Stretching the Pension Dollar:

Improving U.S. Retirement Security and National Saving by Enhancing Employer-Based Pension Plans

by

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Executive Summary

Background

Providing retirement security for the large baby boom generation has become a major concern in the United States, not only because of Social Security's imbalances but also because private savings, both by individuals and by their employers through pension arrangements, may not be adequate. This paper focuses especially on employer-sponsored arrangements and ways to encourage employers to offer plans to their workers. Of course, the importance of social insurance, personal savings, and even some continuing earnings as older workers phase down gradually into retirement is recognized.

Given the low personal savings rates in the United States, individuals should be encouraged to save more on their own. For example, more vigorous communications by employers who are already sponsoring retirement plans can enhance participation and contribution rates. Increased employer matching contributions can stimulate greater employee saving as well. Relaxing rules that discourage phased retirement, such as those that prohibit in-service pension distributions before normal retirement age, would make it easier for individuals to contribute to their retirement income through extended employment toward the end of their working career.

Getting Employer-Based Retirement Plans Back on Track

Most of the legislation adopted since the early 1980s that has limited the funding of private pension plans was motivated by the desire to reduce the federal government's persistent deficits. These deficits have been a serious part of our national savings problem, and their elimination was an important goal. Governmental deficit reduction financed by reductions in personal savings, however, is not effective as a means to increase national savings. A series of funding limits adopted during the 1980s and 1990s had the effect of prohibiting employer contributions to as many as 50 percent of large pension plans in this country for some number of years.

If the twin problems of low savings rates and retirement income security for the baby boom generation are of concern, it is time that employer-based retirement programs were allowed to do an even more effective job of dealing with both of them. In this regard, the following proposals would be helpful.

Employer Plans. The following proposals would help get employer plans back on track.

- Eliminate funding biases between types of plans.
- Reconcile funding limits and PBGC premium policies.
- Allow greater flexibility for individual retirement saving.
- Permit some prefunding for retiree health benefits.

Current Proposals to Foster Employer-Sponsored Plans

There are numerous bipartisan retirement policy bills before Congress. These include H.R. 1102, the Comprehensive Retirement Security and Pension Reform Act, introduced by Rep. Rob Portman (R-OH) and Rep. Ben Cardin (D-MD); S. 741, the Pension Coverage and Portability Act, introduced by Sen. Bob Graham (D-FL) and Sen. Charles Grassley (R-IA); and the Retirement Savings Opportunity Act, introduced by Sen. William Roth (R-DE) and Sen. Max Baucus (D-MT). These bills would stimulate plan sponsorship, especially among small employers, and would allow greater savings among workers at companies of all sizes. Numerous provisions of these three bills are contained in the tax measures passed by the House of Representatives and the Senate in July 1999. Aspects of the various bills that bear special attention include:

- Raising pension contribution limits.
- Allowing "catch up" contributions for workers over age 50 who have not saved adequately earlier in their working careers.
- Easing discrimination testing to reduce administrative barriers to plan sponsorship.
- Mitigating "top-heavy" rules so as to reduce the negative impact of these rules on small employers.
- Simplifying small plan administration rules.
- Easing PBGC premiums for small employers.
- Giving tax credits for small employers who are currently unable to afford a pension plan.
- Enhancing portability by simplifying and clarifying rules under which current and ex-employees can combine their retirement savings into a single plan or IRA.
- Easing minimum distribution rules so that employees need not begin drawing down retirement benefits when they turn age 70.
- Ending the 150 percent full funding limit that restricts employers with new pension plans or young workforces from fully funding their benefit promises as they are being earned.
- Broadening 401(k) incentives (Roth IRAs) and extending the concept to the employer plan arena.

In addition to easing restrictions enacted in the past, however, it is important for Congress not to do further damage and make plans even harder to administer. Policymakers should be cautious in relation to the current proposal to increase disclosure to participants when pension plans change accrual patterns. Employers should be straightforward with their workers when making plan changes, but the proposal to require extensive communications of individual benefit projections involve expensive calculations and can only serve to warn employers that Congress may further complicate matters, even as it considers pension simplification.

The American Council for Capital Formation and the Association of Private Pension and Welfare Plans have asked Watson Wyatt Worldwide to describe barriers to employer-sponsored pension coverage and to suggest ways to lower those barriers and therefore encourage employers to offer plans to their employees. In response to this request, this paper discusses methods for (1) achieving greater retirement security for all workers; (2) allowing workers to save more for their retirement and providing the steps for them to achieve adequate retirement saving; (3) facilitating easier access to pensions and the ability to save for retirement; and (4) improving national saving.

We are writing this paper because we believe unequivocally that providing retirement security is one of the most important public policy issues facing our country today. We are in complete support of the current public debate on these issues, and hope that this paper will spur the involvement of organizations and citizens in providing input on federal policies to stimulate the retirement saving of today's workers.

Providing Retirement Security for America's Workers

Traditionally, we have talked of providing for retirement security for U.S. workers in terms of an analogy to a three-legged stool. The three legs of the retirement stool have been retirement benefits provided under the Social Security Act, employer-sponsored retirement benefits, and individual savings. In recent years, some analysts have spoken of a fourth leg for the stool, namely some continued earnings as workers ease gradually from their long-term career employment into a full state of retirement. The easing from full-time work to full retirement may be accomplished by simply working fewer and fewer hours in a career job, or by shifting to a "shadow career" position that may take advantage of the skills acquired over a working career but less demanding than the career position that a worker previously held.

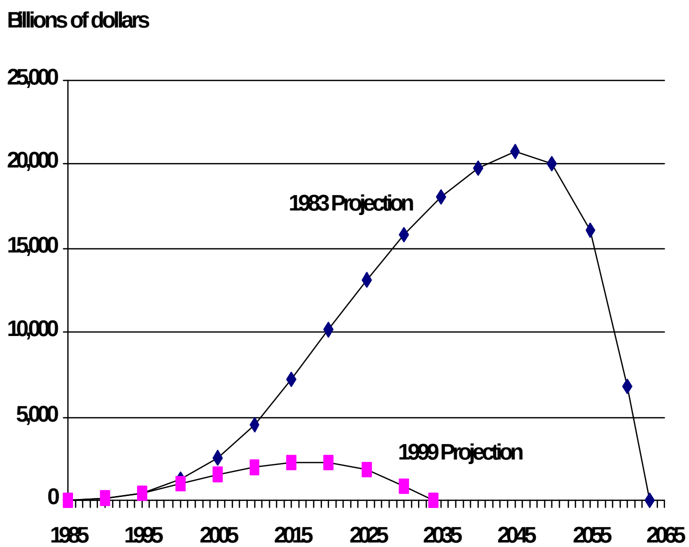
When we look at each leg of the retirement stool, whether it be the three-legged or four-legged version, there is reason for concern. None of the legs appears to be generally sturdy enough at the present time to withstand the pressures that the baby boom generation is going to impose upon it beginning in the next decade. It is now widely understood that the retirement of the baby boom generation is going to put the finances of Social Security and Medicare under tremendous strain. It is less well understood that employers are incurring liabilities that are causing many of them to curtail their commitments to providing pensions and retiree health benefits. There is also considerable evidence that individual workers are not saving adequately to meet their own residual needs even assuming that current levels of Social Security and employer-based benefits would prevail. Given the prospect that these other legs of the retirement stool might not deliver all of the benefits that workers currently expect, the individual saving situation may be even more dire than it currently appears. Finally, the option of extended employment as the baby boomers age may not hold out as much promise as some policy analysts would have us believe.

Social Insurance Promises: A Bridge Too Far

In the early 1980s, Social Security's retirement trust fund was almost depleted. Comprehensive amendments to the system in 1983 included immediate and future increases in the payroll tax rate and increases in the age of normal retirement to take effect after the turn of the century. One practical result of the 1983 reforms was that the baby boom generation's Social Security benefits would be partially prefunded if things worked out as planned, thereby reducing the pay-as-you-go pressure on the system. After the 1983 Social Security amendments, the system actuaries projected that the Old-Age and Survivors Insurance and the Disability Insurance (OASDI) trust funds would grow from their $27.5 billion position at that time to a staggering $20.7 trillion in 2045. Even more reassuring was the finding that these trust funds would remain solvent until 2063 when the trailing edge of the baby boomers would be 99 years old. At the end of 1983, it looked as though Social Security would have funds to pay promised benefits through the normal life expectancy of virtually everyone who was working regularly at that time.

As Figure 1 shows, the future doesn't look as promising today. The latest forecast is that the trust fund will peak at $2.3 trillion in roughly 2009, rather than $21 trillion around 2045. The date of the exhaustion of the retirement and disability trust funds, if the program is not modified, is currently projected to be 2034, not long after the retirement of the youngest baby boomers. It is now clear that the assumptions of the 1983 long-run forecast were far too optimistic and that another round of significant program changes will be required. The sooner the program is changed to achieve long-run fiscal balance, the less drastic the modifications will need to be. It now appears, however, that the program is so far out of balance that any set of policies to correct the situation will necessarily involve major changes.

Figure 1: Projected OASDI Trust Fund Accumulations in Current Dollars by Year of Estimate



Source: Harry C. Ballantyne, "Long-Range Projections of Social Security Trust Fund Operations in Dollars," Social Security Administration, ***Actuarial Notes*** (October 1983), no. 117, p. 2, and ***1999 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*** (March 1999), p. 177.

A significant concern raised by Social Security's current funding status is how it affects the public's confidence in the system. We believe that the inadequate funding of the system under current law is partly to blame for the lack of confidence in the system that exists today. While much of the public might not fully understand the nuances of Social Security financing, workers feel threatened by the news media's annual reports that the Social Security trustees are predicting the trust funds will be depleted during their expected lifetimes. In addition, we believe that the decline in the value of Social Security benefits relative to taxes paid contributes to declining public confidence among younger people and to increased interest in private alternatives to Social Security.

It is vital that the public has full faith and confidence in Social Security if we are to expect future generations of workers to contribute to and support the system. In order to restore confidence in the system, it should be structured to assure the delivery of benefits over the life expectancy of current and future workers. Finally, we believe that a system that provides workers with an opportunity to accumulate real, owned wealth along with a backstop of protection against a lack of success during their working lives is one that will generate much more confidence than the current system based on unfunded political promises.

Besides the additional personal confidence that workers might achieve with the accumulation of wealth as the foundation for their retirement security, the potential increase in real saving that can be achieved by funding some portion of Social Security will provide further benefits to workers. Virtually all economists today believe that savings rates in the United States are too low. They believe that higher savings rates will lead to more investment and to an expansion of the economy that, in turn, will lead to higher levels of real income in future decades. It is imperative that Congress seeks solutions to our Social Security financing problem that translate into significant increases in national saving and investment.

Employer-Sponsored Retirement Programs: To Fund or Not to Fund?

During the 1960s and early 1970s, public policymakers carried on long legislative considerations that led up to the passage of the Employee Retirement Income Security Act (ERISA) in 1974. The fundamental goal of ERISA was to secure workers' retirement benefits by requiring that employers fund promised benefits as they are earned. While the passage of ERISA was not universally endorsed by the business community, the funding of pension obligations came to be seen as good business policy as well as good labor and social policy. After the passage of ERISA, employers with pension plans generally moved aggressively to fund promises being held out to their workers.

The funding of employer-sponsored benefits has taken on increased importance in recent years because we now know that we cannot anticipate the kinds of increases in Social Security benefits that current retirees were granted through significant benefit enhancements adopted in the late 1960s and early 1970s. Indeed, current law already provides that the baby boomers will be facing higher normal retirement ages under Social Security than current beneficiaries faced. Increases in the Social Security retirement age are benefit reductions. If workers hope to make up those benefit reductions, they are going to have to do it through enhanced employer-sponsored benefits or through personal saving.

Since the early 1980s, there have been a number of changes in the regulatory environment affecting pensions that jeopardize the retirement income security of many current workers covered by pensions. Over this period, several new laws have gradually chipped away at the tax preferences accorded employer-sponsored retirement plans by limiting the amount employers can set aside in tax-qualified retirement plans. For example, the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, as well as the Tax Reform Act of 1986, reduced or froze for a period of time the funding and benefit limits for defined benefit plans and the contribution limits for defined contribution plans.

The net result of the changes in the pension regulatory environment over the past 18 years has been a slowing or stalling of the funding of workers' retirement benefits. The risk that the slowdown in pension funding poses is that in the future, plan sponsors may not be able to meet the implied promises that their current plans hold out to covered workers. The benefit formulas in many defined benefit plans will require significantly higher future contributions by plan sponsors than they are currently making. These higher contributions are the result of the aging of the work force in combination with reductions in plan funding that sponsors have implemented in response to the changing regulatory environment.

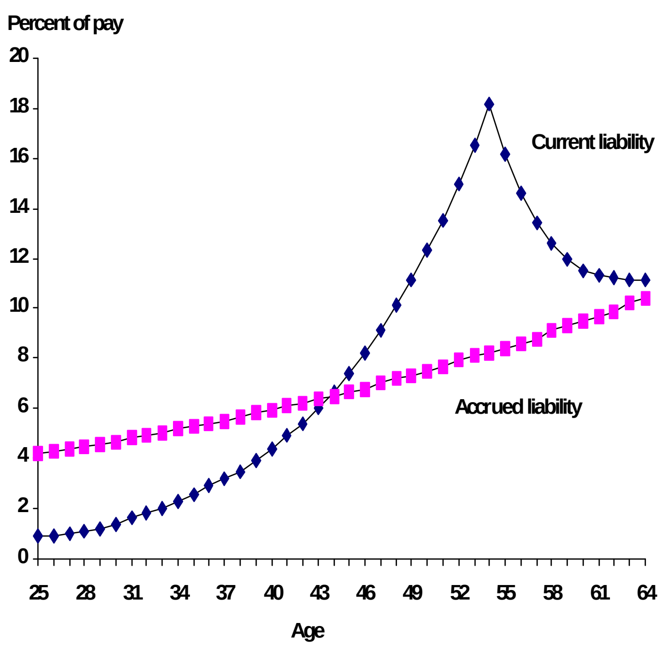
The Omnibus Budget Reconciliation Act of 1987 (OBRA '87) reduced the full funding limits for defined benefit plans from 100 percent of accrued plan liability—i.e., the ongoing plan liability—to the lesser of that value or 150 percent of current liability at the time of each annual valuation. When the funding limit was based solely on the ongoing plan liability, plan sponsors could take into consideration expected pay increases for workers covered by the plan between the time of the annual valuation and their expected date of retirement. In basing the funding limit on the current liability, anticipated pay increases could no longer be considered.

Consider the funding pattern that a plan would take for a hypothetical worker if it were using the projected pay increases, as is done in calculating the accrued benefit liability, in comparison to funding the benefit based on the annual increments in current benefit liabilities as shown in Figure 2. In the case of a worker beginning a 40-year career job at age 25, the current liability benefit contribution rates would be less than the accrued benefit liability contribution rates over the first half of the career. Under OBRA '87 the plan sponsor could fund for up to 150 percent of the current liability benefit, but for workers under age 40 in many cases, 150 percent of the current liability benefit was less than 100 percent of the accrued benefit if the plan was to be ongoing. In 1987 when this legislation was passed, the baby boom generation ranged in age from 23 to 41. Watson Wyatt's 1988 *Survey of Actuarial Assumptions and Funding* of pension plans with more than 1,000 lives estimated that 47 percent of the large plans in the United States would be affected by the new funding limits in OBRA '87.

The situation that OBRA '87 created may be worse in many cases than Figure 2 suggests. Many employers who had been contributing to their plans under alternative funding methods were thrown into an excess funding position by OBRA '87. Basically this meant that they could not contribute to their plans until the current liabilities—i.e., the plan liabilities if it were to be essentially shut down as of the valuation date—caught up with the assets that they had put into the plan under the earlier rules. So rather than continuing to contribute to their plans at the rates implied by the accrued benefit contribution line in Figure 2, they enjoyed contribution holidays where their plans required no funding at all for some years.

Figure 3 shows the percentage of large private pension plans with accrued benefit security ratios equal to 1.00 or greater over roughly the past two decades. An accrued benefit security ratio of 1.00 means that the actuarial value of plan assets is at least as great as the value of plan current liabilities. In other words, it means there is at least enough money in the pension trust to pay benefits that have been earned to date under the plan, assuming the plan is going to continue to operate. The early legacy of ERISA was a steady improvement in the funding status of private pensions. We saw the percentage of large plans with accrued benefit security ratios of 1.00 rise from 25 percent to roughly 85 percent by 1987. The percentage of plans with assets at least equivalent to accrued benefit liabilities held relatively steady for the subsequent five years. During the three-year period ending in 1996, the percentage of plans funded at this level fell and had dropped to 70 percent of plans. The recovery of the past two years is largely attributed to stellar stock market performance. ERISA was very successful in its early years in encouraging employers to fund pension obligations. The raft of pension legislation passed over the last 10 to 15 years has basically communicated to many employers that they should not be funding pension benefits as they are earned. We believe this mixed message is jeopardizing the long-term viability of many plans.

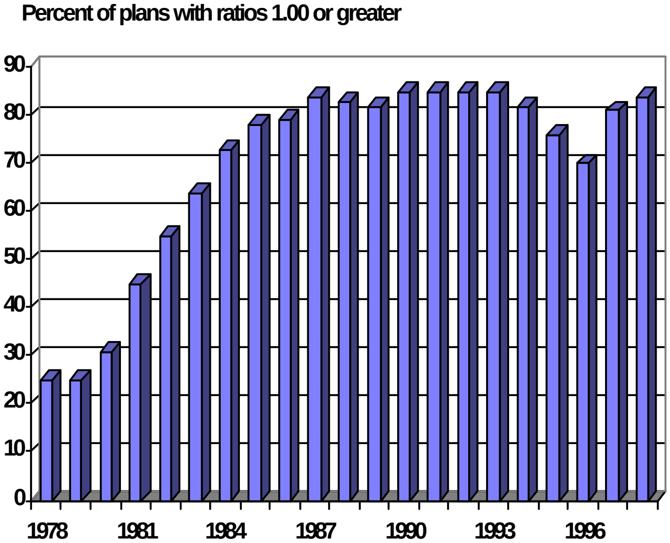
Figure 2: Alternative Pension Funding Perspectives for a 25 Year-Old Worker Over a 40-Year Career Under Alternative Actuarial Cost Methods



Source: Watson Wyatt Worldwide.

The relatively stable percentage of plans with funding ratios of 1.00 or greater since the late 1980s as reflected in Figure 3 does not show what has been happening in recent years to the general funded status of employer-sponsored pension plans as a result of the changing regulatory environment. In Table 1, we show the median funded status of plans that have been included in Watson Wyatt's annual surveys of pension plans with more than 1,000 active participants since 1988. The table shows that the funding status of plans with funding ratios below 1.00 has risen somewhat over the past decade. But the funding status of the plans with assets in excess of their ongoing liabilities has been declining. In 1988, the median funding ratio among overfunded plans stood at 1.57. In 1998, it was down to 1.30 but had dropped to as low as 1.25 prior to the high rates of return realized on plan assets over the past couple of years. These declining funding ratios are not solely attributable to funding limits imposed by OBRA '87.

Figure 3: Accrued Benefit Security Ratios in Private Pensions, 1978-1996



Sources: Watson Wyatt Worldwide, ***1983 Survey of Actuarial Assumptions and Funding***, p. 15, ***1986 Survey of Actuarial Assumptions and Funding***, p. 4, ***1991 Survey of Actuarial Assumptions and Funding***, p. 4, ***1996 Survey of Actuarial Assumptions and Funding***, p. 6, and ***1998 Survey of Actuarial Assumptions and Funding***, p.6 (Bethesda, Maryland).

During the 1980s, interest rates were much higher than they are now and some employers turned to their pension funds as a source of financing for their general business operations. One reason was that capital had become very expensive to obtain any other way. Another reason is the interaction of pension liabilities with interest rates. As interest rates rise, the discounted value of plan liabilities falls. So in a period when asset values were high because of the rising stock market and liabilities low because of high discount rates, pension funds appeared to have greater assets relative to their liabilities than during other periods. Facing the high cost of alternative sources of funds, some corporate executives turned to the excess assets in their pension funds, even though they had to pay income tax on the reversion. Although asset reversions were not commonplace, they received a good deal of attention, most of it quite negative.

Table 1: Funded Status of Pension Plans With More Than 1,000 Active Participants for Selected Years, 1988 – 1998

Year	Median Funded Status All Plans	Percentage of Overfunded Plans	Median Funded Status of Overfunded Plans	Percentage of Underfunded Plans	Median Funded Status of Underfunded Plans
1988	1.45	83	1.57	17	0.82
1989	1.44	82	1.56	18	0.83
1990	1.40	85	1.50	15	0.86
1991	1.36	85	1.45	15	0.83
1992	1.38	85	1.45	15	0.88
1993	1.33	85	1.41	15	0.89
1994	1.27	82	1.35	18	0.88
1995	1.18	76	1.27	24	0.87
1996	1.15	70	1.25	30	0.88
1997	1.20	81	1.27	19	0.91
1998	1.23	84	1.30	16	0.93

Source: Watson Wyatt Worldwide.

Prior to the authorization for asset transfers for retiree health benefits, which began in 1991, the only way for a plan sponsor to obtain funds from an overfunded pension plan was to terminate the plan. Employers who did not want to end their plans found ways to continue to have retirement plans while gaining access to the surplus funds. Some split their plans in two, spinning off the excess assets into plans for retirees, and leaving the plans for active employees with the minimum needed to meet the funding requirements for ongoing plans. Then the sponsors would buy annuities for the retirees and terminate the plans holding surplus funding, recapturing the excess assets that had been spun off into the retiree plans. Other companies terminated their pension plans and recovered excess assets, then started up new plans to provide benefits in addition to those secured in the terminated plan.

The IRS established guidelines in 1983 regulating terminations and reversions. They required the purchase of annuities for all plan benefits to protect employees against market fluctuations and confirmed that employers could reestablish plans after a reversion had taken place. Not surprisingly, reversions continued, even after the Tax Reform Act of 1986 applied a 10 percent excise tax to the reversions. Later the tax rose to 15 percent and the Omnibus Budget Reconciliation Act of 1990 pushed it to as much as 50 percent in addition to corporate income taxes.[1] Together with dropping interest rates, this punitive tax virtually ended the practice of terminating plans to gain access to surplus funds.

By the early 1990s, public policy was conveying to employers that they should be funding their plans on something more akin to a shutdown basis than as ongoing plans. It also conveyed that if the sponsor ended up with too much funding in the plan, there would be no easy access to the surplus funds. One can make a case, at least for private plan sponsors, that doing any funding beyond what was minimally required was not in the economic interests of the sponsoring organization. Indeed, in the case of corporate sponsors, one could argue that tying up surplus assets in a way that would limit their use for the general purposes of the corporation would not be in the best interests of the stockholders of the company. In other words, corporate management was in the potential situation of violating its fiduciary responsibility to stockholders by funding the pension plan as though it was an ongoing commitment of the company.

There have been recent reports in the press about companies who have been able to realize considerable accounting income on their annual financial statements from returns on their pension assets. For example, a front-page article in the *Wall Street Journal* from June 15, 1999, singled out several companies whose annual income reports have benefited significantly from pension returns over the past year.[2] The mere fact that a company can realize accounting income from assets in its pension plan does not change the issues related to the lock-up of excess assets in the plan. For example, consider the case of the excess assets in General Electric's plan. Who is to say that General Electric could not have used those excess assets directly in its business to generate even higher returns for its stockholders than it realized on its pension investment? Indeed, any company that would use excess pension assets instead of leaving them in the plan must reach the conclusion that it could invest them more efficiently outside the plan than inside or they would not take them out in the first place.

Looking back to Figure 2, the longer-run implications of funding a pension on a termination basis suggest that the funding obligations are much more variable over a worker's career than if funded on an ongoing basis. The figure suggests that the variability is largely driven by the age of worker, although it is really a combination of both the worker's age and years of service under the plan. In the example shown in the figure, both age and tenure increase simultaneously. In the case of our national workforce, the aging of the baby boom generation means that the average age of workers is increasing. There is also a strong relationship between a worker's age and tenure with current employer. Older workers tend to have much longer tenures than younger ones. For most employers sponsoring pensions, both average age and average tenure of their workforces has been increasing during the past decade. It is not uncommon that each might be increasing at a rate of one-half to one full year per year.[3] This phenomenon of increasing aging and increasing tenures means that pension liabilities are catching up with whatever overfunding might have been in the funded pension system at the beginning of the 1990s. That is exactly what is reflected in Table 1.

In 1993, one of the current authors and Professor John Shoven of Stanford University developed a long-term simulation of the private pension system somewhat akin to the annual projection of the Social Security system done by its actuaries. The reason for projecting the pension system in this way was to see how the baby boom demographics that are presenting such a challenge to Social Security would affect the funded pension system. In the baseline analysis, Dr. Schieber and Professor Shoven simulated the future of employer-sponsored defined benefit plans. In doing so, they assumed that employers would continue to contribute to their plans at the rates they were contributing to them in the early 1990s and that the plans would pay benefits in accordance with benefit formulas then in existence. Their baseline projection estimated that the funded private defined benefit system would deplete its assets around 2040. In other words, the system was not sustainable over the long run as it was being operated in the early 1990s.[4] When the authors presented their findings at a conference during 1993, a policy analyst from the Office of Pension and Welfare Benefits Administration at the U.S. Department of Labor observed that it was clear that employers would simply have to increase their contributions in the future. Dr. Schieber and Professor Shoven pointed out that the other alternative, and to them the more likely one, was that employers would curtail their defined benefit promises as the liabilities associated with population aging began to mount.

The contribution holidays created by OBRA ’87 ultimately may prove to be a narcotic that will be the death knell for some defined benefit plans. It is one thing for a company to see its annual contributions to its pension program rising by a couple of percentage points from a starting contribution level of 5 or 6 percent of payroll over a decade as its workforce ages. It is quite another to have the contribution rate jump from nothing for several years to 7 or 8 percent of payroll. That is exactly the impact that OBRA ’87 compounded with the expropriative tax on surplus pension asset reversions. With such precipitous changes in plan funding requirements, some sponsors simply will not continue to support their plans at the levels that their benefit formulas imply.

The net effect of the slowdown in pension funding imposed by the regulatory environment over the past decade was to move some of the pension funding that would have occurred early in the baby boomers’ careers to later during their working years. In the long term, it is possible that the reductions in pension saving during the early part of the baby boomers’ careers will be offset by increased employer pension contributions during the latter part of their careers. It may be more likely that many defined benefit pension plans will be curtailed as employers come under the pressure of higher costs of delayed saving to make up for the earlier period when contributions were reduced. In some regards, we have created a double jeopardy situation for employers and workers. Not only do delayed contributions need to be made up, the interest those delayed contributions would have earned has to also be made up by subsequent contributions. If employers curtail their pension plans under the burden of higher costs related to the funding slowdown, then the short-term loss in savings flowing out of tax legislation and regulations since 1982 will never be made up.

In spite of growing concerns about the baby boomers’ retirement security, during the 1990s we have seen the continuing enactment of laws that affect the funding of tax-qualified retirement plans. Witness the provisions in the Omnibus Budget Reconciliation Act of 1993 (OBRA 93) that reduced the level of an individual employee’s compensation that can be considered in funding and contributing to tax-qualified plans. The effects of OBRA ’93, like OBRA ’87, further limited the funding of employer-sponsored retirement programs. OBRA ’93’s provisions have also delayed the funding of retirement promises from early in workers’ careers until later.

The need to raise tax revenues without raising tax rates has encouraged public policymakers to restrict the funding of pensions. But by the early 1990s, the Pension Benefit Guaranty Corporation (PBGC) was becoming increasingly alarmed about its exposure to underfunded plans. The Uruguay Round of the General Agreement on Tariffs and Trade (GATT) legislation enacted in 1994 increased the potential for variable rate premiums for employer-sponsored defined benefit plans based on the level of unfunded liabilities in the plans. Clearly one of the goals of the GATT legislation was to encourage employers to fully fund defined benefit promises as they were earned.

Although there are reasons to be concerned about the funding status of our employer-based pension system, there are even more grave reasons for being concerned about employer-sponsored retiree medical benefits. Tax law does not give employers the ability to effectively prefund these benefits. The same problems that portend funding shortfalls for Medicare, including deteriorating dependency ratios and the rapidly escalating cost of health care services for retirees, apply to employer-sponsored retiree medical plans as well. These problems are magnified at the firm level because the ratio of retirees to workers changes far more dramatically for individual firms than it does for society as a whole. We have seen the dependency ratio in prominent nationally recognized companies increase tenfold within a decade. This does not mean that the company has seen its number of retirees increase tenfold, but that the ratio of retirees to workers has increased by that amount. We have seen one case where the ratio of retirees to production workers for a large operating division of a major company went from four retirees for every three active workers to five retirees for every active worker in a six-year period of time. This unit's retiree medical costs in 1996 were $20,000 per year per active worker. In other words, the active workers in this operation had to produce $20,000 worth of product before their employer could pay them a dime. The employer decided the business was no longer economically viable and sold it.

We are in a situation today where many of our mature firms have nearly as many retirees as active workers. Those who have sponsored retiree health benefits have to finance them out of current operating revenues. Firms with benefits often compete against companies that do not have similar burdens. Consider the case of the auto manufacturing industry in this country. The Big Three auto makers typically have dependency ratios in excess of 1.0 among their blue-collar workforces and are providing health care benefits to their retiree populations. Yet they have to compete against cars produced in this country by operations that have been started in recent years by foreign car producers. These young operations do not have comparable retiree health obligations that have to be embedded in the price of their products. The same is true of the computer industry, the steel industry, and on and on.

The restricted availability of retiree health benefits and the variability of individual employers' businesses suggests that these benefits simply are not viable in the long term. Increasingly employers are curtailing these benefits. In some cases, employers have simply curtailed the benefits for current and future retirees alike. In most cases, however, employers are curtailing the benefits on a prospective basis. In today's environment where employers have relatively large numbers of retirees compared to their active worker populations, they have learned that they cannot afford to take on retiree health liabilities if they cannot accumulate assets to offset such liabilities. The exposures employers face with the aging of the baby boom are simply too large to expect these benefits to persist in any significant measure.

The Move to Do-It-Yourself Retirement Accumulation

At the same time employer contributions to their retirement plans have been falling, we have witnessed a significant shift of the responsibility for retirement saving in employer-sponsored plans. Since the early 1980s, the growing prevalence of section 401(k) plans in the private sector and similar plans in the public and nonprofit sectors have increased the role of individuals in providing for retirement security. Table 2 shows the growth in the role of 401(k) plans in the private, employer-sponsored retirement system between 1984 and 1995. In 1984, 2.9 percent of all private plans and 4.0 percent of all private defined contribution plans had a 401(k) feature. By 1995, 28.9 percent of all plans and 32.2 percent of the defined contribution plans included a 401(k) feature. In 1984, 12.4 percent of all active plan participants and 24.6 percent of all defined contribution participants were in a 401(k) plan. By 1995 this had grown to 42.4 and 65.8 percent respectively. Over the period, the percentage of assets in 401(k) plans grew from 8.8 to 31.7 percent of all plan assets and from 26.7 to 65.4 of defined contribution plan assets. During these years, contributions to 401(k) plans grew from 18.0 to 55.0 percent of all contributions to private plans and from 37.5 to 74.5 percent of contributions to private defined contribution plans.

Table 2: Relative Sizes of 401(k) Plans in Comparison to All Private Tax-Qualified Plans and All Private Defined Contribution Plans, 1984-1995

	Plans		Active Participants		Assets		Contributions	
Year	Percent of All Plans	Percent of DC Plans	Percent of All Plans	Percent of DC Plans	Percent of All Plans	Percent of DC Plans	Percent of All Plans	Percent of DC Plans
1984	2.9	4.0	12.4	24.6	8.8	26.7	18.0	37.5
1985	4.7	6.5	16.6	31.1	11.5	33.7	25.6	45.7
1986	5.2	6.9	18.3	33.4	13.2	37.5	31.9	50.1
1987	6.1	7.9	20.7	37.6	15.4	41.0	36.0	53.3
1988	9.3	11.7	24.5	44.6	18.4	46.8	43.2	60.7
1989	11.4	13.9	28.3	51.0	21.3	51.9	47.1	63.0
1990	13.7	16.3	31.6	55.1	23.0	54.0	49.6	64.7
1991	15.9	18.6	31.1	53.5	22.7	52.8	46.4	63.6
1992	19.7	22.5	34.9	57.6	26.4	58.4	50.0	68.7
1993	22.0	25.0	35.7	58.4	26.6	57.7	45.1	68.3
1994	25.3	28.4	38.8	62.5	29.4	62.0	52.6	72.0
1995	28.9	32.2	42.4	65.8	31.7	65.4	55.0	74.5

Source: U.S. Department of Labor, Pension and Welfare Benefits Administration, ***Private Pension Plan Bulletin, Abstract of 1994 Form 5500 Annual Reports*** (Spring 1999), no. 8, pp. 64-86.

In many regards, the 401(k) story is one of amazing achievement. Today, as much as $2 billion of employee contributions per week pour into these plans. But the growing dependence on these plans has raised its own set of concerns. We know that some workers eligible to participate in these plans are chronic nonparticipants in them. Critics of 401(k) plans suggest that “do-it-yourself” retirement plans will leave many with inadequate retirement accumulations. They argue that workers may start to save too late in life and end up accumulating less than they need for retirement; they may select overly conservative investment options that provide inadequate returns; or they may simply save too little over their working lifetimes. Yet government policies have sometimes created obstacles for employers and others to provide investment education and advice to workers.

Individual Savings: A Mixed Bag

Before the evolution of organized retirement programs, workers were expected to save on their own. For those who saved enough, retirement was a possibility. For those who did not, retirement was often only a dream. From the end of the Civil War until the early 1940s, as many as two-thirds of the men over the age of 60 continued to work in our society. In many cases, this was simply a matter of economic necessity—even old people had to earn a living if they wanted to live. Those who became infirm in their old age who had not saved when they were young, became wards of their families or the public. At the end of the 19th century and the beginning of the 20th century there was a widespread sense that many people could not save adequately on their own to accumulate sufficient wealth that would allow them to withdraw from the workforce at a reasonable age. It was out of this sense—that people did not save adequately on their own and a sense that superannuated workers should be able to retire—that our organized retirement programs arose. Although we have seen the rise of organized retirement programs during this century, Social Security benefits are generally considered to be too small to maintain reasonable standards of living for many retirees. While employer-sponsored pensions are a major source of income and a supplement of Social Security benefits for many retirees, many workers get to the end of their normal working life with little or no pension entitlement. In short, we have not seen the full elimination of the need for individuals to save on their own to meet some of their retirement needs.

At the individual level, one study suggests the typical baby boom household savings rate is only one-third the rate that would be required in order to accumulate sufficient assets so retirees will be able to maintain their preretirement standard of living after they retire. Indeed, this conclusion is characterized as a "best case" scenario that overstates the adequacy of the baby boomers' preparation for retirement.[5] Another study suggests that under current policy the oldest one-third of the baby boom generation will be able to sustain the same level of non-medical consumption as current retirees, but those born in the last third of the generation will be constrained to consumption levels below those of current retirees.[6]

Figure 4: Labor Force Participation Rates of Men and Women Age 65 and Older, 1950-1998

Sources: U.S. Department of Labor, Bureau of Labor Statistics, ***Handbook of Labor Statistics*** (Washington, D.C.: U.S. Government Printing Office, August 1989), Bulletin 2340, pp. 25-27; and U.S. Department of Labor, Bureau of Labor Statistics, ***Employment and Earnings*** (Washington, D.C.: U.S. Government Printing Office, January issues for the years 1990-1999), Table 3.

While many perspectives on the baby boomers' retirement prospects seem to be somewhat gloomy, they are not all so. A recent study published by the Congressional Budget Office that has provided a somewhat more optimistic perspective on the baby boomers' financial status compared the incomes and accumulated wealth of households headed by a person aged 25 to 44 in 1989 with the incomes and accumulated wealth of similarly aged households in 1959 and 1962. In this case, the author found that real household income and the ratio of wealth to income are higher for the baby boomers as they are moving into their middle-aged years than was the case for their parents' generation.[7] Even the CBO, however, tempered its somewhat rosy outlook with the caveat that the baby boomers are not a homogenous mass, and several baby boomer subgroups will most likely be at risk in terms of low standards of living in retirement. These include single persons, those who are less educated, and those that do not own their own homes.

Working into Old Age: Getting Out of the Way as We Gray

Many students of public policy who have been concerned about our aging population and the strains that it will put on our retirement system advocate that one of the most sensible solutions is to keep people in the workforce longer. In the case of Social Security and Medicare, the implications are straightforward. These programs are largely financed on a pay-as-you-go basis. Under such programs, the amount of revenues collected from taxpayers has to roughly equal the expenditures on benefits from year to year. In simple mathematical terms, the revenues of the program are generated by the rate of taxation of wages (t) times the number of workers who are covered by the system (N_w) times their average covered wages (W). The benefits are equal to the number of beneficiaries (N_b) times their average benefit levels (B). Stated alternatively:

$$\text{(1)} \quad t \cdot N_w \cdot W = N_b \cdot B$$

In reality, Social Security's and Medicare's financing have varied from pure pay-as-you-go funding. Financing varies somewhat from year-to-year simply because of cyclical or frictional variations in employment and retirement levels. Since 1983, there has been some build-up in the Social Security trust funds as a result of the 1983 amendments to the Social Security Act that were partially intended to have the baby boomers prefund some portion of their own future retirement benefits. Still, under these programs, the majority of each year's benefits are financed by taxes collected in that year. The total accumulated Social Security trust fund today holds about 20 months' worth of benefits. The Medicare trust fund today holds less than one year's worth of benefits. While Social Security's benefits for the baby boomers are being partially prefunded, even when the trust fund is expected to peak under current law, it is expected to hold less than three years' worth of benefits, far less than the cumulative life expectancy of current beneficiaries at the time and an even smaller share of the total liabilities owed to active workers.

Equation 1 can be manipulated to solve for the tax rate that is required to finance benefits on a pay-as-you-go basis. Specifically,

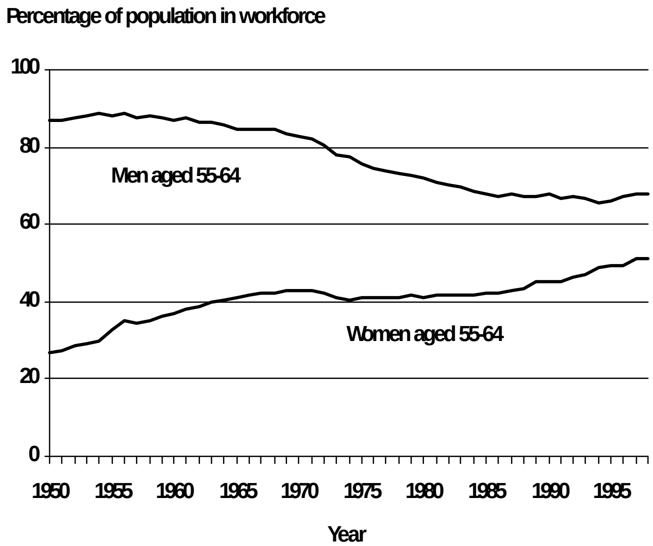
$$\text{(2)} \quad t = (N_b / N_w) \cdot (B/W)$$

where the ratio of beneficiaries to workers can be thought of as the dependency ratio and the ratio of benefits to wages might be thought of as the benefits ratio or, in the parlance of retirement plans, the system's average wage replacement level. Considering the impact of the dependency ratio on the costs of Social Security and Medicare, the implications of raising eligibility ages and keeping workers in the workforce longer is straightforward. Keeping people from retiring and drawing benefits should both reduce the numbers of beneficiaries and increase the numbers of workers. Both would have meritorious effects on the financing costs of these programs. Anything that reduced program costs will make the plans more secure in the long term.

In the case of funded retirement programs, the funding of benefits is accomplished by taking a portion of workers' annual compensation and putting it into a fund that can then be used to finance consumption needs during retirement. Delaying the retirement date for a worker extends the period over which earnings can be tapped while simultaneously shortening the period over which retirement consumption has to be financed through the fund. As in the case of the pay-as-you-go financing, extending working careers for participants in funded plans would make the plans less costly and increase their viability.

While extending working careers has tremendous potential merit, there is some reason to question whether we can keep people working longer in the future than we do today. Figure 4 shows the labor force participation rates of men and women over age 65 between 1950 and 1998. It shows

Figure 5: Labor Force Participation Rates of Men and Women Aged 55 to 64, 1950-1995



Sources: U.S. Department of Labor, Bureau of Labor Statistics, ***Handbook of Labor Statistics*** (August 1989), Bulletin 2340, pp. 25-27, and U.S. Department of Labor, Bureau of Labor Statistics ***Employment and Earnings*** (January issue for the years 1990-1999), Table 3.

the steadily declining labor force participation rates of men 65 and older from 46 percent in 1950 to 17 percent in 1998. For elderly women, the labor force participation rate has hovered around or slightly below 10 percent over virtually all of the period covered in the figure, but this is only part of the story. The declining labor force participation rates of older men reflected in the figure has certainly been affected by the increasing availability of retirement benefits over the period. But it also reflects the tastes of employers for getting older workers out of their operations at ages where they believe productivity levels decline. It reflects workers' tastes also. Increasingly there has been a perception in our society and that of other developed countries that workers should not have to work right up to the end of life.

Figure 5 shows that the retirement phenomenon also has reached further down into the age distribution as the participation rate of men aged 55 to 64 fell from 87 percent in 1950 to 68 percent in 1998. For women, the situation is significantly different. From 1950 to 1998, labor force participation among women aged 55 to 64 grew from 27 percent to 51 percent. Increases in the labor force participation of women between the ages of 55 and 64 almost exactly offset the declines in the rates of their male counterparts.

The balancing phenomena of increasing female labor force participation rates and declining rates of men for those between the ages of 55 and 64 cannot be expected to last indefinitely for reasons that can best be understood by considering Figure 6. The top and bottom lines in the figure show the 1950 labor force participation rates of men and women at various ages. For the prime working ages (25 to 55), there was a differential in the labor force participation rates of men and women in 1950 of 55 to 60 percentage points. Today, the differential in the labor force participation rates of men and women in their prime working ages is consistently about 15 percentage points, as shown by the middle lines in the figure. Over the last half century, labor force patterns of men and women have gone from being extremely divergent to being quite similar.

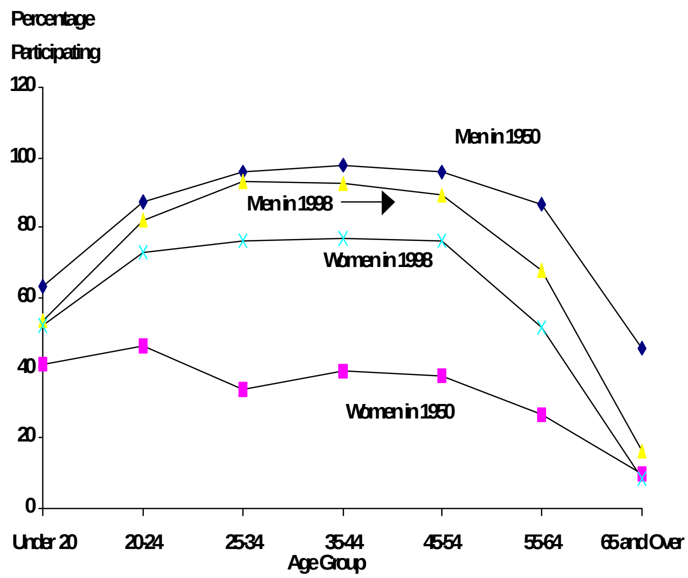
The increase in the labor force participation rates of women between the ages of 55 and 64 over the last half-century is merely part of the larger trend of generally increasing female labor force participation. As most women take on lifetime working careers that correspond closely with those of comparably aged men, however, they most likely will aspire to retirement patterns that parallel those of male workers. The larger point in this discussion is that there is a long-term pattern of full-career workers withdrawing from the workforce on an earlier and earlier basis. This means that earnings have been playing a diminishing role in providing for the needs of the elderly. It is possible that the trends that have been evolving over the past half century will be reversed as the baby boomers come to retirement age. However, given that many workers develop their retirement aspirations on the basis of being able to do as well or better than earlier generations, it is likely that the baby boomers will try to resist extended working lives much beyond the levels that prevail today.

The Need for Greater Retirement Saving and Ways to Achieve It

Figure 7 illustrates the rate of net national saving in the United States between 1951 and 1998 relative to gross domestic product. The “net” aspect refers to the fact that this is saving over and above what is necessary to offset depreciation due to the wear, tear, and obsolescence of the existing capital stock. The bars in the figure show personal saving, business saving, and government saving, while the line shows total net national saving relative to GDP. The line in the graph is simply the sum of the bars. To summarize, the net national savings rate in this economy was relatively stable during the 1950s and 1960s. It began to decline during the 1970s because of the fall-off in business saving and because the government sector began running significant deficits. During the 1980s the government deficits ballooned and during the second half of the decade personal saving fell significantly. We may be seeing a rebound in the national savings rate during the last half of the 1990s driven largely by the curtailment of government deficits and some increase in business saving. Despite the favorable news on government financing and business saving, personal savings rates remain at all time lows. Recently they have fallen below zero.

From Figure 7, it is apparent that all of the major components of saving have contributed to the decline in the national savings rate in the late 1980s and early 1990s. The largest single contributor to the falling national savings rate was the growth in government deficits since the early 1980s, deficits largely concentrated at the federal level. It was the large explosion of federal debt corresponding with the accumulation of the Social Security trust funds from the early 1980s until the last year or so that led many people to conclude that the trust fund build-up was not “saved” in any meaningful sense. If the federal government can sustain its recent surpluses, that would significantly increase the level of national saving as we move into the new millennium. There is widespread apprehension, however, that the baby boomers’ claim on government entitlement programs will once again throw the federal government into persistent deficit financing and place a tremendous drain on the national savings rate.

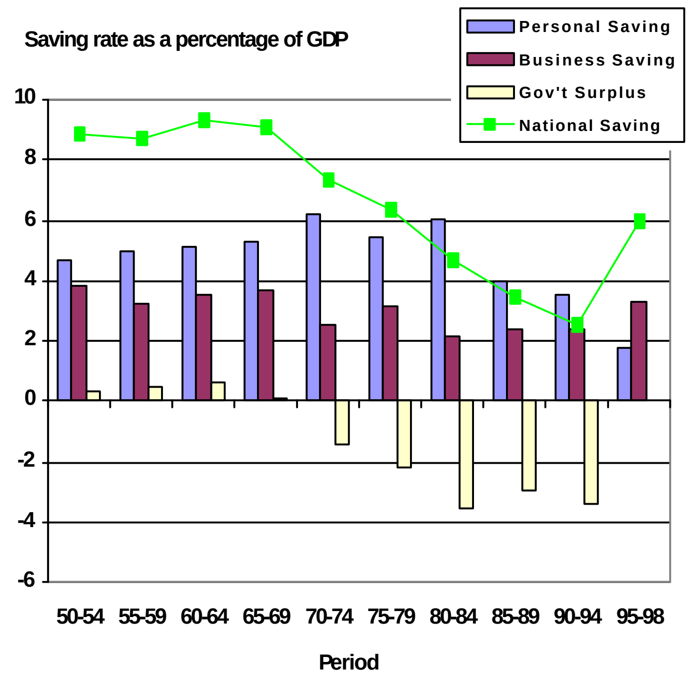
Figure 6: Labor Force Participation Rates for Men and Women at Various Ages in 1950 and 1998



Sources: U.S. Department of Labor, Bureau of Labor Statistics, ***Handbook of Labor Statistics*** (Washington, D.C.: U.S. Department of Labor, August 1989), Bulletin 2340, pp. 13, 14, 19, and 20, and ***Employment and Earnings*** (January 1999), p. 168.

The decline in personal saving has also been a major contributor to the low national savings rate in recent years. Interestingly, more than half of the decline in the personal savings rate in the United States since the early 1980s is attributable to declining employer contributions to retirement and savings plans.[8] The reason that employer contributions to these plans are considered to be personal saving is that the law requires that employer contributions to these plans be for the benefit of the participants in the plans. As discussed earlier, much of the decline in contributions to these plans can be directly linked to legal restrictions adopted since the mid-1980s limiting contributions to these plans. Private sector employer inflation-adjusted contributions to their pension and profit-sharing

Figure 7: Sectoral Saving and U.S. Net National Saving as a Percent of Gross Domestic Product, 1950 - 1998



Source: Calculated by the authors from the ***National Income and Product Accounts.***

plans in the early 1990s were about the same level they were in the early 1970s prior to the passage of ERISA. The per capita inflation-adjusted contributions were about the same level they were in the early 1960s before public policymakers became concerned about the employer funding of workers' pension benefits.[9] Declining employer contributions to their retirement plans has been paralleled by growing concerns about the long-term viability of the defined benefit pension system. Today, there is reason to believe that many defined benefit plans may not deliver the level of benefits that workers have been expecting from them.[10]

Making Social Insurance Programs Vehicles for Saving

The majority of the members of the Social Security Advisory Council that submitted its report to the President and Congress over two years ago thought that some additional funding of Social Security should occur. While they agreed that such additional funding should be done, they split on how to achieve it. As a member of that Council, Dr. Schieber advocated the establishment of Personal Security Accounts (PSAs) as the most likely way to do so. The reason that he advocated the PSA proposal is that he felt strongly that our accumulation of retirement wealth through this mandated basis of our overall retirement system has to contribute to the pool of real national wealth to a greater extent than it has in the past. But this raises the question of whether the government can become an accumulator of real savings to back our social insurance programs. The recent history of using Social Security trust fund accumulations to mask the magnitude of government imbalances in other government programs since the early 1980s is but one reason why he does not believe that the government can become a repository of such wealth. Another is the recurring debate since 1935 over whether Social Security should be funded and the repeated decision not to do so. Finally, there is a concern about the role of the federal government in this society and the implications of it becoming potentially the largest manager of private capital in the economy.[11]

Debating whether we should balance the federal budget on a cash basis, whether we choose to count Social Security or not, is misleading the American public about the true cost of government operations in general, and the expected cost of Social Security in particular. Social Security actuaries annually make 75-year projections of the program's expected operations. Over the past decade, the expected growth in Social Security's liabilities has outstripped the growth in current assets and anticipated revenues by roughly $3 trillion in present value terms. In 1994 alone, the actuaries increased their estimate of the unfunded liabilities by nearly $1 trillion. In other words, while the program ran a cash surplus of about $50 billion that year, it ran up tremendous unfunded obligations that future taxpayers are going to have to pay if we intend to meet the promises being held out in current law. That same year, the federal government's cash debt rose by roughly $200 billion, which garnered a great deal more attention than the much larger increases in unfunded statutory obligations that are not being accounted for on the government's books. Medicare's unfunded obligations increased by an even greater amount over the past decade than did Social Security's.

It is time that we start to accumulate assets to match some of the liabilities that we are accumulating in our social insurance programs. If we do so, such accumulations will become major engines of saving in our economy. If we cannot accumulate such wealth through the auspices of government operations, we should rearrange our programs so we can accomplish such saving outside of government. Reforms of this sort are sweeping across Latin America. Similar reforms have been adopted in a number of countries in the Australasian sphere of the world. They have been implemented in the United Kingdom and are being considered across other countries of Europe.

Some critics of proposals to have Social Security become an engine in creating national saving argue that this most basic social insurance program's other goals are too important to become encumbered in our need to increase national saving. The problem is that Social Security represents the largest single form of wealth accumulation for many workers in our economy. While it represents wealth as a major component of the retirement portfolio of many workers, its unfunded nature means that it does not bring comparable value in national saving. Social Security is simply too large to take off the table in considerations of national saving.

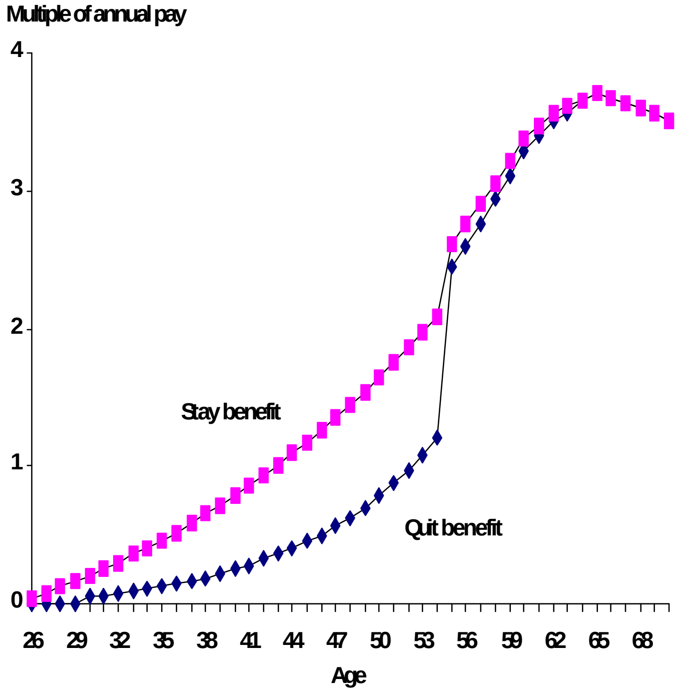
Getting Employer-Based Retirement Plans Back on Track

Most of the legislation adopted since the early 1980s that has limited the funding of private pension plans was motivated by the desire to reduce the federal government's persistent deficits. As we saw earlier, these deficits have been a serious part of our national saving problem, and we heartily endorse significant reductions in them. Governmental deficit reduction that is financed by reductions in personal saving, however, is unlikely to be effective as a means to increase national saving. The change in the funding limits for defined benefit plans under OBRA '87 had the effect of prohibiting employer contributions to 40 to 50 percent of the large pension plans in this country for some number of years. For many plans, the non-contribution period has extended up to the present time. It is highly unlikely that many individual workers undertook increases in their personal saving in order to offset the net effects of OBRA ' 87, slowing down employer contributions to pension plans and possibly jeopardizing the long-term security of the promises being held out to workers. If the slow-down in saving through the defined benefit pension system was not matched by an increase in personal saving, it had the effect of reducing our net savings rate during the younger years of the baby boomers' working career. In this case, we strongly suspect that the marginal reductions in the deficit that flowed through the lower deductions of pension contributions by business generated no more than $0.34 in federal deficit reduction for each $1.00 reduction in national saving. This is no way to increase national saving in the short term.

If we are concerned about the twin problems of low saving rates and retirement income security for the baby boom generation, it is time that we put employer-based retirement programs back to work dealing with both of them. In this regard, we offer a number of specific proposals.

First, further simplify the structure of plan limits. The impact of all the pension legislation passed over the last 15 years has not been fully understood by most policymakers. When OBRA '93 was under consideration, Dr. Schieber wrote a detailed letter to President Clinton and sent a copy to every member of Congress detailing his concerns about the pension provisions on the long-term funding of workers benefits. He received only two responses from members of Congress, both senators. One suggested that before Congress considered any serious pension legislation it would hold hearings and the public would be consulted. No such hearings were ever held. The other senator's response acknowledged Dr. Schieber's letter and assured him that the senator would vigorously oppose the increased taxation of Social Security benefits. Dr. Schieber's letter had nothing to do with Social

Figure 8: Comparison of Stay and Quit Values of Defined Benefit Pensions



Source: Watson Wyatt Worldwide.

Security and had not even mentioned the taxation of Social Security benefits.

If the regulation of employer-sponsored retirement plans may be difficult for policymakers to understand, it is often incomprehensible to the people who deal with these plans on a more intensive basis. No one disputes that our regulatory structure is complex, but there is much less agreement that the complexity is beneficial. For example, the range of limits that are imposed on plans results in significant redundancy. There are dollar limits on how much can be contributed to the plans each year. There are other rules that limit the percentage of a worker's pay that can be contributed to the plans. There are limits on how much of a worker's pay can be considered in the funding of retirement benefits. These limits on the amount of pay that can be considered are particularly onerous because they often limit benefits more for people with lower pay rates than they do for those at higher salary levels. There are rules that require that benefits be paid out of plans on a timely basis and excise taxes on benefits paid out in excess of amounts considered reasonable. There are simply too many limits. The world would be a better place if we could get rid of many of them.

In practical terms, most people with very high salary levels receive some sort of financial or tax planning as they go through life. A set of rules that would require timely distribution of accumulated retirement assets and excise taxes on benefits over some reasonable level could discourage excessive accumulations. Plans could be designed to keep highly compensated individuals from accumulating so much that they are subjected to the excise tax penalties. A reasonable set of distribution rules should eliminate the need for all of the other limits in the tax code and regulatory structure. Society would gain if we could eliminate these other rules because the deadweight loss of redundant compliance activity would be eliminated.

Second, funding biases between plan types should be eliminated. Figure 8 compares the two different concepts of pension value from the perspective of a worker. The bottom line in the figure shows the accumulated value of the benefit for a worker in a given plan on the basis that he or she would terminate employment in any particular year. The top line shows the accumulated value of the benefit for a worker in the same plan from the perspective that he or she would stay in the plan until eligible to retire. The difference in the two benefits is that if the worker stays, the pension benefit would be based on a higher salary than if he or she terminates some period of time prior to retirement eligibility. As discussed earlier, prior to OBRA '87, plan sponsors could fund their defined benefit plans on the basis of projected benefits. After OBRA '87, they could fund the lesser of projected benefits or 150 percent of current benefits. The projected benefit is the equivalent of the "stay benefit" in the graph while the current benefit is the equivalent of the "quit benefit." For younger workers, 150 percent of quit benefits is often less than 100 percent of stay benefits.

For employers with relatively immature pension plans or relatively young workforces, the effective funding constraint on them is 150 percent of current liabilities. These plans cannot fully fund benefits as they are being earned from the perspective of an ongoing plan. It does not make good policy sense to not let plan sponsors fully fund benefits if we expect them to continue to support their plans. In contrast to the defined benefit plans where we restrict sponsors from fully funding benefits in many cases, they do fully fund their obligations in the year in which the obligation occurs in their defined contribution plans. Employers concerned about accruing unfunded obligations would find the difference in the funding rules to be a powerful incentive to sponsor a defined contribution plan rather than a defined benefit plan. To the best of our knowledge, there has never been any public policy deliberation in Congress over this differential incentive toward the two types of plans. Without having discussed the differences, it is not clear why Congress has implemented such a policy.

Third, contrarian funding limits and PBGC premium policies should be reconciled. The earlier discussion focused on the effects of various tax measures in recent years on the funding of pension plans. It also indicated that the GATT legislation passed in 1994 and other legislation passed earlier instituted a system of variable premiums for plans on the basis of their funding status. We have now reached the anomalous situation that a plan can be funded such that the sponsor can obtain no more deductions for tax purposes, but the plan is deemed to be underfunded for purposes of determining PBGC premiums. The PBGC charges the sponsor of such a plan a penalty premium because they are deemed to be "underfunded" but the IRS would not let them deduct further contributions to their plan and would charge them an excise tax on such contributions if they actually made them. This inconsistency in pension policy and the duplicitous penalties that flow therefrom are resulting in considerable contempt for the public agencies regulating pensions and for lawmakers.

The governed in any society will always have some contempt for government's imposition of rules on its citizens. In this sense, it is possible that the contemporary state of pension law and regulation is not a particular threat to our civic organizations. The people sponsoring the plans that are being regulated in this case are business people. They are faced daily with the challenge of operating in highly competitive marketplaces and increasingly are forced to eliminate inefficiencies in their operations. The situation that arises for some employers of paying a penalty for either contributing or not contributing to their pension plans is an inefficiency that cries out for correction. We predict the correction that many plan sponsors will ultimately implement will be the termination of their plans. It may be worth keeping in mind that the sponsors of these plans have generally acted in good faith in establishing and maintaining the plans in the first place. It would be ironic that public policy aimed at securing the benefits in these plans actually led to their elimination in some cases.

Fourth, allow greater flexibility for individual retirement saving. While tax incentives have been extremely effective in encouraging the establishment of employer-sponsored retirement plans for many of our workers, we still have significant numbers of workers who cannot gain access to the incentives provided to others. In other cases, workers have access to the incentives, but periodically cannot take advantage of them because other contingencies or obligations prevent them from doing so. Both of these situations should be addressed.

Many workers cannot gain equal access to the incentives provided to workers with employer-sponsored plans because their employer will not sponsor a plan. Workers not covered by an employer plan can save through an IRA, but the $2,000 annual limit on pretax contributions renders these plans a poor cousin of the 401(k) where the contribution limit is $10,000 this year. It seems unfair that a worker is denied equal access to the tax incentive simply because his or her employer does not sponsor a retirement savings plan.

We recommend that wage and salary workers not covered by an employer-sponsored retirement plan receive a comparable ability to save under individual savings vehicles as workers covered by 401(k) plans. Individuals reporting self-employment income or losses would not be necessarily eligible for higher limits. If the self-employed worker were a sole proprietor, he or she can already invest through a Keogh plan. Self-employed individuals with other employees can set up a Simplified Employee Pension (SEP) or 401(k) plan for all of the members of their firm if they want to gain access to the tax incentives provided to employers through the tax code.

The second proposal relates to the fact that accounting periods are somewhat arbitrary and do not correspond neatly with the experiences of life. If a worker covered by a 401(k) plan cannot make a contribution in one year, the opportunity to make the contribution on a pretax basis is lost forever. Many things can happen to a worker that might preclude contributions in any particular year—e.g., layoffs, illness, other catastrophes, financing a child's education. It hardly seems fair that taking care of these kinds of economic demands should result in reduced retirement income. We recommend the creation of a carryover system so workers can make up for contributions not made in prior years. In some regards this is akin to the funding corridors that employers are allowed pursue with defined benefit plans—i.e., they do not have to make the maximum allowable contribution in each year. If it does not make sense to allow full lifetime carryovers, possibly they could be limited to five or 10 years. Under this proposal, the worker who could not make a pretax contribution in one year because of a layoff could make it up over the next couple of years. The worker who cannot make a pretax contribution while helping to finance a child's college, could make it up after the child graduated. If the administration of such a program is too complicated, then extra contribution room should be allowed for workers over age 50 or 55 to make up for periods earlier in typical workers' careers when they are not able to make full contributions to their retirement savings plans.

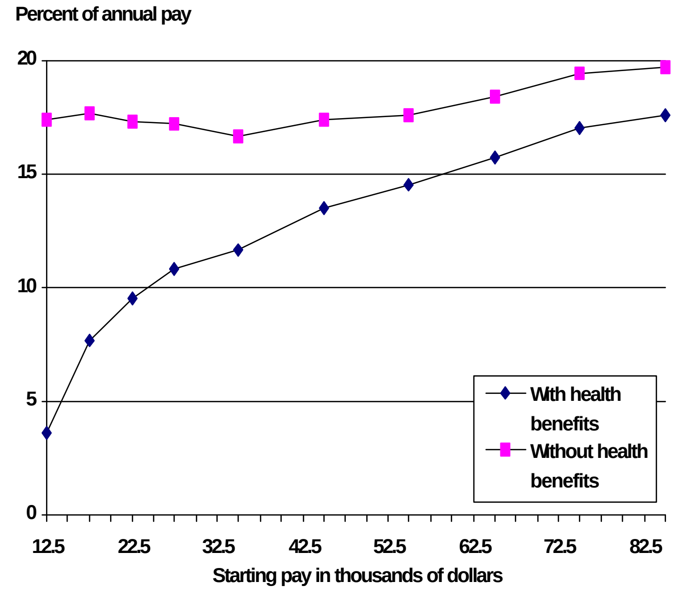
Fifth, allow for some funding for retiree health benefits. The debate over Medicare thus far falls far short of assuring benefits for the baby boom generation. The debate is instructive, however, because it gives us a clue of the direction that policymakers are looking in adjusting the program. The debate that has evolved over the past several years is over how much we will reduce the future stream of benefits provided by the program relative to current law, and how rapidly we will implement these cuts. At the same time that this debate is being carried on, we see many employers curtailing their commitments to their retiree health benefit programs. The curtailment of retiree health benefits by third-party payers for health services means that individual workers will have an increased obligation to fund these services on their own in the future. The increased obligation could be quite substantial.

Historically, the design of employer-sponsored retirement benefit programs focused on the necessary levels of retirement incomes that workers need in order to maintain their preretirement standards of living after retirement. In recent years, with the growth in voluntary contributory retirement programs—namely 401(k) and similar plans, employers have also come to focus on the necessary savings rates required of workers to accumulate adequate resources so workers can maintain their preretirement standards of living once they retire. This kind of analysis is instructive in helping to understand the potential implications of the curtailments to retiree health benefits that we believe we are facing.

Figure 9 shows the effects of having an employer-provided retiree health benefit compared to not having such a benefit. In this case we assumed that the worker would begin pension coverage and retirement accumulation at age 35 and would retire at age 60. We assumed he or she was covered by a pension plan that provided 1.5 percent of final salary at retirement. The only difference in the two cases is the provision of retiree health benefits. In developing the analysis we assumed that the general rate of inflation would be 4 percent per annum, that the worker's wages would grow at a rate of 5 percent per year, and that health premiums would increase at a rate of 6 percent. The results suggest that the lack of a retiree health benefit significantly increases the need for workers to save in order to purchase their own health insurance during retirement. It also suggests that the need for additional saving will have a much greater effect on lower wage workers than on those with higher levels of earned income. The reason is that we assumed all retirees would have to pay the same premium in retirement without regard to their preretirement wage levels. If we had used a higher rate of health cost inflation it would magnify the differences reflected in the figure.

If we expect that future retirees should provide for more of their own health insurance needs than do current retirees, we must expand their opportunities to save to meet these needs. This could be accomplished by setting up special Medical Security Accounts (MSAs) that would operate much like existing IRAs. It could also be accomplished by raising the dollar limits for contributions for IRAs, 401(k)s, or similar types of contributory retirement programs. Finally, it could be accomplished by letting employers prefund retiree health care benefits. The tax treatment of distributions from such accounts would need to be considered in the adoption of this proposal.

Figure 9: Target Saving Rates Required to Maintain Preretirement Standards of Living in Retirement under Alternative Retiree Health Benefit Coverage Scenarios



Source: Dan M. McGill, Kyle N. Brown, John J. Haley, and Sylvester J. Schieber, ***Fundamentals of Private Pensions*** (Philadelphia: University of Pennsylvania Press, 1996), Chapter 18.

Encouraging Individuals to Save on Their Own

Until now, many workers have been able to adequately prepare for retirement without the aid of sophisticated calculations by the economists and actuaries to tell them exactly how much they should be saving. But today's retirees spent their careers during a period when there was tremendous improvement in our Social Security and pension programs. We may be at the end of the era where the retirement programs in which workers participate perform comparably or steadily improve from one generation to the next. The problem that the baby boom generation is facing today is that various elements of the retirement income security system are not likely to perform for them in the same fashion that they have for the earlier generations of workers that they have been observing. Taking into consideration where they are in the wage spectrum, the baby boom workers may face earnings replacement rates from Social Security that are significantly below those that their parents have experienced. In addition, because of the future increased cost of pensions, many of the workers currently participating in defined benefit pension plans are likely to receive lower replacement of their preretirement wages from their pension than workers who are currently transitioning into retirement. Also, the gradual shift from noncontributory defined benefit plans to contributory defined contribution plans in recent years means that more of today's workers are personally responsible for their own retirement savings than earlier generations of workers were.

Given the relatively low personal savings rates that prevail in our economy today and the prospects that the baby boom workers could see a reduction in the level of benefits they will receive from organized retirement programs, now is the time to begin to alert the boomers that they have some options to control their own retirement destinies. In order to do so, however, they must increase their own personal savings rates immediately and sustain those higher rates until they retire. Expecting them to do so without communicating to them the sense of urgency for increased saving on their part will likely result in continuing low levels of personal and national saving, and ultimately in their failure to reach satisfactory retirement goals. Now would be an opportune time to undertake a variety of organized communication programs that will help to educate workers as to their personal responsibilities in saving for their retirement and their possible exposure for not doing so. Such communications programs should be carried out at two levels.

More vigorous communications by employers who are already sponsoring retirement savings programs would potentially enhance the effectiveness of those programs. Professor Robert Clark, an economist at North Carolina State University, and Dr. Schieber have been doing research into the relative effectiveness of communications programs versus higher matching employer contributions as a means to improve the participation in 401(k) plans.[12] They have found, for example, that moving from providing general information to a much more aggressive education program can be as effective in increasing participation in one of these plans as increasing the employer matching of employee contributions from 25 to 100 percent. While the two approaches are equally effective in improving participation, the communications program would be much cheaper. For the employer concerned about its employees' retirement security but not in a position to significantly increase the cost of benefits being offered workers, good communications may be the win-win approach to providing retirement benefits. Full employee participation in a plan that matches 25 percent of contributions up to 8 percent of pay can actually provide greater benefits at lower cost for an employer than a plan that matches 100 percent of 3 percent of pay.

Professor Douglas Bernheim, an economist at Stanford University, and a number of his colleagues have been doing somewhat different research, but also investigating the effects of workers' knowledge about savings issues and their savings levels.[13] The conclusions of their research are very comparable to those mentioned above. Professor Bernheim concludes that education programs are an effective means to improving savings rates among workers.

Employers sponsoring plans have already shown a commitment to the provision of saving opportunities for workers. In most cases, the employer sponsors of these savings plans are already communicating with workers periodically, urging them to take advantage of the tax incentives supporting these plans and the supplemental subsidies that are often available in the plans. Expanding such communications to be more specific about savings targets for workers at various points in the wage spectrum would improve workers' understanding of their role in preparing for retirement and increase the probability that they would come closer to meeting their retirement income targets by the age at which they wish to retire. Even if workers did not respond to the more specific savings goals such communications would provide, they would have a better understanding of the implications of failing to save than they do now.

In addition to increased and more effective communications at the individual employer plan level, we believe it is time to undertake a broad public information program encouraging personal saving. We believe that we are such a consumer-oriented society because of the way most of us gather information about the world around us and because of the content of much of that information. Just to the south of our nation's capitol lies the state of Virginia, a state with, among other points of historic interest: George Washington's home; Thomas Jefferson's home and the university he founded; plus some of the most important battle fields of the Civil War. It is ironic that the Potomac Mills Mall, an outlet mall just a few miles south of Washington, D.C., is more often visited than any of these attractions.[14] This mall has advertised on local television stations using the slogan that "shopping is therapy." In this kind of environment, it is hardly surprising that many of us fail to understand the importance of saving and our own role in doing it.

We have a long history of public service information programs in the United States that are developed and funded by government aimed at altering personal behaviors. If government advertising campaigns can be effective at increasing the prevalence of auto seat belt use or can reduce the incidence of smoking, then why couldn't a similar campaign begin to encourage more appropriate saving behavior on the part of baby boom workers? Television and radio have proven to be an extremely effective vehicle in influencing people's behavior in this country. Day in and day out, listeners are urged to buy cars, vacation cruises, beer, athletic equipment, and a wide range of other goods and services. If these media can be effective at altering ordinary consumers' behavior, then why not direct that power at the extremely important national goal of increasing saving? If the importance of personal saving were given some air time in the national media, then maybe the consumption-savings tradeoffs that workers have to make on a daily basis would become more reasonably balanced than they are today. The Labor Department has already begun a fledgling effort in this regard, but it needs to be aggressively and significantly expanded.

Letting Workers Phase into Retirement

Current pension regulations make it very difficult for an employer to allow a worker to partially retire prior to age 65. For all practical purposes, a worker wishing to phase into retirement gradually cannot receive a partial salary and a partial pension benefit at the same time. The gradual phasing into retirement is a growing phenomenon that is likely to increase as the baby boom begins the transition from their working years to their retirement years. If a worker wants to phase down and work half time it should be possible to receive half pay and also receive half a regular pension benefit. If this were possible, many workers might begin to spend down their pension entitlements more slowly than under current law. The longer we can keep workers' retirement savings from being dispersed, the more positive the effect on our national savings levels. Allowing phased retirement would be good social policy, good labor policy, and good macroeconomic policy.

Current Legislation to Foster Employer Plans

Both Congress and the Administration seem to understand that the revenue-driven cutbacks of the 1980s and 1990s and the ever-increasing complexity of the regulatory environment in which qualified plans operate have become barriers to new plan formation, especially among small businesses. Congress has attempted simplification many times in the past and hearings and staff analyses have long documented the complexities of the law in this area. Recently, for example, the Joint Committee on Taxation staff prepared "*Overview of Present-Law Tax Rules and Issues Relating to Employer-Sponsored Retirement Plans*" (JCX-16-99, March 22, 1999), as background materials for a Ways and Means Committee oversight hearing. That paper's summary of the rules for tax-qualified retirement plans illustrates the daunting task of compliance with the tax rules, while pointing out that the plans are also subject to regulation under the labor law provisions of Titles I and IV of ERISA.

The 106th Congress is currently considering three bipartisan pension bills intended to ease the regulatory burden on qualified plans. In the House, Representatives Rob Portman (R-Ohio) and Benjamin Cardin (D-MD) of the Ways and Means Committee have introduced the Comprehensive Retirement Security and Pension Reform Act (H.R. 1102), which is similar in many ways to legislation they proposed in 1998. The Senate has two bipartisan proposals before it: Senators Bob Graham (D-FL) and Charles Grassley (R-IA) have introduced the Pension Coverage and Portability Act (S. 741), the latest version of their legislation to ease the rules governing pension plans; and Finance Committee Chairman William Roth (R-DE) has cosponsored the Retirement Savings Opportunity Act (S. 649) with Democrat Max Baucus (MT). Numerous provisions of these three bills are contained in the tax measures passed by the House of Representatives and Senate in July 1999. In addition, Representative Richard Neal (D-MA) has introduced the Employee Pension Portability and Accountability Act (H.R. 1213), the pension portion of the Clinton Administration's fiscal year 2000 budget.

Though these legislative proposals differ in many ways, they share the recognition that Washington can and should make it easier for employers to offer their employees pension plans and other opportunities to save for their retirement. An extensive description and analysis of these bills and their differences goes well beyond the scope of this paper, but we have selected the following items as indications of current thinking.

Higher Limits

Proposals to increase limits on retirement saving take numerous forms. Most straightforward are those that simply raise existing dollar limits, such as increasing the amount an individual can defer in a 401(k) plan to $15,000 a year (from today's $10,000) or moving the defined benefit limit from $130,000 to, for example, $180,000 and the defined contribution limit from $30,000 to $45,000. Other proposals to permit greater retirement saving would increase the compensation base used in calculating benefits or contributions from today's level of $160,000 to either $200,000 or $235,000.

Another type of proposal to increase the amount an individual can save in a retirement plan would change the percentage of an individual's compensation that can be put into a defined contribution plan from 25 percent of pay to 100 percent. This would have the effect, for example, of permitting a second earner who has been out of the workforce for a while to devote as much as possible to catching up on forgone saving opportunities. Similarly, proposals to permit "catch-up" contributions of as much as $5,000 a year for people over 50 are intended to encourage older workers who have not saved enough to remedy that situation before they reach retirement age. The likely success of such a measure in actually increasing retirement saving may ultimately rest on whether those amounts are exempted from other restrictions on contributions, such as discrimination testing.

Discrimination Testing

Few would argue against the principle of spreading the tax advantages of qualified plans to workers at all income levels. But as the so-called nondiscrimination rules have evolved over the past two decades, they have become a major administrative problem and therefore a significant deterrent to plan sponsorship. Even Congressional attempts to make discrimination testing optional through the establishment of "safe harbor" arrangements ends up creating yet another set of alternative rules to meet in order to be protected in the safe harbor.

One item in the legislative proposals before Congress would simplify the discrimination testing of 401(k) plans by repealing the so-called "multiple-use test" that currently allows one of the ways to pass the nondiscrimination test to be used either on employee deferrals or on the employer match and after-tax contributions, but not both. Repealing this restriction would not only simplify the burden of testing, but would also allow some employees to make marginally higher savings.

Top-Heavy Relief

Rules designed in the early 1980s to prevent small business owners from designing pension plans primarily to benefit themselves (not the rank and file) require that plans where a significant portion of the benefit belongs to key employees must give quite generous minimum benefits to non-key employees. These so-called top-heavy rules generally are no longer so necessary because so many more discrimination and anti-abuse rules have been added since that time. Thus, the current Congress is considering modifying these rules to minimize their negative effect on plan formation among small business owners. For example, the Portman/Cardin bill proposes that if a defined benefit plan is frozen so that no key employees are earning a benefit, there would be no requirement that non-key employees earn a minimum benefit. Also, in determining whether a plan is top-heavy, employers could apply the test based only on benefits earned in the preceding year (not benefits from all previous years, as now required). This last proposal should significantly reduce the number of plans subject to the top-heavy minimum requirements and therefore make the rules much less onerous overall.

Administrative Simplification for Small Plans

Recognizing the barriers created by administrative burdens, Congress established "Savings Incentive Match Plans for Employees" (SIMPLE) plans. These defined contribution plans for small employers, those with no more than 100 workers earning at least $5,000 in the preceding year. Amounts contributed to SIMPLE plans are limited to no more than $6,000 (indexed), and employers must make matching or nonelective contributions according to given formulas. A SIMPLE plan can take the form of an IRA or 401(k) plan, but in either case it must be the employer's only qualified retirement plan, and it must meet certain vesting rules, as well as contribution requirements. In exchange for meeting these standards, eligible employers enjoy greatly simplified rules. If established in IRA form, a SIMPLE plan is not subject to the nondiscrimination rules (including top-heavy) and simplified reporting requirements apply. If established as part of a 401(k) plan, the SIMPLE does not have to satisfy the special 401(k) nondiscrimination tests and is not subject to the top-heavy rules.

Now members of both parties in Congress are proposing a simplified defined benefit plan, dubbed SAFE. For example, the Graham-Grassley Secure Assets for Employees proposal would provide a guaranteed minimum benefit, as elected by the employer, equal to 1, 2, or 3 percent of employee's compensation for each year of service, plus a higher benefit if investment returns exceed conservative (specified) assumptions. As with SIMPLE plans, eligible employers cannot maintain another plan. Sponsors would not have to pay PBGC premiums, and in time of hardship, an employer could reduce benefits. For small employers who would find the defined benefit structure more appealing than the defined contribution architecture (to allow for up to 10 years of past service credits, for example), the SAFE plan's simplified administration and lack of PBGC premiums could be the deciding factor in whether to offer pension coverage.

PBGC Premium Relief for New Plans of Small Employers

In addition to the proposal to exempt SAFE plans from PBGC premiums, other legislation would grant premium relief to small employers. Both the Administration and the Portman/Cardin bill, for example, suggest that a new defined benefit plan adopted by a small employer would only pay an annual premium of $5 a year for the first five years. By contrast, current law requires defined benefit plans to pay a flat annual premium of $19, plus a variable premium based on their funding status. As with the SAFE proposal, this difference could be enough incentive to encourage some employers to take the leap into pension sponsorship.

Tax Credits for Small Employers

Addressing yet another barrier to plan formation, several of the bills also propose tax credits as an incentive for small businesses to establish plans. The Roth/Baucus bill, for instance would offer a nonrefundable tax credit of up to $500 to small businesses (with up to 100 employees) to defray the administrative costs of establishing a new retirement plan. The credit would be available for the first three years of operation of the plan. In addition, a nonrefundable tax credit equal to 50 percent of employer contributions made on behalf of non-highly compensated employees would be available to small businesses with 50 or fewer employees during the first five years of a plan's operation (up to 3 percent of compensation). So for employers who have declined to establish plans not only because of their complexity but also because of cost, legislation now in front of Congress could lower these obstacles significantly.

Portability

Simplifying and clarifying the rules under which current and ex-employees can combine their retirement savings into a single plan or IRA could pave the way for more coverage. In addition, such a move would help individuals understand their savings needs as they could better monitor their retirement accumulation as it builds in one place. Acknowledging the awkwardness of today's rules, several current bills would improve opportunities for portability:

- Distributions from various types of plans could be rolled over into plans of another type, as well as IRAs. For example, 401(k) plan distributions could be moved to a 403(b) arrangement—a tax sheltered annuity—or a section 457 deferred compensation plan, which is not possible under current law. Rules for withholding, reporting, and so forth would be more evenly applied across the types of plans.

- After-tax contributions could be rolled over into an IRA but not other retirement plans, in most recent versions.

- To encourage employers to accept rollovers from previous employer' plans, amounts rolled over by a participant into a plan would not count in determining whether a terminated participant's benefit is no more than $5,000—and thus can be cashed out without the participant's consent.

Minimum Distribution Relief

One of the most unpopular restrictions from the reforms of the mid-1980s was the requirement that individuals begin drawing down their retirement benefits when they turn 70 ½—or, more precisely, by April 1 of the following year. The idea was to prevent people from using the tax deferral of pension plans to pass along significant estates to their heirs. That provision has been cut back so that it now applies only to individuals who own 5 percent or more of a company. For others, minimum distribution must begin by April 1 of the year following *the later of* the year the individual becomes 70 ½ or the calendar year the employee retires. Thus, most people can delay benefit distribution at least until they retire. There have been numerous recent proposals to further rein in the minimum distribution rules. In the last Congress, for example, Reps. Portman and Cardin proposed moving the age to 75 and exempting the first $300,000 of retirement savings from the minimum distribution rules. Because of the significant estimated federal revenue loss this would imply, the current Portman/Cardin proposal leaves the age at 70 ½ and would exempt only the first $100,000. While it is hard to argue for keeping the rules as they are, providing an exemption for $100,000 could add another layer of administrative complexity and added computations.

150 Percent Funding Limit

As discussed earlier, the 150-percent-of-current-liabilities full funding limit restricts employers with relatively immature pension plans or relatively young workforces from fully funding their benefit promises as they are being earned. Recognizing this problem after several years, Congress included an item in the Taxpayer Relief Act of 1997 that lessened the effect of this limit by increasing it to 155 percent in 1999 and gradually to 170 percent for 2005 and thereafter. Both the Portman/Cardin and Graham/Grassley bills would phase out the limit more quickly and completely repeal it for plan years beginning after 2002. At that time, only the funding limit based on 100 percent of projected benefits would apply, as was the case before the enactment of OBRA '87. The faster phaseout of the 150 percent limit may do little to stimulate new plan formation, but it will surely improve retirement security for those who already have retirement plans.

Roth 401(k)s

One problem with increasing retirement savings under traditional qualified plans or IRAs has been the immediate revenue loss to the federal government. To encourage more saving without a negative impact during the five- or 10-year period Congress looks at during its budgeting, Roth IRAs were established, taking effect in 1998. These vehicles allow people within certain income limits to save $2,000 in *after-tax* dollars—i.e., they receive no current-year tax deduction—but do not pay taxes on the earnings when withdrawn. Anecdotal reports that this legislation has been very successful in stimulating IRAs has led to consideration of extending the concept to the employer plan arena. The Roth/Baucus legislation proposes that participants in 401(k) plans and 403(b) plans be given the opportunity to contribute to these plans on an after-tax basis, with the earnings on such contributions being tax-free when distributed, like the Roth IRA. More than the maximum Roth IRA contribution amount could be contributed under this option; employees would be limited to the maximum 401(k) or 403(b) amount, and regular plan distribution rules (rather than Roth IRA distribution rules) would apply. Though this proposal may not stimulate the formulation of many new plans, revenue estimators project that it will generate tax revenues in the near future, thereby helping to "pay for" other proposals that reduce tax revenues as they stimulate retirement saving.

But Watch Out

Even while the dominant pension proposals in Congress are aimed at encouraging plan formation and retirement saving, legislation that will significantly burden pension plans is also pending. The most troublesome to plan sponsors is a proposal by Senator Daniel Patrick Moynihan (D-NY), S. 659 in the Senate, and by Representative Jerry Weller (R-IL), H.R. 1176, known as the Pension Right to Know Act. This legislation would require companies who convert from one pension plan to another in a way that significantly reduces future accruals for some workers not only to notify participants of the changes but also to show them detailed calculations of how their individual benefits would be affected. Such calculations—20 separate items for each individual—are very expensive to produce on an individual basis and can be quite misleading for participants.

The intent of the Pension Right to Know Act is laudable—to make sure employees know how the pension change will affect them and therefore to encourage employers to make only changes that would be acceptable to employees who understand them. In particular, the legislation is aimed at companies that convert from traditional final-pay pension plans to hybrid plans, such as cash balance plans or Pension Equity Plans, in which the pattern of benefit accruals shifts so that younger workers earn benefits faster than under the prior plan, and older workers earn them more slowly than under the prior plan. As written, though, the legislative language is currently so broad that other pension plan changes would be affected as well.

Some of the problems with the legislation are technical. For example, the disclosure would have to occur before the plan amendments are formally adopted, which is virtually impossible since data on individual accrued benefits is not available in advance—benefits could only be estimated, not calculated exactly. But a far more important consideration from the point of view of stimulating plan formation is the possibility of significant new pension regulation added onto the already burdensome and complex rules that Congress is itself trying to simplify. The seriousness with which this legislation is being received on Capitol Hill certainly should give potential future plan sponsors pause, and definitely sends a mixed message about encouraging plan formation.

Conclusions

All of the elements of the retirement system need to be shored up as we anticipate the claims the baby boomers will make beginning in the next decade. The choice we face if we address these issues now is whether to adopt options that contribute to national saving or ones that will simply place greater burdens on future workers. Improving national saving is vitally important because it has the potential to raise worker productivity over time. If future workers can work in a more productive economy, the burden of financing the consumption needs of an enlarged retiree population will be ameliorated.

Social Security as the base of our retirement system is underfunded and that problem should be addressed sooner rather than later. Some options for doing so would potentially improve the level of saving in the economy and those should be considered carefully. In the case of employer-sponsored pension plans, most of the policy initiatives undertaken during the last two decades have led to restricted saving through these plans. The long-term implication of this result is that plan sponsors are either going to face higher contribution costs in the future than if they had been allowed to contribute to their plans at historical rates, or they will curtail benefits. The potential curtailing of benefits from employer-sponsored plans is a direct threat to the retirement security of today's workers. The current structure of the retirement system leaves some part of the responsibility for acquiring adequate resources to meet retirement needs with workers themselves. Some workers are undoubtedly saving at rates that will allow them to maintain their preretirement living standards after they quit working, but many are not. For those who reach the age that we generally think of as retirement age without adequate resources, the only options are an extended work career or a reduced standard of living in retirement. Given historical working patterns, we are not at all sanguine that extended working careers will be the automatic solution to America's aging challenges that some policymakers assume.

We strongly believe that the time has come for America to begin to change its attitude towards saving. It is imperative that we begin to communicate more effectively to workers the importance and necessity of saving for retirement. Employers should be encouraged to expand existing communications efforts. The government should implement a public service communications program so everyone understands their own responsibility in preparing for retirement and the advantages of doing so through employer-sponsored plans when they are available.

In the case of employer-sponsored plans, we advocate further simplification of the multiple funding and contribution limits to which plans are subject. The funding biases that have made defined benefit plan sponsorship less attractive should be eliminated. The inconsistencies in public policy that result in tax penalties for overfunding, on the one hand, and PBGC penalties for under funding, on the other, should be resolved. Although we are strong advocates of employer-sponsored plans and their expanded availability, we recognize that not everyone has an opportunity to participate in such a plan. For such workers, the playing field should be leveled so they can effectively save on their own through tax-preferred retirement plans. Current law does not allow for the widespread effective funding of retiree health benefits. Given the problems that Medicare is facing and the potential catastrophe of a growing uninsured retiree population, now is the time to reconsider the availability of effective vehicles for workers to fund this vital need during their working careers. Finally, now is the time to reconsider the rules controlling the payment of pension benefits for workers who might want to phase gradually out of their career jobs into retirement. We believe this is a phenomenon that is in the interest of employers and employees alike and current public policy is more a roadblock than catalyst to such desirable opportunities. Fortunately, legislation with broad bipartisan support addresses many of these problems and should be acted upon by Congress in an expedited fashion.

Time is of the essence in the deliberations on the matters raised here. It takes time to acquire the assets needed to provide retirement security. The time the baby boomers have left to save is short. Compound interest on retirement saving is a magnificent phenomenon, but it takes time to gain traction. The leading edge of the baby boom generation is now turning age 53. Those on the trailing edge have another 20 years to prepare. They have better opportunities than their elder counterparts in the baby boom generation, but only marginally so. Each year that we waste is one that creates a double risk for society. One risk is that we will see massive numbers of older Americans with inadequate incomes after the turn of the century. The other is that the older segment of society will be so large that it will be able to force its political will on workers by substituting taxing claims for those that can be won through higher productivity from saving. If the latter is the approach we take, we run the risk of realizing an age class conflict that policymakers will have little power to resolve.

End Notes

1 The excise tax is reduced to 20 percent under any one of the following three conditions: **Bankruptcy**: The plan sponsor is under Chapter 7 or Chapter 11 bankruptcy proceedings. **Transfer to replacement plan**: The plan must cover at least 95 percent of the participants in the original plan. **Pro rata increase**: The employer provides a pro rata increase to participants of at least 20 percent of the reversion amount.

2 Ellen E. Schultz, "Joy of Overfunding, Companies Reap a Gain Off Fat Pension Plans: Fattened Earnings," *Wall Street Journal* (June 15, 1999), p. A1.

3 For a discussion of this phenomenon, see Steven G. Allen, Robert L. Clark, and Sylvester J. Schieber, "Have Jobs Become Less Stable in the 1990s? Evidence from Employer Data," paper presented at "Changes in Job Stability and Job Security," a conference sponsored by the Russell Sage Foundation, New York, New York, February, 1998.

4 Sylvester J. Schieber and John B. Shoven, "The Consequences of Population Aging on Private Pension Fund Saving and Asset Markets" (Cambridge, Mass.: National Bureau of Economic Research, Inc., 1993), Working Paper No. 4665.

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8 Barry Bosworth, Gary Burtless, and John Sabelhaus, "The Decline in Saving Evidence from Household Surveys, ***Brookings Papers on Economic Activity*** (1991), no. 1, pp. 183-254.

9 Sylvester J. Schieber and Laurene Graig, ***The Sleeping Giant Awakens, Retirement Income Policy in the 21st Century*** (Washington, D.C.: Watson Wyatt Worldwide, 1995).

10 Sylvester J. Schieber and John B. Shoven, "The Consequences of Population Aging on Private Pension Fund Saving and Asset Markets" (Cambridge, Mass.: National Bureau of Economic Research, Inc., 1993), Working Paper No. 4665.

11 For a full elaboration of these issues, see Sylvester J. Schieber and John B. Shoven, *The Real Deal: The History and Future of Social Security* (New Haven: Yale University Press, 1999).

12 Robert L. Clark and Sylvester J. Schieber, "Factors Affecting Participation Rates and Contribution Levels in 401(k) Plans," in Olivia S. Mitchell and Sylvester J. Schieber, eds., ***Living with Defined Contribution Plans*** (Philadelphia: University of Pennsylvania Press, 1997).

13 Douglas B. Bernheim, "Personal Saving, Information, and Economic Literacy: New Directions for Public Policy," in ***Tax Policy for Economic Growth in the 1990s*** (Washington, D.C.; Amercian Council for Capital Formation Center for Policy Research, 1994), pp. 53-78; Douglas B. Bernheim, "Do Households Appreciate Their Financial Vulnerabilities? An Analysis of Actions, Perceptions, and Public Policy," in ***Tax Policy and Economic Growth*** (Washington, D.C.; American Council for Capital Formation Center for Policy Research, 1995), pp. 1-30; and Douglas B. Bernheim and Daniel M. Garrett, "The Determinants and Consequences of financial Education in the Workplace: Evidence from a Survey of Households," a paper developed under grants from the Smith-Richardson Foundation and the National Science Foundation, August 1995.

14 Virginia Tourism Corporation, 1997 Virginia Visitors Study.