/LTC plan at age 62 or 65.

To pay for longer periods of care, people would buy private long-term care insurance, much like those Medigap policies that supplement Medicare. Since the social insurance program would provide the basic coverage indicated above, private long-term care insurance would cost less than it does now and thus become more affordable to more people. The visibility of the SS/LTC plan could, in addition, serve as a catalyst to increase awareness of the need to prepare for long-term care. And people would finance additional care out of pocket.

The trade-off principle is already being used in the private sector. For example, a person could buy an insurance policy that combines life insurance and long-term care, which pays for long-term care expenses, if needed, by commensurately reducing life insurance benefits. Although available, this type of combination policy is not wildly popular. Perhaps there is a role for the government to encourage it.

To summarize, because the current system of relying primarily on personal payments and public welfare is inherently unsustainable or problematic and because the uncertain need for long-term care is a risk best protected by insurance, I have proposed a "three-legged-stool" funding model, under which social insurance would provide a basic protection that would be supplemented by private insurance and personal payment, with public welfare as a safety net. These four sources of funds are the same as those used at present, but they would be deployed vastly differently under the proposed model. Moreover, to implement the new funding model, I have also suggested a "trade-off principle" to generate money to pay for social insurance and private insurance because the prospect for new public and private dollars for long-term care appears dim.

The preceding is a summary of my proposed ideas. The balance of this statement, in the form of an attachment, explains my ideas in greater detail. I would be pleased to provide additional materials to the Committee and its staff. Thank you for your attention.

ATTACHMENT: A Fuller Explanation of "How to Create a Social Insurance Program for Basic Long-Term Care Coverage"

Insurance for long-term care in theory and in practice

The uncertain need for long-term care services is a recognized risk that may carry with it substantial—even catastrophic—financial consequences to an individual or his or her family, but it actually occurs only to a relatively small and predictable proportion of persons in a population at any one time. This type of contingency is best protected by insurance mechanisms.

In practice, however, insurance is used only in a limited way to fund long-term care, either in the public sector or in the private sector. Current funding for these services relies heavily on personal payment and public welfare (Medicaid) but only lightly on social insurance and private insurance.[1] This method is akin to sitting on a two-legged stool, which is unlikely to be stable at best and unsustainable at worst, because it tends to impoverish many people and thereby severely strains

[1] Combined, out-of-pocket payment and Medicaid defrayed 70 percent of the total expenditures. Out-of-pocket payment—sometimes called self-insurance—fails to use the insurance principle of pooling risks. Self-insurance, by definition, is assuming the risk by oneself, rather than with others in a large group of persons exposed to the same type of risk. Medicaid has been regarded by some analysts as a public insurance program, but it is not insurance because it lacks risk pooling. Labeling Medicaid—a welfare program—as insurance appears to use the term in a vernacular sense ("something to fall back on"), rather than in its actuarial sense, in terms of risk pooling among a large number of persons exposed to the same type of risk.

Medicaid budgets nationwide. One may regard it as a catastrophe waiting to happen.

Heavy reliance on out-of-pocket payment and public welfare has spawned many calls for reform over the years. But all proposals face the same question: How to obtain additional funding? Many have come to realize that neither the public sector nor the private sector alone has the financial wherewithal to meet the high and growing long-term care costs. A significant challenge for policymakers is how to secure funding from both public and private sectors. New approaches are needed.

A "three-legged-stool" funding model

In my view, a better funding method could be found by (1) more widespread use of the insurance principle for both private- and public-sector programs, and (2) linking several sources of funds in each sector that already exist to generate resources to pay for both social insurance and private insurance. Therefore, I propose a new funding model, one in which social insurance and private insurance will pay for the bulk of the costs, supplemented by personal payment. I call this a three-legged-stool funding model.[2] When these three sources fail to provide for some individuals, public welfare (Medicaid) will serve as a safety net. These are the same sources of funds presently in use, but will be deployed vastly differently in the proposed model.

A trade-off principle for merging resources: A new approach

Assuming acceptance of this model, where might the funds for a new social insurance program and for the purchase of private insurance be found? Many people seem unable or unwilling to devote new resources for meeting long-term care costs. At least part of this may stem from the fact that people, in general, tend to compartmentalize or categorize their total resources (financial and non-financial assets as well as income) into different expenditure items such as food, housing, and the like. Once compartmentalized or categorized, resources will only be available for designated purposes or accounts.

Merging resources could then increase the total utility of existing resources for meeting various costs. In order to merge or combine resources together, it is necessary to create linkages in both public and private sectors. Therefore, I suggest the use of the trade-off principle.

Trade-off is ideologically and politically neutral

The trade-off principle can be applied in both the public and private sectors, as will be illustrated below. While the trade-off is suggested to generate new funding for long-term care when government resources are not available and when individuals are either unable or unwilling to devote new dollars for it, the suggestion does not imply that this method will cover *all* long-term care needs. Far from it—implementation of the trade-off principle in the public sector would still leave much room for private-sector initiatives such as personal insurance and personal savings. Therefore, the concept of trade-off is ideologically and politically neutral in that it favors neither social insurance nor private insurance; it can apply to either or both.

A Social Security/Long-Term Care Plan

Applying the trade-off principle in the public sector, one could fund a social insurance program for providing basic coverage for long-term care by diverting a small portion, such as 5%, of a retiree's Social Security cash benefits for this purpose. I call this a "Social Security/Long-term Care (SS/LTC) Plan." This plan would cover low-income Social Security beneficiaries but exempt them from the trade-off.[3]

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[2] The idea of a three-legged-stool is patterned after the way, as a model or as an ideal, we provide retirement income and acute health care for the older population. Retirement income is provided using Social Security for a floor of protection, with employment-based (occupational) pensions and personal savings supplying supplemental income. When these three sources fail to provide for some individuals, public welfare (Supplemental Security Income) serves as a safety net. Similarly, acute health care for the elderly is provided by Medicare, supplemented by employer-provided health benefits for retirees and by individual payments for non-covered expenses in some cases through Medicare Supplemental (Medigap) policies. When a person's health care needs cannot be met by these sources, public welfare (Medicaid) acts as a safety net. The three-legged-stool funding model may be regarded as a policy approach that would simultaneously foster self-reliance (by means of private insurance and personal payment) and collective assistance (in the form of social insurance). In the same vein, building a three-legged-stool funding model for long-term care would begin with creating a social insurance program for a basic amount of long-term care coverage.This social insurance program would then be supplemented by private long-term care insurance and by personal payment.

[3] Broad outlines of this plan are available in Chen, Yung-Ping (1993). A 'three-legged stool:' A new way to fund long-term care?, *Care in the Long Term: In Search of Community and Security* (pp.54–70). Washington, D.C.: National Academy Press.

Participation in the SS/LTC plan could be mandatory with an opting-out provision. That is, upon receipt of Social Security retirement benefits, people would be enrolled into SS/LTC automatically, but they may opt out of it within a specified timeframe. Or people may be given a one-time opportunity to join SS/LTC plan at age 62 or 65.

Private long-term care insurance

The trade-off principle can and could be applied in the private sector as well.[4]

With respect to private long-term care insurance policy, there are many reasons for the unwillingness of people to buy it. One of the most important reasons on the demand side may be that some people resist buying because it provides no benefit if they do not need services; they dread the so-called "use it or lose it" syndrome. Another reason is the high costs of private long-term care insurance policies for older people.

On the supply side, insurance companies are concerned about moral hazard (greater use of services induced by insurance) and adverse selection (buyers are those who suspect they will need long-term care services).

To substantially reduce the degree of these reservations, the trade-off principle may be used to enhance the willingness of individuals to purchase long-term care insurance, by linking it to life insurance or annuity products.[5]

A combination policy: Example of the trade-off principle

Linking long-term care benefit to life insurance or annuity products already exists in the market; it combines long-term care protection with income protection through life insurance or annuity. For example, for a single premium of $100,000, a 65-year-old woman could buy a life insurance policy that provides an initial death benefit of $190,000. The death benefit, by definition, is payable on the death of the insured. The death benefit can also be used by the insured prior to death to pay for long-term care expenses, such as nursing home or home health care for at least 50 months—at lesser of actual cost or at a monthly rate of 2 percent of the death benefit or $3,800 per month.

In short, with a rider for long-term care, a life insurance policy pre-pays the death benefit for long-term care expenses. If the insured does not need long-term care, then the funds in the insurance policy (such as universal life or variable universal life) continue to grow. Stated differently, unused long-term care benefits will pass to the beneficiaries of the policy. Under this arrangement, in essence, the policyholder trades off some or all of the death benefit for long-term care.

Providing a long-term care rider to a life insurance policy could also reduce, if not eliminate, the moral hazard problem: there would be a built-in resistance to overusing long-term care benefits because that would reduce the eventual insurance proceeds. The adverse selection problem could be limited, too, because such a combination product would appeal to both healthy and not-so-healthy people. The high cost issue could also be moderated, in addition, because people could buy long-term care insurance coverage at younger ages.

Conclusion

In summary, we need fundamental reform of the ways in which we pay for long-term care and I have suggested some potentially viable ideas.

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[4] A fuller discussion may be found in Chen, Yung-Ping (2001). Funding long-term care in the United States: The role of private insurance. *Geneva Papers on Risk and Insurance, 26* (4), 656–666.

[5] Also, it may be possible to increase the ability of individuals to purchase long-term care insurance by linking it to occupational pensions from employers. This includes Teachers Insurance and Annuity Association—College Retirement Equities Fund and government employee retirement programs at federal, state and local levels; or by linking it to individual retirement accounts (IRAs), Keogh plans, or other employment-based saving vehicles, such as 401(k) plans; or linking it to homeownership through home equity conversion plans (e.g., reverse mortgages).