Looking to the Future

A New Perspective on the Social Security Problem
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The pressing need for Social Security reform assumed a prominent place in America’s policy debates in recent years. Yet, in an unfortunate turn of events, this important issue recently took a precipitous drop from the top of the nation’s policy agenda.

However, assuring the retirement security of America’s workers cannot be deferred indefinitely. APPWP, as a public policy organization representing principally Fortune 500 companies and other organizations assisting employers of all sizes in providing benefits to employees, remains concerned that practical resolutions to the funding issues faced by this vital government program have yet to be implemented. Collectively, APPWP’s members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans — plans and individuals that would be directly and indirectly affected by many of the changes required to right the Social Security system.

Social Security is a massive program that has developed over decades. Today’s long-term financing problems present a series of difficult policy trade-offs. As a result, proposals to modify the system necessarily require the careful consideration of a host of issues. Some of those trade-offs and issues are controversial, even among members of APPWP. Others are admittedly beyond the direct expertise of our membership. But many directly impact the retirement and other benefit plans currently sponsored and administered by APPWP members. The recommendations made herein focus on those critical issues where the experience of APPWP’s members can assist policy makers in making wise decisions in devising a national retirement policy.

While a comprehensive Social Security solution will require the input of a wide range of stakeholders, we hope APPWP’s recommendations will help to reignite the public policy debate on Social Security reform. As more fully outlined below, we emphasize that prompt action to address the financial difficulties facing Social Security is important and that such action should be taken in the context of a coordinated national policy incorporating retirement savings as a whole. Social Security reforms that adversely affect savings outside the Social Security system should be avoided. Moreover, changes should include improvements in each of the three components of retirement savings — Social Security, employment-based plans, and private savings.

James A. Klein, President
APPWP
March 2000
Regarding Social Security Reform

More than 50 bills relating to Social Security reform were introduced during the first session of the 106th Congress. But, as of this writing, no fixed program of repair appears in sight. The early promise of Congressional and Presidential commitment to Social Security reform has all but dissolved. And without some renovation, the Social Security system could begin its downward lurch toward insolvency within the next 15 years.

The slow weakening of this vital element of the retirement “three-legged stool” will have extreme impact on the two other supporting pillars: employer-sponsored retirement plans and personal savings. Their interconnectedness cannot be ignored, and any proposal to reform Social Security must address the private retirement system and personal savings as part of a comprehensive national retirement policy.

APPWP provides in this paper a discussion of the Social Security reform ideas currently under consideration by policymakers and their probable effect upon America’s private employer-sponsored retirement system. We affirm that rapid change is needed to rectify the federal system and to enable the private employer-sponsored pension system to assist workers in strengthening the foundations upon which their individual retirement security depends.

On the following pages, APPWP offers our views on:

- The general principles that should guide any Social Security reform effort;
- Proposals changing Social Security’s financing structure;
- Proposals affecting the benefits paid by the Social Security System; and
- New investment approaches for Social Security Trust Fund assets.

Of note, this paper also urges that Social Security reform be accompanied by changes to the employment-based retirement system to:

- Improve savings incentives in workplace retirement plans;
- Simplify and make more flexible the current maze of pension rules and regulations;
• Revise current pension law and regulations to facilitate phased and partial retirement for those employees who wish to collect some retirement benefits while they continue working on a reduced schedule; and

• Implement federal policies to encourage employers to provide retiree health coverage and to help Americans prepare for long-term care expenses.

We hope this paper not only provides some insight into current reform proposals but also encourages the debate to be framed in terms of comprehensive retirement income security. Such an approach, rather than recent piecemeal and narrow efforts, would be closer to the original vision accompanying Social Security’s enactment more than 60 years ago.

This paper was developed by the members of APPWP’s Retirement and Investment Policy Committee, chaired by Howard Weizmann of Watson Wyatt Worldwide. Randy Hardock, Partner, Davis & Harman, Washington, DC, undertook a considerable portion of the drafting on behalf of the committee. APPWP and its members are now looking to the second session of the 106th Congress as an opportunity for real and substantial Social Security and pension reform — proposals such as those described on the following pages.
I. General Issues

Is the financial stability of the Social Security system important to employment-based retirement plans?

Yes. Retirement savings in America has historically rested on three pillars — Social Security, the employment-based retirement system, and individual savings. The mandated Social Security program has historically provided a minimum financial safety net for the vast majority of Americans. Voluntary employment-based retirement plans (encouraged through our tax system) have been the backbone of our nation’s savings effort, supplementing the basic Social Security safety net, particularly for middle income Americans. Finally, individual savings have, at least partially, served to fill in remaining gaps.

These three pillars of retirement savings — sometimes called the three-legged retirement stool (See Figure 1) — are intentionally and necessarily intertwined. As a result, changes in the Social Security system must be examined with an eye toward the impact on the other pillars of retirement savings.

Is reform of the Social Security system needed?

Yes. The long-range financial instability of the Social Security system is well-documented and poses a long-term concern for the retirement security and economic well-being of all Americans. (See, e.g., Figures 2 and 3.)

When should Social Security reforms be enacted and implemented?

Expeditious efforts to improve the financial integrity of, and public confidence in, the Social Security program are important. Delay will only serve to increase the difficulty of achieving the needed program changes. Changes to the system should, however, generally be implemented gradually in order to allow adequate time for individuals and employers to make adjustments to their retirement arrangements.

What should be the main goal of Social Security reform?

Changes in the Social Security system must be part of a cohesive national retirement policy aimed at

1. shoring up the Social Security system; and
2. ensuring that every American has the meaningful opportunity to save adequately for a financially secure retirement.
Figure 2: Projections of Old-Age and Survivors Insurance (OASI) Covered Workers and Beneficiaries, 1996-2070

Projections:

- Optimistic
- Intermediate
- Pessimistic
What principles should govern consideration of Social Security reform proposals?

First, in strengthening Social Security financially there should be a commitment to a long-term balancing of inflows and outflows. In other words, the system should not create an expectation of benefits that is not fiscally achievable. This, in turn, means the Social Security system should provide a reasonable and sustainable level of benefits — a level of benefits that individuals and employers know will actually be paid.

Second, Social Security reform must not harm existing retirement saving incentives and structures. Any attempt to “fix” Social Security, without also considering the impact of Social Security reforms on other savings programs, especially the successful employment-based retirement savings system, would be short-sighted and, most likely, counterproductive.

Third, changes in the Social Security system should be accompanied by corresponding improvements in incentives to save outside the Social Security system. It is highly unlikely that a fiscally balanced Social Security program will yield sufficient benefits, by itself, to provide an adequate income replacement in retirement for most Americans. Nor will those Social Security benefits compensate for the reality that most Americans have fallen behind in the level of savings that is needed for a financially secure retirement. (See Figure 4.)
As stated above, Social Security reform (no matter how well-constructed) could prove futile if an attempt is made to solve Social Security’s financial problems without also simultaneously strengthening the other components of retirement security in America.

In particular, it is imperative that savings under the proven employment-based retirement system be bolstered through enhanced opportunities for retirement savings and the removal of excessively complex, cumbersome, and costly legal requirements. Over the last half century, voluntary employment-based retirement plans have matured into one of our nation’s most effective economic systems, helping to meet a range of critical needs. This system provides economic security for millions of retirees and helps lay the foundation for the retirement security of current workers. Moreover, the employment-based retirement system has created America’s most reliable pool of investment capital. This capital comes from long-term investors and is critical to financing the economic growth that will help ensure future increases in the standard of living and in real wages.

Streamlining the rules applicable to employment-based plans and enhancing the financial incentives to establish and maintain such plans will lead more employers to establish and expand these important retirement security and economic engines.

What avenues should be explored in achieving improved retirement security?

Achieving meaningful improvements in the retirement security of Americans in the next century will require meaningful changes in Social Security and the employment-based retirement system, as well as a reexamination of the incentives for private savings by individuals.
With respect to Social Security, the financial integrity of the Social Security system can be accomplished through three possible types of changes — reductions in benefits, enhancements in financing, and improved investment performance on amounts within the Old Age, Survivors, and Disability Insurance (OASDI) portfolio of investments. All three types of possible changes warrant careful consideration. Specific changes, however, should be analyzed in the context of the general principles discussed above.4

Improving the retirement plan and individual savings components of retirement security requires a focus on proposals that will help to enhance the incentives and opportunities for Americans to save. In the area of employment-based plans, for example, the last few decades have seen excessive and unnecessarily complex laws, stifling government regulation, and policy changes driven by short-range federal budget policy. Individual retirement savings programs suffer under similarly excessive complexity, which has also stemmed from revenue driven legislative decisions. The cumulative effect of decades of adding layer upon layer of legislation, regulations, rulings, advisory opinions and other “guidance” has been to inhibit retirement savings.

The changes recommended herein would improve the effectiveness of the employment-based retirement savings system by enhancing the attractiveness of retirement plans for employers of all sizes, removing unnecessary impediments to plan sponsorship and maintenance, and enhancing retirement benefit security.

No single solution is likely to successfully address Social Security’s financial problems or America’s general retirement savings shortfall. A combination of proposals will clearly be necessary to successfully address these complex issues. However, implementing our recommendations would take America a long way toward the goal of ensuring adequate retirement income for all Americans.

The cumulative effect of decades of adding layer upon layer of legislation, regulations, rulings, advisory opinions and other “guidance” has been to inhibit retirement savings.
II. Changes in the Social Security Financing Structure

Should payroll tax increases be used to help bolster the Social Security system’s finances?

No. Neither the OASDI payroll tax rate nor the OASDI wage base (as currently indexed for inflation) should be changed. Increases in payroll taxes would cause distortions in labor markets and would have a negative influence on job creation. Moreover, current payroll tax increases could create the illusion that the Social Security system’s financial problems have been solved, even if the revenue from those tax increases is spent by the federal government for non-Social Security purposes.

Should other taxes be considered to help bolster the Social Security system’s finances?

Additional taxes on Social Security benefits should not be imposed, although simplification of the complex rules governing the taxation of Social Security benefits should be considered. Proposals that increase federal tax receipts by imposing limits on savings through employment-based retirement plans would be counterproductive and should likewise be rejected.
Figure 5: Americans Age 65 and Over: Past, Present and Future^5

III. Changes in Existing Social Security Benefits

What are the implications of a reduction in Social Security benefits for employment-based retirement plans that integrate benefits with Social Security?

Achieving a meaningful level of retirement security involves ensuring an adequate replacement of income during retirement. All employment-based plans assume the existence of the Social Security benefits currently provided. Most plans are designed to ensure that long-service employees have the ability to continue to receive a reasonable percentage of their employment income after they retire.

Any changes in the Social Security benefit structure, especially any substantial reductions in benefits that go into effect relatively quickly, could have a profound negative impact on the ability of employment-based plans to ensure that the retirement needs of workers are adequately met.

In addition, many plans are specifically designed (or integrated) around the Social Security system. (As of 1997, about 60 percent of defined benefit plans offered by large employers are integrated with Social Security. ^6)

This integration of benefits is an appropriate and critical element of a national retirement income policy designed to provide employers the flexibility to tailor their employee retirement plans in a manner that allows for adequate replacement of pre-retirement income, taking Social Security into account.

Many employment-based retirement plans are specifically designed around the Social Security System.
Changes in the benefits provided under Social Security (e.g., changes in retirement age or the benefit formula) could have a direct impact on employment-based plans that link benefits to Social Security. Employment-based plans should be allowed to maintain current levels of integration with Social Security and any indirect impact of Social Security reform on plans should be alleviated through appropriate changes in the rules governing permitted integration of benefits. In an increasingly competitive world marketplace, the ability of employers to absorb increased costs is limited.

Should the Social Security retirement age be increased?

If a decision is made to increase the Social Security normal retirement age, it should be implemented gradually to ensure that the expectations of those currently approaching retirement are fairly satisfied.

On the one hand, one of the underlying demographic reasons for America’s long-range retirement savings shortfall is the fact that Americans are living longer. For many, but not necessarily all individuals, this means that delayed retirement could be a reasonable alternative.

On the other hand, change in the Social Security normal retirement age should not include a corresponding increase in the Social Security early retirement age. To the contrary, maintaining reasonable flexibility to accommodate early retirement has significant advantages (particularly if the Social Security benefit payable is actuarially reduced to reflect the early retirement and therefore does not create an incentive to retire early).

Also, increasing the eligibility age for Social Security early retirement benefits may lead to increased claims under both the Social Security
Security Disability Income program and private sector disability income plans. These increased claims could offset some of the financial benefits associated with increasing the normal retirement age.

Similarly, it is critical that decisions regarding the appropriate Social Security normal retirement age be decoupled from the age used for determining Medicare eligibility. The policies underlying the two programs are different and a single normal retirement age under both will not necessarily be appropriate.

Social Security old age benefits provide an income stream and can be fairly adjusted to reflect early retirement. This allows the system to build in a level of flexibility for individuals regarding the timing of their retirement. That type of flexibility is more difficult to accommodate with respect to Medicare eligibility — a program that has historically been provided fully to all individuals who have attained the official eligibility age.

What are the implications of an increase in the Social Security retirement age on benefits provided in employment-based plans?

If there is an increase in the Social Security retirement age, it is critical that such change be accompanied by changes in law that clearly provide that employers are allowed (but not required) to amend their retirement plans to include a retirement age consistent with the revised age used for the Social Security system.

Moreover, an increase in the Social Security retirement age would increase the need for changes in the current rules that limit employer flexibility in offering opportunities to workers to accept early retirement.

Similarly, an increase in the Social Security
retirement age (or changes in the Social Security earnings test) would exacerbate the need for a solution to the problems that arise in situations of phased retirement.

Phased retirements (i.e., the reduction in the number of hours worked during the last few years before complete retirement) are becoming more prevalent even with today’s Social Security retirement age and earnings test. (See, e.g., Figure 7.) As discussed below, changes in federal pension law should be enacted to accommodate phased retirement, including appropriate changes in the treatment of these individuals under the nondiscrimination rules and allowing the payment of retirement benefits even though the individual may not be fully retired.

Should Social Security be means tested? 

No. Eligibility to receive Social Security benefits should not be restricted based on the income (or wealth) of the individual after he or she retires. Any such restriction would create a dangerous disincentive to save during working years. Individuals who save would, in effect, be punished for having accepted the responsibility of saving for their retirement during their years of employment.

Should the Social Security earnings test be repealed? 

Yes. The Social Security earnings test inappropriately penalizes individuals for continuing to work.
IV. Changes in the Investment of Social Security Trust Fund Assets

Should Social Security funds be invested in assets other than Treasury securities?

The gradual investment of a portion of the assets in the OASDI Trust Funds in investment vehicles other than Treasury securities has the potential to bolster the long-range financial integrity of the Social Security system and should be explored further.

It is imperative, however, that any parties responsible for investment of these funds be prohibited from becoming involved in the business decisions of companies in which they invest and be fully independent of government influence. Moreover, the potential impact of such investment on overall capital markets must be explored further.

Should any Social Security benefits be financed through individual accounts invested by the individual?

If the administrative and other issues discussed below can be successfully resolved, decision makers are encouraged to consider providing a portion of Social Security benefits through individual accounts.

The successful experience that employers have gained in implementing employment-based individual account plans, including section 401(k) and 403(b) salary reduction plans, shows that individual account plans can play a role in increasing a worker’s focus on and commitment to retirement savings. Figure 8 illustrates the strong growth of defined contribution plans. In addition, many private sector retirement programs have merged the advantages of a defined benefit plan with those of a defined contribution plan.

Social Security individual accounts, serving as a complement to a basic Social Security defined benefit safety net, could provide a mechanism that would help restore confidence in the integrity of the Social Security system and build public awareness of the need for additional retirement savings.

Just as with individual account plans currently provided by employers, giving Social Security individual account holders a retirement benefit that they can readily understand (their growing account balance) and giving them a feeling of ownership and control over those assets (through investment choices), can lead to a greater awareness of the adequacy (or inadequacy) of the individual’s retirement savings.
If individual Social Security accounts are created, what issues must be addressed?

Although there are advantages that may be created by the establishment of individual account plans, certain threshold issues need to be addressed before such accounts are considered. First, the administrative mechanics of the transfer of funds from payroll withholding into the Social Security system would have to be carefully considered. Employers’ responsibilities for the timing of payroll tax deposits and the information relevant to such transfers should remain unchanged. Moreover, any Social Security individual account system must not mandate that employers accept significant additional responsibility for maintenance of Social Security individual accounts. Appropriate and cost-effective procedures and mechanisms for maintaining such accounts should also be in place before accounts begin to receive contributions.

Second, appropriate restrictions on access to Social Security individual accounts should be imposed. Options that should be considered include a prohibition on access prior to becoming eligible for Social Security and limits on premature depletion of retirement assets after becoming eligible for Social Security ensuring access to a lifetime stream of income.

In addition, there should be no requirement that individuals take minimum distributions from their Social Security retirement accounts. Moreover, the impact of individual Social Security accounts on...
Social Security Survivor and Disability Income programs would have to be carefully evaluated.

Third, an intensive and continuous educational mechanism must be in place to:
(1) assure that individuals understand that individual Social Security accounts are not substitutes for private sector plans and individual savings vehicles, and
(2) encourage increased usage of such private savings arrangements.

Fourth, the program of individual Social Security accounts should be designed so that it does not compete with existing, successful savings systems. Thus, individuals should not be permitted to make their own supplemental contributions to Social Security individual accounts. Allowing such contributions could, depending on the tax treatment of the accounts, drain assets away from existing salary deferral and other programs. Moreover, it would increase pressure to allow workers to have access to their Social Security individual accounts prior to retirement.

Fifth, corresponding changes in the rules applicable to retirement plans should be considered to reflect the availability of individual Social Security accounts. These changes could include modification or repeal of the complex average deferral percentage and average contribution percentage tests applicable to 401(k) and other salary reduction retirement savings plans.
V. Needed Changes in the Employment-Based Retirement System: Steps Toward a Coherent National Retirement Policy

Could Social Security reform reduce savings outside the Social Security system? Bolstering Social Security will not address the fact that Americans are not saving enough for retirement. To the contrary, an insidious danger of adopting only Social Security reform is that it will create the impression among Americans that their retirement is now secure — that the reformed Social Security system will fulfill their retirement needs.

Social Security reform must be accompanied by an improvement of the rules governing other savings incentives. As confidence in the Social Security system is restored (See Figure 9 regarding the skepticism of many Americans), there is the potential that other retirement plan savings may decrease, moving us away from the ultimate goal of retirement security. Social Security reform must be accompanied by an improvement of the incentives provided through the proven employment-based system, and by education about the necessity of saving to supplement the revised Social Security benefits.

Where should improvements in the private retirement system begin? The simplest and most effective mechanism for improving the private retirement savings system would be to increase maximum contribution and benefit amounts under employment-based plans.

Throughout the 1980s and early 1990s pension policy shifted to a short-term focus — reducing the amount that could be saved for retirement in an effort to help curb the short-term federal budget deficits (See Figure 10) — while ignoring the long-range budgetary and policy benefits of savings through employment-based plans. The net effect of these reductions in permitted contributions to retirement savings plans has been to stifle the expansion of employment-based plans and reduce retirement savings. It is time for

<table>
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<td>66</td>
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<tr>
<td>51-64</td>
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<td>36-50</td>
<td>17</td>
</tr>
<tr>
<td>18-35</td>
<td>9</td>
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Figure 9: Percentage of Americans who believe that they will receive all the benefits that current retirees receive (n=1,200, +/-=2.8%)\(^{10}\)
“guidance” has inhibited retirement plan formation and growth. The enactment of pension simplification in 1996 was a critical first step in reversing the complexity of the system, and APPWP commends Congress and the Administration for enactment of that legislation. Nonetheless, much more remains to be done. Redundant, outdated, overly broad and excessively complex rules continue to permeate our retirement system and hamper its effectiveness. A more workable structure can be achieved only by adhering to an overall policy that encourages the maximization of fair, secure, and adequate system-wide retirement benefits, rather than focusing solely on ways to inhibit rare (and often theoretical) abuses. Employers must be provided with the flexibility to design retirement savings options for the unique needs of their workforce without being constrained by complex and often arbitrary mechanical testing rules.

Congress to reverse this trend, beginning with
(1) increases in the maximum contributions permitted to defined contribution plans (including 401(k), 403(b), and other salary reduction plans); 
(2) providing mechanisms that allow individuals to catch-up for years in which they may not have saved adequately; and
(3) the repeal of restrictive limits on defined benefit plan benefits and funding.

What other changes promoting additional retirement savings should be included as part of the establishment of a national retirement income policy?

The current maze of pension rules and regulations carry with them an enormous compliance cost for employers who voluntarily maintain retirement plans for their employees. Decades of adding layer upon layer of legislation, regulations, rulings, advisory opinions and other

<table>
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<th>Description of Limitation</th>
<th>Amount of Limit Prior to Cutback (year)</th>
<th>Actual 2000 Limit</th>
<th>Hypothetical 2000 Limit (assuming 3% inflation)</th>
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<td>$45,475 (1982)</td>
<td>$30,000</td>
<td>$77,418</td>
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<td>Compensation</td>
<td>$235,840 (1993)</td>
<td>$170,000</td>
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<tr>
<td>401(k) Elective Deferrals</td>
<td>$30,000 (1986)</td>
<td>$10,500</td>
<td>$45,378</td>
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</table>

Figure 10: Changes in Contributions and Benefits Limitations, Actual and Estimated
A comprehensive review of current rules and regulations should be undertaken in order to ensure that workers are allowed to begin collecting retirement benefits while supplementing their income with wages from continued employment in a reduced capacity.

Are there other changes that should be considered as part of a national retirement policy?

One critical component of retirement security that is often overlooked is the need for reliable and affordable health and long-term care insurance protection in retirement. Despite this clear need, over the last two decades federal tax policy has discouraged employers from providing retiree health protection, either as a supplement to Medicare or as an early retirement benefit.

A meaningful improvement in retirement security could be accomplished through the implementation of federal policies providing additional incentives for employers to continue to provide retiree health benefits, particularly health benefits for those in phased retirement. These incentives could include the loosening of the rules that severely limit the prefunding of retiree health obligations and streamlining

Proposals like those included in pension legislation introduced by Finance Committee Chairman William Roth and Senator Max Baucus, Congressmen Rob Portman and Ben Cardin, and Senators Bob Graham and Charles Grassley, take important steps toward eliminating some of the unnecessary rules, regulations and limits that currently apply to employment-based retirement plans. These proposals should be enacted as soon as possible.

The failure of the current regulatory regime to adequately accommodate phased or partial retirement is another critical problem. The current pension regulatory structure rigidly applies a wide array of rules based on a traditional model of retirement as a change from full-time career employment to complete withdrawal from the labor market. Yet the concept of a specific retirement date triggering a complete withdrawal from the workforce is rapidly becoming outdated as more and more workers extend their working years in reduced capacities allowing for greater flexibility.
the rules that limit the ability of employers to provide tax-advantaged health insurance options to retirees.

Similarly, one of the largest financial risks faced by Americans in retirement is the threat of significant nursing home and other long-term care expenses. These expenses arise when individuals become chronically ill and unable to care for themselves. Today, federal tax policy does little to encourage Americans to prepare for the risk of significant long-term care expenses. Providing meaningful tax incentives for the purchase of long-term care insurance would provide individuals with the opportunity to plan ahead. For example, allowing an income tax deduction for long-term care insurance premiums and allowing employers to offer long-term care insurance through payroll reduction via a cafeteria plan could be important steps in helping Americans prepare for these long-term care risks.
End notes


4 The effect that certain Social Security reform options could have on employment-based retirement plans or on the employment relationship are subsequently discussed more fully.


7 The Urban Institute, “Policy Changes Posed by the Aging of America” (May 1998), Table 3.


