RETIREMENT INCOME · 3

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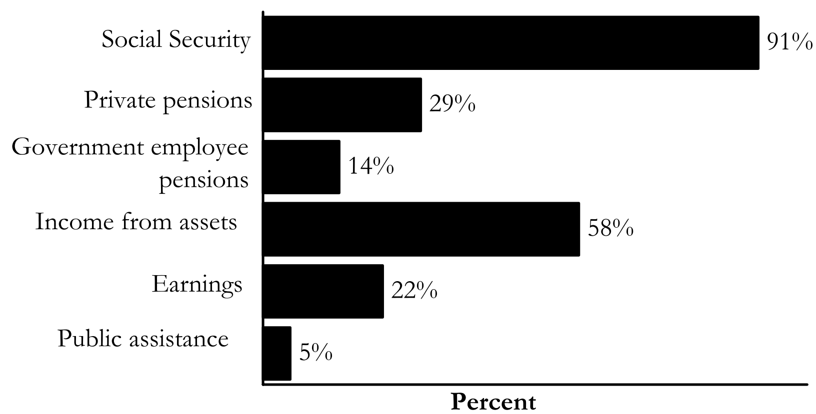
RETIREMENT INCOME

INTRODUCTION

Most Americans' retirement security comes from several sources of income. For the vast majority the Social Security system (Old Age, Survivors and Disability Insurance) is the foundation of economic security in retirement. Many Americans also have income from public- and/or private-employer pensions and/or from personal savings and assets. A large number of people, out of either necessity or personal preference, also have earnings from employment as a source of income in retirement (Figure 3-1). For those below the poverty line, public assistance programs provide a floor of income.

Figure 3-1

Percentage of People Age 65+ Receiving Income from Various Sources, 2001



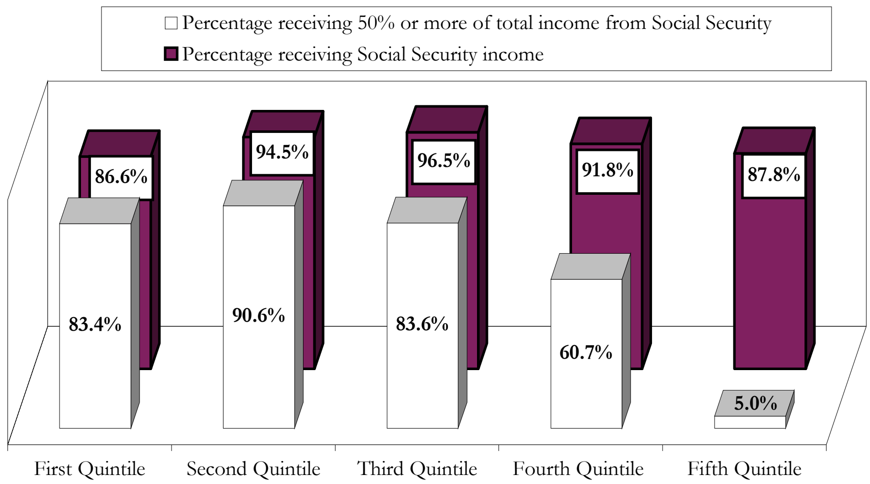
Source: Social Security Administration, 2002 (for all but public assistance data, Social Security Administration, 2000).
Prepared by AARP Public Policy Institute.

Social Security is legally defined as an entitlement because it is a mandatory spending program in which benefits are provided automatically to all who qualify. Benefits are awarded because workers made payroll tax contributions while they were in the paid labor force.

The stable base of income provided by Social Security (Figure 3-2), which is adjusted annually for inflation through cost-of-living adjustments (COLAs), has dramatically improved the economic status of older Americans over the past several decades. Social Security has been found to be more effective in reducing poverty than even those government programs specifically designed for that purpose. Additionally, the importance of Social Security as a predictable and stable income source has been underscored by the turbulence in the stock market. Furthermore, Social Security's benefit formula is progressive, replacing a higher percentage of preretirement income for low-income workers (53 percent) than for high-income workers (33 percent).

Figure 3-2

Percentage of People Age 65+ Receiving Income from Social Security, by Income Quintile,* 2003



*Quintile limits are $8,000, $12,224, $17,912, and $30,733.
Source: US Census Bureau, *March Current Population Survey*, 2004.
Prepared by AARP Public Policy Institute.

Women and minorities, however, remain economically vulnerable for several reasons. They may face limited employment opportunities, earn low wages, and experience periods out of the workforce and are less likely to receive income from a pension. Thus, women and minorities are among those most likely to depend almost exclusively on Social Security for their retirement income. But even the most financially fortunate may not be able to stretch finite resources over a lengthening lifespan. A personal or family crisis can undo the most carefully made plans.

In general, Americans are not well-informed about the amounts they can expect to receive from various income sources in retirement. Surveys reveal, for example, that people with pension coverage consistently overestimate the proportion of retirement income they will receive from pension coverage and underestimate the proportion from Social Security.

Several trends suggest that retirement income may be inadequate for growing numbers of future retirees: Americans' low saving rates and increasing lifespans, coupled with almost no growth in pension coverage (from 1995 to 2001, pension coverage grew from 39.5 percent to 41.1 percent of American workers age 25 to 64) and the trend toward employer-provided defined contribution plans, such as 401(k)s, which are voluntary and place the investment risk on the individual. Other trends toward easy access to retirement savings prior to retirement have renewed interest in the issue of inadequate national saving and its implications both for the pension system generally and for Social Security reform.

RETIREMENT INCOME

AARP PRINCIPLES

A secure retirement comprises four pillars: Social Security, pensions and savings, earnings and health insurance. The following principles will guide the association's decisions on retirement income security policymaking:

- Social Security should continue as the basis of lifetime, guaranteed, inflation-protected retirement income.
- Economic security in preretirement years is essential to retirement security.
- Employers should provide pensions and/or offer opportunities and incentives for all employees to save for retirement.
- Individuals should be encouraged, through incentives and education, to save on their own to supplement other sources of retirement income.
- Individuals should not be discouraged from continued employment, and alternative work options should be available for those who wish to work less than full time.
- Postretirement health benefits should be available to help retirees pay for the rising cost of health care.
- Changes to any of the pillars should be made gradually and in a fiscally and socially responsible manner. Adjustments should be made before major financing problems arise.

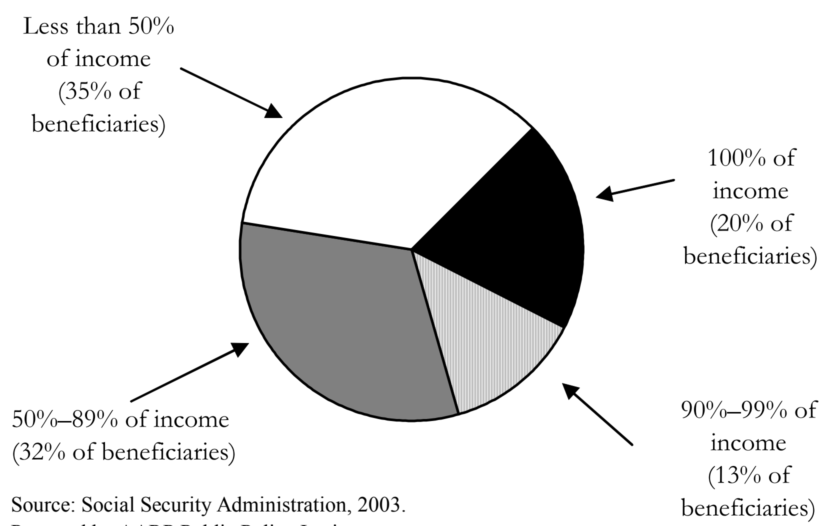
SOCIAL SECURITY

Introduction

Social Security is the primary source of retirement income for most Americans (Figure 3-3). Nearly seven out of ten beneficiaries today derive more than half of their income from Social Security. Among poor households of retirement age, Social Security is virtually the only source of retirement income. Recent research indicates that Social Security will remain a dominant source of retirement income into the future.

Figure 3-3

Social Security as a Percentage of Income for Those Aged 65 and Older, 2001



Source: Social Security Administration, 2003.
Prepared by AARP Public Policy Institute.

Social Security reflects the country's commitment to the economic security of employed and retired individuals and their families. But Social Security is more than a retirement program: It is a social insurance and family protection plan. It provides a guaranteed floor of income for spouses and dependent children of wage earners who die or become disabled during their working lives, for workers who become disabled, for widows age 60 and over, and for widows age 50 and over with disabilities, as well as for retired men and women and their families. Social Security embodies society's recognition that financial hardship resulting from the death, disability or retirement of a wage earner cannot always be anticipated or prevented.

Social Security has strong public support, yet many people—particularly those under age 40—have little confidence that they will receive benefits. Many people also are concerned about the future of Social Security, even though the program's trustees project that it is financially solvent and can pay full benefits until 2042 and nearly three-quarters of promised benefits thereafter, without any changes in the program.

SOCIAL SECURITY

Background

The Long-Term Status of the Trust Funds

The 2004 Social Security Board of Trustees report, in its intermediate estimates, projected that without any change in current law, the trust fund assets will continue to grow through 2028. The report found that trust fund assets, along with accrued interest, will be sufficient to continue paying full benefits on time through 2042 and about 70 percent of current benefits for decades thereafter. The Congressional Budget Office, using somewhat different assumptions and methodology, found that Social Security will have sufficient funds to continue paying full benefits on time through 2052. The assets of the Old Age, Survivors and Disability Insurance trust funds grew to more than $1.5 trillion at the end of 2003 and were expected to grow to more than $1.68 trillion by the end of 2004. This amount is necessary as a cushion against an economic downturn and to help finance retirement benefits for future generations.

Some assert that the trust funds have been raided or are not real. In fact, current law requires that Social Security trust funds be dedicated exclusively for the program's obligations. Any surplus funds are loaned in return for special-issue US Treasury bonds. These bonds are obligations guaranteed by the government. Regardless of how these funds are used by the borrower (e.g., for debt reduction or to help fund other government programs or Social Security program reform), there is no impact on the solvency of the trust funds: The trust funds still hold the same amount of Treasury securities, which obligate the federal government to pay the trust funds, enabling them to pay future benefits (for more on Social Security and the budget, see Chapter 1, The Budget: Federal Budget—Social Security).

These growing reserves have led some to propose either alternative investment strategies for these dollars or a reduction in the size of the buildup necessary to honor the commitment to today's workers.

The Long-Term Status of the Trust Funds

AARP supports the continued buildup of the trust funds, as scheduled under current law, in order to help finance benefits for future generations.

The Old Age, Survivors and Disability Insurance trust funds should maintain a minimum reserve of one and a half to two years as a cushion against economic downturn.

SOCIAL SECURITY REFORM PROPOSALS

Background

Social Security will require some adjustments to ensure the continued payment of fully promised benefits in the future. Most experts agree that if changes are made sooner rather than later, they can be more modest and those affected will have more time to adjust their financial plans. Some proposals adjust the formula used to calculate initial benefits by changing the rates or dollar amounts. Other proposals support covering a larger share of wages.

The need to ensure Social Security's long-term solvency has been used by some to propose basic structural changes that would replace all or part of Social Security's guaranteed benefit promise with individual accounts. This would threaten the program's income insurance and family protection features. It also would alter the retirement income structure by shifting more responsibility to individuals and exposing them to the greater financial risk and uncertainty associated with performance of investments.

There are two basic approaches to individual accounts: those that would maintain the current benefit structure and add on individual accounts and those that would create individual accounts by using part of the taxes that fund Social Security benefits, sometimes called a carve-out (for a further discussion of add-ons, see Chapter 2, Taxation: Income Tax Options—Individual Retirement Savings). The carve-out approach would significantly worsen solvency. Because the Social Security program is not in long-term actuarial balance, some reduction in program benefits and/or an increase in taxes would be necessary. Instituting a carve-out account entails a substantially larger reduction in basic Social Security benefits and/or a greater increase in taxes to maintain the benefits promised to current and near retirees because some payroll tax revenue would be used to fund the accounts. Some proposals also require borrowing, which would increase both the federal debt and deficit.

Actions to ensure Social Security's long-term solvency could affect the private pension system, saving rate, capital markets and workforce. Advocates for certain types of individual accounts, often termed privatization, say any problems could be resolved; those who are opposed express concerns.

AARP recognizes that any Social Security solvency package will involve a mix of changes to the program, including some elements that AARP might oppose. AARP will evaluate such packages in light of the overall balance of their impact on current and future beneficiaries, their consistency with AARP principles, and their effect on continued public support for Social Security.

FEDERAL POLICY

SOCIAL SECURITY REFORM PROPOSALS

The reforms needed to strengthen Social Security for the long term must ensure that future generations of workers and retirees and their families continue to receive an adequate guaranteed benefit that cannot be jeopardized by misfortune, eroded by inflation, or depleted by a long life.

Measures to increase individuals' savings for retirement are to be encouraged, but they should be in addition to, not instead of (as characterized by carve-out or privatized accounts), the guaranteed benefits provided by Social Security. AARP opposes any private accounts carved out of Social Security.

All who participate in the Social Security system (beneficiaries, employers and employees) should share on an equitable basis in the effort to maintain Social Security for coming generations.

SOCIAL SECURITY REFORM PROPOSALS

AARP Principles for Social Security Reform

AARP has policy positions on various proposals for Social Security reform. The following principles have been a guide in the association's formulation of policy positions and will continue to be a guide in developing new positions. These principles establish the general criteria by which the association will evaluate other specific solvency proposals and overall plans.

Any Social Security solvency package should:

- maintain Social Security as a stable defined benefit program that provides guaranteed benefits for life to all who have contributed to the system and meet the qualifications;
- maintain benefits that protect workers and their families from lost wages that result from death, disability and retirement;
- maintain a link between a worker's pay and time in the labor force and that worker's benefit;
- achieve universal participation;
- maintain the system's financial integrity and fairness by requiring earmarked contributions from both employers and employees;
- maintain a progressive benefit formula that continues to replace a greater share of low-wage workers' earnings;
- continue full, annual benefit adjustments to keep pace with inflation; and
- maintain an adequate early retirement benefit.

SOCIAL SECURITY REFORM PROPOSALS

Background

Replacing a Portion of Social Security Benefits with Individual Accounts

Social Security provides vital income protection to workers and their families. The initial benefit amount is wage-indexed, and thereafter, benefits are indexed annually for price inflation. Unlike a savings account, benefits cannot be depleted over a lifetime. Social Security's progressive benefit formula ensures that those who earned lower wages during their working lives receive proportionately larger benefits. Social Security plays a crucial role in reducing poverty among older people, particularly women and minorities. Without Social Security almost half (46.7 percent) of all older Americans would be in poverty. Instead, only 10.4 percent are poor.

Social Security is the foundation upon which beneficiaries can build a secure retirement by adding pensions, individual savings and investments, and health insurance. However, responsibility for pensions has dramatically shifted from employers to individuals. Individual saving rates continue to be low. The lack of savings and the decline in traditional defined benefit pensions and health benefits increase the importance of the guaranteed benefits Social Security provides.

For Social Security to remain the foundation of retirement income security, some adjustments must be made to ensure its long-term solvency. Many Social Security experts would restore long-term solvency in ways that maintain the program's basic features and underlying principles. Others suggest a fundamental restructuring that would move the program away from its social and income insurance foundation to one with individual accounts financed with a portion of current payroll taxes. These accounts, commonly called carve-outs, would replace some of Social Security's guaranteed benefit with a nonguaranteed individual savings plan. Another term for this is "partial privatization." It could expose many individuals to unnecessary risk, particularly low-wage workers who are less able to tolerate risk.

Moreover, carve-outs take money away from Social Security. During the transition to a system with individual accounts replacing part of Social Security, today's young workers would have to pay twice: once for their own benefits and again for the benefits of people currently or soon to be receiving them. Social Security Administration actuaries estimate that the cost of financing a transition from current law to a partially privatized system would be at least $2 trillion.

The returns to individual accounts would be lowered by potentially substantial administrative costs. If the private sector managed individual private accounts, the administrative costs would be comparable to those for an equity mutual fund, which average about 1.5 percent of account balances annually.

Carve-outs particularly disadvantage low-wage earners, predominantly women and people of color, for whom Social Security benefits represent a larger portion of preretirement earnings than they do for average and high-wage earners. For example, 48 percent of Hispanics and 44 percent of African-Americans over age 65 rely on Social Security for at least 50 percent of their income. Low-income earners would have less to invest and might be less able than higher earners to manage and diversify their portfolios. (Low-income workers are already at a disadvantage because if they have a pension, their lower earnings mean lower pension amounts.) These accounts also could eliminate current protections for low-wage workers and those who do not have continuous labor-force participation.

Many women would be disadvantaged because they live longer and are protected by Social Security's lifetime guarantee of annual cost-of-living adjustments. Since these accounts would be individually owned, women could lose important rights to their spouse's benefits.

Individual accounts also could jeopardize Social Security's disability protection. Currently 6.9 million people receive Social Security disability insurance benefits. Young workers who become disabled could receive a smaller lifetime benefit because they would not have had enough time to build up their individual account and might not be able to contribute once they withdraw from the labor force. Carve-out proponents also often overlook the value of disability benefits to African-Americans. This group represents 12 percent of the population, but makes up 18 percent of workers receiving Social Security disability benefits; their children represent 21 percent of those who receive benefits as the child of a disabled worker.

The benefits Social Security provides to surviving spouses, as well as eligible children and parents of workers, are also jeopardized by carve-outs. Currently, 4.9 million widow(er)s receive a survivor benefit because a worker has died. Many individual accounts would be too small to provide meaningful benefits, particularly if the worker dies at an early age.

FEDERAL POLICY

SOCIAL SECURITY REFORM PROPOSALS

Replacing a Portion of Social Security Benefits with Individual Accounts

Social Security's basic floor of income security for future generations should not be replaced by the hypothetical and uncertain gains assumed to come from individual private accounts (privatization). Measures to increase individuals' saving for retirement are to be encouraged but should be in addition to, not instead of, Social Security's guaranteed benefits.

Social Security's guaranteed, lifelong, inflation-protected, old age, survivor and disability benefits should not be replaced by individual accounts financed with the payroll tax dollars necessary to fund current and future benefits.

SOCIAL SECURITY REFORM PROPOSALS

Background

Wage vs. Price Indexing

Social Security uses wage indexing to adjust past earnings to current wage levels when calculating a worker's initial benefit amount (the Average Indexed Monthly Earnings). Wage indexing is also used annually to increase the three separate dollar amounts (bend points) used in the benefit calculation formula (the Primary Insurance Amount). A wage index provides a direct link between the taxes workers pay into the system (based on their work) and the benefits they receive. It also ensures that replacement rates remain relatively constant across cohorts.

Some Social Security reform proposals suggest substituting price growth for wage growth in these calculations. (Over Social Security's 75-year actuarial calculations period, average wages are projected to exceed increases in prices by a full percentage point each year.) Relying on prices to index a worker's wages gives less value to wages earned early in a career.

FEDERAL POLICY

SOCIAL SECURITY REFORM PROPOSALS

Wage vs. Price Indexing

AARP supports retaining wage indexing of both the Average Indexed Monthly Earnings and the Primary Insurance Amount formula rates and points.

SOCIAL SECURITY REFORM PROPOSALS

Background

Diversification of Trust Fund Investments

By law all of the Social Security trust funds must be invested in interest-bearing obligations of the federal government (including special-issue

Treasury securities) or obligations whose principal and interest are guaranteed by the US government, such as securities issued and guaranteed by the Government National Mortgage Association. The reserves may not be invested in corporate equities and bonds, real estate, or most other publicly or privately traded assets. Since 1981 the Treasury has invested trust fund assets only in special-issue securities. US Treasury securities are low risk but generally yield lower average returns than private equities over the long term.

Many Social Security experts have proposed investing, on behalf of all participants, a portion of the trust funds in instruments other than US government securities to increase the rate of return. Higher returns would reduce, though not eliminate, the need for benefit cuts or tax increases to achieve long-term solvency.

Other policy experts have expressed concerns about the government investing in the private market. Many worry that political considerations could drive government investment decisions, that the government might interfere in corporate governance, or that so much government money in the stock market might interfere with or skew the market.

Supporters of equity investment, however, are confident that such concerns can be adequately addressed through careful structuring. For instance, alternative investments could be managed through an expert investment board that contracts with private-sector passive equity index managers. In fact, the Federal Thrift Savings Plan and many state government pension plans already invest in private securities.

Investment of a part of the trust funds has other advantages: Pooling investments reduces risk and keeps transaction and reporting costs to a minimum, thus producing higher net returns than individual accounts similarly invested.

FEDERAL POLICY

SOCIAL SECURITY REFORM PROPOSALS

Diversification of Trust Fund Investments

Congress should authorize the investment of a portion of the Social Security reserves in investments other than Treasury securities. These investments should be made by designated fiduciaries on behalf of the trust funds and for the sole benefit of the trust funds.

Proposals for diversifying investments must:

- be insulated from political influence and structured to protect the integrity of the fund or issuer;

- minimize risk while maximizing yield; and
- prevent interference with or negative effects on markets, corporate governance, economic growth and productivity.

SOCIAL SECURITY REFORM PROPOSALS

Background

Taxation of Benefits

Beginning in 1984 up to 50 percent of Social Security benefits became subject to Federal income tax for filers whose adjusted gross income plus nontaxable interest income and one-half of Social Security benefit exceeds nonindexed thresholds of $25,000 for single people and $32,000 for married couples. The revenue raised reverts to the Social Security trust funds. Some plans to reform Social Security have proposed increasing the percentage of benefits subject to a tax and/or lowering the tax thresholds.

Beginning in 1994, in order to tax Social Security more like a pension, Congress made up to 85 percent of benefits taxable when beneficiaries' annual adjusted gross income plus tax-exempt interest and half of their Social Security benefit exceeds $34,000 for single filers and $44,000 for married couples filing jointly.

Today, more than one in three Social Security beneficiaries age 65 and older is affected by taxation of benefits. About 20 percent of Social Security beneficiaries age 65 and older are subject to the 85 percent tier of benefit taxation.

Of the 41 states that have a broad-based personal income tax, 15 tax Social Security retirement benefits. If those states' tax systems are tied to the federal income tax, as is likely, any additional federal taxation of Social Security benefits automatically translates into an additional state tax burden as well.

AARP opposed the increase to 85 percent, because it disadvantaged people who saved for retirement and cut into people's retirement incomes without giving them time to plan for the increase. Additionally, the revenue raised from taxing the additional 35 percent of benefits, estimated to be $100 billion over a ten-year period, is credited to the Hospital Insurance (Medicare Part A) trust fund and not to Social Security. However, revenue from the new tax is now part of Medicare's financing.

FEDERAL POLICY

SOCIAL SECURITY REFORM PROPOSALS

Taxation of Benefits

No further action should be taken to increase the taxation of Social Security benefits. Any proposal to eliminate the second-tier level for taxing Social Security benefits should also permanently restore any lost revenue to Medicare to keep the Hospital Insurance trust fund whole (for policy on state taxation of Social Security benefits, see Chapter 2, Taxation: Income Tax Options—State Equity Measures).

SOCIAL SECURITY REFORM PROPOSALS

Background

Affluence Testing and Means Testing

Some proposals for Social Security's long-term solvency include affluence testing or means testing. "Affluence testing" generally refers to a partial reduction in the benefits of those with incomes above a certain threshold. "Means testing" would completely eliminate benefits for people above a certain income level. Means testing has been rejected by many analysts because of the potential negative effect on individuals' willingness to save. Both affluence and means testing would change the relationship between contributions to Social Security and benefits received, and erode the principle of universality.

FEDERAL POLICY

SOCIAL SECURITY REFORM PROPOSALS

Affluence Testing and Means Testing

The receipt of Social Security benefits should continue to be based on Social Security-covered work and payroll tax contributions, and not be affected by other income sources or subject to other tests.

SOCIAL SECURITY REFORM PROPOSALS

Background

Cost-of-Living Adjustments

If Social Security benefits did not keep pace with inflation, most beneficiaries would experience a significant decline in their standard of living. The annual cost-of-living adjustment (COLA) does not function as a benefit increase but helps maintain the purchasing power of the benefits over time.

Full COLAs help all beneficiaries keep up with inflation. This is particularly important for those who depend on Social Security for a large portion of their income (Figure 3-2). Any across-the-board cuts in Social Security benefits or reductions or delays in the COLA would disproportionately affect these individuals.

Social Security benefits and other income payments are adjusted annually according to increases in the Consumer Price Index for Wage Earners and Clerical Workers (CPI-W). This index applies to 32 percent of the US population and represents households in which at least one-half of the income is earned from clerical or wage jobs. The Consumer Price Index for All Urban Consumers (CPI-U) represents about 80 percent of the population and includes the spending patterns of retired people. The CPI-U is not used for federal COLAs, although studies suggest that it more closely reflects beneficiaries' and older people's purchasing patterns than does the CPI-W. The Bureau of Labor Statistics calculates the CPI after extensive research and analysis. Yet some analysts suggest that while the CPI may be the best measure of inflation, neither the CPI-W nor the CPI-U accurately measures the cost of living.

Policymakers continue to show interest in lowering or recalculating the CPI in order to reduce Social Security benefits or achieve fiscal savings. The current CPI, however, may not accurately reflect inflation as experienced by older people. This issue is being studied, and experimental indices suggest that the inflation rate for older people has been understated for approximately the past ten years, particularly because of higher medical costs. The Consumer Price Index-Experimental (CPI-E), developed between 1987 and 1988 to focus on people over age 61, raised the possibility that older people face higher inflation than the rest of the population (for a discussion of the CPI and poverty measures, see Chapter 5, Low-Income Assistance: Measures of Poverty and Income).

The Chained Consumer Price Index (C-CPI-U) is a new supplemental index. While it does not replace the CPI-U or the CPI-W, it is published (since August 2002) with those indices. The C-CPI-U is closer to a real cost-of-living index than the other indices because it accounts for consumers' ongoing substitution of new items for old due to changes in income, tastes and preferences or because the quality of an item has improved.

Proposals to cap the COLA permanently for all those with income or benefits above a minimum level also have been advanced as a way of reducing Social Security benefits. To protect the poorest individuals, these proposals allow beneficiaries who have very low benefits to receive a full COLA and all other beneficiaries to receive a COLA capped at a specified level. Eliminating any portion of a COLA has a dramatic compounding effect on a beneficiary's income. Beneficiaries who get partial COLAs become poorer as they get older. Any COLA reductions, such as limits or caps, would substantially reduce the lifetime income of affected beneficiaries.

FEDERAL POLICY

SOCIAL SECURITY REFORM PROPOSALS

Cost-of-Living Adjustments

Social Security should continue to provide automatic annual benefit adjustments based on the full year-over-year change in the Consumer Price Index (CPI). These cost-of-living adjustments (COLAs) should not be reduced to achieve budgetary savings.

Congress should not legislate changes to or politically interfere with the CPI as calculated and adopted by the Bureau of Labor Statistics.

AARP supports using the Consumer Price Index for All Urban Consumers, rather than the Consumer Price Index for Wage Earners and Clerical Workers, as the more appropriate index to calculate Social Security COLAs at this time.

AARP supports continuing research on indices that reflect the spending patterns of all beneficiaries to determine the most accurate index.

SOCIAL SECURITY REFORM PROPOSALS

Background

Full/Normal Retirement Age

The 1983 amendments to the Social Security Act included a gradual increase in the age for receiving full retirement benefits from 65 to 67 (Figure 3-4). In order to reduce costs and improve solvency, some are proposing further increases in the full retirement age. These proposals range from accelerating the timetable for the 1983 increase to raising the age of normal retirement (when an individual receives full benefits) to 70 and indexing the full retirement age to longevity.

Figure 3-4

Age for Full/Normal Retirement Benefits

If you were born in:	Retirement age (Year)	Retirement age (Months)
1937 or earlier	65	0
1938	65	2
1939	65	4
1940	65	6
1941	65	8
1942	65	10
1943–54	66	0
1955	66	2
1956	66	4
1957	66	6
1958	66	8
1959	66	10
1960 or later	67	0

Source: Social Security Administration, *Social Security Handbook (13th ed.),* 1997.
Prepared by AARP Public Policy Institute.

Some believe that age 65 was established when relatively few workers reached that age; that the scheduled increase to 67 is an inadequate response to increased longevity; and that since Social Security faces a shortfall due in part to demographics and increased longevity, increasing the normal retirement age (NRA) must be considered. The Social Security actuaries project that life expectancy at age 65 will increase by approximately 5 years between 2000 and 2080.

Conversely, many concerns have been raised about the impact a change in the NRA would have on certain groups of workers. For instance, African-American men have below-average life expectancies and thus would be disproportionately hurt by a higher retirement age. In addition, increasing the NRA could have a disproportionate impact on women, who tend to rely more heavily on spousal benefits. If the NRA is increased, the actuarial reduction for early retirement is greater, which means women whose husbands retire early will receive a lower benefit for life. Finally, the fact that most people are living longer does not necessarily mean they can work longer; those in physically demanding jobs would be hit hard by a higher retirement age. Of equal concern are age discrimination and the likelihood of suitable jobs being available for workers in their late 60s.

FEDERAL POLICY

SOCIAL SECURITY REFORM PROPOSALS

Full/Normal Retirement Age

No further increase in the normal retirement age should be considered until the effects on older workers of already scheduled increases in the age under current law have been analyzed.

SOCIAL SECURITY REFORM PROPOSALS

Background

Early Retirement Eligibility

The 1983 Social Security Amendments enacted an important retirement disincentive. Under the previous law the penalty for retiring at age 62 was a 20 percent reduction in the benefit that would have been received at age 65. Starting in 2000 the eligibility age for unreduced retirement benefits, now 65 and two months, will gradually increase to 67. When this change is fully phased in, a worker still could receive benefits at age 62, but the benefit rate, although actuarially accurate, would be lower than the rate at age 62 under current law. When the increase in the retirement age becomes fully effective, a worker retiring at age 62 would experience a 30 percent reduction from the benefit at age 67 rather than the former 20 percent reduction. Some of the Social Security solvency packages suggest gradually raising the early retirement age to 65. For some individuals, because of health and/or employment options, working past age 62 is not feasible (for a further discussion of older people seeking work, see Chapter 4, Employment).

FEDERAL POLICY

SOCIAL SECURITY REFORM PROPOSALS

Early Retirement Eligibility

Adequate and actuarially sound early retirement benefits should continue to be available for workers at age 62.

SOCIAL SECURITY REFORM PROPOSALS

Background

Years in the Benefit Calculation

The formula for calculating Social Security benefits for retired workers uses their time in covered employment, their earnings up to the taxable maximum, and the age at which they left the labor force. The worker's highest 35 years of earnings are averaged as the base for applying the formula. To improve solvency some proposals would increase the number of years used for calculating retirement benefits from 35 to 38. This is equivalent to an average benefit reduction of about 3 percent. The reduction for women, whose work histories are less likely to be continuous, could be even greater.

FEDERAL POLICY

SOCIAL SECURITY REFORM PROPOSALS

Years in the Benefit Calculation

The number of years used to calculate benefits should not be increased beyond the 35 years designated in current law.

SOCIAL SECURITY REFORM PROPOSALS

Background

The Wage Base

In 2005 workers and employers each pay 6.2 percent in taxes on wages up to $90,000, the maximum amount taxed for Social Security purposes. Increasing the amount of wages subject to payroll tax is an approach often suggested to help move toward long-term solvency of the Social Security system. While totally removing the wage cap has been discussed as a possible option, there are several concerns:

- Benefits are related to contributions in the benefit calculation formula. If all wages were subject to tax, but not included in the benefit calculation, high-income people would receive very low replacement rates, with likely losses to Social Security's broad-based support.

- Social Security was designed to replace a portion of preretirement income and be supplemented with savings and pensions.

Today, about 84 percent of wages are subject to the payroll tax—historically, the rate was set with the intent of covering 89 percent to 90 percent—and the maximum taxable wage increases annually based on wage growth. Because wages above the taxable maximum have increased more rapidly than wages in general, the wage base covers a smaller portion of total wages than it did in the past. Increasing the contributions and benefit base to cover a larger portion of wages would affect workers earning more than the 2005 level of $90,000. (If the wage base were 90 percent, the taxable maximum would be more than $140,000 by 2008.)

FEDERAL POLICY

SOCIAL SECURITY REFORM PROPOSALS

The Wage Base

AARP supports increasing the percentage of wages subject to the payroll tax to historically intended levels.

SOCIAL SECURITY REFORM PROPOSALS

Background

Coverage of State and Local Government Workers

About 95 percent of American workers—including private-sector workers, all federal government employees hired after 1983, and the majority of state and local government workers—participate in Social Security. Most of those state and local workers participating in Social Security are also covered by a government pension. However, about 30 percent of state and local government workers remain outside Social Security and participate only in their own retirement system. Most of these uncovered workers are teachers and public safety officers, such as firefighters.

Universal participation in Social Security is desirable because it ensures that everyone will receive the program's protections, some of which are missing in existing government plans. Many state and local government workers who are not currently eligible to receive death or disability benefits could receive them if they participated in Social Security. Universality also avoids inequities that can arise when some workers benefit from the program without contributing to it. Mandatory coverage has been included in most major legislative reform proposals, as well as in all three plans proposed by the Social Security Advisory Council.

Covering newly hired state and local workers under Social Security has been suggested as a way of moving toward universal participation that would protect both the pensions of those already participating in state and local plans and the fiscal integrity of current state and local systems.

FEDERAL POLICY

SOCIAL SECURITY REFORM PROPOSALS

Coverage of State and Local Government Workers

Social Security should cover all workers, including all newly hired state and local government workers, because universal participation ensures that all workers and their families will receive the program's benefits and protections.

In making this change, uncovered retirees and workers must be assured that already promised government pension benefits, including any transitional relief, will not be jeopardized.

SOCIAL SECURITY QUALITY OF SERVICE AND ADMINISTRATION

Background

The Social Security Administration (SSA) became an independent agency in 1995 to provide the program with consistent direction and professional management and help insulate it against decisions not based on Social Security-related issues.

Since 2000 all workers age 25 and over employed in jobs covered by Social Security receive a Social Security Statement, an annual update on their contributions and estimate of their retirement, disability and survivor benefits. This information campaign has been a success.

There are, however, ongoing administrative concerns—among them, the need for SSA employees who are able to respond to a multilingual and culturally diverse population of applicants and beneficiaries, the SSA's need for new staff to replace the large group of employees who are scheduled to retire in the next five years, and the agency's failure to reduce significantly its backlog of both disability applications and continuing disability reviews. Efforts to deal with the SSA's service problems, however, are hampered by insufficient funds. Although the SSA's administrative expenses are paid from the trust funds, such payments are insufficient because the agency's administrative expenses have been included in non-Social Security spending caps in past years. This meant the SSA's expenses may have been artificially low in order to comply with spending caps unrelated to Social Security.

If the discretionary spending caps are reimposed, AARP supports removing Social Security's administrative costs from the federal budget cap on domestic spending.

SOCIAL SECURITY BENEFIT ISSUES • Benefit Adequacy

Background

Women

Social Security is a lifeline for older women. With benefits that keep up with inflation, Social Security is women's predominant income source. Women are less likely than men to have adequate pensions or savings. In fact, 26 percent of all unmarried older women rely totally on Social Security, 42 percent depend on Social Security for at least 90 percent of their income, and 74 percent rely on Social Security for at least 50 percent of their income. Without Social Security half of all older women would be in poverty.

As Social Security undergoes examination and change, the benefits women receive must be protected. Women still earn just three-fourths of what men earn and spend far more time than men do out of the labor force caring for children and family members. As a result women's benefit levels are consistently lower than men's. Benefit improvements for women could include providing credits for time taken off as a caregiver, raising the widow's benefit from two-thirds of the couple's combined benefit to three-quarters, and crediting a spousal benefit, rather than the woman's own, lower benefit, with a delayed retirement credit when the worker delays receiving Social Security after age 64. For women who become disabled, a benefit improvement to consider would be allowing widow(er)s with disabilities who do not have a work record of their own to be considered for disability benefits at any age rather than at the current-law age of 50.

Generally, the need to make and keep Social Security solvent for the long term requires that the costs of any improvements be fully offset or minimal. But some changes being proposed to ensure Social Security's long-term solvency would have a disproportionately adverse impact on women. For instance, women have longer life expectancies and face more years of inflation. Therefore, proposals to cut cost-of-living adjustments, which help benefits keep their purchasing power, would especially hurt women.

Women

All proposals designed to ensure the long-term solvency of Social Security should be evaluated for their impact on women. Congress should avoid adopting changes that individually or together appreciably worsen the financial situation of older women.

Consistent with maintaining the long-term solvency of the trust funds, policymakers should consider reforms that would improve Social Security's protections for women and if necessary phase them in gradually.

Delayed retirement credits should be added to spousal benefits.

Congress should reexamine the age threshold for widow(er)s with disabilities.

SOCIAL SECURITY BENEFIT ISSUES

Background

Earnings Limit

The Social Security earnings limit reduces Social Security benefits for beneficiaries whose earnings from work exceed a certain threshold, called the exempt amount. The earnings limit rises annually with the growth in average wages and has long been both a source of confusion and frustration for beneficiaries and an administrative problem for the Social Security Administration.

Effective January 2000 the earnings limit for workers who reach full retirement age was eliminated. For workers under age 65, benefits are now reduced by $1 for every $2 earned over the exempt amount ($11,640 in 2004). Although the limit is not widely understood, workers who receive reduced benefits because of the earnings limit will eventually recapture all of their lost benefits once they retire fully from the workforce.

Some advocate raising or eliminating the earnings limit for those age 62 through 64, which might induce some additional workers to claim Social Security benefits before the normal retirement age. There is some evidence that claiming benefits before the normal retirement age leads to an increase in poverty rates among the very old, particularly widows. This occurs because benefits received before the normal retirement age are reduced permanently since they are paid over a longer period of time. Also, because eliminating the earnings limit for early retirees would encourage additional workers to claim their benefits early, there would be a short-term cost to the Social Security trust funds.

FEDERAL POLICY

SOCIAL SECURITY BENEFIT ISSUES

Earnings Limit

AARP does not support proposals to liberalize the Social Security earnings limit for working beneficiaries age 62 through 64 unless the integrity of the Social Security trust funds is maintained and it can be shown that there would be no adverse impact on the financial well-being of those retirees or their spouses over the short and long term.

THE SOCIAL SECURITY NOTCH

Background

In 1977, to correct a flawed Social Security formula adopted in 1972, Congress enacted a new benefit formula for all those born after 1916. The law provided a five-year transition for those born from 1917 through 1921. This legislatively defined transition period is often called the notch. Because of the 1972 law, people born between the years 1912 and 1916 received unintended "windfall" benefits. This has led many of those born in the transition years to believe mistakenly that they are getting less from Social Security than they deserve. A variety of legislative proposals have been designed to extend additional benefits to those born from 1917 through 1921; others, through 1926. An independent commission appointed by Congress and the President to study the notch reported that the current benefit formula is fair and should not be changed.

FEDERAL POLICY

THE SOCIAL SECURITY NOTCH

AARP supports the findings of the report of the Commission on the Social Security Notch that no beneficiaries are receiving less in benefits under the correction than they earned.

DISABILITY INSURANCE

Background

Social Security Disability Insurance (SSDI) covers all those who work and pay Social Security taxes. In 2004 it provided vital income support for almost

7 million disabled workers and their families. This represents close to 15 percent of Social Security beneficiaries. Older workers (age 50 to 65) with disabilities rely heavily on the SSDI program, because they are less likely than younger workers to recover and be reemployed.

The combined Old Age, Survivors and Disability Insurance (OASDI) trust funds are in short-range actuarial balance—the Disability Insurance (DI) trust fund by itself is projected to increase through 2007. After 2007 the DI trust fund decreases steadily until it is exhausted in 2029. The financial health of the DI trust fund has worsened for a number of reasons: The large population of baby boomers is reaching the age where disability is more likely; the proportion of workers awarded disability benefits has increased; the proportion of beneficiaries whose disability benefits are terminated has decreased; and more workers in their 30s and 40s are receiving benefits.

The Social Security program as a whole needs adjustment to ensure that benefits will continue as promised. In response, some have proposed creating individual accounts that would carve out some of Social Security's current defined benefits. These accounts, because they reduce the income to the overall Social Security program, could reduce DI benefits. Because the person with the disability can no longer work and contribute to the individual account, the total benefit amount from the account would also be reduced (for a further discussion of carve-outs and their impact on benefits, see this chapter's section Social Security Reform Proposals—Replacing a Portion of Social Security Benefits with Individual Accounts).

FEDERAL POLICY

DISABILITY INSURANCE

All covered workers who are too disabled to work (and their entitled family members) should continue to receive Social Security Disability Insurance.

Any changes needed to strengthen Social Security as a total program should continue to provide adequate income support for those with disabilities and their families.

DISABILITY INSURANCE

Background

Administration and Determination of Disability

In recent years the Social Security Disability Insurance program has grown rapidly, requiring additional dollars not only for benefits but also for program administration. There is also evidence, from a 2000 study conducted under the auspices of the Social Security Advisory Board, that determinations of disability are not made in a "uniform and consistent" manner. Many contributing factors have been identified. Among them are lack of face-to-face interviews with claimants until well into the process and inconsistency in initial determinations and quality assurance reviews across the country. Additionally, there is evidence that neither applicants nor beneficiaries understand the disability determination or review process. While the Social Security Administration (SSA) runs the program, initial disability determinations and reconsiderations take place at state disability determination offices. The SSA could improve how it manages this program and could use additional administrative funds to do so.

Under current law receipt of Social Security Disability Insurance (SSDI) benefits is determined by whether the person is unable to engage in substantial gainful activity (SGA) by reason of any medically determinable physical or mental impairment that can be expected to last at least one year or result in death. In 2005 the SGA for nonblind individuals is $830 per month. Workers who receive SSDI for 24 months are then entitled to Medicare Hospital Insurance benefits and are eligible to enroll in the Medicare Supplemental Medical Insurance program, for which they must pay a monthly premium.

Social Security does not provide Temporary Disability Insurance. Rather, it is primarily a state social insurance program designed to partially compensate for lost wages resulting from temporary nonoccupational disabilities and pregnancy. (The distinction between sick leave and temporary disability is minimal—basically it lies in what health conditions each individual plan covers.) Most programs cover wage-and-salary workers in private employment in commercial and industrial organizations, and some jurisdictions cover agricultural workers.

Permanent impairments that limit but do not preclude working are permanent partial disabilities. Little coverage is provided for the costs associated with them because of the uncertainty or inexactness of determining their effects. People may be physically capable of performing jobs for which they are not qualified but may be unable to meet the physical demands of a job for which they are qualified. Today, the only programs that cover permanent partial disability are workers' compensation plans, veterans' compensation plans (which are service-related), and uniformed civilian service plans.

FEDERAL POLICY

DISABILITY INSURANCE

Administration and Determination of Disability

AARP supports allocating additional dollars to strengthen the administrative capacity of the Social Security Administration (SSA) so it can meet the needs of Social Security Disability Insurance (SSDI) applicants and beneficiaries (for a further discussion of the agency's administrative budget, see this chapter's section Social Security Quality of Service and Administration).

AARP supports moving toward federalizing the parts of the disability determination system that are currently state-administered.

The SSA should ensure that SSDI claimants and beneficiaries receive the information they need to understand the disability insurance determination and review process.

AARP supports exploring improvements in the application and appeals process for SSDI and Supplemental Security Income disability benefits through demonstration projects that provide "assistants/advocates" to those applying for benefits or appealing decisions.

To improve the accuracy of decisions, face-to-face interviews should be conducted at the initial determinations point.

The SSA must remain vigilant as it explores new ways to improve the appeals process, so that beneficiaries and applicants are afforded all the rights to which they are entitled.

AARP supports monitoring the SSDI program closely to ensure that eligibility determinations and continuing disability reviews are made in a fair, consistent and timely manner.

AARP recommends that the SSA decouple a finding of disability from fitness-to-work and explore the options of providing temporary-total and permanent-partial disability benefits.

AARP recommends that policymakers eliminate the existing 24-month Medicare waiting period for SSDI beneficiaries.

DISABILITY INSURANCE

Background

Work Incentives

In addition to providing stable benefits for those who cannot work and their families, an essential component of the Social Security Disability Insurance (SSDI) program is encouraging and assisting beneficiaries who may be able to return to work to try to do so. This helps expand the labor force and saves SSDI trust fund dollars. However, the prospect of going without the Medicare coverage provided after two years to beneficiaries with disabilities may dissuade many people with disabilities from returning to work. Beneficiaries' anxiety about the lengthy waiting period for reinstatement of benefits for those unable to continue working, and the generally burdensome reapplication process, also affect the decision to remain on SSDI income support. The Ticket to Work and Work Incentives Improvement programs address this problem by expanding the availability of health coverage through Medicare and Medicaid for working individuals with disabilities (for eight additional years).

FEDERAL POLICY

DISABILITY INSURANCE

Work Incentives

AARP supports continuing efforts by both the administration and Congress to expand work incentives through the Ticket to Work and Work Incentives Improvement programs for Social Security Disability Insurance beneficiaries as long as they continue to provide a measure of economic security and health benefits and do not endanger the long-term integrity of the Social Security trust funds.

DISABILITY INSURANCE

Background

Rehabilitation

People with disabilities may receive disability payments after a waiting period and before physical or vocational rehabilitation. The strict definition of "disability" requires a claimant to prove virtual inability to work. Only at the end of the long determination process is the individual sent for rehabilitation. Currently, a state disability determination service sends appropriate candidates to a state vocational rehabilitation (VR) agency. The option of serving the beneficiary is offered first to the states. If a state's VR agency does not accept a beneficiary for service after a specified time period, the Social Security Administration (SSA) may arrange an alternate provider. These alternate providers usually come from the private sector, and the SSA is making an effort to expand this pool.

Strong evidence suggests that early intervention, using both physical and vocational rehabilitation, helps newly disabled individuals view themselves as disabled but able to work, and thus they are more likely to return to the paid labor force. Early intervention promotes independence and productivity for people with disabilities who wish to return to work. The SSA is currently experimenting with a new process for disability claims that intervenes early and moves the individual more quickly through the system into rehabilitation and work, if possible. The Ticket to Work and Work Incentives Improvement programs, in addition to access to Medicare and Medicaid, provide a network of free vocational rehabilitation, job training and other support services.

FEDERAL POLICY

DISABILITY INSURANCE

Rehabilitation

AARP supports more widespread availability of vocational rehabilitation and employment services.

AARP supports continued expansion by the Social Security Administration (SSA) of its pool of alternate providers of vocational rehabilitation for Social Security Disability Insurance beneficiaries.

AARP supports the SSA's efforts to intervene early in an individual's disability, because using physical and vocational rehabilitation early on for all age groups enhances the probability of employees' returning to work.

The design of rehabilitation programs must take into consideration their impact on state budgets.

PRIVATE PENSIONS

Introduction

Federal pension laws have made pension coverage broader, fairer and more secure. However, private pension coverage has remained largely stagnant during the past 25 years, despite modest improvements for women in the last ten years.

About 29 percent of Americans age 65 and over receive private pensions or annuities, and another 14 percent receive government (federal, state, local or military) pensions. Many of these pensions are modest.

Millions of Americans are in danger of reaching retirement without adequate income, even if they have worked in pension-covered jobs. Workers in retail sales and services industries, part-time and contingent workers, and people working for firms with fewer than 100 employees generally lack meaningful pension coverage. Even retirees with relatively good pensions may not see their benefits keep pace with inflation. Generally, few private plans regularly adjust for the rising cost of living; full cost-of-living adjustments are almost nonexistent, and ad hoc adjustments are becoming less common.

Pension plans are increasingly voluntary employee-paid defined contribution plans rather than employer-paid defined benefit plans. (Some defined contribution plans do include limited employer matching of employee contributions.) In particular, there has been phenomenal growth in employer-sponsored 401(k) plans over the past two decades. Such plans place both the responsibility to participate and the risk and responsibility of investment performance on employees.

Furthermore, at least half of the workers with vested pension benefit plans cash them out prematurely, in whole or in part, when changing or leaving jobs or borrow from them to make purchases before retirement. This is particularly true for lower-paid workers. Among those using their entire lump-sum distributions for one purpose, only 35 percent roll over the entire amount of their distribution to tax-qualified savings. (Approximately 14 percent use the entire distribution for consumption.) Even though workers may use some of this money for necessary or productive purposes—such as medical or higher-education expenses—money not rolled over into another retirement savings vehicle will not be available for economic support in retirement.

PRIVATE PENSIONS

Background

Reforms and Simplification

The low saving rate in the US makes safeguarding the pension system a critical public policy issue. Over the past two decades, Congress has enacted significant tax and employee benefit legislation. Most of these changes in law have expanded access to pension benefits and made pensions fairer to low- and moderate-income workers. However, some legislative and regulatory pension activity has been driven by a desire to find needed government revenues, particularly in the short term, by limiting the tax subsidies provided to pensions. For example, in order to limit revenue losses, Congress capped the size of employers' tax-preferred contributions to defined benefit plans without regard to the plans' funding needs. Such legislation may not represent good long-term policy.

A number of pension reforms supported by AARP have improved benefits for millions of workers. Among the changes are shorter vesting periods, reduced pension integration (so that Social Security benefits are offset by no more than 50 percent of the qualified pension amount), improved coverage standards, and better disclosure requirements (see the Glossary for a further definition of "integration"). These changes substantially increase both the number of people receiving pensions and the average pension amount. Some of the regulations implementing many of these changes have yet to be finalized (for further information on pension and benefit issues and on "phased" retirement, see Chapter 4, Employment).

Because of the vast amounts of money in the pension system and the wide latitude given employers in choosing plan design, pension rules have become numerous and complex. Many of these rules are designed to protect participants, particularly lower-paid employees, and encourage more equitable pension plans. Over the past decade several efforts have been made to simplify the pension laws. However, some proposals—characterized as simplification plans by their proponents—could weaken or eliminate important pension protections.

FEDERAL POLICY

PRIVATE PENSIONS

Reforms and Simplification

Employer-provided pension benefits for retirees should be preserved and expanded.

Short-term fiscal impact should not be the reason for altering incentives for employer-provided benefits. Proposed changes should be judged by their longer-term impact on the preservation and equitable expansion of pension coverage and the efficient and equitable delivery of benefits.

AARP supports regulations that carry out the letter and spirit of pension reforms and opposes actions that diminish protections provided by law.

Efforts at simplification should attempt to broaden coverage and participation among rank-and-file employees, as well as distribute pension benefits more equitably.

PRIVATE PENSIONS

Background

Cash Balance Plans

Increasing numbers of large employers have in recent years replaced their traditional defined benefit plans with hybrid pension plans, particularly cash balance plans. These plans describe their benefits in terms of individual account balances similar to 401(k) plans. Benefits are based on a hypothetical individual account that is credited with a given percentage of the participants' pay each year, plus an annual interest credit. Although they look like defined contribution plans, cash balance plans are legally defined benefit plans and must meet all defined benefit plan requirements. Under these plans, as in traditional defined benefit plans, the employer makes the contributions, invests the assets and bears the investment risk. The Pension Benefit Guaranty Corporation insures the benefits.

There are two major issues surrounding cash balance plans. First, these plans can have a negative impact on older workers when an employer converts a traditional defined benefit plan to a cash balance plan. Second, at least one district court has found that the design of such plans violates the Employee Retirement Income Security Act and the Age Discrimination in Employment Act prohibition against reducing benefit accruals based on an employee's age.

In the conversion of a traditional defined benefit plan to a cash balance plan, older, longer-service workers will, absent appropriate transition relief, almost always experience a reduction in future benefits. Traditional defined benefit plans typically base the largest share of benefits on the later years of a participant's career. In contrast, a cash balance approach may substantially reduce this benefit and gradually diminish the value of any pension accruals as the worker gets closer to normal retirement age (usually 65). In cases where an employer converts from a traditional defined benefit plan to a cash balance formula, it is possible for older, longer-service workers to work for many more years without receiving any additional pension credits under the new cash balance plan (an effect often called wear-away).

Current law prohibits employers from reducing an employee's pension accruals based on his or her age and requires employers to provide older workers with benefits equal to those of younger workers (for further discussion of cash balance plans, see Chapter 4, Employment). In 2003 one district court found that cash balance plans reduced benefit accruals based on the participant's age, thus violating the law. In addition, three different circuit courts have found that such plans must calculate the participants' benefits in accordance with defined benefit plan rules, and not merely provide participants with their account balance.

Prior law required that participants be notified only of a change in the plan, not of the impact of the change. As a result it has been difficult for many older workers to determine whether or not they will be receiving much smaller pensions than they had been promised under their traditional defined benefit plan. Federal law was amended in 2000 to require improved notification, and Internal Revenue Service regulations implementing this law (204 (h) notification) have been issued.

FEDERAL POLICY

PRIVATE PENSIONS

Cash Balance Plans

Congress and the administration should ensure that cash balance plans prohibit age discrimination in benefits and comply with current laws governing the operation of defined benefit plans.

The law should be clarified to ensure that stopping or reducing pension accruals for older, longer-service workers—the so called wear-away period—is illegal.

Employers converting a traditional defined benefit plan to a cash balance plan should provide workers the option, at the time of their retirement, to choose the benefit calculated under the old formula or the benefit available under the new cash balance plan, whichever is greater.

Congress should enact legislation to require that in a plan conversion, employers should provide each affected individual with a personalized benefits statement that compares the benefits under the old plan with the benefits under the new plan. Such information must be shown in a comparable form (e.g., life annuity compared with life annuity) and provided well in advance of the effective date of any plan change.

PRIVATE PENSIONS

Background

Nondiscrimination and Top-Heavy Rules

Legislation in 1996 established new safe harbors for 401(k) plans. (Plans that adopt a safe harbor ensure that Internal Revenue Service regulations are satisfied, and incorporating a safe harbor is an alternative to performing special tests and requirements to ensure qualification under the tax law.) A 401(k) plan providing a specified minimum benefit or a matching contribution under these safe harbor regulations need not comply with rules designed to ensure the participation of rank-and-file employees.

The top-heavy rules are aimed at plans that provide a disproportionate share of their benefits to highly compensated employees. A plan is considered top-heavy when the value of benefits for the top employees exceeds 60 percent of the value of benefits for all other employees. In order to ensure that rank-and-file workers receive some benefits under a top-heavy plan, the top-heavy rules require faster vesting and certain minimum benefits for nonkey employees. The top-heavy rules have led directly to increased benefits for some of the most vulnerable employees covered by plans. Because of the faster vesting and minimum benefits, these rules are of particular help to women, who tend to have lower wages and change jobs more frequently than men. The Economic Growth and Tax Relief Reconciliation Act of 2001, however, weakened some of the important top-heavy protections for retirement plans.

Nondiscrimination and Top-Heavy Rules

Use of 401(k) safe harbors should be assessed to ensure broad plan participation among lower-paid employees.

AARP supports strengthening the top-heavy rules weakened by the Economic Growth and Tax Relief Reconciliation Act of 2001, so that protections for lower-paid workers are restored.

PRIVATE PENSIONS • Coverage and Benefits

Background

Coverage and Participation

To encourage employers to provide pension plans, the tax code includes a tax exemption for employers that deferred US Treasury receipts by more than $116 billion in 2003. This tax-favored status is based on the assumption that the pension system will work fairly and that workers will receive the pensions promised to them. Tax subsidies for retirement savings are sound public policy, yet pension coverage rules continue to permit the exclusion of some (mainly lower-income) people.

Over the past decade the number of defined benefit plans declined and the number of defined contribution plans grew rapidly. However, between 2001 and 2002, there was a decline in retirement plan participation rates, from 55.8 percent to 53.5 percent. Additionally, participation in pension plans is not evenly distributed across income levels and is skewed toward more highly compensated employees. For example, workers earning below $20,000 in 2002 were just one-third as likely to have participated in a retirement plan at work as those earning $60,000 or more.

As one method to increase participation, the Internal Revenue Service has approved plans that automatically enroll employees as participants in 401(k) plans but permit employees to opt out of participation.

Coverage and Participation

To improve pension system equity, AARP supports simplifying and strengthening the coverage rules to increase pension coverage.

Pension rules should encourage broader worker participation by requiring minimum employer contributions or alternative measures such as requiring employers to provide employees the opportunity to make payroll deductions into an individual retirement account.

Employers should be encouraged to give more attention to educating workers about the importance of beginning to save early, contributing regularly, and investing prudently in any retirement accounts available to them.

AARP encourages automatic enrollment plans, which increase participation among those who might not otherwise take part in pension plans.

PRIVATE PENSIONS • Coverage and Benefits

Background

Small-Business, Service Industry, Self-Employed, Contingent and Part-Time Employees

Small-business and services employees, the self-employed, contingent workers, and those who work less than full time or year-round are among the least likely to have pension coverage. Yet many people begin their working lives in small establishments or work less than full time. Research shows that more than 36 percent of workers are in firms with fewer than 100 employees. Pension coverage rates increase with firm size. For example, in firms with fewer than ten employees, only 19 percent of employees were covered by some kind of pension plan. For firms with 50 to 99 employees, the coverage rate was almost 45 percent; for firms with at least 100 employees, the rate was over 58 percent. More than 27 percent of the self-employed have individual retirement accounts or Keogh plans.

Small employers often cite the administrative burdens of providing a pension plan as a primary reason for not covering their workers. Although inexpensive options are available, they are not widely used because many employers are unfamiliar with them. To address this situation, Congress created Savings Incentive Match Plans for Employees (SIMPLE) in 1996. These plans eliminate administrative costs and reduce pension rules (including some protections for lower-paid workers) as a means of encouraging more small-business pension plans. Yet because small businesses are so concerned with bottom-line profitability and cash flow, it is unclear what effect, if any, the creation of new pension vehicles will have on small-business pension coverage and whether such coverage will be equitable.

Current law permits employers to exclude people who work fewer than 1,000 hours annually from pension plans and other employee benefits available to full-time workers. Many employers in some industries and businesses use contingent and part-time work as a means of avoiding the payment of pensions and other benefits. This makes it harder for unemployed or underemployed workers to secure full-time employment. Yet part-time employment continues to be widespread, as secure full-time employment becomes more difficult to find and as two-earner and single-parent families seek to balance work and home responsibilities. Moreover, as employers seek maximum staffing flexibility, they often turn to contingent workers who receive no benefits and can be hired and dismissed on virtually a moment's notice.

FEDERAL POLICY

PRIVATE PENSIONS • Coverage and Benefits

Small-Business, Service Industry, Self-Employed, Contingent and Part-Time Employees

AARP supports prorated pension coverage to provide some measure of retirement income security to employees who work less than full time.

Additional incentives and efforts are needed to encourage pension adequacy for lower-paid employees and those who would not otherwise be covered.

Existing pension plans should be improved and new pension vehicles or incentives, including added tax incentives, created to expand pension coverage in small firms and for the self-employed and contingent workers.

The Department of Labor, the Small Business Administration, the Administration on Aging and other governmental agencies should cooperate in developing programs to publicize pension plan options for small-business employers and employees in order to expand pension coverage.

AARP supports the development of model plans that would enable groups of unrelated small employers to pool resources in plans administered and marketed by financial institutions.

Background

Portability, Preservation and Distributions

When workers who are vested in defined benefit plans change employers, they typically have no mechanism to transfer the value of or right to the benefit to the new employer. The value of deferred pension benefits that remains in a former employer's plan may be substantially eroded by inflation by the time the employee reaches retirement age. In contrast, defined contribution plan participants often can roll over funds to a new employer, although some portability barriers exist between different types of plans. At the very least, lump sums can be rolled over into an individual retirement account (IRA).

Since January 1, 1993, federal law requires that lump-sum pension amounts otherwise eligible to be rolled over into an IRA be directly transferred to an IRA or other retirement vehicle, or the worker faces a 20 percent withholding tax. One goal of this law was to encourage greater preservation of pension funds for retirement. As of 1998, 14.3 million people reported having at some time received a lump-sum distribution from their retirement assets. Only 35 percent of all recipients reported using the entire distribution for tax-qualified savings. Millions of Americans are continuing to jeopardize their future retirement income security to maintain or expand current consumption. In 2000 the law was changed to require that amounts between $1,000 and $5,000 that an employee cashes out be automatically rolled over into a retirement vehicle unless the employee requests a distribution. The provision is intended to discourage cash-outs. Treasury has issued final regulations that will facilitate automatic rollovers.

The rules and choices can be complex and confusing when distributions are ultimately made from pension plans or IRAs. Recipients do not fully understand the implications of annuitizing to reduce the risk of outliving their pension benefits. These often irreversible decisions have a direct impact on long-term economic security and are commonly accompanied by significant tax consequences.

Some workers who are eligible to receive a pension are unable to locate the pension plan provided by their former employer. This problem is more likely to arise when the employer has gone out of business or has been taken over by another company.

Portability, Preservation and Distributions

Pension portability mechanisms should be developed and implemented to protect the value of vested pension benefits and ensure an adequate retirement income for workers who change jobs.

To protect benefits that would otherwise be cashed out, rollovers of lump-sum retirement benefits into another retirement vehicle should be automatic and preretirement access to such funds limited. AARP supported the automatic rollover provision.

Low-cost annuitization options should be readily available and promoted and recipients provided information as to how plan rules, the value of underlying assets, or current economic conditions may influence payout.

The retirement plan distribution rules should be simplified with the goal of improving long-term economic security.

AARP supports the creation of an entity to assist in recording current pensions through a pension registry and in finding lost pensions.

AARP supports creation of an entity or mechanism to facilitate rollovers of defined benefit accounts.

PRIVATE PENSIONS • Coverage and Benefits

Background

Vesting

"Vesting" means that a pension plan participant has completed the years of service as specified under the plan to earn a nonforfeitable right to accrued benefits (under a defined benefit plan) or account balances (under a defined contribution plan). Generally, the vesting period for both defined benefit and defined contribution plans is five years. Employee contributions, however, vest immediately. Because average job tenure is less than five years, the five-year vesting period is too long. This is especially true for employers' matching contributions, which provide workers with an incentive to contribute to the plan. Recently, the vesting period for 401(k) matching contributions, which provide workers with an incentive to contribute to the plan, was reduced to three years.

FEDERAL POLICY

PRIVATE PENSIONS • Coverage and Benefits

Vesting

Employers' matching contributions to 401(k) plans should vest in one year. The vesting period for both defined benefit and all other defined contribution plans should be reduced to three years or less.

PRIVATE PENSIONS • Coverage and Benefits

Background

Integration

Integrated pension plans consider an employer's contributions to Social Security and allow employers who sponsor their own pension plan to take a credit since their FICA (Federal Insurance Contributions Act) contributions on behalf of lower-income workers buy proportionately more generous benefits than their contributions for higher-income workers. Pension benefits, in defined benefit plans and in many defined contribution plans (i.e., those with across-the-board employer contributions), are thereby lowered for all workers, and total retirement benefits (plus Social Security) replace a more uniform percentage of final pay for all employees. However, benefit reductions due to integration (up to 50 percent of Social Security for service after 1988, and up to 100 percent for service before 1989) make it more difficult for lower-income workers to attain retirement income security. The majority of these workers are women and minorities.

FEDERAL POLICY

PRIVATE PENSIONS • Coverage and Benefits

Integration

Pension integration should be limited further, including through the extension of limits to pre-1989 service and the disallowance of integration for simplified employee pensions.

Employers should be required to notify their employees about any integrated pensions plans and the potential impact of this integration on future retirement benefits.

PRIVATE PENSIONS • Coverage and Benefits

Background

Informing Plan Participants

Participants and beneficiaries should be assured of receiving the information they need to make informed decisions about their benefits. Participants should be provided adequate information about their pension plans so that they will be able to anticipate the level of benefits they will receive.

FEDERAL POLICY

PRIVATE PENSIONS • Coverage and Benefits

Informing Plan Participants

AARP supports requirements that would increase the amount of information provided to pension participants. In particular, participants need to be better informed about underfunding in defined benefit plans when those plans make benefit increases and about the benefits' level of Pension Benefit Guaranty Corporation protection.

Participants should be informed about the effects of integration on benefit levels in both defined benefit and defined contribution plans, and about the amount of fees they are paying in defined contribution plans. They should receive this information when hired, subsequently on an annual basis, and when they leave employment.

Employees participating in individual account plans should receive quarterly statements that detail the status of the participant's investments and urge diversification.

PRIVATE PENSIONS • Coverage and Benefits

Background

Spousal Rights

Under the Retirement Equity Act of 1984 (REA), beneficiaries of defined benefit plans must obtain written spousal consent to take payment in a form other than a joint-and-survivor annuity. Such protection for spouses is unavailable in individual retirement accounts and rare in defined contribution plans. Thus, employees can withdraw and use 401(k) plan money in any way (including for nonretirement purposes) without spousal consent. This is an increasingly large loophole in the area of spousal pension protections. In addition, although the REA improved spousal pension rights in cases of widowhood or divorce, these reforms have not solved all inequities.

FEDERAL POLICY

PRIVATE PENSIONS • Coverage and Benefits

Spousal Rights

Spousal protections in the Retirement Equity Act of 1984 (REA) for all defined benefit plans should extend to all defined contribution plans. Spousal protections also should be enacted for individual retirement accounts that contain rollovers or transfers of pension distributions.

Spousal pension rights in cases of widowhood or divorce under the REA for all defined benefit plans should be further improved.

PRIVATE PENSIONS • Coverage and Benefits

Background

Eligibility for Dependent and Nonspouse Survivor Pensions

Customarily, private pensions are paid to workers and their surviving spouses only. Thus, no matter how financially dependent another household member may be on the worker's income, he or she is not eligible to share in or receive survivor pension benefits. There are many situations in which it would be desirable to permit survivor pensions to be paid to someone other than a spouse when that person's financial well-being would be affected by the worker's death.

FEDERAL POLICY

PRIVATE PENSIONS • Coverage and Benefits

Eligibility for Dependent and Nonspouse Survivor Pensions

AARP supports programs and policies that permit people in "kinship care" situations and others with an insurable interest in the pensioner to share in or receive survivor benefits from private pensions.

PRIVATE PENSIONS • Plan Funding and Guarantees

Background

Terminations for Reversions and Plan Transfers

The Omnibus Budget Reconciliation Act of 1990 limits the amount of an employer "reversion" and permits a limited transfer of pension funds to pay for current employer-provided health benefits for specified reasons, such as maintaining employer health benefits for five years. The change in the pension law allowing diversion of pension funds to nonpension purposes may lead to pension instability and open the door to further and less meritorious pension fund transfer proposals.

FEDERAL POLICY

PRIVATE PENSIONS • Plan Funding and Guarantees

Terminations for Reversions and Plan Transfers

AARP strongly supports current limits and penalty taxes on employer reversions.

AARP generally opposes measures that would permit the transfer of pension funds for nonpension purposes. Such transfers undermine the Employee Retirement Income Security Act's "exclusive benefit" rule and place at needless risk the pension benefits of workers and retirees and their families.

PRIVATE PENSIONS • Plan Funding and Guarantees

Background

Pension Benefit Guaranty Corporation

The Employee Retirement Income Security Act created the Pension Benefit Guaranty Corporation (PBGC) to ensure that retirees would receive "timely and uninterrupted payment" of the pension benefits promised them from defined benefit plans, even if their employer went bankrupt. The PBGC performs a vital role in the pensions system. In response to growing PBGC liabilities, reforms enacted in 1994 accelerated funding for underfunded plans, raised insurance premiums for plans most at risk, strengthened the agency's enforcement powers, and required employers to disclose more details of underfunded plans. The recent downswing in the stock market and the failure of a significant number of highly underfunded pensions in bankrupt companies has put the financial status of the PBGC in jeopardy.

Pension Benefit Guaranty Corporation

AARP supports adequate funding rules to improve long-term plan funding and increase benefit security. Enforcement of these rules will ensure the continued viability of the Pension Benefit Guaranty Corporation (PBGC) and will prevent cutbacks and restrictions in PBGC benefit guarantees.

Employers should be required to keep plan participants adequately informed about underfunded plans, and participants should receive their guaranteed benefits from the PBGC when an employer files for bankruptcy or otherwise seeks refuge from making promised pension payments.

Not only should the Department of Labor (DOL) and the PBGC strictly enforce the existing fiduciary rule requiring employers to choose the "safest" annuity provider to protect beneficiaries from benefit loss, but AARP firmly believes current law requires that the PBGC insure defined benefit pension annuities provided through insurance companies. The law may need to be amended to clarify this existing federal obligation.

The DOL must stringently enforce the fiduciary rule to ensure that pensions are handled prudently and in the best interest of plan participants and beneficiaries.

PRIVATE PENSIONS • Plan Funding and Guarantees

Background

Enforcement of Employee Retirement Income Security Act Rights

Recent judicial interpretations of Employee Retirement Income Security Act (ERISA) provisions have limited the substantive rights of pension plan participants and beneficiaries. Even when participants and beneficiaries can prove ERISA violations, courts have severely limited the remedies available, thus undermining participants' and beneficiaries' rights (for a discussion of alternative dispute resolution, see Chapter 13, Personal and Legal Rights). Moreover, such decisions, in combination with the Department of Labor's limited resources, have compromised the agency's ability to enforce the act effectively, thereby endangering the health of ERISA plans. After a lengthy administrative regulatory process, the Labor Department finalized revised benefit claims regulations.

Enforcement of Employee Retirement Income Security Act Rights

The Department of Labor (DOL) should strengthen enforcement under the Employee Retirement Income Security Act (ERISA). This may require better and more productive use of resources, additional funds, strengthened audit procedures, and regulatory actions that assist participants and beneficiaries in securing their benefits and protecting their rights. In particular the DOL should interpret and enforce the revised benefit claims regulations to provide participants and beneficiaries with the ability to receive quickly and efficiently the benefits to which they are entitled.

The DOL and other agencies should improve their efforts to assist individuals both directly, by intervening on their behalf, and indirectly, through publication of pamphlets, public service announcements and other educational efforts.

Congress should enhance private rights of action under ERISA to supplement the DOL's limited ability to monitor the benefits system.

Remedies under ERISA should be improved so employees can recover pension losses due to employer fraud and other violations.

Comprehensive reporting and disclosure requirements must be established, maintained and enforced, and mandatory penalties for failure to provide required information should be considered.

ERISA should be amended to require the award of mandatory attorney's fees in successful fiduciary and benefits claim cases.

ERISA should be amended to provide that courts may in their discretion award attorney's fees for work performed during the administrative review process.

A court reviewing disputed ERISA cases should examine the relevant contracts and documents for itself (that is, provide a de novo review) and not defer to the findings of the plan administrator, who may have an inherent financial conflict of interest.

The DOL should explore alternative dispute resolution forums for those claimants who otherwise would lack adequate remedies.

Background

Management and Investments

Pension management and investments are critical public policy issues. Concerns about the proper administration and management of pension funds, including fiduciary obligations, have frequently been raised, particularly in the context of mergers, acquisitions and other events in which conflicts of interest may exist. Specific issues include greater plan-participant representation, disclosure in investment decisionmaking and pension investment policies, and disclosure of the amount of management fees and expenses charged to participants' accounts.

Legislation in 1996 weakened, for the first time in the history of the Employee Retirement Income Security Act, the fiduciary standard governing pension assets held in insurance company general accounts.

New questions also have arisen with regard to self-directed accounts, typically 401(k)-type plans, in which individuals are the investment decisionmakers. Employee retirement security is put at risk when plans are not properly diversified. Yet in many of these plans, individuals are over-invested in one asset: the employer's stock (even though employers are required by law to provide several investment options). The Taxpayer Relief Act of 1997 limited the amount of employer stock or real estate in which employees can be required to invest their 401(k) contributions under some circumstances. However, these restrictions do not apply to an employee's own investment decisions, employee stock ownership plans, or employers' matching contributions through stock. While many employers provide their employees with tools such as online and print information for investment education, some employees desire more individualized investment advice.

FEDERAL POLICY

PRIVATE PENSIONS • Plan Funding and Guarantees

Management and Investments

Fiduciary responsibility to plan participants must be steadfastly maintained.

Plan sponsors and fiduciaries should ensure that individual account fees are reasonable and should disclose to participants and beneficiaries the types and amounts of fees and expenses charged to their accounts.

When there is potential for conflicts of interest, plan fiduciaries should seek independent advice or step aside from decisionmaking.

Because pension funds are for the benefit of plan participants, participant representatives, active workers and/or retirees should have representation in decisionmaking bodies.

Employees should receive investment advice from a qualified advisor who is not subject to conflicts of interest and who will help them invest and manage their self-directed accounts.

Executives and employees should have the same rights and obligations regarding their employer's stock.

Any economically targeted investments made by pension funds must meet the current, stringent Employee Retirement Income Security Act (ERISA) fiduciary criteria, to ensure the protection of plan participants. Pension fiduciaries must not subordinate the interests of plan participants and beneficiaries in their retirement income to unrelated objectives. The ERISA fiduciary rule, which prohibits the acceptance of reduced return or greater risk to secure collateral benefits, should not be weakened.

The insurance industry, when acting as an investment manager for benefit plan assets, should be subject to the same fiduciary standards as all other investment managers.

AARP supports policies to encourage diversification of 401(k) and other defined contribution plans. Individuals should not be locked into investments such as employer stock when the individual bears all the risk of a retirement investment decision. Mandatory holding periods for employer stock in defined contribution plans, such as 401(k)s, should be limited to no more than the vesting period. In addition, holding periods for employee stock ownership plans should be reduced. AARP supports proposals that would reduce the concentration of company stock in defined contribution plans. For example, employers could have the option of matching employee 401(k) contributions with company stock or allowing employees to purchase company stock within the 401(k) plan, but not both.

PRIVATE PENSIONS • Plan Funding and Guarantees

Background

Employee Retirement Income Security Act Preemption

The Employee Retirement Income Security Act (ERISA) is generally designed to be the applicable law governing employer benefit programs. ERISA thus preempts state laws in order to provide uniformity. In a number of areas, however, courts have interpreted ERISA to deny individuals the protections and benefits of state laws, even when ERISA provides no adequate protection. For example, courts have held that ERISA preempts actions against nonfiduciary violations and preempts state laws against fraud and misrepresentation. Courts also have broadly construed ERISA to allow employers to limit or eliminate health coverage.

FEDERAL POLICY

PRIVATE PENSIONS • Plan Funding and Guarantees

Employee Retirement Income Security Act Preemption

The Employee Retirement Income Security Act (ERISA) should be interpreted and implemented to give participants and beneficiaries full legal protection.

Where ERISA preempts state law, and thus deprives individuals of rights and remedies available under state law, the act should provide an adequate federal remedy.

PUBLIC RETIREMENT SYSTEMS

Background

More than 30 million Americans participate in some form of public pension plan. This number includes people benefiting from plans for federal, state and local government employees; military personnel; teachers, police and firefighters; and everyone entitled to a pension because they work for a government entity. These thousands of plans vary enormously in every aspect: coverage, benefit levels, vesting rules, employee contributions, early retirement provisions, integration with Social Security, inflation protections and funding soundness.

Public pensions are not governed by the Employee Retirement Income Security Act (ERISA) and are partially or substantially paid for out of states' general revenues. The federal civil service retirement system (CSRS) and military pension systems are operated largely on a pay-as-you-go basis, whereas most state and local systems are intended to be advance-funded. Though in better health than a decade ago, these pension plans have suffered funding setbacks since 2001. (Stock market declines have worsened public pension balances and could cause states to increase their contributions at a time when budgets are in deficit.) Because most public plans require worker contributions, participants tend to be better informed about their plan's status and anticipated benefits than are private pension participants.

Compared with private pension plans, public plans provide higher benefit amounts, higher replacement rates, better inflation protection, and lower ages of pension eligibility. Also, disparities between women's and men's pension benefits, and between minorities' and whites' pension benefits, tend to be smaller in the public sector than in private plans.

In order to reduce the federal deficit, federal cost-of-living adjustments (COLAs) have been the subject of periodic cuts. The Omnibus Budget Reconciliation Act of 1993 delayed COLAs for federal civilian and military retirees. COLAs for federal retirement benefits are as important to federal civilian and military retirees as Social Security COLAs are to that program's beneficiaries.

FEDERAL POLICY

PUBLIC RETIREMENT SYSTEMS

AARP strongly supports maintenance of full cost-of-living adjustments for federal retirees.

PUBLIC RETIREMENT SYSTEMS

Background

Railroad Retirement

The Railroad Retirement System is a federally managed retirement program providing benefits to about 1 million retired railroad workers and surviving spouses. The system is financed through employer and employee contributions to a trust fund, and the benefits are coordinated with the Social Security system.

The Railroad Retirement and Survivors' Improvement Act of 2001 provides for the transfer of funds from railroad retirement accounts to a new National Railroad Retirement Investment Trust, whose independent board of seven trustees is empowered to invest trust assets in debt instruments (government securities and nongovernmental debt) and common stock.

FEDERAL POLICY

PUBLIC RETIREMENT SYSTEMS

Railroad Retirement

AARP recognizes that the financial health of the Railroad Retirement System has improved. However, its financial status needs careful monitoring so necessary adjustments can be made.

PUBLIC RETIREMENT SYSTEMS

Background

State and Local Public Pensions

With the return of state budget deficits, some undesirable state government practices related to public employee retirement funds are making a reappearance. For a number of years it was common practice in many states to use these pension funds to pay for programs unrelated to the retirement income security of plan participants or to the costs of administering the plan. During the robust economy of the late 1990s, such practices became less common, but the pressures that motivate these policies are back. In a slower economy states may worsen the situation by cutting back on contributions because of budgetary constraints.

Another concern about many public plans is their insufficient reporting and disclosure to plan participants of funding and asset information that is critical for identifying problems and making sound financial plans. Fund performance information is particularly important to public-sector employees, who typically make regular contributions to their pension plans.

Numerous attempts have been made to improve the soundness of public pension plans and put them on a more stable footing. In 1997 the National Conference of Commissioners on Uniform State Laws proposed uniform pension laws for states and localities. Called the Management of Public Employee Retirement Systems Act, the proposed legislation seeks to tighten fiduciary standards for plan trustees and give trustees independence from political maneuvering, as well as improve the information made available to participants and beneficiaries. The draft law has not been introduced in most legislatures, as it would likely result in reduced legislative control over public pension funds.

STATE & LOCAL POLICY

PUBLIC RETIREMENT SYSTEMS

State and Local Public Pensions

States and localities should maintain or enact, at the first reasonable opportunity, standards that are at least as strong as the standards contained in the proposed Management of Public Employee Retirement Systems Act. Improving the fiduciary reporting and disclosure standards of state and local pension plans would be a first step in strengthening the soundness of pension funds operated on behalf of state, local and municipal employees.

Because pensions are long-term obligations, states should strive for long-term balance between receipts and expenditures to avoid creating or maintaining structural deficits.

Reliable and consistent information on the nation's public-employee pension obligations should be reported to a central government agency for review on a regular basis.

States should monitor carefully the reporting, disclosure and funding practices of local public retirement systems under their jurisdiction and, where appropriate, administer the plans on behalf of local governments.

State and local retirement systems should include active workers and retirees on their investment boards to enhance disclosure and expand participation in decisionmaking.

States and local governments should move toward full funding of their retirement systems, strengthen the funding of their plans, consider the short- and long-term costs of benefit improvements, and enact such improvements only if accompanied by adequate funding.

States and local governments should provide for vesting in conformity with the five-year standard for private plans.

States and localities should improve intrastate and interstate portability of public employees' service credits subject to the financial integrity of each system.

State and local retirement systems should provide annual, automatic and full cost-of-living adjustments.

Employee benefits applied to full-time state and local government workers should be available to part-time workers on a prorated basis.

Pension funds with assets exceeding obligations to active employees should make benefit adjustments to retirees and their spouses. In computing postretirement benefit adjustments, states, where permitted by state law, should give special consideration to the financial needs of those who have been retired the longest and whose pensions therefore have suffered the greatest loss of purchasing power.

Integration of state and local pension benefits with Social Security, which penalizes lower-income people, should be limited and include no more than the 50 percent of benefits allowed under federal guidelines for private pensions.

Adequately funded state and local systems that have no or inadequate health and life insurance coverage for retirees should initiate or expand and appropriately fund such coverage.

PUBLIC RETIREMENT SYSTEMS

Background

Spousal Rights

Changes in federal law, including the Retirement Equity Act of 1984 and the Civil Service Spouse Equity Act, require most public pension plans to treat spouses, former spouses and surviving spouses more equitably. However, there are still some gaps in many public pension systems, especially in the event of divorce, and certain large groups have been left out of legislation to further protect spousal rights.

About half of the states lack adequate protections for surviving spouses of state and local government workers, and about one-fourth of the states fail to protect spouses in the event of divorce.

FEDERAL POLICY

PUBLIC RETIREMENT SYSTEMS

Spousal Rights

Further improvements in protections for spouses and former spouses of federal workers are needed, including the prospective division of pension and survivor benefits for previously excluded military spouses and other unprotected groups.

STATE & LOCAL POLICY

PUBLIC RETIREMENT SYSTEMS

Spousal Rights

Adequately funded systems that lack or have inadequate health and life insurance coverage for surviving spouses and eligible dependents should initiate or expand and appropriately fund such coverage.

The laws governing state and local pension funds should be amended where necessary to provide surviving and divorced spouses of public pensioners with at least the same protections that the Employee Retirement Income Security Act affords to spouses of private pensioners.

State divorce law should consider as marital property all pensions and retirement benefits and provide for their equitable division.

POSTRETIREMENT HEALTH BENEFITS

Background

Some employers provide postretirement health coverage through their group health plans. In recent years most employers sponsoring such plans have been restructuring them to put the costs and risks onto current and future retirees. This trend is driven by health care cost inflation, coupled with the increasing number of years spent in retirement and a declining ratio of active workers to retired workers. Accounting standards developed by the Financial Accounting Standards Board (FASB) reinforced the trend by requiring corporate balance sheets to reflect companies' retiree health obligations. Once the magnitude of the obligations was made apparent, employers started cutting or eliminating benefits (for more on health access, see Chapter 6, Health Care). Employers do not currently prefund retiree health benefits; federal tax incentives similar to those for pensions could encourage them to do so.

Public-sector employers face the same benefit funding issues as private-sector employers do, yet more forcefully. Retirements occur at younger ages in the public sector, and the public-sector workforce is on average slightly older than that of the private sector. Like the FASB, the Government Accounting Standards Board has issued a rule that would require state governments to account for their projected health care obligations. It is expected that this could lead to the reduced availability of postretirement health benefits for public-sector workers.

FEDERAL POLICY

POSTRETIREMENT HEALTH BENEFITS

AARP supports tax incentives that will encourage all employers to provide health coverage to retirees.

Employees should be vested in retiree health plans, as they are in private pensions.

Retiree health benefits should be considered continuing obligations, representing compensation that has been deferred often in lieu of greater wage and salary increases.

Prefunding should be accompanied by vesting and other standards to ensure that retirees receive promised benefits.

Employers should be required to uphold their promises of health care to retirees who left the labor force in response to a buyout or an early retirement incentive; these individuals might have made different choices in the absence of promised postretirement health benefits.

Employers who offer retiree health benefits must do so in a fair and nondiscriminatory manner. Efforts to amend federal laws (e.g., the Age Discrimination in Employment Act) to allow employers to discriminate against retirees eligible for Medicare must be rejected.

STATE POLICY

POSTRETIREMENT HEALTH BENEFITS

States should provide retired state and local employees and spouses with opportunities and options for adequate health insurance coverage at group rates.

Although states should not be expected to duplicate Medicare, states should provide health insurance benefits not provided by Medicare.

States should uphold health care promises made to retirees who left the labor force in response to a buyout or an early retirement incentive; these individuals might have made different choices in the absence of promised postretirement health benefits.

Retiree health benefits are deferred compensation and should be considered continuing obligations.

RETIREMENT SAVINGS AND ASSETS EXPANSION

Background

Americans have been consistently undersaving for retirement and other purposes for more than a decade. Trends in retirement income (including less generous public and private pensions, preretirement distributions from 401(k) plans, and demographically driven reforms to Social Security) suggest an ever-increasing need for higher rates of personal saving.

The 2001 median annual asset income for married couples age 65 and older who have such income was $3,000; for nonmarried people age 65 and older, the amount was $1,555.

Retirement income from savings disproportionately goes to upper-income households. According to tax year 2000 data, approximately 40 percent of all tax filers aged 65 and older have adjusted gross incomes (AGIs) below $20,000, but they received only 14 percent of that income from interest, dividends, and pensions and annuities going to seniors. On the other hand, 9 percent of filers age 65 and older have AGIs above $100,000, but they report more than 35 percent of all income going to seniors from interest, dividends, and pensions and annuities. (For a more complete discussion of savings, see Chapter 1, The Budget and Chapter 2, Taxation.)

Many employers currently offer their workers retirement planning seminars and printed materials on retirement savings options. An increasingly mobile and competitive workforce requires much more education—at all ages—about what employees' income needs in retirement are likely to be and how workers and their families can meet them.

FEDERAL & STATE POLICY

RETIREMENT SAVINGS AND ASSETS EXPANSION

AARP supports strengthening public policies that encourage people to save for retirement and that ensure the preservation of such funds for retirement.

Public policies should more strongly emphasize educating Americans of all ages—through schools, colleges, religious institutions, workplaces and other venues—on the importance of lifelong saving.

AARP supports the development of a coherent and coordinated national strategy for making available a well-researched and well-evaluated series of financial literacy programs and services. This strategy should be targeted to the needs of adult Americans throughout their lives and should be free from conflicts. Such a national education strategy should be developed jointly by relevant agencies, including federal and state departments of education, labor and treasury.

RETIREMENT SAVINGS AND ASSETS EXPANSION

Background

Supplemental Savings Accounts

Social Security was never intended to be a worker's sole source of retirement income. Yet many of today's workers will have inadequate retirement income; less than 50 percent have defined benefit or defined contribution pension coverage. Although people know Social Security will not be enough to live on, they find it difficult to save for the future. In 2001 the baby-boom generation (those born from 1946 through 1964) had a net worth, not counting housing value, of $51,000. In light of this, many workers are concerned about whether they will have enough income in retirement.

To help future generations attain a more financially secure retirement, many have proposed establishing supplemental individual savings accounts as we work toward Social Security's long-term solvency. Proponents observe that by providing workers with accounts of their own, workers become savers. Some propose that these accounts be in addition to or an extension of individual retirement accounts, 401(k)s and other savings opportunities, such as savers' credits, already available and be targeted to low- and moderate-income workers, who find it the most difficult to save. Others suggest that everyone have access to supplemental accounts through payroll deductions (for a discussion of tax credits for new savings, see Chapter 2, Taxation: Income Tax Options—Individual Retirement Savings, Tax credits for qualified plan contributions).

These supplemental accounts could have various designs. Ideally, such accounts should include professional management, be easy and inexpensive to administer, and offer workers incentives to save.

FEDERAL POLICY

RETIREMENT SAVINGS AND ASSETS EXPANSION

Supplemental Savings Accounts

AARP supports the creation and expansion of supplemental individual retirement savings accounts that would enable workers to accumulate retirement savings in addition to Social Security's guaranteed benefits.

AARP supports the availability of supplemental individual accounts in addition to Social Security for all workers through voluntary payroll deduction.

Supplemental individual retirement savings accounts should be accompanied by strong spousal protections, including protections for surviving and divorced spouses. These protections should mirror, as much as possible, the spousal protections for Social Security and traditional defined benefit pensions.