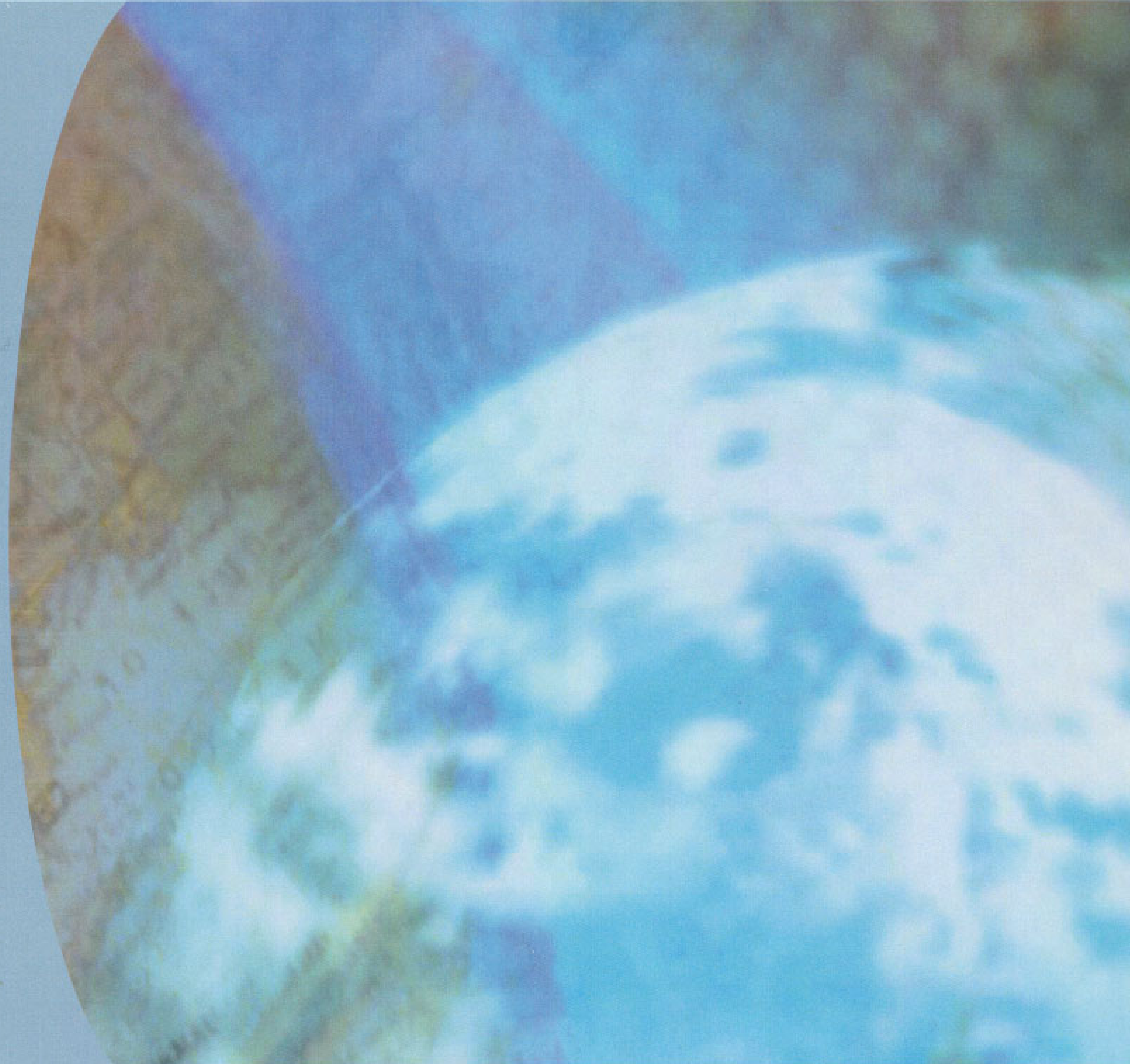
RETIREMENT SECURITY

The Unfolding of a Predictable Surprise



Social Security Advisory Board

March 2005

TABLE OF CONTENTS

MESSAGE FROM THE BOARD i

I. THE GOAL OF ECONOMIC SECURITY IN RETIREMENT 1
Changes in the Last Century 1
The Basic Goal of Retirement Security Policy 3
Some Common Elements of Retirement Security at the Beginning of the 21st Century 3
21st Century Challenges 5
Meeting the Challenges 9

II. RETIREMENT SECURITY: THE ECONOMIC AND BUDGETARY CONTEXT 12

III. SOCIAL SECURITY 14
How the Social Security Program Operates 14
Contribution to Economic Security of Aged Beneficiaries 16
Social Security Solvency 16
Importance of Restoring Solvency 18
Other Social Security Issues 21
Disability Benefit Issues 22

IV. PENSIONS AND SAVINGS 24
Pensions as a Source of Retirement Income 24
Trends in Retirement Plans 25
The Shift from Defined Benefit to Defined Contribution Plans 27
Participation in Pension Plans 28
Integration of Pensions with Social Security 31
Retirement Savings 32
Household Net Worth and Financial Assets 32
Expectations 33
Current Issues 33

V. LABOR FORCE PARTICIPATION OF THE ELDERLY 37
Earnings as a Source of Income for the Aged 37
Labor Force Participation of the Aged 37
Possible Reasons for Recent Increase in Labor Force Participation 38
Age of Retirement 38
Demand for Elderly Workers 39
Social Security and Other Policies to Encourage Remaining in the Labor Force 40

VI. HEALTH CARE AS A RETIREMENT SECURITY ISSUE **42**
Rising Costs of Health Care *42*
The Central Role of Medicare and Medicaid in Retirement Security *43*
Medicare and Medicaid Financial Problems *44*
Trends in Private Health Insurance *46*
Long-Term Care and Retirement Security *47*
Conclusion *50*

VII. SUPPLEMENTAL SECURITY INCOME **51**
Program Description *51*
Implications for Potential Changes in Social Security *53*

VIII. CONCLUSION **55**

APPENDIX: Research about Retirement Security **56**

ABBREVIATIONS KEY **57**

SOCIAL SECURITY ADVISORY BOARD **58**

MESSAGE FROM THE BOARD

Ten years ago Congress enacted the *Social Security Independence and Program Improvements Act of 1994*. That legislation made the Social Security Administration an independent agency and also established the Social Security Advisory Board. In that Act, Congress gave several directives to the Board including the task of:

> *analyzing the Nation's retirement and disability systems and making recommendations with respect to how the old-age, survivors, and disability insurance program and the supplemental security income program, supported by other public and private systems, can most effectively assure economic security.*

Over the past year, the Board has met with experts in the areas of pensions, savings, and health care both in Washington and in the course of public hearings in other parts of the country. We have examined the issues involved and discussed the roles of Social Security and Supplemental Security Income (SSI) in the context of those other sources of retirement security. Here we present our analysis of the issues along with our findings and recommendations.

We intend in this report to focus on the national goal of economic security in retirement, how it has evolved, what are the major public and private elements that work together to achieve that goal, what are the gaps that need to be addressed, and what are the challenges that face these elements in the future.

Hal Daub, Chairman

Dorcas R. Hardy ***Martha Keys***

David Podoff ***Sylvester J. Schieber***

RETIREMENT SECURITY
THE UNFOLDING OF A PREDICTABLE SURPRISE

I. THE GOAL OF ECONOMIC SECURITY IN RETIREMENT

Changes in the last century

The concept of retirement as a typical stage of life, supported by a complex of public and private institutions of economic security, is very different at the beginning of the 21st century than it was at the beginning of the 20th century.

In 1900, there was no national system of Social Security nor was there a needs-tested safety-net program for the aged poor. Employer-sponsored health and pension programs were rare and covered few workers. Indeed, for most of society, our current concept of "retirement" was largely unknown. Most men were still in the labor force well past their 70th birthday and life expectancy at age 65 was about 12 years. Typically, older Americans found it necessary to work until they died or simply had no remaining capacity to work. However, older individuals were not always able to find employment despite the absence of an alternative system of income support, and this problem was to become especially severe in the great depression of the 1930s.

Over the course of the 20th century, the situation changed markedly.

- The *Social Security Act* was enacted into law in 1935 creating both a social insurance program of retirement benefits and a Federal matching program to encourage and assist States in providing needs-based assistance to impoverished elderly persons. Over the past 70 years the scope and coverage of these programs were modified and expanded in many ways.

- In the 1960s, the Medicare program of health insurance was added to the Social Security system of social insurance. This provided on a non-means-tested basis health benefits for both hospital costs (Part A), and doctors' fees and other costs (Part B) for those over age 65 (later expanded to also cover the disabled). The 1960s also saw the enactment of the needs-tested Medicaid program providing health care coverage under State-set income eligibility standards for the aged, the disabled, and low-income families.

- Private pensions, which earlier had been relatively rare, became much more common and substantial. This was especially true for workers employed by large corporations that came to use pension incentives partly as a means to attract and retain employees but also as a means to influence retirement decisions.

- Mortality improvements raised the life expectancy at age 65 by about 50

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percent, from under 12 years in 1900 to over 17 years today.

- Birth rates rose substantially in the years immediately following World War II and then dropped and have apparently stabilized at levels roughly approximating a long-term replacement rate.

- The national labor force grew both as a result of the high post-World War II birth rates and as a result of a large increase in the entry of women into the workforce.

- Although the second half of the 20th century saw some periods of economic slowdown and some periods of high inflation, it was, overall, a highly productive era with real gross domestic product, measured in 2000 dollars, growing fivefold from under $2 trillion in 1950 to nearly $10 trillion in 2000.

- There were large advances in medical knowledge and technology and these were accompanied by very large rates of health care cost inflation.

- Older Americans were experiencing longer retirements through a combination of greater longevity and earlier withdrawal from the labor market. The average retirement age for men dropped from age 70 at mid-century to about 63 in the early 1980s.

- Homeownership rates grew from under half of all families in the first half of the last century to about 69 percent today with homeownership now exceeding 80 percent where the householder is age 65 or over.

- In addition to their homes, Americans also, in varying degrees, have come to hold a range of financial assets such as bank accounts, savings bonds, equities, and insurance contracts. In the latter part of the last century, a number of tax incentives were adopted with the objective of encouraging increased savings and investment such as IRAs and 401(k) plans.

The net result of all these changes was that, by the end of the last century, the typical adult life could be viewed as consisting of two stages—the working years and the retirement years. There is, of course, a great deal of individual variability around that typical picture. Some individuals do not retire; some retire much earlier than others; some experience, by choice or necessity, significant gaps in labor force participation during their "working years;" some spend all or a portion of their "retirement years" in partial employment. Similarly, there is a great deal of variability in the elements that go into providing economic security in retirement. Nearly all American workers participate in the Social Security program, but for some of them Social Security will be the source of 90 percent or more of their retirement income; for others it will represent a much smaller share. Some individuals are covered by private pension plans (or pension and health benefit plans); others are not. Levels of individual savings, investment, and other assets vary widely.

> ***...by the end of the last century, the typical adult life could be viewed as consisting of two stages—the working years and the retirement years.***

The basic goal of retirement security policy

In 1965, Congress enacted the *Older Americans Act* which includes as an objective: "An adequate income in retirement in accordance with the American standard of living." The legislation did not specify how to define the standard of living but other public policy developments help to do so. One evolved from the public deliberations about poverty that occurred during the 1960s. The other evolved from analysis of the goals that underlay pension designs in both the public and private elements of our retirement system.

In the mid-1960s, a methodology was developed for determining, "in dollar terms a minimum level of income adequacy for families of different types in keeping with American consumption patterns."[1] This minimal income level came to be known as the poverty line and is updated annually. It is used to determine what portion of the population is living on income that falls short of meeting their minimal income needs and to target income assistance programs to help alleviate their predicament.

Beyond meeting minimal absolute needs, there has generally been a sense in designing pension systems that retirees should be able to achieve a standard of living in retirement that is comparable to the living standard achieved during their working lives. This concept was somewhat formally codified by a presidential commission empanelled during the late 1970s to take a comprehensive look at pension policy and whether workers were making adequate preparation for their retirement needs.[2]

Despite the diversity in what constitutes the retirement part of life for various individuals and despite the diversity in how different elements of economic security affect different individuals, the objective of an "adequate income in retirement" in the *Older Americans Act* remains an appropriate overall goal for retirement security policy. In this context, income adequacy has come to largely include elements of both the concepts spelled out in the prior two paragraphs; it entails being able to achieve a standard of living in retirement in rough accordance with what was achieved while working as long as it is at least equal to the socially minimal absolute standard of poverty level income.

...the objective of an "adequate income in retirement" in the Older Americans Act remains an appropriate overall goal for retirement security policy.

Some common elements of retirement security at the beginning of the 21st century

Replacement rates.—During the working years, economic security mostly takes the form of earnings from employment (or self-employment). As a general rule, the amount an individual earns and is able to spend determines the "standard of living" for that individual and his or her family. Retirement income policy has, therefore, tried to measure "an adequate income in retirement" by looking at how much of the

[1]Department of Health, Education and Welfare, Office of the Assistant Secretary for Planning and Evaluation, *The measure of poverty: technical paper II, administrative and legislative uses of the terms, "poverty," "low-income," and other related items* (Washington, DC: USGPO, September 1976), p. 8.

[2] President's Commission on Pension Policy, *Coming of age: toward a national retirement policy*, 1981.

individual's earnings in the working years are replaced by the various elements of retirement income.

The "replacement rate" calculation is complicated by several factors. Consumption needs in retirement years are often different than those in working years. Costs associated with housing, child rearing, work expenses, and taxes are often less during retirement than when working. But the cost of maintaining one's health is generally higher at advanced ages. Because some needs are relatively fixed no matter where one falls in the income distribution—health is an example—lower-income individuals are likely to need a higher replacement of pre-retirement income in order to have adequate retirement income. Sources of income also tend to vary across the income spectrum. Those who have spent their working lives at low earnings levels generally are much less likely to have employer-pension income and personal savings than those who have had a career at high-paying jobs. Some will not be able to earn sufficient protection through Social Security, employment-based programs, and individual savings and will have to rely on needs-based safety-net programs that aim not at replacement but at assuring a minimum level of income.

While higher income individuals are able to spend more (that is, enjoy a higher standard of living) during their working years, they also are better able to set aside a portion of their working-years income in accumulating savings or other assets. This means that those with higher incomes are likely in retirement to have significant retirement resources apart from Social Security to help them meet the goal of maintaining their pre-retirement standard of living. It also means that, on a percentage basis, they will need a lower overall replacement of pre-retirement income to maintain the standard of living they had in their working years (since a significant part of that pre-retirement income was devoted to savings rather than consumption).

At lower income levels, a higher overall replacement is needed to maintain the prior standard of living and more of that replacement has traditionally been provided from Social Security. The Social Security program accomplishes this difference through a benefit formula that replaces a significantly higher percentage of pre-retirement income for those who had low working-year earnings than for those at high earnings levels. At the lowest levels of earnings, even very high replacement rates may not be sufficient to provide an acceptable level of income, and the Social Security system has attempted to address that problem through special benefit provisions (such as the minimum benefit for long-term, low income workers) and through the needs-based Supplemental Security Income program.

At lower income levels, a higher overall replacement is needed to maintain the prior standard of living....

Health care costs.—In practical terms, the measure of adequacy of retirement income in most cases is a matter of how much of the individual's working year earnings need to be replaced to maintain his or her standard of living. This calculation should include what is needed to meet the costs of medical care. However, because health care costs can vary widely and unpredictably from one individual to the next, our society has decided to deal with these separately through the public programs of Medicare and Medicaid and, to some extent, through individual and employer-supported programs of retiree health insurance that supplement the public programs. Despite the widespread availability of insurance to cover much of the cost of health care for the elderly, older people generally have to pay some portion

of their health insurance premiums and often incur considerable out-of-pocket expenditures in meeting their health consumption needs.

The employment link.—Retirement income analysts and policymakers have looked to the individuals' earnings levels in their working years as an indicator for approximating the retirement income needed to maintain an adequate standard of living. In addition, a substantial part of retirement income has been financed on an employment-related basis. For the Social Security programs, this has been accomplished by imposing employer and employee payroll taxes on earnings and determining benefit amounts based on the average earnings. Similarly, the Hospital Insurance part of Medicare is financed through a separate payroll tax. Traditional private and public employee pension programs have been seen as a part of the compensation package, and pension benefits typically bear a relationship to earnings levels and years of employment. Even much individual savings and investment has been facilitated through employment-based programs such as payroll savings plans and, more recently, defined contribution (DC) pension programs such as 401(k) plans.

21st century challenges

As our Nation moves into the 21st century, the goal that older Americans in retirement should be able to enjoy an adequate level of retirement income appropriate to the American standard of living should be reaffirmed. But, to meet that goal, many new challenges must be addressed.

> ***As our Nation moves into the 21st century....many new challenges must be addressed.***

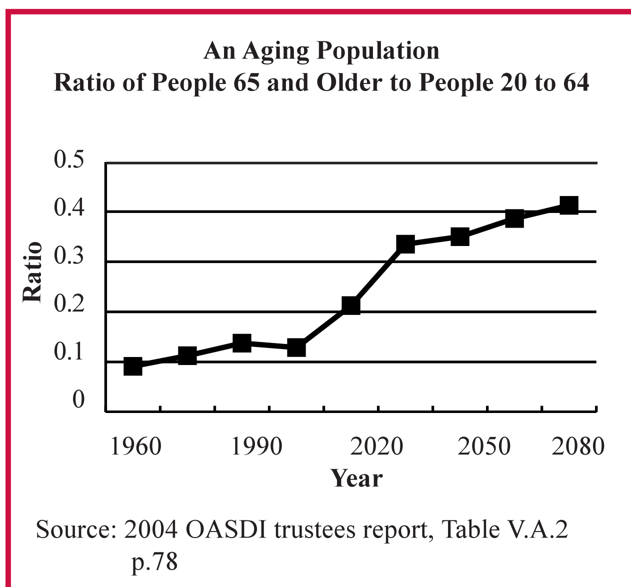
Demographic changes.—In the two decades following World War II, the Nation experienced a surge in birth rates giving rise to what is commonly called the baby boom generation. This was followed by a period in which birth rates dropped sharply (to levels below replacement rates) and then rose again to current levels (which are approximately at replacement rates). Most demographic experts expect that birth rates will continue around or below current levels. Over the past half-century, older Americans have experienced increasing length of life, and demographers expect continuing increases in longevity in the future.

As a result of these changes, the Nation will have a relatively larger population of older persons and a relatively smaller population in the "working ages" in coming years than we have had in recent decades. Chart 1 shows the ratio of people 65 and older to that of the people in the 20-64 "working age" group from 1960 to the present time and then projected forward for the next 75 years. This ratio has not varied appreciably over most of the past half century. But the ratio is expected to rapidly increase as the baby boom generation moves into its older years. Even after the impact of the baby boom, the increase in this ratio is expected to continue to rise as length of life increases. Within the next quarter century, the ratio of the aged to the working age population will nearly double from its current level and then continue to rise more slowly.

Looked at the other way, we now have approximately five people of working age in our society for each elderly person. By 2035, we expect that there will only be 2.7 persons of

> ***...the Nation will have...a relatively smaller population in the "working ages"....***

Chart 1



Source: 2004 OASDI trustees report, Table V.A.2 p.78

working age for each elderly person in our society; by 2080 there will be 2.3 persons of working age for each person aged 65 or over.

This means that programs for the aged which are financed from the on-going earnings of workers will face the pressure of relatively fewer contributors and relatively more beneficiaries. More broadly, however, total economic consumption at any point in time must, for the most part, be produced by the workforce at that time. In the face of the projected relative decline of the workforce, maintaining or increasing living standards will require some combination of increasing the productivity of the workforce or moderating the impact of the expected population shift (for example, by encouraging more workforce participation of older and disabled workers or through increased immigration). The use of 65 as a dividing line between the working age and elderly population is a useful statistical convention for viewing demographic trends but is, nonetheless, arbitrary and may become less appropriate with increasing longevity and changing labor force participation patterns. In the section of the report dealing with Social Security specifically, another common measure is used; the ratio of covered workers to beneficiaries (which is now 3.3 workers per beneficiary but is projected to decline to 1.9 by 2080).

> ***...total economic consumption at any point in time must, for the most part, be produced by the workforce at that time.***

Changing pension realities.—Participation in employer-sponsored pension programs has always been far from universal. Still, for a substantial portion of the population, pension accumulations are a major factor in assuring an adequate income in retirement. However, there has been a shift away from traditional pensions that typically provided a specified annuity at retirement under a formula based on factors such as age at retirement, salary level, and length of service. The number of these traditional "defined benefit" (DB) plans has dropped sharply over the past two decades in favor of "defined contribution" (DC) plans in which workers accumulate individual retirement accounts. These are funded through on-going pre-tax deductions from wages, often with some degree of employer matching. At employment termination, the amount that has been paid into these accounts (plus any investment earnings) is transferred in a lump sum to the worker. There are a number of reasons why this shift has taken place. Defined contribution plans can reduce employer costs and risks and involve lower administrative burdens. The shift to such plans also reflects changes in the nature of employment with the result that workers less frequently stay with an employer for a full career. Defined contribution plans offer workers greater retirement savings portability when they

change jobs, while defined benefit plans are now less effective in discouraging worker mobility.

The shift to the defined contribution approach creates additional challenges in meeting the goal of assuring adequate earnings replacement in retirement. Under the traditional defined benefit approach, workers can calculate how much the pension will provide them in retirement leaving the employer the responsibility of assuring adequate financing to produce that level of income. The worker is further protected because defined benefit pension plans are insured by the Federal government through the Pension Benefit Guaranty Corporation (PBGC). Thus, even if the employer is unable to deliver on the promised benefits, they will be paid by PBGC. (However, there are statutory limits on the amount guaranteed by PBGC. Recently, there have been several large plan terminations that have resulted in individuals getting pensions that are substantially lower than what they had expected. Moreover, these plan terminations are causing a growing unfunded long-term liability for the PBGC.)

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Traditional defined benefit plans typically provide a pension in the form of an annuity at retirement while defined contribution plans typically provide a lump sum payout at termination of employment. The objective of providing an adequate replacement of earnings in retirement can be undermined if the lump sum payouts are used for non-retirement spending. Even if the lump sum is devoted to replacing lost income in retirement, the individual bears a risk of miscalculating his or her longevity. Depending on the nature of the miscalculation, the result could be outliving the availability of funds or reducing his or her standard of living in an attempt to avoid that result.

There are some important advantages to the defined contribution approach. In our current mobile workforce, workers may change jobs either before their defined benefit participation has vested or before they have attained sufficient length of service to benefit substantially from typical benefit formulas. For some workers the ability under defined contribution plans to gain early access to their accounts through lump sum disbursements or loans may enable them to better manage their lifetime stream of income to meet important needs such as education or homeownership. At retirement, they may have options to choose annuities or investments to better protect against inflation as compared with traditional non-indexed pension annuities.

Growing health care costs.—Because health care costs vary widely from one individual to the next, it makes sense to treat them as a separate part of retirement security and handle them essentially on an insurance basis where the individually unpredictable risk is spread broadly so that the costs of financing become predictable. This makes it possible for policymakers to determine how much of the costs of health care in retirement should be financed from payroll taxes on current workers, how much through general revenues, and how much through premiums, deductibles, and other payments by individuals. That, in turn, makes it possible to bring health costs in retirement into the context of an overall objective of an adequate replacement of pre-retirement earnings.

In fact, however, the only sense in which future health care costs are predictable is that they have been growing—and are projected to continue growing—at an unsustainable rate. In their 2004 report, the Medicare Trustees[3] assume that over the 75-year estimating period per beneficiary cost will grow at an annual rate that is 1 percentage point higher than the growth rate of per capita Gross Domestic Product. This is a lower growth rate than has been experienced either over the history of the program or in recent years. Even so, the public Trustees point out that the out-of pocket expenses for premiums, co-pays, and deductibles will rise rapidly and consume a greater and greater part of Social Security benefits. As described in more detail later in this report, out-of-pocket costs for an aged beneficiary, with Medicare experience that is typical, are projected to rise from 37 percent of the average Social Security benefit in 2006 to 49 percent in 2020, and to 97 percent by 2078. Looked at in this light, rising health costs pose a threat to retirees' ability to meet their other consumption needs and pose a major threat to their retirement security.

...rising health costs pose a threat to retirees' ability to meet their other consumption needs....

There are many other ways in which the uncontrolled expansion of health care costs creates challenges to a goal of assuring adequate retirement income security. In the past, many employers have provided health benefits for both workers and retirees. Many employers are now reducing or eliminating retiree health benefits and the burden of increased health costs is affecting the ability to finance pension benefits.

With a larger and older population of retirees in the future, there will also be an increasing need for various forms of long-term care: nursing home, skilled nursing, assisted living, home-based, and hospice care. These are expensive, and the demand for such care will grow rapidly as the baby boom generation reaches age 75 in and beyond 2021. These services are mostly not covered by Medicare for middle-income Americans. (For lower-income persons, Medicaid presently pays these costs.) In looking at how older Americans can be assured an adequate retirement income, these looming long-term care expenses also need to be addressed.

Globalization and economic change.—In seeking to meet the challenges posed by an aging population and rapidly growing health costs, many American employers are also facing increasing domestic and global competition that is shifting the ways of doing business and changing employer and employee relationships. With a stable business model that involved career employment, it made sense from both the employer and employee perspective to devote a significant portion of the compensation package to pension and health benefits that would be available in retirement. Now, some of the promised benefits in industries such as air transportation and automobile production are placing established firms that followed the traditional model at a competitive disadvantage relative to their newer or global competitors.

The American economy of the 21st century is increasingly a highly competitive economy with large and growing connections to the world economy. We have every reason, however, to also expect it to be a healthy and prosperous economy. There is no reason to abandon our national objective that older Americans should enjoy an adequate level of retirement income. However, we need to strengthen our instruments

[3] The Boards of Trustees for the Social Security and Medicare trust funds consist of the Secretaries of Treasury, Labor, and Health and Human Services, the Commissioner of Social Security, and two public Trustees appointed on a bi-partisan basis.

of economic security and modify them so as to assure that they can continue to function appropriately in today's economy.

Meeting the challenges

In the 20th century, America underwent many changes, faced many difficult challenges, and achieved many great objectives. With respect to income and health security for older Americans, it is clear that the 21st century is bringing significant additional challenges. To meet those challenges:

The goal is unchanged.—"An adequate income in retirement in accordance with the American standard of living." This was an appropriate national policy objective when it was enacted in the *Older Americans Act* in 1965, and it remains an appropriate policy goal in the 21st century. For most Americans that goal will be expressed in terms of replacement of pre-retirement income. Much useful research has been done to better inform policymakers and individuals as to what replacement is needed to achieve an adequate level of retirement income but efforts to improve and refine this knowledge should continue.

A comprehensive strategy is needed.—The achievement of an adequate income in retirement is comprised of many elements which will combine in different ways for those in varying income levels and family circumstances. Some of these elements are the basic Social Security program, Medicare and Medicaid, employer-sponsored health insurance, pension, and saving programs, individual asset accumulation including savings and home ownership, and—for many—earnings from employment. These elements are all important to retirement income security. Many of these also serve other policy objectives and come under the purview of a variety of public and private policy shapers. It is crucial that all of those involved—the Administration and its component agencies, Congressional leadership and the relevant Congressional Committees; leaders of the private sector including labor, the financial services industry and, indeed, business generally, advocacy organizations, and academic experts—focus serious attention on finding ways to work together to develop a comprehensive and coordinated approach to meeting the 21st century challenges to assuring an adequate income for older Americans. Without such a comprehensive focus, solutions developed for any one element may undermine the ability to address other elements and will likely leave significant gaps in meeting the overall goal.

A need to strengthen and adapt.—The Nation, over the past century, has built a substantial matrix of income security programs and institutions. This basic structure is being challenged by the need for our businesses to be more competitive, by the expected demands of an aging population, and by unresolved public policy deliberations. If we are to continue to achieve the stated goal of the *Older Americans Act*, the elements of our retirement system need to be maintained and strengthened. At the same time, however, attention needs to be paid to how these elements of income security can be modified or supplemented to reflect the ways in which our 21st century society differs from American society in the middle of the last century. Global competitiveness and other economic changes, for example, have altered income distributions in ways that may require

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new approaches to assuring less skilled, lower paid individuals a retirement income that is adequate in terms of the American standard of living.

Social Security solvency must be restored.—The basic Social Security program is the central element of retirement income security for most of the older population. It is particularly important for the lower and middle parts of the income distribution, with 29 percent of aged households getting 90 percent or more of their income from Social Security and 59 percent getting 50 percent or more. The program has a significant solvency problem that can and should be dealt with. In prior publications, this Board has identified a large number of proposals which, in some combination, could be used to restore program solvency. A number of other proposals have recently been advanced representing a variety of policy perspectives. It is important that policymakers begin to deal with Social Security now while there are still many options and while there is time to phase in changes gradually. As the Board has pointed out, by acting sooner rather than later, Congress will be able to choose among more and less disruptive options.

It is important that policymakers begin to deal with Social Security now while there are still many options and while there is time to phase in changes gradually.

Employer-based programs should be encouraged and strengthened.—Changes in the workplace and increased competition have made it more difficult to maintain the kind of employer-based pension and health coverage that many workers enjoyed in the past. In response to these pressures, there has been a significant move away from providing retiree health benefits and traditional pensions toward defined contribution plans and hybrid pension arrangements. In some cases, these shifts have been controversial and the legal status of certain plan modifications has been challenged. Policymakers have not resolved the uncertainties, and there are growing signs that the remaining sponsors of traditional defined benefit plans are reconsidering their role in our retirement security system. If we are to fulfill the goals of the *Older Americans Act*, it is imperative that policies be adopted that encourage existing plans to meet their obligations and that do not discourage the formation of new plans. Policymakers also need to look at defined contribution plans to encourage wider availability, to improve participation rates, and to facilitate using the proceeds from such plans for retirement security purposes.

Individuals need to understand and accept their role in retirement security.—Our Nation has always been one that encourages and relies on individual initiative and effort as a primary engine of personal and national well-being. Our major social insurance programs were designed with a view to supporting rather than supplanting the role of the individual. Individuals will increasingly need to play a major role in meeting the retirement income security challenges of the 21st century. Policymakers need to find ways to encourage research and promote education that will help workers at all ages understand:

- what resources they will need in order to enjoy an adequate standard of living in retirement;
- how much of that need they can expect from public programs such as Social Security and how much they will need to accumulate additional resources through participation in employment-based programs and personal savings and investment;

- the importance of beginning early in life to plan for and start work on the accumulation of the resources that will be needed for a comfortable retirement;

- the significance to the adequacy of retirement income of choices about when and to what extent to withdraw from the labor force in retirement;

- the role that the individual can play in moderating the impact of growing health costs by becoming a more informed consumer and by adopting a healthier lifestyle.

Health costs must be constrained.—The challenges posed by health care costs are not simply a financing issue. If health costs continue to grow at existing and currently projected rates, no rational planning for retirement income security is possible; indeed, the ability of the economy to function in today's highly competitive global economy may well be undermined. Constraining health costs will not be simple, but neither is it an impossible challenge. Many experts believe that the projected growth is attributable, in large measure, to inappropriate incentives, uneven or inconsistent quality, and new technologies that do not always add value. We need to look for ways to change those incentives, improve quality, and discriminate between more and less valuable technologies. Government funding for a comprehensive research effort to assess the value of new treatments and technologies would be a major step.

Constraining health costs will not be simple, but neither is it an impossible challenge.

II. RETIREMENT SECURITY: THE ECONOMIC AND BUDGETARY CONTEXT

We are at an important juncture in the history of how our Nation assures economic security for its older citizens. We need to understand better how the protections provided by our public income support programs of Social Security and Supplemental Security Income interrelate with each other and with the other public and private elements of economic security. We need to see how they work together and what gaps in protection should be addressed. We also need to think about how these programs are evolving and how they will affect the ability of future generations to meet their economic security requirements.

Planning for lifetime economic security, for individuals or society, is uncertain but necessary. Adjustments will always be needed as circumstances change, but the adjustments are likely to be larger and more disruptive if we do not plan ahead as best we can. We know some things with near certainty such as the relative size of the "baby boom" and "baby bust" generations. Other factors we predict with some confidence but need to continually reassess, such as the projection that life expectancy at age 65 will continue to increase gradually, but significantly, that there will be continuing significant increases in productivity, and that we will continue to realize the benefits of steady immigration in the face of declining birth rates in many of the feeder Nations from whence immigrants have come in recent years. Still other factors like sudden natural disasters or huge technological breakthroughs are not predictable. Overall, however, current "best estimates" such as those by the Social Security Trustees, the Congressional Budget Office (CBO), and others predict a future which presents significant challenges. Success in meeting the challenges of the future will be more likely if we understand and, at least to some extent, coordinate the roles of the various public and private elements that our society looks to for economic security.

The challenges we will face in meeting the future economic security needs of America's older citizens do not exist in isolation but co-exist with all the other needs and capacities of the larger economy. It is essentially the case that what individuals consume at any given point in time has to be produced then by themselves or by other individuals. An individual who has withdrawn from productive participation in the economy whether because of illness, retirement, or other reasons, necessarily consumes someone else's production to meet his or her ongoing needs. This is true whether he finances that need by drawing down on his accumulated savings, by having a need paid for by a third party through health or other insurance, or by spending his Social Security or private pension check. Because of such factors as the baby boom, increasing longevity, and low birthrates we project a future in which the size of the population producing goods and services is shrinking relative to the overall size of the consuming population. Regardless of the way in which individual programs may be financed, output per worker must increase or average real per-capita consumption (what we call standard of living) must fall.

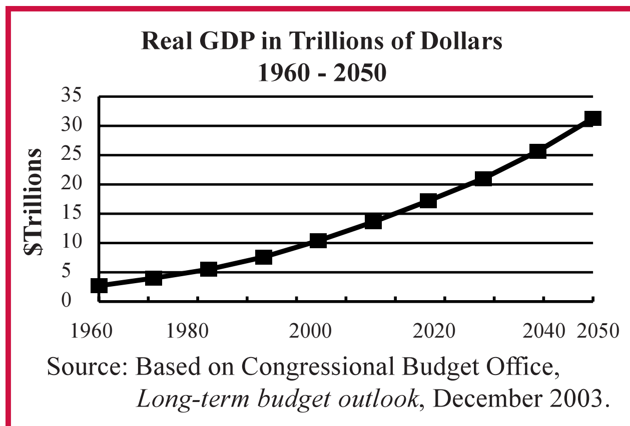
In addition to these demographic pressures, we also need to recognize and address the structural changes in our national—and increasingly international—economy that are affecting how employment-based programs of retirement security operate. The model of

...the future economic security needs of America's older citizens do not exist in isolation but co-exist with all the other needs and capacities of the larger economy.

lifetime work for a large, stable employer, while never universal, was formerly much more common. Today, increasing competition—both domestic and international—results in greater mobility both for workers and firms. Workers increasingly need instruments of retirement security that are portable. They are less likely to find compensation packages attractive that are heavily weighted toward meeting the retirement and health needs of past or future long-time career employees.

Our national economy has grown in the past, and substantial economic growth is expected in the future. The chart below shows a Congressional Budget Office projection[4] of real Gross Domestic Product from 1960 to 2050 as shown in its December 2003 publication, *The Long-Term Budget Outlook*.

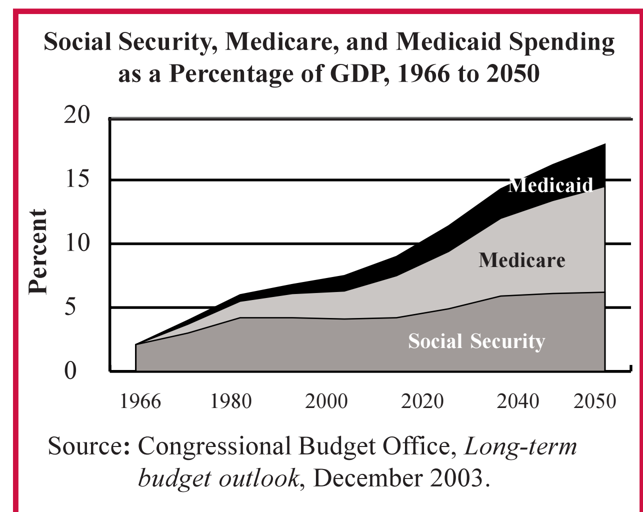
Chart 2



Source: Based on Congressional Budget Office, *Long-term budget outlook*, December 2003.

The CBO projection shows real GDP in 2003 dollars rising from a 2003 level of about $10 trillion to about $31 trillion in 2050. This is a very substantial projected increase, but, as CBO notes in that report, the future path of productivity growth is uncertain. There are many factors that can affect how strongly productivity grows. One such factor is national savings. Federal fiscal policy can also affect national savings. The chart below, again using a CBO projection from the same publication, shows the increasing share of Gross Domestic Product taken by the programs of Social Security, Medicare, and Medicaid. The health programs are projected to continue to increase significantly but by a lower rate than that experienced in any of the last three decades. The Social Security projections are based on the benefits scheduled in present law. The combined impact of these programs is projected to increase from 8 percent of GDP now to 18 percent by 2050. Other Federal spending (defense and domestic, excluding interest) currently consumes about 10 percent of Gross Domestic Product.

Chart 3



Source: Congressional Budget Office, *Long-term budget outlook*, December 2003.

The projected growth of Social Security, Medicaid, and especially Medicare will make it increasingly challenging to accommodate other budgetary priorities within an overall fiscal policy that encourages continuing strong economic growth.

The projected growth of Social Security, Medicaid, and especially Medicare will make it increasingly challenging to accommodate other budgetary priorities.....

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[4]The CBO document projected six scenarios. All of them showed real GDP growth over the 2003-2050 period of between 182 and 192 percent. The data presented here are based on CBO's simulation 5 path, which projects an intermediate level of increase in spending.

III. SOCIAL SECURITY

The Social Security program is our Nation's foundation for providing economic security for America's workers and their dependents in the event of retirement, disability, or premature death. Social Security is not intended to be the sole source of economic security in those circumstances, but it does serve to establish a core of social insurance protection around which individuals can build additional layers of protection through private insurance, participation in employer-based programs, individual savings, and earnings from employment.

How the Social Security program operates

Although the Social Security program has considerable complexity in the details of how benefits are computed upon retirement, disability, or death and in the different types of benefits available for workers and their dependents or survivors, the basic concept of the program is straightforward. The worker pays taxes to support the program (with matching taxes from employers[5]) and, by doing so, earns credits toward eventual benefits for the worker and his or her dependents or survivors.

Although the program is structured somewhat like a private insurance or annuity or investment program, it has a significant social objective and is therefore classified as "social" insurance. While the basic benefit level bears a relationship to the level of earnings on which the wage-earner previously paid Social Security taxes, that relationship is weighted. In absolute terms, higher earners receive higher annual benefits but in relative terms the formula favors those who had lower earnings. This weighting of the formula recognizes the reality that lower earners will have had less ability to accumulate other retirement assets and will consequently need a greater replacement of their prior earnings in order to maintain a reasonable standard of living in retirement. The program also provides additional protection in the form of benefits for dependents of the worker (dependent spouse, minor or disabled dependent children) and provides survivorship benefits and benefits in the case of disability prior to reaching retirement age. The redistributive characteristics of the program in the determination of annual benefits is somewhat tempered from the perspective of lifetime benefits because of differences in life expectancy between individuals across the income spectrum.

> ***...the formula recognizes the reality that lower earners will...need a greater replacement of their prior earnings in order to maintain a reasonable standard of living in retirement.***

In calculating benefits, the formula is applied to average earnings in the highest 35 years of earnings. This is a proxy for "lifetime earnings" (the number of years between the ages of 21 and 62 after dropping out five low years). In the early years of the program, earnings were used at their absolute value but Congress acted from time to time to change the benefit formula, which had the effect of increasing benefit amounts both for those already getting benefits and for new retirees. Under the current program,

[5]Economists generally view employer payroll taxes and other employer-paid benefits as being a part of the overall compensation package and thus, in most cases, substituting for what would otherwise be paid in wages. There is a tax advantage to the worker to the extent that these amounts are excluded from taxable wages.

prior to determining an average, each year's earnings are indexed to reflect wage growth in the economy between the year of the earnings and the year the worker reaches age 60. An adjustment is also made to the benefit formula to recognize increasing average earnings. These adjustments have the effect of increasing benefit levels for new retirees from year to year to keep them up to date with changes in the national standard of living as measured by increases in average wage levels.

Once the benefit rate has been calculated, it becomes a lifetime annuity (paid on a monthly basis) to the worker and any eligible dependents.[6] This annuity (benefit payment) is then adjusted each year for inflation as measured by the increase in the Consumer Price Index.

Benefits under the Social Security program are payable without regard to other income except that prior to the attainment of the Normal Retirement Age (NRA), benefits are reduced or eliminated if earnings exceed certain levels. At NRA an adjustment is made to increase the monthly benefit rate to compensate for withheld benefits. Not reducing benefits because of other income is consistent with the nature of the program as providing a basic core of retirement income support while maintaining incentives for individuals to build additional layers through employer-based programs and individual savings. At the lowest levels of income, however, it is difficult to balance the objectives of providing for income needs, avoiding excessive program costs, and maintaining appropriate incentives. Under current law, the Social Security program has a special minimum benefit which is payable only to those who have significant earnings over a period of 11 to 30 years. This special minimum benefit, however, now applies to very few individuals since it is based on an unindexed amount of $11.50 per month multiplied by the number of qualifying years. For those aged individuals who have very little Social Security eligibility (or none at all), a minimum income is provided through an income-tested program of Supplemental Security Income. This program provides payments which bring an aged individual's income up to $579 per month (2005 rate). For an aged couple, the monthly SSI income support level in 2005 is $869.

Until the 1980s, the Social Security program operated on essentially a pay-as-you-go basis in which taxes upon employment and self-employment were established by law with a view to covering each year's benefit costs and building up a small contingency fund. The contingency fund of approximately one year's benefits would allow the program to deal with routine economic variations and provide some time for Congressional action in the case of unforeseen program imbalances. The 1977 and 1983 amendments to the Social Security Act provided for a temporary departure from this approach. By 2015, the 1983 amendments provided for a substantial fund build-up to about five-and-a-half years' outgo. The accumulated fund would then be drawn down to roughly a year's benefit by 2058—the end of the 75-year estimating period. Current estimates indicate a somewhat smaller build-up with the fund being drawn down to roughly a year's benefit by 2038 and to zero by 2042.[7]

In many ways the Social Security program operates as it was intended. Its coverage is nearly universal, extending to well over 90 percent of all paid employment. Nine out of 10 persons over age 65 receive benefits. Nine out of 10 covered workers would be eligible for benefits in the event of disability; survivorship

[6]Subject to their continuing eligibility; e.g., a dependent minor child who is not disabled would lose eligibility upon reaching majority.

[7]The 2004 Trustees Report intermediate projections show the funds reaching a high of 448 percent of a year's benefits in 2015, declining thereafter to exhaustion in 2042. Under the most recent CBO estimates the funds would be drawn down to zero in 2052.

protection for workers with young children exceeds 95 percent of covered workers aged 20-49.

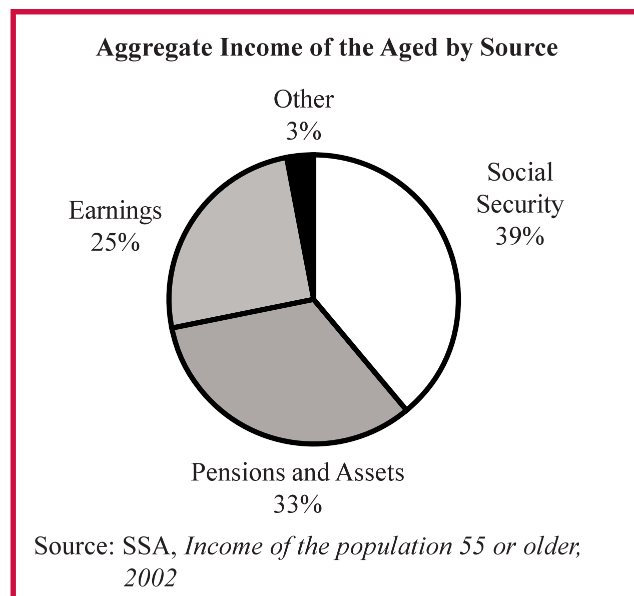
Contribution to economic security of aged beneficiaries

Economic security in retirement comes from a variety of sources: Social Security, private savings, pension plans, housing equity, and continuing earnings. Chart 4 shows the aggregate distribution of various income sources for the aged; however the relative importance of each of these is not uniformly distributed among the population. For example, one study published in 2000 and based on a 1992 survey of those approaching retirement age found that the wealth attributable to Social Security for the top 30 percent of the population represented a quarter or less of total wealth while for the bottom 30 percent it represented well over half. At the median, it represented about 40 percent with the remaining 60 percent about evenly divided among housing, financial, and pension wealth.[8]

While Social Security does play its intended role of providing a solid basis of retirement income security, it is clear that for many beneficiaries the additional layers of protection that should be available to supplement the basic Social Security benefit are missing. For 29 percent of aged households, Social Security is all or nearly all (90 percent or more) of the household's income. Even with Social Security, 21 percent of aged beneficiary households in 2001 had annual income below $10,000, which places them near or below the poverty level.[9]

This should be an important consideration as deliberations about Social Security reform begin to unfold. Any reform options that include potential benefit reductions could have a much greater impact on the retirement income levels of some beneficiaries than others. While there are important issues to be faced in dealing with the Social Security program, there is also a need to find ways to have other parts of the Nation's economic security institutions do a better job of providing additional layers of protection around the core benefits that Social Security provides, particularly for those at the lower half of the income spectrum.

Chart 4



Source: SSA, *Income of the population 55 or older, 2002*

Social Security solvency

Social Security is and will continue to be a core element in retirement security protection both for those now receiving benefits and for those who are still working but who need to plan ahead for their retirement years. To play this role effectively, however, the Social Security program needs to be soundly and believably financed. This is not now the case.

...the Social Security program needs to be soundly and believably financed. This is not now the case.

[8]Moore, James F. and Olivia S. Mitchell, "Projected retirement wealth and savings adequacy," in Olivia S. Mitchell, P. Brett Hammond, and Anna M. Rappaport, eds., *Forecasting retirement needs and retirement wealth.*

[9]SSA, Office of Policy: *Income of the population 55 or over, 2000* and *Income of the aged chartbook, 2001*. In 2001, the census poverty threshold for those aged 65 or over was $8,494 for a single individual and $10,715 for a two-person household.

The Social Security Act establishes a Board of Trustees to oversee the Social Security trust funds and to report annually on the status of those trust funds. This Board of Trustees consists of the Secretaries of Treasury, Labor, and Health and Human Services, the Commissioner of Social Security, and two public Trustees appointed on a bi-partisan basis. In addition, the Social Security Advisory Board periodically convenes a panel of expert economists, actuaries, and demographers to examine and make recommendations for improving the assumptions and methodology used by the Trustees. For the past several years, each of the annual reports by the Trustees has warned that the Social Security program, by a large margin, does not meet the standards for long-range actuarial soundness. A separate analysis by the Congressional Budget Office reaches the same conclusion. This does not mean that the Social Security program is about to collapse or that it will go bankrupt and cease paying any benefits. What it does mean is that, according to the best estimates that can be made to project the future income and outgo of the system, the program will not have sufficient resources to enable it to meet in full the benefits that are payable under the rules and formulas now in the law.

The size of the solvency problem is significant. According to the 2004 report by the Trustees, the program's expected cost over the next 75 years will substantially exceed the program's projected resources for covering that cost. At the present time, Social Security's tax revenues are sufficient to meet all benefit costs and still contribute to a build-up in trust fund balances. Within just a few years, however, the size of these surpluses will begin to decline. By 2018, the program will no longer have an excess of tax revenue over outgo but will have to begin using some of its interest earnings to meet benefit obligations. By 2028, it will be necessary to start drawing down the principal of the trust fund balances. In the absence of changes, the trust funds will be completely drawn down by somewhere around mid-century (2042 under the Trustees projections, 2052 under the CBO analysis.) At that point, substantial revenues would still be coming into the program but they would be significantly less than what would be needed to pay the benefits provided for in current law. Under the Trustees' projections, at the point the trust funds are drawn down, the program would have sufficient income to meet 73 percent of program costs and this would decline over the next 40 years to 67 percent of program costs.

There are several different ways to measure the projected solvency of Social Security. Traditionally the Social Security Trustees have reported the actuarial balance by comparing average income over the next 75 years with average costs over the same period. Costs and income are expressed as a percentage of the total payroll subject to Social Security taxes. (Adjustments are made to income and cost to reflect the starting trust fund balance and a goal of having an ending trust fund balance equal to one year's outgo.) Under this traditional measure, program costs will exceed program income by an amount equal to 1.89 percent of taxable payroll. Another way of stating this same deficit is that the unfunded obligations of the program over the next 75 years have a present value of $3.7 trillion or the equivalent of 0.7 percent of the Nation's Gross Domestic Product over that same period.

These traditional measures of program solvency, however, are averages of very different situations at the start and the end of the period. The current situation shows a large trust fund balance which, for a few more years, is expected to continue increasing. At the end of the period, the program will have ongoing deficits that are much larger than the projected 75-year average deficit. In the 75th year, the projected income rate falls short of the projected cost rate by an amount equal to 6 percent of taxable payroll. In the 2004 Trustees Report, alternative measures are used showing the unfunded obligations over the infinite horizon, including:

- a present value of $10.4 trillion—the amount of money that would have to be put into the fund now to assure that all the benefits currently scheduled in the law could be paid into the indefinite future without any increase in tax rates or other revenues apart from the trust funds and their interest earnings, or

- 3.5 percent of taxable payroll—the immediate increase in the tax rate (from 12.4 percent to 15.9 percent) that would generate sufficient additional revenues to pay all scheduled benefits into the indefinite future, or

- 1.2 percent of Gross Domestic Product—the average amount (as a percent of GDP) over each year in the future that benefits would have to be reduced from those currently scheduled or taxes increased or some combination of the two in order for income and outgo to match.

Projections of the future status of Social Security, like all projections of the future, have a significant degree of uncertainty. The ultimate situation may turn out to be better or worse than now projected. The official estimates represent an intermediate path between more or less optimistic scenarios. These central estimates of the future status of Social Security made by the Trustees indicate that the program will, by a substantial margin, lack sufficient resources to meet its benefit obligations. (A separate estimate by CBO shows a somewhat smaller average deficit but confirms the basic conclusion of a program moving from present-day surpluses to substantial and continuing long-run deficits.) The fundamental elements driving these projections are facts that are already known or assumptions that are widely accepted. The baby boom generation exists and is starting to retire. The number of workers per beneficiary—now 3.3—will decline to 2.6 by 2020, to 2.2 by 2030, and to 1.9 by 2080. Mortality among older Americans is expected to continue declining, increasing the number of years that benefits will be paid. The level of economic growth is less predictable; however, the sensitivity to economic factors is somewhat reduced by the fact that major program elements are indexed to changes in wage and price inflation.

Importance of restoring solvency

The Social Security program is fundamental to the retirement security of the Nation and its workforce. Because it plays this fundamental role, Congress has established it on a self-financing basis to emphasize its importance and assure its stability. Even though the Social Security program has adequate funds to meet scheduled benefits for many years into the future, the confidence of both current retirees and current workers in the program is impaired if, as is presently the case, the system is inadequately financed to meet the benefit obligations that those now paying into the program are accumulating. In previous reports, the Social Security Advisory Board has pointed out that there are many options for how the program can be brought back into long-run financial solvency. Among the many proposals[10] that might, in some combination, be part of a plan to address the issue are:

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[10]See our report: *Social Security: why action should be taken soon*, July 2001 for a more detailed discussion of various proposals. This report and a 2005 memorandum updating the estimated impact of the proposals are available on our website: www.ssab.gov.

...there are many options for how the program can be brought back into long-run financial solvency.

- increasing Social Security revenues through rate increases, increasing the amount of wages subject to Social Security taxes, or expanding program coverage to all new State and local government employees;

- decreasing benefit costs through any of a variety of options such as reduced cost-of-living increases, modifications to the Social Security benefit formula and computation rules, increasing the Normal Retirement Age, or limiting benefits for higher income persons;

- changing the program and its financing in other ways such as investing trust fund reserves in equities, replacing part or all of Social Security with individual accounts on a mandatory or voluntary basis, or using general revenues to meet a part of program costs.

The choices among these and other options will have to be resolved by America's elected policymakers, but there are important reasons why the process of making those choices should begin soon. It will get harder to finance promised benefits as the size of the workforce decreases relative to the size of the older population because of the retirement of the baby boom generation and the continuing increases in longevity. The longer we wait, the fewer the choices and the more radical the needed changes.

> ***The longer we wait, the fewer the choices and the more radical the needed changes.***

Acting soon will offer more options and allow for gradual rather than abrupt changes.—Within just about one year from the point in the future where the trust funds are drawn down to zero, the program will move from a situation in which full scheduled benefits can be paid to a situation in which system resources are approximately 25 percent short of what is needed. Dealing at that point with deficits of that magnitude leaves no options that do not involve sharp and disruptive changes of direction: tax increases, benefit reductions, or general revenue infusions that in turn require increased public borrowing or cuts in other priorities.

The experiences of 1977 and 1983 are instructive. In part because the program was operating then on more of a pay-as-you-go basis without a large reserve account, there was less time available to implement changes in advance of the point where there would be insufficient financing to meet benefit obligations. Even though the size of the projected shortfall was smaller in both of those cases, the necessity for quick action left limited options for a gradual phase-in. In 1977, Congress found it necessary to change the method for indexing the benefit formula because the method that had been adopted in the early 1970s interacted with economic conditions in a way that Congress and other policymakers had not anticipated. This created large deficits that would have exhausted the disability insurance trust funds by 1979 and the retirement fund by 1983.[11] Because there was insufficient lead time, Congress did not have the option of adopting a gradual transition but instead approved a change in the benefit formula that significantly reduced the benefits payable to individuals who were then within just a few years of retirement and may have based their plans on the earlier formula.

In 1983, Congress found it necessary to address Social Security financing in a context where inability to meet benefit obligations was imminent. It adopted a number of provisions that had the effect of reducing benefits. Some of the provisions, such as the increase in the

[11] 1977 OASDI Trustees report.

Normal Retirement Age from 65 to 67 were deferred and gradually phased in, but others, such as the permanent deferral of a scheduled cost-of-living increase, became effective immediately and reduced anticipated benefits for everyone including those already receiving Social Security.

***Individuals need to know what they can expect*.**—Social Security is intended to provide a core of retirement income security around which individuals can build additional layers to provide a more adequate retirement. In order to plan rationally for such additional layers of protection, workers need to know how much of their income will be taken for Social Security taxes during their working years and how much retirement income they can expect the Social Security program to deliver. Retirement planning by individuals should and, to a considerable extent, must be a long-range process. Elsewhere in this report, we point out that too few American workers understand the importance of timely planning and actual saving for their income needs in retirement, and we urge increased efforts to promote financial education and retirement planning. It is inconsistent with this important objective to leave the future status of the Social Security program in a state of uncertainty with the result that those now in the workforce cannot reliably estimate their likely future benefits.

> ***...workers need to know how much of their income will be taken for Social Security taxes during their working years and how much retirement income they can expect the Social Security program to deliver.***

***Other elements of income security policy depend on a predictable Social Security system*.**—Both public policymakers and those who shape private sector programs such as pensions and health insurance need to understand what the core retirement security program upon which they must build will look like. The importance of re-invigorating the defined benefit private pension program and of addressing incentives for defined contribution plans will, to some extent, depend on what the Social Security program will look like in the future. Similarly, there are important interactions between health coverage and Social Security. In planning Medicare's future, it will be important to know how much capacity Social Security beneficiaries will have to meet out-of-pocket costs.

***Meeting multiple challenges in an uncertain future*.**—Over its history, the United States has had to deal with many large challenges and opportunities. In the last century alone, there were four major wars, a great depression, and a devastating flu epidemic; but there were also large advances in technology and medical science, a growing and better educated workforce, and very large increases in national production. We already know some of the potential challenges that lie ahead including an aging population, increasing medical costs, environmental issues, and a continuing need to deal with terrorism. There will undoubtedly be unforeseen issues as well as unforeseen opportunities over the course of the 21st century. Developments in the future may well have an impact on Social Security, and it is likely that the program will need changes and adjustments from time to time in the future. Nonetheless, it makes sense to act now to put the program on a sound footing according to our best ability to project what the future will look like. That approach provides the best hope of assuring that changes needed in the future can be accomplished incrementally rather than disruptively. It also

> ***...it makes sense to act now to put the program on a sound footing according to our best ability to project what the future will look like.***

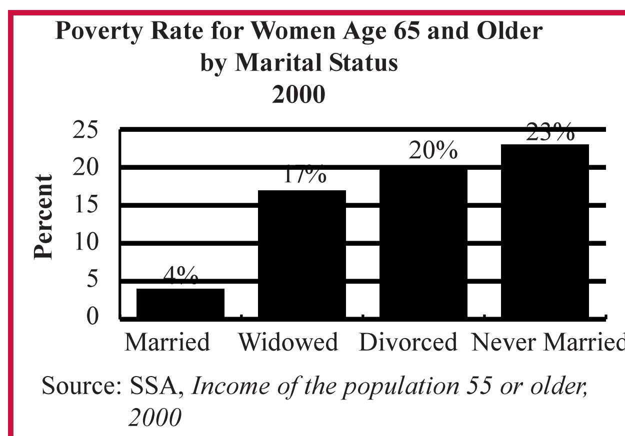
will enable us to coordinate the changes in Social Security with the changes in other institutions so as to allocate our resources in the most rational and desirable ways.

***Program support and confidence*.**—The purpose of the Social Security program is to assure a base of economic security that workers and their families can count on in old age and also in cases of disability or premature death. That assurance was made more believable by designing the program so that it would be able to generate sufficient resources to pay its own benefits without the need to depend on annual discretionary appropriations. The assurance is undermined, however, by the current situation in which the internal financing of the program is, by the best projections available, inadequate by a significant margin to assure the benefits the program seems to promise. This lowers confidence in the program by seeming to imply a lesser commitment to the principle of adequate financing. It can also undermine confidence because some workers, not knowing how much of Social Security they can count on, may tend to question whether they can count on it at all. A May 2004 Roper survey conducted for AARP found that only 44 percent of those aged 38-42 were confident that Social Security will still be available when they retire.

Other Social Security issues

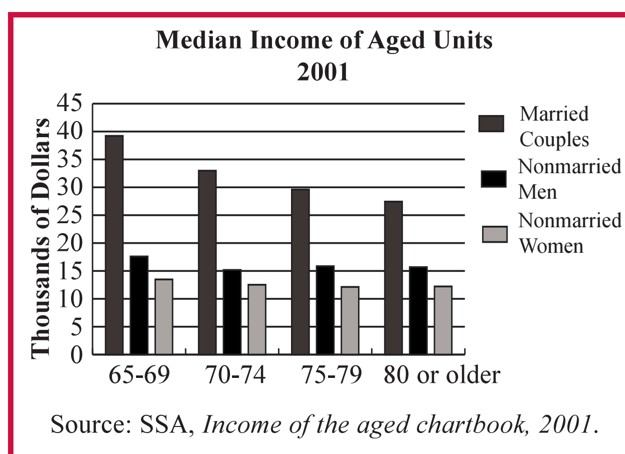
While solvency is the most pressing issue facing the Social Security program, there is also a need to examine whether the program continues to be well targeted to meeting economic security needs of older Americans. In basic design, the program is intended to recognize that those at the lower end of the income scale may have less ability to save and participate in supplementary programs such as employer-based pensions. Program features aimed at meeting that need include the weighting of the benefit formula, and the provision of dependency and survivorship benefits. Despite these features, significant numbers of aged Social Security beneficiaries have incomes at the poverty or near-poverty level. This, as shown in Chart 5, is particularly true for aged women who are single, divorced, or widowed. Also, as shown in Chart 6, there is a very large discrepancy in the income levels of younger and older retirees. As our Nation deals with the solvency issue, it should simultaneously review

Chart 5



Source: SSA, *Income of the population 55 or older, 2000*

Chart 6



Source: SSA, *Income of the aged chartbook, 2001.*

As our Nation deals with the solvency issue, it should simultaneously review other aspects of program design with a view toward improving the protection provided to the most vulnerable of the aged.

other aspects of program design with a view toward improving the protection provided to the most vulnerable of the aged.

Other areas of the program also deserve some reexamination. As beneficiaries enjoy longer and healthier lives, there are for many of them an increased ability and opportunity for continued participation in some work activity. As discussed in more detail elsewhere in this report, this is a development that can contribute to more adequate income for the individuals and increased tax receipts for the program. It can also contribute to meeting the needs of the economy. Program rules should be looked at to see if programmatic changes could better encourage this trend.

Disability benefit issues

In this report, the Board focuses primarily on the issue of retirement security for older Americans. An important part of the Social Security program, however, is the protection it provides to workers against the loss of earnings capacity as a result of disability. We have, in other reports, addressed both the significant administrative issues involved in the Social Security disability programs and the broader issue of whether the program needs basic redirection and possibly a change of definition—one that better meets society's current goals of encouraging and assisting those with impairments to attain maximum independence and self-sufficiency.

Table 1

Social Security Tax Rate Changes: 1970 to Present
(combined employer-employee rates in percent; maximum earnings for year in dollars)

						Maximum earnings subject to taxation*	
Year	Retirement and survivors	Disabiltiy	Cash benefits total tax rate	Medicare hospital Insurance	Total tax rate	Cash programs	Hospital insurance
1970	7.30	1.10	8.40	1.2	9.60	7,800	7,800
1971	8.10	1.10	9.20	1.2	10.40	7,800	7,800
1973	8.60	1.10	9.70	2.0	11.70	10,800	10,800
1974	8.75	1.15	9.90	1.8	11.70	13,200	13,200
1978	8.55	1.55	10.10	2.0	12.10	17,700	17,700
1979	8.66	1.50	10.16	2.1	12.26	22,900	22,900
1980	9.04	1.12	10.16	2.1	12.26	25,900	25,900
1981	9.40	1.30	10.70	2.6	13.30	29,700	29,700
1982	9.15	1.65	10.80	2.6	13.40	32,400	32,400
1983	9.55	1.25	10.80	2.6	13.40	35,700	35,700
1984	10.40	1.00	11.40	2.6	14.00	37,800	37,800
1985	10.40	1.00	11.40	2.7	14.10	39,600	39,600
1986	10.40	1.00	11.40	2.9	14.30	42,000	42,000
1988	11.06	1.06	12.12	2.9	15.02	43,800	43,800
1990	11.20	1.20	12.40	2.9	15.30	51,300	51,300
1994	10.52	1.88	12.40	2.9	15.30	60,600	all
1997	10.70	1.70	12.40	2.9	15.30	65,400	all

Source: SSA, *Annual statistical supplement to the Social Security bulletin*, 2003.Table 2.A3
*Table shows only years with rate changes; some years with maximum earnings changes are not displayed. Maximum for cash programs is $90,000 in 2005.

It is important to recognize, however, that there are interrelationships between the retirement and disability aspects of Social Security. In theory, the disability program is supported by a specific portion of the payroll tax that is allocated to a separate disability insurance trust fund. Unanticipated growth in disability benefits, however, has required on several occasions a shifting of a portion of the overall tax from supporting the retirement and survivors program to supporting the disability program. And it appears likely that this will be necessary again. The 1985 Trustees Report projected that the program would now be paying benefits to about 6 million disabled workers and their families. According to the 2004 Trustees Report, the actual number of such beneficiaries is a third greater than that projection—about 8 million, and the disability program is projected to be unable to meet benefit obligations in full by 2029, 13 years sooner than the retirement program. As shown in Table 1, the disability program tax rate has increased from 1.1 percent in 1970 to 1.8 percent today. In order to meet program costs over the next quarter century, the Trustees estimate in their 2004 report that an additional increase of approximately 0.18 percentage points would be needed.

Even apart from the direct financial impact on the overall Social Security program of disability benefit costs, there are significant reasons why the disability program is related to retirement income security. One challenge facing the future of Social Security arises from the changing ratio of workers to beneficiaries. This would be lessened to the extent that policies are adopted which make the disability program more responsive to the desires of impaired individuals to attain maximum self-sufficiency. Also, in considering proposals aimed at increasing labor force participation of older persons, policymakers will need to recognize that disability tends to become more prevalent with advancing age.

One challenge facing the future of Social Security arises from the changing ratio of workers to beneficiaries. This would be lessened to the extent that policies are adopted which make the disability program more responsive to the desires of impaired individuals to attain maximum self-sufficiency.

IV. PENSIONS AND SAVINGS

Pensions and savings are important elements in retirement income security. Unfortunately, despite legislation to encourage both savings and pension participation, the rate of pension participation has not changed much since the passage of the Employee Retirement Income Security Act (ERISA) in 1974, and, for many, savings inadequately supplement other retirement income.

...for many, savings inadequately supplement other retirement income.

Saving is important not just to individuals' retirement security but to the future of the American economy. Increasing national saving would help prepare for the inevitable budgetary pressures caused by the retirement of the baby boomers. Increased saving could boost productive capacity, enabling the workforce of the future to support the consumption of a growing retiree population. National saving consists of both public and private saving. Federal budget surpluses, as long as they do not come at the expense of private saving, would be one approach to increasing national saving. Strategies to encourage private saving would be another.

Saving is important not just to individuals' retirement security but to the future of the American economy.

The private pension plan system is voluntary. Employers decide whether to establish a plan and determine the design of the plans they decide to sponsor. Pensions are a tool to attract, retain, motivate, and manage the flow of workers. Federal tax law provides favorable treatment to pension plans provided that the plans qualify for such treatment by meeting standards laid out in law and regulations. Employer contributions are deductible as a business expense. Participants in qualified plans typically do not pay taxes on their employer's or their own contributions or on the earnings on those contributions until they receive benefits. After deducting for the present value of future tax payments, the revenue loss for 2003 due to the pension system was $184 billion, an amount equivalent to 40 percent of the payroll taxes collected to support Social Security retirement benefits in that year.[14]

Pensions as a source of retirement income

Employer-sponsored pension benefits are an important source of income to retired people. Survey data from 2002 indicate that 41 percent of aged households report receiving retirement benefits other than Social Security, but that percentage understates the impact of employer-sponsored retirement programs. Such programs increasingly pay benefits in lump sum distributions that may be rolled over into individual savings or insurance contracts, and reported in surveys as asset income. Fifty-five percent of aged households receive asset income, part of which represents income derived from contribution accounts and other retirement

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[14]The *Analytical Perspectives* volume of the President's fiscal year 2005 Budget explains present-value estimates in this way: "The present-value estimates represent the revenue effects, net of future tax payments, that follow from activities undertaken during calendar year 2003 which cause [tax] deferrals or other long-term [revenue] effects. For instance, a pension contribution in 2003 would cause a deferral of tax payments on wages in 2003 and on pension earnings on this contribution (e.g., interest) in later years. In some future year, however, the 2003 pension contribution and accrued earnings will be paid out and taxes will be due; these receipts are included in the present-value estimate. In general, this conceptual approach is similar to the one used for reporting the budgetary effects of credit programs, where direct loans and guarantees in a given year affect future cash flows." (p. 286)

accounts. Together, pension and asset income make up 33 percent of the income of aged households, and over two-thirds of aged households receive income from pensions, assets, or both. Since participation in employer-sponsored retirement programs is significantly greater for workers at middle and upper earnings levels,[15] such programs represent an even larger part of total retirement income for such workers.[16]

Trends in retirement plans

Over the last 25 years, private pensions have significantly shifted from defined benefit plans to defined contribution plans. In 1980, there were 148,096 DB plans covering 39 percent of the workforce. The number of DB plans grew to over 170,000 in 1986, but has since declined to a 1999 level of just under 30,000 plans covering 21 percent of workers. DC plan assets have, since 1997, exceeded those in DB plans.[17]

Defined benefit plans use a formula to determine the pension benefit that participants are ultimately entitled to receive. Benefit formulas typically involve the employee's final average pay or career average pay in combination with years of service. Traditionally these plans have paid benefits as an annuity, or a series of payments over a specified period or for the life of the participant, beginning at an age specified in the plan. This life-long annuity plan is similar to Social Security except that private pension plans are ordinarily not indexed for inflation. The annuity type of payout assures that participants will not outlive their income. The flexible structure of defined benefit plans also allows employers to tailor benefits to the needs of specific populations. For example, subsidized early retirement benefits may be especially important to workers in physically demanding jobs. In recent years there has been a substantial move toward offering participants in these plans a lump sum benefit option, and anecdotal evidence suggests that the vast majority of workers that are offered this option take it when they terminate employment covered by the plans.

Through the Pension Benefit Guaranty Corporation, the Federal government stands behind employers' promises of defined benefit pensions. The PBGC protects about 34.6 million workers and retirees in single-employer pension plans and 9.8 million workers and retirees in multi-employer plans. (Multi-employer plans are set up by collective bargaining agreements and include a number of employers, usually in the same industry.) The PBGC is funded by premiums from plan sponsors, money from investments, and funds from pension plans it takes over. The maximum pension benefit guaranteed by law, currently $3,801.14 per month for a person who retires at age 65 from a single-employer plan, is set by law and adjusted annually. Guaranteed amounts are less for workers who retire before age 65, workers covered by multi-employer plans, and workers who select a joint and survivor annuity.[18]

The PBGC estimates that it is operating with a substantial long-range deficit, which is likely to grow. As of the end of September 2004, the PBGC reported a deficit of $23.3 billion. In other words, while it currently has sufficient funds to meet on-going benefit payments, it will, in the absence of some sort of reform legislation, ultimately be unable to pay benefits in full. However, its situation is less predictable since its long-range deficit could worsen as it takes over additional funds as a result of plan terminations. Overall, the private defined benefit pension

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[15]See Table 2 on page 30.
[16]Data in this paragraph based on SSA's, *Income of the population 55 or older, 2002*, Table 3.6.
[17]See U.S. Department of Labor, Employee Benefits Security Administration, *Private pension plan bulletin*, Summer 2004.
[18]See http://www.pbgc.gov/about/default.htm; http://www.pbgc.gov/press_release/2004/pr05_14.htm#chart.

system is underfunded. In its *Fiscal Year 2004 Performance and Accountability Report*, the PBGC estimated, as of September 30, 2003, that there was a $350 billion gap between assets and liabilities in the private, single-employer defined benefit system. As of September 30, 2004 PBGC estimated the gap at $450 billion, including $96 billion in plans that the agency viewed as reasonably possible of termination.

While the private pension funding situation may be somewhat akin to the Social Security situation, it is important to keep in mind that there are also distinct differences. According to the Federal Reserve Board's *Flow of Funds Accounts,* private defined benefit plans held assets worth $1.7 trillion at the end of 2003. If these plans were underfunded by $350 billion as the PBGC estimated, the combined totals suggest that total obligations at the end of 2003 would have been $2.1 trillion. Assuming that is the case, the $1.7 trillion in funding would represent about 80 percent of the total obligations. By comparison, as of the end of 2003 the Social Security trust fund had assets of $1.5 trillion but accrued obligations of approximately $15 trillion.[19] In other words, approximately 10 percent of obligations are "funded" in the Social Security case. It is important to understand that while pension programs are expected to have a fund sufficient to cover accrued obligations, the Social Security program was designed to meet benefit obligations primarily from ongoing tax receipts. Thus the computation of "unfunded obligations" in the annual Social Security Trustees Report measures whether the amount in the fund plus expected future tax revenues will be sufficient to meet existing accrued benefit obligations plus obligations which are projected to accrue in the future. As indicated in the Social Security section of this report, the 2004 Trustees Report finds that the Social Security program, using that standard, is underfunded by a present value of $3.7 trillion over the next 75 years (the equivalent of 1.89 percent of taxable payroll) and by $10.4 trillion over the infinite horizon (the equivalent of 3.5 percent of taxable payroll).

The underfunding of Social Security poses a risk, albeit a manageable one, to all of the future participants in the program. The underfunding of private pensions, on the other hand, tends to be concentrated in a relatively small number of plans that are underfunded. The participants in these plans are at substantial risk because they face the prospect of receiving benefits substantially below those defined in their plan formulas if their plan sponsors cannot deliver on promised benefits and the plans are turned over to the PBGC. This is an important retirement security issue for the workers and retirees potentially affected. Many plans in the system, however, are adequately funded and their participants should receive benefits in accordance with the plans' formulas.

Participants in defined contribution plans, such as 401(k)s, have individual accounts to which the employer, the employee, or both make periodic contributions. Benefits are based not on a formula but on the contributions to and investment returns (gains and losses) on those accounts. The employee bears the investment risk and often has some control over how individual account assets are invested. By contrast with defined benefit plans, in which the biggest accruals occur toward the end of a career with a given employer, defined contribution

The underfunding of private pensions...tends to be concentrated in a relatively small number of plans that are underfunded.

[19]Social Security Administration, Office of the Chief Actuary, Actuarial note 2004.1. Table 2 shows the "maximum transition cost" at the end of 2003 as $13.5 trillion. This is the amount of accrued obligations computed as though the program were to be terminated less the value of assets. (An adjustment is made to recognize that the program would have received the proceeds of taxation on future benefits.)

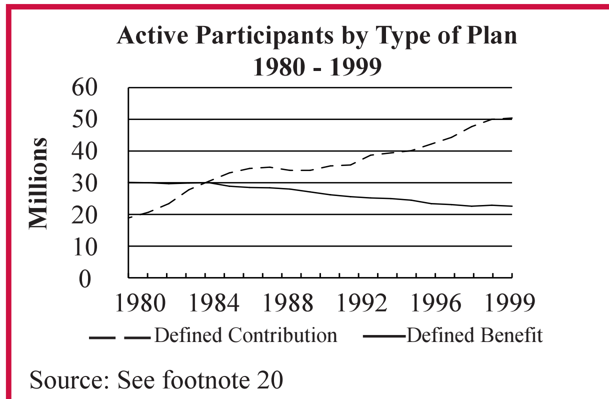
plans allow more level accumulation of retirement assets over a career with several employers. Workers leaving an employer can roll over their balances to the new employer's plan or to an Individual Retirement Account, or they can cash out their balances. At retirement, the worker receives the account balance.

The shift from defined benefit to defined contribution plans

As these charts[20] show, there has been a major shift from the traditional defined benefit type of pension plan to plans in which workers have individual accounts that accumulate assets through defined contributions by employers and employees.

The number of active participants in defined benefit plans dropped by a quarter between 1980 and 1999, while the number in defined contribution plans nearly tripled.

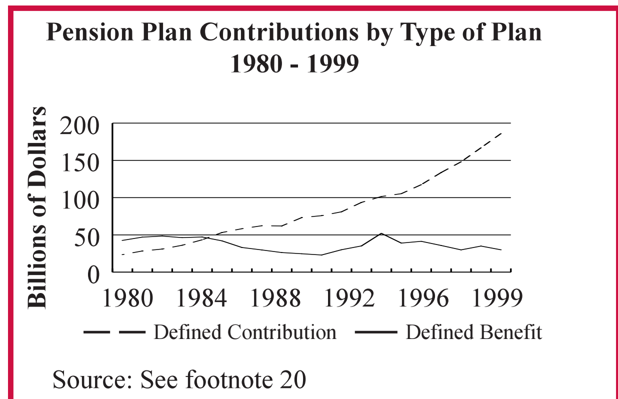
Chart 7



Source: See footnote 20

Contributions to defined benefit pension plans fell by more than a quarter between 1980 and 1999, while contributions to defined contribution plans increased nearly eightfold.

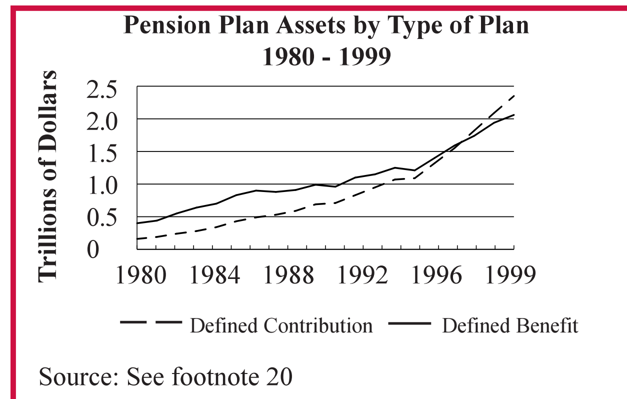
Chart 8



Source: See footnote 20

The value of assets in defined benefit plans increased by a factor of five between 1980 and 1999, while those in defined contribution plans increased nearly fifteen-fold, exceeding those in defined benefit plans in 1997.

Chart 9



Source: See footnote 20

[20]Charts 7-9 are based on U.S. Department of Labor, Employee Benefits Security Administration, *Private pension plan bulletin*, Summer 2004.

Hybrid plans combine certain features of DB and DC plans. The most common type of hybrid plan is the cash balance plan. Cash balance plan formulas regularly credit a percentage of salary or compensation for each participant into a hypothetical participant account. Investment earnings are credited to these accounts at a rate specified by the plan, and the employer bears the investment risk. Participants who separate from their employers before retirement generally can take their current account balances as a lump sum. Since these are technically defined benefit plans under ERISA, hybrid plans are required to offer eligible participants an annuity payable at retirement age, but virtually all plans offer retiring workers the option of a lump sum benefit. Most workers retiring under these plans choose to take the benefit in a lump sum.

The increased importance of defined contribution pensions poses some challenges for workers. The first is the decision to participate.—Defined benefit plans cover all qualified workers, but coverage is not automatic in most defined contribution plans. Workers must also decide how much to contribute. Along with control over how their pension funds are invested comes the financial market risk associated with those investments. When workers change jobs, they must decide what to do with their accumulated balances. They must also decide whether to borrow from their accounts for purposes other than retirement.

The fact that defined contribution distributions are typically available only as a lump sum (and that hybrid plan distributions typically are taken as a lump sum) also presents challenges to workers. They may not understand that they are assuming another form of risk—longevity risk. Annuitized payouts can ensure that retirement benefits last a lifetime, but workers who receive a lump sum have to find a way to make it last for a generally unpredictable remaining lifetime.

...workers who receive a lump sum have to find a way to make it last for a generally unpredictable remaining lifetime.

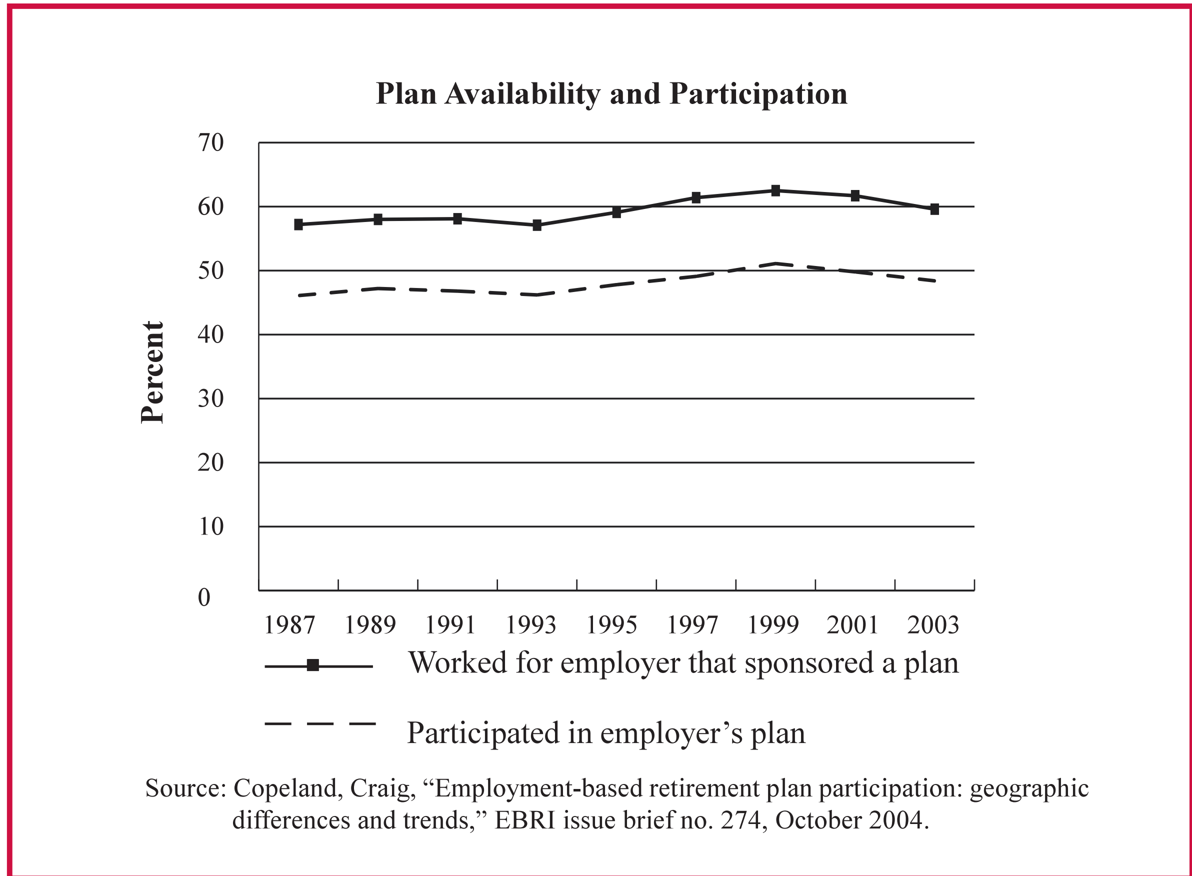
Participation in pension plans

There is no single answer to the question, "What percentage of workers participate in pension plans?" Answers will vary depending on what data source is used and how the population is defined. For example, including government workers in the population will result in a higher percentage, as will restricting the population to ages 25 to 64 or to fulltime workers. While participation is automatic for workers covered under DB plans, it is usually optional under DC plans.

The following figures are from an Employee Benefit Research Institute (EBRI) analysis of the March 2004 *Current Population Survey*[21] and look at wage and salary workers between the ages of 21 and 64. In 2003, there were 125.4 million such workers. Of these, 74.7 million worked for an employer that sponsored a pension plan and 60.7 million participated in an employer's plan. The following chart shows percentages since 1987 of wage and salary workers ages 21 to 64 whose employers sponsored a plan and of workers who participated in a plan.

[21]Copeland, Craig, "Employment-based retirement plan participation: geographic differences and trends," EBRI issue brief no. 274, October 2004.

Chart 10



Source: Copeland, Craig, "Employment-based retirement plan participation: geographic differences and trends," EBRI issue brief no. 274, October 2004.

Over this period, sponsorship and participation have been fairly flat in terms of percentage of workers. Both have fallen since 2000.

Breaking down the overall rate into subgroups shows considerable variations. The following table shows for subgroups of wage and salary workers ages 21 to 64 the percent who work for an employer who has a pension plan and the percent of each subgroup that participates in a plan. Participation percentages are based on all workers in each subgroup, including both those whose employers offer a plan and those whose employers do not offer a plan.

Table 2

Availability of and Participation in Pension Plans in 2003

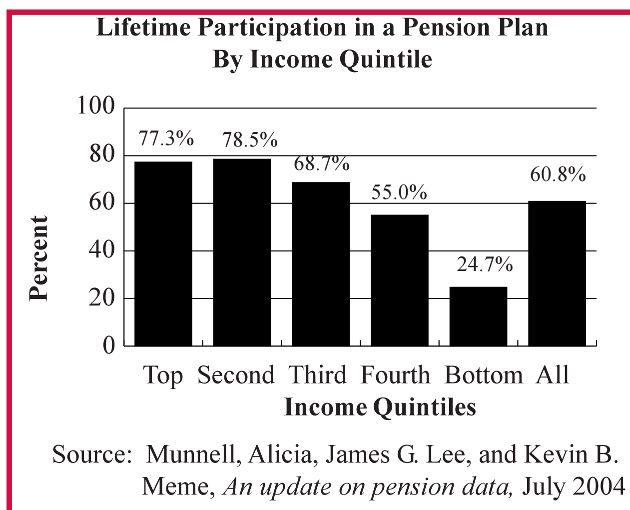
Wage and salary workers	Employer has pension plan (%)	Participate in plan (%)
Age		
21-24	40.2	18.6
25-34	55.3	41.6
35-44	61.8	51.6
45-54	66.8	59.0
55-64	64.2	56.7
Race/Ethnicity		
White	64.0	52.9
Black	57.9	45.0
Hispanic	39.4	29.2
Education		
No HS diploma	31.6	21.9
HS diploma	54.2	42.6
Some college	61.2	48.0
Bachelor's degree	69.8	59.3
Grad/prof degree	77.2	69.8
Marital Status		
Married	63.7	54.3
Widowed	61.6	50.5
Divorced	61.8	49.9
Separated	49.8	36.4
Never married	49.6	34.4
Health Insurance		
None/not own employer	36.2	22.6
Through own employer	75.2	65.6
Health Status		
Excellent	62.5	51.4
Very good	60.9	50.2
Good	56.1	44.1
Fair	51.4	39.2
Poor	45.2	31.8
Annual Earnings		
Less than $5,000	29.4	8.4
$5,000 to $9,999	35.0	14.2
$10,000 to $14,999	36.9	19.8
$15,000 to $19,999	44.6	29.7
$20,000 to $29,999	58.1	45.6
$30,000 to $39,999	69.1	59.9
$40,000 to $49,999	74.3	67.8
$50,000 or more	78.8	74.5
Sector		
Private sector	54.8	43.2
Public sector	84.8	75.8

Source: Copeland, Craig, "Employment-based retirement plan participation: geographic differences and trends," EBRI issue brief no. 274, October 2004.

While most of those workers who are not covered by a pension plan have jobs in which no plan is offered, there are also workers who work in jobs offering a plan but who do not yet meet the age and service requirements for participation, and there are workers who are eligible to participate in an employer-sponsored plan but do not choose to do so. One recent analysis of data from the *Current Population Survey* indicated that the main reason given by those who are eligible but choose not to participate was that they could not afford to do so. Recent research has shown that the "default" provisions of 401(k) plans have a great influence on whether workers participate and how much they contribute. When enrollment is automatic, many more employees participate. And when the default contribution rate is higher, the average contribution is higher.[22]

The figures above are for individual coverage at a point in time. The chart below shows that pension coverage over a lifetime on a household rather than individual basis is more widespread. Researchers for the Center for Retirement Research at Boston College calculated these lifetime pension coverage rates by income quintile for households with a head aged 59 to 69 in 2000.

Chart 11



Source: Munnell, Alicia, James G. Lee, and Kevin B. Meme, *An update on pension data,* July 2004

A study published in 2000 by the Investment Company Institute showed that, for those participating in the most common type of defined contribution plan (401(k), the percentage of wages contributed rose with household income. Those with a household income below $30,000 had a median contribution of 5 percent of wages, while those with incomes of $100,000 or more had a median contribution of 10 percent of wages. The median plan balances for those participating rose with the length of their participation. Those with one year or less in the plan had median balances of $1,600. Those with two-to-five years had median balances of $10,000. And those with six or more years had median balances of $50,000. The median balance for all participants was $14,000.

Integration of pensions with Social Security

Employers have the option of coordinating, or "integrating," the benefits of their pension plans with Social Security benefits. Social Security benefits for lower-paid workers represent a higher percentage of earnings than those for higher-paid workers. Integration allows employers to take into consideration their contributions to Social Security and reduce the pension benefits of lower-paid workers in order to provide retirement income that represents the same percentage of pay for lower-income and higher-income workers. Tax rules define how this integration may take place. A recent study[23] estimates that about one-third of DB plans and one-quarter of DC plans are integrated.

To some extent, pensions and Social Security are complementary. For those with low incomes, Social Security benefits replace a larger percentage of their income and pensions replace a smaller portion. For those with higher

[22] Wise, David A., "Economics of aging program report," http://www.nber.org/aging.html.

[23] Perun, Pamela, "Social Security and the private pension system: the significance of integrated plans," Center for Retirement Research working paper 2002-2, p. 2.

earnings, Social Security replaces a smaller portion of their earnings, while pensions replace a higher percentage.

Retirement savings

Because of the trend away from defined benefit plans, much of the responsibility of preparing for retirement has shifted to workers. Workers whose employers sponsor savings and investment plans, like 401(k) plans, can build retirement savings on a tax-deferred basis. Most people with earned income can also contribute to a tax-favored Individual Retirement Account.

> ***Because of the trend away from defined benefit plans, much of the responsibility of preparing for retirement has shifted to workers.***

The *2001 Survey of Consumer Finances* (SCF) has data on retirement accounts. The SCF definition of retirement accounts includes IRAs as well as employer-sponsored defined contribution plans and "Keogh" plans for the self-employed. Note that in the table below the median values are only for families that have retirement accounts.

Table 3

Retirement Account Holdings

Age of head of household	Percentage of families holding retirement accounts	Median Value
Less than 35	45.1	$6,600
35-44	61.4	$28,500
45-54	63.4	$48,000
55-64	59.1	$55,000
65-74	44.0	$60,000
75 or older	25.7	$46,000

Source: Federal Reserve Board, *2001 survey of consumer finances*

Under the Federal employees' Thrift Savings Plan, $55,000 for a participant retiring at age 65 would currently purchase a level, single-life annuity paying approximately $400 per month. (This is a unisex annuity. Commercially purchased, gender specific annuities would typically pay larger annuities for men than for women because of the life expectancy differential.)

Such plans will continue to increase in importance as more workers have more years of accumulated savings. The ratio of retirement plan assets to wage and salary earnings has increased more than fivefold since 1975. Researchers have debated how 401(k) accounts and similar plans have affected other saving. Some claim that two-thirds or more of the money in 401(k) accounts is new saving. Others argue that contributions to 401(k)s come largely from other saving and only one-third or less contributes to net saving. They agree that 401(k) plans are likely to increase savings for low- and middle-income workers and less likely to do so for high-income workers.

Household net worth and financial assets

Many households own other assets that could be used to pay expenses in retirement. For many people, their most valuable asset is their home. However, the literature does not show clearly the extent to which retirees liquidate their housing wealth to support consumption in retirement. The *2001 Survey of Consumer Finances* found that for households headed by individuals ages 65 to 74, 83 percent owned their home and the median equity value for those who did was $103,000.

> ***...for households headed by individuals ages 65 to 74, 83 percent owned their home and the median equity value for those who did was $103,000.***

Other assets they may own include financial assets, other real estate, and other valuables that may generate income or may be sold to pay for their needs during retirement. Net worth is the difference between assets and liabilities. The *Survey of Consumer Finances* also has data on the financial assets (bank accounts, stocks, bonds, mutual funds, and so on) of the 93 percent of all households that had financial assets. The value of Social Security or defined benefit plans is not included in either net worth or financial assets. The following table, based on that data, shows the median net worth and median financial assets of households (for the 93 percent that had financial assets) in the United States in 2001, by the age of the head of household.

Table 4

Net Worth and Financial Assets

Age of head of household	Median net worth	Median Financial Assets
Under 35 years old	$11,600	$6,300
35-44	$77,600	$26,900
45-54	$132,000	$45,700
55-64	$181,500	$56,600
65-74	$176,300	$51,400
75 or older	$151,400	$40,000
All households	$86,100	$28,000

Source: Federal Reserve Board, *2001 survey of consumer finances*

Expectations

Given the low median levels of saving and pension eligibility even among those who have pensions and savings, one might expect a growing sense of unease as increasing numbers of people approach retirement. Survey data from the Employee Benefit Research Institute, however, indicate that few workers seem to know how much they would need to live comfortably in retirement. Only about 40 percent report having tried to calculate how much they would need to save in order to live comfortably in retirement, and a third of those say they do not know the outcome of that calculation. One of the most striking results of the survey is that almost half of those who have not saved for retirement are at least somewhat confident of having a comfortable retirement.

...few workers seem to know how much they would need to live comfortably in retirement.

Displaying a blissful optimism that something will turn up, some expect to save later, others to rely on Social Security or on family and friends. On the other hand, the survey also indicated that retirement education can change the behavior of at least some workers. More than 40 percent of those who reported trying to calculate their savings needs said that the exercise changed their retirement planning. Almost 30 percent of those who received retirement education through their employer changed their retirement plans.

Current issues

Social Security is and will remain a fundamental part of how this Nation provides economic security in old age. But it is not intended to be the sole source of income in retirement. For many Americans—but nonetheless too few—employment-based pensions and individual savings and investment play a substantial role in supplementing Social Security to provide a more adequate level of retirement income.

By definition, private pensions and private savings and investment are not subject to the type of uniformity of application and participation that is found in a governmental program like Social Security. Employers and individuals will appropriately utilize these elements of economic security in different ways

and provide different levels of protection according to their individual needs, desires, and abilities. But public policies can and should be structured to encourage private pensions and savings and, in particular, to encourage them to better address the economic security needs of those with low to moderate incomes.

...public policies can and should be structured to encourage private pensions and savings....

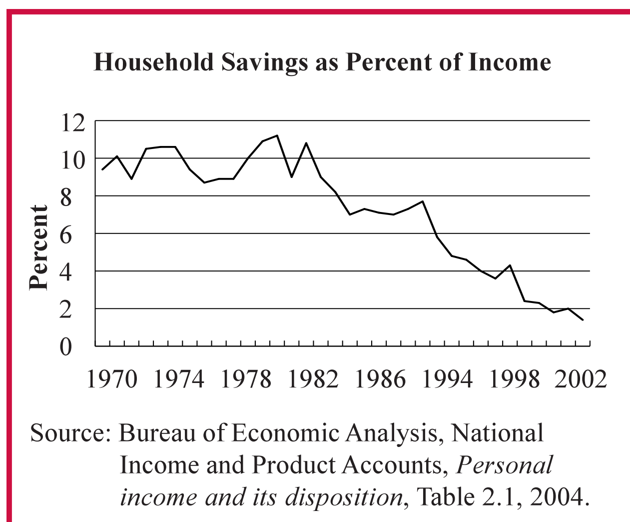
Defined benefit plans.—The shrinkage in the prevalence of traditional employer-sponsored pension plans is to a considerable extent a reflection of changes in the economic structure and, in particular, the relationship between employers and their workforce. Career employment with a single firm is no longer common. There is less inclination on the part of employers to see pensions as a tool for managing the replacement of an aging workforce. Pensions no longer provide the recruiting and retention incentives they once did, and the movement to DC plans has shifted the investment risk from the employer to the employee. Still, defined benefit pensions continue to cover a large number of workers and retirees. They can provide significant advantages for those businesses and employees who do participate in them. As we face a future with possible labor shortages, this type of plan may again become more attractive. Public policies should be aimed at encouraging the continuation and growth of traditional plans for those who find them appropriate. The unresolved issues surrounding hybrid pensions should be resolved so employers understand the requirements and can decide whether to make an ongoing commitment to this form of plan or an alternative. While regulation is needed to protect plan participants and avoid abuses, attempts should be made to simplify the regulatory burden involved in establishing and maintaining private pensions.

Funding standards should be reexamined and modified as necessary to encourage practices which will strengthen the funding of pension plans and to eliminate incentives for plan termination. Current policies that prohibit the build-up of surpluses in good times so as to reduce the burden of meeting funding requirements in downturns (and therefore also reduce the risk of termination) are too restrictive and make little financial sense. Similarly, the structure of how plans are insured through the Pension Benefit Guaranty Corporation needs to be reexamined so that well-funded plans can be established without the expectation that they will be unduly burdened with the costs of bailing out risky plans. One avenue that might be explored is to encourage the adoption of pooled plans for multiple employers, not necessarily in the same industry, similar to those being proposed for health insurance.

Defined contribution plans.— There has been strong growth in recent years in defined contribution plans such as 401(k)s. There are many reasons why this is an encouraging development. The lesser regulatory and financial burden such plans place on employers has undoubtedly encouraged many of them to make defined contribution plans available in cases where no other retirement plan would otherwise have been established. To the extent defined contribution plans have been substituted for traditional pension plans, however, the results are likely lower participation especially among younger and lower-income employees. Defined contribution plans also provide opportunities for participants to gain access to the accumulated savings in such plans through loans and lump sum termination distributions. In some respects, this feature is consistent with the individualized nature of such plans, and it may provide some positive incentives for participation. On the other hand, lump sum distributions both before and at retirement can undermine the basic retirement security objective of these plans.

Policymakers need to carefully review the considerable body of research that is being conducted on these issues and consider incentives to improve the levels of participation and to encourage the appropriate use of defined contribution pension accounts. Some recent research indicates that participation would be increased if employers would make participation, rather than non-participation, the default option for new employees. Similarly, consideration should be given to ways to encourage the retention for retirement and ultimate annuitization of plan distributions. Again setting appropriate default options might be one approach. Another might be the development of incentives for financial institutions to create a more robust market for individual and group annuity contracts.

Chart 12



Source: Bureau of Economic Analysis, National Income and Product Accounts, *Personal income and its disposition*, Table 2.1, 2004.

Individual savings.—Over the past several decades, there have been a number of attempts to encourage increased individual savings through such tax incentives as individual retirement accounts and the savers' credit. Despite those efforts, personal savings rates (which include pension contributions) have, as shown in Chart 12, dropped precipitously over the last quarter-century from over 10 percent in the 1980s to a low of 1.4 percent in 2003. There is also broad agreement that financial assets, especially for moderate to low income persons, are well below what they are likely to need to supplement their Social Security income in retirement. There is a clear need to improve the level of personal savings both to build up the wealth accumulations that current workers will need to assure their own future economic security and to help the national economy prepare for the coming demographic imbalances. These imbalances may, to some extent, see the baby boom generation substantially draw down existing stocks of personal savings to meet their retirement income needs. Policymakers therefore need to look for ways to strengthen current incentives for individual savings. In doing so, particular attention is needed to the development and implementation of policies that will encourage and facilitate the participation in individual savings plans by moderate and lower income workers. In designing any changed incentives, it is important that Congress take into account the overall need to address economic security and adopt changes which will complement and not undermine the incentives for improved protection through other forms of retirement savings such as employment-based pensions and health insurance.

Financial education and retirement planning.—While the Social Security program is a crucial element in the retirement security of Americans, it is clear that, more than ever before, workers at all age levels will need to take responsibility for planning ahead so that they do not enter retirement with insufficient resources to adequately supplement their Social Security benefits. It is also clear that far too small a portion of the population actually does such planning, let alone act upon it. To some extent, this reflects a failure of our society to educate us about the need for such planning and to provide us with the tools to carry it out. There have been some commendable public and private efforts to address this problem such as those of the Department of Labor and the Employee Benefit Research Institute. The Social Security Administration in partnership with the American Savings Education Council (an EBRI-sponsored

nonprofit national coalition of public- and private-sector institutions) has carried out educational campaigns aimed at raising the awareness of the need to save. Under the "Savings Are Vital to Everyone's Retirement Act of 1997," a National Summit on Retirement Savings was convened by the Department of Labor in 1998 and again in 2002, with a third summit scheduled for 2005 or 2006.

Important as such actions are, they are insufficient. Promoting the need for lifetime retirement planning and making financial education widely available must become a national priority. Congress should consider incentives or possibly even requirements to assure that basic financial planning becomes part of the core curriculum in our Nation's schools. The Social Security Administration has undertaken efforts to help workers plan how they will supplement benefits, but increased efforts are needed.

Given the agency's resource constraints, some useful activities would necessarily depend on the availability of additional resources; however, even within current resources, the agency might find ways to improve its support for retirement education. As part of its communications efforts, it should encourage and assist employers in putting on retirement planning workshops for their employees. It should also better utilize the Social Security Statements sent out to workers each year so as to emphasize the need for retirement planning at all ages and to inform them of how to find resources to help with such planning. The current Statement contains a single sentence noting the need for additional retirement resources to supplement Social Security. The SSA website contains links to some resources for financial planning, but these are not prominently located. They are likely to be reached only by those who are already thinking about their retirement needs. SSA should find ways to address the need for financial planning more strongly. It might occasionally include an insert in the annual Social Security Statement specifically targeted to this issue.

The Board recognizes that efforts to educate and motivate individuals to understand and plan ahead for their income security needs in retirement face the same kinds of obstacles as efforts to encourage healthier nutrition and lifestyles. Employers have told the Board of the frustrations they face, even when they make substantial efforts, in motivating employees to become actively involved in retirement planning. Younger workers often have many immediate needs and concerns that crowd out the seemingly distant concern about providing for their older years. Still, the Board believes that, as a Nation, we can and should do a better job of encouraging workers of all ages to recognize and act on the need to plan ahead for their retirement security.

Promoting the need for lifetime retirement planning and making financial education widely available must become a national priority.

V. LABOR FORCE PARTICIPATION OF THE ELDERLY

In addition to what we normally think of as retirement benefits for the elderly (e.g., Social Security, pensions, and savings) another important source of income for this group is earnings from work. As the demography of the U.S. population changes, it could become even more important. The participation of the elderly in the labor force is not only important to individuals' income, but can also be a vital part of the national economy that supports public and private retirement benefits.

> ***The participation of the elderly in the labor force is not only important to individuals' income, but can also be a vital part of the national economy....***

Earnings as a source of income for the aged

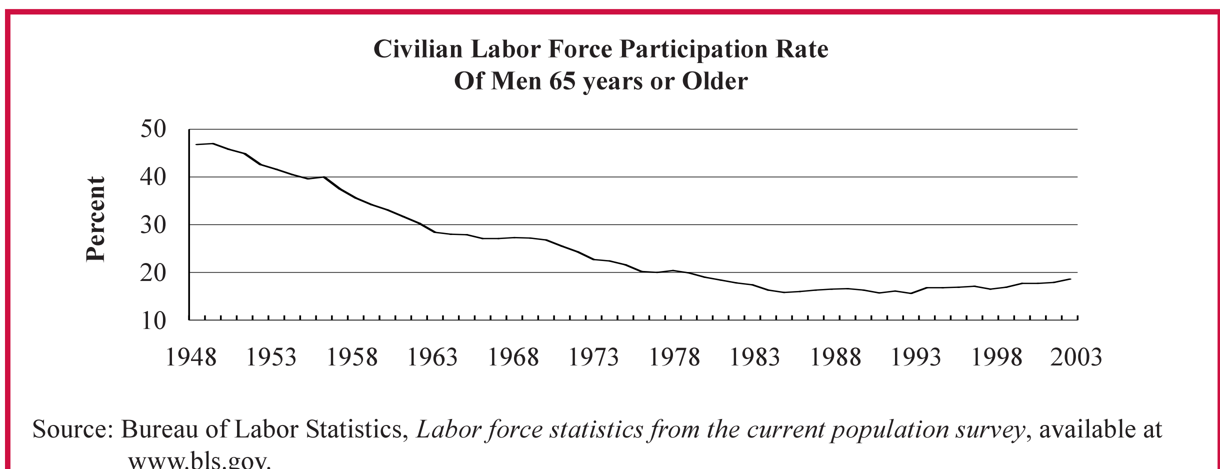
According to the Social Security Administration, in 2001, earnings accounted for nearly a quarter of aggregate income to the population 65 and over. About 22 percent of all aged units had some income from earnings. Since "aged units" are married couples in which at least one person is 65 or over or single individuals 65 or over, the income from earnings may reflect to some extent the earnings of a non-retired spouse under age 65.

Labor force participation of the aged

The concept of leaving the labor force simply because one reaches an arbitrary age is a fairly recent phenomenon. In the past it was quite common for people to remain in the labor force as long as they were physically able to do so. Even as recently as the late 1940s nearly half of the men age 65 and over were still in the labor force. As can be seen from Chart 13 below, this percentage declined steadily until the early 1990s, when it reached a low of around 16 percent. Since that time there has been some slight increase, with the rate at just under 19 percent in 2003. A similar pattern can be seen in the labor force participation rates for men age 60-64. From a low of around 53 percent in the mid-1990s, the rate has risen to more than 57 percent in 2003.

> ***...leaving the labor force simply because one reaches an arbitrary age is a fairly recent phenomenon.***

Chart 13



Source: Bureau of Labor Statistics, *Labor force statistics from the current population survey*, available at www.bls.gov.

Possible reasons for the recent increase in labor force participation

While it is not entirely clear why the labor force participation rate of the aged has increased in recent years, there are several factors that may have had some impact. One of these is the repeal, beginning in 2000, of the Social Security earnings test for beneficiaries past the age of eligibility for full benefits. Prior to that time, Social Security benefits were reduced by a portion of earnings over a specified amount ($15,500 in 1999). The earnings test still applies to beneficiaries below "Normal Retirement Age."[24] It seems reasonable to assume that the repeal of the earnings test would encourage workers to stay in the workforce even after beginning to draw Social Security benefits. However, one recent study has raised doubts about this hypothesis.[25]

A second factor that may have induced older workers to remain in or return to the workforce is the decline in the stock market in recent years. The actual and anticipated lowering of the value of retirement investments likely persuaded some workers of the need to supplement other forms of retirement income with additional earnings. If this has been a major contributor to the recent increase in labor force participation among older workers, then a recovering stock market could slow or even reverse the pattern.

Another factor may be the changes in employer-sponsored retirement plans. The shift from defined benefit plans, which frequently are structured to encourage retirement at a specific age, to defined contribution plans which are neutral in terms of when one retires is removing one of the incentives for early retirement. Since contributions to and, usually, the value of investments in defined contribution retirement accounts increase over time, such plans almost always represent an incentive to remain on the job.

The erosion or threat of erosion of defined pensions and retiree health benefits from some employers has likely made many workers less confident that these benefits will be available as anticipated.

Yet another factor that is commonly cited is the enactment of legislation prohibiting employers from establishing mandatory retirement ages for their employees.

Age of retirement

Applying for Social Security retirement benefits is not necessarily the same thing as leaving the labor force. Nevertheless the age at which people first receive benefits can give a rough indication of their retirement patterns. Prior to 2000, nearly half of all male workers

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[24]The "Normal Retirement Age" is the age at which an individual retiring at that age can receive unreduced benefits. For those who reached age 62 prior to 2000, the Normal Retirement Age was age 65. For those reaching age 62 in 2000-2005, it increases by two months each year to age 66 for those reaching age 62 in 2005-2016. Starting with those reaching age 62 in 2017, it will again increase by two months per year until it reaches age 67 for those who reach 62 in or after 2022. Prior to the year of reaching Normal Retirement Age, benefits are reduced by one-half of the excess of earnings over the "exempt amount," which is $12,000 in 2005. No reduction for earnings is made for the month of reaching Normal Retirement Age or any subsequent month. However, benefits in the year of reaching Normal Retirement Age (but prior to the month that age is reached) are reduced by one-third of the excess of those earnings over a separate exempt amount ($31,800 in 2005).

[25]"Song, Jae G., SSA, Evaluating the initial impact of eliminating the retirement earnings test," *Social Security bulletin*, vol. 65 no. 1, 2003/2004.

being awarded Social Security retirement benefits received them at age 62; only about 15 percent waited until 65. Since 2000, there has been a slight increase in the percentage waiting until 65 to receive benefits.

There are some indications that current workers plan to stay in the workforce longer than previous generations. A survey of baby boomers by AARP found that nearly 80 percent intended to work in some capacity during their retirement years, either for enjoyment or because they thought that they would need the money.[26] Another survey, EBRI's 2004 *Retirement Confidence Survey,* found that current workers expect to retire at somewhat older ages than did current retirees. More than half indicated that they intended to retire at 65 or later (or not at all). However, the survey also found that 37 percent actually leave the workforce sooner than intended, primarily for reasons of health or because of downsizing at or closure of their employer.[27]

Demand for elderly workers

If we want older persons to continue in or return to work, it is not enough to consider policy changes designed to encourage them to want to work. It is also necessary to examine the question of whether there will be jobs available for them.

Some changes have already taken place in the private sector to remove impediments to workers staying in the labor force. One of these noted above is the shift from defined benefit to defined contribution retirement plans. Another is the elimination of mandatory retirement in the mid-1980s. Nevertheless, there are still problems in hiring or retaining older workers for profit-oriented companies. One problem is that older workers frequently are more expensive than younger workers. Salaries and benefit packages tend to grow with seniority. Older workers are also more likely to use more health services, thereby increasing the cost of employer-sponsored health insurance plans.

If older workers are going to increase their participation in the labor force in the future both they and their employers will likely need to make some adjustments. Employers may need to offer part time and shared positions and be more flexible on issues such as work hours and locations. Workers may need to be willing to accept lower rates of pay and fewer benefits in order to be more acceptable to employers.

If older workers are going to increase their participation in the labor force in the future both they and their employers will likely need to make some adjustments.

Population shifts suggest that we are moving toward an era of labor shortages. As the baby boom generation moves into retirement and the "baby bust" generation becomes the core of the labor force, there will be a significant change in the supply of labor. A GAO report in January 2003 noted that some economists predict a labor shortage of as many as 35 million workers by 2030.[28] Such a drastic labor shortage could have a significant negative impact on economic growth and seriously compromise the Nation's ability to fulfill its current obligations in terms of both private and public retirement benefits.

There are relatively few potential pools from which to draw the additional workers that will be

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[26]*Baby boomers envision retirement II-key findings: survey of baby boomers' expectations for retirement*; May 2004.

[27]"EBRI, Will Americans ever become savers? *The 14th retirement confidence survey,* 2004," Issue brief no. 268, April 2004.

[28]General Accounting Office, *Older workers: employment assistance focuses on subsidized jobs and job search, but revised performance measures could improve access to other services*, GAO-03-350, January 2003.

needed. A major source of labor force growth over recent decades has been the entry of women into the labor force. However, following several decades of steady growth, the percentage of women entering the labor force began to level off in the 1990s and has even declined slightly from its peak of around 60 percent in the late 1990s. The 2004 Trustees Report projects that the labor force participation rate for women will change little from the current rate.

Another potential source is immigrants. A 2002 study estimates that new immigrants contributed more than 50 percent of the growth in the U.S. labor force in the 1990s.[29] There is considerable uncertainty about the rate of immigration in the future. If a serious labor shortage develops, national policy may encourage greater immigration. However, other social, cultural, and economic effects of very high levels of immigration may restrain such efforts.

A third pool of potential workers in the event of a labor shortage is older workers who would otherwise be retired. Older workers would have both advantages and disadvantages for employers. They are generally seen as having good work habits and would, in many cases, already have developed needed work skills. On the other hand, they are frequently more expensive and are seen as being less adaptable to changing circumstances.

Social Security and other policies to encourage remaining in the labor force

For each individual, the decision about how and when to retire is a very complex issue involving, in part, the amount of available retirement income and assets and also such factors as job satisfaction, availability and desirability of work opportunities, and personal and family health circumstances. It is an important part of national retirement income policy to encourage and assist with the accumulation of sufficient retirement resources through public and private programs to assure economic security in retirement. But, national policy also needs to recognize that continued labor force participation of older workers can:

- assist the national economy in meeting labor force imbalances that are now foreseen as our population ages;
- assist individuals to have a more adequate income during their older years by postponing the point at which they begin to draw down on their savings or by supplementing their retirement income with some continued earnings; and
- benefit both the worker and his employer by continuing to utilize the skills and abilities of the individual.

As policymakers review Social Security and other aspects of retirement security, they should try to assure that program rules and other policies facilitate and encourage continued labor force participation of older workers wherever such participation would be possible and beneficial.

...policymakers...should try to assure that program rules and other policies facilitate and encourage continued labor force participation of older workers....

Social Security policy can have both an economic and a psychological impact on people's concept of the appropriate time to retire. A number of changes have been made that seem likely to have some impact. However, the rules are sufficiently complicated that it is not clear how well their combined effect is understood.

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[29]National Business Round Table, *Immigrant workers and the great American job machine: the contribution of new foreign immigration to national regional labor force growth in the 1990s*, August 2002.

Until the mid-1950s (and until 1962 in the case of male workers), benefits were not available until age 65. When the age of first eligibility was dropped to 62, benefits taken before age 65 were reduced on an actuarial basis so that, on average, the same lifetime benefit total would be paid out regardless of whether benefits were taken at or before age 65. Moreover there was an earnings test that, until age 72, reduced, and in many cases eliminated, benefits for those who continued to have substantial earnings. Concern over the fairness and work incentive impact of the earnings test, particularly for those over 65 (who suffered a permanent loss of benefits by continuing to work), led to several changes in the law:

- on several occasions the amount that could be earned without loss of benefits was increased, with larger increases (and a lesser reduction rate) for those who reached age 65;

- a "delayed retirement increment" was instituted to partially (and, when fully effective, completely) offset the foregone benefits after 65;

- the age at which the earnings test ceased to apply was reduced, first from 72 to 70 and later to the Normal Retirement Age.

The Normal Retirement Age itself, under provisions of the 1983 amendments, is increasing in steps from 65 to 67 for those reaching age 62 from 2000 to 2022 as described earlier.

From an actuarial standpoint, the continued application of the earnings test prior to the Normal Retirement Age creates no particular incentive or disincentive for continued employment since, at least on average, lifetime benefits are not affected. However, it is not clear how well this is understood by potential beneficiaries. The elimination of the earnings test for those who have reached the Normal Retirement Age has removed a clear economic disadvantage to continued employment.

While some studies have been undertaken, it is too early to measure with great confidence the impact on retirement decisions of the changes in the earnings test and the Normal Retirement Age. The increase in the Normal Retirement Age is still being phased in. The elimination of the earnings test after that age became law in 2000 and may have had limited impact on those who had already made retirement plans.

It is important that individuals deciding when to retire should have a thorough understanding of how that decision affects their Social Security benefits. The Social Security Administration's website does provide extensive information about this aspect of retirement planning. However, the rules are complicated and the agency should continue to review its efforts to disseminate information that will help individuals and those who advise them to understand the impact of those rules on their decision to retire from or remain in the workforce.

In considering changes to Social Security and other policies, policymakers need to give attention to the impact of changes on incentives for continued employment and on making those incentives as understandable as possible. There are many changes which, directly or indirectly, could affect employment incentives. Major changes such as modifying benefit levels or the age of eligibility would have obvious impacts, but other changes could also be considered. For example, employment past age 60 is fully subject to Social Security taxes but often has little or no effect on the individual's benefit entitlement. This is often true even for workers who continue to work at or somewhat above their prior earnings levels, but it is especially true for those who wish to partially retire. If policymakers think it is desirable to encourage continued labor force participation, consideration might be given to providing some reward in the system for such continuing contributions to the program. Elimination of the earnings test for those under the Normal Retirement Age would have costs but also might affect participation in the labor force.

VI. HEALTH CARE AS A RETIREMENT SECURITY ISSUE

Health care, as a retirement security issue, swamps all of the other retirement security issues in our country because of rapidly rising health care costs and the growing share of our national economy expended on health care. This section of our report illustrates the magnitude of health care expenditures in relation to the rest of the economy and discusses their impact on retirement security.

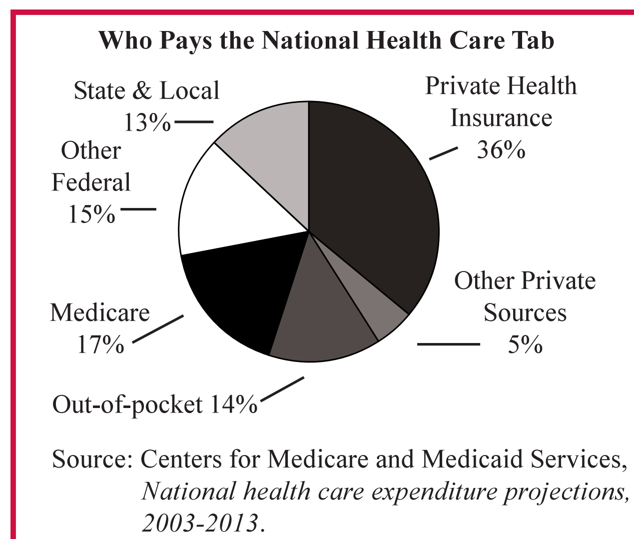
Rising costs of health care[30]

The U.S. spends more on health care than any other Nation in the world. In 2002, Americans spent nearly $1.6 trillion on health care. That is roughly $5,440 per capita or about 15 percent of GDP (about one-seventh of the American economy). As illustrated in Chart 14, our private health insurance system pays about 36 percent of the total. Medicare—the largest *individual* payer and a program that is vital to the economic security of American retirees—currently pays about 17 percent of the Nation's health care tab. Payments from other government programs (at the Federal, State and local levels) total about 28 percent. Out-of-pocket payments account for about 14 percent of the total. Taken together public programs at all levels account for 45 percent and private programs (including individual out-of-pocket costs) account for 55 percent of health spending.

Health care...swamps all of the other retirement security issues....

In addition, health costs are expected to grow rapidly over the coming decades as new therapies proliferate and the population ages. According to the Centers for Medicare and Medicaid Services (CMS), national health spending is projected to grow 2.5 percent per year faster than GDP between now and 2013, at which time health care will constitute about 18.4 percent of GDP. To put these figures in perspective, over the last 50 years, total Federal income tax collections have averaged about 11 percent of GDP.

Chart 14



Source: Centers for Medicare and Medicaid Services, *National health care expenditure projections, 2003-2013*.

A number of factors affect the rate of growth in health care costs in our economy. Among them are increasing life expectancy, the development of more expensive treatments and medical technology, the over-utilization of certain medical services, and the fact that consumers of health care are often ill-equipped to distinguish between more and less useful treatments and, to the extent payment is made through health insurance, have little incentive to make economically rational health care choices.

...health costs are expected to grow rapidly over the coming decades as new therapies proliferate and the population ages.

[30]Data in this section and chart are based on Centers for Medicare and Medicaid Services, *National health care expenditure projections, 2003-2013.*

The 15 most costly medical conditions accounted for half of the overall growth in health care spending between 1987 and 2000. Four out of the top five of the most costly medical conditions—heart disease, pulmonary disease, cancer, and hypertension—are heavily correlated with unhealthy lifestyle choices and potentially more easily prevented. In addition, some experts believe that a significant part of the growing cost of medical care is related to such causes as the delivery of poor quality care and the treatment of conditions that may not warrant the expensive procedures or medications that are devoted to them.

The central role of Medicare and Medicaid in retirement security

In 2003, Medicare provided coverage to approximately 41 million Americans, including 35 million aged and about 6 million non-elderly persons with disabilities.[31] An individual is eligible for Medicare if he or she is age 65 or older or receives Social Security disability benefits (with a two year waiting period for Medicare) or suffers from End Stage Renal Disease; i.e., permanent kidney failure requiring dialysis or a kidney transplant. (For Medicare Part A—Hospital Insurance (HI)—eligibility also requires that the individual be a Social Security beneficiary or be fully insured for Medicare by virtue of employment covered by the Medicare payroll tax.)

Eligibility for Medicaid is somewhat more complicated. There are currently about 42 million persons enrolled in Medicaid programs, including 4.3 million low-income aged individuals and 7.9 million qualified on the basis of blindness or other physical or mental impairment, and about 20 million in low-income families with children. In some cases, Medicaid eligibility flows directly from eligibility for another program such as SSI (in most States). In other cases, specific Medicaid eligibility requirements must be met and evaluated. These may include age; whether the individual is pregnant, disabled, or blind; income and resources (like bank accounts, real property, or other items that can be sold for cash); and status as a U.S. citizen or a lawfully admitted immigrant. The rules for counting income and resources vary from State to State and from group to group. There are special rules for those who live in nursing homes and for disabled children living at home.

Of all of the components of our national healthcare system, Medicare, in particular, is critically important to the financial well-being of older Americans and persons with disabilities. This program pays just under one-fifth of the Nation's total health care tab. However, until recently, Medicare paid more than half of the health care costs for the 41 million Americans enrolled in the program. And with the passage of the new Medicare prescription drug program in 2003, Medicare will become even more central to the economic security of beneficiaries. Nearly 65 percent of Medicare beneficiaries have annual incomes below $25,000. Of the nearly 12 million Medicare beneficiaries who live alone, about 15 percent are over the age of 85, about 72 percent are female, and about 56 percent have annual incomes below $15,000. These beneficiaries are also more likely to suffer from one or more debilitating diseases or chronic conditions that require regular care.

Medicaid, the second tier of health support for many aged and disabled Americans, pays for medical assistance and long-term care services for certain persons with low incomes and limited

Of all of the components of our national healthcare system, Medicare, in particular, is critically important to the financial well-being of older Americans and persons with disabilities.

[31] 2004 Medicare Trustees report.

resources. Some Medicare beneficiaries who do not meet the requirements for full Medicaid eligibility but do meet less stringent income and resource requirements may get help with Medicare premiums and cost-sharing payments through one of several programs available through their State Medicaid program.[32] CMS estimates that Medicaid provides some level of supplemental health coverage for about 6.5 million Medicare beneficiaries who qualify for dual eligibility or premium/co-payment assistance on the basis of low income and limited resources. Medicaid is funded jointly by the Federal and State governments (including the District of Columbia and the territories). For many low-income retirees, Medicaid is the largest source of funding for medical, long-term care, and health-related services.

Medicare and Medicaid financial problems

Like the programs financed through Social Security's Old-Age, Survivors, and Disability Insurance (OASDI) trust funds, Medicare is facing long-term financial shortfalls. But Medicare's financial shortfalls will occur sooner and be much larger—and more difficult to resolve—than those of Social Security. This deterioration is mainly due to higher than expected hospital expenditures, lower than expected taxable payroll, and new legislation that has added significant new costs to the program.

Since the release of the 2003 Trustees Report (which preceded the enactment of the *Medicare Prescription Drug, Improvement and Modernization Act of 2003*), there has been a significant deterioration in the financial outlook of the Medicare program.

With the aging of the baby boomers and recent expansions in the program, the number of people Medicare serves each year is expected to nearly double, from about 41 million today to about 79 million by 2030. As a share of the total population, Medicare beneficiaries are expected to grow from about 14 percent today to around 23 percent by 2030. At the same time, medical prices are expected to continue rising much faster than overall consumer prices. In 2003, Medicare expenditures represented about 2.6 percent of GDP. But with the enactment of the new Medicare Prescription Drug benefit, total Medicare expenditures are expected to rise to 3.4 percent of GDP in 2006. As the Medicare population continues to grow, its share of the economy will increase to about 7.7 percent of GDP by 2035 and to 13.8 percent by the end of the 75-year valuation period.

Starting in 2004 the Hospital Insurance trust fund is paying out more than the tax revenue takes in, thus relying in part on trust fund interest earnings to meet its obligations. By 2019—just 14 years from now—the HI trust fund is projected to reach the point at which it is unable to pay claims in full. The projected 75-year actuarial deficit for the HI trust fund is now projected at 3.12 percent of taxable payroll, up significantly from the 2.40 percent in the 2003 Trustees Report. This deficit is the equivalent of an immediate increase of 3.12 percentage points in the payroll tax. As with Social Security, this representation of the deficit is an average over 75 years. The 2004 deficit is less than a tenth of a percent of taxable payroll but it grows to 1.51 percent by 2025 and to 9.63 percent by 2080. By the end of the 75-year valuation period, scheduled payroll taxes will cover only 25 percent of scheduled benefits.

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[32]Qualified Medicare Beneficiaries (QMBs), Specified Low-Income Medicare Beneficiaries (SLMBs), Qualified Disabled and Working Individuals (QDWIs), and Qualifying Individuals (QIs).

Both the Supplemental Medical Insurance (SMI) Program and the new Medicare Prescription Drug Program are projected to remain adequately financed into the indefinite future since financing for these programs is automatically adjusted, under statute, on an annual basis to meet the next year's costs. However, these automatic adjustments will result in a rapidly growing share of general tax dollars to finance these programs. The general revenue share of these programs is projected to rise from just under 1 percent of GDP today to 6.2 percent by 2078. In addition, substantial increases in beneficiary premiums are also projected over the same period.

The rapid increase in the cost of health care not only drives up the program costs for Medicare but also increases the extent to which individuals must expend part of their retirement income resources to meet costs not paid for by the program. A table by the CMS actuary's office based on the projections in the 2004 Trustees Report (Table 5) shows that out-of-pocket expenses will consume a larger and larger portion of retirement income.

Table 5

Out-of-pocket Costs as Percent of Average Social Security Benefit

	Hospital Insurance	Supplemental Medical Insurance		
		Part B	Part D	Total
2006	2.6	16.0	18.6	37.2
2010	2.6	15.2	21.4	39.2
2020	2.6	17.4	28.8	48.9
2050	4.0	25.1	41.3	70.5
2078	5.7	34.9	56.4	97.0

Source: CMS, Office of the Actuary, July 2004. Based on an example of a 65-year-old beneficiary paying the standard premium, with average level of co-payments and deductibles for all aged beneficiaries, average Social Security benefit.

The rapid increase in the cost of health care not only drives up the program costs for Medicare but also increases the extent to which individuals must expend part of their retirement income resources to meet costs not paid for by the program.

Due to budgetary constraints across the Nation, many State governments plan to undertake Medicaid cost containment strategies in the near future. According to a 2003 survey conducted by the Kaiser Commission on Medicaid and the Uninsured: 39 States have indicated that they plan to reduce or freeze provider payments; 18 States have indicated that they plan to reduce or restrict Medicaid eligibility; 17 States have indicated that they plan to reduce Medicaid benefits; and 21 States have indicated that they plan to increase recipient co-payments. Beginning in 2006, Medicaid spending is expected to decrease markedly from earlier projections as the new Medicare prescription drug benefit goes into effect. Some offset to these Medicaid savings is expected, however, due to an increase in spending from a higher enrollment of dual eligibles. It is expected that, as Medicare beneficiaries apply for the Medicare low-income drug subsidy, some will be discovered to be eligible for Medicaid. Overall growth in Medicaid spending is expected to peak at 9.2 percent in 2006 and then slow to 8.3 percent by 2013. This is still substantially greater than the expected rate of growth for the economy as a whole.

The Board has heard from the Congressional Budget Office and the Government Accountability Office (GAO) that, even without considering the additional costs of prescription drugs through Medicare, if current cost trends continue, the combination of Medicare,

Medicaid and Social Security expenditures will reach about 15 percent of GDP by 2030 and will continue to grow in the years following 2030 reaching (as noted earlier) 18 percent of GDP by 2050. Today, these expenditures account for about 8 percent of GDP.

...if current cost trends continue, the combination of Medicare, Medicaid and Social Security expenditures will reach about 15 percent of GDP by 2030....

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 made a number of significant changes to the Medicare program, including the creation of the new Medicare Part D prescription drug benefit that will begin in 2006. At the time the legislation was enacted, Government estimators placed the total cost of this legislation at somewhere between $395 billion (CBO estimate) and $534 billion (CMS estimate) over 10 years from 2004 to 2013.

Moreover, possible further Medicare and Medicaid expansions have the potential to drive the costs of those programs, and health care costs in general, significantly higher. A number of future program changes that have been discussed include expansions in coverage for services and treatments for Alzheimer's patients, expansion for long-term care, and other changes.

Trends in private health insurance

The double digit increases in health care costs in recent years have also affected private sector programs. In meetings with economists, representatives from the business community, and representatives from organized labor, the Board has heard unequivocally that one of the biggest threats to employer-sponsored pensions is the rising cost of health care and health insurance, and that the viability of private retirement systems depends on controlling health costs. There are three basic pillars to employee compensation: (1) wages and salaries; (2) pensions; and (3) health coverage. The amount of health coverage that employers can provide is inextricably linked with the wages that are paid, and the type and generosity of the private pension system that is offered. Expansions in one area often necessitate contractions in another. Because of rapidly rising health care costs, employers feel that they have to choose between pensions, health coverage, and employee pay. This trade-off often results in higher health care premiums and greater out-of-pocket costs for employees and retirees alike.

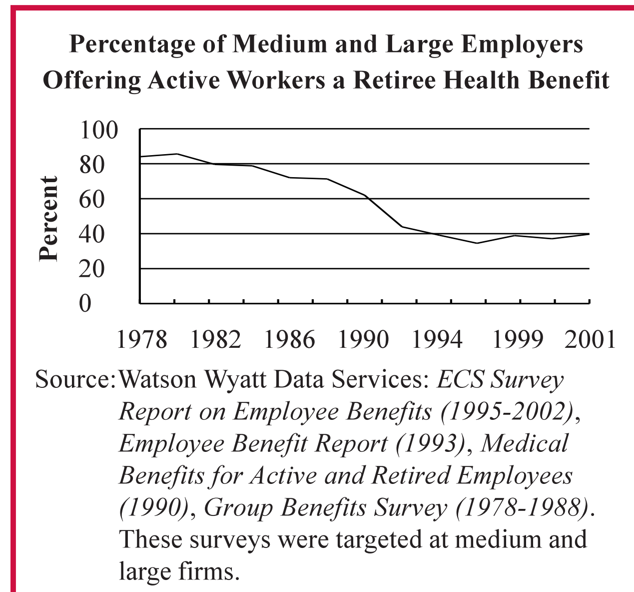
...one of the biggest threats to employer-sponsored pensions is the rising cost of health care....

For all sizes of employers, retiree health care premium increases were substantial in 2003, ranging from about 12 percent to nearly 16 percent. In addition, retirees are now paying a larger and significant share of these health care premiums themselves. Many companies are changing their benefits and premium structures to control costs. For instance, they are creating defined contribution-type health care plans, much like Medical Savings Accounts, that employees or retirees can choose to spend on premiums or other health expenses. Many are also keeping retirees in their health insurance groups or pools so that they can still get group rates but with the employer paying for less and less of the coverage. In addition, many plans are ending benefits for new hires or future retirees.

Department of Labor officials told the Board that smaller firms are much less likely to offer retiree health insurance than larger firms. Even for larger firms, however, there has been a significant decline in retiree health benefit offerings. As shown in Chart 15, the percentage of medium and large employers that offer a retiree health plan to active employees has

declined substantially over the past quarter century, falling from over 80 percent in the late 1970s to about 40 percent in 2001. Moreover, as indicated above, even those employers who still offer such plans have, in many cases, limited the extent of coverage.

Chart 15



Source: Watson Wyatt Data Services: *ECS Survey Report on Employee Benefits (1995-2002)*, *Employee Benefit Report (1993)*, *Medical Benefits for Active and Retired Employees (1990)*, *Group Benefits Survey (1978-1988)*. These surveys were targeted at medium and large firms.

Long-term care and retirement security

The picture of health care coverage as a part of retirement security is greatly complicated by the increasing need for long-term care as the population ages. It has been estimated by CBO that about 55 percent of those who are 85 or older require long-term care.[33] The number of persons in this age category, 4.2 million in 2000, is projected to grow rapidly to 9.6 million by 2030 and to 20.9 million by 2050.[34]

The picture of health care coverage as a part of retirement security is greatly complicated by the increasing need for long-term care as the population ages.

Long-term care has been defined as hands-on assistance provided to people with chronic impairments who are in need, over a substantial period of time, of help with fundamental daily activities, such as eating, walking, dressing, and bathing. This type of assistance is labor intensive and expensive and is typically supplied by a combination of family, friends, volunteers, and hired personnel. It can be provided in the home, in group homes, in adult day-care and other community-based settings, in a hospice, and in institutional settings such as nursing homes or other facilities that offer assisted living or a continuum of care options. It has been estimated that in 2004, about 83 percent of persons needing long-term care services live in their own homes and the majority—78 percent—do not hire any outside or professional help. As such, families, friends, and volunteers play a critically important part in the delivery of long-term care services.[35]

Paying the costs of long-term care.[36]— According to recent estimates from the Congressional Budget Office, total national expenditures for long-term care services provided in the United States in 2004—excluding the value of care donated by family, friends, and volunteers—is expected to be about $135 billion. Costs per person vary widely. CBO has estimated that elderly persons receiving some form of long-term care in 2004 will incur costs that average $15,000. Private room nursing home care in 2003 cost an average of $181 per day ($66,000 per year).

The majority of long-term care recipients rely heavily on public programs to finance the long-term care services they receive. In 2004, the portion of total long-term care expenditures paid by Medicaid and Medicare together is likely to

[33] CBO, *Financing long-term care for the elderly*, April 2004, p. 1.

[34] Federal Interagency Forum on Aging-Related Statistics, *Older Americans 2004: key indicators of well-being*, 2004.

[35] CBO, *Financing long-term care for the elderly*, April 2004.

[36] Except where noted, data in this section based on: CBO, *Financing long-term care for the elderly*, April 2004.

The majority of long-term care recipients rely heavily on public programs to finance the long-term care services they receive.

reach nearly 60 percent, or $81 billion. Of these two large public programs, Medicaid is the dominant payer for long-term care services. The Congressional Budget Office reports that, in 1997, 56 percent of nursing home residents were poor enough to qualify for Medicaid coverage (with another 15 percent receiving some nursing home coverage from Medicare). Medicaid covers the care of people with very low incomes. However, the program's eligibility rules also permit middle-income people—including some whose income in retirement leaves them fairly comfortable—to qualify for coverage by exhausting or "spending down" their income and assets. In 2004, Medicaid paid for 35 percent, about $48 billion, of total long-term care costs.

Medicare, like most private health insurers, covers only limited long-term care services, such as home health care or nursing home care, that aid a beneficiary in recovering from a specific *medical* condition. It does not cover any long-term care services that are needed because of non-medical factors related to old age; i.e., it does not pay for custodial care. Still, in 2004, Medicare is expected to pay for 25 percent, or nearly $34 billion, of total long-term care costs.

Most health care financing experts contend that the value of donated care, which is not included in the estimates above, exceeds that of any other category of long-term care financing. These costs are difficult to quantify precisely in dollar terms because the data and research needed to do so are lacking. However, it is widely agreed that these costs have been undervalued by policymakers in developing financing approaches for long-term care. In 2004, the Congressional Budget Office estimated that replacing donated long-term care services for seniors with professional care would cost between $50 billion and $103 billion per year.[37] Another study published in 1999 indicated that, when measured in terms of foregone wages, donated care also costs the families and friends providing that care about $196 billion per year.[38]

Changes in demand and supply of long-term care services.—As the population ages over the next 15 years, the number of people who need long-term care services is expected to increase by 30 percent. And soon thereafter, the number of people likely to need long-term care is expected to increase even more dramatically. The U.S. Department of Health and Human Services and the U.S. Department of Labor estimate that the number of people needing long-term care services will more than double between 2000 and 2050.[39] These same government estimators also predict that the number of people requiring *paid* long-term care services—such as those delivered in nursing facilities or assisted living facilities, or by home-care professionals—could also nearly double, increasing from 15 million in 2000 to 27 million by 2050. Over the same period, the U.S. Department of Health and Human Services and the U.S. Department of Labor have predicted that spending on long-term care services could nearly quadruple in constant dollars to $379 billion by 2050.

...the number of people needing long-term care services will more than double between 2000 and 2050.

[37] Department of Health and Human Services, Office of the Assistant Secretary for Planning and Evaluations, *Informal caregiving: compassion in action*, June, 1998. CBO has updated these figures to 2004 dollars.

[38] Arno, Peter S., Carol Levine, and Margaret M. Memmott, "The economic value of caregiving," *Health affairs*, vol. 18, n. 2 (1999).

[39] U.S. Department of Health and Human Services and U.S. Department of Labor, *The future supply of long-term care workers in relation to the aging baby boom generation: a report to Congress*, May 14, 2003.

Complicating this picture is the likelihood that there will be considerable challenges in finding an adequate supply of workers to satisfy the increased demand for long-term care occupations. As the baby boom ages, the long-term care sector will increasingly be forced to compete with the rest of the economy for a supply of available workers that is growing slower than demand. Other demographic factors will also shape the supply of informal care-giving. Aging baby boomers are likely to demand paid caregivers or rely more heavily on their spouses for informal caregiving because they have fewer children than previous generations, their grown children are becoming increasingly mobile and often live greater distances from their aging parents, and both husbands and wives are living longer, decreasing the life-expectancy gender gap. However, lower rates of marriage and higher rates of divorce could also result in greater numbers of baby boomers moving into middle and older ages without a spouse to act as caregiver.

Advance funding of long-term care through insurance.—According to recent insurance industry data, since the introduction of private long-term care insurance into the insurance market about a quarter of a century ago, the rate of growth in the number of private long-term care policies sold has averaged about 18 percent per year. Yet the cumulative number of private long-term care policies sold during that same period did not exceed 10 million. Of those policies sold in 2002, 68 percent were sold directly to individuals while 32 percent were offered as part of employer-sponsored benefit packages. All premiums for policies purchased prior to the enactment of the *Health Insurance Portability and Accountability Act of 1996* (HIPAA) qualify for a Federal tax deduction. However, policies purchased after the enactment of HIPAA must conform to specific standards established in the law for their premiums to be tax deductible. The HIPAA standards for tax qualification include such things as specific rules for premium structures and benefit triggers. In 2002, 90 percent of private long-term care policies sold qualified for the tax deduction.[40] This tax benefit is, however, limited to people who itemize and whose total medical and dental expenditures exceed 7.5 percent of adjusted gross income. Despite the tax-advantaged treatment of some premiums for private long-term care insurance, uptake of long-term care policies among the general public has been limited.

Several bills recently introduced in Congress have proposed new tax incentives to encourage greater numbers of individuals to purchase private long-term care coverage and reduce their reliance on public programs to finance their long-term care needs.[41] These proposals have recommended changes to the Internal Revenue Code that authorize “above the line” tax deductions for all or part of insurance premiums for qualified long-term care insurance plans. This change would expand the current tax-advantaged treatment of long-term care premiums to everyone, not just to those individuals who itemize and whose total medical and dental expenditures exceed 7.5 percent of adjusted gross income. A similar proposal was also included in the fiscal year 2005 President’s Budget. In addition, some proposals, both in Congress and from the insurance industry, have recommended including accelerated deduction percentages for persons who are 55 years of age or older or providing other age-based deduction schedules that begin at younger ages.[42]

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[40]America’s Health Insurance Plans, *Research findings: long-term care insurance in 2002*, June 2004.
[41]S. 1335, H.R. 2096, H.R. 1406, and S. 2077.
[42]LTC Consultants, *Legislative backgrounder: long-term care—the real health crisis in America*, 2002.

Conclusion

Health care is the most intractable of all retirement security issues because of rapidly rising health care costs and the growing share of the economy comprised by health care expenditures. As with Social Security, the financial problems of Medicare and Medicaid cause many people to doubt that these programs will be able to continue providing the kind of support for retirees and persons with disabilities as they have in the past.

Over the past year, the Board has discussed the escalation in health care costs with many experts. There are many reasons why health costs are continuing to increase at a rate that exceeds the rate of economic growth, and there is no single, obvious, or simple way to reduce that growth substantially. Some of the major reasons for the current and projected growth are the increase in the size of the aged population, the development of new technologies and treatments, and the nature of the systems for delivering and financing health care. Among the many suggestions that the Board has heard as to how cost escalation might be tempered were: research efforts to better evaluate the relative value of new technologies, efforts to improve the quality of health care so as to reduce wasteful or damaging practices, making consumers better informed, and changing incentives inherent in the system that tend to result in unnecessary or inappropriate expenditures. Finding ways to achieve these general objectives will be a long-term process requiring much careful study and thoughtful policy development by experts and policymakers. This is an on-going process in which some progress has already been made but much more will be needed.

Given the large anticipated demand for long-term care, it is also essential that serious attention be paid to that aspect of retirement security. Some efforts have been made to encourage advance funding of long-term care needs through insurance including tax incentives adopted in the *Health Insurance Portability and Accountability Act of 1996*, but the results to date have been minimal. More attractive, age-related, tax incentive policies for the purchase of long-term health care insurance seem imperative.

Health care is the most intractable of all retirement security issues because of rapidly rising health care costs and the growing share of the economy comprised by health care expenditures.

VII. SUPPLEMENTAL SECURITY INCOME

Program description

Supplemental Security Income is a program that makes cash payments to aged, blind, and disabled individuals with low income and assets. In terms of the overall picture of retirement security, SSI provides a floor of income support at a level which society finds to be the minimum acceptable national standard. The program's expenditures are small compared with those of the Social Security program, but SSI is vitally important for those aged, blind, and disabled individuals who qualify for only a very small Social Security benefit—or none at all—and who lack alternative means of self-support.

The SSI program establishes a Federal benefit rate annually. Most States supplement the Federal SSI payment. Countable income is compared to this combined Federal-State payment level to determine eligibility and payment amount. Many States limit their supplementation to certain categories of individuals with special needs, such as special housing.

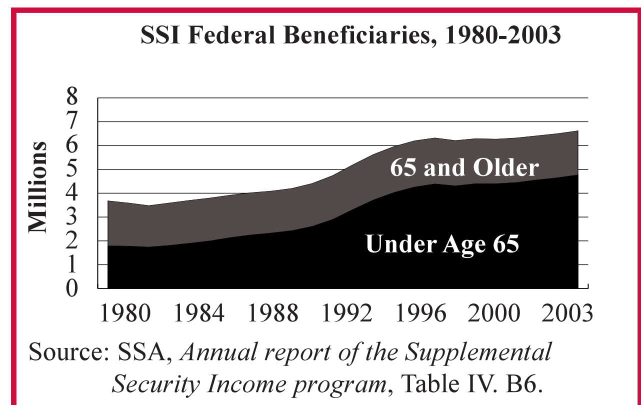
The amount of SSI benefits an individual receives depends on the amount of other income he or she has available. The first $20 per month of earned or unearned income does not affect benefits, but unearned income above that amount reduces SSI benefits dollar-for-dollar. In addition to the disregard of the first $20 of any income, the first $65 per month of earned income does not affect benefits, but amounts over that reduce benefits by $1 for every $2 earned. These amounts, referred to as income disregards, have not changed since the program was enacted in 1972.

...SSI provides a floor of income support at a level which society finds to be the minimum acceptable national standard.

To receive SSI, applicants must have countable resources valued at less than $2,000 for an individual and $3,000 for a couple. The resource limits have been at that level since 1989. Some resources, such as a home and an automobile, are not countable.

The Federal benefit rate for an individual has increased from $140 in 1974 to $579 in 2005. Because benefit rates are adjusted for inflation, however, benefit rates in constant dollars have varied only slightly, and Federal benefits have been about 70 percent of the poverty threshold for an individual under 65. Since the program began, an individual receiving Social Security and SSI would be at about 80 percent of the poverty threshold, and a couple receiving Social Security and SSI would be at about 90 percent of the poverty threshold. (Although the Federal SSI income standards are below the poverty thresholds, not all SSI recipients are below the poverty level. State supplements, income which is not counted because of disregards, or income of other household members may keep an SSI recipient above the poverty line.) Federal payments in constant 2004 dollars grew from $14 billion in 1974 to $33 billion in 2003. Over the life of the program, SSI benefit payments have ranged from 0.2 percent to 0.3 percent of GDP.

Chart 16



Source: SSA, *Annual report of the Supplemental Security Income program*, Table IV. B6.

Table 6

Program Highlights

Benefit Payments

- As of December 2004, 6.7 million people received Federal SSI benefits, of whom 1.8 million were 65 or older.
- The Federal monthly income support level for 2005 is $579 for an individual and $869 for a couple. The average individual Federal payment in December 2004 was $301.21 for beneficiaries 65 or older.
- Federal payments in 2004 were approximately $6.9 billion for beneficiaries 65 or older.

Beneficiaries

- Thirty-six percent of beneficiaries 65 or older have no income other than SSI. Another 47 percent have no income other than Social Security and SSI.
- Ninety-eight percent of beneficiaries 65 or older have Medicaid.

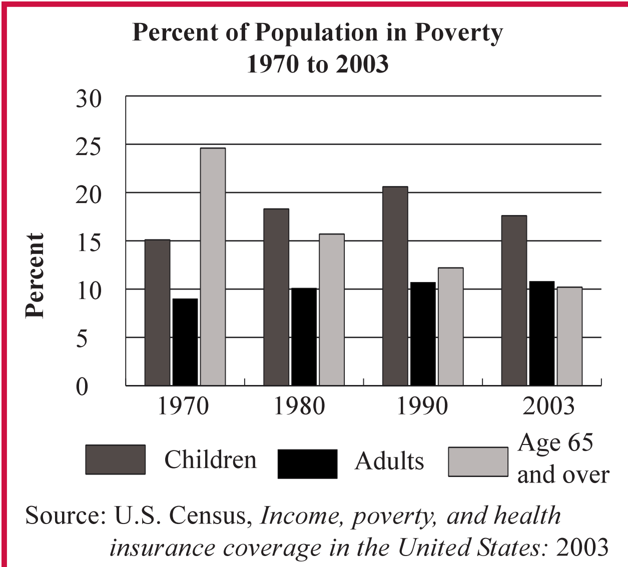
Source: SSA, data from www.SocialSecurity.gov

The Supplemental Security Income program is designed as a safety-net or residual program to meet the very basic needs for income and, through its categorical relationship to Medicaid, health care for those who have not accumulated sufficient protection from Social Security or other public and private programs. In Federalizing the public assistance programs for the aged, blind, and disabled in the 1972 legislation, Congress hoped to assure those individuals a more adequate level of income support through a program that would also be more uniformly and simply administered than was the case under the pre-existing State and county welfare programs.

Substantial progress has been made over the last several decades in the elimination of poverty among the aged. As Chart 17 shows, the percentage of children and non-aged adults in poverty has been relatively stable compared with the aged who have seen poverty rates decline from nearly a quarter of the aged population in 1970 to about a tenth in 2003.

Substantial progress has been made over the last several decades in the elimination of poverty among the aged.

Chart 17

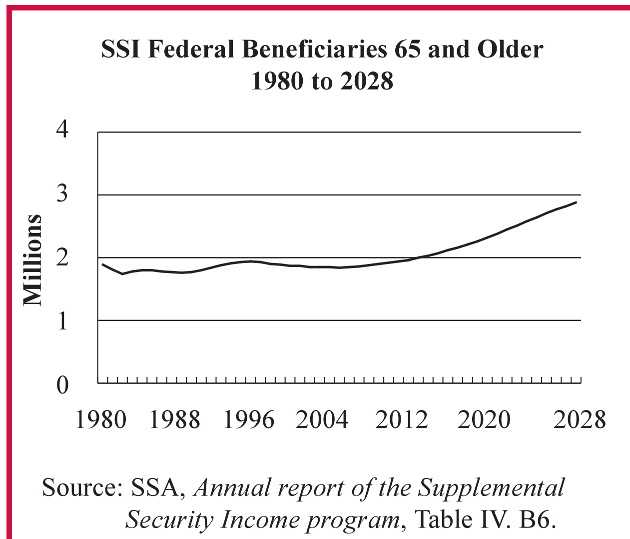


Source: U.S. Census, *Income, poverty, and health insurance coverage in the United States:* 2003

Several factors have contributed to this decline including growth in Social Security benefit levels and growth in the proportion of the aged receiving Social Security benefits. After adjustment for inflation, the average Social Security benefit for a retired worker grew by over 60 percent between 1970 and 2003. As of 1999, there were 3.2 million aged individuals with incomes lower than the poverty level, and about 900,000 of these were SSI recipients. However, an additional 400,000 aged individuals would be in poverty but for their SSI payments.

Ad hoc increases in Social Security benefit levels in 1972 undoubtedly contributed substantially to reducing the proportion of the aged who would otherwise have been receiving SSI. The number of SSI recipients aged 65 and over was relatively stable over the past quarter century even though the population in that age group grew by 40 percent.

Chart 18



Source: SSA, *Annual report of the Supplemental Security Income program*, Table IV. B6.

In part this may be explained by the fact that many of the oldest of those recipients had been of working age at a time when Social Security coverage was not as nearly universal as it now is. Consequently, the more recent cohorts of potential recipients would be more likely to have sufficient Social Security coverage to prevent their needing SSI. Also, the indexing of Social Security initial benefits to wage growth meant that many potential SSI recipients would likely have had higher Social Security benefits that raise their income above SSI eligibility levels. As shown in Chart 18, the situation will change over the next quarter century with the projected absolute number of older SSI recipients increasing by about 1 million. One reason is an even larger growth in the aged population as a result of increasing longevity and the baby boom. The number of individuals aged 65 and over will grow by about 80 percent between now and 2027. The increase in the Normal Retirement Age for Social Security benefits may also contribute to a rise in SSI-aged recipiency. Older individuals with low incomes are likely to take Social Security benefits at age 62, and the increased NRA translates into age-62 benefits which will ultimately be 70 percent rather than 80 percent of the full benefit rate. The large increases in the number of SSI disability recipients also may have implications for the growth in the SSI-aged rolls as these individuals reach age 65.

As policymakers address changes in Social Security and in policies affecting pensions, savings, and health care, they need to be aware of how these policies affect those at the safety-net level and whether the changes can include features that reduce the need for older persons to rely on needs-based programs. The interaction between policy goals for SSI and those for other programs can, however, be complicated.

Implications for potential changes in Social Security

Proposals for reforming Social Security could impact the SSI program. For example, reductions in Social Security benefit levels or

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increases in the Normal Retirement Age, resulting in reduced benefits at a given age, would increase the number of SSI recipients unless the proposals were structured to limit the reductions only to individuals with higher levels of benefits or to affirmatively increase lower level benefits in order to reduce SSI dependency. In considering changes to Social Security that might have the impact of making more individuals eligible for SSI, policymakers should also take into account the fact that a large number of those currently eligible do not apply for SSI benefits. Researchers who have studied the participation rate of people eligible for SSI-aged benefits have estimated it at between 45 and 63 percent. The reason for this low participation rate is not clear. Some have suggested that it results from a lack of knowledge about the program and eligibility standards. Others have suggested that the difficulty of applying or the stigma of receiving needs-based benefits are obstacles. Recent work indicates that eligible individuals who are close to the income and resource limits are less likely to apply than other potential eligibles, and that participation increases with need and with the availability of State supplements.

Proposals involving individual accounts would need to deal with the likelihood that potential SSI eligibility would have an impact on incentives. For example, likely SSI beneficiaries would have an incentive to accept high levels of risk, since they would be unaffected by losses and unlikely to realize gains with moderate risk.

VIII. CONCLUSION

Over the course of the 20th century, America faced and overcame many challenges and made many great advances. In the area of income and health security for our older population, the Nation established the social insurance programs of Social Security and Medicare. These form a solid core of economic security around which other layers of protection are added through employment-based private programs, individual savings, and continuing participation in the workforce. And we also have established important safety-net programs including SSI and Medicaid. All of these elements will continue to be important parts of economic security for today's retirees, for those now of working age who need to prepare for their future, and for generations yet to come. As we move into the new century, we face new challenges that must be addressed so that these institutions on which older Americans rely for economic security can continue to carry out that mission. The future is never perfectly predictable. We are likely to encounter both problems and opportunities that we cannot now foresee. But, we can address those challenges and issues which we now do foresee, and, by doing so, position ourselves better to deal with whatever else the future will bring.

These are the challenges that we can predict and that we need to address:

- The Social Security Old-Age, Survivors, and Disability Insurance program is the Nation's fundamental program of income security for older Americans. The best current projections show that it has significant long-range deficits. These need to be remedied soon so that confidence in the program can be maintained and so that individuals and employers can rationally plan how to supplement it.

- Health care costs are clearly on an unsustainable path that is undermining the financial stability of the Medicare program and also placing great stress on individuals, employer-based health and pension programs, and the Federal budget. Major attention is needed to find ways to rationalize the health care system, constrain its costs, and improve the quality of care.

- Employer-based pensions are undergoing major changes for a variety of reasons including changes in the needs of employers and workers in our modern economy and regulatory burdens and uncertainty. Policies need to be shaped to assure that these pensions continue to contribute to economic security in retirement and to expand their coverage to better fill gaps in protection, particularly for lower-income workers.

- Americans are living longer and enjoying better health in their older years and the relative size of the older and younger population groups is changing in ways likely to increase the need to expand the workforce through greater participation by older workers. Policymakers should examine the rules and incentives provided by public programs and regulations with a view to facilitating and encouraging continuing labor force participation of older workers.

- As a Nation, we need to do a much better job of educating ourselves about economic security. While some commendable efforts have been made by public and private entities in encouraging workers to plan for retirement and to encourage increased savings, the results thus far are clearly inadequate. This needs to become a major national priority.

APPENDIX: Research about Retirement Security

Policymakers depend on research to inform them of the likely consequences of policy changes. There is much that they need to know about the dynamics of retirement choices. For example, on the macroeconomic level, analysis is needed on the potential effect on savings of various approaches to strengthening Social Security. Further work is also needed on the relationships between Social Security and other government-sponsored income security programs, the national economy, and socioeconomic factors. Policymakers also need research that will help them consider the distributional effects of choices they may make on the whole spectrum of economic and demographic groups in our society. They also need insight into the administrative impacts of potential changes to the retirement security system. And the fairly new field of behavioral economics can be expected to shed additional light on the choices that people make and why they make them.

SSA conducts research to provide policymakers with information on the economic, distributional, and administrative aspects of potential new directions for retirement security. SSA is also helping to provide the research that policymakers need through its Retirement Research Consortium. The Consortium consists of research centers housed in three institutions (Boston College, the University of Michigan, and the National Bureau of Economic Research) and is funded by SSA. The main goals of the Consortium are to conduct research and develop research data, to disseminate information on retirement and SSA-related social policy, and to train scholars and practitioners. We commend SSA for undertaking this effort and encourage the agency to guide this effort so that it produces new research that is useful to policymakers.

Microsimulation models are tools to estimate the consequences of proposed changes on groups of beneficiaries. SSA has a microsimulation model that matches actual earnings records with survey data and can conduct a distributional analysis of proposed changes to the Social Security program. SSA's Office of the Chief Actuary provides program projections, analyzes proposals for program change, and provides useful information to policymakers. The Congressional Budget Office has also developed models that provide both financial projections for the program and distributional analyses for potential changes to the program. We encourage both SSA and CBO to continue with this important work.

There are a number of datasets that collect survey data that have proven to be valuable resources to researchers. Linking these datasets to SSA's administrative records expands their usefulness and broadens the range of questions that the data can address. Privacy concerns limit the availability of this matched data, however. SSA is working on making public use files available that match survey data with administrative files in a way that does not disclose the identity of individuals. This is a useful step forward. It is in the public interest to make matched data available to qualified researchers to the greatest extent possible, consistent with privacy concerns.

ABBREVIATIONS KEY

AARP	Originally named the American Association for Retired Persons, now known simply as AARP
BLS	Bureau of Labor Statistics
CBO	Congressional Budget Office
CMS	Centers for Medicare and Medicaid Services
DB	Defined Benefit
DC	Defined Contribution
EBRI	Employee Benefit Research Institute
ERISA	Employee Retirement Income Security Act
GAO	Government Accountability Office (formerly the General Accounting Office)
GDP	Gross Domestic Product
HI	Hospital Insurance
HIPAA	Health Insurance Portability and Accountability Act of 1996
IRA	Individual Retirement Account
NRA	Normal Retirement Age
OASDI	Old-Age, Survivors, and Disability Insurance
Part A Medicare	Hospital Insurance
Part B Medicare	Supplemental Medical Insurance
Part D Medicare	Prescription Drug Program
PBGC	Pension Benefit Guaranty Corporation
QDWI	Qualified Disabled and Working Individual
QI	Qualifying Individual
QMB	Qualified Medicare Beneficiary
SCF	Survey of Consumer Finances
SLMB	Specified Low-Income Medicare Beneficiary
SMI	Supplemental Medical Insurance
SSA	Social Security Administration
SSAB	Social Security Advisory Board
SSI	Supplemental Security Income

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Hal Daub, Chairman

Hal Daub is currently President and Chief Operating Officer of the American Health Care Association and the National Center for Assisted Living, and Of Counsel with the law firm of Blackwell Sanders Peper Martin in Omaha, Nebraska and Washington, D.C. Previously, he served as Mayor of Omaha, Nebraska from 1995 to 2001, and as an attorney, principal, and international trade specialist with the accounting firm of Deloitte & Touche from 1989 to 1994. Mr. Daub was elected to the United States Congress in 1980, and reelected in 1982, 1984, and 1986. While there he served on the House Ways and Means Committee, the Public Works and Transportation Committee, and the Small Business Committee. In 1992, Mr. Daub was appointed by President George H.W. Bush to the National Advisory Council on the Public Service. From 1997 to 1999, he served on the Board of Directors of the National League of Cities, and from 1999 to 2001, he served on the League's Advisory Council. He was also elected to serve on the Advisory Board of the U.S. Conference of Mayors, serving a term from 1999 to 2001. From 1971 to 1980, Mr. Daub was vice president and general counsel of Standard Chemical Manufacturing Company, an Omaha-based livestock feed and supply firm. A former U.S. Army Infantry Captain, Mr. Daub is a graduate of Washington University in St. Louis, Missouri, and received his law degree from the University of Nebraska. Term of office: January 2002 to September 2006.

Dorcas R. Hardy

Dorcas R. Hardy is President of DRHardy & Associates, a government relations and public policy firm serving a diverse portfolio of clients. After her appointment as Assistant Secretary of Human Development Services, Ms. Hardy served as Commissioner of Social Security from 1986 to 1989 and was recently appointed by President Bush to chair the Policy Committee for the 2005 White House Conference on Aging. Ms. Hardy has launched and hosted her own primetime, weekly television program, "Financing Your Future," on Financial News Network and UPI Broadcasting and "The Senior American," an NET political program for older Americans. She speaks and writes widely about domestic and international retirement financing issues and entitlement program reforms and is the author of *Social Insecurity: The Crisis in America's Social Security System* and *How to Plan Now for Your Own Financial Survival*, Random House, 1992. Ms. Hardy consults with seniors' organizations, public policy groups and businesses to promote redesign and modernization of the Social Security, Medicare and disability insurance systems. Additionally, she has chaired a Task Force to rebuild vocational rehabilitation services for disabled veterans for the Department of Veterans Affairs. She received her B.A. from Connecticut College, her M.B.A. from Pepperdine University and completed the Executive Program in Health Policy and Financial Management at Harvard University. She is a Certified Senior Advisor and serves on the Board of Directors of The Options Clearing Corporation, Wright Investors Service Managed Funds, and First Coast Service Options. First term of office: April 2002 to September 2004. Current term of office: October 2004 to September 2010.

Martha Keys

Martha Keys served as a U.S. Representative in the 94th and 95th Congresses. She was a member of the House Ways and Means Committee and its Subcommittees on Health and Public Assistance and Unemployment Compensation. Ms. Keys also served on the Select Committee on Welfare Reform. She served in the executive branch as Special Advisor to the Secretary of Health, Education, and Welfare and as Assistant Secretary of Education. She was a member of the 1983 National Commission (Greenspan) on Social Security Reform. Martha Keys is currently consulting on public policy issues. She has held executive positions in the non-profit sector, lectured widely on public policy in universities, and served on the National Council on Aging and other Boards. Ms. Keys is the author of *Planning for Retirement: Everywoman's Legal Guide*. First term of office: November 1994 to September 1999. Current term of office: October 1999 to September 2005.

David Podoff

David Podoff was a senior advisor to the late Senator Daniel Patrick Moynihan on Social Security and other issues while serving as Minority Staff Director and Chief Economist for the Senate Committee on Finance. While on the Committee staff he was involved in major legislative debates with respect to the long-term solvency of Social Security, health care reform, the constitutional amendment to balance the budget, the debt ceiling, plans to balance the budget, and the accuracy of inflation measures and other government statistics. Prior to serving with the Finance Committee he was a Senior Economist with the Joint Economic Committee and directed various research units in the Social Security Administration's Office of Research and Statistics. He has taught economics at the Baruch College of the City University of New York, the University of Massachusetts and the University of California in Santa Barbara. He received his Ph.D. in economics from the Massachusetts Institute of Technology and a B.B.A. from the City University of New York. Term of office: October 2000 to September 2006.

Sylvester J. Schieber

Sylvester J. Schieber is Director of the Research and Information Center at Watson Wyatt Worldwide, where he specializes in analysis of public and private retirement policy issues and the development of special surveys and data files. From 1981 - 1983, Mr. Schieber was the Director of Research at the Employee Benefit Research Institute. Earlier, he worked for the Social Security Administration as an economic analyst and as Deputy Director at the Office of Policy Analysis. Mr. Schieber is the author of numerous journal articles, policy analysis papers, and several books including: *Retirement Income Opportunities in An Aging America: Coverage and Benefit Entitlement*, *Social Security: Perspectives on Preserving the System* and *The Real Deal: The History and Future of Social Security*. He served on the 1994 - 1996 Advisory Council on Social Security. He received his Ph.D. from the University of Notre Dame. First term of office: January 1998 to September 2003. Current term of office: October 2003 to September 2009.