SOCIAL SECURITY REFORM AND RETIREMENT INCOME POLICY

HEARING

BEFORE THE

SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

WASHINGTON, D.C.

SEPTEMBER 16, 1981

Printed for the use of the Special Committee on Aging

U.S. GOVERNMENT PRINTING OFFICE
88-594 O WASHINGTON: 1982

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

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SOCIAL SECURITY REFORM AND RETIREMENT INCOME POLICY

WEDNESDAY, SEPTEMBER 16, 1981

U. S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, D.C.

The committee met, pursuant to notice, at 2:20 p.m., in room 6226, Dirksen Senate Office Building, Hon. John Heinz (chairman) presiding.

Present: Senators Heinz, Cohen, Chiles, and Bradley.

Also present: John C. Rother, staff director and chief counsel; Larry Atkins and Frank McArdle, professional staff members; Kathleen M. Deignan, minority professional staff member; Ann Gropp, communications director; Robin L. Kropf, chief clerk; Nancy Mickey, clerical assistant; and Eugene R. Cummings, printing assistant.

OPENING STATEMENT BY SENATOR JOHN HEINZ, CHAIRMAN

Senator HEINZ. Our hearing on social security reform and retirement income policy of the Special Committee on Aging will come to order.

Let me say, as we begin this hearing, that I do not think there is any issue of greater current concern to the American people—and especially older persons and workers that are planning to retire—than the solvency of the social security system.

In our earlier hearings, which many of our colleagues, including Senator Cohen of Maine, participated in, we examined the immediate problem in financing social security and discussed alternatives for improving the financial condition of the system in the next 5 years. Today, the committee takes a longer look at social security.

In 35 years, the old-age, survivors, and disability insurance fund may begin to expend more each year than it receives in tax revenues. In 55 years, according to projections, OASDI trust funds may be exhausted.

This projection is due principally to the expected increase in the number of retirees relative to the number of workers. While today there are three workers for every beneficiary of social security, by 2035 there will be only two workers per beneficiary.

These forecasts of future deficits are not new. We have been discussing long-run deficits in the social security system for some time now. What is new and disturbing is the erosion of public confidence in the social security program. I believe Congress must act this year to restore that public confidence not only in the short term, but the long-term future of the social security system.

Today, we will scrutinize the two major long-term proposals before the Congress—raising the retirement age and reducing the rate at which social security benefits replace preretirement wages. Both are controversial. But, nonetheless, I think we have a responsibility to examine these closely and to look further at the relationship between changes in social security and the development of private pension plans and other sources of retirement income.

Social security benefits, we all know, are an important source of income to the retired elderly, but there are many other sources as well. Social security benefits have never been intended, when the law was enacted or since, to be completely adequate to support retirement alone. The administration's proposals to reduce the replacement ratio for social security future beneficiaries raises very significant questions bout the appropriate role for the social security program in relationship to other retirement income mechanisms, specifically, private and public pensions and individual savings.

The second major issue before us is the implication for retirement income of continued low levels of labor force participation on the part of people over age 55. Present evidence suggests that our economy will need these older workers to remain productive longer than has been the case for the current generation of retirees.

At issue here is not just the financial solvency of the social security system, as important as that is. Premature retirement of able workers puts a strain on all retirement programs, private or public, which transfer income from younger workers to older retirees and their dependents. Public policy must begin to develop now, through social security and through other pension mechanisms, the incentives for older workers to remain in the labor force.

In discussing the merits of promoting work and private sources of retirement income, it is important that we remain extremely sensitive to the needs of those who will not be able to work longer. Whenever we speak of encouraging the average worker to work longer, or expecting the average retiree to increase their dependence on other sources of income, we must remember—not everybody will be in a position to respond to incentives to save more or, for that matter, to work longer.

The real issue before us is how to assure an adequate replacement of preretirement income to the retiree from a combination of public and private sources. If, in fact, it becomes necessary to reduce the role of social security benefits in the provision of retirement income, then there must be some assurance that adequate opportunities for employment, and sufficient income from savings and pension can fill the gap.

This hearing, incidentally, may be the last opportunity the Senate will have to carefully review and assess these issues in hearings. I expect the testimony we will receive this afternoon to add clarity to the choices before us and their implications for those of us who will someday retire.

Let there be no mistake about it, I think this committee and the Finance Committee, which may start marking up social security legislation as early as this Friday, is bound and determined to see the social security system remain a vital and important part of the retirement income for older Americans. Those people who say that

the social security system will be no longer for this world, will be, in my judgment, proven totally wrong.

I yield to Senator Cohen.

STATEMENT BY SENATOR WILLIAM S. COHEN

Senator COHEN. Thank you, Mr. Chairman. I have a prepared statement that I would like to submit for the record and just offer perhaps a few observations.

Senator HEINZ. Without objection, so ordered.

Senator COHEN. I am familiar with the expression "Don't just do something, stand there," and I think that is exactly where the Congress finds itself today, because we cannot afford to temporize this issue any longer. We cannot afford to defer the issue indefinitely without deceiving the American public. Something has to be done to make the social security system sound. I think it is important that we do so in a forum like this where we can make the decisions fairly and soundly without emotionalism.

I think we have to try and determine what factors must be taken into account in resolving the issue, what the demographic realities are for today and the trends for tomorrow, and what action can be taken to reassure the people of this country of the integrity of the system. Equally important, we need to know what can be avoided so we do not unnecessarily penalize anyone only to find out later that we were erroneous.

So, Mr. Chairman, I commend you for the way you have conducted these hearings, not only conducted them, but continued with them to see this through to the end for recommendations to come out of the Finance Committee and other committees on the Hill. With the help of these hearings, we can be in a better position to try and make decisions based upon the best possible evidence without resorting to either partisanship or polemics, but with the hard realities that we face.

I want to commend you again for your effort.

Senator HEINZ. I want to thank you.

I want to note one more time that I know of no member of the committee that has been more actively involved in this extremely hot, tough, controversial issue. Thanks to the attention of yourself and Senators like you, the American people can be proud. We will not duck any of these tough issues.

[The prepared statement of Senator Cohen follows:]

PREPARED STATEMENT OF SENATOR WILLIAM S. COHEN

Mr. Chairman, considerable attention has been focused lately on the problems of social security financing. With time running out on the old-age and survivors disability (OASDI) fund, and a short-term deficit projected for as early as the end of next year, the Congress will, for obvious reasons, move to solve the short-term problems as soon as possible.

Solving the short-term problems, however, will not obviate the need to focus attention on the basic problem we face down the road with social security financing. How to keep the system solvent for younger members of the work force who will be working and living longer and whose lifestyles will be dramatically affected by factors over which they will have no control will be our concrern with the long-term financing of social security.

Projections for the long-term social security needs will change constantly. We know that there will be more and more people at the top getting money from a fund supported by fewer and fewer workers at the bottom. Today, three workers support

every social security beneficiary. According to a recent Joint Economic Committee study, the ratio of contributors to beneficiaries will be 2 to 1 by the year 2025.

Over the long term, according to the trustees of the social security system, the deficit could balloon to as much as 14.2 percent of the taxable payroll from the years 2030 through 2054. For the entire 75-year period covered by their projections, the trust funds under the most pessimistic assumptions could average a substantial deficit of 6 percent of taxable payroll.

How we begin to address these problems, of course, will depend on a number of factors. Will there be a substantial shift in fertility rates? Will a shift in the participation by older people and younger women in the labor market make a substantial difference in the number of workers who will be able to support the fund? Will changes in our immigration policy have an effect on the system? Will changes in private pensions influence retirement planning?

I commend Senator Heinz for discussing these issues. Only by sound planning and persistence in seeking the answers to these questions will we be able to plan for the future economic well-being of our younger workers today, and avoid jeopardizing one of the Nation's most effective programs.

Senator HEINZ. Our first witness today will be Joseph M. Anderson. Will you please proceed, Mr. Anderson.

STATEMENT BY JOSEPH M. ANDERSON, PROJECT DIRECTOR, ICF INC., WASHINGTON, D.C.

Mr. ANDERSON. Thank you, Senator Heinz.

I am from ICF Inc. which is a public policy consulting firm in Washington, D.C. Neither ICF or any of its clients should be held responsible for the opinions or information that I offer today.

To provide background for the important hearings the committee is holding today concerning the long-term social security finance problem, I will review three of the very important long-term institutional and demographic factors that characterize the social security finance problem and which must be taken into account in considering any solutions to that problem.

My prepared statement [1] elaborates on these three factors. It also offers illustrative projections of some of the potential effects of several alternative demographic and economic trends and alternative policies that have been considered to deal with the problem.

Three important aspects of the long-term social security picture are: First, the development of alternative sources of retirement income; second, changing trends in retirement years; and third, the demographic changes that influence the dependency rate.

Two alternative sources of retirement income other than social security have emerged since the 1950's that play a big role and must be considered in talking about the long-term social security problem—first, employer-based pensions and, second, public programs other than social security.

Since the 1950's, employer pensions have emerged as an important component of the retirement income system. The number of recipients of all employer pensions increased twelvefold during the period 1950 to 1980, and the number of recipients of private pensions increased seventeenfold.

Specifically, in 1950, the beginning of a decade when important changes in the social security system were brought about, only about 4 percent of the elderly population were receiving private pensions, and about 4 percent were receiving pensions from a former municipal, State or Federal Government employer.

[1] See page 8.

In 1980, about 40 percent of all households that have individuals in the age bracket 65 to 69 were eligible for an employer-based pension or had an individual retirement account, an IRA.

Based on current pension coverage and vesting requirements, and projecting current trends, it is a reasonable guess that roughly half of all households will have employer pensions during the 1990's, and, by the second decade of the next century, up to three-quarters or more of such households will be eligible for employer-based pensions.

These trends do not mean that employer pensions can or should replace social security. A significant number of individuals and households will not be covered by pensions and will not receive benefits. Even among pension beneficiaries, there will be many who will receive small benefits.

Nonetheless, the importance of the employer-based pension system should be considered in formulating social security policy. First, while they cannot replace social security, private pensions and individual arrangements do provide important opportunities for many workers to augment their retirement income considerably. Retirement income growth for many typical workers in the future can come from employer pensions and does not require an expansion of the social security system.

Second, changing the social security system will have important effects on the employer pension system, which must be taken into account. In particular, efforts to reduce social security benefits either through reducing replacement rates or raising the retirement age at which individuals qualify for unreduced social security benefits, will increase pressure on private pension funds to raise or restructure their benefits. This is a matter of public policy importance, in part because employer pensions receive tax preferences. If employer pensions expand as a result of social security cutbacks, some additional cost to the Treasury may arise.

The second important source of retirement income that has emerged in the last three decades are Government programs other than social security. Since 1965, several important sources of income-in-kind for the elderly, especially the low-income elderly, have been developed. The major programs are medicare, which is virtually universal, and medicaid, subsidized housing, energy assistance and food stamps, which are concentrated among the poor. The supplemental security income program provides cash income. If the Congress is concerned about protecting or improving the well-being of elderly poor, then these programs should be the focus of attention.

The second major factor that should be considered in deliberations about financing social security is the change in retirement ages and life expectancy and their effect on the years an individual can expect to live in retirement. The average retiree can now expect to enjoy more years in retirement than he or she could 30 years ago. In 1950, a man retiring at the minimum age for receipt of social security, which was age 65, which was also the typical retirement age, could expect to live an additional 13 years in retirement. A woman retiring at 65, which was also the minimum for women, could expect to have 15 years in retirement.

In 1980, a man retiring at the now lower minimum social security retirement age of 62, which has become the typical age of retirement, could expect to have about 17 retirement years, an increase of over 30 percent. The woman retiring at 62 could expect 22 years in retirement, an increase of almost 50 percent.

This major increase in retirement years is one source of the financial pressures on the system. Life expectancy is expected to continue to increase in the future. Unless modified by policy changes, the trends toward early retirement may also increase.

The employer-based pension system has contributed to the trend toward early retirement. In 1950, retirement ages in most employer-based systems were close to that of the social security system, age 65. Since then, early retirement provisions of employer-based plans have been greatly liberalized. The age of eligibility and years of service required to receive full benefits have been reduced. More and more commonly, benefits available at early retirement are only partly reduced actuarially, and in many plans the full accrued benefit is available at early retirement.

This increased availability of early retirement benefits has accompanied the decline in the average retirement age, and this trend has somewhat exacerbated the financial problems of the social security system.

While the social security retirement benefit is actuarially not sufficient to leave the financial condition of the system completely unaffected by the age of retirement, for two reasons. First, the actuarial reduction considers only benefits and ignores the potential earnings and payroll tax contributions of workers who do not take early retirement benefits. The actuarial reduction is designed so that the expected present discounted value at age 62 of the worker's retirement benefit is unchanged whether he retires at age 62, 63, 64, or 65. However, it ignores the fact that many individuals who do not take early retirement benefits will continue working and paying tax contributions.

Second, although the actuarial reduction leaves the present value of the stream of benefits unaffected by the date of retirement, total benefits are initially increased by a shift toward earlier retirement. Only after several years have passed would the total benefit payments to a population whose members retire earlier be equal to the payments to a population whose members retire later. During years of transition toward earlier retirement, therefore, benefits will be increased.

The contribution of early retirement to the financial problems of social security is small relative to the other causes. Nevertheless, because of the tax preferences extended to employer pension programs, the Congress may be justified in examining whether or not these programs contribute to the financial problems of the social security system by promoting early retirement.

The third important aspect of the long-term social security financing problem is the future trend in dependency rates, which reflect long-term demographic change. The finances of the social security system are highly sensitive to the size of the elderly population relative to that of the working population. Since it is a pay-as-you-go system, retirement benefits are paid from the taxes collected from workers. The size of the retired population relative to

the working population will begin to increase sharply around the year 2015. Because of the fall in fertility rates that has occurred since the mid-1960's, the size of the working population will stop growing at about the turn of the century, while the size of the retired population will continue growing until about 2035.

These demographic trends are the source of the long-term financial problems facing social security. This can be illustrated by the dependency ratio. The size of the elderly population relative to the working age population will roughly double over the next 50 years as the baby boom generation reaches retirement age. However, because the youth dependency rate has fallen since the sixties and is expected to continue to fall, the total dependency rate is not expected to be as high in the next century as during the period from 1960 to 1970.

The long-term social security financing problem, then, is a demographic problem—the potential rise in the size of the retired population relative to the working population. Unlike the short-term problem, it is not an economic problem. Faster economic growth and higher wages and incomes will not take care of the problem, although they may make it easier to find a solution. Voluntarily reducing the trend toward early retirement, without changing the provisions of the social security benefit formula, would also help but would not solve the problem.

In brief, there is no way to maintain the benefit formula and the replacement rates implicit in the current law, and to maintain current retirement ages, and to maintain the current social security payroll tax rates after the baby boom cohorts begin to retire in 2015. Either taxes must increase significantly or other sources of revenues must be found, or replacement rates must be reduced, or the average retirement age must be increased, or some combination of the three.

Thank you.

[The prepared statement of Mr. Anderson follows. Testimony resumes on page 40.]

PREPARED STATEMENT OF JOSEPH M. ANDERSON

Social security represents a complex, very long term set of commitments among individuals of different ages and different generations. Social security is a key element in the long range plans individuals make concerning working, saving and retirement. The structure and characteristics of the social security system provide one of the most important characterizations of how we as a national community manifest responsibility for the well-being of our fellow citizens.

Because of the very long term nature of the system's commitments and processes, it is affected profoundly by the major forces of economic growth and demographic change. For this reason, social security policy must be considered in a very broad and long term context. To provide background for the Committee's consideration of changes in the social security system, this statement briefly reviews the role of the social security system as part of the U.S. retirement income system over a one hundred year period, 1950-2050. This period includes the working lives of most current social security beneficiaries and the years of retirement of most current workers.

The statement has two parts. First, it provides an overview of the retirement income system and its long range prospects. Second, it provides tentative projections of the impacts on the system's finances of alternative demographic, economic, and policy changes in the future.

THE U.S. RETIREMENT INCOME SYSTEM AND ITS LONG RANGE PROSPECTS

The brief overview in this section first describes the main sources of retirement income in the U.S., second examines trends in retirement ages and the number of years spent in retirement and third, reviews past and projected dependency rates.

Sources and Levels of Retirement Income

Table 1 shows the number of beneficiaries of each of the major retirement income programs in the U.S.--the private pension system, the federal civilian and military, state and local government retirement systems, the Supplemental Security Income (SSI) program, and the social security system. The social security system is clearly the most important component of the retirement income system. However, other components have grown rapidly and now provide significant income to a large part of the retired population. The number of private pension benefit recipients was only 14 percent of the number of OASI beneficiaries in 1950 but was 28 percent in 1980.

Table 2 shows that social security provided benefits to 93 percent of the elderly population in 1980. Two thirds of the elderly population now receive a retired worker benefit. Altogether over 35 million people received OASDI benefits in 1980.

In order to provide perspective on the recipient data in Table 1, Table 3 shows the ratios of the number of recipients of each program to the population age 65 and over. Although each program has many recipients that are younger than 65, the ratios shown in Table 3 indicate trends in the relative importance of each system. The growth of the private and the public employer pension systems is notable. In the period 1967 to 1979, the proportion of households with individuals age 65-69 eligible for an employer pension benefit roughly doubled, reaching 39 percent of the total. Increases in pension coverage and vesting that have already occurred indicate that rapid growth in the proportion of elderly individuals with employer pensions will continue in the future. By the first decade of the next century, it is likely that 75 to

TABLE 1

NUMBER OF PERSONS RECEIVING BENEFITS FROM
RETIREMENT INCOME PROGRAMS
(Millions of Persons)

	Private Pensions	Federal Civilian Programs a/	Military	State and Local Government	Old Age Assistance/ SSI b/	Social Security Retirement
1950	0.5	0.2	0.1	0.3	2.8	3.5
1960	1.8	0.5	0.3	0.7	2.3	14.2
1970	4.8	1.0	0.8	1.3	2.1	23.6
1975	7.1	1.4	1.0	1.7	2.6	27.7
1979	8.7	1.6	1.2	2.3	2.0	30.4

a/ Federal Civil Service, Federal Reserve Board, Foreign Service, Tennessee Valley Authority Retirement Programs.

b/ SSI benefits for the aged, 1975 and after. In addition, about .4 million elderly individuals received SSI benefits for the blind and for the disabled.

SOURCES: Social Security Administration, Social Security Bulletin, Annual Statistical Supplement, American Council on Life Insurance, Pension Facts, Defense Manpower Data Center, DOD Statistical Report on the Military Retirement System.

TABLE 2

ELDERLY SOCIAL SECURITY RECIPIENTS AS A PROPORTION
OF THE ELDERLY POPULATION
(in thousands)

	Retired Worker Beneficiaries 65 or Older	Secondary Beneficiaries 65 or Older	Total Beneficiaries 65 or Older	Population Aged 65 or Older	Retired Worker Beneficiaries as Percent of Population	Total Beneficiaries - Age 65 or Older as Percent of Population Age 65 or Older
1950	1,771	828	2,599	12,397	14.3	21.0
1961	8,277	3,473	11,750	16,674	49.6	70.5
1970	12,124	4,868	16,992	20,084	60.4	84.6
1977	15,941	5,783	21,724	23,514	67.8	92.4
1980	17,128	6,642	23,770	25,544	67.1	93.1

Sources: Social Security Bulletin, Annual Statistical Supplements: 1950 (Table 22), 1961 (Table 62), 1970 (Table 67), 1977-79 (Table 65).

TABLE 3

RATIO OF RECIPIENTS OF RETIREMENT BENEFITS TO POPULATION AGE 65 AND OVER[a/]
(Percent)

	Private Pensions	Federal, State, Local Government Civilian	OAA and SSI	OASI Total Beneficiaries	Beneficiaries Age 65 and over
1950	4	4	23	28	21
1960	11	7	14	85	71
1970	24	11	10	117	85
1975	32	14	12	124	91
1979	35	16	8	123	93

a/ Total number of individual recipients divided by total population age 65 and over. Recipients include individuals younger than age 65. The figures understate the proportion of households and individuals benefiting from pension systems by including in the denominator but not in the numerator other members of the household of a pension benefit recipient who may benefit from that pension even though they are not direct recipients.

SOURCE: Calculated from Tables 1 and 2 and Census Bureau population estimates.

80 percent of the newly retiring population will have an employer pension. This situation contrasts sharply to that of the 1950s and 1960s when major expansion of the social security system and increases in benefits were undertaken.

Table 4 shows the average income levels provided to beneficiaries of the major retirement income programs. The increase in real social security benefit levels since 1950 is apparent. Real private pension benefits have remained roughly constant on average. Three offsetting factors have been at work. First, the increase in real incomes over the period would tend to increase pension benefits. However, expansion of the system has brought in more middle and low income workers, so the average benefit has not increased significantly. Finally, many workers have taken advantage of increasing opportunities provided by employer pensions to retire early at reduced benefits. In addition to these three factors, rapid inflation in the 1970s may also have contributed to the eight percent decline in real average benefits from 1970 to 1979.

In addition to employer based pensions, private savings and individual pension plans (IRAs, Keoghs) provide a source of retirement income that may be of increasing importance in the future. Recently enacted reductions in personal income taxes, tax preferences for savings, and liberalized treatment of individual retirement savings may shift workers' preferences toward receiving more of their compensation in wage and salary income to permit greater individual saving, and less in fringe benefits and institutional retirement saving such as employer pensions and social security.

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TABLE 4

AVERAGE INCOME LEVELS PROVIDED BY ALTERNATIVE SOURCES OF INCOME FOR THE ELDERLY[a/]
(1981 Dollars)

	Social Security OASI	Private Pensions	Federal Civilian Retirement	State and Local Retirement	Military Retirement System
1950	1100	3100	4100	4100	NA
1955	2100	3000	4900	5800	8100
1960	2300	3000	5400	5900	8400
1970	2900	3700	6800	6600	8700
1979	3800	3400	9800	5900	10100

a/ Average benefit receipt of individuals receiving benefits.

SOURCES: American Council of Life Insurance, Pension Facts; Social Security Administration, Social Security Bulletin Annual Statistical Supplement, various years; ICF Incorporated, A Private Pension Forecasting Model, 1979.

Employer pensions cannot replace social security. A significant number of individuals and households will not receive pension benefits. Among those who do receive employer pensoins, many benefits will be small. Nevertheless, the importance of the employer-based pension system must be considered in making social security policy from two respects. First, while it cannot replace social security, employer pensions and individual arrangements do provide opportunities for workers to augment their retirement income considerably. Growth in retirement income for many typical workers in the future can come through employer pensions and may not require expansion of social security. Second, changing the social security system will have important impacts on employer pensions. In particular, efforts to reduce social security benefits, either through reducing replacement rates or through raising the age at which individuals qualify for unreduced social security benefits, will put pressure on the employer based pension system to raise or restructure benefits. Because employer pensions receive tax preferences, if pension benefits expand as a result of social security cutbacks, some additional costs to the Treasury may arise.

Another major change affecting the well-being of the elderly since the initial expansion of social security in the 1950s has been the establishment of important in-kind benefits. Medicare and Medicaid were created in 1965. In addition, low income elderly households benefit from subsidized housing, food stamps, and energy assistance. These, plus cash assistance through SSI, provide a significant income floor for the elderly. Table 5 shows the number of participants and average benefit levels for these programs.

TABLE 5

PUBLIC ASSISTANCE AND IN-KIND
BENEFIT PROGRAMS FOR THE ELDERLY, 1980

Programs	Elderly Individuals Participating (Millions)	Level of Benefits (Billions)	Average Benefits per Participant
Medicare	24.5	$28.3	$1,200
Medicaid	5.1	4.3	800
SSI	1.9	2.4	1,300
Subsidized Housing	1.3	1.6	1,200
Energy Assistance	1.9	.7	400
Food Stamps	1.0	.5	500

SOURCE: Participant estimates primarily from Thomas C. Borzilleri, "In-Kind Benefit Programs and Retirement Income," working paper prepared for the President's Commission on Pension Policy (Washington, D.C., 1980).

In summary, social security is one of many programs providing income for the elderly. It is by far the most important and fills important needs that none of the other programs can fill. At the same time, the existence of a variety of other programs provides an important income floor at the bottom of the income distribution, and provides important opportunities for middle and higher income individuals to accumulate additional retirement income if desired.

Retirement Ages and Years in Retirement

The number of years that the average American can expect to spend in retirement has increased significantly since 1950, and is likely to continue to increase. The increase stems from two factors, earlier retirement and greater life expectancy.

Earlier Retirement

Tables 6 and 7 show how labor force participation rates have fallen since 1950 and show projections of the trends into the future. The proportion of men age 55 to 64 in the labor force fell from 87 percent in 1950 to 72 percent in 1980. The proportion of men age 65 and over in the labor force fell from 46 percent to 19 percent. If those participation rates had remained unchanged--i.e., if the same proportion of men age 55 and over had been in the labor force in 1980 as in 1950--an additional 4.2 million men would have been in the labor force, increasing the male labor force by almost seven percent and reducing the male retired population by 61 percent.

Female labor force participation rates for ages 55 to 64 increased from 27 percent in 1950 to 42 percent in 1980, adding about 1.7 million women to the labor force. Labor force participation among women age 65 and over fell from

TABLE 6

CIVILIAN LABOR FORCE PARTICIPATION RATES

Year	Males		Females	
	55-64	65 and over	55-64	65 and over
1950	87	46	27	10
1960	87	33	37	11
1970	83	27	43	10
1980	72	19	42	8
1990	68	16	47	7
2000	59	14	47	5
2010	51	16	42	4
2040	42	15	37	4

SOURCE: Estimates for 1950-1980 from Bureau of Labor Statistics, Handbook of Labor Statistics, December 1980. Estimates for 1990-2040 from ICF Incorporated, A Macroeconomic-Demographic Model of the U.S. Retirement Income System, final report to the National Institute on Aging, September 1981.

TABLE 7

CIVILIAN LABOR FORCE PARTICIPATION RATES

	55-58	59-61	62-64	65-67	68-71	72+
Males						
1963	92	87	76	46	30	19
1970	90	84	69	45	33	15
1980	84	75	54	30	23	12
1990	81	71	47	25	19	10
2000	71	58	35	25	15	10
2010	62	47	35	25	15	11
2040	48	40	35	25	15	11
Females						
1963	46	40	29	18	12	5
1970	50	43	32	19	13	5
1980	49	41	28	16	10	4
1990	54	53	33	17	10	4
2000	54	54	27	13	5	3
2010	52	47	22	10	5	2
2040	48	40	15	10	5	2

SOURCE: Estimates for 1963-1980 from unpublished BLS data. Estimates for 1990-2040 from ICF Incorporated, A Macroeconomic-Demographic Model of the U.S. Retirement Income System, final report to the National Institute on Aging, September 1981.

9.7 to 8.1 percent, reducing the female labor force by about 0.2 million. Trends in female labor force participation, therefore, slightly offset the effects of earlier retirement of men.

If present trends continue, only about half the male population and about 40 percent of the female population aged 55-64 may be in the labor force after 2010. About 15 percent of the male population and less than five percent of the female population over age 65 may be working.

Life Expectancy

The average number of years that individuals live after age 65 has increased significantly since 1950. Table 8 shows that in 1950, at age 65 the average male could expect to live an additional 12.7 years, and the average female could expect 15.0 additional years of life. In 1980, life expectancy for males at age 65 was 14.3 years, an increase over 1950 of almost 13 percent. Life expectancy for females was 18.7 years, an increase of 25 percent. The Social Security Actuary's mid-range projection assumes that in the year 2010 life expectancy at age 65 for males will be 16.1 years (up another 13 percent) and for females 21.6 years (up 16 percent).

Years in Retirement

The combination of earlier retirement and longer average lives have significantly increased the average number of years an individual can expect to live in retirement. Until 1956 for women and until 1961 for men, the earliest that one could receive a social security retirement benefit was age 65. In 1977 over one quarter of new male retirement benefits were awarded to men age 62. Forty-two percent of the newly awarded female retirement benefits went to women age 62. Two-thirds of all awards to retired workers in

TABLE 8

PAST AND PROJECTED LIFE EXPECTANCIES
AT BIRTH AND AT AGE 65, BY SEX

	Male		Female	
	At Birth	At Age 65	At Birth	At Age 65
1950	65.5	12.7	71.0	15.0
1960	66.8	13.0	73.2	15.8
1970	67.0	13.0	74.6	16.8
1980	69.8	14.3	77.7	18.7
1990	71.9	15.3	80.0	20.3
2000	72.9	15.8	81.1	21.1
2010	73.4	16.1	81.6	21.6
2040	74.6	17.0	83.1	22.8

SOURCE: U.S. Social Security Administration, Office of the Actuary, "Social Security Area Population Projections, 1981", Actuarial Study No. 85.

1977 were reduced for early retirement. A male worker who retired at the minimum age of 62 in 1980 could expect to live about 17 years in retirement, compared to the 13 years that a male retiring at the minimum age of 65 in 1950 could expect, an increase of 30 percent. A female retiring at age 62 in 1980 could expect to have almost 22 retirement years, compared to the 15 years life expectation of a female retiring at age 65 in 1950, an increase of almost half.

Dependency Ratios

A dependency ratio is a rough measure of the number of members of the non-working population being supported by each member of the working age population. It is a ratio of the population of an age group or groups, most of whose members are not expected to be in the labor force, to that of an age group that provides most of the labor force. The boundaries of those age groups are somewhat arbitrary. Table 9 shows two measures of the elderly dependency ratio--the ratio of the population age 62 and over to the population age 20 to 61, and the population age 65 and over to the population age 20 to 64. Each ratio is shown for each of two population projections--one assuming a return to a replacement level fertility rate, 2.1, and one assuming that the fertility rate falls to 1.7.

For both elderly dependency measures and both population projections, the elderly dependency ratio rises slowly during the 1980s, is relatively level from 1990 to 2010, then rises sharply over the next two decades as the baby-boom cohorts reach retirement age. The ratio is higher for the low fertility cases (Series III), passing .5 for that projection by 2050 if the elderly population is defined to be 62 and older, meaning that there would be fewer than two members of the working age population for each member of the

TABLE 9

DEPENDENCY RATIOS

	Elderly				Youth		Total	
	Population 62+ / Population 20-61		Population 65+ / Population 20-64		Population 0-19 / Population 20-64		Population 0-19 and 65+ / Population 20-64	
	II	III	II	III	II	III	II	III
1950	.19	.19	.14	.14	.59	.59	.73	.73
1960	.23	.23	.18	.18	.74	.74	.91	.91
1970	.24	.24	.19	.19	.72	.72	.90	.90
1980	.25	.25	.20	.20	.56	.56	.75	.75
1990	.27	.27	.21	.21	.51	.46	.72	.67
2000	.26	.26	.21	.21	.50	.42	.71	.63
2010	.28	.29	.21	.22	.46	.37	.67	.59
2020	.36	.39	.27	.29	.48	.37	.75	.67
2030	.41	.48	.33	.38	.49	.38	.82	.77
2040	.39	.49	.32	.40	.48	.38	.80	.77
2050	.40	.51	.32	.40	.49	.38	.80	.78

II: Population projection based on U.S. Census Bureau Series II assumptions (ultimate cohort completed fertility = 2.1).

III: Population projection based on U.S. Census Bureau Series III assumptions (ultimate completed cohort fertility = 1.7).

retired population. (Projections done by the Social Security Administration Office of the Actuary, which assume a more rapid decline in mortality than these do, show even higher dependency ratios.)

The elderly dependency ratio rises because the fall in fertility means that fewer young people will enter the labor force relative to the number reaching retirement age. However, that fall in fertility reduces the youth dependency ratio, as shown in the third pair of columns in Table 9. The fall in the youth dependency ratio offsets, somewhat, the rise in the elderly dependency ratio, so that the total dependency ratio (the fourth pair of columns in Table 9) is relatively stable. It falls from the high levels reached when the baby boom cohorts were young, reaches a minimum around 2010, then rises as the baby boom cohorts reach retirement age. The total dependency ratio is not expected to reach again the levels of the 1960s.

The notable feature is the shift of the dependent population from youth to old age, rather than a major increase in the total dependency ratio. That shift has important implications for the fiscal composition of public spending. If programs supporting the aged continue to be concentrated at the federal level, as they currently are, the shift in the composition of the dependent population may require a shift in resources toward the federal level away from state and local governments.

Table 10 shows an alternative measure of the dependent population--the ratio of the population age 16 and older, not in the labor force, to the population of those ages that are in the labor force. Historical data are compared to projections based on a model of the U.S. labor market developed at ICF. The ratio has fallen steadily since 1950, a reflection of the sharp

TABLE 10

LABOR FORCE DEPENDENCY RATE

Ratio of the Population Not in the Labor Force, Age 16 and Over, to the Population in the Labor Force, Age 16 and Over, Selected Years 1950-2050

Year	II	III
1950	.67	
1960	.66	
1970	.63	
1980	.60	
1990	.54	.53
2000	.47	.48
2010	.51	.55
2020	.60	.67
2030	.66	.75
2040	.68	.80
2050	.72	.84

increase in the labor force participation of women over the past three decades. This indicates that each person actually in the labor force is supporting fewer non-members of the labor force.

The ratio is projected to continue to fall until the year 2000, even though, as noted above, labor force participation of men over age 55 is expected to continue to decrease in the future. The ratio then begins to rise. In the year 2040, however, in the mid-range (Series II) population projection, it is about the same as in 1950. In the low fertility projection (Series III) the labor force dependency rate is about 12 percent greater in 2030 than in 1950, and in 2050 it is about 25 percent greater. A key point of Table 10 is that, even with declining male labor force participation rates and an increase in the retirement age population, the increase in female participation rates is expected to be sufficient that the ratio of the population over age 16 not in the labor force, including those retired, to the labor force, does not become excessive even during the years of retirement of the baby boom cohorts.

Table 11 shows the changing aged dependency ratio from a different perspective. It shows how the lower age boundary of the elderly population would have to change to maintain a constant dependency ratio in the future equal to its value in 1980. It shows, for each year, the age for which the ratio of the population of that age and older to the population younger than that age, and older than age 21, is equal to the ratio of the population age 65 and older to the population age 21 to 64 in 1980. The figures in Table 11 can be thought of as retirement ages that maintain a constant dependency

TABLE 11

RETIREMENT AGES NECESSARY TO MAINTAIN
1980 AGED DEPENDENCY RATIO

	Series II	Series III
1980	65.0	65.0
1990	65.7	65.7
2000	65.7	65.8
2010	65.7	66.1
2020	68.0	68.7
2030	70.5	71.6
2040	71.2	71.3
2050	70.2	73.2

ratio. They are relatively level from 1980 until 2010. At that time the boundary age must increase sharply if the dependency ratio is to remain unchanged.

The data of Table 11 should be interpreted with caution. One consideration that they do suggest is that if raising the retirement age is to be proposed as a solution to the long term financing problems of the social security system, the need to do so because of dependency ratio pressures does not arise until after 2010.

IMPLICATIONS OF ALTERNATIVE DEMOGRAPHIC, ECONOMIC AND POLICY CHANGES FOR THE FINANCING OF SOCIAL SECURITY

This section assesses the impacts of several alternative future developments on the financial status of the OASDI system. Quantitative estimates of the effects of several potential changes are presented in the following tables.

These estimates were developed by simulating the behavior of the economy and the social security system using a large scale computer model developed under the auspices of the National Institute on Aging. The NIA model was developed to examine the impacts of demographic and economic change on the retirement income system. It is a long term forecasting model that includes representations of the process of economic growth, the labor market, and the major components of the retirement income system.

The tentative estimates presented below illustrate the directions and general magnitudes of the effects of several potential future changes on the financial balance of social security, but they are not intended to be precise estimates. Many assumptions lie behind each estimate. Under different sets of assumptions, the estimates would differ. Nevertheless, the general

directions and levels indicated by the estimates provide useful guidelines to the future prospects of the system.

The estimates provided below are all in terms of changes in the difference between tax collections and benefit payments, stated as a percentage of the taxable earnings base. The estimated future annual deficits or surpluses of the OASDI system are usually reported in this form by the SSA Office of the Actuary. This measure avoids problems of using dollar values of changing purchasing power and provides a perspective on the size of the surplus or deficit.

To provide a point of reference for the tables that follow, Table 12 shows the estimates of past and projected OASDI expenditures, and the scheduled tax rate, from the 1981 OASDI Trustees Report. These are all stated as a percent of taxable payroll. The difference between taxes and expenditures shows the surplus or deficit, also stated as a percent of taxable payroll.

Demographic Changes

The finances of the social security system in the long term are very sensitive to the age structure of the population. The age structure is determined primarily by changes in the fertility rate. The rapid rise in fertility following the end of World War II until the end of the 1950s generated the large cohorts of the baby boom. The sharp fall in fertility in the late 1960s, continuing through the 1970s, means that the labor force that must support the baby boom retirees will be relatively small. This demographic configuration is at the heart of the long term social security financing problem. A smaller labor force can support a larger retired population only by transferring greater resources per worker, i.e., paying a

TABLE 12

PAST AND PROJECTED OASDI EXPENDITURES AS PERCENT OF TAXABLE PAYROLL AND COMPARISON WITH SCHEDULED TAX RATES[a/]

Year	Expenditures	Taxes	Balance
1950	1.17	3.00	+1.83
1960	5.89	6.00	+0.11
1970	8.12	8.40	+0.28
1980	10.77	10.16	-0.61
1985	11.63	11.40	-0.23
1990	11.86	12.40	+0.54
2000	11.19	12.40	+1.21
2010	11.62	12.40	+0.78
2020	14.43	12.40	-2.03
2030	16.79	12.40	-4.39
2040	16.82	12.40	-4.42
2050	16.74	12.40	-4.34

a/ Projections are from the 1981 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds. They correspond to Series IIB, the pessimistic mid-range projection.

higher payroll tax, or by reducing the average benefits provided to each retiree.

Fertility rates will continue to affect profoundly the OASDI system in the future. The effects of alternative paths for fertility in the future are illustrated in Table 13. The estimates in the second column indicate that a sharp increase in births, by providing additional workers in the future and increasing the tax base, will reduce the costs of providing retirement benefits relative to the taxes available to pay them, and will reduce the deficit. It would be necessary for fertility to remain at the high level shown in Table 13, however, to maintain the smaller deficit or larger surplus. As long as the population continues growing, the labor force is larger than the retired population and the ratio of benefit costs to the tax base is correspondingly smaller. However, population growth cannot continue indefinitely.

The first column of Table 13 shows estimates of the effect on the deficit if fertility falls to 1.7 and remains there. The working population is correspondingly smaller, relative to the retired population, and, at unchanged average benefit levels and tax rates, the deficit would be larger.

Economic Changes

Table 14 shows the effects of changes in productivity on the finances of OASDI. Higher productivity raises real wages and hence increases the tax base. It also increases the level of retirement benefits, since they are determined by earnings levels. However, the increase in benefits lags the increase in taxes, so the deficit is reduced (or surplus increased). Lower productivity growth has the opposite effect, increasing the deficit.

TABLE 13

IMPACT OF ALTERNATIVE FUTURE FERTILITY RATES
ON THE ANNUAL OASDI BALANCE
(Relative to a Base Case Assuming Fertility of 2.1)

Year	Lower Fertility Rate (1.7)	Higher Fertility Rate (2.7)
1990	0	0
2000	-0.1	0
2010	-0.4	+0.4
2020	-0.9	+1.0
2030	-1.5	+1.5
2040	-1.8	+1.7
2050	-1.9	+1.6

Figures in this and the following tables show the estimated impact on the difference between tax collections and benefit payments, stated as a percentage of the taxable wage base. Hence, a positive number indicates an increase in tax collections and/or a reduction in benefit payments, i.e., a reduction in the deficit or an increase in the surplus in the given year. These figures can be compared to the balance column in Table 12. The base case to which these figures are being compared is similar to the Series IIB projections in the OASDI Trustees Report.

TABLE 14

IMPACT OF ALTERNATIVE CHANGES IN PRODUCTIVITY GROWTH ON THE ANNUAL OASDI BALANCE

Year	25% Lower Productivity Growth a/	25% Higher Productivity Growth b/
1990	-0.5	+1.0
2000	-0.5	+1.0
2010	-0.5	+1.3
2020	-0.5	+2.0
2030	-0.6	+2.1
2040	-0.5	+2.2
2050	-0.5	+2.4

a/ Exogenous rate of technical change specified to increase at a rate 25 percent less than in the base case.

b/ Exogenous rate of technical change specified to increase at a rate 25 percent greater than in the base case.

Table 15 illustrates the effects of another type of economic change on the system--one perhaps amenable to policy. Social security taxes are levied on wages and salaries. Because wages and salaries as a share of total compensation have steadily fallen over the long term, the OASDI tax base relative to total compensation has fallen. We conducted an experiment to assess the importance of this long term trend. Instead of permitting the ratio of wages and salaries to fall, as it has historically and would in the model without constraint, we held it constant at its estimated 1980 level. The simulation results indicate that over the long term the increased growth of wages and salaries that would result increases the balance as much as 0.4 percent of taxable payroll after 2030. Policy measures that discourage the growth of the share of fringe benefits in total compensation, perhaps through changed tax treatment, may have this effect.

Policy Changes

Under a wide variety of demographic and economic conditions, including most that appear to be reasonable, with currently scheduled tax rates and benefit provisions, the OASDI system will experience large deficits beginning about 2015 and continuing for the next forty or more years. Many policy and program changes have been proposed to deal with the projected long term deficit.

There are three basic approaches: (1) raise taxes or use other revenue sources; (2) reduce benefit levels; (3) raise the age of retirement without changing benefit levels (which, actuarially, reduces benefits). To remove the projected deficits the combined employer-employee payroll tax rate could be raised by the amount of the deficit expressed as a percent of the tax base.

TABLE 15

IMPACT ON PROJECTED ANNUAL OASDI BALANCE IF WAGES AND SALARIES' SHARE OF COMPENSATION REMAINS CONSTANT, VS. PROJECTED DOWNWARD TREND a/

Year	Change in Trust Fund Balance
1990	+0.1
2000	+0.1
2010	+0.2
2020	+0.3
2030	+0.4
2040	+0.4
2050	+0.4

a/ In the base case projections, wages and salaries as a share of total compensation fall from 84.1 percent in 1980 to 73.4 percent in 2055. In the alternative projection reported in this table, the percentage was held constant at 84.1.

That might require a combined employer-employee tax rate during the years after 2030 as high as 17 to 28 percent of payroll. If those taxes had dampening effects on economic activity and labor input, even they might not be sufficient. While social insurance levies of that level are not uncommon abroad, currently in the U.S. alternatives to raising taxes are being sought.

There are two alternatives--reducing replacement rates or raising the age of retirement. Advocates of raising the retirement age note the increasing life expectancy of the elderly and the trend since 1950 toward earlier retirement that were reviewed above. An increase in the average age of retirement of three years in the year 2000 would still leave the average individual retiring more retirement years than he or she would have had in 1950. Critics of proposals to raise the retirement age question why most of the gains in length of life should be spent working when a considerable part of the population seems to prefer retirement.

A variety of proposals have been advocated to reduce the income replacement rate. Before examining those, it is useful to note that changing future replacement rates may reduce benefit levels relative to what they might be in the future under current law, but need not reduce them absolutely from current levels. A rising level of income per capita makes possible rising retirement benefits. The issue concerns how fast benefit levels should rise during a period when changes in the demographic structure raise the burden of providing those benefits.

Three measures to reduce replacement rates have been proposed: (1) index the "bend points" in the benefit formula by only 50 percent of the change in average wages during the 1982-1987 period (the Administration's May 1981 proposal); (2) index benefit formula bend points by prices instead of wages;

(3) index workers' earnings by prices rather than average wages in the calculation of average indexed monthly earnings (AIME). To illustrate the potential effects of these proposals we simulated each of them under a set of mid-range economic and demographic assumptions (similar to the OASDI Trustees Report Series II-B). The results appear in Table 16.

It is worth repeating here that these results are illustrative only. They are sensitive to the assumptions used. One comparison illustrates this sensitivity. The simulations suggest that indexing bend points to prices rather than wages reduces the deficit considerably more than indexing the AIME to prices. This results in part from the relatively high rate of growth of real wages in this particular simulation. Indexing the bend points by price means that the progressivity of the benefit formula applies to real wage growth over time. This reduces real benefits and replacement rates. A relatively high growth of real wages enhances the effects of the progressive benefit formula.

Table 17 reports results of simulations of the effects of raising the retirement age by three years, over the period 1990-2002, assuming that all workers do, in fact, stay in the labor force for an additional three years in response to the policy change. This is clearly an extreme and unrealistic assumption. The additional labor input increases output and tax collections and, in this extreme case, goes far to close the projected deficit.

These projections illustrate the range of potential effects of alternative policies. However, they should not be treated as predictions of the effects of those policies. Specific measures should be carefully specified and analyzed under a variety of assumptions before conclusions are drawn.

TABLE 16

IMPACT ON ANNUAL OASDI BALANCE OF
ALTERNATIVE BENEFIT REDUCTION PROPOSALS

	Index PIA Bend Points to Only 50 Percent of Average Wage Change 1982-1987 (Administration Proposal) a/	Index PIA Bend Points to Prices Rather Than Average Wages	Index AIME to Prices Rather Than Average Wages
1985	+0.1	+0.1	+0.1
1990	+0.2	+0.2	+0.3
1995	+0.3	+0.4	+0.6
2000	+0.4	+0.6	+0.7
2010	+0.6	+1.0	+0.9
2020	+0.8	+1.5	+1.0
2030	+0.8	+1.6	+0.9
2040	+0.7	+1.7	+0.8
2050	+0.7	+2.0	+0.9

a/ Assumes Administration projections of inflation as follows:

1981	11.1%
1982	9.4%
1983	9.0%
1984	8.2%
1985	7.4%
1986	7.4%
1987	7.4%

TABLE 17

IMPACT ON ANNUAL OASDI BALANCE OF
INCREASING ACTUAL RETIREMENT AGE THREE YEARS[a/]

	Change	New Balance
1990	+0.1	0.6
2000	+1.9	3.1
2010	+4.2	5.0
2020	+4.4	2.4
2030	+4.3	-0.1
2040	+4.2	-0.2
2050	+4.1	-0.2

a/ Assumptions: Workers qualify for unreduced retirement benefits at age 68, and for actuarially reduced benefits at age 65. Corresponding changes in ERISA and public employee pension plan benefit provisions. All workers delay retirement for three years. Phased in from 1990 through 2002.

Senator HEINZ. Thank you, Mr. Anderson. I think you have quite successfully laid out the options which you quite correctly state are because of demographic factors. We do not know for certain whether the demographic patterns that we forecast today are going to take place, but they are our best guess, and as such we would be well advised not to ignore them and take at least a significant amount of proper heed of what they portend.

It is my feeling that it would be a mistake for the Congress to simply decide that whatever it is we do today we have to make the social security system totally sound through the year 2055 for the simple reason that if a favorable trend came along, we would have overreacted and possibly in the process have caused a number of people hardship or to be concerned unnecessarily.

By the same token, for us to ignore these trends and not take any action, to solve at least a significant part of that projected problem, would be, in my judgment, equally shortsighted and dangerous. The longer we put off facing this problem, the worse it is going to be for the people who have to bear the brunt of the solution. And there is no doubt that the solution must come, as you say, through higher taxes, lower replacement rates, higher retirement age, or some combination of them.

In your prepared statement, you have several tables. Just so I am clear, are the numbers in those tables the same numbers that people use when they project the long-term deficits in the social security system? Are these the ones the trustees use?

Mr. ANDERSON. Most of the tables are based on the assumptions behind the trustee's series II-B, which is illustrated on the chart on the left. It is referred to as the pessimistic midrange projection. The demographic assumptions in that projection are considered to be the "best guess" and the assumptions about the future course of the economy are considered to be prudent. That projection is not unusually optimistic or pessimistic. The demographic assumptions are consistent with the Census Bureau midrange population assumptions. Those were the the ones I used in my tables.

The deficit numbers that correspond to the chart on the left appear in table 12 of my prepared statement. Projected expenditures expressed as a proportion the expected tax base are compared to the currently scheduled tax rates. When you subtract the tax rates from expenditures expressed as a proportion of the tax base, you can state the future surplus or deficit as a proportion of that tax base.

Senator COHEN. Does that include the indexing provision that was passed by Congress?

Mr. ANDERSON. Yes.

Senator COHEN. You have factored that in long-range projections, in other words, you have in fact indexed inflation?

Mr. ANDERSON. That is right. Specifically, benefits, after they are awarded, are indexed to the Consumer Price Index. The earnings of a worker, that are used to calculate what his retirement benefits will be, are indexed to the average earnings of all workers in each year. Those are the assumptions we used.

Senator HEINZ. And how much divergence is assumed in the projections between increases in workers' earnings and the Consumer Price Index?

Mr. ANDERSON. The trustees' II-B midrange projection assumes a difference of 1.5 percent a year, beginning about 1990. Wages increase 1.5 percent a year faster than prices. That is the growth in real wages.

Senator HEINZ. And what growth rate in productivity, output per man-hours, does that imply?

Mr. ANDERSON. The growth rate in labor force productivity will have to be slightly larger, because in the trustees' projections and in our base case projections, we assume a continuation of the trend of wages and salaries becoming an increasingly smaller share of total compensation. Total compensation per hour rises at the rate of growth of labor force productivity, which in our projections is about 2 percent per year. Because wages and salaries are a continually smaller share of total compensation, wages and salaries then grow slightly less than labor force productivity.

Senator HEINZ. Let me ask one more question. My time has expired.

In 1950, males 65 and over had a 46-percent participation rate. Today, that rate is down around 19 percent. Do you have some idea of the extent to which these forecasts are sensitive to changes in male labor force participation, assuming that there was no change for the sake of argument in female participation, in spite of the fact that a majority of those over 65 are female? What would be the effect on the projected deficits if the labor force participation rates for older men were returned to something like the 1950 level?

Mr. ANDERSON. If male labor force participation rates in 1980 were the same as they were in 1950, the number of retired male workers would be reduced by about 60 percent.

Senator HEINZ. What would be the magnitude of the effect on the long-term social security financing problem that starts hitting in 2020, 2025, and on out?

Mr. ANDERSON. On the social security deficit?

Senator HEINZ. Yes.

Mr. ANDERSON. The effect may be significant. However, it would be mitigated because the social security benefit is actuarially reduced for early retirement. As I tried to explain in my opening remarks, that reduction is designed to make the age of retirement between age 62 and 65 neutral in terms of the cost to the system of providing benefits. However, there would be some effect because the actuarial reduction ignores the fact that many individuals, if they do not take early retirement, will stay in the labor force and continue working and pay social security taxes which help pay for the benefits of others.

Senator COHEN. The upshot is either increase taxes or reduce benefits. Is that it?

Mr. ANDERSON. That is correct.

Senator COHEN. So we cannot have a tax cut, a budget reduction, a Defense increase, and still have it all work out.

Mr. ANDERSON. It is my feeling that that type of economics will not be very successful when applied to social security.

I might say that as far as I can see, in surveying the system, there are not any policies other than a benefit reduction or a tax increase that would generate offsetting effects that would take care of the deficit by themselves.

Senator COHEN. Let me ask you, in trying to project the needs into the 21st century and what the demographics will reveal, are you assuming a static quality of life? For example, what if fertility rates change? What if environmental standards are reduced? Would that have a concomitant effect on life expectancy? In other words, if you do not maintain the same kind of cleanup of toxic wastes, if you reduce levels of emission for coal, for example, if you have more acid rain coming down in Maine and parts of Canada, would that alter in any way, number one, the life expectancy at one end of the spectrum? Or even add—I hope I am not prophetic—but add a war in the middle of that equation and that throws all the projections off, does it not?

Mr. ANDERSON. A war? Yes.

Senator COHEN. War plus rates of fertility, plus environmental standards, would all alter these conclusions based upon this?

Mr. ANDERSON. That is correct.

Senator HEINZ. We wanted to point out that this is neither Senator Cohen's nor the Republican's platform.

Senator COHEN. What I am trying to get at is this: In my personal judgment, and this is just a personal judgment not a political one, the administration has overreacted to Wall Street's failure—as if Wall Street can in fact reduce interest rates as an institution—which I doubt. But it has overacted to Wall Street's failure to come down on interest rates. There is suddenly a new reaction or an overreaction, that we have to cut the budget, cut taxes, and still interest rates are not falling, therefore let us accept another $70 billion deficit or whatever it may be. We start to make changes and cut back in response to Wall Street's failure to drop interest rates.

Now if you take the same sort of situation, we might be overreacting in some instances to the current projections on certain economic data or demographic data. We might recommend some actions in this Congress which may be too severe.

Is that a problem?

Mr. ANDERSON. I think that is probably not the way I would characterize the problem. In our projections, we use a variety of assumptions about what will happen to future demographics and the future of the economy, to those aspects essentially beyond the control of social security policy, for example, productivity growth and real wage change. For a wide range of assumptions about fertility rates and mortality rates and rates of productivity growth, there remains a social security financing problem. Under an optimistic set of assumptions, the problem is much smaller. As you can see from the bottom line on the chart on the left, which never actually goes above the deficit line—with very optimistic assumptions, you can make the problem go away. But I think most observers would agree that it is not prudent to make policy based on the possibility that all of those optimistic things happen. In particular, I think there is one inherent contradiction to one of the very optimistic assumptions that the trustees use. That is with respect to fertility rates. The current optimistic set of assumptions assumes that the fertility rate returns to the level of 2.4. With a fertility rate of 2.4, there is a substantial amount of population growth continuing over the long-term future. But population growth at a significant positive level cannot be sustained forever. More rapid

population growth does not solve the social security financing problem. It only puts it off for another 50 years.

Senator COHEN. A lot is subject to change. For example, we have gone through a phase in our history in which we have entertained very seriously zero population growth, trying to limit birth rates rather than increase them. That emphasis could very well change. We will have a major debate dealing with the right to life. You may very well have a different change in perception, attitude, value. You could have a change in the next decade or so, or two decades from now, in terms of our attitude about death and abortion, as opposed to curtailment. That would change the situation, too, would it not?

Mr. ANDERSON. That is certainly possible.

Senator COHEN. Has that been considered?

Mr. ANDERSON. Yes; at the end of my prepared statement, I present several tables of simulations of the future of the social security system that we have performed taking into account a variety of different assumptions, including a fall in fertility and a rise in fertility, a fall in labor force productivity and a rise in labor force productivity, and a variety of policies to deal with the long-term financing problem. Table 13, on page 24, presents a simulation based on the assumption that the fertility rate falls to 1.7, and another simulation based on the assumption that it rises to 2.7. 2.7 is just about the highest fertility assumption that anybody would entertain, and I think most people think that is exceedingly unlikely. The numbers in table 13 indicate the change in the size of the deficit as a percent of the taxable wage base. The deficit after about 2030, based on the midrange projection, is about 4.4 percent of the tax base. The very high fertility assumption of 2.7 will take care of only 1.5 percentage points, or about a third of the deficit.

We also simulated faster growth in productivity. Higher productivity growth is quite helpful, but even a growth rate of productivity that is considerably higher than the already relatively high rate that is built into our model, takes care of only about half the long-term deficit. We feel these are about the extremes of the assumptions on the optimistic side.

Senator COHEN. What do you do about taking into account—if you increase productivity but actually reduce manpower—in other words, the emphasis is placed upon machinery and equipment and technological innovation and fewer people contributing to work, how does that change?

Mr. ANDERSON. The type of productivity we are focusing on is labor force productivity, which is defined as output per man-hour of input. It may be that fewer man-hours have to be input or that fewer individuals are working. But those working will be earning higher incomes or higher wages, which will determine higher social security benefits for them.

An important trend that I think we should not ignore has not been in the direction of a general reduction of labor input on the part of the population. We are well aware of the falling participation rates of older men, but we should be equally aware of the very rapid increases of participation rates of women of all ages.

In the future, however, because of demographics, because of the sharp fall in fertility rates beginning in the late 1960's and con-

tinuing to the present, the United States will experience a phenomenon that is very new for us, that has never occurred before in this country. Around the turn of the century to 2010, there will be a cessation of growth in the labor force. The actual amount of labor input, for the first time in our history, will reach a plateau, at which it will remain for 30 or 40 years, and then it may taper off. There will be a different economic environment than we have experienced. One thing we should expect to see when that happens is an increase in labor force productivity and real wages as labor becomes relatively scarce compared to capital and other inputs because labor input will have dropped.

Senator HEINZ. Senator Chiles.

Senator CHILES. I have an opening statement.

Senator HEINZ. Please proceed.

STATEMENT BY SENATOR LAWTON CHILES

Senator CHILES. This meeting may well be the last opportunity Congress has to take public testimony before the administration's social security reform measures are considered by other committees and by the Congress as a whole. It comes just before the Finance Committee begins its consideration of the President's proposals—and in the middle of talk of new social security cuts in the budget.

I, and many of my colleaques, have taken the position that the administration's proposals for social security cuts were much more than necessary.

Unlike some, however, I do believe that the long-term funding problems of social security should be addressed now—not just the short-term problem which we will face in a very short time. The long-term problem is a much more serious one, and more difficult to solve. That is what this hearing is about today, and I expect that many of our witnesses will agree.

I also have a clear preference for the way we should address the long-term problem. In the bill I introduced early this year, S. 484, I have proposed to remedy the long-term social security funding gap by gradually raising the retirement age for full benefits, beginning in the next century.

Any option Congress selects to address this problem will be painful. All of the choices are hard ones. But I believe this is the least painful. It allows everyone concerned adequate time to plan for a change—future retirees and their employers. If adjustments have to be made in private pension plans, there will be time. Patterns of employment for older workers must be changed, and more options must be made available for older workers, whether or not we make changes in social security.

The other major option Congress has before it now—to reduce monthly benefits received by all social security beneficiaries—is not one that I consider a viable option. There are simply too many social security beneficiaries who depend on their monthly checks as their primary or sole source of retirement income. We should all be proud of the role social security has played in lifting many elderly above the poverty line. That has been a long struggle. I would hate to see us now turn back that progress.

One way to look at the difference between these two proposals is to see a choice between cutting benefits and encouraging a longer and more productive span of work. I look forward to the debate on this issue today.

I was interested to see that the Consumers Union recommended raising the retirement age. I would like to insert a recent article from Consumer Reports into the record.

Senator HEINZ. Without objection, so ordered.[1]

Senator Chiles has a bill that does a number of things, among them it says the retirement age should be raised to 68 by the year 2012. Senator Cohen will be the male Margaret Chase Smith of Maine at that point. The actuarial deficit, projected through 2055, is stated as a percentage of the taxable wage base, in the neighborhood of 1.7.

Is that about right?

Mr. ANDERSON. The average actuarial deficit over the full 75 years is about 1.7 in the midrange projections.

Senator HEINZ. Now Senator Chiles' bill, from the analysis I have seen of it, just looks at the changes in the retirement age, makes up a very significant portion of that deficit as so stated, almost all of it. I think around 1.4 percent.

Does that sound about right?

Senator CHILES. It would make up between 1.4 and 1.5 percent.

Senator HEINZ. A moment ago you said that changes in labor force participation, men in particular, did not make a lot of difference. Yet, of course, the objective of Senator Chiles' bill is to encourage participation at age 65 because, in his bill, starting in the year 2000, you do not get early retirement benefits at age 65. It would shift gradually.

Senator CHILES. Every 4 months you would have to be 1 month older to retire.

Senator HEINZ. Every 4 months I feel at least an extra month older these days.

My question is how do you reconcile what his bill is able to accomplish with your earlier statement?

Mr. ANDERSON. That is a good question and we should clear tht up. When I addressed the question—simply what would be the effect if the trend toward lower labor force participation among workers was reversed—I was not answering that with reference to changes in the social security system, in particular the benefit formula, that would encourage that trend to be reversed, something like Senator Chiles' bill. I was just trying to estimate what would happen if, because of other social changes or other economic changes, individuals decided to continue to stay in the labor force about the same length they were in the 1950's or 1960's. I was not assuming any change in the social security system and its current benefits structure with the actuarial reduction. Given the actuarial reduction, the fact that people retire earlier, as I said, does have a negative impact on the system, but the impact is not very great, because when individuals retire at age 62, they get only 80 percent of the full benefits they would get at age 65.

[1] See p. 208.

Senator Chiles' bill and the others that raise the retirement age, raise the age at which an individual would qualify for that full benefit.

Senator HEINZ. So instead of getting 100 percent at 65, they would get 80 percent.

Mr. ANDERSON. That is correct, if it was just a simple increase of the retirement age of 3 years. We looked at something similar to what Senator Chiles has proposed, except the retirement age was increased in the year 1990 rather than in the year 2000. To simplify things, we assumed away the very important issue of what would be the effect on retirement behavior of raising the age at which individuals qualify for benefits. We took what I would say is the extreme assumption, that everybody stays in the labor force the additional 3 years by the time the retirement age has increased 3 years. So we do not worry about the fact that some people who wanted to retire at age 62 may stay in the labor force a little longer, but perhaps not until 65. We did not try to guess what the effect on labor force behavior would be of the change in the law. Assuming that everybody stays in the labor force 3 more years and that social security benefits are payable 3 years later—reduced benefits at 65 and full benefits at 68—our simulations indicate that that change alone would relieve almost the entire deficit.

Now, as I said, that may be unrealistic on the optimistic side. But if we could get everyone to work 3 years longer, not only would they be paying taxes for those 3 years, they would not be receiving benefits, and they would be in the work force contributing to output, and the productivity of the capital stock would increase. In the model we are using, which takes into account all of these effects, we have very positive effects on the system.

Senator COHEN. But your model is what, 1990 or 2000?

Mr. ANDERSON. We begin to phase in the increase in the retirement age in 1990.

Senator HEINZ. So yours is a little earlier.

Mr. ANDERSON. That is correct. So it is completed in the year 2002.

Senator HEINZ. Let me ask you one other question which is a problem. You earlier posed to us the choice between changing the replacement ratio and increasing the tax rate and increasing the retirement age. Now, the way we have traditionally financed the social security system in the past was through increasing tax rates, both the earnings base and the rate. The reason most people, I think correctly right, now assume that is not a terribly attractive alternative is real wages are going down, whereas up to 1970, the real wages were going up. People were willing to go along with those increases in taxes because they thought it was perfect policy for someone who is retiring, and they were going to retire themselves sometime. It seems to me that this pattern would be a policy to be considered if we had a sufficiently high growth in productivity. But if we do not have enough growth in productivity, which is to say in real wages, then we would not have that option available to us. To the extent that option is available to us, we avoid the other unpopular choices of changing the replacement ratio and increasing the retirement age, or some choice along those lines.

If productivity is to increase at the rate that we historically experienced prior to what most see as a downturn in 1973–74, let us say to be somewhat conservative, around 2 percent, a percentage point higher than what the trustees project, what would that extra percentage point in productivity mean, if we dedicated all or most of it to the social security system, measured as a percentage of the taxable wage base over the 75-year period?

Mr. ANDERSON. If we could find a way to capture that extra percentage point of productivity growth each year and dedicate it——

Senator HEINZ. First, we have to capture the productivity growth. Then after we do that?

Mr. ANDERSON. That would essentially take care of the problem.

Senator HEINZ. What are we really talking about? How much extra productivity? What percentage increase in productivity growth over the next 75 years, on an annual basis, is the equivalent of the 1.7 percent of taxable wage base in the actuarial deficit under intermediate II–B assumptions? Is that one-half a percent a year?

Mr. ANDERSON. I am afraid I cannot give a simple answer to that question.

Senator HEINZ. Can you give us that later?

Mr. ANDERSON. It is a good question, but let me try to rephrase it to be sure I understand what you are asking. Without talking about changing the tax rate to capture all the productivity growth, with the currently scheduled taxes, productivity growth helps. It does not solve the problem, however. Benefits are based on average wages, so as people's average wages increase because of productivity growth, their benefits increase.

Higher productivity growth helps because it means that the current generation of workers are earning relatively more than the past generation, who are the current beneficiaries. So it increases the tax base relative to the level of total benefits.

Senator HEINZ. Let me be clear. I am assuming for the purposes of answering this question that whatever percent of increase in productivity is captured in its entirety. My question is: Assuming you can capture that increment in its entirety, what annual percentage increase is it? Is it the same or a little bit larger than or a little bit smaller than the deficit that we are trying to zero out?

Mr. ANDERSON. It would be smaller the first year, but if you capture all the productivity growth in future years over some base year, you are capturing a bigger and bigger wedge between future years' incomes and the base year income as time passes. It would not take very long to overcome the deficit. If you are capturing most of, say, a 1-percent additional growth in the economy, over a short period of time that is a tremendous amount of resources.

Senator HEINZ. We would appreciate it if you could calculate what, over 75 years, you need in terms of additional rate of growth that bails us out. If you could capture that.

Now, it is up to us to figure out a way to do that.

Mr. ANDERSON. Each year you would increase the tax rate slightly?

Senator HEINZ. That is a very possible scenario. Do not try to do it now.

Senator Cohen, do you have any additional questions?

Senator COHEN. I do not want to throw any cold water on these parabolic speculations we are going through right now.

Senator HEINZ. Aren't you a supply side economist?

Senator COHEN. I am, but I have a cloud of doom on the horizon. We are talking about increasing productivity. That means you will have to insure a strong economic base which will in turn depend on having access to raw materials which will depend on what takes place in places like South Africa and others, in terms of cobalt, titanium, and so on. Is that not true? Because if you do not have access to those materials and you have a shortage, there goes productivity, there goes that chart.

Mr. ANDERSON. The social security system, because it is such a large part and so integrally tied into our whole economic fabric, is sensitive to all those considerations.

Senator COHEN. What I do not want to see us do is engage in what you suggested before. You get out what you put in. If you put in 3-percent inflation rate, for example, in the calculation of your budget projections—that may be unrealistic. If you put in 3-percent productivity rate, real annual growth rate in this country, then that solves the problem. If in fact you can target a percentage of that to social security, you have no problem. We can go through this all day into next week. It will always balance out. With supply side economics or whatever you want to call it. But, in fact, we have no reasonable way of making projections for the future, inflation rates, and so forth. They are all really dependent and contingent upon a host of things over which we have no control.

So we are left with what can we do on a rational, reasonable basis to say what we think the problem is. This is what we think has to be done at the minimum to cope with these. We cannot lock into the future. We can only base our action on reasonable expectations, and these are our reasonable expectations today. The question is: Is it reasonable? I would ask the chairman, is it reasonable to expect that in the foreseeable future we are back to a 2.5 or even a 3 percent real growth increase in productivity as we were back in the 1960's and 1970's? My judgment is probably no. But it is nice to think so. It would be desirable, and that would solve a good deal of our problem. But I am not sure it is realistic.

Senator HEINZ. I think the Senator from Maine makes the absolutely correct point. It seems to me that we do not know what really we are going to be able to do in terms of the increase in productivity. There is some possibility it may be 20 percent, it may be 5 percent, or it may be 50 percent, which is why I think that the other side of that argument is that it would be a mistake for the Congress to try, taking this set of projections, to "make the social security system actuarially sound in total for the next 75 years."

That, it seems to me, would be equally as bad as relying on a Pollyanna assumption that we will return to the good old days, pre-1973. I think our two points are on the same side.

Senator COHEN. We are in agreement because that is why I feel the Reagan administration overreacted to interest rates not dropping down in a 1-month period of time. Nothing took place between August 1 and September 19. Nothing changed in the world. It did not become a safer place. In fact, it became a more dangerous

place. We had the Libyan incident. So things became more dangerous, not less. We have had a reaction to cut $30 billion here, or over there, without having the tax proposal go into effect. We were reacting to make it actuarially sound for 1984, for a balanced budget. I am simply suggesting that there is a parallel, that there are a number of contingencies that could change that balanced budget or could change the outcome of the projections into 2015. What we have to do is chart a course based on reasonable expectations, not try to lock ourselves into a final judgment as to whether this will make it balanced by the year 2015, or whether we will in fact have to extend the retirement age, or we will in fact have to reduce benefits, or we will have to find some alternative which will, by the year 2015, make things balanced. I do not think we can do that, or we should do that. So I think we are in agreement, Mr. Chairman.

Mr. ANDERSON. We should not pretend to use these analytical tools for forecasting or predicting the future. The best we can do is take a reasonable set of assumptions and then change one of the assumptions and do what is called a sensitivity analysis, to see what difference that assumption makes.

When I was driving in to work this morning, I was thinking about whether or not I should speculate in these hearings about what the future of the social security system would be, when the weatherman on the radio happened to give me some advice. Quoting another weather forecaster, he said that this person's prescription for a long life of a forecaster was, "Either give them numbers, or give them dates, but do not give them both at the same time."

Senator HEINZ. Mr. Anderson, there is a question I would like you to answer for the record since we are running out of time. The question is: If we control the increase in social security benefits in the future, through one of the mechanisms we described, we are essentially shifting, it seems to me, the burden of intergenerational transfers from public to private. What benefit is there if we make that shift? You do not have to answer now.

[Subsequent to the hearing, Mr. Anderson responded as follows:]

With a sound social security system providing a basic retirement benefit for all workers, there may be two benefits if future growth in retirement income is provided primarily through the private system. First, diversity and flexibility. The private system may be able to offer a wider choice of opportunites to workers concerning saving for retirement, saving for other purposes, or spending more of their incomes on current consumption. Workers who desire higher retirement incomes rather than higher current wages would be attracted to relatively generous pension plans. Other groups of workers might select higher current wages rather than higher pensions. The private system may be able to provide more choice.

Second, the public and private systems may have different effects on national savings. The employer pension system is a largely funded pension system. That means that real capital assets are accumulated to back up the pension benefit promises. Such pension savings may serve to increase naitonal savings. Social security, however, is not a funded system. It is run on a pay-as-you-go basis—no capital assets are built up to pay for future benefits. Consequently, it does not add to national savings. If the prospect of receiving a social security benefit prompts workers to reduce their individual savings, social security may even serve to reduce savings.

Senator COHEN. You are not suggesting we go to a voluntary system?

Senator HEINZ. No. If there was an implication there, I thank you for clearing it up.

The intermediate II-B and the 1.7-percent of taxable wage base corresponds to the other, is that correct, in terms of the assumptions?

Mr. ANDERSON. Yes.

Senator HEINZ. If you were——

Mr. ANDERSON. I am using the intermediate B projection. The figures on table 12 refer to what the deficit would be each year, and the figure you were quoting, 1.8, is the average of all 75 years.

Senator HEINZ. Yes. We are using the same intermediate B basis. So just stating it a different way, if you were in a position to make the change by raising the wand, would you try at this point to make all the changes that would make the system sound, based on intermediate II-B? Would you try and undershoot and, frankly, by some proportion, two-thirds of the changes today, or half, or something in that range, a significant amount, but not all? Would you do that, or try to overshoot? From the standpoint of public policy, income security, and just trying to do everything as right as you could, forgetting elections—we may have to at the rate we are going. What would you do, which of those three options would you take? Senator Cohen has a fourth option.

Senator COHEN. Let me give you the fourth choice. Would you take the most rigid view in order to produce a surplus in order to reduce social security tax rates, which I believe is the goal of the administration, as justified before this committee?

Senator HEINZ. You are right, that is a fourth alternative. Three is bad enough.

Mr. ANDERSON. My answer will be in three parts. First, we want to bear in mind the timing of the problem. The long-term financing problem, really only emerges after the year 2010. The social security system, if we can get through the next 5 years——

Senator HEINZ. Let us assume that. Don't ask us how. We do not have to decide that until Friday.

Mr. ANDERSON. The current structure appears to be viable for the remainder of this century. There may be other problems in terms of equity and the effect on the economy, but it appears to be financially viable. So we do not need to do something in terms of changing things until 2010. However—this is the second point of my answer—a lot of the changes being contemplated are of a nature that individuals and the Government should have a very long leadtime to prepare for them, for example, raising the retirement age or reducing the benefits for early retirement, such as the administration proposed. People make their plans—their plans over their entire lifetime—based on their expectations about what the social security system and their private pensions are going to be like. So people need a long time, 10 or 20 years. So we should get efforts underway now to take care of the problem, even though it does not occur for 30 years.

Senator HEINZ. So far there is no disagreement.

My question in the end comes down to how much?

Mr. ANDERSON. That is part three of my answer: I would try to err on the side of being prudent, in terms of how optimistic are the assumptions that I used, because I think the cost of erring is higher if we undershoot and have to try to fix up the system again, especially if the solutions we adopted involve long-term plans. For

example, what if we tell people that for the good of the system they can only receive a full benefit at age 68, and then it turns out when they reach age 65, that we tell them it has to be age 69 or 70. Then I think we will have made a serious mistake. However, I would not base my plans on the extremely pessimistic set of assumptions, because fixing the system itself is very costly. We do not want to bear costs unnecessarily.

Senator HEINZ. Which do you consider intermediate II-B—do you consider that a truly intermediate assumption? Is that the one you would base your course of action on?

Mr. ANDERSON. Yes. That is the assumption we have used.

Senator HEINZ. The answer to my question is you would seek neither to overshoot nor to undershoot. You would use intermediate B. You would try to take actions today, however many years to implement them. That is the course that you would advocate.

Let me ask you one question: In 1977, we put through the largest tax increase in the history of the system, counterbalanced this year by the largest tax decrease ever. How would you characterize, in two words, the set of assumptions that were used when we took that set of tax increases and it was proclaimed that this was going to make the social security system actuarially sound for the next 75 years. What did you consider those assumptions to be back in 1977? Were they pessimistic, optimistic, or like intermediate B?

Mr. ANDERSON. I think there is a good lesson there for us. The assumptions used in 1977 were quite reasonable. We have had an unusually bad experience since then. In 1977, as today, we should have been using a reasonably pessimistic set of assumptions.

Senator HEINZ. And back in 1977, were those assumptions thought to be reasonable and a little bit pessimistic, or what?

Mr. ANDERSON. I would say they were not considered pessimistic. They were considered to be reasonable.

Senator HEINZ. Somewhat optimistic?

Mr. ANDERSON. I would say, looking at the way the assumptions used have changed since 1977, that the social security actuary and the Department of Health and Human Services who must agree on the assumptions, are probably using a relatively more pessimistic set now, in terms of the spectrum of possibilities, than they were in 1977.

Senator HEINZ. Thank you very much. You have been extremely helpful. You have done a lot of excellent work. You have given us a great deal of forethought and I thank you.

Our next panel will be Alicia Munnell of the Federal Reserve Bank of Boston and Peter Diamond, professor of economics at MIT.

STATEMENT OF ALICIA H. MUNNELL, VICE PRESIDENT, FEDERAL RESERVE BANK OF BOSTON, BOSTON, MASS.

Ms. MUNNELL. The large deficits projected for social security in the first half of the 21st century confront policymakers with fundamental decisions about the future of the program.

As mentioned earlier, the options include raising taxes to maintain current benefit levels for a significantly larger aged population or reducing benefits in an effort to avoid major cost increases. Benefits can be lowered either through across-the-board reductions in the replacement rate—the ratio of benefits to preretirement

earnings—or through extending the age at which workers are eligible for full benefits. In my view, if the decision is made to reduce the size of the social security program, raising the retirement age is preferable to lowering the replacement rate. However, it is not clear that slashing social security is necessarily the most sensible response to the significant demographic shifts expected after the turn of the century.

My testimony today consists of three parts. First of all, I would like to put the forecasted social security tax rates in perspective and discuss the possibility of raising taxes to cover projected cost increases.

Second, I want to examine the problems with the proposals to reduce the size of the social security program by decreasing replacement rates, with particular emphasis on the price indexing plan.

And finally, I would like to explore the advantages of raising the retirement age if we decide to cut the size of the social security programs.

First, placing the high tax rates in perspective. According to the 1981 trustees' report, the cost of social security is projected to rise from the current level of 11 percent of taxable payroll to about 17 percent of taxable payroll in the year 2035, remaining at that level through 2055.

Many view a combined employer-employee tax rate of roughly 17. percent as simply "too high" and considerable effort is currently directed toward devising alternative schemes to reduce long-run costs. The high rate, however, does not mean that the social security program will be any more generous in the future than it is today, but rather reflects the fact that after the turn of the century there will be a very large dependent aged population. These elderly and disabled people must receive support from some source—either social security, direct transfers from their children, private pension benefits, or their own saving. The fact that the projected cost increases stem from the demographics rather than from benefit provisions should be kept in mind when considering major structural changes designed to reduce social security outlays after the turn of the century. Whatever changes are made in social security, the burden of a large dependent aged population is inescapable. A reduction in social security benefits may well lead to greater required expenditures for the elderly and disabled through other programs.

Moreover, those concerned about a combined employee and employer social security tax rate of 17 percent during the next century often ignore the fact that lower fertility results in fewer children per worker. Hence, even at the peak, the overall burden of dependents will be lower in the 21st century than it was in 1965. The rise in the ratio of aged to working population will be more than offset by a decline in the number of dependent children, thereby freeing resources which could be devoted to providing for the elderly.

Finally, while a projected tax rate of 17 percent represents a 60-percent increase over the current levy, it is considerably below the present payroll tax rates in many European countries. Italy, Sweden, and the Netherlands all have rates for programs compara-

ble to OASDI in excess of 20 percent of payroll. Austria, with taxes equal to 19.5 percent of payroll, and West Germany, with 18 percent, also already have rates that exceed the rate projected for the United States as the baby boom retires after the turn of the century.

Once the projected cost increases for social security are placed in perspective, maintaining current benefit levels and raising the payroll tax becomes a reasonable option. The alternative is to lower future costs by reducing benefits.

Senator HEINZ. Are those on payroll or——

Ms. MUNNELL. Payroll taxes.

Once you put the major cost increases for social security in perspective, it seems to me that maintaining current benefit levels and raising the payroll tax becomes a reasonable alternative.

The other option, of course, is to lower future costs by reducing benefits. Two major approaches have been proposed for doing this. One is reducing replacement rates and the other is extending the retirement age. The most comprehensive proposal has been to lower replacement rates through price indexing. This approach, which involves the indexing of the bend points in the social security benefit formula by prices rather than wages, would allow the progressivity of the benefit structure to lower replacement rates for future generations of workers as they moved up into higher real earnings brackets. While price indexing proposal would substantially cut costs, it would also create significant hardship for tomorrow's elderly. The problem arises because the rationale for price indexing is based on two fundamental assumptions, both of which are flawed. First, advocates assume that people's absolute level of real income rather than their position in the income distribution determines acceptable and desired standards of living. Second, proponents maintain that in the future private pensions and individual saving will fill the gap left by a reduced social security program. Because neither of these assumptions are valid, price indexing would force many elderly people, particularly those with histories of low earnings, to spend their retirement in poverty.

The first assumption raises the issue of what it means to replace the same proportion of past earnings for people in the same economic circumstances retiring at different times. The current system implies that people's economic well-being is determined by their relative position in the earnings distribution, and therefore the replacement rate for the average worker is held constant over time. The price indexing proposal, however, assumes that since economic well-being is determined by the absolute level of income in real terms, it is sufficient for replacement rates to remain constant for individuals with the same level of real income. For example, a worker in 2055, with annual preretirement earnings of $15,000 in 1981 dollars, would be assumed to have the same spending and saving habits and, therefore, retirement needs as a worker retiring today with earnings of $15,000; therefore, the worker retiring in 2055 should be given the same real pension amount as a worker retiring today. In contrast, the current system assumes that a worker retiring in 2055 will not have the same spending and saving habits as the worker earning the same real income today because he will be much poorer relative to the average; consequent-

ly, this worker will require a much higher replacement rate. The flaw in the price indexing rationale arises because what is considered an acceptable or desirable level of living is not absolute but rather relative to community standards at a given time.

The second assumption that lower replacement rates in the future will be acceptable since individuals will be much better off, save more on their own and receive much greater private pension benefits is not realistic. Lower paid workers are simply not able to save for retirement since their incomes are barely adequate to cover current consumption. Even middle income workers are unlikely to undertake retirement saving, because the widespread myopia with respect to retirement needs that provided the initial justification for the social security program will in all likelihood persist. Decisions about saving for retirement are vastly more difficult than nearly any other economic decision which most people are called upon to make. They depend on anticipation of wants in a much later period and they require that individuals have access to information about yields from various kinds of assets.

At first blush, a new emphasis on private pension plans may seem an appealing alternative to substantial increases in the payroll tax. Indeed, private pension benefits have increased dramatically as a source of retirement income. The private pension system should not be viewed as a panacea, however, since it is plagued with problems of its own. The private system is incapable of offsetting the impact of inflation or of protecting workers who change jobs frequently. Moreover, pension benefits are concentrated among highly paid people; low-wage workers receive almost no private pension benefits. Less than half of the private nonfarm work force is currently covered by private plans.

The people without pension coverage will continue to be primarily lower paid employees, precisely those people who are incapable of saving on their own. For these individuals, social security will remain the sole source of support in retirement. Lowering social security replacement rates for these workers through price indexing, on the assumption that such a reduction will be acceptable because they will have higher real incomes, will simply force a substantial portion of future retirees to suffer a dramatic decline in economic well-being upon retirement.

As mentioned earlier, benefits can also be lowered by extending the retirement age. While 65 was the most acceptable age for retirement when social security was established in 1935, dramatic changes in the characteristics of the elderly population and the economy argue for postponing retirement past age 65 in the 21st century. Tomorrow's elderly will have improved life expectancy, better health, and more education than those retiring today. It is also most likely that older workers will be in greater demand as the growth in the labor force slows and as an increasing proportion of employment is generated by the service industries where the work is less physically stressful.

Increased labor force participation by older people who are physically able to continue working would be beneficial to them, to the social security program, and to society as a whole. Many of the problems affecting the elderly are directly related to the economic hardship caused by retirement, and these would be relieved by

earnings from continued employment. Working might also alleviate their isolation in a society that seems to have no place for them, and restore their dignity and self-reliance.

In recommending an increase in the retirement age, however, it is essential to remember that some older workers will not be able to engage in gainful employment past age 62 and must have access to some form of income support. If they are prevented from working by physical disability, the appropriate way to provide for them is an expanded disability insurance program. While current law makes some allowance for age in determining disability by applying a more liberal test to those aged 50 or older, more explicit recognition of the interaction of age and physical impairment may be required. In addition, some older workers may not be able to find jobs because they have been displaced by automation. We must be mindful of the fact that unless some provision is made for these workers, the costs of later retirement will be borne by the most disadvantaged aged.

In summary, I would just like to say that there are really three options, and not just two. The first is maintaining current benefit levels and raising taxes. The second and third options entail lowering benefit levels through reduction of the replacement rate or extension of the retirement age, respectively.

Several arguments can be marshaled for maintaining current benefit levels and raising taxes. (1) Higher social security taxes in the next century will be offset by a decline in the resources required for the clothing, feeding, and education of children; (2) the scheduled tax rates, while high by current U.S. standards, are actually lower than the current payroll tax levy in many European countries; (3) finally, if the large elderly dependent population is not supported through social security, the working population will probably end up providing equivalent support through some other program.

In the event that the first option is not viable, I argue for lowering the benefit level by extending the retirement age provided that provisions would be made for the older disabled worker and the worker displaced by technology. The second alternative of lowering replacement rates in a society where only half the workers have private pension coverage will cause a significant portion of workers, primarily those with low earnings, to suffer a disastrous decline in income after retirement.

Senator HEINZ. Thank you for an excellent statement.

[The prepared statement of Ms. Munnell follows. Testimony resumes on page 71.]

PREPARED STATEMENT OF ALICIA H. MUNNELL*

The large deficits projected for social security as the baby boom population retires in the first half of the 21st century confront policymakers with fundamental decisions about the future of the program. The options include raising taxes to maintain current benefit levels for a significantly larger aged population or reducing benefits in an effort to avoid major cost increases. Benefits can be lowered either through across-the-board reductions in the replacement rate (the ratio of benefits to preretirement earnings) or through extending the age at which workers are eligible for full benefits. In my view, if the decision is made to reduce the size of the social security program, raising the retirement age is preferable to lowering the replacement rate. However, it is not clear that slashing social security is necessarily the most sensible response to the significant demographic shifts expected after the turn of the century.

The Problem in Perspective

According to the most recent Trustees Report, the cost of the Old Age Survivors and Disability Insurance (OASDI) portion of the social security program is projected to rise from the current level of 11 percent of taxable

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payrolls to about 17 in the year 2035, remaining at that level through 2055.[1] The sharp increase in costs reflects the changing demographic structure of the population. The ratio of the beneficiary population to covered workers is projected to rise dramatically as the sizeable post-World War II baby boom starts reaching retirement age after 2010. At that time, the working population will be composed of the relatively small group born during the period of low fertility that began in the late 1960s. Assuming that the fertility rate will rise gradually from the current level of 1.8 to a long-run rate of 2.1, the Social Security Administration projects that the number of beneficiaries per 100 covered workers will rise from 31 in 1981 to 50 by 2035, an increase of about 60 percent. Since the social security program is financed on a pay-as-you-go basis, with tax contributions by today's workers paying for benefits to today's beneficiaries, the projected increase in the aged population relative to the working population implies a similar increase in OASDI cost from 11 to 17 percent of taxable payroll.

Many view a combined employer-employee tax rate of roughly 17 percent as simply "too high" and considerable effort is currently directed toward devising alternative schemes to reduce long-run costs. The high rate, however, does not mean that the social security program will be any more generous in the future than it is today but rather reflects the fact that after the turn of the century there will be a very large dependent aged population. These elderly and disabled people must receive support from some source—either social security, direct transfers from their children, private

[1] 1981 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds (July 2, 1981), mimeo., Table 26, p. 59.

pension benefits or their own saving. The fact that the projected cost increases stem from the demographics rather than from benefit provisions should be kept in mind when considering major structural changes designed to reduce social security outlays after the turn of the century. Whatever changes are made in social security, the burden of a large dependent aged population is inescapable. A reduction in social security benefits may well lead to greater required expenditures for the elderly and disabled through other programs.

Moreover, those concerned about a combined employee and employer social security tax rate of 17 percent during the next century often ignore the fact that lower fertility results in fewer children per worker. If the economic burden on active workers is measured in terms of total dependents rather than just aged retirees, then the picture looks quite different. The dependency ratio (the ratio of the number of people under age 20 and over age 65 to those between age 20-64) was .95 in 1965 and declined to a level of .75 in 1980. Assuming a long-run fertility rate of 2.1, the ratio is projected to continue to fall to .68 in 2005 after which it is scheduled to rise rapidly to a maximum of .86 in 2035 where it will remain through 2055.[2] Hence, even at the peak, the overall burden of dependents will be lower in the 21st century than it was in 1965. The rise in the ratio of aged to working population will be more than offset by a decline in dependent children, thereby freeing resources which could be devoted to providing for the elderly.

Finally, while a projected tax rate of 17 percent represents a 60 percent increase over the current levy, it is considerably below the present payroll

[2] 1981 Trustees Report, Table A2, p. 74.

tax rates in many European countries. Italy, Sweden and the Netherlands all have rates for programs comparable to OASDI in excess of 20 percent of payroll. Austria with taxes equal to 19.5 percent of payroll and West Germany with 18 percent also already have rates that exceed the rate projected for the U.S. as the baby boom retires after the turn of the century.[3]

Once the projected cost increases for social security are placed in perspective, maintaining current benefit levels and raising the payroll tax becomes a reasonable option. The alternative is to lower future costs by reducing benefits.

Proposals to Reduce Long-Run Deficit

Two major approaches have been proposed to reduce long-run social security costs—lowering replacement rates and extending the retirement age. The specific suggestions for reducing replacement rates include the proposal by the 1976 Consultant Panel on Social Security to index the bend points in the benefit formula by prices rather than wages and the Administration's proposal to make a one-time ad hoc adjustment in the bend points. My position is that, if the decision is made to lower long-run costs, then extending the retirement age is preferable to either form of reducing replacement rates.

Price Indexing. Indexing the bend points in the social security benefit formula by prices rather than wages would allow the progressivity of the benefit structure to lower replacement rates for future generations of workers as they moved up into higher earnings brackets.[4] If price indexing were

[3]Joseph G. Simanis, "World Wide Trends in Social Security, 1979", Social Security Bulletin, vol. 43 (August 1980), Table 2, p. 8.

[4]Report of the Consultant Panel on Social Security to the Congressional Research Service, 94:2 [GPO, 1976].

adopted permanently, benefits as a percentage of preretirement wages for the average earner retiring at age 65 would drop to 30 percent by 2010 and to about 25 percent by 2055. These figures are to be compared with a constant replacement rate of 41 percent under our current wage indexed system. While the price indexing proposal would substantially cut costs, it would also create significant hardship for tomorrow's elderly. The problem arises because the rationale for price indexing is based on two fundamental assumptions, both of which are flawed. First, advocates assume that people's absolute level of real income rather than their position in the income distribution determines acceptable and desired standards of living. Second, proponents maintain that in the future private pensions and individual saving will fill the gap left by a reduced social security program. Because neither of these assumptions are valid, price indexing would force many elderly people, particularly those with histories of low earnings, to spend their retirement in poverty.

The first assumption raises the issue of what it means to replace the same proportion of past earnings for people in the same economic circumstances retiring at different times. The current system implies that people's economic well-being is determined by their relative position in the earnings distribution, and therefore the replacement rate for the average worker is held constant over time. The price indexing proposal, however, assumes that since economic well-being is determined by the absolute level of income in real terms, it is sufficient for replacement rates to remain constant for individuals with the same level of real income. For example, a worker in 2055 with annual preretirement earnings of $15,000 in 1981 dollars would be assumed

to have the same spending and saving habits and, therefore, retirement needs as a worker retiring today with earnings of $15,000; therefore, the worker retiring in 2055 should be given the same real pension amount as a worker retiring today. In contrast, the current system assumes that a worker retiring in 2055 will not have the same spending and saving habits as the worker earning the same real income today because he will be much poorer relative to the average; consequently, this worker will require a much higher replacement rate. The flaw in the price indexing rationale arises because what is considered an acceptable or desirable level of living is not absolute but rather relative to community standards at a given time.

The second assumption that lower replacement rates in the future will be acceptable since individuals will be much better off, save more on their own and receive much greater private pension benefits is not realistic. Lower paid workers are simply not able to save for retirement since their incomes are barely adequate to cover current consumption. Even middle income workers are unlikely to undertake retirement saving, because the widespread myopia with respect to retirement needs that provided the initial justification for the social security program will in all likelihood persist. Decisions about saving for retirement are vastly more difficult than nearly any other economic decision which most people are called upon to make. They depend on anticipation of wants in a much later period--possibly four or five decades. They require individuals to consider their future stream of earnings and other income, and to recognize the probability that they will be married and have a family and the possibility that they may be unemployed involuntarily for considerable periods of time or become disabled. To save intelligently,

individuals must also be able to appraise the probable future purchasing power of the income from various assets. Most important of all, individuals may not be aware of their mistakes until they are close to retirement, when the consequences are irremediable. Empirical evidence shows that most people fail to save enough to prevent catastrophic drops in income after retirement. No reason exists to think that individual saving will comprise a significant source of retirement income in the future.

At first blush, a new emphasis on private pension plans may seem an appealing alternative to substantial increases in the payroll tax. Private pension benefits have increased dramatically as a source of retirement income, amounting to about 33 percent of OASI benefits in 1980 compared to 25 percent in 1970 and 16 percent in 1960, and private plans may meet a larger portion of the income needs for some groups of future retirees. The private pension system should not be viewed as a panacea, however, since it is plagued with problems of its own. The private system is incapable of offsetting the impact of inflation or of protecting workers who change jobs frequently. Moreover, pension benefits are concentrated among highly paid people; low-wage workers receive almost no private pension benefits.

Less than half of the private nonfarm workforce is currently covered by private plans. The largest percentage of covered workers is found in the highly unionized manufacturing, mining and transportation industries and the lowest is found in the nonunion services and retail trade industries. In addition to a lack of unionization, the relatively small size of establishments in services and retail trade contribute to the dearth of pension plans in these industries. Recent data indicate that 79 percent of

noncovered employees work in firms that employ less than 100 people.[5]

Because of the influence of industry structure on pension coverage, the percentage of the workforce covered by pension plans is not expected to increase significantly in the future. Industries with traditionally high pension coverage, such as manufacturing, are expected to employ a declining share of workers, while employment in industries with low pension coverage, such as retail trade and services, is projected to increase. Furthermore, small businesses, which employ the bulk of noncovered workers, are unlikely to adopt pension plans. These businesses operate on a very tight profit margin in a highly competitive environment and cannot afford the additional cost that a pension plan entails, especially since the relative cost of establishing a pension plan tends to be higher for small firms. Moreover, the progressivity of the corporate income tax reduces the value to small firms of the tax deduction for pension contributions.

The people without pension coverage will continue to be primarily lower paid employees, precisely those people who are incapable of saving on their own. For these individuals, social security will remain the sole source of support in retirement. Lowering social security replacement rates for these workers through price indexing, on the assumption that such a reduction will be acceptable because they will have higher real incomes, will simply force a substantial portion of future retirees to suffer a dramatic decline in economic well-being upon retirement.

Adjusting the Benefit Formula. Most of the problems associated with

[5]President's Commission on Pension Policy, Coming of Age: Toward a National Retirement Income Policy (1981), Chart 6, p. 28.

reducing replacement rates by price indexing are equally applicable to lowering benefit levels through a one-time adjustment of the bend points in the benefit formula. The only factor in favor of an ad hoc adjustment is predictability so that corporations and the pension industry will know the level of protection to be provided by social security in order to establish meaningful private pension benefits and realistic integration provisions. Under the price indexing proposal future replacement rates are not predictable but rather depend on the rate of growth of real wages. For example, in the absence of productivity growth replacement rates would remain constant for the average worker; with positive real wage growth they would decline; and with price increases in excess of wage growth, as has been the case in the last few years, replacement rates would actually rise.

The advantage of price indexing over an ad hoc adjustment is that it allows for a more gradual reduction in replacement rates. Avoiding abrupt changes in the level of benefits is essential in order to provide individuals with enough time to revise their saving plans in response to the lower levels of replacement under social security. Lowering replacement rates, however, either through price indexing or by adjusting the benefit formula is an inferior option to extending the age at which individuals are eligible for full benefits.

Extending the Retirement Age. While 65 was the most acceptable age for retirement when social security was established in 1935, dramatic changes in the characteristics of the elderly population and the economy argue for postponing retirement past age 65 in the 21st century. Tomorrow's elderly will have improved life expectancy, better health, and more education than

those retiring today. Older workers will also be in greater demand as the growth in the labor force slows and as an increasing proportion of employment is generated by the service industries where the work is less physically stressful.

Although most of the startling gains in life expectancy during this century are attributable to a substantial reduction in neonatal mortality and elimination of childhood diseases, the life expectancy of older workers has also increased significantly. For men life expectancy at age 65 has risen from 12.1 years in 1940, when social security benefits were first paid, to 14.0 in 1978 and is projected to increase to 15.6 years by 2000. The comparable figures for women are more dramatic, increasing from 13.6 years in 1940 to 18.4 in 1978 and projected to rise to 21.1 years in 2000.[6] With these projected increases in life expectancy, workers will have at least as many years left after age 68 during the first half of the next century as they did after age 65 in the early years of social security. In view of the improved mortality, actuaries at the Social Security Administration recently calculated the retirement age that would be equivalent to retiring at age 65 in 1940. Under any of four measures, the 1980 equivalent to age 65 retirement was 69 years and the 2000 equivalent was more than 71 years.[7]

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[6]U.S. Bureau of the Census, Statistical Abstract of the United States 1980, 101st ed. [GPO, 1980], Table 107, p. 72. The projections for the year 2000 were made by the Office of the Actuary, Social Security Administration and reported in the Final Report of the National Commission on Social Security, Social Security in America's Future (March 1981), p. 124.

[7]Francisco R. Bayo and Joseph F. Faber, "Equivalent Retirement Ages: 1940-2050," Actuarial Note Number 105, Social Security Administration (June 1981).

The projected health of tomorrow's elderly is equally important as longevity in assessing their ability to work past age 65. Current studies of the elderly reveal that a large majority of people under 70 are free of physically disabling limitations.[8] This may be attributable partly to the significant progress that has been made in treating arthritis and cardiovascular diseases, two of the most important barriers to good health at older ages. Most of the evidence indicates that increased life expectancy will be accompanied by a corresponding increase in the physical well-being of the aged.[9]

Older workers after the turn of the century will also be better educated than their counterparts today. The baby boom generation has already achieved a higher level of formal schooling than any previous generation. In 1979, about 85 percent of those aged 22 to 29 had graduated from high school, compared to only 50 percent of the same age group in 1950 and 60 percent in 1960. Over half of those aged 25 to 29 in 1979 had some college education, compared with less than 20 percent of the same age group in 1950. Improved education and training will enable them to adapt to the changing technological demands of the work place.[10]

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[8] Branch, L.G., Understanding the Health and Social Service Needs of People Over Age 65, University of Massachusetts and Joint Center for Urban Studies of M.I.T. and Harvard University, report submitted in partial fulfillment of grants 90-A-641/01 and 90-A-641/02 from the Administration on Aging, Department of Health, Education and Welfare (1977).

[9] See discussion in the Final Report of the National Commission on Social Security, pp. 124-126.

[10] U.S. Bureau of the Census, 1950, special report P-E, no. 5B Education, Table 5; 1960 Census of Population, PC(2)-5B, Educational Attainment, Table 1; Current Population Report P-20, no. 314, Educational Attainment in the United States: March 1979 and 1978, (December 1980), Table 2, pp. 20-28.

The changing conditions in the labor market will lead most likely also to an increased demand for older workers. The growth in the labor force will taper off at the turn of the century, since the low birth rates of today will result in considerably fewer new workers. Unlike the past when the rapid growth in the supply of workers strained the nation's capacity to provide enough new jobs, the new environment should create a tight labor market where the experience and skill of older workers will be in increasing demand. Their employment will be further facilitated by the long-term shift in the industrial structure from mining and manufacturing where health hazards are relatively high, to trade and services, where older workers can perform with less strain and threat to their health.

Considering the improved health and life expectancy of the aged and their potential for playing an important role in the slowly growing labor force at the turn of the century, it is reasonable to recommend that they continue active and productive employment beyond the customary retirement age of 65. Increased labor force participation by older people who are physically able to continue working would be beneficial to them, to the social security program and to society as a whole. Many of the problems affecting the elderly are directly related to the economic hardship caused by retirement, and these would be relieved by earnings from continued employment. Working might also alleviate their isolation in a society that seems to have no place for them, and restore their dignity and self reliance.

In recommending an increase in the retirement age, however, it is essential to remember that some older workers will not be able to engage in gainful employment past age 62 and must have access to some form of income

support. If they are prevented from working by physical disability, the appropriate way to provide for them is an expanded disability insurance program. While current law makes some allowance for age in determining disability by applying a more liberal test to those aged 60 or older, more explicit recognition of the interaction of age and physical impairment may be required. An appropriate procedure might be one analogous to the sliding scale used to determine eligibility for veterans' disability pensions. Under this procedure permanent and total disability is required for receipt of pensions before age 55; 60 to 70 percent disability is sufficient between the ages of 55 and 59 and only 50 percent disability is required between 60 and 64. An expanded disability program is a crucial prerequisite to extending the retirement age.

In addition, some older workers may not be able to find jobs because they have been displaced by automation. These aged will not have access to disability insurance and may face a severe loss of income as a result of extending the social security retirement age. The changing characteristics of the work place, however, indicate that the number of healthy unemployed aged may be quite small. While retraining older workers is generally considered impractical today, in the tight labor markets forcasted after the turn of the century restructuring jobs for older employees may become economical.

The issues raised by the older disabled worker and the worker displaced by technology highlight the potential dangers in raising the age at which full social security benefits are available. Unless some provision is made for these workers, the costs of later retirement will be borne by the most disadvantaged aged. Expanding the disability program, however, necessarily reduces the cost savings of extending the retirement age. After adjusting for

increased disability outlays, proposals which involve a gradual increase of the retirement age from 65 to 68 yield a long-term reduction in costs of about 1 percent of taxable payroll.[11] The major reductions would come after the turn of the century when the new retirement pattern would lead to a cost saving of about 1.6 percent of taxable payroll. With the retirement age at 68 rather than 65, costs in the year 2035 would be 15.4 rather than 17 percent of taxable payroll. Careful consideration should be given to determining whether this cost reduction is worth a dramatic restructuring of our institutions and the potential that some unemployed elderly will be left without a viable source of support.

Conclusion

A large dependent elderly population creates an inescapable burden which is reflected in the required increase in the social security tax to about 17 percent of payroll after the turn of the century. The first question is whether to schedule future tax increases to cover these costs or to reduce benefits as the baby boom generation retires. If benefits are to be lowered, a second question is whether to reduce replacement rates or extend the retirement age. Several arguments can be marshalled for maintaining current benefit levels and raising taxes. 1) Higher social security taxes in the next century will be offset by a decline in the resources required for the clothing, feeding and education of children. 2) The scheduled tax rates, while high by current U.S. standards, are actually lower than the current payroll tax levy in many European countries. 3) Finally, if the large elderly dependent population is not supported through social security, the

[11]For example, see Final Report of the National Commission on Social Security, Table 5-2, p. 125.

working population will probably end up providing equivalent support through some other program, in light of the historical inability of people to save for retirement and the inadequacies of the private pension system.

We may be unwilling, however, to commit the working population in the 21st century to transferring 17 percent of their payroll to the retired and disabled. In that case the relative merits of alternative approaches to reducing long-run costs become important. The improved life expectancy and health of the elderly and the likelihood of increased pressure for older workers to remain in the labor force argue for raising the retirement age, provided that expanded disability benefits are available for those too incapacitated to work. The alternative of lowering replacement rates in a society where only half the workers have private pension coverage will cause a significant portion of workers, primarily those with low earnings, to suffer a disasterous decline in income after retirement.

Senator HEINZ. Mr. Diamond.

STATEMENT OF PETER A. DIAMOND, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MASS.

Mr. DIAMOND. After Joe Anderson testified, Senator Cohen asked him a question which is the centerpiece of all of my remarks. The question was:

> You have told us that if the elderly work longer, it has a small effect on the deficit. On the other hand, we have been told that if we pass the recommended legislation to delay the normal retirement age by 3 years, that will pretty much eliminate the deficit.

How can both of these be right?

Senator HEINZ. You are about 50 percent right. It was my question.

Mr. DIAMOND. My apologies.

Joe Anderson gave the answer by spelling out the different assumptions that went into those two answers. This is a critical question. I want to give my answer, which is to bring out the basic fact of the proposal to delay the normal retirement age. Namely, it is a proposal to cut benefits. A proposal to delay the retirement age is a proposal to cut benefits. That is the central fact about both of these proposals, delaying the retirement age and reducing the replacement rate.

In your introductory remarks, Mr. Chairman, you said we were here to scrutinize and compare these two. It seems to me the central issue seems to be the two different patterns of benefit cuts, which pattern of benefit cuts is more appropriate. One can then go on and ask the question that Alicia asked, of whether you want to cut benefits at all. But first, we have to get out on the table the most attractive set of benefit cuts.

I want to do two things: First, I want to explain very briefly why delaying the normal retirement age is a benefit cut. And second, I want to explain why it is a bad way to design the benefit cut. The point is to consider some particular retiree. We will say in the year 2000 he retires at age 65 and he calculates his benefits under current law and calculates his benefits under the law with a delay of 3 years. He discovers he has 20 percent less benefits. The fact that he may or may not live longer does not change the fact that given how much he has worked he is getting a smaller check.

If we think of someone retiring at age 68, he also gets a benefit cut. That benefit cut though is only 9 percent, slightly under 9 percent, rather than 20 percent. The difference is that the actuarial reduction factor, which now applies to 62- to 65-year-olds, and would then apply to 65- to 68-year-olds, is a lot larger than the delayed retirement increment. So the proposal to delay the normal retirement age is a proposal to make large cuts for early retirees and small benefit cuts for those retiring late.

The question is: Is that a desirable pattern of benefit cuts? And I think the answer is no. The basis for my saying no comes from looking at what we know about the people retiring early. First, let me say that making the benefit cut this way does not attempt to relate the benefit cut to the size of benefits which is the normal way we think of making cuts. With the income tax, we think of

people with different incomes and cuts relative to the income. Here is a plan of making cuts on a different criteria. So we have to ask how does it fall relative to the size of the benefit, and it seems to me peculiar to have to ask that question rather than by starting saying shouldn't we be relating the cuts to the size of benefits.

The first thing we know about the early retirees, and I am concentrating on those who retire at 62, is that on average they have significantly lower earnings over their lifetimes than people retiring later. It shows up year after year in the statistics of the Social Security Administration.

Another significant fact about the early retirees is that if they are people who have been saving something for retirement, and some of them have while some of them have not, then they have had shorter working lives over which to accumulate savings for retirement. And many of them will have a longer retirement life, because they are retiring earlier to finance out of smaller savings. So that is another reason why they are more vulnerable than people retiring later.

The third element comes when we look at the question as to why the people are retiring. This is really the crunch issue, and unfortunately it is an issue about which we do not know a great deal. The problem, of course, is the large tendency for people to say bad health is the reason. Bad health is a very subjective element. It is very difficult to sort out what it means. Some people with a health problem stop working. Other people with the same health problem do not stop working. It is just very hard to know what that means.

One way of getting a feeling for that is to look at the behavior of these people before they retire.

To me, what is a very significant fact, is the tendency for many of the early retirees to have been out of work for a period before they claim benefits. The particular statistics I have are rather old. They come from 1968, when there was a survey of newly entitled beneficiaries by the Social Security Administration. They are in the process now of completing an analysis of a more recent survey. It is not yet available.

In 1968, the unemployment rate was only 3.6 percent. It was a lot easier to find jobs than it is now. Forty percent of the 62-year-old male retirees—I am leaving out the issue of housewives who may not have been in the labor force—40 percent of the 62-year-old male retirees had been out of work at least 6 months before becoming eligible for benefits. One of six of these retirees had been out of work at least 3 years.

Now possibly there are that many wealthy people out there retiring early. We do not have that kind of details. My sense is rather different, that these are people with health problems not severe enough to receive disability benefits and, second, these are people with long-term unemployment. We do not have any other programs to deal with these people. In the absence of other programs, programs of long-term unemployment benefits for older workers, programs dealing with disabilities that are less severe than the disability programs, early retirement is the key option for these people. Cutting benefits for them by a large amount, cutting them by a larger amount than for people retiring late or, more severely, eliminating the option of retirement benefits for 62- to 65-

year-olds completely seems to me to be an extreme move against a set of people who are, by and large, not in a strong financial position.

Now, the advantage of a decision to lower the replacement rate is that that can be patterned across different size benefits. Whether it is done by changing the bend point, whether it is done by a straightforward change in the benefit formula that is phased in well in advance, it is something more directly controlled by Congress in terms of who gets the cuts and who does not get the cuts.

That is the heart of my message and I will stop and turn it over to you for questions.

[The prepared statement of Mr. Diamond follows. Testimony resumes on p. 85.]

PREPARED STATEMENT OF PETER A. DIAMOND

Despite the large changes in the 1977 Amendments to the Social Security Act, current forecasts call for more tax increases. Since this call is not very popular, people are examining various ways to decrease the growth of benefits for future retirees. There has been considerable support for decreasing benefits by increasing the normal retirement age. After briefly reviewing other methods of slowing benefit growth, this proposal is analysed below. The proposal is found unsatisfactory since it concentrates benefit cuts on a relatively poor group, the early retirees. Whatever changes are made to save revenues, it would be good to increase the incentives for more work. An attractive method would be to pay an increasing fraction of benefits to workers as they age, independent of earnings. Equivalently this proposal can be seen as applying the earnings test to a decreasing fraction of benefits.

The 1977 Amendments

In the annual reports of the Trustees and in the evaluation of legislated changes, the Social Security Administration's actuaries try to forecast cash flows for the following 75 years. Since the program will eventually affect even the youngest of today's payroll taxpayers and since it has tremendous financial inertia, advance planning is extremely important. To have the estimates in a meaningful form they are stated as a percentage of taxable payroll, averaged over 75 years. The estimates can then be compared with the payroll tax rate, which was 9.90% in 1977 if we exclude the Medicare. With no change in Social Security, it was forecast then that the deficit would be 8.20% of taxtable payroll. That is, promised benefits were roughly twice the size of what could be financed with

the then current tax rate.

There were many changes voted in the 1977 Amendments. Those that affected benefits saved 4.98% of taxable payroll. Those that raised taxes only added 1.78% of payroll. And the remaining forecasted deficit was 1.46%--about the same size as the tax increase. It is true that the deficit does not appear in the forecasted annual budget until the baby boom generation, now in their thirties, starts retiring. When that happens we will witness a 50% increase in the ratio of the aged to the working age population. Without a large Social Security Trust Fund, this increase is bound to generate pressures. Little has changed since 1977 to alter this general picture of the long term problems, while the short term problems are more severe than was forecast.

Slowing Benefit Growth

Of course, the public response to the 1977 Amendments was not to this picture of a financially straitened distant future. Rather the public noticed the small tax increase of 1978 (which was in place before the 1977 Amendments) and the planned 14% increase in payroll taxes over the next decade. Even more they noticed that a large share of this increase came from raising the maximum earnings subject to tax. Measured by bills introduced, the initial response of Congress was to substitute an income tax increase for the payroll tax increase. This would change the distribution of the tax increase, and might be less visible to angry voters; but would not address the basic question of whether benefits are growing more rapidly than we are willing to pay for.

The 1977 changes provide benefits per new retiree which grow roughly in proportion with wages per worker. However, with the number of retirees per worker growing rapidly, total benefits are scheduled to grow substantially relative to the economy. Increasing tax consciousness is one reason to slow

This rate of benefit increase. A second reason is that real wages are expected to grow over the long run. Future retirees will have had considerably higher incomes than current retirees. It is reasonable to expect them to finance a higher percentage of their retirements themselves. Since part of the payroll tax increase is to accumulate revenue for future benefits, rethinking future benefits permits reconsideration of thepayroll tax level we need now.

Methods of Cutting Planned Benefits

There appears to be a wide consensus that present, and future, retirees should continue getting benefit increases to offset increases in the cost of living. Thus if we want to cut total benefits we must decrease benefits for new retirees or decrease the rate of retirement.*/ I expect we will do both. But there is no reason to think that a single change would be a good way to distribute benefit cuts across the population and simultaneously encourage people to work longer and retire later. So, we need to think about cutting benefits. And to think about encouraging more work. And then put the two pieces together.

There are lots of ways of cutting benefits. The most straightforward is to decrease the benefit table used for determining benefits of new retirees. Under current law the calculation to determine benefits is different for people born in different years. The differences are determined by the growth in average wages in the economy. It would be straightforward to add a second difference to slow the rate of growth of benefits determined by these tables. In this way the legislation to decrease benefits would have direct control over the way the benefit cuts are distributed

*/Also, we could decrease disability, survivor, or dependent benefits.

over retirees of different ages and with different levels of benefits.

Another straightforward method would be to include part (or all) of Social Security benefits in taxable income for the U.S. income tax. This extra tax revenue could be channeled to the Social Security Trust Funds. The virtue of this method is that benefit cuts would be greatest for those in the highest tax brackets, who are best able to absorb a benefit decrease. While this idea has been enormously popular with economists, it has been a repeated non-starter in Congressional discussions.

There are also complicated (and less visible) ways of cutting benefits. With the new Amendments, a wage index is used both to calculate an individual's average indexed earnings and to change the benefit table which relates benefits to past indexed earnings. We could substitute a price index for the wage index in these two steps in the calculation of benefits. Provided that wages grow more rapidly than prices this change would noticeably slow benefit growth. As successive generations of workers have higher real earnings they would move up the benefit table into regions where benefits are smaller fractions of earnings. Wage indexing removes this consequence of higher earnings by shifting the benefit table in step with average wage growth. With price indexing, real benefits depend on an individual's history of real earnings. With wage indexing, those born later receive higher benefits than their elders who had the same real earnings. Compounded over a long time this difference is substantial. Price-indexing received some attention before the 1977 Amendments were voted, although it was a late starter in political discussions.

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A proposal which has received considerable attention and wide support is to delay the normal retirement age for receipt of benefits. The first three methods of cutting benefits seem to me to be good ideas, separately or in combination. Delaying the normal retirement age is a poor way to cut benefits and a poor way to encourage later retirement and fewer beneficiaries. Since it has received so many endorsements (and so little analysis) we need to look closely at its workings.

Delaying the Normal Retirement Age

Although anyone over 62 can stop working and claim retirement benefits, the "normal" retirement age is 65. By this we mean that those retiring before 65 have their benefits decreased for "early" retirement. Those who first claim benefits after 65 have benefits increased for "late" retirement. In other words, benefits are larger the older the retiree when benefits are first claimed. In addition to the semantic difference between reductions for early retirement and increases for late retirement, there is a substantive difference. The reductions are larger than the increases. Retiring at 62 reduces benefits by 20% compared to retirement at 65. Working to 68 rather than 65 only increases benefits by 9% (under the 1977 Amendments). This pattern is shown in Figure 1., which shows the pattern after legislated changes go into effect for 1982. (This discussion of actuarial reduction and the delayed retirement increment ignores the fact that a year of good earnings will raise a worker's AIME, and so the worker's benefits.)

The proposal to change the normal retirement age to 68 is a proposal to shift this schedule of reductions and increases. Someone retiring at 65 would receive a 20% reduction for early retirement rather than the

benefit appropriate for retirement at the normal age. Someone retiring at 68 would be retiring at the normal age and would not receive the present 9% increase for working past the normal age. In this way the proposal to delay the normal retirement age is a proposal to cut benefits. The change is shown in Figure 2.

This approach to cutting benefits does not relate the size of the percentage cut to the size of the benefit, making it important to examine its implications for the distribution of income. Concentrating benefits cuts on early retirees is unattractive since they tend to have longer retirements to finance and to have had shorter periods to accumulate funds for retirement. A further, and more serious, issue arises when we look more closely at the makeup of 62-64 year old retirees. For these contain a very needy group. At present, well over half of new retirees, both male and female, are under 65. Sixty per cent of the early retirees claim benefits at 62. In a detailed survey in 1968 (when the unemployment rate was only 3.6 per cent), it was found that 40% of 62 year old male retirees had been out of work at least six months before becoming eligible for benefits. One in six of the male retirees had been out of work for three years or more before receiving benefits. With this level of hardship one must take care in applying the changes that go with a delay in normal retirement. To simply shift eligibility for retirement benefits by three years, from 62 to 65, would be intolerable. To simply extend the rate of benefit reduction for early retirement for six years rather than three would give a 62 year old retiree a 25% cut in benefits (80% of the benefit at 65 will drop to 60% of the same benefit at 68). With so many of these people receiving low benefits, such a large change would be unduly harsh. There is one proposal to exempt many of these early retirees from any

benefit cut. This would be done by introducing a new, weakened, definition of disability for those between 62 and 65. Those satisfying the new definition, but not the present one, would be given the same benefits as at present without disability. Only those who don't satisfy even the weaker definition would have their benefits cut 25% because of the delay in the normal retirement age. It is not known how many of the hardship cases would be reached in this way. No doubt some of them would be missed.

Incentives for Longer Working Lives

Delaying the normal retirement age is not only inequitable; it also preserves the inefficient incentives to work of the present system. There are better systems of incentives to encourage later retirement. For a worker between 62 and 70 (when Social Security benefits will be paid independent of retirement after 1982) there are two sides to the financial return to further work. One is the immediate financial gain--the excess of take-home pay (plus fringes) over the pension available with retirement. The other side is the increase in future retirement benefits as a result of an extra year's work. The value to a worker of a larger future pension depends on many factors--the size of the pension increase, the date when pension benefits will start, life expectancy of the worker, the presence of any dependents who will also receive larger benefits, and the worker's need for current income relative to future income. Obviously, different workers will value future benefit increases differently relative to current earnings. They may also differ in the accuracy of their understanding of the future payoff to current work.

By only delaying the normal retirement age, we would preserve two unsatisfactory aspects of the current incentives for longer work. One is that we rely too heavily on future benefit increases and not enough on current income to encourage work. We can arrange a more efficient incentive by paying part of the retirement benefit independent of retirement and still preserve the insurance aspect of Social Security. The second unsatisfactory aspect is the pattern of benefit increases with longer work. As workers age, the length of time they expect to collect higher delayed benefits gets shorter. To preserve the level of work incentive the rate at which future benefits grow with delayed claiming of benefits must increase as workers age. But the current system has the reverse pattern--much more rapid benefit growth with additional work at younger ages than at older ones.*

A Proposal to Encourage More Work

To correct these two problems, let us pay a growing fraction of retirement benefits to those between 65 and 70 who continue working. For example 15% of benefits could be paid to 65 year olds who continue working. The remaining 85% would be subject to the same retirement test as at present.** Those who are 66 would receive 30% of benefits independent of retirement, with 70% still subject to the retirement test. The fraction paid independent of earnings would grow until age 70 when, as under the new Amendments, full

* For a theoretical model supporting these two propositions, see two papers I have written with James Mirrlees.

** That is, benefits would be reduced by $.50 for each $1.00 of earnings beyond the exempt amount as at present, but benefits would not be reduced below 15% of their full amount. Alternatively, the benefit amount independent of retirement could be added to reduced benefits (up to 100% of benefits) in the event of work above the exempt amount.

benefits would be paid.*** While these numbers aren't sacrosanct, the principle of paying a growing fraction of benefits independent of retirement would significantly enhance work incentives.

The proposal involves only partial benefits for those between 65 and 70. There have been frequent suggestions to pay full benefits to everyone over 65. This would be going too far, losing significant aspects of the Social Security system. Individuals don't know when they may be forced to retire. If this happens early, they are worse off than if it happens late. By paying only partial benefits if an individual has high earnings, we can finance larger benefits if he has to retire early. This provides important insurance to an individual. A second aspect of the same principle is that, on average, those who continue earning are financially much better off than retirees. By paying lower benefits to late retirees and higher benefits to early ones we give more money to those with greater need. The problem in designing the Social Security system is to strike the right balance between work incentives and the provision of insurance. We need to combine slower aggregate benefit growth, greater incentives for work, and continued provision of greater benefits to those with greater need to have a Social Security system which works more efficiently and costs less.

*** The Office of the Actuary has estimated that this proposal would cost .06% of taxable payroll. This estimate is based on the assumption that the proposal has no effect at all on retirement ages. The cost would be less if some workers respond by working longer.

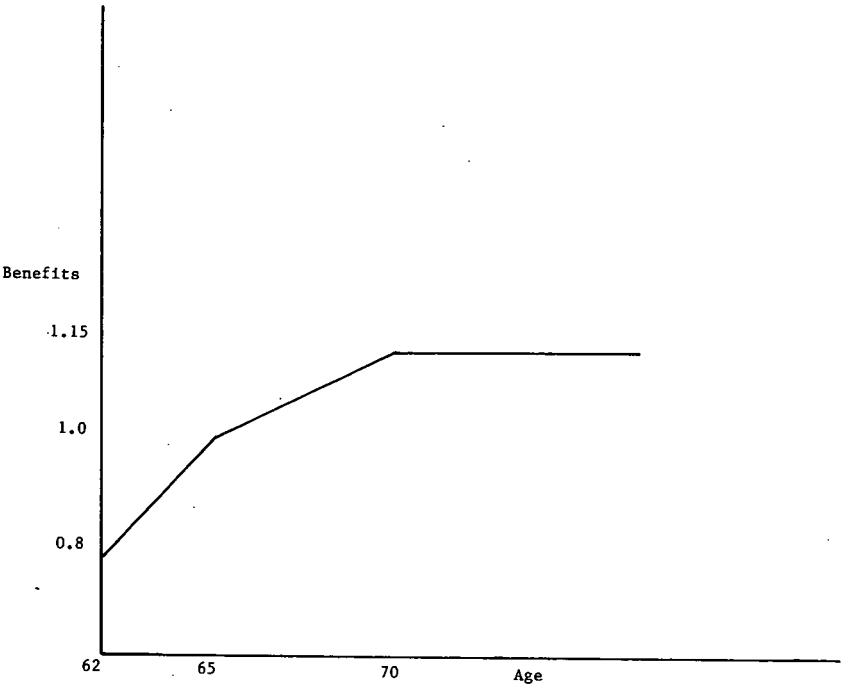

Figure 1. Benefits at different retirement ages, AIME held constant

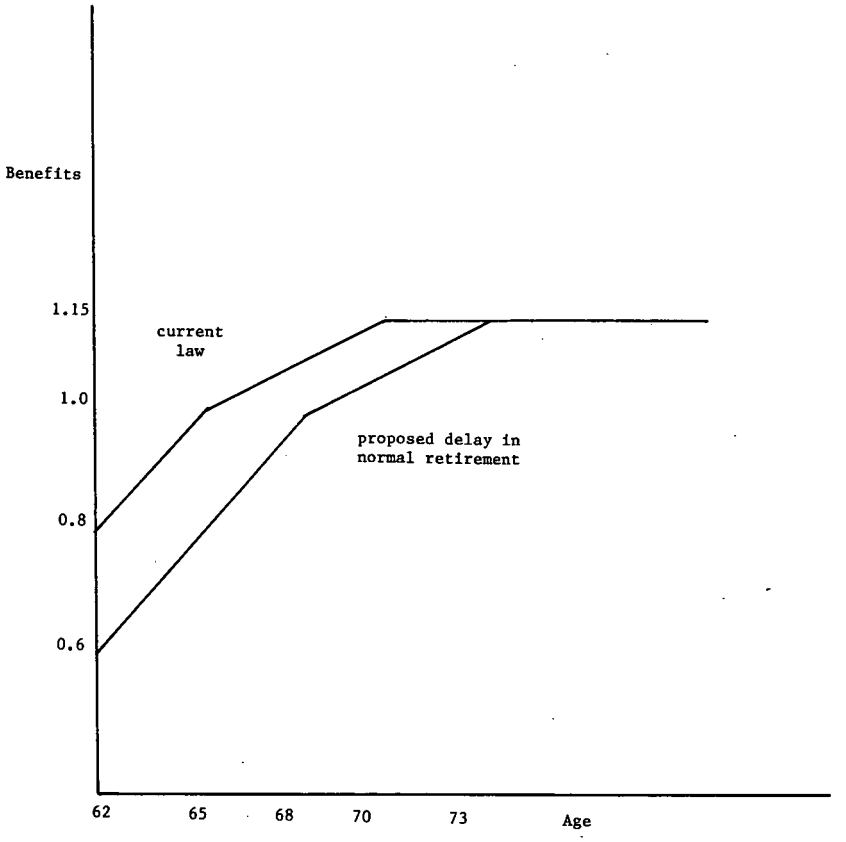

Figure 2. Benefits at different retirement ages, AIME held constant

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Senator HEINZ. Mr. Diamond, let me ask you this question: I think we are all agreed that if people wanted to work longer and you could encourage them to do so through incentives as opposed to punishments, that that would be very beneficial in a variety of ways. It would cut down on expenditures and help on the revenue side too, paying in longer and therefore on a case of first impression, commonsense, it would seem that the way we do the least amount of damage overall is to try and encourage people to do that because then whatever benefit cuts, however we decide to apportion them, whether it is through changes in bend points, or replacement ratios, or through what we have just discussed here, will be all the less necessary.

It would seem, therefore, that it would make some sense to adjust the age at which full benefits are paid in social security if we could find a mechanism, such as Ms. Munnell has suggested, that takes into account disability but not perhaps exactly as we define it today, maybe making age a more sensitive factor, maybe making the history of unemployment, which under some interpretations I understand now is taken into account in some determinations of disability today. Even taking the mix of skills related to the job, if one is smart enough to know how to do that. If someone knows how to be a steeplejack, I would certainly understand that at age 65 you are not quite what you were at 45, in a blizzard on cold, windy day 300 feet up. I would rather be there, if ever, at age 45 as opposed to age 65. I am not sure I would like to be there in any event.

What do you think of Ms. Munnell's suggestion as a way of attacking the very real problem that you described, which is the distribution of age when it comes to the taking of early retirement?

Mr. DIAMOND. I am in favor of expanding the disability program for older workers, taking into account the kinds of things you mentioned.

Senator HEINZ. Could it be done to achieve what she wanted to do, which is to go along with Senator Chiles or Mr. Pickle's proposals which, in effect, raises the retirement ages and takes care of what you see as the problem?

Mr. DIAMOND. I do not think anyone has a firm answer to that question, and I think on this issue you have to put the horse before the cart. We should expand the disability program if that is what makes sense, and then look to see how well it works at reaching the people we think of as being in trouble; and if it reaches those people, then we can think about eliminating or cutting back on the availability of retirement benefits of the people we missed.

It is a basic fact of any of these programs that try to measure individuals available for work, that they will make two kinds of mistakes. Some people we think should get benefits, if we know everything we would like to, would not get them. Some people we think should be denied benefits, if we knew everything, will get them. That is a fact that, no matter how much money we throw at it, will not be solved. Until we have a program in place, it is hard to speculate how successful it will be in reaching the people that need it.

Senator HEINZ. Ms. Munnell, you are an advocate of increasing the retirement age, and you have spoken very effectively on the reasons why we should do so.

We have talked about how that proposal is fair or unfair to low wage workers. One thing that we have not looked at is the extent to which that is a benefit or not to the economy.

Now, one possibility is by having people in the labor force longer and retiring for shorter periods, they could decide that they did not need to save as much for their retirement.

Is there any effect on personal savings if you keep people in the work force longer?

Ms. MUNNELL. If we extend the length of time that people are in the work force, then they will be saving over a long working life for a shorter retirement period. The transition in the retirement age from 65 to 68 could result in fluctuations in saving. However, once the retirement age stabilized at 68, there would be further changes.

Senator HEINZ. Does that wash out, in effect? Is there a benefit or penalty?

Ms. MUNNELL. It would depend also on the rate of population growth. Assuming the rate of population growth slows, then there would be no net effect on savings rates.

Senator HEINZ. You indicated that we should not expect the private pension sector to pick up much of the slack here. Why is that? What is the import of that?

Ms. MUNNELL. I am slightly embarrassed to speak about this when you have a whole cadre of experts here.

Senator HEINZ. They differ, too.

Ms. MUNNELL. I know.

We have seen an enormous growth in pension programs during the 1950's, 1960's, 1970's, and, increasingly, retirees will get some portion of retirement income from private pension plans. My personal assessment is that the degree of coverage is approaching a maximum. Industries with traditionally high pension coverage, such as manufacturing, are expected to employ a declining share of workers, while employment in industries with low pension coverage, such as retail trade and services, is projected to increase. Moreover, 79 percent of noncovered employees work in firms that employ less than 100 people. I do not envision those establishments setting up private pension plans on a voluntary basis.

Senator HEINZ. The President's Commission on Pension Policy, recommended that pensions be in effect mandatory for all employers; and I believe they made some provision for effective portability of those pensions.

What, from an economist's standpoint, are the pros and cons of doing that? Do we drive small businesses out of existence? Do we increase the savings of employment and growth heightened in other ways? What are the consequences of this?

Ms. MUNNELL. It is a complicated proposal and it has various aspects to it. The advantage of the Pension Commission's recommendation is that those people who would otherwise never have supplemental income through private pension plans would be covered. Clearly that is an advantage.

One of the disadvantages, however, is that additional funds will be needed to pay the private pension plan benefits for newly covered low-income workers. As an economist, I have adopted the position that the worker eventually pays for his pension plan benefits through lower wages over his work life. The idea that the employer will suddenly pay out additional benefits, that were not required previously does not seem realistic to me.

On the contrary, employers will introduce the pension plan and, instead of allowing the contracted wage growth, they would have a somewhat lower wage growth. In other words, employees pay for their own pensions through lower wages.

Senator HEINZ. That assumes that these businesses that do not have the pension plan are among the more marginal businesses; that they could not raise prices or take it out of profit. Competition would not permit the latter and they do not have the margin to do the former.

Ms. MUNNELL. The typical assumption is in competitive markets, the firm cannot afford to pay compensation in excess of that being paid by other firms.

Senator HEINZ. Presumably, either competition for labor or competition by labor would force them to do so.

Ms. MUNNELL. You are right. There is very little evidence in the area of who pays either for social security contributions or for fringe benefits. But the evidence that does exist indicates that the workers pay for fringe benefits. My concern, therefore, lies with the low-income workers. For it is the low-income worker who will bear the heaviest burden if his coverage in a pension plan results in a decline in his net pay. Granted, this burden could be alleviated if the worker saved more, but the needs of the present may be more pressing that those of the future.

Senator HEINZ. I see Senator Bradley is here. Do you have any questions for the witnesses, Senator?

Senator BRADLEY. I have no questions.

Senator HEINZ. I think your testimony has been extremely helpful. I think the focus on the power of changing retirement age is quite important, as is the fact that disability and low income are prevalent among the early retirees. I do not think it received anywhere near the amount of understanding and coverage that they deserve. I suspect that if the administration had looked harder at this particular set of problems, they would not have come forward with the particular set of proposals that I think they are trying to forget themselves.

We thank you very much.

Our next witnesses are Peter McColough, chairman and chief executive officer of Xerox, and William Greenough, from the Committee for Economic Development.

Mr. McColough, would you please proceed.

STATEMENT OF C. PETER McCOLOUGH, STAMFORD, CONN., CHAIRMAN AND CHIEF EXECUTIVE OFFICER, XEROX CORP., AND FORMER CHAIRMAN, PRESIDENT'S COMMISSION ON PENSION POLICY, ACCOMPANIED BY PROF. THOMAS C. WOODRUFF, CORNELL UNIVERSITY, AND FORMER EXECUTIVE DIRECTOR, PRESIDENT'S COMMISSION ON PENSION POLICY

Mr. McCOLOUGH. I am delighted to be here with my good friend, Bill Greenough.

On my right, I have with me Prof. Tom Woodruff, of Cornell University, who served as the Executive Director of our President's Commission on Pension Policy.

In our 2½ years, I think we came to certain conclusions, and I will state those briefly and, with your permission, I will summarize my prepared statement.[1]

Senator HEINZ. By the way, I understand we will have a vote in a relatively short time. There is one scheduled for 4 o'clock, so I warn you about that. If it does happen, we will come back and finish up.

Mr. McCOLOUGH. We came to some general conclusions regarding the Nation's retirement program, and the first is that our Nation's retirement programs are dangerously dependent on pay-as-you-go programs, such as social security. These large, tax-supported programs have created an imbalance which has serious implications for the future.

We also felt that private pension coverage is lacking for many. And where individuals are covered, the lack of coordination among programs results in very low benefits for some, while others receive rather excessive benefits.

We also felt that inadequate incentives exist for retirement savings, and there are major inconsistencies in tax treatment of pension benefits.

Our Commission made nearly 50 recommendations that would, if adopted, lead to a shifting of dependence on pay-as-you-go financed Federal programs such as social security, welfare and in-kind benefit programs, to a balanced system of employee pensions, social security, and individual efforts and private savings.

I know—and of course we see a great deal of this in the press—that Congress is now looking at the financial problems facing currently the long term social security problem. There are short term problems and long term problems that will come to fruition after the year 2010. I think both of those problems must be solved, and I think they must be grappled with one way or the other fairly soon, as one is a shortrun problem and the other is a longrun problem. I feel very strongly myself that in resolving particularly the shortrun problems facing the social security system, that we should not take hasty action. I am not advocating procrastination, but we must remember that the aged population of this country needs income. What they get today, particularly if they rely only or largely on social security, is not enough to provide adequate income in their old age.

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[1] See p. 91.

I think it is also clear that to make social security financially sound, we must develop some other sources of income for older people, and we should not look at the retirement income alone as coming entirely from social security.

There have been various proposals for reducing benefits. In the deliberations we had, the President's Commission on Pension Policy, we rejected these. I will not go through them. They have been talked about today, and we have felt that we have not maintained adequate proper living standards for those in retirement.

I think if you look at my testimony, you will see, if you look at table 1, I think it makes it very clear that those who receive only social security in retirement really do not live very well at all. The latest figures, as a matter of fact, from the Bureau of the Census, which show on chart No. 1, indicate that over half of those people over the age of 65 are dependent on social security as their primary source of income, and that lower income families are almost entirely dependent on social security. I think, personally, and I feel very strongly, to cut social security payments now would be a very, very irresponsible action of the Government, because I believe there are better solutions, both for the short term and the long term problems.

The Commission did recommend looking at the long term problems for people retiring at age 68, starting gradually in the year 1990, and that the age for early retirement be moved up from 62 to 65. We have had some testimony and discussion on that this afternoon. I think there is a lot of logic in that. Certainly, life expectancy is 3 years longer than it was in 1935 when the social security system was inaugurated. Workers are not only better educated, but healthier in the main.

Jobs are less strenuous and, most important of all, because we have to be pragmatic and practical, they would relieve a great deal of the strain on the system after the year, say, 2010, when the baby boom starts to really retire themselves.

The other recommendation that we made is that we have in this country to adopt universal coverage. All Americans, regardless of Federal sector or private sector, be covered by social security. At the same time, we eliminate the so-called windfall benefits that some people get. I think if both of these were adopted, the age of retirement moved to 68, and universal coverage adopted, that these would make a great difference in social security financing in the future and I think it would really, if not entirely, go a long way toward eliminating the problems that we see long term.

Now, coming back to the short term, as I said, I think it would be a great mistake to act hastily, to affect people on social security, particularly those who largely rely on social security at retirement because of the current crunch. It seems to me for the short term that the answer is interfund borrowing. I think if we would do this today, rather than acting in haste, we could look at it again in a year or so. We could certainly get through a year. The funds are very, very sensitive to economic conditions, interest rates, inflation rates, and so forth. If we could look at that in a year or so, we could see what the problem is and determine what we should do rather than jumping to some conclusions that these payments should be cut today because of a deficit.

In any case, it seems over the next 4 or 5 years, the most pessimistic of the deficits in social security will not be that great. I think it can be handled one way or the other.

The financial problems of social security and the Nation's elderly cannot be solved by looking at the social security system. What we are tending to do in the country is to assume that the problems of the elderly in retirement financially will be solved only by looking at the social security system. I think we need a greater look at it.

Our studies at the President's Commission indicate that somewhat over 50 percent of the workers today are covered by private pensions, and these are workers in the private sector.

So we really have a two-class system out there. We have those who receive social security only and, therefore, do not live well in retirement, and those who receive some sort of a private pension, in some cases a Government pension, in many cases do live well in retirement.

Therefore, because of this, we on the President's Commission recommended, one member disagreeing, on my left here, that we adopt this minimum system of private pension coverage. I am not going to attempt to go through that. It is in our report.

But it seems to me that it is pretty clear that the private pension coverage is not expanding for a lot of reasons, primarily because more and more people are working in the service area, smaller companies. The workers in larger companies are not expanding and we think it would make a great deal of sense to have more people covered by private pensions, and we will not get that unless it is mandated by the Government.

I will close off at that.

Senator HEINZ. Thank you.

[The prepared statement of Mr. McColough follows. Testimony resumes on p. 102.]

PREPARED STATEMENT OF C. PETER McCOLOUGH

Mr. Chairman and members of the Committee, I am pleased to be with you today to discuss the crisis facing the social security system and other retirement programs in this nation. When I was Chairman of the President's Commission on Pension Policy, I tried to assist the work of this Committee, and I am pleased to be here again today. Accompanying me today is Professor Thomas Woodruff, of Cornell University, who served as Executive Director of the President's Commission on Pension Policy.

I have a brief statement to present to you and then Professor Woodruff and I will respond to any questions that you may have.

As you know, the President's Commission on Pension Policy was asked to examine the nation's retirement, survivor and disability systems in order to develop recommendations for changes that address current problems and meet identified goals. In two-and-a-half years we completed some 50 research projects and held over two dozen hearings on these issues.

In developing our recommendations, we have sought advice from hundreds of experts, interested individuals and groups, private and public sector organizations, Congress, and the many executive branch agencies directly involved with retirement income programs. Our recommendations are the culmination of these efforts.

The Commission's final report contains recommendations for a number of broad, long-range retirement income goals for the nation and spells out the roles of public and private pension systems as well as individual efforts in providing this income. In addition, a number of specific proposals are recommended to meet these long-range goals and to lead us through the transition to a balanced retirement income system.

In its review of the major problems facing our retirement income programs, the Commission made three major findings:

- Our nation's retirement programs are dangerously dependent on pay-as-you-go programs such as social security. These large tax-supported programs have created an imbalance which has serious implications for the future.

- Private pension coverage is lacking for many. And where individuals are covered, the lack of coordination among programs results in very low benefits for some, while others receive excessive benefits.

- Inadequate incentives exist for retirement savings and there are major inconsistencies in tax treatment of pension benefits.

In response to these problems, the Commission made nearly fifty recommendations that would, if adopted, lead to a shifting of dependency on pay-as-you-go financed federal programs such as social security, welfare and in-kind benefit programs to a balanced system of employee pensions, social security, and individual effort.

Congress' attention today is focused on the difficult financial problems confronting the social security system. Social security faces cash flow problems over the next several years and much more serious deficits after the year 2010 when the post World War II baby boom generation begins to retire. Steps must be taken now to solve both of these problems. However, in our haste to find solutions to social security's financial problems, we should not forget that our aged population needs income on which to live, and that the level of benefits provided by social security today is inadequate by itself. Therefore, as we seek to make social security financially sound, we must also develop alternative sources of income for our nation's retired population.

You have heard discussion about three approaches to reducing benefits under social security: changes in the indexing of benefits, reductions in the replacement rates of the benefits, and changes in the age of eligibilty for benefits.

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TABLE 1

HYPOTHETICAL LONG-RUN SOCIAL SECURITY REPLACEMENT RATES COMPARED TO REPLACEMENT RATE FOR MAINTAINING PRE-RETIREMENT STANDARD OF LIVING STEADY WORKERS AT THREE ALTERNATIVE EARNINGS LEVELS[1]

	Maximum		Average[2]		Minimum	
	Social Security	Maintain Standard of Living	Social Security	Maintain Standard of Living	Social Security	Maintain Standard of Living
1. Never-married Person.	28%	58%	42%	65%	53%	80%
2. Married Couple. Only one spouse has earnings.	42	63	63	70	80	85
3. Married Couple[3] Both spouses have the same earnings.	40	63	54	70	77	85
4. Widowed person. Only one spouse has earnings.	28	47	42	53	53	64
5. Widowed person. Both spouses had same earnings.	20	47	27	53	38	64

[1] The three alternative levels of earnings are defined as follows. The maximum level which is the wage base (i.e. the maximum taxable earnings) under the OASDI system, beginning with 1961 (after which time the wage base is automatically indexed). The average level is the level of the average male worker beginning with 1981. The minimum level is the level of a worker who always earns the federal minimum wage, beginning in 1981.

[2] Male worker's earnings level.

[3] Both spouses together earn this level.

Source: Office of the Actuary, Social Security Administration, U.S. Department of Health and Human Services.

The Commission carefully reviewed two proposals to change the indexing of social security benefits. One proposal called for indexing the wage history to prices rather than wages in computing the initial benefit. The other called for indexing the post-retirement benefit to the lesser of wages or prices. The Commission rejected both of these proposals.

There was some sentiment on the Commission to alter the method of post-retirement benefit adjustment. We felt, however, that adopting this proposal would hurt those members of our aged population most in need--low income retirees dependent on social security as their sole source of income.

As I mentioned earlier, the Commission concluded that current social security benefit levels do not permit individuals and couples to maintain their living standards. This is demonstrated in Table 1. Depending on their marital status, career, full-time minimum wage workers currently face an income gap of between 5% to 27% and the average workers face an income gap of 7% to 26%. In reality, this income gap is much larger than in these hypothetical examples since low and moderate income workers tend to have irregular work histories.

The latest figures available from the Bureau of the Census indicate that over half of the over-65 population is dependent on social security as their primary source of income (See Chart 1). Lower income families are almost exclusively dependent on social security benefit payments.

For Congress to adopt policies that would lower social security benefits to these income groups over the next ten to twenty years would be irresponsible. Beyond that time period, there are better ways to deal with social security's long-term deficit.

In contrast to the recommendations of the Reagan administration, the Commission concluded that a new retirement age policy should not be adopted to help solve the short-term deficit problem. However, to help solve the long-run financing problem, an increase in the normal retirement age to 68 should be phased

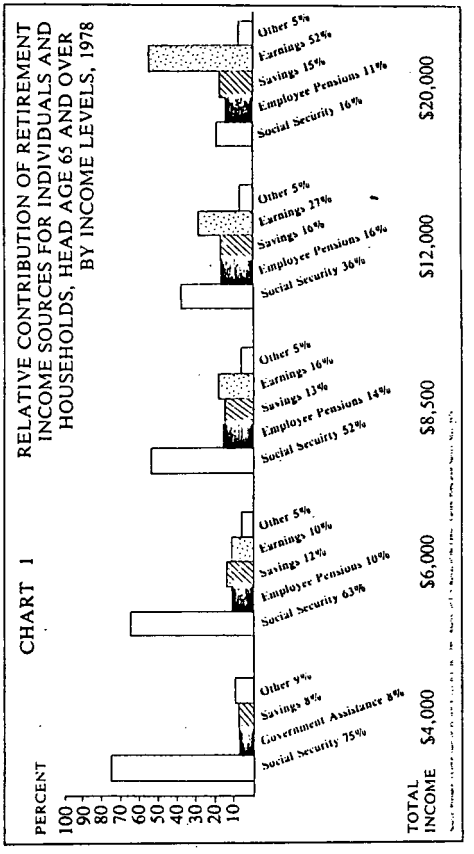


CHART 1
RELATIVE CONTRIBUTION OF RETIREMENT INCOME SOURCES FOR INDIVIDUALS AND HOUSEHOLDS, HEAD AGE 65 AND OVER BY INCOME LEVELS, 1978
PERCENT
100
90
80
70
60
50
40
30
20
10
Other 5%
Earnings 52%
Savings 15%
Employee Pensions 11%
Social Security 16%
Other 5%
Earnings 27%
Savings 16%
Employee Pensions 16%
Social Security 36%
Other 5%
Earnings 16%
Savings 13%
Employee Pensions 14%
Social Security 52%
Other 5%
Earnings 10%
Savings 12%
Employee Pensions 10%
Social Security 63%
Other 9%
Savings 8%
Government Assistance 8%
Social Security 75%
TOTAL INCOME
$4,000
$6,000
$8,500
$12,000
$20,000

in over a twelve-year period beginning in the year 1990. The social security early retirement age, now 62, should be raised to 65, in tandem with the normal retirement age. Disability benefits should be available through the normal retirement age.

The change in normal retirement age gradually to age 68 in the year 2002 is justified for several reasons. First, the average expectation of life has increased substantially since the social security system was adopted in 1935. It is probable that those retiring at age 68 in 2002 will have several more years in retirement than those retiring at age 65 have had in the past. Second, workers are healthier and many jobs are less strenuous today for 65 to 68 year olds than in the past. However, disability benefits should be provided for those who cannot work for health reasons. Third, when the "baby boom" generation retires there will be a severe strain on the financing of social security if the retirement ages stay as they are today. Raising the retirement ages by three years would substantially alleviate the problem. Since many current workers may have already made retirement plans contingent upon receiving social security benefits at age 65, no immediate change in the retirement age was recommended by the Commission.

In addition to a new retirement age policy, the Commission recommended that all new federal, state and local, and non-profit employees be covered by the social security program, and the elimination of so-called windfall benefits. This would significantly improve social security's financial condition.

In fact, the social security administration's actuaries project that these two proposals--raising the age of eligibility for benefits beginning in 1990 and universal coverage--would eliminate the long-term deficit in the system. The Commission's final report to the President and Congress discusses these proposals in more detail.

The magnitude of the short-term deficit is highly sensitive to economic conditions over the next twelve months. We can predict, however, that the deficit will be of short duration due to population changes in the nation. It would be a serious mistake for Congress to enact drastic benefit cuts today that we may later

learn were unnecessary. Therefore, I urge Congress to limit its action this year on the short-term deficit to authorizing interfund borrowing among the various social security trust funds. A year from now, Congress should review the trust fund balances again, after the administration's tax and economic policies have had a chance to affect inflation, employment, and wages.

OTHER REFORMS NECESSARY

The financial problems of social security and of the nation's elderly cannot be solved by looking only at reforms to the social security financing and benefit structure. The Commission developed a comprehensive package of tax reduction proposals that are specifically linked to increasing the role of funded employee pension plans and personal retirement savings. Tax incentives, even those proposed by our report, will not significantly increase the pension plan participation of low and moderate income workers and workers employed by small businesses.

A Commission household survey of 6,100 households, chosen randomly nationwide, reveals that only 48 percent of all active workers 18 years old and over are presently covered by some type of employer-based pension. In the private sector, only 45 percent of all workers (and 54 percent of those ages 25-64) are currently pension plan participants and only half of that number are currently vested in employee plan benefits.

One class of workers fares reasonably well in retirement because it can count on social security, as well as employee pensions and some personal savings. Another class of retirees has failed to become eligible for employee pension benefits and therefore must rely primarily on social security benefits. Inability to vest is often the result of lengthy pension plan service requirements, job mobility, or the lack of a pension plan at a worker's place of employment.

Mr. Chairman, I would like to submit a chapter from the Appendix to the Commission's final report on this subject for the record.

TABLE 2

ESTIMATED COSTS FOR PRIVATE SECTOR EMPLOYERS OF COMMISSION'S MINIMUM UNIVERSAL PENSION SYSTEM (MUPS) PROPOSAL (IN NOMINAL $ BILLIONS)[1]

Year MUPS Contribution Requirements by Size of Establishment	Current Policy Costs	Added Costs	Business Tax Savings[2]	Net Cost Increase
(Expressed In 1982 Dollars)				
Less than 100 employees	$21.1	$3.2	$2.5	$0.7
100-500 employees	13.4	1.1	0.7	0.4
500 or more employees	22.3	1.0	0.5	0.5
Self-employed workers	2.1	1.0	0.7	0.3
Total	$58.9	$6.3	$4.4	$1.9
(Expressed In 1983 Dollars)				
Less than 100 employees	$23.0	$6.3	$4.1	$2.2
100-500 employees	14.6	2.0	1.2	0.8
500 or more employees	24.3	1.7	0.8	0.9
Self-employed workers	2.3	2.2	1.3	0.9
Total	$64.1	$12.2	$7.4	$4.8
(Expressed In 1984 Dollars)				
Less than 100 employees	$24.7	$9.5	$5.7	$3.8
100-500 employees	15.7	2.9	1.7	1.2
500 or more employees	26.2	2.6	1.2	1.4
Self-employed workers	2.5	3.6	1.9	1.7
Total	$69.1	$18.6	$10.5	$8.1

[1] All private and public employers must offer a retirement plan with participation standards no stricter than age 25, one year of service, and 1,000 hours of work annually and full and immediate vesting. These estimates assume a phase-in of MUPS requiring a one percent of earnings contribution by employers in 1982, a two percent contribution in 1983 and a three percent contribution in 1984. The Commission's Special MUPS Business Tax Credit is assumed to apply to the first 3% of payroll contributions to qualified pension plans.

[2] These tax savings estimates have two components. Employees earning below $100,000 who currently contribute to a qualified pension plan are assumed to receive the special MUPS Business Tax Credit for the first 3 percent of payroll contribution. All new contributions by employers due to MUPS are subject to the higher of the tax credit or normal tax deduction.

Sources: ICF, Inc., estimates for President's Commission Pension Policy; Estimates by President's Commission on Pension Policy.

In light of these findings, the Commission recommended federal legislation to establish a national minimum funded pension system which would be required of all employers. Such a system would be financed by employer contributions to either an employer-sponsored plan or a central portability clearinghouse. The benefits would be vested after short service and would be carried from job to job.

Employers who currently provide employee pension plans would be only minimally affected by this proposal. These employers generally provide benefits that are much more generous than the minimum standard called for in the Commission's report. The benefit provisions in their plans would only be modified to take into account the portability features of Minimum Universal Pension System (MUPS).

The Commission was sensitive to the situation of employees and owners of small businesses. The minimum standards plan proposed by the Commission would significantly alleviate the administrative complexities often associated with pension plans. To help mitigate the cost, the program would be phased in over a three-year period. And, employers would be able to take a tax credit of 46 percent of their required contribution to the plan.

Table 2 shows the estimated costs for private sector employers for this plan. A substantial part of the program costs are offset by the special tax credit proposed by the Commission. After the first three years, employers are expected to shift some costs to employees in the form of smaller wage and fringe benefit increases. Employees should be able to absorb this cost without reducing their disposable income because of the tax savings to individuals that will be provided by the Commission's proposal to exclude social security contributions from taxable income.

In addition, availability of a portability clearinghouse for benefit records and a portability fund for plan assets would require minimal record keeping responsibility while allowing employers the investment advantages of large pooled funds.

The establishment of a minimum universal pension system or MUPS will cause a significant shift in the relative roles of social security, employee pensions, and savings as sources of retirement income. By funding a substantial portion of an individual's retirement resources, the nation will be better prepared to provide the resources required to support the retired population. Furthermore, MUPS would result in significant improvement in the incomes of the elderly, particularly those at the lower end of the income distribution (see Chart 2).

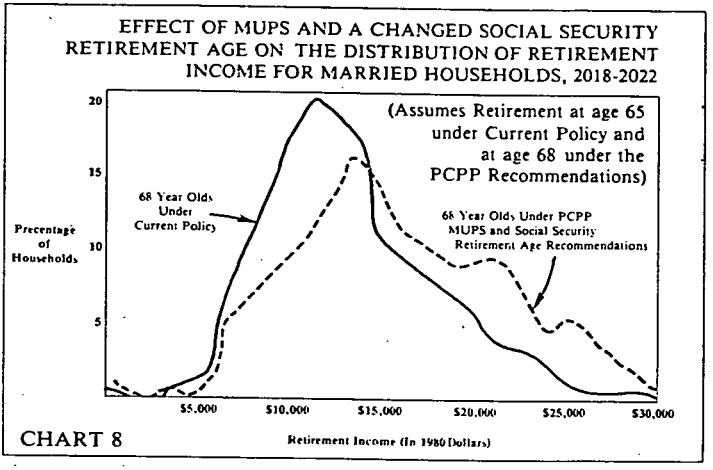
This plan would also increase the proportion of total retirement income financed by funded pension programs. Under the program, benefit payments from employee pension plans would increase by 75 percent. Social security benefit payments would remain about the same, though social security's share of benefit payments would drop 13 percent.

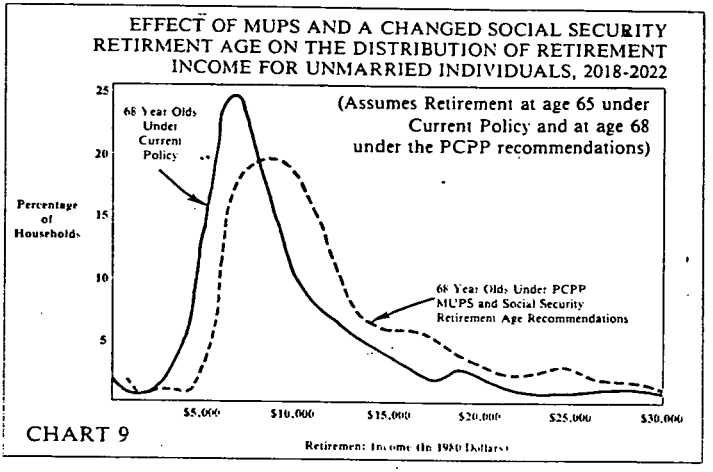
Combined with the MUPS proposal, tax incentives for voluntary employee contributions to IRAs could provide a new mechanism for increasing personal savings for retirement. I doubt if the new tax law will significantly improve retirement saving for most workers.

ECONOMIC EFFECTS OF COMMISSION PROPOSALS

Mr. Chairman, we all are concerned about the condition of our nation's economy. The Commission developed a long-term economic growth model to estimate the effects that its proposals would have on the economy. The combined effect of raising the age of retirement, the Commission's tax proposals, and the Minimum Universal Pension System (MUPS) was positive and dramatic. These proposals would provide significant stimulation to the forecasted economy. I would like to submit the findings of this work to you for inclusion in the record of this hearing.

CHART 2


EFFECT OF MUPS AND A CHANGED SOCIAL SECURITY RETIREMENT AGE ON THE DISTRIBUTION OF RETIREMENT INCOME FOR MARRIED HOUSEHOLDS, 2018-2022
(Assumes Retirement at age 65 under Current Policy and at age 68 under the PCPP Recommendations)
68 Year Olds Under Current Policy
68 Year Olds Under PCPP MUPS and Social Security Retirement Age Recommendations
Percentage of Households
20
15
10
5
$5,000
$10,000
$15,000
$20,000
$25,000
$30,000
Retirement Income (In 1980 Dollars)
CHART 8


EFFECT OF MUPS AND A CHANGED SOCIAL SECURITY RETIRMENT AGE ON THE DISTRIBUTION OF RETIREMENT INCOME FOR UNMARRIED INDIVIDUALS, 2018-2022
(Assumes Retirement at age 65 under Current Policy and at age 68 under the PCPP recommendations)
68 Year Olds Under Current Policy
68 Year Olds Under PCPP MUPS and Social Security Retirement Age Recommendations
Percentage of Households
25
20
15
10
5
$5,000
$10,000
$15,000
$20,000
$25,000
$30,000
CHART 9

CONCLUSION

Mr. Chairman, I do not have time today to list all 50 proposals of the Commission. I hope you and the members of your Committee will read the report carefully.

However, I must stress that our citizens deserve thorough deliberation by Congress on all aspects of our retirement income crisis. A piecemeal approach to policymaking in this area is likely to lead to narrow, discriminatory and inequitable solutions to our problems. I urge you to link your deliberations on social security to your review of tax policy and retirement savings through pension programs and individual effort. In particular, I urge you to hold hearings in the upcoming months on the need for a funded universal pension system in this country.

Thank you.

Senator HEINZ. Mr. Greenough.

STATEMENT OF WILLIAM C. GREENOUGH, CHAIRMAN, SUBCOMMITTEE ON RETIREMENT POLICY, COMMITTEE FOR ECONOMIC DEVELOPMENT, NEW YORK N.Y., AND FORMER MEMBER OF THE PRESIDENT'S COMMISSION ON PENSION POLICY

Mr. GREENOUGH. Mr. Chairman, my name is William Greenough. I am a board member of Teachers Insurance and Annuity Association-College Retirement Equities Fund—TIAA-CREF—chairman of the CREF Finance Committee, and a colleague of Peter's on the President's Commission on Pension Policy.

But today I am speaking as Chairman of the Committee for Economic Development's Subcommittee on Retirement Policy, which has completed a comprehensive statement on retirement policy over 2 years of extremely hard work. We are publishing our report this week.

As you know, our committee consists of over 200 leaders of business and education, who individually have full responsibility. It is an extraordinary process and getting agreement is not always easy. In this study, however, there was a virtual unanimity of opinion. On many issues, the CED report agrees with the conclusions of the President's Commission.

The major point Mr. McColough raised and we similarly emphasize, is the role of the private sector in the pension field. Forty years ago, when there was no public sector, most of our Nation's retirees did not have enough money to maintain a decent standard of living. Since then, we have placed the major responsibility for achieving a livable retirement age on the public sector, and specifically, social security. It is time to turn to the private sector to take over that job. Peter and I agree on that, we merely disagree on the mechanism.

We need, therefore, to strengthen the private pensions and private savings, and there are several reasons:

One, to provide for a secure retirement.

Two, to take the pressure off of social security.

Three, to provide the capital formation so extraordinarily lacking in the United States.

Now, on the subject of retirement age, I would propose a little different way of looking at it.

In each of the last 40 years, we have gradually increased the benefits of social security. Simply because while the retirement age has remained the same, we are living longer after retirement and thus enjoying longer and increased benefits. The suggestion of the President's Commission, CED, and various other groups, is not to reduce retirement benefits; it is to spread them over the same period of time, which because of demographic changes begins today at age 68. We, should, in fact, be at 68 now, had we been properly adjusting the system. But CED believes we should start now to stabilize this unintended growth in benefits. Failure to do this will have a major financial implication, not only for the social security system but for the younger people who will be called on to support it.

Parenthetically, we share Peter's view that we need to have disability benefits until retirement age.

Senator HEINZ. Will your final report have a recommendation on disability?

Mr. GREENOUGH. It points out various things that can be done on disability.

Senator HEINZ. Before we go on, I will put your entire statement in the record.

[The prepared statement of Mr. Greenough follows. Testimony resumes on p. 128.]

PREPARED STATEMENT OF WILLIAM C. GREENOUGH

Mr. Chairman, my name is William C. Greenough. I am a board member of TIAA-CREF, Chairman of the CREF Finance Committee and I was a member of the President's Commission on Pension Policy.

But today I am speaking as Chairman of the Committee for Economic Development's Subcommittee on Retirement Policy which has completed a comprehensive statement on retirement after over two years of extremely hard work. I am pleased to have this opportunity today to introduce you to our thoughts on the important subject of retirement and reform, which I hope you will find useful to your deliberations. I realize there is a surfeit of recommendations being made by various groups. To facilitate matters we have prepared a brief comparison of several proposals, including ours, which I would be happy to provide the Committee.

Our CED trustees have concluded that the nation's retirement systems have an enormous impact on the future economic health of the nation. Inflation has made the cost of providing retirement benefits a substantial burden both on workers and on employers. Declining birth rates and increased longevity mean that proportionately fewer young people will be working to pay these higher costs. The report stresses that unless we curtail the growth of Social Security and strengthen employer pension plans and encourage individual saving for retirement, we will place an unbearable burden on future generations. We will also lose the opportunity to improve the capacity of the economy to provide growth in real income for the elderly and workers alike.

A Comprehensive Approach

First, and perhaps foremost, it is our conviction that the nation requires a comprehensive, broad-based retirement policy and that any piecemeal

approach will not solve either the long-term problems facing our retirement system or contribute to a healthy economy.

In this regard, let me comment for a moment on the Administration's new proposals to reduce certain of the benefits and the scope of the Social Security system. The CED statement strongly endorses limiting the growth of Social Security. Indeed, CED's approach to changing Social Security policy is one that, if implemented, will avoid the short-term financing crisis facing the OASDI trust. While our recommendations for Social Security differ from those proposed by the Administration, I personally endorse the intent of these proposals. But singling out Social Security as the focus in the retirement reform is symptomatic of the same piecemeal approach that has consistently characterized years of decisions on retirement policy. Social Security is the most visible target but it is only one facet of the problems facing the entire U.S. retirement system. Reducing certain kinds of benefits, adjusting cost of living increases, and changing benefit formulas are major improvements, but CED urges the members of this Committee to seek and support additional changes for the entire retirement system.

In essence, the CED report recommends that any national system should be made up of three tiers--each building on the other--Social Security, employer pensions, and personal savings. The goal of this three-tier system, which we believe must be a balanced one, is to provide enough savings and productive capital formation to yield both a decent standard of living for retired workers and a permanent strengthening of the economy.

CED's Three-Tier Approach

Social Security is the first tier. We believe that the relative role of Social Security should be to provide a basic retirement benefit upon which an individual can build. However, to insure this basic level of support for future generations, we recommend a number of changes. We call for gradually raising the normal retirement age for Social Security to 68 and the early retirement age to 65. Again, as I have already stated, I commend the Administration's proposal to reduce early retirement benefits but do not believe that this goes far enough.

The CED statement also calls for revising the current system of indexing Social Security benefits to the Consumer Price Index. If possible, we should have an index which more accurately reflects consumption patterns of older Americans. We also recommend that any raising of Social Security benefits be linked to this newly developed index or the rise in average pre-tax wages for the working population, whichever is less. The CED trustees urge policymakers to consider partial indexing (at less than 100% of the CPI) of the Social Security annual automatic adjustment to benefits. This would reduce the past differential between Social Security increases and increases in average wages. It could also go a long way to solving the short-run financing crisis.

Perhaps the most sweeping change is the recommendation that we share with the President's Commission to exclude employee payments into retirement funds from current taxable income and instead make the ultimate benefit payments a part of taxable income when received. We would apply this principle to Social Security as well as to employer retirement plans. While the cost of this proposal is large, if introduced all at once, we

believe that this could partially be offset by including such a tax change in any future proposals for personal tax reductions. Even given the necessary transition period, I believe that when combined with additional incentives for individual savings, this type of tax change could have real long-term advantages for the economy. We should start examining this concept so that we could eventually move the tax treatment of contributions and benefits in this direction.

It should be noted that if this policy were adopted, very few of those elderly who rely solely on small pensions or Social Security would have to pay any tax at all. In most of these cases, double exemptions and regular exclusions would exclude such elderly from paying taxes.

We also believe that excluding employee pension and Social Security contributions from taxable income and including the ultimate benefits in taxable income when received would make it possible to eliminate the controversial earnings test; otherwise it should be continued intact because Social Security was never designed to tax younger workers in order to transfer funds to untaxed older workers.

In addition to these major changes the report makes a number of other important recommendations on Social Security including, for example, gradually bringing in federal and other noncovered workers to make the system truly comprehensive.

Employer pensions make up the second tier. Since the vast growth of employer pension plans in the '50s, an increasing proportion of workers has become involved and is benefiting from such pension plans. But we believe that certain changes in pension policies and regulations

can improve funding, broaden coverage, help protect pensions from inflation, and increase private pension contributions to capital formation. In this latter regard, CED trustees believe that funded private pension plans, in addition to serving the retirement needs of the American people, can serve as a major source of capital for the economy. Consequently, the CED trustees recommended in the report a number of ways to encourage businesses voluntarily to broaden pension coverage. These include such means as simplifying certain ERISA rules, especially for small employers, and maintaining reasonable vesting periods.

Most importantly, we believe that employee contributions to private plans should not be currently taxed, but instead the ultimate benefits should be included in taxable income. This is a similar recommendation to that which we made for Social Security taxes. We believe this would go a long way toward encouraging greater use of private plans and would make such tax policy consistent in both public and private efforts.

We agree with the President's Commission report that ERISA should be amended to permit employer plans to increase their normal retirement ages to 65 and 68 in tandem with Social Security--on a strictly voluntary basis.

We favor an integration policy that will permit enough flexibility in benefit design to accomplish management and employee objectives.

Personal saving forms the third tier. We believe that not enough emphasis has been placed on encouraging personal saving and

investment to provide a significant portion of retirement income. As I am sure you are all too well aware, the United States has one of the lowest personal saving rates in the industrialized world. To repeat the disturbing litany, between 1973 and 1980, personal savings as a percent of disposable income declined from 8.6 percent to 5.7 percent. This is lower than the rates for Canada, Japan, and West Germany. While inflation is partly responsible for our low rate of saving, there is also a strong consumption bias built into the U.S. tax structure. In sum, there are inadequate incentives for an individual to save for retirement.

We agree with the Administration that policies to encourage greater personal saving and investment through an expansion of private pension programs and individual savings are one of the essential ingredients to the future health of U.S. retirement systems and to the economy as a whole. The enactment of the Economic Recovery Tax Act of 1981 includes a number of tax incentives to encourage saving for retirement. These incentives include raising the annual maximum contribution to IRAs and Keogh plans and permitting active participants in employer-sponsored plans to establish IRAs. Because these policy changes are precisely in the direction recommended by CED, we strongly endorse them. If as we expect, experience shows that these incentives produce significant net savings, we recommend that policymakers consider additional incentives to bring the maximum annual contribution levels under IRAs and Keoghs even closer to the level currently permitted for contributions to corporate plans.

The key to this strategy is the flexibility it gives individuals to plan for their own secure retirement, at the same time

encouraging essential levels of savings and investment in capital formation required for a strong, growing economy. The CED report urges policymakers to develop a comprehensive and well-coordinated reform of U.S. retirement policies which will lead to a better balance among the major components of our retirement system. In strengthening the role of employer plans and personal savings, we do not mean to downgrade the absolutely essential role that Social Security and other government programs have played in the impressive development of the U.S. retirement system.

How then does this approach differ from that of the President's Commission? Let me mention again that I had the privilege of serving as a member of the Commission, and while the CED report may differ from the President's Commission recommendations in several important respects, we also share many similarities and our analysis supports several of their recommendations. For example, we agree with the Commission's findings on the exclusion of Social Secuirty taxes from taxable income and the raising of the retirement age to 68. But in several important respects we disagree. The fundamental difference between the CED paper and the President's Commission report is CED's very strong emphasis on encouraging the voluntary growth of private pensions and individual saving and investment for retirement. We believe that these private pension provisions are uniquely designed to create the capital formation necessary to assure a growing productive economy. The CED report stresses that the long-term health of all retirement systems, public and private, and of

the economy in general, lies in encouraging such capital formation. And it is this particular point that we will continually stress in our future policy statements.

The CED report and the President's Commission differ on setting specific income goals for retirement and on the mandatory universal pension system, or MUPS as it is known.

As you know, the President's Commission recommended a national goal of providing retirement income equal to a worker's disposable income just before retirement. In my view, this is a pleasant goal to contemplate, but not a very realistic one. CED believes that American workers and their families are too diverse in their needs and circumstances for individuals to be well served by such a sweeping and costly national goal. While we believe that Social Security and other government programs should provide a floor of protection, we do not believe that it is appropriate for public policy to prescribe a specific standard of retirement living for all elderly Americans. However, public policy should provide an economic environment in which individuals have an incentive to set and meet their own reasonable retirement objectives beyond Social Security.

We also disagree with MUPS--the concept that each employer be required to establish a pension program for all of his or her employees. While the goal is well-intended, I do not believe that those who support MUPS sufficiently appreciate the cost of making private pensions mandatory. Nor do they comprehend the progress already made in extending private pension plans to individuals since their relatively recent broadscale introduction in the 1950s. The CED report makes a number of recommendations which would make it simpler and more attractive for employers voluntarily

to establish new pension plans. A system of mandated private pensions is likely to resuot in an inflexible pension system which could be inappropriate for many employers and many workers. It could also have serious consequences for new and marginal businesses, causing many either to go out of business or severely restrict wages and employment.

In conclusion, the CED report stresses the following major themes:

- Failure to strengthen our retirement system now will lead to serious consequences for the elderly and for the economy generally.
- While it is absolutely necessary to address the serious problems facing Social Security, broad improvements can be made concurrently in coverage funding and benefits of employer pensions.
- This comprehensive approach should include three tiers which, in addition to Social Security changes now underway, include a balanced retirement system in which private pension plans and personal saving play a more important role than in the past.
- Such an approach should not require a specific retirement goal for all Americans through a mandated system of employer pension plans, but offer a flexible system that allows individuals to make personal decisions leading to secure retirement.

- Any such system should include incentives, in addition to those recently enacted, which will encourage individuals to save to meet their own retirement income goals, and provide a needed source of investment and capital so necessary for a growing and strong economy.

The policies CED recommends, I believe, will provide a workable, affordable and humane retirement system. At the same time we believe our policies will help the economy to break away from the current vicious cycle of low saving, low productivity and high inflation and move into an era in which the long-term saving generated in our retirement system can help to bring about the capital formation that will enlarge the country's productive potential. That in turn, is the only sound way in which our nation can raise the standards of living of both its retirees and its workers. We believe that if these policies are enacted we will achieve the common goal of providing a decent retirement income and a prosperous, sound economy for all Americans.

COMMITTEE FOR ECONOMIC DEVELOPMENT
September, 1981

MAJOR RECOMMENDATIONS FOR REFORMING RETIREMENT POLICIES:

A COMPARISON OF CED APPROACH WITH CURRENT LEGISLATIVE PROPOSALS

Issue	Committee for Economic Development (CED)	1981 Administration Proposals (as of 9/1) (Admin.)	The Business Rountable (BRT)	President's Commission on Pension Policy (PCPP)	The Pickle Bill (H.R. 3207)	The Erlenborn Bill (H.R. 4330)
I. SOCIAL SECURITY						
• Financing: Short-term	- reduce Soc.Sec. "windfall" benefit to workers with a "full" employer pension benefit - consider less than 100% indexing for period of years - gradual rise in normal retirement age starting now (see below) - annual adjustement equal to increase in either price index or average wages--whichever is less	- eliminate minimum benefit & reallocate for those already receiving it (in Senate Com.) - special benefit formula for those receiving pension plan from non-covered employment - eliminate dependent student benefit for from 22 to 18 (gradual reduction of those already eligible)	- Soc.Sec. should continue to be financed by payroll taxes shared equally by employer and employee - gradual increase in age for persons 20 or more years from retirement (see below)	- interfund borrowing	- eliminate minimum benefit for those eligible in 1982 - eliminate "windfall" benefits for persons with pensions from noncovered employment - interfund borrowing (until 1990) - part of HI tax to OASDI with HI fund reimbursed from general revenue	

Issue	CED	Admin.	BRT	PCPP	H.R. 3207	H.R. 4330
Short-term Financing (con'd)		- death benefit only payable to surviving spouse or dependent			- phase-in termination of parent's benefit when youngest child is 16 rather than 18 years	
	- an index which more fully reflects elderly consumption	- average annual adjustment over 12 mths (rather than 3) & apply in Oct. rather than July (Admin. support withdrawn?)			- cost-of-living increase moved from July to Oct. in '83 --in '82 annual adjustment given over 14 mths rather than 12 mths	
		- reduce age 62 benefit from 80% of 65 benefit to 55% (Adjust spouse benefits but not widow's)			- phase-out student benefit (age 18-22)	
		- eliminate children's benefit for early retirees				
• Financing Long-term	- consider changing formula for initial benefit to achieve small reduction in replacement rate	- reduce "replacement" rate several percentage points by making no adjustment to "bend" points for several years (amounts of earnings to which varying replacement % is applied)			- removal of retirement test for the 68 and older by '83 (age 71 kept for '82)	
					- eliminate earnings sharing for divorcees of marriages of 25 or more years (credits to be split between the two spouses)	

Issue	CED	Admin.	BRT	PCPP	H.R. 3207	H.R. 4330
Long-term Financing (con'd)	- increase normal retirement to age 68--phase-in 2 mths per year beginning now--and early retirement at age 65 by 2000 OR (actuarially reduce early retirement benefits gradually) - more effective integration of employer sponsored disability pension benefits with Soc. Sec. benefits	- gradual phase-out of earnings test - slight reduction in initial benefit by by increasing number of years for averaging earnings - slight reduction in Soc. Sec. tax 1985-2010	- gradual increase in age for persons who are 20 or more years from retirement, with changes enacted now so those affected have adequate time to adjust - opposes proposals to provide general revenue tax credits	- increase normal retirement age to 68 with early retirement at 65 (phase-in over 12-yr period beginning in 1990 - disability benefits should be available through normal retirement age	- gradual raise in age for full benefits from 65 to 68 (over 10-yr period--beginning 1990) Early retirement benefits actuarially reduced (e.g., 35% reduction for age 62 benefit) - modify workers' compensation offset provision to apply to persons 62-64, beginning with 1st month of compensation - a "mega-cap" for disability benefits (to be reduced if combined benefits from Soc.Sec. & other programs exceed 80% of predisability earnings	

Issue	CED	Admin.	BRT	PCPP	H.R. 3207	H.R. 4330
• Adjusting Benefits for Inflation	- lesser of annual change in CPI (or more appropriate price index) & annual average change in wages	⋮	- Soc.Sec. benefits should continue to be indexed for inflation to protect the floor of protection (consider developing more appropriate measure of inflation as it affects retirees)	⋮	⋮	⋮
• Universal Social Security Coverage	- all workers should share the responsibility of supporting Soc.Sec. - extend to workers in noncovered occupations	- eliminate "windfall" benefits to workers receiving a pension from noncovered employment	- mandatory universal Soc.Sec. coverage (if not enacted, legislation should be adopted to correct "windfall benefits) - modify existing programs to coordinate with Soc.Sec.	- mandatory universal Soc.Sec coverage - extend to workers in noncovered occupations - eliminate gaps & unintended subsidies to workers who have not had substantial Soc.Sec. coverage - terminate current options allowing covered gov't & nonprofit groups to withdraw from Soc. Sec. program	- eliminate "windfall" benefits for persons with pensions in non-covered employment	- reduces incentive for public employees in Soc.Sec. to withdraw: --those not in Soc.Sec. could deduct $2000 from their pension or IRA --those not in Soc.Sec. would have $2000 deductible reduced by amount of FICA tax

Issue	CED	Admin.	BRT	PCPP	H.R. 3207	H.R. 4330
• Tax Treatment and the Earnings Test	- eliminate earnings test --contingent upon adoption of parallel recommendation that taxable income from contributions to Soc.Sec., regular employee retirement systems & other saving plans for retirement be excluded and benefits from all such sources should be included in taxable income	- phase out retirement earnings test	- retain the age 72 limit for earnings test	- eliminate earnings test (phase out) --contingent upon adoption of recommendation that contributios to & benefits from Soc. Sec. receive the same tax treatment	- removal of retirement test for the 68 & older (keep retirement test until age 71)	
• Special Minimum Benefit Under Social Security	- set minimum standard for all working members of society (no standard specified)	- eliminate the minimum benefit for all new beneficiaries as well as a recomputation of benefits for minimum beneficiaries already on the rolls (as above)	- provide minimum floor of protection	- provide minimum benefit for long-service workers (calculation to take into account receipt of employer pensions)	- eliminate the minimum benefit (for newly eligible beneficiaries in '81 or later (as above)	

Issue	CED	Admin.	BRT	PCPP	H.R. 3207	H.R. 4330
• Miscellaneous Benefits	⋮	- eliminate childrens' benefit when workers retire early	⋮	- reexamination of student, young parent, and parent benefits	⋮	⋮
II. INDIVIDUAL SAVINGS	- liberalization of eligibility requirements for IRAs & Keoghs, Simplified Pension Accounts & Limited Employee Retirement Accounts --initial maximum contribution to IRAs in '80 -- $2,216) or 15% whichever is less Keoghs (in '80 -- $11,063 or 15% whichever is less --contribution level indexed for inflation in future	- increase in maximum contribution to IRA from $1500 to $2000 per year - participantes in employer-sponsored plans may deduct $2000 annually for IRA - increase maximum deductible contributions to Keogh from $7500 to $15,000	- employer contributions to qualified pension plans should be tax-deferred to the extent permitted by an IRA - expansion of IRA limits to recognize inflation	- uniform tax policy for savings for retirement & pension plans - refundable tax credit for low and moderate income people - same treatment of contributions & benefit limitations & all types of retirement savings	⋮	- increases deductible limit on IRA from $1500 to $2000 & some new limit for contributions to employer-sponsored pension or saving plan - for employees not covered by employer pension plan, employer must establish IRA with payroll withholding unless: --10% of employees fail to sign up --employer in business less than 5 years --less than 20 employees

Issue	CED	Admin.	BRT	PCPP	H.R. 3207	H.R. 4330
Individual Savings (con'd)	--ultimate goals: IRA & Keogh contributions level more similar to level under corporate plan - urges companies to establish savings or thrift plans for all employees					- HR10 contribution limits raised from $7500 to $15,000 and coordinated with Soc. Sec.
• Employment of Older Workers	- encourage employer to establish more flexible work patterns for older workers - remove any labor market restrictions on flexible work arrangements if any exist in labor laws	⋮	- encourage continued labor force participation of older workers	- job retraining and job redesign in private industry - greater utilization of older workers in full- and part-time employment - research & demonstration projects for alternative work patterns for existing federal employment programs	⋮	⋮

Issue	CED	Admin.	BRT	PCPP	H.R. 3207	H.R. 4330
III. DISABILITY	- eligibility rules should be tightened - benefits should be included in taxable income - eliminate excess benefits - reduce cost-of-living adjustment for marginally disabled - more effective integration of employer-sponsored disability	- increase work requirement from 20 of last 40 quarters to 6 of last 13 - include federal DI benefits in 80% cap of DI and workers comp. (also extend to workers aged 62-64 - tax first 6 mths. of sick pay - medical only for DI (no age, education, experience) - at least 24 mths. rather than 12 mths. of expected disability - waiting period 6 rather than 5 mths.		- availability through normal retirement age - exploration & debate: --universal disability program --ceiling & floor on replacement ratios for all disability benefits --use of rehabilitation; job redesign, etc. to encourage labor force participation --occupational DI program for older workers	- "mega-cap" for DI benefits (benefits would be reduced if the combined benefits from Soc.Sec. & other gov't programs exceed 80% of pre-disability earnings)	
IV. PUBLIC ASSISTANCE						
• Supplemental Security Income				- eliminate assets test & set SSI benefits at poverty line level		

Issue	CED	Admin.	BRT	PCPP	H.R. 3207	H.R. 4330
V. INFLATION AND RETIREMENT INCOME	- adjustment of federal pension benefits once per year rather than twice - reduce public employee retirement indexing to a portion of the CPI (or other indicator) with a once-a-year adjustment - opposes full indexation of any employer plan - rejects gov't mandate to require employers to adjust pensions for inflation, employees and employers must share the cost of any voluntary and partial upward adjustment in pension payments --For Soc.Sec.: + an index which more fully reflects elderly compensation + price change on increase in average wage--whichever is less	- restraining growth of benefit formula's "bend points"(benefit formula applied to average for worker's earnings from portion of his-lifetime earnings) - round benefits to nearest multiple of .10 cents - Pension Reform Act--Cost Reimbursement (allowing SSA to charge full cost for supplying records to plan participants with earnings histories)	- opposes indexation of pension benefits - continue to permit private plans to respond to inflation through ad hoc adjustments in benefit formula - Soc.Sec. benefits should continue to be indexed for inflation but should be limited when average wages do not increase as rapidly as prices	- rejects proposals to price index earnings records in benefit formula - separate cost-of-living index for retired persons (by BLS) - automatic inflation protection encouraged through tax policy		

Issue	CED	Admin.	BRT	PCPP	H.R. 3207	H.R. 4330
VI. RETIREMENT INCOME GOALS	- minimum retirement income from Soc. Sec. with retiree able to (and responsible for) achieve level of retirement income desired	- For Soc.Sec.: --elimination of "unearned" benefits --protect basic retirement benefits	- establish balanced program providing floor of protection	- maintenance of highest pre-retirement income	- For Soc.Sec.: --similar to Administration but more gradual	⋮
	- income from three sources: --Social Security --personal savings --employer pensions		- income from three sources: --Social Security --personal savings --employer pensions	- income from three sources: --Social Security --personal savings --employer pensions		
	- relative and real absolute level of Soc.Sec. declining as other tiers increase importance					
VII. EMPLOYER PENSION PLANS						
• Minimum Universal Pension System (MUPS)	- rejects any proposal to require all employers to provide pension coverage for their workers	⋮	- does not support mandatory private pension plans, but should be encouraged through properly designed incentives, legislation & regulations	- establish for all workers--funded by employer contributions (phase-in over three years)	⋮	- does not support mandatory private plans - a number of Admin. changes to ERISA which will encourage more private plans

Issue	CED	Admin.	BRT	PCPP	H.R. 3207	H.R. 4330
MUPS (con'd)	- encourage expansion of employer plan by permitting employee contributions from pre-tax income with benefits taxed when received - under ERISA reduce reporting requirements & remove some of restrictions on "prohibited transactions"					- establish Employee Benefit Board (incorporate PBGC, Labor, Treasury functions) - simplifies reporting - exempts severance pay & supplemental adjustments from ERISA requirements - eliminates some auditing of plans - reforms "prohibited transactions" in investing by permitting class exemptions for loans and leases to employer's own plan - excludes employer plans with less than 35 employees from PBGC premium but not coverage

Issue	CED	Admin.	BRT	PCPP	H.R. 3207	H.R. 4330
• Vesting & Portability	- does not support any gov't action to mandate earlier vesting requirements than currently apply		- improved vesting should be attained through voluntary rather than mandatory means	- shorter vesting schedule, especially for mature plans		- generally strengthens multi-employer plans & thereby portability in a number of industries
	- encourage employers to permit transfer benefits into IRA or life insurance company in case of fully-funded plans		- permits tax-deferred employee contributions to either IRA or qualified pension plan	- prohibition of all cash-outs of pension benefits over $500 unless transferred to to plan of subsequent employer or IRA		- greatly strengthens vested benefits after plan failure
• Integration of Social Security & Employer Plans	- Soc.Sec. integration with disability in employer pension plan		- effective integration of private plan benefits & Soc.Sec. benefits - if integration rules are to be changed, they should encourage private plan expansion & simplify the current set of complex rules	- integration of MUPS with Soc.Sec.		- simplifies the integration rules and alters their application by focusing on benefits provided rather than cost of benefits

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Issue	CED	Admin.	BRT	PCPP	H.R. 3207	H.R. 4330
• Investment of Pension Assets	- supports current ERISA regulations (opposes "social" investing)		- pension plan assets should be prudently invested on behalf of plan participants based upon proper analysis of risk & return relationships, & those with the fiduciary responsibility for investments should exercise ownership responsibilities			
• Spouse Beneffits	- important issue but technically difficult to solve; suggests greater use of employer group life insurance as a partial remedy	- establish new maximum on benefits for survivors - modify lump sum death benefit (paying lump sum only when spouse was living with the worker	No Position	- mandatory pre-retirement survivor benefit - automatic provision for 50% joint survivor option - earnings sharing (in case of divorce) - earnings credits (for surviving spouses of 2-earner couples)	- indexed survivor benefits (deceased worker's earnings record would be wage-indexed up through the year he/she would have been 60, or through year the survivor reaches age 58 - extension of grace period of gov't offset to Soc.Sec. spouse's benefit - limited earnings sharing for Soc. Sec. benefits	- clarifies current ERISA options and federal-state jurisdiction issue

Issue	CED	Admin.	BRT	PCPP	H.R. 3207	H.R. 4330
• Retirement Ages	- increase retirement age in tandem with Soc.Sec. (68, with early retirement at 65)	- workers at age 62 would receive 55% of benefits normally entitled at age 65	- gradual increase for persons 20 or more years from retirement	- increase retirement age in tandem with Soc.Sec. (68, with early retirement at 65)	- gradual increase in retirement age to 68	No Position
• Federal, State & Local Government Plans	- actuarially reduced benefit for plans with few years for qualifying for full pension benefits - opposes full indexing of benefits and questions method of calculating benefit increase - require plans to report funds as private-sector and Financial Accounting Standards Board - plans adjusted when all public employers covered by Soc.Sec.: --control of plan assets --oppose any deviation from current ERISA requirement that assets be invested solely for providing benefits for plan participants			- enactment of Public Employer Retirement Income Security Act (PERISA) to cover same areas as ERISA	- speed-up of state & local Soc.Sec. tax deposits - prohibit termination of state & local Soc.Sec. coverage by gov't body after March '81	

Senator HEINZ. Does your report cover a change in disability?

Mr. GREENOUGH. It talks about disability, yes.

Senator HEINZ. But not in great detail?

Mr. GREENOUGH. At this point, I was identifying Alicia Munnell's and my own suggestion in a book of mine 6 years ago, so in the gap with disability benefits and unemployment benefits, not limit it to 22 months, but at age 60, 61, going to early retirement; because at that point, people cannot get new jobs.

The CED report made other recommendations on social security. For example, we suggested changing the index. The present index, as is generally recognized, is somewhat imperfect anyway and fails to deal with the real cost of living for older people. We urge that the Congress take a hard look at that index and attempt to develop one that more accurately reflects the cost of living for retirees. We also recommend readjusting the benefits to offset the experiences.

In real terms, we have increased social security benefits 20 percent beyond what they were in 1972, while real wages have declined slightly. There is room to readjust the social security benefits to wage rates, and these can be done by readjusting the replacement rates. Specifically, you could adopt partial indexing until we recapture the 20-percent override that has occurred since 1972.

A third point CED recommends is to tax benefits when received, but not take them when contributed.

When social security was initiated, we did not include in taxable income social security benefits. Partly, this was because they were small and did not matter. But more importantly, the contribution was so small that it did not matter that we double taxed those who were supporting the system, that is, working Americans, 1 or 19. But today, its quite a different matter. Today, you can be taxed up to a maximum $7,400 before taxes.

Senator HEINZ. I will turn the Chair over to Senator Bradley and come back as soon as I vote.

Mr. GREENOUGH. He is quite a good substitute, sir.

Senator BRADLEY [presiding]. We can proceed in one of two ways. You can learn how the Senate operates and repeat what you have said, or I can catch up with what you have already said. I think I will catch up.

Mr. GREENOUGH. I will proceed. We are on taxes, and I have mentioned that social security started out by not including benefits in taxable income, but including the employee's contribution in taxable income. At some point in the future, this should be changed. It is one of the points of friction that will increasingly divide generations, and is not helpful in our society. It should be noted that to include the benefits in taxable income will not result in taxing the poor. At the present time, you do not start taxing social security recipients until they are earning $19,000, yet a young couple begins being taxed at $7,400.

We also believe all Federal and State employees should be brought in. On the subject of integration, we believe it should continue.

Senator BRADLEY. Integration should——

Mr. GREENOUGH. We should continue to have an integration system whereby private pension benefits have a different proportion of lower paid employees than higher paid employees.

If the individual wants to save on his own, fine. If an employee pension plan wants to supplement it, fine. But don't expect the difference between social security benefits and the retirement income goal to be made up entirely by private pensions paid by an employer. I mentioned the savings rate being very low here. Private pensions are an enormous source of savings, capital formation. An individual has to save enough during each 2 years of his working life during 1 year of retirement—that is a huge amount of savings. If we can do that——

Senator BRADLEY. You say 2 years of savings will provide 1 year of pension? That assumes what rate of saving?

Mr. GREENOUGH. I have done it a different way. An individual's working life will be roughly 35 to 45 years. His period in retirement is around 20 years. So during each 2 years of working life he must either through social security or private pensions support 1 year of retirement, and that is a huge job. If he does it through the private pension and personal saving there will be tremendous leverage for capital formation.

Does that respond to your question?

Senator BRADLEY. Are you talking about savings in the sense of an integration of private savings and whatever he puts away in social security?

Mr. GREENOUGH. Yes, the two together.

Senator BRADLEY. I find when I speak to my constituents about social security and the problems of the elderly, generally they do not understand that social security is an intergenerational transfer, and they look at it as if it were a private pension plan. That leads to all kinds of problems. If you are talking about a single system where you try to make the private pension plan consistent with social security, you really have to be able to accommodate both of those concepts in one kind of approach. Have you done that in your recommendation?

Mr. GREENOUGH. The route taken is quite the contrary; that is, social security is, as you said, both an intergenerational transfer, a higher income to lower income, a smaller family to a larger family transfer. There are a set of social transfers that is perfectly proper.

The private pension plans and private savings are a system whereby the individual and his employer set aside a certain amount individually ascribed to that individual that then is drawn down as a pension. Two derive from different concepts. They work very well together, but they should not be merged together.

Senator BRADLEY. Your argument is that they should stay the way they are and Mr. McColough's argument is that they should not?

Mr. MCCOLOUGH. No. I agree very much with Mr. Greenough. The only difference is, we feel we should not rely on a pay-as-you-go system. We both feel it should be buttressed with a private pension system. We have no disagreement on that. Mr. Greenough is a little more optimistic than I am that it can be done voluntarily. I think it should be mandated.

Senator BRADLEY. A mandated private pension system?

Mr. McCOLOUGH. Right.

Mr. GREENOUGH. That is the clear difference. My experience is different. Mine is in the college experience. There, on a voluntary basis for the last 10 years, 99 percent of the colleges have had pension plans. Ninety-nine percent of the faculty members are eligible for them at some point in their career, and it has worked.

Senator BRADLEY. Why do you say it should be compulsory? You have just drawn a different conclusion.

Mr. McCOLOUGH. I don't want to argue the figures, but not much more than 50 percent of the people in the private work force have a pension. If you only get a social security check, you do not live very well in retirement. I do not think you will see a pension voluntrily given to these people not now covered by private pensions because most people do not have a private pension that are in smaller companies, not unionized, not manufacturing, service industry. There are lower margins. It is difficult for those companies to do it unilaterally. If you put them on the same footing, one drugstore against the other drugstore, would do it. But if you make them do it, they are on the same footing.

Senator BRADLEY. So you are saying we mandate savings out of an individual's compensation?

Mr. McCOLOUGH. Right. We recommend a mandated payment, 3 percent of payroll, ease it in over 3 years, that small employers be given the same tax savings, 46 percent. One year of savings for investing, and so forth.

Senator BRADLEY. Do you think it could be done without major conflicts with laws like ERISA?

Mr. McCOLOUGH. I don't see any conflict with ERISA at all. We tried to make it simple so that the rules would be simpler than the current ERISA rules

Senator BRADLEY. That would be a big help. Then the Senators would be able to understand what they have done. I notice, Mr. McColough, you recommend in the long term that we move the retirement age to 68 and gradually phase out the early retirement from 62 to 65. Now, as I understand, a lot of pension plans provide for retirement at 50 or 55; they do that with the assumption that you will get early retirement under social security at 62. So if you moved the early retirement age from 62 to 65, how would that affect the private pension plans, and how much more would that cost?

What percent of your 3 percent?

Mr. McCOLOUGH. It would not affect the 3 percent. But you would see private pension plans moving out in terms of the effect, which is also desirable, particularly after the turn of the century, as the baby boom starts to retire. I think you will see them move in unison.

Senator BRADLEY. You do not see it as a problem?

Mr. McCOLOUGH. I do not see it as a problem.

Senator BRADLEY. After the year 2000?

Mr. McCOLOUGH. Yes.

The real crunch on the retirement system in this country, social security and everything else, generally is going to come somewhere around or after 2010, as the baby boom starts its demographic change, is very much against us. The figure I remember, at 2010,

or thereabouts, if people retire at 62, which is a kind of tendency, you will only have two workers for one retired person. No system of retirement is viable like that. I think that the answer, why you cannot retire so early——

Senator BRADLEY. In light of the changes that were enacted in the tax law last month, particularly concerning IRA's, do you think there will be any incentive to create private pension plans?

Mr. MCCOLOUGH. To some extent for private savings. But I do not see that as the major answer, no. It is helpful. It is a small step, but only a small step.

Senator BRADLEY. What are your recommendations for the short-term problem?

Mr. MCCOLOUGH. My recommendation is one, do not panic. I see a lot of panic around. It is a short-term problem. I think it can be solved by perhaps interfund transfers for the short term. I am not clear whether that will get us through the next 4 or 5 years, but we will get pretty close. What I would do right now is provide for transfers from the fund so that we can get through at least the next years, see what happens. That is very sensitive to economic conditions, inflation, interest rates, and so forth, and not cut social security because of that. If we do not get through it, we will be close to it. We may be short $5 billion or something.

Senator BRADLEY. What percent reserves do you assume in that? Where do you push the button. Do you push it at 10 or 25 percent? In 1977, we said we needed reserves of 25 percent.

Mr. MCCOLOUGH. What I would do personally—I am not speaking for the President's Commission—I would not go to general revenues. If you got close, I would provide for it by borrowing from the Treasury.

Senator BRADLEY. At market interest?

Mr. MCCOLOUGH. Sure. Or from the Treasury for the short term. Do not go to general revenues, which gets the camel under the door of the tent. But I would not cut social security now. It will be very tight one way or the other. It will be in the range of $5, $10, or $15 billion. That is my solution.

Senator BRADLEY. What about you, Mr. Greenough?

Mr. GREENOUGH. The President's Commission suggested moving the future increases in taxes up by a couple of years, which will help fill in the gap also. But then, getting on with the various other recommendations that will come before your committee on changing retirement age.

If we were to initiate this change now, it would pick up a fair amount of the deficit.

Senator BRADLEY. You mean raise the retirement age to 68?

Mr. GREENOUGH. Yes, but CED suggests your beginning now and phasing it in gradually until the year 2000.

Senator BRADLEY. But what do you do about those persons who worked pretty hard in a blue-collar job in a factory, who expected they would be retiring at 62 and planned for it? Many early retirees also report they have some health problems; about 70 percent of the early retirees cite health reasons.

What do you do about these persons?

Mr. GREENOUGH. CED recommends you make certain that your disability program fills in the gap for those who are totally disabled.

Senator BRADLEY. What else would you do?

Mr. GREENOUGH. There are various recommendations in the CED report that calls for ending the duplication of disability benefits. Some people get more than 100 percent of their former salary because of duplication and this isn't justified.

Some of the ideas were included in the administration's bill. Eliminating educational benefits above age 18, for example, which would be better handled elsewhere.

Senator BRADLEY. We assume those savings in dealing with the problems of social security. The question is really the short term.

Mr. McColough says interfund transfers and, if necessary, borrowing from the Treasury. I am trying to understand your position. Immediately raise the retirement age to age 68?

Is that all?

Mr. GREENOUGH. No; not immediately. Start the process now instead of waiting until 1990, but spread it clear out to the year 2000.

Senator BRADLEY. How much would that save, do you know?

Mr. GREENOUGH. It is included in our report on the CED recommendations for solving the shortrun social security financing crisis which will be published along with "reforming retirement policies."

Senator BRADLEY. Do you have other specific things that you would recommend?

Mr. GREENOUGH. Yes, change the index.

Senator BRADLEY. You would adjust the COLA in some way? How?

Mr. GREENOUGH. Adjust the COLA in two or three ways. One way is to have a more realistic COLA for retired people. The including of housing in the COLA is one example of a factor that distorts the CPI. We recommend that this be studied.

Senator BRADLEY. You would look at the CPI? You think you ought to address the CPI as an appropriate inflation gage?

Mr. GREENOUGH. A CPI for the retired person should be set up. The second thing is a problem. The benefits under social security have gone up in real terms 20 percent since 1972, while wage rates have gone down by a small amount. But there is a 20-percent differential there. The CED, in its report, recommended that we index social security annual adjustment at less than 100 percent for a period of several years until we get back on track. Whenever the CPI exceeded wages, we would use wages as a base. In my view, there is a real problem when you escalate transfer benefits by more than the earnings of those who are paying for it.

Senator BRADLEY. So you want it indexed by your gage of inflation or wages, whichever is less.

Do you have any problem with that? There are people who say: If you do that, you are telling the older person that, (a) if inflation is rampant, he will not fully be protected because he is indexed by the lower of the two, which is wages, and (b) if he happens to be living in a time of great prosperity, he will still not be able to participate in the increasing wages of the American people and have his benefits increased proportionately.

Mr. McCOLOUGH. I disagree with that.

Our President's Commission did recommend that we study a new index for retired people. That will not solve the problem. I did not respond to that in answer to what we should do in the short term.

When looking at what people are receiving, particularly those who are largely dependent, I think we will hurt them in whatever way we cut. I do not think it is necessary. I think we could have interfund borrowing and, if necessary, we can borrow from the Treasury. I think we should not take it out of their hides. I am very much against it.

Senator BRADLEY. Do you support any changes in the reconciliation bills, the student benefits——

Mr. McCOLOUGH. I have no problem with that.

Senator BRADLEY. Lump-sum death benefits?

Mr. McCOLOUGH. I would not lower the students——

Senator BRADLEY. You would advocate that position prior to reconciliation——

Mr. McCOLOUGH. I would.

Senator BRADLEY. I think this has been rather interesting.

Senator HEINZ [resuming chair]. How did you like being chairman?

Senator BRADLEY. I remember those days.

Mr. GREENOUGH. On CED's approach, one of our most important recommendations is to use private pensions as a source of capital formation, as a means of improving the Nation's productivity. As I recall, you were at the Harvard conference on productivity, where we learned that if we are to get the economy working, it is through enough savings and enough real investment to get those wage rates up to the cost-of-living changes. To see a real loss in wages for 15 or 20 years is unthinkable. We believe the major resource to do this is in through private pensions, and to end this system that will only hurt both the workers or the retired individuals in the future.

The CED Research and Policy Committee took a hard look at this issue and concluded that we could not support benefits of social security recipients going up faster than wage rates.

Senator HEINZ. On that point, both of you have recommended expanding private pension systems to cover virtually everybody. We had a few minutes ago one or two witnesses who said that was just impractical; it could not be done. CED represents pretty big companies. Xerox is a pretty big firm, althouqh 40 years ago, it was not.

I am just wondering, did Xerox, when it was small, have fully funded pension systems; would you be where you are today?

It is easy for you as the executives of very big, well-to-do companies, easy for you to recommend that a lot of small and rather marginal businesses, including those in the service sector, where businesses come and go at a much faster rate than those with a high degree of capital investment, have pensions. Isn't it easy for you to do that?

Mr. McCOLOUGH. Having spent my whole life in Xerox—I joined it when it was very small—but despite that, it had excellent benefits—because of our benefits and because of our concern for people, we attracted, and I think a large part of our success comes from

that formula—we attracted good people. We had very good benefits at a very, very early stage of the game.

Senator HEINZ. Take some industries, airlines, some of the new airlines that are springing up in response to deregulation, the trucking industry, that is going through quite a shakeup.

I expect that we will see very serious kinds of problems. There are some that are much less substantial. Distributorships that service industries, they can be here today, gone tomorrow. How could we realistically expect those kinds of businesses to be as sound and secure as Xerox or some other big firm's pension plan?

Mr. MCCOLOUGH. It is a question really of their position, vis-a-vis, their competition and the small airlines, the small trucking firms just established, struggling to get started, probably unilaterally, cannot put a pension plan in because if their competitor does not have it, that is their margin of profit. But if they all have that cost of doing business, just as they have the cost of paying social security, or the cost of leasing their trucks on an equal basis, then the situation will not change and I think they can make it. I think it is only because you cannot do it unilaterally that people get confused as to whether it is affordable.

Senator HEINZ. It is a point that many Members are concerned about because of the nature of smaller firms. They do not have stability either.

I do not know if this is the proper place to debate this issue. There are others that I could look to.

Mr. GREENOUGH. Other than to indicate this is one of the places where the CED and the President's Commission and I personally differ. My background is the colleges. We have 3,000 cooperating institutions. They are not all Princetons and Harvards. Many of them are very small, poorly financed institutions. They have found it proper and good to have pension plans, but they have not been forced to do it.

We at the CED do not believe that we should have a mandated system of private pensions, and we would differ with the figures that about half are not covered now. A very large proportion of it now is under age 25, in the first year of service, or part time. About 70 percent of the full time, over age 25, are covered for 1 year. We have made a lot of progress already, and voluntarily. What CED is saying is that more has to be done and can be done through the voluntary route.

Peter makes the point about the competition between two employers on adjoining corners and states one has a pension plan and that is added on, he will go out of business. He concludes that the only way to get coverage is to force them both to have a pension program.

Actually, the opposite is true. You are sure to drive an employer out of business if he can't afford it to begin with.

Senator HEINZ. Mr. McColough, you also advocated universal coverage under social security. That means, I take it, that you would phase people out out of the Federal employment benefit plan; is that right?

Mr. MCCOLOUGH. Not necessarily phase them out. What you do is integrate that with the social security system. And our proposal was to do this with new employees, do not break the contract.

Senator HEINZ. Let's assume you do it with new employees. Do you not create a deficit, an increased deficit financing situation for the Federal employment benefit program as it now exists? It will continue to pay us benefits. If you start out with new employees; if you pay out benefits for the next 60, 70, 80 years, and at the same time, revenues start declining—does that create a deficit?

Mr. MCCOLOUGH. No. It actually helps it, because social security is paying more.

Senator HEINZ. I am not talking about social security. I am just talking about revenues in and out of the Federal employees benefit program, not social security.

Mr. GREENOUGH. It is a matter of how you do it. You would, of course, have to continue to support the benefits already accumulated under the Federal savings plan. You are going to have to do that anyway. You would not cut them back.

Senator HEINZ. But you will have more people contributing.

Mr. GREENOUGH. You have to start supporting past employment costs that have not been funded under Federal civil service and military, whether or not you have new employees coming in. You might use your new employees' contributions to partially meet that cost.

Senator HEINZ. All I am saying is it sounds to me like what you are doing is transferring some of the funding from the Federal employment benefit program to the social security, and you will have to make up some of that funding, I think, and I would like to see the numbers, from general revenues, and since right now we are all concerned about the amount of general revenues, or should I say general deficits; we are concerned.

Mr. MCCOLOUGH. That is a small percentage of the total, 7 percent of the over 40 percent of payroll.

Senator HEINZ. Do you believe we have to tax social benefits in order to be effective?

Mr. MCCOLOUGH. I do not think anyone is recommending that you tax them. All we are recommending is that we should include it in taxable income.

Senator HEINZ. That is all taxing social security benefits. We will not tax your income; we will just include it in your taxable income.

Mr. MCCOLOUGH. We are saying, you include an exemption for the payments you make to social security which would help young people so they would pay far less going in than coming out.

Senator HEINZ. You are saying it is a question of equity. We do not have to do it for financial reasons. It is a judgment call on how fair we want to be to workers.

Mr. MCCOLOUGH. What we are doing today is entirely inconsistent. It is more consistent to do it this way. You have to look at that with our other recommendations that we have come up with, such as the earnings tests, that people not be penalized for working in their later years, $5,500, 50 percent tax. We are suggesting that you phase it in so you do not make any promises or commitments, but then you also do away with the earnings test so people can work. They are encouraged.

I do not think you can look at this in isolation from the earnings test.

Senator BRADLEY. May I ask a followup question on the Federal employee recommendation?

Your recommendation is that Federal employees keep all of their present rights to retirement benefits but that their future payments into their pension plan simply goes into the same pot as social security, into the social security trust fund?

Mr. MCCOLOUGH. No.

Mr. GREENOUGH. No. Both the recommendations of the President's Commission and the CED is very much like what happened in New York. For the public employees, the assumption under civil service that they are not covered by social security has led to some frictions and unfortunate criticism.

The President's Commission and CED feel that all employment should be under social security. It would be much too heavy a burden to add social security completely on top of the Federal plans, which are in good shape. Yet, 70 percent of Federal employees receive social security benefits on top from their other benefits. For new employees this would end. But the funds for the two plans, social security and the Federal civil service, military, and the other 68 plans would be completely separate from each other, as they are now. There would be no splicing of funds between them.

Senator BRADLEY. So if you are a postal worker, you would still have money deducted to go into your pension plan and you would still be eligible for the benefits that were written into your plan; is that right?

Mr. GREENOUGH. You would have a new plan for new employees that would take into account social security being on top of that.

Senator BRADLEY. So if current Federal employees now have a more generous pension plan than social security, you are saying that the more generous plan will end for new Federal employees.

Mr. GREENOUGH. It will be with social security on top of it. Whatever Congress decides. But there is no need to cut back the total benefits. It is a matter of avoiding the duplicate benefits and avoiding what is happening now. We keep saying these abuses have arisen because Federal employees get social security on top by working outside in part-time work.

So we will amend social security. The amendment ought to be the Federal plan.

Mr. WOODRUFF. If I might add on both these proposals, neither proposal is purporting to eliminate the staff pension plans of the Federal workers. All they are stating is that the benefit levels under the staff pension plan should be adopted to take into account the new social security coverage, and the two systems should be coordinated. But their funds should be kept separate and that the employee contributions that are now being paid should be transferred to social security payments so that the actuarial obligations for new workers would be reduced under the Federal system, and there would be some continuing need for Federal payments, and then the payments would be from workers who go into social security.

Senator HEINZ. Let me change the subject to the issue we really started with today, and that is, whether if we are going to go about a benefit cut, that it is better to raise the retirement age or better, to change the replacement rates.

Now, Mr. McColough, you advocated raising the retirement age and covering everybody under pension plans. It would seem to me more logical that if you are going to cover everybody under pension plans and thereby extend it, if you will, much more easily by a layer of supplemental income to people, that it would make the most sense to reduce the replacement rate under social security; that that would seem to be more logical, given that is the first step of private pension extension.

Why do you favor that?

Mr. MCCOLOUGH. I am very much against reducing the payment for social security now. Many, many people have only social security to live on. If everybody had a private pension plan on top of social security and they were reasonably generous, it would be different.

Senator HEINZ. Suppose we phased in the reduction of the replacement rate to coincide with increased coverage under our pension plan.

Mr. MCCOLOUGH. I think as you look, as we did, as to what would be a reasonable replacement rate—I think you are going to need, both at the lower levels, as you go along. Furthermore, MUPS is not going to be—you can save it in, but it would be quite a few years before you received any payment.

Senator HEINZ. How do you answer Professor Diamond's criticism that for the retiring worker, the change in the replacement rate would amount to, say, about a 9-percent cut at age 65, but a change in the retirement age would be a 20-percent benefit cut at age 65.

Mr. MCCOLOUGH. I think in the first place you have to make sure the systems are financially feasible. Furthermore, people are getting a benefit because every year we live longer and getting more in retirement.

In 1935, people lived 13 years in retirement. Today, it is 16. Something has been added that was unintended, and we cannot afford it any longer.

Senator HEINZ. I understand your rationale for that. But I am trying to get you to focus on a different issue, not your rationale for what you suggest, which is quite logical and reasonable, but having gotten that far with that, the comparison in terms of, if you will, the logic of one alternative against another. I suspect we could probably discuss it for several days. Unfortunately, neither of our schedules permit that.

It does seem to me if you want to rebut Professor Diamond—I suspect that one of the factors that people consider is that what is harder or easier on private pension plans. It is the fact that some are offset by social security and, as a result, if you reduce the replacement rate and social security, you are going to increase the payment rate under existing private pension plans, and that could well be a concern for many existing plans.

Yet, realize that might be as a matter of public policy, not the best public policy answer, notwithstanding those concerns.

Do you have a comment?

Mr. GREENOUGH. Many plans are not offset. Those can either be left as they are or the employee can, as they frequently do, add benefits on top of that.

On the offsetting, it merely transfers a cost from the public plan to the private plan. The private plan is more expensive, but the total need not be more expensive. So I think our position on that basis is not clear.

Senator HEINZ. As I recollect, you favor raising the retirement age.

Mr. GREENOUGH. Yes. Six years ago, I was for it, and now it is conventional wisdom.

Senator HEINZ. It depends where you sit. Past the year 2000, it is becoming conventional wisdom around here.

Let me ask you this: Would you give the same answer that Mr. McColough gave; namely, that it is preferable to cut benefits by raising the retirement age than to reducing the replacement rate?

Mr. GREENOUGH. In a real sense, you are not cutting benefits. The 1935 amount of retirement years, if moved up to the present, would be at age 68. So our recommendation accomplishes by moving the retirement age from 65 to 68 between 1982 and the year 2000, is to return the benefit ratio in retirement back where it was in 1935.

Senator HEINZ. I also understand the rationale for your suggestion. I am just asking for a comparison.

Mr. GREENOUGH. I am very much in favor of raising the retirement age, and to that necessary to enable people who want to, to remain in the labor force. This drastic loss of people out of the labor force is not helpful for the economy.

Senator HEINZ. Would you do that if we found a way to make private pension plans, as Mr. McColough suggested, universal, across the board. Would that change your thinking?

Mr. GREENOUGH. No. Give them an opportunity to work longer, strengthen your labor force process for the older people, training, phasing in, phasing out, and all of that. CED did not take a specific stance on the replacement rate.

Senator HEINZ. Well, gentlemen——

Mr. MCCOLOUGH. Could I make sure we get something into the record? We had a submission on pension coverage information that has been given to the staff. Another one is the economic effects of our proposal and a copy of the executive summary regarding disability.

Senator HEINZ. Without objection, that will all be made a part of the record. [1]

I want to thank you and Mr. Greenough for your very significant work. I know how hard you have worked. I know how hard you worked, Mr. McColough, on the President's Commission on Pension Policy. It is a remarkable and comprehensive report.

Mr. Greenough, I know what you are doing because a relative of mine used to go through that quite often in the CED and still does.

I think both are to be commended.

Mr. GREENOUGH. Our agreements far exceed the disagreements.

Senator HEINZ. Thank you.

[Whereupon, at 5 p.m., the committee adjourned.]

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[1] See p. 216.

APPENDIXES

Appendix 1

BRIEFING MATERIAL FOR HEARING

FORECASTS OF A LONG-TERM OASDI DEFICIT

Forecasts of a long-run deficit in Old Age, Survivors, and Disability Insurance (OASDI) have changed little since 1977. In that year, Congress enacted a change in the indexing method and scheduled increases in the payroll tax rate that were expected to bring the deficit down from a projected 8.20% of taxable payroll to 1.42% of taxable payroll over the next 75 years. Since then, the long-run forecast has deteriorated slightly because of the effect of a downturn in the economy on economic projections. The most recent Trustees Report, issued in July, 1981, forecasts a long-run deficit of 1.82% of taxable payroll. Program changes enacted in the Omnibus Budget Reconciliation Act of 1981 reduce the forecasted long-run deficit to 1.65% of taxable payroll.

The seriousness of the OASDI long-run deficit is a matter for some debate. One interpretation is that the long-run deficit is the result of a major expansion of benefits and coverage in recent decades in conflict with public willingness to support large payroll tax increases necessary to pay for these improvements. Public confidence in the program is eroding as a result of several years of public discussion of a long-run deficit which has not been resolved despite recent and future payroll tax increases. Confidence can only be restored if Congress immediately enacts measures which will offset the projected deficit once and for all.

Another intrepretation emphasizes the sensitivity of the long-run forecasts to the assumptions about trends in the future. The long-run deficit does not begin to develop for thirty years, and in those thirty years the trends upon which the forecast is based may change significantly. It may not be necessary to make any changes in Social Security in the future, and it is certainly unnecessary to make those changes now.

The underlying difference between these two interpretations is a difference in opinion on the appropriate role of a publicly financed social insurance program relative to private pensions, public assistance, and personal initiative in providing income for retirement. For some, the current forcast of a long-run deficit presents an opportunity to re-define the role of Social Security and re-emphasize the importance of private sources of retirement income. For others, the current forecast of a deficit has little effect on their perception of the importance of maintaining the current role of Social Security.

ISSUES

The major objective of this section of the hearing is to establish the probability that there will be a long-run deficit, and to identify the factors producing the deficit which could be susceptible to public policy initiatives. In particular, testimony will address the effects that changes in projected work and retirement behavior trends would have on the deficit. In addition, this section of the hearing will address the necessity of making changes in Social Security to offset the deficit.

BACKGROUND

Forecasts prepared by the Social Security Administration* show that, under intermediate assumptions, annual expenditures for Old Age, Survivors, and Disability Insurance (OASDI) will exceed revenues beginning in the early decades of the next century and continuing through the first half of the century. Under these assumptions, the deficit is expected to first appear around 2015, with the trust funds depleted by 2035. On average, over the next 75 years, expenditures are expected to exceed revenues by an amount equal to 1.82% of the average annual payroll subject to Social Security taxes. This means that if payroll taxes were to be increased to offset this deficit, the average tax rate over the next 75 years would have to be raised from 12.25%, now scheduled for OASDI, to 14.07%.

The picture varies considerably over the three 25 year periods between now and 2055.

In the first 25 year period (1981-2005), revenues are expected to exceed expenditures by an average of 0.43% of taxable payroll. OASDI trust funds are expected to build to 91% of annual expenditures by 2005.

In the second 25 year period (2006-2030), the financial condition of OASDI is expected to turn around. By 2015 the trust funds will have grown to 132% of annual expenditures. Thereafter, annual deficits will erode the trust funds. Over the 25 years, expenditures are expected to exceed revenues by 1.47% of taxable payroll.

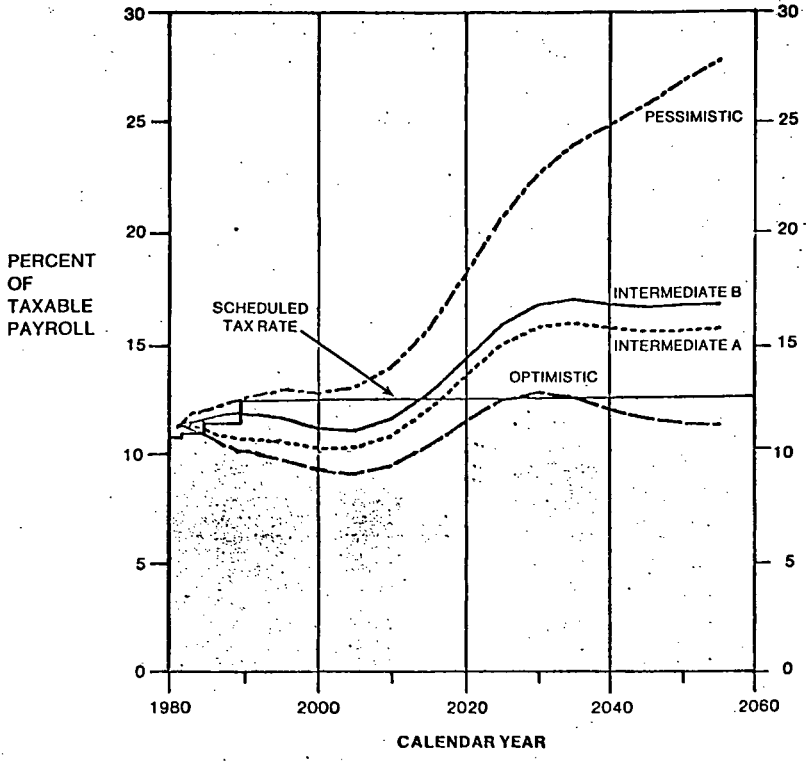
In the third 25 year period (2031-2055) annual expenditures are expected to level off, but remain above annual revenues. The accumulating deficit is expected to exhaust the trust funds in 2035. Expenditures in this period are expected to exceed revenues by 4.41% of taxable payroll.

* These forecasts were prepared prior to enactment of the Omnibus Budget Reconciliation Act of 1981.

Estimated Average OASDI Tax Rates, Expenditures, and Actuarial Balance (Percent of Taxable Payroll)

	25-Year Averages			75-Year Average
	1981-2005	2006-2030	2031-2055	1981-2055
Average Scheduled Tax Rate (Combined Employer-Employee Rate)	11.94%	12.40%	12.40%	12.25%
Estimated Average Expenditures:				
Optimistic Assumptions	9.99	11.07	11.93	10.99
Intermediate-A Assumptions	10.67	13.07	15.79	13.17
Intermediate-B Assumptions	11.51	13.87	16.81	14.07
Pessimistic Assumptions	12.55	17.50	25.43	18.50
Difference (Actuarial Balance):				
Optimistic Assumptions	1.95	1.33	0.48	1.25
Intermediate-A Assumptions	1.27	-0.67	-3.39	-0.93
Intermediate-B Assumptions	0.43	-1.47	-4.41	-1.82
Pessimistic Assumptions	-0.61	-5.10	-13.03	-6.25

ESTIMATED OASDI OUTGO AND TAX RATES, 1981 - 2055



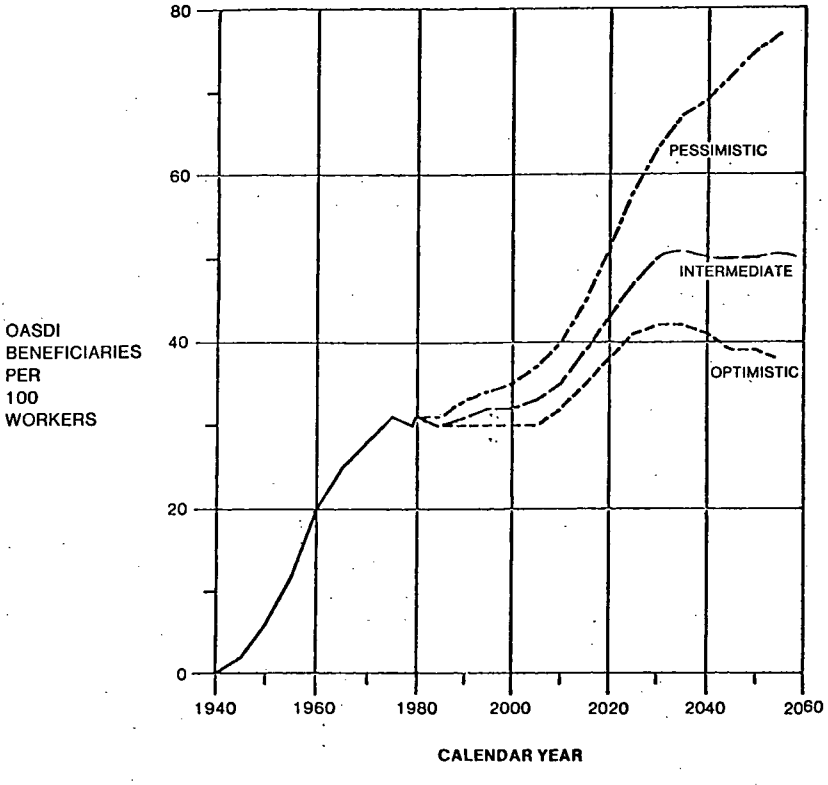
Origins of the Long-Term Problem

The projected long-run deficit in OASDI is a function primarily of a change in the structure of the population. A combination of high birth rates after World War II, a decline in the birth rate in the 1970s and expected low future birth rates, and increasing life expectancy is producing a higher ratio of older persons to total population. This coupled with a trend toward earlier retirement is expected to swell the population of Social Security beneficiaries and to decrease the ratio of workers to retirees in the future.

Demographic Assumptions: The following assumptions about population changes in the future were used by the actuaries in developing Intermediate-B forecasts for OASDI:

	1960	1980	2015	2035	2055
% Population 65+	9.0	11.2	15.4	20.6	20.3
Mortality rate - male	12.6	10.3	8.2	8.2	8.2
-female	8.2	5.9	4.4	4.4	4.4
Fertility rate	3.6	1.8	2.1	2.1	2.1
Dependency Ratios					
- 65+ : 20-64	.174	.195	.265	.386	.378
- under 20 and 65+ : 20-64	.915	.753	.714	.864	.858
Labor Force Partic.					
-male (age adj.)	.824	.781	.777	.777	.777
-female (age adj.)	.371	.512	.596	.596	.596
-male (60-64)	.811	.610	.600	.600	.600
-female (60-64)	.314	.340	.380	.380	.380
Disability Incidence					
-male (age adj.)	4.68	4.66	5.49	5.49	5.49
-female (age adj.)	3.34	3.44	4.05	4.05	4.05
OASDI beneficiaries per 100 covered workers	20	31	39	50	50

NUMBER OF OASDI BENEFICIARIES PER 100 WORKERS



Economic Assumptions: Intermediate-B assumptions for the economy project a return of economic growth in the future, with wages rising more rapidly than prices, low average inflation, and low unemployment.

Average Annual:	1960-64	1980	1990	2000+
% increase in real GNP	4.0	-0.1	3.0	2.7
% increase in average wages	3.4	8.5	5.4	5.5
% increase in CPI	1.3	13.5	4.0	4.0
Real Wage Differential	2.1	-5.0	1.4	1.5
Interest rate	3.7	11.0	6.1	6.1
Unemployment Rate	5.7	7.1	5.9	5.0

One economic assumption which has a particularly strong effect on the deficit is the projected decline in the ratio of the taxable wage base to GNP. In effect this assumes that wages (which are taxed for Social Security) will decline and fringe benefits and other components of income will increase as proportions of total income. This slowdown in the expansion of taxable wages has a significant effect on the amount of Social Security revenues projected for the long run.

	1960	1980	2015	2035	2055
Ratio of Taxable Payroll to GNP	.396	.437	.380	.352	.327

While absolute Social Security costs are expected to rise in the future, the costs of Social Security relative to the economy as a whole are not expected to increase greatly over the long run. Currently Social Security accounts for close to 5% of GNP. Under Intermediate-B assumptions, Social Security will rise to only 6% of GNP by 2035, declining to 5.5% by 2055.

By way of comparison, national expenditures for health which accounted for 5.2% of GNP in 1960 had grown to 9.1% by 1978.

	1960	1980	2015	2035	2055
Cost of OASDI as a % of GNP	5.61(est)	4.96	4.90	6.00	5.50

Sensitivity of the Forecast to Assumptions

It is always likely that some of the assumptions made by the actuaries prove to be erroneous. In some cases these errors in guessing the future make little difference in the conclusions drawn about the size of the deficit. In other cases, however, a small change in the assumptions can make a great change in the deficit. Analysis of the sensitivity of the forecasts to the assumptions can identify the assumptions that can make the most difference in the deficit if they change.

Unfortunately, the actuaries only completed a sensitivity analysis on five variables. There are other variables, such as labor force participation and unemployment, which may have greater policy relevance. The five variables analyzed by the actuaries are presented below.

	Assumptions	Actuarial Deficit as a % of taxable payroll
Fertility (children per woman)	1.7	3.01
	2.1	1.82
	2.4	1.10
Mortality (% decrease in death rate 1978-2055)	58	2.29
	36	1.82
	22	1.14
Disability (% increase in disability incidence rate 1978-80 : 2000)	30	1.98
	15	1.82
	0	1.64
% Increase in Wages/CPI (real wage differential ≐ 1.5)	3.5/2	2.12
	5.5/4	1.82
	7.5/6	1.54
Real Wage Differential (CPI increase =4)	1	2.66
	1.5	1.82
	2	1.05

OPTIONS FOR IMPROVING FINANCING IN THE LONG RUN

To date, major proposals advanced in the Congress for improving the financial condition of the Social Security system in the long run involve either:

1) reducing the percentage of pre-retirement earnings paid as benefits by Social Security after retirement (reducing replacement rates), or

2) raising the age at which full benefits are paid from Social Security.

Both sets of proposals would slow the projected increase in expenditures from the Old Age and Survivor's Insurance (OASI) program after the turn of the century by reducing benefits paid to future retirees below amounts anticipated under current law. In the first case, initial benefit amounts for new retirees would, in the future, increase at a rate slower than the rate of increase in average wages. In the second case, the total amount of Social Security benefits paid over retirement would be lower than under current law. Monthly benefits would remain the same for those working longer, but would be reduced for those retiring before the new age for full benefits.

The trade-off between these two approaches may appear to be insignificant, since they both involve a reduction in future benefit increases. However, there are important differences - both in the effects of these approaches on various groups of retirees, and in their effects on the total retirement income of future generations of the elderly.

ISSUES

The basic issue behind this hearing is: faced with a choice in Social Security between reducing the replacement rate and raising the retirement age, which alternative is to be preferred in light of the resulting:

- o average reduction in future monthly benefit amounts;
- o distribution of benefit reductions among categories of beneficiaries; and
- o effect on the development of alternative sources of retirement income?

In addition, there is the issue of the relationship of Social Security changes to the employment of older workers in the future. Is there a difference in the effect of these two approaches on future work behavior and retirement decisions?

LEGISLATION

Rep. Pickle's bill (H.R. 3207), now in mark-up in the House Ways and Means Committee, and Sen. Chiles' bill (S. 1536), which has been referred to the Senate Finance Committee, both include provisions to raise the age for full benefits under Social Security from 65 to 68. The Administration's Social Security reform proposal , released on May 12, includes a provision to reduce benefits for those retiring before age 65, but does not change the age for full benefits. In addition, the Administration proposal would reduce replacement rates from Social Security by slowing the increase in the "bend points" (used in computing initial benefits for new beneficiaries) for five years. None of these proposals, by themselves, would provide sufficient savings in the long run to offset the deficit projected for OASDI. These remain the only proposals now before the Congress which can provide a substantial portion of the savings needed without the use of general revenues.

Raising the Retirement Age

Section 112 of H.R. 3207 calls for a gradual increase in the age at which full benefits are paid, beginning in 1990. By the year 2000, full benefits would be paid only to those retiring on or after their 68th birthday. Benefits paid to those retiring before age 68 would be actuarially reduced. A person retiring at age 62 in 2000 would receive 64% of their full benefit compared to 80% of the full benefit received at 62 under current law. This proposal would reduce expenditures by an average of 1.35% of taxable payroll over the next 75 years.

Section 4 of S. 1536 calls for a gradual increase in the age for the payment of full benefits, the age for the payment of early retirement benefits, and the age for the payment of widow(er)s benefits, beginning in 2000 and proceeding by one month every four months. By 2012, full benefits would be paid at age 68, early retirement at age 65, and widow(er)s benefits at age 63. A person retiring at age 62 in 2012 would receive no benefits, a person retiring at age 65 would receive 80% of the full benefit. This proposal would reduce expenditures by an average of 1.42% of taxable payroll over the next 75 years.

The Administration's Social Security reform proposals would reduce benefits only to those retiring before age 65, but would put these reductions into effect in January, 1982. Beneficiaries retiring at age 62 in 1982 would receive 55% of their full benefit rather than the 80% provided under current law. Benefit reductions would be greater than actuarial reductions now provided, phasing up to 100% at age 65. This one proposal would reduce expenditures by an average of 0.82% of taxable payroll over the next 75 years, a savings much lower than the other two legislative proposals.

BENEFIT REDUCTION OF REFORM PROPOSALS
RELATIVE TO CURRENT LAW
BY AGE AT RETIREMENT

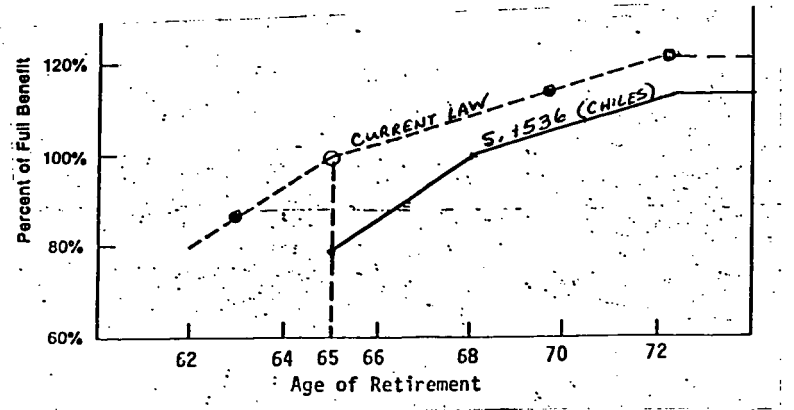
Age at Retirement	H.R.3207	S.1536	Administration
62	20.0%	100.0%	31.0%
63	19.3	100.0	19.3
64	18.5	100.0	8.6
65	18.0	18.0	----
66	12.0	12.0	----
67	6.0	6.0	----
68	----	----	----

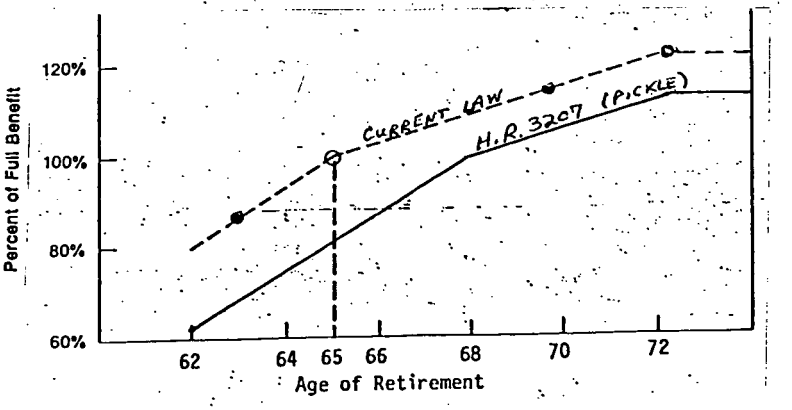
PERCENT OF FULL SOCIAL SECURITY BENEFITS
BASED ON AGE AT RETIREMENT,
CURRENT LAW AND REFORM PROPOSALS

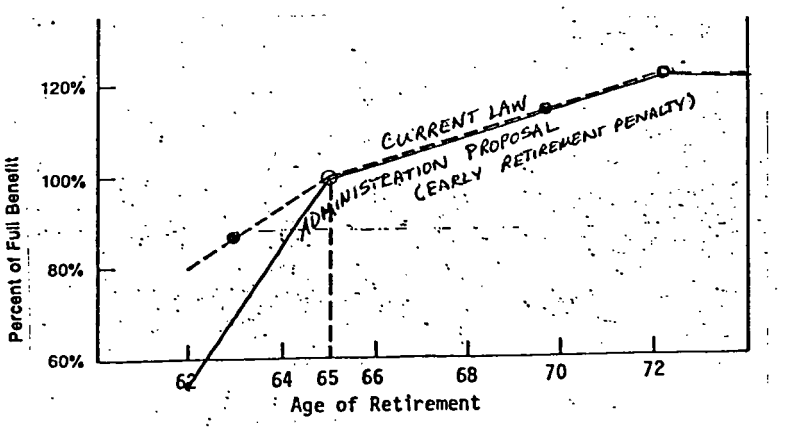
Age at Retirement	Current Law	H.R.3207	S.1536	Administration
62	80.0	64.0		55.0
63	86.7	70.0		70.0
64	93.3	76.0		85.0
65	100.0	82.0	82.0	100.0
66	103.0*	88.0	88.0	
67	106.0	94.0	94.0	
68	109.0	100.0	100.0	

* Effective for beneficiaries retiring in 1982 or thereafter

COMPARISON OF EFFECTS ON BENEFIT STRUCTURE OF ALTERNATIVE BENEFIT/AGE PROPOSALS







Reducing Replacement Rates

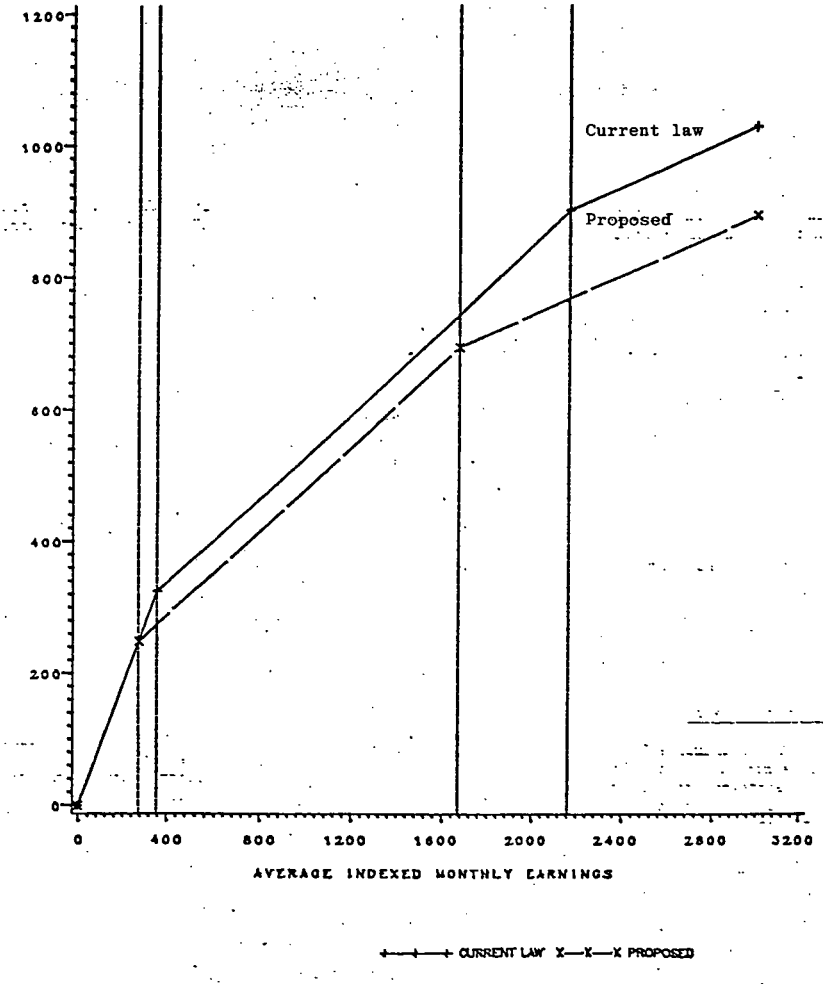
The major proposal from the Administration to reduce expenditures in the long run is the proposal to increase the "bend points" in the formula for calculating the primary insurance amount (PIA) by 50% instead of 100% of the wage increase between 1982 and 1987. The result would be to reduce the amount of the PIA below the amount which would be calculated under current law, and, thus, to reduce resulting benefit amounts below those payable under current law. Beginning in 1982, new beneficiaries would receive lower benefits and hence have less of their pre-retirement earnings replaced by Social Security than they would under current law. The effect on benefits would be phased-in between 1982 and 1987. By 1987 the average new beneficiary would have 38% of their pre-retirement earnings replaced (compared to an average replacement of 42% under current law). Thereafter, the "bend points" would continue to increase by 100% of wage increases - in effect fixing the average replacement rate at 38% for future beneficiaries. For the average person retiring after 1987, this would result in a monthly benefit amount 10% below the amount they could otherwise expect to receive. Over the 75 years, this proposal would reduce expenditures by an estimated 1.30% of taxable payroll.

The mechanics of this proposal are as follows: Social Security benefits are related to each workers earnings record. The relationship is progressive in that lower earnings workers have a higher proportion of their pre-retirement earnings replaced from Social Security. To calculate benefits, the Social Security Administration:

1) indexes the dollar amount of earnings in prior years according to a wage-index to get an updated value;
2) averages the indexed earnings to create an Average Indexed Monthly Earnings (AIME); and
3) applies the AIME to a formula which gives the worker:
   - 90% of the first $211 of AIME, plus
   - 32% of the AIME between $211 and $1,274, plus
   - 15% of the AIME over $1,274,

The result is the Primary Insurance Amount (PIA) which is used as the basis for calculating benefits (workers retiring at age 65 receive 100% of the PIA). The dollar amounts in the formula used to calculate the PIA (e.g. $211 and $1,274) are known as "bend points" (since these are the points at which the graph of the relationship between the PIA and the AIME bends). The "bend points" are also indexed for wage increases - they change each year to keep up with the higher average AIMEs of retiring workers. The Administration's proposal would slow the rate of increase in the "bend-points" for five years in order to reduce the proportion of the AIME which was converted to PIA by the formula. The effect of this change on retiring workers' PIAs can be seen in the chart on the next page.

FIGURE 2
PRIMARY INSURANCE AMOUNTS IN RELATION TO AVERAGE INDEXED MONTHLY EARNIN
CURRENT LAW AND PROPOSED, AFTER FIVE YEARS



USING CBO PROJECTIONS OF GROWTH IN AVERAGE WAGES, 1981—1986

BACKGROUND

All three recent national commissions on Social Security and pensions (the 1979 Advisory Council on Social Security, the National Commission on Social Security, and the President's Commission on Pension Policy) have advocated raising the age of eligibility for full benefits from 65 to 68 sometime in the future.

Raising the retirement age is usually favored as a means for reducing expenditures in the future because of its long phase-in period and because of its correspondence with expected changes in life expectancy, health, and labor supply. This approach would appear to commit the nation to a policy of maintaining older workers in the labor force. The arguments in favor of raising the retirement age usually mention that the long lead time will enable those affected to change their retirement expectations, and will enable Congress to design related initiatives to develop job opportunities for older workers, reduce early retirement incentives, and improve income programs for the disabled and unemployed. Supportive arguments also point out that raising the retirement age is justified because Americans are, on average, living longer. In addition, current preferences for early retirement may be naturally reversed in the future. Demographers project the development of labor supply shortages toward the end of this century which will lead to an increase in the demand for older workers. In addition, today's younger work force may want to work longer than today's generation of retirees. On average, they entered the labor force later, have developed higher levels of education and skills, and have worked in less stressful occupations than their elders. Raising the retirement age could well conform to this change in preference for work in later years.

Opponents of an increase in the retirement age usually emphasize the conflict between this policy and the trend in retirement, and cite the disproportionate effects of this approach on different categories of workers. There has been in recent years a tremendous push in the labor force to earlier and earlier retirement. Workers increasingly prefer to retire early for several reasons:

1) Firms have structured pension and other incentives to encourage the older worker to retire early.

2) With rising incomes, workers have tended to increase their preference for leisure relative to income. Retirement has become more desirable.

3) The availability of improved Social Security and pension benefits has made retirement more attractive.

It is unlikely that in a future with rising incomes and improving retirement income, older workers will reverse this trend. In addition, there are many categories of workers - primarily those in hazardous or stressful occupations - who will need to maintain

the option to retire early. There will continue to be workers with poor health, low skill levels, and inconsistent work histories who will either be unable to work or will be unable to find employment when they are older. For those who can work longer, primarily the white collar and professional workers, raising the retirement age will not affect their monthly benefit amounts. But for the worker who can not work longer, this proposal will substantially reduce the amount of their monthly benefits. In short, the low-income portion of the labor force will suffer most.

Two consultant panels chaired by Dr. William Hsaio (the Consultant Panel on Social Security to the Senate Finance Committee and the Consultant Panel on Social Security to the Congressional Research Service) have recommended reducing replacement rates over time. Both panels suggested a method which would maintain the real value of a retirement benefit for today's standards, but reduce the value of the benefit relative to the standards of the future. The Administration has also proposed reducing the replacement rate from Social Security, but has suggested a method which would result in a one time only change in the replacement rate. After this one-time reduction the replacement rate would be fixed at the new level for future retirees.

Those who favor reducing the replacement rate usually argue that Social Security has become too large a part of the total retirement income picture. Ad hoc benefit increases, combined with over-indexing of initial benefits between 1972 and 1977*has raised the replacement rate substantially in recent years. Not all of this increase has been intentional or necessary. The Administration proposes reducing the replacement rate for the average worker retiring in the future from 42% to 38% - a level similar to the average replacement rate in effect before the 1972 Social Security Amendments. Proponents of reducing the replacement rate usually also believe that high Social Security benefits have discouraged people from deferring consumption and saving for retirement during their working years. Were Social Security benefits reduced, there would not only be greater incentive to save, but also greater incentives to develop adequate pension coverage and benefits. Proponents of reducing the replacement rate may also point to the equity of this approach - it tends to affect benefits of all workers relatively equally and does not interfere with the progressive benefit structure of Social Security.

* The 1977 amendments scheduled reductions in the replacement rate to compensate for over-indexing. By 1986 the average replacement rate will be 42% under current law.

Opponents of reducing replacement rates usually argue that social insurance programs in a normal economy can provide better or equivalent benefits with less risk to the average worker than can pensions or investments. In addition, Social Security can provide an adequate replacement rate to the lowest wage workers who are unlikely to have pension benefits or savings. Since Social Security can provide a secure, low-risk foundation for building a retirement income portfolio for the average worker, and can provide an adequate retirement income for the low-wage worker, public policy should be directed toward increasing public confidence and support for the system and not toward reducing the adequacy of future benefits. With sufficient public support, revenues to Social Security could be increased in the near future to build sufficient surpluses to offset the long-run deficit.

EFFECTS OF SOCIAL SECURITY REFORM ON RETIREMENT POLICY

The adequacy of retirement income for future generations of retirees, in the wake of reductions in Social Security income, depends on the responses of other sources of retirement income to these changes. If Social Security benefits replace less of pre-retirement earnings in the future, then private pensions must improve, personal savings must increase, and older people must be allowed and encouraged to work longer in order to fill in the difference.

Opinions on the capability of other sources of retirement income to fill the gap vary considerably. Some feel that the demographic changes in the future will limit the willingness and the capacity of the society to transfer resources in any form from the working to the retired generations. Others cite the tremendous growth in pensions in the past and the recent legislative changes to improve the quality of pensions and provide incentives for savings as precursers of a long-term trend to shift the burden for intergenerational transfers increasingly from public to private vehicles.

Two groups have recently looked at Social Security financing problems in the context of the entire spectrum of future retirment income: the President's Commission on Pension Policy, and the Committee for Economic Development. These groups reached similar conclusions on the need for changes in Social Security, but provided a different picture of the capability of the private sources of income to fill the gap.

ISSUES

The principle issue in this section of the hearing is: how likely is it that other sources of retirement income will fill in the gap when Social Security is reduced? How are private pensions likely to respond to a reduction in replacement rate or an increase in the normal retirement age? How are older workers likely to adjust work and retirement behavior? What should public policy do to assure that private sources can effectively substitute for private sources?

BACKGROUND

There are several problems with the effectiveness of private retirement income mechanisms as they now stand. These problems raise questions about the capability of private retirement income sources to fill the gap if Social Security benefits are reduced in the long run.

Coverage: Pensions tend to be most attractive to employers with large numbers of employees, most of whom are expected to spend a career with the firm. Pension development, therefore, has been largely concentrated in larger and older firms. Younger and smaller firms have

tended to have a more transient population of workers and to be more labor intensive. In addition, they are often less stable businesses. As a result, more than 79% of the population not covered by pensions work in firms employing under 100 workers.

While pension coverage has grown tremendously since World War II, only 48% of all public and private sector workers are presently covered by some form of pension, profit-sharing, or other retirement plan at their current place of employment (according to Pension Commission studies). 58% of those working in the private sector who qualify for pension coverage under ERISA standards are currently covered.

If pensions are to expand in the future, some way will have to be found to extend pension coverage to workers in smaller firms. This may be difficult not only because of the impediment created by ERISA reporting and disclosure requirements, but also because of the characteristics of small firms and the labor they employ.

TABLE 1

GROWTH IN RETIREMENT COVERAGE
(% OF COVERAGE FOR SPECIFIC LABOR FORCES)

	1940	1950	1960	1970	'75	'77
SOCIAL SECURITY COVERAGE OF ALL PAID EMPLOYMENT	55[1]	65	88	87	90	90
FEDERAL EMPLOYEE RETIREMENT COVERAGE OF ALL FEDERAL EMPLOYMENT	APPROXIMATELY 100	100	100	100	100	100
STATE & LOCAL RETIREMENT COVERAGE OF ALL STATE & LOCAL EMPLOYMENT	NA	NA	82[2]	83[3]	NA	87
PRIVATE PENSION COVERAGE OF NON-GOVERNMENT WAGE & SALARY NON-AGRICULTURAL EMPLOYMENT	14.5	25.0	40.8	45.1	48.6	NA

[1] for year 1939
[2] for year 1962
[3] for year 1972

Source: *Economic Report of the President*, January 1980, Table B. 34. Social Security Bulletin, Annual Statistical Supplement, 1978, Table 7, Special Analysis of the Federal Budget 1981, Table 1-4, p. 288. Statistical Abstract, 1979, Table 543, p. 339. Social Security Bulletin, November 1977, p. 27.

TABLE 2

PRIVATE PENSION PLAN COVERAGE
(active workers, both full-time, and part-time, excluding self-employed)

AGE, YEARS ON JOB, AVERAGE WEEKLY HOURS	PRESIDENTS COMMISSION ON PENSION POLICY HOUSEHOLD SURVEY 1979			DOL/SSA CURRENT POPULATION SURVEY		
	PERCENTAGE					
	ALL EMPLOYEES	MALE	FEMALE	ALL EMPLOYEES	MALE	FEMALE
TOTAL	42	51	32	43	50	31
UNDER AGE 25	27	33	20	19	22	15
AGE 25 AND OVER	47	56	36	52	60	38
ERISA STANDARDS (more than 1 year of service + 1000 hours)	58	64	48	61	67	50

Source: President's Commission on Pension Policy/Department of Labor/Social Security Administration, 1979.

Which Workers Are Not Covered By Pension Plans?

In 1979, 49.4 million workers were not covered by a pension plan:

- 54% of these were men, 46% were women
- 71% of them worked full time, 29% part-time
- 68% were over age 25 and 51% of noncovered were over 25 and have one or more years of service with their employer
- 8.2 million are employed in the public sector
- 38.1 million are wage and salary workers in the private sector

Of private sector noncovered wage and salary workers:

- 77.9% worked in three main industries;
  - 31.9% from trade
  - 27.7% from service
  - 18.3% from manufacturing
- 29.9% earned less than $5,000 in 1978
- 36.4% earned between $5,000 and $10,000 in 1978
- 19.2% earned between $10,000 and $15,000 in 1978
- 14.6% earned over $15,000 in 1978
- 79.0% were in firms with fewer than 100 employees
- 7.5% were in firms with 500 or more employees
- Approximately 90% were not members of union

Source: ICF, Inc., Analysis of May, 1979 Current Population Survey Data; President's Commission on Pension Policy staff estimates. These numbers included imputed values.

Individual Retirement Accounts (IRAs) have been developed as an alternative form of retirement savings which enables an individual working for an employer who does not offer a pension plan (recently extended to any employer) to have tax-deductible contributions made to a savings account. While IRAs effectively extend coverage to employees of small firms, few low-wage workers have the disposible income to make contributions. In addition, the tax advantages are significant only for people in higher marginal tax brackets. As a result, utilization of IRAs has been extremely low among individuals with annual incomes below $15,000.

PERCENTAGE OF PEOPLE WHO ARE ELIGIBLE WHO HAVE IRA'S BY INCOME CLASS, 1977

FAMILY ADJUSTED GROSS INCOME (IN DOLLARS)	PERCENTAGE OF PEOPLE WHO ARE ELIGIBLE	PERCENTAGE OF ELIGIBLE PEOPLE WHO HAVE IRA'S
0 - 5,000	85.0	.2
5,000 - 10,000	70.0	1.3
10,000 - 15,000	60.0	3.3
15,000 - 20,000	45.4	5.5
20,000 - 50,000	24.9	21.7
OVER 50,000	28.6	52.4

Source: President's Commission on Pension Policy

Vesting: Most pension plans now, in conformance with ERISA standards, offer 100% vesting in 10 years. This means that an individual, after working for a firm for ten years, is entitled to receive benefits from the pension plan at retirement. Workers leaving the firm without having vested in a plan receive no pension from the plan at retirement. Not all plans require that a worker vest in the plan. Defined contribution plans, in which worker and employer contributions are made to an account and accrue interest at some specified rate over time, enable the worker to receive benefits on the basis of contributions made, provided they leave their contributions in the plan until retirement. Defined benefit plans, however, which cover the large majority of the covered work force, require

vesting. In most defined benefit plans there are no employee contributions. When the employee retires, the benefits paid are related to the employees years of service, wages, or some combination of the two.

In a highly mobile workforce, vesting presents a problem. It is conceivable that workers can work in pension-covered employment for a life-time, yet receive no pension benefits because they change employers every few years. For this reason, coverage statistics are a misleading indication of the proportion of workers who are likely to ever receive pension benefits.

Portability: Even if a worker vests benefits in a pension plan, the worker can not add years of service to the plan if they leave the employer before retirement. As a result, workers who move around may leave behind several pension plans in which they have vested benefits. The problem with this is that in defined benefit plans in which benefits paid are some function of the workers earnings in their high three or five years, the benefits paid on the basis of earnings ten or twenty years before will be extremely low.

IRAs, particularly with the new features added in the Economic Recovery Tax Act of 1981 which enable pension covered workers to contribute to IRAs as well, avoid the problems of vesting and portability. The account goes with the worker (rather than staying with the firm) and any contributions a worker makes earn benefits. The problem with an IRA is that workers usually make contributions to an IRA in addition to the employer's contribution to their pension plan, rather than in lieu of employer's contributions. Again, this makes IRAs attractive only to higher wage employees.

Inflation Protection: A major problem in shifting emphasis in providing retirement income from public to private sources is the inablility of private sources to provide adequate inflation protection. Practically no private pension plans automatically adjust benefits paid in retirement for inflation. Most plans in recent years have provided some ad hoc adjustment, but the average adjustment has been lower than the rate of inflation. Without adequate inflation protection the value of a pension benefit can decline quickly once the beneficiary retires. An inflation rate of 5% can reduce the real value of a benefit by 40% in ten years.

Without an improvement in the quality of inflation protection in private pensions, a shift from Social Security to private sources of retirement income will leave future retirees poorer as they get older.

Early Retirement Provisions: The current trend in private pensions is to encourage earlier and earlier retirement. Bankers Trust surveys of pension plans have shown a dramatic increase in the benefits payable upon early retirement between 1960 and 1980. In the 1980 study, 90% of the pattern plans surveyed offered a greater than actuarial benefit at the earliest retirement date. This trend clearly works against policies which seek to keep workers in the labor force longer and can only raise the cost of intergenerational transfers in the future. This trend also raises questions about how pension plans would adjust to an increase in the Social Security retirement age.

Pension Integration: A further feature of defined benefit pensions plans is the integration of these plans with Social Security. Often this is accomplished through an offset: the pension benefit is decreased some amount (below a maximum of 83% of the Social Security benefit) for the Social Security benefit amount. Pension offsets are structured to provide higher replacement rates from pensions to higher wage workers, offsetting to an extent the progressive weighting of Social Security benefits.

Pension plans with a Social Security offset will have the effect of partly shielding participants from any Social Security benefit reductions. In particular, the availability of early retirement provisions coupled with pension offsets may reduce the effect of changes in the Social Security retirement age on the retirement decisions of pension-covered workers. This is because benefit reductions at early retirement ages which result will be partly offset by pension benefits - passing the bulk of the cost on to the employer. How this will affect the current trend in pension plans to weight benefits to encourage early retirement, remains to be seen.

Conclusion: In short, private mechanisms for providing retirement income are fragmented and diverse. As a result, it is difficult to determine the effectiveness of these mechanisms in providing retirement income for the current generation of workers. Because of the reliance of the private retirement system on defined benefit pension plans, worker mobility has a disastrous effect on the quality of retirement income. The system is structured to attract career workers and bind them to the employer. However, the worker who spends a career with one firm is becoming less prevalent.

The gaps in the private retirement income system are the most severe for the lower and middle wage worker. This worker is more likely to spend a portion of his or her working life in non-pension-covered employment and is least likely to contribute to IRAs. The low wage worker is and is likely to remain primarily dependent upon Social Security to replace most of his or her pre-retirement income.

SOCIAL SECURITY FINANCING:

ISSUES AND OPTIONS

Prepared by the Special Committee on Aging

United States Senate

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Chairman

July 1981

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INTRODUCTION

Legislative action to solve the Social Security system's financial problems is imminent. This paper presents background on the issues involved and the specific options being discussed.

In reality, Social Security faces two sets of financing problems: an immediate, short-term problem is the years 1982-1986, and a more distant, long-term problem culminating around the year 2030. The origins of the two sets of financing problems are different and distinct; therefore, they invite different kinds of solutions. But, in weighing the best approach to solving the long-term problem, key policy issues have to be decided along the way, issues such as:

What is the appropriate level of income-maintenance that should be supplied by Social Security? What combinations of public and private efforts will yield the desired standard of living in retirement without creating adverse effects on the economy? How will the long-term deficit in Medicare Hospital Insurance be financed and what impact will that deficit have on the way we fund the Social Security deficit?

These and other policy questions, moreover, will have to be evaluated against the backdrop of declining public confidence in the future ability of Social Security to deliver promised benefits.

BACKGROUND

In 1972, Congress increased Social Security benefits by 20 percent and enacted a provision that, effective in 1975, automatically adjusted Social Security benefit payments for each June whenever the Consumer Price Index rises by 3 percent or more, during a specified one-year measuring period. Subsequently, it was learned that, because of a technical flaw in the indexing mechanism, future beneficiaries were unwittingly being overcompensated for inflation, with the result that huge financial deficits were projected in the long term.

In 1977, Congress passed Social Security Amendments which substantially reduced that long-term deficit by changing the indexing formula and by legislating payroll-tax-rate increases for the Social Security and Hospital Insurance programs combined, taking effect in 1979, 1981, 1982, 1985, 1986, and 1990 (see Appendix B).

When the amendments were passed, it was widely publicized that "Social Security has been placed on a sound financial footing for the next 40-50 years."

However, the assumptions used in 1977 to project income and expenditures of the Social Security system proved to be overly optimistic in the short range. The economy performed badly. Because prices have tended to rise faster than wages, the system was committed to paying out more in inflation-adjusted benefits than it took in through payroll taxes. Consequently, the largest of the Social Security Trust Funds, Old-Age and Survivors Insurance, was projected to have insufficient funds in 1981.

In 1980, Congress passed a temporary reallocation of the tax rates for 1980-81, increasing the revenues to the Old-Age and Survivors Insurance program and decreasing the tax rate for the Disability Insurance program, while leaving the combined payroll-tax rate unchanged. This was largely a technical measure to allow time for further action on Social Security financing in the 97th Congress. Because of the temporary reallocation, immediate cash-flow problems were deferred until 1982.

Meanwhile, the recurring news of Social Security's financial problems has sapped public confidence in the ability of Social Security to meet its future commitments. While most Americans support the goals of the Social Security system, they doubt whether it will be around to pay benefits when it's their turn to retire.

"A 1979 Study of American Attitudes Toward Pensions and Retirement" commissioned by Johnson and Higgins and conducted by Louis Harris and Associates, Inc. found that more than 8 out of 10 current employees have less than full confidence that Social Security will pay them benefits to which they are entitled when they retire; 42 percent have "hardly any confidence at all."

"A Nationwide Survey of Attitudes Toward Social Security" prepared for the National Commission on Social Security by Peter D. Hart Research Associates, Inc., found that 61 percent of the non-retired have little confidence that funds will be available to pay their retirement benefits. These doubts were expressed by almost three-fourths of those between ages 25 and 44.

A New York Times/CBS News Poll reported in July 1981 that a majority of the American people, 54 percent, no longer believe

that the Social Security system will have the money available to pay them full benefits at retirement.

SHORT-TERM PROBLEM (1982-1986)

The Social Security system is composed of three payroll-financed trust funds -- Old-Age and Survivors Insurance (OASI), Disability Insurance (DI) and Hospital Insurance (HI) -- and a fourth trust fund -- Supplementary Medical Insurance (SMI) -- financed 70% from general revenues and 30% from premiums by participants. According to the 1981 report by the Social Security Board of Trustees, the largest of the trust funds, Old-Age and Survivors Insurance, would become insufficient to pay benefits in the later half of 1982, under all 5 sets of alternative economic assumptions. Furthermore, in each of the years 1981-1985, expenditures from the OASI Trust Fund are expected to exceed income. Cumulative 1981-85 expenditures are under intermediate B assumptions, projected to exceed income by $78 billion.

In contrast, the financial condition of the Disability Insurance and Hospital Insurance Trust Funds is much better. In the short-range, income to these two trust funds is expected to exceed expenditures in each of the next several years. In 1981-85, DI's income is projected to exceed expenditures by $33 billion, and HI's income is projected to exceed outlays by $25 billion. But shortly after 1985, HI's favorable short-term position is expected to deteriorate and fall into deficit by 1990.

Under current law, however, payroll taxes earmarked for one of the trust funds can only be used to finance benefits and administrative expenses for that program. Thus, the surplus in the Disability and Hospital Insurance Funds cannot, without a

change in current law, be used to offset deficits in the OASI fund.

The origins of the short-term problem are strictly economic. In 1977, the Social Security Board of Trustees assumed that real wages would grow by an average of 2.5% per year in 1977 to 1980. In fact, real wages actually declined by an average of 1.5% during that period. The system has been committed to paying out more in inflation-adjusted Social Security benefits than it has collected from payroll taxes.

Revenues Needed in the Short-Term

Estimates about the revenues needed in the next five years vary substantially, depending upon the economic assumptions. The Social Security Board of Trustees, in its 1981 report, departed from the standard procedure of using three sets of assumptions. Instead, the new report presents five sets of assumptions in the short-term: optimistic, intermediate A (essentially, Reagan budget assumptions), intermediate B (close to the standard, middle range forecast), pessimistic assumptions, and (this is altogether new to the Trustees Report) a worst-case set of assumptions. (See Appendix A for specific economic and demographic assumptions.)

To illustrate how sensitive the short-run deficit is to the estimates used, consider the following: Under Reagan budget assumptions, the administration forecasts that income to the three payroll-financed trust funds, OASI, DI, and HI, would be sufficient to meet expenditures over the next five years. Another $11 billion would be required, the administration says, to bring the trust fund balances to what it calls a "reasonable

level of reserves" to protect against economic fluctuations. Under the administration's worst-case assumptions, however, the cumulative five-year shortfall would be $111 billion. In short, deciding upon the options entails a policy decision about what economic assumptions to follow.

Policy Decisions: Which Economic Assumptions? What Level of Reserves?

The policy decisions are two:

1) What is the most realistic forecast of the economy?

2) How much of trust fund reserve should Social Security maintain to serve as a buffer against unpredicted fluctuations in wages and prices?

Selecting the Appropriate Forecast

There are two options:

1) "Plan for the worst, but hope for the best."

The rationale for this approach is that previous economic policy decisions about Social Security, e.g. the 1972 and 1977 amendments, were based on economic projections that proved to be overly optimistic. As a result, the system is in trouble only 4 years after a long-term solution was widely publicized in 1977. These recurring financing problems further drain public confidence. Therefore, it is imperative to set the Social Security system right, regardless of how the economy performs.

The problem with this approach is that the short-term financing situation can only be solved by increasing taxes, cutting benefits, or diverting tax revenues from other programs. Each of these solutions involve substantial human sacrifice. If policy decisions are based on the worst-possible scenario and

the economy performs in a more reasonable manner, either 115 million taxpayers or 36 million beneficiaries will have been required to make unnecessary sacrifices in their well-being, at the end of a decade of high inflation and low growth in real income.

2) Plan for the most reasonable estimate making provision for the worst.

Using this approach, the sacrifices demanded of the American people would be scaled to the most reasonable estimate of how the economy is likely to perform. These are usually labeled "medium range" or intermediate forecasts (intermediate B assumptions in the new Trustees Report). Here, it can be argued, the human sacrifice is commensurate with the best estimate of the actual need.

The drawback is, in the event that economic conditions are far worse than the intermediate forecast, the financial solution based on intermediate assumptions would not be sufficient. Congress would have to reopen the financing issue.

The drawback can be remedied by providing the Social Security system with more flexibility to weather adverse economic cycles. Flexibility can be achieved in three ways:

A. Enact "safety-valve" provisons that would either reduce benefit growth or infuse additional revenues if conditions warrant. For example, the proposal to index current benefits to the lower of wages or prices would automatically curb benefit growth when the rate of inflation exceeds the rate of wage growth. Another option: either loans or infusions from general revenues could be authorized, triggered by a decline in trust

fund reserves or by the performance of key economic indicators, e.g. a high unemployment rate.

B. Build up somewhat larger reserves than the minimum required to keep the system going. Because Social Security benefit checks are sent out in the beginning of the month, and revenues to the system filter in during the month, the system must have at least one month's worth of benefits on hand, or the checks would be delayed until sufficient payroll tax revenues were actually received. That means the system must have reserves equal to at least 9% of annual outlays. But a reserve ratio of 14% is probably the closest the program should come to depleting its assets and still run smoothly.

If reserves were allowed to reach 20%-25% of annual outlay, Congress would have time to respond to any further deterioration in the economy by legislating savings or additional revenues. An additional $45-55 billion, either through additional revenues or savings, would be required to maintain trust fund reserves, in the three funds combined, under intermediate assumptions.

C. Reenact Statutory Benefit Guarantee. An alternative way of increasing the system's flexibility, without increasing the trust fund ratios by benefit cuts or higher taxes, is to reenact the statutory benefit guarantee that was contained in the Social Security Act between 1944 and 1950.

That provision stipulated: "There is authorized to be appropriated to the Trust Fund such additional sums as may be required to finance the benefits and payments provided under this title." If such a provision were reenacted, it would not necessarily mean that general revenues would be used to finance

the Social Security system. But it would mean that the system could then spend down its trust fund reserves to low levels. If one relies upon a trust fund ratio of 25% of a $160 billion program, that means that the system would need $40 billion less in reserves, if it had a statutory benefit guarantee. That kind of provision would yield enough safety to allow the program to surmount the tight situation of the next several years. It would not automatically infuse general revenues, but only use them if the system ran out of money.

Furthermore, if one contemplates the situation of a Social Security system without money to pay benefits, it is inconceivable that the Congress would allow those benefits to go unpaid. A statutory guarantee would make explicit the government's backing of Social Security.

Whatever stance is taken regarding the economic forecasts for the next five years, a desirable policy objective is to build flexibility into the Social Security system so it can withstand cyclical fluctuations without raising the alarming spectre of "bankruptcy." In fact, the short-term financing problem is serious but manageable.

SPECIFIC OPTIONS FOR SOLVING THE SHORT-TERM PROBLEM

Interfund Borrowing

Most proposals for solving the short-term financing problem include interfund borrowing or merger of the OASI, DI and HI trust funds for the next five to ten years. The Board of Trustees of the Social Security system recently reported that under the two, more optimistic sets of assumptions, interfund borrowing (or reallocation of tax rates among all three funds) would prevent the depletion of any of the trust funds in the short-term (1981-85) but only by a slim margin And, under the intermediate B, pessimistic and worst-case assumptions, the combined assets of these three trust funds would become depleted in 1983 or 1984, as shown in Appendix C.

Similarly, under CBO middle-range forecasts, Social Security could not get by with interfund borrowing alone. The system would require ~~$33~~ $12.9 billion in savings or additional revenues to maintain a combined trust fund balance of 12 percent of annual outlays.

In short, interfund borrowing is not a complete solution to the short-term funding shortfall. But it is a desirable, helpful proposal for managing the trust funds. Loans could be authorized among the trust funds, either permanently, or for a limited 5-10 years. In effect, the loans would be made from DI and HI to OASI, during that time. OASI could repay the loans, either with interest, as the Carter administration proposed in 1980, or without interest, as Senator Moynihan recently proposed.

Alternatives to interfund borrowing, which would have similar financial effects, are reallocation of the payroll tax rates

among the OASI, DI, and HI program, while holding the total payroll tax rate at the schedule under current law.

Another alternative would be to merge OASI and DI -- or even merge all three trust funds -- but retain a separate accounting of expenditures under the programs.

Proposals for interfund borrowing, reallocation, and or merger, must take into account that the HI Trust Fund, which is now running a healthy surplus in revenues, is scheduled to become depleted in the late 1980s or early 1990s, depending upon the economic outlook. In other words, the thrust of interfund borrowing and merging is to make funds available for the OASI program, which needs them now. But after 1990, interfund borrowing or merging of the trust funds would redirect the flow of loans from OASI to HI. The projected HI deficits beginning in the late 1980s compound the problems already discussed for OASI; they underline the need to do more than interfund borrowing to restore the strength of the combined system.

Increasing Revenues to the System

The short-term problems could, of course, be resolved by supplying additional revenues to the system, by either raising the payroll tax, and/or increasing the taxable wage base. or financing all or part of the HI program out of general revenues, or by extending Social Security coverage to new government employees.

1. Tax Increase -- In testimony before the House Social Security Subcommittee, David Stockman stated that a tax increase of 0.5% of payroll by employers and employees would be required

to finance the near-term deficit, which the administration estimates to be $84 billion.

2. Raise Wage Base -- If the ceiling on payroll taxes were eliminated, $20-$30 billion a year could be generated. Over the long-term, however, 1/3 to 1/2 of the added revenues would be offset by higher benefit costs, because the higher wage base would increase the benefits paid. (Source: Staff Report, Senate Finance Committee)

Another consideration about raising the taxable wage base is the impact on private pensions. The National Commission on Social Security, for example, recently expressed concern that increases in the wage base could discourage the supplementation of Social Security by private pensions. The National Commission recommended freezing the wage base in 1985 and 1986 at the 1984 level (estimated at $39,000). As it stands, the wage base will henceforth be increased each year by automatic adjustment provisions.

3. Use General Revenues -- Two bills have been introduced in the House [redacted] that would resolve Social Security's financing problems by financing HI out of general revenues. The Pickle Bill would finance half of HI out of general revenues; the Pepper Bill [redacted] would finance 70% of HI out of general revenues. The Pickle Bill would infuse about $92 billion in general revenues into the HI program over fiscal years 1982-86. The Pepper Bill would infuse $156 billion in general revenues into HI over fiscal years 1981-86.

4. Social Security Coverage of New Government Employees -- Mandatory Social Security coverage of new federal, state and

local government employees would produce about $20 billion in revenues in the next five years. (The long-term savings of such an act are estimated to be 0.5 percent of taxable payroll, or about 30% of the long-term deficit.)

Reconciliation Savings

Savings in Social Security over the next five years can be realized through benefit reductions and, to a much lesser extent, administrative changes in the program. The Budget Reconciliation Bills passed by the House and the Senate would save Social Security approximately $25 billion in 1981-1986.

In addition, the administration forecasts savings of $4.6 billion due to an intensified program of continuing disability investigations, designed to move off the rolls beneficiaries who have ceased to be disabled. Such savings, however, are estimates and by no means guaranteed.

Finally, House and Senate Reconciliation Bills contain cumulative savings in the Medicare, HI Trust Fund, of $1-$2.75 billion in 1981-84 (Savings for 1985 and 1986 have not been estimated). These savings to the HI Trust Fund would become available to the OASI program through interfund borrowing.

Options for Additional Savings

There are several ways of saving money in the short-term by reducing the growth of benefits. The major policy decision is how the sacrifice is distributed between current beneficiaries and those coming on the rolls in the next few years. For example, the administration's Social Security proposals, outside the budget proposals, placed great emphasis on minimizing the impact on current beneficiaries, while requiring the greatest

sacrifice of those turning 62, or becoming disabled, in 1982 or later. These people would bear the full brunt of the short-term sacrifice under the administration's plan. In other words, particular groups, such as early retirees, suffer heavily.

On the other hand, if current beneficiaries shared in the benefit reductions, the sacrifice would be spread among more people (36 million beneficiaries). However, current beneficiaries have already been running their lives based on present benefit estimates, and they have less flexibility than future beneficiaries, who have some opportunity to make adjustments in their work/retirement plans.

Indexing of Current Benefits: Four Proposals for Reducing Benefit Growth

The major proposals for reducing benefit growth over the next five years aim to slow down the automatic adjustment of benefits under current law. The possibilities are four: 1) Delaying the cost-of-living increase by three months; 2) capping the cost-of-living increase at some percentage of the full increase; 3) using the lower of wages or prices, or 4) using a modified CPI.

1. Delaying the COLA Increase by three months.

Both the administration and the Pickle Bill propose to delay the CPI increase by three months, moving payment from July to October. The Pickle Bill has a first year transition provision that softens the impact on current beneficiaries. Under Reagan budget assumptions, the administration's plan would save $6.3 billion in 1982-86 and $13.8 billion under intermediate B assumptions. The Pickle Bill would save less in the short-term, $4.8 billion under Reagan budget assumptions. Over the

long-term, both proposals would save 0.14 of taxable payroll over the next 75 years. The long-run savings are the same because all beneficiaries coming on the rolls in the future would be receiving three month's less of one cost-of-living increase.

Another possibility is a Snap-back COLA delay, i.e., to retain the present computation period but move payment of the CPI increase from July to October, and then, after five years, revert back to July increases, either in several steps, or all at once. Under intermediate B assumptions, estimated savings would be $16.5 billion in 1982-86. Thus, this proposal would yield greater short-run savings than either the administration or the Pickle COLA delay. It could be done as an emergency, interim measure, that could be rescinded sooner if the economy recovered dramatically. It would mean that each beneficiary would get three months less of the annual cost-of-living increase without altering the actual monthly benefit. The calculation of the benefit adjustment would be the same as under present law. So, upon reverting to the present procedure, future Social Security benefits will not have been permanently reduced.

2. Capping the CPI Increase

Congress could reintroduce an ad hoc element in the adjustment process by legislating a Congressional review of the automatic increase each year. In its review, Congress could decide whether the automatic computation is appropriate to the economic situation. For example, Congress could cap the increase at some percentage of the automatic adjustment -- 85% has been an example frequently cited. A crude CBO estimate is that an 85% cap would save a cumulative $28 billion in 1982-86, with modest

savings in the earlier years and larger savings in 1985-86. A Congressional review process would correct the present perception that this large entitlement program is sometimes "out of control" because indexing provisions can "automatically" put the program into a deficit position. Introducing this Congressional review would conceivably work both ways. In times of robust economic growth, and lower inflation, Congress might want to add a benefit increase to the automatic adjustment.

3. Using the Lower of Wages or Prices

Congress could limit the annual cost-of-living increase either to the rise in the CPI or to a wage index, whichever is lower. The National Commission on Social Security recently estimated that if such a provision had been in effect since 1977, the Social Security system would not now face a short-run financing crisis. It adds flexibility to the system. It is not, of itself, a benefit cut, because it would only reduce benefit adjustments during times when real wages are negative. However, for each year that the lower wage adjustment is used, it would permanently reduce future Social Security benefits, because future cost-of-living increases would be applied to a lower base amount.

Although the wage/price formula would add to the system's future flexibility, it would not produce large savings in the next five years. Under intermediate B assumptions, wage growth is projected to lag prices only in 1981, or 1981 and '82 under pessimistic assumptions. In other words, since wage increases are not expected to be lower than the CPI increases, the benefit increase would be as it is under current law.

4. Using a Modified CPI

Many people believe the CPI has overstated the rate of inflation because it overemphasizes new home purchases. COLA increases could instead be computed by using some other index, such as the CPI adjusted for rental equivalence. This would reduce the COLA increases when inflation rates are extreme. But over the long run, assuming economic stability, the rental equivalence measure would perform like the current CPI. CBO cautions that potential savings are highly uncertain. These indexes can fluctuate in ways that are difficult to forecast. A precise level of savings is, therefore, difficult to guarantee. CBO has not made an updated estimate of whether any savings would be realized in 1982-86.

Other Benefit Reductions

Although changes in the method of indexing current benefits could lead to substantial savings, they are not the only mechanisms.

In May, the administration introduced a package of 13 proposals designed to surmount the short-term problem and eliminate the long-run actuarial deficit under intermediate assumptions. Of these 13 proposals, 12 reduce benefits in the next five years, while one proposal, phasing out the retirement test, would increase benefits. Together, the package would save $46 billion in 1982-86 under Reagan budget assumptions, i.e. savings over and above the budget proposal.

The administration's proposals have received so much coverage that they will not be discussed here in great detail. What should be pointed out is that nearly 80% of the plan's net

savings are derived from benefit cuts imposed on two groups of new beneficiaries: early retirees and disability beneficiaries. $18 billion in savings would be realized by a greater reduction in early retirement benefits. The reduction at age 62 would be 45% of primary benefits, compared to a 20% reduction under current law.

The second group of changes -- where the combined savings effect exceeds the savings from the cuts in early retirement -- affects new disability beneficiaries. Nearly $22 billion in savings would be achieved by increasing the disability insured status requirement; by requiring a "medical only" determination of disability and excluding age and vocational factors; by extending the required disability prognosis from 12 to 24 months; and by increasing the waiting period for disability benefits from five to six months. In other words, nearly half of the plan's total net savings come from cuts in the disability program, even though the Disability Insurance Trust Fund is not experiencing financial difficulties and the Old Age and Survivors Insurance Trust Fund is.

Over the long-term, however, the distribution of the savings from the administration's plan is different, and it is to the long-term financing problems of Social Security that we now turn.

LONG-TERM SOLVENCY OF SOCIAL SECURITY

Over the next 75 years, the projected expenditures from the Social Security system are expected to exceed revenues, as scheduled under current law. Before we proceed to measure the extent of the deficit, it is worth emphasizing that the long-term solvency crisis is a projected one. It rests upon specific economic, demographic, and labor-force projections based on reasonable assumptions.

But we must be cautious in relying on the projected developments. The demographic and economic projections are extremely sensitive to the assumptions used. The further out we project in time, the greater is the probable error in the projections and their outcome. For example, this year's pessimistic forecast for 2031-2055 is an average deficit of 1.37% of payroll less than 1980's estimate. In other words, this year's forecast for the average deficit in 2031-2055 is significantly better than 1980's forecast.

Still, even under very favorable future economic and demographic assumptions, we should expect a rise in the number of beneficiaries and program costs in the next century. It is wise to begin planning for the eventuality now, because one of the primary requirements of successful change is that any reform of Social Security programs must be gradual in nature. Major revisions would have to be phased in over a long period of time.

The long-run performance of the Social Security system is usefully measured in terms of the deficit/surplus as a percentage of taxable payroll.

As shown in Figure 1, once the OASDI system surmounts its short-run problems in the 1980s, the system will begin accumulating substantial reserves during the next 25 years, because payroll tax receipts will rise under currently scheduled tax increases, while the numbers of elderly will not grow dramatically in proportion to the working-age population. Over the following 25-year period (2006-2030), the baby-boom population will be reaching retirement age. The surplus accumulated during the prior 25 years is then projected to be drawn down to meet the rising benefit commitments. During the final 25-year period (2031-2055), the system is projected to be in substantial deficit.

Let's look more closely at the performance of the system over these next 75 years, based on 25-year averages presented in Appendix D.

During the 25-year period 1981-2005, OASDI Trust Fund revenues are projected to exceed expenditures under all but the pessimistic set of assumptions. Under the intermediate B assumptions, the actuarial balance (revenues minus expenditures) is a surplus which averages 0.43% of payroll. (To illustrate how sensitive the outcome is to the assumptions used, last year's Trustee Report, under intermediate assumptions, showed a surplus which averaged 1.19% of payroll, i.e., much closer to this year's intermediate A assumptions.) Under pessimistic assumptions, there is an average deficit of 0.61% of payroll.

In 2006-2030, an actuarial deficit averaging 1.47% of payroll is projected under the intermediate B assumptions, compared with

a deficit of only 0.67% under intermediate A assumptions and an average deficit of 5.10% under pessimistic assumptions.

In 2031-2055, the Trustees project an actuarial deficit under all but the optimistic set of assumptions: intermediate A (-3.39%), intermediate B (-4.41%), and pessimistic (-13.03%).

Over the whole 75-year period, the Trustees project a surplus averaging 1.25% of payroll under optimistic assumptions, an average deficit of 0.93% under intermediate A assumptions, an average deficit of 1.82% under intermediate B assumptions, and an average deficit of 6.25% of taxable payroll under pessimistic assumptions.

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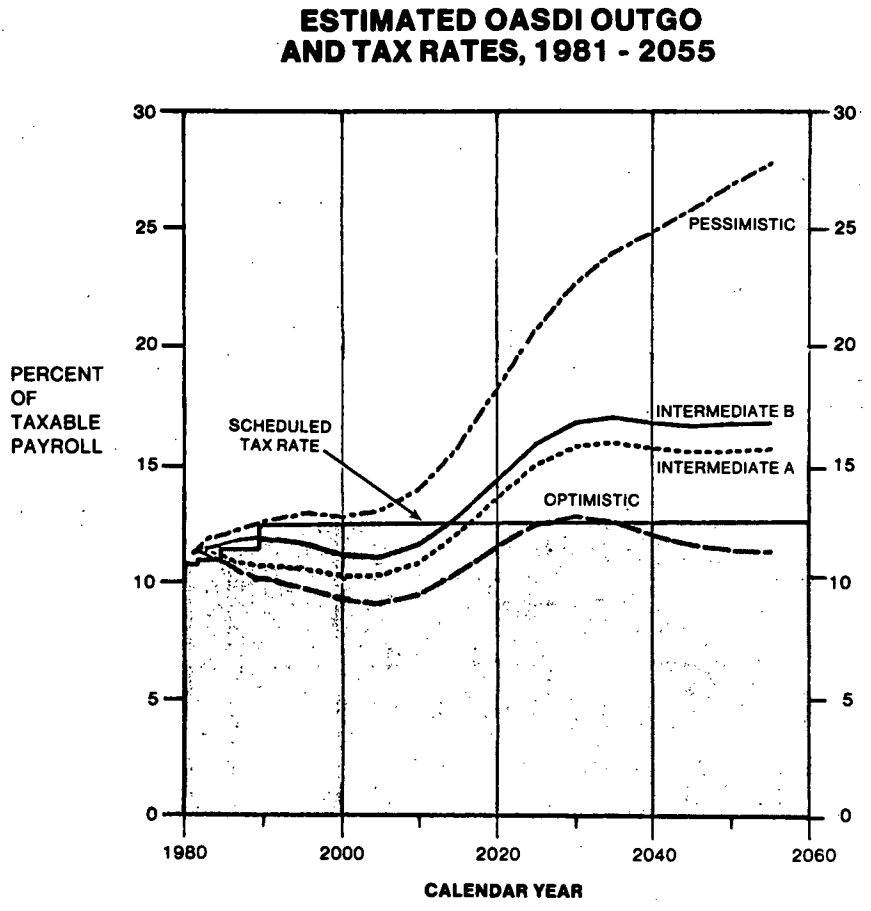
Figure 1



Source: Social Security Administration

Medicare Hospital Insurance (HI)

Long-range cost estimates for the Medicare Hospital Insurance (HI) program are only made for the next 25 years, mainly because the trend of future hospital costs is highly uncertain. As Figure 2 illustrates, the forecast for HI is not good. The Social Security Trustees report that, if a trust fund ratio of 50% of annual outlays is maintained, the HI program will experience an actuarial deficit ranging from 0.42% of taxable payroll under optimistic assumptions to a deficit of 1.44% of taxable payroll under intermediate B assumptions and a deficit of 2.8% of taxable payroll under pessimistic assumptions (see Appendix E).

Although the HI Trust Fund is not in imminent danger, the Social Security Trustees recommend that Congress should investigate ways of strengthening its financing.

The deficit in the HI program results from the projection of high rates of growth in hospital costs. In recent years, hospital costs have increased at an annual rate between 10% and 19%. Under intermediate B assumptions, the rate of hospital cost increases is projected to decline from 15.6% in 1981 to 10.0% in 1995 and 9.3% in 2005. Still, these rates of increase are, after 1985, twice the rate of increase projected in the Consumer Price Index.

Such assumptions are moderate projections of current trends. The forecast will only improve if present trends are reversed by measures such as hospital cost containment or changes in program eligibility and reimbursement reforms. Otherwise, higher payroll

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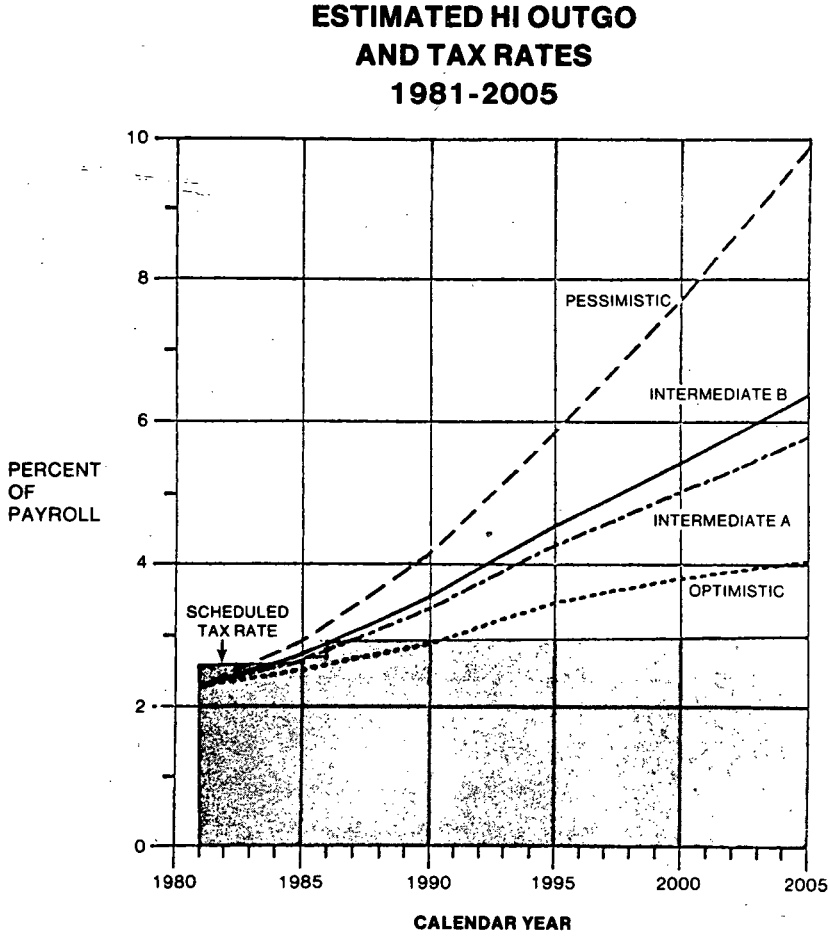
Figure 2



Source: Social Security Administration

Origins of Long-Term Social Security Deficit

The projected long-range deficit in the Social Security system is caused by the fact that there will be more elderly people, who will be living longer but continuing to retire early.

1. More elderly:

In absolute numbers. . . the population 65 and over was 17 million in 1960 and 26 million in 1980, and is estimated to be 36.0 million in 2000, 65 million in 2030, and 69 million in 2055, according to the intermediate estimate.

. . . and in relation to the working age population, the elderly grew from 17.4% of the working age population (age 20-64) in 1960 to 19.5% in 1980, and are estimated to be 22.6% in 2000, 37.8% in 2030, and 37.8% in 2055, according to the intermediate estimate.

2. Living Longer:

The average man reaching age 65 today can expect to live to age 79, on the basis of current mortality rates, as compared to age 77 based on 1940 mortality experience. For women, the corresponding ages are 83 for current experience versus 78 1/2 for 1940 experience.

3. Early Retirement:

Roughly two out of three Social Security retirees now claim benefits before age 65. No solid evidence indicates that trend is being reversed.

4. Working Less:

The long-term trend has been for fewer people to continue working beyond age 65. Although roughly one out of four persons 65 and over was working in 1954, only one out of eight

did so in 1980. The tendency has been particularly strong among male workers: two out of five men age 65 and over worked in 1954, compared to one out of five in 1980.

The same tendency toward reduced labor-force participation is evident among the 60-64 age group, although here, the reduced labor-force participation of men has been offset somewhat by the increased labor-force participation of women. Total labor-force participation of men and women in the 60-64 bracket declined from 55% in 1954 to 45% in 1980. Male labor-force participation declined from 84% to 61%, while labor-force participation of women increased from 27% to 33%.

Because of these four factors, more elderly people will be in beneficiary status for a longer time, thus adding to Social Security costs. Meanwhile, if the birth rate continues to remain relatively low, and immigration does not increase, those of working age won't increase as rapidly as the elderly. Whereas there are about 3.2 covered workers for every OASDI beneficiary today, there are expected to be only 2.0 covered workers for every OASDI beneficiary in the year 2030.

As with the short-term problem, the long-range deficit can only be eliminated by changes in Social Security which, either alone or in combination with other proposals, will have the effect of raising revenues or curbing the growth of outlays by changes in the benefit structure.

SPECIFIC OPTIONS FOR SOLVING THE LONG-TERM PROBLEM

Raising Revenues

Additional revenues to finance Social Security expenditures in the next century could, of course, be obtained by increasing payroll taxes. In 1981, employers and employees each pay 6.65% of payroll for OASDI and HI. In 1982, rates will rise by 0.05% for OASI, bringing the total to 6.70%. In 1985, a rise in payroll taxes for OASI, DI and HI will bring that total to 7.05%. In 1986, the payroll tax will rise to 7.15% because of a 0.1% rise in the rate for HI. Finally, in 1990, the payroll tax rate will rise to 7.65% because of increases in OASI and DI. The 1.82% average deficit of OASDI could be financed by an increase in the OASDI payroll tax rate scheduled for 1990, from 6.2% of taxable payroll to 7.1% by employers and employees.

Another source of higher revenues is to bring new federal, state and local government employees under Social Security. That would save 0.5% of taxable payroll over the next 75 years, or roughly one-third of the estimated deficit.

New Revenue Sources

Both the 1979 Advisory Council and the National Commission on Social Security recommended that general revenues be used to fund all (Advisory Council) or half (National Commission) of HI expenditures. Both groups recommended that the OASDI tax rate then be increased. The Advisory Council recommended that the OASI and DI Trust Funds be merged, and that the payroll tax be raised to 7.25 percent in the year 2005 to finance the rising expenditures in the next century. The National Commission would not allow the rate for employers and employees to exceed 9% each.

The President's Commission on Pension Policy recommended that payroll tax increases scheduled under current law be accelerated.

The administration's plan for Social Security contrasts with these recommendations for higher taxes and/or additional general revenues. One of the key elements in the administration's plan is to reduce long-range Social Security taxes.

The administration's press release announced:

"Assuming enactment of these proposals, and those introduced in the Administration's Budget proposals, it will be possible to lessen the Social Security tax increase now scheduled for 1985 and to actually decrease Social Security taxes below the current level in 1990. Note that while an increase will again become necessary in 2020 due to the aging of the population, the rate will still be lower than the 1990-and-after rate scheduled under current law."

The administration further estimates that a young person entering the labor force next year would pay $33,600 less in Social Security taxes over his or her lifetime, a reduction of 10%.

The administration's plan for Social Security would achieve savings from benefit reductions that would not only make up for the long-range deficit, but would be large enough to permit a reserve ratio of 50% of annual outlays and a tax reduction.

Benefit Reductions

There are really only two types of benefit modifications seriously being proposed to eliminate the long-range deficit: proposals which would raise the retirement age and proposals which would reduce the computation of initial benefits for workers coming on the Social Security rolls in the future.

Raising the Retirement Age: Three Approaches

To curb the growth of Social Security expenditures, interest has focused upon reversing the trend to early retirement. Three

different kinds of approaches can be taken: 1) a statutory increase in the age required to receive full Social Security benefits; 2) an approach that would discourage early retirement and therefore raise the effective age of retirement, without actually raising the age required for full benefits; and 3) an approach that would retain the present age for full benefits but introduce incentives that would voluntarily encourage older workers to continue working, rather than take early retirement benefits.

1. Raise the Age of Eligibility for Full Retirement Benefits -- All three national advisory commissions -- the Advisory Council on Social Security, the National Commission on Social Security, and the President's Commission on Pension Policy -- recommended that the age for full benefits be raised from 65 to 68, after a long phase-in period. The rationale for this change is that, because of longer life expectancies and healthier generations of older Americans, a shift to age 68 would be better suited to the changing conditions and roughly equivalent to the duration of retirement envisaged when the age was first set at 65 back in 1935. Raising the age of eligibility for full benefits is a key part of both the Pickle Bill and the Chiles Bill.

The Pickle Bill gradually increases, beginning in 1990, the reduction in benefits for those taking benefits before age 68, so that by the year 2000, those retiring at 62 would receive 64% of the full benefit, with the percentage gradually increasing to 100% at age 68.

The Chiles bill (S. 484) would raise the normal retirement age to 68 and early retirement age to 65, over a 12-year period

from the year 2000 to 2012. It would also raise the age of benefit eligibility for widows and widowers from 60 to 63. Gradually raising the normal retirement age to 68 is projected to offset 1.07% of the projected 1.82% deficit. This provision, combined with a reduction in benefits available at age 62 from 80% to 64% of full benefits, would offset 1.35% of the total 1.82% deficit.

2. Retain Age 65 But Discourage Early Retirement -- The administration has proposed to increase the actuarial reduction for early retirement benefits, in effect increasing the penalties for those who retire early. This change would save 0.85% of taxable payroll over the long-term. It would probably increase the average age of retirement without a statutory increase in retirement age.

3. Promote Innovative Policies to Encourage Work -- The most satisfactory approach, from the viewpoint of beneficiaries, would be to retain the present retirement age and early retirement provisions but increase the incentives for people to defer retirement, thereby encouraging the healthy and the capable, while making allowance for those who want to retire early because of ill health, unemployment, or preference. Such proposals include increasing the delayed retirement credit for those who defer retirement, lifting the earnings test altogether, exempting 65-year old workers from the payroll tax, instituting special unemployment programs for older workers, etc.

Unfortunately, the impact of these various proposals is unknown. They rely upon very sensitive, hypothetical assumptions about likely changes in labor-force participation as a result of

the incentive. Furthermore, all of these paths, such as eliminating the earnings test, involve additional costs. The question becomes, to what extent will the added savings from increased work offset the costs of eliminating the retirement test? And what will be the global effect on our economy and other sources of income security, such as private pensions?

Changing Computation of Initial Benefits

Besides raising the retirement age, two other major proposals to curb the growth of benefits are the proposals to decrease the replacement rates by altering the adjustment of the bend points in the benefit formula.

1. Administration's Bend Point Proposal -- The Social Security benefit formula is weighted to pay relatively higher benefits to lower-paid workers than to higher-paid ones. This is accomplished by applying a three-bracket benefit formula to the worker's average indexed monthly earnings. To be precise, the formula for persons attaining age 62 in 1981 is equal to the sum of 90% of the first $211 of average indexed monthly earnings, plus 32% of the amount between $211 and $1,274, plus 15% of the amount in excess of $1,274. The dollar amounts at which the percentages change are called "bend points," and these are automatically increased each year -- for the group of persons attaining age 62 then -- by the percentage of increase in national average wages.

The administration's proposal is that, during the six years 1982-87, the dollar amounts of the bend points should be increased by only half of the percentage increase in national average wages, instead of by the full percentage increase in

wages. After 1987, the bend points would again be indexed by 100% of the change in national average wages.

The effect of this change would be to reduce relative benefit levels by 10% below current law.

The replacement rate -- the actual benefit payable as a percentage of the gross pay received just before retirement at age 65 -- for a worker with a history of average earnings is, under present law, about 41% or 42%. If this revision in the calculation procedure goes into full effect -- in 1987 and later -- the replacement rate would be about 37% or 38%. The administration's bend point proposal would save an estimated 1.30% of taxable payroll, far more than the (also substantial) 0.85% of payroll saved by penalizing early retirees.

2. Price Indexing -- Another long-term option is to lower future Social Security costs by having the initial benefit rise somewhat faster than inflation, but not as rapidly as is produced by the current method of wage indexing. Under a price indexing proposal, as illustrated in Appendix F, past earnings and the bend points in the formula would be adjusted for changes in consumer prices. If wages continue their historical tendency to outstrip prices in the long-term, an individual's earnings would rise faster than the adjustments in the benefit formula. As earnings rose, so would the absolute amount of the benefit. But since the real wage increases would put the individual in the upper brackets where the replacement rate is proportionally lower, the size of the benefit would decline in relative terms, that is as a percentage of pre-retirement earnings, and would not

fully reflect improvements in living standards during working lifetimes.

The distinct advantage of the price indexing method is that future increases in total benefit expenditures could be held to a minimum, and roughly offset the effect of the aging population; hence, there might not be a need for any sizable tax increases. Congress would then have the flexibility to legislate future benefit increases that seem most appropriate at a given time. Benefits would still be protected against inflation, and, although replacement rates would decline over time, initial real benefits would continue to rise.

A disadvantage is that workers tend to evaluate their retirement situation in terms of pre-retirement income. So, unless Congress legislated increases, substantial adjustments in living standards might be required of retired persons. But the price of stable replacement ratios, as we have now, is that future taxes have to be increased. On the other hand, to the extent that price indexing would furnish a lower percentage of pre-retirement earnings, a greater range of private initiative would be encouraged. It would mean less involvement of Social Security in the total retirement income picture, but workers would have the tax savings to use as they see fit.

Price indexing was recommended by the expert Consultant Panel to the Finance Committee in 1976. Price indexing of the bend points could eliminate the entire long-term deficit. Price indexing of the wage histories could eliminate most of the long-term deficit.

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Current law provides stable replacement rates. The administration's bend point proposal would lower the replacement rates by roughly 10% below what they will be after 1990, and then stabilize them at the lower level. Price indexing would lower replacement rates to a variable degree, and probably to around 25%-30% in the next century.

CONCLUSION

In evaluating the various options for restoring the long-term solvency of Social Security, answers to several key questions will influence the ultimate choice.

The first question is: What is the appropriate level of income replacement from Social Security benefits? Should Social Security merely provide a floor of protection, to be supplemented by private pensions, savings, and/or earned income? If so, what is the proper level of the floor in terms of income replacement? During the 1970s, the replacement rate for single, low-earners rose from 43% in 1970 to 64% in 1980; that of average earners rose from 34% in 1970 to 51% in 1980; that of high earners rose from 29% in 1970 to 33% in 1980. Because of changes in the 1977 amendments, long-term replacement rates will decline between 1982 and 1990, after which they will be stabilized at 53-54% for low earners, 41-42% for average earners, and 27-28% for high earners.

Another key question is: What should be the relative roles played by Social Security, private pensions, personal initiative, and public assistance (or Supplemental Security Income)? When the Social Security Act was passed in the midst of the Great Depression, the SSI program did not exist. The Act authorized matching federal grants to states who offered old-age assistance, but the resulting programs varied from state to state. Furthermore, when the Social Security Act was passed, private pension plans were limited in number and reeling under the financial impact of the Great Depression. Finally, the early provisions of the Social Security Act included a stiff retirement test, during an era of high unemployment, when older workers were

viewed as "occupying" jobs needed by younger workers. In short, during the past 45 years, there has been a complete change in the mechanisms for delivering income security and in society's attitude toward older workers.

If a greater role is desired for private pensions, the question is: What changes in Social Security will have that effect? Advocates of price indexing argue that by maintaining real benefits but reducing replacement rates, the proposal would encourage the development of private pensions and personal savings for retirement. But it would also mean, most definitely, a relatively smaller role for Social Security in the total mix of income security programs.

As far as retirement age is concerned, is it better to raise the age of eligibility to 68 for full benefits? Or, as the administration proposes, should the penalties on early retirement be increased, but retain full benefits at 65?

Looking toward the future, another question is: What is the appropriate level for Social Security payroll taxes? All of the national advisory groups have recommended that the scheduled tax increases for OASI be raised or accelerated, whereas the goal of the administration is to reduce the overall level of taxation. Most opinion polls generally indicate that people would prefer higher taxes if the alternative is cutting benefits. Other industrialized countries have far higher payroll taxes, without damaging effects on their economies. Moreover, as long as wages continue to grow in real terms, as they have done historically, higher payroll taxes could easily be financed out of higher real incomes without any sacrifice in standard of living. In looking

at future Social Security payroll taxes, however, one has to include the additional amounts that will be required to finance Medicare Hospital Insurance, as well.

Another key question: Is this the appropriate time to pass legislation that will solve the long-term problem? We have seen that estimates about the long-term deficit are hypothetical and very sensitive to the assumptions used. The actual outcome could be quite different. But we also know that people's expectations are formed gradually, over a long period of time, and that they must be protected from abrupt changes. Does the weight of the current projections warrant wholesale changes in the program now? And is this the appropriate time, in the throes of an adverse business cycle, to plan solutions 50-75 years hence?

A comprehensive solution to the Social Security problem is certainly desirable. But realistically, the program will not be "fixed" once and for all. It will require periodic interventions and restructuring by Congress to keep the system in line with a rapidly changing society, just as it has since 1935.

But, if Congress is committed to solving the problems of the next century -- now -- do we have all the information we need to devise the best long-term solution? We have seen that one of the most attractive options for solving the long-term problem is the use of incentives to voluntarily encourage workers to defer retirement, increase savings, and increase their labor-force participation after retirement. Yet we have also seen that this is the one area where the options are the most hypothetical, the most untested.

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Finally, if we are committed to solving the long-term problems, do we have the institutional mechanisms in place to evaluate the options and their impact? One of the biggest needs for effective retirement income policies is coordination of the various programs for economic security. But coordination is sadly lacking, largely because the responsibility for individual income security programs is scattered among numerous federal agencies and groups in the executive branch and in the legislative branch.

The Government Accounting Office (GAO) recently recommended that Congress establish a National Income Security Commission to monitor the progress of all the income security programs and serve in an advisory capacity to Congress and the executive branch. "The income security system lacks overall leadership," says the GAO report. "Because of the system's far-reaching social impacts, deeply rooted difficulties, and projected future cost growth, the time has come to fill the leadership void and bring about changes in its policymaking, management and evaluation. GAO believes such changes can best be brought about through an independent, national body, such as a National Income Security Commission, dedicated to helping the Congress and executive branch meet their program responsibilities."

Perhaps any legislation to solve the problems of the 21st century should include a standing commission, along the lines recommended by GAO, and dedicated to the task of looking at all the programs comprehensively, eliminating waste and duplication, and targeting resources to where they are needed most.

APPENDIX A

Economic and Demographic Assumptions

The table below shows selected values of several of the assumptions used in the projections for OASDI and HI in the 1981 Trustees Reports.

Calendar Year	Real GNP 1/	Percent Increase over Previous Year in Average Annual-- Wages in Covered Employment	Consumer Price Index	Inpatient Hospital Costs 2/	Annual Unemployment Rate	Total Fertility Rate 3/
			Optimistic Assumptions			
1981	1.7%	10.6%	10.7%	15.6%	7.7%	1.9
1985	4.4	6.8	4.1	11.4	5.7	2.0
1995	3.2	4.5	2.0	6.8	4.5	2.1
2005 & later	3.5	4.5	2.0	6.3	4.0	2.4
			Intermediate-A Assumptions			
1981	1.1	10.2	11.1	15.6	7.8	1.9
1985	4.2	7.1	4.7	12.9	5.9	1.9
1995	2.8	5.0	3.0	9.1	5.0	2.0
2005 & later	3.1	5.0	3.0	8.4	5.0	2.1
			Intermediate-B Assumptions			
1981	1.1	10.2	11.1	15.6	7.8	1.9
1985	2.9	8.1	7.4	14.4	6.8	1.9
1995	2.4	5.5	4.0	10.0	5.4	2.0
2005 & later	2.7	5.5	4.0	9.3	5.0	2.1
			Pessimistic Assumptions			
1981	0.7	11.5	12.6	15.6	7.9	1.8
1985	3.0	10.1	9.7	18.8	7.4	1.8
1995	2.3	6.4	5.4	12.9	6.0	1.8
2005 & later	2.2	6.0	5.0	11.9	6.0	1.7
			"Worst-Case" Assumptions (1981-86 Only)			
1981	-0.1	10.6	12.8	15.6	8.3	1.8
1985	4.4	10.4	9.7	15.6	8.0	1.8

1/ Gross National Product (the total output of goods and services) expressed in constant dollars. The percentage increase in real GNP is assumed to change after the year 2005. The values for the year 2055 are 3.4, 2.5, 2.1, and 0.9 percent for the optimistic, intermediate A, intermediate B, and pessimistic assumptions, respectively.

2/ Includes hospital costs for all patients, not just those covered under HI. Figures shown for "2005 & later" are for 2005.

3/ The number of children who would be born to a woman in her lifetime if she were to experience the age-specific birth rates assumed and were to survive the entire child-bearing period.

Source: Social Security Administration

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APPENDIX B

Table --Payroll Tax Schedule

Calendar Year	Contribution Rates (Percent of Taxable Earnings) Payable by Employers and Employees, Each			
	OASI	DI	HI	Total
1981	4.70%	0.65%	1.30%	6.65%
1982-84	4.575	0.825	1.30	6.70
1985	4.75	0.95	1.35	7.05
1986-89	4.75	0.95	1.45	7.15
1990 & later	5.10	1.10	1.45	7.65

Source: Social Security Administration

APPENDIX C

Table --Fund Ratios Projected to 1985

	Fund at January 1 as a Percent of Outgo During Year					
	1980	1981	1982	1983	1984	1985
OASI:						
Optimistic Assumptions.....	23%	18%	14%*	6%*	-1%*	-8%*
Intermediate A Assumptions.....	23	18	13*	5*	-4*	-13*
Intermediate B Assumptions.....	23	18	13*	4*	-5*	-16*
Pessimistic Assumptions.....	23	18	13*	4*	-9*	-22*
"Worst-Case" Assumptions.....	23	18	13*	2*	-13*	-29*
OASI and DI Combined:						
Optimistic Assumptions.....	25	18	14	9*	6*	4*
Intermediate A Assumptions.....	25	18	13	8*	3*	-1*
Intermediate B Assumptions.....	25	18	13*	7*	2*	-5*
Pessimistic Assumptions.....	25	18	13*	7*	-2*	-12*
"Worst-Case" Assumptions.....	25	18	13*	5*	-7*	-18*
OASI, DI, and HI Combined:						
Optimistic Assumptions.....	29	23	21	20	19	19
Intermediate A Assumptions.....	29	23	21	18	15	13
Intermediate B Assumptions.....	29	23	21	18	14	8*
Pessimistic Assumptions.....	29	23	21	17	9*	1*
"Worst-Case" Assumptions.....	29	23	20	15	5*	-5*

* Under present law, the program would be unable to pay timely benefits during this year because financing is projected to be inadequate.

Source: Social Security Administration

APPENDIX D

Estimated Average OASDI Tax Rates, Expenditures, and Actuarial Balance (Percent of Taxable Payroll)

	25-Year Averages			75-Year Average
	1981-2005	2006-2030	2031-2055	1981-2055
Average Scheduled Tax Rate (Combined Employer-Employee Rate)	11.94%	12.40%	12.40%	12.25%
Estimated Average Expenditures:				
Optimistic Assumptions.....	9.99	11.07	11.93	10.99
Intermediate-A Assumptions.....	10.67	13.07	15.79	13.17
Intermediate-B Assumptions.....	11.51	13.87	16.81	14.07
Pessimistic Assumptions.....	12.55	17.50	25.43	18.50
Difference (Actuarial Balance):				
Optimistic Assumptions.....	1.95	1.33	0.48	1.25
Intermediate-A Assumptions.....	1.27	-0.67	-3.39	-0.93
Intermediate-B Assumptions.....	0.43	-1.47	-4.41	-1.82
Pessimistic Assumptions.....	-0.61	-5.10	-13.03	-6.25

Source: Social Security Administration

APPENDIX E

--HI Actuarial Balance 1981-2005
(Percent of Taxable Payroll)

	Optimistic Assumptions	Intermediate-A Assumptions	Intermediate-B Assumptions	Pessimistic Assumptions
Average Scheduled Payroll Tax Rate (Combined Employer-Employee Rate)	2.84%	2.84%	2.84%	2.84%
Expenditures	3.21	3.94	4.19	5.46
Trust Fund Buildup and Maintenance	0.05	0.08	0.09	0.18
Total Cost of the Program	3.26	4.02	4.28	5.64
Difference (Actuarial Balance)	-0.42	-1.18	-1.44	-2.80

Source: Social Security Administration

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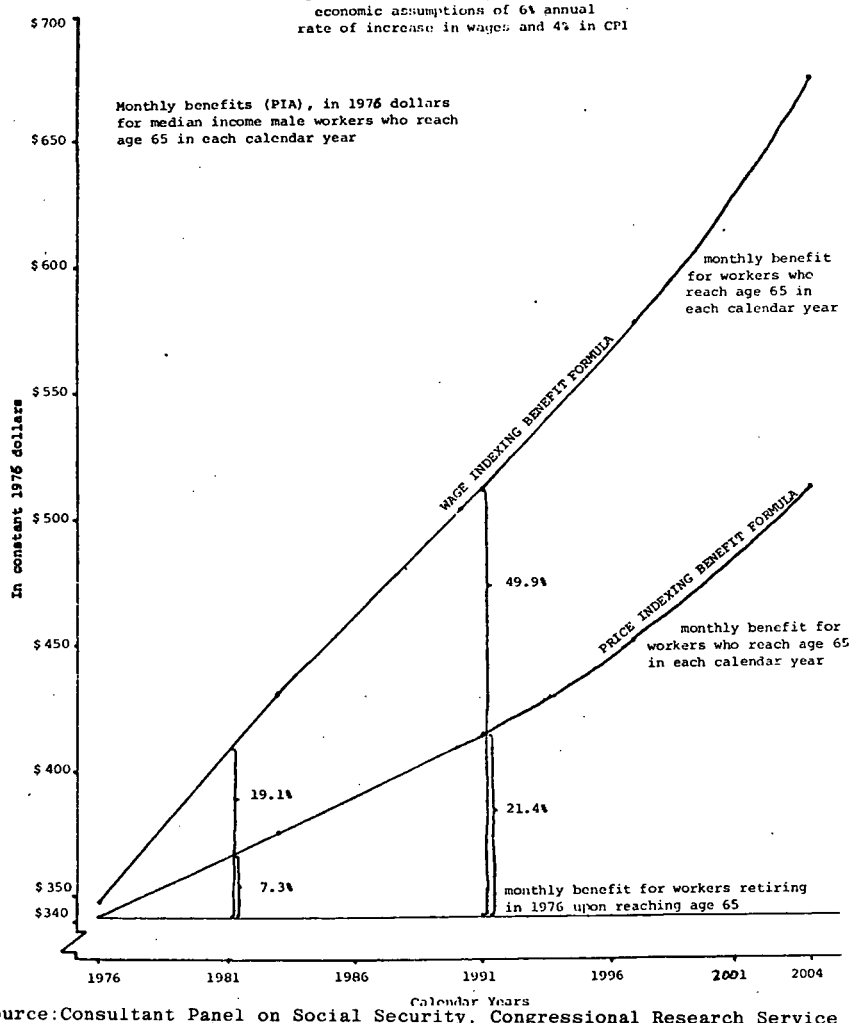
APPENDIX F

Price Indexing vs. Wage Indexing

Benefit illustrations, using ultimate economic assumptions of 6% annual rate of increase in wages and 4% in CPI



Source: Consultant Panel on Social Security, Congressional Research Service
Prepared for: Committee on Finance, U.S.Senate and Committee on Ways & Mea
U.S. House of Representatives August 1976

Your stake in the fight over Social Security

Social Security's problems are real enough, but they are not nearly as serious as you may have been led to believe. In this report, CU examines the basic concepts of the system, what has happened over the years, and the proposals to alleviate the problems. This is the second of an extended series on retirement financing. In the January 1980 issue, we dealt with Individual Retirement Accounts; early next year, we will analyze the private-pension system.

After Labor Day, when Congress returns from its summer recess, it will consider what one member calls the "hottest domestic issue in 30 years"—restructuring the Social Security System. Soon, possibly in the next few weeks, Congress will decide basic policy questions: What benefits will current and future retirees have? Should the retirement age be 65 or 68? What new sources of financing are needed?

The latest financial troubles of the Social Security System have prompted scare headlines warning of the system's impending bankruptcy. The Secretary of Health and Human Services himself spoke of an "inescapable crisis."

Such talk has led to unreasonable, occasionally irrational, concerns. Retirees are afraid of losing the benefits they've come to depend on. Younger employees fear there'll be no Social Security benefits when they retire. A recent New York Times-CBS News Poll found that a majority of Americans believe that the Social Security System will not have the money to pay them full benefits when they retire.

Although the headlines have exaggerated Social Security's troubles, the system does face both short-term and long-term financing problems. The short-term problem will be visible a year from now; the long-term problem won't appear until the so-called baby-boom generation reaches retirement, sometime after the turn of the century.

There are practical and equitable solutions for both problems. But there's a real danger that the problems will be "solved" by returning hundreds of thousands of elderly people to the poverty that Social Security was intended to relieve.

In this report, CU examines the problems of the Social Security System and the proposed solutions. First, however, it is necessary to understand the origins of the system and the concepts on which it has been based. Whether for good or ill, the system has been pasted together with an ideological glue that does not easily dissolve.

In the beginning

The U.S. was one of the last of the industrialized nations to establish an old-age benefit system. Bismarck created the first such program in Germany in the 1880's; other European countries quickly followed suit. They felt it was a nation's responsibility to look after people who had worked all their lives.

In America, however, old people were left to look after themselves. They were expected to save for retirement or depend on their children for help. The poorest among them went "on relief," depending on subsistence payments grudgingly doled out by state and local welfare agencies or by private charities.

But during the Depression, savings set aside for retirement were wiped out, and younger people, often without jobs, could not afford to care for aged parents. It was under the stress of such conditions that, in 1935, under the guidance of President Franklin D. Roosevelt, the Social Security System was born.

Once the Roosevelt Administration had decided on the basic concept of the system, planners faced three critical issues: how to pay for the benefits; how to insulate the system from politics; and how to convince the public to support a plan that might appear to be a "handout" from the Government.

A payroll tax paid equally by employees and employers appeared to solve all three problems.

Paying for the benefits

Social Security is a pay-as-you-go system—that is, the payroll taxes paid by current employees provide benefits only for current retirees. The money is not an annuity invested at interest to pay for the employees' own future benefits. That was a crucial decision and one that has created widespread misunderstanding. "People think the money they send in is sitting in a bank in Baltimore," says former Social Security Commissioner Stanford Ross. "They don't realize it's a cash-in, cash-out system."

(The system might have been designed to be "fully funded"—that is, financed so that there would always be enough money in a reserve fund to pay not only current benefits but also the future benefits to which current employees would be entitled. However, a fully-funded system would have imposed an extraordinary tax burden on at least one generation of employees. It would also have produced a huge supply of capital that the Government would have had to manage.)

The payroll tax was to be a flat percentage of an employee's annual gross wages up to a certain amount, which was termed the "wage base." In 1937, when the Social Security Act took effect, the tax was 2 percent—1 percent paid by the employee and 1 percent by the employer—and the wage base was $3000. Thus, the maximum paid per year by any employee was $30. The planners expected both the tax percentage and the wage base to increase as the system matured, and more people became eligible for benefits. In 1981, the employer and employee are each paying 6.65 percent, and the wage base is $29,700. This year, an employee can pay as much as $1,975.05.

Since everyone pays the same percentage of tax up to the wage base, those whose incomes are below the wage base pay a greater percentage of their total income in Social Security taxes than do people whose incomes exceed the wage base. The Social Security tax is therefore considered regressive.

The money collected from employers and employees goes into trust funds from which current benefits are paid. (Social Security "trust funds" are not like trust

funds set up for private beneficiaries; they were set up primarily to facilitate the flow of money from taxes to benefits.) At the start, there was only one trust fund—for old-age and survivors benefits. But as new programs were added, trust funds for disability insurance, hospital insurance (Medicare), and supplementary medical insurance were established.

Portions of the total payroll tax collected are allocated to each of these trust funds. Each fund has in it only enough reserves to smooth out the fluctuations in tax collections and benefit payments. In the past, such reserves have been set at a level equal to one year's benefits, but in recent years, the reserves have been less than that.

Social Security planners understood from the start that the system might eventually become too expensive to be financed solely by a payroll tax. President Roosevelt's Committee on Economic Security, which drafted the guidelines for the system, thought that the tax would eventually become too burdensome for employees. The committee recommended that general tax revenues be used when the benefits paid out exceeded the income from payroll taxes plus the interest on the small reserve funds. That was expected to occur around 1965, when the combined tax paid by employers and employees reached 5 percent.

The combined tax rate for employers and employees actually reached 5 percent in 1959. But despite the expectation of the system's planners, general revenues have not been used to finance Social Security benefits, except in the most minor way. And the tax burden has continued to increase—it now totals 13.3 percent—as disability and health programs were added, and as more people received benefits.

Insulation from politics

The payroll tax was linked to a fundamental concept of the system—that benefits are earned as a matter of right. If employees paid into the system during their working years, they were entitled to receive benefits at retirement. Unlike other social-welfare programs, there was to be no "means" test—that is, people would receive benefits regardless of what other money they had. By collecting a payroll tax, the Government was obligated to maintain a system that would assure employees of the benefits they had been promised.

Roosevelt recognized the importance of the link between the payroll tax and the right to a benefit. "Those taxes were never a problem of economics," he said later. "They are politics all the way through. We put those payroll contributions there so as to give the contributors a legal, moral, and political right to collect their pensions. With those taxes in there, no damn politician can ever scrap my Social Security program."

Once it was established that people were entitled to their benefits, the system was insulated from political attacks. In fact, it became so well insulated that needed changes have been difficult to make.

The link between the payroll tax and the right to a benefit underlies the current debate over changes in the system.

Those who say that the payroll tax should be the only source of financing, the position maintained by the business community, argue that the linkage holds benefits in check. If the tax increases too much, they contend, people will refuse to pay it. "The payroll tax is a marvelous discipline," says Harrison Givens, senior vice president of the Equitable Life Assurance Society and a director of an industry pension committee. "Once you dip into general revenues, you can promise the moon." The business community believes that using general revenues makes it too easy to hide the pain of paying for the program—and too easy to increase benefits by adding to business or personal income taxes.

Others use the linkage to argue against any cuts in benefits. Because receiving benefits is an earned right and since employees have paid for the benefits through the payroll tax, the argument goes, the benefits can never be cut, or at least not cut very much.

In addition to shielding the system from political attacks, the tax-benefit link has also protected politicians from the ire of their constituents when payroll taxes are raised to pay for increased benefits. People have always been willing to pay the increased taxes—they could readily see that they would receive something for their money.

Earlier this year, when the Reagan Administration proposed severe reductions in some Social Security benefits, it learned how deeply rooted the notion of earned right has become: The proposals met with almost universal disapproval.

Selling the system

In 1935, the idea of accepting support from the Government was an anathema to most people. The payroll tax was a useful device to establish the system's respectability. The tax was highly visible, coming out of each person's paycheck every week. If people could see the connection between their weekly payment and the benefits they would eventually receive, they would, in effect, believe they were paying for the benefits. The idea of earning your own benefits fitted well with the American ethic of hard work and individual responsibility.

In 1939, after the program had been declared constitutional, planners began likening it to an insurance program. The word "insurance" gave the system an aura of respectability that made the program easier to accept. Everyone understood insurance. Insurance premiums were paid in advance to finance emergencies, such as fire losses and hospital bills, that people might ordinarily have trouble paying for out of current income. Social Security seemed similar: Money was paid in advance to insure against the loss of income in old age and, when disability protection was added, the loss of income due to disability.

Government officials used insurance terminology to explain the program. Officials told workers they were making "contributions" or "paying premiums," not paying taxes. The word "contribution" has stuck: To this day, many people incorrectly think of the Social Security payment not as a tax to pay benefits to others but rather as a "contribution" to pay for their own benefits. Officials even spoke of "old-age accounts in Baltimore."

But Social Security is not really like many common types of insurance. With fire insurance, for example, most people never collect; they simply share the risk with those who do. But with Social Security, at least to date, most beneficiaries have received benefits that will total more than they've paid in taxes. The package of benefits available under Social Security—pensions, support for survivors, Medicare, and disability payments—cannot be purchased for the same amount of money in the private insurance market.

The early Social Security recipients received extraordinarily high returns compared to their payments. The first beneficiary, Ida Fuller, paid about $22 in Social Security taxes but lived to the age of 99, long enough to collect about $20,000 in benefits, though her benefits averaged only about $48 a month.

Although Ida Fuller is an extreme example, most other recipients have also received far more than they've paid in. Future beneficiaries, however, are unlikely to fare that well. Social Security actuaries figure that people starting in the work force today and living a normal lifespan will eventually receive, as a group, about 15 percent more in benefits than they and their employers will have paid in taxes.

A delicate balance

Another major question facing the planners of the Social Security System was whether to base benefits on the needs of the recipients or on the amount of "contributions" actually made by them to the system. As it now operates, the system strikes a balance between the recipients' needs and contributions.

Benefits based on needs. The benefit formula is progressive, giving low-paid

employees a greater percentage of their preretirement income than it gives high-paid employees.

For example, employees retiring at age 65 in 1981 who have earned the Federal minimum wage each year they worked will receive 68.6 percent of their preretirement income. The percentage drops to 54.2 for a person who has earned the average wage each year and to 33.4 for a person who has earned at least the taxable wage base each year ($29,700, this year). These percentages received, called replacement rates, are already scheduled to be reduced gradually over the next few years, as we discuss later.

The concept of payment according to need is embedded in other features:

- Employees with dependents get extra benefits. A retiree with a retirement-age spouse or a dependent child can receive an extra benefit equal to one-half of the basic benefit. If an employee dies, certain surviving relatives receive benefits.
- A "special minimum benefit" is given to about 100,000 retirees who have worked 30 to 40 years in jobs covered by Social Security but earned very low wages. Their benefit is greater than it would be under the standard benefit formula.
- A "minimum benefit," currently $122 per month, has been paid to everyone eligible for benefits. That benefit, originally $10, was introduced in 1939 partly to provide benefits to older workers who had not paid enough in taxes to qualify for benefits. Today, about 70 percent of the recipients are elderly women.
- An "earnings test" reduces or eliminates Social Security benefits for those retirees who earn income in addition to Social Security. Retirees between the ages of 65 and 70 in 1982 can have an earned income of no more than $6000 a year. (Investment earnings, rental income, and pensions are excluded.) If a person's earnings exceed this amount, $1 in benefits is withheld for each $2 earned over $6000.

Benefits based on contributions. Even though the benefit formula is weighted to give low-paid employees a greater percentage of their preretirement income, the formula still preserves the principle of basing benefits on contributions. The benefits employees receive are related to the taxes they've paid. An employee who has paid the maximum in Social Security taxes will receive a larger benefit than one who has paid lower taxes. Thus, though payments to low-paid employees represent a greater percentage of preretirement income than do payments to highly paid employees, those payments come to fewer actual dollars.

For example, though a low-income 65-year-old who retired in early 1981 will receive 68.6 percent of his or her preretirement income, the annual benefit amounts to only $4422. Those who have earned average wages will receive $6816 (a 54.2 percent replacement rate), and high-income retirees will receive $8660 (a 33.4 percent replacement rate).

The notion of relating benefits to wages was an important selling point for the system, ensuring public acceptance.

One measure of success

Social Security was designed to provide retirees with a "floor of protection," in the words of one planner. It was a basic benefit to be supplemented by other income. Traditionally, retirement income has been considered a "three-legged stool." Social Security is one leg; company pensions and personal savings are the other two. But pensions and personal savings have never become important sources of retirement income. "Social Security had to take on the job of doing the whole thing for low wage earners," says Robert Ball, a former Social Security Commissioner. "For employees who earn average or below-average wages, Social Security is likely to be the only source of income." Two-thirds of elderly households rely on Social Security for at least half of their income. "Social Security is our most successful anti-poverty program," says Ball. "It keeps 14 to 15 million people out of poverty."

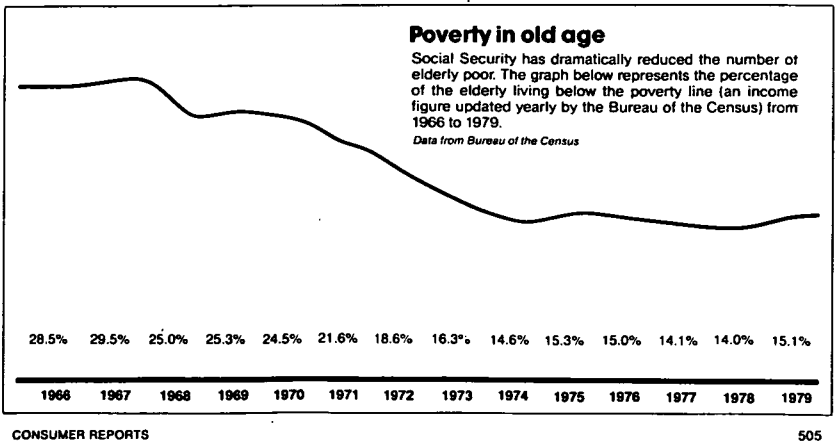
Indeed, poverty rates among the elderly dropped dramatically as Social Security benefits were increased. In 1959, 35 percent of the people age 65 and older subsisted on incomes below the poverty line. By 1969, that figure had fallen to 25.3 percent; by 1979, it was only 15.1 percent (see graph below).

The system's success was achieved through a gradual expansion of benefits.

Growth and change

When Social Security was established, it was designed to pay benefits only to retired employees. In 1939, the system was expanded—benefits were also to be paid to dependents of retirees and to survivors of deceased employees.

At first, only employees in commerce and industry were covered. But as the years went by, more and more groups were taken into the system. By 1958, when coverage was extended to lawyers, dentists, optometrists, and veterinarians, Social Security was nearly universal. Only Federal employees, some other



government employees, and some employees of nonprofit organizations remained outside the system, as they still do today.

Other changes also expanded coverage and increased benefits:

- The retirement age was lowered for women in 1956, for men in 1961. Beneficiaries could now retire at age 62, though with reduced benefits.
- Benefits for disabled employees were authorized in 1956; for their dependents, in 1958. Over the years, eligibility requirements for disability benefits were loosened.
- Medical insurance coverage for the aged (Medicare) was added in 1965. In 1972, Medicare became available to people under 65 who had been disabled for at least two years.
- Basic retirement and survivors benefits were increased. Congress increased benefits substantially in the early 1970's as inflation became worse. Then, in 1975, cost-of-living adjustments began to be made regularly.

1972—a turning point

With each increase in benefits, Congress usually adjusted the Social Security tax rates or the wage base to ensure that enough money would be collected to pay for the higher benefits. Until 1972, Congress had calculated benefits on the assumption that wages would not rise. But of course they did. The rising wages generated more tax revenues than the amount needed to pay for the benefits. That, in effect, created "surpluses," which made it easier to increase the benefits next time around.

But in 1972, Congress made two basic changes that eventually wiped out the surpluses. First, Congress tied benefit increases to the Consumer Price Index (CPI). Whenever the CPI rose, benefits would rise automatically. Second, to help pay for those increasing benefits, Congress tied the wage base on which taxes are levied to a wage index that was also expected to rise. As average wages increased, a larger proportion of the total payroll would be subject to Social Security taxes, thus generating the money to pay for the increasing benefits.

These changes seemed logical at the time; they were based on assumptions about wages and prices that had proved reliable in the past. From 1950 to 1972, the rate of increase for both wages and prices was fairly low: Wages increased 4.7 percent annually and prices about 2.5 percent. If prices and wages followed their historical pattern, rising wages would generate enough additional tax revenues to pay for automatically rising benefits.

However, in its effort to help the elderly, whose purchasing power was being eroded by inflation, Congress had made the system heavily dependent on the economy's performance—and the economy's performance changed.

Shortly after the 1972 amendments were passed, the historical relationship between prices and wages was broken. Prices sometimes rose faster than wages. The result was that the benefits, which are based on prices, outstripped the tax payments, which are based on wages.

At the same time, it became apparent that the 1972 amendments had introduced a flaw into the calculation of a retiree's basic benefit. The technicalities of the matter are not important, but one result was that, under some conditions, Social Security would replace an increasingly larger percentage of preretirement income. It would have been difficult, if not impossible, for working people to pay the high taxes needed to support such benefits.

In 1977, Congress corrected this flaw by changing the way benefits are to be computed. At the same time, it decided to decrease the benefits in gradual steps. The changes will affect people reaching age 65 in 1982 or later. By 1986, when the rates stabilize, Social Security will replace about 55 percent of preretirement earnings for low-income earners (as compared with 68.6 percent today); about 42 percent for those earning average wages (as compared with 54.2 percent today); and about 25 percent for high-income employees (as compared with 33.4 percent today).

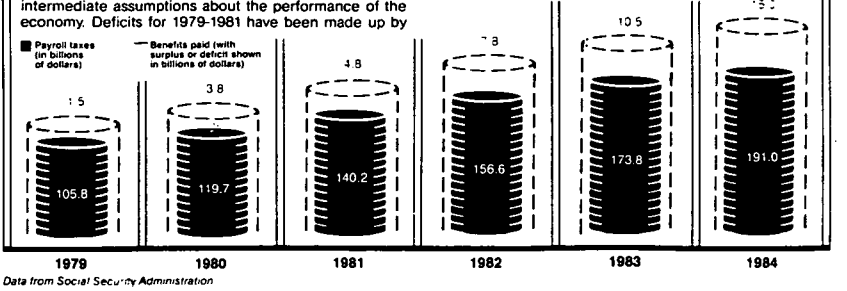
Congress substantially increased the Social Security tax at the same time, partly to compensate for the flaw that caused temporary high benefits and partly to pay for the cost-of-living adjustments that were becoming more expensive as the inflation rate increased. The changes raise the tax rates for both employers and employees from 6.65 percent in 1981 to 7.05 percent in 1985 and to 7.65 percent in 1990 and after. The wage base will rise with increases in future average wages—from $29,700 this year to an estimated $43,500 in 1985 and to $66,900 in 1990.

The short-term problem

The tax increases enacted by Congress in 1977 were expected to make the system financially secure until after the turn of the century. But they were made on the same assumption as in 1972—that wages would increase faster than prices. That assumption again proved wrong. In 1979, prices rose 2.7 percent more than wages; in 1980, they rose 5.9 percent more. By the middle of this year, they were running about 2 percent ahead.

The short-term problem

Unless some changes are made, there will be a cash shortage in the Social Security System by the fall of 1982. The chart below shows the income and outgo for the Old Age and Survivors and Disability Funds (taken together) for the years 1979 to 1990. Projections beyond 1981 are based on intermediate assumptions about the performance of the economy. Deficits for 1979-1981 have been made up by small reserves in the funds, but these will be exhausted by the fall of next year. Note, however, that even without changes, the shortage will resolve itself by the end of the decade, when there will be fewer retirees due to a lower birth rate during the Depression.



Data from Social Security Administration

Since wages are not rising as fast as prices, the taxes collected are insufficient to pay for the rapidly increasing benefits. (See illustration below.) As a result, some of the limited reserves in the Old Age and Survivors Trust Fund have been used to pay benefits, and the reserves are running low. If more money isn't added by the fall of 1982, there could be a shortage. Since, by law, there can be no deficit financing of the Social Security System, some benefits would not be paid.

No one seriously expects Social Security checks to stop. One way or another, Congress will resolve the short-term problem, which is essentially a shortage of actual cash to pay benefits. Nor will the shortage bankrupt the system, as many exaggerated press stories have predicted. "This is a peculiar economic period, not an imbalance in the system," says Alicia Munnell, a vice president of the Federal Reserve Bank of Boston. "Most forecasts show a normal relationship between wages and prices will return."

When this relationship does return (and assuming the cash shortage is resolved), the system will, in fact, be in good financial shape until after the turn of the century. That's because of vagaries in the birth rate. Since the birth rate was low during the Depression, the number retiring in the late 1990's and in the early years of the next century will be low in relation to the number paying taxes. "The 1990's will be a beautiful period as far as financing the system goes," says Robert Myers, Deputy Social Security Commissioner.

The long-term problem

A far more significant problem could appear around 2010, when the so-called baby-boom generation begins to retire. By 2020, 15.5 percent of the population will be over 65, compared with 11 percent today. If the present low birth rates continue, as is generally expected, the ratio of employees who contribute to the system and retirees who take benefits out will change. (See illustration, page 509.)

There are now three working people providing tax revenue for each retiree. By 2015, there will be two-and-a-half working people per retiree, and in 2025, there will only be two workers for each retiree. (Under more pessimistic assumptions, there could be even fewer than two.) As the number of employees available to support one retiree drops, each employee will obviously have to pay higher Social Security taxes.

Under all but the most optimistic assumptions about economic and demographic trends, the currently scheduled payroll tax rates will be too low to pay the present level of benefits to people retiring around 2010, according to studies made by the trustees of the Social Security System.

The first move

Even before Congress could seriously consider the financial problems of Social Security itself, the Reagan Administration moved to reduce or eliminate certain benefits. As part of its omnibus budget-cutting bill, which was approved by Congress in June, it eliminated the $122 minimum benefit—the benefit that goes largely to elderly women who'd held very low-paying jobs. Thus, the first Social Security "reform" has taken money from some of the poorest people, those who have been relying most on it.

The Administration argued that the benefit is a drain on the system because it is also paid to some Government employees who receive civil-service pensions but have also worked long enough in nongovernment jobs to qualify for minimum Social Security benefits. Actually, figures from the Social Security Administration submitted to Congress show that only about 12 percent of the 3.1 million recipients of the minimum benefit fall into this category. Most of those who get the minimum benefit are women over age 65, the group of retirees that has the lowest income.

The Administration claims that those who are "truly needy" will not suffer; other Government programs, such as Supplemental Security Income (SSI), can take care of them, it is asserted. (SSI is a welfare program providing support for the very poor.)

In fact, many of those who have been receiving the minimum Social Security benefit will not qualify for SSI because of the stringent eligibility requirements. That welfare program, for example, makes no payment at all to a person with as little as $1500 in the bank, even if that person has no income. The Administration has made no move to ease SSI's major restrictions. Nor has it budgeted with the assumption that these needy people will receive welfare payments to make up for the loss of Social Security benefits.

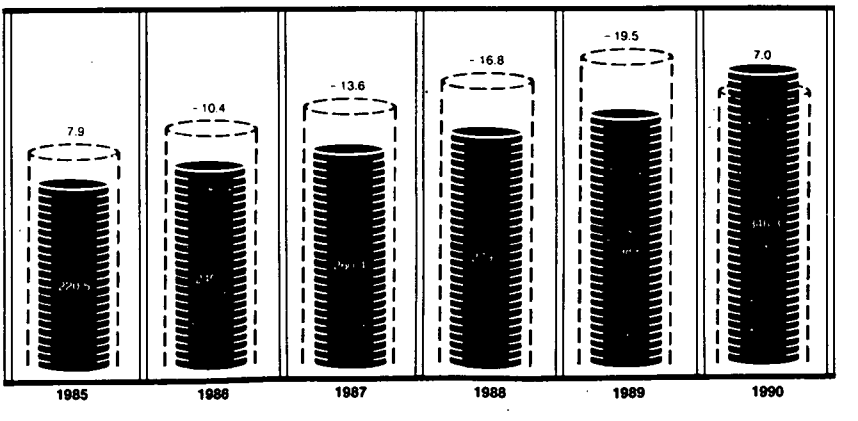
It would have been far better to eliminate the minimum benefit for new recipients than to take it away from those already receiving it.

(As this issue went to press, the Democrats were trying to restore the minimum benefit by including it in their version of a Social Security bill.)

Proposed solutions

Congress is now considering a variety of proposals to deal with both the short-term and long-term financial problems.

Raising the payroll tax again is, of



course, one possibility. Polls show that most people would rather pay higher taxes than accept reduced benefits. One poll done for the National Commission on Social Security (Congress's own study group) found that 63 percent of the people surveyed favored raising the tax rather than cutting benefits; only one in four thought that the current tax is too high.

"People don't mind the tax as much as they fear the uncertainty," says Representative J.J. Pickle (D., Tex.), chairman of the House Subcommittee on Social Security. Pickle said that most complaints about high Social Security taxes have come from employers, not employees. But, he noted, "We did not want to increase the tax and wage base this year. We didn't think it was feasible."

That's not to say that the Social Security tax can't or won't be raised in the future. For now, however, almost all of the proposals to solve both the short- and long-term problems call for other measures. Here are the specifics:

Using general revenues for Medicare. A variety of proposals, differing in their details, suggest financing all or part of Medicare with general tax revenues. In effect, such a move would fulfill the expectation of Social Security's original planners that general tax revenues would eventually be needed to help finance benefits. It would assure that the Old Age and Survivors program would be adequately financed through the 1980's.

Borrowing among the trust funds. At times, one or another of the trust funds may have more money in it than it needs to pay current benefits. That is the case right now with the disability trust fund. But, until recently, the law has prevented transferring funds from one trust fund to another. Last year, Congress authorized some temporary trust-fund borrowing. A bill introduced by Representative Pickle would allow such borrowing until 1990 if one of the funds falls below 20 percent of the estimated benefits it will have to pay for the year preceding the borrowing.

Reducing early-retirement benefits. The Reagan Administration wants to cut benefits drastically, starting next year, for people who take early retirement. Currently, the benefit for people retiring at age 62 is 20 percent less than the benefit they would receive at age 65. The Reagan Administration wants to make it 45 percent less. Since about two-thirds of retirees take early retirement, the Administration's proposal would probably solve the system's current cash shortage. However, if most future retirees, faced with drastically reduced benefits for early retirement, revised their plans and retired at age 65, there would be no appreciable reduction in their total benefits. If that were to happen, the change would achieve no substantial reduction in Social Security costs.

Representative Pickle's bill also reduces the early-retirement benefit. But, unlike the Reagan proposal, the reduced benefit is phased in over a number of years, and the reduction is less sharp. By the year 2000, people taking early retirement would receive 36 percent less than full benefits.

Raising the age of eligibility. Several proposals, including Representative Pickle's bill, suggest raising the eligibility age for full benefits to 68. Some also raise the age for reduced benefits to 65. The higher retirement ages would be phased in over a number of years, giving those affected a chance to plan. Such proposals aim at solving the long-term problem by reducing the total benefits paid, while adding more workers.

Delayed-retirement credits. Delayed-retirement credits encourage people to remain in the work force longer by giving them an additional benefit for each year they put off retirement. Beginning in 1982, under the current law, people can receive a 3 percent bonus for each year they work past the age of 65. The American Association of Retired Persons has proposed that this bonus be made 8 or 10 percent.

Changing the benefit formula. This proposal helps solve the long-term problem by simply reducing the benefits. The Reagan Administration has proposed lowering the automatic indexing in the benefit formula so that employees would receive a lower percentage of their preretirement income (see box on page 510). For example, under existing law, an average-wage employee retiring in 1986 and later will have roughly a 42 percent replacement rate. Under the Reagan proposal, the rate would drop to 38 percent.

"The present level of benefits is too high," says Robert Myers, Deputy Social Security Commissioner. "The Administration believes we should get back to the relative benefit levels of the 1960's."

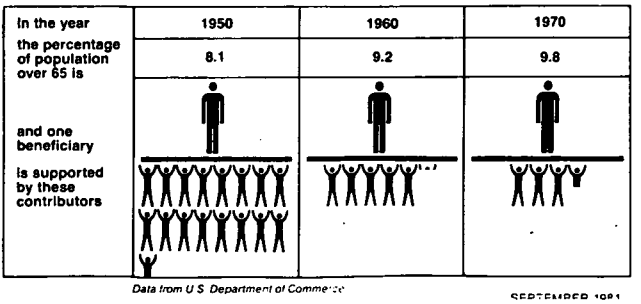
In 1965, however, Social Security replaced only about 31 percent of income for an employee earning average wages and 40 percent for one earning low wages. As a result, more than 25 percent of the people over age 65 lived in poverty, compared with about 15 percent today.

Other proposals would also lower the replacement rates by updating the benefit formula using a price index rather than a wage index (see box on page 510). According to Social Security Administration estimates, price-indexing would result in a sharp drop in replacement rates.

Changing the cost-of-living adjustments. Currently, benefits are increased annually, based on a rise in the Consumer Price Index. Because prices have risen more than wages in the last couple of years, some people argue that the elderly have been compensated for the effects of inflation more than employees have. The National Commission on Social Security has recommended limiting the automatic benefit increases if, over a two-year period, the CPI has risen more rapidly than wages. However, the commission proposal includes a catch-up provision for later years if wages rise faster than prices. Alternative proposals call for cost-of-living adjustments to be based on the lesser of the increase in wages or prices or for the construction of a special cost-of-living index that takes into account only the items in an older person's budget.

The long-term problem

As the number of contributing employees per Social Security beneficiary decreases, it will become difficult, if not impossible, for those working to contribute enough to provide the benefits as currently scheduled.



Data from U.S. Department of Commerce

Restricting the eligibility for disability benefits. The Reagan Administration has proposed applying stricter standards for disability benefits. The Administration wants to lengthen the waiting period for benefits from five to six months, lengthen the working-period minimum from five years (out of the last 10) to 7¼, require that a disability be expected to last at least two years instead of one, and use only medical factors in determining eligibility.

(At present, older employees can qualify for disability based on a combination of medical and nonmedical factors, such as age, education, and work experience. The requirements are actually quite stringent. Of those who apply, more than 70 percent are now refused, compared to 53 percent six years ago. Eighty percent of the applicants who are refused benefits never do work again.)

If fewer people are eligible for benefits, the system will save money in the long run, or so the theory goes. This proposal would not affect the immediate cash shortage, however, since the disability trust fund is not in trouble.

Covering Government employees under Social Security. Federal Government employees and about one-third of the state and local government employees still remain outside the Social Security System. They have their own civil-service retirement plans. Covering these employees would expand the wage base on which taxes are collected and add money to the system.

For 25 years, various Government study groups and commissions have recommended that such employees be covered by Social Security, but the employees and their unions have successfully lobbied against it. They fear that Social Security would yield them lower benefits. This year, as in the past, covering Government workers is not being seriously considered. "Politicians are afraid of the political consequences of all those postal workers voting against them in the next election," says Donald Grubbs, a pension expert with George B. Buck Consulting Actuaries in Washington.

Bringing Government employees into the system, coupled with raising the retirement age, would solve the long-term financing problems. Neither of those moves, however, is supported by the Administration.

CU's recommendations

The immediate cash shortage is serious, but the drastic cuts in early-retirement benefits proposed by the Reagan Administration are not necessary to correct the problem. The Administration appears to be using the shortage to scare the public (and Congress) into accepting its entire package of benefit cuts, which will cause serious hardships for many.

CU believes that the approach taken in Representative Pickle's bill—paying for half of Medicare with general revenues, coupled with interfund borrowing—will solve the immediate cash shortage.

Making the change in Medicare financing will not be easy, however. "I imagine the Administration will get every business group in the country to fight the use of general revenues," Pickle told CU.

Some people argue that using general revenues weakens the link between the payroll tax and the right to a benefit. That argument is only tenuous at best when it comes to Medicare, which is basically an insurance plan to cover medical expenses, not a pension plan to replace wages. Since Medicare benefits depend on medical needs, there's no direct linkage between a person's entitlement to benefits and the amount of wages he or she earns. Indeed, Medicare Part B, the voluntary insurance that covers physicians' fees, is already financed primarily with general revenues.

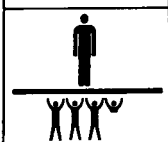
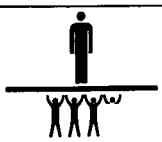
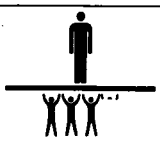
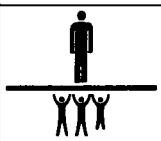
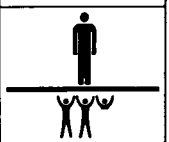
General revenues should be available, CU believes, whenever high unemployment causes a drop in the tax revenues needed to pay pension benefits. As a pay-as-you-go system indexed to wages and prices, Social Security is highly dependent on the performance of the economy. Money from the general fund should be borrowed to make up for fluctuations in revenue collections caused by adverse economic conditions. The founders of the system believed that general revenues would eventually be needed, and the Revenue Act of 1943 even contained an amendment authorizing the use of general revenues. (The amendment, never used, was repealed in 1950.) A similar amendment would be useful today. It would end the uncertainty and concern among Social Security recipients that occur each time tax collections run low.

The long-term problem of financing requires other measures. While some groups are overdramatizing the short-term problem, others are trying to minimize the more serious long-term problem. Nevertheless, immediate cuts in early-retirement benefits, such as those proposed by the Reagan Administration, are unjust and unacceptable, in CU's view. People have planned for their retirement based on benefits they've been promised. To reduce those benefits suddenly is tantamount to breaking a contract, and doing it in so short a time that people cannot easily find replacement funds.

The Administration's proposed cuts in early-retirement benefits coupled with cuts in the disability program will leave many people, particularly those with progressive degenerative diseases and those who are partially disabled, with few options. If they are disabled but can't qualify for disability benefits, they will be forced to take early retirement and live on very low benefits.

We also oppose any effort to solve the long-term problem by reducing the replacement rates, as proposed by the Reagan Administration. Lowering the rates would impose severe financial hardships on those who rely on Social Security as their only source of retirement income.

The President's Commission on Pension Policy, established during the Carter Administration, found that two economic classes exist among the elderly—those who rely solely on Social Security and have trouble getting by, and those who have pensions or private savings as well as Social Security and live more comfort-

1980	1990	2000	2010	2020
11.2	12.2	12.2	12.7	15.5
				

ably. (Only one-quarter of those receiving Social Security old-age benefits have private pensions.) Reducing benefits would simply result in raising the poverty rate, perhaps to the 20 and 30 percent levels common until the early 70's.

The best way to solve the long-term financing problem is to gradually raise the age at which people become eligible for benefits. The original planners of the system arbitrarily chose 65 as the retirement age, and it became embedded in the system. But people are living longer than they did in 1935.

The least painful way to raise the retirement age is to raise it gradually, beginning in 2000. The eligibility age for early retirement should be set at 65; the age for retirement with full benefits, 68. That would go a long way toward solving the long-term financing problem. And if people who will retire in, say, 20 or 25 years are told now that they may have to work a little longer before they receive Social Security benefits, they will be in a better position to plan for their future.

Raising the retirement age is not popular, and no one knows for sure whether the economic and demographic projections that seem to make it necessary will prove correct. But in CU's opinion, it's important to make the move now. If the projections turn out to be incorrect, it will be far easier to lower the eligibility age than to raise it.

Raising the retirement age does pose some serious problems that must soon be addressed. Some people will be unable to work until they are 65. Adequate disability benefits will be necessary to tide them over. The Reagan Administration proposals to restrict eligibility for disability benefits will simply drive such people onto the welfare rolls. A good disability program and a better SSI program are essential if the retirement age is raised.

For retirees, most of whom live on fixed incomes, the cost-of-living adjustment they receive each year is crucial. Basing the adjustment on the lesser of the increase in wages or prices (instead of simply on the CPI) would certainly hurt retirees. Nor does it seem to make sense to construct a special cost-of-living index just for retirees.

If any change is to be made, the recommendation of the National Commission on Social Security is the least harmful: Cost-of-living increases should be limited only if, over a two-year period, the CPI has risen more rapidly than wages. And a catch-up provision should allow retirees to recoup whatever they have lost, if wages eventually rise faster than prices.

CU also favors bringing all *new* Government employees into the Social Security System. Covering them would result in some long-term cost savings, but more important, it would eliminate costly duplication in pension benefits as well as eliminate benefit gaps that exist when a person moves from a job covered by Social Security to one that isn't covered.

Even when steps are taken to solve both the short- and long-term financial problems, there still remains the question of how to provide adequate retirement income for the half of the elderly population that does not now have it. "Those who get only Social Security aren't going to live very well," says Peter McColough, the chairman of Xerox Corp., who served as chairman of the President's Commission on Pension Policy. "It's unfair to have this dichotomy in our society. It's unjust. There's an enormous gap that has to be covered."

The role of the private-pension system in dealing with this problem is the subject of our final report in this series.

Computing Social Security benefits: The crucial points

There's nothing straightforward about how an individual's Social Security benefit is computed. Even minor adjustments to this highly technical computation can have a serious impact on the result. In the brief summary of the steps in that computation, below, we have outlined in color those points that would be affected by one or more of the proposed changes. (For a detailed discussion of the changes and their possible effects, see the accompanying text.) Here are the steps:

1. The number of years to be used in calculating the average of an employee's earnings is figured. An employee who had worked steadily and retired in 1981 at age 65 could use a maximum of 22 years of earnings in figuring the average. (The maximum will increase to 35 years, as the system matures.)

2. An employee's earnings for each year before age 60 are adjusted according to a wage-index factor. Earnings for the years after age 60 are not adjusted but taken in their actual amounts. The years with the highest earnings are selected to make up the number of years determined in Step 1.

3. The earnings in the qualifying years are averaged, then divided by 12 to establish an employee's "average indexed monthly earnings."

4. A "benefit formula" is applied to the average indexed monthly earnings to determine an employee's preliminary benefit. The benefit formula is weighted so that a low-wage earner will receive a greater percentage of preretirement income than a high-wage earner. For someone retiring this year, the formula is as follows: 90 percent of the first $211 of average indexed monthly earnings; 32 percent of the amount between $211 and $1274; and 15 percent of the amount above $1274. The figures of $211 and $1274 are called the "bend points." The bend points in the benefit formula are indexed to average wages for all employees. As those wages increase, the bend points increase.

5. If an employee retires early, at age 62, the early-retirement benefit will come to 80 percent of the preliminary benefit. If an employee works to age 65, the preliminary benefit will be increased by changes in the Consumer Price Index for each year after age 62. (For a person retiring in early 1981 at age 65, the benefit will have been increased by 6.5 percent for 1978, by 9.9 percent for 1979, and by 14.3 percent for 1980.) That is the final benefit—the amount a retiree will receive before possible benefits for dependents.

6. Each July after retirement, a retiree will receive a cost-of-living increase in the benefit based on the increase in the Consumer Price Index from the first quarter of the previous year to the first quarter of the current year. This past July, retirees received an 11.2 percent cost-of-living increase.

The Reagan Administration proposes, for a five-year period, to increase the bend points only half as fast as wages increase. This proposal would decrease benefits for those retiring from 1982 onward. For example, the estimated benefit for an employee who has earned average wages and who retired in early 1987 would be reduced from $736 to $677 per month.

Other proposals would index the bend points to prices, rather than to wages. That would result in higher benefits in the future if prices rise faster than wages, but would result in lower benefits if wages rise faster than prices, as they have in most past years.

The Reagan Administration wants to reduce the early-retirement benefit from 80 percent of the full benefit to 55 percent, effective in 1982. Such a change, if in effect for a person earning average wages and retiring in early 1982, would reduce the estimated early-retirement benefit from $377 to $259 per month. So drastic a cut with so little notice would hit hard at those who had planned an early retirement in just a few years—and still harder at those forced into early retirement by the loss of a job.

Many proposals would tie the cost-of-living increase to increases in the average wage rate, rather than the CPI, during years when wages rise more slowly than prices. The theory, apparently, is that when inflation has gotten so out of hand as to reduce the worker's standard of living, the retiree should suffer as well.

CHAPTER 18: PENSION COVERAGE IN THE UNITED STATES

Thomas C. Woodruff

Introduction

The President's Commission on Pension Policy has been charged with reviewing our nation's various retirement income systems in an effort to identify problems and to recommend solutions to the national policymakers.

During its two year life the Commission has undertaken a number of major research projects in an effort to document difficulties in the present system.

The Commission's final report indicated that expansion of pension plan participation was among its highest priorities. Commission research shows that eligibility for an employee pension, in addition to social security benefits, is often the difference between a marginal retirement income and an adequate standard of retirement living.

In addition, the Commission's final report expressed a desire to insure the actual delivery of pension benefits for workers who were pension plan participants through additional policy initiatives.

Anticipating a need to have the most current and comprehensive data available on pension plan coverage, the Commission initiated a major survey project in the fall of 1979.[1]

The Commission survey also found that even among full-time private sector workers aged 25 and over, pension benefit eligibility (vesting) was less than one-third of the total private work force.

In 1979 the Department of Labor and the Social Security Administration sponsored a pension coverage supplement to the current population survey conducted by the Bureau of the Census.[2] The survey questions were comparable to those asked in the Commission survey.

In almost all respects the composition of the samples used by DOL/SSA and the Commission's household survey were the same with respect to age, sex, and work force characteristics. In almost all categories, the surveys' findings were comparable.

Therefore, the data from the DOL/SSA and the Commission's survey, concerning pension plan coverage and eligibility are considered to be extremely reliable as measures of pension coverage in the United States.

Tabulations of the Commission survey and the DOL/SSA survey are included in this report.

Dr. Woodruff was Executive Director of the Commission Staff. *This paper was completed in April 1981.*

Pension Plan Coverage

It is important to carefully define terms used when determining pension plan coverage. The most frequently used definition of pension coverage means current participation in a pension or profit-sharing plan.

Using this definition, the Commission study found that 48 percent of all public and private sector workers are presently covered by some type of pension, profit-sharing or other retirement plan at their current job, as shown in Table 1.

Some suggest that it is more appropriate to describe pension coverage among those employees who currently meet plan participation standards set by the Employee Retirement Income Security Act (ERISA).[37]

For the group of public and private sector workers meeting these ERISA criteria, 62 percent are already covered by a plan, as shown in Table 1. It should be noted, however, that less than 60 percent of the public and private work force meets the ERISA, criteria of age, service and hours-of-work with their employer.

The incidence of pension plan coverage among private sector workers is less than that of the total work force, according to the Commission survey. Total private pension plan coverage is 42 percent, as shown in Table 2. For males, the figure is 51 percent. For female private sector workers, pension coverage is 32 percent, as shown in Table 2. For the portion of the private sector work force meeting ERISA minimum age, service and hours-of-work standards, coverage increases to 58 percent, as shown in Table 2.

The Commission's tabulations of the DOL/SSA survey in regard to pension plan coverage shows that income plays an important role.

Table 3 shows that pension coverage increases as income climbs.

Characteristics of Noncovered Workers

In 1979, over thirty-four and one-half million private sector workers were not covered by pension plans on their current jobs. It is generally recognized that younger, part-time, low-wage earners and workers employed by small businesses generally are not covered by pension plans. However, the data summarized in table 4 show that many of the noncovered are "mainstream," full-time workers, earning moderate incomes that place them in or near the middle of the earned income distribution.

Over half, 54 percent, of these noncovered workers are men, and 71 percent of the noncovered worked full-time. While most part-time workers are not covered by pension plans, part-time employment comprises a small part of the total job market. While pension coverage among young workers is very low, approximately 68 percent of the non covered population is over the age of 25.

Nearly all, 90 percent, of the noncovered are now union members.

Many noncovered workers are employed by small firms. Nearly 79 percent of the noncovered work in establishments employing fewer than 100 workers.

TABLE I

Pension Coverage Among Total Work Force

Age, Years on Job, Average Weekly Hours	Percent of All Workers[1]	Percentage Covered by Pensions		
		All Employees	Men	Women
Total	100%	48%	56%	39%
Under Age 25	24.2	29	34	23
Age 25 and Older	75.8	53	61	43
Less than one year on job	12.5	25	33	17
One or more years on job	63.3	61	68	51
-less than 1,000 hours/year	4.5	36	52	26
-1,000 hours/year or more	58.8	62	68	55

[1]These figures are based on an ICF analysis of May 1979 Current Population Survey data. Data in this table include private wage and salary workers and state and local government workers age 16 and over. This table does not include federal employees, the self-employed, unpaid family workers, or workers under the Railroad Retirement Board.

Source: Special Tabulations of Household Survey, President's Commission on Pension Policy, October 1980.

Fifty-six percent of all employed men and 39 percent of all employed women are covered by a pension plan, as shown in Table 1. Among workers under age 25, 29 percent of the total work force is covered. Table 1 shows that among workers age 25 and older, 53 percent of the work force is covered. Among workers approaching retirement, age 55-64, coverage increases to 57 percent.

Chart I shows that across all age groups females are less likely to be participants than male workers.

TABLE 2

PRIVATE PENSION PLAN COVERAGE

(active workers, both full-time, and part-time, excluding self-employed)

AGE, YEARS ON JOB, AVERAGE WEEKLY HOURS	PRESIDENT'S COMMISSION ON PENSION POLICY HOUSEHOLD SURVEY 1979			DOL/SSA CURRENT POPULATION SURVEY		
	PERCENTAGE					
	ALL EMPLOYEES	MALE	FEMALE	ALL EMPLOYEES	MALE	FEMALE
TOTAL	42	51	32	43	50	31
UNDER AGE 25	27	33	20	19	22	15
AGE 25 AND OVER	47	56	36	52	60	38
ERISA STANDARDS (more than 1 year of service + 1000 hours)	58	64	48	61	67	50

Source: President's Commission on Pension Policy

TABLE 3

The Percentage of Workers Covered By Pension Plans, 1979 by Income

Annual Earnings	Covered
Less than $5,000	12%
$5,000-7,500	31%
$7,500-10,000	45%
$10,000-12,500	55%
$12,500-15,000	63%
$15,000-20,0069%	
$20,000-25,000	73%
Greater than $75,000	73%
Total	48%

Source: Special Tabulations of DOL/SSA data.

TABLE 4

Which Workers Are Not Covered By Pension Plans?

In 1979, 49.4 million workers were not covered by a pension plan:

- 54% of these were men, 46% were women
- 71% of them worked full time, 29% part-time
- 68% were over age 25 and 51% of noncovered were over 25 and have one or more years of service with their employer
- 8.2 million are employed in the public sector
- 38.1 million are wage and salary workers in the private sector

Of private sector noncovered wage and salary workers:

- 77.9% worked in three main industries;
  - 31.9% from trade
  - 27.7% from service
  - 18.3% from manufacturing
- 29.9% earned less than $5,000 in 1978
- 36.4% earned between $5,000 and $10,000 in 1978
- 19.2% earned between $10,000 and $15,000 in 1978
- 14.6% earned over $15,000 in 1978
- 79.0% were in firms with fewer than 100 employees
- 7.5% were in firms with 500 or more employees
- Approximately 90% were not members of union

Source: ICF, Inc., Analysis of May, 1979 Current Population Survey Data; President's Commission on Pension Policy staff estimates. These numbers included imputed values.

Statistics show a large portion of the noncovered workers earn incomes that place them in or near the middle of the earned income distribution. Nearly thirty percent of the noncovered earned below $5,000 in 1978. Approximately 36 of the noncovered earned between $5,000 and $10,000, and 19 percent earned bewteen $10,000 and $20,000 in that year. Median earned income in 1978 was approximately $10,500 in the private sector work force.

Pension Plan Vesting

Even though a person may be a participant in a pension plan, he or she may not be actually entitled to receive a benefit upon retirement. Pension plans often require participants to be covered by the plan for a number of years before they are considered "vested", i.e. entitled to receive benefits.

The Commission survey found that of the total public and private working population over the age of 18, only 25 percent are vested in a pension plan provided by their current employment. This figure increases with each age cohort, equaling 32 percent for those 35 and older and 37 percent for those 55 and older.

Again, among the total work force, men are more likely to be vested than women. And, younger workers are less likely to be vested than older workers. (see Chart 1)

Twenty-three percent of all private sector workers are currently eligible for a pension with their current employers. Twenty-eight percent of all male workers in private industry and 17 percent of all female workers in the private sector are vested. Thirteen percent of all private sector workers under age 25 are vested. Among workers over 25 vesting increases to 26 percent. Among workers over 25 meeting ERISA standards, vesting is further increased to 30 percent. (see Chart 1)

Redefining Pension Coverage Data

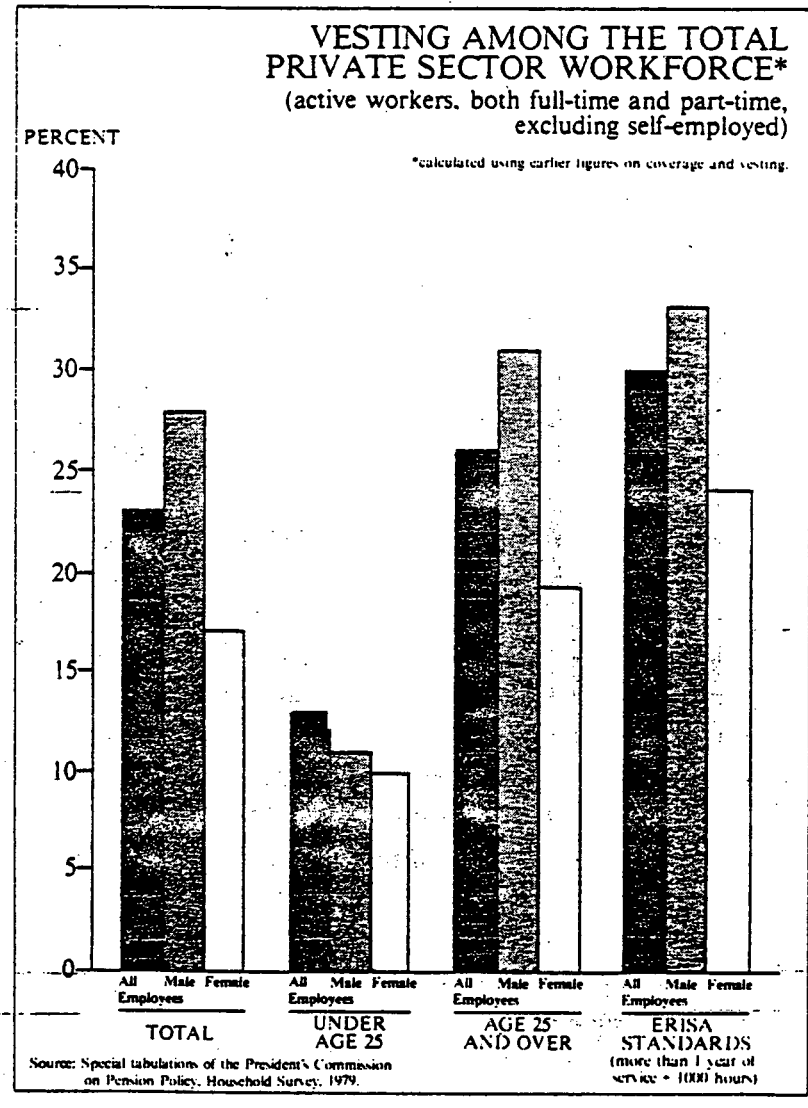
One of the problems with surveys such as those discussed in this report is that some people either do not know their pension participation status or they refuse to answer the questions when asked.

These "refusals" or "don't knows" are either included or excluded from the coverage statistics reported from the surveys. The Commission staff sought to rectify this problem by contracting with ICF Inc. to develop an imputation methodology for these missing values in the DOL/SSA 1979 Current Population Survey.

ICF employed standard regression techniques to assign survey nonrespondents to either the "participant" or"non-participant" categories. In general, this methodology increased the estimated figures only slightly. Thorough documentation of this procedure will be included in the Commission technical appendix to its final report.

The results of this effort are reported in Tables 5-28 of this report. In addition to including imputed values these tables show, for the first time in such surveys, pension plan participation by families as well as by individual worker.

CHART 1


VESTING AMONG THE TOTAL PRIVATE SECTOR WORKFORCE*
(active workers, both full-time and part-time, excluding self-employed)
*calculated using earlier figures on coverage and vesting.
PERCENT
40
35
30
25
20
15
10
5
0
All Employees
Male
Female
TOTAL
UNDER AGE 25
AGE 25 AND OVER
ERISA STANDARDS
(more than 1 year of service + 1000 hours)
Source: Special tabulations of the President's Commission on Pension Policy, Household Survey, 1979.

Tables 5-12 show participation, and vesting figures for all workers, by age, sex, industry, income hours worked and years of service.

With the imputations pension coverage for all workers over the age of 16 is 45 percent for the private sector and 48 percent for all workers. Pension plan participation increases to 54 percent for private sector workers ages 25-64.

Tables 7-9 show that pension participation is highly correlated with the income and sex of the worker.

Table 12 shows how pension coverage is also correlated to the size of the workplace. While pension coverage is very low for private sector workers employed by small establishments (24 percent are participants), about 78 percent of those employed at establishments with 50 or more workers are participants in plans.

Tables 13 and 14 show participation rates for so-called "full-time, full-year" workers. In this table, these workers are defined as those who usually work 35 or more hours per week and 48 or more weeks per year. These figures show that 54 percent of all private sector full-time, full-year workers are participants in pension plans and 59 percent of these public and private workers are participants in plans. Table 14 shows that 31 percent of private sector full-time full-year workers are vested in their plan.

Tables 15-20 show estimates of pension coverage and vesting by marital status. As Table 15 illustrates, married couples tend to have higher pension coverage than non-married individuals. However, among only 29 percent of married two-worker couples do both workers have pension coverage; 23 percent of the two-workers couples have one worker as a participant. In all, 52 percent of all (privately and publicly employed) couples have some form of pension coverage. Only 36 percent of non-married individuals are participants in a plan.

Vesting also varies by marital status. Only 14 percent of two-worker married couples have both workers vested in a plan, while 19 percent have one worker vested. Overall, 26 percent of married couples have some (one or two workers) vested entitlement, while only 19 percent of all non-married individuals are vested.

Tables 21-26 illustrate in detail the characteristics of noncovered workers that were summarized in Table 1.

Myths About Pension Coverage

In the past two years several industry lobbying groupos have asserted, in testimony before the President's Commission on Pension Policy and elsewhere that the "correct" pension coverage figure to use is 70 percent of the workforce rather than the 45 percent to 60 percent figures contained in most of the Commission's written material. The fact is that there is no "correct number to use when discussing pension coverage. The appropriateness of the figures used depends on the issue being discussed.

The authors of the 70 percent coverage figures have chosen to select only a portion of the working population for their analysis. Generally, these authors use phrases such as "full-time workers over the age of 25 who could reasonably expect to receive a pension" or "full-time public and private sector workers who meet ERISA standards" to describe the populations.

The figures from the DOL/SSA survey (modified to include imputed values) indicate the following coverage figures for private sector workers between 25 and 64 years of age.

	Participation Rate
Private wage age salary workers age 25-64, excluding self-employed.	54%
Private self-employed workers age 25-64	15%
Total private wage and salary workers age 25-64	50%

If the group of private sector workers is limited to "full-time, full-year workers" (defined as those who usually work 35 or more hours per week and 48 or more weeks per year) the figures are as follows:

"Full-time Full-year Workers"	Participation Rate
Private wage and salary age 25-64, excluding self-employed	60%
Private self-employed workers age 25-64	22%
TOTAL	56%

The above figures are still significantly different than the sometimes quoted 70 percent number. Some trade groups, such as the Employee Benefits Research Institute (EBRI) and the ERISA Industry Committee (ERIC) sometimes exclude agricultural workers (even those who are full-time, full-year workers) from their analysis. While this exclusion of millions of agricultural wage and salary workers may be appropriate for an industry group concerned about how public policy affects non-agricultural businesses, it is inappropriate for policy discussions concerned with the welfare of the entire noncovered work population.

Forecasting Future Coverage

Snapshot surveys, while limited by themselves, can be used along with labor force and pension forecasting models to predict the likelihood of pension coverage and benefit receipt in the future.

The Commission/DOL forecasting models indicate that the proportion of the labor force covered and vested in employee pension plans is not expected to increase significantly under current policies. Preliminary forecasting results

predict an increase of less than three percentage points in the proportion of the labor force covered by employee pension plans and a growth of only two percentage points in the proportion of the labor force vested in employee pension plans by the year 1990.

This near stagnation of coverage and vesting growth--less than .3 percentage points and .2 percentage points annual growth respectively--is due to several factors. Pension plan growth is predicted in those industries, such as manufacturing and transportation, where coverage is already high, as shown in Table 5. Most economic forecasts, however, predict that these industries will have a declining share of the labor force in the future. Instead, low pension coverage industries, such as trade and services, are predicted to grow in the future.

Conclusion

A comparison of the coverage and vesting figures for the overall work force versus the private sector finds that private industry workers are less likely to be pension plan participants than are public sector workers. This is due to increased pension plan participation among government workers at the federal and the state/local levels.

The Commission's findings also illustrate that other "coverage" criteria, using alternative definitions, do not significantly increase private sector coverage figures.

The data illustrate the importance that the Commission has placed on extending pension coverage to more workers. With less than half of the private sector workforce covered by a pension plan through their current employer and less than a quarter of all private industry workers vested, the Commission has proposed the establishment of a mandatory pension plan for all workers.

(The survey questionnaires used to compile this survey can be found in Appendices D and E of this Volume.)

NOTES

1/ The President's Commission on Pension Policy, the Department of Labor, the Pension Benefit Guaranty Corporation, the Administration on Aging and the Social Security Administration sponsored a $1.2 million nationwide random survey and analysis of 6,100 households on retirement income issues. The first wave of the survey was conducted in October, 1979 by Market Facts, Inc. A follow-up survey on some questions with the same respondents was completed in October, 1980. Final survey analyses on the primary questions relating to the impact of social security, employer pensions and other forms of retirement income on personal savings behavior and capital formation was done by SRI International.

2/ "Survey of Pension Plan Coverage, 1979," DOL/SSA. This survey was based on a sampling of 27,253 workers, including 19,999 private sector employees aged 16 and over. A similar survey was sponsored by the two agencies in 1972.

3/ ERISA does not require private sector employers to provide pension protection to workers who are under age 25, who work less than 1000 hours a year and who have less than one year of service with their companies. For purposes of the Commission's data, meeting ERISA participation standards was defined as over age 25, with one or more years of service and more than 1,000 hours of work annually with the employer.

TABLE 5

THE PERCENTAGE OF ALL WORKERS PARTICIPATING IN PENSION PLANS, BY AGE GROUP AND INDUSTRY, 1979

Group of Workers	Age Group				
	20-64	25-64	35-64	45-64	16 and Over
Mining	72%	76%	84%	82%	71%
Construction	39%	45%	48%	49%	37%
Manufacturing	69%	73%	75%	77%	66%
Transportation	67%	70%	72%	72%	66%
Trade	36%	41%	42%	41%	30%
Finance	52%	57%	58%	56%	50%
Services	33%	36%	38%	38%	30%
Agriculture	17%	20%	23%	22%	14%
Subtotal Private, Wage and Salary	50%	54%	57%	58%	45%
State and Local Government	80%	83%	84%	83%	77%
Federal Government	89%	91%	94%	95%	87%
Subtotal Public, Wage and Salary	82%	85%	86%	86%	79%
Self Employed Workers	14%	15%	17%	20%	13%
Total	52%	56%	58%	58%	48%

Source: ICF analysis of May 1979 CPS data.

TABLE 6

THE PERCENTAGE OF ALL WORKERS VESTED IN PENSION PLANS, BY AGE GROUP AND INDUSTRY, 1979[1/]

Group of Workers	Age Group				
	20-64	25-64	35-64	45-64	16 and Over
Mining	42%	49%	63%	68%	40%
Construction	27%	33%	41%	44%	25%
Manufacturing	37%	42%	51%	58%	36%
Transportation	46%	50%	61%	67%	44%
Trade	21%	25%	31%	33%	17%
Finance	29%	34%	42%	46%	28%
Services	20%	24%	29%	31%	19%
Agriculture	13%	16%	19%	18%	10%
Subtotal Private, Wage and Salary	29%	34%	42%	46%	26%
State and Local Government	59%	62%	69%	72%	56%
Federal Government	75%	78%	85%	89%	73%
Subtotal Public, Wage and Salary	62%	65%	73%	76%	60%
Self Employed Workers	14%	15%	17%	20%	13%
Total	33%	38%	45%	48%	30%

Source: ICF analysis of May 1979 CPS data.

TABLE 7

THE PERCENTAGE OF ALL WORKERS PARTICIPATING IN PENSION PLANS, BY HOURLY WAGE CATEGORY AND INDUSTRY, 1979

Group of Workers	Hourly Wage Category			Total
	Less Than $4.00	$4.00-7.00	$7.01 or More	
Mining	34%	59%	82%	71%
Construction	13%	17%	62%	37%
Manufacturing	35%	65%	85%	66%
Transportation	30%	60%	78%	66%
Trade	13%	37%	61%	30%
Finance	32%	51%	64%	50%
Services	16%	34%	50%	30%
Agriculture	8%	18%	43%	14%
Subtotal Private, Wage and Salary	19%	47%	71%	45%
State and Local Government	52%	82%	93%	77%
Federal Government	49%	82%	96%	87%
Subtotal Public, Wage and Salary	52%	82%	93%	79%
Self Employed Workers	9%	13%	20%	13%
Total	22%	49%	72%	48%

Source: ICF analysis of May 1979 CPS data.

TABLE 8

THE PERCENTAGE OF ALL WORKERS PARTICIPATING IN PENSION PLANS, BY ANNUAL EARNINGS AND INDUSTRY, 1979

Group of Workers	Annual Earnings in 1978					
	Less Than $5,000	$5,000-$10,000	$10,001-$15,000	$15,001-$25,000	$25,000 Or More	
Mining	11%	58%	67%	79%	81%	
Construction	13%	17%	27%	57%	73%	
Manufacturing	20%	46%	70%	84%	87%	
Transportation	24%	45%	65%	78%	79%	
Trade	8%	24%	44%	58%	68%	
Finance	13%	44%	57%	61%	77%	
Services	8%	29%	41%	51%	60%	
Agriculture	5%	12%	28%	46%	23%	
Subtotal Private, Wage and Salary	10%	33%	55%	71%	76%	4
State and Local Government	36%	76%	91%	93%	96%	77%
Federal Government	32%	66%	89%	97%	98%	87%
Subtotal Public, Wage and Salary	35%	75%	90%	94%	97%	79%
Self Employed Workers	4%	12%	16%	21%	18%	13%
Total	13%	38%	59%	70%	73%	48%

Source: ICF analysis of May 1979 CPS data.

TABLE 9

THE PERCENTAGE OF ALL WORKERS PARTICIPATING IN PENSION PLANS BY SEX, AGE GROUP, AND ANNUAL EARNINGS, 1979

	Annual Earnings in 1978					
Sex and Age Group	Less Than $5,000	$5,000-$10,000	$10,001-$15,000	$15,001-$25,000	$25,000 Or More	Total
Male						
Less than 20	4%	13%	19%	37%	47%	8%
20-24	11%	25%	41%	58%	41%	34%
25-34	15%	39%	56%	69%	68%	57%
35-44	20%	37%	59%	73%	74%	63%
45-54	27%	41%	60%	72%	74%	63%
55-64	23%	42%	66%	74%	80%	63%
65 or More	12%	27%	39%	36%	53%	22%
Subtotal	11%	33%	55%	70%	72%	53%
Female						
Less than 20	2%	17%	31%	19%	NA	7%
20-24	9%	31%	49%	58%	49%	29%
25-34	13%	43%	66%	69%	76%	46%
35-44	19%	45%	71%	74%	84%	48%
45-54	21%	50%	72%	80%	93%	51%
55-64	21%	49%	70%	82%	67%	48%
65 or More	15%	31%	63%	45%	100%	23%
Subtotal	13%	41%	66%	73%	79%	41%
Total	13%	38%	59%	71%	73%	48%

Source: ICF analysis of May 1979 CPS data.

TABLE 10

THE PERCENTAGE OF ALL WORKERS PARTICIPATING IN PENSION PLANS, BY HOURS WORKED ANNUALLY AND INDUSTRY, 1979

Group of Workers	Hours Worked Annually: Less Than 500	500–999	1,000–1,499	1,500 or More	Total
Mining	26%	15%	52%	76%	72%
Construction	12%	17%	35%	39%	37%
Manufacturing	20%	20%	34%	68%	66%
Transportation	23%	38%	51%	68%	66%
Trade	7%	9%	12%	37%	30%
Finance	8%	12%	15%	54%	50%
Services	6%	7%	18%	38%	30%
Agriculture	0%	3%	2%	20%	14%
Subtotal Private, Wage and Salary	8%	10%	20%	52%	45%
State and Local	18%	36%	65%	87%	77%
Federal	18%	35%	54%	91%	87%
Subtotal Public, Wage and Salary	18%	36%	65%	88%	79%
Self Employed	1%	5%	9%	17%	14%
Total	8%	14%	27%	55%	48%

Source: ICF analysis of May 1979 CPS data.

TABLE 11

THE PERCENTAGE OF ALL WORKERS PARTICIPATING IN PENSION PLANS, BY YEARS OF SERVICE ON CURRENT JOB AND INDUSTRY, 1979

	Years of Service on Current Job						
Group of Workers	Less Than 1	1-2	3-5	6-10	11-15	16 or More	Total
Mining	43%	67%	76%	88%	89%	92%	72%
Construction	22%	36%	37%	47%	62%	66%	37%
Manufacturing	36%	51%	63%	78%	87%	90%	66%
Transportation	33%	50%	60%	79%	85%	84%	66%
Trade	12%	22%	37%	52%	56%	61%	30%
Finance	25%	37%	54%	69%	73%	76%	50%
Services	13%	23%	36%	46%	58%	54%	30%
Agriculture	6%	9%	11%	23%	30%	32%	14%
Subtotal Private, Wage and Salary	20%	33%	46%	63%	74%	77%	45%
State and Local	47%	65%	78%	90%	91%	95%	77%
Federal	48%	81%	83%	94%	98%	97%	87%
Subtotal Public, Wage and Salary	47%	68%	79%	91%	92%	96%	79%
Self Employed	4%	6%	12%	17%	21%	20%	14%
Total	22%	36%	49%	65%	73%	71%	48%

Source: ICF analysis of May 1979 CPS data.

TABLE 12

THE PERCENTAGE OF ALL WORKERS PARTICIPATING IN PENSION PLANS, BY SIZE OF ESTABLISEMENT AND INDUSTRY, 1979

Group of Workers	Size of Establishment: Less Than 25	25-99	100-499	500 or More	Not Asked	Total
Mining	48%	62%	81%	92%	NA	72%
Construction	29%	47%	62%	69%	NA	37%
Manufacturing	33%	48%	67%	85%	NA	66%
Transportation	46%	71%	72%	80%	NA	66%
Trade	20%	36%	49%	66%	NA	30%
Finance	34%	59%	64%	71%	NA	50%
Services	17%	32%	46%	57%	NA	30%
Agriculture	9%	28%	44%	45%	NA	14%
Subtotal Private, Wage and Salary	24%	44%	61%	78%	NA	45%
State and Local	69%	81%	81%	77%	NA	77%
Federal	69%	87%	93%	94%	NA	87%
Subtotal Public, Wage and Salary	69%	82%	83%	84%	NA	79%
Self Employed	NA	NA	NA	NA	14%	14%
Total	29%	53%	65%	79%	14%	48%

NA: Data not available.

Source: ICF analysis of May 1979 CPS data.

TABLE 13

THE PERCENTAGE OF ALL FULL TIME, FULL YEAR WORKERS PARTICIPATING IN PENSION PLANS, BY AGE GROUP AND INDUSTRY, 1979[1/]

Group of Workers	Age Group				
	20-64	25-64	35-64	45-64	16 and Over
Mining	75%	77%	87%	88%	75%
Construction	40%	47%	50%	50%	39%
Manufacturing	71%	75%	78%	80%	69%
Transportation	71%	74%	77%	79%	70%
Trade	41%	46%	47%	48%	39%
Finance	57%	62%	64%	62%	56%
Services	40%	44%	48%	50%	39%
Agriculture	23%	27%	29%	30%	20%
Subtotal Private, Wage and Salary	56%	60%	64%	65%	54%
State and Local Government	87%	88%	90%	89%	86%
Federal Government	93%	95%	97%	98%	93%
Subtotal Public, Wage and Salary	88%	90%	92%	91%	88%
Self Employed Workers	21%	22%	24%	22%	22%
Total	61%	66%	69%	70%	59%

1/ Full time, full year workers are those who usually work 35 or more hours per week and 48 or more weeks per year.

Source: ICF analysis of May 1979 CPS data.

TABLE 14

THE PERCENTAGE OF ALL FULL TIME, FULL YEAR WORKERS VESTED IN PENSION PLANS, BY AGE GROUP AND INDUSTRY, 1979[1/]

Group of Workers	Age Group				
	20-64	25-64	35-64	45-64	16 and Over
Mining	44%	51%	66%	72%	43%
Construction	29%	35%	44%	47%	28%
Manufacturing	39%	44%	54%	60%	38%
Transportation	49%	54%	66%	73%	49%
Trade	24%	28%	36%	38%	22%
Finance	32%	37%	47%	51%	31%
Services	25%	29%	37%	40%	24%
Agriculture	18%	23%	27%	27%	16%
Subtotal Private, Wage and Salary	33%	38%	47%	52%	31%
State and Local Government	63%	66%	74%	77%	62%
Federal Government	78%	81%	88%	92%	78%
Subtotal Public, Wage and Salary	67%	70%	78%	81%	66%
Self Employed Workers	21%	22%	24%	22%	22%
Total	38%	44%	53%	58%	37%

1/ Full time, full year workers are those who usually work 35 or more hours per week and 48 or more weeks per year.

Source: ICF analysis of May 1979 CPS data.

TABLE 15

THE PERCENTAGE OF INDIVIDUALS PARTICIPATING IN PENSION PLANS BY MARITAL STATUS, 1979

Marital Status	Percentage Participating in: No Plan	1 Plan	2 Plans	Total
Non-Married Individuals				
Male	65%	35%	NA	100%
Female	64%	36%	NA	100%
Subtotal	64%	36%	NA	100%
Married Couples				
2 Workers	49%	23%	29%	100%
1 Worker	47%	53%	NA	100%
Subtotal	48%	34%	18%	100%
All Individuals	54%	35%	12%	100%

Source: ICF analysis of May 1979 CPS data.

TABLE 16

THE PERCENTAGE OF INDIVIDUALS VESTED IN PENSION PLANS, BY MARITAL STATUS, 1979

Marital Status	Percentage Vested in: No Plan	1 Plan	2 Plans	Total
Non-Married Individuals				
Male	82%	18%	NA	100%
Female	79%	21%	NA	100%
Subtotal	81%	19%	NA	100%
Married Couples				
2 Workers	67%	19%	14%	100%
1 Worker	63%	37%	NA	100%
Subtotal	66%	26%	9%	100%
All Individuals	71%	23%	6%	100%

Source: ICF analysis of May 1979 CPS data.

TABLE 17

THE PERCENTAGE OF INDIVIDUALS PARTICIPATING IN PENSION PLANS, BY MARITAL STATUS AND AGE, 1979

Marital Status by Age of Primary Earner	Percentage Participating in: No Plan	1 Plan	2 Plans	Total
Non-Married Individuals				
Male				
Less than 25	81%	19%	NA	100%
25-34	51%	49%	NA	100%
35-44	42%	58%	NA	100%
45-54 More	39%	61%	NA	100%
55-64	41%	59%	NA	100%
65 or More	85%	15%	NA	100%
Subtotal	65%	35%	NA	100%
Female				
Less than 25	83%	17%	NA	100%
25-34	51%	49%	NA	100%
35-44	48%	52%	NA	100%
45-54	42%	58%	NA	100%
55-64	47%	53%	NA	100%
65 or More	75%	25%	NA	100%
Subtotal	64%	36%	NA	100%
Subtotal				
Less than 25	82%	18%	NA	100%
25-34	51%	49%	NA	100%
35-44	45%	55%	NA	100%
45-54	41%	59%	NA	100%
55-64	45%	55%	NA	100%
65 or More	78%	22%	NA	100%
Subtotal	64%	36%	NA	100%
Married Couples with One or More Earners				
Less than 25	64%	26%	10%	100%
25-34	46%	35%	19%	100%
35-44	44%	34%	22%	100%
45-54	45%	34%	21%	100%
55-64	46%	39%	15%	100%
65 or More	78%	16%	6%	100%
Subtotal	48%	34%	18%	100%

Source: ICF analysis of May 1979 CPS data.

TABLE 18

THE PERCENTAGE OF INDIVIDUALS VESTED IN PENSION PLANS, BY MARITAL STATUS AND AGE, 1979

Marital Status by Age of Primary Earner	Percentage Vested in: No Plan	1 Plan	2 Plans	Total
Non-Married Individuals				
Male				
Less than 25	95%	5%	NA	100%
25-34	78%	22%	NA	100%
35-44	59%	41%	NA	100%
45-54	50%	50%	NA	100%
55-64	50%	50%	NA	100%
65 or More	90%	10%	NA	100%
Subtotal	82%	18%	NA	100%
Female				
Less than 25	95%	5%	NA	100%
25-34	76%	24%	NA	100%
35-44	67%	33%	NA	100%
45-54	60%	40%	NA	100%
55-64	56%	44%	NA	100%
65 or More	78%	22%	NA	100%
Subtotal	79%	21%	NA	100%
Subtotal				
Less than 25	95%	5%	NA	100%
25-34	77%	23%	NA	100%
35-44	64%	37%	NA	100%
45-54	56%	44%	NA	100%
55-64	55%	46%	NA	100%
65 or More	81%	19%	NA	100%
Subtotal	81%	19%	NA	100%
Married with One or More Earners				
Less than 25	88%	9%	2%	100%
25-34	74%	20%	5%	100%
35-44	62%	28%	10%	100%
45-54	56%	31%	13%	100%
55-64	54%	35%	11%	100%
65 or More	80%	16%	4%	100%
Subtotal	66%	26%	9%	100%

Source: ICF analysis of May 1979 CPS data.

TABLE 19

THE PERCENTAGE OF INDIVIDUALS PARTICIPATING IN PENSION PLANS, BY MARITAL STATUS AND FAMILY INCOME, 1979

Family Income	Percentage Participating in: No Plan	1 Plan	2 Plans	Total
Non-Married Individuals				
Less than $5,000	82%	18%	NA	100%
$5,000-9,999	66%	34%	NA	100%
$10,000-14,999	54%	46%	NA	100%
$15,000-19,999	57%	43%	NA	100%
$20,000-24,999	61%	39%	NA	100%
$25,000 or More	69%	31%	NA	100%
Total	64%	36%	NA	100%
Married Couples with One or More Employed				
Less than $5,000	84%	14%	1%	100%
$5,000-9,999	73%	23%	2%	100%
$10,000-14,999	60%	33%	6%	100%
$15,000-19,999	46%	40%	10%	100%
$20,000-24,999	39%	38%	18%	100%
$25,000 or More	36%	33%	24%	100%
Total	48%	34%	14%	100%

Source: ICF analysis of May 1979 CPS data.

TABLE 20

THE PERCENTAGE OF INDIVIDUALS VESTED IN PENSION PLANS, BY MARITAL STATUS AND FAMILY INCOME, 1979

Family Income	Percentage Vested in: No Plan	1 Plan	2 Plans	Total
Non-Married Individuals				
Less than $5,000	92%	8%	NA	100%
$5,000-9,999	83%	17%	NA	100%
$10,000-14,999	74%	26%	NA	100%
$15,000-19,999	75%	25%	NA	100%
$20,000-24,999	78%	22%	NA	100%
$25,000 or More	84%	16%	NA	100%
Subtotal	81%	19%	NA	100%
Married Couples with One or More Employed				
Less than $5,000	93%	7%	0%	100%
$5,000-9,999	87%	12%	1%	100%
$10,000-14,999	78%	20%	3%	100%
$15,000-19,999	67%	28%	5%	100%
$20,000-24,999	60%	30%	10%	100%
$25,000 or More	53%	30%	17%	100%
Total	66%	26%	9%	100%

1/ Vested wage and salary workers are those who would receive some benefits from their pension or retirement plan if they left their employer. For the self employed, all workers currently contributing to a Keogh plan are considered to be vested.

Source: ICF analysis of May 1979 CPS data.

TABLE 21

CHARACTERISTICS OF NON-PARTICIPATING WORKERS
BY INDUSTRY, AGE, AND WORKFORCE STATUS, 1979
(As Percent of All Non-Participating Workers)

	Age and Workforce Status					
	Less Than Age 25		Age 25 or Older and:			
Group of Workers	Full-Time	Part-Time	Full-Time	Part-Time	Subtotal	Total
Mining	*	*	*	*	*	0.5%
Construction	1.8%	*	3.1%	*	3.5%	5.7%
Manufacturing	4.2%	0.6%	8.5%	0.8%	9.2%	14.1%
Transportation	0.7%	*	2.3%	*	2.5%	3.4%
Trade	5.7%	5.8%	9.4%	3.5%	13.1%	24.5%
Finance	1.3%	*	2.6%	0.7%	3.3%	4.8%
Services	3.5%	2.9%	9.6%	5.4%	15.1%	21.4%
Agriculture	0.8%	*	1.3%	*	1.6%	2.7%
Subtotal Private, Wage and Salary	18.1%	10.4%	37.1%	11.4%	48.6%	77.2%
State and Local Government	0.8%	1.1%	2.1%	1.7%	3.7%	5.6%
Federal Government	*	*	*	*	0.5%	0.8%
Subtotal Public, Wage and Salary	1.0%	1.2%	2.4%	1.8%	4.2%	6.4%
Self Employed Workers	0.7%	*	11.3%	4.1%	15.4%	16.5%
Total	19.8%	12.0%	50.9%	17.3%	68.2%	100.0%

* Indicates less than 0.5 percent.

Source: ICF analysis of May 1979 CPS data.

TABLE 22

CHARACTERISTICS OF NON-PARTICIPATING WORKERS
BY INDUSTRY, AGE, AND YEARS OF SERVICE ON CURRENT JOB, 1979
(As Percent of All Non-Participating Workers)

	Age and Years on Current Job					
	Less Than Age 25		Age 25 Or Older and:			
Group of Workers	Less Than One Year	One Or More Years	Less Than One Year	One Or More Years	Subtotal	Total
Mining	*	*	*	*	*	0.5%
Construction	1.3%	0.9%	1.1%	2.5%	3.5%	5.7%
Manufacturing	2.6%	2.2%	2.4%	6.9%	9.2%	14.1%
Transportation	*	*	0.6%	1.9%	2.5%	3.4%
Trade	6.8%	4.8%	3.5%	9.4%	13.1%	24.5%
Finance	0.7%	0.8%	1.0%	2.3%	3.3%	4.8%
Services	3.6%	2.8%	4.4%	10.6%	15.1%	21.4%
Agriculture	*	0.7%	*	1.2%	1.6%	2.7%
Subtotal Private, Wage and Salary	16.0%	12.6%	13.5%	35.1%	48.6%	77.2%
State and Local Government	1.1%	0.8%	1.1%	2.7%	3.7%	5.6%
Federal Government	*	*	*	*	0.5%	0.8%
Subtotal Public, Wage and Salary	1.2%	0.9%	1.2%	3.0%	4.2%	6.4%
Self Employed Workers	*	0.7%	2.0%	13.4%	15.4%	16.5%
Total	17.6%	14.2%	16.8%	51.5%	68.2%	100.0%

* Indicates less than 0.5 percent.

Source: ICF analysis of May 1979 CPS data.

TABLE 23

CHARACTERISTICS OF NON-PARTICIPATING WORKERS
BY INDUSTRY AND ESTABLISHMENT SIZE, 1979
(As Percent of Non-Participating Workers)

Group of Workers	Establishment Size (No. of Employees)				
	Less Than 25	25-99	100-499	500 Or More	Total
Mining	*	*	*	*	0.5%
Construction	4.4%	0.9%	*	*	5.7%
Manufacturing	3.4%	4.0%	4.3%	2.4%	14.1%
Transportation	1.5%	0.8%	0.8%	*	3.4%
Trade	15.7%	6.3%	2.2%	*	24.5%
Finance	3.0%	0.9%	0.5%	*	4.8%
Services	13.5%	3.5%	2.4%	2.0%	21.4%
Agriculture	2.2%	*	*	*	2.7%
Subtotal Private, Wage and Salary	43.9%	16.9%	10.6%	5.6%	77.2%
State and Local Government	2.1%	1.7%	1.0%	0.8%	5.6%
Federal Government	*	*	*	*	0.8%
Subtotal Public, Wage and Salary	2.6%	1.8%	1.1%	0.9%	6.4%
Self Employed Workers	NA	NA	NA	NA	16.5%
Total	46.5%	18.7%	11.7%	6.6%	100.0%

* Indicates less than 0.5 percent.

Source: ICF analysis of May 1979 CPS data.

TABLE 24

THE DISTRIBUTION OF NON-PARTICIPATING WORKERS
BY INDUSTRY AND HOURLY WAGE LEVEL, 1979

Group of Workers	Hourly Wage Level			
	$3.50 Or Less	$3.51-7.00	$7.01 Or More	Total
Mining	*	*	*	0.5%
Construction	0.7%	3.4%	1.6%	5.7%
Manufacturing	4.2%	7.5%	2.4%	14.1%
Transportation	0.7%	1.6%	1.2%	3.4%
Trade	13.3%	8.6%	2.6%	24.5%
Finance	1.3%	2.6%	1.0%	4.8%
Services	9.0%	9.1%	3.3%	21.4%
Agriculture	1.4%	1.1%	*	2.7%
Subtotal Private, Wage and Salary	30.7%	34.1%	12.3%	77.2%
State and Local Government	2.5%	2.4%	0.6%	5.6%
Federal Government	*	*	*	0.8%
Subtotal Public, Wage and Salary	2.8%	2.9%	0.8%	6.4%
Self Employed Workers	4.0%	8.7%	3.7%	16.5%
Total	37.5%	45.7%	16.8%	100.0%

* Indicates less than 0.5 percent.

Source: ICF analysis of May 1979 CPS data.

TABLE 25

THE DISTRIBUTION OF NON-PARTICIPATING WORKERS BY INDUSTRY AND ANNUAL EARNINGS, 1979

Group of Workers	Annual Earnings in 1978					
	Less Than $5,000	$5,000-$10,000	$10,001-$15,000	$15,001-$25,000	$25,000 Or More	Total
Mining	*	*	*	*	*	0.5
Construction	0.8%	1.8%	1.7%	1.2%	*	5.7%
Manufacturing	1.7%	6.4%	3.7%	1.9%	*	14.1%
Transportation	0.5%	1.0%	0.9%	0.9%	*	3.4%
Trade	9.9%	8.6%	3.4%	2.1%	0.5%	24.5%
Finance	0.9%	2.0%	1.1%	0.7%	*	4.8%
Services	8.1%	7.3%	3.4%	1.9%	0.7%	21.4%
Agriculture	1.1%	1.0%	*	*	*	2.7%
Subtotal Private, Wage and Salary	23.1%	28.1%	14.7%	9.0%	2.3%	77.2%
State and Local Government	2.8%	1.7%	0.7%	*	*	5.6%
Federal Government	*	*	*	*	*	0.8%
Subtotal Public, Wage and Salary	3.1%	2.0%	0.8%	*	*	6.4%
Self Employed Workers	4.2%	4.1%	3.2%	3.6%	1.4%	16.5%
Total	30.3%	34.2%	18.7%	13.0%	3.8%	100.0%

* Indicates less than 0.5 percent.

Source: ICP analysis of May 1979 CPS data.

TABLE 26

THE DISTRIBUTION OF NON-PARTICIPATING WORKERS
BY AGE GROUP, SEX, AND ANNUAL EARNINGS, 1979

Sex and Age Group	Annual Earnings in 1978					
	Less Than $5,000	$5,000-$10,000	$10,001-$15,000	$15,001-$25,000	$25,000 Or More	Total
Men						
16-19	4.5%	2.0%	0.5%	*	*	7.1%
20-24	1.8	4.0	2.8	1.0	*	9.7
25-34	1.2	3.2	4.0	3.7	0.9	13.0
35-44	0.5	1.7	2.4	2.7	1.1	8.4
45-54	0.5	1.8	2.0	2.4	1.0	7.7
55-64	0.9	1.6	1.4	1.3	0.4	5.7
65 Or More	1.5	0.6	*	*	*	2.7
Subtotal	10.9%	14.9%	13.4%	11.4%	3.6%	54.3%
Women						
16-19	4.5%	1.6%	*	*	*	6.2%
20-24	2.9%	4.7	1.0	*	*	8.7
25-34	3.6	4.9	1.8	0.6	*	10.9
35-44	2.9	3.5	1.0	*	*	7.8
45-54	2.4	2.6	0.8	*	*	6.0
55-64	2.0	1.7	0.6	*	*	4.5
65 Or More	1.3	*	*	*	*	1.6
Subtotal	19.6%	19.2%	5.4%	1.5%	*	45.7%
Men and Women						
16-19	9.0%	3.6%	0.6%	*	*	13.3%
20-24	4.7	8.7	3.8	1.2	*	18.4
25-34	4.8	8.1	5.8	4.3	0.9	23.9
35-44	3.4	5.2	3.4	3.0	1.1	16.2
45-54	2.9	4.4	2.8	2.6	1.0	13.7
55-64	2.9	3.3	2.0	1.4	0.5	10.2
65 or More	2.8	0.8	*	*	*	4.3
Total	30.5%	34.1%	18.8%	12.9%	3.7%	100.0%

* Indicates less than 0.5 percent.

Source: ICF analysis of May 1979 CPS data.

CHAPTER 37: DEVELOPMENT OF A DEMOGRAPHIC MACROECONOMIC MODEL OF THE U.S. ECONOMY

Thomas C. Woodruff

Introduction

The President's Commission on Pension Policy has developed an economic growth model that integrates the retirement income system in the United States with the macroeconomy. The model was developed by ICF Incorporated under contract to the Commission. Begun in March 1980, the model and studies for the Commission will be completed in May 1981.* A federal interagency group was created through a memorandum of understanding and cooperation in which the participating agencies agreed to undertake cooperative efforts to assist in the development of the macroeconomic and demographic growth model and to share pertinent data and analyses regarding the model. The following agencies signed the memorandum: the Department of Health and Human Services, (National Institute on Aging, and the Office of Planning and Evaluation), the Office of Management and Budget, the Department of Housing and Urban Development (Office of Policy Development and Research), and the Department of Labor (Pension and Welfare Benefit Programs).

The goals of this undertaking are consistent with the Commission's mandate under Executive Orders 12100 and 12071. First, studies were conducted concerning the present financial ability of private, federal, state and local government retirement, survivor, and disability systems to meet their future obligations.

* The National Institute on Aging (N.I.A.) joined with the Commission to fund the model development and will receive all contract deliverables and maintain the model after the Commission completes its work.

Second, research was done on the relationships among the retirement income system, private capital formation, and economic growth. Third, some of the implications for the economy of policies recommended by the Commission were examined. This paper reports on the findings of the third area of inquiry: the effects of the Commission's retirement income policies on the economy.

The Need for a Comprehensive Model

No comprehensive model that depicts interactions between retirement programs and the economy or population existed. Naturally, the economy and population affect retirement income programs. For example, the larger proportion of aged individuals in our population projected for the future will create pressures to allocate proportionately more of our total income to this group through social security or private pensions. However, retirement income programs may alter individual behavior and cause effects on the economy or population. For example, the social security retirement test affects labor supply and the level of national income. The lack of feedback from the retirement income system into the economy represents a major gap in model development for policy analysis purposes.

Dr. Woodruff was Executive Director of the Commission. This paper was completed in April 1981.

The New Model's Theoretical Foundations

The theoretical framework of the model is the neoclassical theory of economic growth. This theory provides an analysis of determinants of long-run productivity and economic growth. It explains the determination of investment, consumption, and output; aggregate relative factor shares (labor and capital); substitution between factors; and productivity change. A central role is given to the theory of production and capital. Under the theory of production, outputs are related to inputs in the mathematical expression of a "production function." Capital is viewed as a homogeneous, aggregate factor that depreciates and is replaced and accumulated through investment. Prices and quantities of outputs and factor inputs are determined through the interaction of supply and demand in competitive markets. This theory predicts that the lower the rate of interest, others things equal, the greater the capital intensity of production and the greater the net national product per worker. Thus, policies which change savings and the interest rate have direct effects on the net national product per worker. Also, policies which affect supplies of labor and capital have direct effects on economic growth.

Use of a long-term model is entirely appropriate for analysis of the interaction of the retirement income system and the economy. Social security and other pension systems represent long-term commitments, and the level of benefits depends fundamentally on the productive performance of the nation's economy. Short-run, Keynesian type models are less appropriate because of their focus on the determinants of aggregate demand given a fixed capital stock, rather than the long-run determinants of the nation's income and wealth.

The Components of the Comprehensive Model

The comprehensive model of the retirement income system and the economy developed by ICF Incorporated integrates the Hudson-Jorgenson Macroeconomic Growth Model and the Anderson Labor Market Model and models of each of the major components of the retirement income system. The following is a list of all models included in the comprehensive model:

1. Hudson-Jorgenson Macroeconomic Growth Model
2. Anderson Labor Market Model
3. ICF Population Model
4. Private Employee Pension Model
5. Public Employee Pension Model
6. Social Security Model
7. Supplemental Security Income Model
8. Medicare Model

The integration of these models into one comprehensive model represents a significant and new achievement in the development of macroeconomic models of the U.S. economy. The administrative coordination of the participating agencies ensures wide dissemination of this model throughout the federal government and to the public.

Hudson-Jorgenson Macroeconomic Growth Model

This model is a neoclassical model of the U.S. economy. It depicts household behavior in formulating spending and work plans and producer behavior in formulating production, investment, and employment plans. The model assumes that the forces of demand and supply determine prices, quantities, wages, and interest

rates. The model permits the investigation of the determinants of long-term growth, savings and investment, labor and capital supplies, and productivity.

The Hudson-Jorgenson Macroeconomic Growth Model has four sectors. Producer and household sector behavior is modeled endogenously, and government and foreign sector behavior is given outside the model. The interaction of producer and household behavior determines the quantities and prices of the inputs and outputs. There are two output goods, consumption and investment, and two productive factors, capital and labor.

The model assumes that producers maximize profits or minimize costs subject to the available technology that is described by an aggregate cost function. Linking inputs to outputs, the aggregate cost function permits the demands for labor and capital and the supply of consumption and investment goods to be determined, given the prevailing prices that the producer faces. Furthermore, substitution between capital and labor and the level and change of economic productivity may be determined.

The household maximizes its welfare over time subject to its available resources. The household chooses how to distribute its expected wealth over all years, and, for each year, chooses how much leisure and consumption goods and services it desires to consume. Thus, the household determines how much labor it will supply and how much consumption goods it will demand, given prevailing prices. Savings is the residual between current income and consumption and represents the net change in wealth.

The government sector demands goods and labor services, and government enterprises supply some goods and services. All of these are determined outside the model. The level of taxes and transfer payments are determined in the model, with tax rates given and tax bases modeled. In the foreign sector, net exports of consumption goods and services and of investments goods, purchases of labor services by the foreign sector, and net private claims on the rest of the world are given outside the model.

Over time, conditions of each market change in response to changing technology and availability of factor inputs. As market conditions change, the household sector alters its labor-leisure choice and its consumption and savings, while producers alter the mix of inputs and outputs. Investment and capital accumulation lead to change in the available supply of capital services; population growth and tastes alter labor supply; and production efficiency changes over time. These forces determine the nation's productive capacity. In order to represent the growth path of the economy, the market system is solved each year within the constraints of productive capacity and the behavioral characteristics of the producer, household, government, and foreign sectors. Economists call such a system a "dynamic, general equilibrium model" — dynamic because of the savings-investment mechanism, general because it deals with the whole economy, and equilibrium because all markets clear in each year.

Hudson and Jorgenson used statistical techniques to estimate the parameters of this model. They developed a simulation computer program to solve the simultaneous system of non-linear equations which result from such a dynamic, general equilibrium model.

Anderson Demographic Labor Market Model

In addition to the neoclassical determinants of economic growth, the model focuses on changes in population and labor market behavior and the implications for social security, the pension system, government transfer payments, and Medicare expenditures of these changes. In order to model this aspect of the economy, a population model and a demographically disaggregated labor market model are integrated with the macroeconomic model.

The demographically disaggregated labor market model depicts the demand for labor, the supply of labor, the simultaneous determination of labor and capital service factor inputs, compensation, and unemployment by age and sex. The producer sectors' demand for labor is modeled by disaggregating inputs into four factors--capital services, age 14-24 labor services, age 25-54 labor services, and age 55 and over labor services. The household sector's supply of labor is modeled for twenty age-sex groups. Labor supply in total manhours for each group is determined by population size, labor force participation, employment, and average annual hours-worked per person employed. The demand and the supply of labor are integrated and solved with the macroeconomic model.

Population Model

The composition and size of the U.S. population has important implications for the economy. A population model similar to that of the Census Bureau is incorporated into the macroeconomic model to project the population.

The population model projects the size and composition of population with a probability (Markov) structure. Assuming a fixed set of fertility rates, mortality rates, and number of immigrants, population is dynamically projected for each year by race, age, and sex. This population feeds into the macroeconomic model and labor market model, but there is no feedback from economic activity to the population model.

The user is able to vary the demographic parameters--cohort fertility rate, survival rates, and immigration. Starting with a base case population, e.g. a recent Census Bureau estimate, the implications of changing the demographic assumptions can be determined. Such flexibility is an important analytical tool in assessing how the retirement system will be affected by demographic factors.

Private Employee Pension Model

The model of the private pension system permits the study of interactions between economic and demographic changes and the pension system. Three categories of private pensions are modeled--defined benefit programs, defined contribution programs, and individual arrangements. The private pension model estimates the number of workers covered by private pension plans, the number of retired and separated vested participants, the average benefit per retiree, total benefits and contributions, and the level of assets for each category of pension program. The impact of the pension and social security system on the process of asset accumulation and savings, on labor force behavior, and on output is depicted.

Public Employee Pension Model

The retirement income programs for public employees include the federal civil service and military retirement programs, plus state and local government programs. The models of military and federal civilian programs take into account

the demographic composition of the armed services and the federal civilian work force. The state and local government retirement systems are modeled for general administrative workers, hazardous duty workers, state and local educators, taking into account the demographic characteristics of the different work forces. The public employee pension model predicts the number of participants and beneficiaries, average contribution rates, average benefit per retiree, and total benefits, contributions, and assets. This model permits investigation of changes in the level and demographic composition of public employment on the overall retirement income system.

Social Security Model

The model of the social security retirement and disability systems explores the relationship between changes in the U.S. age structure and economy and the financial flows of the system. The model incorporates not only direct age structure effects, but also changes in age group incomes and factor shares, savings, rates of return, and labor force participation and employment behavior that are affected by age structure and will influence the financial condition of the social security system. Given the forecast of future wages and incomes, the model determines the contribution and benefit bases and the total contributions and benefit payments corresponding to alternative statutory provisions. The model's capability to show the way these respond to alternative demographic scenarios is useful for analysis of the actuarial status of OASDI. The Social Security Model also permits investigation of the impact of social security on the economy, especially the implications for savings and the interaction between social security and employee pensions.

Supplemental Security Income Model

The retirement income system must take into account the Supplemental Security Income (SSI) program designed to assist the low-income elderly population. This model projects the size of the low-income population at retirement ages and estimates the number of SSI beneficiaries. Determined by current statutes and forecast average wage and income levels, the model estimates average SSI benefit payments and total SSI benefit payments by age and sex. The SSI Model is integrated with the macroeconomic model and labor market model.

Medicare Model

The level of Medicare benefits is closely related to retirement income needs and is modeled to reflect demographic and economic factors. The medicare model includes information on average Medicare benefit payment by age-sex group for each of six services, total Medicare expenditures, and total health insurance tax collections. Thus, outlays and revenues can be compared over time in the context of the performance of the economy and demographic trends. There is no attempt to model the complete demand and supply of the health care industry.

Studies

The complete model has been used to study three areas of concern to the President's Commission on Pension Policy. First, pensions, savings, and investment have been studied. Second, the relationship of retirement income programs and labor force participation has been examined. Third, the impact of alternative pension policy proposals on the pension system and the economy has been simulated. The complete model will be a valuable tool for other agencies of the federal government to use in current and future research on the retirement income system.

The first study examines pensions, savings, and investment. The complete model depicts the feedback of the retirement income system on the aggregate economy, as well as the impact of the population and economy on the retirement system. Of particular importance to policy analysis is the question of how private pensions and social security affect savings and the growth of the economy. Given estimates of the effects of private pensions and social security on savings, the overall performance of the economy may be evaluated. The investment in the economy is disaggregated into three components: 1) additions to the productive capital stock; 2) purchases of housing; and 3) purchases of consumer durables. Finally, the effect of the changing age structure on savings is examined.

The second study examines the relationship of retirement income programs and the labor market. In this study, the labor market model plays an important role because the effect of national wealth is incorporated in the labor supply equations. In addition, social security and pension system variables in the labor force participation equations of younger and retired workers permit an assessment of their impact on labor force participation Employee compensation and unemployment is also studied.

The third study examines alternative pension policies and economic-demographic scenarios. As the age-sex structure of the population changes, it has an impact on the pension system. Also, policies to change vesting rules or expand coverage of private pensions and implement new retirement age and tax policies is examined.

Caution Concerning the Use of Economic Models

Any mathematical model of the economy by necessity attempts to simplify economic behavior into quantifiable relationships. This model is no exception. The building of such mathematical models is a process of blending economic theory with empirical research. The success of such efforts is often limited by the appropriateness of both.

Commission and ICF staff have attempted to incorporate the findings of Commission-sponsored research as well as other recent empirical studies into the model. As more empirical studies are completed, the model will hopefully be further improved under the guidance of staff at the National Institute on Aging.

This model should prove useful to policymakers in suggesting retirement policy that is consistent with other objectives of national economic policy. The specific numerical forecasts of the model, however, should be used with caution. The primary usefulness of a model such as this one is to predict the order of magnitude and direction of economic effects, not specific values. Too many uncertainties exist in the real world that render specific long-term forecasts unreliable.

In its use to date, however, this model has proved to be extremely useful. Some of the policy simulations have yielded findings that show that retirement income policy can have a much larger effect on the macroeconomy than many of us expected at the outset of the model-building effort. This suggests that further development of the model by the Federal government might be money well spent during the next several years as retirement income policy is debated.

Policy Simulations

With the model constructed, Commission and ICF staff performed a series of policy simulations to estimate the effect of the Commission's proposals on a number of economic variables. These variables were divided into three groups: macroeconomic variables, labor market variables, and pension and social security variables. The macroeconomic variables studied include savings, investment, consumption, and Gross National Product (GNP). Labor market variables included labor input (measured in total hours worked), total compensation, and unemployment. Pension and Social Security variables included participation, level of benefits, and pension contributions. A number of additional variables were estimated but are not discussed in the paper.

The Commission's final report, issued on February 26, 1981, contained over fifty proposals that would lead to a coordinated national retirement income policy. The Commission made proposals for national policy with regard to employee pensions, social security, savings for retirement, and employment of older workers.

The proposals that would have the most significant effect on the economy if enacted are retirement age policy, the establishment of a minimum universal pension system, and changes in the tax treatment of contributions to and benefits from retirement income programs. These three areas for policy simulations can be summarized as follows:

RETIREMENT AGES AND EMPLOYMENT-The Commission suggested that the age of eligiblity for benefits be raised for all retirement programs and that employment policy be changed to encourage and enable older workers to remain in the labor force. Specifically, the Commission's major recommendations were:

- The normal retirement age of 65 for social security should not be raised for working people who are now approaching retirement. However, an increase in the normal retirement age to 68 should be phased in over a 12-year period beginning in the year 1990. The social security early retirement age, now 62, should be raised to 65, in tandem with the changes in the normal retirement age. Disability benefits should be available through the normal retirement age.

- ERISA should be amended to permit private pension plans, on a voluntary basis, to increase their normal retirement age in tandem with social security.

- As in the private sector, public employee pension plans should increase their normal retirement age in tandem with social security. A retirement age policy that parallels that of social security is recommended for all federal retirement programs. Under this recommendation, the current social security normal retirement age of 65 would be phased in for new retirees. This age would increase in tandem with increases in the social security normal retirement age. Early retirement benefits would be actuarially reduced for new retirees.

- The social security earnings test should be removed. The earnings test limits should be phased out as the Commission's proposal concerning the exclusion of social security contributions and inclusion of benefits in taxable income is phased in.

- Information on alternative work patterns should be encouraged and developed through research and demonstration programs in existing federal employment programs. Job retraining and job redesign for older workers in private industry also should be encouraged.

For purposes of the model, the net effect of all of these policies was assumed to lead to a delay of retirement of three months a year for twelve years beginning in 1990 (when the increase in the age of eligibility for Social Security benefits begins). By the year 2002, all individuals in the labor force would retire three years later than they would have without the introduction of the retirement age and employment policies.

MINIMUM UNIVERSAL PENSION SYSTEM-The Commission recommended that a Minimum Universal Pension System (MUPS) be established for all workers. The system should be funded by employer contributions. The Commission further recommended that a 3 pecent of payroll contribution be established as a minimum benefit standard. All employees over the age of 25, with one year of service and 1,000 hours of employment with their employers, would be participants in the system. Vesting of benefits would be immediate.

To the macroeconomy, the MUPS proposal acts like a compulsory savings program. Contributions made by employers to funded employee pension plans serve to reduce consumption.

TAXATION OF RETIREMENT CONTRIBUTIONS AND BENEFITS-The Commission made a number of a proposals to provide greater tax incentives to encourage retirement savings and to make the tax treatment of retirement contributions and benefits more consistent. The major proposals were:

- Contributions to and benefits from social security should receive the same tax treatment as do those of other retirement programs. At the time of filing, the employee would choose the higher of a tax deduction or a tax credit for the social security employee contribution. Social security benefits would be included in taxable income. As this tax treatment is phased in, the social security earnings test should be phased out.

- Favorable tax treatment should be extended to employee contributions to pension plans. A refundable tax credit for low and moderate income people to encourage voluntary individual retirement savings and employee contributions to plans is recommended. At the time of tax filing, the employee would choose the higher of a tax deduction or a tax credit.

- Contributions and benefit limitations for all individuals should be treated more consistently for all types of retirement savings.

- The tax treatment of savings specifically for retirement should be the same as the tax treatment of pension plans.

- Employers would be eligible for a tax credit equal to 46 percent of their contribution to a qualified employee pension plan, up to a limit of 3 percent of payroll.

All of the above tax proposals would lead to a very large tax cut for individuals and businesses. In addition, the Commission recommended one tax increase: to move the scheduled January 1, 1985 social security payroll tax to January 1, 1982. The net effect of all of these proposals, if enacted, would be to reduce federal taxes to individuals and businesses by approximately $30 billion in 1982.

For purposes of the model, effective tax rates were changed such that federal tax collections were reduced by $30 billion in 1982 and corresponding amounts for years beyond 1982. Separate reductions and taxes on labor earnings and capital income were calculated based on estimates provided by the Department of the Treasury and the Commission, and implemented in the model. For all of the simulations, government spending was reduced by an amount equal to the tax reductions, so that the government deficit was not changed directly.

CHAPTER 38: FINDINGS ON THE IMPACT OF PENSION POLICY ON THE ECONOMY

Thomas C. Woodruff

Computer simulations using the demographic macroeconomic model of the U.S. economy were conducted testing each of the sets of proposals discussed in the previous chapters separately and all of them together. In its final report, the Commission indicated that the proposals should be considered as a package rather than separately, due to the interrelationships among them. In addition, many proposals were specifically tied to each other by the Commission. For example, introduction of the Minimum Universal Pension System (MUPS) was specifically linked to a number of the proposals.

The tables in this paper show the combined effects of all of the proposals. References will be made, however, to the individual simulations when they help explain the economic effects of the policy simulations more clearly.

Savings and Growth Effects

Tables 1-7 show the impact of the Commission's policies on savings, consumption, investment, Gross National Product, capital input, labor input and compensation.

Introducing a minimum universal pension system has the direct effect of reducing consumption and directing the reduction into retirement savings. The Commission's tax reductions, however, more than offset the decreased consumption. Therefore, the net effect is that total consumption increases slightly even with the compulsory savings program. The phase-in of the retirement age policy further increases total consumption. By the year 2000, consumption is up approximately 4%, by 2030 over 7%, and by 2055 over 10%.

In the early years (before 1990) savings increases largely due to the minimum universal pension system. Savings increases by nearly 20 billion dollars in 1985 and 26 billion dollars in 1990 (all values are in 1981 dollars). While this represents a large increase in individual and family savings, it represents a relatively small increase in total savings in the economy.

Increased savings also makes more capital available for investment purposes. In the early years investment increases 2-3% due to the proposals. The effect of the total program is cumulative, however, so that investment continues to increase--by over 10% by the end of the forecasting period.

The Hudson-Jorgenson-Anderson (H-J-A) model is a neoclassical general equilibrium model. Therefore, when savings and investment capital are increased, interest rates (a measure of the cost of capital) tend to decline. While this effect is modest, it is also long-term.

Dr. Woodruff was Executive Director of the Commission. *This program was completed in April 1981.*

Both capital and labor inputs to the economy are increased by the proposals. This leads to a modest increase in GNP in the early years and cumulative increases in the later years. In the early years, the MUPS and tax proposals promote mild (less than 1%) increase in GNP. As the retirement age policies take effect after 1990, GNP increases considerably, due in large part to increased labor input in the economy.

By the year 2000, GNP is estimated to grow by an additional 2% due to Commission recommendations. In 2015 GNP is 5% greater, and in 2050 it is 8% greater in the simulation of the Commission's recommendations.

Labor Market Effects

Total hours of labor input into the economy are predicted to increase due to the Commission's proposals, particularly the three year increase in the retirement age.

Average compensation to workers also is predicted to increase significantly. By the year 2000, average annual compensation has increased about 2% due to the proposals. By 2020, this increase equals 4% and continues at approximately that level for the remainder of the forecast period.

In earlier Commission research, concern was expressed about potential increases in unemployment due to Commission recommendations. One set of concerns centered around the costs of the MUPS program to employers and employees. The economic literature indicates that, in general, increased labor costs are either directly passed on by the employer to workers in the form of smaller wage increases or to consumers in the form of higher prices or are absorbed by the employer, resulting in some degree of unemployment. This prediction would apply to increases in social security payroll taxes as well as increased payroll costs due to a MUPS or any other program.

The Commission, therefore, adopted a series of offsetting payroll-related tax reductions to individuals and businesses. In each year of the forecast period (1982-2055) these tax reductions exceed the increased payroll-related costs of a MUPS program. Therefore, employers and employees should be able to share the costs of the MUPS program without experiencing either an increase in after tax payroll costs or a reduction in take-home pay.

While the combined MUPS and tax proposals should not have a significant effect on total employment, the Commission's retirement age policy might. Raising retirement ages has the effect of increasing the labor supply of older workers. Unless the demand for the labor of older workers increases by a similar amount, either unemployment will result or the average wage of these workers will not increase as much as they would otherwise.

TABLE 1

GROSS PRIVATE SAVINGS*

	BASE CASE	POLICY SIMULATION	DIFFERENCE	PERCENT DIFFEREN
1970	502.0	502.0	0.0	0.0
1975	699.4	699.4	0.0	0.0
1980	605.1	605.1	0.0	0.0
1985	880.4	900.0	19.6	2.2
1990	1220.0	1246.2	26.2	2.1
1995	1549.5	1586.0	36.5	2.6
2000	1919.2	1965.7	46.6	2.4
2010	2420.4	2489.0	68.6	2.8
2020	2555.4	2654.9	99.5	3.9
2030	3074.0	3209.2	135.2	4.4
2040	4401.5	4577.4	175.9	4.0
2050	5951.6	6174.1	222.5	3.7

*Expressed in billions of 1981 dollars.

TABLE 2

CONSUMPTION *

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	1216.776	1216.776	0.0	0.0
1975	1462.235	1462.204	-0.031	-0.0
1980	1811.562	1811.509	-0.052	-0.0
1985	2134.549	2143.620	9.070	0.4
1990	2454.158	2473.219	19.061	0.8
1995	2692.306	2747.028	54.721	2.0
2000	2942.914	3044.546	101.633	3.5
2005	3244.484	3386.778	142.295	4.4
2010	3564.266	3752.958	188.692	5.3
2015	3927.199	4165.973	238.773	6.1
2020	4285.215	4576.004	290.789	6.8
2025	4632.848	4968.895	336.047	7.3
2030	4983.840	5345.293	361.453	7.3
2035	5338.250	5733.645	395.395	7.4
2040	5679.473	6142.727	463.254	8.2
2045	5976.848	6530.645	553.797	9.3
2050	6299.887	6936.176	636.289	10.1
2055	6648.184	7324.273	676.090	10.2

*Expressed in billions of 1981 dollars.

TABLE 3

INVESTMENT*

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	293.633	293.633	0.0	0.0
1975	361.391	361.380	-0.011	-0.0
1980	284.412	284.391	-0.021	-0.0
1985	456.630	467.414	10.784	2.4
1990	663.086	676.808	13.722	2.1
1995	842.212	868.466	26.255	3.1
2000	1026.437	1068.957	42.520	4.1
2005	1144.998	1201.413	56.416	4.9
2010	1190.867	1263.023	72.156	6.1
2015	1184.002	1273.342	89.340	7.5
2020	1202.344	1309.752	107.408	8.9
2025	1275.045	1398.668	123.622	9.7
2030	1409.760	1543.077	133.317	9.5
2035	1605.181	1752.562	147.381	9.2
2040	1777.497	1950.345	172.848	9.7
2045	1940.312	2147.014	206.702	10.7
2050	2093.799	2332.890	239.091	11.4
2055	2266.862	2525.832	258.969	11.4

*Expressed in billions of 1981 dollars.

TABLE 4

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	1985.428	1985.430	0.002	0.0
1975	2362.084	2362.042	-0.042	-0.0
1980	2660.486	2660.414	-0.072	-0.0
1985	3186.919	3194.014	7.095	0.2
1990	3787.295	3807.137	19.843	0.5
1995	4286.848	4354.691	67.844	1.6
2000	4817.250	4947.242	129.992	2.7
2005	5334.004	5517.609	183.605	3.4
2010	5810.426	6055.371	244.945	4.2
2015	6261.949	6573.422	311.473	5.0
2020	6742.418	7123.203	380.785	5.6
2025	7274.949	7716.410	441.461	6.1
2030	7882.891	8358.652	475.762	6.0
2035	8593.980	9116.934	522.953	6.1
2040	9286.266	9901.746	615.480	6.6
2045	9931.707	10670.809	739.102	7.4
2050	10612.273	11465.457	853.184	8.0
2055	11358.359	12270.418	912.059	8.0

*Expressed in billions of 1981 dollars.

CAPITAL INPUT * TABLE 5

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	800.895	800.895	0.0	0.0
1975	975.505	975.505	0.0	0.0
1980	1149.354	1149.354	0.0	0.0
1985	1290.423	1299.140	8.717	0.7
1990	1580.263	1596.823	16.560	1.0
1995	1959.813	1989.823	30.009	1.5
2000	2421.964	2477.100	55.137	2.3
2005	2948.470	3040.585	92.116	3.1
2010	3497.300	3634.671	137.371	3.9
2015	4057.840	4252.379	194.539	4.8
2020	4604.793	4867.660	262.867	5.7
2025	5190.383	5533.602	343.219	6.6
2030	5841.500	6266.344	424.844	7.3
2035	6646.602	7159.668	513.066	7.7
2040	7609.242	8220.340	611.098	8.0
2045	8723.707	9467.180	743.473	8.5
2050	9969.965	10882.231	912.316	9.2
2055	11320.363	12417.918	1097.555	9.7

*Expressed in billions of 1981 dollars.

TABLE 6

LABOR INPUT: TOTAL*

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	192.094	192.094	0.0	0.0
1975	211.599	211.599	0.0	0.0
1980	234.986	234.986	0.0	0.0
1985	252.588	252.680	0.093	0.0
1990	268.681	269.733	1.052	0.4
1995	275.370	280.128	4.758	1.7
2000	277.579	285.581	8.001	2.9
2005	275.095	284.297	9.202	3.3
2010	269.846	280.573	10.728	4.0
2015	264.599	276.677	12.078	4.6
2020	259.943	273.082	13.139	5.1
2025	256.105	269.903	13.797	5.4
2030	253.415	266.582	13.167	5.2
2035	251.183	264.091	12.908	5.1
2040	246.593	260.621	14.028	5.7
2045	239.442	255.067	15.625	6.5
2050	231.773	248.298	16.526	7.1
2055	225.078	240.905	15.827	7.0

*Expressed as millions of hours.

TABLE 7

AVERAGE ANNUAL COMPENSATION: TOTAL *

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	14233.625	14233.625	0.0	0.0
1975	14133.562	14133.562	0.0	0.0
1980	14144.891	14144.891	0.0	0.0
1985	14907.641	14934.074	26.434	0.2
1990	15534.457	15577.883	43.426	0.3
1995	16368.953	16565.305	196.352	1.2
2000	17252.539	17618.809	366.270	2.1
2005	18187.098	18685.531	498.434	2.7
2010	19329.336	19959.930	630.594	3.3
2015	20564.090	21317.402	753.312	3.7
2020	21864.922	22752.281	887.359	4.1
2025	23167.641	24094.648	927.008	4.0
2030	24525.113	25465.336	940.223	3.8
2035	26007.191	26945.527	938.336	3.6
2040	27572.344	28605.078	1032.734	3.7
2045	29175.254	30370.359	1195.105	4.1
2050	30797.047	32109.207	1312.160	4.3
2055	32458.484	33829.172	1370.687	4.2

*Expressed in billions of 1981 dollars.

In its final report, the Commission expressed concern about the employment problem of older workers due to its retirement age recommendations. In its final report the Commission stated:

> "In conjunction with its recommendation to raise the retirement age, the Commission recognizes the problem of long-term unemployment among older workers and the use of early retirement under social security to solve this problem. Rather than utilize the social security system, consideration should be given to improving unemployment benefits to provide both short-term income maintenance for these workers and to keep them in the labor force."

The Commission's concerns about employment conditions among older workers is born out by the model. While wages and unemployment of most age groups are generally unaffected, the model does show the effects of the increased supply of older workers. In the simulations for the report, age groups 55-64 and 65+ do experience a significant drop in average hourly wages relative to the base case. This drop increases significantly (from 8% to 13%) as the post-World War II baby boom enters the older age groups and delays its retirement beginning in the year 2000.

In the policy simulations for this paper, fertility rates were assumed to slowly increase to 2.1 children per female of child-bearing age by the year 2000. Currently, the fertility rate equals approximately 1.8. The potential older-worker labor supply problems cited above might be reduced or eliminated if fertility rates remain at current levels and the total labor force shrinks after the year 2000. Additional model simulations will test this sensitivity.

For all age groups, excess supply of labor does not appear to be a significant problem. Even with an increase in the fertility rate to 2.1 children/female by the year 2000, the labor force after year 2000 is not expected to grow. As the capital stock grows, therefore, labor will become relatively scarce. If the demand for the labor of older workers could be adjusted--through public and private policies--to look more like the demand for workers in general, then the labor supply problems raised by raising the retirement age would be alleviated. If not, then other measures, such as those suggested by the Commission regarding special unemployment benefits for older workers, may be necessary.

Pension and Social Security Effects

Introduction of a minimum universal pension system immediately increases the number of participants in the private pension system by about 50%. Female participants are increased by nearly 70% and male participants by approximately 40%. These increases remain throughout the forecasting period.

Even more significant than the increase in participants is the increase in new retirees who receive private pension benefits. Under current policy, approximately 60% of new private sector retirees may retire with a pension by the year 2000, and approximately 40% may not. If there is no change in the existing private pension system, in the year 2000 about 250,000 private sector workers may enter retirement without pensions. This number may increase to about 460,000 private sector retirees without pensions retiring in 2025. After the year 2000, the number of private sector retirees without pensions may increase from about 3.5 million people in the year 2000, to a peak of nearly 6 million pensionless retirees (out of a total of about 15 million private sector retirees) by the year 2030.

The introduction of a MUPS nearly eliminates the problem of private pension entitlement. Nearly 96% of those who would have retired without a pension retire with one under the Commission's proposals. The proportion of those entering retirement with a pension increases by nearly 50% by the year 2000. During this period, only about 2% of all private retirees enter retirement without a pension benefit under the Commission's program.

The reason for the sharp reduction in those without pensions is twofold. First, pensions are made available to all workers over the of age of 25, with more than a year of service with the employer and with more than 1,000 hours of work. Even with these eligibility standards, most workers eventually qualify for benefits. Second, forefeitures of benefits by workers in existing plans are reduced. Under current policy, a private sector worker may have to be employed for 10 years prior to vesting in a pension benefit. The MUPS proposal would make at least the minimum benefit vested immediately upon participation.

TABLE 8

AGGREGATE HOURLY WAGES (1981 $), AGES 55-64

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	9.317	9.317	0.0	0.0
1975	9.984	9.984	0.0	0.0
1980	10.588	10.588	0.0	0.0
1985	11.315	11.311	-0.004	-0.0
1990	12.251	12.179	-0.072	-0.6
1995	13.609	13.180	-0.429	-3.1
2000	14.672	13.854	-0.818	-5.6
2005	15.466	14.455	-1.012	-6.5
2010	16.401	15.202	-1.199	-7.3
2015	17.496	16.120	-1.376	-7.9
2020	18.925	17.309	-1.616	-8.5
2025	21.208	19.014	-2.194	-10.3
2030	23.651	21.102	-2.549	-10.8
2035	25.947	23.166	-2.781	-10.7
2040	27.680	24.727	-2.953	-10.7
2045	30.168	26.517	-3.651	-12.1
2050	33.620	29.153	-4.467	-13.3
2055	37.303	32.519	-4.784	-12.8

TABLE 9

AGGREGATE HOURLY WAGES (1981 $), AGES 65+

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	5.977	5.977	0.0	0.0
1975	6.387	6.387	0.0	0.0
1980	6.863	6.863	0.0	0.0
1985	7.274	7.265	-0.009	-0.1
1990	8.050	7.933	-0.117	-1.5
1995	9.072	8.347	-0.725	-8.0
2000	9.910	8.606	-1.305	-13.2
2005	10.680	9.261	-1.420	-13.3
2010	11.268	9.789	-1.478	-13.1
2015	12.263	10.563	-1.699	-13.9
2020	13.809	11.724	-2.084	-15.1
2025	15.474	13.084	-2.390	-15.4
2030	17.005	14.413	-2.592	-15.2
2035	18.170	15.417	-2.753	-15.1
2040	19.794	16.603	-3.191	-16.1
2045	21.991	18.289	-3.702	-16.8
2050	24.404	20.387	-4.018	-16.5
2055				

TABLE 10

AGGREGATE HOURLY WAGES (1981 $), AGES TOTAL

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	8.942	8.942	0.0	0.0
1975	9.179	9.179	0.0	0.0
1980	9.429	9.429	0.0	0.0
1985	9.914	9.920	0.006	0.1
1990	10.460	10.450	-0.009	-0.1
1995	11.201	11.139	-0.062	-0.6
2000	12.044	11.943	-0.100	-0.8
2005	12.984	12.876	-0.108	-0.8
2010	14.052	13.915	-0.138	-1.0
2015	15.172	15.004	-0.168	-1.1
2020	16.354	16.163	-0.191	-1.2
2025	17.602	17.394	-0.208	-1.2
2030	18.933	18.736	-0.196	-1.0
2035	20.396	20.192	-0.204	-1.0
2040	22.065	21.799	-0.266	-1.2
2045	23.951	23.606	-0.346	-1.4
2050	26.007	25.592	-0.415	-1.6
2055	28.218	27.782	-0.436	-1.5

Initially, the level of benefits under a MUPS program would be relatively small unless past service credits were granted by the system. For a number of years, therefore, the average benefit paid by private pension plans would actually decline. As the system matures, however, average pension benefits would begin to increase significantly. As the baby boom approaches retirement age in the year 2010, average benefits would have increased over 7%. During the peak baby boom retirement period (2020-2035) average benefits are predicted to be about 25% greater than they would be without the Commission's recommendations.

Total benefits paid by funded private pension plans increase dramatically. Private pension fund contributions increase by over 30% initially and steadily grow to an increase of over 60% by the end of the forecast period. The size of the increase is due to the MUPS as well as the extension of the working years and the growth of the economy as a whole.

As more contributions are made to private employee pension plans, fund balances continue to grow. By 1985 they would have increased by nearly $60 billion, an increase of over 3%. By the year 2000 private pension funds would have increased by an additional $300 billion, additional growth of about 11%. After that time, fund balances are predicted to increase an additional 13-15% for the duration of the forecast period. By the year 2040, Commission policies are predicted to add an additional $1 trillion to private pension fund accounts.

Total benefits paid by funded private pension plans increase modestly at first, but by the year 2000 have increased by 40%. The private pension payments increase as the baby boom retires, peaking at an increase of 83% in the year 2035.

TABLE 11

PRIVATE PENSION SYSTEM, PARTICIPANTS MALE TOTAL (MILLIONS)

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	20.200	20.200	0.0	0.0
1975	21.800	21.800	0.0	0.0
1980	24.000	24.000	0.0	0.0
1985	25.900	36.600	10.700	41.3
1990	27.100	38.300	11.200	41.3
1995	27.800	39.000	11.200	40.3
2000	28.200	39.300	11.100	39.4
2005	28.200	39.100	10.900	38.7
2010	28.100	38.900	10.800	38.4
2015	27.700	38.400	10.700	38.6
2020	27.300	37.800	10.500	38.5
2025	27.000	37.500	10.500	38.9
2030	27.000	37.500	10.500	38.9
2035	27.300	37.900	10.600	38.8
2040	27.300	38.000	10.700	39.2
2045	27.100	37.700	10.600	39.1
2050	26.800	37.300	10.700	39.9
2055	26.800	37.400	10.600	39.6

TABLE 12

PRIVATE PENSION SYSTEM, PARTICIPANTS FEMALE TOTAL (MILLIONS

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	7.800	7.800	0.0	0.0
1975	9.500	9.500	0.0	0.0
1980	11.200	11.200	0.0	0.0
1985	12.400	20.600	8.200	66.1
1990	14.400	24.200	9.800	68.1
1995	15.700	26.200	10.500	66.9
2000	16.300	27.100	10.800	66.3
2005	16.500	27.300	10.800	65.5
2010	16.500	27.200	10.700	64.8
2015	16.700	27.500	10.800	64.7
2020	16.900	27.900	11.000	65.1
2025	16.900	28.100	11.200	66.3
2030	16.800	28.000	11.200	66.7
2035	16.900	28.100	11.200	66.3
2040	16.900	28.300	11.400	67.5
2045	16.900	28.300	11.400	67.5
2050	16.800	28.200	11.400	67.9
2055	16.600	27.900	11.300	68.1

TABLE 13

PRIVATE PENSION SYSTEM, PARTICIPANTS TOTAL (MILLIONS)

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	28.000	28.000	0.0	0.0
1975	31.300	31.300	0.0	0.0
1980	35.200	35.200	0.0	0.0
1985	38.300	57.200	18.900	49.3
1990	41.600	62.400	20.800	50.0
1995	43.500	65.200	21.700	49.9
2000	44.600	66.500	21.900	49.1
2005	44.800	66.300	21.500	48.0
2010	44.600	66.100	21.500	48.2
2015	44.400	65.900	21.500	48.4
2020	44.100	65.700	21.600	49.0
2025	43.900	65.600	21.700	49.4
2030	43.900	65.500	21.600	49.2
2035	44.100	66.000	21.900	49.7
2040	44.200	66.300	22.100	50.0
2045	44.000	66.100	22.100	50.2
2050	43.600	65.600	22.000	50.5
2055	43.400	65.200	21.800	50.2

TABLE 14

PRIVATE PENSION SYSTEM, NEW RETIREES WITH PENSIONS (MILLIONS)

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	0.289	0.289	0.0	0.0
1975	0.323	0.323	0.0	0.0
1980	0.378	0.378	0.0	0.0
1985	0.418	0.672	0.254	60.8
1990	0.417	0.670	0.253	60.7
1995	0.400	0.633	0.233	58.3
2000	0.396	0.593	0.197	49.7
2005	0.461	0.628	0.167	36.2
2010	0.555	0.752	0.197	35.5
2015	0.639	0.960	0.321	50.2
2020	0.709	1.033	0.324	45.7
2025	0.719	1.117	0.398	55.4
2030	0.650	1.083	0.433	66.6
2035	0.610	0.969	0.359	58.9
2040	0.582	0.905	0.323	55.5
2045	0.658	0.934	0.276	41.9
2050	0.704	1.067	0.363	51.6
2055	0.696	1.093	0.397	57.0

TABLE 15

PRIVATE PENSION SYSTEM, NEW RETIREES WITHOUT PENSIONS (MILLIONS

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	0.185	0.185	0.0	0.0
1975	0.206	0.206	0.0	0.0
1980	0.242	0.242	0.0	0.0
1985	0.267	0.013	-0.254	-95.1
1990	0.267	0.013	-0.254	-95.1
1995	0.256	0.013	-0.243	-94.9
2000	0.253	0.012	-0.241	-95.3
2005	0.295	0.012	-0.283	-95.9
2010	0.355	0.015	-0.340	-95.8
2015	0.408	0.019	-0.389	-95.3
2020	0.453	0.021	-0.432	-95.4
2025	0.460	0.022	-0.438	-95.2
2030	0.416	0.022	-0.394	-94.7
2035	0.390	0.019	-0.371	-95.1
2040	0.372	0.018	-0.354	-95.2
2045	0.421	0.019	-0.402	-95.5
2050	0.450	0.021	-0.429	-95.3
2055	0.445	0.022	-0.423	-95.1

TABLE 16

PRIVATE PENSION SYSTEM, ALL RETIREES WITH PENSIONS (MILLIONS)

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	4.918	4.918	0.0	0.0
1975	4.867	4.867	0.0	0.0
1980	4.983	4.983	0.0	0.0
1985	5.009	5.964	0.955	19.1
1990	5.305	7.366	2.061	38.9
1995	5.483	8.338	2.855	52.1
2000	5.452	8.568	3.116	57.2
2005	5.534	8.113	2.579	46.6
2010	6.058	8.200	2.142	35.4
2015	7.028	9.197	2.169	30.9
2020	8.128	10.703	2.575	31.7
2025	9.038	12.216	3.178	35.2
2030	9.345	13.200	3.855	41.3
2035	9.085	13.155	4.070	44.8
2040	8.540	12.579	4.039	47.3
2045	8.301	11.867	3.566	43.0
2050	8.629	11.993	3.364	39.0
2055	9.049	12.634	3.585	39.6

TABLE 17

PRIVATE PENSION SYSTEM, ALL RETIREES WITHOUT PENSIONS (MILLIONS)

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	4.635	4.635	0.0	0.0
1975	4.114	4.114	0.0	0.0
1980	3.729	3.729	0.0	0.0
1985	3.332	2.164	-1.168	-35.1
1990	3.393	1.155	-2.238	-66.0
1995	3.507	0.495	-3.012	-85.9
2000	3.488	0.167	-3.321	-95.2
2005	3.540	0.158	-3.382	-95.5
2010	3.875	0.164	-3.711	-95.8
2015	4.495	0.187	-4.308	-95.8
2020	5.199	0.217	-4.982	-95.8
2025	5.780	0.247	-5.533	-95.7
2030	5.976	0.263	-5.713	-95.6
2035	5.810	0.259	-5.551	-95.5
2040	5.462	0.246	-5.216	-95.5
2045	5.309	0.233	-5.076	-95.6
2050	5.518	0.239	-5.279	-95.7
2055	5.787	0.253	-5.534	-95.6

TABLE 18

PRIVATE PENSION BENEFIT, AVERAGE BENEFIT (1981 DOLLARS)

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	1728.482	1728.482	0.0	0.0
1975	2159.947	2159.947	0.0	0.0
1980	2649.770	2649.770	0.0	0.0
1985	3173.652	2826.958	-346.693	-10.9
1990	3537.450	2948.338	-589.112	-16.7
1995	3794.709	3159.718	-634.990	-16.7
2000	4068.035	3613.650	-454.385	-11.2
2005	4364.750	4269.012	-95.738	-2.2
2010	4669.605	5012.109	342.504	7.3
2015	4948.859	5770.047	821.187	16.6
2020	5204.324	6410.645	1206.320	23.2
2025	5479.898	6884.230	1404.332	25.6
2030	5795.742	7353.285	1557.543	26.9
2035	6169.734	7795.852	1626.117	26.4
2040	6683.465	8186.156	1580.691	23.9
2045	7145.906	8614.371	1468.465	20.5
2050	7733.266	9180.508	1447.242	18.7
2055	8312.242	9789.746	1477.504	17.8

TABLE 19

PRIVATE PENSION BENEFIT, TOTAL BENEFITS (BILLIONS 1981 DOLLARS)

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	8.496	8.496	0.0	0.0
1975	10.516	10.516	0.0	0.0
1980	13.197	13.197	0.0	0.0
1985	15.897	16.860	0.963	6.1
1990	18.767	21.712	2.945	15.7
1995	20.806	26.356	5.551	26.7
2000	22.184	30.963	8.779	39.6
2005	24.148	34.645	10.497	43.5
2010	28.301	41.102	12.801	45.2
2015	34.777	53.072	18.295	52.6
2020	42.310	68.610	26.300	62.2
2025	49.522	84.091	34.569	69.8
2030	54.167	97.062	42.895	79.2
2035	56.055	102.556	46.501	83.0
2040	56.413	102.971	46.558	82.5
2045	59.321	102.235	42.914	72.3
2050	66.722	110.108	43.386	65.0
2055	75.218	123.683	48.465	64.4

TABLE 20

PRIVATE PENSION SYSTEM, TOTAL CONTRIBUTIONS (BILLIONS 1981 DOLLARS)

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	37.817	37.817	0.0	0.0
1975	39.969	39.969	0.0	0.0
1980	42.310	42.310	0.0	0.0
1985	45.539	60.303	14.764	32.4
1990	48.880	65.627	16.747	34.3
1995	52.316	71.536	19.220	36.7
2000	39.818	61.587	21.769	54.7
2005	42.990	66.816	23.827	55.4
2010	45.803	71.706	25.903	56.6
2015	48.050	75.992	27.942	58.2
2020	50.202	80.221	30.019	59.8
2025	52.449	84.431	31.983	61.0
2030	55.602	89.340	33.739	60.7
2035	59.472	95.306	35.834	60.3
2040	63.172	101.499	38.326	60.7
2045	66.250	107.371	41.121	62.1
2050	69.195	112.714	43.518	62.9
2055	72.782	118.227	45.444	62.4

TOTAL 21

PRIVATE PENSION SYSTEM, TOTAL FUND BALANCE (BILLIONS 1981 DOLLARS)

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	925.969	925.969	0.0	0.0
1975	1182.605	1182.605	0.0	0.0
1980	1465.729	1465.729	0.0	0.0
1985	1781.403	1838.610	57.207	3.2
1990	2133.722	2269.791	136.068	6.4
1995	2529.844	2753.383	223.539	8.8
2000	2912.900	3230.745	317.844	10.9
2005	3329.374	3751.436	422.062	12.7
2010	3790.518	4329.031	538.514	14.2
2015	4285.437	4943.215	657.777	15.3
2020	4808.316	5570.426	762.109	15.8
2025	5360.160	6206.023	845.863	15.8
2030	5955.844	6859.383	903.539	15.2
2035	6621.023	7567.836	946.812	14.3
2040	7374.355	8374.410	1000.055	13.6
2045	8220.371	9306.492	1086.121	13.2
2050	9144.109	10349.539	1205.430	13.2
2055	10142.559	11471.312	1328.754	13.1

TABLE 22

TOTAL OASDI BENEFICIARIES*

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	25.898	25.898	0.0	0.0
1975	31.547	31.547	0.0	0.0
1980	36.250	36.250	0.0	0.0
1985	39.911	39.911	0.0	0.0
1990	43.254	43.254	0.0	0.0
1995	45.620	45.660	0.040	0.1
2000	47.175	47.197	0.022	0.0
2005	48.955	48.349	-0.606	-1.2
2010	52.206	50.425	-1.781	-3.4
2015	56.995	53.957	-3.038	-5.3
2020	62.251	58.342	-3.909	-6.3
2025	66.836	62.668	-4.168	-6.2
2030	69.102	65.546	-3.556	-5.1
2035	69.008	65.967	-3.041	-4.4
2040	67.503	64.888	-2.615	-3.9
2045	66.797	63.602	-3.195	-4.8
2050	67.654	63.880	-3.774	-5.6
2055	69.051	65.336	-3.715	-5.4

*Expressed in millions of people.

TABLE 23

AVERAGE OASI BENEFIT*

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	2567.600	2567.600	0.0	0.0
1975	3077.563	3077.563	0.0	0.0
1980	3660.017	3660.017	0.0	0.0
1985	3778.750	3790.935	12.185	0.3
1990	3691.571	3733.561	41.989	1.1
1995	3578.767	3676.941	98.174	2.7
2000	3499.320	3517.473	18.153	0.5
2005	3521.396	3417.109	-104.288	-3.0
2010	3670.881	3626.545	-44.336	-1.2
2015	3822.734	3953.094	130.359	3.4
2020	3857.264	4114.156	256.892	6.7
2025	3829.342	4172.695	343.353	9.0
2030	3742.227	4148.402	406.176	10.9
2035	3624.506	4021.282	396.776	10.9
2040	3583.255	3982.892	399.637	11.2
2045	3652.983	4034.474	381.491	10.4
2050	3845.636	4353.602	507.966	13.2
2055	3921.711	4539.141	617.430	15.7

*Expressed in 1981 dollars.

TABLE 24

AVERAGE DI BENEFIT *

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	3702.954	3702.954	0.0	0.0
1975	4942.352	4942.352	0.0	0.0
1980	5011.687	5011.687	0.0	0.0
1985	4821.656	4822.168	0.512	0.0
1990	4834.930	4839.512	4.582	0.1
1995	4902.539	4872.570	-29.969	-0.6
2000	5032.867	5039.871	7.004	0.1
2005	5172.242	5204.090	31.848	0.6
2010	5319.797	5366.195	46.398	0.9
2015	5494.145	5555.316	61.172	1.1
2020	5683.121	5744.281	61.160	1.1
2025	5878.402	5942.957	64.555	1.1
2030	6074.797	6141.656	66.859	1.1
2035	6269.937	6336.668	66.730	1.1
2040	6476.957	6542.711	65.754	1.0
2045	6682.121	6749.988	67.867	1.0
2050	6869.828	6951.871	82.043	1.2
2055	7049.371	7145.023	95.652	1.4

*Expressed in 1981 dollars.

TABLE 25

TOTAL OASI PAYMENTS*

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	49.528	49.528	0.0	0.0
1975	69.331	69.331	0.0	0.0
1980	95.952	95.952	0.0	0.0
1985	112.255	112.617	0.363	0.3
1990	120.838	122.212	1.374	1.1
1995	123.747	125.939	2.192	1.8
2000	123.360	119.718	-3.642	-3.0
2005	127.147	116.223	-10.924	-8.6
2010	141.623	126.843	-14.779	-10.4
2015	163.958	149.514	-14.443	-8.8
2020	185.396	172.431	-12.965	-7.0
2025	202.741	194.107	-8.634	-4.3
2030	207.599	207.295	-0.304	-0.1
2035	200.947	203.156	2.209	1.1
2040	192.072	195.976	3.904	2.0
2045	192.366	191.117	-1.250	-0.6
2050	205.788	207.004	1.216	0.6
2055	215.411	222.741	7.329	3.4

*Expressed in billions of 1981 dollars.

TABLE 26

TOTAL DI PAYMENTS*

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	7.624	7.624	0.0	0.0
1975	18.414	18.414	0.0	0.0
1980	22.633	22.633	0.0	0.0
1985	23.041	23.043	0.002	0.0
1990	24.553	24.576	0.023	0.1
1995	27.102	28.724	1.622	6.0
2000	31.762	38.049	6.287	19.8
2005	36.865	44.842	7.977	21.6
2010	41.034	51.170	10.137	24.7
2015	43.832	55.596	11.764	26.8
2020	44.742	58.113	13.371	29.9
2025	44.060	57.962	13.901	31.6
2030	44.393	56.851	12.459	28.1
2035	46.099	58.503	12.404	26.9
2040	50.476	62.657	12.181	24.1
2045	53.510	68.191	14.681	27.4
2050	54.724	70.602	15.878	29.0
2055	55.715	71.770	16.056	28.8

*Expressed in billions of 1981 dollars.

TABLE 22

TOTAL OASDI PAYMENTS *

	BASE CASE	ALTERED CASE	DIFFERENCE	PERCENT DIFFERENCE
1970	57.152	57.152	0.0	0.0
1975	87.745	87.745	0.0	0.0
1980	118.585	118.585	0.0	0.0
1985	135.296	135.660	0.364	0.3
1990	145.391	146.788	1.397	1.0
1995	150.847	154.663	3.816	2.5
2000	155.122	157.767	2.645	1.7
2005	164.012	161.065	-2.947	-1.8
2010	182.658	178.014	-4.644	-2.5
2015	207.783	205.110	-2.677	-1.3
2020	230.138	230.544	0.406	0.2
2025	246.801	252.069	5.268	2.1
2030	251.991	264.146	12.155	4.8
2035	247.047	261.660	14.613	5.9
2040	242.548	258.633	16.086	6.6
2045	245.876	259.307	13.431	5.5
2050	260.512	277.606	17.094	6.6
2055	271.126	294.511	23.385	8.6

*Expressed in billions of 1981 dollars.

While private pension participants increase under the Commission's proposals, beneficiaries of the Social Security (OASDI) System actually are decreased due to the retirement age policy. This decrease becomes significant by the year 2005 and peaks at about a 6 percent decline in beneficiaries by the year 2020.

As a result of the decline in beneficiaries, total OASI (Old Age and Survivors) payments decline significantly, the largest decline coming by the year 2010. After that time, however, increased economic growth and labor force input into the economy lessen the decrease; and by 2035, the total payments actually begin to be higher than the base case.

The simulations also show that increases in disability benefits (DI) tend to offset some of the decreased OASI payments. Disability rates among older workers are relatively high, and increased disability payments should be expected to result from a policy to increase the age of eligibility for OASI benefits.

Total OASDI payments, however, decline for approximately a twenty year period starting shortly after the turn of the century until about 2020. After that time, total payments increase due to the increase in average OASI benefits resulting from increased labor input, wages, and economic growth.

Tax Reductions and the Commission's Proposals

Currently, Congress and the Administration are proposing various measures to reduce individual and business taxes. Stated objectives of these proposals include the increase in personal savings and investment funds.

The Commission has proposed tax cuts that are comparable to those of the administration. As the following tables show, combining a tax reduction with a MUPS and the Commission's retirement age policies is a much more effective way of increasing savings and investment than implementing the Commission's tax reduction by itself.

Initially, the MUPS and tax programs combine to provide an initial boost to private savings that is about $20 billion in 1985 (in 1981 dollars). The tax program alone is estimated to increase savings about $1.6 billion in 1985. The increase in investment in 1985 is about $3 billion (or about 40 percent) greater under the Commission's proposals ~~than under~~ the Commission's tax cut alone.

In the later years the differences in both savings and investment continue to increase. Under the Commission's tax cut alone, savings increases by only $0.2 billion in the year 2000 and $3.2 billion in the year 2020. Under the full set of the Commission's proposals, savings increases by over $47 billion in the year 2000 and $100 billion in the year 2020, the latter being 30 times as great as under the tax cut alone.

Investment also is much greater under the Commission's combined approach than under the tax cut alone. More than four times as much ($43 billion) is invested in the year 2000 and more than six times as much ($108 billion) in the year 2020.

In addition to these positive macroeconomic effects, of course, the Commission's proposals also provide for a greater availability of savings for retirement purposes. Under the Commission's program, a large portion of the additional savings would be set aside to alleviate the retirement income crisis that will exist as the post World War II Baby Boom enters retirement.

TABLE 28

Increased Gross Private Savings Due to Tax Reductions and Other Commission Policies

Year	Tax Reduction Alone Increased Saving*	Tax Reduction with MUPS and Retirement Age Policy Increased Saving*
1985	1.6	19.6
1990	1.2	26.2
2000	0.2	46.6
2010	1.6	68.6
2020	3.2	99.5
2030	5.1	135.2
2040	8.6	175.9
2050	10.8	222.5

* Billions of 1981 dollars. This includes business and personal savings.

TABLE 29

Increased Investment Due to Tax Reductions and Other Commission Policies

Year	Tax Reduction Alone Increased Investment*	Tax Reduction with MUPS and Retirement Policy Increased Investment*
1985	7.5	10.8
1990	8.1	13.9
2000	10.3	42.9
2010	13.9	72.2
2020	17.2	107.3
2030	20.8	133.4
2040	26.7	173.1
2050	33.1	239.2

* Billions of 1981 dollars.

Appendix

Assumptions Used in the Simulations

1. MUPS Simulations

   a. Persons not covered by a pension plan may be covered by a MUPS, according to proportions obtained from the PCPP MUPS microsimulation model.

   b. The MUPS is a 3 percent defined contribution plan covering all persons 25 years of age and over, with one year's tenure and 1,000 hours of service. Vesting is full and immediate upon participation. Benefits/contributions are fully portable.

   c. The presence of a MUPS causes an increase in expected pension benefits for other pension recipients of 19 percent. This estimate is based on PCPP MUPS microsimulation model.

   d. The average number of year's tenure for some one solely in a MUPS at retirement is 35 years.

   e. MUPS participants earn the average wage in their age/sex groups.

   f. 89 percent of all new pension contiributions represent new private savings. This estimate is based on Professor Mordecai Kurz's work for the Commission using the Pension and Savings Household Survey. His final report is entitled "The Effects of Social Security and Private Pensions on Family Savings."

2. Delayed Retirement Simulation

In order to implement the delayed retirement simulation, indices of probability-of-new-retirement arrays were moved up by an amount IDEC:

$$IDEC = \begin{cases} 0 & \text{if before 1990} \\ \dfrac{YEAR - 1989}{4}, & \text{if 1990-2012} \\ & \text{rounded to the nearest integar} \\ 3 & \text{otherwise} \end{cases}$$

Additionally, the social security section of the model keeps track of the maximum age for disability eligibility. In the base case, it is 61; in the delayed retirement case, it increases with the minimum age to qualify for retirement benefits.

Labor force participation rates' indices are moved to correspond to the change to retirement behavior.

3. Tax Simulations

a. Corporate Tax Collections

Corporate tax revenues decrease due to the deductibility of MUPS contributions. The tax revenue changes cited in Table 23 of the PCPP Final Report were adjusted as follows:

Year	Nominal	CPI	Real (1972=1.0)	Capital Price Index	Estimates
1982	$ 4.4	2.385	1.84	1.75	3.22
1983	7.4	2.595	2.85	1.92	5.47
1984	10.5	2.798	3.75	2.05	7.69
1985-2055	1984 changes are applied proportionately to all future corporate tax rates.				

b. Deductibility of Social Security Contributions

The effective tax rate on personal income is decreased in 1982 sufficiently to decrease income tax revenues $25.6 billion as shown in table 21 of the PCPP Final Report. In the simulation we adjust tax rates to decrease revenues $22.6 billion ($25.6 billion deflated to 1972 real dollars then inflated by the exogenous price of labor). The adjusted tax rate remains in effect in all future years.

c. Favorable Treatment of Retirement Savings

The effective tax rate is decreased (in addition to the change from Social Security Deductibility) as follows:

Year	Nominal	CPI	Real (1972=1.0)	Labor Price Index	Estimates
1982	$ 10.0	2.385	4.2	2.11	8.86
1983	12.1	2.595	4.7	2.26	10.62
1984	14.1	2.798	5.0	2.41	12.14
1985-2055	1984 changes are applied proportionately to all future labor income tax bases.				

Figures for nominal tax losses were obtained from Treasury estimates done for the Commission.

d. Taxation of Social Security Benefits

All social security benefits of the previous year are taxed beginning in 1982. The tax is phased in -- initially it is 1/15 of the marginal tax rate (set at 10 percent) and it increases in equal increments until it equals the marginal tax rate in 1996.

e. Changes in the Social Security Tax Rate

The 1985 payroll tax increase is implemented in 1982.

f. Phase Out of the Retirement Earnings Test

The effect of the earnings test is phased out in equal increments. In 1982 we eliminate 1/15 of all earnings test effects. In each succeeding year we eliminate an additional 1/15 of earnings test effects until all effects disappear in 1996. Hours worked for all 65-71 year olds increases 9.2 percent when the test is fully phased out. This estimate is consistent with the analysis of Gordon and Schoeplein in their Social Security Bulletin article of 1979. Social Security benefits are increased by 2.65 percent upon full phase out. We obtain this estimate of a 2.65 percent increase when the earnings test is eliminated by dividing $2.1 billion (the OASI Actuary's estimate of the cost of the earnings test) by $79.2 billion, an estimate of OASDI benefits paid in 1978.

g. Federal Government Expenditures

Federal government expenditures were reduced by an amount equal to the Commission's tax reductions. The government deficit, therefore, would not be changed directly by the tax policies.

h. Savings

In the basic H-J-A model, savings is "endogenous", that is, it is a function of other variables in the model. (Savings is a function of income, income transfers and consumption.) When corporate and individual taxes are changed, total savings changes in response.

The Commonwealth of Massachusetts
Department of Elder Affairs
38 Chauncy Street, Boston, Mass. 02111

EDWARD J. KING
GOVERNOR

THOMAS H.D. MAHONEY, Ph.D.
SECRETARY

September 15, 1981

The Honorable John Heinz
Senate Select Committee on Aging
Senate Office Building
Room G-233
Washington, DC 20510

Dear Senator Heinz:

The enclosed Paper, Retirement Income Policy: A State's Interest in Federal Policy Decisions (2 pages) reflects in important ways the partnership which we in positions of State responsibility share with your Committee regarding wise Policy choices as they affect the economic well being of those citizens who are elders. Accordingly, I am taking the opportunity to offer the summary thoughts therein expressed as testimony to the Senate Select Committee in connection with your Hearing on the vital topic, Retirement Income Policy.

We will look forward, at the Department of Elder Affairs, to receiving shared information on developments affecting, or which may affect our older citizens in this regard.

With personal best wishes for a fruitful session.

Very truly yours,

Thomas H.D. Mahoney

Thomas H.D. Mahoney, Ph.D.
Secretary
Department of Elder Affairs

THDM:mf

Attachment:

RETIREMENT INCOME POLICY: A STATE'S INTEREST

IN FEDERAL POLICY DECISIONS

Adequacy of retirement income has for many years been a key component of our pioneering and still growing committment, in the Commonwealth of Massachusetts, to foster all key elements making the life of its older citizenry more worth living, as secure as possible, and butressed where need be by services to the elderly.

Adequacy of retirement income, now more than ever before, is recognized as the principal means most elders require to retain their independence and to promote the creativity in action and freedom in spirit without which the later years can become of so much less value, cheating some elders of the full measure long life can bring. In developing a full response to the need for income in later years, adequate both to the adjustments of aging and to sustaining the promises inherent in life itself, the Department of Elder Affairs has played a leadership role in exploring the several sources from which such income may be derived.

The Elder Service Corps, while not primarily an income producing Program, nevertheless combines providing services where other elders benefit, with rewarding the Corps volunteers doubly, through the satisfaction of giving their time and effort and by a stipend, received free from tax liability. Similarly, Senior Aides across the Commonwealth, themselves eligible for part time employment due to income levels below a specified maximum, earn a worthwhile addition to that income, plus benefits, and do work which has its direct satisfactions and leads on, for many each year, to placements with higher earnings.

Elder employment has become a companion focus of Departmental effort. And, whereas promotion of this objective is clearly an income related one, the record and policy thrust of our emphasis on Older Worker Employment has been the subject of other recent Testimony prepared for the Senate Select Committee on Aging. Hence the balance of this present look at Retirement Income Policy alternatives will center on the three major income sources which traditionally mix together and constitute, at least for most retirees, the basis of retirement income, adequate or not.

These three are of course Social Security, Pensions and individual savings. And at this point it should be pointed out that, whereas an individual State retains primacy in the wish to provide economic security for all elder citizens within its borders, the whole panoply of the national economy, the business cycle and Federal policy making bear in upon the attainment of a balance sought for our own expanding elder population. It is the complexity of interposed forces affecting, or potentially affecting both equity and adequacy in retiree income which calls for our utmost, in applied wisdom, forebearance and rationality, when considering and deciding among the policy alternatives which will affect or govern the dispensation of these crucial income amounts.

As both a leading State in this field and (as are all fifty) as one of many, we commend a recent New York State Task Force report, entitled Keeping Social Security Strong - Analysis and Recommendations. Our reading finds the analysis to be offered with dispassion and the general conclusions and recommendations ones which fit a desireable pattern of reasonableness. With wise counsel guiding present Social Security policy decision making, it will be easier to negotiate the shoals still to be encountered in the Pensions area and to rebuild habits of thrift and Institutions for the thrifty, to complete a sound triad on which to base policy and to which added income amounts may accrue to individuals, through initiative and by modifications of the Social Security earnings test requirements.

Indicators from the recent census as well as authoritative analysis of the Pension Industry itself tell a story of continuous slow growth in coverage of the work force. Still, however, glaring exceptions to the general rule exist for particular groups and populations. Women, Minority Group members and persons employed in Small Business stand out as needful participants. Further, coverage is not the same as vesting; periods shorter than ten years need to be considered and adopted, and provisions need to be made for portability of earned pension credits by individuals changing jobs.

The most authoritative and comprehensive study of Pension needs and further reform options is still that done by the President's Commission on Pension Policy. Presidential Commissions have, by their nature and tradition, a bipartisan character, and these recommendations should be carefully reviewed by the Congress so that the best reasoned proposals have an opportunity for public scrutiny and legislative acceptance or rejection.

Finally, no objective survey of the broad Pension landscape in our Country should overlook the fact that there are still living "Pension Losers", persons who fell "between the cracks" at the time of ERISA*. We believe in Massachusetts that the Nation's committments to the safety and general well being of two groups, those who work diligently at their jobs and those who are aged following such work life, that this national pledge is of such a character as to disallow a cohort of American elders to remain locked out of the benefit closet. We would hope to see the remaining Pension "Losers" provided for by legislative action.

Savings in an era of inflation remains a tricky topic; yet new tax incentives promise a reversal of the picture, particularly insofar as earmarked savings for retirement are concerned. Our own task will be to inform our citizens of the programs now open for individual participation and to participate with you in a spirit of partnership in the inflation taming work you have undertaken. Cost containment also, particularly in the areas where medical and other elder expenditures are made, will remain a part of your concern in which we well retain special interest.

* The Employee Retirement Income Security Act of 1974

The Commonwealth of Massachusetts
Department of Elder Affairs
38 Chauncy Street, Boston, Mass. 02111

EDWARD J. KING
GOVERNOR

THOMAS H. D. MAHONEY, PH.D.
SECRETARY

September 23, 1981

Senator John Heinz
Senate Special Committee on Aging
Room G-233
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Heinz:

I commend your committee on the occasion of its all-important hearing on Social Security reform and retirement income policy and submit the enclosed testimony, which we would like you to consider as part of your records, as a summation of the concerns of elders here in Massachusetts.

Social Security benefits are a principal source of income for a substantial number of low income and retired elderly individuals currently residing in the Commonwealth. Consequently, the Department has been closely following the progress of your committee in its efforts to resolve the immediate and long range problems currently confronting the system; as well as the committee's efforts to restore public confidence in the future of social security programs.

I look forward to receiving the results of your committee's hearing and welcome any available information and schedules of future hearings called by your committee on aging.

Sincerely,

Thomas H.D. Mahoney, Ph.D.
Secretary of Elder Affairs

THDM/GFM:fa
Enclosure

SOCIAL SECURITY REFORM AND RETIREMENT INCOME POLICY

As Secretary of the Massachusetts Department of Elder Affairs, I welcome this opportunity to share our long experience with your Committee on Aging. Our experience, as you no doubt are aware is derived from working on many levels with older persons throughout the Commonwealth, as the first legislatively constituted State Agency on Aging in the Nation.

Social Security Reform and Retirement Income Policy is a subject which we live with each and every day in our own attempt to come to grips with the proposed cuts. As such, we are striving to determine the percentage of low income elderly who are expected to be adversely affected by proposals to end the $122 monthly minimum benefit, eliminate the $255 lump sum death benefit for beneficiaries without survivors and making it harder to qualify for disability assistance.

We are told that the national average benefit for women receiving Social Security is only $2,216.00 annually and that additionally 50% of all older women have median incomes below the poverty level.

Whereas, Social Security Reform affects more than the elderly. I believe that any viable solution to the current crisis in the Social Security System must adequately consider all those members of society who currently participate in the system. Yet, special consideration must be given to those current beneficiaries who most obviously will be gravely affected by any reduction in the current levels of benefits; those beneficiaries who are currently at, near or below, the poverty level with no alternate pension plan. Such a list includes older women, older minorities and low income and disabled elderly in general.

For example, aged women are expected to suffer if minimum benefits are cut, since many older women have been intermittent workers at low wages over their lifetime. These older women currently meet all the Social Security requirements for primary benefits but due to their high number of years out of the labor force (as home makers), their computed benefits will be considerably lower than the current $122 monthly minimum benefit.

Aged minorities are also expected to be hard hit by cuts in the minimum benefits as well as by the proposals to increase the retirment age. The average life expectancy for Native Americans is estimated to be approximately 55 and that of blacks ranges from 59.7 to 65, compared to 70 and above for nonminorities.

Figures supplied by the National Health Institute indicate that proposals to increase the early retirement age to 65 or regular retirement to 68 would "...cut total Social Security benefits..." to Native Americans and those low income elderly blacks with lower life expectancy.

As Secretary of the Department of Elder Affairs in Massachusetts, I am vigorously opposed to any effort to reduce the hard-earned Social Security benefits of those low income older and disabled persons who have earned the right to retire under current law. We must not ignore the all-important role that Social Security benefits have played and continue to play in the lives of millions of poor, disabled and elderly Americans.

As you and your committee members continue to examine the myriad of options necessary to preserve the financial and moral integrity of the current Social Security system, I implore you to be especially cognizant of the needs of those low income elderly, women, minority and disabled Social Security beneficiaries, who depend for their daily sustenance on that system, since they have no other source of income.

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