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Can America Afford to Retire?

U.S. National Commission on Retirement Policy

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Can America Afford to Retire?

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National Commission on Retirement Policy

Can America Afford to Retire?

The Retirement Security Challenge Facing You and The Nation

CSIS

NATIONAL COMMISSION ON RETIREMENT POLICY

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United States Senate

The Honorable John Breaux
United States Senate

The Honorable Jim Kolbe
U.S. House of Representatives

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U.S. House of Representatives

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Mark Weinberger
Principal, Washington Counsel, P.C.
NCRP Senior Advisor and Counsel

The NCRP is an initiative of the Center for Strategic and International Studies, a public policy research institution located in Washington, D.C.

January 1998

Dear Fellow Americans:

One of the most daunting public policy challenges of the next decade is to how to put federal programs for senior citizens on a sound financial footing. In just a few years, the millions of Americans we call the Baby Boom generation will begin to retire, straining the government's capacity to provide benefits promised under federal entitlement programs.

Quite simply, the nation cannot afford the expected growth rates in the costs of these programs. But this is not just an abstract budgetary problem. Fewer resources at the federal level means that families will have to shoulder more responsibilities themselves in order to provide for a financially secure retirement. They will need to save more; by participating in employer-sponsored pension plans, contributing to Individual Retirement Accounts, and investing in mutual funds or other financial instruments. At the same time, Congress will need to implement reforms to ensure the long-term financial viability of programs such as Social Security.

The National Commission on Retirement Policy, which we are privileged to co-chair, was established to respond to this challenge by educating the American public about the important issues; by laying the foundation for non-partisan and informed policy debate; and by building a national consensus for the policy changes necessary to put the nation on a long-term path of economic prosperity and ensure a financially secure retirement for all Americans.

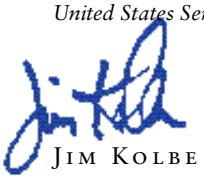
Can America Afford to Retire? is intended to expand public awareness of these issues and provide the American people with basic factual information that will illustrate the scope and magnitude of the fiscal challenges posed by the impending retirement of the Baby Boom generation. In the months ahead, the Commission will meet with citizens groups and interested constituencies from around the country, as well as economists, academicians, and retirement policy experts, with a view to crafting practical policy recommendations that will have the support of the American people and can be enacted into law.

Therefore, we hope that you will take a few minutes to read this publication and share your views and concerns with the Commission and your elected representatives. We all have a stake in this debate.

Sincerely,

JUDD GREGG
United States Senate

JOHN BREAUX
United States Senate



JIM KOLBE
U.S. House of Representatives

CHARLES W. STENHOLM
U.S. House of Representatives

DONALD B. MARRON
Chairman and CEO, Paine Webber Group Inc.

DR. CHARLES A. SANDERS
Retired Chairman, Glaxo, Inc.

CAN AMERICA AFFORD TO RETIRE?

THE ANSWER TO this question is *yes*—but only if we make appropriate policy changes at the national level, and prepare ourselves at the personal level. In recent decades, some Americans have been able to look forward with assurance to a financially secure retirement. Social Security payments, combined with often generous pension benefits and augmented by personal savings, have enabled many elderly Americans to enjoy a reasonable standard of living in their retirement years. However, the prospects for future retirees are not as rosy as they could or should be.

AS A NATION . . . have we promised too much?

America is facing demographic trends that will transform American society and usher in profound economic, social, and political changes. An unprecedented number of Americans—the Baby Boom generation—will begin to reach retirement age in just over a decade, expecting the same benefits received by those before them. Unfortunately, as a nation, we have not yet figured out how to pay for the increasing costs associated with federal entitlement programs as currently structured, and the prospects for supplementing them by employer-provided pension and health care plans are also suspect.

AS INDIVIDUALS . . . have we set aside too little?

At the same time, most individuals are saving too little and consuming too much—not building a sufficient nest egg for their retirement years. Simply put, the retirement of Baby Boomers is a challenge to our nation's fiscal capacity, affecting the prospects of a secure retirement for many Americans and potentially impacting the standard of living for future generations.

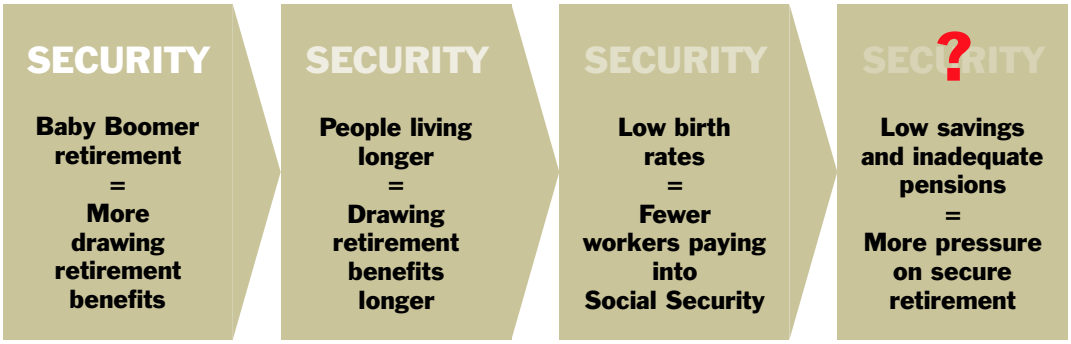


Chart 1

The graying of America...

Percentage of population under 65, and 65 and older

- *Under Age 65*
- *Age 65 and older*

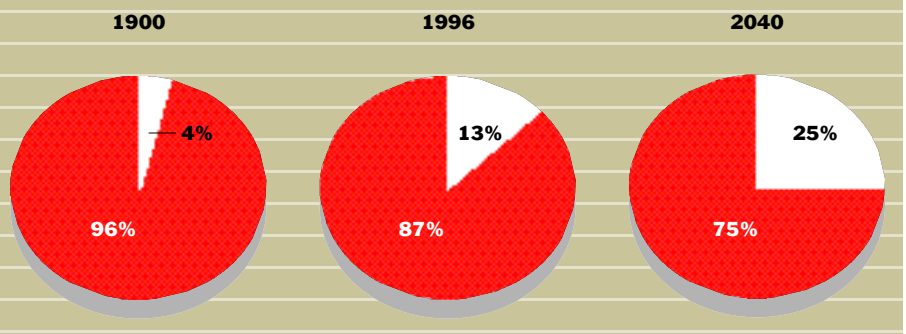


Chart 2

...the fastest-growing segment of the population

Population growth by age group, 1995-2040

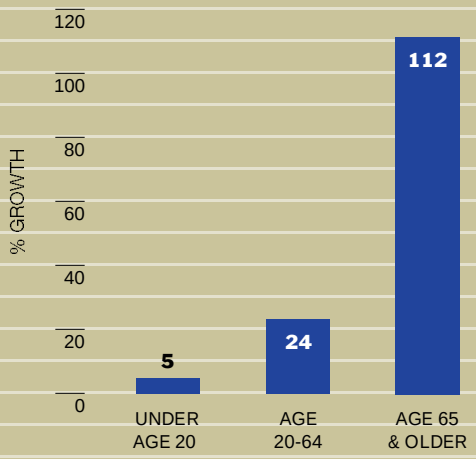
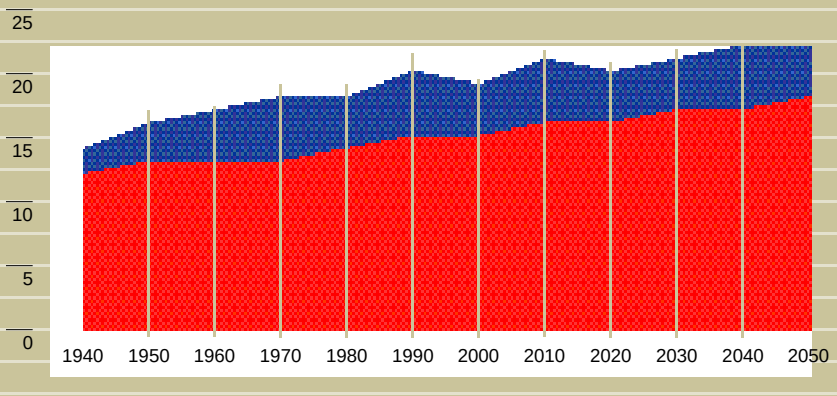


Chart 3

Life expectancy has increased over time

Average remaining life expectancy for those age 65

- *Female*
- *Male*



THE AGING OF AMERICA

CURRENT DEMOGRAPHIC TRENDS contribute to the overall problem of financing federal entitlement programs and raise doubts about the prospects for a secure retirement for many Americans in the future.

We're getting older . . .

- In 1900, one in 25 Americans was older than 65. Today, that number is one in eight. By 2040, one in four Americans will be older than 65[1].
- This year, 200,000 Americans will turn 65. In 15 years, 1.6 million will do so[2].
- The "old-old" population—those 85 and older—will triple by the year 2040[3].

We're spending more years in retirement . . .

- People are living longer. When the Social Security system was created, the average life expectancy was 61 years[4]. Today it is 76 years. By the year 2020, it is expected to be 78 years[5].
- Moreover, men reaching age 65 are expected to live another 15 years—women nearly 20 years[6].
- People are retiring earlier. In 1965, 57% of the population older than 55 was in the workforce. Today, that figure is only 38%. Further, more than 70% of Social Security beneficiaries take early retirement before age 65[7].
- As a result, the average American will spend one-third of his or her adult life in retirement.

While expecting a shrinking future workforce to support us.

- The Baby Boom was followed by a Baby Bust. While the average families had three children from 1946–64, that number decreased to two children from 1970–90[8].
- The number of workers per beneficiary in the Social Security system was 16.5 in 1950 and stands today at 3.3. By 2030, the ratio is expected to be 2.0[9].

Demographic trends will transform American society and place immense pressure on retirement security—or require people to work longer.

Chart 4

Entitlement spending could consume all revenues in 33 years

Federal spending and revenue figures

- *Mandatory*
- *Net Interest*
- *Discretionary*
- *Revenues*

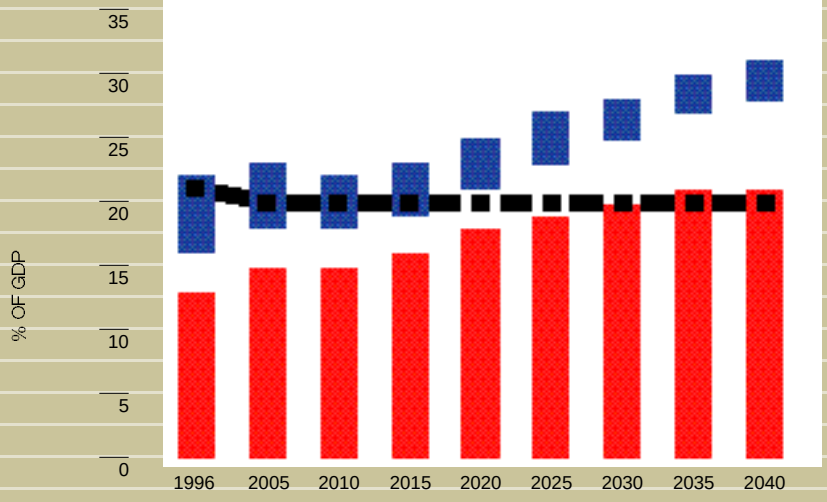
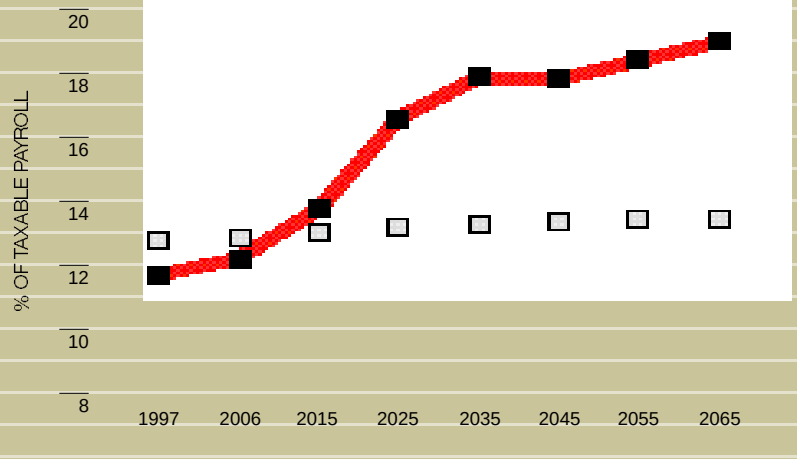


Chart 5

Social Security is not funded to meet future promises

Social Security income and expenditures as percentage of payroll

- *Expenditures*
- *Income*



WHAT DOES THIS MEAN FOR THE NATION?

THE IMMINENT RETIREMENT of the Baby Boom generation could cause an economic crisis. Without major policy changes, entitlement programs could soon absorb the vast majority of federal tax revenues, and Social Security and Medicare could face huge unfunded liabilities. More resources directed to entitlements will mean fewer resources available for other government programs, such as education.

Rapid increases in entitlement spending . . .

- Mandatory spending and interest on the national debt account for 71% of current federal spending, according to the Congressional Budget Office[10].
- The President's Bipartisan Commission on Entitlement and Tax Reform found that, without changes, entitlements would consume all revenue by 2030[11]—and if you add interest on the national debt, this date accelerates to 2018[12].

Spiraling deficits . . .

- While the federal budget is expected to be balanced by 2002, the Congressional Budget Office has stated that deficits will climb rapidly once Baby Boomers begin to retire unless further changes are made in entitlement programs[13]. By one estimate, the deficit could grow to an unprecedented 8% of GDP by 2030[14].

Huge revenue needs . . .

- The current, unfunded liability of Social Security by 2070 is $5.3 trillion[15].
- Under current law, benefits under Social Security and Medicare will exceed current projected payroll tax revenues by nearly $19 trillion between 1997 and 2070[16].

A burden on future generations . . .

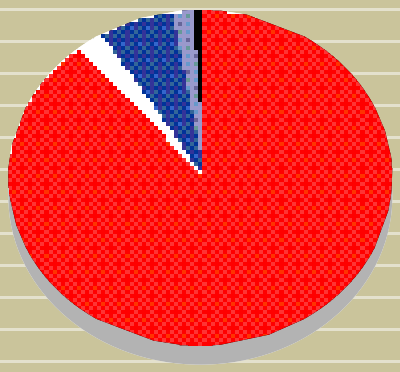
- To maintain current benefit levels in Social Security through 2070, payroll taxes would have to increase from the current combined (employer and employee) rate of 12.4% to nearly 14.6% immediately, or by some estimates to as much as 18% if action is delayed[17].
- For a single, average-wage worker who retired in 1996, the present value of his or her lifetime Social Security benefits will be only 80% of his or her lifetime contributions[18].

According to the Congressional Budget Office, the budget "shortfalls projected for future years are so large that they could put an end to the upward trend in living standards that the nation has long enjoyed[19]."

Chart 6

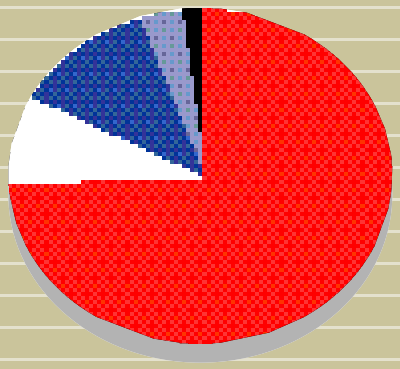
Most retirees depend on Social Security

Source of income for individual elderly Americans, by income level, 1995



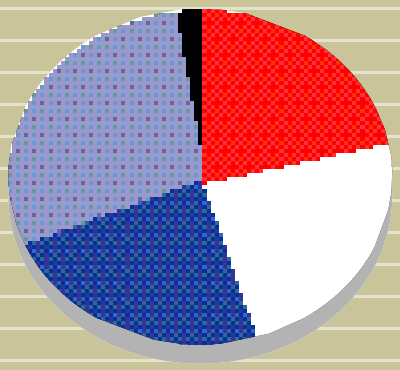
Low income

- *Social Security 88.8%*
- *Pensions 2.3%*
- *Assets 6.1%*
- *Earnings 1.7%*
- *Other 1%*



Mid-income

- *Social Security 74.7%*
- *Pensions 8.3%*
- *Assets 11.6%*
- *Earnings 3.7%*
- *Other 1.7%*



High income

- *Social Security 21.1%*
- *Pensions 24.3%*
- *Assets 23.3%*
- *Earnings 28.8%*
- *Other 2.4%*

WHAT DOES THIS MEAN FOR YOU?

UNLESS STEPS ARE TAKEN to reform the system, as a nation, we will be unable to fund the retirement income and other entitlement promises we have made. A failure to act now will dramatically raise the costs and sacrifices necessary ten to twenty years down the road.

In planning for retirement, most Americans typically depend on three primary sources for retirement income. But as we look ahead, each source of income is in need of being significantly strengthened.

Fortify the social safety net

- Presently, inflows to the Social Security system exceed benefits paid out. However, the program's trust fund will begin paying out more in benefits than it collects in payroll taxes by 2012[20]. Most analysts agree that action needs to be taken now, to avoid the fund's depletion by 2029[21].

Expand employer-based pensions

- Currently, fewer than one-half of retirees report income from a pension plan. Complexity, confusion, and constant rule changes discourage many employers from offering a plan. In addition, nearly one-third of workers who have access to a plan do not contribute to it[22].

Increase personal saving

- Shortfalls in meeting retirement expenses will have to be offset by personal saving. Current levels of retirement savings, however, will not compensate for the projected shortfalls in benefits from Social Security and pension plans. Personal saving has fallen from a peak of more than nine percent in 1974 to less than five percent in 1996[23].

Without strengthening the sources of retirement income, the standard of living for many Americans could decline, and retirement could become a hardship.

Chart 7

Average monthly/yearly Social Security benefits

Based on 35 highest years of earnings

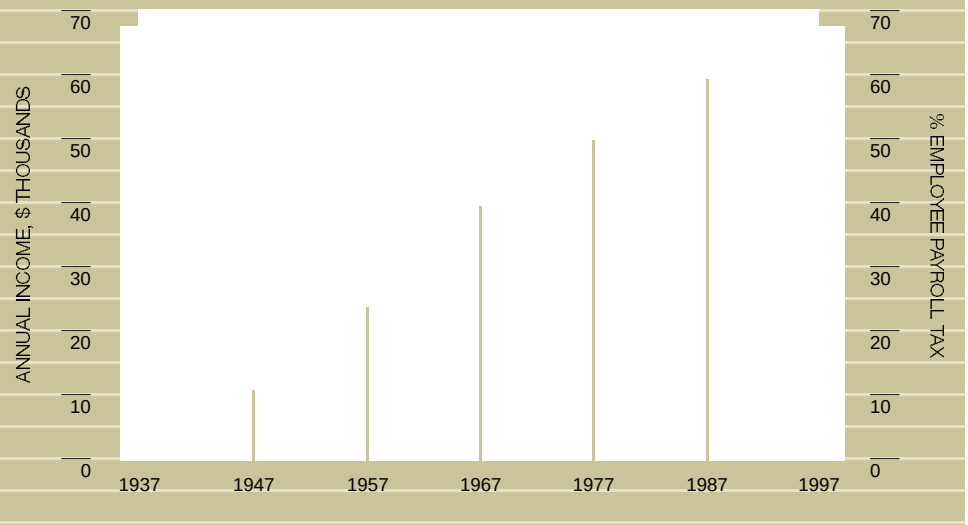
	Wage earner	Wage earner & spouse
Low	$ 537 / 6,444	$ 805 / 9,660
Average	$ 886 / 10,632	$ 1,329 / 15,948
High	$ 1,248 / 14,976	$ 1,872 / 22,464

Chart 8

The payroll tax has risen over time

Increases in tax rates and earnings bases: 1937-97

- *Percentage tax rate*
- *Taxable earnings base, $*



SOCIAL SECURITY

THE SOCIAL SECURITY SYSTEM was created in 1935 to provide a modest floor of retirement income protection for about 60% of the American workforce. Since then, the program has grown dramatically with higher benefit levels. Social Security is a "pay-as-you-go" program, meaning that the payroll taxes contributed by current workers and their employers are used to pay the benefits of current retirees.

Social Security has become an important source of retirement income for many Americans:

- Social Security provides almost 90% of total income for low-income senior households[24].
- It replaces around 43% of pre-retirement income of the average retiree (which under present law will decline to about 36% by 2030)[25].
- It is the *major* source of income for 66% of beneficiaries—and the *only* source of income for 16%[26].

However, fiscal pressures threaten the system:

- By 2012, the Social Security system will be paying out more in benefits than it collects in revenues[27].
- On its current path, after 2029 the Social Security Trust Fund will be depleted. At that time, projected revenues would support only 75% of the promised level of benefits[28].
- In order to provide the current level of benefits, Social Security payroll taxes (employer/employee) have risen since the program's inception from 2% to 12.4%, and the wage base (i.e., the income limit up to which one is taxed) has risen from $3,000 to $65,400[29].

We face some tough choices in fixing Social Security—cut benefits, raise taxes, substantially reduce spending on programs like education and defense, or raise the deficit—decisions that become more difficult with time.

Chart 9

More than 50 million workers have no pension

Pension coverage, in millions of workers

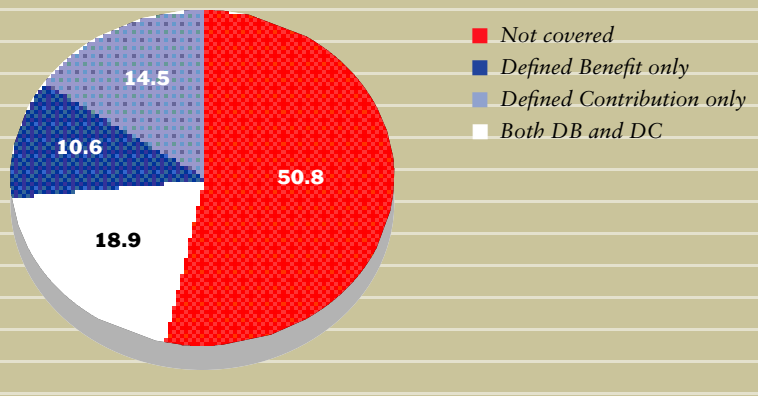


Chart 10A

Workers at small firms are less likely to have a pension

Pension sponsorship rate (% of workforce by firm size), 1993

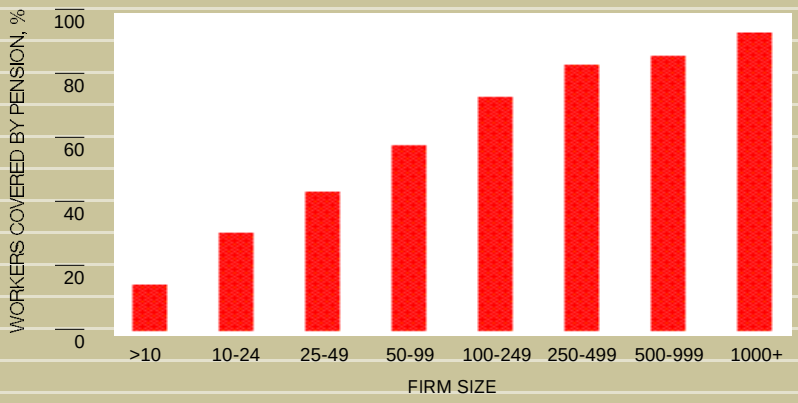
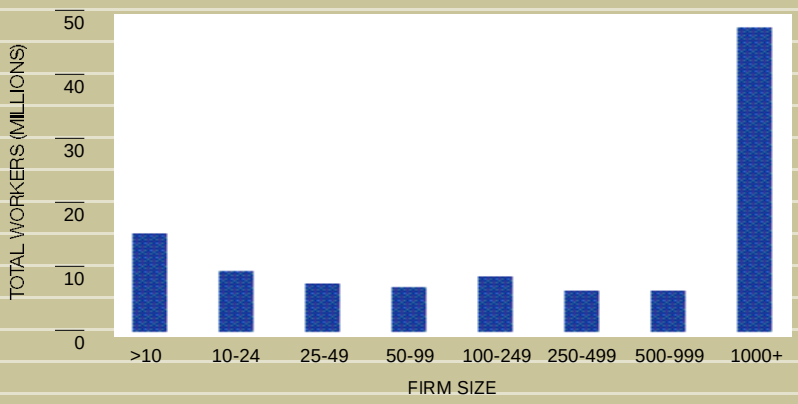


Chart 10B

Total workforce by firm size, 1993



PENSIONS

MANY PRIVATE- AND PUBLIC-SECTOR employers offer their workers a pension plan, either a defined-benefit (DB) plan—in which benefits are calculated by a formula and typically based on pay, years of service, and other factors; or a defined-contribution (DC) plan, such as a 401(k) plan—in which specified contributions are made to participants' individual accounts, coming from either or both the employer and employee.

Pensions can be an important source of retirement income.

- In the last 20 years, the aggregate percentage of retirement income derived from private pensions has grown from 16% to 30%[30].
- From 1988 to 1993, there were slight increases in both employer sponsorship and employee participation in pension plans. And of those participating in plans, the proportion of workers "vested" increased from 77% to 86%[31].

However, many workers don't participate in, or have access to, pensions plans...

- Fewer than 50% of workers have a pension plan at a given time. The coverage challenge has been exacerbated by the expansion of the contingent and part-time workforce in the U.S.[32]
- Less than 30% of low-income workers are covered by pension plans, and only 13% of the 14 million working in small firms have access to a pension plan[33].

...and those who do often fail to utilize employer matches, or use savings for other expenses.

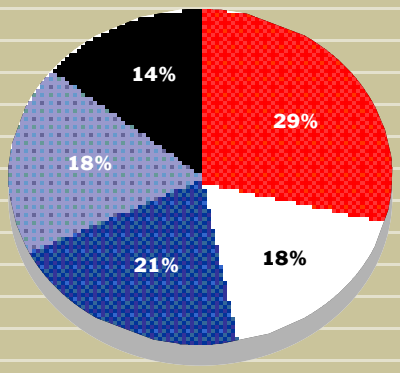
- One out of every four participants intends to use pension savings for a house or a child's education[34].
- One out of five people who leave a job and receive a lump-sum distribution from their retirement plan with $5,000 or more in savings "cash out" the savings rather than "roll over" the funds into a retirement account[35].
- Many workers do not take advantage of a major retirement benefit. Of those contributing to a 401(k)-type plan, only 21% contributed the maximum amount that their employer would match[36].

More should be done to encourage access to, and participation in, private pensions.

Chart 11

Many near-retirees save too little

Retirement savings of those age 51–61

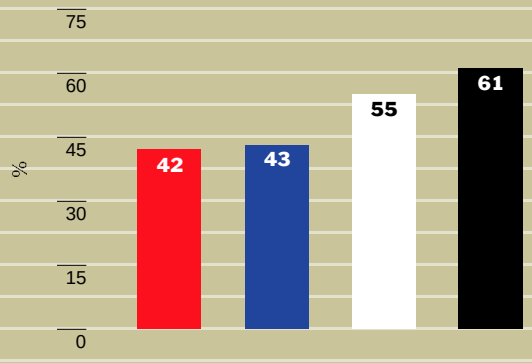


- *$100,000+*
- *$50,000–$99,999*
- *$10,000–$49,999*
- *$1,000–$9,999*
- *$0*

Chart 12

Most younger Americans expect to rely on savings more

Percentage reporting savings as most important retirement income source

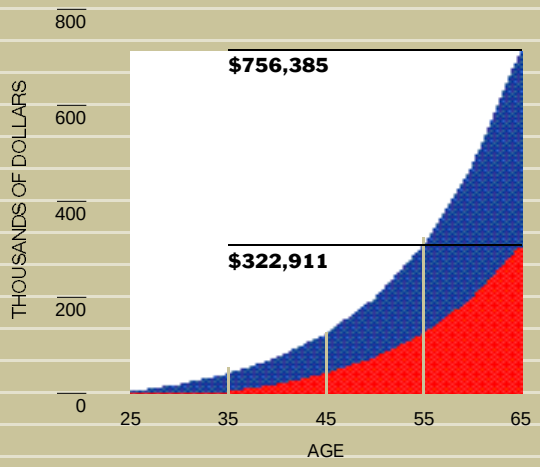


- *Over age 53*
- *Age 45–52*
- *Age 34–44*
- *Under age 33*

Chart 13

Waiting to save costs money

Return on savings for a 25- and 35-year-old ($50 per week, 8% yield)



- *25-year-old*
- *35-year-old*

"Ms. Osceloa McCarty, an 87-year-old woman from Hattiesburg, Mississippi, gave $150,000 to the University of Southern Mississippi. Though she never made more than the minimum wage in her 74 years of work, she saved a little each month, allowing the miracle of compounding to make her investment grow."

The New York Times, August 13, 1995

PERSONAL SAVING

INDIVIDUAL SAVINGS ACCUMULATED during working years can help to ensure a financially secure retirement. This is especially true for those individuals who do not participate in a pension plan, as Social Security provides only a modest floor of income protection.

The final source of retirement income—personal saving—can determine how soon, and how well, you can retire:

- The average retiree depends on personal saving to provide nearly 18% of his or her retirement income[37].
- Saving, especially at an early age, is the best way to ensure a comfortable retirement. For example, through the "miracle of compounding," a 25-year-old saving just $50 per week will accumulate more than $750,000 by age 65, assuming an 8% tax-deferred return—more than seven times the principal investment[38].
- If that same 25-year-old were to delay saving by just 10 years, the amount accumulated would be just $323,000—or 134% less[39].

Where Social Security and pension plans leave off in providing retirement income, personal saving must pick up. Unfortunately, saving levels have not kept up with future needs:

- According to a recent survey, less than half of pre-Boomers, those closest to retirement, have more than $50,000 in retirement accumulations. And 25% of Generation Xers and 15% of late Boomers have no retirement savings at all[40].
- Among adults in their late fifties, the age at which workers are looking soon to retire, median savings are still less than $10,000[41].
- The rate of private saving has declined in recent decades and is the lowest of any of our major economic competitors[42].
- The supply of savings available for private investment, or "net national saving," has dropped from more than 8% of GDP to less than 2% today. This restricts American productivity and growth[43].

Without saving more and planning ahead, Americans will have to work longer or accept more frugal lifestyles.

WHAT NEEDS TO BE DONE?

WHILE THERE IS BROAD AGREEMENT on the need to address issues regarding retirement income security, there is not yet a consensus on specific reforms.

An important factor in reforming the system is to insure that no change to one component of retirement income harm the prospects for any other facet. Therefore, a national, comprehensive retirement policy is necessary.

The essential components of such a comprehensive strategy to address retirement security in the 21st Century must:

- **Reform SOCIAL SECURITY to provide long-term solvency of the system;**
- **Enhance employers' ability to provide PENSIONS and savings plans;**
- **Stimulate growth in PERSONAL SAVINGS;**
- **EDUCATE the American public about the need to plan, save, and invest for retirement.**

THE NATIONAL COMMISSION ON RETIREMENT POLICY was created to help achieve these objectives. The NCRP believes that a national retirement policy should be based upon the following principles:

- **National retirement policy should be designed to enable Americans to enjoy a reasonable standard of living in their retirement years.**
- **National retirement policy should contribute to long-term growth and economic prosperity.**
- **Government programs for elderly retirees should be financially sound and economically sustainable. The costs of financing these programs and other initiatives that encourage and facilitate national saving should be borne equitably among generations and income levels.**

NATIONAL COMMISSION ON RETIREMENT POLICY

Mission Statement

LAYING THE FOUNDATION for economic growth and prosperity in the face of profound demographic changes that will occur early in the next century is perhaps the most difficult challenge facing the nation. The imminent retirement of the Baby Boom generation, combined with longer life expectancies, will place extraordinary fiscal pressure on federal entitlement programs and could imperil the standard of living for future generations.

Unless we save more and spend less, the nation will be confronted with equally difficult choices—dramatically lower benefits for future retirees or an untenable tax burden on the next generation of Americans.

The National Commission on Retirement Policy is charged with responding to this challenge. The objectives of the Commission are three-fold:

- To educate the American public about the scope and magnitude of the retirement financing challenge;
- To provide the foundation for non-partisan and informed policy debate; and
- To build a national consensus for the changes necessary to place the nation on a sound long-term fiscal footing and ensure a secure retirement for all Americans.

To carry out these objectives, the Commission will expand public awareness on these issues by sponsoring conferences, roundtable discussions, and town hall meetings around the country. Further, the Commission will launch an aggressive media outreach campaign. It also will gather the best available analysis and evidence from economists, academicians, and retirement policy experts, with a view to crafting practical, achievable policy recommendations. Finally, the Commission will bring together policymakers and affected constituencies to develop a consensus for implementing these recommendations, including the introduction of appropriate legislation by the Congressional co-chairmen.

For more information, contact the National Commission on Retirement Policy, c/o CSIS, 1800 K Street, NW, Suite 400, Washington, DC 20006; (202) 887-0200; Fax: (202) 775-3199; or visit our website at: www.csis.org/retire/.

Notes

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[43]The 8% savings rate is for the 1960-69 period and the 2% savings rate is for the 1990-93 period. Bipartisan Commission on Entitlement and Tax Reform, *Interim Report to the President,* August 1994, p. 8.

Charts

CHART 1: U.S. Census Bureau, "Sixty-Five Plus in the U.S.", *www.census.gov*, May 1995, p. 1.

CHART 2: Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds (OASDI), *The 1997 Annual Report of the Board of Trustees*, Washington, D.C.: Government Printing Office (GPO), 1997, p. 148.

CHART 3: OASDI, *The 1997 Annual Report of the Board of Trustees*, p. 3.

CHART 4: Based on figures from Congressional Budget Office, "Long-term Budget Outlook," March 1997, p. xv.

CHART 5: Based on Table of Comparison of Estimated Income rates and Cost Rates, OASDI, *The 1997 Annual Report of the Board of Trustees*, p. 173.

CHART 6: Carolyn Pemberton and Deborah Holmes, Eds., *EBRI Databook on Employee Benefits*, Third Edition, 1996, p. 117.

CHART 7: Social Security Administration, *Basic Facts About Social Security*, August 1996, p. 9.

CHART 8: OASDI, *The 1997 Annual Report of the Board of Trustees*, pp. 34-35 (based on Table of Contribution and Benefit Base and Contribution Rates).

CHART 9: Ron Gebhardtsbauer, Senior Pension Fellow, American Academy of Actuaries, *Reasons for a National Retirement Income Policy*, September 8,1997 (speech).

CHART 10: Based on Table of Retirement Plan Sponsorship, Participation and Vesting, Carolyn Pemberton and Deborah Holmes, Eds., *EBRI Databook on Employee Benefits*, Third Edition, 1996, pp. 73-74.

CHART 11: Ron Gebhardtsbauer, Senior Pension Fellow, American Academy of Actuaries, *Reasons for a National Retirement Income Policy*, September 8,1997 (speech).

CHART 12: The 1997 Retirement Confidence Survey, Summary of Findings, EBRI, October 1997, p. 2.

CHART 13: American Savings Education Council, 401(k) Growth Calculator, Boston: Advantage Publications, 1995.NOTE: The advantage of saving earlier is offset somewhat by the effect of inflation; the opportunity cost of saving is greater in the earliest ten years than it is later. However, the benefits of compounding more than make up the difference.

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Center for Strategic and International Studies

1800 K Street, NW, Suite 400

Washington, DC 20006

202 887-0200

202 775-3199 FAX

www.csis.org/retire/