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HELPING AMERICANS SAVE

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BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

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HELPING AMERICANS SAVE

WEDNESDAY, MARCH 10, 2004

UNITED STATES CONGRESS,
JOINT ECONOMIC COMMITTEE,
Washington, DC

The Committee met, pursuant to notice, at 10:00 a.m., in room SD-628 of the Dirksen Senate Office Building, the Honorable Robert F. Bennett, Chairman of the Committee, presiding.

Members Present: Senator Bennett, Representative Saxton.

Staff Present: Donald Marron, Ike Brannon, Brian Jenn, Mike Ashton, Colleen J. Healy, Chris Frenze, Robert Keleher, Jason Fichtner, Wendell Primus, Chad Stone.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT, CHAIRMAN

Chairman Bennett. The hearing will come to order. I'm told that there is a vote on the Floor of the House in 15 minutes, and so we will get started right on time, even though the crowd is a little slow in gathering.

But we want to accommodate the Members of the House who are here, and I appreciate Vice Chairman Saxton coming over, and we will hear from him prior to the time when he has to leave for the House, and then we'll hear from our witnesses.

Good morning and welcome to today's hearing on helping Americans save. We politicians have been bemoaning our nation's low savings rate since well before I came to the Senate.

Two years ago, American households saved only 1.5 percent of their income, an all-time low. Just over a decade ago, households saved 8 percent of their income, and in the 1970s and early 1980s, the savings rate was regularly over 10 percent.

Personal saving is low, not only by historical standards, but by international standards. Nearly every other westernized economy saves more than the U.S., as do many developing countries.

There are a number of reasons, I think, why we save so little. Many households experienced a large gain in wealth in the 1990s from impressive increases in the stock market.

Over one-half of Americans are involved in the stock market in one way or another. People fortunate enough to own property on one of the coasts or in certain areas like Chicago saw the value of their homes increase, as well. A family that's gained significant wealth from stocks or housing might safely assume that they can reduce their saving and still have enough to provide for retirement in an emergency.

But, of course, not every family spent the 1990s calculating their capital gains. For the typical household, capital gains only modestly increased their wealth, yet, while middle- and lower-income households experienced sharp increases in income in the latter years of the previous economic expansion, there is little evidence that it led to higher saving.

The U.S. tax system does not encourage savings. Economists of all stripes have noted that our treatment of investment income is counterproductive.

The U.S. corporate income tax system and the treatment of dividends, capital gains, and interest income lets the governments tax the return from savings, 2 or even 3 times before it reaches the worker's pocket. It's no wonder that many choose to simply spend their money before it is taxed again.

Congress has tried to alleviate the pernicious taxation of savings by offering a plethora of tax-preferred savings accounts. However, the patchwork approach of tax breaks makes navigating these programs exceedingly complicated, even for the most financially savvy person.

We have three different types of individual retirement accounts, medical savings accounts, educational savings accounts, all of which are separate from any employee-sponsored retirement plan. Each account has different contribution limits, tax treatments, income cutoffs, and allocation rules.

Professor Richard Thaler's research has shown that people often make poor decisions when offered too many choices. I suggest that that's precisely what's happening with IRAs.

In discussing the low U.S. savings rate, it's important to recall why saving is important to individual households and society, generally. In the first place, households should have enough wealth at their disposal to be able to retire comfortably and not have to rely on the government.

The present value of the total unfunded debt associated with Social Security is calculated to reach trillions of dollars, and as longevity increases and our obligations to entitlement programs balloon, it is not realistic to expect the Federal Government to pick up the entire tab for everybody's retirement.

Second, savings finances the investment necessary to spur future economic growth. The American economy is driven by ingenuity and entrepreneurship, but even the most ambitious genius with a business plan can do little without ready access to capital.

The innovators of Silicon Valley, from which flowed much of the U.S. technological and economic innovation over the last 15 years, created enormous wealth for themselves and society through the combination of creativity, talent, hard work, and ready access to financial capital. Each was an essential ingredient.

So, it makes sense to look at institutional factors that inhibit savings, and consider what kind of low-cost, common-sense reforms can be adopted to make it easier for individuals to set aside a sufficient portion of their income each year to finance retirement, college education, or other significant financial obligations, and I think we've assembled an outstanding panel to help us deal with that.

Mr. Saxton, we appreciate your being here, and look forward now to your opening comments.

[The prepared statement of Senator Robert F. Bennett can be found in the Submissions for the Record on page 31.]

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, VICE CHAIRMAN

Representative Saxton. Mr. Chairman, thank you very much. It's a pleasure to be here to welcome our witnesses this morning, and I thank you for having the foresight to call this hearing, because personal savings is vital for the financial security of households, and it also finances the investment and capital formation necessary for long-term economic growth.

Unfortunately, and despite recent changes in the U.S. Income Tax, the U.S. Income Tax still retails a systematic bias against savings and investment. Under an income tax, a dollar saved is taxed and its return is taxed yet again, yet each dollar of consumption is taxed only once.

Some of this bias has been reduced through the expansion of IRAs, 401(k)s and similar vehicles. The longstanding anti-savings bias in the income tax is the reason that I have supported higher IRA deductions and 401(k) ceilings over the past several years.

Another problem is that the current tax treatment of mutual fund shareholders regarding capital gains distribution is illogical, and, I think, very unfair. Under current law, mutual fund shareholders must pay taxes on capital gains realized by mutual funds, even though they have not sold one mutual fund share.

Furthermore, they pay such taxes, even when the value of their shares has plummeted, after it did after the collapse of the stock market that began in the first quarter of 2000. In other words, when mutual funds generate huge capital gains, the shareholders get hammered, even when their own unsold shares have declined in value.

This is something that should be changed, and when the mutual funds incur huge capital losses as they did after the bubble burst, most of these losses cannot be immediately passed on to shareholders. This is a "heads-I-win/tails-you-lose" situation for the government.

In addition, given the complexity of the relevant tax provisions, it is very easy for confused taxpayers to pay capital gains taxes on mutual funds twice. I have offered legislation, H.R. 496, which would remedy this inequity by providing a tax deferral on capital gains distributions, large enough to cover all distributions of over 90-percent of shareholders.

Mutual funds are an important savings and investment vehicle for middle-income Americans, and the punitive tax treatment of these taxpayers is unnecessary and counterproductive.

Mr. Chairman, as you mentioned, we're going to have a vote on the House side sometime between now and 10:30, and I'm going to miss, therefore, the question period, so if I may just read into the record the question that I wanted to ask, relative to this mutual fund tax situation, I wanted to ask the panelists, and particularly Mr. Edelman, several questions.

And if I may just read them now, I would appreciate that.

Chairman Bennett. We'd be happy to have you do that, or, if you prefer, you could leave them with me and I will ask them on your behalf.

Representative Saxton. Okay, that will be fine, and I have a copy of them here, and if you would do that, I would appreciate it.

[The prepared statement of Representative Jim Saxton can be found in the Submissions for the Record on page 33.]

Chairman Bennett. I'll do my best to follow up with the brilliance and incisiveness that you always display.

Representative Saxton. That should be very easy.

[Laughter.]

Chairman Bennett. Thank you, thank you very much. We'll look to see the House Members join us a little later when they finish saving the Republic.

Our witnesses are all international experts on savings, and Dr. Thaler, I apologize for mispronouncing your name the first time around. I have been appropriately admonished, and will be accurate from here on in.

Dr. Richard Thaler is a University of Chicago Professor of Economics and he's been at the forefront of developing innovative ways to increase savings through employer-sponsored retirement plans.

Robert Pozen, who is the Non-Executive Chairman of MFS Investment Management, a law professor at Harvard Law School, author and former Vice Chairman of the Board at Fidelity Investments, which is the hat he wore when we first met. He has a unique perspective on how institutions can affect savings and what types of reforms would compliment the work of financial institutions.

And Ric Edelman, who is founder of Edelman Financial Services in Fairfax, Virginia, is the author of three *New York Times* number one best sellers, an award-winning host of radio and television shows, and has taught personal finance at Georgetown University for 9 years.

Peter Orszag is a Senior Fellow at the Brookings Institution who has also published widely on tax policy, Social Security, and pensions. So, gentlemen, we thank you all for your willingness to be with us this morning. I think we will go in the order in which I introduced you, which means we start here at my right with Dr. Thaler.

STATEMENT OF DR. RICHARD H. THALER, ROBERT P. GWINN PROFESSOR OF BEHAVIORAL SCIENCE AND ECONOMICS, GRADUATE SCHOOL OF BUSINESS, UNIVERSITY OF CHICAGO; RESEARCH ASSOCIATE, NATIONAL BUREAU OF ECONOMIC RESEARCH

Dr. Thaler. Thank you very much, Chairman Bennett and other Members of the Committee. Strictly speaking, my name should be pronounced "tall-er," which you might be interested to know——

Chairman Bennett. Does that go back to the Dutch and is the word from which dollar came?

Dr. Thaler. Correct.

Chairman Bennett. So, being in the economics business, we should call you Dr. Dollar?

[Laughter.]

Dr. Thaler. That's right. I'll answer to that.

Chairman Bennett. Very good.

Dr. Thaler. So, thank you for inviting me to participate in this panel on helping Americans save. I'm Richard H. Thaler, a Professor of Behavioral Science and Economics at the University of Chicago's Graduate School of Business.

I'm an economist by training, but for the last 25 years, I've been exploring ways to incorporate the findings of modern psychology into economic analysis. As you all know, America's personal savings rate is hovering near zero, as the Chairman indicated earlier.

Furthermore, as the population ages, there will be growing difficulty in financing Social Security, and future generations face a very likely prospect of having to finance a large fraction of their retirement on their own.

I thus applaud the attention you're drawing to the important question of how to help Americans save, and I come bearing good news. By incorporating simple lessons of psychology and a little common sense about human nature, it can be quite easy to help Americans save.

By tradition, governments are advised by economists on policy matters such as saving. Unfortunately, the traditional economic models that economists rely upon for their advice are not very helpful in two main respects:

First, they assume that households are capable of making the complex calculations necessary to determine how much to consume and how much to save, and as important, that the households have the requisite willpower to delay consumption.

Since the time of Adam and Eve, real humans, as opposed to the imaginary creatures populating economics textbooks, have had difficulty resisting temptation. There's a news story today about obesity that sort of underlines that point.

Another problem with the standard economic model is that it does not give policymakers any guidance on how to increase savings. The primary variable under the control of policymakers is the after-tax interest rate.

But the theory does not tell us whether raising this rate, say, by making some savings tax-free, will increase or decrease saving rates. The problem is that increasing the return to saving has offsetting effects. It makes saving more rewarding, and, thus, more attractive, but at the same time, the higher return implies that households do not have to save as much to achieve any particular savings goal.

In contrast, by studying actual humans, we discover new tools that policymakers can use to increase savings. For example, here are some useful findings to consider:

One, many Americans realize that they should be saving more. One survey finds that two-thirds of the participants in 401(k) plans think they are saving too little.

Two, most people find it easier to accept self-control restrictions that do not begin immediately. Many of us here in this room today are planning to begin diets next month, not today at lunch.

Three, money that is put into designated retirement accounts tends to stay there, compared, say, to money in ordinary savings accounts.

Four, people are loss-averse. Losses hurt more than gains feel good.

Finally, fifth, there's enormous inertia in retirement plans and elsewhere. For the vast majority of participants, once they join the 401(k) plan, they rarely make changes, either to their contribution rate, or to the asset allocation.

So, although participants agree that they should save more, many never get around to doing it. We can think about this list two ways: First, it can be considered a diagnosis, an explanation for why the savings rate is so low, and, second, and, more helpfully, it can provide the ingredients for the cure.

So, what can we do to help Americans save more? One simple step that has been adopted by some organizations is called automatic enrollment. The idea is simple.

In the usual 401(k) plan, when an employee first becomes eligible to join the plan, he or she receives a form that says "if you want to join the plan, please fill out this form." Under automatic enrollment, the employee receives a similar form, but it says, "you are now eligible for the plan, and unless you return this form, we're going to enroll you automatically."

Notice that under the standard economic analysis, these two setups are considered virtually identical. The cost of filling in a form is small, relative to the long-term benefits of joining the plan, especially when the firm provides a match.

Nevertheless, automatic enrollment can have huge effects. In one company studied by Madrian and Shea, when automatic enrollment was adopted, the enrollment rate by new workers jumped from 49 percent to 86 percent. That's the good news.

The bad news is that under automatic enrollment, companies must select some default savings rate, an asset allocation, and employees tend to adopt and stick with these default choices.

So, in the company mentioned above, where the plan administrator selected a default saving rate of 3 percent and 100 percent of the money was invested in a money market account, most employees passively accepted these choices. This is unfortunate, because virtually every expert who has studied the problem concurs that 3 percent is not a high enough contribution rate, and a money market account is not a suitable long-term investment vehicle for 100-percent of one's retirement income.

My collaborator, Shlomo Benartzi from UCLA, and I have discovered a better plan that can be adopted in conjunction with or separately from automatic enrollment. We call our plan Save More Tomorrow, also known as the SMART Plan.

Under SMART, participants are contacted a few months before their next pay increase with the following offer: They can commit themselves now to increasing their savings rates later, specifically when they get their next raise, say, by 2 or 3 percentage points.

Also, their contribution rates will continue to go up whenever they get a pay increase, until they either reach some specified maximum or opt out of further increases. Notice that this plan incorporates the psychological principles I mentioned above.

People are asked to start saving more in a few months, not now, and by linking the savings increase to pay increases, participants never have to experience a cut in their take-home pay. We have

now implemented this plan in several companies, but let me report on the results from the first company to adopt the idea, a mid-sized manufacturing firm in the Chicago area.

The company was concerned that their employees were not saving enough for retirement, so they hired a financial consultant and made him available to meet one-on-one with every worker. The consultant had a computer with software that could help calculate how much the employee should be saving.

Because the employees were not good savers, the software typically recommended that the employee immediately increase his or her saving rate to the maximum allowed. However, few employees were willing to accept this advice, so the consultant typically suggested an increase of 5 percentage points, say, from 3 percent to 8 percent.

This advice was also rejected by most employees, so the consultant would offer these reluctant savers the SMART plan. Specifically, their savings rate would increase by 3 percentage points at the time of every raise.

This plan proved to be popular with the employees. Over 80 percent of those offered the plan, signed up, and the effect on their saving rates was dramatic, as shown in my Table 1.

In just 14 months from the time the consultant spoke to the employees, the participants who enrolled in the SMART Plan increased their saving rates from 3.5 percent to 9.4 percent, and after 2 more years, they were saving 13.6 percent of their salary.

Their saving rates have nearly quadrupled, and this is a group that had been very reluctant savers. Remember that they wouldn't accept this advice to increase by 5 percentage points.

The SMART Plan has implemented by several other employers and companies that administer 401(k) plans, such as Vanguard, are offering the idea to their employer-customers. We're optimistic that hundreds of thousands of employees will be enrolled in SMART Plans within the next few years, and within a decade, the plan could reach most employees in the U.S.

At the moment, the idea does not need government intervention, but two steps are worth considering: First, adopt some version of the SMART Plan for government employees through the Thrift Savings Plan.

Second, give some consideration to firms that adopt the best practice combination of automatic enrollment and SMART, perhaps exempting these firms from cumbersome nondiscrimination testing.

Such action would simply recognize that in implementing a SMART Plan, firms have already met the spirit of the Congressional intent that retirement plans should not disproportionately benefit high income earners. There are other lessons for government to take away from our experience.

First, we've found a winning recipe for helping people save. The key ingredients are: Make it easy to join the plan—the easier the better—and automatic enrollment is the easiest.

Take the contributions directly from the paycheck. If you don't see it, you don't spend it. Once you get people saving, make it a default option to keep saving, or even better, keep increasing their saving rate.

Four, put the money into an account where people are not overly tempted to dip in. These basic principles could be adopted in many existing and proposed tax-saving vehicles.

I would like to make one other behaviorally-motivated suggestion. One way many Americans do manage to save, albeit, temporarily, is through tax refunds. Most Americans receive a refund when they file their tax returns.

Unfortunately, that money is often spent when the refund check arrives, or even quicker, via tax refund loan. One way to get more of that money into long-term savings would be to allow refunds to be deposited directly into an IRA, and still qualify for a tax credit for the previous year.

In other words, people who are now, in March, 2004, filing their 2003 tax returns and claiming a typical $1,500 refund, could send those funds directly into an IRA account. For traditional deductible, not Roth IRAs, the actual amount deposited would be increased by the taxpayer's marginal tax rate, so a taxpayer in the 25-percent tax bracket would be given a choice of getting a $1,500 refund or making a $2,000 IRA contribution. That could be an attractive inducement to save.

My principal conclusion is simple and optimistic. We can succeed at helping Americans save more by employing a combination of basic psychology and common sense.

If I could add one personal note, helping to save is a cause I believe in. We're offering this SMART Plan to any organization at no cost, as long as they agree to provide us with outcome data. This is not a profit-seeking venture. Thank you.

[The prepared statement of Dr. Richard H. Thaler can be found in the Submissions for the Record on page 36.]

Chairman Bennett. Thank you very much.

Mr. Pozen.

STATEMENT OF ROBERT C. POZEN, NON-EXECUTIVE CHAIRMAN, MFS INVESTMENT MANAGEMENT, JOHN M. OLIN VISITING PROFESSOR OF LAW, HARVARD LAW SCHOOL

Mr. Pozen. Thank you. I'd like to begin by supporting Vice Chairman Saxton's suggestion that we change the taxation of mutual funds. As he pointed out, right now, even if mutual fund shareholders do not sell their own shares of a fund, they still are taxed on the capital gains realized by the fund, and his proposal for a deferral of those capital gains until shareholders sell their fund shares is one that I personally support.

I know that this is a little outside the purview of this hearing, but I couldn't help but support the very sound suggestion of your Vice Chairman.

Let me say that my general theme today is that we ought to consider private retirement plans, together with Social Security. From the point of view of the retiree, they are obviously considered together, because a retiree has two sources of income.

But in the past, in a lot of legislative sessions, they have been viewed as entirely separate, so I want to put them together, and I have suggestions for each area.

In the private retirement area, I think we know that the participation rate of people under $50,000 a year is quite low, and under

$25,000 a year in income the participation rate is actually minimal. And it's probably not possible to increase the amount significantly that people can put in a 401(k) plan under $25,000 a year. If they are married and have two children on $25,000 a year, they just don't have enough to live on.

But I believe that we can do a lot for people with incomes between $25,000 and $50,000 per year. We now have a low-income tax credit which Congress adopted a few years ago. Unfortunately, it is a non-refundable tax credit. I ran the numbers on a family of four with two children, who had income of $40,000 a year, and it turns out that if you just apply the four exemptions, the standard deductions, and the child credit of $2,000, their total Federal income tax is $49. If we want this incentive for IRAs and 401(k)s to work, where the low-income tax credit is essentially a form of government matching for these programs, we need to make the low-income tax credit refundable.

Now, that involves money. I had a preliminary estimate run, and it was roughly a 10-year estimate of about $10 billion or $1 billion per year (assuming the existing low-income tax credit is already permanent). This is a relatively modest amount of money that would make this tax credit viable for that group of people with incomes between $25,000 and $50,000, who would like to save if given appropriate incentives.

The other proposal I have builds on one of Dr. Thaler's ideas, and takes it one step further. We know that employers with fewer than 100 employees are the ones who have the lowest percentage of private retirement plans.

Congress has tried to address this problem by introducing the SIMPLE Plan, and what I'm proposing is the ULTRA-SIMPLE Plan, going one step further.

I believe that financial institutions, if the program is simple enough, would offer this program to every employer. The small employer, at the end of the year, would take all employees that earn $25,000 or more, and would put 1 percent of their wages into an IRA. This would be invested automatically in a specified account, whether it be a money market account or a balanced account, unless the employee chose a different type of account.

And the employee could opt out of the whole program. But if the employee didn't opt out, the 1 percent would go into this ULTRA-SIMPLE Plan for retirement.

I am establishing a minimum of $25,000 to reduce paperwork. Otherwise small employers will ask: what about part-time workers, what about temporary workers? So we're eliminating those issues. I'm also limiting the contribution to once at the end of the year, so we know how much money the person has earned. I'm putting the minimum at $25,000 so that the account size will be $250, which will be enough to get financial institutions interested. They are not interested if the number is only $79 or something like that.

So this is an ULTRA-SIMPLE PLAN. It involves no change in the tax law; it just is a way to create a plan that can be offered to all employers who now do not have any type of 401(k) or other retirement plan. It doesn't really have a cost to employers, and if the employees don't want to participate in the plan, they can opt out.

Now, the second subject I want to address is the relationship between Social Security and IRAs. I have to digress a little to explain something that Peter Orszag is very familiar with, but most people are not. And that is the difference between wage-indexing and price-indexing.

In the Social Security area, we usually think of price-indexing because COLAs after retirement are all price-indexed to protect against inflation. But sometimes people don't know that the initial Social Security benefit is based on wage-indexing. That is, we compute your average career earnings, and then we adjust this average up by wage-indexing. This is much more expensive than price-indexing. Indeed, if we only moved from wage to price-indexing of initial Social Security benefits, this would have a huge positive effect on Social Security's long-term deficit.

Now, what I would like to do is divide workers into three categories: We have all those under $25,000 a year in income. As I have said, I think it's very hard for them to save. They have very, very low levels of participation in IRAs and 401(k) plans.

It's going to be very hard to significantly increase that participation rate, so they are going to be almost exclusively dependent on Social Security. Therefore, I would continue to let those people be on wage-indexing.

On the other hand, look at all the people who have $100,000 or more in career earnings. I would move them all on to price-indexing, because almost all those people have IRAs and 401(k)s. The combination of slower-growing Social Security benefit with an IRA and 401(k) will give them more than they would have received under the original schedule for their Social Security benefits.

And the middle ground, say, someone at $50,000 a year, we'd work out some proportional formula whereby their initial Social Security benefits would be part wage-indexed and part price-indexed. So this is a way to treat everybody fairly.

We would have three different groups of Social Security beneficiaries, and their Social Security benefits would grow at different rates. So we would be counting on people to put that 1 percent in IRAs to make up the difference.

We've run the numbers: if the middle and the higher income people would just put 1 percent a year of their wages more into an IRA, they would come out more than whole. And the beauty of this proposal is that it cuts Social Security's long-term deficits by over two-thirds. Thus, if we went to what I call progressive indexing, moving partly from wage-indexing to price-indexing, with the lowest income people staying at wage-indexing and the highest moving to price-indexing, we would cut roughly 68 to 70 percent of Social Security's long-term deficit, as computed by Steve Goss, the Chief Actuary of Social Security, the keeper of the numbers, as we all know.

In short, I propose two rather modest changes in IRAs that would help increase the savings rate, moving from a non-refundable to a refundable credit, and introducing the ULTRA-SIMPLE IRA Plan based on Dr. Thaler's research. Then if we could increase the participation rate in IRAs, we could develop an approach that combines more IRA benefits with slower growing Social Security benefits for higher earners. As a result of this dual approach, we

could keep our retirees at roughly the same total retirement income, while making a big dent on Social Security's long-term deficit. Thank you very much.

[The prepared statement of Robert C. Pozen can be found in the Submissions for the Record on page 41.)

Chairman Bennett. Thank you. That was a very provocative suggestion.

Mr. Edelman.

STATEMENT OF RIC EDELMAN, CHAIRMAN, EDELMAN FINANCIAL SERVICES

Mr. Edelman. Thank you, Mr. Chairman. It's a pleasure to be here this morning. In addition to my work as an author in the field of personal finance and doing radio and television work in the field, my firm, Edelman Financial Services, is the sixth largest financial planning firm in the nation, according to Bloomberg. We manage about $2 billion in assets for 7,000 clients around the country, all of it in mutual funds.

I was also named by *Research Magazine* in November of 2003 as the nation's number one financial advisor for focus on the individual client, and it's that perspective that I think sets me apart from most folks who come here to speak with the Committee, in that I'm in the trenches. I deal one-on-one with individual consumers on a regular basis, and that perspective is perhaps a little bit different from the typical ivory tower environment that we sometimes find ourselves in.

And I can tell you, from having studied Dr. Thaler's research for many years, that one of the most effective things this Committee can do is basically whatever he says.

[Laughter.]

Mr. Edelman. Because the behavioral side of economics is one that has been too largely ignored, and I can tell you, from working one-on-one with consumers, that what he describes in his research and in his work is exactly what we discover in the trenches, dealing with individual clients.

And to that extent, the number one way to help Americans save more is financial literacy. Our American education system is widely regarded as the best in the world. We're unmatched in our ability to teach skills to America's school children, so that they have the ability to get jobs and earn a living.

What we don't teach them, however, is to make money with the money that they've made. We don't teach them how to manage their wealth. We don't teach personal financial literacy in our school systems on a regular basis.

And yet all the statistics show that money has an incredible impact on everyone's life, including at very young ages. According to several studies, the first assisted purchases occur at age 3, and they are not in toy stores, but in the supermarkets. Think carefully as to who is really choosing the cereal that mom and dad buy. It's not mom and dad.

Ask a typical 6-year old where does money come from and the most likely answer is the ATM. After all, they just watch mom or dad punch buttons on a box and money comes out. Ask the typical

consumer. Ask yourself. What's the price of a big-screen TV? It's not $4,000. It's $39.95 a month.

So what we have to recognize is that the legal tax and financial complexities have never been greater. But we have found ourselves letting children graduate school without any information about how money works.

Today life is very complex. Americans are changing jobs, on average, every 4 years. Fifteen percent of Americans move every year. Almost half of marriages end in divorce and more than half of those will remarry. We're also having children later in life than ever. That does not even begin to introduce the concepts of terrorism, technology and new social issues. Everything from gay marriage to euthanasia.

With all these complexities, it's more important than ever that our school children graduate understanding the basics of money management. They are graduating high school without knowing how to balance a checkbook. They don't understand how loans work. They don't understand compound interest.

But, at the same time, they have access to credit cards and will rapidly go into credit card debt. The average indebtedness in college of today's undergrads is over $4,000. High school seniors are now being offered credit cards. We have to recognize that the access to debt is pervasive.

We're finding an increase in bankruptcies. We're finding an increase in indebtedness across all age groups, including seniors. And what we have to do is give them the education they need to be able to survive and thrive financially.

So my primary recommendation is to require the nation's schools to include financial literacy in their curriculum. This is easier than it may at first appear, because it doesn't require, necessarily, a whole new classroom. It simply says that when you teach history, talk about the economic implications of the reasons why nations go to war. Talk about what things cost 200 years ago and what they cost today.

In math classes, talk about compound interest. It's a question of geometry and algebra. Let school children, when they're learning how to count, count coins instead of marbles.

Sir, we just need to incorporate money as a routine facet of everyday life. That means in the classroom as well as in the workplace.

I also think we need to delay Social Security eligibility to age 70 for Americans who are currently under the age of 50. One of the shocking statistics is that 30 percent of working Americans say that Social Security will be providing most of their retirement benefits. There is an over-dependence, an over-reliance on Social Security today.

We need to get the message across to Americans that their future is more up to them than it is up to the government. By letting American workers who are younger, those who are in their 30s and 40s today, by letting them know that they can't rely on Social Security until age 70, they will have a strong incentive to save.

Simultaneously, we should delay mandatory withdrawals from retirement accounts. Currently, Americans are forced to withdraw their money starting at age 70½, the exact opposite of encouraging

them to save. We're demanding that they start spending. We should delay until age 80 the mandatory distribution from IRAs and retirement accounts. We should also replace the current retirement plan contribution regulations with one universal program.

Currently, where you work determines what plan you're offered, whether or not you have a plan, how much money you can contribute and what those choices are. We should not penalize Americans who work at small companies simply because they work at a small company. We should allow them to have the same type of program that those who work for large corporations enjoy.

Fifth, we should permit people to save for retirement even if they are not currently earning an income. There are millions of stay-at-home spouses. They'll tell you they work. They simply don't earn an income. We should encourage people to save by permitting them to establish retirement accounts even if they don't currently have an income.

We should also permit people to save for retirement regardless of their age. One of my inventions is something called a retirement income for everyone trust, which is a retirement planning tool for children. It is a vehicle where the parents and grandparents can set aside money.

Because I'm in the private sector, we had to realistically put the number at $5,000. If we can introduce this in the public sector, we could knock that figure way down. But a $5,000 contribution for a newborn child, where they cannot touch it until age 65, that $5,000, at historical market averages, would grow to $2.4 million by age 65. Effectively, potentially eliminating the need for Social Security income. The key is to allow people to save money at incredibly young ages, regardless of the source, in a mandatory environment where they cannot touch it until retirement.

Number seven is to eliminate the ability for workers to borrow from their retirement plans. Today we allow workers to borrow from their 401(k). As a result, an awful lot do that. Seventeen percent of all American workers have borrowed from their retirement. The average loan is 16 percent of the account balance.

The irony is that most of those who have taken loans earn between $40,000 and $100,000. It is not the lowest income spectrum that have borrowed against their accounts. By borrowing against the retirement plan, they're effectively ensuring that they will not have money at retirement.

Number eight, we should eliminate the ability for employers to distribute funds to terminated employees. Under current retirement plan rules, if you leave the company and there's less than $3,500 in the account, the employer has the right to send you the cash. When that happens you're going to pay taxes, plus a 10 percent penalty, and you'll probably spend the money on something frivolous. We should eliminate the ability of employers to do that and, instead, require that the money remain in a retirement account.

Finally, number nine, we should extend to IRAs the same creditor protection currently available to qualified retirement plans. If you have money in a 401(k) and you are sued, a creditor cannot go after that money. But they can go after money in an IRA. It's an unlevel playing field and serves as a disincentive to move

money to IRAs. That should be eliminated. Thank you very much, Mr. Chairman, for this opportunity.

[The prepared statement of Ric Edelman can be found in the Submissions for the Record on page 49.]

Chairman Bennett. Thank you, sir.

Dr. Orszag, you get to bat cleanup here.

STATEMENT OF DR. PETER R. ORSZAG, JOSEPH A. PECHMAN SENIOR FELLOW IN ECONOMIC STUDIES, THE BROOKINGS INSTITUTE, WASHINGTON, DC

Dr. Orszag. Thank you very much, Mr. Chairman. My testimony this morning addresses two issues.

First, why it is critical to preserve Social Security's core insurance features even while reforming the program to eliminate its long-term deficit. Secondly, how we can expand retirement savings on top of Social Security.

First, on Social Security, the program provides a well-defined basic income that is protected against inflation, the risk of outliving one's assets, and financial market fluctuations. Benefits are progressive, providing a higher replacement rate for low earners than for high earners. The program provides families with important insurance against the disability or death of a wage earner in addition to retirement benefits.

Although we can and should boost retirement savings on top of Social Security, we must not forget that for the majority of the population, the program provides the key layer of financial security during particular times of need.

For example, one-fifth of elderly beneficiaries receive all of their income from Social Security and two-thirds receive the majority of their income from Social Security.

The average Social Security benefit is only a little more than $10,000 a year, underscoring the role of the program in providing a core layer of financial security above which people can build retirement wealth in other forms.

The program does face a long-term deficit and restoring long-term balance to Social Security is necessary. But it's not necessary to undermine the program's important protections in order to save it.

In particular, in my view, replacing part of Social Security with individual accounts is likely to undermine the program's retirement security features because a real-world system of individual accounts is unlikely to require that benefits keep pace with inflation; unlikely to require participants to fully annuitize their account balances when they retire (that is, transform the account balances into something that lasts as long as they are alive); and unlikely to protect surviving spouses as well as the current system does.

Furthermore, and perhaps most importantly, there is likely to be very substantial pressure for early withdrawals under a system of individual accounts, just like we see with 401(k)s and IRAs. Someone with $10-, $20-, $30,000 in an account, a sick kid, and the need for a new car, is going to exert a lot of pressure to get the money before retirement. In which case, the money is not there for retirement.

Professor Peter Diamond of MIT and I have put forward a progressive reform plan that restores long-term balance to Social Security without any accounting gimmicks and while actually boosting some of the social insurance features that the program currently offers.

The second part of my testimony addresses how to boost savings on top of Social Security. Various types of savings incentives already exist for households to supplement Social Security in building up retirement wealth. But most of these savings incentives are upside down. They provide the strongest incentives to participate to higher income households who, on average, are already better prepared for retirement and for whom a dollar going into a retirement account is less likely to represent new savings rather than just asset shifting from a different kind of account, while providing very little incentive to participate for lower or moderate income households who are more likely to need additional funds in retirement and for whom additional dollars going into the accounts are more likely to represent new savings.

In part reflecting this sort of upside sort of incentives, the nation's broader pension system betrays several serious shortcomings. First, participation is low, especially among lower earners. Only about one-fifth of workers in households with income of less than $20,000 participate in any given year.

Even those who do participate rarely make the maximum allowable contributions. Only about 5 percent of 401(k) participants, and only about 5 percent of those eligible for IRAs, make the maximum allowable contribution.

Finally, despite the shift from defined benefit to defined contribution plans over the past few decades, many households approach retirement with meager defined contribution balances.

The median defined contribution balance among all households age 55 to 59 in 2001 was only about $10,000. The median was higher for those with accounts. But, among all households in that age range the median was only $10,000, which does not provide a very large retirement annuity.

The bulk of the policy changes that have been enacted in recent years, moreover, move the system further in the wrong direction. They provide disproportionate tax breaks to higher income households who would have saved the money anyway and for whom the contributions made do not represent net additions to savings, while doing little to boost incentives for participation among moderate and lower income households.

In my view, a better strategy would encourage expanded pension coverage among those lower and moderate income households, through the following steps. First, one could expand the income eligibility range for the saver's credit that Mr. Pozen mentioned and make the credit refundable. The credit is currently scheduled to expire or sunset in 2006. It should be extended, expanded and made refundable, in my opinion.

Second, we could reduce the implicit taxes on saving that exist under various government programs. For example, food stamps and supplemental security income have asset tests that impose significant, implicit taxes on the savings that lower and moderate income households do accumulate.

Financial education is obviously critical. I would join in the call to be providing financial education as part of the core primary and secondary school education, not waiting until people are older before even trying to get to them.

Finally, as the other witnesses have emphasized, I think, perhaps the best thing that we can do is use the force of inertia to boost savings rather than forcing people to overcome inertia in order to save. That would include changing the default choices in 401(k) plans as has already been explained and also include a little-noticed part of the Administration's—well, it wasn't technically the budget, but it was in their Blue Book Treasury proposals—a proposal to allow individuals to split their refunds.

Many people appear to be reluctant to put their entire refund into an IRA. The IRS has thus far been reluctant to allow individuals to split their refunds into two components. Included in the Administration's Treasury proposal this year, it doesn't require a statutory change, but they should be urged to follow-up on this, is a proposal that would allow people to just check a box on the tax return and put part of the refund into an IRA and part into a checking account or some other more liquid asset. I think that does make sense.

Finally, I think we also need to be paying more attention, as the Baby Boomers near retirement, to the withdrawal stage. We've focused a lot on the accumulation stage and trying to build up account balances, but we really do need to worry about how individuals are going to take the money out of their 401(k)s and IRAs.

I have some slight differences of opinion about whether loosening the minimum distribution rules, in general, makes sense. I think some targeted reforms there would be beneficial. But, more broadly, we do need to be worrying a lot about how people are going to be taking their money out of these accounts, not just about how people get the money in them in the first place.

Thank you very much, Mr. Chairman.

[The prepared statement of Dr. Peter R. Orszag can be found in the Submissions for the Record on page 55.]

Chairman Bennett. Thank you, sir.

Let me ask Mr. Saxton's questions so that we're true to the pledge we made to him before he left.

Mr. Edelman, they're all directed to you.

[Laughter.]

Chairman Bennett. You get to be Lucky Pierre on this one. So he says: "I would like to ask you a few questions about the current tax treatment of capital gain distributions made by mutual funds to draw on your experience as a financial advisor.

"Based on your experience, is it possible for ordinary taxpayers to get confused and effectively pay capital gains taxes twice, once on distributions and again when they actually sell their mutual fund shares?"

Mr. Edelman. It's not only possible, Mr. Chairman, for them to get confused, it's almost impossible for them not to get confused. The rules are extraordinarily complex. I wrote about this a lot in my first book *The Truth About Money*. It's one of the biggest tax traps facing mutual fund investors.

When you make an investment, say, you put $10,000 into a mutual fund, you typically reinvest the dividends in capital gains. The mutual fund pays out those distributions and they are reinvested and then at the end of the year you get a 1099. You hand the 1099 to your accountant, who has you pay taxes on your tax return.

Later, when you sell the fund, you get a check in the mail from the fund company and the 1099 referring to the gross distribution. You then give that to your accountant and your accountant says, "How much did you invest?" And you tell him that one day, way-back-when, you invested $10,000.

Your answer is not adjusted for the fact that you've earned dividends and capital gains over time, and you paid taxes on them annually. Thus you pay taxes again because you didn't adjust for all the reinvestments, which should have increased your cost basis.

We have a simple solution. And that is to do away with the annual 1099 distribution.

Mr. Pozen. I ought to add that most fund companies now, as to more recent investments, give you your average cost basis which includes dividend reinvestments.

Chairman Bennett. So they show the increase in basis?

Mr. Pozen. That's built into the system over the last few years. But it wouldn't be possible for somebody who made an investment 20 years ago easily to ascertain his or her basis.

Chairman Bennett. There's been a lot of controversy recently about problems in certain sectors of the mutual fund industry. Isn't the current tax treatment of mutual funds, capital gains distributions, one of the largest costs imposed on owners of mutual fund shares?

Mr. Edelman. There's no question, Mr. Chairman, that the annual cost of taxation on your mutual fund profits is a very significant impediment to future wealth. It's forcing you to pay taxes on money that otherwise could have remained invested.

This does not apply to stocks or bonds. If you own a stock for 20 years, it is, in essence, tax deferred for 20 years. You pay no taxes on the growth until you sell. That same simple rule does not apply to mutual funds and creates a substantial tax and, therefore, decreased wealth for millions of investors.

Chairman Bennett. Thus, isn't the current tax treatment of mutual fund capital gains distributions one of the biggest drawbacks to investing in mutual funds?

Mr. Edelman. It is a very significant drawback, yes. Once investors begin to understand the tax complexity associated with mutual funds, it often serves as an impediment to their long-term savings.

Chairman Bennett. When the stock market is on an upswing and mutual funds generate capital gains, this results in immediate tax liability for shareholders. But when the stock market falls and the funds incur losses, these can not generally be passed through to shareholders. Isn't this tax treatment inconsistent, even if the fund losses are eventually permitted to offset gains over time?

Mr. Edelman. Yes, Mr. Chairman. It is inconsistent. There's a significant disparity between having to pay taxes when there are distributions and not being able to take a tax deduction when there are losses.

It gets worse than that. Many times, mutual funds are selling securities that they've owned for less than a year. So not only are they issuing you a distribution, they're offering short-term distributions which are taxes at the top tax bracket of the taxpayer as opposed to the 15 percent long-term gains rate. It's even worse than the question would suggest.

Chairman Bennett. Others of you can jump in here. Mr. Saxton said this should all be directed to Mr. Edelman, but I don't want to shut anybody else off if they want to comment.

His last comment, he says: "Another bill I've introduced would end mandatory distributions from IRAs at 70½ and also end mandatory distributions from 401(k) accounts.

"Essentially, this is another form of tax deferral that would reduce the negative tax consequences for personal savings. Isn't it desirable to end, at least, delay these mandatory distributions?"

Mr. Edelman. I'm not an economist, so I can't really address the basis or the need to have a date that the money must begin to come out.

It does seem to be illogical to me, from a financial planning perspective and working with individual clients, because the money in an IRA or other retirement plan is eventually going to be withdrawn and add tax if only at the individual's death. It's nothing you escape.

Since it can't be escaped, and we're not worried about a step-up-in-basis at death, for example, which happens on stocks or real estate. Since there's no step-up-in-basis and we are guaranteed to have the money eventually taxed, I'm not quite sure why the government cares when it's taxed. Why does it need to be 70½? Why not let it be at the taxpayer's discretion, either death or another age of their choosing?

Chairman Bennett. Does anyone else want to comment on that? I am just turning 70½, so I have a very strong interest in this.

Dr. Orszag. I have a somewhat different view. And I think it's important to distinguish the 401(k) rules from the IRAs. Under the 401(k) rules, the minimum distribution requirements are that you must begin distributing the funds at 70½ or when you retire, whichever is later. So the rules are different between 401(k)s and IRAs.

Chairman Bennett. As long as I stay in the Senate, I can hang on to them?

Dr. Orszag. A lot of people are worried about the incentives provided for older workers to stay in the workforce. The partial effect, in least in terms of labor incentives from raising that age could be to weaken instead of strengthen incentives to continue working. It'll depend on individual circumstances, but there is, at least, an important distinction between the IRA and 401(k) rules.

Here's also, I think, an important question, which is, why are we providing the incentives for IRAs and 401(k)s in general?

In my view, the reason is to provide an incentive for retirement saving. The minimum distribution rules, and I don't want to defend them in their entirety because I think they are too complicated and there are some reforms that are worthwhile, but it is important to remember the goal. The goal is to make sure that that saving is

actually used during retirement and not as an estate-planning device or for some other purpose.

If there are other ways, and I think there are, of ensuring that the bulk of the saving is serving the public policy purpose for which the tax incentives were provided, that should be explored. I do worry about either eliminating or substantially raising the age because I think it then undermines that public policy objective for putting the rules in, in the first place.

I'd also note one other point. We face, as you know, a very substantial long-term fiscal deficit. That long-term deficit already incorporates, into the projections, trillions of dollars in present value in taxes on withdrawals from 401(k)s and IRAs, which had a tax break up front and tax-free build-up and then are taxed on the way out. I think you—you meaning policymakers in general—are going to come under increasing pressure in the years ahead to reduce those taxes.

A lot of people don't realize that when they've got $15,000, $20,000, $30,000 in their 401(k), they will be taxed on those funds. If we start to reduce those taxes, we make an already really bad fiscal situation that much worse. So anything that crosses the line of either reducing or eliminating the taxes on withdrawals, I think, is risking a very severe loss of revenue. Because I don't know how you stop the ultimate effect from adding up to trillions of dollars in an already bad fiscal outlook.

There is such a danger with regard to the minimum distribution rules. Because as was noted, relaxing those rules is effectively reducing the implicit tax on the withdrawal that you start moving in that direction. That's another consideration to take into account.

Mr. Pozen. Mr. Chairman, I have a slightly different view, though it's not inconsistent. A lot of the current rules allow people to take money out of IRAs and 401(k)s for purposes other than retirement. And I know there's a lot of pressure on Congress to keep expanding the range of permissible withdrawals. Buying a home is a worthwhile objective, but the problem is that these withdrawals undermine the retirement objective, which should be the primary objective. I think we should do more to keep that money in plans for retirement.

Another subject that we struggled with when we were on the President's commission was the form of distribution from a retirement plan. For a lot of people, it would really make sense not to take a lump sum out of their IRA, but rather to buy an annuity so they would be assured of having money for the rest of their life.

But you then meet with somebody who has $200,000 a year in income and they say, "why should I buy an annuity?" For that reason, it probably doesn't make any sense. But I would follow Professor Thaler's idea hereby making the presumptive choice of annuity. And then if people didn't want an annuity, they could opt out.

I think that lifetime annuities, joint and several annuities, are quite important for a lot of families. And if people just take a lump sum out at retirement to buy a car, or they take money out of their plans before retirement, for example, to buy a house, they are really defeating a lot of the purpose of having a retirement plan.

So I would try to keep a choice available. But I'd like to use the force of inertia to push people toward retirement objectives rather than other objectives.

Mr. Edelman. One other point I would like to make about the mandatory distribution rules and I would suspect that I won't get any objection on this point because it's free. It's not going to cost anybody any money or alter policy in a significant way and I know you love to hear things like that.

You had mentioned that you're turning 70½ this year, Mr. Chairman.

Chairman Bennett. This month.

Mr. Edelman. That does not mean happy birthday.

[Laughter.]

Mr. Edelman. Happy day, but not birth. That does not mean you have to withdraw money this year from your retirement account. It means you have to do it by April 1st of the year following the year you turned 70½. That rule is absurd. To tell ordinary consumers that they have to begin taking the money out by April 1st of the year following the year they turned 70½ is silly.

It's far too complex and it should be simply changed to say you have to take out money by December 31 of the year you turn 70 or 71, pick one. But that whole phrase of April 1 following the year in which you turned 70½ is a mathematical jumble that is just pointless and it's a good example of how the tax code is unnecessarily complex.

Chairman Bennett. I have exhausted Mr. Saxton's questions. Let me ask a few of my own.

In 1986, Congress imposed income limits on IRAs so that workers above a certain income level were no longer permitted to receive the tax benefit of an IRA. Following the imposition of those limits, IRA participation levels fell, even among those low-income workers who were still eligible to participate. Any ideas as to why?

Dr. Thaler, you're the psychologist here.

Dr. Thaler. I think it's no big mystery, which is that the financial services industry no longer viewed this as an activity that was worth spending a lot of money advertising.

In the early 1980s, around this time of year, it was hard not to see ads asking people to invest in IRAs. And when you cut that market down, they're going to spend less money advertising.

Mr. Pozen. I would tend to agree. The limits then were that you couldn't get an IRA deduction for a family unless you were earning less than $40,000 a year. And, as we've seen, those deductions are not that valuable for people at those income levels. Many of them have a hard time saving. The financial institutions are interested in the larger accounts and, of course, higher participation rates. So if you're advertising in a market where only a small percentage are effectively eligible, and even a smaller percentage are actually likely to contribute to IRAs, it's not really worth spending large dollars on IRA advertising.

One of the benefits of having a more universal IRA is, without the government paying anything, you do get the advertising dollars of the financial institutions.

I agree with what Mr. Edelman says about financial literacy. In designing savings programs, you ought to try to do something that

implicitly gets the financial services industry behind you and let them carry the ball to a large degree on financial literacy. They will if they see a reasonable return on their advertising investment.

Mr. Edelman. For many in our field, Mr. Chairman, the IRA is a loss leader. The amount of revenue we can earn from opening an IRA account is minimal. But if it enables us to grab additional assets from a client who has other assets, then we'll go through that marketing effort. When you limit us to dealing with individuals whose sole investment is going to potentially be that IRA, then as these two gentlemen have said, we'll shrug or shoulders and not bother.

Dr. Orszag. Senator, I think while agreeing, in part, with the other panelists, there are a couple of other perspectives that are important.

First of all, there was a decline for those below the income limits post-1986. In many cases, it was a pretty modest one. For example, if you look at tax filers with adjusted gross income of less than $20,000 in 1984, 5 percent of those made an IRA contribution. In 1988, 2.4 percent did. So, yes, there's a decline. But it's not like you're going from 90 percent to 15 percent.

Mr. Pozen. I think you're making my case about why you wouldn't advertise for 2.4 percent of those eligible.

Dr. Orszag. There you go.

Chairman Bennett. You're dealing in a political world. On the floor of the Senate, that would be trumpeted as it's cut in half.

[Laughter.]

Dr. Orszag. That is right.

The second thing that is important to realize is the type of advertising matters, also. One advertisement in *The New York Times* in 1984, for example. I'm just going to quote it for a minute: "If you were to shift $2,000 from the right pants pocket to the left pants pocket, you wouldn't make a nickel on the transaction. However, if those different pockets were accounts at"—and I'll leave out the name of the financial services firm—"you'd profit by hundreds of dollars. Setting up an IRA is a means of giving money to yourself."

That is an advertisement for asset shifting. That is not an advertisement for new saving. The type of advertisements that are likely to attract higher-end clientele are not necessarily the type of advertising that will attract where I think the focus should be. I'm getting new saving from the lower and moderate households or middle income households who most need to save more.

I agree that advertising is important. I just want to caution us both to put the magnitudes in perspective and, also, obviously, the type of advertising will affect the type of response that one gets.

Chairman Bennett. Of course, every investment is a form of asset shifting. I have $2,000 in my pocket. I can spend it on a fancy trip or I can invest it in this situation.

Dr. Orszag. Senator, it matters a lot whether the contribution is coming from reduced consumption, i.e., forgoing that trip, or shifting assets from your mutual fund, for example.

Shifting assets from the mutual fund doesn't generate any new savings. It's just moving existing assets from one pocket to another.

Forgoing the trip is a form of raising overall net saving. That's really where we need to be focusing.

In my view, the empirical evidence strongly suggests that as you go up the income ladder, more and more of the dollars that are deposited into the tax deferred accounts do not come from reducing consumption, but rather from shifting assets from other accounts.

Chairman Bennett. We can argue the psychology of that. But let me, Dr. Orszag, get into an area you made reference to. You talked about Social Security. I'd like you and Dr. Pozen, if I could, to get into dialogue with this because he talks about matching the savings with Social Security in an overall plan. And you talk about, perhaps, keeping the two separate so that they don't get matched in the saver's mind.

One of the major problems with Social Security that has come in the last 30 years, and is accelerating, which nobody wants to talk about because it sounds kind of callous; but, in fact, one of the biggest problems with Social Security is people are living longer.

If they just had the courtesy to die on the same schedule that was anticipated when Otto von Bismarck invented it, when the life expectancy for males was in the low 60s, so if you could live long enough to beat the odds, and live until you were 65, then the government would take care of you for the rest of your life with payments from other people who were betting that they, too, would live. But the odds were that most of them would not.

So the lucky retiree who beat the odds and stayed alive past 65 was getting the benefit of what everybody else was paying in. That sounds a little like a Ponzi scheme if you want to put that particular face to it.

Now we're all living pretty much past 65 and we're all getting the benefits. But the guy who now doesn't live to 65, pays in his entire life, dies and doesn't get a dime and his heirs don't get a dime. So there is no wealth creation.

I realize the advantage of what you're talking about when you say if they get a lump sum that can disappear. But if they get an annuity, which Social Security is, they get paid for as long as they live.

And we've got people who are now over 100 who have been drawing Social Security for over 35 years and the amount they've drawn out is staggeringly higher than anything they paid in. They're being paid by the people who are coming in at the bottom.

At some point in this whole retirement situation, particularly in the African American community, which demographically does tend to die more rapidly than the white community, they're not accumulating wealth in the way their white counterparts are, or their healthier white counterparts are.

They have children they would like to leave estates. They would like to have wealth accumulated in their own name that they could do something with in their retirement years. But if their whole focus is on a program that just pays them as long as they stay alive, and allows nothing to be accumulated in their own name in the form of assets, they are missing out on something fairly significant.

Mr. Pozen, you talk about tying the two together so that they move forward and the advantages that Dr. Orszag talks about of

having the payment made as long as you live. If you live to 101, it's still going to be there. That's an enormous, enormous advantage, an important thing.

But the flip side of it is, you turn 65 or 70—right now it's 67 and it's going to be for the Baby Boomers by the time they retire. If it comes to be 70, as you're proposing, Mr. Edelman—and Chairman Greenspan is talking about that, too, whatever the date is, it would be nice to have a mixture of both.

That you have the certainty of the payouts, but you also, from the all the money you have been paying in, some of it has been going in under your name and you have a significant chunk of wealth that at retirement you can do something with because maybe you do need to make a down payment on a house and a little bit of wealth will allow you to do that. Then you can live in the house on the income.

Discuss that whole mix of where we are in these benefits, if you would, the two of you. Because I caught different vibes from the both of you and I'd like to have that conversation.

Dr. Orszag. I can go first. On life expectancy, I just want to emphasize one thing that I think is very important for policymakers and that I was struck by in writing the book with Professor Diamond. While life expectancy is increasing, as you've noted, it is increasing at a particularly rapid rate for higher earners and higher educated workers. In other words, the gap in mortality rates or in life expectancy over the past three or four decades has increased markedly.

Many demographers expect that to continue, both because life-preserving health behaviors are more likely at the upper end of the income distribution and because a lot of the life-extending technologies are really expensive and they won't filter all the way down the income distribution.

The partial effect of that trend is to make Social Security less progressive on a lifetime basis because the higher earners are, on average, getting their benefits for an increasingly longer number of years. And I think it has broader implications for a variety of policies. I just wanted to mention that.

On the mix between the two, my view, it really comes down to how much saving one thinks households will do, even as you move up to the 50th percentile, 60th percentile on top of Social Security.

Again, just to put some numbers in our head, the average Social Security benefit may now be up to $11,000. But it's only a little higher than $10,000. We're not talking about $50-, $60-, $70,000 a year. It's a very modest benefit for the vast majority of the population.

When we talk about substantially scaling that back and replacing it with some non-annuitized form of income, I worry that, basically, you wind up with too little being provided, especially, to the widow. We have to remember that widow poverty rates are already much higher than married women's poverty rates, 3 times as high.

When we don't annuitize wealth, and, particularly, when we spend it up front, the person who's really getting hurt is the widow. That is the reason I'm concerned about substantially scaling back annuitized income. But I think you have identified a fundamental tension in individual account plans, which is, do you force

annuitization of the whole thing or not? The trade-offs there are very difficult. It becomes even more difficult when you think about if the annuitization age were 65 and you had the elderly woman who has cancer and knows she's going to die in 2 or 3 years.

If you're forcing her to annuitize also, that's a substantial loss of wealth that you are imposing on that person in order to protect the widows who live a long time.

Chairman Bennett. Mr. Pozen.

Mr. Pozen. I agree with your basic idea. It's a positive social goal for Congress to allow families, including moderate income families, to have some form of retirement account that they can call their own, and that they can bestow on other members of the family.

But the challenge for many of the proposals for personal retirement accounts is that they are of what I call a carve-out nature. That is, they're taking some portion of the 12.4 percent in payroll taxes, let's say 2 or 3 percent, and putting that portion into a personal account.

As you point out, we already have this big overhanging deficit. The problem with carving out is that you wind up in an even deeper hole for 30 or 40 years until you can get those people who carve out the 2 or 3 percent to take lower Social Security benefits many years later. So you wind up with, essentially, a requirement for a large loan from the government to the Social Security trust fund.

What I was trying to do with my proposal is to reach your goal, but avoid the budgetary problems of carve-outs from Social Security. Also, my proposal avoids the administrative cost of creating a whole new set of personal accounts.

Why don't we declare victory with the IRA as the personal account? The IRA is already there. It has an administrative structure. And if we can encourage people and incent people to build up their contributions to their IRA, that's where they will have their wealth.

But the question remains: how will you deal with Social Security's deficit? That's why I've made a proposal for progressive indexing; it allows you to recognize what Peter says. The life expectancy of the higher-income people is diverging more and more from that of lower-income people. Therefore, we should have a slower-growing Social Security benefit for high-income workers because they're going to live longer.

If we bring in progressive indexing on Social Security, we help the financing of Social Security. We offset, to some degree, the greater life expectancy of the higher income groups. And if we combine progressive indexing with more incentives for IRAs, we achieve your goal of building wealth without having the problem of impairing the financial solvency of Social Security.

I'm trying to say to those people who want personal retirement accounts—use the IRA. We have the administrative structure. Let's use that, instead of taking money out of Social Security, because then you're raising a whole set of other budgetary issues that are very difficult to resolve.

Chairman Bennett. I think what you're saying makes sense, but, having said that, you are cutting into one of the fundamental

principles, political principles of Social Security, which is that it cannot be means-tested in any way.

Mr. Pozen. I don't think I actually am. Social Security, at the moment, is progressive, but it's currently not means-tested; rather it is tilted in a progressive manner. As higher-income people live longer, however, they receive larger total Social Security benefits over their lifetime.

Thus, the progressivity that's currently in the system gradually is undermined and reduced, so I'm not means-testing anything. I'm just bringing in a little more tilt to take into account that middle- and higher-income people are living longer than lower-income people. Therefore, on a lifetime basis, the total value of Social Security benefits are changing on a relative basis.

Chairman Bennett. You're not means-testing directly.

Mr. Pozen. I'm tilting the system, but I'm tilting the system to take into account the point Peter is making. Right now, if you have a person who makes $100,000 a year, his or her chances of living to 90 are much greater than a person who's making $30,000 a year.

So I'm just tilting the system to make the average lifetime Social Security benefit be roughly the same for all income groups.

Chairman Bennett. I happen to agree with that, but it's interesting that people who keep saying, well, the tax system is unfair because we should make the people at the upper end pay most of the taxes, well, actually, they do. Nonetheless, we should make them pay even more and more and more, but when you get to Social Security, you've got to send Ross Perot exactly the same size check you send to one of the clerks that works at EDS, if they have the same earning pattern during their years.

You can't say, but Ross Perot doesn't need it.

Mr. Pozen. Under my system, if Ross Perot and the clerk both made $50,000 a year as a career average, they would both get the same Social Security check. However, the person who now makes $100,000 a year, rather than $50,000, doesn't get twice the earnings check of the person with $50,000. Let's assume the higher earner receives 1.6 times the benefit of the lower earner, so there is a progressivity tilt already built into Social Security.

If we say that we want to maintain the current relationship between the person at $100,000 who gets 1.6 times the check that a person receives at $50,000, we must consider that the person at $100,000 is now going to live 5 years longer than the person at $50,000. We should adjust that tilt a little to reflect this difference.

Chairman Bennett. Dr. Thaler, get into this.

[Laughter.]

Chairman Bennett. Talk about automatic enrollment plans and how they might impact this and how the government could encourage automatic enrollment plans. What would the default investment be and where would you be in this whole question of trying to get something other than just the Social Security into people's deductibility situation, all the way through?

Dr. Thaler. The fortunate thing is that a lot of the things that I'm talking about don't really need the government to get involved. So, the private sector is taking initiatives.

Some companies are doing automatic enrollment, some are adopting our Save More Tomorrow Plan. Many of the companies

that administer 401(k) plans, such as Vanguard and Fidelity, TIAA-CREF, ADP, are offering these escalating savings plans, offering to do the administrative work to allow employers to offer these options.

I will say that we sometimes talk to employers who are reluctant to do this, because they are afraid of getting sued, and probably the most important thing the government can do to facilitate these things is to create safe harbor rules, and the Treasury has been good about issuing rulings, making it explicit that it's fine to automatically enroll people into plans, and automatically.

You want to make it clear that it's fine to automatically enroll them into something other than a money market, like a balanced account. As I said in my testimony, another good thing the government could do would be to set up a showcase by doing this for their own employees through the Thrift Program.

Chairman Bennett. I'm never amazed at the inventiveness of the plaintiff's bar.

[Laughter.]

Chairman Bennett. I can't conceive of the basis on which a suit would be brought here.

Mr. Pozen. Unfortunately, I can.

[Laughter.]

Mr. Pozen. The complaint would say that you're automatically enrolled, unless you opt out, and that the worker wasn't sufficiently appraised of the opt-out, so that would be one basis of the complaint. Then, second of all, if the money did go into a balanced account or in a stock account, which in a particular set of years did less well than a Treasury bond, then the worker might complain that you automatically put me in an investment with a lower return.

Chairman Bennett. Okay.

Dr. Orszag. I think it's important to realize that it's actually not even primarily—my understanding is that it's not Federal law here that's the problem. There are state labor laws that could cause problems here in terms of suits. Frankly, we should just have Federal preemption and narrow-targeted Federal preemption of state labor laws to allow these kinds of plans, and I agree that's one step that the Federal Government could take to try to remove impediments to their adoption.

Dr. Thaler. Let me give you one trivial example of the sort of things that we run up against at my own University. Every November we have to log onto the Web and enroll in open enrollment to choose health plans and so forth and so on.

With our retirement plan, we have a generous retirement plan, and faculty can put an additional amount of money, up to $9,000, into some kind of supplemental retirement account. You have to go onto the Web every year and do that.

Now, I'm trying to convince them to make it so that if you do nothing and you saved last year, you save the same amount again this year, and there is some lawyer who is worried that if we do that, that will violate some rule. I don't think there is any rule it violates, but people are worried that there is such a rule, and we can, by simply making it explicit, that it's perfectly fine to assume

that you want to save the same amount as you did last year, that would help a lot.

Chairman Bennett. Of course, the individual participants in the plan would get no benefit from the lawsuit, but the lawyer who brought it would get rich, presumably run for the Senate——

[Laughter.]

Chairman Bennett. [continuing.]——and go on from there. Let's talk about matching. All of this conversation has been about what the employee would put in. Let's talk about matching, incentives to match. Are there lawsuit possibilities on matching?

Mr. Pozen. I don't think there are a lot of lawsuit possibilities for matching, but when we're talking about this low-income credit, that's essential to increase IRA contributions. We know from the 401(k) experience that matching brings in higher contributions from workers.

People love matching. It's the equivalent to going to the store and seeing a bargain sale. People really like matching. It has a significant effect on participation rates.

However, if you're talking about people who are not in employer-based programs, or people with lower incomes in IRAs, then the question is: how do we create a match? The low-income tax credit is designed to create a government match, a partial match to be precise.

The problem is that the credit is constructed in a way that doesn't really work for a lot of people. In order for the credit to be effective, you have to be paying a significant amount of income tax. The good news is that people with lower incomes aren't paying a significant amount of tax; the bad news is, to the extent you're giving these people the match in the form of a non-refundable credit, the match is not effective.

So, I think the match idea makes a lot of sense, but because income tax rates have been brought down and other credits and deductions have been increased, like the standard deduction, if we're going to have a government match to encourage IRA contributions by lower-income workers, we need to alter the design of the match.

Chairman Bennett. We're running probably later than we should, but let me ask about just one more issue. One of the first public policy questions I got involved in back in the 1960s when I first came to Washington had to do with President Kennedy's proposals with respect to pensions.

It was one of the first recognitions of the fact that Americans were shifting from the old paradigm where your pension and your healthcare and any other form of "benefit," was provided by your employer. We shift employers every 4 years, did I hear that statistic around or something along that line?

Let's talk about portability. The Kennedy proposal was the first towards creating portable pensions.

I did an analysis for myself when I turned 50, just to kind of quantify it, and from the time I turned 20 until the time I turned 50, I changed jobs or situations—this included going to school, going to the Army, what have you—17 times. I had 17 different situations in that 30-year period.

I've gotten a little more stable.

[Laughter.]

Chairman Bennett. Since I turned 50, the 11 years I've put into the United States Senate is the longest period of time I have drawn a paycheck from the same signatory in my life. So, I have a whole series of little buckets that were accumulated along that way, some of which, quite frankly, I have emptied to pay for the new car, to send my kids to school, to do whatever, but some of which I have clung to, and——

Mr. Edelman. I would argue, Mr. Chairman, did you cling to the ones which were later or the ones earlier?

Chairman Bennett. I clung to the ones that were smaller.

[Laughter.]

Mr. Edelman. It wasn't worth bothering.

Chairman Bennett. And my wife now looks at these statements that come in every month and says, "What is this? Why don't we dump this all into a single vehicle, so that when you die, I don't have to go through all of this and find out what's there?"

Let's talk about this whole portability question.

Dr. Thaler. Portability is great. One of the advantages of the whole 401(k) style systems is portability. The idea of unifying all of these tax-favored savings accounts into one type also has some elegance and appeal.

The thing I think that's vital to remember is that for the relevant income group—and I would say it's somewhere between $25,000 and $125,000, relevant meaning they have enough that they could possibly save, and they're not so wealthy that they're kind of saving automatically, for that group, the only way people successfully save is if the money is taken out of their paycheck.

If they have to go write a check, that's a huge problem to overcome.

Chairman Bennett. Mr. Pozen runs the ad, so they would.

Mr. Pozen. On the portability issue, I think you're making a very good point. We now have the rollover IRA. Theoretically, you should be able to consolidate all these small retirement accounts into one rollover IRA.

The problem is, since many of these accounts come from different retirement programs, it is an accounting nightmare to try to figure out the consolidation. For instance, if you paid no tax on all contributions to these accounts and they all had the same distribution rules, then you could put them all into the same IRA and you would know that the tax basis was zero. Then you could make distributions and know the tax implications.

The problem is that some accounts may be partially contributory, some of them may not. Some of these accounts are subject to 401(k) rules and some of them not.

I think the key problem is that we have different rules for 457s and 403(b)s and 401(k)s. As Mr. Edelman says, this is crazy. We ought to have one uniform set of rules called by any name you want.

Another thing we ought to do is try to provide some relief for people who pour this money into rollover IRAs. There should be some sort of mechanical rule about what the basis is in these situations. I've tried it myself sometimes with a rollover IRA. I had a rollover IRA from a 401(k) plan, then I had an IRA that was a non-

deductible IRA, and I tried to put them together. It was a nightmare.

So, we need to make those rules simpler. Maybe we can't do it all into one rollover IRA, but at least we ought to be able to do two—one for all retirement plans where there was no tax on the way in, and second of all, everything else, where you might have had some tax basis.

I think that simplification is the key for consolidation: we need to simplify the rollover; the rollover is the vehicle that should be available to you. You ought to be able to roll over all of those accounts to one account, then be able to invest that account any way you want, but the accounting is a nightmare.

Mr. Edelman. The remaining issue on that is the rule that allows employers to distribute. Seventy-two percent of retirement accounts that are between $5,000 and $10,000, 72 percent of them are distributed prior to retirement, because workers leave; they go somewhere else, and although the portability rules are in place, effectively enough, to a degree, what happens when you leave work? On your final day of work, your HR person or the business owner says, "So what do you want me to do with your retirement plan? Do you want to roll it over, or do you want me to send you a check?"

And, 72 percent of the time, the worker screams, "Sure, send me a check," especially if they are laid off and they don't have another job to go to. They take the check.

We need to prohibit that. We need to require that the money either stay in the account or roll to an IRA.

Mr. Pozen. We do have a rule that says that if you don't roll to an IRA, you are subject to withholding, and we penalize you in that sense. I think when that rule came in, you saw a much greater number of people who rolled over.

To have a rule prohibiting withdrawals doesn't recognize that there are some people who are laid off and they actually need the money. I don't know whether we might increase the penalties in terms of not rolling over——

Mr. Edelman. Or create the default environment.

Mr. Pozen. We do have the default environment in the sense that the money presumptively either stays in the plan now or transfers to a financial institution. But we could make the default a lot stronger by increasing the taxes on withdrawals.

Chairman Bennett. Let me thank you all for your participation. I think it's been a stimulating discussion, and I appreciate the interchange between witnesses. I'm sorry that our associates from the House weren't able to come back and join us, but I think we've created a very significant record here, and I appreciate your willingness to help us do that. The hearing is adjourned.

[Whereupon, at 11:35 a.m., the hearing was adjourned.]

Submissions for the Record

JOINT ECONOMIC COMMITTEE
ROBERT F. BENNETT, CHAIRMAN

For Immediate Release:
March 10, 2004

Contact: Rebecca Wilder (202) 224-0379

CHAIRMAN'S OPENING STATEMENT

SENATOR ROBERT F. BENNETT

Hearing of the Joint Economic Committee
"Helping Americans Save"
March 10, 2004

Good morning and welcome to today's hearing on helping Americans save. Politicians have been bemoaning our nation's low saving rate since well before I took office. Two years ago American households saved only 1.5% of their income, an all-time low. Just over a decade ago, households saved eight percent of their income, and in the 1970s and early 1980s the saving rate was regularly over ten percent. Personal saving is low not only by historical standards but by international standards; nearly every other westernized economy saves more than the U.S., as do many developing countries.

There are a number of reasons why we save so little. Many households experienced a large gain in wealth in the 1990s from impressive increases in the stock market. People fortunate to own property on one of the coasts and in certain areas in Chicago saw the value of their homes increase as well. A family that gained significant wealth from stocks and housing might safely assume that they can reduce their saving and still have enough to provide for retirement or an emergency.

Of course, not every family spent the 1990s calculating their capital gains. For the typical household, capital gains only modestly increased their wealth. Yet, while middle and lower-income households experienced sharp increases in income in the latter years of the previous economic expansion, there is little evidence that it led to higher saving.

The U.S. tax system doesn't encourage saving. Economists of all stripes have noted that our treatment of investment income is counterproductive. The U.S. corporate income tax system and the treatment of dividends, capital gains, and interest income lets the government tax the returns from saving two or even three times before it reaches a worker's pocket. It is no wonder that many choose to simply spend their money before it is taxed again.

Congress has tried to alleviate the pernicious taxation of saving by offering a plethora of tax-preferred saving accounts. However, the patchwork approach of tax breaks makes navigating these programs exceedingly complicated even for the most financial-savvy person. We have three different types of Individual Retirement Accounts, Medical Savings Accounts, and educational savings accounts — all of which are separate from any employer-sponsored retirement plan. Each account has different contribution limits, tax treatments, income cutoffs, and allocation rules. Professor Richard Thaler's research has shown that people often make poor

decisions when offered too many choices. I suggest that is precisely what has happened with IRAs.

In discussing the low U.S. saving rate, it is important to recall why saving is important to individual households and society generally. In the first place, households should have enough wealth at their disposal to be able to retire comfortably and not have to rely on the government. The present value of the total unfunded debt associated with Social Security is calculated to reach trillions of dollars. As longevity increases and our obligations to entitlement programs balloon it is not realistic to expect the federal government to pick up the entire tab.

Second, saving finances the investment necessary to spur further economic growth. The American economy is driven by ingenuity and entrepreneurship, but even the most ambitious genius with a business plan can do little without ready access to capital. The innovators of Silicon Valley, from which flowed much of the U.S. technological (and economic) innovation of the past 15 years, created enormous wealth for themselves and society through the combination of creativity, talent, hard work, and a ready access to financial capital. Each was a necessary ingredient.

It makes sense to look at institutional factors that inhibit saving and to consider what kinds of low cost, common-sense reforms can be adopted to make it easier for individuals to set aside a sufficient portion of their income each year to finance retirement, college education, and other significant financial obligations.

Our witnesses are all internationally recognized experts on saving.

Richard Thaler, a University of Chicago professor of economics, has been at the forefront of developing innovative ways to increase saving through employer-sponsored retirement plans.

Robert Pozen, chairman of MFS Investment Management, law professor at Harvard Law School, author and former vice-chairman of the board at Fidelity Investments, has a unique perspective on how institutions can affect saving and what types of reforms would complement the work of financial institutions.

Ric Edelman, founder of Edelman Financial Services in Fairfax, VA, is the author of three New York Times #1 bestsellers, is an award-winning host of radio and television shows, and taught personal finance at Georgetown University for nine years.

Peter R. Orszag is a Senior Fellow at The Brookings Institution who has published widely on tax policy, Social Security, and pensions.

Gentleman, we thank you for your presence and look forward to hearing your testimony.

CONGRESS OF THE UNITED STATES

JOINT ECONOMIC COMMITTEE

VICE CHAIRMAN JIM SAXTON

PRESS RELEASE

For Immediate Release
March 10, 2004

Press Release #108-106
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STATEMENT OF VICE CHAIRMAN JIM SAXTON "HELPING AMERICANS SAVE"

WASHINGTON, D.C. – It is a pleasure to join in welcoming the panel of witnesses appearing before the Joint Economic Committee today.

Personal saving is vital for the financial security of households, and also finances the investment and capital formation necessary for long-term economic growth. Unfortunately, and despite recent changes, the U.S. income tax still retains a systematic bias against saving and investment. Under an income tax, a dollar saved is taxed, and its return is taxed yet again. Yet each dollar of consumption is taxed only once. Some of this bias has been reduced through the expansion of IRAs, 401 (k)s, and similar vehicles. The longstanding anti-saving bias in the income tax is the reason that I have supported higher IRA deductions and 401 (k) ceilings over many years.

Another problem is that the current tax treatment of mutual fund shareholders regarding capital gain distributions is illogical and unfair. Under current law, mutual fund shareholders must pay taxes on capital gains realized by mutual funds even if they have not sold one mutual fund share. Furthermore, they pay such taxes even when the value of their shares has plummeted, as it did after the collapse of the stock market that began in the first quarter of 2000.

In other words, when mutual funds generate huge capital gains, the shareholders get hammered even when their own unsold shares have declined in value. And when the mutual funds incur huge capital losses, as they did after the bubble burst, most of these losses cannot be immediately passed on to shareholders. This is a 'heads I win, tails you lose' situation for the government. In addition, given the complexity of the relevant tax provisions, it is very easy for confused taxpayers to pay the capital gains tax twice.

I have offered legislation, H.R. 496, which would remedy this inequity by providing a tax deferral on capital gain distributions large enough to cover all distributions of over 90 percent of shareholders. Mutual funds are an important saving and investment vehicle for middle-income Americans, and the punitive tax treatment of these taxpayers is unnecessary and counterproductive.

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WENDELL PRIMUS
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Opening Statement
Representative Pete Stark
Joint Economic Committee Hearing
March 10, 2004

Thank you, Chairman Bennett. I also want to thank you for holding this hearing on "Helping Americans Save" and thank our witnesses for testifying today.

While we all recognize the importance of saving for retirement, we all don't have the means to do so. It's all many low- and moderate-income families can do just to get by each day, let alone put away a little money each month for retirement. One economic disruption to a family, such as unemployment, a medical emergency, or a divorce, can wipe out their savings.

Most Americans actually find it difficult to save. Although consumers realize that they would be better off if they saved, many lack the willpower to put off buying that TV that's on sale today in favor of waiting until they can pay cash. But saving is a key factor in determining how well many Americans will be able to maintain their standard of living during retirement.

While some families are well on their way to a secure retirement, many families have accumulated little or no savings. Seventy-five percent of families with income under $25,000 do not own a retirement plan of any kind, and half of all families who do have a 401(k) have a balance of less than $2,000, according to the most recent data from the Federal Reserve.

Clearly, Social Security will continue to play a key role in maintaining retirement income security for the majority of American families. For one-fifth of seniors, Social Security is their sole means of support in retirement, and two-thirds of the elderly receive the majority of their income from the program. Moreover, Social Security is instrumental in keeping millions of elderly families out of poverty. The poverty rate among the elderly is 10.5 percent, but would be 47.4 percent without Social Security. Over the past fifty years, Social Security has dramatically decreased poverty among the elderly. Privatizing Social Security, as President Bush has proposed, would lead to widespread retirement insecurity.

Most saving for retirement occurs because workers are automatically enrolled in a program such as Social Security or a defined-benefit pension. We've seen higher retirement plan participation rates where employers have applied automatic enrollment – where workers must opt out – to 401(k) type plans. Another successful type of default is to have workers commit to save some portion of future salary increases, so their current take-home pay remains the same.

While these are all innovative approaches to increasing saving, the President has only offered more and bigger tax shelters that largely reward those who can already afford to save. Tax-incentives could be redesigned to increase saving among the low-income population, but existing policies and the President's proposals offer little to low-income families and are not an effective way to increase saving. Not only are the Administration's proposals unlikely to have much of an effect on private saving, they could actually decrease it. Moreover, the Administration's costly proposals would decrease public saving by increasing future budget deficits.

In order for Americans to be able to save, first they need good jobs that pay good wages. The President's policies are clearly failing here, because we still have a huge jobs deficit and workers' productivity gains aren't showing up in their pay checks. But that's a topic for another hearing.

Our witnesses have some sensible suggestions for helping Americans save and promoting retirement income security. Proposals for better financial education and using default options in employer-sponsored pensions should be encouraged. But our first priority must be to preserve and strengthen Social Security for current and future retirees. Every industrialized nation in the world, including this one, has recognized that the social safety net must include a government-sponsored retirement system. Without Social Security, many of the elderly in this country would not be able to live out their golden years with dignity.

I look forward to the testimony of our witnesses today.

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Helping Americans Save

Testimony of Richard H. Thaler
Robert P. Gwinn Professor of Behavioral Science and Economics
Graduate School of Business
University of Chicago

March 10, 2004

Chairman Bennett and other members of the Committee, thank you for inviting me to participate in this panel on Helping Americans Save.

I am Richard H. Thaler, a professor of behavioral science and economics at the University of Chicago's Graduate School of Business. I am an economist by training, but for the last 25 years I have been exploring ways to incorporate the findings of modern psychology into economic analysis.

As you all know, America's personal saving rate is hovering near zero. Furthermore, as the population ages, there will be growing difficulty in financing Social Security, and future generations face a very likely prospect of having to finance a larger fraction of their retirement on their own. I thus applaud the attention you are drawing to the important question of how to help Americans save. And, I come bearing good news. By incorporating simple lessons of psychology, and a little common sense about human nature, it is actually quite easy to help Americans save.

By tradition, governments are advised by *economists* on policy matters such as saving. Unfortunately, the traditional economic models that economists rely upon for their advice are not very helpful, in two main respects. First, they assume that households are capable of making the complex calculations necessary to determine how much to consume and how much to save, and, as important, that the households have the requisite willpower to delay consumption in the way the conventional model predicts they should in order to provide for the future. Since the time of Adam and Eve real humans (as opposed to the imaginary creatures populating economics text books) have had difficulty resisting temptation.

Another problem with the standard economic model is that it does not give policy makers any guidance as to *how* to increase savings. The only variable under the control of policy makers is the after-tax interest rate. But the theory does not tell us whether raising this rate (say, by making saving tax free) will increase or decrease savings rates. (The problem is that increasing the return to saving has offsetting effects: it makes saving more valuable, but means that households do not have to save as much to achieve any particular savings goal.)

In contrast, by studying actual humans, we learn that there are lots of ways to increase savings. Here are some useful findings that we might want to incorporate in a plan to get people to save more.

1. Many Americans realize that they should be saving more. One survey finds that two thirds of the participants in 401(k) plans think they are saving too little.
2. Self-control restrictions are easier to adopt if they are not implemented immediately. Many of us here are planning to begin diets *next month*, not today at lunch.
3. Money that is put into designated retirement savings accounts tends to stay there (compared, say, to money in an ordinary savings account).
4. People are "loss averse"—losses hurt more than gains feel good.
5. There is enormous inertia in retirement plans (and elsewhere!). For the vast majority of participants, once they join the 401(k) plan, they rarely make changes, either to their contribution rate or to the asset allocation. So, although participants agree they should save more, many never get around to doing it.

We can think about this list two ways. First, it can be considered a diagnosis, an explanation of why the savings rate is so low. Second, and more helpfully, it can provide the ingredients for the cure. What can we do to help Americans save more?

One simple step that has been adopted by some organizations is called "automatic enrollment". The idea is simple. In the usual 401(k) plan, when an employee first becomes eligible to join the plan, he or she receives a form that says, "if you want to join the plan, please fill this out, and make some choices". Under automatic enrollment, the employee receives a similar form, but it says "you are now eligible for the plan, and *unless you return this form, we are going to enroll you automatically*". Notice that under a standard economic analysis, these two set-ups are virtually identical. The cost of filling in a form is small relative to the long-term benefits of joining the plan, especially when the firm provides a "matching investment". Nevertheless, automatic enrollment can have huge effects. In one company studied by Madrian and Shea[1], when automatic enrollment was adopted, the enrollment rate by new workers jumped from 49 percent to 86%. That is the good news. The bad news is that under automatic enrollment, companies must select some default savings rate and investment plan, and employees tend to adopt and stick with these default levels. So, in the company studied by Madrian and Shea, where the default savings rate was 3 percent, all of which was invested in a money market account, most employees who were defaulted into these choices still were sticking with them N years later. This is unfortunate, because virtually every expert who has studied the problem concurs that 3 percent is not a high enough contribution rate, and a money market account is not a suitable long-term investment vehicle for 100 percent of one's retirement account.

My collaborator, Shlomo Benartzi from UCLA, and I have developed a better plan that can be adopted in conjunction with, or separately from, automatic enrollment. We call our plan Save More Tomorrow, also known as the SMarT plan[2]. Under SMarT, participants are contacted a few months before their next pay increase with the following

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[1] See Brigette C. Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics,* November 2001, pp. 1149-1187.

[2] Richard H. Thaler and Shlomo Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving" Journal of Political Economy, February 2004, Part 2 S164-S187.

offer. They can commit themselves now to increasing their savings rates later, when they get their next raise, say by two or three percentage points. Also, their contribution rates will continue to go up whenever they get a pay increase until they either reach some specified maximum, or opt out of further increases. Notice that this plan incorporates the psychological principles I mentioned above. People are asked to join in a few months, not now, and by linking the savings increases to pay increases, they never have to experience a cut in their take home pay.

We have now implemented this plan in several companies, but let me report on the results from the first company to adopt the idea, a mid-sized manufacturing company in the Chicago area. The company was concerned that their employees were not saving enough for retirement, so they hired a financial consultant and made him available to meet one-on-one with every worker. The consultant had a computer with software that could help calculate how much the employee should be saving. Because the employees were not good savers, the software typically recommended that the employee immediately increase his or her saving rate to the maximum allowed. However, few employees were willing to accept this advice, so the consultant suggested an increase of 5 percentage points, say from 3 percent to 8 percent. This advice was also rejected by most employees. So, the consultant would offer these reluctant savers the SMarT plan. Specifically, their savings rate would increase by 3 percentage points at the time of every raise.

This plan proved to be popular with the employees. Over 80 percent of those offered the plan signed up. And, the effect on their savings rates was dramatic. (See Table 1). In just 14 months from the time the consultant spoke to the employees, the participants who enrolled in the SMarT plan increased their savings rates from 3.5 percent to 9.4 percent, and after two more years they were saving 13.6 percent of their salary. Their saving rates have nearly quadrupled! And this is a group that had been very reluctant savers.

The SMarT plan has now been implemented by several other employers, and companies that administer 401(k) plans, such as Vanguard, are offering the idea to their employer customers. We are optimistic that hundreds of thousands of employees will be enrolled in SMarT plans within a few years, and within a decade, the plan could reach most employees in the US. At the moment, this idea does not need any government intervention, but two steps are worth considering:

- Adopt some version of SMarT for government employees through the Thrift Savings Plan.
- Give some consideration to firms that adopt a combination of automatic enrollment and SMarT—perhaps exempt these firms from cumbersome nondiscrimination testing. Such action would simply recognize that, in implementing a SMarT plan, firms have already met the spirit of the Congressional intent that these plans should not disproportionately benefit high-earners.

There are other lessons for government to take away from our experience. First, we have shown what the recipe is (or, at least what one recipe is) for helping people to save. The key ingredients are:

1. Make it easy to join. The easier the better, and automatic enrollment is the easiest.
2. Take the contributions directly from the paycheck. If you don't see it, you don't spend it.
3. Once you get people saving, make the default option to keep saving or, even better, to keep increasing their savings.
4. Put the money into an account where people are not overly tempted to dip in on impulse.

These basic principles could be adopted in many existing and proposed tax-favored savings vehicles.

I would also like to make one other behaviorally motivated suggestion. One way many Americans do manage to save (albeit temporarily) is through tax refunds. Most Americans receive a refund when they file their tax returns. Unfortunately, that money is often spent quickly when the refund check arrives (or even quicker, via a tax refund loan). One way to get more of that money into long-term savings would be to allow refunds to be deposited directly into an IRA and still qualify for a tax credit for the previous year. In other words, people who in March of 2004 are now filing their 2003 tax return, and claiming a $1500 refund, could send those funds directly to an IRA account. For traditional deductible (not Roth) IRAs, the actual amount deposited would be increased by the tax payers marginal tax rate. So, for a taxpayer in the 25% bracket, they would be given the choice of getting a $1500 refund or making a $2000 IRA contribution. That could be an attractive inducement to save.

My principle conclusion is a simple and optimistic. We can succeed at helping Americans save more by employing a combination of basic psychology and common sense.

Table 1

Average Saving Rates for the First Implementation of SMarT

	Participants who did not contact the financial consultant	Participants who accepted the consultant's recommended saving rate	Participants who joined the SMarT plan	Participants who declined the SMarT plan	All
Number of participants initially choosing each option.*	29	79	162	45	315
Pre-advice	6.6%	4.4%	3.5%	6.1%	4.4%
1st Pay Raise	6.5%	9.1%	6.5%	6.3%	7.1%
2nd Pay Raise	6.8%	8.9%	9.4%	6.2%	8.6%
3rd Pay Raise	6.6%	8.7%	11.6%	6.1%	9.8%
4th Pay Raise	6.2%	8.8%	13.6%	5.9%	10.6%

* There is attrition from each group over time. The number of employees who remain by the time of the 4th pay raise is 229.

Testimony of Robert C. Pozen

Chairman of MFS Investment Management

Before the Joint Economic Committee

March 10, 2004

Mr. Chairman, Mr. Vice Chairman and other Committee Members, my name is Robert Pozen. I am currently Chairman of MFS Investment Management and a visiting professor at Harvard Law School, though I am here today in my personal capacity rather than representing either institution. I was formerly a member of President Bush's Commission to Strengthen Social Security.

I congratulate the Joint Committee on its efforts to promote savings by Americans. The present savings rate of Americans is low relative to the savings rate in other industrialized countries, and relative to the savings rate in the United States from a historical viewpoint. If we are to grow our economy at a satisfactory rate and provide sufficient income during retirement, Americans need to save more.

While the subject of promoting savings is broad, today I will focus on the relationship between personal contributions to Individual Retirement Accounts (IRAs) and government expenditures through Social Security. These are two programs for retirement that have typically been addressed through separate measures. However, from the viewpoint of a retiree, the programs are closely linked. The income of a retiree is the total of what he or she receives from Social Security and from private retirement programs like IRAs.

I want to begin by proposing two ways to increase personal savings through IRAs and other tax deferred retirement plans such as 401(k) plans. Roughly 60% of U.S. households have income under $50,000 per year, while roughly 40% of U.S. households have income above that amount (according to statistics gathered by the Board of Governors of the Federal Reserve System). But these statistics show a big difference between these groups with regard to participation in IRAs and other tax deferred

retirement plans. Less than one third of households with incomes under $50,000 per year participate in such plans, while over two thirds of households with incomes over $50,000 per year participate in such plans. Moreover, households with incomes below $25,000 per year on average derive over 90% of their retirement income from Social Security because their participation rates in IRAs and other tax deferred retirement plans are minimal.

As a practical matter, it is very difficult for households with incomes under $50,000 per year to save today. In many areas of the country, a family of four earning less than $50,000 per year is struggling to make ends meet. Nevertheless, I believe that many households with annual incomes between $25,000 and $50,000 per year could become savers if properly incentivized. The most powerful incentive to save for retirement is a matching grant from someone else, as demonstrated by years of experience with 401(k) plans. In the context of these plans, an employer match of 50% of an employee's contribution often doubles the participation rates of employees.

Congress recently introduced a kind of matching for couples with annual incomes below $50,000 in the form of a tax credit against federal income taxes for up to 50% of their contributions to IRAs and other tax deferred retirement plans. While this tax credit is a good start, its value is diminished because it applies only to the extent a household is paying federal income taxes. With lower tax rates and more generous deductions, many families with annual incomes below $50,000 pay little or no federal income taxes. For example, a family of four with two children and an annual income of $40,000 would typically pay less than $100 of federal income taxes. The solution is for Congress to make this low-income tax credit refundable to the extent that households have

insufficient federal income tax to offset so long as the tax credit is invested in a long-term retirement account. Assuming the current low-income tax credit is made permanent, my rough estimate is that this new refundability feature would cost less than $1 billion per year for the next decade.

Households with annual incomes over $50,000 per year typically have enough resources to save for retirement. The challenge is to overcome the inertia that appears to prevent some workers from opening retirement accounts. In an effort to overcome this type of inertia in 401(k) plans, Professor Thaler has suggested a negative election procedure for 401(k) plans (as opposed to the positive election or opt-in required under current law). In a negative election, a company with a 401(k) plan would automatically enroll all workers in its plan and contribute a specified percentage of their salary to the plan, unless they opted out. This switch from an opt-in to an opt-out in 401(k) plans would be a powerful tool in the effort to increase retirement savings in America.

However, we know that many employers with fewer than 100 workers do not currently offer them any type of retirement plan. Congress has tried to address this problem by introducing the SIMPLE plans — which are exactly what the name implies. They reduce the paperwork and eliminate many of the complex requirements involved with defined contribution plans. While the SIMPLE plans have gained a measure of popularity, there still is a retirement plan gap for those working for many small employers.

I propose that Congress extend Professor Thaler's opt-out concept to any employer that does not offer its employees any type of retirement plan. Under this ULTRA SIMPLE plan, 1% of the wages of all qualifying employees would be

automatically contributed to an IRA at any qualified financial institution, unless the employee opted out of the plan. The burden would be minimal on small employers because many financial institutions are prepared to do most of the work in order to attract the contributions. And I would provide an extra incentive by giving banks CRA credit for offering an ULTRA SIMPLE plan. In addition, to reduce the burdens associated with part-time or seasonal workers as well as the costs inherent in small accounts, I would limit the 1% contribution to one transfer just after year end and I would limit a qualifying employee to someone with a specified level of annual earnings (e.g., $25,000 per year or a 1% contribution of $250 per year). Furthermore, the 1% contribution would be automatically invested in a money market deposit or money market fund unless the employee made a different choice.

If we could substantially increase the participation in private retirement plans, we would then be in a position to think creatively about the relationship between these plans and Social Security. In general, Social Security should be viewed as providing a floor of defined retirement benefits, which are supplemented by a variable stream of benefits from private retirement plans. The critical question is: how much of a worker's retirement income should be composed of defined benefits versus variable benefits? In my view, the answer depends on the level of a worker's earnings.

Low wage workers earning $25,000 or less per year need most of their retirement in defined benefits from Social Security; as mentioned above, these low wage workers do not tend to participate in IRAs or 401(k) plans. Even if we introduce a refundable tax credit to match their contributions to these plans, wage earners at $25,000 per year and below will be hard pressed to save for retirement. As to high earners over $100,000 per

year, most of their retirement income should be in the form of variable benefits from private retirement plans. Most of these earners already participate in IRAs and 401(k) plans. The middle-level earners need a mix of defined benefits from Social Security and variable benefits from private retirement plans. The proportions of the mix should depend on whether their earnings are closer to $25,000 per year or $100,000 per year.

To implement these "mix" objectives for different groups of earners requires an understanding of the two types of indexing used in Social Security — price and wage indexing. Most people are familiar with the COLAs of Social Security, whereby benefits after retirement are adjusted annually based on changes in prices to protect against inflation. By contrast, when the initial level of Social Security benefits are determined at the date of retirement wage indexing is applied. That is, the average career wages of each retiring worker is increased by the rate wages have risen in the whole American economy during his or her working career.

Since wages rise approximately 1.1% faster per year than prices, the use of wage rather than price indexing of initial benefits has a huge impact on Social Security's finances. An immediate switch from wage to price indexing of initial benefits would eliminate the whole long-term deficit of Social Security! But such a switch would also lower the "replacement ratio" for retiring workers.

The replacement ratio means the percentage that Social Security payments replace of the worker's average wages before retirement. If you earned $80,000 a year before retirement and received $32,000 in Social Security benefits after retirement, your replacement ratio would be 40% and you would very likely have other sources of income from private retirement plans. On the other hand, if you earned $20,000 a year before

retirement and received $8,000 per year in Social Security benefits after retirement, your replacement ratio would also be 40% but you would probably not have other retirement income and would have difficulty living on $8,000 per year.

Therefore, if we want to achieve our "mix" objectives by income group, we should maintain wage indexing of initial Social Security benefits for low-wage workers, while gradually introducing price indexing for middle and high wage workers. In 2012, for example, we could maintain wage indexing for all retiring workers with average career earnings of $25,000 per year or less — the lowest 30 percent of all retiring workers. At the same time, we could have price indexing for all retiring workers with average career earnings of $113,000 per year or more — the maximum wages subject to Social Security taxes in 2012. All workers between $25,000 and $113,000 per year would receive a mix of price and wage indexing based on a proportional formula.

Accordingly, the retirement income of low earners at $25,000 and below would be comprised mainly of Social Security benefits, which would grow relatively quickly for their working years through wage indexing. The retirement income of high earners would be comprised of a modest portion of Social Security benefits, which would grow relatively slowly for their working years under price indexing, plus a large portion from their private retirement plans. The retirement income of middle earners would be comprised of some Social Security benefits, growing for their working years through a mix of wage and price indexing, and other income from their retirement plans. Those earners between $25,000 and $50,000 per year would have been encouraged to contribute to private retirement plans through refundable tax credits.

In summary, this blend of price and wage indexing for Social Security, together with enhanced incentives to save through private retirement plans, would result in the appropriate mix of defined and variable benefits by income group. And, as an added bonus, this proposal would close over two thirds of the long-term deficit of Social Security.

Thank you again for this opportunity to present these proposals. Would be glad to answer any questions a Committee member might have.

"Helping Americans Save"

Ric Edelman
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Statement for the Record before the Joint Economic Committee of the United States Congress

March 10, 2004

Mr. Chairman and Members of the Committee, I am delighted to have this opportunity to present testimony today, and look forward to answering any questions you may have. I am honored to be here, and I commend you for holding a hearing on this vital topic.

Money is inextricably tied to virtually all facets of American life. Children make their first assisted purchases at age 3 – in the supermarket, not the toy store – and if you ask a typical 6-year-old where money comes from, he or she is likely to say, "The ATM!" High school students can get credit cards, college students can borrow tens of thousands of dollars, and workers are forced to make their own investment decisions in the company 401(k). Consumers are offered opportunities daily to "buy-now-pay-later" and if you try to buy a big screen TV, you'll find that the price is not $3,000 but "only $39.99 per month." The legal, tax and financial complexities have never been greater. In 1964, the authoritative tax guide published by Commerce Clearing House was 19,500 pages. Today, it's more than 60,000 pages across 25 volumes.

I'm not here to complain about that tax code. In fact, part of the reason that the tax code is more complex is that life today is more complex than it was a generation ago. For most of the 20th Century, people were likely to spend their entire careers working for one company. They bought one house and lived in it their entire lives. Today, of course, life is much different. The average American changes jobs every four years.[1] Fifteen percent of Americans move each year.[2] Fifty percent of marriages end in divorce, and more than half of those who divorce will remarry.[3] We're also having children later in life than ever.[4] All this is in addition to the massive changes

in our lives due to terrorism, technology and new social issues, from gay marriage to euthanasia.

As a result of today's complexities, it's harder than ever for ordinary consumers to make effective financial decisions, decisions that have huge implications for their future. The real problem is not a complex tax code – although certainly that could use some improvement – but that we don't give Americans the education and information they need to make good decisions for themselves and their families.

The answer to this dilemma is clear: We must establish financial literacy as a primary objective of this government. America's youth are given the training, tools and skills to make money in the workplace, but we do not give them the knowledge they need to manage that money effectively. As a result, debt levels[5] and bankruptcies[6] have never been higher. And, not surprisingly, so are divorce rates, depression and suicide. Indeed, the rich – the few who do know how to handle money properly – are getting richer,[7] and the poor – the masses who do not understand the simple basics of money management – are getting poorer.[8] Indeed, 91% of today's retirees depend on Social Security for critical financial support,[9] compared to only 31% in 1962.[10] Rather than empowering Americans to control their futures through individual financial independence, we are making them dependent on government assistance.

The American Savings Education Council, the Employee Benefit Research Institute, the Jump$tart Coalition for Personal Financial Literacy, the National Endowment for Financial Education and the Edelman Center for Personal Finance Education are devoted to helping you learn how money works and how to make it work for you. But these voluntary charitable programs are not enough. We must get financial literacy programs embedded into our schools as requirements for all students. Along with reading, writing and arithmetic, students must learn the truth about money – how to earn it, save it, spend it and donate it.

Make financial literacy the cornerstone of America's education curriculum. Require it in schools and in the workplace. It's easy to teach, and the audience is receptive – for who doesn't want to learn how to avoid debt, buy a home, pay for college, drive the car of their dreams and become wealthy?

You have asked me to tell you how we can boost America's saving rate. The answer is simple: Many people fail to save because they feel they don't have enough money to save. They think their money is tied up with current bills, and with the pennies left over, they think it's just not worth it. They couldn't be more wrong, and all it takes is a little education to show them why. Here's one simple example: Most high school and college students would agree that they could save $3 a day once they enter the workforce. If they do – if they save just three dollars a day throughout their working careers – they can enter retirement with more than $1 million. You see, it doesn't take money to make money, it takes time. And once people learn the power of time, the power of compound interest, and the ease of saving small amounts over long periods, they can get excited about their future.

For that is what financial literacy is all about: Helping people get excited about the future. The future is the home of our dreams and aspirations, and focusing on the future is the first step in getting from here to there. Mr. Chairman and members of the Committee, there's only one thing you need to do: Add financial literacy to the Three Rs.

To implement this, you'll need the participation of America's educators and employers. The education part is easy: Just provide financial elements in current class work. For example, when teaching gradeschoolers how to count, have them count pennies, nickels, dimes and quarters. When teaching algebra and geometry to junior high school students, teach them the time value of money. And when teaching history to high school students, have them explore how financial considerations influenced major public and social events. Although this sounds like common sense, only eight states currently require students to take a personal finance course.[11] That's only 15% of the nation's high school students. The rest are graduating from high school financially illiterate and completely unprepared when signing up for credit cards, buying a car, renting an apartment, or joining a company 401(k) plan. Often, these kids don't even know how to open a bank account or balance a checkbook.

We have similar problems in the workplace. Today's workers are told to pick mutual funds for their retirement plan, but many don't even know what a mutual fund is, let alone how to pick one. Currently, less than half of the nation's large employers offer financial education programs, and none require participation.[12] We need to require training that helps workers prepare for retirement, and we need similar initiatives for all other aspects of

personal finance, including insurance, saving, wills, home buying, mortgages, and paying for college.

America is the greatest, most prosperous nation on Earth. Our job is to make sure that that prosperity is enjoyed by every member of our society.

Here are specific recommendations for your consideration:

1. **Require that the nation's schools include financial literacy in the curriculum.**

2. **Delay Social Security eligibility to age 70 for Americans under the age of 50.** Thirty percent of American workers say they are "counting on Social Security to provide most of their retirement income."[13] By delaying and reducing those benefits, American workers will get the message that they, not the government, are responsible for their financial future, giving them the inducement they need to save. Most of those who are near retirement have too little time to save the money they need, but younger workers can and should take responsibility for their own future. Furthermore, the Social Security system was not designed to pay any one person so much in benefits for such a long period as it does today. Indeed, when Social Security was created in the 1930s, retirees were expected to receive benefits for 12.7 years.[14] Today, males who attain age 65 can expect to live 15.3 years, or 20% longer. The system cannot afford this, and was never designed to do so. It must be fixed.

3. **Delay to age 80 mandatory withdrawals from IRAs and retirement accounts.** Currently, Americans are required to begin withdrawing money from these accounts at age 70½. This made sense a generation ago, when workers generally retired at age 60 or 62, but today, millions of Americans want or need to work into their 60s and 70s. Therefore, they should not be required to make withdrawals sooner than they need the money. By delaying the age of mandatory withdrawals, their savings can continue to grow until truly needed.

4. **Replace current retirement plan regulations with one universal program.** The amount of money one can save in a retirement plan depends on where he or she works. As a result, workers in large corporations typically can save more money in a retirement plan than

those who work for small employers. This is a big problem for the majority of American workers, because 56% work for small businesses.[15] In fact, 87% of employers have fewer than 20 employees.[16] Furthermore, the variety and complexity of current plans is mind-numbing: 401(k), 403(b), Profit-Sharing, Money Purchase, SIMPLE, SARSEP, SEP-IRA and more. The costs associated with compliance discourage small employers from offering retirement plans to their employees, and the complexity discourages employees from participating. Congress should replace the current myriad rules with one set of universal rules for use by every employer in the nation.

5. **Permit people to save for retirement even if they are not currently earning an income.** Millions of stay-at-home spouses will tell you that they work; they just don't earn an income. To encourage people to save, permit them to establish retirement accounts even if they have no current income.

6. **Permit people to save for retirement regardless of their age.** By allowing parents and grandparents to set money aside for a newborn, small investments can lead to huge future portfolios. For example, a one-time contribution of $5,000 at birth that earns 10% per year would be worth more than $2.4 million when the child reaches age 65. My invention, the Retirement InCome – For Everyone Trust®, should be used as a model for use nationwide.

7. **Eliminate the ability for workers to borrow from their retirement plans**. It's a good intention gone awry: Originally, lower-income workers balked at the idea of diverting some of their paycheck into a retirement plan out of fear they might need the money. Congress responded by allowing workers the opportunity to "borrow" monies from the plan without taxes or IRS penalties. But this has backfired: 17% of all American workers who participate in a retirement plan have borrowed money from their accounts; the average loan is 16% of the account balance.[17] Ironically, those with salaries between $40,000 and $100,000 are more likely to have a loan than those earning less than $40,000.[18] Thus, millions of middle-class and low-income workers have thwarted their retirement savings efforts. The ability to borrow should be eliminated – for their own good.

8. **Eliminate the ability for employers to distribute funds to terminated employees.** Current rules permit employers to close accounts of less than $3,500, returning those funds to workers who have separated from service. Furthermore, 72% of accounts valued from $5,000 to $10,000 are cashed out prior to retirement.[19] Workers receiving these funds often are forced to pay taxes and IRS penalties on the distribution, and the money is typically spent rather than reinvested in an IRA or other savings vehicle. Require employers to maintain these accounts, so that workers are more likely to retain the assets until retirement.

9. **Extend to IRAs the same creditor protection currently enjoyed by qualified retirement plans.** This will enhance the desirability of IRA accounts.

Thank you for this opportunity to share my thoughts.

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[1] U.S. Bureau of Labor Statistics
[2] U.S. Census Bureau
[3] U.S. Census Bureau
[4] U.S. Census Bureau
[5] Federal Reserve
[6] Administrative Office for the U.S. Courts
[7] Internal Revenue Service
[8] Federal Reserve, U.S. Census Bureau
[9] *Implications of Demographic Trends in Social Security and Pension Reform*
[10] *Criteria for Social Security Reform* by Joseph Quinn
[11] NY, KY, IL, ID, KS, SC, UT, LA. Source: Jump$tart Coalition for Personal Finance Literacy
[12] Hewitt Associates
[13] Nationwide Financial Services, BIGResearch
[14] Committee on Economic Security, designers of the Social Security program
[15] Employee Benefit Research Institute
[16] Small Business Administration
[17] Employee Benefit Research Institute
[18] Employee Benefit Research Institute
[19] Hewitt Associates

STRENGTHENING RETIREMENT SECURITY

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Testimony before the Joint Economic Committee
March 10, 2004

Mr. Chairman, my testimony this morning addresses two aspects of strengthening retirement security: why it is critical to preserve Social Security's core insurance features while reforming the program to eliminate its long-term deficit; and how we can expand retirement saving on top of Social Security.

Saving Social Security without destroying it

Social Security is one of America's most successful government programs.[2] It has helped millions of Americans avoid poverty in old age, upon becoming disabled, or after the death of a family wage earner.

Social Security's success as a social insurance program is attributable to several basic features of the system. It provides participants with a well-defined, assured basic income that is protected against inflation, the risk of outliving one's assets, and financial market fluctuations. It is progressive, providing larger annual benefits (relative to previous wages) for lower earners than for higher earners. And it provides families with insurance against the disability or death of a wage earner, in addition to retirement benefits.

Although we can and should boost retirement saving on top of Social Security, we must not forget that for the majority of the population, Social Security provides the key layer of financial security during particular times of need. One-fifth of elderly beneficiaries receive *all* their income from Social Security, and nearly two-thirds receive the majority of their income from Social Security. The average Social Security benefit amounts to slightly more than $10,000 a year, and 20 percent of beneficiaries receive $7,000 a year or less.

Social Security faces a long-term deficit. Restoring long-term financial balance to Social Security is therefore necessary, but it is not necessary to destroy the program in order to save it. One particularly contentious issue involves whether part of Social Security should be replaced with individual accounts. In my view, such an approach would be unwise both because of the

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

[2] Much of the discussion on Social Security in this testimony is drawn from Peter A. Diamond and Peter R. Orszag, *Saving Social Security: A Balanced Approach* (Brookings: 2004).

financing issues it entails and because individual accounts are not likely to provide an adequate replacement for the crucial protections offered by the current system:

- Diverting Social Security revenue into individual accounts creates a substantial financing problem. The revenue diversion by itself worsens Social Security's financial standing. To avoid this, individual accounts must be linked in some way to a reduction in traditional benefits sufficient to offset the cost of the diverted revenue. Even then, however, the flow of revenue into the individual accounts would precede by many years (if not decades) the offsetting reductions in traditional benefits.

- Despite whatever ivory-tower proponents might like to believe, it is unlikely that real-world individual accounts would require that benefits keep pace with inflation, last as long as the beneficiaries are alive, or protect surviving spouses as well as the current system. There would also likely be intense political pressure to allow withdrawals prior to retirement, which would undermine the role of the accounts in providing retirement security. Furthermore, the assets in the accounts are subject to financial market risks. As a result, individual accounts are simply inappropriate for the basic tier of income during retirement, disability, and other times of need. Especially as the private retirement system on top of Social Security shifts from a defined benefit to a defined contribution one, it makes little sense to engineer a shift to individual accounts within the core layer of financial security provided by Social Security.

A final issue regarding Social Security involves the relative magnitudes of the actuarial deficit in Social Security and the cost of the recent tax cuts. Over the next 75 years, the Social Security actuarial deficit amounts to 0.7 percent of GDP. Over the same period, the tax cuts (if they are extended and protected from being erased by the Alternative Minimum Tax) amount to more than 2 percent of GDP. In other words, the tax cuts cost more than three times the actuarial deficit in Social Security.

The relative size of the tax cuts and the Social Security deficit underscores two points:

- First, the tax cuts dissipate revenue that could have instead been used for more constructive purposes, including to shore up the Social Security system. Since the tax cuts sunset in 2010 or before, we still face a choice. Assuming an Alternative Minimum Tax reform, the cost of *extending* the tax cuts (that is, ignoring the costs that arise before the enacted tax cuts sunset) is 1.8 percent of GDP over the next 75 years. That is more than 2.5 times as large as the actuarial deficit in Social Security over the same period.

- Second, even if it were sensible to finance regressive tax cuts through reductions in progressive benefit programs, it is not realistic to "pay for" the tax cuts through reduced Social Security benefits. The relative magnitudes mean that the math doesn't even come close to working (assuming that one is not willing to enact benefit reductions that are even more severe than the extreme of eliminating the entire Social Security deficit on the benefit side).

Expanding retirement saving on top of Social Security

Various types of savings incentives already exist for households to supplement the key protections offered by Social Security. These savings incentives, however, are upside-down:[3]

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

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

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

- Only about half of workers participate in an employer-based pension plan in any given year, and participation rates in Individual Retirement Accounts (IRAs) are substantially lower. Participation is particularly low among lower earners: Only about one-fifth of workers in households with income of less than $20,000 participated in some form of tax-preferred savings plan in 1997.

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

- Despite the shift from defined benefit to defined contribution plans, many households approach retirement with meager defined contribution balances. The median defined contribution balance among all households aged 55 to 59 in 2001 was only about $10,000. Many households thus appear to have substantial difficulty in saving significant amounts for retirement.

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

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

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

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

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

Retirement Security Project

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

I. Saving Social Security

For the majority of the population, Social Security benefits provide the key layer of financial security during particular times of the need. Social Security benefits are particularly valuable for several reasons:

- First, Social Security benefits are indexed for inflation and last for as long as the beneficiary is alive. Beneficiaries therefore do not have to worry that they will exhaust the income flow from their assets before they die, nor do they have to worry that inflation will rob them of the standard of living supported by Social Security.
- Second, Social Security benefits are progressive: they replace a larger share of previous wages for those whose earnings were low during their working life than for those whose earnings were high. This progressivity provides a form of lifetime earnings insurance that is not available in the private market.
- Third, Social Security retirement benefits do not depend on what happens in financial markets. Concern about market risk is greatly heightened by the evidence of how poorly many workers manage their 401(k) investments. Far too many workers do not diversify

[4] See www.brookings.edu/retirementsecurity

properly, over-invest in their employer's stock, choose short-term bonds for a long-term investment, and do not make adjustments in their portfolios as their circumstances change.

- Finally, Social Security provides benefits for surviving spouses, mostly widows, for young children losing a parent, and for disabled workers and their families. The image of Social Security solely as a retirement program is inaccurate: almost 15 percent of beneficiaries are younger than 62.

In any reform to Social Security, it is critically important that these key features of the program be retained. Restoring long-term financial balance to Social Security is necessary, but it is not necessary to destroy the program in order to save it. To be sure, some analysts reject the view that Social Security's projected financial problems are serious enough to warrant any changes right now. Others exaggerate the difficulty of saving Social Security to justify proposals that would undermine the most valuable features of the program. My view is that Social Security's projected financial difficulties are real and that addressing those difficulties sooner rather than later would make sensible reforms easier and more likely. The prospects are not so dire, however, as to require undercutting the basic structure of the system.

Causes of long-term deficit

In exploring reforms to Social Security, it may be helpful to explain the causes of the long-term deficit. Many factors contribute to that deficit. As Peter Diamond and I explain in *Saving Social Security: A Balanced Approach* (Brookings, 2004), three important contributing factors include improvements in life expectancy, increases in earnings inequality, and the burden of the legacy debt resulting from Social Security's history.

Life expectancy at age 65 has risen by four years for men and five years for women since 1940, and it is expected to continue rising in the future. Increasing life expectancy raises the value of Social Security benefits to workers, because benefits last as long as the recipient is alive. By the same token, however, improving life expectancy adversely affects Social Security's financial condition, because beneficiaries then collect benefits over a longer period.

A second factor affecting Social Security's financing is earnings inequality. Over the past two decades, earnings have risen most rapidly among workers who already have the highest earnings. This affects Social Security's financing because the Social Security payroll tax is imposed only up to a maximum taxable level ($87,900 in 2004). Between 1983 and 2002, the share of aggregate earnings above the maximum taxable level increased from 10 to 15 percent. Furthermore, the extent to which people with higher earnings and more education tend to live longer than those with lower earnings and less education has also increased. This increasing gap in life expectancy exacerbates Social Security's financing shortfall and makes the system less progressive on a lifetime basis, since higher earners will collect benefits for an increasingly larger number of years, and thus enjoy larger lifetime benefits, relative to lower earners.

A third important influence on the future finances of Social Security reflects the past. The benefits paid to almost all current and past cohorts of beneficiaries exceeded what could have been financed with the revenue they contributed, including interest. This history imposes a "legacy debt" on the Social Security system. That is, if earlier cohorts had received only the benefits that

could be financed by their contributions plus interest, the Trust Fund's assets would be much greater today. If those assets were present, they would be earning interest that could contribute to paying for benefits.

Social Security's legacy debt is similar in many ways to the explicit public debt. The public debt reflects the accumulated difference between spending and revenue from the beginning of the nation to the present; because spending has exceeded revenue in the past, we are left with a public debt. The cost of financing that public debt requires some combination of higher taxes and lower spending in the future than would have been necessary in the absence of the public debt. So, too, the legacy debt within Social Security reflects the accumulated difference between benefits and revenue for previous and current beneficiaries; the cost of financing that debt will require some combination of higher taxes and lower benefits than the system could otherwise afford for future generations.

Social Security reforms, unless they reduce benefits for current retirees (which no one today is seriously proposing), will have only modest effects on the size of the legacy debt. With the size of the legacy debt thus largely already determined, the type of reform enacted will instead determine how the resultant legacy cost is spread across generations. In other words, how actuarial balance is restored will determine how the costs of the program's legacy debt are shared.

A reasonable estimate of the program's legacy that needs to be financed by those younger than 55 years old is $11.5 trillion. Relative to a world in which the legacy debt didn't exist, future generations will have to bear some combination of higher taxes and lower benefits. The key question is how those higher taxes and lower benefits are spread across different generations in the future, and different people within each generation. Any plan that restores actuarial balance spreads this cost in some way. The challenge is to select a way that seems fair.

As one extreme example, imagine that benefits in the years after 2042 (when the trust fund is projected to be exhausted) are reduced so that they just equal incoming payroll revenue at the existing tax rate. Such an approach would pass most of the legacy debt along to distant generations. The reduction in benefits for those distant generations would have to be substantial, because little of the legacy debt would have been paid down in the meanwhile. At the other extreme, imagine that taxes are raised on current workers by enough to eliminate the entire legacy debt within a generation. Such an approach would transform Social Security into a fully funded system. It would leave generations in the distant future with no legacy debt, but it would impose a substantial burden on the transition generation.

Social Security reform should reflect a balance in the financing of the system's legacy debt between these two extremes of paying off the entire debt immediately and shifting all of it to future generations. The "appropriate" balance between them is clearly a subjective matter.

Individual accounts

Individual accounts within Social Security have two problems: They raise a substantial financing challenge, and they are unlikely to be a particularly effective mechanism for delivering the core layer of financial security during times of need.

If Social Security revenue were diverted into individual accounts without any

corresponding reduction in benefits, Social Security's financial standing would clearly be worsened. To avoid this, individual accounts financed by such revenue diversion must be linked in some way to a reduction in traditional benefits sufficient to offset the cost of the diverted revenue. Even if the traditional benefits that would otherwise be paid to the individual accountholder are reduced in such a way that traditional Social Security finances are unaffected over the accountholder's lifetime, however, the bulk of the flow of revenue into the individual accounts would precede by many years the offsetting reductions in traditional benefits.[5] The benefit offset for, say, a worker age 25 would occur over a period of several decades that does not begin until about four decades hence. Revenue would thus be diverted from the trust fund over many years before the corresponding "debt" would be repaid. For example, if 2 percent of payroll were diverted to individual accounts, with an offsetting reduction in traditional benefits for accountholders upon retirement, the individual accounts have no effect on Social Security in present value terms—the program would eventually be paid back in full for the diverted revenue. However, the cash flow from the individual accounts would be negative over a period of more than forty-five years, because the diverted revenue would exceed the benefit offsets until almost 2050.

The delay between the revenue flow and the corresponding benefit reductions poses a significant problem for the Social Security system. The net cash outflow would cause the Trust Fund to be exhausted more than a decade earlier than in the absence of the generic accounts. To offset this negative cash flow, it would be necessary either to phase in benefit reductions more rapidly, to provide additional revenue to Social Security, or to allow Social Security to borrow from the rest of the budget. The "magic asterisk" approach of simply assuming that trillions of dollars will be provided from the rest of the budget to fill this hole, despite the nation's substantial fiscal gap, is fiscally irresponsible. (This concern is even more pronounced if the traditional benefit reductions linked to individual accounts do not ultimately occur, or do not occur to the extent originally envisioned, because of political pressure to reduce the offset rate.)

Even if it were not for these financing issues, individual accounts would not make sense *within* Social Security. Although tax-favored individual accounts such as 401(k)s and IRAs already provide a useful supplement to Social Security, they are simply inappropriate for the basic tier of income during retirement, disability, and other times of need. Those nearing retirement need a reliable source of income that offsets inflation and lasts as long as they live. This is particularly important for the one-third of the elderly who get at least 90 percent of their income from Social Security. Individual accounts do not provide this type of security. The assets in the accounts are subject to financial market risks.

Furthermore, despite whatever ivory-tower proponents might like to believe, it is unlikely that real-world individual accounts would require that benefits keep pace with inflation, last as long as the beneficiaries are alive, or protect surviving spouses as well as the current system. The result would be that an individual account system would not provide retirement security for the core layer of income as effectively as the current benefit structure.

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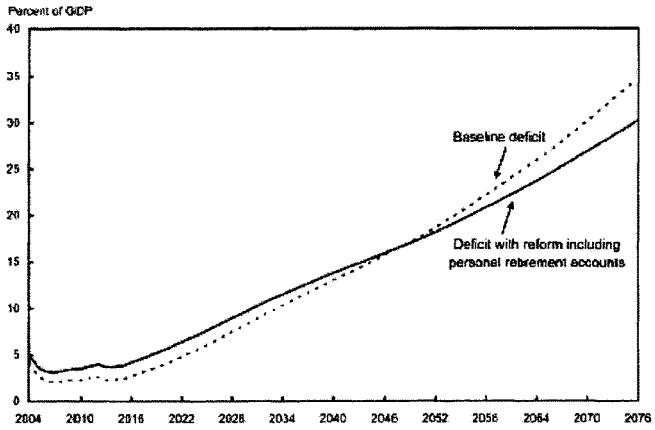
[5] It is worth noting that many recent Social Security reform plans, including both Model 2 and Model 3 put forward by the President's Commission to Strengthen Social Security, would *not* hold Social Security harmless over the life of worker who chooses to divert funds to an individual accounts. Instead, these proposals entail lifetime subsidies to the accounts, and corresponding permanent costs to the government.

Social Security, the tax cuts, and the long-term deficit

A final point worth noting about Social Security reform is that the Social Security deficit plays some role, but a relatively modest one, in explaining our long-term fiscal problems. Perhaps the most vivid demonstration of this point is the chart below, taken from this year's *Economic Report of the President.* It shows the path of the deficit with and without one of the Social Security reform plans proposed by the President's Commission to Strengthen Social Security. The striking feature of the chart is that the long-term budget outlook does not change that much even if the type of reform favored by the Administration for addressing the long-term Social Security deficit were enacted.

Chart 6-6 The Long-Run Budget Deficit with Social Security Reform
Enacting Social Security reform leads to lower unified deficits when fully phased in.



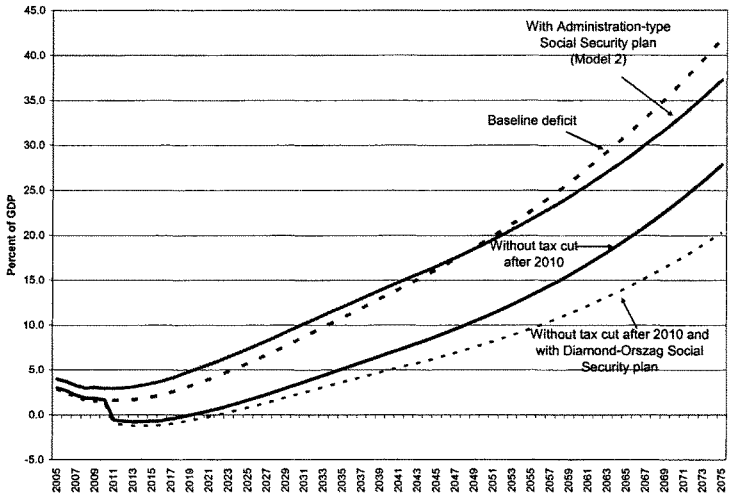
Sources: Social Security Administration, Centers for Medicare and Medicaid Services, Office of Management and Budget, and Council of Economic Advisers.

Figure 1 shows the projected deficit under a somewhat broader array of policy scenarios. The baseline deficits are very close to those presented by the Administration in the figure above; the baseline deficit in 2075 is about 40 percent of GDP, relative to about 35 percent under the Administration projections. As in the figure above, the path of the deficit is little affected by enacting the type of Social Security reform favored by the Administration (Model 2 proposed by the President's Commission to Strengthen Social Security, which was also the basis for the figures presented in the *Economic Report of the President*).

As Figure 1 shows, the tax cuts after 2010 exert a more significant influence on the projected deficit: Not extending the 2001 tax cut raises revenue, which then reduces accumulated

debt service costs. By 2075, the reduction in the unified deficit amounts to 13 percent of GDP – almost three times the reduction from the Administration's type of Social Security reform. (The figure assumes an AMT reform; in the absence of such a reform, the tax cuts would gradually be erased by the AMT even if they were officially extended.) If combined with the type of Social Security reform plan that I have proposed with Peter Diamond, the unified deficit in 2075 could be roughly cut in half relative to the baseline.

Figure 1: Unified deficits under different policy scenarios



II. Expanding retirement saving on top of Social Security

Social Security was always designed as a foundation upon which to build financial security during retirement and disability. The evidence suggests that many households, however, have little additional saving on top of Social Security. For example, only about *one-fifth* of workers in households with income of below $20,000 participated in some form of tax-preferred savings plan (including an employer-provided plan or an IRA) in 1997. As a result, such lower-income workers represented 34 percent of all workers, but just 15 percent of workers who participated in tax-preferred savings plans — and 55 percent of total *non*-participants in such saving plans.

The inequality in pension contributions is also reflected in inequality in pension wealth (the accumulated value in a pension). Table 1 shows the value of defined contribution and IRA assets by income for households headed by someone aged 55 to 59 (and thus on the verge of retirement years) from the 2001 Survey of Consumer Finances. The demonstrates two crucial points:

- First, most households have relatively low levels of defined contribution/IRA assets; the median value of such assets even for households nearing retirement age was only $10,400. (The median balance is $50,000 among those with accounts. But when the 36 percent of the population without an account is included the median declines to $10,400.)

- Second, lower-income households have particularly low levels of such assets. The bottom 40 percent of the income distribution accounts for only 5 percent of total defined contribution/IRA assets among households aged 55-59. The top 10 percent of the income distribution accounts for more than 50 percent of total defined contribution/IRA assets.

Table 1: Ownership of defined contribution or IRA assets, for households aged 55-59, 2001

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

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

Benefits of progressivity in pension policy

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

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

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

[6] Economists continue to debate the impact on private saving from existing pension incentives. Most economists agree, however, that whatever the overall effect, focusing incentives on those with fewer opportunities to shift assets

lower-income workers is much more likely to represent new saving (rather than asset shifting) than tax-preferred retirement saving undertaken by higher-income workers.

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

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

The flaws in recent legislation and proposed legislation

Recent legislative changes and proposals have exacerbated rather than attenuated the regressivity of the pension system and thus have moved (or would move) the pension system in the wrong direction.

A common theme in many recent policy proposals is that they increase the maximum amount that can be saved on a tax-preferred basis. For example, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 raised the maximum amounts that can be contributed to IRAs and employer-based pension plans. Such increases are unlikely to have much effect on the vast majority of families and individuals who had not previously been making the maximum allowable contribution. Information from the Congressional Budget Office on workers constrained by the previous 401(k) limits in 1997 suggests that only 6 percent of all 401(k) participants made the maximum contribution allowed by law.[7] Only 1 percent of participants in households with incomes below $40,000 made the maximum contribution. Among participants in households with more than $160,000 in income, by contrast, 40 percent made the maximum contribution. Increasing the maximum contribution limit is beneficial primarily to higher-income households; for the vast majority of lower- and moderate-income families, such an increase is of no direct benefit.

In this year's budget, the Bush Administration reintroduced, in slightly modified form, its proposal to create a new set of tax-preferred accounts that would expand opportunities for tax-advantaged saving. The proposal would dramatically alter the tax treatment of saving, via the creation of Lifetime Saving Accounts (LSAs), individual Retirement Saving Accounts (RSAs) and Employer Retirement Saving Accounts (ERSAs). The Administration's proposal follows the basic

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from taxable to non-taxable forms is likely to produce a larger increase in private saving for any given reduction in government revenue.

[7] Author's calculations based on Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving," August 2003, Table 2. See, for example, David Joulfaian and David Richardson, "Who Takes Advantage of Tax-Deferred Saving Programs? Evidence from Federal Income Tax Data," Office of Tax Analysis, US Treasury Department, 2001.

thrust of policy changes delineated above in substantially expanding opportunities for tax-sheltered saving by high-income households.[8] The RSA/LSA proposal would also result in growing revenue losses over time; estimates based on Burman, Gale, and Orszag (2003) suggest an annual revenue loss exceeding 0.3 percent of GDP after 25 years.[9] An analysis by the Congressional Research Service reached similar conclusions.[10] The Burman-Gale-Orszag figures suggest that over the next 75 years, the revenue loss amounts to a third or more of the actuarial deficit in Social Security.

A key issue with regard to the RSAs is the absence of an income limit. Indeed, RSAs are basically Roth IRAs without an income limit. In commenting on a similar proposal in the late 1990s, then-Treasury Secretary Robert Rubin explained, "...if you don't have income limits, then you're going to be creating a great deal of benefit for people who would have saved anyway, and all of that benefit will get you no or very little additional savings." Preliminary analysis using the retirement savings module from the Urban-Brookings Tax Policy Center (TPC) model suggests that more than 90 percent of the tax subsidies (in present value) from removing the income limit on Roth IRAs would accrue to the 2 percent of households with Adjusted Gross Income of more than $200,000. Almost 40 percent of the benefits would accrue to the 0.4 percent of households with income of more than $500,000.[11] The implied long-term revenue loss and likelihood of substantial asset shifting in response to removing the income limit on Roth IRAs both suggest the lack of wisdom in pursuing such a course.

A better direction

As the previous section of my testimony argued, the current thrust of pension policy is fundamentally flawed. A change in direction is necessary. A progressive set of reforms should center on factors that would boost participation, especially among lower- and moderate-income workers: (a) expanding the income eligibility range for the saver's credit and making the credit refundable; (b) reducing the implicit taxes on saving done by moderate-income households

[8] LSAs would allow significant amounts of tax-free saving ($5,000 per account per year) for any purpose, with no restrictions on age or income. RSAs would be designed similarly, but tax-free withdrawals could only be made after age 58 or the death or disability of the account holder. RSAs would remove all eligibility rules related to age, pension coverage, or maximum income; eliminate minimum distribution rules while the account owner is alive; and allow conversions of traditional and nondeductible IRAs into the new back-loaded saving vehicles without regard to income.

[9] Leonard Burman, William G. Gale, and Peter R. Orszag, "The Administration's Saving Proposals: A Preliminary Analysis," *Tax Notes*, March 3, 2003.

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

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

through the asset tests under certain government programs; (c) encouraging financial education; and (d) making it easier to save, including through changes to the default choices in 401(k) plans and the "split refund" proposal included in the Administration's budget.

Improving the saver's credit

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

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

One component of the EGTRRA legislation — the saver's credit — reflects the logic of such a progressive matched savings program. The saver's credit provides a matching tax credit for contributions made to IRAs and 401(k) plans. The eligible contributions are limited to $2,000. Joint filers with income of $30,000 or less, and single filers with income of $15,000 or less, are eligible for a maximum 50 percent tax credit. A smaller credit rate applies up to $50,000 in income for joint filers.

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

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

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

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

4. The credit officially sunsets in 2006.

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

Reducing implicit taxes on saving

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

To be eligible for means-tested benefits, applicants generally must meet an asset test as well as an income test. The asset tests are stringent. For example, in SSI, the asset limits are $2,000 for a single individual and $3,000 for a couple. In food stamps, the limit is $2,000 unless a household contains an elderly or disabled member, in which case the limit is $3,000. These limits are not indexed to inflation. In both SSI and food stamps, the limits have not been adjusted since the 1980s. Research suggests that the stringent asset tests that means-tested programs employ have some effect in reducing saving among low-income households.[12]

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

In about half of the states, low-income workers who participate in defined contribution plans generally must withdraw most of the balance in their accounts (regardless of early withdrawal penalties or other tax consequences) and spend those assets down before they can

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

qualify for Medicaid.[13] Similarly, poor elderly and disabled people who otherwise would qualify for SSI are required to consume upfront most of the funds they have accumulated in a defined contribution plan, leaving little for their remaining years, before they can receive SSI benefits. By contrast, benefits that a worker or retiree has accrued in a defined benefit pension plan are not considered an asset for these tests. The monthly income that the defined benefit plan provides is, however, counted as part of an individual's income when the individual retires and begins receiving this income. (In the food stamp program, the treatment accorded defined benefit plans is extended to 401(k) plans and similar employer-sponsored defined contribution plans as well, but not to IRAs or Keoghs. Balances in IRAs and Keoghs count against the food stamp asset limits.)

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

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

Improving financial education provided by disinterested parties

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

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

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

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

My colleague, Mark Iwry, has proposed a different approach: plan sponsors could obtain relief from fiduciary liability if they include a prudently diversified, balanced portfolio in the plan's investment options. An employer could obtain a higher degree of fiduciary protection if it chose to make the standard balanced portfolio option the default -- the automatic investment for employees who do not affirmatively choose another option.[14] As discussed below, defaults exert a substantial influence on saving behavior.

Promoting automatic saving

A final prong of sound retirement saving reform should dramatically expand the force of inertia to be enlisted in favor of saving, not against it. Evidence suggests that participation rates are significantly higher if workers are automatically enrolled in savings plans (unless they object), rather than if a worker has to make an affirmative indication of his or her desire to participate. In other words, participation rates are significantly higher if workers are enrolled in a savings plan unless they specifically opt out of the plan, relative to the participation rate if workers are *not* enrolled in the plan unless they specifically opt in.[15] Most recent studies underscore the importance of encouraging increased saving over time as the default.[16] *These types of plans are likely the most effective way of expanding retirement saving on top of Social Security.*

The challenge for policy-makers is to find ways to encourage more firms to adopt these automatic enrollment approaches. As some examples of helpful steps, policy-makers could clarify the preemption of state laws to the minimum extent necessary to accommodate automatic enrollment; grant fiduciary safe harbor treatment for selected default investments; allow a plan to disburse small account balances to an employee who decides to opt out soon after the automatic

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

[15] Brigitte C. Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics,* February 2002; 116(4): 1149-87.

[16] Richard H. Thaler and Shlomo Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," *Journal of Political Economy*, forthcoming.

enrollment begins without a penalty; and reform the matching safe-harbor contribution requirements (which allow employers to avoid non-discrimination testing under 401(k)s and SIMPLE plans) by requiring automatic enrollment of all eligible rank-and-file employees if the employer chooses to use the safe harbors.

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

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

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

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

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

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