

Prospects for Social Security Reform

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Pension Research Council
The Wharton School of the University of Pennsylvania

PENN

University of Pennsylvania Press
Philadelphia

Pension Research Council Publications

A complete list of books in the series appears at the back of this volume.

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Printed in the United States of America on acid-free paper

10 9 8 7 6 5 4 3 2 1

Published by

University of Pennsylvania Press

Philadelphia, Pennsylvania 19104-4011

Library of Congress Cataloging-in-Publication Data

Prospects for social security reform / edited by Olivia S. Mitchell,
Robert J. Myers, and Howard Young.

p. cm.

"Pension Research Council Publications."

Includes bibliographical references.

ISBN 0-8122-3479-0 (alk. paper)

I. Social security—United States. I. Mitchell, Olivia S.
II. Myers, Robert J. (Robert Julius), 1912– . III. Young,
Howard, 1932– . IV. Wharton School. Pension Research Council.
HD7125.P733 1998

368.4'3'00973—dc21

98-41908

CIP

Frontispiece: Special Treasury securities, stored in a federal government filing cabinet in West Virginia, represent \$700 billion in Social Security Trust Fund assets. Photo: Jeff Baughan.

Chapter 13

Possible Employer Responses to Social Security Reform

Janice M. Gregory

A recent survey of chief financial officers of the largest companies, organizations, and local governments in the United States found that 68 percent reported that concerns about social security had already begun to change the way they communicate to employees about their benefit plans. About a third of them felt that their concerns about social security were already driving plan design. Fewer than one-fifth were indifferent to concerns about social security solvency (Watson Wyatt Worldwide 1997).

These survey results show that many of the changes being considered to address the financial imbalances in the United States social security system will alter the utility of retirement plans sponsored by employers for their employees, and they will also trigger changes in the design of these plans. Enacting social security reforms without sufficient consideration of how such actions will affect employer-sponsored plans could severely disrupt employers' ability to design plans that meet their business needs. It could also harm irreparably millions of workers whose retirement security relies on income from both social security and employment-based retirement savings.

With limited exceptions, employer-sponsored plans presume that plan participants will receive social security benefits. This presumption can be illustrated by comparing the design of private sector employer plans with plans designed for those state and local government employees who have been excluded from social security coverage. For example, among medium and large *private* establishments in 1994–95, plan formulas affecting 51 percent of defined benefit plan participants were integrated with social security. By contrast, among *public* (state and local government) defined benefit plans, only 4 percent of participants were in plans with integrated formulas. The amount of final earnings replaced by the employer pension typically is higher in those state and local government plans where the

employees are not covered under social security than it is in plans where employees are covered. Approximately half of state and local government plans provide automatic cost-of-living increases after retirement, whereas private sector plans rely almost entirely on ad hoc increases, if any post-retirement increase is supplied at all (EBRI 1995).

It is not surprising that most employer-sponsored plans assume receipt of social security benefits, inasmuch as growth of the employer-sponsored retirement system parallels the maturation of the social security program. The social security program was enacted in 1935, and, by 1940, approximately 17 percent of private sector full-time workers enjoyed pension coverage (PWBA 1992). Today, almost all workers are covered under the social security program, while approximately half of the civilian workforce also participate in employer-sponsored retirement plans (EBRI 1994a).

Most employer-sponsored plans assume a social security program structured much like the current one. Although social security has changed since its creation six decades ago, its basic outline has remained the same. Annuity payments are made to retired workers and/or the worker's dependents and survivors, and the size of the payments is based on covered earnings and weighted to replace a greater portion of lower earnings. Social security benefits were not indexed until 1972, but periodic increases in benefit levels before that time approximated the effects of increases in real wages and inflation indexing. The wage replacement rate at retirement under the social security program was 40 percent for an average wage worker in 1940 (Myers 1993) and is only slightly higher today (Board of Trustees 1997). Thus, the U.S. social security program has provided a secure and stable base upon which the employer-sponsored pension system grew.

In addition, employers whose employees are covered under the social security program pay one-half of the social security payroll tax and view this tax, and the benefits it provides, as part of the retirement portion of their compensation package for employees (Graham 1994). To the extent that an employer's business circumstances restrict the amount of resources that profitably can be allocated to compensation, increased social security taxes—or, for that matter, any other increased cost to the employer as a result of social security reform—will result in reductions in other components of the compensation package, including employer sponsorship of and contributions to retirement plans.

Since it is as yet unclear how the social security programs will be changed, it is impossible to discuss with precision how employer-sponsored plans will be adjusted. But it is imperative to increase understanding of the interaction between the social security program and employer-sponsored plans. The goal of this chapter is to establish a framework that can be used to identify the questions that must be asked, and the research that must be undertaken, to identify more clearly the likely interaction between employer-sponsored plans and proposals to reform the social security program. We first outline

the role of employer-sponsored plans in providing retirement income to employees and explain how retirement plans are linked closely to the business needs of the plan sponsor. Next we examine features of employer-sponsored plans that social security reform will influence, including interfering with the employer's business purposes in sponsoring a plan, adding to the plan's cost, and triggering a change in the plan design. Reforms that interfere with the employer's business purposes in sponsoring a plan and reforms that add to the cost of compensation may cause some employers not to offer a retirement plan, while others would reduce their plans as they turn to more efficient means to meet their business goals in a competitive environment. Reforms that trigger changes in a plan design, if not imposed precipitously, may have a lesser effect on plan sponsorship and on the amount of retirement income employees accumulate through employer-sponsored plans, but may raise other important questions.

Our hope is that this discussion and future research will help clarify which common features of employer-sponsored plans will be most at risk under specific social security reform proposals. As support coalesces around one or more options for social security reform, policymakers may then also take steps to address the problems that proposed reforms will engender in employer-sponsored plans.

Role of Employer-Provided Plans in Providing Retirement Security

Pensions provide the largest source of retiree income, other than social security, for the middle three quintiles of the elderly population (Quinn, this volume). Moreover, pensions constitute a larger source than income from assets. Survey responses indicate that many current workers expect that funds provided through employer-sponsored pension or savings plans will be their *most* important source of income when they retire. Over half of all workers surveyed in 1996 responded that funds provided through employer-sponsored savings plans would be their most important source of retirement income (EBRI 1996b). This compares with 23 percent who gave a prominent role to personal savings or investments, 10 percent who named social security, and 15 percent who named other sources as their most important source of retirement income.

These expectations of future retirees have at least some foundation in fact. In 1974, approximately one-quarter of retired families received benefits from employer plans; by 1988, 40 percent of retired families received such payments. By 2018, when the baby boom cohort will be moving rapidly into retirement, it is expected that over 75 percent of retired families will have pension income (EBRI 1997a). "Retired families" in this estimate are defined as married couples living together where at least one spouse is age 55 or over, and nonmarried persons age 55 and older.¹

While current worker expectations that pensions will provide more of their retirement income than social security may or may not be realized, it is true that employer-sponsored plans have been more efficient than individual arrangements, such as IRAs, in accumulating retirement income for workers. Several factors account for this (ERIC 1996). First, employer-sponsored plans often act as a form of automatic savings. Benefits automatically accrue in most defined benefit plans, and employer contributions benefit all employees under many profit-sharing plans. Second, under employer-sponsored defined benefit plans, participants are sheltered from risks that can reduce individual retirement savings. The employee, once vested, is virtually guaranteed whatever benefit he or she has earned under the plan. The employer bears full responsibility for payment of the accrued benefit regardless of whether there are assets in the trust to pay the benefit. Should the employer become bankrupt, the Pension Benefit Guaranty Corporation (PBGC) assumes payment of the promised benefit (up to certain limits). Third, under most defined benefit and defined contribution plans, participants receive the benefit of a professional investment manager. Even in plans where each participant directs the investment of the funds in his or her account, the plan generally allows each participant to allocate his or her account only among designated professionally managed investment funds and index funds. Fourth, plans that allow participants to make contributions through payroll deduction programs make decisions to save less painful and regular savings more likely to occur. Fifth, employees who contribute to employer-sponsored individual account plans (e.g., 401(k) plans) often reap an immediate enhancement of their investments through an employer matching contribution. Finally, participants in employer-sponsored participant-directed individual account plans are more likely to have free access to information and assistance (e.g., decision guides or benefits forecasting software) that enable them to make better informed investment decisions.

While employer contributions to a retirement plan clearly are a boost to employee savings, employer-sponsored plans that offer individual saving opportunities have proven to be more successful in enticing people to save than individual saving initiatives. In 1992, for example, of the approximately 57 million individuals eligible to make deductible contributions to an IRA, only 6 percent (3.6 million) took advantage of this savings opportunity. Even during the period 1981–86, when IRAs were universally available, the maximum number of tax returns claiming an IRA deduction was only 16.2 million, in 1985. By contrast, in 1993, there were 106 million civilian non-agricultural wage and salaried workers in the U.S., of whom 25 million (24 percent) made contributions to employer-sponsored 401(k) plans, even though 401(k) plans are not universally available throughout the workforce (ERIC 1996). Moreover, 401(k) plans attracted participants at earlier ages. While approximately 29 percent of the contributors to both IRAs and

401(k) plans were age 41–50, 53 percent of the 401(k) participants were age 40 or under, compared with 38 percent for IRA contributors.

Even if most workers' benefits were enhanced under social security reform, as some proposals claim will occur, that advantage would be largely erased if those reforms also caused employees to save less elsewhere or caused employers to reduce or eliminate their retirement plans. Thus, if reforms are enacted that cause reductions in pension income, the retirement expectations of many current workers might not be realized.

Business Purposes of Employer-Sponsored Plans

In the United States, employers offer pensions voluntarily to achieve business purposes. These plans are seen as effective management tools to attract and retain high-quality employees, to motivate employees, and to facilitate the departure from the employer's workforce of older employees who either cannot or do not desire to continue working. In recent years, it is also clear that the impact on employees due to the downsizing and reorganizing of many U.S. companies was dramatically reduced through the flexible use of early retirement options under employer-sponsored pension plans (ERIC 1996).

At present, retirement plans provide employers a cost-effective means of providing compensation to employees. Under the current tax structure, retirement plans can represent a significant component of compensation at a cost to the employer that is lower and less immediate than direct cash payments to employees. They also offer employees delayed taxation on their compensation.

An employer can design a retirement plan to further its business and workforce goals. There are traditional defined benefit or profit sharing plans. But employers also are turning to a growing number of new plan designs such as target benefit plans, age-based profit-sharing plans, cash balance plans, pension equity plans, floor offset plans, or retirement bonus plans. The most popular "new" plan by far is the 401(k) plan.

If the employer's business strategy is to use a few experienced and seasoned employees to manage and direct a workforce of primarily young, entry-level people, the employer may offer a target benefit plan or an age-weighted profit-sharing plan. Either can provide a quick buildup of benefits for older employees while minimizing costs for younger employees. If the business requires a constant inflow of new employees, however, the employer may turn to a plan such as a cash balance plan that provides an easily portable benefit, one that does not build up disproportionately larger benefits as the employer's age and service increase, and one that will not penalize employees for leaving (KPMG 1996). Financially stable employers who want to encourage a stable workforce may encourage employee investment in employer stock. Employers who rely on a steady turnover in their workforce

may not. Young start-up companies, strapped for cash, may rely primarily on stock ownership plans or salary-reduction 401(k) plans designed not to require any employer contributions. Many employers who can afford to do so use a mixture of plans to meet various business goals. Most major employers sponsor not only a traditional defined benefit plan but also a 401(k) plan with an employer match, as well as stock option plans and other types of retirement and savings vehicles.

Each substantive social security reform proposal must be compared in detail to the present social security program in terms of benefit adequacy, benefit equity, financial stability, and impact on the economy. Such proposals also must be analyzed to determine how each will affect various employer-sponsored plan designs and, more specifically, how the proposed change in the social security program might disrupt the ability of each design to meet its business objectives. Once reform is enacted, each employer sponsoring a plan or plans will ask those questions—and will modify its plans accordingly.² The majority—73 percent—of chief financial officers of major U.S. enterprises responding to a survey have already expressed concern that social security problems could undermine companies' ability to retire workers on an orderly basis in the future (Watson Wyatt Worldwide 1997).

Effects of Social Security Program Reforms on Employer-Sponsored Plans

If employees do not believe they have accumulated sufficient resources to meet their retirement income expectations, they are not likely to retire. This will have profound effects for the pension system as well as for the employment market. If social security benefits were significantly reduced and/or the program's cost to employers significantly increased, then employers must divert compensation dollars away from their initial goals and toward retirement, must encourage employees to increase their reliance on personal savings, must manage workforce size and cost through increased use of downsizing, or must rely on some combination of these options. This is true regardless of the type of retirement plan(s) the employer now sponsors. Given the intensely competitive nature of today's world-wide business climate, it is not likely that employers will be able to absorb changes in the social security program by increasing overall compensation costs. Rather, several possible outcomes might be envisioned.

Integration of Employer-Sponsored Plan Benefits with Social Security Benefits

Under current law, private sector employers may take the availability of social security benefits into account in their benefit plan formulas. The

rationale for integration, or, more correctly, "permitted disparity," rests on the employer payment of one-half of the social security payroll tax and on the fact that social security benefits are weighted toward lower wage levels. In medium and large private establishments, half of defined benefit plan participants (over 8 million workers) were in integrated plans in 1995. Thirty-seven percent were in plans integrated through a step-rate excess formula and about 14 percent were in offset plans (EBRI 1995). Social security integration is, however, more widespread than this figure would indicate. The figure excludes employees of small firms who participate in integrated pension plans. Some defined contribution plans also are integrated with social security benefits. In addition, even where the benefit structure may not be integrated with social security, the employer may use permitted disparity in meeting the nondiscrimination rules of the Internal Revenue Code. Finally, as stated earlier, virtually all employer-sponsored retirement plans assume their participants will receive social security benefits under a structure similar to the current program. Thus, while discussions of integration tend to focus on plans whose formulas are formally linked in some way to social security benefits, in the broadest sense almost all plans are integrated.

The effect of changes in social security benefits on integrated plans — and on the recipients of benefits from those plans — will vary according to the type of integration used. In many plans, the rate of employer-provided contributions or benefits for compensation below a certain dollar level is less than the rate of employer-provided contributions or benefits for compensation above that level. These are commonly called "excess" plans, and they are the most common form of integration today. Excess formulas can be used in traditional defined benefit plans or in defined contribution plans. Similar results can be obtained in flat-rate (generally union) plans, in profit-sharing plans, in money purchase plans and other plan designs. The dollar level that divides the higher and lower rates can be social security covered compensation (which is the average of the social security taxable wage bases in effect for each of the previous 35 years), the social security taxable wage base, or an arbitrary dollar amount (Canan 1997). The difference between benefits or contributions above and below this integration level is strictly limited by law — hence "permitted" disparity.

Benefits provided to employees under an excess plan will not be automatically adjusted when the social security defined benefit is changed, even if the social security benefit is dramatically reduced. Such plans might be subject to employee demands for higher pensions if employees felt they did not have enough money to retire. Changes to the taxable wage base will, however, affect the vast majority of excess plans, which typically rely on either covered compensation or the taxable wage base as their integration point. Increases in the taxable wage base will reduce the number of employees receiving benefits above the integration level. Social security reform

that both reduced the defined benefit and increased the taxable wage base might intensify pressure on these plans, unless employees, especially middle income employees, think they will accumulate enough retirement savings through other means.

Under an offset plan, the pension benefit is adjusted, within the limits imposed by Internal Revenue Code, for the expected value of the employee's social security benefit. If that expected value is changed through social security reform, the pension benefit may be adjusted automatically to compensate for the change, unless the plan is amended. Depending on how the social security reform provisions are constructed, such a result also could occur even if the overall expected value of the social security benefit was not changed, but a portion of the benefit is shifted to a defined contribution system. Under such proposals, permitted disparity might be limited to the portion of the social security benefit still funded and paid as a defined benefit.

Reducing the dollar amount of the offset without an attendant reduction in plan benefits would be prohibitively costly for most employers. Most analysts conclude that the adjustments in the pension benefits probably would not affect low or high income employees so much as they would affect middle income employees.³ Reduced integration that raised the pension benefits of lower-income employees might be offset by changes that slowed future accruals under the pension plan. Employees at the high end of the scale probably would derive more of their retirement income from non-qualified plans. Because middle-income employees are likely to derive a greater portion of their retirement income from the employer's tax-qualified plans than are either the lower-income employees or very-high-income employees, they have the most to lose if pension benefits are reduced to offset the costs of integration changes.

Finally, statistics are not available on the number of plans that do not integrate their contributions or benefits with social security but that use permitted disparity in meeting the Internal Revenue Code nondiscrimination rules. If the ability to integrate were reduced in any way, however, it is safe to assume that a number of these plans also would have to adjust their plans in order to accommodate the changes at an acceptable cost.

"Bridge" Benefits

Many individuals retire before they begin receiving social security benefits, and some plans provide special benefits that "bridge" the gap between actual retirement and commencement of social security payments, currently age 62 for reduced benefits and age 65 for full benefits.

Most social security reform proposals advocate, at a minimum, speeding up the scheduled increases in the social security normal retirement age from 65 to 66 and then 67. Others would also increase the age for social

security early retirement, now scheduled to remain at 62, albeit with benefits at a reduced level, when the normal retirement age increases.

Plans that provide bridge benefits to age 65 would suffer direct and dramatic cost increases under any of these proposals. Plans that currently bridge to age 62 could come under pressure to extend their payments as age-62 social security benefits decrease and workers want to continue to retire early but to delay commencing their social security benefits to a later age. Workers who retire early and do not have access to bridge payments might draw down balances in their 401(k), IRA, or other savings accounts before social security and annuitized pension payments commence, reducing disproportionately the funds they might need later as a protection against inflation and other contingencies.

Under any future trends and policies, significant numbers of workers will continue to retire early. For proposals providing for social security individual savings accounts, this raises the question of whether and under what conditions an individual should have access to such an account before the early or normal retirement ages specified under the social security program.

Guaranteed Minimum Benefit Levels

Some defined benefit pension plans provide more than one benefit formula, and the employee receives whichever benefit is greatest. In many cases, one of the formulas will be a minimum or guaranteed benefit level. If social security benefits are reduced, some employers may incur a greater outlay for such floor or minimum benefits and may need to curtail them to contain costs. Depending on the extent of the reductions in the social security benefits, however, employers offering such benefits could face pressure to increase them. Whether the employer can sustain or expand such benefits, or whether the employer will reduce the floor on minimum benefit levels, will depend on their cost and on whether such actions are in concert with the employer's business objectives.

Administration of Social Security Defined Contribution Accounts

Currently 145 million workers contribute to the social security program each year (Board of Trustees 1997). If social security defined contribution accounts were established, a system would have to be devised to collect the contributions from or on behalf of workers and to allocate each contribution to the appropriate investment(s). While social security reforms that change the integration of pensions with social security benefits can have a dramatic impact on many employer-sponsored retirement plans, creation of social security defined contribution accounts potentially could affect all employers whether the employer currently sponsors a retirement plan or not.⁴

Under current law, employers remit social security payroll taxes to the

government through a single transfer of funds based on their total payroll up to the social security wage base. How often payments are made depends on the size of the employer, and funds can be deposited as often as daily. However, employers report the wages of individual employees only after the end of the year.

Under a revised social security program that included individual savings accounts, it would be necessary to determine whether employers still will be able to remit all social security contributions through a single transfer, or whether they will be required to remit separate transfers for each employee. It will also be necessary to determine whether transfers will occur on the current schedule (i.e., as often as daily), or whether transfers for the defined benefit portion will occur on one schedule and transfers for the defined contribution portion on another. In addition the employer will need to know where to send the money for the defined contribution portion — to the Internal Revenue Service, to a new social security defined contribution office, directly to investment funds set up by the government or a quasi-governmental body, or directly to investment funds in the general economy.

Over 40 percent of civilian workers currently work at an establishment that does not sponsor a retirement plan for any of its employees (EBRI 1995). Of those who do work for establishments with retirement plans, many of those plans may be funded solely through employer contributions that occur on a quarterly or, more frequently, only on an annual basis. Thus, many employers have no experience whatsoever in handling employee contributions to a retirement plan or in processing contributions as frequently as occurs under a 401(k) plan. Additional administrative requirements on the employer also will reduce the amount of money available to provide other employment-based benefits or compensation for employees.

The simplest, least intrusive, and least costly method for employers would be to require the employers' contributions to be made according to procedures as close to current law as possible, to have the government allocate cash to each worker's individual account, and to have the worker tell the government directly how to allocate his or her account among available investments. The most complicated, intrusive, and costly scenario for employers would be to require the employer to transmit individual account contributions to any fund the employee designated on a daily basis (which would be more rapid than that required under current law for 401(k) deposits). The amounts of these deposits could in many cases be less than the cost of administration (see Pozen and Kimpel, this volume).

Each of these scenarios raises a host of important problems and questions. An individual account system that relied primarily on current schedules of wage reporting and on government administration would minimize burdens on those sponsoring plans for their employees, but employees might find the process unacceptably slow unless the government established a new mechanism for handling the individual accounts. Currently,

individual wages are not reported until after the close of the year, and it takes the Social Security Administration approximately another year to post that information to individual wage records (NASI forthcoming).

A system that relied primarily on employers to make the deposits to the employee's investment account might be quicker in getting cash into the individual's account, but it could also be so expensive that employees might find other parts of their compensation reduced. It could also be a compliance nightmare. The IRS currently tracks whether money deposited to the government matches taxes owed, but it does not track people's earnings records (and thus is not now equipped to track whether deposits made on behalf of an individual actually are made to that individual's account). The Social Security Administration currently tracks individual earnings records, but is not well positioned to determine whether individual taxes paid match with earnings records. Moreover, while the current system under which social security individual earnings records are accumulated has a low reported error rate, each year, about 2 percent of W-2 reports (or about 4.5 million out of 223 million reports filed) cannot be matched with any individual social security file (NASI forthcoming). Deposits made by an employer to investment accounts in the open market could pose the most widespread compliance issues to the government, since it would be difficult to verify that payments actually had been made and that the money was being invested according to acceptable fiduciary standards. Such a system could result in significant and burdensome reporting requirements on employers.

Responsibility for informing the individual worker of the status of his or her social security account is also a significant issue. This important job would be extremely difficult to accomplish through employers, since the information would have to be transferred each time an employee changed jobs and since a significant percentage of employees hold more than one job simultaneously or during any given year.

While these are only some of the possible problems and questions, they are sufficient to show that establishing social security defined contribution accounts without serious study of the administrative issues involved could have adverse effects on employers, on the sponsorship of employer pension plans, on the government, and, of course, on the millions of individuals who will depend on those accounts for a significant portion of their retirement security. Often overlooked and viewed as inconsequential, administrative issues may prove to be some of the more complicated and intractable in social security reform. They should be "forethought" — not an afterthought.

Impact of Social Security Defined Contribution Accounts on Employee Saving

Very little empirical microeconomic research exists regarding what motivates employees to save in a pension plan. Thus, if social security individual

savings accounts are created (whether in addition to current social security benefits or in lieu of a portion of those benefits), the impact that such accounts will have on whether employees save money elsewhere is unknown. Will employees be motivated to increase their savings in 401(k) and other plans as they see their account balances increasing in their social security account? Or will they assume that the social security account will be sufficient and decrease their other retirement savings? If the defined benefit portion of the social security benefit is substantially reduced, will employees be motivated to save more on their own, or will they decide the goals are unreachable and save less? Will they be more aggressive in their investment choices, or will they be more risk-averse?

Employees' responses to these questions will affect the employer's ability to manage its workforce and the employer's decisions on whether and what types of plans to offer. Employers could incur difficulties in meeting non-discrimination rules for their qualified plans if lower-paid employees decrease their savings. Employers may also alter their commitment to offer savings plans at all. On the other hand, if employees are motivated to increase their savings, more employers might decide to sponsor retirement plans for their employees.

Employee Access (or Lack of Access) to Retirement Saving Accounts

Most studies that are optimistic about the retirement prospects of the baby boom cohort assume that the individual keeps all of his or her retirement savings until retirement (EBRI 1994b). Retirement prospects change dramatically if there is too much "leakage" from the system. Allowing access to savings to meet current financial emergencies may be necessary, however, before employees with few other financial resources will be able to participate. Moreover, removing savings from a retirement plan in order to invest in a college degree (for one's self, not one's children) or to purchase a house may enhance the individual's ultimate retirement income.

Proposals to establish social security savings accounts generally require mandatory participation at specified levels. Thus, participation is not an issue. Access to money in those accounts is an issue, however, and the answers provided for a new social security program will have ramifications for savings programs sponsored by employers. For example, if employees are required to contribute additional funds to a social security savings account to which they have no access until they reach the social security retirement age, employees could pressure employers and policymakers to provide greater access to savings in employer-sponsored plans such as 401(k) plans. Employees also could reduce their savings in restricted plans and increase their savings in plans (such as after-tax savings plans) that have fewer restrictions.

If the result is less overall private and pension savings retained until retire-

ment (a possibility, not a foregone conclusion), then many workers will face delayed retirement and a reduced standard of living in retirement.

Education of Employees About Retirement Savings

Many experts agree that future retirees must assume more responsibility for accumulating the assets that they need to retire. Education is central to helping workers meet that responsibility.

Employer-provided education programs have significantly increased the incidence of employee saving. In one survey, among those who have had "a great deal" of assistance in retirement planning from their employers, 62 percent had already done a "fair amount" or a "lot" of retirement planning (Towers Perrin 1991). Among those who received little or no employer planning assistance, 41 percent had already planned for retirement. Among survey respondents who had not saved for retirement, 32 percent said they could not afford to do so, but only 19 percent of respondents receiving a great deal of employer assistance said they could not afford to save money.

Almost three-quarters (71 percent) of current workers participating in some type of salary reduction retirement savings plan, such as a 401(k) or 403(b) plan, say their employer has provided them with educational material or seminars about the plan. Among those with such resources available, the vast majority (81 percent) used the material or attended the seminars (EBRI 1997d). Participants who were provided educational materials that estimated the income needed for retirement appeared to increase the portion of their savings allocated to equity investments (EBRI 1996a).

In addition, when an employee receives a distribution that is eligible for a rollover to an IRA or other qualified plan (and thus the money could continue to be preserved in a tax-deferred fund for retirement), the plan is required to give the employee an explanation of the rollover rules. But serious education about retirement requires sustained effort; a technical explanation of the rollover rules at the time a distribution is made is not likely to enlighten many employees.

As social security reforms are considered, questions that should be asked include: To what extent will proposed changes to the social security program increase or hinder the education of employees about the need to save? If the new social security program has a defined contribution component, will the government undertake an education program for participants, and what impact will the government program have on the effectiveness of employers' programs?

Age of Retirement and of the Workforce

In the coming decades, employers will have to adjust to an older workforce. In the decade from 1990–2000, the number of workers aged 45 to 54 is

expected to increase by over 50 percent while the number of workers aged 25 to 34 is expected actually to decline by 10 percent (Schieber and Graig 1994). The median age of the U.S. population was 28 in 1970, is 33 today, and will climb to 39 by 2010 (Select Committee on Aging 1992). Whether an older workforce will translate into later retirements is a different question, however.

Most social security reform proposals include an increase in the social security normal retirement age. Only recently has information begun to be compiled concerning how often reduced social security benefits for earlier retirement will actually induce workers to delay their retirement.⁵ The trend in recent decades clearly has been for male workers to retire at earlier rather than later ages (EBRI 1997a). Certain plan designs may shelter employees from the effects of rising retirement ages so that employees will have no motivation to delay retirement. Employees have access to 401(k) and IRA savings without penalty beginning at age 59½, and those who accumulate sufficient assets in a defined contribution plan to retire early may do so. Moreover, under some offset plans, benefits under the plan may increase as early retirement benefits under social security decrease so that, for the employee, there is no change in economic status.

If increases in the social security normal retirement age do not induce more workers, particularly male workers, to delay their retirement, pressure on employer-sponsored pensions to provide greater early retirement subsidies will increase. If employers can neither meet the demands for increased early retirement subsidies nor accommodate large numbers of older employees in their workforce, employees will be forced to rely more on individual savings.

Plans That Do/Do Not Provide Additional Accruals Indefinitely

Under some employer-sponsored plans, benefits continue to accrue as long as the individual continues to work for the employer. Under other plans, benefit accruals cease at some point, generally after a certain number of years of service. In addition, in many plans, factors such as early retirement subsidies may make it more advantageous to retire at one age than at a later age.

As the normal retirement age under the social security program rises, pressure may be brought to bear on pension plans that limit accruals, either to uncap the limits (thus encouraging employees to work to later ages) or to provide benefits to bridge any gap between the age at which plan participants typically attain the plan's maximum accrual and the age for retirement under the social security program. Employers will have to decide on a course of action.

Replacement Ratio Targets

Despite recent downward trends, the majority of individuals who participate in employer-sponsored retirement plans still rely on a defined benefit plan for their primary benefit. In 1993, a defined benefit plan was the primary plan for 56 percent of active participants. The number of individuals who rely on defined benefit plans as their primary plan has remained relatively constant at between 25 and 30 million since 1975 (EBRI 1995). Under such plans, employers can predict with some certainty what employees can expect to receive in terms of replacement of their wages.

For these employees, social security reforms that reduce benefits will have an adverse effect on their ability to attain the overall (social security benefits plus pension benefits) income replacement ratio envisioned in their employers' plans. Reforms that shift benefits to defined contribution accounts will make attainment of a desired replacement ratio less certain.

Indeed, as account balances in defined contribution plans have increased, employers have had an increasingly complicated job determining when employees will accumulate sufficient resources to retire. This is especially true where the defined contribution plan is a 401(k) plan or other plan where participation is triggered by employee contributions. In these cases, attainment of a desired replacement ratio is affected not only by the rate of return on investments in an employee's account but also by whether most employees participate in the plan and, for those who do participate, the level and regularity of their contributions.

Concerns are expressed that individuals who do save fail to invest their savings aggressively enough to produce the returns needed to support an adequate retirement income. In one survey, 39 percent of the respondents who participated in 401(k) savings plans did not know how their plan dollars were allocated among asset classes. Among those who did know how their plan dollars were allocated, one-third had no money at all invested in stocks, including 31 percent who were under age 30 (Towers Perrin 1991). But other studies present a more hopeful picture, including one study that analyzed the investment behavior of 36,000 participants in 24 defined contribution plans. This study revealed that almost 60 percent of the aggregate assets were in fixed-income options. However, when the data were further analyzed by age of participant, the high percentage of assets in fixed-income options was primarily attributable to older workers who were nearing retirement and who also had larger account balances. Younger workers in the study had a higher percentage of assets in equity funds (Clark and Schieber 1998). More detailed recent studies present a varied picture *within* age groups. One analysis of investments under three large 401(k) plans revealed that between 17 and 41 percent of younger participants (aged 20–29 and 30–39) had no equity investments whatsoever, while others in these

same age groups had placed more than 80 percent of their investments in equities (EBRI 1996c). A similar analysis also would have to be conducted, of course, on investment choices made if social security individual accounts were enacted.

Provision of Disability and Survivor Protection

The current social security program provides substantial, and often overlooked, survivor and disability protection. A 27-year-old married couple with two small children, where both parents earned average wages, had over \$300,000 in social security survivor protection and \$207,000 in social security disability protection in 1997. Altogether, the social security program provided about \$12 trillion in life insurance protection in 1997, an amount exceeding the combined face value of all private life insurance policies in force. Of the 44 million persons receiving benefits each month, 3 million were children under age 18, mostly children of deceased workers, and 5 million were disabled adults (Advisory Council 1996).

Any change in social security benefits that reduced the life and disability protections currently offered also will have an effect on employer plans. Most employers provide some life insurance protection to their employees, and many who provide pensions also provide disability benefits. The disability benefits are almost always offset by receipt of social security disability payments. While these effects may not be as dramatic as changes affecting retirement payments, they still must be examined carefully before determining that they are not of major consequence. Of course, the effect of reductions in social security survivor and disability protection would be very dramatic for the individuals who otherwise would have received such payments.

Plans That Are Over/Under-Funded

For defined benefit plans, the ability of the plan sponsor to accommodate reductions in social security benefit payments with increases in pension payments, or to provide additional protections against social security benefits that may fluctuate in value (e.g., from social security individual accounts), will be influenced to some degree by the status of the plan's funding before such changes are effective. A plan that enters such a transition heavily overfunded obviously will have a wider range of financially viable options available to it than a plan that enters such a transition already strapped for cash, or even than a plan that is adequately funded but incurring substantial annual funding requirements.

However, several factors may impede the ability even of heavily overfunded plans to accommodate changes in social security benefits. One is that repeated changes in the tax laws over the past two decades have sub-

stantially reduced the ability of defined benefit plans to fund adequately for their long-term obligations and/or have reduced allowable contributions to defined contribution plans.

Prior to 1982, periodic revisions in the law generally were intended to increase retirement savings by liberalizing the tax treatment of individual and employer-sponsored plans. This practice produced long-term national savings and dramatically increased retirement savings but reduced current revenues to the federal government. Legislation enacted in 1982 reversed this trend, and at least eight other laws enacted since 1982 imposed even more limits on qualified plans.⁶ As Congress struggled to reduce the burgeoning federal deficit it looked increasingly to retirement plans to increase current revenues to the government.

Some policymakers have begun to express the view that the trend of previous years should be reversed. For example, legislation⁷ enacted in 1997 increases a critical funding cap that applies to many defined benefit plans. Analysis shows that such funding restrictions merely delay funding for working baby boomers, ensuring that companies will be faced with increasing funding requirements in the future precisely when they may also be facing the effects of social security reforms (ERIC 1996).

Other limits constraining the benefits that can be paid from tax qualified plans have a similar, but less often highlighted, effect. An employer designs its plans to meet business purposes and to provide employees with the resources, in combination with social security benefits, to replace enough of their wages in order that they will be able to retire. When this goal is not met through the employer's qualified plans, then employees may receive supplemental benefits from nonqualified plans. As Congress repeatedly narrowed the range of retirement income that can be supplied from qualified plans, reliance on nonqualified plans boomed. Benefits from nonqualified plans are not funded; they are paid out of the employer's available cash when the employee retires. Unless the limits on qualified plans are increased now, the demand for nonqualified payments will increase dramatically in the future, strapping the employer's future cash flow at precisely the same time that increased funding may be required for qualified plans and social security reforms may be taking effect.

The deferred tax treatment afforded qualified plans is a very cost-effective way for the government to help finance the retirement needs of American workers. The relationship between current tax expenditures and future tax receipts is evident in the impact of pre-funding of retirement benefits on the current tax expenditure attributable to private sector plans. Over the 1995–1999 period, only 29 percent of the pension tax expenditure is attributable to private sector plans. By contrast, 57 percent of the expenditure is attributable to federal (non-military), state, and local government employee plans, and 15 percent is attributable to military plans (Joint Committee on

Taxation 1995). The private sector figure is low today relative to the expenditure attributed to public sector plans in part because today's private sector retirees are paying taxes on benefits financed by funds for which the deferral of taxes occurred in previous years.

Design and Administration of Plans During a Transition Period

Much discussion has already ensued regarding transition requirements if social security reform results in significant changes in the social security benefit structure. Little or no discussion has occurred about the transitional effects of such changes on an employer's workforce and plans.

Employers sponsoring plans will face enormous challenges of their own during any transition period. They must design and simultaneously administer plans suitable for older employees who may be grandfathered under the current social security system, for middle-aged employees under one or more transition systems, and for younger employees under a new social security system. All the problems and costs of design, administration, and employee education will be, at a minimum, tripled. Employers who change their plans to meet changing business objectives do so after careful study and intensive employee education. In this case, employers will be dealing with changes that may or may not be coherent in terms of the company's business needs.

Conclusion

Employer plans have proved to be a reliable, effective, and efficient way to provide workers participating in those plans important tools to prepare for retirement. Employees expect to rely on these plans in the future for a greater portion of their retirement security than has been the case in the past. The design of those plans and the role they will play in the future can change from current expectations, however, because of the effects of social security reform.

The most immediate impact of social security reform will be on both the explicit and implicit integration of pension benefits with social security benefits and the administrative and other issues that arise if individual savings accounts are established under social security. Over the long term, the design of employer retirement plans will shift to accommodate the new social security program, business needs, costs, and employee desires. This paper has examined some of the possible changes that could occur in employer plans. As support coalesces around one or more approach to social security reform, each should be examined for possible impact in the areas studied in this paper. Only then can one determine whether the new combined system will meet societal goals of providing retirement income to

individuals, since neither the social security system nor the pension system were designed as stand-alone retirement programs.

Views expressed in this paper are those of the author and do not represent the views of the author's employer.

Notes

1. The data assume that lump sum distributions are preserved until retirement and that income is paid in the form of an annuity.

2. Once the effect of a given social security reform proposal on current employer-sponsored plan designs is understood, we must additionally ask whether the new combined system is likely to meet societal goals of providing retirement income to individuals, since neither the social security system nor the pension system have been designed as stand-alone retirement programs. However, this larger question is left for a later discussion. In addition, employers may urge a particular form of social security reform because they think that it will further general business purposes, such as increasing international competitiveness, even though the reform may require extensive renovation of their own employee benefit plans. A discussion of this point is premature at this time, since most businesses are only beginning their study of the issue.

3. For example, see Select Committee on Aging (1992). Graham (1994) reports that, for employees earning \$35,000 or more, pensions available from integrated plans are greater than those from non-integrated plans.

4. Here we focus on administrative issues that arise from the employer point of view. The government would face many other issues as well. For an examination of many of those issues, see the NASI study, in progress.

5. A 1997 EBRI/Gallup survey begins to build a base upon which to examine the potential impact of future changes in the social security retirement age (EBRI 1997b). For a survey of studies conducted prior to the 1983 amendments to the social security program see Special Committee on Aging (1982).

6. For a list of laws containing provisions that reduced amounts that could be contributed to or paid from tax-qualified plans, see ERIC (1996).

7. The Taxpayer Relief Act of 1997, PL 105-34, increases the 150 percent of current liability funding limit to 170 percent over a period of years.

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