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STRENGTHENING PENSION SECURITY FOR ALL AMERICANS: ARE WORKERS PREPARED FOR A SAFE AND SECURE RETIREMENT?

HEARING

BEFORE THE

COMMITTEE ON EDUCATION
AND THE WORKFORCE
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

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STRENGTHENING PENSION SECURITY FOR ALL AMERICANS: ARE WORKERS PREPARED FOR A SAFE AND SECURE RETIREMENT?

Wednesday, February 25, 2004
U.S. House of Representatives
Committee on Education and the Workforce
Washington, DC

The Committee met, pursuant to notice, at 10:34 a.m., in room 2175, Rayburn House Office Building, Hon. John Boehner (Chairman of the Committee) presiding.

Present: Representatives Boehner, Petri, McKeon, Johnson, Ehlers, Isakson, Platts, Tiberi, Osborne, Porter, Kline, Burns, Miller, Kildee, Payne, Woolsey, Tierney, Holt, Davis, McCollum, Grijalva, Van Hollen, Ryan, Wu and Bishop.

Staff present: David Connolly, Jr., Professional Staff Member; Stacey Dion, Professional Staff Member; Kevin Frank, Professional Staff Member; Ed Gilroy, Director of Workforce Policy, Chris Jacobs, Staff Assistant; Alexa Marrero, Press Secretary; Greg Maurer, Coalitions Director for Workforce Policy; Jim Paretti, Professional Staff Member; Deborah L. Samantar, Committee Clerk/Intern Coordinator; Kevin Smith, Senior Communications Counselor; and Jo-Marie St. Martin, General Counsel.

Michele Varnhagen, Labor Counsel/Coordinator; Peter Rutledge, Senior Legislative Associate/Labor; Jody Calemine, Counsel Employer-Employee Relations; Mark Zuckerman, General Counsel; Margo Hennigan, Legislative Assistant/Labor; and Daniel Weiss, Special Assistant to the Ranking Member.

Chairman BOEHNER. A quorum being present, the Committee on Education and the Workforce will come to order. The chair recognizes the gentleman from California, Mr. Miller.

Mr. MILLER. Thank you, Mr. Chairman, and I request a minute of personal privilege. Yesterday in a meeting with the U.S. Senate with the Members of the Senate Committee on Education, I told Secretary Paige that I was deeply disappointed in his remarks calling the National Education Association a terrorist organization; that his remarks were harmful and polarizing at a time when we need to bring all people together to make sure that No Child Left Behind is a success.

His remarks were hurtful and unfair and wrong, and I think that they strongly undermine his effectiveness as the President's leader on education.

I am also deeply disturbed that during that meeting when Members of the Senate and myself asked the Secretary repeatedly about the context of a letter that we had sent him on January 8th, that he told us that he would continue to discuss with us those items, and then of course at the end of the meeting, handed over the letter with his responses to our questions. I must say, he handed over a letter of general responses to our very specific questions, and it's very unfortunate. And I wanted to make sure that this was on the public record since that meeting was private.

Thank you.

Chairman BOEHNER. We're holding this hearing today to hear testimony on Strengthening Pension Security for All Americans: Are Workers Prepared for a Safe and Secure Retirement?"

Opening statements are limited to the Chairman and Ranking Member, so if other Members have written opening statements, they can be submitted for the record. And with that, I ask unanimous consent for the hearing record to remain open for 14 days to allow Members' statements and other extraneous material referenced during the hearing today to be submitted for the official record. Without objection, so ordered.

STATEMENT OF HON. JOHN A. BOEHNER, CHAIRMAN, COMMITTEE ON EDUCATION AND THE WORKFORCE

I want to welcome everyone and thank our distinguished witnesses for coming today. The issue of strengthening the pension security of American workers is a top priority for this Committee. Last year the Committee held four hearings on the future of defined benefit plans, and today's hearing is the first this year as we look to reform and strengthen retirement plans, particularly defined benefit plans, on behalf of workers and employers.

We've taken a two-pronged approach to address defined benefit pension reform on a short-term and a long-term basis. Last October, the House passed on a bipartisan basis the Pension Funding Equity Act, a bill that would replace the current 30-year Treasury interest rate with a conservative corporate bond rate for 2 years through 2005. And while the Senate-approved version includes additional pension funding relief beyond what the House passed, I'm pleased that the Senate took action and we stand ready to work with our friends in the other chamber to craft a final bill that is limited and responsible. Now this measure will provide short-term help while we carefully consider more permanent solutions to the underfunding problems that are putting the pension benefits of working families at risk.

And that's the reason we're here today. Because the Pension Benefit Guaranty Corporation has now accumulated an $11.2 billion deficit, the need for long-term solutions to reform and strengthen the defined benefit system is greater now than ever before.

Unfortunately, the PBGC may have to assume responsibility for more underfunded pension plans on behalf of numerous financially weak companies. And although the agency has enough resources to pay benefits for the foreseeable future, this poses a serious question of whether the PBGC will be looking for a taxpayer bailout

down the road if the financial condition of the agency continues to deteriorate.

We've already announced that we plan to use this year to put together a comprehensive legislative proposal to reform and strengthen the defined benefit system for workers and employers over the long term and put the PBGC on a sound financial footing so that it can protect the pension benefits of American workers.

In future hearings that we are planning, we'll examine specific aspects of the defined benefit system in more detail, but today's hearing looks at broader questions that affect us all. Are workers taking the steps necessary to adequately plan for their retirement? How has the increasingly complex statutory and regulatory structure impacted employers' ability to provide retirement plans for the good of their workers? Will reforming and strengthening the defined benefit system help ensure that workers have a reliable and stable stream of retirement income during the life of their retirement?

Study after study shows that many retirees and baby boomers now realize that they have not saved enough to retire and only have a short time to accumulate more money for retirement. Personal savings, IRAs and 401(k) accounts are important, but none of these options provide a stable stream of guaranteed monthly income that cannot be outlived.

Reforming and strengthening the defined benefit pension system, which traditionally provides a lifetime stream of income or retirement insurance, is essential in preventing retiree poverty and helping solve the problems of retirees outliving their assets. Unfortunately, many employees underestimate how much money they should be saving compared to the recommendations by financial planners of how much they'll actually need in retirement.

Today, workers have a heightened responsibility to set retirement goals and decide how to save sufficient funds to achieve their objectives. Yet studies show that many workers are not planning adequately for their retirement, and as a result, their retirement security is in jeopardy. For example, a study by the Employee Benefit Research Institute shows that American retirees will have approximately $45 billion less in retirement income in the year 2030 than they'll need to cover basic retirement expenses.

Last year, the House took an important step when it passed the Pension Security Act, a bipartisan bill that would have allowed employers to provide workers with access to high quality, professional investment advice. This would help inform workers of the need to diversify their investments and adequately save for their retirement. Unfortunately, the Senate has yet to act on this measure.

We should be providing Americans with meaningful retirement savings opportunities along with education and advice to help them protect and enhance their savings. What we shouldn't do is undermine employer-sponsored retirement programs. Indeed, we should be taking steps to strengthen these programs and increase participation by both employers and their employees. Saving for retirement may seem like a future goal, but workers need to know that retirement planning should be a lifelong effort. We have a lot of work ahead of us on this important issue, and I am anxious to hear

from our witnesses, and I look forward to working with the Administration and my colleagues as we move ahead.

With that, I yield to Mr. Miller.

[The prepared statement of Chairman Boehner follows:]

Statement of Hon. John A. Boehner, Chairman, Committee on Education and the Workforce

I'd like to welcome everyone and thank our distinguished witnesses for coming to testify today. The issue of strengthening the pension security of American workers is a top priority for the Education & the Workforce Committee. Last year, the Committee held four hearings on the future of defined benefit pension plans, and today's hearing is the first this year as we look to reform and strengthen retirement plans, particularly defined benefit plans, on behalf of workers and employers.

We've taken a two-pronged approach to address defined benefit pension reform on a short- and long-term basis. Last October, the House acted on a bipartisan basis by passing the Pension Funding Equity Act, a bill that would replace the current 30-year Treasury interest rate with a conservative corporate bond rate for two years through 2005. While the Senate-approved version includes additional pension funding relief beyond what the House passed, I'm pleased the Senate took action and we stand ready to work with our friends in the other chamber to craft a final bill that is limited and responsible. This measure will provide short-term help while we carefully consider more permanent solutions to the underfunding problems that are putting the pension benefits of working families at risk.

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Unfortunately, the PBGC may have to assume responsibility for more underfunded pension plans on behalf of numerous financially weak companies. Although the agency has enough resources to pay benefits for the near future, this poses a serious question of whether a PBGC taxpayer bailout would be necessary down the road if the financial condition of the agency continues to deteriorate.

We have already announced that that we plan to use 2004 to put together a comprehensive legislative proposal to reform and strengthen the defined benefit system for workers and employers over the long-term and put the PBGC on sound financial footing so that it can protect the pension benefits of American workers.

In future hearings we are planning, we'll examine specific aspects of the defined benefit system in more detail, but today's hearing looks at broader questions that affect us all. Are workers taking the steps necessary to adequately plan for their retirement? How has the increasingly complex statutory and regulatory structure impacted employers" ability to provide retirement plans for the good of their workers? Will reforming and strengthening the defined benefit system help ensure that workers have a reliable and stable stream of retirement income during the life of their retirement?

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Reforming and strengthening the defined benefit pension system, which traditionally provides a lifetime stream of income or retirement insurance, is essential in preventing retiree poverty and helping solve the problem of retirees outliving their assets. Unfortunately, many employees underestimate how much money they should be saving compared to the recommendations by financial planners of how much they'll actually need in retirement.

Today workers have a heightened responsibility to set retirement goals and decide how to save sufficient funds to achieve their objectives. Yet studies show that many workers are not planning adequately for their retirement, and as a result, their retirement security is put in jeopardy. For example, a study by the Employee Benefit Research Institute shows that American retirees will have approximately $45 billion less in retirement income in the year 2030 than they'll need to cover basic retirement expenses.

Last year, the House took an important step when it passed the Pension Security Act, a bipartisan bill that would allow employers to provide their workers with access to high-quality, professional investment advice. This would help inform workers

of the need to diversify their investments and adequately save for retirement. Unfortunately, the Senate has yet to act on this measure.

We should be providing Americans with meaningful retirement savings opportunities, along with education and advice to help them protect and enhance their savings. What we shouldn't do is undermine employer-sponsored retirement programs. Indeed, we should be taking steps to strengthen these programs and increase participation by both employers and workers. Saving for retirement may seem like a future goal, but workers need to know that retirement planning should be a lifelong effort. We have a lot of work ahead of us on this important issue, and I am anxious to hear from our witnesses. I look forward to working with the administration and my colleagues as we move ahead.

STATEMENT OF HON. GEORGE MILLER, RANKING MEMBER, COMMITTEE ON EDUCATION AND THE WORKFORCE

Mr. MILLER. Thank you, Mr. Chairman, and thank you very much for convening this hearing. You had told the Members of this Committee that when we considered the short-term 30-year fix, the 2-year bill, that you were going to commit this Committee to holding a series of comprehensive hearings and trying to work out some of the problems that you alluded to in your opening statement. I'm gratified that we have started this early to do this, and I look forward to working with you and the other members of the Committee, and I welcome to our panel, people who are testifying today who I think will start to set the stage for the kinds of decisions that we will have to make.

Retirement security and the threat to retirement security for millions of Americans is one of the most pressing issues facing our country today. We are at a critical juncture. Between 2011 and 2030, over 75 million baby boomers will be eligible to retire. Globalization, changing tax incentives, rising health care costs, falling rates of unionization are reducing the willingness and the ability of employers to maintain their private pension plans. Employers are looking to cut costs, and pensions are on the cutting table. Many employers are only interested in funding their pension plans now when it reduces their corporate tax liability, it cooks their books, or it boosts their executive bonuses. Regrettably, the Bush Administration has failed to protect workers' pensions and have contributed to this problem. Since the Bush Administration has taken office, workers' retirement security has declined dramatically:

Pension coverage has declined for three consecutive years, from 57 to 53 percent.

Defined benefit pension funding has declined from 120 percent to 80 percent.

The PBGC, the agency which insures defined benefit pension plans, went from an $8 billion surplus to an $11.2 billion deficit.

The private pension deficit is now estimated to be about $350 billion, the highest ever.

401(k) plans lost over $60 billion and have been rocked by corporate scandals like Enron, when executives protect their pensions while letting workers lose everything.

Mutual fund abuses such as late trading, market timing, secret insider deals, personal trades by fund managers victimized pension funds through millions of dollars in excessive management fees and fund losses.

The GAO has put the PBGC on a watch list and recommended that Congress pass major pension reform.

All during this time, the Bush Administration has done virtually nothing to address these problems and everything to increase pension instability.

Over the past 2 years, the Bush Administration has ignored the repeated warnings that the private pension plans and the PBGC were becoming seriously underfunded.

The Bush Administration has been promising to propose comprehensive funding reforms to shore up underfunded pension plans for over a year but have yet to do so.

The Democrats had to force the Bush Administration to withdraw the cash balance regulations which would have permitted companies to slash pensions for older workers by up to 50 percent.

The Administration continues to propose fanciful and costly schemes: Lifetime and Retirement Savings Accounts for the wealthiest taxpayers and privatization of Social Security, which would leave individuals at the mercy of the stock market.

Democrats believe that the Congress needs to protect and strengthen Social Security. We need to ensure that Social Security is adequately funded for the long term, and stop diverting the Social Security trust fund to pay off this huge deficit;

Improve disclosure of pension plan finances. Representative Doggett and I have introduced legislation to provide workers the information on their pension plan's funding status. We need to pen up these secret employer reports that affect the retirement security of millions of Americans.

We need to adequately fund pension plans. We must require companies to adequately fund the pension plans on a timely basis. Representative Sanders, myself and 135 Members of Congress have introduced legislation that would ensure that employers may only convert traditional defined benefit plans to cash balance plans if older workers with 10 or more years of service do not lose promised benefits.

The Congress must pass legislation to appeal special pension protections provided to executives at the expense of rank-and-file workers, let workers know when executives are dumping company stock, and let workers have a voice in how their money is being invested by representation on the pension boards.

We have a very long agenda, Mr. Chairman, that I have outlined, that you have outlined. But I think it's most important on the eve of the retirement of the baby boomers, that we provide a secure system for those individuals for money that they have contributed, money that they have put aside, and money that they need to put aside. And I think these hearings can be the most important catalyst in bringing the Congress together around a policy to help protect and secure people's retirements.

Mr. JOHNSON. Mr. Chairman?

Chairman BOEHNER. Mr. Johnson.

Mr. JOHNSON. May I respond?

Chairman BOEHNER. The Chair recognizes the gentleman from Texas.

Mr. JOHNSON. Thank you. I'd like to correct the record. The Bush Administration didn't cause this. As you know, we passed pension

reform from this Committee with the President's support, the Bush Administration's support, and I believe it's the other body that's been our stumbling block in this matter.

Thank you, Mr. Chairman.

Chairman BOEHNER. Thank you. We've got a distinguished panel of witnesses today, and I'd like to take a moment to introduce them. Our first witness will be Mr. Ben Stein. He's the new Honorary Chairperson for the National Retirement Planning Coalition in addition to being a noted author, economist and actor/comedian.

In 1973 and '74, he was a speech writer and lawyer in the Nixon and Ford White Houses. He served as an editorial writer for The Wall Street Journal, a syndicated columnist, and a frequent contributor to Barrons. He has also worked as a lawyer in Connecticut and Washington, and as an adjunct law professor.

Mr. Stein grew up in Silver Spring, Maryland and holds degrees from Columbia University and Yale Law School.

The second witness will be Mr. Dan McCaw, who is the president and chief executive officer of Mercer Human Resource Consulting. He serves on the Executive Committee of the Global Leadership Group and the board of Mercer Consulting Group. He joined Mercer in 1973, and in 2000 he assumed responsibility for Mercer's American operations and became the company's chief executive officer.

Mr. McCaw has a bachelor of commerce degree with honors from the University of Manitoba, and we want to welcome him to our Committee today.

Next is Mr. C. Robert Henrikson, President of the U.S. Insurance & Financial Services Businesses of Met Life, which includes group insurance and retirement savings business, as well as insurance, annuity and financial services. Mr. Henrikson currently serves as a member of the Executive Committee of the American Benefits Council and a member of CSIS's Commission on Global Aging. Mr. Henrikson received his B.A. from the University of Pennsylvania and his J.D. degree from Emory University School of Law. He is also a graduate of the Wharton School's Advanced Management Program.

And last, we'll have Mr. Peter Orszag, a Senior Fellow with the Brookings Institution here in Washington. He previously served as Special Assistant to the President for Economic Policy, as Senior Economist and Senior Adviser on the President's Council of Economic Advisers, and as an economic adviser to the Russian government.

His areas of expertise include fiscal and tax policy, Social Security, pensions, higher education, macroeconomics and homeland security. Dr. Orszag holds a bachelor's degree from Princeton University and master and doctoral degrees from the London School of economics.

And before the witnesses begin, I just want to remind all the members, all the witnesses will testify, and then we'll have questions from the panel. And I heard those bells. I think we're in recess subject to the call of the chair. It usually means when we have votes, they always occur in the middle of our guests' testimony, but we got a reprieve today.

So with that, Mr. Stein, we have a 5-minute rule. We won't bring the guillotine out if you go beyond it, but—and you want to push those little buttons when it's your turn right in front of you, on the bottom—on the base of the—on the base.

STATEMENT OF BEN STEIN, HONORARY CHAIRPERSON, THE NATIONAL RETIREMENT PLANNING COALITION, WASHINGTON, DC

Mr. STEIN. Thank you very much. It is an honor to be here to speak on behalf of the National Retirement Planning Coalition. I have testified a number of times before congressional Committees, and I am always mindful of the advice that my father gave me about this kind of testimony. His name was Herbert Stein, and he had testified before congressional Committees hundreds of times, starting from the days of Truman, and his main advice was these hearings can go on for a long time. If they put a big glass of water in front of you, don't drink it.

[Laughter.]

There is a crisis haunting this nation. It is the retirement planning crisis. At least 77 million Americans are in the baby boom generation racing toward retirement. Other millions are in the war baby cohort, already at retirement age. These men and women expect and want to have a decent, comfortable retirement, at least roughly similar to the way of life they have before retirement. Yet the amount that the ordinary, average American family has saved for retirement is less than $50,000. A startling largely percentage, perhaps as much as 40 percent, have almost nil savings for retirement. And we know that Social Security, which assume you in government will maintain in a vital, strong form, will not be able to pay for much more than a third of living costs for the average retiree, and much, much less for a large fraction of retirees.

The defined benefit corporate retirement plan is rapidly becoming an endangered species. At this point, roughly 25 percent of American workers will have defined benefit plans when they retire. In other words, there is a very large gap between what Americans have in the way of income for retirement and what they're going to need to retire on. In the aggregate, this amount is in the trillions. On a per family basis, it is in the hundreds of thousands of dollars.

Our group, The National Retirement Planning Coalition, is traveling around the country teaching that the solution to this problem will come partly from individual action by tens of millions of American families, largely in fact—making a retirement savings plan, finding a competent, respectable financial adviser to help with the plan, and then substantially adding to savings to make the plan a reality, and sticking with the plan during and after retirement.

We believe these plans should call for diversification of savings—mutual funds, bonds, real estate, stocks and annuities. I especially like variable annuities because I saw them work so incredibly well in my parents' lives, and because they shift the risk of outliving one's savings from the retiree to the insurer. And outliving your savings is a very undesirable situation to be in.

The main requirement is to address the problem in one's head, then take action and to start now. Any amount of planning and

preparation is better than none, and none is what far too many Americans are doing. People always ask me when I talk about this subject if it's too late to start when you're in your late forties or fifties. I always say it is never too late to do better than not starting at all. And for younger workers, the earlier they start, the easier the entire process will be. But it takes sacrifice and self-discipline. It is impossible for anyone but my wife or other people to spend as much as you want and save as much you want.

We are a nation that is unmatched in spending. Now we have to learn about savings. And for baby boomers, we have to learn fast. The prospect of being old and without adequate funds should be more than sufficient inducement to all but the very most resistant boomers. The National Retirement Planning Coalition stands ready to help, especially with our web site, www.retireonyourterms.org. There's a wealth of information there, including an extremely ingenious retirement calculator that tells users how much they need to save to reach their goals. If you use it, no salesman will call. We hope people will use it and take heed of its numbers.

In America, the greatest of free countries, we create our own reality in large measure. The National Retirement Planning Coalition's goal is to educate Americans to create the reality of a comfortable, secure retirement by planning and action to increase and diversify their retirement savings. Old age is hard enough, facing loneliness, illness and immortality. Older Americans should not have to face poverty and fear or both as well.

Thank you very much, and I welcome any questions you might have.

[The prepared statement of Mr. Stein follows:]

Statement of Ben Stein, Honorary Chairperson, The National Retirement Planning Coalition, Washington, DC

NRPC
National Retirement Planning Coalition

STATEMENT of

Benjamin J. Stein
Honorary Chairperson
The National Retirement Planning Coalition

Before the:

United States House of Representatives
House Committee on Education and the Workforce
Washington D.C. 20515

Hearing on: "Preparing for Retirement: Strengthening Pension Security for All Americans"

The "Retirement Readiness" Crisis in the United States

Wednesday, Feb. 25, 2004

Thank you very much for having me here today to speak on behalf of the National Retirement Planning Coalition. It is an honor. I have testified many times before Congressional Committees and I am always mindful of the advice my father gave me about such testimony. His name was Herbert Stein and he had testified before Congressional Committees hundreds of times. His main advice was, "These hearings can go on a long time. If they put a big glass of water in front of you, don't drink it all."

There is a crisis haunting this nation, and I am here this morning to discuss it. Tens of millions of Americans are seriously under-prepared to meet their financial needs in retirement.

These men and women expect and want to have a decent, comfortable retirement, at least roughly similar to the way of life they have before retirement. Yet the amount that the ordinary, average American family has saved for retirement is less than $50,000 – a startlingly large fraction of pre-retirees, perhaps as much as 40 percent, have almost nil savings for retirement.

My testimony is in three parts. First, I will discuss the problem the country is facing and some of the underlying causes of this problem. Second, I will share a number of alarming statistics we have found that demonstrate the seriousness of this problem. Third, I will discuss some of the things Americans can do today to better plan for retirement.

Part I: Background

In the United States today we are facing a crisis in "retirement readiness." More than 77 million "baby boomers" are rapidly approaching retirement. The majority are seriously under-prepared to meet the huge financial needs they will face. Other millions are in the "war baby" cohort already at retirement age and likewise have seriously under funded pension provisions on a personal level.

There are a number of factors fueling this crisis. Comprehensive pension plans, so called defined benefit plans, are rapidly becoming an endangered species. Instead, the responsibility for funding and managing retirement is now in the hands of the future retirees themselves through vehicles including 401(k)s, IRAs and other retirement vehicles.

While Social Security, which we assume you in government will maintain in a vital, strong form, was never intended to be the primary source of an individuals' retirement income, it may play a diminishing role in the future for a variety of reasons.

At the same time, Americans are living longer, healthier lives. This means that retirement incomes will need to last longer than ever. In addition, healthcare costs are rising dramatically, putting a further demand on individuals' retirement income needs.

And, on top of all of this, the stock market drop between 2000 and 2003 dramatically reduced a significant portion of many Americans' accumulated assets earmarked for retirement.

In other words, there is a very large gap between what Americans have in the way of income for retirement and what they are going to need to retire. In the aggregate, the amount is in the trillions. On a per family basis, it is in the hundreds of thousands.

As a result, millions of Americans will fall short of accumulating the assets necessary to maintain the standard of living they have grown accustomed to when they retire. For many, this will require that they retire later than planned, try to find some form of employment in retirement to generate additional income or dramatically scale back their retirement lifestyles. None of these is desirable.

Part II: Key Statistics

There are a number of alarming statistics underscoring the seriousness of the retirement readiness crisis.

Many Americans assume that their retirement income will come primarily from Social Security. The reality is that Social Security was never intended to be the sole means of an individual's retirement income. According to the Social Security Administration, in 2001, Social Security supplied only 39 percent of total retirement income for persons 65 and older.[1] **This percentage is likely to fall in the future.**

Thus, the ability of Social Security to fully support the desired lifestyles of large numbers of baby boomers approaching retirement is clearly inadequate.

In the past, many Americans could depend on employer-sponsored pension programs to fund their retirement, but these programs are becoming less and less common. In 2001, only 30 percent of participants in private sector retirement plans were in defined benefit plans.[2] And, according to Wilshire Associates, a global investment advisory firm, a significant majority of corporate pension plans are under funded.

Individually, many Americans have failed to plan for two key retirement income risk factors that may cause their retirement resources to run out well before their retirement objectives are fulfilled.

The first is "Longevity Risk," the risk of outliving retirement assets. According to the Society of Actuaries, for those individuals that reach 65, more than 50 percent of single women and more than 40 percent of single men will still be alive at age 85. For married couples, in over 70 percent of the cases at least one spouse will still be alive at age 85. Consequently, if these survivors had planned to have their retirement income last just until their life expectancy of 85, they would have depleted their retirement savings considerably before they die, again, a highly undesirable situation.

The second, "Financial Market Risk," is the risk that capital market fluctuation may result in the reduction and/or depletion of the value of one's retirement assets. Unfortunately, there are market events, such as the recent three-year sustained market downturn, where a constant withdrawal strategy combined with prolonged negative market forces can result in a complete depletion of assets far sooner than planned.

The dramatically rising costs of healthcare have added to the problem. AARP estimates that 46 percent of people over 65 will live in nursing homes for some time during the next 20 years, costing as much as $100,000 per year.[3] This is a devastating drain on resources for many retirees. The reality is that all healthcare costs are increasing year-to-year at a staggering pace. And it is clear that many pre-retirees have not planned for these costs.

For women, these challenges are even more dramatic. Since women live, on average, considerably longer than men, their money will need to last longer in retirement. Yet there is no sign that they have saved accordingly.

Probably the biggest factor fueling the retirement readiness crisis is that Americans simply are not saving enough. Charles Schwab estimates that individuals need to save $230,000 for every $1,000 they will need in monthly retirement income. However, only 31 percent of working Americans have saved $100,000 or more for retirement in total.[4] Obviously, a major disconnect between needs and resources is in the making.

In addition, only about 15 percent of working-age Americans have an IRA, and only 22 percent contribute to a 401(k) plan,[5] according to the Employee Benefit Research Institute and the U.S. Census Bureau.

Part III: What Can Be Done to Avert the Crisis

To address the retirement readiness crisis, it is imperative that all Americans develop a personal retirement plan. Americans need to understand that they must take personal responsibility for their financial futures.

Our group, The National Retirement Planning Coalition, is traveling around the country teaching that the solution to this problem will come from individual action by tens of millions of American families: making a retirement savings plan; finding a competent, respectable financial advisor to help with the plan; substantially adding to savings to make the plan a reality; and sticking to the plan during and after retirement.

A personal retirement plan enables each American to set specific retirement goals, put specific mechanisms in place to help them reach those goals and ensure a steady stream of income to support their retirement lifestyles. While each person's retirement plan will be unique, most retirement plans will include a mix of savings and investment strategies.

We believe these plans should call for diversification of savings: mutual funds, bonds, real estate, stocks, and annuities. I especially like variable annuities because I saw them work so well in my parents' lives and because they shift the risk of outliving one's savings from the retiree to the insurer – and outliving your savings is a highly undesirable situation to be in.

The first place Americans should start is to evaluate their personal finances. Uncontrolled debt, particularly from credit cards, can significantly hinder retirement savings efforts. Reducing or eliminating such debt – which may first require evaluating personal spending patterns – will help ensure more money is available each month to put aside for retirement. This should be a top priority for prospective retirees.

Americans should also be sure to take advantage of available tax-deferred investment opportunities. Many companies offer 401(k), profit sharing or defined benefit retirement plans. These offer tax advantages and often incorporate matching contributions made by the employer. This option also makes it easy for Americans to save since the money is taken directly from their paychecks.

Other tax-deferred vehicles, such as IRAs, Roth IRAs and Keogh plans, should also be considered. And, by diversifying investment vehicles to include lifetime income-producing financial instruments, retirees can significantly minimize the impact of longevity and financial market risks to their accumulated assets. It is hard to overestimate the value of transferring risk from oneself to a large insurer where issues of lifetime financial security are concerned.

With the complexity of financial options available today for retirees, many people will need help and guidance. For many Americans, this will mean consulting with a certified financial advisor or retirement planner. Keeping current with tax law changes, private letter rulings and complicated tax planning can be a difficult task. In addition, portfolio risk exposure may need to be reduced as retirement nears. There are thousands of qualified financial professionals who can help Americans get started developing a plan, or direct them to the appropriate person. These people include bankers, life insurance agents, investment brokers, accountants, and estate-planning attorneys. They are there to help, and should be called upon.

The main requirement is to address the problem in one's head, then take action, and to start now. Any amount of planning and preparation is better than none, and none is what far too many Americans are doing. People always ask me if it's not too late to start when you're in your late forties or fifties. I always say, "It is never too late to do better than not starting at all." And for younger workers, the earlier they start, the easier the entire process will be.

But it will take some sacrifice and self-discipline. It is impossible to both spend as much as you want and save as much as you want for most people. We are a nation that is unmatched in spending. Now we have to learn about savings – and for the baby boomers, we have to learn fast. The prospect of being old and without adequate funds should be more than sufficient inducement to all but the very most resistant boomers.

The National Retirement Planning Coalition stands ready to help, especially with our website, www.retireonyourterms.org. There is a wealth of information there, including an extremely ingenious retirement calculator that tells users how much they need to save to reach their goals. We hope people will use it and take heed of its numbers.

In America, the greatest of free countries, we create our own reality in large measure. The National Retirement Planning Coalition's goal is to educate Americans to create the reality of a comfortable, secure retirement by planning and action to increase and diversity their retirement savings.

Americans need to begin planning for their retirements immediately to make sure they will have the income necessary to achieve their desired retirement lifestyles, and also to have the peace of mind knowing that their financial futures are secure. My message to Americans is that it is not too late to ensure that you can Retire On Your Terms.

Thank you very much. I welcome any questions you might have.

Respectfully submitted,
Ben Stein
Honorary Chair, National Retirement Planning Coalition

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[1] Social Security Administration, 2003
[2] Form 5500 Series Reports filed with the Internal Revenue Service for plan years beginning in 1998
[3] AARP
[4] Charles Schwab, Inc.
[5] Employee Benefit Research Institute (ERBI) and the U.S. Census Bureau

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Chairman BOEHNER. Mr. Stein, thank you. Mr. McCaw, you may begin your testimony.

STATEMENT OF DAN McCAW, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, MERCER HUMAN RESOURCE CONSULTING, WASHINGTON, DC

Mr. MCCAW. Thank you, Mr. Chairman. While many Americans are prepared for a safe and secure retirement, the evidence is that many workers will not have sufficient retirement savings to meet their retirement needs.

And the trends today are in the wrong direction. Retirement needs are increasing. Perhaps the best example of that is post-retirement health care costs. Defined benefit plans are declining. Individual savings are certainly not sufficient for many Americans. We're living longer in our retirement years, and more of us are taking lump sum distributions rather than annuities as we go into retirement.

We believe it's essential to consider all aspects of the traditional three-legged retirement stool: Social Security, employer plans, individual savings. First, given current projections, both financial and economic, around Social Security, we expect it will be a challenge enough to assure that the Social Security continues to provide base levels of retirement income.

Second, encouraging more Americans to save more for their own retirement is very important. But given research on individuals' understanding of retirement needs, how much they have to save each year to meet those needs, how to invest their savings, how to manage against the longevity risk, and the competing demands they face today on salaries between saving and spending, we're really right concerned that the individual savings leg will not suc-

cessfully close that retirement security gap sufficiently in the coming years.

Employer 401(k) and defined benefit plans are the remaining leg of the stool, and it's this leg, and we would argue particularly defined benefit plans, that we believe holds the greatest promise for a significant closing of that gap.

401(k) plans can and will continue to play an important role in workers' retirement security. But because many of these plans depend significantly on voluntary contributions by employees, we're concerned that these plans do suffer from many of the same challenges that face the individual savings of the three-legged stool.

So in our view, employer funded defined benefit plans do hold a great promise of closing the gap between a base level of income through Social Security and an adequate level of income at retirement. And these plans provide several unique components and benefits:

Covering more low income and middle income workers.

Not linking retirement benefits to employee contributions.

Providing for employer (not employee) funding of plans and the investment of those assets.

Offering workers and spouses annuity options, lifetime monthly incomes.

Pooling and managing workers' and spouses' longevity risks.

And assisting workers in retiring when they choose, without regard to the current stock market.

While all three legs have important roles to play, our focus is on strengthening defined benefit plans. And we'd like to focus on areas that would help create a growing and robust defined benefit system.

There's a growing perception among senior executives that the open-ended nature of commitments that employers make to defined benefit plans imposes business risks that can unpredictably, uncontrollably, and unacceptably affect a company's business financial success.

Our written testimony includes several recommendations for assisting employers in managing risks around defined benefit plans with respect to contribution stability, open legal issues that present major risks. The cash balance issue is one right now. And future legal and regulatory changes, such as PBGC reforms.

But we're concerned that these items will not be enough to create growing and robust defined benefit plan systems. So we believe that Congress should consider additional incentives for defined benefit plans, and I'd just offer two quick possibilities: Excluding from taxable income some of the annual distributions under lifetime annuities in defined benefit plans, and extending the current law to allow employers with overfunded DB plans—that does happen on occasion—to use a portion of the assets for retiree health benefits and nonelective employer contributions under 401(k) plans.

I want to thank the Committee for this opportunity. Mercer Human Resource Consulting stands ready to work with you to consider these and any other recommendations intended to improve the retirement income security of American workers.

Thank you.

[The prepared statement of Mr. McCaw follows:]

Statement of Dan McCaw, Chairman and CEO, Mercer Human Resource Consulting, Washington, DC

Statement of Daniel L. McCaw
Chief Executive Officer and President
Mercer Human Resource Consulting
New York, New York

Before the
Committee on Education and the Workforce
US House of Representatives

"Strengthening Pension Security for all Americans:
Are Workers Prepared for a Safe and Secure Retirement?"

February 25, 2004

Mr. Chairman and Members of the Committee, thank you for this opportunity to meet with you to discuss one of the most important domestic policy issues confronting American workers and employers – strengthening pension security for all Americans. I am representing Mercer Human Resource Consulting, Inc.

I. Background

Mercer Human Resource Consulting, Inc. is the US operating company of Mercer Human Resource Consulting LLC and a member of the consulting business of Marsh & McLennan Companies, Inc. Mercer has more than 4,500 employees in offices across 40 US cities, serving about 5,000 employers and other organizations, large and small, in the public and private sectors.

Mercer Human Resource Consulting helps employers and other organizations understand, develop, implement, and quantify the effectiveness of their human resource programs and policies. We work with employers and other organizations to address a broad array of their most important human resource issues, both in the United States and around the world. We have specialist expertise in all areas of human resource consulting, including compensation, retirement, health, other employee benefits communication, and human capital strategy. Of equal importance are our investment consulting expertise and the solutions we provide in retirement and health program administration.

I am the president and chief executive officer of Mercer Human Resource Consulting LLC, and serve on the Executive Committee of the Global Leadership Group and the board of Mercer Inc. I'm a Member of the American Academy of Actuaries and a Fellow of both the Society of Actuaries and the Canadian Institute of Actuaries.

II. Are Workers Prepared for a Secure Retirement?

While there are many retirees and workers who are well prepared for retirement, there are significant numbers of workers who will in all likelihood not have sufficient retirement savings – through Social Security, Medicare, employer-provided retirement programs, and individual savings – to meet their retirement needs. And, in our view, the trends are in the wrong direction – retirement needs are increasing, defined benefit plans are declining, individual savings are falling, and lump sum distributions are increasing. It's hard to escape the conclusion that the number of American workers likely to confront significant retirement challenges is increasing at an alarming rate.

Increasing retirement needs, but less savings. Our experience working with employers tells us that there are many retirees and workers who are well prepared for safe and secure retirements. This is particularly true of the 20 million or so Americans who, in addition to Social Security, Medicare, and 401(k) and other individual retirement savings, are eligible for regular monthly lifetime benefits from employer-maintained defined benefits plans.

Several parts of the retirement picture for American workers appear to be in good shape today: many Americans are able to choose to retire; there's much lower poverty among the elderly; 401(k) plans have become widespread and encourage employees to save; and workers with long-term employment in major companies and the public sector have typically accumulated significant retirement benefits.

But there's also much to be concerned about. Current workers now retire earlier, live longer, and use more medical care, which is itself becoming more expensive, than any previous generation. The result is that workers need to accumulate more to meet their retirement needs, unless they are willing to work longer or have significant declines in living standards during retirement.

As workers' retirement savings needs have increased, Social Security, which was never intended to provide full retirement security, is less able to satisfy workers' retirement savings needs. And so it's become even more important for employers to supplement Social Security and Medicare with employer-provided 401(k) and retirement plans and for workers to increase their individual savings.

Even though individuals are able to save significant amounts on a tax-favored basis through 401(k) plans, IRAs, Roth IRAs, and the like, research shows that the savings rate of Americans in many of these individual arrangements is not sufficient. (In general, 401(k) plans with employer matching and nonelective contributions are more successful than 401(k) plans without employer contributions and IRAs.) Indeed, because savings under these arrangements is voluntary, many workers – particularly those at lower income levels – choose (or are able) to save only minimal amounts, and a surprising number of workers put nothing aside in these voluntary arrangements. And over the last several years, many workers and retirees have lost money on their equity investments. The inescapable conclusion is that individual workers can't or won't save enough on their own.

In addition, it's unfortunate that, since the 1980s, the trend has been toward fewer employer-maintained defined benefit plans. For example, the total number of PBGC-insured defined benefit plans has decreased from 114,500 in 1985 to fewer than 33,000 in 2002. From just 1999 through 2002, there was a decrease of over 7,500 PBGC-insured plans – from 39,882 to 32,321 plans (19%). Of these, about 1,000 plans are cash balance and other hybrid plans (covering about 7 million workers).

Until recently, over the last 20 years or so, the total number of defined benefit plan participants remained roughly constant – at about 40 million – but the lack of new defined benefit plans has meant that an increasing percentage of these participants are retirees (now over 50%). And with respect to active workers (there are about 130 million active workers in the US), defined benefit plan coverage is falling in absolute numbers and even more rapidly as a percentage of all active workers.

And even Americans still covered by defined benefit plans are at risk. Employers are increasingly squeezed by economic conditions and global competition, by greater demands from shareholders and customers, by rapidly rising health care costs, by significant and volatile risks flowing from their defined benefit plans, and by complex, uncoordinated, and changing defined benefit plan regulation, thus making financial management, administration, communications, and employee appreciation more difficult.

As a result, we're seeing more employers question whether they should continue their defined benefit plans and, over the last year or so, many have decided to terminate, freeze, or reduce benefits under their defined benefit plans. Current estimates are that between 10% and 25% of defined benefit plan sponsors have terminated or frozen their plans, or are very likely to do so in the near term.

It's no surprise that more employers are pessimistic about how much they'll be able to assist their workers in meeting their retirement needs; employers are increasingly of the view that their employees will need to take on even more retirement savings responsibility. And, as the baby boomers are beginning to retire, many workers are themselves projecting a sharp decline in their standard of living during retirement and the need to tap into their other assets (e.g., family home) and to continue working after retirement.

Inadequate risk management. Our experience is that many workers don't understand the retirement risks they confront or how to manage these risks. This is reflected not only by the low retirement savings patterns exhibited by many workers, but also by the choices workers and retirees make with the retirement funds they do accumulate.

For example, workers generally express a preference for regular lifetime income during retirement. But when given the choice, they typically take their retirement benefits as lump sums. This is the case even in the growing number of defined benefit plans that offer lump sum payments, where the presumptive form of distribution still is a lifetime annuity (with survivor benefits, for married participants). Part of the reason is that legally mandated interest rates for calculating lump sums make the lump sums more valuable than the annuity options (particularly joint and survivor annuities). But the prevalence of lump sums is evident even where lump sums are not heavily subsidized. By taking lump sums, workers create for themselves (and their surviving spouses) a very real risk of outliving their retirement funds and, probably unknowingly, forfeit significant value in their annuity options.

The importance of better worker and retiree understanding of retirement risk and how to manage it – particularly around investment and longevity risks – becomes even greater as workers and retirees have less retirement savings to meet their growing retirement needs.

III. What to Do?

Our answer to the Committee's question only begs the further question: What can and should Congress, employers, and workers do to enable more Americans to have safe and secure retirements?

To answer this further question, we believe that it's important to consider Social Security, employer-maintained 401(k) and retirement plans, and individual retirement savings – all legs of the three-legged stool! But, as described below, we believe that a key component of the retirement security solution is that Congress, the Administration, employers, and employees come together to consider ways to create a growing and robust defined benefit plan system.

Social Security. Social Security was generally designed to provide working Americans (and spouses) with a base level of retirement income. But Social Security alone does not provide Americans with adequate levels of retirement income.

Enhancing Social Security benefits for all Americans is one way to provide more Americans with greater retirement income, but given the significant challenges currently confronting the system – particularly the combination of the system's unfunded status and the rapidly approaching demographic crisis – we do not expect that Social Security will contribute to closing the retirement security gap.

Nevertheless, it is also important to recognize that Social Security is the only (or nearly the only) source of retirement income for many Americans – people without steady employment, some employees of small companies, people who spent their lump sums and/or chose not to save for retirement, and many elderly widows and divorced women. While we can't expect Social Security to assist in closing the retirement security gap, it's also important that the system not be allowed to deteriorate and make the gap larger.

Employer plans. In our view, the employer-maintained retirement plan system is the key to moving significantly more working Americans from a base to an adequate level of retirement income. Many Americans are covered by employer-maintained retirement plans – 401(k) plans, other defined contribution plans, and defined benefit plans – and these typically do a good job of delivering significant additional retirement income.

But, of course, all employer-maintained retirement plans are not equal. Indeed, employers have a great deal of discretion about how to design their plans, and so the approaches can range from (i) employers with only 401(k) plans that provide only for pre-tax employee contributions (without employer matching contributions or additional nonelective employer contributions) to (ii) employers with defined contribution plans or defined benefit plans that provide significant employer-funded contributions or benefits to broad ranges of workers. It's not surprising that many employers have both 401(k) plans and defined benefit plans, finding that a combination of employer-funded basic retirement benefits and additional employee-funded retirement savings (often with employer matching contributions) best meets their human resource and retirement objectives.

While 401(k) and other defined contribution plans are important parts of the retirement security solution, we believe that defined benefit plans are most effective at closing the gap between the base level of retirement income provided by Social Security and a more adequate level of retirement income allowing retirees to maintain (or come close to maintaining) their pre-retirement standards of living. Indeed, most defined benefit plans provide several benefits that are unique and key to solving our retirement security challenges:

- Cover more low-income and middle-income employees.
- Do not link retirement benefits to employee contributions.
- Provide for employer (not employee) responsibility for funding the plans and investing plan assets, thus providing greater investment efficiencies, higher returns, and larger benefits per dollar contributed. We estimate that defined benefit plan returns have been 100 to 200 basis points higher than defined contribution plan returns.
- Offer all workers (and spouses) annuity distribution options providing monthly retirement income for life. In some plans, annuities are the only options available.

- More efficiently manage post-retirement longevity risk, thus creating value for employers and employees by making it less costly to provide any particular level of benefit and to assure that retirees (and spouses) will not outlive their retirement savings. We estimate that longevity risk pooling increases the value per dollar contributed in defined benefit plans by 15% to 35%.
- Allow employers to adjust benefit payouts to reflect cost-of-living increases.
- Assist employees in retiring when they choose without regard to stock market ups and downs.
- Allow employers to cushion employee transitions to retirement and other employment.

In light of these unique and key features, defined benefit plans can provide both employers and employees with significantly greater value (per dollar of contribution) than do defined contribution plans. See the Appendix for a short overview of defined benefit plans and how they create value for employers and employees.

Individual savings. The third piece to improving retirement security is individual retirement savings. Encouraging more Americans to contribute more toward their retirement security is an important goal – individual savings supplementing Social Security and employer-provided retirement benefits will enable more Americans, including those working for employers that don't provide significant benefits, to receive more than base levels of retirement income. And for those Americans who are able and motivated to set aside significant funds on their own to supplement employer-provided benefits, individual retirement savings will allow them to retain discretion over when they retire and maintain standards of living at or even above their pre-retirement standards.

Nevertheless, we are pessimistic that relying more heavily on individuals to save enough on their own will be enough to meet our retirement security challenge. Research shows that most workers are not saving enough on their own to meet their retirement income needs.

Workers and their families have many competing, priority demands on their salaries – job, house, children, education, and health care – and these demands often make it difficult to set aside funds for retirement. Examples of Americans facing particularly difficult challenges include single parent families, families with disabled family members, and lower-income families.

In addition, experience and research support the view that most individuals don't understand how much they need to accumulate in order to have a safe and secure retirement, how much they need to set aside each year, how to invest their retirement savings, and how best to manage their retirement savings to minimize the likelihood that they will outlive their savings.

We agree with those who want to provide more individuals with better retirement and financial education. And we agree with providing Americans with meaningful retirement savings opportunities, so long as these do not undermine employer-funded retirement programs. But even with better worker education and understanding, we believe that relying too much on the individual will produce bad retirement results for too many Americans.

Our view. Each of the three legs on the retirement stool does and must continue to play an important role in enabling more Americans to have safe and secure retirements. But, as described above, we believe that employer-maintained defined benefit plans are essential to meeting our retirement security challenges, as these plans provide employers and workers with several unique and key benefits. We thus recommend that Congress and the Administration, employers, and employees come together to consider ways to create a growing and robust defined benefit plan system.

IV. Recommendations to Strengthen Defined Benefit Plans

Based on our experience working with all types of employers on their defined benefit plans, we would like to put forward several general recommendations for reversing the decline of defined benefit plans and, indeed, for creating a growing and robust defined benefit plan system. We would be very happy to work with the Committee, others in Congress and in the Administration, employers, and employees to consider these and other recommendations further. We've organized our recommendations into the following categories:

A. Assist employers in managing business risks
B. Reduce unnecessary burdens
C. Level the playing field
D. Enhance incentives

A. Assist employers in managing business risks

In our view, the most important challenge to creating a growing and robust defined benefit plan system involves the growing perception among senior corporate executives – and based on real world examples over the last several years – that defined benefit plans carry with them significant business and financial risks that can unpredictably, uncontrollably, and adversely affect a company's business and financial success.

Complexity, change, and uncertainty are challenges to businesses anytime and everywhere, but they have become particularly so with respect to defined benefit plans. In part, the business risks flow from the unique nature of defined benefit plans and the promises that employers make with respect to them. In a 401(k) plan, an employer's current commitment is to make an annual contribution, and so it is entirely discharged at or soon after the end of each year – barring extraordinary circumstances, the year is closed at that point.

By contrast, in making a benefit promise under a defined benefit plan, an employer is making a current commitment to fund and provide retirement benefits for the plan's participants many years in the future. The current commitment can not be discharged now, but remains open until it is discharged many years in the future when the benefits are paid. As such, the amount of the commitment – and the employer's funding, financial, and legal obligations with respect to such commitment – can change for better or worse in a variety of unpredictable and uncontrollable ways.

An additional reason for the focus of more senior executives on defined benefit plan risks is that the amounts of liabilities and assets in many plans – no matter how they're measured – are now very large and growing relative to many employers' core businesses. For example, many large, corporate defined benefit plans have assets that are five to ten times their sponsor corporations' market capitalization. It's thus not surprising that the senior executives in these and similarly situated employers are highly sensitive to the volatility and unpredictability of assets and liabilities that represent such large portions of their total business and financial results.

Low interest rates, the decline in equity market returns, and other business challenges (e.g., health care costs, global competition, and reduced profitability) have combined in recent years to produce, for many defined benefit plan sponsors, significant increases in their

funding obligations and significant reversals in the financial effects of their defined benefit plans just when they could least tolerate such volatility and burdens. This "perfect storm" of circumstances has presented many senior executives with large, real world, and negative examples of the business risks associated with defined benefit plans and of how they can adversely affect the sponsoring employers.

To top it off, the trend toward greater "transparency" in the accounting world – e.g., "mark-to-market" valuation of assets and liabilities, and full, current recognition of plan changes and income/expense – would increase the volatile and uncontrollable effects that defined benefit plans have on employers' reported business and financial results. The Financial Accounting Standards Board (FASB) has undertaken a three-year project to discuss how best to harmonize US accounting standards with the "transparent" standards that have been adopted by the International Accounting Standards Board and the United Kingdom. Standard & Poor's, Moody's Investors Service, and other financial analysts have already adopted "earnings" definitions that move toward greater transparency now for US companies. While more accounting "transparency" may be the right answer from many perspectives, the proposed standards do not harmonize well with the long-term nature of defined benefit plans and the open commitments that their sponsors make to them.

In the face of these and other risks, we are not surprised that more senior executives are questioning the business value of defined benefit plans and whether the benefits for companies and employees outweigh the associated business and financial challenges. And given the current and emerging environment around defined benefit plans, it's not surprising that some senior executives are concluding that the business risks are not justified.

We thus believe that Congress, the Administration, employers, and employees should come together to consider policy and statutory changes to assist employers in managing the contribution, legal and litigation, and future regulation risks associated with defined benefit plans.

Enhance contribution stability. Congress is currently considering adopting, for the short term, a new pension funding interest rate to replace the 30-year Treasury rate. The new rate would be based on a composite of corporate bond maturities that is more reasonable for calculating a plan's liabilities. We recommend that Congress and the Administration quickly adopt this new rate.

We also recommend that, in considering new defined benefit plan funding rules to improve benefit security and replace the current "Rube Goldberg" contraption that is the current funding regime, Congress consider changes that would enable employers with defined benefit plans to enjoy greater year-over-year contribution stability and predictability. This is not an argument for or against any particular rates or methodologies for measuring or smoothing plan assets or liabilities, but instead is a call for a careful evaluation of any funding changes by reference to the goal of improving contribution stability and predictability. If the changes do not significantly enhance contribution stability and predictability, then we believe that they will likely fail to encourage a growing and robust defined benefit plan system.

In addition, we recommend that Congress consider modifying the funding rules for defined benefit plans to allow employers to contribute and deduct more in good years so as to produce asset cushions for bad years. For example, one possible approach would be to allow a deduction for contributions that bring a plan's total assets up to 150% of the plan's total liability. Of course, there are many other approaches for moving in the same, positive direction.

Resolve open legal questions. We recommend that Congress and the federal agencies do all they can to resolve open legal uncertainties relating to defined benefit plans, where such uncertainties are creating business risks having a major chilling effect on the willingness of employers to maintain defined benefit plans.

One major area of uncertainty is cash balance and other hybrid plans. There are open issues about the validity of these plans and of conversions from final pay plans to cash balance and other hybrid plans. There have been congressional hearings, media reports, and continuing litigation around these and related issues. And, the Internal Revenue Service has put a moratorium in place on determination letters blessing cash balance plan conversions.

Perhaps more importantly, one court has reached the preliminary conclusion that cash balance plans are inherently age discriminatory, and many of the informal estimates of potential employer liability are daunting to say the least. These estimates – right or wrong – are making their way around informal corporate communication channels, and so it's very difficult for senior executives not to take notice and be concerned.

Treasury has proposed certain principles for resolving some of the open issues around cash balance plans, and we believe that Congress, the Administration, employers, and employees should work together to resolve the issues in ways that reflect an understanding of the value of defined benefit plans and a commitment to strengthening the defined benefit plan system.

In our view, this means that the legislation should recognize that neither cash balance plans nor conversions of final pay plans to cash balance plans are inherently age discriminatory. Also, we believe that proposals to bind employers to pre-existing benefit formulas for all future service for a large segment of current participants (until they have retired) would significantly reduce an employer's ability to control its commitment and liabilities, and thus would discourage employers from adopting and maintaining defined benefit plans into the future.

While cash balance plans are certainly not perfect, they do provide many of the same unique and key benefits associated with defined benefit plans generally (e.g., employer funding, higher investment returns, and annuity availability). Also, in our view, imposing barriers on shifts from traditional defined benefit plans to cash balance plans may well be more successful in encouraging employers to move to defined contribution plans or exit the retirement system entirely than to stay with their defined benefit plans.

Future legal and regulatory changes. We recommend that Congress and the Administration consider evaluating future statutory and regulatory changes – both so-called "pro-participant" and "pro-employer" changes – against the standard of whether they increase or reduce employers' business risks around defined benefit plans and thus whether they contribute (or not) to a growing and robust defined benefit plan system. In our view, absent significant policy reasons to the contrary, only those changes that contribute to a growing and robust system should be adopted.

For example, with respect to proposals to promote the PBGC's financial stability and to protect plan participants, we are concerned that ever-tightening funding and liability requirements and ever more aggressive PBGC intervention into corporate mergers, dispositions, and other business transactions will only tighten the noose around the system, generally discouraging employers from continuing to maintain defined benefit plans. In our view, the long-term solution to restoring the PBGC to financial health requires that we increase the number of participants for whom PBGC premiums are paid, and that means more, not fewer, defined benefit plans. Otherwise, it may be Congress – on behalf of taxpayers generally – that has to bail out the PBGC.

One practical implication of this is that the PBGC and any related funding reforms focus on the specific sources of plan underfunding. In our view, changes that apply additional requirements to all plans simply because of specific problems that can be addressed on a targeted basis will further discourage defined benefit plan sponsorship.

B. Reduce unnecessary burdens

In our view, too many of the requirements that apply to employer-maintained plans generally, and to defined benefit plans in particular, implement their underlying policy objectives in ways that are unnecessarily complex, burdensome, and costly to defined benefit plans. And these requirements can significantly interfere with the effective communication of defined benefit plans to employees, only furthering their lack of understanding and appreciation.

We recommend that Congress and the Administration consider reviewing all current ERISA and tax qualification rules to identify those requirements that can be significantly simplified without sacrificing their underlying policy objectives.

For example, the anti-cutback rule prevents employers from amending their defined benefit plans to eliminate optional forms or other features with respect to already earned benefits. This requirement is not terribly burdensome for 401(k) and defined contribution plans, as some relief has recently been provided for these plans. But it remains a burden for many defined benefit plans, as they must continue to offer and communicate optional forms and features that have little or no value to participants and are often available only to closed groups of participants (e.g., following a corporate merger or acquisition). We recommend that the Congress and Administration consider anti-cutback relief for defined benefit plans.

Another example involves the recent changes allowing retroactive annuity starting dates and requiring the disclosure to participants of the relative values of optional forms of benefits. These are technical, but nonetheless important rules that all defined benefit plans must comply with, and unfortunately the new rules are complex, internally inconsistent, too often uncertain, and uncoordinated in substance and procedure (e.g., multiple plan amendments). We believe that, in the aggregate, the burdens placed on defined benefit plan sponsors and administrators by these and other requirements far exceed what is necessary to achieve the underlying policy objectives.

C. Level the playing field

In certain respects, current law and regulations favor 401(k) and other defined contribution plans in ways that are not necessary and have the effect of discouraging employers from maintaining defined benefit plans. We recommend that Congress and the Administration consider modifying existing laws and regulations to create a more level playing field between 401(k) plans and defined benefit plans.

Here are two examples of possible changes worthy of consideration. First, Congress should consider allowing employers to design their defined benefit plans to permit workers approaching retirement to receive "partial or phased retirement" distributions while they are still working for the employer. Also, these distributions should be exempt from the 10% early distribution tax.

Phased retirement distribution options would recognize that more employees find it necessary to continue working (and saving) for longer than they had expected and thus would allow any partially retired workers to make up for the reductions in their current salaries or wages due to their partial or phased retirements (without moving to a different employer). Today, many employees are choosing to continue working, but often find that to do so they must move to a new employer.

Second, some in the benefits community support proposals that would allow employees to make pre-tax employee contributions (and receive employer-provided matching benefit accruals) under defined benefit plans. We believe that Congress should consider such proposals. We are generally supportive of such proposals.

But we must also note that there are significant challenges in assuring that employees properly understand the complex relationship between annual contributions at various ages and the ultimate retirement benefits that can be "purchased" with such annual contributions. Also, we are concerned about not undermining the unique features that make defined benefit plans important components of the retirement security solution. So, for example, we believe that Congress should consider requiring that in order for employees to make pre-tax contributions to a particular defined benefit plan, the plan must provide at least a minimum level of employer-funded, nonelective benefits to at least a broad cross-section of employees.

D. Enhance incentives

Modifying, correcting, or tinkering with the current rules around defined benefit plans to reduce risks, reduce unnecessary burdens, and level the playing field with 401(k) and other defined contribution plans will help employers get more comfortable with defined benefit plans. In our view, however, these changes won't be sufficient to reverse the general decline in defined benefit plans, which we expect will accelerate greatly if and when the international "transparency" accounting rules are adopted for the United States. (Several reports indicate that, because the United Kingdom adopted "mark-to-market" accounting rules for defined benefit plans, between 50% and 75% of the employers with defined benefit plans in that country have closed their plans to new participants.)

Given the risks and costs that employers (and senior executives) take on with defined benefit plans – only some of which can be managed, as they flow from the inherent nature of the employer's open-ended commitment – and in order to create a growing and robust defined benefit plan system, we recommend that Congress and the Administration consider the following additional incentives for defined benefit plans:

- Exclude from taxable income a portion (e.g., 50% exclusion, up to a specified dollar amount) of the annual distributions under a lifetime annuity option provided under a defined benefit plan. In addition to strengthening defined benefit plans, this proposal would also encourage workers to take their benefits as annuities, rather than as lump sums, thereby enabling them to benefit from the post-retirement longevity and investment pooling capabilities of defined benefit plans. (Benefits that are transferred from 401(k) and other defined contribution plans to defined benefit plans and paid out as life annuities would quality for this additional tax benefit.)

- Extend current law to allow employers with defined benefit plans that are overfunded by at least a specified percentage or amount to use a portion of the assets (without tax) for retiree health benefits and nonelective employer contributions under 401(k) and other defined contribution plans. This will encourage employers to contribute more to their defined benefit plans, while still assuring that the plan's assets will be used to meet the retirement security needs of their employees.

- Increase the ratio between the annual dollar limit on the benefit that may be provided to any individual under a defined benefit plan and annual dollar limit on the contributions that any individual can receive under 401(k) and other defined contribution plans. From 1974, when ERISA was enacted, to 1986, the ratio between the defined benefit plan limit and the defined contribution plan limit was 3-to-1. Since 1987, the ratio has been 4-to-1. In our view, Congress should consider moving to a ratio of 5-to-1 or even 6-to-1, as these would more appropriately balance defined benefit plans with defined contribution plans. Increasing the ratio would not directly benefit average Americans, but it would increase the incentives for many employers and their senior executives to maintain defined benefit plans.

- Provide additional tax incentives to employers that maintain defined benefit plans that go beyond the current law coverage and benefit nondiscrimination requirements to provide additional employees with additional benefits (e.g., income or employment tax relief). The rationale is that by maintaining such plans, the employers are significantly reducing the pressure on Social Security and other government programs. Congress should weigh any resulting short-term federal revenue losses against the value of such enhanced retirement income security.

V. Conclusion

Because of Social Security, Medicare, employer-maintained retirement benefits, and individual retirement savings, many Americans are now enjoying safe and secure retirements and many are projected to enjoy secure retirements in the future. Nevertheless, research and our experience strongly indicate that far too many Americans are unlikely to have safe and secure retirements, and the trend is that many more Americans will be joining this group in the coming years.

Retirees and workers are already adjusting by reducing spending and working longer, but these changes alone will not be enough to meet this country's retirement challenges. Also, in our view, it's unlikely that Social Security will be able to close the retirement security gap, and we believe that relying too much on individual savings will lead to too many retirement security shortfalls. Our experience is that employer-funded defined benefit plans are able to make several unique and key contributions to improving the retirement security of more Americans.

As a result, we recommend that the Congress and Administration, employers, and employees join together to recognize the important role that employer-funded defined benefit plans have and can continue to play in solving this country's retirement security challenges and to consider proposals that will create a growing and robust defined benefit plan system.

Mercer Human Resource Consulting is eager to assist the Committee – through data and information sharing, policy and technical discussions and analyses, and in whatever other ways would be helpful – in its ongoing efforts to strengthen the defined benefit plan system as part of its broader goal of assuring that all Americans have safe and secure retirements.

Appendix: Defined Benefit Plans

Traditional defined benefit plans generally provide benefits to a group of covered employees (or participants) funded through a common pension fund. The employer makes contributions to assure that, in the aggregate, there are sufficient assets to pay benefits when they are due. As employees' benefits are determined based on a formula described in the plan, there are no funds earmarked for individual employees and retirees. (Many public sector defined benefit plans are funded by both employer and employee contributions.)

The typical benefit formula bases a worker's retirement benefit on the worker's salary (annual salary, career average, or final average salary) and the worker's years of service. An example of a straightforward formula is 1% times years of service times final average salary. In addition, many collectively bargained defined benefit plans are flat dollar plans, basing benefits on formulas that depend on a specified dollar amount per year of service.

An employer that sponsors a defined benefit plan is obligated to fund the plan according to complex, actuarial funding rules designed to assure that the plan has enough assets to pay benefits when the benefits are due. Employees may make contributions to defined benefit plans, but only on an after-tax basis. The tradition in the US is that private sector defined benefit plans are generally non-contributory. An employer also oversees the investment of the plan's assets. Workers' accrued benefits are guaranteed by the PBGC (up to specified dollar limits).

Finally, participants are not able to receive in-service distributions under defined benefit plans prior to their normal retirement dates. Many plans allow distributions when workers terminate employment before retirement. At retirement, all defined benefit plans are required to offer lifetime annuity distribution options to retirees and their spouses. Many also offer other distribution forms to their participants, such as lump sum distributions.

Background. Most mature defined benefit plans were established many years ago, in the 1940s, 1950s, and 1960s, long before employers began (in the 1980s) to add 401(k) plans to their benefit programs. During the bull market of the 1990s, many employees began to believe that their 401(k) plans – many of which were heavily invested in employer stock – would provide a luxurious retirement at an early age. And many employers – particularly their senior executives – enjoyed funding holidays and net pension income flowing from their defined benefit plans.

Also, during the mid-1980s through the 1990s, a new type of defined benefit plan developed – cash balance plans. These are defined benefit plans that define workers' benefits as the balance of hypothetical accounts to which employers make annual hypothetical contributions (typically stated as a percentage of that year's salary) and within which the hypothetical assets grow at a pre-determined rate specified in the plan. Employers fund and invest assets held in cash balance plans under the same rules that apply to other defined benefit plans, and these plans are required to offer retirees with the same lifetime monthly payout options that other defined benefit plans must offer.

Cash balance plans have raised a variety of legal issues – still open and uncertain – around the proper calculation of lump sums ("whipsaw" issue), conversions from traditional defined benefit plans to cash balance plans, and the validity of the core benefit accrual pattern under such plans.

Typically, employers that shifted from traditional defined benefit plans to cash balance plans were responding to changing workforce issues and global competition, so as to change the emphasis from early retirement toward retirement age neutrality, to produce plans that were balanced to provide better benefits to employees who left in mid-career, and to increase satisfaction among younger employees (in support of attraction efforts). Also, these employers hoped that employees would better understand and appreciate cash balance plans than had been the case with traditional defined benefit plans.

Perceptions of defined benefit plans have changed in the last three years. With our slowed economy and bear market, workers' and retirees' 401(k) benefits values have not grown as many expected and hoped. The result has been increased worker anxiety about retirement security, and recognition among many that it may be necessary to work longer than they had planned. At the same time, low interest rates (increasing projected plan liabilities) and the equities market (reducing plan asset values) have combined to confront employers with having to make significant contributions to their defined benefit plans.

Value Creation. By their very nature, defined benefit plans offer a number of unique features that enhance the retirement security of workers and retirees in ways that 401(k) and other individual account plans can't. In the aggregate, these features create real value for workers and employers beyond the "mere" tax-favored accumulation of retirement savings dollars.

The main sources of defined benefit plans value creation are that these plans pool longevity and investment risks, provide for higher net returns on investments, and allow employers to more fairly manage their workforces (particularly in slow economic times). Value creation effectively reflects the ability to provide greater benefits for less total cost.

Pooling longevity risk creates value in two ways. To understand the first, consider how long an individual will need to receive retirement income. If the individual's retirement savings are adequate to last the average life expectancy, he stands a 50-50 chance of outliving his savings. In all likelihood, these are not the odds that an individual would choose for such a critical issue. But how much more is really enough? If a person is satisfied with 2-1 odds that he will not outlive his retirement savings, he'll need about 11% more in assets; for 4-1 odds, he'll need about 20% more; and for 10-1 odds, he'll need at least 26% more in assets.

On the other hand, a defined benefit plan that covers thousands of employees can pool each individual's longevity risk and fund for the average life expectancy for the group with a high level of confidence that the plan's funds will be sufficient for all employees. The value created by such longevity risk pooling ranges from +10% to +25%.

The second way in which pooling longevity risk in defined benefit plans creates value flows from the fact that a defined benefit plan can fund benefits more effectively even for a specific number of years (not just for life expectancy). A defined benefit plan will have some participants who die well before the average life expectancy and some who die much later. The benefits saved (not paid) to those who die early are invested and earn income that is then used to pay the benefits to the longer-lived participants.

Consider a lump sum payment from a defined benefit plan. A retirement benefit of $1,000 per month at age 65 converted to a lump sum would be about $141,500 (using 5%). If this same amount is invested at 5% (ignoring all transaction costs), how long will it last? The answer is about 17-1/2 years. But the average life expectancy at age 65 (male/female blended) is about 19-1/2 years. So, the lump sum at the same investment rate will only last about 90% of the life expectancy.

The two longevity risk pooling factors combine to produce net positive value creation of 15% to 35%.

Investment pooling in defined benefit plans also creates value in several ways – liquidity, professional management, asset allocation, and expense reduction.

A retiree needing a monthly income from an individual account must keep some funds in liquid form, perhaps cash or money market investments. This lowers the account's investment income. A defined benefit plan needs to keep a much smaller percentage of its funds in liquid form due to the mix of active and retired employees and the continuing inflow of employer contributions.

Many 401(k) plans rely on the participant to make investment decisions. Thus, defined contribution plan benefit levels are dependent on an individual's investment skills or luck, and on the individual's conceptions and misconceptions. The result is a wide variation of ultimate retirement benefits across participants based on individual choices, skill, luck, and understanding.

Defined benefit plans generally have a team of investment professionals making all investment decisions around the millions of dollars in these plans. Transaction costs and investment management costs are significantly lower. Also, because benefits under a defined benefit plan are typically based on the plan formula, these plans provide more consistent benefits across all participants. And participants who lack the knowledge, skill, or luck to be good investors are not disadvantaged and can plan on a level of retirement income that is not subject to the vagaries of the investment markets.

Taking these investment factors together, it's not surprising to see why the typical defined benefit plan's investment return exceeds the typical 401(k) plan's return by 100-200 basis points over the long run. This means that the contributions required to produce a certain level of retirement income are considerably less for defined benefit plans than for 401(k) and other defined contribution plans. Alternatively, the same contributions produce greater benefits under defined benefit plans.

A simple proxy for the combined value created by defined benefit plan pooling of longevity and investment risks is to look to the dozens of financial websites and software tools that help individuals plan for retirement. Because of the inability of a retiree to recover from adverse investment fluctuations, these tools typically recommend that an individual accumulate assets of 15-20 times the amount of annual income needed. But a defined benefit plan invested only in risk-free treasury securities would only need to accumulate about 12 times the annual benefit.

A defined benefit plan also creates value for the employer and employees in the workforce management area. During the working years, defined benefit plans typically encourage continued employment, thus lowering employer turnover costs and helping to retain intellectual capital within the company. Studies demonstrate that employers incur very significant costs due to turnover and the required re-hiring. And a typical defined benefit plan encourages workers who have reached retirement age to retire.

Also, an employer is able to use a defined benefit plan to modify these general effects as its workforce needs change, such as by providing early retirement subsidies, early retirement window benefits, and/or higher post-65 benefit accruals. In the case of employees covered only by a 401(k) plan, if the economy is slow and equity markets are down, it's very difficult for the employees to retire or find other employment. And this situation is made even worse if the employer is faced with having to initiate layoffs or other corporate restructuring and the employer doesn't have a defined benefit plan to cushion transitions.

Chairman BOEHNER. Mr. McCaw, thank you. Mr. Henrikson, you may begin.

STATEMENT OF C. ROBERT HENRIKSON, PRESIDENT, U.S. INSURANCE & FINANCIAL SERVICES, METLIFE, NEW YORK, NY

Mr. HENRIKSON. Good morning, Chairman Boehner and members of the Committee. I want to thank you first for holding this Committee here today on what MetLife considers to be an extremely important issue.

For the first time in our history, we are asking individuals to do something we have never asked of them before: To finance their own retirement and manage their retirement money to ensure that it lasts through the 20, 30, even 40 years they will live in retirement.

We are asking people to determine how much they must save, invest that money appropriately, and then draw down that money and hope it does not run out prematurely. With continued increases in life expectancies and continuing shift from employer-managed and funded pension plans to individually controlled defined contribution plans, we are entering a period of great risk.

This threat is magnified exponentially when you factor in that the 36 million Americans over the age of 65 will grow to 62 million 20 years from now. If that sounds far off in the future, consider that the first baby boomer will turn 65 in 2011. Believe me, I'm aware of that.

While the number of defined contribution plans has increased rapidly, the number of defined benefit plans, more commonly known as pension plans, has fallen by 50 percent. We applaud the Committee for introducing defined benefit plan reforms that will help to maintain and perhaps even reverse the decline of these plans.

Reforms must be put in place to ensure responsible funding of these plans while preserving employers' flexibility to make additional contributions during profitable periods.

Despite the importance of pension plans, however, the reality is that defined contribution plans have become the primary retirement plan for many individuals. Employees generally like their 401(k)s. They are popular. But they have not yet proved to be successful, if success is defined as providing a secure retirement. The problem with overreliance on 401(k) programs is that most are incomplete. Individuals are left on their own to replicate the lifetime security previously provided by traditional benefit plans, security that was created by teams of actuaries, pension experts, investment consultants, accountants, lawyers, and protected by the government through the PBGC. Stripped of this expertise and protection, today's employees need our help.

Last June, MetLife created the retirement income IQ. Twelve hundred men and women within 5 years of retiring were asked 15 questions to assess their level of retirement preparedness. Ninety-five percent of these respondents scored 60 percent or less. The average score was 33. Perhaps most unsettling was that they did not understand that a 65-year-old man has a chance of living beyond his average life expectancy of 85. That's what average life expect-

ancy means. About half the population will live past that point, and the other half won't.

A couple consisting of a 65-year-old man and woman have a 25 percent chance that one of them will live beyond the age of 97. It's no wonder that these respondents underestimate how much money they need and overestimate the rate at which they can safely withdraw. In short, Americans don't know what their retirement savings are really worth.

What's the answer? Well, individuals value better retirement education at advice at the workforce—at the workplace. H.R. 1000 takes an important step in ensuring that individuals receive the investment advice they need to succeed.

We also support the provision in the bill that would allow employees to set aside pre-tax money to pay for retirement planning services.

There is one solution for retirees who have diligently saved during their working years and want their savings to last throughout their lifetime. That solution is to join a group of retirees and to share or pool mortality experience. The pooling concept is a powerful one, one that's at the heart of all insurance products. It's also the concept behind the traditional defined benefit pension plan.

In a pool, the retiree who lives a long time is balanced by the retiree who dies early. Individuals who are not part of a group cannot self-insure the risk of outliving their money, because they cannot predict how long they will live. An income annuity is an insurance product that guarantees a stream of income throughout the lifetime of the policyholder. It is in effect a personal pension plan, and it works because the insurance company provides an individual access to a mortality pool just like a pension plan does. Funds from individuals who do not live to life expectancy are held and invested for those who live longer. Not only does an income annuity transfer longevity risks from an individual to an insurer, it does so in an extremely efficient manner. The annuity purchaser needs to save only 75 percent of what the person who tries to go it alone needs to save. What's more, the annuity purchaser has 100 percent chance of not outliving his money, while the person without an annuity has no such guarantee.

H.R. 1776 takes an important step in educating individuals about the value of income annuities by including a limited income tax exclusion for retirement plan distributions taken in the form of annuity payments. The bill also contains an important fiduciary safe harbor for employers that offer specific annuity or IRAs at the time of distribution.

We are now seeing interest by employers to offer income annuities in a 401(k) distribution option because without this option, 401(k) plans are simply incomplete.

I want to thank the Committee again for holding this hearing and allowing me to testify, and I'd be glad to answer any questions you might have.

[The prepared statement of Mr. Henrikson follows:]

Statement of C. Robert Henrikson, President, U.S. Insurance and Financial Services, MetLife, New York, NY

Written Testimony of C. Robert Henrikson to the House Education and Workforce Committee. February 25, 2004

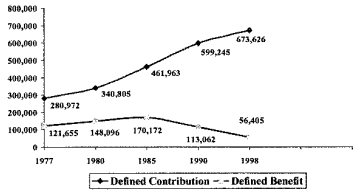
By now most of us are aware that many Americans have not saved enough for retirement. Though there are signs of recovery, the recent stock market decline has added to this problem by wiping out a significant portion of retirement assets. There are other factors at work that are compounding the problem. First, we are living longer than at any time in our nation's history. Second, fewer and fewer people will be able to rely on the security and guarantee of a fixed level of lifetime income afforded by traditional pension plans. The convergence of these factors has created the real possibility that many retirees will outlive their retirement assets or needlessly adjust their lifestyles and standard of living.

To better understand the magnitude of the problem we face, we will begin with a discussion of the demographic and market forces that have gotten us to this point. We'll highlight research results that speak to people's overall retirement preparedness and review some of the risks that are unique to retirees. And finally, we'll describe in some detail one important solution to the need for lifetime retirement income - - annuities.

The Impending Retirement Crisis

The looming crisis facing us today is not one that happened overnight. We have slowly been evolving to this point over the last 20 years as the burden of saving for retirement has been steadily shifting to the individual. Over that time the number of defined contribution plans (DC) plans, such as 401(k)s, has been accelerating rapidly while the number of defined benefit programs (DB), with their guarantee of lifetime income, has been

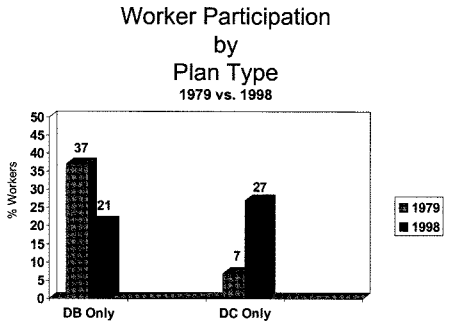
Number of Defined Contribution & Defined Benefit Plans
1977-1998



Source:Department of Labor

steadily decreasing.

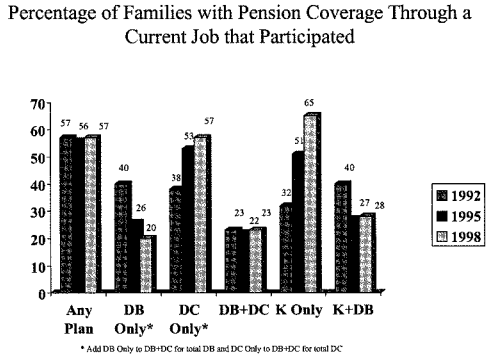
In the period 1979 to 1998, the Department of Labor reported that the percentage of workers who participated in a primary defined benefit plan fell by 16 percentage points while the percentage participating in a primary defined contribution rose by 20 percentage points.



Source: Department of Labor; GAO report on private pensions July 2003

Today, only 23 million workers are covered by a traditional pension plan, with half of those plans allowing employees to take their distribution in a lump sum rather than as a lifetime monthly check. We believe that this movement away from traditional pension plans will have a significant adverse impact on individuals' retirement security, especially for the Baby Boom generation.

The shift away from traditional defined benefit plans has put increasing pressure on retirement savings plans such as 401(k)s to be the primary source of retirement income. With it comes a tremendous challenge for our citizens as they are being asked to determine on their own **how much** to save, **how to invest** that money

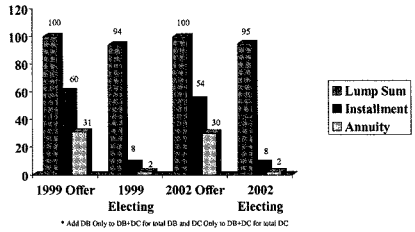


Source: EBRI Analysis of 1992,1995 and 1998 Survey of Consumer Finances

wisely and **how to prudently draw down** their savings so they are not depleted prematurely.

So what choices are people making at the point of retirement? In its report on private pensions, the General Accounting Office (GAO) analyzed the types of pay-out workers actually received at retirement from defined benefit and defined contribution plans. The analysis covered the period 1992-2000. They found that retirees

Payment Forms and Selection



Source: EBRI Analysis of 1992,1995 and 1998 Survey of Consumer Finances

in greater numbers are selecting benefits in a form other than a guaranteed lifetime payment (i.e., annuities). An increasing proportion of more recent retirees chose to directly roll over lump sum benefits into an IRA or to leave their assets in the plan. Between 1992-1994 retirees choosing either of these options represented about 32% but grew to 47% by 1998-2000. Clearly, much of this can be explained by the shift toward defined contribution plans, less than one-third of which offer an annuity option. But the report went on to state that a growing percentage of retirees who reported having a choice among benefit pay-out options chose pay-outs other than annuities. An analysis conducted by the Employee Benefit Research Institute (EBRI) would support the GAO findings:

All indications are that when given the choice to replicate the benefit provided by a traditional pension - i.e., an annuity, few individuals are making that choice.

We applaud the Committee for introducing defined benefit plan reforms that will help to maintain and perhaps even reverse the decline of these plans. In particular, 30-year Treasury interest rate relief is desperately needed today, as many defined benefit plan sponsors are now freezing or terminating their plans because they cannot meet funding requirements. Beyond that, more fundamental DB funding reforms must be put in place to ensure responsible funding of these plans while preserving employers' flexibility to make additional contributions during profitable periods. We encourage Congress to pass legislation on these issues and others quickly so that we can maintain the viability of these critical retirement income plans.

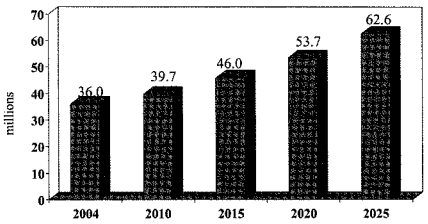
Given the clear trend away from traditional pensions, people are largely left to rely on programs such as 401(k) plans that do not provide the same guarantee of benefits. They will be left on their own to replicate the security previously provided by defined benefit plans - - security that was created by teams of actuaries, pension experts, investment professionals, benefit consultants, accountants, attorneys and by the

government through the protection offered by the Pension Benefit Guaranty Corporation. Stripped of this expertise and protection, today's employees need our help.

Consumer Preparedness

With continued increases in life expectancy, the continuing shift from employer managed and funded traditional pension plans to individually controlled defined contribution plans, and the financial challenges faced by government supported programs, we are entering a period of great risk with regard to retirement security. This triple threat is magnified exponentially when you factor in that the 36 million Americans over the age of 65 will grow to 62 million 20 years from now. With its projected growth, the 65+ segment of our society will represent 20% of the population (compared to 12% today). Furthermore, Cerulli Associates estimates that 25% of current 401(k) participants will retire by 2015. If that sounds far off, consider that the first Baby Boomers will reach the traditional retirement age of 65 in 2011.

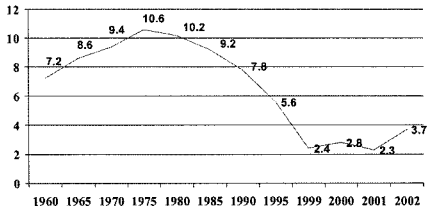
The 65+ Population is Growing Rapidly



Source: U.S. Census Bureau

So how prepared for retirement are these millions of people? The savings rate in the country remains low. Though the rate increased by approximately one and a half percent between 2001 and 2002, the fact remains that the personal savings rate in our country is one of the lowest among the industrialized nations.

Personal Savings - % of Disposable Income



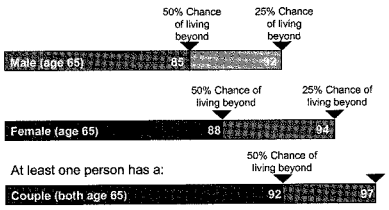
Source: Dept. of Commerce, Bureau of Economic Analysis, June 2003

In January of 2002, EBRI released its Retirement Risk Survey. When the accumulated savings and investments for retirees and pre-retirees were compared, the results were similar:

- Almost three in ten (28%) say they have saved less than $50,000.
- Between one and two in ten report having saved $50,000-$99,999 (12% of retirees and 17% of pre-retirees).
- Roughly two in ten claimed to have saved between $100,000 and $250,000 (20% of retirees and 24% of pre-retirees).

Last June, MetLife created the Retirement Income IQ. 1200 men and women between 56 and 65 years of age and within five years of retiring were asked 15 questions to assess their level of retirement preparedness. 95% of the respondents scored 60% or less; the average score was 33 on a grading scale of 100 points. Perhaps most disturbing was the misunderstanding surrounding how long people will live. A 65 year-old man has a 50% chance of living beyond his average life expectancy. That's what average life expectancy means - about half the population will live past that point and the other half won't. Yet when we posed that question to 1200 individuals, the majority of them thought there was only a 25% or less likelihood of living beyond average life expectancy. Only 16% of respondents replied correctly that a couple consisting of a 65 year-old man and woman have a 25% chance that one of them will live beyond age 97.

People Underestimate the Time Spent in Retirement



When you combine underestimating longevity with other findings, the picture gets even more unsettling. Respondents also *underestimated* how much money experts recommend they need for retirement and they *overestimated* the rate at which experts recommend they can safely withdraw from savings to help make their money last throughout their retirement. Over one-third believe they can safely withdraw 7% from their savings annually, even though planning professionals suggest limiting annual withdrawals to no more than 4%.

Our findings from the Retirement Income IQ are corroborated by many other industry studies. EBRI's 2003 Retirement Confidence Survey asserts that little more than one-third (37%) of workers have even done a basic retirement calculation. Other results of note from this survey include:

- One-third of respondents are not confident of having enough money to live comfortably in retirement (up from 29% in 2002).
- The percentage of those who are not at all confident of having enough money to meet basic expenses in retirement jumped from 6% in 2002 to 11% in 2003.
- Almost one-half (49%) believe they will need less than seventy percent of their pre-retirement income while retired.
- 71% of all workers have given little or no thought as to how they will manage their money in retirement so that it doesn't run out.

MetLife's 2003 Employee Benefits Trend Study found that nearly half of workers rank "outliving their assets" as their greatest fear. Among employees in the 41 to 60 age group, only 4% have reportedly reached their goals. What's worse is that employers are signaling less intent to offer retirement planning and 401(k) investment education in the future. Other results from the survey of note include:

- More than half (52%) of all those surveyed report that they manage their finances by living paycheck-to-paycheck. 51% of those in the 61 to 69 age cohort responded accordingly.
- Less than one-third (30%) of those surveyed are confident in their ability to make the right financial decisions for themselves and their families. One-quarter have done no specific financial planning.

- Lack of retirement planning explains why more than one-third (39%) of employees cannot estimate their annual income needs for retirement and do not know how many years they need to plan for living beyond retirement (44%).

Survey results are very enlightening but we sometimes tend to forget that there are real people with real concerns behind the numbers. We have all heard or read disheartening stories about retirees losing their entire life savings and, where possible, returning to work in order to make ends meet. It is also not uncommon to see retirees needlessly adjusting their lifestyle for fear of running out of money in retirement. They spend too little, often denying themselves many of the things they had planned to do or buy in their Golden Years. Following are a few quotes taken from a number of focus groups MetLife has conducted surrounding this issue of retirement security:

- "I would say no, I don't have a plan. I don't sit down on a monthly basis and see what I have spent and where it's going…I don't plan for the future" (female worker, New York)
- "I don't know but that is a fear of mine. I fear that I will become a burden" (female retiree in Tampa when asked how she plans to not run out of money)
- "I'd get a job at Wal-Mart as a greeter" (female pre-retiree in Tampa when asked what she would do if she started running out of money in retirement)
- "I never even figured that out" (male retiree in Tampa when asked what his monthly expenses were)
- "Those are questions you don't deal with…you block them out" (female worker in New York when asked how long she thought she would live)

What is the answer? Individuals must receive better retirement planning education. MetLife believes the most effective delivery mechanism for that education is in the workplace. Beyond that, we believe individuals must receive investment advice so they understand how to maximize their retirement dollars. Our 2001 Retirement Crossroads study found that retirees who received retirement education and investment advice were more satisfied in retirement than those who did not. MetLife believes that H.R. 1000 takes an important step in ensuring that individuals receive the investment advice they need to succeed. We also support the provision contained in the bill that would allow employees to set aside pre-tax money to pay for retirement planning services. This is another important step in encouraging individuals to seek the critical retirement planning services they need.

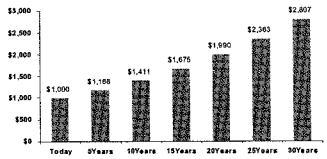
We also need to shift the conversation from retirement *assets* to focus on retirement *income* and offer tools to make this happen. Even those who have built a relatively large nest egg do not know how much income that nest egg will produce throughout their retirement. In short, Americans don't know what their savings are really worth.

Risks in Retirement

Once they reach retirement, there are certain risks people face that they did not have to confront during their working years.

In its Retirement Risk Survey, EBRI reports that the biggest financial concern for retirees and pre-retirees alike is **inflation**.

Income Required to Keep Pace With Inflation



Based on 3.5% rate

Over half of retirees and nearly two-thirds of pre-retirees are *very* or *somewhat* concerned that they will not be able to maintain the value of their savings and investments relative to inflation. In addition, pre-retirees expressed a greater concern than retirees over the possibility of not having enough money to pay for good health care (58% of pre-retirees are *very* or *somewhat* concerned as opposed to 43% of retirees). Pre-retirees are also more concerned with their ability to pay for quality nursing care.

Market volatility is another risk that can have a unique impact on retirees.
Recent stock market experience has taught us all how quickly and how adversely our savings can be affected when exposed to a bear market. But for people who are still saving they have the benefit of time on their side and have a reasonable expectation of seeing their assets return to or even surpass pre-downturn levels. But for retirees, market downturns, especially early on in their retirement years, can have a devastating impact.

Too often people rely on averages and base their planning (if any) on the assumption that their account will return the average. They research the historical market returns, plan to withdraw an amount less than the historical average return and then feel confident their money will last them well into their retirement years. However, a market downturn in retirement can have a much greater impact on a retiree's nest egg if they are taking withdrawals than if they are simply saving and still have time to recover from any stock market losses. Using average returns while planning is dangerous because the market does not earn averages in any given year and once you withdraw in a down market, you realize losses never to be recovered.

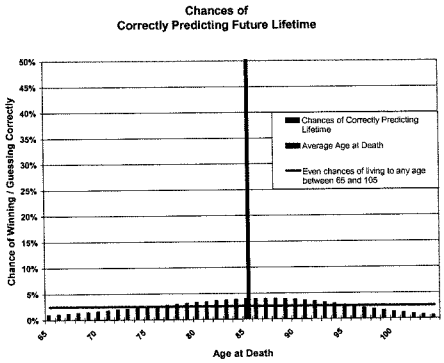
But the biggest risk facing retirees is **longevity**. An earlier graph illustrated the average life expectancies for males, females and couples. When we have shared these statistics with consumers most expressed shock

and some even disbelief. But the numbers are accurate and as we continue to make advances in medicine and adopt healthier, more active lifestyles the chances are the life expectancy tables will stretch out longer.

The reason we believe longevity is the greatest retirement risk we face is because it is the only one an individual cannot manage on his or her own. Market risk can be alleviated somewhat through asset allocation and inflation risk can be addressed by investing in growth equities. But longevity risk only serves to exacerbate these other two risks by increasing the length of time an individual is exposed to them.

Managing Longevity Risk

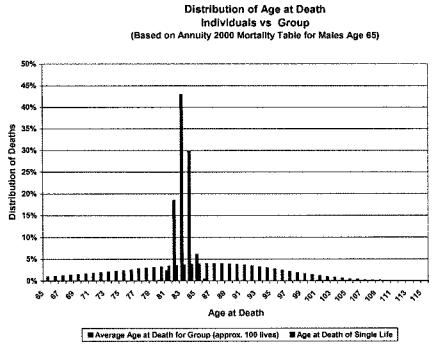
How long one individual will live is extremely uncertain. The following graph, which was prepared by MetLife, shows that the chances are close to a sweepstakes in which you pick a number between 1 and 40 (the red



line).

If you choose age 85 you have even odds of not outliving your assets. In order to get 10 to 1 in your favor you must choose age 97 and live on a lot less. People can take a guess as to how long they are going to live...plan so that their retirement assets last the right amount of time...and then pray that they haven't underestimated their life expectancy. But there is a better way than trying to win at life expectancy roulette. Join a mortality pool and ensure that you will not outlive your assets.

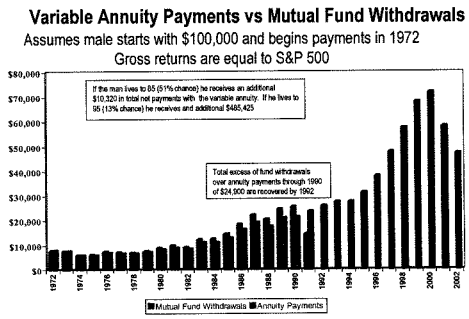
The pooling concept is a powerful one that's at the heart of all insurance products (as well as the mortality element within defined benefit plans). Individuals cannot self-insure the risk of outliving their money because they cannot accurately predict how long they will live. Longevity creates a much smaller risk for large defined benefit pension plan sponsors since the "law of large numbers" permits them to fund for the average life expectancy of the entire group of retirees. When a large group of retirees are pooled together, the retiree who lives a long time is offset by the retiree who dies early. The following chart, also prepared by MetLife, depicts how by pooling even a small group of slightly over 100 individuals, the uncertainty of the age at death **on average** for the entire group is greatly reduced.



The longevity risk faced by an individual retiree is comparable in magnitude, but not in nature, to the investment risk that he or she faces at retirement. Whereas an individual can decrease his investment risk by changing his investment strategy, there is no way that an individual can, on his own, reduce his longevity risk. The only way that an individual can manage this risk is by converting his savings to an annuity. Annuities, like a large plan sponsor, use the averaging effect created by pooling together the mortality experience of a large number of annuitants. Through annuities, a retiree can manage longevity risk and may choose to keep some portion of investment risk (along with its potential return) through a variable income annuity. Or a retiree can manage both longevity and investment risk with a fixed income annuity. An income annuity, also known as an immediate or payout annuity, is an insurance product that converts a sum of money into a stream of income that is guaranteed to last throughout the lifetime of the policyholder. It is, in effect, a personal pension plan and it works because the insurance company pools the lives of many individuals.

The Value of Annuities

The core value of an annuity is its guarantee of lifetime income. To demonstrate this benefit, we compared it to another popular method of generating income in retirement -- systematic withdrawals from an investment

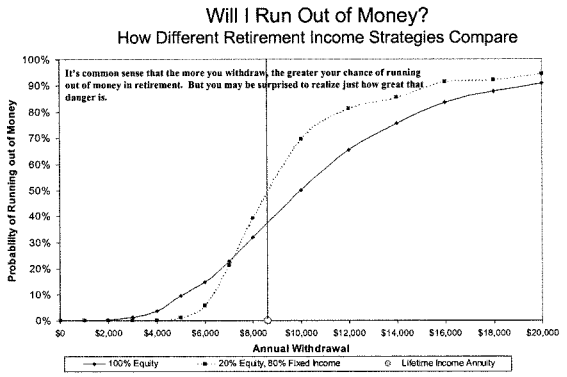


Annual fund withdrawals are equal to annuity payments made before the reduction of a 95 basis point separate account fee. Other charges and expenses apply to a continued investment in mutual funds and annuities. If these charges and expenses and applicable taxes had been factored into the above example, the value of the payments would be reduced. Opening balance of the IRA mutual fund account is $100,000 with returns equal to those of the S&P 500. Annuity payments are based on an initial purchase amount of $100,000 for a single life male age 65 and assume a 100% variable option using an AIR of 4% and investment returns equal to those of the S&P500. Should the annuitant die before age 64 in this hypothetical example, annuity payments would cease whereas the balance in the mutual fund would pass to the accountholder's beneficiary or estate. Certain income or lump sum options are available for designated beneficiaries of annuity contracts. Costs for these options will reduce income payments to the annuity holder. The above example is hypothetical and does not represent the income stream of any MetLife product. Actual income will fluctuate and there is no guarantee they

portfolio.

The graph compares the results of systematic withdrawals from a fund with an opening balance of $100,000 versus a variable immediate annuity purchased with this same amount. The fund withdrawal is equal to the payments generated from the annuity before the reduction of the fees associated with the annuity. We assume the return on both the fund and the annuity is equal to the S&P 500 and the payments and withdrawals started in 1972. The fund would have been depleted by 1991 (age 84 in this example), whereas the annuity will continue income payments for as long as the annuity owner lives. Considering that a 65 year old man has more than a 50% chance of living beyond this age, there is a very good chance that he will run out of money without an annuity.

We have seen enough evidence, factual and anecdotal, that people are concerned about running out of money and are looking for strategies to minimize this risk. The following graph, prepared by MetLife, compares different strategies and measures the probability of running out of money. It compares two strategies involving a $100,000 investment. In the first strategy the entire amount is allocated to equity funds and in the other, the allocation is 20% to equities and 80% in fixed income. If you withdraw $8,600 each year, there is a 38% and 48% chance respectively of running out of money. If the withdrawal amount is raised to $10,000 those probabilities jump to 50% and 70%. That same $100,000 would purchase a fixed



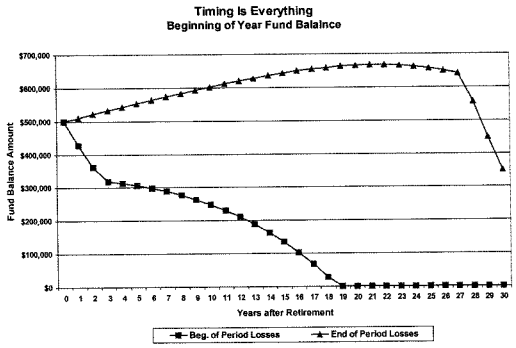
Lifetime fixed income annuity for a male age 65, purchased at $100,000 with assumed 6% interest rate. Equity returns normally distributed, with 10% mean average return and 20% standard dev. Fixed income account normally distributed, with mean return 6% and standard dev. 5%. Combined equity/fixed income is assumed constantly instantaneously rebalanced. Mortality table: Annuity 2000 male (no projection).

income annuity that guarantees an annual payment of approximately $8,600 for the rest of your life.

On January 4, 2004 the New York Times ran an article entitled "For Boomers Near Retirement, Toolboxes Aplenty". The gist of the article dealt with the wave of sophisticated online financial calculators intended to help investors solve the often confusing problems involved in building a nest egg and then safely consuming it. The article discussed the long-term impact of just a few years of negative returns early into retirement. To illustrate this point, it contained a graph entitled "Timing is Everything" that shows how a $500,000 retirement

account that has losses in the first few years of retirement will run out of money faster than one with the same losses in later years.

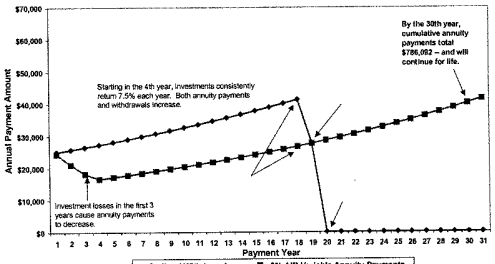
In this example, one account has losses of 10 percent in the first two years and 5 percent in the third year. The other account has losses of 5,10 and 10 percent in the last three years. Both accounts have annual returns of 7.5 percent in every year in which they do not have losses. In both, $25,000 is taken out in the first year, increasing by 3 percent each year to account for inflation. The graph from the article is duplicated



below.

We thought it would be interesting to see how a variable income annuity would behave given the same performance assumptions. We assumed that the $500,000 was used to purchase an annuity with a 3% Assumed Investment Return for a fifty-five year old man and we then plotted the resulting annuity payments against the fund withdrawals where the losses occur early.

The Lifetime Income Advantage:
How Early Losses in Retirement Affect Fund Withdrawals and Annuity Payments



Opening balance for mutual fund is $500,000. Withdrawals are assumed to be taken at the beginning of each year, starting at $35,000 and increasing each year thereafter by 3%. Annuity payments are based on a $500,000 purchase payment for an immediate life income annuity with an AIR of 3%, with annual payments at the beginning of each year. The annuity is assumed purchased at the beginning of the period, by a male annuitant aged 65. Mortality is based on 75% of the GAM94 Basic Male Table, with mortality improvement to 2004 and thereafter based on Projection Scale AA for males. * Based on Annuity 2000 Mortality Assumptions.

Clearly, the real benefit to the annuity is seen in this scenario. Even though the returns bounced back to a constant 7.5 percent in years 4 and later, the early losses coupled with the withdrawals result in the fund balance being depleted in the twentieth year. Keep in mind this individual would be 75 years of age with every expectation of living another 10 to 15 years. On the other hand, the annuity keeps on generating income payments even though the losses in the early years caused its payments to decrease initially and lag behind the fund withdrawals.

The conclusion is that fund withdrawals during a down market significantly increase the risk of outliving your income by locking in your losses. But with a variable income annuity, losses are not irreversible - - payments bounce back when the market does and bring with them the valuable benefit of continuing for life.

The Outlook

We believe annuities can be an important part of the solution to helping people secure guaranteed lifetime income in retirement. Market research indicates that there is greater receptivity to annuities once their benefits are explained. Furthermore, we are beginning to see more in the way of innovative product design that is intended to meet the needs of today's retirees. For example, we are seeing more products offer liquidity options that allow purchasers to access money in an emergency. In addition, products are offering features (such as, more investment choices, transfers and rebalancing) that provide individuals with the flexibility and control that they are used to seeing within their 401(k) plans.

H.R. 1776 takes an important step in educating individuals about the value of income annuities by including a limited income tax exclusion for retirement plan distributions taken in the form of annuity payments. The bill also contains an important fiduciary safe harbor for employers that offer a specific annuity or IRA at the time of distribution, which will encourage employers to offer annuities to 401(k) plan participants. We believe that a concentrated effort to educate consumers on the benefits of annuities, coupled with the legislative proposals now in Congress will go a long way in helping us meet and overcome the retirement crisis facing the country.

Chairman BOEHNER. Thank you, Mr. Henrikson. Mr. Orszag, you may begin your testimony.

STATEMENT OF PETER R. ORSZAG, JOSEPH A. PECHMAN SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. ORSZAG. Thank you very much, Mr. Chairman. As the baby boomer generation nears retirement, the shortcomings in the nation's upside down system of incentives for retirement saving are becoming increasingly apparent. The existing structure, in my opinion, is upside down for two reasons:

First, it gives the strongest incentives to participate to higher income households who least need help in saving for retirement and who are most likely to use the tax preferences as a mechanism to shift assets from other accounts rather than as a vehicle to raise overall saving.

Second, the tax preferences are worth the least to households who most need to save more for retirement, and who if they did contribute, would be most likely to use the accounts to raise their overall net saving.

In part reflecting this upside down set of incentives, the nation's broader pension system suffers from several serious shortcomings:

First, only about half of the workforce participates in an employer-provided plan in any given year, and participation rates in IRAs are substantially lower than that.

Second, even those workers who do participate in tax-preferred retirement savings plans, rarely make the maximum allowable contribution. Only about 5 percent of 401(k) participants make the maximum allowable contribution permitted by law, and only about 5 percent of those eligible for IRAs make the maximum allowable contribution.

Third, and despite the shift from defined benefit to defined contribution plans over the past several decades, most households approach retirement with meager defined contribution balances. The median defined contribution balance among all households age 55 to 59 in 2001 was only about $10,000. And even among those households with an account, the median balance was only about $50,000. That does not buy you very much in terms of a lifetime annuity in retirement.

Given the current gaps in the system, sound pension reform in my view entails encouraging more participation by middle and lower income workers who currently are saving little if anything for retirement. Tax incentives to boost pension saving will raise national saving only if they encourage more private saving than the cost to the government. And you don't encourage private saving if you just induce asset shifting.

The empirical evidence very strongly suggests that as you move up the income distribution, tax preferences for saving are much more likely to induce asset shifting than new saving.

The bulk of the policy changes that have been enacted in recent years, however, moved the pension and broader saving system in the wrong direction. They provide disproportionate tax incentives to high income households who again already save adequately for retirement even in the absence of those additional tax breaks,

while doing little to encourage lower and moderate income households to save more.

The Administration's new Retirement Savings Account proposal would exacerbate this trend. The RSA proposal is basically a Roth IRA with no income limit. It would induce substantial asset shifting by high income households, do little to boost saving among moderate income households, and substantially reduce revenue over the long term.

According to estimates from the Tax Policy Center, the RSA proposal would deliver more than 90 percent of its tax subsidies in present value to the top 2 percent of households, those with incomes of more than $200,000. It would also result in growing revenue losses over time. Over the next 75 years, the RSA and LSA proposals combined would reduce revenue by about a third of the Social Security deficit.

A better strategy would encourage expanded pension coverage and participation among lower and moderate income households.

First, the 2001 tax legislation created a saver's credit, which provides a matching tax credit for contributions made to 401(k) plans and IRAs. IRS data indicate that 3.7 million tax filing units claimed the credit in 2002, the first year it was in effect.

To strengthen the credit, policymakers should make it refundable, extend the 50 percent credit rate, up the income distribution so that more of the middle class can benefit from it, phase the credit rate down more smoothly so that you avoid the cliffs that are in the current system, and extend the credit beyond its 2006 sunset.

Second, the rules under means tested benefit programs like foods stamps, SSI and Medicaid, create a large disincentive for low and moderate income households to save in defined contribution plans, because defined contribution plans count against those assets, whereas defined benefit assets don't. That's largely because when the rules were written, defined contribution plans were not that prevalent. It doesn't make any sense to have that kind of bias built into the system.

A final prong of sound retirement saving reform should expand the use of inertia in favor of saving, not against it. The evidence very strongly suggests that if the default is a worker is in the saving plan unless he or she affirmatively has to opt out of it, savings rates are much higher, participation rates are much higher than if the opposite is true; that if you have to affirmatively sign up for the plan. And we should be encouraging those sorts of automatic enrollment plans much more than we already do.

In addition, the Administration came forward in a little noticed part of its budget this year with a very helpful proposal to allow split refunds. This would allow you to check a box on your tax return and have part of your refund go into a checking or other account, and part go into an IRA. That would be a very helpful step to make it easier for households to save.

And I know that I'm running out of time, but if I could just very briefly follow up on two of the themes that came up in earlier testimony.

One is—and I know this won't be popular—but as the defined benefit—as the private pension system shifts from a defined benefit one to a defined contribution one, in my opinion it makes ever less

sense to take the core layer of income security, Social Security, and also transform that from a defined benefit plan into a defined contribution plan, not just because it means workers will be accepting more risks in the core layer of their retirement income when they're facing more above that core layer, but also because many of the reasons that were already mentioned as to why we would prefer defined benefit plans for additional retirement income would equally apply to a Social Security reform, I worry about workers wanting the money before retirement, making bad investment decisions and not annuitizing their accumulated balances within the core layer of financial security.

The final point has to do with tax preferences for annuities. I think promoting annuities is a very important step, and we should be looking at ways of doing it. But a tax preference for annuitized income is a mistake, in my opinion, and here's why. The budget outlook is already very bad. The budget outlook assumes trillions of dollars in taxes on withdrawals from 401(k)s and IRA plans that already had a tax break on the way in. If you start to provide tax breaks for the money that's coming out of those tax preferred accounts, even for worthy goals like annuitized income, you're going to make an already bad fiscal outlook that much worse.

Given the fiscal outlook, we simply can't afford trillions of dollars more in revenue losses that are currently assumed in the baseline.

And I know I've gone over, and I thank you for your accommodation, Mr. Chairman.

[The prepared statement of Mr. Orszag follows:]

Statement of Peter R. Orzag, Joseph A. Pechman Senior Fellow, The Brookings Institution, Washington, DC

PROGRESSIVITY AND SAVING: FIXING THE NATION'S UPSIDE-DOWN INCENTIVES FOR SAVING

Peter R. Orszag[1]
Joseph A. Pechman Senior Fellow, The Brookings Institution
Director, Retirement Security Project
Co-Director, Urban-Brookings Tax Policy Center

Testimony before the House Committee on Education and the Workforce
February 25, 2004

As the baby boomer generation nears retirement, the shortcomings in the nation's upside-down system of incentives for retirement saving are becoming increasingly apparent.[2] The existing structure is upside down for two reasons:

- First, it gives the strongest incentives to participate to higher-income households who least need to save more to achieve an adequate retirement living standard and who are the most likely to use pensions as a tax shelter, rather than as a vehicle to raise saving.

- Second, the subsidies are worth the least to households who most need to save more for retirement and who, if they do contribute, are most likely to use the accounts to raise net saving.[3]

In part reflecting this upside-down set of incentives, the nation's broader pension system betrays several serious shortcomings:

- Only about half of workers participate in an employer-based pension plan in any given year, and participation rates in Individual Retirement Accounts (IRAs) are substantially lower.

- Even those workers who participate in tax-preferred retirement saving plans rarely make the maximum allowable contributions. Only about 5 percent of 401(k) participants make the maximum contribution allowed by law, and only about 5 percent of those eligible for IRAs make the maximum allowable contribution.

- Despite the shift from defined benefit to defined contribution plans, many households approach retirement with meager defined contribution balances. The median defined contribution balance among all households aged 55 to 59 in 2001 was only about $10,000.

The bulk of the policy changes that have been enacted in recent years, moreover, move the pension and broader saving system further in the wrong direction: They provide disproportionate tax benefits to high-income households who would save adequately for retirement even in the absence of additional tax breaks, while doing little to encourage lower- and moderate-income households to save more.

The Administration's new savings proposals would exacerbate this flawed approach. The Retirement Saving Account proposal and Lifetime Saving Account proposal would induce substantial asset shifting by high-income households, do little to boost saving among moderate income households, and significantly reduce revenue over the long term. Over the next 75 years, the revenue cost of the proposals would amount to a third or more of the actuarial deficit in Social Security.

A better strategy would encourage expanded pension coverage and participation among low- and middle-income households by:

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[1] The views expressed are mine alone and should not be attributed to the trustees, officers, or staff of the Brookings Institution or the Tax Policy Center. They also do not necessarily represent the views of, and should not be attributed to, the Retirement Security Project or the Pew Charitable Trusts. Much of this testimony draws directly upon joint work with William Gale and Mark Iwry of Brookings, Robert Greenstein of the Center on Budget and Policy Priorities, and Gene Sperling of the Center for American Progress. My co-authors should not be held responsible for the views expressed in this testimony, however. I thank Jennifer Derstine and Emil Apostolov for excellent research assistance.

[2] For a broader discussion of these issues, see William G. Gale and Peter R. Orszag, "Private Pensions: Issues and Options," in H. Aaron et. al., eds., *Agenda for the Nation* (Brookings: 2003).

[3] Evidence indicates that (a) high-income households are the least likely, and low- and moderate-income households are the most likely, to need additional saving to have adequate living standards in retirement (see Eric M. Engen, William G. Gale, and Cori E. Uccello, "The Adequacy of Household Saving," *Brookings Papers on Economic Activity* 1999(2), pp. 65–165) and (b) high-income households are the most likely to shift assets from other accounts into tax-preferred form, and hence not raise private or national saving, while low- and moderate-income households, when they do participate, tend to raise their net private saving (see Eric M Engen and William G. Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," The Brookings Institution, August 2000, and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification" Mimeo, London School of Economics, 2001).

- Expanding the income eligibility range for the saver's credit and making the credit refundable;
- Reducing the implicit taxes on saving done by moderate income households through the asset tests under certain government programs;
- Encouraging financial education provided by disinterested parties; and
- Promoting automatic saving, including through changes to the default choices in 401(k) plans and through the "split refund" proposal included in the Administration's budget.

I would also like to note that a new Retirement Security Project at Brookings and George Washington University, funded by the Pew Charitable Trusts, is studying ways of bolstering financial security for America's aging population by raising retirement savings and improving long-term care insurance products.[4] It brings together pension researchers and health care experts to examine areas such as the opportunities and challenges involved in using home equity to purchase long-term care insurance; reforming the existing saver's credit to strengthen its incentives for moderate-income households to save; and removing the disincentive for pension saving implicit in the existing asset tests under various means-tested government programs.

I. Overview of shortcomings in current pension system

Data from the Current Population Survey suggest that the percentage of full-time private-sector wage and salary workers covered by a pension has fluctuated only narrowly over the past three decades, between 48 and 51 percent (see Table 1). Over this period, coverage has shifted from defined benefit to defined contribution plans, but the overall coverage rate has changed little.

Table 1: Retirement plan coverage rates for full-time, private-sector workers

Year	All	Male	Female
1972	48%	54%	38%
1979	50%	55%	40%
1983	48%	52%	42%
1988	48%	51%	44%
1993	50%	51%	48%
1999	51%	52%	49%

Sources: U.S. Department of Labor, *Report on the American Workforce 1997*, Table 3-1, for 1972-1993, and U.S. Department of Labor, Pension and Welfare Benefits Administration, "Coverage Status of Workers under Employer Provided Plans," 2000, available at http://www.dol.gov/dol/pwba/public/programs/opr/CWS-Survey/hilites.html, for 1995-1999.

Table 2: Participation rates by income, 1997

Adjusted gross income	Number of workers (in thousands)	Share of workers	Percent participating in employer plan or IRA	Share of total participants	Share of total non-participants
Under $20,000	45,790	34%	22%	15%	55%
$20,000 to $40,000	32,867	25%	56%	27%	22%
$40,000 to $80,000	37,145	28%	70%	38%	17%
$80,000 to $120,000	10,812	8%	79%	13%	3%
$120,000 to $160,000	3,097	2%	78%	4%	1%
$160,000 and Over	3,686	3%	76%	4%	1%
All Income Groups	133,397	100%	51%	100%	100%

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

The figures displayed in Table 1 obscure substantial differences in pension coverage and participation rates by income. Table 2 shows data from the Internal Revenue Service compiled by the Congressional Budget Office (CBO). Only about one-fifth of workers in households with income of below $20,000 participated in some form of tax-preferred savings plan (including an employer-provided plan or an Individual Retirement Account) in 1997. As a result, such lower-income workers represented 34 percent of all workers, but just 15 percent of workers who participated in tax-preferred savings plans — and 55 percent of total *non*-participants in such saving plans. The number of workers in households with less than $20,000

[4] See www.brookings.edu/retirementsecurity

in income was more than 2.5 times as large as the number of workers in households with over $80,000 in income, but the absolute number of tax-preferred savings participants was significant lower in the lower-income category (10.0 million) than in the higher-income category (13.8 million). In addition to participation rates, contribution rates (contributions as a percentage of income) in defined contribution plans also vary across workers, resulting in another source of inequality. Low-income workers typically contribute a smaller percentage of their pay to 401(k)-type pension plans than higher-income workers.

The inequality in pension contributions is also reflected in inequality in pension wealth (the accumulated value in a pension). Table 3 shows the value of defined contribution and IRA assets by income for households headed by someone aged 55 to 59 (and thus on the verge of retirement years) from the 2001 Survey of Consumer Finances.

Table 3: Ownership of defined contribution or IRA assets, for households aged 55-59, 2001

Percentiles of income	Percent of households with DC/IRA retirement assets	Median DC/IRA assets	Median DC/IRA assets among those with an account	Share of aggregate DC/IRA assets
Less than 20	25.0%	$0	$8,000	1.1%
20-39.9	49.6%	$0	$12,000	4.2%
40-59.9	61.6%	$7,200	$28,000	8.6%
60-79.9	91.0%	$50,000	$54,000	16.7%
80-89.9	95.4%	$148,000	$190,000	18.8%
90-100	92.1%	$215,000	$299,000	50.6%
Total	63.6%	$10,400	$50,000	100%

Source: Author's calculations using the 2001 Survey of Consumer Finances.

Table 3 demonstrates two crucial points: First, most households have relatively low levels of defined contribution/IRA assets; the median value of such assets even for households nearing retirement age was only $10,400. (The median balance is $50,000 among those with accounts. But when the 36 percent of the population without an account is included the median declines to $10,400.) Second, lower-income households have particularly low levels of such assets. The bottom 40 percent of the income distribution accounts for only 5 percent of total defined contribution/IRA assets among households aged 55-59. The top 10 percent of the income distribution accounts for more than 50 percent of total defined contribution/IRA assets.

II. Benefits of progressivity in pension policy

Given the gaps in the current system, sound pension reform entails encouraging more participation by middle- and lower-income workers who currently are saving little, if anything, for retirement. This emphasis on workers with low pension coverage is warranted both to raise national saving and to minimize the likelihood of poverty in old age.

One of the nation's economic imperatives is to raise the national saving rate to prepare for the retirement of the baby boom generation. Tax incentives intended to boost pension saving will raise national saving only if they increase private saving by more than the cost to the government of providing the incentive. (National saving is the sum of public saving and private saving. All else being equal, every dollar of lost tax revenue reduces public saving by one dollar. Consequently, for national saving to increase, private saving must increase by more than one dollar in response to each dollar in lost revenue.[5]) To raise private saving, the incentives must not simply cause individuals to shift assets into the tax-preferred pensions but must generate *additional* contributions.

Since those with modest or low incomes are less likely to have other assets to shift into tax-preferred pensions, focusing pension tax preferences on moderate- and lower-income workers increases the likelihood that lost tax revenue will reflect additional contributions rather than shifts in assets.[6] The empirical evidence suggests that tax-preferred retirement saving undertaken by lower-income workers is much more likely to represent new saving (rather than asset shifting) than tax-preferred retirement saving undertaken by higher-income workers.

[5] If the revenue loss is fully offset through other fiscal measures, then the net impact on national saving is simply the change in private saving. In this case, public saving would be unchanged.

[6] Economists continue to debate the impact on private saving from existing pension incentives. Most economists agree, however, that whatever the overall effect, focusing incentives on those with fewer opportunities to shift assets from taxable to non-taxable forms is likely to produce a larger increase in private saving for any given reduction in government revenue.

A second motivation for progressive reforms is that higher-income workers are less likely to be in danger of living in poverty in older age. Focusing attention on lower-income workers in fashioning new tax-favored pension initiatives is a more efficient anti-poverty tool.

These findings indicate problems with the current pension system as well as opportunities for reform. The problem is that pension benefits accrue disproportionately to high-income households with little improvement in the adequacy of saving for retirement and little increase in national saving. By contrast, lower- and middle-income households gain less from the pension system, but these benefits — where they exist — appear both to increase saving and to help households who would otherwise save inadequately for retirement. The goal of reform should be to encourage expanded pension coverage and participation among low- and middle-income households, a step that would boost national saving and build wealth for households, many of whom are currently saving too little.

III. Recent legislation and proposals

Recent legislative changes and proposals have exacerbated rather than attenuated the regressivity of the pension system and thus have moved (or would move) the pension system in the wrong direction. These proposals include the pension component of the 2001 tax legislation and the Bush Administration's Retirement Saving Account and Lifetime Savings Account proposal.

(A) 2001 tax legislation

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 included a series of important changes to the pension and IRA laws. Unfortunately, most of the changes did not represent sound pension reform. For example, the retirement saving provisions in EGTRRA are disproportionately aimed at higher earners; they are therefore unlikely to raise national saving and will exacerbate the inequities in the distribution of tax subsidies for retirement saving. Analysis by the Institute for Taxation and Economic Policy found that roughly 75 percent of the pension and IRA tax reductions would accrue to the top 20 percent of the income distribution.

To be sure, the legislation included several helpful reforms in the pension laws. For example, it simplified the rules on rolling over account balances from one type of retirement account to another, which may increase pension portability for some workers. The legislation also included a progressive matched savings tax credit, which is described further below.

The major pension and IRA provisions, however, involved various changes that allow larger contributions by high-income workers and do little to simplify the system. The theory behind this approach is that liberalizing the rules for higher-income executives will lead more businesses to adopt pension plans and thereby help their middle- and lower-income employees. The theory, however, lacks any significant empirical support.

Among the most expensive retirement saving provisions in EGTRRA were:

- Increased Dollar Limits for Employee Contributions to 401(k) Plans. In 2001, workers were allowed to deposit a maximum of $10,500 in a 401(k) account. EGTRRA raised the maximum to $15,000 by 2006 (and by an additional $5,000 for those age 50 or over).

- Increased Maximum Employer-Employee Contributions. The aforementioned limit on deposits to a 401(k) account applies to employee contributions. There also is a limit on combined employee-employer contributions. Previous tax law required that combined employee-employer contributions to 401(k)s and other defined contribution pension plans not exceed $30,000, or 25 percent of pay, whichever is lower. EGTRRA raised the maximum combined employer-employee contribution to $40,000, and also eliminated the requirement that such contributions not exceed 25 percent of pay.

- Expansions of Individual Retirement Accounts. EGTRRA more than doubles the amount that a taxpayer and spouse can contribute each year to an IRA. Under prior law, a taxpayer and spouse could each contribute $2,000; EGTRRA raises the maximum contribution to $5,000 by 2008.

- Increased Maximum Considered Compensation. Prior to EGTRRA, tax-favored pension benefits were based on compensation up to a maximum compensation level of $170,000. For example, if a firm contributed five percent of wages to a defined contribution pension plan, the maximum contribution was $8,500 (five percent of $170,000). EGTRRA raised the maximum compensation level from $170,000 to $200,000.

- Increase in Benefit Payable under a Defined Benefit Pension Plan. Under prior law, the maximum allowable annual payment from a defined benefit pension plan was $135,000. EGTRRA increased the $135,000 limit to $160,000. In addition, EGTRRA raised the amounts that can be paid from a defined benefit pension plan for early retirees by an even larger proportion, which allows plans to incorporate even larger early retirement subsidies than were allowable under prior law.

A common theme in many of these provisions is that they increase the maximum amount that can be saved on a tax-preferred basis. Such increases are unlikely to have much effect on the vast majority of families and individuals who had not previously been making the maximum allowable contribution. For example, 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.[7] 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."[8] 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.[9]

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.[10] Table 4 presents information from the Congressional Budget Office on workers constrained by the previous 401(k) limits in 1997. Only 6 percent of all 401(k) participants made the maximum contribution allowed by law. Only 1 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.

Table 4: 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	Number at maximum (thous.)*	% of total contributing maximum
Under $20,000	2,695	7.6%	1%	27	1.2%
$20,000 to $40,000	8,914	25.0%	1%	89	3.9%
$40,000 to $80,000	15,020	42.1%	4%	601	26.1%
$80,000 to $120,000	5,739	16.1%	10%	574	24.9%
$120,000 to $160,000	1,624	4.6%	21%	341	14.8%
$160,000 and Over	1,673	4.7%	40%	669	29.1%
TOTAL	35,666	100.0%	6%	2,301	100.0%

Source: Author's calculations based on Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving," August 2003, Table 2.
* Number may be imprecise because of rounding in official estimates.

Participants in that high-income category represented fewer than 5 percent of total participants but almost 30 percent of participants making the maximum contribution. Participants with household income of more than $120,000 represented 44 percent of those making the maximum contribution. Table 4 underscores the point that increasing the maximum contribution limit is beneficial primarily to higher-income households; for the vast majority of lower- and moderate-income families, such an increase is of no direct benefit.

(B) Bush Administration's Lifetime Saving Account and Retirement Saving Account proposal

In this year's budget, the Bush Administration reintroduced, in slightly modified form, its proposal to create a new set of tax-preferred accounts that would expand opportunities for tax-advantaged saving. The proposal would dramatically alter the tax treatment of saving, via the creation of Lifetime Saving Accounts (LSAs), individual Retirement Saving Accounts (RSAs) and Employer Retirement Saving Accounts (ERSAs).[11] Some elements of the proposal — in particular, some of the simplifications — could form the basis of a useful pension reform package. Other elements are troubling because they would be regressive, could reduce saving among the most vulnerable populations, and would exacerbate the already bleak long-term budget outlook.

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[7] 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.

[8] Robert Carroll, "IRAs and the Tax Reform Act of 1997," unpublished mimeo, Office of Tax Analysis, Department of the Treasury, January 2000.

[9] 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.)

[10] 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, US Treasury Department, 2001.

[11] Much of this section draws upon Leonard Burman, William G. Gale, and Peter R. Orszag, "The Administration's Saving Proposals: A Preliminary Analysis," *Tax Notes*, March 3, 2003.

The Administration's proposal follows the basic thrust of policy changes delineated above in substantially expanding opportunities for tax-sheltered saving by high-income households. LSAs would allow significant amounts of tax-free saving ($5,000 per account per year) for any purpose, with no restrictions on age or income. RSAs would be designed similarly, but tax-free withdrawals could only be made after age 58 or the death or disability of the account holder. RSAs would remove all eligibility rules related to age, pension coverage, or maximum income; eliminate minimum distribution rules while the account owner is alive; and allow conversions of traditional and nondeductible IRAs into the new back-loaded saving vehicles without regard to income.

A particular shortcoming of the RSA and LSA proposals is that they may diminish interest in employer-provided pension plans, although the size of the effect is unknown. Any such adverse effect on employer plans is particularly disturbing given the relatively low level of participation in non-employer-based plans like IRAs, compared to the conditional participation rate in employer-based plans like 401(k)s. That differential may highlight several important factors in encouraging saving, including a positive matching rate; financial education in the workplace; peer effects; and the role of the non-discrimination rules (which tie maximum contribution rates for higher-income workers to those undertaken by lower-income workers).

The RSA/LSA proposal would also result in growing revenue losses over time; estimates based on Burman, Gale, and Orszag (2003) suggest an annual revenue loss exceeding 0.3 percent of GDP after 25 years. An analysis by the Congressional Research Service reached similar conclusions.[12] The Burman-Gale-Orszag figures suggest that over the next 75 years, the revenue loss amounts to a third or more of the actuarial deficit in Social Security.

The RSA proposal, income limits, and the "advertising effect"

A key issue with regard to the RSAs is the absence of an income limit. Indeed, RSAs are basically Roth IRAs without an income limit. 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." That perspective is consistent with the evidence cited above about the effect of saving incentives on asset shifting as one moves up the income distribution.

Preliminary analysis using the retirement savings module from the Urban-Brookings Tax Policy Center (TPC) model suggests that more than 90 percent of the tax subsidies (in present value) from removing the income limit on Roth IRAs would accrue to the 2 percent of households with Adjusted Gross Income of more than $200,000. Almost 40 percent of the benefits would accrue to the 0.4 percent of households with income of more than $500,000.[13]

The implied long-term revenue loss and likelihood of substantial asset shifting in response to removing the income limit on Roth IRAs both suggest the lack of wisdom in pursuing such a course. A counter-argument is that eliminating income limits could allow financial services firms to advertise more aggressively and thereby encourage more saving by moderate-income households. Three points are worth noting about this "advertising effect" argument:

- First, it is extremely unlikely that the overall result would be progressive, especially given the types of advertising that are likely, since that would require not only that the advertising "trickle down" the income distribution but that the effect actually grow relatively stronger as it moved down the income ladder (which could perhaps be referred to as an "avalanche" version of the trickle-down effect).

- Second, advocates of the 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

[12] Congressional Research Service, "Effects of LSAs/RSAs Proposal on the Economy and the Budget," January 6, 2004. CRS estimated that the long-term costs of last year's proposal could reach the equivalent today of $300 billion to $500 billion over ten years. Due to changes made in this year's proposal, which reduced the maximum contribution limit from $7,500 to $5,000 — a one-third reduction — the long-term cost of the new proposal would be lower, although not substantially lower. For those who would have contributed the full $7,500, the change would reduce their benefit by one-third. For all others, the benefit reduction would be smaller, and those contributing $5,000 or less would see no change. Preliminary estimates by CRS indicate that the total impact of the lower contribution limits may be to reduce the ultimate cost of the proposal by as little as one-sixth, to about $250 billion to $420 billion over ten years. Even if the cost of the proposal were reduced by one-third — which is the maximum possible reduction — the ultimate cost would still be large.

[13] The TPC estimates also suggest that reducing the contribution limit to approximately $3,000 while removing the income limit on Roth IRAs would result in no net change in aggregate contributions to Roth IRAs, which is one proxy for no revenue effect in present value. In other words, the present-vale revenue losses from removing the income cap on Roth IRAs could be approximately offset by reducing the contribution limit from its scheduled level of $5,000 to about $3,000.

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, especially given the rise in 401(k) availability and changes in income tax rates, both of which may well have diminished interest in IRAs. For example, 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. (The declines in contribution rates to IRAs were larger, in absolute terms, between $20,000 and $40,000 in AGI.) 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."[14]

- Finally, the advertisements used prior to 1986 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."[15] This type of advertising is extremely unlikely to generate new saving among moderate-income households.

IV. A better direction

As the previous section of my testimony argued, the current thrust of pension policy is fundamentally flawed. A change in direction is necessary. A progressive set of reforms should center on factors that would boost participation, especially among lower- and moderate-income workers: (a) expanding the income eligibility range for the saver's credit and making the credit refundable; (b) reducing the implicit taxes on saving done by moderate income households through the asset tests under certain government programs; (c) encouraging financial education; and (d) making it easier to save, including through changes to the default choices in 401(k) plans and the "split refund" proposal included in the Administration's budget.

(A) Improving the saver's credit

One promising approach to bolstering retirement income security among lower- and moderate income workers would involve a progressive government matching formula – one that provides relatively larger matches to lower-income workers than higher-income workers. A progressive government matching formula could be beneficial for at least two (potentially related) reasons.

First, the tax treatment of pension contributions naturally creates an implicit *regressive* government matching formula. To offset the regressivity of the implicit match provided by the tax code, the explicit government match should be progressive. Second, although the conditional participation rate for lower-income workers offered 401(k) plans is higher than many analysts may have suspected, it is substantially lower than that for higher-income workers. Encouraging more participation may require a more aggressive matching formula for the lower-income workers.

One component of the EGTRRA legislation — the saver's credit — reflects the logic of such a progressive matched savings program. The saver's credit provides a matching tax credit for contributions made to IRAs and 401(k) plans. The eligible contributions are limited to $2,000. Joint filers with income of $30,000 or less, and single filers with income of $15,000 or less, are eligible for a maximum 50 percent tax credit. As Table 5 shows, a smaller credit rate applies up to $50,000 in income for joint filers. The table also shows that a 50 percent tax credit is the equivalent of a 100 percent match on an after-tax basis: A $2,000 contribution generates a $1,000 credit on the individual's tax return, so that the net after-tax contribution by the individual is $1,000, and the government's implicit contribution is $1,000.

Table 5: Saver's credit for married couples

AGI above	AGI not above	Credit rate	Tax credit for $2,000 contribution	After-tax contribution for $2,000 account balance	Effective after-tax matching rate
0	$30,000	50%	$1,000	$1,000	100%
$30,000	$32,500	20%	$400	$1,600	25%
$32,500	$50,000	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 any employer matching contributions or the effects of tax deductions or exclusions that might be associated with the contributions.

[14] Congressional Research Service, "Effects of LSAs/RSAs Proposal on the Economy and the Budget," January 6, 2004.
[15] William G. Gale, "Saving and Investment Incentives in the President's Budget: The Effects of Expanding IRAs, Testimony before the Committee on Ways and Means, March 19, 1997.

IRS data indicate that 3.7 million tax filing units claimed the credit in 2002, the first year it was in effect.[16] This figure likely reflects more than 3.7 million qualifying individual savers, however, as a significant portion of these returns represent married couples filing jointly, where both spouses may have made a separate qualifying contribution.[17] Preliminary estimates of the distributional effects of the saver's credit using the Urban-Brookings Tax Policy Center micro-simulation model suggest that roughly 60 percent of the benefits accrue to filers with AGI of $30,000 or under.[18]

Despite the promise of the saver's credit in helping to address the upside-down nature of the nation's savings incentives, several crucial details of the credit as enacted result in its being of limited value:

1. Since the tax credit is not refundable, it provides *no* additional saving incentive to families who otherwise qualify on paper for the 50 percent credit rate based on their income (under $30,000 for married couples and $15,000 for singles with no children). These people are excluded from the credit because they have no income tax liability against which the credit could be applied. In particular, 57 million returns have incomes low enough to qualify for the 50 percent credit. Because the credit is non-refundable, however, only one-fifth of these tax-filers could actually benefit from the credit if they contributed to an IRA or 401(k). Furthermore, only 64,000 — or slightly more than one out of every 1,000 — of the returns that qualify based on income could receive the maximum possible credit ($1,000 per person) if they made the maximum eligible contribution.

2. For families with somewhat higher incomes, the fact that the credit is not refundable poses much less of a problem. But for these families, the credit provides a relatively modest incentive for saving. For example, a married couple earning $45,000 a year receives only a $200 tax credit for depositing $2,000 into a retirement account. This small credit represents a low implicit matching rate (see Table 5) and therefore provides little incentive to participate.

3. The steep declines in the credit rate as income rises can result in very high marginal tax rates for those savers who use the credit. For example, consider a married couple contributing $2,000 to an IRA. If the couple's AGI increases from $30,000 to $30,001, the tax credit for that contribution declines from $1,000 to $400 – a $600 increase in tax liability triggered by a $1 increase in income.

4. The credit officially sunsets in 2006.

To address these shortcomings, policy-makers should make the saver's credit refundable, extend the 50 percent credit rate up the income distribution, address the current "cliffs" by phasing the credit rate down more smoothly, and extend the credit beyond its 2006 sunset. Estimates from the TPC model suggest that making the credit refundable would add about $5 billion per year to its cost. The current credit costs about $2 billion a year; making the credit refundable would raise this cost to about $7 billion per year. Expanding the 50 percent credit rate to $50,000 for joint filers, and phasing the credit down over the next $10,000, would add about $4 to $5 billion a year in cost. Each $10,000 increment in the availability of the 50 percent credit rate above $50,000 in income for joint filers then adds another $4 to $5 billion or so a year in revenue cost.

Combining improvements to the saver's credit and the RSA proposal

Some policy-makers are apparently exploring the possibility of combining a refundable, expanded saver's credit with the RSA proposal. Although the details of such proposals remain unclear, some insight into their potential effects may be obtained by examining the impact of (a) eliminating the income limit on Roth IRAs while making the existing saver's credit refundable; or (b) eliminating the income limit on Roth IRAs, expanding the 50 percent credit rate under the existing saver's credit up to $50,000 for joint filers (phased out by $60,000), and making the credit refundable.

Preliminary TPC estimates suggest that under option (a), more than a third of the tax benefit in present value would accrue to households with incomes above $100,000, and roughly a quarter would accrue

[16] IRS Taxpayer Usage Study.

[17] The IRS data are based on the number of tax returns that claimed the saver's credit by entering an amount on line 49 of Form 1040 ("retirement savings contributions credit") and filing Form 8880 ("Credit for Qualified Retirement Savings Contributions"). The data do not show a breakdown of contributions by type of plan (employer plan versus IRA, for example) or size of contribution. However, partial data that shed some light on these issues are available from other sources because a significant portion of the returns claiming a saver's credit were filed with the aid of tax preparers.

[18] The model is based on data from the 1999 public-use file produced by the Statistics of Income (SOI) Division of the Internal Revenue Service (IRS). The model contains additional information on demographics and sources of income that are not reported on tax returns through a constrained statistical match of the public-use file with the March 2000 Current Population Survey (CPS) of the U.S. Census Bureau. The retirement savings module also uses data from the Survey of Consumer Finances (SCF) and the Survey of Income and Program Participation (SIPP). For more detail about the model, see www.taxpolicycenter.org.

to the top 2 percent of the income distribution. Under option (b), about a fifth of the aggregate benefit in present value would accrue to households with incomes above $100,000, and about 15 percent would accrue to the top 2 percent of the income distribution. For many purposes, however, it is better to examine the percentage change in after-tax income than the share of tax cuts by income class. Under both option (a) and option (b), the percentage change in after-tax income first declines as income increases, then increases. In other words, the proposals deliver tax benefits both at the bottom and at the top of the income distribution, with almost no effect on households with income between $50,000 and $100,000.

My own view, given the evidence on the degree to which subsidies for saving merely induce asset shifting among high-income households, is that eliminating the income limit on Roth IRAs would carry an excessively high price in terms of national saving -- and that price would likely be too high to pay even in exchange for other measures that improve retirement policy, such as substantially strengthening the saver's credit, and for any marginal beneficial effect from increased advertising effort by financial services firms.

(B) Reducing implicit taxes on saving

Another area related to pension policy that warrants examination is the treatment of pensions under the asset tests used in means-tested government benefit programs. The basic rules governing the treatment of pensions under the asset tests used in programs such as Medicaid, the food stamp program, and the Supplemental Security Income program were established in the 1970s. Federal policymakers have given them little attention since, and significant problems have arisen.

To be eligible for means-tested benefits, applicants generally must meet an asset test as well as an income test. The asset tests are stringent. For example, in SSI, the asset limits are $2,000 for a single individual and $3,000 for a couple. In food stamps, the limit is $2,000 unless a household contains an elderly or disabled member, in which case the limit is $3,000. These limits are not indexed to inflation. In both SSI and food stamps, the limits have not been adjusted since the 1980s. Research suggests that the stringent asset tests that means-tested programs employ have some effect in reducing saving among low-income households.[19]

Some resources are typically excluded from these asset tests, including an individual's home, household goods, and some or all of the value of an automobile, as well as assets that are not accessible. Other assets generally count, including retirement accounts that can be cashed in prior to retirement, even if there is a penalty for early withdrawal. In Medicaid, states have the ability to alter these rules and to eliminate the asset test altogether or to exempt more items from it.

In about half of the states, low-income workers who participate in defined contribution plans generally must withdraw most of the balance in their accounts (regardless of early withdrawal penalties or other tax consequences) and spend those assets down before they can qualify for Medicaid.[20] Similarly, poor elderly and disabled people who otherwise would qualify for SSI are required to consume upfront most of the funds they have accumulated in a defined contribution plan, leaving little for their remaining years, before they can receive SSI benefits. By contrast, benefits that a worker or retiree has accrued in a defined benefit pension plan are not considered an asset for these tests. The monthly income that the defined benefit plan provides is, however, counted as part of an individual's income when the individual retires and begins receiving this income. (In the food stamp program, the treatment accorded defined benefit plans is extended to 401(k) plans and similar employer-sponsored defined contribution plans as well, but not to IRAs or Keoghs. Balances in IRAs and Keoghs count against the food stamp asset limits.)

As the number of low-income workers with defined contribution plans continues to grow, an increasing number stand to lose various means-tested benefits if the balances in these accounts are counted as assets. In addition, workers with defined contribution pensions who experience temporary periods of need, such as during a recession, can be forced to liquidate their accounts (and also to pay early withdrawal penalties) before they can qualify for certain forms of means-tested assistance.

Reforms in this area merit consideration. Under current law, if an individual (whether working or retired) withdraws funds from a tax-deferred retirement account, the amounts withdrawn are counted as income. That is as it should be. But policymakers should consider excluding amounts in a pension account from the asset tests used in means-tested programs, regardless of whether the pension is a defined benefit plan or a defined contribution plan. Whether a worker is entitled to a means-tested benefit should not depend on whether the worker has a defined benefit or defined contribution pension.

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[19] See Peter R. Orszag, "Asset Tests and Low Saving Rates Among Lower-Income Families," Center on Budget and Policy Priorities, April 2001.

[20] Technically, in Medicaid, states can address this problem by excluding amounts in defined contribution accounts, using the authority of sections 1902(r) and 1931 of the Medicaid statute to do so. These authorities are not well understood by states. We are not aware of a state that has an asset test in its Medicaid program that has acted specifically to exclude defined contribution plans.

(C) Improving financial education provided by disinterested parties

A new book by Alicia Munnell and Annika Sunden (*Coming Up Short: The Challenge of 401(k) Plans*, Brookings 2004) documents the multiple mistakes that workers make in saving on their own for retirement. One clear explanation for such poor decision-making is a lack of financial education. As an example of the "education gap," a 1998 EBRI survey concluded that only 45 percent of workers have even attempted to figure out how much they will need to save for their retirement. Other surveys have also found a lack of financial knowledge.

The evidence suggests that the impact of employer-provided financial education on lower-income workers is greater than on higher-income workers. Higher-income workers tend to be more financially sophisticated to begin with, and employer-provided education consequently does not benefit them as much as lower-income workers. Expanded financial education campaigns and more encouragement to firms to provide financial education in the workplace may prove to be beneficial in raising retirement security for lower- and moderate-income workers.

Employers generally avoid giving specific investment advice to workers because doing so could expose them to potential fiduciary liability with respect to investment decisions. Unfortunately, the general financial education that may be provided under the Employee Retirement Income Security Act (ERISA) without triggering possible fiduciary exposure is too abstract to be of much use for many workers. As a result, Congress has considered measures to relax ERISA's constraints on investment advice. A measure considered by the Senate after the Enron debacle would allow independent third-party financial advisors to provide such advice under certain circumstances. An earlier bill, passed by the House, would permit investment advice to be provided by the firms that provide financial products to the plan; this approach is problematic, since it creates a conflict of interest that is subject to abuse. The experience in the United Kingdom with financial advice clearly underscores the critical importance of fully disinterested parties providing the advice.

My colleague, Mark Iwry, has proposed a different approach: plan sponsors could obtain relief from fiduciary liability if they include a prudently diversified, balanced portfolio in the plan's investment options. An employer could obtain a higher degree of fiduciary protection if it chose to make the standard balanced portfolio option the default -- the automatic investment for employees who do not affirmatively choose another option.[21] As discussed below, defaults exert a substantial influence on saving behavior.

(D) Promoting automatic saving

A final prong of sound retirement saving reform should dramatically expand the force of inertia to be enlisted in favor of saving, not against it. Evidence suggests that participation rates are significantly higher if workers are automatically enrolled in savings plans (unless they object), rather than if a worker has to make an affirmative indication of his or her desire to participate. In other words, participation rates are significantly higher if workers are enrolled in a savings plan unless they specifically opt out of the plan, relative to the participation rate if workers are *not* enrolled in the plan unless they specifically opt in.

One recent study examined 401(k) savings behavior of employees in a large U.S. corporation before and after changes to the 401(k) plan. Before the plan change, the employees had to elect to participate in the 401(k); after the change, employees were automatically enrolled unless they specifically requested to opt out. Given that none of the economic features of the plan changed, the purely "rational" model of economic behavior would suggest that the change would have no effect on 401(k) savings behavior. Contrary to the predictions of the model, however, the study found that 401(k) participation increased dramatically once automatic enrollment went into effect. It also found that the change affected not only participation, but also the amount people chose to contribute. The authors conclude that their results suggest that "changes in savings behavior can be motivated simply by the 'power of suggestion.'"[22]

To encourage the use of these effective plans, policy-makers could remove obstacles that prevent some plan sponsors from adopting them by steps such as clarifying the preemption of state laws to the

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[21] Iwry argues that this approach, while still allowing employees the freedom to choose among any other plan options, "would steer employees away from not only excessive investment in employer stock but also investments that fail to reflect reasonable asset allocation and diversification, including frequent investment changes, attempts at market timing, failure to rebalance, and excessive reliance on money market funds. Ultimately, such an approach could help move the defined contribution system back from investing on a "retail" basis to investing on more of a collective, wholesale basis, with the associated economies of scale and professional management. J. Mark Iwry, "Promoting 401(k) Security," Urban-Brookings Tax Policy Center Issues and Options Paper No. 7, September 2003.

[22] Brigitte C. Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics*, February 2002; 116(4): 1149-87. See also Richard H. Thaler and Shlomo Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," *Journal of Political Economy*, forthcoming.

minimum extent necessary to accommodate automatic enrollment; granting fiduciary safe harbor treatment for selected default investments; allowing a plan to disburse small account balances to an employee who decides to opt out soon after the automatic enrollment begins without a penalty; and reforming the matching safe-harbor contribution requirements (which allow employers to avoid non-discrimination testing under 401(k)s and SIMPLE plans) by requiring automatic enrollment of all eligible rank-and-file employees if the employer chooses to use the safe harbors.

Another way of making it easier to save was included in the Administration's Fiscal Year 2005 budget: allowing tax refunds to be deposited into more than one account. This "split refund" proposal, which reflects work by Lily Batchelder and Fred Goldberg of Skadden Arps along with others, would allow taxpayers to split their tax refunds and direct portions of their refund into different accounts. As Batchelder and Goldberg note, the proposal is highly promising as a mechanism for raising saving because:

- Refunds are a significant potential source of savings for many families. The average taxpayer's refund is approximately $2,100 per year, or 5 percent of median income. In addition, many lower-income families receive sizable refunds as a result of the Earned Income Tax Credit, and those refunds are often their only realistic opportunity to save during the year.

- The current IRS practice of only permitting taxpayers to direct their refund to one account significantly reduces the portion of tax refunds that are saved for two reasons. First, many families are reluctant to have their entire refund deposited to a tax-preferred savings account, like an IRA, because such accounts are intended for retirement saving and therefore cannot be used for every-day transactions. Second, while taxpayers can have their entire refund deposited into a checking account, and then transfer a portion of the deposit to a savings vehicle, it is likely that this additional step significantly reduces the extent to which refunds are saved.

- The split refund proposal would increase refund saving because it would make the process of saving refunds much simpler. It would also provide tax preparers with a natural opportunity to suggest that clients save a portion of their refund, educate clients about the tax and non-tax benefits of saving, and open new savings vehicles for clients who do not already have one. Some tax preparation firms already offer a service in which they serve as intermediaries for clients who want to split their refunds between a taxable account and a tax-preferred account. The interest in these services suggests substantial opportunities for gains from an IRS program of splitting refunds, which would be simpler and more universal than the services offered by tax preparation firms.

- The proposal is particularly attractive because it would not require additional legislation, and could be implemented under current law.

V. Conclusion

The nation's pension system is not living up to the task we have set for it. At any point in time, it covers only half the work force. Despite its substantial revenue costs, it may do substantially less to bolster retirement security than is commonly assumed, since it provides the largest tax incentives to households that would save sufficiently for retirement even in the absence of such incentives.

Recent policy shifts have exacerbated these shortcomings, and the Administration's Retirement Saving Account proposal would continue to move in the wrong direction. A change of course is necessary to enlarge the number of workers who reach retirement with sufficient assets to sustain their living standards. Major reforms may be desirable, but they require a measure of political consensus that is as scarce in pension policy today as it is elsewhere in American political life. Incremental reforms -- from improving the default options under 401(k) plans to allowing split refunds, expanding the low-income saver's credit and making it refundable, and exempting defined contribution plan assets from the asset tests in means-tested programs -- would be important steps in the right direction.

Chairman BOEHNER. Mr. Orszag, thank you for your testimony. I want to thank all of our witnesses for your excellent testimony and your input into this very important subject.

Let's begin with the basics. Retirement plans are voluntarily provided by employers. And as has been noted, about half of American employees have some coverage either through a defined benefit plan or a defined contribution plan.

I'd like to ask Mr. McCaw or Mr. Henrikson what the biggest obstacles are in employers' willingness to offer defined benefit plans.

Mr. HENRIKSON. I can take a shot at that. Defined benefit plans, over the years—I've been in this business for 31 years, and I think one way or another, the difficulty of maintaining a defined benefit plan because of perhaps a well meaning regulatory effects over the years has been very difficult.

It's very difficult to maintain and commit to a defined benefit plan, particularly considering the fact that it is a liability of the corporation, and the corporations are looking for things that can smooth out their expected financials.

So that's one thing. And the other thing, quite frankly, I think leads to lack of education in the population in general, because employees for a period of time back in certainly the '80's through the '90's, were not clamoring for defined benefit plans at all, and quite frankly seemed to be more focused on the idea of having financial freedom and investing the money any way they'd want to, being able to see their account balances and so forth. And I don't think people understood what they had in the defined benefit arena, an the employer was not being rewarded by sticking to those plans.

Now of course people realize what's happened.

Chairman BOEHNER. Mr. McCaw?

Mr. MCCAW. I would essentially agree with everything that Mr. Henrikson has said. Plus we've got, as we all realized in the last two or 3 years, some pretty difficult economic times that have a very dramatic impact on defined benefit plans, which of course the employer is insuring the employees against. He's taking the risk, providing the benefit. We've got more litigation. We've got legal uncertainties.

We do have well meaning legislation, but I think some of the legislation makes it very difficult and very expensive to run a defined benefit plan in this country right now, despite the fact that the legislation by and large was very well meaning.

And we've got some other outside influences that go beyond this room. We're looking at adopting international accounting standards for defined benefit plans in the U.S., which would bring the costing of pension plans to much more of a current market basis, which in my view does not take account of the long-term nature of both the assets and liabilities and provides inappropriately little ability to smooth and transition from good to bad economic times and back again.

So there's all kinds of things that are putting enormous pressure on what we believe is a very important part of the system, as I said earlier.

Chairman BOEHNER. Some believe that with the recent gains in the market over the last year that the need to replace the 30-year Treasury rate is not as urgent as it once was. Do either of you have any comment with regard to the replacement of the 30-year Treasury rate?

Mr. MCCAW. The only comment I would make is good times or bad times, I personally don't believe that the 30-year Treasury rate is a reasonable representation of long-term yield rates as far as pension plans are concerned, and as a result, since it's somewhat lower, it puts significant pressure on funding, and you could argue in terms of cashouts, which are also based on that rate, it may be paying bonuses on cashout that are in addition to the fair market value of the benefit.

So I'm not sure that the change in the economic environment changes the need for taking a long, hard look at changing that rate.

Mr. HENRIKSON. I would agree with everything Dan said, and I would emphasize that point about the discount rate being used for cashouts. Here again, you have a population that has a very difficult time understanding the longevity risk they're looking at, and yet they're actually being encouraged by a rate for cashouts that is not fair to the plan, and on the other side encourages the person, the individual to take a lump sum, which is not good for them either.

So I think it's a lose-lose all the way around.

Chairman BOEHNER. So you're both suggesting that the use of the 30-year Treasury rate for lump sum distributions is not in the best interest of companies or employees?

Mr. HENRIKSON. Well, not to get technical, and Dan's being an actuary would be better able to answer this, but actually when somebody takes cash out of a plan, you really don't know whether the plan was a winner or a loser until several years, many years have gone by.

And so it's just like, you know, weakening the financials of the plan by encouraging people to take lump sums, which hurts the strength of the plan for those who remain.

Chairman BOEHNER. Mr. Orszag, you talked about more employee participation in plans. And you made—you had some recommendations. But to have more employee participation, we need, one, more employers who are willing to offer plans, and second, we need more incentives for employees to participate in those plans. Do you have any further ideas about how we get more employers to offer plans?

Mr. ORSZAG. Well, I do think it's a difficult question. I don't think that, if you look at where the bulk of noncoverage occurs, it is in small businesses, and the surveys that EBRI and others have done that ask firms that don't offer pensions, why don't you offer them, provide some guidance. And many of the reasons are not that amenable to policy. Fluctuating revenues, workers who don't demand retirement saving as opposed to current wages. Those sorts of things are very difficult to grapple with at the Federal policy level.

I also think it's a mistake to think that we are going to get substantial increases in employer-provided plans by providing ever larger incentives for the corporate executives to participate. And I think that for two reasons.

With regard to the small businesses, many of the plans that are offered in small businesses, let's take a defined benefit plan, which I agree with the other panelists has a lot of benefits for most workers. In some small business settings, however, it doesn't, frankly. In a lot of small business settings, it is effectively a way for the owner and maybe a couple other key employees to obtain very large tax subsidies without covering the full array of workers through the various loopholes that already exist.

So I think we do in small business settings have to be careful about defined benefit plans. In larger corporate settings, I don't think policymakers should be, regardless of what we read about in the newspaper, corporate decisionmakers should not be making decisions of their overall compensation packages for workers as a whole based on their own personal interests. And regardless of

what read in the newspaper about that sort of thing happening, I think it's a very bad mistake to motivate Federal policy on that kind of personal corporate—personal executive interest. It's a violation of fiduciary duty to the shareholders basically.

So either in the small business community or in the large business community, I worry about this argument that the way that we're going to get better coverage is to provide yet more incentives for executives, especially given the evidence, which I think is overwhelming, that the tax preferences at the high end just lead to asset shifting.

So you're asking a very difficult question. I've pointed out things we shouldn't do. There are some suggestions I made both in my testimony and in some longer written materials about areas that I do think would be helpful.

I do think the nondiscrimination rules, for example, are too complicated, and they could be simplified. There are a variety of regulatory things that we can do to try to encourage more coverage, but there are also a lot of ways that we can go wrong here. And I think the fundamental thrust of policy over the past several years has not gotten it right.

Chairman BOEHNER. Mr. Miller.

Mr. MILLER. Mr. Orszag, you said that you felt that the default position, if you will, is that the employee is in the plan, and I assume in there you're talking about a 401(k) plan.

Mr. ORSZAG. Right.

Mr. MILLER. That they would participate. And your other point was that you believed that Social Security should remain at the core of the savings plans and these other efforts I assume are to supplement that and to improve the status of individuals to provide for their retirement.

I'd just like to ask the other members in your agreement on that, do you believe that we should—that the default position should be that the employee is in a 401(k) plan in that instance?

Mr. HENRIKSON. I think that would be great.

Mr. MILLER. Mr. McCaw?

Mr. MCCAW. I think it would probably actually help participation in the programs.

Mr. MILLER. Mr. Stein?

Mr. STEIN. Should have to opt out if they want to be out.

Mr. MILLER. They would—if they want to opt out, but—

Mr. HENRIKSON. Congressman, could I—one of the things that Mr. Orszag said, and the tax policy question is connected to this, it has to do with consumer behavior. I mean, everything we're talking about is consumer behavior in terms of whether or not something becomes effective or not.

The tax incentives, I couldn't agree more that we shouldn't drive retirement policy by tax incentives for executives. But I have to disagree with a statement relative to giving people a little bit, a tiny bit of tax incentive to look at retirement income annuities. The cost to the country, to the Federal Government, however you measure it, to have the kind of costs he's talking about, literally every person in the United States would buy an annuity contract. And since that's the consumer behavior we're trying to turn, I don't think that would happen.

So I just couldn't let that go relative to tax incentives. That's not—

Mr. MILLER. Let me raise another point here, and this goes—you've all testified how poor a job the baby boomers and everyone else in society is doing. In every, you know, financial writer that's designed for the average person, whether it's Money Magazine or Jane Bryant Quinn or Newsweek or Time, and people ask for advice, what do I do? What should I do? It's an up market, it's a down market, and everybody says the same thing. First and foremost if you're in—if you are offered a 401(k) plan and your employer matches, you must do that and maximize that contribution first and foremost. Then you can think about other things you want to do. And yet, huge—half of America doesn't do this that has it available to them. I mean, we're spending billions of dollars telling these people that if they don't keep consuming, the economy is going to go int he tank. I mean, we just need—we've got them in long-distance training now. We've got them past Christmas. We're getting them toward—we got them past Easter, they're heading into the summer season, we've got to get them right there for back to school. Come on, folks, and you're pulling them along. Get your grandkids, you know. I mean, these are the fittest people in the world. They're the fittest people in the world.

But what they're not doing is that they—I mean, they're obviously consuming. And I'm not here to bash whether their decisions about what they want to do with, you know, their personal lives. But a lot of people say there's really not enough discretionary income left over for people to then save. Which is it? What's going on here?

Mr. STEIN. Well, there are societies in which people are encouraged to spend, and also encouraged to save, and to save a lot more than we do.

Mr. MILLER. That's not this society.

Mr. STEIN. There's been a secular downward trend in how much households save in this country. Presumably, it can be reversed. It has been reversed in the last 3 years. The trend say from 1999 to 2004 is up in terms of personal household savings. It could be reversed quite a lot more. We need people with your eloquence to explain to people what the consequence of non-saving.

Mr. MILLER. You don't know me very well.

[Laughter.]

Mr. STEIN. The consequence of not saving enough when you're old and too feeble to work or too tired to work is disastrous. That has to be explained.

Mr. MILLER. Having never been called eloquent before, I'm going to leave.

[Laughter.]

Mr. MILLER. And go save.

Mr. ORSZAG. If I could just—

Mr. MILLER. Excuse me. Peter?

Mr. ORSZAG. Sure. Just quickly add two things. One is that I think it's very important, again, this inertia and the defaults is crucially important. If you show people the money and say, OK, here's $100, you can either save it or spend it, you're not going to get very good results. We've seen that over and over again. If you

say, Person A, you're about to get some raises over the next several years. How about if you pre-commit to saving a good chunk of those raises? People are more likely to agree to that, and they're more likely to save the money, because they don't feel like they ever had it.

And the empirical evidence on this is overwhelming. I don't think there's a single thing that you guys could do that would be more important than to encourage these sorts of precommitted automatic default savings plans in the 401(k) world.

So there is some hope that we can raise savings rates. But if you just sort of throw the money at people and say go out and do it, I don't think it works.

Mr. MILLER. Just one point. Let's take it to the next step. They decide to do that. Then, you know, Mr. Stein, your argument is what we've really got to do is make tools available to these investors. We've got to educate them. They've got to see that they can put together a plan, they can cobble it together in some fashion or another.

The other item that they're being deluged with is that this game isn't on the level. There were guys that got there after four o'clock and got to buy at the nine o'clock price and got to sell before the eight o'clock price. You know, there's this law professor from the University of South Carolina says maybe it's nine—Mr. Freeman says maybe it's $9 billion in excessive fees that have been raked out of the mutual funds system.

So we've got two hurdles, it seems. One to get them to save, and then if they save beyond what's controlled in one fashion through the 401(k) plan, you've got to then build some confidence in this consumer that this is a market where they want to go back into. You know, people are flooding into the market, but they're flooding in kind of on the blind pig theory.

Mr. STEIN. I think that can be done, sir, because it is true that every penny that is taken unethically is a shame, and everyone who does it should be prosecuted and punished to the full extent of the law. But the amounts that have been taken in this late trading and market timing are incredibly trivial, and by the scales of the amount that has been saved in these plans—any is too much. There's no doubt about that. And anyone who does it should be punished. But people should be informed that the fact that there are people who are misbehaving in this arena is no excuse for them not to save.

Mr. MILLER. No, but you see the comparisons of, you know, if you just take sort of the vanguard style index fund and the people who run the same kind of funds, but the fees here are .25 and the fees here are—I mean 2.13, and then they say, well, this is what it means to you over 15 years. If I think I'm going to save, I say what the hell's going on here? These people are providing the same service.

Mr. STEIN. But people have to understand that often when you are paying the higher fee—not always—but often when you're paying a higher fee, you're getting more service. I am reminded of something someone—well, I'm reminded of something someone said to me recently, which made a lot of sense, which is if you call up to buy 100 shares of GM, you do it through E-Trade, for which I

used to be a spokesman, you can just press a button and it's done, and nobody, not one single live human being has to do anything. If you buy a variable annuity, some man or woman has to come to your house, explain it to you, come back to your house, draw up a plan, explain it to you over and over again. It's an incredibly greater service.

Mr. MILLER. That's an argument for E-Annuity, or what?

Mr. STEIN. Excuse me?

Mr. MILLER. Is that an argument for E-Annuity?

Mr. STEIN. No. It's an argument for buying something that is customized to your situation by somebody who's spent some time investigating your situation.

Mr. MILLER. One final point if I might, Mr. Chairman, this point that Mr. Orszag made, we constantly are sort of raising the ceiling. But if I listen to a lot of your testimony, it's not the ceiling that's the problem. It's all the people that are well down below that that aren't contributing for one fashion or another. They're not making the maximum contribution under the current laws. And the question raised, Mr. Orszag, is at some point you get into asset shifting. Do you agree with that or don't agree with that?

Mr. MCCAW. I would agree with a lot of what Dr. Orszag said about who is taking advantage of the system as it currently stands, and it by and large is not low and middle income Americans.

This is a very difficult and complicated subject for an individual to deal with. How much do I need to put away? How much will it grow to by the time I retire? As you said a moment ago, why does this particular manager want to charge me X percent and this one Y? They kind of look the same to me. And when I do retire, how long am I going to live? And if something happened to me, how much should I leave for my spouse?

I'm not sure too many people are really capable of dealing with all of those issues, and I agree with everything that Mr. Stein said, but I'm not sure that people are very capable of dealing with those issues unless there's a huge increase in the amount of education that people have, and this is going to take years and years. I'm not sure we have years and years to deal with this gap. It'll help. It'll definitely help.

Mr. STEIN. Well, if I may just add to that, that is in some way an argument for having people come to your house and explain it to you in some regard rather than just calling up on the phone or using your computer to buy. There is some merit in having someone who has some education in the area explain it to you.

Mr. HENRIKSON. If I might, the other thing—there's a lot of good points being made here, and I echo them. The part of the problem in terms of education, you mentioned the press. You mentioned Jane Bryant Quinn and you mentioned so forth and so on.

In fact, we did a very interesting survey. And actually, most people get most of the information that they rely on from the press on financial matters. They get it from what they read in the newspaper. They get it from what they read and so forth.

One of the chilling aspects of what's happening today is that bad acting out there, and, you know, Ben's right about this in terms of the amount of relative dollars, it has more of a chilling effect on the consumer behavior. People focus on that. Whereas—and gath-

ering wealth. And so the focus has been on save to have a pile of money. And somehow, when you get to 65, you're home free. The most difficult time of your life in taking a pile of money and turning it into income is when you're 65 and going forward. A pension expert, a pension plan manager who's managing a large pension plan for a large corporation, if you freeze that plan and stop putting new contributions into it, and have to have a stream of income to pay all of those retirees for the rest of their lives, that individual needs to change the entire scope and format of the investment portfolio and then monitor it continuously to make sure there's enough money.

We're asking individuals to do that for themselves. It's absolutely impossible. So education is the name of the game. People do need face-to-face advice. People do not take care of this stuff themselves. They do not buy over the net financial products. They need help. They need someone to encourage them to do what they need to do for themselves and their families.

Mr. JOHNSON. Thank you for your comments. Since it's my turn to question, I think I will. I'd like any of you who want to answer, you know, in the Bush Administration pension reform proposals from last summer, one of the items would have prevented underfunded plans from increasing benefits, sort of if you're in a hole, stop digging it, you know. They keep promising more and more, but they keep delivering less and less it seems like. Would you all care to comment on that, whether or not that's a good policy change for us or not?

Mr. HENRIKSON. Let me take a shot at just commenting a little bit about history. In the first place, as was said one way or another before, the business we're in, that we've all been connected to in our careers, takes a long time for things to unfurl. I don't think to point to any particular 4-year period and say this caused it or didn't, it's just not true, because it takes a long time for financial experience to emerge.

There were times back with major manufacturing corporations where there were negotiations around wages, for example, six cents more per hour. No, we'll give you another ten dollars a month in your retirement plan. And that caused a huge problem in the United States. And so to try to stop that or slow that activity down and make sure that it doesn't happen again I think is a healthy thing to do. Now how to do that and what kind of regulatory methodology to use is—

Mr. JOHNSON. Well, it seems to me the more we regulate, the less people want to provide these plans, you know. It was a kind of a voluntary thing to start with. I think Boehner pointed that out earlier. If we start laying laws on them to make them do that kind of thing, I don't think that's going to work in a free enterprise system.

Mr. MCCAW. Well, I think we've already seen that, haven't we? I mean, one of the biggest reasons for a lot of organizations leaving the defined benefits system, because they haven't just been leaving in the last two or 3 years of difficult economic times. A lot of them are leaving the system in the '90's, plans and big surpluses. It wasn't a financial consideration largely. In large part, for many of these organizations, it was, as well meaning as it all was, regu-

latory considerations. If you talk to people in the boardrooms of America today, a lot of them will say on the pension issue, we just felt overregulated. We just felt that—it might have all been well intentioned, but to some degree, we just felt that it was just getting too expensive to run the program. And as one of the panelists mentioned a little bit earlier, and this is back to education, defined benefit plans as far as employees are concerned are also a little bit more difficult to understand. Perhaps you could argue, it's less important they understand them because they're not driving the car, the employer is. I think it is important that they understand them, by the way. But employees didn't understand them particularly well. So I'm paying all this money for a program. My employees don't appreciate it. I'm feeling overregulated. Let me think. What might I do about that? And we've seen what some of them have done.

Mr. STEIN. And if I may say, all of this goes back again to the fact that the individual has to take some responsibility here. The guy is sitting in the chairman's office or in the boardroom of a corporation, he's got pressure from all sides. He's got to cut his costs. He wants to avoid legal costs with regulation. Simple thing. Cut down or cut out the pension plan. Again, always the burden goes back to the individual.

And at the end of the day when some guy is in a nursing home thinking to himself, am I going to have enough money to pay my bill this month? He's not going to go to the guy who was chairman of his corporation 20 years before. He's got to rely on himself. Self-reliance is the American way. I mean, it's a cliche, but it's true.

Mr. JOHNSON. Well, you know, one of you made a comment in your remarks that we don't know how long we're going to live. I went to the doctor the other day. He told me I was going to be 105 when I died. So maybe I know. You ought to check with your doctor.

You know, would you talk to the 30 year Treasury rate? Is it an accurate measure? And what do we need to do about that? Because that really is affecting what's happening, too.

Mr. STEIN. Well, it's not an accurate measure in the sense that it—in many different ways. I mean, it's not an accurate measure in the sense that it doesn't really measure the real discount rate of long-term lendable funds, and it's not an accurate measure in that it doesn't accurately measure what people can expect to earn on the money, so it really is not an accurate rate.

Mr. JOHNSON. OK. Thank you. I appreciate your comments.

Ms. WOOLSEY. It would be me.

Mr. JOHNSON. OK. The chair recognizes you.

Ms. WOOLSEY. All right.

Mr. JOHNSON. Me is recognized.

Ms. WOOLSEY. Oh, thank you very much, Mr. Johnson.

Mr. JOHNSON. Thank you.

Ms. WOOLSEY. All right. In response to the free enterprise system. If the free enterprise system protects only the wealthy, it is very clear that that gentleman in the nursing home is going to then depend on the—become a ward of the state, depend on Medicaid.

So what we should be protecting here and what we should be preventing is that need, that the wealthy stay wealthy, which they will, you know, and have every right to be. They've earned it. But that middle income and low income people don't become wards of the state, which every—the taxpayers, middle income and the poor workers, et cetera, pay for also.

So I'd like us to start talking—and something that Mr. Hendriks said—Henrikson said—is that 401(k) plans are not as secure as we would think they are, which we've seen, because of the economy and the ups and downs in the stock market. So I think all of us should take that as a really fair warning about what we are talking about when we're talking about going even further by privatizing Social Security. We need a base. We need a secure base.

OK. Now I would like to talk to Mr. Orszag about the fact that if we're going to turn this around, if we're really going to protect low income and middle income workers, because you see, they have the same overhead as this wealthy family. I mean, the basics of what a person needs when they get older, I mean, so you've got a lifestyle that you need to support. That's different than the absolute basics. How can we put together a plan where we turn it around where we actually contribute more to the low income worker and contribute less as the workers earn more? Because they then can afford to do more on their own.

Mr. ORSZAG. I think there's several elements to that kind of package that would make sense. I mentioned some of them. Removing the disincentives to saving. For example, the asset tests under means tested benefit programs. Enlisting the force of inertia to get these lower and moderate income households into the plan and saving and pre-committing their future pay raises toward saving has been shown in studies to be particularly effective.

And then I think we have a tool that is on the books but that is limited and flawed as enacted, which is the saver's credit. The saver's credit provides a 50 percent credit, and actually on an after-tax basis, that's like 100 percent matching rate. It's a very powerful incentive, but it's not refundable, which means there's millions of households who qualify on paper for it but receive actually no incentive to save because they have no income tax liability against which to offset with the credit.

I think if we made the credit refundable and we extended that 50 percent credit rate a little bit up the income distribution, combine that with automatic enrollment and the split refund kind of proposal that the Administration has already put forward, do a few other things like remove the asset tests or the disincentives from the asset tests, and I've laid out a few other more minor things, that would be at least a substantial step int he right direction.

And I can't promise that we would then get 90 percent participation rates, but it would help, and it would at least be pointing in the right direction rather than continuing to move in the wrong direction as I think Federal policy largely has been over the past several years.

Ms. WOOLSEY. And would there be any suggestion of when there's matching funds that the employer then would match more for the low income worker than the higher income worker? Reverse.

Mr. ORSZAG. One of the things about saver's credit and one of the things that's very important in designing these sorts of incentives is that the saver's credit applies not just to IRA contributions but also to 401(k) contributions. You don't want to be creating an incentive for more low or moderate income household saving that dissipates interest in employer-provided plans.

I couldn't agree more with the other panelists that basically employer-provided plans are the way to go, because if you look at the do it yourself, go off and save on your own, participation rates are very low. It's striking. If you look at $20,000 or $30,000 in earnings, the worker is offered a 401(k) plan at those earnings levels, participate 50, 60, 70 percent rates. It varies a little bit depending on exactly what your cutoff is. Participation rates in IRAs at those income levels, about 5 percent. I mean, striking difference in the sort of do it yourself approach of an IRA and an employer-based plan where you have the water cooler effects of people talking about it. You have the employer match. You have the nondiscrimination rules that may be helping, and a variety of other forces. We can't afford to lose the benefits from that kind of pooled employer provided approach.

Mr. STEIN. May I make a comment? We can't really afford to lose any source of saving whatsoever. So the self-motivated saving, which is not subsidized through a 401(k) plan, through the employer, is vital too. The savings gap for retirement is so enormous, madam, that anything we can get is very valuable. There's nothing it seems to me that should be overlooked, including, I go back to something as basic and seemingly trivial as education, which doesn't necessarily have a large cost to the taxpayers, but which will we hope frighten people enough to start them saving.

Ms. WOOLSEY. Well, I agree with that, but I believe the President's budget has cut funding for pension education.

Mr. JOHNSON. Thank you, Ms. Woolsey, for your comments. Mr. Ehlers, you're recognized for 5 minutes.

Mr. EHLERS. Thank you, Mr. Chairman. And I really appreciate the hearing. I apologize. I had to step out for a Transportation Committee markup, so I hope my questions aren't redundant with something you said or someone else has asked.

This is a very important hearing, and I really appreciate that we're having it, Mr. Chairman. I've been concerned for some time, because I've read some of the statistics that you quoted, particularly Mr. Stein, about how little Americans know about this issue, how many think that their nest egg plus Social Security will carry them through.

But let me ask a couple questions about a different stage where I think education is very important, and that is when they are retiring and they have to make decisions about what to do with the money they have.

Now what options are typically the best for them to consider, and how can we help educate the public about that particular aspect? For example, are annuities the best retirement instrument because they provide a steady rate of return or a guaranteed rate of return until they die? How does inflation affect those? If there's considerable inflation and they're on a fixed annuity revenue, what happens? And do variable annuities fit into this? Are these the best in-

struments for people to look at, or is there something here that I'm not understanding? We'll just go down the line. Mr. Stein?

Mr. STEIN. I would always recommend a diversified portfolio. It seems to me diversification is the best friend the investor has. But annuities have a valuable place in that diversified portfolio because they do distribute the risk away from the retiree, who cannot really afford to take the risk, and toward a large pool in the form of an insurance company who can afford to take the risk and have the understanding of how to take that risk. That's incredibly valuable.

There are instruments that can be variable annuities take advantage of what we hope and has historically been a long-term growth in assets, especially in the stock market. So to some extent would offset inflation. But this again is why it's valuable to consult with an adviser, and it's extremely valuable to consult with an adviser who understands the individual situation that each retiree is in, rather than trying a one-size-fits-all approach so you buy over the Internet or over the phone.

Mr. EHLERS. Are these advisers licensed, certified? I mean, how does the consumer know?

Mr. STEIN. They are trained in various ways. I think any respectable or large insurance company or broker would only have employees who have a certain amount of training. I must say my experience in buying annuities recently has been that they put you through an exhaustive treadmill of tests to see what is appropriate for you.

Mr. EHLERS. And what are the guarantees for the consumer? You know, we have the bill to protect the pensions of workers, but what if the economy really goes bust and the insurance company is in financial problems? Is there any protection then?

Mr. STEIN. Well, that's a good point, but that's another argument in favor of diversification. I'm not sure that, aside from the companies in the Drexel junk bond insurance empire that any large insurance companies have gone bankrupt in the United States in the postwar period. So I think you would be fairly safe with any of them.

Mr. EHLERS. OK. Let's go down—yes, Mr. Henrikson?

Mr. HENRIKSON. Yes. A couple of things I'd like to emphasize. First, your point about people coming close to retirement at the workplace and needing help at that time is right on. I mean, I couldn't agree with that more. And leveraging the power of the workplace, bringing people together, giving them information in either a seminar setting or a pre-retirement setting for a group of people is actually very, very effective. Because, in the first place, people know that they are hearing the same information that others are hearing. They can ask any questions. Others can ask questions that they may not have thought of. And so this really leverages advice at the work site in a major way.

In terms of the annuity contracts, in the first place, I don't think anyone's suggesting that just blanket that everybody should put all of their money in an annuity contract. It's very much up to the individual and what their particular needs are.

The underlying investments in a payout annuity now in today's world with the amount of options available and so forth, the retiring employee literally can take the mortality risk portion of his life

off the table and buy that protection from the insurance company and invest in the underlying securities in any diversified way, as Mr. Stein pointed out, he or she so desires. So today you can buy an annuity that you might say 50 percent of my income I'd like to have it just guaranteed. The other 50 percent, maybe I could live with market fluctuations.

That monthly paycheck will vary depending on those market fluctuations. But the person can never outlive their assets. This is extremely important to understand. So there's a lot of option today. People can tailor make financial instruments to their own desires. But the one thing that I mentioned about mortality guarantees is if you look at it from the standpoint of risk to the individual, the difficulty of pinning what your longevity risk is dwarfs, dwarfs what the risk is in investing, for example, in small cap stocks only. The mortality risk is much more difficult, and it can be insured simply by individuals joining that pool.

Mr. EHLERS. And just getting back to the education for a moment. Both of you have talked about education in the workplace. But there are many individuals who don't work in much of a workplace. A person that is self-employed or there are three people in the firm. Are there advisers or educational programs available for those individuals?

Mr. STEIN. I know that in California, where I'm from, in Southern California, a number of the community colleges offered courses and programs in that. But I certainly would ask that whatever you can do to encourage the broadcast media to talk about this, it would be very helpful.

I'm mindful of the fact that I'm on a show on Fox News every Saturday talking about the stock market, and they always ask me what my prediction is for the stock market for the next week, and I always say my prediction is you're going to get another week older and closer to retirement, and you'd better make preparation for it. And I wish some people would be talking more about that.

Mr. EHLERS. Well, that's precisely why I'm raising these questions, but I want the word to get out.

Chairman BOEHNER. I thank the gentleman for his questions. The chair recognizes the gentleman from Ohio, Mr. Ryan, for 5 minutes.

Mr. RYAN. Thank you, Mr. Chairman. And I appreciate you all coming today. I have a couple of questions. Mr. Stein, you were talking about the education process. Can you tell us a little bit—face-to-face, are you really talking about going to these people's homes and educating these folks?

Mr. STEIN. No, we—well, I think that should be done by local—the people who go face-to-face and go to people's homes are people who are selling financial instruments or financial planners or people who have passed various financial planning tests, and those people have a financial interest in making a sale. But they also have a financial interest in making the right sale so that people will be coming back to them.

And we do have data, by the way, that people who buy annuities, I don't know if there's data for other financial instruments, but people who buy annuities are very happy with them on an over-

whelming basis. But I think there should be some kind of national program about this at schools and the community colleges.

I grew up in the schools of Montgomery County and went to the schools in Montgomery County, Maryland, right next door. We were taught even in elementary school and junior high school about the incredible importance of saving for retirement when we were playing with Hopalong Cassidy toys. And I notice that the people I went to school with seem to be in very good financial shape by and large no matter what their jobs were. This doesn't seem to be taught anymore, and I wish it would be taught at every level.

It seems to me no matter what you do to incentivize employers, it's still going to be the basic responsibility of the employee and the worker to take care of himself or herself, and that should be taught more.

Mr. ORSZAG. If I could just add to Mr. Stein's comments quickly. The evidence—there is empirical evidence suggesting that people who are exposed to financial literacy and financial education courses in high school do wind up saving more than others. And yet in the education debate, one doesn't really hear about financial literacy being part of the core curriculum for high school students. I think it should be.

Mr. RYAN. Well, given that this is the Education Committee as well, maybe we can take that up, Mr. Chairman, and include that in the No Child Left Behind.

Mr. HENRIKSON. This was, by the way, a conclusion at the Saver's Summit here in Washington both times—both times it came up that focus for education at the grammar school level was absolutely essential.

Mr. RYAN. For some of those people, too, Mr. Stein, you may have to teach them who Hopalong Cassidy is.

[Laughter.]

Some of us don't know that either. One other question. You talked a little bit about the defined benefit and the fact that it's overregulated, and that's one of the main reasons why. And then someone also mentioned too simplifying the nondiscrimination rules. Is that the only thing we can do? What else can we do to try to make this simpler, to lessen the regulatory burden?

Mr. MCCAW. Well, the comment about anti-discrimination rules being simplified, that certainly is one area. There are all kinds of rules, as I'm sure you know, that apply to defined benefit plans, all well meaning. Some of the legislation around the PBGC, some of the legislation around this 30-year bond issue that is currently being looked at. It's quite a long list of things that could and should be looked at in terms of putting us in a position where the defined benefit system is more appealing to American companies.

There are still going to be risks associated with it, of course, because by definition, if you have a defined benefit pension plan, it's the company, not the employee, who's taking the risk and delivering the benefit, by definition. You have defined the benefit. And once you've defined the benefit, the cost of that benefit fluctuates with the economic times, and that fluctuating cost goes to the employer. That's understood.

But I think there's sort of a basic premise here that we should all recognize and really hasn't exactly come up other than indi-

rectly. One of the great things about a defined benefit plan is that the organization is taking the risk and the organization, most of them in any event, go on for years and years and years.

You and I retire on a pretty predetermined by our parents essentially, fairly narrow range. And where the economy is, and we're at that point in time when we choose to retire or when we come to the point where we must retire, is something that's completely beyond our control. The employer can go with the ups and downs of the economy, and many have for 40, 50, 60 years. That's not our choice.

Mr. ORSZAG. Yeah. I guess I basically agree with much of what was said. And I think you face a very difficult challenge in trying to convince corporations at this point to go back to traditional or to renew interest in traditional defined benefit plans. So we can perhaps nudge on the margins, but we should be realistic that it seems like that is a very high hurdle to cross.

I want to just, if I have a second, just to follow up on the annuities question. Because I think annuities are a very important source of protection for retirees that are currently underappreciated. But it is important to realize that for a typical worker, because insurance companies naturally have to price the annuities based on the people who actually purchase the annuities, who tend to be higher income and have longer lives than the typical worker, research has shown that for the typical worker in present value, there is about a 10 or 15 percent reduction in the value of your balance when you annuitize, and that's because insurance companies naturally have to price based on the people who are actually buying annuities rather than the overall population. And that is a sort of selection effect that is very important to realize.

The question is, how do we get more people into annuities? The question had arisen earlier about tax incentives. The reason that I'm skeptical about the modest tax incentive that was included in Portman-Cardin last year is that two-thirds or three-quarters of workers are in the 15 percent or smaller, or lower marginal tax bracket. You're not providing a huge incentive for them.

And I do want to clarify. I did not mean to say that that provision alone would cause trillions of dollars in revenue losses, but rather we are assuming that there are trillions of dollars in revenue losses on withdrawals from these 401(k)s and IRA plans. And I worry that as soon as we violate the principle that if you got the tax break up front and enjoyed tax-free accumulations, you pay tax on withdrawals, even if it's for a good purpose, like annuities, as soon as you violate that principle, the floodgates will open, and you won't be able to prevent tax breaks for this, that and the other thing on withdrawals, and then we are talking about trillions of dollars in revenue.

So I just wanted to clarify that I didn't mean to imply that provision alone would be trillions of dollars.

Mr. STEIN. But you don't get the tax break on the annuities going in, so it would not be violating that principle.

Mr. ORSZAG. I'm sorry. The proposal, as I understood it, was to allow up to a couple thousand dollars in annuity income to be tax free even if it's coming out of a 401(k) or IRA plan which had upfront tax breaks associated with it.

Mr. STEIN. I thought you were referring to an idea in which there would be no—there would be a reduction in tax on contingent annuity payments if there had not been a deduction—

Mr. ORSZAG. No. This is a proposal that was in Portman-Cardin last year.

Chairman BOEHNER. The chair recognizes the gentleman from Georgia, Mr. Isakson.

Mr. ISAKSON. Mr. Henrikson, I've read your testimony, listened to part of it and I was called out. So I read all of it when I got back, and particularly the survey and the results of the survey of what Americans know about retirement and what they know about planning for it, and I have a question for you.

The survey and all your comments indicate we're in deep trouble in terms of the working knowledge of the individual and what they need to do to be prepared. Do you have any strategies that you recommend that we would be better off in terms of preparing people, No. 1? And No. 2, is there a role for the Federal Government in that preparation and that knowledge?

Mr. HENRIKSON. Well, let me start with the second. Anything that the Federal Government does in a public way I think is very helpful in the debate around this topic. So, for example, in a related area, when the Federal Government decided to provide a long-term care insurance for Federal employees, it was a terrific lift in the United States in education going out around long-term care programs. So anything that fosters discussion and education around these issues is very, very helpful. And of course the Federal Government is powerful in being able to do that.

We are working and have been working for a long time on this problem, and it is a difficult one. I would not, by the way, and I don't know that anybody implied this, but this is not just the recent generation phenomenon. When I said in my testimony that we're asking people to do the first time, something for the first time in U.S. history, I really believe that. If you look at people in my parents' generation, they were not saddled in the same way with something that I think is just a wonderful phenomenon in the country today, is that people are going to live a long time. But that creates a very, very difficult issue relative to retirement and savings.

So I think if we can speak in the retirement community about not accumulation of wealth, around how much you might leave your children if you pass away, but taking care of yourself first and having your children be very, very happy that you are self-sufficient is a bigger reward to your kids for most people in the United States than trying desperately through fear to stop spending money as you become older and older.

One of the biggest problems in this country is not only the people that don't have enough, but the people that have saved enough, but when they go into retirement, we see what happens. We have data on this. That folks look at their 401(k) balance, they look at their savings, they don't live off of it, because they're afraid. And one way to get rid of the fear is to knock out the impossible task of self-insuring your own mortality.

So it all has to come together in a way that, from an education point of view, in a simple way that people can understand things.

We have in the 401(k) arena, for example, and I love 401(k) plans. We're a major provider of 401(k) plans, and I think they're wonderful. But we know some interesting things about them. There is a correlation between the number of options people have in 401(k) plans and their participation. I.e., the more options they have, the lower the participation is. Why? Because they're confused.

We know major corporations that we've done recordkeeping for where we do status reports for them, that major, well known corporations, sophisticated corporations with sophisticated employees, have 401(k) plans where no one changes the assets. Seventy percent of the people don't change their asset allocation at all. And we don't know whether that's because they're reconfirming something they think is right, or whether they're scared to death. We don't know.

But I know something for sure. If you think income averaging into the marketplace is difficult, you ain't seen nothin' until you try to income average out.

Mr. ISAKSON. Right.

Mr. HENRIKSON. There was a very well known individual, very respected individual, who made a very good point not too many years ago when the market started bouncing around, saying that, you know, income averaging in is not the right way to go. People should value average in. So if the market goes down 30 percent, just increase your contributions by 30 percent. Well, I don't know what planet that individual lives on, but I do know that what that means to retirees, if you follow that logic, that when the market goes down 30 percent just cut your income by 30 percent.

People can't live that way. And all of this has to get to the forefront through education.

Mr. ISAKSON. Mr. Chairman, I know my time is about up, but I would like to make one comment. I agree with you that it is a historical problem of people not being well enough educated on planing for their retirement, but I do think there's a difference in this generation and previous generations. I think previous generations expected that they were going to have to take care of themselves. Today's generation, or a lot of them, believe somebody's going to do it. And somebody oftentimes ends up being the government. And so this is not really a question but a comment.

We have an obligation to the taxpayers of the United States of America to help them see the light on being prepared for their retirement, because if we don't, when they do retire and it's not enough, even to subsist on, they're going to come to the government which in turn is back on the taxpayer, and it's a cycle that—and the numbers looking at the baby boomers is very, very serious consequences for economic policy in the country. And that's just a comment.

Thank you, Mr. Chairman.

Chairman BOEHNER. As we near the end of this, let me ask this question. As much work as we're going to put into helping save defined benefit plans for American workers and help encourage employers to offer them, does anyone at the table believe that the exodus will slow down or come to an end and that we're not likely to

see a continuing shift to defined contribution plans like 401(k) plans?

Mr. McCAW. Well, I'll take a start at that. I think a lot of what we've talked about today and a lot of—the possibility of making some changes in legislation and so on, will at the very least slow down the exodus. And I continue to have some hope that in the right economic and regulatory environment, we may come to the day where we see more employers or some employers prepared to put forward a defined benefit plan for employees if for no other reason that I do see one thing in America today in terms of how organizations see their organization, and I think this is great, by the way. More and more companies are truly seeing the future of their organization doesn't rest in their fixed assets, doesn't rest in the raw materials. It rests in their people, having the best people, keeping the best people. That's going to be their competitive advantage. And as they look around at how they do that and how they keep those people and how they attract those people, I think this may be one of the programs that American industry may be looking at to make that happen. But there has to be some changes for them to be prepared to do that.

Mr. HENRIKSON. I agree wholeheartedly. The one thing that I would say, I think major corporations, very, very large corporations, who have exited the defined benefit business, I don't think there's much we can do in the short term to have them turn on their heels and go back.

I do think that formation in the middle market, smaller companies, can be encouraged and in fact could be—could be seen to be in a period of an uptick there, particularly if regulatory weight is not too heavy. If it's simple for them to do it, I think because of the human resource values that employers see, we could see an uptick in defined benefit formation.

Mr. ORSZAG. I think the answer really depends on whether workers change their perceptions of the attractiveness of defined benefit plans versus 401(k) plans. One of the reasons we've seen the shift is workers seem to prefer 401(k) plans.

With stock market fluctuations, which have really hit home to some near retirees, it's possible that workers will develop a larger appreciation for the benefits of a defined benefit plan. If that were to occur, then I think you will see more firms offering them as a way to attract high quality workers. But in the absence of that, it's a hard sell.

Mr. STEIN. It's a very hard—and it's a question which is really extremely difficult to answer, especially in light of the extraordinary burden of foreign competition, especially in manufacturing. But what we do know is no matter what they do, no matter what the employer does, the employee will be very well served to provide as well as he or she can for his own needs.

Chairman BOEHNER. Well, I thank all of our witnesses today for your excellent testimony and your assistance in what will become I think one of the biggest issues that this Committee will be dealing with over the next several years.

Thank you all very much. This hearing is adjourned.

[Whereupon, at 12:10 p.m., the Committee was adjourned.]

[Additional material submitted for the record follows:]

Statement of Hon. Jon C. Porter, a Representative in Congress from the State of Nevada, Submitted for the Record

Good morning Mr. Chairman. Thank you for convening this committee on this most important issue. I also wish to extend my appreciation to this panel of witnesses for sharing their experience and knowledge on the need to reevaluate our current pension system. Ensuring that Americans are financially secure in their retirement should remain one of the highest priorities of this committee and this Congress.

As an increasing number of Americans prepare for a retirement that will last significantly longer than past generations, our job of examining the pension security of all Americans becomes increasingly important. The need for adequate education on and understanding of the financial needs of retirees has become paramount. As we look at means of augmenting the dissemination of this kind of knowledge, we must acknowledge that significant numbers of Americans lack the essential knowledge to ensure that their retirements are not fraught with the distresses of poverty.

While we must work to make Americans informed consumers when it comes to their retirements, we need also to make significant progress in reforming the defined benefit pension system in this country. Reforms of this important system, and taking steps to ensure that the Pension Benefit Guaranty Corporation is based on a sound financial footing, will allow greater flexibility and portability among working Americans as they seek to prepare themselves for retirement. Americans today and for generations to come will reap the benefits of these reforms as a strengthened pension system will provide an essential aspect of retirement security.

The hard work of America's retirees deserves our greatest efforts in bringing to them the highest levels of comprehension on the need to plan adequately for a secure retirement. This hearing serves as a starting point in our effort to bring to our constituents this message of fiscal responsibility. I believe that spreading this message to our constituents will enhance their ability to plan for their old age effectively and with minimal constraint on their lives before and after their retirements. Again, thank you Mr. Chairman for convening this necessary hearing. I am sure that the insight of these witnesses will better equip all of us who sit on the committee to better comprehend the need for work in this important area as we try to ease the potential burdens of retirement for our constituents.

Statement of Hon. Charlie Norwood, a Representative in Congress from the State of Georgia, Submitted for the Record

Thank you Mr. Chairman for holding today's hearing on the very important subject of pension security. I look forward to the testimony of our witnesses, and as always, I appreciate their time and expertise in shedding light on this absolutely critical issue facing the American workforce today.

Mr. Chairman, I am pleased that our Committee is continuing to explore solutions to the pension security system for workers, and look forward to working with you and the rest of my colleagues on the Committee in developing comprehensive legislation to improve the long-term viability of private pension plans. Simply put, it is time we address this growing problem and begin to tackle the issue before millions of hard-working Americans are forced to retire with an insecure future.

Too many Americans do not have the information or resources at their disposal to make proper plans for their future, and as we well know from previous Hearings on this very subject, the structure of our private pension system may in fact be structurally inadequate to meat their retirement needs.

Mr. Chairman we cannot allow this trend to continue. If American workers are to enjoy their golden years in a secure retirement, Congress must be prepared to enhance pension security by reversing the decline of the defined benefit pension system, providing workers with sufficient information and decision-making tools, and expanding retirement plan coverage for those that do not have it already.

As I alluded to earlier, this Committee hosted a similar hearing in 2003 where we learned about the poor financial health of the Pension Benefit Guaranty Corporation (PBGC), including the startling fact that the PBGC continues to face an $8.8 billion deficit. The PBGC is responsible for guaranteeing payment of basic pension benefits for 44 million American workers and retirees participating in some 30,000 private sector defined benefit pension plans. However, this number is down dramatically from 170,000 in 1985, and does not include a number of plans that have been frozen to exclude new employees.

This decline in the number of defined benefit pension plans is symptomatic of the increasingly elaborate and inefficient nature of the private pension system, and di-

rectly contributes to the lack of retirement security for employees in the private pension system.

It is also disturbing that so many American workers and retirees have dramatically underestimated how much money they will need in order to retire after a lifetime of hard work. Statistics consistently suggest that the American workforce is not prepared to make the decisions today that will directly impact their quality of life tomorrow, including a recent survey conducted by the Employee Benefit Research Institute that found less than 4 out of 10 American workers have even calculated how much money they must save before retirement. If this is indeed the case, and there is a "pervasive lack of knowledge about key retirement financial issues," Congress must consider alternative methods to provide workers with the education and decision-making tools they need to plan for a secure retirement.

At the same time, we cannot ignore the fact that 6 1 % of all workers between the ages of 24 and 64 have no retirement accounts at all! Even those lucky enough to enjoy a private pension account carry a median balance of less than $25,000.

Mr. Chairman, I don't know many families from Augusta, GA that can retire on less than $25,000.

What is it going to take to reverse these alarming statistics? What is it going to take to make sure hard working Americans are not left penniless in their retirement? These are the questions I look forward to exploring as this Committee begins to delve more deeply into the issue of private pension security for the American workforce.

Today, I look forward to hearing our witness' thoughts on how Congress and the Administration can begin to reform our system to ensure that our workers retire with dignity and security. As a proud supporter of your bill, the Pension Security Act of 2003, you can be sure that I will continue to actively seek out reforms to our private pension system that will expand coverage, improve decision-making and restructure the Defined Benefit Pension System in an appropriate way.

Thank you Mr. Chairman and I yield back.

Statement of American Council of Life Insurers, Washington, DC, Submitted for the Record

The American Council of Life Insurers, ACLI, is the major trade association of the life insurance industry, representing nearly 400 life insurance companies. Our member companies provide life insurance, annuities, pensions, long-term care insurance, disability income insurance and other retirement and financial protection products designed to help Americans plan for and achieve retirement security. Insurers hold one-fifth of the privately administered retirement assets in the United States—approximately $1.3 trillion. Life insurers are the fourth largest institutional source of investment capital, holding over $3 trillion dollars in U.S. Capital markets in 2002.

ACLI applauds the Committee's continued interest in reviewing and modernizing the Employee Retirement Income Security Act of 1974 ("ERISA"). The bipartisan review begun by Chairman Boehner and Representative Andrews over the past several years represents the first time Congress has looked in depth at ERISA's statutory framework in light of the many changes that have occurred in the retirement plan market place in the 30 years since ERISA's enactment.

ACLI strongly supports the Pension Security Act of 2003 (H.R. 1000), which was introduced by Chairman Boehner and passed the House by a vote of 271-157. That bill provides additional protections to participants in defined contribution plans in light of the Enron bankruptcy and promotes the provision of retirement investment advice to workers managing their retirement income assets. In addition, ACLI supports efforts by the Committee to develop legislation to replace the 30-year Treasury rate with a rate based on long-term corporate bonds for purposes of pension plan funding requirements. We note that Chairman Boehner's bipartisan bill to replace the rate, H.R. 3108, passed the House by a whopping 397-2 vote. A replacement rate is critically important to the employer community (our clients) who administer and maintain defined benefit plans for their employees.

Clearly, when ERISA was enacted, defined benefit plans were the predominant type of employer-sponsored retirement plan. ERISA sought to strike a balance between encouraging employers to adopt and maintain these plans and protecting participants covered by them. ACLI believes this Committee has tried to strike that balance in adopting a temporary replacement rate for the 30-year Treasury rate while continuing to come up with a permanent solution to the critical issue of funding of defined benefit pension plan obligations. ACLI wishes you well in conferencing with the Senate version of H.R. 3108 because this funding relief is so urgently needed.

The Chairman and the Members of the Committee are to be commended for this timely hearing on an issue of extreme importance to the nation. Years ago, Congress recognized the importance of the private sector in helping working Americans achieve adequate retirement income. As a result, it encouraged employers and employees to use a voluntary private retirement system to supplement the economic protection offered by public programs such as Social Security. The issues of planning for retirement and strengthening defined benefit plans are being considered at a critical time. With the aging of the baby boom generation, coupled with the uncertain future of government entitlement programs, including Social Security, it is critical that voluntary employer-sponsored plans and individual savings be strengthened to meet the retirement security challenges of the 21st century.

Highlighting the need to plan for retirement is right on target. Planning for retirement would be easy if we knew when we were going to die and if we would need long-term care and for what duration. Planning and preparing for the unknown is scary. Americans need to understand the importance not just of earning benefits or accumulating savings, but of planning to *protect* these savings against the uncertainties of what life might hold, such as outliving one's income or needing long-term care. We need to do more to encourage all Americans to accept the dual challenges of accumulating retirement assets and managing risks to these savings during retirement.

What we have seen since the enactment of ERISA is a decline in the number of defined benefit plans and an explosion in the growth of defined contribution plans. The diminishing number of defined benefit pension plans is a significant loss to our nation's retirees as American workers' retirements are lasting longer and longer. Thanks to our nation's increased longevity 20 or 30 year retirements are becoming more common.

One of the critically important aspects of defined benefit plans is that the payment of benefits must be offered in the form of a joint and survivor annuity. A joint and survivor annuity covers the lives of the worker and spouse for as long as both live. This

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[1] ACLI believes Defined Contribution plans should be required to offer a joint and survivor annuity to plan participants as well.

means that defined benefit plan participants have the opportunity to protect against outliving their retirement assets by availing themselves of a guaranteed stream of income for life.

Over the years, defined benefit plans have offered additional payment options to their participants. Many of these plans offer a lump sum payment option. Moreover, when benefits are offered in a lump sum, participants tend to take their benefits in that form. Unfortunately, focus groups suggest the reason is that many workers believe they can better manage their assets in retirement. However, as the attached chart shows, these participants would clearly do better if they had chosen to "annuitize" their benefits, i.e., if they had chosen to have benefits paid over a lifetime.

A 65-year old retiree annuitizing $100,000 in savings today would receive $8,800 annually for the rest of his or her life,[1] no matter how long he or she lives. An individual cannot do better by self-managing the money, assuming the same rate of return on investments. This is due to the insurance element of annuitization, i.e. the pooling and sharing of longetivity risks.

If the retiree self-annuitizes the money and draws out $8,800 each year, he or she will deplete the savings by age 80. An individual could try to ensure steady income till age 100, but this means less retirement income each year ($5,250) compared to annuitization and assets would still be exhausted if the individual lived past 100. An individual could even execute a self-managed withdrawal program guaranteeing that income would never run out; but again, income would always be less than that from annuitization, especially at older ages.

Annuities are contracts sold by insurance companies that provide periodic payments for life or for a specified number of years. Annuities are the only investment product that can guarantee income to retirees over their lifetime, no matter what happens to the stock market. Installment payments or programmed withdrawals from mutual funds do not offer a guaranteed stream of income. Moreover, annuities are flexible and can be offered in a range of choices to accommodate individual needs. They can offer significant spousal protections, protections against inflation and protections against premature death. For example:

- Joint and survivor annuities protect retirement income for the lives of both spouses.
- Refund annuities protect retirees who fear dying too early. Under this annuitization option, the beneficiary or the estate receives an amount equal to the premium if the annuitant dies before this amount has been paid as a benefit.
- Indexed annuities provide inflation protection.
- Life annuities with 10 year (or longer) guarantees ensure that payments continue to beneficiaries if the annuitant dies before receiving benefits for at least 10 years.

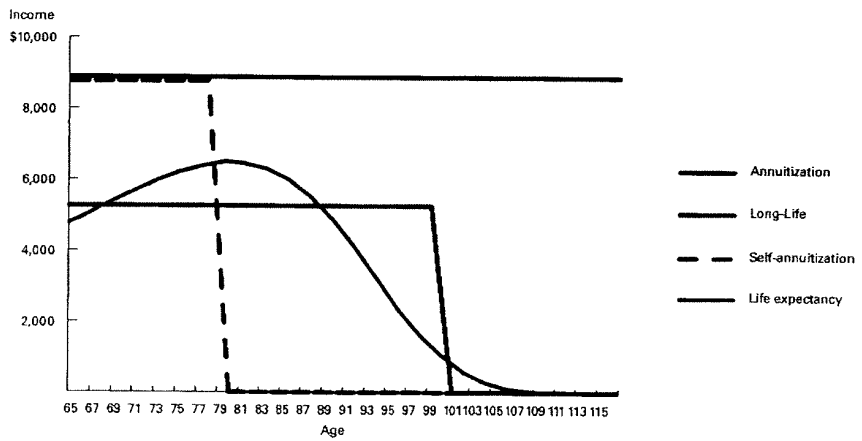
ACLI believes that incentives to annuitize at least part of participants' retirement benefits should be enacted. Other Members of Congress including Members of this Committee have supported such legislation. H.R. 1776, the next generation of Portman/Cardin, contains such a provision. It provides for an exclusion from income for up to $2000 annually from an annuity stream of income. Representatives Earl Pomeroy and Johnny Isakson have introduced a similar stand-alone measure contained in the Secure Annuity Income for Life the SAIL Act, H.R. 2458.

Getting back to the chart, if participants are educated about the advantages of planning for retirement with an annuity and are provided with an incentive to do so, we will have come a long way in securing retirement for millions of Americans.

ACLI looks forward to working with this Committee as you move forward in efforts to strengthen defined benefit pension plans and to encourage American workers to plan for their retirements. Again, retirement security is not just about earning benefits or accumulating assets---it is about managing those benefits and assets during retirement. Please feel free to contact us if we can provide any assistance in these efforts.

101 CONSTITUTION AVENUE, N.W.
WASHINGTON, D.C. 20001
WWW.ACLI.COM

ANNUITIZATION VS. ALTERNATIVE ASSET MANAGEMENT STRATEGIES



Sources: Jeffry R. Brown, *Taxing Retirement Income: The Case of Non-Qualified Retirement Annuities*, paper presented at Stanford Life Insurance Taxation Workshop, Washington, D.C., December 2000; and Ron Gebhardtsbauer, American Academy of Actuaries Senior Pension Fellow, testimony presented to the U.S. Department of Labor Advisory Council on Employee Welfare and Pension Benefit Plans, Task Force on Leakage, June 9, 1998.

Notes: Assumed rate of return on investments is 4.25 percent, which is the TSP underlying interest rate February 19,2004. Mortality is based on IRS Single Life Expectancy Table (unisex)