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RETIREMENT PLANNING: DO WE HAVE A CRISIS IN AMERICA?

HEARING

BEFORE THE

SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

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RETIREMENT PLANNING: DO WE HAVE A CRISIS IN AMERICA?

TUESDAY, JANUARY 27, 2004

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room SD–628, Dirksen Senate Office Building, Hon. Larry Craig (chairman of the committee) presiding.

Present: Senators Craig and Carper.

OPENING STATEMENT OF SENATOR LARRY CRAIG, CHAIRMAN

The CHAIRMAN. Well, good morning, everyone. The U.S. Senate Special Committee on Aging will be convened. I appreciate all of you for braving the weather of today. Our hearing is on retirement planning, do we have a crisis in America as it relates to that?

I am pleased to reconvene the Special Committee on Aging for the Second Session of the 108th Congress. Today's hearing is on a topic of strong interest to me and my colleague, John Breaux. Senator Breaux had planned to be here this morning. I think, you know, Southerners just do not cope well with this kind of weather. We Westerners oftentimes find this a slight inconvenience but somehow are able to kind of push through. I will never live that down. John will be all over me on that one.[Laughter.]

But having said that, both of us have shown a keen interest in the issue of retirement security for our senior Americans. Just 2 years ago, Senator Breaux and I served as delegates to the Savers Summit. At that time, I remarked that the summit was the beginning, not the end, of our commitment to help Americans plan for their retirement. This hearing is a continuation of that effort.

America has come a long way in building a stronger retirement system compared to the early part of the 20th Century. We should not lose sight of those accomplishments; however, we have seen a dramatic increase in longevity and a trend toward healthy aging. Americans are living longer and healthier than ever before. This means they must plan to save more to keep them from outliving their retirement nest eggs. I know in talking with our elderly today, oftentimes, that is a growing concern that they express.

A recent report from the Department of Commerce shows that the personal savings rate has actually declined from 7.7 percent in 1992 to 2.3 percent in 2002. At a time when savings should be going up, we see a dramatic decline. Today's hearing should help us understand the impact of this dramatic decline in personal savings and the leading ideas for addressing the decline.

With that, let me say how pleased I am to welcome two of our three experts today. One of those is snowbound in Texas, or at least, his planes were not flying, and he apologizes for not being here. But we are very proud that the two gentlemen who are here before us this morning were able to weather the elements: Dr. Jack VanDerhei of Temple University and the Employment Benefit Research Institute; we appreciate you for being here.

The gentleman who is not with us, but we trust we will be able to get his testimony to put in the record, John Goodman, president of the National Center for Policy Analysis in Dallas.

[The prepared statement of Dr. Goodman follows:]

Statement

on

America's Private Retirement System: The Need for Reform

by

Dr. John C. Goodman
President
National Center for Policy Analysis

Testimony
Before the
U.S. Senate Special Committee on Aging

January 27, 2004

Introduction

The current tax law has a bias against saving and investment. That bias retards capital formation and reduces productivity, employment and wages. In general, income that is spent on consumption is taxed once, but income that is saved is taxed as many as four times:

- Income is taxed when earned, and if it is spent on consumption, there is generally no additional federal tax on the enjoyment of that consumption except for a few selective excise taxes.
- If the earnings are saved, however, the saver has to pay taxes on the rewards for the saving — interest, dividends and capital gains.
- If the saving was put into corporate stock, there was also a corporate tax to be paid before the income becomes a dividend or is retained by the company.
- If an individual has saved a great deal, the accumulated savings may be additionally subject to the estate and gift taxes.

These biases in the tax code affect behavior.

The Need to Save

Careful studies have shown that the greatest degree of inequality exists among senior citizens, and the single most important cause of that inequality is not differences in pre-retirement income but differences in the degree to which people with the same income save

rather than consume.[1] Clearly, some people are not saving enough. According to the "Survey of Consumer Finances," conducted every three years by the Federal Reserve:[2]

- 61 percent of all workers between the ages of 24 and 64 have no retirement savings account.
- Of the 42.5 million workers who do have an account, the median balance (half are larger, half are smaller) is $14,000.

Among workers nearing retirement the picture improves only slightly:[3]

- 53 percent of workers age 55 to 64 have no retirement savings account.
- Among those who do have one, the median balance is less than $25,000.

To put that in perspective, $25,000 at retirement will provide a pension annuity of little more than $200 a month. The failure to save adequately is a special problem for women. For example, one study found that:[4]

- Among employees age 18 to 62, the average in 401(k)s and similar accounts for women was half that of men.
- Among those nearing the retirement age, the average balance for women was only 20 percent of that of men.

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[1] B. Douglas Bernheim, Jonathan Skinner and Steven Weinberg, "What Accounts for the Variation in Retirement Wealth Among U.S. Households?" National Bureau of Economic Research, Working Paper No. W6227, October 1997. http://papers.nber.org/papers/W6227.

[2] See Patrick J. Purcell, "Retirement Savings and Household Wealth in 1998: Analysis of Census Bureau Data," Congressional Research Service, May 2001.

[3] Ibid.

[4] See Vickie Bajtelsmit, Alexandra Bernasek, and Nancy Jianakoplos, "Gender Differences in Defined Contribution Pension Decisions," *Financial Services Review*, Vol. 8 (1999), p. 5.

In general, women more than men are experiencing the problem of inadequate retirement incomes. This is partly due to the fact that many senior women live alone. Nearly half of all women over age 65 are widows.[5] This is important because compared to two-person households, one-person households have smaller retirement savings, smaller Social Security benefits and less personal savings. Of seniors living in poverty, almost three-fourths are women.[6]

Obstacles to Saving

In the area of retirement savings there are large differences between the amount of tax-free savings available to people at their workplace and what they can do on their own. Thus, employer-sponsored retirement plans have become a coveted part of employee compensation. Yet current vehicles for saving at work are far from perfect.

Problem: Lack of Portability. For most of the period since World War II, the dominant form of retirement plan provided by employers was the *defined-benefit plan*. Under these plans, employees acquire pension benefits, sometimes for the rest of their lives, based on their wages and years of service to the company. The plans promise a specific monetary sum, and the promise is backed by the employer. For employees who work for the same employer for their entire work lives, for example, the pension benefit is typically 60 to 70 percent of final pay.[7]

Although defined-benefit plans work well for people who work continuously for the same employer, they do not work well for employees who switch jobs. Although it is possible to design defined benefit plans otherwise, the majority of these plans calculate benefits under

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[5] Vickie Bajtelsmit, "Women as Retirees," *Women's Agenda: Ideas to Reform Institutions,* National Center for Policy Analysis, March 2002, p. 75-98.

[6] C. Eugene Steuerle, "Divorce and Social Security," National Center for Policy Analysis, NCPA Brief Analysis No. 291, May 21, 1999.

[7] Although millions of employees are participating in such plans, virtually no defined-benefit plans are being established today.

formulas that are "back-end loaded." That means the 40th year is weighted a lot more heavily than say the 10th year. To see what this means in practice, consider a worker who works for four different companies — each for ten years — and all four have identical pension plans. Upon retirement, she will get four separate pension checks, but her combined income will be less than half of what it would have been if she had stuck with just one company for the full 40 years.

Under this system, people will sacrifice substantial pension benefits if they switch employers frequently throughout their career, even though they remain fully employed for their entire work lives. It is a system that is not in sync with the needs of a dynamic, mobile labor market.

Unlike defined-benefit plans, *defined-contribution plans* are fully portable As long as the employees are fully "vested," they do not lose the employer match if they move to another employer. In all cases the amount of compensation that they have contributed remains in their account. Today more than half of all workers with an employer-provided retirement savings program are in a defined-contribution plan.[8]

Defined-contribution plans place the responsibility for saving and investing on the employee and better accommodate a dynamic, highly skilled workforce. However, while defined contribution plans have solved some of the problems of the older system, they have created a new set of problems on their own.

Problem: Vesting Requirements. The idea behind vesting is that employees must work for an employer for a certain number of years before they obtain full rights to the promised retirement benefits. An employee who leaves before fully vesting in a defined-benefit plan will

[8] More than 48 million workers have accumulated more than $1.8 trillion in defined-contribution plans. See Abstract of 1997 Form 5500 Annual Reports, U.S. Department of Labor, Pension and Welfare Benefits Administration, "Private Pension Plan Bulletin," No. 10 (Winter 2001).

receive a smaller pension during the retirement years because of that fact. Employees who make contributions to a defined-contribution plan are automatically entitled to whatever they have contributed. But they typically are not entitled to the full amount of an employer's matching contribution until they have logged a minimum number of years of service. At one time, it was not unusual for employers to require 10 or 15 years of service before vesting was complete. Today the law requires vesting periods to be no longer than three years. But even a three-year vesting requirement has a disparate effect on women[9] and interferes with workforce mobility.

Why have vesting at all? One could argue that some vesting period makes sense, to allow the employer to recover some administrative costs in cases of employees who pop in and out of employment. However, many employers, competing for highly skilled workers, have dropped vesting requirements altogether, and match employees' contributions from their first day on the job. By contrast, other employers see long vesting requirements as a way to reward employees who are "loyal" (i.e., those that don't leave to work for a competitor), and to punish those who are not. Thus, vesting requirements are among employers' recruitment and retention tools.

In a free labor market, employees and employers would be able to strike any compensation bargain that both sides agree to. If it makes sense to reward long-term employment, employers should be free to do that. But retirement plans involve something more than voluntary exchange. The ability to build up funds tax-free involves a taxpayer subsidy, and the social purpose of that subsidy is to encourage the private sector to make private provision for retirement income needs.

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[9] K. Ferguson and K. Blackwell, *The Pension Book: What You Need to Know to Prepare for Retirement* (New York, NY: Arcade Publishing, 1995), pp. 37-47.

Employers who exact onerous vesting requirements are using a tax-subsidized vehicle created to achieve a socially desirable end in order to achieve a purely private, corporate end. In pursuing their own goals, these employers are hindering the achievement of the social goal. Vesting requirements not only undermine the social goal of encouraging people to have a reasonable retirement income, they also interfere with the labor market mobility that our modern economy requires.

Problem: Arbitrary Limits on Contributions. One of the most remarkable characteristics of our retirement system is the completely arbitrary limits that are placed on the opportunities of different people to engage in tax-deferred saving:

- Some people are able to deposit as much as $40,000 per year in tax-deferred savings plans.[10]
- Others are limited to the $11,000 maximum in allowed contributions to a 401(k) plan.[11]
- Yet those who do not have access to an employer-sponsored plan, including those who are not in the labor market at all, are limited to a $3,500 maximum contribution to an IRA account.[12]

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[10] Employer plus employee total annual contributions to a defined-contribution plan like a 401(k) or 403(b) is limited to $40,000 per year, or 25 percent of the employee's compensation, whichever is less. The Economic Growth and Tax Relief Reconciliation Act of 2001 raised the previous $30,000 limit to $40,000 in 2002.

[11] Employee contributions to 401(k)s, 403(b) and other tax deferred accounts is limited to $11,000 in 2002. The Economic Growth and Tax Relief Reconciliation Act of 2001 incrementally raises the maximum annual individual contribution by $1,000 per year to $15,000 by 2007.

[12] Individuals who are not participating in an employer-sponsored plan can only contribute $3,000 to an IRA in 2002. The Economic Growth and Tax Relief Reconciliation Act of 2001 incrementally raises the maximum contribution to $5,000 by 2008. While this limit will increase under current law, it is still only about half of the contribution allowed to an employer-sponsored plan.

If it is socially desirable for some people to save for their own retirement, presumably it is just as desirable for others to do so as well. There is no socially justifiable reason why the amount of tax-free saving a person is allowed should be conditioned on where a person happens to work or whether the person is in the labor market.

Problem: Poor Investment Choices. Defined-contribution plans not only allow employees to make their own investment choices, they virtually require it. While many employees cherish this freedom, for others it is an unwelcome burden. Moreover, employees nationwide appear to do a very poor job investing their own money. A study of 503 employers by Watson Wyatt company found that from 1990 through 1995:

- The defined-benefit plans averaged an annual rate of return 1.9 percentage points better than the 401(k) plans — 10 percent versus 8.1 percent.[13]
- To illustrate what difference that makes, consider investing $4,000 a year for 30 years: at 10 percent, the account will grow to about $690,880, while at 8.1 percent the account will grow to only $480,224 — a difference of $210,665![14]

One might suppose that the investment results would be highly sensitive to the type of work employees perform, with better-educated, more sophisticated employees doing better. But this is not necessarily the case. A study by the National Center for Policy Analysis looked at the 401(k) performance of employees of firms that specialize in investing other people's money and/or giving advice on how money should be invested. The conclusion: over a four-year period ending in 1998, none of the financial service firms' average 401(k) earnings came close to

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[13] "Investment Relations: Defined-Benefits vs. 401(k)," Watson Wyatt Insider, September 1998.

[14] Brooks Hamilton and Scott Burns, "Reinventing Retirement Income," National Center for Policy Analysis, NCPA Policy Report No. 248, December 2001.

matching the performance of the stock market as a whole or a mixed portfolio of stocks and bonds.[15]

Why is the performance of 401(k) plans so poor? There are a number of reasons, but the most important is that all too often unsophisticated investors make one or both of two bad investment decisions: (1) they invest in their employer's stock, and/or (2) they invest in what they think is safe.

As the experience of Enron employees makes clear, putting all your financial eggs in one basket is a risky strategy — not a safe one — even if the basket is the company you work for. Enron employees invested heavily in their employer's stock and suffered large losses. This case is not unique. A recent survey of 105 larger public companies found 40 in which more than half of 401(k) assets were invested in the employer's own stock.[16]

The other mistake employees make is to be too conservative: They invest in securities that are safe, but pay a low rate of return. This is especially true of lower-paid employees. One study found that:[17]

- Almost two-thirds of the assets invested by the lowest-paid employees were in a money market fund or bond fund.
- By contrast, about 85 percent of the assets invested by the highest-paid employees were in stocks.

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[15] Hamilton and Burns, "Reinventing Retirement Income."

[16] Brooks Hamilton, "Learning Our Lesson from Enron," *Washington Times*, February 2, 2002.

[17] Hamilton and Burns, "Reinventing Retirement Income," p. 12.

To put this in perspective, compare two portfolios: one consisting of all stocks and the other consisting of all bonds. Based on historical averages, the all-stock portfolio will accumulate 10 times as much wealth as the all-bond portfolio over the course of a work life.[18]

Interestingly, there are important differences in the investing behavior of men and women when other things are equal. On the one hand, a number of studies have found that women are more risk averse. For example, they are significantly more likely to choose bonds over stocks — given a choice.[19] On the other hand, men are more likely than women to engage in frequent changes in their portfolios. Such excessive trading reduces the net returns on men's investments by a full percentage point, relative to women.[20] Part of the problem is that men are excessively confident in their own abilities, according to a number of psychological studies. As one economist put it, "Men tend to think their successes are the result of their own skill rather than dumb luck."[21]

Problems: Getting Reliable Investment Advice. Surprisingly, a number of employees in 401(k) plans do not actually make an investment choice. For example, at least one-third of the lowest-paid employees have their funds invested in the "default" option, either by choosing it or by letting the employer choose for them. In these cases, the employees' investments are simply "defaulted" into a money market fund.[22] Why don't employers "default" employees into

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[18] For example, Vickie L. Bajtelsmit, "Conservative Pension Investing: How Much Difference Does It Make?" *Benefits Quarterly,* Vol. 12, No. 2, 1996, pp. 35-39.

[19] See the review of the literature in Vickie L. Bajtelsmit and Alexandra Bernasek, "Why Do Women Invest Differently Than Men?" *Financial Counseling and Planning*, Vol. 7, 1996, pp. 1-10; and in Bajtelsmit, "Women as Retirees."

[20] Brad Barber and Terrance Odean, "Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors," *Journal of Finance*, Vol. LV, No. 2, April 2000, pp. 773-806. http//faculty.haas.berkeley.edu/odean/papers/returns/returns.html

[21] Hal R. Varian, "Economic Scene: Investor Behavior Clouds the Wisdom of Offering Wider Choice in 401(k)s," *New York Times*, February 14, 2002.

[22] Hamilton and Burns, "Reinventing Retirement Income," p. 13.

portfolios that make more sense for retirement planning? The answer is that employers choose the most conservative investment alternative because they are afraid of lawsuits. For the same reason, most employers also do not give investment advice to their employees.[23]

Many books have been written on investing, and an entire industry exists to give advice. But the nonprofessional investor does not need to read any of the books or pay any investment fees in order to invest wisely for the long term. There is a mountain of economic research that points to a simple conclusion: the best and most prudent strategy for the nonprofessional is to invest in the market as a whole. And an efficient way to invest in the market as a whole is through an "index fund."

Take the 15-year period ending on December 31, 2001. An investment in the Vanguard 500 Index 15 years ago would have averaged an annual rate of return of 13.56 percent. This is considerably better than the average return generated by all other types of mutual funds, and it is almost a point and a half better than the return produced by the average equity fund. Financial columnist Scott Burns calls this the "couch potato" approach to investing. His columns over the years show that couch potatoes consistently do better than mutual funds managed by professional analysts.[24]

It is very hard to beat the market. In fact, most people who try to beat the market, including most professional fund managers, do worse than the market as a whole. So an unsophisticated investor who is willing to settle for whatever return the market pays will do very well over time. In fact, such an investor will do better than the vast majority of professionals.

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[23] Only about a third of large, multi-site corporations who are members of the Profit Sharing Council of America give investment counseling to employees, usually through online resources. Half of all members provide such advice, up from 35.2 percent in 2000. Source: David Wray, President, Profit Sharing Council of America.

[24] See for example, Scott Burns "Go Index Funds for the Long Term," *Dallas Morning News*, February 12, 2002.

For this reason, a simple change in the law would greatly improve the performance of the 401(k) plans for millions of Americans.[25] The change would give employers a safe harbor against lawsuits if they default employees who do not make an investment choice into an index fund or similar broadly diversified portfolio, and encourage employees who do make choices to make similar investments.

Problem: Tax Deferral May Not Always Be A Good Idea.[26] Most people believe — and almost all investment advisers reinforce the belief — that deferring taxes through 401(k)s, IRAs and similar accounts will reduce their lifetime taxes. There are two reasons for this belief. First, tax deferral is like an interest-free loan. Instead of giving money to the government, the taxpayer is allowed to use it and invest it and pay the government much later in life. Second, most people expect that they will be in a lower tax bracket after they retire (since their incomes will be lower). So deferral means shifting the payment of taxes from the time when they are in a high tax bracket to the time when they are in a lower one.

The problem is that the second of these assumptions is wrong for most young people in low- and moderate-income families. The reason: the Social Security benefits tax. Although this tax is nominally a tax on Social Security benefits, as a practical matter it turns out to be a tax on other income. And during the retirement years "other income" will mean income from pensions and savings accounts. Today the Social Security benefits tax is paid by only about one-fifth of seniors. But the impact of this tax will grow over time because the tax thresholds are not

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[25] See the discussion in Hamilton and Burns, "Reinventing Retirement Income," pp. 17-19. Hamilton and Burns would also discourage pre-retirement, lump sum distributions. A 1988 *Current Population Survey* found that women were 40 percent more likely than men to receive such a payment. Only half of each group rolled the payment over into another savings or retirement plan. See also Bajtelsmit and Berask, "Why Do Women Invest Differently Than Men?" p. 5.

[26] This section is based on Jagadeesh Gokhale and Laurence J. Kotlikoff, "Tax-Favored Savings Accounts: Who Gains? Who Loses?" National Center for Policy Analysis, NCPA Policy Report No. 249, January 2002.

indexed to inflation and eventually will be paid by virtually all young people during their retirement years.[27]

Indeed, most people who are earning less than $100,000 a year and who are in their twenties will be in a higher tax bracket during their retirement years than during their working years. Tax deferral in these cases means moving the payment of taxes from the time when they are in a lower tax bracket to the time when they are in a higher bracket. And the effect of being in a higher bracket during the retirement years can more than swamp the effects of the interest-free loan.

On the brighter side, researchers find that regardless of the amount invested, people almost always gain if they can invest through a Roth IRA.[28] Like a regular IRA, Roth IRAs allow tax-free growth. The difference is that deposits to the Roth IRA are made with after-tax dollars and withdrawals are tax free. For most people, the Roth IRA allows taxes to be paid at the time of life when the taxpayers are in the lowest tax bracket.

Problem: High — and Hidden — Administrative Costs and Management Fees. Administering a 401(k) plan and managing its investments costs money. Many plans have selected low-cost funds, with fees fully disclosed to plan participants and often paid by the employers. However, many other plans have higher fees mostly paid by the participants. Some of the latter contain mutual funds with high retail price structures.[29] Participants often are unaware that they are paying administrative fees for these funds from their accounts. In some

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[27] For the explanation of the Social Security benefits tax and how it affects marginal tax rates, see Stephen J. Entin, "Reducing the Social Security Benefits Tax," National Center for Policy Analysis, NCPA Brief Analysis No. 332, August 2000.

[28] Gokhale and Kotlikoff, "Tax-Favored Savings Accounts."

[29] Retail mutual funds generally charge higher management fees than institutional funds, which have lower expenses and generally are available only to institutional investors.

cases, especially with smaller employers, plan sponsors choose these funds because in return the mutual funds handle administrative chores such as keeping track of account balances, sending out statements and answering questions.

According to a *New York Times* report, some fund companies rebate part of the administrative fees to employers or outside plan administrators. The administrative fees, which the *Times* said usually amount to about 0.25 percent of the assets in an account for large plans, add up. For example:[30]

- An investment of $5,000 a year for 30 years with a 10 percent annual return amounts to $863,594.
- Annual fees of 0.25 percent will reduce that amount by $40,883.
- If fees are 1 percent, as they often are in smaller plans, the benefit reduction is $151,387 (or 21 percent) — and some plans have costs exceeding 2 percent.

Even if there are no rebates or cost-shifting, companies sponsoring 401(k) plans have little incentive to monitor the fees closely or to negotiate lower fees for plan participants when the costs are paid from the participants' and not the company's funds.

Problem: Cashing Out. Even modest contributions to one's 401(k) at an early age can grow to a significant sum by the time of retirement. However, almost a third of people with accounts — and 39 percent of those ages 18 to 34 — cash them out when they change jobs. Plan sponsors can (but are not required to) cash out an account balance valued at under $5,000 when the participant terminates employment.[31] The employee can roll over the money into an

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[30] Virginia Munger Kahn, "When Hidden Fees Erode 401(k)s," *New York Times*, July 22, 2001.

[31] Beginning in 2002, this amount was reduced to $1,000.

individual retirement account (IRA), move it to a new employer's plan, or take a lump sum payment minus income tax and a penalty for early withdrawal.[32] The ERISA Advisory Council reported that only 20 percent of individuals who received lump sum distributions rolled the entire sum into another tax-deferred account.[33] A report to the advisory council recommended that all defined contribution plans be required to accept rollovers of cash from other qualified plans. Putnam Investments, a money management firm, estimates:[34]

- Withdrawals amount to between $33 billion and $39 billion per year.
- Those withdrawing the money pay $7.1 billion to $8.3 billion in unnecessary federal taxes and penalties each year.

Problem: Hardship Distributions and Consumer Loans. Many plans allow an employee to make a hardship withdrawal, usually to purchase a primary residence, pay college tuition, pay unreimbursed medical expenses or prevent eviction from or foreclosure on a principal residence. These withdrawals are subject to income tax and a 10 percent early withdrawal penalty.[35] Further, the participant cannot contribute to the account for one year after a hardship withdrawal, thus losing any matching contribution from the employer.[36]

Most 401(k) plans also allow a participant to borrow from his or her account for non-hardship purposes, such as buying a boat or a big-screen television, and to repay the loan to the account with interest. This can be tempting because the interest rate is lower than credit card

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[32] "Retirement Savings in an Unsettled Economy," survey for Putnam Investments, May 22, 2001.

[33] *"Are We Cashing Out Our Future?"* Working Group Report to the ERISA Advisory Council on Employee Welfare and Pension Benefits, November 13, 1998.

[34] Ibid.

[35] The 10 percent tax penalty may apply if the employee is under age 59 ½; there is no penalty for withdrawal if one becomes disabled as defined by the Internal Revenue Service.

[36] Under legislation effective in 2002, the one-year prohibition is reduced to six months.

interest and the interest goes into the participant's own account. However, the interest is paid with aftertax money, which will be taxed again when it is withdrawn in retirement. In addition, the participant loses the return while the funds are out of the 401(k).

Bush Administration Proposals

2001 Reforms. At President Bush's urging a tax bill passed in 2001 addressed some of these issues. Over time, the act raises the allowable contribution to IRAs and Roth IRAs from $2,000 to $5,000 per person by 2008. This will narrow somewhat the arbitrary difference between the maximum allowed contribution to 401(k) and IRA accounts. The act also will allow employers to offer a 401(k) plan that is taxed like a Roth IRA, beginning in 2006. However, all these provisions are scheduled to disappear and the nation will revert to the old tax rules after 2010!

New Tax-Advantaged Savings Accounts. The President also has proposed two new savings vehicles for all Americans: Retirement Savings Accounts and Lifetime Savings Accounts. Both accounts would essentially create universal Roth IRAs, in which workers invest after-tax money and distributions would be tax free.

The first type of account is "Retirement Savings Account," to which individuals could contribute $7,500 a year and from which they could withdraw funds tax-free after age 58. A recent NCPA study shows that every income group would benefit from taking advantage of this form of taxation. But it is especially beneficial to low- and moderate-income families who, if they save on a tax-deferred basis, can expect to face higher tax rates after they retire." The second new account is a "Lifetime Savings Account" to which people could contribute similar amounts and from which they could withdraw funds any time for any purpose. Lifetime savings

accounts will simplify personal savings because American families can save for their child's education, save for a house or save for medical expenses, all in the same tax-advantaged account.

Health Savings Accounts. As part of the recently-passed Medicare prescription drug bill, non-elderly Americans can now own a Health Savings Account — or HSA — which is coupled with a high-deductible insurance policy. In his State of the Union address, President Bush proposed taking the next step by making high deductible insurance premiums tax deductible to encourage greater participation in HSAs. Currently, the maximum contribution that can be made to the HSAs is $2,600 for an individual; and about twice that amount for a family. Over a period of 30 or 40 years, funds have the potential to accumulate. HSAs can become a tremendous source of funds for long term care or medical expenses in retirement, as well as for non-healthcare needs.

Goals of Reform

In general, a well-functioning retirement system that meets the needs of men and women, married and single, should strive to:

- Create retirement plans that are personal and portable, traveling with people as they move from job to job.
- Eliminate rules that arbitrarily punish people who work part-time, or switch jobs frequently, or move in and out of the labor market.
- Eliminate arbitrary ceilings on retirement savings plan contributions that unfairly favor people in some sectors over people in other sectors.
- Establish procedures that encourage people to invest wisely and prudently over the course of a work life.

- Establish a system for taxing retirement income that does not unfairly penalize people because of changes in their tax bracket over time.

Some of the reforms advocated by the Bush administration are a step in the right direction. Other steps are needed.

Suggestions for Private Pension Reform

The concept of defined contribution plans is a sound one. The assets are owned by the employee, are portable from job to job and a participant's benefits are not affected by job changes. However, as with most new concepts, there are flaws that can be eliminated to the benefit of both employees and employers. To remedy the flaws, pension consultant Brooks Hamilton and financial writer Scott Burns proposed a new type of 401(k) plan called the American Freedom 401(k).[37] Employees now in a 401(k) plan would have a choice of remaining there or moving to the American Freedom 401(k) plan. Employers who offer all the features of the American Freedom 401(k) plan would receive a "safe harbor" from litigation, explained below. The plan would have these features:

Enrollment and Minimum Contributions. Employers would automatically enroll all employees after they satisfy the plan's eligibility period unless they execute a rejection form opting out. The plan would also set an initial minimum contribution rate of about 4 percent to 6 percent of income — an amount that could prudently be expected to provide a reasonable retirement income — unless the employee specifically opts for a smaller amount.[38] This minimum contribution requirement would help limit a too-common practice today, where

[37] See Hamilton and Burns, "Reinvesting Retirement Income."

[38] This would not prevent the employee from later changing the contribution rate or withdrawing from the plan altogether.

company human resource departments, to make participation rates in 401(k) plans appear to be high, urge employees to "just contribute a dollar or two out of each paycheck."

Premixed Portfolios and Professionally Directed Investments. Since index funds and the managers of defined benefit pension plans have historically produced higher yields on investments, companies adopting the American Freedom 401(k) plan would have to agree to include in participants' options premixed efficient portfolios — ones that give the maximum rate of return at different risk levels — or a professionally directed investment option or both.[39] Companies should be encouraged (but not required) to provide employees who choose to manage their own accounts with access to investment advice.

Default Option. The contributions of a participant who made no initial choice of funds should go into a premixed efficient portfolio (e.g., 60 percent stocks and 40 percent bonds) or into the professionally directed investment as a default option.

Fees and Expenses. A plan sponsor either would pay all fees and expenses or would reimburse the plan. This would give employers an incentive to limit fees and expenses (currently there is no required oversight of such spending) and would raise the net returns received by plan participants. As an alternative, fees and expenses might be capped at, say, 1 percent, with the employer required to pay anything above the cap.

Automatic Rollover. The American Freedom 401(k) plan would prohibit benefit cash-outs by the plan or the employee following termination of employment before retirement, death or disability. Instead, the account could be rolled over into a similar qualified plan or could remain in the previous employer's plan if the new place of employment has no qualified plan.

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[39] Premixed portfolios typically would comprise one or more index funds.

Vesting. Vesting would be 100 percent and immediate.

Hardship Loans. The American Freedom 401(k) plan would have a new feature, the hardship loan, funded from and paid back to the plan's trust fund, not the participant's account. Consumer-type loans and hardship distributions to plan participants from their accounts, now permitted by most plans, would be prohibited. A hardship loan would simply be a loan from plan assets (not the borrower's account), limited to conditions that would meet the legal criteria for a current hardship distribution. This would enable participants to get money from the plan for a true hardship or emergency and pay it back with interest without (i) losing the matching employer contributions for a time, (ii) paying increased taxes due to the prohibition on personal contribution for a time, (iii) being subject to a tax and penalty on the hardship distribution and (iv) affecting the investment return on the account. At the same time, participants seeking a loan for some other purpose could turn to a source of consumer credit and leave retirement funds in the account to grow.

Safe Harbor for Employers. Because the American Freedom 401(k) plan would be so beneficial to participants, employers should be given an incentive to establish such a plan. Legislation should provide that, in exchange for providing a plan offering all the features, an employer would have to meet only the basic coverage and nondiscrimination requirements. In addition, the plan would be deemed to comply with technical testing standards now required.[40] Finally, the plan sponsor would receive "safe harbor" protection, exempting it from class action civil suits and similar actions alleging breach of fiduciary standards. We would expect industry service providers to respond quickly to such a program.

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[40] The complex testing is supposed to ensure that more highly compensated employees do not receive better treatment that less highly compensated employees.

The CHAIRMAN. We also have Dr. Gokhale—I am struggling with your first name—who is a senior fellow at the Cato Institute, who will offer his observations and analysis today before the committee.

So we look forward to your testimony on what we believe is an ever-important issue for our country and for the seniors of our country and those who are obviously beginning to think and plan toward their retirement.

With that, Doctor, we will turn to you first to start the testimony.

STATEMENT OF JACK L. VANDERHEI, PH.D., CEBS, PROFESSOR, THE FOX SCHOOL OF BUSINESS AND MANAGEMENT, TEMPLE UNIVERSITY, PHILADELPHIA, PA

Dr. VANDERHEI. Thank you. Senator Craig, I am Jack VanDerhei from Temple University and research director of the EBRI Fellows Program. It is my pleasure to appear before you today to discuss the extremely important topic of whether we do have a retirement crisis in America.

As you will note from my written testimony, I believe the answer is yes for some groups and no for others. However, another question of equal public policy concern is how severe is this crisis, and is it feasible to expect the vulnerable groups to be able to deal with those projected problems through increased savings?

As you know, the ability of future retirees to have broadly defined levels of retirement security has been the focus of several Congressional hearings as well as countless public policy analyses in the past. However, in recent years, there have been several reasons to revisit earlier studies and conclusions. Most significant among these is the evolution from defined benefit plans to defined contribution plans in the private sector in the last two decades.

In addition, there have been advances in research and analysis in recent years. While several studies have attempted to project retirement income and wealth, there have been few attempts to reconcile their results with the uncertain amount and duration of retiree expenditures. A new computer model I have developed with my co-author Craig Copeland of the Employee Benefit Research Institute allows a quantification of the gap between basic future retirement needs and assets under various comfort levels, if you will.

The Employee Benefit Research Institute and the MilBank Memorial Fund, working with the Governor of Oregon, set out to see if the necessary retirement security analysis could be undertaken on a State-specific basis and undertook an initial study on the future retirees of Oregon. The results, released in 2001, made it clear that there is a significant shortfall and that major decisions lie ahead if the State's population is to have adequate resources in retirement.

Subsequent to the release of the Oregon study, it was decided that the approach could be carried to other States as well. Kansas and Massachusetts were chosen as the second and third States for analysis, and we completed their results in 2002. The model was recently expanded so it could be national in scope, and initial estimates were published in the November 2003 EBRI Issue Brief and were discussed at a day-long EBRI policy forum held December 4, 2003.

While I would be happy to answer any questions regarding the components of this model, I think it is important to note that the primary objective of this analysis is to combine simulated retirement income and wealth with simulated retiree expenditures to determine how much each family would need to save today as a percentage of their current wages to maintain some prespecified comfort level that they will be able to afford simulated expenses for the remainder of their lifetime once they retire.

We report these savings rates by age cohort, by family status, and by gender in figures A and B of the written testimony that I have submitted. It is important to note that these percentages represent savings that need to be generated in addition to what retirement income and or wealth is simulated by the model. Therefore, if the family unit is already generating savings for retirement that is not included in defined benefit plans or defined contribution plans or IRAs or Social Security or net housing equity, that value needs to be deducted from the estimated percentages.

Figure A, which is on page 13 of my written testimony, shows the median percentage of compensation that must be saved each year until retirement for individuals to have adequate retirement income in three out of four of their simulated outcomes. This represents our baseline assumptions that current statutory Social Security benefits are paid and that housing equity is never liquidated, although we do run alternative scenarios in the model.

The results show that for the median individual in birth cohorts on the verge of retirement, there is little possibility of them saving enough to supplement the simulated retirement wealth to provide adequate retirement income to meet basic needs. However, younger birth cohorts would benefit from the increased years of contributions and would have savings targets that are feasible for most groups.

However, there are some notable exceptions: single females in the lowest income quartile are predicted to need in excess of 25 percent of compensation per year to have sufficient retirement wealth regardless of the birth cohort. Figure B, which is on page 14 of the written testimony shows the median additional savings required to provide retirement adequacy if one wanted a 90 percent confidence level, in essence, to have nine out of 10 of their simulated life paths sufficient.

We have purposely structured many of our assumptions to provide conservative estimates of the amounts that would be needed to be saved while employees are working to alleviate any deficits. For example, we have assumed in this version of the model that all employees continue to work until Social Security normal retirement age, even though there has been a long-term trend toward early retirement, albeit one that seems to be reversing in recent years.

But even with these conservative biases built in, the numbers appear troubling for some age cohorts and almost fatalistic for others. The good news is that if many of the younger cohorts begin saving a reasonable amount to supplement their Social Security and qualified retirement plans now, they have a good chance of providing themselves with reasonable assurance that they will at least be able to cover basic retirement expenditures.

However, changes in public policy and additional resources from families and charities would be required to provide adequate retirement income for retirees with greater longevity who suffer serious and persistent chronic disease.

To wrap up, both for individuals and public policymakers, being able to quantify the extent of the impending shortfall in basic retirement income adequacy has obvious implications. For those lucky enough to be young and disciplined at saving, getting started now is likely to assure them a comfortable retirement. Since there are many who are older, nearing retirement age, and in the lower income brackets, public resources are likely to be called upon either directly or indirectly to deal with their inability to finance their old age.

Knowing the extent of the future problem will at least allow policymakers at both the State and Federal levels to try to prepare to deal with these issues when they arrive.

Thank you very much and I look forward to your questions.

[The prepared statement of Dr. VanDerhei follows:]

T-141

Statement for the

Senate Special Committee on Aging

Hearing on

Retirement Planning: Do We Have a Crisis in America?
Results From the EBRI-ERF Retirement Security Projection Model

Jan. 27, 2004

by
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Retirement Planning: Do We Have a Crisis in America? Results From the EBRI-ERF Retirement Security Projection Model

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Jack L. VanDerhei, Ph.D., CEBS
Temple University and EBRI Fellow
Jan. 27, 2004

Sen. Craig, Sen. Breaux, and members of the Committee. I am Jack VanDerhei, Temple University and research director of the EBRI Fellows' Program. It is my pleasure to appear before you today.

Background

The ability of future cohorts of retirees to have broadly defined levels of retirement security has been the focus of several congressional hearings as well as countless public policy analyses in the past. In recent years, there have been several reasons to revisit earlier studies and conclusions. Perhaps foremost among these is the long-term evolution away from "traditional" defined benefit pension plans to individual-account defined contribution retirement plans, such as the 401(k) (at least in the private sector).[1] In addition to transferring investment risk from the employer to employee, this evolution has also resulted in many employees increasing their exposure to longevity risk as well as being put in a situation where they may make one or more of a number of choices that would adversely impact their eventual retirement income. Moreover, those employees who remain active participants within the defined benefit plan system may have already had unexpected modifications to the type of plan sponsored by the employer. Recent legal actions and lack of legislative clarity and/or regulatory guidance may suppress future activity in this regard; however, projecting future benefit accruals may prove problematic even for those employees still participating in a traditional form of final-average defined benefit plans.

While several studies have attempted to project retirement income and wealth, there have been few attempts to reconcile their results with the uncertain amount and duration of retiree expenditures. Moore and Mitchell (1997) estimated how much Health and Retirement Study (HRS) respondents ages 51 to 61 would need to save from the current year until retirement assuming they wanted to preserve preretirement consumption levels after retirement. They found that the savings requirement for the median family would be 7 percent of compensation if the retirement age were 65. As expected, they found tremendous heterogeneity among families with respect to the required savings rate. Another approach was followed by Engen, Gale, and Uccello (1999) using both HRS and the Survey of Consumer Finances (SCF). Using a theoretical model, the authors estimated the ratio of a household's wealth to its earnings as benchmarks to evaluate savings adequacy. Using intermediate wealth measures, the authors estimated that 59.7 percent of the SCF households exceeded the simulated median wealth-to-earnings ratio in 1992. While this model includes the capacity for sensitivity analysis on an ad hoc increase in simulated retirement needs and/or life expectancy, there is no attempt to empirically estimate the incidence, duration or cost of potentially catastrophic medical costs.

EBRI/Milbank Study for Oregon, Kansas and Massachusetts

The Employee Benefit Research Institute (EBRI) and the Milbank Memorial Fund, working with the governor of Oregon, set out to see if the necessary retirement security analysis could be undertaken on a state-specific basis and undertook an initial study on the future retirees of Oregon. The results,

released in 2001, made it clear that there is a significant shortfall and that major decisions lie ahead if the state's population is to have adequate resources in retirement. Subsequent to the release of the Oregon study, it was decided that the approach could be carried to other states as well. Kansas and Massachusetts were chosen as the second and third states for analysis. Results of the Kansas study were presented to the state's Long-Term Care Services Task Force on July 11, 2002, and the results of the Massachusetts study were presented on Dec. 1, 2002.

The Employee Benefit Research Institute's Education and Research Fund (EBRI-ERF) Retirement Security Projection Model was used to estimate the accrued benefits earned and assumed to be retained by defined benefit participants as well as the annual retirement income that could be produced from the balances of any defined contribution plan, cash balance plan, and/or individual retirement account (IRA) of the states' residents at Social Security normal retirement age. We added to this amount the expected retirement income from Social Security under current law as well as under two reform options. In an attempt to provide an approximation of the aggregate amount of additional money that would be needed to provide basic expenditures, we estimated the deficits that are likely to be produced by comparing projected retirement income with projected retirement expenses (both deterministic and stochastic) over the simulated lifetime of each future retiree. These deficits approximate the additional money that would be required in addition to the retirement income and wealth already projected from defined benefit and defined contribution retirement plans, IRAs, Social Security, and (under some of the output) liquidation and/or annuitization of housing net worth to cover the projected expenses of maintaining the families' economic standard of living. The present value of any deficits were accumulated annually and then averaged for all retirees in the same birth cohort and gender/family categories.

The model was expanded so that it could be national in scope and initial estimates were published in the November 2003 *EBRI Issue Brief* ("Can America Afford Tomorrow's Retirees: Results From the EBRI-ERF Retirement Security Projection Model") and was discussed at a day-long EBRI policy forum ("Assessing Future Retirement Security With the Results of the EBRI/ERF Retirement Income Projection Model") held Dec. 4, 2003.[2] In an attempt to make the results easier to comprehend, the primary output metric was changed to one that represents the additional percentage of compensation that each simulated observation would need to save (in addition to the other components already modeled) from 2003 until the time they retired. The entire distribution of outcomes was arrayed and charts displaying median compensation percentages were created for each cohort for a variety of confidence levels and assumptions regarding Social Security and liquidation of housing equity. Additional analysis was conducted to show the probability of retirement security if each individual would save an additional 5 percent of compensation for the remainder of his or her working career.

Accumulation Phase of EBRI Model

The EBRI-ERF model is based on a six-year time series of administrative data from more than 10 million 401(k) participants and more than 30,000 plans, as well as a time series of several hundred plan descriptions used to provide a sample of the various defined benefit and defined contribution plan provisions applicable to plan participants. In addition, several public surveys based on participants' self-reported answers (the Survey of Consumer Finances [SCF], the Current Population Survey [CPS], and the Survey of Income and Program Participation [SIPP]) were used to model participation, wages, and initial account balance information.

This information is combined with U.S. Department of Labor Form 5500 data to model participation and initial account balance information for all private-sector defined contribution participants, as well as contribution behavior for non-401(k) defined contribution plans. Asset allocation information is based on previously published results of the EBRI/ICI Participant-Directed Retirement Plan Data

Collection Project and employee contribution behavior to 401(k) plans is provided by an expansion of a method based on both employee demographic information as well as plan matching provisions.

A combination of Form 5500 data and self-reported results were also used to estimate defined benefit participation models; however, it appears information in the latter is rather unreliable with respect to estimating current and/or future accrued benefits. Therefore, a database of defined benefit plan provisions for salary related plans was constructed to estimate benefit accruals.

Combinations of self-reported results were used to initialize IRA accounts. Future IRA contributions were modeled from SIPP data, while future rollover activity was assumed to flow from future separation from employment in those cases in which the employee was participating in a defined contribution plan sponsored by the previous employer. Industry data are used to estimate the relative likelihood that the balances are rolled over to an IRA, left with the previous employer, transferred to a new employer, or used for other purposes.

Defined Benefit Plans

A stochastic job duration algorithm was estimated and applied to each individual in the EBRI-ERF model to predict the number of jobs held and age at each job change. Each time the individual starts a new job, the EBRI-ERF model simulates whether or not it will result in coverage in a defined benefit plan, a defined contribution plan, both, or neither. If coverage in a defined benefit plan is predicted, time series information from the Bureau of Labor Statistics (BLS) is used to predict what type of plan it will be.

While the BLS information provides significant detail on the generosity parameters for defined benefit plans, preliminary analysis indicated that several of these provisions were likely to be highly correlated (especially for integrated plans). Therefore, a time series of several hundred defined benefit plans per year were coded to allow for assignment to the individuals in the EBRI-ERF model.

Although the Tax Reform Act of 1986 at least partially modified the constraints on integrated pension plans by adding Sec. 401(l) to the Internal Revenue Code, it would appear that a significant percentage of defined benefit sponsors have retained Primary Insurance Amount (PIA)-offset plans. In order to estimate the offset provided under the plan formulae, the EBRI-ERF model computes the employee's Average Indexed Monthly Earnings, Primary Insurance Amount, and covered compensation values for the birth cohort.

Defined Contribution Plans

Initial Account Balances—Previous studies on the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project have analyzed the average account balances for 401(k) participants by age and tenure. Recently published results show that the year-end 1999 average balance ranged from $4,479 for participants in their 20s with less than three years of tenure with their current employer to $198,595 for participants in their 60s who have been with the current employer for at least 30 years (thereby effectively eliminating any capability for IRA rollovers).

Unfortunately, the EBRI/ICI database does not currently provide detailed information on other types of defined contribution plans nor does it allow analysis of defined contribution balances that may have been left with previous employers. The EBRI-ERF model uses self-reported responses for whether an individual has a defined contribution balance to estimate a participation model and the reported value is modeled as a function of age and tenure.

Contribution Behavior—Previous research on employee contribution behavior to 401(k) plans has often been limited by lack of adequate data. This is primarily due to the types of matching formulae

utilized by sponsors. While these formulae are often complicated due to the desire of sponsors to provide sufficient incentives to non-highly compensated employees to contribute in order to comply with technical nondiscrimination testing, this complexity makes it virtually impossible to appropriately analyze the employee's behavior if one is forced to observe either aggregate plan data or use information on the plan contribution formulae provided by the participant.

With the exception of studies based on administrative data, employee contribution behavior is typically assumed to be a function of employee demographic data and perhaps an employee's estimate of the employer matching rate or a proxy based on Form 5500 data. However, a significant amount of the employee contribution behavior appears to be determined by plan-specific provisions. For example, the percentage of employees contributing up to either the maximum amount of compensation matched, the 402(g) limit, or the plan maximum was studied by EBRI in 1996. It would appear that well over 50 percent of the employee contribution is explained by these "corner points," which would not be picked up in the data described above.

Recently, EBRI provided preliminary findings[3] introducing new methodology to expand the usefulness of modeling these data, as well as a better understanding of contribution behavior by 401(k) plan participants. We utilize a sequential response regression model to allow for the differing incentives faced by the employees at various levels of contributions. Based on findings from 137 distinct matching formulae, we have estimated a behavioral model that is able to control for the tendency of employers to substitute between the amount they match per dollar of employee contribution and the maximum percentage of compensation they are willing to match. We decompose employee contribution behavior into a series of 1 percent of compensation intervals and therefore are able to model not only the marginal incentives to contribute at that interval but also the "option value" that making the contribution at that interval provides for the employee.

Contribution behavior for defined contribution plans other than 401(k) plans is estimated from self-reported responses to public survey data.

Investment Returns—Although the EBRI-ERF model has been designed to generate investment rates of return on a stochastic basis, for purposes of this analysis we are presenting the results obtained from running it in a deterministic mode. We adopt the same asset-specific rates of return that were used in the Social Security Administration's Model of Income in the Near Term (MINT) model.[4]

Retiree Expenditures

The expenditures used in the model for the elderly consist of two components—deterministic and stochastic expenses. The deterministic expenses include those expenses that the elderly incur from a basic need or want of daily life, while the stochastic expenses in this model are exclusively health-event related—e.g., an admission to a nursing home or the commencement of an episode of home health care—that occur only for a portion, if ever, during retirement, not on an annual basis.

Deterministic Expenses

The deterministic expenses are broken down into seven categories—food, apparel and services (dry cleaning, haircuts), transportation, entertainment, reading and education, housing, and basic health expenditures. Each of these expenses is estimated for the elderly (65 or older) by family size (single or couple) and family income (less than $15,000, $15,000 to $29,999, and $30,000 or more in 2002 dollars) of the family/individual.

The estimates are derived from the 2000 Consumer Expenditure Survey (CES) conducted by the Bureau of Labor Statistics of the U.S. Department of Labor. The survey targets the total noninstitutionalized population (urban and rural) of the United States and is the basic source of data

for revising the items and weights in the market basket of consumer purchases to be priced for the Consumer Price Index. CES data provide detailed data on expenditures and income of consumers, as well as the demographic characteristics of those consumers. The survey does not provide state estimates, but it does provide regional estimates. Thus, the estimates are broken down into four regions— Northeast, Midwest, South, and West—to account for the differences in the cost of living across various parts of the country. Consequently, an expense value is calculated using actual experience of the elderly for each region, family size, and income level by averaging the observed expenses for the elderly within each category meeting the above criteria. The housing expenses are further broken down by whether the elderly own or rent their home. The basic health expenditure category has additional data needs in addition to those in the CES.

Health—The basic health expenditures are estimated using a somewhat different technique and are comprised of two parts. The first part uses the CES as above to estimate the elderly's annual health expenditures that are paid out-of-pocket or are not reimbursed (covered) or at least not fully reimbursed by Medicare and/or private Medigap health insurance, e.g., prescription drugs.

The second part contains insurance premium estimates, including Medicare Part B premiums, and is not income related. All of the elderly are assumed to participate in Part B, and the premium is determined annually by the Medicare program and is the same nationally. For the Medigap insurance premium, we assume all of the elderly purchase a Medigap policy. A regional estimate is derived from a 2000 survey done by Weiss Ratings Inc. that received average quotes for three popular types of Medigap policies (A, F, and J) in 47 states and the District. The estimates are calculated from the three policy types averaged over the states in the respective regions to arrive at the estimate for each region.

This approach is taken for two reasons. First, sufficient quality data do not exist for the matching of retiree medical care (as well as the generosity of and cost of the coverage) and Medigap policy use to various characteristics of the elderly. Second, the health status of the elderly at the age of 65 is not known, let alone over the entire course of their remaining life. Thus, by assuming everyone has a standard level of coverage eliminates trying to differentiate among all possible coverage types as well as determining whether the sick or healthy have the coverage. Therefore, averaging of the expenses over the entire population should have offsetting effects in the aggregate.

The total deterministic expenses for elderly individuals or families are then the sum of the value in all the expense categories for family size, family income level, and region of the individual or family. These expenses make up the basic annual (recurring) expenses for the individual or family. However, if the individual or family meet the income and asset tests for Medicaid, Medicaid is assumed to cover the basic health care expenses (both parts), not the individual or family. Furthermore, Part B premium relief for the low-income elderly (not qualifying for Medicaid) is also incorporated.

Stochastic Expenses

The second component of health expenditures is the result of simulated health events that would require long-term care in a nursing home or home-based setting for the elderly. Neither of these simulated types of care would be reimbursed by Medicare because they would be for custodial (not rehabilitative) care. The incidence of the nursing home and home health care and the resulting expenditures on the care are estimated from the 1999 National Nursing Home Survey (NNHS) and the 2000 National Home and Hospice Care Survey (NHHCS). NNHS is a nationwide sample survey of nursing homes, their current residents and discharges that was conducted by the National Center for Health Statistics from July through December 1999. The NHHCS is a nationwide sample survey of home health and hospice care agencies, their current and discharge patients that was conducted by the National Center for Health Statistics from August through December 2000.

For determining whether an individual has these expenses, the following process is undertaken. An individual reaching the Social Security normal retirement age has a probability of being in one of four possible assumed "health" statuses: 1) Not receiving either home health or nursing home care, 2) Home health care patient, 3) Nursing home care patient, 4) Death, based upon the estimates of the use of each type of care from the surveys above and mortality. The individual is randomly assigned to each of these four categories with the likelihood of falling into one of the four categories based upon the estimated probabilities of each event. If the individual does not need long-term care, no stochastic expenses are incurred. Each year, the individual will again face these probabilities (the probabilities of being in the different statuses will change as the individual becomes older after reaching age 75 then again at age 85) of being in each of the four statuses. This continues until death or the need for long-term care.

For those that have a resulting status of home health care or nursing home care, their duration of care is simulated based upon the distribution of the durations of care found in the NNHS and NHHCS. After the duration of care for a nursing home stay or episode of home health care, the individual will have a probability of being discharged to one of the other three statuses based upon the discharge estimates from NNHS and NHHCS, respectively. The stochastic expenses incurred are then determined by the length of the stay/number of days of care times the per diem charge estimated for the nursing home care and home health care, respectively, in each region.

For any person without the need for long-term care, this process repeats annually. The process repeats for individuals receiving home health care or nursing home care at the end of their duration of stay/care and subsequently if not receiving the specialized care again at their next birthday. Those who are simulated to die, of course, are not further simulated. As with the basic health care expenses, the qualification of Medicaid by income and asset levels is considered to see how much of the stochastic expenses must be covered by the individual to determine the individual's final expenditures for the care. Only those expenditures attributable to the individual—not the Medicaid program—are considered as expenses to the individual and as a result in any of the "deficit" calculations.

Total Expenditures

The elderly individual or families' expenses are then the sum of their assumed deterministic expenses based upon their demographic characteristics plus any simulated stochastic expenses that they may have incurred. In each subsequent year of life, the total expenditures are again calculated in this manner. The base year's expenditure value estimates excluding the health care expenses are adjusting annually using the assumed general inflation rate of 3.3 percent from the 2001 OASDI Trustees Report, while the health care expenses are adjusted annually using the 4.0 percent medical consumer price index that corresponds to the June 2002–June 2003 level.

Results

The primary objective of this analysis is to combine the simulated retirement income and wealth with the simulated retiree expenditures to determine how much each family unit would need to save today (as percentage of their current wages) to maintain a pre-specified "comfort level" (i.e., confidence level) that they will be able to afford the simulated expenses for the remainder of the lifetime of the family unit (i.e., death of second spouse in a family). We report these savings rates by age cohort, family status (at retirement), and gender. Six five-year birth cohorts are simulated. The oldest group was born in the period 1936 to 1940 inclusive while the youngest group was born in the period 1961 to 1965 inclusive. Three combinations of gender/family status at retirement were reported: family, single male, and single female. In addition, the relative income was reported by estimating lifetime income quartiles (from 2002 though retirement age) for each of the 18 combinations of birth cohort and gender/family status at retirement.

It is important to note that within each of the groups modeled there will undoubtedly be significant percentages in the zero category as well as those at levels beyond which anyone could reasonably assume more than a de minimis number of individuals could possibly save. We account for these situations in two ways. First, we report medians for each of the groups. In other words, the numbers presented in Figures A and B provide a number representing the estimate for the 50th percentile when ranked by percentage of compensation. Second, we limit the reported values to 25 percent of compensation under the assumption that few, if any, family units would be able to contribute in excess of this percentage on a continuous basis until retirement age.

It is also important to note that these percentages merely represent savings that need to be generated in addition to what retirement income and/or wealth is simulated by the model. Therefore, if the family unit is already generating savings for retirement that is not included in defined benefit or defined contribution plans, IRAs, Social Security and/or net housing equity, that value needs to be deducted from the estimated percentages.

After the retirement income and wealth was simulated for each family unit, we simulated 1,000 observations (from retirement age until death of the individual for single males and single females or the second person to die for families) and computed the present value of the aggregated deficits at retirement age. At that point, we rank ordered the observations in terms of the present value of the deficits and determined the 75th and 90th percentiles of the distribution. Next we determined the future simulated retirement income accumulated to retirement age and used this information to determine the percentage of compensation that would need to be saved to have sufficient additional income to offset the present value of accumulated deficits for the 75th and 90th percentiles of the distribution.

Figure A (pg. 13) shows the median percentage of compensation that must be saved each year until retirement for a 75 percent confidence level when combined with simulated retirement wealth, assuming current Social Security benefits and that housing equity is never liquidated.

For example, all median gender/family combinations in the first two income quartiles for the oldest birth cohort are at the 25 percent of compensation threshold. For those in the highest income quartile for this birth cohort, the percentages of compensation needed to be saved are 23.8 percent for singe females, 13.9 percent for single males, and 6.1 percent for families.

Figure B (pg. 14) shows the median additional savings required to provide retirement adequacy for a 90 percent confidence level (9 out of 10 simulated life paths). In this case, nearly all of the gender/family status at retirement combinations for the first three income quartiles of the earliest birth cohort are at the threshold (the median for families in the third quartile is estimated at 24.8 percent of compensation). Those in the highest income quartile for this birth cohort all have requirements that would prove difficult if not impossible to implement: median single females are estimated to now need to save more than 25 percent of compensation, single males 22.1 percent of compensation, and families 10.1 percent of compensation.

Will Individuals Be Able to Save Enough on Their Own (Over and Above What is Already Modeled)?

Figure C (pg. 15) provides another way of illustrating which cohorts may be the most vulnerable to inadequate financial resources in retirement. This figure starts with the baseline scenario described above (current Social Security benefits and no liquidation or annuitization of net housing equity) and assumes that each worker contributes an additional 5 percent of compensation from 2003 until retirement age to supplement his or her Social Security and tax-qualified retirement plans. The percentage of each cohort estimated to have sufficient retirement income and/or wealth to cover the

simulated retirement expenses described earlier is displayed. For example, approximately 30 percent of the simulated life paths for the lowest income quartile for those in the 1936–1940 birth cohort would be expected to have sufficient retirement resources. However, at least 85 percent of the simulated life paths for the third or fourth income quartiles for those in the 1961–1965 birth cohort would be sufficient. This is in large part due to the fact that the younger cohorts will have additional years to accumulate the additional 5 percent of compensation. For each birth cohort, the lower income quartiles are in more risk of insufficient retirement income than their higher paid counterparts. Moreover, single females tend to exhibit more vulnerability than single males while families are typically the least vulnerable.

Alternative Scenarios

It is important to note that the analysis presented in the three figures above is limited to the baseline assumptions with respect to future Social Security benefits and liquidation of housing equity. Specifically we have assumed the current statutory benefits will continue to be paid regardless of the estimated funding difficulties. In VanDerhei and Copeland (2003), we ran two reform scenarios designed to ensure 75-year solvency of the program. Under the first alternative, benefits were reduced.[5] Under the second alternative, both the Social Security normal retirement age and the tax rates were increased.[6] As expected, the estimated deficits increased under both alternative scenarios, especially for the younger birth cohorts.

Moreover, in our baseline analysis above we assumed that retirees would not use their net housing equity to supplement their retirement income in any way (including housing equity loans). In VanDerhei and Copeland (2003) we estimate two additional responses. Our second scenario assumed any net housing equity is annuitized at retirement. Given the stochastic nature of the analysis we were also able to model a third scenario where we assume that housing equity is not liquidated until the time it is first needed to mitigate an annual deficit. At that point we assume any residual value is invested in the same manner as an individual account retirement plan. The relative impact of the second scenario was relatively minor; however, the third scenario had a much more dramatic impact, reducing the annual deficits for 2003 by 23 percent.

Conclusions

We have purposely structured many of our assumptions to provide conservative estimates of the amounts that would be needed to be saved while employees are working to alleviate any deficits. For example, we have assumed in this version of the model that all employees continue to work until Social Security normal retirement age, even though there has been a long-term trend toward earlier retirement (albeit one that seems to be reversing in recent years). We have also assumed that individual account balances are "self-annuitized" over a period of time that expands the individual and/or family life expectancy by five years, even though there appears to be limited evidence that this type of buffer is actually contemplated by retirees as a risk-reduction device.

Even with these conservative biases built in, the numbers appear troubling for some age cohorts and almost fatalistic for others. The good news is that if many of the younger cohorts begin saving a reasonable amount to supplement their Social Security and qualified retirement plans now, they have a good chance of providing themselves with reasonable assurance that they will at least be able to cover basic retirement expenditures. However, changes in public policy and additional resources from families and charities would be required to provide adequate retirement income for retirees with greater longevity who suffer serious and persistent chronic disease. Our estimates include both the status quo for Social Security benefits as well as two reform scenarios that would decrease benefits for future generations.

As we continue our simulation efforts with this model, we hope to pursue other public policy avenues relevant to economic security for retirees. For example, we hope to be able to integrate empirical data on long-term care insurance purchases into the model within the next year that will allow us to determine the impact of these policies on an individual's prospects for adequate retirement income, as well as the potential benefits to federal and state governments via the likely reduction in Medicaid expenditures.

Both for individuals and for public policymakers, being able to quantify the extent of the impending shortfall in basic retirement income adequacy has obvious implications. For those lucky enough to be young and disciplined at saving, getting started now is likely to assure them a comfortable retirement. Since there are many who are old (or nearing retirement age) and in the lower-income brackets, public resources are likely to be called upon either directly or indirectly to deal with their inability to finance their old age. Knowing the extent of the future problem will at least enable policymakers to try to prepare to deal with these issues when they arrive.

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_____. "The Changing Face of Private Retirement Plans." *EBRI Issue Brief* no. 232 (April 2001).

Witness Disclosure Statement,
pursuant to Clause 2(g)(4) of Rule XI of the Rules of the House:

- **The Witness:**
  Jack VanDerhei is a faculty member at Temple University's School of Business and Management (Department of Risk, Insurance, and Healthcare Management), and also is Research Director of the Employee Benefit Research Institute (EBRI) Fellows' Program, Washington, DC. EBRI is a private, nonprofit, nonpartisan public policy research organization based in Washington, DC. Founded in 1978, its mission is to contribute to, to encourage, and to enhance the development of sound employee benefit programs and sound public policy through objective research and education. EBRI does not lobby and does not take positions on legislative proposals.

- **The Organization:**
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- **Contracts:**
  EBRI does not have any contracts with the federal government in 2003, and did not in 2002 or 2001.

Endnotes

[1] See *EBRI Issue Briefs* no. 249, "An Evolving Pension System: Trends in Defined Benefit and Defined Contribution Plans" (September 2002); no. 232, "The Changing Face of Private Retirement Plans" (April 2001); and no. 190, "Defined Contribution Plan Dominance Grows Across Sectors and Employer Sizes, While Mega-Defined Benefit Plans Remain Strong: Where We Are and Where We Are Going" (October 1997).

[2] See *EBRI Issue Brief* no. 266 (February 2004), "Americans' Future Retirement Security: Implications of the EBRI-ERF Retirement Security Projection Model" (forthcoming).

[3] Jack VanDerhei and Craig Copeland, "A behavioral model for predicting employee contributions to 401(k) plans." *North American Actuarial Journal* (First Quarter, 2001).

[4] MINT assumes a CPI growth rate of 3.50 percent, a real rate of return for stocks of 6.98 percent, and a real rate of return for bonds of 3.00 percent. It subtracts 1 percent from each of the stock and bond real rates of return to reflect administrative cost (See Eric Toder et al., *Modeling Income in the Near Term: Projections of Retirement*

Income Through 2020 for the 1931–1960 Birth Cohorts, Final Report, SSA Contract No: 600-96-27332 (Washington, DC: The Urban Institute, 1999).

[5] This scenario involves gradually reducing the benefits of those starting to receive retirement and survivor's benefits. The reduction starts immediately and reaches 10 percent of present law benefits in 2010, 15 percent in 2016, and 22 percent in 2022.

[6] Under this reform alternative, the normal retirement age continues its increase from 65 to 67 but at a faster pace than under current law. Thereafter, the normal retirement age is indexed to longevity (currently assumed to be one month every two years). An increase from 10.6 percent to 12.35 percent in 2030 and to 13.50 percent in 2050 of the OASI tax rate completes the proposal.

Figure A

Percentage of Added Compensation That Must Be Saved Annually Until Retirement For a 75% Chance of Covering Basic Retirement Expenses

(assumes current Social Security and housing equity is never liquidated)

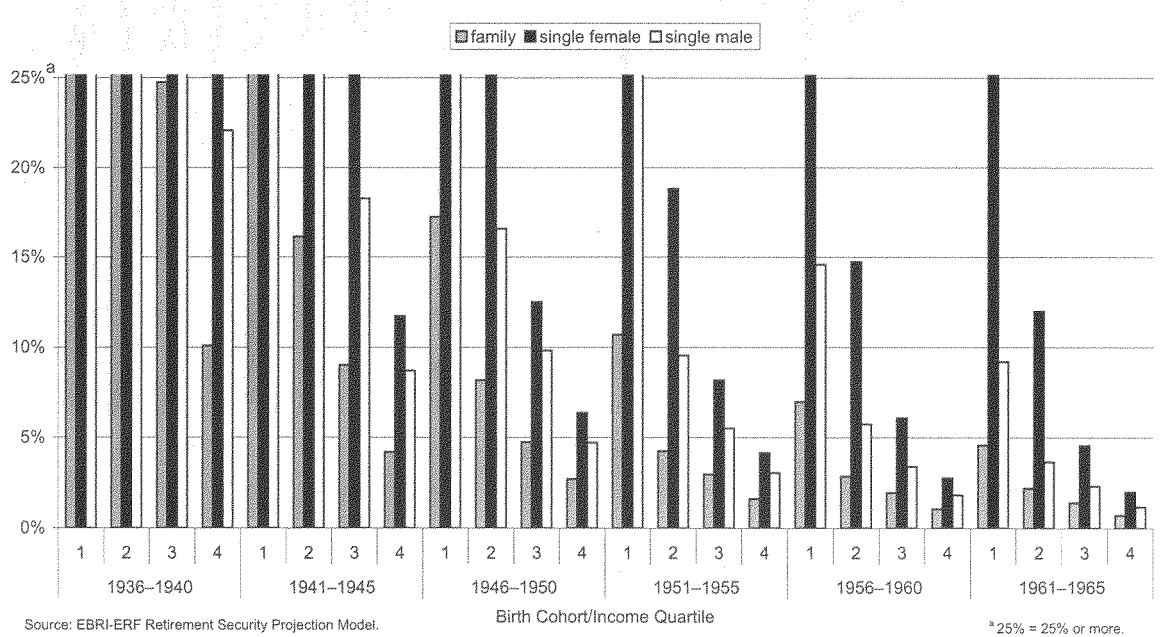
Source: EBRI-ERF Retirement Security Projection Model.

[a] 25% = 25% or more.

Figure B

Percentage of Added Compensation That Must Be Saved Annually Until Retirement For a 90% Chance of Covering Basic Retirement Expenses

(assumes current Social Security and housing equity is never liquidated)



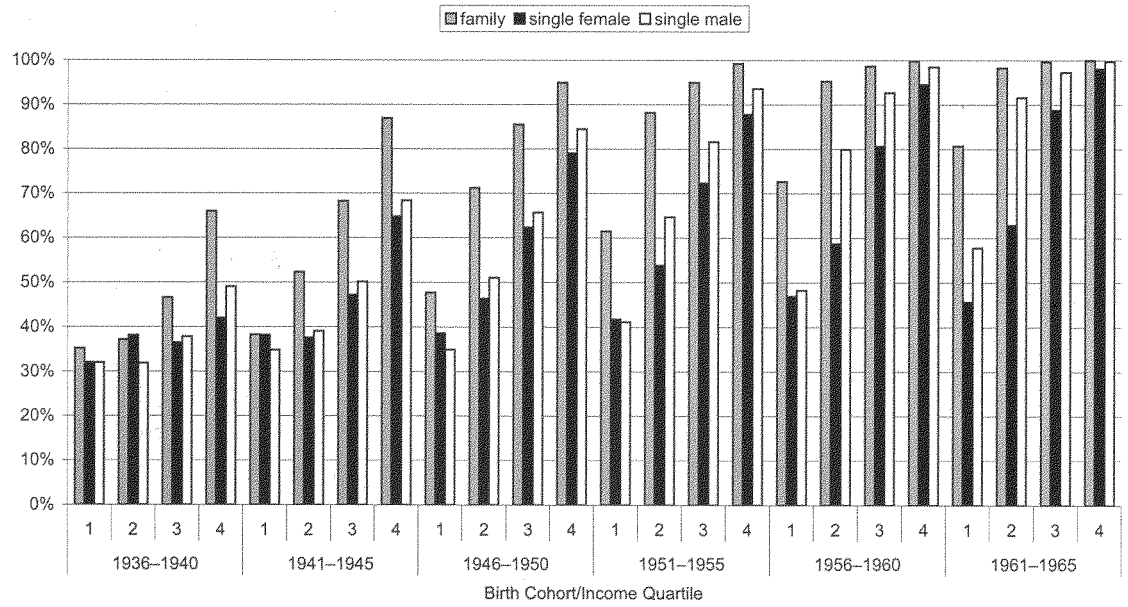
Source: EBRI-ERF Retirement Security Projection Model.

[a] 25% = 25% or more.

Figure C

Percentage of Retirees Estimated to Have Sufficient Retirement Income/Wealth[a] by Saving Additional 5% of Compensation Each Year From 2003 Until Retirement

(assumes current Social Security benefits)



Source: EBRI-ERF Retirement Security Projection Model. Assumes current Social Security, and that housing equity is never liquidated. The model includes the possibility of chronic long-term home health care and nursing home expenses.

The CHAIRMAN. Doctor, thank you very much.

Now, let me turn to our second panelist this morning, Dr. Gokhale, senior fellow at our Cato Institute. Welcome.

STATEMENT OF JAGADEESH GOKHALE, PH.D., SENIOR FELLOW, CATO INSTITUTE, WASHINGTON, DC

Dr. GOKHALE. Thank you very much. I am quite honored to have this opportunity to testify about retirement planning in the United States.

The answer to that question about whether there is a retirement crisis is simply yes. There is a significant crisis that we face. The crisis should be attributed more to the public policies that we have adopted over the last several decades rather than to private saving behavior that generates inadequate saving in a benign policy environment. As I go along, I think it will become clearer as to why I say that.

With regard to whether we have a crisis, well, we know that the baby boom generations are going to exit the work force over the next couple of decades, and that means two things: Their exit from the labor force means that labor force growth rates will fall, dragging down with it output growth rates. Second, the share of the population that is retired will increase considerably, and therefore, retiree consumption as a share of total consumption must also increase significantly. Those two things are quite clear in the projections that we see today.

Therefore, we need to transfer more resources toward retirees. Even if we were to maintain overall retiree living standards at the same real level as today's retiree standards, it implies that the share of retiree consumption in total consumption would have to increase from 20 percent today to about 35 percent. If we have to provide a higher living standard to future retirees consistent with the growth in the trend of retiree living standards from the past, that share would have to increase to about 43 percent, as I have documented in my testimony.

So, we need to transfer more resources toward retirees, but this transfer essentially means a transfer of resources from younger generations to older generations. That transfer will downward pressure on national saving. The reason for that is younger generations, because they have a longer life span ahead of them, generally spend less per dollar of resources than retirees.

So, if resources are transferred from low spenders to high spenders, total consumption in the economy will rise and savings rates will decline. That is one observation. In the past, we have accomplished the same kind of transfer from younger to older generations through expansions of Social Security and Medicare benefits. But that expansion was feasible because national output growth remained high.

In turn, high output growth occurred because we had this big, productive cohort of baby boomers in their working years. National output was high and continued to grow, despite a decline in productivity in the mid-1970s. That, labor force growth however, is going to be slower from now on. We have the following vexing dilemma facing us as a result: we know that the exit of the baby boomers from the work force is going to reduce labor force growth.

That has a dampening effect on output growth. We need the high output growth in order to be able to transfer these resources to retirees for consumption. But the very act of transferring these resources by way of entitlement programs itself puts a dampening effect on saving because we are transferring resources from low spenders to high spenders.

As a result, we are caught in this dilemma: we need output growth to be fast in order to be able to transfer these resources, but in implementing this transfer, we are going to dampen output growth itself. That is kind of a vicious logic that we are faced with, and the only thing we can do about it is really to encourage more saving on the part of the population.

We cannot do anything about the demographic trends except by additional immigration of young, skilled workers, but that only postpones the problem, because when more immigrants come into the country, they will work and contribute payroll taxes, which will help us transfer more resources to the elderly, but then, they, in turn will qualify for benefits in the future, and the problem does not necessarily go away; it just gets postponed.

We could try and affect saving behavior in the U.S., but admittedly, doing so is quite difficult. We have in place several types of tax incentives for encouraging additional saving on the part of workers, but the evidence shows that those incentives result at most in 25 to 30 percent of new saving in the economy. The reason is that the rules of our tax incentive saving programs are quite complicated, and therefore, may discourage employers from offering those plans—I am talking about traditional 401(k) and traditional IRA plans.

An additional complication arises because the rules of those plans, interact in significant ways with the rest of the tax code to dilute the tax incentives such plans provide for additional saving. We need to properly design these saving incentives to maximize the tax incentive. The rules should be less uncomplicated, as uncomplicated as possible, and the structure of the programs should be frontloaded so that the plans follow the Roth type design. That means plan contributions are made on an after-tax basis, but withdrawals are not subject to income taxes.

Now, doing it in this manner implies very few interactions with the rest of the tax code and therefore a higher tax saving incentive. However, in providing such saving incentives, we know that the Government would lose revenue. It is also important to consider what other tax or spending policy adjustments should be put in place to deal with that lost revenue. If we raise other taxes to make up the lost revenue from the initial incentive, then, we may end up with very little net incentive to save. If we finance for a short-term basis the lost revenue through higher deficits, well, higher deficits will soak up some of the saving, and therefore, again, we do not have an overall increase in saving.

It appears that to maximize the tax incentive, we should deal with the lost revenue through lower spending. That would be the better way to provide a tax saving incentive. But again, what is ultimately done to make up the lost revenue is a very difficult question to answer, because lots of changes occur simultaneously in taxes and spending.

So with that, let me close my spoken remarks. I would like my written remarks to be submitted into the record, and I welcome any questions.

Thank you.

[The prepared statement of Mr. Gokhale follows:]

The Future of Retirement in the United States

Testimony submitted to

United States Senate
Special Committee on Aging
Washington D.C. 20510

by

Jagadeesh Gokhale,
Senior Fellow
Cato Institute

Submitted: January 22, 2004
Revised draft Submitted: March 16, 2004

Thank you for this opportunity to testify on future retirement prospects in the United States. I feel extremely honored to have received it.[1]

My testimony is in three parts. First, I provide an economic overview of factors that will determine future economic growth which, in turn, will determine retirement living standards over coming decades. This section identifies the types of policies that appear necessary to maximize each factor's contribution to future growth. It concludes that a faster rate of saving and capital formation is crucial to sustain high economic growth.

Next, I provide an overview of the long-term federal budget implications of current fiscal policies with particular emphasis on Social Security and Medicare finances. This section concludes with a recommendation for a budget-accounting reform for the federal government.

Finally, I describe the potential hazards households could face from participation in tax-deferred saving plans. "Back-loaded' tax-favored plans such as 401(k)s and traditional IRAs—that permit tax-free accumulations before retirement and subject post-retirement withdrawals to income taxes—could end up harming some households on a lifetime basis. This is especially true for low earners who receive moderate to high rates of return on their plan contributions. In contrast, 'front loaded' plans are likely to be more effective as saving incentives. However, when considering the overall efficiency of such tax incentives in promoting greater national saving, it is important to also consider the nature of future tax and spending policy adjustments that are employed to compensate for lost federal revenues.

Part I: Economic Overview

Retirement has been widespread in America during the past few decades because of robust growth in national output: The huge size and productivity of the baby-boom generation ensured sufficient resources for extending generous support to their retired grandparents and parents—who, on the whole, suffered much smaller declines in their post-retirement living standards compared to retirees in the prewar period.

Many are questioning whether the baby-boomers themselves will be able to continue enjoying living standards close to their pre-retirement ones after they exit the workforce. I present some calculations to indicate the size of transfers that must occur to support a growing older population.

I. Bulge in the Retiree Cohort: Population projections by the Social Security Administration indicate that between the year 2003 and 2030, the number of working-aged individuals (those aged 20-64) will increase by just 13.3 percent. The number of those aged 65 and older, however,

[1] I am Jagadeesh Gokhale, Senior Fellow at the Cato Institute in Washington D.C. I have conducted several studies on federal fiscal policy including Social Security and Medicare. I have also written on labor markets, national saving, inequality, and intergenerational transfers, and the (in)adequacy of saving and life insurance in the United States. I have also analyzed the potential financial hazards households could face over their lifetime from participating in tax-deferred saving plans.

will increase by 93.1 percent. (These rates of population increase were 51.6 percent and 71.1 percent respectively during the previous 30 years.)

Table 1
Average Annual Consumption and Total Present Value of Resources
Total Versus Retiree Populations

	Age Group	
	20 and older	**65 and older**
Average Annual Consumption Outlays (Thousands of constant 2003 dollars)		
1960-61	16.8	12.4
1987-90	27.3	28.2
Percent change	62.6	126.8
Total Resources by Age Cohort (Present values in thousands of constant 2003 dollars)		
1960-61	283.3	161.3
1987-90	453.8	314.1
Percent change	60.2	94.8

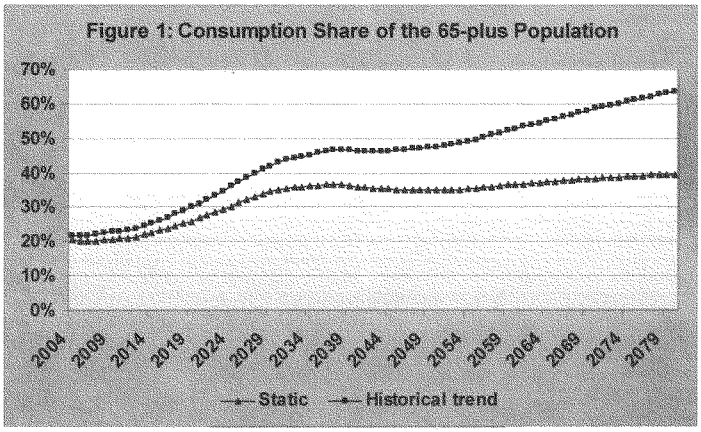
Source: Author's calculations based on *Understanding the Postwar Decline in U.S. Saving: A Cohort Analysis* by Jagadeesh Gokhale, Laurence J. Kotlikoff, and John Sabelhaus; Brookings Papers on Economic Activity, I:1996.

Table 1 shows that compared to their counterparts in the early 1960s, those who were aged 65 and older in the late 1980s enjoyed a 95 percent increase in resources per capita and spent 127 percent more on consumption per capita. Overall, however, total resources and average annual consumption per person increased by only about 60 percent.

This information can be used to project retiree consumption under "static" and "historical growth" assumptions. In the static case, I assume that per capita annual consumption will stay constant for everyone through the foreseeable future. I also assume that consumption of the 65-plus group relative to that of the overall population is the same today as it was in 1987-90—again a static assumption. Under these assumptions, I calculate that annual consumption of the 65-plus group equals 20 percent of total consumption in 2004. Projecting consumption into the future using population projections suggests that by 2030, the 65-plus group will consume about 35 percent of total consumption. Their "static" consumption share continues to increase gradually through 2080 (see Figure 1).

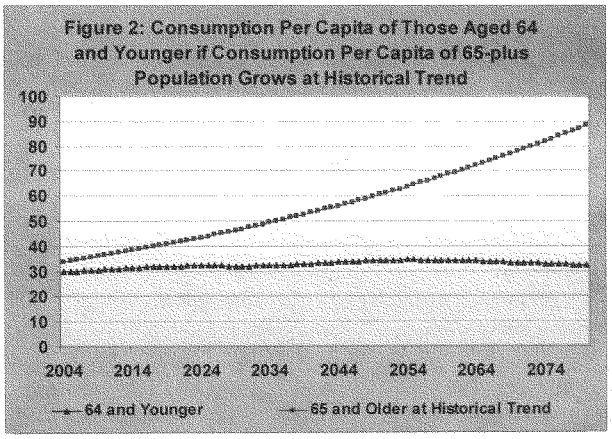
During the 1970s and 1980s, rising health-care cost was the main impulse underlying consumption growth for the 65-plus population. Medicare actuaries project that those costs will continue outpacing overall economic growth as retirees use more intensively newer, more effective, but costlier health care technologies. Hence, I make an alternative projection that is consistent with "historical trends" in consumption growth for the 65-plus and the overall population. First, I calculate the relative consumption per capita of the 65-plus to total population in 2004 by applying the average annual growth rate in consumption between 1960-61 and 1987-90 (see Table 1). Future per-capita consumption is also assumed to grow at these differential rates for the 65-plus and the overall population. This yields in the "historical trend"

projection shown in Figure 1. Here, the share of consumption by the 65-plus group equals 22 percent in 2004 and it nearly doubles by 2030—to 43 percent. After 2030, it continues to increase at a more rapid pace compared to the "static" projection.



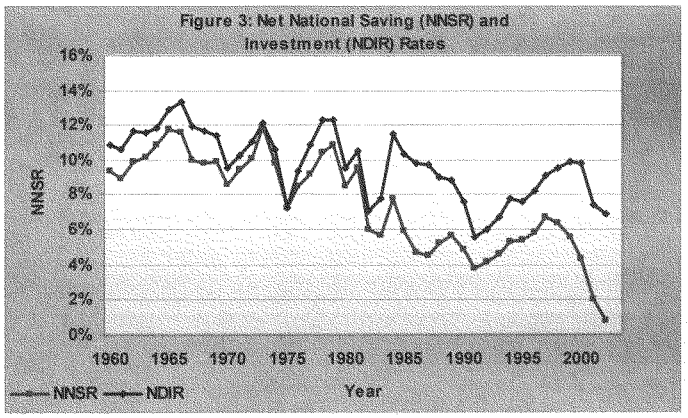
Source: Author's calculations.

What are the implications of allowing retiree consumption per capita to grow at historical rates? Figure 2 contains the answer: It shows that the consumption per capita of those 64 and younger would have to be kept essentially constant throughout this century in order to transfer the needed resources to retirees.



II. Growth in Output: The amount of resources that future retirees will be able to access will depend on the rate of future economic growth realized in the United States. The rate of growth will depend upon the growth of inputs—*labor* and *capital*—and their *productivity*.

A. Capital growth: Capital formation is constrained by the amount Americans save and can borrow from abroad. During past decades, the *net national saving rate* –the amount not consumed out of net national output as a share of output—has trended down, pulling with it the *net domestic investment rate*—investment net of capital consumption as a share of national output (see Figure 2). The investment rate has been sustained above the saving rate because foreign savers have chosen to direct their savings to the United States for investment. Prior to 1975, the net national saving averaged more than 10 percent. Since then, however, it has trended down to being barely positive in 2001. There is considerable uncertainty about how much of foreign savings the U.S. will continue to receive in the future. The fact that net domestic investment has also trended down along with the net saving rate suggests that national saving constrains domestic capital formation.



Source: Author's calculations based on data from the Bureau of Economic Analysis.

National saving is the sum of saving by households, businesses, and the government. The recent decline in national saving is primarily the result of high government deficits. However, household consumption levels have also remained high as households have been able to cash out their rapidly appreciating home equities.

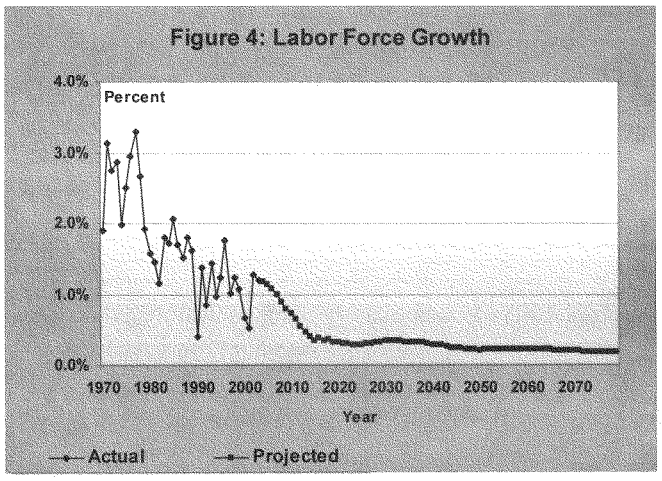
Furthermore, continued dependency on foreign savings implies a need to repay it with interest—reducing Americans' claims on future national output. If the trend of declining national saving were to be reversed, we would be less dependent on foreign savings to finance domestic investment.

Conclusion: *Need to provide effective incentives for Americans to save and invest.*

B. Labor force growth: Beginning in just a few years, labor-force growth is expected to slow simply because more baby-boomers will retire than the number of young-adults entering the labor force.

An immigration-friendly policy can help alleviate labor shortages that appear imminent.

Another way to counter slower labor-force growth is to increase the growth of the "effective" work-force by increasing worker skills. Many consider education and job-training subsidies to be effective means of upgrading worker skills and education. Such subsidies probably help, but are not necessarily the most effective means of promoting skill acquisition. At the margin, they may generate larger school systems that produce degreed graduates but not necessarily with additional skills. The real proof of skill acquisition is higher future labor earnings. Hence, a more effective inducement to skill acquisition would be the ability to retain the higher earnings as disposable income. Tax rates may be low today, but workers (and savers) must *believe that they will remain low* for them to make the desirable choices.



Source: Author's calculations based on projections made by the Social Security Administration.

Labor force growth may not slow as much as projected if promised Social Security and Medicare benefits cannot be paid. A shortfall in retirement resources may force some workers to stay in the labor force longer, and induce some recently retired individuals to return to work.

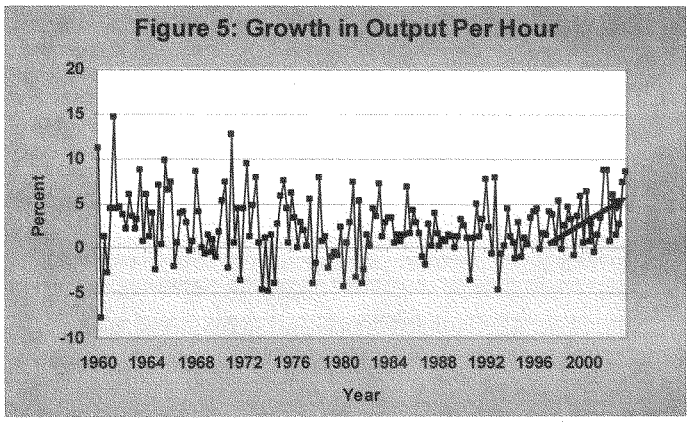
Conclusion: *Need to maintain a credible low-tax environment for increasing the "effective" labor force.*

C. Productivity growth: Productivity growth remained surprisingly high during the 2001/2 recession and has surged thereafter. Most observers ascribe this to continued diffusion of internet and IT technologies through other "old" sectors. If productivity continues to improve, it could (perhaps more than) offset the decline in output growth because of slower labor-force growth. Researchers have documented that in earlier episodes of technological breakthroughs (steam engine, electricity), the new technology's diffusion throughout the economy took several decades to complete.

Unfortunately, whether the "new economy" will be fleeting or is here to stay is extremely difficult to predict. Moreover, continued productivity growth has usually resulted from successive technological breakthroughs, not from applying the same technology repeatedly.

Because of the slower projected labor force growth, uncertainty about how long superior productivity growth will last and because, at source, continued technological advances require prior capital investments, *increasing the rate of saving and capital formation—both physical and human—is likely to be the most important determinant of future retiree (and overall) living standards.*

Conclusion: *Higher saving and investment are critical; needed to fuel continued Tech. advance*



Source: Bureau of Labor Statistics.

Summary: Future retiree living standards will be determined by the size of future national output and the amount we allocate for retiree consumption. Output growth depends on the growth of future production factors and their productivity. Given that labor force growth will shrink and

the sustainability of the current high productivity growth is uncertain, the rate of acquisition of human and physical capital will be the most significant determinant of future output growth and living standards.

Part II: Social Security, Medicare, and the Federal Budget

Social Security is the most important source of retirement support, and Medicare provides the overwhelming portion of retiree medical care.[2]

Financial projections for the Social Security (OASDI) program that I constructed as of fiscal year-end 2002 suggest that it has a "fiscal imbalance" of $7 trillion. These projections consider the program's entire future without limit.[3] This figure shows the size of the total future financial shortfall that Social Security faces.

Here's another way to interpret the $7 trillion number: It is the amount of money the federal government must have on hand *today*, invested in an interest earning account, in order to *never* have to change future Social Security payroll taxes or benefit rules.[4] Not having this amount on hand, of course, implies that future Social Security benefits must be cut, or future payroll tax revenues must be increased to raise an equivalent amount of resources ($7 trillion in present discounted value) to eliminate Social Security's financial imbalance.

My calculations show that the accumulated value of past taxes and benefits plus the present discounted value prospective taxes and benefits of those currently alive (as of 2002) equals $8.7 trillion. This amount is called the "generational imbalance."

Since the program's total financial shortfall (throughout the future) equals $7.0 trillion and the shortfall on account of past and currently alive generations equals $8.7 trillion, easy math says that future generations contribute excess taxes of $1.7 trillion dollars in present value (as of 2002).

A positive fiscal imbalance (the $7.0 trillion) implies that the program's current rules are not sustainable. Someone must pay more or receive less than they are scheduled to under those rules.

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[2] Social Security provides 37.6 percent of income for those over 65—more than earnings (20.7 percent), asset income (19.9 percent), employer benefits (18.7 percent), and other sources (3.1 percent). (Monthly Labor Review: http://www.bls.gov/opub/ted/2001/May/wk3/art03.htm)

[3] The numbers I cite here are taken from my study with Kent Smetters: *Fiscal and Generational Imbalances: New Budget Measures for New Budget Priorities.* All dollar figures cited here are as of the end of fiscal year 2002.

[4] The calculations in the study cited in footnote 3 extend the Office of Management and Budget's fiscal projections as of fiscal year-end 2002. They use OMB's economic assumptions and the Social Security Administration's population projections. OMB's economic assumptions incorporate a higher rate of interest than the rate used by the Social Security Administration when calculating present discounted values of future budget calculations reported in the 2003 Social Security Trustees' report. I believe that the appropriate rate of discount is that which the federal government must pay on long-term borrowing (reflecting its true opportunity cost of obtaining funds), and not the average rate on the maturity range of non-marketable Treasury Securities that are held in the Social Security Trust Fund.

If we postpone making any changes to Social Security's tax and benefit rules for a sufficiently long time and then change them to eliminate the imbalance, today's (2002's adult) generations will receive excess benefits over their payroll taxes worth $8.7 trillion and future generations will pay $8.7 trillion in excess taxes over benefits—$1.7 trillion that they are scheduled to pay under current rules plus $7.0 trillion in additional taxes levied via changes in the distant future.

Alternatively, we could make rule changes now and reduce the excess benefits of current generations down from $8.7 trillion under current rules. The main point here is that a calculation of fiscal and generational imbalances allows us to understand the trade-offs available in choosing between alternative ways of restoring balance to the Social Security system.

Fortunately, the Social Security's actuaries have already begun reporting the fiscal and generational imbalance measures, and Medicare is to begin reporting them Medicare beginning with this year's Medicare Part A (Health Insurance) Trustees' report. Similar calculations would be useful for the entire federal government as well.

According to my calculations, Medicare's fiscal imbalance amounts to $36 trillion in present value (as of fiscal year-end 2002), using standard assumptions for projecting future health care outlays.
Medicare, Part A, which covers inpatient hospital and other services, faces a financial imbalance of $20.5 trillion and a generational imbalance $8.5 trillion. That is, both future and living generations are scheduled to receive more than they will pay in Medicare payroll taxes.

Medicare Part B's fiscal imbalance amounts to $16.5 trillion dollars and its generational imbalance equals $6.6 trillion. These imbalances include the un-dedicated general revenue transfers that finance approximately 75 percent of Medicare Part B's outlays.

Medicare's imbalances cited above do not include the effects of the prescription drug coverage enacted in 2003. Independent calculations show that law to add $8 and $13 trillion in Medicare's long-term financial shortfall.

Hence, Social Security and Medicare (including prescription drugs) altogether contain a total fiscal imbalance of between $50 and $60 trillion.

As of fiscal year-end 2002, federal non-Social Security and non-Medicare programs ("rest-of-federal government) contributed only $0.5 trillion in present value to the total federal fiscal imbalance. However, federal defense and non-defense discretionary spending has recently been growing at a very rapid pace. Were these calculations to be updated, I am confident that the rest-of-federal government's fiscal imbalance would be considerably larger.

As of fiscal year-end 2002, I had estimated total federal fiscal imbalance at $44.2 trillion. Eliminating an imbalance of that magnitude, by my calculations, would require a more than doubling the payroll tax rate *immediately and permanently*. Alternatively, income tax revenues would have to be increased by about 70 percent, again immediately and forever. If spending cuts are considered, future Social Security and Medicare benefits would have to be cut by 45 percent.

Eliminating federal discretionary outlays today (as of 2002) and forever would not have been sufficient to eliminate federal fiscal imbalance

These required policy changes to raise the resources necessary to pay for scheduled government outlays are drastically large and would devastate the economy. However, waiting to make policy changes would make the cost of doing so even more. The simple reason for this is that, just like debt, fiscal imbalances accrue interest. Not dealing with the imbalance now means today's generations receive a windfall gain (they don't pay any additional dollars toward closing the funding gap), and future generations must finance this 'giveaway'—that is, bear a higher fiscal burden.

Implications: The size of federal unfunded obligations calculated here mirror the calculations of Part I: where it was shown that the transition of the baby-boomers into retirement requires a massive shift in consumption toward the elderly. Part II shows, that continuing on the current public policy course is not feasible and massive policy changes are required to bring federal revenues and outlays—that are used to effect the transfer of consumption resources—into balance.

Were retirements in the United States fully funded—perhaps self-financed through mandatory personal savings—the boomers would by now have accumulated much more by way of financial assets. Correspondingly, the U.S. economy would have been much better capitalized and worker productivity and incomes would have been higher than it is today. That would mean higher national output to be distributed toward retirees. And retirees would have the necessary financial claims to use to facilitate that transfer. The financial and real economy would work in complementary fashion to achieve retiree economic security.

First: A big chunk of the consumption transfer toward retirees occurs via pay-as-you-go Social Security and Medicare. By design and because of their generosity toward earlier generations of retirees, these programs face massive unfunded obligations and must depend upon future payroll tax revenues to continue paying retirement benefits. Their pay-as-you-go financial design is such that the very act of extinguishing benefit obligations to current retirees creates new and larger obligations to today's workers (future retirees). And, the expectation of future benefits and the burden of payroll taxes render workers unwilling and unable to accumulate savings. This leaves the economy with less capital and lower worker productivity.

Second: Although the current impasse is mostly generated by unavoidable demographic developments, the tools of fiscal analysis that are currently employed to assess future policy choices—backward-looking measures such as national debt and short-horizon projections of annual deficits—are ill suited for clarifying the fundamental choices policymakers face. Had fiscal and generational imbalance measures been regularly published by official budget reporting agencies during the past several decades, policymakers would have been more fully informed and may have begun addressing the oncoming resource crunch.

Third: It would be better to move away from continuing to finance the transfer of consumption toward retirees through pay-as-you-go programs such as Social Security and Medicare. Although these programs are thought to have been very successful in eliminating poverty in the past, that

success has likely been very costly in terms of the cumulative loss--over 7 decades in the case of Social Security and 4 decades in the case of Medicare—in the economy's capitalization and productivity growth. Unfortunately, these costs are not readily observed, which prevents a balanced assessment of these programs' net economic contribution.

Part III: Saving Incentives

The demographic changes slowing work-force growth cannot be easily countered except through massive immigration. That leaves capital accumulation—to increase output via more machines, better worker skills, and better technology—which requires greater saving.

Basic economic theory suggests that in a world with perfectly functioning capital markets and rational individuals, providing saving incentives through tax-policy would be sub-optimal. A subsidy to saving would generate a welfare-lowering distortion in the consumption-saving trade-off that people face.

However, we have (inherited) an economy that already contains considerable saving disincentives—in the form of public transfer programs that lower the return to saving, reduce households' abilities to save because of heavy income and payroll taxation, and transfer resources from high savers (the young) to low savers (retirees). In addition, raising revenues through income rather than consumption taxation results in heavier taxation of resources devoted to future rather than current consumption via saving: Earnings are taxed before saving occurs and the return to saving is taxed again in through interest and dividend taxes. This makes current consumption cheaper relative to future consumption—leading to lower household saving. The provision of saving incentives in such a world is equivalent to reversing existing economic distortions that reduce saving.

Unfortunately, providing tax incentives that generate substantial *new* saving is not easy. The incentive must come in the form of lowering the price of future consumption relative to current consumption. However, simply providing a subsidy to future consumption (by increasing the after-tax return on asset income) generally increases a household's net lifetime resources. For those who would have saved even in the absence of the tax-subsidy, the increase in lifetime resources may stimulate more rather than less current consumption. The consensus view in the economics profession is that only about 25-30 percent of contributions into tax-favored saving accounts represent net additions to saving.

The multiplicity of tax-deferred saving vehicles and complexity of rules may have discouraged some potential savers from participating in tax-favored saving plans. The complexity of "back-loaded" saving vehicles [401(k)s and regular IRAs] is not restricted to their rules; it also emerges from potential interactions with income tax rules, including taxes on Social Security benefits, itemized deductions and exemptions.

A recent study that I co-authored analyzes the potential lifetime gains from participating in 401(k) plans and Roth IRAs. These plans are almost universally recommended for households as a way of saving on their lifetime taxes. However, the study's surprising result is that low-earners who make substantial contributions to their 401(k) accounts and receive moderate to high

rates of return on those contributions, could end up paying *more* in taxes on a lifetime basis. Hence, such households would enjoy *smaller* lifetime consumption because of their participation in such plans.

This counter-intuitive result arises because of the tax interactions of "back-loaded" plans mentioned earlier. To summarize briefly, participation in such plans lowers current taxes, but increases future taxes. The extent of current and future tax changes depend on participants' tax brackets when contributing versus when withdrawing from such plans. The changes in these tax-brackets can be potentially quite large—depending on the sizes of contributions and the rates of return earned on plan balances through retirement. Large account accumulation through retirement can trigger larger withdrawals, pushing participants into higher tax brackets relative to those faced without participation. In addition, high withdrawals can potentially increase the amount of Social Security benefits that become subject to tax and can result in a greater phase-out of itemized deductions relative to non-participation.[5] Finally, plan contributions can potentially lower participants' tax brackets when working, and reduce the value of itemized deductions and exemptions, again compared to non-participation.

Using a model of lifetime consumption and saving that incorporates in considerable detail provisions of the federal income tax, state taxes, and Social Security taxes and benefits, the study calculates the implications of participating in 401(k) plans and Roth IRAs for stylized households at different income levels.[6]

Table 2 shows results for low income households. The calculations incorporate the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 which expanded contribution limits on several types of plans, including 401(k), 403(b), Keogh, traditional and Roth IRAs.[7] EGTRRA also provides a non-refundable tax credit for qualified account contributions up to $2000 for households with low earnings, which phases out for households with AGI larger than $50,000). Because this credit is sunset, and the phase-out dollar thresholds are not indexed, the tax-treatment of plan participants was calculated under alternative assumptions about whether the credit is indexed or not, and whether it is extended beyond 2010 or not.

The results show that in each case, some categories of low-earning households would pay more in lifetime taxes (present value of future taxes) if they participated in a "back-loaded" savings plan and received a moderate (6 percent) rate of return on their contributions. In addition, the tax interactions dilute the lifetime tax savings for even those households that benefit, on net, from participating in "back-loaded" plans.

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[5] The Economic Growth and Tax Relief Reconciliation Act gradually removes the limitation of itemized deductions between 2006 and 2010, but the limitation is reinstated in 2011 when this EGTRRA provision is sunset.
[6] "Who Gets Paid to Save" by Jagadeesh Gokhale and Laurence J. Kotlikoff published in *Tax Policy and the Economy*, NBER, vol 17, 2003, pages 111-39.
[7] For results on stylized households at higher earning levels, see Gokhale and Kotlikoff cited in footnote 5.

Table 2: The Percentage Change in Lifetime Taxes and Spending from 401(k) Participation Under Alternative Assumptions For Selected Household Earning Less Than $50,000 6.0 Percent Real Rate of Return

Age-25 Earnings	401(k) and Traditional IRA				Roth IRA	
	Non-Refundable Tax Credit Not Extended and Not Indexed		Non-Refundable Tax Credit Extended and Indexed			
	Taxes	Spending	Taxes	Spending	Taxes	Spending
25,000	1.35	-0.29	-0.68	0.02	-8.96	1.29
35,000	-0.68	0.05	-2.08	0.34	-3.85	0.77
50,000	1.07	-0.36	0.58	-0.24	-3.25	0.81

Note: Lifetime taxes and spending refer to the present values of the couples' annual taxes and spending on consumption, housing, college tuition, and life insurance premiums.

Despite the non-refundable credit for low earners, Table 2 shows that some low earner households would lose on a lifetime basis from participating in 401(k) plans and IRAs.

How many U.S. households actually face this jeopardy? I am currently co-writing a study on this issue using survey data from the Board of Governors of the Federal Reserve. A preliminary result from this study suggests that roughly 10 percent of participating households may suffer an increase in lifetime taxes (and a reduction in lifetime consumption) as a result of continued participation at their current levels in 401(k) plans.[8]

Because Roth IRA contributions are made from post-tax resources and withdrawals are not subject to tax, participating in such "front-loaded" plans does not result in the tax-interactions described above for "back-loaded" plans. Hence, Roth IRA-type incentive plans provide a lifetime tax subsidy even at low earning levels. The new proposals to introduce Retirement Savings Accounts and Lifetime Savings Accounts are structured similar to Roth IRAs and, therefore, should work better as saving incentives compared to 401(k) plans and traditional IRAs. They may be also better than Roth-IRAs because of their simpler regulations.

The remaining concern about all such (traditional- and Roth-IRA-type) saving incentives is their impact on the federal budget. Providing tax-incentives to promote greater saving implies a loss of federal revenue. Absence of other concurrent tax or spending changes to make up the revenue loss implies a larger accumulation of debt, which must ultimately must be serviced or re-paid through future tax or spending adjustments. If short term deficits are increased, they could soak up privately investible savings and produce only minor net addition to the capital stock, if any. If concurrent tax or spending changes are included to avoid larger debt accumulation, those tax-policy initiatives may partly or fully offset the initial saving incentives. Therefore, judgment

[8] The study finds that 7 percent of all households may pay more in lifetime taxes by participating in 401(k) plans using survey data pertaining to 1995. A recent KPMG retirement study finds that in 1995, about 65 percent of employees participated in employer sponsored tax-deferred saving plans.

about the efficacy of such incentives requires careful consideration of the tax structure on a revenue neutral basis.

Conclusion: The impending entry of baby-boomers into retirement will require a steep increase in retiree consumption. Even if real consumption levels per capita stay constant, retirees will consume an additional 15 percent of national output by the year 2030 compared to today. If retiree consumption levels are to continue increasing at historical rates, the transfer of consumption toward retirees will have to be doubled by the year 2030 compared to today. To achieve this result, the consumption of per-capita consumption of younger cohorts will have to be kept constant at today's levels.

The rate at which retiree consumption can grow will be constrained by the rate of growth of national output. Unfortunately, the transition of baby-boomers into retirement implies significantly slower labor-force growth. Declining national saving is constraining domestic capital formation despite sizable borrowing from abroad. Finally, although productivity growth has trended up recently, we have little information about the sustainability of such a trend. Maintaining high productivity requires rapid capital formation and human skill acquisition—both of which necessitate higher rates of saving and investment.

The allocation of consumption resources toward retirees is accomplished in the United States through public transfers via Social Security and Medicare. Both of these programs face sizable fiscal imbalances. Social Security's overall fiscal imbalance equals $7 trillion and that of Medicare including the recently enacted Prescription Drug coverage for seniors is roughly 7 times as large as that of Social Security's. Restoring financial balance to these programs will require large tax/benefit changes. Understanding the trade-offs in making such policies requires us to carefully re-structure federal budget accounting systems.

Inducing greater saving through tax policies is desirable to rectify existing disincentives arising from income taxation and other public policies. Those policies are continuing to transfer sizeable amounts of resources from young workers with low propensities to consume toward older individuals with higher and growing consumption propensities. In addition, the pay-as-you-go financing structures of Social Security and Medicare sap workers' saving incentives and ability.

Providing greater saving incentives via Roth-type tax-favored plans is superior than via traditional IRA or employer sponsored 401(k) plans. The latter plan-types allow tax-free contributions, but withdrawals are subject to the income tax. These features generate interactions with other income tax provisions and reduce the lifetime tax-subsidy that "back-loaded" plans can provide. The initiatives to introduce Retirement Saving Accounts and Lifetime Saving Accounts are similar in design to Roth IRAs and impose fewer restrictions; hence, they should be more effective in encouraging greater net saving. However, their ultimate efficiency in increasing saving and investment will also depend upon how current and future tax and spending changes make up the lost federal revenue.

The CHAIRMAN. Thank you very much, Dr. Gokhale.

All of your testimony and your charts and everything will become a part of our record.

In part, both of you may have answered this, but let me ask the question, because I think it is at the core of what we are not doing versus what we are doing that is affecting the savings rate. There have been several national educational efforts designed to increase savings over the past decade. Yet, the savings rate continues to decline. How are we to view these educational efforts in light of a declining personal savings rate, and I ask that of both of you as a general question?

Dr. VANDERHEI. Well, not to change the question, but I really think what one wants to focus on as an output metric is not necessarily personal savings rates. There are many components that have long been debated as perhaps not being totally effective in determining what you are trying to accomplish in those educational campaigns.

I think what one might want to look at in more specificity is what is happening to certain targeted groups of those educational campaigns; for example, with 401(k) participants, there was a lot of conventional wisdom recently that with the recent 3-year bear market, 401(k) participants would have given up and started to reduce their contributions or get out of the 401(k) plans altogether.

A recent study I have done on approximately 10 million individual 401(k) participants with Sarah Holden from the Investment Company Institute shows there has only been a very, very minor decrease. One of the reasons for that is the educational campaigns that the employers and the service providers have been able to transmit to the 401(k) participants. I think if you look at particular groups of individuals that are likely recipients of those educational campaigns, you can get a better feel than if you look at some aggregate overall statistic.

So overall, I would say that the employer-provided educational campaigns have been quite effective, not only in increasing the employee contributions going into 401(k) plans but also keeping them at a substantial rate, even over one of the worst bear markets we have seen in the last recent history.

The CHAIRMAN. Dr. Gokhale.

Dr. GOKHALE. Well, as far as education campaigns, my answer is going to be somewhat general, but I will speak to the issue of whether encouraging more participation in 401(k)s, especially on the part of lower-income individuals, is really desirable and how effective that is really as a savings incentive.

Well, increased education can improve a person's perception of the alternatives available. But if those alternatives are all bad, then, it is not going to result in a higher saving rate necessarily. So, my view is these programs are probably misguided, and you should not spend as much time and effort into these educational programs, because the policy environment within which people operate today has built into it disincentives to save.

I have studied the decline that we have had over the last several decades in the national saving rate. I came up with three reasons for why that decline has occurred. First, we have transferred resources from low spenders to high spenders, essentially through

the expansion of Social Security and Medicare. Well, that means the elderly who consume a higher fraction of every dollar of their resources are getting resources to consume, and that is reducing national output, whereas, younger individuals who consume less per dollar of their resources are losing resources.

Second, the provision of greater Social Security and Medicare benefits in annuitized form, meaning that they are paid as annual income rather than as a lump sum at retirement, provides longevity insurance, meaning they insure individuals from the uncertainty about how long they are going to live.

But as a result of providing that insurance, people who receive these annuitized benefits are able to consume at a faster rate out of their Social Security wealth, and therefore, again, consumption goes up, and national saving goes down.

Finally, because of higher health care costs, the retirees over the last several decades have increased their rate of consumption out of every dollar of resources. We have transferred resources towards retirees, and their rate of consumption out of resources has been rising over time. That is the third reason for the decline in national saving.

One may try to encourage younger generations to save more, but imagine the situation these generations face. They have high necessary expenditures in bringing up their children, providing for childrens' expenses paying mortgages on their homes, and on top of that, paying 15.3 percent as payroll taxes. If they did not have to pay those taxes they would, presumably, have more to save. They might expect, incorrectly, that the Government is doing the saving for them, taking this 15.3 percent of earning and promising them these Social Security and Medicare benefits when they retire.

But we know there is a funding shortfall in these programs; that it is not clear how fully people appreciate that funding shortfall. So the public policy stance here is to provide retirees with the ability and incentive to consume at a faster rate, because we are giving them additional resources. We provide younger individuals with diluted tax incentives to save. As I mentioned the 401(k) plans, even though they save taxes on the accrual of interest and capital gains on the account balances, once these balances are withdrawn, they are subject to tax.

Depending on how well the plan does in the accumulation phase the individual might end up in a higher income tax bracket upon retiring because of high withdrawals from the plans and, therefore may pay more in taxes on a lifetime basis. In addition, you might have more of your Social Security benefits subject to tax because of these high withdrawals. In the withdrawal phase, you would have, if you downshift your tax bracket, you would lose on your exemptions, the value of your exemptions and deductions.

So younger individuals, even though they receive tax-saving incentives, those incentives are really very dilute. The 401(k)-type tax incentive is not as efficient as one might believe, especially for low earners, some of whom might lose on a lifetime basis. They would be able to afford less consumption over their lifetime and pay more taxes as a result of participating in these plans.

Within this public policy environment, where the elderly are receiving resources and are encouraged to consume more, and the

young are in a situation where they have huge necessary expenses and inefficient tax incentives to save, educational efforts to get them to save more are not going to work.

Thank you.

The CHAIRMAN. Thank you.

Dr. VanDerhei, your testimony presented 5 percent as an additional increase in savings needed to reduce the income expenses gap for future retirees. Have you calculated what total percentage of savings would be necessary to meet retirement expenses and, if so, what would that be?

Dr. VANDERHEI. Actually, I believe you are referring to figure C in the written testimony.

The CHAIRMAN. Yes.

Dr. VANDERHEI. One of the things that we did, which I did not have time to mention in the oral testimony, is an addition to compute what savings rates individuals would need to make to have a particular comfort level that they will be able to meet their retirement expenditures. We wanted to try to find out if there was some relatively feasible goal, savings goal, target savings that individuals could all do and see how that was going to impact the overall probability of having sufficient retirement income.

The 5 percent was more or less an ad hoc number that seemed relatively reasonable. Most groups could probably afford that. And if you take a look at—actually, Craig, could you—we have a chart over here, chart C.

I apologize, Senator. Can you see that from there?

The CHAIRMAN. I can, and I have it in your testimony. I will refer to that. Go ahead.

Dr. VANDERHEI. OK; basically, as you look out, as a function of age, the younger birth cohorts, obviously, since they would have the longer period of time to be able to put in that 5 percent have a much higher probability regardless of income quartile and regardless of family status and gender to be able to have sufficient income. But the 5 percent only gets you over a 90 percent probability if you are in the very youngest birth cohort and one of the highest two income quartiles. That is what the red circle represents.

After we put together the written testimony, actually Money magazine is running a special article in their March issue based on similar types of things, and they asked much the same question: that is fine for the youngest cohort, but what about people that are currently in their fifties—or born in the 1950's, excuse me, which would be the next two younger cohorts?

I went back and ran the same type of analysis, and it would indeed take a 10 percent additional savings rate to be able to get the upper two income quartiles for people born in the fifties up to the 90 percent level. But even at that 10 percent level, the lower two income quartiles do not even come close to that. So again, I think you need some caution when you come up with, quote, the savings rate; it is going to largely depend on, unfortunately, their family status, their gender and their income quartile as far as how much they have generated already within the defined benefit, the defined contribution, and the IRA environment.

But I would say for the third and fourth quartile, people born in the 1950's or later, 10 percent would seem to be adequate.

The CHAIRMAN. OK; your testimony included a reference to scenarios where you assume retirees use their home equity to finance their expenses in retirement. Could you elaborate on the findings and the message seniors should take away from those results?

Dr. VANDERHEI. I would be glad to. Again, something I did not have a chance to talk about in the oral testimony is that we knew that there was anything but a general consensus in what retirees should do, much less what they actually do do, with their net housing equity when it comes to financing retirement.

Some individuals suggest that you should just keep it and never liquidate it; not use it for retirement. Other say that as soon as you retire you should sell the house, take the net equity, perhaps annuitize it in something known as a reverse annuity mortgage. Others would say just hold on to it as long as you can, but when you need it, whether it is for a catastrophic medical cost or something else, that is the time to sell it, and instead of annuitizing it, to basically keep it as a lump sum.

So we ran all three scenarios. What I presented earlier today was a baseline, where you assume there was never any liquidation, but we find that in the third scenario, where you hang onto the house after you retire, as long as you can until you need it for some financial reason, perhaps catastrophic health care costs, that basically, the aggregate deficits for all people in a particular year decrease by as much as 23 percent.

So certainly, from all of the scenarios we ran, it seems to make sense when possible to hold on to that as long as you can as another part of your nest egg that you are going to easily be able to liquidate to use for other purposes later.

The CHAIRMAN. Can you explain why percentages for some groups differ so widely? You have done that in part, but figures A and figures B, you have got a wide spread there.

Dr. VANDERHEI. Sure; just to quickly flip to figure A—and this is all in the written testimony if you are interested—one of the problems we have with the types of retirement planning devices which are widely available is they do a very good job of simplifying the assumptions so that they are easily used, but oftentimes, they use averages: what is your average life expectancy? What is the average rate of return you expect? The problem is that if you do not deal with uncertainty, you are basically going to end up planning for how much money do I need to be able to survive through retirement 50 percent of the time?

I think if you ask most individuals "is having enough money just 50 percent of the possible times in retirement sufficient?" they are going to say no. So what we did in figure A was to run the scenario so that you are going to have enough money three out of four times; hence, the 75 percent confidence level. Just to focus on a particular group to give you an example, the circled number there is for the single females in the next to lowest income quartile, born between 1951 and 1955. The median individual in that cohort, we assume, if you want enough money to have enough retirement income three out of four times, would have to save an additional 11 percent.

But if you flip that to figure B, the exact same cohort, if they want enough money to have sufficient retirement income nine out of 10 times in retirement, obviously is going to have to save more. For this particular group, you see that 11 percent on the previous chart now escalates all the way up to 18 percent. So you are going to need to have a bigger buffer against some of these consequences if indeed you want to have more certainty that you are going to be able to meet, for example, the longevity risks that were just mentioned previously.

The CHAIRMAN. Let me ask you this last question before I turn to Dr. Gokhale: what is the best way to interpret your results in figure C, given the current public policy debates that are underway?

Dr. VANDERHEI. The good news about figure C is that overall, the numbers seem to get better as you go further and further to the right. What that is saying is that those individuals that start saving and start saving early are obviously going to have a much, much higher probability of having sufficient income overall. So that would be the overall message, I think, from a public policy standpoint is to start saving and to start saving early.

When you go back, and you compare not just the retirement wealth, but whether retirement wealth will be sufficient to meet retirement expenditures, you find a much higher probability overall.

The CHAIRMAN. Thank you very much.

Dr. Gokhale, you said in your statement something that really caught my attention, because not long ago we had Chairman Greenspan before the committee to talk about the demographics of aging and cultures and economies and the impact that those aging demographics have on given public policy and economies. He used Japan as an example. But he also said something that I want to clarify in what you said. He said because we have a dynamic immigration policy in this country, we will not hit the same indices, if you will, that Japan did, where as we grow older, and the baby boomers leave the work force, we will not have anyone to replace them in the work force.

Now you mentioned, and I believe these were your words, labor force growth rates will fall as the baby boomers exit. In reality, if we have a dynamic immigration policy, will that be the case? I understand, and I think most who look at this clearly understand, that if we have a declining labor force committed to pay for the public commitment that we have toward our baby boomers, we are in real trouble. We are in real trouble anyway.

But having said that, if we have—and the reason I find that important is because we are right in the midst of a fairly aggressive debate on immigration policy in this country and how we deal with immigrants and undocumented workers and all of that. Expand on that, if you will.

Dr. GOKHALE. Well, I think a friendlier immigration policy that encourages immigrants to enter the United States and work and contribute and pay taxes will definitely alleviate the problem we are facing with a growing commitment toward financing consumption for retirees. Having said that, current immigration levels do not, I think, even approach the level of immigration that would be needed to completely overcome the problem we are facing.

I think today—I may be off a little in the numbers I am citing, but I think roughly about a million immigrants, a little under a million immigrants enter the United States every year.

The CHAIRMAN. That is about right.

Dr. GOKHALE. I have documented that by 2030, the retiree population will essentially double. Now, if you are going to keep everything in the same proportions, then, the working proportion should also double in order to have sufficient resources through tax revenues coming in to pay the retirees the consumption resources they will need.

Doubling the worker population is going to require a huge increase in immigration, which I do not believe is going to be possible or even contemplated. I think that the immigrants who are in this country and who wish to come into the United States and work would be welcome, but I think immigration as a solution to the retirement crisis we are taking is probably not on the cards.

The CHAIRMAN. Well, that puts your statement in context, then, of the kind that helps me understand what you are saying and why you are saying it.

In your testimony, you have suggested that short-term budget concepts like deficits are inappropriate. How would the longer-term measures that you recommend help us solve entitlement finances?

Dr. GOKHALE. Well, we know that Social Security and Medicare involve very long-term commitments. The budget concepts that are regularly published by the official budget reporting agencies such as the Congressional Budget Office and the Office of Management and Budget, essentially look five or 10 years ahead into the future. That implies that these short-term budget measures do not capture the longer term implications of current policies, because most of the budget crunch, the shortfall or revenues to cover the promised benefits, will occur beyond that projection horizon.

The budget measures that I am recommending would be much longer-term in their focus. They would essentially help us in two ways. We know that there is a budget shortfall. We need to quantify how big that shortfall is. Those budget measures essentially tell us how much additional resources the Government has to raise or have on hand in order to make those policies sustainable. That is one message that my recommended budget measures would help us to understand.

The other way in which those budget measures would help us is choosing between alternatives policies that we could use to fix the problem. We have a choice between many different ways of implementing those policies in order to close the funding gaps for these programs.

Of course, depending on what type of policies are implemented, different groups in the population, including future populations, are going to be affected differently. We need to understand how those different effects will occur under different policies in order to be able to make informed choices about the most desirable ways to address the funding shortfalls of Social Security and Medicare.

The CHAIRMAN. You mentioned that economists believe that only 25 or 30 percent of the total savings benefiting from tax-favored savings accounts would be new savings. In light of this, can you

elaborate on the benefits of expanding Roth IRA-like savings accounts?

Dr. GOKHALE. Well, if you save more, then, obviously, you acquire a claim on real, productive assets. Greater saving has significant beneficial effects—completely the opposite of when there is inadequate saving in the economy. That sounds tautological, but let me elaborate a little bit.

If people save more, they acquire a claim on real, productive assets. The counterpart to there claims in the real economy would be more capital per work, making workers more productive.

When the high savers retire, we need to transfer consumption resources towards them. But they would then have the claims that are needed to effect that transfer. So, the financial mechanism that we need to transfer these additional resources from younger to older generations, for the retirees to be able to draw on resources—they would already have the financial claims on resources. So, the transfer would be easily effected.

Both the real and the financial economies would work in a complementary fashion to effect the required transfer toward the retiree populations.

The CHAIRMAN. You seem to favor the after-tax type Roth account, after-tax dollars going in but tax-free dollars coming out.

Dr. GOKHALE. Right.

The CHAIRMAN. We obviously found early on that tax-free dollars going in up to a certain amount was a phenomenal incentive. After-tax dollars are less incentivized, and not until you are much older do you recognize the value of tax dollars coming out being untaxed.

You still hold that it is preferable that it be after-tax dollars going into a Roth-style IRA?

Dr. GOKHALE. That is correct. There are several reasons why the saving incentives, such that before-tax dollars go in, but the withdrawals are taxed, provide a very diluted savings incentive on a lifetime basis to those who participate. I mentioned three reasons earlier. Essentially the reasons are the withdrawals can put you in a higher tax bracket. The higher withdrawals, if they are sufficiently high, can subject more of the retiree's Social Security benefits to taxation and therefore increase total tax liability over the lifetime.

In the contributions phase, if a person downshifts across tax brackets, then, the value of exemptions and deductions and mortgage interest and all of those things that you take deductions for, the value of those deductions would reduce.

An additional reason is that if plan withdrawals are taxed, capital gains accruals in the accounts, which would ordinarily be taxed at a lower rate, would now be subject to an income tax, and that tax would perhaps be at a 30 percent rate. If you could keep these resources outside the tax incentivized saving vehicle, those would be subject to a capital gains tax rate, which would be much lower.

So these tax interactions dilute the saving incentives of the traditional IRA type savings plans.

The CHAIRMAN. Thank you. Is Tom coming back? Do you know? Oh, he is on the phone.

Well, then, I will ask one more question, and then, we have been joined by our colleague, Tom Carper, Senator Carper. See if he has any opening comments or questions.

Dr. Gokhale, you elaborated on your view of the two approaches to solving the Social Security's financial problems, i.e., maintaining the existing systems with benefit cuts and tax increases or moving to personal retirement accounts.

Elaborate on that, if you could, for the record. That is a debate that we are moving toward; no question about it, and we have to. I think collectively, in a bipartisan way, most of us recognize that Social Security, especially for younger ones coming into it, needs to produce a greater return as it relates to dollars in, dollars out. At the same time, being able to sustain a secure system for those who are moving quickly toward it. If you would expand on those approaches.

Dr. GOKHALE. I recently did a study about the funding shortfalls for Social Security and Medicare in the entire Federal Government. It has been published in a book by the American Enterprise Institute. In that, I show that Social Security's shortfall over the entire future is about $7 trillion, and that of Medicare is even larger, at about $36 trillion. These numbers are as of the fiscal year 2002. These are huge shortfalls.

It essentially means that going forward under current policy, not enough tax dollars will come in to pay the scheduled benefits of these programs. Now, at some point in the future, either the scheduled benefits will have to be cut in order to bring them in line with the amount of resources, the revenues that we have under current tax laws, or the tax rates, the payroll tax rates, would have to be increased. We could do that, just a simple fix to Social Security and Medicare's financing problem; either cut the benefits in the future or raise taxes but keep the financing mechanism the same. That is one alternative. I call it the status quo alternative.

Now, the problem with this alternative is that when we either cut benefits—future benefits of workers and future generations—or raise their taxes in order to close the funding shortfall, we would delink benefits from taxes, which means, on net, we would increase the taxes of these individuals. On net, whether we cut benefits, or whether we raise taxes, the net effect is to increase the take from them in terms of net tax dollars.

Higher net tax rates distort individual behavior and essentially impose an economic loss in addition to the amount of tax revenue raised by that measure. So, if we raise taxes, let us say, to cover the $7 trillion shortfall in Social Security, it is not only the $7 trillion that will be a cost to future workers, but in addition, their behavior will change. They will work less, perhaps, because their tax rates are high.

That distortion will create an additional economic loss. My simple calculation suggests that that loss will be about a 30 percent additional cost on top of the amount of funding gap that exists in Social Security today. So, the alternative to that is to not make the additional transfers required for future retirees now that the baby boomers are going to retire. We will need to expand these transfers; at the margin, not do that expansion through the existing Social Security system but do it through reforming the system such

that we get people to save in these type of tax-incentivized saving vehicles through a personal or individual account reform of the Social Security system.

The benefit of an individual account reform would be to reduce the additional distortions from tax or spending measures that are taken to close the funding gap. The distortion would be minimized, because now, the individual account is owned and controlled by the individual. That has some benefit, some value, to individuals. Hence, the distortionary impact of these tax law changes would be lowered. They can own the account; they can invest it in their preferred investment directions, subject to some regulations, of course, but the investments would be matched to their personal risk preferences.

In addition, once they pass away, they can bequeath those account balances to their loved ones, which means those additional features, because they add value to the benefits, will minimize the distortions arising from the necessary tax and benefit changes that have to occur in the future.

The CHAIRMAN. In those studies, did you go on to discuss the type of personal account and how it got managed as relates to the individual? Or did you compare it to a Federal—the current system that we have for Federal employees to invest in an IRA-like account, if you will?

Dr. GOKHALE. The Cato Institute has just released an outline of an individual accounts reform plan for Social Security. In that, we have a fairly elaborate mechanism whereby these account balances would be set up. There would be a three-tier regulation of the investments allowed. Initially, when workers contribute into these accounts, until their accounts reach a certain size such that they could purchase, let us say, an annuity that would allow them a living standard about 120 percent of the poverty level, they would have to restrict their investments in reasonably safe and conservative investments.

But once they have accumulated sufficient amounts in these accounts, they could broaden their investment choice. We are working on estimating how, exactly, the finances would work, but the Cato Institute just released an outline of such a plan, and we are working on designing its details.

The CHAIRMAN. Do you also propose in that a phase-in period for those who are currently participating in this system, if they choose, or new work force coming in—

Dr. GOKHALE. Right.

The CHAIRMAN [continuing.] Percentages of a total amount going in, move toward a personal account?

I have looked at a variety of models, and of course, the frustration for those of us who believe that we ought to move toward personalized accounts, is how do you continue to fund, over a period of time, the existing commitment, i.e., liability, to Social Security from the current work force while allowing them to move toward personalized accounts?

Dr. GOKHALE. Right, the existing liability is there. The only problem is that it is not reported in official budget reports.

The CHAIRMAN. Right.

Dr. GOKHALE. That does not make it—

The CHAIRMAN. No.

Dr. GOKHALE. It does not make it disappear. It is there. It is just not as visible as it would otherwise be.

So, sure, when you take a part of today's payroll tax payments and invest them in individually owned and controlled accounts, then, we have a problem in financing current benefits to current retirees.

For a period of time, that may have to be done through borrowing more from the markets. That implies higher debt levels, but that simple transaction is just replacing an implicit debt that exists—off the books, but it still exists—an implicit debt for an explicit debt.

The CHAIRMAN. I see.

Dr. GOKHALE. That is a transition mechanism that we are working on designing.

The CHAIRMAN. That is a clear way of stating it. I had not thought of it in that total context.

Do you want to check and see if Senator Carper has any comments he wants to make? I do not have any further questions of these gentlemen.

Well, I want to thank both of you for being here this morning. This is obviously a dialog for the record of an oversight committee like this one that I think is increasingly valuable as we look at a variety of instruments. Our President has proposed a variety within the Medicare prescription drug package. We established something that I have worked on for a good number of years, as have others; the health savings account concept, which I think hopefully will begin to showcase the value of these kinds of tools out there that citizens can go toward to advance their own needs, whether it be health care or retirement. I think that is extremely valuable.

Senator Carper, we are pleased you have joined us this morning. I have concluded my questioning, and if you have any comments to make of these gentlemen or questions, please proceed.

Senator CARPER. Mr. Chairman, I was just talking with a retiree, a fellow who is 86 years old, and he lives in the Riverdale section of Brooklyn. His last name is Biaggi, Biaggi. Does that name ring a bell with you?

The CHAIRMAN. Biaggi.

Senator CARPER. Used to be a captain in the New York Police Department.

The CHAIRMAN. I will be darned.

Senator CARPER. Later a Congressman.

The CHAIRMAN. Oh, of course, Mario.

Senator CARPER. Mario.

The CHAIRMAN. I will be darned.

Senator CARPER. Eighty-six years old. I just try to keep tabs on him.

The CHAIRMAN. Very colorful gentleman.

Senator CARPER. He is a great guy.

The CHAIRMAN. Yes, he is.

Senator CARPER. He is a great guy; 86, he is a widower now, and he just returned my call, and I felt my cell phone vibrating, and I slipped in back to take it. So I have missed what was said here,

but he asked to be remembered, and I know you and I served with him—

The CHAIRMAN. Absolutely.

Senator CARPER [continuing.] In the House.

Gentlemen, thank you for joining us this morning. I am glad you did not get stuck in Dallas with the storm or bad weather.

I was looking at a chart that came with the materials for today's hearing, and I do not know that—I think you might be able to tell it. It starts over here on the left hand side in 1981, and we are measuring the personal savings rates from 1981 over here to 2003. You do not need very good eyesight, I think, to see that the trend is going in the wrong direction. When I look at this number, it says in 2003, our savings rate was down to almost 2 percent. Let me just start off, if we could, by just asking you to tell me what do we count when we talk about the personal savings rate?

Dr. GOKHALE. Well I generally tend to—

Senator CARPER. Maybe what do we not include that we ought to think about?

Dr. GOKHALE. Well I have—I mean, the personal savings rate is calculated as personal disposable income minus household outlays. The remaining part is the amount not consumed, essentially, and that is how I prefer to calculate the saving rate—as the rate of the amount not consumed divided by the income base over which the saving rate is defined.

I prefer doing it that way rather than adding up different saving components; that gets to be pretty difficult.

Senator CARPER. Go ahead, Mr. VanDerhei. Would you want to add to that or take away?

Dr. VANDERHEI. Well, I would agree with that. I think there have been some long-acknowledged deficiencies with it. I remember back in the days when retirement plans were primarily defined benefit plans, that the primary difference that we had was if you are looking at employer contributions going into the plans as the component of savings rates as opposed to what the actual benefit accruals of the employees were that when you had artificial restrictions, as were imposed in 1987 with the so-called full funding limit, that you had these time series out of whack for awhile.

Obviously, as defined benefit plans have diminished in overall importance, that becomes less and less of a problem. But actually, Senator Craig had asked a very similar question earlier, and I guess my response to him was I think if you are really wanting to concentrate on what this problem with the savings rate is for future retirement income, that perhaps the aggregate number is not what you want to focus on; that you want to focus on what pockets of the population are vulnerable and, basically, what types of savings rates they would have to have prospectively.

We realize there is a problem historically, but prospectively, what would they need to have to get to some adequate retirement income by the time they hit, say, Social Security normal retirement age? Unfortunately, those types of vulnerabilities get masked in those aggregate numbers.

So I guess breaking them out into individual components, I think, is the important point.

Senator CARPER. Well, when I was Governor of Delaware, our administration spent a fair amount of time encouraging homeownership. We ended up with a homeownership rate that approaches 75 percent in my little State, which is pretty good. I continue to focus on that as a United States Senator, with a real focus on my home State.

I am wondering if—we have seen a lot of refinancing of home mortgages; in some cases, people taking the equity out of their homes in order to pay for other debt and to pay off other debt, maybe more expensive debt, and to end up with a lower mortgage payment. Does that explain some of the reduction in the savings rate? Do we count here the equity in people's homes? Is that reflected here in this personal savings rate?

Dr. GOKHALE. I think the personal savings rate does not reflect the capital gains accruing on homes. Essentially, it is an income—it is a measure of how much income is not spent on consumption. But the income measure does not include capital gains accruing on homes. So even though capital gains affect the amount we consume, the gains themselves are not part of the income definition. So even though it affects the saving rate, the measure does not directly address the fact that you are also receiving value through appreciation in your home.

Senator CARPER. Some other countries that have a historically high rate of savings—Japan comes to mind—I used to kid the guy who was the Prime Minister of Japan; I remember meeting with him a number of years ago, and I said, "you know, your country is so different from ours." I was giving him a little bit of encourage to stimulate his economy, and I said, "in our economy, if you cut taxes by, a dollar, people will go out and spend $2."

In Japan, if you cut taxes by, like 1 yen, people will go out and save 2 yen. But Japan and other countries where they do not invest as much of their money in housing, they have a pretty high savings rate. I wondered if maybe our capital accumulation, is a little bit better than is reflected in these numbers, because we do inordinately invest in our homes.

I like to think that probably for the majority of people in our country, probably, that the biggest source of capital accumulation for a lot of folks is the equity in their home. We use that equity to, in some cases, reverse mortgages to help pay for our lives at the end of our lives, and to sustain it, some people use the equity in their homes to start a small business, you know, to send their kids to school, that kind of thing.

But could one of the reasons why—let me make up an example. Let us say a person makes $50,000 a year, and they put $500, let us say $1,000 a year in savings of some kind, stocks, whatever, a 401(k). But they also pay a mortgage every month, and part of the principal for that mortgage might, we will say, adds up to over the course of a year to, say, $5,000 just for principal, and they have seen accumulation of equity and the capital gains in their home.

Do I understand it that this personal savings rate reflects the $1,000 that they might put in their 401(k), but it does not reflect the $5,000 in principal payments that they have made in their home or the increase in capital accumulation on their home, increase of value in their home? If that is true, does that make

sense? Either one of you, feel free. I do not want to pick on you, Doctor.

The CHAIRMAN. Let me add this, because this is an excellent question. Is not the indices or the numbers that we calculate personal savings rate in this country include IRAs, 401(k)s, defined benefit pensions and personal retirement accounts, all other forms of accumulation are not a factor in these figures? Is that an accurate thought? Is that accurate?

Dr. GOKHALE. My understanding is that all saving is included in the personal saving rate. The way I calculate it, if you do not consume something, you are saving it out of the income definition we use.

The CHAIRMAN. So your definition would include—

Dr. GOKHALE. My definition would include the budget—

The CHAIRMAN. The buildup of—

Dr. GOKHALE. The buildup of—no, would include the buildup of equity through paying the mortgage, because essentially, by paying a mortgage, you are buying part of a durable good, the home. If you appropriately adjust the personal savings rate to take into account the fact that you are purchasing a durable good, it would be included.

Usually, however, in the definition of outlays includes purchases of durable goods. So there are some subtleties—alternative ways of calculating the personal savings rate to adjust for purchases of durable goods.

What is not included is the appreciation of that $5,000, because home values go up. So you might be paying off $5,000 in principal, but at the end of the year, that $5,000 appreciates and becomes $6,000, because the home's value has increased. That additional $1,000 of home appreciation will not be included.

The CHAIRMAN. Intriguing.

Senator CARPER. OK; let me just ask each of you: just give me some really basic responses in terms—and you have already, I am sure, gone over this in your testimony and with the Chairman. But if our interest is in encouraging greater savings in this country for capital formation, for investments to make us more productive, it is kind of interesting: we continue to be more and more productive as a nation, our work force is, while our savings rate is going to pot.

I do not know if there is an easy explanation for that or not. But just a couple of basic things that we ought to be doing, particularly with us in the Congress, to encourage greater savings.

Dr. GOKHALE. Well, my recommendation is to essentially design saving incentives in the style of Roth IRAs rather than traditional IRAs and 401(k)s, simply because Roth IRA rules minimize the interactions of contributions and withdrawals with the rest of the income tax code and that dilutes the saving incentives.

The Roth design does not involve such interactions with the rest of the income tax code, and therefore, the tax incentive remains strong. But an important additional qualification is that when we provide either a Roth or a traditional type of saving incentive, the government loses revenues. Which type of other tax and spending policies are used to recoup lost revenues is also important.

If we raise other taxes to make up for lost revenues, we may not, on net, be providing significant saving incentives. If we finance the lost revenues through incurring larger deficits, then, we would have to raise future taxes by even more, not only to recoup lost revenues but to pay interest on the debt accumulated along the way. That would dilute the savings incentive even more. But if we cut spending in response to lost revenues, then, we would preserve the saving incentive. So we need to couple such saving incentives with control over federal spending.

Senator CARPER. OK.

Dr. VANDERHEI. I would say fundamentally, you want to look at what is doing the best job of producing retirement savings at this point in time. I think if you look at the private retirement system, you would want to look at both what you can do for employers that currently do not sponsor plans to give them the incentives to start doing it, because that will, by definition, increase the participation in retirement plans for their employees and then also look at the employees.

One of the problems on the employee side is not necessarily that employees are not responding to employer incentives, because when a 401(k) plan is offered with a match, a large, large percentage even of the lower income employees will respond to that. The problem is, however, that currently, it is, in many people's opinion too easy for that money to slip out of the retirement system at job change.

Currently, there are tax incentives to keep it in the system, but those incentives, obviously, are not sufficient, especially when the employees are young. Instead of rolling over those account balances from the old employer to the new employer or into an IRA, many times, even with the 20 percent withholding and even with the 10 percent premature tax, young employees will think, well, I will work with the next employer long enough to have sufficient retirement income.

Iteration by iteration, they cash out those early accumulations. The problem is, oftentimes, they end up with just the last employer or the last two employers' account balances for their overall retirement savings. Finding ways of encouraging them to retain those, I think, would go a long way to increasing overall retirement account balances, especially as we become more and more dependent on defined contributions going forward.

Senator CARPER. OK; let us just talk for a moment about middle-income and lower middle-income workers. You know, when you offer somebody who makes over $100,000 an IRA the ability to defer—whether it is a Roth IRA or a traditional IRA—but the ability to delay, in some cases, for a long time, your tax obligation, I can see where there is a real incentive for upper-income families to participate. They have more disposable income anyway.

When I was State treasurer of Delaware, we started a deferred compensation program for our State employees, and the participation was pretty good among higher paid State employees. It was not very good among lower-paid State employees. When I was Governor, we changed the program up a little bit so that the State would match, literally for everybody, a relatively small match for what people deferred and put into the plan.

For people whose income was low, it was really rather significant. For people whose income was high, it was a little incentive, but comparatively speaking, not much. Just talk to me a little bit about how we get more lower-income folks to save for their retirement, because my sense—and I think I heard the Chairman saying this, and I believe I heard Mr. Gokhale—did I get that right, Dr. Gokhale?

Dr. GOKHALE. Gokhale, that is fine.

Senator CARPER. OK; Gokhale; all right. Has anyone ever mispronounced your name? [Laughter.]

Dr. GOKHALE. Nobody but you right now. [Laughter.]

Senator CARPER. I am the first; I do not believe that. [Laughter.]

I guess my question is, what would we be doing more to encourage not just people whose income is $100,000 and above to save; I think they will anyway, but the people whose income is, say, under $40,000 or under $30,000, who are not saving much at all, but they are just trying to get through the day? There are a lot of them, as you know.

Dr. GOKHALE. Well, low-income individuals have huge amounts of necessary expenditures. I mean, they have to pay for bringing up their kids, pay for kid's college expenses. Even sending them to a community college at that income level, is a significant expense. On top of that, they have to pay, payroll taxes, which is a huge burden. Ultimately, in some sense, it is saving for them. Government is doing that saving for them. It takes the 15 percent in payroll taxes and promises some retirement benefits.

Unfortunately, those benefits cannot be paid as promised. So that saving essentially provides a very low rate of return. If, instead, we could somehow redirect that 15 percent payroll tax into an individual account, that would earn a higher rate of return. Of course, I recognize that somehow we have to finance the benefits of existing retirees.

Senator CARPER. That is the $64,000 question, is it not?

Dr. GOKHALE. That is right, but that debt is on the books. The question is should we make it explicit, and allow low-income individuals to access higher returns in the market or whether we should continue under the current system and make future changes as they become necessary, which has not just costs in terms of higher taxes but also costs in terms of distorting labor market behavior on the part of low income individuals. So I think we observe low saving rates because low earners have tremendous responsibilities and necessary expenditures that they need to make.

Senator CARPER. Dr. VanDerhei.

Dr. VANDERHEI. Senator, I think you touched on what is absolutely the most important way of accomplishing this, and that is by the employers offering a match. Craig Copeland and I have an article in the North American Actuarial Journal that shows, because we actually went back and took from millions of different participants and looked at their match rates, that when you control for age, and you control for wage, and you control for gender, that the larger the match and not only that, the larger you go out with the match—

Senator CARPER. When you say the larger you go out, what do you mean?

Dr. VANDERHEI. Three percent of compensation versus 6 percent of compensation; the higher the participation and the higher the contribution percentage from those employees.

So, without a doubt, we found that statistically, that is the single most significant thing. With respect to what else could happen, I truly think that although it is difficult, there is a role that the Government could play as far as educating individuals, again not solely with respect to the message that you need to save now to have bigger accumulations, because accumulations really do not mean that much, certainly to young individuals.

But if you are able to show them how the likelihood of them having sufficient money for their retirement expenses to match up retirement income versus retirement expenses and show what you are doing as far as likelihood of being able to have a significant retirement income is going to be able to help most individuals. This is something I have been teaching, now, for my undergraduates for 25 years, and while it is tough to get a 20-year-old to think about retirement, we oftentimes use their parents as guinea pigs as far as what types of educational devices would indeed get them to start contributing more to their retirement plans, to their IRAs, whatever.

If you move away from the exclusive focus on retirement wealth to one that looks at the expenses they are going to have to cope with also, you find much better response upon those people in their forties and fifties.

Senator CARPER. Thank you both, Dr. VanDerhei, Dr. Gokhale.

Dr. GOKHALE. Gokhale.

The CHAIRMAN. Gokhale.

Senator CARPER. Gokhale; all right, we will get it.

Thank you both for being here and for your testimony.

I would just say in closing—I will go back to sort of the issue that I raised initially, Mr. Chairman, and that is the notion that for a lot of families in this country, the biggest form of savings for them is the equity in their homes and just to close by saying again how important it is that we make the idea of homeownership a reality for a lot of families, and not just those income is fairly high but particularly for those whose income is low but for whom owning their own home would just be a very good thing for their current life but also for their later years.

Thank you, and thanks for being so generous with that time.

The CHAIRMAN. Both you and I totally agree on that. It is extremely valuable, and it is one of the tools that we promoted in this country, and obviously, we have incentivized it through the tax code and found it very valuable and not only for savings but I think for community stability and all of the other kinds of social benefits that are gained from it.

Gentlemen, thank you very much for your testimony, your involvement in these issues. They grow increasingly important for those of us who are going to have to make some tough decisions in the future. A few of us spend time looking at those projections in those out years and $7 trillion liabilities and $36 trillion liabilities and recognize that those are very ominous figures against any

economy, let alone ours, being the largest in the world. But one that we want to try to keep there and all of the factors that play into that, recognizing that that economy pays for the social commitment this Government has made long-term to its citizens.

So those are important issues. Thank you very much for weathering the weather to be with us today.

Dr. VANDERHEI. Thank you.

Dr. GOKHALE. Thank you.

The CHAIRMAN. The committee will stand adjourned.

[Whereupon, at 11:19 a.m., the Committee adjourned.]

APPENDIX

PREPARED STATEMENT OF SENATOR JOHN BREAUX

I would first like to thank Chairman Craig for holding this vital hearing on retirement savings. I would also like to take this opportunity to thank all of the witnesses who have come before us to testify today. Your testimony will be of great value as the Committee works to address some of the critical challenges that exist in ensuring financial security for both today's and tomorrow's retirees.

The need for retirement income security for our nation's retirees is great. This need will only grow, as 77 million baby boomers stand on the doorstep of retirement. We, as a nation, can no longer wait to address issues of retirement security nor turn a blind eye to them. In recent years, several competing theories have come to the fore. Before we as legislators can attempt to implement any of these theories, we must first understand the implications of each. That is why this hearing is so important. I look forward to hearing what our witnesses have to say and to working with my them along with my colleagues here in the Senate on this crucial issue.

PREPARED STATEMENT OF SENATOR GORDON H. SMITH

Today's hearing on retirement planning is of vital interest to all Americans. With America's changing demographics and the increased mobility of our citizens, it is essential that every American be able to adequately prepare for their own retirement. Our retirement system must face the realities of our time. Unlike in the past, employees do not have the same jobs for life; increasingly, they switch both employers and professions. Families have become increasing separated by distance, and retirees must be able to financially provide for their own care as they get older. In addition, Americans longevity rate in increasing—we as a nation are living longer, healthier lives.

With these trends taken together, it is imperative that the federal government promote a retirement system that encourages all American's to prepare for their financial future. At a time when Americans should be saving more, they are not. American's personal savings rate has been on the decline. We must have a strong retirement system that encourages private savings. The federal government and future generations cannot be made to bore the cost of an every increasing size of retirees who are living longer than there predecessors.

Since the early 20th Century, America has made important headway in building a stronger retirement system by encouraging innovate ways of saving for retirement. We have made significant improvements, however, much needs to be done to ensure the income security for Americans during their retirement.

Therefore, I join the Chairman, and look forward to learning more about creating innovative policies to encourage American's to increase their personal savings in an effort to provide for their future.